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FROM: MRS R LOMAX
DATE: 17 March 1986

MR SCHOLAR

cc: Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr F E R Butler
Sir G Littler
Mr Anson
Mr Byatt
Mr Cassell
Mr Kemp
Mr Lavelle
Mr A Wilson
Mr Evans
Mr Monger
Mr Odling-Smee
Mr Culpin
Miss O'Mara
Miss Sinclair
Mr Pratt
Mr Dyer
Mr Cropper
Mr Lord
Mr H Davies

Sir L Airey - IR
Mr Battishill - IR
Mr Isaac - IR
PS/IR

Sir A Fraser - C&E
Mr Knox - C&E
PS/C&E

Mr Norgrove - No.10

Governor - B/E

Section B only
Mr Kelly

Sections D & H only
Mr Peretz

Section H only
Miss Noble

Sections C & J only

Mr Robson

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B.L.O.

BUDGET SPEECH - FINAL DRAFT

I attach a final draft of the Budget speech, reflecting the changes the Chancellor made over the weekend, in response to comments received by Friday 14 March.

2. I would be grateful if Mr Kelly would update the figures in Section B for changes in exchange rates since the Plaza agreement, in the light of today's closing prices; and if Mr Monger would consider (with PE) whether any changes need to be made to the references to petrol prices in Section J. Any other comments should reach this office as soon as possible, and no later than lunchtime today.

RL

RACHEL LOMAX

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1986 BUDGET SPEECH

Index

A. Introduction

The background to this year's Budget is the dramatic and unprecedented fall in the world oil price.

But the Government's objectives remain unchanged: the conquest of inflation and the creation of an enterprise culture.

And the Government's policies are unchanged, too: policies of sound money and free markets.

Not least, because these are the only routes to more jobs, and jobs that last.

So my Budget today will carry forward the themes of my two previous Budgets, and sow some seeds for the future.

In the course of my speech I shall begin by reviewing the general economic background to the Budget, and go on to deal with the specific issue of oil.

I shall next discuss monetary policy and the fiscal prospect, both this year and next.

I shall then turn to the question of direct help for the unemployed.

Finally, I shall propose some changes in taxation designed to assist in achieving the economic objectives I have already outlined.

As usual, 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. The Economic Background

I start with the economic background.

The strength and durability of the current economic upswing continues to confound the commentators.

We can now look back to very nearly five years of growth at around 3 per cent a year.

Even more important, 1985 was the third successive year in which we secured the elusive combination of steady growth and low inflation - the first time this has been achieved since the 'sixties.

In 1985 as a whole, output grew by a further 3½ per cent, the highest rate of growth in the European Community, and higher than the United States, too.

Within that total non-oil exports grew by 7 per cent, to reach yet another all-time record.

Despite a marked slowdown in the growth of world trade from the heady pace of 1984, the current account of the balance of payments was in surplus for the sixth year in succession - this time by some £3 billion.

Inflation ended the year at around 5½ per cent and falling.

Employment continued to rise, though still not fast enough to reduce the distressingly high number of people out of work.

I shall have more to say about unemployment later.

Manufacturing industry, the subject of so much ill-informed comment, had another successful year, with its output up by 3 per cent, its productivity up by almost 4 per cent, and both its investment and its exports up by 6 per cent.

At the heart of this success lies a remarkable turn-around in productivity.

In the six years prior to 1979, Britain's annual rate of growth of manufacturing productivity, at less than 1 per cent, was the lowest of all the Group of Five major industrial nations.

In the six years since 1979, our annual rate of growth of manufacturing productivity, at 3½ per cent, has been second only to that of Japan.

Looking ahead, I expect 1986 to be a further year of steady growth with low inflation.

Indeed, with output forecast to rise by 3 per cent, and inflation to fall to 3½ per cent, 1986 is set to register our best overall performance in terms of output and inflation for a generation.

The pattern of growth should show a satisfactory balance, too, with exports and investment expected to grow rather faster than consumer spending - as indeed they have during the sustained upswing as a whole.

But the uncertainties inherent in all these forecasts, good though their track record has been, are reinforced by constant reminders that we live in an uncertain and turbulent world.

One particularly difficult aspect of this is the febrile nature of the world currency markets.

There has been some improvement here.

The Plaza Agreement between the Group of Five Finance Ministers last September has undoubtedly led to a more sustainable pattern of exchange rates worldwide.

Since that meeting, the dollar has fallen by some (15) per cent against the other major currencies as a whole, with the pound moving up by (7) per cent, the Deutschemark by (25) per cent and the Yen by (32) per cent - a pattern broadly in line with what those of us who were party to the agreement had hoped to see.

This process will be assisted further if the passage of the Gramm-Rudman amendment succeeds in securing its objective of a much-needed reduction in the United States budget deficit.

Meanwhile, the Plaza Agreement has already succeeded in reducing, at least for the time being, the dangerous protectionist pressures that were building up in the United States.

Provided we are not over-ambitious, I believe that the Plaza accord is something we can usefully build on.

But the most dramatic development on the world economic scene, and one of considerable importance to this country, has of course been the collapse in the price of oil.

C. Oil

I presented my Budget last year at the end of a 12-month coal strike.

I observed at the time that it was a remarkable tribute to the underlying strength of the British economy that it had been able to withstand so long and damaging a strike in such good shape.

We now have to face a challenge of a very different kind.

Over the past few months the price of oil has almost halved, and with it our prospective North Sea oil tax revenues and earnings from oil exports.

In real terms, the price is now back to what it was before the first oil shock in 1973.

Not surprisingly, perhaps, this initially caused a fair amount of turmoil in the financial markets with sterling under pressure.

I decided that it was right to respond with an immediate one per cent rise in short term interest rates in early January, and this helped to prevent the downward movement of the exchange rate from developing an unhealthy momentum of its own.

