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BUDGET PAPERS 1989

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COVERING BUDGET CONFIDENTIAL

From: C D FORD
Date: 15 February 1989

MISS WALLACE

cc: Mr Culpin
Mr Gilhooly
Mr Matthews
Miss Hay

BUDGET SPEECH - UNIT TRUSTS

I attach a draft section on unit trusts. Notes on Europe to follow.

Chris Ford

CHRIS FORD

UNIT TRUSTS

It has become clear that the existing tax system puts UK unit trusts which hold a mixed portfolio at a competitive disadvantage [relative to offshore funds and direct investors]. The welcome liberalisation of European financial markets would accentuate this problem and provide an incentive for UK funds to move abroad. I have therefore decided that, as from 1 January 1990, the corporation tax rate on unit trusts should be cut from 35 per cent to 25 per cent. Unit holders' CGT position and the additional income tax paid by higher rate tax payers will be unaffected. Rules will be introduced to prevent corporate investors using this change as a tax shelter.

The tax system has also encouraged investment in offshore "umbrella" funds which reduce and defer CGT. This is unfair to UK based funds; I therefore propose that investors who switch investments within an offshore umbrella fund should be liable to tax in the same way as investors in onshore funds. This will take effect for disposals on or after Budget day.

HM CUSTOMS AND EXCISE
New King's Beam House, 22 Upper Ground, London SE1 9PJ
Telex
Telephone 01-620 1313 Ext 5059
GTN Number 3019

Ms Moira Wallace
Chancellor's Office
HM Treasury
Parliament Street
LONDON SW1P 3AG

Your reference

Our reference

Date 15 February 1989

Dear Moira

DRAFT BUDGET SPEECH: UNLEADED PETROL

As requested, I attach a draft contribution to the Budget speech on unleaded petrol. As you will see it is both full and long, but as the Chancellor has asked for a "clear explanation of the full implications of the changes in petrol duty" it seemed right to make it too long rather than too short. You may think that we have over-egged the pudding (despite the risk of salmonella - is there the germ of a joke there?) so do feel free to make cuts.

At the end of this month, we will be able to update the figures for unleaded sales (see fourth para) to give uptake to 14 February.

Finally, a request. Could you please copy future papers on the speech to my Assistant Secretary, Richard Allen (PRII, not to be confused with RIG in the Treasury) as well as Brian Unwin and Peter Jefferson Smith.

Copies go to Peter Wilmott, Richard Allen, Derek Gaw and Keith Vernon here.

Yours sincerely

Alison.

ALISON FRENCH
DPU 1

BUDGET SECRET

CONTRIBUTION TO BUDGET SPEECH: UNLEADED PETROL

~~and specifically to~~

"I turn now to the excise duties. ~~With the exception of one important set of measures, I do not propose to change the existing rates of excise duty.~~

Last year I increased the tax differential in favour of unleaded petrol to nearly 11p a gallon. As a result, the price of unleaded at the pump is generally about 6p a gallon lower than that of 4 star.

The Government is committed to phasing out leaded petrol over the coming years - as are the oil companies and car manufacturers. Efforts to increase public awareness of the benefits of unleaded petrol by the Department of the Environment in conjunction with groups like CLEAR (the Campaign for Lead Free Air) have had increasing success in recent months. The number of garages selling unleaded is growing at a rate of about 60 a week. Some 80 per cent of new cars can now run on unleaded without modification. And from October 1990, all new cars will be able to use unleaded.

More drivers are using unleaded petrol. But, despite its growing availability, lower prices and environmental benefits, in January 1989 it still only accounted for [4 per cent] of petrol sales. Yet two thirds of all cars on the road can be cheaply adjusted to run on unleaded. And nearly three and a half million cars can use it without any adjustment. Contrary to popular belief, using unleaded does not have a marked effect on performance or economy. And cars which have been converted can still use leaded if necessary. Frankly, in spite of the best efforts of Government and industry, progress so far has been disappointing. The process of education will continue, as will the increase in garages selling unleaded and the number of cars able to run on it.

For my part, I propose two further measures today that will encourage a further significant switch to unleaded petrol.

First, I propose to reduce the tax on unleaded petrol by a something over 3p a gallon. If this reduction is passed on to consumers - and I see no reason why the oil companies should not pass it on in full - the price of unleaded petrol will generally be about 9p a gallon, or 2p a litre, below that for 4 star leaded petrol. I hope that this increased price incentive will reinforce the upward trend in switching from 4 star to unleaded.

Secondly, in order to encourage motorists to switch from 2 and 3 star to unleaded, I propose to introduce a surcharge of 5p a gallon on leaded petrol other than 4 star. This will bring the price of these grades broadly into line with that of 4 star. Virtually all cars which use 2 and 3 star can run on unleaded petrol without any conversion and I hope the 1 million or so motorists who currently buy these grades will now switch to unleaded. I hope this will also encourage those garages still selling 2 and 3 star to change over to unleaded.

Both changes will have effect from 6 o'clock this evening."

OTHER PENSION ITEMS:

The proposals here are:

(i) to restrict companies' ability to reserve profits to amounts which are demonstrably (ie in actuarial terms) needed for future bonuses to pension policyholders;

(ii) to bring into tax "recognised" gains whether or not they are realised. (At present unrealised recognised gains can appear in the debit side of the calculation of pension business but not the credit side.)

2. The Revenue has yet to put exact proposals to Ministers on these points. But - assuming that Ministers accept them - I doubt if they should get any reference in the Budget speech. If they did, something along the following lines might do:

> " I shall also take the opportunity in the Finance Bill to deal with defects in the present tax treatment of companies in the pension business. "

fim2.cd/neilson/min40 **BUDGET CONFIDENTIAL**

FROM: M J NEILSON

DATE: 15 February 1989

MISS WALLACE

cc: Mr Culpin
Mr Odling-Smee
Mr Ilett
Mr Barker
Mr Walker IR

BUDGET SPEECH : PEPS ETC.

As agreed I attach a first draft of the section of the Budget Speech covering PEPs, ESOPS and Employee Share Schemes. I have not, in the time available, been able to clear this with copy recipients, who may wish to pass you comments.

2. I have included a reference to this years share ownership survey, the results of which should be available at the end of this month. I think we should plan on the basis that there should be reference in the Budget Speech, though, if the figures are too awful, this could be dropped.

Pat

Can you get hold of this by machine and take on amendments, and add to speech (rm/mw/5)

M J NEILSON

fim2.cd/neilson/min39

BUDGET SPEECH : PEPs, ESOPs, AND EMPLOYEE SHARE SCHEMES

Introduction

Wider share ownership has always had a central place in our economic strategy. [detail of share ownership survey - available end February]. But there is still further to go. Accordingly I am announcing today ~~further~~ a number of measures to widen share ownership further.

PEPs

2. I announced my proposals for Personal Equity Plan exactly three years ago as a radical new scheme to encourage investment in British equities. In the first two years that the scheme has been in operation more than 350,000 plans have been taken out. This despite the stock market crash. But ~~the scheme has now been in operation long enough for me to consider whether changes are needed. I have decided to introduce a package of changes~~ now that we have more experience of the scheme, I have a number of improvements to propose, ~~which will~~ which will make PEPs cheaper, more flexible and more attractive for first time investors.

3. First, I propose ~~raising~~ to raise the overall PEP limit from £3,000 to £4,800, and the limit on holdings of unit and investment trusts from £750 to £2,400. I am more than trebling the trust limit in recognition that unit and investment trusts are a good way for smaller investors to enter the equity market for the

first time. They provide diversification of risk at low cost. But those with more to invest, or more experience, can combine trusts with equities, or invest their entire PEP in equities.

Third

4. ~~Second,~~ I am radically simplifying the PEP rules. I propose to ~~abolishing~~ abolish the one year holding period; if investors choose to cash in their PEPs within a year of purchase, they will, in future be able to do so without tax penalty. ~~Since the tax benefits of PEPs build up only gradually, the~~ Any tax lost through early withdrawal will be negligible, while the cost to both the Inland Revenue and plan managers of collecting such small amounts of tax is inordinate. [The only remaining requirement will be that only £4,800 can be invested in any PEP year.]

5. I am also abolishing the cash rules, which have been criticised as making it difficult for plan managers to switch investments. Instead, interest on cash held in PEPs will, in future, be subject to composite rate tax.

Move paras 6+7 up to X

6. ~~Third,~~ I intend to make ~~making~~ it possible for PEP holders to apply for new share issues, and to place their resulting allocation in their PEP, provided this does not breach the overall limit. This change will mean that many of the new breed of investors, whose only experience of share ownership is from

subscribing for privatisation, will be encouraged to take out a PEP.

7. There is a close link between the substantial increase in the trust limits and this change on new issues. The investor who chooses to take out a unit or investment trust only PEP may also subscribe for new issues. Once these changes have been made, this investor's plan manager will be able to hold any new issue shares as part of the PEP. This will have a double benefit; unit trust holders will be encouraged to buy equities directly, and to retain any shares they are allocated in new issues.

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

9. Taken together, these changes will make PEPs more attractive to first time investors. I am confident that the package will lead to a substantial increase in PEP take up, and a substantial widening and deepening in share ownership.

Ownership

Employee Share ~~Schemes and ESOPs~~

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

This year a number of further

11. I have made improvements to the employee share legislation ~~in eight out of the last nine Budgets. And this year is no exception.~~ to propose

12. The limits on the 1978 profit sharing scheme have not changed since 1983, and those on the 1980 SAYE option scheme since 1984. I therefore propose to raise the limit on annual ~~appropriation~~ value of shares which can be given tax-free to employees under the 1978 scheme, ~~which currently stands at~~ from £1,250 or 10% of salary, subject to an overall limit £5,000, to £2,000 or 10% salary, subject to a limit £6,000. This concentrates the increase at the lower end of the scale. ~~where it exceeds the rise in average earnings since the last increase took place.~~

13. I also intend to raise the maximum monthly savings limit for participants in the ~~1980~~ all-employee SAYE scheme from £100 to £150. And I propose to increase the maximum discount from market value at which options can be granted from 10% to 20%.

14. These changes should give a substantial further boost to existing share schemes. ~~I turn now to~~ are a new form of employee share ownership, which ~~has~~ have had much recent publicity; employee share ownership plans. A number of ~~ESOPs~~ have already been put in place in the UK. They are particularly appropriate for employee buyouts, and for some private companies who are not in a position to offer the existing Inland Revenue approved schemes. ~~It has been suggested that this form of employee share ownership is inhibited by uncertainty of tax treatment. Accordingly, I propose to establish a statutory definition of an employee benefit trust to provide the certainty required. To qualify a trust must meet a number of~~ requirements, designed to ensure that ~~its genuine purpose is to place~~ their shares are placed in the hands of employees within a reasonable time. ~~In return the company will have certainty that its contributions to such an employee benefit trust will qualify for corporation tax relief.~~ I hope that, as a result ~~of this greater certainty~~, more firms will be encouraged ~~decide~~ to consider establish up ESOPs.

¶ But there has been some uncertainty whether contributions to an ESOP from a company qualify for tax relief. I now propose to clarify the tax position by establishing a new tax relief for contributions to employee share trusts which meet certain

15. I also propose to modify ~~legislating to deal with problems caused by~~ the so-called material interest tests ~~for~~ ~~to acquire their shares~~ where companies ~~who~~ have established trusts for the benefit of their employees. ~~Under current law, all the beneficiaryies of a trust which exceeds the~~

These tests are designed to exclude from tax relief employees who already have a significant interest in the company. But where there is a trust holding the shares for the benefit of employees the present rules can exclude employees ~~[illegible]~~ too

~~material interest threshold, are each deemed to~~ have
~~a material interest. This means they will~~ are not ~~be~~
~~eligible to participate in an Inland Revenue~~
~~approved all employee share scheme~~. The changes I
propose will ensure that only those employees who
~~genuinely~~ have a significant material interest in the company will be ~~so~~
excluded, in future.

This change will benefit conventional employee share schemes, and profit-related pay schemes as well as ESOPS.

swm2.15.2

Covering BUDGET SECRET

COPY NO 1 OF 11 COPIES

FROM: S W MATTHEWS
DATE: 15 February 1989

MISS WALLACE

cc Mr Culpin
Mr Gilhooly
Miss Hay
Mr Macpherson
Mr Wilson
Mr Lawton
Mr Ford

BUDGET STATEMENT : SAVINGS

I am attaching a few paragraphs on the rationale for the budget measures affecting savings. I have concentrated at this stage on setting down the main arguments, rather than polishing the presentation. There is probably more material here than you need, and you may wish to edit it to omit some of the detail and the less attractive arguments.

SM

S W MATTHEWS

BUDGET SECRET

TAXATION OF SAVING

The long period of sustained growth under this Government has contributed to a remarkable buoyancy in individuals' confidence about the future. The associated fall in household saving in relation to income has, though, caused concern in some quarters. What is less widely appreciated is that the saving of the private sector as a whole has been a relatively stable proportion of GDP throughout the 1980s, since saving by companies has increased. Furthermore, "national saving", that is private plus public saving, has been boosted by the unprecedented improvement in public finances, which we have achieved since 1979.

2. There is no need therefore to introduce a series of tax concessions to promote savings, as some commentators calling for a "budget for savings" have urged. [As I have already indicated,] I expect the fall in the personal saving ratio to be temporary. Indeed, the growth of consumers' expenditure is already slowing as a result of the tightening of monetary policy during the course of 1988. So higher interest rates are already encouraging more saving.

3. In considering the case for tax concessions to boost saving we must consider whether such concessions would be justified on a permanent basis. As I have stressed on numerous occasions, the objective of my tax policy is not to fine-tune demand, but to create a more efficient economy and a higher rate of sustainable non-inflationary growth.

4. Privileges for certain types of saving have historically proved highly durable. Different media for saving have long been subject to very different tax treatments in this country, producing wide variations in the gap (or wedge) between their pre-tax and post-tax rates of return.

5. Savings through house purchase and through life assurance and pension funds have been particularly favoured by the tax system. Contractual saving to provide for one's old age and other

contingencies is a very socially desirable form of saving, but one can sometimes take a good thing too far. The result has been a massive shift in the form in which households have held their assets.

6. In 1957 direct holdings of shares and bonds accounted for some 37 per cent of the personal sector's financial assets. By 1979 their share had fallen to 17 per cent. Over the same period the share of life assurance and pension funds rose from 17 per cent to 35 per cent. [There was also an even more dramatic shift from holdings of financial assets to house ownership].

Ownership

7. Over a long period of years the effect of the privileges granted by the tax system to certain forms of saving has encouraged saving through institutions at the expense of direct personal holdings of securities. The rampant inflation permitted by Governments in the 1970s reinforced the effects of the tax system in producing a wide array of degrees of tax privilege, distorting the allocation of saving and impairing the efficiency of our economy.

8. Tax privileges served to segment financial markets, providing financial institutions with a captive clientele and reducing the pressures on them to operate efficiently. They thus tended to raise the cost of financial intermediation (in broad terms the difference between the rate at which a financial institution attracts funds and the rate at which it on-lends them) to the detriment of both savers and investors.

9. The deregulatory measures introduced by this Government have done much to improve the efficiency of financial intermediation, as have the reductions in stamp duty that we have implemented. In planning this budget I have examined what further tax changes could be made in support of this end [including the question of whether the present arrangements for deductibility of Life Office's expenses encourage them to run high cost businesses.]

10. Since 1979 we have done much to reduce the dispersion in the amount of privilege (or lack of it) enjoyed by different types of saving:-

- inflation has been brought down and then kept low, reducing the distortion involved in income tax being applied to nominal rather than real interest receipts;

- abolition of the investment income surcharge, and reductions in basic and higher rate taxes have all reduced the relative privilege enjoyed by savings whose return is not subject to income tax;

- rates of income tax and CGT have been aligned;

- life assurance premium relief on new contracts was withdrawn in 1984;

- the ceiling for mortgage interest relief has been increased by less than inflation, and shifted to a residence basis from August 1988;

- the introduction of PEPs has enabled direct investment by individuals in shares on a semi-privileged basis;

[- removal of tax privileges on forestry].

