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From the Private Secretary

6 March, 1987.

BUDGET PROPOSALS

The Prime Minister has seen the Chancellor's minute of 5 March which set out his proposals for this year's Budget. As you know, the Prime Minister and the Chancellor have discussed the majority of these at bilaterals in recent weeks, and the Prime Minister is content. She has noted ~~that~~ the Chancellor will be minuting separately about his proposals for monetary targets and PSBR.

(David Norgrove)

Alex Allan, Esq.,
HM Treasury.

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PRIME MINISTER

Prime Minister

Entirely as expected.

Content?

DER 5/3.

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

2. My aim, as in previous years, has been to devise a Budget which will give us a solid financial framework, with a safety margin built into it, for the year ahead; which will reduce taxation within the limits of prudence; and which will improve incentives and encourage enterprise.

3. I will minute you separately about my proposals for monetary targets and the PSBR when the final pieces of the jigsaw are available, early next week. But it is already plain that we shall be able this year both to plan on a PSBR substantially below the level envisaged in last year's MTFS and at the same time to afford a tax reduction of £2½ billion in 1987-88 rising to just under £3 billion in 1988-89.

actually given
as £2.6 bn

Income tax

4. I propose to increase the main personal allowances by the statutory indexation factor of 3.7 per cent. As last year, I am sure our priority must be to cut the basic rate - the starting rate for everyone, and the marginal tax rate for 95 per cent of all taxpayers. I am therefore proposing a 2p cut, to 27 pence in the pound. This will do more than any other measure available to us to add momentum to the growth of the enterprise culture. It is desirable in itself and is the best means of improving the longer term potential of the economy. It also highlights the difference between our approach and that of the Opposition.

5. Our presentation of these proposals should, I suggest, follow closely the line which we got across so successfully last year:

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that it is aimed at the vast majority of taxpayers and will help all the sensitive groups in the middle - the nurse, the teacher married to a bank clerk and so on. To strengthen our presentation I propose, as last year, to set the higher rate bands so as to ensure that higher rate taxpayers will not benefit disproportionately from the income tax changes as a whole. Thus the first (40 per cent) higher rate threshold would be fully revalorised, the second (45 per cent) threshold partially revalorised, and the subsequent higher rate thresholds left unchanged.

6. For two groups I propose increases in the allowances beyond simple indexation: for those over 80 the age allowance will be increased by twice the indexation factor, ie by 7.4 per cent; and the blind allowance will go up from £360 to £540.

Excise duties

7. Apart from three minor changes in Vehicle Excise Duty and an increase in gaming machine duty, I am proposing no increases in the excise duties this year. This means that the overall impact of the Budget on the RPI as conventionally measured will be about 0.15 per cent (entirely reflecting the effect of the basic rate cut on mortgage payments), well below last year's 0.5 per cent. Although I expect some criticism from the health lobby I am sure that public opinion will well understand why I am not proposing tax increases on fuel, drinks and tobacco this year. I shall be reducing the duty on unleaded petrol by 5p a gallon, this honouring my promise last year; and I shall be abolishing the duty on on-course betting, recouping the revenue by the increase in the gaming machine duty.

Business and enterprise

8. My other Budget proposals are designed to carry further the themes of my previous Budgets. I am again taking action to tilt the balance towards small businesses, both by cutting their tax rates and by lightening the administrative load they bear. The small

companies' rate of Corporation Tax comes down to 27 per cent, in line with the basic rate cut. The self-employed will benefit from the reductions in income tax.

9. I am also legislating to ease the burden of VAT on small businesses. My proposals here follow the lines of the consultation exercise we launched last autumn. The main change here is the introduction of "cash accounting" which will mean that companies with an annual turnover of up to £ $\frac{1}{2}$ million (and not £100,000, as in the consultation document) will not have to pay VAT until they themselves have been paid by their customers. This will help their cash flow, as well as giving them automatic bad debt relief, something for which they have long asked. I would personally have liked to set a still higher limit, probably £ $\frac{1}{2}$ million; but I have reluctantly concluded, on the basis of legal and other expert advice, that that would jeopardise our prospects of getting the necessary derogation from the EC Commission. I shall also be introducing optional annual accounting, which will enable small companies to make VAT payments on account and send only one return a year to Customs and Excise; and a number of other changes, including a further increase to the VAT threshold to keep it to the maximum currently possible under European Community law.

10. I am making a number of changes to streamline the taxation of the corporate sector. These changes have been made possible by, and build upon, the 1984 corporation tax reform, which has proved an outstanding success. It is improving both the environment for business and the quality of business decisions, and at the same time increasing the yield of the tax.

11. At present companies pay corporation tax at different times depending on whether they were established before or after 1965. This difference of treatment no longer has any justification. It is also open to abuse: you may remember the Habitat case last year. I therefore propose that all companies (and building societies)

should be treated in the same way, so that all will be liable to pay corporation tax nine months after the end of the accounting period on which the tax is due. The change will be phased in. For the longer term I am taking steps now to introduce a more streamlined method of collecting corporation tax, called Pay and File.

12. I am also making changes to the taxation of companies' capital gains. In future these will be taxed at the same rate as company income - either 35 per cent or, for small companies, 27 per cent - not, as now, at 30 per cent. Companies will be allowed to offset payment of Advance Corporation Tax against their tax liability on gains, something which will be generally welcomed.