But equally I thought it right to resist the pressure, which for a time was very strong indeed, to raise interest rates still further.

OPEC out.

Meanwhile, let me repeat that there is no question whatever, and never has been any question, of the UK cutting back its oil production in an attempt to secure a higher oil price.

In the first place, the whole outstanding success of the North Sea has been based on the fact that it is the freest oil province in the world, in which decisions on levels of output are a matter for the companies and not for the Government.

And in the second place, we are not only, or even principally, a major oil producer; we are also a major world producer and trader of other goods and services, and a major oil consumer.

There is no overall UK national interest in keeping oil prices high.

I am of course aware that a Report, recently published in another place, and which attracted a certain amount of publicity at the time, predicted that

> "as the oil revenues diminish the country will experience adverse effects which will worsen with time"

- effects of a most alarming nature.

Had the authors of that Report dreamed at the time that half the oil revenues were about to disappear within a matter of months, their conclusions would no doubt have been even more apocalyptic.

As the House knows, I have always believed their analysis, which was widely shared by Rt hon and hon Members opposite, to be profoundly mistaken.

But certainly it is going to be put to the test sooner than anyone expected.

The United Kingdom is likely to remain an oil producer, of a gradually diminishing volume of oil, for the next 25 years or so.

If we can survive unscathed the loss of half our North Sea oil revenues in less than 25 weeks, then the prospective loss of the other half over the remainder of the next 25 years should not cause us undue concern.

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It is, of course, true that in relative terms we do lose from the collapse of the oil price.

That is to say, the really big gains will be made by the major non-oil-producing countries such as Germany and Japan, where growth will be boosted and inflation, already low, is likely to fall virtually to zero.

But the oil price fall will be beneficial for the industrialised world as a whole, and even for the United Kingdom what we gain on the swings should, over time, more than offset what we lose on the roundabouts.

In particular, I expect that the levels of economic activity and inflation will if anything be slightly better than they would have been without the oil price collapse.

And what of the balance of payments?

Thanks to the abolition of exchange control in 1979, we have been able to use a good part of our earnings from North Sea oil since then to build up a massive stock of overseas assets.

Our net overseas assets have in fact risen more than sevenfold from £12 billion at the end of 1979 to almost £90 billion at the end of last year.

This is a far bigger total than that possessed by any other major nation, with the perhaps inevitable exception of Japan.

The earnings from those assets will be of increasing value to our balance of payments in the years ahead.

So, too, should the improvement in our manufacturing trade balance.

For while the British economy may not gain a great deal overall as a result of the oil price collapse, there will be considerable differences <u>within</u> the economy.

No mention of gains and losers.

The major potential beneficiary will be the internationally traded sector of industry ~~in general~~, and manufacturing in particular, which is already enjoying both cheaper energy and a lower exchange rate against most of its major competitors, at a time when inflation is falling.

This provides British industry with an outstanding opportunity both to increase its exports and to reduce import penetration in the home market.

But it will only be able to seize that opportunity if it meets two conditions.

First, it must keep firmer control of its labour costs.

Second, it must spend more of its much healthier level of profits on investing for the future in Research and Development and in training.

Both the opportunity, and the responsibility to see that it is not thrown away, rest fairly and squarely on the shoulders of British management.

Meanwhile, despite the massive fall in oil prices, I expect the current account of the balance of payments to remain in sizeable surplus this year, by some £3½ billion.

As I have indicated, there will be pluses and minuses within the economy.

If industry is the main gainer, the main loser, at least today, is the Chancellor of the Exchequer.

I can live with that.

But it does mean that North Sea oil revenues, which are likely to amount to some £11½ billion for 1985-86, are bound to be very much less in 1986-87.

Indeed, on the assumption of an average North Sea oil price of for the rest of this year $15 a barrel, which is close to the average for the past month of around $16 a barrel, oil revenues in 1986-87 will be virtually halved at some £6 billion.

This has obvious implications for the Budget.

But the important fact is that, just as we successfully weathered a year long coal strike, so we have been able to take the unprecedented collapse in the oil price in our stride.

We have been able to do so, first, because of the underlying strength of the economy in terms of growth, inflation and the external account.

And, second, by virtue of the reputation we have earned over seven years for sound and prudent financial management.

D. Monetary Policy

The framework within which that sound and prudent financial management has been pursued, and will continue to be pursued, is the Government's Medium Term Financial Strategy.

At the heart of the MTFS lies the objective of steadily reducing the growth of total spending power in the economy, as measured by GDP in cash terms, at a pace that will gradually squeeze inflation out of the system while at the same time leaving adequate room for sustained growth in real output.

That we have done.

Over the past six years the rate of growth of money GDP has been halved.

And this has brought about a combination of low inflation and steady growth.

We shall continue to maintain steady downward pressure on inflation.

That means above all controlling the growth of money in the economy.

Last year I set target ranges of 3 to 7 per cent for narrow money, MO, and 5 to 9 per cent for broad money, £M3.

During 1985-86 the targeted measure of narrow money has grown towards the bottom end of its range.

The target range for next year will be 2-6 per cent, as foreshadowed in last year's MTFS.

For broad money it has been clear since the autumn that the range was set too low.

Throughout the 1980s - and in sharp contrast to the 1970s - broad money has grown far faster than money GDP.

Experience has demonstrated that this has not posed a threat to inflation.

This rapid growth largely reflects the increased attractions of holding interest bearing deposits, at a time both of low inflation and high real interest rates, and of innovation and liberalisation in the financial system.

Accordingly, I am setting next year's target range for broad money well above that indicated in last year's MTFS, at 11-15 per cent.

Given the experience of the past six years, I believe this is not only a more realistic range, but one which is wholly consistent with the further decline in inflation I intend to achieve.

