FILE NUMBER

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FILE TITLE

BUDGET PAPERS 1989

1/2

FILE BEGINS 08/03/1989 ENDS 13/03/1989

ECONOMIC SECRETARY TO THE TREASURY

Moira

Economic section.

A few tiny amendments from me EST on the pages below.

Sheila
8/3

chex.md/mw/29 **BUDGET SECRET** REF: MPW/BS/89/5

COPY NO 5A OF 34

FROM: MISS M P WALLACE

DATE: 7 March 1989

SIR T BURNS

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

Sir A Battishill IR
PS/IR

Mr Unwin C&E
PS/C&E

Removal of discussion of adjustment of figures is definitely an improvement.

713

BUDGET STATEMENT: ECONOMIC SECTION

I attach the Chancellor's redraft of the Economic section of the speech. He would be grateful for quick comments, if possible to reach me by lunchtime tomorrow, Wednesday 8 March.

MPW.

MOIRA WALLACE

27. In a free economy, it is up to them to ensure that the temporary rise in inflation during the first half of this year does not lead to an unwarranted rise in pay and other costs. Any failure by industry to control its costs will only make the necessary reduction in the growth of nominal GDP more painful, not least in terms of employment prospects.

28. But over the medium-term, it is clear from experience over the past ten years that it is inflation that will come down, while steady growth will resume. Indeed, it is clear that over anything but the very short term, the use of fiscal and monetary policy to promote growth merely leads to inflation; whereas the use of macroeconomic policy to curb inflation, when coupled with the right supply side policies, produces sustainable real growth.

Monetary policy

29. Monetary policy, to which I now turn, plays and must always play, the central role in the battle against inflation. It is at the very heart of the medium-term financial strategy, the 10th Edition of which I am publishing today.

30. I have already described the monetary tightening that has taken place over the past nine months. This has lead to a sharp deceleration in the rate of growth of the target aggregate, M0, although for 1988-89 as a whole it is likely to have grown at some [2] percentage points above its target range.

31. For 1989-90, the target range will be 1-5 per cent, as envisaged in last year' MTFS. Although starting the year above the top of that range, its very low growth over the past six months - some $2^1/_2$ per cent at an annualised rate - suggests that it will soon come back within it. The exchange rate is also of particular importance in the conduct of monetary policy. The Government's clear commitment not to accommodate increases in domestic costs by exchange rate depreciation remains a key safeguard against inflation. It has recently been demonstrated in the markets by our readiness to make use of the massive reserves we have accumulated. In this context, we will continue to work with our G7 partners to maintain the exchange rate stability that has been a feature of the past two years.

zero growth since Oct?

32. As for the past [three] years, there is no target for the growth of broad money, or liquidity, but it will continue to be taken into account.

39. Nothing like this has ever been achieved since the War. And no other major country enjoys a comparable budget surplus. It has not been easy, even though we were assisted in the year now ending by a combination of an extra £2 billion of privatisation proceeds, and by the exceptional buoyancy of the economy, which both boosted tax receipts and reduced public expenditure well below the planned level. As a result, total public debt as a proportion of GDP is now lower than at any time since before the First World War.

40. Moreover, the substantial repayment of public debt over the past two years has permanently reduced the burden of debt servicing, both now and for future generations. For the coming year, for example, the debt repayments of the last two years mean that debt interest costs are lower by £[X] billion a year. Indeed, debt reduction on this scale means that in this year's Finance Bill I shall have to take a new power, not needed before, to enable gilts to be acquired by the National Loans Fund ~~NLF~~, for cancellation.

41. The dramatic improvement in the United Kingdom's public finances has also provided a welcome opportunity to devote more attention to the structure of the debt

if.mm/hpe14/6.3 **CONFIDENTIAL**

FROM: HUW EVANS
DATE: 8 MARCH 1989

MS WALLACE

cc Sir T Burns
Mr Sedgwick
Mr Hurst
Mr Ramsden

BUDGET STATEMENT: ECONOMIC SITUATION

Two comments:

(i) in the first sentence, it is not true that "throughout the world" inflation is edging up; "in most countries", or "virtually throughout the industrialised world" would be accurate. And add "significantly" after "edging up".

(ii) The debating point in the second sentence in paragraph 20 should be omitted because the comparison is only valid for that particular six months period; over twelve months, the rise in G7 inflation is only about ¾ per cent; compared to the UK's 1.8 per cent.

EVANS

Moreover, the comparison between UK RPI (ex MIPS) and the other G7 inflation is a bad one. Some other countries (all the G3) include imputed rent in their figures and if we included imputed rent in ours (and if we measured it using house prices) then the comparison would again be much less favourable to us. If we took out imputed rent from the inflation indices of the G3, then the current figure of 3.7 per cent for the G7 excluding UK would be a bit lower: we are pursuing.

poss?

HME

H P EVANS

mp.pc/Riley/099

CONFIDENTIAL

FROM: C J RILEY
DATE: 8 March 1989

RILEY

MISS WALLACE

cc Sir P Middleton
Sir T Burns
Mr Scholar
Mr Peretz
Mr Sedgwick
Mr A C S Allan
Mr Gieve
Mr Mowl
Mr Pickford

BUDGET STATEMENT : ECONOMIC SECTION

Some comments on the draft you circulated yesterday.

Paragraph 7

2. As a general statement about the role of fiscal policy, I find the third sentence rather too precise; the balanced budget comes later in the speech. I would therefore prefer to replace it by:

> "Fiscal policy is used to support monetary policy, limiting the burden of debt on the economy and the Government's claim on the nation's saving."

Paragraph 8

3. Isn't the final sentence somewhat of an own goal, making explicit the fact that we have made no progress on inflation since 1983? Have we used this formulation before? If not, I suggest:

> "Over the last six years it has averaged 5%."

Paragraph 11

4. Although the quality of investment has in all probability improved immeasurably, the dramatic improvement in profitability may be due in large part to other factors - scrapping of inefficient capital and shake out of labour in the early 1980s, improved working practices, above trend growth over the past two years, etc. I would therefore prefer to rephrase:

"And its quality has improved immeasurably, too: companies are now investing because it is profitable to do so, not because of the subsidies offered to them."

5. Colin Mowl is commenting on the figures in the section on public finances. Both the figures and, probably, the text will need to be changed when the Chancellor has made his final decisions on the PSDR.

C J RILEY

mg.ee/dlcp/8.3-mw

BUDGET SECRET

COPY NO. 1 OF 12.

From : D L C Peretz
Date : 8 March 1989

PERETZ

MISS WALLACE

cc PS/EST
Sir P Middleton
Sir T Burns
Mr Wicks
Mr Scholar
Mr Riley
Mr Sedgwick
Mr A C S Allan
Mrs Chaplin
Mr Tyrie

BUDGET STATEMENT : ECONOMIC SECTION

A number of points on the draft circulated yesterday. I give these in the order they appear in the draft, not in order of importance.

2. **Paragraph 7, second and third sentences.** Others will no doubt have comments on these two sentences. One minor difficulty with playing up monetary policy as the only cure for inflation is that it somewhat undermines the argument we have been advancing on EMU (including in the Chancellor's Chatham House speech) that a European monetary policy would have to be supported by a European fiscal policy. A possible reformulation would be :-

> "Inflation is a disease of money; and monetary policy the correct medicine. Fiscal policy is used to bring the public accounts into balance and keep them there, and thus support the process of re-establishing sound money."

3. **Paragraph 8.** Only a small point. Do you "stamp out" "forces", and do forces "rage"? How about inflationary "fires"?

4. **Paragraph 21.** The last two sentences are repeated later on in paragraphs 31 and 33. They could be deleted.

5. **Paragraph 23, penultimate sentence.** To say that MO has slowed down "appreciably" is a bit of an understatement. Why not "sharply"?

6. **Paragraph 30, second sentence.** The target for MO is for its 12 month growth rate, month by month. To avoid confusion I suggest the second half of the sentence might read :-

> " ... although on average during 1988-89 it has been some 2 percentage points above its target range."

7. **Paragraph 31, penultimate sentence.** This sentence is a bit high profile - and a break with the tradition of not commenting on intervention. The point could be made in another way as follows :-

> "We have accumulated massive reserves and are ready to use them as and when necessary. We will continue to work ..."

8. **Paragraph 32.** This looks a bit isolated where it is. If the sentence is to be retained I would suggest adding the words "in assessing monetary conditions" at the end, and then placing it after the second sentence of the present paragraph 31, starting a new paragraph with the next sentence beginning "The exchange rate is also ...".

9. **Paragraph 37.** There is I understand a problem with saying that "we started to repay the national debt". The national debt, as defined in the statistics, is a gross concept. The increase in the reserves in 1987-88 means that it actually increased quite sharply. Nor, I believe, can we even say that in 1987-88 we reduced the public sector's <u>net</u> debt. This is because valuation changes (eg to the sterling value of the foreign exchange reserves and foreign currency borrowing) outweighed repayments. I suggest either "and we had a debt repayment" or "and we moved into financial surplus".

10. **Paragraph 40.** For a similar reason I suggest inserting the word "net" before "repayment" in the first sentence and before "debt interest costs" in the second sentence. Partly for accuracy, can we amend the last sentence to read :-

> "Indeed, <u>continuing</u> debt reduction on this scale means that in this year's Finance Bill I shall <u>be taking</u> a new power, not needed before, to enable gilts to be acquired <u>with money from</u> the <u>National Loans Fund</u>, for cancellation."

11. **Paragraph 41.** I suggest the following shorter version of the second sentence :-

DLCP:

> "We will continue to seek to minimise the cost of servicing the Government's domestic debt and to improve its quality by relying less on the more liquid borrowing instruments."

12. **Paragraph 42.** In the first sentence insert the words "and payable" after "denominated". This is one of the features that marks our ecu bills out from other countries'. The second sentence should begin :-

> "The initial series of six monthly tenders for these bills has proved ..."

We do not need to specify the period for which the programme will continue (see separate submission today from Miss O'Mara).

D L C PERETZ

SCHOLAR

COPY NO 6 OF 8 COPIES

FROM M C SCHOLAR
DATE 8 MARCH 1989

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Peretz
Miss Wallace

BUDGET STATEMENT: ECONOMIC SECTION

You asked for comments.

2. I like the sober note right at the beginning as in your paragraph 1. But there is each year an overriding need to bear down on inflation, and 'bear down' seems very flat for the opening sentence. I suggest instead:-

MCS new 1

"This year's Budget comes at a time of concern, worldwide and at home, that the forces of inflation are beginning to gain ground again for the first time this decade. Against this background we must be more than ever vigilant, and more than ever resolute in our efforts to combat inflation, whenever and wherever it occurs.

2. It is only by doing this ..."

3. Paragraph 7 line 6 delete "complete" and substitute "to provide vital support for".

4. Paragraph ~~4~~ 9 line 2 delete "less progress was made in improving" and substitute "we saw no immediate results in our efforts to improve".

5. Delete last sentence of paragraph 16, which interrupts the flow?

6. I suggest a re-ordering and rewording (too many "pick-ups" at present) of paragraphs 19 and 20 in order to provide cover for the deduction of mortgage interest payments from the RPI, as follows:-

MCS new 19 +20

"19. But there has also been some increase in inflation, at home and worldwide. Indeed, the rate of inflation in the rest of the Group of 7 major industrialised countries has, over the past six months, risen slightly more rapidly than in Britain, if we exclude, as all the other countries except Canada do, mortgage interest payments from the comparison. On this basis the RPI, which rose by 5¼ per cent in 1983, increased by 4½ per cent last year; but the rate picked up markedly throughout the year, and the most recent figure is 5½ per cent."

7. Insert comma after 'means' in line 2 of paragraph 21.

✓ 8. No need for the last two sentences of paragraph 21 in view of paragraph 33. But if, instead, you keep paragraph 21 as it is and shorten paragraph 33, delete "the struggle" in the antepenultimate line and substitute "our achievements in the battle".

9. Paragraph 23 4 lines from the bottom "sharply" instead of "appreciably".

10. The bracketed words in the first line of paragraph 24 p8 might better be omitted. If they are retained you need "including mortgage interest payments" after "5½ per cent" in the penultimate line.

11. I think it will seem paradoxical to many to say that the Government has no objective as regards a hard or soft landing for the economy. Your point would not be diminished if this sentence were omitted.

12. Delete one of the "it is clear"s from paragraph 28.

13. Wouldn't paragraph 33 be better inserted after the second sentence of paragraph 31, to bring both the monetary aggregates together? You could then start a new paragraph on the exchange rate "The exchange rate is also of particular ...".

14. I can see why you have omitted the tax reference in the sterling capital markets section. But, as it stands, this section leaves out the most important part of the liberalisation (opening up the market for sterling issues). I suggest you add:

MCS
1 after
§35

> "This new freedom will be enhanced by a further, important, set of deregulatory measures for the sterling capital market which are being promulgated today in notices issued by the Bank of England. These measures will open up the market for sterling paper of less than 5 years' maturity by extending the range of institutions which can make such issues; and they will create a unified regime for all these issues.
>
> Taken together the changes I have described constitute a major liberalisation of the arrangements for London's capital markets. They will give issuers greater flexibility and investors wider choice."

Or if you want something shorter you could model it on the section we put in the note for the Queen ~~(attached)~~ below.

15. Paragraph 39 last sentence. Delete "As a result".

16. Paragraph 42. Delete the hyphen in "six-monthly". The Bank would prefer the last sentence to read:

> "The initial series of six monthly tenders for these bills has proved extremely successful, and I can today inform the House that this is an innovation that we plan to continue."

The point of this change is not to give an amount (to give ourselves flexibility to increase it if necessary). I think you could retain your own wording if you prefer; but it would be best to leave out the amount, or at least not to fix it to a period of time for it.

D. Cane

pp M C SCHOLAR

Capital Markets liberalisation

I shall be announcing on Budget day a substantial liberalisation of the London sterling capital market. I am abolishing the queue for bond and equity issues which has been operated by the Bank of England since 1946, opening up the market for sterling paper and at the same time simplifying its regulatory regime. I am also making some consequential changes in the taxation of deep discount and other bonds. Taken together all these changes ~~should~~ will give greater flexibility to those who issue capital in London; and wider choice to those who invest here.

cst.ps/4jm8.3/mins

JM/89/2

0453

BUDGET SECRET

COPY NO 1 OF 9 COPIES

FROM: CHIEF SECRETARY
DATE: 8 March 1989

CHANCELLOR

cc: Financial Secretary
Paymaster General
Economic Secretary
Mrs Chaplin
Mr Tyrie
Mr Call

BUDGET STATEMENT ECONOMIC SECTION

I like the latest draft although it has a sombre feel. The anti inflation and prudence messages come through strongly. So does the fact that our current inflationary problem exists elsewhere as well and that our public finances are very strong.

2. Several points:

Paragraph 17: I would delete "another name for errors and omissions" and replace with "which may well mean we have been under recording exports and over recording imports."

Paragraph 26: I think the first sentence is open to wilful misinterpretation. I would delete it or amend as follows:

"But the question of how "soft' or "hard" the landing is as we get the economy back on track is not wholly within the control of Government".

Or alternatively: "But the impact of slower growth on real output and jobs is not a matter which the Government alone can determine".

A wider question is whether we want to raise the spectre of a hard landing. On balance I would prefer not to.

Paragraph 32

This sounds a bit dismissive. Perhaps:

"As for the past 3 years, I will continue to take into account the growth of broad money, or liquidity, but I see no need to set a target for it".

JOHN MAJOR

rc 1989/8.3.02

BUDGET CONFIDENTIAL

FROM: ROBERT CULPIN
DATE: 8 March 1989

MISS WALLACE

SPEECH: PEPS

My only point on PEPs (from last night) is that they are pretty well the first highlight in the tax section; the TV and radio pundits will have to say something about them; raising the overall limit sounds boring, because not many people are up against it; so the best bet is to play up the relaxation for unit and investment trusts. We could do with a few unit and investment trust people welcoming it. So it might help if the Chancellor said something nice about them. Draft attached.

ROBERT CULPIN

chex.pj/jc/8.3.1

BUDGET SECRET

COPY NO 1 OF 10

FROM: MRS JUDITH CHAPLIN
8th March 1989

MISS M WALLACE

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

CHAPLIN

BUDGET SPEECH: ECONOMIC SECTION

I am worried by the wording of the first two paragraphs. It is clearly important to set the whole Budget in the context of the control of inflation but, as written at the moment, it reads as though this is a new policy rather than a continuing one. It therefore invites the sort of comment that the Chancellor is a late convert to the importance of inflation and is making recompense now for the mistakes of last year's Budget. I think the paragraph should be framed more in terms of a continuing policy, for example by replacing "over-riding" with "continuing" or by putting a sentence at the beginning of the second paragraph such as:

> "The control of inflation is, as it has always been, a key element of this Government's policy."

2. **Paragraph 6:** I think the second sentence is a bit cavalier. It needs the thought that the Government is vigilant and prepared to act on changes in economic indicators before the dismissal of instance responses.

3. **Paragraph 7:** The third sentence gives a very definite and limited role to fiscal policy - is that right?

4. **Paragraph 9:** I think it might be worth stressing the real world changes that have taken place by inserting a paragraph after paragraph 9, something along the lines of:

"The fundamental changes that have taken place in business in this country are too often forgotten: modernising work practices, improving industrial relations, better marketing, and ..."

It would put in perspectives businesses' concerns about higher interest rates and give them a pat on the back.

5. **Paragraph 11:** Would it be sensible to point up the reason why increased investment bodes well for the future, for example by inserting after "twice as fast as consumption" "creating the increased capacity necessary to meet future demand. Total business investment ....".

6. **Paragraph 13:** Is it worth getting in the plus point that underlying resilience of the economy was under-estimated by just about everyone?

7. **Paragraph 20:** A small point: the second sentence needs "here" after "probably risen" to make it clear.

8. **Paragraph 22:** I think this paragraph should have the thought in it that precisely because the policy is well targeted and working it is unpopular.

9. **Paragraph 23:** Monetary growth, the slowdown of which is mentioned later anyway, sticks out rather oddly as more technical between the housing market and retail sales.

10. **Paragraphs 26/27:** If I were a businessman reading these two paragraphs I would say my costs had shot up because my interest charges had risen. I think therefore the speech needs a paragraph, after paragraph 25, giving figures of the investment intentions in the coming year, that they are holding up well and the reasons why industry's investment decisions are less affected by interest rate rises now. Paragraph 26 could then go on "but ultimately the question ...".

11. **Paragraph 27:** The first sentence seems to me to be dangerous - it could well be argued that the Government allowed the temporary

rise in inflation during the first half of this year which has caused the pressure for higher pay rises. I would put the thought more neutrally:

> "It is essential that business and industry do not allow unwarranted rises .....".

12. **Paragraph 28** is very unclear and does not follow on from paragraph 27. Presumably it is saying that if industry controls their costs, and if Government controls inflation, steady growth will resume; that the post-war consensus that Government could act directly to promote growth through fiscal and monetary policy merely led to inflation and that the new strategy of using macro economic policy to curb inflation, coupled with the right supply side policies, produces real growth. It is certainly important to have a summing-up paragraph stressing the change of policy and then the consistent pursuit of that policy - control of inflation and supply side improvement - but at the moment the Mais lecture in one paragraph is a bit garbled.

JC

JUDITH CHAPLIN

BUDGET CONFIDENTIAL

H.M. CUSTOMS AND EXCISE
DEPARTMENTAL PLANNING UNIT
NEW KING'S BEAM HOUSE, 22 UPPER GROUND
LONDON SG1 9PJ
01-620 1313 Ext 5059

UN-LEADED INTER-NATIONAL COMP-ARISONS

FROM: ALISON FRENCH
Departmental Planning Unit

DATE: 9 March 1989

MISS WALLACE

UNLEADED PETROL: INTERNATIONAL COMPARISONS

1. We spoke this morning and you asked for further information about unleaded petrol differentials in the European Community. The attached annexes show, respectively, tax and price differentials between unleaded and 4 star petrol in those other EC member states for which information is available.

