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PART B

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PART B

1986 BUDGET CHEVENING

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PART B

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12-2-87

Budget 1986

Chevening

B

PT. B

FROM: E P KEMP
2 January 1986

SIR PETER MIDDLETON

cc Sir T Burns
Mr F E R Butler
Mr Monck
Mr Scholar
Mr Gilhooly

CHEVENING - PAY AND UMEMPLOYMENT

I have seen copies of some of the papers for Chevening, in particular Sir T Burns and Mr Monck's notes.

2. At the risk of going over old ground, and because surely Chevening is the sort of occasion when these things can be talked about, it does seem to me that these papers might say more about the problem of prospective earnings increases, both in reality and presentationally. Ministers have by now well and truly established the position that unjustified increases in earnings are a serious risk to the economic recovery. (It is true that there are variations on this theme, such as Mr Tebbit's line that we must not talk ourselves into being simply a low earnings economy but an economy where high earnings are possible where this is justified by high productivity, and Mr Clarke's slightly odd letter of 31 December) but the message of Ministers has come across loud and clear, through the Odling-Smee paper which justifies it intellectually down through eg endorsement of the CBI campaign and now, for instance, in the Chancellor's New Year interview with the Financial Times ("I very much hope that average pay settlements could come down. This is the single most important factor in getting unemployment down ...."). What is more, it is a point of view which is held over a pretty wide spectrum of political thought, as well as economic thought, even if different people come at it from different angles.

3. And yet, all that said, we have the paradox that with unemployment one of the most important single factors, both economically and politically,

78/1/108

that are now on the scene, and with this now well developed link between earnings and unemployment, there is still no attempt made to bridge the gap, and to help the Chancellor to answer the question "well, all that being so, what is the Government doing about it?".

4. Neither Sir T Burns paper or Mr Monck's paper addresses this issue. Sir T Burns suggests that pay increases might moderate through the prospect of tax cuts and through continued financial pressure on companies through a high exchange rate. Experience shows that the first of these seems to have very little effect, and the second is surely just as likely to come out in more unemployment as in lower settlements. (We have got to remember that there are many employers, who are not keen to pick a fight over pay and who will judge - even if short-sightedly - that avoidance of industrial action and the maintenance of delivery dates is more important in recovering and holding lost markets than keeping down unit prices.) Mr Monck's paper notes that there are signs that some of the many efforts to free up the labour market may be starting to work - hardly a resoundingly encouraging message after this Government has been at it for 6 years - but it then largely devotes itself to ideas for using public expenditure and tax revenues on the creation of what seem to me to be often rather unreal jobs, and to discuss ideas about the register; but it has very little about the direct cause of the problem as perceived. Weitzman is mentioned, but my understanding is that Ministers look like giving this the thumbs down, and the Brittan idea is also mentioned, albeit not very enthusastically. Layard/JAC is also mentioned, but as Mr Monck rightly says this has been in front of Ministers twice in the past 12 months and little enthusiasm has been shown for it, although I have to say I still think it could have value in one form or another.

5. It may be that we are, in fact, therefore played out so far as positive initiatives in this front go, and that the risks on the pay front (both to the economy generally so far as the overall scene goes and to public expenditure so far as the public sector goes) just have to be faced. After all, it can be argued, if one of the main objects of a Government is to

increase the living standards of its citizens a scenario under which 87 per cent of the workforce can in the short-term anyway look forward to a 3 or 4 per cent real increase in their pay cannot be all bad, and quite a lot of this is spent usefully even if quite a lot of goes on imports. Presumably Ministers have a wider picture in view, including immediate budgetary decisions and perhaps questions such as the date of the next Election. But it seems to me that a decision to carry on as now so far as pay goes (keep her steady as she goes, in the same way as the economy as a whole should be kept steady as she goes, even if she is going rather slowly at least on unemployment) ought to be a positive one. If Ministers are so decided, so be it. But if there is a feeling that this is not in fact quite good enough, whether for real or presentational reasons, then they might wish to go round the track once again.

6. The track, of course, is a very familiar one; in ascending order of action it includes :-

a. Do nothing - discussed above.

b. Continue with exhortation and public services example - the first of these is not very effective and the second may be becoming counter-productive after some years of fairly modest public service settlements

c. Cuts in personal tax (whether income tax or NIC) - unlikely in my view to sway pay negotiators who tend to think in gross terms (particularly where tax cuts as opposed to tax increases are involved).

d. Continued financial pressure on companies and other employers - companies have got quite a lot of money at the moment and anyway may be reluctant to pick fights (discussed above) and we have no effective weapons to bring to bear on local authorities who collectively are the biggest public services employer.

e. Ideas such as Weitzman, JAC/Layard, and Brittan which aim at making new jobs or lower pay settlements financially attractive and few jobs and high pay settlements financially unattractive - complicated, interventionist, untested, and in some cases costly and/or ill-targetted.

f. Formal pay policy and pay controls, freezes, and the like - 'nuff said.

7. It does not have to be said that all of these (except (a) and perhaps (b)) are pretty uncomfortable, which is why presumably Ministers might wish to stick with (a) and (b). But against the possibility that Ministers felt they had to make some move in face of the "don't just stand there, do something" pressures which may come up, it seems worth parading some of the options. If it would be helpful to you we could write them up more fully as a personal brief for you for Chevening.

E P KEMP

Rachel's copy amended.

CONFIDENTIAL

FROM: CHRIS ALLEN

DATE: 3 January 1986

Chris folder

Rachel

POLICY BACKGROUND TO THE 1986 MTFS: CORRECTIONS

There are a couple of minor corrections to the tables in the Chevening paper. The sense of the paper is not at all affected.

In table 2, Manufacturing Output Growth, the figures -4.3 and -5.7 should be replaced by -0.7 and -0.9 respectively. In table 3, Growth in Stockbuilding, the figures -1.4 and -1.0 should be replaced by -0.4 and -0.1 respectively.

Chris Allen

CHRIS ALLEN

Distribution:

Recipients of Sir T Burns' minute of 20 December 1985 to the Chancellor.

Plus Mr P Spencer

RR7.31 SECRET

bg 9/1

FROM: MRS R LOMAX
DATE: 6 January 1986

PGP

cc Chief Secretary
Financial Secretary
Minister of State
Economic Secretary
Sir P Middleton
Mr Cassell
Mr Monger
Mr Scholar

PS/CUSTOMS AND EXCISE

CHEVENING: INDIRECT TAXES

The Chancellor was grateful for the paper attached to Sir Angus Fraser's minute of 20 December.

2. He has requested the following additional information in time for the Chevening meeting this weekend:-

(i) Supplementary tables showing the combined effect of 1 per cent on VAT with various revalorisation options, showing the implications for the price change including VAT for typical items and for the RPI impact effect; this should include estimates of the combined yield of the packages, bringing out the interactions between the various changes.

(ii) Some further explanation of why Customs now see no particular reason for special treatment of cigars and pipe tobacco.

(iii) The Chancellor has also asked for further explanation of the final sentence of paragraph 9 (and in particular the recommendation that all the main drinks should receive the same treatment).

3. The Chancellor has commented that Mr Ridley's desire to see a change in the balance of taxation between VED and fuel duties is politically not on - except in the sense that over-indexation should not apply to VED.

RL

RACHEL LOMAX

RT4.24

Racket

To see.

Kuczys → Davies 6/1

FROM: A W KUCZYS

DATE: 6 January 1986

For Chevening b/gd pps?

cc Chief Secretary
Financial Secretary
Minister of State
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Kemp
Mr Byatt
Mr Monck
Mr Cassell
Mr Burgner
Mr Odling-Smee
Mr G White
Mr Riley
Mr Gilhooly
Mr Cropper
Mr Lord
Mr Isaac - IR
PS/IR

AWK

Yes by 10/1

MR H J DAVIES

PROFIT SHARING

The Chancellor has seen your minute of 2 January. He had already decided that this subject should remain on the menu for Chevening, where you will be able to deploy the arguments in favour. He hopes Sir Lawrence Airey will also come to Chevening well briefed on this.

AWK

A W KUCZYS

ANNEX 7
INCOME TAX
HIGHER RATES

CONFIDENTIAL

FROM: R J EASON
DATE: 8 January 1986

INLAND REVENUE
STATISTICS DIVISION
SOMERSET HOUSE

Thanks. For Chevening. folder

b/f 10/1 pl

PS / CHANCELLOR OF THE EXCHEQUER

INCOME TAX HIGHER RATES

1. Mr Wynn Owen's minute of 2 January asked for details of the 28% variants of the 4 higher rate options when contrasted with the 1985-86 regime. Earlier submissions describing the options are given in Annex 7 of the Chevening paper "Approach to the 1986 Budget: Options for Personal Tax Changes".

2. The costs of the options against indexation are given in Paragraph 2 of my submission of 19 December. Compared with the 1985-86 regime, all the options would avoid any cash losers because any loss from the proposed higher rate structure would be less than the gain obtained from the 2p reduction in the basic rate.

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cc. Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir Peter Middleton
Sir Terence Burns
Mr Littler
Mr F E R Butler
Mr Cassell
Mr Scholar
Miss Sinclair
Mr Cropper
Mr Lord
Mr Davies
Sir Lawrence Airey
Mr Isaac
Mr Blythe
Mr Painter
Mr Calder
Mr Lewis
Mr Mace
Mr Eason
Dr Keenay
Mr McManus
PS/IR

3. This note therefore concentrates on the cash gains ... obtained under each option. The attached table details the options and the gains at various levels of income for single people and married men. The patterns of gains are quite complex because of the basic rate cut and the changes to the structure and thresholds for higher rates. The two graphs ... attached plot the gains for married men. Please note that log scales are used to allow the wide range of income to be covered and hence the linear growth in gains at basic rate levels is drawn as a curve.

4. Some comments on the options are given below:

i. For incomes up to the top of the previous basic rate band (£16,200) plus the appropriate personal allowance, all options give the same gains. Those taken out of tax by indexing personal allowances gain up to 75p per week if single, £1.15 per week if a married man. The cut of 2p in basic rate gives further gains of up to £6.18, making a total of £6.93 for a single person. If married, the total gain is £7.33.

ii. At the first higher rate levels, the options give contrasting gains. For options A2 and B2, the 45% rate abates the gains obtained from the basic rate cut to reduce the gain to about £5 and £8 respectively for married men earning just over £20,000 per annum. For options C2 and D2, there is no abatement and gains increase rapidly at that level of income.

iii. The highest gains are almost £20 per week for options B2 and D2 for married men earning about £38,000. This occurs at the top of the 45% rate for option B2 and the 50% rate for option D2.

iv. For the highest earners, all the options give a limited cash gain, ranging from £5 per week to £15 per week.

5. The Chancellor queried the graphs attached to my minute of 19 December. These only showed the options involving basic rate cuts of 1p or 2p and showed gains and losses against the indexed regime in the Autumn Statement. I apologise if the headings of the graphs caused confusion.

R J EASON

Weekly Cash Gains (£)
(1986-87 Compared with 1985-86)
For Higher Rate Options Including Basic Rate Cost of 2p

Income as % of average Earnings (1)	Options (2)							
	Single				Married			
	A2	B2	C2	D2	A2	B2	C2	D2
0.50	← (1.99) →				← (1.89) →			
0.75	← (3.06) →				← (2.96) →			
1.00	← (4.13) →				← (4.02) →			
1.50	← (6.27) →				← (6.16) →			
2.00	4.47	7.41	8.03	10.11	5.48	8.42	7.77	9.85
2.25	4.47	7.41	10.70	12.78	5.08	8.02	10.04	12.12
2.50	5.61	8.56	12.48	16.59	5.08	8.02	12.71	14.79
2.75	8.29	11.23	12.48	17.25	7.69	10.63	13.15	17.92
3.00	10.96	13.90	12.48	17.25	10.36	13.31	13.15	17.92
3.25	11.17	18.14	11.74	18.81	13.18	16.34	13.52	18.29
3.50	8.49	16.63	9.07	17.49	10.50	18.64	11.08	19.50
3.75	5.82	13.96	6.40	14.82	7.83	15.97	8.41	16.83
4.00	5.13	13.27	5.71	14.13	5.94	14.08	6.52	14.94
5.00	5.13	13.27	5.71	14.13	5.94	14.08	6.52	14.94

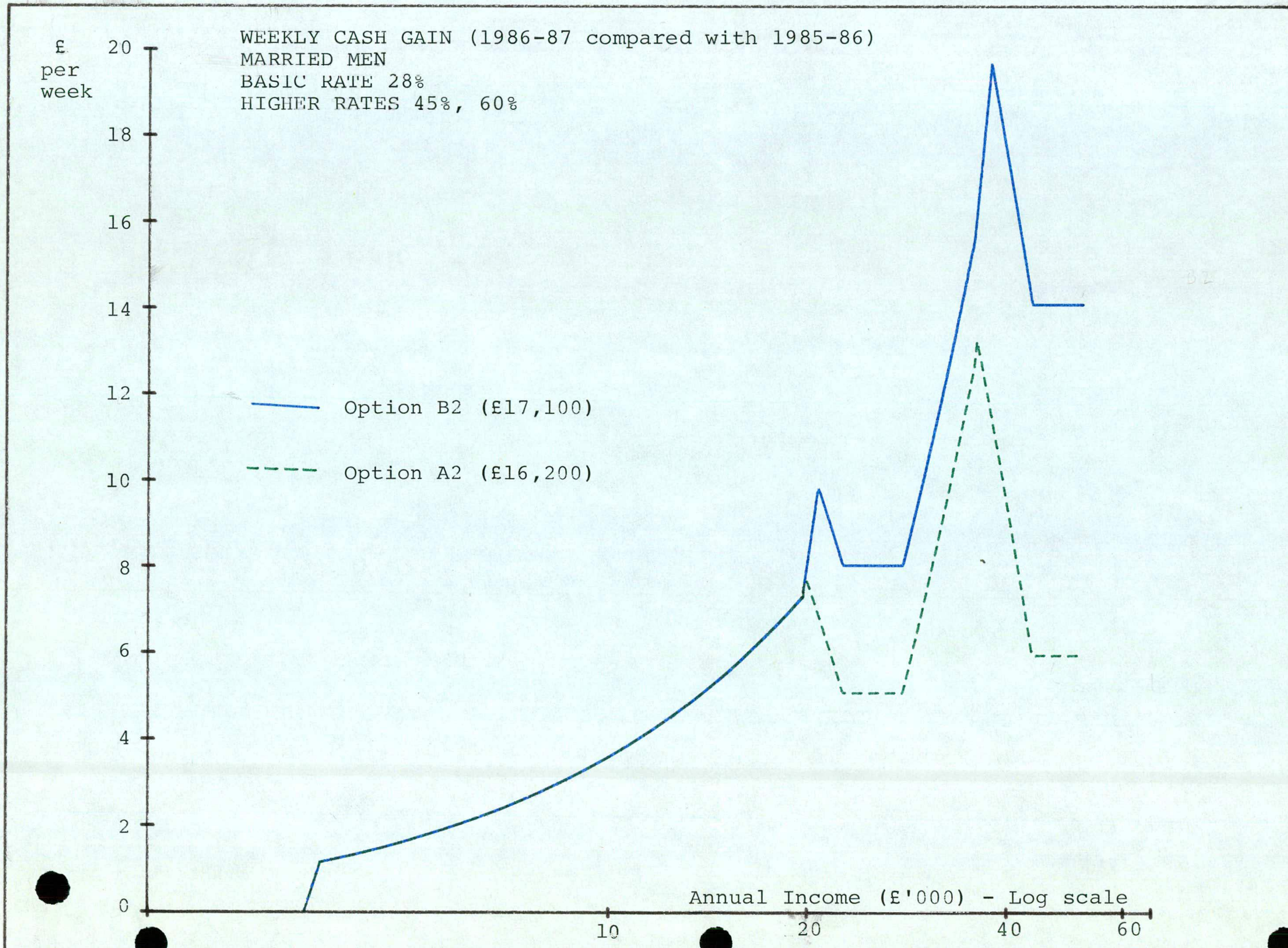
Notes

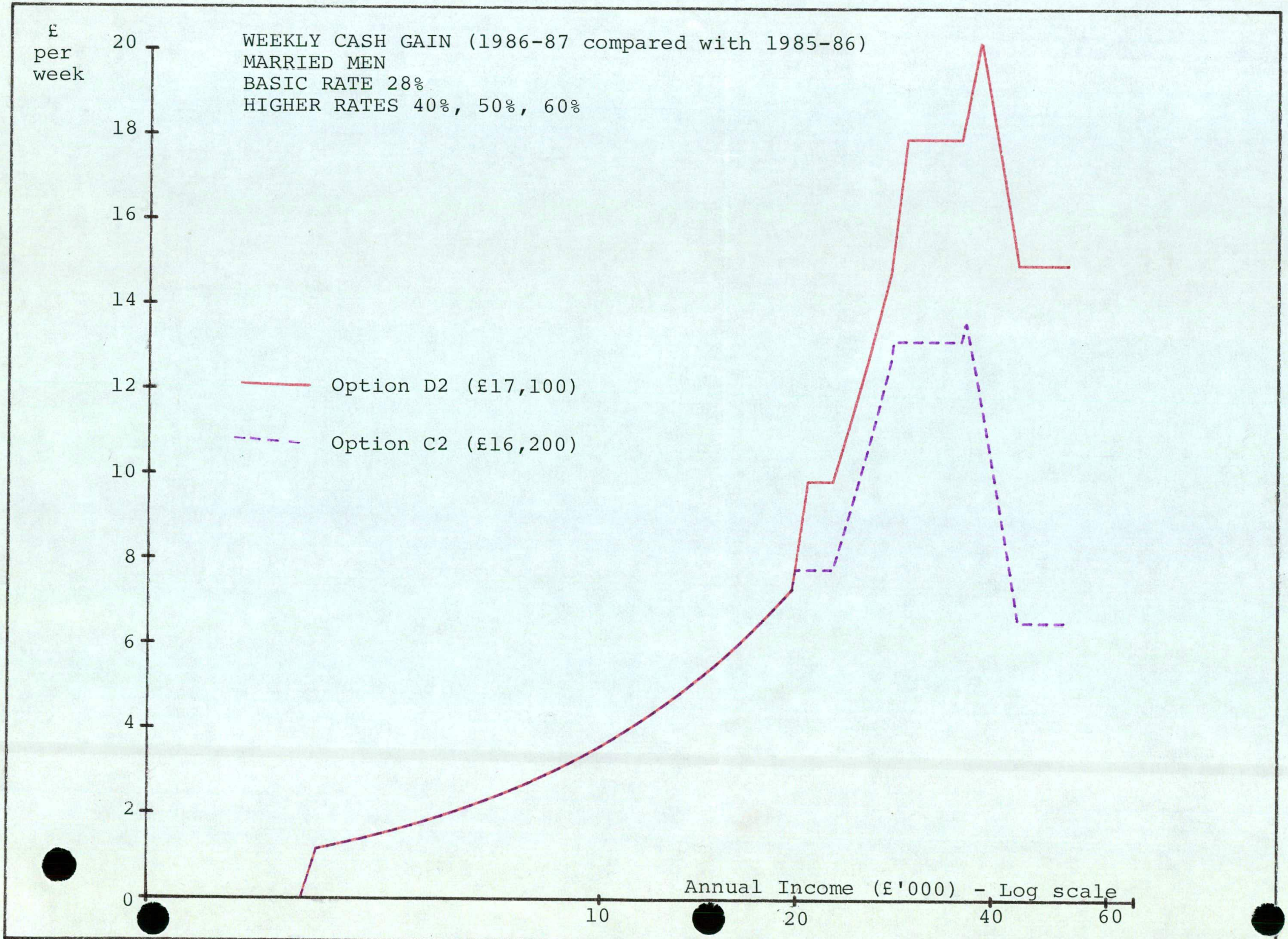
1. Forecast average earnings, 1986-87, about £214 pw or £11,125 pa.

2. Options defined as follows:

Tax Rates	Option A2 £	Option B2 £
28%	0-16,200	0-17,100
45%	16,201-32,400	17,101-34,200
60%	32,401+	34,201+

Tax Rates	Option C2 £	Option D2 £
28%	0-16,200	0-17,100
40%	16,201-24,400	17,101-25,800
50%	24,401-32,600	25,801-34,500
60%	32,601+	34,501+


WEEKLY CASH GAIN (1986-87 compared with 1985-86)
MARRIED MEN
BASIC RATE 28%
HIGHER RATES 45%, 60%
£ per week
20
18
16
14
12
10
8
6
4
2
0
Option B2 (£17,100)
Option A2 (£16,200)
Annual Income (£'000) - Log scale
10
20
40
60



£ per week
WEEKLY CASH GAIN (1986-87 compared with 1985-86)
MARRIED MEN
BASIC RATE 28%
HIGHER RATES 40%, 50%, 60%
Option D2 (£17,100)
Option C2 (£16,200)
Annual Income (£'000) - Log scale
0
2
4
6
8
10
12
14
16
18
20
10
20
40
60

FROM: C J RILEY

DATE: 8 January 1986

SIR T BURNS

Chevening

May

thanks

cc Mr Odling-Smee
Mr Grice
Mr Spencer
Mr Johns

SAVING OF TRANSITORY OIL REVENUES

You asked for some material which might throw light on the extent to which transitory oil revenues have in the past been saved by running a lower PSBR. Chris Johns has prepared the attached note.

2. Any method used to calculate the extent of saving ex post is dependent crucially on assumptions about other factors affecting the PSBR. The three methods described in the note are very crude, assuming in turn:

- that in the absence of North Sea revenues the UK debt/income ratio would have risen by the same absolute amount as the other major seven countries (in spite of the very different starting levels)

- that fiscal policy would have been set so as to bring about a zero current account in the absence of transitory oil revenues, and that for an open economy the current account surplus measures the extent of the PSBR saving

- that when setting the PSBR, allowance has been made only for transitory North Sea revenues and transitory unemployment (with a natural rate of 8%), and that the debt/income ratio would otherwise have been flat.

25/1/1

3. The first and third methods suggest if anything that the proportion saved has been rather higher than 50%. But all three ignore such things as the acquisition of unfunded pension liabilities, asset sales, and low levels of public investment, all of which point towards a relatively low PSBR. To the extent that we have taken these into account in practice, the calculations will overstate the extent to which transitory North Sea revenues have been saved.

CJR

C J RILEY

cc Sir T. Burns.

FROM: C B JOHNS

DATE: 9 January 1986

MR RILEY

cc Mr Odling-Smee
Mr Grice
Mr Spencer

OIL REVENUES

You asked for some calculations designed to indicate the extent to which North Sea Oil revenues have been saved. We can approach this problem in a variety of ways, and with varying degrees of sophistication. The approach adopted here is, as you suggested, relatively simple. We focus on the period since 1979, when the receipts of oil revenues become significant.

2. Firstly, we can examine movements in the UK debt/income ratio relative to other countries since 1979.

TABLE 1. Debt/Income Ratios for the UK and Major OECD Countries

	1979	1980	1981	1982	1983	1984	1985	1986
UK	48.6	48.3	47.5	46.6	47.2	49.2	49.2	49.9
Major 7 less UK	19.4	20.1	21.3	24.3	27.7	29.6	31.9	33.8

Source: OECD

3. It is easily seen that the difference between the change in the debt/income ratios of the UK and the major 6 OECD countries between 1979 and 1985 is of the order of 11%. This can be related to oil revenues themselves.

TABLE 2 **£M**

	1979	1980	1981	1982	1983	1984	1985
Cumulated Oil Revenues	1517	4947	10896	18062	26856	37780	50501
Cumulated Current Balance	-117	5780	10778	15735	18273	17690	22993

4. 11% of GDP in 1985 amounts to around £38,500 m. This compares with cumulated oil revenues of £50,501. It can be argued that one of the reasons why debt has not grown so fast in the UK is because of the oil revenues which, in fact, have (in part at least) been saved; if this line of reasoning is correct then the implied savings rate has been of the order of 75%.

5. Table 2 also gives details of the cumulated current balance. Under the assumptions that the oil revenues saved were the counterpart of net acquisition of overseas assets, and that the underlying current balance was zero throughout, the actual current balance represents a savings rate of around 45%.

6. Another approach would be to investigate the implications of assuming we had adjusted the PSBR for North Sea Oil and transitory unemployment. Consider the following.

Actual Debt/Income Ratio	=	Flat Debt/Income Ratio	+	Unemployment Adjustment	+	Oil Revenue Adjustment

We can obtain approximate estimates of the two adjustments from the methodology outlined in my minute to Joe Grice of 13 December (contained as Annexes 2 and 3 of the PSBR Adjustments paper to Sir T Burns of the same date). It should be stressed that the following adjustments are rough estimates and subject to the difficulties discussed in my previous minutes.

TABLE 3

% GDP

	1979	1980	1981	1982	1983	1984	1985
Flat Debt/Inc Ratio (1)	48.6	48.6	48.6	48.6	48.6	48.6	48.6
Unemployment Adj* (2) (Cumulated)	-	-	1.0	2.8	4.8	6.9	9.1
Oil Revenue Adj (3) (Cumulated)	0.4	1.1	2.2	3.5	5	6.9	8.5
(1) + (2) - (3)	48.2	47.5	47.4	47.9	48.4	48.6	49.2
Actual Debt/Income Ratio	48.6	48.3	47.5	46.6	47.2	49.2	49.2

*Based on a natural rate of 8%.

7. Although we should once again emphasise that the numbers in table 3 are only rather rough estimates of the required adjustments they tell an interesting story. The most interesting result is clear: the path for the hypothetical adjusted debt/income ratio broadly follows that of the actual when full allowance is made for both oil and unemployment. I would be reluctant for any strong conclusions to be drawn from this table, mainly because of the problems associated with the calculations of the oil and unemployment adjustments alluded to above.

C.B. Johns

C B JOHNS

CHEVENING

Charities:	27/11	Jefferson Smith/MST	VAT & Charities
	13/12	Stewart/FST	Charitable giving
	9/1	Stewart/C/Ex	Charities
City/Stamp Duty:	20/12	Draper/EST	Stamp Duty Package
	20/12	Corlett/EST	Stamp Duty
	23/12	Sinclair/FST	Tax on Credit Cards
	20/12	Sinclair/FST	City Tax
	9/1	Draper/EST	Stamp Duty
Employment etc:	20/12	Monck/ CEx	Employment and Enterprise
	2/1	Kemp/Middleton	Pay and unemployment
+ various Profit	23/12	Young/C/Ex	Budget '86
sharing back papers	25/11	Elliott/FST	Enterprise
	20/12	Farmer/FST	Co-ops
Monetary/Macro:	13/12	Middleton/C/Ex	Monetary policy and MTFS
	16/12	Grice/C/Ex	Macroeconomic assumptions
	20/12	Burns/C/Ex	Policy background to MTFS
	7/1	B/E/C/Ex	Bank Budget submission
	8/1	Wood/C/Ex	Cab 9/1 Financial developments
Indirect Taxes:	20/12	Fraser/C/Ex	Indirect Taxes
Income tax/ Car and fuel	22/11	Prescott/FST	Car and fuel benefits
	19/12	Blythe/C/Ex	Personal Tax options
	19/12	Blythe/FST	NICs
	20/12	Monger/C/Ex	Oil duties
	20/12	Monger/C/Ex	Tax issues
	23/12	Mace/C/Ex	Personal Tax options
	23/12	Lomax/Monger	Oil duties
	23/12	Calder/Lomax	Transferable Allowances
	30/12	Walker/Moore	Review of Taxation
	23/12	Isaac/FST	Relief:Domestic employees
	2/1	Life/C/Ex	Relief: " "
	6/1	Pegler/FST	" " "
	6/1	Cropper/C/Ex	"
	6/1	Lomax/Blythe	Personal Tax options
	8/1	Eason/C/Ex	Income Tax higher rates
	9/1	Blythe/C/Ex	Personal Tax
	22/11	Isaac/C/Ex	IRAs
Savings/Pensions/IRA	22/11	Munro/C/Ex	Taxation of savings
	22/11	Sinclair/C/Ex	IRAs
	20/12	Corlett/FST	Pensions Taxation
	20/12	Life/Corlett	Tax relief for Savings
	11/11	Kuczys/FST	IRAs
	2/12	Kuczys/FST	IRAs
	8/1	Munro/FST	Taxation of pensions
	9/1	Corlett/FST	Tax Relief for Savings
Miscellaneous:	23/12	Kuczys/Cassell	North Sea
	30/12	Baker/C/Ex	Budget '86
	8/1	Baker/C/Ex	BES

Clever paper

MONETARY AND FISCAL STANCE

(figures in brackets adjusted for coal strike)

	Money GDP Growth		Real GDP Growth		GDP Deflator	3 monthly Interest Rate: Nominal	3 monthly Interest Rate: Real[1]	PSBR: Actual	PSBR: ex Privatisation receipts	Exchange Rate: Nominal	Exchange Rate: Real[2]	Money Supply: Mo	Money Supply: £M3	Major 6 Industrial Countries: GDP	Major 6 Industrial Countries: GDP Deflator	Major 6 Industrial Countries: 3 month Interest rate
1980-81	14.0		-3.8		18.7	15.5	-3.2	5.4	5.5	98.2	103.5	7.1	17.1	0.8	8.8	12.5
1981-82	10.1		-.1		10.2	14.2	4.0	3.3	3.3	92.3	97.6	3.8	16.4	1.7	8.2	13.9
1982-83	9.4		2.3		7.1	11.5	4.4	3.1	3.3	88.0	93.6	1.6	12.4	-0.3	6.2	10.8
1983-84	7.8	(7.9)	3.2	(3.4)	4.5	9.7	5.2	3.2	3.6	83.5	89.0	6.0	12.3	4.0	4.7	9.2
1984-85	7.3	(8.7)	2.5	(3.6)	4.6	10.9	6.3	3.1 (2.3)	3.8 (3.0)	76.2	82.2	5.5	9.5	4.4	3.9	9.5
1985-86	8.7	(7.3)	3.7	(2.5)	5.1	11.7	6.6	2.2	2.9	80.7	87.9	4.3	13.5	3.0	4.0	8.0
1986-87	7.2	(7.3)	2.8	(2.7)	4.3	10.4	6.1	2.0	3.2	81.0	88.7	4.2	11.9	2.9	3.8	7.3

1 relative to GDP deflator

2 In terms of relative GDP deflators

	Price of Oil[3] $	Price of Oil[3] £	North Sea Oil Revenues (£)		NSO Revenues as proportion of GDP[4]	House Price[5] Inflation
1980-81	34.7	14.9	3.74	3.7	1.8	22.3
1981-82	37.3	18.4	6.49	6.5	2.9	5.9
1982-83	33.1	18.9	7.81	7.8	3.2	0.5
1983-84	30.0	19.8	8.78	8.8	3.3	9.3
1984-85	29.4	22.0	12.00	12.0	4.2	9.6
1985-86	27.6	21.3	11.45	11.5	3.7	9.2
1986-87	25.0	17.2	9.19	50.3	2.8	6.2

3 Calendar year

4 at Factor cost

5 RPI component index

SP/069

CONFIDENTIAL AND PERSONAL

FROM: MRS R LOMAX
DATE: 7 JANUARY 1986

SIR T BURNS

cc Sir P Middleton

POLICY BACKGROUND TO THE 1986 MTFS

The Chancellor has made a number of comments on your paper for Chevening. None, I think, require further action; however you might like to know that in the context of the monetary framework, he said that he hoped you would do some more thinking about how we could give money GDP a slightly more prominent role in this year's MTFS and general Budget presentation.

2. The Chancellor's general reaction to your cover note was that it failed to answer one key question - namely, to what extent is an easier monetary policy (ie lower real interest rates) on. In particular, he commented that paragraph 9 is based on the implicit assumption that we have a free choice. He has expressed general scepticism about the conclusion in the third sentence of paragraph 11 - that longer term arguments point towards a tighter fiscal and easier monetary policy, with a continuation of the policy of reducing the PSBR over the medium term. He agrees with the argument at the end of paragraph 12 - that the downward revision to expected North Sea revenues provides an argument for not fully adjusting the PSBR profile for higher privatisation receipts.

3. He has noted that he disagrees with your general preference for a PSBR figure in the lower half of the range £6-7½ billion, and asked what the market is expecting (his impression is that the market expectation is certainly not less than £7½ billion and probably more).

4. The main paper prompted the Chancellor to suggest that there might be attractions in planning (and possibly announcing in the Budget Speech) that if the oil price were to fall below the level assumed in the forecast, leading to a loss of revenue, such a loss would be made good by increasing petrol and derv duties, either during the course of the Finance Bill or subsequently using the regulator.

1/1/1

5. He had the following more detailed comments:-

(i) Paragraph 35 second indent: The Chancellor would like to discuss the desirability of being more precise about the expected path for inflation with reference to practice in other well-governed countries.

(ii) Paragraph 43: He agrees with the judgement in the first sentence - that on balance it is better to use money GDP rather than any of the usual inflation measures as an indicator of underlying inflationary pressures.

(iii) Paragraph 45: The Chancellor thinks the suggestion that monetary ranges should only be published in the year immediately ahead is well worth considering for sterling M3.

(iv) Paragraph 62: The Chancellor has added the comment that the decision to cease over-funding had implications for the yield curve.

(v) Paragraph 63: He attaches considerable importance to the point in the final sentence (attempting to move our real interest rates against the world trend runs the risk of periodic bouts of exchange rate pressure).

(vi) Paragraph 67 to 77: The Chancellor has commented extensively on this section which he evidently found very unconvincing, with the exception of paragraph 76 to which he would attach <u>some</u> weight. He has noted that we are in fact running sizeable balance of payments surpluses, and accumulating overseas assets against the time when North Sea oil will run out (indeed he would find it interesting to compare the build up of overseas assets in recent years with some measure of the income from North Sea that we might in principle have saved). He has commented that the argument about a high real exchange rate is all very well - but lower interest rates could well lead to much bigger problems including an unsustainable exchange rate dive with all that would ensue. He was quite unconvinced by paragraph 70 and the points about industrial composition in paragraph 72; and clearly sceptical about the arguments in paragraph 74. On paragraph 77, he agrees that it is evidently risky to reduce interest rates rapidly - but finds it difficult to understand the proposition that a high interest rate, high PSBR policy is also risky but in another way.

6. On a general point, he has noted that there is no mention of the debt income ratio in this year's paper.

6. The Chancellor also read Mr Grice's paper on macro-economic assumptions for the MTFS. He shares your preference for option B in pagraph 36 and agrees with your comment that there is a clear case for revising the growth of productive potential upwards; and that we should continue to assume actual growth a little faster than potential. He has noted that he wants to discuss the presentational issues briefly outlined in paragraph 35.

RL.

RACHEL LOMAX

SECRET

H.M. CUSTOMS AND EXCISE
KING'S BEAM HOUSE, MARK LANE
LONDON EC3R 7HE

Please Dial my Extension Direct:
Use Code (01)-382 followed by
Extension Number 5.023.....

From: P G WILMOTT
Date: 9 January 1986

PRINCIPAL PRIVATE SECRETARY

cc PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State
PS/Economic Secretary
Sir P Middleton
Mr Cassell
Mr Monger
Mr Scholar

CHEVENING : INDIRECT TAXES

1. Here is the additional information requested in your note of 6 January.

Tables

2. The effects of a combined excise duty and VAT rate change are complex. There is a risk of double counting - whether of revenue effects or of RPI impact effects - if the two changes are not kept separate. But for the consumer it is the price effect that matters, and here of course an aggregate figure must be given.

3. I attach a new table (Table 4) to go with Sir Angus Fraser's minute of 20 December. It shows for the main excise commodities the **price changes** to be expected from revalorisation and multiples of it. If VAT stays at 15 per cent, the only VAT effect is the extra revenue generated by the additional excise duty. But an increase in the standard rate generates extra VAT on the whole of the (duty-inclusive) retail price. There is thus a significant difference not just in the size but also in the nature of the price effects at different VAT rates. This is because excise duty increases with a constant VAT rate produce price changes that hold good whatever the selling price of the goods. But to quantify the effect of a combined duty and VAT change it is necessary to choose an illustrative price, and the effect quoted will not then be universally applicable.

IN-DIRECT TAXES: ADDITIONAL INFON

Internal circulation: CPS, Mr Knox, Mr Jefferson Smith, Mr Bone, Mrs Hamill

SECRET

The price effects shown in Table 4 for a 16 per cent VAT rate have assumed typical prices (which are shown); but these would probably not be the figures applicable at Budget time, as the price of some commodities will rise between now and then.

4. The simplest convention to adopt for the calculation of **revenue and RPI effects** is to take the excise and VAT changes separately. If VAT goes up, it will do so on all Vatable commodities, and the total revenue and RPI impact effects will be as shown in Table 3B of minute of 20 December. The revenue yields quoted in Table 2 of minute of 20 December for the various excise duty options include - as is our convention - the yield from consequential VAT at 15 per cent (ie the VAT on the extra duty): so this is not counted in the figures quoted in table 3B. "Mixing and matching" elements of table 2 with the VAT effects in Table 3B will give a reasonably accurate guide to overall effects, and although in practice there would be some (quite complex) revenue interactions between simultaneous tax changes, the effects would not be significant enough to invalidate this approach for broad planning purposes. The RPI effects quoted can in any case be combined at will for any package to give an accurate total impact effect.

5. An example might make this easier to follow: an overall package of one-and-a-half times revalorisation plus VAT at 16 per cent would look like this

	Full year yield (£m)	RPI impact effect (%)	
drinks	250	0.20	)
oils	490	0.19	)from
VED	195	0.08	)table 2
tobacco	210	0.18	)
VAT	925	0.50	from table 3B
Total	2070	1.15	

Cigars and pipe tobacco

6. The revenue at stake here is of course too small to be significant in the planning of overall options. But these duty changes do have some presentational impact. Our starting point for assessing changes in excise duties is the "sensible presumption" that their real value will be maintained from one Budget to the next. Most excise industries have come to see this presumption as the norm. Pipe tobacco manufacturers are probably the exception as there has been no duty increase since 1982. The real value of the duty level has declined by getting on for 20% since then (and the real value of receipts by more, because of the continuing fall in consumption). As tax-collectors we are not generally in favour of the withering away of duties, and in the absence of a policy decision to revalorise pipe tobacco duty we think the industry may assume that the real value of the duty is set to fall for the foreseeable future. This sort of concession could easily become a 'right', and this year may be the one in which to remove that impression.

7. The concession for cigars is less entrenched, as last year was the first standstill for some time. However, we have yet to see any evidence that the sensible presumption should not apply again in 1986 and, in its absence, we would recommend that revalorisation should be the first resort.

8. The effect of previous concessions persists, of course, in the lower base from which subsequent rises are made. And presentationally, if you chose to over-index the duty on cigarettes, revalorisation for cigars and pipe tobacco would not constitute special treatment: it would be cigarettes which were being specially treated.

Drinks

9. Our recommendation that all the main drinks should receive the same treatment follows from the arguments in paragraph 6 of Sir Angus' paper. Beer is the major revenue-raiser among drinks and the duty has been over-indexed in 3 of the last 5 Budgets, with the result that it is now 27% higher in real

terms than in 1979. Consumption is sluggish (down 1% in the first 11 months of 1985 compared with the same period in 1984). By contrast the real level of spirits duty has fallen 21% in that time. Although sales of table wine are buoyant, its duty rate is inextricably linked with that of beer. Our view is that further compression of relative duty levels would be undesirable this year since that would entail either a further squeeze on beer or a further decrease in the real value of the spirits duty, or both. And principally because of our views on beer, but also to a lesser extent because of our assessment of the taxable capacity of most drinks other than wine, we do not regard alcoholic drinks as such good candidates for over-indexation as road fuels and cigarettes.

P G WILMOTT

TABLE 4: PRICE EFFECTS

Table 4: PRICE EFFECTS

(pence)

	(UNIT) VAT RATE(1)	Revalorisation(2)	1 1/2 times revalorisation	twice revalorisation	Typical prices
Beer	(p/pint)				78
	15%	1.2	1.7	2.3	
	16%	1.8	2.4	3.0	
Wine	(70cl)				
table					179
	15%	4.3	6.5	8.7	
	16%	5.9	8.1	10.3	
sherry					392
	15%	7.5	11.2	15.0	
	16%	11.0	14.7	18.5	
port					539
	15%	8.6	13.0	17.3	
	16%	13.4	17.8	22.1	
sparkling					979
	15%	7.2	10.8	14.3	
	16%	15.7	19.4	23.0	
Spirits	(75cl)				
	15%	29.9	44.9	59.9	779
	16%	37.0	52.1	67.1	
Tobacco	(20KS)				137
	15%	4.5	6.8	9.0	
	16%	6.1	8.4	10.7	
Petrol	(gal)				192
	15%	5.2	7.7	10.3	
	16%	6.9	9.5	12.1	
Derv	(gal)				
	excl VAT(3)	3.8	5.7	7.6	163
	15%	4.4	6.5	8.7	188
	16%	6.0	8.2	10.4	
VED	(cars and light vans) no VAT	£5.50	£8.25	£11.00	£100

(1) Includes total effect of increased VAT, assuming typical prices shown.
(2) Revalorisation assumed to be 5.5%.
(3) VAT registered traders can reclaim any VAT paid.

FROM: E P KEMP
9 January 1986

SIR PETER MIDDLETON

cc Sir G Littler
Sir T Burns
Mr F E R Butler
Mr Monck
Mr Scholar
Mr Gilhooly
Mr Halligan

PAY ETC - CHEVENING

In response to my note of 2 January (copy attached for Sir G Littler) you asked for a short brief which might be of use at Chevening.

2. This is below; I am indebted to Mr Halligan for producing it.

3. That said, I do put it forward with a feeling of some desparation. Whatever one may believe about the theoretical good sense of wage bargainers on both sides of the table, or about the good will and energy of eg the CBI in pushing the lower pay message, one cannot help feeling that workforces generally are going to scramble for more and get it. Apart from one or two very rare cases, the link between pay and jobs is just not perceived; redundancy resulting from excessive pay claims (whether ones own or somebody elses) is something which happens to other people, rather like motor accidents resulting from excessive drinking. People want more and better, and the availability of easy (if in fact expensive) credit enables people to get it, and then the bills have to be paid. It is difficult to see the way out. The four "funnies" on the table, discussed in Mr Halligan's note, are in fact none of them at all attractive, save perhaps from the short-term presentational point of view as showing that the Government is in fact doing something. I would not want to play this down as an argument in its own right, but equally I would not want to pretend that it is in anyway sufficient.

4. Of the funnies, I myself doubt if two-tier bargaining is going to get very far (at least it might, but there is not a lot the Government

43/1/2

can do to make it happen), and I think we have to regard JAC as dead, though I am not quite sure why. Weitzman is fine as far as it goes, but the fact is that it is not a weapon for quickly getting more jobs; it could lead to desirable longer-term shifts in the relationship between employer and employee but in the short-term anyway it is more likely to point in the direction of more pay for fewer people than the same or less pay for more people. As far as Layard/Brittan goes, this has the disadvantage of, on the face of it, dead weight and all that, but it does have the advantage of going fairly directly to the root of what is perceived to be the present problem; I am not sure that we have fully examined all the possible variants here and that might be a possible way forward now.

5. Interestingly one variant which simply does not appear anywhere now is that of cutting social security benefits. As far as I know neither supplementary benefit nor unemployment benefit are among those "pledged", and although it is a hard thing to say it is still likely to be the case that for quite a lot of people anyway these benefit levels set a floor to wage levels. One can see the political difficulties (at least from one angle - there may be advantages from other angles); one wonders whether even now this is something worth further examination?

E P KEMP

SPEAKING NOTE

PAY AND UNEMPLOYMENT

1. The failure of pay to adjust is the root cause of unemployment. Until it does there is little prospect of reducing unemployment. We cannot rely on economic expansion - Sir T Burns paper anticipates faster growth in labour supply and productivity leaving little room for reduction in unemployment. Most of the measures discussed in Mr Monck's paper - redefining the count and public expenditure - are directed to reducing the numbers of unemployed, but in their nature are unlikely to create real, lasting jobs: that requires a slower rate of growth in pay.

2. While there seems no "explosion" ahead prospects for current pay round are not encouraging. At best, we can expect settlements averaging about 6 per cent and average earnings growth of 8 per cent in the private sector, and similar increases in the public services. With inflation falling this means even greater growth in real earnings than before. This means further damage to employment prospects and pressure on the public expenditure totals.

3. In the face of these threats there is a publicly perceived "policy gap." Ministers have tried exhortation and example with little effect. Long-term, the answer will come from labour market reform, but this is a slow acting process.

4. What about the immediate future? Doubtful whether the present macro policy stance will have much effect on pay - companies are currently profitable and liquid. Tightening the stance could lead employers to respond - as they have done in the recent past - by cutting jobs rather than seeking lower pay increases. Income tax reductions are not going to influence pay negotiators, who bargain in gross terms. Exhortation is all very well, but limited in effectiveness. Example in the public services does not seem to work any miracles.

5. Can the "policy gap" be bridged by financial incentives to encourage low settlements and higher employment and/or discourage high settlements? In the past we have kicked around

four sets of ideas under this general heading. It is questionable whether any of them would have much effect on pay or unemployment for a few years. But they may have the presentational advantage of showing that the Government is actually doing something about a problem over which it expresses such concern.

6. Profit-sharing (Weitzman). This gives employers an incentive to hire more people by introducing flexibility in wage levels so that adjustments to profit fluctuations are not simply borne by employment. It can also be justified as a measure to improve employee involvement; but by the same token it encourages employees to seek increases in output per head, rather than increases in employment: indeed for employees, the two conflict. And giving certain categories of employees a generous tax exemption for accepting such arrangements could lead to excluded categories (notably public service workers) to press for higher wages on broad "comparability" grounds. Might be worthwhile for other reasons but not very relevant to wage flexibility or unemployment as such in the short-term.

7. Layard/Brittan Marginal Employment Subsidies. Layard proposes a wage subsidy to employers who take long-term unemployed off the register. Brittan proposes remitting employer NICs or Corporation Tax to companies who increased employment or kept pay increases down or both. We have looked at Layard several times before. Problem is high "deadweight" cost which puts cost per job well above SEMs. (£15,000 per person off the unemployment count compared with £2,000 from Community Programme). We have not costed the Brittan proposal but indications are that it would be more costly than Layard. That said, there are clearly many variants on this theme, not all of which have necessarily been fully explored. For example, ingenuity might enable dead weight to be reduced e.g by going initially for pilot schemes in defined areas of exceptionally high unemployment.

8. JAC. It could be constructed in a revenue-neutral way and is workable at reasonable administrative cost. Problem, of course, is that it looks like an incomes policy. Ministers considered this before the 1985 Budget but decided against and had another look since, with the same result.

9. Two-Tier Wage Bargaining. Could a financial incentive be designed to encourage either employers to adopt it or new employees to accept it? When this was floated last year the Chancellor considered it a matter for the CBI to pursue rather than the Government. Nothing much seems to have happened. Any case for reconsidering a Government initiative?

10. All these proposals have drawbacks. But the absence of a policy on private sector pay increases is increasingly seen as a gap in the Government's armoury. Do Ministers want us to consider any of these ideas further?

ANNEX A

BASIC FACTS

Unemployment

November 1985: 3,165,000. (adults) 13.1 per cent. Forecast is for unemployment to average 3,110,000 in 1986 and 1987.

Duration of Unemployment (July 1985):

Period	Number	% of Total
More than 6 months	1,876,000	60.1
More than 12 months	1,269,000	40.7
More than 2 years	760,000	24.4

Special Employment Measures will cover 690,000 by 1986 Q2, reducing adult unemployment count by 360,000 and total count by 490,000. Current p.e. provision allows for an increase in SEMs between 1986 Q2 and 1988 Q2 that will reduce adult unemployment count by a further 30,000 and total count by a further 60,000.