Short term interest rates are the essential instrument of monetary policy.

Changes in interest rates have a reasonably quick and direct effect on narrow money, as they do on the exchange rate.

Their effect on broad money is more complex and much more delayed.

As explained in the Red Book, there is thus an important difference in the operational significance of the targets for narrow and broad money.

Needless to say, I shall continue to monitor the evidence of other financial indicators, of which the most important is the exchange rate.

I will say no more about monetary policy today.

Except to repeat what I said at the Mansion House last Autumn: that while financial liberalisation and innovation have inevitably made the process of monetary management more complicated, there has been no change whatever in the essence of policy.

The Government continues to attach the highest priority to sound money.

E. Public Sector Borrowing

Though there is nothing sacrosanct about the precise mix, monetary policy must always be supported by an appropriate fiscal policy. That means, in plain English, keeping public [sector] borrowing low.

? Government

The outturn for the public sector borrowing requirement in 1984-85, which had to bear the bulk of the cost of resisting the coal strike, was £10 billion, or just over 3 per cent of GDP.

In my Budget last year I planned to reduce it substantially in 1985-86, to £7 billion, or 2 per cent of GDP.

In the event, despite the loss of £2 billion of North Sea oil revenue, this year's PSBR looks like turning out at a little under £7 billion, given that the total for the first eleven months comes to under £3 billion.

This successful outcome, which represents the most substantial reduction in the PSBR as a proportion of GDP since 1981-82, is attributable to two factors.

First, public expenditure has been kept under firm control.

Not only is the outturn likely to be within the planning total, but spending in 1985-86 is expected to be below the previous year's level in real terms, even after allowing for the effects of the coal strike.

And the second factor behind the successful PSBR outturn for 1985-86 is that the £2 billion shortfall in oil revenues has been offset by the increased buoyancy of non-oil revenues, reflecting a healthy economy and an increasingly profitable corporate sector.

Last year's MTFS indicated a PSBR for 1986-87 of £7½ billion, or 2 per cent of GDP.

Some would argue that, in the light of the £2½ billion increase in projected privatisation proceeds, I ought to aim well below that.

Others would claim that, since the sharp drop envisaged in oil revenues is more than double the rise in privatisation proceeds, a higher figure would be appropriate.

As last year, my judgement is that the wisest course is to stick broadly to our pre-announced figure.

But given the uncertainties over the oil price, I have decided, within that framework, to err on the side of caution, and provide for a PSBR of £7 billion, or 1¾ per cent of GDP.

Needless to say, this does not enable me to reduce taxation by anything like the £3½ billion foreshadowed in last year's MTFS.

Indeed, given the assumed loss of more than £5 billion of oil revenues in 1986-87, compared with what was envisaged a year ago, I would have expected to have had to increase taxes in this year's Budget.

However, not only have the tax revenues this year from the 95 per cent of the economy that is not oil proved to be notably buoyant, but there is every sign that this will continue into 1986-87, assisted by a rather higher rate of economic growth than was foreseen in last year's MTFS.

This continued vigour of the non-North Sea economy, which is likely to add more than £3 billion to expected non-North Sea tax revenues, coupled with public spending which remains under firm control, has transformed what might have been a bleak prospect.

As a result, I am able this year to accommodate a relatively modest net reduction in the burden of taxation, of a shade under £1 billion.

F. Help for the unemployed

I turn now to the continuing problem of high unemployment.

It is a problem that can be solved - and there is no secret about how.

The solution to the problem of unemployment - and it is the only solution - requires progress on two key fronts.

The first is a sustained improvement in the performance of business and industry, and thus of the economy as a whole.

That is what every aspect of the Government's economic policy has been designed to assist, and it is already achieving impressive results.

The second is a level of pay which enables workers to be priced into jobs instead of pricing them out of jobs, and which in particular ensures that British industry can hold its own against our major industrial competitors.

It is here that Britain's weakness lies.

For the plain fact is that labour costs per unit of output in British business and industry continue to rise faster than is consistent with low unemployment and faster than our principal competitors overseas.

Productivity is, indeed, rising quite rapidly.

But pay is rising faster still.

It is this - and not our alleged dependence on oil - that constitutes the Achilles heel of the British economy.

And in a free economy - as the CBI has frankly and commendably acknowledged - it is the responsibility of employers and management to control industry's cost structure in general and its wage costs in particular.

In the new and improved climate of industrial relations, and with inflation falling and set to fall further, there can be no excuse for failure to discharge that responsibility.

I have, however, considered whether there is anything further Government can do to assist this over the longer term.

The problem we face in this country is not just the level of pay in relation to productivity, but also the rigidity of the pay system.

If the only element of flexibility is in the numbers of people employed, then redundancies are inevitably more likely to occur.

One way out of this might be to move to a system in which a significant proportion of an employee's remuneration depends directly on the company's profitability per person employed.

Coal
Leyland
Public sector
Steel?

But this doesn't wash.

This would not only give the workforce a more direct personal interest in their company's success, as existing employee share schemes do.

It would also mean that, when business is slack, companies would be under less pressure to lay men off; and (by the same token) they would in general be keener to take them on. ~~on than if pay costs were fixed, irrespective of company profitability.~~

? bankruptcy ?

This would clearly be in industry's own interest, and most emphatically in the best interests of the unemployed.

It should therefore occur without any prompting from government.

But there is considerable inertia to overcome.

So it might make sense to offer some temporary measure of tax relief to the employees concerned to help get profit sharing agreements of the right kind off the ground, and to secure the benefits that would undoubtedly accrue if they really caught on.

Inevitably, the design of such a relief, and the precise definition of qualifying agreements, would need to be drawn with considerable care. ~~would be matters of some complexity.~~

The Government therefore propose to discuss with employers and others to see if a workable scheme can be defined which offers the prospect of a worthwhile and broadly-based take up.