2. Annex 1 shows that we can state with confidence that the UK will have the second highest tax differential in the EC behind Denmark).

3. Annex 2 puts us fourth in the EC league as far as price differentials are concerned. On that basis the proposed statement in the Budget speech that "we will have one of the most substantial differentials between the price of leaded and unleaded petrol in the EC" seems reasonable. But I should stress, first, that the price information is less reliable than that on tax and, secondly, that it is liable to fluctuate (indeed individual price differentials - though not our position in the league - have changed over the past fortnight,

(just)

Circulation: PS/Economic Secretary
Mr Scholar
Mr Culpin
Mr Michie

CPS
Mr Jefferson Smith
Mr Wilmott
Mr Gaw
Mr Allen
Mr Broyd

since the previous set of figures were published). Given that our differential looks little different from those shown for the fifth and sixth countries in the league, it might be safer to stick to comparisons in tax rather than price terms.

Alison French
ALISON FRENCH
Departmental Planning Unit

ANNEX 1

LEADED/UNLEADED TAX DIFFERENTIAL IN EC MEMBER COUNTRIES

	TAX DIFFERENTIAL (including VAT) BETWEEN UNLEADED AND 4 STAR PETROL	
	pence/Litres	pence/Gallons
Denmark	3.92	17.81
UK	3.11	14.16
Germany	2.85	12.95
Netherlands	2.23	10.15
Belgium	1.87	8.50
Luxembourg	1.68	7.62
Greece	0.94	4.28
Ireland	0.83	3.78

(1) Exchange rates as at 8 March 1989

(2) France, Italy, Portugal and Spain have no preferential rate of duty for unleaded petrol.

ANNEX 2

LEADED/UNLEADED PRICE DIFFERENTIALS IN EC MEMBER COUNTRIES

	Premium Price	Unleaded Price	Differential
	pence per litre		
Germany	37.6	33.3	4.3
Denmark	55.5	51.9	3.6
Luxembourg	32.5	29.2	3.3
UK	38.8	36.7	2.1
Netherlands	46.0	44.0	2.0
Belgium	40.4	38.6	1.8
Ireland	49.1	49.1	0.0
Italy	58.1	59.2	-1.1

eh? There must be an explanation!

1) Exchange rates as at 8 March 1989

2) Source: Petroleum Times Price Report March 3 1989

3) UK unleaded price adjusted to take account of Budget changes.

4) Figures for France, Greece, Portugal, Spain unavailable.

a v. simple one: unleaded costs more to manufacture. So it does if we tax it in its former, & we will be in a position to reduce the price when we can

ANNOTATED

chex.md/mw/29 BUDGE

COPY NO 19 OF 35

FROM: MISS M P WALLACE
DATE: 9 March 1989

SIR T BURNS

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

Sir A Battishill IR
PS/IR

Mr Unwin C&E
PS/C&E

Ch/ other pencil comments are mine. Everyone else's in pen.

Ch

My comments marked. If it's easier, send them back & Mossa can incorporate them in the consolidated annotations.

MPW. 10/3

Many thanks.
I have read quickly. Comments in principle. Will go back for more details & refinements.

BUDGET STATEMENT: ECONOMIC SECTION

The Chancellor was grateful for the comments he has had on the version of the Economic section of the speech circulated with my minute of 7 March.

... 2. I now attach his revised version. He will be working further on it during the day tomorrow and will want to show a near

final version to the Prime Minister in the evening. He would be grateful if final comments, could reach me by lunchtime tomorrow, Friday 10 March.

MOIRA WALLACE

BUDGET SPEECH - FIRST SECTION

The background to this year's Budget is the continuing need to combat inflation, at a time when, throughout the world, it is unmistakably edging up again.

This is a very down-beat opening.

v. sombre

JG: building on

2. It is only by doing this, whatever the short-term difficulties, that we can be sure of preserving the great gains we have made in this country over the past ten years, gains which offer the prospect of an even better future.

3. I shall begin, as usual, with the economic background to the Budget, I shall then deal with monetary policy and the public sector finances. Finally, I shall propose a number of measures to carry forward the process of tax reform.

4. As usual, the Financial Statement and Budget Report, together with a number of Press Releases filling out the details of my [tax] proposals, will be available from the Vote Office as soon as I have sat down.

[COBO, NICs, bills - cd omit, have on some occasions in past]

optional →

[I start with the economic background]

5. The Government's first ten years in office have seen a transformation both in the way in which economic

What about the national plan (64) says J. Ansar: "nominal" wd distinguish

policy is conducted, and in the results that have been achieved.

This Govt has been the first to set ← SJP

6. [For the first time,] economic policy has been set firmly and explicitly in a nominal medium-term context. We stand ready to act and act decisively whenever inflationary pressures [threaten to] re-emerge. [But that is within] the We have adhered to basic philosophy that the Government should set a sound medium-term financial framework and leave the private sector free to operate with confidence within it. [But] in the short term

now v. compressed doesn't follow entirely clearly. I suggest re-ordering PNS

7. The Government came to office with two central objectives - to defeat inflation, and to breathe new life into a moribund economy - and a clear idea of how to achieve those objectives [them]. Inflation is a disease of money; and monetary policy is its cure. The role of fiscal policy is [used] to bring the public accounts into balance and keep them there, and thus provide vital support for the process of re-establishing sound money. [Within the context of sound money,] allowing markets [have to be allowed] to work again, and restoring the enterprise culture [restored], by [the removing removal of unnecessary restrictions and controls, by [the reform reforming of trade union law and promoting [promotion of] all forms of capital ownership, and by [the reform reforming and reducing and reduction of] taxation.

I don't like 'vital support' sounds like first aid, or a crutch. If we can't have buttress, how about": this is an essential part of the process ..."

And strong, steady and sustainable growth is achieved not through any artificial stimulus but by

RL: add privatisation / reduced role of state

(Just because I feel present paragraph skips past too quickly + risks underplaying point)

When we came to office it was X per cent + rising. But we brought it down dramatically, and

8. Our first and most urgent task was to stamp out the inflationary fires that had raged in the '70s, and wrought so much economic and social havoc. Between 1974 and 1979 inflation averaged over 15 per cent. Over the past six years, it has averaged under 5 per cent.

had

been much lower, ing

problems: SJP

This success created an entirely new economic climate to

AA

9. On the supply side, once business and industry recognised the fundamental changes that were taking place, they responded to the new economic climate with vigour and confidence. As a result, we have experienced the longest period of strong and steady growth since records began. Indeed, output in the United Kingdom has grown faster than in all the other main European nations during the '80s - a marked contrast to the previous two decades, when we were bottom of the league. And this growth has been based on a dramatic and sustained improvement in productivity, which for the economy as a whole has been second only to that of Japan among all the major nations during the '80s. In manufacturing it has exceeded even that of Japan.

productivity & growth

"this century?" AGT

SJP is checking.

mpw

mpw

mpw

MCS.

rapidly falling unemployment and

10. In Britain today we have more people in work than ever before, they are better motivated, and their living standards have improved beyond recognition. [add some numbers?]

in our history

mpw

mpw Alternative: This created an entirely new economic climate, and one to which business and industry responded with vigour and confidence

11. But it is not just our economic performance [over the past ten years] that has been transformed: so have our prospects for the future. For over the past seven years, investment has grown [more than twice] as fast as consumption, creating the increased capacity necessary to meet future demand. Total business investment is now a higher proportion of [national income GDP] than ever before. And its quality has improved immeasurably, too; as has the quality of British management. Hence the dramatic and long overdue improvement in company profits. And the total number of businesses is growing at the rate of [over 1,000 new companies] a week.

12. [So the outlook is good,] provided we remain firm in our resolve to get on top of inflation. And, at least on this side of the House, we do.

13. A year ago, in the aftermath of the worldwide stock market crash, it looked as if there would be some slowing down from the rapid growth of 1987. In fact that was not to be.

14. It now appears that we had in 1988 a second successive year of growth at $4^1/_2$ per cent - [the first time this has happened for 30 years] - with unemployment falling by [over] half a million to well

He agrees, but we'd drop the other one.

below the European average. This means, incidentally, that we have had four successive years of growth at 3 per cent or better, the first time this has ~~ever~~ occurred.

Too many of these comparisons get confusing

↑ PNS dislikes. CSO use GDP 86 = 2.9 as does compromise since the war (SJP - NB 1938-42)

15. Manufacturing output grew particularly rapidly, by more than 7 per cent, to a level well above the previous peak reached as far back as the first half of 1974.

done checking SJP

16. But total domestic demand probably also grew by getting on for 7 per cent, considerably faster than the economy's capacity to supply, mainly because of the boom in industrial investment, in itself a welcome event, but also because of continued strong growth in consumer spending. This last was financed to an unprecedented degree by borrowing, overwhelmingly mortgage borrowing. Of all borrowing by households, almost 85 per cent is accounted for by mortgages compared with under 5 per cent by credit cards.

lots of jargon

spending ?

On your last version you ringed this, and wrote STET. Did you mean it to stay? (My own view is that the point you are making will be not be appreciated by enough people. And it does rather spoil the flow.

17. Inevitably the rapid growth of total spending led to renewed inflationary pressure. To some extent this was diverted into a sharp rise in imports, and hence in the deficit on the current account of the balance of payments. This is officially recorded as having reached [£14 3/4] billion in 1988, although given the

a higher current account deficit

The [recorded / published] figures show this

or "... figures put this at X billion ..."

14 1/2.

15

[£15 1/4] billion positive balancing item - another name for errors and omissions - the true figure is almost certainly less than this. But whatever the true figure, it is undoubtedly a large deficit and a sharp increase on [the deficit] that recorded in 1987 after seven successive years of surplus.

mpw

I would restore the "but" - or "but the important thing is that

AA

18. [But] given sound policies it can readily be financed. Moreover, unlike previous current account deficits we have known in this country, it reflects not excessive Government borrowing a budget deficit, but rather [the excess of private sector investment over total private savings.] And this is something that will in due course correct itself.

a boom in private investment that has not been matched by private savings

however, as the House knows,

19. [But] there has also been some pick up in recorded inflation. Excluding the distorting effect of mortgage interest payments, the RPI rose by 4 1/2 per cent last year, much the same as the average over the previous five years. But the rate increased significantly through the year, and now stands at 5 1/2 per cent.

X

20. Moreover this pick up in inflation appears to be a worldwide trend. Taking the seven major industrial nations as a whole, inflation is now at its highest level for some three years, [and still heading upwards.]

(sets funny tone)

21. In the UK, as in a number of other countries, it became clear that it was necessary to tighten monetary policy sharply. This meant raising short-term interest rates, which I duly did, starting last June.

22. I am of course keenly conscious of the difficulties [for] many borrowers, particularly home owners, [caused by the rise in interest rates.] But however unwelcome high interest rates are, they are infinitely preferable to the damage that would be done by high inflation.

23. There are now increasing signs that the determined action I have taken is having the desired effect. The housing boom that played such a large part in the events of last year has subsided. Monetary growth has slowed down appreciably. And retail sales, too, seem to have levelled off over the past four months, presaging a gradual recovery in the personal savings ratio.

24. The outlook for 1989 is for inflation to rise a little further, from $7^1/_2$ per cent including mortgage interest payments to close to 8 per cent, before falling back in the second half of the year to $5^1/_2$ per cent in the fourth quarter and perhaps $4^1/_2$ per cent in the second quarter of 1990.

mpw Some

25. [A] slowdown in real growth is inevitable as we get inflation back onto a downward path - indeed, it has almost certainly already begun to happen. Overall growth is forecast to fall from the $4^1/_2$ per cent [recorded] last year to 2 per cent this year, with domestic demand growth also at 2 per cent. Within this, investment, which is holding up well, is once again forecast to grow faster than consumption. The current account deficit is forecast to remain at the same level as last year.

not recorded! PNS · growth 4½-year slowdown plan thus see TBT

2½ 2½

26. But the question of just how "soft" or "hard" the landing is as we get the economy back on track, is not in the hands of Government alone. The Government's task is to [reduce inflation by acting, through monetary policy, to bring down the growth of GDP in money terms.] The extent to which, over the short term, this is reflected in a reduction in inflation, and the extent to which it is reflected in slower output growth, is up to business and industry.

(do you land on a track?)

maintain sound money

['GDP in money terms' and 'nominal GDP' are v jargony - but I accept that my amendments do lose something for the cognoscenti & the MTFS]

27. The better industry succeeds in controlling its pay and other costs, the less painful the necessary [reduction in the growth of nominal GDP] will be, not least in terms of employment prospects.

that ?

adjustment

(can say otherwise)

28. But over the medium-term, it is clear from our experience over the past ten years that the policy we are pursuing will bring inflation down, and steady growth will resume. Indeed, over anything but the very short term, the use of fiscal and monetary policy to promote growth merely leads to inflation; whereas the use of macroeconomic policy to curb inflation, when coupled with the right supply side policies, produces real growth.

Monetary policy

29. Monetary policy, to which I now turn, plays and must always play, the central role in the battle against inflation. It is at the very heart of the medium-term financial strategy, the tenth edition of which I am publishing today.

30. I have described the monetary tightening that has taken place over the past nine months. This has already led to a sharp deceleration in the rate of growth of the target aggregate, M0.

31. For 1989-90, the target range for M0 will be 1-5 per cent, as envisaged in last year' MTFS. Although starting the year above the top of that range, its very

low growth over the past six months - under 3 per cent at an annualised rate - suggests that it will fairly soon come back within the range it. As for the past [three] years, there is no target for the growth of broad money, or liquidity, but I will continue to take it into account in assessing monetary conditions.

32. The exchange rate is of particular importance in the conduct of monetary policy. The Government's clear commitment not to accommodate increases in domestic costs by exchange rate depreciation remains a key safeguard against inflation. This has been demonstrated both by the level of interest rates and by our readiness to use the massive reserves we have accumulated. In this context, we will continue to work with our G7 partners to maintain the exchange rate stability that has been a feature of the past two years.

33. Short-term interest rates remain the essential instrument of monetary policy. I repeat what I have stated clearly on a number of previous occasions: interest rates will stay as high as is needed for as long as is needed to get on top of inflation.

Public Sector finances

34. I now turn to fiscal policy. When we first took office the public sector borrowing requirement was over 5 per cent of GDP - equivalent to ~~more than~~ £25 billion in today's terms.

35. This was steadily reduced over the years as a deliberate act of policy, until, by 1987-88, the PSBR had been eliminated altogether and we started to repay (the national) debt.

36. Accordingly, last year I budgeted for a further Public Sector Debt Repayment, or PSDR, of some £3 billion. In the event, it looks like turning out almost five times as large, at £14 billion, or 3 per cent of GDP. Even if there had been no privatisation proceeds at all, the public finances would still be in surplus, to the tune of some £7 billion.

37. Nothing like this has ever been achieved in the past 40 years. And no other major country enjoys a comparable budget surplus. It has not been easy, even though we have been assisted [in] this [in the] year [now ending] by the exceptional buoyancy of the economy, which both boosted tax receipts and reduced public expenditure

If you move better to change "as a result"

well below the planned level. As a result, Government debt as a proportion of GDP is now lower than at any time since the First World War.

All this means that

38. Moreover, the substantial net repayment of public debt over the past two years has permanently reduced the burden of debt servicing, both now and for future generations. For the coming year, for example, the debt repayments of the last two years mean that net debt interest costs will be lower by some £$1\frac{3}{4}$ billion a year. This saving is being put to good use, allowing extra spending on priority programmes within our overall public expenditure objectives.

39. The objective of funding policy remains unchanged: to achieve a full fund of the Government's borrowing requirement, which nowadays translates into using the Budget surplus to buy back ~~an equivalent amount of~~ DLCP Government debt. With the PSDR this year likely to be considerably larger than earlier expected, it may not be practicable to buy back sufficient longer term debt to meet the funding rule this financial year, in spite of innovations such as a reverse gilt auction. Any The (EST undershoot will therefore be carried forward into the next financial year. Because there are unusually heavy maturities of gilt-edged stock in 1989-90, this is unlikely to require any major change in the rate at which the Bank of England purchases gilts.

AGT: "after taking into account any underlying change in reserves"

JG
Too long

to meet our so-called 'funding rule' — though [in the 'Through the Looking Glass' world of a Budget surplus] this is strictly an 'unfunding' rule now.

40. The dramatic improvement in the United Kingdom's public finances has also provided a welcome opportunity to devote more attention to the structure of the debt that remains. We will continue to seek both to minimise the cost of servicing the Government's domestic debt and to improve its quality by relying less on the more liquid borrowing instruments.

41. We have also been able to restructure part of the Government's foreign currency debt, launching an innovative and cost-effective programme of Treasury Bills denominated and payable in ecu. The first series of six monthly tenders for these bills has proved very successful, and this is an innovation we plan to continue. / The programme will remain at around the current level for the time being.

[moved]

too long

42. Meanwhile, I am today adding one more entry to the long list of financial controls which we have swept away during our term of office. The last surviving relic of the post-War apparatus for the direction of capital by the State is the Control of Borrowing Order, which since 1946 has involved first the Treasury and then the Bank of England in giving consents for equity and bond issues in the capital markets. The Treasury has today made a General Consent [under the Control of Borrowing Order 1958,] so that it will no longer be necessary for

companies? [SJP - LA problem]

those who wish to make capital market issues to obtain the Bank of England's consent to the timing of such issues; and we will, as soon as possible, revoke the Order itself and repeal the legislation on which it depends, the 1946 Borrowing (Control and Guarantees) Act.

43. The sterling capital market has in recent times been going through a period of considerable adjustment, as the Government has changed from being a large issuer to a large purchaser of its own debt. I will have more to say about that in a moment. The abolition of the Control of Borrowing Order will remove an unnecessary and bureaucratic restriction on issuers of capital as they move into the space formerly occupied by the Government when it was a borrower.

44. This new freedom will be enhanced by a further, important, set of derogatorily measures for the sterling capital market which are being promulgated today in notices issued by the Bank of England. These measures will open up the market for sterling paper of less than 5 years' maturity by extending the range of institutions which can make such issues; and they will create a unified regime for all these issues.

45. Taken together the changes I have described constitute a major liberalisation of the arrangements for London's capital markets. They will give greater flexibility to issuers and wider choice to investors.

46. In last year's Budget Speech , I set out the principle of a balanced budget as a proper objective of fiscal policy, in these terms:

> "A balanced budget is a valuable discipline for the medium term. It represents security for the present and an investment for the future. Having achieved it, I intend to stick to it. In other words, henceforth a zero PSBR will be the norm. This provides a clear and simple rule, with a good historical pedigree."

47. It is a rule that ensures that, as GDP continues to rise, the ratio of public debt to GDP continues to fall, and with it the burden of debt interest. It ensures, too, that the State makes no claim either on the savings of the private sector or on flows of finance from overseas. But to go further than this, and seek to achieve the maximum possible repayment of public debt, would not be consistent with the Government's policy,

as it would mean deferring for a very long time the benefits of a reduction in the burden of taxation.

Rt ? which have already been earned by our great success in controlling public Expenditure.

See her minute.

48. So I reaffirm the principle of the balanced budget. However, given the substantial surplus we now have, the path of prudence and caution is clearly to return to balance not overnight, but gradually, over a period of years. Thus we can expect to have a number of further years of debt repayment ahead of us. Moreover, given the particular uncertainties there are at the present time, I believe it would be right to budget for 1989-90 for a surplus similar to that secured in the year now ending; in other words, a further public sector debt repayment, or PSDR, of some £14 billion. What this means is that it will not be possible in this Budget to reduce the burden of taxation; that is to say, to reduce taxation as a share of GDP.