Pay

Average earnings have been increasing 2%-3% per year in real terms. UK unit labour costs are increasing at about 6 per cent per year, more than twice that of our major competitors. 1 per cent off pay would, according to Treasury calculations, generate an extra 110,000 to 220,000 jobs.

1985-86 Pay Round

Too early to discern trends but out-turn unlikely to be below 1984-85 round. CBI and Department of Employment monitoring estimates average settlements to date of 6%-6½%.

Cost Per Job of Various Employment Measures (Effect on Count)

Juvenile Schemes	£1,200 to £1,500
Community Programme	£2,000
Job Release Scheme	£2,000
Layard	£15,000
Brittan	£15,000 +

ANNEX B

Profit-Sharing (Weitzman)

Proposal. Income tax relief on 10 per cent (up to a maximum of £2,000 per year) of employees total remuneration for those employees participating in a scheme in which at least 20 per cent of their total remuneration depends on profitability of their employers.

Objective. To reduce employers fixed labour costs, increase wage flexibility and so make employers more likely to increase employment. Also to improve employee identification with company performance.

Problems. Employers have an incentive to restrict employment in order to maximise profit share per head. They may demand compensation in form of higher base wage for accepting contracts involving a risk of downward wage flexibility (although the tax sweetener may moderate that). Workers barred from such contracts e.g. public service workers, may seek compensating increases.

Costing. £250M full-year revenue cost for every 1 million employees who take it up. Maximum cost £3 billion, if restricted to private sector, or £3½ billion if public trading sector also eligible.

Employment Effects. Uncertain. Could be reduction in short-term. Treasury calculations showed that a Weitzman contract which worked according to theory would increase the optimal labour force of an individual firm by 4 per cent to 15 per cent. For the economy as a whole the effect would be much less.

References. Mr Monck 16 August 1985
Mr Isaac 12 December 1985

ANNEX C

MARGINAL EMPLOYMENT SUBSIDIES

(a) Layard.

Proposal. Various. Most recent was a subsidy of £80 per week for every employee unemployed for more than 6 months newly taken on. [Currently 1,875,000].

Objective. Reduce the marginal cost of employing a target group - the long-term unemployed.

Problems. Deadweight cost. Danger of some leakage into higher wages.

Cost. Estimated new jobs 125,000. Effect on unemployment count 95,000. Net Exchequer cost per job £5,000. Gross cost per person off unemployment count £15,000. (Difference reflects the cost of unemployment benefit saved and extra tax revenue generated by new jobs.) Public expenditure cost £1½ billion. Exchequer cost £625M.

(b) Brittan (16 December "FT" article - see Appendix)

Proposal. Remit Corporation Tax on employee NICs to companies:

(a) increasing labour force by x% or more; or

(b) increase pay per head by less than 7%; or

(c) both.

Objective. Reduce marginal employment cost to employers and/or give fiscal incentive to conclude low pay settlements.

Problems. Deadweight cost (likely to be higher than Layard as not targetted on long-term unemployed).

Cost. Brittan suggests an incentive of £500 per head for 2 million employees costing £1 billion. Basis of these calculations not explained. Using Layard cost per job figures (probably underestimates for this proposal) effect on unemployment count of spending £1 billion would be 67,000.

.NANCIAL TIMES
Lombard

Memo for budget weekend

By Samuel Brittan 19

"IF ANYTHING can be misunderstood, it will be misunderstood." In my Wincott Memorial Lecture, I questioned the present fashion for small, highly paid, labour forces at a time when employment is the major economic problem.

As a result, I have been accused of every sin — from believing in a "lump of demand" to "knowing better" than th.. paid directors of British b..ess, or being against a high growth prosperous economy. I have tried to knock these misconceptions on the head in the fuller published version (Two Cheers for Self Interest) to be published on Thursday by the Institute of Economic Affairs.

The most interesting criticism of it has come from Sir John Hoskyns of the Institute of Directors, who thinks it illegitimate to try to second-guess the decisions of a managing director in the firing line. I hesitate to take him on, because the institute has taken the lead in promoting ideas which would enable labour and other markets to work better — most recently plans for simple legal changes which would make it easier for individual workers to claim self-employment status and thus contract out of the whole collective bargaining ..dmill.

If all pay bargains were individual contracts chancellors and economic commentators would indeed be well advised to keep their distance. But as Sir John himself explains, many are not. The predominant model is still, as Sir John concedes, "collective bargaining within an adversarial relationship" often buttressed with some degree of monopoly, especially in the public sector.

Unfortunately, the collective bargaining model influences decisions even where unions are weak, both through a desire to keep them that way, and through a climate of opinion which, whenever there is any margin of uncertainty, gives preference to higher pay over more jobs.

My criticism of the Chancellor is not that he denounces excessive pay settlements in The World at One but that he stops at exhortation. A financial incentive that benefited companies which favoured jobs over pay would do far more than any amount of words to signal a new climate of opinion.

The incentive is neither difficult nor expensive. It could consist of a remission of either corporation tax or National Insurance contributions to a company which, to enumerate alternative variants:

- Increased its labour force by more than a threshold percentage; or
- Increased pay per head by less than another threshold; or
- Did both (a belt and braces approach).

This has the great advantage over the much canvassed across-the-board reduction of employers' contributions in that by definition it would not apply where the concession is eroded in pay increases.

If, for instance, the incentive applied to enterprises employing 2m workers at the rate of £500 per head the annual cost would be £1bn.

The payroll incentive has the great advantage over the Layard-SDP inflation tax in being a bonus rather than a penalty. Thus problems of definition and demarcation would not be so crucial. The onus would be on employers to apply.

It has the further advantage of being reasonably easy to apply in a regionally differential form, as the Secretary of State for Industry might note.

Obviously, abuses would accumulate if the scheme applied for decades, and corporate reorganisations were designed to establish fictitious increases in employment or artificially low pay increases.

But until a more competitive and individualistic labour market can be established a payroll incentive could be a valuable transitional measure, which would itself encourage more fundamental change.

It would almost certainly do far more good for jobs than any feasible basic rate tax cuts or threshold increases, or more infrastructure spending.

Those who care to shed more than crocodile tears about unemployment will use every working day until the pre-budget Treasury weekend on January 11-12, to campaign for the payroll incentive in place of the generalised distribution of largesse to those of us with the good fortune to have jobs already.

2/4

ANNEX D

JOBS-ADDED CONTRIBUTION

Proposal. A schedule of penalties would be imposed upon employers based on increases in average hourly earnings over the previous year. The penalty revenue would then be recycled back to employers according to their paybill in the previous year. Employers would thus have an incentive to settle below the average and this would put downward pressure on settlements.

Objective. To reduce pay settlements.

Problems. Distortion of labour market. Looks like an incomes policy. But note that no need for an explicit pay norm.

Cost. Revenue gain in first year when only penalty income is collected. Thereafter revenue - neutral. Illustrative scheme assumed penalties and refunds of £1¼ billion per year.

Employment. Assuming a scheme on the lines of the illustrative one reduced earnings growth by ¾ per cent, employment effects of 40,000 to 160,000, which would reduce unemployment count by 30,000 to 120,000.

Reference. Mr Kemp and Mr Gilhooly notes of 17 September 1985.

ANNEX E

TWO-TIER WAGE BARGAINING

Proposal. A fiscal incentive to encourage the employment of new workers "outsiders" at lower pay rates than the current rate for the job received by "insiders". The incentive could be paid either to employers to encourage them to adopt such schemes, "outsiders" to encourage them to accept lower pay, or "insiders" to encourage them to accept erosion of the rate for the job principle.

Objective. To reduce marginal employment costs.

Problems. Likely union resistance; abuse (employers recycling each others employees).

Cost. If employers were paid the subsidy at Layard rates (£80 per week) we could expect a minimum Exchequer cost of £5,000 per net job and £15,000 per person off the unemployment count. Substitution of new employees for existing employees would tend to increase this.

Employment. Depends on take-up.

References. Mr Gilhooly 29 July 1985

Mr Monck 16 August 1985

CONFIDENTIAL

From: J ODLING-SMEE
9th January 1986

SIR PETER MIDDLETON

cc Sir Terence Burns
Sir Geoffrey Littler
Mr Scholar
Mr S Matthews
Mr Riley

OECD ON UK POLICY

You asked what the OECD have said about monetary and fiscal policies in the UK in the light of the following sentence in the Bank's paper for Chevening:

> "We believe that this perception is shared by a growing body of market analysts and will have increasing impact on market sentiment; and it is shared also by the IMF, who expressed worries about the mix of fiscal and monetary policies during the recent consultation, and the OECD, whose estimates also suggest that fiscal stance in the UK is not tighter than the average of other OECD countries."

2. The estimates that this sentence refers to are shown in the attached tables. Table 1 (Economic Outlook December 1985) shows that the financial deficit in the UK is larger than that in Japan, Germany and France and only just below that in the US. Table 2 (same source) suggests that fiscal policy has been eased more in the UK since 1982 than in the average of the other major six countries, on the basis of the changes in the structural budget balance. (However, there are serious measurement problems about this, and one should not put too much weight on these numbers.) The third table (also called Table 2, from a paper for the WP1 meeting next month) shows that the level of net public sector debt relative to GDP is considerably higher in the UK than in other major seven countries except Italy.

3. The OECD have not been very explicit about their view of the macro-economic policy stance in the UK. Indeed, only a year or two ago they were

saying that we had "room for manoeuvre" by which they meant that we should raise the fiscal deficit. However, the Economic Survey which is coming out later this month makes various references to tight monetary policy, and includes the following sentence:

> "The failure to reduce the PSBR as much as intended has put additional pressure on the operation of monetary policy."

There is also a certain amount of comment about the limited meaningfulness of the PSBR as a measure of fiscal stance given asset sales, North Sea revenues, etc. But they do not say explicitly that fiscal policy is now, or is likely to be in 1986-87, too loose.

Patrick E James

PP J ODLING-SMEE

debt interest payments and income tax cuts for the lower paid. The Swedish budget for FY 1985/86 aimed at a reduction in the deficit via both expenditure restraint and higher revenue. In Switzerland, the central government budget deficit is forecast to be about ¼ per cent of GDP in 1985, with a small surplus in 1986.

Fiscal policy is less restrictive in some other smaller countries. In Finland, the draft budget for 1986 is mildly expansionary, with reductions in taxes expected to outweigh expenditure restraint. In Ireland, the central government budget deficit is also likely to have increased in 1985, but the medium-term financial plan calls for reductions in future years. In Norway, the draft 1986 budget projects an increase in the central government deficit (excluding the oil sector) of 0.5 per cent of GDP notwithstanding quite strong economic growth. Given the expected substantial decline in the surplus of the oil sector, the overall surplus of the general government sector could be almost eliminated in 1986.

Indicators of budget balances, government claims on private saving and public debt accumulation

The budget indicators shown in Tables 1 and 2 suggest little further progress in reducing fiscal deficits in 1985 and 1986. The general government financial deficit for the major seven countries as a group is expected to have been essentially unchanged in 1985. This reflects a deterioration in the United States, France and Canada offset by reductions elsewhere. In 1986 the deficit is projected to decline slightly to 3.5 per cent of GNP. The deficit for the smaller countries taken together is projected to stabilise in 1986 following a decline of about ½ per cent of GNP in 1985. By 1986 the OECD deficit excluding the United States is expected to be back to the level of 1979 in relation to GNP. This primarily reflects large improvements in the Japanese and German budget situations; Italy, Canada, France and the smaller countries as a group would still have deficits well above 1979 levels.

The structural (i.e. cyclically-adjusted) component of the OECD area budget deficit – changes in which give an indication of the discretionary impulse of fiscal policies[1] – after remaining stable in 1985, is projected to decline marginally in 1986, compared with the estimated ½ per cent of GNP increase between 1981 and 1984. This apparent modest move towards restriction in the overall stance of fiscal policy in OECD countries is likely to go along with some narrowing of cross-country differences. The structural budget balance in the United States is expected to stabilise in 1986 after moving in the direction of deficit by about 2½ per cent of GNP over the four preceding years. In the six other major countries the improvement in structural balances is expected to continue (Canada in 1985 and the United Kingdom in 1986 are notable exceptions), while the aggregate structural balance for the smaller countries may be broadly constant over the two years.

As inflation rates are projected to remain stable, adjustments to budget balances for the effect of price increases on the value of government debt[2], also shown in Table 2, do not change the conclusions about the stance of fiscal policy in 1985 and 1986 that can be drawn from the structural budget balance estimates. On this "inflation-adjusted" basis, fiscal policy had

Table 1

General government financial balances[a]

Surplus (+) or deficit (-) as a percentage of nominal GNP/GDP

	1979	1980	1981	1982	1983	1984	1985[b]	1986[b]
United States	+0.6	−1.2	−0.9	−3.8	−4.1	−3.4	−3.9	−3.7
Japan	−4.8	−4.5	−4.0	−3.6	−3.5	−2.7	−1.7	−1.1
Germany	−2.6	−2.9	−3.7	−3.3	−2.5	−1.9	−1.2	−0.9
France	−0.7	+0.2	−1.8	−2.7	−3.1	−2.8	−3.3	−3.2
United Kingdom	−3.5	−3.5	−2.8	−2.3	−3.7	−3.8	−3.4	−3.6
Italy	−9.5	−8.0	−11.9	−12.6	−12.4	−13.5	−13.4	−13.1
Canada	−1.8	−2.7	−1.6	−5.0	−6.2	−6.3	−6.5	−5.3
Total of above countries[c]	−1.7	−2.4	−2.5	−4.0	−4.2	−3.8	−3.8	−3.5
Australia	−2.2	−1.3	−0.2	0.0	−3.8	−3.2	−2.9	−2.5
Austria	−2.4	−1.7	−1.7	−3.2	−3.8	−2.3	−2.2	−2.3
Belgium	−6.5	−8.4	−14.2	−12.5	−13.3	−11.3	−10.0	−9.4
Denmark	−1.7	−3.3	−6.9	−9.1	−7.3	−4.3	−2.4	−0.6
Finland	+0.5	+0.5	+1.3	−0.4	−1.6	+0.2	+0.7	−0.3
Greece	−2.4	−2.7	−11.9	−7.3	−9.4	−10.3	−11.6	−9.6
Ireland	−10.4	−11.7	−12.7	−14.3	−12.6	−10.5	−12.3	−12.0
Netherlands	−3.7	−4.2	−5.6	−7.2	−6.6	−6.4	−5.3	−6.6
Norway	+3.4	+5.7	+4.7	+4.4	+3.8	+6.2	+5.2	+0.2
Spain	−1.8	−2.0	−3.0	−5.3	−5.3	−5.0	−4.8	−4.6
Sweden	−2.9	−3.7	−4.9	−6.1	−5.1	−3.3	−2.4	−1.9
Total of smaller countries[c]	−2.5	−2.6	−4.1	−4.9	−5.5	−4.4	−4.0	−4.1
Total of above countries[c]	−1.8	−2.4	−2.7	−4.1	−4.4	−3.9	−3.8	−3.6

a) On a SNA basis except for the United States, the United Kingdom, Greece and the Netherlands which are on a national income account basis.
b) OECD estimates and forecasts.
c) 1982 GNP/GDP weights and exchange rates.

Table 2

Cyclical and structural changes in general government financial balances[a,b]

As a percentage of nominal GNP/GDP

Country	Year	Change in actual balance	Change in built-in stabilizers[c]	Change in structural budget balance[d]	Change in inflation-adjusted structural budget balance[e]
United States	1982	−2.8	−1.9	−0.9	−1.5
	1983	−0.3	+0.4	−0.7	−1.0
	1984	+0.7	+1.4	−0.7	−0.7
	1985	−0.5	−0.2	−0.3	−0.3
	1986	+0.1	0	+0.1	+0.2
Japan	1982	+0.4	0	+0.3	0
	1983	+0.1	−0.5	+0.6	+0.4
	1984	+0.9	+0.3	+0.5	+0.7
	1985	+1.0	+0.2	+0.8	+0.9
	1986	+0.6	−0.2	+0.8	+0.6
Germany	1982	+0.4	−0.8	+1.2	+1.2
	1983	+0.8	−0.5	+1.3	+1.1
	1984	+0.5	0	+0.5	+0.4
	1985	+0.8	+0.2	+0.5	+0.5
	1986	+0.3	+0.2	0	−0.2
France	1982	−0.9	−0.4	−0.6	−0.6
	1983	−0.3	−0.6	+0.2	+0.1
	1984	+0.3	−0.9	+1.2	+1.0
	1985	−0.5	−0.5	0	−0.1
	1986	+0.1	−0.2	+0.3	+0.2
United Kingdom	1982	+0.5	−1.0	+1.5	+0.2
	1983	−1.4	−0.1	−1.3	−2.6
	1984	−0.1	+0.3	−0.4	−0.4
	1985	+0.4	+0.2	+0.2	+0.2
	1986	−0.1	+0.3	−0.5	−0.8
Italy	1982	−0.7	−1.2	+0.6	−0.2
	1983	+0.2	−1.5	+1.7	+1.9
	1984	−1.2	−1.0	−0.2	−2.0
	1985	+0.1	0	+0.1	−0.4
	1986	+0.4	−0.1	+0.5	−1.1
Canada	1982	−3.4	−3.0	−0.4	−0.3
	1983	−1.2	+0.5	−1.7	−1.6
	1984	−0.2	+0.8	−1.0	−0.9
	1985	−0.2	+0.7	−0.9	−0.7
	1986	+1.3	+0.3	+1.0	+1.1
Average of major six (excluding United States)[f]	1982	−0.2	−0.7	+0.5	+0.1
	1983	−0.1	−0.5	+0.3	0
	1984	+0.3	0	+0.3	+0.1
	1985	+0.4	+0.1	+0.3	+0.3
	1986	+0.4	0	+0.4	0
Average of major seven countries[f]	1982	−1.5	−1.3	−0.2	−0.6
	1983	−0.2	0	−0.2	−0.5
	1984	+0.5	+0.7	−0.2	−0.3
	1985	0	0	0	0
	1986	+0.3	0	+0.2	+0.1
Average of total OECD countries[f,g]	1982	−1.4	−1.2	−0.2	−0.5
	1983	−0.3	−0.1	−0.2	−0.5
	1984	+0.5	+0.7	−0.1	−0.2
	1985	0	0	0	0
	1986	+0.2	0	+0.2	+0.1
Total of smaller countries[f]	1982	−0.8	−0.7	−0.1	+0.1
	1983	−0.6	−0.2	−0.4	−0.7
	1984	+1.1	+0.6	+0.4	+0.5
	1985	+0.5	+0.3	+0.1	0
	1986	−0.1	+0.1	−0.2	−0.2

Country	Year	Change in actual balance	Change in built-in stabilizers[c]	Change in structural budget balance[d]	Change in inflation-adjusted structural budget balance[e]
Australia	1982	+0.2	−0.8	+0.9	+1.1
	1983	−3.7	−1.0	−2.7	−3.0
	1984	+0.5	+1.8	−1.3	−1.7
	1985	+0.3	+0.9	−0.6	−0.4
	1986	+0.5	+0.9	−0.5	−0.2
Austria	1982	−1.4	−0.8	−0.7	−1.0
	1983	−0.6	+0.1	−0.7	−1.4
	1984	+1.4	+0.4	+1.1	+2.1
	1985	+0.2	+0.5	−0.3	−1.0
	1986	−0.1	−0.1	0	−0.2
Belgium	1982	+1.7	−0.1	+1.8	+2.9
	1983	−0.8	−1.2	+0.4	−0.2
	1984	+2.0	−0.2	+2.2	+1.7
	1985	+1.3	0	+1.2	+0.1
	1986	+0.7	−0.2	+0.8	+0.4
Denmark	1982	−2.2	+0.9	−3.1	−2.5
	1983	+1.9	+0.2	+1.7	+2.0
	1984	+2.9	+1.4	+1.6	+1.8
	1985	+2.0	+0.4	+1.5	+1.4
	1986	+1.7	+1.3	+0.5	+0.1
Finland	1982	−1.7	+0.1	−1.8	−1.5
	1983	−1.2	+0.1	−1.2	−1.1
	1984	+1.8	+0.1	+1.7	+1.9
	1985	+0.4	+0.5	−0.1	0
	1986	−1.0	−0.3	−0.7	−0.6
Greece	1982	+4.6	−0.7	+5.3	+4.9
	1983	−2.1	−0.7	−1.5	−1.7
	1984	−0.9	+0.1	−1.0	−0.7
	1985	−1.3	−0.3	−1.0	−0.2
	1986	+2.0	−1.3	+3.2	+4.5
Ireland	1982	−1.6	−3.1	+1.5	−0.2
	1983	+1.7	−2.8	+4.5	+2.0
	1984	+2.1	+0.2	+1.9	+1.7
	1985	−1.7	−1.2	−0.5	−1.5
	1986	+0.2	+0.2	+0.1	+0.1
Netherlands	1982	−1.6	−1.6	0	−0.2
	1983	+0.6	+0.1	+0.5	−0.8
	1984	+0.2	+0.5	−0.3	−0.3
	1985	+1.1	+0.6	+0.5	+0.3
	1986	−1.3	+0.5	−1.8	−2.1
Norway	1982	−0.4	−0.9	+0.5	+0.6
	1983	−0.6	+0.8	−1.5	−1.4
	1984	+2.5	+0.8	+1.6	+1.5
	1985	−1.0	+0.5	−1.5	−1.6
	1986	−5.0	+0.1	−5.1	−5.2
Spain	1982	−2.3	−0.5	−1.8	−1.4
	1983	0	−0.1	+0.1	+0.2
	1984	+0.3	−0.1	+0.4	+0.6
	1985	+0.2	−0.3	+0.5	+0.4
	1986	+0.2	0	+0.2	+0.5
Sweden	1982	−1.2	−0.8	−0.3	+0.7
	1983	+1.0	+0.4	+0.6	+0.8
	1984	+1.8	+1.0	+0.8	+1.3
	1985	+0.9	+0.4	+0.5	+0.7
	1986	+0.5	−1.0	+1.5	+1.6

a) OECD estimates and forecasts.
b) A positive sign indicates a move towards restriction (surplus); a negative sign indicates expansion (deficit). A plus sign therefore indicates public expenditure *cuts* and tax *increases*. Column 1 corresponds to the year-to-year changes in financial balances shown in Table 1.
c) "Built-in-stabilizers" represent the cyclical component of the budget deficit or surplus, estimated as the reaction of the budget to variations in real GDP around the trend growth of productive potential.
d) Reflects both deliberate policy actions and fiscal drag.
e) Adjusted for the impact of price increases on net outstanding government debt.
f) 1982 GNP/GDP weights and exchange rates.
g) For the eighteen countries shown in the Table.

TABLE 2

NET PUBLIC DEBT AS A PERCENTAGE OF NOMINAL GNP/GDP

	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984 (a)	1985 (b)	1986 (b)
UNITED STATES	26.3	23.5	22.8	25.6	25.6	24.7	22.5	20.5	20.4	19.7	22.8	25.4	26.8	29.3	31.4
JAPAN	-6.5	-6.1	-5.4	-2.1	1.9	5.4	11.3	15.0	17.5	21.0	23.5	26.3	27.4	27.6	27.5
GERMANY	-5.8	-6.7	-4.7	1.0	4.6	7.0	9.4	11.5	14.3	17.4	19.8	21.8	23.0	23.3	23.2
FRANCE	9.1	8.3	8.8	11.1	10.9	10.2	10.2	9.8	9.1	9.9	11.3	13.4	15.1	17.3	19.3
UNITED KINGDOM	64.3	57.2	54.6	57.3	56.7	55.7	53.4	48.6	48.3	47.5	46.6	47.2	49.2	49.9	51.2
ITALY	50.0	52.1	49.2	59.9	60.9	60.7	64.5	65.5	60.0	66.2	70.8	84.1	91.2	99.2	107.4
CANADA	4.3	2.7	1.0	4.3	5.2	7.1	11.6	12.3	13.3	11.6	18.8	23.9	30.0	35.9	40.2
TOTAL MAJOR SEVEN	19.3	17.4	17.0	20.6	21.7	22.0	22.4	22.0	22.3	23.1	25.9	28.9	30.8	33.0	34.9
TOTAL MAJOR SEVEN(LESS USA)	13.0	11.9	11.8	16.0	18.1	19.5	22.3	23.3	24.0	26.2	28.6	32.1	34.5	36.4	38.1
AUSTRALIA	35.9	31.8	29.2	28.5	27.8	29.1	30.3	29.3	26.2	23.4	22.9	24.8	24.9	25.2	24.8
AUSTRIA	17.5	17.5	17.6	23.9	27.4	30.1	33.9	36.0	37.2	39.2	41.3	45.8	47.1	48.5	50.2
BELGIUM	59.8	56.7	53.7	54.1	54.2	58.0	60.9	65.5	69.7	82.1	90.6	100.0	106.2	111.0	115.5
DENMARK	-9.1	-12.3	-13.6	-10.1	-7.7	-5.0	-2.2	1.9	7.2	16.3	26.1	34.2	37.6	38.7	37.6
FINLAND	-8.1	-10.7	-10.6	-9.5	-10.5	-10.0	-8.3	-6.8	-6.1	-4.7	-1.9	0.7	1.2	1.1	2.0
GREECE	23.2	19.4	20.3	22.4	22.1	22.4	29.4	27.6	27.7	32.8	36.4	41.4	47.5	53.2	56.8
IRELAND	32.7	31.9	36.9	45.2	51.6	50.3	56.0	63.1	68.4	73.4	81.8	91.1	97.1	106.2	113.6
NETHERLANDS	44.4	39.4	37.2	38.0	37.2	36.9	38.1	40.8	43.8	48.2	53.2	59.7	64.3	67.7	72.7
NORWAY	0.6	-1.4	-1.8	0.7	3.5	9.5	14.0	16.9	6.9	3.2	1.2	-2.2	-8.7	-13.4	-10.8
PORTUGAL	n.a.	13.4	13.5	21.3	26.5	28.6	28.6	32.4	28.8	37.0	35.4	36.0	37.4		
SPAIN	2.1	1.7	1.3	1.3	0.7	2.0	3.1	5.0	7.1	10.3	13.8	18.1	22.6	26.0	28.6
SWEDEN	-29.7	-31.2	-30.2	-28.9	-29.9	-29.1	-25.5	-19.8	-13.6	-5.3	4.5	10.8	14.2	16.2	18.0
SWITZERLAND	15.2	15.9	16.7	19.8	20.9	21.2	20.2	20.7	19.2	18.1	17.3	17.4	16.7		
TOTAL SMALL COUNTRIES (c)	16.9	14.4	13.4	14.7	14.8	16.4	18.7	21.0	22.3	25.9	30.0	34.7	37.4	39.6	41.8
TOTAL OF ABOVE COUNTRIES (c)	19.0	17.0	16.6	19.8	20.8	21.3	21.9	21.9	22.3	23.4	26.4	29.7	31.7	33.8	35.8
OECD LESS USA (c)	13.9	12.4	12.1	15.7	17.4	18.9	21.5	22.8	23.6	26.1	28.9	32.7	35.2	37.1	38.9

(a) PARTLY ESTIMATED
(b) FORECASTS
(c) EXCLUDING PORTUGAL AND SWITZERLAND
SOURCE:OECD

LOLLIPOPS

FROM: M C SCHOLAR
DATE: 9 January 1985

1. SIR PETER MIDDLETON

2. CHANCELLOR OF THE EXCHEQUER

cc: Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir G Littler
Mr F E R Butler
Sir T Burns
Mr Cassell
Mr Monck
Mrs Lomax
Mr Cropper
Mr Lord
Sir L Airey - IR
Sir A Fraser - C&E

CHEVENING

Attached below is an annotated agenda for the weekend discussions.

MCS

M C SCHOLAR

CONFIDENTIAL

CHEVENING: 11-12 January 1986

Papers

1. **POLICY BACKGROUND TO THE 1986 MTFS: Sir T Burns of 20 December**

[Also relevant:
(l) Macroeconomic assumptions for the MTFS - Mr Grice's minute of 16 December, with Sir T Burns' mss comment on it dated 18 December

(ii) Winter forecast: preliminary indications - Mr H P Evans of 10 January, to follow.

2. **EMPLOYMENT AND ENTERPRISE ISSUES: Mr Monck of 20 December**

3. **TAX ISSUES: Mr Monger of 20 December**

[Also relevant:
(i) Approach to the 1986 Budget: options for personal tax changes: Mr Blythe of 19 December, as amended by Mr Mace of 23 December, and as further supplemented by Mr Blythe's minute of 9 January.

(ii) Chevening: indirect taxes: Sir Angus Fraser of 20 December, as further supplemented in response to Mrs Lomax's minute of 6 January to PS/C&E.

(iii) CBI: Tax Reform Working Party Report: Mr Painter of 6 January

(iv) Ministers' Budget Representations: summary note by Central Unit to follow]

4. **PRESENTATIONAL ISSUES: to follow from Mr Culpin**

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AGENDA

1. **THE POLICY BACKGROUND TO THE 1986 MTFS**

[references are to Sir T Burns' paper]

(a) Introduction (paragraphs 1-10)

Assessment of economy's progress since 1979 - comparison with 1975-79; success in reducing money GDP - improved output/inflation split (but still worse than for OECD 6) - excessive real earnings growth, higher productivity - large rise in unemployment. Is the analysis in paras 1-10 accepted?

(b) The Medium Term Prospect (paragraphs 11-25)

Scope for output growth consistent with declining inflation is now revised upwards and put at about 2½% (para 25) a year. Does this seem a reasonable medium term projection, taking proper account of the prospects for productivity, labour supply and the North Sea (para 18 and Table 8); the beneficial movements in commodity prices (paragraph 14 and 22); as well as the continuing failure of the labour market to adjust (paras 8-9 and Table 8 of the Annex)?

(c) Inflation objectives (paragraphs 28-34)

Should we stick to the profile of 3% inflation by 1988-89 (and 2½% by 1989-90)? How important is it to ensure that this is achieved? Is the projected path of money GDP sufficient to secure it?

(d) Role of money GDP and monetary policy (paragraphs 35-45)

It is not proposed to discuss the presentation of monetary policy and money GDP in detail at this stage; there are a lot of technical questions to be sorted out first. The usual procedure is to return to this at a later stage in the context of the MTFS chapter of the FSBR.

(e) <u>The overall stance of policy</u> (paragraphs 46-56)

Is the assessment, that the overall policy stance was eased in 1983-84, tightened in the first few months of 1985 and needs no further tightening for the year ahead (still?) accepted?

(f) <u>Balance of fiscal and monetary policy</u> (paragraphs 57-77)

(i) If the need to avoid sterling weakness and to apply downward pressure on earnings, the rapid growth of £M3 and high world interest rates point to a cautious approach towards monetary policy, do the short term arguments, together with the unexpectedly sharp North Sea revenue decline, suggest (as paragraph 67 indicates) that an easier fiscal stance might be desirabl/possible?

(ii) Or is monetary policy now uncomfortably tight, with a real exchange rate and real interest rates high in relation to our competitors'? Would a tighter fiscal stance offer the prospect of lower interest rates?

No

(iii) We have acknowledged that asset sales are taken into account in setting the PSBR, and our presentation (eg in the Autumn Statement) has begun to show them separately. Do the higher receipts in prospect point (paragraph 73) to a much lower PSBR than planned in the 1985 MTFS? What weight should be given to the other arguments for fiscal caution - the undesirability of a boost to consumption, and worries about debt interest, confidence, and loss of room for manoeuvre (paragraphs 74-77)?

(g) <u>PSBR arithmetic for 1986-87: balance of arguments</u> (paragraphs 78-94)

(i) Should the PSBR for 1986-87 be in the range £6-7½ billion?

(ii) If so, where in the range?

(iii) What working assumption should we adopt at this stage for the scale of the fiscal adjustment?

(iv) Is it agreed that macro-economic considerations do not give any decisive pointers to the use of the fiscal adjustment next year (paragraphs 92-94)?

(v) If oil prices fall sharply higher interest rates would be needed to keep monetary conditions on track and limit the fall in the exchange rate. In these circumstances should non-North Sea taxes (fuel duties?) be raised to limit the likely rise in [interest rates and] the PSBR?

2. **EMPLOYMENT AND ENTERPRISE ISSUES**
[references are to Mr Monck's paper]

Paragraph 56 poses the main questions for discussion:

(a) In the light of the unemployment position and prospect (paragraphs 1-9), the scale of the existing special employment measures (especially those in the 1985 Budget whose effects have not yet come through fully), and the need to hold to the public expenditure plans and reduce taxation, is there any need for a further public expenditure package of employment and enterprise measures? (Note that our Budget arithmetic will have to show any such extra public expenditure being financed not from the fiscal adjustment, but from within published spending plans.)

(b) What is the scope for definitional change (paragraphs 17-18 and 26) or administrative measures, eg removing earners and drawers or those languishing on the count (paragraphs 21-27)? Should we make all possible progress with these measures - which will require work with the Department of Employment - in any event?

(c) If there is a need for a package

(i) should its scale be such that it can realistically be charged to the Reserve for 1986-87 and fitted within the planning total for later years (note the projection in Mr Evans' submission that the Reserve will not be able to accommodate this and other likely demands in 1987-88 and 1988-89)?

(ii) should the measures be taken from Lord Young's November list - ie those in the top half of Table 3 (paragraph 31), with their 'enterprise' bias - ie

- Enterprise Allowance (Annex B paras 2-3)
- Loan Guarantee Scheme (ibid paras 4-5)
- New Workers' Scheme (paras 6-11)
- Derelict Land Grant (paras 27-29) Small / [illegible]
- more fraud staff?

Should those in the bottom half of the Table be rejected - ie the remainder of Lord Young's November proposals:

- extending the pilot measures for the long-term unemployed (Annex B paras 8-11);
- more Community Programme places (paras 13-16);
- extension of the Technical and Vocational Education Initiative (paras 18-19);
- and almost all of the CBI's proposals (eg introducing a Building Improvement Programme, extending the Urban Development Programme, expansion of Job Release and Job Splitting Schemes).

(d) Given the importance of pay, the poor labour market adjustment performance of recent years and the increased profile of the pay and jobs connection, would it be worthwhile, if only to buttress our exhortatory efforts, to consider a scheme of the Sam Brittan variety (paras 36-39)?

(e) Is there an employment case for a general reduction in the CT rate or in employers' NICs?

(f) Should profit-sharing (Weitzman) be pursued, for substantive or presentational reasons (paras 41-42; other relevant papers are Mr Monck's submission of 16 August, Mr Isaac's of 12 December, PS/FST's minute of 20 December and Mr H J Davies' of 2 January)?

(g) Which of the minor measures in paragraphs 44-45 look worth pursuing? Viz:

(i) Small Business Investment Companies

(ii) Cooperatives - increase in maximum shareholding
- reduction in registration charge
- access to profit-sharing schemes
(Mr Farmer's submission of 20 December)

(iii) Training Loan Pilot Scheme

(iv) Exempting Enterprise (and Jobstart) Allowances from tax (Mr Elliott's submission of 25 November)

(v) Increase VAT limit beyond indexation.

3. **TAX ISSUES**

[references are to Mr Monger's paper, except where stated)

(1) General Approach

(a) The tax issues need to be approached against the background of the earlier discussion under 1(g) above together with the preliminary prospects for expenditure and revenue indicated in Mr Evans' note on the Winter Forecast.

(b) The main tax questions are identified in paras 3-5 of Mr Monger's paper:-

(i) the overall scope for income tax cuts, from rate reductions or threshold increases or both;

(ii) whether additional revenue might be raised through higher indirect taxes, either by over-indexation of excise duties, or by an increase in the VAT standard rate;

(iii) what other major changes - on, for example, CTT, stamp duty, BES, pension funds surpluses, charitable giving - are to be included.

(2) Excise Duties and VAT (paragraphs 15-18)

(a) Should we set an overall limit on the impact effect of the Budget measures on the RPI?

(b) Should we take an interim decision - interim until the major decisions have been taken - to aim for some overall over-indexation on the excise duties (1½ times revalorisation on all duties increases the RPI by 0.6 per cent compared with 0.4 per cent for straight revalorisation; and raises £370-£385 million)?

(c) Is there a case for higher, or lower increases for specific duties -

(i) bigger increases in derv and petrol and tobacco duties (Sir A Fraser, paragraphs 7 and 8)?

(ii) smaller changes in VED (Mr Ridley wants no change for cars and a reduction for lorries, perhaps made up for by extra increases in fuel duties) (Sir A Fraser, paragraph 8)?

(iii) more lenient treatment (Sir A Fraser, paragraph 6) for drinks, and all the main drinks to get the same treatment?

(d) Should the VAT rate be increased and, if so, by how much?

(e) Should there be any VAT exemption for charities (Sir A Fraser, paragraph 4)?

(3) <u>Personal Income Tax</u>

(a) The balance between increased allowances and cuts in the basic rate (paragraphs 7-10)

(i) To what extent does the case for giving preference to a basic rate cut this year (over a further increase in allowances) depend on the prospect (and cost) of a substantial increase in allowances accompanying the move to transferable allowances in 1990?

(ii) Have the Fowler reforms permanently altered the balance of advantage between action on allowances and on the basic rate (paragraph 8)?

(iii) What is the minimum acceptable increase in allowances - 5½ per cent (prices indexation) or 7 per cent (earnings - the minimum necessary to avoid an increase in the number of taxpayers and Inland Revenue manpower)? What might be adopted as a target increase?

(iv) What is the minimum acceptable cut in the basic rate - is anything less than a 2p cut worth doing? What might be adopted as a target cut?

(b) What changes to the higher rate structure are worth considering (paragraph 11, and Annex 7 to Mr Blythe's paper)?

(i) simplification, by stretching out the rate bands (including the relatively short first slice of £3000 at 40 per cent), on a revenue-neutral basis? Would the resultant pattern of gainers/losers be acceptable?

(ii) should such restructuring be combined with restriction of mortgage interest relief to the basic rate (paragraph 12)?

(c) What other personal tax changes are runners:

(i) Is it confirmed that a reduced rate band is ruled out (paragraph 13)?

(ii) An increase in the mortgage interest relief ceiling (paragraph 14)?

(iii) An increase in car benefit scale changes (paragraph 14)?

(iv) Is it confirmed that relief for domestic employees is ruled out (paragraph 14)?

(4) <u>Business Taxes</u> (paragraph 19 and Annex 4)

(a) Is it confirmed that there will be no changes in the basic CT structure announced in 1984? Can the Ernst and Whinney Study be ignored (Mr Bush's paper of 30 December)?

(b) Is there a case for help to the small firms/ unincorporated sector (Annex 4, paras 12-13) -

either (i) a cut in the small firms' CT rate (if the basic rate of income tax is cut)?

or (ii) an increase in the small companies profit limit?

(c) Mining and oil allowances -

(i) is it agreed that there should be no change in the North Sea fiscal regime (paragraph 21)?

(ii) would it be worthwhile to include a statement on the tax treatment of incremental projects (paragraph 21)?

(5) <u>Capital Taxes</u>

(a) Should the Capital Transfer Tax lifetime charge be abolished (paragraph 22)?

(b) Is it confirmed that there should be no major changes in Capital Gains Tax in 1986?

(c) On Stamp Duty (paragraph 24) -

(i) is it agreed that reduction/abolition of duty on share transactions by individuals/ institutions is desirable?

(ii) should this be revenue-neutral, and if so, what offsetting changes can be made to gilts and to other city financial transactions?

(iii) what other changes should be made - eg duty on houses, on capital duty and unit trust duty?

(iv) what scope is there for an alternative tax on financial services (paragraph 25)?

(6) <u>Pensions and Saving</u> (paragraphs 26 and 27)

(a) What action should be taken this year on surpluses? Is it confirmed that action on personal pensions is for 1987?

(b) Is there a case for a further tranche of tax-privileged savings possibly linked to retirement or targeted on equities?

(7) <u>Enterprise and Employment: tax measures</u>

(a) Mostly considered in the discussion of Mr Monck's paper; but provisional decisions on <u>Business Expansion Scheme</u> have been taken (paragraph 28).

(b) Are the changes to <u>employee share schemes</u> in paragraph 30 accepted?

(8) Charitable Giving (paragraphs 31 and 32)

(a) Should the £10,000 limit on higher rate relief for covenants by individuals be abolished, and should 'private indirect' charities be excluded?

(b) Should any of Sir Adam Ridley's suggestions be taken further -

(i) CT relief for single gifts by companies?

(ii) encouragement for payroll giving?

(iii) partial tax relief for single gifts by individuals?

4. Next Steps

(1) What are the priorities for further work?

(2) Does the following outline timetable look acceptable?

31 January	Report of the Winter forecast
13 February	Cabinet discussion of economic prospects
21 February	First draft of Budget Statement and FSBR
3-7 March	Deadlines for decision on main tax changes
14 March	Final draft of FSBR and Budget decisions
18 March	Budget Day

(3) Which Ministers should be seen (last year: S/S Environment, Transport, Employment, Home Secretary, Minister of Agriculture)?

Lord Young
Mr Ridley
Mr Fowler
Mr Brittan (who has asked for a meeting)
Mr Baker

(4) Anything to be added on the presentation of the Budget?

(5) Any other points?

RESTRICTED

From: MISS E A CLARKE

Date: 9 January 1986

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir Peter Middleton
Sir Geoffrey Littler
Sir Terence Burns
Mr F E R Butler
Mr Cassell
Mr Scholar
Mr Monck
Mr Cropper
Mr Lord
Mr H Davies
Mrs Lomax

Sir Lawrence Airey - IR
Sir Angus Fraser - C&E

CHEVENING: SATURDAY 11 JANUARY AND SUNDAY 12 JANUARY

... I attach the programme for Chevening.

2. Dress for the weekend is informal, with lounge suits for dinner on Saturday evening.

3. For Christian names please refer to my minute of 11 December 1985. There is one addition: Mr Mike Lomax.

E A Clarke

MISS E A CLARKE
Assistant Private Secretary

SECRET

H.M. CUSTOMS AND EXCISE
KING'S BEAM HOUSE, MARK LANE
LONDON EC3R 7HE

Please Dial my Extension Direct:
Use Code (01)-382 followed by
Extension Number 5.023.....

From: P G WILMOTT
Date: 9 January 1986

PRINCIPAL PRIVATE SECRETARY

cc PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State
PS/Economic Secretary
Sir P Middleton
Mr Cassell
Mr Monger
Mr Scholar

CHEVENING : INDIRECT TAXES

1. Here is the additional information requested in your note of 6 January.

Tables

2. The effects of a combined excise duty and VAT rate change are complex. There is a risk of double counting - whether of revenue effects or of RPI impact effects - if the two changes are not kept separate. But for the consumer it is the price effect that matters, and here of course an aggregate figure must be given.

3. I attach a new table (Table 4) to go with Sir Angus Fraser's minute of 20 December. It shows for the main excise commodities the **price changes** to be expected from revalorisation and multiples of it. If VAT stays at 15 per cent, the only VAT effect is the extra revenue generated by the additional excise duty. But an increase in the standard rate generates extra VAT on the whole of the (duty-inclusive) retail price. There is thus a significant difference not just in the size but also in the nature of the price effects at different VAT rates. This is because excise duty increases with a constant VAT rate produce price changes that hold good whatever the selling price of the goods. But to quantify the effect of a combined duty and VAT change it is necessary to choose an illustrative price, and the effect quoted will not then be universally applicable.

Internal circulation: CPS, Mr Knox, Mr Jefferson Smith, Mr Bone, Mrs Hamill

SECRET

The price effects shown in Table 4 for a 16 per cent VAT rate have assumed typical prices (which are shown); but these would probably not be the figures applicable at Budget time, as the price of some commodities will rise between now and then.

4. The simplest convention to adopt for the calculation of **revenue and RPI effects** is to take the excise and VAT changes separately. If VAT goes up, it will do so on all Vatable commodities, and the total revenue and RPI impact effects will be as shown in Table 3B of minute of 20 December. The revenue yields quoted in Table 2 of minute of 20 December for the various excise duty options include - as is our convention - the yield from consequential VAT at 15 per cent (ie the VAT on the extra duty): so this is not counted in the figures quoted in table 3B. "Mixing and matching" elements of table 2 with the VAT effects in Table 3B will give a reasonably accurate guide to overall effects, and although in practice there would be some (quite complex) revenue interactions between simultaneous tax changes, the effects would not be significant enough to invalidate this approach for broad planning purposes. The RPI effects quoted can in any case be combined at will for any package to give an accurate total impact effect.

5. An example might make this easier to follow: an overall package of one-and-a-half times revalorisation plus VAT at 16 per cent would look like this

	Full year yield (£m)	RPI impact effect (%)	
drinks	250	0.20	)
oils	490	0.19	)from
VED	195	0.08	)table 2
tobacco	210	0.18	)
VAT	925	0.50	from table 3B
Total	2070	1.15	

Cigars and pipe tobacco

6. The revenue at stake here is of course too small to be significant in the planning of overall options. But these duty changes do have some presentational impact. Our starting point for assessing changes in excise duties is the "sensible presumption" that their real value will be maintained from one Budget to the next. Most excise industries have come to see this presumption as the norm. Pipe tobacco manufacturers are probably the exception as there has been no duty increase since 1982. The real value of the duty level has declined by getting on for 20% since then (and the real value of receipts by more, because of the continuing fall in consumption). As tax-collectors we are not generally in favour of the withering away of duties, and in the absence of a policy decision to revalorise pipe tobacco duty we think the industry may assume that the real value of the duty is set to fall for the foreseeable future. This sort of concession could easily become a 'right', and this year may be the one in which to remove that impression.

7. The concession for cigars is less entrenched, as last year was the first standstill for some time. However, we have yet to see any evidence that the sensible presumption should not apply again in 1986 and, in its absence, we would recommend that revalorisation should be the first resort.

8. The effect of previous concessions persists, of course, in the lower base from which subsequent rises are made. And presentationally, if you chose to over-index the duty on cigarettes, revalorisation for cigars and pipe tobacco would not constitute special treatment: it would be cigarettes which were being specially treated.

Drinks

9. Our recommendation that all the main drinks should receive the same treatment follows from the arguments in paragraph 6 of Sir Angus' paper. Beer is the major revenue-raiser among drinks and the duty has been over-indexed in 3 of the last 5 Budgets, with the result that it is now 27% higher in real

terms than in 1979. Consumption is sluggish (down 1% in the first 11 months of 1985 compared with the same period in 1984). By contrast the real level of spirits duty has fallen 21% in that time. Although sales of table wine are buoyant, its duty rate is inextricably linked with that of beer. Our view is that further compression of relative duty levels would be undesirable this year since that would entail either a further squeeze on beer or a further decrease in the real value of the spirits duty, or both. And principally because of our views on beer, but also to a lesser extent because of our assessment of the taxable capacity of most drinks other than wine, we do not regard alcoholic drinks as such good candidates for over-indexation as road fuels and cigarettes.

