PO-CH/NL/0749 PART A

2/2

BUDGET LIST ONLY

COPY 7

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

10 March 1989

Paul Gray Esq
10 Downing Street
LONDON
SW1

Dear Paul,

BUDGET SPEECH: ECONOMIC SECTION

... I enclose, as promised, two copies of the latest draft of the
... Economic Section of the Budget speech. I also enclose, for completeness, two copies of the peroration for the end of the speech.

Yours,

Moira.

MOIRA WALLACE

BUDGET SPEECH - FIRST SECTION

The background to this year's Budget is the unprecedented strength of the British economy, coupled with the continuing need to combat inflation, at a time when, throughout the world, it is unmistakably edging up again.

2. I shall begin with an account of the performance of the economy in 1988 and the prospects for 1989, set in the context of the past ten years. 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.

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

ECONOMIC PERFORMANCE AND PROSPECTS

4. 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.

5. For the first time, financial policy has been set firmly and explicitly in a medium-term context. We have been guided by 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.

6. 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. Inflation is a disease of money; and monetary policy is its cure. The role of fiscal policy is to bring the public accounts into balance and keep them there, and thus complete the process of re-establishing sound money. And strong sustainable growth is achieved, not through any artificial stimulus, but by allowing markets to work again and restoring the enterprise culture, by removing unnecessary restrictions and controls and rolling back the frontiers of the State, by reforming trade union law and promoting all forms of capital ownership, and by reforming and reducing taxation.

7. 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. And we succeeded. Between 1974 and 1979 inflation had averaged more than 15 per cent. Over the past six years it has averaged 5 per cent.

8. 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 this century. 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. For the economy as a whole our productivity growth has been second only to that of Japan among all the major nations during the '80s. In manufacturing it has exceeded even Japan's.

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

10. But it is not just our economic performance 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 than ever before. And its quality has improved immeasurably, too; as has the quality of British management. We have seen a dramatic and long overdue improvement in company profits. And a remarkable growth in the total number of businesses, now at the rate of more than a thousand a week.

11. Provided we stand firm in our resolve to get on top of inflation, the prospects before us are excellent. And at least on this side of the House, we do.

12. 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.

13. As the House knows, the state of the national income statistics leaves much to be desired. But it now appears that we had in 1988 a second successive year of

growth at $4^1/_2$ per cent, with unemployment falling by over half a million to well below the European average.

14. Manufacturing output grew particularly rapidly, by more than 7 per cent, to a level well above the previous peak.

15. But total spending also grew by getting on for 7 per cent, 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.

16. 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. The published figures put this at £$14^1/_2$ billion in 1988, although given the £15 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.

17. 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, but rather an upsurge of private investment unmatched by private savings. This is something that will in due course correct itself.

18. As the House knows, however, 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 this underlying rate increased significantly through the year, and now stands at $5^1/_2$ per cent.

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21. I am of course keenly conscious of the difficulties many borrowers, particularly home owners, and now experiencing. But however unwelcome high interest rates are, they are infinitely preferable to the damage that would be done by high inflation.

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24. Some slow down 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 $2^{1}/_{2}$ per cent this year, with

growth through the year at 2 per cent. Domestic demand is forecast to slow down even more markedly. But 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.

25. But the question of just how "soft" or "hard" the so-called landing will be 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 national income 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 largely up to business and industry.

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27. But over the medium-term, it is clear from our experience over the past ten years that the policy we are pursuing <u>will</u> bring inflation down, and steady growth will resume. The best contribution the

Government can make to this is to carry forward the process of supply side reform, to help make the economy work better. That is the objective of the specific measures to which I shall turn in the second part of my speech.

Monetary policy

28. As I said at the outset, monetary policy 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.

29. 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, narrow money, or M0.

30. For 1989-90, the target range for M0 will be 1-5 per cent, as envisaged in last year' MTFS. Although it will start 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. As in the past two 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.

31. The exchange rate is of particular importance in the conduct of monetary policy. A 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.

32. 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. For there will be no letting up in our determination to get on top of inflation.

<u>**Public Sector finances**</u>

33. I now turn to fiscal policy.

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

35. This we 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 public 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. Government debt as a proportion of GDP is now lower than at any time since the First World War.

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 this year by the exceptional buoyancy of the economy, which both boosted tax receipts and reduced public expenditure well below the planned level.

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, allowing extra spending on departmental programmes within our overall public expenditure constraints.

39. 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.

40. 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, at around the current level.

41. 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. As from today it will no longer be necessary for companies 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 1946 Act from which it stems.

42. 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. 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.

43. 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.

44. 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.

45. In last year's Budget Speech, I set out the principle of a balanced budget as the 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."

46. It is a rule that ensures that, as national income continues to rise, the ratio of public debt to national

income 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. 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.

47. So I reaffirm the principle of the balanced budget. However, given the substantial surplus we now have, the path of prudence and caution must be 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.

48. 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. This means that, in the space of three years, we shall have repaid roughly a sixth of the public debt that has accumulated over two centuries. But it also means that it will not be possible in this year's Budget to reduce

the burden of taxation; that is to say, to reduce taxation as a share of national income.

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/22 **BUDGET SECRET**

REF: MPW/BS/89/8

COPY NO 6 OF 8 COPIES

FROM: MISS M P WALLACE
DATE: 10 March 1989

MR SCHOLAR

cc Financial Secretary
Sir P Middleton
Sir T Burns
Mr Culpin

BUDGET SPEECH

The Chancellor was very grateful for your minute of 10 March. On your various questions, his answers are, seriatim:

2. (i) The section on the world is deliberately short. We are in a glass house, so it would not be wise to throw stones, even small ones - and generally speaking, the world scene is pretty uneventful at the present, so the Chancellor does not feel compelled to say something.

2.(ii) The silence on falling unemployment was deliberate, since it may well rise again this year. But, on second thoughts, the Chancellor agreed that we should insert the words you suggested in paragraph 10.

3.(i) As you surmise, IHT, Keith, the MIR ceiling, ITV, and trusts were all deliberate omissions.

3.(ii) He notes what you say about the present coverage of Lloyds.

3.(iii) He agrees that there is a case for making something of housing associations. He would be grateful for drafting suggestions.

MPW.

MOIRA WALLACE

gep.md/mar/pscx10

RL/35/1

BUDGET SECRET

COPY NO 1 OF 13 COPIES

FROM: MRS R LOMAX
DATE: 10 MARCH 1989

PS/CHANCELLOR

cc: PS/Chief Secretary
Sir P Middleton
Mr Anson
Sir T Burns
Mr Scholar
Mr Culpin
Mr Riley
Mr A C S Allan
Mr Gieve
Mr Tyrie

BUDGET STATEMENT: ECONOMIC SECTION

I have two suggestions on the draft attached to your minute of 9 March:-

Para 7. The fourth sentence lists some of the developments that have helped to breathe new life into a moribund economy. Could we add a reference to the reduced role of the State (or privatisation: I suspect firm control of public expenditure is pushing it a bit).

RL

Paras 47 and 48. Could we inject the thought that "the benefits of a reduction in the burden of taxation", referred to at the end of para 47, have already been earned, in that the GGE ratio has fallen dramatically, while the tax burden has, if anything, risen. While it may not be prudent to reduce the surplus now, for the reasons given in paragraph 48, when the time comes, reducing the tax burden will have a prior claim. This thought now appears in the MTFS, and, without making a great meal of it, I think it is worth picking up in the speech. One way of doing this would be to add the following to the end of para 47:

> ... "which have already been earned by our great success in controlling public expenditure".

RL

RACHEL LOMAX

CONFIDENTIAL

FROM: P N SEDGWICK
DATE: 10 MARCH 1989

MS WALLACE

cc Sir P Middleton
Sir T Burns
Mr Scholar
Mr Riley
Mr Hibberd
Mr O'Donnell
Mr Pickford
Mr Owen

BUDGET STATEMENT : ECONOMIC SECTION

I have a few minor comments on the version you circulated yesterday.

Paragraph 6

In current circumstances I would remove the words "threaten to" from the second sentence.

Paragraph 15

There is still a problem with the last sentence. The CSO's latest figures show growth of the average measure of GDP at 2.9 per cent for 1986: tantalisingly below the 3 per cent mentioned in the speech. Our 'compromise' measure of GDP will show the same growth.

Paragraph 25

In the second sentence it would probably be better to delete the word 'recorded' (because we use a compromise measure of GDP). Growth for 1989 is 2½ per cent not 2 per cent.

P.N.S

P N SEDGWICK

COPY NO 1 OF 16

BUDGET SECRET

FROM: A G TYRIE
DATE: 10 March 1989

CHANCELLOR

cc: PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir T Burns
Sir P Middleton
Mr Anson
Dame A Mueller
Mr Wicks
Mr Peretz
Mr Pickford
Mrs Chaplin
Mr Call

BUDGET STATEMENT: ECONOMIC SECTION

In general, I think this now reads very well, particularly the opening section, which is now much more up beat.

2. A few minor points:

- Paragraph 9, second sentence. If it is true, I think it would be more punchy to say: "We have experienced the longest period of strong and steady growth this century". Mr Pickford has kindly agreed to check this. "Since records began" sounds less forceful to me; in any case, records began during the Attlee Government.

- Paragraph 12. This is still a bit half-hearted. What about: "provided we remain firm on inflation the prospects remain excellent".

AGT

- Paragraph 35. Is this right? I think we increased the reserves rather than repaid debt. It could read: "Until 1987-88, we were enjoying a fiscal surplus".

- Paragraph 39. This new paragraph on funding policy doesn't look quite right to me. Would it not be more accurate to say as the first sentence: "The objective of funding policy remains unchanged: to achieve a full fund of the government's borrowing requirement, which nowadays means using the budget surplus to repay an equivalent amount of government debt, after taking into account any underlying change in reserves".

  (Incidentally, it crosses my mind that part of the bumper crop of maturities in the coming year, of £12 billion as opposed to about £8 billion, might be attributable to the last Labour government. I have asked for this to be checked. Even if we could attribute the bumper crop to Labour I think this is probably not a budget speech point. It could be deployed in the debate.)

