

Po-CH/NL/0361

PART H

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PO -CH /NL/0361



PART H

1988 BUDGET SPEECH AND
STATEMENT

PO -CH /NL/0361

PART H

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CLOSED

ON:-

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BUDGET SECRET: TASK FORCE LIST

Inland Revenue

The Board Room
Somerset House
London WC2R 1LB

FROM: T J PAINTER

11 March 1988

COPY no 011

MR HUDSON

BUDGET STATEMENT: FIFTH DRAFT

G.9.

1. I am concerned that the latest, still further condensed, paragraph could colourably be represented as misleading - or at least excessively disarming - as regards UK incorporated companies (which are the overwhelming majority). The Press notice will, of course, spell out the realities. But the Speech itself could create a false impression that a UK incorporated company would "free to migrate" and still remain incorporated here.

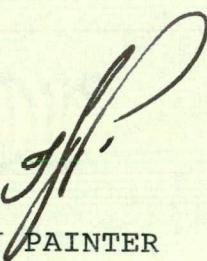
2. As a minimum I suggest reinstating the sentence "In future, companies will be resident in the UK if they are incorporated here," after "our major competitors". It would also help considerably to insert "Subject to that, instead of . . ." at the beginning of the last sentence.

cc Mr Scholar
Mr Culpin
Miss Sinclair

Mr Battishill
Mr Isaac
Mr Beighton
Mr McManus
Mr Houghton) comment
Mr Fawcett) on G9
only
PS/IR

L.8.

3. The phrase "taking commercial woodlands out of the tax system altogether" is still in. Could I reinforce the point Mr McManus will again be making on this?


T J PAINTER

BUDGET SECRET: TASK FORCE LIST

Copy no 10 of 14

FROM: A G TYRIE

DATE: 11 MARCH 1988

CHANCELLOR

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Mr Culpin
Mr Scholar
Mr Odling-Smee
Mr Turnbull
Mr Hudson
Mr Cropper
Mr Call

BUDGET STATEMENT: FIFTH DRAFT

Some more, mostly very minor, comments.

B7. Last sentence: this continues the pattern of the 1980s, in which British manufacturers have maintained their share of the expansion in world trade, the crucial test of competitiveness, after decades during which Britain's share was steadily declining'.

B11. Final sentence: 'I foresee no difficulty in financing this temporary current account deficit'. 'Magnitude' doesn't sound good.

Incidentally, were the money GDP figure to turn out above £457 billion for the coming year, we would be able to say that the £4 billion balance of payments deficit forecast is 'equivalent to just over $\frac{3}{4}\%$ of GDP,' rather than 'less than 1% of GDP'. £457 billion happens to be the best guess for 1988-89 so the calendar year figure will most certainly come out lower than that. A pity.

C5. This reads much more crisply. It benefits from the omission of the reference to the greater importance of building societies in broad money.

D2. An alternative formulation to the last sentence would be: 'Labour were borrowing £1 in every £5 they spent'.

D3. Instead of the last sentence I suggest: 'It also added massively to the burden of debt interest. We and future generations are still paying the interest on that debt'.

D8 and D11. I would still prefer to see D8 omitted.

'The path of prudence and caution' has been put into D11, which improves it. An alternative formulation for the second sentence could be: 'Moreover I have decided to buttress downward pressure on inflation with a particularly cautious and prudent fiscal stance. So I am budgeting for a further surplus ...'.

This makes it clear that the £3 billion PSDR has not merely come out in the wash. It is part of your budget judgement. Against that, you might feel that my formulation smells of demand management.

D9. Line 3. (I have had a word with Andrew Turnbull about this!) I prefer his formulation along the lines: '... expenditure plans for 1988-89 of £2½ billion, and resources allocated to programmes up by over £4½ billion.'

D10. Line 1. Suggest replace 'public expenditure' with 'spending on programmes'.

E3. I think this now reads extremely well.

F8. Third line from the bottom. I suggest: 'But what matters most is that'.

F14. Last sentence. I suggest: 'I propose to put unmarried couples on the same footing as married couples by confining them to a single ...'.

G21. This is a bit of a mouthful. What about: 'Deregulation will give a future to the private rented sector. This change will hasten its revival'.

J2. Do you want to excite people a little more by replacing 'affecting' (line 1) with 'extending'?!

The Healey joke is definitely amusing but on reflection it is a bit gratuitous. He might also stand up, if he can think of a quick reposte, and you would have to give way. So, gutless though it may be, I reluctantly favour deletion. If you were to decide to keep it I would replace 'obsolete' with 'redundant'.

K4. Last sentence. I suggest deleting 'the habit of'.

K21. The penultimate sentence reads a bit oddly, I think caused by the word 'then' (line 5). I suggest you delete it.

K24. The reference to the protection of the income tax yield works very well at the end of this CGT section.

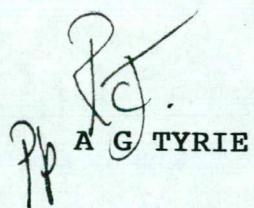
L13. Do we need the last sentence?

L16 to L18. This section on cars now reads very well. You have not foreclosed your options altogether on further action with the clause (in L16): 'it cannot be put right in a single year'.

L19. Perhaps we can do without the commitment to retain higher rate mortgage interest relief in the last couple of lines. I suggest deletion after 'aim'.

L37. Are we absolutely sure that the last couple of sentences are right?

M2. I would either delete the reference to the Autumn Statement. You have already paid your dues to public spending. This could sound a little ~~defensive~~; or I would add a sentence at the beginning of M2 making it clear that you are describing the hat-trick. Something like: 'For the second successive year the Government has taken a hat-trick. After an Autumn Statement ...'.



A G TYRIE

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Copy no 1 of 14

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PJ.
AG TYRIE

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FROM: A. P. HUDSON
DATE: 11 March 1988

COMMENTS

cc Mr ACS Allan

CHANCELLOR

BUDGET SPEECH =

I attach the version including the amendments you made this morning

It is 9628 words, quite a lot shorter than Monday's version. At 135 wpm, that's 1 hour 11 minutes; at 130 wpm, 1 hours 16 minutes.

c.

1. Clean(ish) copy below.
2. I've put on various comments from the office, some of which I'm sure you won't want to take. There's still fuss about debt interest.
3. I've also made some suggestions of my own, to try to make it easier to read and for listen to. ~~This~~

~~A/H~~

B.L.O.
A/H
W.H.M
or
(so)
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Draft of 10 March (2nd)

CHANCELLOR OF THE EXCHEQUER'S BUDGET STATEMENT

15 MARCH 1988

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G		BUSINESS TAXATION
H		COVENANTS AND MAINTENANCE
J		TAXES ON SPENDING
K		TAXES ON CAPITAL
L		INCOME TAX
M		PERORATION

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A INTRODUCTION

Al. I am reliably informed that my Budget speech last year was the shortest this century. My Budget speech this year is likely to have a different claim to a place in the history books. Not, the House will be glad to learn, as the longest [Budget speech] this century, but as the last untelevised Budget speech.

ES7

AG7

A2. As I once again present the first Budget of a new Parliament, ~~except~~ I find the British economy ^{is} _h stronger than at any time since the War. As the British people recognised last June, this has not happened by chance. It has happened because, for almost nine years now, we have followed the right policies and stuck to them. I reaffirm those policies today. In particular, there will be no letting up in our determination to defeat inflation.

A3. I shall begin, as usual, with the economic background to the Budget. I shall then deal with monetary policy, and with the public finances this year and next, and indeed for the remainder of this Parliament. Finally, I shall propose a number of measures designed to improve the performance of the economy still further, by changing the structure of taxation. For this will be a tax reform Budget.

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A4. As usual, the Financial Statement and Budget Report, together with a number of press releases filling out the details of my tax proposals, will be available from the Vote Office as soon as I have sat down.

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B. THE ECONOMIC BACKGROUND

Bl. I start with the economic background.

B2. The strength and durability of the economic upswing has now exceeded all post-War records. We are about to enter our eighth successive year of sustained growth, and the sixth in which this has been combined with low inflation. And even without looking to 1988, the six years to 1987 have been the longest period of steady growth, at a rate averaging 3 per cent a year, for half a century.

B3. This performance compares favourably not only with our own past, but also with the economic performance of other countries. During the 1960s and the 1970s, Britain's growth rate was the lowest of all the major European economies. During the 1980s, [our growth rate] has been the highest [of all the major European economies].

B4. In 1987 as a whole, output grew by $4\frac{1}{2}$ per cent, while ^{RPI} inflation averaged $4\frac{1}{4}$ per cent. Thus last year, for the first time for a generation, the rate of growth exceeded the rate of inflation. At the same time unemployment fell more than in any other year since the War, in every region of the country, and faster than in any other major nation.

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AGT

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AGT

B5. The plain fact is that the British economy has been transformed. Prudent financial policies have given business and industry the confidence ^{and the room} to expand, while supply side reforms have progressively removed the barriers to enterprise.

B6. Nowhere has this transformation been more marked than in manufacturing, where output rose last year by $5\frac{1}{2}$ per cent. This outstanding performance was founded on a further big improvement in [manufacturing] productivity. In the 1980s, output per head in manufacturing has gone up faster in Britain than in any other major industrial country, and we led the way once again last year. This is in stark contrast to the 1960s and 1970s, when in manufacturing productivity [growth], as in so much else, we were bottom of the league.

B7. The current account of the balance of payments is now estimated to have been in deficit last year, after seven successive years of surplus, by a little over £1 $\frac{1}{2}$ billion. This is [well] below the deficit I forecast at the time of last year's Budget, despite growth turning out stronger than forecast. The reason for this was the better than expected performance of visible trade, with exports of manufactures up by $8\frac{1}{2}$ per cent. This continues the pattern of the 1980s, with British manufacturers maintaining their share of an expanding world trade, ^{-the crucial test of competitiveness-} after decades during which Britain's share was steadily declining.

P. Sedwick -
in case revised!

AGT (see minute)

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APH: I know ~~this~~ is "But"
strictly right, but I'm
not sure it helps the
listener.

B8. Looking ahead, I expect 1988 to be yet another year of healthy growth with low inflation; and there is every prospect that unemployment will continue to fall, although probably not as rapidly as last year.

B9. The pace of non-oil growth is likely to ease from now on, returning to the underlying trend of the past few years. [But] output for 1988 as a whole is forecast to be 3 per cent higher than in 1987, with the non-oil economy up by $3\frac{1}{2}$ per cent. Business investment is forecast to grow particularly strongly, with a rise of $8\frac{1}{2}$ per cent.

B10. As last year, inflation is forecast to end the year at 4 per cent. While this is still too high, it is a testimony to the soundness of our policies that the present strong and sustained upswing, unlike almost all its predecessors, has not led to a resurgence of inflation.

B11. With growth in the UK economy likely to continue to outpace that of most other major countries, particularly in continental Europe, and with our oil surplus falling as North Sea oil production declines, the current account of the balance of payments is forecast to remain in deficit this year, by some £4 billion, equivalent to less than one per cent of GDP. Given the strength of the economy in general, and of our public finances in particular, not to mention our massive net overseas asset

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position, I foresee no difficulty in financing ^{this} [a] temporary current account deficit [of this magnitude.]

B12. But the outlook both for exports and for jobs will depend critically on employers keeping their costs firmly under control. Unit labour costs in manufacturing scarcely rose at all in 1987. It is vital that employers do not let this slip, and keep a tight grip on all their costs, not least pay.

B13. In my Budget speech last year, I warned that:

"Given the continuation of present policies in this country, the biggest risk to the excellent prospect I have outlined is that of a downturn in the world economy as a whole."

That remains the case. The dramatic collapse in the world's equity markets last October was not the second coming of 1929 and the harbinger of a 1930s-style world slump, as so many feared at the time - although it could have been a great deal nastier had the authorities in the major nations not responded in a prompt and appropriate way. It was essentially an overdue market correction which did little more than reverse the rapid rise in share prices of the previous year. Certainly, business confidence does not seem to have been greatly affected, and growth in the seven major industrial countries as a whole this year is likely to be only slightly lower than last year.

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B14. But Black Monday was also a warning. The world's three largest economies - the United States, Japan and Germany - have made a number of the policy adjustments necessary to reduce the imbalances which have for so long afflicted them, and there is evidence that the measures they have taken are starting to bear fruit. But there is still a long way to go; and meanwhile there is the constant danger that the process of adjustment, and with it the world economy as a whole, could be gravely damaged either by further wild gyrations in the dollar exchange rate or by a lurch into protectionism.

B15. There are some who continue to insist that the simple and only solution to these imbalances lies in a further substantial fall in the dollar, even though the source of the problem lies elsewhere. They see exchange rate changes as a miracle cure, whatever the illness. They wholly ignore the damage that exchange rate volatility does to economic health, and distract attention from the fundamental causes of the imbalances.

B16. Success in reducing these imbalances depends on countries putting the right fiscal and monetary policies in place, and keeping them there. But the necessary adjustments are much more likely to be achieved if the objective of greater exchange rate stability is given an explicit role in the process of international co-operation, as has been the case for well over

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two years now. I can assure the House that we shall play our full part.

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Overtaken by enclosed.

C. MONETARY POLICY

ES7: weather &
whether

C1. Meanwhile, the maintenance of sound money and prudent public finances will keep us in the best possible position to weather any shocks we may face, [whether] at home or abroad.

C2. The Medium-Term Financial Strategy, now entering its ninth year, will continue to provide the framework for reducing the growth of money GDP, and hence inflation, over the medium term. These will be achieved by maintaining firm monetary discipline, buttressed by a prudent fiscal stance.

C3. Short term interest rates remain the essential instrument of monetary policy. Within a continuous and comprehensive assessment of monetary conditions, I will continue to set interest rates at the level necessary to ensure that inflationary pressures are not accommodated.

C4. I believe that most businessmen have welcomed the greater stability between sterling and the Deutschmark that has persisted over the past year. It is important that they also accept the financial discipline inherent in this policy.

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C5. Achieving the gradual eradication of inflation also requires a steady reduction in monetary growth in the medium term. While I shall continue to take account of broad money, or liquidity, as last year there will be no explicit target. For narrow money, MO, the target range for 1988-89 will be 1-5 per cent, as foreshadowed in last year's MTFS.

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D. PUBLIC SECTOR FINANCES

D1. As I pointed out a moment ago, a sound monetary policy needs to be buttressed by a prudent fiscal stance.

D2. At one time, it was regarded as the hallmark of good government to maintain a balanced budget; to ensure that, in time of peace, government spending was fully financed by revenues from taxation, with no need for government borrowing. Over the years, this simple and beneficent rule was increasingly disregarded, culminating in the catastrophe of 1975-76, when the last Labour Government had a budget deficit, or Public Sector Borrowing Requirement, equivalent in today's terms to some £40 billion.

D3. This profligacy not only brought economic disaster and the national humiliation of a bail-out by the IMF. It also added massively to the burden of debt interest, [not merely now but for generations to come.] *We and future generations are still paying the interest on that debt.*

D4. Thus one of our main objectives, when we first took office in 1979, was to bring down government borrowing. We steadily reduced the Public Sector Borrowing Requirement from the 5½ per cent of GDP we inherited to only three quarters of one per cent in 1986-87. Today I

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am able to tell the House that in 1987-88, the year now ending, we are set to secure something previously achieved only on one isolated occasion since the early 1950s: a balanced budget.

D5. Indeed, we have gone even further. It looks as if the final outturn for 1987-88 will be a budget surplus of £3 billion. Instead of a PSBR, a PSDR: not a Public Sector Borrowing Requirement, but a public sector debt repayment.

D6. And, incidentally, even if there had been no privatisation proceeds at all, the resulting PSBR, at a half of one per cent of GDP, would still have been the lowest in all but one year since the early 'fifties.

D7. A balanced budget is a valuable discipline for the medium term. It represents security for the present and an investment for the future. Having achieved it, I intend to stick to it. In other words, henceforth a zero PSBR will be the norm.

D8. In the very nature of things, there are bound to be fluctuations on either side from year to year. It is in this context that I have to set the precise fiscal stance for the year ahead, 1988-89.

D9. I have already announced, in the Autumn Statement last November, a substantial increase in public expenditure plans for 1988-89, [with spending on]

FST would put in a para on revenue buoyancy. (See his minute.) I've attached to his minute the old para we had on this, in case you want it.

A. Turnbull, 1 see
RPC minute, 1 AGT
of £2½ billion,
with resources allocated to

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APT: Care for reversing
the order of these.

programmes up by over £4½ billion. In particular, we have increased our plans for spending on health and personal social services by £1 billion, on education and science by £900 million, and on law and order by £500 million.

Jos

See Jos minute -
I suspect you
won't buy his
drafting, but I think
he's right on the
figures.

D10. These large increases in public expenditure ^{programmes} for the coming year will be financed partly from the saving in debt interest resulting from the reduction in Government borrowing. Debt interest now accounts for ^{about 3/4 of a} more than half a percentage point less of GDP than it did only three years ago. This may not sound very much, but it implies a saving of ^{about} [almost] £3 billion a year. And the balanced budget path I have set out in this year's MTFS will help to reduce debt interest payments still further.

D10A. We have thus secured an enviable virtuous circle in public finance: lower borrowing and lower tax rates create both the scope and the incentive for the private sector to expand. And the private sector then generates higher revenues which permit further reductions in borrowing or tax.

D11. But even so, the increased public spending now planned for 1988-89 inevitably implies less scope for reducing taxation. Moreover, I have decided that for the year immediately ahead, the path of prudence and caution is to budget for a further surplus of the same size as this year's expected outturn - that is to say, a further public sector debt repayment of some £3 billion.

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See AG7 minute,
though I doubt if
you'll buy his draft.

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D12. What this means is that it will not be possible in this Budget to reduce the burden of taxation; that is to say, to reduce taxation as a share of GDP.

D13. However, the House may be pleased to know that, with a strong and healthy economy, a constant burden of taxation implies a reduction in tax rates.

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E. TAX REFORM

E1. I indicated at the outset that this will be a radical, tax-reforming Budget.

E2. Over the past few years there has been increasing recognition, throughout the industrialised world, of the importance of tax reform in improving economic performance. And for us in this country, the lesson is underlined by the success of the reform of business taxation I announced in my first Budget, at the start of the last Parliament.

E3. But while tax reform is a simple matter for the armchair critic, it is very much more difficult in practice. It is difficult technically and difficult politically - since any tax system, however it arose, creates powerful vested interests in favour of the status quo. Nor, indeed, is it right that change should be too violent. People have a right to expect a reasonable degree of stability in the framework within which they order their affairs. But stability should not mean immobility. That way lies national decline.

L. Brighton thinks
sounds defensive.
AGT this this
para v. good.

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E4. The tax-reforming Chancellor thus has to tread a careful path. That I have sought to do in this Budget. The proposals I shall be making today amount to a substantial and coherent package which will be of increasing benefit to the taxpayer and the economy as a whole in the years to come.

E5. I have been guided by four basic principles. First, the need to reduce tax rates where they are clearly too high. Second, the need to reduce or abolish unwarranted tax breaks. Third, the need to make life a little simpler for the taxpayer. And, fourth, the need to remove some manifest injustices from the system.

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F. INDEPENDENT TAXATION AND TAX PENALTIES ON MARRIAGE

F1. My first reform concerns the taxation of marriage.

F2. The present system for the taxation of married couples goes back 180 years. It taxes the income of a married woman as if it belonged to her husband. Quite simply, that is no longer acceptable.

F3. This is a matter on which there has already been extensive consultation. The time has come to take action.

F4. I therefore propose a major reform of personal taxation, with two objectives. First, to give married women the same privacy and independence in their tax affairs as everyone else. And second, to bring to an end all the ways in which the tax system can penalise marriage.

F5. I have decided to introduce, at the earliest practicable date, April 1990, a completely new system of independent taxation.

F6. Under this new system, a husband and wife will be taxed independently, on income of all kinds. All taxpayers, male or female, married or single, will be entitled to the same personal allowance, which will be

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*(R (Now use same
words twice - my
fault))*
E.George (b)
AMWB

available against any income of all kinds, whether from earnings, pensions or savings.

F7. In addition, there will be a married couple's allowance, ^{equal} [equivalent in value] to the difference under the ~~present~~ ^{current} system between the married man's allowance and the single allowance. This new allowance will go in the first instance to the husband, so that his tax threshold does not fall. But if he does not have enough income to use it in full, [he will be able to transfer] any unused portion ^{can be} [to his wife, to] set against ^{his wife's} [her] income.

F8. This ensures that the tax system will continue to recognise marriage, as it should do. At the same time, from 1990 married women will pay their own tax, on the basis of their own income, and have their own tax return, when one is necessary. There will, of course, be nothing to stop married women from asking their husbands to handle their tax affairs, as before; and many will no doubt do so. But what matters is that, for the first time ever, married women will have the right to complete independence and privacy so far as tax is concerned.

F9. In the same way, a husband and wife will be taxed independently on any capital gains they may have, with an annual exemption each, instead of one between them, as now. But transfers of capital between husband and wife

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will continue to be entirely free of any liability to tax.

F10. As I have said, the new system will come into force in 1990. This is much sooner than would have been possible for most of the alternatives that have been canvassed. The necessary legislation will be contained in this year's Finance Bill. The cost of this historic reform, which for the first time ever gives a fair deal to married women, will be £550 million in 1990-91.

F11. I mentioned a few moments ago the tax penalties on marriage. It is clearly wrong that some couples should find themselves paying more tax, simply because they are married. I propose to put that right.

F12. Independent taxation by itself will remove the most common penalty - the taxation of a married woman's income at her husband's marginal rate. But there are other tax penalties on marriage, and I propose to abolish all of them. These changes need not await the introduction of Independent Taxation.

F13. Under the present system an unmarried couple can get twice as much mortgage interest relief as a married couple. This has attracted increasing - and justified - criticism. I propose to put a stop to it as from August this year. Thereafter, the £30,000 limit on mortgage

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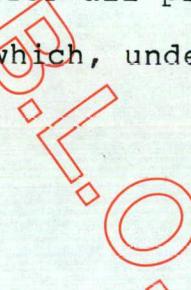
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interest relief will be related to the house or flat, irrespective of the number of borrowers. This was the solution put forward in the 1986 Green Paper on Personal Taxation, and it was widely welcomed. Existing mortgages will be unaffected.

B. Mace thinks this makes the para sound odd. If for single parents, why let ~~the~~ couples keep even one APA.
(APM: I think it's OK.)

F14. Another anomaly is that an unmarried couple with children can each claim the Additional Personal Allowance [intended for single parents], and thus get more tax relief than a married couple in the same position. I propose to confine them to a single Additional Personal Allowance, with effect from April 1989.

F15. Thus this Budget will not only, for the first time ever, give married women a fair deal from the tax system. It will also eliminate, for all practical purposes, all the other tax penalties which, under the present system, can arise on marriage.



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G. BUSINESS TAXATION

G1. I turn now to business taxation.

G2. The major reform of business taxation, which I introduced in 1984, and which was completed in 1986, has given us one of the lowest Corporation Tax rates in the world. This has encouraged overseas companies to invest in Britain and, most important of all, has greatly improved the quality of investment by British firms. It is a crucial part of an environment in which company profitability has recovered to its highest level for some twenty years. It has succeeded in its objectives.

