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For P GRAY

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COPY NO. 2 OF 7.

10 March 1988

Paul Gray Esq
10 Downing Street
LONDON SW1

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Dear Paul,

BUDGET SPEECH

... I attach a copy of the Chancellor's latest draft of the Budget Speech. He would be grateful for any comments the Prime Minister may have, if possible by close of play tomorrow (Friday).

He has asked me to say that he attaches great importance to the new target of a 20 per cent basic rate. He feels this is necessary for three reasons. First, to avoid an air of complacent finality, as if we had achieved all we want to achieve on the tax front. Second, to provide an important balance in a year when the higher rates are being cut dramatically but the basic rate only by a widely expected 2p. Third - a point strongly held by the Chief Secretary - that the absence of a new tax reduction target would, given the very strong fiscal position, make the task of containing public expenditure very much more difficult.

Yours,
Alex

A C S ALLAN
Principal Private Secretary

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A INTRODUCTION

A1. I am reliably informed that my Budget speech last year was the shortest this century. My Budget speech this year is likely to have a different claim to a place in the history books. Not, the House will be glad to learn, as the longest Budget speech this century, but as the last untelevised Budget speech.

A2. As I once again present the first Budget of a new Parliament, I find the British economy stronger than at any time since the War. As the British people recognised last June, this has not happened by chance. It has happened because, for almost nine years now, we have followed the right policies and stuck to them. I reaffirm those policies today. In particular, there will be no letting up in our determination to defeat inflation.

A3. I shall begin, as usual, with the economic background to the Budget. I shall then deal with monetary policy, and with the public finances this year and next, and indeed for the remainder of this Parliament. Finally, I shall propose a number of measures designed to improve the performance of the economy still further, by changing the structure of taxation. For this will be a tax reform Budget.

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Draft of 10 March (2nd)

BUDGET

CHANCELLOR OF THE EXCHEQUER'S BUDGET STATEMENT

15 MARCH 1988

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A4. As usual, the Financial Statement and Budget Report, together with a number of press releases filling out the details of my tax proposals, will be available from the Vote Office as soon as I have sat down.

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B. THE ECONOMIC BACKGROUND

B1. I start with the economic background.

B2. The strength and durability of the economic upswing has now exceeded all post-War records. We are about to enter our eighth successive year of sustained growth, and the sixth in which this has been combined with low inflation. And even without looking to 1988, the six years to 1987 have been the longest period of steady growth, at a rate averaging 3 per cent a year, for half a century.

B3. This performance compares favourably not only with our own past, but also with the economic performance of other countries. During the 1960s and the 1970s, Britain's growth rate was the lowest of all the major European economies. During the 1980s, our growth rate has been the highest of all the major European economies.

B4. In 1987 as a whole, output grew by 4½ per cent, while inflation averaged 4¼ per cent. Thus last year, for the first time for a generation, the rate of growth exceeded the rate of inflation. At the same time unemployment fell more than in any other year since the War, in every region of the country, and faster than in any other major nation.

Contrast para B9 and B10 where inflation next year is forecast to exceed growth by 1%.

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B5. The plain fact is that the British economy has been transformed. Prudent financial policies have given business and industry the confidence to expand, while supply side reforms have progressively removed the barriers to enterprise.

B6. Nowhere has this transformation been more marked than in manufacturing, where output rose last year by 5½ per cent. This outstanding performance was founded on a further big improvement in manufacturing productivity. In the 1980s, output per head in manufacturing has gone up faster in Britain than in any other major industrial country, and we led the way once again last year. This is in stark contrast to the 1960s and 1970s, when in manufacturing productivity growth, as in so much else, we were bottom of the league.

B7. The current account of the balance of payments is now estimated to have been in deficit last year, after seven successive years of surplus, by a little over £1½ billion. This is well below the deficit I forecast at the time of last year's Budget, despite growth turning out stronger than forecast. The reason for this was the better than expected performance of visible trade, with exports of manufactures up by 8½ per cent. This continues the pattern of the 1980s, with British manufacturers maintaining their share of an expanding world trade, after decades during which Britain's share was steadily declining.

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B8. Looking ahead, I expect 1988 to be yet another year of healthy growth with low inflation; and there is every prospect that unemployment will continue to fall, although probably not as rapidly as last year.

B9. The pace of non-oil growth is likely to ease from now on, returning to the underlying trend of the past few years. But output for 1988 as a whole is forecast to be 3 per cent higher than in 1987, with the non-oil economy up by 3½ per cent. Business investment is forecast to grow particularly strongly, with a rise of 8½ per cent.

B10. As last year, inflation is forecast to end the year at 4 per cent. While this is still too high, it is a testimony to the soundness of our policies that the present strong and sustained upswing is the first for more than a generation that has not led to a resurgence of inflation.

B11. With growth in the UK economy likely to continue to outpace that of most other major countries, particularly in continental Europe, and with our oil surplus falling as North Sea oil production declines, the current account of the balance of payments is forecast to remain in deficit this year, by some £4 billion, equivalent to less than one per cent of GDP. Given the strength of the economy in general, and of our public finances in particular, not to mention our massive net overseas asset

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position, I foresee no difficulty in financing a temporary current account deficit of this magnitude.

B12. But the outlook both for exports and for jobs will depend critically on employers keeping their costs firmly under control. Unit labour costs in manufacturing scarcely rose at all in 1987. It is vital that employers do not let this slip, and keep a tight grip on all their costs, not least pay.

Is this true in the latter half

B13. In my Budget speech last year, I warned that:

> "Given the continuation of present policies in this country, the biggest risk to the excellent prospect I have outlined is that of a downturn in the world economy as a whole."

