



2(A-F)

10 DOWNING STREET

PRIME MINISTER

DINNER AT DORNEYWOOD

1. I have had an informal briefing for the Chancellor's office of the sort of package he will describe to you. The Chancellor does not know this and would be horrified if he did.

So please do not give any indication that you have been briefed.

The Package

2. There are no great surprises. The key elements are:
- overall net tax reductions from an indexed base of £1.1 billion in 1989-90 and £1.5 billion in 1990-91. (1988 Budget figures were £4.0 billion in 1988-89 and £6.2 billion in 1989-90).
 - on present forecasts this will mean a 1989-90 PSDR of £12-13 billion, the same as now expected for 1988-89.
 - it will also mean a broadly unchanged ratio of tax and NICs / GDP between 88-89 and 89-90.
 - the net tax reduction is all accounted for by a freeze on all excise duties (ie non-indexed). This costs £1.18 b. from an indexed base. And a 5p. reduction in duty on unleaded fuel costing £40m.

- no change in income tax rates and normal indexation of tax allowances.
- extra revenue resulting from the estimated impact of the European Court judgement on VAT for non-domestic construction. Put at £345m. in 89-90 and £645m. in 90-91. Most of this extra revenue flows for public sector projects - for which the extra expenditure provision was allowed in the PEP round.
- no change in Vehicle Excise Duty on cars, but a substantial increase for coaches; yields £40m.
- a 20% increase in ^{company} car scales (following last year's 50%). Any bigger increase could produce significant losses for the Budget among relatively lowly paid people with company cars. 20% yields £90m.
- a mini-savings package:
 - main element to be the abolition of stamp duty on shares from 1/1/90. Costs £150m. in 1989-90 and £970m. in 1990-91.
 - some tightening up on the tax treatment of life assurance ^{business} yielding perhaps £250m. in 1990-91.
 - modest improvements for PEPs (life limits), share schemes and unit trusts.

Will go on with premiums

● a miscellany of other measures, including:

- a small package to help charities
 - some easing of age allowances
 - (possibly) extending employers NICs contribution to various benefits - in-kind, principally cheap mortgages.
 - a major ~~simplification~~ simplification of close company legislation (favoured by Emmanuel Kaye).
- probably nothing on tax treatment of residence. As you know he has dropped the idea of taxing world-wide earnings. The only issue now is some "tidying-up", which is likely to be left until next year.

The Forecast

The pre-Budget forecast is not yet completed. But emerging key changes from the October forecast are:

- a faster slowdown. GDP growth in 1989 (year on year) down from 3 1/2% to 2 1/2%. And unemployment possibly rising again by the end of the year.
- RPI (assuming full Budget indexation) year-on-year increase reaching 7.4% by February, fluctuating between 7.4 and 7.6 until June, 7.3 in July and then dropping fairly quickly as the mortgage effect works its way out of the figures.
- balance of payments figures improving in 2nd

L. Johnson
VBS return

(4)

D.

half of 1989, but annual 1989 total as high as 1988.

- an attempt to allocate out the residual errors suggests the current account deficit should be about £4 billion lower than the recorded figures.

The Key Issues

① The Fiscal Stance

Is £12-13 billion PSDR about right? Answer, probably yes:

- means a small surplus after privatisation and other current sales
- no change for 88-89 carries the right message about not indulging in fiscal fine-tuning (NB Alan Walker's point).
- difficult to prevent an increase in the tax and NICs / GDP ratio.

② Freeze on Excise Duties

Is this the best way to "spend" the fiscal adjustment?

This is more debatable.

The case for this (which the Chancellor will probably use) is the RPI benefit. Rather than the RPI staying at around 7 1/2% until mid-year with indexation (see above) a freeze will bring it down to 6.9% in April. However expenditure on all other related benefits - Spott/James

● The case against is:

- drink and tobacco are already too cheap.
- Better to use money to fund tax reforms, extraneous allowances or cutting rates (on last year's figures 1p off basic rate of income tax costs £1.5b. full year).
- wrong to distort budget in attempt to "control" inflation (the job of monetary policy).

You will want to consider the balance of the arguments.

③ Tax Allowances

Is normal indexation right? Answer, probably yes.

We discussed earlier the possibility of not indexing. But that was mainly in the context of ensuring the overall fiscal stance was sufficiently tight. Assuming the PSBR forecasts don't change, that point is not. In tax policy terms indexation is the right course - and perhaps the only issue now is whether allowances should be more than indexed instead of freezing excess duties, as under ② above.

④ Tax Reform

I have not yet had details of the various tax reform measures. But, stamp duty apart, it seems relatively minor stuff. Should it be more radical? Answer, probably not.

(6)

F.

⑤ Boring Budget?

This links with the last point. As we feared, I gather the Chancellor ~~is~~ is concerned that this is an unexciting, boring budget. You should aim to reassure him. Last year's Budget was exceptional. The principles this year must be consolidation and soundness, not excitement.