- Paragraph 48. The last sentence is strikingly similar to the introduction to the tax section of last year's budget. But I think it's ok to repeat the formula.

AGT.

A G TYRIE

BUDGET SECRET
Covering BUDGET SECRET: BLO

CSM/12/1

Inland Revenue
Central Division

Somerset House
London WC2R 1LB
Telephone 01-438 7221

10 March 1989

Miss M P WALLACE
Room 13/2
CHANCELLOR'S OFFICE
H M TREASURY

Dear Moira

BUDGET STATEMENT: TAX SECTION

Thank you for copying your submission of 9 March with the latest version of the Budget Statement. I am returning copy 34 with amendments annotated in red, and a few comments in blue.

As agreed, you may want to discuss later this afternoon.

I have only one further comment, apart from those indicated on the draft. This is that we would still like the short piece on trusts, submitted last time, to be included. The attached note - from Mr Corlett - explains why.

Yours

Charles

C. S. MACNICOL

COPY 6

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

10 March 1989

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10 Downing Street
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SW1

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35. This we 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 public 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. Government debt as a proportion of GDP is now lower than at any time since the First World War.

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 this year by the exceptional buoyancy of the economy, which both boosted tax receipts and reduced public expenditure well below the planned level.

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, allowing extra spending on departmental programmes within our overall public expenditure constraints.

39. 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.

40. 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, at around the current level.

41. 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. As from today it will no longer be necessary for companies 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 1946 Act from which it stems.

42. 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. 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.

43. 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.

44. 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.

45. In last year's Budget Speech, I set out the principle of a balanced budget as the 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."

46. It is a rule that ensures that, as national income continues to rise, the ratio of public debt to national

income 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. 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.

47. So I reaffirm the principle of the balanced budget. However, given the substantial surplus we now have, the path of prudence and caution must be 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.

48. 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. This means that, in the space of three years, we shall have repaid roughly a sixth of the public debt that has accumulated over two centuries. But it also means that it will not be possible in this year's Budget to reduce

the burden of taxation; that is to say, to reduce taxation as a share of national income.

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.

COPY NO 1 OF 6 COPIES

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

chex.rm/mw/27

FROM: MISS M P WALLACE
DATE: 10 March 1989

CHANCELLOR

SPEECH: TAX SECTION

As promised, trivial comments marked on the version behind. There are one or two more meaty issues to decide:

- Unleaded (see Michael Scholar's minute, behind).
- Life assurance (a minute from Robert).
- Pensions (I have attempted a rejigged version, as you suggested, on a separate sheet behind). Also a note from Tony Kuczys.

Flagged.

2. Otherwise, most of the changes really are fairly trivial - although I know that Peter Middleton feels fairly strongly that there must be some reference to public sector pensions - see his minute.

3. I should also record that Michael Scholar is rather uneasy about the inclusion of the "National Trust" starter: I was not aware of the background to this but apparently what has happened here is that the Revenue have only just tumbled to the fact that they ought not to be giving tax relief on covenants to the National Trust, since members who pay their subscriptions this way are in fact getting a benefit in exchange. They have warned the Trust that they will have to start clobbering them, but as far as Michael is aware, it is not known more generally. So it is not as if there is a great public campaign for it. It is also pretty tortuous to explain. So you might just want to think again about whether it should be in. Anyway, I thought I ought to set out the background.

4. Finally, can I return to you on a NIC question which I am afraid I rather misexpressed in my note to you earlier in the week. You are, of course, right that we do not "abolish the steps before we explain them". What I ought to have said was that the explanation of the steps at present comes after the sentence: "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 earning scale." If we do it in that order, it is just a little more difficult for the non expert to understand this sentence. So I would still advocate the change I have indicated in pencil on the annotated version. Robert agrees. So I thought it worth one more try. But it is only a matter of taste.

5. One final thought. Are you happy with the headings as we have them at present? I am not, myself, in favour of a separate heading for NICs.

MOIRA WALLACE

Ch / just arrived.

CONFIDENTIAL

FROM: SIR T BURNS
DATE: 10 MARCH 1989

CHANCELLOR

cc Sir P Middleton
Mr Scholar

BUDGET SPEECH: FIRST SECTION

Paragraph 25 uses out-of-date numbers and does not mention the contrast of growth for 1989 as a whole of 2½ per cent and growth through the year of 2 per cent. I suggest:

> "..... Overall growth is forecast to fall from the 4½ per cent recorded last year to 2½ per cent this year, with growth through the year at 2 per cent. Domestic demand is expected to slow down even more rapidly. But within this, investment, which is holding up well, is once again forecast to grow faster than consumption."

2. There is some repetition between the second sentence of paragraph 7 and the opening sentence of paragraph 29. Maybe paragraph 29 should begin

> "As I said at the outset, monetary policy .....".

3. I am also struck on re-reading that the first mention of the MTFS is in paragraph 29. It gets no mention in the success story of the last 10 years set out in the early section. I can see the reason for mentioning it in 29 but it looks like a demotion.

4. Like Sir Peter Middleton I find the Funding/COBO sector a bit long. And we need a reference to the statistics before the current account.

5. As Mr Scholar points out the speech may contain fewer words on the world economy than any "since records began". I can see that it now interrupts the flow of what is a good listen but it may be a little tactless. There were some chunks of world economy in the draft I provided last weekend if you want to rescue a paragraph.

you have opined.

TB

T BURNS

BLO

PS/CST
PERM TB
MCS, CJR,
SP, JG, JC AGT

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

4.

10 March 1989

Paul Gray Esq
10 Downing Street
LONDON
SW1

Dear Paul,

BUDGET SPEECH: ECONOMIC SECTION

I enclose, as promised, two copies of the latest draft of the Economic Section of the Budget speech. I also enclose, for completeness, two copies of the peroration for the end of the speech.

Yours,

Moira.

MOIRA WALLACE

MPW

A few changes

w..

BUDGET SPEECH - FIRST SECTION

and overriding

The background to this year's Budget is the unprecedented strength of the British economy, coupled with the continuing need to combat inflation, at a time when, throughout the world, it is unmistakably edging up again.

2. I shall begin with an account of the performance of the economy in 1988 and the prospects for 1989, set in the context of the past ten years. 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.

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

ECONOMIC PERFORMANCE AND PROSPECTS

4. 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.

5. For the first time, financial policy has been set firmly and explicitly in a medium-term context. We have been guided by 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.

6. 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. Inflation is a disease of money; and monetary policy is its cure. The role of fiscal policy is to bring the public accounts into balance and keep them there, and thus complete the process of re-establishing sound money. ~~And s~~ Strong sustainable growth is achieved, not through any artificial stimulus, but by allowing markets to work again and restoring the enterprise culture, by removing unnecessary restrictions and controls and rolling back the frontiers of the State, by reforming trade union law and promoting all forms of capital ownership, and by reforming and reducing taxation.

7. ~~Our~~ The first and most urgent task (we faced) was to ~~stamp~~ damp down out the inflationary fires that had raged in the '70s, and wrought so much economic and social havoc. And we succeeded. Between 1974 and 1979 inflation had averaged more than 15 per cent. Over the past six years it has averaged 5 per cent – still not good enough, but a massive improvement.

8. 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 this century.~~ 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. For the economy as a whole our productivity growth has been second only to that of Japan among all the major nations during the '80s. In manufacturing it has exceeded even Japan's.

9. In Britain today we have more people in work than ever before in our history; they are better motivated than ever before, and their living standards have improved beyond recognition. The seven years to 1988 have seen the longest period of strong and steady growth ~~this century,~~ since the war.

10. But it is not just our economic performance 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 than ever before. And its quality has improved immeasurably, too; as has the quality of British management. We have seen a dramatic and long overdue improvement in company profits. And a remarkable growth in the total number of businesses, now at the rate of more than a thousand a week.

11. Provided we stand firm in our resolve to get on top of inflation, the prospects before us are excellent. And at least on this side of the House, we do.

12. 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.

13. As the House knows, the state of the national income statistics leaves much to be desired. But it now appears that we had in 1988 a second successive year of

growth at $4^1/_2$ per cent, with unemployment falling by over half a million to well below the European average.

14. Manufacturing output grew particularly rapidly, by more than 7 per cent, to a level well above the previous peak.

15. But total spending also grew by getting on for 7 per cent, 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.

16. 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. The published figures put this at £$14^1/_2$ billion in 1988, although given the £15 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.

17. 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, but rather an upsurge of private investment unmatched by private savings. This is something that will in due course correct itself.

18. As the House knows, however, there has also been a rise ~~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 this underlying rate increased significantly through the year, and now stands at $5^{1}/_{2}$ per cent.

19. Moreover the increase ~~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.

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

21. I am of course keenly conscious of the difficulties many borrowers, particularly home owners, and now experiencing. But however unwelcome high interest rates are, they are infinitely preferable to the damage that would be done by high inflation.

22. 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.

23. The outlook for 1989 is for inflation to rise a little further over the next few months, from $7^1/_2$ per cent including mortgage interest payments to about 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.

24. Some slow down 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 $2^1/_2$ per cent this year, with

growth through the year at 2 per cent. Domestic demand is forecast to slow down even more markedly. But 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.

25. But the question of just how "soft" or "hard" the so-called landing will be 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 national income in money terms. ~~He~~ The task of business and industry is to control its pay and other costs. The more successfully it does so, ~~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 largely up to business and industry.~~

~~26. The better that industry succeeds in controlling its pay and other costs,~~ the less ~~painful~~ difficult in terms of output and employment the ~~necessary~~ adjustment will be, ~~not least in terms of employment prospects~~.

27. But over the medium-term, it is clear from our experience over the past ten years that the policy we are pursuing <u>will</u> bring inflation down, and steady growth will resume. The best contribution the

Government can make to this is to carry forward the process of supply side reform, to help make the economy work better. That is the objective of the specific measures to which I shall turn in the second part of my speech.

Monetary policy

28. As I said at the outset, monetary policy 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.

29. 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, narrow money, or M0.