That remains the case. The dramatic collapse in the world's equity markets last October was not the second coming of 1929 and the harbinger of a 1930s-style world slump, as so many feared at the time - although it could have been a great deal nastier had the authorities in the major nations not responded in a prompt and appropriate way. It was essentially an overdue market correction which did little more than reverse the rapid rise in share prices of the previous year. Certainly, business confidence does not seem to have been greatly affected, and growth in the seven major industrial countries as a whole this year is likely to be only slightly lower than last year.

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B14. But Black Monday was also a warning. The world's three largest economies - the United States, Japan and Germany - have made a number of the policy adjustments necessary to reduce the imbalances which have for so long afflicted them, and there is evidence that the measures they have taken are starting to bear fruit. But there is still a long way to go; and meanwhile there is the constant danger that the process of adjustment, and with it the world economy as a whole, could be gravely damaged either by further wild gyrations in the dollar exchange rate or by a lurch into protectionism.

Alternative draft on this + next section already proposed

B15. There are some who continue to insist that the simple and only solution to these imbalances lies in a further substantial fall in the dollar, even though the source of the problem lies elsewhere. They see exchange rate changes as a miracle cure, whatever the illness. They wholly ignore the damage that exchange rate volatility does to economic health, and distract attention from the fundamental causes of the imbalances.

B16. Success in reducing these imbalances depends on countries putting the right fiscal and monetary policies in place, and keeping them there. But the necessary adjustments are much more likely to be achieved if the objective of greater exchange rate stability is given an explicit role in the process of international co-operation, as has been the case for well over

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two years now. I can assure the House that we shall play our full part.

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C. MONETARY POLICY

C1. Meanwhile, the maintenance of sound money and prudent public finances will keep us in the best possible position to weather any shocks we may face, whether at home or abroad.

C2. The Medium-Term Financial Strategy, now entering its ninth year, will continue to provide the framework for reducing the growth of money GDP, and hence inflation, over the medium term. These will be achieved by maintaining firm monetary discipline, buttressed by a prudent fiscal stance.

C3. Short term interest rates remain the essential instrument of monetary policy. Within a continuous and comprehensive assessment of monetary conditions, I will continue to set interest rates at the level necessary to ensure that inflationary pressures are not accommodated.

C4. I believe that most businessmen have welcomed the greater stability between sterling and the Deutschmark that has persisted over the past year. It is important that they also accept the financial discipline inherent in this policy.

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C5. Achieving the gradual eradication of inflation also requires a steady reduction in monetary growth in the medium term. While I shall continue to take account of broad money, or liquidity, as last year there will be no explicit target. For narrow money, MO, the target range for 1988-89 will be 1-5 per cent, as foreshadowed in last year's MTFS.

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D. PUBLIC SECTOR FINANCES

D1. As I pointed out a moment ago, a sound monetary policy needs to be buttressed by a prudent fiscal stance.

D2. At one time, it was regarded as the hallmark of good government to maintain a balanced budget; to ensure that, in time of peace, government spending was fully financed by revenues from taxation, with no need for government borrowing. Over the years, this simple and beneficent rule was increasingly disregarded, culminating in the catastrophe of 1975-76, when the last Labour Government had a budget deficit, or Public Sector Borrowing Requirement, equivalent in today's terms to some £40 billion.

D3. This profligacy not only brought economic disaster and the national humiliation of a bail-out by the IMF. It also added massively to the burden of debt interest, not merely now but for generations to come.

D4. Thus one of our main objectives, when we first took office in 1979, was to bring down government borrowing. We steadily reduced the Public Sector Borrowing Requirement from the 5¼ per cent of GDP we inherited to only three quarters of one per cent in 1986-87. Today I

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am able to tell the House that in 1987-88, the year now ending, we are set to secure something previously achieved only on one isolated occasion since the early 1950s: a balanced budget.

D5. Indeed, we have gone even further. It looks as if the final outturn for 1987-88 will be a budget surplus of £3 billion. Instead of a PSBR, a PSDR: not a Public Sector Borrowing Requirement, but a public sector debt repayment.

D6. And, incidentally, even if there had been no privatisation proceeds at all, the resulting PSBR, at a half of one per cent of GDP, would still have been the lowest in all but one year since the early 'fifties.

D7. A balanced budget is a valuable discipline for the medium term. It represents security for the present and an investment for the future. Having achieved it, I intend to stick to it. In other words, henceforth a zero PSBR will be the norm.

D8. In the very nature of things, there are bound to be fluctuations on either side from year to year. It is in this context that I have to set the precise fiscal stance for the year ahead, 1988-89.

D9. I have already announced, in the Autumn Statement last November, a substantial increase in public expenditure plans for 1988-89, with spending on

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programmes up by over £4½ billion. In particular, we have increased our plans for spending on health and personal social services by over £1 billion, on education and science by £900 million, and on law and order by £500 million.

D10. These large increases in public expenditure for the coming year will be financed partly from the saving in debt interest resulting from the reduction in Government borrowing. Debt interest now accounts for more than half a percentage point less of GDP than it did only three years ago. This may not sound very much, but it implies a saving of almost £3 billion a year.

D11. But even so, the increased public spending now planned for 1988-89 inevitably means less scope for reducing taxation. Moreover, I have decided that for the year immediately ahead, the path of prudence and caution is to budget for a further surplus of the same size as this year's expected outturn - that is to say, a further public sector debt repayment of some £3 billion.

D12. What this means is that it will not be possible in this Budget to reduce the burden of taxation; that is to say, to reduce taxation as a share of GDP.

D13. However, the House may be pleased to know that, with a strong and healthy economy, a constant burden of taxation implies a reduction in tax rates.