11. Considerable disparities in the tax treatment of different savings media remain. Yet some variation is both inevitable and desirable.

12. A completely uniform approach would involve some drastic levelling up (eg no tax relief for contributions to pension funds, taxation of pension fund income, taxation of imputed rent from owner occupation) or levelling down (ie tax relief for all saving, including bank and building society deposits). I rejected the latter approach to tax reform, known as an expenditure tax system, in my first Budget in 1984 as wholly impractical and unrealistic. I still believe this to be the case. The only realistic option is a hybrid system.

13. But we must keep tax privileges under continuous review, restricting those which are no longer justified on social and economic grounds, while liberalising elsewhere. This has been my aim in this Budget.

14. In doing this, I have been concerned to tilt the balance away from indirect saving through large institutions, with a view to encouraging ways of saving which give people a greater sense of personal investment, and in particular promoting wider share ownership.

15. Access to all privileged forms of saving is rationed in some way, and I have reviewed these limits. In the case of pension funds the limits imposed by the Inland Revenue for a tax privileged pension have become the limit for all types of pension. The Budget will remove this restriction, and at same time set maxima for tax privileged pensions.

[16. I have decided to keep the ceiling for mortgage interest tax relief at £30,000 for another year. This now represents some 43 per cent of the average new house price, compared with 112 per cent for the ceiling of £25,000 when Labour lost office in 1979.]

17. The Government has already carried through a number of measures to make share purchase and ownership accessible. Stamp duty has been reduced, personal equity plans introduced and employee share schemes encouraged. My budget today builds on these earlier measures.

BUDGET CONFIDENTIAL

From: A A B WILSON
Date: 15 February 1989

MISS WALLACE

cc: Mr Culpin
Mr Gilhooly
Mr Matthews
Miss Hay
Mr Macpherson
Mr Michie
Miss Simpson
Mr Flanagan
Mr Lawton
Mr Ford

BUDGET: CORPORATION TAX BACKGROUND

The main (bull) points on corporation tax seem to me to be:

(i) Stability. Now 5 years since reforms were announced and 3 years since system has been operating in current form. Stability helps companies to plan for the future.

(ii) Investment. Reforms have led to more efficient investment, based on real returns rather than tax advantages. Investment now at record levels, 5 1/2% higher in 1987 than 1986 and 5 1/2% higher in 1988Q3 than 1987Q3.

(iii)Profits. Results can be seen in bouyant profits of corporate sector. Gross trading profits (net of stock appreciation) of non-North Sea ICCs up nearly 20% in 1988 compared with 1987 and 17% in year to 1988Q3.

(iv) Conclusion. System is working well, therefore no need to change it. Now is not the time to reduce pressure on companies to keep wage costs down by reducing CT rate.

BUDGET CONFIDENTIAL

(v) Small companies. 24,000 companies will pay less CT as a result of the increases in the thresholds for small companies' CT. Piecing together various Revenue submissions gives the following breakdown of companies by size of profits:

Profits £ 000s	Number of companies (000s)	Current tax regime		New tax regime	
		Marginal tax rate	Average tax rate	Marginal tax rate	Average tax rate
0-100	200-250	25%	25%	25%	25%
100-150	6	37 1/2%	25-29%	25%	25%
150-500	14	37 1/2%	29-35%	37 1/2%	25-34%
500-750	4	35%	35%	37 1/2%	34-35%
over 750	16	35%	35%	35%	35%

(The figure of 24,000 companies paying lower tax is the sum of the numbers of companies in the middle three rows of the table. This may be reduced by about 1,000 if changes are applied to the rules for taxing close companies.)

Alan Wilson

ALAN WILSON

BUDGET CONFIDENTIAL

FROM: N I MACPHERSON
DATE: 16 FEBRUARY 1989

MISS WALLACE

cc. Mr Culpin
Mr Gilhooly
Miss Hay

PENSIONS SECTION OF BUDGET SPEECH

Attached is an outline of the pensions' section. Mr Kuczys has seen it and is content. Let me know if you need assistance putting it into prose.

Nick Macpherson

N I MACPHERSON

Alex

What do you think of this.
I feel it is rather too much of
a sleight of hand. I wd prefer
a more straightforward approach.

fp.ac.hay/28

COVERING BUDGET CONFIDENTIAL

FROM: MISS M HAY

DATE: 16 February 1989

MISS WALLACE

cc Mr Culpin
Mr Matthews
Mr Macpherson

BUDGET SPEECH

I attach some words on capital gains tax threshold/gifts relief. They are half baked but may give you a start.

MARY HAY

BUDGET CONFIDENTIAL

pl type up as amended

CAPITAL GAINS TAX

Last year, in moving the base date for capital gains tax to 1982, I completed the process of taking purely paper gains out of ~~the~~ tax ~~system~~. At the same time I reduced the exempt threshold ~~to £5,000 recognising that~~ as it no longer needed to compensate for the lack of indexation relief for pre-1982 gains. The only remaining function of the threshold is to exclude relatively small gains from capital gains tax. ~~Moreover,~~ following independent taxation in 1990 husbands and wives will ~~no longer have to~~ of course benefit from a double ~~share a single~~ exemption. ~~I do not therefore see a need to increase the threshold this year and I~~ I judge that it still performs that function perfectly adequately and I therefore propose to maintain it at its current level of £5000.

2. My reforms of capital gains tax have produced a fairer and more neutral system. There ~~remains one~~ is however one ~~further~~ remaining ~~distortion, however,~~ anomaly which I now propose to remove. The holdover relief ~~available~~ for gifts postpones tax on past gains made by the giver until the recipient disposes of the asset. Before the abolition of capital transfer tax on lifetime transfers, this relief was necessary to avoid a double capital tax charge on a gift. ~~indeed that is why it was introduced.~~ But this need no longer remains. ~~Moreover in recent years this relief has become increasingly exploited for tax avoidance purposes.~~ I therefore propose to abolish the

Moreover, ~~with~~ now that a single rate of capital gains tax has been replaced by 2 rates aligned with income tax marginal rates ~~there is potential for~~ the gift relief ~~can be~~ is open to exploitation by ~~those~~ higher rate taxpayers wishing to avoid paying ~~tax~~ CGT at their marginal rate.

general gifts relief. There are circumstances where tax deferral continues to be justified for wider economic reasons, notably in the case of ~~on~~ gifts of business assets and gifts to charities. For these cases, The relief will be retained. ~~for these categories of gifts~~.

fp.nh/sf/25 **BUDGET CONFIDENTIAL**

FROM: S J FLANAGAN
DATE: 15 February 1989

MISS WALLACE

cc Mr Culpin
Mr Gilhooly
Mr Macpherson
Mr Michie

BUDGET SPEECH: LICENCE NUMBERS

I don't suppose you need much on this. A passage might read:

> "[link from previous bit] We know that there are many people willing to pay for an amusing or opposite number plate. I therefore propose that such numbers should be made available for sale to the public. A pilot scheme will begin later this year [/in December]".

2. If you want anything more, you might draw on:

- numbers for sale (over ¼ million) previously unreleased;
- numbers expected to have high values will be auctioned, the rest available at set prices;
- entirely new market;
- normal licence numbers unaffected.

S J FLANAGAN

P.S. This may now be redundant: a report on the vehicle licensing system is going to the PM on 16 March, and depending on her response, DTp may want to withdraw this before Committee stage. So it may be best not to draw attention to it in the Budget speech.

fp.nh/mh/46 **BUDGET CONFIDENTIAL** typed

FROM: MISS MARY HAY
DATE: 15 February 1989

MISS WALLACE

cc Mr Culpin
Mr Matthews
Mr Macpherson

BUDGET SPEECH

I attach some notes/prose on the two issues I volunteered ie:

(i) pre-trading

(ii) close company apportionment.

3. My idea of getting Mr Cayley to do COBO tax consequences was thwarted since he is not in the lead on this and thought it would be "improper" to poach. So I have had a go.

4. All this is complicated and I can't promise that the words would be acceptable to the Revenue. Mr Mace has promised me something on Independent Tax by close today.

MH

MISS MARY HAY

BUDGET CONFIDENTIAL

Extension of relief for pre-trading expenditure

I propose to extend tax relief available for expenditure incurred by individuals or companies prior to their commencing trading. The period for which relief applies will be extended from 3 to 5 years before trading commences. This will benefit new companies undertaking projects requiring long lead times.

Close Company Apportionment

Major simplification made possible by last year's reform of personal tax.

Propose to abolish apportionment rules for close companies. Under current rules undistributed income and gains of close companies apportioned among its shareholders in order to determine tax payable. In future income and gains of a close company will be subject to normal corporation tax rules subject to one caveat.

To prevent use of close companies as a shelter from higher rate tax, a special tax rate of 40 per cent will be applied to income and gains of close companies failing a distribution test.

This measure will remove 20 pages of complex legislation from the statute book and will replace complicated apportionment rules by a straightforward distribution test.

fp.nh/mh/45

BUDGET CONFIDENTIAL

CGT AND CORPORATE BONDS AND COBO AND DEEP DISCOUNT BONDS

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

First I propose to exempt from capital gains tax, sterling non-convertible corporate bonds [not qualifying for exemption under existing legislation]. [This will prevent exploitation of indexation relief to manufacture capital losses].

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

This will be achieved by extending the special 1984 regime for corporate, non-variable, deep discount bonds to all other non-variable bonds; while taxing the whole of the return on variable bonds as income.

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

rgml.16.2

BUDGET CONFIDENTIAL typed.

FROM: R G MICHIE
DATE: 16 February 1989

MISS WALLACE

Rosa pl type up highlighted as separate paras.

cc Mr Culpin
Mr Gilhooly
Mr S Matthews
Miss Hay
Mr Macpherson
Mr Flanagan

BUDGET SPEECH

I promised some notes on three topics for the Budget Speech: the VAT deregulation package, the list of charities give-aways, and VED. You have already commissioned a note on unleaded petrol from Customs.

VAT Deregulation

2. There are three measures with a strong deregulatory or "good for business character". They are (listed in order of importance):

(i) VAT Bad Debt Relief: except in limited circumstances, traders are liable to VAT on their sales whether or not their customers pay them. Bad debt relief can be claimed only where the debtor has become insolvent, and this can be a slow and complicated process. But as from 1 August, all debts which are over eighteen months old will qualify. This will bring a considerable measure of administrative and financial relief for a great many businesses.

(ii) Simplification of the VAT registration requirements: at present there are quarterly and annual turnover limits, supplemented by a requirement to look ahead to the next twelve months to see if the limits might be exceeded. This can be a difficult and uncertain exercise. As from Budget Day there will be a single rule for determining registration based on turnover in the past twelve months.

(iii) Default surcharge: at present, the default surcharge rises by stages per default, each of 5 percentage points, from 5 percent to 30 per cent. Experience suggests that by the time a business reaches a surcharge rate of over 20 per cent, it has moved from the "won't pay" to "can't pay", and the even higher surcharge rates do little practical good. As from 1 April the default surcharge rate will be capped at 20 per cent.

Charities Give-Aways

3. o special reliefs for charities contained in proposals for implementing European Court of Justice ruling on certain of our zero-rates : all construction, fuel and power for charities' non-business activities will remain zero-rated, as will water for all their activities;

o in addition three new reliefs for charities will be introduced:

(i) there will be exemption from VAT for charities' fund-raising events up to a turnover limit of ten times the standard registration threshold;

(ii) sterilising equipment will be added to the list of goods which are zero-rated when purchased by charitable or voluntary funds for medical purposes; and

(iii) there will be an extension to the existing zero-rating which applies to certain expenditure on advertising [to include classified advertising and advertising in concert programmes, annuals and on posters].

o Minutes of Chancellor's meeting of 23 January on ECJ Judgement records that he may wish to mention in his Budget Speech, the improvement in the position of charities arising from the changes to the local authority rating system.

VED

I have a numbers of

I am leaving

- Once ~~again main rates of VED unchanged. But some~~ important measures to propose which will greatly ~~simplify~~ the structure of vehicle excise duty ~~structure~~ and make it more equitable.

There are at present x rates of VED. I propose a

- reduction in the number of tax classes by over 70 : this will make vehicle licencing far easier for businesses, and ~~easier for officials to operate;~~ to deal with and cheaper and simpler to administer.

¶ At the same time I am taking the opportunity to rectify some manifest anomalies in the present structure ~~bring~~

- ~~buses and coaches~~ : under present system a bus or a coach has to have sixty six seats before (the) it pays as much Vehicle Excise Duty as a family car. Even the largest coach pays only marginally more. So there will be increases for ~~the heaviest~~ ~~Propose to end this anomaly and impose~~ ~~significant~~ increases ~~[so as to bring buses and coaches as a~~ the relevant rates of VED to bring this group up to track cost ~~coverage];~~ ~~to the similar~~

- There will also be increases also in the rate of VED for the heaviest of the rigid HGVs so as to put them on a more equal footing with articulated HGVs. ~~(Note - similar increases for rigids not mentioned last year)].~~ Apart from these changes, I propose to leave the main rates of VED ~~at~~ the same as ~~at~~ now.

R G MICHIE

fp.ac.gilhooly/202

BUDGET SECRET

COPY NO. 1 OF 9 COPIES

FROM: J F GILHOOLY

DATE: 16 February 1989

Pat

again, please add to speech

M.

MISS WALLACE

cc Mr Culpin
Mr Matthews
Miss Hay
Mr Macpherson
Mr Ford

BUDGET SPEECH : LIFE ASSURANCE

The Revenue are putting forward a note for the next Overview Meeting which I expect to cover presentation and a number of secondary decisions which have yet to be put to Ministers. So please treat the attached as very much a draft, which is likely to move around a fair bit.

2. I have gone on at some length because there is quite a lot of fairly complicated material to mention. Even so, I have omitted two areas:

(a) details of other changes proposed for pensions business on which I attach a separate note. These might fit into the pensions package - as indeed, at a stretch, might the ringfencing described in the draft below.

(b) details of the 1990 part of the package. Handling this needs thinking about, but for the moment I am working on the basis that anything in the Budget Speech should be kept general and short.

J F GILHOOLY

LIFE ASSURANCE

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

2. Since ~~Following publication~~, there has now been a very full process of consultation with the industry and others. I have considered the representations made very carefully. My conclusions are as follows.

3. The Life Assurance industry is unique, not just in the product it provides but also in the tax regime which applies to it. Broadly speaking, the policyholder's returns and the shareholder's profits are not, as in a normal business, taxed individually but jointly by taxing the funds held by the Life Offices on their policyholders' and shareholders' behalf.

4. One ~~It is a~~ peculiarity of this system that relief is given up front for the expenses (commission and so forth). This ~~is~~ has two distortive effects: first it means ~~The effect of this is~~ that policyholders receive a tax break - "up front" relief on initial costs which ~~is~~ would ~~not~~ be ~~available for any other form of investment~~ if he invested directly in shares. And ~~this~~ it distorts the incidence of tax as between one Life Fund

and another. The system unduly favours the rapidly expanding Life Office where tax can be deferred for many years.

5. I have considered very carefully whether this problem is best resolved by improving the existing system; or by adopting a completely new basis of taxation for the Life Office ~~along the lines discussed in the consultative document. But~~ I have concluded that the defects can be dealt with within the present regime. ~~In reaching this conclusion, I have given full weight to the representations made by the industry and others.~~

6. I shall therefore be bringing forward in the Finance Bill measures which would mean that, in future, relief for the initial expenses associated with new policies will be spread forward so that one-seventh only would be available for relief against tax in each of the first and subsequent six years. Taken on its own this would ~~clearly~~ indeed increase the tax liability of life offices, ~~but~~ quite ~~sharply~~ markedly in the early years. This effect will be eased by phasing provisions to give the industry time to adjust to the new regime, and by other measures which I have to propose.

