PO/CH/NL/745
Part. A

PO/CH/NL/745
Part. A

CHEVENING 1988 PAPERS

18.1.88

BUDGET SECRET: TASK FORCE LIST

COPY NO 1 OF 20 COPIES

FROM: M C SCHOLAR
DATE: 6 JANUARY 1988

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Sir Geoffrey Littler
Sir Terence Burns
Mr Anson
Mr Odling-Smee
Mr Culpin
Mr Cropper
Mr Tyrie
Mr Call
Mr A C S Allan
Mr Battishill - IR
Mr Mace - IR
Mr Unwin - C&E

(Forecast)

patterns

Trends of private sector savings

Fiscal stance of other countries

as proportion of tax as % of GDP

MTO target

Fiscal stance - & tax as % of GDP

CHEVENING: AGENDA

... I attach an agenda for the weekend discussions.

MCS

M C SCHOLAR

Ch

I have detached the 2nd half of the agenda & put it with the tax papers in the separate folder.

AA

BUDGET SECRET: TASK FORCE LIST

CHEVENING 9-10 JANUARY 1988

PAPERS

1. **Policy Background to the 1988 Budget**

Sir Terence Burns' paper of 18 December

Also relevant:

(below)

Mr Sedgwick's paper on economic prospects of 7 January

2. **Tax Reform**

Mr Culpin's paper of 18 December

Also relevant:

Budget 1988: Excise Duties
Mr Knox's paper of 16 December

VAT zero rates infraction case
Mr Knox's paper of 8 January

separate folder.

CONFIDENTIAL

CHEVENING: ANNOTATED AGENDA

POLICY BACKGROUND TO THE 1988 BUDGET

The performance of the economy

Sir Terence Burns' paper shows that both output growth and inflation have been higher in recent years than expected in successive MTFSs. Higher output growth is largely attributable to an improved supply performance. Higher inflation does not reflect easier settings of fiscal or, since early 1985, monetary policy than intended, although in the event tighter settings would have been necessary to have achieved the original inflation objectives.

2. If monetary policy is aimed at maintaining a stable DM/£ exchange rate, Sir Terence Burns argues that money GDP growth and inflation will tend to fall. Mr Sedgwick's paper suggests that domestic inflationary pressures in the next year or two could be somewhat greater than we thought in the autumn.

? not RPI, but perhaps GDP defl.

3. **Points for discussion:**

(a) Is the interpretation of what has happened in recent years generally agreed?

(b) Medium-term prospects for inflation, assuming a DM/£ link.

Fiscal policy

4. Sir Terence Burns concludes that the projections for the public finances in the October forecast, updated for the fall in share prices, are sustainable. Mr Sedgwick's paper suggests that, while the prospect for 1988-89 seems robust, there is a possibility that the public finances may not turn out to be quite as comfortable thereafter as implied by the October figures. (These show a negative PSBR of about 1% of GDP and a fiscal adjustment of £6 billion over the next two years.)

5. **Points for discussion:**

(a) The appropriateness of a declining public sector debt/GDP ratio given the pattern of privatisation proceeds, North Sea taxes and public pension liabilities.

What is behind this (given large PSBR surplus)?

(b) The implications of the need to finance the PSBR in a non-inflationary way given relatively low private saving, high private investment, and large overseas assets.

(c) Risks related to the sustainability of the present comfortable fiscal position.

(d) Provisional conclusions about the PSBR and fiscal adjustment in 1988-89, taking account of the above points as well as objectives for taxation.

SEDGWICK ON RECENT DEVELOPMENTS

SECRET

FROM: P N SEDGWICK
DATE: 7 JANUARY 1988

CHANCELLOR

Thanks. N

cc	Chief Secretary	Mr Peretz
	Financial Secretary	Mr Turnbull
	Paymaster General	Mr Bottrill
	Economic Secretary	Mr Hibberd
	Sir P Middleton	Mr Matthews
	Mr Anson	Mr Mowl
	Sir T Burns	Mr A Allan
	Sir G Littler	Mr Hudson
	Mr Scholar	Mr Cropper
	Mr Culpin	Mr Tyrie
	Mr Evans	Mr Call
	Mr Odling-Smee	
		Mr Battishill I/R
		Mr Unwin C & E

PAPER ON RECENT ECONOMIC DEVELOPMENTS AND PROSPECTS FOR CHEVENING

I attach a paper that summarises the provisional conclusions that we have reached in the current forecasting exercise. Some of the judgements could change significantly by the time we report to you on January 22.

P.N.S

P N SEDGWICK

[see last para]

ECONOMIC PROSPECTS

The principal uncertainty is the effect on the domestic and world economy of the recent turmoil in world securities and foreign exchange markets. This note considers the evidence that has become available since the Autumn Statement forecast (itself completed within ten days of the initial stock market crash on October 19). A final section considers recent developments in and prospects for the UK's public finances.