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E. TAX REFORM

E1. I indicated at the outset that this will be a radical, tax-reforming Budget.

E2. Over the past few years there has been increasing recognition, throughout the industrialised world, of the importance of tax reform in improving economic performance. And for us in this country, the lesson is underlined by the success of the reform of business taxation I announced in my first Budget, at the start of the last Parliament.

E3. But while tax reform is a simple matter for the armchair critic, it is very much more difficult in practice. It is difficult technically and difficult politically - since any tax system, however it arose, creates powerful vested interests in favour of the status quo. Nor, indeed, is it right that change should be too violent. People have a right to expect a reasonable degree of stability in the framework within which they order their affairs. But stability should not mean immobility. That way lies national decline.

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E4. The tax-reforming Chancellor thus has to tread a careful path. That I have sought to do in this Budget. The proposals I shall be making today amount to a substantial and coherent package which will be of increasing benefit to the taxpayer and the economy as a whole in the years to come.

E5. I have been guided by four basic principles. First, the need to reduce tax rates where they are clearly too high. Second, the need to reduce or abolish unwarranted tax breaks. Third, the need to make life a little simpler for the taxpayer. And, fourth, the need to remove some manifest injustices from the system.

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F. INDEPENDENT TAXATION AND TAX PENALTIES ON MARRIAGE

F1. My first reform concerns the taxation of marriage.

F2. The present system for the taxation of married couples goes back 180 years. It taxes the income of a married woman as if it belonged to her husband. Quite simply, that is no longer acceptable.

F3. This is a matter on which there has already been extensive consultation. The time has come to take action.

F4. I therefore propose a major reform of personal taxation, with two objectives. First, to give married women the same privacy and independence in their tax affairs as everyone else. And second, to end ways in which the tax system can penalise marriage.

F5. I have decided to introduce, at the earliest practicable date, April 1990, a completely new system of independent taxation.

F6. Under this new system, a husband and wife will be taxed independently, on income of all kinds. All taxpayers, male or female, married or single, will be entitled to the same personal allowance, which will be

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available against income of all kinds, whether from earnings, pensions or savings.

F7. In addition, there will be a married couple's allowance, equivalent in value to the difference under the old system between the married man's allowance and the single allowance. This new allowance will go in the first instance to the husband, so that his tax threshold does not fall. But if he does not have enough income to use it in full, he will be able to transfer any unused portion to his wife, to set against her income.

F8. This ensures that the tax system will continue to recognise marriage, as it should do. At the same time, from 1990 married women will pay their own tax, on the basis of their own income, and have their own tax return, when one is necessary. There will, of course, be nothing to stop married women from asking their husbands to handle their tax affairs, as before; and many will no doubt do so. But what matters is that, for the first time ever, married women will have the right to complete independence and privacy so far as tax is concerned.

F9. In the same way, a husband and wife will be taxed independently on any capital gains they may have, with an annual exemption each, instead of one between them, as now. But transfers of capital between husband and wife

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will continue to be entirely free of any liability to tax.

F10. As I have said, the new system will come into force in 1990. This is much sooner than would have been possible for most of the alternatives that have been canvassed. The necessary legislation will be contained in this year's Finance Bill. The cost of this historic reform, which for the first time ever gives a fair deal to married women, will be £550 million in 1990-91.

F11. I mentioned a few moments ago the tax penalties on marriage. It is clearly wrong that some couples should find themselves paying more tax, simply because they are married. I propose to put that right.

F12. Independent taxation by itself will remove the most common penalty - the taxation of a married woman's income at her husband's marginal rate. But there are other tax penalties on marriage, and I propose to abolish all of them. These changes need not await the introduction of Independent Taxation.

F13. Under the present system an unmarried couple can get twice as much mortgage interest relief as a married couple. This has attracted increasing - and justified - criticism. I propose to put a stop to it as from August this year. Thereafter, the £30,000 limit on mortgage

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interest relief will be related to the house or flat, irrespective of the number of borrowers. This was the solution put forward in the 1986 Green Paper on Personal Taxation, and it was widely welcomed. Existing mortgages will be unaffected.

F14. Another anomaly is that an unmarried couple with children can each claim the Additional Personal Allowance intended for single parents, and thus get more tax relief than a married couple in the same position. I propose to confine them to a single Additional Personal Allowance, with effect from April 1989.

F15. Thus this Budget will not only, for the first time ever, give married women a fair deal from the tax system. It will also eliminate, for all practical purposes, all the other tax penalties which, under the present system, can arise on marriage.

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G. BUSINESS TAXATION

G1. I turn now to business taxation.

G2. The major reform of business taxation, which I introduced in 1984, and which was completed in 1986, has given us one of the lowest Corporation Tax rates in the world. This has encouraged overseas companies to invest in Britain and, most important of all, has greatly improved the quality of investment by British firms. It is a crucial part of an environment in which company profitability has recovered to its highest level for some twenty years. It has succeeded in its objectives.

G3. I do not therefore propose any further changes to the structure of Corporation Tax. And the main Corporation Tax rate for 1988-89 will be unchanged at 35 per cent.

G4. But I do have some changes to propose to specific aspects of business taxation.

G5. British exporters have done extremely well in recent years, thanks to major improvements in efficiency and quality. But no exporter could honestly claim that his success hinges on the fact that the cost of entertaining

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overseas customers is tax deductible, whereas business entertainment generally is not. I therefore propose to simplify the system by making all business entertainment non-deductible for tax purposes, including for VAT.

G6. In conjunction with my rt. hon. Friend the Secretary of State for Energy, I propose to restructure the tax regime for the new generation of Southern basin and onshore fields, so as to relate tax liability more closely to profitability. Accordingly, my rt hon Friend will shortly be bringing forward legislation to abolish royalties, from 1 July, for all such fields. At the same time, I propose to reduce the Petroleum Revenue Tax oil allowance for these fields. This will mean the end of royalties for all future fields.

