PREM 19/2628

MT.

PART 18

SECRET

SECRET

CONFIDENTIAL FILING.

The 1988 Budget.
1989 Budget

ECONOMIC POLICY.

PT1: May 1979

PT18: April 1988

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~5.4.88~~							
~~19.10.88~~							
31.10.88							
~~15.12.88~~							
~~17.1.89~~							
15.2.89							
~~22.2.89~~							
~~3.3.89~~							
14.3.89.							
22-11-88.							
CLOSED							

PREM 19/2628

PART 18 ends:-

ACT to PM 22-11

PART 19 begins:-

R. Wilson to PG 6.12.89

 COPY ON MANPOWER: SEM'S P.22

PRIME MINISTER

MEETING OF E(A): 23 NOVEMBER

We have arranged an E(A) tomorrow morning, following immediately after Cabinet, to resolve two outstanding issues on which you saw papers last weekend. Neither should take too long.

The papers for each item are organised in the dividers below.

1. **National Insurance Fund**

   You wanted to discuss with colleagues the proposals to end the NHS "stamp" element of the National Insurance Fund, which you commented was a "shifty device". The Lord President had also commented that he thought it would be a good idea for E(A) to look at this issue.

   In response both Tony Newton and the Chancellor have provided further notes for tomorrow's meeting.

   The full list of papers enclosed is:

   Flag A - the earlier note you saw last weekend
   Flag B - Tony Newton's formal E(A) paper, which does not add much to the earlier note
   Flag C - a minute from the Chancellor, which sets out much more clearly and succinctly the case for the proposed change than does Tony Newton's paper
   Flag D - a note from Andrew which strongly supports the proposed change
   Flag E - a Cabinet Office brief.

   Andrew's note at Flag D suggests that, if you are persuaded of the merits of the change, there will be no need to have any substantive discussion in E(A); the other Ministers principally affected (the Chancellor, Tony Newton and Ken Clarke) are all agreed.

2. **Future of the Employment Service**

There have been various exchanges with Norman Fowler about the proposed changes to the Employment Service when it is changed into a Next Steps agency. Norman Fowler wanted to make an announcement earlier this week about the establishment of the agency. While you strongly supported this organisational change you were reluctant to let him go ahead with an announcement until the issues about future operation of the agency had been resolved.

The large number of the earlier minutes and letters are formally on the agenda, and these are all included in Folder 2. But you do not need to go through all these again. The key papers are:

<u>Flag F</u> - the latest minute that Norman Fowler has sent in this evening seeking once again to respond to your concerns. His latest arguments do seem to me rather more persuasive

<u>Flag G</u> - a further summary note from Andrew Dunlop, written before he had seen Norman Fowler's latest note, identifying the key issues to resolve before you agree to the agency announcement going ahead

<u>Flag H</u> - a Cabinet Office brief

<u>Flag I</u> - the earlier two minutes from Andrew Dunlop which set out in more detail the points of concern.

The earlier papers, which you need only have for reference, are organised in chronological order at <u>Flag J</u>.

PRCG

(PAUL GRAY)

<u>22 November 1989</u>

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D. D

PRIME MINISTER

E(A): NHS ALLOCATION

You reacted to the proposal to abolish the NHS allocation by describing it as a "shifty device". In my view it is the existence of the device that is shifty. I believe that the right course is to abolish it and that the timing for this is good.

(i) The presentation need not be difficult. While the NHS was being reviewed it made sense to retain the NHS allocation as there was a possibility that arrangements would be agreed which built on it in some way. We can now say that the review has been completed and a decision taken for the NHS to be funded entirely from taxation and (to a limited extent) charges. As a result the NHS allocation has no further role and now is therefore the right time to wind it up.

as now

(ii) To retain the NHS allocation is to put book-keeping above real money in the real world. The only genuine alternative is to put up NICs. To maintain a fiction about the way the NHS is funded, and one which is no longer needed, at the cost of a genuine rise in NICs and hence employer costs would be a mistake.

(iii) A National Insurance fund shorn of oddities like the NHS allocation would make the contributory principle for pensions even clearer.

If you do decide to accept the abolition of the NHS allocation there will be no need for it to be taken on the E(A) agenda.

AT

(ANDREW TURNBULL)

22 November 1989

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hex.ps/ds/29 **CONFIDENTIAL**

C C

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

PRIME MINISTER

E(A), THURSDAY 23 NOVEMBER: NATIONAL INSURANCE FUND

We are to discuss at E(A) on Thursday Tony Newton's proposal for dealing with the projected deficiency in the national insurance fund. As Tony's letter of 14 November to Geoffrey Howe makes clear, he has agreed his approach with Kenneth Clarke and me. But I thought it would be helpful if, in advance of the meeting, I set out briefly the reasons why I support Tony's proposal.

The Government Actuary estimates that the balance in the national insurance fund will fall below the prudential minimum (equivalent to 17 per cent of annual benefit expenditure from the fund) sometime in 1991-92. The balance was already expected to fall substantially as a result of the reform of employees' NICs announced in the Budget and implemented last month. What has taken the projections below the prudential minimum is the reduction in income to the fund arising from the success of personal pensions. Nearly 3½ million people have so far taken out personal pensions (the great majority having opted out of SERPS), far more than anyone expected. This is, of course, extremely welcome and will reduce expenditure on SERPS in the long term. But, in the short term, it is clear that we have to take action to maintain the balance in the fund.

In principle, there are several options available (all of which would require primary legislation):

(a) increase national insurance contributions;

(b) reinstate the Treasury Supplement, the taxpayers' subvention to the fund which was abolished in the 1989 Social Security Act;

(c) allow the fund to borrow;

(d) abolish the NHS allocation.

An increase in NICs is obviously unattractive, particularly as the increase would take effect in April 1991, and reinstating the Supplement would be an embarrassing reversal. Tony and I have considered (c). As he says, I would be most unwilling to take the risk that allowing the fund to borrow would be portrayed as a relaxation of financial prudence and raise doubts about our overall fiscal stance.

This leaves the NHS allocation. At present, about 10 per cent of total NICs are used to help pay for the NHS, instead of national insurance benefits. As you know, from the point of view of public finances, this is purely an accounting device, which makes no difference to the level of expenditure on the NHS nor to the amount of money we raise through NICs. If we were to abolish it, the same level of expenditure on the health service would be financed entirely out of taxes (plus income from charges etc) rather than a mixture of taxes and NICs. NICs would be devoted entirely to financing national insurance benefits, and the Government Actuary estimates that the balance in the fund would remain comfortably above the prudential minimum.

The Opposition may try to argue that ending the allocation would reduce resources available for health. But this would be an entirely bogus argument, and I doubt whether they could make much of it. The allocation is worth £4 billion, and it would not be credible to contend that we were reducing the health programme by such a large amount, especially as we have just announced a significant increase in planned expenditure over the Survey period.

So while ending the allocation will need careful explanation (and a robust dismissal of any Opposition mischief - making) I think it is the best solution to the problem we must tackle.

I am copying this minute to the other members of E(A).

John M.

JOHN MAJOR
22 November 1989

ECON POL: Budget pt 18.

E

14a-e

PRIME MINISTER

P 03581

NATIONAL INSURANCE FUND

E(A)(89) 31: Memorandum by the Secretary of State for Social Security. Also letter from him of 14 November. Minute of 22 November from the Chancellor of the Exchequer.

DECISIONS

Mr Newton says that the high uptake of personal pensions will put the National Insurance Fund into deficit in 1992-93. He proposes to avoid this by legislating this Session to abolish the payment from the Fund to the National Health Service from April 1991. The Chancellor of the Exchequer and Mr Clarke agree.

2. You will wish to consider the options:

i. abolish the NHS allocation. The main issue is whether or not it is right to abolish the contribution from the Fund to the NHS, leaving the latter to be funded entirely from taxation plus receipts from charges and income generation.

ii. temporary reduction. Mr Newton's letter of 14 November referred to the possibility of legislating to set the allocation at zero until the Fund's problems are overcome. Mr Clarke is opposed to this on presentational grounds.

iii. other measures to reduce outgoings. Mr Newton's paper lists other options which in a package combined with limited borrowing powers for the Fund would solve its problems. But the Chancellor is strongly opposed to the borrowing powers.

iv. increase National Insurance contributions. An alternative would be to increase the Fund's income from contributions. Mr Newton rejects this.

v. defer a decision. A further possibility might be to

6

defer a decision for a year to see how the uptake in personal pensions develops. But this might mean rushing a Bill through in the 1990-91 Session.

BACKGROUND

3. The income of the National Insurance Fund, nearly all from National Insurance contributions, is expected to be £28.5 billion this year. Most of this goes to finance National Insurance benefits but £4 billion goes to the National Health Service (NHS) and covers about 16% of NHS expenditure. Mr Newton says that because of personal pensions, the Fund as a whole will fall below the Government Actuary's minimum recommended level in 1991-92, and into deficit in 1992-3. He proposes to prevent this happening by abolishing the Fund's contribution to the NHS from April 1991, in this Session's Social Security Bill.

ISSUES

Mr Newton's proposal

4. As Mr Newton says, many people believe that the whole or a large part of their National Insurance contribution goes to the NHS as the "health stamp". It has been thought that payment for Welfare State benefits through the NICs is very effective at bringing home their cost. You may want to explore the effect on public perception of the cost of the NHS if the contribution from the NI Fund is abolished.

5. Throughout its term the Government has raised the NHS contribution. In 1979-80 it totalled only £877 million, covering under 10% of NHS costs; it now totals £4 billion and covers 16% of NHS costs. It is not clear how the Government would explain the change of course, if the contribution from the Fund were to be dropped. Given the widespread misunderstanding about the importance of the NHS contribution, you might ask whether abolishing it would be regarded as harming the NHS to meet the cost of the Fund's subsidy to private pensions.

C

A temporary reduction in the Fund's contributions

6. A variation on Mr Newton's proposal, set out in his letter of 14 November, would be to take power to set the Fund's contribution to the NHS at zero, but to make it clear that this would only be done until the Fund's problems had been overcome. The Government would still hold to the principle of partly financing the NHS from National Insurance contributions but would waive it for the time being.

7. Mr Clarke is opposed to this approach on presentational grounds. He believes that it would look like short-term expediency and lead to criticism that the NHS was to suffer because of subsidies for private personal pensions. But it might be argued that the same criticisms apply to complete abolition of the Fund's contributions to the NHS. You may wish to consider whether setting the Fund's contributions at zero until its problems have been overcome is an option which should be pursued.

Other measures to reduce outgoings

8. Mr Newton's paper sets out other options for helping to avoid the Fund going into deficit: see Table 1. They involve removing industrial injuries benefits from the Fund; possibly removing statutory sick pay and statutory maternity pay from the Fund; and reducing the NHS allocation rather than eliminating it. A package of such measures, combined with giving the Fund limited borrowing powers so as to allow it to fall below the minimum recommended level, could be sufficient to solve the Fund's problems. This is what Mr Newton originally proposed. The Chancellor is however strongly opposed to borrowing powers since they could be portrayed as a relaxation of financial prudence and cast doubt on the Government's fiscal stance. You may wish to agree that borrowing powers should not be taken.

The alternative of raising NICs

9. Mr Newton's proposal would mean that from April 1991 NHS spending would be financed entirely from taxation, apart from

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relatively small contributions from charges and income generation. The alternative would be to raise National Insurance contributions in order to keep the National Insurance Fund in balance. Mr Newton says that a sharp increase in NIC rates would be "unattractive" and undermine the Government's record of cutting taxes and contributions. You may want to consider the case for a rise in NICs as an alternative to putting the burden on general taxation.

Defer a decision?

10. Mr Newton wants to legislate this Session to make the change from April 1991. A number of points arise:

i. could the decision be taken this time next year, with a view to legislating at the beginning of the 1990-91 Session? This would allow time to see the level of uptake of personal pensions, which is hard to predict. Table 1 shows the balance still well above the minimum level in April 1991.

ii. Mr Newton says that in 1991-2 the Fund will not go into deficit, but its balance will fall below the Government Actuary's recommended minimum level. You may want to ask about the status of this minimum level and the practical consequences of falling below it. Table 1 to the paper shows that even with no change there would be a balance of 11% in the Fund in April 1992.

iii. The options in table 1 might be used to postpone the decline in the Fund's finances and keep the balance above the Government Actuary's minimum at the end of 1991-2. You may wish to explore whether the problem could be handled in this way.

HANDLING

11. The Secretary of State for Social Security will wish to

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introduce the subject. The Secretary of State for Health will also wish to speak. (These two Secretaries of State hope to leave at about 12 o'clock for press conferences). The Chancellor of the Exchequer will be interested in any implications for taxation, and the Lord President of the Council in the implications for the Social Security Bill.

RTJ.

R T J WILSON
Cabinet Office
November 22, 1989

CONFIDENTIAL

Tho MRM

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

20 November 1989

Dear Helen,

NATIONAL INSURANCE FUND

The Prime Minister has seen your Secretary of State's letter of 14 November to the Lord President. The Prime Minister would like to discuss with colleagues the proposed abolition of the allocation from the Fund to the Health Service. We are hoping to arrange a meeting of E(A) for later this week when this issue can be placed on the agenda.

I am copying this letter to Private Secretaries to members of E(A), H Committee and to Sir Robin Butler.

Yours,
Paul

PAUL GRAY

Ms. Helen Dudley,
Department of Social Security

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DEPARTMENT OF SOCIAL SECURITY

Richmond House, 79 Whitehall, London SW1A 2NS

Telephone 01 - 210 3000

From the Secretary of State for Social Security

Paul Gray Esq
Private Secretary
to the Prime Minister
10 Downing Street
LONDON SW1

16 November 1989

Dear Paul

RA

NATIONAL INSURANCE FUND

I have been asked by Cabinet Office to ensure that members of E(A) receive a copy of a letter my Secretary of State has sent to the Lord President, copied to members of H Committee, on the National Insurance Fund, dated 14 November. This is attached, and I am copying it to private secretaries to members of E(A).

Yours

Helen

HELEN DUDLEY
Private Secretary

CONFIDENTIAL

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DAC6 20/11

PRIVY COUNCIL OFFICE

WHITEHALL, LONDON SW1A 2AT

16 November 1989

Dear Stuart,

will obtain if required

The Lord President has seen your Secretary of State's letter of 14 November about the National Insurance Fund.

He can see why the conclusions set out in the letter were reached and agrees that there might indeed be scope for presenting such a change very positively. However, he considers that such a major policy change deserves collective discussion to ensure that all the potential difficulties have been identified. This could most appropriately take place in E(A) where such matters have been discussed in the past.

I am copying this letter to the Private Secretaries of members of H and E(A) Committees.

Yours sincerely,

Gillian Baxendine

GILLIAN BAXENDINE
Private Secretary

Stuart Lord Esq
PS/Secretary of State for Social Security

10 DOWNING STREET

Prime Minister

You were not able to finish the attached last night. Content with the proposed change?

BRCG
17/11

I would rather speak to them about it. It is a 'shifty' device.

MT

A A

DEPARTMENT OF SOCIAL SECURITY
Richmond House, 79 Whitehall, London SW1A 2NS
Telephone 01 - 210 3000

From the Secretary of State for Social Security

Prime Minister
This proposes ending all links between the NI Fund and the NHS – a principle to which you have attached importance in the past. My own view is that the present arrangements are artificial, and there is a good case for the change proposed – see the points at X on the next page. But are you content to let the proposal go ahead?
PRCG 16/11

The Rt Hon Sir Geoffrey Howe QC
Lord President of the Council
Privy Council Office
Whitehall
LONDON
SW1A 2AT

14 NOV 1989

Dear Geoffrey,

NATIONAL INSURANCE FUND

I am writing to let you know the outcome of recent discussions I have had with John Major and Kenneth Clarke about the future management of the National Insurance Fund; and to seek colleagues agreement to the action I propose to take. This will involve legislation in my 1989-90 Bill so as to abolish from April 1991 the current practice whereby a proportion of the Fund's income is used to finance the Health Service.

Despite this year's Budget reductions in the amount of national insurance paid by employees, the balance in the Fund will remain well above the Government Actuary's recommended minimum level until the end of 1990-91. But this situation will change significantly as the costs of our personal pension initiative begin to be felt. On the basis of current economic assumptions, the Actuary has forecast that the balance will fall below his minimum recommended level in 1991/92; and that, by the following year, the Fund is likely to go into deficit and remain there well into the mid 1990s.

The take up of personal pensions has been much higher than we expected. Already over 3 million applications have been approved and this figure is likely to go as high as 5 million within the next two years. The success of the initiative is much to be welcomed because it means that a large proportion of the working population are now taking responsibility for their own pension arrangements by choosing not to rely on the state earnings related scheme. Eventually, this will produce benefit savings but, in the short term, the costs of rebates and incentives associated with our initiative will push the Fund into deficit unless remedial action is taken.

J

The prospect of having to meet these costs with sharp increases in national insurance contributions is plainly unattractive. I therefore proposed to the Chancellor that we could overcome our difficulties with a package of measures, the main element of which was a set of borrowing powers for the Fund. These powers would have removed the obligation to maintain the Fund at a certain percentage of benefit expenditure while the other measures were designed to ensure that the Fund did not fall below zero. However, John Major felt strongly that borrowing powers could be portrayed as a relaxation of financial prudence and might cast doubt on our overall fiscal stance.

The Chancellor and I have therefore concentrated our attention on the allocation made each year from the Fund to the Health Service. This currently stands at over £4 billion and is calculated as a percentage of the contributions paid by employees, employers and the self-employed. By using powers already available to vary the percentage by a small amount each year, we have allowed the allocations to rise steadily since we took office. This has enabled us to prevent the Fund from reaching too high a surplus. The allocation does not, of course, affect Government decisions on the overall level of public expenditure on the NHS; it is purely a technical funding device.

X

The existing powers do not permit us to reduce the allocation by a sufficient amount to rescue the NI Fund. We have considered the possibility of legislating to set the allocation at zero until the Fund's problems are overcome but Kenneth Clarke has expressed grave reservations about the presentational problems this would pose. It would mean, in effect, that although we still believed in the principle of partly financing the Health Service from national insurance contributions we were unwilling to support that principle in practice for reasons of short-term expediency. This would maximise the opportunity for the Opposition to claim that we had mis-managed the Fund - even perhaps to argue that the NHS was to suffer because of subsidies for private pension provision. Both John Major and I accept that this approach must be ruled out because of the presentational difficulties.

Our proposal, supported by Kenneth Clarke, is to abolish the allocation altogether leaving a situation in which the health Service is visibly seen to be funded only from taxation, and from receipts from charges and income generating activity. There are of course many people who believe that the whole, or a large part, of their NI contribution goes to the NHS and influences expenditure on it. We shall need to correct that. Indeed, I believe we can present the change very positively, emphasising that access to the NHS does not depend upon an individual having paid contributions. The abolition of the allocation is entirely logical and follows naturally on last year's decision to end the Treasury Supplement.

X

It never did

The abolition of the NHS allocation will resolve the problems facing the Fund and ensure that the balance remains above the Actuary's recommended minimum for the next five years at least. It will mean that no other action will be necessary and will enable us to maintain our record of no increases in contributions for employers and employees since 1983/84. I hope colleagues will agree that this represents the best possible solution.

I am copying this minute to other members of H Committee and Sir Robin Butler.

Yours ever,
Tony

TONY NEWTON

ECON POL: Budget pr [illegible]

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cc PU

CONFIDENTIAL

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

13 November 1989

Dear Helen,

NATIONAL INSURANCE CONTRIBUTIONS: RE-RATING 1989/90

Thank you for your letter of today's date, which the Prime Minister has seen and noted.

I am copying this letter to Jonathan Taylor (Treasury), Andy McKeon (Department of Health) and Stephen Pope (Northern Ireland Office).

Yours,
Paul

PAUL GRAY

Ms Helen Dudley
Department of Social Security

CONFIDENTIAL

DEPARTMENT OF SOCIAL SECURITY
Richmond House, 79 Whitehall, London SW1A 2NS
Telephone 01 · 210 3000
From the Secretary of State for Social Security

Prime Minister

Spells out the material you saw at the weekend.

PRG 13/11

CONFIDENTIAL

Paul Gray Esq
Private Secretary to the
Prime Minister
10 Downing Street
London
SW1A

13 November 1989

Dear Paul

NATIONAL INSURANCE CONTRIBUTIONS RERATING 1989-90

My Secretary of State has now conducted the annual review of National Insurance Contributions, and the proposals, which will come into effect from April 1990, are summarised in the attached table. The Chancellor will refer to the proposals in his oral Autumn Statement, and a written PQ will be answered on the same day. No change is proposed to the main NIC rates, but some flat rates will go up in line with the normal rerating of earnings limits. The earnings brackets for the reduced rates of contributions payable by employers are being increased broadly in line with the rise in prices.

I am copying this letter to Jonathan Taylor (Treasury), Andy McKeon (Health) and Steve Pope (Northern Ireland).

Yours

Helen

HELEN DUDLEY
Private Secretary

CONFIDENTIAL

NATIONAL INSURANCE CONTRIBUTIONS RERATING 1990-91

<u>Class 1 employee's share</u> (no change except in lower and upper earnings limits)

Rate	Present Band	Proposed Band
2%	First £43	First £46
9%	Balance of earnings from £43.01 to £325	Balance of earnings from £46.01 to £350

<u>Class 1 Employer's share</u>

Rate	Present Band	Proposed Band
5%	£43 - £74.99	£46 - £79.99
7%	£75 - £114.99	£80 - £124.99
9%	£115 - £164.99	£125 - £174.99
10.45%	£165 and above	£175 and above

(Having found the appropriate band, the contribution is assessed at 5%, 7%, 9% or 10.45% as appropriate on <u>all</u> the earnings.)

	Present	Proposed
Class 2 (self employed)	£4.25 a week	£4.55 a week
Small earnings exception level (annual)	£2,350	£2,600
Class 3 (voluntary)	£4.15 a week	£4.45 a week
Class 4 (self employed) lower profits limit (annual)	£5,050	£5,450
upper profits limit (annual)	£16,900	£18,200
Class 4 Rate	6.3%	6.3%

NHS Allocation (no change)

Employees: 1.05%
Employers: 0.9%

CHANCELLOR OF THE EXCHEQUER'S BUDGET STATEMENT
14 MARCH 1989

INDEX

A. INTRODUCTION

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.

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.

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.

B. ECONOMIC PERFORMANCE AND PROSPECTS

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.

For the first time, economic 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.

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 underpin 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.

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.

Once business and industry recognised the fundamental changes that were taking place, they responded to the new economic climate with vigour and confidence. As a result, we have experienced the longest period of strong and steady growth since the War. 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 productivity growth in manufacturing has exceeded even that of Japan.

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.

But it is not just our economic performance that has been transformed: so have our prospects for the future. 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, last year at the rate of more than a thousand a week.

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 stand firm.

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.

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 4½ per cent, with unemployment falling by over half a million, to well below the European average.

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

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.

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 into the deficit on the current account of the balance of payments. The published figures put this at £14½ 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.

Given sound policies, however, 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 imbalance is something that will in due course correct itself.

The real threat is posed by the increase in inflation itself. Excluding the distorting effect of mortgage interest payments, the RPI rose by 4½ 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 5½ per cent.

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 three and a half years.

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.

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

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.

The outlook for 1989 is for inflation to rise a little further over the next few months, from 7½ per cent including mortgage interest payments to about 8 per cent, before falling back in the second half of the year to 5½ per cent in the fourth quarter and perhaps 4½ per cent in the second quarter of 1990.

Some slowdown in real growth is inevitable as we get inflation back onto a downward path - indeed, it has almost certainly already begun to happen. Overall growth is forecast to fall from the 4½ per cent recorded last year to 2½ 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.

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 their pay and other costs. The more successfully they do so, the less costly in terms of output and employment the necessary adjustment will be.

But over the medium-term, it is clear from our experience over the past ten years that the policy we are pursuing will bring inflation down, and steady growth will resume. 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.

C. MONETARY POLICY

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.

