

BUDGET SECRET
BUDGET LIST ONLY

NOT TO BE COPIED

COPY NO 2 OF 11
REF NO: CH/30

PRIME MINISTER

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

2. My aim, as always, has been to devise a Budget which will give us a solid financial framework, with a safety margin built into it. My specific objectives this year are to balance the budget, reduce income tax rates, and carry forward the process of tax reform. Even with conservative forecasts of revenues, I can finance the measures I am about to describe within a budget surplus for 1988-89 of about the same size as now seems likely in 1987-88. I will be sending you a separate note shortly about the MTFS, including my proposals for monetary targets and the precise level of the PSBR.

Income tax

3. I propose to redeem our Manifesto pledge to reduce the basic rate to 25p in the pound. But I do not wish to give the impression that this means that our task is now completed. I therefore propose to announce a new target for the basic rate of income tax, of 20p in the £, to be reached as and when it is prudent to do so.

4. I propose to increase the personal allowances, including the age allowance for pensioners, and the upper limit for the basic rate band, by twice the amount required for indexation - ie roughly 7½ per cent. The main personal allowances will then be 26 per cent higher in real terms than they were when we came into office. This increase in allowances meets the concern about those at the bottom of the income tax scale which was expressed by a number of colleagues when we discussed the Budget prospect in Cabinet.

BUDGET SECRET
BUDGET LIST ONLY

NOT TO BE COPIED

**BUDGET SECRET
BUDGET LIST ONLY**

NOT TO BE COPIED

5. I propose to tidy up the system by doing away with three very minor personal allowances - those for a housekeeper, a son's or daughter's services, and a dependent relative. These are a left-over from the inter-war period, before Beveridge. They have been frozen for years, and are tiny: the largest is only worth about 50p a week. Few people claim them; and any losses will be swamped by gains from the main income tax reductions.

6. To simplify the system still further, I propose to do away with two other rules about dependent relatives. First, I propose to abolish the tax relief on new mortgages taken out to buy houses or flats for dependent relatives: the relatives themselves will be able to claim the relief instead. Second, I propose to end the special CGT exemption for sales of assets held by dependent relatives: they are no different in principle from any other assets.

7. The changes to the basic rate and the allowances will benefit about 25 million people - far more than will be affected by any other measures in the Budget. The married man on average earnings will gain nearly £5 a week.

8. This is clearly the year to bring down the higher rates as well. I propose to abolish all the higher rates of tax above the first higher rate of 40 per cent. This will give us one of the lowest top rates in the world, and a simple tax system consisting of a basic rate of 25 per cent and a single higher rate of 40 per cent (which will be reached at a taxable income of £19,300.)

9. Taken together, these measures will give the clearest possible boost to the enterprise culture and so help to strengthen the economy further. And we can point to a proven record of success. The top 5 per cent of incomes now contribute a higher proportion of income tax revenues than when they were subject to Labour's penal rates; and companies have gone from strength to strength since I cut corporation tax, so that they too are contributing a higher proportion of total tax revenues.

**BUDGET SECRET
BUDGET LIST ONLY**

NOT TO BE COPIED

USA.
New Zealand

ie double inheritance for people £17,900.

Capital Gains Tax

10. With the basic rate down to 25 per cent, the flat rate tax of 30 per cent on capital gains looks high for basic rate taxpayers. With the top rate down to only 40 per cent, I believe the right course is to align CGT with income tax. Capital gains will then be charged at the same two rates as income - 25 per cent and 40 per cent. This will greatly reduce the excessive incentive to invest for capital gain rather than income, and the artificial conversion of income into capital gain.

11. Alignment with income tax will put CGT on the same footing as in the United States, though our effective top rate of tax on capital gains will in fact be significantly lower than the Americans', because they have no provision for indexation.

12. At the same time, I propose to abolish altogether the taxation of paper gains. CGT has been indexed since 1982, when it was reformed by Geoffrey Howe. But indexation really came too late. It indexes away the low inflation of recent years, but does nothing about the ravages of the '70s. There are people and companies who have held assets since the 1960s or 1970s, or even earlier, and cannot realise them without paying substantial tax on pre-1982 paper gains. I propose to put a complete end to the taxation of all gains made before 1982. CGT will be charged only on real gains made since then.

13. When Geoffrey Howe introduced indexation in 1982, he made explicit rough-and-ready compensation for the problem of pre-1982 gains by exempting an extra £2,000 a year of gains from tax. That compensation will no longer be justified. I therefore propose to reduce the annual CGT exemption from its present £6,600 to a round £5,000. The Americans, incidentally, have no such exemption at all. The further change described in paragraph 23 below is also relevant in this context.