G7. The 1986 Building Societies Act gives Building Societies the power, to convert themselves into companies, if they so wish. At present, however, they would face a heavy, and unintended, tax charge if they did so. I propose to rectify this.

G8. I have two changes to propose to the tax arrangements for Lloyd's. The first meets the only point Lloyd's have raised on last year's legislation on reinsurance to close. The second will benefit both Lloyd's and the Inland Revenue by simplifying the administrative arrangements for taxing Lloyd's members.

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G9. I also propose to simplify the Section 482 rules for companies who wish to migrate overseas, so as to bring them broadly into line with most of our major competitors. Instead of having to ask for Treasury consent, companies will be free to migrate, provided only that they pay their tax first.

G10. I now turn to a number of proposals to give further help to small businesses and new businesses, whose encouragement is a central theme of Government policy. The rate of new business formation, net of failures, has averaged 500 a week, week in, week out, since 1979. This shows beyond any doubt the continuing vigour of this sector, which is such an important source of enterprise, innovation, and new jobs.

If 500 is an average - it is unlikely to be 500 week in week out!

G11. Many new businesses have been greatly assisted by the Business Expansion Scheme, which has now been running for nearly five years. During that time it has enabled new and expanding companies to raise equity finance amounting to some £150 million a year.

G12. However, the rapid growth of the venture capital market since 1983 has meant that companies seeking relatively large amounts of equity investment can now raise these readily, while smaller companies looking for more modest amounts can still find it difficult to do so.

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G13. To improve the targeting of BES, I therefore propose to introduce a limit of half a million pounds on the amount any company can raise under the scheme in any one year. Investment should thus be better directed at the smaller, newer and riskier businesses, particularly those outside the South-East of England, which can still find it hard to raise equity finance in other ways. In the special circumstances of the ship chartering industry, however, the limit will be £5 million.

G14. I have one further proposal affecting the Business Expansion Scheme.

G15. One of the key reasons for our economic transformation has been the reform of the supply side of the economy.

G16. The tax relief I introduced last year for profit-related pay will, in time, help to increase pay flexibility and improve the working of the labour market. But if successful firms are to expand further, and create still more jobs, we also have to make it easier for people to move to where the new jobs are.

G17. For years, the shortage of private rented accommodation has been an obstacle to labour mobility. The Government's proposals to deregulate new rents are already going through the House. Deregulation will, over

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time, substantially increase the supply of housing for rent. But this will not happen overnight, and there is a case for a special incentive to speed up the process in the early years.

G18. I therefore propose to extend the Business Expansion Scheme to include companies specialising in the letting of residential property on the new assured tenancy basis.

G19. The BES is well suited to this task. Since full tax relief is given immediately, it should bring forward new investment straight away. And we will be building on success.

G20. The limit for this type of investment will be £5 million a year for any one company. But since the relief is specifically designed to provide an extra stimulus in the early years of deregulation, it will run only for investments made before the end of 1993.

G21. This change will powerfully reinforce the impact of decontrol in reviving the private rented sector of housing in Britain.

G22. In last year's Budget I raised the ceiling for capital gains tax retirement relief from £100,000 of gain to £125,000. But I believe it is necessary to do more to help the small businessman whose entire wealth is tied up

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in his business and who is faced with the disincentive of a heavy capital gains tax bill when he sells up on retirement. I therefore propose to extend capital gains tax retirement relief so that, on top of the exemption, half of any gain between £125,000 and £500,000 will also be completely free of tax.

G23. Lastly, on the small business front, I propose to increase the VAT threshold to £22,100, the maximum permitted under existing European Community Law.

G24. Throughout my time as Chancellor, I have been on the look-out for taxes to abolish. Abolition is clearly the simplest variety of reform. I have already abolished the National Insurance surcharge, the Investment Income surcharge, Development Land Tax, and the tax on lifetime gifts. Today I propose to abolish a further tax: Capital Duty.

G25 At present, companies have to pay a 1 per cent duty whenever they raise new capital - whenever, for example, a new company is formed or an existing company sells new shares to the public. This is undesirable on two counts. It is a burden on companies who need to secure external finance for expansion. And it discriminates against equity capital as compared with debt finance and bank borrowing.

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G26. Capital Duty is a relatively recent impost which had to be introduced in 1973 in compliance with our obligations under European Community Law. But the relevant Community Directive has now been amended. Accordingly, I propose to abolish Capital Duty with effect from midnight tonight.

G27 At the same time, I propose to get rid of the Unit Trust Instrument Duty, a similar though much less substantial tax, which is levied at the rate of ¼ per cent on all property put into a unit trust. I know the unit trust movement will welcome this minor relief, and I trust the benefit will be fully passed on to investors.

G28. The cost of abolishing these two taxes will be of the order of £100 million in 1988-89. Not counting minor imposts, the demise of Capital Duty brings the number of taxes I have abolished up to five: an average of one a Budget.

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H. COVENANTS AND MAINTENANCE

H1. I now turn to an important area of personal taxation which is ripe for reform and simplification: the taxation of payments made under deeds of covenant and maintenance arrangements.

H2. Covenants to charity will be wholly unaffected by the changes I am about to propose.

H3. Other covenants, and maintenance arrangements, are essentially ways of transferring income from one individual to another, usually from one member of a family to another, whether it is a parent or grandparent covenanting to a child, or a husband paying maintenance to an ex-wife. Most financial transfers that take place within families are rightly and properly outside the scope of the tax system altogether. I propose, as far as is practicable, to take covenants and maintenance out as well. This will greatly simplify an unnecessarily complex part of the tax system.

