PO-CH/NL/0040

PART B

SECRET

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PO -CH /NL/0040

PART B

1986 BUDGET BRIEFING AND BUDGET PRESENTATION

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PO -CH /NL/0040
PART B

STARTS:-10-03-86

45/17

Pmp

FROM: ROBERT CULPIN

DATE: 10 MARCH 1986

FINANCIAL SECRETARY

cc Chancellor

BUDGET PRESENTATION: INLAND REVENUE

I understand that, at prayers last week, the Chancellor asked you to discuss with Mr Battishill the Inland Revenue's proposal to hold a briefing for journalists on the Thursday after the Budget.

2. The background is this. The Revenue's press officer, Miss Tyrrell, told me that the Board had decided in principle on a briefing by officials, probably over lunch. She says it will concentrate on details rather than policy: it will be designed, in the main, to influence reflective weekend reporting. I have checked today that the plan is still on.

3. I reported it to the Chancellor. The briefing would be an innovation. Even though the emphasis might be technical, it would be bound to cover the Green Paper, for example. I asked if he was content - hence his request to you. His initial reaction to me is that it is "not a good plan".

4. The Chancellor himself will see the City/economics editors on Budget Wednesday. If the Revenue were to see tax writers on Thursday, I am not sure how, if at all, we could best fit in the suggestion in Mr Scholar's note of 6 March - that you might want to talk personally to a few personal finance writers on the Green Paper, and perhaps some business correspondents on the BES and other matters.

5. Would it, I wonder, be worth politely suggesting to the Revenue that they might invite you to lead their Thursday briefing?

RC

ROBERT CULPIN

CONFIDENTIAL

FROM: R A L LORD

DATE: 11 MARCH 1986

cc. Chancellor
Financial Secretary
Minister of State
Economic Secretary
Mr Cropper
Mr Davies
Miss O'Mara
Miss Peirson
Mr Pickering

CHIEF SECRETARY

SDP-LIBERAL "BUDGET"

You asked for briefing on the so-called SDP-Liberal Budget produced yesterday. I attach a copy.

2. The main feature seems to be downgrading of their hopes for cutting unemployment, from 1m. to ¾m. The costing of Labour's pledges may be inducing an extra degree of caution in the other opposition parties.

3. The measures themselves are little different from those in the 1985 SDP-Liberal "Autumn Statement" (copy attached). In the "Budget" they are set out on page 4. Doubling the CP is less ambitious than giving all unemployed over 1 year a job guarantee but they have added £0.3bn. for training.

4. Overall they are suggesting measures with a gross cost of £5.5bn. in the first full year. The PSBR cost is put at £3.5bn., but the initial reaction from PSF is that it would probably be higher. PSF will provide a note. The "Autumn Statement" presented a £5bn. "budgetary boost" which appeared to equate gross cost and PSBR effect.

5. The document makes the astonishing claim that "Britain is becoming a low growth, low productivity, low skill economy. (page 1, para 3). This is about as accurate as the Fulham letter.

6. As far as the exercise costing SDP and Liberal spending commitments is concerned I suggest we should go ahead with costing their full programmes as outlined in "The only way to a fairer Britain" and "These are Liberal Policies", both published last month. But we must be prepared to concede that they would not increase expenditure by the total amount in one year. A basic rate of 50p (or whatever) in the course of a single Parliament is almost as useful a rock.

GB

For R A L LORD

ALLIANCE (archive)

FACING THE JOBS CHALLENGE

The SDP/Liberal Alliance Autumn Statement 1 September 1985

THE CHALLENGE

Britain is faced with a challenge. The challenge is to get the economy growing fast enough to bring down unemployment, but to make sure that the economic growth is real and that the prospects for more jobs are not swept away by rising inflation.

The Conservatives have failed to meet the challenge. They cannot get the economy growing fast enough to cut unemployment significantly because of the depth of their commitment to the failed monetarist policy.

The Labour Party cannot meet the challenge. The growth they promise will disappear as inflation accelerates and as sterling collapses. They are imprisoned by economic dogma and trapped by the millstone of trade union sectional interests. They recoil from any serious strategy for incomes.

The Alliance, free from these constraints, will meet the challenge head on. Our policies will give Britain the growth that is needed to start reducing unemployment; they will keep a firm grip on inflation; and they will create real jobs, based on a sustained economic recovery.

THE ALLIANCE ALTERNATIVE

The Alliance alternative means investment in Britain's future, higher growth, reduced unemployment and controlled inflation. The three main elements in the Alliance programme are:

- A £5 bn budgetary boost to expand the economy and create more jobs;
- A firm monetary policy, including full membership of the European Monetary System, helping to stabilise sterling and preserve our competitiveness; and
- An incomes strategy to prevent inflation wiping out the gains in jobs.

What would this mean for Britain? For our Autumn Statement, we have tested the effects of these policies on the Treasury Model which itself forecasts that on present Government policies, unemployment will still be as high as 3.1 million by 1989. The results of our latest simulations show that a budgetary boost of £5 billion, combined with a firm incomes strategy and a steady monetary policy, would cut unemployment by almost half a million in two years. This Treasury Model simulation is based on an increase in public expenditure by a further £1 billion from our March figures. But no one should under-estimate the scale of the task. The number of people seeking work will continue to grow fast until the end of the 1980's and without further action our forecasts show that there would still be 2.44 million unemployed in 1989. We will have to create thousands of extra jobs to keep pace with an expanding labour force, as well as to tackle the task of cutting back the number of those registered as unemployed.

But this does not tell the whole story. We believe that the longer term policies such as those set out in the Alliance Programme for Government, which will be updated and developed in our Joint Statement, "Priorities for the 1990s", to be published next year, can succeed in reducing unemployment below 2 million by the end of the decade. The effects of a reversal of the reduction of public investment which has taken place over the last ten years, of a new strategy of industrial partnership, of new policies to stimulate innovation and industrial training, and of the policies of constitutional reform and decentralisation which will bring new vigour to the economies of the regions of Britain, will make this possible. A Government in Britain which is seriously committed to co-ordinated expansion with our European and international partners to prevent the return of world recession would get even more people back to work.

SIX WASTED YEARS

The history of Mrs Thatcher's Government has been one of lost opportunity for Britain. After the Government took office in 1979, they plunged Britain deeper into recession than any other Western economy. Industrial production collapsed. Export industries were battered. Nearly 1.7 million manufacturing jobs were lost. On current economic policies, there is little chance of unemployment falling below three million for the rest of the decade.

The present Government has failed to reverse Britain's relative economic decline. Their policies have stayed afloat so far only because of North Sea oil. Instead of using the oil revenues and the proceeds from asset sales to develop our nation, the Government has used them to patch up the damage to output caused by recession. Manufacturing output is still 10% below 1979 levels. Britain's non-oil trade has deteriorated to an alarming degree – more than £11 billion in the red last year. Once the workshop of the world, we are now importing £4 billion worth of manufactured goods a year more than we are exporting. As oil production starts to run down, the many deep-seated problems which still remain will come to the surface again. Inflation has risen since the last election. It is still too high. Our unit labour costs in manufacturing are rising at a worryingly high rate, while those of our competitors are rising slowly or even falling.

Although the CBI forecast shows the prospect of continuing recession, ministers dismiss industry's grave warnings as "whining". They call our economic difficulties the problems of success, and the Chancellor claims that this is the longest continuous recovery since the war. But the levels of growth achieved have been quite inadequate. It is no great achievement to get output back to its 1979 level. The stock of manufacturing plant and equipment is smaller now than it was six years ago. The number of new jobs has not kept pace with the growth in the labour force, so unemployment still keeps rising.

Even the Chancellor's so-called recovery is now slowing down. The prospect for the next two years is gloomy. Most forecasters expect growth to halve next year. And because manufacturing competitiveness is taking another battering from the rising pound, there is the real danger of another round of job losses in 1986.

The Government's conduct of monetary policy has been erratic and incompetent. The Chancellor has said that the reduction of inflation is the Government's central objective. "The Government's overriding aim will be to maintain monetary conditions consistent with a declining rate of growth of money GDP and inflation. Short-term interest rates will be held at the levels needed to achieve this." The consequences of this policy have, however, been disastrous.

Twice since the 1983 General Election, the Government has had to take panic action to prop up the pound: once last July, and again early this year. Interest rates have been put up to real levels not seen for fifty years. New, tighter monetary targets were imposed, to reassure financial markets. Budgetary policy was restricted still further so that it is now the most severe in the Western World.

The danger now is that the Government's return to tight money and spending cuts will squeeze British industry once more in the painful vice in which it was trapped in 1979-81. Already, much of the gain in competitiveness acheived in 1983-84 has been wiped out by sterling's sharp rise this year. The Government has boxed itself into a corner and is using a high sterling exchange rate to take the strain off inflation, never mind the damaging consequences for industrial competitiveness and jobs.

LABOUR'S FALSE PROSPECTUS

The Government cannot escape from the consequences of its policies and from the damage they are causing. The people of this country want alternative policies which are effective, realistic and durable. It is clear that if they look to the Labour Party for that alternative, they will look in vain.

The Labour Party and the TUC have just produced a new policy document calling for major increases in spending to help bring down unemployment. Out of its 65 proposals, 42 would involve extra expenditure. But nowhere in their document is there a single reference to how they would tackle the problem of rising inflation which their proposals would create.

Three years ago the Labour Party, in a flash of honesty, tested their strategy of massive expansion and devaluation on the Treasury Model. The results showed that, lacking any firm monetary policy or any kind of incomes strategy, the Labour Party programme would collapse in disaster, with rocketing inflation and a huge balance of payments crisis.

This year, they produced a new package of proposals, but have refused to come clean about the costs and likely effects. Labour plans to boost spending by £8 billion and would pay for part of this by increasing taxation and national insurance by £3 billion. But they and their trade union allies have ruled out any serious pay strategy or monetary policy. They will not explain how Labour would tackle the massive sterling depreciation, balance of payments deficit and accelerating inflation which these policies would produce. Indeed, it is likely that Labour's plans would provoke a massive outflow of capital before they could do anything about cutting unemployment.

Their plans to clamp down on pension funds and unit trusts investing abroad would backfire. They would destroy international confidence in Britain. They would cut the value of people's savings and push up pension contributions.

ALLIANCE ALTERNATIVE – BUDGETARY EXPANSION

The scope for expansion will depend on the success of our counter-inflation strategy. This issue cannot be fudged. If the rate of growth of average earnings **is** kept low, there will be room for £5 billion extra spending. It would be used for cutting the costs of employing people, rebuilding run-down Britain, giving a job guarantee to the long-term unemployed and helping those in greatest need. If our strategy for earnings restraint is successful in getting inflation below our forecast, in the later years of the strategy a further expansion of the economy would be possible to get unemployment down to the two million mark and below.

(1) [Our policies of expansion] which seek to combine a dynamic private sector and a healthy public sector, [are] (2)

(1) – (7) are 1 quotation, if possi

3 ◆ **A 1% reduction in all employers' national insurance contributions.**

The Government's restructuring of national insurance helped some low-paid workers, but only at the expense of relatively well-paid, skilled employees in the service and high-technology sectors, for whom employers have to pay substantially more in employment costs. Our proposal would help **all** firms improve their competitiveness and would encourage more employment by reducing tax on jobs.

4 ◆ **A £1 billion programme of public sector capital investment, concentrated mainly on construction.**

Public investment in the fabric of Britain, in new buildings and works other than housing, has fallen by a third since 1979. Housing investment has been halved. The Government's public expenditure White Paper projects a further cut of 25% in real terms in capital programmes, excluding defence. The recent National Economic Development Office (NEDO) report revealed just how much of Britain's basic infrastructure is not being properly maintained and highlighted the scale of the problems which are being stored up for the future. For instance, in many areas, the maintenance budget for roads is less than half what it ought to be to prevent further deterioration. Nationally, £2 billion needs to be spent on hospital maintenance, and another £5 billion on public sector housing. Schools, water supplies and sewerage systems all require repair, improvement or replacement.

The Prime Minister has never been able to justify her claim that infrastructure investment costs £35,000 to £50,000 per job created; most independent experts put the cost per job at well under half these figures. The Alliance would spend an extra £1 billion each year for three years to build up and help restore the nation's assets as part of our job creation programme. This expenditure would be concentrated on housing construction, renovation and insulation (£800 million) and increased spending on road building and maintenance (£200 million).

5 ◆ **A further expansion of the Community Programme to give a job guarantee to all those unemployed for over a year.**

This would give the long-term unemployed the chance to make a contribution to their communities, as well as providing enhanced training opportunities. Special attention should be given to those long-term unemployed under 25, over half of whom have never had the experience of a proper job. Resources should be used to encourage job sharing to provide this group with at least meaningful part-time opportunities.

6 ◆ **Special help on benefits for the long-term unemployed under 60 and for those in greatest need.**

The long-term unemployed have been discriminated against by being refused the long-term rate of supplementary benefit. The Government's recent Review still ignored this problem. We would make the long-term unemployed eligible for this benefit, which will give single people an extra £8 per week and married couples an extra £12·15 per week.

The Government's proposed family credits scheme is at best a hesitant step towards integrating the tax and benefit scheme. Our own proposals on taxation and social security go much further. Until the new system can fully benefit people in need, we would give special help to working families in poverty. We would add £500 million first to the Family Income Supplement programme, and then to the new scheme. And we would remedy the Government's deplorable failure to up-rate child benefit in line with inflation.

7 ◆ **A £1 billion boost to current expenditure.**

This would include extra resources for education and training through a new crash programme for skills designed to break the bottleneck which threatens to throttle industrial recovery, and relaxing expenditure targets for local authorities which would create many new jobs in the personal social services and the community.

MONETARY POLICY AND THE EXCHANGE RATE

Under this Government, excessive importance has been attached to monetary policy. Monetary targets have become the be-all and end-all of economic policy without regard to the consequences for growth and jobs.

It is now time to adopt a different approach. Monetary policy has an important part to play in supporting our economic strategy which allows real economic expansion and a reduction in inflationary pressure. This means keeping a firm grip on money supply and stabilising the sterling exchange rate to protect our competitiveness.

To do this, we would make Britain a fully-participating member of the European Monetary System (EMS). This policy is already supported by the CBI, the Governor of the Bank of England and the President of the European Commission. It is a scandal that the Government did not join at the time of the Budget. This was yet another wasted opportunity. Active membership of the EMS would be an important first step towards greater international monetary stability and towards establishing a new international monetary system based on the three major currency blocs – the dollar, the yen and the EMS.

INCOMES STRATEGY

As we have made clear, the critical challenge is to stop inflation wiping out the gains in jobs. That is why Britain must have a strategy for incomes. Holding the growth in money earnings steady at or below its present level will help to sustain a substantial increase in employment.

In the private sector, the Alliance believes that voluntary pay bargaining must reflect the economic realities facing individual firms. Moreover, we believe that it is the duty of Government to make sure that wage settlements do reflect those realities. The Alliance would seek to channel increased demand into higher output and growth through a positive incomes strategy.

We would hope to reach agreement on voluntary restraint in the first year of this strategy. But we would be prepared to introduce legislation to ensure that earnings grow less quickly than at present. Inflationary pay pressure must be contained in this way. That is the price of reflation. That is the price of creating jobs. During this period, we would establish the legislative framework for an inflation tax to be brought into operation in the second year if voluntary restraint could not be achieved.

Beyond this, more widespread arbitration in pay determination would be introduced. This would avoid the rigidities and excessive centralisation which characterised previous pay policies. Much greater support will be given to profit-sharing schemes and these would apply to the whole workforce, and not be limited, as most are at present, to share-option schemes for management.

Public sector pay has been in the headlines recently, with the fiasco over top peoples' pay and the continuing teachers' dispute. We believe that there is a solution. This is to introduce a new, comprehensive, and long-term procedure for maintaining pay comparability. A non-inflationary pay comparability system would involve the establishment of a single, independent pay research and information body covering the whole of the public services. It would make data on changes in comparable pay available to negotiators, and would offer them access to binding arbitration procedures. This could be coupled with a commitment to employees in central and local government and the other public services to pay them a "catch-up" equivalent to the private sector's real pay increase minus last year's public sector pay norm. Such a system could be established in essential public services in return for no-strike arbitration agreements.

THE SCALE OF THE TASK

The prospect for the next four years shows how difficult the task of reducing unemployment has become. Government policies over the past six years have dug us into a deeper and steeper hole out of which to climb. The gains in productivity which have been achieved are being frittered away. Of course, more could be done if those in work were prepared to sacrifice more for those out of work. We ask for such a sacrifice in our incomes strategy. At this stage, we think it unrealistic to bank on more. That does not mean we would not seek to achieve it. But winning people's hearts and minds to such policies after years of Thatcherism is not an easy task. The sooner the scale of the problem is recognised by the British people, the easier it will be to tackle it.

MACRO-ECONOMIC SIMULATION ON THE TREASURY MODEL OF ALLIANCE AUTUMN STATEMENT

% Change unless otherwise shown	Actual 1985	Forecast 1986	1987
GDP : output	3.5	2.8	2.9
New Jobs Created (000's)	293.1	466.6	583.8
Unemployment (UK millions)	3.1	2.7	2.64
Inflation* (retail prices)	6.9	5.9	7.5
Current Balance of Payments (£bn)	+ 2.5	− 2.2	− 4.8
Exchange Rate (Sterling Index)	75.02	74.4	71.4
PSBR (£bn fin years)	7.1	10.7	10.8
Money Supply (£M3)	11.9	7.2	10.5
Interest Rates (3mth Inter-Bank Rate)	10.9	10.4	10.6
Average Earnings	8.3	7.7	8.2

* *in the twelve months to July 1985*

This Autumn Statement is a revised and updated version of "Alliance Budget Priorities For 1985" drawn up by the SDP and Liberal Parliamentary Parties in March. It is a background document to inform the debates at the SDP and Liberal Assemblies.

Research: Tony Humphris
Alex de Mont

Published by Alliance, 4 Cowley Street, London SW1. Printed by Jaguar Press Limited, Jaguar House, 116 Lordship Lane, London SE22

2153/31

BUDGET: CONFIDENTIAL

Pps tonight pl'

FINANCIAL SECRETARY TO THE TREASURY

FROM: VIVIEN LIFE
DATE: 11 March 1986

PS/CHANCELLOR

cc PS/Chief Secretary
PS/Economic Secretary
PS/Minister of State
Sir P Middleton
Mr Monger
Mr Scholar
Mr Culpin
Miss O'Mara
Mr Pratt
Mr Cropper
Mr H Davies
Mr Lord
Mr Battishill IR
Mr Isaac IR
PS/IR

C See Tony B's note. He is the driving force behind this idea. The FST thinks that to veto it would sit oddly alongside regular exhortations to the Revenue to improve their PR. You might like to discuss with Robert before taking a decision.

I am content for this to go ahead, and understand from FST that this will be on the basis of A. Battishill's 11/3. However, I think that for liaison purposes someone from FP (or, failing that, a tax-knowledgeable person from IDT) should be (silently) present. NL

BUDGET PRESENTATION: PROPOSED INLAND REVENUE POST-BUDGET PRESS BRIEFING

1. I attach a minute from Mr Battishill setting out the Inland Revenue's proposals for a press briefing on tax aspects of the Budget on the Thursday of Budget week.

2. The Financial Secretary has discussed this at some length with Mr Battishill and Mr Isaac. In his view, the Revenue proposal is a sound one.

3. He had not himself been aware of the extent to which key officials have in previous years been involved in handling telephone queries from journalists. He agrees that the proposed arrangements would be a more cost-effective professional way of handling such queries.

4. The nature of the occasion would be very different from press briefings provided by Ministers. Those being invited are already well known to the Inland Revenue and would expect briefing on technical rather than political points.

5. The Financial Secretary therefore hopes the Chancellor will agree that the Revenue should go ahead. However, he will of course be happy to have a brief word with the Chancellor if that would be helpful.

VL

VIVIEN LIFE

ENC

BUDGET: CONFIDENTIAL

BUDGET CONFIDENTIAL

FROM A M W BATTISHILL

THE BOARD ROOM
INLAND REVENUE
SOMERSET HOUSE

11 March 1986

FINANCIAL SECRETARY

PROPOSED INLAND REVENUE POST-BUDGET PRESS BRIEFING

1. We propose, if Ministers agree, to hold a press briefing on the tax aspects of the Budget on the Thursday of Budget week. It would be followed, for those who wish, by a short buffet lunch.

2. This was conceived in response to journalists' suggestions on how we might improve our post-Budget briefing.

3. The key officials have traditionally handled telephone queries from journalists on Budget night and the days following. The briefing/lunch format is an attempt to augment that briefing in a cost-effective and more professional way.

4. The format would consist of briefing for about an hour, on the direct tax aspects of the main Budget proposals, followed by lunch.

5. We suggest inviting the following journalists and broadcasters who have shown themselves interested in tax matters:

---

c Mr Culpin

Will Dorkins)	
Eric Short)	
Philip Stephens)	Financial Times
Margaret Dibben	
Richard Northedge	The Guardian
Sarah Hogg)	Daily Telegraph
Lawrance Lever)	
Margaret Stone	The Times
Roger Carroll	Daily Express
Joanna Slaughter	Sunday Telegraph
Diana Wright	Observer
Francis Cairncross	Sunday Times
Louise Botting	The Economist
Brian Widlake	BBC Radio 4 Money Box
Michael Braham	BBC TV The Money Programme
Alison Mitchell	Channel 4 Money Programme
	BBC Breakfast Time TV

6. On the Revenue side the following can best speak on the issues most likely to attract press interests:

Peter Lewis) Brian Mace) Andrew Hudson)	On Personal taxation; Green Paper/profit sharing primarily.
Clive Corlett) Neil Munro) Don Draper)	On PEP, pensions, charities, and stamp duty.
Brian Houghton) John Battersby)	On capital taxation, mainly CTT
Leonard Beighton) Julian Reed) Geoff Bush)	On BES and capital allowances.
Michael Cayley	On non-resident entertainers.
David Pitts) Car~~r~~olyn Hubbard)	On oil
Terry Painter	On implications for the Department, eg manpower, etc.

7. Tony Battishill and John Isaac would participate in the briefing. The Chairman would join for the lunch.

8. Sue Tyrrell, the Press Secretary, would introduce the briefing. We hope Robert Culpin would also be able to come - or be represented.

AMB

A M W BATTISHILL

FINANCIAL SECRETARY TO THE TREASURY

FROM: VIVIEN LIFE
DATE: 11 March 1986

PRINCIPAL PRIVATE SECRETARY

cc PS/Chief Secretary
PS/Economic Secretary
PS/Minister of State
Sir P Middleton
Mr Monger
Mr Culpin
Miss O'Mara
Mr Pratt
Mr H Davies
Mr Cropper
Mr Lord
PS/IR

BUDGET PRESENTATION

1. The Financial Secretary has read Mr Scholar's minute of 6 March. He has the following points on the suggestions as to his contribution to Budget Presentation.

Green Paper

2. The discussion of Party contacts is, understandably, fairly sketchy. He suggests that Peter Cropper should ask Emma Nicholson to give a few suggestions as to those who should receive personal copies of the Green Paper. She may also be able to give suggestions as to the "others" who might receive a letter.

3. He sees no need to meet Marion Roe again: he discussed the issues in general with her before she spoke at the recent conference on the EC Directive. He does not think much would be gained by meeting Ruth Lister.

Savings and Investment and Business/Enterprise Packages

4. The Financial Secretary is quite happy to meet Lord Vinson, Philip Chappell, and David Howell but further thought needs to be given as to when would be most appropriate.

5. He is meeting Mr Battishill on Tuesday 11 March to discuss the briefing which the Revenue are proposing to hold.

Other Areas

6. The Financial Secretary thinks that, given what is in the Budget, there is little gain from his meeting with the British Venture Capital Association prior to meetings at official level after Easter.

VL

VIVIEN LIFE

RP2.86

BUDGET CONFIDENTIAL

FROM: P WYNN OWEN

DATE: 12 March 1986

1-R
2-PMP

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Economic Secretary
PS/Minister of State
Sir P Middleton
Mr Monger
Mr Scholar
Mr Culpin
Mr Cropper
Mr H Davies
Mr Lord

BUDGET PRESENTATION:

PROPOSED INLAND REVENUE POST-BUDGET PRESS BRIEFING

The Chancellor has seen your minute of 11 March and Mr Battishill's minute of the same day. He is content to be guided by the Financial Secretary and he is reassured that this will be in the safe hands of Mr Battishill. However, he thinks that for liaison purposes someone from FP (or, failing that, a tax-knowledgeable person from IDT) should be (silently) present.

Rs.

P WYNN OWEN

BUDGET CONFIDENTIAL

pa

10 DOWNING STREET

From the Private Secretary

H/EXCHEQUER
REC. 13 MAR 1986
ACTION CST, FST, EST, MST
COPIES TO SIR P MIDDLETON
SIR T BURNS, MR FER BUTLER
MR CASSELL
MR MONCK
MR SCHOLAR

√ 14/3

13 March 1986

Dear Rachel,

1986 BUDGET

The Prime Minister is entirely content with the proposals set out in the Chancellor's two undated minutes, one about the MTFS for this year's Budget and the other about employment measures.

Yours,

David.

(David Norgrove)

Mrs. Rachel Lomax,
HM Treasury.

BUDGET CONFIDENTIAL

FINANCIAL SECRETARY TO THE TREASURY

RP

MR BATTISHILL - IR

FROM: VIVIEN LIFE
DATE: 13 March 1986

cc PS/Chancellor
Sir P Middleton
Mr Cassell
Mr Monger
Mr Scholar
Mr Cropper
Mr Lord
Mr H Davies
PS/IR

BUDGET DAY CHANGES

Mr Kuczys' minute of 7 March records the Chancellor's suggestion that the Financial Secretary could include some warning about the timing of future income and corporation tax changes in future years in his speech in the Budget Debate.

2. The Financial Secretary would be grateful if you could provide a concise form of words which he could include.

VL

VIVIEN LIFE

BUDGET CONFIDENTIAL

FROM: A W KUCZYS

DATE: 7 MARCH 1986

MR BATTISHILL IR

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Monger
Mr Scholar
Mr Cropper
Mr Lord
Mr H Davies
PS/IR

BUDGET DAY CHANGES

The Chancellor was grateful for your note of 27 February, which he had intended to raise at the last Overview meeting. He agrees with your conclusions at paragraph 9: there is no need to depart from the usual commencement rules this year. As to your paragraph 10 (a warning about future years), the Chancellor suggests that the Financial Secretary could make this point in his speech in the Budget Debate.

AWK

A W KUCZYS

BUDGET DAY
CHANGES

BAT'HILL
TO
CH/EX
27/2

BUDGET CONFIDENTIAL

FROM: A M W BATTISHILL

THE BOARD ROOM
INLAND REVENUE
SOMERSET HOUSE
27 February 1986

CHANCELLOR OF THE EXCHEQUER

BUDGET DAY CHANGES

I raised with you in the Autumn the possibility of changing the timing of Budget Day changes where there was scope for significant forestalling in the hours remaining on Budget Day. After discussion with other Treasury Ministers you agreed in principle that Budget announcements in such cases should take effect from midnight on the previous day. But you decided to leave open whether the new arrangements should apply this year, or simply be announced to take effect in the future. A copy of my earlier note is attached below.

2. I think the shape of the main Budget measures is now clear enough to decide whether to apply the new arrangements this year. As far as we can see at present, timing on Budget Day is unlikely to be critical for most of the Budget measures. But we have looked more closely at two exceptions and one potential problem of a different kind. The exceptions are the CTT changes, particularly those relating to the insurance schemes, and the new rules for charities. The problem is over ADRs. The considerations are rather different in each case.

---

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr F E R Butler
Sir G Littler
Mr Cassell
Mr Monck
Mr A Wilson
Mr Monger
Mr Odling-Smee
Mr Scholar
Mr Pratt
Mr Cropper
Mr Lord
Mr H Davies

Sir Lawrence Airey
Mr Isaac
Mr Battishill
Mr Beighton
Mr Corlett
Mr Houghton
Mr Painter
PS/IR

Sir Angus Fraser C & E
Mr Knox C & E

CTT

3. The normal practice for CTT is already to make changes operative for transfers "on or after Budget Day". The fact that this applies to events before the Budget Speech has not, so far as we are aware, previously given rise to any difficulty, because the changes made in this way have generally been of a relieving kind.

4. There is a good reason to keep to the same rule this year. Not to apply the changes to events on Budget Day would:

(a) defer the effect of the relieving element in the package (a gift on Budget Day from one individual to another would not benefit from the change);

(b) give taxpayers an opportunity for making gifts back to donors to avoid the pre-change lifetime charge;

(c) encourage taxpayers to rush into insurance schemes - to the extent that the insurance industry could respond quickly - immediately after the Budget Speech. (The Press Release will need to make it clear that the new gifts with reservation provisions will catch schemes entered into after the Budget Speech).

5. That is why we suggested (in our submissions on gifts with reservation) that the normal CTT commencement provisions should apply, with the changes effective from midnight before Budget Day. This will deal even-handedly with the changes which advantage the taxpayers and those which do not. And will avoid souring the reception of the changes with stories of taxpayers forestalling on schemes which the Finance Bill will make ineffective.

Charities

6 . The problem area here is the new anti-avoidance measures against private indirect charities, which would normally take effect from the day after Budget day. We have been worried that some smart operators might spot the few hours' gap and try to get large sums into and out of indirect charities on Budget night (eg by telexing money abroad). It is not easy to assess the risk: the prudent ones might well have concluded their schemes before the Budget anyway (especially following the recent press interest).

7. To be quite sure of blocking Budget Day forestalling we suggested (in our minute to the Financial Secretary of 17 February) bringing in the new provisions from the morning of Budget day. But on further reflection this would not, of course, work: people cannot be expected to deduct tax from gifts before they are told to do so in the Budget Speech. We have considered whether the new rules might be introduced instead with effect from 5pm on Budget Day. This might have some limited deterrent effect: but not a lot. In practice we should often be unable to tell at what time a transaction was effected, and people would know that. So the choice is between a fairly empty gesture or facing <u>some</u> risk by introducing the new rules from midnight on Budget Day. We do not think the risk in practice is all that great and, on balance, we are inclined to suggest taking it. (The press notice need not invite forestalling by being too explicit on timing: it might simply refer to the measures having "immediate effect".)

Stamp Duty

8. On stamp duty, the main question is over possible forestalling of the new charge (provisionally 3%) on conversions into ADRs. The period of risk here is not so much Budget Day itself, but the remaining 6 days before the Budget Resolution takes effect on the first Monday evening of the Budget debates (as you know, stamp duty does not take effect retrospectively). We have asked the Bank for a considered and authoritative assessment of the risk here, and will report separately if further action is needed.

Conclusion

9. If Ministers agree there seems no pressing need to depart from the usual commencement rules this year. For CTT this is anyway to apply changes from midnight before Budget Day; and this will be made clear in the Budget Day press notice. For charities the anti-avoidance rules would apply after Budget Day. Similarly, nothing special needs to be said about this year's commencement provisions. We will report separately on ADRs.

10. For the future you could, if you wish, include a suitable warning about the timing of future income and corporation tax changes in the Budget Speech - perhaps linked to the section on the CTT changes. Alternatively, if preferred, it could be done later by Written Answer, and perhaps expanded in one of the speeches on Second Reading of the Finance Bill.

AMB

A M W BATTISHILL

COPY NO..7.OF 32

BUDGET SECRET

THE BOARD ROOM
INLAND REVENUE
SOMERSET HOUSE

ISAAC
To
CH/EX
ADR

FROM: A J G ISAAC
DATE: 27 FEBRUARY 1986

ECONOMIC SECRETARY

STAMP DUTY: ADR

1. Mr Battishill's note earlier today to the Chancellor said that we should be reporting separately to you on the starting date for the new charge on conversions into ADRs - provisionally put at 3 per cent.

2. The problem is that - for the familiar reasons - stamp duty changes cannot be applied retrospectively. The new change, therefore, cannot take effect until the Budget Resolutions are passed on the final day of the Budget debates - that is, Monday evening of 24 March. In consequence, there will be some six days (including the weekend) during which a quick operator can convert stockholdings into ADR form, without paying the new charge.

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cc Chancellor of the Exchequer
Chief Secretary
Financial Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr F E R Butler
Sir G Littler
Mr Cassell
Mr Monck
Mr A Wilson
Mr Monger
Mr Odling-Smee
Mr Scholar
Mr Pratt
Mr Cropper
Mr Lord
Mr H Davies

Sir Lawrence Airey
Mr Isaac
Mr Battishill
Mr Beighton
Mr Corlett
Mr Houghton
Mr Painter
Mr Pipe
Mr Draper
Mr Gonzalez
PS/IR

Mr D Walker, Bank of England

Mr P Graham, Parliamentary Counsel

3. In principle, there is clearly a risk of forestalling here. I have now had a chance to discuss with Mr Walker at the Bank of England how serious this risk may be. The Bank's view is that it is serious. Understandably, they cannot put a figure to it. But it would be realistic to assume that stockholdings worth some £ tens of millions could flow through the gap; and if the fashion caught on, the sum could be £ hundreds of millions.

4. I understand that it is not possible, consistent with the House rules, to bring forward the stamp duty Resolution to Budget Day. As we see it, therefore, there are three possible lines of action.

5. **Approach A:** table the ADR Resolution (as planned) on Budget Day; accept that the new stamp duty charge on ADRs will not take effect until the end of the Budget debates; accept that a fair slice of the first year yield from the new charge could slip through the six-day gap and that duty on the shares that escape could be lost for years to come.

6. **Approach B:** legislate, so that the new "transactions tax", which will in any event be needed to underpin the stamp duty (for example, as it applies to intra-account dealing) should be extended - so that it applies to ADR conversions during the six-day gap. This should technically be possible. But it would mean additional and complex legislation, coming at a time when time is very short and Parliamentary Counsel himself is under heavy pressure; and there is a limit to what even he can achieve,

7. **Approach C:** table the ADR Resolution, not on Budget Day, but on Monday 24 March, for passing the same day. We have confirmed with Parliamentary Counsel that this would be possible, and consistent with the rules of the House. So far as we have been able to trace, it would be unprecedented, at least in modern times. It would have to be defended on the basis that the new ADR charge has to take immediate effect,

in order to prevent forestalling; and this might perhaps be less unacceptable to the House, in so far as it was intended to prevent business going abroad to our competitors.

8. If you wish to follow Approach C, we shall need to make some detailed adjustments to the Budget Statement, FSBR and press notices. But I hope that we can still provide the correct "net" figures for the stamp duty package in the FSBR. There will be other formalities which we should need to discuss in detail with Parliamentary Counsel and perhaps the Whips' Office.

9. I am sorry that we have to bring this new problem to you now, but the problem arises essentially because the market advisers now take the view that an ADR conversion rate should be almost "penal". Now that we have identified it, however, I think that both Mr Cassell and Mr Walker share my feeling that it would be risky to leave it unplugged. I should be grateful to know whether you agree and, if so, whether you regard either Approach B or Approach C above as acceptable.

<u>Statistics</u>

10. For convenience, I also attach some further figures showing how the package is now expected to affect the yield of stamp duty on shares, as requested at last week's Overview.

C.J.G.

A J G ISAAC

	1986-87 £m		1987-88 £m	
Transfers now subject to duty				
Duty at 1 per cent		560		625
Duty reduced to ½ per cent from Big-bang		490		515
Cost of reduction in rate		-70		-110
Tax on capital gains		-		+ 35
Net cost of reduction in rate		-70		- 75
Other changes from Big-bang				
Intra-account deals	+10		+20	
Renounceable documents	+10		+15	
		+20		+ 35
Changes from Budget day				
Takeovers	+20		+20	
Loan stock	+20		+20	
Own shares	+ 1		+ 1	
ADRs at 3 per cent	+10		+10	
		+50		+ 50
Net effect of package		NIL		+10

FROM: A M W BATTISHILL

THE BOARD ROOM
INLAND REVENUE
SOMERSET HOUSE

28 October 1985

CHANCELLOR OF THE EXCHEQUER

BUDGET DAY CHANGES

1. We have been considering, in the light of recent experience, whether it is not time to consider taking a somewhat more robust line on the precise timing of Budget tax changes when there may be scope for significant forestalling by professional operators in the hours remaining on Budget Day. This short note reflects discussions with Mr Cassell and Mr George. Though Customs have been consulted this seems to be mainly applicable to the Inland Revenue.

2. The present position is as follows. When a tax change is to be given immediate effect the usual practice is to express it as operating "on or after Budget Day" if it is wholly relieving, or "after Budget Day" if to any significant extent it imposes or increases a charge on the taxpayer. In recent years however the speed of modern commercial practice has been such that a great deal of

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cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Mr Cassell
Mr Monger
Mr Peretz
Mr Hosker (Tsy Sol)
Mr George (B/E)
Mr Wilmott (C/E)

Chairman
Mr Battishill
Mr Isaac
Mr Beighton
Mr Blythe
Mr Corlett
Mr Houghton
Mr Lawrance
Mr Painter
Mr Pitts
Mr Taylor-Thompson
Mr Spence
PS/IR

business can be done on the evening of Budget Day in the knowledge of the change which is about to be made. The leading example of late evening trading followed the change in our practice on building society gilts; you will recall that on that occasion several £m'00 of gilts were traded after the announcement at 5pm mainly between societies and discount houses outside the Stock Exchange. Although this was not actually a Budget announcement, as you pointed out at the time precisely the same problem would have arisen if you had announced it in the Budget Speech.

3. No single solution to this difficulty will always be appropriate. On occasions the present rule may well be adequate. On other occasions, despite the risk of trading outside the area of regulation, it may be possible to express a change as taking effect from a stated time, eg 3.30pm, without giving rise to impossible problems of policing. But there may also be changes which we simply could not operate effectively from mid-way through Budget Day. In those cases the only way to baulk a smart operator may be to make the change effective "on or after Budget Day" despite the small amount of retrospection that this would involve.

4. Mr George's clear preference is to leave things as they are. He wants to avoid any element of retrospection, however small. In most cases he believes there is likely to be a case for giving notice and applying changes to transactions after the date of announcement. If exceptionally there were a case where the risk of forestalling seemed particularly acute, he would recommend making an overnight announcement on the morning of Budget Day. But this might then mean having to take a particular measure out of the Budget Speech and announcing it early, solely because of its tax dimension; and avoiding just this was one of the considerations you had in mind when the changes to the gilts prospectuses were made a few months ago.

5. I do not want to make too much of this issue. Most Budget Day changes give rise to few problems in practice - but there are exceptions and the timing can then be critical. In those cases it could be valuable to have the flexibility to consider some minimal retrospection without seeming to change the rules of the game without warning. If you agree, and feel that you should at least reserve the right on occasions to make changes effective from the beginning of Budget Day, then it would be as well to say so, by announcing (we suggest in a Written Answer) well away from the Budget that in future you would be allowing yourself this extra flexibility. People would then know that they would be undertaking business on Budget Day at their own risk. (The same logic cannot apply to announcements outside the Budget: these would continue to have to be handled on their merits as now).

6. If you think, as we do, that this is worth considering for Budget announcements we will prepare a Question and Answer for you to look at.

A M W BATTISHILL

37

CONFIDENTIAL

From: K F MURPHY

Date: 14 March 1986

MISS O'MARA

cc PPS
Mr Scholar

BUDGET BRIEFING

Sir Peter Middleton has a few comments on the version of the Budget brief circulated under cover of your minute of 12 March.

2. Brief A1. Factual (iii) should immediately proceed (vii). Positive (iii) should read "Economy has weathered halving of ...". Defensive (v) should read "Cautious response right, given major changes and uncertainties in oil markets".

3. Brief A2. Section A(ii). This should begin "Money GDP, MO and PSBR paths ...". The phrase "and illustrative ranges for MO from 1987-88 - 1989-90" should be deleted.

4. Brief B1 factual 12. Sir Peter Middleton thinks the table might be improved if a line could be drawn under the row weights in 1984.

5. Brief B2(ii) point (a). Sir Peter Middleton thinks this should read "In current upswing (1981 H1 to 1985 H2) growth has averaged around 3% a year." But he wonders if this is true if the calculation is done on a half-year basis? Are we using half years because we don't want to show quarters?

6. Brief B2 factual (vi). He wonders whether we could not omit this sentence.

7. Brief C1 factual 1(c). The prices for Brent for 14 March are some little way away from the actual figures for today.

KFMurphy

K F MURPHY
Private Secretary

BP/5

1 – JK

2 – PWO

FROM: P WYNN OWEN

DATE: 14 MARCH 1986

MRS LAWSON

cc Chancellor
Mrs Lomax
Mr Dyer
Mrs Lester
Mr T J Davies

SEATING ARRANGEMENTS FOR BUDGET DAY

As in the last two years, there is a seat reserved for you in the Distinguished Strangers Gallery.

2. If you are content, perhaps we could stay with the arrangements we used last year. Namely, Tony Davies from Parliamentary Section picks your ticket up from the policeman in the Central Lobby soon after 2.15pm on Budget Day. He meets you in the Speaker's Court when you arrive with your husband and he then escorts you to your seat.

3. Let me know soon if you would prefer any other arrangements.

Pwo.

P WYNN OWEN

CHANCELLOR OF THE EXCHEQUER

Ch/

Pensions tax as discussed with Peter. Spreads aspects to board round.

Helpful to have this point out ahead of the Overview so Ministers can get involved in the leadership at an early stage, through our lobbying tactics.

What about the Advisers?

Some obvious suggestions -

<u>Cropper</u> Personal Tax C.P.

Charities

? Pension fund surplus

Howard

West Zones

Stamp duty

Start-up Plan?

Rodney

? Employment &

Enterprise / Business

KL

28/2.

who deals with what

Chair group look out

last year's hot tip [illegible]

ymp

BUDGET SECRET
BUDGET LIST ONLY

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BUDGET SECRET

Presentation of the Budget: Allocation of Ministerial responsibilities

Chancellor

Macroeconomic issues
- Fiscal stance
- MTFS
- Monetary policy
- Effects of oil price fall

Chief Secretary

Employment measures
- Community Programme
- Extension of Counselling and Job Start Schemes
- New Workers Scheme
- Enterprise Allowance Scheme

Enterprise measures
- Loan Guarantee Scheme
- Profit Sharing (Weitzman)

Budget and business (A)
- Effect of Budget on small and unincorporated businesses
- Final phase of 1984 corporate tax changes
- Mines and oil wells allowances
- North Sea tax regime (but not effect of oil price fall on North Sea tax revenue)
- Agricultural buildings and minor business tax changes

take to FK
~~FST~~

Staffing implications of Budget

Rates v. Threshold

B.I.O. SECRET

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Financial Secretary

Budget and individuals

- Personal Tax Green Paper
- Income tax changes (whether any or none)
- NIC changes (if any)
- Savings Plan ~~(or Economic Secretary)~~
- Capital Transfer Tax
- Business Expansion Scheme
- Car and fuel benefits

Budget and business (B)

* Insert.

Minor starters of which Financial Secretary has so far been in charge

Economic Secretary

Savings and investment

- Stamp duty
- City revolution: tax consequentials
- ?Pension fund surpluses ~~(or Financial Secretary)~~

Minor starters of which Economic Secretary has been in charge so far

Minister of State

Charities etc

- Higher rate relief
- Company giving
- Payroll giving
- VAT
- Abuses
- Pension relief for Nazi victims

BUDGET SECRET
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Excise duties + VAT	- Petrol, derv and minor oils
	- VED
	- Alcoholic drinks
	- Tobacco duty
	- Increase in VAT threshold
VAT	and motoring
Minor starters of which Minister of State has so far been in charge	

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 Ref No F32

00199

RESOLUTIONS TO BE MOVED BY THE CHANCELLOR OF THE EXCHEQUER

Ch/
Just to see
AWK
17/3

18th MARCH 1986

LAST DRAFT BEFORE BUDGET DAY PRINT

Third Proof (Third Print) — 14.3.86

Mr Chancellor of the Exchequer

PROVISIONAL COLLECTION OF TAXES: That, pursuant to section 5 of the Provisional Collection of Taxes Act 1968, provisional statutory effect shall be given to the following Motions:—

(*a*) Tobacco products (Motion No. 2);

(*b*) Hydrocarbon oil (Motion No. 3);

(*c*) Vehicles excise duty (hackney carriages and farmers' goods vehicles) (Motion No. 4).

ARRANGEMENTS OF WAYS AND MEANS RESOLUTIONS

1. Amendment of the law.
2. Tobacco products.
3. Hydrocarbon oil.
4. Vehicles excise duty (hackney carriages and farmers' goods vehicles).
5. Vehicles excise duty (trade licences).
6. Abolition of certain excise licence duties.
7. General betting duty, pool betting duty and bingo duty.
8. Customs and excise duties (warehousing).
9. Value added tax (registration).
10. Value added tax (zero-rating).
11. Value added tax (relief on importation).
12. Value added tax (provision of accommodation).
13. Income tax (charge and rates for 1986–87).
14. Income tax (indexed personal reliefs etc.): operative date for PAYE.
15. Relief for interest (limit for 1986–87).
16. Advance corporation tax (rate for financial year 1986).
17. Building societies.
18. Shares and rights to acquire shares obtained by directors and employees.
19. Occupational pension schemes.
20. Enterprise allowance.
21. Business expansion scheme.
22. Company reconstructions.
23. Loans to participators.
24. Charities.
25. Value added tax penalties etc. (income tax and corporation tax).
26. Associated companies (oil and gas industry).
27. Capital allowances (machinery and plant etc.).
28. Capital allowances (mineral exploration and extraction).
29. Dual resident trusts: capital gains tax.
30. Securities (income tax, capital gains tax and corporation tax).
31. Stamp duty reserve tax.
32. Stamp duty (transfers for purpose of issuing depositary receipts).
33. Stamp duty (depositary receipts: other transfers).
34. Stamp duty (clearance services).
35. Stamp duty (reconstructions etc.).
36. Stamp duty (acquisitions).
37. Stamp duty (loan capital).
38. Stamp duty (bearer letters of allotment etc.).
39. Stamp duty (letters of allotment).
40. Stamp duty (company's purchase of own shares).
41. Tax under Capital Transfer Tax Act 1984.
42. Oil taxation: light gases.
43. Oil taxation: attribution of chargeable receipts and allowable expenditure.
44. Relief from tax (incidental and consequential charges).

1. Amendment of the law

That it is expedient to amend the law with respect to the National Debt and public revenue and to make further provision in connection with finance; but this Resolution does not extend to the making of any amendment with respect to value added tax so as to provide—

(*a*) for zero-rating or exempting any supply;

(*b*) for refunding any amount of tax;

(*c*) for varying the rate of that tax otherwise than in relation to all supplies and importations; or

(*d*) for any relief other than relief applying to goods of whatever description or services of whatever description.

2. Tobacco products

That, as from 21st March 1986, the rates of duty on cigarettes and hand-rolling tobacco specified in Schedule 1 to the Tobacco Products Duty Act 1979 shall be increased—

(*a*) in the case of cigarettes, to an amount equal to 21 per cent of the retail price plus £30.61 per thousand cigarettes; and

(*b*) in the case of hand-rolling tobacco, to £49.64 per kilogram:

And it is hereby declared that it is expedient in the public interest that this Resolution should have statutory effect under the provisions of the Provisional Collection of Taxes Act 1968.

3. Hydrocarbon oil

That, as from 6 o'clock in the evening of 18th March 1986,—

(1) the rates of duty specified in section 6(1) of the Hydrocarbon Oil Duties Act 1979 shall be increased—

(*a*) in the case of light oil, from £0.1794 a litre to £0.1938 a litre; and

(*b*) in the case of heavy oil, from £0.1515 a litre to £0.1639 a litre; and

(2) in subsection (1) of section 11 of that Act (rebate on heavy oil) for paragraphs (*a*) and (*b*) there shall be substituted—

"(*a*) in the case of fuel oil, of £0.0077 a litre less than the rate at which the duty is for the time being chargeable;

(*b*) in the case of gas oil, of £0.0110 a litre less than the rate at which the duty is for the time being chargeable; and

(*c*) in the case of heavy oil other than fuel oil and gas oil, equal to the rate at which the duty is for the time being chargeable"; and

(3) for subsection (2) of section 11 of that Act (definition of types of heavy oil) there shall be substituted—

"(2) In this section—

'fuel oil' means heavy oil which contains in solution an amount of asphaltenes of not less than 0.5 per cent or which contains less than 0.5 per cent but not less than 0.1 per cent of asphaltenes and has a closed flash point not exceeding 150°C; and

'gas oil' means heavy oil of which not more than 50 per cent by volume distils at a temperature not exceeding 240°C and of which more than 50 per cent by volume distils at a temperature not exceeding 340°C":

And it is hereby declared that it is expedient in the public interest that this Resolution should have statutory effect under the provisions of the Provisional Collection of Taxes Act 1968.

4. Vehicles excise duty (hackney carriages and farmers' goods vehicles)

That the Vehicles (Excise) Act 1971 and the Vehicles (Excise) Act (Northern Ireland) 1972 shall have effect, in relation to licences taken out after 18th March 1986, with the amendments set out below;

But this Resolution shall not authorise the making of amendments which would result in different provisions being in force in different parts of Great Britain:

And it is hereby declared that it is expedient in the public interest that this Resolution should have statutory effect under the provisions of the Provisional Collection of Taxes Act 1968.

(1) For Part II of Schedule 2 to each of the Acts of 1971 and 1972 (annual rates of duty for hackney carriages) there shall be substituted the following—

PART II

Description of vehicle	Rate of duty
	£
Hackney carriages	52.50 with an additional £1.05 for each person above 20 (excluding the driver) for which the vehicle has seating capacity.

(2) In Schedule 4 to each of the Acts of 1971 and 1972 (annual rates of duty on goods vehicles)—

(*a*) in Part I, in sub-paragraph (2) of paragraph 6 (farmer's goods vehicle or showman's goods vehicle having a plated gross weight or a plated train weight) in paragraph (b) (weight exceeding 7·5 tonnes but not exceeding 12 tonnes) for "£135" (which applies to farmers' goods vehicles only) there shall be substituted "£155"; and

(*b*) in Part II, for Tables A(1), C(1) and D(1) (rates for farmers' goods vehicles having plated weight exceeding 12 tonnes) there shall be substituted the Tables set out below:

TABLE A(1)

RATES OF DUTY ON RIGID GOODS VEHICLES EXCEEDING 12 TONNES PLATED GROSS WEIGHT

RATES FOR FARMERS' GOODS VEHICLES

Plated gross weight of vehicle		Rate of duty		
1. Exceeding	2. Not exceeding	3. Two axle vehicle	4. Three axle vehicle	5. Four or more axle vehicle
tonnes	tonnes	£	£	£
12	13	210	170	170
13	14	280	175	175
14	15	350	175	175
15	17	475	180	175
17	19	—	240	175
19	21	—	320	180
21	23	—	420	245
23	25	—	720	330
25	27	—	—	465
27	29	—	—	665
29	30.49	—	—	1,090

BUDGET SECRET—BUDGET LIST ONLY

TABLE C(1)

RATES OF DUTY ON TRACTOR UNITS EXCEEDING 12 TONNES PLATED TRAIN WEIGHT AND HAVING ONLY 2 AXLES

RATES FOR FARMERS' GOODS VEHICLES

Plated train weight of tractor unit		Rate of duty		
1. Exceeding	2. Not exceeding	3. For a tractor unit to be used with semi-trailers with any number of axles	4. For a tractor unit to be used only with semi-trailers with not less than two axles	5. For a tractor unit to be used only with semi-trailers with not less than three axles
tonnes	tonnes	£	£	£
12	14	235	215	215
14	16	290	220	220
16	18	330	220	220
18	20	385	220	220
20	22	435	270	220
22	23	465	300	220
23	25	530	365	225
25	26	530	405	265
26	28	530	500	345
28	29	555	555	390
29	31	765	765	495
31	33	1,115	1,115	780
33	34	1,230	1,230	1,150
34	36	1,405	1,405	1,405
36	38	1,580	1,580	1,580

TABLE D(1)

RATES OF DUTY ON TRACTOR UNITS EXCEEDING 12 TONNES PLATED TRAIN WEIGHT AND HAVING THREE OR MORE AXLES

RATES FOR FARMERS' GOODS VEHICLES

Plated train weight of tractor unit		Rate of duty		
1. Exceeding	2. Not exceeding	3. For a tractor unit to be used with semi-trailers with any number of axles	4. For a tractor unit to be used only with semi-trailers with not less than two axles	5. For a tractor unit to be used only with semi-trailers with not less than three axles
tonnes	tonnes	£	£	£
12	14	215	215	215
14	20	220	220	220
20	22	270	220	220
22	23	300	220	220
23	25	365	220	220
25	26	405	225	220
26	28	500	230	225
28	29	555	270	230
29	31	765	325	240
31	33	1,115	495	250
33	34	1,140	725	315
34	36	1,205	1,035	475
36	38	1,390	1,390	710

5. Vehicles excise duty (trade licences)

That provision may be made with respect to the rates of duty applicable to trade licences under section 16 of each of the Vehicles (Excise) Act 1971 and the Vehicles (Excise) Act (Northern Ireland) 1972.

6. Abolition of certain excise licence duties

That no excise licence duty shall be chargeable on the grant after 18th March 1986 of an excise licence under any provision of the Alcoholic Liquor Duties Act 1979 or under section 2 of the Matches and Mechanical Lighters Duties Act 1979:

And it is hereby declared that it is expedient in the public interest that this Resolution should have statutory effect under the provisions of the Provisional Collection of Taxes Act 1968.

7. General betting duty, pool betting duty and bingo duty

That provision may be made extending to Northern Ireland the provisions of the Betting and Gaming Duties Act 1981 relating to general betting duty, pool betting duty and bingo duty.

8. Customs and excise duties (warehousing)

That provision may be made with respect to the matters which may be dealt with in regulations under section 93 of the Customs and Excise Management Act 1979 (warehousing regulations).

9. Value added tax (registration)

That for the purposes of the Value Added Tax Act 1983 provision may be made with respect to the registration of two or more persons as one taxable person.

10. Value added tax (zero-rating)

That provision may be made for the imposition of conditions with respect to the zero-rating of supplies of goods by virtue of section 16(6) of the Value Added Tax Act 1983.

11. Value added tax (relief on importation)

That provision may be made with respect to conditional relief from value added tax under section 19 of the Value Added Tax Act 1983.

12. Value added tax (provision of accommodation)

That provision may be made with respect to the valuation for the purposes of value added tax of certain supplies of services consisting in the provision of accommodation.

