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Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

9 March 1989

Paul Gray Esq
10 Downing Street
LONDON
SW1

Dear Paul,

... I enclose, as promised, two copies of the latest draft of the
taxation section. The Economic Section will follow tomorrow.

Yours,

Moir

MOIRA WALLACE

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MPW/89/82

*downgraded to:***CONFIDENTIAL****TAXPAYER CONFIDENTIALITY**

Before I turn to my proposals for changes in taxation, I have one other change of a specific nature to announce.

2. As the House knows, the new official secrets legislation currently passing through Parliament is very much narrower in scope than the present Official Secrets Act. In particular, it does not cover information in the possession of either the Inland Revenue or Customs & Excise concerning the private affairs of specific taxpayers.

3. I am sure that the whole House will agree that it is essential for taxpayer confidentiality to be properly protected. I therefore propose to introduce provisions in this year's Finance Bill to ensure that it will continue to be a criminal offence for officials or former officials of either of the Revenue Departments to reveal information about the private affairs of a specific taxpayer.

4. I would only add that the need for this protection is in no sense a reflection on the probity and integrity of the members of those two Departments. Indeed, after nearly six years as Chancellor and more than eight years

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as a Treasury Minister, I would like to take this opportunity to pay public tribute to the outstanding service I have consistently received from the officials of both Departments.

BUSINESS TAXATION

5. I now turn to taxation. As I have done on a number of previous occasions, I propose to divide this into three broad sections: the taxation of business, the taxation of savings, and the taxation of personal income and spending.

6. First, taxes on business.

7. Ever since the corporation tax reform I introduced in 1984, the rate of corporation tax for small companies, defined for this purpose as those with annual profits of less than £100,000, has been set at the basic rate of income tax, currently 25 per cent. Large companies, defined as those with profits of £¹/₂ million or more, pay the main rate of corporation tax of 35 per cent, one of the lowest rates of tax on company profits in the world. Between £100,000 and £¹/₂ million the average rate of tax gradually rises from 25 to 35 per cent.

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8. I propose to keep the small companies rate in line with the basic rate of income tax for 1989-90 and to leave the main corporation tax rate unchanged. But I propose to increase the small companies' rate band substantially, by 50 per cent.

9. Thus the small companies' rate will apply to companies with profits of under £150,000, and the 35 per cent rate will only be reached at profits of £³/₄ million. These changes will reduce the corporation tax burden for more than half of all those companies that do not already enjoy the benefit of the small companies rate.

10. I propose to increase the VAT threshold to £23,600, the maximum permitted under European Community law.

11. I also have to set the scales for the private use of company cars. This remains far and away the most widespread benefit in kind. When I doubled the car scales in last year's Budget, I made it clear that this still left this benefit significantly undertaxed.

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12. Accordingly, I propose to increase the car scales by one third for 1989-90. The yield from this will be £160 million in 1989-90 and £200 million in 1990-91. There will be no change in the fuel scales.

13. Over the years I have received a number of representations from business complaining about the long-standing tax treatment of foreign exchange gains and losses. I recognise that as business becomes more global this subject becomes increasingly important. However, I have to say that I find it one of the most intractable I have encountered. Certainly, there can be no question of any change in the present system until a number of crucial and complex issues have been satisfactorily resolved. I have therefore authorised the Inland Revenue to publish today a consultative document which explores those issues and examines the scope for reform.

14. Finally, on business taxation, I have two major simplifications to propose, both of which follow from the income tax reforms I introduced last Budget.

15. One of the many undesirable features of an income tax system with several higher rates was that since a taxpayer's marginal rate could well be very different in

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different years, the question of which year income related to made a great deal of difference. This was true of Schedule E where the strict rule is that income is taxed in the year to which it relates, on an accruals basis.

16. For the vast majority of employees, this basis of assessment for Schedule E poses no problem. But for about half a million people, mainly directors, who do not receive all their income in the year to which it relates, it causes complications and often needless assessments and correspondence long after the tax year is over. It is also open to manipulation.