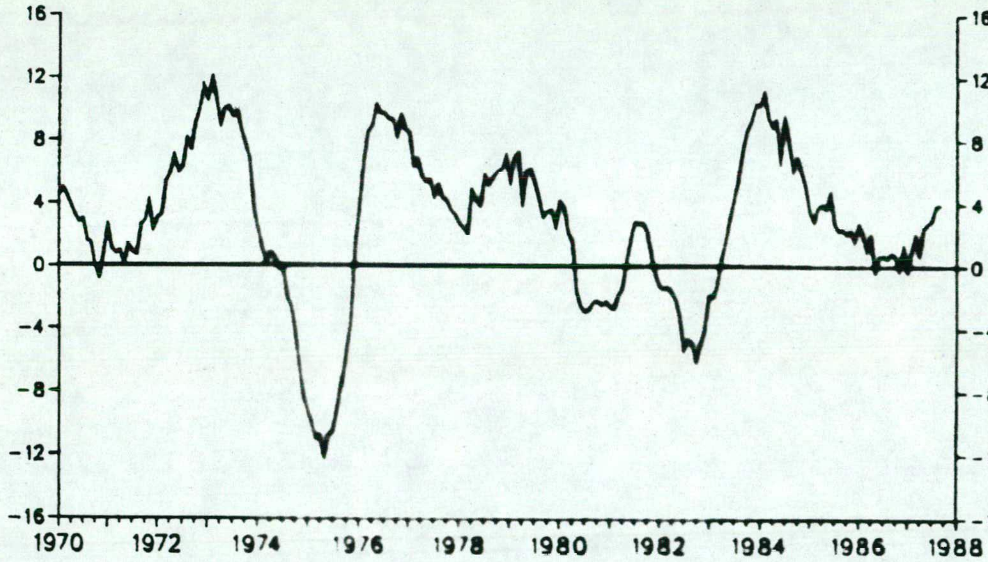
(1) THE WORLD ECONOMY

Recent developments

Activity and demand

1.1 Although there is little information relating to the behaviour of demand since the stock market crash there is considerable evidence that activity in the major countries in 1987 was stronger than perceived at the time of the Autumn Statement. The rather higher than previously expected growth of G5 GNP has been helped by a recovery in the volume of net exports to the rest of the world that compensated for some slowdown in domestic demand. (See Table 1.) Industrial production, which tends to respond to trade performance, has been growing particularly strongly, especially in the US and Japan, and for the G5 as a whole was over 4 per cent higher in October than a year earlier.

CHART A: G5 INDUSTRIAL PRODUCTION



PERCENTAGE CHANGE OVER YEAR EARLIER

Table 1: Growth of real expenditure in the G5 countries

	Private Consumption	Investment	Government Expenditure	Domestic* Demand	Exports	Imports	Real GNP
			Annual percentage change				
1983	3.6	3.2	1.4	3.5	0.3	3.4	2.9
1984	3.4	8.1	3.2	5.5	9.5	12.9	4.9
1985	3.6	4.2	4.6	3.2	3.2	3.3	3.2
1986	4.1	3.2	3.4	3.9	0.5	7.3	2.7
			Change from four quarters earlier (per cent)				
1986 Q1	3.7	3.8	3.5	3.9	-0.4	4.3	3.0
Q2	4.4	3.5	4.1	4.5	-0.6	7.9	3.0
Q3	4.3	2.8	2.7	3.9	1.3	9.4	2.4
Q4	3.8	2.7	3.5+	3.4	1.8	7.5	2.4
1987 Q1	3.1	1.7	2.6	3.1	3.2	6.5	2.5
Q2	2.6	2.7	1.9	2.5	4.0	5.1	2.3
Q3	2.4	5.5	2.2	3.1	7.0	6.3	3.2
			Indices (1980=100)				
1986 Q1	116.4	112.9	114.8	116.1	115.3	122.8	114.8
Q2	118.1	114.3	116.4	117.8	116.1	128.7	115.6
Q3	119.8	115.1	117.4	118.9	117.0	132.1	116.2
Q4	119.8	116.7	120.2+	119.2	118.1	132.2	116.8
1987 Q1	120.1	114.8	117.7	119.7	119.1	130.8	117.7
Q2	121.1	117.4	118.6	120.8	120.7	135.4	118.3
Q3	122.7	121.4	120.0	122.6	125.1	140.5	119.9

* Including stockbuilding

\+ Inflated by Japanese Government's issue of commemorative medals.

World trade

1.2 Although little information is available for the second half of the year it appears that total world trade, like G5 activity, grew faster in 1987 than expected at the time of the Autumn Statement. OECD countries' imports have grown slightly faster than expected, and non-OPEC developing countries imports appear to have been quite strong. The available scraps of information on total world trade in manufactures suggest that it grew strongly in 1987 - by approximately by 4¾ per cent following weak growth in 1986.

1.3 Table 2 compares our latest view of 1987 with earlier forecasts.

TABLE 2 : FORECASTS OF ACTIVITY AND TRADE IN 1987

	FSBR	June Internal Forecast	Autumn Statement	Latest Estimate
Major 7 Real GNP	2½	2½	2½	2¾-3
Total World trade in goods	3½	3	3½	3¾-4
World trade in manufactures	4	4	3¾	4½-5