13. Income tax (charge and rates for 1986–87)

That—

(1) Income tax for the year 1986–87 shall be charged at the basic rate of 29 per cent and, in respect of so much of an individual's total income as exceeds £17,200 (the basic rate limit as determined under subsection (4) of section 24 of the Finance Act 1980—indexation), at such higher rates as are specified in the Table below:

TABLE

Higher rate bands	*Higher rate*
The first £3,000	40 per cent.
The next £5,200	45 per cent.
The next £7,900	50 per cent.
The next £7,900	55 per cent.
The remainder ...	60 per cent.

(2) Section 24(4) of the Finance Act 1980 (indexation of thresholds) shall not, so far as it relates to the higher rate bands, apply for the year 1986–87:

(3) This Resolution shall not require any change to be made in the amounts deductible or repayable under section 204 of the Income and Corporation Taxes Act 1970 (pay as you earn) before 18th May 1986:

And it is hereby declared that it is expedient in the public interest that this Resolution should have statutory effect under the provisions of the Provisional Collection of Taxes Act 1968.

14. Income tax (indexed personal reliefs etc.): operative date for PAYE

For the year 1986–87, in subsection (7) of section 24 of the Finance Act 1980 (which specifies the date from which indexed changes in income tax thresholds and allowances are to be brought into account for the purposes of PAYE) for "5th May" there shall be substituted "18th May":

And it is hereby declared that it is expedient in the public interest that this Resolution should have statutory effect under the provisions of the Provisional Collection of Taxes Act 1968.

15. Relief for interest (limit for 1986–87)

That, for the year 1986–87, the qualifying maximum referred to in paragraphs 5(1) and 24(3) of Schedule 1 to the Finance Act 1974 (limit on relief for interest on certain loans for the purchase or improvement of land) shall be £30,000:

And it is hereby declared that it is expedient in the public interest that this Resolution should have statutory effect under the provisions of the Provisional Collection of Taxes Act 1968.

16. Advance corporation tax (rate for financial year 1986)

That the rate of advance corporation tax for the financial year 1986 shall be twenty-nine seventy-firsts.

17. Building societies

That provision may be made with respect to the treatment for the purposes of income tax and corporation tax of dividends and interest payable in respect of shares in or deposits with or loans to a building society.

18. Shares and rights to acquire shares obtained by directors and employees

That charges to income tax may be imposed by provisions amending section 186 of the Income and Corporation Taxes Act 1970 (directors and employees granted rights to acquire shares) and section 79 of the Finance Act 1972 (share incentive schemes).

19. Occupational pension schemes

That provision may be made with respect to—

(*a*) payments to employers out of funds held for the purposes of occupational pension schemes; and

(*b*) exemptions and reliefs from tax under section 21 of the Finance Act 1970.

20. Enterprise allowance

That provision may be made about enterprise allowance.

21. Business expansion scheme

That provision may be made amending Schedule 5 to the Finance Act 1983.

22. Company reconstructions

That provision may be made with respect to relief from tax where a company ceases to carry on a trade or part of a trade.

23. Loans to participators

That provision may be made with respect to tax chargeable under section 286 of the Income and Corporation Taxes Act 1970.

24. Charities

That provision may be made with respect to—

(*a*) exemption under section 360 of the Income and Corporation Taxes Act 1970 (exemptions for charities from tax under Schedules A to F);

(*b*) section 145 of the Capital Gains Tax Act 1979 (certain gains accruing to charities not to be chargeable gains); and

(*c*) covenanted payments to charities and payments by one charity to another.

25. Value added tax penalties etc. (income tax and corporation tax)

That charges to income tax and corporation tax may be imposed by provisions with respect to penalties, interest and surcharge under Chapter II of Part I of the Finance Act 1985 (value added tax).

26. Associated companies (oil and gas industry)

That provision may be made extending the cases in which two companies are associated with one another for the purposes of Part II of the Oil Taxation Act 1975.

27. Capital allowances (machinery and plant etc.)

That provision may be made with respect to allowances in respect of expenditure on the provision of machinery or plant for leasing and on the provision of certain vehicles.

28. Capital allowances (mineral exploration and extraction)

That provision may be made with respect to allowances under Chapter III of Part I of the Capital Allowances Act 1968 (mines, oil wells etc.)

29. Dual resident trusts: capital gains tax

That provision may be made for denying or recovering relief under section 79 of the Finance Act 1980 (general relief for gifts) where the transferee is a body of trustees which is or becomes treated as resident both in the United Kingdom and elsewhere.

30. Securities (income tax, capital gains tax and corporation tax)

That charges to income tax, capital gains tax and corporation tax may be imposed by provisions about events occurring after 18th March 1986 in relation to securities.

31. Stamp duty reserve

That a tax shall be charged in respect of events occurring after 18th March 1986 in relation to securities.

32. Stamp duty (transfers for purpose of issuing depositary receipts)

That the following provisions shall have effect for the period beginning 25th March 1986 and ending 31 days after the earliest of the dates mentioned in section 50(2) of the Finance Act 1973—

(1) Subject to paragraph (4) below, this Resolution applies where an instrument transfers shares in or marketable securities of a company registered in the United Kingdom to a person whose business is or includes holding shares in or marketable securities of that company as nominee or agent for—

(*a*) a person whose business is or includes issuing depositary receipts for shares in or marketable securities of the company, or

(*b*) persons each of whom falls within sub-paragraph (*a*) above.

(2) If stamp duty is chargeable on the instrument under the heading "Conveyance or Transfer on Sale" in Schedule 1 to the Stamp Act 1891, the rate at which the duty is charged under that heading shall be the rate of £5 for every £100 or part of £100 of the amount or value of the consideration for the sale to which the instrument gives effect.

(3) If stamp duty is chargeable on the instrument under the heading "Conveyance or Transfer of any kind not hereinbefore described" in Schedule 1 to the Stamp Act 1891, the rate at which the duty is charged under that heading shall be that mentioned in paragraph (2) above; and for this purpose the transaction to which the instrument gives effect shall be treated as a sale for a consideration equal to the value of the shares or marketable securities at the date the instrument is executed.

(4) This Resolution does not apply where the transfer is from one company which falls within paragraph (5) below to another company which falls within that paragraph, and the transferor held the shares or securities for the purposes of its business and the transferee acquires them for the purposes of its business.

(5) A company falls within this paragraph if it is resident in the United Kingdom at the time of the transfer, and its business is exclusively that of holding shares in or marketable securities of a company or companies registered in the United Kingdom as nominee or agent for—

(*a*) a person whose business is or includes issuing depositary receipts for shares in or marketable securities of a company or companies registered in the United Kingdom, or

(*b*) persons each of whom falls within sub-paragraph (*a*) above.

(6) For the purposes of this Resolution a depositary receipt for shares in or securities of a particular company is an instrument acknowledging—

(*a*) the deposit of such shares or securities or of an instrument evidencing the right to receive them, and

(*b*) the entitlement of a person to rights, whether expressed as units or otherwise, in or in relation to such shares or securities.

(7) For the purposes of paragraph (3) above the value of shares or securities at the date the instrument is executed shall be taken to be the price they might reasonably be expected to fetch on a sale at that time in the open market.

(8) Where paragraph (3) above applies, section 15(2) of the Stamp Act 1891 (stamping of instruments after execution) shall have effect as if the instrument were specified in the first column of the table in paragraph (d) and the transferee were specified (opposite the instrument) in the second.

(9) References in this Resolution to shares in a company include references to stock of a company.

(10) This Resolution applies to any instrument which is executed after 24th March 1986 unless it is executed in pursuance of a contract made on or before 18th March 1986

And it is hereby declared that it is expedient in the public interest that this Resolution should have statutory effect under the provisions of section 50 of the Finance Act 1973.

33. Stamp duty (depositary receipts: other transfers)

That the following provisions shall have effect for the period beginning 25th March 1986 and ending 31 days after the earliest of the dates mentioned in section 50(2) of the Finance Act 1973—

(1) This Resolution applies where shares in or marketable securities of a company registered in the United Kingdom are transferred from one company which falls within paragraph (2) below to another company which falls within that paragraph, and the transferor held them for the purposes of its business and the transferee acquires them for the purposes of its business.

(2) A company falls within this paragraph if it is resident in the United Kingdom at the time of the transfer, and its business is exclusively that of holding shares in or marketable securities of a company or companies registered in the United Kingdom as nominee or agent for—

(*a*) a person whose business is or includes issuing depositary receipts for shares in or marketable securities of a company or companies registered in the United Kingdom, or

(*b*) persons each of whom falls within sub-paragraph (*a*) above.

(3) This Resolution also applies where shares in or marketable securities of a company registered in the United Kingdom are transferred to the holder of a depositary receipt for shares in or securities of the company concerned and the transfer is made in satisfaction of his entitlement under the receipt to receive such shares or securities.

(4) The maximum stamp duty chargeable on an instrument effecting a transfer which falls within paragraph (1) or (3) above shall be 50p.

(5) For the purposes of this Resolution a depositary receipt for shares in or securities of a particular company is an instrument acknowledging—

(*a*) the deposit of such shares or securities or of an instrument evidencing the right to receive them, and

(*b*) the entitlement of a person (the holder of the receipt) to rights, whether expressed as units or otherwise, in or in relation to such shares or securities.

(6) References in this Resolution to shares in a company include references to stock of a company.

(7) This Resolution applies to any instrument which is executed after 24th March 1986 unless it is executed in pursuance of a contract made on or before 18th March 1986.

And it is hereby declared that it is expedient in the public interest that this Resolution should have statutory effect under the provisions of section 50 of the Finance Act 1973.

BUDGET SECRET—BUDGET LIST ONLY

34. Stamp duty (clearance services)

That the following provisions shall have effect for the period beginning 25th March 1986 and ending 31 days after the earliest of the dates mentioned in section 50(2) of the Finance Act 1973—

(1) This Resolution applies where an instrument transfers shares in or marketable securities of a company registered in the United Kingdom—

(*a*) to a person whose business is or includes the provision of clearance services for the purchase and sale of shares or marketable securities, or

(*b*) to a person whose business is or includes holding shares or marketable securities as nominee for a person or persons falling within sub-paragraph (a) above.

(2) If stamp duty is chargeable on the instrument under the heading "Conveyance or Transfer on Sale" in Schedule 1 to the Stamp Act 1891, the rate at which the duty is charged under that heading shall be the rate of £5 for every £100 or part of £100 of the amount or value of the consideration for the sale to which the instrument gives effect.

(3) If stamp duty is chargeable on the instrument under the heading "Conveyance or Transfer of any kind not hereinbefore described" in Schedule 1 to the Stamp Act 1891, the rate at which the duty is charged under that heading shall be that mentioned in paragraph (2) above; and for this purpose the transaction to which the instrument gives effect shall be treated as a sale for a consideration equal to the value of the shares or marketable securities at the date the instrument is executed.

(4) For the purposes of paragraph (3) above the value of shares or securities at the date the instrument is executed shall be taken to be the price they might reasonably be expected to fetch on a sale at that time in the open market.

(5) Where paragraph (3) above applies, section 15(2) of the Stamp Act 1891 (stamping of instruments after execution) shall have effect as if the instrument were specified in the first column of the table in paragraph (*d*) and the transferee were specified (opposite the instrument) in the second.

(6) References in this Resolution to shares in a company include references to stock of a company.

(7) This Resolution applies to any instrument which is executed after 24th March 1986 unless it is executed in pursuance of a contract made on or before 18th March 1986.

And it is hereby declared that it is expedient in the public interest that this Resolution should have statutory effect under the provisions of section 50 of the Finance Act 1973.

35. Stamp duty (reconstructions etc.)

That the following provisions shall have effect for the period beginning 25th March 1986 and ending 31 days after the earliest of the dates mentioned in section 50(2) of the Finance Act 1973—

(1) In section 55 of the Finance Act 1927 and in section 4 of the Finance Act (Northern Ireland) 1928 (reconstructions and amalgamations) in paragraph (B) of subsection (1) for the words "not be chargeable" there shall be substituted the words "be chargeable at the rate mentioned in subsection (9) of this section" and for the words "nor shall any such duty be chargeable" there shall be substituted the word "or".

(2) In consequence, each of those sections shall be further amended as follows—

(*a*) at the beginning of paragraph (B) of subsection (1) there shall be inserted the words "If a claim is made under this section";

(*b*) in paragraph (*a*) of the proviso to subsection (1) the words from "either it" to "liable or" and from "either that" to "duty or" shall be omitted, and in paragraph (*c*) of that proviso the words "for exemption" shall be omitted;

(*c*) in subsection (2) for the words "for exemption under paragraph (B) of subsection (1) of" there shall be substituted the word "under";

(*d*) in subsection (5) the words "for exemption" shall be omitted;

(*e*) in subsection (6), in paragraph (*a*) the words "for exemption from duty" shall be omitted, in paragraph (*c*) for the word "exemption" there shall be substituted the word "claim", and in the words following paragraph (*c*) for the word "exemption" there shall be substituted the word "claim", for the word "remitted" (in the first place where it occurs) there shall be substituted the word "unpaid" and the words from "in the case of duty remitted under paragraph (A)" to "the said subsection" shall be omitted;

(*f*) in subsection (7) for the words "for exemption from duty under subsection (1) of" there shall be substituted the word "under", for the words "such exemption" there shall be substituted the words "such a claim to be allowed" and for the words "have been remitted" there shall be substituted the words "not have been chargeable".

(3) At the end of each of those sections there shall be inserted—

"(9) The rate is the rate of 50p for every £100 or part of £100 of the amount or value of the consideration for the sale to which the instrument gives effect."

(4) In paragraph 12 of Schedule 18 to the Finance Act 1980 (demergers) for sub-paragraph (1) there shall be substituted—

"(1) If a document executed solely for the purpose of effecting an exempt distribution is chargeable with stamp duty under the heading 'Conveyance or Transfer on Sale' in Schedule 1 to the Stamp Act 1891, the rate at which the duty is charged under that heading shall be the rate of 50p for every £100 or part of £100 of the amount or value of the consideration for the sale to which the document gives effect.

(1A) If a document executed solely for the purpose of effecting an exempt distribution is chargeable with stamp duty under the heading "Conveyance or Transfer on Sale" in Schedule 1 to the Stamp Act 1891, it shall not be treated as duly stamped unless it is stamped in accordance with section 12 of the Stamp Act 1891 with a particular stamp denoting that it is duly stamped."

(5) In paragraph 12(3) of Schedule 18 to the Finance Act 1980 for the words "this paragraph" there shall be substituted the words "sub-paragraph (2) above".

(6) In section 78 of the Finance Act 1985 (takeovers) the following shall be substituted for subsection (2)—

"(2) If the instrument transferring the shares in company B by way of the exchange is chargeable with stamp duty under the heading 'Conveyance or Transfer on Sale' in Schedule 1 to the Stamp Act 1891, the rate at which the duty is charged under that heading shall be the rate of 50p for every £100 or part of £100 of the amount or value of the consideration for the sale to which the instrument gives effect."

(7) In section 79 of the Finance Act 1985 (voluntary winding-up: transfer of shares) the following shall be substituted for subsection (2)—

"(2) If the instrument transferring the shares in company B to company A is chargeable with stamp duty under the heading 'Conveyance or Transfer on Sale' in Schedule 1 to the Stamp Act 1891, the rate at which the duty is charged under that heading shall be the rate of 50p for every £100 or part of £100 of the amount or value of the consideration for the sale to which the instrument gives effect."

(8) In section 78 and in section 79 of the Finance Act 1985—

(*a*) in subsection (3) for the word "ignored" there shall be substituted the words "treated as reduced by 50 per cent.";

(*b*) subsection (9) shall be omitted;

(*c*) in subsection (10) for "(3)" there shall be substituted "(2) or (3)".

(9) This Resolution applies to any instrument which is executed after 24th March 1986 unless—

(*a*) it is executed in pursuance of an unconditional contract made on or before 18th March 1986, or

(*b*) it transfers stock or marketable securities and is executed in pursuance of a general offer (for the stock or securities) which became unconditional as to acceptances on or before 18th March 1986.

And it is hereby declared that it is expedient in the public interest that this Resolution should have statutory effect under the provisions of section 50 of the Finance Act 1973.

36. Stamp duty (acquisitions)

That the following provisions shall have effect for the period beginning 25th March 1986 and ending 31 days after the earliest of the dates mentioned in section 50(2) of the Finance Act 1973—

(1) This Resolution applies where a company (the acquiring company) acquires the whole or part of an undertaking of another company (the target company) in pursuance of a scheme for the reconstruction of the target company.

(2) If the first and second conditions (as defined below) are fulfilled, stamp duty under the heading "Conveyance or Transfer on Sale" in Schedule 1 to the Stamp Act 1891 shall not be chargeable on an instrument executed for the purposes of or in connection with the transfer of the undertaking or part.

(3) An instrument on which stamp duty is not chargeable by virtue only of paragraph (2) above shall not be taken to be duly stamped unless it is stamped with the duty to which it would be liable but for that paragraph or it has, in accordance with section 12 of the Stamp Act 1891, been stamped with a particular stamp denoting that it is not chargeable with any duty.

(4) The first condition is that the registered office of the acquiring company is in the United Kingdom and that the consideration for the acquisition—

(*a*) consists of or includes the issue of shares in the acquiring company to all the shareholders of the target company;

(*b*) includes nothing else (if anything) but the assumption or discharge by the acquiring company of liabilities of the target company.

(5) The second condition is that—

(*a*) the acquisition is effected for bona fide commercial reasons and does not form part of a scheme or arrangement of which the main purpose, or one of the main purposes, is avoidance of liability to stamp duty, income tax, corporation tax or capital gains tax,

(*b*) after the acquisition has been made, each shareholder of each of the companies is a shareholder of the other, and

(*c*) after the acquisition has been made, the proportion of shares of one of the companies held by any shareholder is the same as the proportion of shares of the other company held by that shareholder.

(6) This Resolution applies to any instrument which is executed after 24th March 1986 unless it is executed in pursuance of an unconditional contract made on or before 18th March 1986.

And it is hereby declared that it is expedient in the public interest that this Resolution should have statutory effect under the provisions of section 50 of the Finance Act 1973.

37. Stamp duty (loan capital)

That the following provisions shall have effect for the period beginning 25th March 1986 and ending 31 days after the earliest of the dates mentioned in section 50(2) of the Finance Act 1973—

(1) The following provisions shall cease to have effect—

(*a*) in section 62 of the Finance Act 1963, subsections (2) and (6) (commonwealth stock);

(*b*) in section 11 of the Finance Act (Northern Ireland) 1963, subsections (2) and (5) (commonwealth stock);

(*c*) section 29 of the Finance Act 1967 (local authority capital);

(*d*) section 6 of the Finance Act (Northern Ireland) 1967 (local authority capital);

(*e*) section 126 of the Finance Act 1976 (loan capital).

(2) Stamp duty under the heading " Bearer Instrument " in Schedule 1 to the Stamp Act 1891 shall not be chargeable on the issue of an instrument which relates to loan capital or on the transfer of the loan capital constituted by, or transferable by means of, such an instrument.

(3) Stamp duty shall not be chargeable on an instrument which transfers short-term loan capital.

(4) Where stamp duty under the heading " Conveyance or Transfer on Sale " in Schedule 1 to the Stamp Act 1891 is chargeable on an instrument which transfers loan capital, the rate at which the duty is charged under that heading shall be the rate of 50p for every £100 or part of £100 of the amount or value of the consideration for the sale to which the instrument gives effect.

(5) In this Resolution " loan capital " means—

(*a*) any debenture stock, corporation stock or funded debt, by whatever name known, issued by a body corporate or other body of persons (which here includes a local authority and any body whether formed or established in the United Kingdom or elsewhere);

(*b*) any capital raised by such a body if the capital is borrowed or has the character of borrowed money, and whether it is in the form of stock or any other form;

(*c*) stock or marketable securities issued by the government of any country or territory outside the United Kingdom.

(6) In this Resolution " short-term loan capital " means loan capital the date (or latest date) for the repayment of which is not more than five years after the date on which it is issued or raised.

(7) In construing sections 80(3) and 81(3) of the Finance Act 1985 (definitions by reference to section 126 of the Finance Act 1976) the effect of this Resolution shall be ignored.

(8) This Resolution applies to any instrument which falls within section 60(1) of the Finance Act 1963 and is issued after 24th March 1986.

(9) This Resolution applies to any instrument which falls within section 60(2) of that Act if the loan capital constituted by or transferable by means of it is transferred after 24th March 1986.

(10) This Resolution applies, in the case of instruments not falling within section 60(1) or (2) of that Act, to any instrument which is executed after 24th March 1986, unless it is executed in pursuance of a contract made on or before 18th March 1986.

(11) In this Resolution references to section 60(1) of the Finance Act 1963 include references to section 9(1)(*a*) of the Finance Act (Northern Ireland) 1963 and references to section 60(2) of the former Act include references to section 9(1)(*b*) of the latter.

38. Stamp duty (bearer letters of allotment etc.)

That the following provisions shall have effect for the period beginning 25th March 1986 and ending 31 days after the earliest of the dates mentioned in section 50(2) of the Finance Act 1973—

(1) In Schedule 1 to the Stamp Act 1891, in the heading "Bearer Instrument", paragraph 2 of the exemptions (bearer letter of allotment etc. required to be surrendered not later than six months after issue) shall be omitted.

(2) This Resolution applies to any instrument which falls within section 60(1) of the Finance Act 1963 and is issued after 24th March 1986, unless it is issued by a company in pursuance of a general offer for its shares and the offer became unconditional as to acceptances on or before 18th March 1986.

(3) This Resolution applies to any instrument which falls within section 60(2) of that Act if the stock constituted by or transferable by means of it is transferred after 24th March 1986.

(4) In this Resolution the reference to section 60(1) of the Finance Act 1963 includes a reference to section 9(1)(a) of the Finance Act (Northern Ireland) 1963 and the reference to section 60(2) of the former Act includes a reference to section 9(1)(b) of the latter.

And it is hereby declared that it is expedient in the public interest that this Resolution should have statutory effect under the provisions of section 50 of the Finance Act 1973.

39. Stamp duty (letters of allotment)

That provision may be made for abolishing the exemption from stamp duty provided by section 65(1) of the Finance Act 1963 and section 14(1) of the Finance Act (Northern Ireland) 1963.

40. Stamp duty (company's purchase of own shares)

That provision may be made for charging stamp duty on returns delivered under section 169 of the Companies Act 1985 or Article 53 of the Companies (Northern Ireland) Order 1982.

41. Tax under Capital Transfer Tax Act 1984

That charges to tax under Capital Transfer Tax Act 1984 may be imposed—

(*a*) by provisions relating to deaths occurring on or after 18th March 1986;

(*b*) by provisions removing relief referable to mutual transfers where at least one of the transfers occurs on or after that date; and

(*c*) by provisions relating to relief under Chapter I (business property) or Chapter II (agricultural property) of Part V of that Act in the case of transfers of value on or after that date.

42. Oil taxation: light gases

That, for the purpose of petroleum revenue tax, provision may be made with respect to the valuation of light gases.

43. Oil taxation: attribution of chargeable receipts and allowable expenditure

That, in any case where—

(*a*) tariff receipts or disposal receipts arising in a chargeable period ending after 30 June 1982, or

(*b*) allowable expenditure, within the meaning of Part II of Schedule 1 to the Oil Taxation Act 1983,

fall to be (or have at any time since the passing of the said Act of 1983 fallen to be) attributed to one of two or more oil fields and development decisions relating to those fields were first made on the same day, provision may be made for determining which of those decisions is to be presumed to have been made first.

44. Relief from tax (incidental and consequential charges)

That it is expedient to authorise any incidental or consequential charges to any duty or tax (including charges having retrospective effect) which may arise from provisions designed in general to afford relief from tax.

PROCEDURE RESOLUTION

PROCEDURE (FUTURE TAXATION): That, notwithstanding anything to the contrary in the practice of the House relating to matters which may be included in Finance Bills, any Finance Bill of the present Session may contain provision taking effect in a future year with respect to—

(*a*) the treatment for the purposes of value added tax of fuel which is or is to be provided or appropriated by a taxable person for private use in a motor vehicle;

(*b*) relief for investment in corporate trades; and

(*c*) relief in respect of payments to charities.

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COVERING BUDGET SECRET

FROM: **JILL RUTTER**

DATE: **18 March 1986**

MR MONGER

cc:
PS/Chancellor
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir P Middleton
Mr Scholar
Miss O'Mara
Miss Noble
Miss Sinclair
Mr H Davies

PS/Inland Revenue

CHIEF SECRETARY's SPEECH

I attach the Chief Secretary's draft on rates v thresholds.

2 I would be grateful for comments by 5.30 today.

Jill Rutter

JILL RUTTER
Private Secretary

003/2761

THE RT HON JOHN MACGREGOR OBE MP
OPENING THE BUDGET DEBATE
ON WEDNESDAY, 19 MARCH 1986

SAID:

I turn now to what I regard as the major themes of this year's Budget. My Rt hon and honourable friends will be enlarging upon them and developing others from the front bench in the course of the next few days' debates. I see them as being under three broad headings.

First, this Budget marks a further step in our programme of reducing the burden of income tax of the British people, despite the constricting circumstances resulting from the loss of North Sea Oil revenue.

Our reasons are well known. Income tax as a proportion of most people's earnings has increased enormously over the years; [here Richard to put in the quotation from Edinburgh Chamber of Commerce Speech about the proportion of the average married man earnings compared with the 1950s]. We want to enlarge the area of personal choice, so that individuals are able to keep more of what they earn to choose to spend it as they wish, including on areas which in more socialist dominated states would be the preserve of central government expenditure and choice. We want to see more and more people being able to make choices and decisions of their own and to have the have the will to do so - and more of that later.

It is important for incentives, not only for enterprising entrepeneurs and small businesses but also for most of our citizens to ensure that if they obtain qualifications or additional skills, or work longer hours, they can reap the rewards of doing so. At too many ordinary income levels the marginal incentive to earn more is still too small.

And it is important for jobs, because it helps to promote further the climate among employers and employees in thousands of businesses throughout the country, particularly in the small ones, that it is worth building the business up because the rewards do come home.

There are however four featrues of this year's income tax changes which I would like to single out

First, the gains have been quite deliberately concentrated on the vast majority of ordinary taxpayers, those in the broad income band fluctuating around the average, in other words from about half the national earnings to twice such earnings. I noted in all the pre-Budget comments some concerns expressed about reducing direct tax rates generally because this would particularly benefit the higher paid. The House will have noted that we have deliberately skewed the changes so that it does not do so. Those at the top of the earnings scale get no greater gain that they would have done from simple indexation of allowances. The starting points for the higher rates of tax other than the first will be raised by less than indexation so as to offset the effect of the reduction in the basic rate. The result is that the maximum gain, by which I mean the biggest gain in £ cash, from the Budget will be almost exactly what it would have been for indexation.

And this is right. Because it means that the biggest proportional benefits from the combined tax change of the basic rate cut and the indexation of thresholds will be concentrated on all those income groups who deserve it most.

All income ranges have seen their direct tax reduced in real terms as a percentage of their tax liability in the last year of the Labour Government, in other words assuming normal indexation since that year. Until this Budget the percentage tax reduction had been greatest at both ends of the income scale. For those earning under £5,000 that percentage reduction was 15 per cent. For those earning between £20,000 and £30,000 it was 13 per cent, and for those over £30,000 21 per cent - I make no apology for that because the tax regimes for the higher paid under the last Labour Government were crippling, harmful to incentives, internationally highly uncompetitive and therefore bad for the economy as a whole - and as the House knows it has cost comparatively little in terms of tax foregone to deal with them. But the key point is that those between the income ranges of £5,000 and £20,000 have seen a percentage tax reduction of 12 per cent - less than all the others.

That is why there was a strong case for concentrating on this large income band, for whom the 1p percentage reduction in the basic rate means most. That is has not been at the expense of the lowest paid. They too benefit in terms of their reduced percentage liability to tax - now up to 19 per cent compared with the Labour Government - but it is the income groups in between who compared with other years now benefit most, and it is the higher paid who benefit least.

This brings me to my second point, the rates thresholds argument. Prior to the Budget there was quite a body of opinion arguing that any tax reductions should be concentrated on the threshold, based partly on the belief that to do otherwise would benefit the highest paid. I have just dealt with that argument.

But I think that most of that debate is wrong, and based on a misunderstanding of the Government's intentions and the affect of tax changes. It is extremely important to get the record straight therefore I wish to dwell on this argument now.

In choosing to make a 1p reduction in the basic rate this year, the Government is not saying that basic rate reductions are in some sense "better" than threshold increases. The fact is that we need both as part of our programme of reducing the burden of tax.

Our record shows the importance we attach to raising the threshold. The basic allowances will be over 22 per cent higher in real terms next year than they were in 1978-79. We have spent more money (Jill figure please) in raising allowances than in reducing rates.

This substantial increase in allowances means that there are 1.4 million fewer taxpayers than if we had merely indexed allowances since 1978-79. It also means that the real value of the married man's allowance is the highest since 1945 - over 40 years ago.

And of course in this Budget we have increased allowances too. Some 550,000 will be taken out of tax altogther as a result. What is more, and this is a very important point, the increases in allowances are based on an inflation rate of 5.7 per cent. In fact the effective rate of inflation over the coming year is likely to be very much less, so the increase in allowances will in effect be above inflation.

We have therefore taken action to raise thresholds over the past few years and in this Budget. In our Green Paper on personal tax reform we described a possible strategy for the future. One of the main purposes of the paper is to show how we could increase thresholds in a way which is more cost effective and gives more help to those whose family commitments are high. My Rt hon Friend the Financial Secretary will be dealing in greater detail with the Green Paper later in this debate. I will therefore keep out of this subject now except to say that it shows that our long term objective continues to be to make further substantial increases in allowances.

So the Government's record in raising allowances and dealing with thresholds is clear and unequivocal.

But it was time that something was done about the basic rate. And it is very wrong to imagine that a basic rate reduction helps only a small group in the middle of the earning distribution. Rather it helps people on very wide range of incomes. It is bound to do so when some 95 per cent of taxpayers pay at the basic rate. For all those taxpayers, their marginal rate will fall and so incentives will improve.

In my view, and partly because of our success in improving the level of thresholds in recent years and so taking many more of those on lowest incomes out of tax, the arguments about thresholds have become distorted. Too many people have forgotten the effect on quite modest incomes of doing more on the basic rate rather than on thresholds.

Let me elaborate.

The reduction in the basic rate is actually of greater benefit than an increase in allowances which cost the same in terms of tax foregone for single people and married women with incomes as low as £115 a week. This is little more than half average earnings. I think it is time that that fact was reflected in some of the debates and discussions about the rates of the thresholds argument.

And the reduction in the basic rate is of greater benefit for married men earning £180 a week, which is still well below average male earnings. [Please check figure of £180 a week].

Let me take some typical examples.

The single nurse earning £140 a week has become a test case. Everyone agrees she is paying too much tax. Everyone would like to help her. So I suspect that in most people's minds she is the kind of person who is thought to benefit from a greater than indexation increase thresholds rather than from the basic rate reduction. Quite the contrary. She will gain 95p a week from the reduction in the basic rate, compared with 69p a week for a equal cost increase in allowances.

The sames applies to the single primary school teacher earning £195 a week. He or she will gain £1.50 a week from the reduction in the rates compared with 69p for an equal cost increase in allowances.

And married men on average earnings will also gain more from this Budget compared with an equal cost increase in allowances. (RICHARD)

The reduction in the basic rate will therefore bring significant gains over a very wide rage of incomes, extending to those below average earnings. By no stretch of the imagination can it be said to be concentrating on the higher paid. Indeed any single person or working wife earning more than about £120 a week, or any married man earning below average earnings at about £180 a week, benefits more by this Budget change rather than by concentrating on thresholds.

Moreover, the House needs to address itself to the fact that only a small minority -some 20 per cent - of those taken out of tax by threshold increases are married men. That is the normal definition of "the needy". But not all of them will have families. The remainder are young single people, working wives and of course pensioners. I suspect that the myth has grown up that by increasing thresholds to the maximum amount of tax relief available the Chancellor helps most the breadwinner with a family on a comparatively low income. The facts proves that that is not the case. The choice between rates and thresholds should turn on the effect on the majority, not on those at the bottom of the income scale irrespective of their need and family situation. I hope that I have demonstrated that the balance of the argument has changed, and that it was right to put this focus on a basic rate reduction this year.

But there are other arguments for doing so, and my third point is that it helps the very small businesses and the self employed. As a former Minister for Small Businesses, I know only too well the argument that we have greatly helped the small incorporated business by big reductions in the small rate business rate of corporation tax; that all other businesses have benefited by having the lowest rate of corporation tax - at 35 per cent - in most developed industrial countries (RICHARD TO CHECK); but that the self employed and our incorporated businesses do not feel that they have always benefited to the same extend.

In fact 90 per cent of all self employed non-incorporated businesses have earnings at the basic rate of tax. So this 1 per cent reduction in the basic rate will be particular benefit to them, on top of the other measures we have taken, bringing their basic rate of taxation down from the 35p in the £ at the peak point on the last Labour Government and from the 33p which we inherited. That is factor which weighs heavily in my mind in favour of basic rates reduction.

And finally, on this theme, I wish to draw attention to pay implications. For the employee on average earnings, the reduction in tax [CHECK WITH RICHARD WHETHER THIS IS THE BASIC RATE OF REDUCTION OR THE OVERALL RATE REDUCTION BASIC RATE PLUS THRESHOLDS] is the equivalent of £4 per week in gross pay. That equals a 2 per cent pay increase. This is another very important reason for concentrating on the basic rate reduction this year, because for the person on average earnings the effect on net take home pay, and hence gross pay increases, is greater by what the Chancellor has proposed than by concentrating on thresholds.

But it is of wider implication than that. The House is well aware that one of the greatest threats to jobs in this country today is the fact that our labour unit costs have been rising faster than our major competitors. I make no apology for repeating the figures again. (RICHARD TO PUT FIGURES IN COMPARED WITH JAPAN GERMANY AND UNITED STATES).

As the CBI has acknowledged it is essential that we bring of increase in unit labour cost more into line with those of our competitors. Indeed I would go so far as to say that that is one of the biggest threats to jobs and hence to unemployment at the present time. By increasing the take home pay without necessity of that increase in gross earnings, this Budget is making a major contribution. I hope that both employers and employess will take note and act accordingly.

1. Rachel
2. RJP

INLAND REVENUE
STATISTICS DIVISION
SOMERSET HOUSE

FROM: R J EASON

DATE: 18 March 1986

MR SCHOLAR
H M TREASURY

BUDGET BRIEF, SECTION M1

I attach, as requested, a table comparing the effects of the income tax proposals for 1986-87 with those for an equal cost option increasing allowances by 5.4% more than indexation.

The table can be added to the Budget Brief, Section M1, A Factual, paragraph (xiv).

R J EASON

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cc PS/Chancellor	Mr Isaac
PS/Chief Secretary	Mr Lewis
PS/Financial Secretary	Mr Painter
PS/Economic Secretary	Mr Calder
PS/Minister of State	Mr Mace
Sir Peter Middleton	Mr Johns
Mr Monger	Mr Eason
Miss Sinclair	Mr Hudson
Mr Culpin	Mr Walker
Miss O'Mara	Mr McManus
	PS/IR

TABLE

SINGLE AND MARRIED COUPLES - ANNUAL FIGURES
COMPARISON BETWEEN PROPOSED CHARGE FOR 1986-87 AND EQUAL COST ALLOWANCES INCREASE

Income	Proposed charge for 1986-87		Equal cost allowances increase (5½ per cent over indexation)		Extra tax paid compared with equal cost allowances increase	
	Income tax	Percentage of total income taken in tax	Income tax	Percentage of total income taken in tax	Income tax	As percentage of total income
£	£	per cent	£	per cent	£	per cent
SINGLE PERSONS						
3,000	193	6.4	164	5.5	29	1.0
4,000	483	12.1	464	11.6	19	0.5
6,000	1,063	17.7	1,064	17.7	-1	-0.0
8,000	1,643	20.5	1,664	20.8	-21	-0.3
10,000	2,223	22.2	2,264	22.6	-41	-0.4
12,000	2,803	23.4	2,864	23.9	-61	-0.5
15,000	3,673	24.5	3,764	25.1	-91	-0.6
20,000	5,174	25.9	5,298	26.5	-124	-0.6
25,000	7,297	29.2	7,405	29.6	-108	-0.4
30,000	9,660	32.2	9,738	32.5	-78	-0.3
40,000	14,879	37.2	14,900	37.2	-21	-0.1
50,000	20,702	41.4	20,642	41.3	60	0.1
60,000	26,702	44.5	26,642	44.4	60	0.1
MARRIED COUPLES						
4,000	100	2.5	47	1.2	53	1.3
6,000	680	11.3	647	10.8	33	0.6
8,000	1,260	15.8	1,247	15.6	13	0.2
10,000	1,840	18.4	1,847	18.5	-7	-0.1
12,000	2,420	20.2	2,447	20.4	-27	-0.2
15,000	3,290	21.9	3,347	22.3	-57	-0.4
20,000	4,740	23.7	4,847	24.2	-107	-0.5
25,000	6,703	26.8	6,780	27.1	-77	-0.3
30,000	9,000	30.0	9,043	30.1	-43	-0.1
40,000	14,153	35.4	14,135	35.3	18	0.0
50,000	19,910	39.8	19,808	39.6	102	0.2
60,000	25,910	43.2	25,808	43.0	102	0.2

Calculations assume that only the husband has earned income.

H M THE QUEEN

1986 BUDGET: SUMMARY OF MAIN POINTS

This year's Budget comes at a time of great change, with the dramatic and unprecedented collapse of the oil price. But the Budget's main themes are those of its predecessors - the defeat of inflation, and the creation of an enterprise culture which will promote the growth of output and employment.

Economic Background: the effects of the oil price fall

2. Output in the world economy has been rising since early 1983 and world inflation has been coming down since 1980. The fall in the oil price will be of particular help to oil-importing countries, both in the developed and the developing world. A period of low inflation and good growth in output and trade is in prospect.

3. At home, inflation, after the temporary upward movement last year, is now down to 5½ per cent and is set to fall to below 4 per cent within the next few months. Output continues to grow strongly. In 1985, the UK economy grew by 3½ per cent, faster than any other country in the European Community, and faster than the United States, too. We are now about to enter our sixth successive year of growth at an average level of 3 per cent.

4. The pattern of growth remains broadly based. Manufacturing exporters have fully maintained their share of world trade - and a further 6 per cent growth in manufactured exports is forecast in 1986. Investment is expected to grow by about 5 per cent this year. On the balance of payments the forecast is for a current account surplus of £3½ billion.

5. Employment has continued to rise - there are around 600,000 more people in work than in June 1983 - but unemployment remains stubbornly and disappointingly high.

6. Because of the UK's position as a major oil producer, the oil price fall will help most other major industrial countries more than it will help us. There will also be an adverse effect on our terms of trade, because we lose more from our export earnings than we gain from lower import prices, and inevitably the Government's oil revenues will be sharply reduced. But against this, there will be valuable benefits for the non-oil economy, especially for manufacturing, with lower costs and higher profits. The increase in world trade which should follow lower oil prices will provide an excellent opportunity for British exporters. Overall there should be a modest net benefit to Britain in terms of output and inflation.

Budget Strategy

7. The Government's Medium Term Financial Strategy (MTFS) is extended for a further year, to 1989-90, in the Budget. It is designed steadily to reduce the growth of total spending power in the economy over a period of years, at a pace which will gradually squeeze inflation out of the system, while leaving room for further sustained economic growth. Target ranges are set for the growth of narrow and broad money in 1986-87, and the Government will continue in operating policy to have regard to a range of other evidence about monetary conditions - of which the most important is the exchange rate.

8. To support monetary policy the Government intends to keep public borrowing at a low level. The 1985-86 Public Sector Borrowing Requirement (PSBR) is expected to come out at a little under £7 billion or 2 per cent of GDP, the lowest level since 1971-72. This outcome was achieved in spite of the fall in oil revenues, because of restraint in public expenditure and the buoyancy of non-oil revenues, reflecting a healthy economy and an increasingly profitable corporate sector.

9. Last year's MTFS indicated for 1986-87 oil revenues of £11½ billion, and scope for possible tax reductions of £3½ billion. Since then the outlook for the public finances has been substantially affected by the sharp fall in oil prices. Assuming the oil price averages $15 a barrel for the rest of 1986 and in

1987, oil revenues for 1986-87 are projected at £6 billion. But for the buoyancy of non-oil revenues and firm restraint on public spending, a significant increase in taxation would have been necessary in this year's Budget.

10. Last year's MTFS also indicated a PSBR for 1986-87 of £7½ billion, or 2 per cent of GDP. The Chancellor has decided to stick broadly to this figure, but, given the uncertainties over the oil price, to go a little below it and provide for a PSBR of £7 billion, or 1¾ per cent of GDP. That figure takes account of the Budget measures, which provide for a reduction in the real burden of taxation of a shade under £1 billion.

Help for the unemployed

11. The continuing high level of pay settlements is continuing to inhibit the growth of employment. In the longer term greater wage flexibility is essential for the creation of lasting jobs. This year, to add to the measures the Government has already taken to encourage such flexibility, and to encourage identification between employee and enterprise, the Government is to consider issuing a consultative document, if preliminary discussions are satisfactory, about a possible incentive scheme of tax relief to encourage profit sharing schemes in which total pay is directly affected by the success of the enterprise.

12. For the more immediate future, the measures announced in last year's Budget are still to show most of their effect. The expansion of the Youth Training Scheme to cover all 16 and 17 year olds comes into effect next month. The increase in the size of the Community Programme (which provides work of community benefit, for the long term unemployed) is going ahead fast. This year the Government is raising the target for expansion from 230,000 places by June 1986, to 255,000 by the end of 1986, compared with the present level of about 200,000 places.

13. The long term unemployed will also benefit from the development of the pilot schemes, originally announced by the Secretary of State for Employment last year, into a single programme covering the whole country (Restart) . As a result of this programme all the long term unemployed will be called for counselling interview and offered help to find work; and those who take a job at less than £80 a week will receive a "Jobstart" £20 a week grant for 6 months.

14. In addition, the Enterprise Allowance Scheme is being expanded to an annual entry of 100,000 to give more unemployed people help to start their own business; and a new scheme - the New Workers Scheme - will provide a cash incentive to employers to create jobs for young people aged 18-20 at realistic wages.

15. The public expenditure cost of these and other changes will be £195 million in 1986-87 and £290 million in 1987-88. After

allowing for social security savings, the net public expenditure cost will be £100 million and £165 million respectively. The cost will be charged to the public expenditure Reserve and so there will be no increase in the public spending planning total.

Taxes on Business and Enterprise

16. The Corporation Tax structure announced in 1984 comes fully into force this year with the main rate coming down to 35 per cent.

17. In addition, the Business Expansion Scheme which was due to come to an end in April 1987 will be extended indefinitely. It is already attracting substantial amounts of new equity capital into unquoted companies. A number of improvements to the Scheme are proposed, including measures to ensure that it is genuinely focussed on high risk investment. It will also be extended to certain forms of UK ship chartering.

18. Small businesses will also benefit by the extension of the Loan Guarantee Scheme for three years, and the halving of the premium charged for the Government guarantee from 5 per cent to 2½ per cent. The abolition of the Capital Transfer Tax on gifts between individuals during their lifetime will be a further help to family businesses. The tax will be renamed the Inheritance Tax.

Savings and investment

19. The Budget includes a number of further measures to reform the taxation of savings and investment. There is to be a radical new scheme to encourage individuals to invest directly in equities. This scheme should, in time, bring about a further considerable extension of share ownership in Britain. Any adult will be able to invest up to £200 a month in shares. As long as the investment is kept in a special account - called the Personal Equity Plan - for a relatively short minimum period, all reinvested dividends and capital gains will be free of tax.

20. To retain its international pre-eminence as a financial centre the City of London must be fully competitive, world-wide. The ending of fixed commissions (the 'Big Bang') on 27 October will help reduce dealing costs. But the Chancellor has concluded that to meet successfully the increasingly fierce competition from New York and Tokyo, it is necessary to reduce from 1% to ½% the Stamp Duty on share transactions. The cost will be recouped by bringing into tax a range of financial transactions which are at present entirely free of Stamp Duty.

21. The present rules relating to pension fund surpluses will be clarified. Under the new arrangements, where a refund is made to employers it will be subject to tax at 40%.

Charities

22. A number of specific concessions will be made, relieving charities from VAT in respect of certain purchases. In addition, the Government has decided to supplement the measures it has already taken to assist charities with a substantial new package, directed towards charitable giving rather than towards the charities themselves. By

- abolishing the upper limit on relief at higher rates of income for convenants
- allowing tax relief to companies for one-off gifts up to a maximum of 3 per cent of dividends
- providing relief to individuals for regular gifts of up to £100 a year to charity where these are deducted at source by their employers

the Budget should eventually stimulate additional charitable giving by probably twice the £70 million cost to the Exchequer of these measures.

Taxes on Spending

23. Overall, excise duties will be increased by the same amount as would be required to keep pace with inflation. Petrol and derv duties will be increased by rather more than this -by 7½p a gallon and 6½p respectively. Given the recent increase in oil companies' profit margins these increases should not be passed on to the consumer. The real tax burden on the road user will be kept

unchanged, with no general increase in Vehicle Excise duty on cars and lorries. In recognition of the dangers to health cigarettes and hand rolling tobacco will be increased by the equivalent of just over 11p a packet of 20 king size. Cigars and pipe tobacco duties will not be changed. There will be no increase in the duties on any alcoholic drinks. This should help with the difficulties currently faced by the Scotch whisky industry.

24. No major changes are proposed in VAT.

Income Tax

25. As foreshadowed in the Budget Statement last year, the Government has published a Green Paper on personal taxation discussing options. In particular, it outlines a possible reform (made possible by computerisation) of the system of income tax personal allowances. Everyone would have a basic tax allowance in his or her own right. A husband and wife would be taxed independently, but would be able to transfer unused allowances to each other. Married women would for the first time have the opportunity of privacy in their tax affairs; the existing tax penalties on marriage would be removed; and more tax relief would go to couples at the point when they are most likely to need it, when the wife gives up paid work to start a family.

26. The Government is making further reductions in income tax, in order to increase incentives. Since 1979, allowances have been

increased by 22 per cent in real terms so that they are now higher, as a proportion of average earnings than, for example, in Germany or the United States. This year, basic allowances are increased in line with prices and the basic rate of income tax is reduced by 1 penny - improving incentives for the 95 per cent of employees, and for the 90 per cent of all self-employed people and unincorporated businesses, for whom the basic rate is also the marginal rate. This is the first cut in the basic rate for seven years. The new basic rate will be 29p in the £. There will be a comparable change in the small firms Corporation Tax rate.

Summary

27. The Budget maintains the Government's strategy to defeat inflation and to create the conditions for further growth of output and employment. The overall burden of taxation is being modestly reduced. Specific measures will be taken to help the unemployed; to promote enterprise and initiative; to reform the taxation of savings, and investment, and to increase charitable giving.

HM Treasury
17 March 1986

RT8.35

A W KUCZYS

DATE: 19 March 1986

PS/FINANCIAL SECRETARY

cc PS/Minister of State
PS/Economic Secretary
Sir P Middleton
Mr Scholar
Mr Cassell
Mr Monger
Miss Sinclair
Mr Battishill - IR
PS/IR

BUDGET DAY TAX CHANGES

The Chancellor has seen Mr Battishill's minute of 17 March, and the draft passage for inclusion in the Financial Secretary's winding up speech tonight. He had thought that in future all changes would take effect from the start of Budget Day. He wonders whether such an approach would not be clearer, simpler, and lead to less argument than "picking and choosing". He has asked, what is the case against it?

2. Mr Battishill is now considering this. Meanwhile, as you know, he suggested some amendments to the passage in the Financial Secretary's speech - which the Chancellor is content with - to leave the point open for now.

AWK

A W KUCZYS

QUOTED UK plc

PRESS RELEASE

BUDGET ASSESSMENT

A Satisfactory Budget for QUOTED UK plc and a PEP For The City!

I am delighted to note that in his Budget speech Chancellor Lawson paid due regard to the major achievements of QUOTED UK plc in recent years. Our trading position today has never been more encouraging and budgets for 1986 show 15% profits growth, with earnings up by 16% and dividends likely to rise by 12%. Cash flow remains buoyant and it was interesting to see a recent survey which pointed out that our profitability is now running ahead of QUOTED US Inc. Red Book arithmetic tends to support the optimistic views of my divisional chairmen who were particularly pleased to see positive reference made to our strategic build up of overseas assets in recent years.

Turning to the statement itself, I find it difficult to agree with claims of currency stability given recent gyrations in the foreign exchange markets whilst there was a notable lack of commitment to lower interest rates but I assume at least a one point reduction very soon — after all, those highly paid City analysts all anticipate much more than this in coming months.

I look forward to making full representation on the subject of personal tax reform where I see scope to reduce quite markedly those classified as unemployed; while the prospect of remuneration linked more directly to profitability per person looks an intriguing prospect.

I take issue with comments relating to the need for tighter control on labour costs and the recommendation for higher R&D spending. I am pleased with our progress on both fronts and would simply refer the Chancellor to our productivity record.

Whilst the package in total will have no marked impact on trading conditions, one or two specific measures were surprising.

A penal 5% up-front duty on conversion of our shares into ADRs smacks of protectionism for the City and will clearly undermine our planned drive to add US shareholders to the list. I shall be lobbying most strongly against this move.

Pension fund surplus rules come as a mixed blessing. This whole area does require clarification but I have some concern about lessening the degree of conservatism. After all, investment markets and inflation rates will not always look so attractive. The official figures show an additional tax take of £750m over three years from these changes or the creation of more than £2bn of taxable income. This could be a substantial under estimate. Our pension fund managers will now certainly see a marked reduction in their new cash flow.

On a divisional basis, senior company chairmen in the drinks division have already been reminiscing about the 50's when the Government of the day last showed such understanding. Although tobacco duties cause some concern the major problem area in the group today is the oils and official numbers only serve to highlight their plight.

As I look back on today's Budget late this evening, smoking a cigar, downing a glass of my favourite tipple, assessing my next BES investment, forgetting P11Ds, pondering my favourite charity and planning the distribution of my wealth to friends tax free, it has, perhaps, been a good day after all. Indeed, a PEP for me and the City.

not v. helpful

18th March 1986

Notes for Editors
The accounts for QUOTED UK plc have been derived from the Hoare Govett Aggregate Model. This computerised database contains historic and projected financial data on 150 of the major UK quoted companies which represent some 70% of the London equity market in capitalisation terms. The figures for individual sectors have been grossed up to take account of the proportion of each sector not captured in our research universe to give numbers which approximate to the total UK equity market. Oils profits are shown gross of production taxes. Financials are included under the equity method of accounting.

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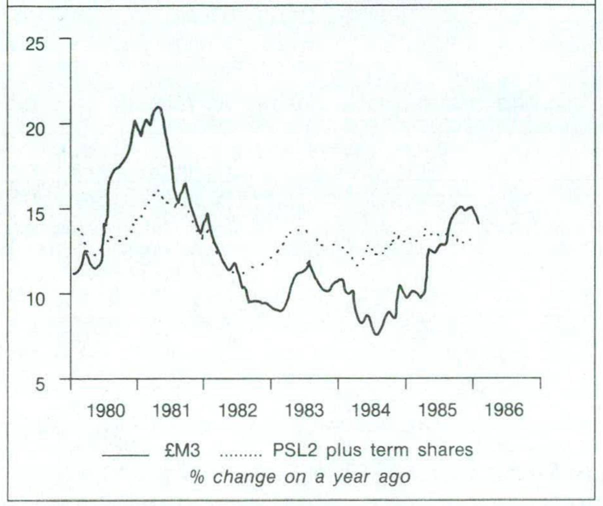
Broad Monetary Aggregates



growth comes from bank lending to the private sector which we forecast at a rate of £1¾bn per month, marginally above the average level over the last twelve months (£1.6bn). With contractionary other counterparts that also points to £M3 growth around the centre of its range.

In recognition of the difficulty of predicting the velocity trends of £M3, target ranges for later years have not been set, a marked break with the tradition of the Medium Term Financial Strategy.

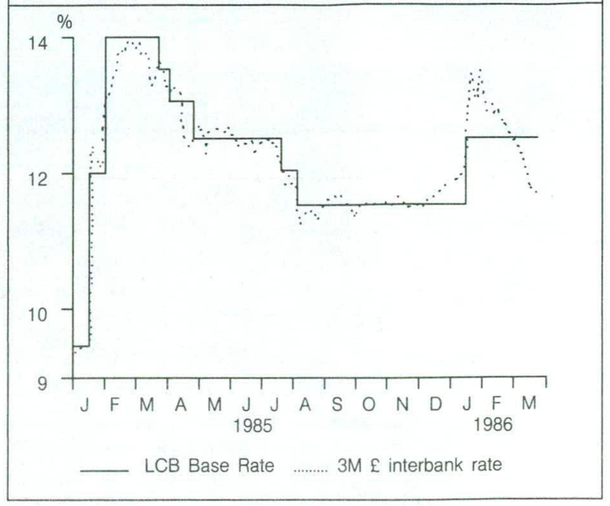
M0 target

The target range for M0 growth was set in line with that put down in last year's *FSBR*. We anticipate no difficulty whatsoever in achieving this target and predict growth of 3½% at the end of the financial year. For the years further ahead the target bands for M0 do not decline as quickly as previously set down (see table on the *The MTFS and Monetary Growth*): even in the most distant years we do not envisage any difficulty with achieving in-target growth.

Nominal GDP projections

As last year, the target ranges for monetary growth have been set down alongside those for nominal GDP growth with the one percentage point fall in the mid-point of the M0 target range between 1986/87 and 1989/90 alongside a 1¼% fall in nominal GDP growth (from 6¾% to 5½%). An innovation, however, is that the *real* and *price* components of the nominal GDP growth are isolated with real growth steady at 2½% in each of the three financial years 1987/88 to 1989/90 and inflation falling steadily to 3% in the final year.

LCB Base Rates and 3 Month Interbank Rates



GDP growth during the MTFS* (%)

Financial Year:	Nominal GDP	Real GDP	Price Deflator
1980/81	14.9	-3.3	18.7
1981/82	9.3	-0.7	10.0
1982/83	9.3	2.1	7.0
1983/84	7.7	3.1	4.4
1984/85	6.3	1.9	4.3
1985/86E	9.0	3.4	5.4
1986/87F	7.8	3.3	4.4

* the measure of GDP chosen is expenditure at market prices
E = HG estimate F = HG forecast

Exchange rate as a monetary indicator

As expected, no firm exchange rate commitment was announced. The *FSBR* repeated last year's statement that there is no mechanical formula for taking the exchange rate into account when assessing monetary conditions.