30. For 1989-90, the target range for MO will be 1-5 per cent, as envisaged in last year' MTFS. Although it will start the year above the top of that range, its very low growth over the past six months - ~~under~~ below 3 per cent at an annualised rate - suggests that it will fairly soon come back within the range. As in the past two 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.

31. The exchange rate is of particular importance in the conduct of monetary policy. A 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 greater exchange rate stability that has been a feature of the past two years.

32. 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. For there will be no letting up in our determination to get on top of inflation.

Public Sector finances

33. I now turn to fiscal policy.

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

35. This we 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 public 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~~ between four and 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. Government debt as a proportion of GDP is now lower than at any time since the First World War.

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

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, allowing extra spending on departmental programmes within our overall public expenditure constraints.

39. 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.

40. 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, at around the current level.

41. 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. As from today it will no longer be necessary for companies ~~who wish~~ wishing to make capital market issues to obtain the Bank of England's consent to the timing of such issues; The new issue queue will be a thing of the past. ~~and we will, as soon as possible,~~ And, as soon as practicable, we will revoke the Order itself and repeal the 1946 Act from which it stems.

42. 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. 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.

43. 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.

44. 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.

45. In last year's Budget Speech, I set out the principle of a balanced budget as the 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."

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income 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. 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.

47. So I reaffirm the principle of the balanced budget. However, given the substantial surplus we now have, the path of prudence and caution must be 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.

48. 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. This means that, in the space of three years, we shall have repaid roughly a sixth of the public debt that has accumulated over two centuries. But it also means that it will not be possible in this year's Budget to reduce

the burden of taxation; that is to say, to reduce taxation as a share of national income.

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.

pmg.vd

PMG

BUDGET CONFIDENTIAL

FROM: MALCOLM BUCKLER
DATE: 10 March 1989

MISS WALLACE

BUDGET STATEMENT

I promised you the details of the Paymaster General's comments on your minutes of 9 March.

In the economic section:

- line 3, page 10: replace "for" with "in" or "during";
- paragraph 44, second line: fourth word should be "deregulatory"?

In the tax section:

- the last two lines of paragraph 77 might read "..... accommodation such as hospices, old peoples homes and student hostels.";
- first line, paragraph 80: is "allow" right?
- paragraph 82: delete;
- third line, paragraph 88: replace "help to lead" with "contribute";
- third sentence of paragraph 89: being with "At";
- the last sentence of paragraph 93: is this actually a change, as referred to in paragraph 92?
- third line, paragraph 101: replace "extend" with "expand";
- fourth line, paragraph 104: replace "has" with "sees", and in the last line replace "give" with "five"?
- third line, page 33: add "achieved" after "was".

PMG

MALCOLM BUCKLER
Private Secretary

est.ld/james/10 Mar/Wallace

EST

BUDGET SECRET

Copy No: 1 of 14

ECONOMIC SECRETARY TO THE TREASURY

FROM: S M A JAMES
DATE: 10 March 1989

MISS WALLACE

cc: PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Sir P Middleton
Mr Scholar
Mr Culpin
Mr Riley
Mrs Chaplin
Mr Tyrie
Mr Call

PS/IR

PS/C&E

BUDGET STATEMENT : TAX SECTION

The Economic Secretary has seen the latest draft circulated yesterday. He has the following comments:

(i) Paragraph 2 redraft lines 5-7 "...information provided to the Inland Revenue or Customs and Excise by individual taxpayers about their private affairs";

(ii) Paragraph 24, lines 1-2 delete "in... say";

EST

(iii) Paragraph 84 1st sentence: we are not certain that atmospheric lead does damage children's brains etc. But it seems highly probable. To reflect this without sounding sceptical we might make the following changes:

- insert "potential" before "damage" (line 1)

- line 4, to read "...is a matter of increasing concern";

(iv) **Paragraph 86** : retain the square bracketed sentence. Delete "the price of" and insert "tax" before differentials;

(v) **Paragraph 87, line 7** insert "and pumps" after "capacity".

S M A JAMES
PRIVATE SECRETARY

BUDGET CONFIDENTIAL

Inland Revenue

Savings and
Investment Division
Somerset House

FROM: A W KUCZYS
10 MARCH 1989

1. MR CORLETT ✓ I agree ACWB 10/3

2. PS/CHANCELLOR (Mr Allan)

Chy/ Good. (And, as always, a joy to read!)

BUDGET SPEECH: PENSIONS

1. You asked for a quick note on whether we could justify the sentence in paragraph 69 of the Budget Speech:

> "... while setting for the first time a reasonable cash limit on the tax relief available to any individual."

I do not think there is a real problem.

2. The limit on tax relief takes different forms. For those in occupational pensions it involves a ceiling on benefits. For those in personal pensions it is a ceiling on contributions. For someone who has more than one career, as the Chancellor has already noted, it will be possible to build up a generous level of pension provision: in the most extreme case, perhaps £40,000 from the first employer for just 20 years' service, plus almost as much again from a personal pension built up during a second employment (the "Tyrie-Macpherson wheeze", with a genuine change of employment). Or, as Mr Tyrie has pointed out, someone contributing the absolute maximum to a personal pension throughout working life could enjoy a personal pension of well over £40,000 a year. (I am providing a separate note expanding on that.)

---

cc PS/Chief Secretary
PS/Financial Secretary
Mr Scholar
Mr Culpin
Mr Macpherson
Mrs Chaplin
Mr Tyrie
Mr Isaac
Mr Corlett
Mr Bush
Mr Kuczys
Mr Hinton
PS/IR

3. But all this is just a reflection of the fact that a group of people, all with the same pattern of earnings, can end up with quite different pensions, according to how generous their employers' schemes are, or how well their personal pension contributions are invested. The consistent feature of the new tax regime is that earnings over £60,000 will always be ignored, for tax-privileged pension arrangements.

4. For some people that will still allow a pension in excess of £40,000 a year. But even on the most extreme assumptions, the most that could be contrived is about £80,000 to £90,000. For someone whose final salary is £1 million, who under present rules could have a tax-privileged pension of £666,667 from just one employment, that is still a fairly striking cash cap on tax privilege.

X

5. In conclusion, I do not see any reason why the Chancellor should not keep to the present wording in the Speech.

AWK

A W KUCZYS

pso.jt/Sargent/2.10.3

BUDGET SECRET

PEM

Copy No 1 of 14 Copies

From: S D H SARGENT

Date: 10 March 1989

MISS WALLACE

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir T Burns
Mr Anson
Dame A Mueller
Mr Scholar
Mr Culpin
Mr L Harris

Sir A Battishill - IR

BUDGET STATEMENT: TAX SECTION

Sir Peter Middleton had just one comment on the near final draft you circulated on 9 March. He is sure that we need a reference to public sector schemes in the pensions section, and he suggests that this could best be achieved by adding the following sentence to the end of paragraph 60:

"Public sector schemes will be amended to comply with this".

Sir PEM

S D H SARGENT
Private Secretary

BUDGET CONFIDENTIAL

FROM: ROBERT CULPIN
DATE: 10 March 1989

CHANCELLOR

cc: Chief Secretary
Financial Secretary
Sir Peter Middleton
Mr Scholar
Mr Gilhooly
Mr Pickford
Miss Wallace
Miss Hay
Mr Ford

CULPIN LIFE ASSU- RANCE

LIFE ASSURANCE

I hesitate to send you another note about life assurance. I understand that you have been inundated with Revenue quibbles, and I do not want to add to them; but I should like to suggest a minor change to the speech. More importantly, I hope that, when you are finalising it, you might find it mildly helpful to have this summary of the key facts (such as they are).

2. The crucial distinction we want to make is really this:

- we are putting the tax treatment of the pensions business of life offices on to a proper basis, and that has a yield in all years

- we are not changing the tax burden on life assurance proper to any significant extent; but we are improving the distribution of that burden, by charging a lower rate on a broader base.

3. Putting the taxation of pensions business on to a proper footing means that:

(a) pensions expenses will only be deductible from pension profits, and not from life assurance income and gains;

(b) the life offices will no longer be able to transfer pension profits to artificial reserves, purely for the purpose of reducing their tax bills; and

(c) they will be required to account for their capital gains on a consistent basis, instead of treating them differently on the two sides of the account.

4. The speech focuses on (a). The ABI has acknowledged the case for it; and it accounts for two thirds of the pensions yield at the start, and a rising proportion thereafter.

5. However, the other pensions measures are also important. They account for a third of the pensions yield in 1990-91; one of them - (b) - comes into force on Budget day this year, not in 1990; and the other - (c) - is contentious, because it involves levying CGT on an accruals basis (for good but controversial reasons).

6. As to life assurance proper, the best estimate we can make is that we are probably reducing the tax burden; but the orders of magnitude are well within the margin or error. We simply say that the package is broadly neutral.

7. I wondered whether to point up more sharply this difference between the taxation of pension profits and the taxation of life assurance proper, for example by adding a summary sentence at the end of paragraph 54. But it is probably best to keep the speech itself fairly deadpan. We will carry the distinction through to the briefing and so on.

8. I attach a minimalist drafting suggestion: changes marked.

9. I also attach two tables (on one page). The Revenue have never provided anything quite like this, and the figures are highly uncertain. (Beyond the red book period, they are Treasury guesses, based on other Revenue estimates and assumptions.) But I think you need something of the kind if you want to check, as you finalise the presentation, that you have got the different measures in roughly the right perspective. I think it is all right: I hope the tables will help you form your own judgement.

RC

ROBERT CULPIN

DRAFT

49. First, many life offices run a pension business <u>as well as a</u> life assurance business, and they are not required to keep the two entirely separate for tax purposes. [Reason for change: for some life offices, pensions are the <u>main</u> business.] 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. This change will come into force on 1 January 1990. [Reason for change: one of the related measures comes into force in 1989.] Together with some related measures to put the taxation of life offices' pensions business on to a proper footing [Reason for change: avoids calling the changes"minor", and explains their objective], it will yield some £150 million in 1990-91.

