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MASTER 113

BUDGET - SECRET

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FROM: MISS M P WALLACE
DATE: 27 February 1989

PS/FINANCIAL SECRETARY

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

ring Michie re 97 sig-by
 101 - What are "main"
 VED rates?
 [perhaps for me to rewrite VED.]

~~NB PERs
 reordering
 I.T. rewrite and Ind Tax beef-up
 VED?
 RELOC?
 AWK pr on lump sum~~

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

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

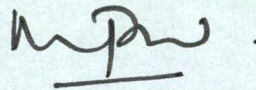
3. You will see that the Chancellor has also issued various remits to other Ministers:

- (i) he would like the Financial Secretary to draft a short paragraph on unit trusts CT rate. He would also like the Financial Secretary to draft a short paragraph on Keith: he has not yet decided whether to include this in the Speech or not, but would like to consider this again;
- (ii) he would be grateful for the Economic Secretary's advice on what and how much should be said about the ECJ judgement. He would also like his views on whether we should list all the new VAT reliefs for charities;
- (iii) he would be grateful if the Paymaster General could vet the section on Payroll Giving, and redraft as necessary.

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

- Pre-trading expenses (doesn't need to be mentioned in the Budget Speech).
- ITV levy (already announced, and doesn't fit in very well).
- Schedule E receipts basis, and CGT set-off for unincorporated companies (both to be discussed at this afternoon's Overview).

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



MOIRA WALLACE

BUDGET - SECRET B20

TAXPAYER CONFIDENTIALITY

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

[2nd reading HOL
9/3: Committee
3 or 4/4.]

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

ACSA X
IR [covers corp as well] X

mw AGT

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

ACSA
IR
IR

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

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

BUSINESS TAXATION

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

[JC wanted to make more of small business package.]

6. First, taxes on business.

CST where I have a series of changes to propose

JG

7. The rate of corporation tax for small companies, defined for this purpose as those with annual profits of less than £100,000, has, ever since the corporation tax reform I introduced in 1984, been set at the basic rate of income tax, currently 25 per cent. Large companies, defined as those with profits of £1/2 million or more, pay the main rate of corporation tax of 35 per cent, one of the lowest rates of tax on company profits in the world. Between those two monetary limits, intermediate

ACSA

(FST)

✓

rates are payable. 25 and 35%.

the effective rate of tax will vary between

ex... [M. rate exceeds 35% - SWM]

to keep the small companies rate in line with the basic rate of income tax for 1989-90

Gives away IT rate [JS] ACSA

8. I propose to leave both the small companies rate and the main corporation tax rate unchanged for 1989-90

But I propose to increase the monetary limits substantially, by 50 per cent.

9. Thus the 25 per cent rate of tax will apply to companies with profits of under £150,000, and the 35 per cent rate will only be reached at profits of £³/₄ million.

These changes will reduce the corporation tax burden for more than half of all those companies that do not already enjoy the full benefit of the small companies rate. X companies above the small profits limit

[facts?] FST

10. The reduction in the top rate of income tax to 40 per cent in last year's Budget enables me to make a major simplification of the tax treatment of close companies - generally, unquoted companies that are controlled by five or fewer people. a small number of people [unquoted]

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

FST IR

J. broadly, five or fewer people

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

NB PST minute AA - time?

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

IR

JG redraft / The company car remains

SWM prefers in IT

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

14. Accordingly, I propose to increase the car scales by ^{one third} ~~a further [25] per cent~~ for 1989-90. The yield from this will be ^{£160} £110 million in 1989-90 and ²⁰⁰ £135 million in 1990-91. There will be no change in the fuel scales.

XX

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

Needs redraft in IT

IR

JC

IR

[See their text]
IR

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

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

AA!
m'my 8
yis as a Treasury
Minister

FST.

* [swaps]

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

I have also authorised the issue of a consultative document on the tax treatment of interest and currency swaps [where there is a case for simplifying] ^{and updating} the legislation ^{and updating}.

[and updating]

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

[GM]

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

[GM]

[GM]

[C+E
had
comments
O'Brien]

keep here
or move?

19. ^{Lastly, on the business front,} I ~~also~~ propose to increase the VAT threshold to £23,000, the maximum permitted under European Community law.

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

21. Third, there is the perennial problem of VAT on bad debts. In general, traders are liable to pay VAT on their sales at the time they render their invoice, irrespective of whether the customer actually pays the bill. Bad debt relief can then be claimed only where the debtor has been formally declared insolvent, a requirement which, for the smaller business, is frequently prohibitive. It was partly in order to meet this problem that I introduced, in my 1987 Budget, the option for traders with a turnover of under £¹/₄ million to account for VAT on a cash basis, so that no VAT is due unless and until the bill is paid.

22. But there remains the problem of those traders with a turnover greater than £¹/₄ million, the highest figure for which I was able to secure a derogation from the European Community's sixth VAT directive. I therefore propose that, as from 1 October, all debts which are more than 18 months old and which have been written off in the trader's accounts should automatically qualify for bad debt relief.

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

TAXES ON SAVING

CST redraft attached - thinks this too defensive.

