

BUDGET SECRET
BUDGET LIST ONLY

1 of 5
NOT TO BE COPIED

8(a-e)

PRIME MINISTER

1990 BUDGET

... It may be helpful before our meeting on Wednesday if I set out more fully my current thinking on the Budget. I attach the latest Scorecard together with explanatory notes and longer annexes on capital limits, sovereign debt provision, charities, and saving.

Fiscal Prospect

2. I have reviewed carefully the fiscal prospect for the year ahead and beyond. As you know we know expect a much lower PSDR both this year and next than we had previously forecast. Our current forecasts are for £7 billion in the current financial year and £6 billion next year.

3. In the current year, the undershoot reflects a number of special factors, notably: the reduction in privatisation proceeds (£3 billion), the unexpected success of personal pensions (£2½ billion), and overspending by local authorities in anticipation of the capital controls (£2 billion). While these factors will not apply next year, we will begin to see the effects of the economic cycle, particularly on corporation tax and expenditure. We will also see a further build up in the cost of the 1988 and 1989 Budgets (£2½ billion).

BUDGET SECRET
BUDGET LIST ONLY

NOT TO BE COPIED

4. I need not stress how uncertain these projections are. The average error on our forecasts for the year ahead is in the region of £4 billion and some of the independent forecasters are expecting a higher debt repayment.

5. Projections beyond next year are even more uncertain. For what its worth our economists' central guess is set out below. It would be wrong to put too much weight on these. Nonetheless the figures do bring home how little room for manoeuvre we may have in the next few years if, as I think we should, we continue to aim for a balanced Budget in the medium-term.

The PSDR in the medium term

	1989-90	1990-91	1991-92	1992-93	1993-94
£ billion	7	6	-1	-2	-1
% of GDP	1½	1	-¼	-¼	-

6. These projections are on the basis of a forecast that we will overshoot our expenditure plans. When we publish projections in the FSBR we will show expenditure figures consistent with the plans. Given the uncertainties, I think it would be wrong to show a net borrowing requirement so I propose to publish the following

(assuming £5 billion of privatisation proceeds in each year from 1990-91):

	£ billion				
	1989-90	1990-91	1991-92	1992-93	1993-94
PSDR	7	6	2	0	0
after fiscal adjustment:					
- annual			1	1	1
- cumulative			1	2	3

Budget Arithmetic

7. I have reconsidered the Budget package in the light of this prospect. I am not inclined to make substantial changes. We have long set fiscal policy on the basis of medium-term trends and I think a substantial tax increase would give quite the wrong message politically as well as being of questionable effect economically. However, I am persuaded that the package should contribute and be seen to contribute to a resolute anti-inflationary policy. For that reason, I think we need to reduce the net cost in 1991-92 by some £300 million from the figure set out in the Scorecard. There are four main options:

- 40-91
B
- (a) introducing a progressive structure of car tax;
 - (b) freezing the married couples' allowance;
 - ✓(c) not cutting the corporation tax rate; and
 - (d) a combination of minor adjustments namely increasing the married couples' allowance and basic rate limit by 5 per cent rather than 7.7 per cent and not over-indexing the age allowances.

8. A case can be made for the first option. Customs and Department of Transport are satisfied that a graduated car tax ranging from 7½ per cent on the most fuel-efficient cars to 15 per cent on the least fuel-efficient would be feasible and could raise some £250 million in 1991-92. We could present it as a green measure and much of the cost would fall on imports and on companies. On balance, however, I am not attracted to this approach, at any rate this year when the Midlands is already having to adjust to a slowdown in growth, the car industry is about to face an unwelcome MMC investigation into UK car prices and we wish to bring voluntary restraints on Japanese imports to an early end. I suspect the measure would provoke more criticism both in the industry and in parts of the Party than would be justified by its modest yield. We may, however, want to come back to it next year in the light of the environment White Paper.

9. I am also inclined to reject option (b). Although the married couples' allowance is something of an anomaly and there is a case for letting it wither on the vine, I don't think this is the year to start. The allowance is of most importance to couples with only one income, some of whom will be facing substantial increases in Community Charge.