NB "strikingly similar to last year" AGT.

chex.rm/mw/20

COVERING BUDGET SECRET
BUDGET LIST ONLY

TOP COPY

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

9 March 1989

Paul Gray Esq
10 Downing Street
LONDON
SW1

Dear Paul,

... I enclose, as promised, two copies of the latest draft of the taxation section. The Economic Section will follow tomorrow.

Yours,

Moira.

MOIRA WALLACE

Copy no 6 of 6
MPW/89/8

TAXPAYER CONFIDENTIALITY

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

2. As the House knows, the new official secrets legislation currently passing through Parliament is very much narrower in scope than the present Official Secrets Act. In particular, it does not cover information in the possession of either the Inland Revenue or Customs & Excise concerning the private affairs of specific taxpayers.

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

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

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

BUSINESS TAXATION

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

6. First, taxes on business.

7. Ever since the corporation tax reform I introduced in 1984, the rate of corporation tax for small companies, defined for this purpose as those with annual profits of less than £100,000, has been set at the basic rate of income tax, currently 25 per cent. Large companies, defined as those with profits of £$^1/_2$ million or more, pay the main rate of corporation tax of 35 per cent, one of the lowest rates of tax on company profits in the world. Between £100,000 and £$^1/_2$ million the average rate of tax gradually rises from 25 to 35 per cent.

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

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

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

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

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

13. Over the years I have received a number 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.

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

15. One of the many undesirable features of an income tax system with several higher rates was that since a taxpayer's marginal rate could well be very different in

different years, the question of which year income related to made a great deal of difference. This was true of Schedule E where the strict rule is that income is taxed in the year to which it relates, on an accruals basis.

16. For the vast majority of employees, this basis of assessment for Schedule E poses no problem. But for about half a million people, mainly directors, who do not receive all their income in the year to which it relates, it causes complications and often needless assessments and correspondence long after the tax year is over. It is also open to manipulation.

17. I therefore propose that income tax under Schedule E should in future be assessed on a receipts basis, with the simple principle that you pay the tax when you receive the income. This will have a transitional cost of £80 million in 1989-90 and £60 million in 1990-91, but in the long term it will yield both extra revenue and a significant saving in both taxpayer's time and Inland Revenue staff.

18. The reduction in the top rate of income tax to 40 per cent in last year's Budget also enables me to make a major simplification of the tax treatment of the

vast bulk of the incorporated sector of small businesses: those known as close companies - generally speaking, unquoted companies that are controlled by five or fewer people.

19. The rules for the so-called apportionment of close companies' income are notoriously complex, taking up some twenty pages of impenetrable legislation. These rules are no longer needed and I propose to abolish them. I believe that family businesses in particular will welcome this substantial simplification.

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

TAXES ON SAVING

21. I now turn to the taxation of saving.

22. The sharp decline in the ratio of personal saving to personal income, over the past two years in

particular has led to even more discussion than usual of the merits of providing greater tax incentives for personal saving.

23. Certainly it is desirable that, over the medium-term, we generate as a nation a level of saving sufficient to finance a high level of investment. But what matters for that is not personal savings alone, but corporate savings too, which are running at historically high levels, and public sector savings, which have been boosted by the move to budget surplus.

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

25. Above all, the role of tax reform is to encourage enterprise and improve economic performance in the medium term. It is wholly inappropriate as an answer to short term or cyclical phenomena. So for the taxation of savings, the Government's policy is clear. It is to

strengthen and deepen popular capitalism in Britain, by encouraging in particular wider share ownership.

26. I have a number of specific tax measures to announce today to that end.

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

28. 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.

29. Since then, however, the take-up of new PEPs has slowed down, not least as a result of the changed climate in the equity market which followed the October 1987 Stock Exchange crash.

30. So the time has come to improve and simplify PEPs and give them a new boost.

31. 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.

32. Second, within that, I propose to raise substantially the amount that can be invested in unit trusts or investment trusts. For many small savers, these provide an excellent introduction to shareholding. At present PEP investors may only place £540 a year, or a quarter of their PEP, in unit or investment trusts. I propose to more than treble this amount, to £2,400 a year; and I propose to allow the whole of a PEP to be invested in unit or investment trusts, up to this limit. To qualify for tax relief, the unit or investment trusts will be required to invest wholly or mainly in UK equities.

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

34. Finally, I propose to make a number of important simplifications to the PEP rules so as to make the

scheme more flexible, better directed to the needs of small and new investors, and cheaper to administer.

35. I am confident that the changes that I have announced today will enable personal equity plans to play an important part in stimulating the spread of ownership of British equities in the years ahead.

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

37. 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 some $1\frac{3}{4}$ million employees. At present the annual limits on the value of shares which can be given under all-employee profit-sharing schemes are £1,250 or 10 per cent of salary up to a ceiling of £5,000. I propose to raise these cash limits to £2,000 and £6,000 respectively.

38. Second, I propose to increase the monthly limit on contributions to all-employee save-as-you-earn share option schemes from £100 to £150, and at the same time to double the maximum discount from market value at

which options may be granted from 10 per cent to 20 per cent.

39. Third, a number of my Hon. Friends have been concerned that current tax law may be inhibiting the development of employee share ownership plans, otherwise known as ESOPs. These are distinguished from ordinary approved employee share schemes by the fact that they use a wider variety of finance, acquire more shares and tend to operate on a longer timescale. I propose to make it clear that companies' contributions to ESOPs qualify for corporation tax relief, provided they meet certain requirements designed to ensure that the employees acquire direct ownership of the shares within a reasonable time. I hope that this will encourage more British companies, particularly in the unquoted sector, to consider setting up ESOPs.

40. Those firms with employee share ownership schemes have no doubt that giving the workforce a direct personal interest in their profitability and success improves the company's performance. The same benefits flow from profit related pay.

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

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

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

44. Taken together, the package of measures I have announced to encourage wider share ownership in general, and employee share ownership in particular, will help to ensure that the idea of a share-owning democracy becomes

ever more entrenched as a part of the British way of life.

45. Last June, the Inland Revenue issued with my authority a major consultative document on the taxation of life assurance.

46. The tax regime for life assurance is sui generis. The present system dates back to the First World War and has developed over the years in a piecemeal way, leading to a state of affairs in which the incidence of tax is extremely uneven, with some successful life offices paying no tax at all.

47. 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.

48. , I have considered very carefully the representations the industry has made, and taken full account both of the changes to the regulation of life assurance proposed by the Securities and Investment Board under the Financial Services Act and the prospects for increased competition within the European Community after 1992. In the light of these factors, I have

decided not to proceed with the more radical reforms canvassed in the consultative document. But I do have a number of important changes to propose, based for the most part on the general tax reform principle of seeking lower rates on a broader base.

49. First, many life offices run a pension business alongside their main 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 business, thus giving their life profits unduly favourable tax treatment. The life offices themselves have accepted that this treatment is anomalous and I propose to end it.

50. This change, along with some minor related changes, will come into force on 1 January 1990, and will yield some £150 million in 1990-91. The remainder of the changes I have to propose constitute a broadly balanced package which, because of the transitional provisions, will reduce the taxation of life assurance in 1990-91 by some £100 million.

51. I propose that the expenses incurred by life offices in attracting new business should continue to be

fully deductible for tax purposes from the income and gains of life funds, but should in future be spread over a period of seven years. To give the industry time to adjust, this change will be phased in gradually over the next four years, starting on 1 January, 1990.

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

53. But I can say here and now that I propose, as from 1 January 1990, to abolish Life Assurance Policy Duty. And I also propose, from the same date, that the rate of tax payable on the policyholder's share of 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, should be reduced to the basic rate of income tax.

54. The net effect of all these changes to the taxation of life assurance will be a cost of £20 million in 1989-90 and a yield of £45 million in 1990-91, rising somewhat in subsequent years.

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

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

57. I now turn to pensions.

58. The tax treatment accorded to pension schemes is quite rightly particularly favourable; and the extent of this privilege has to be circumscribed by Inland Revenue rules. So pension schemes only qualify for tax relief if they meet certain conditions, notably that the pension paid may not exceed two-thirds of final salary:

and if they fall foul of any of these rules, they lose all relief.

59. This has the perverse result that tax law effectively constrains the overall pension an employer can pay his employee. This is neither desirable nor necessary. Accordingly, I propose to make it possible for employers to provide whatever pensions package they believe necessary to recruit and reward their employees.

60. However, while it is clearly right that employers should be free to provide whatever pension they see fit, it would not be right to make the present generous tax treatment available with no upper limit at all. I therefore propose to set a limit on the pensions which may be paid from tax-approved occupational schemes, based on final salary of £60,000 a year.

61. 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.

62. The new ceiling will apply only to pension schemes set up, on or after today, or to new members joining existing schemes after 1 June. And, as I have already said, there will now be complete freedom to provide benefits above the Inland Revenue limits, though without the tax relief.

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

64. I also propose to simplify very substantially the rules concerning additional voluntary contributions to pension schemes, or AVCs. In particular, the present requirements for free standing AVCs place a heavy administrative burden on employers. These requirements will be greatly reduced. Indeed, in many cases employers will not need to be involved at all.

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

This will remove the penalty on good investment performance.

66. 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.

67. First, I propose to make it easier for people in personal pension schemes to manage their own investments.

68. Second, I propose to increase substantially the annual limits, as a percentage of earnings, on contributions to personal pensions for those over the age of 35. 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 in relation to occupational schemes. The new limits will be subject to an overall cash ceiling based on earnings of £60,000, corresponding to the new ceiling for occupational pensions, and similarly indexed.

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

69a. Coupled with the changes I made in 1987, this is as far as I wish to go in amending the tax treatment of pensions.

70. Finally, on the taxation of saving, it should not be overlooked that a far-reaching reform which I announced in last year's Budget, to come into effect in April 1990, is relevant in this context.

71. I refer to Independent Taxation. For there can be little doubt that one of the greatest disincentives to saving in the present tax system is the treatment of the savings of married women. At present a wife's income from savings has to be disclosed to her husband and taxed at his marginal rate. Independent Taxation will change all that. In particular, those married women who have little or no earnings will in future have their own personal allowance to set against their savings income. Independent Taxation may well do much to encourage the growth of personal saving in this country.

TAXES ON SPENDING

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

73. As the House knows Her Majesty's Government are obliged to implement the European Court's judgement that certain of our zero rates of VAT on supplies to business, notably on non-residential construction, but also on fuel and power and on water, are not lawful. This derives from the Court's interpretation of the Community's Sixth VAT directive to which the UK agreed in 1977. The necessary changes will be introduced in this year's Finance Bill, and draft clauses have already been published.

74. In implementing the judgement I have sought to do as much as possible to minimise the burden. From 1 April VAT will be payable in respect of all non-residential construction unless carried out under a agreements entered into before the court ruling. And from 1 August landlords will have the option to tax rents, which means that in most cases no extra VAT will be paid at all.

75. These measures will reduce the burden of VAT on construction so far as the private sector is concerned to just £35 million in 1989-90 rising to £110 million in 1992-93. Without them the yield from VAT on construction in the private sector would have risen to £450 million. There will also be a yield of £250 million from construction carried out for the public sector, and the public sector programmes concerned have already been protected by compensatory adjustments where necessary.

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

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

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

79. I also propose to relieve from car tax cars leased to the disabled. This is equivalent to an overall saving of about £400 on each vehicle leased to a disabled person.

80. I also propose to allow the present rules on tax relief for membership subscriptions paid by covenant to heritage and conservation charities. If the member is given the right of full entry to view the charity's property, that benefit will be ignored in determining whether relief is due. This will be of particular benefit to organisations such as the National Trust.

81. But in general, I continue to believe that the best way of helping charitable causes through the tax system is by directly encouraging the act of charitable giving. The Payroll Giving Scheme, which I introduced in my 1986 Budget, has been growing steadily. Some 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 for tax relief. I now propose to double that limit to £480, or £40 a month.

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

83. I now turn to the excise duties.

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84. The damage to the environment in general, and to child health in particular, from lead in the atmosphere, and the contribution of ordinary leaded petrol to this problem, is increasingly widely known. The government is committed to phasing out leaded petrol altogether, and in successive Budgets I have sought to assist this. I first introduced a tax differential in favour of unleaded petrol in 1987, and increased it last year. But although sales are undoubtedly rising, unleaded petrol still accounts for only some 5 per cent of total petrol sales, even though two-thirds of the cars now on

the road could use it, either without any adjustment or else with a conversion costing only some £20 or so.

85. 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 usually is. Others wrongly imagine that their car's performance would suffer were they to use unleaded fuel. Many are under the false impression that, if they do switch to unleaded petrol, their cars will no longer be able to use leaded petrol.

86. 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 nearly fourpence a gallon. If this reduction is fully passed on to the customer - and I look to the oil companies to see that it is - it means that the price of unleaded petrol at the pump will generally be getting on for tenpence a gallon, or just over twopence a litre, cheaper than four star leaded petrol. This will be one of the most substantial differentials between the price of leaded and unleaded petrol within the European Community.

87. But I do not intend to stop there. I also propose to raise the tax on two and three star petrol, so that the pump price of these grades will be at least as high as that of four star. This should encourage garages to phase out two star petrol, which is already down to about 6 per cent of the total market, thus enabling them to switch storage capacity to unleaded petrol - quite apart from the incentive to the remaining two-star users to switch to unleaded fuel.

88. 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.

89. They will of course also lead to a loss of revenue of some £40 million in 1989-90. I propose to recoup this from Vehicle Excise Duty. A the present time a bus or a coach has to have 66 seats before it pays as much in Vehicle Excise Duty as a family car. I propose to rectify this anomaly by increasing the tax rates of this group of vehicles so that they cover their track costs. I also propose to increase the rates of duty for the heaviest non-articulated lorries, to put them on a more equal footing with articulated lorries. These changes

will also simplify the system, greatly reducing the number of separate rates of Vehicle Excise Duty.

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

TAXATION OF INCOME

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

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

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

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

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

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

97. In the case of gifts of personal belongings, these benefit from chattels relief, under which any items worth less than £3,000 on disposal are entirely exempt from capital gains tax. I propose to double the chattels exemption limit to £6,000.

98. Lastly, on capital gains tax, I propose 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.

99. To return to income tax, I propose to raise all the main income tax thresholds and allowances by the statutory indexation factor of 6.8 per cent, rounded up. Thus the single person's allowance will rise by £180 to £2,785, and the married man's allowance will rise by £280 to £4,375. The basic rate limit will rise by £1,400 to £20,700.

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

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

102. The income limit for the age allowance will rise by £800 to £11,400, again in line with indexation. However, I propose to reduce the rate at which the age allowance is withdrawn above this income limit. I propose that in future it should be withdrawn at the rate of £1 of allowance for each £2 of income above the limit, instead of the present rate of £2 in every £3. This means that the marginal tax rate for those in the withdrawal band will be reduced to well below 40 per cent, thus meeting a large number of representations I have received over the past year.

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

104. I have one further change to make to help pensioners. Under the earnings rule, any pensioner who decides to continue to work after reaching the statutory retirement age has his or her pension docked at a rate of 50 per cent on every £1 earned between £75 and £79 a week, rising to 100 per cent for every £1 earned over £79 a week. This rule applies until he or she has reached give years beyond the State pension age.

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

106. That is precisely what we shall do. My Rt.Hon Friend the Secretary of State for Social Services and I have agreed that the pensioners' earnings rule should be abolished from the beginning of October, the earliest practicable date. The necessary legislation will be included in the Social Security Bill currently before the House.

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

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

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

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

NATIONAL INSURANCE CONTRIBUTIONS

111. I have one further measure to propose.

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

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

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

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

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

essential feature of the contributory principle. But my proposals will more than halve this step, to only 86 pence a week in 1989-90.

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

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

118. The new system will take effect from the beginning of October, the earliest practicable date. The cost will be £1 billion in 1989-90 and £2.8 billion in 1990-91. The necessary legislation will be included in the Social Security Bill currently before the House.

119. The total additional cost of all the measures in this Budget, on an indexed basis, is under £2 billion in 1989-90 and £$3^{1}/_{2}$ billion in 1990-91.

[PERORATION]

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COPY NO 5A OF 35

FROM: MISS M P WALLACE

DATE: 9 March 1989

SIR T BURNS

Two tiny points where paper folded. Strangely – no specific reference to the 1 million fall in unemp. PBL 9/3

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

Sir A Battishill IR
PS/IR

Mr Unwin C&E
PS/C&E

BUDGET STATEMENT: ECONOMIC SECTION

The Chancellor was grateful for the comments he has had on the version of the Economic section of the speech circulated with my minute of 7 March.

... 2. I now attach his revised version. He will be working further on it during the day tomorrow and will want to show a near

well below the planned level. As a result, Government debt as a proportion of GDP is now lower than at any time since the First World War.

38. Moreover, the substantial net repayment of public debt over the past two years has permanently reduced the burden of debt servicing, both now and for future generations. For the coming year, for example, the debt repayments of the last two years mean that net debt interest costs will be lower by some £1 3/4 billion a year. This saving is being put to good use.

39. The objective of funding policy remains unchanged: to achieve a full fund of the Government's borrowing requirement, which nowadays translates into using the Budget surplus to buy back an equivalent amount of Government debt. With the PSDR this year likely to be considerably larger than earlier expected, it may not be practicable to buy back sufficient debt to meet the funding rule this financial year, in spite of innovations such as a reverse gilt auction. Any The undershoot will therefore be carried forward into the next financial year. Because there are unusually heavy maturities of gilt-edged stock in 1989-90, this is unlikely to require any major change in the rate at which the Bank of England purchases gilts.

those who wish to make capital market issues to obtain the Bank of England's consent to the timing of such issues; and we will, as soon as possible, revoke the Order itself and repeal the legislation on which it depends, the 1946 Borrowing (Control and Guarantees) Act.

43. The sterling capital market has in recent times been going through a period of considerable adjustment, as the Government has changed from being a large issuer to a large purchaser of its own debt. I will have more to say about that in a moment. The abolition of the Control of Borrowing Order will remove an unnecessary and bureaucratic restriction on issuers of capital as they move into the space formerly occupied by the Government when it was a borrower.

44. This new freedom will be enhanced by a further, important, set of derogatory measures for the sterling capital market which are being promulgated today in notices issued by the Bank of England. These measures will open up the market for sterling paper of less than 5 years' maturity by extending the range of institutions which can make such issues; and they will create a unified regime for all these issues.

45. Taken together the changes I have described constitute a major liberalisation of the arrangements for London's capital markets. They will give greater flexibility to issuers and wider choice to investors.

46. In last year's Budget Speech , I set out the principle of a balanced budget as a proper objective of fiscal policy, in these terms:

> "A balanced budget is a valuable discipline for the medium term. It represents security for the present and an investment for the future. Having achieved it, I intend to stick to it. In other words, henceforth a zero PSBR will be the norm. This provides a clear and simple rule, with a good historical pedigree."

47. It is a rule that ensures that, as GDP continues to rise, the ratio of public debt to GDP continues to fall, and with it the burden of debt interest. It ensures, too, that the State makes no claim either on the savings of the private sector or on flows of finance from overseas. But to go further than this, and seek to achieve the maximum possible repayment of public debt, would not be consistent with the Government's policy,

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Mark

EST is comments when I will minute out this afternoon. Jonathan 10/3

TAXPAYER CONFIDENTIALITY

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

2. As the House knows, the new official secrets legislation currently passing through Parliament is very much narrower in scope than the present Official Secrets Act. In particular, it does not cover information ~~in the possession of~~ either the Inland Revenue or Customs & Excise ~~concerning~~ their private affairs ~~of specific taxpayers~~.