24. I now turn to the taxation of saving.

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

mpw

X

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

Jo's
[CST]

X
X

[The totality of savings within the economy. In other words we must include

27. But what matters here is not personal savings alone, but corporate savings too, which are running at historically high levels, and [even] public sector savings, which have of course been boosted by the record Budget surplus are higher than they have been for some considerable time.]

PST

True? - SWM
JC

X AA
X AA

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

JC which is a net figure has occurred more than the gross saving falling.

PST: has not occurred because gross saving has fallen; rather it is the result

Can this be worked out a simple way that has caused the sharp increase

appropriate remedy for that is to raise the cost of borrowing, ^{and the return to saving} as we have done.

JC

"too defensive"
AA

AA

JC

29. [But] above all, it is essential that tax reform is seen in a medium-term, even a long-term context. It is wholly inappropriate as an answer to ^{changes which are temporary} [what are essentially cyclical or even conjunctural difficulties].

[In that context,] the Government's policy is clear. It is to strengthen and deepen popular capitalism in Britain, by encouraging in particular wider share ownership.

really no mention at all of level playing field? SHM JOS

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

invites comment that this not what has happened in last 10 yrs - J Gil

MN.

I can now announce that this year's
31. [The latest] Treasury/Stock Exchange survey, ^{shows how successful we have been} conducted earlier this year, reveals that there are now ^{almost 9} million individual shareholders in this country, equivalent to one adult in every (five), and some three times as many as there were ten years ago.

[In spite of B. Manday-

JG, FST]

Not so,

Jc!

[Indeed, there are now more individual shareholders than there are trade unionists. (Check).]
and many of these trade unionists are shareholders.

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

AA x

33. Meanwhile, I have a number of ^{specific by} measures to announce today to the same end.

34. ^I Personal equity plans were first announced in my 1986 Budget, and started up in January 1987. As the House knows, those who invest in these plans pay no tax

[JS - disingenuous, investment comes out of taxed income] ditto - IR

[at all, either on] the dividends they receive or on any capital gains they may eventually make - indeed, there ^{is} will normally be no need for them to get involved with the Inland Revenue at all.

35. Personal equity plans got off to a good start, with over a quarter of a million investors, many who had never owned shares before, subscribing almost

FST, IR x

| £1/2 billion between them ⁱⁿ 1987.

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

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Even so, another 115,000 plans were taken out in 1988 - many more than some commentators have suggested. [IR]

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

X 37. So the time has come to ^{improve + simplify PEPs and} give ^{PEP} them a ^{further boost} new lease of life. SWM

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

39. Second, within that, I propose to raise substantially the amount that can be invested in unit trusts or investment trusts from £750 to £2,400 a year. Moreover, the requirement that the amount invested in unit or investment trusts should not exceed one-quarter of the total amount invested in a PEP will be dropped,

^{There will however be a} [and replaced simply by the] requirement that, to qualify for PEP ^{investment through a} treatment, a unit or investment trust ^{must} be ^{preponderately} ^{mostly} invested in UK equities.

This change will be of particular importance to the small investor as a simple means of investing in British companies (AA)

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

Half the total amount invested in PEPs £200

IR) (wholly or mainly) (FST)

MN (waterworks have RLAs)

MCJ PEPs for... I hope that... New P... to S.O. and use of PEPs as a vehicle for... 11

sounds like
shorten? mpr

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

IR

IR - cd confuse w/ Loi Manory

IR - bwr NB Isaac note.

FST comments.

See IR note

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

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

Some link needed
MN.

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eh? MH

AA
are £1250 or 10% of salary up to a ceiling of £5000. I propose to raise these limits to £2000 and £6000 respectively.

to almost 1,600 today, involving [number] companies and benefiting some 1³/₄ million employees. ~~I propose, first, to increase~~ ^{At present} the annual limits on the value of shares which can be given income tax-free to employees under all-employee profit-sharing schemes ~~from £1,250 to £2,000; and for the alternative limit of 10 per cent of salary, to raise the ceiling from £5,000 to £6,000.~~

44. Second, I propose to increase the monthly limit 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. IR

[FST] →

45. Third, a number of my Hon. Friends have been concerned that current tax law may be inhibiting the development of employee share ownership plans, otherwise known as ESOPs. (Insert brief definition/description of what an ESOP is.) I propose to make it clear that for companies that ~~place their shares in ESOPs~~ ^{that the ESOP} qualify for corporation tax relief, provided they meet certain requirements designed to ensure that the shares ~~become~~ ^{don't like mpw} directly owned by their employees within a reasonable time. I hope that this will encourage more British companies, particularly in the unquoted sector, to consider setting up ESOPs.

IR definition
better.
see FST definition.

[FST]

Make payments to enable an ESOP to purchase shares in the company, these payments will

This relief will override the existing reliance on case law which is proving restrictive
FST

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

mpw -
Link needs
improving

IR

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

48. First, as I have previously announced, I propose to abolish the restriction that to qualify for the tax relief, profit-related pay must be expected to 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.