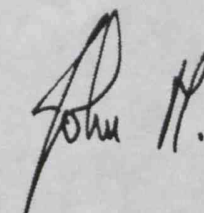
10. Dropping the Corporation Tax reduction would clearly deal with the arithmetic neatly but I still see considerable attractions in making this a Budget for business as well as for savers. The reduction would also make clear that we still intend to reduce tax rates in the medium-term and that our policy is to aim for low rates on a broad base (rather than, for example, the pre-1984 Corporation Tax system which offered high allowances at a high rate).

11. That would point to the last option but I would like to discuss the matter with you before reaching a decision.

Excise Duties

12. In the light of the truly appalling news on local authority budgets, we now expect the RPI to rise in April above 8½ per cent. I have considered, therefore, whether we should hold down excise duties. I am still of the view that we should broadly uprate the duties and do a little more on cigarettes and petrol. With hindsight, our decision last year to freeze the duties won us very little relief in the short-term and has made our position both on inflation and the fiscal balance appreciably more difficult this year. I am most concerned that we should not make our job in 1991 any harder. If we under-index the duties this year we will unavoidably be obliged to do so again next year and that will further restrict the scope for reductions in direct tax rates; indeed it could remove them. I was encouraged in this view by the almost unanimous support for raising the duties at Cabinet two weeks ago. Moreover if we did under-index we would have to show a lower PSDR in 1990-91 and 1991-92 unless we freeze personal tax allowances. Neither is attractive.

13. However, if we decide on option (d) above, we would raise extra revenue in 1990-91 as well as 1991-92 and on that basis, I think it would be worth amending the package to some extent: for example by indexing the duty on spirits (instead of increasing by 10 per cent as I had proposed) and also for increasing the duty on unleaded petrol by 7.7 per cent rather than 10 per cent. That will edge down the RPI effect a little and be welcome both to the whisky industry and our Scottish colleagues and to the environmental lobby.



JOHN MAJOR

BUDGET SECRET
BUDGET LIST ONLY

NOT TO BE COPIED

CONFIDENTIAL
DIRECT EFFECTS OF BUDGET MEASURES

	£ million		yield (+)/cost (-)
	1990-91	1991-92	
	Changes from a non-indexed base	Changes from an indexed base	Changes from an indexed base
1. Index income tax allowances	- 1690	nil	nil
2. * 10% on age allowances	- 35	- 35	- 50
3. 20% on car scales	+ 160	+ 160	+ 200
4. Excise duties	+ 1425	+ 35	+ 65
BUSINESS			
5. * 1% off main CT rate	- neg	- neg	- 315
6. Raise small companies' CT thresholds by a third	- neg	- neg	- 25
7. VAT: bad debt relief, simpler registration rules	- 35	- 35	- 225
SAVINGS			
8. Tax exempt special savings account	- 40	- 40	- 210
9. Abolish composite rate tax from 6/4/91	nil	nil	*
10. Abolish stamp duty on shares from introduction of TAURUS (assume 1/1/92)	+ neg	+ neg	- 120
11. PEPs, ESOPs etc	- neg	- neg	- neg
OTHER			
12. Phase relief on banks' sovereign debt provisioning	neg	neg	+ 200
13. Relief for workplace nurseries	- 10	- 10	- 10
14. Life assurance	+ 50	+ 50	+ 100
15. Relief for charities	- 5	- 5	- 5
16. Other	- 5	+ 30	+ 30
17. TOTAL	- 185	+ 150	- 365
18. Raise capital disregards for community charge benefit etc	- 95	- 95	- 95

* Uncertain cash flow yield : see note 8

BUDGET SECRET
BUDGET LIST ONLY

NOT TO BE COPIED

CONFIDENTIAL

N O T E S

Figures show cost (-) or yield (+) in £ million unless otherwise indicated.
Indexation 7.7 per cent.