But first I have one other proposal which will also restrict the amount of relief available against the life offices tax liability. At present nothing requires life offices to keep their pensions and life assurance businesses separate. So

7. ~~For~~ Life Offices carrying on pension business, ~~the Finance Bill will also include provisions to end the present facility for~~ can set the unrelieved expenses of pension business ~~to be relieved~~ against the income and realised gains of Life Funds. This facility means that their pensions profits enjoy unduly favourable tax treatment. The Finance Bill will include provisions to end this anomaly.

8. [The Finance Bill will also include a number of lesser measures, [giving a better specification of

charge, and bringing into charge miscellaneous items of income which currently fall outside the tax net].

9. These measures would cover the main part of the proposals discussed in the consultative document. But there are other, more technical items which require further consultation with the industry which the Revenue will put in hand [timing?]. Any legislative changes which might follow such consultation will be included in the 1990 Finance Bill.

10. These measures give a fairer basis for the taxation of the Life Companies. In isolation they would increase the long-run tax burden by £[ ]m. The Finance Bill will provide for ~~the measures~~ them to be introduced from 1 January 1990. ~~There will be phasing provisions to give the industry time to adjust to the new regime.~~

11. Putting the tax base on a broader and more rational footing gives me the opportunity to reduce the rates. At present, Life Funds pay tax at 35 per cent on unfranked investment income and 30 per cent on realised capital gains of their policyholders. As from 1 April 1990, these rates will be reduced to 25 per cent ~~as regards policyholders~~. These reductions, together with the abolition of Life Assurance Premium Duty I announced a few minutes ago, will be worth £[ ]m to Life Assurance in a full year. ~~[Stamp Duty]~~

12. [~~If possible, something on the~~ Net effect of these changes on the industry as a whole] ~~i.e. that the cost to the life offices, as a whole, of the loss of the present favourable treatment of acquisition expenses is largely balanced by the savings from the rates cut and LAPD abolition.]~~

FROM: MISS M P WALLACE
DATE: 16 February 1989

MR RILEY

Miss Wallace

A few comments. Some of the text will have to change when decisions have been taken - eg on fiscal policy.

MCS 17/2

cc Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Mr Peretz
Mr Sedgwick
Mr Pickford
Miss Simpson

BUDGET SPEECH: ECONOMIC SECTION

... I attach a (still very rough) draft of the economic section of the speech. There are still some sections entirely missing (notably an introduction, and the section on COBO, and the "bonfire of controls"). I shall work on these tomorrow. I also hope to do quite a bit of polishing on some of the at present rather ropey sections on, for example, the economic background, and the "first 10 years". In the meantime, I should be grateful for any comments you or copy recipients may have. In particular, I should be grateful if EB could have a good look at the economic background section, filling in some of the blanks which I am afraid I have had to leave, and alerting me to the places where I have completely garbled the standard line.

2. A draft of the whole thing has to go to the Chancellor tomorrow evening. I should be grateful if comments could reach me by, say, 2.30pm.

MOIRA WALLACE

THE ECONOMIC BACKGROUND

I start with the economic background.

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

3. In the UK, growth has [again?] been above the G7 average, and ahead of all our major European competitors. I now judge that the figure for 88 as a whole will turn out to be around 4½ per cent - in line with the income and output measures of GDP, but rather higher than suggested by the notoriously unreliable expenditure measure of output.

4. Discrepancies between these different measures of GDP have existed for some time. But in 1988 they reached unprecedented levels. This has been part of a wider problem with economic statistics generally, which has been of concern to the Treasury and Civil Service Select Committee, and to outside commentators, as well as to the Government. The Government set up a review of economic statistics [outcome].

5. But that is for the longer term. The task of policy making goes on, however unclear the statistical background. In the meantime, we have to take the most sensible view that we can of what is happening in the economy, on the basis of the raw data that exists.

6. The CSO have now published the results of their exercise to produce a balanced set of national accounts, covering the years up to 1987. I am today publishing in the FSBR figures which take this process a little further forward, to cover the more recent past as well. The FSBR also, of course, sets out the unadjusted figures, and a full description of the methodology that has been used is being made available in a press notice. [I should emphasise that the statistics for the public finances, prices, unemployment and employment are unaffected by the specific problems that have bedevilled economic statistics this year, and have therefore, of course, not been adjusted in any way.

7. For the rest,] in some cases, adjustment makes little difference. In a number of cases, the adjustment makes the figures look less favourable. However, it is plainly the case that these adjusted figures are nearer an accurate picture of what is happening to demand and output, and it is therefore these that I shall be using in setting out the economic background.

8. Overall output growth of 4½ per cent means that in this upswing we have now recorded x years of sustained growth. Indeed, we have enjoyed healthy growth rates for so long that it already seems unduly modest to describe it as an upswing: rather, year after year of respectable growth has become a way of life throughout the last x years.

9. Within this overall very vigorous growth performance, the performance of manufacturing has again been particularly strong, with growth of going on for 7 per cent in 1988, taking manufacturing output past its previous all time peak.

10. The key to this sustained improvement in manufacturing performance has been the major improvement in productivity that has ~~have~~ been secured under this Government. In the '80s, our manufacturing productivity has grown faster than that of any other industrial country - following years at the bottom of the league in the '60s and '70s.

11. Employment and unemployment [what will the new bull points be with the new LFS figures?]

12. Another very satisfactory feature of the recent past, and a good omen for the future, is the strength of investment, which looks to have grown by

some x per cent in 1988. Indeed, over the last [5] years, investment has grown about twice as fast as consumption.

13. This strong growth of investment - and indeed the strong growth of consumers expenditure too - is no doubt in great part a reflection of confidence in the Government's handling of the economy. But with domestic demand growing rather faster than output, imports have grown appreciably, and the current account now looks to have been in deficit by some £10 billion in 1988. ~~This~~ is a sizeable deficit, clearly, but it has been financed without difficulty. The Government's commitment to monetary discipline, and fiscal prudence continues to be valued in the markets.

Some expansion needed here

14. With stronger growth of domestic demand, the UK has also seen some resurgence of inflationary pressures. I have had no hesitation in acting to nip this in the bud, by tightening monetary policy. Increased interest rates have already begun to have their desired effect.

will need to say more than this

15. However, in the short-term, the fact that the UK, unlike almost all other EC nations, includes mortgage interest payments in its consumer price index, means that the very action taken to combat inflation appears to cause it to rise. Thus, annual inflation as measured by the retail price index, ended the year at x per cent,

while the underlying rate of inflation remained little changed at z per cent.

16. Looking ahead to 1989, we are already seeing more and more evidence that inflationary pressures are coming back under control. [Bull points of evidence]

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

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

19. The underlying path of inflation will, of course, continue to be obscured by the influence of mortgage interest rates. First we will see a peak in annual RPI

inflation [at around x per cent] [next month] before it falls back to [y per cent] by the end of the year.

20. As I have always made clear, the current account may take longer to improve. Import growth should slow, as consumer spending eases a little. And trade performance should improve as new capacity comes on stream. Although I expect the monthly deficits to be on an improving trend throughout the year, I expect that the deficit for the year as a whole will be much the same for that of 1988 [with a more marked improvement thereafter]. In the meantime, there is no sign of any financing problems, so long as the UK is seen to maintain its prudent policies.

too negative / defensive

21. A far more real threat to the relative stability that has been enjoyed in the financial markets over the last year is the persistence of sizeable current account imbalances between the very largest economies, and in particular, the stubborn external deficit of the United States. The latter is that dangerous animal, an external deficit that is the counterpart of a stubborn budget deficit. I know that the US Government is seized of the need to restrain its public sector deficit. This, combined with action from the surplus countries to remove the obstacles which restrict the growth of their domestic markets, should remove the major threat to an

otherwise strong and healthy prospect for the world economy as a whole.

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

The Medium Term

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

24. This describes exactly what has been achieved in the UK. This Government has now been in power for nearly ten years, during all of which time economic policy has been remarkably consistent. ~~and~~ This has brought outstanding success.

steady ~~stable~~ and essentially unchanged ~~unchanging~~

25. At the very heart of the Government's strategy has been the determination to bear down on inflation. For ten years now, the medium term financial strategy has

provided a clear and disciplined framework for reductions in the growth of money GDP, and hence inflation. [What is best inflation comparison over last ten years?]

26. This is the answer to those who doubted that the MTFS would be successful in bringing inflation down, and who imagined that the answer still lay in the policies that had been tried - and discredited - in the 1970s.

27. There were others who maintained that although the Government's inflation objectives would be achieved, but only at the expense of lost output, or falling living standards, or savage public expenditure cuts. They too have been confounded.

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

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

seen [Z] successive years of growth averaging above X per cent, with inflation remaining remarkably stable, at an average of Y per cent, and never exceeding Z per cent. [Reference to higher long term sustainable rate of growth?]

30. The cornerstone of this dramatic improvement in the performance of British industry has been a massive and sustained improvement in productivity. Whole economy productivity has improved by [$2^3/_4$] per cent a year since 1980 - [putting the UK, with Japan, ahead of all other major industrialised countries in terms of productivity growth.]

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

32. These ten years, then, have been a time of unprecedented improvement to the economic fundamentals in the UK. When we came to power, Britain was a

textbook example of relative economic decline. Now it is out-performing the competition, and the policies that have brought success - tax reform, and the determination to improve the supply side - are being imitated the world over.

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

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

35. But that is exactly what has happened under this Government: with a dramatic recovery in company profitability, company saving has risen to offset the decline in personal savings. In addition, of course, the Government itself has moved from deficit to surplus. So, in fact, total national saving has been rising in

recent years, and now stands at [roughly the same percentage of GDP as we inherited].

36. I certainly expect the personal savings ratio to recover. ~~It's~~ Its present low level is mainly a result of the current level of personal borrowing - a highly cyclical phenomenon, which I would expect to see unwound slightly over the next few years.

no - we want to talk about financial innovation instead

37. But in the meantime, I am not going to be alarmed into gimmicky schemes to increase the personal savings ratio. To the extent that an increase in personal saving is desirable, it will already come about as a consequence of the action I have taken in raising interest rates to their present level.

38. The other notable respect in which commentators have failed to catch up with the transformation of the British economy is in the significance they attribute to a deficit on the current account of the balance of payments. Here again they demonstrate that they are still stuck in the '70s. Then a current account deficit was indeed something to worry about.

39. There are only two reasons why a current account deficit need cause concern: first, if it is a consequence of a Budget deficit, and second, if the Government does not have the confidence of markets, or

if its foreign exchange reserves are inadequate. In the latter case there is nothing to stop a current account deficit turning into a sterling crisis.

40. The position today could not be more different. First of all, the deficit on current account has arisen at a time when the public sector, far from being in deficit, is running an unprecedented surplus. The external deficit is, in fact, the result of private sector behaviour - and not all of it undesirable behaviour.

41. For example, a great deal of the growth in imports over the past year has been the result of the UK's unprecedented, and welcome, investment boom. To the extent that this is the case, the deficit contains the seeds of its own correction: as domestic firms import capital goods, and expand, the capacity constraints that have been appearing will be eased, and the UK's trade performance will improve.

42. On the other hand, to the extent that the sharp growth in imports has been the result of consumer spending moving ahead ~~a little~~ too fast, action has already been taken, in the form of higher interest rates, and the effects will show through in time.

too alarmist

"will stick to its well-tried and proven policies/remedies"

43. But it will take time, as I have repeatedly made clear. There are no quick fixes, and in the meantime, the role of Government lies not in the half baked panic measures that are sometimes urged on it by outsiders, but rather in keeping its nerve, and sticking to its policies.

Monetary policy

44. From this point of view, as from every other, it is essential that we remain prepared to take whatever action is necessary - however unpalatable it may be - to bear down on inflation. [Within MTFS] the central role in bringing inflation down belongs to monetary policy, buttressed by a prudent fiscal stance. As I have always made clear, short-term interest rates are the essential instrument of monetary policy: this Government will set interest rates at whatever level is necessary to bear down on inflation, and will keep them at that level for as long as is necessary.

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

46. But here again, we have to have an eye to the medium-term. It is already difficult to remember the days of runaway inflation. But all those who can cast their minds back know that the pain of higher interest rates for a time now is as nothing compared with the damage that was done to working families, pensioners, industry, and the whole of the nation's economic and social fabric, by those years of rapidly rising prices. The Government is determined that there shall be no return to those days.

47. Interest rates are indeed, a remarkably well-directed instrument to deal with the particular inflationary pressures we have seen reappearing in the last year. First, they are well targeted on the housing market, which has been the principal force behind the strong consumer credit growth [of the last ? months/ years?]. In this respect, they are also very well targeted from a regional point of view, as they will tend to focus the adjustment on the South of England, where inflationary pressures have arguably been strongest, as more people in the South have mortgages in excess of £30,000, and so do not have the full effect of increased repayments cushioned by tax relief.

48. Most importantly, perhaps - and this point does not seem to be well understood - they are also well targeted as between households and companies. While the

household sector has moved from being a net lender to being a substantial net borrower, the company sector's finances are in far better shape than a few years ago, so that it is far less vulnerable to increases in short-term interest rates. The company sector is also well placed to benefit from the fact that long-term interest rates have risen by far less than short rates.

remained remarkably stable, well below the recent levels

49. Now all the evidence is that the tightening of the monetary stance is taking effect in exactly the way we predicted. [M0, retail sales, etc.] This is, of course, welcome. I can assure the House that I shall not keep short-term interest rates at their present level for any longer than is necessary: on the other hand, there will be no question of relaxing the monetary stance before it is appropriate to do so.

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

omit

objective - stability/overriding need to bear down on inflation.]

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

52. Accordingly, I propose no relaxation in the target range of 1-5 per cent for M0 growth in 1989-90 envisaged in last year's MTFS. Measured on a twelve month basis, M0 will start the next financial year above the top of this range, reflecting the high growth figures in the spring and summer of 1988. However, the growth of M0 over the last six months has been appreciably slower - equivalent to [X] at an annual rate - so I am confidant that the twelve month figures will come within the target range [within a few months].

53. [COBO/financial market deregulation.]

PUBLIC SECTOR FINANCES

Do we now need something along these lines, or not?

Yes, I think so

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

55. During our term of office we have made steady progress in reducing the burden of Government borrowing, to the point where, in 1987-88, the budget moved into surplus, something the UK had previously achieved only once since the beginning of the '50s.

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

57. Second, privatisation proceeds are appreciably higher than expected, at some £[X] billion for the year as a whole - a very welcome boost to the public

finances, and one that not many would have predicted a year ago, in the aftermath of the stock market fall.

58. Finally, a more buoyant economy has led to tax revenues significantly higher than expected. [Is there anything good we could stick in here about the contribution of the last Budget - eg proportion paid by top 5 per cent - Budget not a giveaway etc.] Taking all these factors into account, I now expect that the final outturn for the current year will be a Budget surplus of £[X] billion.

Better not

59. In the last two years, then, we have seen the largest sustained repayment of public debt for [how long?]. This has permanently reduced the burden of debt servicing, both now and for future generations. For the coming year, the debt repayments of the last two years mean that debt interest costs are lower by £[X] billion a year.

60. We have already seen one beneficial effect of lower debt interest payments - namely that spending on priority services can be increased, without jeopardising the Government's overall objective for public expenditure. In the Autumn Statement I was able to announce that within an unchanged planning total we were able to allocate significant extra resources to our priority programmes. Those who saw a conflict between

tax cuts and spending on the health service have been confounded, with a record increase in resources for the NHS in the UK of some £[X] billion. And there were significant increases for other priorities, notably capital spending on the prisons programme, and in the transport field for road maintenance and improvement, and for improved safety programmes.