~~[illegible]~~ and No mention of next year's Finance Bill.

If these preliminary discussions are sufficiently encouraging, we would prepare a consultative document setting out a detailed scheme for wider consideration.

Meanwhile, there is more we can do of an immediate nature to help the unemployed.

In my Budget last year I announced the Government's intention to launch a new two-year Youth Training Scheme, leading to recognised vocational qualifications.

The new and expanded YTS will duly come into operation next month. It will be a giant step towards our objective of ensuring that no youngster under the age of 18 need be unemployed.

I also announced in last year's Budget a substantial expansion of the Community Programme to help the long-term unemployed - those who have been out of work for over a year, or, in the case of those between 18 and 24, for more than six months.

The Community Programme, which offers work for up to a year on projects of benefit to the community, is currently providing almost 200,000 places.

I have agreed with my Rt. Hon. and Noble Friend the Secretary of State for Employment to provide the funds to raise the eventual target for this year to 255,000 places - very nearly double the number that existed a year ago.

At the same time, the average wage limit for the Community Programme will be raised to £67 a week from next month.

Last November my Rt. Hon. and Noble Friend announced two pilot schemes to provide further help for the long-term unemployed. These new initiatives, which began in January, are a counselling scheme open to all the long-term unemployed in the pilot areas, and a Jobstart allowance of £20 a week for six months for those long-term unemployed who take a job at less than £80 a week.

The pilot schemes are already proving effective, and I have accordingly decided to provide the funds to develop them into a single programme covering the entire country.

This means that every single one of the long-term unemployed throughout the land will be called for an interview and offered help in finding a job.

I shall also be providing the resources to launch a brand new scheme - the New Workers Scheme - to help 18-20 year olds to find a job.

This will provide for a payment of £15 a week for a year to any employer taking on an 18 or 19 year old at up to £55 a week or a 20 year old at up to £65 a week.

The New Workers Scheme should provide a worthwhile incentive for employers to create jobs for young people.

Finally, I have agreed to a substantial enlargement of the proven and highly successful Enterprise Allowance Scheme, which makes payments of £40 a week for up to a year to assist unemployed men and women to set up in business on their own account.

Funds will be provided that will enable the annual rate of entry to the Enterprise Allowance Scheme to be increased from its present figure of 65,000 to 100,000 by April 1987, and to provide more training for those involved.

At the same time I propose to improve the tax treatment of payments made under this scheme.

The total public expenditure cost of the measures I have outlined, together with consequential spending in Northern Ireland, comes to £195 million in 1986-87 and £290 million in 1987-88.

£200m

These gross costs will, however be partly offset by savings on social security benefits, leaving a net public expenditure cost of £100 million in 1986-87 and £165 million in 1987-88.

This will be financed from the Reserve, and there will therefore be no overall addition to planned public spending.

G. Business and Enterprise

I now turn to the taxation of business and enterprise.

While the measures I have just announced help the unemployed directly, in the long run what really matters is the creation of a climate in which business and industry flourish.

For it is companies, not Governments,which create jobs.

The reformed system of business taxation which I introduced in my 1984 Budget has reached the end of its transitional phase and comes fully into force next month.

From then on the United Kingdom will have, at 35 per cent, the lowest rate of Corporation Tax of any major industrial nation.

This year I have only two further amendments to make.

First, I propose to ensure a full measure of depreciation for tax purposes for short life agricultural buildings and works, by giving the taxpayer the option of making balancing adjustments on the sale or destruction of such buildings.

Second, I propose to reform the mines and oil wells allowances broadly along the lines of the proposals published in last July's consultative document.

The overall net benefit of this to the industries concerned will amount to £45 million in 1987-88.

Otherwise I propose only minor technical changes to the taxation of North Sea oil; but I am continuing to keep the economics of incremental investment under review, and shall not hesitate to introduce at the earliest opportunity any changes which may prove necessary to ensure that worthwhile projects are not frustrated by the fiscal regime.

I need to set the 1987-88 car and fuel benefit scale charges for those with company cars.

At the same time the motor industry has represented to me that the discrepancy between the engine size break points in these scales and the break points in the new European Community directive on car exhaust emissions is potentially damaging to its international competitiveness.

Accordingly I propose, from April 1987, to change our break points to those in the new directive.

At the same time, as last year, I propose to increase the (restructured) car benefit scale charges by 10 per cent.

This will still leave the scale charges well short of the true value of the benefit.

The fuel scale will also be restructured, but there will be no general increase in the charges; and as from April 1987 the same scale will also be used to assess the VAT due on petrol used by registered traders and their employees.

This will be simpler and more equitable than the present system, and will also bring in an extra £40 million of revenue in 1987-88.

I propose to increase the VAT threshold to £20,500, in line with the maximum permitted under existing European Community law.

I also propose to correct an anomaly in the taxation of international entertainers and sportsmen.

When British entertainers or sportsmen work overseas, the foreign tax authorities normally levy a withholding tax on their earnings.

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But at the present time we levy no such tax on the earnings of foreign entertainers and sportsmen when they work in the United Kingdom.

I believe that, in future, we should fall into line with most of the rest of the world.

Accordingly, I propose to withhold tax at the basic rate on the earnings of overseas entertainers and sportsmen in the UK. This should yield £75 million in 1987-88.

A key element in the Government's strategy for jobs is the encouragement of new businesses.

As the House knows, I have been reviewing the future of the Business Expansion Scheme, which is due to come to an end in April 1987.

I have been assisted in this review by the independent report commissioned by the Inland Revenue from the consultants Peat, Marwick, which is being published in full today.

I am placing a copy in the Library of the House.