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

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 - 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.

The exchange rate is of particular importance in the conduct of monetary policy. The Government's clear commitment not to accommodate increases in domestic costs by exchange rate depreciation remains a key safeguard against inflation. 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.

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.

D. PUBLIC SECTOR FINANCES

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 £25 billion in today's terms.

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.

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.

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.

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 over £1½ billion a year. This saving is being put to good use, allowing extra spending on departmental programmes within our overall public expenditure constraints.

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.

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 a highly successful innovation. We plan to continue the programme at around the current level.

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 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.

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.

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

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

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."

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.

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 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. 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.

E. TAXPAYER CONFIDENTIALITY

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

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

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

I would only add that the need for this protection is in no sense a reflection on the probity and integrity of the members of those two Departments. Indeed, after nearly six years as Chancellor and more than eight years as a Treasury Minister, I would like to take this opportunity to pay public tribute to the outstanding service I have consistently received from the officials of both Departments.

F. BUSINESS TAXATION

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

First, taxes on business.

Ever since the corporation tax reform I introduced in 1984, the rate of corporation tax for small companies, defined for this purpose as those with annual profits of less than £100,000, has been set at the basic rate of income tax, currently 25 per cent. Large companies, defined as those with profits of £½ million or more, pay the main rate of corporation tax of 35 per cent, one of the lowest rates of tax on company profits in the world. Between £100,000 and £½ million the average rate of tax gradually rises from 25 to 35 per cent.

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

Thus the small companies' rate will apply to companies with profits of under £150,000, and the 35 per cent rate will only be reached at profits of £¾ million. These changes will reduce the corporation tax burden for more than half of all those companies that do not already enjoy the benefit of the small companies rate.

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

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

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

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

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

One of the many undesirable features of an income tax system with several higher rates was that since a taxpayer's marginal rate could well be very different in different years, the question of which year income related to made a great deal of difference. This was true of Schedule E, where the strict rule is that income is taxed in the year to which it relates, on an accruals basis.

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

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

The reduction in the top rate of income tax to 40 per cent in last year's Budget also enables me to make a major simplification of the tax regime for the vast bulk of the incorporated sector of small businesses: those known as close companies - generally speaking, unquoted companies that are controlled by five or fewer people.

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

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

G. TAXES ON SAVING

I now turn to the taxation of saving.

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

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

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

Above all, the role of tax reform is to encourage enterprise and improve economic performance in the medium term. It is wholly inappropriate as a response to short term or cyclical phenomena. So for the taxation of savings, the Government's policy is clear. It is to strengthen and deepen popular capitalism in Britain, by encouraging in particular wider share ownership.

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

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

Personal equity plans got off to a good start, with over a quarter of a million investors, many of whom had never owned shares before, subscribing almost £½ billion between them in 1987.

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

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

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

Second, within that, I propose to raise substantially the amount that can be invested in unit trusts or investment trusts. For many small savers, these provide an excellent introduction to shareholding. At present, PEP investors are limited to £540 a year, or a quarter of their PEP, whichever is the greater, in unit or investment trusts. I propose to increase this limit very substantially, to £2,400 a year; and the whole of a PEP will be able to be invested in unit or investment trusts, up to this limit. To qualify for tax relief, the unit or investment trusts will be required to invest wholly or mainly in UK equities.

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

Finally, I propose to make a number of important simplifications to the PEP rules so as to make the scheme more flexible, better directed to the needs of small and new investors, and cheaper to administer.

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

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

It is a striking fact that the number of approved all-employee share schemes has risen from a mere 30 in 1979 to almost 1,600 today, benefiting some 1¼ million employees. At present the annual limits on the value of shares which can be given under all-employee profit-sharing schemes are £1,250 or 10 per cent of salary up to a ceiling of £5,000. I propose to raise these cash limits to £2,000 and £6,000 respectively.

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

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

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

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

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

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

Taken together, the package of measures I have announced to encourage wider share ownership in general, and employee share ownership in particular, will help to ensure that the idea of a share-owning democracy becomes ever more entrenched as a part of the British way of life.

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

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

There is clearly a powerful case for reform, with a view to securing a tax regime which is more equitable both within the industry and as between life assurance and most other forms of savings.

I have considered very carefully the representations the industry has made, and taken full account both of the changes to the regulation of life assurance proposed by the Securities and Investment Board under the Financial Services Act and the prospects for increased competition within the European Community after 1992. In the light of these factors, I have decided not to proceed with the more radical reforms canvassed in the consultative document. But I do have a number of important changes to propose, based for the most part on the general tax reform principle of seeking lower rates on a broader base.

First, many life offices write pension business as well as life assurance, and they are not required to keep the two businesses entirely separate for tax purposes. This enables them to set the unrelieved expenses of the pensions business against the income and gains of their life business, thus giving their life profits unduly favourable tax treatment. The life offices themselves have accepted that this treatment is anomalous and I propose to end it.

This change will come into force on 1 January 1990. Together with some related measures to put the taxation of life offices' pension business onto a proper footing, it will yield some £150 million in 1990-91.

The remainder of the changes I have to propose constitute a broadly balanced package which, because of the transitional provisions, will reduce the taxation of life assurance in 1990-91 by some £100 million.

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

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

But I can say here and now that I propose, as from 1 January 1990, to abolish Life Assurance Policy Duty. And I also propose, from the same date, that the rate of tax payable on the policyholders' share of income and gains of life offices, which at present stands at 35 per cent on unfranked investment income and 30 per cent on realised capital gains, should be reduced to the basic rate of income tax.

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

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

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

I now turn to pensions.

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

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

However, while it is clearly right that employers should be free to provide whatever pension they see fit, it would not be right to make the present generous tax treatment open ended. I therefore propose to set a limit on the pensions which may be paid from tax-approved occupational schemes, based on a final salary of £60,000 a year.

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

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

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

I also propose to simplify very substantially the rules concerning additional voluntary contributions to pension schemes, or AVCs.

In particular, the present requirements for freestanding AVCs place a heavy administrative burden on employers. These requirements will be greatly reduced. Indeed, in many cases employers will not need to be involved at all.

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

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

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

Second, I propose to increase substantially the annual limits, as a percentage of earnings, on contributions to personal pensions for those over the age of 35. This will be of particular value to those running their own business, who are often unable to make contributions until later on in their working life. It will also improve the position of personal pensions in relation to occupational schemes. The new limits will be subject to an overall cash ceiling based on earnings of £60,000, corresponding to the new ceiling for occupational pensions, and similarly indexed.

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

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

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

I refer to Independent Taxation, about which three new explanatory leaflets are now available from all tax offices.

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

H. TAXES ON SPENDING

I now turn to taxes on personal income and spending.

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

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

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

So far as water for industry and fuel and power for business use are concerned, VAT will not be payable until July 1990. VAT on fuel and power will apply to business users above a specified threshold. Private households will remain zero rated.

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

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

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

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

I now turn to the excise duties.

For some years now, the potential damage to the environment in general, and the risk to child health in particular, from excessive lead in the atmosphere has been a matter for concern. 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 I have sought to assist this. I first introduced a tax differential in favour of unleaded petrol in 1987, and increased it last year. But although sales are undoubtedly rising, unleaded petrol still accounts for only some 5 per cent of total petrol sales, even though two-thirds of the cars now on the road could use it, either without any modification, or else with only a minor modification which should not usually cost more than £20 and in many cases will be carried out free.

One of the problems is ignorance of the facts. Many motorists do not realise that their cars can already use unleaded petrol. Others are unaware how modest the modification cost usually is. And many are under the false impression that, if they do switch to unleaded petrol, their cars will no longer be able to use leaded petrol.

It is clearly essential that these myths are rapidly dispelled. Meanwhile, I propose to take the opportunity of this Budget to increase still further the tax differential in favour of unleaded petrol, by nearly fourpence a gallon. This means that, at a shade over 14 pence a gallon, or more than threepence a litre, our tax differential in favour of unleaded petrol will be greater than that of any other country in the European Community, with the solitary exception of Denmark. If the benefit of today's change is fully passed on to the customer - and I look to the oil companies to see that it is - it means that the price of unleaded petrol at the pump will generally be getting on for tenpence a gallon, or just over twopence a litre, cheaper than four star leaded petrol.

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

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

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

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

J. INCOME TAX

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

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

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

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

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

But while the general holdover relief will go, I propose to retain it for gifts of business, farm and heritage assets. And of course gifts between husband and wife will continue to be exempt.

Moreover I propose to extend the existing relief for all gifts to charities to gifts of land and buildings to housing associations. Where instead of being given away the land is sold at less than market value, any capital gains tax will be based on the actual proceeds rather than, as now, on the market value. I also propose that such gifts and concessionary sales be normally exempt from inheritance tax.

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

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

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

The single age allowance will rise by £220 to £3,400, and the married age allowance by £350 to £5,385. The higher level of age allowance will rise by £230 to £3,540 for a single person, and by £360 to £5,565 for a married couple.

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

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

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

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

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

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

The cost to public expenditure will be £190 million in 1989-90, which will be entirely met from the Reserve. But the net cost of this measure will be significantly reduced by the income tax payable on the increased pensions.

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

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

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

K. NATIONAL INSURANCE CONTRIBUTIONS

I have one further measure to propose.

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

The two reduced rates, which I introduced for both employers nd employees in my 1985 Budget, cut the cost of employing the young and unskilled, among whom unemployment was then high and rising, and cut the burden of National Insurance contributions on the low paid. But the highly desirable reduction in the steep step at the lower earnings limit was achieved at the expense of creating two small steps further up the earnings scale.

This is not a real problem so far as employers' contributions are concerned. But it is for employees. For it inevitably means that, at certain points on the income scale, people can still be worse off if they earn more. Their extra earnings take them from a lower rate band to a higher one, and they therefore lose more in National Insurance contributions than they gain in extra pay.

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

This will abolish altogether the steps which at present exist at earnings, for 1989-90, of £75 and £115 a week, and thus remove a serious work disincentive from the system. The step which has always existed at the lower earnings limit, where people first come into the National Insurance system, is the entry ticket to the full array of contributory benefits. As such, it is an essential feature of the contributory principle. But my proposals will more than halve this step, to only 86 pence a week in 1989-90.

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

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

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

The total additional cost of all the measures in this Budget, on an indexed basis, is under £2 billion in 1989-90 and £3½ billion in 1990-91.

L. 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 of, and reduction in, employees' National Insurance contributions; and I have honoured our pledge to abolish the earnings rule for pensioners.

I commend this Budget to the House.

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FROM: S J PICKFORD
DATE: 14 MARCH 1989

TO ALL BUDGET BRIEF RECIPIENTS

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CC81/S.

PRIME MINISTER

BUDGET DAY CABINET

This is the special Cabinet meeting for the Chancellor to reveal his Budget proposals.

You will want to start by inviting the Chancellor to speak. As in recent years he does not propose to circulate any pieces of paper.

After the Chancellor has spoken you will want to give an opportunity to any other Members of the Cabinet who want to to comment. Some of them may, I imagine, welcome the extent to which the Chancellor has responded to the February pre-Budget discussion.

In concluding the discussion, you will want to stress two points:

- the warm Cabinet endorsement of the package;

- the need for absolute secrecy until after the Chancellor's speech.

RRCG.

PAUL GRAY
13 March 1989

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chex.md/aa/27 ~~BUDGET SECRET~~ B

downgraded to: CONFIDENTIAL

COPY NO 1 OF 14

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

Note

Seen and agreed by Prime Minister. PRCG 11/3

PRIME MINISTER

With PSDR figures now available for the first 11 months of the year - the last figures we shall have before the Budget - I am in a position to let you have my usual note on the Medium Term Financial Strategy.

This will be the tenth occasion on which we have set out the MTFS in the Red Book. I propose to use this opportunity to highlight the transformation of the economy that has followed our pursuit of sound financial policies coupled with supply-side reforms. I will stress that, although the details of the MTFS have changed over the last decade as the economy has evolved, the essence of the strategy has remained unchanged.

At the centre of the MTFS, as always, is the over-riding requirement to bring down the rate of inflation and not to accommodate inflationary impulses. Over the past two years, money GDP growth has exceeded the rate we have been aiming for. In part this reflects a better supply performance in the economy; but it also reflects stronger inflationary pressures. We have taken firm action since the summer to bring the economy back onto track, and the decline in money GDP growth which I propose to aim for over the medium term should bring about a decisive reduction in inflation.

Fiscal policy

The PSDR in 1988-89 will turn out significantly higher than the £10 billion I forecast at the time of the Autumn Statement. So far, we have a surplus of £16 billion with one month to go, though with the usual surge of spending in the final month the figure for the year as a whole is likely to turn out somewhat lower. I intend to publish a figure of £14 billion as our best guess.

Last year I set out the principle of a balanced budget as the norm for fiscal policy, and I intend to reaffirm it this year. I do not believe that we should aim for the maximum possible repayment of debt, because that would unnecessarily delay the reductions in taxation needed to build on the supply side improvements already achieved. But given the size of the present surplus, and the need to maintain a prudent and cautious approach, I am sure we should only aim to return to balance gradually over a period of years.

The tax and national insurance package we have agreed will enable me to budget for a PSDR of almost £14 billion in 1989-90, the same as in 1988-89. This implies no change in the overall tax burden between the two years: the package merely offsets the fiscal drag in the system. (It also means that excluding privatisation proceeds, which will total £7 billion in 1988-89 but are planned to return to £5 billion in 1989-90, I am budgeting for a rise in the PSDR, from £7 billion to almost £9 billion.) Thereafter I propose to show a gradual return towards budget balance, and thus a number of further years of debt repayment. Provided we continue to restrain the growth of public expenditure, this should enable us to bring down the tax burden over the medium term.

Monetary policy

The MTFS will once again emphasise that the task of exerting downward pressure on inflation falls to monetary policy. It will also make it clear again that short-term interest rates are the essential instrument of monetary policy; that interest rate decisions are made on the basis of a comprehensive assessment of monetary conditions, with particular weight given to the behaviour of MO in relation to its target range and to exchange rate; and that the Government is not prepared to accommodate increases in domestic costs by exchange rate depreciation.

I intend to set a target range for MO growth in 1989-90 of 1 to 5%, as foreshadowed in last year's MTFS; this is the same as the range for 1988-89. Although the 12 month growth rate of MO is likely to start the year above the target range, the tightening of monetary policy since the summer should bring it back within the range before too long. We have already seen a sharp deceleration, with the annualised six month growth rate now well within the range.

For subsequent years I propose to show a declining path for monetary growth in line with that shown in last year's MTFS. The range -1 to 3% for the final year (1992-93) should be consistent with money GDP growth of around 5%, and hence a decisive fall in inflation from the average rate of the last five years.

Capital market liberalisation

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

N.

[NL]
10 March 1989

 S 13(A-B)

PRIME MINISTER

FINAL BUDGET DOCUMENTS

I attach:

Flag A: the formal minute from the Chancellor summarising the Budget package. There is no need for you to go through this in detail, as you are already familiar with all the key points.

Flag B: a further minute from the Chancellor on the MTFS. I suggest you do look at this carefully. See separate comments below.

Flag C: draft of the Budget speech itself; this is in two main sections, on tax and the economy. Again, you will want to go through this carefully, and the Chancellor would welcome your detailed drafting comments.

MTFS (Flag B)
You will want to consider what the Chancellor has to say both about fiscal policy and monetary policy.

On fiscal policy, he proposes including in the MTFS a gradual return towards Budget balance rather than maintaining the present level or surplus. I think this is right. Although high levels of debt repayment have obvious attractions, it is unrealistic to plan for the present level of PSDRs continuing. We only need such high levels at present because the personal sector is not saving enough. As the economy readjusts and personal saving picks up again, one would expect to see the PSDR coming down (as Alan Walters has argued). So it would involve an exceptionally tight fiscal policy to try to keep the PSDRs up; as the Chancellor says this would conflict with your objectives for the tax burden.

B

On monetary policy, the Chancellor proposes to include in the MTFS the same figures as already published for the period up to 1991-92 - ie. a range of 1-5 per cent in 1989-90, and 0-4 per cent in each of 1990-91 and 1991-92. For the new final year, 1992-93, the Chancellor now proposes publishing a lower figure of -1 to 3 per cent. This gives a helpful signal of planned further squeezing of inflation.

Budget Speech draft (Flag C)
I have marked some small comments in the margin.

It would be helpful if you are able to have a look at the draft speech before lunch time on Saturday, so that we could have a brief word after Alan Greenspan leaves and I can then phone through comments to the Treasury. Alternatively, if you had any major worries you could then yourself phone the Chancellor in Leicestershire.

PAG.

PAUL GRAY

10 March 1989

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

10 March 1989

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10 Downing Street
LONDON
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Yours,

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MOIRA WALLACE

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... 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

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.

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.

19. Moreover the 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

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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.

26. The better that industry succeeds in controlling its pay and other costs, the less painful 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

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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.

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

9 March 1989

Paul Gray Esq
10 Downing Street
LONDON
SW1

Dear Paul,

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

Yours,

Moira.

MOIRA WALLACE

Copy No 2 of 6

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TAXPAYER CONFIDENTIALITY

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

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

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

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

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

BUSINESS TAXATION

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

6. First, taxes on business.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

TAXES ON SAVING

21. I now turn to the taxation of saving.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

37. It is a striking fact that the number of approved employee share schemes has risen from a mere 30 in 1979 to almost 1,600 today, involving some $1^3/_4$ million employees. At present the annual limits on the value of shares which can be given under all-employee profit-sharing schemes are £1,250 or 10 per cent of salary up to a ceiling of £5,000. I propose to raise these cash limits to £2,000 and £6,000 respectively.

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

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

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

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

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

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

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

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

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

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

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

47. There is clearly a powerful case for reform, with a view to securing a tax regime which is more equitable both within the industry and as between life assurance and most other forms of savings.

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

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

49. First, many life offices run a pension business alongside their main life assurance business, and they are not required to keep the two businesses entirely separate for tax purposes. This enables them to set the unrelieved expenses of the pensions business against the income and gains of their life business, thus giving their life profits unduly favourable tax treatment. The life offices themselves have accepted that this treatment is anomalous and I propose to end it.

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

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

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

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

53. But I can say here and now that I propose, as from 1 January 1990, to abolish Life Assurance Policy Duty. And I also propose, from the same date, that the rate of tax payable on the policyholder's share of income and gains of life offices, which at present stands at 35 per cent on unfranked investment income and 30 per cent on realised capital gains, should be reduced to the basic rate of income tax.

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

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

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

57. I now turn to pensions.

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

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

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

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

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

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

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

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

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

This will remove the penalty on good investment performance.

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

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

68. Second, I propose to increase substantially the annual limits, as a percentage of earnings, on contributions to personal pensions for those over the age of 35. This will be of particular value to those running their own business, who are often unable to make contributions until later on in their working life. It will also improve the position of personal pensions in relation to occupational schemes. The new limits will be subject to an overall cash ceiling based on earnings of £60,000, corresponding to the new ceiling for occupational pensions, and similarly indexed.

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

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

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

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

TAXES ON SPENDING

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

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

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

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

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

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

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

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

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

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

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

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

83. I now turn to the excise duties.

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

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

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

86. It is clearly essential that these myths are rapidly dispelled. Meanwhile, I propose to take the opportunity of this Budget to increase still further the tax differential in favour of unleaded petrol, by nearly fourpence a gallon. If this reduction is fully passed on to the customer - and I look to the oil companies to see that it is - it means that the price of unleaded petrol at the pump will generally be getting on for tenpence a gallon, or just over twopence a litre, cheaper than four star leaded petrol. This will be one of the most substantial differentials between the price of leaded and unleaded petrol within the European Community.

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

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

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

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

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

TAXATION OF INCOME

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

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

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

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

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

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

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

98. Lastly, on capital gains tax, I propose to change the tax treatment of certain bonds so as to simplify the tax rules and prevent a loss of yield by the use of

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

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

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

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

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

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

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

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

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

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

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

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

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

NATIONAL INSURANCE CONTRIBUTIONS

111. I have one further measure to propose.

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

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

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

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

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

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

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

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

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

119. The total additional cost of all the measures in this Budget, on an indexed basis, is under £2 billion in 1989-90 and £3$^1/_2$ billion in 1990-91.

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PRIME MINISTER

This minute sets out my proposals for the Budget this year.

2. I have decided to give priority to a major reform of employees' national insurance contributions, and to measures which will further encourage wider share ownership. I am not therefore proposing further reductions in the basic rate of income tax this year, or increases in allowances over and above the rate of inflation. I do not propose to raise excise duties. I can finance these and the other measures I am about to describe while continuing to repay debt on a very substantial scale. I shall send you a separate note shortly about the MTFS, including my proposals for monetary targets and the precise level of the PSDR.

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National insurance contributions

3. My main reason for giving priority to the reform of national insurance contributions is to deal with the so-called "steps", those points on the earnings scale at which people can find themselves worse off if they earn more, because they lose more in national insurance contributions than they gain in extra pay. The NIC reform is also the best way to lighten the load on the lower paid and will leave everyone on just under half average earnings or more with £3 a week more of their own money.

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4. Under the present system, anyone earning less than £43 a week pays no NICs at all. Anyone earning between £43 and £75 pays 5 per cent on the whole of his or her earnings, including the first £43. Anyone earning between £75 a week and £115 a week pays 7 per cent, again on the whole of their earnings. Anyone earning between £115 a week and the upper earnings limit of £325 pays 9 per cent on all their earnings.

5. There are thus three steps, at £43, £75 and £115. At each of these points, an extra pound of earnings can trigger more than an extra pound of NICs.

6. I propose instead that, from 2 October (1 October is a Sunday), employees who pay NICs will do so at only 2 per cent on their earnings up to £43. On their earnings above this they will pay 9 per cent, up to an unchanged upper earnings limit.

7. This will increase by £3 a week the take home pay of those earning £115 a week or more. That is about 40 per cent of male average earnings. With indexation of the personal allowances for income tax, the combined burden of income tax and NICs for someone on half average earnings will fall by over 2 per cent of gross pay.

8. The reform will greatly reduce marginal rates at the present steps. It will abolish altogether the steps at £75 and £115, and reduce the last remaining step at £43 to only 86 pence. I have thought it right to retain this modern-day equivalent of the old national insurance stamp because it is the entry ticket to contributory benefits and essential to the contributory principle.

9. There may need to be a consequential reduction in the voluntary NIC rate which those not in employment can make, if they so wish, to maintain their national insurance records. This detail is yet to be finally decided. There will be no change for employers or the self-employed. (The steps are nothing like such a problem for employers as for employees; and to extend the changes to employers would roughly double the cost.)

10. The reform needs primary legislation, which will be introduced at the Report Stage of the Current Social Security Bill. It will cost £1 billion in 1989-90 and £2.8 billion in 1990-91. I have discussed these proposals with John Moore, who greatly welcomes them. They will meet the concerns expressed by colleagues and others that the Budget should reduce the burden on the lower paid.

Income tax

11. I do not propose to change the basic or higher rate of income tax. I shall increase the personal allowances and the basic rate limit by the amount required for statutory indexation, which is 6.8 per cent rounded up. The main personal allowances will thus be maintained at a level 26 per cent higher in real terms than when we came to office.

The elderly

12. I think it right to do something for the elderly.

13. First, I propose to redeem our 1979 election pledge by abolishing the pensioners' earnings rule from 2 October. If people wish to defer taking their pensions, they will continue to be free to do so, and to earn a higher pension when they retire; but that will be entirely a matter of

choice. The public expenditure cost will be about £185 million in 1989-90, and about £370 million in 1990-91 and will be met from the Reserve. The net cost will be considerably less, because we shall get back additional revenue from the increased pensions in payment, and from pensioners' higher earnings. I have agreed this, too, with John Moore.

14. Second, I propose to extend the higher age allowance which currently applies to those aged 80 and over to take in all those aged 75 and over. This will take an additional 15,000 pensioners out of tax. Single pensioners in the 75-80 age band will have a tax reduction of £1.73 a week, and married couples £2.55.