1. Index income tax allowances

Cash gain, in £ per week:

	<u>Single</u>	<u>Married</u>
Basic rate taxpayer		
under 65	1.06	1.68
age 65-74	1.30	2.07
over 75	1.35	2.12
Higher rate taxpayer	6.31	7.31

Variants

	<u>1990-91</u>		<u>1991-92</u>
Increase basic rate limit by 5%	+ 65	+ 65	+ 110
Increase married couple's allowance by 5%	+ 115	+ 115	+ 145
Freeze basic rate limit	+ 215	+ 215	+ 390
Freeze married couple's allowance	+ 300	+ 300	+ 405

CONFIDENTIAL

2. 10% on age allowances

Table shows extra cost, on top of indexation in line 1. Aged income limit raised by 10%.

Extra cash gain, in £ per week:

	<u>Single</u>	<u>Married</u>
Basic rate taxpayer		
aged 65-74	0.34	0.53
over 75	0.38	0.63
Higher rate taxpayer	0.00	0.00

3. Increase car scales by 20 per cent

Cash cost, in £ per week, to typical Cavalier driver:

Basic rate taxpayer	1.78
Higher rate taxpayer	2.84

**BUDGET SECRET
BUDGET LIST ONLY**

CONFIDENTIAL

NOT TO BE COPIED

4. Excise Duties

10% increase in petrol, derv, spirits and cigarette duties; freeze VED for cars, and duty on pipe tobacco; half-index VED for lorries; 2½ percentage point reduction in pool betting duty; index rest.

	Price rise (pence)	<u>1990-91</u>		<u>1991-92</u>	RPI impact effect
		non-indexed base	indexed base	indexed base	
Cigarettes	9.6	+ 320	+ 75	+ 85	0.18
Cigars	3.7	+ 5	nil	nil	0.01
Pipe tobacco	nil	+ nil	- 5	- 5	0.00
Leaded petrol gallon litre	10.7 2.4	+ 400	+ 90	+ 85	0.13
Unleaded petrol gallon litre	9.3 2.0	+ 235	+ 55	+ 75	0.04
Derv gallon litre	9.0 2.0	+ 145	+ 30	+ 35	0.01
Beer (pint)	1.7	+ 155	nil	nil	0.07
Wine (75cl bottle)	6.8	+ 50	nil	nil	0.06
Spirits (bottle)	54.4	+ 100	+ 20	+ 25	0.05
Cider (pint)	0.9	+ 5	nil	nil	0.00
Other oils	neg	+ 15	nil	nil	0.00
VED: cars	nil	nil	- 180	- 185	0.00
other (see below)	neg	+ 15	- 30	- 30	0.00
Pool betting duty	nil	- 20	- 20	- 20	0.00
TOTAL		+ 1425	+ 35	+ 65	0.55

**BUDGET SECRET
BUDGET LIST ONLY**

NOT TO BE COPIED

CONFIDENTIAL

Very roughly, raises price of:

20 king size cigarettes costing	£1.60 to £1.70	(6½ per cent)
gallon of leaded petrol costing (litre	£1.80 to £1.91 40p to 42½p)	(6 per cent)
gallon of unleaded petrol costing (litre	£1.66 to £1.75 37p to 39p)	(5½ per cent)
gallon of derv costing (litre	£1.70 to £1.79 38p to 40p)	(5½ per cent)
pint of beer costing	£1 to £1.02	(2 per cent)
bottle of spirits costing	£8 to £8.54	(6½ per cent).

Widens unleaded/leaded tax differential from 14.2p to 15.6p a gallon, 3.1p to 3.4p a litre.

Assumes take-up of unleaded petrol rises from 29½% in January 1990 to 40% in 1990-91 and 50% in 1991-92.

Variants:

Index unleaded petrol:	reduces yield by	- 55	- 75
Index spirits:	reduces yield by	- 20	- 25

5. 1% off main corporation tax rate

Assumes start date 1 April 1990.

6. CT: raise small companies' threshold

From 1 April 1990:

- small companies' CT rate of 25 per cent available on profits up to £200,000 (instead of £150,000)
- benefit not fully withdrawn until profits £1 million (instead of £750,000).