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

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

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particular has led to even more discussion than usual of the merits of providing greater tax incentives for personal saving.

23. Certainly it is desirable that, over the medium-term, we generate as a nation a level of saving sufficient to finance a high level of investment. But what matters for that is not personal savings alone, but corporate savings too, which are running at historically high levels, and public sector savings, which have been boosted by the move to budget surplus.

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

25. Above all, the role of tax reform is to encourage enterprise and improve economic performance in the medium term. It is wholly inappropriate as an answer to short term or cyclical phenomena. So for the taxation of savings, the Government's policy is clear. It is to

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TAXES ON SPENDING

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

73. As the House knows Her Majesty's Government are obliged to implement the European Court's judgement that certain of our zero rates of VAT on supplies to business, notably on non-residential construction, but also on fuel and power and on water, are not lawful. This derives from the Court's interpretation of the Community's Sixth VAT directive to which the UK agreed in 1977. The necessary changes will be introduced in this year's Finance Bill, and draft clauses have already been published.

74. In implementing the judgement I have sought to do as much as possible to minimise the burden. From 1 April VAT will be payable in respect of all non-residential construction unless carried out under a agreements entered into before the court ruling. And from 1 August landlords will have the option to tax rents, which means that in most cases no extra VAT will be paid at all.

Although true, this will sound pretty rum. However, no comprehensible explanation could be remotely as succinct.

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employees are already participating, quite a few of them giving the full £240 annual limit for tax relief. I now propose to double that limit to £480, or £40 a month.

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

83. I now turn to the excise duties.

84. The potential 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 a matter of increasing concern ~~widely known.~~ The government is committed to phasing out leaded petrol altogether, and in successive Budgets I have sought to assist this. I first introduced a tax differential in favour of unleaded petrol in 1987, and increased it last year. But although sales are undoubtedly rising, unleaded petrol still accounts for only some 5 per cent of total petrol sales, even though two-thirds of the cars now on

We actually are not certain that atmospheric lead does damage children's brains etc. But it seems highly probable. The change reflects this without sounding sceptical.

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the road could use it, either without any adjustment or else with a conversion costing only some £20 or so.

85. 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 usually is. Others wrongly imagine that their car's performance would suffer were they to use unleaded fuel. Many are under the false impression that, if they do switch to unleaded petrol, their cars will no longer be able to use leaded petrol.

86. 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 nearly fourpence a gallon. If this reduction is fully passed on to the customer - and I look to the oil companies to see that it is - it means that the price of unleaded petrol at the pump will generally be getting on for tenpence a gallon, or just over twopence a litre, cheaper than four star leaded petrol. This will be one of the most substantial tax differentials between ~~the price of~~ leaded and unleaded petrol within the European Community.

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87. But I do not intend to stop there. I also propose to raise the tax on two and three star petrol, so that the pump price of these grades will be at least as high as that of four star. This should encourage garages to phase out two star petrol, which is already down to about 6 per cent of the total market, thus enabling them to switch storage capacity to unleaded petrol - quite apart from the incentive to the remaining two-star users to switch to unleaded fuel.

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89. They will of course also lead to a loss of revenue of some £40 million in 1989-90. I propose to recoup this from Vehicle Excise Duty. At the present time a bus or a coach has to have 66 seats before it pays as much in Vehicle Excise Duty as a family car. I propose to rectify this anomaly by increasing the tax rates of this group of vehicles so that they cover their track costs. I also propose to increase the rates of duty for the heaviest non-articulated lorries, to put them on a more equal footing with articulated lorries. These changes

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REF
COPY NO 17 OF 43 COPIES

FROM: MISS M P WALLACE
DATE: 9 March 1989

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Monck
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

68
75

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

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

BUDGET STATEMENT: TAX SECTION

... The Chancellor was most grateful for all the further comments on the speech version I circulated on 6 March. I now attach his virtually final version*. It has been sent to No.10 in this form.

* amendments sidelined.

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2. If you or copy recipients have any further comments - essential changes or factual corrections - could they reach me by lunchtime tomorrow, Friday 10 March, please.

MOIRA WALLACE

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SECRET

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B.L.O.

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

BUSINESS TAXATION

SECRET B.L.O. SECRET

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

6. First, taxes on business.

7. Ever since the corporation tax reform I introduced in 1984, the rate of corporation tax for small companies, defined for this purpose as those with annual profits of less than £100,000, has been set at the basic rate of income tax, currently 25 per cent. Large companies, defined as those with profits of £$^{1}/_{2}$ million or more, pay the main rate of corporation tax of 35 per cent, one of the lowest rates of tax on company profits in the world. Between £100,000 and £$^{1}/_{2}$ million the average rate of tax gradually rises from 25 to 35 per cent.

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

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

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

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

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

13. Over the years I have received a number 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.

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

15. One of the many undesirable features of an income tax system with several higher rates was that since a taxpayer's marginal rate could well be very different in

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different years, the question of which year income related to made a great deal of difference. This was true of Schedule E where the strict rule is that income is taxed in the year to which it relates, on an accruals basis.

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16. For the vast majority of employees, this basis of assessment for Schedule E poses no problem. But for about half a million people, mainly directors, who do not receive all their income in the year to which it relates, it causes complications and often needless assessments and correspondence long after the tax year is over. It is also open to manipulation.

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17. I therefore propose that income tax under Schedule E should in future be assessed on a receipts basis, with the simple principle that you pay the tax when you receive the income. This will have a transitional cost of £80 million in 1989-90 and £60 million in 1990-91, but in the long term it will yield both extra revenue and a significant saving in both taxpayer's time and Inland Revenue staff.

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18. The reduction in the top rate of income tax to 40 per cent in last year's Budget also enables me to make a major simplification of the tax treatment of the

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vast bulk of the incorporated sector of small businesses: those known as close companies - generally speaking, unquoted companies that are controlled by five or fewer people.

19. The rules for the so-called apportionment of close companies' income are notoriously complex, taking up some twenty pages of impenetrable legislation. These rules are no longer needed and I propose to abolish them. I believe that family businesses in particular will welcome this substantial simplification.

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

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TAXES ON SAVING

21. I now turn to the taxation of saving.

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22. The sharp decline in the ratio of personal saving to personal income, over the past two years in

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particular has led to even more discussion than usual of the merits of providing greater tax incentives for personal saving.

23. Certainly it is desirable that, over the medium-term, we generate as a nation a level of saving sufficient to finance a high level of investment. But what matters for that is not personal savings alone, but corporate savings too, which are running at historically high levels, and public sector savings, which have been boosted by the move to budget surplus.

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

25. Above all, the role of tax reform is to encourage enterprise and improve economic performance in the medium term. It is wholly inappropriate as an answer to short term or cyclical phenomena. So for the taxation of savings, the Government's policy is clear. It is to

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strengthen and deepen popular capitalism in Britain, by encouraging in particular wider share ownership.

26. I have a number of specific tax measures to announce today to that end.

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

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28. 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.

29. Since then, however, the take-up of new PEPs has slowed down, not least as a result of the changed climate in the equity market which followed the October 1987 Stock Exchange crash.

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30. So the time has come to improve and simplify PEPs and give them a new boost.

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31. 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.

32. Second, within that, I propose to raise substantially the amount that can be invested in unit trusts or investment trusts. For many small savers, these provide an excellent introduction to shareholding. At present PEP investors may only place £540 a year, or a quarter of their PEP, in unit or investment trusts. I propose to more than treble this amount, to £2,400 a year; and I propose to allow the whole of a PEP to be invested in unit or investment trusts, up to this limit. To qualify for tax relief, the unit or investment trusts will be required to invest wholly or mainly in UK equities.

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

34. Finally, I propose to make a number of important simplifications to the PEP rules so as to make the

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scheme more flexible, better directed to the needs of small and new investors, and cheaper to administer.

35. I am confident that the changes that I have announced today will enable personal equity plans to play an important part in stimulating the spread of ownership of British equities in the years ahead.

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

37. 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 some $1\frac{3}{4}$ million employees. At present the annual limits on the value of shares which can be given under all-employee profit-sharing schemes are £1,250 or 10 per cent of salary up to a ceiling of £5,000. I propose to raise these cash limits to £2,000 and £6,000 respectively.

38. Second, I propose to increase the monthly limit on contributions to all-employee save-as-you-earn share option schemes from £100 to £150, and at the same time to double the maximum discount from market value at

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which options may be granted from 10 per cent to 20 per cent.

39. Third, a number of my Hon. Friends have been concerned that current tax law may be inhibiting the development of employee share ownership plans, otherwise known as ESOPs. These are distinguished from ordinary approved employee share schemes by the fact that they use a wider variety of finance, acquire more shares and tend to operate on a longer timescale. I propose to make it clear that companies' contributions to ESOPs qualify for corporation tax relief, provided they meet certain requirements designed to ensure that the employees acquire direct ownership of the shares within a reasonable time. I hope that this will encourage more British companies, particularly in the unquoted sector, to consider setting up ESOPs.

40. Those firms with employee share ownership schemes have no doubt that giving the workforce a direct personal interest in their profitability and success improves the company's performance. The same benefits flow from profit related pay.

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

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

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

44. Taken together, the package of measures I have announced to encourage wider share ownership in general, and employee share ownership in particular, will help to ensure that the idea of a share-owning democracy becomes

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ever more entrenched as a part of the British way of life.

45. Last June, the Inland Revenue issued with my authority a major consultative document on the taxation of life assurance.

46. The tax regime for life assurance is sui generis. The present system dates back to the First World War and has developed over the years in a piecemeal way, leading to a state of affairs in which the incidence of tax is extremely uneven, with some successful life offices paying no tax at all.

47. 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.

48. I have considered very carefully the representations the industry has made, and taken full account both of the changes to the regulation of life assurance proposed by the Securities and Investment Board under the Financial Services Act and the prospects for increased competition within the European Community after 1992. In the light of these factors, I have

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decided not to proceed with the more radical reforms canvassed in the consultative document. But I do have a number of important changes to propose, based for the most part on the general tax reform principle of seeking lower rates on a broader base.

49. First, many life offices run a pension business alongside their main 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 business, thus giving their life profits unduly favourable tax treatment. The life offices themselves have accepted that this treatment is anomalous and I propose to end it.

50. This change, along with some minor related changes, will come into force on 1 January 1990, and will yield some £150 million in 1990-91. The remainder of the changes I have to propose constitute a broadly balanced package which, because of the transitional provisions, will reduce the taxation of life assurance in 1990-91 by some £100 million.

51. I propose that the expenses incurred by life offices in attracting new business should continue to be

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fully deductible for tax purposes from the income and gains of life funds, but should in future be spread over a period of seven years. To give the industry time to adjust, this change will be phased in gradually over the next four years, starting on 1 January, 1990.

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

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53. But I can say here and now that I propose, as from 1 January 1990, to abolish Life Assurance Policy Duty. And I also propose, from the same date, that the rate of tax payable on the policyholder's share of 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, should be reduced to the basic rate of income tax.

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54. The net effect of all these changes to the taxation of life assurance will be a cost of £20 million in 1989-90 and a yield of £45 million in 1990-91, rising somewhat in subsequent years.

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

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

57. I now turn to pensions.

1) lumpsums?
2) Covered with 69a.

58. The tax treatment accorded to pension schemes is quite rightly particularly favourable; and the extent of this privilege has to be circumscribed by Inland Revenue rules. So pension schemes only qualify for tax relief if they meet certain conditions, notably that the pension paid may not exceed two-thirds of final salary:

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and if they fall foul of any of these rules, they lose all relief.

59. This has the perverse result that tax law effectively constrains the overall pension an employer can pay his employee. This is neither desirable nor necessary. Accordingly, I propose to make it possible for employers to provide whatever pensions package they believe necessary to recruit and reward their employees.

60. However, while it is clearly right that employers should be free to provide whatever pension they see fit, it would not be right to make the present generous tax treatment available with no upper limit at all. I therefore propose to set a limit on the pensions which may be paid from tax-approved occupational schemes, based on final salary of £60,000 a year.

61. 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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62. The new ceiling will apply only to pension schemes set up, on or after today, or to new members joining existing schemes after 1 June. And, as I have already said, there will now be complete freedom to provide benefits above the Inland Revenue limits, though without the tax relief.

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

64. I also propose to simplify very substantially the rules concerning additional voluntary contributions to pension schemes, or AVCs. In particular, the present requirements for free standing AVCs place a heavy administrative burden on employers. These requirements will be greatly reduced. Indeed, in many cases employers will not need to be involved at all.

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

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This will remove the penalty on good investment performance.

66. 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.

67. First, I propose to make it easier for people in personal pension schemes to manage their own investments.

68. Second, I propose to increase substantially the annual limits, as a percentage of earnings, on contributions to personal pensions for those over the age of 35. 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 in relation to occupational schemes. The new limits will be subject to an overall cash ceiling based on earnings of £60,000, corresponding to the new ceiling for occupational pensions, and similarly indexed.

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

69a. Coupled with the changes I made in 1987, this is as far as I wish to go in amending the tax treatment of pensions.

70. Finally, on the taxation of saving, it should not be overlooked that a far-reaching reform which I announced in last year's Budget, to come into effect in April 1990, is relevant in this context.

71. I refer to Independent Taxation. For there can be little doubt that one of the greatest disincentives to saving in the present tax system is the treatment of the savings of married women. At present a wife's income from savings has to be disclosed to her husband and taxed at his marginal rate. Independent Taxation will change all that. In particular, those married women who have little or no earnings will in future have their own personal allowance to set against their savings income. Independent Taxation may well do much to encourage the growth of personal saving in this country.

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TAXES ON SPENDING

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

73. As the House knows Her Majesty's Government are obliged to implement the European Court's judgement that certain of our zero rates of VAT on supplies to business, notably on non-residential construction, but also on fuel and power and on water, are not lawful. This derives from the Court's interpretation of the Community's Sixth VAT directive to which the UK agreed in 1977. The necessary changes will be introduced in this year's Finance Bill, and draft clauses have already been published.

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74. In implementing the judgement I have sought to do as much as possible to minimise the burden. From 1 April VAT will be payable in respect of all non-residential construction unless carried out under a agreements entered into before the court ruling. And from 1 August landlords will have the option to tax rents, which means that in most cases no extra VAT will be paid at all.

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75. These measures will reduce the burden of VAT on construction so far as the private sector is concerned to just £35 million in 1989-90 rising to £110 million in 1992-93. Without them the yield from VAT on construction in the private sector would have risen to £450 million. There will also be a yield of £250 million from construction carried out for the public sector, and the public sector programmes concerned have already been protected by compensatory adjustments where necessary.

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

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

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

79. I also propose to relieve from car tax cars leased to the disabled. This is equivalent to an overall saving of about £400 on each vehicle leased to a disabled person.

80. I also propose to allow the present rules on tax relief for membership subscriptions paid by covenant to heritage and conservation charities. If the member is given the right of full entry to view the charity's property, that benefit will be ignored in determining whether relief is due. This will be of particular benefit to organisations such as the National Trust.

81. But in general, I continue to believe that the best way of helping charitable causes through the tax system is by directly encouraging the act of charitable giving. The Payroll Giving Scheme, which I introduced in my 1986 Budget, has been growing steadily. Some 3,400 schemes have now been set up, and over 100,000

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employees are already participating, quite a few of them giving the full £240 annual limit for tax relief. I now propose to double that limit to £480, or £40 a month.

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

83. I now turn to the excise duties.

84. The damage to the environment in general, and to child health in particular, from lead in the atmosphere, and the contribution of ordinary leaded petrol to this problem, is increasingly widely known. The government is committed to phasing out leaded petrol altogether, and in successive Budgets I have sought to assist this. I first introduced a tax differential in favour of unleaded petrol in 1987, and increased it last year. But although sales are undoubtedly rising, unleaded petrol still accounts for only some 5 per cent of total petrol sales, even though two-thirds of the cars now on

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the road could use it, either without any adjustment or else with a conversion costing only some £20 or so.

85. 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 usually is. Others wrongly imagine that their car's performance would suffer were they to use unleaded fuel. Many are under the false impression that, if they do switch to unleaded petrol, their cars will no longer be able to use leaded petrol.

86. 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 nearly fourpence a gallon. If this reduction is fully passed on to the customer - and I look to the oil companies to see that it is - it means that the price of unleaded petrol at the pump will generally be getting on for tenpence a gallon, or just over twopence a litre, cheaper than four star leaded petrol. [This will be one of the most substantial differentials between the price of leaded and unleaded petrol within the European Community.]

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87. But I do not intend to stop there. I also propose to raise the tax on two and three star petrol, so that the pump price of these grades will be at least as high as that of four star. This should encourage garages to phase out two star petrol, which is already down to about 6 per cent of the total market, thus enabling them to switch storage capacity to unleaded petrol - quite apart from the incentive to the remaining two-star users to switch to unleaded fuel.

88. 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.

89. They will of course also lead to a loss of revenue of some £40 million in 1989-90. I propose to recoup this from Vehicle Excise Duty. At the present time a bus or a coach has to have 66 seats before it pays as much in Vehicle Excise Duty as a family car. I propose to rectify this anomaly by increasing the tax rates of this group of vehicles so that they cover their track costs. I also propose to increase the rates of duty for the heaviest non-articulated lorries, to put them on a more equal footing with articulated lorries. These changes

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will also simplify the system, greatly reducing the number of separate rates of Vehicle Excise Duty.

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

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TAXATION OF INCOME

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

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

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

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

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

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

97. In the case of gifts of personal belongings, these benefit from chattels relief, under which any items worth less than £3,000 on disposal are entirely exempt from capital gains tax. I propose to double the chattels exemption limit to £6,000.

98. Lastly, on capital gains tax, I propose 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

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

99. To return to income tax, I propose to raise all the main income tax thresholds and allowances by the statutory indexation factor of 6.8 per cent, rounded up. Thus the single person's allowance will rise by £180 to £2,785, and the married man's allowance will rise by £280 to £4,375. The basic rate limit will rise by £1,400 to £20,700.

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

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

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102. The income limit for the age allowance will rise by £800 to £11,400, again in line with indexation. However, I propose to reduce the rate at which the age allowance is withdrawn above this income limit. I propose that in future it should be withdrawn at the rate of £1 of allowance for each £2 of income above the limit, instead of the present rate of £2 in every £3. This means that the marginal tax rate for those in the withdrawal band will be reduced to well below 40 per cent, thus meeting a large number of representations I have received over the past year.

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

104. I have one further change to make to help pensioners. Under the earnings rule, any pensioner who decides to continue to work after reaching the statutory retirement age has his or her pension docked at a rate of 50 per cent on every £1 earned between £75 and £79 a week, rising to 100 per cent for every £1 earned over £79 a week. This rule applies until he or she has reached give years beyond the State pension age.

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

106. That is precisely what we shall do. My Rt.Hon Friend the Secretary of State for Social Services and I have agreed that the pensioners' earnings rule should be abolished from the beginning of October, the earliest practicable date. The necessary legislation will be included in the Social Security Bill currently before the House.

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

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

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

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

NATIONAL INSURANCE CONTRIBUTIONS

111. I have one further measure to propose.

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

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

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

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

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

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essential feature of the contributory principle. But my proposals will more than halve this step, to only 86 pence a week in 1989-90.

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

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

118. The new system will take effect from the beginning of October, the earliest practicable date. The cost will be £1 billion in 1989-90 and £2.8 billion in 1990-91. The necessary legislation will be included in the Social Security Bill currently before the House.