Conclusion for interest rates

We expect that the behaviour of the two targetted monetary aggregates will not act as any constraint on a reduction in interest rates in the 1986/87 financial year. Even wayward £M3 is likely to grow within its new, more comfortable, range. This will mean that it will be the behaviour of the exchange rate which will effectively determine the pace of reductions. A cut of one percentage point in base rates is expected as early as the day after the Budget and further cuts are likely to follow reasonably swiftly. Base rates back within single figures by the end of the year seem a reasonable objective.

Paul Temperton

The Gilt Market

- *Light gilt sales programme with PSBR of only £7bn and no planned overfunding*
- *Inflation expected to be lower than official forecast*
- *Substantial interest rate cuts as sterling remains firm*
- *Long gilt yields below 8½% at year end*

Economic background

The general economic circumstances in the remainder of 1986 are expected to be a fundamentally favourable influence on the gilt market. Most significantly, inflation is set to fall further with the Chancellor's forecast of 3½% at the end of 1986 on the pessimistic side. We expect the rate to be 3% and falling to 2½% in mid-1987, with the prospect of a much lower rate if the pace of wage increases starts to moderate.

The Chancellor's PSBR target of £7bn, some £½bn lower than projected at the time of the last Budget, does not look achievable, despite buoyant non-oil revenues and higher than planned proceeds from privatisation (see the separate section on the PSBR). Even so, along with the policy of no overfunding of the PSBR during the course of the financial year as a whole this means that the likely scale of new gilt issues will be modest (see below).

The monetary targets are unlikely to be a constraint in the process of reducing interest rates. As discussed in the previous section, even £M3 is likely to grow within its new, more liberal, target range (as will M0). This will mean that the behaviour of the exchange rate will be the overriding brake on the process of interest rate reductions by the authorities. With the dollar in continued decline, however, sterling's effective rate is set to behave satisfactorily. In this environment, progress to single figure base rates is likely to be relatively speedy and we would envisage them as low as 7½% by the end of 1986.

Problems further ahead?

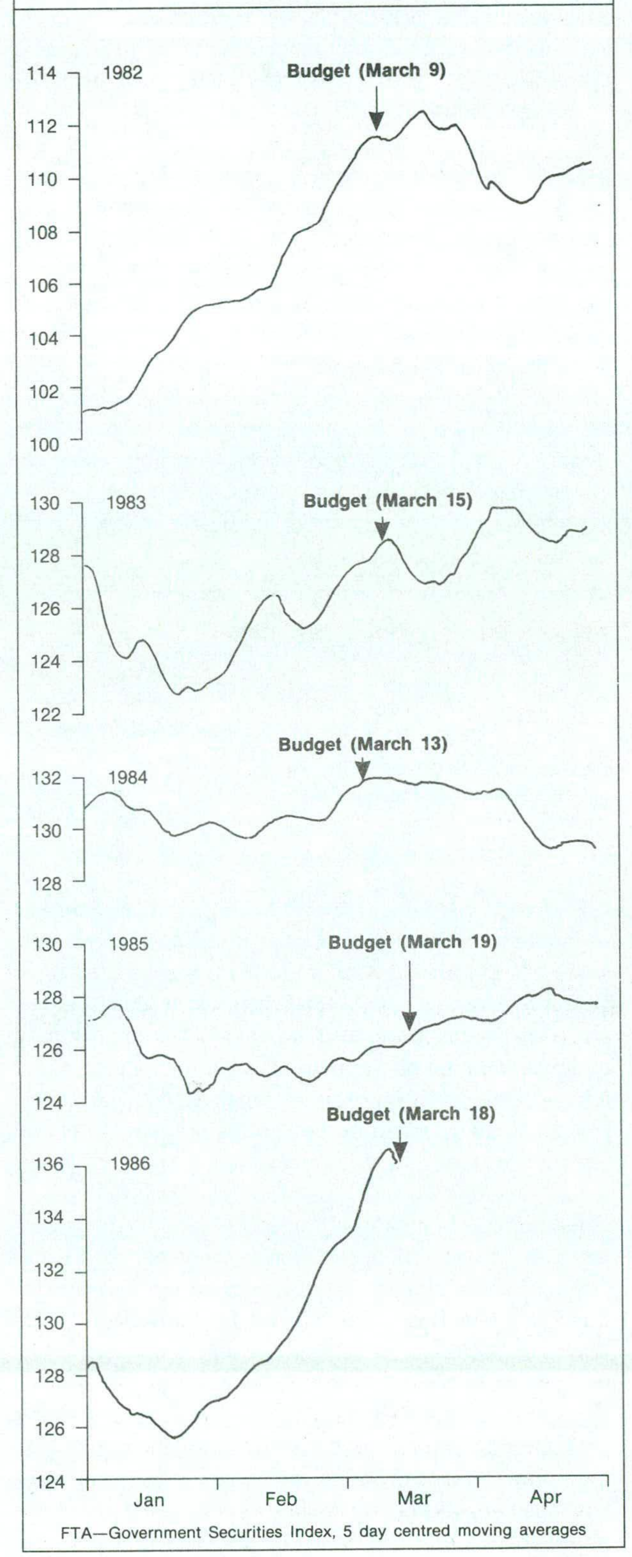
The authorities' tolerance of fast growth of the broad measures of the money supply must raise some question over the long run prospects for inflation. Although very few people indeed would any longer argue on the basis of strict mechanistic rules between monetary growth and future inflation, there must remain lingering doubts about the eventual consequences of allowing continued double-digit growth rates of broad money.

Also adding to the longer-term uncertainty for gilts is the political situation with continued nervousness about the inflationary consequences of a Labour government's economic policies. The effect of the Budget itself on the Conservative's popularity remains to be seen but it is unlikely the influence will be so favourable as to remove this element of uncertainty entirely.

Specific Tax Changes

Some technical amendments to the accrued income

Gilt Market Performance and Recent Budgets



scheme were made, but generally there are no specific tax changes in the Budget which impact on relative values in the gilt market. The introduction of stamp duty on loan stock, however, seems anomalous given that the government have, in the recent past, been actively trying to encourage the development of this market.

Funding

Following the policy changes announced by the Chancellor in his 1985 Mansion House speech, the role of funding has been clarified: simply, it is to finance the PSBR — and not to counteract excessive growth in the broader measures of money supply. Funding, as newly defined, includes debt sales to the UK non-bank private sector, gilt sales to the overseas sector and other external finance of the public sector (mainly reflecting the underlying change in official reserves).

1986/7: The table below shows average monthly gilt sales to the UK non-bank private sector and the overseas sector on the basis of a fully funded PSBR of both £7bn (the official target) and £8bn (which allows for either an overshoot on the PSBR or a measure of over-funding). We have assumed a target for National Savings during the year of £3bn (in line with previous years). In addition to this source of income, we have allowed for other debt sales during the year of £0.5bn (comprising mainly CTDs, Treasury Bills). Sales of debt by the local authorities and public corporations have been assumed to be zero, as have other external finance of the public sector and net gilt sales to the monetary sector.

Average Monthly Gilt Sales: 1986/87 *£m*

		PSBR £7,000	PSBR £8,000
Average monthly gilt sales to NBPS and overseas:	Gross	933	1,017
	Net	175	258

Assumptions: PSBR fully funded, other debt sales of £3.5bn.

Redemptions during 1986/7 will be particularly heavy — hence the volume of part paid stocks issued recently with calls in banking April and May (these issues have guaranteed receipts of £1.4bn in the next financial year — and have been allowed for in the table). The total amount of stock due to be redeemed comes to £9.1bn and although there may have been some early buying-in, this is likely to be matched by similar buying-in at the end of the year of stock due to be redeemed in 1987/8.

As the table indicates, although net funding may seem relatively low at £260m per month (even with a PSBR of £8bn), there is likely to be a steady flow of new issues during the year due to the high level of redemptions. This flow is expected to be particularly heavy during the first four months to compensate for a bunching of redemptions during the period. Despite this, and allowing for a heavy programme of public sector asset sales, the capacity of the market is unlikely to be stretched. Insitutional cash flow has been extremely healthy over the past few years, and with further significant increases in real personal disposable incomes in 1986/7 this is expected to remain the case.

With the change in attitude that led to new long issues now enshrined, it is unlikely that any areas of the conventional market will be avoided by the GB in 1986/7. However, following 'Big Bang' there may initially be a tendency towards issuing taplets rather than new stocks, so as to be able to alleviate shortages that may occur in the new environment. Index linked gilts have not been in strong demand, of late, and in the near future this position is unlikely to change. However, during the second half of the year, a combination of the high real returns available in the sector and a measure of insurance buying (in anticipation of the next election) may increase the interest in this area. If so, the authorities are likely to satisfy demand with an increased flow of index linked issues.

Gilt issues will not be allowed to conflict with the heavy programme of public sector asset sales, and this will require windows being left in the funding schedule at various times —particularly around the time of the British Gas issue. This necessity will tend to increase the burden of funding in the open months.

1985/6: As commented above, mid way through 1985 the Chancellor announced a change in funding policy. This appeared to limit the sale of central government debt to the level of the PSBR. In fact, despite lower receipts from National Savings than planned (probably £0.5bn less than the £3bn target), the PSBR is still likely to be over-funded. Current estimates suggest that this will be of the order of £1bn — compared with over-funding of £4.9bn in 1984/5 (though only £2.8bn on the old definition). Over the first ten months of the financial year, net gilt sales to the NBPS and overseas sector averaged £600m per month, a level of sales considerably higher than that required during 1986/7. In gross terms, we estimate that sales to the NBPS and overseas sector during 1985/6 to date have averaged £1.0bn per month.

A considerable variety of stocks has been issued during the period, from low coupon shorts to high coupon longs. The issue of the latter — especially of new tap stocks — indicated that the authorities had fully abandoned the policy of not issuing stock at this end of the market. Recently, a number of part paid stocks have been issued, so as not to exacerbate the over-funding problem while still taking advantage of the strength of the market. By nominal value, less than 10% of the stock issued has been index linked, with a complete absence of new stock over the last six months.

Richard Jeffrey
Paul Temperton

Monetary Policy

- *£M3 retained as a target aggregate*
- *Growth likely to be around centre of 11-15% target range*
- *Path clear for interest rate reductions: 1% this week and more to follow*

Broad Money target

Last year's £M3 target range was suspended in the Mansion House speech in October and many had expected that no formal objective for its growth rate would be announced in this Budget. Its reinstatement is surprising given that the arguments about it being affected by structural changes in the banking system had been well rehearsed by the authorities in advance of the Budget. The *FSBR* points out that:

Monetary Growth: 1985/86 and 1986/87
12 month growth rates, % p.a.

		1985/86	1986/87
Targetted measures			
M0	target range	3-7	2-6
	outturn	3½ [1]	3½ [2]
£M3	target range	5-9	11-15
	outturn	14¾ [1]	13½ [2]
Other measures			
M2		9.5 [3]	8½ [2]
PSL2		13.8 [3]	13 [2]
Broad liquidity		12.4 [3]	11½ [2]

Notes:
[1] twelve month growth rate to banking February
[2] forecast for twelve month growth rate at end of 1986/87
[3] twelve month growth rate to banking January 1986

£M3 and counterparts, 1980/81 to 1985/86 £bn

Year:	PSBR	Debt sales to nbps	External fin. of pub.sec	Under(+)/ over(-) funding	Bank lending	Other c'nter-parts	£M3
80/81	12.7	-10.8	-0.1	1.7	9.2	-0.7	10.3
81/82	8.6	-11.3	-1.0	-3.7	14.9	-1.5	9.7
82/83	8.9	-8.4	-2.3	-1.9	14.4	-2.7	9.8
83/84	9.7	-12.6	-1.3	-4.1	15.4	-3.6	7.6
84/85	10.1	-12.4	-2.2	-4.5	18.6	-2.2	11.9
85/86E	7.7	-6.8	-2.2	-1.4	19.4	-1.9	16.2
86/87F	8.4	-8.4	0.0	0.0	21.0	-3.6	17.4

E = HG estimate F = HG forecast

high real interest rates have increased the relative attractiveness of financial assets; and financial liberalisation and increased competition between banks and building societies have led to a rapid build up of both liquidity and debt

This trend has led to a steady fall in the velocity of £M3 since 1980 at a rate of around 4% p.a. Adding to that the government's forecast of 6¾% nominal GDP growth during the 1986/87 financial year would point to £M3 growth of around 11%, at the bottom of the target range which has been set. We expect nominal GDP growth to be rather faster than that predicted by the Chancellor (8%) and would expect, on the basis of this calculation to see £M3 growth nearer the centre of the target range.

A similar conclusion is reached by assessing the likely behaviour of the credit counterparts to £M3. The table shows our projections for these in 1986/87. With the PSBR fully funded (taking into account external finance of the public sector as well as sales of government debt to the non-bank private sector), the main stimulus to £M3

The MTFS and Monetary Growth

Targets/ projections set on:	Monetary Aggregate(s)	Financial Year:[1] 80/1	81/2	82/3	83/4	84/5	85/6	86/7	87/8	88/9
26 March 1980	£M3	7-11	6-10	5-9	4-8					
10 March 1981	£M3		6-10	5-9	4-8					
9 March 1982	£M3, M1, PSL2			8-12	7-11	6-10				
15 March 1983	£M3, M1, PSL2				7-11	6-10	5-9			
13 March 1984	£M3					6-10	5-9	4-8	3-7	2-6
	M0					4-8	3-7	2-6	1-5	0-4
19 March 1985	£M3						5-9	4-8	3-7	2-6
	M0						3-7	2-6	1-5	0-4
18 March 1986	£M3							11-15		
	M0							2-6	2-6	1-5
Outturn	*£M3*	*19.4*	*12.8*	*11.2*	*9.5*	*11.9*	*14¾*			
	M1	-	-	*12.4*	*14.0*	-	-			
	PSL2	-	-	*11.6*	*12.6*	-	-			
	M0	-	-	-	-	*5.6*	*3½*			

[1] For 1980/81 to 1984/85 inclusive, the rate of growth quoted is the annualised rate of growth over the fourteen banking months February to April. The method of calculation was changed in May 1985 so that growth rates are now assessed by the rate of growth over the previous twelve months. For 1985/86 the twelve month growth rates shown are those for banking February.

non-oil corporation tax receipts are also expected to rise strongly at 13% — with company profits benefitting both from wider margins and increasing turnover.

Within the range of duties, there were some changes, but overall these were self financing. The duty on petrol was over-indexed — but only by 2p (far less than had been expected). Cigarettes were also hit, while there were no duty increases on alcoholic drinks at all. The cut in stamp duty is also expected to be self-financing, with the extension of the base and increased turnover making up for the halving of the rate.

1985/6: Receipts during 1985/6 have been remarkably buoyant, despite the anticipated £2bn shortfall in oil revenues. £1bn extra in VAT has been received during the year, compared with the Budget '85 forecast, and although there has been a marginal shortfall in income tax, this has been more than offset by a surge in corporation tax receipts. Overall, therefore, consolidated fund revenue during the year is likely to undershoot the original target by only £700m.

Expenditure
The government's expenditure plans were published earlier during the year. Summarising, they showed an estimated outturn for 1985/6 only marginally higher than that allowed for in the 1985 plans. Since then it has become clear that although the local authorities have over-spent, central government has fallen short of the target set last year (at £141.1bn, current and capital expenditure is estimated to have undershot by £1.1bn, with only a small overshoot on asset sales). Spending by the public corporations during the period has also been lower than expected.

For 1986/7, central government current and capital expenditure is targetted to rise by 4.4% (i.e. a real increase of zero) — mainly to to higher Social Services spending. Both local authority and public corporations spending, defined similarly, are expected to drop, leaving a total increase in public sector expenditure of just 2.5%. At face value, this seems almost wildly optimistic. However, a contingency reserve of £4.5bn will allow a maximum spending increase of 5.3%. Still somewhat restrictive, the extent of any overshoot can be limited by raising asset sales. In central government accounting terms, these are treated as negative expenditure —and are currently planned at £4¾bn. In fact, given the range of assets which the government intends to sell off, this figure could rise as high as £6bn.

Richard Jeffrey

Public Sector Expenditure and the PSBR *£bn*

	1985/6 Budget Forecast	1985/6 Est. Outturn	1986/7 Budget Forecast
Public Expenditure Planning Total (per White Paper)	132.1	133.9	139.1
plus			
Increase in Reserve	2.0	-	-
Budget measures	0.1	-	-
Revised Planning Total	134.2	133.9	139.1
plus			
Interest payments	18.0	17.7	18.2
Other adjustments	7.3	6.2	6.1
General Government Expenditure	159.5	157.7	163.4
less			
General Government receipts	150.1	149.6	155.9
General Government Borrowing Requirement	9.4	8.1	7.5
Public Corporations' Market and Overseas Borrowing	-2.3	-1.3	-0.4
Public Sector Borrowing Requirement	7.1	6.8	7.1

Public Sector Expenditure: Planning Total by Department

£ billions

	1985/6 Plans	1985/6 Est. Out-turn	1986/7 Plans	1986/7 Inc.on yr (£)
Defence	18.06	18.22	18.53	0.30
Foreign and Commonwealth Office	1.87	1.89	1.96	0.07
European Community	0.75	0.80	0.65	-0.15
Ministry of Agriculture, Fisheries and Food	2.08	2.53	2.17	-0.36
Trade and Industry	1.62	1.96	1.58	-0.38
Energy	-0.07	1.03	0.12	-0.91
Employment	3.37	3.33	3.74	0.41
Transport	4.54	4.58	4.81	0.23
DOE — Housing	2.28	2.74	2.75	0.01
DOE — Other Environmental Services	3.45	3.94	3.62	-0.32
Home Office	5.13	5.31	5.55	0.24
Education and Science	13.60	14.46	14.32	-0.14
Arts and Libraries	0.64	0.72	0.73	0.01
DHSS — Health and Personal Social Srvcs	16.49	16.68	17.72	1.04
DHSS — Social Security	40.04	41.22	42.93	1.71
Scotland	7.16	7.36	7.57	0.22
Wales	2.74	2.78	2.90	0.12
Northern Ireland	4.25	4.27	4.52	0.25
Chancellor's Departments	1.75	1.82	2.01	0.19
Other Departments	1.33	1.33	1.53	0.20
Reserves	5.00	-	4.50	4.50
Asset Sales	-2.50	-2.62	-4.75	-2.13
Adjustments	0.59	-0.15	-0.40	-0.25
Planning Total	134.17	134.21	139.06	4.86

The Equity Market

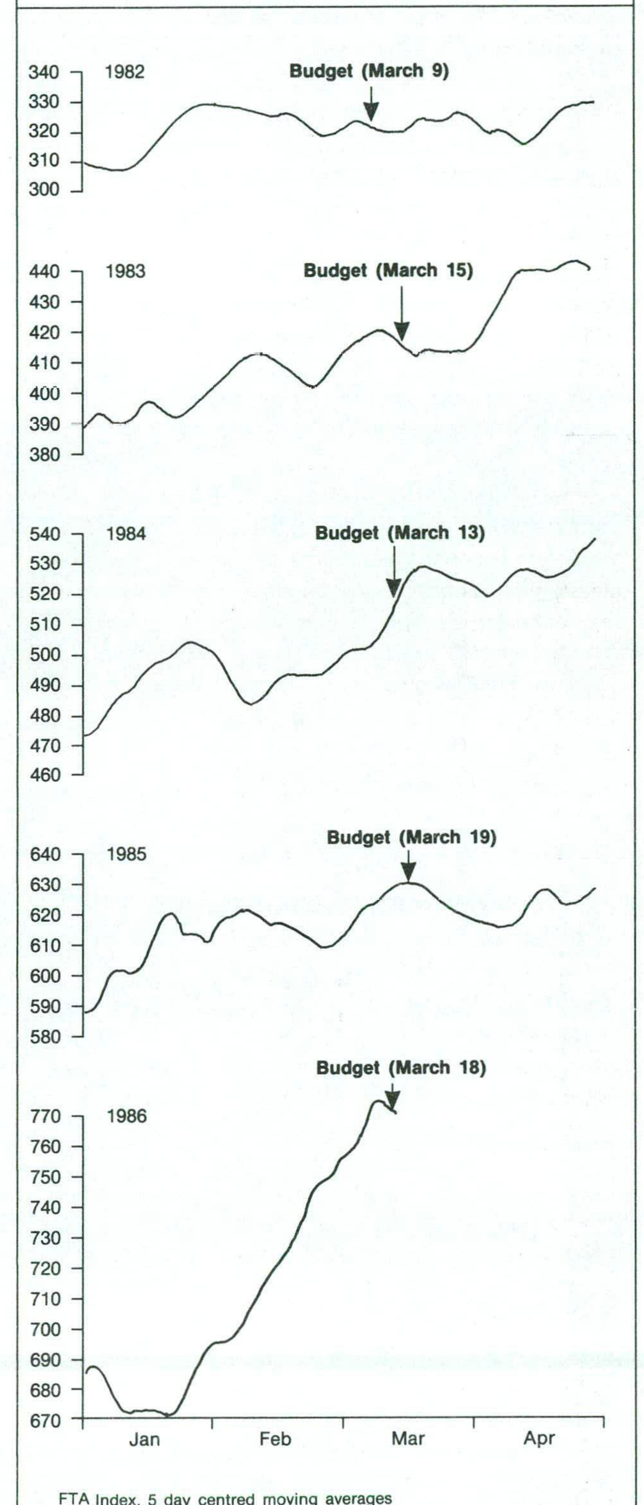
- *The balance of the Budget is good for the markets, with the fiscally cautious approach promising well for interest rates and gilts and the buoyancy of the economy pointing to strong profits growth.*
- *Notable more for its leniency than burdens, the Budget imposed no special levy on banks and no duty increases on drinks.*
- *While the tax give-aways were less than they might have been, we still look for buoyant consumer spending to benefit stores.*
- *Overall, however, the biggest gains still look set to come from the lowly rated stocks in the capital goods area, where profits in many cases have probably received a further boost from pressure to reduce pension fund surpluses.*

The Budget has also held out a number of significant developments for the future of the London market. The halving of stamp duty on equity trading from "Big Bang" clearly goes some way to improve international competitiveness. However, the new 5% rate on the conversion of shares into depositary receipts looks like a protectionist measure which would have been made irrelevant by the total elimination of stamp duty. As an undesirable complexity, it will not endear itself to companies or major international investors. Its overall impact on share prices is likely to be relatively limited in the longer term. Short term, however, it may have dried up some US demand for the major ADR stocks, i.e. that from those domestic US funds favouring dollar securities. It also raises major questions about the acceptability in the US market of critical new issues, *viz.* British Gas.

The efforts further to promote the involvement of the populus at large in the equity market are broadly good news, although they represent a further nibbling at the privileges which have been enjoyed by institutions in the savings field. This will impact the insurance companies and fund management businesses to some extent but looks well pitched to boost the investment trust industry, not to mention helping the privatisation programme.

Before considering the market, sectors and stocks in more detail, a look at the corporate sector trading background is appropriate.

Equity Market Performance and Recent Budgets



FTA Index, 5 day centred moving averages

The Corporate Sector
The slowing of world economic activity during the latter part of 1984 and much of 1985, coupled with adverse exchange rate movements, was reflected in the results of the UK corporate sector, the quoted portion of which saw profits growth of 18% in the first half of last year trimmed back to just 6% for the year as a whole. In fact, the combined effects of currency movements, slower growth in the US economy and some specific disappointments meant that overseas profits made very little progress post translation, with virtually all of the reported growth coming through in the UK. Fortunately, the UK economy was relatively strong, with growth in GDP of better than 3½%, well above the OECD average, which fell below 3%.

However, it has been evident for some time that profits growth would accelerate again in 1986. Indeed, there have been clear signs of the pace of world economic activity reviving since the third quarter of last year. Meanwhile, the decline of input costs as a result of the falling US dollar price of oil, the relative softness of commodity prices and the weakness of the US dollar itself, coupled with the fall in the value of sterling relative to other currencies, notably the Deutschemark, has created a very favourable scenario for profits growth. The impact of rising labour costs is being held in check by impressive productivity gains in the face of strong demand.

Further, it appears that this favourable position should last for some time. Most of the governments of the free world are taking the opportunity to stimulate demand while the fall in input prices is limiting the inflationary risk of such a strategy.

Whilst the picture is not without its worries, notably in relation to the various debt problems of the third world and the USA, it currently seems unlikely that prospects will change for the worse until well into the second half of the year, if then. The underlying worry must be that increasing concern about the US current account deficit will eventually drive that country to adopt either a deflationary or protectionist stance. While we do not envisage this leading to a serious economic setback in 1987, it could clearly bring about a significant slowing of growth as the rest of the world responds to any such moves in the USA.

Thus, for 1986 as a whole, we see OECD growth rising to around 3½%, with the USA expanding at perhaps 4%. The UK should see GDP growth of 3½% or so, led by strong consumption and exports.

Growth of GNP in OECD Countries

	Weight in Total[1]	% change from previous year 1984	1985	1986
United States	44.5	6.8	2.8	4.0
Germany	7.5	2.7	2.2	2.4
France[2]	6.0	1.9	2.0	2.6
United Kingdom [2]	5.2	1.8	3.3	3.5
Italy [2]	4.2	2.6	2.6	2.9
Canada	4.1	5.0	2.1	2.8
Other OECD	28.5	2.5	3.5	3.4
Total OECD	**100.0**	**4.5**	**2.9**	**3.5**

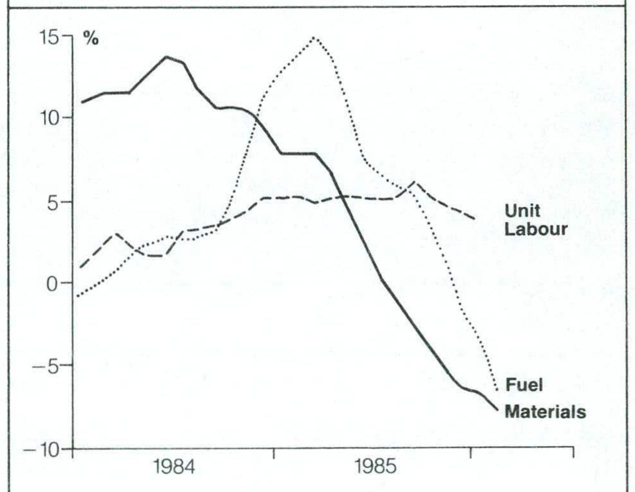
[1] Based on provisional 1984 data
[2] *GDP*

For those relevant economies not in our table, Japan is expected to sustain growth in the 4½-5% region; Australia seems set to slow economically; S. Africa is seeing some recovery but from an extremely depressed base.

Overall, the outlook for the near 40% of UK group profits generated overseas looks relatively good in local currency terms, with strong advances in prospect in Europe and the USA. Exports should be notably strong and profitable. Although the weakening of the dollar has brought about some erosion of margins in exports to North America and in third markets where US producers have begun to regain competitive positions, European currency relationships have improved significantly.

As far as trading in the UK is concerned, our GDP growth forecast of 3½% (Red Book 3%) and our expectation of strong growth of consumer expenditure (in line with the Red Book at 4%) provides a favourable background.

Increase in Input Costs
(year on year)



Note 3 month moving average

Coupled with the previously noted decline in input costs and the containment of labour cost pressures by productivity increases, such an outturn should enable profits for industrial group companies to grow by 15% or more in the current year.

In reported sterling terms, the overall outcome for *QUOTED UK plc* remains, as ever, currency sensitive. While average exchange rates for sterling relative to the US, Canadian and Australian dollars and the Rand look set to be less favourable than in 1985, others, notably the

Sterling Exchange Rates

	1984 Av.	1984 Year end	1985 Av.	1985 Year end	1986 (to date) Av.	1986 (to date) Current
US$	1.34	1.16	1.30	1.45	1.43	1.46
DM	3.79	3.65	3.78	3.54	3.42	3.29
Yen	317	292	307	290	275	257
Aus.$	1.52	1.40	1.86	2.12	2.06	2.07
S.A. Rand	1.95	2.30	2.92	3.73	3.25	2.94

Oil Revenues

- *1986/7 Oil revenues (including corporation tax element) forecast at £6.1bn*
- *Revenues for 1985/6 expected to undershoot £13.5bn target (set in 1985 Budget) by £2bn*

The Chancellor's forecast of oil revenues of £6.1bn in 1986/7 breaks down as follows:

PRT	£2.4bn
Royalties	£1.0bn
Corpn.Tax	£2.7bn

Based on a Dollar/Sterling exchange rate of approximately $US1.45 (in the words of the Treasury, the exchange rate is assumed "not to change much") and an average oil price of $15 per barrel, the official forecast is considerably more prudent that it might have been (the same assumption method as that used last year would have suggested an oil price of almost $20 per barrel). In fact, despite the likelihood that the average exchange rate will be considerably higher than $1.45, it appears that Mr. Lawson may have been overly pessimistic. Our own forecast (highlighted in the revenue matrix below) incorporates an exchange rate of $US1.55 and an oil price of $15.00/bbl but still points to revenues of £6½bn — almost £½bn more than the official forecast.

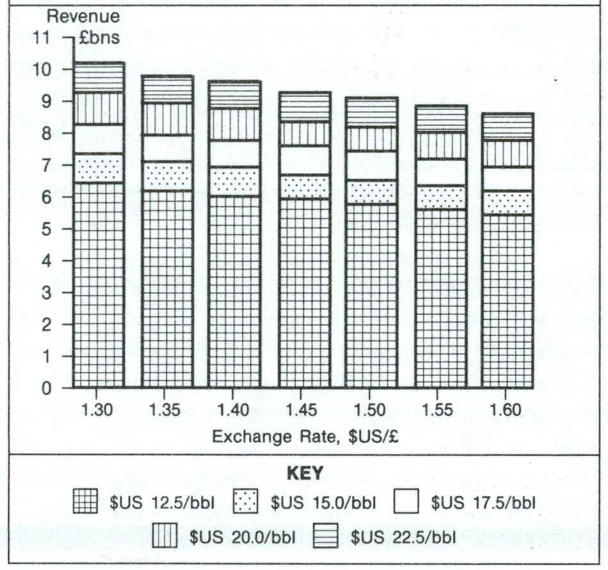
Oil Revenue Forecasts and Outturns

£ bns	Forecasts Treasury	Forecasts Hoare Govett	Outturn
1980/81	4.2	-	3.9
1981/2	5.9	-	6.5
1982/3	6.2	-	7.8
1983/4	7.9	-	8.8
1984/5	10.2	-	12.0
1985/6	11.5	11.5	
1986/7	6.1	6.4	

Broadly, revenues from PRT and Royalties during a particular financial year reflect the sterling value of production in the corresponding calendar year; those during 1986/7, therefore, will be affected by exchange rates, prices and production during 1986. Because of this, it is PRT and Royalties that are most likely to show a shortfall. On the other hand, because most oil company year-ends are 31st December, Corporation Tax receipts in 1986/7 will reflect profits made during 1985. The Chancellor estimates that this element of oil receipts will be around £2.7bn — a figure consistent with our own forecasts. So far as production is concerned, it has been assumed that it will be more or less stable during 1986.

Rules of thumb for the sensitivity of oil revenues to price and exchange rate movements have been calculated by the Treasury as follows: an average $1 per barrel change in the price would change revenues by £400m in 1986/7;

Government Oil Revenues



a 1% change in the average $/£ exchange rate would change revenues by £65m.

In last year's Budget, Mr. Lawson forecast that total oil revenues would reach £13½bn in 1985/6 — including £2¾bn from corporation tax (now estimated at £3bn). This was based on the average prices and exchange rates that prevailed during the first two months of the year (which were $US28.65/bbl and $US1.12, respectively). At the same time, the Treasury suggested as a rule of thumb that a 1% change in the Sterling price of oil would lead to a £150m change in revenues. In the event, the Sterling price of oil during 1985 was some 22.5% lower than budgetted for. On an extrapolation of the Treasury's rule, this would have implied a shortfall in revenues of £3.4bn. In fact, the shortfall has been estimated by the Treasury at only £2bn (a figure that conforms with our own estimates). The implication is, therefore, that either oil production has been much greater than predicted at the time of the Budget or the Treasury's rule is non-linear. Since, at 2.58m barrels per day, output was in line with expectations, it is the latter explanation that appears to hold the key to the resilience of oil revenues over the year.

Oil Revenue Matrix £bns

$/£ Ex. rate	Oil Price — $US per barrel 12.5	15.0	17.5	20.0	22.5
1.40	6.0	6.9	7.8	8.7	9.6
1.45	5.9	6.7	7.6	8.4	9.3
1.50	5.7	6.5	7.4	8.2	9.0
1.55	5.6	**6.4**	7.2	8.0	8.8
1.60	5.5	6.2	7.0	7.8	8.6

Ironically, had the Chancellor used the same oil price and exchange rate assumptions as in the 1984 Budget (that they would be substantially unchanged over the average for the previous year), he would have over-estimated the sterling price of oil by only 8%.

Public Sector Borrowing Requirement

£ millions	1984/5 Outturn	1985/6 Budget Forecast	1985/6 Estimated Outturn	1986/7 Forecast
CENTRAL GOVT. BORROWING REQUIREMENT	10.1	11.1	10.7	
Central government on own account	6.6	5.3	4.9	4.2
Local Authorities' Borrowing Requirement	2.4	1.3	2.1	-0.7
Public Corporations' Borrowing Requirement	1.1	0.6	-0.2	-0.9
Unallocated Reserve	-	-	-	4.5
PUBLIC SECTOR BORROWING REQUIREMENT	10.1	7.2	6.8	7.1

The PSBR and the Medium Term Financial Strategy: The history of the PSBR within the MTFS is the history of the attempt to limit the role of the public sector in the economy. As the tables below indicate, this has by no means been as successful as was originally hoped. The aim was to lower the PSBR as a proportion of GDP by restricting the real growth in expenditure to zero while revenues were growing in line with nominal GDP. Fine in theory, this proved almost impossible to achieve and successive versions of the MTFS had upwards revisions to the target PSBR/GDP ratio. Initially, asset sales played a relatively small role within this strategy; more recently, however, their importance has increased.

Looking at the table, it is clear that although the targeted PSBR/GDP ratios appear to have stabilised over the past four years (especially after allowing for the effects of the miners' dispute in 1984/5), this does not reflect the success of the original intention. Rather, it indicates the substantial shift towards financing expenditure via asset sales. Net of asset sales, therefore, the PSBR is planned to increase as a ratio of the PSBR in 1986/7 — back to the level seen between 1981/2 and 1984/5. Viewed in this light, the fall in the ratio in 1985/6 seems something of an aberration.

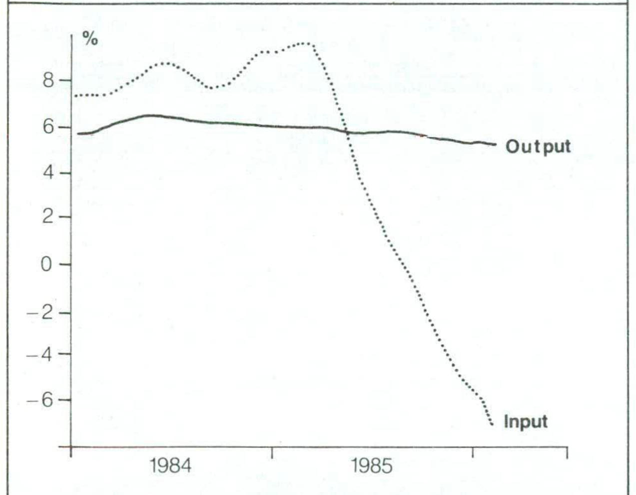
Revenues

1986/7: The Chancellor's oil revenue forecasts are treated in detail in the accompanying section; in this part we comment on total and non-oil receipts. Consolidated fund revenues are forecast to increase by 2.6% in 1986/7, despite the dramatic fall in PRT and other oil taxes. Most areas are predicted to rise strongly: income tax up 9.7% (an underlying increase of 12.7% after allowing for the cut in basic rate tax), reflecting continued strong growth in earnings — this may actually prove rather optimistic; VAT is expected to rise by a more modest 7.2% — more or less in line with the anticipated rise in consumers' expenditure;

Consolidated Fund Revenue

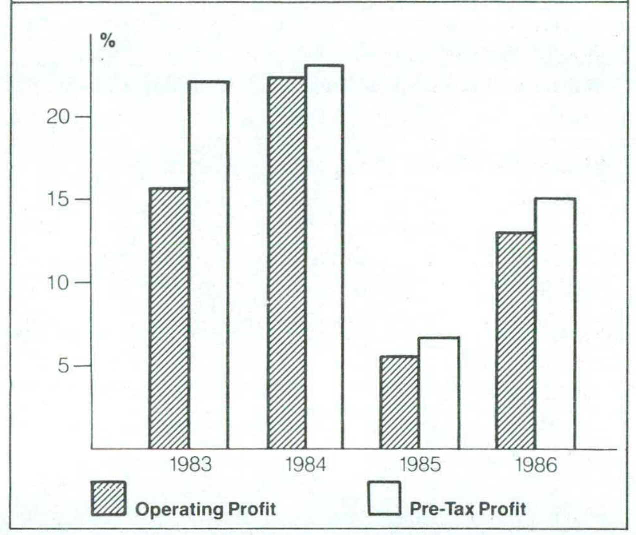
	1984/5 Outturn	1985/6 Budget Forecast	1985/6 Estimated Outturn	1986/7 Forecast	*% chng on '85/6 Est. Outturn*
Inland Revenue					
Income Tax	32,507	35,200	35,100	38,500	*9.7*
Corporation Tax	8,341	10,100	10,700	11,700	*9.3*
Petroleum Revenue Tax	7,177	8,200	6,400	2,400	*-62.5*
Capital Gains Tax	730	790	930	1,050	*12.9*
Development Land Tax	81	55	60	35	*-41.7*
Estate Duty	6	-	-	-	-
Capital Transfer Tax (Inheritance tax)	658	760	890	910	*2.2*
Stamp Duties	911	1,100	1,230	1,430	*16.2*
Adjustment	(61)	(5)	(10)	(25)	
Total Inland Revenue	50,350	56,200	55,300	56,000	*11.3*
Customs & Excise					
Value Added Tax	18,534	18,300	19,300	20,700	*7.3*
Oil	6,201	6,500	6,500	7,300	*12.3*
Tobacco	4,140	4,300	4,300	4,700	*9.3*
Spirits, Beer, Wine, Cider & Perry	3,763	4,200	4,200	4,400	*4.8*
Betting & Gaming	653	700	730	800	*9.6*
Car Tax	743	760	880	980	*11.4*
Other Excise Duties	12	20	20	20	*0.0*
EC Own Resources	1,457	1,500	1,360	1,460	*7.3*
Adjustment	2	20	10	40	
Total Customs & Excise	35,505	36,300	37,300	40,400	*8.3*
Vehicle Excise Duties	2,219	2,500	2,400	2,500	*4.2*
National Insurance Surcharge	924	30	30	-	-
TOTAL TAXATION	88,998	95,100	95,030	98,900	*4.1*
Miscellaneous Receipts	9,252	11,380	10,770	9,700	*-9.9*
CONSOLIDATED FUND REVENUE	98,250	106,500	105,800	108,600	*2.6*

Increase in Input and Output Prices
(year on year)



Note 3 month moving average

FTA Industrial Group Profits Growth
(% change on previous year)



important Deutschemark and Yen, should be more advantageous. We expect to see further weakness of the US dollar become evident as 1986 progresses, while sterling may see some further modest weakness relative to the world's stronger currencies. Prospects for the Australian dollar and Rand are for further relative weakness but adverse movements on the scale of those of 1985 should not recur. Overall, therefore, translation losses should prove to be relatively limited, but it seems clear that UK domestic business and exports will set the overall profits pace this year.

All this adds up to profits growth of around 13% at the operating level for industrial group companies. This should be extended to perhaps 15% at pre-tax by lower borrowings and interest rates, while at the earnings per share level an advance of 16% or so is indicated. This compares with just 4% in 1985 and 14% in the previous year.

On this basis, which represents a return on capital of about 19%, cash flow should again be strong (with the ACT provisions giving a marginal boost) and the industrial group should see a further reduction in its gearing to year-end levels of around 14% (capital) and 7½% (interest). Against such a background, dividend growth of 12% (1985 10%) is on the cards.

Such prospects — impressive against an official expectation of 3½% inflation by the year-end — have underpinned a strong market to date and should continue to provide a favourable background.

FTA Industrial Group

Profit & Loss Accounts

	1984 *£bn*	1985 *£bn*	1986 *£bn*
Turnover	270.8	301.6	333.9
Operating Profit	22.4	23.7	26.8
Investment Income	0.2	0.2	0.3
Associates	1.5	1.7	1.8
Profit before Interest	**24.1**	**25.6**	**28.9**
Net Interest Payable	2.4	2.4	2.2
Profit before Taxation	**21.7**	**23.2**	**26.7**
Taxation	7.5	8.3	9.3
Profit after Taxation	14.2	14.9	17.4
Minorities	0.7	0.7	0.8
Preference Dividends	0.1	0.1	0.1
Attributable Profit	**13.4**	**14.1**	**16.5**
Ordinary Dividends	4.4	5.0	5.7
Extraordinary Items	0.6	0.3	-
Retained Profit	8.4	8.8	10.8
Earnings per Share (1985=100)	**96**	**100**	**116**
Dividends per Share (1985=100)	**91**	**100**	**112**

FTA Industrial Group

Balance Sheets

	1984 *£bn*	1985 *£bn*	1986 *£bn*
Fixed Assets			
Tangible Assets	88.0	95.3	101.0
Investments/Associates	11.8	12.7	13.8
	99.8	**108.0**	**114.8**
Current Assets			
Stocks	44.2	47.5	51.4
Debtors	43.2	47.0	50.5
	87.4	**94.5**	**101.9**
Total Assets	**187.2**	**202.5**	**216.7**
Creditors			
Trade Creditors	47.9	51.4	55.0
Current Taxation	6.1	6.8	7.7
Dividends	2.9	3.3	3.8
Other Provisions	11.6	12.6	13.2
	68.5	**74.1**	**79.7**
Capital Employed	**118.7**	**128.4**	**137.0**
Capital and Reserves	92.4	103.3	114.3
Minority Interest	4.9	5.5	6.3
Net Debt	21.4	19.6	16.4
	118.7	**128.4**	**137.0**

Left out of the encouraging picture are the oil companies. Clearly, the fall in the price of oil in recent months has dramatically changed the prospects for such businesses. While the majors are currently enjoying a downstream boom, that will quickly give way to sharp declines in earnings, which overall may fall by a quarter or more.

Where the Market Goes Next
Our bullish stance on the UK equity market over a number of years is well known to most fund managers. At the beginning of 1986 we emphasised our optimism about the year ahead, pencilling in a rise of 20%, largely concentrated in the first half. After the unsettling initial effects of the oil price slide on sterling, and the consequent 1% base rates increase, the subsequent surge in the equity market has, in fact, seen the bulk (17%) of our projected gain already achieved.

Following the Budget, we see no reason to change our positive stance. A combination of strong corporate profits growth and cash flow, coupled with a relatively loose monetary policy, falling interest rates and an inflation rate which is low and falling, provide a background against which the market looks poised to rise further. Although some have expressed worries about the absolute value of equities relative to other securities, the sustained strong growth of dividends provides a basis for reviewing some of the old relationships. An immediate post-budget fall in interest rates of 1% or so should be followed by further substantial cuts in the months ahead, and this too will act as a considerable spur. Domestic demand can also be expected to find support from overseas investors, even if the Chancellor has not endeared himself to the major players in the ADR market.

FTA Industrial Group

Flow of Funds

	1984 £bn	1985 £bn	1986 £bn
Source of Funds			
Profit before tax	21.7	23.2	26.7
Adjustments involving the movement of funds;			
Depreciation	8.3	9.3	10.3
Associates	(1.0)	(1.0)	(1.0)
Sundries	(2.2)	(0.2)	-
Other Sources	2.2	4.2	0.4
	29.0	**35.5**	**36.4**
Application of Funds			
Net additions to fixed assets	17.7	19.1	16.5
Increase in working capital			
Stocks	6.4	3.3	3.9
Debtors	6.0	3.8	3.5
Creditors	(6.4)	(3.5)	(3.6)
	6.0	**3.6**	**3.8**
Tax paid	4.9	6.4	7.6
Dividends paid	3.7	4.6	5.3
	32.3	**33.7**	**33.2**
Decrease in net Debt	**(3.3)**	**1.8**	**3.2**

Such a market should be well placed to cope with the calls on it for new funds. The government's privatisation ambitions, on target so far, include £4.7bn for 1986/87, an unchanged projection for which investors have long been prepared. There is little chance of a flood of rights issues emerging to seriously swamp capacity.

Meanwhile, the level of bid/merger activity can be expected to remain high as companies make use of their strong financial positions and the increased value of their equity currency.

On this basis we expect the FTA All Share Index to sustain the strong upwards momentum which it has shown in recent months in spite of the dead weight of the oil sector. Our best guess is that the Index will put 900 behind it by the third quarter of 1986.

Thereafter, the scope looks much more limited but a consolidation phase does not at this stage look set to give way to any major setbacks.

At its present level, we see the actual PER for the market as a whole on a real time basis moving down from 13.5 to 11.8 by the end of this year (as reported during the first half of 1987). The yield on the market is set to rise from 4.1% to 4.5% over the same time frame. For the industrial group, the PER should fall from 15.2 to 13.1 and the yield should rise from 3.4% to 3.8%.

Sectors and Stocks
In looking at the impact of the budget on sector and stock selections, we start with our previous stance and consider the extent to which it needs modified in the light of the budget provisions and, of course, market developments.

The starting point is our assessment at the beginning of 1986. At this point we said that it was difficult to fathom clear sector messages given that previous over and under performers looked likely to move back towards the norm. The following general positions were:

Stores	neutral
Food Retailing	neutral
Textiles	neutral
Health & Household	positive
Tobacco	positive
Electricals	positive
Electronics	negative
Building Materials	positive
Telephone Networks	positive
Shipping	positive
Oils	neutral
Mining Finance	negative
Overseas Traders	negative
Banks	positive
Insurance	neutral
Property	neutral
Merchant Banks	negative

It is early in the year, but at this stage we are reasonably happy with most of these, the notable exception being Oil, where we turned severely negative during January on the grounds that what had already been discounted was not the worst. We hold to this revised view.

Public Sector Finance

- *PSBR target of £7.1bn for 1986/7; oil revenues forecast at £6.1bn*
- *PSBR outturn for 1985/6 of £6.8bn predicted - despite £2bn shortfall in oil receipts*
- *Net cost of tax changes (excluding indexation) £1.0bn*
- *Net cost of expenditure measures £0.1bn*

The Public Sector Borrowing Requirement
1986/7: At £7.1bn, the PSBR target for 1986/7 is £0.4bn lower than that projected in the 1985 edition of the Medium Term Financial Strategy and later confirmed in the Autumn Statement. This reduction has been made so as to "err on the side of caution" (in the Chancellor's words). The most uncertain element of the target is oil revenue. However, forecasting receipts of only £6.1bn, the Chancellor has, if anything, been somewhat pessimistic — though, it may be argued, prudent.

Within this borrowing requirement, the Chancellor has incorporated net tax cuts of £985m, excluding indexation (£1,350m, including indexation). Most of this reflects the cost of cutting the basic rate of income tax to 29%, with other tax and duty changes largely self-financing.

Despite the relatively small anticipated increase in the PSBR, the Public Sector's financial deficit is expected to increase by £2bn to £12.2bn in 1986/7. Offsetting this, however, are increased asset sales.

Broadly, the reduced PSBR target reflects tight control over public sector expenditure, in combination with extremely robust non-oil revenues. While our projections suggest that the Chancellor may have been slightly over optimistic —especially on the former — there is considerable scope to offset any threatened overshoot by raising the level of asset sales.

1985/6: The Chancellor forecast the PSBR outturn for 1985/6 would undershoot both the original £7bn target and the revised £8bn target. At £6.8bn, he was not only making a forecast for the financial year, however, he was also predicting that borrowing during March would be £4bn. In our view, despite the notorious volatility of borrowing in the last month of the year, it is unlikely that it will come in quite this high — suggesting that Mr. Lawson's first attempt at being a monthly forecaster may have left him being a little cautious.

The main reason for the undershoot (which has come about despite a £2bn shortfall in oil revenues) is to be found in a surge in non-oil receipts — particularly VAT and corporation tax. Nevertheless, total central government revenues are still likely to be £0.7bn lower than expected at the time of the last Budget. Since the remainder of the public sector (i.e. the public corporations and local authorities) are expected to borrow as much as originally targetted, another significant factor behind the undershoot on the PSBR appears to be central government expenditure of lower magnitude than that allowed in the 1985 Budget (this may have reduced borrowing by slightly more than £1bn).

Budget Measures: Direct Effects on Public Sector Transactions *£ million at current prices*

	Effect in 1986-87		Effect in 1987-88
	Changes from an indexed base	**Changes from a non-indexed base**	**Changes from a non-indexed base**
Tax proposals			
Income tax basic rate	-950	-950	-1,305
Income tax allowances and thresholds	+15	-1,125	-1,470
Capital transfer tax (inheritance tax)	-35	-55	-100
VED	-135	+5	+5
Other Excise duties	+135	+790	+840
Stamp duties — reduction in rate	-70	-70	-75
extension of base	+70	+70	+85
Other tax changes	-15	-15	+135
Total tax measures	-985	-1,350	-1,885
Expenditure measures			
Employment measures	+195	+195	+290
Less offsetting savings in social security benefits	-95	-95	-125
Net call on reserves	+100	+100	+165

eration in housebuilding is expected. Already there are signs of this developing, a process which may be helped by cuts in the mortgage rate later in the year. The housing sector tends to be a fairly accurate lead indicator of developments within the economy as a whole. As such, the slowdown in the sector during 1984 and early 1985 suggested that general economic growth might come under pressure during 1985. This possibility was averted by a shift in the government's monetary stance, however. Since then the danger signals from the housing sector have been lowered.

In total, the Treasury's forecast increase in capital spending is very similar to our own — and above the growth rate anticipated for the economy as a whole.

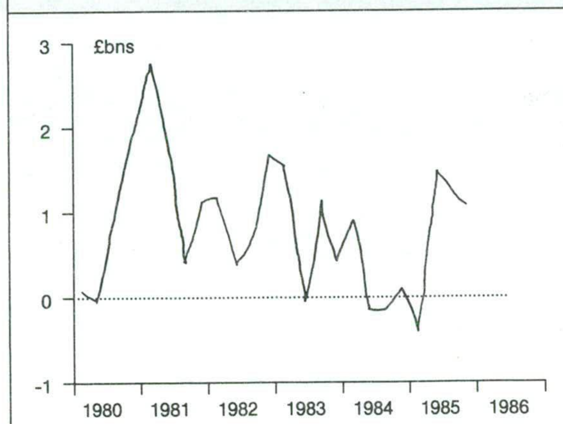
Trade

- *Treasury forecast: £3½bn current account surplus in 1986*

In his Budget speech, the Chancellor noted that the UK's share of world trade in 1985 had expanded (even excluding the oil sector) and that net exports had risen appreciably —giving rise to a current account surplus of nearly £3bn during the year (with an invisible surplus of £5bn more than counteracting a visible deficit of £2bn). Nevertheless, his expectations for 1986 are not quite so optimistic, with the slump in the oil price likely to reduce the surplus on oil trade (£8bn in 1985) by £3-4bn. He also noted that the invisible balance will actually benefit from lower repatriation of profits earned by overseas companies on their operations in the North Sea — leading to a sharp rise in the invisible surplus to £8bn (benefitting in comparison with the previous year from several one-off factors and changes in timing of the EEC rebate). Nevertheless, excluding the impact of the miners' dispute and the change in timing of EEC rebates, the Chancellor is forecasting an underlying deterioration of £1½bn in the current account. Slightly more optimistically, we are forecasting a current account surplus of close to £4bn during the year.

An apparent inconsistency in the Treasury's Autumn Expenditure Statement forecasts for the UK's external position has been removed in the Red Book. At under 4% it had been predicted that the increase in imports would be lower than the forecast increase in consumer spending — and considerably less than the increase in 1985. Our own view, and one now supported by the Treasury, is that

Current Account Balance



UK Current Account Balance (quarterly)

imports will rise somewhat faster than consumer demand. In fact, at 6%, the rise now officially forecast is slightly larger than that we expect. At the same time, the Treasury has also bumped up its forecast for the increase in exports during the year — to 5% (leading to a reversal of the 1985 improvement in net exports). Given that the reflationary stance being adopted by the major industrialised countries at the present time is likely to be reflected in an increase in world trade in excess of 5% during the year, this rate of increase is considerably more realistic than the 2% anticipated in the Autumn Statement — and in line with our own forecast.

Current Account, Treasury Forecast *£bns*

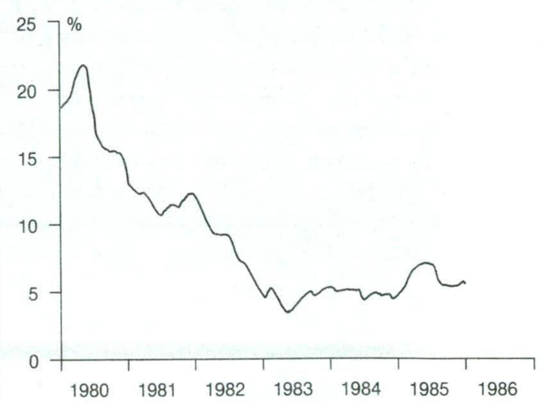
	Manufacturing	Oil	Other goods	Invisibles	Total
1983	-2½	7	-5½	4	3
1984	-4	7	-7½	5½	1
1985	-3	8	-7	5	3
1986	-3	5	-6½	8	3½

Inflation

- *Treasury forecast: 4th Qtr '86 inflation of 3½%*

Only slightly above the Treasury's anticipated year end rate for 1985 and falling fast, Mr. Lawson predicted that by the end of 1986, inflation will have fallen to just 3.5% (the Budget will add a modest 0.5%). This lower rate is expected to be maintained until at least the second quarter of 1987 — for which the Treasury's forecast inflation rate is also 3.5%. Even so, the Chancellor was not quite so sanguine about the pace of wage increases — these are still regarded at a threat to the long term inflationary pattern.