13. Peter Walker and I have been looking closely at the effect of the last year's oil price on North Sea producers and their suppliers. We have already legislated to bring forward to 1986-87 the repayment of over £300 million of Advance Petroleum Revenue Tax. As agreed last November, I propose to introduce two further reliefs designed to encourage research and development in the North Sea oil sector. These have been carefully aimed where they should do most good. They are to allow part of the expenditure on new fields to be set against PRT liabilities on other fields; and to allow special relief for R&D even though it is not related to any individual field.

14. As in all previous years, I propose that the scale charge for assessing the taxable benefit of company cars should be increased by 10 per cent. There will be no change in the car fuel benefit scales.

15. The Budget will also contain a number of measures designed to block up loopholes where substantial losses of tax are at stake. On one of these, VAT partial exemption, we have already exchanged minutes (my minute to you of 16 December and David Norgrove's reply of 18 December) and it is now clear that the scale of avoidance is larger than we at first supposed (£300 million in 1987-88 and £400 million in 1988-89). The business community accepts that we must act to stop this practice. As you know, I am also proposing action, in line with what the US are doing, on dual resident

companies, to stop them getting tax relief twice on the same interest payment. And I am bringing to an end the present over-generous treatment of tax credit relief for foreign withholding tax paid on interest on bank loans.

16. I have one further measure in this category. Lloyd's have now discovered a loophole in the law which prevents the Revenue from challenging for tax purposes syndicates' "Reinsurance to Close" - ie their provision for outstanding liabilities. I am proposing to put this right and to bring the arrangements for Lloyd's into line with the tax treatment of provisions for outstanding liabilities made by ordinary insurance companies. The Revenue will consult Lloyd's on the details immediately after the Budget.

17. I am convinced that, where we can, we must give a push to moves towards more flexibility on pay throughout the economy. I accordingly propose now to introduce a scheme of tax relief broadly on the lines floated in the Green Paper on Profit Related Pay which David Young, Paul Channon and I published last July. But it will be a little more generous: half, rather than a quarter, of profit-related pay will be relieved from income tax, subject to limits; even so, the very small cost of this relief will, I fear, lead to accusations that this is derisory. All the same, for someone on average earnings receiving 5 per cent of their pay in profit-related form, the tax relief will be equivalent to a penny off the basic rate of income tax. The administration will be kept simple.

Savings

18. I have agreed with Norman Fowler a major package of proposals on pensions which will complement the reforms in 1985 and 1986 Social Security Acts. Our aim is wider pension ownership, and to encourage people to provide for themselves in old age.

19. There are several strands to the proposals. First, I am introducing a system of tax relief for personal pensions on broadly the same lines as that now applying to retirement annuities. This will make it easier for employees to opt out of their employers' schemes and make their own arrangements; and it will also benefit

those whose employers do not offer an occupational pension scheme. Second, I propose changes which will make it simpler for employers to set up occupational schemes with the minimum of red tape and with less of an open-ended commitment on the size of final pensions. This should encourage wider pension coverage and be of particular benefit to the 10 million or so employees who are not covered by occupational schemes.

20. Third, I am introducing arrangements to allow members of occupational schemes to make additional voluntary contributions, with full tax relief, to a plan outside their employer's scheme. They will be able to top their pension right up to the present tax approval limits. This goes well beyond what we have already announced. It will be good for choice and individual responsibility.

21. The generous tax treatment of pensions can be justified only if it is not abused. I propose, therefore, to introduce some limited changes to the present rules to restrict the excessive relief which can be obtained in some circumstances by a few people, including an upper limit of £150,000 on the tax-free lump sum and more rigorous rules for calculating final salary.

22. Last year's Budget abolished the tax on lifetime gifts between individuals. This year I propose to extend the same exemption from tax to gifts involving settled property where there is an interest in possession. This will be welcomed by many of our own supporters.

23. I am also making a substantial increase in the threshold for inheritance tax, from £71,000 to £90,000 and reducing the number of tax rates from seven to four. This change will mean worthwhile reductions in tax liability at all levels, particularly for smaller estates, and take a third of the estates currently liable to inheritance tax out of the tax net altogether.

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24. Last year's Budget contained a substantive package of measures to help charities. The encouragement we give to charitable giving is now very generous; and the Payroll Giving Scheme which starts next month will give it a further boost. I therefore have no major new proposals in this field, though I propose to extend slightly the VAT reliefs for charities which I introduced last year. These extensions will meet points which have been put to me by the charities lobby.

... 25. I attach a table which summarises the revenue effects of these changes. I would be grateful to know if you are content with my proposals.

N.L.

N.L.

5 March 1987

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REVENUE EFFECTS OF BUDGET CHANGES

£m
(rounded to £5m)

	1987-88 (cost (-)/yield (+))	1988-89
Income tax (including higher rates)	-2160	-2740
Excise duties	- 535	- 575
VAT - small business package	- 115	- 60
- change in partial exemption rules	+ 300	+ 400
Corporation tax - small companies rate	*	- 45
- capital gains	*	+ 60
- payment dates	*	+ 100
- dual residents	*	+ 125
- tax credit relief for banks	*	+ 20
Car and car fuel benefits	nil	+ 30
North Sea oil	- 5	- 15
Profit related pay	*	- 35
Pensions	*	- 65
Inheritance Tax	- 70	- 150
Other	- 30	+ 40
Total	-2595	-2900

Note: (All figures are net of the cost or yield of indexation or revalorisation, which is included in the base forecast)

(* means negligible)

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