119. The total additional cost of all the measures in this Budget, on an indexed basis, is under £2 billion in 1989-90 and £$3^{1}/_{2}$ billion in 1990-91.

[BRIEF PERORATION TO COME]

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FROM: MISS M P WALLACE
DATE: 9 March 1989

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Monck
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]

& No 10
+ AGT

Moira,
One or two, very minor, comments/amendments are shown in red against the 'taxes/on spending' paras.
Alison French
10/3

BUDGET STATEMENT: TAX SECTION

The Chancellor was most grateful for all the further comments on the speech version I circulated on 6 March. I now attach his virtually final version*. It has been sent to No.10 in this form.

* amendments sidelined.

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2. If you or copy recipients have any further comments - essential changes or factual corrections - could they reach me by lunchtime tomorrow, Friday 10 March, please.

MOIRA WALLACE

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TAXPAYER CONFIDENTIALITY

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

2. As the House knows, the new official secrets legislation currently passing through Parliament is very much narrower in scope than the present Official Secrets Act. In particular, it does not cover information in the possession of either the Inland Revenue or Customs & Excise concerning the private affairs of specific taxpayers.

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

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

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

BUSINESS TAXATION

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

6. First, taxes on business.

7. Ever since the corporation tax reform I introduced in 1984, the rate of corporation tax for small companies, defined for this purpose as those with annual profits of less than £100,000, has been set at the basic rate of income tax, currently 25 per cent. Large companies, defined as those with profits of £$^1/_2$ million or more, pay the main rate of corporation tax of 35 per cent, one of the lowest rates of tax on company profits in the world. Between £100,000 and £$^1/_2$ million the average rate of tax gradually rises from 25 to 35 per cent.

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

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

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

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

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

13. Over the years I have received a number 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.

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

15. One of the many undesirable features of an income tax system with several higher rates was that since a taxpayer's marginal rate could well be very different in

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different years, the question of which year income related to made a great deal of difference. This was true of Schedule E where the strict rule is that income is taxed in the year to which it relates, on an accruals basis.

16. For the vast majority of employees, this basis of assessment for Schedule E poses no problem. But for about half a million people, mainly directors, who do not receive all their income in the year to which it relates, it causes complications and often needless assessments and correspondence long after the tax year is over. It is also open to manipulation.

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17. I therefore propose that income tax under Schedule E should in future be assessed on a receipts basis, with the simple principle that you pay the tax when you receive the income. This will have a transitional cost of £80 million in 1989-90 and £60 million in 1990-91, but in the long term it will yield both extra revenue and a significant saving in both taxpayer's time and Inland Revenue staff.

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18. The reduction in the top rate of income tax to 40 per cent in last year's Budget also enables me to make a major simplification of the tax treatment of the

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vast bulk of the incorporated sector of small businesses: those known as close companies - generally speaking, unquoted companies that are controlled by five or fewer people.

19. The rules for the so-called apportionment of close companies' income are notoriously complex, taking up some twenty pages of impenetrable legislation. These rules are no longer needed and I propose to abolish them. I believe that family businesses in particular will welcome this substantial simplification.

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

TAXES ON SAVING

21. I now turn to the taxation of saving.

22. The sharp decline in the ratio of personal saving to personal income, over the past two years in

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particular has led to even more discussion than usual of the merits of providing greater tax incentives for personal saving.

23. Certainly it is desirable that, over the medium-term, we generate as a nation a level of saving sufficient to finance a high level of investment. But what matters for that is not personal savings alone, but corporate savings too, which are running at historically high levels, and public sector savings, which have been boosted by the move to budget surplus.

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

25. Above all, the role of tax reform is to encourage enterprise and improve economic performance in the medium term. It is wholly inappropriate as an answer to short term or cyclical phenomena. So for the taxation of savings, the Government's policy is clear. It is to

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strengthen and deepen popular capitalism in Britain, by encouraging in particular wider share ownership.

26. I have a number of specific tax measures to announce today to that end.

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

28. 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.

29. Since then, however, the take-up of new PEPs has slowed down, not least as a result of the changed climate in the equity market which followed the October 1987 Stock Exchange crash.

30. So the time has come to improve and simplify PEPs and give them a new boost.

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31. 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.

32. Second, within that, I propose to raise substantially the amount that can be invested in unit trusts or investment trusts. For many small savers, these provide an excellent introduction to shareholding. At present PEP investors may only place £540 a year, or a quarter of their PEP, in unit or investment trusts. I propose to more than treble this amount, to £2,400 a year; and I propose to allow the whole of a PEP to be invested in unit or investment trusts, up to this limit. To qualify for tax relief, the unit or investment trusts will be required to invest wholly or mainly in UK equities.

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

34. Finally, I propose to make a number of important simplifications to the PEP rules so as to make the

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scheme more flexible, better directed to the needs of small and new investors, and cheaper to administer.

35. I am confident that the changes that I have announced today will enable personal equity plans to play an important part in stimulating the spread of ownership of British equities in the years ahead.

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

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37. 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 some $1\frac{3}{4}$ million employees. At present the annual limits on the value of shares which can be given under all-employee profit-sharing schemes are £1,250 or 10 per cent of salary up to a ceiling of £5,000. I propose to raise these cash limits to £2,000 and £6,000 respectively.

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38. Second, I propose to increase the monthly limit on contributions to all-employee save-as-you-earn share option schemes from £100 to £150, and at the same time to double the maximum discount from market value at

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which options may be granted from 10 per cent to 20 per cent.

39. Third, a number of my Hon. Friends have been concerned that current tax law may be inhibiting the development of employee share ownership plans, otherwise known as ESOPs. These are distinguished from ordinary approved employee share schemes by the fact that they use a wider variety of finance, acquire more shares and tend to operate on a longer timescale. I propose to make it clear that companies' contributions to ESOPs qualify for corporation tax relief, provided they meet certain requirements designed to ensure that the employees acquire direct ownership of the shares within a reasonable time. I hope that this will encourage more British companies, particularly in the unquoted sector, to consider setting up ESOPs.

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40. Those firms with employee share ownership schemes have no doubt that giving the workforce a direct personal interest in their profitability and success improves the company's performance. The same benefits flow from profit related pay.

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

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

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

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44. Taken together, the package of measures I have announced to encourage wider share ownership in general, and employee share ownership in particular, will help to ensure that the idea of a share-owning democracy becomes

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ever more entrenched as a part of the British way of life.

45. Last June, the Inland Revenue issued with my authority a major consultative document on the taxation of life assurance.

46. The tax regime for life assurance is sui generis. The present system dates back to the First World War and has developed over the years in a piecemeal way, leading to a state of affairs in which the incidence of tax is extremely uneven, with some successful life offices paying no tax at all.

47. 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.

48. I have considered very carefully the representations the industry has made, and taken full account both of the changes to the regulation of life assurance proposed by the Securities and Investment Board under the Financial Services Act and the prospects for increased competition within the European Community after 1992. In the light of these factors, I have

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decided not to proceed with the more radical reforms canvassed in the consultative document. But I do have a number of important changes to propose, based for the most part on the general tax reform principle of seeking lower rates on a broader base.

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49. First, many life offices run a pension business alongside their main 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 business, thus giving their life profits unduly favourable tax treatment. The life offices themselves have accepted that this treatment is anomalous and I propose to end it.

50. This change, along with some minor related changes, will come into force on 1 January 1990, and will yield some £150 million in 1990-91. The remainder of the changes I have to propose constitute a broadly balanced package which, because of the transitional provisions, will reduce the taxation of life assurance in 1990-91 by some £100 million.

51. I propose that the expenses incurred by life offices in attracting new business should continue to be

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fully deductible for tax purposes from the income and gains of life funds, but should in future be spread over a period of seven years. To give the industry time to adjust, this change will be phased in gradually over the next four years, starting on 1 January, 1990.

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

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53. But I can say here and now that I propose, as from 1 January 1990, to abolish Life Assurance Policy Duty. And I also propose, from the same date, that the rate of tax payable on the policyholder's share of 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, should be reduced to the basic rate of income tax.

54. The net effect of all these changes to the taxation of life assurance will be a cost of £20 million in 1989-90 and a yield of £45 million in 1990-91, rising somewhat in subsequent years.

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

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

SECRET B.L.O.

57. I now turn to pensions.

58. The tax treatment accorded to pension schemes is quite rightly particularly favourable; and the extent of this privilege has to be circumscribed by Inland Revenue rules. So pension schemes only qualify for tax relief if they meet certain conditions, notably that the pension paid may not exceed two-thirds of final salary:

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and if they fall foul of any of these rules, they lose all relief.

59. This has the perverse result that tax law effectively constrains the overall pension an employer can pay his employee. This is neither desirable nor necessary. Accordingly, I propose to make it possible for employers to provide whatever pensions package they believe necessary to recruit and reward their employees.

60. However, while it is clearly right that employers should be free to provide whatever pension they see fit, it would not be right to make the present generous tax treatment available with no upper limit at all. I therefore propose to set a limit on the pensions which may be paid from tax-approved occupational schemes, based on final salary of £60,000 a year.

61. 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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62. The new ceiling will apply only to pension schemes set up, on or after today, or to new members joining existing schemes after 1 June. And, as I have already said, there will now be complete freedom to provide benefits above the Inland Revenue limits, though without the tax relief.

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

64. I also propose to simplify very substantially the rules concerning additional voluntary contributions to pension schemes, or AVCs. In particular, the present requirements for free standing AVCs place a heavy administrative burden on employers. These requirements will be greatly reduced. Indeed, in many cases employers will not need to be involved at all.

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

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This will remove the penalty on good investment performance.

66. 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.

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67. First, I propose to make it easier for people in personal pension schemes to manage their own investments.

B.L.O.

68. Second, I propose to increase substantially the annual limits, as a percentage of earnings, on contributions to personal pensions for those over the age of 35. 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 in relation to occupational schemes. The new limits will be subject to an overall cash ceiling based on earnings of £60,000, corresponding to the new ceiling for occupational pensions, and similarly indexed.

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

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69a. Coupled with the changes I made in 1987, this is as far as I wish to go in amending the tax treatment of pensions.

B.L.O.

70. Finally, on the taxation of saving, it should not be overlooked that a far-reaching reform which I announced in last year's Budget, to come into effect in April 1990, is relevant in this context.

71. I refer to Independent Taxation. For there can be little doubt that one of the greatest disincentives to saving in the present tax system is the treatment of the savings of married women. At present a wife's income from savings has to be disclosed to her husband and taxed at his marginal rate. Independent Taxation will change all that. In particular, those married women who have little or no earnings will in future have their own personal allowance to set against their savings income. Independent Taxation may well do much to encourage the growth of personal saving in this country.

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TAXES ON SPENDING

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

73. As the House knows Her Majesty's Government are obliged to implement the European Court's judgement that certain of our zero rates of VAT on supplies to business, notably on non-residential construction, but also on fuel and power and on water, are not lawful. This derives from the Court's interpretation of the Community's Sixth VAT directive to which the UK agreed in 1977. The necessary changes will be introduced in this year's Finance Bill, and draft clauses have already been published.

74. In implementing the judgement I have sought to do as much as possible to minimise the burden. From 1 April VAT will be payable in respect of all non-residential construction unless carried out under a agreements entered into before the court ruling. And from 1 August landlords will have the option to tax rents, which means that in most cases no extra VAT will be paid at all.

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75. These measures will reduce the burden of VAT on construction so far as the private sector is concerned to just £35 million in 1989-90 rising to £110 million in 1992-93. Without them the yield from VAT on construction in the private sector would have risen to £450 million. There will also be a first year yield of £250 million from construction carried out for the public sector, and the public sector programmes concerned have already been protected by compensatory adjustments where necessary.

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

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

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

79. I also propose to relieve from car tax cars leased to the disabled. This is equivalent to an overall saving of about £400 on each vehicle leased to a disabled person.

80. I also propose to allow the present rules on tax relief for membership subscriptions paid by covenant to heritage and conservation charities. If the member is given the right of full entry to view the charity's property, that benefit will be ignored in determining whether relief is due. This will be of particular benefit to organisations such as the National Trust.

81. But in general, I continue to believe that the best way of helping charitable causes through the tax system is by directly encouraging the act of charitable giving. The Payroll Giving Scheme, which I introduced in my 1986 Budget, has been growing steadily. Some 3,400 schemes have now been set up, and over 100,000

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employees are already participating, quite a few of them giving the full £240 annual limit for tax relief. I now propose to double that limit to £480, or £40 a month.

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

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83. I now turn to the excise duties.

B.L.O.

84. The damage to the environment in general, and to child health in particular, from lead in the atmosphere, and the contribution of ordinary leaded petrol to this problem, is increasingly widely known. The government is committed to phasing out leaded petrol, ~~altogether~~, and in successive Budgets I have sought tc assist this. I first introduced a tax differential in favour of unleaded petrol in 1987, and increased it last year. But although sales are undoubtedly rising, unleaded petrol still accounts for only some 5 per cent of total petrol sales, even though two-thirds of the cars now on

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the road could use it, either without any adjustment or else with a conversion costing only some £20 or so.

85. 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 usually is. Others wrongly imagine that their car's performance would suffer were they to use unleaded fuel. Many are under the false impression that, if they do switch to unleaded petrol, their cars will no longer be able to use leaded petrol.

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86. 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 nearly fourpence a gallon. If this reduction is fully passed on to the customer - and I look to the oil companies to see that it is - it means that the price of unleaded petrol at the pump will generally be getting on for tenpence a gallon, or just over twopence a litre, cheaper than four star leaded petrol. This will be one of the most substantial differentials between the price of leaded and unleaded petrol within the European Community.

This now looks rather confusing, with "increase" and "reduction" referred to within 3 lines. It also leaves the listener to guess how the bigger differential is going to be achieved. A return to the previous wording would be clearer.

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87. But I do not intend to stop there. I also propose to raise the tax on two and three star petrol, so that the pump price of these grades will be at least as high as that of four star. This should encourage garages to phase out two star petrol, which is already down to about 6 per cent of the total market, thus enabling them to switch storage capacity to unleaded petrol - quite apart from the incentive to the remaining two-star users to switch to unleaded fuel.

88. 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.

89. They will of course also lead to a loss of revenue of some £40 million in 1989-90. I propose to recoup this from Vehicle Excise Duty. At the present time a bus or a coach has to have 66 seats before it pays as much in Vehicle Excise Duty as a family car. I propose to rectify this anomaly by increasing the tax rates of this group of vehicles so that they cover their track costs. I also propose to increase the rates of duty for the heaviest non-articulated lorries, to put them on a more equal footing with articulated lorries. These changes

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will also simplify the system, greatly reducing the number of separate rates of Vehicle Excise Duty.

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

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TAXATION OF INCOME

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

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

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

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

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

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

97. In the case of gifts of personal belongings, these benefit from chattels relief, under which any items worth less than £3,000 on disposal are entirely exempt from capital gains tax. I propose to double the chattels exemption limit to £6,000.

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98. Lastly, on capital gains tax, I propose 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

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

99. To return to income tax, I propose to raise all the main income tax thresholds and allowances by the statutory indexation factor of 6.8 per cent, rounded up. Thus the single person's allowance will rise by £180 to £2,785, and the married man's allowance will rise by £280 to £4,375. The basic rate limit will rise by £1,400 to £20,700.

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

B.L.O.

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

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102. The income limit for the age allowance will rise by £800 to £11,400, again in line with indexation. However, I propose to reduce the rate at which the age allowance is withdrawn above this income limit. I propose that in future it should be withdrawn at the rate of £1 of allowance for each £2 of income above the limit, instead of the present rate of £2 in every £3. This means that the marginal tax rate for those in the withdrawal band will be reduced to well below 40 per cent, thus meeting a large number of representations I have received over the past year.

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

104. I have one further change to make to help pensioners. Under the earnings rule, any pensioner who decides to continue to work after reaching the statutory retirement age has his or her pension docked at a rate of 50 per cent on every £1 earned between £75 and £79 a week, rising to 100 per cent for every £1 earned over £79 a week. This rule applies until he or she has reached give years beyond the State pension age.

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

106. That is precisely what we shall do. My Rt.Hon Friend the Secretary of State for Social Services and I have agreed that the pensioners' earnings rule should be abolished from the beginning of October, the earliest practicable date. The necessary legislation will be included in the Social Security Bill currently before the House.

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

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

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

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

SECRET

NATIONAL INSURANCE CONTRIBUTIONS

111. I have one further measure to propose.

B.I.O.

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

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

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

SECRET B.L.O. SECRET

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

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

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essential feature of the contributory principle. But my proposals will more than halve this step, to only 86 pence a week in 1989-90.

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

SECRET

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

B.L.O.

118. The new system will take effect from the beginning of October, the earliest practicable date. The cost will be £1 billion in 1989-90 and £2.8 billion in 1990-91. The necessary legislation will be included in the Social Security Bill currently before the House.

119. The total additional cost of all the measures in this Budget, on an indexed basis, is under £2 billion in 1989-90 and £$3^{1}/_{2}$ billion in 1990-91.

[BRIEF PERORATION TO COME]

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JC → (I don't like this - save for defensive)

"And for those below this level of earnings the change, together with the earlier reduction in their contribution, leaves them with a similar amount.

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[BRIEF PERORATION TO COME]

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CONCLUSION

Mr Deputy Speaker, in this Budget I have reaffirmed the Government's commitment to the defeat of inflation through the maintenance of prudent monetary and fiscal policies. I have budgeted for a debt repayment of £14 billion - the largest ever. I have announced a major reform and reduction in employees national insurance contributions; and I have fulfilled our pledge to abolish the earnings rule for pensioners.

I commend this Budget to the House.

chex.rm/mw/19

B. Secret - Bud

REF MPW/894
COPY NO 43 OF 43 COPIES

FROM: MISS M P WALLACE
DATE: 9 March 1989

PS/FINANCIAL SECRETARY

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

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

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

BUDGET STATEMENT: TAX SECTION

The Chancellor was most grateful for all the further comments on the speech version I circulated on 6 March. I now attach his virtually final version*. It has been sent to No.10 in this form.

...

*amendments sidelined.

Version of 9/3, noon.

TAXPAYER CONFIDENTIALITY

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

2. As the House knows, the new official secrets legislation currently passing through Parliament is very much narrower in scope than the present Official Secrets Act. In particular, it does not cover information in the possession of either the Inland Revenue or Customs & Excise concerning the private affairs of specific taxpayers.

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

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

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

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

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

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

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

13. Over the years I have received a number 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.

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

15. One of the many undesirable features of an income tax system with several higher rates was that since a taxpayer's marginal rate could well be very different in

different years, the question of which year income related to made a great deal of difference. This was true of Schedule E where the strict rule is that income is taxed in the year to which it relates, on an accruals basis.

16. For the vast majority of employees, this basis of assessment for Schedule E poses no problem. But for about half a million people, mainly directors, who do not receive all their income in the year to which it relates, it causes complications and often needless assessments and correspondence long after the tax year is over. It is also open to manipulation.

17. I therefore propose that income tax under Schedule E should in future be assessed on a receipts basis, with the simple principle that you pay the tax when you receive the income. This will have a transitional cost of £80 million in 1989-90 and £60 million in 1990-91, but in the long term it will yield both extra revenue and a significant saving in both taxpayer's time and Inland Revenue staff.

18. The reduction in the top rate of income tax to 40 per cent in last year's Budget also enables me to make a major simplification of the tax ~~treatment of~~ payment for the

vast bulk of the incorporated sector of small businesses: those known as close companies - generally speaking, unquoted companies that are controlled by five or fewer people.

19. The rules for the so-called apportionment of close companies' income are notoriously complex, taking up some twenty pages of impenetrable legislation. These rules are no longer needed and I propose to abolish them. I believe that family businesses in particular will welcome this substantial simplification.