G3. I do not therefore propose any further changes to the structure of Corporation Tax. And the main Corporation Tax rate for 1988-89 will be unchanged at 35 per cent.

G4. But I do have some changes to propose to specific aspects of business taxation.

G5. British exporters have done extremely well in recent years, thanks to major improvements in efficiency and quality. But no exporter could honestly claim that his success hinges on the fact that the cost of entertaining

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overseas customers is tax deductible, whereas business entertainment generally is not. I therefore propose to simplify the system by making all business entertainment non-deductible for tax purposes, including for VAT.

G6. In conjunction with my rt. hon. Friend the Secretary of State for Energy, I propose to restructure the tax regime for the new generation of Southern basin and onshore fields, so as to relate tax liability more closely to profitability. Accordingly, my rt hon Friend will shortly be bringing forward legislation to abolish royalties, from 1 July, for all such fields. At the same time, I propose to reduce the Petroleum Revenue Tax oil allowance for these fields. This will mean the end of royalties for all future fields.

X G7. The 1986 Building Societies Act gives Building Societies the power, to convert themselves into companies, if they so wish. At present, however, they would face a heavy, and unintended, tax charge if they did so. I propose to rectify this.

G8. I have two changes to propose to the tax arrangements for Lloyd's. The first meets the only point Lloyd's have raised on last year's legislation on reinsurance to close. The second will benefit both Lloyd's and the Inland Revenue by simplifying the administrative arrangements for taxing Lloyd's members.

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G9. I also propose to simplify the Section 482 rules for companies who wish to migrate overseas, so as to bring them broadly into line with most of our major competitors. Instead of having to ask for Treasury consent, companies will be free to migrate, provided only that they pay their tax first.

*T. Painter
(d. instead otherwise.)
In future, companies
will be resident in
the UK if they are
incorporated here.
Subject to that,*

G10. I now turn to a number of proposals to give further help to small businesses and new businesses, whose encouragement is a central theme of Government policy. The rate of new business formation, net of failures, has averaged 500 a week, week in, week out, since 1979. This shows beyond any doubt the continuing vigour of this sector, which is such an important source of enterprise, innovation, and new jobs.

G11. Many new businesses have been greatly assisted by the Business Expansion Scheme, which has now been running for nearly five years. During that time it has enabled new and expanding companies to raise equity finance amounting to some £150 million a year.

G12. However, the rapid growth of the venture capital market since 1983 has meant that companies seeking relatively large amounts of equity investment can now raise these readily, while smaller companies looking for more modest amounts can still find it difficult to do so.

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G13. To improve the targeting of BES, I therefore propose to introduce a limit of half a million pounds on the amount any company can raise under the scheme in any one year. Investment should thus be better directed at the smaller, newer and riskier businesses, particularly those outside the South-East of England, which can still find it hard to raise equity finance in other ways. In the special circumstances of the ship chartering industry, however, the limit will be £5 million.

G14. I have one further proposal affecting the Business Expansion Scheme.

G15. One of the key reasons for our economic transformation has been the reform of the supply side of the economy.

G16. The tax relief I introduced last year for profit-related pay will, in time, help to increase pay flexibility and improve the working of the labour market. But if successful firms are to expand further, and create still more jobs, we also have to make it easier for people to move to where the new jobs are.

G17. For years, the shortage of private rented accommodation has been an obstacle to labour mobility. The Government's proposals to deregulate new rents are already going through the House. Deregulation will, over

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time, substantially increase the supply of housing for rent. But this will not happen overnight, and there is a case for a special incentive to speed up the process in the early years.

G18. I therefore propose to extend the Business Expansion Scheme to include companies specialising in the letting of residential property on the new assured tenancy basis.

G19. The BES is well suited to this task. Since full tax relief is given immediately, it should bring forward new investment straight away. And we will be building on success.

G20. The limit for this type of investment will be £5 million a year for any one company. But since the relief is specifically designed to provide an extra stimulus in the early years of deregulation, it will run only for investments made before the end of 1993.

G21. This change will powerfully reinforce the impact of decontrol in reviving the private rented sector of housing in Britain.

G22. In last year's Budget I raised the ceiling for capital gains tax retirement relief from £100,000 of gain to £125,000. But I believe it is necessary to do more to help the small businessman whose [entire] wealth is tied up

AG7:
Deregulation will give a future to the private rented sector. This change will hasten its revival.

APT: Don't think this is wise.

pjc

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in his business and who is faced with the disincentive of a heavy capital gains tax bill when he sells up on retirement. I therefore propose to extend capital gains tax retirement relief so that, on top of the exemption, half of any gain between £125,000 and £500,000 will also be completely free of tax.

G22A. While on the subject of capital gains tax, I propose to extend rollover relief to a group of assets whose common characteristic is that they did not exist when the present list of qualifying assets was drawn up. They are milk quotas, potato quotas, satellites and spacecraft. I know that this will be warmly welcomed in the farming and extra-terrestrial communities alike.

G23. Lastly, on the small business front, I propose to increase the VAT threshold to £22,100, the maximum permitted under existing European Community Law.

G24. Throughout my time as Chancellor, I have been on the look-out for taxes to abolish. Abolition is clearly the simplest variety of reform. I have already abolished the National Insurance surcharge, the Investment Income surcharge, Development Land Tax, and the tax on lifetime gifts. [Today I propose to abolish a further tax: Capital Duty.]

APH:
Case for keeping the
House guessing for a
bit longer?

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G25 At present, companies have to pay a 1 per cent duty whenever they raise new capital - whenever, for example, a new company is formed or an existing company sells new shares to the public. This is undesirable on two counts. It is a burden on companies who need to secure external finance for expansion. And it discriminates against equity capital as compared with debt finance and bank borrowing.

G26. Capital Duty is a relatively recent impost which had to be introduced in 1973 in compliance with our obligations under European Community Law. But the relevant Community Directive has now been amended. Accordingly, I propose to abolish Capital Duty with effect from midnight tonight.

G27 At the same time, I propose to get rid of the Unit Trust Instrument Duty, a similar though much less substantial tax, which is levied at the rate of $\frac{1}{4}$ per cent on all property put into a unit trust. I know the unit trust movement will welcome this minor relief, and I trust the benefit will be fully passed on to investors.

G28. The cost of abolishing these two taxes will be of the order of £100 million in 1988-89. Not counting minor imposts, the demise of Capital Duty brings the number of taxes I have abolished up to five: an average of one a Budget.

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H. COVENANTS AND MAINTENANCE

H1. I now turn to an important area of personal taxation which is ripe for reform and simplification: the taxation of payments made under deeds of covenant and maintenance arrangements.

IR:
N.B. basic rate
change does affect
covenants.

H2. Covenants to charity will be wholly unaffected by the changes I am about to propose. [for other covenants.]

H3. Other covenants, and maintenance arrangements, are essentially ways of transferring income from one individual to another, usually from one member of a family to another, whether it is a parent or grandparent covenanting to a child, or a husband paying maintenance to an ex-wife. Most financial transfers that take place within families are rightly and properly outside the scope of the tax system altogether. I propose, as far as is practicable, to take covenants and maintenance out as well. This will greatly simplify an unnecessarily complex part of the tax system.

H4. First, covenants. Charitable covenants apart, I propose to take all new covenants made by individuals on or after today out of the tax system altogether. In other words, people receiving payments under covenants

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will not be liable to tax on them, and those making the payments will not be able to claim tax relief on them. The tax treatment of existing covenants will continue unchanged.

APM ?

H5. The largest single group of people affected by this change will be students, together with their parents, many of whom nowadays choose to make their contributions to the student maintenance grant by covenant. This has arisen as an unintended by-product of the reduction in 1970 of the legal age of majority from 21 to 18.

H6. As I have already indicated, those who have already made such covenants will continue to benefit from them. For new students, the parental contribution to the maintenance grant will be assessed on a new and more generous scale, to reflect the withdrawal of tax relief on new covenants. My rt hon Friend the Secretary of State for Education and Science will be publishing the new scale tomorrow.

C.Cordell

H7. One desirable side-effect of this reform is that future students will no longer be deterred from taking vacation jobs because their covenant income has already absorbed their personal allowance.

H8. Student covenants apart, there will be no compensation for the loss of tax advantage arising from these proposals. But once rates of income tax are set at

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reasonable levels, this is precisely the sort of tax shelter it is right to dispense with.

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H9. Next, maintenance. Here, we tax the recipient, only to give tax relief to the payer. The present rules can be complex and confusing for people going through separation and divorce. The tax system ought to intrude as little as possible, though it is reasonable that there should be some recognition of the fact that an ex-husband is continuing to support his ex-wife, or vice versa.

AMWB

IR
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H10. Accordingly, I propose that, for new arrangements, recipients will not be liable to any tax whatever on maintenance payments. Relief to the payer will be restricted to payments to a separated or divorced spouse, up to a limit equal to the difference between the married and single allowances. But there will no longer be any tax relief either for payments above this limit, or for maintenance payments to anyone other than a separated or divorced spouse.

IR
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H11. For existing arrangements, the present rules will continue to apply in 1988-89, except that a separated or divorced spouse will be exempt from tax on receipts up to the difference between the married and single allowances. Full relief will continue for all those who are making payments under existing Court Orders or agreements. The same protection will also apply to those who have already applied for Court Orders, provided these are made by

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30 June. From April 1989 there will be special transitional rules to continue protection for pre-existing arrangements.

APH

APH (drafting)

IR

FST / APH (!)

under maintenance
orders
maintenance
payments

APH: CF. H6.

H12. While the transitional provisions are inevitably somewhat complex, the new system will be very much simpler than the old, for all concerned. At the same time, while it will reduce the tax relief that can be obtained by the better-off payers of large amounts of maintenance, for many couples, the ex-husband will continue to enjoy full tax relief while the ex-wife will no longer be taxed.

H13. The reform of the tax treatment of maintenance I am proposing today will also remove one of the lesser known tax penalties on marriage. Tax relief greatly in excess of that which is available to a married couple will no longer be available to an unmarried couple who make large income transfers either between themselves or to their young children, and get far more tax relief than is available to a married couple. My reform will put an end to that.

H14. As I have already indicated, this reform and simplification of the taxation of covenants and maintenance, which I have proposed today, in no way affects covenants to charity. Indeed, I have a proposal to help charities further.

H15. The payroll giving scheme has now been running for nearly a year. I am glad that so many employers have

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already set up schemes, and I hope as many employees as possible will take advantage of them. In order to give further encouragement to charitable giving, and to assist the growth of the payroll giving scheme, I propose to double the annual limit on tax-allowable donations under the scheme to £240, or £20 a month.

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AG7

J. TAXES ON SPENDING

J1. I now turn to the taxation of spending.

J2. I have one change to propose today [affecting] the coverage of Value Added Tax, which will remain at 15 per cent. Confectionery was brought in to VAT by the *t. hon. Member RHM* for Leeds East in 1974, and the legal definition of confectionery goes back further still to the days of purchase tax. The emergence of new products has rendered this definition somewhat *redundant* [*obsolete*]. In particular, recent legal decisions mean that some cereal bars are subject to VAT, while others are not. I propose to clarify the law so that all cereal bars are taxed.

*C. Evans.
(N.B. because of
juggernauts, Table 1.1
shows overall +2.0m on
Excise Duties.)*

J3. I propose to raise the excise duties as a whole in line with inflation, but to make some modest adjustments within the total. The duty on cigarettes and hand-rolling tobacco will be increased, by the equivalent, including VAT, of between threepence and fourpence for a packet of 20 cigarettes. This will take effect from midnight on Thursday. The duty on a packet of five small cigars will rise by twopence, but that on pipe tobacco will remain unchanged.

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J4. As to the alcohol duties, I propose increases which, including VAT, will put about a penny on the price of a pint of average-strength beer and cider, fourpence on a bottle of table wine, and sixpence on a bottle of sparkling or fortified wine. There will once again be no increase in the duty on spirits. These changes will take effect from 6 o'clock tonight.

The existing duty structure discourages sales of

I propose to introduce new, lower rates of duty for these products,

CBE: The proposal is to bring in new rates to encourage new coolers to enter the market, not to bring in reduce rates on existing coolers.

, as they are, though there will be some minor adjustments within the HGV classes.

J5. I propose to reduce the duty on drinks known as 'coolers', which are mixtures of an alcoholic drink and a soft drink, so as to encourage the young in particular to move to drinks with a lower alcohol content. For the same reason, I propose from 1 October to abolish the minimum duty charge on beer, which will encourage the promotion of low-alcohol beers.

J6. I propose once again to leave the main rates of Vehicle Excise Duty unchanged. To recover the revenue forgone, I propose increases in petrol and derv duty over and above the rate of inflation, which, including VAT, will raise the price of petrol by between fivepence and sixpence a gallon, and that of derv by less than fivepence a gallon. These changes will take effect from 6 o'clock tonight.

J7. In my Budget last year, I sought to promote the use of lead-free petrol, with all the environmental benefits it brings, by introducing a duty differential in its

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favour. As a result, the number of garages selling lead-free petrol has more than trebled. But consumption remains disappointingly low.

J8. Accordingly, I propose to double the duty differential in its favour by exempting it altogether from the duty increase I have just announced for leaded petrol. This means that, despite the higher production costs, the pump price of unleaded petrol should in future be below that of ordinary 2-star petrol. I very much hope the petrol companies will now reinforce this concession by vigorously promoting the use of lead-free petrol.

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K1. I now turn to taxes on capital.

K2. The emergence of the capital-owning democracy has been one of the most remarkable features of the 1980s.

Encouraged by Government policy, ~~over £1000 2½~~^{almost three} million families have bought their homes, bringing the total to nearly two households in three. And our proposals for personal pensions, which come in to effect in July, will give a new dimension to pension ownership.

K3. But the most dramatic change has been in share ownership. In last year's Budget, I announced the results of a joint Treasury/Stock Exchange survey of the number of shareholders in this country. This revealed that some $8\frac{1}{2}$ million people - one adult in five - owned shares, about three times the number in 1979.

K4. A similar survey has been carried out this year. Despite all the stories of people taking quick profits on privatisation shares, and despite the stock market collapse, the results show that the number of individual shareholders has if anything risen further over the past 12 months, to very nearly 9 million. This illustrates in

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a quite remarkable fashion how [the habit of] share ownership is now taking root.

K5. I have two proposals to encourage share ownership still further to announce today.

K6. First, Personal Equity Plans are off to a successful start. Over a quarter of a million people took out PEPs in 1987, and subscribed nearly £½ billion between them. To give further encouragement to this form of investment, I propose to increase the annual limit from £2,400 to £3,000. The new higher limit will apply to all plans taken out this year.

K7. Second, measures to encourage employee share ownership have featured in seven out of the last eight Budgets. As a result, the number of approved all-employee share schemes has risen from 30 in 1979 to over 1400 today, involving well over 10,000 companies, and providing shares and options for well over 1½ million employees.

K8. Following extensive consultation, including the publication of draft clauses, I propose to relax the provisions of Section 79 of the 1972 Finance Act. This will make it easier for companies to provide shares to their employees outside the approved schemes without giving rise to an undue charge to tax. This will be of

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particular benefit to subsidiary companies and their employees.

K9. In previous Budgets I have already substantially reformed the taxation of capital, with the replacement of Capital Transfer Tax by Inheritance Tax. But I believe this process can and should be taken further. Last year, I reduced the number of inheritance tax rates from seven to four. This year, I propose to simplify the tax still further by levying it at a flat rate of 40 per cent.

K10. At the same time I propose to raise the threshold from £90,000 to £110,000.

AG7

K11. The increase in the threshold will reduce the number of estates liable to tax by a quarter, allowing many more people to inherit the family home free of tax. And the flat rate of 40 per cent means that for the family business, enjoying 50 per cent business relief, the effective rate of tax can never exceed 20 per cent, one of the lowest inheritance tax rates in the industrialised world.

K12. The cost of these changes will be £100 million in 1988-89.

K13. Lastly, Capital Gains Tax. Strictly speaking, this should not be a tax on the original capital at all. Nor

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is it, so far as gains which have arisen since 1982 are concerned, thanks to the indexation provisions introduced by my predecessor in 1982, and extended in my 1985 Budget.

K14. But for gains that arose before 1982, the tax falls largely on purely paper profits resulting from the rampant inflation of the 'seventies. In other words, it bites deeply, and capriciously, into the capital itself.

K15. This has long been recognised as manifestly unjust. Indeed, from the time I first entered this House I have argued that Capital Gains Tax should fall only on real gains, and not on paper gains. I have therefore looked hard to see if the indexation provisions could be applied right back to the inception of the tax in 1965. Unfortunately, they cannot. The necessary information is in many cases no longer available.

K16. Accordingly, I have decided to bring the base date for the tax forward from 1965 to 1982. That is to say, for all disposals on or after 6 April, that part of any capital gain which arose before April 1982 will be exempt from tax altogether, for individuals and companies alike.

K17. This Budget thus ends once and for all the injustice of taxing purely inflationary gains. This will benefit the economy by unlocking assets which have been virtually

In content, but
N.B. rolled-over gains
still brought into
rebasing will not
exclude pre-82
element in rolled-
over gains. To be
precise, begin 2nd
sentence
"Where, on or after 6 April,
a taxpayer disposes of
an asset, which he has
held since before April 1982,
that part of..."

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sterilised because of the penal tax that would have arisen on any sale. And it will help many small businessmen and farmers in particular.

K18. At present, the first £6,600 a year of capital gain is tax free. The relatively high level of this threshold stems from the substantial increase my predecessor made in 1982, explicitly as rough and ready partial compensation for the continued taxation of pre-1982 paper gains. Now that I have taken pre-1982 gains out of tax altogether, I propose to reduce the capital gains tax threshold to £5,000. It should also be borne in mind that, with the introduction of independent taxation in 1990, a husband and wife will each have their own threshold for capital gains tax as well as for income tax.

K19. Rebasing the tax so as to produce a fully indexed system makes it possible to bring the taxation of gains closer to that of income. In principle, there is little economic difference between income and capital gains, and many people effectively have the option of choosing to a significant extent which to receive. And, insofar as there is a difference, it is by no means clear why one should be taxed more heavily than the other. Taxing them at different rates distorts investment decisions and inevitably creates a major tax avoidance industry.

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K20. Moreover, at present, with capital gains taxed at 30 per cent for everybody, higher rate taxpayers face a lower - sometimes much lower - rate of tax on gains than on investment income, while basic rate taxpayers face a higher rate of tax on gains than on income. This contrast is hard to justify.

K21. I therefore propose a fundamental reform. Subject to the new base date, capital gains will continue to be worked out as now, with the present exemptions and reliefs. In particular, the principal private residence will remain tax-free. But the indexed gain will [then] be taxed at the income tax rate that would apply if it were the taxpayer's marginal slice of income. In other words, I propose in future to apply the same rate of tax to income and capital gains alike.

AG7

K22. These changes will not take effect until 6 April.

K23. Taxing capital gains at income tax rates makes for greater neutrality in the tax system. It is what we now do for companies. And it is also the practice in the United States, with the big difference that there they have neither indexation relief nor a separate capital gains tax threshold.

K24. The changes I have announced represent a thoroughgoing reform of capital gains tax which will

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benefit the economy and eradicate a major injustice. They will sharply reduce the damaging effects of the tax, while ensuring that capital gains remain properly taxed and the yield of income tax adequately protected.

K25. They are expected to cost £210 million in 1989-90.

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L. INCOME TAX

L1. Finally, I turn to income tax.

L2. The way to a strong economy is to boost incentives and enterprise. And, that means, among other things, keeping income tax as low as possible.

L3. Income tax has now been reduced in each of the last six Budgets - the first time this has ever occurred. And the strength of the economy over that period speaks for itself.

L4. However, reforming Income Tax is not simply a matter of cutting the rates. I also have to look at all the various allowances and reliefs to ensure that they are still justified.

L5. With this in mind, I have a number of proposals to announce.

L6. First, forestry. I accept that the tax system should recognise the special characteristics of forestry, where it can take anything up to a hundred years between the costs of planting and the income from selling the felled timber.

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L7. But the present system cannot be justified. It enables top rate taxpayers in particular to shelter other income from tax, by setting it against expenditure on forestry, while the proceeds from any eventual sale are effectively tax free.

N. Monck/
IR (NB CG7-1 HFT still
charged.)

L8. The time has come to bring it to an end. I propose to do so by the simple expedient of taking commercial woodlands ~~out of the tax system~~ ^{income tax} altogether. That is to say, as from today, and subject to transitional provisions, expenditure on commercial woodlands will no longer be allowed as a deduction for income tax and corporation tax. But, equally, receipts from the sale of trees or felled timber will no longer be liable to tax.

EST

AG7

L9. It is, perhaps, a measure of the absurdity of the present system that the exemption of commercial woodlands from tax will, in time, ^{increase tax revenues by} produce a yield of over £10 million a year.

L10. [But] in order to further the Government's objectives for the rural areas, I have agreed with my hon. Friends who have responsibilities for forestry and the environment that, in parallel, there should be increases in planting grants. Full details of the new grant scheme will be announced next week.

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L11. The net effect of these changes will be to end an unacceptable form of tax shelter; to simplify the tax system, abolishing the archaic Schedule B in its entirety; and to enable the Government to secure its forestry objectives with proper regard for the environment, including a better balance between broad-leaved trees and conifers.

L12. One of the legacies of the years of penal top tax rates is the complicated special relief for large redundancy payments. This is no longer justified. I propose to increase the exemption limit for these payments from £25,000 to £30,000, and to abolish the additional relief for larger amounts.

(APH: A bit late, I know,
but cd we drop L13?)

IR

IR

AGT wd drop.

L13. I have a few changes to propose following from the recommendations of the Keith Committee [on the Inland Revenue taxes]. Most are designed to improve compliance, and to help the ^{Inland} Revenue to uncover taxpayers who do not declare all their income, particularly where large amounts of tax are being lost. At the same time I have reviewed the VAT enforcement regime, and have a number of relaxations to propose which will make life easier for businesses, while safeguarding tax revenue. Some of the penalties will be reduced from midnight tonight.

L14. Next, benefits in kind - perhaps better known as perks. One of the biggest tax-induced distortions in the economy today is the growing tendency to provide

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remuneration in kind rather than in cash. It must be right to move towards a system of lower taxes all round and fewer tax breaks of this kind.

L15. Far and away the most widespread benefit in kind is the company car, which is substantially undertaxed. Independent studies, based on figures supplied by the AA, suggest that an employee with a typical company car may be taxed on only ^{about} _{1/4} a quarter of its true value [to him].

IR
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L16. This discrepancy is too great to be allowed to continue. On the other hand, the scale of the undertaxation is so great that it cannot be put right in a single year. But in a Budget when I am able to reduce tax rates, there is a strong case for a substantial increase in the taxation of these benefits. I therefore propose to double the car scales for 1988-89. This increase replaces the 10 per cent increase which I had already announced for 1988-89. The yield [from this] will be £260 million in 1988-89.

APP

L17. The scales for the taxation of car fuel adequately reflect the value of the benefit, and I propose to leave them unchanged for 1988-89.

L18. However, the taxation of the benefit of free car parking threatens to become an administrative nightmare. I propose to exempt this particular benefit from tax altogether.