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

62. The dramatic improvement in the UK's public finances has also provided a welcome opportunity to devote more attention to the structure of the debt that remains. Now that the Government has become a net purchaser of debt, it has been possible to tailor buying-in policies so as to reduce future interest costs, and to improve the quality of funding by relying less on the more liquid borrowing instruments.

63. For example, it has been possible to increase the proportion in ~~percentage~~ of indexed gilts in the remaining stock: since the Government is determined to eliminate inflation, index-linked borrowing is particularly

cost-effective. The authorities have also been able to achieve a desirable adjustment in the average life of Government debt: in the past year, we have taken the view that long yields are higher than the future prospects for inflation warrant. Accordingly buying-in has concentrated on longer maturity issues, that in future years even the debt that remains will have a relatively lower interest cost.

We can't this anyway MTFS - speech will need to be consistent.

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

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

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

?

Why say this?

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

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

chex.rm/mw/4 SECRET

cc Mr. Riley Mr. Moat
Mr. Hibberd

Ms. Wallace

I have had time only to make some manuscript comments and drafting changes, given your deadline. The material on the adjustment to statistics will need [illegible] rework in. [illegible]

P.N.J
17.II

FROM: MISS M P WALLACE
DATE: 16 February 1989

MR RILEY

cc Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Mr Peretz
Mr Sedgwick
Mr Pickford
Miss Simpson

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MPW

MOIRA WALLACE

119/89

THE ECONOMIC BACKGROUND

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6. The CSO have now published the results of their exercise to produce a balanced set of national accounts, covering the years up to 1987. I am today publishing in the FSBR figures which take this process a little further forward, to cover the more recent past as well. The FSBR also, of course, sets out the unadjusted figures, and a full description of the methodology that has been used is being made available in a press notice. [I should emphasise that the statistics for the public finances, prices, unemployment and employment are unaffected by the specific problems that have bedevilled economic statistics this year, and have therefore, of course, not been adjusted in any way.

This whole paragraph will need to be redrafted very carefully once we have clear ideas about the FSBR treatment.

7. For the rest,] in some cases, adjustment makes little difference. In a number of cases, the adjustment makes the figures look less favourable. However, it is plainly the case that these adjusted figures are nearer an accurate picture of what is happening to demand and output, and it is therefore these that I shall be using in setting out the economic background.

8. Overall output growth of 4½ per cent means that in this upswing we have now recorded ~~x~~ 7 years of sustained growth. Indeed, we have enjoyed healthy growth rates for so long that it already seems unduly modest to describe it as an upswing: rather, year after year of respectable growth has become a way of life throughout the last x years.

9. Within this overall very vigorous growth performance, the performance of manufacturing has again been particularly strong, with growth of going on for 7 per cent in 1988, taking manufacturing output past its previous all time peak.

x this category of GDP has increased been seriously underestimated, the true growth rate could have been much higher. A reasonable estimate would be [ ] per cent.

10. The key to this sustained improvement in manufacturing performance has been the major improvement in productivity that ~~have~~ has been secured under this Government. In the '80s, our manufacturing productivity has grown faster than that of any other industrial country - following years at the bottom of the league in the '60s and '70s.

11. Employment has grown strongly over recent years, and ~~unemployment [what will the new bull points~~ be ~~with the new LFS figures?]~~ ~~employment~~ and is now at its highest level ever. Unemployment has shown the largest and most sustained fall since the war (or since records began: comparison with 1930s to be checked.

There is a good deal of uncertainty as to the true growth of investment in 1988. One thing is certain, and namely that it grew strongly. The official figures show growth of 10 per cent. But if the suspicions of the direction of the CSO are correct – and X

12. Another very satisfactory feature of the recent past, and a good omen for the future, is the strength of investment, which looks to have grown by

~~some x per cent in 1988.~~ Indeed, over the last [5] years, investment has grown about twice as fast as consumption.

Precise figures to be checked.

13. ~~This~~ The strong growth of investment - and indeed the strong growth of consumers expenditure too - is no doubt in great part a reflection of confidence in the Government's handling of the economy. But with domestic demand growing rather faster than output, imports have grown appreciably, and the current account now looks to have been in substantial deficit ~~by some £10 billion in 1988. This is a~~ ~~sizeable deficit, clearly, but it~~ has been financed ~~without difficulty~~ surprisingly easily. The Government's commitment to monetary discipline and fiscal prudence continues to be valued in the markets.

NB we raised interest rates to v. high levels: a major difficulty.

The latest official estimate is for a deficit of £14.6b. in 1988; but with a very large balancing item in the accounts the true deficit may well have been some [5] billion less. Whichever estimate is taken, there was clearly a large deterioration in the current account between 1987 and 1988.

14. With stronger growth of domestic demand, the UK has also seen some resurgence of inflationary pressures. I have had no hesitation in acting to nip this in the bud, by tightening monetary policy. Increased interest rates have already begun to have their desired effect on spending. clearly not yet on inflation

15. However, in the short-term, the fact that the UK, unlike almost all other EC nations, includes mortgage interest payments in its consumer price index, means that the very action taken to combat inflation appears to cause it to rise. Thus, annual inflation as measured by the retail price index, ended the year at x per cent,

while the underlying rate of inflation remained little changed at z per cent.

16. Looking ahead to 1989, we are already seeing more and more evidence that inflationary pressures are coming back under control. [Bull points of evidence]

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

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

19. The underlying path of inflation will, of course, continue to be obscured by the influence of mortgage interest rates. First we will see a peak in annual RPI

not necessarily

inflation [at around x per cent] ~~[next month]~~ before it falls back to [y per cent] by the end of the year.

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I don't think that this juxtaposition of the UK's c/a and the big 3" current account imbalances works. I would deal with the world first.

21. A far more real threat to the relative stability that has been enjoyed in the financial markets over the last year is the persistence of sizeable current account imbalances between the very largest economies, and in particular, the stubborn external deficit of the United States. The latter is that dangerous animal, an external deficit that is the counterpart of a stubborn budget deficit. I know that the US Government is seized of the need to restrain its public sector deficit. This, combined with action from the surplus countries to remove the obstacles which restrict the growth of their domestic markets, should remove the major threat to an

otherwise strong and healthy prospect for the world economy as a whole.

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

The Medium Term

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

24. This describes exactly what has been achieved in the UK. This Government has now been in power for nearly ten years, during which time economic policy has been remarkably consistent, and has brought outstanding success.

25. At the very heart of the Government's strategy has been the determination to bear down on inflation. For ten years now, the medium term financial strategy has

provided a clear and disciplined framework for reductions in the growth of money GDP, and hence inflation. [What is best inflation comparison over last ten years?]

26. This is the answer to those who doubted that the MTFS would be successful in bringing inflation down, and who imagined that the answer still lay in the policies that had been tried - and discredited - in the 1970s.

27. There were others who maintained that although the Government's inflation objectives would be achieved, but only at the expense of lost output, or falling living standards, or savage public expenditure cuts. They too have been confounded.

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

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

Stephen Pilford
checking such numbers.

?

?

7
seen ~~[2]~~ successive years of growth averaging above
RPI
3 ~~X~~ per cent, with inflation remaining remarkably stable, at an average of Y per cent, and never exceeding Z per cent. [Reference to higher long term sustainable rate of growth?]

30. The cornerstone of this dramatic improvement in the performance of British industry has been a massive and sustained improvement in productivity. Whole economy productivity has improved by [$2^3/_4$] per cent a year since 1980 - [putting the UK, with Japan, ahead of all other major industrialised countries in terms of productivity growth.]

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

32. These ten years, then, have been a time of unprecedented improvement to the economic fundamentals in the UK. When we came to power, Britain was a

textbook example of relative economic decline. Now it is out-performing the competition, and the policies that have brought success - tax reform, and the determination to improve the supply side - are being ~~imitated~~ emulated the world over.

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

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

35. But that is exactly what has happened under this Government: with a dramatic recovery in company profitability, company saving has risen to offset the decline in personal savings. In addition, of course, the Government itself has moved from deficit to surplus. So, in fact, total national saving has been rising in

recent years, and now stands at [roughly the same percentage of GDP as we inherited].

36. I certainly expect the personal savings ratio to recover. It's present low level is mainly a result of the current level of personal borrowing - a highly cyclical phenomenon, which I would expect to see unwound slightly over the next few years.

37. But in the meantime, I am not going to be alarmed into gimmicky schemes to increase the personal savings ratio. To the extent that an increase in personal saving is desirable, it will already come about as a consequence of the action I have taken in raising interest rates to their present level.

My strong inclination is to drop this. Sir T [illegible] and MP may not agree. It will carry no conviction whatsoever.

38. The other notable respect in which commentators have failed to catch up with the transformation of the British economy is in the significance they attribute to a deficit on the current account of the balance of payments. Here again they demonstrate that they are still stuck in the '70s. Then a current account deficit was indeed something to worry about.

39. There are only two reasons why a current account deficit need cause concern: first, if it is a consequence of a Budget deficit, and second, if the Government does not have the confidence of markets, or

if its foreign exchange reserves are inadequate. In the latter case there is nothing to stop a current account deficit turning into a sterling crisis.

40. The position today could not be more different. First of all, the deficit on current account has arisen at a time when the public sector, far from being in deficit, is running an unprecedented surplus. The external deficit is, in fact, the result of private sector behaviour - and not all of it undesirable behaviour.

41. For example, a great deal of the growth in imports over the past year has been the result of the UK's unprecedented, and welcome, investment boom. To the extent that this is the case, the deficit contains the seeds of its own correction: as domestic firms import capital goods, and expand, the capacity constraints that have been appearing will be eased, and the UK's trade performance will improve.

42. On the other hand, to the extent that the sharp growth in imports has been the result of consumer spending moving ahead a little too fast, action has already been taken, in the form of higher interest rates, and the effects will show through in time.

43. But it will take time, as I have repeatedly made clear. ~~There are no quick fixes, and in the meantime,~~ the role of Government lies not in the half baked panic measures that are sometimes urged on it by outsiders, but rather in keeping its nerve, and sticking to its policies.

Monetary policy

44. From this point of view, as from every other, it is essential that we remain prepared to take whatever action is necessary - however unpalatable it may be - to bear down on inflation. [Within MTFS] the central role in bringing inflation down belongs to monetary policy, buttressed by a prudent fiscal stance. As I have always made clear, short-term interest rates are the essential instrument of monetary policy: this Government will set interest rates at whatever level is necessary to bear down on inflation, and will keep them at that level for as long as is necessary.

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

46. But here again, we have to have an eye to the medium-term. It is already difficult to remember the days of runaway inflation. But all those who can cast their minds back know that the pain of higher interest rates for a time now is as nothing compared with the damage that was done to working families, pensioners, industry, and the whole of the nation's economic and social fabric, by those years of rapidly rising prices. The Government is determined that there shall be no return to those days.

47. Interest rates are indeed, a remarkably well-directed instrument to deal with the particular inflationary pressures we have seen reappearing in the last year. First, they are well targeted on the housing market, which has been the principal force behind the strong consumer credit growth [of the last ? months/years]. In this respect, they are also very well targeted from a regional point of view, as they will tend to focus the adjustment on the South of England, where inflationary pressures have arguably been strongest, as more people in the South have mortgages in excess of £30,000, and so do not have the full effect of increased repayments cushioned by tax relief.

48. Most importantly, perhaps - and this point does not seem to be well understood - they are also well targeted as between households and companies. While the

household sector has moved from being a net lender to being a substantial net borrower, the company sector's finances are in far better shape than a few years ago, so that it is far less vulnerable to increases in short-term interest rates. The company sector is also well placed to benefit from the fact that long-term interest rates have risen by far less than short rates.

Higher short term interest rates do not benefit industrial and commercial companies: indeed the reverse is true.

49. Now all the evidence is that the tightening of the monetary stance is taking effect in exactly the way we predicted. [M0, retail sales, etc.] This is, of course, welcome. I can assure the House that I shall not keep short-term interest rates at their present level for any longer than is necessary: on the other hand, there will be no question of relaxing the monetary stance before it is appropriate to do so.

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

objective - stability/overriding need to bear down on inflation.]

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

52. Accordingly, I propose no relaxation in the target range of 1-5 per cent for M0 growth in 1989-90 envisaged in last year's MTFS. Measured on a twelve month basis, M0 will start the next financial year above the top of this range, reflecting the high growth figures in the spring and summer of 1988. However, the growth of M0 over the last six months has been appreciably slower - equivalent to [X] at an annual rate - so I am confidant that the twelve month figures will come within the target range [within a few months].

53. [COBO/financial market deregulation.]

PUBLIC SECTOR FINANCES

Do we now need something along these lines, or not?

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

55. During our term of office we have made steady progress in reducing the burden of Government borrowing, to the point where, in 1987-88, the budget moved into surplus, something the UK had previously achieved only once since the beginning of the '50s.

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

57. Second, privatisation proceeds are appreciably higher than expected, at some £[X] billion for the year as a whole - a very welcome boost to the public Delete

Delete

finances, and one that not many would have predicted a year ago, in the aftermath of the stock market fall.]

The tax burden is lower than forecast in the 1988 FSBR

58. Finally, a more buoyant economy has led to tax revenues significantly higher than expected. [Is there anything good we could stick in here about the contribution of the last Budget - eg proportion paid by top 5 per cent - Budget not a giveaway etc.] Taking all these factors into account, I now expect that the final outturn for the current year will be a Budget surplus of £[X] billion.

Figures to be provided by PJF

59. In the last two years, then, we have seen the largest sustained repayment of public debt for [how long?]. This has permanently reduced the burden of debt servicing, both now and for future generations. For the coming year, the debt repayments of the last two years mean that debt interest costs are lower by £[X] billion a year.

60. We have already seen one beneficial effect of lower debt interest payments - namely that spending on priority services can be increased, without jeopardising the Government's overall objective for public expenditure. In the Autumn Statement I was able to announce that within an unchanged planning total we were able to allocate significant extra resources to our priority programmes. Those who saw a conflict between

tax cuts and spending on the health service have been confounded, with a record increase in resources for the NHS in the UK of some £[X] billion. And there were significant increases for other priorities, notably capital spending on the prisons programme, and in the transport field for road maintenance and improvement, and for improved safety programmes.

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

62. The dramatic improvement in the UK's public finances has also provided a welcome opportunity to devote more attention to the structure of the debt that remains. Now that the Government has become a net purchaser of debt, it has been possible to tailor buying-in policies so as to reduce future interest costs, and to improve the quality of funding by relying less on the more liquid borrowing instruments.

63. For example, it has been possible to increase the percentage of indexed gilts in the remaining stock: since the Government is determined to eliminate inflation, index-linked borrowing is particularly

cost-effective. The authorities have also been able to achieve a desirable adjustment in the average life of Government debt: in the past year, we have taken the view that long yields are higher than the future prospects for inflation warrant. Accordingly buying-in has concentrated on longer maturity issues, that in future years even the debt that remains will have a relatively lower interest cost.

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

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

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

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

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

chex.rm/mw/4

SECRET

CHANCELLOR OF THE EXCHEQUER

FROM: MISS M P WALLACE
DATE: 16 February 1989

MR RILEY

Miss Wallace

P.1 Action.

CJR
17/2

cc Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Mr Peretz
Mr Sedgwick
Mr Pickford
Miss Simpson

BUDGET SPEECH: ECONOMIC SECTION

... I attach a (still very rough) draft of the economic section of the speech. There are still some sections entirely missing (notably an introduction, and the section on COBO, and the "bonfire of controls"). I shall work on these tomorrow. I also hope to do quite a bit of polishing on some of the at present rather ropey sections on, for example, the economic background, and the "first 10 years". In the meantime, I should be grateful for any comments you or copy recipients may have. In particular, I should be grateful if EB could have a good look at the economic background section, filling in some of the blanks which I am afraid I have had to leave, and alerting me to the places where I have completely garbled the standard line.

