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10 DOWNING STREET

From the Private Secretary

PRIME MINISTER

1988 BUDGET - Your Dinner AT NO. 11

The Treasury have given me, unofficially, the outline of the Chancellor's package. This note summarises the main elements and suggests some points to raise. But please do not reveal your advance knowledge!

A. INCOME TAX / NICs

There are two packages still in play:

- (a) Basic rate from 27% to 25% plus some changes to reduce NICs at the bottom of the earnings scale.
- (b) Basic rate from 27% to 24% with no changes on NICs.

Either of these would be coupled with a new single higher rate at either 40 or 45%.

Personal allowances would receive normal indexation. The threshold for the new high rate (40 or 45) would be increased sufficiently for there to be no losers and no-one paying a higher marginal rate.

The earlier idea of removing the upper earnings limit (UEL) for employees NICs seems to have been dropped - this removes the difficulty of a substantial number of losers in the band above the UEL where the NICs cost exceeds the income tax gain.

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Issues on Income Tax / NICs:

- ① Cost of the different elements?
- ② Are there any losers? What is the pattern of gainers across the income range?
- ③ Which of the ~~25% and 24%~~ 25% + NICs or 24% options does most for the poverty and unemployment traps + incentives to work? =

B. TAXATION OF MARRIED WOMEN

The Chancellor wants to go for a system of independent taxation, with effect from 1990/91. Key elements seem to be:

- (a) No transferability of allowances.
- (b) Married man's allowance to become "married couples" allowance, with provision for breadwinners wives rather than the husband to claim it when it suits couples to do so.
- (c) Otherwise husband and wife taxed independently e.g. for investment income

The main effects ^{advantages} seem to be: (plus single allowance for 2nd earner,

- (i) Married couples allowance (rather than 2 single allowances, avoids losers where both work and where only one works.
- (ii) No transferability avoids major costs.
- (iii) ~~Cost~~ There would be some costs eg where husband and wife can split investment income and avoid higher a rate. Any other costs? And how much?
- (iv) Change would avoid tax penalties on marriage, and provide a substantial measure of privacy to spouses in their tax affairs if they wish it.

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C. CAPITAL GAINS TAX

If he opts for the 40% higher rate of income tax the Chancellor may want to assimilate CGT with income tax, with ~~the~~ capital gains being taxed at the same rates (say 25/40). There is a reasonable supply side case for this e.g. to avoid transactions undertaken solely for tax reasons.

He may also want to re-base CGT on 1982 - i.e. write-off tax on gains between 1965 and 1982 - and provide for indexation from this new base point. But a write-off would be costly - you might ask the Chancellor how much and query whether this money would be better "spent" by keeping the overall fiscal stance tighter.

D. EXCISE DUTIES

An earlier preference for more than indexation seems to have receded in favour of straight indexation.

You may want to ~~argue~~^{probe} the case for more ~~than~~ indexation as one means of having a tighter fiscal stance. There is a short term RPI cost, but as long as the overall policy stance is tight it won't add to underlying inflationary pressure.

E. VAT

3 points:

- (i) The Chancellor wants to put VAT on newspapers and periodicals, but not learned journals or books. Yield is put at £200-300m. Key issue - is it worth the hassle?
- (ii) He may also want to VAT "chewy bars" but not sandwiches or filled rolls. Again is it worth it? And too clever by half given commitments on food?

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(iii) The EC Court judgment on non-domestic construction is not expected before the Budget, so the issue will not arise this year.

F. INHERITANCE TAX

Possible proposal for a flat rate of 40%, to replace the existing 30/40/50/60% bands, with the starting threshold raised enough to prevent any "losers" at the bottom end. A sensible complement to the higher rate of income tax change?

National home
to children - 40%
much too high

G. MORTGAGES

The Chancellor will not try to touch the £30,000 limit or eligibility to relief at both basic and higher rates. But he does want to light up on "home improvement loans", many of which equal effective tax relief on cars / kitchens etc. So he may propose:

- (i) Switch the £30,000 relief to a residence basis i.e. one relief per ^{principal} residence rather than per non-married borrower.
- (ii) Abolish relief on home improvements, ^{possibly} by giving relief only on the basis of initial purchasers of property.

My source is vague about how this would work. Questions include:

- (a) Is this seen as necessary to avoid all married couples getting double £30,000 allowances with the move to independent taxation?
- (b) Could the changes be in any way interpreted as conflicting with your commitments?
- (c) Could the new basis be poised e.g. won't people split houses into 2 residences?

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H. FRINGE BENEFITS

The Chancellor is considering a major change from 1990-91, shifting the taxation of benefits in kind from employees to employers. His main target is company cars where the present tax arrangements on average cover only about 1/4 of the benefit. He will want to accompany the change with a big increase in effective taxation of cars.

There seem good arguments both of policy and tax simplification for this sort of change. But it could be controversial. There could be a read-across to health.

I. CORPORATION TAX

As part of a package with fringe benefits, also from 1990-91, the Chancellor may also propose a 1-2% reduction in the CT rate - which would reduce it to or below the US rate of 34%. It's not clear to me there's a strong case for announcing such a commitment 2 years in advance.

J. COVENANTS AND MAINTENANCE

2 possible elements here:

(i) Restricting relief on covenants just to charities. Students would be compensated by a pro-rata adjustment in parental contribution scales (implying an offsetting public expenditure cost).

Key issues are:

- potential political sensitivity of any move on covenants.
- would there be any individual losers amongst students - eg parents getting higher rate relief?

(ii) Restricting relief on maintenance payments, by limiting the size of eligible payments to divorcees and restricting eligible

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payments for children to cases where children live with the claimant. Seems a reasonable proposition, but again is it worth the row?

K. OTHER

Minor items include tidying up administration of arrangements for Lloyds and extending Business Expansion Scheme relief for private business renting. Apparently no changes on stamp duty.

L. OVERALL COST

Total cost is put at £4-5 billion. I don't have a breakdown. But it looks to me as if an attractive and reduced package could be put together for, say, £2½-3 billion - eg more on excise duties, limit basic rate cut to 25%, no write-off for CGT - if you wanted to argue for more caution..

M. NEXT STEPS

You might press the Chancellor to authorise release of key papers to me, stressing they will not be circulated widely in No. 10.

RAC

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