Retail Price Inflation



% change on a year ago

Self congratulatory though the Chancellor may have been, it is still the case that inflation quickened to 7.0% in the first half of 1985 — the blame for which he laid firmly at the door of mortgage rates and the increase in input prices caused by earlier sterling weakness. Though not incidental factors, we would ascribe as much if not more of the blame to unit labour costs. With lower productivity gains coming through in the second half of 1984, these began to move up alarmingly, foreshadowing the acceleration in retail prices. Since then, however, productivity improvements have come through more quickly and unit labour

Stamp Duty

- *Stamp duty to halve at Big Bang.*
- *Net widened to maintain stamp duty take.*
- *Penal 5% duty on creation of ADRs.*

The Chancellor has cut stamp duty on share transactions from 1% to ½% from the date of the Big Bang. Essentially this decision on rate is the result of a balancing act where the need for international competitiveness in share trading has been set against the danger of appearing over-indulgent to the City. When the UK 1% rate on share purchases is seen against an average of ¼/⅓% in Europe (though on both purchases and sales), nil in the US and ½% in Japan, reduction if not abolition was needed to give London a reasonable competitive position. Far from being indulgent, however, the Chancellor has introduced measures which widen the areas chargeable to duty and Red Book numbers show his take no lower in 1985/6 and indeed higher in the following year.

Three major areas of exemption gone

Loan Stock : Since the 1970s, when exemptions were introduced to encourage loan capital to be raised, certain loan stock transfers have been exempt from stamp duty. Although the wide reaching exemption now goes, there remain a number of specific let-outs: Gilts, international loans with treaty obligations, stock in bearer form and short term loans continue exempt. Thus, euro-bonds, for example, remain out of charge. These changes in the rules on loan stock come into effect this month.

Temporary documents of title : Under this heading comes letters of allotment. To date, the practice has been to issue subscribers with a renounceable letter of allotment when new shares are issued in a flotation, rights issue or in an acquisition of shares. These letters were transferable without duty becoming payable provided the renunciation period was less than 6 months, with the period usually being nearer 2 months. This did, however, contribute to the level of interest in new issues and the loss of this feature (from Big Bang date) will be felt to some degree both in flotation and secondary funding exercises.

Perhaps even more fundamental to the UK share trading philosophy has been the exemption from Stamp Duty of transactions opened and closed within the same Stock Exchange account. Again from Big Bang, this exemption disappears and stamp duty at the new ½% rate becomes payable.

ADRs : Where the trading of receipts incurred no duty previously, a 'penal' 5% (up from the present 1%) is to be charged from this month on the initial conversion of shares into depositary receipts. This up-front charge is intended to compensate the Revenue for the lack of income from receipt transfer and to equalise the effective price to share purchasers be they concerned with an ADR or direct share investment. For the UK investor, this is the closing of a Stamp Duty avoidance loophole, but for the overseas investor, particularly the US, this will be seen as nothing short of protectionism and contrary to the liberalisation of world capital markets. As such the Chancellor's move on ADR's is likely to arouse a strong political response from the US and draw equally harsh comment from the UK's large public companies where increasingly international interest in their shares has been set high on the priority list.

The US money managers began to diversify overseas in the late 1970s for three principal reasons: the lacklustre performance of the US domestic equity markets; the better performance of overseas markets; and the enactment of the Employment Retirement Security Act (ERISA) which resulted in a number of funds rethinking their investment policy, and deciding that overseas diversification was justified by their fiduciary responsibilities as fund managers.

By 1980 approximately $3 billion of US pension fund assets was invested overseas, $11bn by 1983 and the trend has continued upwards. In 1982, ADRs as against direct investment outside the US,became important. This was a direct consequence of the entry of US domestic rather than internationally biased managers onto the scene and their appetite for overseas securities has led to an enormous rise in ADR offerings including many from the UK.

Clearly the result is that the 5% Stamp Duty on ADRs could have a serious short term impact on a number of major UK shares and an on-going effect on the potential shareholder base. Domestic US funds, both retail and institutional, have been significant buyers in ADR form of oils (BP and Shell Transport), pharmaceuticals (Glaxo), tobaccos (BAT and Imperial Tobacco), chemicals (ICI), and motors (Jaguar). We emphasise that these funds should be distinguished from dedicated "international" US pension funds managed overseas which by and large deal direct in the London market. The exact split between overseas and domestic US funds invested in non-American equities is hard to estimate, but the latter are certainly large. For example 40% of Jaguar's capital is currently held in ADR form.

Many of these domestic funds do not have the option of buying UK stocks in the London market, being forbidden from buying non-US paper by their trustees. Many funds, put off by the 5% Stamp Duty, will turn to other non-UK ADRs or remain in the US market.

The Lesser Changes

Amongst the lesser changes, we note that there will now be stamp duty on certain takeovers following on a winding up, schemes of reconstruction and amalgamation and demergers. Perhaps, surprisingly in the light of the recent impetus to companies to purchase their own shares, duty now arises on such purchases.

Analyst : Marian MacBryde

Pension Fund Surpluses

- *The Chancellor has announced proposals to tackle the well publicised pension fund surpluses in UK companies.*
- *Under the provisions which apply from 6th April 1987 Pension Funds will be required to reduce surpluses to a figure not exceeding 5% of scheme liabilities.*
- *The proposals will allow companies to obtain refunds as a recognised method of reducing surpluses.*
- *Where trustees choose to reduce or curtail contributions to a pension fund the maximum period is now to be restricted to 5 years.*

The Chancellor has announced proposals to tackle the problem of tax revenue shortfall arising from large pension fund surpluses built up over the last few years as a result of strong investment markets and high redundancy levels. Estimates of the extent of current surpluses have ranged from £25bn to £50bn on total funds in excess of £140bn. The extent of the surplus as calculated under these new proposals is unknown.

Under the current rules, few companies have been successful in obtaining approval from the Inland Revenue for a refund of contributions. Redfearn National Glass recently succeeded in a £1.6m refund following the Revenue's refusal to Gomme Holdings some months previously. All in all, the use by the Revenue of their discretionary powers has led to confusion among trustees over whether or not refunds would be approved. The proposals now allow for refunds as a direct means of reducing surpluses. For other companies tackling their fund surpluses the options have been to increase benefits or reduce or curtail their contributions. This has led to some significant holidays being taken with a corresponding improvement in market perception of the companies.

Under the Chancellor's proposals trustees will now be required from 6th April 1987 to reduce the excess of a funds assets over liabilities to 5% or less. The basis of calculating this surplus will be advised by the Government actuary and trustees will need to submit a valuation to the Inland Revenue in support of the calculation of any surplus. The options afforded to trustees to deal with the surplus include a combination of the following: increased benefits; reduced or suspended contributions; or a refund. Where a company takes a refund it will attract tax at 40% to be deducted at source by the trustees. There will be no available reliefs to mitigate this charge such as ACT, losses or expenses. For applications already submitted the old rules will still apply.

These new provisions clearly now afford companies far greater flexibility and certainty in dealing with surpluses. It will be possible for trustees to refund surpluses to companies where they consider it desirable or necessary.

However company Chairmen may not be happy at this lessening of conservatism and will no doubt point out that markets and inflation rates will not always be so favourable.

Red Book arithmetic shows £750m additional tax payable over 3 years — or £2bn plus of additional taxable income as a result of the measures. This could well prove an underestimate. Those companies set to show biggest releases are among our *lowly rated* category where capital investment and labour shedding have boosted productivity, profits and stockmarket perception. This is a broadly based boost for manufacturing industry and will surely push the re-rating of our favourite stockmarket sub-sector further in the next few months.

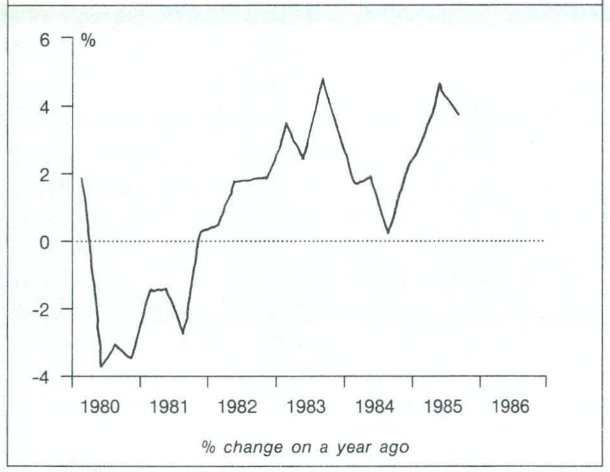
Analyst : Richard Hickinbotham

1986 will be some 10% above this level and 14% above that hit in 1981.

Underlying this increase in activity, the Treasury is predicting that manufacturing output will increase by 3% after a rise of 3.2% in 1985. This would take output in this sector of the economy to within 2% of the cyclical peak reached in 1979 (the highest levels of manufacturing output were recorded in 1973 and 1974 — but resulted in severe economic overheating and inflation).

The Treasury's predicted rate of growth in GDP during 1986 is slightly below our own but above consensus expectations. The most interesting feature is that it is expected to come through against a background of unchanged oil production (which is thought to have peaked) — and, therefore, may begin to bring about one of the goals of the pre-election period: that is, lower unemployment.

Gross Domestic Product



Consumers' Expenditure

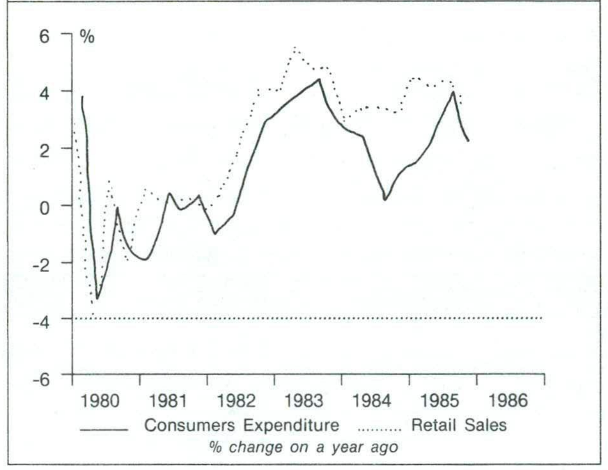
- *Treasury forecast:* +3.9% in 1986

Despite a relatively muted start to the year, the Treasury is predicting that over the year as a whole, consumer spending will rise considerably faster than in the previous two years (1984 and 1985 showed increases of 1.6% and 2.7%, respectively). Although the tax cuts (slightly more generous than the pre-Budget PR would have had us expect) will be a factor in this acceleration, of much greater importance will be an expected 5% increase in real personal disposable incomes.

While our own forecast is for slightly lower growth in expenditure, it is still expected to be the most important element in the overall rise in GDP during the year. As commented below, however, it is likely to be accompanied by a much stronger increase in imports than that suggested by the Treasury.

At one point, it appeared that spending during 1985 would rise only marginally from that recorded in 1984; commenting on policy at the time of the last Budget, it was realised that the broad money targets would prove extremely restrictive — and we felt that the attempt to keep £M3 (the broader of the two targetted monetary aggregates) within target would squeeze demand. However, Mr. Lawson proved rather more pragmatic than was thought

Consumers Expenditure and Retail Sales



likely, de-emphasising £M3 as a monetary indicator and making no attempt to bring its growth inside the planned range. As laid out in this Budget, this benign attitude to fast broad money growth is likely to be maintained over the next year — stimulating consumption.

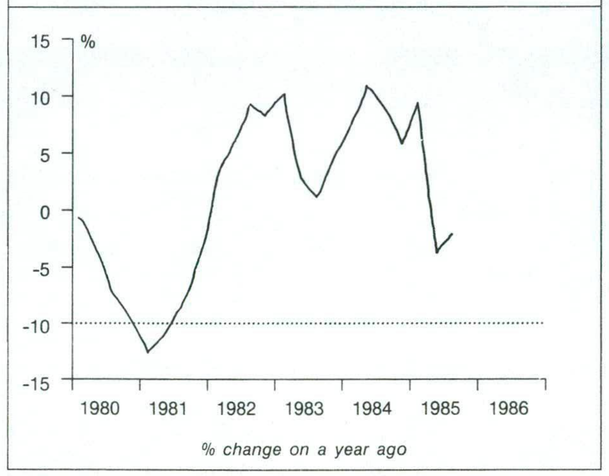
Capital Investment

- *Treasury forecast:* +5.0% in 1986

After two years of rapid growth in industrial capital spending by industry, stimulated to a certain extent by the phased withdrawal of capital allowances announced in the 1984 Budget, there is considerable debate over what will happen in this area over the next few years. Two camps appear to have emerged: those who expect a collapse in spending and those who anticipate continued strength. Clearly from the words used in the Red Book, the Chancellor is in the latter camp —as are we. Our contacts with industry suggest that the obvious benefits from investment will maintain a considerable proportion of the momentum that was generated by the tax changes. On this basis, and taking into account the latest CBI survey results, the Chancellor is forecasting a similar increase in capital investment by industry in 1986 as in 1985 (manufacturing industry raised its capital expenditure by 5% in 1985, following 15% in 1984).

The split expected by the Treasury between investment by industry and investment in the housing stock suggests that the latter will also grow by 5%. From a relatively low rate of increase in 1985, therefore, a considerable accel-

Gross Domestic Fixed Capital Formation



Economics Background — reflation without tears?

Mr. Lawson may not have had the easiest run as Chancellor (the currency markets have seen to that) but he is one of the few over the past twenty years to have presided over an economy which has not at any time been in recession. Indeed, during 1985 (the year that threatened a slowdown) he was able to take a considerable risk with monetary policy in order to keep the economy on a high. The risk was that the fast rate of money growth which was allowed (and endorsed in the Mansion House speech) would stimulate inflation as much as it did growth. That it did not was due to two influences: productivity growth and falling commodity prices. This became reflected in a fall in retail price inflation during the second half of the year —a process that is likely to continue more or less uninterrupted at least until the end of 1986. Meanwhile, the economy grew by an impressive 3½% (according to the output measure of GDP) and although around 1% of this reflected the rebound in activity following the conclusion of the miners' dispute, underlying growth was still 2½%.

This record provided an extremely favourable backdrop to the Chancellor's Budget speech. However, as he emphasised, the scene has been clouded over the last four months by the collapse in oil prices. For the UK, this is a two edged sword: as a net exporter of oil, the trade accounts will suffer over the year ahead (though probably not by as much as many appear to believe); on the other hand, industry will benefit from lower energy costs and this is likely to be reflected in a higher level of economic activity. The government, of course, has the problem of lower oil revenues to contend with — an area particularly pertinent to the Budget and covered in detail later in this book. Unfortunately, until recently, the problems associated with the falling oil price have overshadowed the gains that are likely to accrue — and this has given Sterling a petro rating by the exchange markets. With knee-jerk simplicity, therefore, exchange dealers embarked on the now traditional hard sell of the UK unit in the first month of this year — forcing a 1% hike in interest rates. This problem was not helped by lax monetary controls and by mid January there was an uncomfortable feeling of deja-vu in the markets. After an uneasy start, the authorities rode the storm quite successfully, however, and behind the smoke-screen of a falling dollar, the status quo appeared to be maintained. To be sure, there were momentary periods of anxiety as the pound slumped against the deutschmark and yen — but these soon passed.

Since then there has been a remarkable change in attitude, not only in the UK but around the world. What was once perceived as a major problem for mixed economy nations such as the UK has come to be viewed much more in the light of the advantages that might be forthcoming. At the core of this change in attitude has been a review of inflation prospects — much improved by the decline in energy costs. This has allowed a concerted reduction of interest rates by G5 member nations, with the aim being to stimulate economic activity without the associated risk of inflation. The UK was a laggard in this process — perhaps because the Chancellor wanted an interest rate hike to be perceived as a part of the Budget package, and perhaps because of residual fears over the market's reaction to the weekend OPEC meeting. Nonetheless, with an election a short two years away and with unemployment still rising, the Chancellor is unlikely to pass by the opportunity of reflation without tears.

In what follows, we review the UK's economic prospects over the year ahead, as laid out by the Chancellor, and draw the conclusion that the management of the economy over the next year will be aimed at fast non-inflationary growth.

Short Term Economic Forecast Comparisons

Constant Prices, % change on previous year

		HG	Treasury
GDP (Expenditure based):	1986	3.5	3.1
Consumers' Expenditure:	1986	3.6	3.9
General Gov't Consumption:	1986	2.0	0.8
Fixed Investment:	1986	3.6	5.0
Imports of Goods & Services:	1986	5.2	5.8
Exports of Goods & Services:	1986	5.2	4.9
Current Prices, £ billions			
Current Account:	1986	3.9	3.5
Public Sector Borrowing Req:	1985/6	7.0	6.8
	1986/7	8.0	7.1
% change on year ago			
Retail Price Index:	1986, Q4	3.0	3.5
	1987, Q2	2.5	3.5

Gross Domestic Product

- *Treasury forecast:* +3.1% in 1986

Stimulated mainly by an increase in consumers' expenditure, the official forecast is for the expenditure measure of GDP to show an increase of 3.1% in 1986 after an increase of 3.3% in 1985. Taking out the effect of the rebound after the coal strike leaves the underlying growth rates at 2.3% and 2.6% in 1985 and 1986. If these expectations are fulfilled, by the end of the year, the UK will be enjoying its sixth consecutive year of economic growth — a record unparalleled since the period up to 1974/5 recession. What is more, this has been achieved in a low inflation environment — a point given some emphasis in the Chancellor's speech. In the last economic cycle, gross domestic product hit a peak of £203.5bn in 1979 (at constant 1980 prices); according to the Treasury, GDP in

Gross Domestic Product (Expenditure based)

Constant Prices, % change on previous year

	1981	'82	'83	'84	'85	'86
Consumers' Expenditure	-0.4	0.8	3.8	1.6	2.6	*3.6*
General Gov't Final Cons.	0.1	0.9	1.9	1.3	0.6	*2.0*
Gross Dom. Fix. Cap.	-9.3	6.4	4.5	8.2	2.1	*3.6*
Increase Stocks & WIP*	0.3	1.4	1.8	-0.8	0.2	*0.9*
Exports of Gds & Services	-1.7	1.2	2.6	7.1	6.1	*5.2*
Total Final Sales	-1.7	2.1	3.9	3.4	3.1	*4.0*
Imports of Gds & Services	-3.1	5.1	5.6	9.4	3.8	*5.2*
Taxes & Subsidies	-1.8	1.4	3.1	4.1	1.0	*4.2*
GDP (at factor cost)	-1.3	1.4	3.5	1.4	3.2	*3.5*

*actual change, £bns

Figures in italics represent Hoare Govett forecasts

Personal Taxation

- *Basic rate of income tax cut by 1% to 29%. Personal allowances indexed giving increases of 5.7%.*
- *Long-awaited Green Paper on personal tax reform published with emphasis on integration with NIC and benefits, and transferable allowances.*
- *Tax on lifetime gifts abolished, with taper relief for last 7 years. CTT to be re-named Inheritance Tax.*

Income Tax

Nigel Lawson maintained his reputation as a reforming Chancellor by cutting the basic rate of income tax for the first time since 1979. As he put it, the reduction was *one penny in the pound.* Given the economics background, and in particular reduced oil revenues, Budget forcasters had just about given up hope of such a cut this time around. The 1% reduction to 29% will cost £830m in 1986/87 and an estimated £1,245m in the following year. Knock-on effects of the cut include a reduction in the rate of ACT to 29/71sts and a lowering of the small companies rate of corporation tax. The change also affects the amount paid by borrowers under the MIRAS scheme: broadly net interest payable after deduction of tax at 29% will be £71 for every £70 presently payable. The limit for mortage interest relief stays at £30,000 for 1986/87.

If commentators were surprised by the basic rate cut they were disappointed by the increases in allowances and thresholds. Personal allowances were raised in line with inflation, which involved increases of 5.7%, when over-indexation might have been expected. The single person's allowance will rise by £130 to £2,335, the married allowance by £200 to £3,655, and age allowances to £2,850 (single) and £4,505 (married), with the income limit raised to £9,400. Thresholds for higher rates of tax were raised by exactly £1,000, which represented indexation for the first — 40% — higher rate, but less than half statutory indexation for the top — 60% — rate.

The Chancellor stated that the combined effect of the various income tax changes in this Budget was to concentrate the benefit *not on the rich but on the great majority of ordinary taxpayers.* The Inland Revenue calculated that nearly all taxpayers will pay between 1 and 2% less of their income in tax, and that the cut in the basic rate is worth a maximum of £172 a year to any taxpayer.

Minor changes to income tax include; a 10% increase in the taxable benefits of company cars and fuel, a measure of relief for overseas travel expenses and a simplification of the rules for reporting directors' perks. For covenanted donations to charities the £10,000 limit on higher rate relief will be abolished, and from April 1987 tax relief will be introduced for charitable donations of up to £100 a year made through payroll deduction schemes.

Green Paper

As promised in last year's Budget, a Green Paper has been published on personal tax reform. This discusses options opened up by the computerisation of PAYE, ranging from integration of the income tax, NIC and benefit systems to independent taxation of husband and wife, with allowances transferable between them. As well as reducing the burden of income tax — an electoral commitment — the paper aims to take more people out of the unemployment and poverty traps for a given amount of tax relief than is possible under the present regime. The Chancellor has committed the Government to careful consideration of the response to the Green Paper before taking any decision on how to proceed; given the timetable of computerisation at the Inland Revenue the new improved system could not be implemented until the 1990s in any event. Presumably Nigel Lawson will take credit for this tax reform too, however.

Capital Transfer Tax : Inheritance Tax

As we have come to expect, yet another tax was abolished this Budget, falling victim to the Chancellor's reforming zeal and sharing the fate of the National Insurance surcharge, the Investment Income surcharge and Development Land Tax in his previous two Budgets. Capital Transfer Tax on lifetime gifts to individuals was abolished this time. There will be a tapered charge on gifts made within seven years of death. The remains of CTT will in future be known as Inheritance Tax to reflect this new structure. Abolishing the tax on lifetime gifts will cost £35m in 1986/87 and £55m in 1987/88. Thresholds and rate bands for Inheritance Tax will be raised in line with the RPI for 1986/87. The new rates will apply to transfers made on or after 18th March 1986.

Capital Gains Tax

After major reforms to CGT last year a quiet Budget this time was to be expected. The exempt annual amount was increased in line with inflation from £5,900 to £6,300. Gains on *futures and options* in gilts and qualifying corporate bonds will be exempt for disposals after 2nd July 1986, in line with the exemption from CGT on the underlying stock. CGT changes also arise where other Budget measures could give rise to gains e.g. with respect to the Business Expansion Scheme and the Personal Equity Plan.

PEPs

We would not be surprised if the Personal Equity Plan introduced in this Budget and discussed elsewhere in this document proves to be a key change. This is a clear further move away from institutional investment management back toward the personal investor.

Analyst: Jill Whitelam

Oil

- *The Chancellor acknowledges £5.5bn drop in oil revenues, but refuses to reduce UKCS production in order to help OPEC and boost prices.*

- *Minimal changes in UK oil taxation and increased excise duties on products are less than expected.*

- *The imposition of a 5% duty on new ADR's could deter ongoing US investor support for UK oil majors.*

The Chancellor categorically rejected production cutbacks in the North Sea to support OPEC and increase prices. Underlying the Budget speech, was the impact of an assumed $15 a barrel crude oil price on Government revenues. North Sea revenues (royalties, petroleum revenue tax and corporation tax) are expected to fall from the £11.5bn level projected in the 1985 Financial Statement and Budget Report (FSBR) to £6bn in 1986/7 and £4bn in 1987/8. However, it is envisaged that this negative influence will be "offset by buoyant non North Sea revenues". Overall, the effect of a lower oil price has been to reduce the Chancellor's freedom to manoeuvre and restricted his ability to cut taxes.

The direct influence on the sector through proposed changes in mines and oil wells capital allowances, which will merely bring these allowances more in line with the general system of capital allowances, and adjustments to oil product taxation, will be minimal. The increase in duty on petrol and derv was less than expected and the Chancellor expressed a wish to see the oil companies absorb part or all of the increases. Downstream operations have been depressed for several years and the return on capital employed has been pitifully low. The recent upturn in profit margins created by the rapid fall in crude oil input costs is likely to be short lived in any case due to the re-emergence of strong competitive pressures. The promise of preferential taxation treatment for lead-free petrol to offset the higher production cost will be welcome.

However, a new worry for the oil sector arises from the imposition of a 5% duty on the conversion of shares to depositary receipts with effect from 19th March 1986. This duty applies to the creation of new ADR's where beneficial ownership has not been established to date. Thus, it will be a deterrent to the creation of new ADR's and could result in US buyers' becoming reluctant to purchase additional shares in BP, Shell Transport & Trading and Britoil. Undoubtedly, some of the larger US international funds will deal direct in the London market, thereby obviating the ADR system, but other funds could be deterred. With oil companies being valued more highly in the US than the UK there has been a considerable increase in US ownership of certain UK oil companies. For example, Shell Transport has 8.5% US ownership currently compared with less than 1.5% at the end of 1984. BP's US ownership has increased slightly since a low point reached in early 1985 and it currently stands at slightly under 2%. However, BP had planned to increase its exposure in the US by a more active promotion campaign and it remains to be seen if this programme goes ahead. Royal Dutch, which is currently 6.5% more expensive than Shell Transport in New York and 6.1% more expensive in London, could become more favoured by US investors due to the fact that it is not subject to ADR's, being a New York quoted stock. Thus, the disparity between the two shares could widen to the extent that US investors are discouraged from buying Shell Transport.

On a more positive note, the abolition of excise duty on most lubricating oils will have a beneficial impact on **Burmah Oil** due to the relative importance of Castrol's UK operation in group results.

We maintain our negative stance on the oil sector attributable to a worldwide oversupply of oil and the inability of OPEC to control prices in a depressed market. Oil prices are likely to fall to an economic price in the $10 a barrel range and reduced earnings, cash flow and dividend payment capacity will have a subdued effect on the sector for some time to cover. **Burmah** and **IC Gas** are considered to be specialised companies and their re-rating could continue whilst **BP, Shell** and **Britoil** are likely to be less affected by poor industry fundamentals than their weaker exploration and production brethren.

Analysts: John Toalster
Tom Miskell

Summary of the Measures

Economics Background
Inflation : Forecast to fall to 3.5% in the 4th quarter of 1986 and remain at 3.5% in the 2nd quarter of 1987. Measures in this Budget will increase RPI by 0.5%.
PSBR : Estimated for 1985/86 at £6.8bn or 2.0% of GDP. Forecast for 1986/87 is also £7.1bn or 1.75% of GDP. Oil revenues in 1986/87 are forecast at £6.1bn, roughly half their level in 1985/86.
GDP (expenditure based) : To grow by 3.0% in 1986 following 3.5% in 1985.
Miners' Strike : Estimated to have increased GDP growth in 1985 by around 1.0%.
Monetary Targets : For 1986/87 target ranges are for MO 2-6% (1985/86 3-7%) and for £M3 11-15% (1985/86 5-9%).
Current Account : Surplus forecast of £3.5bn in 1986 after £3.0bn surplus in 1985.
Fixed Investment : To increase by 5.0% in 1986 following a 0.9% increase in 1985.

Income Tax
Tax Rates : Basic rate reduced from 30% to 29%.
Thresholds and Bands : Increased by £1,000 each (equivalent to indexation for first band - 5.7%).
Allowances : Indexed. Single allowance raised by £130 to £2,335, married allowance by £200 to £3,655.
Benefits : Car and fuel taxable benefits to be increased by 10% for 1987/88. Engine-size break points to be brought in line with EEC.
Mortgage Interest Relief : Limit remains at £30,000.
Personal Tax Reform : A Green Paper has been published, dealing particularly with transferable allowances, with the system to be in place for the 1990's.

Capital Taxes
Capital Gains Tax : No major changes after reform last year.
CGT Annual Exempt Amount : Raised in line with inflation to £6,300.
Capital Transfer Tax : To be abolished on lifetime gifts to individuals, made on or after Budget Day, with taper tax relief within seven years of death. CTT will now be known as the inheritance tax.
Stamp Duty : Halves to 0.5% on share transactions post Big Bang. Scope widened to include takeovers and mergers (from Budget day), certain loan stock (from Budget day), letters of allotment (partly from Budget day, partly from October), dealing in the account (from October) and company purchase of own shares (from October). No change for houses etc.
ADRs : 5% duty imposed where shares are converted into depositary receipts, from midnight on Budget day.

Corporation Tax
Tax Rates : Unchanged. Tax rates as set out in Budget 1984 to remain in force; 1985/86 40%, 1986/87 and thereafter 35%.
Small Companies : Special rate reduced from 30% to 29%.
ACT : Reduced to 29/71sts of the distribution, as a consequence of the reduction in the basic rate of income tax.
Capital Allowances : Main capital allowances to remain as announced in 1984. Minor changes proposed to allowances on agricultural buildings.

Oil Taxes
PRT : No major changes.
Mines & Oil Wells Allowances : Capital allowances code will be updated.

Indirect Taxes & Duties
VAT : Registration limit increased to £20,500 p.a., standard rate unchanged at 15%. No extension of VAT base.
Drink : Duties on alcoholic drinks will remain unchanged.
Fuel : 7.5p on a gallon of petrol, 6.5p on a gallon of derv from 6pm on Budget day.
Tobacco : 11p on a packet of 20 cigarettes from midnight on Thursday. No change in duty on pipe tobacco and cigars.
Vehicle Excise Duty : No change for cars.

Others
Personal Equity Plans : Investment of up to £2,400 p.a. in equities, held for a minimum period of not more than two years, will be free of tax on both capital gains and reinvested dividend income.
Charities : Single gifts of up to 3% of ordinary dividends paid by non-close companies are eligible for tax relief. The £10,000 limit on charitable donations eligible for higher rate relief by individuals will be abolished. From April 1987, employees whose employers participate in a new scheme will get tax relief on donations up to £100 p.a. Certain equipments and services used by charities will be exempt from VAT.
Business Expansion Scheme : The scheme will be extended indefinitely. New BES shares will be exempt from capital gains tax on first sales. Certain low risk activities will be excluded; certain forms of chartering UK-registered ships will be included.
Pension Fund Surpluses : Surplus of pension funds assets over liabilities must be reduced to not more than 5% by 1) an increase in pension benefits, 2) a contribution reduction by either employer or employee, 3) a refund to the employer (subject to 40% tax) or 4) by a combination of the above options. No refund may reduce the surplus to less than 5%.
Employee Share Scheme : Tax relief on shares which must be disposed of when employment ends will be extended. Employee controlled companies and worker cooperatives will more easily take advantage of existing schemes. A more liberal regime for savings-related share options.

James Culverwell
Jill Whitelam

- *The pace of change in the personal sector savings market has accelerated again; with more measures towards the Chancellor's stated goal of the de-institutionalisation of investment.*

- *Pension fund managers are to be forced to pay back their surpluses; but individuals are to be encouraged by generous tax concessions to buy equities through the new PEP scheme.*

- *The mechanics of the PEP scheme encourage long term savings. The Chancellor also confirmed that an earlier step on the de-institutionalisation route - Portable Pensions - will too attract generous tax concessions.*

- *This year's tax loophole closure was the insurance based CTT avoidance schemes. Legal & General is the biggest player in this market.*

Pepping up the Savings Market
The Chancellor continued along the road for de-institutionalisation of investment with his proposals for personal equity plans. (PEPs). The individual is now to be encouraged, not only to have his personal pension but also direct equity investments. PEPs like personal pensions, are to be afforded substantial tax privileges, highlighting the advantages of this form of investment.

The introduction of a new tax attractive product to the savings arena should be welcomed by the life industry following the loss of LAPR. Similar schemes have proved popular in France and the US. Bearing in mind the fairly low level of individual investors in the UK (roughly 6% of the adult population) there seems to be ample scope for take up of the scheme.

Whilst the scheme is likely to prove popular the question of competition immediately arises: competition between the various types of financial institutions that will apply to become authorised PEP managers and competition from the various sources of funds that are used for contributions. Existing share investments will be one obvious source. Bank and building society deposits are other sources that also come to mind. Traditional life investment products and unit trusts however cannot be excluded. The competitive presure on life companies' traditional products may be stepped up but we believe that these companies retain inherent advantages over their competitors. Marketing skills and the computer networks of the life companies should be well able to take advantage of the increased volume of, albeit less profitable, business. There is still room for life in the savings market and this new source of business post January 1987 should be welcomed.

The budget also contained proposals for controlling pension fund surpluses. As from April 1987 the size of surpluses must be measured on a regular basis according to standardised actuarial assumptions. If, on the prescribed basis, assets exceed liabilities by 5% the trustees will be required to reduce that surplus to a figure not exceeding 5%. The surplus released from the fund can be used to provide contribution holidays, increased benefits or refunds to the employer - or any combination of these options.

This compulsory release of funds adds another dimension to the highly competitive area of fund management. The successful fund manager may actually have funds taken away from him on a regular basis. This is not much of a reward for success when fees are traditionally charged on a set percentage of funds under management. The Government estimates that the new measures will generate an extra £2bn of taxable income over 3 years. Fee income is likely to come under pressure and diversification into the personal pension market may now become a higher priority for many fund management concerns.

Whilst the individual may gain certain tax advantages from personal pensions and PEPs, those investments with tax avoidance overtones are to be stamped out. Insurance policies that avoid Capital Transfer Tax, now renamed Inheritance Tax will in future become ineffective. Some life companies, notably Legal & General, have enjoyed past success in this market.

Overall the budget presents challenges for the life industry in terms of new competition but also opportunities for those with the systems and marketing skills to exploit the potentially substantial PEP market. The need to sharpen these skills has already been established by earlier measures by the Chancellor and others.

Analyst : Angela Coad

Tobacco

- *The 11p increase is greater than expected and likely to result in a 3% drop in volume in calendar 1986.*
- *The structure of the market should be little affected by the increase.*
- *BAT, at a discount to the US majors, still looks very cheap. Rothmans problems remain and a bid looks some way away.*

The 11p per packet increase in duty (straight indexation would have called for 4p) is significantly more than anticipated. On the basis of the experience of recent years we would expect this to result in a 3% fall in the cigarette market over the course of the year, allowing for the customary immediate sharp fall in consumption followed by gradual recovery. The 6p increase of last year resulted in a fall in consumption for calendar 1985 of some 0.9%. In fact the extent of the swing in consumption this year may be somewhat more limited. Manufacturers have been restricted as to their clearances from bond this year and therefore there has been no incentive to encourage pre-Budget stockbuilding by either the trade or the consumer. Moreover, this system appears likely to operate in future. In summary, the size of the increase appears to indicate that the lesson of 1981 (diminishing returns) continues to have largely been heeded, albeit that the current rise might be considered on the verge of inducing such a reaction.

The duty increase is likely to have little impact on the structure of the market. The damage on that score has already been done, with cheap brands and private label products — largely imported from the Continent and priced on a marginal cost basis — now having a combined market share of some 10%. The comparatively recent rise in share of these products appears to have been halted by UK manufacturers stepping into the ring with low priced brands (Lambert & Butler from Imperial and Berkeley from Gallaher) as well as by the category now being priced over £1. In the mainstream of the market, Imperial's share continues in the low 40's, gradually being overhauled by Gallaher (now around 33%) whose share has increased at the expense of Rothman's, now believed to be under 12%.

Pricing flexibility has remained intact throughout the onslaught from imports and looks likely to be maintained, whilst the industry's cost base has also been somewhat reduced. Whatever the outcome of the battle for Imperial, no change is likely in either of the above processes. It also relevant to point to the sizeable discretionary sums spent by the industry on advertising and promotion as a potential source of additional profit either by choice or as a result of government action. It is perhaps not exaggerating too much to say that an element of disillusion may be creeping in, with the sheer cost of new brand launches (the 'Rothmans Special' launch for example — far from being a conspicuous success — is reputed to have cost some £12m in advertising and various accompanying promotional deals). The new voluntary agreement on advertising is likely to have been finalised by the end of the month with some additional restrictions in the area of health warnings. Moves on sponsorship are also likely shortly, although many in the industry view the dependence on tobacco sponsorship of many sports to be too great (with no effective substitutes) to permit any draconian restrictions.

From the stockmarket viewpoint little impact is expected. Clearly **Imperial** is much more influenced at present by bid considerations than the trading environment. We are brokers to Hanson Trust and therefore not permitted by the Takeover Code to make forecasts and stockmarket recommendations. At both BAT and Rothmans, events in the UK cigarette market are of little or no significance. **BAT** has significantly underperformed, and stands at a significantly lower multiple than the equivalent American counters with the poor 1985 results (due next Wednesday) already well in the price. We expect further strong outperformance — even after their recent rise the shares should be bought for a further resumption of their rerating.

At **Rothmans,** recent bid rumours look misplaced, and current trading appears poor. Moves by either major shareholder are possible in the longer term (two years or more out) but meanwhile the shares are likely to be dull.

Analyst : Peter Temple

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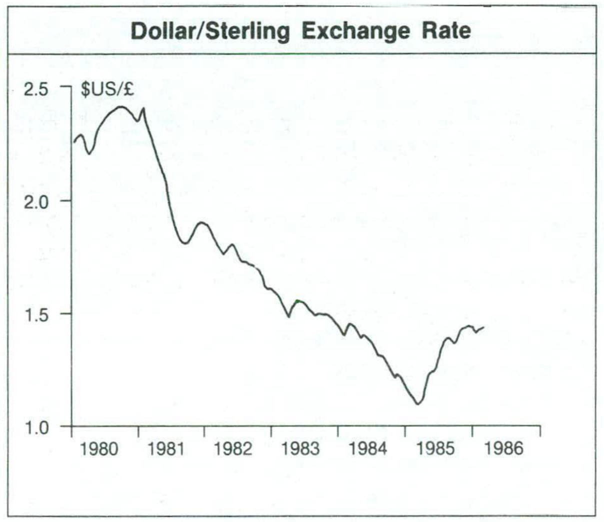
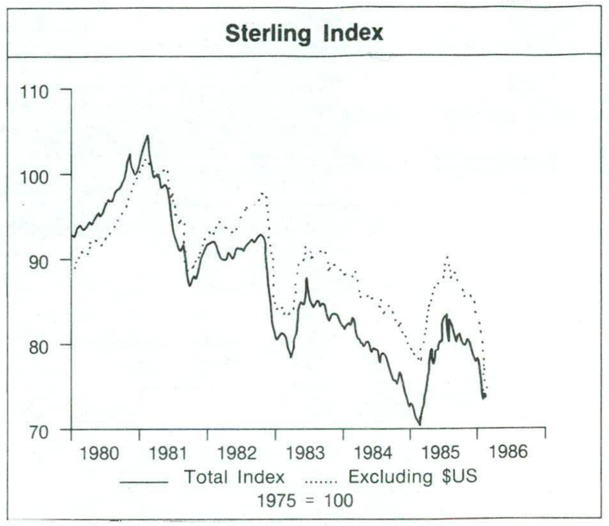


likely to be repeated, if not exceeded, in 1986. Improvements in manufacturing productivity have been even more impressive, with output per man rising by 5% during the year up to November 1985 (the latest data available).

Productivity increases have been a major and necessary offset to the fast growth in earnings seen over the past few years —and as such have been important in limiting their inflationary impact. While this pattern is expected to continue over the period ahead, productivity growth cannot be considered a substitute for lower wage inflation.

Company Profits
The Chancellor pointed to the fast rate of growth in UK company profits as evidence of the health of the corporate sector. The net real rate of return for all industrial and commercial companies is estimated by the Treasury to have been at its highest in 1985 since 1960. Our own forecasts suggest that net of stock appreciation, industrial and commercial companies' profits rose by around 15% in



1985 (excluding the oil sector and Telecom). We expect this fast rate of growth to be maintained in 1986, based both on widening margins (a feature of the current period) and on rapidly increasing turnover.

The Exchange Rate
The role of the exchange rate as a monetary indicator is covered in detail later in this book. The assumption used in the Treasury's economics forecasts is that the exchange rate will not deviate substantially from the rate at the time of the Budget — an assumption which proved erroneous last year and led to considerable overestimation of likely oil receipts. Our own view is that sterling will continue to gain against a weak dollar for most of the remainder of 1986, but that there could be some further slippage against currencies such as the deutschmark and yen later in the year.

Richard Jeffrey

From here on, we see scope for a bounce in Stores and remain positive on BAT and hence the Tobacco sector but elsewhere, the consumer sectors will be hard pressed to outperform (after Brewers and Distillers surely moving ahead tomorrow). The same probably now goes for Health & Household after a strong run. Despite the early-year rally, we still do not count ourselves among the bulls of electronics.

Notable, however, in the year-to-date performance has been the relative strength of the other capital good sectors. This has fitted well with our earlier views on stock selection, among which we particularly selected a number of lowly rated stocks in this area. So far, with the exception of BP, for the reasons mentioned above, and Vantona Viyella, which acquired Coats Patons, our selections are all ahead of the rising market.

The groups of stocks we selected were concentrated in three areas:

The Lowly Rated
In this group we look for stocks where the market has simply failed to recognise fundamental change that has taken/is taking place in the companies and where ratings are typically well below the market average. Baker Perkins, Laird and Metal Box were examples we gave here. New additions to the list would include Heywood-Williams, Vickers, old favourite Delta Group, British Aerospace and possibly Courtaulds.

Unfashionable Stocks
These were seen as stocks which might show useful performance as investors look for sound value in a more highly rated London market. Here we listed BAT, BOC and Sears. On the back of its Bradbury-Wilkinson deal, De La Rue could be added, while Hawker-Siddeley must begin to look attractive to one of today's aggressors.

Sector Stocks
This category was intended to embrace companies set to outdistance sectors which themselves were set to do reasonably well. Our suggestions here now need some revision. Glaxo may have seen the best of its strength for the time being but there is probably now scope for Smith & Nephew and Reckitt & Colman to take up the running in Health & Household. In Building Materials, we would add Wolseley-Hughes to Meyer International. Following the Coats Patons deal, we also see long term attractions in Vantona Viyella. We stick with Dixons in the Stores Sector.

Analyst : Charles Brown

Personal Equity Plan

- *The proposed 'Personal Equity Plan' (PEP) is a further stage in the government's policy of encouraging share ownership.*

- *Money invested in PEP's will, if held for the qualifying period, build up entirely free of income tax and capital gains tax.*

- *Funds likely to be drawn into PEP's over a period years are impossible to estimate but potentially very large. Assuming reasonable equity markets, £2.5bn - £5.0bn annually could be flowing in within a five year time span.*

The Personal Equity Plan (PEP) is an important new tax incentive to encourage savings through the purchase of shares. Under these proposals, individuals aged 18 and over will be allowed to invest up to £2,400 per annum on a PEP and, provided shares are held for the qualifying period, any capital gains and reinvested dividends will be entirely free of tax. This tax free status remains for as long as the investor retains his PEP investments. This investment does not have to be the original shares purchased — they can be switched to maximise gains in the normal way.

Funds in a PEP must be invested in ordinary shares quoted in a UK stock exchange or dealt in on the USM. The investment will be conducted by an authorised PEP manager who will retain custody of the shares. However the individual will choose the investment and retain beneficial ownership of the shares.

Enabling legislation will be introduced in the Finance Bill and, after a period of consultation, the main provisions will be included in Regulations laid in the autumn. The scheme is due to start on 1st January 1987, working on a calendar year basis. Qualification for tax free status is at least one full year from the investment of funds. Thus, funds invested at any time during 1987 quality for tax free status from 1st Janaury 1989.

The government justifiably reckons that this proposal provides flexibility for investors, avoiding the complex rules needed to police schemes such as IRA in the US or Loi Monory in France. Those schemes offer tax relief on the cost of investment whereas the UK proposal offers tax relief on the return on the investment. The PEP scheme also has the benefit of low initial cost to the Exchequer (with £25m pencilled in for 1987/88), building up over time depending on the success of the scheme.

The size of the funds held within PEP's is impossible to estimate accurately but potentially very large. There are approximately 2.5m individual shareholders in the UK, approximately 6% of the adult population. This compares with 17%-18% in France and the US. If the UK percentage rose to 10% of the population as a result of PEP's this would bring another 1.7m individual shareholders into the ring. Together with funds from existing shareholders moving into PEP's, it is possible to see an annual flow into these plans of £2.5bn-£5.0m over perhaps the next three to five years (always assuming no unfortunate major setback in the equity market meantime). Over a period of years, it is clear that funds in PEP's could grow to a very significant size.

If it is difficult to estimate the potential size of the inflow of funds, it is similarly difficult to say from where they will be drawn. Existing share investments will be one source, together with equity-linked products like life assurance and unit trusts. Surplus liquidity must also be a potential source, adding further to competition for building societies and banks. Perhaps too in a low inflationary world, individuals will finally be persuaded to reduce consumption and invest!

Existing institutions will have a potent new product in their midst which will doubtless win some of their business from them. Many will have the opportunity to become authorised plan managers, however, and add PEP's to their own product list. The spoils will fall to those with sound systems, powerful marketing and low costs.

One obvious negative for a small portfolio, at least at the outset, is the difficulty of obtaining an adequate spread of risk. It is possible that PEP holders will thus be attracted to broadly spread investment trusts during the initial phases of the proposals.

Analyst: Rod Barrett

costs have begun to decelerate. In combination with lower material and energy costs and some unwinding of the mortgage rate increases, this has been reflected in a fall in the inflation rate to 5.5%.

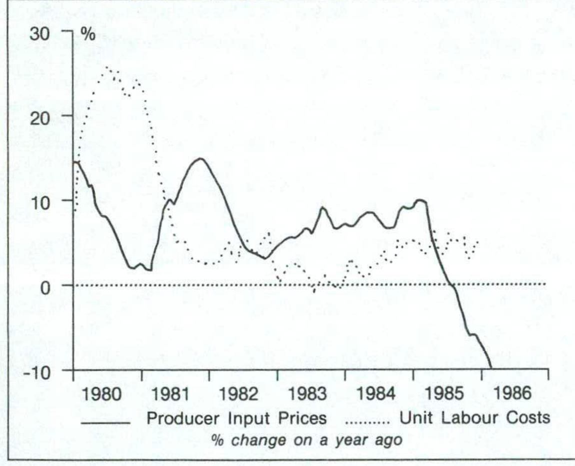
Retail Prices Index, Treasury Forecast

% changes on a year earlier

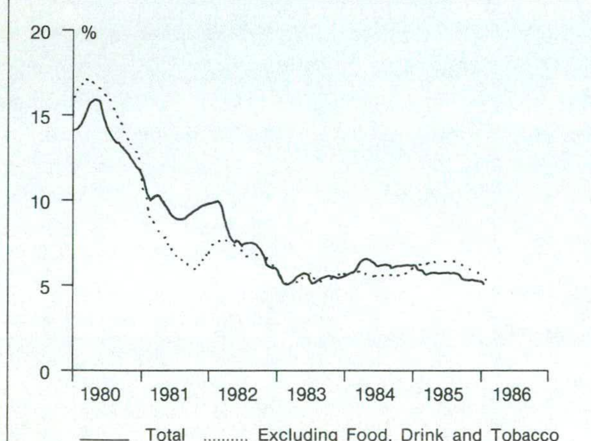
				Forecast	
	Weight	**1984 Q4**	**1985 Q4**	**1986 Q4**	**1987 Q2**
Food	19	3½	3	3	3½
Nationalised Inds. (incl. water)	9	4	5½	4	3
Housing	14	10½	9½	7½	5
Other	58	4	5½	3	3½
Total	100	5	5½	3½	3½

The currency has clearly been and will continue to be a major factor in the decline in inflationary pressures. The 1985 rebound in sterling, particularly against the dollar, showed through almost immediately in lower input prices and by February of 1986 these were almost 10% lower than a year earlier. The recent collapse in the price of oil has helped extend this trend — not only in the UK but around the world. This has led to a revising of inflation forecasts in most industrialised countries.

Input Prices and Unit Labour Costs



Output Price Inflation



Our forecast for UK inflation at the end of 1986 is lower than the Treasury's at 3.0% (it may even be slightly under). The benefit of lower energy and material costs may continue this trend into the first half of 1987, taking inflation as low as 2.5%, though there must be a danger that over aggressive reflation in preparation for the next election will then begin to show through in price levels. Continued productivity growth is likely to keep the increase in unit labour costs at manageable proportions for the present — but there remains the danger that these, too, could become a more significant inflationary factor if the pace of wage increases is not checked.

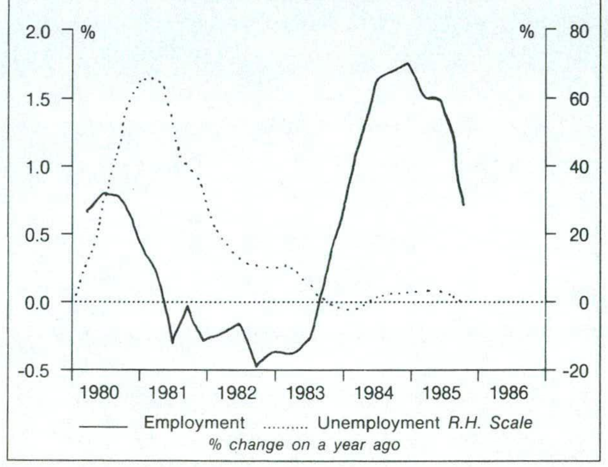
Employment and Productivity

As usual, Mr. Lawson was keen to point out that although demographic and social changes have continued to put upward pressure on unemployment, employment has risen significantly over the past few years — a trend which he expected to continue. Latest figures indicate that employment in all industries had risen by 102,000 over the first three quarters of 1985 and 709,000 since the low point reached in the first quarter of 1983.

The Treasury never makes explicit forecasts for unemployment — and an unchanged level is assumed in the Department of Health and Social Security spending plans. Recently there has been a significant increase in the unemployment rate, after a period during which it appeared to have stabilised. Our own expectation is that unemployment may continue to increase over the remainder of the first half of 1986, but that the level will stabilise again in the second half. A higher proportion of growth in the UK is likely to come from manufacturing industry in 1986 and this is likely to benefit employment levels considerably. At the same time demographic influences may become more helpful, leading to a more direct feedthrough from increasing employment to unemployment. The authorities will be hoping also that the employment schemes announced will act to reduce the jobless total.

A major area of success in the UK over the 1980s has been productivity. Despite dismal forecasts that the gains made earlier on in the cycle would not be sustained, underlying productivity growth has remained positive throughout the period. In 1985, output per man in the whole economy rose by around $2\frac{1}{4}$% — a rate of increase

Employment and Unemployment



The Tory backbenchers reacted quite enthusiastically to the Budget speech, and the likelihood is that the securities markets will corroborate that judgement. Both equities and gilts rose while the man was speaking and, on mature consideration, the gains are likely to be extended. Gilts will run on the back of the prospect of very low inflation and the reduction in interest rates that will follow. Long dated issues have already discounted the first $3\frac{1}{2}$ points off base rates, but anything more (and we envisage an additional $1\frac{1}{2}$ points) will provide room for a rally. Investors will probably stay cautious and be distrustful of claims of protracted periods of low inflation, but a significant advance does seem justified. Longer maturities look set to lead the way, and only the index linked variants will disappoint.

Equities also have plenty of room to appreciate. Sharp rises in profits, coupled with scope for multiple enhancement, could see the indices streaking into new ground. By the Autumn, we anticipate the FTSE testing the 2000 barrier. What happens thereafter is more difficult. Deteriorating international conditions (the Americans look dangerous) will be a negative, but optimism on the back of PEP schemes could preserve an element of enthusiasm.

Roger Nightingale

Stores

- *Effect of raising petrol duty by only $7\frac{1}{2}$p could be to put as much as £2bn into consumers' pockets in 1986/87.*
- *This plus 1p off basic rate could, therefore, be equivalent to almost 3p off income tax, enough to substantially influence sentiment.*
- *Government now forecasts 5% growth in real personal disposal income in 1986; enough to fuel good increase in discretionary spending.*

The major benefit to the stores sector in the Budget is hidden between the lines, as it does not stem directly from any of the Chancellor's tax-changing measures. But his decision not to raise petrol duties directly to compensate for the loss of North Sea oil revenues could have much the same effect as a cut in income tax.

The likely effect of raising petrol duty only by $7\frac{1}{2}$p a gallon will be that the retail price of petrol will eventually fall substantially, possibly enough to put, or keep, around £2bn in consumers' pockets. This is much the same as the benefit the consumer would have got if, say, 2p had been cut off the basic rate of income tax and simultaneously petrol duties had been raised in such a way as to maintain petrol's retail price.

On top of this, of course, 1p is being cut off the basic rate of income tax. In all, therefore, one can say that the Chancellor is giving, in round terms, £3bn rather than the £1bn he will widely be interpreted as giving away. Putting this amount into context, on the one hand the cash injection is not really great when seen against the backdrop of consumer spending which totals about £155bn; on the other hand it should be interpreted as very good for sentiment because had this amount been given away solely in the form of income tax cuts then sentiment would have been very positive indeed.

More importantly, though not so obtrusively, the factors that will really ensure a strong profits growth from stores in 1986 remain in place. The most relevant of these is strong growth in real incomes. In this context it was encouraging to see that the Chancellor's own forecasts for inflation have been revised down to $3\frac{1}{2}$% to coincide with the sort of figures expected by economic forecasters generally. And the Government now forecasts an exceptional 5% growth in real personal disposable income in 1986. This sort of growth could greatly enhance discretionary consumer spending.

Almost equally important, the Budget did nothing to harm prospects for falling interest rates. Indeed, to the extent that the forecast PSBR is now £7bn rather than £$7\frac{1}{2}$bn as indicated in the Autumn, the Budget has helped the trend to lower rates.

On the margins one can speculate on the spin-off effect on stores of changes to stamp duty and incentives to buy shares. The effect may be to make house purchase comparatively less favourable which may lead to some slow down in housing transactions. Given that moving house generates a good deal of discretionary spending on consumer durables, then this effect could be mildly unfavourable.

As regards the sector's rating, we expect the impact to be beneficial. The sector has been trading within a range of 105-08 since mid-January. It is now possible to see the relative rating trading in a higher band, say 108-114. There seems to be enough in both the Budget and the Government's rosy view of the economy to expect that the sector's profits may be restored to the sort of premium over the market that was being forecast at the end of last year before dropping crude oil prices put it in doubt.

Given that the benefit to the sector will come from macroeconomic influences, the largest stocks are the ones to go for on this basis. Among these, **Marks & Spencer** should figure; it is, after all, by far the biggest with some 25% of the sector weighting. **Dixons Group** operates wholly at the discretionary end of the spectrum and therefore should benefit. Of the less highly-rated shares, **Woolworth** still looks the one to go for.

Analyst : Philip Ryland

Brewers & Distillers

- *Though no increase in duty is welcome, drawbacks like absent profit on duty-paid stocks and the lack of opportunity for an extra price rise mute the benefits.*
- *Negative factors like the OFT investigation into the 'tie' and the delaying of flexible licensing hours are not yet reflected in share prices.*
- *Major tied estate brewers continue to look overvalued - Grand Met and S&N underrated.*

Other than the 'Budget that never was' pre-the 1979 Election, most analysts (apart from those in advancing middle age) would find it hard to recall a Budget when no increase was imposed on the drinks sector. Though falling short of a cut in duty (the cynics sign of an imminent election) many might be justified in feeling today's measures to be the prelude to an early poll. From the viewpoint of assessing the whole sector, the judgement is more complex and perhaps less optimistic, depending partly on the absence of an immediate price increase and partly on the degree of stimulus introduced to the economy in general and consumer spending in particular. Our own view of this is that, from a macro-economic perspective, the Budgetary implications would appear relatively neutral for the sector. The industrial background of buoyant consumer expenditure forecast to rise 3.6% in 1986/87 will not alter but should, however, have previously been discounted by the market. The expected 0.2m drop in unemployment is probably not a major positive. Beer production should return to around the 1983 level.