2. A draft of the whole thing has to go to the Chancellor tomorrow evening. I should be grateful if comments could reach me by, say, 2.30pm.

MPW

MOIRA WALLACE

Take?

THE ECONOMIC BACKGROUND

I start with the economic background.

to go

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

3. In the UK, growth has [again?] been above the G7 average, and ahead of all our major European competitors. I now judge that the figure for 88 as a whole will turn out to be around 4½ per cent - in line with the income and output measures of GDP, but rather higher than suggested by the notoriously unreliable expenditure measure of output.

4. Discrepancies between these different measures of GDP have existed for some time. But in 1988 they reached unprecedented levels. This has been part of a wider problem with economic statistics generally, which has been of concern to the Treasury and Civil Service Select Committee, and to outside commentators, as well as to the Government. The Government set up a review of economic statistics [outcome].

5. But that is for the longer term. The task of policy making goes on, however unclear the statistical background. In the meantime, we have to take the most sensible view that we can of what is happening in the economy, on the basis of the raw data that exists.

not [gratuitous?] a balanced set, I think — check PNS

6. The CSO have now published the results of their exercise (to produce a balanced set of) [on balancing] national accounts, covering the years up to 1987. I am today publishing in the FSBR figures which take this process a little further forward, ~~to~~ cover[ing] the more recent past as well. The FSBR also, of course, sets out the unadjusted figures, and a full description of the methodology that has been used is being made available in a press notice. [I should emphasise that the statistics for the public finances, prices, unemployment and employment are unaffected by the specific problems that have bedevilled economic statistics this year, and have therefore, of course, not been adjusted in any way.

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9. Within this overall very vigorous growth performance, the performance of manufacturing has again been particularly strong, with growth of going on for 7 per cent in 1988, taking manufacturing output past its previous all time peak.

10. The key to this sustained improvement in manufacturing performance has been the major improvement in productivity that ~~have~~ has been secured under this Government. In the '80s, our manufacturing productivity has grown faster than that of any other industrial country - following years at the bottom of the league in the '60s and '70s.

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11. Employment and unemployment [what will the new bull points be with the new LFS figures?]

12. Another very satisfactory feature of the recent past, and a good omen for the future, is the strength of investment, which looks to have grown by

 ~~[CSO [figures admitted published are subject to major problems.]~~

some x per cent in 1988. Indeed, over the last [5] years, investment has grown about twice as fast as consumption.

13. This strong growth of investment - and indeed the strong growth of consumers expenditure too - is no doubt in great part a reflection of confidence in the Government's handling of the economy. But with domestic demand growing rather faster than output, imports have grown appreciably, and the current account now looks to have been in deficit by some £10 billion in 1988. This is a sizeable deficit, clearly, but it has been financed without difficulty. The Government's commitment to monetary discipline, and fiscal prudence continues to be valued in the markets.

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Special pleading – spl HPE ?

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seen [Z] successive years of growth averaging above X per cent, with inflation remaining remarkably stable, at an average of Y per cent, and never exceeding Z per cent. [Reference to higher long term sustainable rate of growth?]

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

32. The~~se~~ last ten years, then, have been a time of unprecedented improvement to the economic fundamentals in the UK. When we came to power, Britain was a

textbook example of relative economic decline. Now it is out-performing the competition, and the policies that have brought success - tax reform, and the determination to improve the supply side - are being imitated the world over.

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

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

35. But that is exactly what has happened under this Government: with a dramatic recovery in company profitability, company saving has risen to offset the decline in personal savings. In addition, of course, the Government itself has moved from deficit to surplus. So, in fact, total national saving has been ~~rising in~~

wealth has grown dramatically

little changed in the 1980s, and national ~~recent years, and now stands at [roughly the same percentage of GDP as we inherited]~~.

36. I certainly expect the personal savings ratio to recover. ~~It's~~ Its present low level is mainly a result of the current level of personal borrowing - a in part ~~highly~~ ~~cyclical phenomenon,~~ but also reflecting the impact of financial deregulation ~~which~~ I would expect to see its unwound slightly over the next few years.

37. But in the meantime, I am not going to be alarmed into gimmicky schemes to increase the personal savings ratio. To the extent that an increase in personal saving is desirable, it will already come about as a consequence of the action I have taken in raising interest rates to their present level.

38. The other notable respect in which commentators have failed to catch up with the transformation of the British economy is in the significance they attribute to a deficit on the current account of the balance of payments. Here again they demonstrate that they are still stuck in the '70s. Then a current account deficit was indeed something to worry about.

39. There are only two reasons why a current account deficit need cause concern: first, if it is a consequence of a Budget deficit, and second, if the Government does not have the confidence of markets, or

if its foreign exchange reserves are inadequate. In the latter case there is nothing to stop a current account deficit turning into a sterling crisis.

40. The position today could not be more different. First of all, the deficit on current account has arisen at a time when the public sector, far from being in deficit, is running an unprecedented surplus. The external deficit is, in fact, the result of private sector behaviour - and not all of it undesirable behaviour.

none!

41. For example, a great deal of the growth in imports over the past year has been the result of the UK's ~~unprecedented, and~~ welcome, investment boom. To the extent that this is the case, the deficit contains the seeds of its own correction: as domestic firms import capital goods, and expand, the capacity constraints that have been appearing will be eased, and the UK's trade performance will improve.

bigger in 1964!

42. On the other hand, to the extent that the sharp growth in imports has been the result of consumer spending moving ahead a little too fast, action has already been taken, in the form of higher interest rates, and the effects will show through in time.

43. But it will take time, as I have repeatedly made clear. There are no quick fixes, and in the meantime, the role of Government lies not in the half baked panic measures that are sometimes urged on it by outsiders, but rather in keeping its nerve, and sticking to its policies.

Monetary policy

44. From this point of view, as from every other, it is essential that we remain prepared to take whatever action is necessary - however unpalatable it may be - to bear down on inflation. [Within MTFS] the central role in bringing inflation down belongs to monetary policy, buttressed by a prudent fiscal stance. As I have always made clear, short-term interest rates are the essential instrument of monetary policy: this Government will set interest rates at whatever level is necessary to bear down on inflation, and will keep them at that level for as long as is necessary.

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

46. But here again, we have to have an eye to the medium-term. It is already difficult to remember the days of runaway inflation. But all those who can cast their minds back know that the pain of higher interest rates for a time now is as nothing compared with the damage that was done to working families, pensioners, industry, and the whole of the nation's economic and social fabric, by those years of rapidly rising prices. The Government is determined that there shall be no return to those days.

47. Interest rates are indeed, a remarkably well-directed instrument to deal with the particular inflationary pressures we have seen reappearing in the last year. First, they are well targeted on the housing market, which has been ~~the principal~~ a major force behind the strong consumer credit growth [of the last ? months/ years?]. In this respect, they are also very well targeted from a regional point of view, as they will tend to focus the adjustment on the South of England, where inflationary pressures have arguably been strongest, as more people in the South have mortgages in excess of £30,000, and so do not have the full effect of increased repayments cushioned by tax relief.

48. Most importantly, perhaps - and this point does not seem to be well understood - they are also well targeted as between households and companies. While the

much less exposed now -

household sector has moved from being a net lender to being a substantial net borrower, the company sector's finances are in far better shape than a few years ago, so that it is far less vulnerable to increases in short-term interest rates. The company sector ~~is~~ also ~~well placed to~~ benefits from the fact that long-term interest rates have risen by far less than short rates, because markets remain confident that inflation will be brought down

Can we say gearing is now much lower than at [illegible]?

49. Now all the evidence is that the tightening of the monetary stance is taking effect in exactly the way we predicted. [M0, retail sales, etc.] This is, of course, welcome. I can assure the House that I shall not keep short-term interest rates at their present level for any longer than is necessary: on the other hand, there will be no question of relaxing the monetary stance before it is appropriate to do so.

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

objective - stability/overriding need to bear down on inflation.]

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

52. Accordingly, I propose that ~~no relaxation in~~ the target range should be ~~of~~ 1-5 per cent for M0 growth in 1989-90 as envisaged in last year's MTFS. Measured on a twelve month basis, M0 will start the next financial year above the top of this range, reflecting the high growth figures in the spring and summer of 1988. However, the growth of M0 over the last six months has been appreciably slower - equivalent to [X] at an annual rate - and ~~so~~ I am confidant that the twelve month figures will come within the target range [within a few months].

53. [COBO/financial market deregulation.]

Do we now need something along these lines, or not?

PUBLIC SECTOR FINANCES

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

55. During our term of office we have made steady progress in reducing the burden of Government borrowing, to the point where, in 1987-88, the budget moved into surplus, something the UK had previously achieved only once since the beginning of the '50s.

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

57. Second, privatisation proceeds are appreciably higher than expected, at some £[X] billion for the year as a whole - a very welcome boost to the public

finances, and one that not many would have predicted a year ago, in the aftermath of the stock market fall.

58. Finally, a more buoyant economy has led to tax revenues significantly higher than expected. [Is there anything good we could stick in here about the contribution of the last Budget - eg proportion paid by top 5 per cent - Budget not a giveaway etc.] Taking all these factors into account, I now expect that the final outturn for the current year will be a Budget surplus of £[X] billion.

59. In the last two years, then, we have seen the largest sustained repayment of public debt for [how long?]. This has permanently reduced the burden of debt servicing, both now and for future generations. For the coming year, the debt repayments of the last two years mean that debt interest costs are lower by £[X] billion a year.

60. We have already seen one beneficial effect of lower debt interest payments - namely that spending on priority services can be increased, without jeopardising the Government's overall objective for public expenditure. In the Autumn Statement I was able to announce that within an unchanged planning total we were able to allocate significant extra resources to our priority programmes. Those who saw a conflict between

tax cuts and spending on the health service have been confounded, with a record increase in resources for the NHS in the UK of some £[X] billion. And there were significant increases for other priorities, notably capital spending on the prisons programme, and in the transport field for road maintenance and improvement, and for improved safety programmes.

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

62. The dramatic improvement in the UK's public finances has also provided a welcome opportunity to devote more attention to the structure of the debt that remains. Now that the Government has become a net purchaser of debt, it has been possible to tailor buying-in policies so as to reduce future interest costs, and to improve the quality of funding by relying less on the more liquid borrowing instruments.

63. For example, it has been possible to increase the percentage of indexed gilts in the remaining stock: since the Government is determined to eliminate inflation, index-linked borrowing is particularly

cost-effective. The authorities have also been able to achieve a desirable adjustment in the average life of Government debt: in the past year, we have taken the view that long yields are higher than the future prospects for inflation warrant. Accordingly buying-in has concentrated on longer maturity issues, that in future years even the debt that remains will have a relatively lower interest cost.

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

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

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

but using the proceeds to increase spending (or cut taxes) wd not be a sustainable policy.

~~(but it would be wrong simply to spend the proceeds~~

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

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

BUDGET CONFIDENTIAL AND PERSONAL

FROM: MRS JUDITH CHAPLIN
21st February 1989

CHANCELLOR

BUDGET STATEMENT DRAFT

I had read the first draft of the Budget Statement and had noted that the tone of it - the actual words and phrases - would have to be substantially altered. I was waiting until I was sure we had all the bits of it assembled before embarking on a major exercise.

2. More important, it lacks a coherent framework, not only overall but within certain sections. I have therefore noted below the sort of framework which I think it needs, particularly for the wider ownership/pensions part which is clearly one of the most important parts of the Statement.

3. The first part, the economic background, starts weakly and is repetitive. Would it be a good idea to launch straight into an attack by saying that many commentators are implying that much of the achievement in the last 10 years has been undone. But totally disproved by facts. Then give all the figures on growth, falling unemployment (seldom mentioned now it's going the right way), productivity, rising living standards etc. And that this is set to continue - figures for investment etc.

4. If there is any criticism due it is because of underestimating economic growth rather than over estimating it. And then reference back to last year and all the forecasts and what has actually happened. Then the too much of a good thing paragraphs and the resulting inflationary pressures.

5. Putting inflation levels in perspective. Right that we are worried about it but 10 years ago would have greeted the current figure with relief.

6. Then the paragraphs warning that inflation will rise further before it falls and details of the figure without mortgage interest

relief included. The facts that there are already signs of the economy slowing down and the eventual impact this will have on the current account deficit.

7. That section would be followed by the sections on monetary policy and the section on public sector finances.

8. I think the details about what has been happening to savings and the fact that it is an increase in borrowing rather than a fall in savings that is causing the low savings ratio should come just before details of the measures on PEPs, employee share schemes, ESOPs and the pension changes. They would fit within a framework which started by saying there had been calls for measures to increase savings - artificial measures would distort - and that that is done by higher interest rates. Particular reliefs tend merely to switch savings between different savings vehicles and you are determined to continue a policy of removing distortions as much as possible.

9. That does not mean that it is never appropriate to introduce a tax relief. The reasons PEPs were introduced - to <u>widen</u> share ownership. Despite the stock market crash substantial numbers taken out but further improvements to be made. Increased proportion in unit trusts as such diversification particularly appropriate for an investor embarking on share ownership, perhaps for the first time. The other changes to PEPs and the various other changes to employee share schemes, and the measures to make the introduction of ESOPs easier. (Particularly to encourage employee share ownership in private companies.) With stamp duty abolition here somewhere.

10. The changes to PEPs, a degree of levelling up to encourage direct investment. Then announce a measure of levelling down. Should be no business of government to interfere in what the employer is prepared to provide for an employee's pension or how an employee wishes to save. Details of deregulation and details of the cap. Stress that employer can still, if he wishes, provide further pension either through building up a fund or by making contributions to a personal pension or by pay-as-you-go contributions, but that such provision for the employee will not be tax privileged. Similar arrangements for public sector pensions. Details of the personal pension change and the various simplifications eg AVCs.

11. A major reform - as already said will not affect current schemes and only gradually make changes at high levels of income where people are likely anyway to save in a variety of ways. Over time the reform will introduce a major change in the balance of ways in which people save. how big

12. The various life assurance proposals and unit trust change would logically follow this section, but I think all of this needs to come nearer to the end of your Budget Statement with possibly only the changes to NICs and income tax and excise duty after. It might even be the last section as it does contain the possible theme for the Budget (apart from the simplification and reform theme) of Budget for Savings. ?? Not in the sense of Government measures to encourage saving, but in the sense of Government savings to pay off debts incurred by past governments, changes to lessen distortions between different saving choices and in sense of holding your savings within the company for which you work.

13. These are very much first thoughts on the whole Budget Statement and I will be thinking further about the actual words needed, particularly in such sections as the pension section or that on life assurance. You will presumably tell me tomorrow exactly how you would like me to contribute.

JC

JUDITH CHAPLIN

BUDGET SECRET

FROM: A G TYRIE
DATE: 24 January 1989

CHANCELLOR

cc: FST
Mr Culpin
Ms Wallace
Mrs Chaplin
Mr Call

TYRIE

BUDGET SPEECH

I have been through the tax section with Judith. She is providing redraft of share ownership (PEPs/ESOPS etc) section and I have redone the company taxation piece. [behind]

2. On the latter, I think that we can dress up these measures to look like a pretty friendly small business section and have reordered it, with some redrafting in an accompanying note. Some general points on it:

- I would put company cars scales with income tax as we did last year. It does not sit well in the company tax section.

Yes for different reasons!

might be a row on this one

- I would delete the ITV levy and the deep discounted bonds. Neither of them fit well in this speech but both would look alright in one of the budget debate speeches.