⑥ Monetary Policy

You should emphasise the importance of a strong anti-inflation section in the budget speech, re-explaining the role of monetary policy.

Do you want to urge him to state a firm zero-inflation target?

⑦ Handling of Papers

The Chancellor is excessively secretive over sharing papers about the Budget with us. It would be helpful if you could urge him to send you within the next week a summary of the present proposals, so you can have it to hand for future bitakeds. (Budget papers will, as usual, be handled as an exceedingly restrictive paper in the Private Office.)

Rleb
w/1

ANNEX 3: PUBLIC FINANCES AND THE TAX BURDENTaxation, Expenditure and Borrowing

Since the Government first took office, total taxes and NICs have risen by 4 percentage points of GDP, though the ratio has fallen from its peak in 1981-82. This has enabled us to make net repayments of government debt in the last two years.

Table 1Overall Taxation, Expenditure and Borrowing

(percentage of GDP at market prices*)

	Non-North Sea Taxes plus NICs (as per cent of non-North Sea GDP)	Total Taxes plus NICs	General Government Expenditure (excluding privatisation proceeds)	PSBR
1978-79	34.2	33.9	43.3	5.3
1979-80	35.1	35.1	43.5	4.8
1980-81	36.2	36.3	46.1	5.3
1981-82	38.7	39.3	46.6	3.3
1982-83	38.1	38.9	46.8	3.1
1983-84	37.7	38.5	45.9	3.2
1984-85	37.8	39.1	46.2	3.1
1985-86	37.1	38.5	44.5	1.6
1986-87	37.8	38.1	43.7	0.9
1987-88	37.6	37.9	41.6	-0.9

[*Treasury estimates for 1986-87 and 1987-88]

Personal Taxation

2. Despite reductions in income tax, total personal taxes (direct and indirect, including employees' NICs and domestic rates) in 1988-89 are over £30 billion higher in real terms (ie 1988-89 prices) than they were in 1978-79. For income tax and national

insurance contributions the following table shows how the proportion of gross pay they represent rose up to 1981-82:

Table 2

Income Tax and NICs as a per cent of Gross Earnings*

	$\frac{1}{2}$ average earnings	average earnings	2 average earnings
1978-79	16.0	27.8	31.4
1981-82	20.8	29.3	32.2
1982-83	20.8	29.8	32.3
1983-84	20.1	29.6	31.7
1984-85	19.3	29.2	31.5
1985-86	18.9	29.0	31.5
1986-87	18.9	28.5	30.9
1987-88	19.1	27.6	29.9
1988-89 (estimate)	18.5	26.3	28.2
1989-90 (indexation)	18.6	26.3	28.3

*Adult male earnings (all occupations). Married couple, wife not working: the couple are assumed to have no children, to avoid distortion of the figures from the abolition of child tax allowances.

3. These figures reflect the rise in the standard employees' NIC rate from $6\frac{1}{2}$ per cent to 9 per cent. The lower rates introduced in the 1985 Finance Act do not affect the cases shown. So far as income tax is concerned, personal allowances have increased by about 25 per cent in real terms since 1978-79, slightly less than earnings. The basic rate has been reduced from 33p to 25p.

4. Average earnings have of course increased by substantially more than prices since 1978-79. So a married man on average earnings has seen his real take-home pay rise by $\pounds X$ per week. The increase for a married man on half average earnings has been $\pounds Y$ per week, and on twice average earnings $\pounds Z$ per week.

4. As the table shows, indexation of allowances in the Budget, with no reduction in the basic rate, would lead to a very slight rise in the proportion of incomes taken in tax and NICs. This is because earnings are assumed to rise by more than the increase in tax thresholds, which is indexed to changes in prices.

Business Taxation

5. Following the sharp rise in corporation tax receipts over the past three years, as a result of the substantial recovery in company profits, total taxes paid by businesses (outside the North Sea) are now higher as a percentage of GDP than in 1978-79. Within this total, the major change has been a fall in employers' NICs (and NIS) as a "percentage of GDP, offset by increases in corporation tax, business rates and 'other' taxes as the following table shows:

Table 3

Tax paid by Businesses £bn in 1988-89 prices

(figures in brackets are per cent of GDP)

	Corporation Tax	Taxes on self employment incomes	Employers' NICs and NIS	Rates	Other ²	Total
1978-79	8.3	2.8	13.6	5.5	4.3	34.4
	(2.2)	(0.7)	(3.6)	(1.4)	(1.1)	(9.1)
1988-89 (estimate)	15.9	3.7	13.0	8.1	7.4	48.1
	(3.4)	(0.8)	(2.7)	(1.7)	(1.6)	(10.2)

¹Excludes North Sea, but includes ACT

²VED, car tax, road fuel duty, duty on rebated oils, capital taxes

1st and

at the
with ~~by~~
~~the~~
The
the ~~the~~
in the
The
the

[line agreed at
Cabinet
18/2/88]

PS/ CST
MR R. I. G. Allen