7. VAT: bad debt relief, simpler registration rules

Costs against indexed base:

	<u>1990-91</u>	<u>1991-92</u>
(i) bad debt relief	nil	- 150
(ii) simplification of registration rules	- 35	- 75

8. Abolish composite rate tax from 6/4/91

In principle revenue neutral. In practice, likely to be cash flow yield in 1991-92, as most bank and building society savers have to pay basic rate of tax on interest receipts instead of (lower) composite rate. Cash flow cost in 1992-93, as tax refunds paid to non-taxpayers, more non-taxpayers allowed interest gross, etc. Orders of magnitude very uncertain.

9. Tax exempt special savings account

Assumes:

- (i) scheme starts January 1991;
- (ii) cumulative limit of £9,000 over 5 years;
- (iii) limit on investment £3,000 in first year, then £1,800 a year (£150 a month);
- (v) initial interest rate 12 per cent, falling by stages to 7 per cent by 1994-95 in line with MTFS projections.

10. Abolish stamp duty on shares from introduction of TAURUS (assume 1/1/92)

Cost of order of -900 in 1992-93, -950 in 1993-94.

CONFIDENTIAL

11. PEPs, ESOPs etc

	1990-91		1991-92
	non-indexed base	indexed base	indexed base
PEPs: increase limits	- neg	- neg	- neg
PEPs: investment trusts	- neg	- neg	- neg
ESOPs: CGT relief	nil	nil	- neg

PEP limits rise from

- £4,800 to £6,000 for total annual investment
- £2,400 to £3,000 for unit and investment trust element
- £750 to £900 for unit and investment trusts which do not satisfy UK equities test.

Investment trusts: for inclusion in PEPs, only 50% of trusts' portfolio, instead of 75% as now, need be invested in UK equities.

ESOPs: CGT rollover relief for sales of shares to ESOP trusts.

Further savings measure in line 18.

12. Banks' sovereign debt provisioning

Yield assumes that there will be a gradual worsening of sovereign debt repayment prospects; and that tax relief on banks' provisions is phased in two ways:

- (i) relief for 1990 provisions will be capped at 1989 levels, as determined by the Bank of England matrix in new statutory form. Relief for 1991 provisions will be capped at 1989 levels increased by 5 percentage points;
- (ii) tax relief on debt sales will be phased analogously, or over 5 years.

13. Relief for workplace nurseries

Details being sorted out.

CONFIDENTIAL

14. Life assurance

Already announced.

Life assurance companies gain of the order of 50, from 1992-93, from abolition of stamp duty.

15. Charities

Breakdown:

	<u>1990-91</u>		<u>1991-92</u>
New VAT reliefs	- 5	- 5	- 5
Relief for one-off donations	-neg	-neg	-neg
Raise payroll giving limit to £600	nil	nil	-neg

Cost of relief for one-off donations assumes basic rate relief available to charities for donations of £600 or more up to limit of £5 million a year. Cost of -5 in 1992-93.

16. Other

E.g. raise BES limit from £500,000 to £750,000; freeze annual exempt amount for CGT (which doubles for married couples with independent taxation); remove VAT relief from company accommodation provided for directors; double blind person's allowance.

17. Total

Cost in 1992-93 just over -1,500.

18. Raise capital disregards

Housing benefit and community charge benefit: from £8,000 to £12,000.

Income support and family credit: from £6,000 to £9,000.

MEANS-TESTED BENEFITS: CAPITAL LIMITS

I promised you a note on my proposal that the upper capital limits should be increased. I have now discussed this with Tony Newton. (I am sorry the note is so long but this matter is very complex.)

2. There are, of course, many different options. Details of three of them are set out in the annex.

3. Option A would involve a 50 per cent increase in all the limits. It would cost about £60 million in 1990-91, if the change in the community charge benefit limit only were made retrospective. The full year cost would be £90 million. There would be around 130,000 gainers, including 80,000 pensioners. Among the gainers would be 50,000 couples, so that 180,000 individuals in all would gain.