H4. First, covenants. Charitable covenants apart, I propose to take all new covenants made by individuals on or after today out of the tax system altogether. In other words, people receiving payments under covenants

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will not be liable to tax on them, and those making the payments will not be able to claim tax relief on them. The tax treatment of existing covenants will continue unchanged.

H5. The largest single group of people affected by this change will be students, together with their parents, many of whom nowadays choose to make their contributions to the student maintenance grant by covenant. This has arisen as an unintended by-product of the reduction in 1970 of the legal age of majority from 21 to 18.

H6. As I have already indicated, those who have already made such covenants will continue to benefit from them. For new students, the parental contribution to the maintenance grant will be assessed on a new and more generous scale, to reflect the withdrawal of tax relief on new covenants. My rt hon Friend the Secretary of State for Education and Science will be publishing the new scale tomorrow.

less onerous?

H7. One desirable side-effect of this reform is that students will no longer be deterred from taking vacation jobs because their covenant income has already absorbed their personal allowance.

H8. Student covenants apart, there will be no compensation for the loss of tax advantage arising from these proposals. But once rates of income tax are set at

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reasonable levels, this is precisely the sort of tax shelter it is right to dispense with.

H9. Next, maintenance. Here, we tax the recipient only to give tax relief to the payer. The present rules can be complex and confusing for people going through separation and divorce. The tax system ought to intrude as little as possible, though it is reasonable that there should be some recognition of the fact that an ex-husband is continuing to support his ex-wife.

H10. Accordingly, I propose that, for new arrangements, recipients will not be liable to any tax whatever on maintenance payments. Relief to the payer will be restricted to payments to a separated or divorced spouse, up to a limit equal to the difference between the married and single allowances. But there will no longer be any tax relief either for payments above this limit, or for maintenance payments to anyone other than a separated or divorced spouse.

Nyd - ∴ it will be better tax-wise to back the marriage rather than the girl friend - is this the intention?

H11. For existing arrangements, the present rules will continue to apply in 1988-89, except that a separated or divorced spouse will be exempt from tax on receipts up to the difference between the married and single allowances. Full relief will continue for all those who are making payments under existing Court Orders or agreements. The same protection will also apply to those who have already applied for Court Orders, provided these are made by

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30 June. From April 1989 there will be special transitional rules to continue protection for pre-existing arrangements.

H12. While the transitional provisions are inevitably somewhat complex, the new system will be very much simpler than the old, for all concerned. At the same time, while it will reduce the tax relief that can be obtained by the better-off payers of large amounts of maintenance, for most couples the ex-husband will continue to enjoy full tax relief while the ex-wife will no longer be taxed.

H13. The reform of the tax treatment of maintenance I am proposing today will also remove one of the lesser known tax penalties on marriage. Tax relief greatly in excess of that which is available to a married couple will no longer be available to an unmarried couple who make large income transfers either between themselves or to their young children.

H14. As I have already indicated, the reform and simplification of the taxation of covenants and maintenance, which I have proposed today, in no way affects covenants to charity. Indeed, I have a proposal to help charities further.

H15. The payroll giving scheme has now been running for nearly a year. I am glad that so many employers have

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already set up schemes, and I hope as many employees as possible will take advantage of them. In order to give further encouragement to charitable giving, and to assist the growth of the payroll giving scheme, I propose to double the annual limit on tax-allowable donations under the scheme to £240 or £20 a month.

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J. TAXES ON SPENDING

J1. I now turn to the taxation of spending.

J2. I have one change to propose today affecting the coverage of Value Added Tax, which will remain at 15 per cent. Confectionery was brought in to VAT by the RHM for Leeds East in 1974, and the legal definition of confectionery goes back further still to the days of purchase tax. The emergence of new products has rendered this definition, like the RHM, somewhat obsolete. In particular, recent legal decisions mean that some cereal bars are subject to VAT, while others are not. I propose to clarify the law so that all cereal bars are taxed.

J3. I propose to raise the excise duties as a whole in line with inflation, but to make some modest adjustments within the total. The duty on cigarettes and hand-rolling tobacco will be increased, by the equivalent, including VAT, of between threepence and fourpence for a packet of 20 cigarettes. This will take effect from midnight on Thursday. The duty on a packet of five small cigars will rise by twopence, but that on pipe tobacco will remain unchanged.

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J4. As to the alcohol duties, I propose increases which, including VAT, will put about a penny on the price of a pint of average-strength beer and cider, fourpence on a bottle of table wine, and sixpence on a bottle of sparkling or fortified wine. There will once again be no increase in the duty on spirits. These changes will take effect from 6 o'clock tonight.

J5. I propose to reduce the duty on drinks known as 'coolers', which are mixtures of an alcoholic drink and a soft drink, so as to encourage the young in particular to move to drinks with a lower alcohol content. For the same reason, I propose from 1 October to abolish the minimum duty charge on beer, which will encourage the promotion of low-alcohol beers.

J6. I propose once again to leave the main rates of Vehicle Excise Duty unchanged. To recover the revenue forgone, I propose increases in petrol and derv duty over and above the rate of inflation, which, including VAT, will raise the price of petrol by between fivepence and sixpence a gallon, and that of derv by less than fivepence a gallon. These changes will take effect from 6 o'clock tonight.

This will be the headline.

J7. In my Budget last year, I sought to promote the use of lead-free petrol, with all the environmental benefits it brings, by introducing a duty differential in its

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favour. As a result, the number of garages selling lead-free petrol has more than trebled. But consumption remains disappointingly low.