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L19. Next, mortgage interest relief. This Government is committed to the further spread of home ownership. Mortgage interest relief has an important role to play in achieving that aim, [and will continue in place, against both the basic and higher rates of tax.]

AGT wd date

AGT

[R: "one" implies that's all; in fact you've got relief for dep. relative, tho' not in speech.]

L20. However, in addition to the decision to apply the £30,000 limit to the house or flat, which I have already announced, and which will remove [the most] widely-resented tax penalty on marriage, I have ^a one further reform to propose in this area.

L21. This concerns the parallel tax relief for home improvement loans. Most of these loans are for fittings such as double glazing, and have played a significant part in the recent growth of consumer credit without in any way contributing to the expansion of home ownership. This may be partly due to the substantial scope for abuse, as loans ostensibly taken out for home improvements are used for other purposes, a matter which was the subject of a recent report from the Public Accounts Committee.

L22. I propose, therefore, to end tax relief for all new home improvement loans taken out after 5 April. Existing home improvement loans will be unaffected. [This is expected to yield £80 million in 1988-89.]

PJC wd omit. Not the main aim of the exercise.

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L23. Finally, I turn to income tax itself.

L24. The statutory indexation formula means that I should increase all the principal income tax allowances and bands by the increase in the RPI over the year to last December, or 3.7 per cent, rounded up. I propose to do more than that; indeed twice as much.

L25. Thus the single allowance will go up not by £90, as required by indexation, but by £180, to £2605; and the married allowance will go up not by £150 but by £300, to £4095. The additional personal allowance and widow's bereavement allowance will thus rise by £120 to £1490. Similarly the single age allowance will rise by £220 to £3180 and the married age allowance by £360 to £5035. The higher allowances for taxpayers aged 80 and over, which I introduced in the last Budget, will correspondingly be increased by £240 and £360 to £3310 and £5205 respectively, and the new age allowance income limit will be £10,600. The upper limit of taxable income for the basic rate band will be increased to £19,300.

L26. The increases I have just announced mean that the basic tax thresholds will be fully 25 per cent higher, in real terms, than they were in 1978-79, Labour's last year. Indeed, the married man's tax threshold will be at its highest level in real terms for nearly half a century.

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L27. Given these substantial increases in the main allowances, I am taking the opportunity to simplify the system by abolishing three minor personal allowances which have been unchanged, in cash terms, for over twenty years: the housekeeper allowance, the dependent relative allowance, and the son's or daughter's services allowance.

L28. In our general election manifesto last year, we committed ourselves to reducing the basic rate of income tax to 25 pence in the £ as soon as it was prudent to do so. This pledge followed a reduction of twopence in the £ to 27 pence in last year's Budget.

L29. At the time, this was regarded with some scepticism, not to say cynicism, by the Opposition, who no doubt recalled that Labour Governments used to reduce tax only in front of an election, and at all other times increased it. Indeed, shortly before last year's Budget the rt hon Gentleman the deputy leader of the Labour Party said this:

"I must advise the Chancellor of something he already knows: whichever party wins the general election, the tax cuts he makes in this Budget will be reversed." *that*

APH
(checked Hansard
20 Jan 87)

L30. The time has come to put the rt hon Gentleman out of his misery. So far from reversing the 1987 Budget tax reductions, I propose to take this, the first opportunity

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since the general election, to fulfil our manifesto pledge. The basic rate of income tax for 1988-89 will be 25 pence in the pound.

L31. The small companies' rate of corporation tax will similarly be reduced to 25 per cent. This means that the basic rate of income tax, and the corporation tax rate for small companies, will both be at their lowest level since the War.

L32. Life Assurance premium relief remains in place for policies taken out before the 1984 Budget. It has traditionally been given at half the basic rate of income tax. I therefore propose to reduce it from 15 per cent to 12½ per cent. But, to give life offices time to adjust, this change will not take effect until 6 April 1989.

L33. I also propose to reduce the additional rate which applies to the income of discretionary trusts and for certain other purposes from 18 per cent to 10 per cent.

L34. It is now nine years since my predecessor, in his first Budget in 1979, reduced the top rate of tax from the absurd 83 per cent that prevailed under Labour to 60 per cent, where it has remained ever since.

L35. At that time, this was broadly in line with the European average for the top rate of tax. It is now one

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of the highest. And not only do the majority of European countries now have a top rate of tax below 60 per cent, but in the English-speaking countries outside Europe - not only the United States and Canada, but socialist Australia and New Zealand, too - the top rate is now below 50 per cent, sometimes well below.

L36. The reason for the worldwide trend towards lower top rates of tax is clear. Excessive rates of income tax destroy enterprise, encourage avoidance, and drive talent to more hospitable shores overseas. As a result, so far from raising additional revenue, over time they actually raise less.

L37. By contrast, a reduction in the top rates of tax can, over time, result in a higher, not a lower, yield to the Exchequer. Despite the substantial reduction in the top rate of tax in 1979, and the subsequent abolition of the investment income surcharge in 1984, the top five per cent of taxpayers today contribute a third as much again in real terms as they did in 1978-79, Labour's last year; while the remaining 95 per cent of taxpayers actually pay less.]

IR are getting cold feet about this, & I was unable to contact R.Eason. Safe bet is to replace with either "the remaining 95%... pay about the same" or the top 5%... pay a signif. higher share of total yield.

L38. After nine years at 60 per cent I believe the time has come to make a further reduction in the top rate of income tax. At present there are no fewer than five higher rates of income tax: 40 per cent, 45 per cent,

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50 per cent, 55 per cent, and 60 per cent. I propose to abolish all the higher rates of tax above 40 per cent.

L39. This major reform will leave us with one of the simplest systems of income tax in the world, consisting of a basic rate of 25 per cent and a single higher rate of 40 per cent. And, indeed, a system of personal taxation in which there is no rate anywhere in excess of 40 per cent.

L40. I believe that 40 per cent is an acceptable top rate of tax. But, bearing in mind that the basic rate of income tax is also the starting rate, 25 per cent is still too high.

APH
("now" in next sentence, too)

L41. Since we first took office in 1979, we have [now] reduced the basic rate of income tax from 33 per cent - one third - to 25 per cent - a quarter. Our aim should now be to get it down to a fifth - a rate of 20 pence in the pound - as soon as we prudently and sensibly can.

L42. Meanwhile, I have today been able to reduce income tax at all levels, with increases in both the personal allowances and the basic rate limit, and reductions in both the basic and higher rates. The tax reduction for a married man on average earnings [in 1988-89] will be worth nearly £5 a week. The changes will take effect under PAYE on the first pay day after 14 June. They will cost

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£4 $\frac{1}{4}$ billion in 1988-89 over and above statutory indexation, of which three quarters represents the cost of increasing tax thresholds and reducing the basic rate.

L43. The total cost of all the measures in this year's Budget, again on an indexed basis, is £4 billion.

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M. PERORATION

Mr Deputy Speaker,

M1. In this Budget, I have reaffirmed the prudent policies which have brought us unprecedented economic strength. I have announced a radical reform of the taxation of marriage, which for the first time ever will give married women a fair deal from the tax system. I have eliminated the long-standing injustice of taxing inflationary gains, and abolished a fifth tax. I have radically reformed the structure of personal taxation, so that there is no rate anywhere in the system in excess of 40 per cent.

For the second successive year, the Government has taken a hat-trick.

M2. After an Autumn Statement which substantially increased public spending in priority areas, I have once again cut the basic rate of income tax, fulfilling our manifesto pledge of a basic rate of 25 pence in the £ and setting a new target of 20 pence in the £.

M3. And I have balanced the Budget.

M4. I commend this Budget to the House.

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FROM: MRS T C BURNHAMS

DATE: 11 March 1988

PS/CHANCELLOR OF THE EXCHEQUER

**cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir Peter Middleton
Mr Scholar
Mr Culpin
Miss Sinclair
Miss Evans
Miss Hay
Mr Michie**

BUDGET RESOLUTIONS

I attach a copy of the last draft of the Resolutions for information. As before, Inland Revenue, Customs and Department of Transport will do the main scrutiny but any comments you may have should reach me by noon on Monday 14 March.

B.L.O.

Teresa Burnham

MRS T C BURNHAMS

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Ref: APH / 49
Copy No. 5
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FROM: A. P. HUDSON
DATE: 11 March 1988

BUDGET
CHANCELLOR

cc: Mr A C S Allan

BUDGET SPEECH =

I attach the version including the amendments you made this morning.

It is 9628 words, quite a lot shorter than Monday's version. At 135 wpm, that's 1 hour 11 minutes; at 130 wpm, 1 hours 16 minutes.

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Draft of 10 March (2nd)

BUDGET

CHANCELLOR OF THE EXCHEQUER'S BUDGET STATEMENT

15 MARCH 1988

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BUDGET**A INTRODUCTION**

Al. I am reliably informed that my Budget speech last year was the shortest this century. My Budget speech this year is likely to have a different claim to a place in the history books. Not, the House will be glad to learn, as the longest Budget speech this century, but as the last untelevised Budget speech.

A2. As I once again present the first Budget of a new Parliament, I find the British economy stronger than at any time since the War. As the British people recognised last June, this has not happened by chance. It has happened because, for almost nine years now, we have followed the right policies and stuck to them. I reaffirm those policies today. In particular, there will be no letting up in our determination to defeat inflation.

A3. I shall begin, as usual, with the economic background to the Budget. I shall then deal with monetary policy, and with the public finances this year and next, and indeed for the remainder of this Parliament. Finally, I shall propose a number of measures designed to improve the performance of the economy still further, by changing the structure of taxation. For this will be a tax reform Budget.

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A4. As usual, the Financial Statement and Budget Report, together with a number of press releases filling out the details of my tax proposals, will be available from the Vote Office as soon as I have sat down.

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BUDGET**B. THE ECONOMIC BACKGROUND**

B1. I start with the economic background.

B2. The strength and durability of the economic upswing has now exceeded all post-War records. We are about to enter our eighth successive year of sustained growth, and the sixth in which this has been combined with low inflation. And even without looking to 1988, the six years to 1987 have been the longest period of steady growth, at a rate averaging 3 per cent a year, for half a century.

B3. This performance compares favourably not only with our own past, but also with the economic performance of other countries. During the 1960s and the 1970s, Britain's growth rate was the lowest of all the major European economies. During the 1980s, our growth rate has been the highest of all the major European economies.

B4. In 1987 as a whole, output grew by $4\frac{1}{2}$ per cent, while inflation averaged $4\frac{1}{4}$ per cent. Thus last year, for the first time for a generation, the rate of growth exceeded the rate of inflation. At the same time unemployment fell more than in any other year since the War, in every region of the country, and faster than in any other major nation.

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B5. The plain fact is that the British economy has been transformed. Prudent financial policies have given business and industry the confidence to expand, while supply side reforms have progressively removed the barriers to enterprise.

B6. Nowhere has this transformation been more marked than in manufacturing, where output rose last year by $5\frac{1}{2}$ per cent. This outstanding performance was founded on a further big improvement in manufacturing productivity. In the 1980s, output per head in manufacturing has gone up faster in Britain than in any other major industrial country, and we led the way once again last year. This is in stark contrast to the 1960s and 1970s, when in manufacturing productivity growth, as in so much else, we were bottom of the league.

B7. The current account of the balance of payments is now estimated to have been in deficit last year, after seven successive years of surplus, by a little over £1 $\frac{1}{2}$ billion. This is well below the deficit I forecast at the time of last year's Budget, despite growth turning out stronger than forecast. The reason for this was the better than expected performance of visible trade, with exports of manufactures up by $8\frac{1}{2}$ per cent. This continues the pattern of the 1980s, with British manufacturers maintaining their share of an expanding world trade, after decades during which Britain's share was steadily declining.

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B8. Looking ahead, I expect 1988 to be yet another year of healthy growth with low inflation; and there is every prospect that unemployment will continue to fall, although probably not as rapidly as last year.

B9. The pace of non-oil growth is likely to ease from now on, returning to the underlying trend of the past few years. But output for 1988 as a whole is forecast to be 3 per cent higher than in 1987, with the non-oil economy up by $3\frac{1}{2}$ per cent. Business investment is forecast to grow particularly strongly, with a rise of $8\frac{1}{2}$ per cent.

B10. As last year, inflation is forecast to end the year at 4 per cent. While this is still too high, it is a testimony to the soundness of our policies that the present strong and sustained upswing, unlike almost all its predecessors, has not led to a resurgence of inflation.

B11. With growth in the UK economy likely to continue to outpace that of most other major countries, particularly in continental Europe, and with our oil surplus falling as North Sea oil production declines, the current account of the balance of payments is forecast to remain in deficit this year, by some £4 billion, equivalent to less than one per cent of GDP. Given the strength of the economy in general, and of our public finances in particular, not to mention our massive net overseas asset

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position, I foresee no difficulty in financing a temporary current account deficit of this magnitude.

B12. But the outlook both for exports and for jobs will depend critically on employers keeping their costs firmly under control. Unit labour costs in manufacturing scarcely rose at all in 1987. It is vital that employers do not let this slip, and keep a tight grip on all their costs, not least pay.

B13. In my Budget speech last year, I warned that:

"Given the continuation of present policies in this country, the biggest risk to the excellent prospect I have outlined is that of a downturn in the world economy as a whole."

That remains the case. The dramatic collapse in the world's equity markets last October was not the second coming of 1929 and the harbinger of a 1930s-style world slump, as so many feared at the time - although it could have been a great deal nastier had the authorities in the major nations not responded in a prompt and appropriate way. It was essentially an overdue market correction which did little more than reverse the rapid rise in share prices of the previous year. Certainly, business confidence does not seem to have been greatly affected, and growth in the seven major industrial countries as a whole this year is likely to be only slightly lower than last year.

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B14. But Black Monday was also a warning. The world's three largest economies - the United States, Japan and Germany - have made a number of the policy adjustments necessary to reduce the imbalances which have for so long afflicted them, and there is evidence that the measures they have taken are starting to bear fruit. But there is still a long way to go; and meanwhile there is the constant danger that the process of adjustment, and with it the world economy as a whole, could be gravely damaged either by further wild gyrations in the dollar exchange rate or by a lurch into protectionism.

B15. There are some who continue to insist that the simple and only solution to these imbalances lies in a further substantial fall in the dollar, even though the source of the problem lies elsewhere. They see exchange rate changes as a miracle cure, whatever the illness. They wholly ignore the damage that exchange rate volatility does to economic health, and distract attention from the fundamental causes of the imbalances.

B16. Success in reducing these imbalances depends on countries putting the right fiscal and monetary policies in place, and keeping them there. But the necessary adjustments are much more likely to be achieved if the objective of greater exchange rate stability is given an explicit role in the process of international co-operation, as has been the case for well over

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two years now. I can assure the House that we shall play our full part.

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BUDGET**C. MONETARY POLICY**

C1. Meanwhile, the maintenance of sound money and prudent public finances will keep us in the best possible position to weather any shocks we may face, whether at home or abroad.

C2. The Medium-Term Financial Strategy, now entering its ninth year, will continue to provide the framework for reducing the growth of money GDP, and hence inflation, over the medium term. These will be achieved by maintaining firm monetary discipline, buttressed by a prudent fiscal stance.

C3. Short term interest rates remain the essential instrument of monetary policy. Within a continuous and comprehensive assessment of monetary conditions, I will continue to set interest rates at the level necessary to ensure that inflationary pressures are not accommodated.

C4. I believe that most businessmen have welcomed the greater stability between sterling and the Deutschmark that has persisted over the past year. It is important that they also accept the financial discipline inherent in this policy.

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C5. Achieving the gradual eradication of inflation also requires a steady reduction in monetary growth in the medium term. While I shall continue to take account of broad money, or liquidity, as last year there will be no explicit target. For narrow money, MO, the target range for 1988-89 will be 1-5 per cent, as foreshadowed in last year's MTFS.

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D. PUBLIC SECTOR FINANCES

D1. As I pointed out a moment ago, a sound monetary policy needs to be buttressed by a prudent fiscal stance.

D2. At one time, it was regarded as the hallmark of good government to maintain a balanced budget; to ensure that, in time of peace, government spending was fully financed by revenues from taxation, with no need for government borrowing. Over the years, this simple and beneficent rule was increasingly disregarded, culminating in the catastrophe of 1975-76, when the last Labour Government had a budget deficit, or Public Sector Borrowing Requirement, equivalent in today's terms to some £40 billion.

D3. This profligacy not only brought economic disaster and the national humiliation of a bail-out by the IMF. It also added massively to the burden of debt interest, not merely now but for generations to come.

D4. Thus one of our main objectives, when we first took office in 1979, was to bring down government borrowing. We steadily reduced the Public Sector Borrowing Requirement from the 5½ per cent of GDP we inherited to only three quarters of one per cent in 1986-87. Today I

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am able to tell the House that in 1987-88, the year now ending, we are set to secure something previously achieved only on one isolated occasion since the early 1950s: a balanced budget.

D5. Indeed, we have gone even further. It looks as if the final outturn for 1987-88 will be a budget surplus of £3 billion. Instead of a PSBR, a PSDR: not a Public Sector Borrowing Requirement, but a public sector debt repayment.

D6. And, incidentally, even if there had been no privatisation proceeds at all, the resulting PSBR, at a half of one per cent of GDP, would still have been the lowest in all but one year since the early 'fifties.

D7. A balanced budget is a valuable discipline for the medium term. It represents security for the present and an investment for the future. Having achieved it, I intend to stick to it. In other words, henceforth a zero PSBR will be the norm.

D8. In the very nature of things, there are bound to be fluctuations on either side from year to year. It is in this context that I have to set the precise fiscal stance for the year ahead, 1988-89.

D9. I have already announced, in the Autumn Statement last November, a substantial increase in public expenditure plans for 1988-89, with spending on

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programmes up by over £4½ billion. In particular, we have increased our plans for spending on health and personal social services by £1 billion, on education and science by £900 million, and on law and order by £500 million.

D10. These large increases in public expenditure for the coming year will be financed partly from the saving in debt interest resulting from the reduction in Government borrowing. Debt interest now accounts for more than half a percentage point less of GDP than it did only three years ago. This may not sound very much, but it implies a saving of almost £3 billion a year. And the balanced budget path I have set out in this year's MTFS will help to reduce debt interest payments still further.

D10A. We have thus secured an enviable virtuous circle in public finance: lower borrowing and lower tax rates create both the scope and the incentive for the private sector to expand. And the private sector then generates higher revenues which permit further reductions in borrowing or tax.

D11. But even so, the increased public spending now planned for 1988-89 inevitably implies less scope for reducing taxation. Moreover, I have decided that for the year immediately ahead, the path of prudence and caution is to budget for a further surplus of the same size as this year's expected outturn - that is to say, a further public sector debt repayment of some £3 billion.

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D12. What this means is that it will not be possible in this Budget to reduce the burden of taxation; that is to say, to reduce taxation as a share of GDP.

D13. However, the House may be pleased to know that, with a strong and healthy economy, a constant burden of taxation implies a reduction in tax rates.

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E1. I indicated at the outset that this will be a radical, tax-reforming Budget.

E2. Over the past few years there has been increasing recognition, throughout the industrialised world, of the importance of tax reform in improving economic performance. And for us in this country, the lesson is underlined by the success of the reform of business taxation I announced in my first Budget, at the start of the last Parliament.

E3. But while tax reform is a simple matter for the armchair critic, it is very much more difficult in practice. It is difficult technically and difficult politically - since any tax system, however it arose, creates powerful vested interests in favour of the status quo. Nor, indeed, is it right that change should be too violent. People have a right to expect a reasonable degree of stability in the framework within which they order their affairs. But stability should not mean immobility. That way lies national decline.

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E4. The tax-reforming Chancellor thus has to tread a careful path. That I have sought to do in this Budget. The proposals I shall be making today amount to a substantial and coherent package which will be of increasing benefit to the taxpayer and the economy as a whole in the years to come.

E5. I have been guided by four basic principles. First, the need to reduce tax rates where they are clearly too high. Second, the need to reduce or abolish unwarranted tax breaks. Third, the need to make life a little simpler for the taxpayer. And, fourth, the need to remove some manifest injustices from the system.

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F1. My first reform concerns the taxation of marriage.

F2. The present system for the taxation of married couples goes back 180 years. It taxes the income of a married woman as if it belonged to her husband. Quite simply, that is no longer acceptable.

F3. This is a matter on which there has already been extensive consultation. The time has come to take action.

F4. I therefore propose a major reform of personal taxation, with two objectives. First, to give married women the same privacy and independence in their tax affairs as everyone else. And second, to end ways in which the tax system can penalise marriage.

F5. I have decided to introduce, at the earliest practicable date, April 1990, a completely new system of independent taxation.

F6. Under this new system, a husband and wife will be taxed independently, on income of all kinds. All taxpayers, male or female, married or single, will be entitled to the same personal allowance, which will be

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available against income of all kinds, whether from earnings, pensions or savings.

F7. In addition, there will be a married couple's allowance, equivalent in value to the difference under the old system between the married man's allowance and the single allowance. This new allowance will go in the first instance to the husband, so that his tax threshold does not fall. But if he does not have enough income to use it in full, he will be able to transfer any unused portion to his wife, to set against her income.

F8. This ensures that the tax system will continue to recognise marriage, as it should do. At the same time, from 1990 married women will pay their own tax, on the basis of their own income, and have their own tax return, when one is necessary. There will, of course, be nothing to stop married women from asking their husbands to handle their tax affairs, as before; and many will no doubt do so. But what matters is that, for the first time ever, married women will have the right to complete independence and privacy so far as tax is concerned.

F9. In the same way, a husband and wife will be taxed independently on any capital gains they may have, with an annual exemption each, instead of one between them, as now. But transfers of capital between husband and wife

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will continue to be entirely free of any liability to tax.

F10. As I have said, the new system will come into force in 1990. This is much sooner than would have been possible for most of the alternatives that have been canvassed. The necessary legislation will be contained in this year's Finance Bill. The cost of this historic reform, which for the first time ever gives a fair deal to married women, will be £550 million in 1990-91.

F11. I mentioned a few moments ago the tax penalties on marriage. It is clearly wrong that some couples should find themselves paying more tax, simply because they are married. I propose to put that right.

F12. Independent taxation by itself will remove the most common penalty - the taxation of a married woman's income at her husband's marginal rate. But there are other tax penalties on marriage, and I propose to abolish all of them. These changes need not await the introduction of Independent Taxation.

F13. Under the present system an unmarried couple can get twice as much mortgage interest relief as a married couple. This has attracted increasing - and justified - criticism. I propose to put a stop to it as from August this year. Thereafter, the £30,000 limit on mortgage

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interest relief will be related to the house or flat, irrespective of the number of borrowers. This was the solution put forward in the 1986 Green Paper on Personal Taxation, and it was widely welcomed. Existing mortgages will be unaffected.

F14. Another anomaly is that an unmarried couple with children can each claim the Additional Personal Allowance intended for single parents, and thus get more tax relief than a married couple in the same position. I propose to confine them to a single Additional Personal Allowance, with effect from April 1989.

F15. Thus this Budget will not only, for the first time ever, give married women a fair deal from the tax system. It will also eliminate, for all practical purposes, all the other tax penalties which, under the present system, can arise on marriage.