14. I remain concerned with the impact CGT can have on the small businessman selling up on retirement. People are more reluctant to build up capital if they feel they will face a

**BUDGET SECRET
BUDGET LIST ONLY**

NOT TO BE COPIED

large tax bill at the end of it. At present, they can realise £125,000 without paying tax. I propose to extend this retirement relief, so that half of any gain between £125,000 and £500,000 will be completely free of tax.

Inheritance tax

15. For similar reasons, I propose to reduce and simplify inheritance tax. I propose to raise the starting point from £90,000 to £110,000, sweep away three rates altogether, and set a single flat rate of 40 per cent. This means that we shall have reduced inheritance tax from seven rates to one in the course of two budgets.

16. It also means that the number of estates caught by inheritance tax will be reduced by a quarter, and that ordinary people will be able to pass on ordinary homes without being taxed. And with 50 per cent business relief, the effective rate for family businesses passing from one generation to the next will be only 20 per cent. That, too, will be one of the lowest rates in the world.

17. I propose to abolish the limit on bequests to political parties which are free of inheritance tax. This will put political parties back on a par with charities for inheritance tax, as they originally were.

The personal tax system

18. These changes to income tax, capital gains tax and inheritance tax will leave no rate in the personal tax system above 40 per cent.

19. I propose to complement this reduction in rates with further reforms. The first is to put the tax treatment of marriage on to a sound footing.

**BUDGET SECRET
BUDGET LIST ONLY**

NOT TO BE COPIED

**BUDGET SECRET
BUDGET LIST ONLY**

NOT TO BE COPIED

Tax penalties on marriage

20. I propose to end in this Budget the three main tax penalties on marriage.

21. First, there is the fact that cohabiting couples can get twice as much mortgage interest relief as married couples. This is widely resented and criticised, and quite rightly so. We paved the way for a change in the 1986 Green Paper on the Reform of Personal Taxation. I propose to implement the proposal there, which is to make the £30,000 limit on mortgage relief apply per house, flat or "residence". This will not take effect until August 1988, to give the building societies and borrowers time to adjust. Existing mortgages, and those taken out before August 1988, will not be affected.

22. Second, there is the abuse that a cohabiting couple with two children can claim two additional personal allowances - the tax relief designed for single parents. I propose to limit them to one from 1989.

23. Third, there is the fact that married couples are allowed only one annual CGT exemption between them. I propose to give husbands and wives separate annual exemptions with effect from 1990.

Independent taxation

24. This last proposal is part of my wider proposals to introduce independent taxation for husbands and wives in 1990. I propose to give separate personal allowances to husbands and wives, just as if they were single, but with a special married couple's allowance on top, equivalent under the present system to the difference between the single and married allowance. This will meet the growing demand (vigorously expressed at last year's Party Conference) for privacy and independence for married women.

**BUDGET SECRET
BUDGET LIST ONLY**

NOT TO BE COPIED

**BUDGET SECRET
BUDGET LIST ONLY**

NOT TO BE COPIED

and guarantee them a fair deal from the tax system. It will do this sooner than most people are expecting, and at relatively modest cost. No-one will lose, but a number will gain. My Private Secretary has sent yours a draft press notice which sets out the proposals at greater length.

Maintenance and Covenants

25. I propose to reform and greatly simplify the taxation of maintenance and covenants, other than covenants to charity, which will not be touched. The tax system is currently involved in all sorts of transactions between individuals which should be nothing to do with the Inland Revenue. In the normal case, if one person gives income to another (for example a husband giving money to a wife or child), the Inland Revenue is not involved. But if someone gives the money by way of a covenant or maintenance payment, we tax the recipient and return the money to the donor in tax relief. This is absurdly complex. It would be a great prize to simplify it.

26. Covenants are the easier case. Most (but not of course all) of those affected by my proposals are from parents to students: they have grown in a quite unintended way as a result of the decision to reduce the age of majority to 18. For the future, I propose to stop both taxing students (or any other covenant recipients) on their receipts, and giving tax relief to the parents (or other covenanting donors), thus taking the tax man out of the transaction altogether. I propose to make a broadly compensating reduction in the parental contribution to student grants at mandatory rates. Existing covenants will be unaffected. There will be a modest yield from this reform, since high tax payers will lose the ability to make a tax saving via covenanting. Kenneth Baker is content.