4. I know that you are concerned at the justification for higher limits in income support and family credit. But I think it would be difficult to defend leaving these limits unchanged at £6,000 while increasing the limits for housing and community charge benefits. In principle, there is no reason why we should help people up to a certain amount of capital with their housing costs and community charge bills but not with their other living expenses. And income support is a benefit which goes to many pensioners and disabled people as well as those who are unemployed, while family credit is, of course, an in-work benefit for those on low incomes.

5. This is the argument for Option B in the annex - a £10,000 limit for all the benefits, costing £100 million in a full year. However, Option A better meets our political objectives, in providing for a larger increase in the community charge benefit limit.

6. Tony and I have considered carefully the possibility of a higher limit for couples in community charge benefit (for example

on the lines of Option C in the annex). This has some attractions and would seem an appropriate response to the introduction of the community charge, which is a personal liability. However, upon examination, it has significant disadvantages too:

(a) If we conceded a higher couples limit in community charge benefit, we might well be pressed to do the same in the other benefits, at further substantial cost.

(b) Unless the rules for taking into account assumed income from capital were relaxed, a great many couples at the upper end of the new range (say at £15,000 or £16,000) would not benefit. However, relaxing these rules would help all those with capital above £3,000 and so add substantially to the cost of the change.

(c) The computer operations of most local authorities are programmed to deal with housing and community charge benefits on the same basis, with common rules for capital and income. It would be a major task to re-programme to provide for different treatment of capital, especially if we were also to introduce a new limit for couples.

(d) For this reason, it is unlikely that a higher limit for couples only in community charge benefit could be achieved by a large number of authorities in the course of 1990-91; we would have to wait until April 1991.

(e) We would be faced with some difficult cases of widows (and widowers) who would lose all their benefit entitlement on the death of their spouse, because the single person's limit would then apply. If only community charge benefit were affected, this would probably be defensible. But some people would also lose significant amounts of housing benefit, if the rules for the two benefits remained the same.

(f) Much of the present political pressure comes from widows with just over £8,000, who would not benefit from a couple's limit equivalent to £8,000 per person.

(g) Some of the pressure for a separate couple's limit comes from those who see an inconsistency between independent taxation and the fact that a couple's capital is jointly assessing in community charge benefit. We could only fully meet this point by providing that each partner in a couple should have a separate capital limit. This would breach the key principle that means-tested benefits are assessed for couples on the basis of joint incomes and capital. Departing from this principle would, of course, be extremely expensive. If we introduced a higher limit for couples while retaining joint assessment, we would then be pressed to bring in separate limits. I think we must maintain the position that it is right to treat taxes and benefits differently.

7. Option A would avoid these problems and would, in practice, provide more help to couples than to single people with the same income and capital. This is, of course, our intention, and there are two reasons for this. First, the income taper which reduces benefit entitlement (15p for each extra £1 of net income in the case of community charge benefit) does not start to operate for couples until a higher level of income than for single people. Second, community charge benefit pays for up to 80 per cent of the charges people actually pay, so that where two charges are payable entitlements will be higher for any given level of income and capital.

8. Having discussed these options in detail, Tony and I think that, on balance, a 50 per cent increase in all the limits (Option A) would be the most effective way of meeting our objectives - to encourage savings, while continuing to target help on those who need it most, and to provide additional help for people, especially pensioners, who are faced with high community charge bills. Another important consideration is that it could be

implemented by October, with the possibility of backdating the community charge increase to April. Other more complicated options (involving, for example, a separate higher limit for couples) might be feasible for some local authorities by October, but Tony is clear that a sufficiently large number of authorities would be unable to make such changes that we could not safely propose them.

9. The Chief Secretary has agreed that the first year cost of £60 million in 1990-91 (assuming retrospection for community charge benefit only) could be met from the Reserve.