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BUDGET**G. BUSINESS TAXATION**

G1. I turn now to business taxation.

G2. The major reform of business taxation, which I introduced in 1984, and which was completed in 1986, has given us one of the lowest Corporation Tax rates in the world. This has encouraged overseas companies to invest in Britain and, most important of all, has greatly improved the quality of investment by British firms. It is a crucial part of an environment in which company profitability has recovered to its highest level for some twenty years. It has succeeded in its objectives.

G3. I do not therefore propose any further changes to the structure of Corporation Tax. And the main Corporation Tax rate for 1988-89 will be unchanged at 35 per cent.

G4. But I do have some changes to propose to specific aspects of business taxation.

G5. British exporters have done extremely well in recent years, thanks to major improvements in efficiency and quality. But no exporter could honestly claim that his success hinges on the fact that the cost of entertaining

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overseas customers is tax deductible, whereas business entertainment generally is not. I therefore propose to simplify the system by making all business entertainment non-deductible for tax purposes, including for VAT.

G6. In conjunction with my rt. hon. Friend the Secretary of State for Energy, I propose to restructure the tax regime for the new generation of Southern basin and onshore fields, so as to relate tax liability more closely to profitability. Accordingly, my rt hon Friend will shortly be bringing forward legislation to abolish royalties, from 1 July, for all such fields. At the same time, I propose to reduce the Petroleum Revenue Tax oil allowance for these fields. This will mean the end of royalties for all future fields.

G7. The 1986 Building Societies Act gives Building Societies the power, to convert themselves into companies, if they so wish. At present, however, they would face a heavy, and unintended, tax charge if they did so. I propose to rectify this.

G8. I have two changes to propose to the tax arrangements for Lloyd's. The first meets the only point Lloyd's have raised on last year's legislation on reinsurance to close. The second will benefit both Lloyd's and the Inland Revenue by simplifying the administrative arrangements for taxing Lloyd's members.

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G9. I also propose to simplify the Section 482 rules for companies who wish to migrate overseas, so as to bring them broadly into line with most of our major competitors. Instead of having to ask for Treasury consent, companies will be free to migrate, provided only that they pay their tax first.

G10. I now turn to a number of proposals to give further help to small businesses and new businesses, whose encouragement is a central theme of Government policy. The rate of new business formation, net of failures, has averaged 500 a week, week in, week out, since 1979. This shows beyond any doubt the continuing vigour of this sector, which is such an important source of enterprise, innovation, and new jobs.

G11. Many new businesses have been greatly assisted by the Business Expansion Scheme, which has now been running for nearly five years. During that time it has enabled new and expanding companies to raise equity finance amounting to some £150 million a year.

G12. However, the rapid growth of the venture capital market since 1983 has meant that companies seeking relatively large amounts of equity investment can now raise these readily, while smaller companies looking for more modest amounts can still find it difficult to do so.

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G13. To improve the targeting of BES, I therefore propose to introduce a limit of half a million pounds on the amount any company can raise under the scheme in any one year. Investment should thus be better directed at the smaller, newer and riskier businesses, particularly those outside the South-East of England, which can still find it hard to raise equity finance in other ways. In the special circumstances of the ship chartering industry, however, the limit will be £5 million.

G14. I have one further proposal affecting the Business Expansion Scheme.

G15. One of the key reasons for our economic transformation has been the reform of the supply side of the economy.

G16. The tax relief I introduced last year for profit-related pay will, in time, help to increase pay flexibility and improve the working of the labour market. But if successful firms are to expand further, and create still more jobs, we also have to make it easier for people to move to where the new jobs are.

G17. For years, the shortage of private rented accommodation has been an obstacle to labour mobility. The Government's proposals to deregulate new rents are already going through the House. Deregulation will, over

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time, substantially increase the supply of housing for rent. But this will not happen overnight, and there is a case for a special incentive to speed up the process in the early years.

G18. I therefore propose to extend the Business Expansion Scheme to include companies specialising in the letting of residential property on the new assured tenancy basis.

G19. The BES is well suited to this task. Since full tax relief is given immediately, it should bring forward new investment straight away. And we will be building on success.

G20. The limit for this type of investment will be £5 million a year for any one company. But since the relief is specifically designed to provide an extra stimulus in the early years of deregulation, it will run only for investments made before the end of 1993.

G21. This change will powerfully reinforce the impact of decontrol in reviving the private rented sector of housing in Britain.

G22. In last year's Budget I raised the ceiling for capital gains tax retirement relief from £100,000 of gain to £125,000. But I believe it is necessary to do more to help the small businessman whose entire wealth is tied up

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in his business and who is faced with the disincentive of a heavy capital gains tax bill when he sells up on retirement. I therefore propose to extend capital gains tax retirement relief so that, on top of the exemption, half of any gain between £125,000 and £500,000 will also be completely free of tax.

G22A. While on the subject of capital gains tax, I propose to extend rollover relief to a group of assets whose common characteristic is that they did not exist when the present list of qualifying assets was drawn up. They are milk quotas, potato quotas, satellites and spacecraft. I know that this will be warmly welcomed in the farming and extra-terrestrial communities alike.

G23. Lastly, on the small business front, I propose to increase the VAT threshold to £22,100, the maximum permitted under existing European Community Law.

G24. Throughout my time as Chancellor, I have been on the look-out for taxes to abolish. Abolition is clearly the simplest variety of reform. I have already abolished the National Insurance surcharge, the Investment Income surcharge, Development Land Tax, and the tax on lifetime gifts. Today I propose to abolish a further tax: Capital Duty.

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G25 At present, companies have to pay a 1 per cent duty whenever they raise new capital - whenever, for example, a new company is formed or an existing company sells new shares to the public. This is undesirable on two counts. It is a burden on companies who need to secure external finance for expansion. And it discriminates against equity capital as compared with debt finance and bank borrowing.

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G26. Capital Duty is a relatively recent impost which had to be introduced in 1973 in compliance with our obligations under European Community Law. But the relevant Community Directive has now been amended. Accordingly, I propose to abolish Capital Duty with effect from midnight tonight.

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G27 At the same time, I propose to get rid of the Unit Trust Instrument Duty, a similar though much less substantial tax, which is levied at the rate of $\frac{1}{4}$ per cent on all property put into a unit trust. I know the unit trust movement will welcome this minor relief, and I trust the benefit will be fully passed on to investors.

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G28. The cost of abolishing these two taxes will be of the order of £100 million in 1988-89. Not counting minor imposts, the demise of Capital Duty brings the number of taxes I have abolished up to five: an average of one a Budget.

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H. COVENANTS AND MAINTENANCE

H1. I now turn to an important area of personal taxation which is ripe for reform and simplification: the taxation of payments made under deeds of covenant and maintenance arrangements.

H2. Covenants to charity will be wholly unaffected by the changes I am about to propose.

H3. Other covenants, and maintenance arrangements, are essentially ways of transferring income from one individual to another, usually from one member of a family to another, whether it is a parent or grandparent covenanting to a child, or a husband paying maintenance to an ex-wife. Most financial transfers that take place within families are rightly and properly outside the scope of the tax system altogether. I propose, as far as is practicable, to take covenants and maintenance out as well. This will greatly simplify an unnecessarily complex part of the tax system.

H4. First, covenants. Charitable covenants apart, I propose to take all new covenants made by individuals on or after today out of the tax system altogether. In other words, people receiving payments under covenants

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will not be liable to tax on them, and those making the payments will not be able to claim tax relief on them. The tax treatment of existing covenants will continue unchanged.

H5. The largest single group of people affected by this change will be students, together with their parents, many of whom nowadays choose to make their contributions to the student maintenance grant by covenant. This has arisen as an unintended by-product of the reduction in 1970 of the legal age of majority from 21 to 18.

H6. As I have already indicated, those who have already made such covenants will continue to benefit from them. For new students, the parental contribution to the maintenance grant will be assessed on a new and more generous scale, to reflect the withdrawal of tax relief on new covenants. My right hon. Friend the Secretary of State for Education and Science will be publishing the new scale tomorrow.

H7. One desirable side-effect of this reform is that students will no longer be deterred from taking vacation jobs because their covenant income has already absorbed their personal allowance.

H8. Student covenants apart, there will be no compensation for the loss of tax advantage arising from these proposals. But once rates of income tax are set at

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reasonable levels, this is precisely the sort of tax shelter it is right to dispense with.

H9. Next, maintenance. Here, we tax the recipient only to give tax relief to the payer. The present rules can be complex and confusing for people going through separation and divorce. The tax system ought to intrude as little as possible, though it is reasonable that there should be some recognition of the fact that an ex-husband is continuing to support his ex-wife.

H10. Accordingly, I propose that, for new arrangements, recipients will not be liable to any tax whatever on maintenance payments. Relief to the payer will be restricted to payments to a separated or divorced spouse, up to a limit equal to the difference between the married and single allowances. But there will no longer be any tax relief either for payments above this limit, or for maintenance payments to anyone other than a separated or divorced spouse.

H11. For existing arrangements, the present rules will continue to apply in 1988-89, except that a separated or divorced spouse will be exempt from tax on receipts up to the difference between the married and single allowances. Full relief will continue for all those who are making payments under existing Court Orders or agreements. The same protection will also apply to those who have already applied for Court Orders, provided these are made by

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30 June. From April 1989 there will be special transitional rules to continue protection for pre-existing arrangements.

H12. While the transitional provisions are inevitably somewhat complex, the new system will be very much simpler than the old, for all concerned. At the same time, while it will reduce the tax relief that can be obtained by the better-off payers of large amounts of maintenance, for most couples the ex-husband will continue to enjoy full tax relief while the ex-wife will no longer be taxed.

H13. The reform of the tax treatment of maintenance I am proposing today will also remove one of the lesser known tax penalties on marriage. Tax relief greatly in excess of that which is available to a married couple will no longer be available to an unmarried couple who make large income transfers either between themselves or to their young children.

H14. As I have already indicated, the reform and simplification of the taxation of covenants and maintenance, which I have proposed today, in no way affects covenants to charity. Indeed, I have a proposal to help charities further.

H15. The payroll giving scheme has now been running for nearly a year. I am glad that so many employers have

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already set up schemes, and I hope as many employees as possible will take advantage of them. In order to give further encouragement to charitable giving, and to assist the growth of the payroll giving scheme, I propose to double the annual limit on tax-allowable donations under the scheme to £240 or £20 a month.

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J. TAXES ON SPENDING

J1. I now turn to the taxation of spending.

J2. I have one change to propose today affecting the coverage of Value Added Tax, which will remain at 15 per cent. Confectionery was brought in to VAT by the RHM for Leeds East in 1974, and the legal definition of confectionery goes back further still to the days of purchase tax. The emergence of new products has rendered this definition somewhat obsolete. In particular, recent legal decisions mean that some cereal bars are subject to VAT, while others are not. I propose to clarify the law so that all cereal bars are taxed.

J3. I propose to raise the excise duties as a whole in line with inflation, but to make some modest adjustments within the total. The duty on cigarettes and hand-rolling tobacco will be increased, by the equivalent, including VAT, of between threepence and fourpence for a packet of 20 cigarettes. This will take effect from midnight on Thursday. The duty on a packet of five small cigars will rise by twopence, but that on pipe tobacco will remain unchanged.

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J4. As to the alcohol duties, I propose increases which, including VAT, will put about a penny on the price of a pint of average-strength beer and cider, fourpence on a bottle of table wine, and sixpence on a bottle of sparkling or fortified wine. There will once again be no increase in the duty on spirits. These changes will take effect from 6 o'clock tonight.

J5. I propose to reduce the duty on drinks known as 'coolers', which are mixtures of an alcoholic drink and a soft drink, so as to encourage the young in particular to move to drinks with a lower alcohol content. For the same reason, I propose from 1 October to abolish the minimum duty charge on beer, which will encourage the promotion of low-alcohol beers.

J6. I propose once again to leave the main rates of Vehicle Excise Duty unchanged. To recover the revenue forgone, I propose increases in petrol and derv duty over and above the rate of inflation, which, including VAT, will raise the price of petrol by between fivepence and sixpence a gallon, and that of derv by less than fivepence a gallon. These changes will take effect from 6 o'clock tonight.

J7. In my Budget last year, I sought to promote the use of lead-free petrol, with all the environmental benefits it brings, by introducing a duty differential in its

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favour. As a result, the number of garages selling lead-free petrol has more than trebled. But consumption remains disappointingly low.

J8. Accordingly, I propose to double the duty differential in its favour by exempting it altogether from the duty increase I have just announced for leaded petrol. This means that, despite the higher production costs, the pump price of unleaded petrol should in future be below that of ordinary 2-star petrol. I very much hope the petrol companies will now reinforce this concession by vigorously promoting the use of lead-free petrol.

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K. TAXES ON CAPITAL

K1. I now turn to taxes on capital.

K2. The emergence of the capital-owning democracy has been one of the most remarkable features of the 1980s. Encouraged by Government policy, almost three million families have bought their homes, bringing the total to nearly two households in three. And our proposals for personal pensions, which come in to effect in July, will give a new dimension to pension ownership.

K3. But the most dramatic change has been in share ownership. In last year's Budget, I announced the results of a joint Treasury/Stock Exchange survey of the number of shareholders in this country. This revealed that some $8\frac{1}{2}$ million people - one adult in five - owned shares, about three times the number in 1979.

K4. A similar survey has been carried out this year. Despite all the stories of people taking quick profits on privatisation shares, and despite the stock market collapse, the results show that the number of individual shareholders has if anything risen further over the past 12 months, to very nearly 9 million. This illustrates in

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a quite remarkable fashion how the habit of share ownership is now taking root.

K5. I have two proposals to encourage share ownership still further to announce today.

K6. First, Personal Equity Plans are off to a successful start. Over a quarter of a million people took out PEPs in 1987, and subscribed nearly £ $\frac{1}{2}$ billion between them. To give further encouragement to this form of investment, I propose to increase the annual limit from £2,400 to £3,000. The new higher limit will apply to all plans taken out this year.

K7. Second, measures to encourage employee share ownership have featured in seven out of the last eight Budgets. As a result, the number of approved all-employee share schemes has risen from 30 in 1979 to over 1400 today, involving well over 10,000 companies, and providing shares and options for well over 1 $\frac{1}{2}$ million employees.

K8. Following extensive consultation, including the publication of draft clauses, I propose to relax the provisions of Section 79 of the 1972 Finance Act. This will make it easier for companies to provide shares to their employees outside the approved schemes without giving rise to an undue charge to tax. This will be of

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particular benefit to subsidiary companies and their employees.

K9. In previous Budgets I have already substantially reformed the taxation of capital, with the replacement of Capital Transfer Tax by Inheritance Tax. But I believe this process can and should be taken further. Last year, I reduced the number of inheritance tax rates from seven to four. This year, I propose to simplify the tax still further by levying it at a flat rate of 40 per cent.

K10. At the same time I propose to raise the threshold from £90,000 to £110,000.

K11. The increase in the threshold will reduce the number of estates liable to tax by a quarter allowing many more people to inherit the family home free of tax. And the flat rate of 40 per cent means that for the family business, enjoying 50 per cent business relief, the effective rate of tax can never exceed 20 per cent, one of the lowest inheritance tax rates in the industrialised world.

K12. The cost of these changes will be £100 million in 1988-89.

K13. Lastly, Capital Gains Tax. Strictly speaking, this should not be a tax on the original capital at all. Nor

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is it, so far as gains which have arisen since 1982 are concerned, thanks to the indexation provisions introduced by my predecessor in 1982, and extended in my 1985 Budget.

K14. But for gains that arose before 1982, the tax falls largely on purely paper profits resulting from the rampant inflation of the 'seventies. In other words, it bites deeply, and capriciously, into the capital itself.

K15. This has long been recognised as manifestly unjust. Indeed, from the time I first entered this House I have argued that Capital Gains Tax should fall only on real gains, and not on paper gains. I have therefore looked hard to see if the indexation provisions could be applied right back to the inception of the tax in 1965. Unfortunately, they cannot. The necessary information is in many cases no longer available.

K16. Accordingly, I have decided to bring the base date for the tax forward from 1965 to 1982. That is to say, for all disposals on or after 6 April, that part of any capital gain which arose before April 1982 will be exempt from tax altogether, for individuals and companies alike.

K17. This Budget thus ends once and for all the injustice of taxing purely inflationary gains. This will benefit the economy by unlocking assets which have been virtually

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sterilised because of the penal tax that would have arisen on any sale. And it will help many small businessmen and farmers in particular.

K18. At present, the first £6,600 a year of capital gain is tax free. The relatively high level of this threshold stems from the substantial increase my predecessor made in 1982, explicitly as rough and ready partial compensation for the continued taxation of pre-1982 paper gains. Now that I have taken pre-1982 gains out of tax altogether, I propose to reduce the capital gains tax threshold to £5,000. It should also be borne in mind that, with the introduction of independent taxation in 1990, a husband and wife will each have their own threshold for capital gains tax as well as for income tax.

K19. Rebasing the tax so as to produce a fully indexed system makes it possible to bring the taxation of gains closer to that of income. In principle, there is little economic difference between income and capital gains, and many people effectively have the option of choosing to a significant extent which to receive. And, insofar as there is a difference, it is by no means clear why one should be taxed more heavily than the other. Taxing them at different rates distorts investment decisions and inevitably creates a major tax avoidance industry.

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K20. Moreover, at present, with capital gains taxed at 30 per cent for everybody, higher rate taxpayers face a lower - sometimes much lower - rate of tax on gains than on investment income, while basic rate taxpayers face a higher rate of tax on gains than on income. This contrast is hard to justify.

K21. I therefore propose a fundamental reform. Subject to the new base date, capital gains will continue to be worked out as now, with the present exemptions and reliefs. In particular, the principal private residence will remain tax-free. But the indexed gain will then be taxed at the income tax rate that would apply if it were the taxpayer's marginal slice of income. In other words, I propose in future to apply the same rate of tax to income and capital gains alike.

K22. These changes will not take effect until 6 April.

K23. Taxing capital gains at income tax rates makes for greater neutrality in the tax system. It is what we now do for companies. And it is also the practice in the United States, with the big difference that there they have neither indexation relief nor a separate capital gains tax threshold.

K24. The changes I have announced represent a thoroughgoing reform of capital gains tax which will

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benefit the economy and eradicate a major injustice. They will sharply reduce the damaging effects of the tax, while ensuring that capital gains remain properly taxed and the yield of income tax adequately protected.

K25. They are expected to cost £210 million in 1989-90.

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BUDGET**L. INCOME TAX**

L1. Finally, I turn to income tax.

L2. The way to a strong economy is to boost incentives and enterprise. And, that means, among other things, keeping income tax as low as possible.

L3. Income tax has now been reduced in each of the last six Budgets - the first time this has ever occurred. And the strength of the economy over that period speaks for itself.

L4. However, reforming Income Tax is not simply a matter of cutting the rates. I also have to look at all the various allowances and reliefs to ensure that they are still justified.

L5. With this in mind, I have a number of proposals to announce.

L6. First, forestry. I accept that the tax system should recognise the special characteristics of forestry, where it can take anything up to a hundred years between the costs of planting and the income from selling the felled timber.

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L7. But the present system cannot be justified. It enables top rate taxpayers in particular to shelter other income from tax, by setting it against expenditure on forestry, while the proceeds from any eventual sale are effectively tax free.

L8. The time has come to bring it to an end. I propose to do so by the simple expedient of taking commercial woodlands out of the tax system altogether. That is to say, as from today, and subject to transitional provisions, expenditure on commercial woodlands will no longer be allowed as a deduction for income tax and corporation tax. But, equally, receipts from the sale of trees or felled timber will no longer be liable to tax.

L9. It is, perhaps, a measure of the absurdity of the present system that the exemption of commercial woodlands from tax will, in time, produce a yield of over £10 million a year.

L10. But in order to further the Government's objectives for the rural areas, I have agreed with my hon. Friends who have responsibilities for forestry and the environment that, in parallel, there should be increases in planting grants. Full details of the new grant scheme will be announced next week.

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L11. The net effect of these changes will be to end an unacceptable form of tax shelter; to simplify the tax system, abolishing the archaic Schedule B in its entirety; and to enable the Government to secure its forestry objectives with proper regard for the environment, including a better balance between broad-leaved trees and conifers.

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L12. One of the legacies of the years of penal top tax rates is the complicated special relief for large redundancy payments. This is no longer justified. I propose to increase the exemption limit for these payments from £25,000 to £30,000, and to abolish the additional relief for larger amounts.

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L13. I have a few changes to propose following from the recommendations of the Keith Committee on the Inland Revenue taxes. Most are designed to improve compliance, and to help the Revenue to uncover taxpayers who do not declare all their income, particularly where large amounts of tax are being lost. At the same time I have reviewed the VAT enforcement regime, and have a number of relaxations to propose which will make life easier for businesses, while safeguarding tax revenue. Some of the penalties will be reduced from midnight tonight.

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L14. Next, benefits in kind - perhaps better known as perks. One of the biggest tax-induced distortions in the economy today is the growing tendency to provide

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remuneration in kind rather than in cash. It must be right to move towards a system of lower taxes all round and fewer tax breaks of this kind.

L15. Far and away the most widespread benefit in kind is the company car, which is substantially undertaxed. Independent studies, based on figures supplied by the AA, suggest that an employee with a typical company car may be taxed on only a quarter of its true value to him.

L16. This discrepancy is too great to be allowed to continue. On the other hand, the scale of the undertaxation is so great that it cannot be put right in a single year. But in a Budget when I am able to reduce tax rates, there is a strong case for a substantial increase in the taxation of these benefits. I therefore propose to double the car scales for 1988-89. This increase replaces the 10 per cent increase which I had already announced for 1988-89. The yield from this will be £260 million in 1988-89.

L17. The scales for the taxation of car fuel adequately reflect the value of the benefit, and I propose to leave them unchanged for 1988-89.

L18. However, the taxation of the benefit of free car parking threatens to become an administrative nightmare. I propose to exempt this particular benefit from tax altogether.

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L19. Next, mortgage interest relief. This Government is committed to the further spread of home ownership. Mortgage interest relief has an important role to play in achieving that aim, and will continue in place, against both the basic and higher rates of tax.

L20. However, in addition to the decision to apply the £30,000 limit to the house or flat, which I have already announced, and which will remove the most widely-resented tax penalty on marriage, I have one further reform to propose in this area.

L21. This concerns the parallel tax relief for home improvement loans. Most of these loans are for fittings such as double glazing, and have played a significant part in the recent growth of consumer credit without in any way contributing to the expansion of home ownership. This may be partly due to the substantial scope for abuse, as loans ostensibly taken out for home improvements are used for other purposes, a matter which was the subject of a recent report from the Public Accounts Committee.

L22. I propose, therefore, to end tax relief for all new home improvement loans taken out after 5 April. Existing home improvement loans will be unaffected. This is expected to yield £80 million in 1988-89.

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L23. Finally, I turn to income tax itself.

L24. The statutory indexation formula means that I should increase all the principal income tax allowances and bands by the increase in the RPI over the year to last December, or 3.7 per cent, rounded up. I propose to do more than that; indeed twice as much.