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

TAXES ON SAVING

21. I now turn to the taxation of saving.

22. The sharp decline in the ratio of personal saving to personal income, over the past two years in

particular, has led to even more discussion than usual of the merits of providing greater tax incentives for personal saving.

23. Certainly it is desirable that, over the medium-term, we generate as a nation a level of saving sufficient to finance a high level of investment. But what matters for that is not personal savings alone, but corporate savings too, which are running at historically high levels, and public sector savings, which have been boosted by the move to budget surplus.

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

25. Above all, the role of tax reform is to encourage enterprise and improve economic performance in the medium term. It is wholly inappropriate as ~~an answer~~ a response to short term or cyclical phenomena. So for the taxation of savings, the Government's policy is clear. It is to

strengthen and deepen popular capitalism in Britain, by encouraging in particular wider share ownership.

26. I have a number of specific tax measures to announce today to that end.

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

28. Personal equity plans got off to a good start, with over a quarter of a million investors, many of whom had never owned shares before, subscribing almost £$^{1}/_{2}$ billion between them in 1987.

29. Since then, however, the take-up of new PEPs has slowed down, not least as a result of the changed climate in the equity market which followed the October 1987 Stock Exchange crash.

30. So the time has come to improve and simplify PEPs and give them a new boost.

31. 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.

32. Second, within that, I propose to raise substantially the amount that can be invested in unit trusts or investment trusts. For many small savers, these provide an excellent introduction to shareholding. At present PEP investors may only place £540 a year, or a quarter of their PEP, in unit or investment trusts. I propose to more than treble this amount, to £2,400 a year; and I propose to allow the whole of a PEP to be invested in unit or investment trusts, up to this limit. To qualify for tax relief, the unit or investment trusts will be required to invest wholly or mainly in UK equities.

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

34. Finally, I propose to make a number of important simplifications to the PEP rules so as to make the

scheme more flexible, better directed to the needs of small and new investors, and cheaper to administer.

35. I am confident that the changes that I have announced today will enable personal equity plans to play an important part in stimulating the spread of ownership of British equities in the years ahead.

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

37. It is a striking fact that the number of approved all- employee share schemes has risen from a mere 30 in 1979 to almost 1,600 today, ~~involving~~ (bringing) some $1\frac{3}{4}$ million employees. At present the annual limits on the value of shares which can be given under all-employee profit-sharing schemes are £1,250 or 10 per cent of salary up to a ceiling of £5,000. I propose to raise these cash limits to £2,000 and £6,000 respectively.

38. Second, I propose to increase the monthly limit on contributions to all-employee save-as-you-earn share option schemes from £100 to £150, and at the same time to double the maximum discount from market value at

which options may be granted from 10 per cent to 20 per cent.

39. Third, a number of my Hon. Friends have been concerned that current tax law may be inhibiting the development of employee share ownership plans, otherwise known as ESOPs. These are distinguished from ordinary approved employee share schemes by the fact that they use a wider variety of finance, acquire more shares and tend to operate on a longer timescale. I propose to make it clear that companies' contributions to ESOPs qualify for corporation tax relief, provided they meet certain requirements designed to ensure that the employees acquire direct ownership of the shares within a reasonable time. I hope that this will encourage more British companies, particularly in the unquoted sector, to consider setting up ESOPs.

40. Those firms with employee share ownership schemes have no doubt that giving the workforce a direct personal interest in their profitability and success improves the company's performance. The same benefits flow from profit related pay.

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

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

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

44. Taken together, the package of measures I have announced to encourage wider share ownership in general, and employee share ownership in particular, will help to ensure that the idea of a share-owning democracy becomes

ever more entrenched as a part of the British way of life.

45. Last June, the Inland Revenue issued with my authority a major consultative document on the taxation of life assurance.

46. The tax regime for life assurance is ~~sui~~ generis. unique. The present system dates back to the First World War and has developed over the years in a piecemeal way, leading to a state of affairs in which the incidence of tax is extremely uneven, with some ~~successful~~ life offices paying no tax at all.

47. 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.

48. I have considered very carefully the representations the industry has made, and taken full account both of the changes to the regulation of life assurance proposed by the Securities and Investment Board under the Financial Services Act and the prospects for increased competition within the European Community after 1992. In the light of these factors, I have

decided not to proceed with the more radical reforms canvassed in the consultative document. But I do have a number of important changes to propose, based for the most part on the general tax reform principle of seeking lower rates on a broader base.

49. First, many life offices run a pension business ~~alongside their main~~ as well as a 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 business, thus giving their life profits unduly favourable tax treatment. The life offices themselves have accepted that this treatment is anomalous and I propose to end it.

Together with some related measures to part the taxation of life offices' pension business onto a proper footing, it

NP/ Ster/

50. This change, along with some minor related changes, will come into force on 1 January 1990, ~~and will yield some £150 million in 1990-91~~. The remainder of the changes I have to propose constitute a broadly balanced package which, because of the transitional provisions, will reduce the taxation of life assurance in 1990-91 by some £100 million.

51. I propose that the expenses incurred by life offices in attracting new business should continue to be

fully deductible for tax purposes from the income and gains of life funds, but should in future be spread over a period of seven years. To give the industry time to adjust, this change will be phased in gradually over the next four years, starting on 1 January, 1990.

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

53. But I can say here and now that I propose, as from 1 January 1990, to abolish Life Assurance Policy Duty. And I also propose, from the same date, that the rate of tax payable on the policyholder's share of 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, should be reduced to the basic rate of income tax.

54. The net effect of all these changes to the taxation of life assurance will be a cost of £20 million in 1989-90 and a yield of £45 million in 1990-91, rising somewhat in subsequent years.

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

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

57. I now turn to pensions.

58. The tax treatment accorded to pension schemes is ~~quite rightly~~ particularly favourable; and the extent of this privilege has to be circumscribed by Inland Revenue rules. So pension schemes only qualify for tax relief if they meet certain conditions, notably that the pension paid may not exceed two-thirds of final salary:

and if they fall foul of any of these rules, they lose all relief.

59. This has the perverse result that tax law effectively constrains the overall pension an employer can pay his employee. This is neither desirable nor necessary. Accordingly, I propose to make it possible for employers to provide whatever pensions package they believe necessary to recruit and reward their employees.

60. However, while it is clearly right that employers should be free to provide whatever pension they see fit, it would not be right to make the present generous tax treatment ~~available with no upper limit at all.~~ open ended. I therefore propose to set a limit on the pensions which may be paid from tax-approved occupational schemes, based on a/ final salary of £60,000 a year. ~~[illegible]~~

61. 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.

62. The new ceiling will apply only to pension schemes set up on or after today, or to new members joining existing schemes after 1 June. And, as I have already said, there will now be complete freedom to provide benefits above the Inland Revenue limits, though without the tax relief.

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

64. I also propose to simplify very substantially the rules concerning additional voluntary contributions to pension schemes, or AVCs. In particular, the present requirements for free standing AVCs place a heavy administrative burden on employers. These requirements will be greatly reduced. Indeed, in many cases employers will not need to be involved at all.

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

This will remove the penalty on good investment performance.

66. 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.

67. First, I propose to make it easier for people in personal pension schemes to manage their own investments.

68. Second, I propose to increase substantially the annual limits, as a percentage of earnings, on contributions to personal pensions for those over the age of 35. 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 in relation to occupational schemes. The new limits will be subject to an overall cash ceiling based on earnings of £60,000, corresponding to the new ceiling for occupational pensions, and similarly indexed.

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

69a. Coupled with the changes I made in 1987, this is as far as I wish to go in amending the tax treatment of pensions.

70. Finally, on the taxation of saving, it should not be overlooked that a far-reaching reform which I announced in last year's Budget, to come into effect in April 1990, is relevant in this context.

71. I refer to Independent Taxation, for there can be little doubt that one of the greatest disincentives to saving in the present tax system is the treatment of the savings of married women. At present a wife's income from savings has to be disclosed to her husband and taxed at his marginal rate. Independent Taxation will change all that. In particular, those married women who have little or no earnings will in future have their own personal allowance to set against their savings income. Independent Taxation may well do much to encourage the growth of personal saving in this country.

TAXES ON SPENDING

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

73. As the House knows Her Majesty's Government are obliged to implement the European Court's judgement that certain of our zero rates of VAT on supplies to business, notably on non-residential construction, but also on fuel and power and on water, are not lawful. This derives from the Court's interpretation of the Community's Sixth VAT directive to which the UK agreed in 1977. The necessary changes will be introduced in this year's Finance Bill, and draft clauses have already been published.

74. In implementing the judgement I have sought to do as much as possible to minimise the burden. From 1 April VAT will be payable in respect of all non-residential construction unless carried out under agreements entered into before the court ruling. And from 1 August landlords will have the option to tax rents, which means that in most cases no extra VAT will be paid at all.

75. These measures will reduce the burden of VAT on construction so far as the private sector is concerned to just £35 million in 1989-90 rising to £110 million in 1992-93. Without them the yield from VAT on construction in the private sector would have risen to £450 million. There will also be a four-year yield of £250 million from construction carried out for the public sector, and the public sector programmes concerned have already been protected by compensatory adjustments where necessary.

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

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

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

79. I also propose to relieve from car tax cars leased to the disabled. This is equivalent to an overall saving of about £400 on each vehicle leased to a disabled person.

80. I also propose to allow the present rules on tax relief for membership subscriptions paid by covenant to heritage and conservation charities. If the member is given the right of full entry to view the charity's property, that benefit will be ignored in determining whether relief is due. This will be of particular benefit to organisations such as the National Trust.

81. But in general, I continue to believe that the best way of helping charitable causes through the tax system is by directly encouraging the act of charitable giving. The Payroll Giving Scheme, which I introduced in my 1986 Budget, has been growing steadily. Some 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 for tax relief. I now propose to double that limit to £480, or £40 a month.

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

83. I now turn to the excise duties.

84. The damage to the environment in general, and to child health in particular, from lead in the atmosphere, and the contribution of ordinary leaded petrol to this problem, is increasingly widely known. The government is committed to phasing out leaded petrol, and in successive Budgets I have sought to assist this. I first introduced a tax differential in favour of unleaded petrol in 1987, and increased it last year. But although sales are undoubtedly rising, unleaded petrol still accounts for only some 5 per cent of total petrol sales, even though two-thirds of the cars now on

the road could use it, either without any ~~adjustment~~ or else with a ~~conversion costing only some £20 or so.~~

85. 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 usually is. ~~Others wrongly imagine that their car's performance would suffer were they to use unleaded fuel.~~ Many are under the false impression that, if they do switch to unleaded petrol, their cars will no longer be able to use leaded petrol.

86. 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 nearly fourpence a gallon. If this ~~reduction~~ is fully passed on to the customer - and I look to the oil companies to see that it is - it means that the price of unleaded petrol at the pump will generally be getting on for tenpence a gallon, or just over twopence a litre, cheaper than four star leaded petrol. [This will be one of the most substantial differentials between the price of leaded and unleaded petrol within the European Community.]

87. But I do not intend to stop there. I also propose to raise the tax on two and three star petrol, so that the pump price of these grades will be at least as high as that of four star. This should encourage garages to phase out two star petrol, which is already down to about 6 per cent of the total market, thus enabling them to switch storage capacity to unleaded petrol - quite apart from the incentive to the remaining two-star users to switch to unleaded fuel.

88. 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.

89. They will of course also lead to a loss of revenue of some £40 million in 1989-90. I propose to recoup this from Vehicle Excise Duty. At the present time a bus or a coach has to have 66 seats before it pays as much in Vehicle Excise Duty as a family car. I propose to rectify this anomaly by increasing the tax rates of this group of vehicles so that they cover their track costs. I also propose to increase the rates of duty for the heaviest non-articulated lorries, to put them on a more equal footing with articulated lorries. These changes

I propose to will also simplify the system, greatly reducing the number of separate rates of Vehicle Excise Duty.

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

TAXATION OF INCOME

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

92. Since I aligned the rates of income and capital gains tax in last year's Budget, it follows that I also propose no change this year in the capital gains tax rates. However, I do have a few ~~chances to~~ capital gains tax ~~to propose~~. announcement & make consulting

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

pf.dc.169 **BUDGET CONFIDENTIAL**

[See para 96]

FROM M C SCHOLAR
DATE 10 MARCH 1989

MISS WALLACE

cc Mr Culpin
Mr Gilhooly

GIFTS TO HOUSING ASSOCIATIONS

Few days old!

You asked for a slightly extended draft on housing associations.

2. I suggest deleting the second sentence of paragraph 96 (which I missed when I wrote my minute - or was it new?), beginning paragraph 98 "Next on capital gains, I propose ...", then adding a new paragraph 98a as follows:

"~~Finally~~ Moreover, I propose to extend the existing relief for all gifts to charities to gifts of land and buildings to housing associations. ~~This means that all such gifts will be entirely relieved of inheritance tax; and that where instead of being given away the land is sold at less than market value any capital gains tax will be based on the actual proceeds rather than, as now, on the market value. I hope that these two changes will encourage both gifts and cheap sales of land and buildings to housing associations.~~"

X

A

3. I have agreed this with Mr McManus of the Revenue.

I also propose that ~~In addition,~~ such gifts and ~~cheap~~ conveyances sales ~~will~~ be normally exempt from inheritance tax.

MLS

Ch/ my manuscript amendment is IR-approved as logic at X was flawed.

MPW.

M C SCHOLAR

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

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

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

INSERT (A) (MCS) HOUSE

97. In the case of gifts of personal belongings, these benefit from chattels relief, under which any items worth less than £3,000 on disposal are entirely exempt from capital gains tax. I propose to double the chattels exemption limit to £6,000.

98. ~~Lastly, on capital gains tax,~~ THIRD, I propose 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.

99. To return to income tax, I propose to raise all the main income tax thresholds and allowances by the statutory indexation factor of 6.8 per cent, rounded up. Thus the single person's allowance will rise by £180 to £2,785, and the married man's allowance will rise by £280 to £4,375. The basic rate limit will rise by £1,400 to £20,700.

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

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

102. The income limit for the age allowance will rise by £800 to £11,400, again in line with indexation. However, I propose to reduce the rate at which the age allowance is withdrawn above this income limit. I propose that in future it should be withdrawn at the rate of £1 of allowance for each £2 of income above the limit, instead of the present rate of £2 in every £3. This means that the marginal tax rate for those in the withdrawal band will be reduced to well below 40 per cent, thus meeting a large number of representations I have received over the past year.

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

104. I have one further change to make to help pensioners. Under the earnings rule, any pensioner who decides to continue to work after reaching the statutory retirement age has his or her pension docked at a rate of 50 per cent on every £1 earned between £75 and £79 a week, rising to 100 per cent for every £1 earned over £79 a week. This rule applies until he or she has reached five years beyond the State pension age.

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

106. That is precisely what we shall do. My Rt.Hon Friend the Secretary of State for Social Services and I have agreed that the pensioners' earnings rule should be abolished from the beginning of October, the earliest practicable date. The necessary legislation will be included in the Social Security Bill currently before the House.

£190

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

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

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

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

NATIONAL INSURANCE CONTRIBUTIONS

111. I have one further measure to propose.

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

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

is not a real problem so far as employees' contributions are concerned. But it is for employers. For it

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

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

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

and thus remove a serious work disincentive from the system.

essential feature of the contributory principle. But my proposals will more than halve this step, to only 86 pence a week in 1989-90.

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

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

118. The new system will take effect from the beginning of October, the earliest practicable date. The cost will be £1 billion in 1989-90 and £2.8 billion in 1990-91. The necessary legislation will be included in the Social Security Bill currently before the House.

119. The total additional cost of all the measures in this Budget, on an indexed basis, is under £2 billion in 1989-90 and £$3^{1}/_{2}$ billion in 1990-91.

[BRIEF PERORATION TO COME]

CONCLUSION

Mr Deputy Speaker, in this Budget I have reaffirmed the Government's commitment to the defeat of inflation through the maintenance of prudent monetary and fiscal policies. I have budgeted for a debt repayment of £14 billion - the largest ever. I have announced a major reform and reduction in employees' national insurance contributions; and I have fulfilled our pledge to abolish the earnings rule for pensioners.

I commend this Budget to the House.

chex.md/mw/29 BUDGET SECRET

COPY NO 35 OF 35

FROM: MISS M P WALLACE
DATE: 9 March 1989

SIR T BURNS

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

Sir A Battishill IR
PS/IR

Mr Unwin C&E
PS/C&E

BUDGET STATEMENT: ECONOMIC SECTION

The Chancellor was grateful for the comments he has had on the version of the Economic section of the speech circulated with my minute of 7 March.

... 2. I now attach his revised version. He will be working further on it during the day tomorrow and will want to show a near

final version to the Prime Minister in the evening. He would be grateful if final comments, could reach me by lunchtime tomorrow, Friday 10 March.

MOIRA WALLACE

BUDGET SPEECH - FIRST SECTION

The background to this year's Budget is the continuing need to combat inflation, at a time when, throughout the world, it is unmistakably edging up again.

2. It is only by doing this, whatever the short-term difficulties, that we can be sure of preserving the great gains we have made in this country over the past ten years, gains which offer the prospect of an even better future.

3. I shall begin, as usual, with the economic background to the Budget, I shall then deal with monetary policy and the public sector finances. Finally, I shall propose a number of measures to carry forward the process of tax reform.

4. As usual, the Financial Statement and Budget Report, together with a number of Press Releases filling out the details of my [tax] proposals, will be available from the Vote Office as soon as I have sat down.

COBO, Ecu bills — cd omit, have on some occasions in past.

Optional → [I start with the economic background.]

5. The Government's first ten years in office have seen a transformation both in the way in which economic

policy is conducted, and in the results that have been achieved.

6. For the first time, economic policy has been set firmly and explicitly in a medium-term context. We stand ready to act and act decisively whenever inflationary pressures threaten to re-emerge. But that is within the basic philosophy that the Government should set a sound medium-term financial framework and leave the private sector free to operate with confidence within it.

This is now v. compressed, and doesn't follow entirely clearly. I suggest reordering.

7. The Government came to office with two central objectives - to defeat inflation, and to breathe new life into a moribund economy - and a clear idea of how to achieve them. Inflation is a disease of money; and monetary policy is its cure. Fiscal policy is used to bring the public accounts into balance and keep them there, and thus provide vital support for the process of re-establishing sound money. Within the context of sound money, markets have to be allowed to work again, and the enterprise culture restored, by the removal of unnecessary restrictions and controls, by the reform of trade union law and promotion of all forms of capital ownership, and by the reform and reduction of taxation.

8. Our first and most urgent task was to stamp out the inflationary fires that had raged in the '70s, and wrought so much economic and social havoc. Between 1974 and 1979 inflation averaged over 15 per cent. Over the past six years, it has averaged under 5 per cent.

9. On the supply side, once business and industry recognised the fundamental changes that were taking place, they responded to the new economic climate with vigour and confidence. As a result, we have experienced the longest period of strong and steady growth since records began. Indeed, output in the United Kingdom has grown faster than in all the other main European nations during the '80s - a marked contrast to the previous two decades, when we were bottom of the league. And this growth has been based on a dramatic and sustained improvement in productivity, which for the economy as a whole has been second only to that of Japan among all the major nations during the '80s. In manufacturing it has exceeded that of Japan.

10. In Britain today we have more people in work than ever before, they are better motivated, and their living standards have improved beyond recognition.

11. But it is not just our economic performance over the past ten years that has been transformed: so have our prospects for the future. For over the past seven years, investment has grown twice as fast as consumption, creating the increased capacity necessary to meet future demand. Total business investment is now a higher proportion of GDP than ever before. And its quality has improved immeasurably, too; as has the quality of British management. Hence the dramatic and long overdue improvement in company profits. And the total number of businesses is growing at the rate of 1,000 companies a week.