15. Third, I propose to reduce the rate at which the age allowances are withdrawn. This has given rise to complaints because, after last year's abolition of the top rates of income tax, the withdrawal rate now exceeds the higher rate of tax. It will come down from nearly 42 per cent to 37½ per cent.

16. Finally, the Finance Bill will include the new tax relief for pensioners' health insurance premiums announced in the Health White Paper; it will come into effect in April 1990.

Company car scales

17. I plan a further increase in the scales for taxing the benefit from company cars, which continues to be undertaxed. I have decided they should be increased by a third, a significant increase but less than is generally expected. The great majority of company car drivers will be better off from the Budget as a whole; and in the second half of the year, when the effects of the NIC reform come in, significantly so.

Schedule E

18. I propose to simplify the taxation of income under Schedule E, to remove a major complication which stemmed from the days when there were many different higher rates, and which mainly affects directors. In future, they will be taxed when they receive income, instead of when they are deemed, after complicated adjustments, to have earned it. This will have a short-term cost, but in the long-term will save a significant number of Revenue staff and produce a revenue yield.

Excise duties

19. I propose to make no changes in excise duties this year save for two areas.

20. First, I shall reduce the tax on unleaded petrol by getting on for 4 pence a gallon. That should make unleaded nearly 10 pence a gallon or a little over 2 pence a litre cheaper at the pumps than four star - one of the largest differentials in the EC. At the same time, I propose to increase the tax on two and three star petrol by roughly 4 pence a gallon, so that the pump price of these grades will be at least as high as that for four star. This should accelerate the phasing out of two star, which is already underway, and free storage space and pumps for unleaded petrol. I have told Nicholas Ridley about this proposal, and he welcomes it.

21. Second I propose a number of changes to the Vehicle Excise Duties, which I have agreed with Paul Channon. At present, a bus or coach has to have 66 seats before it pays as much tax as a family car. I propose to increase the rates

for this group of vehicles. I also propose to increase the rates on non-articulated lorries, to put them on a more equal footing with the tax paid by articulated lorries. And I propose to simplify VED, cutting the number of main rates by about a third.

Value added tax

22. As usual, I propose to raise the VAT registration threshold as much as I can under EC law, namely from £22,100 to £23,600.

23. The only change to the coverage of VAT I have to propose this year has already been announced - the measures to implement the ECJ judgement of last June requiring us to end the zero-rating of non-domestic construction; of supplies of electricity and gas to non-domestic consumers, and of water and sewerage services to industry; of protective clothing and headgear supplied to employers; and of news services (but not newspapers, which continue to be zero rated). As you know, I have decided to give generous transitional arrangements for non-domestic construction, and have agreed to defer until July 1990 the standard rating required for fuel, power, water and sewerage to enable these industries to cope more easily with the administrative changes involved. The loss of these zero rates derives from the 6th EC VAT Directive agreed by our predecessors in 1977.

Charities

24. The effects of the ECJ judgement on charities is a sensitive issue and I have done all I can to soften the blow, as the charities themselves have acknowledged. All fuel and

power supplies and construction for their non-business activities will remain zero-rated, as will water for all their activities. But some charities may still have to pay extra VAT. I have therefore decided to introduce some additional reliefs.

25. I propose to extend exemption from VAT to fund-raising events by charities (and certain other fund-raising organisations, including political parties and trade unions); and to extend zero-rating to all advertisements placed by charities, and to sterilising equipment used by medical charities. And I propose to exempt from special car tax vehicles purchased by Motability for leasing to the disabled.

26. I also propose a change in the rules on covenanted membership subscriptions so that it is clear beyond doubt that charities such as the National Trust can offer members free or cheap entry to their properties without loss of tax relief. This will remove a long-standing anxiety.

27. I continue to believe that the best way to help charities is to encourage charitable giving. I therefore propose to double the annual amount which can be given tax free to charities under the payroll giving scheme from £240 to £480 a year.

Capital gains tax

28. I shall keep the annual exemption from CGT at £5,000 this year. Married couples will then in effect have a £10,000 exemption when independent taxation comes in next year.

29. I propose to restrict the deferral of CGT on gifts. This was originally introduced by Geoffrey Howe to prevent a double tax charge when Capital Transfer Tax was levied on

lifetime gifts. Now that CTT has gone, the continued CGT exemption for gifts has become a popular form of tax avoidance. I therefore propose to restrict the exemption, but I shall keep it for gifts of business, farm and heritage assets, gifts to charities, and of course gifts between husband and wife. Gifts or sales of ordinary personal belongings are already exempt from CGT if they are worth less than £3,000. I propose to double this to £6,000.

30. Finally on CGT, I propose to block off a device for turning income into capital through deep discounted bonds.

Company taxation

31. I propose to reduce the burden of corporation tax on many companies, not by changing the main rate of 35 per cent, which is still one of the lowest in the world, but by making the benefit of the 25 per cent small companies rate available to more companies. Ever since the corporation tax reform I introduced in 1984, the small companies' rate has applied to companies with an annual profit of less than £100,000. The benefit is only gradually withdrawn, so that companies only pay the full 35 per cent rate if they have an annual profit of £500,000 or more. I propose to increase both the £100,000 and the £500,000 limits by 50 per cent, reducing the CT burden for more than half the companies which do not already benefit from the small companies rate.

32. I intend to simplify the tax rules for close companies. At present, 20 pages of complex legislation - the apportionment rules - are in force to ensure that they are not used for tax avoidance. After last year's reforms, the rules are no longer necessary, and I shall abolish them. Special provisions will be required to prevent the use of close investment companies for avoidance purposes, but these will be pretty straightforward.

Wider share ownership

33. I propose a number of measures to encourage the further widening of share ownership.

Personal equity plans

34. I propose to raise from £3,000 to £4,800 the limit on the overall amount which can be invested in a Personal Equity Plan each year. Within that, I propose to raise the amount which can be invested in unit trusts or investment trusts from £750 to £2,400 a year. I shall drop the rule that no more than a quarter of a PEP may be invested on unit or investment trusts, but require instead that such trusts be invested mainly in UK equities. (We may in time have to face the wrath of the Commission over this, but I see no point in anticipating it.)

35. So far, investors in privatisations and other new issues have not been able to take advantage of the tax reliefs which PEPs provide, because of the rule that only cash may be invested in a PEP. I propose to change this so that all shares obtained from a new equity issue can be placed directly in a PEP. This should not only encourage wider use of PEPs but also contribute to the success of future privatisations, in particular Water and Electricity.

36. Finally, I propose to make a number of important simplifications to the rules, to make PEPs more flexible, better directed to the needs of small and new investors and cheaper to administer.

Employee share schemes

37. All-employee share schemes have been a major success, growing in number from 30 in 1979 to some 1500 at present. We need to ensure that the limits governing such schemes do not hamper this growth. I therefore propose to increase the annual limit on the value of shares which can be given to an employee income-tax free; to increase the monthly limit for all-employee save-as-you-go share schemes; and to double the maximum discount from market value at which options may be granted, from 10 per cent to 20 per cent.

Employee share ownership plans (ESOPS)

38. I have been impressed by the enthusiasm for Employee Share Ownership Plans in the representations I have received about the Budget, both from some of our own backbenchers and from outsiders. These schemes involve putting shares into a trust for later transfer to employees. They are a relatively new development in the UK, but could have a useful potential for increasing employee share ownership, especially in unquoted companies. They are at present being hindered by uncertainties about the deductibility for corporation tax of employers' contributions to ESOPs. I propose to clarify the legislation to put this beyond doubt.

Profit related pay

39. Profit related pay schemes have been spreading, but more slowly than I would like. In the light of experience, I propose to abolish the restriction that PRP must equal at least 5 per cent of total pay; to raise the limit on the

amount which can attract relief from £3,000 to £4,000 a year; and to relax the rules which prevent headquarters staff from using the profits of the whole company or group in calculating their PRP.

Life assurance

40. I propose to make reforms in the tax treatment of life assurance and pensions. You will recall that last June I authorised the Revenue to issue a consultative document on the taxation of life assurance. This drew attention to defects in the tax regime, which mean that the incidence of tax is uneven between companies, and the overall yield lower than it should be by any reasonable yardstick. There has been a full response from the industry and others, and the Financial Secretary and the Revenue have had consultations with the main representative bodies, including in particular the Association of British Insurers.

41. I have concluded that it is right to make a number of changes within the existing tax regime, which is special to life assurance, but not to pursue the more radical alternatives canvassed in the consultative document. More radical reform could arguably place an unnecessary burden on the industry when it is adjusting to the changes flowing from the Financial Services Act, and when it is preparing for the increased competition it may face in the 1990s in the European Community.

42. I propose, first, to separate for tax purposes the pension business of the life offices from life assurance proper. This will stop the life offices from setting pensions expenses against life business profits. The ABI has itself acknowledged that it is anomalous to allow this at present. This single measure is the source of the net yield of the life assurance package: the other measures are broadly neutral over a run of years, with a modest reduction in yield to start with.

43. I propose to spread over seven years the deductibility of expenses associated with selling new life assurance policies, which the present regime allows to be deducted all at once; to reduce the tax on life assurance policyholders' funds from 35 per cent on income and 30 per cent on capital gains to a single rate of 25 per cent; and to abolish Life Assurance Policy Duty, the special stamp duty paid on Life Assurance Policies. The changes will come into effect on 1 January 1990; but, to give the life offices time to adjust, the spreading of expenses will be phased in over four years.

Unit trusts

44. I also propose to reduce the rate of tax on unit trusts to 25 per cent. This will remove a tax disadvantage which UK unit trusts face. The change will apply to authorised trusts recognised in the Community as "Undertakings for Collective Investment in Transferable Securities", for whom the EC UCITS directive comes into effect later this year.

Pensions

45. For pensions, I propose first to make an important deregulatory change. At present the tax reliefs for contributions to occupational pensions, for the fund itself, and for the lump sum, are tied to schemes which comply with the relevant Inland Revenue rules and limits. If an employer wants to pay pensions beyond the Inland Revenue limits, the whole of the tax relief is lost. I propose to end this all-or-nothing rule. Employers will be free to pay larger pension benefits, but from non-tax privileged funds.

46. At the same time, I propose to put a limit on the tax relief which occupational pensions can receive. This will be related to final salary of £60,000, indexed to prices. Even if it were applied immediately, only some 50,000 employees would be affected; but I propose that the measure should only apply to new entrants to existing schemes, and to new schemes.

47. I also propose to improve the tax regime for personal pensions, by increasing the proportions of salary which people of 35 and over can invest tax-free in a personal pension. Of all the pensions measures, this will be the one with the largest immediate impact, and will encourage further growth in personal pension provision. There will be a cash limit on the total contributions which can be made tax-free.

48. Public service pension schemes including the Civil Service pension scheme will have to be amended to comply with these new rules before the implementation date of 1 June. I have told colleagues most directly involved about my proposals. After the Budget, I will want to consider with them the implications of the new rules for public service pensions.

Other measures

49. I propose, at Paul Channon's request, to include in the Finance Bill provision for the sale to the public of "cherished" car registration numbers.

50. I propose to exempt from taxation as a benefit-in-kind the security equipment which a few employers now have to provide at the home of key employees at risk from terrorist or other attacks.

51. I also propose, as you know, to include in the Bill provisions to restore criminal sanctions against Revenue or Customs officials who reveal information about the private affairs of individual taxpayers.

52. I intend to issue consultative documents on the tax treatment of gains and losses on foreign currency borrowing, and of interest swaps between companies and on proposals to simplify the administration of the tax scheme for sub-contractors in the construction industry.

53. Finally, I should let you know the conclusion I have reached on residence. The representations on the consultative document the Revenue published last summer have convinced me that the world wide income approach would be damaging and unworkable. I intend to have it made clear during the Budget debates that we do not intend to continue with this proposal.

Cost

... 54. I attach a table which summarises the revenue effects of the Budget measures.

N.L.

N.L.
7 March 1989

Table 1.1 The Budget measures[1]

	£ million		yield(+)/cost(−)
	1989–90		1990–91
	Changes from a non-indexed base	Changes from an indexed base	Changes from an indexed base
National insurance			
~~reform~~ employee contributions ~~reformed~~	−980	−980	−2305
Income tax			
personal allowances and basic rate limit indexed	−1 465	—	—
car benefit scales increased	+160	+160	+200
new basis of assessment for Schedule E	− 80	− 80	−60
Excise duties			
petrol, derv etc	—	−545	−580
duty on unleaded petrol reduced, duty increased for 2 and 3 star petrol	−40	−40	−100
vehicle excise duty	+40	−150	−170
tobacco	—	−235	−250
alcohol	—	−255	−280
Value Added Tax			
non-domestic construction etc	+315	+315	+540
Life assurance ~~businesses'~~ tax regime reformed	−20	−20	+45
Corporation tax			
small companies' rate threshold increased	*	*	−35
Other tax changes	−80	−45	+ 5
Pensioners' earnings limit abolished[2]	—	—	—
Total	− 2150	− 1875	− 3490

[1] *These measures and the basis of the costings shown, are described in detail in Chapter 4.*

[2] *Public expenditure cost of £~~125~~ 190 million in 1989–90 and £~~285~~ 375 million in 1990–91 will be met from the Reserve. See Chapter 5.*

* = Negligible — = Nil

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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 need to combat inflation, at a time when, throughout the world, it is unmistakably edging up again.

Note
PM's comments asked passed on to Chancellor's office.
Reeb 11/3

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

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

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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.

Has this the year it hasn't worked

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. (They will think this long-term as it is now 7½% - and that we are happy with 5%

is this stamping out

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.

Over the 80's as a whole?

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.

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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

But in inflation well above the average.

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.

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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.]

? Also purchase of consumer goods –

18. As the House knows, however, there has also been some pick up (increase) 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.

'pick up' – better to be used in connection with something good or encouraging e.g. 'business has picked up'.

19. Moreover the 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.

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too strong?

I think this is all right

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

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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.

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

so it will be painful

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

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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

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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 [to resist downward pressure on sterling]. 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. [But for reasons we all know it has not been [illegible]. Nor can we have two priorities.]

?? I do not like relying so heavily on intervention like this. It helps them to predict what we will do.

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.

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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.

Do we need to put this credit so bluntly - and kept public expenditure in check?

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.

It may come faster than that, if the economy slows down

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

This makes it sound as if it were the only reason for not reducing tax?

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

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TAXPAYER CONFIDENTIALITY

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

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

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

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

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

BUSINESS TAXATION

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

6. First, taxes on business.

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

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

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

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

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

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

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

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

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

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

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

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

Also open to manipulation!

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

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

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

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

What prop^n is 'most'

TAXES ON SAVING

21. I now turn to the taxation of saving.

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

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

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

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

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

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

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

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

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

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

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

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

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

Quadruple
[I've passed this comment to Treasury already]

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Use English
delete.

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

47. There is clearly a powerful case for reform, with a view to securing a tax regime which is more equitable both within the industry and as between life assurance and most other forms of savings.

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

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

49. First, many life offices run a pension business alongside their main life assurance business, and they are not required to keep the two businesses entirely separate for tax purposes. This enables them to set the unrelieved expenses of the pensions business against the income and gains of their life business, thus giving their life profits unduly favourable tax treatment. The life offices themselves have accepted that this treatment is anomalous and I propose to end it.

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

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

A long time because in [illegible] or normally dealings' accounts after 6 years

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

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

53. But I can say here and now that I propose, as from 1 January 1990, to abolish Life Assurance Policy Duty. And I also propose, from the same date, that the rate of tax payable on the policyholder's share of income and gains of life offices, which at present stands at 35 per cent on unfranked investment income and 30 per cent on realised capital gains, should be reduced to the basic rate of income tax.

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

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

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

57. I now turn to pensions.

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

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

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

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

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

will be inflation proofed

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

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

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

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

S

This will remove the penalty on good investment performance.

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

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

68. Second, I propose to increase substantially the annual limits, as a percentage of earnings, on contributions to personal pensions for those over the age of 35. This will be of particular value to those running their own business, who are often unable to make contributions until later on in their working life. It will also improve the position of personal pensions in relation to occupational schemes. The new limits will be subject to an overall cash ceiling based on earnings of £60,000, corresponding to the new ceiling for occupational pensions, and similarly indexed.

T

Treasury ensure we these words do not preclude future "tidying up" measures – eg raising the £60,000 figure!

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

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

Keep open a small loophole for anomalies

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

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

J.

TAXES ON SPENDING

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

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

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

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

With regard to the other aspect of the European Court's judgment

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

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

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

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

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

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

X

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

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

83. I now turn to the excise duties.

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

4

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

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

86. It is clearly essential that these myths are rapidly dispelled. Meanwhile, I propose to take the opportunity of this Budget to increase still further the tax differential in favour of unleaded petrol, by nearly fourpence a gallon. If this reduction is fully passed on to the customer - and I look to the oil companies to see that it is - it means that the price of unleaded petrol at the pump will generally be getting on for tenpence a gallon, or just over twopence a litre, cheaper than four star leaded petrol. This will be one of the most substantial differentials between the price of leaded and unleaded petrol within the European Community.

2

87. But I do not intend to stop there. I also propose to raise the tax on two and three star petrol, so that the pump price of these grades will be at least as high as that of four star. This should encourage garages to phase out two star petrol, which is already down to about 5 per cent of the total market, thus enabling them to switch storage capacity to unleaded petrol - quite apart from the incentive to the remaining two-star users to switch to unleaded fuel.

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

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

AA

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

This is very brief, but I gather follows exactly the precedent when duties were last held down.

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

TAXATION OF INCOME

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

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

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

6B

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

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

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

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

98. Lastly, on capital gains tax, I propose to change the tax treatment of certain bonds so as to simplify the tax rules and prevent a loss of yield by the use of

CC

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

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

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

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

DD

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

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

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

EE

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

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

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

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

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

FF

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

NATIONAL INSURANCE CONTRIBUTIONS

111. I have one further measure to propose.

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

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

GG

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

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

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

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

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

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

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

119. The total additional cost of all the measures in this Budget, on an indexed basis, is under £2 billion in 1989-90 and £3$^1/_2$ billion in 1990-91.

[PERORATION]

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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.

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10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

6 March 1989

TAX RELIEF FOR RELOCATION

Thank you for your letter of 3 March setting out more of the details on these proposals. As I mentioned to you when we spoke early this morning, the Prime Minister continues to have major reservations about the proposal to remove the concession giving tax relief from employers' contributions to employees' additional ongoing housing costs where an employee is compulsorily moved by his employer to a more expensive area. You told me later this morning that the Chancellor had now decided to drop the idea for this year's Budget.

PAUL GRAY

Alex Allan, Esq.,
H.M. Treasury.

EAMAPA

PRIME MINISTER

TAX RELIEF FOR RELOCATION

When you saw the Chancellor yesterday you urged him to reconsider his proposal to remove tax relief from employers' contributions to employees' additional housing costs where an employee has been compulsorily moved by his employer to a more expensive area.

The Treasury letter at Flag A sets out the position more fully. Your main concern was on the potential adverse effect on public sector employees; but it now emerges that, because the present relief is only available when a person is moved by his existing employer, there will be no change in the position faced by teachers and policemen. Civil servants, and possibly a few health authority employees, are the only public sector groups affected.

You will also see from the second Treasury letter (Flag B) that the Chancellor suggests that pressing ahead with the change on housing costs would enable him to include in the Budget a further measure of benefit to corporate businesses, in particular to farmers, while keeping within the overall envelope agreed for 1990-91. I must say I would be surprised if the arithmetic worked out quite as precisely as this!

Are you content to let the Chancellor proceed with the housing costs proposal on the basis now described?

or

Do you still wish to question this? Yes. The argument the Chancellor uses is a false one.

PRCG.

There will be many occasions when a promotion will require a removal from say the North to a head office in London or something similar in the S.East. If the Chancellor has his way, this will be virtually impossible without some help. The resentment at cancellation [illegible] especially if it is announced as £100m in total [illegible] present concession will be enormous.

PAUL GRAY

3 March 1989

chex.md/aa/21 **BUDGET CONFIDENTIAL** A

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

3 March 1989

P R C Gray Esq
Private Secretary to
Prime Minister
10 Downing Street
LONDON
SW1

Dear Paul,

TAX RELIEF FOR RELOCATION

The Chancellor and Prime Minister discussed the Budget proposals on relocation expenses yesterday. In the light of that discussion, the Chancellor has asked me to write to you to set out some more of the details.

There are at present two extra statutory concessions in this area: the first gives tax relief for removals expenses paid by an employer; this applies to both new recruits and to existing employees. The second gives tax relief for employers' contributions to employees' additional on-going housing costs (eg mortgage payments, rent etc) where an employee is compulsorily moved by his employer to a more expensive housing area; this concession is available only to existing employees.

The Budget proposals are that the first of these reliefs, for removals expenses, should be placed on a proper statutory footing. And that the second relief, on additional housing costs, should be abolished. The effects of the housing cost relief is to reduce the market pressures on employers to relocate to lower cost areas, and to exacerbate (rather than alleviate) existing house price differentials. Removing the concession will produce an eventual yield of around £100 million a year, though anyone who has moved (or has entered into a commitment to move) before Budget day will continue to receive the relief.

The Civil Service is a large employer and we must have some in London i.e. in say the Treasury and

can they i.e. 'could' join — golden hello.

Most public sector employees, other than those in the Civil Service, do not benefit from the present relief. Teachers, firemen, policemen etc are employed by individual local authorities. The relief is therefore not available when they move from one authority to another, since they are joining a new employer. The same applies to NHS employers employed by district or regional health authorities - though in the case of regional health authority employees it is conceivable that a few employees could benefit if they were to be compulsorily transferred to a higher housing cost area within the region's borders.

We shall be considering the implications for the Civil Service with departments after the Budget. We shall need to consider, among other things, whether payments should be grossed up to reflect the changed tax treatment and whether any additions to running costs would be justified.

The relief does not, as I have mentioned, apply to new employees. So abolishing the relief will not affect the tax treatment of housing cost allowances or other inducements to people to take up employment ("Golden Hellos" etc), which will all remain taxable.

The Chancellor hopes that, in the light of these points, the Prime Minister is content for these proposals to proceed.

Yours

Alex

A C S ALLAN

Principal Private Secretary

i.e. if under different public sector employers – a golden hello is in order, if under the same employer help is cancelled.

chex.rm/aa1/58

BUDGET CONFIDENTIAL AND PERSONAL

B

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

3 March 1989

Paul Gray Esq
10 Downing Street
LONDON
SW1

Dear Paul,

TAX RELIEF FOR RELOCATION

The Chancellor has asked me to make one additional point relevant to the decision on removing the relief on additional housing costs. This is that the revenue yield from this measure in 1990-91 (about £30 million) would enable him to include an additional Budget proposal with an equivalent revenue cost, which would be of particular benefit to small businesses, while keeping the size of the Budget package for 1990-91 below £3½ billion. The additional proposal would be to allow unincorporated businesses to set trading losses against realised capital gains in computing CGT liabilities. At present, incorporated businesses can do this but unincorporated businesses cannot. This measure would be of particular benefit to farmers.

Yours,
Alex

A C S ALLAN
Principal Private Secretary

PRIME MINISTER

cc.
Mr. Lennox-Boyd

BUDGET EVENING PARTY

The Chancellor very much hopes you will be able, as usual, to look in at his Budget evening party in No.11 on 14 March. Mark Lennox-Boyd and I are also invited.

Content for me to confirm that you will be attending?

PG

3 March, 1989.

SECPOT

S 10

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

MT

PRIME MINISTER

BUDGET

The only issue left outstanding from your talk with the Chancellor this morning is tax treatment of housing subsidies paid by employers to employees moving to more expensive areas.

2. The Chancellor said he wanted to finalise this today. I have now agreed with his office they will prepare a note that you can look at over the weekend; and that a decision must therefore wait till Monday.