L25. Thus the single allowance will go up not by £90, as required by indexation, but by £180, to £2605; and the married allowance will go up not by £150 but by £300, to £4095. The additional personal allowance and widow's bereavement allowance will thus rise by £120 to £1490. Similarly the single age allowance will rise by £220 to £3180 and the married age allowance by £360 to £5035. The higher allowances for taxpayers aged 80 and over, which I introduced in the last Budget, will correspondingly be increased by £240 and £360 to £3310 and £5205 respectively, and the new age allowance income limit will be £10,600. The upper limit of taxable income for the basic rate band will be increased to £19,300.

L26. The increases I have just announced mean that the basic tax thresholds will be fully 25 per cent higher, in real terms, than they were in 1978-79, Labour's last year. Indeed, the married man's tax threshold will be at its highest level in real terms for nearly half a century.

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L27. Given these substantial increases in the main allowances, I am taking the opportunity to simplify the system by abolishing three minor personal allowances which have been unchanged, in cash terms, for over twenty years: the housekeeper allowance, the dependent relative allowance, and the son's or daughter's services allowance.

L28. In our general election manifesto last year, we committed ourselves to reducing the basic rate of income tax to 25 pence in the £ as soon as it was prudent to do so. This pledge followed a reduction of twopence in the £ to 27 pence in last year's Budget.

L29. At the time, this was regarded with some scepticism, not to say cynicism, by the Opposition, who no doubt recalled that Labour Governments used to reduce tax only in front of an election, and at all other times increased it. Indeed, shortly before last year's Budget the rt hon Gentleman the deputy leader of the Labour Party said this:

"I must advise the Chancellor of something he already knows: whichever party wins the general election, the tax cuts he makes in this Budget will be reversed."

L30. The time has come to put the rt hon Gentleman out of his misery. So far from reversing the 1987 Budget tax reductions, I propose to take this, the first opportunity

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since the general election, to fulfil our manifesto pledge. The basic rate of income tax for 1988-89 will be 25 pence in the pound.

L31. The small companies' rate of corporation tax will similarly be reduced to 25 per cent. This means that the basic rate of income tax, and the corporation tax rate for small companies, will both be at their lowest level since the war.

L32. Life Assurance premium relief remains in place for policies taken out before the 1984 Budget. It has traditionally been given at half the basic rate of income tax. I therefore propose to reduce it from 15 per cent to 12½ per cent. But, to give life offices time to adjust, this change will not take effect until 6 April 1989.

L33. I also propose to reduce the additional rate which applies to the income of discretionary trusts and for certain other purposes from 18 per cent to 10 per cent.

L34. It is now nine years since my predecessor, in his first Budget in 1979, reduced the top rate of tax from the absurd 83 per cent that prevailed under Labour to 60 per cent, where it has remained ever since.

L35. At that time, this was broadly in line with the European average for the top rate of tax. It is now one

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of the highest. And not only do the majority of European countries now have a top rate of tax below 60 per cent, but in the English-speaking countries outside Europe - not only the United States and Canada, but socialist Australia and New Zealand, too - the top rate is now below 50 per cent, sometimes well below.

L36. The reason for the worldwide trend towards lower top rates of tax is clear. Excessive rates of income tax destroy enterprise, encourage avoidance, and drive talent to more hospitable shores overseas. As a result, so far from raising additional revenue, over time they actually raise less.

L37. By contrast, a reduction in the top rates of tax can, over time, result in a higher, not a lower, yield to the Exchequer. Despite the substantial reduction in the top rate of tax in 1979, and the subsequent abolition of the investment income surcharge in 1984, the top five per cent of taxpayers today contribute a third as much again in real terms as they did in 1978-79, Labour's last year; while the remaining 95 per cent of taxpayers actually pay less.

L38. After nine years at 60 per cent I believe the time has come to make a further reduction in the top rate of income tax. At present there are no fewer than five higher rates of income tax: 40 per cent, 45 per cent,

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50 per cent, 55 per cent, and 60 per cent. I propose to abolish all the higher rates of tax above 40 per cent.

L39. This major reform will leave us with one of the simplest systems of income tax in the world, consisting of a basic rate of 25 per cent and a single higher rate of 40 per cent. And, indeed, a system of personal taxation in which there is no rate anywhere in excess of 40 per cent.

L40. I believe that 40 per cent is an acceptable top rate of tax. But, bearing in mind that the basic rate of income tax is also the starting rate, 25 per cent is still too high.

L41. Since we first took office in 1979, we have now reduced the basic rate of income tax from 33 per cent - one third - to 25 per cent - a quarter. Our aim should now be to get it down to a fifth - a rate of 20 pence in the pound - as soon as we prudently and sensibly can.

L42. Meanwhile, I have today been able to reduce income tax at all levels, with increases in both the personal allowances and the basic rate limit, and reductions in both the basic and higher rates. The tax reduction for a married man on average earnings in 1988-89 will be worth nearly £5 a week. The changes will take effect under PAYE on the first pay day after 14 June. They will cost

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£4½ billion in 1988-89 over and above statutory indexation, of which three quarters represents the cost of increasing tax thresholds and reducing the basic rate.

L43. The total cost of all the measures in this year's Budget, again on an indexed basis, is £4 billion.

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M. PERORATION

M1. In this Budget, I have reaffirmed the prudent policies which have brought us unprecedented economic strength. I have announced a radical reform of the taxation of marriage, which for the first time ever will give married women a fair deal from the tax system. I have eliminated the long-standing injustice of taxing inflationary gains, and abolished a fifth tax. I have radically reformed the structure of personal taxation, so that there is no rate anywhere in the system in excess of 40 per cent.

M2. After an Autumn Statement which substantially increased public spending in priority areas, I have once again cut the basic rate of income tax, fulfilling our Manifesto pledge of a basic rate of 25 pence in the £ and setting a new target of 20 pence in the £.

M3. And I have balanced the Budget.

M4. I commend this Budget to the House.

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

11 March 1988

Robert Culshaw Esq MVO
PS/Secretary of State for Foreign and
Commonwealth Affairs
Downing Street
LONDON SW1A 2AL

Dear Robert,

POST-BUDGET MINISTERIAL STATEMENTS

This year, as usual, the Treasury will be providing other Departments with full copies of the Budget Brief soon after the Chancellor completes his Budget Statement. EB Division here have been in touch with your Department to make the detailed arrangements for delivery or collection. The Brief covers all the Budget measures and the economic background in full, and the Chancellor very much hopes that this will help Ministers and their Departments to take a common line in press conferences, PQs, or when making other statements. If for any reason your Minister wishes to go beyond the line set out in the Brief, I should be grateful if you could arrange for this to be cleared with the Treasury first - Carys Evans (270 5170) and Judith Simpson (270 5211) will be the initial contact points in our Fiscal Policy and Economic Briefing Divisions.

I am copying this to the Private Secretaries to all Cabinet Ministers, and to the Minister for the Arts.

Yours sincerely,

Moira Wallace
MOIRA WALLACE

UNCLASSIFIED



FROM: MISS M P WALLACE
DATE: 11 March 1988

mp

MR CROPPER
MR TYRIE
MR CALL
MR ODLING-SMEE

SEATS FOR THE BUDGET SPEECH

I understand that you are all able to accept the Chancellor's offer of a seat in the Special Gallery (East) for the Budget speech on Tuesday 15 March.

2. Your tickets can be collected from the Admissions Order Office in the House at anytime from 2.00pm onwards on Tuesday afternoon. The Chancellor is due to speak at approximately 3.30pm and I recommend that you take your seats at least a quarter of an hour in advance.

mpw

MOIRA WALLACE

K1

CONFIDENTIAL

app
FROM: CHRISTOPHER KELLY
DATE: 11 March 1988

CHANCELLOR

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Anson
Mr Scholar
Mr Culpin
Mr Odling-Smee
Mr Sedgwick
Mr Turnbull
Mr R I G Allen
Mr S Davies
Mr Pickford
Mr Riley
Mr Hudson
Mr Cropper
Mr Tyrie
Mr Call

BALANCED BUDGETS

You may be interested in the attached note which gives a brief history of the balanced budget doctrine.

C. Kelly
CHRISTOPHER KELLY
MP1

~~CONFIDENTIAL~~~~BALANCED BUDGETS: HISTORICAL PEDIGREE~~

1. From the time of Adam Smith, the founder of classical political economy, writing around the advent of the industrial revolution, until the Keynesian challenge to classical economics, balancing the budget was the dominant principle governing both the theory and practice of public finance. Moreover, the Keynesian principle of deficit finance took a long time to make inroads into the orthodoxy of practical policy making, and has been increasingly called into question since the mid-1970's. This note charts the history of the balanced budget doctrine. An appendix lists some supporting quotations.

The Classical Propositions

2. Adam Smith clearly thought that governments were prone to engage in extravagant and wasteful expenditure, and that unbalanced budgets encouraged such tendencies by removing the discipline of people feeling the complete burden of public expenditure in the form of annual taxation. Balanced budgets were thus seen as an important means of containing the size of government. Finance of public expenditure, whether by taxation or borrowing, was viewed as depriving industry, commerce and agriculture of much needed capital. However, borrowing (particularly the procedure of 'perpetual funding') seems to have been regarded as more 'pernicious', not only because it encouraged irresponsible government, but also because it tended to destroy existing capital while taxation only hindered new capital formation. Moreover, the temptation of debt finance led government into bankruptcy, frequently revealed in debasing of the currency.

3. Smith's general antipathy towards deficit finance and public debt was shared by Say, Ricardo and J.S. Mill, although after Mill the classical economists devoted less and less attention to problems of the national debt and the degree of antipathy became more muted. The marginalists still tended to approve of balanced budgets, which were seen as the natural implication of the application of marginalist principles, but public expenditure in a richer society was seen as less of a drain on private capital formation, and

Marshall, for example, did not view governments as reckless spenders. Nevertheless, classical doctrine on deficits and debt can be distilled into the following relevant propositions:

- i. Deficit finance of either current or capital expenditure, by postponing payment, represents an easy option for governments, and so encourages irresponsible expenditure.
- ii. Both debt and taxes deprive the private sector of capital resources for productive investment, but debt is more harmful than taxation and the availability of debt finance leads to higher expenditure and thus higher overall demands on the private sector.
- iii. Debt finance builds up trouble for the future by requiring higher future taxes to meet interest payments.
- iv. Debt finance and the reluctance to raise tax burdens leads eventually to public bankruptcy revealed in debasing of currency, and hence inflation.
- v. Balanced budgets provide a good rule for guiding the transfer of resources from the private to the public sector.

4. Together these propositions provided the rationale for the classical balanced budget doctrine. Certain writers advocated exceptions to this rule. For example Bastable (1892) allowed that it might be appropriate to use debt finance for

- a. financially remunerative investments;
- b. large non-recurrent expenditures.

An obvious non-recurrent expenditure is war, but the most prominent earlier classical economists can hardly be said to have advocated debt finance for this purpose, despite acknowledging that it was regrettably often necessary. Smith referred to 'the necessity of contracting debt in time of war' but only because of 'the want of parsimony in time of peace', and Ricardo made proposals for financing war emergencies using a pay-as-you-go financial plan to get rid of the 'terrible scourge' of debt.

19th Century Budgetary Practice

5. With growing industrialisation in the 19th century irresponsible expenditure by monarchs and governments posed less of a problem to economic progress than in Adam Smith's time. On the other hand Britain's national debt more than doubled during the Napoleonic Wars (having escalated over ten-fold during the 18th Century), and the abolition of the Napoleonic income tax in 1817 created further budgetary problems. By this time servicing of the national debt had come to comprise almost half of public expenditure. Following a period of rising government expenditure, accumulating deficits, and virtual loss of control over the public finances from the late 1830's, income tax was reintroduced by Peel in 1842, and reviewed at intervals thereafter until it gained a permanent place in the tax structure. This paved the way towards the establishment of Victorian budgetary orthodoxy in Gladstone's first Financial Statement in 1853, and his administrative reforms of the 1860s which sought to set up formal and effective budgetary accounting and control procedures.

6. The cornerstone of Gladstonian finance was the ever-balanced (or over-balanced) budget, which was seen as crucial in delivering the all-important virtue of economy in public expenditure. Also evident was an awareness of the virtuous circle whereby 'on economy follows reduction of burden and elasticity of revenue; taxation can then be lightened - thus leading to an expansion of real incomes' (quoted by Hicks (1953)). Gladstone set an entirely new precedent in the accuracy, clarity and annuality of Financial Statements and saw budget balance as paramount in providing accountability in the conduct of government. Thus the balanced budget convention came to be accepted as the first principle of public finance. The theory tended to ensure budget surpluses in practice, which were seen as desirable to repay the national debt.

7. As economic growth slowed down in the latter part of the 19th century Chancellors showed more reluctance to raise taxation in order to balance the budget, and adherence to Gladstonian doctrine was more tempered by pragmatism. But the basic orthodoxy remained intact until the Keynesian challenge of the 1930s started to gain a foothold.

The Early Keynesian Debate

8. Keynesian economists saw budgetary policy as an instrument of compensatory finance whereby the government could lean against the economic wind to produce stability of national output and full employment. Subordinating government expenditure and taxation to controlling the overall level of economic activity left no role for the balanced budget rule, at least in the short run. Keynes himself seemingly saw the need for budget balance over a period of years, but some of the Keynesians, particularly in the US (eg Hansen and Lerner), went further in viewing the limits on public debt as quite flexible. In any case it was argued that in the circumstances of the 1930s the orthodox tenets that deficit finance would crowd our private sector demand or that it could be inflationary lost all relevance.

9. The extent to which classical economic arguments continued to hold sway over Treasury opinion in the 1930s has sometimes been exaggerated, but clearly Treasury allegiance to orthodoxy remained strong. However, this was based not only on economic principles, but also on political considerations which were probably more dominant in explaining resistance to unbalancing the budget. The main fear seemed to be that once a precedent of deficit finance had been set any special circumstances that might have justified the move would soon be forgotten and it would become 'impossible' to preserve expenditure control under more normal circumstances, particularly in the run up to elections. The Treasury was aware that the private sector would anticipate such problems, and hence that there would be adverse economic consequences via loss of business confidence.

10. Undoubtedly the ground shifted somewhat during the 1930s, but the budget remained broadly balanced until rearmament necessitated a relaxation of expenditure control and large scale borrowing in the late 1930s. However, this change represented more a pragmatic response to circumstances than any deep-seated change of view.

The Era of Keynesian Orthodoxy

11. The 1941 UK budget was the first designed according to Keynesian principles of macroeconomic management, and the 1944 Employment and Social

Insurance White Papers represented the arrival of the new orthodoxy. In theory the Keynesian fiscal constitution for the most part envisaged budget balance over the cycle, as proposed by the Employment White Paper and the writings of Meade, Dalton and Kaldor. But the reality to date has turned out strikingly different. Government expenditure, instead of showing contra-cyclical variation, grew more or less continuously through to the mid-1970s, and apart from the immediate post-war period and 1969-70 the public finances have been in persistent deficit until this year.

12. In the US, Keynesian doctrine was rather slower in gaining a foothold in government. During the Eisenhower years of the 1950s much of the budgetary rhetoric was pre-Keynesian, although in practice a willingness was shown to acquiesce in passive budget imbalance. Meanwhile Keynesian economists backtracked somewhat from total abandonment of any form of balanced budget rule (as most clearly advocated by Lerner in 1943 and 1944) to the notion of balance over the cycle and the more sophisticated but open-ended version of balance at full employment. Erosion of political resistance to the principle of unbalancing the budget was a long drawn out process, but the watershed finally came as Keynesian advisers gained the upper hand in the Kennedy period and the 1964 tax cut signalled the arrival of the 'New Economics'. Thereafter US fiscal policy charted a course of unprecedented expenditure growth financed increasingly and disproportionately by debt.

The Enduring Relevance of the Classical Doctrine

13. It is clear that in both the UK and the US the early Keynesian theory of balancing the budget over the cycle was ignored in practice. Indeed there are good reasons to suggest that this was a fairly inevitable outcome under representative democratic government. As Buchanan¹ and Wagner (1977) remark

'The predicted proclivities of politicians to spend unwisely unless they are required simultaneously to impose taxes offer the bases for the existence of the balanced-budget norm in the first place. The events of fiscal history strongly support the hypothesis that unconstrained access to public borrowing will tend to generate excessive public spending. The lacuna in the Keynesian prescription is the absence of some counter force, a control or governor that will keep public spending within limits.'

14. Buchanan et al (1977, 1978) argue further that even if business cycles are predictable and their length independent of economic policy the 'balanced budget over the cycle' rule will be applied asymmetrically in a democracy, with a permanent bias towards deficit finance and continuous growth of public expenditure, giving rise to economic instability and inflation. And this bias is considerably stronger once the unpredictability of business cycles is acknowledged. Keynesianism ignored the realities of institutional behaviour, political, bureaucratic and electoral; fundamentally weakened the UK and US fiscal constitutions by removing their lynchpin (the balanced budget rule), and providing no substitute; and hence promoted economic instability, not least in giving birth to the political business cycle.

15. This is all very much as the classical economists might have predicted. Once institutional factors are taken into account the five classical propositions listed earlier would all seem to stand the test of time and to be relevant, to varying degrees, to present day policy debate.

16. The durability of the balanced budget doctrine has no doubt also been sustained by the popular appeal of Adam Smith's observation that 'what is prudence in the conduct of every private family, can scarce be folly in that of a great kingdom'.

APPENDIX SAMPLE OF RELEVANT QUOTES

A Smith 'The Wealth of Nations' (1775)

'The ruinous practice of perpetual funding'

'When for defraying the expence of government a revenue is raised within a year from taxes... the public expence... no doubt hinders more or less the further accumulation of capital; but it does not necessarily occasion the destruction of any actually existing capital. When the public expense is defrayed by funding, it is defrayed by the annual destruction of some capital which had before existed in the country'.

'Were the expence of war to be defrayed always by a revenue raised within a year... Wars would in general be more speedily concluded and less wantonly undertaken'.

'The practice of funding has gradually enfeebled every state which has adopted it'.

'The liberation of the public revenue, if it has ever been brought about at all, has always been brought about by a bankruptcy... frequently by a pretended payment. The rising of the denomination of the coin has been the most usual expedient by which a real public bankruptcy has been disguised under the appearance of a pretended payment. ...Nations have sometimes, for the same purpose, adulterated the standard of their coin'.

J B Say 'A Treatise on Political Economy' (18th Century)

'Governments... are too apt to intermeddle in every political arrangement, and to conceive gigantic projects, that lead sometimes to disgrace, sometimes to glory, but always to a state of financial exhaustion'.

W Bagehot, 'The English Constitution' (1867)

'The House of Commons is more apt to spend money than the Minister of the day. If there were not some check, the "people's house" would soon outrun the people's money. That check is the responsibility of the Cabinet ... the Ministry must find the money. Accordingly they have the strongest motive to oppose extra outlay. They will have to pay the bill for it; they will have to impose taxation, which is always disagreeable, or suggest loans, which under ordinary circumstances, are shameful'.

C F Bastable, 'Public Finance', (1892)

'...Tax revenue ought to be kept up to the amount required to defray expenses This general principle must, however, admit to modifications. Temporary deficits and surpluses cannot be avoided... The safest rule for practice is that which lays down the expediency of estimating for a moderate surplus, by which the possibility of a deficit will be reduced to a minimum'.

A Marshall 'Money Credit and Commerce'

The work of credit in the modern age differs from that of earlier times... now it is chiefly given by people who are living within their incomes to States which do not spend recklessly. Monarchs used to be large borrowers; chiefly for the purposes of war; largely to support extravagance on the part of themselves and their favourites; and occasionally for financing expenditure on good roads, and other requisites of national wellbeing'.

President Truman, Economic Report of the President, 1951

'We should make it the first principle of economic and fiscal policy in these times to maintain a balanced budget, and to finance the cost of national defence on a pay-as-we-go basis'.

President Eisenhower, State of the Union Message, 1953

'The first order of business is the elimination of the annual deficit... A balanced budget is an essential first measure in checking further depreciation in the buying power of the dollar'.

R Musgrave, Theory of Public Finance, (1959)

'It is the discipline function of taxation to avoid the illusion of either the under - or overpricing of public services'.

H Stein 'The Fiscal Revolution in America (1969)

'Kennedy's fiscal thinking was conventional. He believed in budget-balancing. While he was aware of circumstances in which the budget could not or should not be balanced, he preferred a balanced budget, being in this respect like most other people but unlike modern economists'.

James Callaghan, Speech to Labour Party Conference, 1976

'We used to think that you could just spend your way out of recession, and increase employment, by cutting taxes and boosting government spending. I tell you in all candour that this option no longer exists, and that in so far as it did ever exist, it worked by injecting inflation into the economy. And each time that happened, the average level of unemployment has risen. Higher inflation, followed by higher unemployment. That is the history of the last twenty years.'

CONFIDENTIAL

J M Buchanan and R E Wagner, 'Democracy in Deficit: The Political Legacy of Lord Keynes' (1977)

'Before the Keynesian challenge, an effective "fiscal constitution" did exist, even if this was not embodied in a written document. This "constitution" included the precept for budget balance, and this rule served as an important constraint on the natural proclivities of politicians'.

'A regime of permanent budget deficits, inflation, and an increasing public sector share of national income - these seem to us to be the consequence of the application of Keynesian precepts in American democracy.'

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1. J M Buchanan and RE Wagner (1977): 'Democracy in Deficit: The Political Legacy of Lord Keynes.' Academic Press
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3. J Burkhead (1954): 'The Balanced Budget'. Quarterly Journal of Economics, reprinted in AEA Series 'Readings in Fiscal Policy'. Allen and Unwin (1955).
4. R Harrod (1963): 'The British Economy', McGraw-Hill.
5. UK Hicks (1953): 'The Budget as an Instrument of Policy, 1837-1953', Three Banks Review.
6. R Middleton (1985): 'Towards the Managed Economy: Keynes the Treasury and the Fiscal Policy Debate of the 1930s'. Methuen.
7. J Odling-Smee and C Riley (1985): 'Approaches to the PSBR', National Institute.
8. E Roll (1973): 'A History of Economic Thought', Faber.

✓
FROM: MICHAEL GUNTON
DATE: 11 MARCH 1988

PGP

1. MR ALLEN ✓ RA.
2. CHANCELLOR WJ3

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Cropper
Mr Tyrie
Mr Call
Mr Bush

BUDGET MEDIA BIDS

I attach details of the arrangements made for Treasury Ministers to appear on television and radio after the Budget.

RA.

Mr. MICHAEL GUNTON

BUDGET 1988 - MINISTERIAL TELEVISION AND RADIO ENGAGEMENTS**Budget Day**

The Financial Secretary will go to Norman Shaw North immediately after the Budget Speech for the BBC's Budget Special Programme and for ITN's Budget Special Programme. He will be met in Speaker's Court by Michael Gunton and escorted to Norman Shaw.

The Economic Secretary will go to Channel 4 News at 7.00 studio in Wells Street, arriving at 6.50 p.m. He will be escorted by Michael Gunton. This should take about 15 minutes.

The Paymaster General will go to Norman Shaw North for BBC Radio 4 News. No time has yet been fixed but is normally about 6.00 p.m. He will be met in Speaker's Court by Michael Gunton and escorted to the studio. This takes no more than 10 minutes.