50 The remainder of the changes I have to propose...

Table One

	1989-90	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-2000	00-01	2001-02	2002-03
pension measures		155	232	255	267	279	292	305	318	333	348	363	380	397
Life Assurance proper	-20	-110	-108	-87	-17	4	13	-52	-53	-120	-127	-199	-206	-214
Total	-20	45	124	167	250	283	305	253	265	213	221	165	174	183

Table Two

	1989-90	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-2000	00-01	2001-02	2002-03
Pensions Measures														
Ring fence pension business		105	180	200	210	219	229	240	250	262	273	286	299	312
Other pensions		50	52	55	57	60	62	65	68	71	74	78	81	85
Life Assurance measures														
Spread acquisition expenses		80	130	160	240	270	290	235	245	190	195	136	142	148
Reduce tax rate		-110	-160	-165	-171	-177	-183	-190	-196	-203	-211	-218	-226	-235
Abolish LAPD	-20	-80	-78	-82	-86	-89	-93	-98	-102	-107	-111	-116	-122	-127
Total	**-20**	**45**	**124**	**167**	**250**	**283**	**305**	**253**	**265**	**213**	**221**	**165**	**174**	**183**

Figures assume 4.5% per cent real growth per annum in new business and in income

SCHOLAR 10/3

FROM M C SCHOLAR
DATE 10 MARCH 1989

MISS WALLACE

cc PS/EST
Sir Peter Middleton
Sir Terence Burns
Mr Culpin
Mr Michie
Mr Gieve
Mr Pickford

PS/C&E

Ch/ MCS feels quite strongly about all this. I have checked that there will still be time to change briefing etc if you're content with his proposal in para 6. There will. Even on Monday. But, clearly, sooner is better.
MPW.

LEAD: BUDGET SPEECH

I have, as requested, discussed paragraphs 84-88 with Mr Sanders, the DoE's lead expert.

2. He says

(i) the government does not admit to lead actually doing damage, because of the potential public expenditure cost of having to replace all the Scottish lead water pipes. We speak rather of increasing the safety margin;

(ii) we should not say that we are committed to phasing out leaded petrol altogether, because vintage and veteran cars may need it for ever, and we do not want 10,000 letters from vintage car clubs next week;

(iii) the DoE prefer to say 'adjustment' rather than 'conversion' of cars, because the latter sounds a more radical change than it really is. Vauxhall has undertaken to convert their cars free, and Ford has recommended their dealers to make the adjustment free;

you have opined: modification

(iv) because some 2-star users cannot switch to unleaded he would prefer us to say "if they can do so" at the end of paragraph 87. I said I thought this was unnecessary, given the meaning of "incentive"; he does not press his amendment if we dislike it;

3. So he suggests

(i) replacing the first two sentences of paragraph 84 with

V. inelegant. Can't we say simply that we want to reduce amount of lead in atmosphere?

"It is increasingly clear that we must raise the safety margins for exposure to lead both for the environment in general and for child health in particular. Lead in petrol accounts for 80 per cent of lead in the atmosphere. The Government is firmly committed to phasing out leaded petrol, and in successive Budgets ...";

(ii) ending paragraph 84

"...the road could use it, either without any adjustment or with only a minor adjustment which should not usually cost more than £20 and in many cases will be carried out free.";

good

(iii) in line with paragraph 85 delete "conversion cost" and substitute "cost of ~~adjustment~~"; modification.

(iv) insert "significantly" after "suffer" four lines from the bottom of paragraph 85. Mr Sanders does not insist on this, but says that the person who likes to get from 0-60 mph in six seconds will notice the difference with unleaded fuel. I think we should say "significantly";

4. Mr Sanders ended by thanking us for all the help we are giving his campaign!

5. Mr Sanders has now returned these paragraphs to Mr Ridley's office. We talked about Budget secrecy.

6. May I make a final plea for centring our presentation on the tax differential of 14p rather than on the price differential of nearly 10p (I understand that both Mr Culpin and the Customs would support this)? There is further argument for this in Ms French's minute of 9 March which shows that the oil companies are taking more of the differential for themselves in the UK than they are in many other European countries

X

MCS

M C SCHOLAR

Ch/ re X, what Robert + Customs wd prefer is, in fact, the best of both worlds: viz - mention in speech both tax differential (big number, good place in Euro league) and price differential (~~wha~~ so Joe Public won't feel he was misled).

But Robert recognises that this wd probably overload yr speech unduly.

I strongly favour tax differential only. If the pump price differential is less that is for the oil companies to explain, not us.

MPW.

Copy 12A

Budget Secret

Mr ~~Mount~~

I think this is OK now? (with one change) (This morning's version)

MLS 10/3

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.

shd be deleted

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~~ over four 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.

it's only 4⅓ times as large

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$^3/_4$ 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.

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.

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BLO

REF: MPW/89/11

FROM: MISS M P WALLACE

DATE: 13 March 1989

SIR T BURNS

cc PS/Chief Secretary
Sir P Middleton
Mr Scholar
Mr Riley
Mr Gieve
Mr Pickford
Mrs Chaplin
Mr Tyrie
Mr Culpin
Mr Sedgwick
Mr Peretz
Mr Mowl.

BUDGET SPEECH: ECONOMIC SECTION

... I attach the Chancellor's final draft of the Economic Section of the Budget Speech. Could any final comments reach me by 4.00pm this afternoon please.

MPW.

MOIRA WALLACE

BUDGET - SECRET

BLO

chex.ps/mw/19

BUDGET SECRET
BCD

FROM: MISS M P WALLACE
DATE: 13 March 1989
REF: MPW/89/12

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Mr Scholar
Mr Culpin
Mr Gilhooly
Mr Gieve
Mr Pickford
Mr Macpherson
Mr Michie
Mrs Chaplin

Sir A Battishill - IR
Mr Isaac - IR
Mr Beighton - IR
Mr Painter - IR
Mr McNicoll - IR
Mr Unwin - C&E
Ms French - C+E
Mr McIntyre [paras 99-end only]

BUDGET SPEECH: TAX SECTION

... I attach the Chancellor's final draft of the Tax Section, which now includes a peroration. Can I have any vital corrections of fact by <u>4.00pm this afternoon</u>, please.

MPW.

MOIRA WALLACE

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REF. MPW/89/11

BUDGET

FROM: MISS M P WALLACE

DATE: 13 March 1989

SIR T BURNS

cc PS/Chief Secretary
Sir P Middleton
Mr Scholar
Mr Riley
Mr Culpin
Mr Gieve
Mr Pickford
Mrs Chaplin
Mr Tyrie

BUDGET SPEECH: ECONOMIC SECTION

... I attach the Chancellor's final draft of the Economic Section of the Budget Speech. Could any final comments reach me by 4.00pm this afternoon please.

SECRET

MPW

MOIRA WALLACE

B.L.O.

M.,

Some v. minor suggestions to make it easier to read etc.

A. 13. iii.

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BUDGET SPEECH - FIRST SECTION

The background to this year's Budget is the unprecedented strength of the British economy, coupled with the continuing and overriding need to combat inflation, at a time when, throughout the world, it is unmistakably edging up again.

2. I shall begin with an account of the performance of the economy in 1988 and the prospects for 1989, set in the context of the past ten years. 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.

B.L.O.

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

ECONOMIC PERFORMANCE AND PROSPECTS

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

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

5. For the first time, financial policy has been set firmly and explicitly in a medium-term context. We have been guided by 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.

6. 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. Inflation is a disease of money; and monetary policy is its cure. The role of fiscal policy is to bring the public accounts into balance and keep them there, and thus complete the process of re-establishing sound money. Strong sustainable growth is achieved, not through any artificial stimulus, but by allowing markets to work again and restoring the enterprise culture, by removing unnecessary restrictions and controls and rolling back the frontiers of the State, by reforming trade union law and promoting all forms of capital ownership, and by reforming and reducing taxation.

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7. The first and most urgent task we faced was to damp down the inflationary fires that had raged in the '70s, and wrought so much economic and social havoc. And we succeeded. Between 1974 and 1979 inflation had averaged more than 15 per cent. Over the past six years it has averaged 5 per cent - still not good enough, but a massive improvement.

8. 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 this century.~~ 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. For the economy as a whole our productivity growth has been second only to that of Japan among all the major nations during the '80s. And our ~~In~~ manufacturing productivity growth it has exceeded even that of Japan~~'s~~.

TB

9. In Britain today we have more people in work than ever before in our history; they are better motivated than ever before, and their living standards have

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improved beyond recognition. The seven years to 1988 have seen the longest period of strong and steady growth since the War.

10. But it is not just our economic performance 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 than ever before. And its quality has improved immeasurably, too; as has the quality of British management. We have seen a dramatic and long overdue improvement in company profits. And a remarkable growth in the total number of businesses, [now] at the rate of more than a thousand a week.

JG (a mid 88 figure)

SECRET

B.L.O.

11. Provided we stand firm in our resolve to get on top of inflation, the prospects before us are excellent. And at least on this side of the House, we ~~do~~ will stand firm.

JG: "I can assure you, Mr S, that we will stand firm"

Each time I read this line it needs a second glance. This slight amendment makes things clearer.

12. 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.

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13. As the House knows, the state of the national income statistics leaves much to be desired. But it now appears that we had in 1988 a second successive year of growth at $4^1/_2$ per cent, with unemployment falling by over half a million, to well below the European average.

14. Manufacturing output grew particularly rapidly, by more than 7 per cent, to a level well above the previous peak.

15. But total spending also grew by getting on for 7 per cent, 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.

16. 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. The published figures put this at £$14^1/_2$ billion in 1988, although given the £15 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

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undoubtedly large, and a sharp increase on the deficit recorded in 1987, after seven successive years of surplus.

17. ~~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, but rather an upsurge of private investment unmatched by private savings. This is something that will in due course correct itself.

SECRET

18. As the House knows, however, there has also been a rise 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 this underlying rate increased significantly through the year, and now stands at $5^1/_2$ per cent.

B.L.O.