10. Tony and I have discussed how far these changes could be backdated to 1 April. Changes to benefit rules are not normally backdated. And in administrative terms, exact backdating would be immensely difficult because in many cases, claimants' circumstances (eg levels of income and capital) will have changed in the intervening period. However, Tony believes that it would be possible for local authorities to apply a rough and ready retrospection of the increase in the community charge benefit limit. This could be done by making lump sum payments in October, which would be based on claimants' entitlements at that time. Although some claimants' personal circumstances may change between April and October, their community charges will (except in any capped authorities) be fixed over that period.

11. I think we need to give further urgent consideration to this point. Although there would be some presentational attractions in retrospection for community charge benefit, there might be anomalies which would be hard to defend. For example, some claimants might be entitled to benefit during April to September but not in October; they would get no benefit in respect of the earlier period. I am also uneasy as to whether we could defend retrospection for community charge benefit only and not the other benefits.

12. However, the main conclusion which Tony and I have reached is that I should announce in my Budget Statement a 50 per cent increase in the upper capital limits, as in Option A. I would welcome your views, following which Tony and I will consult further on the timing of implementation and, in particular, on how far the community charge change should be made retrospective.

13. I am sending a copy of this note to Tony Newton.

CAPITAL LIMITS: OPTIONS

Option A

	<u>Current limit</u>	<u>Proposed</u>
Income support/ family credit	£6,000	£9,000
Housing benefit/ community charge benefit	£8,000	£12,000

Cost: £90 million in full year

Gainers: 130,000 single people and couples.

Option B

	<u>Current limit</u>	<u>Proposed</u>
Income support/ family credit	£6,000	£10,000
Housing benefit/ community charge benefit	£8,000	£10,000

Cost: £100 million in full year

Gainers: 105,000 single people and couples

Option C

	<u>Current limit</u>	<u>Proposed</u>
Income support/ family credit	£6,000	£8,000
Housing benefit	£8,000	£10,000
Community charge benefit (single)	£8,000	£10,000
Community charge benefit (couples)	£8,000	£15,000

Cost: £75 million in full year

Gainers: 120,000 single people and couples.

Note: It is assumed that the existing lower capital limit of £3,000 (ie below which capital is ignored) is retained for all benefits. Costs exclude extra administration costs still to be agreed.

TAX RELIEF ON BANKS' SOVEREIGN DEBT LOSSES

Since the mid-1980s the banks have been making increasing provisions against their sovereign lending to third world countries, as the prospect that these loans will be repaid has receded. At the same time the Inland Revenue have been discussing with the banks, but have so far failed to reach agreement with them, about what tax relief may be allowed against these provisions. Tax relief of the order of £2-3 billion or so is at stake if the debts go wholly bad. I have concluded that I must act in the Budget to protect the Exchequer from excessive or premature tax relief, and to bring more certainty to the tax treatment of such provisioning.

2. The law at present is rather cryptic. It says that tax relief is available for bad debts and for doubtful debts to the extent to which they are estimated to be doubtful. But because a country cannot go bankrupt it is difficult to demonstrate that its debts are bad; and hard to reach an objective estimate of how doubtful they are.

3. The Inland Revenue have tried to deal with this difficulty by conducting their discussions with the banks around the Bank of England's matrix, which is an analytical tool used by the Bank to encourage the banks to make the prudential provision for such lending which is required by the Banking Act.

4. The Revenue have had partial success. But the banks have not yet come to an agreement with them and there is a real risk that the courts could find much higher amounts of tax relief are due under existing law. The prospect of repayment of these debts continues to recede and a step-change for the worse, such as we have seen in 1989, is always a possibility. That carries an unacceptable and unpredictable risk for the Exchequer.

5. I have accordingly decided to legislate in the 1990 Finance Bill to remove the uncertainties in the present law and to provide

for a planned phasing of this tax relief. Banks' tax relief will be capped in 1990 at 1989 levels as determined by the Bank of England's matrix in new statutory form; and in 1991 at a level 5 per cent above that, in 1992 10 per cent above and so on. If the banks sell their debt and crystallise their losses their tax relief on those losses will generally be similarly phased. Because we were forecasting a more rapid build-up of tax relief this change generates a tax yield of around £200m in 1991-92 and smaller amounts thereafter; this will unwind later on.