The Paymaster General has also agreed to do BBC Local Radio but they have not yet decided whether to go ahead. A decision will be taken on Monday.

The Chief Secretary has agreed to appear on *Newsnight* where he will be in discussion probably with John Smith and Alan Beith. He should arrive at the BBC TV Centre at about 10.30 p.m. Michael Gunton will accompany him if required.

The Chief Secretary has also made arrangements to appear on two of his Local Radio stations at around 6.30 p.m. at Norman Shaw North.

Wednesday, 16 March

The Chief Secretary has agreed to appear on BBC Breakfast Time at Lime Grove. The programme goes out between 7.00 a.m. and 9.00 a.m. but they have not yet decided what time they would like the

Chief Secretary. It would be helpful if Miss Rutter could escort him to this as Michael Gunton would prefer to escort the Financial Secretary to the more treacherous TV-AM.

The Financial Secretary will be needed at TV-AM's Camden Lock Studios at around 8.00 a.m. It is likely, but not confirmed, that John Smith and Alan Beith will also be on the programme.

The Chancellor will be appearing on BBC Radio 4's "Today" programme - in a radio car in Downing Street at 8.10 a.m. He will also be appearing on LBC's "AM" programme - in a radio car in Downing Street at around 8.30 a.m.

The Economic Secretary is due to appear on the BBC's "Kilroy" programme at Lime Grove at about 9.30 a.m. He will be notified of the requested arrival time on Monday. He will be escorted by Michael Gunton.

Thursday 17 March

The Chancellor will be pre-recording his appearance on the Jimmy Young Programme at 9.30 a.m. He should arrive at the Hallam Street entrance (the usual one) at about 9.20 a.m.

The Chief Secretary is appearing on BBC's "Question Time" at the Greenwood Theatre. The invitation requests him to arrive for dinner at 6.30 p.m. I understand there are a number of problems which make this impossible. Perhaps Miss Rutter will let me know what time he wants to arrive.

Friday 18 March

The Chief Secretary has made arrangements to appear on Anglia Questions.

The Economic Secretary is due to appear on BBC Radio's "Any Questions". Details of travel arrangements to Oxford Royal College of Nursing have been sent to him direct.

Sunday 20 March

The Chief Secretary is due to appear on the BBC's "This Week Next Week" Programme at Lime Grove. The programme goes out between 1.00 and 2.00 p.m. Details of requested arrival time will be confirmed on Monday.

No bids

We have not received confirmed bids from the Financial World Tonight (EST), COI Overseas Radio, BBC Radio 4 "Moneybox", BBC 2's "Money Programme" or Channel 4's "Business Programme". It is unlikely that these will now be made although the BBC's "Moneybox" programme will respond if there is something of profound interest to savers or investors in the Budget.

UNCLASSIFIED



FROM: MOIRA WALLACE
DATE: 11 MARCH 1988

MR HUTSON, Parliamentary

cc Sir P Middleton
Sir T Burns
Sir G Littler
Mr Anson
Mr Scholar
Mr A C S Allan
Mr Hudson

→
Andrew
Mr Battishill - IR
Mr Unwin - C&E
Mr Gray - No.10

BUDGET DAY: OFFICIAL BOX

Could you please let the House Authorities know that the following people will be occupying the Official Box for the Chancellor's Budget Speech on 15 March:

1. Sir P Middleton
2. Sir T Burns
3. Sir G Littler
4. Mr J Anson
5. Mr M Scholar
6. Mr A C S Allan
7. Mr A Hudson
8. Mr A Battishill - *Inland Revenue*
9. Mr B Unwin - *Customs*
10. Mr P Gray - *No. 10*

I will shortly let you have a list of people who will be covering the Box for the rest of Budget Day and during the three days of the debate.

Mpw.



MW

FROM: MOIRA WALLACE
DATE: 11 MARCH 1988

MR HUTSON, Parliamentary

cc Sir P Middleton
Sir T Burns
Sir G Littler
Mr Anson
Mr Scholar
Mr A C S Allan
Mr Hudson

Mr Battishill - IR

Mr Unwin - C&E

Mr Gray - No.10

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9. Mr B Unwin - *Customs*
10. Mr P Gray - *No. 10*

I will shortly let you have a list of people who will be covering the Box for the rest of Budget Day and during the three days of the debate.

MW



A handwritten signature in black ink, appearing to read "Moira Wallace".

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

11 March 1988

D J Lord Esq
Speaker's Office
House of Commons
London SW1

Dear Mr Lord,

SEATS FOR THE BUDGET SPEECH

Further to our telephone conversations, I am now able to let you know the names of the people that the Chancellor of the Exchequer would like to sit in the Distinguished Stranger's Gallery and Speaker's Gallery.

Distinguished Stranger's Gallery

- (a) Mr Robin Lee Pemberton - Governor, Bank of England
- (b) Mr George Blunden - Deputy Governor, Bank of England
- (c) Mrs Nigel Lawson
- (d) Master Tom Lawson - (the Chancellor's son)

Speaker's Gallery

- (a) Mrs John Major
- (b) Mrs Peter Lilley
- (c) Mr Nigel Althaus - Government Broker, Bank of England
- (d) Mr Eddie George - Executive Director, Bank of England.

I have written to all of the Chancellor's guests to let them know that they should pick up their tickets from the policeman in the Central Lobby on Budget afternoon itself.

The Chancellor is most grateful to the Speaker for making these seats available to him.

Yours sincerely,

Moira Wallace

MOIRA WALLACE
Private Secretary



MP

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

11 March 1988

Mr Palfrey
Admissions Order Office
House of Commons
LONDON
SW1

Dear Mr Palfrey,

SEATS FOR THE BUDGET SPEECH

Further to our recent telephone conversations, I am writing to give you the names of the people who will be taking up the Chancellor of the Exchequer's allocation of seats in the Under and East Galleries on Budget afternoon. They are as follows:

East Gallery

1. Mrs J E Lawson
2. Mr P Hyde Thomson
3. Miss C Roberts
4. Mr P Cropper
5. Mr A Tyrie
6. Mr M Call
7. Mr J Odling-Smee
8. Miss M Wallace

Under Gallery

1. Mr J Taylor

All the tickets will be collected from your office on the afternoon of Budget Day. Miss Roberts will be accompanying Mrs Lawson senior, and may pick up her ticket on her behalf.

Yours sincerely,

Moira Wallace

MOIRA WALLACE



Mr Pickford
RWF

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

11 March 1988

Colin Phillips Esq
Chief Whip's Office
12 Downing Street
London

Dear Colin,

ARRANGEMENTS FOR BUDGET AFTERNOON

I mentioned to you on the telephone that Sir Antony Jay would be helping the Chancellor with the Budget Broadcast on Tuesday. He told me that, in previous years, he had watched the coverage of the Budget speech on a TV in No.12, and would like to do the same again.

You kindly agreed to this, subject to Murdo Maclean's agreement. Sir Antony also said that it would be helpful for somebody from the Treasury to join him. I shall let you know who this will be, and also when Sir Antony will be arriving.

Please could you let me know as soon as possible if there are any problems, so that we can make alternative arrangements.

Yours sincerely,

Andrew Hudson

A P HUDSON

CONFIDENTIAL

PUP

FROM: CHRISTOPHER KELLY
DATE: 11 March 1988

CHANCELLOR

Ch
X is quite a nice quote
for writing / TESC.
AA

Many thanks & regards
Inters

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Anson
Mr Scholar
Mr Culpin
Mr Odling-Smee
Mr Sedgwick
Mr Turnbull
Mr R I G Allen
Mr S Davies
Mr Pickford
Mr Riley
Mr Hudson
Mr Cropper
Mr Tyrie
Mr Call

BALANCED BUDGETS

You may be interested in the attached note which gives a brief history of the balanced budget doctrine.

C. Kelly

CHRISTOPHER KELLY

MPL

CONFIDENTIAL

BALANCED BUDGETS: HISTORICAL PEDIGREE

1. From the time of Adam Smith, the founder of classical political economy, writing around the advent of the industrial revolution, until the Keynesian challenge to classical economics, balancing the budget was the dominant principle governing both the theory and practice of public finance. Moreover, the Keynesian principle of deficit finance took a long time to make inroads into the orthodoxy of practical policy making, and has been increasingly called into question since the mid-1970's. This note charts the history of the balanced budget doctrine. An appendix lists some supporting quotations.

The Classical Propositions

2. Adam Smith clearly thought that governments were prone to engage in extravagant and wasteful expenditure, and that unbalanced budgets encouraged such tendencies by removing the discipline of people feeling the complete burden of public expenditure in the form of annual taxation. Balanced budgets were thus seen as an important means of containing the size of government. Finance of public expenditure, whether by taxation or borrowing, was viewed as depriving industry, commerce and agriculture of much needed capital. However, borrowing (particularly the procedure of 'perpetual funding') seems to have been regarded as more 'pernicious', not only because it encouraged irresponsible government, but also because it tended to destroy existing capital while taxation only hindered new capital formation. Moreover, the temptation of debt finance led government into bankruptcy, frequently revealed in debasing of the currency.

3. Smith's general antipathy towards deficit finance and public debt was shared by Say, Ricardo and J.S. Mill, although after Mill the classical economists devoted less and less attention to problems of the national debt and the degree of antipathy became more muted. The marginalists still tended to approve of balanced budgets, which were seen as the natural implication of the application of marginalist principles, but public expenditure in a richer society was seen as less of a drain on private capital formation, and

Marshall, for example, did not view governments as reckless spenders. Nevertheless, classical doctrine on deficits and debt can be distilled into the following relevant propositions:

- i. Deficit finance of either current or capital expenditure, by postponing payment, represents an easy option for governments, and so encourages irresponsible expenditure.
- ii. Both debt and taxes deprive the private sector of capital resources for productive investment, but debt is more harmful than taxation and the availability of debt finance leads to higher expenditure and thus higher overall demands on the private sector.
- iii. Debt finance builds up trouble for the future by requiring higher future taxes to meet interest payments.
- iv. Debt finance and the reluctance to raise tax burdens leads eventually to public bankruptcy revealed in debasing of currency, and hence inflation.
- v. Balanced budgets provide a good rule for guiding the transfer of resources from the private to the public sector.

4. Together these propositions provided the rationale for the classical balanced budget doctrine. Certain writers advocated exceptions to this rule. For example Bastable (1892) allowed that it might be appropriate to use debt finance for

- a. financially remunerative investments;
- b. large non-recurrent expenditures.

An obvious non-recurrent expenditure is war, but the most prominent earlier classical economists can hardly be said to have advocated debt finance for this purpose, despite acknowledging that it was regrettably often necessary. Smith referred to 'the necessity of contracting debt in time of war' but only because of 'the want of parsimony in time of peace', and Ricardo made proposals for financing war emergencies using a pay-as-you-go financial plan to get rid of the 'terrible scourge' of debt.

19th Century Budgetary Practice

5. With growing industrialisation in the 19th century irresponsible expenditure by monarchs and governments posed less of a problem to economic progress than in Adam Smith's time. On the other hand Britain's national debt more than doubled during the Napoleonic Wars (having escalated over ten-fold during the 18th Century), and the abolition of the Napoleonic income tax in 1817 created further budgetary problems. By this time servicing of the national debt had come to comprise almost half of public expenditure. Following a period of rising government expenditure, accumulating deficits, and virtual loss of control over the public finances from the late 1830's, income tax was reintroduced by Peel in 1842, and reviewed at intervals thereafter until it gained a permanent place in the tax structure. This paved the way towards the establishment of Victorian budgetary orthodoxy in Gladstone's first Financial Statement in 1853, and his administrative reforms of the 1860s which sought to set up formal and effective budgetary accounting and control procedures.

6. The cornerstone of Gladstonian finance was the ever-balanced (or over-balanced) budget, which was seen as crucial in delivering the all-important virtue of economy in public expenditure. Also evident was an awareness of the virtuous circle whereby 'on economy follows reduction of burden and elasticity of revenue; taxation can then be lightened - thus leading to an expansion of real incomes' (quoted by Hicks (1953)). Gladstone set an entirely new precedent in the accuracy, clarity and annuality of Financial Statements and saw budget balance as paramount in providing accountability in the conduct of government. Thus the balanced budget convention came to be accepted as the first principle of public finance. The theory tended to ensure budget surpluses in practice, which were seen as desirable to repay the national debt.

7. As economic growth slowed down in the latter part of the 19th century Chancellors showed more reluctance to raise taxation in order to balance the budget, and adherence to Gladstonian doctrine was more tempered by pragmatism. But the basic orthodoxy remained intact until the Keynesian challenge of the 1930s started to gain a foothold.

The Early Keynesian Debate

8. Keynesian economists saw budgetary policy as an instrument of compensatory finance whereby the government could lean against the economic wind to produce stability of national output and full employment. Subordinating government expenditure and taxation to controlling the overall level of economic activity left no role for the balanced budget rule, at least in the short run. Keynes himself seemingly saw the need for budget balance over a period of years, but some of the Keynesians, particularly in the US (eg Hansen and Lerner), went further in viewing the limits on public debt as quite flexible. In any case it was argued that in the circumstances of the 1930s the orthodox tenets that deficit finance would crowd our private sector demand or that it could be inflationary lost all relevance.

9. The extent to which classical economic arguments continued to hold sway over Treasury opinion in the 1930s has sometimes been exaggerated, but clearly Treasury allegiance to orthodoxy remained strong. However, this was based not only on economic principles, but also on political considerations which were probably more dominant in explaining resistance to unbalancing the budget. The main fear seemed to be that once a precedent of deficit finance had been set any special circumstances that might have justified the move would soon be forgotten and it would become 'impossible' to preserve expenditure control under more normal circumstances, particularly in the run up to elections. The Treasury was aware that the private sector would anticipate such problems, and hence that there would be adverse economic consequences via loss of business confidence.

10. Undoubtedly the ground shifted somewhat during the 1930s, but the budget remained broadly balanced until rearmament necessitated a relaxation of expenditure control and large scale borrowing in the late 1930s. However, this change represented more a pragmatic response to circumstances than any deep-seated change of view.

The Era of Keynesian Orthodoxy

11. The 1941 UK budget was the first designed according to Keynesian principles of macroeconomic management, and the 1944 Employment and Social

Insurance White Papers represented the arrival of the new orthodoxy. In theory the Keynesian fiscal constitution for the most part envisaged budget balance over the cycle, as proposed by the Employment White Paper and the writings of Meade, Dalton and Kaldor. But the reality to date has turned out strikingly different. Government expenditure, instead of showing contra-cyclical variation, grew more or less continuously through to the mid-1970s, and apart from the immediate post-war period and 1969-70 the public finances have been in persistent deficit until this year.

12. In the US, Keynesian doctrine was rather slower in gaining a foothold in government. During the Eisenhower years of the 1950s much of the budgetary rhetoric was pre-Keynesian, although in practice a willingness was shown to acquiesce in passive budget imbalance. Meanwhile Keynesian economists backtracked somewhat from total abandonment of any form of balanced budget rule (as most clearly advocated by Lerner in 1943 and 1944) to the notion of balance over the cycle and the more sophisticated but open-ended version of balance at full employment. Erosion of political resistance to the principle of unbalancing the budget was a long drawn out process, but the watershed finally came as Keynesian advisers gained the upper hand in the Kennedy period and the 1964 tax cut signalled the arrival of the 'New Economics'. Thereafter US fiscal policy charted a course of unprecedented expenditure growth financed increasingly and disproportionately by debt.

The Enduring Relevance of the Classical Doctrine

13. It is clear that in both the UK and the US the early Keynesian theory of balancing the budget over the cycle was ignored in practice. Indeed there are good reasons to suggest that this was a fairly inevitable outcome under representative democratic government. As Buchanan and Wagner (1977) remark

'The predicted proclivities of politicians to spend unwisely unless they are required simultaneously to impose taxes offer the bases for the existence of the balanced-budget norm in the first place. The events of fiscal history strongly support the hypothesis that unconstrained access to public borrowing will tend to generate excessive public spending. The lacuna in the Keynesian prescription is the absence of some counter force, a control or governor that will keep public spending within limits.'

14. Buchanan et al (1977, 1978) argue further that even if business cycles are predictable and their length independent of economic policy the 'balanced budget over the cycle' rule will be applied asymmetrically in a democracy, with a permanent bias towards deficit finance and continuous growth of public expenditure, giving rise to economic instability and inflation. And this bias is considerably stronger once the unpredictability of business cycles is acknowledged. Keynesianism ignored the realities of institutional behaviour, political, bureaucratic and electoral; fundamentally weakened the UK and US fiscal constitutions by removing their lynchpin (the balanced budget rule), and providing no substitute; and hence promoted economic instability, not least in giving birth to the political business cycle.

15. This is all very much as the classical economists might have predicted. Once institutional factors are taken into account the five classical propositions listed earlier would all seem to stand the test of time and to be relevant, to varying degrees, to present day policy debate.

16. The durability of the balanced budget doctrine has no doubt also been sustained by the popular appeal of Adam Smith's observation that 'what is prudence in the conduct of every private family, can scarce be folly in that of a great kingdom'.

APPENDIX SAMPLE OF RELEVANT QUOTES

A Smith 'The Wealth of Nations' (1775)

'The ruinous practice of perpetual funding'

'When for defraying the expence of government a revenue is raised within a year from taxes... the public expence... no doubt hinders more or less the further accumulation of capital; but it does not necessarily occasion the destruction of any actually existing capital. When the public expense is defrayed by funding, it is defrayed by the annual destruction of some capital which had before existed in the country'.

'Were the expence of war to be defrayed always by a revenue raised within a year... Wars would in general be more speedily concluded and less wantonly undertaken'.

'The practice of funding has gradually enfeebled every state which has adopted it'.

'The liberation of the public revenue, if it has ever been brought about at all, has always been brought about by a bankruptcy... frequently by a pretended payment. The rising of the denomination of the coin has been the most usual expedient by which a real public bankruptcy has been disguised under the appearance of a pretended payment. ...Nations have sometimes, for the same purpose, adulterated the standard of their coin'.

J B Say 'A Treatise on Political Economy' (18th Century)

'Governments... are too apt to intermeddle in every political arrangement, and to conceive gigantic projects, that lead sometimes to disgrace, sometimes to glory, but always to a state of financial exhaustion'.

W Bagehot, 'The English Constitution' (1867)

'The House of Commons is more apt to spend money than the Minister of the day. If there were not some check, the "people's house" would soon outrun the people's money. That check is the responsibility of the Cabinet ... the Ministry must find the money. Accordingly they have the strongest motive to oppose extra outlay. They will have to pay the bill for it; they will have to impose taxation, which is always disagreeable, or suggest loans, which under ordinary circumstances, are shameful'.

C F Bastable, 'Public Finance', (1892)

'...Tax revenue ought to be kept up to the amount required to defray expenses This general principle must, however, admit to modifications. Temporary deficits and surpluses cannot be avoided... The safest rule for practice is that which lays down the expediency of estimating for a moderate surplus, by which the possibility of a deficit will be reduced to a minimum'.

A Marshall 'Money Credit and Commerce'

The work of credit in the modern age differs from that of earlier times... now it is chiefly given by people who are living within their incomes to States which do not spend recklessly. Monarchs used to be large borrowers; chiefly for the purposes of war; largely to support extravagance on the part of themselves and their favourites; and occasionally for financing expenditure on good roads, and other requisites of national wellbeing'.

HM Treasury (Document commenting on Keynes's 'Means to Prosperity', 1933)

'Members of the House of Commons will realise how impossible it would be once we had abandoned the principle of paying our way to stop a rising tide of expenditure. Within a year or two (ie very near the next General Election) there would be the sort of situation we had in 1931, ie the need for new cuts and new taxes.'

HM Treasury (Public Records Office paper, 1933)

'Uncertainty and apprehension as to the future would very quickly cancel out any immediate psychological benefit which the reduction of taxation by unbalancing the Budget would promote.'

Cmd 6527, 'Employment Policy' White Paper, (1944)

X // 'At the same time, to the extent that the policies proposed in this paper affect the balancing of the budget in a particular year, they certainly do not contemplate any departure from the principle that the budget must be balanced over a longer period'.

Beveridge W H 'Full Employment in a Free Society', (1944)

The Treasury is 'still far too inhibited in regard to central finance, too fearful of increasing the national debt'.

M Friedman 'Monetary and Fiscal Framework for Economic Stability', American Economic Review, (1948)

'The budget principle might be either that the hypothetical (tax) yield should balance government expenditure (at the same hypothetical level of income), or that it should lead to a deficit sufficient to provide some secular increase in the quantity of money. Under the proposal, government expenditure would be financed entirely by either tax revenues or the creation of money, that is, the issue of non-interest bearing securities. Government would not issue interest bearing securities to the public'.

CONFIDENTIAL

President Truman, Economic Report of the President, 1951

'We should make it the first principle of economic and fiscal policy in these times to maintain a balanced budget, and to finance the cost of national defence on a pay-as-we-go basis'.

President Eisenhower, State of the Union Message, 1953

'The first order of business is the elimination of the annual deficit... A balanced budget is an essential first measure in checking further depreciation in the buying power of the dollar'.

R Musgrave, Theory of Public Finance, (1959)

'It is the discipline function of taxation to avoid the illusion of either the under - or overpricing of public services'.

H Stein 'The Fiscal Revolution in America (1969)

'Kennedy's fiscal thinking was conventional. He believed in budget-balancing. While he was aware of circumstances in which the budget could not or should not be balanced, he preferred a balanced budget, being in this respect like most other people but unlike modern economists'.

James Callaghan, Speech to Labour Party Conference, 1976

'We used to think that you could just spend your way out of recession, and increase employment, by cutting taxes and boosting government spending. I tell you in all candour that this option no longer exists, and that in so far as it did ever exist, it worked by injecting inflation into the economy. And each time that happened, the average level of unemployment has risen. Higher inflation, followed by higher unemployment. That is the history of the last twenty years.'

CONFIDENTIAL

J M Buchanan and R E Wagner, 'Democracy in Deficit: The Political Legacy of Lord Keynes' (1977)

'Before the Keynesian challenge, an effective "fiscal constitution" did exist, even if this was not embodied in a written document. This "constitution" included the precept for budget balance, and this rule served as an important constraint on the natural proclivities of politicians'.

'A regime of permanent budget deficits, inflation, and an increasing public sector share of national income - these seem to us to be the consequence of the application of Keynesian precepts in American democracy.'

References

1. J M Buchanan and RE Wagner (1977): 'Democracy in Deficit: The Political Legacy of Lord Keynes.' Academic Press
2. J M Buchanan, J Burton, and R E Wagner (1978): 'The Consequence of Mr Keynes'. Hobart Paper No 78.
3. J Burkhead (1954): 'The Balanced Budget'. Quarterly Journal of Economics, reprinted in AEA Series 'Readings in Fiscal Policy'. Allen and Unwin (1955).
4. R Harrod (1963): 'The British Economy', McGraw-Hill.
5. UK Hicks (1953): 'The Budget as an Instrument of Policy, 1837-1953', Three Banks Review.
6. R Middleton (1985): 'Towards the Managed Economy: Keynes the Treasury and the Fiscal Policy Debate of the 1930s'. Methuen.
7. J Odling-Smee and C Riley (1985): 'Approaches to the PSBR', National Institute.
8. E Roll (1973): 'A History of Economic Thought', Faber.