AA

[yuk] IR

Enable employers to set up schemes for

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

[Tim Burr]

[IR suggest add back material interest]

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

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

51. I now turn to life assurance.

[unique]

FST
AA

52. The tax regime for life assurance is sui generis.

The present system dates back to the First World War and
X ~~Moreover it~~ has developed over the years in a piecemeal way, leading to a state of affairs in which the incidence of tax is extremely uneven, with some successful life offices paying no tax at all. [and some policyholders suffering a correspondingly unfair amount.]

FST [eh?]

53. There is clearly a powerful case for reform, with a view to securing a tax regime which is more equitable both within the industry and as between life assurance and most other forms of savings. Accordingly, last July the Inland Revenue issued with my authority a major consultative document on the taxation of life assurance. Since then, I have considered very carefully the representations the industry has made, and taken full

JC.

IR

IR

X account both of the ~~forthcoming~~ changes to the ^{regulation of} ~~regulatory regime for~~ life assurance proposed by the Securities and Investment Board under the Financial Services Act and the prospects for increased competition within the European Community after 1992. // In the light

AGT

AA "that it would not be right" / JC "rather than"

of these factors, I have decided ~~not~~ ^{rather than} to proceed with the

FST & IR [more radical things still in play for 1990]

[more radical] reforms canvassed in the consultative

CST also dislikes (see his minute)

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JC

[to introduce changes within existing tax structure]

JC

document. [But I do have a number of ^[AA Substantial] ~~less radical~~ changes]

JC

The changes ^I to propose, ^{are} based for the most part on the general tax reform principle of seeking lower rates on a broader base. [and bringing tax treatment broadly into line with regime applied to direct investment by individuals.]

SWM

IR

XX 54. First, many life offices run [a] pensions business

IR

[as well as a life assurance business, and they are not

IR

required to keep the two businesses entirely separate for tax purposes. This

enables them to set the unrelieved expenses of the

pensions business against the income and gains of their

life funds, thus giving their life profits unduly

favourable tax treatment. I propose to end this anomaly.

other life business

FSI

omit - J. Gil

and other changes intended to put the calculation for the tax of pensions business on a more commercial footing

IR (yuk)

FSI wants to emphasise whole thing neutral here

55. This change, which will come into force on 1 January 1990, will yield £ million in 1990-91.

The remainder of the changes I have to propose constitute a balanced package which, overall, [will]

IR

may in the long term slightly reduce the taxation of life assurance. (true?)

Needs justification - SWM

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

being deductible AA

gradually over the next four years, starting on 1 January, 1990.

X

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

on these issues

MC JC

XX

58. But I ^{can say} propose 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 ^{the policyholder's 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, ~~25 per cent.~~

IR

JS: gives game away

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

JS: needs to line up with para 55 - clarify!

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

AA

This reform of the taxation of life assurance is thus fully in line with our general tax strategy of lowering the rates and broadening the base wherever that is possible.

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

NB sentence on public sector.

[Time? BES etc - SWM]

61. I now turn to pensions.

perhaps - IR

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

AA, JC

63. I do not propose to do away with such rules as a means of limiting the tax relief available - indeed, there is a case for tightening them in some respects.

JG) not only to determine tax charged but also form and structure of pension provisions particularly

But it is quite wrong that tax law has, effectively, come to set a limit on the overall pension someone can receive. Accordingly, I propose to remove the obstacles in the way of employers setting up pension schemes to provide benefits above the tax limits. Such "top-up" schemes will carry no limit on benefits whatsoever, but, equally, will have no special tax privileges. Employers will now be free, therefore, to provide whatever pensions package they believe necessary to recruit and reward their employees.

FST suggests to put limit first then deregulation

SWM

AA X

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

arall

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pension they can have, and the more tax relief goes with it. Of course, someone who receives a very high salary will expect a ^[commensurate] pension of a comparable level, so as to maintain his or her standard of living on retirement.]

SWM

xx
x

But given that one man's tax relief is another man's tax increase, and [in the light of the income tax reforms I introduced last year,] it is hard to justify a state of affairs in which the tax advantages of pension provision are available with no upper limit whatever.

JC
[as tax rates overall have been reduced substantially]

[or move to end of para - CST]

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

Will audience follow? - SWM

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

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

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

X
IR! X

69. I also propose to simplify very substantially the rules concerning additional voluntary contributions. 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.

Drop AVCs?
JG

IR X

X

Furthermore

IR

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

X to employees, subject to a special tax charge. This will remove the ^{anomalous} penalty on good investment performance.

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

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

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

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

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

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

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

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

BUDGET - SECRET BLO

AA

an even more marked effect ^{on} [in encouraging the growth of] personal saving.

X XX

77. I refer, of course, to I Independent T taxation. For there can be no doubt that [the greatest disincentive to saving in the whole of the present tax system is] the treatment of the savings of married women, which have to be disclosed to their husbands and taxed at the husband's marginal rate. In particular, those married women who have little or no earnings will be able to set their personal allowances against their savings income, [in many cases removing such income from tax altogether.] (Insert brief announcement of new publicity leaflet: IR to draft.)

Time? AGT,
IR, JG

is a great disincentive to saving

What about CRT? - SWM, IR

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

IR X

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

? AA

IR [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 available from Inland Revenue offices to explain all the main features of the new system.]