It is quite clear - and this is confirmed by the evidence in the Peat Marwick report - that the Business Expansion Scheme, which my predecessor introduced in 1983 as an improvement on the 1981 Business Start-up Scheme, has been an outstanding success.

It has fully achieved its aim of attracting new equity capital into unquoted companies.

The amount subscribed has been running at well over £100 million a year, and steadily rising; and a high proportion of this has gone into new and small businesses.

Roughly half the companies involved raised sums of less than £50,000 each.

I therefore have no hesitation in proposing to extend the life of the Business Expansion Scheme, which is due to expire next year, indefinitely.

But at the same time, despite the exclusions of farmland and property development in my two previous Budgets, I am concerned that too much BES money is being diverted from the high risk areas for which the scheme was always intended into areas where the risk is very much less.

Accordingly, I propose, from now on, to exclude from the scheme all companies holding more than half their net assets in the form of land and buildings.

I also propose to exclude companies whose main purpose is to invest in objects, such as fine wines, whose value may be expected to rise over time.

At the same time, I have one new inclusion to announce.

I have decided to bring within the scope of the BES companies engaged in the chartering of UK-registered ships.

This will provide new opportunities for investment in shipping engaged in the coastal, short sea and offshore trades.

I propose to take power to make further changes in the ambit of the scheme by Order.

Finally, having taken steps to target the Business Expansion Scheme more carefully, I propose to improve it.

BES shares issued after today will be entirely free of Capital Gains Tax on their first sale.

And as a further measure of help for small and new businesses, the Loan Guarantee Scheme, under which the Government guarantees 70 per cent of qualifying bank loans, will also be extended, in this case for a further three years.

The House will be glad to learn that the premium will be halved from 5 per cent to 2½ per cent.

My last proposal in this section concerns Capital Transfer Tax, which ever since its introduction by the Labour Government in 1974 has been a thorn in the side of those owning and running family businesses, and as such has had a damaging effect on risk-taking and enterprise within a particularly important sector of the economy.

In addition to statutory indexation of the threshold and rate bands, I propose this year to reform the tax radically.

In essence, the Capital Transfer Tax is two taxes, as its two separate scales imply: an inheritance tax and a lifetime gifts tax.

We have had an inheritance tax in some shape or form ever since Sir William Harcourt reintroduced the Estate Duty in 1894.

But the lifetime gifts tax which the Labour Government introduced in 1974, in the teeth of united Conservative opposition, is an unwelcome and unwarranted impost.

By deterring lifetime giving, it has had the effect of locking in assets, particularly the ownership of family businesses, often to the detriment of the businesses concerned.

Accordingly, I propose to abolish entirely the tax on lifetime gifts to individuals.

As with the old Estate Duty, there will be a tapered charge on gifts made within seven years of death and provisions to charge gifts made with reservation; and the regime for trusts, which is needed as a protection for the death charge, will be kept broadly unchanged.

The cost of abolishing the tax on lifetime giving will be £35 million in 1986-87 and £55 million in 1987-88.

In recognition of the radically changed nature of the tax I have decided to rename it the Inheritance Tax.

My two previous Budgets abolished three unnecessary taxes.

The National Insurance Surcharge, the Investment Income Surcharge, and Development Land Tax.

The abolition of the tax on lifetime gifts adds a fourth.

H. Savings and Investment

I now turn to the taxation of savings and investment.

In my 1984 Budget I introduced a major reform of the taxation of savings and investment designed to improve the direction and quality of both.

Today I propose to carry this reform further forward.

The Social Security Bill now before Parliament proposes important and far-reaching changes in pension provision, notably by encouraging the growth of personal pensions.

Those changes - to which the Government attach the highest importance - have been warmly welcomed, both for the greater freedom they will give to existing pension scheme members and for the new scope they will offer to the millions of working people who are not in an occupational pension scheme.

In the light of these changes, I intend later this year to publish detailed proposals designed to give personal pensions the same favourable tax treatment as is currently enjoyed by retirement annuities.

Publication of these proposals will enable there to be the widest possible consultation prior to legislation in next year's Finance Bill.

Meanwhile, I can assure the House that, as I made clear last year, I have no plans to change that favourable tax treatment.

New insert

But I do need to deal with the growing problem of the rules governing pension fund surpluses.

The dramatic improvement in the financial climate compared with a decade ago, most notably as a result of the sharp fall in inflation, has seen a number of pension funds become heavily overfunded.

This presents a double problem, both aspects of which the Inland Revenue is at present having to deal with through the exercise of its discretionary powers.

In the first place, excessive surpluses, even if they arise unintentionally, represent the misuse of a tax privilege which was intended to assist the provision of pensions, and for no other purpose.

So the Inland Revenue requires from time to time that surpluses be diminished.

But at the same time the Revenue feels obliged to turn down many of the increasing number of requests from companies which, often for good reasons, wish to take refunds from their pension funds into the company itself.

The absence of clear rules on how surpluses should and may be dealt with, and the consequent reliance that has to be placed on the exercise by the Inland Revenue of its discretion, have created considerable uncertainty and have unnecessarily constrained trustees' freedom of action.

I therefore propose to replace these discretionary arrangements with clear and objective statutory provisions.

In future, the amount of any surplus in a fund will be determined for tax purposes in accordance with published guidelines, based on a secure funding method and prudent actuarial assumptions, as advised by the Government Actuary.

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Where a surplus is 5 per cent or less of total liabilities no action will need to be taken.

Where it is higher than that action will be required to eliminate the excess.

It will be entirely a matter for the trustees and employers to decide whether the reduction is to be achieved by increasing benefits, or reducing contributions, or making a refund to the company.

If, and only if, they choose to make a refund, the employer will be liable to tax at a rate of 40 per cent of the amount refunded, so as broadly to recover the tax relief previously given.