P G WILMOTT

Table 4: PRICE EFFECTS

(pence)

	(UNIT) VAT RATE(1)	Revalorisation(2)	1 1/2 times revalorisation	twice revalorisation	Typical prices
Beer	(p/pint)				78
	15%	1.2	1.7	2.3	
	16%	1.8	2.4	3.0	
Wine	(70cl)				
table					179
	15%	4.3	6.5	8.7	
	16%	5.9	8.1	10.3	
sherry					392
	15%	7.5	11.2	15.0	
	16%	11.0	14.7	18.5	
port					539
	15%	8.6	13.0	17.3	
	16%	13.4	17.8	22.1	
sparkling					979
	15%	7.2	10.8	14.3	
	16%	15.7	19.4	23.0	
Spirits	(75cl)				
	15%	29.9	44.9	59.9	779
	16%	37.0	52.1	67.1	
Tobacco	(20KS)				137
	15%	4.5	6.8	9.0	
	16%	6.1	8.4	10.7	
Petrol	(gal)				192
	15%	5.2	7.7	10.3	
	16%	6.9	9.5	12.1	
Derv	(gal)				
	excl VAT(3)	3.8	5.7	7.6	163
	15%	4.4	6.5	8.7	188
	16%	6.0	8.2	10.4	
VED	(cars and light vans] no VAT	£5.50	£8.25	£11.00	£100

(1) Includes total effect of increased VAT, assuming typical prices shown.
(2) Revalorisation assumed to be 5.5%.
(3) VAT registered traders can reclaim any VAT paid.

FROM: ROBERT CULPIN
DATE: 10 JANUARY 1986

CHANCELLOR

cc CST
FST
EST
MST
Sir P Middleton
Sir G Littler
Mr F E R Butler
Sir T Burns
Mr Cassell
Mr Monck
Mr Scholar
Mrs Lomax
Mr Cropper
Mr Lord
Mr H Davies

THE PRESS BEFORE THE BUDGET

Sir Peter Middleton asked me to do a note for Chevening.

Background

2. We go into the Budget much stronger than last year. At the beginning of 1985, inflation and unemployment were unequivocally rising, the pound was on a toboggan, and interest rates were heading to 14%. Miners were striking. We were about to launch a Public Expenditure White Paper with its head in the sand.

3. This followed a bad autumn. You had an unfortunate Party Conference and poor receptions in the House. Thanks to the student grant row, it took a police escort to get us back from a TCSC hearing. We were forced before Christmas into a reassurance about pension lump sums, and then faced non-stop lobbying from special interests on VAT.

4. Our credibility was low. The rhetoric was of battening down the hatches.

5. We have turned much of this around. And although this week has seen interest rates and unemployment up, Wednesday's action

has clearly strengthened our credibility.

6. We may now be in for one of those happy periods when inflation and unemployment both fall. I think it would be the first time this has happened for 8 years. We should have a favourable background against which to present the Government's policies. A small cloud is that RPI inflation will be rising after the summer.

7. I see no real problem about **monetary policy.** People say it is unclear, but know quite well what puts interest rates up, and what lets them come down. We must have another go at explaining it in and around the Budget, as we discussed this morning. But until then, we rest on the Mansion House speech, and the evidence that you mean what you say.

8. On **fiscal policy,** we have succeeded in dumping the fiscal adjustment, and we are no longer arguing (much) about infrastructure versus tax. Some still think there is a choice between letting people keep more of their own money and doing something about unemployment - and the CBI's Budget representations won't help. But in the main, most people assume the priority to be tax. There are two simple questions: how much and what measures?

<u>Amounts</u>

9. The consensus expectation is tax reductions of about £2 billion. That is what our survey of outside forecasts shows. It is also what we read in the papers. Give or take about £½ billion, it is the figure most journalists mutter to me.

10. On average, the outside forecasters assume that £2 billion of tax cuts will leave the PSBR at about £8½ billion. So if they were to constrain it to something like the Red Book figure, the implied fiscal adjustment would only be about £1 billion.

11. This precision is spurious, if only because the average forecast does not take full account either of the fall in oil prices or of the acceleration in the privatisation programme. Nor is

it[illegible] sum I have seen in print. But journalists have the impression that the consensus estimate is edging down: they now put it at £2 billion or less, rather than £2-3 billion.

12. So if the Budget were to reduce taxes by a net £2 billion, my customers would not be surprised. Significantly more or less and they would be.

13. This is not to say they would describe fiscal policy as unchanged. Most would see it as a mild easing, taking privatisation proceeds into account: sub-sub-Reaganomics.

14. If we took £2 billion off taxes and set the PSBR at £6½-7 billion, consistently with our last forecast, the surprise would not be the figure for taxes but that for the PSBR. To most of my customers, it would look implausibly low. A major reason, of course, is that most outsiders doubt our public expenditure figures. The first **essential** in the run-up to the Budget will be to persuade people next week that the **Public Expenditure** White Paper is **realistic**.

15. It is helpful that the consensus expectation for tax reductions is coming down. The only specific contribution we have made to this is to state the obvious - that lower oil prices mean lower revenues. You have said that in the House, and we should clearly go on saying it.

16. If you wanted me to go further, I could draw attention to the arithmetic in paragraph 10, and remind people how relatively small previous fiscal adjustments have been. But this is a delicate game. While it would suit us politically to lower expectations further - and I rather like the figure of £1 billion - anything which comes as a nice surprise to taxpayers risks being a nasty surprise to markets.

17. I think the **line** should be this:-

- we are giving no estimate whatever of the fiscal adjustment for any assumed PSBR

- you have acknowledged that lower oil prices mean lower revenue

- on the fiscal stance, you have told the FT to wait for the Budget, but said prudence will continue to be your watchword

18. If journalists speculate about the PSBR, adjustments for privatisation proceeds and so on, we should simply acknowledge what is already on the record:-

- the Red Book is a starting point

- the path for borrowing has always taken "account of important influences such as the pattern of North Sea oil revenues, and the level of asset sales arising from the privatisation programme" (1984 Budget Speech)

- "there is nothing sacrosanct about the precise mix of monetary and fiscal policies" (1985 Budget Speech).

The object should be to confuse them.

Measures

19. On measures, we face some problems of success. We have ended speculation on many, so it has narrowed to few. You have done companies and national insurance, ruled out VAT extension, and remitted personal taxes to a Green Paper. No one believes you could make much headway on mortgage relief or pensions (surpluses apart).

20. The popular question is **rates versus thresholds.** People have had thresholds dinned into them over the last few years, but you are now seen as a rate cutter. The links with Fowler and with transferable allowances have both been made (especially by Hogg and Raphael). There is some expectation of what John Cole called the old "tanner off".

21. The **line** on this is clear:

- rates and thresholds are both important
- the Government has reduced one and raised the other
- the first thing to establish is whether we can afford either

22. An increasing risk is that, looking further ahead, colleagues will start describing to journalists umpteen "better" ways of using £5 billion than to introduce transferable allowances. Most of these will be ways of spending more. If this happens, we shall just have to repeat that the only question is what form any tax reductions should take, if any can be afforded.

23. These issues apart, interest focusses on what more you can do to improve the **labour market** and the prospects for employment. People expect more of the same on special employment measures. Some are touting marginal employment subsidies or inflation taxes or incentives to profit sharing.

24. The most difficult conversation I have is with people who support or understand the Government's policy. "OK, you set the nominal framework and leave the split to the market. OK, unemployment has much more to do with real wages being too high than with macro policy. But the labour market manifestly isn't working properly. After six years of non-accommodation, union reforms and micro measures, pay is rising well above market clearing rates, and those with jobs are expropriating those without. What are you going to do to make the market work better?"

25. One answer is to build up case by case examples of increasing flexibility and realism. We are trying to do that.

26. But people will be looking for some measure or measures in the Budget. If, for instance, you could build on previous Budgets by giving further incentives to profit sharing schemes, it would be a great help.

27. People are not, so far, speculating about higher VAT to finance

lower income tax.

Conclusion

28. My present forecast of what journalists will forecast is this:-

- monetary targets for MO (probably unchanged) and £M3 (certainly raised)

- EMS nearer

- some traditional employment measures, plus something or other to fill the role of NIC restructuring last time

- indexed thresholds: if anything, indexed plus rather than indexed minus

- the usual bundle of taxes going up (?fuel) and down (? stamp duty)

- whatever reduction in the basic income tax rate you can afford for about a net £2 billion of tax reliefs

- a PSBR in the region of this year's likely outturn - around £8 billion - which would be perceived (a) as a modest easing, given privatisation proceeds, and (b) as a number we would probably overshoot slightly.

The **line** on all such packages is blindingly obvious: wait for the Budget.

RC

ROBERT CULPIN

1-32a

SECRET

FROM: R PRATT
DATE: 10 JANUARY 1986

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir Peter Middleton
Sir Geoffrey Littler
Sir Terence Burns
Mr Butler
Mr Cassell
Mr Monck
Mr Monger
Mr Scholar
Miss Sinclair
Mr Haigh
Mr Romanski
Mr Cropper
Mr Lord
Mr Davies
PS/Inland Revenue
PS/Customs & Excise

MINISTERIAL BUDGET REPS NOTE BY CU

MINISTERIAL BUDGET REPRESENTATIONS

You have received letters from Lord Young, Mr Baker, Mr Younger, Mr Brittan, Mr Ridley and Mr Jopling. You asked for a commentary for Chevening.

... 2. I attach a summary chart showing which Minister has made representations on which taxes. I also attach brief commentaries on the various proposals made.

Richard Pratt

RICHARD PRATT

SECRET

MINISTERIAL BUDGET REPRESENTATIONS

		DEm	MAFF	DoE	DTI	SO	DoT
(i) **Income tax/ NICs**	- Thresholds rather than basic rate				√		
	- Small business allowance	√					
	- Deeds of covenant for 17 yr olds					√	
	- Landlords repairs to be offset against income			√			
	- Relief for charitable donations			√			
	- Right to be self employed	√					
	- Abolish Class 2 NICs	√					
(ii) **Excise duties**	- less on VED for cars, more on petrol-derv						√
	- VED reduction for lorries						√
	- No increase for unleaded petrol			√			
(iii) **VAT**	- Large increase in threshold	√			√		
	- Easement on penalties resulting from Keith	√					
	- Remove VAT from buildings & repairs					√	
	- No (further) extension to construction or to water, heritage or sport			√			
(iv) **Business taxes**	- Concession on capital allowances for Agricultural buildings		√				
	- Stock relief for Scotch Whisky					√	
	- Relief on pre trading R&D				√		
	- Widen definition of scientific research				√		
	- Scientific Research Allowances for metals				√		
	- Retain present treatment of Second hand cost				√		
	- Expenditure on restoring land after mining				√		
	- CT on Associated companies	√			√		
	- 'Disincorporation' relief	√			√		
	- Alter tax treatment of EAS receipts				√		
	- Concession for oil recovery R&D					√	
	- Give 50% ship allowance for 3 years only						√
	- Roll over relief for balancing charges in shipping						√
(v) **Capital taxes**	- 100% CTT relief for transfer of business assets	√	√		√	√	
	- Stamp duty, abolish for shares	√			√		
	- Concessions on stamp duty for house sales			√			
	- CGT exemption for unquoted capital venture funds	√					
	- Farmers to roll over CGT liabilities		√				
	- More CGT relief for inflationary gains		√				
	- Extension of retirement relief		√				
	- Abolish unit trust instrument duty				√		
	- Domestic corporate bonds to bear interest gross				√		
	- CTT exemptions for land of outstanding interest			√			
(vi) **Other**	- Loans by charities to small businesses should be regarded as for charitable purposes	√					
	- Align break points on car tax with EC emission directive				√		
	- Amend BES restrictions on overseas subsidiaries				√		
	Amend BES to accept shares subject to call options				√		
	- Allow ship chartering in BES						√
	- increase PIID threshold	√					
	- Employee share schemes/Employee controlled companies	√			√		
	- Forestry - tax concessions for coniferous woodlands			√			

SECRET

(i) **Income tax** - NIC's.

Thresholds rather than basic rate - DTI

Discussed in Mr Monger's paper.

Small business allowance - DEm

Small businessmen would be allowed to claim a flat-rate minimum expense deduction (saving paperwork) or actual expenses if greater.

Ministers have already looked at something similar this season albeit primarily in the context of small landlords: FST decided not to pursue it this year, but to keep it in reserve as a possible sweetener for an eventual IR 'Keith' package (Mr Williams' note of 21 November). The size of allowance would be a problem: anything large enough to cover expenses for a useful proportion of full-time self-employed would be expensive in revenue terms and over-generous in many cases, particularly for part-time self-employed (eg "hobby" businesses, subsidiary freelance income of full time employees). And the minor expenses Lord Young has in mind probably do not cause much paperwork in any case.

Deeds of covenant for 17 year olds - Scottish Office

Allow tax relief to students under age of 18.

This has been rejected in previous years, however, as it would mean breaching the principle of the general law that parents cannot obtain tax relief for children who are minors by making settlements on their behalf.

Landlords repairs to be offset against income - DoE

Should be allowable against all other income, rather than just rental income.

This would breach general principle that costs/losses resulting from particular activities should only be offset against revenue from same source, and thus create precedent. The Chief Secretary has commented that more incentives are needed in this area and he has some sympathy with Mr Baker's proposal.

Relief for charitable donations - DoE

Support HO proposals to encourage charitable giving (tax relief for single donations etc), disagree with Lord Young's contention that this would prompt demands for more state aid.

SECRET

Right to be self employed

Lord Young is not here asking for major shifts in the employed/self-employed boundary, but for clarity in the tests applied, and consistency as between IR and DHSS.

Current developments (Mr Prescott's minute to FST of 18 December) aim to publicise the criteria used to determine employment status; promote consistency of treatment between DHSS and IR: and resolve such cases of inconsistency as to arise. A progress report was sent to the Enterprise Unit shortly before Christmas.

Abolish Class 2 NICs for self employed

Entitlement to benefit is earned by the self employed by paying flat rate Class 2 NICs on earnings over £1925. Class 4 contributions (6.3 per cent of profit between £4150 and £13780) do not confer benefits but shift the burden to the better paid.

Abolishing Class 2 would either remove benefit entitlement for all those not paying Class 4, or require wholesale rethink of Class 4 to make it appropriate as a basis for benefit entitlement. Moreover Class 4 rates of 6.3 per cent would have to be more than doubled to recoup revenue from lost Class 2 NICs. This would increase their marginal rates and produce an odd pattern of gainers and losers.

Class 2 NICs were, in any case, reduced last year by £1.25pw. 50 per cent of Class 4 NICs were made eligible for tax relief.

SECRET

(ii) **Excise duties**

Less on VED for cars, more on petrol-derv - DoT

Mr Ridley proposes an increased proportion of tax from fuel duty, with an equivalent decrease in the proportion from VED. To be achieved, in 1986, by pegging VED and increasing fuel duty.

This change would reduce the significance of VED evasion; benefit low mileage users, and increase incentive for fuel efficiency.

On the other hand, high mileage essential users would be hit. It would be a reverse of last year's policy. Relying on fuel duties would limit the room for manoeuvre, particularly if a real increase in fuel duties were made necessary.

VED reduction for lorries - DoT

Mr Ridley proposes a shift from VED to derv and constraint on total lorry taxation to ensure that it does not exceed lorry road track costs by more than 25 per cent (as at present). This would imply, for 1986, a 2p increase in derv duty, over revalorisation, and a reduction in VED of 8 per cent. Overall a reduction in yield of £30m compared with revalorisation of both duties.

Again, this links taxation to mileage, and is an incentive to fuel efficiency and would help international competitiveness of UK hauliers. The change would halt the big increases in the excess of lorry taxation over track costs over the past 3 years (although this reflects the change in the number and types of lorries more than changes in the level of taxation).

But the policy would be a reverse of that pursued last year and might limit room for manoeuvre with one tax instead of two.

It would be difficult to pursue different policies for lorries and cars. Quite apart from obvious inconsistency, an increase in petrol duty requires an increase in derv duty to avoid distortion. The latter affects total taxation on lorries and would anyway limit the scope for VED increases. The Chancellor has commented that Mr Ridley's proposal ignores the embarrassment of reversing last year's policy. Instead VED for cars should be kept constant in real terms, with only petrol duty being over-indexed. Derv duty to keep pace with petrol and extra revenue to be given back by way of a reduction in VED on lorries.

SECRET

No increase for unleaded petrol - DoE

No increase for unleaded petrol.

This seems premature, not least because DoE themselves have yet to see the results of their questionnaire on the general treatment of unleaded petrol).

SECRET

(iii) **VAT**

Large increase in threshold - DEm, DTI

EC negotiations are most unlikely to be complete in time for decisions to be taken in this year's Budget. In the longer term, if we gain flexibility, the consideration which would determine the level of threshold include the compliance costs of VAT for small businesses, the effects on employment, the revenue loss and the distortions of competition. On Lord Young's suggestion that very small firms be exempt if we do not get flexibility on the threshold we would, of course, wish to examine other means of helping small business, but his actual suggestion is not clear - small firms under the registration threshold would in any case be exempted, but we would not be able to exempt any larger firms, even selectively.

Easement on penalties resulting from Keith - DEm

The Keith package was a balanced package, replacing criminal sanctions with more certain, civil penalties. Without penalties compliance would deteriorate. The default surcharge (which is probably what Lord Young is most concerned about) is needed to reduce the VAT debt - by £600 million by end 1988-89. Mr Gow gave Mr Clarke an undertaking that his operation would be reviewed after 1 year. On the keeping of records, the maximum period was extended from 3 years to 6 years to bring into line with Customs powers to assess arrears of tax for up to 6 years. The extension of the period also reflects the long period between visits from control officers, which can be up to 8 years.

Remove VAT from buildings and repairs - Scottish Office

VAT only extended to building alterations in 1984. Reversal now would be unjustified.

No (further) extension to construction or to water, heritage or sport - DoE

The extension of VAT to any of these areas is ruled out by the Chancellor's statement in last year's Budget Statement that he did not intend to make any further extensions of the VAT base during the lifetime of this Parliament, subject to our European commitments. Although the EC Commission is threatening infraction proceedings over our zero-ratings for non-domestic construction and water, as well as certain other of our zero-ratings, the Government is publicly committed to fighting the case.

SECRET

(iv) **Business taxes**

Concession on capital allowances for Agricultural buildings - MAFF

Allow balancing adjustments for short life buildings only.

The Revenue's forthcoming submission on starter 113 - ABA restructuring - will cover this.

Stock relief for Scotch Whisky - Scottish Office

Support Scotch Whisky Association's proposal for stock relief through a statutory maturation allowance.

Ministers have previously rejected ideas on these lines, since the reintroduction of stock relief - albeit for one particular industry only - would run directly counter to the aims of the 1984 business tax reforms, which included the abolition of stock relief.

Relief on pre-trading R&D - DTI

Treating R&D as a trade for tax purposes.

Cost could be considerable if oil exploration included - £25-30m in full year. Dropped last year, but resurfaced as starter 149: Revenue submission to follow.

Widen definition of scientific research - DTI

Definition of research for Scientific Research Allowance (SRA) clear enough; Chancellor retained 100 per cent SRA exceptionally, despite removal of most incentive allowances in CT reforms: no obvious case for extension to development, or testing to demonstrate commercial feasibility.

Scientific Research Allowance for metals - DTI

Extend SRA to include metals.

If exploring for metals is scientific research, miners can pursue a claim for SRA under existing law.

Retain present treatment of second hand cost - DTI

The approach proposed in the Consultative Paper (to which DTI object) is consistent with other capital allowances. However, the FST is considering this point.

SECRET

Expenditure on restoring land after mining - DTI

Lengthen the qualifying time limit for expenditure on restoring land to 6 years - after cessation of trade, rather than 3 years as at present.

Relief for 3 years after cessation of trading is a major concession. If the taxpayer is continuing to trade elsewhere, which is usually the case, relief beyond 3 years is already available.

CT on associated companies - DEm, DTI

This is a highly technical point about the rules which prevent CT avoidance by "splitting" companies (to get them below the "small companies" rate threshold). Long and technical legislation would be needed to tackle a minor (and avoidable) problem.

'Disincorporation' relief - DEm, DTI

The Revenue will be minuting on this shortly. Indications are that pressure for this change has diminished - if only because the 1984 business tax package makes disincorporation less attractive.

Alter tax treatment of EAS receipts - DTI

Tax EAS receipts separately from trading profits, as under Case VI of Schedule D.

Under consideration as starter 125. Case VI treatment cheaper than exemption, but not readily seen as beneficial. Conversely exemption could look inconsistent with decision to tax pilot £20 job start allowance.

Concession for oil recovery R&D - Scottish Office

Use tax regime to encourage enhanced oil recovery R&D, so as to stimulate work for Scottish platform yards and companies.

Industry has hitherto been unable to respond to the Government's request for evidence to support the case for this.

Give 50% ship allowance (temporarily - ie for 3 years only) - DoT

Shipping industry already get favourable treatment ("free depreciation", extended last year) to help with "lumpiness" of investment. Incentive depreciation would cut across the logic of the 1984 reform, and open the way to "special cases" elsewhere. Cost in the range £50-£100 million a year from 1987-88 to 1989-90 (for a permanent relief): unrealistic to expect it could be withdrawn after 3 years. Calculated to hinder Community-wide reduction in subsidies.

Roll over relief for balancing charges in shipping - DoT

This effectively reintroduces 100 per cent first-year depreciation and so cuts across 1984 reforms. Other "special cases" would want same treatment. Existing "free depreciation" provision for shipping already gives some help here.

SECRET

(v) **Capital taxes**

100% CTT relief for transfer of business assets - DEm, MAFF, DTI, Scottish Office

This has been considered and rejected as a starter for 1986: it is, of course, overtaken by events so far as life-time transfers are concerned.

Stamp duty, abolish for shares - DEm, DTI

A reduction to half-per-cent (Lord Young's fall-back position) is a current starter (Mr Draper's note of 20 December).

Concessions on stamp duty for house sales - DoE

Move to slice basis, and increase property threshold to at least £35,000.

The slice basis move would be very costly, - well over £200m - although an increase in the threshold is still under consideration - starter 103.

CGT exemption for unquoted capital venture funds - DEm

Indications are that this would not by itself do much to bring funds back "onshore"; the industry would also want favourable tax treatment of the returns to fund promoters. BVCA are focussing their attentions elsewhere this year.

Farmers to roll over CGT liabilities - MAFF

Extend "roll-over" relief to sales by farmers of land to cut borrowing.

IR have been discussing with Country Landowners Association the latter's proposal on this, but are not enthusiastic about its feasibility; the CLA have gone away to do more work.

More CGT relief for inflationary gains - MAFF

More relief for inflationary gains - eg exemption for assets held over more than 10/12 years. The idea of such a cut-off is far from new, but has always been ruled out on cost grounds.

Extension of retirement relief - MAFF

a) Reduce restrictions on proportion of land holdings which can be sold off to count for retirement relief.

IR automatically allow sales of more than 50% of land to qualify; smaller sales are not ruled out, but are looked at on a case by case basis. Retirement relief rules were made more generous in 1985 FA, and difficult to justify further relaxation now.

b) Allow retirement relief for agricultural landlords where letting occurs only after owner reaches retirement age.

This is a variant on an old proposal put forward by the CLA etc. Ministers have not so far been persuaded of case to extend relief to let assets. It is not clear that the tax system is a major disincentive to landlords.

Abolish unit trust instrument duty - DTI

Part of stamp duty package; desirable if resources allow, but cannot be regarded as top priority.

Domestic corporate bonds to bear interest gross - DTI

Unlikely to encourage borrowing in market; could cost £15m per £ billion bonds in issue per year.

CTT exemptions for land of outstanding interest - DoE

Extend 'douceur' concession for sales of heritage assets to specified general public bodies to certain non-public nature conservancy bodies. Ministers have always to date resisted this as setting an unacceptable precedent - no guarantee that the line could be held at the bodies listed by Mr Baker.

SECRET

(vi) **Other**

Loans by charities to small businesses should be regarded as for charitable purposes - DEm

This was covered in Mr Stewart's note to FST of 13 December (para 35). Modifying the charity law definition of "charitable purposes" looks unattractive, given the scale of the likely benefits. Ministers are aware of existing abuse by "money-box" charities. Tax relief is already available for assistance channelled through approved local enterprise agencies: relief for the costs of employees seconded to such agencies is a starter for 1986.

Align break points on car tax with EC emission directive - DTI

Already agreed for 1986 Finance Bill, to take effect from April 1987.

Amend BES restrictions on overseas subsidiaries - DTI

Ministers have decided to meet this point, and include companies with overseas subsidiaries in scheme. Further Revenue paper to follow.

Amend BES to accept shares subject to call options - DTI

No strong objections, subject to watching for avoidance possibilities.

Allow ship chartering in BES - DoT

GCBS would see this as no substitute for action on incentive capital allowances. Legislation would be difficult and create unwelcome precedents, for leasing and for overseas trades, outside the shipping field. An overriding limit on BES subscriptions (if that turns out to be necessary) would effectively exclude shipping anyway.

Increase PIID threshold - DEm

The Chancellor has agreed (Mr Kuczys' minute of 3 January) that the threshold should not be increased. Administrative simplification (abolition of the form PIIDA 'nil return') will reduce compliance burdens - but not as drastically as Lord Young would wish.

Employee share schemes/Employee controlled companies - DEm, DTI

a) Encouragement to spread schemes: Ministers have agreed an extension to shares subject to pre-emption conditions: this should improve take-up among the smaller companies Lord Young mentions.

SECRET

b) 'Material interest' restriction: FA1984 share option schemes are barred to those with more than 10 per cent interest in a close company. Extending this to 25 per cent would be beyond intended target of the scheme.

c) Increased allocation limits: No evidence that limits on all-employee schemes (significantly increased since first introduced) are much restricting take-up. Most schemes do not use full ration already available.

d) Employee-controlled companies: Ministers have agreed to allow ECCs (with more than one class of share) access to employee share schemes. Extension to redeemable shares of co-operatives is being considered.

Forestry – tax concessions for coniferous woodlands - DoE

Reduce tax concessions for coniferous woodlands.

Although a good idea in principle, this would antagonise the forestry lobby, and Ministers have hitherto concluded that the taxation of forests should be left well alone.

273/001

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CHEVENING: 11-12 January 1986

Papers

1. **POLICY BACKGROUND TO THE 1986 MTFS: Sir T Burns of 20 December**

[Also relevant:

(1) Macroeconomic assumptions for the MTFS - Mr Grice's minute of 16 December, with Sir T Burns' mss comment on it dated 18 December

(ii) Winter forecast: preliminary indications - Mr H P Evans of 10 January, ~~to follow~~. (+ policy assumptions on the forecast)

2. **EMPLOYMENT AND ENTERPRISE ISSUES: Mr Monck of 20 December**

3. **TAX ISSUES: Mr Monger of 20 December**

[Also relevant:

(i) Approach to the 1986 Budget: options for personal tax changes: Mr Blythe of 19 December, as amended by Mr Mace of 23 December, and as further supplemented by Mr Blythe's minute of 9 January.

(ii) Chevening: indirect taxes: Sir Angus Fraser of 20 December, as further supplemented in response to Mrs Lomax's minute of 6 January to PS/C&E.

(iii) CBI: Tax Reform Working Party Report: Mr Painter of 6 January

both with you,

(iv) Ministers' Budget Representations: summary note by Central Unit ~~to follow]~~

4. **PRESENTATIONAL ISSUES: to follow from Mr Culpin**

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J1

cc(5)

FROM: M C SCHOLAR
DATE: 13 January 1986

SIR P MIDDLETON

(when the papers with PC like, I alter privately)

cc: Mr Cassell
Mr Monck (items 1 & 2)
Mrs Lomax

FOLLOW-UP TO CHEVENING: WORK PRIORITIES

As I promised this morning, I attach a list of work priorities which, if you agree, can be circulated more widely tomorrow. When - later tomorrow, I hope - we have estimates of the delivery dates of these pieces of work we can then work out a rough agenda for the first few overview meetings.

MCS

M C SCHOLAR

R/

PEM's box closed at 6.30 -

I promised him this tonight as the price of postponing the mtg - I've told him not yet checked with you & will make it consistent with your record before both are circulated tomorrow.

M.

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Follow-up to Chevening discussions: work priorities

Employment and enterprise issues

(1) Mr Monck to pursue with Department of Employment the possibility for scaling down the measures under (f) and (g) in Table 3 of his paper - ie interviews of long-term unemployed: extend existing pilots, and jobstart, and extend existing pilot. Aim: to identify a list of measures whose total cost could be contained within the figures suggested by Mr Monck (ie with gross PE cost of a maximum of £100m in 1986-87, and £200m in 1987-88 - min only, less if Lord Young could be persuaded to make offsetting savings).

Yes of course, [illegible] practical politics?

(2) Chief Secretary to negotiate such a package with Lord Young (Mr F E R Butler to submit advice on tactics).

Tax issues

(3) IR to produce a paper on possible changes to higher rates of income tax. Aim: to reduce gains for those high-earners who would gain most from basic-rate change, simplify higher rate structure, avoid creating an awkward pattern of gainers/losers. Paper should show effects on up to 10 x average earnings, and possibility of not price-indexing higher-rate thresholds not to be ruled out.

(4) IR to produce a paper on possibilities for a reduced rate band - the earliest date at which it could be introduced, some illustrative costings with and without indexation of allowances, the manpower consequences, the implications for the introduction of transferable allowances.

(5) IR to produce a note on the consideration affecting use of one-half percentage points for the basic rate of income

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tax - in particular on the ~~10~~ 2½p reduction option.

(6) IR to produce a paper on stamp duty. Aim: revenue-neutral package with reduction of rate from 1% to ½% on share transactions by individuals and institutions, financed by broadening base of tax, including loan stocks but not gilts, introducing a higher rate of duty of at least 1½% and up to a ceiling of 5% on conversion of shares into ADRs.

(7) Economic Secretary to investigate possibility of a very broadly based tax, at a very low rate, on money transfers.

(8) IR to produce a paper on pension fund surpluses. Aim: to devise a regime to replace existing discretionary IR practice, with a cut-off point X beyond which there would be discretion but no obligation to remove a surplus (either by contribution holiday, benefit changes, or refund from the pension fund to the company) and a cut-off point Y beyond which removal of the surplus would be mandatory; refunds to involve an exit charge. Advice required on whether refund of surplus below point X should be prohibited: on where X and Y might be set; on whether there should be a margin for the application of the GAD's standardised assumptions; on the CT consequences (ringfenced or not?); and on ~~whether~~ how soon the new régime could be in place ~~for 1986-87~~.

(9) Financial Secretary to work up a package on charitable giving, on the basis of the abolition of the £10,000 limit on higher rate relief, a discretionary scheme to encourage payroll giving and - possibly - some incentive for single gifts by individuals and companies.

(10) Minister of State to investigate possibilities for help to charities on VAT.

(11) IR to produce their promised further paper on the Business Expansion Scheme

(12) IR to produce their promised further note on Weitzman, against the possibility that the Budget will announce that the government will consult on a scheme on these lines, perhaps limited to pilot areas.

(13) IR to produce a paper on a minimum tax, indicating the areas of tax shelter which might be included and the criterion for excluding areas from the list.

(14) IR (Mr Corlett) to develop the approach on tax relief for savings in his minute of 9 January.

(15) IR to produce a paper on the beneficiaries of the CTT reforms.

(16) Financial Secretary to consider possibility of converting CGT owner-occupier relief into a roll-over relief.

(17) Financial Secretary to pursue package of changes on employee share schemes.

(18) Financial Secretary to look at possibilities for enabling co-operatives to have access to profit-sharing schemes (para 50(c) - not (a) and (b) - of Mr Monck's paper).

(19) Treasury, IR and C&E to consider scope for new compassionate lollipops, perhaps for disabled or handicapped.

(20) IR to work up briefing on Ernst and Whinney study.

In addition, Sir P Middleton was asked for a paper on presentation.

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Inland Revenue

Policy Division
Somerset House

FROM: R A BLYTHE

DATE: 19 DECEMBER 1

APPROACH TO THE 1986 BUDGET: OPTIONS FOR PERSONAL TAX CHANGES

19.12

1. MR ISAAC

2. CHAIRMAN 19/12

3. CHANCELLOR OF THE EXCHEQUER

APPROACH TO THE 1986 BUDGET: OPTIONS FOR PERSONAL TAX CHANGES

1. The attached paper looks in detail at a range of possible options for changes in personal allowances and the basic rate in 1986-87. The aim is to give you a first broad indication of how the options measure up against the standard criteria, the impact on our staff numbers, and the consequences for the eventual cost of changing over to transferable allowances.

2. The options range from statutory prices indexation (5½ per cent on 1985-86 allowance levels) to earnings indexation (7 per cent on 1985-86 allowances) plus 2p off the basic rate. Revenue costs on top of indexation range up to just over £2 billion in 1986-87. The note does not look at the possibilities for changes to the higher rate structure but for completeness copies of our recent submissions which consider higher rate options in which you have expressed an interest are attached as Annex 7 to the paper.

---

cc Chief Secretary	Sir Lawrence Airey
Financial Secretary	Mr Isaac
Economic Secretary	Mr Battishill
Minister of State	Mr Rogers
Sir Peter Middleton	Mr Pollard
Sir Terence Burns	Mr Blythe
Mr Cassell	Mr Painter
Mr Byatt	Mr Calder
Mr Scholar	Mr Crawley
Mr Watson	Mr Mace
Mr Monger	Mr Lewis
Miss Sinclair	Mr Eason
Mr G P Smith	Mr Hudson
Mr Haigh	Dr Keenay
Mr Cropper	Mrs Ayling
Mr Lord	PS/IR
Mr Davies	

3. The note shows that at least Option 2A - an increase in allowances of 7 per cent in line with the assumed rise in earnings - is needed if we are not to fall back against various criteria compared with the position reached in 1985-86. At a revenue cost in 1986-87 of £1200 million on top of indexation Option 4A (13 per cent on allowances) would achieve, or nearly achieve, a number of presentationally attractive targets including

- single allowance at its highest level since 1973-74 as a percentage of earnings

- married allowance at its highest level since 1972-73 as a percentage of earnings

- income tax as a percentage of earnings lower than in 1978-79 for all married men

- no losers after tax and NIC (nearly)

- nearly $1\frac{1}{4}$ million fewer taxpayers compared with no change in allowances

- reduction of 140 units against our 1988 manpower target

4. The note examines a number of alternative options with approximately the same revenue costs in 1986-87 so that the distributional effects of basic rate reductions and equal cost allowance increases may be compared. The broad picture here is that for those of working age a basic rate cut provides a bigger cash reduction in tax to married men on more than about 90 per cent of average earnings (and to single people on more than about 60 per cent of average earnings) than an equal cost increase in allowances. In broad terms just under 60 per cent of all taxpayers would be better off with allowance increases than with equal cost basic rate reductions.

5. Amongst options involving basic rate reductions Option 4B (earnings indexation of allowances plus 1p off the basic rate) would (for the same revenue cost as Option 4A in 1986-87) maintain the

position on thresholds reached in 1985-86; the basic rate reduction would give up to an extra £3.29 per week to the basic rate taxpayer on top of the minimum tax reduction of £1.44 per week for the married man and 92p per week for the single person from the allowance increase. It would also mean no cash losers after tax and NIC compared with 1985-86. At an 1986-87 revenue cost on top of indexation of £2,150 million Option 6B (13% on allowances plus 1p off the basic rate) would achieve all the targets listed in paragraph 3 above for Option 4A as well as some further points. In particular it would mean that everyone on average earnings and above would be paying a smaller proportion of their income in tax and NIC than in 1978-79.

6. Finally the note considers the impact of the options on the eventual cost of moving to transferable allowances without losers - which, under statutory indexation (Option 1A), would be £5.4 billion. With one exception (Option 6A) the options do not change this cost by more than ~~£400~~ 250 million in either direction.

hers is the latest version of £5.3bn

R A BLYTHE

Approach to the 1986 Budget: Options for Personal Tax Changes

Introduction

1. This note considers a range of illustrative options for changes in personal allowances and the basic rate in 1986-87. It does not look at options for changes in the higher rate structure. The note examines how each option measures up to a number of standard target points, considers their distributional effects and describes the impact of each option on Inland Revenue manpower and the revenue cost of changing to transferable allowances.

Options Considered and Costs

2. The options are

Option	% increase over 1985-86 allowances	Reduction in basic rate	Revenue costs on top of statutory indexation* £ million 1986-87	Full Year
1A	5½ (Prices Indexation)	-	-	-
2A	7 (Earnings indexation)	-	220	275
3A	10 (£2 per week for married man)	-	710	900
4A	13	-	1200	1500
4B	7	1p	1200	1450
5B	10	1p	1725	2100
5.5BX ("Main")	5½	2p	1950	2350
6A	19	-	2150	2700
6B	13	1p	2150	2650
6BX	7	2p	2150	2600
7BY ("Target")	5½	3p	2925	3525

* Approximate and subject to change. Indexed levels of allowances and thresholds are as in the Autumn Statement. Costs are based on the latest information available and differ slightly from those in the Autumn Statement.

3. The detailed specification of each option is set out in Annex 1. The options are ordered by reference to their 1986-87 revenue cost. "A" options involve increase in Allowances only; "B" options include a reduction of 1p in the Basic rate. "BX" options include a reduction of 2p in the basic rate. Basic rates involving fractions of 1p are not at present possible with COP.

Why? !!

4. The main assumptions made in calculating the costs of each option are:

i. The higher rate threshold and bands have been increased only in line with statutory indexation. The higher rates themselves have been kept at their 1985-86 levels.

ii. For each option the age allowances have been increased by the same cash amount as the corresponding basic allowances (or by statutory indexation where this is greater). The aged income limit is increased by the same proportion as the percentage increase in the married age allowance.

iii. Increases in allowances and thresholds have been rounded in accordance with the rules of the statutory indexation formula. Increases in allowances have to be multiples of £10 so that employers can implement the changes under PAYE using the special Budget uprating procedures.

Costs

5. The figures given in the paper reflect direct revenue costs in 1986-87 (first year) and in a full year at forecast 1986-87 levels of income. These costs are approximate and subject to change. Second year costs are

broadly similar to the full year costs. The PSBR costs for 1986-87 are likely to be similar to the 1986-87 revenue costs but the detailed basis for determining the PSBR effect of revenue changes for 1986-87 and 1987-88 has not yet been settled.

6. Options involving changes in the basic rate assume that the composite rate for bank and building society interest would not be reduced in line with any basic rate cut until 1987-88. This is in accordance with statutory provisions in the 1984 Finance Act which govern the determination of the composite rate. Annex 6 explains in more detail the implications of a basic rate reduction for the composite rate. Our recommendation is that the composite rate should not be changed in 1986-87 in line with any reduction in the basic rate but Ministers will wish to consider the points which are raised in the Annex. (If the composite rate were to be reduced in 1986-87 in line with a reduction in the basic rate next year this would increase the 1986-87 cost of a 1p reduction in the basic rate by about £100 million.)

Choice of Options

now extended to include 2 additional options

7. The options have been chosen to cover a range of targets which might prove presentationally attractive next year and with revenue costs up to about £2 billion on top of indexation in 1986-87 (up to £2 3/4 billion in a full year.) Each of the options involving a reduction in the basic rate has been combined with at least earnings indexation (7per cent) of the basic allowances. This is necessary to ensure that we do not fall back from the position reached in 1985-86 on targets such as the level of thresholds as a percentage of earnings, and so that no taxpayer whose earnings increase in line with the average suffers an increase in his average rate of tax between 1985-86 and 1986-87. It also means that there is broadly no increase in our staffing requirement as a result of the increase in the

Options this (can form part of attacks on basic rate) overall number of taxpayers (but see paragraphs 21 and 27). In selected cases we have examined alternative options with approximately the same revenue costs in 1986-87 so that the distributional effects of basic rate reductions and equivalent-cost allowance increases may be compared. As the table in paragraph 2 shows, options having the same revenue cost in 1986-87 do not necessarily have exactly the same full year revenue cost. This is because the proportion of the full year cost of a basic rate change which comes through in the first year is somewhat larger than the corresponding proportion of the full year cost of an allowance increase.

Examination of options

8. Paragraphs 9-25 below consider the options briefly in comparison with a number of targets:

- tax reductions per week; and gains and losses including the effect of NIC changes in April 1986 at the 1986-87 UEL (£285 per week) (paragraphs 9-13)
- threshold levels in relation to prices and earnings (paragraphs 14-17)
- average rates of tax and tax plus NIC (paragraphs 18-20)
- numbers of taxpayers (paragraphs 21-22)
- the poverty and unemployment traps (paragraphs 23-25).

The remainder of the note (paragraphs 26-42) looks at further aspects of the options:

- manpower consequences (paragraphs 26-27)
- comparison of equal cost allowance increases and basic rate reductions (paragraphs 28-32)
- other aspects of basic rate reductions (paragraphs 33-37)
- implications for the eventual cost of transferable allowances (paragraphs 38-39)
- higher rates (paragraphs 40-42).

Tax Reductions Per Week

9. Annex 2 shows the weekly reductions in tax compared to 1985-86 at different levels of earnings.

10. Earnings indexation (Option 2A) gives a tax reduction worth £1.44 per week for the married couple and 92p per week for a single person paying tax at the basic rate. So options involving a reduction in the basic rate on top of earnings indexation (Options 4B & 6BX) would give at least this much to all taxpayers. A one penny reduction would give up to an extra £3.29 per week for basic rate taxpayers. Paragraphs 28-32 look in more detail at the options involving equal cost increase in allowances and reductions in the basic rate. In very broad terms, however, an allowance increase provides a bigger cash reduction in tax to married men on less than about 90 per cent of average earnings (and to single people on less than about 60 per cent of average earnings) than an equal cost reduction in the basic rate.

Income Tax and NIC

11. Annex 3 shows the combined effect in cash terms of tax and NIC changes for a basic rate taxpayer with earnings at the new UEL (from April 1986) of £285 per week. At this level of earnings and above the contracted-in will pay an extra £1.80 per week in contributions and the contracted-out an extra £1.42. The Annex focuses on the UEL level of earnings since that is where losses, if any, from the combined tax and NIC changes would be greatest.

12. As the Annex shows, with allowance increases only, Option 3A (10 per cent) avoids losers after tax and NIC amongst married men. It would be necessary to go a bit beyond Option 4A (13 per cent) in order to avoid any losers after tax and NIC. But any option involving a reduction in the basic rate is sufficient to avoid losers.

NB. M

13. On earnings below the present UEL of £265 per week, the contracted-in will face no increase in contributions while the contracted-out contribution will increase by 5p per week as a result of the increase in the LEL to £38.

Value of allowances in real terms

14. The value of the married man's allowance is at its highest level in real terms since the war. All the options would at least maintain this position. In real terms the single person's allowance is at its highest level since 1973-74 and options involving 10 per cent or more on allowances would improve on this. Option 6A (19 per cent) would take the single allowance almost to its highest level in real terms since the war.

15. Allowances are now about 20 per cent higher in real terms than in 1978-79. All the options except prices indexation (Option 1A) would improve on this.

Allowances as a percentage of average earnings

16. The table below shows the personal allowances as a percentage of average earnings for 1985-86 and for each of the options.

Table 1

Allowances as a percentage of average earnings (all occupations)

	Single Allowance	Married Allowance
1985-86	21.2	33.3
Option 1A (5½%)[4]	21.0	32.9
Option 2A (7%)[1]	21.2	33.3
Option 3A (10%)[2]	21.9	34.2
Option 4A (13%)[3]	22.4	35.1
Option 6A (19%)	23.6	37.0

1 Also Options 4B (7% + 1p off BR) and 6BX (7% + 2p off BR).

2 Also Option 5B (10% + 1p off BR).

3 Also Option 6B (13% + 1p off BR).

4 Also Options 5.5BX (5½%+2p off BR) and 7BY (5½% + 3p off BR).

The earnings figures used here assume an increase of 7 per cent between 1985-86 and 1986-87 in line with the assumptions given to the Government Actuary for the Social Security uprating.

Allowances as a percentage of average earnings

16. The table below shows the personal allowances as a percentage of average earnings for 1985-86 and for each of the options.

Table 1

Allowances as a percentage of average earnings (all occupations)

	Single Allowance	Married Allowance
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3 Also Option 6B (13% + 1p off BR).

The earnings figures used here assume an increase of 7 per cent between 1985-86 and 1986-87 in line with the assumptions given to the Government Actuary for the Social Security uprating.

So what? 17. As the table shows, on the Autumn statement assumptions, it is necessary to go to at least Option 2A (7 per cent) to prevent allowance levels falling as a percentage of average earnings compared with 1985-86. At present both single and married allowances are at their highest level as a percentage of average earnings since 1977-78. Option 4A (13 per cent) would be sufficient to take the single allowance to its highest level since 1973-74 and the married allowance to its highest level since 1972-73. The peak reached in 1972-73 (and to a lesser extent in 1973-74 for the single allowance) is still some way off.

Average Rates

- tax only

18. Annex 4 shows income tax as a percentage of earnings for some standard multiples of average earnings in 1978-79, 1985-86 and for each of the options in 1986-87. It is necessary to go to Option 2A (7 per cent) to maintain the position reached in 1985-86 (which showed an improvement over 1978-79 except below about 50 per cent of average earnings). Option 4A (13 per cent) would be enough to reduce income tax as a percentage of earnings below its 1978-79 level for all married men. (It would be necessary to increase the single allowance by about 16 per cent to achieve the same result for all single people). Amongst the basic rate options Option 4B (7 per cent plus 1p off BR) is not quite sufficient to achieve the result for all married men; it is necessary to go at least to Option 5B (10 per cent plus 1p off BR) for the married man and to Option 6B (13 per cent plus 1p off BR) for the single person.

19. Under the present Government income tax as a percentage of average earnings reached its lowest level in 1979-80. Slightly more than Option 4A (13 per cent) or better on allowances and any of the options involving basic rate reductions would improve on this. Going slightly further than Option 4A on allowances would reduce tax as a percentage of average earnings to its lowest level since 1973-74 for the single person, and since 1972-73 for the married man. Option 6BX (7 per cent plus 2p off BR) would give the lowest level since 1972-73 for the single person and since 1968-69 for the married man.

- tax and NIC

20. Annex 5 shows similar figures to Annex 4 but for average rates of tax and NIC combined as a percentage of earnings. The table has been partitioned to show the groups which would have lower average rates than in 1978-79. In 1985-86 only those at more than twice average earnings had lower rates of tax and NIC than in 1978-79. The partitioning in the table shows that this would be achieved at average earnings in 1986-87 for single people under Options 6B and 6BX and for married men under Options 6A, 6B and 6BX. The table also shows that for those on half average earnings options involving only allowance increases produce a larger reduction in the burden of tax plus NIC than the equal cost options with basic rate reductions.

Numbers of taxpayers

21. Our latest data, based on the most recent Survey of Personal Incomes (for 1983/84) shows fairly substantial growth (of about 800,000) in the overall number of taxpayers between the Budget estimate for 1985-86 and the position in 1986-87 if allowances and thresholds were left unchanged. It is necessary to go slightly further than earnings indexation (Option 2A (7 per cent)) to maintain the overall number of taxpayers compared with 1985-86. The latest estimates show a large increase (about 100,000 more) in the number of higher rate taxpayers in 1985-86 compared with the forecast made at the time of the Budget. We now expect that there will be over 1 million higher rate taxpayers in 1985-86. The reason for this rise is that increases in earnings and investment income at these levels have been both higher than expected and substantially larger than the corresponding increases in prices. The higher rate thresholds on the other hand have been increased only in line with indexation over the past few years. This increase in the number of higher rate taxpayers has implications for our manpower requirements (see paragraph 27 below).

22. The table below shows how each option would reduce the number of taxpayers in 1986-87 compared with the number expected if allowances were left unchanged at their 1985-86 values.

Table 2

Taxpayers in 1986-87: reduction in number compared with no change in allowances

	Reduction 000s
Option 1A (5½%)	570
Option 2A (7%)	680
Option 3A (10%)	950
Option 4A (13%)	1210
Option 4B (7% + 1p off BR)	680
Option 5B (10% + 1p off BR)	950
Option 5.5BX (5½% + 2p off BR)	570
Option 6A (19%)	1740
Option 6B (13% + 1p off BR)	1210
Option 6BX (7% + 2p off BR)	680
Option 7BY (5½% + 3p off BR)	570

22. The table below shows how each option would reduce the number of taxpayers in 1986-87 compared with the number expected if allowances were left unchanged at their 1985-86 values.