J8. Accordingly, I propose to double the duty differential in its favour by exempting it altogether from the duty increase I have just announced for leaded petrol. This means that, despite the higher production costs, the pump price of unleaded petrol should in future be below that of ordinary 2-star petrol. I very much hope the petrol companies will now reinforce this concession by vigorously promoting the use of lead-free petrol.

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K. TAXES ON CAPITAL

K1. I now turn to taxes on capital.

K2. The emergence of the capital-owning democracy has been one of the most remarkable features of the 1980s. Encouraged by Government policy, almost three million families have bought their homes, bringing the total to nearly two households in three. And our proposals for personal pensions, which come in to effect in July, will give a new dimension to pension ownership.

K3. But the most dramatic change has been in share ownership. In last year's Budget, I announced the results of a joint Treasury/Stock Exchange survey of the number of shareholders in this country. This revealed that some 8½ million people - one adult in five - owned shares, about three times the number in 1979.

K4. A similar survey has been carried out this year. Despite all the stories of people taking quick profits on privatisation shares, and despite the stock market collapse, the results show that the number of individual shareholders has if anything risen further over the past 12 months, to very nearly 9 million. This illustrates in

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a quite remarkable fashion how the habit of share ownership is now taking root.

K5. I have two proposals to encourage share ownership still further to announce today.

K6. First, Personal Equity Plans are off to a successful start. Over a quarter of a million people took out PEPs in 1987, and subscribed nearly £½ billion between them. To give further encouragement to this form of investment, I propose to increase the annual limit from £2,400 to £3,000. The new higher limit will apply to all plans taken out this year.

K7. Second, measures to encourage employee share ownership have featured in seven out of the last eight Budgets. As a result, the number of approved all-employee share schemes has risen from 30 in 1979 to over 1400 today, involving well over 10,000 companies, and providing shares and options for well over 1½ million employees.

K8. Following extensive consultation, including the publication of draft clauses, I propose to relax the provisions of Section 79 of the 1972 Finance Act. This will make it easier for companies to provide shares to their employees outside the approved schemes without giving rise to an undue charge to tax. This will be of

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particular benefit to subsidiary companies and their employees.

K9. In previous Budgets I have already substantially reformed the taxation of capital, with the replacement of Capital Transfer Tax by Inheritance Tax. But I believe this process can and should be taken further. Last year, I reduced the number of inheritance tax rates from seven to four. This year, I propose to simplify the tax still further by levying it at a flat rate of 40 per cent.

K10. At the same time I propose to raise the threshold from £90,000 to £110,000.

K11. The increase in the threshold will reduce the number of estates liable to tax by a quarter allowing many more people to inherit the family home free of tax. And the flat rate of 40 per cent means that for the family business, enjoying 50 per cent business relief, the effective rate of tax can never exceed 20 per cent, one of the lowest inheritance tax rates in the industrialised world.

Nor in London and the S. East.

K12. The cost of these changes will be £100 million in 1988-89.

K13. Lastly, Capital Gains Tax. Strictly speaking, this should not be a tax on the original capital at all. Nor

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is it, so far as gains which have arisen since 1982 are concerned, thanks to the indexation provisions introduced by my predecessor in 1982, and extended in my 1985 Budget.

K14. But for gains that arose before 1982, the tax falls largely on purely paper profits resulting from the rampant inflation of the 'seventies. In other words, it bites deeply, and capriciously, into the capital itself.

K15. This has long been recognised as manifestly unjust. Indeed, from the time I first entered this House I have argued that Capital Gains Tax should fall only on real gains, and not on paper gains. I have therefore looked hard to see if the indexation provisions could be applied right back to the inception of the tax in 1965. Unfortunately, they cannot. The necessary information is in many cases no longer available.

K16. Accordingly, I have decided to bring the base date for the tax forward from 1965 to 1982. That is to say, for all disposals on or after 6 April, that part of any capital gain which arose before April 1982 will be exempt from tax altogether, for individuals and companies alike.

K17. This Budget thus ends once and for all the injustice of taxing purely inflationary gains. This will benefit the economy by unlocking assets which have been virtually

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sterilised because of the penal tax that would have arisen on any sale. And it will help many small businessmen and farmers in particular.

K18. At present, the first £6,600 a year of capital gain is tax free. The relatively high level of this threshold stems from the substantial increase my predecessor made in 1982, explicitly as rough and ready partial compensation for the continued taxation of pre-1982 paper gains. Now that I have taken pre-1982 gains out of tax altogether, I propose to reduce the capital gains tax threshold to £5,000. It should also be borne in mind that, with the introduction of independent taxation in 1990, a husband and wife will each have their own threshold for capital gains tax as well as for income tax.

K19. Rebasing the tax so as to produce a fully indexed system makes it possible to bring the taxation of gains closer to that of income. In principle, there is little economic difference between income and capital gains, and many people effectively have the option of choosing to a significant extent which to receive. And, insofar as there is a difference, it is by no means clear why one should be taxed more heavily than the other. Taxing them at different rates distorts investment decisions and inevitably creates a major tax avoidance industry.

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K20. Moreover, at present, with capital gains taxed at 30 per cent for everybody, higher rate taxpayers face a lower - sometimes much lower - rate of tax on gains than on investment income, while basic rate taxpayers face a higher rate of tax on gains than on income. This contrast is hard to justify.

K21. I therefore propose a fundamental reform. Subject to the new base date, capital gains will continue to be worked out as now, with the present exemptions and reliefs. In particular, the principal private residence will remain tax-free. But the indexed gain will then be taxed at the income tax rate that would apply if it were the taxpayer's marginal slice of income. In other words, I propose in future to apply the same rate of tax to income and capital gains alike.

K22. These changes will not take effect until 6 April.