27. Maintenance payments are more difficult, and I have made some adjustments in the details of my original proposals. Most of these payments are from divorced men to their ex-wives or

**BUDGET SECRET
BUDGET LIST ONLY**

NOT TO BE COPIED

**BUDGET SECRET
BUDGET LIST ONLY**

NOT TO BE COPIED

children. It is, in principle, easy to stop taxing future recipients, and I propose to do that. The pure logic would be to stop giving tax relief altogether to future donors; but this could, in practice, be unduly harsh, and there is no equivalent of the parental contribution to student grants by which to compensate them. I have therefore decided that, in future, a man supporting a separated or divorced wife should still be able to enjoy tax relief on the payments he makes, but only up to the difference between the married allowance (which he formerly had) and the single allowance (to which he was reduced following the separation or divorce). For 1988-89 this will be £1,490.

28. I would have liked to say that existing maintenance agreements will be unaffected. But this could look harsh to existing recipients of maintenance payments, all of whom would prefer to switch to the new system, and so be freed from tax on their receipts. I have therefore decided, in these cases, to exempt up to £1490 of receipts from tax straightaway. There will be other transitional arrangements to protect the interests of existing donors.

29. The Lord Chancellor has been most helpful to me in refining these proposals. He is kindly arranging for his Department to get the necessary messages to the Courts after the Budget. And I am also having leaflets prepared to explain the new rules to those affected.

Charities

30. As I mentioned above, I propose to leave unchanged the tax relief for covenants to charities. At the same time I propose to double the amount people can give to charities, tax free, under the payroll giving scheme.

Company cars

31. The big reductions in income tax rates will enable me to tackle a number of areas where the tax system provides reliefs

**BUDGET SECRET
BUDGET LIST ONLY**

NOT TO BE COPIED

**BUDGET SECRET
BUDGET LIST ONLY**

NOT TO BE COPIED

which are hard to justify. The most significant in revenue terms is the taxation of company cars. At present, we value them for tax purposes at only a quarter of what they are worth. I clearly could not move to full valuation in one go. But I propose to double the car scales in 1988-89.

32. About 95 per cent of those with company cars will still benefit from the Budget overall, because they gain more on income tax rates and allowances than they lose on cars. I do not expect these measures to have a large effect on the car industry. David Young is content.

*probably needed overall
on base I would guess.*

33. As a minor simplification, I propose to exempt from tax the benefit of free car parking provided by an employer.

Forestry

34. I shall, as agreed, announce in the Budget our main conclusions on forestry. We shall be ending a tax shelter which has become more and more ludicrous and widely criticised, and switching to an improved grant regime which should be much better for the environment. I have not yet secured agreement on the new grant regime (which is not strictly speaking a Budget measure), but hope to do so soon.

Home improvement relief

35. I propose to abolish the tax relief on home improvement loans taken out after April. They have become a form of cheap consumer credit. Few are used to finance extensions or loft conversions. Most go on items such as double-glazing which could reasonably be expected to be met out of savings. Some, in practice, finance cars or holidays. It is virtually impossible to police what they are used for, and PAC criticism has been mounting.

**BUDGET SECRET
BUDGET LIST ONLY**

NOT TO BE COPIED

**BUDGET SECRET
BUDGET LIST ONLY**

NOT TO BE COPIED

36. Most of the loans affected are small - half are for less than £3,000. And, of course, no existing loans will be affected. I do not, therefore, expect a significant effect on the construction industry. Nicholas Ridley is content.

Life assurance premium relief

37. The tax relief for pre-1984 life assurance premium payments is traditionally set at half the basic rate of tax. For simplicity, we have not adjusted it every time we have reduced the basic rate; but I propose to reduce it this year to 12½ per cent.

Share ownership

38. I shall be reporting in the Budget that share ownership has increased slightly in the last year, despite the stock market collapse. To encourage it further, I propose to raise the limit on Personal Equity Plans from £2,400 to £3,000, and to relax the restrictions on employee shares obtained outside the approved employee share schemes.

Business expansion scheme

39. I propose to extend the BES, for five years, to companies providing property for rent on an assured tenancy basis. This should help Nicholas Ridley give a kick-start to the private renting initiative, which I strongly support.

40. At the same time, I propose to limit the amount which any one company can raise through the BES, so as to encourage the flow of funds into smaller firms in general and start-ups in particular.

Other taxes on business

41. So far as the main rate of corporation tax is concerned, I intend to leave well alone. But I shall bring the small companies' rate down to 25 per cent, in line with the basic

**BUDGET SECRET
BUDGET LIST ONLY**

NOT TO BE COPIED

**BUDGET SECRET
BUDGET LIST ONLY**

NOT TO BE COPIED

rate of income tax.

42. I propose to abolish capital duty altogether. This is a 1 per cent tax on companies which raise new capital, introduced in 1973 to meet EC obligations which have since been relaxed. I also propose to abolish the unit trust instrument duty of $\frac{1}{4}$ per cent on all property put into a unit trust.