Table 2

Taxpayers in 1986-87: reduction in number compared with no change in allowances

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Option 4A (13%)	1210
Option 4B (7% + 1p off BR)	680
Option 5B (10% + 1p off BR)	950
Option 6A (19%)	1740
Option 6B (13% + 1p off BR)	1210
Option 6BX (7% + 2p off BR)	680

Poverty and Unemployment Traps

23. Annex 3 of the Treasury's Tax Issues paper considers in some detail the effects of income tax changes on the poverty and unemployment traps. On the basis of entitlement, about 450,000 working families are currently subject to combined marginal rates of tax and benefit withdrawal of over 70 per cent and may be regarded as being in the poverty trap. In practice the number with such high marginal rates is rather smaller than this because the take up of benefits is less than complete (for example it is estimated that only about half the families entitled to FIS actually claim it.)

24. Since they effectively reduce marginal rates for some taxpayers by 30 percentage points, increases in personal allowances are more effective in cutting the number of families in the poverty trap than reductions in the basic rate of tax. Under earnings indexation (Option 2A) there would be about 450,000 families with marginal rates over 70 per cent in 1986-87, the same number as at present. Option 4A (13 per cent) would reduce this by about 20,000 to 430,000 whilst Option 6A (19 per cent) would reduce it by about 40,000. Reducing the basic rate would not in itself cut the numbers of people in the poverty trap, though it would slightly reduce marginal rates for all 450,000 families affected.

25. About 2 million working families currently have replacement ratios over 70 per cent and may be said to be in the unemployment trap. By giving larger cash gains at lower income levels where replacement ratios tend to be relatively high, increases in allowances have a bigger impact on these families than cuts in the basic rate. Option 6A (19 per cent) would reduce the number of families with replacement ratios over 70 per cent by 230,000 whereas Option 6BX (7 per cent plus 2p off BR) would cut the numbers by 160,000.

Manpower Consequences

26. The table below sets out the effect on our 1988 manpower target of each of the options. The figures assume that COP is fully implemented by 1988 and take account of the effects of the estimated 4,000 savings from COP by then in local offices.

Manpower Consequences

26. The table below sets out the effect on our 1988 manpower target of each of the options. The figures assume that COP is fully implemented by 1988 and take account of the effects of the estimated 4,000 savings from COP by then in local offices.

Table 3

	Effect on 1988 Manpower Target
Option 1A (5½%)	+140
Option 2A (7%)	+ 90
Option 3A (10%)	- 25
Option 4A (13%)	-140
Option 4B (7% + 1p off BR)	+ 90
Option 5B (10% + 1p off BR)	- 30
Option 5.5BX (5½% + 2p off BR)	+140
Option 6A (19%)	-355
Option 6B (13% + 1p off BR)	-140
Option 6BX (7% + 2p off BR)	+ 85
Option 7BY (5½% + 3p off BR)	+140

Table 3

	Effect on 1988 Manpower Target
Option 1A (5½%)	+140
Option 2A (7%)	+ 90
Option 3A (10%)	- 25
Option 4A (13%)	-140
Option 4B (7% + 1p off BR)	+ 90
Option 5B (10% + 1p off BR)	- 30
Option 6A (19%)	-355
Option 6B (13% + 1p off BR)	-140
Option 6BX (7% + 2p off BR)	+ 85
Main option (5½% + 2p)	+135 (?)

27. Rather more than earnings indexation (Option 2A) is needed overall to achieve a neutral effect on our April 1988 manpower target. Although Option 2A is broadly enough to prevent any increase in the overall number of taxpayers between 1985-86 and 1986-87 (and hence to keep this component of our workload constant) the disproportionate rise in the number of higher rate taxpayers compared with the 1985 Budget estimate (see paragraph 21) means that there is an overall increase in our staffing requirement under Option 2A. Reductions in the basic rate have essentially no effect on our manpower requirement. (The small differences between the effects under some of the options when combined with a basic rate cut are due to differences in the expected number of wife's earnings elections under each option and hence in the number of higher rate taxpayers.) As the table shows Option 6A (19 per cent), for example, would reduce our 1988 manpower requirement by some 440 more than the equivalent cost Option 6BX (7 per cent plus 2p off BR).

Comparison of Equal Cost Allowance Increases and Basic Rate Reductions

28. The table below shows for the options which are alternative equal cost allowance increase and basic rate reductions the level of income - "break-even point" - at which the reduction in tax is the same under the basic rate reduction as under the option involving an allowance increase only. The figures are for taxpayers of working age.

Table 4

Break-even points: Equal cost Allowance increases and Basic Rate Reductions

Gross income £ per annum (£ per week)

Options	Single Person	Married Man
Option 4A (13%)		
Option 4B (7% + 1p off BR)	6265 (120)	9,705 (187)
Option 6A (19%)		
Option 6B (13% + 1p off BR)	6395 (123)	10,205 (196)
Option 6BX (7% + 2p off BR)	6265 (120)	9,855 (190)

v. similar results for Options 5.5BX + 7:B7

Taxpayers with incomes below the break-even points shown in the table would get a larger tax reduction from the option involving allowance increases only; taxpayers with incomes above the break-even points would get a larger reduction from the basic rate option.

29. The table below shows the numbers of taxpayers who would gain or lose under the options involving reductions in the basic rate compared with the equal cost allowance increase options.

ie S with >60% average earnings } better off with combination
MM with >90% av. earnings } of allowances + basic rate, than with equal cost increase in allowances (45% of taxpayers better off)

Table 5

Equal cost options: gainers and losers ('000s)

Options		Single	
Option 4B	Non-aged	Aged	Total
Gain relative to Option 4A	3,850 (48%)	400 (28%)	4,250 (45%)
Lose relative to Option 4A	4,100 (52%)	1,000 (72%)	5,100 (55%)
Option 6B			
Gain relative to Option 6A	3,700 (47%)	350 (25%)	4,050 (43%)
Lose relative to Option 6A	4,250 (53%)	1,150 (75%)	5,300 (57%)
Option 6BX			
Gain relative to Option 6A	3,850 (48%)	400 (28%)	4,250 (45%)
Lose relative to Option 6A	4,100 (52%)	1,000 (72%)	5,100 (55%)
Options		Married	
Option 4B	Non-aged	Aged	Total
Gain relative to Option 4A	4,300 (45%)	350 (27%)	4,650 (42%)
Lose relative to Option 4A	5,350 (55%)	950 (73%)	6,300 (58%)
Option 6B			
Gain relative to Option 6A	3,900 (40%)	350 (27%)	4,250 (39%)
Lose relative to Option 6A	5,750 (60%)	950 (73%)	6,700 (61%)
Option 6BX			
Gain relative to Option 6A	4,250 (44%)	300 (23%)	4,550 (42%)
Lose relative to Option 6A	5,400 (56%)	1,000 (77%)	6,400 (58%)

Worth mentioning

30. As the table shows, in each case fewer taxpayers would benefit from the basic rate option than would benefit from an equal cost increase in allowances. In broad terms amongst those of working age about 55% of single taxpayers and about 60% of married taxpayers would be better off with the allowance increase options (Option 4A (13%) and Option 6A (19%)) than with the corresponding equal cost basic rate reductions.

31. Amongst elderly taxpayers a much higher proportion (over 70%) would be better off with allowance increases than with basic rate reductions.

32. For illustration Chart 1 shows the percentage change in income net of tax under Options 6A (19 per cent), 6B (13 per cent plus 1p off BR) and 6BX (7 per cent plus 2p off BR) against income in £ per week for a married man. Chart 2 shows the similar picture for a single person. A feature which emerges from these charts is that Option 6B gives a greater proportionate increase to those with small incomes than to those with larger incomes. But under Option 6BX the largest proportionate increases go to those with the largest incomes.

Basic rate cuts combined with prices indexation

33. As paragraph 7 explains we have combined options involving a reduction in the basic rate with at least earnings indexation since this is necessary to maintain the position reached in 1985-86 on a number of target points. If Ministers wished, a basic rate cut could of course be combined with prices indexation of all the allowances and thresholds and this would cost some £220 million less in 1986-87 (£275 million in a full year) than the corresponding earnings indexation option. The table below sets out comparative figures.

Table 6

	Revenue costs on top of indexation £ million	
	1986-87	Full Year
Prices indexation + 1p off basic rate	980	1175
Earnings indexation + 1p off basic rate (Option 4A)	1200	1450
Prices indexation + 2p off basic rate	1930	2325
Earnings indexation + 2p off basic rate (Option 6BX)	2150	2600

Basic rate cuts combined with prices indexation

33. As paragraph 7 explains we have combined options involving a reduction in the basic rate with at least earnings indexation since this is necessary to maintain the position reached in 1985-86 on a number of target points. If Ministers wished, a basic rate cut could of course be combined with prices indexation of all the allowances and thresholds and this would cost some £200-£220 million less in 1986-87 (£250-£275 million in a full year) than the corresponding earnings indexation option. The table below sets out comparative figures.

Table 6

	Revenue costs on top of indexation £ million	
	1986-87	Full Year
Prices indexation + 1p off basic rate	975	1175
Earnings indexation + 1p off basic rate (Option 4A)	1200	1450
Prices indexation + 2p off basic rate (Option 5.5BX)	1950	2350
Earnings indexation + 2p off basic rate (Option 6BX)	2150	2600
(Prices indexation + 3p off basic rate (Option 7BY)	2925	3525)

34. Under prices indexation the single allowance would be increased by £30 less than under earnings indexation and the married allowance by £50 less. The minimum tax reduction under prices indexation for a basic rate taxpayer would be 75p for a single person and £1.15 for a married man. This compares with 92p for the single person and £1.44 for the married man under earnings indexation of the allowances.

35. As Table 1 in paragraph 16 shows, prices indexation would mean that the value of the personal allowances as a percentage of average earnings would fall compared with 1985-86. In addition some taxpayers would suffer an increase in their average rate of tax between 1985-86 and 1986-87 even if prices indexation is combined with a cut in the basic rate. For example under an option involving prices indexation +2p off the basic rate single taxpayers whose earnings grow in line with the average would suffer an increase in their average tax rate if they earn less than about £52 per week in 1986-87; married taxpayers would suffer an increase if they earn less than about £82 per week in 1986-87.

but marginal rate of tax reduced for these people as well

Implications of a basic rate change

36. A change to the basic rate would affect the amount of any payment which an individual makes under deduction of tax. In particular borrowers paying mortgage interest under MIRAS would be required to increase their payments in 1986-87 as a result of a reduction in the basic rate. Payments under deed of covenant will also be affected. Where a covenant deed provides for a certain gross amount to be paid each year (many student covenants are of this kind) the covenantor would need, following a basic rate reduction, to increase the net payment which he actually makes to the beneficiary since he would be deducting less tax than before from the gross payment. Where the covenant deed provides

for a net amount to be paid (many charitable covenants are of this kind) this would be unaffected by a change in the basic rate but the amount of income tax which can be recovered by the beneficiary would be reduced. So the beneficiary would be worse off, unless the covenantor took steps to increase the net payment.

37. If there is a change in the basic rate in 1986-87 a number of provisions will need to be reconsidered in the light of the new rate. These include the rate of tax deduction for subcontractors in the construction industry; the rate of life insurance premium relief and the additional rate for discretionary trusts. If it is decided that a reduction in the basic rate is a strong option for 1986-87 we will let Ministers have notes on the implications for these and some other items.

Yes please

Effect on Cost of Transferable Allowances

38. Under Option 1A (statutory indexation) the cost of changing over to transferable allowances without losers would be £5.4 billion. The table below shows how this cost would vary for the other options.

Effect on Cost of Transferable Allowances

38. Under Option 1A (statutory indexation) the cost of changing over to transferable allowances without losers would be £5.4 billion. The table below shows how this cost would vary for the other options.

Table 7	Effect on cost of changing to transferable allowances	Overall cost of changing to transferable allowances without losers
	£ million	£ billion
Option 2A (7%)	+ 50	5.45
Option 3A (10%)	+ 150	5.55
Option 4A (13%)	+ 250	5.65
Option 4B (7% + 1p off BR)	- 100	5.30
Option 5B (10% + 1p off BR)	-	5.40
Option 5.5BX (5½% + 2p off BR)	- 300	5.10
Option 6A (19%)	+ 500	5.90
Option 6B (13% + 1p off BR)	+ 100	5.50
Option 6BX (7% + 2p off BR)	- 250	5.15
Option 7BY (5½% + 3p off BR)	- 450	4.95
[Prices indexation + 1p off BR	-150	5.25].

Higher rate options

40. The options in this paper are on the assumption of indexation of the higher rate threshold and bands. For the 1985 Budget a number of possible packages for rationalising the higher rate structures were considered (both with and without abolition of mortgage relief at the higher rates). We can provide updated costings of particular packages if Ministers wish.

41. In 1985-86 the first higher rate of tax is reached at a level of gross earnings about 10 per cent higher in real terms than in 1978-79 for both married and single taxpayers. Relative to earnings, however, the higher rate threshold has fallen compared with 1978-79. For example under indexation the higher rate threshold for a married man will be at about 1.87 times average earnings compared with about 1.97 times average earnings in 1978-79. To restore the 1978-79 position for a married man the length of the basic rate band would have to be increased from £17,100 under statutory indexation to about £18,300 of taxable income if allowances are only price indexed and by slightly less if allowances are raised in real terms.

42. For completeness we attach (as Annex 7) a copy of our two recent submissions which analyse the effects of those higher rate options in which the Chancellor has recently expressed interest.

CHART 1

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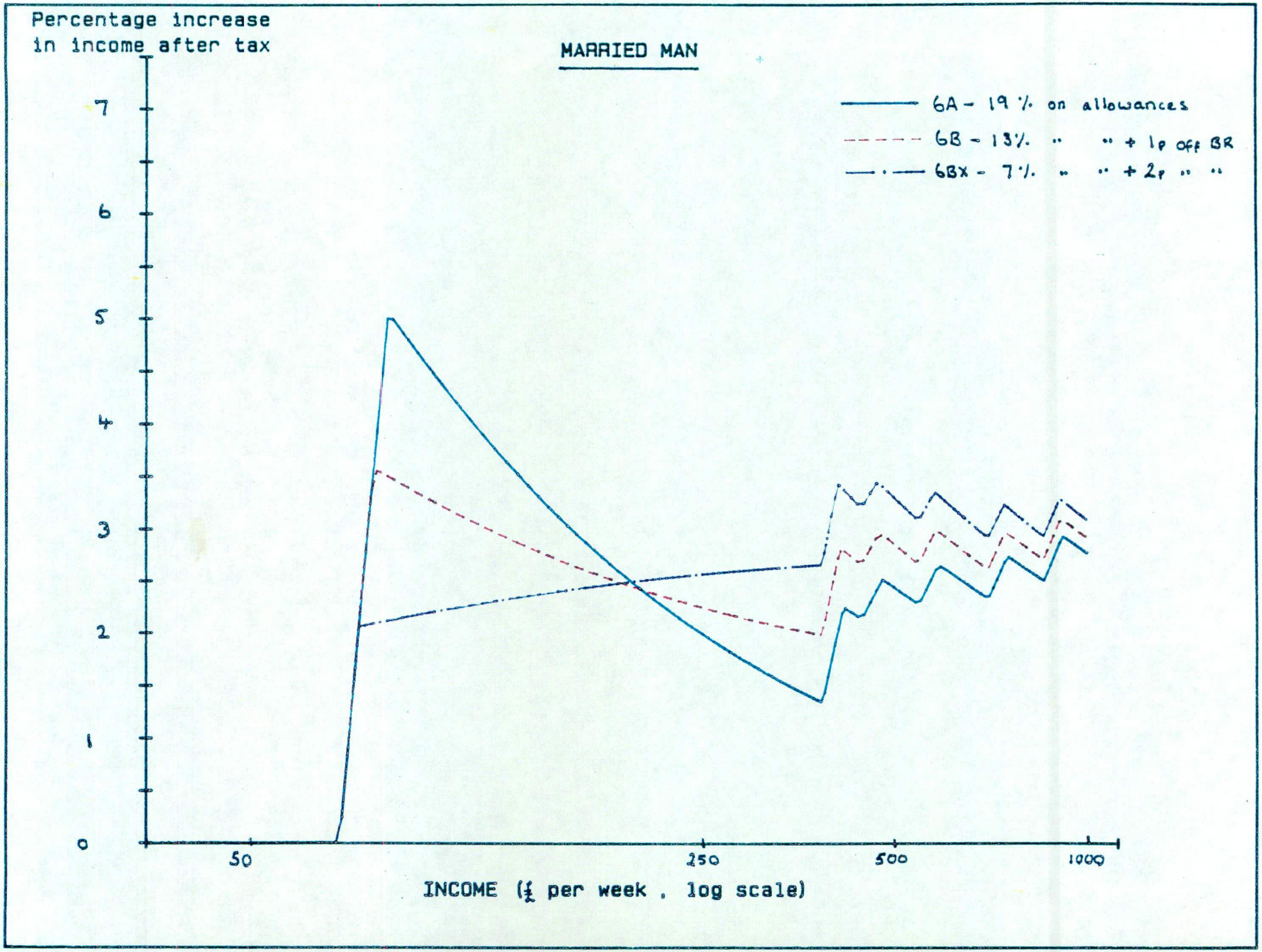
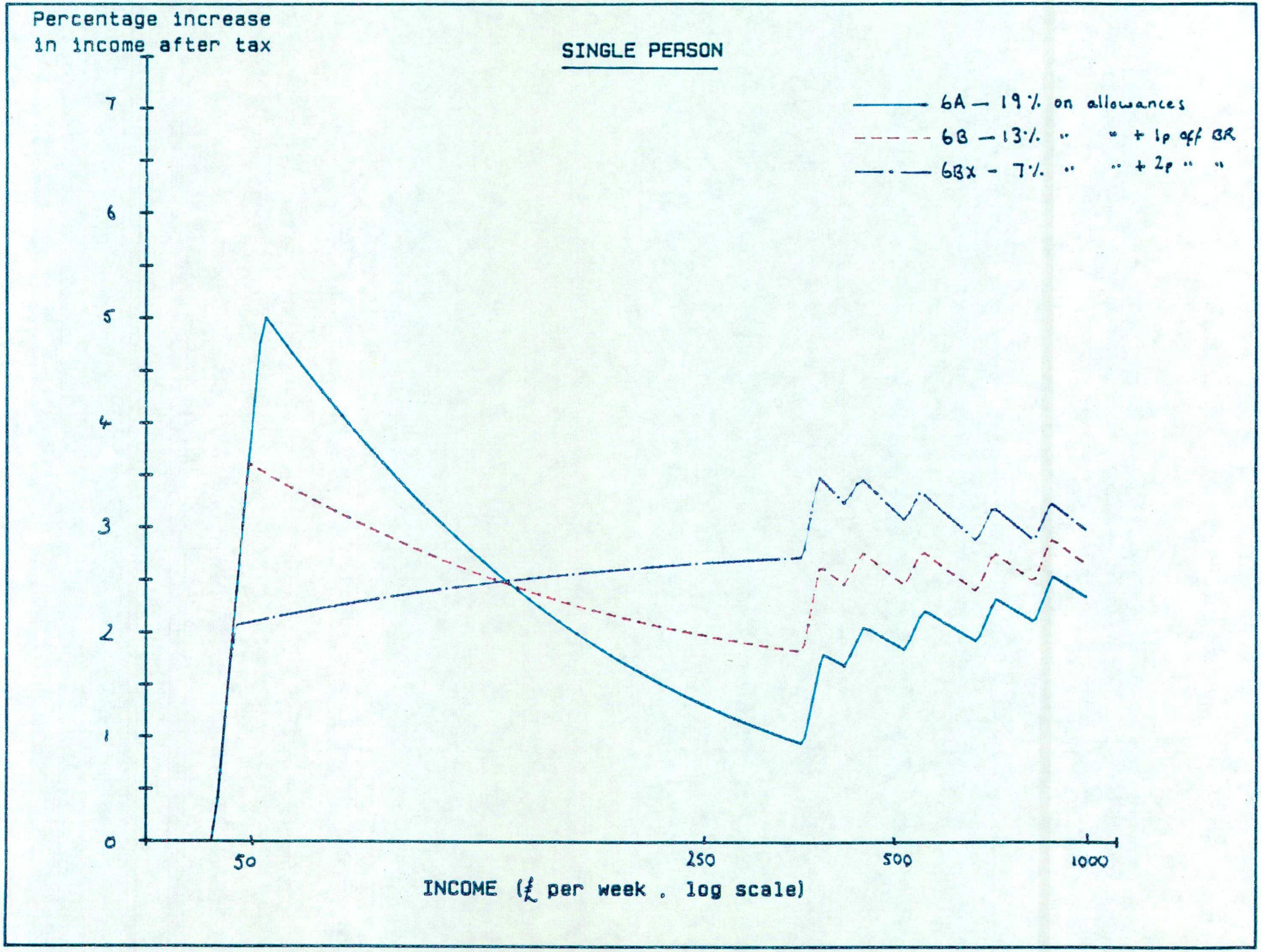


CHART 1



Percentage increase in income after tax
SINGLE PERSON
6A — 19% on allowances
6B — 13% " " + 1p off BR
6BX - 7% " " + 2p " "
0
1
2
3
4
5
6
7
50
250
500
1000
INCOME (£ per week . log scale)

CHART 2

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ANNEX 1

ANNEX 1

ANNEX 1: DETAILS OF 1986-87 OPTIONS

1986-87
Details of the Options*

	Percentage increase over 1985-86 allowances	Reduction in Basic Rate	Cost on top of indexation** 1986-87 Revenue £m	Cost on top of indexation** Full Year Revenue £m	Basic Single Allowance £†	Basic Married Allowance £†	Aged Single Allowance £†	Aged Married Allowance £†	Aged Income Limit £†
Option 1A (prices indexation)	5.5	-	-	-	2,335 (130)	3,655 (200)	2,840 (150)	4,495 (240)	9,300 (500)
Option 2A (earnings indexation)	7	-	220	275	2,365 (160)	3,705 (250)	2,850 (160)	4,505 (250)	9,400 (600)
Option 3A	10	-	710	900	2,435 (230)	3,805 (350)	2,920 (230)	4,605 (350)	9,600 (800)
Option 4A	13	-	1,200	1,500	2,495 (290)	3,905 (450)	2,980 (290)	4,705 (450)	9,800 (1,000)
Option 4B	7	1p	1,200	1,450	2,365 (160)	3,705 (250)	2,850 (160)	4,505 (250)	9,400 (600)
Option 5B	10	1p	1,725	2,100	2,435 (230)	3,805 (350)	2,920 (230)	4,605 (350)	9,600 (800)
Option 5.5BX (Main)	5.5	2p	1,950	2,350	2,335 (130)	3,655 (200)	2,840 (150)	4,495 (240)	9,300 (500)
Option 6A	19	-	2,150	2,700	2,625 (420)	4,115 (660)	3,110 (420)	4,915 (660)	10,200 (2,400)
Option 6B	13	1p	2,150	2,650	2,495 (290)	3,905 (450)	2,980 (290)	4,705 (450)	9,800 (1,000)
Option 6BX	7	2p	2,150	2,600	2,365 (160)	3,705 (250)	2,850 (160)	4,505 (250)	9,400 (600)
Option 7BY (Target)	5.5	3p	2,925	3,525	2,335 (130)	3,655 (200)	2,840 (150)	4,495 (240)	9,300 (500)
**Cost of indexation; and 1985-86 allowances			1,150	1,450	2,205	3,455	2,690	4,255	8,800

* Higher rate thresholds indexed

† figures in brackets show increase over 1985-86 allowances

ANNEX 2. WEEKLY CASH GAIN COMPARED WITH 1985-86 £/WEEK

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ANNEX 2

WEEKLY CASH GAIN COMPARED WITH 1985-86 £ PER WEEK

Multiples of average earnings

Single		½	3/4	1	1½	2	5
Option 1A	5½%	0.75	0.75	0.75	0.75	3.36	9.77
Option 2A	7%	0.92	0.92	0.92	0.92	3.59	10.12
Option 3A	10%	1.33	1.33	1.33	1.33	4.13	10.92
Option 4A	13%	1.67	1.67	1.67	1.67	4.59	11.62
Option 4B	7%, -1p	1.53	2.06	2.59	3.65	6.88	13.40
Option 5B	10%, -1p	1.92	2.45	2.98	4.04	7.42	14.21
Option 5.5BX	5½%, - 2p	1.99	3.06	4.13	6.27	10.00	16.35
Option 6A	19%	2.42	2.42	2.42	2.42	5.59	13.12
Option 6B	13%, -1p	2.25	2.78	3.31	4.37	7.88	14.90
Option 6BX	7%, -2p	2.13	3.19	4.26	6.38	10.17	16.69
Option 7BY	5½%, -3p	2.59	4.19	5.78	8.97	13.28	19.63

WEEKLY CASH GAIN COMPARED WITH 1985-86 £ PER WEEK

Multiples of average earnings

Married		½	3/4	1	1½	2	5
Option 1A	5½%	1.15	1.15	1.15	1.15	3.27	10.58
Option 2A	7%	1.44	1.44	1.44	1.44	3.65	11.15
Option 3A	10%	2.02	2.02	2.02	2.02	4.42	12.31
Option 4A	13%	2.60	2.60	2.60	2.60	5.19	13.46
Option 4B	7%, -1p	1.79	2.32	2.85	3.91	6.94	14.44
Option 5B	10%, -1p	2.35	2.88	3.41	4.47	7.71	15.60
Option 5.5BX	5½%, -2p	1.89	2.96	4.02	6.16	9.85	17.15
Option 6A	19%	3.81	3.81	3.81	3.81	6.81	15.88
Option 6B	13%, -1p	2.91	3.44	3.97	5.03	8.48	16.75
Option 6BX	7%, -2p	2.14	3.20	4.26	6.38	10.23	17.73
Option 7BY	5½%, -3p	2.24	3.83	5.43	8.62	13.13	20.44

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ANNEX 3

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GAINS (+)/LOSSES (-) AT 1986-87 UEL

Tax and NIC — £ per week — 1986-87 compared with 1985-86

	Contracted in		Contracted Out	
	Single Person or earning wife	Married man	Single Person or earning wife	Married man
Option 1A (5½%)	-1.05	-0.65	-0.67	-0.27
Option 2A (7%)	-0.88	-0.36	-0.50	+0.02
Option 3A (10%)	-0.47	+0.22	-0.09	+0.60
Option 4A (13%)	-0.12	+0.79	+0.25	+1.17
Option 4B (7%, -1p)	+1.52	+1.78	+1.90	+2.16
Option 5B (10%, -1p)	+1.91	+2.34	+2.29	+2.72
Option 5.5BX (5½%, - 2p)	+3.75	+3.65	+4.13	+4.03
Option 6A (19%)	+0.62	+2.01	+1.00	+2.38
Option 6B (13%, -1p)	+2.24	+2.90	+2.62	+3.27
Option 6BX (7%, -2p)	+3.91	+3.92	+4.29	+4.30
Option 7BY (5½%, -3p)	+6.15	+5.80	+6.53	+6.18

ANNEX 4:
TAX AS %
OF INCOME

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ANNEX 4

TAX AS A PERCENTAGE OF INCOME

Multiples of average earnings

Single		1/4	½	3/4	1	1½	2	5
1978/79		4.6	17.1	22.4	25.0	27.7	29.5	50.5
1985/86		4.3	17.2	21.4	23.6	25.7	27.9	43.0
1986/87								
Option 1A	5½%	4.6	17.3	21.5	23.6	25.8	28.0	43.2
Option 2A	7%	4.3	17.1	21.4	23.6	25.7	28.0	43.2
Option 3A	10%	3.5	16.8	21.2	23.4	25.6	27.8	43.1
Option 4A	13%	2.9	16.4	21.0	23.2	25.5	27.7	43.0
Option 4B	7%, -1p	4.1	16.6	20.7	22.8	24.9	27.2	42.9
Option 5B	10%, -1p	3.4	16.2	20.5	22.6	24.7	27.1	42.8
Option 5.5BX	5½%, -2p	4.4	16.2	20.1	22.1	24.1	26.5	42.6
Option 6A	19%	1.4	15.7	20.5	22.9	25.2	27.5	42.9
Option 6B	13%, -1p	2.8	15.9	20.3	22.4	24.6	26.9	42.7
Option 6BX	7%, -2p	4.0	16.0	20.0	22.0	24.0	26.4	42.6
Option 7BY	5½%, -3p	4.2	15.6	19.4	21.3	23.2	25.7	42.3

TAX AS A PERCENTAGE OF INCOME

Multiples of average earnings

Married		1/4	½	3/4	1	1½	2	5
1978/79		0	9.5	17.4	21.3	25.2	27.2	48.8
1985/86		0	9.9	16.6	19.9	23.3	25.4	41.6
1986/87								
Option 1A	5½%	0	10.1	16.7	20.0	23.4	25.6	41.8
Option 2A	7%	0	9.8	16.6	19.9	23.3	25.5	41.7
Option 3A	10%	0	9.3	16.2	19.7	23.1	25.3	41.6
Option 4A	13%	0	8.8	15.8	19.4	22.9	25.2	41.5
Option 4B	7%, -1p	0	9.5	16.0	19.3	22.5	24.8	41.4
Option 5B	10%, -1p	0	9.0	15.7	19.0	22.3	24.6	41.3
Option 5.5BX	5½%, -2p	0	9.5	15.7	18.7	21.8	24.1	41.2
Option 6A	19%	0	7.6	15.1	18.8	22.5	24.8	41.3
Option 6B	13%, -1p	0	8.5	15.3	18.7	22.2	24.4	41.2
Option 6BX	7%, -2p	0	9.2	15.5	18.6	21.7	24.0	41.1
Option 7BY	5½%, -3p	0	9.2	15.1	18.1	21.1	23.3	40.9

ANNEX5: TAX +NIC AS % OF INCOME

CONFIDENTIAL

ANNEX 5

TAX + NIC AS A PERCENTAGE OF INCOME

Multiples of average earnings

Single		1/4	½	3/4	1	1½	2	5
1978/79		11.1	23.6	28.9	31.5	33.3	33.7	52.2
1985/86		9.3	26.2	30.4	32.6	33.7	33.9	45.4
1986/87								
Option 1A	5½%	9.6	26.3	30.5	32.6	33.8	34.1	45.6
Option 2A	7%	9.3	26.1	30.4	32.6	33.8	34.0	45.6
Option 3A	10%	8.5	25.8	30.2	32.4	33.6	33.9	45.5
Option 4A	13%	7.9	25.4	30.0	32.2	33.5	33.8	45.5
Option 4B	7%, -1p	9.1	25.6	29.7	31.8	32.9	33.2	45.3
Option 5B	10%, -1p	8.4	25.2	29.5	31.6	32.8	33.1	45.2
Option 5.5BX	5½%, -2p	9.4	25.2	29.1	31.1	32.1	32.5	45.1
Option 6A	19%	6.4	24.7	29.5	31.9	33.3	33.5	45.3
Option 6B	13%, -1p	7.8	24.9	29.3	31.4	32.7	33.0	45.1
Option 6BX	7%, -2p	9.0	25.0	29.0	31.0	32.1	32.5	45.0
Option 7BY	5½, -3p	9.2	24.6	28.4	30.3	31.2	31.8	44.7

TAX + NIC AS A PERCENTAGE OF INCOME

Multiples of average earnings

Married		1/4	½	3/4	1	1½	2	5
1978/79		6.5	16.0	23.9	27.8	30.8	31.4	50.5
1985/86		5.0	18.9	25.6	28.9	31.3	31.5	44.0
1986/87								
Option 1A	5½%	5.0	19.1	25.7	29.1	31.4	31.7	44.2
Option 2A	7%	5.0	18.8	25.6	28.9	31.3	31.6	44.1
Option 3A	10%	5.0	18.3	25.2	28.7	31.2	31.4	44.0
Option 4A	13%	5.0	17.8	24.8	28.4	31.0	31.2	43.9
Option 4B	7%, -1p	5.0	18.5	25.0	28.3	30.6	30.8	43.8
Option 5B	10%, -1p	5.0	18.0	24.7	28.0	30.4	30.6	43.7
Option 5.5BX	5½%, -2p	5.0	18.5	24.7	27.7	29.9	30.1	43.6
Option 6A	19%	5.0	16.6	24.1	27.8	30.6	30.8	43.7
Option 6B	13%, -1p	5.0	17.5	24.3	27.7	30.2	30.4	43.6
Option 6BX	7%, -2p	5.0	18.2	24.5	27.6	29.8	30.0	43.5
Option 7BY	5½%, -3p	5.0	18.2	24.1	27.1	29.1	29.4	43.3

ANNEX 6: COMPOSITE RATE: IMPLICATION OF REDUCTION IN BASIC RATE

CONFIDENTIAL

ANNEX 6

COMPOSITE RATE: IMPLICATIONS OF A REDUCTION IN THE BASIC RATE

1. Section 26 FA 1984 provides that the composite rate (reduced rate for building societies) for any year of assessment should be determined by Treasury Order before the preceding 31 December. The determination is to be based only on information relating to periods before the end of the year of assessment in which the order is made. There is thus a complete preceding year basis so that the composite rate for 1986/87 is based on tax rates and the tax status of investors in 1985/86.

2. Following the Financial Secretary's agreement (note of 18 November) the composite rate for 1986/87 has been fixed at 25.25 per cent (the same as 1985/86). A Treasury Order determining this rate was laid before Parliament on 29 November and the Statutory Instrument (SI 1985 No.1836) was published on 6 December.

3. This preceding year basis was introduced at the request of the banks. They claimed that liability to composite rate tax had to be known in advance because of the fine margins and narrow profits on which they worked. Computer problems were also mentioned. Interest might well be earned, probably at fluctuating interest rates over a period of six months or more beginning before the tax year in which it is paid. Typically interest is paid in June and December and June interest would start accruing on 1 January. In making this representation the banks were well aware that rejection of a current year basis would result in an unduly high composite rate in a year when basic rate was reduced. Even in these circumstances they preferred the advance notice available on the preceding year basis.

4. Under the former system, prior to the introduction of composite rate, the reduced rate for building societies was calculated by negotiation on a current year basis. This meant that it reflected any reduction in basic rate. But the building societies offered no comment when they were informed of the proposal to introduce the preceding year basis.

5. Any reduction in basic rate tax in 1986/87 which is not matched by a comparable reduction in composite rate is likely to provoke some complaints particularly from non-taxpayers unable to obtain a refund of composite rate tax. They might find it small consolation that a 1986/87 reduction in basic rate will work through to composite rate in 1987/88. But the decision, as recently as 1984, to introduce a preceding year basis was taken in the full knowledge of this delayed effect. In his note of 5 March 1984 to the Financial Secretary Mr Crawley suggested that

action to override the preceding year basis should be considered only in circumstances when the basic rate was reduced below the composite rate.

6. In arithmetical terms a strictly pro rata adjustment of composite rate would involve a reduction of $1\tfrac{3}{4}$ pence for every 2 pence reduction in basic rate. If such a reduction were passed on to investors an interest rate of 10 per cent net of composite rate tax would be increased to $10\tfrac{1}{4}$ per cent. It is unlikely that this would happen because building societies and banks would either not pass on the reduction or would do so selectively by weighting the interest rates on those accounts which they consider would enhance their competitive position. In any even such a modest increase would probably not be made in isolation. It would be submerged in adjustments which followed general movements in interest rates.

Conclusion

7. The preceding year basis was introduced at the request of the banks who claimed they could not operate composite rate without the advance notice thus provided. The building societies did not dissent.

8. The composite rate for 1986/87 has been announced and any reduction to match any possible adjustment of basic rate would require legislation and a change in the rules determined as recently as 1984.

9. We recommend, therefore, that provided basic rate for 1986/87 is higher than 25.25 per cent the composite rate for that year should remain as determined at 25.25 per cent.

ENTERPRISE AND EMPLOYMENT

REF NO 45
COPY NO 1 OF 1

EXTRACT FROM CHEVENING MINUTES

BUDGET - SECRET

CHEVENING 1986.

Employment and Enterprise Issues

9. The meeting reached the following provisional conclusions:-

(i) There was a political and presentational (but not economic) case for some employment package but it was very important to accommodate the cost within the existing planning totals.

(ii) All possible progress should be made on administrative measures to reduce the numbers unemployed. There was considerable scepticism about the value and scope for reducing the unemployment total by changes in definition.

BUDGET - SECRET

(iii) The Treasury should be thinking in terms of a gross addition to public expenditure of the order of £100 million in 1986-87 and £200 million in 1987-88 (and perhaps £50 million and £100 million on net public expenditure). The package should consist of a range of measures drawn exclusively from Lord Young's menu. There might be scope for agreeing additional measures if Lord Young was prepared to find the money from within his own programme (which had been consistently underspent in previous years).

(iv) The CBI package should be ignored. Careful thought should be given to handling the CBI in the run up to the Budget. The Chancellor and the Chief Secretary should seek to persuade Sir James Cleminson and Sir Terence Beckett not to over sell their proposals.

(v) On the detailed measures (listed in table 3 of Mr Monck's paper):-

- Extension of <u>derelict land grant</u> was ruled out for the Budget.

- It would be better to keep an expansion of the <u>Community Programme</u> out of the Budget.

- Extension of the <u>technical and vocational education initiative</u> (TVEI) should be kept for the Survey (unless Lord Young could find the money himself).

- Lord Young's proposals for extending existing pilots for interviewing the long term unemployed and the Jobstart Scheme should be considered together. <u>Mr Monck</u> should examine urgently whether these proposals could be substantially scaled down.

10. The <u>Chief Secretary</u> was asked to negotiate with Lord Young, making it clear that there could be no increase in the planning total, but that it might be possible to make money available from the reserve (without initially specifying the full figure) in

addition to anything that he could find from his own programme. On measures, he should be prepared to negotiate some combination of:-

- An expansion of the Enterprise Allowance Scheme.
- Extending the Loan Guarantee Scheme.
- A New Workers Scheme.
- A scaled down version of Lord Young's proposals on interview LTU and Jobstart.

11. On tax options:-

(i) The Sam Brittan Scheme (and variants of it) were ruled out.

(ii) It was agreed that profit sharing (Weitzman) had some conceptual appeal, but posed real problems, especially the exclusion of the self employed. Action in this Budget was ruled out, but urgent consideration should be given to announcing that there would be consultation on the merits of such a scheme. There was some interest in the scope for "test marketing" by Inland Revenue. Sir Lawrence Airey agreed to provide a note.

12. It was agreed that there was no employment case for a general reduction in the CT rate or in employers NICs.

13. On the minor measures suggested in paragraphs 44 to 45 of Mr Monck's paper, the following provisional conclusions were reached:-

(i) Small business investment companies (SBIC): This was not a strong runner.

(ii) Co-operatives: The Financial Secretary should look further at the case for allowing co-operatives access to profit sharing schemes under the 1978 Finance Act. Increasing the maximum shareholding, and reducing the charge for registration were not worth pursuing.

(iii) Training Loan Pilot Scheme: Announcement of the Pilot Scheme due to start in April might be worth a sentence or two in the Budget speech, following consultation with Lord Young.

(iv) Exempting Enterprise and Jobstart allowances from tax: complete exemption would create unfortunate precedents. An alternative might be to switch enterprise allowances from Case 1 to Case 6 for income tax purposes to avoid apparent treble taxation, but this would not be a simplification. The best solution would be to make no change; this might need reconsidering if there was a lot of political pressure.

(v) Increase VAT limit beyond indexation: This was not on for EC reasons.

(vi) Tax relief for personal employees: This was ruled out.

EMPLOYMENT AND ENTERPRISE ISSUES

This paper considers possible employment and enterprise options for the Budget against the background of:

(a) the unemployment position and prospect, given the major measures already taken, both in the 1985 Budget and since;

(b) public expenditure constraints; and

(c) the large proposals for more public spending from Lord Young and from the CBI and other external bodies (pages 1-4).

The options are considered in three groups:

(d) reducing the unemployment count by redefining the statistics and by administrative action (pages 5-6);

(e) public expenditure measures (pages 7-9); and

(f) tax and other measures (pages 10-13).

Questions for discussion are listed at the end (pages 14-15)

EMPLOYMENT AND ENTERPRISE ISSUES

I. BACKGROUND

Unemployment: present position ...

2. The November figure for adult unemployment was about 70,000 higher than a year earlier at 3,165,000 or 13.1 per cent of the employee labour force. The average for the EC (excluding the UK) is about 10.3 per cent, compared with 10.2 per cent a year earlier.

3. In the UK the position has recently improved. Adult unemployment in total and for males and females separately has fallen in each of the last three months. Over the last six months the average monthly fall has been 2,000. Although unemployment also fell for a period in 1983, this is the best six months result since October 1979. Vacancies are at the highest level since 1980.

4. DE estimate that over the last six months the expansion of the Community Programme has taken an additional 5,000 people off the unemployment count each month and that the effect is increasing. Other DE measures have been running down and the net contribution of employment measures has been 3-4,000 a month.

So most of the change from a monthly increase in unemployment of 10-15,000 in 1984 and early 1985 to a monthly fall of 2,000 now has reflected an underlying improvement.

5. The unemployment rate in July was highest (about 20 per cent) for people under 25 (including non-adults). For 18 and 19 year olds it was nearly 25 per cent, slightly lower than a year earlier (see Annex A).

6. In July 1¼ million people or 40 per cent of the total had been unemployed for over a year. ¾ million or nearly 25 per cent had been unemployed for more than 2 years (110,000 more than a year earlier). These 2 year long-term unemployed were a quarter or more of the total in Scotland, Yorks and Humberside, Wales, the North, the North West and West Midlands (30 per cent). Annex A gives a breakdown.

... and the prospect

7. This time last year adult unemployment was (correctly) thought more likely to rise slightly than to stabilise or fall. This year the balance of probabilities is for a slight fall in adult unemployment during 1986. But this is, as always, uncertain and the prospect after 1986, though less clear, is less favourable, partly because the period of most rapid expansion of the economy is past, and partly because there is less help from further DE employment measures after mid-1986 (see paragraph 9).

8. The forecasters' pre-Christmas numbers, which may be revised in early January, are:

Table 1

Unemployment Count, UK, Men and Women, Excluding School Leavers, Seasonally Adjusted, Million

	Level	Plausible, but not maximum range based on average errors from past forecasts
Actual		
November 1985	3.17	
Forecast		
1986 (average)	3.10	3.0-3.2
1987 (average)	3.10	2.9-3.3

Most outside forecasters expect some fall in unemployment over the next year: the average of outside forecasts is for 3.11 million adults unemployed in the

UK in the fourth quarter of 1986, close to EA's own assessment. Employment is generally expected to go on rising at about 1 per cent a year (the Treasury forecast is for slightly faster growth in 1986 as the main impact of the 1985 Budget measures on employment is felt). The growth of the labour force is expected to continue to fall back from the exceptionally high rates experienced in 1984 and apparently in the early part of 1985 as well.

9. The present total effect of SEMs (described in Annex C) on unemployment is estimated at about 490,000 and on adult unemployment about 340,000. Existing public expenditure provision for Special Employment Measures (SEMs) allows for rising places and effects on unemployment:

Table 2

thousands

	Numbers on SEMs	Reduction in Unemployment Count: Adult	(change)	Total	(change)
1985 Q2	580	300		420	
1986 Q2	690	360	(+60)	490	(+70)
1987 Q2	775	380	(+20)	530	(+40)
1988 Q2	840	390	(+10)	550	(+20)

The main reasons for the falling effect on the adult count over the period are that the expansion of Community Programme places is due to stop in June 1986, the number on the Job Release Scheme is falling, and the Young Workers Scheme will be running down from the Spring of 1986.

The Labour Market and Pay

10. There are some signs that the many measures the Government has taken to make the labour market more flexible are bringing benefits. — TU measures etc, but not SEMs

11. But at the aggregate level, there is no sign of downward pay flexibility in response to high unemployment. Average earnings continue to increase at 2-3 per cent a year faster than prices, and unit wage and salary costs in manufacturing are increasing faster than our main competitors'. Despite the CBI's efforts to shift the level of settlements down by 2 per cent, private sector settlements and earnings growth in the current pay round are expected to be at about the same level as in 1984-85. Private sector wage growth is putting increasing pressures on public sector wage negotiations, which in turn

threaten to add to public expenditure (about 30 per cent of which is accounted for by pay). This failure of pay to adjust is the root of the unemployment problem. Most of the options discussed later are not aimed at pay behaviour. But a few would exert some downward pressure and Sam Brittan's 'incentive' and Weitzman's 'profit-sharing' (paragraphs 36-39 and 41-42) are designed to affect pay.

Public Expenditure

12. After large additions to the public expenditure planning totals in the 1985 Budget and to programmes in the Autumn Statement we need to demonstrate that control has been effectively restored. From this point of view the first choice would be to have no public expenditure employment package in the Budget. But if there is a package there is a strong case for keeping any increase in programmes to a scale that can be realistically charged to the Reserves. At present that condition looks particularly hard to fulfill for 1987-88 and 1988-89.

Proposals made so far

13. The main proposals for Budget announcements by Lord Young (in his November minute to the Prime Minister) and by the CBI in their Budget representations are summarised below. There is a detailed commentary in Annex B:

LORD YOUNG	CBI
Expand Enterprise Allowance	More Urban Development Grants
Extend Loan Guarantee Scheme	More Derelict Land Grants
Additional anti-fraud staff	Building Improvement Programme etc.
New Workers Scheme	Development of Enterprise Allowance; training allowances and vouchers
Expand Community Programme	Reduce Job Release Scheme age limit to 62 (or less)
National extension of pilot measures for long-term unemployed, starting in January 1986 (a) £20 job start allowance (b) interview and follow-up.	Raise SB Earnings Disregard from £3 to £18.
Extension of TVEI* - no expenditure till September 1987 ∴ 1986 Survey	

What does he give?

14. If Lord Young's proposals were all accepted, the total cost to the Exchequer would be about £½ billion in a full year. His priorities have apparently not altered since November. He has also proposed "reserve measures" which could if necessary be announced in November (a further expansion of the Community

*Technical and Vocational Education Initiative (MSC expenditure in schools).

Programme and a carefully timed temporary reduction in the age limit for the Job Release Scheme).

15. The CBI's proposals are very large though they describe them as a call on the fiscal adjustment available within the MTFS. The full year net PSBR cost is put at £1 billion and the 1986-87 cost at £680 million (mostly net public expenditure). They claim that their programme would reduce unemployment by 330,000 over two years to about 2.8 million in 1987; and argue that action in the 1986 Budget is needed to ensure that. The CBI claim that these proposals have a higher priority among their membership than the 10 per cent real increase in income tax thresholds which they also recommend. Their proposals will probably re-appear in their paper on Urban Policy for the February meeting of NEDC. They are not well thought out but their existence and size is unhelpful.

16. More employment measures have been supported not only by the OECD but also by the IMF team. — of a somewhat different (if vague) nature

II. **REDUCING THE UNEMPLOYMENT COUNT BY REDEFINITION OR BY ADMINISTRATIVE MEASURES**

17. The Chief Secretary has suggested the numbers in the count could be reduced at nil or low cost by definitional change or by administrative action. We propose to examine the options with DE and the comments here are provisional.