PRCG 4/3

pso.jt/Sargent/2.28.2

H M Treasury

Parliament Street London SW1P 3AG

Switchboard 01-270 3000
Direct Dialling 01-270 4360

Sir Peter Middleton GCB
Permanent Secretary

Covering RESTRICTED

A Turnbull Esq
10 Downing Street
LONDON
SW1

28 February 1989

Dear Andrew,

BUDGET SECURITY

This is just to confirm that you and Paul Gray have been added to the Budget list. I enclose a copy of the Budget Security Instructions. As you know, Budget papers should be seen only by the Prime Minister, Paul and yourself.

Yours ever,

S D H SARGENT
Private Secretary

HM TREASURY

BUDGET SECURITY

THESE INSTRUCTIONS SHOULD BE READ IN CONJUNCTION WITH THE GENERAL SECURITY NOTES.

BUDGET SECURITY INSTRUCTIONS

INDEX

BUDGET SECURITY

References to the pre-Budget period should be taken to mean the period between the beginning of January to Budget Day itself.

<u>Relations with the Press and other Outside Contacts</u>

1. This first subsection applies to <u>all Treasury staff</u> in the pre-Budget period, including officials who are not involved in work connected with the Budget.

2. Formal contacts with journalists in the pre-Budget period may be undertaken only with the prior authority of the Permanent Secretary or, in his absence, either the Grade 3 (FP) or one of the Second Permanent Secretaries. If permission for such contact is granted, a report should be submitted immediately after it takes place to the head of IDT, copied to the Permanent Secretary and the Budget Security Officer, whatever the subject matter of the discussion.

3. Telephone calls from journalists are to be referred in the first instance to IDT, and no return or other calls to journalists may be made without prior IDT approval. If any conversation takes place directly with a journalist in the pre-Budget period a report is to be sent to IDT copied to the Budget Security Officer, whatever the subject matter of the conversation.

4. If any other contacts take place with journalists in the pre-Budget period, no matter how informal, a report of the fact is to be made to IDT copied to the Budget Security Officer, together with a very brief account of any discussion of official matters.

5. Contacts with banks, brokers and others who provide commentaries on economic and Financial affairs, contributors to specialist and academic publications, brokers' circulars, newsletters and other similar publications which are to take place

outside the office, may only be undertaken with prior authority of the Deputy or Permanent Secretary responsible for the relevant work area.

General

6. Special security arrangements apply to certain information connected with the Budget, as described in paragraph 8. The arrangements apply in addition to the normal departmental security procedures and are intended to provide additional protection for information about Budget decisions. It is the responsibility of every person involved in Budget work to be familiar with, and operate, these instructions. EOG will ensure that those most heavily involved understand the procedures.

7. The recipient of a Budget classified document is, at all times, personally responsible for its security. This applies even if custody of the document is entrusted to another member of his or her staff (where this is permitted).

Use of Budget prefix

8. The Budget prefix should be used in the period between the beginning of January and the Budget Day itself, but only for documents which contain information concerning Ministerial decisions on:

(a) the Budget judgment and in particular the PSBR;
(b) all taxation matters connected with the Budget; and
(c) any social security or other public expenditure changes to be announced in the Budget.

The Budget classification should be applied also to documents in which no decisions are recorded, where the papers are particularly sensitive - for example, where the very fact that a matter is being discussed is sensitive, where there is a serious danger of forestalling or where a document might reveal the approach to the

Budget likely to be adopted by Ministers. The Budget prefix should not be used on other papers which do not reveal Ministerial decisions.

9. A Budget classification is not, in general, required for papers containing:

(a) Ministerial decisions relating to economic forecasts, monetary policy, exchange rate policy and other items not directly related to tax or public expenditure decisions, even where these are in the context of a Budget;

(b) arguments for and against a particular course of action, recommendations from officials to Ministers or other Ministers to the Chancellor unless the papers are particularly sensitive (see above); or

(c) list of options in which no decision is recorded.

It should be borne in mind that a submission to a Minister on a Budget matter, suggesting a range of options, may properly not have a Budget classification, but a note from a Ministerial Office recording a decision on it should be given a Budget classification.

10. Care and common-sense are needed in using the Budget prefix. In any cases of doubt the Treasury Budget Security Officer is to be consulted.

Level of Budget classification

11. "BUDGET SECRET - BUDGET LIST ONLY" is a special security classification to be used for certain Budget documents, i.e. for those papers which reveal the contents or probable contents of the whole, or a very substantial or particularly sensitive part, of

the Budget. The Chancellor may also decide that papers dealing with particular subjects be given this classification. Examples of papers which are to be given this classification include:

- papers, including records of meetings, which give an overall picture of Budget strategy;

- complete drafts of the Budget speech (and the most sensitive extracts such as complete drafts of the tax sections);

- full drafts of the Budget Brief, or particularly sensitive parts of it;

- full draft of the FSBR (and early drafts of the sections dealing with Budget proposals); and

- the Budget Resolutions, as a whole.

Papers dealing with an individual tax would not normally require BUDGET SECRET - BUDGET LIST ONLY classification, unless this is required by the Chancellor.

12. BUDGET TOP SECRET should be used only where the material would fall clearly within the definition of TOP SECRET even if it were not to be included in the Budget (see paragraph 18 for further guidance on this). BUDGET SECRET is the correct classification for all other papers on the main Budgetary items (i.e. the main tax rates and social security benefits and other major changes in tax legislation or public expenditure). Strict rules are laid down for access to, and handling of, documents with this classification. BUDGET CONFIDENTIAL should be used for papers recording decisions on other Budget matters, including all other decisions on tax items. The classification of a document is <u>not</u> necessarily the appropriate classification for a minute commenting on or replying to it, even if the original document is classified BUDGET SECRET: BUDGET LIST ONLY. For example, a minute

containing comments on a document should bear the classification appropriate to its contents and should only bear the same classification as the original document where it is appropriate.

Communications of Budget classified information

13. Documents for which the "BUDGET LIST ONLY" classification is appropriate may be shown only to persons who are on the circulation list approved by the Permanent Secretary. Under no circumstances are they to be circulated or shown, or the contents communicated in any other way, to a person not on those lists. A copy of the Budget list will be made available, as appropriate, to each person who is on the list. If it is considered essential to show a BUDGET LIST ONLY document to a person not on the Budget list, the prior approval of the Permanent Secretary must be obtained in writing. Any requests for names to be added to the Budget list should be addressed in the first instance to the Budget Security Officer. This applies right up to the Budget Day.

14. The circulation of all Budget classified documents is to be restricted to the absolute minimum consistent with operational requirements. Before writing Budget classified material all originators must ask themselves:

(a) Is the document necessary at all? (A private face-to-face conversation is more secure than a written note).

(b) If the document is necessary, need it be circulated? (Only copy a document to those people who need to be aware of its contents).

(c) Need the document quote precise details of decisions e.g. proposed tax rate?

(d) Does the document require a Budget classification?

(e) Do all recipients need a copy of the whole document? If a part of the document would suffice, send only that part. It is essential that persons do not see parts of documents containing classified material which they have no operational need to see.

15. BUDGET LIST ONLY documents may not be shown to anybody who is not on the Budget list (except for the normal arrangements whereby the Queen, Prime Minister, certain staff at Number 10 and the Governor of the Bank of England are told the contents of the Budget). Other BUDGET classified information may be communicated to staff in the Chancellor's Departments (and the Office of the Parliamentary Counsel), only if they need to know about it for the efficient performance of their duties.

16. Budget classified information must not be communicated to anyone outside the Chancellor's Departments and the office of the Parliamentary Counsel without prior authority having been obtained from the Budget Security Officer. There are three general exceptions to this rule. First, FP group have authority to communicate to specified Department of Transport officials, Budget decisions on VED and the duties on hydrocarbon oils. Second, the head of FP has authority to communicate to specified officials in the Department of Social Security certain information about Budget changes in personal taxation. Third, as is appropriate for public expenditure matters, ST group will discuss any social security changes to be announced in the Budget with DSS officials. In all these instances the Divisions concerned must ensure that these Departments are aware of the need for particular care in handling the information. Similarly, if a Treasury Minister writes to a Minister in another Department on a Budget classified matter, his Private Secretary should ensure that the other Private Office are aware of the significance of the Budget classification, and in particular of the need to ensure that the letter is shown or copied only to those who need to see it.

<u>Preparation and handling of BUDGET SECRET: BUDGET LIST ONLY documents</u>

17. In addition to the normal security instructions regarding handling of SECRET documents, the following special instructions apply to the handling of BUDGET SECRET: BUDGET LIST ONLY documents:

(a) The document must be typed on plain paper. The security classification is not to be typed. Documents may be typed by a Personal Secretary <u>only</u> if she is on the BUDGET LIST. The typist's initials should appear on each page of the document. The originator is responsible for the security of the typed master, which must be given a number in the sequential series used for copies.

(b) Copies of the typed master must be made onto the special paper bearing printed 'BUDGET SECRET: BUDGET LIST ONLY' markings on one side of the paper only. Each copy of the document must be sequentially numbered, e.g. copy No 3 of 5 copies. A full record of copy numbers and recipients <u>must</u> be kept in the sender's security register.

(c) The documents must always be enclosed in the special distinguishing folder marked "BUDGET SECRET: BUDGET LIST ONLY" for transmission. They must always be transmitted in double envelopes even if sent within the building. The inner envelope must bear the special "BUDGET SECRET: BUDGET LIST ONLY" label completed with the relevant details mentioned in paragraph (d) below. If more than one document is sent in one envelope, the reference number (see (d) below) of <u>each</u> document must be shown on the label. A receipt must always be obtained for all copies of "BUDGET SECRET: BUDGET LIST ONLY" documents. It is the responsibility of the originator to ensure that a receipt is returned for each copy which has been sent out. These receipts must be retained until after Budget day.

(d) Titles of BUDGET SECRET: BUDGET LIST ONLY documents are not to be shown on receipt forms (which are unclassified) or on BUDGET SECRET: BUDGET LIST ONLY labels. Instead the 'reference no' or 'title' section of the receipt form or label should show: the sender's initials; the serial number of the entry in the sender's security register and the copy no. e.g. MCS/28/3.

(e) If they are being sent to other departments, the documents must be sent by messenger or by the special van service which operates between the Treasury, the Revenue Departments and Parliamentary Counsel's Office. If these are not available, the documents should be sent by special signature service of the IDS. In every case receipts must be obtained for the documents. <u>In no circumstances</u> may the documents be sent by post or transmitted on facsimile equipment except for the secure facsimile link between the Treasury, (Room 14/2), HM Customs and Excise, Inland Revenue, Department of Transport, DVLC and the Bank of England (see paragraph 22 for transfers via Officepower).

(f) Each recipient is responsible for ensuring that every BUDGET SECRET: BUDGET LIST ONLY document is entered in the appropriate security register. He must do this himself if no-one else is available or authorised to do it - this applies particularly at Grade 7 level. A document may be entered in the security register by the Personal Secretary or allocated Clerk from the information shown on the label, <u>without opening the inner envelope</u>. If this is done, the number of the security register entry is to be written on the label. The recipient of the document is to ensure that the security register number is shown and should copy it onto the document itself. In some areas, Personal Secretaries or Clerks may themselves be included on the Budget list authorised to handle BUDGET SECRET: BUDGET LIST ONLY material. <u>In such cases only</u> may they open the inner envelopes, in which case the security register number may be written on the document itself. BUDGET SECRET: BUDGET LIST ONLY documents may not be filed until after Budget Day except where the Clerk concerned is on the Budget List.

(g) Each copy of a BUDGET SECRET: BUDGET LIST ONLY document is personal to its recipient. It may not be shown to any person not on the Budget list in any circumstances. It may be shown (but not copied) to a person <u>who is on the Budget list</u> only if there is a real operational need for him to see it. The fact that a person is on the Budget list does not mean that he must see all BUDGET LIST ONLY documents. It is the recipient's responsibility to ensure that the document is not seen by any person who is not authorised to have access to it. It can be kept in the recipient's own security cupboard <u>only if</u> all persons who are entitled to know the combination number have been specifically authorised to handle BUDGET SECRET: BUDGET LIST ONLY documents. Otherwise it will be necessary to store such documents in a separate document box or security cupboard whose combination number is known only to the recipient (and any authorised handler of such material). Officials who require additional security furniture for this purpose should requisition it as soon as possible from the Assistant Budget Security Officer in EOG2 (Ext 4859).

(h) It is essential that BUDGET SECRET: BUDGET LIST ONLY documents are not left unattended by the person who is responsible for their custody - he must lock them away whenever he leaves his room.

(i) BUDGET SECRET: BUDGET LIST ONLY documents may on no account be photocopied except by the originator (or his Personal Secretary, on his authority, if she is on the Budget list). If a person not on the original list of copy addressees is subsequently to be given a copy of such a document, it must be provided by the originator and the name of the recipient properly recorded. He may retain a small stock of additional numbered copies of the document for this purpose (which are to be treated as accountable documents). If he needs to take an additional copy of the document, it must be numbered in the original series. The above rules as to handling and control of the document apply to additional copies.

(j) BUDGET SECRET: BUDGET LIST ONLY documents may be taken out of the office to meetings only if this is absolutely unavoidable. They may be taken home only if the Permanent Secretary has given his prior approval, either for a particular occasion or generally for a particular individual. Permission will normally be given only if the person concerned has a security container at his home. Any documents taken out of the office must be carried in a locked briefcase, box or pouch and kept securely at all times. A record of these documents must be kept in the office security register and checked on return.

(k) Where a person only needs to see a part of a BUDGET SECRET: BUDGET LIST ONLY document, he should be sent a copy only of the relevant extract. The copy extract should be given a number in the same series as the full copies. It should be given the security classification, appropriate to the sensitivity of the matter contained in it - the security classification at the top of the front page should be amended in manuscript if necessary. The recipient of the extract should treat it in accordance with the security classification shown on the document.

(l) If a BUDGET SECRET: BUDGET LIST ONLY document is to be destroyed before the Budget, it is to be sent to the Budget Security Officer in double envelopes, the inner envelope bearing the appropriate label, and marked for destruction. The Budget Security Officer will carry out the destruction in accordance with the standing instructions.

18. If a Budget sensitive document meets the criteria for classification as TOP SECRET (as defined in annex 1 of the Treasury Security Instructions) it should be classified "BUDGET TOP SECRET: BUDGET LIST ONLY". The distinguishing folder and address labels for "BUDGET SECRET: BUDGET LIST ONLY" documents are to be used amended accordingly in manuscript. The instructions of paragraph 17 are to be followed, except where the normal security instructions for TOP SECRET documents impose more stringent requirements, in which case those should be obeyed.

<u>Preparation and handling of BUDGET SECRET documents</u>

19. The normal rules for the control and transmission of SECRET documents must be applied, except as modified below:

(a) Titles of BUDGET SECRET documents are <u>not</u> to be shown on receipt forms (which are unclassified) or on BUDGET SECRET labels. Instead the 'reference no' or 'title' section of the receipt or label should show: the sender's initials; the serial number of the entry in the sender's security register and the copy number e.g MCS/ 28/3.

(b) BUDGET SECRET documents must always be transmitted in double envelopes, even if sent only within the building and the inner envelope must bear a BUDGET SECRET label completed in accordance with paragraph (a) above. Any person not entitled to see BUDGET SECRET papers and

above, and who is likely to have access to envelopes bearing this classification, must be instructed not to open them.

(c) BUDGET SECRET documents sent outside the building must be accompanied by receipts.

(d) If they are being sent to other Departments, the documents must be sent by messenger or by the special van service which operates between the Treasury, the Revenue Departments and Parliamentary Counsel's Office. If these are not available, the documents may be sent by special signature service of the IDS. In every case receipts must be obtained for the documents. <u>In no circumstances</u> may the documents be sent by post or transmitted on facsimile equipment except for the secure facsimile link between the Treasury (Room 14/2), HM Customs and Excise, Inland Revenue, Department of Transport, DVLC and the Bank of England (see paragraph 22 for transfers via Officepower).

(e) Each recipient is responsible for ensuring that every document classified BUDGET SECRET and above is entered in the appropriate security register. He must do this himself if no-one else is available or authorised to do it - this applies particularly at Grade 7 level. Staff who are not authorised to handle BUDGET SECRET documents may record them in the security register, provided that they have been received in double envelopes, using the information shown on the label which should be in accordance with paragraph (a) above. If this is done, the inner envelope must be passed to the recipient <u>unopened</u>, the number of the security register entry being shown on the label. If this procedure is followed it does not detract from the recipient's responsibility that receipt of the document has been recorded, so he should ensure that the security register number is shown on the label and copy it to the document itself.

(f) BUDGET SECRET documents are not to be filed or otherwise handled by Divisional Clerks until after the Budget. They my be placed on divisional folders, but only by clerks entitled to see these papers. Such folders must bear the appropriate classification on the outside and must be kept so that unauthorised persons cannot have access to them. Officials who require a combination lock document box or security cupboard for BUDGET SECRET material should requisition it as soon as possible from the Assistant Budget Security Officer in EOG2 (Ext 4859).

(g) All copies of documents of BUDGET SECRET classification or higher must be sequentially numbered, e.g. copy no 10 of 25 copies. A full record of copy numbers and recipients must be kept in the sender's security register.

(h) The recipient of a BUDGET SECRET document may authorise its copying to a person who is entitled to see it, provided that the person authorising the copying is of Grade 7 level or above. Care must be taken to ensure that this does not enable persons to see papers dealing with proposals other than those with which they are directly concerned.

(i) BUDGET SECRET documents may be taken out of the office to meetings only if this is absolutely unavoidable. They may be taken home only if a Grade 5 or above has given his prior approval. Permission should be given only if the authorising officer is content that there is no alternative and that the document(s) will be secure, i.e. transported in a locked briefcase, box or pouch and kept at home in a security container. A record of those documents must be kept in the office security register and checked on return.

(j) BUDGET SECRET waste must be destroyed by shredding; arrangements for this may be made with EOG (extension 4859). Recipients must keep a proper record of any such documents they destroy. Production of such a record is necessary to meet the requirements of the spot checks described in paragraph 24.

Preparation and handling of BUDGET CONFIDENTIAL documents

20. The normal rules for the control and transmission of confidential documents must be applied, except as modified below:

(a) BUDGET CONFIDENTIAL documents may be sent within the building in a single sealed envelope. Documents being sent outside the building should always be transmitted in double envelopes with the inner envelope marked 'BUDGET CONFIDENTIAL'.

(b) BUDGET CONFIDENTIAL documents should be sent by messenger, the IDS or the special van service which operates between the Treasury, the Revenue Departments and Parliamentary Counsel's Office. In no circumstances may the documents be sent by post or transmitted on facsimile equipment except for the secure facsimile link between the Treasury (Room 14/2), HM Customs and Excise, Inland Revenue, Department of Transport, DVLC and the Bank of England (see paragraph 22 for transfers via Officepower).

(c) Copies of BUDGET CONFIDENTIAL documents need not be sequentially numbered, nor need they be recorded in security registers.

(d) The recipient of a BUDGET CONFIDENTIAL document may authorise its copying to a person who has a strict operational need to see it, provided that the person authorising the copying is at Grade 7 level or above

Care must be taken to ensure that this does not enable persons to see papers dealing with proposals other than those which they are directly concerned.

(e) BUDGET CONFIDENTIAL documents may be taken out of the office to meetings only if this is <u>absolutely unavoidable</u>. They may be taken home <u>only</u> if a Grade 7 or above had given prior approval. Papers taken from the office should be carried in a locked briefcase, box or pouch and kept securely at all times.

(f) BUDGET CONFIDENTIAL documents are not to be filed or otherwise handled by Divisional Clerks until after the Budget. They may be placed on divisional folders, but only by Clerks entitled to see these papers. Such folders must bear the appropriate classification on the outside and must be kept so that unauthorised persons cannot have access to them. Officials who require a combination lock document box or security cupboard for BUDGET CONFIDENTIAL material should requisition it as soon as possible from the Assistant Budget Security Officer in EOG2 (Ext 4859).

(g) BUDGET CONFIDENTIAL waste <u>must</u> be destroyed by shredding; arrangements for this may be made with EOG (Extension 4859).

<u>Checklist for distribution of BUDGET documents</u>

21. The following table acts as a guide for those distributing Budget classified documents:

	BUDGET SECRET: BUDGET LIST ONLY		BUDGET SECRET		BUDGET CONFIDENTIAL	
	Internal	External	Internal	External	Internal	External
BLO Folder	✓	✓				
Double envelopes	✓	✓	✓	✓		✓
Single envelopes					✓	
BLO label on inner envelope	✓	✓				
BS label on inner envelope			✓	✓		
Receipts	✓	✓		✓		
Sequentially numbered	✓	✓	✓	✓		

<u>Office Automation</u>

22. Users of Officepower must exercise great care to ensure that unauthorised persons do not obtain access to files containing Budget classified material. In particular, the following rules must be observed:

(a) All persons on the Budget list who use the Officepower system must ensure that their user ID is protected by the password <u>and</u> key decoder system, and not by password alone. Queries on the adequacy of individual systems should be addressed to EOG5 (Mr Cobb x5347).

(b) Passwords should be changed regularly (at least monthly) and should not be written down or told to colleagues. Avoid obvious words such as "Password", "HMT", or "BUDGET" etc which might be easily guessed.

(c) Terminals should not be left unattended whilst they are logged into the system. Log-out if you leave the room.

(d) Computer key tokens for the decoder system should be treated with the same respect as the combination number of a security cabinet; they must not be left lying around or placed in a desk drawer. When not in use, key tokens should be kept in a combination lock document box or security cupboard; these can be requisitioned from the Assistant Budget Security Officer in EOG2 (Ext 4859). If a key token protecting Budget information is lost or mislaid this should be reported immediately to EOG5 (Mr Cobb Ext 5437) and to the Budget Security Officer (Ext 4922).

(e) Exercise care when printing Budget classified material. Printers should be either in the same room as the user, in the room of another user who is cleared to see the material, or in a locked room. If the existing positioning of printers causes difficulties EOG5 (Ext 5437) should be consulted.

(f) **Great care must be exercised before any Budget classified material is sent electronically via the Officepower system** (see paragraphs 17(e), 19(d) and 20(b) for transfers by facsimile). Electronic transfers should be used only where there is a <u>real</u> operational need; and the following guidelines must <u>always</u> be observed:

(i) ring the potential recipient to tell them the information is to be sent shortly. If they are not available, do <u>not</u> leave a message on the Officepower system but call back later. Do <u>not</u> commence sending procedures until personal contact has been made;

(ii) both 'delivery' and 'view' acknowledgements must be used, and the acknowledgements received by the sender must be printed and retained. The Assistant Budget Security Officer may ask to inspect these prints as part of his examination of the security of classified papers;

(iii) any instances where the system appears to have 'broken-down' e.g. if information has been sent but has not been received, are to be report to the Budget Security Officer (Ext 4922) and EOG5 (Ext 5347) immediately.

23. Systems support staff must not allow an Officepower user access to the files of an individual on the Budget list without consulting the Budget Security Officer first (Ext 4922). If he is not available, the Assistant Budget Security Officer (Ext 4859) should be consulted. If neither the Budget Security Officer nor his assistant are available, the Deputy or Permanent Secretary responsible for the relevant work area should be consulted, and a written report made to the Budget Security Officer. In all instances, access to the files of an individual on the Budget list may only be given if there is a clear operational need, and a record of the authorisation must be kept by both the systems support staff and Budget Security Officer.

General Points

24. To ensure that the required procedures are being adhered to, Budget classified documents will be subject to a series of spot checks. There will be random checks of individual copies of classified documents sent to named individuals. There will also be more systematic searches of complete circulation lists of particularly sensitive Budget classified papers. These checks will be carried out by FP and EOG.

25. Budget classified papers must not be typed in typing pools. Particular care should be taken about the custody of carbons, photocopies, dictating machine tapes, word-processing discs, shorthand notes etc containing classified information.

26. Care should be taken not to include Budget classified papers (or related papers) in divisional 'floats'.

27. The disposal of any document classified BUDGET SECRET or above is to be recorded in the security register. When arranging for the disposal of classified documents, officials are to take care that they do not enable any unauthorised person to see its contents.