Undoubtedly, while the 4-5% rise in real earnings in 1986/87 will generate a higher alcoholic spend per capita, past evidence would tend to indicate that the benefit to beer volume is not directly proportionate. Rather a discretionary pattern in consumption occurs, whereby the individual develops a preference for drinks other than beer, whose gross margins to the brewer are far less substantial.

So far as the industry itself is concerned, we have long argued that the companies own pricing policies have been of more significance than the actions of the Chancellor whilst the overall level of the economy and social attitudes (drinking and driving, alcohol abuse etc) also have a potent influence.

The announcement of no change in duty rates should be seen in this context. Brewers (indeed any manufacturer of a dutiable product) had been accustomed to take the profit on duty paid inventory as well as possibly slipping in a disguised price increase along with the duty impost. Neither of these options is open to the industry this time round. Calculation of a price elasticity for the industry is so blurred by different product categories as to be of minimal use although intuitively one had felt that spirits on the whole have proved more price sensitive than beer in the past with the latter, as the more populist product, being more subject to broad economic conditions.

For these reasons we are less optimistic about the outlook for the brewing sector than might be indicated by the immediate market response to the measures; even though the macro background is undeniably positive for the market little has changed from pre-Budget expectations which were presumably already discounted. Indications of tax allowances and other measures to benefit the lower paid had already been built into forecasts — indeed as in previous years.

At the political level, forces are operative with a far larger potential impact. The current OFT investigation into lack of consumer brand choice, may lead to an MMC referral by Easter, with the corollary being a negative influence upon sentiment. Linked to this, is the concept of flexible-hours. The potential impact of liberated licensing hours would be substantial (though not universal) adding some 5-10% of relatively high volume drinking time to the average working week. The primary beneficiaries would be those pubs in urban/suburban locations, tourist locations with a primarily southern geographic bias. In this respect, the recent announcement of a legislative postponement until post election is disappointing and has yet to be reflected in share prices.

In investment terms, corporate connections again prelude us from detailed comment an **Allied-Lyons, Guinness** and **Distillers**. Broadly speaking though — despite the market's initially positive reactions and for the reasons described above we view the overall outcome as neutral. Political factors, in particular the OFT investigation and the delaying of the introduction of flexible licensing hours, seemingly to date ignored by the market, should assume more prominence and impact particularly severely on the major tied estate brewers, notably **Bass** and **Whitbread.**

Grand Metropolitan remains in our view significantly underrated with highly professional management and a broad spread of businesses worldwide. The downward rerating over the past eighteen months largely on the back of problems in generic cigarettes looks to have been overdone and the shares are attractive. Likewise, **S&N** management changes over the past few years have not yet fully appreciated by the market and profits of well underpinned by rationalisation measures for the current year and beyond.

Selected regionals, notably **Wolverhampton** and **Dudley** and **Mansfield**, could well see benefits from a freer trading environment which might accompany flexible hours and a loosening of the 'tie'.

Analysts: Peter Temple
Russell Hart

A well balanced package which shrugs aside the loss of oil revenues and draws the resources for its limited concessions from the resilience of the economy

The 1986 Budget represents a fairly cautious response to the vexed fiscal circumstances surrounding the UK economy at the present time. The big problem, of course, has stemmed from the sudden halving in the oil price and the consequent disappearance of some £6bn of anticipated tax revenue. The Chancellor might have reacted to this body blow by temporarily abandoning the self-imposed constraints of his Medium Term Financial Strategy. Alternatively, he could have chosen to recoup through consumer taxes a good deal of the revenue which he had lost on upstream oil operations. We had anticipated an element of each of these courses of action in our pre-package speculation but, in the event, he did neither. Instead, he cut back on concessions, and left the projected PSBR just within the MTFS requirement. At £7bn, the outturn forecast by the Treasury represents $1\frac{3}{4}$% of GDP.

What rescued the Chancellor from a much larger borrowing requirement was the resilience of other tax revenues during 1985, and the presumption of a continuation of the buoyancy in these items in 1986. The key here has been the very encouraging performance of the economy. As he pointed out, the behaviour of demand and output in Britain in the last year or so has been extremely gratifying. Activity accelerated to produce growth of $3\frac{1}{2}$% (likely to be revised up to 4%) in 1985, but showed no signs at all of strain in doing so. From inflation, the balance of payments and the level of unemployment, the message was unanimously one of adequate capacity. This led the Treasury to think in terms of an advance of 3% in 1986, and that was sufficient to produce enough strength in income tax, VAT, and corporation tax to keep public borrowing under satisfactory control.

If, as seems likely, their growth figure falls short of reality (we anticipate an advance of more than 4%), the PSBR in 1986/87 will undershoot again. Accordingly, in his fourth Budget, the Chancellor will probably be in a position to take a much bolder line. Another pleasant surprise may come on the inflation front. The official forecast looks for a moderation in the RPI to $3\frac{1}{2}$% by the year end, but the actual figure could be rather lower. The softer oil price, the reduction in interest rates and further rapid increases in productivity are key elements here, but the big unknown concerns wages. If there should be no moderation in settlements in response to the lower price inflation, the official figure could well be right (albeit accompanied by a massive consumer boom). If, alternatively, pay increases do give ground to some degree, the result could be a still hectic pace of personal spending, but accompanied by a significantly lower inflation rate.

Severely limited by the MTFS, the Chancellor had to review his priorities for tax concessions very rigorously. What he chose to do was concentrate on three items: spending on job training; reducing the basic rate of income tax; and halving stamp duty. The first of these measures was a fairly predictable response to the general anxiety about the size of the jobless queues. The second represented the redemption (in part) of the pledge made by his predecessor. The third was forced on him by the desire to see London maintain its position as a financial centre of some significance in the environment of global securities trading.

There were two genuinely innovative aspects to the proposals. One was aimed at the promotion of wider share ownership, and the other sought to regulate the surpluses of the pension funds. The government has long believed that there are a variety of political and economic benefits to be gained from a more diverse ownership of equity securities, and successive Budgets have been prepared to spend tax revenues to this end. Options schemes and employee share arrangements have been introduced with this objective in mind, and the major privatisations have deliberately favoured the small investor.

Something new, but along these general lines, was expected in the 1986 package, but most people thought it would be modelled on the French arrangements introduced by Monory. As it happens, the Chancellor selected a scheme whose costs (and benefits) would be fairly modest in the short term, but which would build progressively over time to become enormously powerful. Instead of allowing people to invest out of gross income, the chosen proposal would permit them to take dividends with no deduction of tax. What this means, of course, is that the old discrimination against what used to be called unearned income has been turned on its head. Today, it is ironically wage income which is penalised.

How successful the new mechanism will be in spreading share ownership depends crucially on how it is marketed, and by whom. What is clear, however, is that if large numbers of people do start to use it, and if the equity market remains fairly strong, it will ultimately have a dramatic impact on public attitudes, and on the muscle of various elements of the community in the securities marketplace.

At precisely the time that the private client may be making a comeback, the pension fund manager could be withdrawing. This time last year, the Chancellor said that he had no intention of taxing superannuation funds during the life of the current Parliament. What he has done in the 1986 package, however, will have almost that effect. The requirement that the funds dispose of any significant surpluses (defined by the authorities) and that they do so in ways which yield a tax benefit to the Treasury, constitutes an effective impost, albeit an indirect one. More importantly though, the measure acts as a modest constraint on the growth of securities held by the funds. What the Chancellor did in one way to the life assurance offices two years ago, he is now doing in another to the pension funds. The revenue he picks up on the way is a useful, but subsidiary matter: his longer term objective is the transfer of wealth from the anonimity of the financial institution to the visibility of the participating (and voting) individual.

Unlisted Securities Market

- *The Chancellor's measures provide an encouraging backdrop for the USM.*
- *Specific measures to encourage wider share ownership should give an additional boost.*
- *BES changes, in removing asset situations, were widely foreshadowed.*

With the Chancellor's freedom of manoeuvre having been progressively restricted by the downward spiral in oil prices little dramatic was perhaps expected from todays budget. In the event this has proved too pessimistic, aside from the £1bn injection the picture that emerges is generally encouraging with inflation levels likely to run at lower than projected levels and monetary targets a little more relaxed than might have otherwise been anticipated. All this, together with measures to stimulate wider equity ownership, should be encouraging to the capital markets which reinforces our view that they will show further strength during the next few months. Meanwhile in the very short term a cut in interest rates looks likely. Gearing levels on the USM have been creeping up over the last year from 15% to 19% on the capital front and 8% to 13% on the income side. These figures are a little deceptive being distorted disproportionately by the USM's property sector. Excluding these and the foreign stocks the markets capital and income gearing figure would fall to 15% and 10%.

Investment Incentives

Against an already active USM further incentives are positive news. One of the noteworthy features of the USM over the last 18 months has been the increase in the 'free capital' element of the market. This increase has been both absolute (eg from £0.95bn in October 1984 to virtually £1.5bn currently) and relative (from 34% of the total market to 38% over the same period). The extent that the USM has been utilised by companies for acquisition either directly or through funding exercises via rights issues, moreover, can be illustrated by reference to the differential that exists between the average free capital percentage for the market at 38% and the average for new companies at 26%. We calculate that in the last 15 months over 80 USM companies have made acquisitions.

Clearly in one sense the Chancellor's budget measures in respect of stamp duty will be a little negative. In widening the net to include, for example, letters of allotment, rights issues become possibly marginally less attractive for potential investors. In the last 15 months some £147m has in fact been raised on the USM via rights. Equally the 'new issue market' generally (and the USM has hitherto been a new issue market par excellence with 105 flotations since the beginning of 1985) may now be somewhat less lucrative to those who are perhaps looking for a very short term gain particularly given that the average premium on USM flotations has declined.

Also falling into the stamp duty net for the first time are purchases of companies own shares although in USM terms this is less than significant. To date only two companies have availed themselves of this option namely Chemical Methods (in the USA), and more recently Aspreys. Any negatives however, are easily offset for the junior market by the very positive encouragement that the Chancellor has provided to widen share ownership. The general reduction in the Stamp Rate duty to ½% is to be welcomed, as is the proposed Personal Equity Plan.

The PEP will allow investment of up to £2,400 a year through an authorised PEP manager which, if maintained for a minimum period of 12-24 months will be free of both income and capital gains tax. The investments can be traded, and can be held for as long as is desired with no capital gains tax liability. Importantly shares qualifying must be quoted on a 'UK Stock Exchange' or the USM which would seem to exclude Over-the-Counter stocks. Some, but by no means all OTC stocks, qualify under the BES rules, for those that do not however these measures do not look to be good news particularly given the importance of private client money generally in the OTC. Although the PEP provides relief both on the income and capital front, we think the latter is the most significant. Again this should favour the USM which, with admittedly higher risk, is a market geared to younger companies and thereby to the potential of capital appreciation as against yield. Within the context of risk, moreover, it is noteworthy that PEP's will be restricted to ordinary shares which assumably include Investment Trusts. These could prove significant beneficiaries if investors are anxious to spread their risk.

Profit Sharing

The Chancellor has indicated that a consultative

USM Labour Statistics

	3/85	3/86
USM companies	267	323
No. of employees	52,622	75,557
Total remuneration	£449.3	£662.5m

	3/85	3/86
Average no. employed	197	234
Average remuneration	£8,538	£8,768
Average sales per employee	£47,778	£48,003
Average profit per employee	£4,164	£3,026
Average sales per £1 of remuneration	£5.50	£5.47

Note : Predominantly foreign companies are excluded document will be prepared setting out schemes for profit sharing arrangements. Comment was made as to the attraction of moving to a system where a significant proportion of employee remuneration would depend directly on the company's profitability per person employed. The relevant statistics for the USM are reproduced in the accompanying table together with the comparatives of a year ago. It will immediately be noted that over the last year the USM's average profit per employee has, on our calculation, actually fallen by £1,000. It should be remembered, however, that the USM is a shifting market with a shifting make-up as companies come and go. Certainly our initial thought is that a number of more labour intensive companies have come onto the market recently. Average remuneration, it will be seen, has not shifted noticeably.

Tax Changes

The evolution of CTT into 'Inheritance Tax' and the abolition of tax on most gifts made before 7 years of death, is likely to have major implications for tax planning within family companies, particularly those thinking of public quotation via the USM. Elsewhere the reduction in the standard rate of personal taxation to 29% clearly has ACT implications. Generally we estimate that the USM's collective ACT bill to be roughly of the order of £19.7m at 30% falling to £18.8m at 29%. The reduction will primarily provide a small timing benefit for cash flow although for perhaps 10% of USM companies there could be an actual reduction in total tax payable given a fall in non-recoverable ACT. The new rules on Pension Fund surpluses are probably not relevant in a USM context. The reduction in the rate of small business taxation to 29% will not have any marked effect although marginal relief between profits of £0.1m and £0.5m may be helpful to the more than 60 companies whose current profitability levels fall below the upper limit. The changes in the rules for loans to participators in close companies are not likely to impact given that most of the these will have been cleared before flotation.

Duty

The USM brewing sector can take heart from the Chancellor's self restraint in respect of excise duty as can Merrydown on the cider front.

Business Expansion Schemes

The major study undertaken by Peat Marwick into BES at the behest of the Government has now been published. In brief BES, which was originally scheduled to end in April 1987 has been extended indefinitely and new BES shares will now be exempt from CGT. One of the findings of the Peat report, not surprisingly, is that a trend has developed since 1983/84 to 'less risky investments particularly through public issues'. The Chancellor has therefore moved to further eliminate 'asset situations' from the schemes purview. After disqualifying property companies last year, companies with 'secure asset backing', ie where the value of land and buildings (after deduction of certain liabilities) exceeds one half of the net value of net assets, will also be prohibited as will wholesalers or retailers trading in goods which can be held as an investment, (goodbye to wines and antiques!). Conversely ship chartering will now be included in the scheme if the ships are all UK registered. Activity levels in BES pre the budget have been high with hotels and nursing homes particularly to the fore. The significance of BES over the last three years is shown in the accompanying table.

Business Expansion Scheme

	1983/4A	1984/5E	1985/6E
	£m	*£m*	*£m*
Total Raised :			
funds	35	47	35
direct invest.	70	103	125 (c.75 to date)
	105	**150**	**160**
Invested :			
funds	42	50	35
direct invest.	60	103	125
	Nos.	Nos.	Nos.
Investee Cos:			
funds	205	220	205
direct invest.	715	800+	900+

Note: Prepared with the assistance of John Harrison of BES Magazine.

Analyst : Geoffrey Douglas
Marian MacBryde
Philippa Cross

Budget Assessment

March 1986

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C. K. Brown
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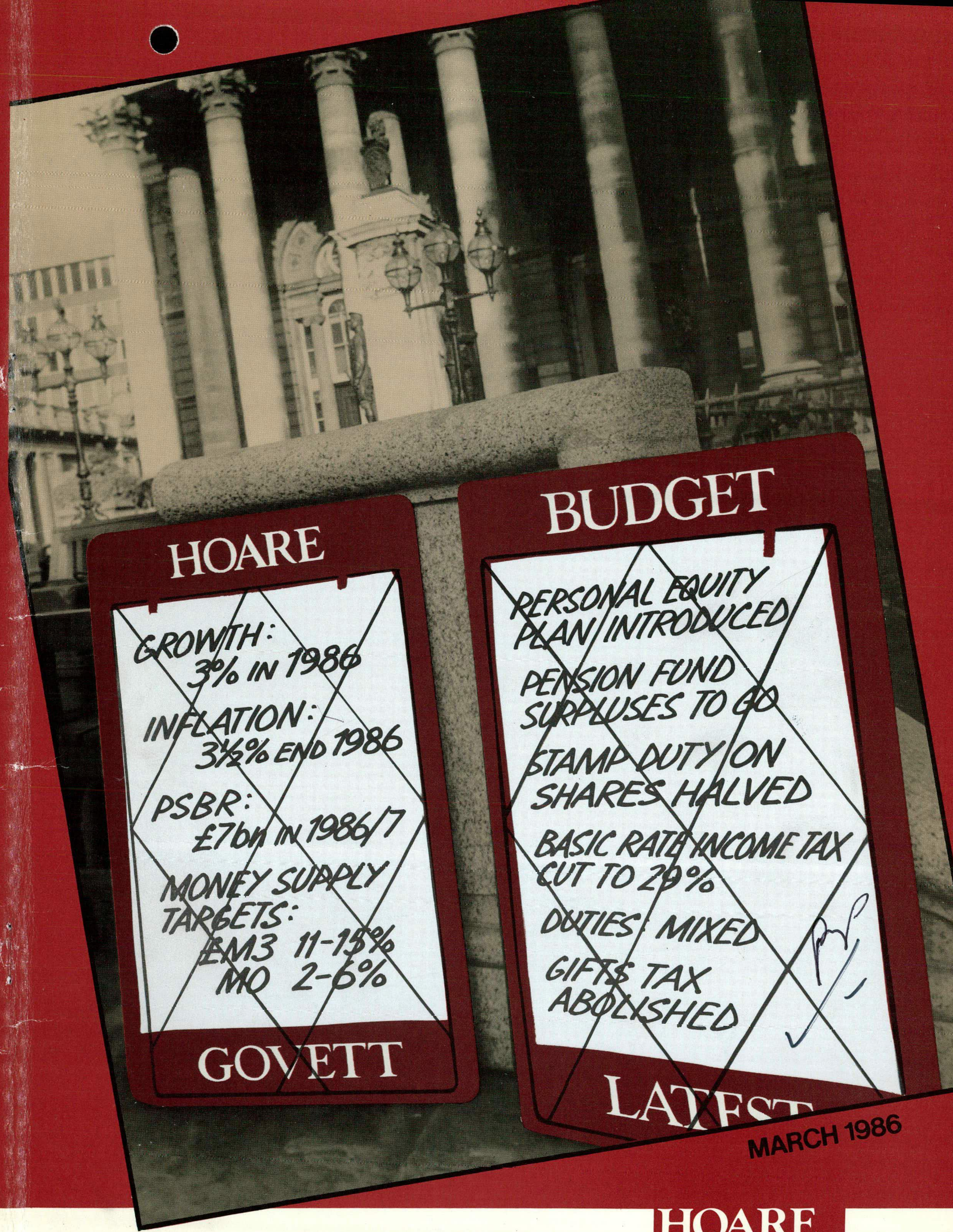

MARCH 1986

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From
Sir Terence Beckett CBE
Director-General

CBI
INDUSTRY
YEAR 1986

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	SIR P. MIDDLETON
	Mr F. BUTLER
	MR MONCK

MR SCHOLAR
Mr BURGNER Mr H. DAVIES
Mr CROPPER
Mr LORD

19th March 1986

Dear Nigel,

Following our telephone discussion last night, I am attaching a copy of the statement I put out immediately after your Budget speech. I look forward to seeing you in the very near future to discuss it at greater length.

Yours sincerely,

Terry.

The Rt. Hon. Nigel Lawson, MP,
Chancellor of the Exchequer,
H.M. Treasury,
Parliament Street,
London, S.W. 1.

Enc

~~Mr Kue~~
cc Mr Kelen
Mr MacAuslan
Mr Guy
PAS

MCU

I have agreed with Mr Kuczys that no action is required
TAS
19/3

Debbie

We spoke. You are d/w
T.

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Director-General
Sir Terence Beckett CBE

Secretary
Denis Jackson

CBI

Statement by the Director-General of the CBI
following the Chancellor's Budget Speech : 18th March 1986

CBI members are clear that the priorities in this Budget should be to help the unemployed. We therefore welcome the concern the Chancellor has shown. The programme he has announced for the long term unemployed will be of practical help to those without jobs. We also welcome the New Workers Scheme, the extension of Enterprise Allowances and the further development of the Community Programme, on which we have some proposals to involve more private capital and management from building companies.

The encouragement of wider share ownership is an imaginative step and has the support of everyone who believes in the free enterprise system. The reduction in stamp duty on share transactions will make the City more competitive in world markets. We shall also be happy to discuss with the Government its proposals on company profit sharing schemes.

There are a number of real improvements in the treatment of smaller firms. We welcome the indefinite extension of the Business Expansion Scheme, the commitment to and improvement of the Loan Guarantee Scheme. The abolition of the life time gift tax and the tax on buying back shares will be very important for family owned businesses but there are some other problem areas we shall want to discuss with Government.

The revenue raising proposals skilfully avoid increasing inflation and the overall shape of the Budget should enable interest rates to be brought down.

BR/52

you p.

FROM: MRS R LOMAX

DATE: 19 MARCH 1986

MR PERETZ

cc Financial Secretary
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Monger
Mr Hall
Mr Walsh
Mr Culpin
Mr Cropper
Mr H Davies

BUDGET: GREENWELL'S REACTION

The Chancellor was pleased to see Gordon Pepper's report of the general City reaction to the Budget, in your note of 18 March. On his point about sterling fixed interest debt, however, the Chancellor is not clear why it is such a tragedy if companies finance themselves to some extent by the euro markets.

2. The Chancellor has also noted various Pepper inspired comments about the stamp duty package in todays Financial Times. He thinks that the Bank should be encouraged to fight back, possibly through a controlled use of David Walker.

RL

RACHEL LOMAX

043/11

FROM: D L C PERETZ
DATE: 18 MARCH 1986

SIR PETER MIDDLETON

cc: Chancellor
Financial Secretary
Economic Secretary
Sir T Burns
Mr Cassell
Mr Monger
Mr Hall
Mr Walsh
Mr Culpin
Mr Cropper
Mr H Davies

In addition to X, I am not clear why it is such a big thing if companies finance themselves for some tax reason via the euro market.

BUDGET: GREENWELL'S REACTION

[illegible]

I should report that I took a call from Gordon Pepper this afternoon. He reported an excellent City reaction to the Budget. He asked me to pass that on to you.

2. The purpose of his call, however, was to point out that by putting stamp duty, even at ½ per cent, on sterling fixed interest debt we had killed any prospect of a revival in the domestic sterling debenture market. In future all issues would take place in the euro market. He thought, however, that the euro market would soon develop to handle longer term issues, as well as the 5-15 year maturity where it concentrates at present.

X 3. I pointed out that domestic issues of short bonds were also exempt.

DLCP

D L C PERETZ

FINANCIAL TI WEDNESDAY, 19 MARCH 1986

PLP

A supply-side mini-budget

28

MR NIGEL LAWSON, following one of the artistic fashions of the moment, is a very able minimalist. Given hardly any room for fiscal adjustment, he has contrived a penny cut in income tax to catch the headlines, partly financed with a small claw-back from the highly paid, and offered a glimpse of a new vision of a profit-sharing democracy. If he has a strategy, it is to lay increasing stress on supply-side measures, aimed above all to improve the workings of the labour market. The medium term financial strategy is rhetorically intact, but becoming steadily vaguer in operational terms. There is a modest package of measures affecting the City which appear ill-considered, some controversial but still green proposals for the reform of personal taxation, and barely a passing mention for industry's exchange rate worries. Not so much a curate's egg as a Chinese meal of a Budget, with some tempting flavours, some less so, and unlikely to satisfy the appetite.

The most important proposal, in its long-term potential, is still in the future: Mr Lawson will discuss with industry how he might encourage effective schemes to encourage profit-sharing as an element in industrial rewards. As Japanese experience has shown, profit-sharing has enormous potential in encouraging constructive industrial relations, and in enabling industry to adapt to changing cyclical and competitive conditions by allowing rewards to fall in line with market returns, rather than sacking people.

The industrial relations climate is by now ripe for such a development, and—just as important — non-oil industry now has some worthwhile profits to share. The forecast return on non-oil investment for 1986 is some two-and-a-half times its low point in 1981, and nearly back to the levels of the mid-1960s. The workforce is at present claiming its share of the radically improved cash flow through excessive wage increases, too readily conceded. It is sad that the Chancellor has had to take the initiative here: industry should be taking the lead, not waiting for bribes.

Most of the Chancellor's more immediate measures are welcome as far as they go, but are likely to earn higher marks for political acumen than for economic sophistication. The cut in income tax, combined with under-indexation of the higher rate bands, is both welcome and ingenious—and will just about leave the average smoking wage-earner back where he started. The scheme to allow individuals to accumulate a personal retirement fund in a tax-free portfolio should encourage personal share-ownership, and has the great advantage to the Treasury that its revenue cost will only build up over a long period of years. The abolition of tax on gifts *inter vivos*, after all the previous nibbles at Capital Transfer Tax, was virtually a tidying-up operation.

If there is a strategy at work here, however, it is undeclared. Mr Lawson seems to move inch by haphazard inch towards an expenditure tax, a principle he has explicitly rejected, but there is still a very long way to go. Meanwhile we do not have even the routine commitment to fiscal neutrality, and indeed in its modest way this is an interventionist Budget, not a neutral one, encouraging profit-sharing, charity and employment, discouraging smoking.

So far, so good; but if most voters will be pleasantly surprised, three groups will be less happy—the poor, the professional economists and the financiers. The poor get nothing at all, except those of the unemployed for whom jobs may now be created. Mr Lawson has been admirably frank in the past about the scandal of the poverty trap, which leaves little or no incentive to work at low pay levels. It is sad that he has let a year pass without doing something, however modest, to reduce it.

Protectionism

The financiers will simply be annoyed. They were resigned to paying for the abolition of stamp duty, but to be left with half of it, with the attempt to collect duty on whole new classes of transactions—some of which are virtually untraceable, and others which will simply go offshore—looks plain ham-fisted. The 5 per cent duty on the transfer of securities to authorised depositaries overseas is worse—it is more or less naked financial protectionism. It is neither logical nor neighbourly to try to maintain London as a major international capital market while trying to prevent UK-originated business being shared overseas.

There is happily time to improve these measures during the passage of the Finance Bill; but there will be no opportunity then to fill in the blanks in the Budget—to explain how Sterling M3 can remain a meaningful target when the Government has explicitly abandoned over-funding, its only means of counteracting the growth of bank credit, to discuss the creation of a sterling commercial paper market (which would let the private sector control M3), or for that matter to mention the European Monetary System. Industry has stated a case which deserves an answer.

FINANCIAL TIMES
BRACKEN HOUSE, CANNON STREET, LONDON EC4P 4BY
Telegrams: Finantimo, London PS4, Telex: 8954871
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Saturday March 15, 1986

Budgeting for cheap oil

EVERY Chancellor of the Exchequer finds that he has a horde of unpaid advisers as each budget day approaches; but this year none of them has been able to suggest anything terribly exciting which could be done with the £1bn or so which it is thought Mr Lawson will have to dispense on Tuesday. These days £1bn is simply not a great deal of money — enough to take 1p off income tax, and not much more than is needed to meet the latest cost over-runs on Nimrod and Trident.

It is true that the recent figures for public borrowing suggest that revenue may be more buoyant than anyone has yet dared to forecast, and one surprise could be the discovery that there is a bit more than the round sum to give; but since the oil price is still falling, the buoyancy is probably in the past tense.

Small sums need not make a dull budget, however: if Mr Lawson rises to the occasion, he should be able to deliver a fascinating budget speech — a counterpart to the speech which Sir Geoffrey Howe conspicuously failed to make in 1979 or 1980. The great rise in oil revenues was allowed to arrive almost unremarked, and this was more than an oratorical failure; there was no clear policy adjustment to accommodate this enormous impact on government revenues and on the balance of payments, so the adjustment was all borne by the private sector. Oil was allowed to crowd out other activities. The unemployed have been paying the human cost (and the Treasury has been footing the social security bill) ever since.

Opportunity

Mr Lawson is an economist, and has a taste for the dramatic and he must sense a political opportunity to take his place as the senior Minister with a clear strategy while all around him are muddling and apologising. He must also sense that even if he wanted one of the "muddy solutions" favoured by Sir Geoffrey, the markets would punish him. They want to be given new bearings for post-oil Britain.

If his advisers agree with the latest analysis from the London Business School, Mr Lawson may well start off by saying that while the Treasury has certain housekeeping problems, the impact of cheap oil on the UK economy as a whole is far less dramatic than most comment has suggested. The build-up of foreign *and domestic* capital which has been made possible by oil income will ensure that the country is still some £4bn or so better off annually even when the oil has run out completely.

The "collapse" of oil income and oil revenue is in any case a matter of perspective. It will fall by half, perhaps, from the very high peak [illegible] (and still coming through to the Treasury thanks to the time lag in tax collection); but revenues had doubled in the previous three years, and everything collected during that short sharp peak is now reflected in UK investments abroad. The LBS, arguing that the market has always perceived this peak as temporary, concludes that no change in economic policy is now required. The private sector has done it again.

While this is no doubt an extreme view, the private markets have indeed responded dramatically. They have marked sterling down to a level when the most efficient companies can compete very profitably in world markets. They have marked up British equities to reflect this, and thus enabled the non-oil sector to get cheaper access to capital. Thus the markets have achieved what a Chancellor of a dirigiste turn of mind might suppose was entirely up to him —a strategy to substitute new products for oil.

What Mr Lawson needs to do is to say how he plans to assist and smooth this process, which will be the national economic objective for several years to come. The tax regime is part of this strategy, but probably not the major part. The real question is not how fast Mr Lawson can cut the total tax burden, where we already know the broad answers, but whether he is allowed to make significant progress towards his declared aim of neutrality—a system which does not distort the decisions of a free market. The Government's confusions may leave him in a stronger personal position.

Industrialists increasingly argue, though, that what matters to them is not so much the tax environment as the financial environment; and they are also becoming more vocal about social issues. They would, to judge from their public statements, welcome a stable exchange rate, help for the unemployed, and lower interest rates in roughly that order, with tax cuts far behind.

What the Chancellor has to say about the European Monetary System, and perhaps about US pressure for international stabilisation, what he has to say about domestic monetary policy, and what he is able to do for the young and the long-term unemployed, will probably determine whether his Budget is welcomed at Centre Point, where British industrialists survey the scene, and in the City.

His biggest dilemma may be not so much to balance his fiscal sums as how best to balance these demands, which he has it partly in his power to satisfy, with the demands of the party managers for the purchase of some sorely needed votes in time for the local elections and a small wave of by-elections.

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FRIDAY 14 MARCH 1986

FINANCIAL TIMES

4

Mr Lawson's tax options

24/1

Mr Nigel Lawson must be tempted to cast himself in his old role of "tax reforming" Chancellor when he delivers the British Budget next Tuesday. Plunging oil revenues have narrowed his other options and obliged the Treasury to stress the radicalism of his tax plans in pre-Budget presentations to Cabinet.

Outside Great George Street, speculation on personal tax reform has had three main targets this year: the Green Paper on matrimonial taxation; the possibility of a more generous tax regime for charities; and a lower band of income tax, say, 25 per cent on the first £1,500 of taxable income.

Mr Lawson delights in surprises and so could have something more ambitious up his sleeve than these relatively tame options. But this seems unlikely; indeed both the charity lobby and those in favour of a lower rate band could end up disappointed on Tuesday. The Chancellor could opt for a simple, tidy Budget and try to concentrate attention on the prospect of higher employment and lower inflation in the wake of the 50 per cent drop in oil prices.

Tidiness would certainly rule out a reduced rate band of income tax. Mr Lawson's predecessor, Sir Geoffrey Howe, abolished it in 1979 because he was striving to simplify the tax code: he was wisely not impressed by the fact that many other countries indulge in a plethora of different rate bands. A lower rate band may seem caring but would actually do less for the lowest paid than the same money spent on higher thresholds. Both equity and efficiency considerations suggest the Chancellor should concentrate on raising the floor of taxation.

Allowances

The taxation of charities and the arts poses difficult dilemmas. State subsidy is in many ways a less attractive form of finance than personal corporate donations: besides being more bureaucratic and less flexible, it is likely to be less imaginative and varied. Individual and corporate donations would get a huge boost if they became straightforwardly tax-deductible. But the cost would be a dangerous move away from fiscal neutrality. Tax concessions nearly always have an apparently sound initial justification but they tend to multiply uncontrollably and ensure that average tax rates elsewhere are higher.

The Green Paper is expected to argue that every adult, regardless of sex or circumstances, should have the same, standard personal tax allowance. This seems highly desirable: the phasing out of the enhanced married man's allowance (MMA) is long overdue and essential if the blatant sex discrimination in the present code is to be removed.

Discrimination

Much less logical, however, is the proposed second leg of the Green Paper: the idea that the new and equal allowances should be transferable—but only between husband and wife. The plan seems to run quite counter to the philosophy behind the Government's social security reforms, which is that relief should be carefully targetted on genuine need. Under Mr Lawson's scheme, every married man, regardless of circumstances, would have potential access to two standard allowances: much of the revenue raised by phasing out the MMA would be thrown away in arbitrary concessions—for example, to well-off couples in which the wife chooses to stay at home.

The simpler alternative Mr Lawson appears to have overlooked is equal but non-transferable allowances. This would avoid explicit fiscal discrimination in favour of marriage. All the money released by running down the MMA could be phased on, through the social security system, to households (whatever their marital status) with special needs: for example, those supporting children or elderly people.

Transferability of allowances would be expensive and complex. Mr Lawson should save his energy, and money, for more important reforms of the tax base. The real distortions lie in special interest concessions like mortgage interest relief.

The Budget plot thickens

Saturday, March 1, 1986

FINANCIAL TIMES

MR Nigel Lawson, clearly a man who understands power plays, will appreciate the poker game now going on in the oil market. It seems to be one of those games in which most of the cards are played face up, so there is no great mystery about the hand which the leading gambler, Sheikh Yamani, is trying to play. As he has explained, he is driving down the price of oil in order to persuade other producers to share in the cost of controlling the market.

With one notable exception, he appears to be achieving his objectives. A number of other producers, some of them previously undisciplined members of Opec, and some of them large non-members such as Mexico, are now calling for production restraints. They would rather have a smaller share of a more rewarding market, and also incidentally conserve their oil reserves.

Of course it is one thing to make plaintive noises, and quite another to re-establish an effective international cartel with wider membership, so it is far from clear what the outcome of the Saudi gamble will be. The most that can be said is that Sheikh Yamani has raised the stakes boldly, and seems willing to follow poker-playing precepts: only a player prepared to risk a big loss can make a big coup.

Miscalculation

The one miscalculation of the Saudis has concerned Great Britain itself, originally singled out as the prime target. The Government refused to be panicked when the falling oil price brought sterling down with it; and the financial markets, instead of recoiling in dismay, mounted a celebration.

Thanks to this robust political and financial response, the Government can now convincingly argue that it, at least, is undismayed by anything the Saudis can do. Indeed, Britain now appears to be more in the position of the Saudis themselves than of other producers. Just as the Saudis can live with a lower price because they have a large reserve capacity to produce oil, Britain can live with it because it has a large unused potential to produce things other than oil.

The Saudis now seem to have acknowledged that Britain will not throw its hand in, but are continuing their play just the same — meanwhile shrewdly marketing their oil through netback deals which will yield high revenues if they achieve their major objective, and get effective restraint from most other producers. It will be harder without Britain, but not impossible; British production is already past its peak.

It will obviously be many months before the oil prospect is anything like clear; indeed the first serious meeting to discuss production restraint will be held only two days before the Budget itself. Equally obviously, the economic judgment on which every Budget is based will be highly tentative.

The uncertainty over the Government's own revenues is only part of the problem; if that were the whole story, an offsetting rise in the retail tax on petrol, as proposed by M Delors in Paris, could be part of a solution. There is also uncertainty over what the price fall means for the world economy, assuming that the price stays down. The consensus of stock market opinion, led by Wall Street, is that it offers a bounteous free lunch, but the international organisations, notably the IMF, are not so sure. They are aware that there are losers as well as winners, and that adjustment to large structural changes is seldom smooth. Britain does rather a high proportion of her trade with the potential losers, so the Treasury view may well be decidedly subdued by stock market standards.

All this suggests that the Chancellor would be wise to keep some large options open on March 18; and Mr Lawson has a further personal motive for keeping something in reserve. He still believes that the corporate tax changes he introduced in 1984, reducing the fiscal incentive to substitute machinery for men, will help employment. These changes become fully effective in April.

Minimalist

Both personal confidence and genuine uncertainty, then, argue for a rather minimalist approach this year. On the other side of the argument are the Government's weak standing in the opinion polls, and the apparently strong buoyancy of this year's tax revenue. If this is more than a one-month aberration, Mr Lawson will be able to give something away while passing the test of prudent caution.

Should this be spent overtly on job creation, as the CBI and the National Institute suggest? If this is the aim, a cut in taxes on employment is the obvious route. It seems likely, though, that the Chancellor will argue that past cuts of this kind have simply helped to finance excessive wage increases, and that even at a forecast 3½ per cent, British inflation will still be high compared with Germany, where it may be below 1 per cent, and Japan, where prices are already falling. In any case, the fall in sterling has done much for competitiveness. The main options are no doubt still tax rates or tax thresholds. Our poker-playing Chancellor has dropped no hints.

Saturday February 15 1986

FINANCIAL TIMES

Mr Lawson's opportunity

Financial Times

WITH just over a month to go before Mr Lawson presents his Budget, newspaper readers—and readers of brokers' circulars—have been getting a pretty dismal picture of the choices facing him. On the one side, his oil revenues will be up to £5bn less than he was expecting; on the other hand, the Government's standing in the polls is falling almost as fast as the oil price. The Cabinet is reported to be split on the right response (as it is reported to be split on so many other matters). A dwindling band of purists defend the established medium-term strategy with the Prime Minister apparently at their head. A growing rebel group yearns for the high uplands of Heath and Maudling conservatism: tackle unemployment and get the City to finance a boom through gilt purchases rather than an increasingly feverish equity boom.

Like most sketchy account of events, this one is a caricature; and much more careful analysis is needed to produce a picture which turns out to be both less exciting and less depressing than the popular version. Happily this careful analysis has been done by the invaluable Institute for Fiscal Studies, which has provided figures which show the effect of lower oil prices not just next year, but for the next three years.

The £5bn loss for 1986-87 turns out to be about right—and could even be a mild underestimate; but what also emerges is that the loss of revenue in future years will be considerably smaller. This is not because of any forecast rebound in the oil price but simply because revenue from the North Sea will be falling from a peak. The percentage cut in each future year is a percentage of a smaller sum.

It might still seem that a loss of oil revenues starting at £5bn, and falling slowly after that, would hold out the prospect of a succession of dismal years in the Treasury, but this is a simple error of logic. If, for instance, the Chancellor cancelled £3bn of tax cuts this year, he would have an extra £3bn in hand not just next year, but every year.

This means that even if the Chancellor is puritanically strict this year, and maintains his PSBR target unchanged, the scope for tax cuts in future years is not reduced at all. On the contrary, it would be slightly bigger than was projected in the Autumn Statement, since the higher level of non-oil revenues would persist, but the loss of oil revenues would slowly taper off.

However, this also opens out another opportunity. Suppose the Chancellor spreads out the "fiscal adjustment" which would still be permissible in 1987-88 over two years. This would involve a modest overshoot in the PSBR next year; but this would be a one-shot event. By next year, he would be on track. Provided the City is reassured about long-term trends in borrowing, there would clearly be no difficulty in finding an extra billion or two for just one year.

Indeed, if the arguments were based on pure arithmetic, it would be clear that the Chancellor would have quite a lot of room for manoeuvre. The trouble is that recent rows and revelations have dented confidence in the Government, and Mr Lawson will probably want to err on the cautious side.

However, there is more than one way to skin a cat, according to tradition, and certainly more ways than one to arrive at a reassuring PSBR. There is privatisation, which raises money without borrowing; but this does not inspire much confidence in the City these days. An accelerated programme does seem to be contemplated, but if the efforts are too strenuous, they are likely to be badly received.

Suffer slightly

Then there is robbing Peter to pay Paul. These are two clear candidates for Peter this year: the City, and the motorist. The rumours of a windfall tax brought up in parliament this week by Dr David Owen look highly likely to be true.

The motorist may suffer slightly; the Chancellor will be tempted to take back some of the price fall at the petrol pumps which the crude price fall should make possible.

Finally there is a quite legitimate adjustment which could be made to the economic forecasts which formed the basis of the Autumn Statement. Thanks to the collapse of the oil price cartel, sterling has been marked down to a much more competitive rate against our European and Japanese competitors at a minimal inflationary risk; and thanks to the fact that we have a substantial current account surplus at the moment, any impact effect—the so-called J-curve—can be absorbed without trouble. This should be good both for export orders and for British sales in the home market and correspondingly good for growth and revenues. A mere half percentage point of extra growth would raise non-oil revenues by something like £1bn.

The Chancellor could still, then, offer a modest stimulus in the Budget within Mrs Thatcher's demand for responsible prudence. Mr Lawson's big problem is to maximise the political—and, we hope, the employment—return for every pound disbursed. He is rather good at that.

FINANCIAL TIMES FRIDAY, 14 FEBRUARY 1986

Priorities for the Budget

18

IT IS EASY to lose sight of the main purpose of budgets. These annual rituals are not just vehicles for tax cuts of some description but the Chancellor's main opportunity to address serious economic problems. The blackspot in the UK remains unemployment: companies are continuing to shed large numbers of jobs. The main focus of the Budget on March 18 should therefore be job-creation. The task is to find non-inflationary ways of increasing employment.

Since the seriousness of unemployment—in both human and economic terms—is directly related to its duration, the priority should be to reduce long-term unemployment. This has been growing steadily more acute. More than 500,000 people have been without work for at least three years; 1.4m have been jobless for at least 12 months. It is difficult to maintain that all that can be done to alleviate this problem is being done. The Community Programme has so far filled only 175,000 places; expansion to 230,000 is planned. Yet this hardly measures up to the problem. Fewer than one in six of the long-term unemployed are touched by any government programme.

Long spells

A convincing solution may require an unaccustomed touch of iconoclasm from the Government and the abandoning of some prejudices. The private sector needs to be mobilised to help the long-term unemployed (at present all but 2 per cent of Community Programme schemes are run by the public and voluntary sectors). If private employers are to be encouraged in a big way, the Government may need to overcome its distaste for direct employment subsidies for companies. These involve "dead-weight" costs; some jobs would be created anyway and so some public money is thrown away. But the alternative is to waste more on benefits for the totally unproductive.

The economic case for subsidies is bolstered by the fact that people's skills deteriorate after long spells of unemployment, making them less attractive to private employers. The Government should heed the advice of the Commons Employment Select Committee. It argues that any employer willing to give a long-term unemployed person a job for a year (and not cheat by reducing his non-subsidised employment) should be offered £40 a week (the average cost of benefits). It would be helpful if the subsidy could also be linked to a promise to provide training of some sort. Such a measure—although open to some abuse—might be expected to create about 350,000 jobs at an estimated cost per job of only £4,000 (less than a tenth the cost of job creation through general reflation).

A second source of jobs for the long-term unemployed, emphasised by both the select committee and the independent Employment Instiute, lies in urban rehabilitation, house renovation and building projects. The Government could subsidise both private and local authority employers willing to take on the long-term jobless to do such work. The problem of ensuring "additionality" would again be acute, but it is worth facing simply because there are so few credible alternatives. About 300,000 jobs might be created at a net cost per job of about £5,000.

Natural source

Another prejudice which the Government needs to overcome is that public sector employment is invariably bad. Social services are a natural source of relatively unskilled jobs for the long-term unemployed. There is a shortage of helpers and carers for the elderly, disabled and recently discharged from hospital that will intensify as the planned shift from "institutional" to "community" care gathers pace. These personal service jobs could provide employment for at least 100,000 again at an estimated net cost per job of about £4,000. It would be irrational to rule out such employment simply because it would be mainly in the public sector—through the NHS and local authorities.

These proposals, soberly discussed by the select committee, are not outlandish. Some Cabinet ministers are reportedly already showing enthusiasm for such schemes. Phased in over three years they would cost about £3.5bn—well within the expected scope for tax cuts over this horizon. There is a sporting chance they would create nearly 750,000 jobs: enough to break the back of the long-term unemployment problem. If the Budget is to address the country's main economic headache, it cannot ignore the case for robust initiatives of this type.

WEDNESDAY 15th JANUARY 1986.

FINANCIAL TIMES

Wages, taxes and jobs

THE Confederation of British Industry does not want a cut in the standard rate of income tax this year. It has even deferred its often-repeated request for a cut in employers' social charges. Instead, it wants a package of job creation measures costing about £1bn, and a sizeable real increase in personal tax allowances, to give the maximum benefit and working incentive at the bottom end of the wage scale. It is not, of course, at this stage campaigning for its own radical proposals for a move towards an expenditure tax, which have yet to be put to its own members.

This restrained set of proposals not only confirms that weare in a new era of realism from the CBI, which used routinely to ask for the moon, but that this realism is now supported by a growing sense of responsibility. The employers acknowledge in so many words that competitiveness is largely up to them to achieve, and admit implicitly that since they have given dangerously much at the bargaining table, there is no economic case for any general tax concession to earners this year. This further implies that the reductions in taxes and interest rates which they still favour in the long term will be justified when—and only when—a more moderate wage trend has been established.

EEC strategy

This is a line of reasoning which should appeal strongly to the Chancellor in his economic role, though it may well not match the Government's political priorities. As a strategy of combined restraint and job creation, keeping some fiscal powder dry to boost demand should the growth of real incomes slow down, it looks to the medium term. Indeed, the one important question which arises is whether it goes far enough.

It is revealing to compare the CBI's approach with the strategy proposed by the European Commission in its recent annual economic review. This puts the issue of wages and taxation not in the context of competitiveness, which is a somewhat insular concern within Europe, but of long-term job creation. The main proposals are similar in principle —wage moderation offset by some fiscal support for demand; but the analysis and the consequent numbers are different.

The Commission is above all worried by the tendency throughout Europe for investment to go mainly to labour substitution rather than the expansion of capacity, and thus to the destruction rather than the creation of jobs. This is seen mainly as a result of excessive wage increases, compressing the share of profit in the economy. In most European countries, as in Britain until 1984, governments have sought to offset the pressure on profits by tax concessions designed to encourage investment. This has only sharpened the incentive to substitute machines for men, as Mr Lawson has already recognised.

Indeed, the EEC's fiscal approach is very like Mr Lawson's — its stress is on simplification and fiscal neutrality, and the removal of subsidies and other distortions on the spending side. On wages and taxes, however, it takes the CBI line and projects it a good deal further. It argues that since it is necessary to restore profit incentives for expansion, wages should not simply be restrained, but restrained below the growth of national productivity — rather than, as the CBI proposes, brought into line with productivity.

Fiscal adjustment should be used as far as prudence permits to maintain the growth of demand.

In the words of Dr Heinrich Matthes, second-in-command of economics in Brussels, productivity bargaining, so well-rooted in the country as economically enlightened, is a misleading paradigm when labour is overabundant; it simply perpetuates the over-pricing of labour which sustains labour-substitution. The experience of the US, Japan and West Germany seems to confirm this analysis. The CBI is now on the road to the same conclusion: if it can express it in action, that will be more important than any tax adjustment in creating jobs.

92:1

pep

FROM: MISS M O'MARA
DATE: 18 MARCH 1986

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Mr Scholar
Mr Culpin
A/41

1986 BUDGET: KEY FACTS AND FIGURES

I attach a note which pulls out some of the key points and more interesting statistics from the Budget Brief. It does not purport to be a full or balanced summary but simply attempts to extract some of the more interesting information which might otherwise be buried in the welter of material.

MOM

MISS M O'MARA

Industry Act forecast

	per cent changes 1985 to 1986
GDP	3
of which manufacturing	3
Inflation	
1985Q4 to 1986Q4	3½
1986Q2 to 1987Q2	3½
Balance of payments £billion	
1986	3½
1987H1 (at ar)	1½
PSBR £billion	
1985-86	7
1986-87	7

(i) Six years to 1987H1 forecast to show nearly 3 per cent annual growth.

(ii) 1986 forecast to be best combined performance on growth and inflation for a generation.

(iii) Growth balanced: investment and exports forecast to grow faster than consumption.

(iv) Growth in non-oil GDP, adjusted for coal strike, is 2½ per cent in 1985; forecast to grow at 2½ per cent in 1986 and 3 per cent in year to 1987H1.

Assumptions

(a) Sterling will not change much from present level either in dollar or effective terms

(b) Oil prices, both North Sea and world, average $15/bl for rest of 1986 and in 1987.

Manufacturing

- Productivity growth since 1979 three times that under Labour Government.
- Profitability highest since 1973.
- Manufactured export volumes up 6 per cent 1985 and further 6 per cent expected in 1986. Since 1981 volume grown at least as fast as world trade in manufactures which itself has grown very fast. 1974-79 growth only half that of world trade.
- No previous 5 year period in recent history in which manufacturing industry so successful in holding market share and keeping pace with world output.
- Output up 3 per cent in 1985 and expected to grow further 3 per cent in 1986. Same growth since trough as major competitors.
- CBI Trends Enquiry best combined response on prospects for output and prices since began in 1975.
- Manufacturing stands to gain from oil price fall in terms of cheaper raw materials and exchange rate adjustment.

Key facts about oil

Brent spot prices	$	£
March 1985	28.0	24.9
First half of March (average) 1986	14.4	9.9

Per cent change in Brent spot price		
From March 1985 to first half March 1986	-49	-60
From November 1985 to first half of March 1986	-52	-52

Real oil prices

- currently at lowest level since 1973
- currently about 60 per cent below peak in 1981-82

Petrol prices: Pump prices down around 15p a gallon since November 1985. Since November 1985 crude oil prices fallen by about 50 per cent in sterling terms. Much smaller fall in petrol prices implies large increase in margins.

Budget duty increase on petrol 7.5p a gallon - 8 per cent up, compared with 5.7 per cent increase under straight revalorisation. But no need for any of increase to be passed to consumer, given fat in companies' margins.

10 per cent fall in pump prices reduces RPI directly by about ½ per cent.

Contribution to GNP: about 5 per cent in 1985. Expected to be 2½ per cent in 1986.

Share of North Sea revenues in total tax and NIC receipts: 8½ per cent in 1985-86. Expected to fall to 4 per cent in 1986-87.

North Sea investment: 5 per cent of total UK capital investment in 1985. Expected to recover in 1986 to level similar to that in 1984.

Net oil exports: 8 per cent of total exports of goods and services in 1985.

Employment: Offshore employment in 1985 30,000.

Effect on GDP

- contributed under ½ per cent a year to average growth rate of economy of about 3 per cent a year (1981H1-19852). Contributed about 1 per cent a year 1975-79;
- fall in oil output between 1986H1 and 1987H1 may cut total GDP growth by over ½ per cent.

Beneficial effects of lower oil prices

Encourage higher world trade and output; lower world inflation.

Overall effect on UK economic activity and inflation broadly neutral - if anything, slightly beneficial.

Companies gain through reductions in raw materials and energy costs. Sustained $1/bl fall in crude oil prices reduces industry's costs by over £100 million a year. Associated fall in exchange rate helps competitiveness.

Consumers gain through lower prices.

North Sea tax revenues

	1984-85	1985-86	1986-87	1987-88	1988-89	1989-90
1985 FSBR	12	13½	11½	9½	8½	not app
1986 FSBR	12	11½	6	4	4	4

Ready reckoners

	1986-87	£million full year
$1 barrel difference in oil price on average in 1986 ceteris paribus	400	500
1 per cent difference in $/£ exchange rate on average in 1986	65	75
1 million tonnes difference in production in 1986 spread evenly	55	60

How do the figures add up?

1986-87

	£billion	Or	£billion
Oil revenues	-5½	Fiscal adjustment in 1985 MTFS	+3½
Other taxes and contributions before Budget package	+3½	Oil revenues	-5½
	-2		-2
		Other taxes and contributions before Budget package	+3½
			+1½
Budget package	-1	Budget package	-1
PSBR reduction	- ½	PSBR reduction	- ½
Equals fiscal adjustment in 1985 MTFS	-3½		0

In 1987-88 and 1988-89 similar picture but

- increase in non-oil receipts greater;
- leaves annual fiscal adjustment of £2 billion in 1987-88 and £4 billion in 1988-89.

Non-North Sea revenues higher in 1986-87 than forecast in 1985 FSBR because

Non-oil money GDP forecast £13-14 billion higher in 1986-87:

(a) level expected to be £8 billion higher in 1985-86;

(b) growth forecast higher between 1985-86 and 1986-87 (9½ per cent compared with 8 per cent in 1985 MTFS). Reflects higher non-oil output, profits and earnings, partly due to increases in 1985-86 levels and partly other factors eg lower oil prices.

£3½ billion increase in non-North Sea revenues represents around 25 per cent of extra money GDP - reasonable average for overall marginal tax rate on persons, companies, consumption (VAT) etc.

In particular:

- expenditure and capital taxes: £1½ billion higher in 1985-86, feeds through into 1986-87;
- personal taxes would have increased significantly before 1986 Budget measures, given growth in money incomes;
- company profits (of non-oil ICCs) expected to be 20 per cent up in 1985, affecting CT in 1986-87, compared with 12 per cent in 1985 FSBR.

Public expenditure

	1985-86 (estimated outturn)	1986-87 (plan)	1987-88 (plan)	1988-89 (plan)
Planning total				
1986 PEWP	134.2	139.1	143.9	148.7
FSBR	133.9	139.1	143.9	148.7
real terms	126.3	126.6	126.2	126.0
GGE				
1986 PEWP	158.2	163.6	168.9	174.7
FSBR	157.7	163.4	170	175
as % GDP	44	42½	41½	40½

(i) Real terms fall in 1985-86 planning total of £3.3 billion compared to 1984-85. First break in upward trend since 1977-78.

(ii) GGE in 1985-86 lower percentage of GDP than in any year since 1979-80

(iii) By 1988-89, GGE lowest percentage of GDP since 1972-73.

MTFS

£billion

(a) PSBR

	1985-86	1986-87	1987-88	1988-89 MTFS projections	1989-90
PSBR	7	7	7	7	7
% of GDP	2	1¾	1¾	1½	1½

(i) PSBR averaged 3¾ per cent of GDP under this Government. Averaged nearly 7 per cent under Labour Government.

(ii) PSBR in 1985-86 lowest percentage of GDP (2 per cent) since 1971-72 - even if privatisation proceeds excluded (3 per cent).