RW

C.



SPEECH

Word count 9593.

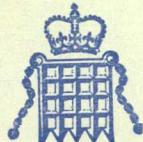
1. Speech attached. ~~(or having a word count done).~~
- 1A. A few ^{suggested} _w amendments marked.
2. Brian Mace's view, on para 1.36, is as follows. On one basis, the bottom 95% are paying £300m less than in 1978-79, 1% down. On another basis - apparently it depends on how you treat the composite rate, inter alia - the bottom 5% are paying up to £50m more. Either way, the numbers are ^{very} _h small.

So:

- Brian would prefer to say "the remaining 95 per cent of taxpayers pay about the same in real terms" or "... pay no more in real terms than in 1978-79".
- But, if you wanted to stick to the existing form of words, he could defend it in PQs etc.

A/H

14.3.



H.M. CUSTOMS AND EXCISE
KING'S BEAM HOUSE, MARK LANE
LONDON EC3R 7HE
01-626 1515

R.W.H.

Ref. RA 235/88

Copy no. 1 of 15

FROM: P R H ALLEN

DATE: 14 March 1988

MR HUDSON

cc Economic Secretary
Mr Culpin
Mr A C S Allan
Mr Pickford
Mr R I G Allen
Miss Sinclair
Mr Michie
Mr Cropper
Mr Tyrie
Mr Call

BUDGET STATEMENT : FIFTH DRAFT

1. This is to confirm our conversation of last Friday afternoon.
2. We have only one comment on the latest draft.

J5: Existing duties are not being reduced; a new duty structure is being introduced. Accordingly we would suggest amending the first sentence as follows:-

Internal Circulation: CPS, Mr Knox, Mr Jefferson Smith

"The existing duty structure discourages sales of drinks known as 'coolers', which are mixtures of an alcoholic drink and a soft drink. I propose to introduce new, lower rates of duty for these products, so as to encourage the young"

RA.

P R H ALLEN

COMMENTS

Ref No APH / 33
 Copy No 43

APH II

FROM: A P HUDSON
 DATE: 7 March 1988

14

D

/ CHIEF SECRETARY

cc	✓ Financial Secretary	Mr Pickford
	✓ Paymaster General	Mr R I G Allen
	✓ Economic Secretary	Miss Sinclair
	✓ Sir P Middleton	Mr Riley
?	— Sir T Burns	Miss Simpson
	✓ Sir G Littler	Miss C Evans
	✓ Mr Anson	Miss Hay
	Dame A Mueller	Mr Michie
	Sir A Wilson	Mr Cropper
	Mr Byatt	Mr Tyrie
	✓ Mr Monck	Mr Call
	✓ Mr Scholar	Mr Battishill - IR
	✓ Mr Sedgwick	Mr Isaac - IR
	✓ Mr Odling-Smee	Mr Painter - IR
	Mr Culpin	Mr Beighton - IR
	✓ Mr Turnbull	Mr McManus - IR
	✓ Mr Peretz	Mr Unwin - C&E
	Mr A C S Allan	Mr Knox - C&E
	✓ Mr Mowl	Mr P R H Allen - C&E

FINAL

BUDGET STATEMENT: FOURTH DRAFT

... I attach the ~~fourth~~ ^{final} draft of the Budget Speech, which the Chancellor has worked through over the weekend.

2. The Chancellor would be grateful for comments by 6pm on Wednesday 9 March, at the latest.

2. Any essential comments by 1 p.m. today if possible, please.

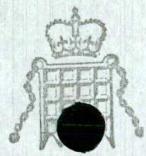
APH

A P HUDSON

B7. Manufacturing exports rose by ~~£~~ 8½ per cent, contributing to a better than expected performance of visible trade. As a result, the deficit on the current account of the balance of payments was well below the forecast I made at the time of last year's Budget, at a little over £1½ billion.

British manufacturers

During the 1980s, British manufacturers



H.M. CUSTOMS AND EXCISE
KING'S BEAM HOUSE, MARK LANE
LONDON EC3R 7HE
01-626 1515

Ref. RA 235/88

Copy no. 4 of 15

FROM: P R H ALLEN

DATE: 14 March 1988

MR HUDSON

cc Economic Secretary
Mr Culpin
Mr A C S Allan
Mr Pickford
Mr R I G Allen
Miss Sinclair
Mr Michie
Mr Cropper
Mr Tyrie
Mr Call

BUDGET STATEMENT : FIFTH DRAFT

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"The existing duty structure discourages sales of drinks known as 'coolers', which are mixtures of an alcoholic drink and a soft drink. I propose to introduce new, lower rates of duty for these products, so as to encourage the young"

RA.

P R H ALLEN



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

14 March 1988

John Footman Esq
PS/Governor
Bank of England
Threadneedle Street
LONDON EC2

pp

Dear John,

SEATS FOR THE BUDGET SPEECH

As I told you this morning, the Chancellor would like to offer Mrs Leigh-Pemberton a seat in the Distinguished Strangers' Gallery for his Budget Speech tomorrow. In order to do this, I am afraid we have to move the Deputy Governor to the Speaker's Gallery, and Mr George to the Special Gallery (East). All the tickets should be collected from the policeman in the Central Lobby, except for Mr George's which should now be collected from the Admissions Order Office. I enclose a map of the House on which this is marked.

*Yours,
Moir.*

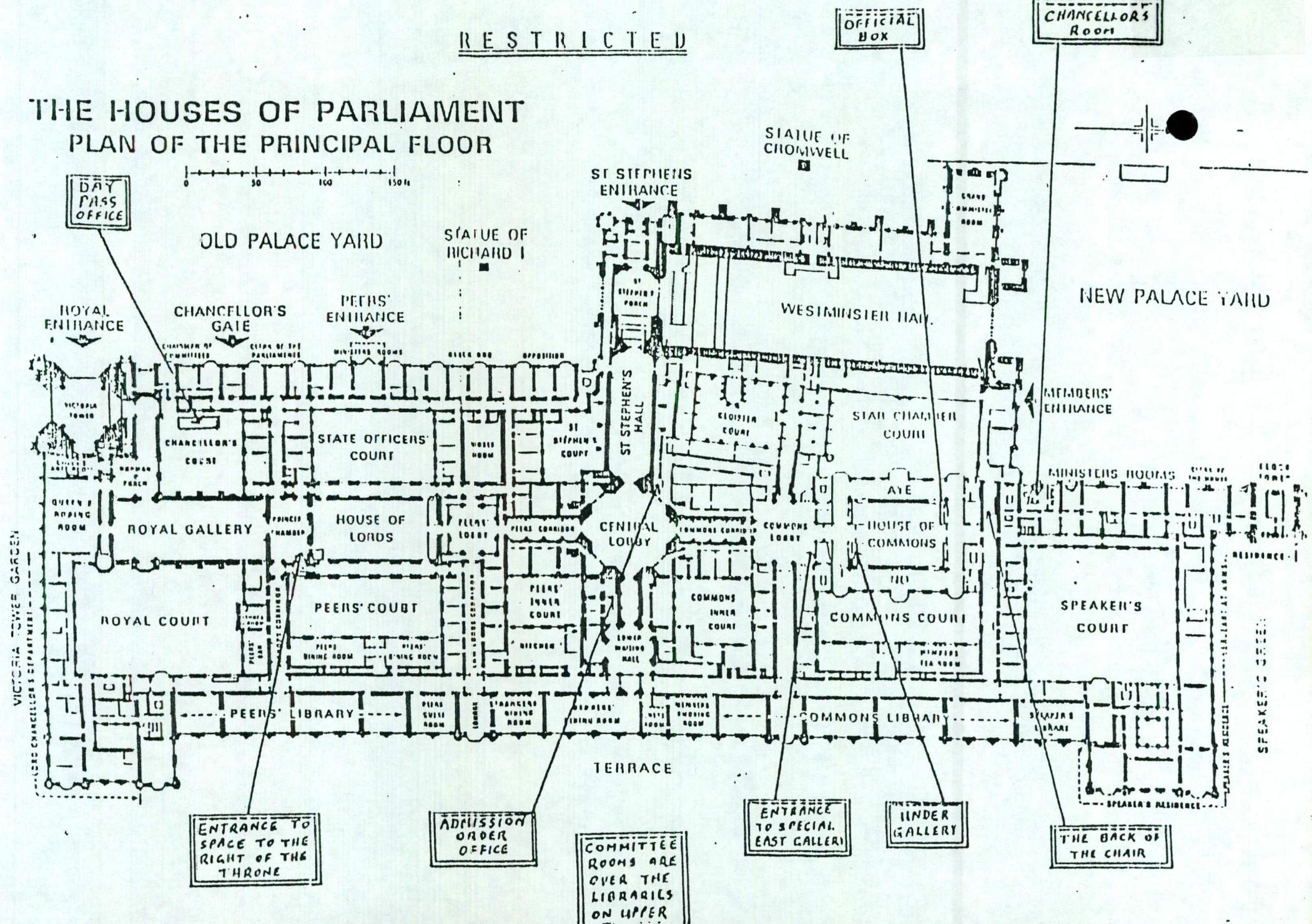
MOIRA WALLACE
Private Secretary

Floor plan

RESTRICTED

THE HOUSES OF PARLIAMENT

PLAN OF THE PRINCIPAL FLOOR





FROM: A C S ALLAN
DATE: 14 March 1988

Pry

CHANCELLOR

cc Mrs Lawson
Mr R I G Allen
Mr Woodall
Mr Flitton

BUDGET DAY LOGISTICS ETC.

Walk in the park

The police see no reason at all to expect any disturbances. But we will check first thing in the morning.

2. If it's drizzling, it seems best for you to go ahead, with umbrella. You could keep to the L-shaped road/Mountbatten statue area, but that does miss the main photo-opportunity, at the pond.

3. If it's bucketing down, best to cancel altogether.

Journey to House

4. It would cause great difficulties for BBC and ITV schedules if you left before 3.00pm.

5. Simon Woodall has taken charge of this, and will ring police at about 2.45pm. If they advise that there is any danger, then both cars will go through Foreign Office/Treasury. But, again, police do not expect any difficulties.

6. I will do some further investigation in the morning about the practicability of umbrellas if it's raining.

7. We now have the updated Allan guide to ballroom dancing. I have been through it with Nigel Forman. One point on it is not entirely clear: as Tom and I head off for the car, he will move behind you two, to stand on the left (ie out of the way of the Budget Box) for a few brief photos. He will then peel off stage left to join me in the car.

ACSA

A C S ALLAN

PWP



FROM: G R WESTHEAD
DATE: 14 March 1988

NOTE OF A MEETING HELD IN ROOM 52/2, TREASURY CHAMBERS, WEDNESDAY 9 MARCH 1988

Those Present:

Economic Secretary	-	Treasury
Mr Finlinson	-	Customs & Excise
Mr Wilmott	-	"

BUDGET STARTER 63 : TIME LIMITS FOR PROSECUTION

The background to the meeting was Mr Wilmott's submission of 2 March and the Economic Secretary's preference for the time limit for bringing proceedings on indictment to be limited to 6 years rather than the 20 proposed by Customs. Customs had requested a meeting to put further representations to the Economic Secretary.

2. Mr Finlinson said that a maximum time limit of 6 years for prosecution on indictment would seriously limit Customs capability to prosecute serious fraudsters. Fraud cases often went back over a very long period. Although there was no legal requirement to keep documents people sometimes did so in practice, longer than 6 years, and Customs were at present working on a case where the base document dated from 1977.

3. Mr Finlinson explained that the civil penalties regime, implemented in the 1985 Finance Act, allowed Customs to go back 20 years so a 6 year time limit on criminal proceedings might look illogical. The same section of the Finance Act permitted Customs to assess tax where there had been a fraud conviction. If it was decided to go for criminal proceedings and Customs were limited to offences committed within 6 years, they would be precluded from assessing the tax back over a 20 year period.

4. Mr Finlinson explained that tax fraud tended to involve continuous

offences that once started, continued until detected by Customs. The difficulty was that 6 years or more could elapse between control visits. With a 6 year time limit, Customs could still pray in aid documents going back over more than this period, but the indictment would cover only the 6 year period and the Court's penalties would be assessed accordingly. Mr Finlinson explained that it was the very large fraud cases which tended to go back more than 6 years. He very much hoped the Economic Secretary would feel able to reconsider his decision on this.

5. The Economic Secretary said that the proposals had initially caused him difficulty on two grounds. First, he thought fraudsters were only likely to hold documents a maximum of 6 years. Second, he felt the proposal would raise hackles about Customs' supposed draconian powers.

6. Mr Wilmott said that he well understood the Economic Secretary's concerns, particularly as far as the latter criticism was concerned. However, financial crime was the in-thing. It had already been tackled in City reforms. He noted too that there was no prosecution limit in the Theft Act and Companies Act. Mr Finlinson added two further arguments. First, Lord Keith himself had proposed no limit, so Customs' proposal was far short of that. Also, Customs proposed 20 years would bring civil penalties and criminal penalties into line.

7. The Economic Secretary asked what reaction accountancy bodies were likely to make to 20 years. Mr Finlinson did not think they would be against it as they had no intention to defend fraudsters in any way (they were more likely to challenge civil penalty changes).

Mr Finlinson said that Customs could perhaps manage with a compromise of 12 years. But the disadvantage of this was that it might need to be increased later. With 20 years, it was very unlikely Customs would need to trouble Ministers again this century! Also, a half-way house measure of 12 years could open up a possible attack on the 20 year period in Section 13 of the Finance Act and these civil penalties would be open to scrutiny.

8. The Economic Secretary said that he noted Customs' strength of feeling on this subject and there were very good Customs reasons for a 20-year limit. His main reason for opposing it earlier had been that he could not be sure that there was an operational need for 20 years. Now that this had been explained to him he was quite content for Mr Wilmott's proposal of 20 years to stand and agreed that Parliamentary Counsel should be instructed to prepare the Clause for the Finance Bill on that basis. Mr Finlinson said that the latter would be instructed immediately.

Guy Westhead.

GUY WESTHEAD

Assistant Private Secretary

Distribution

Those Present

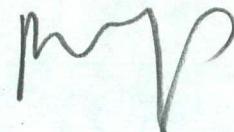
PS/Chancellor

Miss Sinclair

Mr Hoare

PS/C&E

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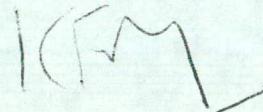
FROM: K F MURPHY
DATE: 14 MARCH 1988

MR BARNES

CC PPS
Mr Scholar
Mrs Lomax
Miss Noble
Mr Allan

BUDGET: BUILDING SOCIETIES: LETTER TO ALLIANCE AND LEICESTER

Your minute of 9 March to Miss Noble commissioned a letter for the Economic Secretary to send to the Alliance and Leicester. I attach a draft. I think we can keep it short and enclose a copy of the admirably clear IR press notice.



K F MURPHY

DRAFT LETTER FROM ECONOMIC SECRETARY TO:

S Duward Esq
Alliance and Leicester Building Society

BUDGET: BUILDING SOCIETY CONVERSIONS

In the light of our meeting on 4 February which I found very helpful, I thought I might draw your attention to the changes in tax law relating to building society conversions which the Chancellor announced in his Budget today. I attach a copy of the Inland Revenue press notice which lists changes in detail. The necessary legislation will appear in the Finance Bill in the usual way and will take effect from Royal Assent to that Bill, likely to be towards the end of July.

[P.L.]

FROM: R I G ALLEN
DATE: 14 MARCH 1988

CHANCELLOR

cc Mrs Lawson
Mr N Forman MP
Mr A C S Allan
Mr Flitton
Mr S Woodall
Mr E King
Mr J Beattie
Ms M Collier

DEPARTURE FROM NO.11: ARRANGEMENTS FOR TOMORROW

I attach the operational note for tomorrow and an up-date of Alex Allan's action chart.

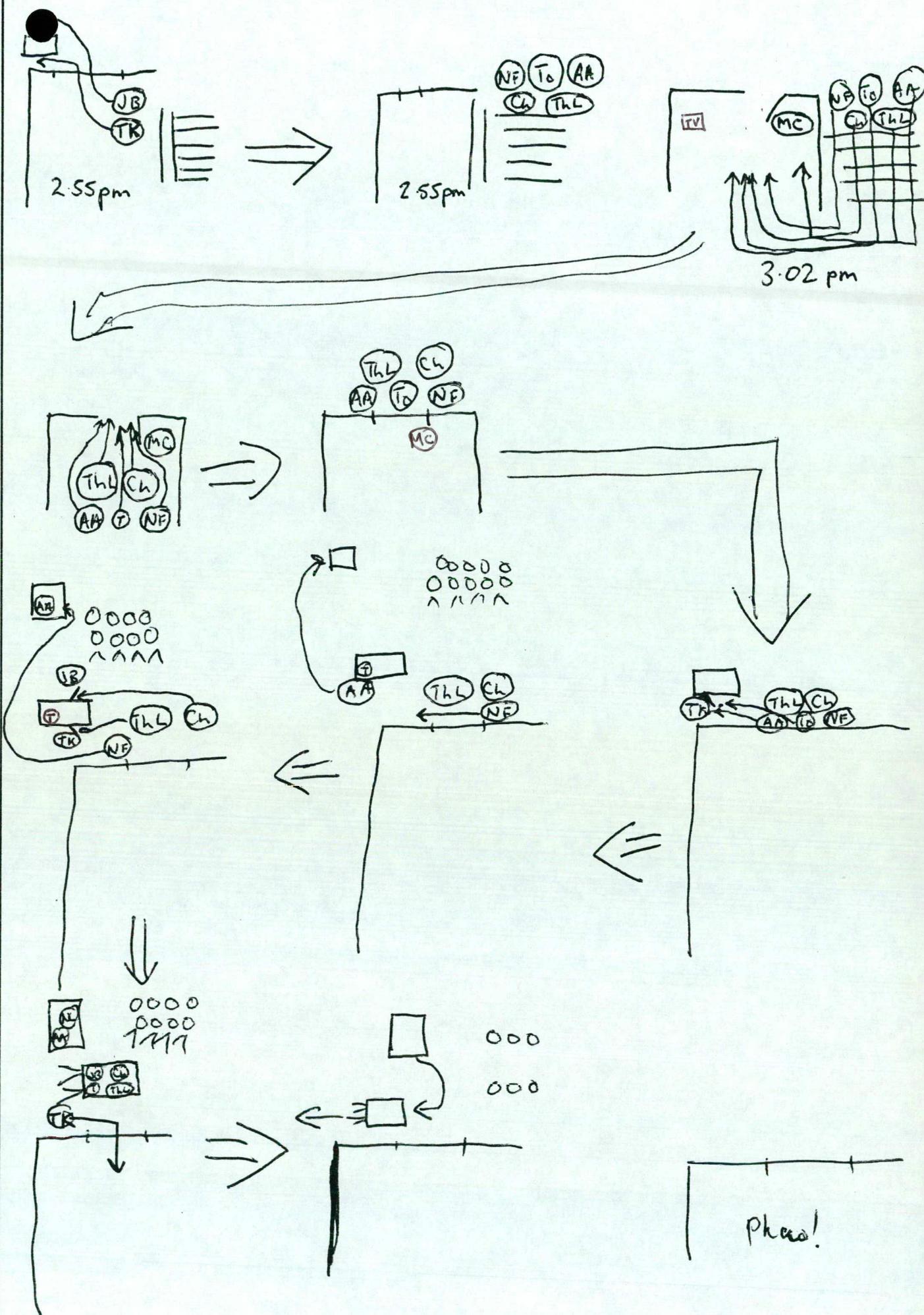
2. In Michael Gunton's absence, Simon Wodall has very kindly agreed to step into the breach for the afternoon: he will be at No.11 from 2.30 p.m. onwards to ensure that all goes smoothly.

RGA

R I G ALLEN

OPERATIONAL NOTE: DEPARTURE FROM NO.11

1. At 2.55pm **Joe Beattie** and **Ted King** (Security Guard) leave No.11 to be ready to open the car doors for the Chancellor, Mrs Lawson and Tom when they depart for the House.
2. At 2.55pm the **Chancellor**, **Mrs Lawson**, **Tom**, **Alex Allan** and **Nigel Forman** gather in the upstairs hall with **Simon Woodall**.
3. At 3.02pm they make their way to the downstairs hall in the following order: the **Chancellor** with **Mrs Lawson** on his left, followed immediately by **Nigel Forman** (behind the Chancellor) with **Tom** and **Alex Allan** to his left.
4. **NB** The party will come into camera range as soon as they enter the downstairs hall.
5. As the party enters the downstairs hall **Marie Collier** will open the front door and the party will walk through the hall (without stopping).
6. Immediately the party enters Downing Street **Marie Collier** will close the front door.
7. **Alex Allan** and **Tom** will immediately move to the near-side of the Chancellor's car. **Ted King** will open the front near-side door for **Tom**. **Alex Allan** will then wait in the Government car on the far side of Downing Street. **Nigel Forman** will move to the left (and behind) Mrs Lawson.
8. After posing for the photographers, the **Chancellor** and **Mrs Lawson** will move to the car. **Joe Beattie** will open the off-side door for the Chancellor and **Ted King** the near-side door for Mrs Lawson. **Nigel Forman** will move to the Government car on the far side of Downing Street.
9. **Joe Beattie** should switch on the car headlights for the journey to the House.





✓
Final version
14/3/88.

copy

1988 BUDGET: SUMMARY OF MAIN POINTS

The background to this year's Budget is an extremely favourable one. The economy is growing strongly, unemployment is falling rapidly, while inflation remains low. The public finances are exceptionally strong. This year's Budget will help the economy to continue this excellent progress, by improving incentives and encouraging enterprise, against the background of sound financial policies.

2. The main points are:

- a Budget surplus of £3 billion in both 1987-88 and 1988-89, and the prospect of a balanced budget over the medium term;
- major reform and simplification of personal taxation;
- income tax allowances raised by twice as much as inflation, the basic rate reduced to 25p in the £, and all higher rates above 40 per cent abolished;
- a completely new system of taxation for married couples, to take effect in 1990, which will, for the first time ever, give married women privacy and independence and end tax penalties on marriage.

Economic Background

3. The strength and durability of the economic upswing in Britain has now exceeded all post-War records. The UK is about to enter its eighth successive year of sustained growth, and the sixth in which this has been combined with low inflation. It has now seen the longest period of steady growth, at a rate averaging 3 per cent a



year, for half a century. During the 1960s and the 1970s, Britain's growth rate was the lowest of all the major European economies; during the 1980s, it has been the highest.

4. In 1987, total output grew by $4\frac{1}{2}$ per cent, substantially stronger than forecast a year ago, while inflation averaged $4\frac{1}{4}$ per cent. Unemployment fell by half a million, more than in any other year since the War, in every region of the country, and faster than in any other major nation. The substantial fall in long-term unemployment is particularly encouraging.

5. Manufacturing industry performed particularly well in 1987. Manufacturing output rose by $5\frac{1}{2}$ per cent, and there was a further large improvement in manufacturing productivity: in the 1980s, output per head in manufacturing industry has risen faster in Britain than in any other industrial country.