The effect of these new arrangements is likely to be a yield of £20 million in 1986-87 and £120 million in 1987-88.

Next, Stamp Duty.

I have no change to propose in the stamp duty on houses and other property, which I reduced to 1 per cent, with a higher threshold, in my 1984 Budget.

But there is a formidable case this year for a further reduction in the rate of stamp duty on share transfers.

The City of London is the pre-eminent financial centre of Europe.

The massive £6 billion it contributes to our invisible earnings is but one measure of the resulting benefit to the British economy.

But competition in financial services nowadays is not continental, but global.

The City revolution now under way, due to culminate with the ending of fixed commissions - the so-called Big Bang - on 27 October, is essential if London is to compete successfully against New York and Tokyo.

And if London cannot win a major share of the global securities market, its present world pre-eminence in other financial services will be threatened.

Successful competition depends on a number of factors, but one of the most important is the level of dealing costs.

The abolition of fixed commissions will certainly help.

But with no tax at all on share transactions in New York, and roughly ½ per cent in Tokyo, under the existing tax regime London will still be vulnerable.

I therefore propose to reduce Stamp Duty on share transactions from 1 per cent to ½ per cent as from the date of the Big Bang.

But I believe it is right that the full cost of this should be met from within the financial sector itself.

Accordingly, I propose to bring into tax at the new ½ per cent rate a range of financial transactions which are at present entirely free of Stamp Duty.

These include transactions in loan stock other than short bonds and gilt edged securities, transactions unwound within a single Stock Exchange account, letters of allotment, the purchase by a company of its own shares, and takeovers and mergers.

There will also be a special rate of 5 per cent on the conversion of UK shares into ADRs and other forms of depositary receipt.

Some of these changes, including the new ADR charge, will take effect immediately: others will be delayed until the Big Bang.

This further halving of the stamp duty on equities should enable London to compete successfully in the worldwide securities market.

It will also provide a further fillip to wider share ownership in the UK.

Just as we have made Britain a nation of home owners, it is the long-term ambition of this Government to make the British people a nation of share-owners, too; to create a people's capitalism, in which more and more men and women have a direct personal stake in British business and industry.

Both through the rapid growth of employee share schemes, and through the outstandingly successful privatisation programme, much progress has been made.

But not enough.

Nor, I fear, will we ever achieve our goal so long as the tax system continues to discriminate so heavily in favour of institutional investment rather than direct share ownership.

Accordingly I propose to introduce a radical new scheme to encourage direct investment in UK equities.

Starting next January, any adult will be able to invest up to £200 a month, or £2400 a year, in shares.

These will be held in a special account which I am calling a Personal Equity Plan.

So long as the investment is kept in the plan for a relatively short minimum period, of between one and two years, all reinvested dividends, and all capital gains on disposals, will be entirely free of tax.

The longer the investment is kept in the plan, the more the tax relief will build up and the greater will be the benefits.

And there will be no need to provide any information to the Inland Revenue.

Although the scheme will be open to everyone, it is specially designed to encourage smaller savers, and particularly those who may never previously have invested in equities in their lives.

So the plans will be simple and flexible to operate.

Anyone who is legally able to deal in securities will be eligible to register as a plan manager.

But the investor himself will own the shares - and the rights that go with them, including voting rights.

And it will be for the investor to choose whether to make the investment decisions himself or to give the plan manager authority to act on his behalf.

The cost of the scheme will be around £25 million in 1987-88, but will build up in later years as more plans are taken out.

This is a substantial, innovative and exciting new scheme.

I am confident that, over time, it will bring about a dramatic extension of share ownership in Britain.

Although wholly different in structure from the Loi Monory in France, I expect it to be every bit as successful in achieving its objective.

I am sure the whole House will welcome this far-reaching package of measures to reform the taxation of savings and investment.

I. **Charities**

I now turn to the tax treatment of charities and charitable giving.

In almost every facet of the nation's affairs it becomes increasingly clear that private action is more effective than State action.

This is particularly well illustrated by the success of charitable organisations up and down the land in the fields of famine relief, social welfare, medicine, education (including the universities), the arts and the heritage.

This Government has already done a great deal to assist charities, both through the tax system and in other ways.

I believe the time has come to take a further step forward.

The first question is whether any further fiscal relief should be given to the charities themselves, through relief from VAT, or to the act of giving.

In the light of representations from the Charities VAT Reform Group, I am prepared this year, exceptionally, to make a number of specific concessions on the VAT front.

I propose to relieve charities from VAT on their non-classified press advertising; on medicinal products where they are engaged in the treatment or care of people or animals, or in medical research; on lifts and distress alarm systems for the handicapped; on refrigeration and video equipment for use in medical applications purchased by charities from donated funds; on recording equipment for talking books and newspapers used by charities for the blind;

List has stayed.

and on welfare vehicles used by charities to transport the deaf, blind or mentally handicapped.

But in general I am convinced that the right way to help charities is not by relieving the charities themselves from VAT, but by encouraging the act of charitable giving.

I say this for two principal reasons.

First, it is clearly better that the amount of tax relief is related to the amount of support a charity is able to attract, rather than to the value of goods and services it happens to purchase.

And, second, whereas a £ of VAT relief is worth precisely that, a £ of tax relief on giving is likely to generate more than a £ of income going to charity.

My principal proposals therefore relate directly to the act of giving to charity.

First, I propose to abolish altogether the upper limit on relief at the higher rates of income tax on charitable covenants.

At the same time I propose to act to stop the abuse of the tax system by ensuring that tax relief goes only to money which is used for charitable purposes.

Next, companies.

It is widely believed that corporate giving to charity would be more generous than it is at present if tax relief did not depend on the company entering into a four-year covenant.

Accordingly, I propose to allow companies (other than close companies) to enjoy tax relief on one-off gifts to charity up to a maximum of 3 per cent of the company's annual dividend payment to its shareholders.