18. The Labour Force Survey suggested that of those on the Spring 1984 count 940,000 had not been looking for work in the relevant week (including 200,000 "looking after the home", 125,000 "long term sick/disabled" and 60,000 "retired"). Only about 540,000, however, had not looked for work during the past four weeks, a period closer to the international definition.

Redefinition

19. Two earlier changes in definition in 1982 and 1983 removed about 200,000 people over 60 from the count.

20. New moves to exclude the categories in paragraph 18 above (or the roughly 150,000 people getting credits only, because their other income disqualifies them from benefit) would be criticised as fiddling the figures. In particular there would be pressure to bring into the count some of the 870,000 people

looking for work but not claiming benefit who are at present excluded. Future improvements in employment would bring more benefit to the unemployed not on the count and reduce the count less.

? Ld Young's attitude to all this

Administrative action

21. Removing some groups from the count by administrative action looks more promising. The two main groups are the "earners and drawers" (the black economy) and those "languishing on the count" (those not really seeking work), eg because they are retired or sick or looking after the home).

22. Following the 1981 Rayner Scrutiny, compulsory registration by the unemployed at Jobcentres was ended. For many of the long term unemployed, and the unemployed in general, the requirement that they be available for work has not recently been effectively applied. Even if it were, the existing but rarely used test of "availability" for work does not test whether a person is actively seeking work. It is difficult to apply the weaker test of availability unless either jobs or places on Government schemes can be offered.

23. DE believe their fraud exercises have already been very successful in removing earners and drawers and languishers in particular areas from the count. 1½ per cent to 2 per cent of the people on the count were "frightened off" in the Thames Valley and the Chilterns and benefit savings were six times the cost. These two exercises were targetted on high employment areas. In more depressed areas similar exercises might only reduce the count by about 0.5 per cent. But the agreed addition of 730 fraud staff might reduce the count by 25,000 by the end of 1987-88. DE estimate that a further 300 staff would reduce the count by a further 10,000.

24. There are a number of different ways in which the existing work test could be applied more rigorously to discourage claims. One is the pilot scheme for the long term (over one year) unemployed, under which people are summoned to interview and directed towards jobs or places on employment or training measures. Those who do not come to the interviews could lose benefit entirely, while those who refuse suitable places can have benefit cut for 6 weeks. Lord Young hopes that a national scheme of this sort might reduce the count by as much as 50,000. We think that this figure is too high (see Annex B, paragraph 11).

25. Ministers have also considered the "benefit minus" or workfare proposal under which benefit is only paid, or only paid in full, to those who join schemes

of work for community benefit; but have not concluded in favour of pilot schemes. In the summer of 1985, Ministers decided to postpone further discussion of such proposals until the report commissioned from Professor Blaug on workfare was ready (now due to be submitted by about February). useless timing: why not finish in January?

26. An alternative would be to tighten the rules on availability for work so that those not actively seeking work, or already significantly engaged in part-time work, were excluded. This could be examined in joint work with DE, along with a DE/DHSS study on "availability for work" which will be available by the end of 1985.

?

27. These options are well worth pursuing essential but their size and timing seems unlikely to remove the need to consider whether or not to have an employment/enterprise package. but cd affect the size of need - package

III. PUBLIC EXPENDITURE OPTIONS

Criteria

28. In considering whether to have an Employment and Enterprise package; and, if so, how big it should be and how it should be made up, Ministers may wish to weigh the following criteria:

(a) the contribution such a package may make to winning political support for maintaining the Government's strategy (in the CBI's words) and whether this is needed; if it is, it would be useful to distinguish a major reduction in unemployment from a modest package aimed at politically important targets with no stress on its overall numerical effect;

(b) the differing economic effects of different measures. Some of them have long-term beneficial effects on the supply side, for example by increasing the supply of skills, reducing pay pressures, or helping the creation or expansion of small enterprises. Others may inhibit the slow process of labour market adjustment; for instance the Job Release Scheme reduces the labour supply. The effects on employment are not necessarily the same as those on output, which in some cases does not increase;

Hence low PX the main criterion

(c) in all cases the opportunity cost of taking such measures is likely to be a smaller reduction in the burden of taxation - and hence smaller long-term benefits from improving incentives - than would otherwise be compatible with a given PSBR. This argues for measures which minimise the net Exchequer cost in total and per person off the count unless the supply side or other benefits in (b) are unusually large.

No package?

29. There are good arguments for having no public expenditure package:

(a) the scale of action announced in the 1985 Budget and since then*, the fact that most of this has not yet come through, and the diminished scope for measures bringing supply side benefits;

(b) the improved unemployment position and prospect, at least for 1986.

(c) successive increases in spending on employment measures mask the failure of pay to adjust but no affordable package is likely to make a really major improvement on the count;

The smaller the available fiscal adjustment, the stronger these arguments might seem. But if it were relatively large, it might be harder to get away without a public expenditure package of some sort (though the relative attraction of the employment/enterprise and the inner cities themes may change by the Budget).

What kind of package?

30. If a public expenditure package were needed, it could either be slanted towards the "Enterprise" end of the spectrum or the "Employment" end with more stress on big numbers of places or people off the count, particularly in 1987. The former would clearly be smaller and less difficult to accommodate within present public expenditure plans.

31. If that were Ministers' preference, the commentary in Annex B suggests that the front-runners at this stage might be the illustrative options in the upper half of Table 3:

(a) more Enterprise Allowance places (£40 a week for a year for people unemployed for more than 8 weeks who are starting a business);

(b) a continuation of the Loan Guarantee Scheme beyond March 1986, preferably with terms revised to motivate banks, and also borrowers,

---

*The Budget measures included: Expansion of the Community Programme and the Youth Training Scheme, the restructuring of national insurance contributions, the form of Wages Councils and wider exemptions from Employment Protection. Since then there have been further expansions of the Enterprise Allowance and the new pilot measures for the long term unemployed.

Permanent Secretary
H M TREASURY

Ch/ Gx

We cd break
for lunch after
this + let the
other ministers speak
on the broad issue
as soon as we return

PEM

SECRET

TABLE 3

COSTS OF POSSIBLE MEASURES

Measure	1986-87 Gross	1986-87 Net PE	1986-87 Net exch £m	1987-88 Gross	1987-88 Net PE	1987-88 Net exch	Effect on count 86-7 (Numbers)	Effect on count 87-88
(a) EAS (now to reach 80,000 places) 86-87: 92,000 87-88: 110,000	10	10	10	50	40	25	5,000	10,000
(b) LGS extended beyond March 1986	1-2	0	0	10-20	5-10	5-10	10,000	10,000-15,000
(c) New Workers 100,000 places	25	15	10	50	30	25	19,000	23,000
NO (d) Derelict Land Grant doubled over 2 years	40	35	30	80	65	40	2,000	8,000
(e) Fraud staff (300 extra staff) Nil or negative net cost for DE & DHSS together	2	0	0	3	0	0	3,000	5-10,000
Totals	**80**	**60**	**50**	**200**	**145**	**100**	**40,000**	**60,000**
without (d)	40	25	20	120	80	60	38,000	52,000
Other options								
(f) Interview LTU*: extend existing pilots nationwide	(165) 50-100	25-75	(100) 20-70 12-48 (30/45) 95	120-180	50-150	40-130 24-78 (50/85) 210	10,000-20,000 16,000	20,000-40,000
(g) Jobstart: extend existing pilot	50	25-40	25-40 (30)	80-100	45-85	45-85 (65)	1,000	5-20,000
(h) Community Programme: (i) 50,000 extra	110	75	45	230	160	100	45,000	45,000
(ii) 70,000 extra	160	110	70	335	225	145	65,000	65,000

Notes All figures are rough Treasury estimates, rounded to nearest £5 million. Totals are heavily rounded.

Estimates for the net costs and effect on the count of LGS, the interview of the LTU, and DLG are particularly uncertain, and would not be recognised by the Departments. 1988-89 costs would be similar to 1987-88 figures except that EAS would be about 30 per cent higher and Interviews for LTU probably lower.

First year net Exchequer cost per person off the count is £3,000 for (a), under £2,000 for (b) and/(c). There are no reliable figures yet for (f) and (g), but on plausible assumptions the cost could be above £5,000.

*LTU defined as people unemployed for more than a year. If the cut off was 2 years, all costs would be reduced by about 40 per cent.

does this assume higher CP pay levels?

need to give L'y a ration - overall size say (1987-88 here £g) (say £200m) (£100m in 1986-87) to bear more of the risk and hence to reduce the failure rate and the public expenditure cost of called guarantees;

(c) a New Workers Scheme providing an employment subsidy of £15 a week for employers of 18 and 19 year olds earning less than £55 a week and for employers of 20 year olds earning less than £65 a week. This would put downward pressure on pay, help the age group with the highest unemployment rate;

(d) an expansion of Derelict Land Grant (the table illustrates doubling over two years). These grants, at a rate of 50-100 per cent go mainly to local authorities but also to the private sector (with a grant rate of 80 per cent) in selected areas; generally there is a particular use of the site in mind though no formal link with it;

Why on Earth do this? NO

(e) more fraud staff: this could have a negative net public expenditure cost, though it would add little or nothing to employment or output and would add to the problem on civil service numbers.

32. (a) to (c) would all generate "real jobs" in a cost-effective way and have some supply side benefits. (d) would be less cost-effective in terms of jobs. But it has been regarded in the Treasury as a cost-effective way of helping inner cities and is the most promising of the CBI's environmental proposals. If Ministers were attracted by this, the merits of spending more on Derelict Land Grants would need further examination. It would need to be compared, among other things, with other possible inner city measures (including the proposals on "Clean up Britain" which the Prime Minister asked Mr Baker to produce soon after Christmas).

NO

33. A package composed of some or all of (a)-(e) would involve:

(a) rejecting almost all the CBI proposals except possibly Derelict Land Grants); and

(b) rejecting Lord Young's proposals at (f)-(h) in Table 3 and for announcing more spending on TVEI in 1987, relying mainly on the arguments in paragraph 29 (a)-(c) above.

(c) a modest reduction in the unemployment count.

34. Sizable further additions would put the planning totals under strain. However, Lord Young is likely to press for extending the pilots for the long-term unemployed ((f) and (g) in Table 3) nationally even though it will not be possible

to evaluate them properly by the time of the Budget. Once extended nationally, it would be difficult to reverse these schemes if evaluation showed that they had not been cost-effective, for instance because the people disappearing from the register because of the schemes do so only briefly. If there is pressure to do more in the Budget for the long term unemployed, one possibility would be to propose higher rates of Enterprise Allowance or of Community Programme pay for people unemployed for more than two years. Other options would be to extend only one of the two pilots nationally or to restrict the national extension to people unemployed for more than two years, though people unemployed for more than one year are eligible for the pilots. But as Table 3 showed, a further expansion of the Community Programme could well be both cheaper in total and more cost-effective than extending the pilots nationally. Such an extension might well require an increase in the present ceiling of £63 a week on average Community Programme pay. If there were further sizable additions, there would be a strong case for raising the planning totals in the Budget rather than unrealistically charging the package to the Reserve.

Estimates? [illegible]

35. Lord Young will be expecting to meet the Chancellor in mid-January and further advice will be provided on tactics. Much will depend on the extent of support the Prime Minister will give him.

IV. TAX AND OTHER OPTIONS

Sam Brittan's incentives

36. Sam Brittan suggested on 16 December that employers' National Insurance Contributions or Corporation tax should be remitted if:

(a) employment in their businesses rose by more than X per cent; or

(b) pay per head rose by less than Y per cent; or

if both happened. He suggested, for instance, that £1 billion might be spent on such an incentive rather than "largesse to those .... with ... jobs already". He makes these proposals in order to counter the effects of unions and collective bargaining which he expects to persist.

37. In the past the objection to schemes on the lines of (a) has been their low cost-effectiveness. It would be surprising if the net cost per person off the count were not higher than for the main current or proposed employment measures.

38. Schemes on the lines of (b), combined with the Layard-SDP inflation tax on a revenue neutral basis, have been submitted twice in the last year but have not been pursued.

39. The prospects for pay are poor. Competitiveness is suffering and employment growth is being damaged. Given the central role of pay in the strategy for reducing unemployment and the ineffectiveness of exhortation, is further work worthwhile on (a) and (b)?

General reductions in empoyers' NIC or Corporation Tax rate

40. These are mentioned for completeness. Both would increase the income available to companies and might lead them to spend more in ways that would increase employment over a period. A cut in employers' NICs would be possible from October 1986 and should increase jobs, like low pay increases, by reducing labour costs. However, they are less cost-effective in terms of employment creation than employment measures, and the extent of any benefits depends crucially on the extent to which lower NICs leak into high pay. A low CT rate would not affect labour costs but would reward success. The healthy financial outlook for companies and the need to keep a reasonable amount of pressure on them does not point to either of these steps which could be expensive.

Profit-sharing (Weitzman)

41. This scheme would give tax relief on 10 per cent of total remuneration, if employers and employees had agreed on a scheme which would initially link at least 20 per cent of total remuneration to profits. It would be presented partly as an innovation designed - by increasing the flexibility of labour costs - to improve the operation of the labour market and give employers an incentive to hire more people and partly as a further way of promoting employee identification with the business - like conventional profit-sharing schemes. The balance between these two lines of presentation would need to be carefuly considered.

42. The self-employed would be excluded and this would be contentious. Although there would be special rules for eligibility for the tax relief, it would not be possible for the Government to enforce the conditions about pay increases and new hiring necessary to ensure flexible pay and more jobs. Employees would have an incentive to restrict new employment and would try to compensate for falling share income by higher pay increases. But it would clearly be in employers' interests to prevent the scheme becoming a bonus at their expense.

The number of extra Revenue staff required would depend on the take-up: a relatively simple mechanism, operating largely outside the existing tax office structure, has already been devised. The Revenue cost is hard to predict but might well be low. For each 1,000,000 employees covered, the full year cost would be £275 million on the assumption that they were on average earnings. A decision on whether this is a runner is desirable because of the Revenue's need to make preparations if it is.

Business Expansion Scheme

43. The announcement about the extension of BES (see the Tax Issues paper) and CGT exemption from the first sale of BES shares would fit in well with extending the Loan Guarantee Scheme and more Enterprise Allowance places.

Small Business Investment Companies (SBIC)

44. Ministers agreed to look at this again in the light of the BES changes. The scheme was aimed at filling the very small equity gap. SBICs would be eligible for some effective subsidy (at a much lower rate than BES) provided sufficient private money was at risk. The advantages were:

(a) provision of management experience (a 'hands on approach'); and

(b) the ability of a SBIC to provide debt as well as equity.

The disadvantages included the public expenditure cost, considerable uncertainty of success if BES and LGS continued, some resemblance to a National Investment Bank, and the possible need for primary legislation outside the Finance Act.

45. The BES changes hardly affect the potential advantages, but on balance this does not seem a strong runner now.

Co-operatives

46. The Chancellor has said in the House that co-operatives have grown faster since 1979 than before. He has asked whether there were tax or other obstacles to development of this form of small business.

47. On tax the very large majority of co-operatives pay corporation tax at the small companies rate and so they benefitted by the immediate cut in the rate to 30 per cent in 1984. But the handful of largest co-operatives who do not qualify as small companies have in relative terms not done well out of the corporation tax reform. Since they formerly had a privileged rate, a corporation

tax rate of 35 per cent is a reduction for them of only 5 percentage points, though they have lost capital allowances and stock relief like companies. But co-operatives still have certain advantages (notably tax relief on interest for people who borrow to invest in them).

48. To allow members of co-operatives BES relief for investment in their own Society would require a fundamental change in the scheme which was designed to encourage outside investors, and would run counter to the provisional decision not to widen the scheme generally in this way.

49. The specific complaints by co-operative interests include some minor issues about the cost and delay involved in registration by the Registry of Friendly Societies and the maximum size of shareholding (these do not affect the majority of new co-operatives which register as companies). Bigger problems, which largely reflect the nature of co-operatives themselves, concern the ability to raise capital and ineligibility for profit-sharing schemes.

50. A possible collection of small steps might be:

(a) an increase (by secondary legislation) in the maximum shareholding, though we have not consulted the Chief Registrar, who has statutory responsibility on a specific proposal;

(b) a reduction (at very small cost) in the charge for registration, though this would run counter to general policy on fees and charges;

(c) enabling co-operatives to have access to profit sharing schemes under the 1978 Finance Act using only redeemable shares.

worth considering on NI [illegible]

(c) would probably be practicable and would fit in with other proposals for widening access to these schemes, but the arguments against it need to be considered carefully. Without (c) these steps do not seem worth considering for the Budget.

Training Loan Pilot Scheme

51. It was announced last year that money would be available for a pilot scheme, which will start in April. But the detailed arrangements have not yet been announced. It might be worth a sentence or two in the Speech to foreshadow a full announcement by Lord Young, as it ties in with encouraging enterprise.

Exempting Enterprise Allowances (and the Jobstart Allowance) from tax

52. This would cost less than £5 million in 1986-87 but £25 million and £30 million in the next two years. It would look inconsistent with Treasury Ministers' insistence that the pilot £20 Jobstart Allowance should be taxable and that it provides a big incentive on this basis. If Jobstart were extended nationally and exempted from tax, as seems likely once the EAS was exempt, there would be an additional exchequer cost of £10-15 million a year. Exemptions would be a simplification and have some appeal. But it is not clear what substantive gains would be achieved at a potential combined cost of £40 million a year.

VAT limit

53. Increasing the limit by more than indexation would be contrary to present EC rules and have some disadvantage, but it would fit well with an enterprise package.

Tax relief for domestic servants

54. This is another possible component though the main motive may not be employment. It is being examined by the Inland Revenue.

black economy

Income Tax and the traps

55. Any effects of income tax changes on the unemployment trap (see Annex 3 of the paper on Tax Issues) could be prsented as part of an employment/enterprise package.

V. QUESTIONS FOR DISCUSSION

56. In the light of the unemployment prospects upto 1987, the scale of the 1985 Budget measures, the need to re-establish credible public expenditure control, and the likely size of the fiscal adjustment, is there any need for a further public expenditure package on employment and enterprise? Extending the Loan Guarantee Scheme may be effecitvely unavoidable but all the other measures are optional.

57. If there is a need for a package:

(i) should its scale be such that it can realistically be charged to the Contingency Reserve for 1986-87 and fitted within the planning total for later years?

(ii) does the "enterprise" bias of the illustrative measures in the top half of Table 3 look on the right lines, subject among other things to proposals which may emerge later on inner cities? (The measures are Enterprise Allowance, Loan Guarantee Scheme, new Workers' Scheme, Derelict Land Grant, and more fraud staff).

A package of this size involves rejection of several of Lord Young's proposals (extending the pilot measures for the long-term unemployed, more CP places, and TVEI extension) and almost all of the CBI's.

58. On the tax and other measures:

(i) given the importance of pay and the poor pay outlook, would it be worthwhile to consider one of Sam Brittan's incentives?

no

(ii) is there any case for a general reduction in the CT rate or employers' NICs?

no

(iii) should profit-sharing (Weitzman) be pursued?

(iv) which of the minor measures in paragraphs 44 to 55 look worth pursuing?

20.12.1985
HM TREASURY

What scope for L.Y.'s further [illegible] programme? Then [illegible] some scope for unemployment [illegible]

ANNEX A

TABLE 1

UNEMPLOYMENT: AGE AND DURATION JULY 1985
(Great Britain)

	Under 18	18-19	20-24	25-34	35-44	45-54	55-59	60 or over	Total
A. Total Unemployment									
Unemployed rates by age (in July 1985)	18.3	24.6	19.9	13.9	8.9	9.3	14.4	5.6	13.4
Numbers (in thousands)	(173)	(322)	(692)	(728)	(451)	(405)	(273)	(72)	(3,116)
B. Long-Term Unemployed									
(i) 6-12 months Unemployed									
Number (thousands)	40	84	132		286		42	23	607
As % of unemployed in age group	22.9	26.0	19.0		18.0		15.2	31.7	19.4
(ii) 1-2 years Unemployed									
Number (thousands)	10	61	107		269		54	8	509
As % of unemployed in age group	5.7	18.8	15.4		17.0		19.6	11.1	16.3
(iii) Over 2 years Unemployed									
Number (thousands)	1	27	131		474		118	9	760
As % of unemployed in age group	-	8.4	18.9		29.9		43.2	12.2	24.4

ANNEX A: UNEMPLOYMENT: AGE + DURATION JULY 1985 (GB)

ANNEX B: COMMENTARY ON PROPOSALS FOR ADDITIONAL EXPENDITURE BY LORD YOUNG + CBI

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ANNEX B

COMMENTARY ON PROPOSALS FOR ADDITIONAL EXPENDITURE BY LORD YOUNG (PARAS 1 TO 20) AND CBI (PARAS 21 ONWARDS)

LORD YOUNG'S PROPOSALS: ENTERPRISE AND EMPLOYMENT

The Prime Minister's meeting on 7 November decided that two of the schemes should be started as pilots: the Jobstart allowance and the interview/course for the long term (over 1 year) unemployed. Lord Young put forward other proposals for that meeting in which no decisions were taken.

Enterprise Allowance Scheme (EAS)

2. The Enterprise Allowance Scheme is popular and relatively cost-effective, although the basis for assessing the net cost per person off the count (of £2,900 in year one with a lower figure in year two) is not secure, in view of the difficulty of measuring displacement. Its main supply side effect is to increase the number of self-employed. So far for every 100 running businesses, 99 extra jobs have been created for employees after 3 years. 50 per cent of EAS businesses survive for at least 2 years. The EAS has not appealed only to the short term unemployed, as nearly 30 per cent of EAS entrants have been unemployed for over a year.

3. Lord Young proposed an expansion of the target for entrants from 80,000 to 130,000 a year. It is not clear whether rule changes (which would worsen cost-effectiveness) would be needed. It would be preferable to increase marketing in the hope of reaching say 92,000 entrants by the end of 1986-87 and 110,000 by the end of 1987-88 (gross cost in 1987-88: £50 million); and not to change the rules.

Loan Guarantee Scheme

4. Lord Young proposed a revised Loan Guarantee Scheme to start from April 1986. Although the existing Loan Guarantee Scheme has failed to meet its original objective of nil cost, the £½ billion of loans since the scheme began in 1981 have been associated with 125,000 new jobs of which around half may well have been net additions in the short-term to the total number of jobs in the economy. About 15 per cent of the jobs supported by LGS may last in the medium-term (leaving

aside macro-economic effects). Although there has been little recent evaluation, its cost-effectiveness compares well with the EAS. But we do not accept Lord Young's claim that the LGS provides a net saving to the Exchequer per person off the unemployment count.

5. The terms of any new scheme are important. The Chief Secretary has told Lord Young that although there may well be a case for reducing the premium paid by borrowers from 5 per cent towards 3 per cent, the proportion of each loan guaranteed by the Government ought to be reduced from 70 per cent. Lord Young will argue that a lower guarantee proportion will reduce take up and job creation. But a guaranteed proportion closer to 50 per cent would mean a more equitable sharing of risk between the Government and the banks. and reinforce the banks' incentives to maintain the improved appraisal and monitoring of loans begun in January 1985 which raised the survival rate. A revised LGS scheme would contribute to a small firms package. Compared with BES it focuses on the lower end of the market and can help unincorporated. Subject to agreeing satisfactory terms with Lord Young it looks a strong candidate.

New Workers Scheme

6. Lord Young also proposed a New Workers Scheme to replace the present Young Workers Scheme. It would provide a subsidy of £15 a week for the employers of 18-19 year olds earning less than £55 a week and for the employers of 20 year olds earning less than £65 a week. The present YWS is for 16-17 year olds, who will now be eligible for the new 2-year Youth Training Scheme; it will therefore close from March 1986. Survey evidence has shown the YWS to be an increasingly cost-effective scheme (net Exchequer cost per person off the count: £1,200), which has exerted some downward effect on wages. The NWS should be as cost-effective as YWS although there are inevitable uncertainties about the proportion of new jobs created. It might lead to greater downward pressure on wages.

7. Take-up is hard to forecast, but might be about 100,000 in a full year (gross cost: £50 million), reducing the count by about 20,000. To ensure maximum cost-effectiveness, applications for jobs that had already started (which would simply represent deadweight) should be disallowed.

Long-term Unemployed

8. The two pilots for the long-term unemployed will start from 6 January 1986. The Jobstart allowance is a weekly taxable £20 for the long-term unemployed who

get full time jobs paying under £80. Under the other scheme, the MSC will call the long-term unemployed for interview, and direct them towards jobs or other employment and training measures; the hope is that a small proportion will get jobs, while a larger number not really looking for work will leave the count. ? The scheme may well increase the demand for other schemes such as the Community Programme.

Scarcely fallen [illegible] argument [illegible] that is given more in CP [illegible] further [illegible]

9. The schemes are to be thoroughly evaluated. The full results will not be available until Spring 1987. There will be some useful data for the 1986 Survey but very little by the Budget. but surely sooner [illegible]

10. Lord Young will probably press for the extension of these pilots nationwide as a 1986 Budget measure. It will not then be clear whether or not they are cost-effective, or what sort of gross costs we should expect from a national scheme. On both, there is a wide margin of uncertainty. On not implausible assumptions, the net Exchequer cost per person off the register for both could be over £5,000 although we would expect the Interview Scheme to be more cost-effective than the Jobstart allowance; Lord Young suggested that for the Interview Scheme it would be zero and for Jobstart £2,000.

11. It would be best to await full evaluation results before extending either of these schemes, partly because extending the pilots would increase the demand for places in other schemes. If early results suggest that a very high number of people being called for interview are leaving the count, extension of the Interview Scheme might be worth considering: although we could not judge the net Exchequer cost, we could estimate an upper limit. That sort of estimate would not be possible for the Jobstart scheme, which should therefore not be extended at that stage. Lord Young is likely to resist extending the Interview Scheme without extending the Jobstart Scheme. yes If all those unemployed over one year are covered, the gross cost of extending the Interview Scheme might be £50-100 million in 1986-87 and £120-180 million in 1987-88, with, according to Lord Young, a prospect of a reduction in the count of nearly 50,000 full year equivalents in 1986-87 and over 80,000 in 1987-88. This assumes 10 per cent of the LTU leave the count for an average of 22 weeks. 5 per cent for 10 weeks looks more plausible.

12. The Jobstart allowance should continue to be taxable.

Community Programme

13. Lord Young's other major proposal for the Budget is for a continued expansion of the Community Programme. At present, the target is for CP to grow to 230,000 plus by June 1986. Lord Young proposes that it be expanded by 10,000 places a month for the rest of 1986, ie to 300,000 places; and, as a reserve measure for announcement next Autumn further expansion beyond 300,000.

14. CP has a net Exchequer cost per person off the count of about £1,900. It is said to increase the chances that participants will get jobs: one-third of participants get jobs, compared to one-sixth of the long term unemployed in general. The work done is intended to be of community benefit, but valuing it is difficult.

ie (presumably 230,000 will be reached at a later date than June '86?)

15. The Chief Secretary earlier this month withheld approval for an increase in the limit on the average wages reimbursed by MSC from £63 to £66. MSC say that that will result in the current cumulative shortfall in filled places of 6,000, increasing to between 15,000 and 30,000 by the end of the financial year. There must therefore be a question whether a further expansion could be achieved without an increase in the average pay limit. Every 10,000 places not filled saves about £45 million gross or £20 million in net Exchequer terms.

16. If the employment situation continues to improve, the Treasury might want to argue for reductions in the number of filled places below the 230,000 announced in the 1985 Budget. In any case, such reductions might well be the best way to finance other schemes which are agreed to be desirable.

Job Release Scheme

17. Lord Young also mentioned as a reserve measure the possibility of relaxing the rules on the Job Release Scheme for a 6 months 'window' in April-September 1987 when men aged 62-63 (gross cost in 1987-88: £90 million) or perhaps 60-63 (gross cost £180 million) could apply. The scheme at present covers men aged 64, women aged 59 and the disabled from 60-64. Extension of the age range in this way would reduce the cost-effectiveness of the scheme, from a net Exchequer cost per person off the count of about £1,900 now to perhaps £2,300. Moreover, the JRS reduces the supply of labour, especially skilled labour, which would be disproportionately worsened. These effects put upward pressure on wages and so in the long-term may worsen unemployment.

Technical and Vocational Education Initiative (TVEI)

18. Lord Young has argued for an extension of the Technical and Vocational Education Initiative to be announced in the Budget, though expenditure would not start till 1987. The aim is to get more and better teaching on technical and vocational subjects into school curricula. Pilots covering 3 per cent of all 14-18 year olds are now in progress. Initial responses have been generally favourable, but hard evaluation will not be available for another couple of years. The costs to the MSC of an extension nationwide would be large (£40 million in 1987-88, rising to £100 million a year in the early 1990s); there would also be extra costs of the same order borne by LEAs (and LEAs would eventually have to take over the full costs as the MSC contribution ran out). The whole cost might therefore be about £1 billion over 10 years. Such commitments should not be entered into without full evaluation.

19. DE are opening discussions with DES about the merits of the proposal. We and HE will keep closely involved in these discussions. The obvious reply is that this proposal cannot be considered before the 1986 Survey.

CBI PROPOSALS – Ignore

20. The total gross public spending cost of what the CBI proposed was about £2 billion (on their estimates). The package can be divided into two parts: the larger one concerned with environmental improvement, and the rest.

Environmental

21. About £650 million gross (£400 million net exchequer cost) would be spent on their new Building Improvement Programme, and another £250 million gross (£150 million net) on each of the existing Urban Development and Derelict Land Grant programmes.

22. These proposals are unrealistic. It would be virtually impossible to spend such large sums on the Urban Develoment Programme without a severe deterioration in cost effectiveness, and difficult to expand Derelict Land grants so fast. The Building Improvement Programme would be two or three times more expensive per person off the count than CP. The CBI has overstated the impact on the unemployment count.

Urban Development Grant (UDG)

23. UDG is provided at the minimum rate necessary (upto a maximum of 50 per cent grant) in support of private sector development projects in the inner cities

which would not otherwise have taken place there. Since the start of UDG in April 1983, the public sector has contributed £78 million and the private sector £324 million (a leverage ratio of private to public funds of 4:1). Actual spend is likely to be only £25 million in 1985-86 and £30 million in 1986-87 because of the delay between approvals being given and developers actually proceeding with their schemes.

24. UDG is reckoned to be a cost-effective way of bringing physical and economic regeneration into the inner city. But it is probably not a cost-effective way to reduce unemployment nationally. It is not clear how far jobs and investment coming to the inner city are diverted from elsewhere but the percentage is probably very high.

25. There is minimal scope for cost-effective expansion of the scheme, at least without legislation. Injecting funds into UDG is a slow process because central government is dealing through local authorities and the private sector: it must wait for suitable projects to be put forward and subsequently to be carried out. DOE considered expanding the scheme by allowing private developers to deal directly with central government, thus by-passing unco-operative authorities who sometimes block worthwhile schemes. This might allow cost-effective expansion of UDG but seems to have been dropped by DOE because it would require primary legislation and might alienate authorities from the existing scheme. It is possible that the idea will re-emerge as a result of the review of policy towards the inner cities.

26. If more applications are to be approved, this would require relaxing the focus on the most deprived areas or the criteria of additionality and viability. Either way cost-effectiveness would deteriorate. For the moment, there are sufficient funds to approve all worthwhile projects that come forward.

Derelict Land Grant (DLG)

27. The aim of DLG is the reclamation of derelict land for new development and environmental improvement with grants being paid both to local authorities and the private sector. There is an increasing focus on the inner cities and on reclamation which will lead to subsequent private development.

28. Spend by DOE in 1985-86 will be about £82 million. DLG has been substantially increased (from £23 million in 1979-80) in recognition of the increasing amount of derelict land from industrial restructuring. DOE reckon than an extra

£20 million DLG is needed each year to keep clearance abreast of dereliction and that about £1 billion is needed to clear the backlog.

29. There is a queue of eligible reclamation schemes and DOE consider that over a period they could double expenditure without damaging effectiveness. DLG is regarded as a cost-effective means of clearing derelict land. Investment and jobs that occur on reclaimed land will have been displaced from 'green-field' sites, with distributional but not net benefit. The programme does not generate many jobs. Doubling it over two years would only generate on a rough guess 10,000 jobs in that period and in overall job creation terms it does not compare well with employment measures. An increase in DLG looks more promising than the CBI's other two environmental proposals. But its merits need to be compared with other Inner City proposals which may be made in the New Year.

Building Improvement Programme (BIP)

30. This would be a new scheme. The MSC would negotiate permission to make improvements with the owners of land, housing, inner city areas, etc. The MSC would then let contracts by competitive tender to building firms, paying all the costs and a management fee. The long term unemployed would be paid at the rate for the job to do the unskilled work.

31. The attraction of this idea is that it combines environmental improvement with a focus on the long-term unemployed. But its cost-effectiveness is poor. The CBI estimate a net exchequer cost per person off the register of £5,000, or about 3 times worse than CP because of higher pay, materials and supervision costs. In practice, it may be worse yet, as the programme will displace other building work. It would also damage CP since average pay on BIP would be at least £90-100 compared to about £60 on CP.

32. To the extent that more building improvement or renovation is judged desirable, the resources are likely to be used more cost-effectively if they are chanelled through existing programmes.

Employment and Training Measures

33. The CBI also propose a range of other measures, including expansion of the Job Release Scheme and the Enterprise Allowance Scheme, further measures to encourage flexible working (part-time jobs and sabbaticals), and more training for the unemployed.

Job Release Scheme

34. The CBI propose that the Job Release Scheme be available to men aged 62 at a gross cost of around £350 million in 1987-88. The disadvantages of expanding the scheme are set out in paragraph 17 above.

Part-time Schemes

35. The CBI also propose that the part-time JRS and the Job Splitting Scheme should be expanded. But they put forward no particular ideas. The schemes are cost-effective schemes in the narrow sense of net exchequer cost per person off the count. But they have negligible take-up, partly because employers rarely see advantage in splitting jobs. From a supply side point of view we would not want to subsidise employers to do what would reduce their efficiency. Making the schemes more attractive might worsen their cost-effectiveness.

Enterprise Allowance Scheme

36. As well as recommending an expansion of the Enterprise Allowance Scheme (merits discussed in paragraphs 2-4 above) the CBI also recommend that those setting up co-operatives and partnerships should be eligible. But they already are. They also recommend more counselling for EAS recipients. The problem has in the past been the willingness of recipients to take up what is on offer. But DE are considering further what could be done.

New Training Allowance

37. The CBI propose that a new training allowance be payable to the 6 month+ unemployed to replace benefit; and that the Government offer a limited number of training vouchers to cover the training fees as well. But the Government already pays grants to cover training fees and living expenses for about 100,000 unemployed people a year. Other employment measures help here too. The training loans pilot and the pilot interview/course for the long term unemployed are experiments with other ways to achieve similar ends. New measures are not required.

Earnings Disregard

38. The CBI also propose that the earnings disregard for benefit entitlement should be raised to £18 for the long term unemployed, to encourage them to take part-time work. The Green Paper on social security recommended raising the disregard from £4 to £15 for married people unemployed over two years. This would be likely to cost about £5-10 million, and might lead to a small net increase in the number of people on the register.

EXISTING TRAINING AND EMPLOYMENT MEASURES

	1985-86 Cost	Eligibility	Payment to Sponsors	Payment to participants	Coverage October 1985	Coverage October 1987	Impact on unemployment October 1985	Impact on unemployment October 1987
Youth Training Scheme	£795 m	a) 16 year old school leavers both employed and unemployed	Employers receive about £2000 a year per filled place; other sponsors' costs are fully reimbursed; within this, trainee allowance is £26.25 a week (£1365pa)		350,000	530,000	250,000	310,000
		b) unemployed 17 year old						
Community Programme	£705 m	a) 18-24 year olds unemployed for over 6 months	Sponsors receive on average of about £4500 per place per year; of this, the average wage paid to participants (for full and part time work) is about £62 a week or £3225 a year		160,000	230,000	145,000	210,000
		(b) those aged 25 or over unemployed for more than a year						
Job Release Scheme								
Full time	£185 m	a) Able-bodied men aged 64	£50-63 a week		55,000	30,000	45,000	25,000
		b) Disabled men aged 60-63	£58-71 a week					
		c) Women aged 59	£50-63 a week					
Part time	£0.5 m	a) Men aged 62-64 b) Women aged 59	About 60% of the corresponding full time rates		230	1,000	200	900
Job Splitting Scheme	£0.5 m	Employers taking on the unemployed to fill part-time posts left by splitting jobs	£840 grant paid to employers		280	1,000	210	900

ANNEX C: EXISTING TRAINING AND EMPLOYMENT MEASURES

	1985-86 Cost	Eligibility	Payment to Sponsors	Payment to participants	Coverage		Impact on unemployment	
					October 1985	October 1987	October 1985	October 1987
Young Workers Scheme	£ 30 m	17 year olds in their first year of employment earning £50 a week or less	Employers receive £15 a week for up to a year		55,000	-	15,000	-
Enterprise Allowance	£ 110 m	Those over 18 unemployed for more than 13 weeks		£40 a week for up to a year	50,000	75,000	16,000	22,000
Community Industry	£ 25 m	Disadvantaged 16-19 year olds	CI Ltd is paid a grant to cover costs	£30-44 a week depending on age	8,000	8,000	8,000	8,000
Total	£1850 m				680,000	870,000	480,000	575,000

RR7.32

SECRET

FROM: MRS R LOMAX
DATE: 7 January 1986

MR MONCK

EMPLOYMENT AND ENTERPRISE ISSUES: CHEVENING

The Chancellor is not at all interested in the CBI package. He wants to aim for the smallest possible additional expenditure on employment measures and thinks this means selecting from Lord Young's menu. He is attracted to the idea of giving Lord Young a ration - for example an overall net exchequer cost of around £100 million in 1986-87 and say £200 million in 1987-88 (figures which might conceivably be met from within the reserve) and, if Lord Young wants to go beyond this, making him find the money from within his existing programme. He has asked what scope Lord Young has in fact for further switches within his programme; he feels sure there must be some scope for compromise here.

2. On the community programme, the Chancellor has asked whether the figures in table 3 of your paper assume higher community programme pay. He has noted that the MSC expect the current cumulative shortfall in filled places to increase between 15,000 and 30,000 by the end of the financial year. He presumes that the final total of 230,000 places will eventually be reached but at a later date than June 1986. What are we expecting? What does your remark about the need for an increase in average pay limits imply - that we are not now expecting 230,000 to be reached at all?

RL.

RACHEL LOMAX

SECRET

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276/001

J6

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COPY NO 2 OF ~~25~~ 27

FROM: M C SCHOLAR
DATE: 14 January 1985

CHANCELLOR OF THE EXCHEQUER

cpwp

FOLLOW-UP TO CHEVENING DISCUSSIONS: WORK PRIORITIES

As a supplement to Mrs Lomax's record of the Chevening discussions I have prepared the attached list of work priorities, as a starting-point for determining the agenda of the first few overview meetings.

MCS

M C SCHOLAR

Copies as on the attachment

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JT

cc: Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Sir G Littler
Mr F E R Butler
Mr Cassell
Mr Monck
Mr Monger
Mr Pratt

Sir L Airey)
Mr Battishill) IR
Mr Isaac)

Sir A Fraser) C&E
Mr Knox)

Mr Cropper
Mr Lord
Mr H J Davies

JT
276/002

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Follow-up to Chevening discussions: work priorities

Employment and enterprise issues

(1) Mr Monck to prepare a negotiating brief, if possible by Friday, 17 January, for the Chief Secretary to use at a meeting with Lord Young. The aim would be to settle a small but varied package with a gross public expenditure cost of £100m in 1986-87 and £200m in 1987-88. This would be a maximum unless Lord Young could be persuaded to finance more of his proposals from offsetting savings within his existing programme. These sums could accommodate (a), (b), (c) and (e) in Table 3 of Mr Monck's paper, plus some other measures, probably a scaled-down version of (f) and (g).

(2) Chief Secretary to negotiate such a package with Lord Young.

Tax issues

(3) IR to produce a paper on possible changes to higher rates of income tax. Aim: to reduce gains for those high-earners who would gain most from basic-rate change, simplify higher rate structure, avoid creating an awkward pattern of gainers/losers. Paper should show effects on up to 10 x average earnings, and possibility of not price-indexing higher-rate thresholds not to be ruled out.

(4) IR to produce a paper on pension fund surpluses. Aim: to devise a regime to replace existing discretionary IR practice, with a cut-off point X beyond which Funds would have discretion but be under no obligation to remove a surplus (either by contribution holiday, benefit changes, or refund from the pension fund to the company) and a cut-off point Y beyond which removal of the surplus would be

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mandatory; refunds to involve an exit charge. Advice required on whether refund of surplus below point X should be prohibited: on where X and Y might be set; on whether there should be a margin for the application of the GAD's standardised assumptions; on the CT consequences (ringfenced or not?); and on whether the new regime could be in place for 1986-87.

(5) IR to produce a paper on stamp duty. Aim: revenue-neutral package with reduction of rate from 1% to ½% on share transactions by individuals and institutions, financed by broadening base of tax, introducing a higher rate of duty of at least 1½% and up to a ceiling of 5% on conversion of shares into ADRs.

(6) Economic Secretary to investigate possibility of a very broadly based tax, at a very low rate, on money transfers.

(7) IR to produce a paper on possibilities for a reduced rate band - the earliest date at which it could be introduced, some illustrative costings with and without indexation of allowances, the manpower consequences, the implications for the introduction of transferable allowances.

(8) IR to produce a note on the considerations affecting use of one-half percentage points for the basic rate of income tax - in particular on the 2½% reduction option.

(9) Financial Secretary to work up a package on charitable giving, on the basis of the abolition of the £10,000 limit on higher rate relief, a discretionary scheme to encourage payroll giving and - possibly (but a paper on this will be required in any event) - some incentive for single gifts by individuals and companies.

(10) Minister of State to investigate possibilities for help to charities on VAT.

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(11) IR to produce their promised further paper on the Business Expansion Scheme.

(12) IR, in consultation with Mr Monck and Mr H J Davies, to produce their promised further note on Weitzman, against the possibility that the Budget will announce that the government will consult on a scheme on these lines, perhaps limited to pilot areas.

(13) IR to produce a paper on a minimum tax, indicating the areas of tax shelter which might be included and the criterion for excluding areas from the list.

(14) IR (Mr Corlett) to develop the approach on tax relief for savings in his minute of 9 January.

(15) IR to produce a paper on the beneficiaries of the CTT reforms.

(16) Financial Secretary to pursue a package of changes on employee share schemes.

(17) Financial Secretary to pursue package of changes in car benefit scale rates.

(18) Financial Secretary to look at possibilities for enabling co-operatives to have access to profit-sharing schemes (para 50(c) - not (a) and (b) - of Mr Monck's paper).

(19) Treasury, IR and C&E to consider scope for new compassionate lollipops, perhaps for disabled or handicapped.

(20) IR to work up briefing on Ernst and Whinney study.

(21) IR to consider possibility of converting CGT owner-occupier relief into a roll-over relief.

In addition, Sir P Middleton was asked for a paper on presentation.

RR7.58

PERSONAL AND CONFIDENTIAL

FROM: MRS R LOMAX
DATE: 15 January 1986

MR CROPPER

PST

POLICY

The Chancellor was grateful for your minute of 13 January.

2. On your comments on macro economic policy, he shares your assessment of the politics of mortgage rate hikes, but thinks that we delude ourselves if we imagine that the chance of these can be in anyway lessened by having a PSBR at the lower rather than the upper half of the Chevening range.

3. On labour markets and unemployment, the Chancellor has much sympathy with your assessment. However, the Howard Davies argument, as he understands it, is not that a Weitzman scheme would in fact do any good, but that it would profoundly change for the better the political reception of the Budget.

4. He has noted that we will be discussing tax relief for savings and the charities package further over the next few weeks, and your contributions will be important. However he has commented that the political pressures on charities are and will be very much greater than on tax relief for savings, where a modest scheme which might subsequently be expanded is probably all we need to contemplate. The Chancellor takes your point on charities, but he has commented that the payroll scheme on its own would be an important step forward. The Chancellor is old-fashioned enough to prefer individual rather than corporate generosity.

RL.

RACHEL LOMAX

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Cy
Reflects points we made at Chevening
RL 14/1

<u>Personal and Confidential</u>

FROM P J CROPPER

DATE: 13 January 1986

cc Financial Secretary

CHANCELLOR

<u>POLICY</u>

One or two thoughts arising out of the weekend:

1 <u>Macro considerations</u>. The advocates of caution had a fair innings and, I think, probably came away reassured. Above all we will want to avoid crisis movements in mortgage rates during the twelve month run up to the General Election.

!!!

2 <u>Labour Markets and Unemployment</u>. The discussion of Nick Monck's paper left me with the feeling that we are close to the end of the road on fiscal means to job creation. I myself doubt whether Weitzmann could be made to work without loads of abuse and deadweight. The stark fact is that unemployment is only going to come down substantially in response to :

i) tighter administration of the availability for work rules;

ii) better education and training;

iii) loosening up of the labour market and real wages.

(The attached Times article by Charles Handy shows, rather encouragingly, how the labour market is already adjusting.)

Unfortunately the Treasury is not in the lead on administration of benefits,education or labour markets. But if it is agreed that we cannot offer much more at the fiscal level it might be right to say so. We do not want frustrated David Youngs going round complaining about lack of co-operation.

Thanks. Re (i), I share Mr Cropper's assessment of the politics of mortgage rate hikes, but the political analysis of those who imagine that the chance of these can be anything but lessened by having a PSBR in the lower rather than the upper half of the Chevening range.

Re (ii) I have much sympathy with this assessment. However, the Howard Davies argument, as I understand it, is not that a Weitzman scheme would in fact do any good, but that it would profoundly change (for the better) the political reception of the Budget. Re (iii) & (iv) we should be discussing these further over the next few weeks, & Mr Cropper's contributions will be important. However the political pressure on (iv) is ~~was~~ (& will be) v. much greater than on (iii), where a modest scheme which might subsequently be expanded is probably all we can contemplate. On (iv), I take Mr C's pt, but the payroll scheme on the table will be an important step forward. And I am old-fashioned enough to prefer individual rather than corporate generosity. N.

3 <u>Tax Relief for Savings</u>. Clive Corlett's paper of 9 January was rightly commended, but I am not entirely sure that the "Income Tax" scheme <u>will</u> work. Relief from CGT on exit is irrelevant to the small/medium investor with a threshold of £5,900; while the advantages of tax free roll up of dividends have to be seen in proportion. Even when an IRA has reached £10,000, the yield from dividends may not exceed £500 gross or £350 net. By the time administrative costs have been taken out of that £150 income tax margin, there will not be much left. My initial reaction to the "income tax" idea was favourable: I am beginning to doubt whether, without a measure of front end tax relief, the thing can be made to lift off.

4 <u>Charities</u>. Although I accept the force of the close company/ apportionment argument, it would be disappointing if we failed to find a way of allowing tax relief on once-off corporate donations. This seems to me where the big money lies. The present "wholly and exclusively" requirement, which means in effect that only sponsorship payments qualify for tax relief, is a tiresome restriction if people are looking for the development of company giving on the American scale. I do not yet see a way through the apportionment problem but will keep trying.

PJC.

P J CROPPER

[redacted]

THE TIMES

GENERAL APPOINTMENTS

January 9, 1986

The intense job life, working very hard and retiring very early, is the thinking behind the 'shamrock organization'. Charles Handy explains

We are witnessing the rise and the spread of the shamrock organization. This is not some kind of Irish takeover but a recognition of the fact that more and more organizations have a clear three-petalled workforce – three distinct categories of people working for them or with them. The emergence of these three categories may well turn out to be the most lasting and significant legacy of the employment shakedown of the past decade.