17. I therefore propose that income tax under Schedule E should in future be assessed on a receipts basis, with the simple principle that you pay the tax when you receive the income. This will have a transitional cost of £80 million in 1989-90 and £60 million in 1990-91, but in the long term it will yield both extra revenue and a significant saving in both taxpayer's time and Inland Revenue staff.

18. The reduction in the top rate of income tax to 40 per cent in last year's Budget also enables me to make a major simplification of the tax treatment of the

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vast bulk of the incorporated sector of small businesses: those known as close companies - generally speaking, unquoted companies that are controlled by five or fewer people.

19. The rules for the so-called apportionment of close companies' income are notoriously complex, taking up some twenty pages of impenetrable legislation. These rules are no longer needed and I propose to abolish them. I believe that family businesses in particular will welcome this substantial simplification.

20. I do, however, have to guard against the avoidance of tax on investment income by channelling it through a closely controlled investment company. Any such company which does not distribute most of its profits and other investment income will therefore be taxed at 40 per cent, equivalent to the higher rate of income tax.

TAXES ON SAVING

21. I now turn to the taxation of saving.

22. The sharp decline in the ratio of personal saving to personal income, over the past two years in

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particular has led to even more discussion than usual of the merits of providing greater tax incentives for personal saving.

23. Certainly it is desirable that, over the medium-term, we generate as a nation a level of saving sufficient to finance a high level of investment. But what matters for that is not personal savings alone, but corporate savings too, which are running at historically high levels, and public sector savings, which have been boosted by the move to budget surplus.

24. Moreover, the personal saving ratio is measured in net terms, that is to say as gross saving net of borrowing, and it has fallen not because of a decline in gross saving but as a result of the sharp increase in personal borrowing. And the appropriate remedy for that is to raise the cost of borrowing, and with it the return on saving, as we have done.

25. Above all, the role of tax reform is to encourage enterprise and improve economic performance in the medium term. It is wholly inappropriate as an answer to short term or cyclical phenomena. So for the taxation of savings, the Government's policy is clear. It is to

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strengthen and deepen popular capitalism in Britain, by encouraging in particular wider share ownership.

26. I have a number of specific tax measures to announce today to that end.

27. Personal equity plans, or PEPs, were first announced in my 1986 Budget, and started up in January 1987. As the House knows, those who invest in these plans pay no further tax at all, either on the dividends they receive or on any capital gains they may make - indeed, there is no need for them to get involved with the Inland Revenue at all.

28. Personal equity plans got off to a good start, with over a quarter of a million investors, many who had never owned shares before, subscribing almost £¹/₂ billion between them in 1987.

29. Since then, however, the take-up of new PEPs has slowed down, not least as a result of the changed climate in the equity market which followed the October 1987 Stock Exchange crash.

30. So the time has come to improve and simplify PEPs and give them a new boost.

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31. First, I propose to raise the annual limit on the overall amount that can be invested in a PEP from £3,000 to £4,800.

32. Second, within that, I propose to raise substantially the amount that can be invested in unit trusts or investment trusts. For many small savers, these provide an excellent introduction to shareholding. At present PEP investors may only place £540 a year, or a quarter of their PEP, in unit or investment trusts. I propose to more than treble this amount, to £2,400 a year; and I propose to allow the whole of a PEP to be invested in unit or investment trusts, up to this limit. To qualify for tax relief, the unit or investment trusts will be required to invest wholly or mainly in UK equities.

33. Third, at present, only cash may be paid into a PEP. I propose that investors should also be permitted to place directly into a PEP shares obtained by subscribing to new equity issues, including privatisation issues.

34. Finally, I propose to make a number of important simplifications to the PEP rules so as to make the

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scheme more flexible, better directed to the needs of small and new investors, and cheaper to administer.

35. I am confident that the changes that I have announced today will enable personal equity plans to play an important part in stimulating the spread of ownership of British equities in the years ahead.

36. I also have a number of improvements to announce specifically designed to encourage employee share ownership.

37. It is a striking fact that the number of approved employee share schemes has risen from a mere 30 in 1979 to almost 1,600 today, involving some $1\frac{3}{4}$ million employees. At present the annual limits on the value of shares which can be given under all-employee profit-sharing schemes are £1,250 or 10 per cent of salary up to a ceiling of £5,000. I propose to raise these cash limits to £2,000 and £6,000 respectively.