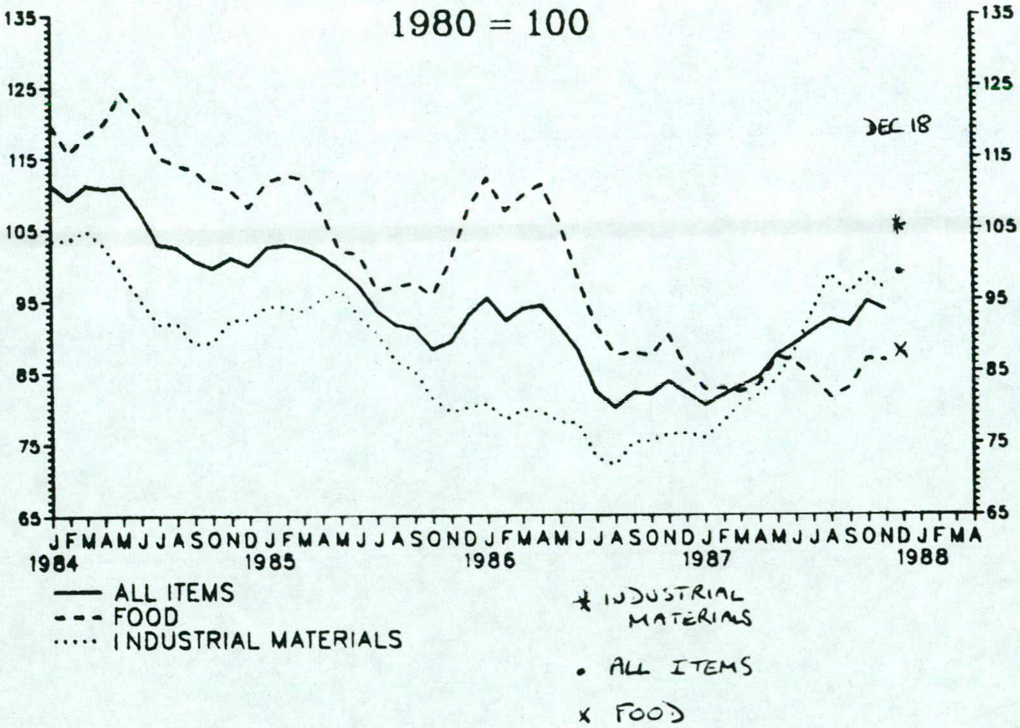
Current accounts

1.4 The composition of demand within the G5 has not adjusted to the extent that had been hoped. In the year to the third quarter domestic demand grew by 2.3 per cent in the US, by 4.8 per cent in Japan, but by only 2.2 per cent in Germany. As a result current account imbalances remain large, though there are signs that the Japanese surplus, and to a lesser extent the German surplus, are contracting. The US deficit, of course, remains large even though trade volumes have been adjusting for some time.

Inflation

1.5 As expected consumer price inflation in the G5 has risen from 1 per cent at the start of the year to around 3 per cent in October as the effects of the earlier fall in the oil price dropped out. Reflecting exchange rate movements, inflation in the US has picked up to 4¼ per cent, while in Japan and Germany it remains at or below 1 per cent. Real commodity prices recovered rapidly during the first half of the year, levelled off in the third quarter and, despite the stock market collapse, rose further in the last two months of 1987. Average world oil prices weakened further following the recent OPEC meeting, but have since recovered somewhat.

CHART B : ECONOMIST SDR COMMODITY PRICE INDICES



Exchange rates and interest rates

1.6 Since the Washington meetings in September/October the dollar's exchange rate index has fallen some 8 per cent. Short term interest rates in the US are now 1 per cent lower than on 19 October, German short rates have fallen 1½ per cent over the same period, while Japanese short rates have been unchanged for almost three months, although long rates have fallen.

Prospects

1.7 Prospects for world activity, inflation and trade in 1988 depend crucially on the behaviour of foreign exchange markets and stock markets, and on the continuing policy response to these developments.

1.8 **Fiscal policy** plans for 1988 seem unlikely to change much, if at all. The agreed package to reduce the US Federal deficit by $30 billion in fiscal 1988 is expected to produce a deficit of around $160 billion - slightly <u>above</u> the 1987 outcome. Japanese fiscal policy for 1988-89 was set out in the recent budget. Despite the Government's commitment to maintain public works spending at its 1987-88 level the government deficit is projected to decline between 1987-88 and 1988-89 because of buoyant revenues. Germany will probably do no more than implement the cuts in personal taxes already announced for 1988. The recent package to encourage investment is likely to have only a marginal impact on demand.

1.9 It is harder to assess prospects for monetary policy, especially in the US. The current account deficit is unlikely to fall much, if at all in the first half of 1988 (in part due to the J-curve effects of the recent depreciation of the dollar). Attracting the necessary private flows to finance the current account will probably involve a still lower dollar exchange rate, an even higher differential between interest rates in the US and those elsewhere, or some combination of the two. Since the scope for lower interest rates outside the US is limited, this points to a rise in US rates.

1.10 It still seems that the Administration is more concerned to avoid the risk of slowing growth before the Presidential election than about a further fall in the dollar. If the Federal Reserve acquiesces in this approach then a sharp depreciation of the dollar in 1988 could be accompanied by only modest rises in US interest rates. A sharp fall in the dollar during 1988 would, however, at some stage lead to some further tightening of monetary policy and - probably somewhat later - to further action to reduce the Federal deficit. Such policy adjustments could lead to at least a partial reversal of the earlier fall in the dollar exchange rate. The prospect is therefore for prolonged exchange rate instability.