The first category is that of the professional core, the key managers, professionals, technicians and skilled workers who together embody the organizational knowledge which gives the organization its own identity and added value.

They are valuable people, worth binding to the corporation with all the inducements available, be they high salaries, good pensions, job security or a variety of perks and privileges.

As a result they are expensive. Organizations are therefore slimming down their professional cores, working them more intensively and "functionally flexibly" – to quote John Atkinson of the Institute of Manpower Studies – promoting them younger and retiring them earlier.

The second category is the contractual fringe. Whereas it used once to be conventional wisdom to keep everything in-house for better control, it is now fashionable to outsource everything that is not of strategic consequence to the organization. This gives added flexibility to the organization or, to put it less kindly, it allows the organization to export some of its uncertainty.

Most organizations, if they do the sums, will find that they now have as many people working *with* them, on some sort of contract of supply or service, as working *for* them.

The third category is the flexible labour force. These are the people, mostly part-time, usually women, to whom the organization offers not careers but work, and work often of a temporary and changing nature. One large organization today employs none of its workforce full-time but only full-day and then decides how many days in every particular month it needs from every person.

In this category work is a commodity traded for money, work in which the conditions and the pay can be good but the promise for the future small. The result? The self-employed and part-timers are now up to 50 per cent of the full-time population and growing fast.

Why is this happening? It is happening because management wants to keep its flexibility, even in times of growth. It is happening because more and more organizations are needing to stretch their operational days or weeks to make better use of their plant and buildings, to keep up with the competition or to satisfy customers.

Few businesses can afford to sleep these days. More organizations are becoming like hotels or airlines – round the clock and round the week – which have to supplement their core with a large contractual fringe and a flexible labour force if they are to make it work.

More importantly, however, it may be happening because management has at last discovered how to do more with fewer people or, at least, with smaller bits of them.

It is interesting to note that while salary and wage rates have been rising faster than either the CBI or the Government would like, the total cost of wages and salaries has represented a decreasing percentage of national income in the past few years.

In other words, efficient employers have sought to hold down labour costs, not by restricting rates but by cutting the number and size of jobs. We may be trying to move towards a high-wage, small-job economy.

That may be an effective way of distributing work but it is often small comfort to the man, or woman, who would like the high wage *and* the bigger job. What seems certain is that, once discovered, this new philosophy will not readily be abandoned.

The implications are considerable. One way of highlighting them is to look at the length of the lifetime job. A generation ago it used to be 100,000 hours or 47 hours a week, including overtime, for 47 weeks a year for 47 years. It may now be down to 50,000 for someone starting work today.

That is not because we have halved the working week or the working year but because the cube law in mathematics conceals things from us. In fact 37 × 37 × 37 = 50,000 or, to take another combination, so do 45 hours × 45 weeks × 25 years, the sort of intense job life which the professional core can expect, working very hard and retiring early, although it may not feel like, or be called, retirement.

Sports stars, commodity brokers, pop singers and officers in the armed services already experience this sort of career. It will get more common. Another combination would be 22 hours a week for 45 weeks for 50 years, the part-time combination with work extending well into one's sixties because it provides a continuing part but not the whole of life.

We may, in fact, see simultaneous pressures for earlier retirement and later retirement from different parts of the workforce.

Thirdly, there will be those, mostly women but more and more men, who sandwich it, doing 10 years in a job, taking 10 years off to raise a family and going back in for 15. That, too, works out at 50,000.

The precise numbers are not important. What is important is that we appear to have split the job in half in one generation without really noticing it. Most of us are going to have an unanticipated extra 50,000 hours which used to be in the job.

For some that will be called unemployment, for some extra leisure, for some early retirement. Some will have it during their job life, others at the end. Most of us, however, will need to use it for work, either to make more money or, by more work in the home, to save spending money or, by work in the community, to save others spending money.

It is not, in fact, going to be an era of less work and more leisure but of different kinds of work at different times of life, for few will make enough or save enough in their 50,000 hours to keep them for the rest of life, even if the state helps out quite a bit.

The 50,000-hour job is just one of the unanticipated outcomes of the shamrock organization. There are many more. What is already clear is that the employee society has changed fundamentally and won't change back, no matter how well the economy does.

It is the difference between the different types of 50,000 hours that should now be worrying us as much as the total of them all.

Charles Handy is author of The Future of Work *(Blackwell, 1984) and visiting professor at the London Business School*

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COPY NO 1 OF 25

FROM: MRS R LOMAX

DATE: 14 January 1986

CHANCELLOR
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 SCHOLAR
MR CROPPER
MR LORD
MR H DAVIES
SIR LAWRENCE AIREY- IR
SIR ANGUS FRASER - C&E

CHEVENING: 11-12 JANUARY 1986

I attach a note of the main conclusions reached during the weekend discussions at Chevening. As in previous years it does not aim to be a complete record of all that was said.

2. I should remind participants that nothing that took place at the Chevening weekend - including social activities! - should be disclosed without authorisation. Guidance on possible Budget measures should be disclosed to those who need to know in line with the Budget security instructions.

RACHEL LOMAX

CHEVENING: 11-12 JANUARY 1986

This minute records the main points emerging from the weekend's discussions.

Policy background to the 1986 MTFS

2. Sir Terence Burns' paper argued that, after a period in which the overall stance had been eased, there had been a significant tightening in both fiscal and monetary policy over the past year. The policy framework envisaged in the 1985 MTFS seemed capable of delivering a further downward movement in inflation and a slightly lower, but still respectable, growth of real output. There was no need for any overall tightening in policy over the year ahead. This analysis was broadly agreed.

3. The general aim of reducing inflation to 3 per cent by 1988-89 was confirmed. The Government should not commit itself to more precise published targets for inflation (though assumptions about the inflation profile would of course be needed for the MTFS).

4. The presentation of monetary policy in the MTFS was not for discussion at this stage, pending further technical work. The Chancellor noted that there were great difficulties with the definition of monetary policy and it would almost certainly be necessary to give a higher profile to money GDP in the presentation. But this had no operational implications.

5. On fiscal policy:-

(i) It was agreed that the PSBR should be set within the range £6-7½ million. No decision was taken about the precise figure that should be chosen within this range. A number of views were expressed, with a majority of those who spoke favouring a PSBR in the lower part of the range.

(ii) Further work should assume a fiscal adjustment of £2 billion. This working assumption should be reviewed in the

/

light of the forecasts, when a decision was taken about the PSBR.

6. The Chancellor emphasised that the PSBR forecast should be based on realistic central estimates for both public expenditure and revenue. Any allowance for a margin of caution in the published PSBR arithmetic should be a matter for conscious decision.

7. It was agreed that the assumption about oil prices proposed in Mr Evans' minute of 10 January was reasonable; presenting an assumption lower than the lowest forward oil price would be extremely difficult. But the risks of a sharper fall in oil prices were significant, and should be taken into account in planning the Budget. Lower oil prices would put downward pressure on the exchange rate which might require at least some offsetting rise in interest rates. There was a presumption that lower oil revenues should be offset in part by an increase in other taxes - probably in the form of higher petrol and derv duties which would need to be kept in reserve.

8. It was agreed that macro economic considerations did not give any decisive pointers to the use of the fiscal adjustment in the 1986 Budget.

Employment and Enterprise Issues

9. The meeting reached the following provisional conclusions:-

(i) There was a political and presentational (but not economic) case for some employment package but it was very important to accommodate the cost within the existing planning totals.

(ii) All possible progress should be made on administrative measures to reduce the numbers unemployed. There was considerable scepticism about the value and scope for reducing the unemployment total by changes in definition.

(iii) The Treasury should be thinking in terms of a gross addition to public expenditure of the order of £100 million in 1986-87 and £200 million in 1987-88 (and perhaps £50 million and £100 million on net public expenditure). The package should consist of a range of measures drawn exclusively from Lord Young's menu. There might be scope for agreeing additional measures if Lord Young was prepared to find the money from within his own programme (which had been consistently underspent in previous years).

(iv) The CBI package should be ignored. Careful thought should be given to handling the CBI in the run up to the Budget. The Chancellor and the Chief Secretary should seek to persuade Sir James Cleminson and Sir Terence Beckett not to over sell their proposals.

(v) On the detailed measures (listed in table 3 of Mr Monck's paper):-

- Extension of derelict land grant was ruled out for the Budget.

- It would be better to keep an expansion of the Community Programme out of the Budget.

- Extension of the technical and vocational education initiative (TVEI) should be kept for the Survey (unless Lord Young could find the money himself).

- Lord Young's proposals for extending existing pilots for interviewing the long term unemployed and the Jobstart Scheme should be considered together. Mr Monck should examine urgently whether these proposals could be substantially scaled down.

10. The Chief Secretary was asked to negotiate with Lord Young, making it clear that there could be no increase in the planning total, but that it might be possible to make money available from the reserve (without initially specifying the full figure) in

addition to anything that he could find from his own programme. On measures, he should be prepared to negotiate some combination of:-

- An expansion of the Enterprise Allowance Scheme.

- Extending the Loan Guarantee Scheme.

- A New Workers Scheme.

- A scaled down version of Lord Young's proposals on interview LTU and Jobstart.

11. On tax options:-

(i) The Sam Brittan Scheme (and variants of it) were ruled out.

(ii) It was agreed that profit sharing (Weitzman) had some conceptual appeal, but posed real problems, especially the exclusion of the self employed. Action in this Budget was ruled out, but urgent consideration should be given to announcing that there would be consultation on the merits of such a scheme. There was some interest in the scope for "test marketing" by Inland Revenue. Sir Lawrence Airey agreed to provide a note.

12. It was agreed that there was no employment case for a general reduction in the CT rate or in employers NICs.

13. On the minor measures suggested in paragraphs 44 to 45 of Mr Monck's paper, the following provisional conclusions were reached:-

(i) Small business investment companies (SBIC): This was not a strong runner.

(ii) Co-operatives: The Financial Secretary should look further at the case for allowing co-operatives access to profit sharing schemes under the 1978 Finance Act. Increasing the maximum shareholding, and reducing the charge for registration were not worth pursuing.

(iii) Training Loan Pilot Scheme: Announcement of the Pilot Scheme due to start in April might be worth a sentence or two in the Budget speech, following consultation with Lord Young.

(iv) Exempting Enterprise and Jobstart allowances from tax: complete exemption would create unfortunate precedents. An alternative might be to switch enterprise allowances from Case 1 to Case 6 for income tax purposes to avoid apparent treble taxation, but this would not be a simplification. The best solution would be to make no change; this might need reconsidering if there was a lot of political pressure.

(v) Increase VAT limit beyond indexation: This was not on for EC reasons.

(vi) Tax relief for personal employees: This was ruled out.

Tax issues

14. It was agreed that since macro economic considerations gave no decisive pointers to the use of the fiscal adjustment, the choice of tax measures should be based on micro economic grounds.

(a) Indirect Taxes

15. The RPI effect of the Budget, relative to the forecast, should be limited to ½ per cent. Given the inflation profile in the forecast, largely reflecting the favourable outlook for commodity prices, there was scope for some addition (since it would be helpful if the inflation rate was falling rather than rising at the time of the 1987 Budget). But the outlook for wages, the uncertainties, especially on interest rates, and the pressure on public expenditure argued against going beyond ½ per cent.

16. It was provisionally agreed that:-

(i) There was a case for a further shift in the burden of taxation from direct to indirect taxes this year.

(ii) Increasing the rate of VAT by 1 per cent (to 16 per cent) was the obvious front runner. Discussion of other tax changes should be based on this assumption.

(iii) There was a presumption against over indexing the specific duties, since the price of goods subject to excise duties would be affected by a VAT change.

(iv) There were only two candidates for over indexation: the oil duties, and tobacco. Real increases in oil duties should be held in reserve, as a possible response to much lower oil prices. There was a strong health case for increasing tobacco duty in real terms.

17. Customs and Excise were asked to consider how rapidly a VAT change could be implemented; the inflation profile in the forecast pointed to early implementation, possibly before 1 April.

18. Mr Ridley's plea for smaller changes in VED (especially a reduction for lorries) could not be met.

19. A higher VAT rate would increase the pressure for preferential treatment for charities. The Minister of State was asked to consider possible VAT concessions for charities.

(b) Personal income tax

20. It was agreed that there was a strong case for giving priority to cutting the basic rate of income tax this year. The Government's tax objectives involved reducing marginal rates as well as raising thresholds. Thresholds had been raised by 20 per cent in real terms since 1979, while there had been no change in the basic rate since the Government's first Budget. Marginal rates for companies had been reduced from 52 to 35 per cent, while the combined marginal rate on persons from income tax and NICs had fallen by only ½ per cent since 1979. The prospect, and cost, of a

substantial increase in allowances accompanying the move to transferable allowances in 1990 argued for giving priority to cuts in the basic rate over the next few years. A cut of 1p was not worth doing; the choice lay between doing nothing and a cut of at least 2p. Even with 1 per cent on VAT, a cut of more than 2p could probably not be accomodated within a fiscal adjustment of £2 billion. Inland Revenue should consider whether 2½p ("a tanner") was an option.

21. A minimum uprating of personal allowances in line with prices only (5¾ per cent on the latest figures) should be assumed for working purposes. A larger increase in personal allowances would be one possible option for using any remaining room within the fiscal adjustment.

22. Careful thought should be given to presenting the switch of emphasis from thresholds to rates. Further urgent work by Inland Revenue was needed on possible changes to the higher rate structure to limit the cash gains at top incomes. Ideally, changes in higher rate thresholds should lead to a simpler structure, without producing an unduly spiky pattern of gains and losses over the income range. Despite the manpower implications, reductions in higher rates thresholds in real terms could not be ruled out. Restriction of mortgage interest tax relief to the basic rate was not a starter this year.

23. The feasibility of reintroducing a reduced rate band needed urgent reconsideration. The case for cutting the basic rate would depend in large part on the relatively high starting rate for income tax. It would be important to explain clearly why a reduced rate band - the most obvious answer to this problem - was not an option, certainly for this year. Sir Lawrence Airey promised a paper on reduced rate bands, setting out the cost, manpower, timing, and other considerations in detail.

24. It was agreed that an increase in the mortgage interest relief ceiling should be resisted, not least because it would probably lead to higher mortgage rates.

25. It was noted that the Financial Secretary was considering changes in the car benefit scale rates. There was a presumption in favour of a 10 per cent increase for 1987; the distributional effects of the proposed realignment of engine size break points would need careful handling.

(c) Business taxes

26. It was confirmed that there should be no change in the basic CT structure announced in 1984. Vigorous briefing should be prepared to counter the Ernst and Whinney Study.

27. It was provisionally agreed that the small companies CT rate should be reduced in line with the basic rate of income tax. An increase in the small companies profit limit was not a runner.

28. It was confirmed that there should be no change in the North Sea Fiscal Regime. A statement on the tax treatment of incremental projects would probably be needed in the speech, but it should go no further than previous statements.

(d) Capital taxes

29. The main runners were:-

(i) Abolition of the CTT lifetime charge. Presentation should pay particular attention to the benefits for the proprietorial family business and unincorporated sector. The Inland Revenue were asked for a paper on the main beneficiaries.

(ii) A ½ per cent reduction in stamp duty on equities, to coincide with the Big Bang, financed by broadening the base to include inter alia intra account dealing and probably loan stock. Revenue neutrality was essential for political reasons. There was a strong case for increasing the charge on ADR conversions above 1½ per cent (but not more than 5 per cent). Further work on ADR conversions should look at practice in other countries, and could involve the Bank of England.

The Chancellor said his preference was to implement the full stamp duty package on 1 November; an earlier start for changes in the base could be contemplated if this was the only way of securing revenue neutrality.

30. A tax on the balance sheets of financial institutions was ruled out. But the Economic Secretary was asked to pursue his idea of an infinitesimal tax on money transfer in consultation with the Revenue departments.

31. No major changes in Capital Gains Tax were contemplated for 1986. There was no need to reduce the rate in line with the basic rate of income tax. The CGT threshold should be indexed. The Chancellor asked the Revenue to consider (before the Budget, resources permitting) the case for converting the CGT exemption for owner occupiers into a roll over relief

(e) Pensions and Savings

32. It was confirmed that action on pension fund surpluses was a strong runner for the 1986 Budget. Further urgent work was needed on a scheme that would replace Inland Revenue discretion by known rules, which would:-

- allow pensions funds to divest themselves of objectively calculated surpluses (using standardised GAD assumptions), if they were below a certain level;

- compel them to do so, if surpluses were above a certain level;

Inland Revenue should consider whether there should be some minimum level below which companies would be prevented from taking money out of pension funds; and whether the means used should be a matter solely for the trustees (in both permissive and mandatory cases). The tax treatment of different ways of withdrawing money should be carefully considered; the presumption was that refunds should be subject to an exit charge and ring-fenced for CT purposes, while contribution holidays would not be subject to an exit charge, and might or might not be ring-fenced for CT purposes. It was suggested that standardised assumptions provided by GAD might be subject to a margin. On <u>timing</u>, the aim should be to legislate in the 1986 Budget, with implementation as soon as possible thereafter, and not later than 1 April 1987.

33. The proposal for a further tranche of tax privileged savings targetted on equities, set out in Mr Corlett's minute of 9 January, was very promising. Further work was needed, especially on the tax treatment of dividends.

(f) Enterprise and Employment: Tax Measures

34. Sir Lawrence Airey said a further paper was coming forward on the Business Expansion Scheme. On employee share schemes, the package of changes proposed by the Financial Secretary was broadly accepted.

(g) Charitable giving

35. It was agreed that the Budget would need to include a Charities package; the effect on charities of the proposals to cut the basic rate and increase VAT would add considerablly to existing pressures. The scale should be fairly modest. The main runners were:

(i) concessions on VAT (see above);

(ii) abolition of the £10,000 limit on higher rate relief for covenants by individuals (as a sweetener for further changes discriminating between different charities which would probably be necessary anyhow);

(iii) encouragement for payroll giving, on the lines of the Sainsbury/Jacomb scheme. This should probably be permissive rather than mandatory to minimise the burden on companies.

36. Tax relief for single gifts by companies and individuals should be looked at together to avoid problems with close companies. This was not a front-runner, but Inland Revenue were asked to do further work.

(h) Minimum tax

37. The Chancellor was attracted by the proposal outlined in Mr Isaac's minute of 10 January. While action in this Budget was ruled out, an announcement that the Government was prepared to consult might help to defuse criticism of the effect of income tax reductions on the rich. The next step was to draw up a list (with some underlying rationale) of possible tax shelters for inclusion within such a scheme. Mortgage interest tax relief should not be included.

Compassionate lollipops

38. The Chancellor invited suggestions.

Next steps

39. The timetable outlined in Section 4 of Mr Scholar's minute was confirmed. The deadline for decisions on the VAT rate was 28 February; given Green Paper complications, it was important to stick to the Inland Revenue deadline of 4 March for decisions on main personal income tax changes.

40. The Chancellor said he would be seeing Mr Hurd, Mr Ridley, Mr Fowler, Mr Brittan and Mr Baker in the run-up to the Budget. The Chief Secretary would be negotiating with Lord Young on employment measures, and the Chancellor and the Financial Secretary should see him on the Business Expansion Scheme. It was desirable to avoid a meeting with Mr Walker on incrementals but that might not be possible.

41. There should be a meeting on the presentation of the Budget at an early stage. Sir Peter Middleton agreed to provide a note, bringing out the issues discussed over the weekend.

RACHEL LOMAX

Distribution: Those Present

CHANCELLOR OF THE EXCHEQUER

Ch

There is quite a strong view — which I share — that we shouldn't get into a lengthy correspondence with the Bank on this. We have other fish to fry & frankly I don't see why we should treat their views on fiscal policy with tremendous seriousness.

But you will want to have a word with the Governor; I also think Terry might go over the technical stuff with John Flemming (I don't think he has yet), and Frances or Pete might have a word with Eddie. I would be quite interested to know what Eddie's market sense tells me;

I can't believe he has much sympathy with John Flemming's very academic approach to all this. (I would however expect him to be generally in favour of fiscal caution, because of anxiety about broad money, as well as Prudent's challenge).

Chris Riley's note is rather good.

RL

16/1

THE BANK'S BUDGET SUBMISSION

CONFIDENTIAL

FROM: T BURNS
DATE: 16 January 1986

SIR T BURNS to CH/EX 16/1

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary	Mr Scholar
Financial Secretary	Mr Evans
Economic Secretary	Mr Monger
Minister of State	Mr Odling-Smee
Sir Peter Middleton	Mr Turnbull
Sir Geoffrey Littler	Mr Sedgwick o r
Mr F E R Butler	Mr Riley
Mr Byatt	Miss Peirson
Mr Cassell	Mr H J Davies
Mr Monck	

THE BANK'S BUDGET SUBMISSION

I attach a note by Mr Riley on the Bank's Budget submission as you requested. He makes a number of points.

2. The Bank's paper does not present the arguments in a balanced way and ignores possible reasons for a higher PSBR. It is fascinating to watch fashion change. Until recently many commentators only made an adjustment for rising unemployment; here is an example where adjustment is made for almost everything but unemployment. Although I have some sympathy with taking account of some of these factors I would not propose trying to add them together to obtain a unique measure of fiscal stance. And there are factors pointing in the other direction as set out in my Chevening paper.

3. The Bank is very grudging about progress in tightening fiscal policy in the last couple of years. It presents figures for the fiscal stance which Mr Riley argues are misleading in important respects. For example they apply an inflation adjustment based on forecasts of inflation at the time to the outcome for the PSBR. If the adjustment was based on actual inflation the figures would show a tightening of fiscal policy this year even on the methodology used here. And any inflation adjustment carries the bizarre message that the more successful you are on inflation the more you must raise taxes.

4. It also appears that the Bank's view about the scope for, and likely sustainability of, tax cuts is based on very pessimistic assumptions for growth next year and public expenditure in the following years. They do not seem to take account of the factors we usually quote; for example a slow-down in defence spending and the end of the rise in unemployment. And they are under the impression that the tax Green Paper will be implemented in 1987-88.

5. The paper provides an assessment of the likely market reaction to the size of the fiscal adjustment which is unqualified and seems to take no account of possible variations in the forecast.

6. Despite the irritating nature and one-sidedness of the Bank's paper, I am not in favour of sending them a detailed rebuttal. It would probably drag us into an exchange of correspondence that we can do without at this time of year. But it is probably worth raising the matter of our general reaction with the Governor. You could use some of the arguments in this note in emphasising to him the extent of your disagreement with the analysis and the conclusion that there is no scope for tax cuts this year. You might also suggest that you would be upset if this line of argument appeared in their draft assessment for the BEQB.

TB

T BURNS

ENC

CONFIDENTIAL

THE BANK'S BUDGET SUMMISSION

Summary

1. The main points made in the Bank paper are:

- that financial markets might accept a fiscal adjustment in 1986-87 of up to (but, by implication, no more than) £2 billion without an "immediate severe adverse reaction", given pessimism about prospects for public expenditure and oil revenues. But the Bank would advise against using the whole £2 billion.

- that the PSBR is increasingly misleading as an indicator of the effects of fiscal policy on the economy, and currently overstates the restrictiveness of the fiscal stance.

- that recent easing of the fiscal stance, and imbalance between monetary and fiscal policy, is leading to a growing imbalance in the economy. This shows up in disproportionate growth of consumption, a worsening non-oil trade balance, high real interest rates and a high real exchange rate.

- that this perception of an easing of fiscal policy is shared by a growing body of market analysts and international bodies.

Fiscal Stance

2. The Bank produce a series of figures for the fiscal stance, with the aim of demonstrating that fiscal policy eased significantly between 1981-82 and 1984-85 and has probably tightened only slightly in 1985-86. Figures for both the PSBR and the PSFD are given, and adjustments made (where appropriate) for:

- asset sales, including council houses
- the coal strike
- transitory North Sea revenues
- inflation tax

The Bank's tables are attached.

3. The figures based on the PSFD indicate a greater loosening of the fiscal stance between 1981-82 and 1984-85 than those based on the PSBR, even after aligning the adjustments for differences in the definitions. The reason is that changes over the period in net lending, the accruals adjustment and other financial transactions (such as trade credit) reduced the PSBR over the period by around $1\frac{1}{2}$% of GDP relative to the PSFD. While there are considerable problems with using the PSFD as an indicator of fiscal stance, including the errors in the national accounts which are incorporated in it, it does generally contain useful information.

4. Over this period there was very little change in unidentified items - ie measurement errors. Borrowing was raised relative to the financial deficit in 1981-82 by delays in revenue due to the Civil Service strike, but reduced in 1984-85 by the once-for-all effect of advancing VAT on imports. There was also a considerable contraction over the period in net trade credit granted by public corporations and other public sector lending, which reduced borrowing without altering the underlying deficit. In neither case would the impact on fiscal conditions be as great as regular changes in expenditure and taxation. It is therefore appropriate to take these factors into account when assessing the fiscal stance, though not necessarily one-for-one as the Bank have done by using the PSFD.

5. In other respects the Bank analysis is more obviously flawed and one-sided, and thus the picture obtained misleading. First, the paper presents adjustments which point over the period to a lower PSBR, but conveniently ignores those which point in the opposite direction. There is no attempt to allow for the cycle, for example, and no recognition of the argument that some rise in the PSBR was probably desirable over this period on account of the rise in unemployment.

6. Secondly, the legitimacy of the adjustment for inflation tax is open to serious doubt. Lower inflation does indeed imply a loosening of fiscal conditions, and gives a boost to demand and activity. But it is misleading to present this - the beneficial effect of lower inflation - as a loosening of the fiscal stance.

7. Furthermore the Bank base their adjustments on Treasury inflation forecasts for the years in question, rather than on actual inflation, and errors in inflation forecasts are effectively ignored. On this basis the adjusted figures show a further loosening of fiscal policy in 1984-85, even after allowing for the coal strike, before the tightening we expect in 1985-86. But in the absence of inflation adjustments, or with adjustments based on actual inflation, the figures would show a tightening in both 1984-85 and 1985-86. Our view is that the inflation adjusted figures given by the Bank are highly misleading.

8. Finally there is a confusion about the rationale for the adjustments. The paper claims to be concerned primarily with the effects of fiscal policy on demand, yet the justification for the adjustments for "transitory" oil revenues has to be based on quite different criteria - namely their effects on the distribution of consumption over time, and the sustainability of existing fiscal plans. The effects of North Sea revenues on demand are thought to be rather low, so much the same sort of answer might be obtained if the oil adjustment were done on this basis. But this highlights a general deficiency of the analysis - that effects on demand and longer term structural factors are not clearly distinguished, and neither is given a complete and satisfactory treatment.

Economic Prospects and Fiscal Implications

9. The paper argues that little of any available fiscal adjustment should be used in the 1986 budget on the grounds that:

- domestic demand is already buoyant, and being met to a considerable degree from higher imports, so there is no short term case for stimulating it.

- activity is more likely to slacken after 1986, so there is a case for deferring the fiscal adjustment to 1987.

- there would also be advantage in postponing some of the available fiscal adjustment until 1987 because this is the earliest possible date for the proposed reform of personal taxation, when a large fiscal adjustment is desirable.

- it would be difficult to sustain any tax cuts made in 1986, even on relatively favourable assumptions about public expenditure. The position after 1988-89 will also be difficult.

10. It is quite likely that activity will slacken in 1987. This was a feature of the forecast underlying the Autumn Statement, but the Bank clearly expect a sharper slowdown. In any event, it does not follow from this that taxes should be cut in 1987 rather than earlier, given the lag between policy changes and the effects on the economy.

11. The Bank is clearly misinformed on personal tax reform. There would indeed be some advantage in having a large fiscal adjustment when the reform is implemented, but the earliest date for this is 1990. The confusion may have arisen because we have said it would be possible to introduce legislation in 1987, but there would be no advantage from a large fiscal adjustment then.

12. On sustainability, the Bank argue that tax cuts made in 1986 might have to be reversed even if public expenditure were to grow at only half the rate in the recent past, rather than remaining flat in real terms as in current plans. This is obviously possible, but only on rather pessimistic assumptions. Average growth of general government expenditure in real terms since 1981-82 has been nearly 2% pa. An extra 1% in 1987-88 would pre-empt about £1.6 billion of the fiscal adjustment in that year, compared with the total available which was put at £3 billion in the last MTFS, and more than that in the recent Industry Act forecast.

13. Only if growth in activity were to slacken very considerably - perhaps to a mere 1% or thereabouts - or the effective tax rate were to fall significantly, would it be necessary to claw-back some of the 1986 tax cuts to achieve the PSBR profile in the last MTFS. But if the cyclical position of the economy were weaker, there would be a good case for allowing some rise in the PSBR rather than raising taxes and further reducing the growth of output. In practice, of course, we see the prospect for activity as having improved since the last MTFS, and we are intending to revise the assumed growth rate upwards.

14. The Bank also argue that if public expenditure were to grow in line with non-North Sea GDP after 1988-89, having been frozen in real terms up to then, tax cuts made earlier would be hard to sustain. That is not how we see it, though again the possibility cannot be ruled out. Government policy is to reduce public expenditure as a share of GDP, not to maintain the share unchanged. Expenditure may turn out higher than the government would wish, but there are good reasons - including a less buoyant defence budget and the end of rising unemployment - for believing that we can achieve lower growth than over the last few years. The Bank may also be taking a more pessimistic view about the prospects for North Sea revenues or the real burden of interest payments, though we have no details of their calculations.

15. Quite apart from their pessimism about activity growth and public expenditure prospects, the Bank do not mention the case for a higher PSBR. Sir Terence Burns' paper for Chevening set out a number of arguments for combining a tight monetary policy a relatively easy fiscal stance, including:

- the need to avoid sterling weakness

- the need to maintain pressure on companies to limit wage increases, possibly by means of a higher real exchange rate

- the need for a more cautious approach to setting UK interest rates, given the rapid growth of broad money and the end of overfunding

- the possibility that a tight money/looser fiscal policy combination might have favourable short term effects on the price/output split

- the desirability of allowing declining North Sea revenues to be reflected in part in a less rapidly declining PSBR path than would otherwise be the case.

16. These arguments cannot be considered over-riding, and the case for fiscal caution remains strong. But the Bank paper does not present the arguments in a balanced way: on the contrary, it gives a very one-sided view.

Implications of a sharper oil price fall

17. The paper concedes in this section that a sharper fall in oil prices may justify a higher PSBR path, but argues that the scope for this may be limited if the exchange rate were to fall sharply. One reason given is that it would be wrong to support sterling primarily by means of higher interest rates since already there is "an inadequate proportion of capital spending" in prospect. This last point is made without any supporting evidence or justification. And the general point is once again slanted to stress the pessimistic side.

Monetary Implications

18. The paper argues that the PSBR gives as misleading an indication of the impact of fiscal policy on the demand for credit and money as on aggregate demand. This is particularly so in the context of asset sales and measures which simply transfer credit demand from the public to the private sector. (They are also particularly worried about developments in mortgage demand, and the risk that withdrawal of the guidance to building societies may further increase the availability of credit for non-housing purposes.) There is something in these arguments, and the implied need for fiscal caution.

Tax Changes in the Financial Area

19. The paper argues for a reduction or abolition of stamp duty on equities in the budget and, given the limited overall scope for tax cuts, that this should be financed by a tax on consumer credit. It is suggested that credit from banks and building societies should be treated equally for the purposes of such a tax, given the diminishing differences between their activities and, presumably, the Bank's general worries about mortgage lending. A reduction in stamp duty is, of course, under consideration. A consumer credit tax has been considered in the past and rejected, for reasons which are still considered valid. (tax on mortgages??)

TABLE 1 ADJUSTED PSBR

% of GDP at market prices	(1) Recorded PSBR	(2) PSBR adjusted for coal strike (a)	(3) col (2) adjusted for sales of assets (b)
1979/80	4.8	4.8	5.6
1980/81	5.4	5.4	5.8
1981/82	3.3	3.3	4.0
1982/83	3.1	3.1	4.2
1983/84	3.4	3.4	4.5
1984/85	3.1	2.3	3.5
1985/86 (c)	2.3	2.0	3.3

(a) HMT estimates

(b) Special sales of assets plus sales of council houses etc

(c) Estimated

TABLE 2 ADJUSTED PSFD

% of GDP at market prices	(1) Recorded PSFD	(2) PSFD adjusted for special factors (a)	(3) Col (2) plus temporary N. S. revenues	(4) Col (3) <u>less</u> inflation tax
1979/80	3.7	4.0	4.0	-3.7
1980/81	5.1	5.3	5.9	0.2
1981/82	2.2	2.8	4.3	1.0
1982/83	3.1	3.8	5.3	2.4
1983/84	3.9	4.4	6.8	4.3
1984/85	4.0	3.7	6.3	4.7
1985/86 (c)	3.1	3.3	5.5	4.0

(a) Coal strike effects, sales of council houses etc, uplift of maturing index-linked gilts in 1987/8.

(b) In part, Bank estimates, using HMT inflation forecasts.

(c) Estimated

Conclusion

20. The paper makes a number of valid arguments about fiscal policy; and the conclusion that caution is needed is one that we would accept. But the analysis is very one-sided and negative, and in some respects clearly wrong. A major weakness is its complete failure to consider arguments which point in the other direction.

21. Furthermore, although there may well be a general perception, which we would share, that fiscal policy eased after 1981-82, it clearly tightened again in underlying terms in 1984-85 and a further tightening is expected in 1985-86. The paper is very grudging in tone, and barely acknowledges the progress that has been made.

22. In principle, at least, we should pay particular attention to the Bank's views on likely reactions in the markets. The paper clearly implies that a fiscal adjustment greater than £2 billion would be met by an "immediate severe adverse reaction", but it does not back this up with any serious analysis. Does it apply, for example, irrespective of the resulting PSBR forecast, or the level of North Sea revenues assumed?

23. The views in the paper clearly reflect a considerable pessimism, in both the markets and the Bank, about the government's ability to keep public expenditure to its planned path. This implies doubts about the true scope for tax cuts, both now and in the future. On past form we would have to concede that these are legitimate doubts, but the treatment in the paper is very scanty.

24. Overall, the paper is not convincing, largely because the arguments are not presented in a balanced way.

FROM: R A L LORD

DATE: 31 JANUARY 1986

CHANCELLOR'S MORNING MEETING 42nd MEETING

NOTE FOR THE RECORD

PRESENT: Chancellor
Financial Secretary
Minister of State
Economic Secretary
Mr Cropper
Mr Lord

1. BUDGET ISSUES

The Chancellor asked Ministers and Advisers to reflect again over the weekend on the shape of the Budget. The background had changed considerably since discussions at Chevening. The main change was in the oil price which would be reflected in the new forecast now being circulated. Political events had also changed the mood and this week's unemployment figures were not helpful. The mood could have altered by the time of the Budget but it was doubtful that it would be as favourable as earlier this month.

The main questions to be addressed were:

a) should we continue to plan on the basis of the presently assumed fiscal adjustment or move towards greater austerity ?

b) has the balance of advantage between increases in thresholds and cuts in the basic rate altered ? Is a 1p cut still considered derisory ?

c) does the slightly worsening outlook for inflation following the fall in sterling alter our attitude towards increases in indirect taxes ?

d) should we look again at tax incentives to employment ?

2. It was agreed that the Party needed a lift and that tax cuts were certainly desirable. On the other hand an austerity budget would now be more understandable.

R A L LORD

<u>Circulation</u>

Chancellor	Sir P Middleton	Mr Cropper
CST	Sir T Burns	Mr Lord
FST	Sir G Littler	Mr H J Davies
MST	Mr Butler	
EST	Sir A Fraser C&E	
	Sir L Airey	

CONFIDENTIAL

pmp

From: MISS E A CLARKE

Date: 10 December 1986

CHANCELLOR

cc PS/Chief Secretary
PS/Financial Secretary
Sir P Middleton
Sir G Littler
Sir T Burns
Mr F E R Butler
Mr Scholar
Mr Ross Goobey

Mr Battishill - IR

Those coming alone or Saturday/
Sunday only:
PS/Minister of State
PS/Economic Secretary
Mr Cassell
Mr Cropper
Mr Tyrie
Mr Allan
Sir A Fraser - C&E

(for information)
Mrs A Morrison - FCO

CHEVENING: SATURDAY 10 JANUARY AND SUNDAY 11 JANUARY

Sir Peter Middleton has decided that the charge this year for those taking their wives to Chevening should be £30.

2. I should be grateful therefore if you could send me a cheque for that amount payable to HM Treasury.

3. Dress for the weekend is informal, with lounge suit for dinner on Saturday evening.

4. A programme will be available just before the weekend containing room allocation, maps, menus etc.

5. For those who have not been before, the approximate starting time for the weekend is 10.45 am Saturday and approximately 2.00 pm departure on Sunday.

E A Clarke

MISS E A CLARKE
Assistant Private Secretary

PX10

RESTRICTED

From: MISS E A CLARKE
Date: 7 January 1987

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir G Littler
Sir T Burns
Mr F E R Butler
Mr Cassell
Mr Scholar
Mr Cropper
Mr Ross Goobey
Mr Tyrie
Mr Allan

Mr Battishill - IR
Sir Angus Fraser - C&E

CHEVENING: SATURDAY 10 JANUARY AND SUNDAY 11 JANUARY

... I attach the programme for Chevening.

2. Dress for the weekend is informal, with lounge suits for dinner on Saturday evening.

... 3. I attach my minute of 10 December 1986 which contains Christian names, for ease of reference.

E A Clarke

MISS E A CLARKE
Assistant Private Secretary

CONFIDENTIAL

From: MISS E A CLARKE

Date: 10 December 1986

MR A ALLAN

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir P Middleton
Sir G Littler
Sir T Burns
Mr F E R Butler
Mr Cassell
Mr Scholar
Mr Cropper
Mr Ross Goobey
Mr Tyrie

Mr Battishill - IR
Sir A Fraser - C&E (Saturday only)
Mrs A Morrison - FCO

CHEVENING: SATURDAY 10 JANUARY AND SUNDAY 11 JANUARY 1987

Below is a list of acceptances for Chevening:

Chancellor of the Exchequer (Nigel Lawson)	& Mrs Lawson (Thérèse)
Chief Secretary (John MacGregor)	& Mrs MacGregor (Jean)
Financial Secretary (Norman Lamont)	& Mrs Lamont (Rosemary)
Economic Secretary (Ian Stewart)	& Mrs Stewart (Deborah) - there for Saturday dinner only not staying overnight
Minister of State (Peter Brooke)	

Sir Peter & Lady Middleton	(Peter & Valerie)
Sir Geoffrey & Lady Littler	(Geoffrey & Shirley)
Sir Terence & Lady Burns	(Terry & Anne)
Mr & Mrs Butler	(Robin & Jill)
Mr Cassell	(& possibly Mrs Cassell)
Mr & Mrs Scholar	(Michael & Angela)
Mr Cropper	(Peter)
Mr & Mrs Ross Goobey	(Alastair & Sarah)
Mr Tyrie	(Andrew)
Mr Allan	(Alex)
Mr & Mrs Battishill	(Tony & Heather)

<u>Saturday only</u>

Sir Angus Fraser.

2. Please could recipients of this minute check carefully for any mistakes in Christian names etc.

3. Also please could I ask at the same time for the registration number, colour and make of car you will be taking to Chevening, and to indicate whether you will be driving yourself or driven there by a Government driver; also if by Government driver could you let me know if they would like to have the buffet lunch at Chevening on Sunday 11 January.

EA Clarke

MISS E A CLARKE
Assistant Private Secretary

SECRET AND PERSONAL

FROM: H J DAVIES
DATE: 13 JANUARY 1986

MRS LOMAX

cc Sir P Middleton
Mr Monck

CHEVENING DISCUSSION ON EMPLOYMENT: DRAFT MINUTES

As we agreed I have prepared minutes of the discussion on employment and enterprise issues based on Mr Monck's paper of 20 December, which went through from before lunch on Saturday to the middle of the afternoon.

2. I have dictated a fairly full note, though without all the jokes and asides. At this stage I am copying it only to Sir Peter Middleton and Mr Monck. It might be useful if Mr Monck could make any factual corrections he sees as necessary. You will be giving further thought to the circulation of the minutes. In the meantime I shall not copy these notes further.

HJD

H J DAVIES

CHEVENING: 11 JANUARY: EMPLOYMENT AND ENTERPRISE ISSUES

Introducing his paper of 20 December, **Mr Monck** said that though there might be some fall in recorded unemployment over the next year the central assumption was that it would remain broadly flat. Excessive pay rises were thought to be the principal factor preventing a fall, but there was little in the paper directed towards that problem.

There were three groups of proposals:

i) Redefinition and administrative action

ii) Public expenditure measures

iii) Tax and other options

Taking these in turn he saw little scope for redefinition, but there was a strong case for pursuing the earners and drawers problem and tightening up the work test. This was something on which the Treasury could work with DHSS officials. But it was unlikely to remove the political need for a package within the Budget, on employment and enterprise. The question was how costly such a package would need to be. Drawing attention to Table 3 of his paper **Mr Monck** said that the measures in the top half of the table could be charged against the reserve, with no need for recourse to the fiscal adjustment. But it seemed likely that Lord Young would ask for at least some of the items in the bottom half of the table.

The **Chancellor** invited comments on the general issues, before taking the specific measures in turn. For his part he saw very little scope on redefinition, which would look like an attempt to fiddle the figures. He believed, however, that it was necessary to do something on the administrative points, even though there was a potential political problem in that if the Government were successful in "cleaning up the count" this might show up north/south differences even more starkly.

The difficult elements were the public expenditure and tax measures. He considered that politically it would be necessary to do something on the public expenditure side. It was not absolutely necessary to act on the taxation front, though he would like to find some sensible changes. As for the scale of package required, his view was that Lord Young would not expect to gain agreement to all his proposals. At the outset we should be thinking in terms of a ceiling of £100 million in the first year and £200 million in the second, in gross public expenditure terms. He did not wish to change the planning total in the budget for a second successive year. As for particular measures we should confine ourselves to those items which Lord Young had proposed. They were ingenious and well thought through, for the most part, and any new proposals from the Treasury would be an addition to his list, rather than substituting for any components of it.

The **Chief Secretary**, on reflection, agreed that the redefinition ideas should not be pursued. He saw a severe problem on the Reserve, particularly in 87-88. There was only scope for an additional £50 million in 86-87 and £100 million in 87-88. But Lord Young would certainly argue that that was too low. There would be presentational difficulties also in relation to the CBI who had argued strongly for a large package of public expenditure measures.

He agreed that the political arguments pointed to Lord Young's measures rather than those proposed by the CBI, which in any event created greater public expenditure difficulties. We would, nonetheless, need to think how to handle relationships with the CBI in the run up to the Budget.

Looking at the individual measures, he was not convinced about the case for an expansion of the Community Programme, but was more attracted to items f and g in Table 3.

The **Chancellor** also hoped that it would not be necessary to do much on the Community Programme. Expansion was something we could have up our sleeves in case the unemployment prospect worsened significantly during the course of the year.

Mr Butler thought it important to work within the White Paper numbers which were about to be published. It was undesirable in principle to add public expenditure measures in the Budget. But it was important to recognise that we had set a reserve in the survey which <u>did not</u> allow for substantial increases in expenditure on employment measures. The forecast of claims on the reserve was not necessarily accurate to within £100 million but the position was certainly very tight and we needed a net reduction in public expenditure in the next two surveys. We should not make that task harder by agreeing to extra bids now. The position was made even tighter by the higher uprating which the indirect tax measures provisionally agreed would bring. He appreciated that the Government needed to do something, though he thought the case was largely political and presentational. He thought there ought to be some scope for redistribution of expenditure within the Department of Employment budget, which was generally underspent. Lord Young should be encouraged to find room within his programmes for these new proposals and the Treasury should start negotiations with a lower figure than we expected to concede.

The **Chancellor** noted these concerns but considered that it would be difficult to persuade Lord Young to take gross public expenditure as the benchmark. He will wish to look at the net exchequer cost from the start. The Chancellor agreed on the principle of no public expenditure measures in the Budget.

Mr Butler thought it better to concentrate on the range of measures rather than on the money. The **Chancellor** agreed. An imaginative package of a number of different measures could have considerable political mileage.

Sir Terence Burns questioned the treatment of any further expenditure on employment measures. It was concluded that this depended on whether the cost could plausibly be charged to the Reserve or not. If it could, then it did not form part of the fiscal adjustment. If not, then it did. But in any case it was necessary for the economists to take account of the expenditure internally in forecasting the PSBR.

Resuming the discussion after lunch the **Financial Secretary** questioned the political requirement for a package of employment measures. The national political considerations were somewhat different from those within the Cabinet. The danger was of creating the impression that this was the way to cut unemployment.

The **Economic Secretary** wondered whether there were any methods open to us of converting expenditure to allowances within the Department of Employment budget. **Mr Cassell** thought this was a dangerous route to follow. We should not distort the tax system in this way. **Sir Lawrence Airey** agreed.

The **Minister of State** thought that the Manpower Services Commission was not without resources which it could devote to these measures.

The **Chancellor** thought there was a stronger case for public expenditure than for adjustments to tax allowances. There was a lot in what the **Financial Secretary** said. But, on balance, he thought the arguments <u>for</u> a package in the Budget were stronger. The **Chief Secretary** said he was very sceptical about the long term benefits of the measures under discussion. But he still acknowledged the need to do something. The figures we were talking about would, after all, indicate some scaling down when compared with last year's package.

Sir Peter Middleton thought that some public expenditure unemployment measures was not an irrational response to the present economic situation. But we must not leave the Reserve obviously overspent.

<u>Employment Measures</u>

Turning to the particular measures outlined in the paper, the **Chancellor** thought that the doubling of Derelict Land Grant (d) should be rejected. The Loan Guarantee Scheme (b) could not be killed now so we could assume that it would be extended beyond March of this year. There were presentational issues, but those could be left aside for the moment.

The Enterprise Allowance Scheme (a) was attractive, and the New Worker scheme (c) also had advantages. But since Lord Young would argue that (f) and (g), the interview programme of the long term unemployed and Jobstart were closely linked, even if we dropped the Community Programme, we were left with a package which, in expenditure terms, would be outside the limit set. The question was therefore whether to scale that package down or use surpluses on other Department of Employment programmes. He suspected that there were such surpluses and we should argue that from the outset.

Mr Monck drew attention to considerable uncertainties surrounding the cost of measures (f) and (g). In the first place the take-up was uncertain, but also the length of time people would stay off the count if they realised that there were no further sanctions. We might see considerable flowback to the register after a period. It was also quite impossible at this stage to say whether the programme as a whole would be more or less effective than the Community Programme. There was almost no evidence available from the initial pilots. There were, however, some possible methods of reducing the cost. Taking those unemployed for more than two years only would reduce the cost by 40 per cent.

The **Chief Secretary** agreed that there were uncertainties. The sensible course was to await the results of the pilots, but the political pressure argued otherwise. He wondered whether there was a halfway house, involving extending the pilots to the whole of selected regions only. The difficulty would be that if Job-start was offered as well as the interview programme this could even be seen as a bias in favour of the more prosperous areas.

The **Chancellor** thought that regional extension was possible, but we would need to say that we were extending it nationwide, but that resources were not yet available to achieve complete coverage.

The **Financial Secretary** favoured waiting until the next budget. This would be far preferable to going ahead with a half-cock scheme now. The **Economic Secretary** commented that the Community Programme was popular with the House of Commons. **Mr Monck** reported that

Department of Employment officials were in favour of expanding the Community Programme. It could be a useful pre-election back up and in order to keep open the possibility of expanding it rapidly there was a case for keeping the numbers on a gently upward path throughout.