28. If BUDGET classified papers do not state the post-Budget classification, recipients should alter the classification as appropriate after Budget day. The 'BUDGET' prefix should always be deleted after Budget day, as it no longer has any significance. Papers which refer only to decisions which were announced in the Budget may be declassified. Papers containing advice or background to such decisions should generally be classified CONFIDENTIAL. Papers containing references to courses of action which were not pursued, which were classified BUDGET SECRET should remain SECRET.

<u>Queries</u>

29. Any questions about the Budget Security instructions should be addressed to the Budget Security Officer, who is the Grade 7 in FP Division (Indirect taxation branch) (extension 4922).

chex.md/jmt/43 **RESTRICTED**

cc

RA

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

22 February 1989

Richard Gozney Esq
PS/Secretary of State
Foreign and Commonwealth Office
Downing Street
LONDON
SW1A 2AL

Dear Richard

BUDGET DAY PRESS NOTICES

As you will be aware, the Chancellor will be giving his Budget Statement on Tuesday 14 March. In handling press notices, we propose to follow the arrangements of previous years under which all press notices, including those issued by Departments other than the Chancellor's, are collated by the Treasury and issued both the to the press and the House.

Your Department and others will no doubt already be considering what press notices you wish to issue on Budget Day. I would be grateful to know your intentions **by close on Monday 6 March** and the subject matter of any notices which you will be producing. It would also be helpful if you could let Steven Flanagan here (270-5666) have by then a contact point (name and telephone number, together with a proxy) for any subsequent enquiry on each. All press notices should, of course, be cleared in draft with the appropriate public expenditure divisions in the Treasury as early as possible.

As you will appreciate, the Treasury will be photocopying and collating a large volume over the weekend before the Budget. As a consequence, I am afraid that we must ask for copies of press notices to be sent to us by no later than **midday on Friday 10 March** and preferably beforehand. We will require 1995 copies in all. These should be sent to Mr M C Ralph in our Committee Section (Rm 30/G, Treasury Chambers) split within the package into three sets numbering 1150, 670 and 175 copies respectively.

If you are issuing more than one press notice, it would ease our handling problems considerably if they could be packaged separately.

I am sending a copy of this letter to the Private Secretaries to all other Cabinet Ministers, Paul Gray (No.10), Trevor Woolley (Cabinet Office) and all Chief Press Officers.

Yours ever

[signature]

J M G TAYLOR
Private Secretary

BUDGET - SECRET

S 9 (A-B)

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

PRIME MINISTER

BUDGET UPDATE

The Chancellor promised to reflect on a number of points. I gather he will report back as follows. As usual, please do not reveal prior knowledge of his views.

NICs

He will propose:

- no increase in the upper earnings limit, so everyone on higher earnings will get the £3 weekly benefit
- the 2% / 9% variant described at the last meeting rather than the more complex original idea
- cutting self-employed NICs by £1.30 a week

I imagine you will be content with this package. But, in exchange for allowing everyone to benefit by £3, he now proposes a bigger increase in company car scales than originally proposed - 33% rather than 20%. You may want to probe this.

That isn't fair.

Abolition of CGT deferral on gifts

You were concerned to allow a chattels exemption.

In fact there is already a exemption for chattels up to £3000 per item. The Chancellor will now propose doubling this to £6000 per item.

Pensions

You were concerned about the £60,000 tax limit. But I gather the Chancellor proposes to stick to his guns. (I think you should stick to yours i.e. a limit of no less than £75,000. My sources tell me some in the Treasury share your doubts) [illegible]

PRCG
28/2

BUDGET - SECRET

5

8.(A-E.)

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

PRIME MINISTER

BUDGET PACKAGE

1. You saw the Chancellor's aide-memoire over the weekend, and marked a number of queries on it.

2. I am now able to alert you to what the Chancellor is likely to propose for a further package on basic rate/allowances/NICs. As before please do not reveal that you have been briefed.

3. The key points are:

- the Chancellor still thinks he should publish PSDR figures of £14b. in 1988-89 and £12b. in 1989-90. Net of privatisation proceeds this implies an unchanged figure of some £7b. in the 2 years.

- a PSDR of this size in 89-90 allows room for about £1 billion extra £1b. tax reductions over and above the table at the back of the aide memoire.

- in the light of your and Cabinet's views he has now decided against a 1p. tax cut.

BUDGET - SECRET (2) B.

- he wants to stick with normal indexation of tax allowances and, in line with Cabinet comments, now proposes a NICs package

NICs Package

4. Following the normal annual review the 1988 Autumn Statement proposed that from April 1989:

   - employees pay no NICs below weekly earnings of £43 (the lower earnings limit, which is in line with the single pension rate).
   - from £43 to £75 earnings employees pay 5% NICs on all their earnings, ie there is a "cliff edge" as you cross the £43 threshold.
   - from £75 to £115 earnings employees pay 7% NICs on all earnings - ie another cliff-edge as you cross the £75 threshold.
   - from £115 to £325 (the upper earnings limit) employees pay 9% NICs; another cliff edge at £115.
   - above £325 employees pay no further NICs (though employers do).

5. The only changes in this package were normal uprating of the lower and upper earnings limits and the 5/7/9% thresholds.

BUDGET - SECRET (3)

C.

6. Apparently the Chancellor now proposes:

- to retain the 5% "cliff-edge" threshold at £43. ~~[illegible]~~ This step is justified on the "passport" to entitlement to pensions and other benefits.

- but to get rid of the remaining "cliff-edges". Instead of a jump to 7% contributions on all earnings at £75 introduce a marginal NICs rate at £75 of 9%. This marginal 9% rate would then apply right up to the upper earnings limit.

- This means that everyone earning over £115 will gain £3 a week; ie they currently pay 9% on all earnings but in future would pay only 5% on the first £75 - ∴ they save £75 × 4% = £3.

- Between £75 and £115 the impact is more complex. But there are no losers. Those just below £115 gain the least; those just over £75 gain more eg £1.35 gain at £80 a week.

- The Chancellor has not yet decided whether to couple these changes with an increase in the upper earnings limit. If that stays at £325 the £3 gain would also go to all top earners. But the UEL could be increased from £325 sufficient to offset the gain for top earners; an increase of £33 to £358 would balance the sums. The case for ~~an~~ a UEL increase

D.

would be to reduce the cost slightly and, if this was wished, target the gain on lower earnings. The case against is that raising the UEL brings complications, eg increasing future SERPS entitlement.

- These changes would come into effect on 1 October 1989. With no UEL increase the cost in 89-90 would be £1.1b. and £2.2b. in a full year; with a UEL increase the figures are roughly £1b. and £2b.

Line to Take

7. You will want to consider the respective merits of this NICs package and "spending" an equivalent sum on more than indexing allowances:

- in tax policy terms the NICs package involves a worthwhile reform.
- it also provides, via a UEL increase, a means of not giving any benefit for top earners. In any event, even with the UEL unchanged, top earners would only get the same £3 cash gain as the majority; whereas higher allowances are worth more to those on a 40% marginal rate.
- at the bottom end the NICs package does nothing for those below £75, and more for those over £115 than those between £75 and £115. Tax allowances have similar effects except that those earning just under £115 might do better from higher allowances than the NICs change

E.

Other Points

8. The unleaded fuel proposal (para. 2 of aide memoire) implies a new price differential of 9p. a gallon. Is it not worth trying to get at least a 10p differential?

(para. 9 of aide memoire)

9. On the pensions limit of £60,000 [I gather this has been exercising some people in the Treasury because of the implications for the public sector (not to be revealed). Would £75,000 be a better figure?

10. On the earnings rule (para. 14 of aide memoire) presumably the reference to deferring pensions refers to recurrent payments only and not to lump sums.

PRCB
21/2

BUDGET - SECRET

7 (A-B)

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

PRIME MINISTER

BUDGET PACKAGE

1. The Chancellor has now ~~~~ agreed to send you a written aide-memoire summarising the Budget package - in the enclosed folder. You will be able to go through this with him at your bilateral next week - which I have extended to one-hour.

2. Some of the material is perhaps not as full as it might be - eg para. 7 on life assurance and para. 9 on pensions. But in part this is because he has not yet finalised his own thinking.

3. The main point, however, is that the paper includes no proposal for a further package on basic rate / allowances / NICs on the lines you discussed last Sunday. This is deliberate. The Chancellor is still considering his position following your earlier talk and the comments in Cabinet.

B.

As you know his strong preference is to go for the basic rate. But when you discuss this with him on Wednesday, you will be able to draw on the virtually unanimous view in Cabinet (of those who spoke on the point) that allowances — or some action on NICs — is much to be preferred.

4. At the back of the file is a separate note for the Chancellor on the build-up of Payroll Giving.

ACG

17/2

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ACSA/89/7.
COPY 1 of 4
6 (A-F).

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

17 February 1989

Paul Gray Esq
10 Downing Street
LONDON SW1

Dear Paul

I attach an aide memoire on the Budget. You will have received a copy of the Budget Security Instructions and I should stress that the aide memoire should not be shown to anyone other than the Prime Minister and yourself.

Yours
Alex

A C S ALLAN
Principal Private Secretary

BUDGET - SECRET (A-F)

AIDE MEMOIRE ON BUDGET

Income tax and NICs

For the purposes of the figuring in the attached table, it has been assumed that personal allowances and the basic rate limit are indexed; that there is no change in the basic rate; and that there are no changes to NICs. A NICs reform is still under consideration.

Excise duties

2. No change in any of the main excise duties. The duty on unleaded petrol reduced to produce a pump price differential of 2p a litre (approximately 9p a gallon) with 4 star leaded petrol; a surcharge on 2 star leaded petrol to bring it up to the same price as 4 star. Increased VED for coaches and rigid heavy goods vehicles (agreed with DTp).

VAT

3. Implement the changes resulting from the European Court of Justice decision, as already announced; the bulk of the additional yield comes from the public sector (the impact of this on public expenditure was taken into account in the Autumn Statement). No other changes in VAT coverage.

Company cars

4. Car scales (which determine amount of taxable benefit from company cars) to be increased by 20 per cent.

£375

B.

Corporation tax

assume this is within European maximum.

5. Thresholds for the small companies' rate increased by 50 per cent; rate itself assumed to remain at 25p.

Stamp duty on shares

Seems to have changed from 1/1/90 RRCG.

6. Abolish stamp duty on share transactions, probably from 1 April 1990. Announcement and legislation needed now to enable the Stock Exchange's new paperless transactions system ('TAURUS') to be planned and implemented on this basis.

Life assurance

7. Maintain the existing structure of taxation. Reduce the tax rates on policyholder's income and gains to 25 per cent (from 35 per cent and 30 per cent respectively). Ring-fence life offices' pension business, so that expenses there cannot be set off against income on life business. Abolish life assurance premium duty. (Life offices will also gain about £100 million a year from the abolition of stamp duty on shares: this is included in the costings of that measure). Allow selling expenses to be deducted from taxable income and gains only over seven years, instead of being offset in full against income and gains in the first year; phase this change over four years.

Unit trusts

8. Reduce the Corporation Tax rate on unfranked income (principally dividends on gilts) from 35 per cent to 25 per cent from January 1990.

C.

This is below Perm Sec level. However unless indexed it will soon be rather a low sum.

Pensions

9. For final salary schemes, place a limit on tax privileged pensions. Deregulate, so that the Revenue no longer lay down how much pension someone can be paid, but only how much tax-privileged pension. Pensions will be payable from tax privileged funds on earnings of up to £60,000 a year. This translates into limits of £40,000 a year on the total pension and £90,000 on the tax-free lump sum. These limits will apply only to new pension scheme members, and will be indexed to prices. Employers will be free to pay additional amounts without tax privilege.

10. For personal pensions, increase the percentage of earnings which may be contributed with tax relief, subject to a cash limit.

PEPs

11. The limit on the total annual investment to be raised from £3,000 to £4,800; and within that the limits on investments in unit and investment trusts from £750 to £2,400. Rules greatly simplified.

Employee share schemes and ESOPs

12. Various increases in the limits for employee share schemes. And to enable the development of ESOPs, Corporation Tax relief on company contributions.

CGT

13. Abolition of the tax deferral on gifts (but not to charities, or on business assets, or between husband and wives). This was introduced in [1980] to avoid the double charge to CGT and CTT on lifetime gifts, but the CTT charge has since been abolished. The

D.

exemption limit for CGT to be frozen, pending the effective doubling (for married couples) when independent taxation comes in next year.

Pensioners' Earnings Rule

14. Pensioners' earnings rule to be abolished. Gross public expenditure cost of about £½ billion to be met from the reserve. Retain the option to defer pensions in return for higher pension later.

Deregulation/Simplification

15. A number of measures of deregulation and simplification: additional VAT bad debt relief; simplification of VAT registration rules; changing Schedule E to be charged on a receipts basis; a radical simplification the rules on close investment companies: unincorporated businesses to be allowed to set capital gains against trading losses; the Control of Borrowing Order to be abolished.

Other proposals

16. Other proposals include:

(i) converting the higher age allowance for the over-80s to one that covers all those over 75; and reducing the marginal withdrawal rate for age allowances to below 40 per cent;

— profit-related pay

(ii) increasing the PRP limits to £4000, and other simplifications to the PRP rules;

E.

— see separate note below.

(iii) increasing the Payroll Giving limit from £240 to £480;

(iv) implementing the tax relief for private health insurance for the elderly.

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Copy 1 of 1

F.

TABLE 1.1 THE BUDGET MEASURES[1]

	£ million 1988-90		yield (+)/cost (-) 1990-91
	Changes from a non-indexed base	Changes from an indexed base	Changes from an indexed base
Income Tax			
personal allowances and basic rate limit indexed	-1465	-	-
car benefit scales increased	+ 90	+ 90	+ 110
Schedule E put on receipts basis	- 60	- 60	- 80
Excise duties			
petrol, derv etc	-	- 545	- 580
duty on unleaded petrol reduced, surcharge added to 2 star petrol	- 30	- 30	- 75
vehicle excise duty	+ 40	- 150	- 170
tobacco	-	- 235	- 250
alcohol	-	- 255	- 280
Value Added Tax			
non- domestic construction etc	+ 315	+ 315	+ 540
bad debt relief, reform of registration rules etc	- 105	- 105	- 270
Stamp duty on shares abolished	-	-	- 850
Life assurance businesses' tax regime reformed	- 20	- 20	+ 45
Reforms to pensions, personal equity plans, share schemes and unit trusts	- 5	- 5	- 10
Corporation Tax			
small companies' rate threshold increased	*	*	- 35
Petroleum revenue tax			
incremental investment relief introduced	- 10	- 10	- 20
Other tax changes	- 65	- 30	+ 40
Total	-1315	-1040	-1885

1 These measures, and the basis of the costings shown, are described in detail in chapter 4.

89-90

2 3 = 3.0

850
145
995

995
270
1265

1.5

NIC £3bn

80/2

66/29

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RESTRICTED

Agreed by Cabinet and handed to B. Ingham.

PRCG 16/2

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

15 February 19~~88~~ 89

Paul Gray
10 Downing Street
LONDON SW1

Dear Paul,

I understand that, at their bilateral today, the Chancellor and the Prime Minister agreed that the No.10 Press Office should, after tomorrow's Cabinet discussion on the economy, follow the line:

> "The Cabinet today held their usual pre-Budget economic discussion. They reaffirmed the Government's economic strategy and the central objective of bringing down inflation, and agreed that economic policy should remain prudent and cautious."

If the Prime Minister is content, perhaps you could pass on this form of words to Bernard Ingham.

Yours,
Alex

A C S ALLAN

PERSONAL

PRIME MINISTER

CABINET DISCUSSION OF BUDGET PROSPECTS

You discussed the handling of this item with the Chancellor this afternoon.

You may like to open the discussion by stressing that public expenditure decisions for 1989/90 are over and already implemented in the Autumn Statement and Public Expenditure White Paper. The purpose of this discussion is to focus on the tax and debt repayment decisions for the Budget.

You can then invite the Chancellor to introduce his paper.

Order of Subsequent Interventions

As agreed this afternoon, you will invite Mr. Younger to speak next. I have alerted his office to this.

You will want to invite at least one further supporter to speak - ? Mr. Ridley or Mr. MacGregor.

Thereafter you will want to inter-leave the contributions as discussed with the Chancellor. I suggest you ensure that after each person in the left-hand list below you have at least one from the right-hand list, with either Mr. King or Mr. Parkinson speaking after Mr. Walker.

The Rt. Hon. Peter Walker	The Rt. Hon. Tom King
The Rt. Hon. Douglas Hurd	The Rt. Hon. Cecil Parkinson
The Rt. Hon. Kenneth Baker	The Rt. Hon. Norman Fowler
not present. RRCG. The Rt. Hon. Paul Channon	The Rt. Hon. The Lord Young of Graffham
The Rt. Hon. Kenneth Clarke	The Rt. Hon. Malcolm Rifkind
The Rt. Hon. John Moore	The Rt. Hon. John Wakeham
	The Rt. Hon. John Major
	The Rt. Hon. The Lord Belstead
	~~The Rt. Hon. Antony Newton~~ not present RRCG.
	The Rt. Hon. Lord Mackay of Clashfern

You may then like to end the contributions with Sir Geoffrey Howe and finally to invite the Chancellor to make a brief response.

You also need to agree on the form of words that Bernard will use to brief the press. The formula you discussed with the Chancellor was:

- "The Cabinet today held their usual pre-Budget economic discussion. They reaffirmed the Government's economic strategy and the central objective of bringing down inflation, and agreed that economic policy should remain prudent and cautious."

PWG.

PAUL GRAY

15 February 1989

SW2ARD

CONFIDENTIAL

~~SECRET~~ downgraded.

PRIME MINISTER

BILATERAL WITH THE CHANCELLOR: 15 FEBRUARY

I have discussed the following agenda items with the Chancellor's office:

(i) handling of the pre-Budget economic discussion in Cabinet this Thursday. You may like to take the Chancellor's mind on a possible order for the proceedings, and the line that Bernard might take afterwards in briefing the press;

(ii) the Budget. The Chancellor is not yet ready to come back on the key points you discussed on Sunday. You might like to ask him for a progress report on some of the structural changes he mentioned at your Dorneywood session. e.g. life assurance and pensions.

You might then schedule a fuller discussion of the Budget for next week's bilateral on 22 February. You might ask him in advance of that meeting to set down his proposals in writing;

(iii) you might like to report the outcome of your talk with Norman Fowler earlier today. (The Chancellor was present for the first item but not the rest.);

(iv) the Chancellor does not want to discuss tax approximation; he is waiting for the Foreign Secretary's reactions. But you may want to raise this yourself.

PRG.

(PAUL GRAY)

14 February 1989

~~SECRET~~

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

Prime Minister[2]

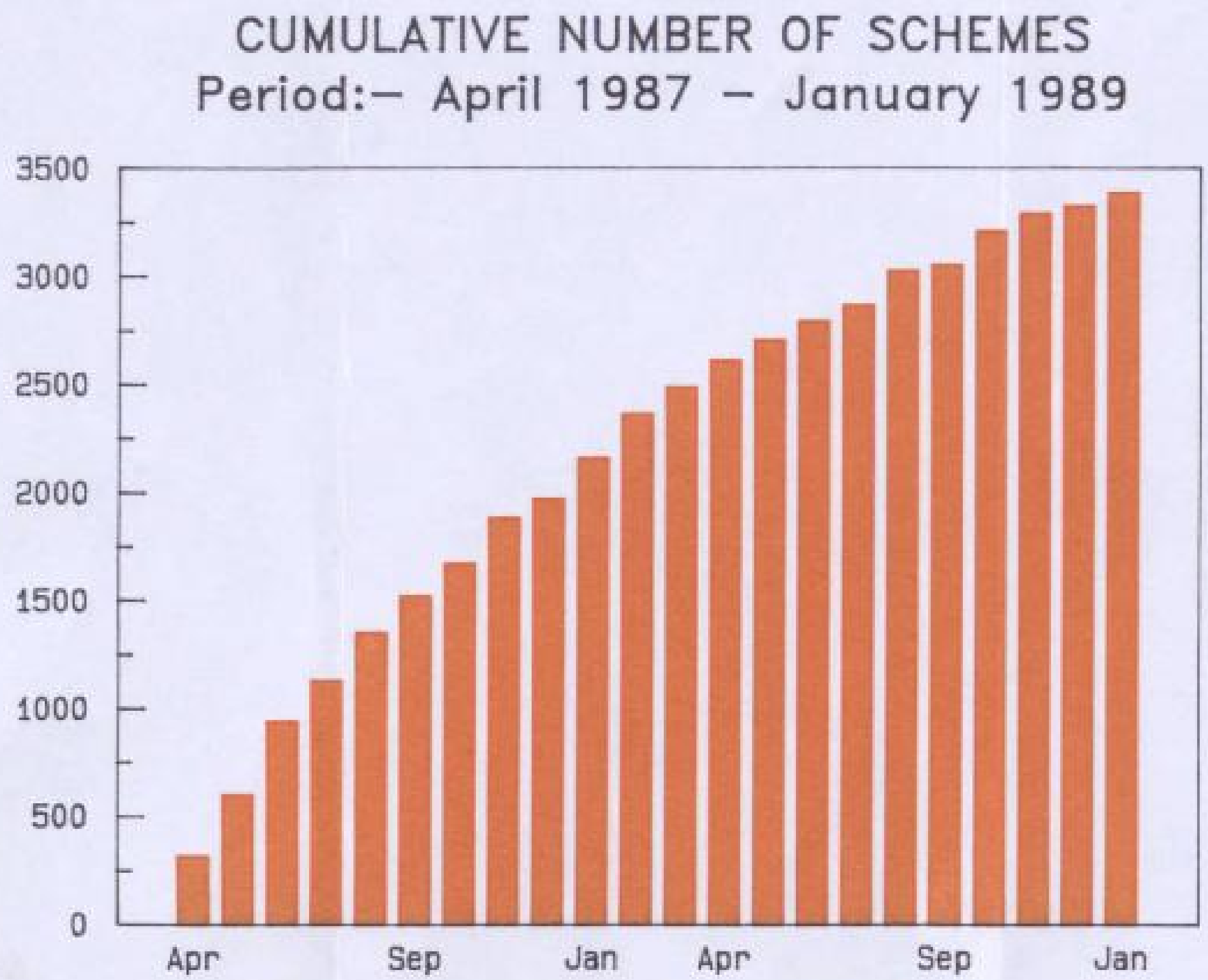
PRIME MINISTER

PRCG
17/2

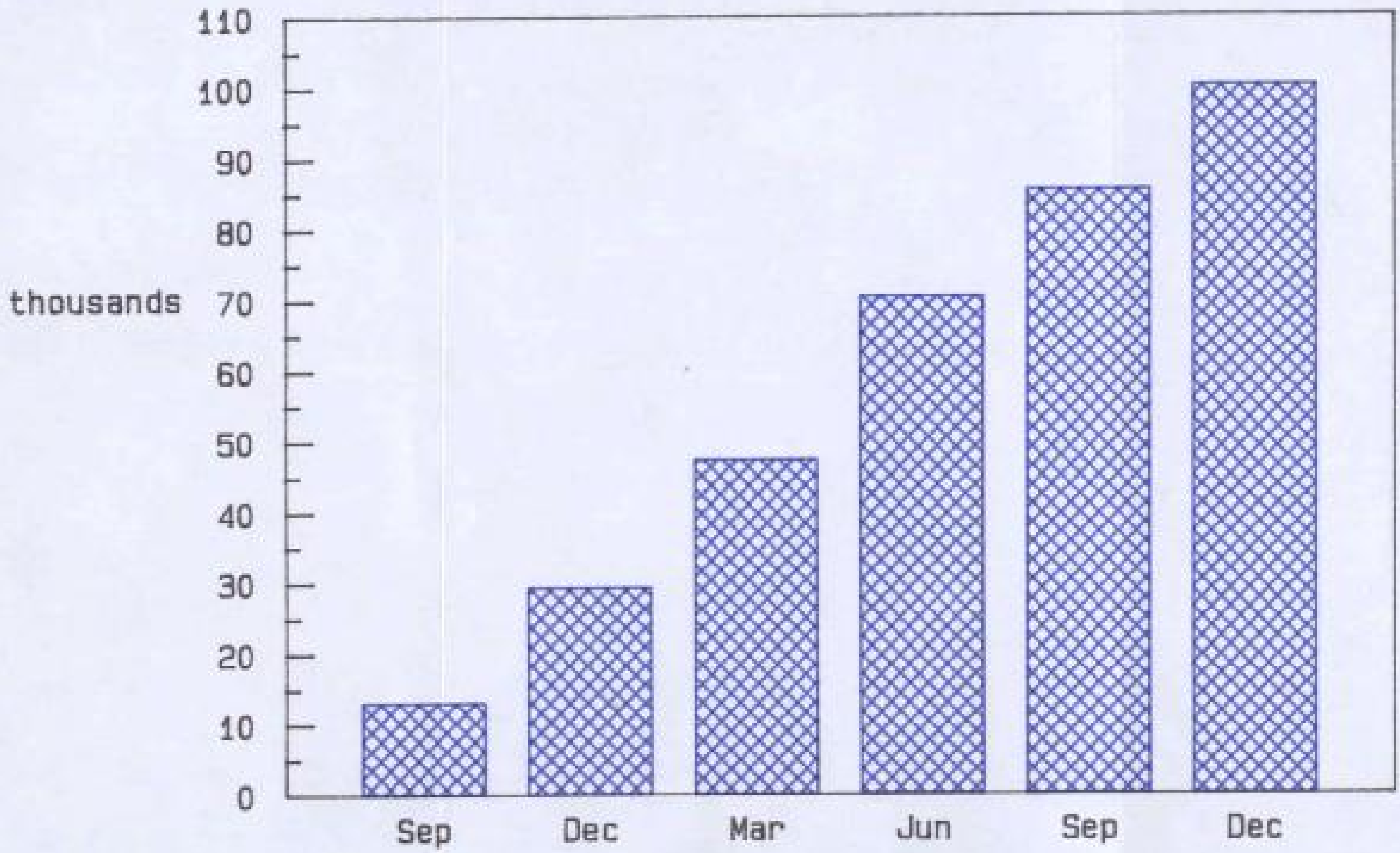
PAYROLL GIVING

I said I would send you some information on the build-up of the Payroll Giving Scheme. I attach two graphs, one showing the cumulative number of schemes set up by employers - now totalling over 3,400 - and one showing the number of individuals who are giving to charity by this method - now totalling over 100,000.