38. Second, I propose to increase the monthly limit on contributions to all-employee save-as-you-earn share option schemes from £100 to £150, and at the same time to double the maximum discount from market value at

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which options may be granted from 10 per cent to 20 per cent.

39. Third, a number of my Hon. Friends have been concerned that current tax law may be inhibiting the development of employee share ownership plans, otherwise known as ESOPs. These are distinguished from ordinary approved employee share schemes by the fact that they use a wider variety of finance, acquire more shares and tend to operate on a longer timescale. I propose to make it clear that companies' contributions to ESOPs qualify for corporation tax relief, provided they meet certain requirements designed to ensure that the employees acquire direct ownership of the shares within a reasonable time. I hope that this will encourage more British companies, particularly in the unquoted sector, to consider setting up ESOPs.

40. Those firms with employee share ownership schemes have no doubt that giving the workforce a direct personal interest in their profitability and success improves the company's performance. The same benefits flow from profit related pay.

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41. This was one of the reasons why in my 1987 Budget, I introduced a tax relief to encourage its development. I have some improvements to make to this scheme, too.

42. First, as I have previously announced, I propose to abolish the restriction that, to qualify for the tax relief, prospective profit-related pay must equal at least 5 per cent of total pay. Second, I propose to raise the limit on the annual amount of profit-related pay which can attract relief from £3,000 to £4,000.

43. Third, I propose to enable employers to set up schemes for headquarters and other central units using the profits of the whole company or group for their profit calculations. And fourth, to help share schemes and ESOPs as well as profit related pay, I propose to change the so-called material interest rules which may at present unnecessarily exclude employees from schemes where they can already benefit from a trust set up for employees.

44. Taken together, the package of measures I have announced to encourage wider share ownership in general, and employee share ownership in particular, will help to ensure that the idea of a share-owning democracy becomes

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ever more entrenched as a part of the British way of life.

45. Last June, the Inland Revenue issued with my authority a major consultative document on the taxation of life assurance.

46. The tax regime for life assurance is sui generis. The present system dates back to the First World War and has developed over the years in a piecemeal way, leading to a state of affairs in which the incidence of tax is extremely uneven, with some successful life offices paying no tax at all.

47. There is clearly a powerful case for reform, with a view to securing a tax regime which is more equitable both within the industry and as between life assurance and most other forms of savings.

48. , I have considered very carefully the representations the industry has made, and taken full account both of the changes to the regulation of life assurance proposed by the Securities and Investment Board under the Financial Services Act and the prospects for increased competition within the European Community after 1992. In the light of these factors, I have

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decided not to proceed with the more radical reforms canvassed in the consultative document. But I do have a number of important changes to propose, based for the most part on the general tax reform principle of seeking lower rates on a broader base.

49. First, many life offices run a pension business alongside their main life assurance business, and they are not required to keep the two businesses entirely separate for tax purposes. This enables them to set the unrelieved expenses of the pensions business against the income and gains of their life business, thus giving their life profits unduly favourable tax treatment. The life offices themselves have accepted that this treatment is anomalous and I propose to end it.

50. This change, along with some minor related changes, will come into force on 1 January 1990, and will yield some £150 million in 1990-91. The remainder of the changes I have to propose constitute a broadly balanced package which, because of the transitional provisions, will reduce the taxation of life assurance in 1990-91 by some £100 million.

51. I propose that the expenses incurred by life offices in attracting new business should continue to be

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fully deductible for tax purposes from the income and gains of life funds, but should in future be spread over a period of seven years. To give the industry time to adjust, this change will be phased in gradually over the next four years, starting on 1 January, 1990.

52. There are certain other, more technical matters raised in the consultative document which will require further discussion with the industry, and any legislative changes on these issues will have to wait for next year's Finance Bill.

53. But I can say here and now that I propose, as from 1 January 1990, to abolish Life Assurance Policy Duty. And I also propose, from the same date, that the rate of tax payable on the policyholder's share of income and gains of life offices, which at present stands at 35 per cent on unfranked investment income and 30 per cent on realised capital gains, should be reduced to the basic rate of income tax.