19. Moreover the increase 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~~ over three years.

SJP (Aug 85)

SECRET

20. In the UK, as in a number of other countries, it became clear that it was necessary to tighten monetary

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policy sharply. That meant raising short-term interest rates, which I duly did, starting last June.

21. I am of course keenly conscious of the difficulties many borrowers, particularly home owners, ~~and~~ are now experiencing. But however unwelcome high interest rates ~~are~~ may be, they are infinitely preferable to the damage that would be done by high inflation.

22. 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.

23. The outlook for 1989 is for inflation to rise a little further over the next few months, from $7^{1}/_{2}$ per cent including mortgage interest payments to about 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.

24. Some slow down in real growth is inevitable as we get inflation back onto a downward path - indeed, it has

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almost certainly already begun to happen. Overall growth is forecast to fall from the $4^1/_2$ per cent recorded last year to $2^1/_2$ per cent this year, with growth through the year at 2 per cent. Domestic demand is forecast to slow down even more markedly. But 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.

25. But the question of just how "soft" or "hard" the so-called landing will be 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 national income in money terms. The task of business and industry is to control its pay and other costs. The more successfully it does so, the less difficult in terms of output and employment the necessary adjustment will be.

26. But over the medium-term, it is clear from our experience over the past ten years that the policy we are pursuing <u>will</u> bring inflation down, and steady growth will resume. The best contribution the Government can make to this is to carry forward the process of supply side reform, to help make the economy

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work better. That is the objective of the specific measures to which I shall turn in the second part of my speech.

Monetary policy

27. As I said at the outset, monetary policy 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.

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

29. For 1989-90, the target range for M0 will be 1-5 per cent, as envisaged in last year' MTFS. Although it will start the year above the top of that range, its very low growth over the past six months - below 3 per cent at an annualised rate - suggests that it will fairly soon come back within the range. As in the past two 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.

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? disembodied? MCS.

30. The exchange rate is of particular importance in the conduct of monetary policy. A clear commitment not to accommodate increases in domestic costs by exchange rate depreciation remains a key safeguard against inflation. In this context, we will continue to work with our G7 partners to maintain the greater exchange rate stability that has been a feature of the past two years.

SECRET

31. 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. For there will be no letting up in our determination to get on top of inflation.

B.L.O.

Public Sector finances

32. I now turn to fiscal policy.

33. When we first took office the public sector borrowing requirement was over 5 per cent of GDP - equivalent to £25 billion in today's terms.

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34. This we 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 public debt.

35. 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 between four and 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.

36. Nothing like this has ever been achieved in the past 40 years. Indeed, Government debt as a proportion of GDP is now lower than at any time since the First World War. And no other major country enjoys a comparable budget surplus. It has not been easy, even though we have been assisted this year by the exceptional buoyancy of the economy, which both boosted tax receipts and reduced public expenditure.

37. 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

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CM, CJR "over 1½" (nearer)

repayments of the last two years mean that net debt interest costs will be lower by some £1¾ billion a year. This saving is being put to good use, allowing extra spending on departmental programmes within our overall public expenditure constraints.

38. 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.

39. 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, at around the current level.

DLCP: MCS

The programme, innovation.

40. 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

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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. As from today it will no longer be necessary for companies wishing to make capital market issues to obtain the Bank of England's consent to the timing of such issues. The new issue queue will be a thing of the past. And, as soon as practicable, we will revoke the Order itself and repeal the 1946 Act from which it stems.

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41. 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. 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.

B.L.O.

42. 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

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which can make such issues; and they will create a unified regime for all these issues.

43. 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.

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44. In last year's Budget Speech, I set out the principle of a balanced budget as the 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."

B.L.O.

45. It is a rule that ensures that, as national income continues to rise, the ratio of public debt to national income 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. To go further than

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CHANCELLOR

BUDGET SPEECH

Attached is my first (near) full draft, which I shall circulate to the full BLO cast on Monday morning.

The main idea for this weekend is that you should have a chance to see how the general balance of the thing is shaping up, and say what you think needs most work. You have two weekends of "real speechwriting" pencilled in later on.

I am conscious that some of this is very patchy - particularly the tax section. We will be able to do a lot more work on this, when we've had the first discussion of presentation, and when some of the remaining decisions have been taken. In the meantime, for example, the pensions section is really little more than notes produced by FP. And the income tax etc. section at the end is just square brackets pro tem. On the macro section, the COBO/ deregulation piece is as yet unwritten, but I shall attack that next.

(Apologies, too, that the typing is a bit curious in places - there wasn't time to run off a clean version.)

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FIRST DRAFT

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MPW.

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[INTRODUCTION - to follow]

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THE ECONOMIC BACKGROUND

I start with the economic background.

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

3. In the UK, growth has again been above the G7 average, and ahead of all our major European competitors. I now judge that the figure for 88 as a whole will turn out to be around 4½ per cent.

4. Overall output growth of 4½ per cent means that in this upswing we have now recorded x years of sustained growth. Within this overall very vigorous growth performance, the performance of manufacturing has again been particularly strong, with growth of getting on for 7 per cent in 1988, ~~with~~ and manufacturing output now 10 per cent above its previous all time peak.

X

5. The key to this sustained improvement in manufacturing performance has been the major improvement in productivity that has been secured under this Government. In the '80s, our manufacturing productivity

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has grown faster than that of any other industrial country - following years at the bottom of the league in the '60s and '70s.

6. [We now know that] employment has risen continuously since 1983, by a total of [over 2½] million, to an all-time record high. Unemployment has now been falling for 30 consecutive months, the longest period of continuous decline since the War, taking it below 2 million.

7. Another very satisfactory feature of the recent past, and a very good omen for the future, is the strength of investment, which looks to have grown by some 14 per cent in 1988. Indeed, over the last 7 years, investment has grown twice as fast as consumption. In the previous 14 years consumption grew faster on all but three occasions. ¶ The recorded figures for investment growth show a smaller increase in 1988. But it is perfectly clear from the well-known discrepancies within the National Income accounts that the estimates of expenditure, and of investment spending in particular, are inconsistent with all the other evidence. The Treasury has, in consultation with the CSO, undertaken an exercise to produce a set of accounts that ~~produces~~ gives a more consistent picture of how the economy developed between 1986 and 1988, and it is those

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figures which form the basis for the forecast I shall be giving today. Full details are published in the Financial Statement and Budget Report

8. The strong growth of investment - and indeed the strong growth of consumers expenditure too - is no doubt in great part a reflection of confidence in the British economy. But with domestic investment exceeding domestic saving, some of the investment has had to be financed from overseas. As a result the current account now looks to have been in deficit by some £10 billion in 1988. This is a sizeable deficit, clearly, but it has been financed without difficulty, thanks to the Government's firm commitment to monetary discipline and fiscal prudence.

9. At home, it became clear during 1988 that the growth of domestic demand was stronger than thought, and had come to be too much of a good thing. There was evidence of some resurgence of inflationary pressures. I had no hesitation in acting to nip this in the bud, by tightening monetary policy. The first effects of higher interest rates began to show through at the end of the year, for example, in the figures for M0 growth, retail sales, and house prices.

unsustainable

needs slightly more elaboration

10. However, in the short-term, the fact that the UK, unlike ~~almost~~ all other EC nations, with the exception of Italy, includes mortgage

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interest payments in its consumer price index, means that the very action taken to combat inflation appears to cause it to rise. Thus, annual inflation, as measured by the retail price index, ended the year rather higher, while the underlying rate of inflation remained fairly steady in the second half of the year, at around 5 per cent.

ask Alex

11. Looking ahead to 1989, we are already seeing more and more evidence that inflationary pressures are coming back under control. M0 has slowed markedly since last summer, retail sales have been broadly flat for the last six months, and the housing market shows clear signs of cooling off. This is backed up by surveys of consumers' and retailers' confidence.

12. But some of the effect of higher interest rates is only just beginning to have an impact. For example, those whose mortgages are adjusted only once a year, will only now be feeling the effects of last year's increases in interest rates. So further slowing in consumer spending is to be expected. This will bring overall output growth down to a more modest rate of [2½] per cent in 1989.

year a yr, the year, pr

13. This may seem disappointing by the standards we have come to expect in the last few years. But it is a respectable figure, by any standards, historical or

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international. And with investment likely to remain high - a view confirmed by all the latest surveys of investment intentions - the growth prospects beyond 1989 are good.

14. The underlying path of inflation will, of course, continue to be obscured by the influence of mortgage interest rates. First we will see a peak in annual RPI inflation [at around x per cent] [next month] before it falls back to [y per cent] by the end of the year.

15. As I have always made clear, the current account will take longer to adjust. Import growth should slow, as consumer spending eases a little. And trade performance should improve as new capacity comes on stream. Although I expect the monthly deficits to be on an improving trend through the year, I expect that the deficit for the year as a whole will be much the same for that of 1988 [with a more marked improvement thereafter].

16. Turning to the world economy .....[strong/steady growth; US budget deficit; imbalances.]

17. In parallel, it is clearly desirable that the major nations should continue the process of international cooperation, to guard against the risks of renewed

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turbulence in the international markets. I can assure the House that the UK will continue to play its full part in this co-operation.

The Medium Term

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

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19. This describes exactly what has been achieved in the UK. This Government has now been in ~~power~~ other for nearly a decade, [during all of in this economy which time economic policy has been steady ~~and essentially unchanged~~. This] has brought outstanding [success]. achievements.

can't read!
[I don't like this formulation]
nor do I

B.L.O.

20. At the very heart of the Government's strategy has been the determination to bear down on inflation. For ten years now, the medium term financial strategy has provided a clear and disciplined framework for reductions in the growth of money GDP, and hence inflation. Between 1974 and 1979 inflation averaged over 15 per cent [~~and was~~ rising]; between 1984 and 1989 it has averaged with 5 per cent ~~[and is now set to fall]~~.

~~(? growth 1974-79 v 1984-89)~~

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21. This is the answer to those who doubted that the MTFS would be successful.

~~22~~. Or those who maintained that the Government's inflation objectives could only be achieved at the expense of lost output, or falling living standards, or harsh public expenditure cuts.