1.11 On the basis of these assumptions our provisional conclusions on prospects for 1988 are set out in Table 3:

TABLE 3 : FORECASTS FOR 1988

	OECD	Autumn Statement	Provisional January WEP
Major 7 real GNP	2½	2	2-3
Major 7 inflation*	3¼	2¾	3-4
Total world trade	4½	3½	3½-4½
World trade in manufactures	5¼	4	4½-5½

* consumers expenditure deflator

Activity

1.12 Growth of domestic demand and real GNP in the G7 is expected to remain buoyant in the first half of 1988, though both may slow a little. Real GNP may increase by 2½ per cent in 1988 (compared to nearly 3 per cent expected in 1987). Industrial production growth will remain high, due in part to a continued strong net export performance. The stock market collapse is likely to have a perceptible effect on demand in the US, though much weaker effects are expected in other economies. The recent realignment of exchange rates will, cet.par., benefit activity in the US at the expense of other major countries. It is probable that the real exchange rate of the G7 as a whole has appreciated again against the rest of the world, which could dampen activity in their tradeables' sectors.

Inflation

1.13 Consumer price inflation in the US could pick up to almost 6 per cent by the end of 1988. In other countries inflation will be held down by the appreciation of their currencies against the dollar, but G7 inflation could still reach 3½ per cent.

Trade

1.14 Total world trade growth is expected to continue to grow at around 4 per cent in 1988, with trade in manufactures again growing faster.

1.15 This is a more buoyant world economic outlook than presented in the Autumn Statement reflecting the emerging evidence of the strength of activity in 1987 and a less pessimistic view about the confidence effects of lower equity prices on world activity. Should the US authorities raise interest rates earlier and by more than assumed, a less buoyant world economy would be in prospect. At the moment this policy-induced slowdown seems likely to be "postponed" until 1989.

(2) THE UK

Recent developments

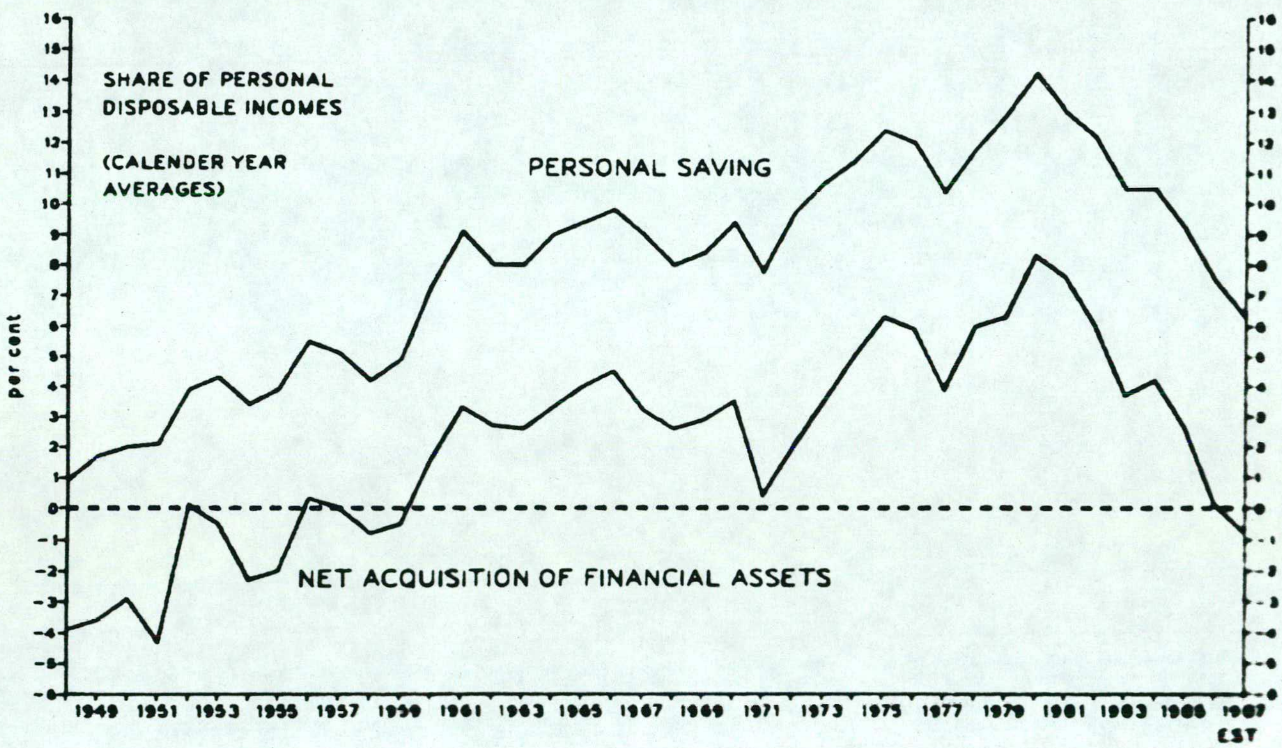
Activity and Domestic Demand

2.1 The three measures of GDP show growth of about 5¼ per cent in the year to 1987Q3. This rare agreement between the measures, however, masks considerable differences in the first half of 1987. The output measure is probably still the most reliable measure of recent short term trends. It shows particularly strong growth in the last year and a half and is consistent with the sharp fall in unemployment.

2.2 The CSO's first estimate of growth in 1987, which is available around budget time, may show growth of 4 per cent. On past experience the CSO are likely to revise up their early estimates of growth and the average measure of GDP in 1987 could eventually show growth above this - perhaps of 4½ per cent or even more. Much of the upward revision is likely to be to the expenditure measure, with investment, stockbuilding and consumption the principal candidates for revision.