54. The net effect of all these changes to the taxation of life assurance will be a cost of £20 million in 1989-90 and a yield of £45 million in 1990-91, rising somewhat in subsequent years.

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55. But above all it will provide a more efficient and equitable tax regime for this most important industry.

56. Later this year, UK unit trusts will be able to compete freely in Europe and will face competition from analogous Community investment schemes here. At present, trusts investing in gilt-edged securities or other bonds face a tax disadvantage. They pay corporation tax at 35 per cent on their income but can pass on a credit of only the basic rate to their investor. So I propose that from 1 January 1990, as for life assurance companies, the corporation tax rate on unit trusts that come within the new European Community rules will be equal to the basic rate of income tax. Their investors will then get full credit for all the tax the trusts pay.

57. I now turn to pensions.

58. The tax treatment accorded to pension schemes is quite rightly particularly favourable; and the extent of this privilege has to be circumscribed by Inland Revenue rules. So pension schemes only qualify for tax relief if they meet certain conditions, notably that the pension paid may not exceed two-thirds of final salary:

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and if they fall foul of any of these rules, they lose all relief.

59. This has the perverse result that tax law effectively constrains the overall pension an employer can pay his employee. This is neither desirable nor necessary. Accordingly, I propose to make it possible for employers to provide whatever pensions package they believe necessary to recruit and reward their employees.

60. However, while it is clearly right that employers should be free to provide whatever pension they see fit, it would not be right to make the present generous tax treatment available with no upper limit at all. I therefore propose to set a limit on the pensions which may be paid from tax-approved occupational schemes, based on final salary of £60,000 a year.

61. I have deliberately set the ceiling at a level which will leave the vast majority of employees unaffected, and it will be subject to annual uprating in line with inflation. It will still be possible for a tax-approved occupational scheme to pay a pension of as much as £40,000 a year, of which up to £20,000 may be commuted for a tax-free lump sum.

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62. The new ceiling will apply only to pension schemes set up, on or after today, or to new members joining existing schemes after 1 June. And, as I have already said, there will now be complete freedom to provide benefits above the Inland Revenue limits, though without the tax relief.

63. The introduction of this ceiling on tax relief also enables me to simplify and improve the rules for the majority of pension scheme members, in particular to ease the conditions under which people can take early retirement.

64. I also propose to simplify very substantially the rules concerning additional voluntary contributions to pension schemes, or AVCs. In particular, the present requirements for free standing AVCs place a heavy administrative burden on employers. These requirements will be greatly reduced. Indeed, in many cases employers will not need to be involved at all.

65. Furthermore, if AVC investments perform very well, occupational pensions may at present have to be reduced to keep total benefits within the permitted limits. I propose that in future any surplus AVC funds should be returned to employees, subject to a special tax charge.

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This will remove the penalty on good investment performance.

66. The most important development in the pensions field in recent years has undoubtedly been the introduction and success of personal pensions. Since July last year, a million people have already taken advantage of the new flexibility and opportunities these offer. I have two proposals today to make personal pensions still more attractive.

67. First, I propose to make it easier for people in personal pension schemes to manage their own investments.

68. Second, I propose to increase substantially the annual limits, as a percentage of earnings, on contributions to personal pensions for those over the age of 35. This will be of particular value to those running their own business, who are often unable to make contributions until later on in their working life. It will also improve the position of personal pensions in relation to occupational schemes. The new limits will be subject to an overall cash ceiling based on earnings of £60,000, corresponding to the new ceiling for occupational pensions, and similarly indexed.

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69. These changes build on, and complete, the pension measures I introduced in my 1987 Budget. They represent a significant deregulation which will allow more flexibility, while setting for the first time a reasonable cash limit on the tax relief available to any individual. They should give a boost, in particular, to saving through personal pensions and through AVCs.

69a. Coupled with the changes I made in 1987, this is as far as I wish to go in amending the tax treatment of pensions.

70. Finally, on the taxation of saving, it should not be overlooked that a far-reaching reform which I announced in last year's Budget, to come into effect in April 1990, is relevant in this context.