(b) Output/inflation split

Percentage change on previous financial year

	1979-80	1984-85	1985-86
RPI	15.8	5.1	5.9
Real GDP	2.7	2.6	3.4

(c) Growth of money GDP

Percentage change on previous financial year

1979-80	1985-86	1986-87 estimate	1987-88	1988-89 MTFS projections	1989-90
19.7	9.6	6¾	6½	6	5½

Over past six years, rate of growth of money GDP halved.

Income tax

Allowances in 1986-87

	£
Married man's	3,655
Single (and wife's earned income)	2,335
Age: married	4,505
Age: single	2,850

Threshold for 40 per cent rate increased in line with statutory indexation. All higher rate thresholds increased by £1,000.

Allowances up 22 per cent in real terms under this Government.
Real value of married man's allowance highest since War.

Some 550,000 fewer taxpayers than if allowances had remained at 1985-86 levels.

1.4 million fewer taxpayers in 1986-87 compared with indexed 1978-79 regime.

Elderly

July transitional uprating for retirement and widows' pensions completely exempt from income tax. About 3½ million benefit.

Age allowance over 10 per cent higher in real terms than in 1978-79.

About 60 per cent of elderly households will pay no tax. About 60,000 fewer widows wil pay tax in 1986-87, compared with no change in allowances.

Basic rate cut

Improves incentives for over 20 million taxpayers of working age (95 per cent of total) whose marginal rate is basic rate. Also true of 90 per cent of unincorporated businesses/self employed.

Improves incentives for more people than equivalent increase in allowances (same money would have paid for allowance increase of 5.4 per cent above indexation).

29 per cent is lowest basic/standard rate of increase tax since before War. (NB lower reduced rates in 1950s were marginal rates for majority of taxpayers.)

Basic rate cut more than equal cost increase in allowance to single person at over 60 per cent average earnings (£115 a week), married man at over 90 per cent average earnings (£180 a week).

Reduced rate band

(i) Very costly. For 1p off basic rate, band of only £1,000 at 25 per cent.

(ii) Would reduce marginal rates of for single earning less than £64 a week; married earning less than £90 a week ie only 2.3 million taxpayers. Basic rate improves incentives for 20.4 million.

(iii) Additional compliance costs for employers. Need up to 12 months' notice to adjust payroll systems. (Also heavy administrative costs for Inland Revenue.)

Typical weekly tax reductions for basic rate tax payers
£per week

Income £ per week	Single	Married
100	1.30	1.45
150	1.80	1.95
200	2.30	2.45
250	2.80	2.95

In pay packets on first pay day after 17 May.

Income tax burden down for all in 1986-87, compared with indexed 1978-79 regime.

Highest paid

60 per cent taxpayer gains only 23p a week more than under statutory indexation with no basic rate cut (because less than full indexation of higher bands).

Gains as large for lowest paid as for those at top of basic rate band in terms of percentage of income taken in tax.

Compared with average reduction in tax liability, those with incomes over £30,000 will do less well in 1986-87 than in 1985-86.

Green Paper on Personal Tax Reform

One earner married couples with man sole earner: would gain substantially.

Two-earner married couples: no cash loss. Where wife currently earns less than single allowance would gain.

One earner married couples where wife is sole earner: no cash loss.

62.4 per cent of married women of working age in paid work or looking for it

Of rest: 66 per cent looking after children or other relatives;
5 per cent permanently unable to work;
only 12 per cent under 50 and keeping house.

Indirect taxes

Petrol duty up by 7.5p a gallon
Derv up by 6.5p a gallon
Cigarettes up a little over 11p a packet of 20
Small changes in minor oil and VED duties

Alcoholic duties unchanged
Pipe tobacco and cigars unchanged.
Car and main lorry VED unchanged

Duty abolished on aviation kerosene and most lubricating oil.

VAT registration threshold up in line with inflation to £20,500 a year.

Annual petrol bill

Typical private and rural motorist both up by £22 of which £16 due to revalorisation.

Increase over revalorisation offset by no increase in VED, worth nearly £6 compared with revalorisation.

Employment measures

Restart Programme:	pilots extended to whole country; offers interviews to all long term unemployed, places on employment or training schemes or in Jobclubs or 1-2 week Restart training courses; Jobstart allowance of £20 a week taxable for six months to those with full time job of £80 a week or less; of those so far interviewed on pilot schemes, 92 per cent have been made a position offer; £100 million 1986-87; £70 million 1987-88.
Community Programme:	currently about 200,000 places; current target 230,000 places by June 1986; Budget increase to 255,000 places in 1986 plus increase in average wage limit from £63 a week to £67 a week; Ex CP workers twice as likely to get jobs as other long term unemployed; £60 million 1986-87; £120 million 1987-88.
New Workers Scheme:	introduced from 1 April 1980; £15 a week allowance for 12 months for employers of 18-19 year olds earning £55 a week or less and 20 year olds earning £65 a week or less; provision for up to 100,000 entrants in 1987-88. £25 million 1986-87; £50 million 1987-88
Enterprise Allowance Scheme:	current annual entry about 65,000; current target 80,000 by April 1987; Budget increase to 100,000 and improved tax treatment of Allowance; after 3 years, 3 out of 5 businesses still trading. Every 100 of those create 99 extra jobs; £5 million in 1986-87; £35 million in 1987-88.
Also: Loan Guarantee Scheme:	16,600 loans guaranteed to end February worth £540 million; Scheme extended for 3 years and premium halved to 2½ per cent; negligible cost 1986-87; £5 million 1987-88.

Business Expansion Scheme

1983-84: Investment of £105 million in 715 companies

1984-85: Investment of £135 million in 688 companies
(Preliminary figures; final results will be higher.)

Peats study Showed

(a) Finance

- 72 per cent of companies raising finance under 5 years old.
- 54 per cent raised £50,000 or less.

(b) Trades

- 42 per cent of companies in manufacturing.
- 30 per cent in services.

(c) Geographical spread

- 39 per cent of investment made in South East.
- Average of 5 per cent for other regions.

Peats found almost half investment would not have been raised in any form without Scheme and over 70 per cent would not have been raised as equity.

Extrapolating, one year after BES issue, over 4,000 jobs and £100 million extra turnover could be attributed to Scheme.

"Big Bang"

International comparison of current dealing costs (£100,000 buy/sell)
per cent

UK	$2\frac{1}{2}$
Japan	$1\frac{3}{4}$
US	1

Stamp duty reduction will bring UK costs down to $1\frac{3}{4}$ per cent.

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19 March 1986

1% Off Basic Rate

BUDGET SPECIAL

Lawson leads the Bull

Budget contents....

NET TAX CUTS	About £1bn from an indexed base in 1986/87.
PSBR TARGET	Little changed at £7bn for 1986/87 (1.75% of GDP).
MONETARY GUIDELINES	For 1986/87: M0 range 2-6%, £M3 range 11-15%.
EMPLOYMENT MEASURES	Further measures and expansion of existing schemes to help the unemployed. The gross cost of these will be £195m in 1986/87 and £290m in the following year.
CTT	Abolished for lifetime gifts. Gifts within seven years of death will be charged but with taper relief.
STAMP DUTY	To be reduced to 0.5% (from 1%) on share transactions from October 1986. However, duty will be charged for the first time on allotment letters and intra account dealing. With immediate effect, 0.5% duty will be charged on certain loan stocks and takeovers. Furthermore, a 5% duty will be imposed when shares are converted into depository receipts.
WIDER SHARE OWNERSHIP	Individuals can invest up to £2,400 each year in equities and will be free of tax on capital gains and reinvested dividend income if held for a full calendar year.
PENSION FUND SURPLUSES	Rules relating to the treatment of surpluses have been clarified. Refunds to employers will be subject to 40% tax.
EXCISE DUTIES	Petrol up 7½p per gallon. Cigarettes up 11p per 20. Alcoholic drinks unchanged. In total, changes in duty will raise £800m in 1986/87 from a non-indexed base, but only £130m after indexation.
INCOME TAX	Personal allowances up in line with inflation. Higher rate bands up £1,000. Basic rate down from 30% to 29%. These will cost about £850m after indexation in 1986/87.

Extracts of this note can be found on the P&D *Closed User TOPIC* **service. See page* 3003 #**

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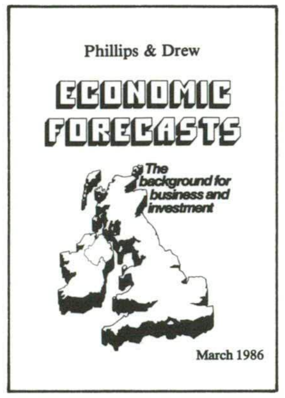
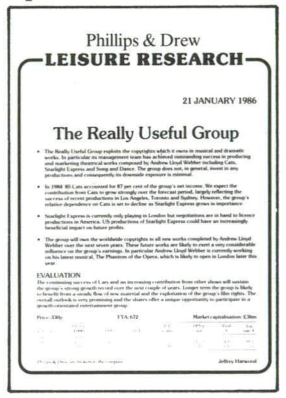
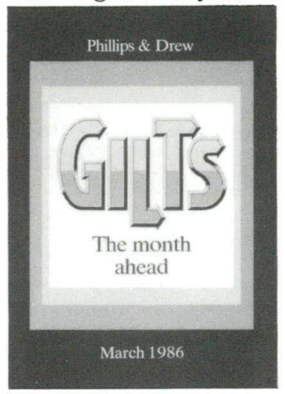
Economic Forecasts



Special Studies



Gilt-Edged Analyses



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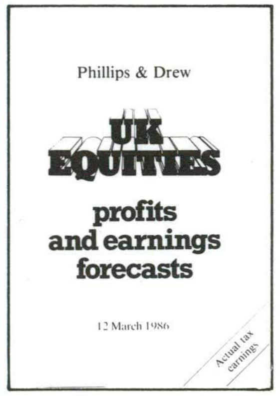

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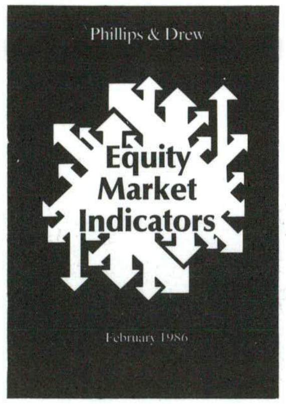

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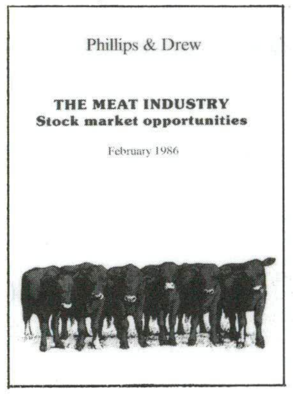

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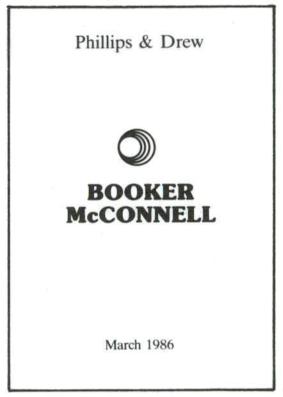

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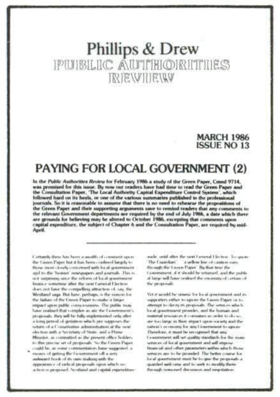

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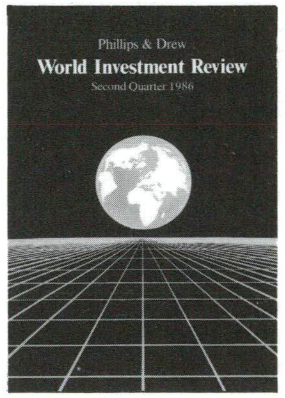
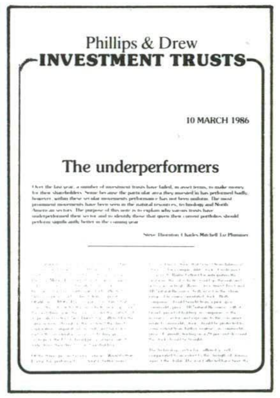
International Review



Eurosterling Bonds

Investment Trusts



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Photoset and Printed by Apollo Offset Limited, 53 Curtain Road, London EC2

Fixed interest securities *Eddie O'Sullivan*

The Chancellor has decided to reintroduce stamp duty on certain fixed interest securities. Stamp duty is to be levied on qualifying stocks at a rate of 0.5% on all bargains settled after 25 April 1986.

SECURITIES EXEMPT FROM STAMP DUTY

- Gilt-edged securities.
- Eurosterling securities.
- Supra-national bulldogs.
- Bulldogs dealt in bearer form.
- Securities issued with a maturity of less than five years.

Securities that we expect to be free of stamp duty (except shorts) are shown in the tables.

The introduction of stamp duty on registered bulldogs is a retrograde step, especially as this comes two weeks before dealings under dual capacity start in this section of the market. An easy option for the Inland Revenue to adopt to avoid confusion, would be to redefine the section qualifying for exemption as 'Sterling Issues by Overseas Borrowers'. This has already been identified by The Stock Exchange as a separate section of the market place (ie Bulldog bonds).

DOMESTIC ISSUES

All domestic debentures and loans will be subject to 0.5% stamp duty from today (19 March).

Supra — national bulldogs

African Dev Bank	11 1/8%	2010	IADB	12 1/2%	2003
Asian Dev Bank	10 1/4%	2009	IADB	9 3/4%	2015
EIB	11%	2002	World Bank	11 1/2%	2003
EIB	10 3/8%	2004	World Bank	9 1/2%	2010

Bulldogs with bearer option

Australia	9 1/2%	2012	Greece	10 3/4%	2010
Australia	11 3/8%	2015	INCO	15 3/4%	2006
Credit National	13 1/2%	1989	Ireland	12 1/2%	2008
Credit National	13 1/2%	1993	Malaysia	10 3/4%	2009
CNA	16%	2006	Mexico	16 1/2%	1988/08
CFF	14 3/4%	2007	N Zealand	11 1/4%	2008
CFF	10 1/4%	2011/14	N Zealand	11 1/2%	2014
CCCE	12 1/4%	2013	Spain	11 3/4%	2010
Eaton Finance	12 1/2%	2014	Sweden	9 3/4%	2014
EDF	11 3/4%	2009/12	Sweden	11%	2014
EDF	12 1/2%	2008	Sweden	13 1/2%	2010
Finland	11 1/2%	2009	Trinidad	12 1/4%	1989/09

The reintroduction of stamp duty on domestic issues will result in these securities being regarded less favourably by investors than those from overseas borrowers and therefore is likely to increase their yield margin over gilts. Given that the biggest deterrent to domestic borrowers accessing the fixed interest market has been high long-term interest rates, it seems ludicrous that the Chancellor should slap a tax on this section of the market just when he has achieved a level of long-term interest rates that could tempt companies to borrow.

THE ADR DUTY IMPOSITION

David Bailey

The Chancellor proposed that 'duty will be charged at 5% on the conversion of shares into depository receipts' with effect from 19 March 1986. This has fatal implications for ADR arbitrage operations, which were anyway expected to vanish after 'Big Bang'. The Chancellor intends, by this move, to pull foreign activity in leading UK stocks back into London, although this constraint on 'free markets' seems contrary to Tory philosophy. The total abolition of stamp duty was, presumably, too expensive an option.

The impact of the decision should be to create a small premium on the pool of existing ADRs as US investors who are unable to buy the registered shares bid up the ADR price, while unrestricted holders of ADRs would arbitrage back into the registered if the premium rose too high. Prospective ADR flotations are much more seriously affected and it is difficult to foresee any increase in the current number of stocks with ADRs, as sponsored issues would presumably require shareholders to sanction the issue of shares to the sponsoring bank at a sizeable discount, while unsponsored dealings would have an inherent major disadvantage.

Companies which had planned an ADR marketing included Wellcome and Plessey. Wellcome, in particular, has performed well in anticipation of US buying and, while the payment of the current 1% stamp duty through buying the UK registered stock will not be relished, it is only at the margin that we would expect US enthusiasm to be dampened.

. . . . Budget consequences

★ **The Chancellor is rightly optimistic about the growth and inflation prospects for 1986.**

★ **We also subscribe to his growth forecast for 1987, but we must part company on inflation. His assumption of inflation sinking towards 3% as the election approaches looks rather fanciful to us.**

★ **We think — contrary to the Chancellor — that the balance of payments may yet emerge as a problem during 1987.**

★ **The Budget leaves the way clear for an early 1% reduction in base rates. The £M3 target gives companies and individuals a licence to borrow.**

★ **The overall Government funding burden, including privatisation sales, will be heavier in the year ahead, but gilts are likely to be impressed — at least initially — by the prospect of a £7bn PSBR. Achievement of the latter depends upon continuation of the recent extraordinary buoyancy of non-oil tax revenues.**

★ **There is nothing for the equity bears to chew on in this Budget. The promise of stronger growth, lower inflation and a big give-away next year makes a heady combination for investors. The old bull still lives!**

★ **The Chancellor's proposals include added PEP — in the form of a Personal Equity Plan designed to stimulate private share ownership.**

★ **Gamblers and drinkers are offered absolution — but no let-up on the dwindling band of cigarette smokers. Overall, the Chancellor has shown more mercy on the consumer than might have been expected.**

★ **The Chancellor has acknowledged the implications of Big Bang in cutting stamp duty by half. His swingeing attack on ADRs provides further cushioning for the London market.**

★ **The clear winners — if only by default — are the brewers, where we favour Bass, S&N and Whitbread, and also the banks, where we like Lloyds and Midland. The prospect of lower interest rates should also encourage the builders, such as Blue Circle and Tarmac.**

Economic and financial outlook

Bill Martin

Judged by its modest impact on growth, this was a largely neutral Budget. Neutral, but not neutered. By deft handling of his tax measures, Mr Lawson went some way towards satisfying the Government's longer-term objective to bring down the basic rate of income tax, while providing a modest boost to jobs. At the same time, the Chancellor has rightly resisted the siren calls for large increases in public borrowing or for the bringing forward of substantial handouts from future years. He has indeed been laudably cautious on his Budget arithmetic. While Mr Lawson's performance yesterday is unlikely to leave financial markets ecstatic, they should at least experience a warm after-glow.

The arithmetic

With oil revenues sliding away and with huge uncertainties over the likely path of oil prices, the Chancellor must have been sorely tempted to fudge the Budget arithmetic. We are happy to find that the temptation has been largely, though not wholly, resisted. Mr Lawson reckons that his modest net fiscal injection, worth £1bn in 1986/87, over and above the cost of indexation of allowances and revalorisation of duties, is consistent with a 1986/87 PSBR target of £7.1bn, 1.75% of GDP.

The new PSBR target is little changed from the £7.5bn number pencilled into last year's Medium Term Financial Strategy. Since then, however, the Government has announced an extra £2.5bn of asset sales for 1986/87, so that £7.5bn figure should have been reduced to £5bn, 1.25% of GDP. The increase in the effective PSBR target from £5bn to £7bn represents, to our mind, a modest relaxation against previous plans.

The public spending plans are similarly distorted by the extra privatisation receipts, disguising a rise since the 1985 Budget in planned programme expenditure. Yesterday's announced public spending figures are essentially those presented in the Autumn Statement and January White Paper, but now include the extra £100m to be spent in 1986/87 on job creation schemes. This cost will be met out of the contingency reserve. The reserve nevertheless remains substantial at nearly £4.5bn in 1986/87. Even so, we cannot share the Chancellor's optimism that public spending will broadly stabilise in real terms after years of significant and unplanned real growth. After allowing for debt interest payments, we expect total general government expenditure, the spending concept used in the MTFS, to overshoot by £1bn in 1986/87, and by £2.5bn in 1987/88.

General government spending

FY	*1985*		*1986*			*1987*		
£bn cash	*A*	*B*	*A*	*B*	*C*	*A*	*B*	*C*
Planning total	134	134	139	139	140	144	144	146.5
Debt interest	18	18	18	18	18	18.5	19	19
Other	7.5	6	7	6	6	6.5	7	7
Total*	159.5	158	164	163	164	169	170	172.5

A = 1985 Budget estimate; B = 1986 Budget estimate; C = P&D estimate. * Subject to rounding error.

General government receipts

FY	*1985*		*1986*			*1987*		
£bn cash	*A*	*B*	*A*	*B*	*C*	*A*	*B*	*C*
North Sea tax	13.5	11.5	11.5	6	6	9.5	4	4
Non-oil taxes	124.5	125.5	135	138	137	145.5	148	147.5
Int receipts etc	12	12	12.5	12	12.5	13	12	12.5
Accruals adj	–	–	–0.5	–	–	–	–	–
Total*	150	150	159	156	155.5	168	164	164

A = 1985 Budget estimate; B = 1986 Budget estimate; C = P&D estimate. * Subject to rounding error.

On the revenue side, the Chancellor has been helped out by the buoyancy in non-oil revenues which has contributed to the reduction in the estimated PSBR outturn for 1985/86 from the £8bn forecast in the Autumn Statement to £6.8bn. The assumption that non-oil revenues will rise somewhat in excess of money GDP growth is reasonable. The Chancellor is also to be commended on the assumptions which he has used to project North Sea oil revenues. The Brent oil price is put by the Treasury at $15 from now onwards, while the sterling/dollar rate is assumed not to change much. This leaves it, presumably, at around $1.45. Every $1 fall in the oil price would reduce North Sea revenues in 1986/87 by £400m at unchanged exchange rates. However, if OPEC finally manages to restore order to oil markets, the chance is that the price could bounce above $15. Mr Lawson would then have more scope than he currently plans for tax cuts in later years.

On balance, the Chancellor's PSBR target for 1986/87 looks more like £8.5bn rather than £7bn, because of public spending pressures. The public sector financial deficit (PSFD), a more appropriate measure of fiscal stance which is net of special asset sales, is put at £12.2bn, 3% of GDP, on the Chancellor's analysis; £13.5bn, 3.5% of GDP on ours. Our figuring also suggests that the PSFD will have risen over the next two years relative to the likely outturn in 1985. These borrowing numbers are higher than we would like to see but we believe financial markets will forgive the Chancellor as long as inflation prospects remain favourable.

STAMP DUTY

Trevor May

By halving stamp duty on share purchases to 0.5%, the Chancellor aims to assist the London Stock Exchange to maintain a leading position in rapidly changing global markets. In terms of capitalisation and turnover, London is the third largest exchange in the world; however, in terms of turnover per stock it ranks much lower and high transaction costs must be considered as a major factor — the changes proposed will reduce transaction costs and hence stimulate turnover. Since the last reduction in stamp duty in 1983, activity in relation to market capitalisation has risen by 50% and it is widely anticipated that this latest reduction will also have a beneficial effect.

As well as increasing turnover, lower transaction costs will increase the attraction of equities relative to other forms of investment such as bonds and consequently exert upward pressure on equity prices. This prospect is reinforced by the Chancellor's decision to impose an extra 0.5% transaction tax on long-dated loan stock deals and also not to reduce stamp duty on property purchase (and by implication on property unit trusts). Nonetheless, some offset to these equity market benefits is found in the decision to levy the 0.5% stamp duty on share transactions closed within a stock exchange account which were previously exempt.

The majority of changes will be implemented in the autumn to coincide with the City 'Big Bang', the uncertain influences of which could, in themselves, stimulate activity to a greater extent than the changes in stamp duty. Hence, we consider that the changes announced by the Chancellor will assist the London Stock Exchange to maintain a strong position in global markets during the forthcoming turbulence and should be viewed in this context rather than simply in terms of the extra activity generated.

PENSION FUND SURPLUSES

Bob Barber

The main points arising from the Budget are as follows.

- Excess surpluses will no longer be allowed to accumulate. Funds must be valued using a 'Projected Unit Credit' basis similar to that used by the Government Actuary for state pension purposes. Any surplus must be reduced to a figure of no more than 5%.
- Normally, the actuarial valuation will be carried out every three years. No scheme will be required to make an adjustment before 6 April 1987.
- Surpluses can be reduced by either improving benefits, lowering employer/employee contributions or else repaying the surpluses to the company.
- Any surpluses repaid to the company will be subject to 40% taxation (no offset allowable).

We expect a stepping-up in the number of announcements about future pension contribution holidays or, possibly, repayments. We have examined likely beneficiaries using three criteria:

- pension contributions as a percentage of payroll,
- the rate at which labour has been shed in recent years,
- contributions as a percentage of the company's market capitalisation.

The following is the list of companies that we believe should benefit from the Chancellor's action and which have not yet made any announcements concerning their pension funds.

Possible beneficiaries

%	*Contribution/ payroll*	*Rate of job loss pa*	*Contribution/ market cap*
Birmid Qualcast	7	10	5
Babcock Int	5	9	6
Delta	8	8	3
AE	5	10	4
GKN	5	10	3

For comparative purposes, we give below the data for those companies which have already announced contribution holidays and whose shares have risen as a consequence.

Companies having announced contribution holidays

%	*Contribution/ payroll*	*Rate of job loss pa*	*Contribution/ market cap*
Lucas	8	7	7
TI	7	10	6
Armstrong	5	9	2

Personal Equity Plan *Andrew Goodwin*

The proposals for a 'Personal Equity Plan' (PEP) give individuals, as from January 1987, the opportunity to invest up to £200/month or £2,400/year in equities without paying any capital gains tax or income tax on dividends, provided the investment is held throughout the calendar year following the year of purchase. Although not nearly as tax-advantageous as the various 'Monory Laws' introduced in several European countries, where investments are allowable to some degree against taxable income, these changes will no doubt encourage additional personal investment. It should, however, be remembered that given the very high capital gains tax exemption (now £6,300 pa), the tax advantages are fairly small.

Life companies offering regular premium unit-linked policies and unit trust groups may well see a loss of business to the more tax-advantageous PEP as unit trusts are not deemed to be shares. As last year regular premium unit-linked business was in excess of 20% of all new life business, this could have significant implications for the life insurance industry and in particular those companies with a major involvement in unit-linked products, ie Abbey Life, Equity & Law and Sun Life. Also those fund management groups with a preponderance of unit trust business could also be hit by these proposals.

Although a wide range of bodies will be able to register as plan managers, it is not at first sight clear who will be able to market the PEP most successfully. It is likely to be a high cost operation and, to this extent, banks, building societies and life companies, who are all used to high volume, low value transactions should be best placed. In addition, these companies all have good distribution networks and should be able to market successfully a plan, providing an attractive alternative to unit-linked investments.

High yielders

Company	*Market capitalisation £m*	*Historic yield %*
LASMO	235	12.2
Britoil	927	10.0
Enterprise Oil	296	8.9
BP	10,255	8.7
Harrisons & Crosfield	482	8.6
Ultramar	505	8.1
Electronic Rental	168	7.8
Powell Duffryn	165	7.7
Barratt Developments	256	7.6
BPCC	329	7.6
Midland Bank	1,140	7.4
Inchcape	301	7.3
United Newspapers	401	7.3
NEI	225	7.3
Consolidated Goldfields	945	7.2

In terms of individual stocks, there are two clear areas to consider, first, the companies who may manage these schemes and, secondly, the companies that individuals may invest in. As we have outlined above, these proposals do put a short-term cloud over the prospects for the unit-linked life insurance companies and the fund management groups, although the scope to operate as PEP managers should offset this. On the other side of the coin, the small investor is likely to be attracted, given the tax advantages, to high yielding, well-known stocks. We give a list above of all shares with a market capitalisation of over £100m, which are yielding more than 7%.

Clearly, in certain cases, the historic dividend may be cut. More attractive situations, which should appeal to the private individual, are BP and Midland Bank. In addition, investment trusts could also come back into favour as they will provide the individual with a broad spread of stocks whilst still coming under the definition of an equity within the meaning of the PEP.

DIVIDEND REINVESTMENT SCHEMES *Alastair Alcock*

The introduction of a Personal Equity Plan means that companies should seriously consider setting up dividend reinvestment schemes. These are common in the United States and BOC has introduced such a scheme in the United Kingdom. Investors are given the choice of taking a dividend or the equivalent worth of new shares in the company. As Personal Equity Plans grow, private investors will often opt to take the shares as part of the Plan and thereby receive the tax benefits of reinvesting their dividend income without incurring transaction costs.

CLEARING BANKS *Peter Toeman*

A key message of the Chancellor's speech is that the UK's economic health hinges on the well-being of the corporate sector. With this in mind, no doubt, he has refrained from singling out the banking sector for any special taxation measures such as those imposed in 1981 and again in 1984. Overall, therefore, a favourable Budget by omission rather than commission, providing further upside for bank shares. Despite recent rises the sector is still some way from its relative high against the All-Share Index.

By avoiding the temptation of a large increase in borrowing and big tax cuts this year, the Chancellor has given himself some scope for tax reductions in his 1987 Budget. He has pencilled in a 'fiscal adjustment' (Treasury code for tax cuts) of £2bn in 1987 with the PSBR at £7bn, 1.75% of GDP. On the assumption of a $15 a barrel oil price and some public overspending, we calculate that the Chancellor would in fact have room for only £1.5bn of tax cuts while leaving the PSBR outturn — at £9bn — around the same percentage of GDP as in 1986. If, however, the Treasury continues to enjoy the degree of success on control of public expenditure which it had in 1985/86, we could well be favourably surprised by the scale of tax reduction in next year's Budget.

Public sector borrowing

FY	*1985*		*1986*			*1987*		
£bn cash	*A*	*B*	*A*	*B*	*C*	*A*	*B*	*C*
General govt								
Expenditure	159.5	158	164	163	164	169	170	172.5
Receipts	150	150	159	156	155.5	168	164	164
FA cumulative	–	–	–	–	–	3.5	–	–
Annual FA	–	–	3.5	–	–	3	2	1.5
General govt borrowing	9.5	8	8.5	7	8.5	8	8	10
PCs borrowing	−2.5	−1	−1	–	–	−1	−1	−1
PSBR*	7	7	7.5	7	8.5	7	7	9
(% of GDP)	(2)	(2)	(2)	(1.75)	(2.25)	(1.75)	(1.75)	(2.25)
PSFD	10	10	n/a	12	13.5	n/a	n/a	14
(% of GDP)	(2.75)	(2.75)	n/a	(3)	(3.5)	n/a	n/a	(3.5)
Money GDP	354	358	377	382	382	399	407	407

A = 1985 Budget estimate; B = 1986 Budget estimate; C = P&D estimate. FA = Fiscal adjustment. * Subject to rounding error.

GROWTH AND INFLATION

Even though British households are unable to enjoy anything like the £3.5bn of tax cuts pencilled in for 1986 in last year's MTFS, British companies are getting their own tax cut in the form of lower oil costs and, as a result, a more competitive exchange rate. Indeed, lower oil prices are refreshing parts of the economy which Mr Lawson's own policies failed to reach. The result should be more sustainable and balanced growth in the economy over the next two years, with inflation at a tolerably low level. That growth, coupled with the Government's job creation measures, may also bring some reduction in unemployment though probably not below 3 million.

We estimate that the Budget measures will add directly less than 0.25% to real GDP over the next 12 months. The Chancellor's forecasts of 3% real expansion in 1986 and 2.5% in the first half of 1987 are both a little more optimistic than our own.

The main features of both forecasts are strong consumer spending coupled with a revival of investment growth. The Treasury expects more of both these components of demand in 1986, and are especially optimistic on investment. But, overall, we regard the differences in the forecast GDP growth rates as marginal and well within the usual range of forecaster's error (the Treasury's as well as ours!).

More substantial differences emerge on inflation. The Budget measures on excise duties add directly 0.5% to the RPI, the same as last year's Budget. The Chancellor is forecasting continued low inflation at 3.5% by the end of 1986 and in 1987Q2. These compare with our figures of about 4% and 4.5%, rising to 5% by end-1987.

Treasury and Phillips & Drew forecasts

	1985	*1986*			*1987*		
	year	*H1*	*H2*	*Year*	*H1*	*H2*	*Year*
Consumers' expenditure %							
Treasury	3.0	3.9	3.8	3.9	3.9	n/a	n/a
P&D	2.6	3.1	3.3	3.2	3.4	3.6	3.5
Fixed investment %							
Treasury	1.0	3.9	5.7	5.0	0.4	n/a	n/a
P&D	0.9	1.4	2.2	1.7	1.7	4.2	2.8
Exports (goods & services) %							
Treasury	6.0	3.5	6.3	4.9	3.1	n/a	n/a
P&D	6.0	1.3	4.7	3.0	3.1	2.4	2.7
Imports (goods & services) %							
Treasury	3.1	4.3	7.1	5.8	4.9	n/a	n/a
P&D	3.0	2.5	4.6	3.5	4.8	4.6	4.6
GDP (average est) %							
Treasury	3.3	2.8	3.3	3.1	2.4	n/a	n/a
P&D	3.4	2.3	2.4	2.4	2.2	2.2	2.2
B of P current account £bn							
Treasury	3.0	n/a	n/a	3.5	1.5*	n/a	n/a
P&D	3.0	0.3	0.1	0.4	−1.0	−1.1	−2.1
	Q4	*Q2*	*Q4*		*Q2*	*Q4*	
Retail price inflation %							
Treasury	5.5	n/a	3.5		3.5	n/a	
P&D	5.5	3.3	3.9		4.5	5.0	

* First half (at an annual rate).

The pick-up we foresee in the inflation rate next year stems from the 6% advance in unit wage costs, economy-wide, over the foreseeable future reflecting earnings growth of 7.5-8%. The Treasury is more optimistic than ourselves on prospects for world inflation and also, we suspect, for the path of earnings in 1987. (They are coy about spelling out explicitly their assumptions on pay.)

The stickiness of earnings remains a key difficulty for the UK. Earnings growth has been at 7.5% or more on an underlying basis since 1983, despite price inflation being at times as low as the rate now in prospect in 1986. As the graphs illustrate, it was only in the midst of recession, during the period of sharply rising unemployment and falling profit margins, that earnings fell below price increases. Since then, the flattening of the increase in unemployment has meant a significant relaxation of pressures in the labour market, now characterised by skill shortages and acute segmentation between those in and out of work. Rising profits went hand-in-hand with rising real incomes after 1981. The boost to company cash flow as a result of lower oil costs and lower sterling is almost certain to spill over into pay. Real wages are thus likely to continue their upward march.

It matters little, of course, that profitable companies should pay higher wages; the problem is that other companies feel bound to meet these higher rates in an economy experiencing reasonable growth, fairly tight labour market conditions and generally ample lines of credit, reflected in the rapid growth in broad money supply. A pick-up in pay remains a key threat to the Chancellor's inflation optimism. This is why we would have preferred a tighter budgetary stance. A tighter Budget would have helped to nip in the bud potential excess demand pressures and the consequential bidding-up of wages.

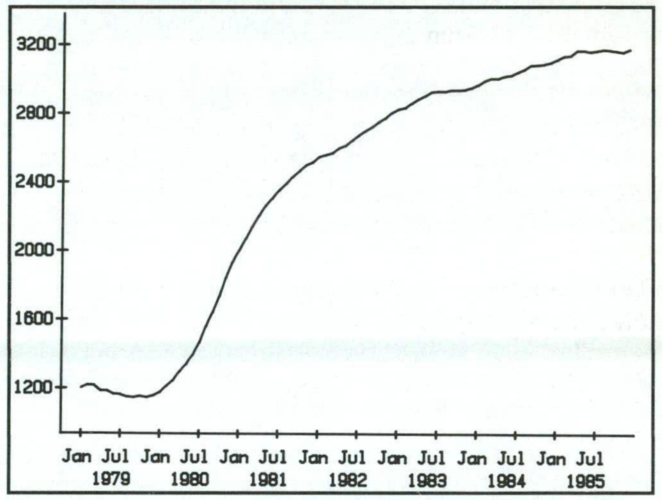
now?

STERLING AND INTEREST RATES

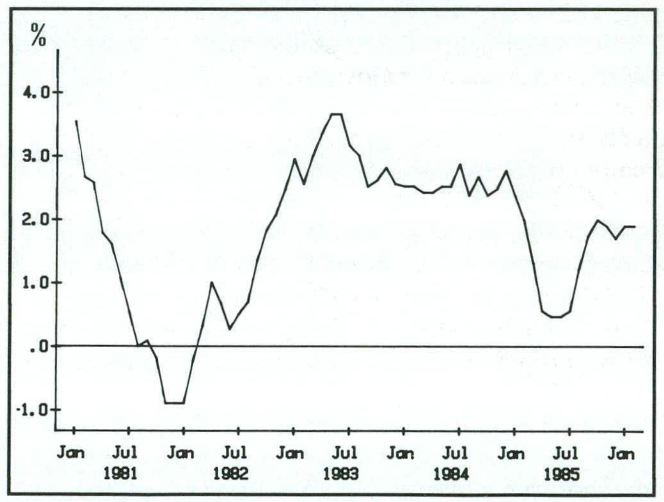
If our fears on pay come to pass, the Chancellor will have to rely on sterling remaining reasonably firm in order to deliver lower inflation. His Budget forecast assumes the effective rate remains broadly unchanged. One factor which could upset this assumption is a more rapid move into balance of payments deficit than the Treasury is currently forecasting.

Their forecast surplus of £3.5bn in 1986 compares with our expectation of a £0.5bn surplus on current account. Differences of even this magnitude are not especially significant given the range of past forecasting error (£2.5bn for the year ahead) and both the Treasury and ourselves could prove to be wide of the mark. However, nothing stands or falls by one year's number on the current account. Rather, it is the medium-term prospect of a deteriorating external position which we foresee which could eventually cause sterling to crack. Unless, that is, UK interest rates remain well above those of overseas competitors. Despite the fact that the Treasury is forecasting a much stronger external position than ourselves over the next 18 months, they appear to recognise the need for a considerable interest rate prop to sterling.

UK unemployment (thousands)



Underlying real earnings growth % p.a.



Judged by the housing element of the retail price index, the Treasury has built into its forecast only a modest reduction in UK base rates to perhaps 11% by end-1986 and to 10% by mid-1987. We doubt if even this level of interest rates would succeed in stabilising the exchange rate at around current levels, as the Treasury assumes.

Overall, thanks to the impact of lower oil prices on company profits and competitiveness, the UK's prospects look far rosier than they did but six months ago. No wonder the Chancellor sounded so happy yesterday despite the absence of a massive tax give-away. If Lawson's luck can deliver, in addition, moderate pay rises in the UK and a marked improvement in industrial performance against the overseas competition, supporting the UK's balance of payments, we will all have good reason to applaud.

RETAILERS

Alun Jones

The net injection into the personal sector at just under £1bn is slightly greater than was generally expected by the market, whilst lower interest rates now appear more probable. Against this background, we are raising our consumer spending forecasts, and now look for 3.2% real growth this year, compared with our earlier projection of 3%. The emphasis of the Chancellor's measures was towards helping the lower paid, implying that the main impact will be on basic areas of spending, but given the general buoyancy of consumer demand and the lower interest rate profile, we continue to look for the major volume gains to come in the durables sectors.

Although the outlook for the retail sector has improved slightly, profits growth at around 17% is unlikely to be significantly ahead of the market as a whole, given the boost to manufacturing sectors from the weakness in sterling and oil prices. Despite the apparently good retail sales figures for February, trade comment suggest that the underlying trend in sales is sluggish, whilst the forthcoming results season could well produce some disappointments. Against this background, we recommend reducing holdings in the sector.

Considering individual shares, we regard the sharp rise in the prices of Burton and Marks & Spencer as unjustified and suggest taking profits, whilst we remain cautious of Sears at current levels. By contrast, we see Harris Queensway as a major beneficiary of lower interest rates, with Storehouse and GUS, which are more marginal gainers from the Budget, also looking cheap. Amongst the food retailers both ASDA-MFI and Tesco look cheap and are likely to have gained from the measures.

CONVERTIBLES — GOOD NEWS

Jim Grantham

Good news for the convertibles market! Market liquidity should benefit from the reduction in stamp duty in the autumn to 0.5% and convertible switching will become more worthwhile. Thus, a switch between a convertible and a share which previously made, say, a 2% profit would make a 2.5% profit on the same prices.

Meanwhile, the reduction in ACT to 29% marginally increases the yield advantage of convertible loan stocks and, as an extreme example, it adds some £3/8 to the value of the Hanson 10% CUL 2007/12 offered in the bid for Imps (or 0.57p per Imps share).

Convertible preference share yields fall marginally (a 7% net coupon is now worth 9.86% against 10% previously). But do not expect a de-rating of convertible preference shares; the lower ACT on the ordinary share dividends broadly maintains a convertible's gross income advantage.

Unresolved problem: Unresolved, though, is whether, under the Accrued Income Scheme, the Revenue is to impose a fresh tax on net investors who convert their convertible loan stocks. Almost all convertible trust deeds specify that investors who convert their stocks forfeit the accrued income notionally earned up to the conversion date. Readers may be surprised to learn that there is a risk that the Revenue may decide to tax all accrued income as at a conversion date, even if the investor converts and never receives the interest payment. It is manifestly unfair to tax investors on income which they never reasonably would be expected to receive.

This situation could be resolved fairly by taking convertible loan stocks outside the Accrued Income Scheme, alongside convertible preference shares, thereby additionally achieving fiscal simplicity. Surely that is better than looking at changing the conversion dates on over 100 convertible loan stock trust deeds, an alternative method of securing fair tax treatment.

Consumer sectors

BREWERS

Eric Frankis

The Chancellor's decision not to increase any of the duties on alcoholic drinks is as pleasant as it is surprising and represents real good news for the brewery sector. Given a reasonable summer, we had already hoped that the current year would see a very modest recovery in beer sales. The Budget reinforces this hope and we look for production figures for the current year to rise by some 2% to 37.2m barrels — compared with our original forecast of a 1% rise.

UK beer production

	Q1 m bls	Q1 %	Q2 m bls	Q2 %	Q3 m bls	Q3 %	Q4 m bls	Q4 %
1983	8.3	+1	9.3	−5	10.1	+6	9.1	+2
1984	8.4	+1	9.5	+2	9.6	−5	9.2	+1
1985	8.3	−1	9.2	−3	9.6	−1	9.4*	+1
1986	8.3	0	9.5	+3	9.9	+3	9.5	+1

* Last actual.

The inflation in beer relative to other consumer goods has always had a significant effect on beer sales. The Budget means that this year the brewers should be able to implement their late summer price rise of perhaps 3p per pint without causing the price of a pint — currently 80p — to go up by more than inflation and have a consequent detrimental effect on sales. Margins should therefore be easily maintained. The better growth, however, will continue to come from the retail end of the trade, reflecting the benefit of the very considerable investment programmes of the brewery groups and the favourable background for consumer spending.

The shares: We believe that profits of the major brewery groups may increase by some 15-17% this year. Just how this is likely to compare with industrial profits generally, rather depends upon sterling. However, we would take the view that the sector looks good value on a prospective P/E ratio a little below the market average. Another encouraging factor is that the brewery sector has not yet reflected the benefit to costs from lower oil prices — see the article on oil and share prices. We would particularly favour the shares of Bass and Scottish & Newcastle, for both of which beer and pubs still provide the bulk of profits, and Whitbread, where we believe the shares have been too influenced by North America and not enough by what has been achieved in the retail division.

TOBACCO

Eric Frankis

The Chancellor has taken a tough line on cigarettes. The specific element of the duty has been increased by £3.66/1,000 or 13.6% and the consequent rise in the retail price will be 11p/packet — about 8%. Although the final figures are not yet available it would appear that the UK cigarette market only suffered a small decline last year to about 97.5 billion, despite the 6p duty increase. This year's larger rise could cause the market to contract to some 94 billion.

In the forecast made in its defence document, Imperial Group indicated that it was looking for an increase in trading profits from £123m to £125m for its tobacco division. We believe this forecast was made on the assumption of a tough Budget.

UK cigarette sales

Units	1979	1980	1981	1982	1983	1984	1985
Billion	124.5	121.5	110.3	102.0	101.6	98.5	97.5*

*Estimate.

Individual shares

Company	Evaluation	Price p	Rel price since 1.1.86	Historic year-end	Yield % forecast year	1st forecast year Pre-tax £m	1st forecast year P/E	1st forecast year P/E rel	2nd forecast year Pre-tax £m	2nd forecast year P/E	2nd forecast year P/E rel
Burton	Sell	320	−1	Aug '85	2.6	150	17.8	131	186	14.5	125
Marks & Spencer	Sell	212	+4	Mar '85	2.7	370	24.7	169	420	21.0	167
Sears	Sell	129	+1	Jun '85	3.8	180	15.8	108	210	13.9	111
Harris Queensway	Buy	254	−8	Dec '84	2.8	37	18.8	130	48	13.4	108
Great Universal Stores	Buy	909	−4	Mar '85	3.1	290	12.5	88	325	10.7	86
Storehouse	Buy	340	n/a	Mar '85	3.2	111	19.5	133	130	16.7	131
ASDA-MFI	Buy	148	−11	Apr '85	2.9	167	16.3	116	195	12.9	107
Tesco	Buy	333	0	Feb '85	2.5	123	19.0	131	145	15.5	125
Bass	Buy	755	−1	Sep '85	3.2	298	13.4	100	335	11.9	102
Scottish & Newcastle	Buy	209	+7	Apr '85	4.8	75	12.2	85	85	11.0	90
Whitbread	Buy	285	−1	Feb '85	3.9	129	12.4	85	150	11.1	90

Gilts

Stephen Lewis

The gilt-edged market had looked to the Budget to confirm the Government's commitment to its anti-inflation strategy. This is broadly what the market got, with the Chancellor appearing to improve on the terms of the MTFS in setting a public sector borrowing target for 1986/87 of only £7bn. The £M3 money supply target of 11-15% looks very loose, implying no slowdown in £M3 from the likely actual outturn in 1985/86 despite the Chancellor's forecast of a lower inflation rate in the year ahead. However, the market is likely to be willing, at least initially, to accept the Chancellor's explanation that changes in the financial system will tend to boost £M3 growth.

INCREASED FUNDING

As the article on the Economic and Financial Outlook argues, the PSBR for 1986/87 is likely to turn out higher than the Chancellor's £7bn estimate. It is on this basis that we project our figures in the tables, which show the implication for Government funding of the achievement of £M3 growth in 1986/87 at the mid-point of the Chancellor's target range. On these assumptions, there would be a rise in the funding requirement in the year ahead. This leaves out of account the burden of the Government's public sector asset sales, which are set to increase from £2.7bn in this financial year to £4.8bn next. Even if the Chancellor were to reach his PSBR target in 1986/87, therefore, there would still be a net increase year-on-year in the burden of Government financing.

In the short run, however, gilt investors are likely to overlook these longer-term supply considerations and take their cue from the performance of sterling. The pound's first reaction to the Budget has been favourable, perhaps partly because the Chancellor omitted to mention in his speech the prospects for an early cut in interest rates. Sterling's firmness is likely to encourage buyers of gilts who may well soon exhaust official supplies of the Conversion 9% 2000 'tap'. Later this week, we expect clearing bank base rates to be cut by a full one percentage point.

LONGER-TERM PROSPECT

The longer-term resilience of the market will depend on whether inflation can be brought down below 4% on a durable basis. Our fear is that with wage settlements remaining stubbornly high, the 'core' inflation rate in the UK, as perceived by investors, will remain in the 5-6% range. This is much higher than the inflation rates to be expected in the other major industrial countries. It is questionable whether the yield differential between gilts and US Treasury bonds is currently wide enough to reflect the difference in inflation performance between the UK and USA.

Furthermore, with a 'core' inflation rate of 5-6% and long-dated index-linked now yielding about 3.75%, fixed coupon gilt yields of 9.5% provide very little allowance for risk. Consequently, we expect long-dated gilt yields later in 1986 to drift back up above 10% to give a more comfortable risk allowance.

PSBR, £M3 and funding

£bn	1985/86*	1986/87*
PSBR	6.8	8.5
Add: increase in sterling bank lending	21.0	22.0
Less: external finance of public sector and banks	3.5	4.0
Less: increase in banks' non-deposit liabilities	2.0	2.5
Less: growth in £M3 (% growth)	16.3 (14)	17.0(13)§
= Net funding requirement	6.0	7.0

* Phillips & Drew forecasts.
§Assumes 13% growth at mid-point of official guidelines.

Funding prospect

£bn	1985/86*	1986/87*
Gilt-edged	5.2	6.0
Certificates of tax deposit	−1.0	0.0
National Savings	2.2	1.5
Other	−0.4	−0.5
Net funding requirement	6.0	7.0

* Phillips & Drew forecasts.

UK gilt/US bond yield differential

%	UK	US	Differential
1979	13.0	9.3	3.7
1980	13.8	11.4	2.4
1981	14.7	13.7	1.0
1982	12.9	12.9	0.0
1983	10.8	11.3	−0.5
1984	10.7	12.6	−1.9
1985	10.7	11.2	−0.5
Nov	10.4	10.2	0.2
Dec	10.4	9.8	0.6
1986 Jan	10.8	9.6	1.2
Feb	10.4	9.1	1.3
Current	9.5	7.9	1.6

UK equities

Kenneth Inglis

DOES THE BUDGET REALLY MATTER?

Does the UK Budget fundamentally affect the outlook for the UK equity market as a whole? One may have legitimate reason to doubt it after the experience of the last few months, during which time the Chancellor's scope for giving further tax reliefs has melted away, yet the market has soared to new highs.

The answer to the conundrum has several strands, of which two are of paramount importance. Firstly the market believes that the Chancellor's loss of oil revenue is largely the private sector's gain in lower input prices, and that in effect an extra stimulus has already been applied to the economy. Further major action in the Budget would therefore be unnecessary and dangerous. Secondly the market took a deal of convincing that Mr Lawson was to be trusted in the first place, and his stock with investors was not really established until the 1985 Budget was fully digested. The market much prefers Mr Lawson to play safe on the economy, given his unhappy earlier experiences with sterling.

What the market craves above all else is the absence of shock to the economic system, and the Budget should therefore be assessed principally in terms of its contribution to the maintenance of a steady and stable growth path for the economy.

A TOUCH OF STIMULUS

After a period of fairly intensive opinion preparation with a view to removing expectations of fiscal stimulus in this year's Budget, it comes as no great surprise to find that the Chancellor has found scope to indulge in a moderate degree of reflation. We imagine that equity investors will find this type of package broadly acceptable, and be content to wait a further year for the major give-away which can only be secured by a year of solid success in controlling public expenditure. The 1% reduction in the standard rate of income tax is really just a 'taster' for an even bigger cut next year.

PROFITS OUTLOOK

Market attention will soon re-focus on the fundamentals for the corporate sector, in particular on the outlook for company profit growth. Having hit a low of 20% in 1981, the share of profits in value added in the industrial and commercial company sector looks set to climb above 28% in 1986, and there is no especial reason to look for a convincing break in this trend while inflationary pressure remains so low. Competitive pressures on the corporate sector have been substantially eased by the recent fall in sterling.

Supply/demand for UK equities

£bn	*1985*	*1986*
Capital issues	6.1	5.2
Government	2.3	4.5
Personal	1.5	1.0
Total sales	9.9	10.7
Other purchases*	3.5	4.0
Available for institutions	6.4	6.7
Cash flow	17.8	19.0
as % of cash flow	36	35

* Including corporate purchases of 1985 — £1.6bn/1986 — £2.5bn

With consumer demand continuing healthy, and some help from falling interest rates, it seems likely that industrial profits will produce a gain of some 15% this year, and possibly even a bit more if oil prices fail to recover some of the lost ground.

SUPPLY/DEMAND

The amazing surge in takeover activity has imparted a somewhat frothy look to the market in recent weeks. One side benefit is the buying of strategic equity stakes by aggressor companies, which tends to improve the supply/demand picture illustrated in the table. The proportion of cash flow going into UK equities of around 35% looks comfortable compared with the overall portfolio proportion of over 45%. However, supply does not always arrive in a conveniently smooth progression over the year, and it looks as if the easy conditions of recent months will tighten somewhat over the remainder of the year.

CONCLUSION

On our aggregations the industrial sector is on an average P/E of 15 on 1985 earnings and 13 on 1986 earnings. We would argue that early omens for 1987 profits look quite favourable, but it may be too early to be discounting that far ahead. The market yield has fallen below 4%, with the industrials yield an exiguous 3¼%, well below the yield on index-linked stock.

The bull run in equities has in large part been validated by the break in gilt yields below 10%. The absolute valuation numbers on equities begin to look rather demanding, and we are not overly-optimistic that long bond yields will stay below 10% indefinitely. However, there is nothing in this Budget for the bears and, with high cash balances still proving oppressive for many fund managers, the chances of a major downward break in the market look remote. There's life in the old bull yet!

Oil — the industrial impact

Bill Martin, Alan Scowcroft, Chris Tinker

Since the turn of the year, equities have bathed in the sunshine of higher prospective company profits resulting from the collapse in oil prices and decline in sterling. But the way in which lower oil prices affect industrial activity is very complex and probably has not yet been fully assessed. We give in this article a brief account of our current research in this area.

CHANNELS OF INFLUENCE

At least three separate channels of influence can be identified. *First* and most obviously, lower oil costs directly boost company profits. The cost impact on individual industrial sectors will depend not only on oil purchased directly but also on the extent of the oil-induced reduction in costs of materials supplied. For example, we estimate that the oil purchased directly by food manufacturers accounts, on average, for only 0.8% of their sales (column (1) in the table). But this figure is boosted to 3.5% once account is taken of 'indirect purchases' of oil. Moreover, lower oil prices will also reduce the cost of producing other forms of energy. We estimate that the direct and indirect use of energy accounts for 7.5% of food manufacturers' sales (column (2) of table).

A *second* way in which lower oil prices affect the economy is via movements in the composition of demand in the economy. Lower Government oil revenues and, thus, smaller tax cuts will weaken consumer spending in the short term. By contrast, investment and export demand are likely to increase.

A *third* channel of influence concerns the impact of lower oil prices on export markets for UK goods. Lower oil revenues will lead to cutbacks in OPEC economies, but we would expect extra growth in developed and, in particular, in non-oil developing economies.

OVERALL IMPACT

We have used the latest input-output tables (which date from 1979) to collate these three effects. Column (3) shows the result of a simple exercise to assess the effect of a 10% fall in world dollar oil prices on UK industrial activity. Column (4) shows the ranking of absolute sector share price performance since mid-January. There is a degree of correlation between columns (3) and (4), but some interesting divergences are also thrown up. There are some important sectors which have substantially underperformed on the basis of their exposure to oil prices, eg metals and metal forming, industrial materials (which includes building materials for this purpose), and brewing. On the other side, the sectors which have done better than expected on this test alone include textiles, pharmaceuticals and aerospace.

Of course, there are many other factors which have affected share prices recently, eg bid activity, but the exercise nevertheless provides a useful focus for analysing the extent to which the share market has reacted sensibly or otherwise to the oil price collapse.