3. On the draft in general, the order now looks broadly right. Some random points:

(i) On themes for savings it seems to me that the three themes of our reforms are:

- removing the bias against saving;

- reducing the bias/distortion between different forms of saving;

- the introduction of targeted encouragement to saving and investment in areas (of the savings market or the country) which have been maltreated or neglected by previous administrations. BES, PEPs, enterprise zones, PRP etc can all fit into this last category.

(ii) I think that the removal of deferral of CGT on gifts is going to be pretty unpopular. I think we could defend ourselves a little better by saying something like:

"My predecessor introduced a deferral of CGT on gifts in 1981 to avoid the wholly unacceptable double taxation whereby a gain would be taxed both as a CGT gift and would also be liable to CTT. But that unacceptable double taxation is no longer in the system, and I therefore propose to restrict ... (back into paragraph 27)".

(iii) On PEPs I think it is worth bringing out clearly that plan managers have made a number of detailed representations to us to make the scheme simpler and cheaper to administer. We are responding to them.

(iv) I think it is worth explaining why we are not doing Loi Monory, not by referring to it directly but by saying that countries which have been drawn into front end relief have also been drawn into a mass of complex entangling legislation to ensure taxation on exit. That is one reason why we have gone for the much simpler PEPs route.

(v) On ESOPS I think this section should begin: "I propose to clarify the rules on ESOPS. Their lack of clarity has undoubtedly been a major inhibition ...".

(vi) I think the pensions section reads well. But I think that the sentence: "I have no plans to tax lump sums paid from tax approved pension schemes" although correct, will be seen as a bit of dirty trick. There is an important lump sum consequential to our reform. At best we can avoid mentioning it.

I am inclined to agree.

now gone altogether

(vii) I would spell out the rate of the tax charge (30% I think) on AVC funds.

(viii) I would state the new contribution limits on PPPs.

(ix) I think more could be made of the simplification to the VED structure. I would be happy to draft something next week.

has been slightly improved by Robert since this

RJ

pp A G TYRIE

fst.jf/Lamont/sb7.24.2.

FINANCIAL SECRETARY TO THE TREASURY

FST

FROM: FINANCIAL SECRETARY
DATE: 24 February 1989

CHANCELLOR

BUDGET STATEMENT

You asked for comments on the detailed tax part of the first draft of the Budget Statement (Miss Wallace's minute of 20 February). Since a further draft will be coming up this evening, I shall confine my comments to fairly general suggestions rather than points of detail.

Share Ownership

done ✓

para 4 : I would put the raising of the overall PEP limit first. This is the bigger "news" item.

para 6 : change to "I propose a number of measures to make PEPs simpler and more flexible for both managers and investors".

more or less done ✓

overtaken [dropped - too long]

para 7/8 : I would put the abolition of the cash rules first, then the switch to a fiscal year. The first point in para 7 needs to be explained (as the third change) or dropped. As it is, it does not sound like a sensible change.

fst.sb/Lamont/7.24.2

para 12 : there is a phrase missing; insert "which have remained unchanged" before "since 1984".

para 15/16 : this needs rewriting. We should define what an ESOP is, and then say we wish to encourage its development in the UK. The tax relief could then be included along the lines of "we will bring in legislation in the Finance Bill in order to make it certain that employers' contributions to an ESOP trust are deductible for CT purposes".

Indeed - but no-one ~~[illegible]~~ seems to know. I shall pursue.

gone

para 17 : this is a bit muddled.

Unit Trusts

Quite right. Drastically cut.

I think the whole structure of this is round the wrong way. It is the EC UCITS directive that is driving the change, not UK unit trust concerns. Furthermore, to do otherwise risks encouraging the "me-too" attitude from other collective investment vehicles <u>not</u> covered by UCITS, such as the futures and options funds.

Pensions

para 30 : I would drop the reference to IRAs.

paras 32-30 : I would put para 38 and the first half of para 39 after para 30. Thjese all relate to Personal Pensions and should come together.

para 33 : It also seems odd to mention decoupling in para 33 before you have announced the details of the cap in

Still true, but less disingenuous

paras 34 and 35. Surely they should be the other way round. The second half of para 39 will have to be moved as well.

para 40 : the last (key) sentence in this paragraph needs to come much earlier in the section. We have to make it clear we are not ignoring pledges already given.

overtaken

Life Assurance

I do not think the piece on life assurance is quite right. We need first to get across the point that the current tax regime has developed in a piecemeal way. As a result, the incidence of tax is uneven between different offices, and some policyholders are paying an unfair amount. We also need a system of taxation that is more equitable between life assurance and other forms of saving.

?

Then I would certainly <u>not</u> start with acquisition expenses. My line would be:

done

1. sort out the mess between life and pensions business by ring-fencing pension expenses and doing other pensions measures (para 49 etc);

2. have carefully considered the options for the life business. Have put forward a broadly neutral <u>package</u> consisting of cuts in the rate, abolition of LAPD and changes to the treatment of acquisition expenses.

at the moment our draft is a tease!

fst.sb/Lamont/7.24.2

<u>Other</u>

changed para 64 : the <u>gains</u> of close companies are not currently apportioned.

paras 69/70 : perhaps we should give the Schedule E receipts change more prominence. Although it affects few people in practice, it is a major conceptual change.

?

Finally, there are a number of omissions apart from those highlighted. On residence, you have decided I shall handle it; do you want me to do the same for the consultative documents on swaps and foreign exchange gains and losses? We also need to say something about relocation costs, relief for trading losses against capital gains and (possibly) trusts. ?

NL

NORMAN LAMONT

cst.rj/docs/24.2.5

COPY NO 1 OF 8

BUDGET SECRET

FROM: A G TYRIE

DATE: 24 February 1989

CHANCELLOR

cc: Financial Secretary
Mr Culpin
Ms Wallace
Mrs Chaplin
Mr Call

[Sorry rec'd too late to incorporate]

BUDGET SPEECH

TAXES ON BUSINESS: SUGGESTED REDRAFT OF THIS SECTION

In 1984 I radically reformed corporation tax. Those reforms have played a key role in the revival of the profitability of industry, which is now running at record levels. Profitability in turn has made British industry more attractive to invest in, resulting in recent years in a massive investment boom. And the quality of investment has improved too, with companies investing for a return, not for a tax subsidy.

2. I do not intend to make substantial alterations to this successful reform package, and I propose to leave the mainstream rate of corporation tax unchanged at 35%, one of the lowest rates in the world.

[Curious not to do small companies limit here?]

3. I do, however, have two proposals for simplification. First, the rules on close company apportionment. These are ripe for reform. The apportionment of close companies retained earnings is governed by a notoriously complex set of rules, taking up some twenty pages of legislation. They are a relic of the days when we had six or more rates of income tax and a penal top rate.

4. I therefore propose to abolish them.

5. In future, close companies will be taxed under the normal corporation tax rules, subject only to two simple provisions. As a safeguard against abuse, the profits of close investment companies will be taxed at 40%, the higher rate of income tax. This means that there will be no tax advantage in channelling investment income through a close company.

6. Also, to prevent this from being unduly restrictive, the higher rate will not apply where close investment companies distribute 85% or more of their profits.

7. These simple rules will cut through a mass of red tape.

8. Secondly, I have an important simplification to propose in the treatment of income tax, which mainly affects company directors. At present, under Schedule E, employees' income tax is assessed on the basis, not of earnings received <u>in</u> a year, but instead on earnings <u>for</u> a given year. I propose to change this, so that in future it is assessed on a receipts basis.

9. For the vast majority of ordinary employees this makes no difference. But it will considerably simplify the tax affairs of about half a million people - mostly directors whose fees may not be formally voted until well after the

year to which they relate. This substantial simplification carries transitional costs of £60 million in 1988-90 and £80 million in 1990-91. In the long run there will be a revenue yield of (about £50 million per year).

10. Finally, I propose a further change to corporation tax to help new companies undertaking capital investment with very long lead times. I propose to extend pre-trading expenditure relief to cover a full five years before trading begins, rather than the three years as at present.

Small business

11. A striking feature of transformation of the British economy has been the enormous increase in the number of business start-ups. The health of the small business sector is crucial to the economy as a whole. [I have therefore decided to take a number of measures to help both the incorporated and the unincorporated sectors [mention that small businesses have been most affected by high interest rates?].]

no

To main business section

12. First, the incorporated sector. The vast majority of companies pay at the lower small business rate of corporation tax. The remainder of small businesses either have no liability at all, or pay at reduced rates, determined by the small company profit limit. These limits, the border between small company and the mainstream corporation tax rate, have not changed since [I] set them in 1983. For the incorporated sector, I now propose to

increase them by a full 50%, [to £150,000?] This will reduce the tax liability of some 18,000 companies.

13. For the unincorporated sector I have one change to capital gains tax which will be of substantial benefit to them. At present, although unincorporated businesses can offset trading losses against realised capital gains, unincorporated ones cannot. I propose to remedy this to enable an unincorporated trader who sustains a trading loss and realises a capital gain in the same year to set the income loss off against the capital gain. Furthermore, I propose to extend the offset not only to capital gains of that business or trade but also to cover all the traders capital gains.

14. I also have several deregulatory measures to propose in the VAT field which will be of considerable benefit to the small business sector.

15. First, bad debt relief. At the moment, traders normally have to pay VAT on their sales whether or not their customers pay their bills. Bad debt relief can be claimed only where the debtor has become formally insolvent. This is far too complicated so I propose that, from 1 October, all debts which are over 18 months old and have been written off in the traders accounts will qualify for bad debt relief.

16. Secondly, I propose to simplify the rules which determine who has to register for VAT. At present there are both quarterly and annual turnover thresholds. Furthermore businesses have to say if they see any chance of their exceeding the thresholds in the following 12 months.

17. This is unnecessarily complicated. As from budget day I propose to introduce a single rule based on the turnover in the preceding 12 months.

18. Thirdly, I propose to simplify what is know as the VAT default surcharge. At present this surcharge rises by 5% each time a business defaults, to a maximum of 30%. Experience suggests that by the time a business reaches a surcharge of over 30%, it is often in no position to pay. I propose to recognise this by capping the default surcharge rate at 20%.

19. Finally, I propose to increase the VAT threshold to £23,600, the maximum allowed under European Community law.

20. These VAT measures will cost £x million in 1989-90.

AGT.

A G TYRIE

Ret No: MPW/89/4

Copy No 10

BUDGET SECRET
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BUDGET

FROM: MOIRA WALLACE
DATE: 24 FEBRUARY 1989

MR CULPIN

cc: Mr Scholar
Mr Gilhooly
Miss Hay
Mr Macpherson
Mr Michie
Mrs Chaplin
Mr Tyrie

SECRET

BUDGET SPEECH: TAX SECTION

I attach my redraft of the tax section, reordered as the Chancellor has suggested. All comments, improvements and corrections, of course, gratefully received.

Overall, I think this order will work better. But this version is still pretty patchy, and there are some gaps to fill. You are doing something on NICs and the earnings rule. And I still need bright ideas for the peroration. Otherwise, my main caveats and questions are :

I still don't like cars and - particularly - Schedule E receipts in the business section. Will they look too awful in the income tax section?

I also don't like the CGT odds and sods in their present slot, after independent taxation. It's contrived, breaks up the flow of the savings logic, and is very difficult to get into, and out of again. Where else can these go?

Also on CGT, you will see I have made up the paragraph on CGT gifts relief. It does mention chattels - since I have the impression the Chancellor wants to - and it doesn't mention abuse. Does this seem right?

On PEPS, I've messed around with the Walker draft. But the pensions bit is almost unadulterated Kuczys: the only changes I made to his text are marked on my copy at annex A, and I'll fax him a copy for checking.

I've taken on quite a lot of comments from the Revenue as I went along. The bulk of them were in Charles MacNicol's letter to me, attached at Annex B (sorry the copy's so faint). I shall offer the Chancellor the contributions on relocation, Keith, and exchange rate gains and losses. I'm not sure that he'll want any of them in the speech. But do you or copy recipients have strong views?

B.L.O. SECRET

101/2

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Finally, I'm conscious costs and yields still need to be mentioned in a number of places. Where? Is there a hard and fast rule?

As you'd expect, comments and suggestions required ASAP please.

MPW.

MOIRA WALLACE

chex.rm/mw/9

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TAX SECTION

Before I turn to my specific tax proposals, I should tell the House of a general measure which will be of considerable importance to all taxpayers, and indeed to the integrity of the tax system as a whole.

2. The new Official Secrets Bill [?Act] removes the sanctions contained in the previous legislation against leaks by staff of the Revenue departments about the private affairs of individual taxpayers. That is because the Bill is quite properly concerned only with official secrets. In the tax system it is the individual's right to privacy that needs to be protected.

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3. When taxpayers give information to the Inland Revenue or the Customs and Exercise about their private affairs, they have a right to expect that the information will be kept entirely confidential. That assurance is essential, and there can be no compromising on it.

4. I therefore propose to restore the provision that it should be a criminal offence for officials or former officials of the Revenue Departments to reveal information about an individual taxpayer's affairs.

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Appropriate provision will be included in the Finance Bill.

TAXES ON BUSINESS

5. I now turn to my specific tax measures, and first to the taxation of businesses.

6. I have to set the main corporation tax rate for 1989-90. I propose to leave it unchanged at 35 per cent, one of the lowest corporation tax rates in the world.

7. At the moment only a small minority of companies pay at the full rate. The remainder have no liability at all, or pay at reduced rates, determined by the small companies profits limits. These limits have not changed since 1983. I now propose to increase them by 50 per cent. [Do we need to spell out the limits or the reduced rates etc?] This will reduce the tax liability of some [18,000] companies.

8. I have a further change to corporation tax to propose, to recognise industry's growing willingness to undertake capital investment with very long lead times. To help new companies planning this kind of investment,

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I propose to extend pre-trading expenditure relief to cover a full five years before trading begins, rather than three years as at present.

9. I have one change to capital gains tax which will be of substantial benefit to unincorporated businesses. At present, although incorporated businesses can offset trading losses against realised capital gains, unincorporated ones cannot. I propose to remedy this [so that in future an unincorporated trader who sustains a trading loss and realises a capital gain in the same year can set off the loss against the gain] [I propose further to extend the offset not only to capital gains of the business but to all the trader's capital gains.]

x 10. [The Finance Bill will also set out the new arrangements for the levy on independent television

x contractors.] [Following consultation with the Independent Broadcasting Authority] [as RHF Home Secretary has already announced] the levy for the period January 1990 to December 1992 will be three quarters based on net advertising revenue, with the remainder based on profits. It is intended that this levy should yield broadly the same amount of revenue as would have arisen under the pre-1986 regime. Compared with the present system, this will raise an extra £60 million a

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year. [Another reason for not having this in the speech - apart from the fact that it is boring - is that as far as I can remember the PAC criticised us for letting the broadcasters off since 1986, and I don't see why the Chancellor should admit that!]

11. I have to set the 1989-90 car benefit scales. I propose to increase them by 20 per cent. [I propose no change to the fuel scales.]

No: it's income tax

[Could we put Schedule E in here , if it must go in business taxation at all?]

12. I have one measure to propose which will simplify an area of the tax system which is ripe for reform. The apportionment of close companies' retained earnings is governed by a notoriously complex set of rules, taking up some 20 pages of legislation. ~~This is~~ These are a relic of the days when we had six or more rates of income tax and a penal top rate.

I therefore propose to abolish them.

13. In future, close companies will be taxed under the normal corporation tax rules, subject only to two simple provisions. First, as a safeguard against abuse, the profits of close investment companies will be taxed

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at 40 per cent, the ~~top~~ higher rate of income tax. This means that there will be no tax advantage in channelling investment income through a close company.