71. I refer to Independent Taxation. For there can be little doubt that one of the greatest disincentives to saving in the present tax system is the treatment of the savings of married women. At present a wife's income from savings has to be disclosed to her husband and taxed at his marginal rate. Independent Taxation will change all that. In particular, those married women who have little or no earnings will in future have their own personal allowance to set against their savings income. Independent Taxation may well do much to encourage the growth of personal saving in this country.

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TAXES ON SPENDING

72. I now turn to taxes on personal income and spending.

73. As the House knows Her Majesty's Government are obliged to implement the European Court's judgement that certain of our zero rates of VAT on supplies to business, notably on non-residential construction, but also on fuel and power and on water, are not lawful. This derives from the Court's interpretation of the Community's Sixth VAT directive to which the UK agreed in 1977. The necessary changes will be introduced in this year's Finance Bill, and draft clauses have already been published.

74. In implementing the judgement I have sought to do as much as possible to minimise the burden. From 1 April VAT will be payable in respect of all non-residential construction unless carried out under a agreements entered into before the court ruling. And from 1 August landlords will have the option to tax rents, which means that in most cases no extra VAT will be paid at all.

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75. These measures will reduce the burden of VAT on construction so far as the private sector is concerned to just £35 million in 1989-90 rising to £110 million in 1992-93. Without them the yield from VAT on construction in the private sector would have risen to £450 million. There will also be a yield of £250 million from construction carried out for the public sector, and the public sector programmes concerned have already been protected by compensatory adjustments where necessary.

76. VAT will not be payable until July 1990 on water for industry or on fuel and power - then only on business users above a specified threshold. Private households will remain zero rated.

77. I have been particularly concerned about the impact of the European Court's ruling on charities. Unfortunately charities' business activities cannot lawfully be shielded from the effects of the ruling but I have been able to retain zero-rates for construction, water, fuel and power for all charities' non-business activities, for churches and for most residential accommodation such as old people's homes, students' hostels and hospices.

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78. I have considered whether there is anything further I can sensibly do to assist charities with their VAT bills in these special circumstances. I propose to relieve charities from VAT on fund raising events, on sterilising equipment for medical use, and on classified advertising.

79. I also propose to relieve from car tax cars leased to the disabled. This is equivalent to an overall saving of about £400 on each vehicle leased to a disabled person.

80. I also propose to allow the present rules on tax relief for membership subscriptions paid by covenant to heritage and conservation charities. If the member is given the right of full entry to view the charity's property, that benefit will be ignored in determining whether relief is due. This will be of particular benefit to organisations such as the National Trust.

81. But in general, I continue to believe that the best way of helping charitable causes through the tax system is by directly encouraging the act of charitable giving. The Payroll Giving Scheme, which I introduced in my 1986 Budget, has been growing steadily. Some 3,400 schemes have now been set up, and over 100,000

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employees are already participating, quite a few of them giving the full £240 annual limit for tax relief. I now propose to double that limit to £480, or £40 a month.

82. But for the Payroll Giving Scheme to achieve its full potential, it is clearly necessary for the charities themselves, and others involved, to mount a major information and marketing campaign to promote it. I am particularly glad that my Rt.Hon. Friend, the Viscount Whitelaw, has agreed to become Chairman of the new Payroll Giving Association, which will co-ordinate efforts in this field.

83. I now turn to the excise duties.

84. The damage to the environment in general, and to child health in particular, from lead in the atmosphere, and the contribution of ordinary leaded petrol to this problem, is increasingly widely known. The government is committed to phasing out leaded petrol altogether, and in successive Budgets I have sought to assist this. I first introduced a tax differential in favour of unleaded petrol in 1987, and increased it last year. But although sales are undoubtedly rising, unleaded petrol still accounts for only some 5 per cent of total petrol sales, even though two-thirds of the cars now on

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the road could use it, either without any adjustment or else with a conversion costing only some £20 or so.

85. One of the problems is ignorance of the facts. Many motorists do not realise that their cars can already use unleaded petrol. Many others are unaware how modest the conversion cost usually is. Others wrongly imagine that their car's performance would suffer were they to use unleaded fuel. Many are under the false impression that, if they do switch to unleaded petrol, their cars will no longer be able to use leaded petrol.