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

comparison 1984/9 v 1974/9

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

B.L.O.

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

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

SECRET

27. The last ten years, then, have been a time of unprecedented improvement to the economic fundamentals in the UK. When we first came to ~~power~~ office, Britain was a textbook example of relative economic decline. Now it is out-performing the competition, and the policies that have brought success - tax reform, firm fiscal and monetary policy and the determination to improve the supply side - are being emulated the world over.

B.L.O.

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

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

Long settled
for this posn

30. But that is exactly what has happened under this Government: with a dramatic recovery in company profitability, company saving has risen to offset the decline in personal savings. In addition, of course, the Government itself has moved from deficit to surplus. So, in fact, total national saving has been rising in recent years, and now stands at [roughly the same percentage of GDP as we inherited].

31. I expect the personal savings ratio to recover during 1989. High interest rates will discourage consumer borrowing and increase the incentives to save. They are indeed the appropriate market route to dealing with [any pressures caused by] low personal savings.

32. ~~But~~ The other notable respect in which commentators have failed to catch up with the transformation of the

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British economy is in the significance they attribute to a deficit on the current account of the balance of payments.

33. There are clearly some circumstances in which a current account deficit would be cause for concern: if it were a consequence of a Budget deficit, if monetary conditions were too loose, or if the Government did not have the confidence of markets.

34. The position today could not be more different. The current account deficit has arisen at a time when the public sector, far from being in deficit, is running an unprecedented surplus. The external deficit is, in fact, the result of private sector behaviour. And in time private sector behaviour will correct it.

A 62
Two caveats (so far)
on inflation

35. But it will take time, as I have repeatedly made clear. There are no quick fixes, and there is no need for them. In the meantime, the Government will stick to its well-tried and proven policies.

Monetary policy

36. From this point of view, as from every other, it is essential that we remain prepared to take whatever action is necessary - however unpalatable it may be - to bear down on inflation. [Within MTFS] the central role

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in bringing inflation down rightly belongs to monetary policy, buttressed by a prudent fiscal stance. As I have always made clear, short-term interest rates are the essential instrument of monetary policy: this Government will set interest rates at whatever level is necessary to bear down on inflation, and will keep them at that level for as long as is necessary.

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

38. But here again, we have to have an eye to the medium-term. It is already difficult to remember the days of runaway inflation. But those who can cast their minds back know that the pain of higher interest rates for a time now is far preferable to the damage that was done to working families, pensioners, industry, and the whole of the nation's economic and social fabric, by years of rapidly rising prices. The Government is determined that there shall be no return to that.

39. Interest rates are indeed, a remarkably well-directed instrument to deal with the particular inflationary pressures we have seen reappearing in the last year. First, they are well targeted on the housing

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market, which has been the major force behind the strong consumer credit growth [of the last year]. In this respect, they are also very well targeted from a regional point of view, as they will tend to focus the adjustment on the South of England, where inflationary pressures have arguably been strongest, as more people in the South have mortgages in excess of £30,000, and so do not have the full effect of increased repayments cushioned by tax relief.

X 40. Most importantly - and this point is not, perhaps, well understood - they are also well targeted as between households and companies. While the household sector has moved from being a net lender to being a substantial net borrower, the company sector's finances are in far better shape than a few years ago, so that it is far less vulnerable to increases in short-term interest rates. The company sector is also well placed to benefit from the fact that long-term interest rates have remained very stable, and well below short rates - an indication of the markets' confidence that inflation will be brought down.

41. Now all the evidence is that the tightening of the monetary stance is taking effect in exactly the way we predicted. [M0, retail sales, etc.] This is, of course, welcome. [But the process is bound to take time. I can assure the House that I shall not keep

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short-term interest rates at their present level for any longer than is necessary: on the other hand, there will be no question of relaxing the monetary stance before it is appropriate to do so.]

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

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

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44. Accordingly, I propose in that the target range for M0 growth in 1989-90 should be 1-5 per cent exactly as envisaged in last year's MTFS. Measured on a twelve month basis, M0 will start the next financial year above the top of this range, reflecting the high growth figures in the spring and summer of 1988. However, the growth of M0 over the last six months has been appreciably slower - equivalent to [X] at an annual rate - and I am confident that the twelve month figures will come within the target range [within a few months].

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PUBLIC SECTOR FINANCES

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

B.L.O.

46. In our early years of office we made steady progress in reducing the burden of Government borrowing. Now the public finances have been completely transformed with the budget in surplus since 1987-88.

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47. Last year I budgeted for this surplus to continue in 1988-89, the year now ending. In fact, we have done rather better, for a variety of reasons. First, the

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success of the economy, particularly the now very marked reductions in unemployment~~, and the continued success of the right to buy programme~~, reduced the expected claims on public expenditure, so that the outturn for the year is likely to be some £[X] billion below the planning total we provided for.

1988-89 GGDS
cf 1984-85 GGDS

48. Second, privatisation proceeds are appreciably higher than expected, at some £[X] billion for the year as a whole [- a welcome boost to the public finances, and one that not many would have predicted a year ago, in the aftermath of the stock market ~~fall~~ collapse.]

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49. Finally, a more buoyant economy has led to tax revenues significantly higher than expected. Taking all these factors into account, I now expect that the final outturn for the current year will be a Budget surplus of £[X] billion.

B.L.O.

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

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51. We have already seen one beneficial effect of lower debt interest payments - namely that spending on priority services can be increased, without jeopardising the Government's overall objective for public expenditure. In the Autumn Statement I was able to announce that within an unchanged planning total we were able to allocate significant extra resources to our priority programmes. Those who saw a conflict between tax cuts and spending on the health service have been confounded, with a record increase in resources for the NHS in the UK of some £[X] billion. And there were significant increases for other priorities, notably capital spending on the prisons programme, and in the transport field for road maintenance and improvement, and for improved safety programmes.

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

53. [The dramatic improvement in the UK's public finances has also provided a welcome opportunity to devote more attention to the structure of the debt that remains. Now that the Government has become a net purchaser of debt, it has been possible to tailor

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buying-in policies so as to reduce future interest costs, and to improve the quality of funding by relying less on the more liquid borrowing instruments.

54. For example, it has been possible to increase the proportion of indexed gilts in the remaining stock: since the Government is determined to eliminate inflation, index-linked borrowing is particularly cost-effective. The authorities have also been able to achieve a desirable adjustment in the average life of Government debt: buying-in has concentrated on longer maturity issues, so that in future years even the debt that remains will have a relatively lower interest cost.]

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

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

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

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

needs more explanation

£30bn repayment in 3 yrs: purpose of this?

B.L.O.

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

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SHARE OWNERSHIP

[SAVINGS & INVESTMENT?]

Introduction

I place first in my Budget measures to encourage Wider share ownership. Over the last 10 years the number of shareholders has risen from X to Y; and with this increase has come a greater sense of identification with British industry. [Survey results]

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2. Exactly three years ago I introduced the Personal Equity Plan - a radical new scheme to encourage investment in British equities. In the first two years that the scheme has been in operation more than 350,000 plans have been taken out. This despite the stock market crash. I now have a number of improvements to propose.

B.L.O.

3. First, I propose to raise the limit on the amounts that can be invested in unit and investment trusts. It will rise from £750 to £2,400. Unit and investment trusts are a good introduction to the equity market for smaller investors, and I want to encourage them. This increase will apply only to unit and investment trusts which invest mainly in UK equities.

see what Walker produces

MJS.

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4. Second, I propose to raise the overall PEP limit from £3000 to £4,800.

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also

5. I intend to make it possible for PEP holders who apply for new share issues, to put their resulting allocation straight into their PEP, provided this does not breach the overall limit.

6. Third, I propose to abolish a number of restrictions on PEPs, and to simplify them as much as possible.

SECRET

7. I propose to to do away with the rule that PEPs nmust be held for a full year; if investors choose to cash in their PEPs within a year of purchase, they will, in future be able to do so without tax penalty. I also propose to abolish the rules governing the amount of an investment that may be held in cash. Instead, interest on cash held in PEPs will, in future, be subject to composite rate tax.

B.L.O.

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

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9. Taken together, these changes will make PEPs simpler to administer and more attractive to first time

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investors. I am confident that the package will lead to a considerable increase in PEP take-up, and a substantial widening and deepening in share ownership.

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

SECRET

11. This year I have a number of further improvements to the employee share legislation to propose.

12. I propose to raise the limits on the 1978 profit sharing scheme and on the 1980 SAYE option scheme since 1984. The limit on the annual value of shares which can be given tax-free to employees under the 1978 scheme, will rise from from £1,250 or 10% of salary, subject to an overall limit of £5,000, to £2,000 or 10% salary, subject to a limit of £6,000. [This will be of particular benefit to lower paid employees.]

IR ?

(+20% on when last set?)

B.L.O.

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

1984 scheme?

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

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

16. A number have already been put in place in the UK.

To encourage their development, I propose to introduce a new tax relief for contributions to employer share trusts provided they meet certain requirements, designed to ensure that their shares are placed in the hands of employees within a reasonable time. I hope that, as a result, more firms will be encouraged to consider establishing ESOPs.

[17. I have one further change to propose which will benefit conventional employee share schemes, ESOPs, and profit-related pay schemes alike I propose to modify the so-called material interest tests where companies have established trusts to acquire their shares for the benefit of their employees. These tests are designed to exclude from tax relief employers who already have a significant interest in the company. Sometimes, however, the present rules can exclude

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employees too. The changes I propose will ensure that only those employees who have a significant material interest in the company will be excluded in future.]

<u>**Unit trusts**</u>

18. As I mentioned a moment ago, unit trusts have a valuable role to play in providing, for many people, the first introduction to direct investment and share ownership. I therefore consider it desirable to remove an anomaly which means that the tax system bears unduly harshly on unit trust investors, compared with other forms of direct investment.

19. Normally a unit trust investor pays the same tax on dividends and capital gains as someone who had invested in the same shares or securities independently. But if the trust invests in gilts or other securities, and is not an <u>all</u>-gilt trust, it has to pay corporation tax on the income, so the saver ends up bearing tax at 35 per cent, rather than 25 per cent.