BUDGET - SECRET BLO

~~X~~ 1980
80. This was rightly introduced by my predecessor in 1981, when there was still capital transfer tax on lifetime gifts, in order to avoid a form of double taxation. But the tax on lifetime giving has since been abolished, and the relief is increasingly used as a popular form of tax avoidance.

IR) 81. But while the general [holdover] relief will go, I propose to retain it for gifts of business, farm and heritage assets, and also for all gifts to charities. Tax. *and gifts where there is an immediate charge to inheritance tax.*
And of course gifts between husband and wife will continue to be exempt.

AA →
Gifts of personal belongings can benefit from the so-called chattels relief, under which items

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

AGT (1980) →
IR

[FST thinks this is a vantage]

That, I propose ~~also propose~~
83. ~~[My last capital gains tax proposal is]~~ to change the tax treatment of certain bonds so as to simplify the tax rules and prevent a loss of yield by the conversion of income into capital gains.

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

BUDGET - SECRET BLO

this from 2 per cent to 1 per cent in my 1984 Budget, and again from 1 per cent to $\frac{1}{2}$ per cent in my 1986 Budget.

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

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

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

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

[What about LAPD? - JC]

TAXES ON SPENDING

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

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

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

GM →
[I agree]

XX

[however modest,]

[GM - law
will cover
any organisation
that does this, tho'
M-bility only one at present]

[ditto C+E]

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

CS1: add: which shd reduce the cost to the [X] disabled drivers by [Y]

570 X

in

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

IR caveat

- Will charities
Expect Govt to
pay?

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

[PMG to check this para, please, and redraft as necessary.]

95. I now turn to the excise duties.

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

BUDGET - SECRET

BLO

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 about} less than 5 per cent of total petrol ^{sales} savings, even though two-thirds of the cars now on the road could use it, either without any adjustment or else with a conversion costing only some ^{on average} £15-£20. (check).

C+E -
[clearances to
14/2 5.5%] X

['Which' is the
source, claim
this an average.
Some cost more]

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

C+E (yuk!)
C+E

[GM] X

98. It is clearly essential that these myths are rapidly dispelled. Meanwhile, I propose to take the opportunity of this Budget to increase still further the tax differential in favour of unleaded petrol, by reducing the tax on it by ^{nearly 4 p} [something over 3 pence] a gallon. If this reduction is fully passed on to the

C+E

This will mean that the tax differential stands at around 13 pence a gallon.

BUDGET - SECRET

BLO

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

99. But I do not intend to stop there. I also propose to raise the tax on two and three star petrol by roughly 4 pence a gallon, so that the pump price of these grades

JG GM

CTE

GM

bring up
Y?

(Y) will be [at least] as high as that of four star. This should expedite the phasing out of two star petrol, which is already down to ^{about} 6 per cent of the total market, thus enabling garages to switch storage capacity and [in some cases] a pump [too], to unleaded petrol - quite apart from the incentive to the remaining two-star users to switch to unleaded fuel.

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

GM dislikes
+ SWM

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

BUDGET - SECRET
BLO

Duty. At 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. ~~Finally on Vehicle Excise Duty, I propose to~~ At the same time wish simplify the system by reducing the number of separate rates of tax from ~~x~~ 220 to

X [mpw]

[mpw - part of same measure as buses + rigids.]
[GM]

70%
X [Mention that main rates of VED unchanged]

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

COPY NO 1 OF 42 COPIES

FROM: MISS M P WALLACE

DATE: 28 February 1989

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Dame A Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Monck
Mr Scholar
Mr Culpin
Mr Sedgwick
Mr Riley
Mr A C S Allan
Mr Gieve
Mr Gilhooly
Mr Matthews
Mr McIntyre
Mr Pickford
Mr Macpherson
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

BUDGET STATEMENT: TAX SECTION

... As promised in my minute of yesterday, I now attach the Chancellor's revise of the sections on income tax, and the earnings rule. The rest will follow in due course.

2. Again, I should be grateful for comments by close tomorrow,
Wednesday 1 March.

MW.

MOIRA WALLACE

BUDGET - SECRET

TAXATION OF INCOME

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

104. I propose to raise all the main thresholds and allowances by the statutory indexation factor of 6.8 per cent, rounded up. Thus ^{for example} the single person's allowance will rise by £180 to £2,785, and the married man's allowance will rise by £280 to £4,375. [The basic rate limit will rise by £1,400 to £20,700. The single age allowance will rise by £220 to £3,400, and the married age allowance by £350 to £5,385. The higher ^{level} 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.]

can this be simplified?

IR

X
X

CST:
In 1987 I introduced a new

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, ^{I now propose to extend this to} should be extended to cover all ~~those~~ aged 75 and over. [This will take an additional ^{single people + married couples} £15,000 ~~elderly pensioners~~ out of tax altogether.] ^{As a consequence 3/4 of all those over 75 will not be liable to tax}

IR

X

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

BUDGET - SECRET

J. Gil.

AA X allowance is withdrawn above this income limit. [But] I propose that in future it should be withdrawn at the ^{of allowance} rate of £1 for each £2 of income ^{above the limit}, instead of the present ^{IR^{xx}} withdrawal rate of £2 in every £3. This will mean that the marginal tax rate for those in ^{the withdrawal} this income band ^{of income} will be reduced to well below 40 per cent.