K23. Taxing capital gains at income tax rates makes for greater neutrality in the tax system. It is what we now do for companies. And it is also the practice in the United States, with the big difference that there they have neither indexation relief nor a separate capital gains tax threshold.

K24. The changes I have announced represent a thoroughgoing reform of capital gains tax which will

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benefit the economy and eradicate a major injustice. They will sharply reduce the damaging effects of the tax, while ensuring that capital gains remain properly taxed and the yield of income tax adequately protected.

K25. They are expected to cost £210 million in 1989-90.

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L. INCOME TAX

L1. Finally, I turn to income tax.

L2. The way to a strong economy is to boost incentives and enterprise. And, that means, among other things, keeping income tax as low as possible.

L3. Income tax has now been reduced in each of the last six Budgets - the first time this has ever occurred. And the strength of the economy over that period speaks for itself.

L4. However, reforming Income Tax is not simply a matter of cutting the rates. I also have to look at all the various allowances and reliefs to ensure that they are still justified.

L5. With this in mind, I have a number of proposals to announce.

L6. First, forestry. I accept that the tax system should recognise the special characteristics of forestry, where it can take anything up to a hundred years between the costs of planting and the income from selling the felled timber.

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L7. But the present system cannot be justified. It enables top rate taxpayers in particular to shelter other income from tax, by setting it against expenditure on forestry, while the proceeds from any eventual sale are effectively tax free. Indeed a whole industry has grown up to promote this particular tax shelter.

L8. The time has come to bring it to an end. I propose to do so by the simple expedient of taking commercial woodlands out of the tax system altogether. That is to say, as from today, and subject to transitional provisions, expenditure on commercial woodlands will no longer be allowed as a deduction for income tax and corporation tax. But, equally, receipts from the sale of trees or felled timber will no longer be liable to tax.

L9. It is, perhaps, a measure of the absurdity of the present system that the exemption of commercial woodlands from tax will, in time, produce a yield of over £10 million a year.

L10. But in order to further the Government's objectives for the rural areas, I have agreed with my rt hon. Friends who have responsibilities for forestry and the environment that there should be a parallel increase in planting grants. Full details of the new grant scheme will be announced next week.

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L11. The net effect of these changes will be to end an increasingly blatant form of tax avoidance; to simplify the tax system, abolishing the archaic Schedule B in its entirety; and to enable the Government to secure its forestry objectives with proper regard for the environment, including a better balance between broad-leaved trees and conifers.

L12. One of the legacies of the years of penal top tax rates is the complicated special relief for large redundancy payments. This is no longer justified. I propose to increase the exemption limit for these payments from £25,000 to £30,000, and to abolish the additional relief for larger amounts.

L13. I have a few changes to propose following from the recommendations of the Keith Committee on the Inland Revenue taxes. Most are designed to improve compliance, and to help the Revenue to uncover taxpayers who do not declare all their income, particularly where large amounts of tax are being lost. At the same time I have reviewed the VAT enforcement regime, and have a number of relaxations to propose which will make life easier for businesses, while safeguarding tax revenue. Some of the penalties will be reduced from midnight tonight.

L14. Next, benefits in kind - perhaps better known as perks. One of the biggest tax-induced distortions in the economy today is the growing tendency to provide

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remuneration in kind rather than in cash. It must be right to move towards a system of lower taxes all round and fewer tax breaks of this kind.

L15. Far and away the most widespread benefit in kind is the company car, which is substantially undertaxed. Independent studies, based on figures supplied by the AA, suggest that an employee with a typical company car may be taxed on only a quarter of its true value to him.

L16. This discrepancy is too great to be allowed to continue. On the other hand, the scale of the undertaxation is so great that it cannot be put right in a single year. But in a Budget when I am able to reduce tax rates, there is a strong case for a substantial increase in the taxation of these benefits. I therefore propose to double the car scales for 1988-89. This increase replaces the 10 per cent increase which I had already announced for 1988-89. The yield from this will be £260 million in 1988-89.

L17. The scales for the taxation of car fuel adequately reflect the value of the benefit, and I propose to leave them unchanged for 1988-89.

L18. However, the taxation of the benefit of free car parking threatens to become an administrative nightmare. I propose to exempt this particular benefit from tax altogether.

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L19. Next, mortgage interest relief. This Government is committed to the further spread of home ownership. Mortgage interest relief has an important role to play in achieving that aim, and will continue in place, against both the basic and higher rates of tax.

L20. However, in addition to the decision to apply the £30,000 limit to the house or flat, which I have already announced, and which will remove the most widely-resented tax penalty on marriage, I have one further reform to propose in this area.

L21. This concerns the parallel tax relief for home improvement loans. Most of these loans are for fittings such as double glazing, and have played a significant part in the recent growth of consumer credit without in any way contributing to the expansion of home ownership. This may be partly due to the substantial scope for abuse, as loans ostensibly taken out for home improvements are used for other purposes, a matter which was the subject of a recent report from the Public Accounts Committee.

L22. I propose, therefore, to end tax relief for all new home improvement loans taken out after 5 April. Existing home improvement loans will be unaffected. This is expected to yield £80 million in 1988-89.

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L23. Finally, I turn to income tax itself.

L24. The statutory indexation formula means that I should increase all the principal income tax allowances and bands by the increase in the RPI over the year to last December, or 3.7 per cent, rounded up. I propose to do more than that; indeed twice as much.

L25. Thus the single allowance will go up not by £90, as required by indexation, but by £180, to £2605; and the married allowance will go up not by £150 but by £300, to £4095. The additional personal allowance and widow's bereavement allowance will thus rise by £120 to £1490. Similarly the single age allowance will rise by £220 to £3180 and the married age allowance by £360 to £5035. The higher allowances for taxpayers aged 80 and over, which I introduced in the last Budget, will correspondingly be increased by £240 and £360 to £3310 and £5205 respectively, and the new age allowance income limit will be £10,600. The upper limit of taxable income for the basic rate band will be increased to £19,300.