20. I have therefore decided that as from 1 January 1990, the Corporation Tax rate on unit trusts should be cut from 35 per cent to 25 per cent. [Unit holders' CGT position will be unaffected, as will the additional income tax paid by higher rate taxpayers.

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And rules will be introduced to prevent corporate investors using this change as a tax shelter.]

21. This reduction in the tax rate on unit trusts will incidentally have the beneficial effect of removing the competitive disadvantage which UK mixed unit trusts would otherwise have faced in the near future, when firms from other EC countries acquire the right to sell collective investment vehicles in the UK.

Stamp duty

22. I have one further measure to propose in this context.

23. In my 1984 Budget, I was able to reduce the 2 per cent stamp duty on share transactions to 1 per cent. I halved it again to ½ per cent in 1986. I have now decided to abolish it altogether, with effect from 1 April 1990 [to coincide with the introduction of paperless transactions on the Stock Exchange.] ~~This~~ These measures will remove a barrier to ownership, and eliminate an aspect of the tax system which puts the British financial services sector at a disadvantage compared with some of its competitors.

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Tax reform

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

Pensions
£40 p.a.
+ insurance

25. As such, their longer-term effect may be to redress an imbalance that arguably exists in the pattern of savings in the UK, which, in the last 30 years has become increasingly dominated by institutional forms of saving, such as life assurance and pensions. Throughout our time in government, our approach to the provision and taxation of savings has had two common threads. First, as far as possible, we have been concerned to ensure maximum choice for individuals. Second , we have tried to ensure that choices are distorted as little as possible by the tax system.

26. This is not an area where one can make great changes overnight. Nonetheless we have made considerable progress in improving choice, and reforming the tax system in step. Today, I have more progress to announce.

27. I turn first to pensions.

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28. The Government record is one of widening pensions choice and encouraging private provision. We have reformed SERPS, improved the rights of pension scheme members and, most important of all, introduced personal pensions. These have been a great success with a million taken out in the first 6 months of operation.

29. But there is still scope for further widening of choice, deregulation of the tax system. I have a number of changes to propose.

> First, I propose to make it easier for people in personal pension schemes to manage their own investments. Pension savings are highly institutionalised with scheme members having little involvement in investment policy. This measure will encourage greater individual involvement in pension plans [as IRAs have in US].
>
> I also propose a number of changes to simplify and improve rules for occupational pension schemes, in particular to improve the conditions on which people can take early retirement.

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- And I intend to simplify the rules for additional voluntary contributions. [At present, if AVCs perform well, occupational pensions may be reduced. In future any surplus contributions will be returned to employees subject to special tax charge.]

- And finally I propose to rectify the anomaly whereby limits for tax relief have come to determine limits on pensions paid. With a tax relief as generous as that for pensions, it is clearly essential that there should be some upper limit. But that is no reason for tax law effectively to constrain the size of the pension an employer may choose to provide. Accordingly, I propose that employers should now be able to set up "top-up" schemes for their employers, with no limits on benefits but without any special tax privileges.

Rationale for limits

30. With employers able to pay whatever pensions they like, it is clearly appropriate to put a cap on amount of relief. All other reliefs - BES, PEPS, mortgage interest - are subject to a ceiling.

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31. I therefore propose to build on my 1987 changes by making final salary schemes subject to a cash limit on pensions paid from tax approved schemes, based on earnings of £60,000 a year. This is consistent with a privileged pension of £40,000 a year or a tax free lump sum of £90,000 a year. I intend that this earnings limit should be indexed ~~to prices~~, and that these changes should apply to members joining new or existing schemes on or after Budget day.

still needs to be turned into prose!

[32. Clear that unfettered relief for pensions savings distorts savings choice:

- people pay less tax if save through pension funds than if invest directly in equities or put money in building society [Allowed tax relief on contributions. Returns untaxed in hands of pension funds, though tax paid on pensions when received].

- savings financing pension lump sums escape tax altogether. Not taxed on way in or out. Anomalous by any standard.

33. With 1988 reductions in top rate of tax, less need for tax breaks for higher paid. Can afford to save out of taxed income, by investing directly in equities etc.]

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34. I also propose changes to the rules for personal pensions, to enable them to equal the benefits of final salary schemes. The self-employed are often unable to contribute to personal pension schemes until late in life, at which point they may fall foul of contributions limits. I therefore propose to increase the contribution limits for personal pension scheme members over 50.

SECRET

This will improve position of PPs relative to final salary schemes. Indeed it will pay some employees to leave FS schemes and take out personal pensions.

However I also propose to subject to an overall cash limit on contributions.

B.L.O.

Like the final salary scheme limit, the personal pension cash limit will be tied to prices.

Conclusion

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35. These proposals represent an important long-term reform of pensions system. However, the effects will take time to come through. Because of the level at which limits will be set only a few thousand high paid employees

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will be affected at first, rising to 50,000 by end of century. But that is how it should be. There is no question of undermining pension saving by a huge upheaval.

Bryznols

36. The long term effect, though, is likely to be considerable. It will result in major turnround in the balance of savings in the course of 21st century.

37. The last few years have seen a large number of pension reforms. It is time they were allowed to settle down. Accordingly, I do not plan any further changes in this Parliament.

LIFE ASSURANCE

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

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

40. The Life Assurance industry is unique, not just in the product it provides but also in the tax regime which

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applies to it. The policyholder's returns and the shareholder's profits are not, as in a normal business, taxed individually but jointly by taxing the funds held by the Life Offices on their policyholders' and shareholders' behalf.

Front end

[see Herman presentation]

41. It is a peculiarity of this system that relief is given "up front" for expenses incurred on the policyholder's behalf. This has two distortive effects: first it means that policyholders receive a tax break - "up front" relief on initial costs which would not be available if they invested directly in shares. And it distorts the incidence of tax as between one Life Fund and another. The system unduly favours the rapidly expanding Life Office where tax can be deferred for many years.

[42. I have considered very carefully whether this problem is best resolved by improving the existing system; or by adopting a completely new basis of taxation for the Life Office. I have concluded that the defects can be dealt with within the present regime.]

43. I shall be bringing forward in the Finance Bill measures which will mean that in future, relief for the initial expenses associated with new policies will be spread forward so that one-seventh only is available for relief against tax in each of the first and subsequent

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six years. Taken on its own this would increase the tax liability of life offices, indeed quite markedly in the early years. But this effect will be eased by phasing provisions to give the industry time to adjust to the new regime, and by other measures which I have to propose.

44. But first I have one other proposal which will also restrict the amount of relief available. At present nothing requires life offices to keep their pensions and life assurance businesses separate. So some Life Offices can set the unrelieved expenses on the pensions side of their business against the income and realised gains of Life Funds. This means that their pensions profits enjoy unduly favourable tax treatment. The Finance Bill will include provisions to end this anomaly.

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

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

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Any legislative changes following that consultation will be included in the 1990 Finance Bill.

47. These measures give a fairer basis for the taxation of the Life Companies. In isolation they would increase the long-run tax burden by £[ ]m. However, here as throughout the tax system, widening the tax base allows tax rates to be reduced. This I propose to do.

SECRET

48. At present, Life Funds pay tax at 35 per cent on unfranked investment income and 30 per cent on realised capital gains of their policyholders. ~~As from 1 April~~ 1990, these rates will be reduced to 25 per cent. Life Assurance Premium Duty will be ~~abolished from the~~ same date. Together these will be worth £[ ]m to Life Assurance in a full year. On top of this, the industry, like all those who deal in shares, will benefit from the abolition of stamp duty to the tune of X a year.

Basic rate

B.L.O.

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

[And a conclusion still needed for this tax reform section]

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50. I now have a number of other, less daunting, reforms to propose. Most of them represent simplifications and deregulation.

51. The first is a piece of tidying up which follows from the major reforms of income and capital gains tax in my last Budget.

52. My reforms of capital gains tax have produced a fairer and more neutral system. However they have exacerbated one existing anomaly, which I now propose to remove. The holdover relief for gifts postpones tax on past gains made by the giver until the recipient disposes of the asset. When we still had capital transfer tax on lifetime transfers, this relief was necessary to avoid a double capital tax charge. But this need no longer remains. Moreover, now that a single rate of capital gains tax has been replaced by 2 rates aligned with income tax marginal rates the gifts relief is open to exploitation by higher rate taxpayers wishing to avoid paying CGT at their marginal rate. I therefore propose to abolish the general gifts relief. There are some circumstances where tax deferral continues to be justified for wider economic reasons, notably in the case of gifts of business assets and gifts to charities. For these cases, the relief will be retained.

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

54. First I propose to exempt from capital gains tax, all sterling non-convertible corporate bonds. This will prevent exploitation of indexation relief to manufacture capital losses.

SECRET

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

B.L.O.

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

57. Last year, by rebasing capital gains tax to 1982, I completed the process of taking purely paper gains out of tax. At the same time I reduced the exempt threshold as it no longer needed to compensate for the lack of indexation relief for pre-1982 gains. Its only remaining function is to exclude small gains from the tax. I judge that it still performs that

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function perfectly adequately and I therefore propose to maintain it at its current level of £5000. Following independent taxation in 1990, husbands and wives will, of course, benefit from a double exemption.

58. The taxation of close companies is another area ripe for simplification. Again this has been made possible by last year's reform of personal tax.

SECRET

59. Under the current rules undistributed income and gains of close companies are apportioned among its shareholders in order to determine tax payable. The rules governing this are an exceptionally complicated area of the tax system, running to some 20 pages of legislation. I therefore propose to abolish apportionment rules for close companies. In future income and gains of a close company will be subject to normal corporation tax rules, subject only to simple rules to prevent abuse. This reform will represent a major simplification of the tax affairs of a great many small businesses.

NB 40% rate!

wow

Business Taxation

B.L.O.

60. The next set of deregulation measures I have to propose will also benefit the small business sector. TGhese measures relate to the operation of VAT.