X 107. The Finance Bill will also include the provisions to establish the new tax relief for the ^{over 60s} pensioners' health insurance premiums, which I announced to the House in January, and which will take effect from April next year.

CST:

Have one further change to make which will benefit many pensioners

P.McI
CST

XX 108. Under the [notorious] earnings rule, any pensioner who decides to continue to work after reaching the statutory retirement age has his or her pension docked at a rate of 50 per cent on every £1 earned between £75 and £79 a week, rising to 100 per cent for every £1 earned over £79 a week.

[Why took so long? and repercussions]

109. The Manifesto on which we were first elected in 1979 acknowledged that it was wrong to penalise pensioners who wished to work beyond retirement age in this way, and pledged that we would abolish the earnings rule.

BUDGET - SECRET

Judith C.V. unhappy
See her minute.

needs
checking

110. Of all the pledges in our 1979 Manifesto, that is the only one to remain unfulfilled. It will do so no longer. My Rt.Hon Friend the Secretary of State for Social Services and I have agreed that the pensioners' earnings rule should be abolished as from 1 October. The necessary legislation will be included in the Social Security Bill currently before the House.

111. The cost to public expenditure will be £[X] million in 1989-90, which will be entirely met from the Reserves. But the true cost of this measure will be considerably less than this, given the additional income tax and employers' National Insurance Contributions that will flow from the increase in the numbers of elderly ^{people} at work, once this harsh disincentive has been removed.

8/PMCI

IR

112. Those who wish to defer taking their pension will, of course, remain entirely free to do so, and will continue to earn a higher pension in return.

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

114. If one were to adopt the so-called "duck test" now in vogue across the Atlantic, the pensioners' earnings rule would qualify as a tax, and I would now be able to

BUDGET - SECRET

JS claim to have abolished a ^{6th sixth} ~~seventh~~ tax. But my innate
AGT modesty and natural reticence ^{inhibits} me from doing so.

Anson + McIntyre
unhappy. EST +
CST do not think
audience will get joke

AGT

[apart from sound
tax principles]

PMG: } and scoring a duck
a less satisfactory
connotation w/ our
own culture

but scoring a duck has never
appealed to me.



COPY NO 5 OF ³⁷ COPIES

FROM: MISS M P WALLACE
DATE: 2 March 1989

PS/CHIEF SECRETARY

cc PS/Financial 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 McIntyre
Mr Pickford
Mr Macpherson
Miss Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

Change on p 2

→ Miss Wallace

Sir P Middleton would like a change
to the last para on p. 2, as
shown below.

See 3/3

Sir A Battishill - IR
Mr Beighton - IR
Mr Isaac - IR
Mr Painter - IR
Mr G Bush - IR
Mr B Mace - IR
Mr C MacNichol (plus 1)

Mr Unwin - C&E
Ms A French - C&E

BUDGET STATEMENT: TAX SECTION

... I attach the Chancellor's draft of the NIC section of the speech.
As he will be working further on this over the weekend, he would
be grateful for quick comments as soon as possible tomorrow,
Friday 3 March.

Mpw. 62-2-3
MOIRA WALLACE

~~pl add this to end of Tax section~~

Ch /

For comments
on this see
Mace, McIntyre

NATIONAL INSURANCE CONTRIBUTIONS

Scholar.

X over is

FEM.

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 up to the upper earnings limit. There are three different rates - 5 per cent and 7 per cent for those on low pay, and the standard rate of 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 high and rising, and cut the burden of national insurance contributions on the very low paid. But at the same time they produce a rather jagged pattern of contribution rates; and this 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 with my Rt Hon Friend the Secretary of State for Social Security, 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 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 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.

Just square
bracket, do
not delete.

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

These measures will take effect from 1 October, the earliest practicable date. 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 currently before the House.

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.



✓
a → TB
b → JC

FROM: MISS M P WALLACE
DATE: 28 FEBRUARY 1989

SIR T BURNS

Some papers
removed

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

① Miss Wallace Some comments. I still

think the account passage is best with
the GDP numbers - which are relatively
uncontroversial rather than by investment
which it reads as though he has just made
up a figure & is now going to boast about
it.

② Back to me

JL

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 sharpen 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.

M. P. W.

MOIRA WALLACE

The economic background

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.

X
2. Our first ten years in office have ~~been a decade~~ ^{seen a} of complete transformation for the British economy. 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 ^{at home} ~~with~~

They have altered the basic framework of the economic debate in this country with

3. The economic strength and prosperity that Britain has enjoyed in these ten years have occurred 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.

4. In an increasingly open world economy, no nation can be insulated from the impact of events like these. But what governments ^{have to do} can guarantee is that ^{to} they will put the right economic policies in place, and stick to them. Provided they do this, they can survive the difficult

Even the parties opposite having to accept - it still to an inescapable degree - the need for low taxes & supply side reform.

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 ~~and to put the government's finances on a sound basis~~ 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.

The results are clear
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.

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.