The **Chancellor** said that his priorities were, first, the Enterprise Allowance Scheme, second the New Workers Scheme and third a combination of the interview processs and Jobstart. But we needed to recognise that Lord Young wanted to do something new, and that there was more support from the Prime Minister for the interview programme than for anything else.

The **Financial Secretary** said that there was a subsidiary problem related to the Enterprise Allowance Scheme, the question of the taxable status of allowances. **Sir Lawrence Airey** said that Department of Employment Ministers seemed to want the sums to be treated under case 6. This was better on all counts except the presentation which was complex.

The **Chief Secretary** thought the Enterprise Allowance Scheme might come into disrepute eventually because of the "triple taxation" catch.

On the Loan Guarantee Scheme the **Chief Secretary** said that he remained worried about the extension and its terms. He wanted to push the banks to a 50-50 scheme and then agree 2 per cent over base rate. But we should put strong pressure on Lord Young to begin serious negotiations with the banks now. **Mr Monck** reported that the banks had been reluctant to talk seriously but there were now some signs of movement. Lord Young should be allowed to proceed with the negotiations for the time being, though reserving the possibility of a role for the Treasury or the Bank of England in due course.

Concluding the specific measures in Mr Monck's paper the **Chancellor** thought that increased spending on TVEI had no place in the Budget. Lord Young should be put off until the public expenditure round.

Summarising the conclusions on the range of public expenditure measures the **Chancellor** invited Mr Monck to do some further work on halfway houses for (f) and (g) involving more modest extensions of the existing pilots. The **Chief Secretary** should negotiate provisionally with Lord Young from a menu of measures (a) (b) (c) (e) (f) and (g) (in the last two cases the Monck variants). The starting point should be no increase in the planning total and a modest contribution from the Reserve to supplement switches in Department of Employment programmes.

Tax and Other Options

The meeting then turned to discussion of the ideas in paragraphs 36-58 of **Mr Monck's** paper.

Sam Brittan's Incentives

Sir Lawrence Airey was unenthusiastic about the Sam Brittan proposals. **Mr Scholar** on the other hand, thought the administrative complexity could be worthwhile if a scheme could be devised at no expenditure or revenue cost. Though the jobs added contribution idea which the Treasury had put forward last year would be better. **Sir Lawrence Airey** thought, however, that it would be too easy to manipulate the definitions. It was hard to define the concept of pay at all precisely.

The **Chief Secretary** saw considerable difficulties in the House of Commons. **Sir Terence Burns** saw deadweight problems in that some companies would be rewarded for what they planned to do anyway. **Sir Peter Middleton** reported some support on the pay side of the Treasury for these ideas. But **Sir Lawrence Airey** pointed out that since the scheme would take some time to put in place there would be no increases in employment before it took effect. This could be a serious problem in the next year or so.

The **Chancellor** thought this an important and perhaps decisive argument. A few well-publicised avoidance cases would be a major political embarrassment. Since there was little support around the table he suggested that the idea should not be pursued further.

NIC/Corporation Tax reductions

The **Chancellor** also saw no case for general reductions in employer's National Insurance Contributions or the Corporation Tax rate (paragraph 40).

Profit Sharing

Mr Davies said he saw a strong case for a tax incentive for profit sharing schemes on the lines set out in paragraphs 41-42. The reception of the budget would be influenced by the widely held view that pay was the major economic problem faced by the country. This scheme would show that Government recognised that concern. In addition it would build on another strand of policy, the expansion of share ownership and employee share schemes. The fundamental economics of the scheme were straightforward. Employees would be trading future volatity in wages for a cash receipt now. One did not need to believe in the more extreme propositions put forward by Weitzman to believe that this would improve employment prospects in the long run. There would be difficult questions of presentation, but the idea did seem to have long term structural benefits as well as short term political attractions.

Sir Peter Middleton said that there had been more support for this scheme in PCC than for other proposals in this area. There seemed to be long term benefits and few short term problems, together with some quite strong presentational advantages.

Sir Lawrence Airey said he had some sympathy with the objectives of the scheme, but was quite clear that the Revenue could not make it work in its present form. He thought that it showed more faith than was justified in the Inland Revenue's ability to control the use of reliefs of this kind. It would be exploited by the City, where it would come as an uncovenanted benefit. He also doubted the extent of take up. Unions had not touched share option schemes, for the most part. There would also certainly be complaints from those kept outside the scheme, such as the self-employed, those in non-profit organisations and in the public sector. He suspected that the basic wage would be used as a balancing factor in the event of a profits downturn.

Mr Davies thought that the cash limit of £2,000 a year would minimise City abuses, and that some unions, notably the electricians, would be willing to undertake such experiments, particularly where they had agreed no strike arrangements.

Sir Terence Burns said he too had been quite attracted by the idea. If the technical arguments against were overwhelming, so be it, but in principle there was no doubt that it had attractive elements. The Government was weak in this area and some mileage could be had from a gesture in the direction of wage flexibility.

The **Financial Secretary** on the other hand, saw a conflict between shares and wage rates. These schemes did not, on the whole, affect wage rates. They amounted to an add-on for the most sophisticated bargainers. He agreed with **Sir Lawrence** that there was considerable scope for avoidance.

The **Chancellor** saw a strong logical case for moving towards this form of remuneration. Obviously it was desirable to generate greater flexibility in wages, to minimise flexibility in employment levels. He took the point about the benefits of this scheme at downturns in the economic cycle. In principle, employers should be prepared to negotiate such arrangements without bribes, but he recognised that for the most part they did not do so. There were two problems with the tax concession. First, the substantial implementation problems identified by **Sir Lawrence Airey.** But second, that if the take-up was small and abuses well publicised, the presentational advantages of the gesture could be very short lived. He was, therefore, apprehensive about moving too quickly in this direction, though acknowledged that he had come to this conclusion with considerable reluctance.

In further discussion **Mr Monck** doubted the extent of the abuse. **Mr Lord** wondered whether a regional trial could be established, perhaps in assisted areas only. The **Minister of State** was attracted by that proposal. The **Financial Secretary** on the other hand was against introducing new rigidities through the tax system, and commented that the evidence suggested that firms with an element of profit sharing in their remuneration did not have lower wages. **Sir Lawrence Airey** thought that any substantial moves would need to be preceded by a consultative document of some kind.

The **Chancellor** concluded that the scheme should not be abandoned at this stage. We could not now decide firmly for or against. There might be attractions in a low revenue cost operation, even though it may be seen as the thin edge of the wedge. Indeed there would be attractions if it were. We might possibly think about an announcement in the budget that the Government was interested in encouraging further moves towards profit sharing and would be bringing forward a consultative document in the near future. He invited **Sir Lawrence Airey** to produce a further note on the enforcement problems and to consider the possibility of a consultative document and/or some test marketing.

Business Expansion Scheme

Sir Lawrence Airey reported that a further paper exploring the implications of the tentative decisions at the Chancellor's recent meeting would be coming forward shortly. Final decisions could be made on the basis of that work.

Small Business Investment Companies

The **Chancellor** agreed with the conclusion in the paper that they were not now worth pursuing.

Co-operatives

The **Chancellor** saw no case for an increase in the maximum share holding or a reduction in the registration charge, but saw some value in enabling co-operatives to have some access to profit sharing schemes (paragraph 50 (c)).

The **Financial Secretary** thought there was no real logic in the change, though the co-operative movement was strongly in favour. In response to a question from the Chancellor, **Mr Davies** reported that Mr Oakeshott of Job Ownership Limited argued for the amendments put forward y Nigel Forman MP in last year's Finance Bill. The Co-operative Development Agency itself did not produce a strong case for either an increase in the maximum shareholding or a reduction in the registration charge, but favoured an expansion in the Government's publicity activity, drawing public attention to the facilities for co-operatives.

The **Chancellor** invited **Mr Monck** to pursue 50 (c) and to look into the other changes put forward by Mr Oakeshott.

Training Loan Pilot Scheme

The **Chancellor** thought this might be a part of an enterprise package.

Enterprise Allowances and Tax

Picking up the earlier discussion **Sir Lawrence** said the cost of putting the Enterprise Allowance Scheme into case 6 was not very great and, indeed, the Inland Revenue gained in year 1.

Sir Peter Middleton wondered what the gains were for a loss in revenue of £40 million. The **Chief Secretary** thought this was principally a reduction in pressure from Lord Young. The **Chancellor** did not accept the analogy with taxing unemployment benefit. The aim here was to get people off unemployment and onto a scheme. Nonetheless, he thought the idea should not be pursued at the moment, though we might have to reconsider it if there were more pressure.

VAT limit

The **Chancellor** accepted **Sir Angus Fraser's** advice that there was no point in pursuing an increase in the limit for the time being.

Domestic employees

The **Financial Secretary** said he had been attracted by the idea but understood the Inland Revenue difficulties. **Sir Lawrence Airey** shared views of other Treasury Ministers and advisers about the lack of political attraction in the idea. The **Chancellor** concluded that the idea should be dropped.

H J DAVIES
13 January 1986

RESTRICTED

pup

The Chancellor of Exchequer's
Informal Seminar

Chevening

10 - 11 January 1987

RESTRICTED

Annex D

LIST OF USEFUL TELEPHONE NUMBERS

Treasury	01-270 3000
Chevening House (in the Hall)	(0732) 460 654
Foreign and Commonwealth Conference Officer, Mrs Anne Morrison	(0732) 460 391
Emergency night line to Sir Peter Middleton's bedroom	(0732) 460 541

(In the unlikely event that there is no reply on the above numbers, the following number will ring throughout the entire house - (0732) 452 353.)

Secretary of the Trustees Captain J D W Husband OBE RN	
Estate Office (Weekdays)	(0732) 454 091
Home	(0732) 453 447
House Manager's Flat Mr Ennis	(0732) 457 925
Kent Constabulary Supt Rackcliffe	(0622) 654 32 Ext 251, 325, 434

Hospitals

Cottage Hospital Sevenoaks	(0732) 55155 (5 minutes by car)
Orpington General Orpington	(94) 27050 (5 minutes by car)
Farnborough General Farnborough (Intensive Care)	(94) 53333 (15 minutes by car)

Doctors

Dr W R Drysdale, Eilean Donan, Sevenoaks, Otford	Private:	(93) 23288
	Surgery:	459255
Dr Bakkar, 70 Bradbourne Road, Sevenoaks	Private:	459063
	Surgery:	457070

1. **PROGRAMME**

The programme is given at Annex A, together with room allocations. Menus are given at Annex B.

2. **TRANSPORT**

Transport arrangements for the party will be made by the Private Offices.

3. **DIRECTIONS**

Directions plus map to Chevening House, Kent, are given at Annex C.

4. **USEFUL TELEPHONE NUMBERS**

Useful telephone numbers are given at Annex D.

5. **SECURITY**

The Police have a list of all the visitors. Members of the party not arriving in official cars should be prepared to offer some form of identification to the Police Officer on duty at the entrance gate to Chevening House.

6. There are some lovely walks at Chevening and those interested should bring suitable walking shoes or gumboots. The less energetic are advised to bring reading material. Alternatively arrangements can be made for those who wish to go shopping in Sevenoaks or in historic Tunbridge Wells.

Anne Morrison

Mrs Anne Morrison
Visits Section
Protocol Department

January 1987

FOREIGN AND COMMONWEALTH OFFICE

ROUTES TO CHEVENING

BY ROAD

The basic rule is to get on to the M25 and to exit at Junction 5, following the detailed instructions under Routes 1 or 3 below. But if you are coming from the East (Maidstone etc) on the M20/M26, there is no exit at Junction 5; you have to take Route 4 below.

ROUTE 1

Get onto M25 Eastbound (towards "SEVENOAKS" and "DARTFORD TUNNEL")

- from West Midlands, Wales & the South West: via M40/M4/M3/A30
- from Heathrow (Terminals 1,2,3): via M4 Westbound
  (Terminal 4): via A3113 and M4 Westbound
- from Gatwick (& the South): via M23 Northbound
- from West, South West, South & Central London:

A316 Chiswick	A3 Putney	A219 Putney	A23 Lambeth
Twickenham	Kingston bypass	Wimbledon	Croydon
M3 Sunbury	M25 Junction 10	A24 Merton	Purley
M3/M25 Junctions 2/12		A297 Morden	Hooley
		A217 Banstead	M25 Junction 7
		Kingswood	
		M25 Junction 8	

At Junction 5 do not branch left on M25 ("M25 THE NORTH DARTFORD")

- take second exit (400 yards on: "A21 SEVENOAKS HASTINGS")

A - after ½ mile on A21: take first slip road "A25 SEVENOAKS MAIDSTONE"
- after 50 yards on A25 turn sharp left: "CHIPSTEAD ½ MILE"

B - at Chipstead Post Office, fork left onto Chevening road
- Fly-over motorways, stop at crossroads
- Straight over crossroads: "CHEVENING CHURCH: NO THROUGH ROAD"
- Past Church and police gate, bear left into forecourt.

ROUTE 2 - from South East London:

- A20, Lewisham to Footscray roundabout, 3rd exit to A224, Southbound: "ORPINGTON A224" (Sevenoaks way)

OR - A21, through Lewisham and Bromley, to join A224 (4th exit from roundabout: "BADGERS MOUNT A224 DUNTON GREEN")

C - Continue on A224 to Morants Court Cross roundabout, take 2nd exit: "SUNDRIDGE, WESTERHAM & BRASTED"
- After 1 mile, crossroads, turn right: "CHEVENING CHURCH, NO THROUGH ROAD"
- Past Church and police gate, bear left into forecourt.

ROUTE 3 - through Dartford Tunnel, from North/East of London:

- Follow M25 Southbound
- To Junction 4, take slip road: "BROMLEY A21, ORPINGTON A224"
- After 1 mile on A21, take A224 (first exit from roundabout "BADGERS MOUNT A224 DUNTON GREEN")
- Then as from C in Route 2

OR - To Junction 5, keep right onto A21: "A21 SEVENOAKS HASTINGS"
- Then as from A in Route 1.

ROUTE 4 - from East (Maidstone etc) on M20/M26:

- leave M26 at Junction 2A on A25 to Sevenoaks
- go through Riverhead, following signs to "A25 WESTERHAM", "A21 HASTINGS"
- 1 mile after Riverhead, turn right: "CHIPSTEAD"
- then as from B in Route 1.

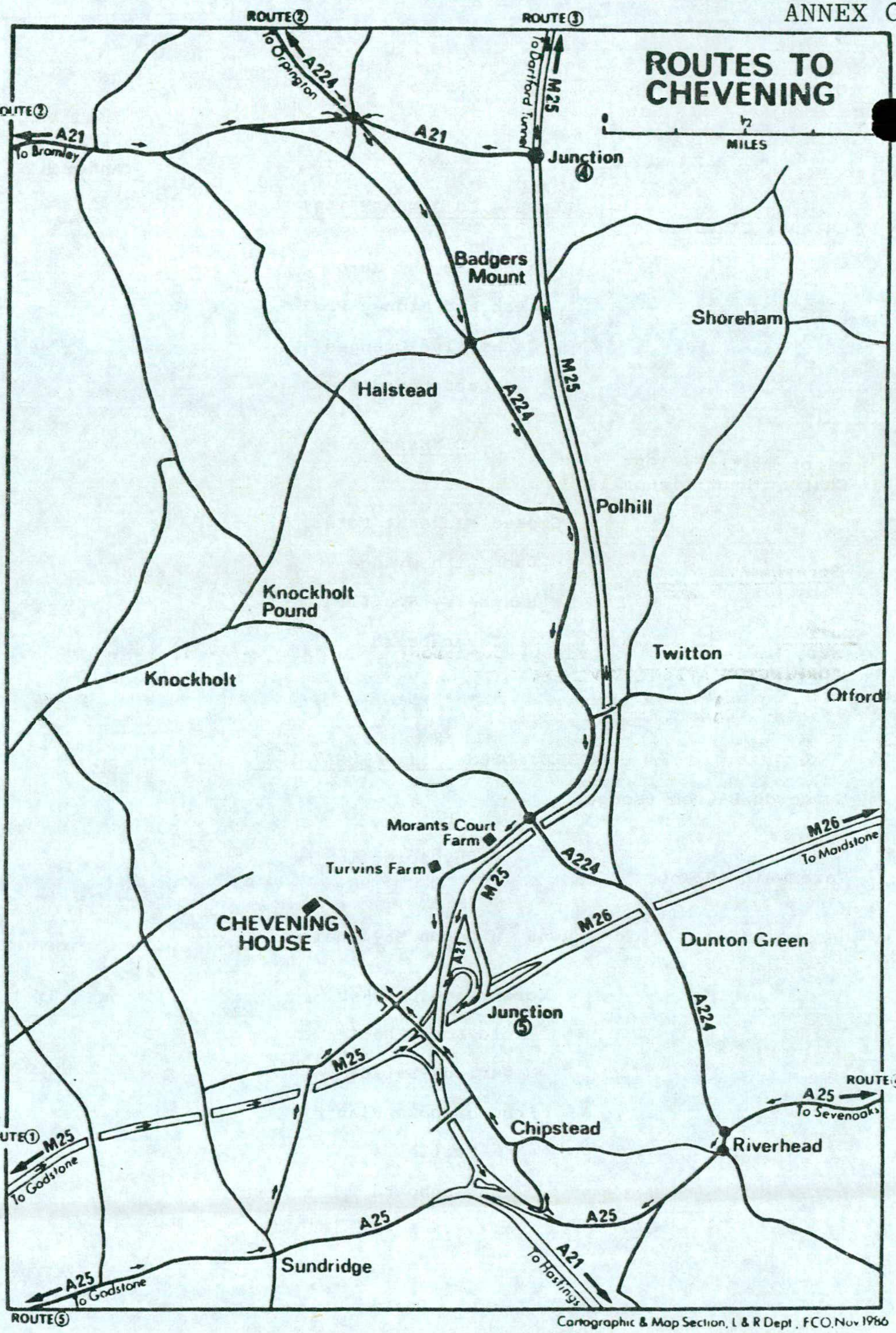
ROUTE 5 - from East Surrey:

- A25 through Westerham, Brasted to traffic lights at Sundridge
- turn left at lights: "CHEVENING"
- Fly-over M25, follow road as it bears to right
- After ½ mile, crossroads, turn left: "CHEVENING CHURCH, NO THROUGH ROAD"
- past Church and police gate, bear left into forecourt.

BY TRAIN

From Charing Cross or Waterloo East to Sevenoaks (35 minutes).
Then by car/taxi to Chevening (10 minutes)

ANNEX C



Cartographic & Map Section, L & R Dept, FCO, Nov 1986

Annex A

PROGRAMME

Saturday 10 January

1045	Party arrive Chevening Coffee will be served
1100	Talks in the Tapestry Room
1245	Drinks will be served in the Drawing Room
1300	Luncheon in the Dining Room/Alcove Room
1430	Talks resume in the Tapestry Room
1630-1700	Tea will be served in the Drawing Room — here.
1705-1845	Talks continue in the Tapestry Room
1915	Drinks in the Drawing Room
1945	Dinner

Sunday 11 January

0800-0830	Breakfast in the Dining Room/Alcove Room
0900	Talks in the Tapestry Room
1030	Coffee will be served in the Tapestry Room and Drawing Room
1200	Drinks and Buffet Luncheon in the Dining Room
1400 approx	Departure

CHEVENING HOUSE, ROOMS

First Floor	Room No	Room Name*	Occupant	Ext	Bathroom
	1.	Study Bedroom	The Rt Hon Nigel Lawson and Mrs Lawson	36	attached
	2.	Yellow Satin	The Rt Hon John MacGregor and Mrs MacGregor	34	attached
	3.	Red Bedroom	The Rt Hon Norman Lamont and Mrs Lamont	35	attached
	4.	Chatham	Tom and Emily Lawson	23	No. 4
Second Floor	5.	Pitt Room	Mr and Mrs Battishill		No. 5
	6.	Centre Bedroom	Mr Stewart	20	No. 7/10
	7.	Dressing Room	Mr Cropper		No. 7/10
	8.	Green Bedroom	Sir Geoffrey and Lady Littler	22	attached
	9.	Don's Room	The Hon Peter Brooke		attached
	10.	Bachelor's Room	Mr Cassell		No. 7/10
	11.	Minister's Room	Sir Peter and Lady Middleton	attached (Direct Line 460 541)	No. 11

* (Traditional Stanhope Room Names have been retained)

Hailsham Apartments	Room	Occupant	Ext
	Room 1	Mr Allan	37
	Room 2	Mr and Mrs Butler	
	Room 3	Mrs A Morrison	
	Room 4	Sir Terence and Lady Burns	38
	Room 5	Mr and Mrs Scholar	
Cottage	Room 1	Mr and Mrs Ross Goobey	
	Room 2	Mr Tyrie	
	Room 3		
	Room 4		

Annex B

LUNCH - 10 JANUARY 1987

Chianti Classico

Palma Ham and Melon

Steak and Kidney Pie

Caramelled Oranges

Cheeseboard

DINNER

Pinot D'Alsace 1983
Chateau Haut Lignon 1978

Smoked Mackerel Paté

Duck with Orange

Raspberry Souffle

Cheeseboard

* * * * * *

BUFFET LUNCH - 11 JANUARY 1987

Cuvee du Patron (Rouge)

Tafelwein (Blanc)

Hot

Vichyssoise

Cold

Prawns in Lemon Mayonnaise

Coronation Chicken

Cold Roast Beef

Various Salads

French Apple Flan

Trifle

Cheeseboard

* * * * * * *

CE22

12.2.87

CONFIDENTIAL

Date	CHX diary & Parliament	FSBR and Budget	External Events
Monday 9 February	ECOFIN	Chancellor's meeting on MTFS issues etc Overview 3. Paper for EcoCab circulated	ECOFIN
Tuesday 10 February		Briefing for EcoCab to Chancellor Chancellor's meeting on Budget broadcast charts	Jan PSBR (internal)
Wednesday 11 February			RPI (internal)
Thursday 12 February		EcoCab Papers for Overview 4	Unemployment figures
Friday 13 February	TCSC report on PEWP published	Revised Budget statement outline to Chancellor	RPI published provisional money (internal)
Monday 16 February		Overview 4	
Tuesday 17 February		First draft of MTFS (early sections) to Chancellor	Jan PSBR published
Wednesday 18 February	PEWP debate	Chancellor's meeting on MTFS draft (and target ranges)	GDP(O)
Thursday 19 February		Papers for Overview 5	Provisional money published
Friday 20 February		First draft of Budget statement to Chancellor 1st drafts of chapters 4, 5 and 6 to Chancellor	

12.2.87

CONFIDENTIAL

Date	CHX diary & Parliament	FSBR and Budget	External Events
Monday 23 February		Chancellor comments on Chapters 4,5,6 by noon Overview 5 Chancellor's comments on statement circulated	Trade figures
Tuesday 24 February		Full drafts of chapters 2 and 3 (MTFS/IAF) to Chancellor	
Wednesday 25 February		Chancellor to comment on chapters 2 and 3 by 10am Submission to Chancellor on revised MTFS assumptions. Draft of chapter 1 to Chancellor last date for decisions on VED	
Thursday 26 February	1st Order	Chancellor to comment on chapter 1 by 10am Papers for Overview 6	
Friday 27 February		Second draft of Budget statement to Chancellor 1st draft of FSBR (all chapters, typescript) to Chancellor [last date for VAT, excise duties changes]	
Saturday/Sunday 28 February/1 March		Chancellor works on Budget Statement	

CONFIDENTIAL

Date	CHX diary & Parliament	FSBR and Budget	External Events
Monday 2 March		Chancellor to comment on draft FSBR by 10am Overview 6 FSBR to printer, incorporating Chancellor's amendments. Submission to Chancellor on post-Budget fiscal projections Chancellor's office circulate revised version of Budget statement [Last for income tax changes]	Full money
Tuesday 3 March		Draft Budget broadcast circulated	Feb CGBR 1st estimate
Wednesday 4 March	NEDC	Chancellor meetings with HMT and (separately) Bank on MTFS	Reserves
Thursday 5 March		Papers for Overview 7	
Friday 6 March		Chancellor's office submit third draft of statement to Chancellor 1st proof of FSBR (all chapters) to Chancellor	
Saturday/Sunday 7-8 March		Chancellor works on Budget statement	

CONFIDENTIAL

Date	CHX diary & Parliament	FSBR and Budget	External Events
Monday 9 March	ECOFIN	Chancellor to comment on 1st proof of FSBR by 10am Overview 7 FSBR to printers incorporating Chancellor's comments Chancellor's office circulate revised version of Budget statement	
Tuesday 10 March		Draft EPR supplement to Chancellor Draft notes for Queen and overseas posts to Chancellor	PSBR (internal)
Wednesday 11 March		Chancellor comments on EPR, notes for Queen and overseas posts by 10am 2nd proof of FSBR to Chancellor List and presentation of press notices to Chancellor	RPI (internal)
Thursday 12 March		Chancellor comments on FSBR proof by 10am EPR supplement to printer Final proof of FSBR to printer (last opportunity for substantive changes)	
Friday 13 March		Final draft of statement to Chancellor EPR proof to Chancellor Copy of Budget statement to Prime Minister Telegram for overseas posts: final draft to Chancellor Note for Queen: final draft to Chancellor Final version of Budget broadcast to Chancellor PS/Chancellor sends copy of statement section on oil taxation to PS/Mr Walker (if necessary)	RPI published prov money (internal)
Saturday 14 March		am FSBR proofs checked in HMT am EPR proof with Chancellor's comments to printer pm FSBR proofs returned to printer, copy to Chancellor	
Saturday/Sunday 14/15 March	Chancellor finalises Budget statement		

CONFIDENTIAL

Date	CHX diary & Parliament	FSBR and Budget	External Events
Monday 16 March	Audience with Queen	Budget Cabinet Budget statement finalised (am) Read at press (FSBR and EPR)	
Tuesday 17 March	Budget Day	FSBR and EPR published	FSBR published
Wednesday 18 March	Budget debate		
Thursday 19 March	Budget debate		prov money unemployment
Friday 20 March			
Monday 23 March	Budget debate concluding day	Finance Bill 1st Reading	
Tuesday 24 March	TCSC (officials)		
Wednesday 25 March	TCSC		

RESTRICTED

The Chancellor of Exchequer's Informal Seminar

Chevening

11 - 12 January 1986

RESTRICTED

1. PROGRAMME

The programme is given at Annex A, together with room allocations. Menus are given at Annex B.

2. TRANSPORT

Transport arrangements for the party will be made by the Private Offices.

3. DIRECTIONS

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4. USEFUL TELEPHONE NUMBERS

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5. SECURITY

The Police have a list of all the visitors. Members of the party not arriving in official cars should be prepared to offer some form of identification to the Police Officer on duty at the entrance gate to Chevening House.

6. There are some lovely walks at Chevening and those interested should bring stout walking shoes or gum boots. The less energetic are advised to bring books and magazines. Alternatively arrangements can be made for those who wish to go shopping in historic Tunbridge Wells.

Anne Morrison

Mrs Anne Morrison
Visits Section
Protocol Department

January 1986

FOREIGN AND COMMONWEALTH OFFICE

Annex B

CHEVENING HOUSE, ROOMS

First Floor	Room No	Room Name*	Occupant	Ext	Bathroom
	1	Study Bedroom	The Rt Hon Nigel Lawson & Mrs Lawson	36	attached
	2	Yellow Satin	The Rt Hon John MacGregor & Mrs MacGregor	34	attached
	3	Red Bedroom	The Rt Hon John Moore	35	attached
	4	Chatham	Sir Peter & Lady Middleton	23	No 4
Second Floor	5	Pitt Room	Mr Stewart		No 5
	6	Centre Bedroom	Sir Terence & Lady Burns	20	No 7
	7	Dressing Room	Mr Cassell		No 10
	8	Green Bedroom	Mr Brooke	22	attached
	9	Don's Room	Sir Lawrence & Lady Airey		attached

Annex A

PROGRAMME

Saturday 11 January

1045	Party arrive Chevening Coffee will be served
1100	Talks in the Library
1245	Drinks will be served in the Drawing Room
1300	Luncheon in the Dining Room
1430	Talks resume in the Library
1630-1700	Tea will be served in the Drawing Room
1705-1845	Talks continue in the Library
1915	Drinks in the Drawing Room
1945	Dinner

Sunday 12 January

0800-0830	Breakfast in the Dining Room
0900	Talks in the Library
1030	Coffee will be served in the Library and Drawing Room
1200	Drinks and Buffet Luncheon in the Dining Room
1400 approx	Departure

Annex B

Niersteiner Gutes Domthal 1983	<u>LUNCH - 11 JANUARY 1986</u> Chicken Liver & Orange and Almond Pâté Plaice Veronique Caramelled Oranges Cheeseboard ************
Sancerre 1983 Brouilly Thorin 1979	<u>DINNER</u> Smoked Salmon Roulades Fillet of Beef Dijon Crêpes Suzettes Cheeseboard
Cuvee de Patron Rouge et Blanc	<u>BUFFET LUNCH - 12 JANUARY 1986</u> <u>Hot</u> Vichyssoise Prawns in Lemon Mayonnaise - Cold <u>Cold</u> Pork & Spinach Terrine Coronation Chicken (in mild curry and apricot mayonnaise) Cold Roast Beef

Room No	Room Name*	Occupant	Ext	Bathroom
10	Bachelor's Room	Mr Cropper		No 10
11	Minister's Room	Sir Geoffrey & Lady Littler	(direct attached line 460 541)	No 11

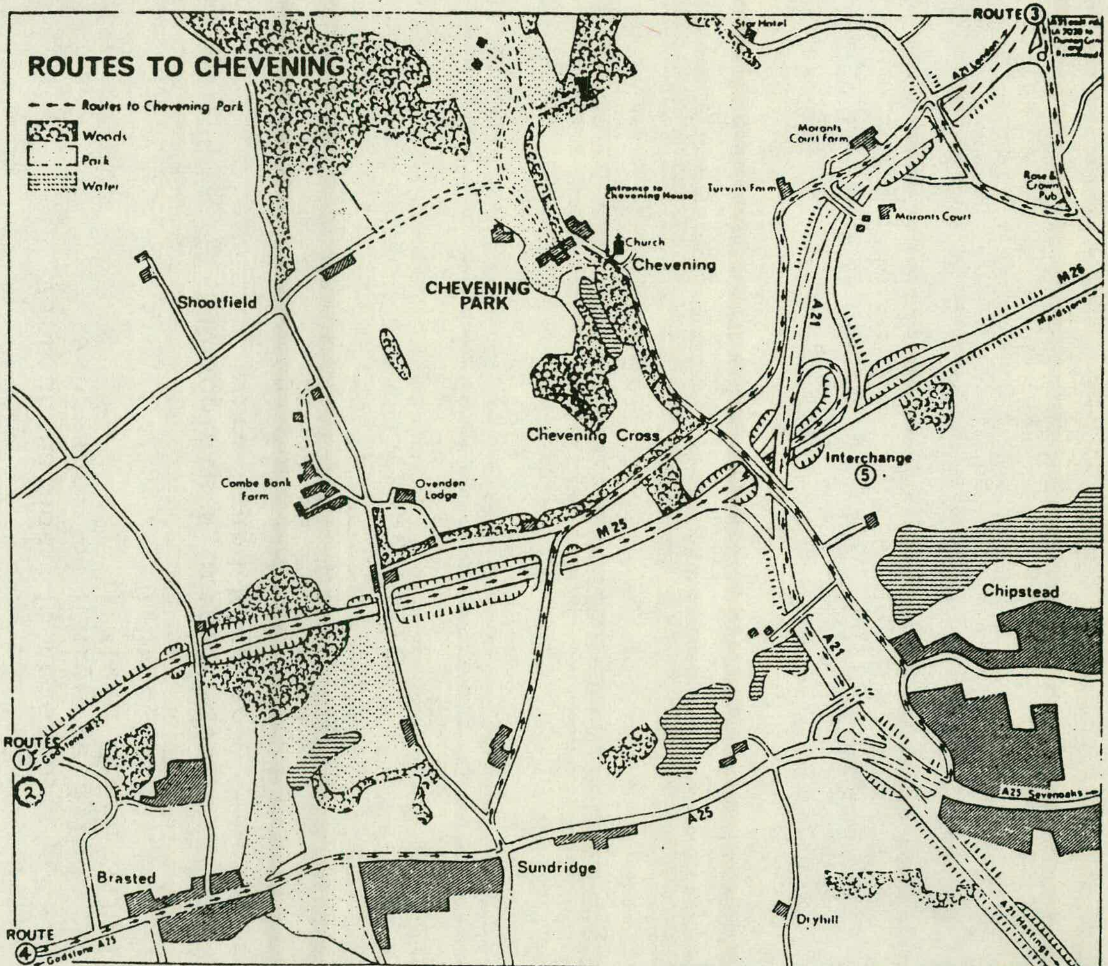
*(Traditional Stanhope Room Names have been retained)

Hailsham Apartments

Room 1	Mr and Mrs Butler	37
Room 2	Mr and Mrs Scholar	
Room 3	Mrs Morrison	
Room 4	Mr and Mrs Lord	38
Room 5	Mr and Mrs Lomax	

Cottage

Mr and Mrs Davies



Map Section L&R Dept FCO Oct 1983

Various Salads } Coleslaw
& Breads } Niçoise Salad
} Mixed Green Salad
} Rice Salad

Chocolate & Orange Mousse
with Grand Marnier

Lemon Lattice Flan

Cheeseboard

left into Forecourt of Chevening House.

From East Surrey

Either

Join M25 at Merstham or Godstone and proceed East, following exit directions as in 1 above.

Or

Route 4

Proceed along A25 through Westerham and Brasted to the traffic lights in Sundridge. Turn left at lights to 'Chevening'. Proceed over bridge across M25, bearing right with the road. Proceed about half a mile to Chevening crossroads. Turn left at crossroads - signed 'Chevening Church No Through Road'. Go through hamlet of Chevening, past Church, through Police Gate, follow road round to left into Forecourt of Chevening House.

Train

From Charing Cross to Sevenoaks (35 mins)
Then by car/taxi to Chevening (10 mins)

Motor Routes to Chevening from London

Normally the drive from London to Chevening takes one hour, but this can vary by ten to fifteen minutes, either way, depending on the time of the day and the traffic.

Route 1

Go over Putney Bridge, follow A219 through Putney High Street - Wimbledon Common - South Wimbledon - Merton - Morden - Rosehill - A217 - Banstead Downs - Burgh Heath - Kingswood to Junction with M25 two miles north of Reigate. Take the M25 towards Sevenoaks - pass the Surrey/Kent County boundary sign and about 3 miles thereafter the large sign marking Exit 5, 'A21 South and A21 North' - continue along M25 but move over to the right and get into the centre lane under the arrow marked 'Sevenoaks' on the large overhead sign - (Do not take the left hand lanes marked A21 Orpington!) Continue 1/2 mile down motorway and look on big overhead bridge for arrow marked 'Sevenoaks Hastings' (Exit 5) - take this exit to left driving up a long curving incline - stay in left lane and be prepared to take the first turning left (warning sign marked 'Sevenoaks and Maidstone A25 one third mile') - take this turning where signed 'Sevenoaks and Maidstone A25' - proceed up hill for a short distance to the 'Give Way'signs: halt there for safety. Directly in front you will see a sign marked 'Riverhead (straight ahead) 1 mile and Chipstead (to the left) 1/4 mile' - turn left to Chipstead. At Chipstead Post Office Y junction turn left along Chevening Road (with lake on right side) for about 1/2 mile - over large new bridge over Motorways - straight over crossroads - go through hamlet of Chevening, past Church, follow road round to left into Forecourt of Chevening House.

Route 2

Take A23 (Brighton Road) to junction with M23/M25 north of Redhill turn east on to M25, then follow exit directions as in 1 above.

Route 3 - SE London route

Vauxhall Bridge - Kennington Oval - A202 (this road is regularly signed to 'Sevenoaks') - Camberwell - New Cross - A20 - Sidcup bypass - St Pauls Cray - St Mary Cray - A224 past Chelsfield to junction with A21 at Badger's Mount roundabout. Follow A21 towards Sevenoaks and Hastings passing on right Black Eagle pub and on your left Polehill Garden Centre and, after 1/4 mile, Esso Garage - follow sign marked 'Dunton Gr and Riverhead' - the road then runs steeply down hill with iron barrier to left - stay in left hand lane on reaching dual carriageway - ignore sign to Otford but fork left where marked 'Dunton Green and Riverhead A2028' and Yellow sign 'Diverted Traffic London' - proceed through Dunton Green passing on your left Emma Hotel - 200 yards thereafter at Rose and Crown pub turn right at signs marked 'London A21' and Yellow sign 'Diverted traffic' - follow Morants Court Road for one third mile and turn left at signs marked 'Sundridge 2 1/2 Brasted 3 1/4'. The road narrows and twists but after 1 mile will bring you to the Chevening Crossroads - at crossroads turn right where signed 'Chevening Church No Through Road' - go straight through to end of village, past Church and through Police Gate. Follow road round to

/left

Hospitals

Cottage Hospital, Sevenoaks	(0732) 55155 (5 mins by car)
Orpington General, Orpington	(94) 27050 (5 mins by car)
Farnborough General, Farnborough (Intensive Care)	(94) 53333 (15 mins by car)

Doctors

Dr W R Drysdale Eilean Donan Sevenoaks Otford	932 3288
Dr Bakkar 70 Bradbourne Road Sevenoaks	459608

Annex D

LIST OF USEFUL TELEPHONE NUMBERS

Treasury	01-233 3000
Chevening House (in the hall)	(0732) 460 654
Foreign and Commonwealth Conference Officer, Mrs Anne Morrison	(0732) 460 391
Emergency night line to Sir Peter Middleton's bedroom	(0732) 460 470

(In the unlikely event that there is no reply on the above numbers, the following number will ring throughout the entire house - (0732) 452 353.)

Secretary of the Trustees
Major General J D C Graham CB CBE

Estate Office (Weekdays)	(0732) 454 091
Home	(0732) 453 447
House Manager's Flat Mr Ennis	(0732) 457 925
Kent Constabulary Supt Rackliffe	(0622) 654 32 Ext 251, 325, 434

1253/33

FROM: A ROSS GOOBEY
DATE: 12 FEBRUARY 1987

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Mr Cropper
Mr Tyrie

CHANCELLOR'S MEETING WITH PPSs - 11 FEBRUARY

Present:	Chancellor	
	John Cope, MP	David Atkinson, MP
	Peter Lilley, MP	Martin Brandon-Bravo, MP
	Tony Baldry, MP	Alistair Burt, MP
	Mrs V Bottomley, MP	Michael Colvin, MP
	Graham Bright, MP	Stephen Dorrell, MP
	Kenneth Carlisle, MP	Tony Favell, MP
	Jim Couchman, MP	Eric Forth, MP
	Greg Knight, MP	Robert Hayward, MP
	David MacLean, MP	Ken Hind, MP
	Steve Norris, MP	Robert Key, MP
	Tom Sackville, MP	Andrew Mackay, MP
	Michael Stern, MP	Patrick Nicholls, MP
	Ian Mills, MP	Derek Spencer, MP
	Richard Ottaway, MP	Spencer Batiste, MP
	Alastair Ross Goobey	

Tony Baldry thought the choice between tax cuts and higher spending is a false one. The starkest fact to remember is that in the US the highest rate of tax will soon be lower than Britain's lowest rate. There is much to be gained from pushing Mr Hattersley down his cul-de-sac on this.

Graham Bright wanted the special car tax removed. He also thought companies spent unproductively merely to avoid tax, and supported "enterprise bonds".

Jim Couchman wanted pensioners to share in any largesse - no more penny increases.

David MacLean thought the time inopportune to cut top rates.

Andrew Mackay said that in 1983 the mortgage relief limit had been raised. That was a mistake and should not be repeated.

Tom Sackville thought that every pound an elector saves in mortgage interest is worth twice that received in tax cuts, so a Budget achieving lower interest rates is desirable.

Stephen Dorrell agreed that the most unpopular factor would be an increase in interest rates at an inopportune moment, and the Budget should be framed with that in mind - if there was a chance that interest rates could rise again after an initial fall, we should forego the initial fall. The marginal rates of NICS/tax and means-tested benefits can be addressed and would substantially embarrass Mr Hattersley.

Ian Mills put in a plea for a commitment to the Trade Mark Office in the Budget speech.

Kenneth Carlisle thought that the strength of the economy indicated a lower PSBR but 1p off income tax would be a taster for the electorate, and better than thresholds. It would be a mistake not to index tobacco and drink.

David Atkinson wants continuing progress towards 25p and maintained linkage with the small business rate. The top rates should be cut at another time. The tobacconists lobby would be pleased if cigarettes were no more than indexed. He asked that the 40,000 over-80's who do not qualify for full state pensions should be uprated.

Virginia Bottomley asked for a crumb towards regional policy, suggesting variable rate NICS in regions. She was strongly opposed to multi-mortgages on single properties, would like relief restricted to basic rate and the limit raised to £35-40,000.

Robert Hayward suggested a widening of VAT and a reduction in the rate to 10% in the next Parliament. He reminded the Chancellor that Airbus and Rover support were sensitive election issues and asked for something for pensioners.

Steven Morris was concerned with the starting rate of tax and would like a 15% rate phased in for a lower band.

Michael Colvin asked for a different approach this year to the fat and lean cats; the former will have to wait. Having been a thresholds man he is now firmly in favour of a rate cut. He asked whether the Treasury could make some transitional contribution to the costs to farmers of the changes promulgated in the ALURE document.

Patrick Nicholls said he would prefer to face a room of NFU delegates than of pensioners since the latter simply do not believe the good story.

Robert Key wanted implementation of some form of Green Paper personal tax reform. He would also like extension of the charities package and something to be done about excise duties on British vineyard produce.

Ken Hind wanted to continue the trends on NICS and thresholds. He also wanted capital allowance on greenhouses.

Derek Spencer said that in normal times he would favour a rate reduction but today he would prefer something for the less well off.

Martin Brandon-Bravo asked whether there was evidence on the flow-back through VAT from income to cuts.

Spencer Batiste observed that despite the level playing field, take up of items like the BES favoured the South. Greater simplification would suit the North.

Alistair Burt identified guilt as the burden of our soft support; and the Budget shsould cater for these feelings. He wanted more funds for housing and home improvement grants.

Tony Favell was more robust. He wanted no U-Turn on tax cuts since the guilt-ridden will vote SDP anyway. He would hope for some reduction in interest rates as well.

ARG

A ROSS GOOBEY

CONFIDENTIAL

3217/2

FROM: P J CROPPER
DATE: 12 FEBRUARY 1987

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Mr Ross Goobey
Mr Tyrie

CHIEF SECRETARY'S PRE BUDGET BACKBENCH MEETING

WEDNESDAY 11 FEBRUARY 1987

Michael Morris would cut the rate by 2p and hold another 2p in the shop window. Capital Gains Tax needed more attention: ordinary people in Northamptonshire were paying unreasonable amounts of tax. The Budget should have something for the elderly - raise the income disallowance for pensioners?

Bill Cash thought we must cut taxes, but also try and bring down interest rates.

John Butterfill wanted a little off Income Tax and some more off Corporation Tax. He invited the Treasury to look at a "Help the Aged" submission on aspects of the annunity scheme for the elderly based on "sale and leaseback" of the home. Could last year's VAT concession on medical supplies be extended to veterinary? BES charges were too high.

Peter Bruinvels thought interest rates were still too high. He favoured 2p off this year and 2p off next year.

Robert Banks wanted something significant off Income Tax, and more to encourage sponsorship of the arts (not fully aware, seemingly, of last year's charity measures).

David Ashby wanted top rates cut. We should have top and bottom rates - 40% and 25%. We should abolish the iniquitous Class 4 NI.

Peter Bruinvels hoped we were going ahead with transferable allowances. Michael Morris hoped we were not.

Michael Morris recommended a Bill Cash speech on interest rates that had been delivered to the Banking Bill committee.

All agreed, under questioning, that the heart had gone out of the campaign for more public expenditure in preference to tax cuts.

P J CROPPER

psl/95A

Pup.

Note
Transcript A
mtg notes
give to
Sir T
Burns.

PERSONAL

POLICY IMPLICATIONS: CHEVENING DISCUSSION

Chancellor: continuity is absolutely crucial. Must manifestly be seen to be a continuation of what we have been doing hitherto. Perception of last Budget before Election may affect detailed contents. Basic fiscal (and monetary) stance should be exactly what it would be with no Election on horizon.

Terry: mature stage in recovery. Had benefits in 1986 to inflation from lower oil prices. Continued growth of demand. Some signs of pressure on imports and inflation. Danger of finding ourselves on path above MTFS path. Inflation of 4-5 per cent rather than ambitions of decline. But very good outturn on fiscal side. Revenue very buoyant. Profits and demand greater than what can be delivered over medium-term. CT reforms now mean more revenue than expected. Tax exhaustion running-off faster than expected. Important to maintain continuity. Danger of demand and money GDP growing too rapidly. For reasons not entirely clear. Earnings growth remains rather strong.

Terry continued: my bias is for cautious approach, to avoid correction later. Have started that by keeping interest rates up (to stop exchange rate falling in particular). For Budget, to what extent should we take more cautious approach to fiscal policy than in MTFS? Paper sets out arguments why some of the strain might be taken on interest rates. But also cautious approach on fiscal policy. Conclusion I reached is strong case for taking some on fiscal policy. PSBR is benefiting from rapid growth of consumption. So just as in 1981, allowed PSBR above path, in present buoyant stage have PSBR below. PSBR adjusted for privatisation proceeds is short-hand. And more comfortable. Can influence how outsiders think!

Yet more Terry: present our case, demonstrate clearly we have a good case. Reassure them not biasing it in one general direction. People expect bias towards ease. I want bias towards caution. At moment awash with revenue. Projections show fiscal adjustments of £4-5 billion. Nervousness in having adjusted revenue projections so rapidly, can't be too confident. Whole direction is upwards. So there is room for caution.

and again: Some of scope is public expenditure growth less than underlying growth of economy. No reason why this shouldn't be returned to taxpayer: that's our policy! Split fiscal adjustment into earned and cyclical. When times are difficult we have consistently moved PSBR adjusted for inflation upwards. 1986 in particular time to take it in other direction. I am by nature cautious - give large part to PSBR.

Chancellor: agree question of striking balance. Balance between opportunity to get PSBR down a bit. Compelling reasons for earlier period not now there. Opportunity to continue to make progression on income tax cuts. Fiscal/monetary balance. Must not delude ourselves. Whatever conclusion we reach on fiscal side unlikely to affect monetary side. Given extent to which monetary policy looks a problem (credit growth, M0), very very important to avoid fall in exchange rate. Delude ourselves if we think we can buy a loosening of monetary policy in foreseeable future by having tighter fiscal policy. Assumption of interest rates remaining at this level is reasonable. Think it rash to embark on policy designed to get interest rates down. At the moment very poor trade-off between exchange rates and interest rates. If sentiment improves, then in position to get interest rates down a bit. Rash to count on that.

Terry: very lucky to see interest rates come down. What concerns me is threats which might force them up further. Don't see gain on interest rates if fiscal policy tighter. But if don't take cautious approach we are more vulnerable to run of bad figures. Given what is happening to inflation, the exchange rate and the external position, people won't give us benefit of doubt. More at risk that in summer we could be forced to higher rates.

Peter: at end before beginning. Relative path of exchange rate is interesting. Is it measure of broad consequence of our policies? If we were all going to be here for next five years what policy stance? Current stance seems to be money GDP at 7 per cent. Implies inflation cycling at 4-5 per cent. Is that good enough? Should we try to make money GDP path come down? Taking decisions against background where at best constant.