86. It is clearly essential that these myths are rapidly dispelled. Meanwhile, I propose to take the opportunity of this Budget to increase still further the tax differential in favour of unleaded petrol, by nearly fourpence a gallon. If this reduction is fully passed on to the customer - and I look to the oil companies to see that it is - it means that the price of unleaded petrol at the pump will generally be getting on for tenpence a gallon, or just over twopence a litre, cheaper than four star leaded petrol. This will be one of the most substantial differentials between the price of leaded and unleaded petrol within the European Community.

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87. But I do not intend to stop there. I also propose to raise the tax on two and three star petrol, so that the pump price of these grades will be at least as high as that of four star. This should encourage garages to phase out two star petrol, which is already down to about 6 per cent of the total market, thus enabling them to switch storage capacity to unleaded petrol - quite apart from the incentive to the remaining two-star users to switch to unleaded fuel.

88. I am confident that the duty changes I have announced, which will take effect from six o'clock this evening, will help to lead to a marked increase in the use of unleaded petrol over the next twelve months.

89. They will of course also lead to a loss of revenue of some £40 million in 1989-90. I propose to recoup this from Vehicle Excise Duty. At the present time a bus or a coach has to have 66 seats before it pays as much in Vehicle Excise Duty as a family car. I propose to rectify this anomaly by increasing the tax rates of this group of vehicles so that they cover their track costs. I also propose to increase the rates of duty for the heaviest non-articulated lorries, to put them on a more equal footing with articulated lorries. These changes

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will also simplify the system, greatly reducing the number of separate rates of Vehicle Excise Duty.

90. I have no further changes to propose this year in the rates of excise duty.

TAXATION OF INCOME

91. Nor do I propose any change this year to either the basic or higher rate of income tax.

92. Since I aligned the rates of income and capital gains tax in last year's Budget, it follows that I also propose no change this year in the capital gains tax rates. However, I do have a few changes to capital gains tax to propose.

93. With the advent of independent taxation from April 1990, married women will acquire their own capital gains tax threshold, so that a married couple will enjoy two such exemptions. In the light of this, I propose to maintain the capital gains tax threshold at £5,000 for 1989-90.

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94. Second, I propose to abolish the general holdover relief for gifts.

95. This was introduced by my predecessor in 1980, when there was still capital transfer tax on lifetime gifts, in order to avoid a form of double taxation. But the tax on lifetime giving has since been abolished, and the relief is increasingly used as a simple form of tax avoidance.

96. But while the general holdover relief will go, I propose to retain it for gifts of business, farm and heritage assets. I also propose to extend the existing relief for all gifts to charities to gifts of land to housing associations. And of course gifts between husband and wife will continue to be exempt.

97. In the case of gifts of personal belongings, these benefit from chattels relief, under which any items worth less than £3,000 on disposal are entirely exempt from capital gains tax. I propose to double the chattels exemption limit to £6,000.

98. Lastly, on capital gains tax, I propose to change the tax treatment of certain bonds so as to simplify the tax rules and prevent a loss of yield by the use of

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indexation to create losses and the conversion of income into capital gains.

99. To return to income tax, I propose to raise all the main income tax thresholds and allowances by the statutory indexation factor of 6.8 per cent, rounded up. Thus the single person's allowance will rise by £180 to £2,785, and the married man's allowance will rise by £280 to £4,375. The basic rate limit will rise by £1,400 to £20,700.

100. The single age allowance will rise by £220 to £3,400, and the married age allowance by £350 to £5,385. The higher level of age allowance will rise by £230 to £3540 for a single person, and by £360 to £5565 for a married couple.

101. I have a number of measures to help the elderly. In 1987 I introduced a new higher age allowance, for those aged 80 and over. I now propose to extend this to all those aged 75 and over. This will take an additional 15,000 elderly single people and married couples out of tax altogether. Three quarters of all those aged 75 and over will not be liable to income tax at all.

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102. The income limit for the age allowance will rise by £800 to £11,400, again in line with indexation. However, I propose to reduce the rate at which the age allowance is withdrawn above this income limit. I propose that in future it should be withdrawn at the rate of £1 of allowance for each £2 of income above the limit, instead of the present rate of £2 in every £3. This means that the marginal tax rate for those in the withdrawal band will be reduced to well below 40 per cent, thus meeting a large number of representations I have received over the past year.