Company sector	*Energy use expressed as a % of sales* Oil direct (1)	Energy overall (2)	*Estimated rise in output if 10% fall in oil prices* (3)	*Ranked sector performance since mid-January* (4)
1. Chemicals	16.0	28.0	3.2	4
2. Metals & metal forming	2.6	20.3	2.8	10
3. Sea transport	16.1	17.9	2.7	9
4. Industrial materials	3.8	15.6	1.9	15
5. Motors	1.6	9.3	1.7	2
6. Mechanical engineering	1.1	8.4	1.5	5
7. Electronics	0.6	5.4	1.5	7
8. Electricals	1.6	8.1	1.3	11
9. Textiles	1.9	9.2	1.3	3
10. Pulp & paper products	2.2	10.3	1.2	12
11. Aerospace	1.1	5.7	1.1	1
12. Construction	0.4	5.2	1.0	17
13. Pharmaceuticals	1.6	7.3	1.0	6
14. Brewers	1.7	8.4	0.9	22
15. Office equipment	1.0	5.9	0.7	8
16. Banking & finance	0.2	2.3	0.6	21
17. Printing & publishing	0.4	3.9	0.6	13
18. Distribution	1.3	6.1	0.5	18
19. Hotels & catering	0.5	7.0	0.5	14
20. Posts & telecommunications	0.4	2.7	0.4	16
21. Food manufacturing	0.8	7.5	0.4	20
22. Tobaccos	0.3	3.4	−0.1	19

PROPERTY

Company	Price	Pre-Tax Hist.	Profit Est.	Fully Diluted NAV	Disc. to NAV	Gross DPS Est	Prosp Yield	Advice
	p	£m	£m	p	%	p	%	
Bradford Prop	500	10.5	12.0	575	13	15.7	3.3	HOLD
British Land	167	11.8	14.6	204	18	3.9	2.4	HOLD
Brixton Estate	149	9.0	9.6	195	24	8.0	5.4	HOLD
Chesterfield	475	6.4	7.3	572	17	16.8	3.5	HOLD/SELL
Frogmore	186	10.2	10.6	226	18	11.1	6.0	HOLD/SELL
Gt. Portland Est	176	16.8	18.6	210	16	9.4	5.4	SELL
Hammerson 'A'	460	33.4	38.0	602	24	13.6	3.0	HOLD
Laing Prop.	301	15.5	17.5	367	18	11.1	3.7	SELL
Land Sec.	315	95.6	110.5	425	26	13.0	4.1	HOLD/BUY
London Shop	157	6.5	7.2	177	11	6.9	5.5	SELL
MEPC	345	51.6	58.0	415	17	17.1	5.0	HOLD
Peachey	270	10.3	10.0	355	24	12.9	4.8	HOLD/BUY
PHIT	126	5.8	6.4	147	14	4.0	3.2	SELL
Slough Estates	167	33.6	38.0	215	22	8.3	5.0	HOLD
Stock Conversion	585	20.6	24.5	630	7	9.3	1.6	HOLD
Warner	780	3.5	3.9	946	18	30.7	3.9	HOLD

THE EFFECT OF THE BUDGET

The Chancellor raised few issues in his Budget speech that will have a direct impact on the property sector. Indirectly however the stimulation of improving consumer expenditure (real personal disposal income is forecast to rise by 5% in 1986) is expected to have a positive knock-on effect on shop rents. The possibilities of an interest rate cut in the near future were also not eliminated. The measures (or lack of) relating most specifically to the sector are outlined below.

1) No reduction in the rate of stamp duty applied to property transfers. Prior to the Budget there was specualtion that the rate of stamp duty applied to property transfers would be cut from 1% to ½%. Any such reduction would of course have been to the benefit of property companies and in particular trading companies with a high turnover of properties.

2) No reduction in the rate of Capital Gains Tax. The market had not anticipated any change to the Capital Gains Tax provisions though with their historic tax liability any such reduction would have been particularly beneficial.

3)The indefinite extension of the Business Expansion Scheme and the exemption of high asset-backed activities from the scheme. This proposal effectively closes a loop-hole previously exploited by several property based activities.

OUTLOOK AND CONCLUSION

In the direct property market we expect the rental growth from shops and retail warehouses to once again outperform during 1986. With the exception of the City where we predict further impressive growth in rents we do not anticipate any major improvement in office rents. The industrial letting market is likely to once again be depressed except in the South East, particularly around the M25. Given the recent bullish RICS house price forecast and the prospects of a cut in the mortgage rate the residential sector should outperform.

The sector average discount to net assets currently stands at just 17% with the sector relative at the historically low level of 0.93. We currently regard the sector as fully valued and despite the promising personal expenditure forecasts and interest rate cut hopes recommend investors to reduce their sector weightings.

Nigel Phillips

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1986

BUDGET COMMENTARY

SUMMARY

We anticipate short term reductions in interest rates of at least 1%, and we continue to recommend purchases of long gilts, which remain on high yields by international standards.

We believe company profits will advance at a faster rate as a result of this Budget, and although the market may sustain a technical setback after its recent rapid rise, we would use this as a buying opportunity as the long-term bull trend, in our view, remains.

We believe that the outlook for **EQUITIES** has been further strengthened by the introduction of the Personal Equity Plan, and recommend purchases in the following areas.

STORES:	**GUS, Burton, Storehouse, Harris, Kwik Save, Tesco**
BREWERIES:	**Bass, Scottish, Grand Met.**
BUILDING MATERIALS:	**RMC, EEC, Steetley, Travis.**
We also recommend:	**Legal & General, General Accident, Racal, Thorn** and **Vickers.**

MAIN POINTS

Output Forecast +3% Inflation +3.5%
M3 Target 1986/87 at 11-15%
Forecast PSBR 1986/87 £7bn
Balance of Payments forecast at £3.5bn (1986)

Stamp Duty on shares reduced to ½%
New 5% duty on conversion of shares to ADR's
Introduction of Personal Equity Plan

No change on Beer or Spirit Duties
Thresholds raised 5.7%
Basic Income Tax reduced to 29%

ECONOMIC VIEW

Mr. Lawson's third Budget has continued to emphasise the objectives of sound money, free markets and enterprise culture.

Although the fall in world oil prices has substantially reduced UK government revenues from the North Sea to perhaps £6bn in 1986/7 from an autumnal forecast of 11.5bn, the Chancellor has nevertheless found room for significant personal tax cuts while increasing the incentives for individual share ownership. This ability has arisen from buoyant tax revenues within a growing economy worth an extra £2bn in 1985/6 and £3bn in 1986/7.

Economic Framework

The medium term financial strategy continues to be the touch-stone of Budget changes. The objective of price stability is paramount. The fall in world oil prices this year has ensured a further cut in inflation and will contribute to higher economic growth in 1985/86 of 3.5%, falling to a steady 2.5% p.a. in the years 1987-90.

Monetary growth in its broader manifestation is allowed to "roam free" with a generous £M3 range of 11-15% per annum reflecting the fact that the velocity of circulation (the amount of "work" the money stock has to do) has continued to contract since 1979.

Fiscal policy is to be correspondingly restricted relative to previous years. PSBR is predicated at only 1 3/4% of GDP in 1985/6 after averaging 3.2% in the previous four years. Further reductions to 1 1/2% of GDP are projected for 1988/9 and 1989/90 on the basis of a steady £7.0bn PSBR in the years 1985-90. Such fiscal rectitude - amply demonstrated by the latest PSBR figure for February - suggests scope for lower interest rates.

Interest Rates

High "real" interest rates, which are a symptom of Western governments' determination to achieve financial control and to eliminate inflation, have increased the desire to hold personal financial - as opposed to tangible - assets. This trend is officially expected to continue in the next few years, reinforced by the Chancellor's tax concessions to private shareholders.

Prosperity in 1986 would nevertheless be much enhanced by some further fall in nominal interest rates. The worldwide "interest rate disarmament", assumed to be instigated by the G5 accord of September 1985, has yet to affect the UK. Short-term money market levels now suggest potential for an immediate 1% cut in UK base rates to a level of 11 1/2% which is still unduly high on international comparisons.

Industrial Activity

Apart from the benefits to consumers, and especially mortgagees, from a cut in the UK short-term interest rate level, industrial/commercial companies will also be induced to restock if financing costs are eased, thus reversing the trend of the past six years towards a declining stock/output ratio and maintaining buoyant industrial production levels. The gradual recovery from the nadir in the second quarter of 1981 should be further extended with some economic resources being diverted away from oil-related activities towards the UK manufacturing base.

With monetary ease and fiscal constraint the prospects for corporate profitability remain sound. The net returns for industrial/commercial companies were higher in 1985 than at any time since 1960; falling oil prices should further increase the profits of those companies not directly involved in North Sea activity.

INSURANCE

Company	Price p	Pre-tax Profit Hist. £m	Pre-tax Profit Est. £m	EPS Est. p	DPS Est. p	P/E	Yield %	Advice
COMPOSITES								
CU*	304	0.2+	49.5	1.1	16.9	-	5.6	HOLD
GA*	868	26.5	93.2	43.9	35.7	19.8	4.1	BUY
GRE	845	92.2	32.0	9.4	40.0	-	4.7	HOLD
Royal*	876	41.4	158.0	49.4	41.1	17.7	4.7	HOLD/BUY
Sun Alliance	703	47.6	23.0	2.8	23.6	-	3.4	HOLD
LIFE								
Legal & General	812	44.7N	45.2N	29.5	35.7	27.5	4.4	BUY
Pearl	1,458	14.6N	15.2N	42.2	61.4	34.5	4.2	HOLD/BUY
Prudential	892	45.2N	63.0N	20.9	36.4	42.7	4.1	HOLD/BUY
BROKERS								
Hogg Robinson	333	14.2	18.0	24.5	13.4	13.6	4.0	BUY
Sedgwick*	378	124.3	155.0	27.1	17.9	13.9	4.7	HOLD/BUY
Willis Faber	447	47.0	60.0	20.5	11.4	21.8	2.6	HOLD

N - Net of tax * - these companies have reported recently + - Excludes exceptional claims provision of £59m.

THE EFFECT OF THE BUDGET

For the life sector, changes in the treatment of pension fund surpluses may be considered in a slightly negative light in the very short-term. Pension fund assets and liabilities will be valued, for tax purposes only, on standard assumptions advised by the Government Actuary. Where such valuation shows an actuarial surplus of assets over liabilities of more than 5%, the trustees shall be required to reduce it to not more than 5% by: (i) an increase in pension benefits (within existing limits), or (ii) a contribution reduction or holiday by either employer or employee, or (iii) a refund to the employer (taxable at 40%) or (iv) any combination of these measures, the choice of method being for the trustees to decide. Clearly, pension benefits will be made more attractive to policyholders and this may be expected to increase competition for business as other financial institutions enter the fray. On a more positive note, the abolition of capital transfer tax on lifetime gifts may encourage the life offices to create additional 'inheritance trust' schemes while the introduction of Personal Equity plans will be exploited by the unit trust groups, and therefore by the life companies as well. The reduction in the rate of stamp duty will be of some small help, although loan stocks are once again subject to this duty.

The Budget proposals will have a negligible impact on the broker and composite sectors. The likelihood of lower prevailing interest rates is obviously negative for investment income, although rate increases will continue to outweigh this development, with buoyant brokerage earnings and reducing underwriting losses.

OUTLOOK AND CONCLUSION

The favourable tax status of the pension funds remain intact and any adverse market reaction is likely to be short-lived. Legal & General derives less than a third of its total life earnings from UK pensions and we expect surplus growth from the sector to remain strong. Our other favoured stocks are Hogg Robinson (buoyant travel interests and US broking) and General Accident (strong balance sheet).

Charles Coyne

U.K. CLEARING BANKS

Company	Price p	Pre-tax Profit Hist. £m	Pre-tax Profit Est. £m	EPS Est. p	DPS Est. p	P/E	Yield %	Advice
Barclays	550	854	980	85.0	28.6	6.5	5.2	HOLD
Lloyds	610	561	661	122.4	34.7	5.0	5.7	HOLD
Midland	505	351	420	86.2	38.2	5.9	7.6	HOLD
Nat. West	855	804	940	144.0	44.3	5.9	5.2	HOLD

THE EFFECT OF THE BUDGET

The absence of any punitive form of taxation on the banking sector is obviously a relief and can be construed as being quite positive. For the past number of months we have strongly advocated the positive merits of the sector, primarily the strength of balance sheets, the quality of domestic earnings and a slightly more relaxed attitude to overseas debt. Obviously the conservation of the U.K clearing banks in respect of their L.D.C Exposure has enhanced their investment merits.

We recently suggested taking a strongly overweight investment approach in the sector, but we now feel that the recent very strong performance mitigates our enthusiasm. Our best advice at the moment is "caveat emptor".

Banks Index Relative to All-Share

OUTLOOK AND CONCLUSION

The recent strength in share prices leads us to believe that buyers may be better rewarded when current bull positions are unwound.

N.J. Mercer

Trading Prospects

World trade in general will be stimulated by the reversion of oil costs to their level in 1973 in real terms; with sterling now lower than recently against non-US currencies, non-oil exports should contribute much more to UK growth in 1986/7. The fall in oil prices is nevertheless officially expected to cut GDP growth by 0.5% due to oil's current 6% contribution to GDP.

Much is expected from "overseas" earnings in 1986 and the UK's net stock of overseas assets is estimated at £90bn (25% of GDP) in 1985 after £12bn (6%) in 1979. The current account surplus is expected to have fallen to £3.5bn in 1986 after £4.5bn in 1985 due to the fall in oil prices. A stubbornly high deficit on manufactures of £3bn per annum, while the oil surplus falls to £5bn in 1986 after £8bn in 1985, places the onus of recovery on invisible earnings; even so, the clamour for a rejuvenation of manufacturing industry will undoubtedly grow, in the hope of both export earnings and unemployment reduction. We deem this Budget neutral in its treatment of labour v capital costs.

Inflation

The thrust of the government's policy continues to imply lower inflation. The main threat to a stable sterling rate and to RPI is the growth in earnings which have risen at around 7.5% per annum in the last two years. Allowing for productivity gains, this does not represent a disastrous rise in costs though the Red Book does show that UK unit labour costs in manufacturing have been rising faster than in other industrial countries since 1984. A major escalation in wage costs throughout the economy would quite upset the Chancellor's strategy; it has yet to emerge to any great extent but remains the greatest threat to current sterling levels.

Principal tax changes in summary (1986/87 non-indexed base)

£m Concessions	1986-87	1987-88	£m Imposts	1986-87	1987-88
Reduction basic rate 1p	830	1,245	Excise duties	790	910
Personal allowances	1125	1,470	Petrol	380	400
ACT reduction	120	60	Tobacco	315	335
CTT	55	100	Stamp duties (net)	-	10
Sundries net	10	70	Net concessions	1,350	1,885
	2,140	2,805		2,140	2,805

The taxation reductions of £1,350m in 1986/7 and £1,885m in 1987/8 are usefully more than had been generally anticipated; they have been able to be financed by surprisingly buoyant tax revenues which have endorsed supply-side theories of economic growth.

The Budget also has convenient political aspects for the government with the main emphasis of tax reduction taking effect in the year preceding the next election while at the same time there remains the possibility of further concessions in the next Budget.

Michael Cook

THE GILT MARKET

Despite its recent strength, the gilt market should take further heart from the general tenor of this Budget. There are not many bond situations that combine such high yields with:-

a) several years of current account surplus with £3.5bn scheduled for 1986;

b) falling inflation with 3.5% projected for the fourth quarter of 1986 and with the Government reiterating its economic objective of defeating inflation;

c) a PSBR for 1986/7 of £7.1bn, only 1 3/4% of GDP; and

d) an easy money policy epitomised by a £M3 target of 11-15% p.a., after a growth rate of 14.75% in the year to mid-February.

It is important to realise that the above official arithmetic has been based on an oil price of $15 per barrel for the remainder of 1986; oil revenues in 1985/6 are again estimated at £11.5bn (v £13.5bn in last year's Red Book) and £6bn is forecast for 1986/7 with the $/£ rate remaining around recent levels i.e. $1.45. On an unchanged exchange rate North Sea revenues vary about £500m with every $ per barrel change.

We consider gilt investors are justified in being relaxed over the balance of the Budget. It seems that the Chancellor is well satisfied to continue the recent mix of steady growth and controlled inflation; indeed the scale of the direct and indirect taxation changes was surprisingly low. The £795m rise in excise duties (worth 0.5% on R.P.I.) was merely the statutory indexation amount and demonstrates the Chancellor's desire to keep inflation down.

The other factor which may not have been fully discounted in recent weeks is the remarkable PSBR performance in the first two months of 1986. January's repayment of £4.5bn was widely assumed to have been 'borrowed' from February, but the latter's outturn (a repayment of £373m) has enabled the 1985/6 forecast to revert down to £7bn. This is unduly cautious for it assumes a March borrowing of £4.2bn which would be excessive, even allowing for lower PRT receipts.

The above makes the recent rash of funding even more perplexing in its immediate need; we ascribe this funding policy to:-

a) desire to fill the vacuum caused by the postponement of the TSB flotation;

b) content to sell stock while the market is hungry;

c) satisfaction at the reducing cost of debt servicing; and

d) awareness of £9.14bn maturities in 1986/7 (v £5.90bn in 1985/6).

We remind investors of the time-table of £3,753m outstanding calls:-

Date	Stock	Due	Amount £m	Date	Stock	Due	Amount £m
7th April	10 93	20%	240	**12th May**	9 00A	25%	250
9th April	B Telecom	40p	1200	**19th May**	10 93	54 1/2%	654
14th April	10 03	58 1/2%	585	**2nd June**	9 1/2 05A	36 1/2%	292
28th April	9 1/2 05A	40%	320	**16th June**	9 00A	46 1/2%	462

With no privatisation issue yet announced for June, little 'indigestion' should arise, though four simultaneous partly-paids is, we believe, an unprecedented situation.

Bank base rates can be comfortably reduced by 1%, thereby allowing a reduction in mortgage rates.

Gilt yields, even on stocks as short as 4/5 years, have recently shown little relation to base rates - and thus may be little affected by such moves. They will, however, respond favourably to the Chancellor's annual report on UK Ltd, showing that **the UK can fully partake in the further interest rate disarmament which is likely ahead of the Tokyo summit in early May.**

Roger Parsons

STORES

Company	Price p	Pre-tax Hist. £m	Profit Est. £m	EPS Est. p	DPS Est. p	Prospective P/E	Prospective Yield %	Advice
Boots	279	190.0	208.0	18.3	10.0	15.2	3.6	HOLD
Burton Group	320	80.0	145.0	17.3	7.3	18.5	2.3	BUY
Dixons Group	330	39.6	70.0	12.4	2.6	26.6	0.8	SELL
Freemans	406	22.0	28.5	26.0	9.0	15.6	2.2	BUY
GUS - A	909	253.5	285.0	73.8	28.5	12.3	3.1	BUY
Harris Queensway	254	27.3	37.5	16.6	7.1	15.3	2.8	HOLD/BUY
Marks & Spencer	212	303.4	365.0	9.0	5.7	23.6	2.7	HOLD
John Menzies	341	17.1	20.0	22.8	5.5	15.0	1.6	BUY
Next	264	20.1	27.0	12.6	7.1	21.0	2.7	HOLD
Sears Group	128.5	175.0	195.0	8.4	5.0	15.3	3.9	HOLD
Storehouse	343	103.0	118.0	19.0	11.0	18.1	3.2	HOLD/BUY
W.H. Smith A	312	43.1	53.0	19.8	8.4	15.8	2.7	HOLD/BUY
Woolworth	608	56.8	80.0	30.0	15.0	20.3	2.5	HOLD

THE EFFECT OF THE BUDGET

The Budget is generally very favourable for the stores sector.

1) There will be a net stimulus to consumers' expenditure because of the lower than expected increase in indirect taxation and the reduction in the standard rate of income tax, which will particularly benefit those on average and below-average incomes.

2) Money market interest rates are likely to continue to decline, which should lead to some reduction in mortgage interest rates.

3) The confectionery, tobacco and newsagents sector will be adversely affected by the 13½% rise in cigarette duties. The CTN sector performed poorly last year, following the 7½% increase in cigarette duties, when value sales rose by only 4% implying a decline in volume sales.

Overall, we believe that consumers' expenditure will increase by 3.2% in real terms in 1986, which compares with +2.7% last year and our earlier forecast of +2.5%. Retail volume sales are forecast to increase by 4% against 4.2% last year and our earlier forecast of +3.5%. Our quarterly estimates are shown below:-

Quarters	1986 I	1986 II	1986 III	1986 IV	1986 Year
Volume of Retail Sales	117.5	119.0	121.0	122.0	119.9
% Change	+3.6	+3.5	+4.0	+4.6	+4.0
Consumers' Expenditure	38.0	38.3	39.0	39.1	154.4
% Change	+3.5	+2.7	+3.2	+3.2	+3.2

OUTLOOK AND CONCLUSION

The stores sector has declined by nearly 10% in relative terms from its all-time high of 119% in November 1985, although in absolute terms it has surpassed the November level. Given the bullish implications of the Budget for the sector, we would expect it to show a stronger relative performance over the next few months and would recommend an increase in sector weighting.

We continue to recommend **Burton Group, Freemans, GUS-A** and **John Menzies** as buys and believe that **Harris Queensway, W.H. Smith 'A'** and **Storehouse** also look attractive. **Dixons Group** looks somewhat vulnerable after its very strong rise.

Richard Sanderson

OILS

	Price p	Net Income Hist £m	Net Income Est £m	EPS Est. p	DPS Est. p	P/E Est	Yield Est %	Advice
BP	560	1,402	1,598*	87.2*	48.6*	6.4	8.7	HOLD/BUY
Britoil	185	169.4	190	37.8	18.6	4.9	10.0	HOLD/BUY
Burmah	347	41.1	52.0	36.2	18.2	9.6	5.2	HOLD/SELL
Enterprise	137	62.6	68.0	32.1	12.1	4.2	9.0	HOLD/BUY
I.C. Gas	355	42.2	46.0	35.3	23.6	10.1	6.6	HOLD
Lasmo	143	31.6	33.0	28.4	17.7	5.0	12.4	HOLD/SELL
Shell	758	3,648	3,032*	83.3*	50.0*	9.0	6.7	HOLD/BUY
Tricentrol	103	30.2	23.0	24.8	14.3	4.2	13.9	SELL
Ultramar	186	127.6	71.6*	26.3*	15.0*	7.1	8.1	HOLD

* Actual

THE EFFECT OF THE BUDGET

Against the backdrop of an OPEC meeting, the Chancellor reiterated the Government's stance that the UK would not cut oil production to help firm prices. However, with demand likely to be stimulated to some extent by the sharp fall in prices so far this year, the Chancellor indicated that the oil price in 1986 could average about $15/bbl.

The Budget will have a broadly neutral impact on the oil sector. The Chancellor's decision to raise the duty on a gallon of petrol by 7½p/gallon (inclusive of VAT), diesel fuel by 6½p/gallon (inclusive of VAT) and gas oil by 1½p/gallon will raise some £800m for the Treasury. In the near term, these measures will have a marginally negative impact on the integrated companies such as BP and Shell, since they are now more exposed to pass on the shift in oil prices to the end-users. The limited duty increases on petrol and diesel oil for motor vehicles allow the industry to pass on more of the lower oil prices to the users. For this reason, forecourt competition could become more intense to the detriment of the major integrated companies should the current very low oil prices prevail.

The absence of any higher duties on fuel oils should benefit industrial users as the full oil price shift can be passed on. From the oil industry perspective, fuel oils could become more competitive in the inter-fuel market at the lower crude prices.

The Chancellor has limited the increase on gas oil, used mainly for heating, which gives oil companies again more flexibility to move the end-user price up or down according to the price levels of crude oil.

The changes in the oil taxation regime affecting the upstream activity of the oil industry are of minor importance as they relate only to technical anomalies and do not spell out a shift in the actual tax burden, offshore or onshore.

OUTLOOK AND CONCLUSION

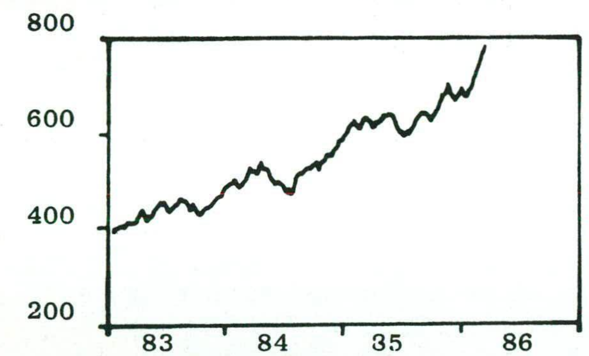
The overall impact of the Budget on the oil sector is broadly neutral, although in the near term increased competition on the petrol station forecourt may lead to reduced margins as the majors are now more exposed.

The sector's underperformance so far this year, has been wholly justified given the collapse of the oil price. While some nervousness over the course of the oil industry is likely to remain, the underlying price trend should be firmer as the year progresses. To this end we feel that oil prices have effectively bottomed out and will settle in the $18-20 range later in the year. With this secenario in mind, we recommend selective purchases of the main line stocks, such as Shell, BP, Britoil and Enterprise.

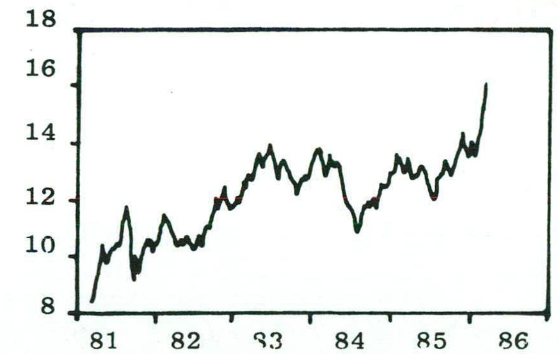
B.Evers/M.Beudell.

THE EQUITY MARKET

Mr.Lawson has produced a series of minor measures which will provide positive encouragement to the equity market and has avoided any signficant disappointments. With his freedom to act severely constrained by the short fall in oil revenues, the £1bn tax "give away" was up to optimistic expectations. The Chancellor confirmed his intention to keep inflation on a downward trend and we would anticipate outside forecasts to follow his lead, particularly if base and mortgage rate cuts occur as expected. The Government remains more optimistic on growth than other commentators but with revisions likely to be upwards the market should respond positively.



— FTA All Share Index



— FTA Industrials - PER

Within the limited scope available to him, Mr.Lawson sought to confound expectations as much as possible. No measures were introduced to penalise high wage payments. No bank service taxes were introduced while the higher tax on petrol was lower than anticipated. The loading of duties against tobacco while obviously negative can have come as no great shock to the sector. The Budget surprise was to exempt alcoholic drink from any increase in tax and this sector should respond positively.

Monory Comes to Britain

For some time the Government has been pressed to introduce a scheme to encourage private investor interest in equities. The highly successful Loi Monory has been seen as a model for encouragement of "People's Capitalism". Under the French scheme, limited equity investment was allowed free of income tax on the initial purchases. Mr.Lawson has not gone this far but is allowing freedom from capital gains tax and tax on dividends re-invested to those who invest up to £2,400 a year and hold the stocks for a minimum period. By so doing he has created a wider clientele for the privatisation issues expected over the next two years who will be locked in over the initial dealing period.

Taxing the Surplus

The strong performance of stock markets over the last few years has created surpluses on many pension funds. The surpluses have been an attracton to corporate raiders and those fending them off. The clarification of the rules, so that companies reclaiming the surplus suffer tax at 40% will lessen the attractions of these refunds. Company contribution holidays are not affected in the same way.

Preparing for Big Bang

The equity market will also be pleased with the reduction in stamp duty to ½% though optimists may have hoped for its abolition. The cost to the Exchequer will be made up by extending stamp duty into account dealing and onto certain loan stocks and takeovers. The new tax on transferring stock into ADR's will help keep trade in UK companies on the UK stock exchange after the Big Bang. The net effect of all these moves on equity turnover is expected to be positive.

Conclusions

The UK equity market has been responding positively to a spate of takeovers and to the world wide lowering of interest rates. While looking expensive in historic PER terms, the market is likely to continue upwards as a result of this Budget.

Tony Little

BREWERS & DISTILLERS

Company	Price p	Pre-tax Profit Hist. £m	Est. £m	EPS Est. (Act Tax) p	DPS Est. p	Prosp P/E	Prosp Yield %	Advice
Allied	312	219.0	260	24.6	13.39	12.7	4.3	HOLD
Bass	750	255.2	305	60.0	24.00	12.5	3.2	BUY
Grand Met	383	347.3	380	33.9	14.27	11.3	3.7	HOLD/BUY
Guinness	287	86.1	130	26.4	11.32	10.9	3.9	HOLD
Scottish	207	65.2	75.5	17.0	10.00	12.2	4.8	HOLD/BUY
Whitbread	282	110.1	127	22.7	10.92	12.4	3.9	HOLD

THE EFFECT OF THE BUDGET

The decision to leave the duties on drink unchanged comes as a considerable and welcome surprise against market expectations. The key impact as far as the brewers are concerned is less in terms of any direct stimulus to consumer demand, but rather the favourable options given to them for their own net of duty pricing policies. Given that the combined duty and VAT proportion of the retail price of an average pint is some 37%, a round of retail price increases in line with inflation of a forecast 3.5% would amount to 5.5% at the net of duty level. This, of course, would amount to a 2% increase in real beer revenues accruing to the industry assuming unchanged beer volumes. This would have a sharp effect on wholesale beer margins. Alternatively, the brewers might choose to adopt a pricing policy at the retail level implying a decline in real terms on the bar price, in order to stimulate a better volume trend, without implying any erosion of net of duty margins. Given the high profitability of the marginal barrel, even the comparatively small volume increases to be anticipated from such a policy would have a significant effect on profitability.

Whichever policy mix between the margin or volume preferences is chosen by individual brewery companies, we would expect the annualised earnings growth of the sector to be raised by an aggregate of 5% in the 1986/87 fiscal year from 12% to 17% as a result of this budget. The clear beneficiary is **Bass** as the company with the lowest unit costs of production and the strongest beer brands, and with 82% of profits arising from its traditional brewing, drinks and pub retailing activities. The operational gearing effect on its wholesale brewing profitability is likely to be substantial.

The growth in the volume of wine consumption is unlikely to falter below the high rates of the past two years as a result of this continuing favourable fiscal environment. The marked revival of UK scotch whisky consumption, with an increase of 6.3% in calendar 1985 reversing the decline of recent years will receive a further stimulus. A return to near to the pre-recessionary levels of scotch consumption is conceivable during the current year in consequence.

Tim Clarke, Sandy Soames, Marcus Edwards-Jones

HOLDING COMPANIES

Company	Price p	Pre-Tax Profit Hist £m	Est £m	EPS Est p	DPS Est p	P/E	Yield %	Advice
BAT	403	1,405.0	1,150.0	42.1	17.2	9.6	4.3	BUY
BET	423	103.5	127.0	31.8	23.0	13.3	5.4	HOLD
PEARSON	478	99.4	108.0	27.7	14.6	17.2	3.1	SELL
P & O	525	90.2	122.0	33.8	22.0	15.5	4.2	BUY
TDG	182	29.7	36.0	15.3	10.0	11.9	5.5	BUY

THE EFFECT OF THE BUDGET

The UK budget has little effect on the big holding companies which principally operate in an international environment. The imposition of a 5% levy on conversion of ordinary shares into **ADRS** is encouraging for the ongoing London market dealings in such companies as **BAT**, where a substantial business is done in New York and on other exchanges. A price differential will arise penalising ADR dealings which should encourage greater trading in such stocks in the UK.

Overall, the Chancellor has presented a relatively favourable view of the world economy, and the UK economy in particular for 1986. The 3½%-4% economic growth forecast for the major industrialised countries in the current year, combined with lower oil and commodity prices and consequently lower inflation, are favourable. In the UK, lower inflation (forecast around 3½% in 1986) should promote better wage and productivity deals in manufacturing industry and higher real wages should stimulate demand. We view the prospects for the construction/housing industry and oil consumers in general as positive and we feel companies such as **BET, P & O** and **TDG**, with construction and haulage interests, will all be beneficiaries.

OUTLOOK AND CONCLUSION

We regard the Budget as generally favourable for the savings industry, notably with greater share ownership encouraged by the £200 per month or £2,400 per year proposed tax free saving scheme. Of the holding companies reviewed, we regard **BAT** as undervalued with a low prospective p/e and an increasing dividend, covered 3.4 times for 1985 and payable out of the company's large positive cash flow.

Pearson has been the subject of unsubstantiated consortium bid rumours leaving the current multiple looking exposed on 17.2 times 1985 earnings. We regard the stock as overvalued on fundamentals and recommend sales.

At present, we regard **BET** as fairly valued after the stock's recent rise, which included an element of re-rating.

P & O is at an interesting stage of development as the company has been invigorated by the Sterling Guarantee management impact. Longer term, we expect P & O's assets to work harder and combined with Sterling's highly efficient property and services' businesses, we expect this company's overall profitability to improve at an above average rate and recommend clients to add to existing holdings.

TDG is currently undergoing a phase of increased profitability which will be assisted by the lower than expected duty increase on diesel fuel in the Budget. Despite the recent outperformance against the market, the shares are still good value.

A. Giardini/J. Bagwell

FOOD RETAILING

Company	Price p	Pre-tax Profit Hist. £m	Pre-tax Profit Est. £m	EPS Est. p	DPS Est. p	P/E	Yield %	Advice
Argyll*	338	53.1	64.0	19.4	11.1	17.5	3.3	BUY
Asda-MFI	148	158.0ϕ	170.0	9.7	4.3	15.3	2.9	HOLD/SELL
Bejam	158	19.2	20.5	10.7	6.2	14.8	3.9	HOLD
Dee Corp	268	64.3	83.5	11.6	11.0	23.1	4.1	HOLD
Hillards	183	7.7	8.6	11.7	4.3	15.6	2.3	HOLD/SELL
Kwik Save	260	36.0	41.0	17.7	8.0	14.7	3.1	BUY
Wm Low	605	6.2	8.2	40.8	20.0	14.8	3.3	BUY
Wm Morrison	192	11.7	15.0	10.5	1.9	18.2	1.0	HOLD/SELL
Nurdin & Peacock	172	13.2	14.8	12.9	6.0	13.3	3.5	HOLD/BUY
J. Sainsbury	396	156.4	186.0	19.2	7.5	20.6	1.9	HOLD/SELL
Tesco*	330	81.3	118.0	18.6	8.4	17.7	2.5	HOLD/BUY

* Fully Diluted ϕ Proforma

THE EFFECT OF THE BUDGET

The Chancellor, both through unexpectedly low increases in indirect taxation (except for cigarettes) and the changes to income tax, has done much to ensure that the current buoyant levels of consumers' expenditure will continue into the next financial year. The Chancellor suggests a 4% increase, we believe this to be slightly optimistic but would still expect consumers' expenditure to rise by over 3%. The stage looks set for a further cut in interest rates, with a cut in mortgages to follow, but the market has largely taken this into account. The Chancellor has reaffirmed the Government's wish to see the base rate of tax to fall to 25% in future years, suggesting the possibilities of a further cut next year which, again, can only be good for consumers' expenditure over the longer term. On a lesser point, the food retailers may have been caught with excess levels of stocks of wines and spirits (as some reported last year) with the Chancellor's unexpectedly generous attitude to drinkers. However, keeping prices down will bode well for longer term sales.

OUTLOOK AND CONCLUSION

The overall effect of the Budget on consumers' expenditure must be beneficial to the food retailing industry. The outlook for earnings growth still remains above the market average, however, this is reflected in the significant premium given to food retailing stocks. Our view that such high ratings (against a background of intensifying competition between the multiples) left little room for short term appreciation has been borne out by the sector underperforming the market by 12% over the past three months. This budget should put a stop to such a rate of decline.

Some of the smaller multiples no longer look too expensive particularly Kwik Save, and William Low. We would recommend Tesco and Argyll for the longer term as both have opportunities for growth through margin improvement and physical expansion. Dee's actual tax rating is on a par with the sector and the price is supported by an above average yield. We feel that Sainsbury's and Wm.Morrison's rating are high enough and would continue to recommend investors to avoid ASDA-MFI for the time being.

Detta Rossi

CONSTRUCTION/BUILDING

Company	Price p	Pre-tax Profit Hist. £m	Pre-tax Profit Est. £m	EPS Est. p	DPS Est. p	P/E	Yield %	Advice
Costain	550	54.3	61.0	46.9	25.6	11.7	4.7	BUY
Tarmac	448	109.6	130.0	25.6	12.1	17.5	2.7	BUY
Taylor Woodrow	565	42.5	45.0	41.0	22.0	13.8	3.9	BUY
Blue Circle	661	113.2	120.0	59.0	30.0	11.2	4.5	HOLD
BPB	446	78.6	88.0	30.0	12.5	14.9	2.8	HOLD
E.C.C.	359	74.6	90.0	28.7	17.0	12.5	4.7	BUY
Hepworth	185	35.2	29.0	12.0	10.0	15.4	5.4	BUY
Hewden Stuart	53	6.4	6.7	5.0	2.3	10.6	2.3	BUY
Ibstock	190	12.4	13.5	16.7	6.8	11.4	3.7	BUY
Magnet & Southerns	162	28.2	27.0	9.9	6.7	16.4	4.1	BUY
Marley	118	19.6	30.2	9.3	5.3	12.7	4.5	HOLD
Redland	420	108.2	112.0	29.0	16.5	14.5	3.9	BUY
R.M.C	572	81.3	80.0	54.0	19.7	10.6	3.4	BUY
Steetley	453	32.7	37.2	39.5	19.0	11.5	4.2	BUY
Travis & Arnold	376	9.6	8.3	32.3	12.0	11.6	3.2	BUY
Wolseley Hughes	568	31.5	45.0	42.0	13.5	13.6	2.4	BUY

THE EFFECT OF THE BUDGET

There are no measures in the Budget which diminishes the already encouraging outlook for the building and material supply sector. The Budget changes particularly favour the private housing and renovation sectors, through increased disposable income for average wage earners.

However it is disappointing that in spite of strong lobbying from all sectors, that there have been no changes in the Government's stringent policy on spending on the infrastructure (notably public sector work). This will provide no relief from the difficult conditions which the major civil engineering groups have experienced recently.

OUTLOOK AND CONCLUSION

All the current evidence from the industry increasingly suggests that the Autumn 1985 construction output forecasts for 1986 from NEDO (+1.5%) and the Building Material Producers (+2.5%) will prove too conservative. Expectations of a reduction of at least 1% point in interest and mortgage rates provides further support for this view. Moreover, this trend should continue strongly into 1987 as the effect of reduced mortgage relief is minimal.

Although the sector has performed strongly against the F.T.A. All Share Index, over the past year, this stems largely from a growing awareness of the improved demand outlook for the industry. While increased company earnings in the current year are expected, this is already reflected in the rating of some shares, and has influenced our selections. We particularly favour **Costain, E.C.C., Hewden Stuart, Ibstock, RMC, Steetley, Travis & Arnold** and **Wolseley-Hughes.**

Ian Macgregor
John George

ELECTRICALS

Company	Price p	Pre-tax Profit Hist. £m	Pre-tax Profit Est. £m	EPS Est. p	DPS Est. p	P/E	Yield %	Advice
British Telecom	246	148.0	1,810.0	18.6	10.7	13.2	4.4	HOLD
Cable & Wireless	680	245.0	290.0	33.9	13.5	20.1	2.0	HOLD
Atlantic Comps.	275	10.5	16.5	19.6	3.2	14.0	1.2	HOLD/BUY
Cambridge Ind.	308	10.3	12.5	21.1	12.5	14.6	4.1	FULLY VALUED
Cray Electronics	301	4.2	6.5	16.3	5.5	18.5	1.8	BUY
Eurotherm	365	9.0	11.5	21.2	6.8	17.2	1.9	HOLD/BUY
Ferranti	152	40.0	49.5	7.4	2.4	20.5	1.6	FULLY VALUED
FKI Electricals	62	3.5	5.1	3.2	0.8	19.7	1.3	HOLD
GEC	204	725.0	705.0	16.4	5.9	12.3	2.9	HOLD
Oxford Instruments	493	9.2	16.0	23.4	2.6	21.1	0.5	HOLD
Plessey	228	163.7	164.0	14.5	7.0	15.6	3.1	HOLD
Racal	204	132.3	94.0	10.6	4.3	19.1	2.1	HOLD/BUY
S.T.C	118	(11.4)	90.0	10.7	5.7	10.8	4.9	SELL
Thorn EMI	472	108.0	90.0	24.8	25.0	19.1	5.3	HOLD/BUY
V.G. Instruments	392	10.6	13.8	17.6	3.1	22.3	0.8	HOLD

THE EFFECT OF THE BUDGET

The Budget will have a negligible effect on the Electricals and Electronics sectors. There are no changes to corporation tax other than those previously outlined nor to capital investment allowances which have always been important to companies in this industry. Moreover, there are no changes to N.I. contributions which could have effected an industry with relatively high unit labour costs.

The Chancellor's financial statement does confirm that defence spending is still budgeted to fall in real terms from an estimated £18 billion this year to a planned £19 billion in 1988/89.

OUTLOOK AND CONCLUSION

During the first quarter of 1986, the sector has rebounded convincingly from its relative low last November. This performance has been underpinned by recent statements from the likes of Thorn EMI, Racal, Plessey and STC which indicate that the worst of last year's problems are now over and that order books are picking up at an encouraging rate. This is confirmed in the US where the important book-to-bill ratio for the semiconductor industry recovered to above 1 last month. At the same time, the rationalisation measures conducted over the past year by most companies within the sector mean that they are well geared towards profitable growth on the back of this demand recovery.

The table above shows that several companies in the sector are trading on premium multiples, evidently looking forward to strong earnings growth in the coming financial year. The market is now fully resilient to last year's problems and should have no trouble in digesting poor figures in the forthcoming results season. STC has provided a precedent, returning an unexpected loss for 1985 in an effort to write off everything in one year rather than prolong its restructuring. Nevertheless, investors in the sector have secured attractive gains already this year and there may be some temptation to take profits in the short term in the face of the optimistic ratings. After a period of consolidation we would expect the sector to move ahead again, but for the time being the Budget may attract more attention back to the consumer sector.

Andrew Learoyd

ENGINEERING

Company	Price p	Pre-tax Profit Hist. £m	Pre-tax Profit Est. £m	EPS Est. p	DPS Est. p	P/E	Yield %	Advice
British Aerospace	558	120.2	150.0	40.1	22.8	13.9	4.1	BUY
Vickers	438	45.1	55.0	38.0	21.4	11.4	4.9	HOLD/BUY
TI	519	30.6	45.0	46.8	22.8	11.1	4.4	HOLD/BUY
EIS	269	4.2	5.4	18.6	9.6	14.5	3.6	HOLD/BUY
Smiths Industries	296	47.6	56.5	17.0	7.9	17.4	2.7	HOLD
GKN	346	132.7	150.0	36.0	19.0	9.6	5.5	HOLD
AE	176	22.6	27.0	16.6	7.9	10.6	4.5	HOLD
Dowty	215	44.2	44.0	13.8	7.9	15.6	3.7	HOLD/SELL
Jaguar	465	121.3	130.0	46.7	13.6	10.0	2.9	HOLD/SELL
Dobson Park	96	8.7	10.0	7.8	8.3	12.2	8.6	SELL

THE EFFECT OF THE BUDGET

The impact of the Budget upon this sector is likely to be marginally positive. The few measures announced which affect engineering companies should have the result of reducing cost pressures. Manufacturing investment is already at high levels, and the scope for increases in annual rates appears limited, however, should the Budget coax the investment cycle into maintaining these levels, then the prospects beyond 1986 are brightened for the engineering companies that supply the manufacturers.

The Budget measures which will affect the sector's prospects are as follows:-

1) The reduction in the basic rate of income tax to 29% and the increase of personal income tax allowances in line with historic inflation.

These measures, when taken with the current year expectations for inflation, will aid efforts to limit current wage settlements - important when attempting to contain costs in such a relatively labour intensive industry.

2) The absence of an increase in the duty on fuel oil and the abolition of duties on most lubricating oils and on aviation kerosene.

These measures will help in two ways, stimulating demand by reducing manufacturers' costs and by assisting the engineers' own cost control.

3) The introduction of a 40% tax on refunds of pension fund surpluses to the employer.

This will have little effect on the engineers' utilisation of their large pension fund surpluses, since the method generally adopted is one of reduced contributions or pension fund holidays. Neither of these would be subject to the tax.

OUTLOOK AND CONCLUSION

The strength of the sector relative to the market prior to the Budget will, we feel, preclude substantial outperformance in the immediate post-Budget period. Besides, much of the good news relating to lower fuel and labour costs has already been discounted in the sector's prices.

However, our analysis of the sector's prospects leads to expectations of continued growth in profits and we believe the sector will continue to perform at least in line with the market.

Tom Hawkings/David Hawkins

Miss O'Mara

cc PS/Chancellor
PS/FST
PS/EST
PS/MST
Sir P. Middleton
Mr Scholar
Mr H.P. Evans
Mr. H.J. Davies

CHIEF SECRETARY'S SPEECH : ECONOMIC BACKGROUND

I attach the extract ~~for~~ from the Chief Secretary's speech in the Budget Debate on the economic background. The Chief Secretary is particularly anxious to stress the record on industrial profitability.

2. Could I have comments by <u>5.30 today</u>.

JILL RUTTER.

001/2761

Economic Background

My RHF observed yesterday that we live in an uncertain and turbulent world. I do not think there are many here, or either side of House, who would argue with that observation. And it is that, perhaps more than anything else, which makes it so very important for everyone concerned - for government, for industry, for every individual - to work towards a strong and growing economy based on the industrial success which underpins future prosperity.

This is the goal which the policies of this Government, and the successive budgets it has introduced since 1979, are directed at. And the signs are that these policies are working - really working, out in industry and commerce where it matters and where tomorrow's jobs and wealth truly lie.

For example, the real rate of return of industrial and commercial companies rose to 12 per cent in 1985, the highest level since 1960 and three times more than that of 1975. Excluding North Sea profits. Manufacturing profitability reached its highest point since 1973. The UK has in the past had one of the lowest rates of profitability but the gap is now narrowing.

To judge from the record of the Government ~~at~~ of which he ~~is~~ was a member, the RHG opposite may not think company profitability matters. That it is some how "wrong" for real profitability to return to this country. It is not wrong. It is essential. It is the engine of future investment, of future jobs, of confidence among those with the capital available to invest in the future of this country. The return of profitability to industry and commerce is one of the signs ~~in~~ that the real economy ~~that it~~ is getting stronger.

The signs can also be seen in investment. Total fixed investment rose by 8 per cent in real terms in 1984 to reach an all time high. Further increases are expected to have occurred in 1985. Total business investment was up 15 per cent in 1984 and a further 7 per cent in 1985. There is no sign of a down turn. The last intentions survey for 1986 indicated further growth. The investment is happening now. And every increase in investment, every figure that I stand here and quote, means the economy is getting stronger and stronger, building on the base given it by our policies.

The signs of what is really happening can~~not~~ also be seen in the balance of trade. The current account surplus was £3 billion in 1985 - the sixth successive year of surplus. Non-oil export volume rose 7½ per cent in 1985. Manufacturing exports rose by 8½ per cent to reach an all time high. Since 1981 UK exports in volume terms have grown at least as fast as world trade. We are taking on the competition - and matching it. That is a measure of our new strength. And what a welcome change it is from the story of earlier years.

Underlying these successes are the real changes which companies have made to become competitive. To become strong. To become successful. The number of industrial disputes in 1985 was the lowest for 50 years. We are at last ceasing ~~in~~ to inflict on ourselves the wounds that almost bleed us white during the 60s and 70s.

Productivity, where we have lagged behind for so long, is rising. Steadily. Since 1979 productivity has increased by around 3½ per cent. Every year. Compared with 1 per cent between 1974 and 1979. This means that our productivity has improved more than in France, and in Germany. More signs that we are getting stronger again.

Above all, we must never forget the essential part played by the reductions achieved by this Government's policies ~~and~~ in inflation, and which it remains ~~a~~ our priority to reduce further. The devastating effect of high and fluctuating rates of inflation on industry, trade, commerce; on confidence; on exchange rates and interest rates can scarcely be measured. We are trying to give industry the opportunity is deserves by getting inflation down. And it has come down. It is down to 5.5 per cent; my RHF told the House yesterday that inflation is forecast to be below 4 per cent by the end of the year. A further reduction, and a reduction from ~~the~~ a level the previous Labour Government never achieved in the five years to 1979.

Chancellor 12/2

Bmp

CHANCELLOR - INTERVIEW ON BUDGET

Transcript from: LBC, AM Reports, 19 March 1986

INTERVIEWER: (DOUGLAS MOFFATT) Mr Lawson good morning, when we talked to Dr Owen on this programme earlier this morning he said your Budget has nothing in it for industry and will do precious little for unemployment, his exact words. And surely for people without jobs this is a Budget without hope?

CHANCELOR: Not at all. I think Dr Owen is right in one thing, that is to link industry with unemployment. Because of course it isn't the Government that creates jobs it's business and industry that creates jobs. And therefore what my task is to do as Chancellor is to create an economic climate in which business and industry can flourish. And that is what is happening now increasingly and that is what this Budget will contribute further to. And in that way business and industry will create the jobs opportunities increasingly throughout the country.

INTERVIEWER: Chancellor, you say a safeguard for the present and a springboard for the future. But how can you be so sure that you can be more generous next time, since you came unstuck with oil revenues this time?

CHANCELLOR: Well of course one can't be sure. It's an uncertain world in which we live. But the oil price having fallen as dramatically as it has certainly there is no scope for any further fall of that magnitude or anything like that. But we shall have to see. I'm not predicting anything for certain in the next Budget but we're on course I think for a very good year ahead this year, 1986, with output up by 3%, for the sixth year and inflation down 3 1/2%, the lowest we've had and indeed the best combined performance for a generation. And so in so far as things are in our own power things are looking reasonably promising. But of course there are outside events.

INTERVIEWER: Can I pick you up then on that point that Peter made; the really big surprise for all of us and congratulations by the way for making all of us forecasters look absolute fools yesterday, but the really big surprise was that you were able to lose £5,500 million of North Sea oil revenue and yet still have £1,000 million to play with. But let's just look at that prediction for this year. Are we really going to get the £6,000 million from North Sea oil that you're anticipating and are we really going to get the extra revenues from other sources to make up for that drop, or have you been maybe a little less than prudent in your forecasting in your optimism there?

CHANCELLOR: No, I've been very careful. Very cautious and indeed this is shown by the fact for example that I'm proposing to borrow rather less than I'd indicated last year I would wish to borrow in 1986/87. I think it's safer to cut the borrowing a little bit because of these uncertainties. No, the plain fact is it is a remarkable thing that we have lost £5 1/2 billion on my assumptions - you say it may be more - but £5 1/2 billion of North Sea oil revenues and yet we're still on course, still on track and I'm still able to reduce income tax by a penny in the £ and make various other changes. Now the assumption on which I have Budgeted is that the oil price will average over the rest of this year, 1986, $15 a barrel. I don't know whether it will be that. I think that is a cautious and a prudent and a reasonable forecast. If it dips below that on a temporary basis then that has no policy implications. It will only have policy implications if it looks as if it's going to stay permanently or for a very long time below that level. But I don't see that at the present time.

INTERVIEWER: At the risk of seeming graceless about taxes that haven't gone up, which of course is always difficult to criticise a Chancellor who doesn't put taxes up - I suppose we should be thankful, why do you , have you, suddenly decided that there was no need to follow the policy which the Government has told us it had to follow for all of the 6 previous years and that is to raise those fixed taxes on drink, tobacco and petrol you have done - but on drink - automatically each year just to make up for inflation?

CHANCELLOR: WELL YOU DO HAVE TO DO IT AUTOMATICALLY IF YOU'RE GOING TO MAINTAIN THE REVENUE FROM THE EXCISE DUTIES FROM THESE INDIRECT TAXES. AND THAT IS PRECISELY WHAT I'VE DONE. BUT WHAT I HAVE DONE THIS TIME IS TO CHANGE THE PATTERN FROM CIGARETTES AND THE OTHER ITEMS YOU MENTIONED, ALCHOHOL AND INDEED PIPE TOBACCO AS WELL, BY PUTTING IT ALL ON CIGARETTES SO THAT THERE WASN'T ANY NEED TO PUT UP THE DUTY ON ALCHOHOL AT ALL. AND I DID THIS FOR TWO REASONS. FIRST OF ALL, I THINK THERE IS A VERY STRONG HEALTH REASON, A STRONGER HEALTH REASON EVEN THAN THE CASE OF ALCHOHOL, FOR PUTTING UP THE TAX ON CIGARETTES. SO

SECONDLY, YOU WILL RECALL A COUPLE OF YEARS AGO AS A RESULT OF A COMMON MARKET JUDGEMENT I WAS FORCED TO PUT THE TAX ON BEER UP MORE THAN I WISHED TO DO. AND THIS WAS REALLLY COMPENSATION, HOLDING IT STEADIER THIS YEAR - I'M NOT PROMISING TO DO IT IN FUTURE YEARS - BUT HOLDING IT STEADY THIS YEAR WAS COMPENSATION FOR HAVING HAD TO DO MORE THAN I'D REALL INTENDED TO DO IN 84.

INTERVIEWER: But it means in future Lawson Budgets, unlike Sir Geoffrey Howe's Budgets, we don't automatically look for indexation of those duties?

CHANCELLOR: No what you can automatically look for is recouping the total amount that we get from those duties. But how it is shared around the various duties that is a matter which I have to judge in the circumstances at the time.

INTERVIEWER: Now the other big surprise in your Budget I suppose was the cut in the basic rate of income tax. You made the point that you were directing resources primarily towards the lower paid but surely it would have been more advantageous to simply raise the tax thresholds, the point at which we start paying tax, as far as the low paid and the poor are concerned?

CHANCELLOR: It is important to have thresholds up and that's why we put thresholds up very substantially. Thresholds are now more than 20% higher in real terms, that means even after taking account of inflation, than they were when we took office. And the bulk of that 20% gain, as I say, has happeneed in my own two previous Budgets. So I've done a lot there and thresholds now as a proportion of average earnings in this country are actually higher than they are in the United States and higher than they are in Germany. So I felt we'd done a fair amount there and it's time we looked at the basic rate of tax, which is the rate of tax that affects people most if they decide if theyre going to work a little bit more, a little bit harder, that is the tax on the extra £ they earn. And it's the marginal tax, the economists call it, for 95% of the working population of this country and for 90% of the self employed and unincorporated businesses. So I felt it was really very important to make a start after a long gap, several years, to make a start at getting that down again.