14. Second, to prevent this from being unduly restrictive, ~~the 40 per cent~~ this higher rate will not apply where close investment companies distribute 85 per cent or more of their profits.

Finally, I have two important ~~simpli~~ measures ~~simplifications~~ to propose which will make life a great deal simpler for ~~both~~ businessmen and the Inland Revenue, and which will cut through a mass of unnecessary red tape.

~~15. These simple rules will cut through a mass of unnecessary calculations and red tape.~~

16. ~~I have an important simplification to propose in~~ The first ... the income tax field. At present, under schedule E, employees' income tax is assessed on the basis not of earnings received in a year, but instead on earnings for the year. I propose to change this, so that in future it is assessed on a receipts basis. For the vast majority of ordinary employees this makes no difference. But it will considerably simplify the tax affairs of about half a million people - mostly directors whose fees may not be formally voted until well after the year to which they relate. There are transitional costs of £60 million in 1989-90 and £80 million in 1990-91, but in the long term there will be a revenue yield [of about £50 million per year].

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X ~~[Deep discounts]~~

17. In my 1984 Budget, I reformed the tax treatment of deep discounted bonds issued by UK corporations. The regime I put in place then has stood the test of time. So far, overseas government borrowers have been unable to issue such bonds in London, because they have been prevented under the Control of Borrowing Order. But I have already announced that this will go. I therefore propose to make the tax regime for corporate deep discounted bonds available for similar bonds issued by other borrowers. This will ensure parity of treatment for all borrowers who wish to make use of these instruments.

18. To counter an avoidance device, I propose to extend similar treatment to index-linked bonds issued for less than 3 years maturity.

19. I now have one set of deregulation measures to propose in the VAT field, which will be of considerable benefit to the small business sector.

20. At the moment, traders normally have to pay VAT on their sales whether or not their customers pay their

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bills. Bad debt relief can be claimed only where the debtor has become formally insolvent. This is far too complicated. I therefore propose that from 1 October, all debts which are over eighteen months old and have been written off in the trader's accounts will qualify for bad debt relief.

21. I also propose simpler rules to determine who has to register for VAT. At present there are quarterly and annual turnover thresholds, and businesses also have to say if they see any chance of their exceeding the [annual] threshold in the next twelve months. This complication, too, is unnecessary. As from Budget Day I propose a single rule ["for most businesses", Customs say - who are the exceptions?] based on turnover in the past twelve months. For 1989-90, I propose to increase the threshold to £23,600 a year, the maximum allowed under European Community law.

22. Finally, I propose to simplify the VAT default surcharge. At present this rises by stages of 5 per cent each time a business defaults, to a maximum of 30 per cent. Experience suggests that by the time a business reaches a surcharge rate of over 20 per cent, the problem is not that it won't pay but rather that it

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can't. I propose to recognise this by capping the default surcharge rate at 20 per cent.

23. Together, these measures will cost £X in 1989-90. They represent a major simplification and deregulation of the VAT system, and will be of considerable benefit to a great many small businesses.

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TAXATION OF SAVINGS AND INVESTMENT

["subject to facts"]

24. I now turn to the taxation of savings and investment. Reforms in this area of the tax system have been a common theme throughout our ten years in office. ~~in all my Budgets as Chancellor.~~ Reform has had two strands. First we have taken steps to remove long-standing biasses against saving in the tax system. And second, we have shaped the tax system so as to promote greater choice amongst different forms of saving, and to influence that choice in directions that are of wider economic benefit.

25. I was able to make Progress in removing a major disincentive~~s~~ to saving ~~began~~ as long ago as my first Budget, in 1984, with the abolition of the investment income surcharge. And last year, I was able to announce the removal of perhaps the major fiscal disincentive to saving. Independent taxation, which will come into operation in April 1990, will end the 200 year old injustice whereby a married women's investment income was taxed as if it belonged to her husband. [More about how wonderful this is, and some link (?!) to next para....].

26. With the introduction of independent taxation next year married couples will benefit from a double exempt threshold for capital gains tax. For this year, I have

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[therefore] decided to leave the exempt threshold unchanged at £5,000.

What's this doing in the middle of savings measures?

27. I have also decided to restrict the circumstances in which capital gains tax on gifts may be deferred. When capital transfer tax still existed, deferral of CGT on gifts had to be allowed so as to avoid a double tax charge. But that need is gone, and I therefore propose to restrict this provision to gifts made to charities, and gifts of business and heritage assets. The vast majority of everyday possessions will, of course, continue to be entirely exempt from CGT as long as their value does not exceed the chattels exemption threshold. This currently stands at £3,000 and I now propose to raise it to £5,000.

28. As I mentioned a moment ago, in the second strand of our reforms in the taxation of savings ~~has~~ we have addressed the balance between different forms of saving. Here we have taken the approach that choice should be distorted as little as possible by the tax system. Where more investment of particular kinds would help the economy to work better, we have removed fiscal disincentives, or offered fiscal encouragements.

One form of saving we have always encouraged is share ownership, where specific tax measures to promote investment in equities

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have complemented the success of the privatisation programme. Over the last ten years the number of shareholders has risen from [X] to [Y], and with this increase has come a greater sense of participation in British industry. [Survey results.]

29. Personal Equity Plans have now been running for just over two years. In that time, despite the Stock Market crash, [nearly 400,000] plans have been taken out. The scheme has encouraged some people to invest in equities for the first time, and it has helped existing shareholders to deepen their commitment to equity investment.

30. I want more people to take up this opportunity. Accordingly, I am making a number of improvements.

31. First, I propose to raise the annual amount that can be invested in a plan. From 6 April, I am raising the overall limit from £3,000 to £4,000. At the same time, in recognition of the useful role played by ~~I recognise that investment trusts and~~ unit trusts ~~offer a good introduction~~ in introducing investors to the equity market ~~for smaller investors,~~ I am ~~therefore~~ raising the amount that can be invested in authorised unit trusts and investment trusts substantially, from a maximum of £750

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to £2,400. In future there will be nothing to stop holders investing all their PEP in unit trusts.

32. However, Personal Equity Plans have always been intended to encourage investment in British companies. I therefore propose that, from 6 April 1990, where a plan invests in a unit or investment trust, the trust itself should invest mainly in UK equities.

33. I am proposing other improvements to PEPs which will take effect from 6 April 1989. First, I propose to enable PEP holders to apply for new issue shares, including privatisation shares, outside their PEP, and subsequently bring the shares into the plan.

34. Second, [as a number of plan managers have indicated that they find some of the scheme rules are too complicated and restrictive,] I am proposing a number of simplifications which will help plan managers keep their costs - and their charges - to a minimum.

[35. This leaves out a lot of the detail. Any objections?] Overall, the changes I propose will cost £5 million in 1989-90 and £10 million in 1990-91.

Yes. Or sneer at Loi Monory more fully. But best omit.

[1 wd. omit]

[36. There have been suggestions that I should give a grater measure of tax relief to PEPs; for example, along the lines of the - now defunct - Loi Monory in France. I do not, however, believe that British investors need to be bribed in this way. Nevertheless,] taken together, the changes I am proposing will make PEPs more attractive to new investors in equities. The scheme will continue to play an important part in helping to build up individual ownership of British equities.

37. The various schemes that exist to encourage employee share ownership are another important element of our strategy in this area. This year I have a number of further improvements to the employee share legislation to propose.

38. The limits on the 1978 profit sharing scheme have been unchanged since 1984. I propose to raise them. The annual limit on the value of shares which can be given income tax-free to employees will rise from £1,250 to £2,000. For the alternative limit of 10 per cent of salary, the overall ceiling will be raised from £5,000 to £6,000. [Can anyone make sense of this?]

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39. The maximum monthly savings limit for the 1980 all-employee SAYE scheme has been unchanged since 1983. I propose to increase it too, from £100 to £150. And I propose to increase the maximum discount from market value at which options can be granted from 10 per cent to 20 per cent.

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

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

(They're not that new in the US)

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

43. The growing trend [?] towards employee share ownership is, of course, doubly desirable. In addition to

increasing share ownership <u>per se</u> it promotes employee participation and commitment to the firms for which they work.

44. The desire to see increasing workforce participation in industry was one of my principal motives in introducing the Profit Related Pay Scheme in my 1987 Budget.

X

X

45. The Scheme has had an encouraging start. But it is also clear that some firms who are interested in launching schemes are not able to comply with all the present rules. I therefore propose to make the following modifications to the scheme in this year's Finance Bill.

46. First as I have already announced, I intend to abolish the requirement that PRP must equal at least 5 per cent of pay.

47. Second, I propose to raise the limit on the amount of PRP which can attract relief from £3,000 to £4,000. Finally, I propose to relax the rules preventing headquarters units from using the profits of the whole company or group for their profit calculations, as I am

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persuaded that this too is unnecessarily restrictive. I am confident that these modifications will ensure further growth in the number of firms offering some element of profit related pay.

48. The package of measures I have just announced will make it easier and more attractive for ordinary people to join the ranks of those who already have a direct stake in the fortunes of industry, either because their pay is linked to their employer's profits or because they own shares directly. ~~in British companies.~~

49. However, disincentives to direct equity investment remain, not least the [still disproportionate] cost of share transactions for small investors. In this context I am pleased to see that the Stock Exchange is forging ahead with its plans to get rid of paper transactions and move to a cheaper and more efficient system. To give the Exchange a firm basis on which to plan this ambitious undertaking, I think it right to make clear now the tax regime that will apply. I have fully considered the difficulties of applying stamp duty in a world where there is nothing to stamp. And I am happy to say that I have found the problem insuperable. I therefore propose to take this ~~the~~ opportunity to abolish stamp duty on shares altogether. This is the sixth

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major tax I have abolished as Chancellor, and one I take particular pleasure in adding to the list. I have long regarded it as inefficient, and have progressively reduced the rate as I was able to do so. Abolition will take effect from 1 April 1990, the earliest date at which the Stock Exchange is likely to introduce paperless transactions. In 1990-91 it will have a revenue cost of [X].

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

[51. As such, their longer-term effect may be to redress an imbalance that arguably exists in the pattern of savings in the UK, which, in the last 30 years has become increasingly dominated by institutional forms of saving, such as life assurance and pensions. ¶ The taxation of these institutional forms of saving is one of the more complex and idiosyncratic areas of the tax system. And it is not an area where one can make great changes overnight. These factors argue for caution, and we have proceeded cautiously. Nonetheless we have made

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considerable progress in improving choice, and reforming the tax system in step. Today, I have more progress to announce.

52. I turn first to pensions.

53. Over the past few years, we have seen through an important series of measures in the pensions field. Taken together, these are encouraging a shift away from dependence on the State, towards individuals taking more responsibility for their own pension arrangements, on the basis of improved rights as pension scheme members, better information about their pensions, and a much wider choice of pensions options. I propose to bring this process to a conclusion [one step further?] today.

[?]

54. First, I intend to rectify a long-standing anomaly. The tax rules for occupational pension schemes set limits on the pensions which can be paid. I do not propose to do away with the notion of rules to limit the tax relief available - indeed, there is a case for tightening them in some respects. But it is quite wrong that tax law has, effectively, come to set a limit on the overall pension someone can receive. Accordingly, I propose to remove the obstacles in the way of employers setting up pension schemes to provide benefits above the

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tax limits. I propose that in future 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.

55. The other anomaly with the tax reliefs for pensions is that there is no limit to them, in cash terms: the higher someone's salary, the greater the pension they can have, and the more tax relief goes with it. Of course, someone who receives a very high salary will expect a pension of a comparable level, so as to maintain his or her standard of living on retirement. But there is no reason why the tax advantages of pension provision should be available with no upper limit, [any more than (for example) tax relief for mortgage interest.]

? MIR is not indexed. Pensions will be (see para 57). Best avoid this comparison?

56. 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.

57. 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 indexation. 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. [Is this the best way to put the last point?]

58. The House will, I am sure, be interested to know that I have no plans to tax lump sums paid from tax-approved pension schemes.

59. The new ceiling will only apply 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.

60. The introduction of this ceiling on tax relief also enables me to simplify and improve the rules for the majority of pension scheme ~~numbers~~ mem[bers], 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.

Additional voluntary contributions

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

X·X

62. Still on AVCs, I intend to rectify the present anomaly in the system which can mean that, if AVC investments perform very well, occupational pensions have to be reduced to keep total benefits within the permitted limits. Instead, in future any surplus AVC funds will be returned to employees, subject to a special tax charge. This will remove the penalty on good investment performance.

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

Personal Pensions

64. The most important development in the pensions field in recent years has undoubtedly been the

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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 encourage take-up still further.

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

66. Second, I propose to increase substantially the annual limits, as a percentage of earnings, on contributions to personal pensions for those aged 35 or more. This will be of particular value to those running their own business, who are often unable to make contributions until later on in 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 index.

Conclusion

67. These proposals build on, and complete, the measures I introduced in my 1987 Budget. They represent a deregulation which will make life simpler for employers and employees, and allow more flexibility in a number of circumstances, while setting a limit on the tax relief available to any individual. They should give a boost, in particular, to personal pensions and free-standing AVCs.

68. At the same time, there is no question of undermining pension saving by a huge upheaval, and I am not proposing any fundamental change to the tax treatment of pensions. The last few years have involved important changes for pensions. It is now time they were allowed to settle down. Accordingly, I propose to make no further changes in their tax treatment this Parliament.

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LIFE ASSURANCE

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

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

71. The Life Assurance industry is unique, not just in the product it provides but also in the tax regime which applies to it. The policyholder's returns and the shareholder's profits are not, as in a normal business, taxed individually but jointly by taxing the funds held by the Life Offices on their policyholders' and shareholders' behalf.

X

72. In this system ~~that~~ relief is given "up front" for expenses incurred on the policyholder's behalf. This has two distortive effects: ~~first~~ It means that policyholders receive a tax break - "up front" relief on initial costs which would not be available if they invested directly in shares. And it distorts the

["first" but no "second"]

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incidence of tax as between one Life Fund and another. The system unduly favours the rapidly expanding Life Office where tax can be deferred for many years.

73. I have considered very carefully whether this problem is best resolved by improving the existing system; or by adopting a completely new basis of taxation for the Life Office. I have concluded that the defects can be dealt with within the present regime. In this, I accept the main conclusions and proposals put forward by the industry.

74. I shall be bringing forward in the Finance Bill measures which will mean that in future, relief for the initial expenses associated with new policies will be spread forward so that one-seventh only is available for relief against tax in the year in which expenses are incurred and in each of the subsequent six years. Taken on its own this would increase the tax liability of life offices, indeed quite markedly in the early years. But this effect will be eased by phasing provisions to give the industry time to adjust to the new regime, and by other measures which I have to propose.

75. But first I have one other proposal which will also restrict the amount of relief available. At present

nothing requires life offices to keep their pensions and life assurance businesses separate. So some Life Offices can set the unrelieved expenses on the pensions side of their business against the income and realised gains of Life Funds, giving their pensions profits unduly favourable tax treatment. The Finance Bill will include provisions to end this anomaly.

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

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

78. These measures give a fairer basis for the taxation of the Life Companies. In isolation they would increase the long-run tax burden by £[ ]m. However, here as

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throughout the tax system, widening the tax base allows tax rates to be reduced. This I propose to do.

79. At present, Life Funds pay tax at 35 per cent on income and ~~30 or 35 per cent on capital gains of their policyholders and~~ shareholders capital gains ~~respectively~~. As from 1 January 1990, all these rates will be reduced and aligned with the basic rate of income tax. Life Assurance Premium Duty will be abolished from the same date. Together these changes will be worth £[ ]million to Life Assurance in a full year. On top of this, the industry, like all those who deal in shares, will benefit from the abolition of stamp duty to the tune of £X a year.

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

81. I have just added tax on life funds to the list of tax rates that are aligned to the basic rate of income tax. I now propose similar treatment to deal with a problem we will shortly face in the taxation of unit trusts.