61. At present, traders are normally liable to VAT on their sales whether or not their customers pay them.

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Bad debt relief can be claimed only where the debtor has become insolvent. This takes far too long. I therefore propose that from 1 August, all debts which are over eighteen months old will qualify for bad debt relief. This will be of great help, from both an administrative and financial point of view, to a great many businesses.

62. I also propose simpler rules to govern registration for VAT. At present there are quarterly and annual turnover thresholds, and businesses are required to look ahead to the next twelve months to see if the limits <u>might</u> be exceeded. This complication is unnecessary. As from Budget Day I propose a single rule for determining registration based on turnover in the <u>past</u> twelve months.

SECRET

63. Finally, I propose to simplify the VAT default surcharge. At present this rises by stages each time, a business defaults, to a maximum of 30 per cent. Experience suggests that by the time a business reaches a surcharge rate of over 20 per cent, it has moved from the "won't pay" to "can't pay" category. I propose to recognise this by capping the default surcharge rate at 20 per cent.

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Perhaps mention

+ VAT threshold

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Schedule E

64. ~~Finally~~, I propose one simplification in the income tax field . At present, under Schedule E, tax assessments are done on the basis not of earnings received in a year, but instead on earnings for the year - accruals rather than receipts. I propose to change this, so that in future it is assessed on a receipts basis.

65. For the vast majority of ordinary taxpayers this will make no difference at all. But it will greatly simplify the tax affairs of about half a million people. It will also make the tax system simpler and cheaper to administer. There will be no lasting loss of revenue, but there is a transitional cost of £[X] in the first two years, offset thereafter.

Who?

Corporation Tax

66. I now turn to the taxation of businesses generally.

67. It is now five years since I announced the major reform of business taxation which has given us one of the lowest corporation tax rates [in the world?]. Our neutral system of business taxation, combined with low rates, has set the scene for a dramatic improvement in the performance of British firms. The reform of capital

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allowances has encouraged more efficient investment, based on real returns rather than tax advantages. And the removal of the bias against job creation has played a key role in the UK's impressive employment growth. In this healthier climate, company profitability has recovered dramatically.

68. The system we have is clearly right, and is working well. Accordingly, I have no change to propose to the main Corporation Tax rate for 1988-89.

69. However, at the moment, only a small minority of companies pay this main rate of 35 per cent. The remainder have no liability at all, or pay at reduced rates, determined by the small companies' profits limits. These limits have remained unchanged since 1983. I propose now to increase them, so that the lower limit, below which companies pay at 25 per cent, will increase from £100,000 to £150,000. Above that level, companies pay at a gradually increasing rate, until they reach the main rate threshold of £500,000. I propose to increase this, too, by 50 per cent, to £750,000.

investment

70. [I have one other minor change to CT. I propose to extend relief available for expenditure incurred by individuals or companies prior to their commencing trading from the present 3 years before trading

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commences to 5 years. This will benefit new companies undertaking projects requiring long lead times.]

Cars

71. I have to set the 1989-90 car and fuel benefit scales for those with company cars. For years, the car scale charges have fallen significantly short of the true value of the benefit, and in successive Budgets I have made significant progress to redress this. I intend to continue this, and increase the car scales by a further 20 per cent for 1989-90. I propose no change to the fuel scales.

[illegible]

with IT

Profit Related Pay

72. Two years ago, I introduced in my Budget a tax relief for Profit Related Pay Schemes, designed both to give workers a more direct sense of identification with the firms that employ them, and to promote a greater degree of pay flexibility. The current success of British firms is built on improvements in both these respects.

73. The Profit Related Pay Scheme has played its role in this process, but it is also clear that more firms are interested in launching schemes, but are not able to comply with all the present

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rules. I therefore propose to make three modifications to the scheme in this year's Finance Bill. First as I have already announced, I intend to abolish the requirement that PRP must equal at least 5 per cent of pay.

74. Second, I propose to raise the limit on the amount of PRP which can attract relief from £3,000 to £4,000. Finally, I propose to relax the rules banning headquarters and other central units from using the profits of the whole company or group for their own profit calculations, as I am persuaded that this too is unnecessarily restrictive. I am confident that these modifications will ensure continued growth in the number of firms offering some element of profit related pay.

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TAXES ON SPENDING

B.L.O.

75. I now turn to taxes on spending.

76. First, VAT. I have already announced a package of significant deregulatory measures. The FB will also implement the changes necessary to comply with the ECJ's judgement on certain of the UK's zero rates, notably that on non-domestic construction. The only other change I propose to make to the coverage of VAT is to introduce a small number of extra reliefs for charities,

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of which the most important is the exemption of their fund-raising events, subject to an upper limit.

77. The main thrust of Government encouragement to charities, however, continues to be focused on the act of giving. Accordingly, I propose to increase the weekly limit for the PRG scheme fro X to Y.

VED

SECRET

78. Next, I have a number of measures to propose which will greatly simplify the structure of vehicle excise duty and make it more equitable.

79. There are at present X rates of VED. I propose to reduce the number of tax classes by over 70 - a major simplification.

B.L.O.

how many seats does normal coach have?

80. At the same time I propose to rectify anomalies in the present structure of rates. At the moment a bus or a coach has to have sixty six seats before it pays as much VED as a family car. I propose to increase the relevant rates to bring this group up to track cost.

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81. There will also be increases in the rate of VED for the heaviest of the rigid HGVs so as to put them on a more equal basis with articulated HGVs.

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82. I turn now to the duty on petrol. Last year I increased the tax differential in favour of unleaded petrol to nearly 11p a gallon. This has undoubtedly helped to increase the take up of unleaded petrol.

83. But the Government is committed to phasing out leaded petrol, and progress is still too slow. Unleaded petrol still accounts for only 4 per cent of total sales, when X per cent of cars can use it without any adjustment, and most of the remainder could be adjusted to use it at very little cost.

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

Growth figs

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

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4 star. This in itself should provide a strong encouragement for 4 star users to have their cars converted.

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

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

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

[<u>Income tax</u>/rates, allowances, NICs]

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[Earnings rule]

[Conclusion and peroration].

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chex.rm/mw/28

Ch/ This is a very quick attempt at rejigging BZ which I have not had chance to show to either Alex or Robert. But it may give you an idea of how it wd work. I prefer original, myself.

MPW.

PENSIONS - FST STYLE VERSION

PENSIONS FST STYLE VERSION

I now turn to pensions.

2. The tax treatment accorded to pension schemes is particularly favourable; and the extent of this privilege necessarily has to be circumscribed by Inland Revenue rules.

3. However, at present, these rules do not limit the amount of tax privilege in cash terms. Instead, they limit the percentage of an employee's final salary that his employer may pay him by way of a pension. Thus, the higher an individual's salary, the more tax privilege he gets on his pension.

Shortenable

4. Given that one man's tax relief is another man's tax increase, [and in the light of the reforms I introduced last year,] it is hard to justify a state of affairs in which a tax advantage of this order is effectively available with no upper limit whatsoever. 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.

5. I have deliberately set this 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.

6. [Setting a cash upper limit to the tax privilege in this way will bring the tax treatment of pensions more into line with that of other forms of saving. More importantly,] this change enables me to effect a major liberalisation of the rules which currently restrict pension provision. [As I said a moment ago,] at present the tax rules effectively limit the overall pension an employer can pay his employee to two thirds of final salary. This was always undesirable, and - with a cash ceiling on the pensions that may attract tax relief - it will now be unnecessary. Accordingly, I propose to remove the obstacles in the way of employers setting up pension schemes to provide benefits above the tax limits. Such "top up" schemes will carry no limit on benefits whatsoever, but, equally, will have no tax privileges. Thus, employers will henceforth be free to provide whatever pensions package they believe necessary to recruit and reward their employees.

[Timing of change] §62 et seq.

The Chancellor announced a three-fold change to the tax treatment of *pensions*. From now

- there will be a new limit on pensions which may be paid from a pension scheme enjoying tax relief, based on earnings of £60,000 a year;
- but employers will be given freedom to provide pensions above that level so long as thay do so from a scheme which does not benefit from tax relief.
- better arrangements for *personal pensions* including higher contribution limits for those over 35~~, a better way of calculating lump sum benefits,~~ and greater freedom for members to control the investment of their money.

X ✓

The new arrangements will apply only to pension schemes set up on or after Budget day or to new members joining existing schemes after 1 June. They will apply to both public and private sectors. The £60,000 limit will be raised annually in line with inflation.

The rules on additional voluntary contributions to pension schemes will also be simplified and improved.

Business taxes

The main and small companies' rates of corporation tax will be unchanged but the ~~small~~ profit limits will be raised:

- the 25 per cent rate will apply to firms with profits under £150,000—up from £100,000;
- the 35 per cent rate will apply to firms with profits over ~~£¾ million~~ £750,000—up from ~~£½ million;~~ £500,000;
- between those rates, as now, intermediate rates will be payable.

The annual limit above which companies have to register for VAT will be raised ~~from £22,100~~ to £23,600. The tax regime for close companies will be simplified. The Corporation tax on certain unit trusts will be reduced from 35 to 25 per cent.

Charities

Charities will be relieved from VAT on fund raising events, sterilising equipment for medical use, and classified advertising.

Cars ~~leased~~ bought for leasing to the disabled will be relieved from car tax.

The tax relief for payroll giving to charity will be doubled from £240 to £480 a year.

Should both this & tax confidentiality

Ended

Other

As previously announced, certain zero rates of *VAT* on supplies to business, notably on non-residential construction, are to be ~~abolished~~ ended following a judgement of the European Court. There is no change in *Vehicle Excise Duty* for most vehicles but the duty on ~~coached~~ buses and coaches and some non-articulated lorrics is increased to reflect track costs. The *capital gains* tax threshold remains at £5,000 in 1989–90. *Cherished number plates* will be made available for sale. ~~Last year the Chancellor doubled the *scale taxes on company cars* and this year he is increasing them again, by one third.~~ The Chancellor also announced measures to deregulate the sterling capital market, including the abolition of the queue for new issues of bonds and equities

CGT gift relief

or 'Scale taxes on company cars will be increased by one third'

2048