2.3 Even though the statisticians have not yet allocated all of recent growth to expenditure categories recorded **consumers' spending** has been growing rapidly, and retail sales in November showed no signs of any slowing down following the stock market crash. The saving ratio has now fallen from 14 to 5 per cent since its peak in 1980. The latest data - which could be revised substantially - shows the personal sector's net acquisition of financial assets to be negative for the first time since the late 1950s.

CHART C : PERSONAL SAVING AND NET ACQUISITION OF FINANCIAL ASSETS



2.4 The latest DTI Investment Intentions Survey (mid-December) suggests that, after falling in 1986, **business investment** picked up in 1987, broadly in line with Autumn Statement projections. Company expenditure on **stocks** showed little growth in the first half of the year and stock-output and stock-sales ratios continued to decline. There was, however, significant stockbuilding during the third quarter of 1987, which probably accounts for a good deal of the surge in imports. Export volumes (partly the result of faster growth in world trade) and import volumes (responding to rapid increases in domestic demand), both rose faster than was expected at the time of the FSBR.

Money GDP

2.5 Following upward revisions to the preliminary data the "undershoot" of money GDP in 1986-87 has disappeared. Money GDP growth in 1987-88 will almost certainly overshoot its value in the 1987 MTFS, mainly as a result of higher than expected growth in real GDP.

Inflation

2.6 Both RPI and producer price inflation for 1987Q4 are turning out very slightly higher than in the Autumn Statement. RPI inflation for the majority of consumer goods appears to have shown a slight upward shift over the past three months (though the recently announced error in the RPI makes it difficult to interpret the November figure). Nevertheless once seasonal factors are accounted for, recent CBI surveys show no sustained rise in the proportion of firms expected to raise prices in the next few months.

Pay

2.7 Pay settlements in manufacturing industry monitored by the Department of Employment fell by about a point in the pay round just concluded. However, manufacturing behaved differently from the rest of the private sector, where the decline was much less pronounced. In both manufacturing and the rest of the private sector there was a discernible upward trend in settlements during the 1986-87 pay round. Overtime working in manufacturing is now at record levels.

The exchange rate and competitiveness

2.8 In spite of the reduction in domestic interest rates and at times heavy intervention the sterling exchange rate has recently been firmer than assumed in the Autumn Statement. The rise in the sterling index during 1987 as a whole has reversed a large part of the exceptionally large competitiveness gain that occurred during 1986, but still leaves UK manufacturers' relative unit labour costs some 7 per cent lower (ie more favourable) than the average of 1984 and 1985.

The current account

2.9 The current account which swung temporarily into small surplus in early 1987, has returned to deficit and for 1987 as a whole the deficit should be close to the £2½ billion in the FSBR and Autumn Statement forecasts. One significant feature has been a lower surplus on invisibles than previously expected, partly reflecting the effect of the pound's appreciation which reduced the sterling value of overseas earnings.

GDP defl 88-89
4½ 5¼-6¼

Prospects

TABLE 4: PROSPECTS FOR THE DOMESTIC ECONOMY

	Autumn Statement November 1987	Preliminary View of current forecast
GDP growth		
1987	4	4
1988	2½	2½-3½
Money GDP growth		
1987-88	8½	10
1988-89	7¼	8-10
Current balance, £ billion		
1987	- 2½	- 2½
1988	- 3½	-4 to -6 -4
RPI		
1987) change over previous) year to the fourth	4	4
1988) quarter	4½	3½-4½

Activity

2.10 GDP growth in 1988 could be higher than the 2½ per cent envisaged in the Autumn Statement. Consumer spending is expected to rise at about the same rate as in 1987, reflecting a substantial increase in real personal disposable income - partly due to the a large assumed reduction in personal taxes in the 1988 Budget. The latest DTI Investment Intentions Survey suggests that business investment is likely to be higher than in the Autumn Statement. There is no sign yet of any serious dent to business confidence as a result of the equity price fall and the effect of higher equity yields on the cost of capital has probably been offset by the fall in interest rates. The balance of investment is expected to shift relative to 1987; manufacturing investment is expected to grow considerably faster than other private non-manufacturing.

Inflation and Pay

2.11 The increase in the RPI over the year to 1988Q4 is likely to be below the 4½ per cent in the Autumn Statement if recent trends in the exchange rate and short term interest rates persist.

The current account

2.12 The UK's recent loss of competitiveness and the prospect of growth continuing to be more rapid than overseas is likely to lead to a further widening of the current account deficit. Any weakening of the oil price would add to this widening. It is probable that the forecast current account deficit for 1988 will be greater than the £3½ billion published in the Autumn Statement.

(3) PUBLIC FINANCES

1987-88

3.1 A first estimate of the CGBR(O) in December is now available (though it will not be published until January 19), showing a considerably larger surplus than had been expected, mainly the result of higher Inland Revenue receipts. (But the provisional figure is more liable to revision in December than in other months.) The first estimate of the LABR and PCBR, and therefore the PSBR as a whole, will not be available until Tuesday, 12 January. At end November central government own account borrowing had accounted for the vast bulk of the PSBR undershoot of the 1987 Budget profile - £4½ billion out of a total £5½ billion. (The undershoot of the budget profile for the CGBR(O) increased further in December.)