[N.L.]
16 February 1989


CUMULATIVE NUMBER OF SCHEMES
Period:— April 1987 — January 1989
3500
3000
2500
2000
1500
1000
500
0
Apr
Sep
Jan
Apr
Sep
Jan

CUMULATIVE NUMBER OF EMPLOYEES GIVING
Period: - September 1987 - December 1988



BUDGET - SECRET

S 5(A-B)

10 DOWNING STREET

From the Principal Private Secretary

Paul.

Meeting with Chancellor.

The Prime Minister gave me an account of the meeting with Ch/Ex. As expected he said he would be free to give a very slightly more and still retain a sound fiscal position. He set out the options

(i) 1p off income tax. This still seems his preference. PM said she was against it. Psychology is wrong, looks like cutting taxes to achieve pre set target even when conditions not right.

(ii) More than indexation of allowances. Favoured by PM. She told him that if allowances went up by 6.8 per cent they would be out of date even before people had seen the benefit. She also takes the point that only indexation year after year reduces relative value of threshold. It was agreed to consider this closer nearer the Budget.

(iii) Cut in CT. They agreed that this was likely to fuel wage increases

(iv) Abolish income tax on State retirement pensions and scrap the earnings rule. On former they agreed there was an intellectual case as contributions are not tax allowable. But

(a) biggest benefit goes top rate tax payers (while earnings rule benefits the younger fitter pensioners) Poorest get least ∴ likely to lead to higher public expenditure

(b) inconsistent with treatment of long term and other contributory benefits

They agreed not to proceed - would look good on Day 1 but holes would then appear. Did agree to scrap earnings rule

(v) I am not sure that adjusting NICs was pressed, other than in context of smoothing the cliffedge as 9% rate is reached.

BUDGET - SECRET

B

10 DOWNING STREET

From the Principal Private Secretary

She told him there must be no easing of monetary policy. This was not contested. No mention of putting down a paper but with Cam still tell Alec she did.

She mentioned some problems over Lloyds where tax rules prevent accumulation of adequate reserves.

She agreed the paper was too complacent at the points we indicated. I have marked a couple of extra points she mentioned.

AT

14.ii

BUDGET - SECRET

4 (A-D)

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

PRIME MINISTER

BUDGET UPDATE - 10/2/89

1. As before I have had an informal briefing of what the Chancellor may say to you on Sunday evening. Please do not reveal that you have been briefed.

Latest Developments

2. Terry Burns' latest view is that the 1988-89 ~~and~~ ~~[illegible]~~ and 1989-90 PSDRs will be higher than in the Treasury forecast (Flag C). On the basis of the ~~[illegible]~~ original package of net tax reductions of £1.1 billion they now believe:

- the tax and NICs / GDP ratio would rise between 88-89 and 89-90
- although the total PSDR would stay the same between 88-89 and 89-90, the PSDR excluding privatisation proceeds would rise.

B

3. So the Chancellor is now contemplating further tax reductions of about £1¼ billion, so that:

- tax and NICs / GDP ratio is the same in the 2 years
- PSDR excluding privatisation is the same, and total PSDR falls about £1 billion between the 2 years.

4. The Chancellor is also influenced by:

- worries that a bigger PSDR – ? £14-15 billion – will fuel demands for extra public spending.

Possible Tax Reductions

5. 5 ideas are in play for "spending" the extra £1¼ billion:

(a) 1p off the basic rate

(b) ✓More than indexation of tax allowances in view of RPI forecasts

(c) Some adjustment to the lower bands of NIC contributions. ×

(d) 2 percentage points off corporation tax

(e) Abolish income tax on the state retirement pension, abolish age allowances and scrap the ✓pensioners' earnings rule.

C

6. The Chancellor may not mention all of these. If not, you might reasonably be expected to think on the spur of the moment of any of (a) to (d), but for you spontaneously to suggest (e) might alert the Chancellor to the fact that you had been briefed!!

7. But if he mentions (e), it certainly sounds worth exploring. The political attractions could be considerable – and it might help to ease the Chancellor's worries of a "boring Budget".

Line to Take

8. Stress the need to err on the side of caution this year. The dangers of too ~~expansive~~ restrictive a policy stance are far less – and to some extent easier to address – than the reverse.

9. Emphasise the fundamental importance of tight monetary policy. Arguably the most important thing about the whole Budget is that it should not be the traditional occasion for an interest rate cut.

10. Question the forecast that the budget surplus will stay high. Have the Treasury fully allowed for how

D.

● quickly the surplus could fall as the economy slows down – both from slower growth of tax revenues and upward pressure on public spending? This last year shows just how sensitive the PSDR / PSBR is to variations in economic growth – and the same is true in both directions.

11. If, on balance, you are satisfied on (10) give a fair hearing to the case for a slightly ~~[illegible]~~ bigger tax reduction. NB what he may now be proposing is roughly consistent with what Alan Walters recommended to you.

12. Of the options (a) to (d) in (5), I would discount (c) and (d). And I would strongly favour (b) – tax allowances – rather than (a) – the basic rate. NB as long as earnings rise in real terms, simply indexing in line with prices implies a higher real tax take.

Handling

13. Press the Chancellor ~~to~~ quickly to put his proposals down on paper for you!

RRC 6.1.0/2

3(A-B)

S

PRIME MINISTER

BILATERAL WITH THE CHANCELLOR: 12 JANUARY

As arranged, the Chancellor will be looking in to see you at 8.00 to 8.30 p.m. on Sunday evening. Andrew will be on hand to de-brief after the meeting.

The main item of business is to carry forward the discussion of the Budget that you had at Dorneywood last month. My earlier note, prepared before Dorneywood is at Flag A. A new note alerting you to what the Chancellor may now say, is at Flag B. The Treasury forecast, which you saw earlier in the week, is at Flag C.

But there are one or two other items which, if time permits, you may want to discuss:

i. Chancellor's draft paper for next Thursday's pre-Budget Cabinet discussion (Flag D). Are you content with it?
Andrew and I have marked some queries on it.

Much too complacent. Gives impression that we have abandoned [illegible] of policy [illegible] [illegible]

ii. The complex of sensitive issues currently under consideration in the Employment field. Following your talk this morning with Robin Butler I have arranged for Mr Fowler to have a bilateral with you next Tuesday morning to take stock of the position on five sensitive areas - Dock Labour Scheme, Wages Councils, trade union law, Job Centres and Skill Centres. Mr Fowler will be letting you have a note on Monday on his overall plan for handling these points but you might want to mention all these to the Chancellor on Sunday and take his mind on the handling.

B

iii. You have had three letters recently from people in Lloyd's - Stephen Merrett, Murray Lawrence and Francis Dashwood - all complaining about the Inland Revenue's treatment of Lloyd's members, in particular in relation to the treatment of reserves. (The latest letter from Francis Dashwood is in the signature folder.) None of these letters are suitable for passing on to the Treasury and Inland Revenue, but if you agree I thought I would send a short letter to the Chancellor's Office saying that you have had a number of representations on all this recently and asking for a note about it. But you may also want to mention it to the Chancellor yourself.

PRG.

Paul Gray

10 February 1989

MJ2DGE

BUDGET - SECRET

5

A

2(A-F)

10 DOWNING STREET

PRIME MINISTER

DINNER AT DORNEYWOOD

1. I have had an informal briefing from the Chancellor's office of the sort of package he will describe to you. The Chancellor does not know this and would be horrified if he did. So please do not give any indication that you have been briefed.

The Package

2. There are no great surprises. The key elements are:

- overall net tax reductions from an indexed base of £1.1 billion in 1989-90 and £1.5 billion in 1990-91. (1988 Budget figures were £4.0 billion in 1988-89 and £6.2 billion in 1989-90).
- on present forecasts this will mean a 1989-90 PSDR of £12 - 13 billion, the same as now expected for 1988-89.
- it will also mean a broadly unchanged ratio of tax and NIC / GDP between 88-89 and 89-90.
- the net tax reduction is all accounted for by a freeze on all excise duties (ie non-indexation). This costs £1.18 b. from an indexed base. And a 5p. reduction in duty on unleaded fuel costing £40m.

(2)

B

- no change in income tax rates and normal indexation of tax allowances.

- extra revenue resulting from the extended impact of the European Court judgement on VAT for non-domestic construction. Put at £345m. in 89-90 and £645m. in 90-91. Most of this extra revenue flows from public sector projects – for which the extra expenditure provision was allowed in the PES round.

- no change in Vehicle Excise Duty on cars, but a substantial increase for coaches; yields £40m.

- a 20% increase in company car scales (following last year's 50%). Any bigger increase could produce significant losers from the Budget among relatively lowly paid people with company cars. 20% yields £90m.

- a mini-savings package:

  - main element to be the abolition of stamp duty on shares from 1/1/90. Costs £150m. in 1989-90 and £970m. in 1990-91.

  - some tightening up on the tax treatment of life assurance pensions business yielding perhaps £250m. in 1990-91.

  - modest improvements for PEPs (higher limits), share schemes and unit trusts.

will go to [illegible] premiums

(1)

C

- a miscellany of other measures, including:
  - a small package to help charities
  - some easing of age allowances
  - (possibly) extending employers NICs contribution to various benefits-in-kind, principally cheap mortgages.
  - a major ~~simplification~~ simplification of close company legislation (favoured by Emmanuel Kaye).
- probably nothing on tax treatment of residence. As you know he has dropped the idea of taxing world-wide earnings. The only issue now is some "tidying-up", which is likely to be left until next year.

The Forecast

The pre-Budget forecast is not yet completed. But emerging key changes from the October forecast are:

Lawson VAT returns

- a faster slowdown. GDP growth in 1989 (year on year) down from 3½% to 2½%. And unemployment possibly rising again by the end of the year.
- RPI (assuming full Budget indexation) year-on-year increase reaching 7.4% by February, fluctuating between 7.4 and 7.6 until June, 7.3 in July and then dropping fairly quickly as the mortgage effect works its way out of the figures.
- balance of payments figures improving in 2nd

④ D.

half of 1989, but annual 1989 total as high as 1988

- an attempt to allocate out the residual errors suggests the current account deficit could be about £4 billion lower than the recorded figures.

The Key Issues

① The Fiscal Stance

Is £12-13 billion PSDR about right? Answer, probably yes:

- means a small surplus after privatisation and other asset sales
- no change for 88-89 carries the right message about not indulging in fiscal fine-tuning (NB Alan Walter's point).
- difficult to present an increase in the tax and NICs/GDP ratio.

② Freeze on Excise Duties

Is this the best way to "spend" the fiscal adjustment? This is more debatable.

The case for this (which the Chancellor will probably use) is the RPI benefit. Rather than the RPI staying at around 7½% until mid-year with indexation (see above) a freeze will bring it down to 6.9% in April. Lower expenditure on all indexed linked benefits - £[illegible]

- The case against is:

  - drink and tobacco are already too cheap.

  - better to use money to fund tax reforms, extra personal allowances or cutting rates (on last year's figures 1p off basic rate of income tax costs £1.5b full year).

  - wrong to distort budget in attempt to "control" inflation (the job of monetary policy).

You will want to consider the balance of the arguments.

(3) Tax Allowances

Is normal indexation right? Answer, probably yes.

We discussed earlier the possibility of not indexing. But that was mainly in the context of ensuring the overall fiscal stance was sufficiently tight. Assuming the PSDR forecasts don't change, that point is met. In tax policy terms indexation is the right course — and perhaps the only issue now is whether allowances should be more than indexed instead of freezing excise duties, as under (2) above.

(4) Tax Reform

I have not yet had details of the various tax reform measures. But, stamp duty apart, it seems relatively minor stuff. Should it be more radical? Answer, probably not.

F.

(5) Boring Budget?

This links with the last point. As we feared, I gather the Chancellor is concerned that this is an unexciting, boring budget. You should aim to reassure him. Last year's Budget was exceptional. The principles this year must be consolidation and soundness, not excitement.

(6) Monetary Policy

You should emphasise the importance of a strong anti-inflation section in the budget speech, re-emphasising the role of monetary policy.

Do you want to urge him to state a firm zero-inflation target?

(7) Handling of Papers

The Chancellor is excessively secretive over sharing papers about the Budget with us. It would be helpful if you could urge him to send you within the next week a summary of the present proposals, so you can have it to hand for future bilaterals. (Budget papers will, as usual, be handled as an exceedingly restricted paper in the Private Office)

PRCB
20/1.

ANNEX 3: PUBLIC FINANCES AND THE TAX BURDEN

Taxation, Expenditure and Borrowing

Since the Government first took office, total taxes and NICs have risen by 4 percentage points of GDP, though the ratio has fallen from its peak in 1981-82. This has enabled us to make net repayments of government debt in the last two years.

Table 1

Overall Taxation, Expenditure and Borrowing
(percentage of GDP at market prices*)

	Non-North Sea Taxes plus NICs (as per cent of non-North Sea GDP)	Total Taxes plus NICs	General Government Expenditure (excluding privatisation proceeds)	PSBR
1978-79	34.2	33.9	43.3	5.3
1979-80	35.1	35.1	43.5	4.8
1980-81	36.2	36.3	46.1	5.3
1981-82	38.7	39.3	46.6	3.3
1982-83	38.1	38.9	46.8	3.1
1983-84	37.7	38.5	45.9	3.2
1984-85	37.8	39.1	46.2	3.1
1985-86	37.1	38.5	44.5	1.6
1986-87	37.8	38.1	43.7	0.9
1987-88	37.6	37.9	41.6	-0.9

[*Treasury estimates for 1986-87 and 1987-88]

Personal Taxation

2. Despite reductions in income tax, total personal taxes (direct and indirect, including employees' NICs and domestic rates) in 1988-89 are over £30 billion higher in real terms (ie 1988-89 prices) than they were in 1978-79. For income tax and national

insurance contributions the following table shows how the proportion of gross pay they represent rose up to 1981-82:

Table 2

Income Tax and NICs as a per cent of Gross Earnings*

	½ average earnings	average earnings	2 average earnings
1978-79	16.0	27.8	31.4
1981-82	20.8	29.3	32.2
1982-83	20.8	29.8	32.3
1983-84	20.1	29.6	31.7
1984-85	19.3	29.2	31.5
1985-86	18.9	29.0	31.5
1986-87	18.9	28.5	30.9
1987-88	19.1	27.6	29.9
1988-89 (estimate)	18.5	26.3	28.2
1989-90 (indexation)	18.6	26.3	28.3

*Adult male earnings (all occupations). Married couple, wife not working: the couple are assumed to have no children, to avoid distortion of the figures from the abolition of child tax allowances.

3. These figures reflect the rise in the standard employees' NIC rate from 6½ per cent to 9 per cent. The lower rates introduced in the 1985 Finance Act do not affect the cases shown. So far as income tax is concerned, personal allowances have increased by about 25 per cent in real terms since 1978-79, slightly less than earnings. The basic rate has been reduced from 33p to 25p.

4. Average earnings have of course increased by substantially more than prices since 1978-79. So a married man on average earnings has seen his real take-home pay rise by £X per week. The increase for a married man on half average earnings has been £Y per week, and on twice average earnings £Z per week.

4. As the table shows, indexation of allowances in the Budget, with no reduction in the basic rate, would lead to a very slight rise in the proportion of incomes taken in tax and NICs. This is because earnings are assumed to rise by more than the increase in tax thresholds, which is indexed to changes in prices.

Business Taxation

5. Following the sharp rise in corporation tax receipts over the past three years, as a result of the substantial recovery in company profits, total taxes paid by businesses (outside the North Sea) are now higher as a percentage of GDP than in 1978-79. Within this total, the major change has been a fall in employers' NICs (and NIS) as a "percentage of GDP, offset by increases in corporation tax, business rates and 'other' taxes as the following table shows:

Table 3

Tax paid by Businesses £bn in 1988-89 prices

(figures in brackets are per cent of GDP)

	Corporation Tax	Taxes on self employment incomes	Employers' NICs and NIS	Rates	Other[2]	Total
1978-79	8.3	2.8	13.6	5.5	4.3	34.4
	(2.2)	(0.7)	(3.6)	(1.4)	(1.1)	(9.1)
1988-89 (estimate)	15.9	3.7	13.0	8.1	7.4	48.1
	(3.4)	(0.8)	(2.7)	(1.7)	(1.6)	(10.2)

[1]Excludes North Sea, but includes ACT

[2]VED, car tax, road fuel duty, duty on rebated oils, capital taxes

pup

The Cabinet today held ~~the~~ their usual pre-Budget economic discussion. They reaffirmed the Government's economic strategy. They welcomed the satisfactory prospects for the economy, ~~and~~ They and agreed that economic policy should remain prudent and cautious.

They noted that increases in public expenditure programmes for the coming year of £4½ thousand million had already been decided, announced and would be debated next week.

The Cabinet stressed that the forthcoming Budget is the occasion to review taxation and borrowing.

[line agreed at Cabinet 18/2/88]

PS/CST
MR R.I.G. Allen

PRIME MINISTER

MEETING WITH ALAN WALTERS: 18 JANUARY

We have arranged tomorrow's meeting so that you can talk to Alan about the Budget in advance of your dinner with the Chancellor at Dorneywood next Sunday.

You will remember that you agreed that Alan could not see Budget papers this year in advance of his return to the No.10 payroll. (He will of course have full access next year.) Against this background, it would probably be best if you did not talk to Alan about Budget matters again after tomorrow's discussion prior to 14 March.

I suggest tomorrow that you should take Alan's mind on:

- the latest economic position and the response to the higher interest rates;

- the sort of overall fiscal stance the Budget should be setting;

- any particular proposals that should be considered for inclusion in the Budget;

- any particular questions that you should be putting to the Chancellor in your discussion with him on Sunday.

PRG

PAUL GRAY
17 January 1989

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HM TREASURY

OFFICE NOTICE

ON (GENERAL)(88) 124
22 December 1988

BUDGET SECURITY

I attach a note setting out this year's Budget security instructions. They apply without exception to Ministers, advisers and officials. Breaches of these instructions will be treated as a serious matter.

2. The special arrangements for Budget security are designed to give additional protection to information about Budget decisions. The instructions have been approved by the Chancellor of the Exchequer. This year's instructions follow the general line of last year's instructions. The Budget security arrangements have generally worked well in the last four years, but that must not be a reason for complacency. It is important that all concerned continue to observe these instructions strictly.

3. All members of the department should recognise the sensitivity of Budget material, and take every care to ensure that its integrity is preserved. Heads of Divisions and Private Offices should ensure that staff who are likely to handle Budget papers understand the instructions. The Assistant Budget Security Officer in EOG2 will also help ensure that the staff most heavily involved understand the procedures and have the equipment to carry them out.

4. All members of the department should note also that the Budget Security instructions contain guidance on contacts with journalists, in the period from the beginning of January to Budget day, which apply whether or not you have any involvement with Budget work. The term "journalist" should be interpreted widely to include any contacts with banks, brokers, and others who provide commentaries on economic and financial affairs for their

clients, contributors to specialist publications, brokers circulars, newsletters etc; indeed, anyone who is in a position to make easy contact with the media. Most staff will not have any such contacts. But if you do, you must observe these instructions, to protect your own position and that of the department against suspicion. In any contacts, you must take particular care, as inferences can be drawn from the most casual remark or refusal to comment.

5. There are two major changes to the instructions this year. Last year the classification 'BUDGET SECRET' was replaced with 'BUDGET SECRET: TASK FORCE LIST' to reflect security procedures which operated outside the Budget period. This year the classification will revert to 'BUDGET SECRET'. Secondly, there is a new section in the instructions dealing with the implications of Budget Security on office automation. Users of the **Officepower system are asked to take particular note of this section.**

6. There are a number of other points in the instructions to which I would draw particular attention:

(a) The rule of handling <u>Budget Secret: Budget List Only</u> documents set out in paragraph 17 must be adhered to strictly. In particular, documents for which this classification is appropriate must not be sent or shown to anybody who is not on the authorised list of recipients (the "Budget List") which has been approved by me. Any alterations to the list require my prior approval. Special care should be taken over the custody of typed originals of Budget Secret: Budget List Only documents (Paragraph 17(a)).

(b) A minute containing Budget classified material should not be written unless it is strictly necessary and, if it is, should not be circulated to those who do not have a real operational need to see it. If a person only needs to see part of a document, he should only be sent that part, not the whole document (Paragraph 14).

(c) Each copy of every document classified Budget Secret or above must be individually numbered, in sequence (Paragraphs 17(a), 19(g)).

(d) Documents which are classified Budget Secret or above must always be sent in double envelopes, even if they are being sent within the Treasury. The inner envelope should bear the appropriate address label with all details fully completed (Paragraphs 17(c), 19(b)).

(e) Budget classified papers may not be filed by allocated Clerks (or Sector Registries) until after Budget Day, unless specifically authorised. (Paragraphs 17(f), 19(f), 20(f)).

(f) Taking any Budget classified document out of the office involves a risk and should not be done unless <u>absolutely unavoidable</u>. If a genuine need arises, prior approval must be obtained, and the documents transported in a locked briefcase, box or pouch. If kept at home, the documents must be placed in a security container.

(g) Additional security furniture will be required by some staff. It is essential that requisitions be made as soon as possible to the Assistant Budget Security Office in EOG2 - extensions 4859 (Paragraphs 17(g), 19(f), 20(g)).

7. A copy of the Budget list is being sent today to those persons whose names are included on it.

8. The system of special spot checks on Budget classified documents (Paragraph 24) will continue. These checks are carried out on my authority. I ask all members of staff to co-operate so that the checks can be carried out with the minimum of disturbance.