12. So the outlook is good, provided we remain firm in our resolve to get on top of inflation. And at least on this side of the House, we do.

13. A year ago, in the aftermath of the worldwide stock market crash, it looked as if there would be some slowing down from the rapid growth of 1987. In fact that was not to be.

14. It now appears that we had in 1988 a second successive year of growth at $4^{1}/_{2}$ per cent - the first time this has happened for 30 years - with unemployment falling by half a million to well

below the European average. This means, incidentally, that we have had four successive years of growth at 3 per cent or better, the first time this has ever occurred.

15. Manufacturing output grew particularly rapidly, by more than 7 per cent, to a level well above the previous peak reached as far back as the first half of 1974.

16. But total domestic demand probably also grew by getting on for 7 per cent, considerably faster than the economy's capacity to supply, mainly because of the boom in industrial investment, in itself a welcome event, but also because of continued strong growth in consumer spending. This last was financed to an unprecedented degree by borrowing, overwhelmingly mortgage borrowing. Of all borrowing by households, almost 85 per cent is accounted for by mortgages compared with under 5 per cent by credit cards.

17. Inevitably the rapid growth of total spending led to renewed inflationary pressure. To some extent this was diverted into a sharp rise in imports, and hence in the deficit on the current account of the balance of payments. This is officially recorded as having reached [£$14^{3}/_{4}$] billion in 1988, although given the

[£15$^{1}/_{4}$] billion positive balancing item - another name for errors and omissions - the true figure is almost certainly less than this. But whatever the true figure, it is undoubtedly large, and a sharp increase on the deficit recorded in 1987 after seven successive years of surplus.

18. But given sound policies it can readily be financed. Moreover, unlike previous current account deficits we have known in this country, it reflects not a budget deficit, but rather the excess of private sector investment over total private savings. And this is something that will in due course correct itself.

19. But there has also been some pick up in recorded inflation. Excluding the distorting effect of mortgage interest payments, the RPI rose by $4^{1}/_{2}$ per cent last year, much the same as the average over the previous five years. But the rate increased significantly through the year, and now stands at $5^{1}/_{2}$ per cent.

20. Moreover this pick up in inflation appears to be a worldwide trend. Taking the seven major industrial nations as a whole, inflation is now at its highest level for some three years, and still heading upwards.

21. In the UK, as in a number of other countries, it became clear that it was necessary to tighten monetary policy sharply. This meant raising short-term interest rates, which I duly did, starting last June.

22. I am of course keenly conscious of the difficulties for many borrowers, particularly home owners, caused by the rise in interest rates. But however unwelcome high interest rates are, they are infinitely preferable to the damage that would be done by high inflation.

23. There are now increasing signs that the determined action I have taken is having the desired effect. The housing boom that played such a large part in the events of last year has subsided. Monetary growth has slowed down appreciably. And retail sales, too, seem to have levelled off over the past four months, presaging a gradual recovery in the personal savings ratio.

24. The outlook for 1989 is for inflation to rise a little further, from $7^1/_2$ per cent including mortgage interest payments to close to 8 per cent, before falling back in the second half of the year to $5^1/_2$ per cent in the fourth quarter and perhaps $4^1/_2$ per cent in the second quarter of 1990.

25. A slowdown in real growth is inevitable as we get inflation back onto a downward path - indeed, it has almost certainly already begun to happen. Overall growth is forecast to fall from the $4^{1}/_{2}$ per cent recorded last year to 2 per cent this year, with domestic demand growth also at 2 per cent. Within this, investment, which is holding up well, is once again forecast to grow faster than consumption. The current account deficit is forecast to remain at the same level as last year.

26. But the question of just how "soft" or "hard" the landing is as we get the economy back on track, is not in the hands of Government alone. The Government's task is to reduce inflation by acting, through monetary policy, to bring down the growth of GDP in money terms. The extent to which, over the short term, this is reflected in a reduction in inflation, and the extent to which it is reflected in slower output growth, is up to business and industry.

27. The better industry succeeds in controlling its pay and other costs, the less painful the necessary reduction in the growth of nominal GDP will be, not least in terms of employment prospects.

28. But over the medium-term, it is clear from our experience over the past ten years that the policy we are pursuing will bring inflation down, and steady growth will resume. Indeed, over anything but the very short term, the use of fiscal and monetary policy to promote growth merely leads to inflation; whereas the use of macroeconomic policy to curb inflation, when coupled with the right supply side policies, produces real growth.

Monetary policy

29. Monetary policy, to which I now turn, plays and must always play, the central role in the battle against inflation. It is at the very heart of the medium-term financial strategy, the tenth edition of which I am publishing today.

30. I have described the monetary tightening that has taken place over the past nine months. This has already led to a sharp deceleration in the rate of growth of the target aggregate, M0.

31. For 1989-90, the target range for M0 will be 1-5 per cent, as envisaged in last year' MTFS. Although starting the year above the top of that range, its very

low growth over the past six months - under 3 per cent at an annualised rate - suggests that it will fairly soon come back within it. As for the past DLCP two ~~[three]~~ years, there is no target for the growth of broad money, or liquidity, but I will continue to take it into account in assessing monetary conditions.

32. The exchange rate is of particular importance in the conduct of monetary policy. The Government's clear commitment not to accommodate increases in domestic costs by exchange rate depreciation remains a key safeguard against inflation. This has been demonstrated both by the level of interest rates and by our readiness to use the massive reserves we have accumulated. In this context, we will continue to work with our G7 partners to maintain the exchange rate stability that has been a feature of the past two years.

33. Short-term interest rates remain the essential instrument of monetary policy. I repeat what I have stated clearly on a number of previous occasions: interest rates will stay as high as is needed for as long as is needed to get on top of inflation.

Public Sector finances

34. I now turn to fiscal policy. When we first took office the public sector borrowing requirement was over 5 per cent of GDP - equivalent to more than £25 billion in today's terms.

35. This was steadily reduced over the years as a deliberate act of policy, until, by 1987-88, the PSBR had been eliminated altogether and we started to repay the national debt. had a debt repayment. moved into financial surplus.

DLCP

36. Accordingly, last year I budgeted for a further Public Sector Debt Repayment, or PSDR, of some £3 billion. In the event, it looks like turning out almost five times as large, at £14 billion, or 3 per cent of GDP. Even if there had been no privatisation proceeds at all, the public finances would still be in surplus, to the tune of some £7 billion.

37. Nothing like this has ever been achieved in the past 40 years. And no other major country enjoys a comparable budget surplus. It has not been easy, even though we have been assisted in this in the year now ending by the exceptional buoyancy of the economy, which both boosted tax receipts and reduced public expenditure

well below the planned level. As a result, Government debt as a proportion of GDP is now lower than at any time since the First World War.

38. Moreover, the substantial net repayment of public debt over the past two years has permanently reduced the burden of debt servicing, both now and for future generations. For the coming year, for example, the debt repayments of the last two years mean that net debt interest costs will be lower by some £$1\frac{3}{4}$ billion a year. This saving is being put to good use.

39. The objective of funding policy remains unchanged: to achieve a full fund of the Government's borrowing requirement, which nowadays translates into using the Budget surplus to buy back [an equivalent amount of] Government debt. With the PSDR this year likely to be considerably larger than earlier expected, it may not be practicable to buy back sufficient debt to meet the funding rule this financial year, in spite of innovations such as a reverse gilt auction. The undershoot will therefore be carried forward into the next financial year. Because there are unusually heavy maturities of gilt-edged stock in 1989-90, this is unlikely to require any major change in the rate at which the Bank of England purchases gilts.

DLCP [didn't in 87-8]

40. The dramatic improvement in the United Kingdom's public finances has also provided a welcome opportunity to devote more attention to the structure of the debt that remains. We will continue to seek both to minimise the cost of servicing the Government's domestic debt and to improve its quality by relying less on the more liquid borrowing instruments.

41. We have also been able to restructure part of the Government's foreign currency debt, launching an innovative and cost-effective programme of Treasury Bills denominated and payable in ecu. The first series of six monthly tenders for these bills has proved very successful, and this is an innovation we plan to continue.

[moved]

42. Meanwhile, I am today adding one more entry to the long list of financial controls which we have swept away during our term of office. The last surviving relic of the post-War apparatus for the direction of capital by the State is the Control of Borrowing Order, which since 1946 has involved first the Treasury and then the Bank of England in giving consents for equity and bond issues in the capital markets. The Treasury has today made a General Consent under the Control of Borrowing Order 1958, so that it will no longer be necessary for

those who wish to make capital market issues to obtain the Bank of England's consent to the timing of such issues; and we will, as soon as possible, revoke the Order itself and repeal the legislation on which it depends, the 1946 Borrowing (Control and Guarantees) Act.

43. The sterling capital market has in recent times been going through a period of considerable adjustment, as the Government has changed from being a large issuer to a large purchaser of its own debt. I will have more to say about that in a moment. The abolition of the Control of Borrowing Order will remove an unnecessary and bureaucratic restriction on issuers of capital as they move into the space formerly occupied by the Government when it was a borrower.

44. This new freedom will be enhanced by a further, important, set of derogatorily measures for the sterling capital market which are being promulgated today in notices issued by the Bank of England. These measures will open up the market for sterling paper of less than 5 years' maturity by extending the range of institutions which can make such issues; and they will create a unified regime for all these issues.

45. Taken together the changes I have described constitute a major liberalisation of the arrangements for London's capital markets. They will give greater flexibility to issuers and wider choice to investors.

46. In last year's Budget Speech , I set out the principle of a balanced budget as a proper objective of fiscal policy, in these terms:

> "A balanced budget is a valuable discipline for the medium term. It represents security for the present and an investment for the future. Having achieved it, I intend to stick to it. In other words, henceforth a zero PSBR will be the norm. This provides a clear and simple rule, with a good historical pedigree."

47. It is a rule that ensures that, as GDP continues to rise, the ratio of public debt to GDP continues to fall, and with it the burden of debt interest. It ensures, too, that the State makes no claim either on the savings of the private sector or on flows of finance from overseas. But to go further than this, and seek to achieve the maximum possible repayment of public debt, would not be consistent with the Government's policy,

as it would mean deferring for a very long time the benefits of a reduction in the burden of taxation.

48. So I reaffirm the principle of the balanced budget. However, given the substantial surplus we now have, the path of prudence and caution is clearly to return to balance not overnight, but gradually, over a period of years. Thus we can expect to have a number of further years of debt repayment ahead of us. Moreover, given the particular uncertainties there are at the present time, I believe it would be right to budget for 1989-90 for a surplus similar to that secured in the year now ending; in other words, a further public sector debt repayment, or PSDR, of some £14 billion. What this means is that it will not be possible in this Budget to reduce the burden of taxation; that is to say, to reduce taxation as a share of GDP.

chex.md/mw/29 **BUDGET SECRET**

COPY NO 17 OF 35

FROM: MISS M P WALLACE

DATE: 9 March 1989

SIR T BURNS

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

Sir A Battishill IR
PS/IR

Mr Unwin C&E
PS/C&E

c Miss Wallace

One or two comments on the figures.

CDL 10/3

BUDGET STATEMENT: ECONOMIC SECTION

The Chancellor was grateful for the comments he has had on the version of the Economic section of the speech circulated with my minute of 7 March.

... 2. I now attach his revised version. He will be working further on it during the day tomorrow and will want to show a near

19713

8. Our first and most urgent task was to stamp out the inflationary fires that had raged in the '70s, and wrought so much economic and social havoc. Between 1974 and 1979 inflation averaged over 15 per cent. Over the past six years, it has averaged under 5 per cent.

9. On the supply side, once business and industry recognised the fundamental changes that were taking place, they responded to the new economic climate with vigour and confidence. As a result, we have experienced the longest period of strong and steady growth since records began. Indeed, output in the United Kingdom has grown faster than in all the other main European nations during the '80s - a marked contrast to the previous two decades, when we were bottom of the league. And this growth has been based on a dramatic and sustained improvement in productivity, which for the economy as a whole has been second only to that of Japan among all the major nations during the '80s. In manufacturing it has exceeded that of Japan.

Is this being checked by SP. Richards.

10. In Britain today we have more people in work than ever before, they are better motivated, and their living standards have improved beyond recognition.

below the European average. This means, incidentally, that we have had four successive years of growth at 3 per cent or better, the first time this has ever occurred.

15. Manufacturing output grew particularly rapidly, by more than 7 per cent, to a level well above the previous peak reached as far back as the first half of 1974.

16. But total domestic demand probably also grew by getting on for 7 per cent, considerably faster than the economy's capacity to supply, mainly because of the boom in industrial investment, in itself a welcome event, but also because of continued strong growth in consumer spending. This last was financed to an unprecedented degree by borrowing, overwhelmingly mortgage borrowing. Of all borrowing by households, almost 85 per cent is accounted for by mortgages compared with under 5 per cent by credit cards.

17. Inevitably the rapid growth of total spending led to renewed inflationary pressure. To some extent this was diverted into a sharp rise in imports, and hence in the deficit on the current account of the balance of payments. This is officially recorded as having reached [£14 3/4] billion in 1988, although given the

14½ in Brief

[£15 1/4] billion positive balancing item - another name for errors and omissions - the true figure is almost certainly less than this. But whatever the true figure, it is undoubtedly large, and a sharp increase on the deficit recorded in 1987 after seven successive years of surplus.

18. But given sound policies it can readily be financed. Moreover, unlike previous current account deficits we have known in this country, it reflects not a budget deficit, but rather the excess of private sector investment over total private savings. And this is something that will in due course correct itself.

19. But there has also been some pick up in recorded inflation. Excluding the distorting effect of mortgage interest payments, the RPI rose by 4 1/2 per cent last year, much the same as the average over the previous five years. But the rate increased significantly through the year, and now stands at 5 1/2 per cent.

20. Moreover this pick up in inflation appears to be a worldwide trend. Taking the seven major industrial nations as a whole, inflation is now at its highest level for some three years, and still heading upwards.

25. A slowdown in real growth is inevitable as we get inflation back onto a downward path - indeed, it has almost certainly already begun to happen. Overall growth is forecast to fall from the $4^{1}/_{2}$ per cent recorded last year to 2 per cent this year, with domestic demand growth also at 2 per cent. Within this, investment, which is holding up well, is once again forecast to grow faster than consumption. The current account deficit is forecast to remain at the same level as last year.

26. But the question of just how "soft" or "hard" the landing is as we get the economy back on track, is not in the hands of Government alone. The Government's task is to reduce inflation by acting, through monetary policy, to bring down the growth of GDP in money terms. The extent to which, over the short term, this is reflected in a reduction in inflation, and the extent to which it is reflected in slower output growth, is up to business and industry.

27. The better industry succeeds in controlling its pay and other costs, the less painful the necessary reduction in the growth of nominal GDP will be, not least in terms of employment prospects.

rc 1989/9.3.03

Ch/ These are comments on earlier draft but still relevant. M.

RPC

FROM: ROBERT CULPIN
DATE: 9 March 1989

MISS WALLACE

cc: Mr A C S Allan

BUDGET STATEMENT: ECONOMIC SECTION

I think the draft of 7 March is excellent, so I won't waste your time with pettifogging points.

2. You asked what is missing. My main answer is microeconomics - not missing, but understated. But on the whole I should let it go: you can't do everything.

new better

3. I attach two small suggestions from the repertoire, both entirely optional.

4. If you can see a better way of doing it - I can't at the moment - it could be worth making more explicitly this point from the Tax Reform pamphlet:

> "for obvious reasons, Budgets are presented each year as strings of measures, each explained in its own terms... while the economic section of the Budget speech is reported separately. ...[This] has the unfortunate effect that tax reform and economic performance are seen as wholly unconnected. Yet my main objective in reforming taxes has been to improve the performance of the economy; and that is the overriding test by which the reforms stand to be judged."

This bit cd go in v. early in opening paras.

Rc

ROBERT CULPIN

33. Short term interest rates have always been the essential instrument of monetary policy. For years, their role was obscured by exchange controls, corsets, mortgage rationing and over funding; and Governments showed themselves afraid to use interest rates properly, because they feared the political unpopularity of changes in the mortgage rate. But a decade of deregulation has set the financial markets free to allocate resources to projects which offer the highest return [and enabled us, among other things, to build up one of the largest stocks of overseas assets in the world]. At the same time, it has made interest rates a more potent weapon, because they have come to act on a wider base. So monetary policy is now free to do the job it ought to do. This puts a greater burden on the use of interest rates [or rationing by price]. The Government has shown by its track record that it is fully prepared to use them as they should be used.

chex.pj/jc/9.3.3

BUDGET SECRET

COPY NO 1 OF 10

FROM: MRS JUDITH CHAPLIN
9th March 1989

CHANCELLOR

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

BUDGET STATEMENT: TAX SECTION - NICS

I had discussed with Paul McIntyre the difficulty that stressing that "everyone on just under half average earnings or more" stands to gain £3 a week, invites the question "what do those under half average earnings gain?". The Inland Revenue press release shows that they gain but, of course, gain less. This is because they are already paying at a lower rate due to the pre-1985 reforms.

2. But if account is taken of the two changes (the 1985 reform and the current one), then those earning between LEL £43 a week and £115 a week gain exactly the same amount, ie £3.

3. I think this should be in your Budget Statement, with a sentence at the end of paragraph 117 which is something like:

> "And for those below this level of earnings the change, together with earlier reduction in their contribution, leaves them with a similar amount."

JUDITH CHAPLIN

CHAP-LIN

ANNOTATED

chex.rm/mw/19

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FROM: MISS M P WALLACE
DATE: 9 March 1989

PS/FINANCIAL SECRETARY

Ch/ This incorporates the trivial points. At various points I refer you to separate minutes. 'Paul Gray' are his personal reactions rather than PM's.

mpw

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Monck
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]

B.L.O. SECRET

BUDGET STATEMENT: TAX SECTION

The Chancellor was most grateful for all the further comments on the speech version I circulated on 6 March. I now attach his virtually final version*. It has been sent to No.10 in this form.

* amendments sidelined.

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2. If you or copy recipients have any further comments - essential changes or factual corrections - could they reach me by lunchtime tomorrow, Friday 10 March, please.

MOIRA WALLACE

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Version of 9/3, noon.

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OK?

TAXPAYER CONFIDENTIALITY

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

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

EST/ I — K by individual taxpayers about their private affairs

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

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

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

OK?

BUSINESS TAXATION

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

6. First, taxes on business.

7. Ever since the corporation tax reform I introduced in 1984, the rate of corporation tax for small companies, defined for this purpose as those with annual profits of less than £100,000, has been set at the basic rate of income tax, currently 25 per cent. Large companies, defined as those with profits of £$^1/_2$ million or more, pay the main rate of corporation tax of 35 per cent, one of the lowest rates of tax on company profits in the world. Between £100,000 and £$^1/_2$ million the average rate of tax gradually rises from 25 to 35 per cent.

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

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

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

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

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

13. Over the years I have received a number 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.

SECRET B.T.O. SECRET

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

15. One of the many undesirable features of an income tax system with several higher rates was that since a taxpayer's marginal rate could well be very different in

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different years, the question of which year income related to made a great deal of difference. This was true of Schedule E where the strict rule is that income is taxed in the year to which it relates, on an accruals basis.

16. For the vast majority of employees, this basis of assessment for Schedule E poses no problem. But for about half a million people, mainly directors, who do not receive all their income in the year to which it relates, it causes complications and often needless assessments and correspondence long after the tax year is over. It is also open to manipulation.