Chancellor: very fair (~~question~~ ? too defeatist). Abolished stock cycle, not trade cycle. Extremely difficult to get inflation down in the up-swing of the cycle. In the past had secular deterioration, with inflation coming down less in the down-swing than it went up in the up-swing. We have improved trade-off. During up-swing inflation gone up very little. Dip because of oil but underlying flat. Suspicion that it is very difficult indeed to make further progress until next stage of cycle. Then consolidate. Ratchet down.

The sundry interventions and not involving you.

Terry: very much agree with cyclical point. Never in past got inflation down after early stage of recoveries. Have to minimise increase in up-swing. Would not regard undershooting PSBR profile as a great tightening. Because of its nature PSBR can't come down fast. CT paid late etc. Revenue cycle. PSBR cycle moves in exact opposite to inflation cycle (as EST said). So no great tightening or discontinuity. Previous year turned out at £5.8 billion to our great surprise! So old path looks a bit out of date. But principle of continuity is right.

[A few more bits missed out, mainly about new assumption on use of fiscal adjustments.]

SECRET

TAX ISSUES

This paper gives a preliminary assessment of the main tax issues which arise for the 1986 Budget.

2. Annex 1 gives a summary of the main Budget starters.

3. The main questions appear to be:

- the scope for income tax cuts, from rate reductions or threshold increases or both

- whether additional revenue might be raised through higher indirect taxes, either by over-indexation of excise duties, or by an increase in the VAT standard rate

- what other major changes are to be included.

4. On the last, although no firm decisions have yet been taken, the firmer candidates seem to be:

- abolition of the CTT lifetime charge

- a stamp duty package

- provision for the future of the Business Expansion Scheme

- action on pension fund surpluses and other possible measures against abuse.

5. Other possibilities you will want to consider include:

- action in the "ration of savings" area

- action in the business tax field on consequentials of thc 1984 packagc

TAX ISSUES

- extended relief for charitable giving

- enterprise and employment measures: SBICs, Weitzman, research and development

6. You have also asked for a commentary on the recent CBI tax reform proposals, the main one of which is that we should move towards an expenditure tax. The Inland Revenue will be providing this early in the New Year.

<u>**Personal income tax**</u>

7. There are new features on the scene this year which suggest that the choice between action on thresholds or on tax rates, or a combination of the two, is more open than it has seemed in recent years. In particular, the Green Paper (now likely to be published at the time of the Budget) will set out a strategy for the restructuring of personal taxation. The proposals in this Green Paper have some implications for the way in which tax reductions should be made during the period leading up to the introduction of the new system. Threshold increases in the next few years will push up the cost of implementing transferable allowances. Conversely, reductions in the basic rate will cut the cost of TAs. Costings for a range of options are set out in Annex 2.

8. Mr Fowler's proposals to calculate income related benefits (family credit and housing benefit) on the basis of net income will eliminate the problem of 'marginal tax rates' above 100 per cent, at the cost of increasing the numbers with rates over 70 per cent. This change is not planned until 1988-89, but when it is made it will somewhat weaken the arguments for threshold increases both in terms of poverty trap effects and of their proportionate benefit to the lower paid.

Discuss – + see Annex 3 below

? as compared with rate reductions

9. Applying the statutory indexation provision would mean raising allowances and thresholds at least in line with prices (5½ per cent on Autumn Statement assumptions). The next obvious target is 'earnings indexation' (7 per cent on Autumn Statement

assumptions) at a 1986-87 cost over statutory indexation of about £220m. Anything less than this would mean an increase in the number of taxpayers as earnings rise and hence an increase in Revenue staff requirements - in fact something rather more would be needed to avoid extra staff costs because of the estimated increase in the number of higher rate taxpayers.

10. Each further pecentage point on allowances would cost £175m in 1986-87, and £215m in a full year. Each point off the basic rate would cost £1,025m* in the first year, and £1,200m in a full year. Threshold increases reduce the Revenue staff requirement but reductions in the basic rate do not. Annex 3 attached (with a one page summary) discusses the distributional and incentive effects of selected equal-cost rate and threshold changes. The separate Inland Revenue 'sighting shots' paper (Mr Blythe's submission of 19 December) sets out fuller details of a range of possible options.

11. <u>Higher tax rates</u>: A number of packages were looked at in the run-up to the 1985 Budget. Ministers will want to want to consider what options are worth considering this year. The Chancellor has asked for costings of options which:

- stretch out the rate bands (including the relatively short first slice of £3,000 at 40 per cent)

- reduce the number of bands

- reduce the top rate.

As with the personal allowance/basic rate choice, there is an important distinction between changes which reduce Inland Revenue workloads (increasing the <u>first</u> higher rate threshold) and those which do not (anything else).

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* An extra £100m if the composite rate is also changed. (Under last year's legislation the 1986-87 rate will be based on the circumstances of 1985-86.)

SECRET

12. Another option which would reduce the Inland Revenue workload would be restriction of mortgage interest relief to the basic rate.

always [illegible]!

13. Ministers have also looked at the options for a reduced rate band. The Revenue have advised (Mr Mace's note 'Steps towards transferable allownces' of 1 November) that the change would not in substance ease the problems of the Green Paper transition, quite apart from the fact that the lead timc for introduction - and current work-state problems - rule out early action. The Chancellor has said that no further work is needed.

this will [illegible] substantial

14. Other personal tax issues: There are two important subjects for regular annual decision:

- the car benefit scale charges: these still look to be well below realistic levels (Mr Prescott's note of 22 November). A 10 per cent increase for 1987-88 would yield £35m. The proposed re-alignment of the engine size 'break points' to meet the industry's wishes will however mean that the distributional effects of both changes together would need careful handling.

- the mortgage interest relief ceiling: this was last increased in 1983. A £5,000 increase to £35,000 would cost £80m-£120m in 1986-87 and save 75 Revenue staff.

Keep this in hand for CP negotiations with PM.

Apart from this, the only other major candidate is tax relief for the costs of domestic employees. (to combat some of the black economy)

Is there any work on this.

Excise Duties and VAT

15. The first candidate for raising additional tax revenue from indirect taxation is the over-indexation of some excise duties. Increasing the rates of all the specific excise duties by one and a half times the revalorisation factor of 5½ per cent would yield an additional £370 million in 1986/87 and £380 million in a full year. The RPI impact effect of this package would be some 0.6 per cent compared with the 0.4 per cent for straight

revalorisation. The RPI impact effect of last year's Budget measures was 0.5 per cent. There would, of course, be scope for varying the individual components of such a package - last year VED was increased by more than double revalorisation and beer, wine and tobacco by 1½ times revalorisation. This year, OPEC developments make a strong case for over-indexation of the oil duties. Mr Ridley would however like to leave VED for private cars unchanged, and perhaps reduce it for some lorries (his letter of 18 December).

below -

16. The only option for raising any significant amount of revenue from VAT would be an increase in the standard rate. Raising it by one percentage point (on the existing coverage) would produce an extra £675 million in 1986/87 and £925 million in a full year, and have an RPI impact effect of 0.5 per cent. Extension of the VAT base is ruled out by the statement in this year's Budget speech that there was no intention to extend the VAT base during the lifetime of this Parliament. Although this was qualified by the need to take account of European Community law and treaty obligations, Ministers have said that we will fight the infraction proceedings proceedings on our VAT zero-rates in the European Court. There is no sign that these are being pressed at present. But in any case, the infraction proceedings would affect only a limited area of our zero-rates, of which non-domestic construction is the most important. We could not say that European law required us to withdraw our zero-rates more generally, because the need for unanimity means that the UK has the power of veto over any such changes.

17. The Commission's White Paper on Completing the Internal Market said that they would make proposals for harmonisation of excise duty and VAT structures and approximation of rates. As a step towards their goal, the Commission have published draft proposals for a 'standstill' on VAT and excise duties. But these proposals, even if adopted in their present form, would not inhibit us from increasing any of the major excise duties, or from raising the standard rate of VAT up to 17½ per cent.

18. The staffing costs of the excise duty and VAT rate options would be small. Further details of the indirect tax options, and a ready-reckoner, are in a separate paper by Customs and Excise (Sir Angus Fraser's minute 20 December).

below -

Business taxes

19. Implementation of the 1984 reform package will continue in 1986-87 without further legislation. The main capital allowance rates for 1986-87 and the corporation tax rates for 1985-86 and for 1986-87 were fixed in the 1984 Finance Act (the rate is generally set in arrears). 1986-87 is the first year of the complete, post-transition regime. Annex 4 outlines the 1984 package; gives a brief account of the outlook for the company sector (further details are in IFG(85)12); and sets out the latest assessment of the impact of the 1984 package on business tax burdens.

below background page

Mining and Oil Allowances

20. There is a commitment to include a revised Mines and Oil Wells Allowance (MOWA) code in the 1986 Finance Bill. A recent consultation paper has proposed changes to bring the code more closely into line with the post-1984 regime for capital allowances generally.

you have seen + agreed this. (steady as she goes)

21. Mr Cassell's note of 18 December reports the outcome of this year's Review of North Sea Fiscal Regime. He concludes that falling oil prices, and lower future oil price expectations are affecting North Sea economics, but not so as to require change to the fiscal regime. The only other substantial issue is the tax treatment of incremental projects. No cost-effective candidates for a relief have emerged since last year, but there is a case for a statement in the 1986 Budget that Ministers retain an open mind on the issue. There are also, as usual, a few proposals for minor technical change to the oil tax regime.

Capital Taxes

22. The Chancellor has provisionally decided in favour of abolishing the capital transfer tax lifetime charge. Subject to wide uncertainty about the possible behavioural effects, this might cost about £40m in the first year. On the illustrative assumption that lifetime gifts would double this might build up to about £250m by early next century.

23. **Capital Gains Tax** was substantially reformed in the 1985 Budget. The Chancellor has provisionally decided against major change in 1986.

?

24. **Stamp Duty** Ministers are considering:

In folder below

(i) a broadly revenue-neutral package on stamp duty on share transactions (Mr Draper's note of 20 December). This might consist of:

✓ a. abolition of the tax on share transactions by individuals;

Plus. as from 1st Nov.?

? b. reduction in the rate to ½% for share transactions by institutions etc;

hows compl? Considering (for many of these [illegible])

c. an extension of the duty to a wider range of city financial transactions, including intra-account dealing, but going a good deal further;

✓ d. increasing the charge on ADR conversions.

✓ ii. keeping the rate of duty on houses unchanged (though perhaps with an increase in the threshold).

? iii. abolition of capital duty (costing £160m in 1986-87) and unit trust duty (£15m in 1986-87).

iv. a number of more-or-less technical changes to prepare for the Stock Exchange "Big Bang" next autumn.

25. Minister have also asked for the possibilities of an alternative tax on financial services to be considered. Miss Sinclair's submission of 20 December discusses three possible candidates:

In same folder below

i. A broadly based tax on financial transactions.

ii. A tax on financial institutions balance sheet.

iii. More effective tax of certain lump sums received by individuals.

–

Pensions and saving

26. Ministers have decided to defer until 1987 legislation on the tax implications of Mr Fowler's 'personal pension' proposals, since they will not now take effect until 1988. The Revenue have also put forward a package of further possible changes to streamline administration, curtail abuse, and modify the treatment of pension fund surpluses (Mr Munro's notes of 28 November). The Chancellor is minded to take action on pension fund surpluses, and is considering loan-backs and self-investment further.

You have seen this & the follow-up note.

27. Ministers are also considering the case for a further tranche of tax-privileged savings possibly linked to retirement or targeted on equities. (Miss Sinclair's note of 22 November). The Chancellor has rejected all except the "income tax" option. The Financial Secretary has asked for further work to be done on the details of this option.

Enterprise and Employment

28. The present Business Expansion Scheme expires in April 1987. The Chancellor has promised publicly that he will say something about the future of the scheme in the 1986 Budget. He has decided provisionally that:

i. The scheme should be extended indefinitely, though subject to review.

Nick Folger was v. vehement about the need to do this when I saw him on Friday.

ii. Asset based activities should as far as possible be excluded by general formulae, although there should also be a power to include or exclude specific trades or types of trades by statutory instrument.

iii. A decision as to whether a ceiling should be placed on the amount raised by a company should be postponed until we see how effective the general formulae under ii would be, and in particular whether a restriction to land and buildings would be practical.

iv. BES shares should be exempt from CGT on first sale.

29. The Revenue are preparing advice on the options for 'Weitzman' pay arrangements. They will also be reporting on the case for

a relaxation in the rules for expenditure on R&D before a business is able to start trading. The options for assistance to co-operatives are considered in Mr Monck's paper of 20 December.

below

Employee share schemes

30. The Financial Secretary has proposed a package of changes in the existing provisions:

- to permit the use of shares subject to a pre-emption condition when the employee leaves (eg in small family companies)

- to ease the rules hindering the introduction of schemes by employee controlled companies

- to improve the rights of participants in savings related share option schemes.

Charitable giving

you've seen + it's back in your box with further comments from Mr + Advisers

31. Mr Stewart's submission of 13 December considers the possibility of further tax reliefs for charitable giving possibly coupled with an exclusion of 'private indirect' charities, newly defined. These include:

a. abolition of the present £10,000 limit on higher rate relief for covenants by individuals. This would, incidentally, remove the need for apportionment of covenanted giving by close companies;

E kaye!

b. the measures proposed by the Home Secretary and Sir Adam Ridley - corporation tax relief for single gifts by companies (instead of the present restriction to covenants); some sort of incentive for single gifts by individuals - perhaps tax remission at half basic rate; and measures to encourage payroll giving.

32. Another option is the possibility of selective VAT relief for charities - either for all purchases by certain kinds of charity, or for certain purchases by any charity. This is examined in Mr Jefferson Smith's note of 27 November.

on the charitable giving string

839/04 ANNEX 1

CL's Covering folder (Note 1 ...)

ANNEX 1: REVENUE & STAFFING EFFECTS OF MAIN BUDGET STARTERS

SECRET

REVENUE AND STAFFING EFFECTS OF MAIN BUDGET STARTERS

	REVENUE Cost(-)/Yield(+) £m against indexed base 1986/87	Full year	STAFF Addition(+) /Saving(-) At April 1988	COMMENTS
A. EXCISE DUTIES AND VAT				
Revalorisation of all specific excise duties (including VED):				
i. by 5.5%	NIL	NIL	NEG	(Costs £m 770(86/7) £m785(f/y) (0.4 per cent increase in RPI.
ii. by 1.5 times revalorisation	375	385	NEG	0.6 per cent increase in RPI
VAT: Motoring expenses	25	50	NIL	
VAT: Avoidance by disaggregation	10-15	15-20	NIL	
VAT: Long term lettings of accommodation	3	10	NIL	
VAT increasing rate to 16%	675	925		RPI impact effect 0.5
[17%	[1340	1835	?	" 1.0]
B. PERSONAL TAXATION				
Income tax thresholds and rates				
i. Prices indexation (5.5%)	NIL	NIL	+140	Costs £m1150(86/7),£m1450 (f/y)
ii. Earnings indexation (7%)	-220	-275	+90	
iii. £2 per week for married man (10% on basic allows)	-710	-900	-25	
iv. 13% (approx) on basic allowances	-1200	-1500	-140	Options ii-ix same cash
v. Earnings indexation plus 1p off Basic Rate	-1200	-1450	+90	increase for aged. 1987-88
vi. 10% plus 1p off Basic Rate	-1725	-2100	-30	costs approximately equal
vii. 19% on basic allowances	-2150	-2700	-355	full-year costs
viii. 13% plus 1p off Basic Rate	-2150	-2650	-140	
ix. Earnings indexation plus 2p off Basic Rate	-2150	-2600	+85	
x. Prices indexation plus 1p off Basic Rate	-980	-1175	+140	
xi. Prices indexation plus 2p off Basic Rate	-1930	-2325	+135	
xii Prices indexation plus 3p off basic rate	-2895	-3485		

(NB 2½p option)

	REVENUE Cost(-)/Yield(+) £m against indexed base 1986/87	Full year	STAFF Addition(+) /Saving(-) At April 1988	COMMENTS
Tax relief for wages of domestic employees				
i. Full time staff only	see	-100	+30	Cost in 1986-87
ii. All domestic staff	comment	-250	+120	depends on decisions
Car & Fuel benefit uprating and related breakpoints				
i. Adjusted breakpoints only	NIL	NIL	NIL	45-70 units setting up costs in 1986-87
ii. Adjusted breakpoints +10% scale charge increase	NIL	+35	NIL	Yields £35m in 1987-88
Benefits in Kind: Threshold (£8500) (Options assume that P11DA replaced by certificate)				
i. Maintaining existing threshold	NIL	NIL	-50	
ii. Raising threshold for all benefits to £15,000	NIL	-160	-450	
iii. Abolition of threshold	NIL	+80	+150	FST has recommended option i.
Relief for overseas travel expenses	-10	-5	+20	Estimates very uncertain
Employee shares scheme package	NEG	-7	+10	
Pensions				
Surpluses, loanbacks, self-investment				Depends on decisions
Savings relief				Cost depends on decisions
Charitable giving package				
i. Abolition of £10,000 limit on HR relief	-1	-2	+10	
ii. New reliefs (single gifts etc)				Depends on form of relief
Mortgage interest relief limit for 1986/87				
i. £30,000 (present limit)	NIL	NIL	NIL	
ii. £35,000	-75 to -100	-80 to -120	-60	Eventual cost at 86/7 income levels £m200 to £m300 building up over 5 years

	REVENUE Cost(-)/Yield(+) £m against indexed base 1986/87	Full year	STAFF Addition(+) /Saving(-) At April 1988	COMMENTS
C. BUSINESS AND OIL				
Business Expansion Scheme			NEG	Probably some yield from improved targetting
Capital Allowances: Expensive cars: abolition of ceiling amounts of allowance	NEG	-60	NEG	
Mines and Oil Wells Allowance (MOWA)	NEG	-45	NEG	
Tax treatment of Enterprise Allowance (exemption option)	-3	-23	NIL	
Capital Allowances: Technical amendments consequent on abolition of first year allowances	NEG	-	NIL	Full year cost of £50m eventually rising to £200m if no action taken. Forecast assumes no significant costs.
Section 252 ICTA: Tax loss on transfer of trade between companies in common ownership	NEG	+40	NIL	
Deposit interest: Payment gross outside composite rate scheme	-10 to -30	NIL	NEG	Cost in first year only
D. CAPITAL TAXES				
CTT: Indexation of thresholds and bands	NIL	NIL	NEG	
CTT: Abolition of charge on personal life time gifts	-40	-55		Some long term staff saving
CGT: Threshold indexation	NIL	NIL	NEG	
CGT: Dual resident trusts	see comment		NIL	Loss could run into £m100s if no action taken. Forecast assumes no significant loss
CGT: Futures and traded options in gilts	see comment		NEG	Could be significant loss of tax if no action taken

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	REVENUE Cost(-)/Yield(+) £m against indexed base 1986/87	Full year		STAFF Addition(+) /Saving(-) At April 1988		COMMENTS
Stamp duty package:						
i. Reducing duty 1% to 0.5% on share transactions	-180	-180	)		)	
ii. A £5000 increase in £30,000 threshold for houses	-75	-80	)		)	First year revenue costs
iii. A charge on intra-account transactions	+5 to +15	+5 to +15	)		)	depend on start dates
iv. Capital duty repeal	-160	-160	)		)	
v. Unit trust duty repeal	-15	-15	)		)	
vi. Abolition of duty on share transfers by individuals	up to -100	-100	)	NEG	)	
vii. Reducing duty to 0.5% on share transactions by institutions	-130	-135	)		)	
viii. Increased charge on ADR conversion	small yield					

Can't be anything like £100m. surely: substantiate (incl effect of Nov: standards on 1st yr ~~[illegible]~~ yield)

ANNEX 2: COST OF IMPLEMENTING TRANSFERABLE ALLOWANCES

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ANNEX 2

COST OF IMPLEMENTING TRANSFERABLE ALLOWANCES

The figures below assume that transferable allowances would be implemented on a "no cash losers" basis; costs are for a full year at 1986/87 income levels. Option numbers are those in the Inland Revenue 'sighting shots' paper (Mr Blythe's note of 19 December).

OPTION		COST £bn	INCREASE/DECREASE OVER 1A £m
1A	Allowances indexed in line with prices (5½%)	5.40	-
2A	Allowances increased in line with earnings (7%)	5.45	+50
3A	Allowances increased by 10%	5.55	+150
4A	Allowances increased by 13%	5.65	+250
4B	Allowances increased by 7%; 1p off Basic Rate	5.30	-100
5B	Allowances increased by 10% ; 1p off Basic Rate	5.60	+200
6A	Allowances increased by 19%	6.15	+750
6B	Allowances increased by 13%; 1p off Basic Rate	5.80	+400
6BX	Allowances increased by 7%; 2p off Basic Rate	5.15	-250
-	Allowances increased in line with prices; 1p off Basic Rate	5.25	-150
-	Allowances increased in line with prices; 2p off Basic Rate	5.10	-300

([illegible] £5 bn)

ANNEX 3

TRAP AND DISTRIBUTIONAL EFFECTS OF INCOME TAX OPTIONS: SUMMARY

The options examined are a 2p cut in the basic rate and an equal cost increase of 11% in the basic allowance.

The poverty trap

2. **Pre-Fowler** the number of people with marginal rates over 70% is about 450,000. The rate option would have virtually no effect. The allowance option would reduce the number by about 40,000. These are people at the bottom of the trap taken out of tax.

3. **Fowler** would abolish marginal rates above 100%, but double to about 900,000 the number with rates above 70%. The rate option would reduce this number by about 50,000, and the allowance option by about 80,000. These are people at the top of the trap floated off benefit. Because these are not the lowest paid, the rates option has more effect than it does pre-Fowler, though still less than the allowance option.

The unemployment trap

4. **Pre-Fowler**, there are about 2m families with replacement ratios above 70%. The rates options would reduce this number by about 160,000 and the allowance option by about 230,000.

5. **Post-Fowler**, the number of families with ratios above 70% will fall slightly to about 1.9m. The rates option will reduce it by about 110,000 and the allowance option by about 150,000. Both tax options have less effect because after Fowler tax reductions will mean lower benefits, but the relativity between the two options is unchanged.

Distributional effects

6. Those on lower incomes gain more from the allowance option, those on higher incomes gain more from the rates option. Pre-Fowler, the breakeven point is about £120 a week for single people and about £180 a week for one-earner couples. The average gains for those at work would be larger under the rates option. For the unemployed and pensioners the average gain would be larger under the allowance option.

7. These relativities are broadly unaffected by Fowler. But his changes would reduce the gains from both tax options at lower incomes since they would lead to reductons in benefits when tax was cut. For one earner couples with children the gains from either option would on average be about halved for incomes up to the £100-150 per week range.

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TRAP AND DISTRIBUTIONAL EFFECTS OF INCOME TAX OPTIONS

In view of para 4 how relevant is all this to the 1986 Budget?

This annex examines the effects on the poverty and unemployment traps and on net incomes of tax-units ("families") of two income tax options:

(a) a 2p cut in the basic rate;

(b) an 11 per cent increase in the single and married man's allowance with equal cash increases in the age allowances;

2. These would both have a full year cost of about £2.4 billion in terms of tax revenue if introduced in 1986-87 on top of earnings indexation. The first year cost of the allowance increase would, however, be below that of the rate cut.

3. The quantitative analysis was derived from the DHSS Policy Simulation Model. Of necessity, this had to be based on the effects of similar changes imposed on top of a base incorporating November 1985 tax and benefit rates and income levels. These effects should, nonetheless, be broadly equivalent to those of the above options introduced from a 1986-87 base incorporating earnings indexation, although there would be differences in the effects on net incomes in cash terms because of the higher base allowances and thresholds in 1986-87. Because of the difference in base and because the DHSS Model is based on a small sample of families, and on entitlement to income-related benefits, the quantitative analysis should only be regarded as broadly indicative.

4. The effects of the options are considered both under the existing social security system and under the Fowler system. Although the latter will not be introduced until 1988-89 it will significantly alter the impact of income tax changes, in particular, on the traps and hence will change the effects of tax changes introduced in the next two years.

Poverty trap

Present benefit system

5. On the basis of entitlement, about 450,000 heads of working families currently have effective marginal tax rates of over 70 per cent - the conventional definition of the poverty trap - of which about 120,000 have rates of over 100 per cent (see Table 1). The vast majority of those in the trap are basic rate taxpayers.

6. Under the present benefit system, the main difference between the options is that, whereas a basic rate cut would produce a small cut in marginal rates for most of those in the trap, an increase in allowances would produce a large cut for a more limited group.

7. A 2p cut would reduce marginal rates for basic rate taxpayers by 2 percentage points. It would reduce the maximum marginal rate from 110 to 108 and would produce a small reduction in rates for about 370,000 taxpaying families in the trap. It would not, however, reduce the number in the poverty trap.

8. An 11 per cent increase in allowances would take about 150,000 working families out of tax and hence would reduce their marginal rates by 30 percentage points. Of these, about 50,000 would be those with rates of over 70 per cent. The result would be a reduction of about 20,000 in the number with marginal rates over 100 per cent and a further (net) reduction of about 20,000 in the number with rates between 70 and 100 per cent.

Post-Fowler benefit system

9. The introduction of the Fowler benefit system will significantly change both the number in the trap with the present tax system and the effects of the options.

10. The net income basis for withdrawal of income-related benefits will effectively eliminate marginal rates of over 100 per cent. However, the number with marginal rates of over 70 per cent under the present tax system will double, mainly because of the wider coverage of in-work family support.

11. The net income basis also means that taking families out of tax would no longer have a significant <u>direct</u> effect on the number in the trap because, for those who continue in receipt of benefits, the effect on the marginal rate would be offset, sometimes almost completely, by a rise in the effective rate of withdrawal of income-related benefits. For example, being taken out of tax by an allowance increase would only mean a reduction from 96 to 94½ per cent in the maximum effective marginal rate. One implication is that families who would be taken out of the trap by an allowance increase in the next two years could find themselves once again with marginal rates of over 70 per cent after the introduction of the new benefit system.

12. Tax cuts would have an impact on the number in the trap post-Fowler but this effect would be an indirect one and would operate through the resulting rise in post-tax income floating families off entitlement to income-related benefits. The families affected would generally be different from those taken out of the trap by an allowance increase - in particular, their incomes would tend to be higher. Also the difference between the options in the number taken out of the trap would be less marked than under the present system.

13. A 2p cut in the basic rate would have a negligible effect on marginal rates for those continuing to receive benefits. It would, however, float about 40,000 families off family credit and a further 10,000 families without children off housing benefit. These would have their marginal rates reduced from 75 per cent plus generally to 37 per cent.

14. An 11 per cent increase in allowance would produce a moderate cut in marginal rates for some benefit recipients - for example, about 40,000 families receiving just family credit would have their rates cut from 81 to 73 per cent - but would not directly take families out of the trap. It would float about 60,000 families off family credit and a further 20,000 off housing benefit. These would have their marginal rates cut from 75 per cent plus generally to 39 per cent.

Unemployment trap

Present benefit system

15. On the basis of entitlement, about 2 million heads of working families have replacement ratios - ratios of out-of-work to in-work incomes - of over 70 per cent, of which about 100,000 have ratios of over 100 per cent (see Table 2).

16. The majority of families with high replacement ratios have children. For a couple with two older children the replacement ratio is likely to be over 70 per cent for earnings levels up to almost £200 a week (male average earnings in 1985-86). The ratio typically drops below 70 per cent at just over £100 per week for a couple without children and at well below £100 for a single person.

17. Neither of the options would have a large impact on families with the highest replacement ratios, many of whom are close to or below tax threshold. Under the present benefit system, both options would reduce the number with ratios over 100 per cent by about 20,000. These are largely families near the top end of the FIS taper where ratios rise above 100 per cent over an earnings band where all options would produce broadly similar effects on net incomes in-work.

18. The main difference between the options is in their effects at lower ratios. A basic rate cut would produce larger net income gains at higher income levels where replacement ratios are relatively low; an allowance increase would produce larger gains at lower income levels where ratios are relatively high.

19. A basic rate cut would reduce the number with ratios between 70 and 90 per cent by 130,000 and, because of its relatively large effect on higher income groups, it would also reduce the number with ratios between 50 and 70 per cent.

20. An allowance increase would reduce the number with ratios between 70 and 90 per cent by rather more, 190,000, but most of these would be shifted to the 50 to 70 per cent band where the number would rise.

Post-Fowler benefit system

21. The introduction of the Fowler benefit system will again affect both the number in the trap and the effects of the option.

22. Most families will have their replacement ratios changed by the new system, but the net effect of the changes on the overall distribution of replacement ratios will be fairly small - a reduction of about 160,000 in the number with ratios of over 70 per cent and of about 30,000 in the number with ratios of over 100 per cent (see Table 2). The levels of earnings at which replacement ratios fall below 70 per cent will be broadly similar to those under the existing system, although ratios will generally fall more smoothly than currently as income rises.

23. The net income basis for the withdrawal of income-related benefits will again reduce the effects of tax cuts - for those in receipt of benefits, cuts in taxes would be partly offset by reductions in benefits. This effect would be particularly great for an allowance increase which would have a relatively large effect on tax payments at lower income levels where families would be more likely to be entitled to benefits.

24. A rate cut would still produce a lower cut in the number with ratios of over 70 per cent - a reduction of 110,000 as against 150,000 with an allowance increase - but the difference would be smaller than under the present benefit system. Also a rate cut would produce a much larger cut in the number with ratios between 50 and 70 per cent - 130,000 as against 70,000 for an allowance increase. Those with ratios in this range will tend to be at higher income levels where the basic rate cut would produce larger tax reductions and where relatively few families are in receipt of benefits making the benefit offset less important.

Effects on net incomes

25. This section looks at net incomes (taken to include social security benefits but net of housing costs) for all families - including those where the head is not working and pensioners. The main figures are based on 1985-86 tax/benefit levels, prices and

earnings as explained in paragraph 3. Where it is possible to calculate 1986-7 equivalent figures they are shown in brackets. The figures in brackets are changes from an earnings indexed base in 1986-87. Changes from actual 1985-86 tax payments will be larger by the value of indexation to the taxpayer.

26. Most taxpaying families have incomes high enough to exclude them from entitlement to means tested benefits before and after the social security changes. For them the effects on net income of both of the changes are those that could be predicted from examination of their tax position. Cutting the basic rate will give gains ranging from nothing for those earning just above the tax threshold to a maximum of £6.20 (£6.70) for those subject to higher rates of tax.

27. An 11% increase in allowances would give £1.40 (£1.50) to single people and working wives subject to basic rate tax and £2.20 (£2.35) to married men. Those earning between the old and new allowance levels would have smaller tax reductions. Those paying higher rate tax would have larger tax reductions of up to £4.40 (£4.70).

28. With present social security arrangements both of the options would have a small interaction with housing benefit where the earnings disregard would fall in response to tax changes. Housing benefit entitlements would be reduced as a consequence and some non-taxpayers could be net losers from the tax changes. The formula for calculating the Housing Benefit earnings disregard is not, however, statutorily fixed and its level might be set to avoid losers. (Under either social security system the basic rate cut would also lead to reductions in income net of housing costs for some low income mortgagees. Mortgage payments would increase for everybody as MIRAS was reduced in line with the basic rate, but for most people this would be more than offset by tax cuts. For those with low incomes, the increase in repayments could be larger than their tax cut. This effect is not included in the figures but is estimated to be at least 30,000.)

29. With present social security arrangements neither of the tax options affect net incomes by more than 5% and most of the changes are concentrated in the 0-3% range of gains (see Table 3). With the cut in the basic rate 60,000 families would gain more than 3% while 30,000 would lose more than 1%. With increased allowances 210,000 would gain more than 3% and 70,000 lose more than 1%. The picture is largely the same after the social security changes, but there are no losers because the housing benefit earnings disregard would no longer be linked to the tax regime.

30. Although the social security changes would reduce the benefits of tax cuts to those on low incomes, the proportion entitled to benefits is small so that on average whichever social security system is considered the gains from the increase in allowances would be proportionately largest for taxpayers with low incomes while the gains from the cut in basic rate are proportionately largest for those with incomes towards the top of the basic rate band. The increase in allowances gives the largest average gains to those in the £3,000-£10,000 income range (see Table 4). Those with incomes of £10-15,000 have about the same gains from both options but those with incomes above £15,000 gain 60% more with the basic rate cut than with the allowance increase.

31. The relative tax reductions from the options depend very much on the characteristics of the family and its income. Thus single people earning below about £112pw (£129) would benefit most from the increase in allowances but gain more from the basic rate cut at higher earnings. One earner couples earning below £180pw (£201) gain most from the increase in allowances but more from the basic rate cut above that. For two earner couples the gains depend on the earnings of the two partners, but they are most likely to have the largest gain from the cut in basic rate.

32. When this mixture of positions is applied to the actual make up of the population through the PSM (see Table 5), single people gain most on average from a basic rate cut at £1.75 and only £1.30 from increased allowances. One earner couples gain most from the basic rate cut on average at £2.70, and £2.20 from the allowance increase. The results of both options are very close for two earner

couples with the basic rate cut being best at £3.30 and the increase in allowance slightly less good at £3.10.

33. Pensioner families have gains of 50p-80p on average from the tax options, doing rather better from the increase in allowances than from the cut in the basic rate, because of their relatively low incomes. Most families where the head is not working will be unaffected by any tax changes, but those where the wife is working or where they have unearned income will gain. The average gains are, however, small at 25p-35p.

34. The differences between the effects with the two social security systems are small because most taxpayers are outside the social security net. For those who are entitled to benefits the effects can be quite different and the differences are magnified when family types with high entitlement to benefits are examined - the lower part of Table 4 shows the effect on one earner couples.

35. One earner couples with children with incomes of £5,000-£7,500 gain £1.76 on average from the 11% increase in allowances under the current social security system. But after the social security changes, the reduction in tax liability will be offset by reductions in benefit entitlement and for these families the average gain will fall by more than 50% to 83p. Lone parents in the same income band will see their gains fall from £1.40 to 52p. A similar pattern of relative gains under the two social security systems arises with the reduction in the basic rate although the absolute differences are smaller as the rate cut is worth less to people in this income range.

36. Thus the tax options would have similar effects for most people both before and after the social security changes. But for certain groups, particularly low income, one earner couples with children, the benefits of any of the tax options will be considerably reduced.

TABLE 1

DISTRIBUTION OF MARGINAL TAX RATES OF HEADS OF WORKING FAMILIES[1]

(thousands)

Marginal tax rates (per cent)	0-30	30-50	50-70	70-100	100 plus
Present benefit system					
Present tax system	180	14200	450	330	120
Change due to:					
(1) 2p off basic rate	-	+ 20	- 20	-	-
(2) 11 per cent increase in allowances	+100	- 40	- 20	- 20	- 20
Post-Fowler benefit system					
Present tax system	190	14120	80	890	-
Change due to:					
(1) 2p off basic rate	-	+130	-80	-50	-
(2) 11 per cent increase in allowances	+ 90	+ 10	-20	-80	-

[1] Figures based on entitlement to income-related benefits

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ANNEX 2

COST OF IMPLEMENTING TRANSFERABLE ALLOWANCES

The figures below assume that transferable allowances would be implemented on a "no cash losers" basis; costs are for a full year at 1986/87 income levels. Option numbers are those in the Inland Revenue 'sighting shots' paper (Mr Blythe's note of 19 December).

OPTION		COST £bn	INCREASE/DECREASE OVER 1A £m
1A	Allowances indexed in line with prices (5½%)	5.40	-
2A	Allowances increased in line with earnings (7%)	5.45	+50
3A	Allowances increased by 10%	5.55	+150
4A	Allowances increased by 13%	5.65	+250
4B	Allowances increased by 7%; 1p off Basic Rate	5.30	-100
5B	Allowances increased by 10%; 1p off Basic Rate	5.40	Nil
6A	Allowances increased by 19%	5.90	+500
6B	Allowances increased by 13%; 1p off Basic Rate	5.50	+100
6BX	Allowances increased by 7%; 2p off Basic Rate	5.15	-250
-	Allowances increased in line with prices; 1p off Basic Rate	5.25	-150
-	Allowances increased in line with prices; 2p off Basic Rate	5.10	-300

TABLE 3

DISTRIBUTION OF GAINS AND LOSSES (THOUSANDS OF FAMILIES*)

	Losing more than 1%	Gain or loss less than 1%	Gain 1-3%	Gain over 3%
Present benefit system				
Change due to:				
(1) 2p off basic rate	30	16780	10760	60
(2) 11% increase allowances	70	15670	11680	210
Post-Fowler benefit system				
Change due to:				
(1) 2p off basic rate	0	16830	10740	60
(2) 11% increase allowances	0	16330	11080	220

* This table includes all family types (ie with head working, with head not working, and pensioners).

TABLE 4

AVERAGE CHANGES IN WEEKLY NET INCOME (£ per week) BY INCOME RANGE

Annual gross income (£000)	0-3	3-5	5-7.5	7.5-10	10-15	15+
All Families						
Present benefit system						
Present tax system	42.85	66.20	89.50	116.45	157.65	256.50
Change due to:						
(1) 2p off basic rate	+0.01	+0.32	+0.99	+1.73	+2.79	+5.18
(2) 11% increase allowances	+0.11	+0.85	+1.45	+2.05	+2.54	+3.20
Post Fowler benefit system						
Present tax system	42.10	65.20	89.40	116.30	157.30	256.10
Change due to:						
(1) 2p off basic rate	+0.01	+0.32	+0.94	+1.67	+2.76	+5.16
(2) 11% increase allowances	+0.09	+0.77	+1.33	+2.00	+2.52	+3.20
One earner couples with children						
Present benefit system						
Present tax system	75.20	89.40	95.90	111.90	145.30	235.10
Change due to						
(1) 2p off basic rate	-0.01	-0.05	+0.74	+1.63	+2.90	+5.17
(2) 11% increase allowances	-0.05	+0.44	+1.76	+2.14	+2.20	+2.57
Post Fowler benefit system						
Present tax system	78.50	90.20	99.80	112.50	149.00	234.80
Change due to						
(1) 2p off basic rate	0	+0.02	+0.35	+1.45	+2.86	+5.5
(2) 11% increase allowances	0	+0.19	+0.83	+1.91	+2.18	+2.56

TABLE 5

ERAGE GAINS IN NET INCOME FOR DIFFERENT FAMILY TYPES

	Head working				
	Single	One earner couple	Two earner couple	Head not working	Pensioner
Present benefit system					
Change due to:					
(1) 2p off basic rate	1.75	2.75	3.30	0.25	0.50
(2) 11% increase allowances	1.35	2.20	3.10	0.35	0.80
Post Fowler benefit system					
Change due to:					
(1) 2p off basic rate	1.75	2.70	3.30	0.25	0.50
(2) 11% increase allowances	1.35	2.10	3.10	0.35	0.75

ANNEX 4: BUSINESS TAXATION

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ANNEX 4

BUSINESS TAXATION

1. 1986/87 will see the completion of the transition to a low rate, broad base, Corporation Tax regime under the business tax reforms introduced in 1984. This annex covers:

i. the framework of the 1984 reforms;
ii. the outlook for the company sector;
iii. trends in the tax burden on business;
iv. the impact of the 1984 reforms on the tax take;
v. outside opinion; and
vi. the 1986 Budget.

<u>The 1984 Corporation Tax Changes</u>

2. The 1984 reform involved:

i. the phased abolition of 100% first-year allowances for plant and machinery (reducing to 75% in 1984-85, 50% in 1985-86, and nil thereafter), but retaining a 25% writing-down allowance on a reducing balance basis;

ii. the phased abolition of the 75% initial allowance for industrial buildings (reducing to 50% in 1984-85, 25% in 1985-86, and nil thereafter), but retaining a 4% straight-line writing-down allowance;

iii. the immediate abolition of stock relief; and

iv. the phased reduction in the main CT rate from 52%, through 45% in 1984-85, 40% in 1985-86, and 35% in 1986-87, with the small companies' rate being reduced immediately to 30%.

3. The 1985 Budget included some refinements to this basic structure, notably:

i. "de-pooling" for short life assets, with balancing allowance if disposed of at less than written-down value within 5 years; and

ii. continuation of 100% scientific research allowance in recognition of exceptional high-risk nature of this expenditure.

Outlook for the Company Sector

4. A full appraisal of recent developments and future prospects for the company sector is in the recent report of the Industrial Finance Group. The main findings of the report are as follows:

i. The rapid profit growth of non North Sea industrial and commercial companies (ICCs) in 1984 and 1985 is expected to slow down in 1986, with only a small rise in 1987. Net real rates of return seem likely to peak at nearly 8½% in 1986 - 2½ times the 1981 level (see table 1 below).

ii. Investment is forecast to continue to grow in 1986 and 1987, albeit at a slightly reduced pace. Stockbuilding seems likely to pick up in 1986 after the reductions which came in the wake of the abolition of stock relief in 1984. (Table 2 gives a breakdown of the forecast for company incomes, appropriations and savings).

iii. Despite the current high levels of profits, bank borrowing by ICCs has been running at very high levels (some £10 billion in 1985). Liquidity indicators are not showing a clear pattern. There seems to have been some deterioration in the liquidity position of manufacturing companies, but not to the extent of constraining activity. Overall, companies appear to be in a reasonably strong position to weather some reduction in profitability.

Table 1

Net pre-tax real rates of return of Non-North Sea ICCs (adjusted for privatisation)

1973-79 average	6.1%
1980	3.9%
1981	3.3%
1982	4.0%
1983	5.1%
1984	6.5%
1985 estimate	7.9%
1986 forecast	8.4%
1987 forecast	7.9%

Table 2

Non-North Sea ICC Incomes etc (net of stock appreciation and adjusted for privatisation). £billion at current prices.

	1983	1984	1985	1986	1987
(a) UK trading profits	25.0	30.8	37.5	41.2	42.8
(b) Overseas/other income	11.3	12.5	14.4	14.5	15.6
(c) Total income	35.3	43.3	51.8	55.7	58.4
(d) Interest	7.5	9.2	11.6	11.6	12.2
(e) Corporation tax	4.1	5.3	6.2	6.7	7.5
(f) Dividends	5.0	6.0	6.6	7.6	8.1
(g) Other payments	1.8	2.8	3.1	3.2	3.4
(h) Total payments	18.5	23.3	27.5	29.1	31.3
(i) Retained profits [(c)-(h)]	16.8	19.9	24.4	26.6	27.1
(j) Capital transfers	0.5	0.4	0.4	0.7	0.6
(k) Fixed investment	13.5	15.8	17.7	19.2	21.4
(l) Stockbuilding	0.2	0.2	-0.1	0.9	1.8
(m) Financial surplus [(i)+(j)-(k)-(l)]	3.7	4.3	7.7	7.1	4.5

Tax Burden on Business

5. Taking the total burden of all taxes, rather than CT alone, there has been some real increase in the tax estimated to have been paid by non-North Sea companies, largely reflecting the growth in profits since 1981. However, the total tax burden has fallen slightly as a proportion of GDP. Table 3 provides a breakdown.

Table 3

Taxes paid by non-North Sea business

£bn in 1984-85 prices; figures in brackets are % of GDP.

	1978/79	1981/82	1984/85	1985/86
Corporation tax (including ACT but excluding North Sea)	6.8 (2.2%)	4.8 (1.6%)	6.1 (1.9%)	7.0 (2.1%)
Taxes on self-employed	2.3 (0.7%)	2.2 (0.7%)	2.2 (0.7%)	2.6 (0.8%)
Employers' NICS and NIS	9.4 (3.1%)	9.5 (3.1%)	7.9 (2.4%)	7.6 (2.2%)
Rates	4.4 (1.4%)	5.5 (1.8%)	5.6 (1.7%)	5.6 (1.7%)
Other*	3.5 (1.1%)	4.2 (1.4%)	4.4 (1.3%)	4.4 (1.3%)
Total	26.5 (8.6%)	26.3 (8.7%)	26.2 (8.0%)	27.2 (8.0%)

* 'Other' includes VED, car tax, road fuel duty, duty on rebated oils, capital taxes.

6. Non-North Sea business tax as a share of GDP has fallen by about ½ of a percentage point since 1978/79; it has also fallen as a share of total tax (from 25½% in 1978/79 to 21% in 1985/86).

Effects of the 1984 CT changes

7. The 1984 reforms were originally expected to be broadly revenueneutral over the business sector as a whole over the transitional period, though with modest gains and losses in particular areas - those expected to lose included manufacturing, and the unincorporated, while North Sea business was expected to gain. The phasing out of capital allowances was expected to bring forward investment to some extent.

8. At the time of the 1985 Budget, however, it was thought the changes might result in a moderate increase in business tax yield - some £600m a year from 1986/87 onwards. Ministers last year considered, but rejected, options for slowing down the phasing out of capital allowances to offset this effect.

9. The latest estimates now show little difference in the total tax take before and after the 1984 and 1985 changes to rates and allowances - see table 4. But within this total the unincorporated sector pay more (income) tax because they lose incentive allowances without gaining from lower CT rates. Conversely, non-North Sea companies are now expected to gain significantly relative to the pre-1984 regime compared to the 1984 forecasts. This is because their increased profits forecast means that the lower tax rates will have a higher revenue cost.

Table 4

Estimated change in business tax yield as a result of 1984/85 changes (£million cash)

	1984/5	1985/6	1986/7	1987/8	1988/9
Non-North Sea companies*	-210	-200	-	+100	-500
North Sea companies	-70	-300	-400	-100	+100
Unincorporated businesses	-	+60	+200	+400	+600
Total	-280	-400	-200	+400	+200

* Excluding public sector and British Telecom

Outside Opinion

10. There has so far been little pressure for general relaxation of the 1984 package (as opposed to concessions for specific sectors such as shipping). The CBI, which pressed for relaxations last year, is looking elsewhere this year. The recent studies by Bath University on the impact of the 1984 reforms on corporate tax and investment, and by Ernst and Whinney comparing the tax treatment of investment in the UK with that given by our overseas competitors (commissioned by the Equipment Leasing Association) provide no real cause for concern.

The 1986 Budget

11. There is no strong argument, on current evidence, for adjusting the 1984 package, nor any sign of real pressure to do so. For reference, however, the cost of selected changes is set out in table 5 below. It is evident that even quite modest-looking relaxations have a heavy revenue cost.

Table 5

Revenue impact of possible CT concessions (£million: cost-/yield+)

	1987/88	1988/89	1989/90	1990/91
37½% first year allowance in 1986/87	-600	-200	+150	+150
CT rate cut 5% to 30% from 1986/87	-1100	-1900	-2000	N/A
30% writing down allowance (reducing balance basis) from 1986/87	-400	-700	-700	-700

NB: for unincorporated businesses, reduction in basic rate of income tax is relevant (small co's CT rate is lower in step)

Small/unincorporated firms

12. If it was decided to reduce the basic income tax rate, it would be for consideration whether to make a corresponding reduction in the 30% small firms CT rate. A 1% cut in the small firms rate would cost £20m in 1987/88, and £35m in a full year. A possible alternative, if the income tax rate stayed at 30%, would be a substantial increase in the "small companies" £100,000 profit limit. A £200,000 limit would cost £13m in 1987/88, and £25m in a full year, assuming the £500,000 starting point for the full CT rate was unchanged.

13. Those representing the unincorporated sector do of course complain that they have not been directly compensated for the loss of incentive capital allowances. But this ignores, for example, this year's concessions on self-employed NICs, which were worth £155 million in a full year to unincorporated businesses. The unincorporated have also gained from the reductions in income tax and the abolition of National Insurance Surcharge, and would benefit either from increased personal allowances or a reduced basic rate for 1986/87.

but presumably more from the latter