9. Further guidance on any aspect of the Budget security instructions can be obtained from the Budget Security Officer, Mr Michie the Grade 7 in FP (Indirect taxation branch - extension 4922), who will be assisted in the performance of his duties during the Budget season by the Assistant Budget Security Officer, Mr M Rees, EOG2 (extension 4859) and Mr K Sedgwick, FP (extension 5169).

10. Please file these instructions with other security papers in your possession and destroy the previous version.

PETER MIDDLETON

HM TREASURY

BUDGET SECURITY

THESE INSTRUCTIONS SHOULD BE READ IN CONJUNCTION WITH THE GENERAL SECURITY NOTES.

BUDGET SECURITY INSTRUCTIONS

INDEX

BUDGET SECURITY

References to the pre-Budget period should be taken to mean the period between the beginning of January to Budget Day itself.

Relations with the Press and other Outside Contacts

1. This first subsection applies to all Treasury staff in the pre-Budget period, including officials who are not involved in work connected with the Budget.

2. Formal contacts with journalists in the pre-Budget period may be undertaken only with the prior authority of the Permanent Secretary or, in his absence, either the Grade 3 (FP) or one of the Second Permanent Secretaries. If permission for such contact is granted, a report should be submitted immediately after it takes place to the head of IDT, copied to the Permanent Secretary and the Budget Security Officer, whatever the subject matter of the discussion.

3. Telephone calls from journalists are to be referred in the first instance to IDT, and no return or other calls to journalists may be made without prior IDT approval. If any conversation takes place directly with a journalist in the pre-Budget period a report is to be sent to IDT copied to the Budget Security Officer, whatever the subject matter of the conversation.

4. If any other contacts take place with journalists in the pre-Budget period, no matter how informal, a report of the fact is to be made to IDT copied to the Budget Security Officer, together with a very brief account of any discussion of official matters.

5. Contacts with banks, brokers and others who provide commentaries on economic and Financial affairs, contributors to specialist and academic publications, brokers' circulars, newsletters and other similar publications which are to take place

outside the office, may only be undertaken with prior authority of the Deputy or Permanent Secretary responsible for the relevant work area.

General

6. Special security arrangements apply to certain information connected with the Budget, as described in paragraph 8. The arrangements apply in addition to the normal departmental security procedures and are intended to provide additional protection for information about Budget decisions. It is the responsibility of every person involved in Budget work to be familiar with, and operate, these instructions. EOG will ensure that those most heavily involved understand the procedures.

7. The recipient of a Budget classified document is, at all times, personally responsible for its security. This applies even if custody of the document is entrusted to another member of his or her staff (where this is permitted).

Use of Budget prefix

8. The Budget prefix should be used in the period between the beginning of January and the Budget Day itself, but only for documents which contain information concerning Ministerial decisions on:

(a) the Budget judgment and in particular the PSBR;
(b) all taxation matters connected with the Budget; and
(c) any social security or other public expenditure changes to be announced in the Budget.

The Budget classification should be applied also to documents in which no decisions are recorded, where the papers are particularly sensitive - for example, where the very fact that a matter is being discussed is sensitive, where there is a serious danger of forestalling or where a document might reveal the approach to the

Budget likely to be adopted by Ministers. The Budget prefix should not be used on other papers which do not reveal Ministerial decisions.

9. A Budget classification is not, in general, required for papers containing:

(a) Ministerial decisions relating to economic forecasts, monetary policy, exchange rate policy and other items not directly related to tax or public expenditure decisions, even where these are in the context of a Budget;

(b) arguments for and against a particular course of action, recommendations from officials to Ministers or other Ministers to the Chancellor unless the papers are particularly sensitive (see above); or

(c) list of options in which no decision is recorded.

It should be borne in mind that a submission to a Minister on a Budget matter, suggesting a range of options, may properly not have a Budget classification, but a note from a Ministerial Office recording a decision on it should be given a Budget classification.

10. Care and common-sense are needed in using the Budget prefix. In any cases of doubt the Treasury Budget Security Officer is to be consulted.

Level of Budget classification

11. "BUDGET SECRET - BUDGET LIST ONLY" is a special security classification to be used for certain Budget documents, i.e. for those papers which reveal the contents or probable contents of the whole, or a very substantial or particularly sensitive part, of

the Budget. The Chancellor may also decide that papers dealing with particular subjects be given this classification. Examples of papers which are to be given this classification include:

- papers, including records of meetings, which give an overall picture of Budget strategy;
- complete drafts of the Budget speech (and the most sensitive extracts such as complete drafts of the tax sections);
- full drafts of the Budget Brief, or particularly sensitive parts of it;
- full draft of the FSBR (and early drafts of the sections dealing with Budget proposals); and
- the Budget Resolutions, as a whole.

Papers dealing with an individual tax would not normally require BUDGET SECRET - BUDGET LIST ONLY classification, unless this is required by the Chancellor.

12. BUDGET TOP SECRET should be used only where the material would fall clearly within the definition of TOP SECRET even if it were not to be included in the Budget (see paragraph 18 for further guidance on this). BUDGET SECRET is the correct classification for all other papers on the main Budgetary items (i.e. the main tax rates and social security benefits and other major changes in tax legislation or public expenditure). Strict rules are laid down for access to, and handling of, documents with this classification. BUDGET CONFIDENTIAL should be used for papers recording decisions on other Budget matters, including all other decisions on tax items. The classification of a document is <u>not</u> necessarily the appropriate classification for a minute commenting on or replying to it, even if the original document is classified BUDGET SECRET: BUDGET LIST ONLY. For example, a minute

containing comments on a document should bear the classification appropriate to its contents and should only bear the same classification as the original document where it is appropriate.

<u>Communications of Budget classified information</u>

13. Documents for which the "BUDGET LIST ONLY" classification is appropriate may be shown only to persons who are on the circulation list approved by the Permanent Secretary. Under no circumstances are they to be circulated or shown, or the contents communicated in any other way, to a person not on those lists. A copy of the Budget list will be made available, as appropriate, to each person who is on the list. If it is considered essential to show a BUDGET LIST ONLY document to a person not on the Budget list, the prior approval of the Permanent Secretary must be obtained in writing. Any requests for names to be added to the Budget list should be addressed in the first instance to the Budget Security Officer. This applies right up to the Budget Day.

14. The circulation of <u>all</u> Budget classified documents is to be restricted to the <u>absolute minimum</u> consistent with operational requirements. Before writing Budget classified material all originators must ask themselves:

(a) Is the document necessary at all? (A private face-to-face conversation is more secure than a written note).

(b) If the document is necessary, need it be circulated? (Only copy a document to those people who need to be aware of its contents).

(c) Need the document quote precise details of decisions e.g. proposed tax rate?

(d) Does the document require a Budget classification?

(e) Do all recipients need a copy of the whole document? If a part of the document would suffice, send only that part. It is <u>essential</u> that persons do not see parts of documents containing classified material which they have no operational need to see.

15. BUDGET LIST ONLY documents may not be shown to anybody who is not on the Budget list (except for the normal arrangements whereby the Queen, Prime Minister, certain staff at Number 10 and the Governor of the Bank of England are told the contents of the Budget). Other BUDGET classified information may be communicated to staff in the Chancellor's Departments (and the Office of the Parliamentary Counsel), <u>only if</u> they need to know about it for the efficient performance of their duties.

16. Budget classified information <u>must not</u> be communicated to <u>anyone</u> outside the Chancellor's Departments and the office of the Parliamentary Counsel without prior authority having been obtained from the Budget Security Officer. There are three general exceptions to this rule. First, FP group have authority to communicate to specified Department of Transport officials, Budget decisions on VED and the duties on hydrocarbon oils. Second, the head of FP has authority to communicate to specified officials in the Department of Social Security certain information about Budget changes in personal taxation. Third, as is appropriate for public expenditure matters, ST group will discuss any social security changes to be announced in the Budget with DSS officials. In all these instances the Divisions concerned <u>must</u> ensure that these Departments are aware of the need for particular care in handling the information. Similarly, if a Treasury Minister writes to a Minister in another Department on a Budget classified matter, his Private Secretary should ensure that the other Private Office are aware of the significance of the Budget classification, and in particular of the need to ensure that the letter is shown or copied <u>only</u> to those who <u>need</u> to see it.

<u>Preparation and handling of BUDGET SECRET: BUDGET LIST ONLY documents</u>

17. In addition to the normal security instructions regarding handling of SECRET documents, the following special instructions apply to the handling of BUDGET SECRET: BUDGET LIST ONLY documents:

(a) The document must be typed on plain paper. The security classification is not to be typed. Documents may be typed by a Personal Secretary <u>only</u> if she is on the BUDGET LIST. The typist's initials should appear on each page of the document. The originator is responsible for the security of the typed master, which must be given a number in the sequential series used for copies.

(b) Copies of the typed master must be made onto the special paper bearing printed 'BUDGET SECRET: BUDGET LIST ONLY' markings on one side of the paper only. Each copy of the document must be sequentially numbered, e.g. copy No 3 of 5 copies. A full record of copy numbers and recipients <u>must</u> be kept in the sender's security register.

(c) The documents must always be enclosed in the special distinguishing folder marked "BUDGET SECRET: BUDGET LIST ONLY" for transmission. They must always be transmitted in double envelopes even if sent within the building. The inner envelope must bear the special "BUDGET SECRET: BUDGET LIST ONLY" label completed with the relevant details mentioned in paragraph (d) below. If more than one document is sent in one envelope, the reference number (see (d) below) of <u>each</u> document must be shown on the label. A receipt must always be obtained for all copies of "BUDGET SECRET: BUDGET LIST ONLY" documents. It is the responsibility of the originator to ensure that a receipt is returned for each copy which has been sent out. These receipts must be retained until after Budget day.

(d) Titles of BUDGET SECRET: BUDGET LIST ONLY documents are not to be shown on receipt forms (which are unclassified) or on BUDGET SECRET: BUDGET LIST ONLY labels. Instead the 'reference no' or 'title' section of the receipt form or label should show: the sender's initials; the serial number of the entry in the sender's security register and the copy no. e.g. MCS/28/3.

(e) If they are being sent to other departments, the documents must be sent by messenger or by the special van service which operates between the Treasury, the Revenue Departments and Parliamentary Counsel's Office. If these are not available, the documents should be sent by special signature service of the IDS. In every case receipts must be obtained for the documents. In no circumstances may the documents be sent by post or transmitted on facsimile equipment except for the secure facsimile link between the Treasury, (Room 14/2), HM Customs and Excise, Inland Revenue, Department of Transport, DVLC and the Bank of England (see paragraph 22 for transfers via Officepower).

(f) Each recipient is responsible for ensuring that every BUDGET SECRET: BUDGET LIST ONLY document is entered in the appropriate security register. He must do this himself if no-one else is available or authorised to do it - this applies particularly at Grade 7 level. A document may be entered in the security register by the Personal Secretary or allocated Clerk from the information shown on the label, without opening the inner envelope. If this is done, the number of the security register entry is to be written on the label. The recipient of the document is to ensure that the security register number is shown and should copy it onto the document itself. In some areas, Personal Secretaries or Clerks may themselves be included on the Budget list authorised to handle BUDGET SECRET: BUDGET LIST ONLY material. In such cases only may they open the inner envelopes, in which case the security register number may be written on the document itself. BUDGET SECRET: BUDGET LIST ONLY documents may not be filed until after Budget Day except where the Clerk concerned is on the Budget List.

(g) Each copy of a BUDGET SECRET: BUDGET LIST ONLY document is personal to its recipient. It may not be shown to any person not on the Budget list in any circumstances. It may be shown (but not copied) to a person who is on the Budget list only if there is a real operational need for him to see it. The fact that a person is on the Budget list does not mean that he must see all BUDGET LIST ONLY documents. It is the recipient's responsibility to ensure that the document is not seen by any person who is not authorised to have access to it. It can be kept in the recipient's own security cupboard only if all persons who are entitled to know the combination number have been specifically authorised to handle BUDGET SECRET: BUDGET LIST ONLY documents. Otherwise it will be necessary to store such documents in a separate document box or security cupboard whose combination number is known only to the recipient (and any authorised handler of such material). Officials who require additional security furniture for this purpose should requisition it as soon as possible from the Assistant Budget Security Officer in EOG2 (Ext 4859).

(h) It is essential that BUDGET SECRET: BUDGET LIST ONLY documents are not left unattended by the person who is responsible for their custody - he must lock them away whenever he leaves his room.

(l) If a BUDGET SECRET: BUDGET LIST ONLY document is to be destroyed before the Budget, it is to be sent to the Budget Security Officer in double envelopes, the inner envelope bearing the appropriate label, and marked for destruction. The Budget Security Officer will carry out the destruction in accordance with the standing instructions.

18. If a Budget sensitive document meets the criteria for classification as TOP SECRET (as defined in annex 1 of the Treasury Security Instructions) it should be classified "BUDGET TOP SECRET: BUDGET LIST ONLY". The distinguishing folder and address labels for "BUDGET SECRET: BUDGET LIST ONLY" documents are to be used amended accordingly in manuscript. The instructions of paragraph 17 are to be followed, except where the normal security instructions for TOP SECRET documents impose more stringent requirements, in which case those should be obeyed.

Preparation and handling of BUDGET SECRET documents

19. The normal rules for the control and transmission of SECRET documents must be applied, except as modified below:

(a) Titles of BUDGET SECRET documents are not to be shown on receipt forms (which are unclassified) or on BUDGET SECRET labels. Instead the 'reference no' or 'title' section of the receipt or label should show: the sender's initials; the serial number of the entry in the sender's security register and the copy number e.g MCS/ 28/3.

(b) BUDGET SECRET documents must always be transmitted in double envelopes, even if sent only within the building and the inner envelope must bear a BUDGET SECRET label completed in accordance with paragraph (a) above. Any person not entitled to see BUDGET SECRET papers and

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(b) BUDGET SECRET documents must always be transmitted in double envelopes, even if sent only within the building and the inner envelope must bear a BUDGET SECRET label completed in accordance with paragraph (a) above. Any person not entitled to see BUDGET SECRET papers and

above, and who is likely to have access to envelopes bearing this classification, must be instructed not to open them.

(c) BUDGET SECRET documents sent outside the building must be accompanied by receipts.

(d) If they are being sent to other Departments, the documents must be sent by messenger or by the special van service which operates between the Treasury, the Revenue Departments and Parliamentary Counsel's Office. If these are not available, the documents may be sent by special signature service of the IDS. In every case receipts must be obtained for the documents. In no circumstances may the documents be sent by post or transmitted on facsimile equipment except for the secure facsimile link between the Treasury (Room 14/2), HM Customs and Excise, Inland Revenue, Department of Transport, DVLC and the Bank of England (see paragraph 22 for transfers via Officepower).

(e) Each recipient is responsible for ensuring that every document classified BUDGET SECRET and above is entered in the appropriate security register. He must do this himself if no-one else is available or authorised to do it - this applies particularly at Grade 7 level. Staff who are not authorised to handle BUDGET SECRET documents may record them in the security register, provided that they have been received in double envelopes, using the information shown on the label which should be in accordance with paragraph (a) above. If this is done, the inner envelope must be passed to the recipient unopened, the number of the security register entry being shown on the label. If this procedure is followed it does not detract from the recipient's responsibility that receipt of the document has been recorded, so he should ensure that the security register number is shown on the label and copy it to the document itself.

(f) BUDGET SECRET documents are not to be filed or otherwise handled by Divisional Clerks until after the Budget. They my be placed on divisional folders, but only by clerks entitled to see these papers. Such folders must bear the appropriate classification on the outside and must be kept so that unauthorised persons cannot have access to them. Officials who require a combination lock document box or security cupboard for BUDGET SECRET material should requisition it as soon as possible from the Assistant Budget Security Officer in EOG2 (Ext 4859).

(g) All copies of documents of BUDGET SECRET classification or higher must be sequentially numbered, e.g. copy no 10 of 25 copies. A full record of copy numbers and recipients must be kept in the sender's security register.

(h) The recipient of a BUDGET SECRET document may authorise its copying to a person who is entitled to see it, provided that the person authorising the copying is of Grade 7 level or above. Care must be taken to ensure that this does not enable persons to see papers dealing with proposals other than those with which they are directly concerned.

(i) BUDGET SECRET documents may be taken out of the office to meetings only if this is <u>absolutely unavoidable</u>. They may be taken home <u>only</u> if a Grade 5 or above has given his prior approval. Permission should be given only if the authorising officer is content that there is no alternative and that the document(s) will be secure, i.e. transported in a locked briefcase, box or pouch and kept at home in a security container. A record of those documents must be kept in the office security register and checked on return.

(j) BUDGET SECRET waste <u>must</u> be destroyed by shredding; arrangements for this may be made with EOG (extension 4859). Recipients must keep a proper record of any such documents they destroy. Production of such a record is necessary to meet the requirements of the spot checks described in paragraph 24.

<u>Preparation and handling of BUDGET CONFIDENTIAL documents</u>

20. The normal rules for the control and transmission of confidential documents must be applied, except as modified below:

(a) BUDGET CONFIDENTIAL documents may be sent within the building in a single sealed envelope. Documents being sent outside the building should always be transmitted in double envelopes with the inner envelope marked 'BUDGET CONFIDENTIAL'.

(b) BUDGET CONFIDENTIAL documents should be sent by messenger, the IDS or the special van service which operates between the Treasury, the Revenue Departments and Parliamentary Counsel's Office. <u>In no circumstances</u> may the documents be sent by post or transmitted on facsimile equipment except for the secure facsimile link between the Treasury (Room 14/2), HM Customs and Excise, Inland Revenue, Department of Transport, DVLC and the Bank of England (see paragraph 22 for transfers via Officepower).

(c) Copies of BUDGET CONFIDENTIAL documents need not be sequentially numbered, nor need they be recorded in security registers.

(d) The recipient of a BUDGET CONFIDENTIAL document may authorise its copying to a person who has a strict operational need to see it, provided that the person authorising the copying is at Grade 7 level or above

Care must be taken to ensure that this does not enable persons to see papers dealing with proposals other than those which they are directly concerned.

(e) BUDGET CONFIDENTIAL documents may be taken out of the office to meetings only if this is absolutely unavoidable. They may be taken home only if a Grade 7 or above had given prior approval. Papers taken from the office should be carried in a locked briefcase, box or pouch and kept securely at all times.

(f) BUDGET CONFIDENTIAL documents are not to be filed or otherwise handled by Divisional Clerks until after the Budget. They may be placed on divisional folders, but only by Clerks entitled to see these papers. Such folders must bear the appropriate classification on the outside and must be kept so that unauthorised persons cannot have access to them. Officials who require a combination lock document box or security cupboard for BUDGET CONFIDENTIAL material should requisition it as soon as possible from the Assistant Budget Security Officer in EOG2 (Ext 4859).

(g) BUDGET CONFIDENTIAL waste must be destroyed by shredding; arrangements for this may be made with EOG (Extension 4859).

Checklist for distribution of BUDGET documents

21. The following table acts as a guide for those distributing Budget classified documents:

	BUDGET SECRET: BUDGET LIST ONLY		BUDGET SECRET		BUDGET CONFIDENTIAL	
	Internal	External	Internal	External	Internal	External
BLO Folder	✓	✓				
Double envelopes	✓	✓	✓	✓		✓
Single envelopes					✓	
BLO label on inner envelope	✓	✓				
BS label on inner envelope			✓	✓		
Receipts	✓	✓		✓		
Sequentially numbered	✓	✓	✓	✓		

Office Automation

22. Users of Officepower must exercise great care to ensure that unauthorised persons do not obtain access to files containing Budget classified material. In particular, the following rules must be observed:

(a) All persons on the Budget list who use the Officepower system must ensure that their user ID is protected by the password and key decoder system, and not by password alone. Queries on the adequacy of individual systems should be addressed to EOG5 (Mr Cobb x5347).

(b) Passwords should be changed regularly (at least monthly) and should not be written down or told to colleagues. Avoid obvious words such as "Password", "HMT", or "BUDGET" etc which might be easily guessed.

(c) Terminals should not be left unattended whilst they are logged into the system. Log-out if you leave the room.

(d) Computer key tokens for the decoder system should be treated with the same respect as the combination number of a security cabinet; they must not be left lying around or placed in a desk drawer. When not in use, key tokens should be kept in a combination lock document box or security cupboard; these can be requisitioned from the Assistant Budget Security Officer in EOG2 (Ext 4859). If a key token protecting Budget information is lost or mislaid this should be reported immediately to EOG5 (Mr Cobb Ext 5437) and to the Budget Security Officer (Ext 4922).

(e) Exercise care when printing Budget classified material. Printers should be either in the same room as the user, in the room of another user who is cleared to see the material, or in a locked room. If the existing positioning of printers causes difficulties EOG5 (Ext 5437) should be consulted.

(f) **Great care must be exercised before any Budget classified material is sent electronically via the Officepower system** (see paragraphs 17(e), 19(d) and 20(b) for transfers by facsimile). Electronic transfers should be used only where there is a <u>real</u> operational need; and the following guidelines must <u>always</u> be observed:

(i) ring the potential recipient to tell them the information is to be sent shortly. If they are not available, do <u>not</u> leave a message on the Officepower system but call back later. Do <u>not</u> commence sending procedures until personal contact has been made;

(ii) both 'delivery' and 'view' acknowledgements must be used, and the acknowledgements received by the sender must be printed and retained. The Assistant Budget Security Officer may ask to inspect these prints as part of his examination of the security of classified papers;

(iii) any instances where the system appears to have 'broken-down' e.g. if information has been sent but has not been received, are to be report to the Budget Security Officer (Ext 4922) and EOG5 (Ext 5347) immediately.

23. Systems support staff must not allow an Officepower user access to the files of an individual on the Budget list without consulting the Budget Security Officer first (Ext 4922). If he is not available, the Assistant Budget Security Officer (Ext 4859) should be consulted. If neither the Budget Security Officer nor his assistant are available, the Deputy or Permanent Secretary responsible for the relevant work area should be consulted, and a written report made to the Budget Security Officer. In all instances, access to the files of an individual on the Budget list may only be given if there is a clear operational need, and a record of the authorisation must be kept by both the systems support staff and Budget Security Officer.

<u>General Points</u>

24. To ensure that the required procedures are being adhered to, Budget classified documents will be subject to a series of spot checks. There will be random checks of individual copies of classified documents sent to named individuals. There will also be more systematic searches of complete circulation lists of particularly sensitive Budget classified papers. These checks will be carried out by FP and EOG.

25. Budget classified papers must <u>not</u> be typed in typing pools. Particular care should be taken about the custody of carbons, photocopies, dictating machine tapes, word-processing discs, shorthand notes etc containing classified information.

26. Care should be taken not to include Budget classified papers (or related papers) in divisional 'floats'.

27. The disposal of any document classified BUDGET SECRET or above is to be recorded in the security register. When arranging for the disposal of classified documents, officials are to take care that they do not enable any unauthorised person to see its contents.

28. If BUDGET classified papers do not state the post-Budget classification, recipients should alter the classification as appropriate after Budget day. The 'BUDGET' prefix should always be deleted after Budget day, as it no longer has any significance. Papers which refer only to decisions which were announced in the Budget may be declassified. Papers containing advice or background to such decisions should generally be classified CONFIDENTIAL. Papers containing references to courses of action which were not pursued, which were classified BUDGET SECRET should remain SECRET.

<u>Queries</u>

29. Any questions about the Budget Security instructions should be addressed to the Budget Security Officer, who is the Grade 7 in FP Division (Indirect taxation branch) (extension 4922).

dti
the department for Enterprise

The Rt. Hon. Lord Young of Graffham
Secretary of State for Trade and Industry

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
SW1P 3AG

Department of Trade and Industry

1-19 Victoria Street
London SW1H 0ET

Switchboard
01-215 7877

Telex 8811074/5 DTHQ G
Fax 01-222 2629

Direct line 215 5422
Our ref PB4AGZ
Your ref
Date 15 December 1988

NBPM

PRG
14/12

Dear Nigel,

1989 BUDGET

I would like if I may to comment on your 1989 Budget and to suggest measures you might like to consider for inclusion in that Budget which I consider would contribute to a further improvement in the supply potential of the economy.