17. I therefore propose that income tax under Schedule E should in future be assessed on a receipts basis, with the simple principle that you pay the tax when you receive the income. This will have a transitional cost of £80 million in 1989-90 and £60 million in 1990-91, but in the long term it will yield both extra revenue and a significant saving in both taxpayer's time and Inland Revenue staff.

Ch/ This I would accept. Apparently not at all clear true that apportionment 'bites' on all the hundreds of thousands of close companies.

M.

[regime for] or [system applying to]

18. The reduction in the top rate of income tax to 40 per cent in last year's Budget also enables me to make a major simplification of the tax ~~treatment of~~ the

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vast bulk of the incorporated sector of small businesses: those known as close companies - generally speaking, unquoted companies that are controlled by five or fewer people.

19. The rules for the so-called apportionment of close companies' income are notoriously complex, taking up some twenty pages of impenetrable legislation. These rules are no longer needed and I propose to abolish them. I believe that family businesses in particular will welcome this substantial simplification.

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

OK ?

TAXES ON SAVING

21. I now turn to the taxation of saving.

22. The sharp decline in the ratio of personal saving to personal income, over the past two years in

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particular, has led to even more discussion than usual of the merits of providing greater tax incentives for personal saving.

23. Certainly it is desirable that, over the medium-term, we generate as a nation a level of saving sufficient to finance a high level of investment. But what matters for that is not personal savings alone, but corporate savings too, which are running at historically high levels, and public sector savings, which have been boosted by the move to budget surplus.

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

25. Above all, the role of tax reform is to encourage enterprise and improve economic performance in the medium term. It is wholly inappropriate as an answer to short term or cyclical phenomena. So for the taxation of savings, the Government's policy is clear. It is to

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strengthen and deepen popular capitalism in Britain, by encouraging in particular wider share ownership.

26. I have a number of specific tax measures to announce today to that end.

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

28. Personal equity plans got off to a good start, with over a quarter of a million investors, many (of whom) who had never owned shares before, subscribing almost £$^{1}/_{2}$ billion between them in 1987.

29. Since then, however, the take-up of new PEPs has slowed down, not least as a result of the changed climate in the equity market which followed the October 1987 Stock Exchange crash.

30. So the time has come to improve and simplify PEPs and give them a new boost.

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31. 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.

32. Second, within that, I propose to raise substantially the amount that can be invested in unit trusts or investment trusts. For many small savers, these provide an excellent introduction to shareholding. At present ~~[PEP investors may only place £540 a year, for a quarter of their PEP,]~~ (cannot place more than £750 of their PEP) in unit or investment trusts. I propose to more than treble this amount, to £2,400 a year; and I propose to allow the whole of a PEP to be invested in unit or investment trusts, up to this limit. To qualify for tax relief, the unit or investment trusts will be required to invest wholly or mainly in UK equities.

Paul Gray said he thought this read oddly: 2400 > (4x540) The missing link is the £750. My pencil amendment would clarify - but original draft was fine, too.
M.

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

34. Finally, I propose to make a number of important simplifications to the PEP rules so as to make the

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scheme more flexible, better directed to the needs of small and new investors, and cheaper to administer.

35. I am confident that the changes that I have announced today will enable personal equity plans to play an important part in stimulating the spread of ownership of British equities in the years ahead.

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

37. 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~~ benefitting some $1\frac{3}{4}$ million employees. At present the annual limits on the value of shares which can be given under all-employee profit-sharing schemes are £1,250 or 10 per cent of salary up to a ceiling of £5,000. I propose to raise these cash limits to £2,000 and £6,000 respectively.

38. Second, I propose to increase the monthly limit on contributions to all-employee save-as-you-earn share option schemes from £100 to £150, and at the same time to double the maximum discount from market value at

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which options may be granted from 10 per cent to 20 per cent.

39. Third, a number of my Hon. Friends have been concerned that current tax law may be inhibiting the development of employee share ownership plans, otherwise known as ESOPs. These are distinguished from ordinary approved employee share schemes by the fact that they use a wider variety of finance, acquire more shares and tend to operate on a longer timescale. I propose to make it clear that companies' contributions to ESOPs qualify for corporation tax relief, provided they meet certain requirements designed to ensure that the employees acquire direct ownership of the shares within a reasonable time. I hope that this will encourage more British companies, particularly in the unquoted sector, to consider setting up ESOPs.

40. Those firms with employee share ownership schemes have no doubt that giving the workforce a direct personal interest in their profitability and success improves the company's performance. The same benefits flow from profit related pay.

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

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

SECRET

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

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44. Taken together, the package of measures I have announced to encourage wider share ownership in general, and employee share ownership in particular, will help to ensure that the idea of a share-owning democracy becomes

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ever more entrenched as a part of the British way of life.

45. Last June, the Inland Revenue issued with my authority a major consultative document on the taxation of life assurance.

Paul Craig, like the FST, thinks this too erudite!

46. The tax regime for life assurance is sui generis. The present system dates back to the First World War and has developed over the years in a piecemeal way, leading to a state of affairs in which the incidence of tax is extremely uneven, with some [successful] fast-growing life offices paying no tax at all.

AGT

47. 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.

48. I have considered very carefully the representations the industry has made, and taken full account both of the changes to the regulation of life assurance proposed by the Securities and Investment Board under the Financial Services Act and the prospects for increased competition within the European Community after 1992. In the light of these factors, I have

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decided not to proceed with the more radical reforms canvassed in the consultative document. But I do have a number of important changes to propose, based for the most part on the general tax reform principle of seeking lower rates on a broader base.

See RPC's minute

49. First, many life offices run a pension business alongside their main 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 business, thus giving their life profits unduly favourable tax treatment. The life offices themselves have accepted that this treatment is anomalous and I propose to end it.

50. This change, along with some minor related changes, will come into force on 1 January 1990, and will yield some £150 million in 1990-91. The remainder of the changes I have to propose constitute a broadly balanced package which, because of the transitional provisions, will reduce the taxation of life assurance in 1990-91 by some £100 million.

51. I propose that the expenses incurred by life offices in attracting new business should continue to be

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fully deductible for tax purposes from the income and gains of life funds, but should in future be spread over a period of seven years. To give the industry time to adjust, this change will be phased in gradually over the next four years, starting on 1 January, 1990.

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

SECRET

53. But I can say here and now that I propose, as from 1 January 1990, to abolish Life Assurance Policy Duty. And I also propose, from the same date, that the rate of tax payable on the policyholder's share of 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, should be reduced to the basic rate of income tax.

B.T.O.

54. The net effect of all these changes to the taxation of life assurance will be a cost of £20 million in 1989-90 and a yield of £45 million in 1990-91, rising somewhat in subsequent years.

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

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

SECRET B.L.O.

See mpw 'FST-style' version

57. I now turn to pensions.

MCS — ? — lump sums not quite right" he thinks point adequately made in 69a

58. The tax treatment accorded to pension schemes is quite rightly particularly favourable; and the extent of this privilege has to be circumscribed by Inland Revenue rules. So pension schemes only qualify for tax relief if they meet certain conditions, notably that the pension paid may not exceed two-thirds of final salary:

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and if they fall foul of any of these rules, they lose all relief.

59. This has the perverse result that tax law effectively constrains the overall pension an employer can pay his employee. This is neither desirable nor necessary. Accordingly, I propose to make it possible for employers to provide whatever pensions package they believe necessary to recruit and reward their employees.

60. However, while it is clearly right that employers should be free to provide whatever pension they see fit, it would not be right to make the present generous tax treatment available with no upper limit at all. I therefore propose to set a limit on the pensions which may be paid from tax-approved occupational schemes, based on final salary of £60,000 a year. PEM / Public sector Schemes will be amended to comply with this.

61. 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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62. The new ceiling will apply only to pension schemes set up on or after today, or to new members joining existing schemes after 1 June. And, as I have already said, there will now be complete freedom to provide benefits above the Inland Revenue limits, though without the tax relief.

SECRET

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

64. I also propose to simplify very substantially the rules concerning additional voluntary contributions to pension schemes, or AVCs. In particular, the present requirements for free standing AVCs place a heavy administrative burden on employers. These requirements will be greatly reduced. Indeed, in many cases employers will not need to be involved at all.

Ch/
The idea is, apparently, that they do get involved when pensions are paid. I think the meaning is clear as it stands. If you did want to change, I'd favour "at this stage" when AVCs are paid

BLO.

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

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This will remove the penalty on good investment performance.

66. 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.

67. First, I propose to make it easier for people in personal pension schemes to manage their own investments.

68. Second, I propose to increase substantially the annual limits, as a percentage of earnings, on contributions to personal pensions for those over the age of 35. 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 in relation to occupational schemes. The new limits will be subject to an overall cash ceiling based on earnings of £60,000, corresponding to the new ceiling for occupational pensions, and similarly indexed.

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

SECRET

69a. Coupled with the changes I made in 1987, this is as far as I wish to go in amending the tax treatment of pensions.

70. Finally, on the taxation of saving, ~~it should not be overlooked that~~ a far-reaching reform which I announced in last year's Budget, to come into effect in April 1990, ~~is relevant in this context.~~ should not be overlooked

B.T.O.

Original is fine! (achieves some shortening)

71. I refer to Independent Taxation. For there can be little doubt that one of the greatest disincentives to saving in the present tax system is the treatment of the savings of married women. At present a wife's income from savings has to be disclosed to her husband and taxed at his marginal rate. Independent Taxation will change all that. In particular, those married women who have little or no earnings will in future have their own personal allowance to set against their savings income. Independent Taxation may well do much to encourage the growth of personal saving in this country.

Please see over.

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We would still like a sentence about the leaflets, if possible, [redacted]

Would the Chancellor agree to include the following, shorter, sentence:

"Three new leaflets have just become available from tax offices to explain the new system"?

Ch/ ↑
RPC has discussed all this with Brian Mace, who will not be surprised if you say no. I'm afraid I don't think it has a place in the speech.

M.

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TAXES ON SPENDING — OK?

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

73. As the House knows Her Majesty's Government are obliged to implement the European Court's judgement that certain of our zero rates of VAT on supplies to business, notably on non-residential construction, but also on fuel and power and on water, are not lawful. This derives from the Court's interpretation of the Community's Sixth VAT directive to which the UK agreed in 1977. The necessary changes will be introduced in this year's Finance Bill, and draft clauses have already been published.

74. In implementing the judgement I have sought to do as much as possible to minimise the burden. From 1 April VAT will be payable in respect of all non-residential construction unless carried out under agreements entered into before the court ruling. And from 1 August landlords will have the option to tax rents, which means that in most cases no extra VAT will be paid at all.

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75. These measures will reduce the burden of VAT on construction so far as the private sector is concerned to just £35 million in 1989-90 rising to £110 million in 1992-93. Without them the yield from VAT on construction in the private sector would have risen to £450 million. There will also be a first-year yield of £250 million from construction carried out for the public sector, and the public sector programmes concerned have already been protected by compensatory adjustments where necessary.

C+E

SECRET

B.L.O.

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

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

PMG. I agree.

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

79. I also propose to relieve from car tax cars leased to the disabled. This is equivalent to an overall saving of about £400 on each vehicle leased to a disabled person.

80. I also propose to ~~allow~~ relax the present rules on tax relief for membership subscriptions paid by covenant to heritage and conservation charities. If the member is given the right of ~~full~~ free entry to view the charity's property, that benefit will be ignored in determining whether relief is due. This will be of particular benefit to organisations such as the National Trust.

Might this go better after para 82? At present para 81 reads a little oddly.

See my covering note. MPW

81. But in general, I continue to believe that the best way of helping charitable causes through the tax system is by directly encouraging the act of charitable giving. The Payroll Giving Scheme, which I introduced in my 1986 Budget, has been growing steadily. Some 3,400 schemes have now been set up, and over 100,000

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employees are already participating, quite a few of them giving the full £240 annual limit for tax relief. I now propose to double that limit to £480, or £40 a month.

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

SECRET B.L.O. SECRET

83. I now turn to the excise duties.

See MCS minute for comments on this section

EST

84. The potential damage to the environment in general, and to child health in particular, from lead in the atmosphere, and the contribution of ordinary leaded petrol to this problem, is [increasingly widely known]. The government is committed to phasing out leaded petrol [~~altogether,~~] and in successive Budgets I have sought to assist this. I first introduced a tax differential in favour of unleaded petrol in 1987, and increased it last year. But although sales are undoubtedly rising, unleaded petrol still accounts for only some 5 per cent of total petrol sales, even though two-thirds of the cars now on

EST/a matter of increasing concern

C+E
MCS.

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the road could use it, either without any adjustment or else with a conversion costing only some £20 or so.

85. 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 usually is. Others wrongly imagine that their car's performance would suffer were they to use unleaded fuel. Many are under the false impression that, if they do switch to unleaded petrol, their cars will no longer be able to use leaded petrol.

SECRET

86. 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 nearly fourpence a gallon. If this reduction is fully passed on to the customer - and I look to the oil companies to see that it is - it means that the price of unleaded petrol at the pump will generally be getting on for tenpence a gallon, or just over twopence a litre, cheaper than four star leaded petrol. This will be one of the most substantial differentials between the price of leaded and unleaded petrol within the European Community.

B.L.P.

SECRET

X C+E

See MCS + C+E notes

Everyone wants you to quote tax differential, and passage in brackets not true of price.

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87. But I do not intend to stop there. I also propose to raise the tax on two and three star petrol, so that the pump price of these grades will be at least as high as that of four star. This should encourage garages to phase out two star petrol, which is already down to about 6 per cent of the total market, thus enabling them to switch storage capacity and pumps to unleaded petrol - quite apart from the incentive to the remaining two-star users to switch to unleaded fuel.

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

89. They will of course also lead to a loss of revenue of some £40 million in 1989-90. I propose to recoup this from Vehicle Excise Duty. At the present time a bus or a coach has to have 66 seats before it pays as much in Vehicle Excise Duty as a family car. I propose to rectify this anomaly by increasing the tax rates of this group of vehicles so that they cover their track costs. I also propose to increase the rates of duty for the heaviest non-articulated lorries, to put them on a more equal footing with articulated lorries. These changes At the same time I propose to

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will also simplify the system, greatly reducing the number of separate rates of Vehicle Excise Duty.

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

X This is what you said in 87. Is singular right or 'duties' better. (My 'trivial' comment! M)

TAXATION OF INCOME ← ok?

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

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

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

PMGashs is this a change? (I'm sure it is)

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

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

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

MCS: δ) + add version opposite

97. In the case of gifts of personal belongings, these benefit from chattels relief, under which any items worth less than £3,000 on disposal are entirely exempt from capital gains tax. I propose to double the chattels exemption limit to £6,000.

98. ~~Lastly, on capital gains tax,~~ Third, I propose 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

2 points:
– there are other CGT measures which are not mentioned in the Speech
– the bonds mentioned here will be subject to an income tax not a CGT charge.

MCS agrees.

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

99. To return to income tax, I propose to raise all the main income tax thresholds and allowances by the statutory indexation factor of 6.8 per cent, rounded up. Thus the single person's allowance will rise by £180 to £2,785, and the married man's allowance will rise by £280 to £4,375. The basic rate limit will rise by £1,400 to £20,700.

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

ignorable, I feel.
↓
i.e. the allowance referred to in the previous paragraph

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

expand (PMG)
(I disagree)

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102. The income limit for the age allowance will rise by £800 to £11,400 again in line with indexation. However, I propose to reduce the rate at which the age allowance is withdrawn above this income limit. I propose that in future it should be withdrawn at the rate of £1 of allowance for each £2 of income above the limit, instead of the present rate of £2 in every £3. This means that the marginal tax rate for those in the withdrawal band will be reduced to well below 40 per cent, thus meeting a large number of representations I have received over the past year.

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

104. I have one further change to make to help pensioners. Under the earnings rule, any pensioner who decides to continue to work after reaching the statutory retirement age has his or her pension docked at a rate of 50 per cent on every £1 earned between £75 and £79 a week, rising to 100 per cent for every £1 earned over £79 a week. This rule applies until he or she has reached give years beyond the State pension age.

PMCI - points out no earnings rule for widows pensions I think you can ignore.

PMG (agree)

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

SECRET

106. That is precisely what we shall do. My Rt.Hon Friend the Secretary of State for Social Services and I have agreed that the pensioners' earnings rule should be abolished from the beginning of October, the earliest practicable date. The necessary legislation will be included in the Social Security Bill currently before the House.

B.L.O.

CJR £190

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

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

SECRET

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

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

NATIONAL INSURANCE CONTRIBUTIONS [Retain or not?]

111. I have one further measure to propose.

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

See my covering note

It is an inevitable consequence of this system [(A) over]. These points have come to be known, somewhat inelegantly as the National Insurance steps.

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

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PMG.

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

A

SECRET

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

PMGI (I see no need for this)

The contracted-out rebate for employees will remain 2 per cent.

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

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FROM M C SCHOLAR
DATE 10 MARCH 1989

CHANCELLOR OF THE EXCHEQUER

cc Financial Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Culpin

BUDGET SPEECH

You asked me to check if we have left anything out.

2. In the economic section

(i) you scarcely say anything about the world - paragraphs 1 and 20 are the only references to anything outside the UK. You normally, of course, say very little - but in each of the last three years you have had a short section pointing to the risks which the current account imbalances/febrile currency markets etc might pose for us. Are you content to leave things as they are, or would you like us to concoct something, perhaps elaborating after paragraph 20 on the inflationary threat?

(ii) there is no reference to the fall in unemployment. You could put "rapidly falling unemployment and" after "We have" at the beginning of paragraph 10.

3. In the taxation section

(i) you say nothing about IHT, Keith, the MIR ceiling, ITV and trusts. But all those were, I think, conscious omissions, and I see no reason why you should mention any of them.

(ii) the only reference to Lloyd's in the Speech and the FSBR is in footnote 38 to Chapter 4, the minuscule stock lending concession. But the change which will most affect them is, obliquely, referred to in paragraph 98 and they are being written to by Mr Nield. I (and Mr Johns) think that is just about defensible.

(iii) there are two lollipops which you could put in

(a) capital allowances for safety expenditure at sports grounds. This is, perhaps, too insignificant - a minor extension of an existing concession;

(b) gifts to housing associations to be exempted from IHT and to be given a CGT concession. This is a bit borderline: all we are doing is aligning the treatment of gifts to non-charitable housing associations with that for gifts to charitable housing associations. But it might make paragraphs 92-98 end in a more friendly way. Would you like us to draft something?

MCS

M C SCHOLAR

pso.jt/Middleton/2.10.3

BUDGET CONFIDENTIAL

Ch/ I have cut and pasted X, attached behind. (H) is just the press releases para.

From: SIR PETER MIDDLETON
Date: 10 March 1989

CHANCELLOR

cc Sir T Burns

PEM

BUDGET SPEECH: FIRST SECTION

You might like to consider an alternative ordering of the first two pages. It would, I think, still say all the sombre things which need to be said about inflation. But they would be in a rather more upbeat context. And they look rather more like you.

X

Paragraph 7
Paragraph 5
Paragraph 6
Paragraph 8
Paragraph 1
Paragraph 2
Paragraph 9
Paragraph 10
Paragraph 11 (Paragraph 4 would join the tax section after Paragraph 5)
Paragraph 12
Paragraph 3.

2. We ought to make some reference to the quality of the statistics, otherwise the first mention is in the balance of payments context. I should add, before paragraph 14, something like:

16?

"As everyone knows, the state of the national income statistics leaves a lot to be desired. But it now appears ....."

3. I wonder if we could cut down the Funding/COBO sections a bit. The pace of the speech slackens at this point; and it is not very exciting stuff for the House. Could paragraph 39 be left to the Budget debates? We could manage without paragraph 43.

p.p. P E MIDDLETON