TABLE 5 : THE PSBR IN 1987-88 (£ billion)

	Outturns Apr-Nov	Budget Profiles Apr-Nov	1986-87 Outturns Apr-Nov
CGBR(O)	0.6	5.1	7.3
LABR	-0.8	-0.2	-0.7
PCBR	-0.8	-0.5	-0.9
PSBR	-1.1	4.4	5.7

Memo:-	Apr-Dec Outturn	Apr-Dec Budget Profile
CGBR(O)	-0.2	5.5

3.2 Forecasts for 1987-88 as a whole are still subject to significant margins of error. Average errors on the final internal January forecast of the PSBR have, over the last ten years, been equivalent to £1½ billion.

3.3 Our latest estimate of the outturn for the year as a whole is a public sector surplus of £2-3 billion. This assumes privatisation proceeds around £5 billion and a planning total outturn of £147.1 billion. The rest of this section discusses the outturn so far and the forecast for the year in a little more detail.

3.4 At end December the cumulative undershoot on **central government** own account borrowing was £5¾ billion, three quarters of which was accounted for by higher than expected receipts and the other quarter by lower than expected expenditure. On the receipts side:

- North Sea receipts were about £½ billion above profile as a result of the higher than assumed average oil price in 1987.

- The largest single contributor to the revenue overshoot is non-North Sea corporation tax, including ACT, which was around £1 billion above profile and could be about £2 billion above the Budget forecast in 1987-88 as a whole. This overshoot is mainly due to the profits data for 1986 available at Budget time being too low and to higher than expected dividend payments in 1987. The latter generates more ACT (at the expense of mainstream CT later on).

- Income tax and national insurance contributions are above profile due to higher than expected wages and salaries.

- VAT is £½ billion above profile - the main explanation is probably higher than expected consumers'expenditure. Specific duties by contrast are about £¼ billion below profile.

3.5 Table 6 shows the massive changes in the composition of the receipts that have taken place in recent years with large increases in onshore corporation tax and in capital taxes continuing unabated in the current financial year.

TABLE 6

(a) COMPOSITION OF TAX REVENUES, 1983-84 TO 1987-88
(% OF TOTAL TAXES AND NICS)

	1983-84	1984-85	1985-86	1986-87	1987-88 (Forecast)
Income Tax	27	26	26	26	25
Corporation Tax (Non-N.Sea incl. ACT)	4½	5½	6	7½	9½
North Sea Revenues	7½	9½	8	3½	3
VAT	14	15	16	16	16
Capital Taxes & Stamp Duty	2½	2	2½	3	3½
Other Taxes	27	25	24	25	25
NICs	18	18	18	18	18

(b) GROWTH IN TAX REVENUES, 1983-84 TO 1987-88
(% growth on year earlier)

	1983-84	1984-85	1985-86	1986-87	1987-88 (Forecast)
Income Tax	+4	+5	+7½	+7½	+5½
Corporation Tax (Non-N.Sea incl. ACT)	+3½	+24	+22	+34	+39
North Sea Revenues	+12	+37	-5½	-58	-5
VAT	+11	+16	+14	+8½	+11
Capital Taxes & Stamp Duty	+20	-2½	+33	+30	+20
Other Taxes	+2	+1	+4	+10	+7
NICs	+14	+6½	+8½	+8½	+9
Total Taxes & NICs	+7	+9	+8	+5½	+10

3.6 Central government expenditure (on a cash basis) is about £1¼ billion, 1¼ per cent, below the profile forecast at Budget time. Our forecast assumes that the underspend in the year as a whole is less than the underspend so far.

3.7 Although the LABR and PCBR are each about £½ billion below profile they are at much the same levels as in the equivalent period in 1986-87. The undershoot on local authority borrowing is probably the result of higher than expected capital receipts. On the public corporations' side BSC, the Post Office, the water authorities and New Towns have all borrowed less than forecast. It is reasonable to assume that the LABR and PCBR outturns for the year as a whole will be in line with those for 1986-87.

Prospects 1988-89 and beyond

3.8 The most recent (October) forecast showed, taking the 1987 MTFS PSBR ratio of 1 per cent of GDP as the starting point, a total fiscal adjustment in 1988-89 of £13½ billion (of which £1 billion was due to an assumed increase in privatisation proceeds). For forecasting purposes it was assumed that one third (£4.2 billion) of the total fiscal adjustment (net of higher privatisation proceeds) was allocated to reducing personal taxes and the remainder to increasing the public sector surplus. There was scope for a further modest tax cut in 1989-90, whilst at the same time maintaining the PSBR at its assumed 1988-89 level.

3.9 There are likely to be a number of changes to the detailed forecasts for public sector flows in 1988-89, but at the moment it does not look as if the total fiscal adjustment will be below the October forecast. North Sea revenues could be lower and the fall in stock market prices and lower turnover will reduce the forecast for Stamp Duty receipts. But profits in 1987 could turn out even higher than expected, which would boost onshore mainstream corporation tax receipts in 1988-89.