1. WSD group
inflation & government
borrowing / debt repayment
here
ie. Our aim has
been sound money &
finances - result
low inflation &
PSDR up and the 1st
seen since 1981.

11. Nor is it only at home that we have been accumulating wealth. ^{we have built up an unprecedented share} In terms of net overseas assets ⁽²⁾ the UK is now in the top [three] internationally.

*True
We cannot submit
this in our new
letter to say the
higher the wages
the higher the wages*

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 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. Growth throughout the world was more buoyant last year than forecast a year ago, exceeding expectations in each of the major industrial countries. Overall, output in the G7 looks to have risen by an average of 4 per cent, and world trade in manufactures probably grew by 10 per cent.

*Facing page
(A)*

14. ~~The UK experienced, if anything, stronger growth than most of its G7 partners.~~ The sustained upswing of the last 8 years continued ^{in 1988} with a second successive year of GDP growth at about 4½ per cent, [the first time this has happened since the mid-sixties.] Manufacturing

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.

~~16. Investment growth clearly has 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 of investment spending in particular, are completely 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.]~~

for 1986 & 1987 *to have been quoted by a*
17. In a recent article ^{*in 1986*} 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.

Investment growth has clearly been very strong. Our key judgement is
18. ~~On the basis of this exercise, I judge that~~
^{it} 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].

19. However, although consumption did grow less strongly than investment in 1988, there was still a ~~marked~~ 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 government's handling of the economy, and because with buoyant house prices they feel

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.

21. (An essential feature of the MTF5 is that it points to the appropriate policy action when 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. 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

measures will fall] ^{necessary?} ~~[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.

* | 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.

unnecessary.
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,

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.

2. The central role in bringing down inflation belongs to monetary policy ~~buttressed by a prudent fiscal stance~~ ^{and this means the use of} ~~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.]

unlike? →

^{M₂ (?)}
3. ~~The~~ ultimate objective is stable prices. No Government can be proof against short term fluctuations along the way, but ^{the} ~~Governments~~ ^{is determined} ~~can guarantee the will to~~ ensure that they are only short term.

4. ~~The determination to~~ ^{Keeping} keep interest rates at the appropriate level ~~however unpalatable that may be~~ ^{needed} ~~sometimes is the key to bringing~~ ^{down} inflation down. And it does require determination, ~~for~~ ^{for} higher interest rates are always unwelcome to home owners and other borrowers.

unpopular. It, it may be, we

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

We learnt under Labour

to pensioners

5. ^{And} 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.~~

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

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?]

here ✓

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 M0, which has a reliable and predictable relationship with money GDP. The target range for M0 growth in 1989-90 will be 1-5 per cent, as envisaged in last year's MTFs. Measured on a 12 month basis, M0 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 an ^{important buttress to monetary} central feature ~~policy~~ of the MTFPS, buttressing a sound monetary policy. The primary focus ^{is} ~~is~~ the ^{medium} ~~medium~~ term, ^{and the impact of} ~~and the impact of~~ taxation, expenditure and borrowing ^{on a sustainable course in the medium term} ~~on the supply side~~.

But its role is very different from monetary policy: ~~it~~ 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} ~~much~~ too inflexible for that: fiscal changes take time to implement and are difficult to reverse. ~~Furthermore,~~

our strategy to curb inflation

for fiscal policy

and within this to make structural reforms to improve the supply side of the economy.

and their 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, and I now expect a debt repayment of [£14 billion] in 1988-89.

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

I would
Delete B 2/4

unclear

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.

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.

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.

In the long term, as I said last year, ^{our} objective is to achieve a balanced budget. But

17. It would not be wise to revert to a ~~balanced~~ ^{the} 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.

19. Most importantly however in present circumstances, 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 will help maintain confidence and provide a general support for monetary policy.

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 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.]



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

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.

M. Wallace

MOIRA WALLACE

The economic background

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 of complete transformation for the British economy. 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.

3. The economic strength and prosperity that Britain has enjoyed in these ten years have occurred 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.

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 the difficult

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

X 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.

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.

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.

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 ^{near} at the bottom of the league compared with our ^{major} 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.

Clearly not!

9. This improvement in Britain's economic performance has been matched by very much improved living standards 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.

X
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 personal wealth, with the expansion of owner occupation and share ownership.

*Difficult to justify
when we are doing
figures from the PSBR*

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.

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 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.

X

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

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**

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.

16. Investment growth clearly has 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 of investment spending in particular, are completely 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.]

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

Why not replace this along the lines of "How some accounts indicators have been showing a positive of recent developments over the last 5 or 3 years. For example
Then use investment as an example not an introduction.
Better to have that on output.

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 ^{press release?} being published by the Treasury today.

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].

19. 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 government's handling of the economy, and because with buoyant house prices they feel

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.

21. An essential feature of the MTF5 is that it points to the appropriate policy action when 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. 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

It only fell in the last 2 quarters!

intensions?

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.

X
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 ^{with} mortgages that are adjusted only once a 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.

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

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.

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.

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,

Just

V. high risk strategy!

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.]

if you want to shorten this

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

However we

must also look to see continued co-operation on monetary and fiscal policy, to help the process of reducing imbalances and to maintain ^{downward pressure on world inflation and} 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.]