103. The Finance Bill will also include the provisions to establish the new tax relief for the over-60s' health insurance premiums, which I announced to the House in January, and which will take effect from April next year, at a cost of £40 million in 1990-91.

104. I have one further change to make to help pensioners. Under the earnings rule, any pensioner who decides to continue to work after reaching the statutory retirement age has his or her pension docked at a rate of 50 per cent on every £1 earned between £75 and £79 a week, rising to 100 per cent for every £1 earned over £79 a week. This rule applies until he or she has reached five years beyond the State pension age.

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105. The Manifesto on which we were first elected in 1979 acknowledged that it was wrong to discourage people who wished to work beyond retirement age in this way, and pledged that we would abolish the earnings rule.

106. That is precisely what we shall do. My Rt. Hon Friend the Secretary of State for Social Services and I have agreed that the pensioners' earnings rule should be abolished from the beginning of October, the earliest practicable date. The necessary legislation will be included in the Social Security Bill currently before the House.

107. The cost to public expenditure will be £125 million in 1989-90, which will be entirely met from the Reserve. But the net cost of this measure will be significantly reduced by the income tax payable on the increased pensions.

108. Those who wish to defer taking their pension will remain entirely free to do so, and will continue to earn a higher pension in return.

109. I am sure the whole House will welcome this long overdue reform.

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110. If I were to adopt the so-called "duck test" now in vogue across the Atlantic, the pensioners' earnings rule would probably qualify as a tax, and I would now be able to claim to have abolished a sixth tax. But sound tax principles coupled with my innate modesty and natural reticence prevent me from doing so.

NATIONAL INSURANCE CONTRIBUTIONS

111. I have one further measure to propose.

112. It has long been a feature of the National Insurance system that, once people earn more than the lower earnings limit, which in 1989-90 will be £43, they have to pay National Insurance contributions at the same rate on the whole of their earnings up to the upper earnings limit. There are currently three different rates - 5 per cent and 7 per cent for those on lower pay and the standard rate of 9 per cent,

113. The two reduced rates, which I introduced for both employers and employees in my 1985 Budget, cut the cost of employing the young and unskilled, among whom unemployment was then high and rising, and cut the

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burden of national insurance contributions on the low paid. But the highly desirable reduction in the steep step at the lower earnings limit was at the expense of two small steps further up the earnings scale. This inevitably means that, at certain points on the income scale, people can still be worse off if they earn more. Their extra earnings take them from a lower rate band to a higher one, and they therefore lose more in National Insurance contributions than they gain in extra pay.

114. In agreement with my Rt Hon Friend the Secretary of State for Social Security, I now propose to build on my 1985 reform. For everyone who pays employee National Insurance contributions, I propose to reduce to only 2 per cent the rate of contributions on earnings up to and including the lower earnings limit. On earnings above that limit, there will be a single rate of 9 per cent, up to the upper earnings limit, which has already been set for 1989-90 at £325 a week.

115. This will abolish altogether the steps which at present exist at earnings, for 1989-90, of £75 and £115 a week. The step which has always existed at the lower earnings limit, where people first come into the National Insurance system, is the entry ticket to the full array of contributory benefits. As such, it is an

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essential feature of the contributory principle. But my proposals will more than halve this step, to only 86 pence a week in 1989-90.

116. There will be no change in the contributions payable by employers.

117. This reform will significantly reduce the burden of employees' National Insurance contributions across the board. For the lowest paid, that burden is now heavier than the burden of income tax. This is the most effective measure I can take to lighten it. For everyone on just under half average earnings or more, it will leave them £3 a week more of their own money.

118. The new system will take effect from the beginning of October, the earliest practicable date. The cost will be £1 billion in 1989-90 and £2.8 billion in 1990-91. The necessary legislation will be included in the Social Security Bill currently before the House.

119. The total additional cost of all the measures in this Budget, on an indexed basis, is under £2 billion in 1989-90 and £3¹/₂ billion in 1990-91.

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