6. The banks will complain about this change but it is a less severe outcome than some of them have feared. We can argue that no change has been made to the principle that tax relief is available for bad and doubtful debts, and that the peculiarity of this lending and its scale requires clarification of the law in order to protect the Exchequer. On the international front my assessment is that this change will cause us some, but not unmanageable, difficulty, and that some will welcome it.

THE BUDGET : CHARITIES

This annex deals with my proposed measures to help charities this year

2. First, I want to give a boost to large one-off donations to charities, by giving income tax relief on them. David Waddington and Richard Luce have suggested that this would be helpful, and the charities have been pressing for it. I think we need this to fill a gap in the reliefs for charitable giving: regular donors can use either the payroll giving scheme or covenants; but the covenant system is ill-suited to encourage large gifts by the better-off.

3. What I propose is a scheme where a charity can claim back basic rate tax on large donations. The reason for giving the relief to the charity rather than to the donor is that the entire benefit will go to charity even if the donor does not increase his donations. (The danger of giving relief to donors is that they may pocket the tax relief without increasing their donation). Charities could then encourage further giving by saying "for every donation you give, we can claim an extra 33 per cent from the tax man". I would not - exceptionally - give higher rate tax relief here as that would complicate the scheme.

4. I have still to settle the details of the scheme, including the limits of the relief. I want a minimum amount on the size of donations which attract relief, because giving relief for millions of small donations would be prohibitively costly, both to the Exchequer and in administration. I am proposing to set this lower limit at £600 per donation.

5. I should also like an upper limit which would set a maximum on what the Exchequer would be prepared to contribute. I nevertheless have in mind a fairly high limit of £5 million.

6. The gross cost of this, depending on the take-up, might be about £15 million; but some of this may be offset by a reduction in the use of covenants, in which case the net cost would fall to about £5 million. (The reasons for the modest cost is the high threshold of £600.)

7. The remaining measures I propose for charities are :

- increase the payroll giving limit from £480 a year to £600 a year (ie an amount equal to the minimum for tax-relieved one-off donations);
- extend zero rates of VAT to ancillary work for charities' advertising, waterborne ambulances and in-shore rescue boats; and further extend the concessions for medical equipment (you will recall that European obligations prevent us from exempting charities from VAT entirely);
- introduce measures to simplify covenants further.

I am also considering relaxations in the existing provisions for relief for charitable donations by companies.

8. The cost of these measures will be about £6 million. So overall, the charities' package will have a gross cost of around £20 million in the first full year.

SAVINGS MEASURES

This annex describes the Budget proposals on savings.

Tax exempt small savings accounts.

2. The first measure is a new tax-exempt special savings account (TESSA, for short), to encourage and reward the saving habit among ordinary people. It will be a savings account, to be available from January 1991, into which individuals will be able to make contributions over 5 years. I particularly wish to encourage the banks and building societies to offer facilities for regular contractual saving in a TESSA, but the scheme will be sufficiently flexible to permit saving on a more ad hoc or intermittent basis. The interest will be completely free of both basic and higher rate tax provided no capital withdrawals are made until the end of 5 years. But withdrawal of interest will be allowed.

3. While I particularly want to attract the small saver, I have chosen not to make the limits on the amounts that can be saved too restrictive: £9,000 in total over five years, with an annual maximum of £1,800 (£150 per month). During the first year, however, investment of up to £3,000 will be permitted to allow pensioners, in particular, to invest a slightly larger lump sum initially if they wish, and draw on the interest. It will also encourage others to invest small lump sums they receive, perhaps on bonuses from their job or an inheritance.

4. I expect this scheme to be very popular with small savers, and to signal strongly our commitment to longer-term saving. If the banks and building societies rise to the challenge - as I expect they will - take-up could be significant. It is always difficult to make accurate projections for new schemes like this, but I would not be surprised to see it building up to, say,

5 million accounts over a few years. On this basis, the annual cost could then be £500 million or more a year.