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.

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.]

3. The ultimate objective is stable prices. No Government can be proof against short term fluctuations along the way, but Governments can guarantee the will to ensure that they are only short term.

4. The determination to keep interest rates at the appropriate level - however unpalatable that may be sometimes - is the key to bringing inflation down. And 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.

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.

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

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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.

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Needs Curb.

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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
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Mr Gieve
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Mr O'Donnell
Mr Pickford
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Mr Call

BUDGET STATEMENT: ECONOMIC SECTION

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90/89B



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 - (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.

M. P. S.

MOIRA WALLACE

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Too validating?

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3. ^{And} The economic ^{growth} strength and prosperity that ^{has been achieved} Britain has ~~enjoyed~~ in these ten years have occurred 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.

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4. In an increasingly open world economy, no nation can be insulated from the impact of events like these. But ~~what~~ ^{which have} 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~~

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times, and excel in the ^{casual} 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 ^{has been} very heart of ^{our} economic strategy. This we have pursued consistently within the clear and disciplined nominal framework of the medium-term financial strategy.

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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 ^{Trailing} bottom of the league compared with our ^{major} European competitors. In the '80s, we have been at the top of the ^{growth} 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.

And the

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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.

People forget too easily the situation at the end of the 1970's

12. The last ten years, then, ~~have been a time of extraordinary improvement to the economic fundamentals in the UK.~~ When we came to ^{office} power, Britain was a ~~textbook case of~~ ^{big word} 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. Growth throughout the world was more buoyant last year than forecast a year ago, exceeding expectations in each of the major industrial countries. Overall, output in the G7 ^{is likely to} looks to have risen by an average of 4 per cent, and world trade in manufactures probably grew by 10 per cent.

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

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.

16. Investment growth clearly has 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 of investment spending in particular, are completely 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.]

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

① like JG
SS

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 ^{at} 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.

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].

19. However, although consumption did ^{grow} ~~grow~~ less strongly than investment in 1988, there was still a marked pick-up in the growth of consumers' ^{spending} expenditure. This was not surprising. People have been prepared to finance their spending by borrowing more because they have confidence in the government's handling of the economy, and because with buoyant house prices, they feel ^{confident about employment} ~~have higher real incomes, they are~~ confident about employment.

wealthier. The house price ^{rise} 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.

21. An essential feature of the MTF^s is that it points to the appropriate policy action when things ^{circumstances} 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. 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

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} Those mortgages that are adjusted ~~only~~ once a year ^{is} ~~will~~ only now be ^{working through.} ~~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.

But these changes take time.

24. ~~All this will show through in the RPI in time.~~
And ~~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

whereas the RPI

By the 4th qtr

is likely to fall
measures will fall] with RPI inflation itself coming
back to 5½ per cent by the fourth quarter of this year
and ^{to} 4½ per cent by the second quarter of 1990.

With 25. ~~The slowdown~~ *slowing* 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.

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 ^{is likely to} 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,

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 ^{that rise} 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.]

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.

2. The central role in bringing down inflation belongs to monetary policy, ^{and that means} 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.]

or usual formula
left is a mon. phenomenon
etc.

3. ^{can} The ultimate objective ^{remains} is stable prices. ^{But} No Government ^{is} can be proof against short term fluctuations along the way, ^{we} but Governments ^{are determined} can guarantee the will to ensure that they are only short term.

4. ^{is} The ~~determination to~~ ^{keep} keep interest rates at the appropriate level - however unpalatable that may be ^{needed} sometimes - is the key to bringing inflation down. ^{is not popular} And 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.

P. But
with the
workers
many of them parents
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.

And
well
has got
to cope
defeat

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.

that they
discourage
increased mortgages and buying
for house purchases
Here

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

well
on consumer spending
so that it is particularly affected by interest rate changes.

§ 25
expanded
on investment

In contrast companies with higher profits and substantial retained earnings are

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.

§ 22/23

8. ~~Now~~ ^T 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?]

here

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 M0, which has a reliable and predictable relationship with money GDP. The target range for M0 growth in 1989-90 will be 1-5 per cent, as envisaged in last year's MTFs. Measured on a 12 month basis, M0 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 ^{buttressing} also a central feature ^{of the MTFE} of ~~the MTFE~~, ^{buttressing} a sound monetary policy. ~~The 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; ^{the} it cannot be used effectively in the short term as a means of ^{primary focus is medium term and its impact through} managing demand and ^{tax, exp. and borrowing is on the supply side} keeping the growth of money GDP on track. That was the mistake of the 70s. It is much too inflexible for that: ^P fiscal changes take time to implement and are difficult to reverse. Furthermore, ^{have effect}

g 26/27

last year we budgeted for a PDR of X and no change in the tax burden. In the event the fiscal stance was even tighter than anticipated with a PDR of X.

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.

Frequent change
change long term
supply side
benefits
changes need that
are sustainable

12. From our early years of office, we made steady progress in reducing the burden of Government borrowing. But now the public finances have ^{are} 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, and I now expect a debt repayment of [£14 billion] in 1988-89.