X

3.10 Our figuring for 1989-90 is at a preliminary stage. It is just possible that there could be a small fall in the cumulative fiscal adjustment in that year because some components of revenues could be falling or growing more slowly than in the past. North Sea revenues could continue to decline. The adverse effect of the stock market falls on receipts of capital taxes, which will take a year or so to build up, are likely to be more substantial by then. Finally the growth of profits in 1988 could be a good deal lower than in recent years. The resulting reduction in the growth of onshore corporation tax in 1989-90 could be even more marked if capital investment and dividends - and hence ACT - , which are offsets to liability to mainstream CT in the following year, continue to growth strongly in 1988. These worries on revenues are no more than straws in the wind at the moment. They may indicate, however, that the surge in public sector revenues, which has outstripped all expectations during the last two financial years, may moderate.

NB, but on what basis?

BUDGET OVERVIEW MINUTES OF 1st MEETING

BUDGET SECRET
BUDGET LIST ONLY

NOT TO BE COPIED

REF NO. J88/4

COPY NO. 2 OF 38.

BUDGET

B.L.O.

SECRET

RECORD OF THE FIRST BUDGET OVERVIEW MEETING:
AT 3.00PM ON MONDAY, 18 JANUARY 1988

Present

Chancellor
Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Anson
Sir A Wilson
Mr Monck (Item 5 only)
Mr Scholar
Mr Culpin
Mr Odling-Smee
Mr Sedgwick
Miss C Evans
Mr Michie (Item 5 only)
Mr Cropper
Mr Tyrie
Mr Call

Mr Battishill - IR
Mr Isaac - IR
Mr Painter - IR
Mr Lewis - IR (Item 5 only)
Mr McGivern - IR (Item 5 only)
Mr Mace - IR (Items 1 and 2 only)
Mr Prescott - IR (Item 5 only)

Mr Unwin - C&E
Mr Knox - C&E

Papers: (i) Scorecard: Mr Culpin's minute of 14 January.

(ii) Income tax options: Mr Eason's minute of 14 January.

(iii) Excise duties: Mr Knox's minute of 14 January.

(iv) VAT base: Mr Knox's minute of 14 January.

(v) Fringe benefit tax: Mr Lewis's minute of 14 January; and Miss Sinclair's agenda of 15 January.

SECRET

BUDGET SECRET
BUDGET LIST ONLY

NOT TO BE COPIED

Scorecard

The following points were made:

(i) Mr Mace agreed to produce a note on a further option for the APA, under which it would not be paid at all to co-habiting couples; this would extend the number of couples affected from the 5-10,000 who claimed a double APA now, to the 150,000 couples who at present claimed a single APA; but it was arguable that the APA was always intended strictly for one parent families.

(ii) The provisional scorecard figures for the effect of assimilating CGT and income tax were very awkward: people would ask what was the point of an increase in the CGT rate if it led to a loss of tax yield. This loss came about because the Inland Revenue model assumed that there was a reduction in realisation immediately after an increase in the CGT rate. The Treasury and the Revenue would look at the figures again.

(iii) It was noted that the car scales for 1988-89 had already been set and would be in the base; Mr Scholar would check whether an increase in 1989-90 was in the base.

(iv) In Note 1, the figures for the double revalorisation of alcohol and tobacco duties showed the additional revenue, but the total RPI effect; this was inconsistent.

(v) In Note 2, the yield from extending the VAT base to non-domestic construction should also show the yield if the option to tax rents was allowed; the judgement on spectacles was expected shortly.

(vi) Among the minor starters, it would be helpful to have a list of the minor personal allowances which were being eliminated (Starter 103).

(vii) The Economic Secretary was considering whether there should be any changes to the North Sea fiscal regime for the Southern Basin; if the proposed package was implemented, it would have a small revenue cost in the early years, offset by additional revenue subsequently.

(viii) The Notes to the scorecard should show the second year costs/yields (ie in 1991-92) from introducing Independent Taxation and a Fringe Benefit Tax. Further consideration should be given to whether the figures for FBT yield should include behavioural effects.

Income tax options

2. No decision on the choice between Option 1 and Option 2 was needed now; discussion would be resumed at the following Overview Meeting, when a further paper would be available on NICs at the lower end. It would be helpful if, before then, further information could be circulated by the Revenue about the numbers of tax units at different income levels affected significantly differently by the two Options; and about taxes and NICs as a percentage of income for those earning various proportions of average earnings.

Excise duties

3. Because of the RPI effects, it was unlikely to be possible to do both a double revalorisation and the proposed extension of the VAT base; of the two, the extension of the VAT base was much to be preferred.

4. Assuming no more than simple revalorisation overall, the following provisional package was agreed:

(i) the duties on pipe tobacco and cigars should remain unchanged. Revenue of £100 million should be raised from cigarettes alone;

(ii) on alcohol duties, the duty on spirits should be left unchanged, with revenue of £110 million raised from increases in beer, cider and wine duties. Cider was relatively under-taxed, and the increase in cider duty should be the same number of pence per pint as the increase in beer duty;

(iii) on motoring taxes, VED should be left unchanged, as should the duty on unleaded petrol. Revenue of £345 million should be raised from increases in the duties on leaded petrol and derv.

VAT base

5. It was agreed that the Treasury Solicitor, currently in Brussels, should be asked to sound out the European Court in a neutral, low-key way, about when judgement was expected. It was perfectly natural for us to do this, given the questions put to the Economic Secretary by the TCSC, and the fact that the Advocate General's Opinion had been recommended for debate in the House of Commons. If it looked as though the judgement was likely to arrive too late for this year's Budget (as seemed likely) Customs would provide a further note on how we should react when the judgement arrived.