L26. The increases I have just announced mean that the basic tax thresholds will be fully 25 per cent higher, in real terms, than they were in 1978-79, Labour's last year. Indeed, the married man's tax threshold will be at its highest level in real terms for nearly half a century.

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L27. Given these substantial increases in the main allowances, I am taking the opportunity to simplify the system by abolishing three minor personal allowances which have been unchanged, in cash terms, for over twenty years: the housekeeper allowance, the dependent relative allowance, and the son's or daughter's services allowance.

L28. In our general election manifesto last year, we committed ourselves to reducing the basic rate of income tax to 25 pence in the £ as soon as it was prudent to do so. This pledge followed a reduction of twopence in the £ to 27 pence in last year's Budget.

L29. At the time, this was regarded with some scepticism, not to say cynicism, by the Opposition, who no doubt recalled that Labour Governments used to reduce tax only in front of an election, and at all other times increased it. Indeed, shortly before last year's Budget the rt hon Gentleman the deputy leader of the Labour Party said this:

> "I must advise the Chancellor of something he already knows: whichever party wins the general election, the tax cuts he makes in this Budget will be reversed."

L30. The time has come to put the rt hon Gentleman out of his misery. So far from reversing the 1987 Budget tax reductions, I propose to take this, the first opportunity

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since the general election, to fulfil our manifesto pledge. The basic rate of income tax for 1988-89 will be 25 pence in the pound.

L31. The small companies' rate of corporation tax will similarily be reduced to 25 per cent. This means that the basic rate of income tax, and the corporation tax rate for small companies, will both be at their lowest level since the war.

L32. Life Assurance premium relief remains in place for policies taken out before the 1984 Budget. It has traditionally been given at half the basic rate of income tax. I therefore propose to reduce it from 15 per cent to 12½ per cent. But, to give life offices time to adjust, this change will not take effect until 6 April 1989.

L33. I also propose to reduce the additional rate which applies to the income of discretionary trusts and for certain other purposes from 18 per cent to 10 per cent.

L34. It is now nine years since my predecessor, in his first Budget in 1979, reduced the top rate of tax from the absurd 83 per cent that prevailed under Labour to 60 per cent, where it has remained ever since.

L35. At that time, this was broadly in line with the European average for the top rate of tax. It is now one

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of the highest. And not only do the majority of European countries now have a top rate of tax below 60 per cent, but in the English-speaking countries outside Europe - not only the United States and Canada, but socialist Australia and New Zealand, too - the top rate is now below 50 per cent, sometimes well below.

L36. The reason for the worldwide trend towards lower top rates of tax is clear. Excessive rates of income tax destroy enterprise, encourage avoidance, and drive talent to more hospitable shores overseas. As a result, so far from raising additional revenue, over time they actually raise less.

L37. By contrast, a reduction in the top rates of tax can, over time, result in a higher, not a lower, yield to the Exchequer. Despite the substantial reduction in the top rate of tax in 1979, and the subsequent abolition of the investment income surcharge in 1984, the top five per cent of taxpayers today contribute a third as much again in real terms as they did in 1978-79, Labour's last year; while the remaining 95 per cent of taxpayers actually pay less.

in real terms?
as a proportion?

L38. After nine years at 60 per cent I believe the time has come to make a further reduction in the top rate of income tax. At present there are no fewer than five higher rates of income tax: 40 per cent, 45 per cent,

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50 per cent, 55 per cent, and 60 per cent. I propose to abolish all the higher rates of tax above 40 per cent.

L39. This major reform will leave us with one of the simplest systems of income tax in the world, consisting of a basic rate of 25 per cent and a single higher rate of 40 per cent. And, indeed, a system of personal taxation in which there is no rate anywhere in excess of 40 per cent.

L40. I believe that 40 per cent is an acceptable top rate of tax. But, bearing in mind that the basic rate of income tax is also the starting rate, 25 per cent is still too high.

L41. Since we first took office in 1979, we have now reduced the basic rate of income tax from 33 per cent - one third - to 25 per cent - a quarter. Our aim should now be to get it down to a fifth - a rate of 20 pence in the pound - as soon as we prudently and sensibly can.

L42. Meanwhile, I have today been able to reduce income tax at all levels, with increases in both the personal allowances and the basic rate limit, and reductions in both the basic and higher rates. The tax reduction for a married man on average earnings in 1988-89 will be worth nearly £5 a week. The changes will take effect under PAYE on the first pay day after 14 June. They will cost

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£4¼ billion in 1988-89 over and above statutory indexation, of which three quarters represents the cost of increasing tax thresholds and reducing the basic rate.

L43. The total cost of all the measures in this year's Budget, again on an indexed basis, is £4 billion.

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M. PERORATION

M1. In this Budget, I have reaffirmed the prudent policies which have brought us unprecedented economic strength. I have announced a radical reform of the taxation of marriage, which for the first time ever will give married women a fair deal from the tax system. I have eliminated the long-standing injustice of taxing inflationary gains, and abolished a fifth tax. I have radically reformed the structure of personal taxation, so that there is no rate anywhere in the system in excess of 40 per cent.

M2. After an Autumn Statement which substantially increased public spending in priority areas, I have once again cut the basic rate of income tax, fulfilling our Manifesto pledge of a basic rate of 25 pence in the £ and setting a new target of 20 pence in the £.

M3. And I have balanced the Budget.

M4. I commend this Budget to the House.

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