82. Later this year, collective investment schemes from other EC countries will acquire the right to sell their

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products here. It is important that the tax system should not place UK products at a competitive disadvantage, and normally it will not do so. The exception is that if a trust invests in gilts or bonds, and is not a gilt only trust, it pays corporation tax at 35 per cent on the income and can pass on a credit at only 25 per cent to the investor. The simple solution is to align this special corporation tax rate with the basic rate, and this I propose to do with effect from [ ].

TAXES ON SPENDING

83. I now turn to taxes on spending.

84. First, VAT. I have already announced a package of significant deregulatory measures which will be included in this year's Finance Bill. The FB will also implement the changes necessary to comply with the ECJ's judgement on certain of the UK's zero rates. The Government has had no choice but to implement the Court's judgement by applying VAT to [x,y,z]. However, where possible, steps have been taken to mitigate the effects of the changes, particularly as they bear on charities. These changes

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will take effect from [ ] and will have a revenue yield of [ ].

85. The only other change I propose to make to the coverage of VAT is to introduce a small number of extra reliefs for charities, of which the most important is the exemption for their fund-raising events [I trust this change will be welcomed by the ...].

86. I also propose to relieve from car tax vehicles leased to the disabled. [Explicitly refer to Motability?]

Yes. The relief is available only via Motability.

87. The main thrust of Government encouragement to charities, however, continues to be focused on the act of giving. The Payroll Giving Scheme, which I introduced in my 1987 (?) Budget, has been growing steadily: about 3400 schemes have now been set up and over 100,000 employees are already participating, quite a few of them giving up to the full annual limit. To allow scope for more generous donations, I propose to double the annual limit for the PRG scheme to £480, or £40 a month.

88. I turn now to the duty on petrol. Last year I increased the tax differential in favour of unleaded

petrol, giving it a price advantage of some 6p a gallon over 4 star. This has undoubtedly helped to increase the take up of unleaded petrol.

89. But the Government is committed to seeing ~~leaded~~ ~~phasing out~~ leaded petrol phased out, and progress is still too slow. Unleaded petrol still accounts for only 4 per cent of total sales, even though two out of three cars on the road can use it - either without any adjustment, or with a relatively inexpensive conversion.

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

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

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below that of 4 star. This in itself should provide a strong encouragement for motorists to have their cars converted.

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

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

~~VED~~

94. The measures I have proposed on petrol duty will have a revenue cost of X in 1989-90. I propose to

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recover this cost from vehicle excise duty. At the moment a bus or a coach has to have sixty six seats before it pays as much VED as a family car. I propose to increase the relevant rates to bring this group up to cover their track costs - that is, the wear and tear they cause to the roads. There will also be increases in the rate of VED for the heaviest of the rigid HGVs so as to [put them on a more equal basis?] with articulated HGVs.

Is this right?

95. [The other main rates of VED will remain unchanged?] However, I also propose a major simplification of the structure of VED by reducing the number of tax classes by over 70.

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

TAXATION OF INCOME

97. Nor do I propose any change this year to the basic rate of income tax.

98. For 1989-90 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

persons' 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 £1400 to £20700. The single age allowance will rise by £220 to £3400 for a single person, and the married age allowance will rise by £350 to £5385. For those over 80, the higher rate of age allowance will rise by £230 to £3540 for a single person, and the married allowance by £360 to £5565. ~~However,~~ Moreover, I propose that the higher age allowances, which are currently for the over eighties only, should be extended to cover all those aged 75 and over. So all those between 75 and 80 will have their tax allowances rise by more than normal indexation.

99. The income limit for age allowance will rise by £800 to £11400, again in line with normal indexation. However, I propose to change the rate at which age allowance is withdrawn above this income limit. I propose that it will now be withdrawn at the rate of £1 for each £2 of income, rather than the present sharper withdrawal rate of £2 in every £3. [This will mean that the marginal tax rate for those in this income band will be reduced to X per cent.]

100. The Finance Bill will also include the provisions to establish the new tax relief for the premia on

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pensioners health insurance, which I announced to the House in January.

101. [Earnings rule etc - to be supplied].

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FROM: J GIEVE
DATE: 27 February 1989

CHANCELLOR

MTFS - FISCAL POLICY

As you know, I think the section on fiscal policy in this year's draft MTFS will lead to questions on what is taken into account in deciding the fiscal stance. For example:

(a) If it was prudent and cautious to make £4 billion of tax reductions last year with a view to achieving a PSDR of £3 billion (when the economy was expected to grow above trend) why is it appropriate to make smaller tax reductions this year and aim for a PSDR of £X billion when the economy is forecast to slow down substantially?

(b) Do we believe that fiscal policy has any impact on domestic demand and inflationary pressures? Are these potential effects taken into account in the Budget judgement?

(c) Is there a trade-off between fiscal and monetary policies ie if we aim for a larger PSDR do we think this will ceteris paribus allow us to have lower interest rates?

2. As I understand it, we do believe that very substantial changes in fiscal stance (eg eliminating the PSDR in two years) would have an impact on domestic demand and inflationary pressures and would, therefore, require changes in monetary policy. But, within practical limits, while changes in fiscal policy may affect activity both directly and through expectations, these effects are likely to be small ie the trade-off with monetary policy is slight. You also indicated in your IMF speech that in some (unlikely) circumstances it might be appropriate to vary fiscal policy to compensate for a low level of private sector saving.

GIEVE
FISCAL
POLICY

3. I don't think we need include anything on the last point in the FSBR. We can point to the increase in public sector saving in the last couple of years without admitting that private sector savings are in some structural sense inadequate. But I think it would help to say that returning gradually to budget balance will buttress an anti-inflationary monetary policy. This might be done on the following lines.

> "The speed with which it is prudent to move towards the long term objective depends on a number of considerations. A gradualist approach to reducing tax rates has always been a feature of the MTFS. This caution in fiscal policy both supports monetary policy in bearing down on inflation and serves to maximise the supply side benefits of reductions in tax rates by ensuring that they are sustained in the medium term. With expenditure plans also set on a medium term basis, the PSDR will tend to be increased by GDP growth above trend and to be reduced in periods when growth is below trend.
>
> Para 229. In the light of these considerations, the Government intends to move from the present surplus towards a balanced budget gradually over the medium term. The PSDR for .... As usual, the PSDR to be set in future Budgets will be reviewed in the light of circumstances at the time."

J.a. Gieve

JOHN GIEVE

IR
COMMENTS

chex.ps/mw/5

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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
Miss Hay
Miss Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

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

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

IR comments

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B.L.O.

BUDGET STATEMENT: TAX SECTION

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

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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.

MPW

MOIRA WALLACE

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TAXPAYER CONFIDENTIALITY

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

2nd reading in House of Lords on 9 March: not in Committee until 3 or 4 April.

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 personal information in the possession of either of the Revenue Departments concerning the private affairs of ~~individual~~ taxpayers.

covers corporate taxpayers as well

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

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

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

BUSINESS TAXATION

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

6. First, taxes on business.

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

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

see covering note

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

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

or, more simply perhaps, "...close companies, in particular, family companies"

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

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* Distribution rules will apply to dividends received by a close investment company and these are not part of what would normally be regarded as profits

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.

SECRET

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

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

B.L.O.

The taxation of payments to employees moving house with their jobs also needs to be put on to a more rational basis.

15. ~~There is one further tightening in this general area which I believe it right to make.~~ I propose ~~to~~ putting the extra-statutory concession which ~~relieves from tax~~ exempts 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-

no!

SECRET

Constitutional point: strictly speaking, the Revenue grants concessions with, of course, the authority of Ministers. More neutral passive might ∴ be better

← eh?

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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~~ it artificially blunts the market forces which should be leading employers to consider locating in lower cost areas.

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

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

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

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

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

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

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

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

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

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TAXES ON SAVING

24. I now turn to the taxation of saving.

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

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

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

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

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

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

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

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

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

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

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

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

35. Personal equity plans got off to a good start, with over a quarter of a million investors, many who had never owned shares before, subscribing almost £$^1/_2$ billion between them in 1987.

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

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climate in the equity market since the October 1987 Stock Exchange crash. Even so, another 115,000 plans were taken out in 1988 - many more than some commentators have suggested.

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

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

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

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

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41. Fourth, I propose to simplify the PEP rules in a number of important respects, so as to make the scheme more flexible, better directed to the needs of small and new investors, and cheaper to administer. // 41A 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 sake in both cases,] ϕ all experience shows ~~those countries~~ that any (scheme of [illegible]) ~~which have opted~~ for front-end relief ~~have been forced~~ would need to be festooned ~~it~~ with a complex web of restrictions to prevent abuse. (I prefer the simpler approach and) 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.

New paragraph

* Could confuse: most people will have in mind a Loi Monory-type subsidy & so we suggest omitting this.
Mr Isaac has suggested a different formulation for this sentence: please see his note attached.

ϕ see ~~note~~ covering 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

to almost 1,600 today, involving [over 10,000] [number] companies and benefiting some $1\,^{3}/_{4}$ million employees. I propose, first, to increase the annual limit on the value of shares which can be given income tax-free to employees under all-employee profit-sharing schemes from £1,250 to £2,000; and for the alternative limit of 10 per cent of salary, to raise the ceiling from £5,000 to £6,000.

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

Is this needed?

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 [company contributions to an] ~~companies that place their shares in~~ ESOPs [trust] qualify for corporation tax relief, [if] ~~provided they meet~~ certain requirements designed to ensure that the shares become directly owned by the~~ir~~ employees within a reasonable time [are met]. I hope that this will encourage more British companies, particularly in the unquoted sector, to consider setting up ESOPs.

Like approved employee share schemes, the purpose of ESOPs is to encourage employee share ownership through the acquisition and distribution of shares. But in so doing ESOPs may use a wider variety of finance, acquire more shares and operate on a longer timescale than existing share schemes.

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

* A useful link passage to paragraph 47.

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

48. First, as I have previously announced, I propose to abolish the restriction that profit-related pay must (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.

49. ~~And,~~ Third, I propose ~~to~~ relaxing the rules preventing headquarters units from using the profits of the whole company or group for their profit calculations.* [And fourth, to help share schemes and ESOPs as well as profit related pay, I propose changing the material interest rules which can at present unnecessarily exclude employees from their schemes where they already benefit from a trust set up for employees.]

* Optional; but would be useful in that the measure applies to share schemes, ESOPs and PRP.

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

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

51. I now turn to life assurance.

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

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

(mainly in place already)

See covering note

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

* Strictly, pension business *is* 'life' business.

54. First, many life offices run ~~a~~ pensions business ~~as well as a~~ * alongside other life ~~assurance~~ business, and they are not 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~~ other life business, thus giving ~~their pensions profits~~ ∅ [them] [the life offices] unduly favourable tax treatment. I propose to end this anomaly.

∅ It is the 'other' life business that benefits from the present spillover.

55. This change, ~~which~~ and other changes intended to put the calculation for the tax of pension business on a more commercial footing, will come into force on 1 January 1990. They will yield £155 million in 1990-91. The remainder of the changes I have to propose constitute a balanced package which, overall, [will ~~slightly~~ may, in the long run, reduce the taxation of life assurance. (true?)] ‡

‡ Depends on a variety of factors: not true over the "hump" years

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

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

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

58. But I propose here and now, as from 1 January 1990, to abolish Life Assurance Premium Duty. And I also propose, from the same date, to reduce the rate of tax payable on (the 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.

see covering note

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

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

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

61. I now turn to pensions.

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

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

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

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

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

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

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.]

* We normally do not refer to press releases given that there are so many.

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.

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

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

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

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

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

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

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

x

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

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

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

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At present, a wife's income from savings has to be disclosed to her husband and taxed at his marginal rate. Independent Taxation will change all that.

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

CAPs

77. I refer, of course, to independent taxation. For there can be ~~no~~ little doubt that one of the greatest disincentives 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 (in future) be able to set their personal allowance~~s~~ against their savings income~~, in many cases removing such income from tax altogether~~. ~~(Insert brief announcement of new publicity leaflet: IR to draft.)~~

ɸ Not true for composite rate income (from banks & building societies) which is the majority.

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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.

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* There are other CGT proposals - housing associations, branches & agencies - which are not mentioned.

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

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~~ available from Inland Revenue offices to explain all the main features of the new system.

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

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

φ They will if there is an immediate IHT charge.

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

83. ~~My~~ The last (of these three) capital gains tax proposals is to change the tax treatment of certain bonds so as to simplify the tax rules and prevent a loss of yield by the use of indexation to create losses and the conversion of income into capital gains.

Paragraphs 84-88: redraft attached.

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

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this from 2 per cent to 1 per cent in my 1984 Budget, and again from 1 per cent to $^1/_2$ per cent in my 1986 Budget.

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

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

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

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

TAXES ON SPENDING

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

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

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

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

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

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

See covering note

95. I now turn to the excise duties.

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

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

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

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

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

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

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

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

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Duty. 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 rate of duty for the heaviest non-articulated lorries, to put them on a more equal footing with articulated lorries. Finally on Vehicle Excise Duty, I propose to simplify the system by reducing the number of separate rates of tax from x to y.

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

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FROM: MISS M P WALLACE
DATE: 27 February 1989

PS/FINANCIAL SECRETARY

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

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

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

Moira,

keep.

A few, fairly minor, suggested amendments and comments are shown in red against paras 18-21, 91-92 and 96-99. I hope they're all self-explanatory - but do get in touch if you have any queries.

Alison French
1/3

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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 <u>by close of play on Wednesday, 1 March</u>.

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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

TAXPAYER CONFIDENTIALITY

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

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

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

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

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

BUSINESS TAXATION

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

6. First, taxes on business.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(Return to wording of first draft, which factually more accurate).

19. I also propose to increase the VAT threshold to £23,600, the maximum permitted under European Community law.

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

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

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

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

TAXES ON SAVING

24. I now turn to the taxation of saving.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

51. I now turn to life assurance.

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

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

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

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

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

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

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

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

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

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

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

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

61. I now turn to pensions.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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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

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

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

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

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

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

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

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

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

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

this from 2 per cent to 1 per cent in my 1984 Budget, and again from 1 per cent to $^1/_2$ per cent in my 1986 Budget.

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

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

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

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

TAXES ON SPENDING

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

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

91. Although I have done my best to mitigate the effect of the European Court judgement on charities, as the charities themselves have generously acknowledged, I have been unable to protect them altogether. I have therefore, in these special circumstances, considered whether there is anything further I can sensibly do, however modest, to assist charities with their VAT bills. Accordingly, I propose to relieve charities from VAT on ~~[complete list]~~, [charitable] fund-raising events, autoclaves [and other medical sterilising equipment] and certain types of advertising.

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

(Should Motability be mentioned by name? Not something normally do – and, in theory, relief extends to any business whose main purpose is to lease cars to the disabled. (In practice, only Motability likely to benefit)).

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

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

95. I now turn to the excise duties.

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

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

(clearances to 14/2 were 5.5% of total. Sales likely to follow suit)

(Some adjustments cost nothing, some more than £20. £15-20 range is average/typical quoted in 'Which?').

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

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

(actual increase is 3·64p/gall – could be 'over 3p' or 'nearly 4p'. In FSBR, ChEx changed text so litres appear before gallons – does he want to lead with gallons in speech?).

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customer - and I look to the oil companies to see that it is - it means that the price of unleaded petrol at the pump will ~~generally~~ typically 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.

(We are checking this - certainly true for tax differential, may not necessarily follow for prices).

99. But I do not intend to stop there. I also propose to raise the tax on two and three star petrol by roughly 4 pence a gallon, so that the pump price of these grades will be at least as high as that of four star. This should expedite the phasing out of two star petrol, which is already down to 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.

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

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

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

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