INTERVIEWER: Now looking at some of the small print of the Budget; you seem to be being cautious in your projections about the scope for lower interest rates. We seem to have the worst of all worlds. We've got a very low public sector borrowing requirement which we were always told was needed to get interest rates down and yet we're left with the highest interest rates in the industrialised world - a bad combination?

CHANCELLOR: Well you said a bad combination, I would like to see interest rates lower but let's not exaggerate the problem of high interest rates. On the one hand high interest rates provide a very, very good return for the saver and there are many, many small savers up and down the country with money in building societies and so on who are extremely grateful for this and benefit from this. And secondly, although it is a higher rate than I would like to see it it hasn't stopped industry having a very good year indeed. But I'd like to see interest rates lower and we'll have to see how soon they can come down. But we have got two problems in this country when you compare us with other countries which are very ...... We have got two problems in this country which other countries don't have. One I think we're getting through but has been the way the financial markets have been worried about what's happening in the oil market and this has caused a certain amount of difficulties and turbulence which I've had to cope with. I think, as I say, we're getting through that one. The other one which is not getting through that is the tendency for wages in this country to go up faster compared with productivity than it's happening in our competitors. In other words, the markets are afraid that British goods are going to become uncompetitive because wage costs are going up too fast. And really to put a lid on that I'm forced to have interest rates higher than I would like to be. If wage costs were going up less rapidly we certainly wouldn't need this level of interest rates. Even so I am hopeful that this Budget - we'll have to see what reception it has in the market today, the financial market - but I'm hoping that this Budget, which is a sound and prudent Budget, will pave the way to lower interest rates.

INTTRVIEWER: And the Budget forecast does seem to include at least a 1% cut in the mortgage rate in its assumptions. The other bit of small print that's perhaps a bit more distsurbing; you seem to be anticipating a slow down in growth in 1987. Is there a danger then that the party might be coming to an end?

CHANCELLOR: No, the slow down in growth which you see projected for 1987 is really entirely confined to the oil sector which clearly is going to be worth less as not only the combination of a lower price of oil and indeed output falling slightly. So those two things. If you look at the main economy, the non oil economy, the economies on shore which is where people are employed and you will find no slow down projected at all. And so I think that the prospects for employment are still good.

INTERVIEWER: So finally Chancellor you've got scope for tax cuts of up to £2,000 million if all goes well in 1987 and a further £4,000 million in 1988. That will be enough to enable you to get the basic rate down to that talked about 25%. Does that suggest that on financial we should be anticipating a later rather than earlier election?

CHANCELLOR: Well the date of the election unlike the Budget is not a matter for me.

CHIEF SECRETARY, ROY HATTERSLEY, DAVID STEELE - INTERVIEWS ON BUDGET

Transcript from: BBC 2 TV, Newsnight, 18 March 1986

INTERVIEWER: (..... .....) ... Mr Hattersley, you heard Michael Portillo saying there to John Cole a few minutes ago that this Budget gave a little, only a little, but did give a little to everybody. What do you say to that?

HATTERSLEY: Well first of all it's not true. On the BBC earlier on they gave some more figures, for instance, which showed what this Budget has done for an unemployed family. And the unemployed family, according to your own figures, are 44 pence a week worse off. Well this Budget has done virtually nothing for the unemployed at all. I share Mr Dorrell's view that the real crisis this Budget should have faced is a reduction in unemployment. And the additional job creation measures announced today on top of last year, which were re-announced today and the additional numbers are 90,000. Now that's less than the increase in unemployment in January alone. It didn't touch unemployment. It hasn't touched poverty either. The two great crises, social and economic, have been virtually ignored.

INTERVIEWER: But you yourself recently have been giving greater emphasis than before to the containment of inflation. Could the Government have done more for the unemployed and for the poor without threatening to put inflation back up again?

HATTERSLEY: Yes of course it could. What I said about inflation and what I mean by inflation is that you can't reduce unemployment if you allow your inflation rate to get out of hand. But that doesn't mean you have to abandon every other target and every other objective. This Government could have done a great deal more had it concentrated its efforts on the 3 things that really matter. One is reducing unemployment; the second is aleviating poverty and the third is tr ying to re-establish manufacturing industry. And none of those things were touched. It's been a Budget in fundamental terms of staggering triviality.

INTERVIEWER: Mr Steele, as Will Hutton was saying just a little while ago, it was the Liberals who were really first in the field many years ago with the idea of profit sharing. The Government in the Budget today appears to have pinched your cause on that front?

STEELE: Let me come to that in a second. But can I first say that I agree with those throughout this programme who've been commenting on the sharp divide between a Budget for the haves, those of us who are in work and are going to get some benefit from this, and those who are not. And I do think that that's going to be the most serious criticism and fundamental criticism of the Budget. It isn't just the numbers in the dole queue it's all the consequences that are now seeping through to the rest of the public. The consequences of high unemployment, the rising vandalism rates, the appalling explosion of crime. These are related. And I think that therefore even those in work are now in a mood to say come on let's have a bit of priority to cutting the dole queues rather than indulging in tax giveaways. But having said that and agreed with those who commented in that vein, yes of course I welcome some of the positive things in the Budget. I welcome the concessions to charities and I certainly welcome the new share option scheme. Now that is different of course from employee participation and he's got no further than offering us a consultative paper. We in the Alliance of course have gone a great deal further because our papers are already out.

INTERVIEWER: BUT THAT WILL GO FURTHER BEFORE THE ELECTION?

STEELE: Let me be gracious, let me be gracious, I always welcome converts and I think this is a very healthy step in the right direction.

INTERVIEWER: Mr Macgregor, what about that basic criticism that this is a Budget for the haves and for those in work and not for those who have not and have no work?

CHIEF SEC: Can I start by saying that I think the basic message of this Budget is that the economy is doing extremely well It is a remarkable feat compared with what might have happened a few years ago, that with the big drop in oil prices and the perception that has existed until now that we're dependent so much on oil, a remarkable thing that the Chancellor was able to announce this kind of Budget today. And that we've come through without what would have happened in past, big increases in interest rates and a sterling crisis. So that's the first point, the economy is doing well. We have growth rates higher than most of our competitors and we have inflation rates to levels we haven't seen for years. A combination which gives us a big better prospect than for a a generation. Now that is the best guarantee for future jobs. Secondly, I of course share everyone's concern about unemployment. It's a worldwide phenemon. I think it's important to stress that we're spending £2,500 million already on employment measures and this Budget has added extra ones. What it has done has concentrated on the ones which have been proved to be most cost effective, mainly from creating enterprise for people going out and starting their own businesses. I announced 2 of them in the House of Commons myself. So we have really concentrated the taxpayers money in the right things. Now what Roy Hattersley totally fails to understand is that every extra bit of Government expenditure, for job creation measures or whatever, has to be met by other taxpayers in work or by much higher Government borrowing, which means much higher interest rates which clobbers everyone out there in work, in firms, who've got jobs and who are building up our economy. And that is not the sensible way to get the balance right. So I believe this is a Budget which has acted very good for the economy and will gradually get unemployment down. It's a problem that every country faces.

INTERVIEWER: But if the economy is doing so splendidly as you say it is would it really do any harm for the Government to borrow a little more as people like Mr Dorrell and Mr Heseltine and others in your own party are advocating in order directly to get unemployment down more?

CHIEF SEC: LOOK, getting inflation down is the best way to guarantee long term jobs. Roy Hattersley himself has said that. Our record of inflation is far better than his Government. We don't want to take steps which put inflation up. Getting interest rates down is important, very important, to industry. All these things help, inflation and interest rates, to create a more vibrant economy as we've been doing now over the last 5 years and therefore creating the real jobs.

INTERVIEWER: Do you think interest rates will come down soon now?

CHIEF SEC: That's a matter for the market although I think it's quite clear from this Budget is that we've had a responsible management of the economy, we've handled public expenditure prudently. And therefore I hope the market will seee that the signs are there.

INTERVIEWER: If the market does see that, Roy Hattersley, and interest rates do come down that could give the economy a considerable injection could it not and thus perhaps disprove some of your gloomy prognistications?

HATTERSLEY: It would be quite extrordinary if interest rates don't come down. I mean the interest rates in this country are now higher than they've ever been. The real interest rate in Gt Britain is higher than anyone would have contemplated 5 years ago. Our interest rates were higher than those in our international competitors until last month when our international competitors began to reduce theirs, and ours hasn't gone down. I mean the catastrophe would be if our real interest rates didn't come down by 2 or 3%. Tomorrow I think it will come down by 1% and weak minded Conservative Back Benchers will cheer because tragedy has been changed only into catastrophe.

Our interest rates are now ludicrously high. And that's very largely the result of Nigel Lawson, who isn't leaving it to the market - and John Macgregor knows he isn't and he shouldn't decieve the public - it isn't being left to the market. The interest rate is being kept artificially high in order to keep the exchange rate high and that is against the interests of British industry as well.

INTERVIEWER: Isn't it possible, David Steele, that if interest rates do come down then the Government's much wanted enterprise culture could perhaps start to work and cut the unemployment queues as Newsnight's version of the Treasury Model suggested?

STEELE: I've always accepted that this theory could probably work in the long run. But the point that the Conservative Party's critics inside the the Conservative Party make as well as those of us who are on the outside is very simply that other economies, free market economies, operate much bigger public sector deficits than we do and still have lower rates of inflation. There is no automatic link between those. Look at what's happening in the United States, that's maybe an extreme example. There is no reason at all why we shouldn't be acting directly to remove the scurge of unemployment. And I repeat it is really the social consequences of large concentrations of unemployment. It's not a even figure over the whole country, even that would be a tragedy. It is the hopelessness which you see - we saw it in that little discussion in the North East of England, parts of Scotland, Merseyside and so on. These are the problems the Government is just passing by in the course of this Budget. And to talk about interest rates coming down, which I hope they do, having an effect on unemployment it's not going to help any of these people in the next couple of years.

CHIEF SEC: But it will. The whole point of the policy and the extra growth and the lower inflation is that it will undoubtedly help over the longer term to create new jobs.

INTERVIEWER: How many jobs, how long?

CHIEF SEC: All countries are finding it difficult to get unemployment down. That's undoubtedly what's necessary to create the real jobs. Could I just say to David Steele that if public sector deficits were the way to achieve success that was tried by the last Labour Government and it was a total disaster in this country, rocketing inflation, increasing uncompetitiveness, many of the problems that we've had to sort out ever since. And as far as Roy Hattersley's concerned; he's saying that it's easy to get interest rates down

HATTERSLEY: I said it was easy to get them down because you were keeping them up.

CHIEF SEC: ... when preaching a policy which actually very substantially increases Government spending and put interest rates through the roof. And could I say one other thing because I think David Steele made a point about wider share ownership and what we're trying to do to extend share ownership and very successfully over the last 6 years. I entirely share his approach to this. I think building on the extension of home ownership which has been hugely increased by the sale of council houses the next stage is to increase wealth throughout the whole community giving people a personal stake through shares and financial independence. And it is we who've acted persistently over the years in order to achieve that. And I think to go in with that what's been done on charities is the biggest boost to charities that any Budget has ever seen and will be an enormous help to charities..

INTERVIEWER: The Government have been saying ever since 1979 that the way to tackle unemployment is to create this famous enterprise culture. Is it not therefore fair, as Roy Hattersley has bee pressing you to say, when is it going to work?

CHIEF SEC: All over the country now one sees companies who are actually doing extremely well in overseas markets. The exchange rate position is very good for them at the present time. All over the country one sees new businesses starting up. People have been getting rid of their overmanning. All these things take time after the vast loss of competitiveness that we suffered for a very long time. And that is coming right and that is the way a real economy with jobs that really last.

STEELE: During the lifetime of your Government we have started to import more manufactured goods than we export. That didn't happen before. This is the turn round. We are now less dependent on our manufacturing industry than we were befor you took office. And I think that's the main criticism that we direct at you. And when you talk about the share ownership scheme fine. You can save £2,400 a year, that's great, if you're one of the lucky one like me who might possibly be able to save £2,400.

INTERVIEWER: Look, we had our two economic commentators John Redford and John Kay saying earlier that this time next year the Chancellor may have up to £4 or 5 billion to give away in tax cuts. Now even if you think that is socially undesirable if he does it aren't you worried that this is going to help the Tories to win the election?

STEELE: I'm not actually. I believe that he may well do it because that sums up the whole of his philosophy. But I actually believe now that the mood of the country is not to be fooled by a pre-election tax giveaway. And I don't think it'll work. I think that people will judge the Government on its whole record of stewardship over its 7 or 8 years in office and I think it'll be found wanting on what it has done to the basic structure of our country.

HATTERSLEY: Can I just first correct John Macgregor because it's rather his habit of not telling the truth about the record. Interest rates now are higher than they've ever been, far higher than they were under the Labour Government. And it's one of the great detrements to industry that real interest rates are so high. Exchange rate has deteriorated and helped industry. But the Government's been struggling to keep the exchange rate up on behalf of the City and against industrial activity. Now if the Government were to do something that would produce new jobs whether it won the election or not I wouldn't mind. I happen to represent a constituency in which 50% of the men, the adult men, are unemployed. And this is not a matter of winning elections. One of the things that I despise about Mr Lawson's performance today was a concern with votes when it should be concerned with people who are very poor and people who have been out of work for a year or more.

CHIEF SEC: Manufacturing exports are at an all time high. Manufacturing investment is at an all time high. These are very important factors at the present time. I think our concern is actually to get the real jobs. Our concern is to continue the sustained growth of the economy. Our concern is to keep to get unemployment down in that way. And the Chancellor has never said that there would be, that his target was a drop of 4 points in income tax for the next Budget. He has said it's his long term aim. What we are doing is a prudent responsible management of the economy to achieve that sustained growth.

FINANCIAL SECRETARY - INTERVIEW ON BUDGET

Transcript from: ITV, TV AM, 19 March 1986

INTERVIEWER: (Nick .....) Good morning to you Mr Moore, what do you make of what the Holmes have said, that's a cry from the heart?

FST: It was a very sensible cry if I might say in many ways because the Holmes are answering a lot of the people who keep saying you know, why do you want to reduce tax? They've identified in fact some of the real problems that people who are decent, trying to work, trying to bring up a family actually face. I hope they won't mind if I just say one or two things though. I fully accept what they want. They want much more incentives to actually work, the State to take much less from what they earn. But what might have happened in this country might actually also be interesting to them. We've seen a very radical change in the world oil price. We've lost half the value of our oil revenues in about 25 weeks. So I think many people might have thought and they might have been one of those that we might have to raise taxes. You know, £5 1/2 billion lost in 25 weeks is very significant. So the important thing first of all is we've not had to raise we've been able - and I agree with them enormously.

INTERVIEWER: But all that doesn't help does it, what you're saying there may explain things but it doesn't help them? They're depressed, they'd be better off unemployed.

FST: Just a second Nick. I mean supposing we hadn't in fact managed our affairs wisely and prudently and we had now not to offer them, I accept a very modest, about £2 a week better off in terms of the Government taking less. Supposing we'd had to raise taxes. And secondly I hope they looked at the inflation forecast. Again a factor in the prudent policies. 3 1/2% for the end of this year is the sort of thing that they,, who are decent working people, I know will regard as right. All I can take from what they're saying is for goodness sake faster to get your reductions in tax. I hear what they're saying and I think they're right.

INTERVIEWER: But stay depressed for the time being?

FST: Not depressed.

INTERVIEWER: You just said he's depressed?

FST: Well, of course, I mean to the extent that they obviously would like to have seen more changes they obviously aren't totally satisfied. But what I'm trying to say is compare that to what it might have been if in the face of t he most radical shift in one of our key revenue providers we'd actually had to raise taxes. We haven't.

INTERVIEWER: But when you're sitting there working out a Budget are you actually caring and worrying about how people like the Holmes feel?

FST: Of course Nick. You're caring not just for the Holmes but for everybody. But you've also got to care significantly for the way in which our country has in fact in the past had seen the value of their earnings, the value of their savings, if they had savings decl ine because of inflation. And the erradication, the ways in which business the prospects for them. He said he was a carpenter and joiner I hear. Now when you actually look at the nature of the business prospects for this year we're going to have 3% plus real growth as well declining inflation. Now that will create the kind of business conditions that will help his business. I accept fully his desire to see taxes further reduced. But he wouldn't want us to do it in such a way that we saw inflation rocket up again. That would take away with one hand what we give him with another wouldn't it.

INTERVIEWER: Perhaps you'd like to come in there?

MR HOLMES: We hear this every year, every Budget year we hear the same thing, year after year and nothing has been done. You say you're a caring Government but I don't see it. I'm at the lower end of the scale.

MRS HOLMES: WHAT WE SHOULD BE WE SHOULD BE ON WELFARE BENEFITS. IF YOU TAKE OUR TAX FROM US THEN WHY NOT GIVE US BACK SOME OF THE WELFARE

BENEFITS THAT WE'RE PAYING FOR?

FST: What you're husband was saying that what he actually wanted was a reduced burden of tax. Now what we've actually done in 7 years is to reduce taxes in the basic rate. This is the first time in 7 years but he is right. We've reduced them by 4p in the £ and since that's a significant move. We've also increased thresholds in real terms by over 20%. Those have been a real help to the working people, real help to people like yourself. I'm accepting entirely that we ought to do more.

INTERVIEWER: Can I just come in a second here; you talk about working people if that is one of the argumens that it's a Budget for working people but for the jobless it's just no good at all. You've done something I know but how much - you've spent about £195 million on them but £900 million on tax cuts?

FST: There are two things for people out of work Nick. One is of course to try and help those who are unemployed, and you're right, in gross terms it's terms it's £300 million nearly a year. The other thing is to try and ensure business conditions are such to allow these kind of people to go to work, to hire more people. The changes there in the business climate, and very major significant changes, I think will be of significant improvement. I don't know whether you've seen the OECD data where the OECD suggest that 1986 Britain will probably will top the growth employment league. Now one of the reasons for this is that for the last few years the bulge in people in work has been growing by something like 500,000 "new people a year. In 1986 that will have dropped to 100,000 for the first time. You know the bulge is ending.

PPS Chancellor
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CHANCELLOR - INTERVIEW ON BUDGET

Transcript from: BBC Radio 4, Today, 19 March 1986

INTERVIEWER: (PETER HOBDAY) NIGEL LAWSON'S 9,000 word Budget speech has now been gone through with a fine toothcombe by political friend and foe alike. There's a lot of praise but there's also quite a large measure of criticism, especially on what his critics see as the lack of real measures to bring down unemployment. Well Mr Lawson is in our radio car so I'll put many of those criticisms to him. Good morning Mr Lawson, first of all can I quote Mr Heseltine who says that the money that you're spending on job creation doesn't meet the scale of the challenge that we face in the inner cities?

CHANCELLOR: We're doing a tremendous amount in the inner cities. Of course, as you know, to the extent that Mr Heseltine is talking about public expenditure that's something which we discuss at another time of the year, we discuss during the annual public expenditure round, and our conclusions when we've weighed up the various priorities are announced in November. And then in the March Budget that is primarily a time for determining how much it is wise for the country to borrow, for the Government to borrow, and what the tax rates should be and what tax changes there should be. In so far as of course that it's a wide issue then what really matters is for us to have a vigorous, enterprising economy. That is the answer to unemployment in the long run, that is the answer to the inner cities. And we've seen it where there has been success in the inner cities and that is what all the Government's measures are dedicated to achieving. And you know the economy is now doing pretty well. We need to do a lot better but we're doing very well compared with what we've ever done in the past or what our rivals are doing overseas.

INTERVIEWER: Isn't that what again some of your critics call jam tomorrow? Mr Norman Willis for example was saying that your attempts to create that enterprise culture, that enterprise economy, those measures to encourage people to invest in shares, is going to take a very long time to come through, as indeed those talks about profit sharing to encourage employment - as Mr Willis put it - don't hold your breath?

CHANCELLOR: Well I make no apology whatever for thinking of the future and preparing for the future and taking measures now which will have a long term beneficial effect. You know, one of the troubles in this country is that Governments in the past have just thought for the present. They've just been interested in the next few weeks or the next few months. This is a Government which does think far ahead and plan for the long term. But it's not a question of jam tomorrow. That is quite wrong. If you look at what's been happening in this economy, we're now in our fifth year and about to embark on our sixth successive year of growth at 3% a year. We've had inflation low now ever since the end of 1982. It remains low and this year, 1986, I'm forecasting the best year ever with inflation down to 3 1/2%. In fact if you look at output inflation combined this year is going to be building on what we've done already. The best year for a generation.

INTERVIEWER: Mr Kinnock's central criticism was despite what you say is that you've done nothing to restore the UK's manufacturing base. In fact all you have done, he says, is juggle with taxes?

CHANCELLOR: Well British manufacturing is now doing very well indeed. I don't think really Mr Kinnock knows a great deal about either the economy or industry. Certainly listening to him that is the impression one can't fail to get. The plain fact is that manufacturing industry is now going ahead very well indeed. It has made itself far more productive, far more efficient than it has ever been before. If you look at the 6 data years up to 1979 manufacturing productivity rose only 1% a year. The slowest of any of any of the major 5 industrial countries. Over the 6 years since 1979 the growth in manufacturing productivity has been a shade over

3 1/2% a year which is better than any of the major countries apart from Japan. There has been a big change and manufacturing exports are at an all time record level and output is rising fast. And now, and now manufacturing industry really does have a real boost from the reduction in the cost of the oil it uses.

INTERVIEWER: Except that the manufacturing sector is now smaller than it was when you came to office in 1979?

CHANCELLOR: Output is smaller but of course it was smaller, it's been going down for some time as it did under t he Labour Government. Although I would think that by the time that we have ended this Parliament you will find that manufacturing output has in fact if anything risen whereas it was falling under the Labour Government. But the main point is not the size of the output but how competitive we are. And we are winning a bigger share of the world markets. Our manufacturing exports are at an all time record level and rising fast and manufacturing industry is far more efficient and productive. The parts of manufacturing industry which we've lost were the parts which weren't in fact creating wealth for the nation or for the people who were .....

INTERVIEWER: Can I quote you Mr Lawson the last paragraph of the Guardian this morning; and it says all the basic problems Mr Lawson inheritted remain to haunt future administrations; appalling infra structure, desperate housing conditions, low manufacturing investment, a withering technological base and a growing army of disenfranchised poor and unemployed.

CHANCELLOR: Well that's typical Guardian claptrap. It's what you'd expect isn't it.

INTERVIEWER: there's no truth whatsoever in the fact that our infra structure is appalling or there's low manufacturing investment or our technology is not keeping pace?

CHANCELLOR: Not at all. Manufacturing investment is rising fast and what is more, and as a result of the changes I've made in the tax system, the quality of manufacturing investment is improving. You know there's no benefit in of hardware for the sake of hardware. What we want is manufacturing investment which is actually going to bring a worthwhile return and that is what is going on now. Now I mean everybody abroad recognises this. Our standing overseas is far higher than it's been for a very long time. Everybody abroad understands the transformation there's been to British industry. It's only the carpers like the Guardion here who don't wish to do so.

INTERVIEWER: But what are you going to say to the Financial Times' carping when it says that even if you take your economic philosophy, so called supply side which is cutting taxes to boost demand to generate jobs, that this to a certain extent is a Chinese meal, there's very little substance in it?

CHANCELLOR: No, there's a lot of substance in it and of course a supply side policy is not a policy to boost demand as you suggested. A supply side policy is a supply side policy. That is to say to make the economy more efficient. The demand is there, there's plenty of demand. A lot of the demand at the moment goes to buy imported goods. The need is to make British industry more efficient, more efficient in satisfying the domestic markets, more efficient in satisfying markets overseas. I believe this is well understood by British industry and I believe it's made remarkable strides. Of course there's a great deal still to be done. But you know it really isn't terribly clever to spend all your time running our country down and certainly that's not how foreigners see it.

INTERVIEWER: One final point from Mr Roy Jenkins, a man who had your job a few years ago, he says that it's a complacent Budget. It has to be complacent because we still have a stubborn level of unemployment at over 3 million and that this Budget is going to do very very little to reduce it?

CHANCELLOR: Of course we have far too high a level of unemployment and I recognise this and the whole Government recognises this. And I introduced a whole range of new measures, far reaching measures, to help the unemployed, particularly the long term unemployed and the youngsters. And those are on top of all the measures that we had introduced over the past 3 years. And these are having an effect. But you know there's no easy answer to unemployment neither in this country nor in any other countries who suffer from it. And the way to get unemployment down are first to make t he economy more efficient to that industry is generating more jobs - and that is happening. Second, to have reasonable levels of pay so that, and it's a management job this, so that people are priced into work not priced out of work. And thirdly, while there is high unemployment to take the humane and helpful measures that we are taking in order to try and find jobs for those who are out of work.

ECONOMIC SECRETARY - INTERVIEW ON BUDGET

Transcript from: BBC Radio 4, PM Budget Special, 18 March 1986

PRESENTER: ... our reporter John Silverman the criticism that this was a jam tomorrow Budget?

EST: Well the first thing I would say is that the Opposition parties in the House of Commons were very disappointed because they found that the Budget was very well received. Of course we have to be cautious this year because with the problems in the oil market and the foreign exchange markets it would be irresponsible not to have a prudent Budget this year. And so the Chancellor didn't have as much resources at his disposal as he would have liked. But despite that we've been able to make a reduction in the basic rate of income tax, we've introduced a lot of measures to help the charities, to help smaller businesses, measures to help the unemployed. And I think it all adds up to a Budget for today. If it gives us greater opportunities in the future that would be even better. But we're maintaining the progress after 5 years of steady growth we're now looking forward to 6.

INTERVIEWER: You talk about measures to help the unemployed; surely the measures which Mr Lawson did outline were few and far between and really don't come anywhere near tackling the scale of the problem?

EST: There are two points I should like to make in reply to that. The first is that they are not in isolation, they are of course a continuation of a lot of measures to help particularly long term unemployed and young people which were already in place. The Youth Training Scheme which is now going to be from 2 years only comes into force for its second year from next month. We've introduced the enterprise allowance which is now being increased, the community programme which is now being increased. We've got the job start scheme for the long term unemployed. And this year the new and imaginitive scheme, the new workers scheme to help particularly younger people getting their first job. That's the first half of the problem. The second half of the problem, and the only way to get enduring jobs in the longer term, is to maintain the growth and the recovery in the economy and the Budget is designed to do that.

INTERVIEWER: But last year's Budget surely was designed to do that and a number of people who've joined the dole queue is an extra 100,000?

EST: I should say to you that over the last year for which we've got figures the number of new jobs increased by more than 200,000. In fact since the last election we've had an increase in jobs of over 600,000. Now in any ordinary times that would be seen as a very impressive performance. The fact is that there's still the baby bulge of the 60s working through and that has offset it. But the strong rise in the number of new jobs in the last 2 years is very encouraging.

INTERVIEWER: Nevertheless 7 years into two Tory administrations surely people, especially long term unemployed people, might have expected something more dramatic to try and aleviate their position?

EST: In the past when fairly dramatic measures - usually large increases in public expenditure - have been tried for those sort of purposes they've blown themselves out within a year or two and they've caused problems with higher interest rates, higher borrowing costs for successful industry and they've contributed to a lot of our long term decline which we're now reversing.

INTERVIEWER: But what the Chancellor had to say about pay outstripping productivity; this sounds like the sort of message that he was pressing very early on in the Conservative Government. Surely people are expecting something a bit more positive now?

EST: I think the CBI have recognised fully that there is a responsibility on employers. Of course higher pay settlements if they're not matched by increased productivity do mean fewer new jobs will be created. But the general strength of the economy has increased our revenues - and that indeed was one of the reasons why the Chancellor had some room for manoeuvre. So that is living proof of the fact that business is expanding, the companies sector's doing very well, jobs are being created. So far they're just about keeping pace with the increased number of the workforce. But we hope that that will now improve.

MINISTER OF STATE - INTERVIEW ON BUDGET

Transcript from: IRN, LBC Budget Report, 18 March 1986

INTERVIEWER: (.... ....) ... But first for the Government, Treasury Minister Peter Brooke. He says one of the main planks in the Government's policy is the incentive plans to extend share ownership.

MST: He announced that as from 1 January next year everyone will be able to invest £200 a month, or £2,400 a year, in a personal equity plan of their own. That plan, provided the shares are held - the individual is going to be able to choose which shares he buys and he's going to be able to change the shares when he wishes to - but provided he's held them for between a year and 2 years - the date wasn't specifically specified but that will be part of the consultation - they will be free of capital gains tax. And the dividends which flow from those shares, provided they are ploughed back into the scheme, will also be tax free. So there's a major opportunity for individuals in fact to build up their own equity portfolio.

INTERVIEWER: On the subject of unemployment; he announced an extension of the community programme which is going to see 55,000 more people brought into it but in general it was scorned by the Opposition - you could hear cries of tea and sympathy when they were talking about it and some of the various other schemes. I mean really he didn't do a lot for unemployed?

MST: Well he announced measures which in a full year will cost just under £200 million - in the first year it will cost just under £200 million and then in the subsequent will cost just under £300 million. The aspect which they referred to "tea and sympathy" was the extension of the pilot scheme which has been going extremely well so far this year in different selected pilot parts of the country where the long term unemployed are being invited in to discuss their circumstances and are being given the opportunities to go and look at particular job chances. And it's because that experiment has gone so well that we've announced its extension to the whole country.

INTERVIEWER: But, as the Opposition are pointing out all the time, no jobs involved, no jobs?

MST: Well, that's a question of whether you can secure a job for the person as a consequence of his coming in, and as a consequence of the dialogue and his going off to look at a particular thing. If he didn't want to come in for that occasion then quite clearly that job wouldn't eventuate. And there's I think good evidence in terms of the experience so far that jobs are coming out of this simply because of the linkage with the individual with the opportunity.

INTERVIEWER: Now the charities benefitted quite considerably from this Budget though they've been lobbying for a long time for some relief on VAT. What exactly have they been given relief on?

MST: Well they were given relief on about half a dozen individual items like the sound equipment for the blind, the refrigeration and medical equipment in particular forms of medical research, medicinal products in research both for humans and for animals. And a range of products for the disabled, including lifts and ramps, including the reconstruction of buses for the transportation of the blind, the deaf and the handicapped. There was a range of those sort of projects which the charities VAT reform group have been specifically asking for. They've come to us with a shopping list and said we would like help in these areas if you felt able to do it. The one which is in a sense different from the others is he's removed VAT from advertising, except the classified advertising, for charities so that their fund raising if they're using advertising for fund raising will in fact be VAT free.

FINANCIAL SECRETARY - INTERVIEW ON BUDGET

Transcript from: BBC 1 TV, Budget Special, 18 March 1986

INTERVIEWER: (Robin Day) ... Mr Moore may I ask you first of all by how much will this Budget reduce unemployment?

FST: I mean Robin obviously that would depend a great deal on how much business responds. We're seeing a very major improvement in business and if you noticed the latest OECD comment they're saying that they think employment in Britain will actually improve better than in the whole of the rest of the OECD in 1986.

INTERVIEWER: Will the Budget reduce unemployment?

FST: Well I hope so. If you look through the Red Book - which you probably haven't had time to read yet, I understand that - you will see that as opposed to the last few years where the growth in those coming into the labour market, the bulge as it were, has been growing at something like 500,000 a year, it's only likely to be 100,000 this year. In the oil price decline and with greater labour mobility I think we can be much more hopeful at this time.

INTERVIEWER: Does that mean you say that within the next year unemployment will be reduced?

FST: Well you know Robin we don't like to be so precise as that. I said I hope looking at the basic figures, looking at the way in which the Chancellor has managed to sustain the economic position in the face of the very radical overshot, I hope to see some improvement in the unemployment figures.

INTERVIEWER: But do not many of the people on your own side of the House, especially some senior ex Ministers, do they not believe that the Chancellor should have taken some measures which would enable you to do more than hope about reducing unemployment and say it will be brought down?

FST: I just left the House Robin and the reaction was extremely good to the Chancellor. And he has in fact taken measures in two counts. He's taken measures specifically, directly to help the unemployed, very substantial measures. But much more important he's tried to ensure that business has in fact the right conditions to flourish. The prospects for this year are for a 3% growth with a declining inflation to 3 1/2%. Now that's the basis on which you can see better opportunities for work, better opportunities for employment.

INTERVIEWER: Is this really a Budget for the bottom half of wage earners as Mrs Thatcher predicted it would be?

FST: Well it's a Budget for all Britain. It's a Budget to try and ensure that we continue to grow as successfully the way we have and it's a Budget to ensure that business has the capacity to offer new job opportunities.

INTERVIEWER: I understand that but it was said by Mrs Thatcher and others that attention should be paid now to what she called the bottom half of workers because she said we've done things for the rich now let's do things for the lower half?

FST: You're right in so far as the tax changes help very specifically those in the middle bracket considerably more, the way in which the upper brackets have not been increased proportionately. That obviously means that a very great deal of help has been tailored to those who in fact haven't probably benefitted quite as much by the previous tax reductions.

INTERVIEWER: The average earners will get more from this Budget than will the lower paid?

FST: Well I think you'll find if you go through the figures that pretty well everybody does relatively well. But what you're asking was do people who are very rich do as well as they might - no they do less well than they would have done on pure indexation.

INTERVIEWER: I understand that but the lower paid haven't done as well as a lot of people expected they might do if in fact he did something else but take a penny off the income tax and had say adjusted the child benefit or the employees surcharge?

FST: Well the lower paid will do much better by having better job opportunities and seeing inflation kept under control I would have thought Robin.

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FINANCIAL SECRETARY - INTERVIEW ON BUDGET

Transcript from: BBC 1 TV, 9 O'CLOCK NEWS, 18 March 1986

INTERVIEWER:(John Cole) Nigel Lawson left No 11 with a political craftsman's Budget in his box. With little economic scope he chose to play to the political gallery, primarily his own anxious Back Benchers but with a sideglance at by election voters too. He cheered the Tories by spreading his limited cheer subtly; charities, shares, gifts, a reprieve for dirnkers but a clobbering for public enemy No 1 the smoker and a penny offincome tax to win him his loudest cheer. But whether it'll help employment is what the Parties are debating tonight.

FST What we think is that the reductions in tax will actually encourage people to work harder, to go to work, encourage businesses actually to hire more people. We think the two go together. We've actually not just reduced the basic rate we've also of course increased thresholds quite substantially, with threshold increases of 5.8% with the rate of inflation going down to 3 1/2%, another gain there.

ROY HATTERSLEY: It failed wholly to meet the great issues which are facing the economy and facing the country. It did virtually nothing for unemployment. It did literally nothing for the very poor and it did virtually nothing to rehabilitate manufacturing industry. That's what the Budget should have been about. Instead of that it was Mr Lawson's usual prescriptions; excuses for the past, promises for the future and a few phr ases which he hopes will make headlines tomorrow morning. And headlines don't create jobs.

ROY JENKINS: It's a complacent Budget. Complacency would be in place if everything was all right, if we weren't facing a very bleak future with the oil revenues going quite fast and with unemployment at a stubborn and unacceptable level and a danger indeed of it rising still further.

JOHN COLE: The Cabinet met this morning but its crucial decision's been left till July. It could then choose to go for broke by leaving the

Chancellor room to bring income tax down to 25 pence before the general election or, as some Ministers would prefer, it could hedge its bets by spending more on roads, housing, schools and hospitals and so creating jobs directly. No doubt what the Prime Minister, her Chancellor and Norman Tebbit would prefer. They believe another 4 pence off income tax is the best chance of creating the enterprise culture which so far they've found British industry so unable to generate. Some Tory critics fear the Chancellor has already pre-empted that decision by setting his tax rate target at 25 pence and making higher public spending impossible. Nigel Lawson denies this saying it's a target not a promise.

But the big battle for the rest of this parliament is to decide which comes first, tax cuts or higher public spending.

FINANCIAL SECRETARY - INTERVIEW ON BUDGET

Transcript from: ITN, Budget Special, 18 March 1986

INTERVIEWER: (David Walter) John Moore, Neil Kinnock called this Budget jam tomorrow from a Chancellor in a jam today. Isn't that the situation?

FST: No it really isn't David at all. When you actually think what's happened - the extrordinary shock in the world oil market - the fact that we've been able to absorb a £5 1/2 billion loss in revenue and still look to a year ahead of 3 1/2% inflation by the end of the year, a considerable reduction happily, a 3% pattern of growth and been able to modestly but still significantly reduce overall taxation I think that's a little bit of jam today, very sensible jam as well.

INTERVIEWER: Well the Chancellor did have a billion £s to give away which he spent on a cut in the basic rate; wasn't that a waste of money, couldn't that have been used more directly to help jobs?

FST: Well we are already spending, and we did in fact of course increase in this Budget other spending on jobs, there was something like £300 million in gross terms, expenditure to help the unemployed. What he's trying to do is to ensure that the business community is in fact able to generate more jobs. We've seen very major increases in jobs from the business community in the last couple of years and we want to encourage that.

INTERVIEWER: Shouldn't there have be£m more though for research in manufacturing industry where large numbers of jobs come from?

FST: Well happily manufacturing, again as the Chancellor said, is doing rather well. Much better than it's been doing for many years in productivity, in its exports, in its growth and its investment. He wants to encourage that clearly.

INTERVIEWER: But it's not producing the jobs?

FST: Well it is in fact. If you look at the OECD comment about us they reckon we're going to be the best country in the OECD in 1986 in terms of new jobs. The problem has been the unemployment level. That's still much too high. The new jobs have been coming along and for the first year we'll be seeing a major reduction in the bulge of people coming into the labour market. It's been growing at half a million a year for some years and now at only 100,000. That should show a major improvement therefore this year in employment.

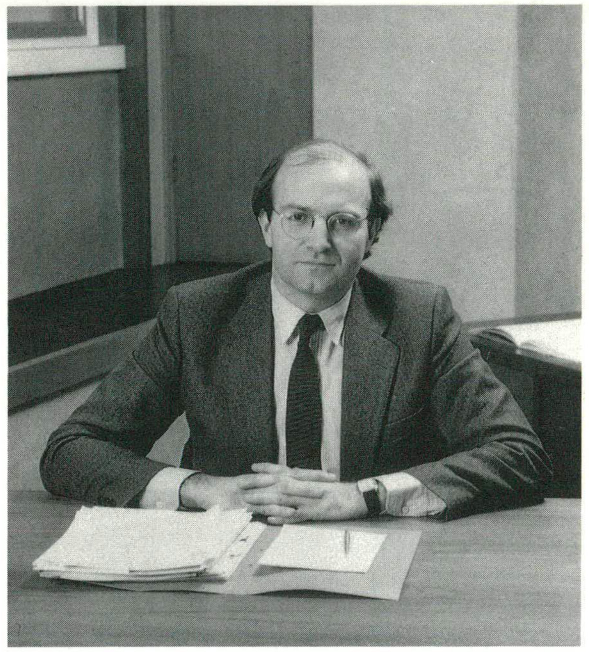
LLOYDS MERCHANT BANK GOVERNMENT BONDS

Budget Assessment

18 March 1986

Budget Assessment

Edited by Roger Bootle, Chief Economist



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The Reaction of the Markets

Base Rates The reduction in the PSBR, the low inflation forecast and the introduction of a monetary target which looks like being met, are all helpful to base rates. A 1% reduction in base rates should follow more or less immediately, with further falls later in the year. Single figure base rates are on the horizon.

The foreign exchange market Lower interest rates are not good news for sterling but they must have been discounted by now. Of more importance will be the lower PSBR target, low inflation, and perhaps most important of all, the enhanced chance of continued Conservative rule for the foreseeable future. In short, the pound should show strength over the next few weeks and months, pace oil.

The gilt-edged market There are several factors in this Budget to please the gilt edged market, notably the lower PSBR number, the prospect of lower base rates (partly discounted), and the low inflation forecast. Two aspects which may leave a nasty taste in the mouth are the 11 - 15% target range for £M3 (and its implied maximum of £24 bn growth in bank lending) and the suspicion that, taking account of special sales of assets, the Chancellor's stance is decidedly expansionary. But the doubts should not weigh heavily. Sterling M3 has lost credibility and the point about special assets sales should have been in the market since last November. Of more importance should be the improving auspices for the Chancellor and his policies now that he has inflation, interest rates, growth, tax rates, and soon even unemployment moving the right way.

The equity market This should be the star performer. Not only does it have all the bullish factors above going for it, but it also enjoys the boost to consumer spending implicit in the cuts in income taxes and the relief at the minor rises in excise duties in contrast to the substantial imposts on petrol and tobacco it had expected. The reduction in Stamp Duty, the move against over-funded pension schemes and the scheme to assist individual share-ownership should also go down well.

In short the equity market should give the Chancellor a resounding vote of confidence.

Roger Bootle

18th March 1986

SUMMARY

- In his third Budget Nigel Lawson has done his best to lay the economic foundations for a Conservative victory at the next election.
- With at least £2 bn stored up for net tax cuts next year, and £4 bn earmarked for the following year, he will be hoping to deliver a 25p basic rate of income tax in his next Budget.
- Buoyant non-oil revenues have allowed the Chancellor scope for £1 bn of tax cuts this year, and a £1/2 bn reduction in the planned PSBR, despite a drop in oil revenues of £5 1/2 bn.
- But if account is taken of the £2 1/4 increase in Special Asset Sales between the current financial year and the next, the package represents an injection of demand into the economy of £2 1/2 bn.
- Moreover, the monetary targets have been relaxed. It should be possible to keep £M3 within its new 11 - 15% target range. But this is consistent with growth in bank lending of up to £24 bn.
- Few people, however, will take the monetary targets seriously any more. Despite its minor rôle in the Chancellor's Statement the exchange rate is now the principal intermediate policy target. Management of the exchange rate is the policy that dares not speak its name.
- The official forecast of 3% real growth in the economy this year is credible but the balance may be even more heavily tilted towards consumption than the Chancellor expects.
- The forecast of 3 1/2% inflation may prove to be too conservative. We feel that inflation will be within a whisker of 3% by late spring, and will more or less hold that level over the year.
- Meanwhile, the Chancellor can now realistically hope for a reduction in unemployment, albeit a small one, before the next election. 3% growth could create 200,000 jobs and Government special employment schemes are planned to take more people off the register.
- Bank base rates should fall promptly by 1%, followed by further falls in coming months.
- The foreign exchange, gilt-edged, and equity markets should all register a favourable verdict. But the equity market may go further. The promised consumer boom may cause it to give the Chancellor a resounding vote of confidence.

Roger Bootle
Chief Economist
Lloyds Merchant Bank.

BUDGET ASSESSMENT

by Roger Bootle

To many observers this will seem a boring Budget, with no major tax initiatives. But nevertheless it is remarkable for all that. For with £5 1/2 bn knocked off his oil revenues for the coming financial year, many commentators have suggested that the Chancellor would either have to raise taxes, or raise the PSBR, or both. His objective has been to do as little of either of these as he possibly could, whilst bending every effort to tailor the Budget with the next election in view. Assessed in this light, he has scored a success.

The borrowing target has been reduced, and so have taxes. Meanwhile, the general economic background begins to look consistent with a Conservative election victory - inflation at 3 1/2% and falling; interest rates falling; consumer spending booming; and even a fall in unemployment in prospect.

How has he done it? Table 1 shows the changes in the Chancellor's basic arithmetic for 1986/7 compared with the estimates he made in last year's Budget.

Table 1

How the loss of oil revenue in 1986/7 was absorbed*, £bn

Lost oil revenue	- 5 1/2
Higher non-oil revenue (before Budget measures)	+ 3 1/2
Budget tax measures	- 1
Built-in fiscal adjustment	+ 3 1/2
Net effect of Budget expenditure measures	0
Reduction in PSBR (+)	+ 1/2

* Compared with the plans for 1986/7 published in last year's Red Book.

The lost oil revenue has been absorbed principally by non-oil revenues running some £3 1/2 bn above the levels assumed in last year's Red Book. This has left a gap of £2 bn to be filled. But since the original plans allowed for a tax cut of £3 1/2 bn, and the Budget measures amounted to a reduction of only £1 bn (from an indexed base in 1986/7), and the public expenditure total was held to the original planned level (admittedly with the help of an increase of £2 1/4 bn of special asset sales), this has left him with £1/2 bn to reduce the PSBR.

Income Tax and the Next Election

The £1 bn available for net tax cuts was taken up entirely by a 1p reduction in the basic rate of income tax.

more favourable than this. Inflation in the OECD area could be 3% or less by the end of the year. (In Germany it could even be zero.) Sterling prices of manufactured goods will, of course, rise by more than this due to the fall of the pound. With the effective index at 74, sterling is down 5% since the end of last year, and down by the same amount against the average of last year.

But commodity prices have fallen sharply. In SDR terms they are down about 8% over the year (and nearly 18% in sterling terms). And the dollar oil price has just about halved. Together, these factors have caused the index of manufacturer's cost to show a year on year fall to February of 9 1/2%. This is yet to be fully reflected in manufacturer's output costs.

These factors will help to restrict all measures of overall inflation in the domestic economy, but the RPI will probably register much lower figures than other inflation measures. We anticipate substantial falls in interest rates this year, in which mortgage rates should share. A 2% fall in mortgage rates would knock nearly 1% off the RPI.

Naturally, the Budget's increases in excise duties will push up the index, but not unduly. Indexation of excise duties will add about 1/2%, which is the same as last year's effect.

In sum, we think that RPI inflation will be within a whisker of 3% by late spring, and will just about hold that level throughout the year.

Unemployment

The Government studiously avoids giving a forecast of unemployment in the Budget and there have been too many false dawns for it to make confident pronouncements outside the Budget. Yet there was an underlying confidence about unemployment in the Chancellor's statements, and in the Red Book. This is based on several factors:

(i) The two year YTS introduced by the Chancellor last year comes into operation only in April of this year;

(ii) The Chancellor has announced an increase in the Community programme of 55,000 places,

(iii) 3% real economic growth may translate into a net addition of 200,000 jobs;

(iv) The rapid growth in the labour force appears to be slowing down.

It goes without saying that even with these factors working favourably, only a small reduction in unemployment is on the cards, hence leaving it at an appallingly high level. Moreover, the measured figures bear only a tenuous relation to the "true" level. Nevertheless, the Government has not set its sights very high. And if Nigel Lawson could deliver a fall, albeit a modest one, running into the next election it would undoubtedly be seen as a feather in his cap. It now looks on the cards.

(not least because building societies are due to enter this market from the beginning of 1987), it is difficult to believe that the savings ratio will rise appreciably. Accordingly, we suspect that the Treasury's forecast of 4% growth in consumer spending may prove to be too conservative.

By contrast, we are more pessimistic about overseas trading performance. Since the Autumn Statement, the Treasury has reduced its forecast for the oil surplus on the balance of payments by only £3 bn. Given oil prices of $15 per barrel or below, that looks a little on the optimistic side. Moreover, in the Treasury's forecast the balance of trade in goods has improved by £1/2 bn, and the balance on invisibles by no less than £2 bn, leaving the whole account only £1/2 bn lower. Despite stronger world trade and a lower exchange rate, these improvements in the non-oil balance look too good to be true.

But even excepting the Treasury's forecast of these components, the economic recovery is looking very lopsided. As table 4 shows, the economy is being driven almost entirely by consumption. And on the Treasury's forecast for the first half of 1987, by then the growth in consumption spending more than accounts for the whole of the increase in GDP.

This makes the decision to use the available fiscal headroom to reduce the basic rate of income tax all the more questionable.

Table 4

Contributions to Projected GDP growth in 1986*

	% Growth	Contribution to GDP growth	% Contribution
Consumers' Expenditure	+ 3.9	+ 2.7	90.0
General Govt. Consumption	+ 0.8	+ 0.2	6.7
Total Fixed Investment	+ 5.0	+ 1.1	36.7
Exports	+ 4.9	+ 1.6	53.3
Change in Stocks	-	(0.1)	(3.3)
Less: Imports	(5.9)	(1.9)	(63.3)
Less: Adjustments	(3.8)	(0.6)	(20.0)
= GDP at factor cost	3.0	3.0	100

*Source: Adapted from the Red Book forecast tables. (Figures may not add up exactly due to rounding).

Inflation

Is the Chancellor's forecast of 3 1/2% inflation credible? We think it is. It may even be a shade too pessimistic. Although domestic labour costs are likely to rise by something like 5%, external costs will be

Why did the Chancellor opt to reduce the basic rate rather than raise personal allowances?

Firstly, because he now believes that a 25p in the £ basic rate is possible - and it is a vote winner.

The Red Book plans for 1987/8 envisage scope for a fiscal adjustment of £2 bn, followed by a further £4 bn in 1988/9, by which time the General Election may already be upon us. But with 2p in the £ in hand for next year, it should not be too difficult to find the wherewithal (possibly by "borrowing" it from 1988/9?) for an extra 2p, particularly since the Chancellor's revenue assumptions for 1987/8 look a little pessimistic. (Oil revenues are assumed to fall by another £2bn to only £4bn.)

Secondly, he has made clear his intention of shifting to a system of single transferable allowances. In order to make such a system widely acceptable, he will have to ensure that there are no (substantial) losers from the shift. This means compensating tax-payers for the value of their existing allowances. So the lower those allowances are, the less the Chancellor has to find to effect the shift! And this factor is compounded if the basic rate of tax is reduced.

But income tax cuts are merely a part of the story. What does the whole Budget package imply about the fiscal stance?

An injection of demand

Judging whether a Budget is neutral, expansionary or contractionary is never easy. There are several different bases on which to make the judgement. Certainly a budget is not expansionary simply because it cuts taxes. But the PSBR is a good guide, provided that it is adjusted in certain key ways. Most important of these in the current context is special asset sales. These serve to reduce the PSBR by dint of an accounting quirk. Yet public spending financed by asset sales stands on all fours with spending financed by gilts. Accordingly, the total for asset sales must be added to the PSBR to get a measure of fiscal stance.

Table 2

Asset Sales and the Fiscal Stance

	1985/6	1986/7
PSBR	6.8	7.1
Asset Sales	2.6	4.7
Adjusted PSBR	9.4	11.8

The appropriate figures for 1985/6 and 1986/7 are shown in Table 2. They suggest that the 1986/7 PSBR represents an injection of demand into the economy of about £2 1/2 bn.

In this context it will be particularly interesting to see how accurate the Chancellor's estimate of £6.8 bn 1985/6 for the PSBR proves to be. For it requires the March PSBR to be a full £4 bn. If it falls short of this figure, and the 1986/7 PSBR is unaffected, then the fiscal expansion between the two years would be even greater.

Monetary Policy

The continuing saga of monetary targets must be just about the longest running Whitehall farce. The resurrection of £M3 cannot be because the Chancellor now seriously believes in it. Rather, it is a case of "faute de mieux". M0, his favourite measure, although well-behaved, commands no confidence in the City (and for good reason!), and hence cannot be allowed to stand alone; Money GDP is more an intermediate objective than an intermediate target; PSL2 is subject to distortion; M2 is both prone to distortion and has been running insufficiently long for the seasonal adjustments to be reliable.

When the Chancellor dropped £M3 in his Mansion House speech, doubtless his advisers at the Treasury must have hoped that by the time the Budget came round they would have been able to ease Mrs Thatcher out of her trenchant opposition to the EMS. The exchange rate could then have been erected as the centrepiece of anti-inflation policy, allowing monetary targets to fade quietly into the background. Instead, they have had to call that old campaigner sterling M3 back to the colours, and even to post him straight to the front line!

But can a target range of 11 - 15% serve any useful purpose? It will convey nothing of the authorities' determination to reduce inflation. Indeed, at one time it would have set off a marked bear reaction in the gilt-edged market as traders jumped to the conclusion that it implied higher inflation. But not now. Setting the monetary targets higher does not imply anything about the tightness or looseness of money because the authorities have no control over money. The only implication is that the targets are more likely to be met. Given that the authorities still feel duty - bound (or is it hidebound?) to have some sort of target for presentational reasons, it helps if they have one which does not stand in the way of reductions in interest rates. This time, £M3 may be just that. Table 3 shows how the target may be met.

Table 3

How the £M3 target may be reached, £bn

PSBR			+ 7
Funding			- 7
Of which:	Net gilt sales	4 1/4	
	National savings	2 1/2	
	Others	1/4	
Net non-deposit Liabilities			- 3
External Items			- 2
Implied maximum level of bank lending			24
= 15% (maximum) of £M3 (February)			19

On the assumption that the PSBR is fully funded and the net non-deposit liabilities and external items follow recent trends, the 15% maximum of £M3 growth is consistent with an expansion of no less than £24 bn in bank lending. Given that lending grew by about £19 1/2 bn in the year to February, it ought to be possible to contain lending growth within the limit of £24 bn for the coming year.

For there are several factors working favourably. Firstly, the expiry of full capital allowances may trim the corporate sector's appetite for funds. Secondly, with long yields plunging, at long last some corporates may be persuaded to issue long paper. Lastly, the fall in oil prices will substantially boost the profits of most industrial and commercial companies. Since the losers from the oil price fall, the owners of the oilfields, are not likely to make recourse to sterling bank borrowing, the net effect may well be to reduce the total demand for bank finance.

Looking into 1987, these factors will be dwarfed by the entry into the consumer lending business of the building societies, which will have the effect of diverting lending from the banks to the societies, and hence away from £M3.

Does any of this make £M3 more credible as a target? No. So, what is driving monetary policy? Two things - inflation, and the exchange rate. Although sterling's plunge earlier this year prompted a rise of only 1% in bank base rates, this should not be taken to imply that the Government has now abandoned the exchange rate as its key monetary indicator. Rather, the authorities took the view that a fall in the pound brought about by a fall in oil prices was a different kettle of fish from a fall caused by a loss of confidence in policy, or by monetary indiscipline. They argued that in the first instance, the disinflationary effects of lower oil prices would largely offset the inflationary effects of a lower exchange rate. And containment of inflation remains the ultimate objective of monetary policy.

The exchange rate lacks an announced target because the Government is afraid of the constraints of membership of the EMS, and yet also afraid that if it announced a target outside the confines of the EMS, it would be vulnerable to speculative attack. Management of the exchange rate is the policy that dares not speak its name.

The Official Forecast

The official view of the future has not changed much since the Autumn Statement, with growth continuing at 3%, and inflation rather lower at 3 1/2% by end year. But the Treasury gives us a first glimpse of their view of the first half of 1987. And it is more of the same - slightly lower growth (2 1/2%), and inflation still at 3 1/2%.

Is this forecast credible? We find ourselves in sympathy with the Treasury view of output, but differ somewhat on its composition. With personal taxes cut in the Budget and the inflation rate falling well below the increase in average earnings, RPDI will probably grow by about 5% over the year. Given that interest rates, including mortgage rates, are expected to fall, and consumer lending is likely to remain buoyant,