43. I propose to simplify the system further by ending the special corporation tax deduction for entertaining overseas customers, thus putting all business entertainment on the same footing. The corresponding VAT exemption on entertaining foreign customers should also go.

44. I propose to increase the VAT threshold to £22,100, the maximum permitted under EC law.

45. On more technical matters, I propose to remove an unintended tax obstacle to building societies converting into companies; to simplify the administrative arrangements for taxing members of Lloyd's, and to sort out a problem for members of Lloyd's when they leave syndicates.

Company residence and migration

46. I propose to change the rules for the minority of companies which wish to change their country of residence. At present the rules require the Treasury to give formal consent and are backed up by criminal sanctions. I propose to substitute objective tests. Companies will be free to migrate if they wish, but will have to pay their accrued UK taxes first. This will avoid the loss of what could be very substantial sums of revenue, and is in line with the practice in most other countries.

Excise duties

47. Finally, I propose to raise the excise duties broadly in line with inflation. But I propose no change in the tax on unleaded petrol: this means that the differential between leaded

**BUDGET SECRET
BUDGET LIST ONLY**

NOT TO BE COPIED

and unleaded will double to just over 10p a gallon. I also propose no change in the tax on spirits or pipe tobacco, or in the main rates of vehicle excise duty: the cost of keeping VED unchanged will be financed by a slightly larger increase (some 6p a gallon) in the petrol tax. I propose to reduce the taxation of some low alcohol drinks. And I propose to introduce a higher VED charge on juggernauts which exact a considerable toll on the road system. Table 1 sets out the proposals in detail.

48. I have a small change to announce on VAT, to apply the tax to all cereal bars, instead of just to some as now; this tidies up an awkward borderline.

Cost and RPI effect

49. Table 2 shows the revenue effects of the package (which are still subject to minor revisions). It will add about 0.4 per cent to the RPI as conventionally measured - about 0.28 per cent from indexing the excise duties (which is of course already in the baseline) and the other 0.12 per cent from reducing the basic rate of income tax (which increases the net cost of mortgage payments).

50. I should be glad to know that you are content.

NL

N.L.

4 March 1988

**BUDGET SECRET
BUDGET LIST ONLY**

NOT TO BE COPIED

Table 1 Excise Duties

Product	Unit	Duty increase (per cent)	Price increase (pence)	
			Proposed	Diff. from Reval.
Beer	Pint	4.7	1.0	+0.2
Cider	Pint	9.7	1.0	+0.6
Table wine	75cl	4.5	3.8	+0.7
Sparkling wine	70cl	4.5	5.9	+1.1
Sherry	70cl	4.5	6.1	+1.1
Spirits	75cl	nil	nil	-20.1
Cigarettes	20KS	3.7	3.4	nil
Cigars	5 whiffs	3.7	1.9	nil
Pipe tobacco	25 grams	nil	nil	-2.7
Petrol (leaded)	Gallon	5.5	5.5	+1.8
Petrol (unleaded)	Gallon	nil	nil	-3.6
Derv	Gallon	5.5	4.7	+1.5
VED (cars)	-	nil	nil	-£3.70
VED (other)	-	nil	nil	-(various)
Gas oil	Litre	nil	nil	-0.2
Fuel oil	Litre	nil	nil	-0.1

**BUDGET SECRET
BUDGET LIST ONLY**

NOT TO BE COPIED

**BUDGET SECRET
BUDGET LIST ONLY**

NOT TO BE COPIED

Table 2 Revenue effects of Budget measures

	£ million 1988-89	yield(+)/cost(-) 1989-90
Income tax		
personal allowances double indexed	-690	-895
basic rate limit double indexed	-75	-130
basic rate reduced to 25p	-2560	-3190
higher rates above 40p abolished	-965	-2080
car benefit scales doubled	+260	+310
home improvement loans relief abolished	+80	+200
covenants and maintenance	+35	+100
Independent taxation	*	-20
Capital gains tax		
annual exemption reduced to £5,000	-	+15
gains charged at income tax rates	+70	+80
tax rebased to 1982	-	-70
Inheritance tax		
flat rate of 40% above £110,000	-100	-200
Corporation tax		
tax on capital gains rebased to 1982	-25	-235
small companies' rate reduced to 25p	*	-50
Capital duty abolished	-90	-100
Excise duties		
petrol and derv	+100	+65
vehicle excise duty	-100	-110
tobacco	*	-5
alcohol	*	-10
Other tax changes	+55	+75
Total	-4005	-6250

- = nil. * = negligible.

All figures net of cost/yield of indexation.

**BUDGET SECRET
BUDGET LIST ONLY**

NOT TO BE COPIED