This year the supply side response has been particularly encouraging with output, productivity and investment surging ahead. Business confidence is high. But demand has been growing at an even faster, unsustainable, rate resulting in increased inflationary pressures and a rapid deterioration in the external balance. I agree that policy should be to concentrate on reining back the growth of domestic demand to a more sustainable level but, at the same time, we need to be careful not to damage business confidence and supply potential. There are already some signs that the increases in interest rates are beginning to have their desired effect.

Of course, high interest rates and the associated strengthening of sterling are not an ideal combination, either for business or to improve the current account, although I accept that it is the price that has to be paid to squeeze out the upsurge in inflation. But I would urge, in these circumstances, a very cautious stance on the 1989 Budget even to the exclusion of a further cut in income tax. A restrained fiscal policy will yield a more balanced policy mix and holds out the best hope of containing both interest and exchange rates and restraining the growth of domestic demand whilst sustaining business confidence and supply potential. I am sure that such an approach is in the best long term interests of business.

dti

the department for Enterprise

In addition to commenting on personal savings, my suggestions for the Budget are primarily cost-effective measures designed to improve the supply responsiveness of the economy while adding little or nothing to domestic demand.

In my view measures to encourage an increase in personal sector savings could have an important influence on industrial performance. The sharp drop in the personal sector saving ratio means that personal sector savings in relation to income are at very low levels. Of course, given the state of the national accounts it is very difficult to be at all certain about how far the ratio has fallen, but it is certainly true that savings have been much lower than expected and conversely that consumption has been much higher than expected. This has been a key factor in explaining the much faster than anticipated growth in domestic demand which, in turn, has led to a build up of inflationary pressures and the sharp deterioration in the current account. The necessary response has been a tightening of monetary policy with higher interest rates and stronger sterling. A higher level of personal saving would produce a better and more sustainable relationship between demand and output in the economy, thus easing inflationary pressures and allowing a reduction in interest rates.

It is impossible to be certain why the savings ratio has slumped so far: lower inflation, improved consumer confidence, rising employment, pensions, holidays and the increased wealth (particularly stemming from the increased value of the housing stock) are all important. Some of these factors are cyclical and likely to be reversed as the economy slows and most commentators expect the savings ratio to increase in the next year or so. But any further measures to increase household savings would be welcome and should allow the same level of economic growth with a lower level of interest rates.

You have already announced your intention of introducing a new National Savings instrument in the new year. But national savings constitute only one small component of savings. I note that the Treasury have recently invited suggestions on ways of making Personal Equity Plans more popular. A "Savers Budget" would be a prudent use of a small part of the large fiscal surplus likely next year. Thus consistent with my letter of 1 December on taxation of personal savings and life insurance I would strongly support more general tax encouragement of savings.

TRAINING

I remain very concerned about the low level of vocational training in this country by comparison with our main competitors. A number of improvements have been made in publicly funded training schemes, and Norman Fowler is proposing improvements in the delivery mechanisms. But the fiscal environment must have a strong influence on the amount and quality of training undertaken in the private sector. When training is financed by the employer, our tax treatment is as favourable as that in most other countries. But there is one improvement I should like to suggest. Where an employer pays for a training course for his employee, the employee sometimes has to meet some incidental expenditure himself, the latter cannot be set off against the employee's tax liability.

An extrastatutory concession allows the employee to claim a deduction where the course is a full time one of at least four weeks' duration. But it would be helpful if this provision were given statutory force, and if its scope could be widened to cover all courses where the cost of the training itself is met by the employer. This would be in line with the general trend towards more varied and flexible training modes, including open and distance learning.

I turn now to training financed by the individual. I supported last year a proposal by Kenneth Baker that expenditure by members of professional institutions on continuing professional development should be allowable against tax; and myself proposed that an individual's expenditure on his own management education should be allowable, with a facility to carry forward unused relief to set off against future income. I still consider that these two changes would give good value in stimulating additional high quality training. But they would still leave our tax treatment of training financed by the individual less generous than that in any other European country. I know that concessions in this area are not easy, because they are open to abuse by people claiming relief for courses with no real vocational function. This might be overcome by limiting relief to courses taken in pursuit of approved qualifications; or by limiting the amount any individual could claim by way of tax relief for his expenditure on training.

COLLABORATIVE R&D

When I wrote to you a year ago about the 1988 Budget, I proposed the extension to consortia set up to undertake collaborative R&D the tax treatment enjoyed by trading consortia - notably the ability to set off initial losses against profits achieved by consortium members on their other business. This would be achieved, (subject to appropriate safeguards, already discussed between officials) by deeming R&D to be a trading activity for the purposes of consortium relief. My predecessors had also urged the merits of this suggestion, and I remain convinced of its value. It is not primarily an incentive to firms to carry out more R&D. Rather, it removes a feature of the tax system which discriminates in favour of "in house" R&D by big companies, and against collaborative R&D. The change would therefore support the new direction my Department's innovation policy is seeking to encourage. It would also have the following advantages:

a) it would encourage two or more companies to set up joint subsidiaries to undertake R&D which was too risky, or too demanding in resources, for them individually;

b) companies would be encouraged to "spin out" R&D projects peripheral to their main activity into separate companies in which others could have an equity stake. At present, such projects too often remain "on the shelf";

c) financial institutions would be enabled to invest in an R&D company on the same basis as they can invest in a trading company; and

d) there would be a convenient new vehicle for collaborative research, not only between companies, but between companies and education institutions.

The cost would depend on take up, but is most unlikely to be significant. I hope that you will examine the case for the proposal seriously.

COMPANY CARS

In your last Budget, you increased sharply the car benefit scales, and indicated that you intended to make further increases in real terms. I accept the case in logic for greater neutrality between the taxation of company cars and other forms of remuneration. But I am concerned about the impact. The effect of higher benefit scales will be felt most sharply by middle management in the private sector, on salaries somewhat below the threshold for higher rate tax. This group has benefited rather modestly from our tax cuts, and higher mortgage interest rates have hit them hard. I do wonder if this is the right time to increase the tax burden on their company cars, particularly if there are few if any cuts in general taxation to soften the blow.

If and when you do increase car benefit scales, I hope that you will take the opportunity to introduce full neutrality into the tax on company cars, by ending the limitation on the rate at which expenditure on so-called "expensive" cars is written down, and discontinuing the rule that input VAT on a company's purchases of cars cannot be offset against output VAT on the company's products and services. These restrictions impose both a tax and a significant regulatory burden on companies; and once the incentive for employers to give remuneration in the form of a company car rather than cash disappears, there will be no reason to treat cars differently from other business assets for tax purposes.

UNLEADED PETROL

You will be urged to increase the tax differential in favour of unleaded petrol, given the heightened concern about the environment and the very small number of retail outlets selling unleaded petrol even now. Hitherto, this Department has not favoured using the tax system to promote the use of unleaded petrol, since the majority of models sold by the Rover Group are difficult to convert to the use of unleaded petrol. But despite this, I now believe that it would be right to widen the tax differential in favour of unleaded petrol.

COMPANY PURCHASE OF OWN SHARES

Last year, I suggested a relaxation in the tax arrangements arrangements where a company, with the approval of its shareholders as required under the Companies Acts, purchases its own shares. At present, such purchases are treated for tax purposes as distributions, with a very limited exception confined to unquoted companies. I remain convinced that a company ought to be able, without tax penalty, to organise repurchases of its own shares where it feels that the market is undervaluing them. Simply to abandon the present treatment of purchase of own shares as a distribution could lead to avoidance if companies operated repeated small share purchase programmes instead of paying dividends. This could

dti

the department for Enterprise

be avoided if the only transactions exempted from Advance Corporation Tax were those carried out on the market through intermediaries. The requirement to obtain consent from the shareholders for any programme of company share purchases should remain, as should the law against wrongful manipulation of share prices.

STAMP DUTY ON SECURITIES TRANSACTIONS

You have reduced this duty successively from 2% to 0.5%. On each occasion, the result was an increase in the yield thanks to the expansion of the volume of trading. But since the October 1987 crash volume has fallen sharply. The International Stock Exchange is still handicapped on its competition with New York and Tokyo by being the only centre of the three where securities are subject to a transaction tax. Other EC Governments are considering ways in which they can increase the attractiveness of their own financial centres in the run up to 1992. (The recent Lebegue report on the French system of taxation of financial assets included a recommendation that the French abolish their stamp duty on stock exchange transactions.) I note that the Chairman of the Stock Exchange in his representations to you on the 1989 budget drew particular attention to the implications of 1992 in expressing concern over the continued imposition of stamp duty. London will face increasing competition for its role as the key financial centre in the European time zone. It would greatly help London to maintain and enhance her competitive position if stamp duty on securities was finally removed, and with it the 1.5% Stamp Duty Reserve Tax.

I have written to you separately about the Inland Revenue proposals for changes in the tax regime for individuals who are resident but not domiciled in the UK; about the tax treatment of all forms of personal saving, in the context of Inland Revenue proposals for a new tax regime for life insurance companies; and I am currently considering together with Kenneth Baker writing to you about the tax treatment of gifts to educational institutions.

I also have a number of more detailed proposals, which are set out in the memorandum enclosed with this letter.

I am copying this letter to the Prime Minister, to Norman Fowler and Kenneth Baker, and to Sir Robin Butler.

Love.

David

the Enterprise initiative

ANNEX

1 This Annex includes:

i) two more detailed tax points; and

ii) four deregulation points

I TAX POINTS

A CAPITAL GAINS AND LOSSES OF BUSINESSES

2 Private individuals are subject to separate Income Tax and Capital Gains Tax. Capital losses cannot be offset against income, nor can expenses be set off against capital gains. For companies, both trading profits and capital gains are subject to corporation tax, at a common rate; and trading losses of the same year (but not earlier years) can be offset against that year's capital gains. But capital losses may never be set off against trading profits.

3 This separation of profits and gains is a long-standing source of complaint from business who argue that the distinction between trading profits and capital gains is artificial in a business context, and can lead to harmful decisions. For example, a loss-making retailer may go out of business sooner than would be necessary if he could sell some valuable property and offset his losses against the resulting gain.

4 It is proposed that the limited degree of cross-offsetting already permitted for companies should be extended to unincorporated business. This would end a form of discrimination against unincorporated businesses; and the cost would not be heavy. There would be no need to draw new distinctions between the business and personal affairs of an unincorporated trader if the trading losses were allowable only against capital gains eligible for CGT rollover relief.

B ENTREPRENEURS SCHEME

5 The rapid growth of the venture capital industry in recent years has greatly improved the supply of equity finance for new businesses. The British Venture Capital Association (BVCA) now believe that the main constraint on further growth is not finance as such but the dearth of experienced managers willing to involve themselves in new companies with high growth potential. Paradoxically, the tax changes in the last Budget have not helped. The reduction in the higher rates of Income Tax, and the alignment of Capital Gains Tax rates with Income Tax, have reduced the attractions of the gains from successful participation in venture capital; and increased those of the salaries available in secure jobs in big companies.

6 At present, reliefs under the Business Expansion Scheme (BES) are not available to investors who are directly involved in

managing the company. The reasons are deadweight, and the risk of avoidance. The BVCA have put forward what is in effect a variant of BES for the managers and employees of unquoted companies. The initial investment would not be relieved of Income Tax (unlike the BES proper), but any gains on the disposal of shares would be exempt from Capital Gains Tax; the maximum qualifying investment in any year would be £120,000 (against £40,000 for the BES), but anyone claiming relief under this scheme would be debarred for up to three years from taking advantage of the BES proper. Most of the conditions for BES relief would also attach to the new scheme; but two would be relaxed. The rule against a change of ownership of the company during the qualifying period would not apply; neither would the condition that any subsidiaries must be at least 90% owned by the company receiving the investment.

7 The DTI cannot assess the technical feasibility of the BVCA proposal. But we urge that it be examined carefully; and that Treasury Ministers should give serious consideration to this, or other possible, fiscal incentives to experienced managers to participate in the launch of new unquoted companies.

II DEREGULATION POINTS

C VAT THRESHOLD SCHEME

8 EDU have been discussing with Customs and Excise ways of mitigating the effect on small traders of the way the VAT threshold is operated. At present traders have to register as soon as their turnover passes certain quarterly limits or if they expect their turnover to exceed the threshold in the following 12 months. The Customs have proposed the abolition of the quarterly turnover limits and the 12 months forward look; traders would register only when their turnover actually passed the registration threshold. Under this proposal traders would be able to benefit by having up to 12 or 13 months tax-free trading if they wished. Traders who found it advantageous to register straight away would still be able to do so. The cost of this has been estimated at £80-100m per annum. The DTI support the prompt implementation of this proposal.

D VAT REVIEWS

a) <u>Bad Debt Relief</u>

9 VAT is accounted for on the basis of invoice sales rather than cash receipts (unless the business has a turnover under £250,000 and can opt for cash accounting in which case see Item E). Relief in respect of VAT on debts which turn out to be bad is only available if the customer becomes formally insolvent. A form has to be signed and stamped by the Official Receiver acknowledging the claim before any relief can be granted. In contrast the Inland Revenue allows bad debt relief for income tax and corporation tax by reference to standard accountancy practice for the type of business involved. The Inland Revenue's approach is practical and realistic. The DTI suggest that Customs & Excise should introduce a similar system.

D) Default Surcharge

10 Where two VAT returns from the same trader have been received late by Customs & Excise in a 12 month period he becomes liable to the penalty regime. Any further late VAT return in the following 12 months triggers a default surcharge of 5% of the VAT payable on that return. For any subsequent late return the surcharge increases in steps of 5% up to a maximum of 30%. There has to be a system to deter habitual late payers. But the rate of the surcharge particularly at the maximum level gives cause for concern. As long as the "offence" is simply one of late payment, without any evidence of intent to defraud, it would be sufficient to set the level of the maximum surcharge so that it is approximately equivalent to a commercial rate of interest.

11 At the initiative of EDU, both the above systems are presently being reviewed by Customs & Excise. DTI hope that any proposals for change flowing from these reviews be included in the 1989 Finance Bill.

E VAT CASH ACCOUNTING

12 The 1987 Budget introduced a new scheme to simplify VAT for small traders. Businesses with turnover of up to £250,000 have the option of accounting for VAT on the basis of cash receipts and payments rather than invoiced sales and expenditure. This means that small businesses need not have to pay VAT on unpaid sales invoices.

13 The new scheme has not had as good a level of take up as had been hoped and Customs and Excise are to review it at the end of this year.

14 DTI hope that if the review identifies a need for legislative changes these will be included in the 1989 Budget.

F FREE STANDING ADDITIONAL VOLUNTARY CONTRIBUTIONS (FSAVCs)

15 Members of occupational pension schemes may top up their pension entitlement under the scheme by making FSAVCs, provided that their pension provision as a whole does not exceed the Revenue limits for tax relief.

16 The arrangements needed to police these limits place a burden both on the pension provider who must confirm that total contributions do not exceed 15% of salary; and the employer, who must certify that total pension benefits do not exceed two thirds of final salary. The Inland Revenue do not think it practicable to transfer to the individual pensioner responsibility for ensuring that the limits are not exceeded; but the Financial Secretary has promised to review procedures to see if the burden of compliance can be reduced. The DTI hope that this review can be completed soon, and any resulting changes implemented as quickly as possible.

Department of Trade and Industry
November 1988

DAS.

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

31 October 1988

Dear Rod,

NATIONAL INSURANCE CONTRIBUTIONS RERATING 1989-90

Thank you for your letters of 28 and 31 October. The Prime Minister was grateful for the details of the outcome of the annual review of national insurance contributions.

I am copying this letter to Alex Allan (HM Treasury), Andy McKeon (Department of Health) and Martin Donnelly (Northern Ireland Office).

Yours,
Paul

PAUL GRAY

Rod Clark, Esq.
Department of Social Security

DEPARTMENT OF HEALTH AND SOCIAL SECURITY
Richmond House, 79 Whitehall, London SW1A 2NS
Telephone 01-210 3000

From the Secretary of State for Social ~~*Services*~~ Security

CC PU

Paul Gray Esq
Private Secretary
10 Downing Street
LONDON
SW1A

31 October 1988

Dear Paul

NATIONAL INSURANCE CONTRIBUTIONS RERATING 1989-90

I regret that a line slipped out of my attached letter of 28 October, the third sentence of which should have read:

> "No change is proposed to the main NIC rates, but some flat rates will go up in line with the normal rerating of earnings limits."

I apologise for any confusion this may have caused.

A copy of this letter goes to Alex Allan (Treasury), Andy McKeon (Health) and Martin Donnelly (Northern Ireland).

Yours sincerely

Rod Clark

ROD CLARK
Private Secretary

DEPARTMENT OF HEALTH AND SOCIAL SECURITY
Richmond House, 79 Whitehall, London SW1A 2NS
Telephone 01-210 3000

From the Secretary of State for Social ~~Services~~ Security

CONFIDENTIAL

Prime Minister 2
Simply confirms that the Chancellor has already told you.
PRCG 28/10

Paul Gray Esq
Private Secretary
10 Downing Street
LONDON
SW1A

28 October 1988

Dear Paul

NATIONAL INSURANCE CONTRIBUTIONS RERATING 1989-90

My Secretary of State has now conducted the annual review of National Insurance contributions, and the proposals, which will come into effect from April 1989, are summarised in the attached table. The Chancellor will refer to the proposals in his oral Autumn Statement, and a written PQ will be answered on the same day. No change is proposed to the main rerating of earnings limits. With one exception all the changes will be implemented by secondary legislation; the abolition of the Treasury Supplement to the National Insurance Fund will be effected by the next session's Social Security Bill. The supplement, which is a contribution from the taxpayer to the National Insurance Fund, has been steadily cut since 1981. The Fund, which pays for contributory benefits, has substantial resources from contributions, and the supplement is no longer required.

I am copying this letter to Alex Allan (Treasury), Andy McKeon (Health) and Martin Donnelly (Northern Ireland).

Yours sincerely

Rod Clark

ROD CLARK
Private Secretary

CONFIDENTIAL

NATIONAL INSURANCE CONTRIBUTIONS RERATING 1989-90

CLASS 1 EMPLOYED EARNERS CONTRIBUTIONS

Rate		Present Band (weekly earnings)	Proposed Band for 1989-90 (weekly earnings)
Employees	Employers		
5%	5%	£ 41 (LEL) to £ 69.99	£ 43 (LEL) to £ 74.99
7%	7%	£ 70 to £104.99	£ 75 to £114.99
9%	9%	£105 to £154.99	£115 to £164.99
9%	10.45%	£155 to £305 (UEL)	£165 to £325 UEL
9% to UEL	10.45%	Above £305 (UEL)	Above £325 UEL

	Present	Proposed
Class 2 (Self employed)	£4.05 a week	£4.25 a week
Small earnings exception level (annual)	£2250	£2350
Class 3 (voluntary)	£3.95 a week	£4.15 a week
Class 4:		
Lower profits limit (annual)	£4750	£5050
Upper profits limit (annual)	£15860	£16900
Rate	6.3%	6.3%
NHS allocation (Class 1 Contributions)		
Employees	0.95%	1.05%
Employers	0.80%	0.90%
Treasury Supplement	5% (of gross contributions)	Nil (to be abolished)

CONFIDENTIAL

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary 19 October 1988

DATE OF THE 1989 BUDGET

The Prime Minister has seen your letter to me dated 17 October, and is content for the Chancellor to plan on the basis of the 1989 Budget being on 14 March.

PAUL GRAY

Alex Allan, Esq.
H.M. Treasury

CONFIDENTIAL

chex.ps/mw/62 CONFIDENTIAL

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

17 October 1988

Prime Minister

You pressed the Chancellor on the possibility of a 7 March Budget. Content now to accept 14 March?

PRCG 18/10

P R C Gray Esq
10 Downing Street
LONDON
SW1

Dear Paul, Yes mt

DATE OF THE 1989 BUDGET

The Chancellor and Prime Minister discussed the date of the 1989 Budget at a bilateral a few weeks ago. The Chancellor has now considered the various possible dates and has concluded that 14 March is the date he should aim for. A later date would run into problems with Easter and an earlier date would mean that important economic data (such as the CSO's estimates of 1988 GDP and current account) would not be available in time to be taken account of in finalising the FSBR forecast. As you know, we normally announce the date in a suitable Parliamentary occasion soon after the House resumes after the Christmas Recess.

Yours
Alex

A C S ALLAN

1-2 CFI

CJG

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

5 April 1988

OVERSEAS PRESS REACTIONS TO THE BUDGET

The Prime Minister was most grateful for the anthology of overseas comments on the Budget (your letter of 31 March), which she commented was "marvellous".

I am copying this letter to Simon Judge (Paymaster General's Office).

Paul Gray

Alex Allan, Esq.,
HM Treasury.

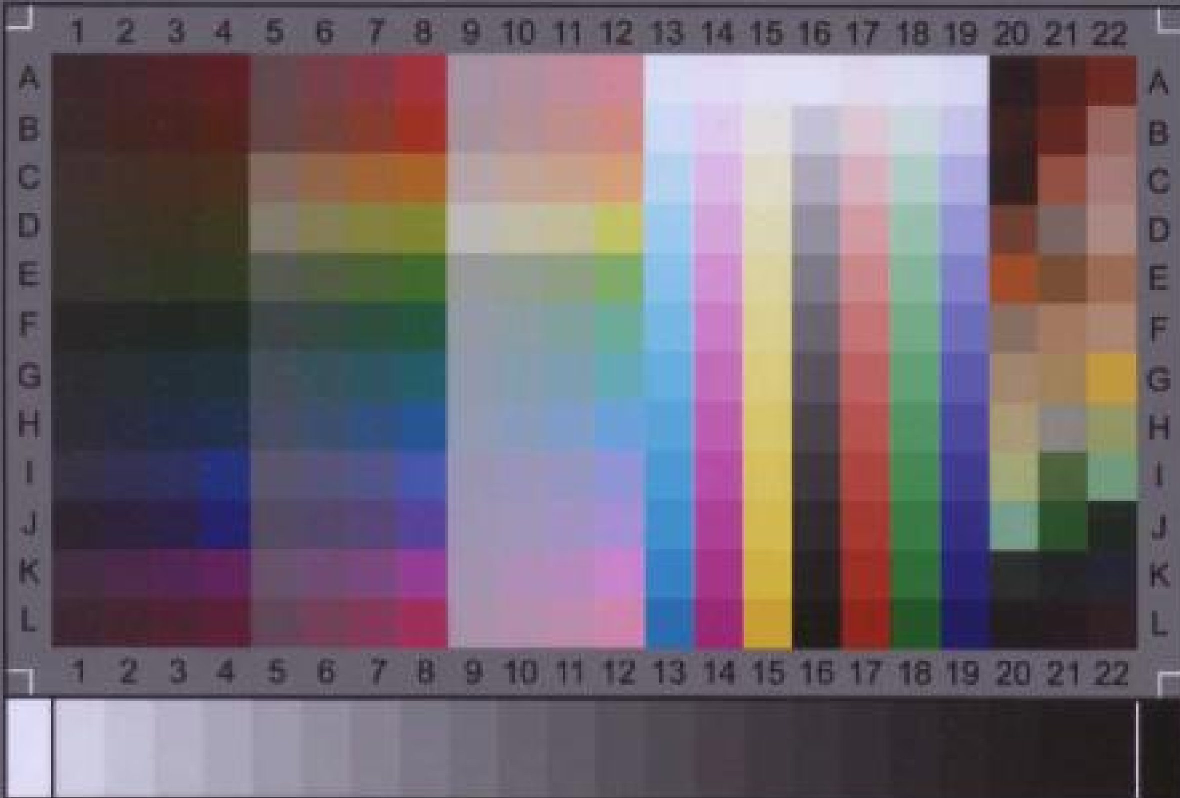
PW

PART 17. ends:-

HMT to PG. 31.3.88

PART 18 begins:-

PG to HMT. 5.4.88



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