There will, of course, continue to be no limit on the amount a company can covenant to charity.

Many charities have made clear to me their fear that to introduce a similar relief for one-off donations by individuals would weaken them by reducing the stability they enjoy as a result of the binding force of covenants.

Instead, therefore, I propose to encourage individual giving to charity by a different means, that of tax relief for payroll giving.

From April 1987 it will be open to any employer to set up a scheme under which employees can have charitable donations of up to £100 a year deducted from their pay, and get tax relief on them.

All in all, the proposals I have announced today add up to a very substantial package of assistance to charities and charitable giving.

Their cost to the exchequer will depend on how generously companies and employees respond to this initiative.

But my best estimate is that it could amount to as much as £70 million in 1987-88.

This will be partly paid for by the measures to curb abuse, which may save some £20 million a year.

I would hope, too, that the additional charitable giving these concessions stimulate will be at least twice the amount of the extra tax relief given.

J. Personal Taxes: Taxes on spending

I now turn to the taxation of spending.

So far as the indirect taxes are concerned, the overriding question this year is how far I should recover from the oil consumer the tax revenues I have lost from the oil producer, as a result of the massive fall in the oil price.

Since November the price of petrol at the pump has fallen by roughly 12 pence a gallon.

If the oil companies had passed on the full amount of the fall in the oil price to date, the price of petrol at the pump could easily have been a further 12 pence a gallon lower still.

There is clearly scope, therefore, for a sizeable increase in petrol tax this year.

I have concluded, however, that at the present time, while I must certainly maintain the real value of the revenue I get from the motorist, I will not increase it.

But I do believe it makes sense to look again, in the light of the radically changed circumstances, at the relative weight of petrol tax and Vehicle Excise Duty.

Accordingly, I propose to increase the duty on petrol by an amount which, including VAT, would - if it were wholly passed on to the consumer - raise the price at the pump by sevenpence halfpenny a gallon.

This is twopence more than is needed to keep pace with inflation, and that enables me to keep VED at last year's level of £100 for cars and light vans, leaving the overall burden on the motorist unchanged in real terms.

Moreover, given the very substantial increase in the oil companies' margins, there is clearly no need for the pump price of petrol to go up at all.

Indeed, it ought to fall further.

In the same way, I propose to increase the duty on derv by an amount which - if it were wholly passed on to the consumer, which, to repeat, it should certainly not be - would raise the price at the pump by sixpence halfpenny, including VAT.

This will enable me to avoid any increase this year in the Vehicle Excise Duty on lorries, too.

So far as the other oil duties are concerned, I have one or two changes to make.

Not to the duty on heavy fuel oil, which will remain unchanged as it has done since 1980.

No mention of central heating

But I propose to increase the very modest duty on gas oil, by a penny-halfpenny a gallon.

And I propose to abolish altogether the duties on aviation kerosene, or Avtur - which at present is taxed for domestic flights only - and on lubricating oils.

All these changes in duty will take effect from 6 o'clock this evening.

Finally, so far as oil products are concerned, I am anxious to do what I reasonably can to assist the introduction of lead-free petrol.

The case for this on health grounds is clear.

I have therefore decided to create a duty differential in its favour to offset its higher production costs.

My officials will be discussing with the oil companies how this can best be achieved in time for next year's Budget.

Next, tobacco.

In the light of the representations I have received on health grounds, I have decided to increase the duty on cigarettes by appreciably more than is needed to keep pace with inflation.

I therefore propose an increase in the duty on cigarettes and hand-rolling tobacco by the equivalent, including VAT, of approximately eleven pence on a packet of 20 cigarettes.

This will take effect from midnight on Thursday.

As last year, I propose no increase at all on the duties on cigars and pipe tobacco, which are more heavily taxed here than in most comparable countries.

Finally, drink.

As the House will recall, I was obliged in 1984 to increase the duty on beer by slightly more than I would have wished as a consequence of the judgement against the UK in the European Court of Justice.

I now propose no increase at all in the duty on beer.

Nor do I propose any increase in the duties on cider, table wine, sparkling wine, fortified wine or spirits.

This last decision will, I hope, be particularly welcome in Scotland.

Next, VAT.

I propose to stop the abuse of long stay relief for hotel accommodation, and make certain other minor changes.

But I have no proposals for major changes in Value Added Tax this year.

The changes I have announced in the excise duties will, all told, raise an extra £795 million in 1986-87, the same amount as I would have raised had I simply increased all the excise duties in line with inflation.

The overall impact effect on the RPI, if all the increases were fully passed on, would be one half of one per cent.

This has already been taken into account in the forecast I have given the House of $3\frac{1}{2}$ per cent inflation by the end of the year.

K. Income Tax

Finally, I turn to income tax.

In my Budget speech last year I undertook to issue a Green Paper on the reform of personal taxation.

As the House is aware, I am publishing the Green Paper today.

It discusses a range of options which will in due course be opened up by the computerisation of PAYE, from the relationship between income tax and employees' national insurance contributions to the closer integration of the tax and benefit systems.

In particular, however, it outlines a possible reform of the present system of personal allowances.

The responses to my predecessor's 1980 Green Paper revealed widespread dissatisfaction with the existing arrangements, but - inevitably - no clear consensus as to what should replace them.

Married women increasingly resent the fact that a wife's income is treated for tax purposes as that of her husband, depriving her of the independence and privacy she has a right to expect.

There is growing complaint, too, of the way in which, in a number of respects, the present system penalises marriage itself.

And it cannot be right that the tax system should come down hardest on a married couple just at the time when the wife stops work to start a family.

Yet that is what happens today.

The alternative system set out in the Green Paper, of independent taxation with allowances transferable between husband and wife, would remedy all these defects.