13. This is a remarkable achievement, and a reward for many years of hard work in reducing the deficit. No other major country enjoys a comparable Budget surplus. The improvement ^{results from 91 with} owes something to higher tax revenues, from a more buoyant economy, and in particular ^{from} 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.

See note.

Turkey debt repayment of X is likely in X and in future years

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 ^{is} of a balanced Budget. ^{with} This is a position in which the state makes ^{ing} 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 ^{£x6} lower by ^{in the} £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.

16. The dramatic improvement in the UK's public finances has also provided ^s a ^{the} 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.

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.

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.

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

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 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.]



SIR T BURNS

FROM: MISS M P WALLACE
 DATE: 28 FEBRUARY 1989

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,
 A few comments.
 Andrew. 2-iii.

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.

338/B-



- (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 sharpen 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.

M. P. W.

MOIRA WALLACE

The economic background

improved | 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 of complete transformation for the British economy. 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.

✓ 3. The economic strength and prosperity that Britain ~~has enjoyed in these ten years~~ ^{is ~~has + continued to enjoy~~ ~~now enjoys~~ has 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~~ ^{crash}.

✓ 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 the difficult

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.

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.

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.

*Too sophisticated.
Most people think
nominal = piffing!*

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 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.

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.

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.

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 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. Growth throughout the world was more buoyant last year than forecast a year ago, exceeding expectations in each ^{all} of the major industrial countries. Overall, output in the G7 looks to have risen by an average of 4 per cent, and world trade in manufactures probably grew by 10 per cent.

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~~Figure fiddling?~~

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19. 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 government's handling of the economy, and because with buoyant house prices they feel

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.

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*It didn't! till two
late.*

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

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.

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.]

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,

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

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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.

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

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. *That's this the market's verdict on our the anti-inflation strategy.*

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. *Nonetheless* 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?]

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

✓ They generate uncertainty for individuals and companies alike with an inevitable economic cost.

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, and I now expect a debt repayment of [£14 billion] in 1988-89.

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

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 ^{stick to} achieve the ~~medium term~~ objective of a balanced Budget ^{in 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.

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.

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.

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.

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.]

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

This is a new principle, at least when expressed so explicitly.

implies we have doubts ourselves.

firm backbone

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 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.]

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FROM: MISS M P WALLACE

DATE: 28 February 1989

PS/FINANCIAL SECRETARY

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

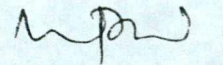
Sir A Battishill IR
Mr Beighton IR
Mr Isaac IR
Mr Painter IR
Mr G Bush IR
Mr C McNicol IR (+1)

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

BUDGET STATEMENT: TAX SECTION

... As promised in my minute of yesterday, I now attach the Chancellor's revise of the sections on income tax, and the earnings rule. The rest will follow in due course.

2. Again, I should be grateful for comments by close tomorrow,
Wednesday 1 March.



MOIRA WALLACE

BUDGET - SECRET

TAXATION OF INCOME

103. Nor do I propose any change this year to either the basic or higher rates 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 ^(level) 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 ^{people} the elderly. I propose that the higher age allowances, which ~~are~~ ^{is} currently ^(given to) for those over 80, should be extended to cover all those aged 75 and over. This will take an additional ~~15,000~~ ^(single people and married couples) 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

I understand "the elderly" is disliked by those representing them!

BUDGET - SECRET

allowance is withdrawn above this income limit. ~~But~~ I propose that in future it should be withdrawn at the rate of £1 ^(of allowances) for each £2 ^(above the limit) of income, instead of the present withdrawal rate of £2 ^(of allowances for) in every ^(additional) £3 ^(of income). This will mean that the marginal tax rate for those in ^(the withdrawal) ~~this income~~ ^(of 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 ^{over 60s'} ~~pensioners'~~ health insurance premiums, which I announced to the House in January, and which will take effect from April next year.

108. Under the notorious earnings rule, any pensioner who decides to continue to work after reaching the statutory retirement age has his or her pension docked at a rate of 50 per cent on every £1 earned between £75 and £79 a week, rising to 100 per cent for every £1 earned over £79 a week.

109. The Manifesto on which we were first elected in 1979 acknowledged that it was wrong to penalise pensioners who wished to work beyond retirement age in this way, and pledged that we would abolish the earnings rule.

BUDGET - SECRET

110. Of all the pledges in our 1979 Manifesto, that is the only one to remain unfulfilled. It will do so no longer. My Rt.Hon Friend the Secretary of State for Social Services and I have agreed that the pensioners' earnings rule should be abolished as from 1 October. The necessary legislation will be included in the Social Security Bill currently before the House.

111. The cost to public expenditure will be £[X] million in 1989-90, which will be entirely met from the ~~Reserves~~. But the true cost of this measure will be considerably less than this, given the additional income tax and employers' National Insurance Contributions that will flow from the increase in the numbers of elderly ^(people) at work, once this harsh disincentive has been removed.

112. Those who wish to defer taking their pension will, of course, remain entirely free to do so, and will continue to earn a higher pension in return.

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

114. If one were to adopt the so-called "duck test" now in vogue across the Atlantic, the pensioners' earnings rule would qualify as a tax, and I would now be able to

BUDGET - SECRET

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