5. Much of the initial investment will come from switching out of existing bank, building society and National Savings accounts. I see no problem here. Some may also come from investors choosing a TESSA rather than other forms of saving, including life assurance companies. Life offices will not welcome this, particularly as a package of measures we announced in December (primarily aimed at preventing life companies getting tax free capital gains) will have some cost for them. But the package was discussed in advance with the life industry, and they recognised that the capital gains loophole would have to be closed.

6. This will be the first time that ordinary savers will have been able to save in the High Street with banks and building societies (their preferred vehicles) and avoid tax on modest savings.

Composite rate tax on deposit interest.

7. As you know, at present, nearly 15 million people pay CRT who are not really liable for tax at all. Apart from the fact that this is unfair, Independent Taxation would make it very apparent and I am sure we have to have to take action. (If we do not, much of these savings will go off-shore and there will be a growing public perception of the unfairness of the present system.) To deal with this, the second significant savings measure is the abolition of composite rate tax (CRT) on bank and building society accounts. Like you, I want to see this implemented as quickly as possible, so that it will help non-taxpayers (including those who become non-taxpayers as a result of independent taxation) from the earliest possible date.

8. I am still discussing the practical details with the Revenue but I hope that it will prove possible to abolish CRT from April 1991. From that date, banks and building societies would

deduct tax at the basic rate on deposit interest. So the rate would rise from 22 per cent to 25 per cent for taxpayers, unless we cut the basic rate next year.

9. To achieve that, we shall need

- to work up with the banks and building societies special arrangements to enable as many as possible of the 15 million or so non-taxpayers to receive their interest gross; and
- to put the Inland Revenue in a position to repay tax to all those who do not or cannot take advantage of those special arrangements.

10. This is a big programme to be achieved in a very short time. There will be a significant cost (and some risk) in getting the new arrangements up and running. We shall need to explore with the banks and building societies how best to meet the 1991 timetable.

11. In Exchequer terms, the abolition should be more or less self-balancing over time, with a small net loss of revenue from taxpayers transferring assets to their non-taxpaying spouses (and perhaps other relations). But initially, differences in the timing of tax payments could give a yield of perhaps £800 million in 1991-92, which would be largely unwound in 1992-93 as the cost of repayments to non-taxpayers built up. The exact figures will depend on the number of non-taxpayers receiving payments gross.

12. All this is bound to require extra civil servants in the Inland Revenue and more office accommodation. While I shall of course keep the numbers down as far as is reasonably possible, I think a substantial increase is a price we have to pay.

Other measures

13. I am proposing a number of more modest savings measures:

- (i) Personal equity plans (PEPs): The annual investment limit is to be raised from £4,800 to £6,000 for 1990-91. Within that overall level, the limit for investment in unit or investment trusts will be raised from £2,400 to £3,000. I also propose to relax the requirement that to qualify, unit and investment trusts must themselves invest at least 75 per cent in UK equities: the figure will be reduced to 50 per cent.
- (ii) I propose to raise the capital disregards for means tested benefits, including the community charge benefit. I am minuting you separately about this.
- (iii) I am giving capital gains tax relief on transfers of shares into employee share ownership plan (ESOP) trusts. The effect will be that someone selling shares to the trust will be able to use the proceeds to buy another asset and will be able to defer tax on any gain until that asset is disposed of. We legislated a statutory framework for corporation tax relief for company contributions to ESOPs last year, but so far no one has taken this up. I believe that this new relief is needed to get things moving.
- (iv) We have spoken about the friendly societies tax-exempt limit. I plan to increase it so that policies with premiums of £150 will be exempt (the present limit is £100). I shall, of course, want to review the tax treatment of friendly societies again when we have decided what to do about the powers and regulation of friendly societies

- (v) I want to extend to banks the ability to offer SAYE share contracts. These contracts, which require regular savings over 5 years, are often linked to approved share option schemes. At present, only the Department for National Savings and building societies can operate them; but the banks have pressed to be able to offer them - they point out that it looks odd if, for the purpose of the bank's own share option scheme, employees have to save through a building society or DNS. And this measure fits well with the general thrust of savings package.