To be acceptable, however, it would need to be accompanied by a substantial increase in the basic tax threshold.

The Government is committed to reducing the burden of income tax, and the proposal in the Green Paper suggests one way of doing that which would achieve a number of other worthwhile objectives - including the ability to take more people out of the unemployment and poverty traps for a given amount of tax relief than is possible under the present tax system.

Given the timetable of computerisation, none of this could in practice be implemented until the 1990s.

But we need to start planning for the 1990s today.

The Government will therefore carefully consider the responses to today's Green Paper before taking any decision on how to proceed.

Meanwhile, I have to set the tax rates and thresholds for the coming year.

But first I have two minor proposals to announce, both of which I hope the House will welcome.

First pensions paid by the German and Austrian Governments to victims of Nazi persecution are free of tax in both Germany and Austria.

In this country, however, the tax relief on such pensions is set at 50 per cent.

In future, I propose that pensions paid to victims of Nazi persecution should be free of tax altogether.

Second, the House will be aware that, as from next year, social security benefit upratings will be moved to April, to coincide with the tax year.

This will enable them to be fully taken into account before PAYE codes are issued for 1987-88.

However, to bridge the gap between the November 1985 and April 1987 upratings my Rt Hon friend the Secretary of State for Social Services proposes to have a special transitional uprating in July, the details of which he has recently announced.

Much shorter now

But as hon Members will know from their postbags, it could be confusing for many old-age pensioners and widows to undergo a special mid-year tax recoding on account of the July uprating.

I have therefore decided that, for pensioners and widows, the benefit increases payable in July will be exempt from income tax in 1986-87.

The cost of this will be £15 million.

Since we first took office in 1979, we have cut the basic rate of income tax from 33 per cent to 30 per cent and sharply reduced the penal higher rates we inherited from Labour.

We have increased the main tax thresholds by some 22 per cent more than inflation - and the greater part of that 22 per cent has been achieved during the present Parliament.

It is a good record, but it is not good enough.

The burden of income tax is still too great.

Nothing could be further from the truth than the claim that we have a choice between cutting tax and cutting unemployment.

The two go hand in hand.

It is no accident that the two most successful economies in the world, both overall and specifically in terms of job creation, the United States and Japan, have the lowest level of tax as a proportion of GDP.

Reductions in taxation motivate new businesses and improve incentives at work.

They are a principal engine of the enterprise culture, on which our future prosperity and employment opportunities depend.

The case for higher tax thresholds is well understood.

In my two previous Budgets I have raised the married man's allowance to its highest level in real terms since the war, and higher as a proportion of average earnings than in either Germany or the United States.

But we should not overlook the need for reductions in the basic rate of tax, too.

The basic rate is the starting rate of tax.

And it is the crucially important marginal rate of tax for some 95 per cent of all employees and 90 per cent of all self-employed and unincorporated businesses.

Clearly, given the massive fall in oil revenues, this is not a year for substantial reductions in tax of any kind.

But provided the economy continues to grow as it has been, and provided we continue to maintain firm control of public expenditure, the scope should be there in the years ahead.

Meanwhile, I propose for 1986-87 to raise all the main thresholds and allowances by the statutory indexation figure of 5.7 per cent, rounded up.

The single person's allowance will therefore rise by £130 to £2,335 and the married man's allowance by £200 to £3,655.

Similarly, the single age allowance will rise by £160 to £2,850 and the married age allowance by £250 to £4,505.

The age allowance income limit becomes £9,400.

I propose to raise all the higher rate thresholds by exactly £1,000.

This is fully in line with statutory indexation for the first - 40 per cent - higher rate, but less than half statutory indexation for the top - 60 per cent - rate.

Given the need for caution in the light of current circumstances, I do not have scope this year for a reduction in the basic rate of income tax, beyond one penny in the pound.

But this reduction from 30 per cent to 29 per cent still represents the first cut in the basic rate of income tax since my predecessor took it down from 33 per cent to 30 per cent in 1979.

So long as this Government remains in office, it will not be the last.

There will, of course, be a consequential reduction in the rate of Advance Corporation Tax.

And I also propose a corresponding cut in the small companies' rate of Corporation Tax from 30 per cent to 29 per cent.

The combined effect of the various income tax changes I have just announced is to concentrate the benefit, modest as I readily concede it to be, not on the rich but on the great majority of ordinary taxpayers.

As a result of the adjustments I have made to the higher rate thresholds, the gain for those at the top of the income scale is more or less confined to what they would have received under simple indexation alone.

By contrast, the married man on average earnings will be some £2.60 a week better off, an improvement of £1.45 a week over simple indexation alone.

The income tax changes I have announced today will take effect under PAYE on the first pay day after 17 May.

They will cost £935 million in 1986-87, over and above the cost of statutory indexation.

Seven years ago, when my predecessor cut the basic rate of income tax from 33 per cent to 30 per cent, he added:

> "Our long-term aim should surely be to reduce the basic rate of income tax to no more than 25 per cent."

I share that aim.

L. Conclusion

In this Budget, Mr Deputy Speaker, I have reaffirmed the prudent policies that have brought us three successive years of steady growth with low inflation, and the prospect of a fourth ahead of us.

I have described how we can take in our stride the dramatic collapse in the oil price, and benefit from its consequences.

Shortened

In collaboration with my rt hon and Noble Friend the Secretary of State for Employment, I have announced a further substantial range of measures to help the unemployed.

I have proposed a radical and far-reaching new scheme for tax-free investment in equities, so that we may truly become a share-owning democracy, and abolished a fourth tax.

I have announced the most substantial package of assistance to charitable giving ever, and cut the basic rate of income tax.

Building as it does on the achievements of the recent past, this Budget is a safeguard for the present and a springboard for the future.

I commend it to the House.