6. It would, with hindsight, have been better if the Customs Memorandum to the TCSC in December 1986 had not used the passage about tax on information. But this was not thought to rule out imposing VAT on newspapers. It had been made clear in the Election that while there were pledges on some items, these did not extend to books and newspapers. The fact that the Economic Secretary was due to put a note to the TCSC setting out the Government's pledges were, was quite helpful in this context. Customs would be providing further advice to the Economic Secretary about the proposed exclusion for learned journals.

Fringe benefit tax

(a) Car benefits

7. There was extensive discussion about whether the valuation of car benefits should be based on a scale or on the cost to the employer. On the one hand, a move to an employer-based tax was the perfect opportunity to switch the basis of charge to the cost to the employer, and this was likely to provide the only route for increasing car scales to the full value of the benefit. And if companies found the tax onerous, they always had the option of requiring employees to use their own cars for travel to and from work, and to use an employer's car for business purposes only. It might be possible to have scale deductions from the true cost to allow for business mileage. But on the other hand, it was arguable that the tax was aimed at the benefit to the employee of having a car for use at home, and this was independent of the amount of business use; it was reasonably represented by a scale charge.

And charging the full cost would create difficulties over apportioning, for example, maintenance costs; it would also open up the scope for evasion by employees taking company cars home without they (or their employers) reporting it. On balance, a scale charge would be simpler; we would anyway face considerable difficulties from employers in getting the principle of a FBT accepted, and in these circumstances it was more sensible to go for scale charges. The immediate target should be a scale charge of 50 per cent of the standing charges plus running costs, which represented slightly more than a doubling of the existing scales.

8. It would be helpful to have a note on the likely implications for the motor industry. The Chancellor would be seeing Lord Young, but would probably only raise with him the possibility of a major increase in car scales, without at this stage discussing the FBT. The Treasury would provide further advice on consultations with DTI officials, but in the meantime work on a paper on the implications for the motor industry should be started in-house.

9. After a brief discussion, it was confirmed that if an FBT was introduced, then the increase in car scales in 1989-90 should be no more than 10 per cent. The increase planned for 1990-91 should be announced in the Budget, but there was no need to announce a programme for later years. It did not seem likely that it would be attractive to raise to 5,000 miles the present 2,500 mileage limit.

(b) <u>FBT rate</u>

10. For larger firms, a 45 per cent FBT rate would be significantly tougher for benefits paid to basic rate taxpayers than the present system, and marginally tougher for those above the higher rate threshold. The 50 per cent rate had the advantage of being rather tougher on higher rate taxpayers, but at the expense of being very much tougher indeed on basic rate taxpayers, particularly on those in the "kink". It would be possible to increase the rate of FBT subsequently if behavioural changes pointed to that. <u>It was agreed</u> that further work should plan on the assumption of a 45 per cent rate.

11. The proposal was that the tax on fringe benefits should not be deductible in computing profits for corporation tax purposes, but the value of the benefits themselves should be.

(c) Payment arrangements

12. There were administrative arguments for choosing annual payments for FBT, but that would produce a once-for-all revenue loss of £700 million in the year of introduction. That was most unattractive, and the Revenue would consider further how a quarterly system could be introduced as simply as possible. The intention was that the cut in CT should be phased in to match the build-up of FBT payments. The Revenue agreed to provide as much information as was possible on the gainers and losers, both by sector and by size and type of company from the introduction of the FBT and the cut in CT rates.

(d) Coverage

13. The following points were made:

(i) in principle, canteens, luncheon vouchers and directors' lunches should all be included. The only practicable basis of charge seemed to be the variable costs incurred by the employers. The Revenue would provide estimates of the yield, which could be very large indeed, though the figures were very uncertain;

(ii) similarly, sports facilities and workplace nurseries should in principle be within the scope of the tax; but there were some tricky problems about what the basis for tax for sports facilities should be. It would be very odd to have taxed workplace nurseries in the hands of the employee, but then to exempt the employer;

(iii) car parking on an employer's own premises should be exempt from the tax, but the scope for taxing parking off the employer's premises should be examined further;

(iv) we had recently introduced new exemptions for entertainments and gifts, and these should be continued;

(v) the existing exemptions for heating, lighting and other expenses of "lower paid" clergymen, and board and lodging provided to "lower paid" agricultural workers should be ended. In principle it must be right to tax free accommodation.

(vi) even though there were some arguments that low interest mortgages did not confer a taxable benefit on the employee, it nonetheless would appear very odd if they were exempted from FPT; it was agreed that they should be included. If there were tax relief for private health insurance, logic pointed to it being treated in the same way.

14. In general, we should use this opportunity to cast the broadest net possible. But there remained some benefits which it would be necessary to exempt. The question was whether too much broadening of the base would exacerbate the difficulties with getting the FBT accepted. The Financial Secretary would consider further, in the light of the points made in discussion, the coverage of the FBT and the basis of valuation. He would report back to the Chancellor, for discussion at a further meeting.

(e) Fall-back if FBT not introduced

15. The Revenue would produce a paper as soon as possible on the increases in car scales in 1989-90 and subsequently which we might introduce if we did not proceed with an FBT.

ACSA

A C S ALLAN
19 January 1987

Distribution

Those present
PS/IR
Mr P R H Allen - C&E

BUDGET SECRET
BUDGET LIST ONLY
NOT TO BE COPIED