6. After seven successive years of surplus, the current account of the balance of payments is now estimated to have been in deficit last year by a little over £1 $\frac{1}{2}$ billion. This is a smaller deficit than forecast in last year's Budget, thanks to a better than expected performance on visible trade, with exports of manufactured goods up by $8\frac{1}{2}$ per cent.

7. The Chancellor expects 1988 to be another year of healthy growth with low inflation; and there is every prospect that unemployment will continue to fall, although probably not as rapidly as last year. The pace of growth is likely to ease somewhat, returning to the underlying trend of the past few years. Output for 1988 as a whole is forecast to be 3 per cent higher than in 1987, with the non-oil economy up by $3\frac{1}{2}$ per cent. Business investment is forecast to grow particularly strongly, with a rise of $8\frac{1}{2}$ per cent. As last year, inflation is forecast to end the year at 4 per cent.



8. With growth in the UK likely to continue to outpace that of most other major countries, particularly in continental Europe, and with the oil surplus falling as North Sea production declines, the current account of the balance of payments is forecast to remain in deficit in 1988, by some £4 billion, equivalent to less than 1 per cent of GDP. The forecast assumes that the oil price will remain close to recent market levels.

Budget Strategy

9. The Medium Term Financial Strategy continues to provide the framework for the Government's economic policy, as it has done since 1980. It is designed to reduce the growth of total spending power in the economy steadily over a period of years, at a pace which will gradually squeeze inflation out of the system, while leaving room for further sustained economic growth.

10. The Chancellor is setting a target range of 1 to 5 per cent for narrow money in 1988-89; like last year, there will be no explicit target for broad money. Short-term interest rates remain the essential instrument of monetary policy, and interest rate decisions will continue to be based on a continuous and comprehensive assessment of monetary conditions. Exchange rates play a central role in both domestic monetary decisions and in international policy co-operation. In their communique of 23 December the Finance Ministers and Central Bank Governors of the seven major industrialised countries re-emphasised their common interest in more stable exchange rates.

11. One of the Government's main objectives, since it first took office in 1979, has been to bring down Government borrowing. It has been reduced from 5½ per cent of national income in 1978-79 to only three-quarters of one per cent in 1986-87. In 1987-88, it now looks



as if the outturn will be a Budget surplus - something previously achieved on only one isolated occasion since the beginning of the 1950s.

12. The Chancellor believes that a balanced budget is a valuable discipline for the medium term, and intends that a zero borrowing requirement should be the norm from now on, though there are bound to be fluctuations on either side from year to year. For 1988-89, the Chancellor has decided that it is prudent to budget for a surplus of £3 billion, the same size as expected in 1987-88. This is after allowing for the substantial increases in public expenditure announced in last November's Autumn Statement, including additional spending of £1 billion on health and personal social services.

Taxation

13. The Chancellor is introducing major reforms in personal taxation, designed to sharpen incentives and provide a further boost to the supply side of the economy.

Income tax

14. The Chancellor is raising the main personal allowances by twice the amount needed to compensate for inflation - that is, by roughly 7½ per cent. This includes the special age allowance for pensioners. It also applies to the upper limit for the basic rate band (ie the point at which the higher rates of tax begin).

15. He is reducing the basic rate of income tax by 2p in the £, to 25p. This meets the Government's manifesto commitment. He is also announcing a new target for the basic rate, of 20p in the £, to be reached as and when it is prudent.



16. The Chancellor is radically reforming the higher rates of tax. He is abolishing all the higher rates above 40p. Income tax will thus be reduced from a six rate to a two rate system; and the higher rate (reached at a taxable income of £19,300) will be one of the lowest top rates in the world.

17. The income tax changes will benefit all 25 million taxpayers. A married man on average earnings will gain nearly £5 a week.

18. At the same time the Chancellor is reducing some of the special reliefs in the income tax system.

19. First, he is ending the tax shelter for forestry, which has been widely criticised, and switching to an improved system of grants for forestry. Support through grants will be better targeted, eg to encourage better balance between broad-leaved trees and conifers. There is no change in the Government's planting aim.

20. Second, he is abolishing the tax relief on home improvement loans, most of which are small and finance minor improvements such as double-glazing, rather than extensions or conversions, and which have been widely abused. This concentrates mortgage interest relief on its primary purpose: house purchase.

21. He is also doubling the income tax liability on company cars, which have long been taxed at substantially less than they are worth.

Capital gains tax

22. Since 1982, capital gains tax has been charged only on 'real' gains: the paper gains which simply reflect inflation are no longer taxed. But these arrangements do not apply to gains made before 1982. This means that there are people and companies who have held



assets since the 1960s or 1970s, or even earlier, who cannot realise them without paying substantial tax on purely paper gains made before 1982.

23. The Chancellor proposes to rectify this by exempting from tax all gains made before 1982. There will then be no taxation of inflationary gains whatever.

24. The annual exempt amount of gains which individuals can make without paying tax is being reduced from £6,600 to £5,000. The present high level of the exemption was introduced explicitly to compensate for the fact that paper gains made before 1982 were, until now, subject to tax. The need for such compensation falls away under the Chancellor's reforms.

25. The real gains which are subject to tax will be charged at the same tax rates as income - 25 per cent and 40 per cent. This will reduce the incentive to convert income artificially into capital, and to invest for speculative gain rather than income. (Companies' gains are already taxed at the same rate as their profits: this change was made in the last Budget.)

26. At the same time the Chancellor is increasing the amount of relief from capital gains tax which is available to a small businessman selling his business on retirement.

Excise duties

27. The Chancellor is raising the excise duties, as a whole, broadly in line with inflation. However:

- a. there is no change in the tax on unleaded petrol: this means that the differential between leaded and unleaded will double to just over 10p a gallon;



b. there is no change in the tax on spirits or pipe tobacco, or in the main rates of vehicle excise duty: the cost of keeping VED unchanged will be financed from the increased petrol duty, which will go up by nearly 6p a gallon;

c. there are reductions in the taxation of some low alcohol drinks so as to encourage switching, particularly by the young, from high-alcohol to low-alcohol drinks.

Inheritance tax

28. The Chancellor is raising the threshold for inheritance tax from £90,000 to £110,000. This will reduce by a quarter the number of estates which are taxed. In particular, it will allow ordinary people to pass on their homes without being taxed.

29. The Chancellor is also reducing the tax from four rates to one (having reduced it from seven last year). The new flat rate will be 40 per cent. For many family businesses passing from one generation to another, this means the effective rate will be only 20 per cent, because there is 50 per cent business relief.

Taxes on business

30. The main Corporation Tax rate remains at 35 per cent. The small companies' rate is reduced from 27 per cent to 25 per cent, in line with the basic rate of tax.

31. The VAT threshold is being increased by the maximum permitted under EC law, to £22,100.



32. Capital Duty, the 1 per cent tax paid by companies which raise new capital, is being abolished, as is the $\frac{1}{4}$ per cent duty paid on all property put into a unit trust.

33. The special tax reliefs for entertaining foreign customers are also being abolished, so that the entertainment of foreign business contacts is put on the same footing as domestic ones.

34. There will be a change in the rules affecting the small number of companies which wish to change their country of residence for tax purposes. At present the rules require an application to the Treasury for formal consent, and are backed up by criminal sanctions. New rules, similar to those which exist in most other countries, will be introduced to allow companies to migrate if they wish, provided they pay the tax due to the UK Exchequer first. The rules will be based on objective criteria and will no longer involve either an application to the Treasury for consent, or criminal sanctions.

Business Expansion Scheme

35. The Chancellor is extending the Business Expansion Scheme, under which investors obtain immediate tax relief for investment in new businesses in particular, to include investment in companies providing housing for rent. This extension will last for five years. It is designed to help revive the private rented sector, in conjunction with the deregulation of rents. These measures should make it easier for people seeking work to find accommodation for themselves and their families.



Share ownership

36. The Chancellor is increasing the limit on the amount which can be invested by individuals in Personal Equity Plans from £2,400 to £3,000, and relaxing some of the restrictions on shares owned by employees in the companies in which they work.

Maintenance and Covenants

37. The Chancellor proposes to reform the taxation of maintenance and covenant payments, other than covenants to charity which are untouched. The present arrangements are complex and involve unnecessary work for both taxpayers and the Revenue.

38. Most maintenance payments are made by divorced men to their ex-wives or children. At present the Inland Revenue taxes the recipients, and returns the money to donors in tax relief. The Chancellor proposes instead that future recipients should be freed from tax on their maintenance. Donors will still be able to enjoy tax relief on payments to separated or divorced wives, but only up to a limit, set equal to the difference between the married allowance and the single allowance. In 1988-89 this will be £1,490. Existing arrangements will be protected, and existing recipients will be freed from tax on the first £1,490 of their maintenance.

39. For covenants between individuals, the Chancellor is again making the income tax free in the hands of recipients. Tax relief for donors is being abolished. The largest single group affected will be students and their parents: covenants have simply become a convoluted way of getting State support into the hands of students, in a way that shelters the parents' income from tax. There will be a broadly compensating reduction in the parental contribution to student grants at mandatory rates.



Charities

40. As well as leaving tax relief on covenants to charity unchanged, the Chancellor is doubling the amount which people can give to charities free of tax under the payroll-giving scheme.

Independent taxation

41. The Chancellor is announcing in the Budget that a major reform of the taxation of married couples will take effect in 1990, the earliest practicable date. The present system, which dates back 180 years, taxes the income of a married woman as if it belonged to her husband. This denies privacy and independence to married women. It can also lead to a tax penalty on marriage, with married couples paying more tax simply because they are married.

42. Under the new system a husband and wife will be taxed independently, on all their income. Married women will pay their own tax on their own income, and be responsible for their own tax return if one is necessary. All tax payers, male or female, married or single, will be entitled to the same personal allowance.

43. The tax system will continue to recognise marriage. Married couples will get a married couple's allowance equal in value to the difference under the present system between the single allowance and the married man's allowance.

Tax penalties on marriage

44. The new system will remove a number of the tax penalties on marriage. The most common penalty, the taxation of a married woman's savings income at her husband's marginal rate, will disappear altogether; and husband and wife will be taxed



independently on any capital gains they may have, with an annual exemption each instead of one between them. Transfers of capital between husband and wife will continue to be free of tax.

45. The Chancellor is abolishing two other tax penalties on marriage, ahead of Independent Taxation. First, under the present system of mortgage interest relief an unmarried couple can get twice as much relief as a married couple. From August 1988 the limit of £30,000 will be applied to the house or flat, so that married and unmarried couples will get the same amount of relief. Existing borrowers will not be affected.

46. The second penalty arises because an unmarried couple with children can each claim an Additional Personal Allowance, giving them more tax relief than a married couple in the same position. In future unmarried couples will be entitled to only one Additional Personal Allowance.

47. Thus the Chancellor is abolishing, for all practical purposes, all the tax penalties which, under the present system, can arise on marriage.

Summary

48. The Budget continues the economic policies which have brought about the renewed strength of the British economy. It introduces major reforms of personal taxation including: new arrangements for taxing husbands and wives which will give married women privacy and independence in their tax affairs for the first time; an end to the taxation of inflationary gains; and the elimination of all personal tax rates over 40 per cent. The Chancellor has reduced the basic rate of income tax to 25 per cent, and set a new target of 20 per cent. And he has done this within the context of a balanced budget.

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FROM: A P HUDSON

DATE: 14 March 1988

CHIEF SECRETARY

cc Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Mr Monck
Mr Scholar
Mr Sedgwick
Mr Odling-Smee
Mr Culpin
Mr Turnbull
Mr Beretz
Mr A C S Allan

Mr Pickford
Mr R I G Allen
Mr Cropper
Mr Tyrie
Mr Call
Mr P R H Allen - C&E

BUDGET STATEMENT: FINAL DRAFT

... I attach the final draft of the Budget Speech.

2. Any essential comments by 1.00pm if possible, please.

A P HUDSON

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Draft of 14 March (2000)

BUDGET

CHANCELLOR OF THE EXCHEQUER'S BUDGET STATEMENT

15 MARCH 1988

INDEX

SECTION	PAGE	TITLE
A		INTRODUCTION
B		THE ECONOMIC BACKGROUND
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E		TAX REFORM
F		INDEPENDENT TAXATION
G		BUSINESS TAXATION
H		COVENANTS AND MAINTENANCE
J		TAXES ON SPENDING
K		TAXES ON CAPITAL
L		INCOME TAX
M		PERORATION

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BUDGET**A INTRODUCTION**

Al. I am reliably informed that my Budget speech last year was the shortest this century. My Budget speech this year is likely to have a different claim to a place in the history books. Not, the House will be glad to learn, as the longest Budget speech this century, but as the last untelevised Budget speech.

A2. As I once again present the first Budget of a new Parliament, the British economy is stronger than at any time since the War. As the British people recognised last June, this has not happened by chance. It has happened because, for almost nine years now, we have followed the right policies and stuck to them. I reaffirm those policies today. In particular, there will be no letting up in our determination to defeat inflation.

A3. I shall begin, as usual, with the economic background to the Budget. I shall then deal with monetary policy, and with the public finances this year and next, and indeed for the remainder of this Parliament. Finally, I shall propose a number of measures designed to improve the performance of the economy still further, by changing the structure of taxation. For this will be a tax reform Budget.

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A4. As usual, the Financial Statement and Budget Report, together with a number of press releases filling out the details of my tax proposals, will be available from the Vote Office as soon as I have sat down.

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B. THE ECONOMIC BACKGROUND

B1. I start with the economic background.

B2. The strength and durability of the economic upswing has now exceeded all post-War records. We are about to enter our eighth successive year of sustained growth, and the sixth in which this has been combined with low inflation. And even without looking to 1988, the six years to 1987 have been the longest period of steady growth, at a rate averaging 3 per cent a year, for half a century.

B3. This performance compares favourably not only with our own past, but also with the economic performance of other countries. During the 1960s and the 1970s, Britain's growth rate was the lowest of all the major European economies. During the 1980s, our growth rate has been the highest of all the major European economies.

B4. In 1987 as a whole, output grew by getting on for $4\frac{1}{2}$ per cent, rather more than the rate of inflation which averaged 4.2 per cent. At the same time unemployment fell faster than in any other year since the War, in every region of the country, and more than in any other major nation.

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B5. The plain fact is that the British economy has been transformed. Prudent financial policies have given business and industry the confidence to expand, while supply side reforms have progressively removed the barriers to enterprise.

B6. Nowhere has this transformation been more marked than in manufacturing, where output rose last year by $5\frac{1}{2}$ per cent. This outstanding performance was founded on a further big improvement in productivity. In the 1980s, output per head in manufacturing has gone up faster in Britain than in any other major industrial country, and we led the way once again last year. This is in stark contrast to the 1960s and 1970s, when in the growth of manufacturing productivity, as in so much else, we were bottom of the league.

— We see the same in exports too.

B7. The current account of the balance of payments is now estimated to have been in deficit last year, after seven successive years of surplus, by a little over £1½ billion. This is well below the deficit I forecast at the time of last year's Budget, despite growth turning out stronger than forecast. The reason for this was the better than expected performance of visible trade, with exports of manufactures up by $8\frac{1}{2}$ per cent. This continues the pattern of the 1980s, with British manufacturers maintaining their share of an expanding world trade - the crucial test of competitiveness - after

*On reflecting
the original
contains a
clumsiness,
some "Reason
for this" seems
to refer to
growth & less
slower &
expected.*

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decades during which Britain's share was steadily declining.

B8. Looking ahead, I expect 1988 to be yet another year of healthy growth with low inflation; and there is every prospect that unemployment will continue to fall, although probably not as rapidly as last year.

B9. The pace of non-oil growth is likely to ease from now on, returning to the underlying trend of the past few years. Output for 1988 as a whole is forecast to be 3 per cent higher than in 1987, with the non-oil economy up by $3\frac{1}{2}$ per cent. Business investment is forecast to grow particularly strongly, with a rise of $8\frac{1}{2}$ per cent.

B10. As last year, inflation is forecast to end the year at 4 per cent. While this is still too high, it is a testimony to the soundness of our policies that the present strong and sustained upswing, unlike almost all its predecessors, has not led to a resurgence of inflation.

B11. With growth in the UK economy likely to continue to outpace that of most other major countries, particularly in continental Europe, and with our oil surplus falling as North Sea oil production declines, the current account of the balance of payments is forecast to remain in deficit this year, by some £4 billion, equivalent to less than one per cent of GDP. Given the strength of the

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economy in general, and of our public finances in particular, not to mention our massive net overseas assets position, I foresee no difficulty in financing a temporary current account deficit of this scale.

B12. But the outlook both for exports and for jobs will depend critically on employers keeping their costs firmly under control. Unit labour costs in manufacturing scarcely rose at all in 1987. It is vital that employers do not let this slip, and keep a tight grip on all their costs, not least pay.

B13. In my Budget speech last year, I warned that:

"Given the continuation of present policies in this country, the biggest risk to the excellent prospect I have outlined is that of a downturn in the world economy as a whole."

That remains the case. The dramatic collapse in the world's equity markets last October was not the second coming of 1929 and the harbinger of a 1930s-style world slump, as so many feared at the time - although it could have been a great deal nastier had the authorities in the major nations not responded in a prompt and appropriate way. It was essentially an overdue market correction which did little more than reverse the rapid rise in share prices of the previous year. Certainly, business confidence does not seem to have been greatly affected, and growth in the seven major industrial countries as a

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whole this year is likely to be only slightly lower than last year.

B14. But Black Monday was also a warning. The world's three largest economies - the United States, Japan and Germany - have made a number of the policy adjustments necessary to reduce the imbalances which have for so long afflicted them, and there is evidence that the measures they have taken are starting to bear fruit. But there is still a long way to go; and meanwhile there is the constant danger that the process of adjustment, and with it the world economy as a whole, could be gravely damaged either by further wild gyrations in the dollar exchange rate or by a lurch into protectionism.

B15. Success in reducing these imbalances depends on countries putting the right fiscal and monetary policies in place, and keeping them there. But the necessary adjustments are much more likely to be achieved if the objective of greater exchange rate stability is given an explicit role in the process of international co-operation, as has been the case for well over two years now. I can assure the House that we shall continue to play our full part.

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BUDGET**C. MONETARY POLICY**

C1. Meanwhile, the maintenance of sound money and prudent public finances will keep us in the best possible position to weather any storms we may face, either at home or abroad.

C2. The Medium-Term Financial Strategy, now entering its ninth year, will continue to provide the framework for reducing the growth of money GDP, and hence inflation, over the medium term. These will be achieved by maintaining firm monetary discipline, buttressed by a prudent fiscal stance.

C3. Achieving the gradual eradication of inflation requires a steady reduction in monetary growth in the medium term. While I shall continue to take account of broad money, or liquidity, as last year there will be no explicit target. For narrow money, MO, the target range for 1988-89 will be 1-5 per cent, as foreshadowed in last year's MTFS.

C4. Short term interest rates remain the essential instrument of monetary policy. Within a continuous and comprehensive assessment of monetary conditions, I will continue to set interest rates at the level necessary to ensure downward pressure on inflation.

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C5. Exchange rates play a central role in domestic monetary decisions as well as in international policy co-operation. I believe that most businessmen have welcomed the greater exchange rate stability over the past year. It is important that they also accept the financial discipline inherent in this policy.

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D. PUBLIC SECTOR FINANCES

D1. As I pointed out a moment ago, a sound monetary policy needs to be buttressed by a prudent fiscal stance.

D2. At one time, it was regarded as the hallmark of good government to maintain a balanced budget; to ensure that, in time of peace, government spending was fully financed by revenues from taxation, with no need for government borrowing. Over the years, this simple and beneficent rule was increasingly disregarded, culminating in the catastrophe of 1975-76, when the last Labour Government had a budget deficit, or Public Sector Borrowing Requirement, equivalent in today's terms to some £40 billion.

D3. This profligacy not only brought economic disaster and the national humiliation of a bail-out by the IMF. It also added massively to the burden of debt interest, not merely now but for generations to come.

D4. Thus one of our main objectives, when we first took office in 1979, was to bring down government borrowing. We steadily reduced the Public Sector Borrowing Requirement from the $5\frac{1}{4}$ per cent of GDP we inherited to only three quarters of one per cent in 1986-87. Today I am able to tell the House that in 1987-88, the year now

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ending, we are set to secure something previously achieved only on one isolated occasion since the beginning of the 1950s: a balanced budget.

D5. Indeed, we have gone even further. It looks as if the final outturn for 1987-88 will be a budget surplus of £3 billion. Instead of a PSBR, a PSDR: not a Public Sector Borrowing Requirement, but a public sector debt repayment.

Defensive?

D6. And, incidentally, even if there had been no privatisation proceeds at all, the resulting PSBR, at a half of one per cent of GDP, would still have been the lowest in all but one year since the beginning of the 'fifties.

D7. Some two thirds of this substantial undershoot of the PSBR I set at the time of last year's Budget is the result of the increased tax revenues that have flowed from a buoyant economy; while the remaining third is due to lower than expected public expenditure, again the outcome of a buoyant economy: less in benefits for the unemployed, higher receipts from council house sales, and improved trading performance by the nationalised industries.

D8. A balanced budget is a valuable discipline for the medium term. It represents security for the present and an investment for the future. Having achieved it, I intend to stick to it. In other words, henceforth a zero

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PSBR will be the norm. This provides a clear and simple rule, with a good historical pedigree.

D9. In the very nature of things, there are bound to be fluctuations on either side from year to year. It is in this context that I have to set the precise fiscal stance for the year ahead, 1988-89.

D10. I have already announced, in the Autumn Statement last November, a £2½ billion increase in public expenditure plans for 1988-89, with resources allocated to programmes up by over £4½ billion. In particular, we have increased our plans for spending on health and personal social services by over £1 billion, on education and science by £900 million, and on law and order by £500 million.

D11. These large increases in public expenditure programmes for the coming year will be financed partly from the saving in debt interest resulting from the reduction in Government borrowing. Debt interest now accounts for about three quarters of a percentage point less of GDP than it did only three years ago. This may not sound very much, but it implies a saving of some £3 billion a year. And the balanced budget path I have set out in this year's MTFS will help to reduce debt interest payments still further.

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D12. We have thus secured an enviable virtuous circle in public finance: lower borrowing and lower tax rates create both the scope and the incentive for the private sector to expand. And the private sector then generates higher revenues which permit further reductions in borrowing or tax.

D13. But even so, the increased public spending now planned for 1988-89 inevitably implies less scope for reducing taxation. Moreover, I have decided that for the year immediately ahead, the path of prudence and caution is to budget for a further surplus of the same size as this year's expected outturn - that is to say, a further public sector debt repayment of some £3 billion.

D14. What this means is that it will not be possible in this Budget to reduce the burden of taxation; that is to say, to reduce taxation as a share of GDP.

D15. However, the House may be pleased to know that, with a strong and healthy economy, a constant burden of taxation implies a reduction in tax rates.

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**BUDGET SECRET
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E1. I indicated at the outset that this will be a radical, tax-reforming Budget.

E2. Over the past few years there has been increasing recognition, throughout the industrialised world, of the importance of tax reform in improving economic performance. And for us in this country, the lesson is underlined by the success of the reform of business taxation I announced in my first Budget, at the start of the last Parliament.

E3. But while tax reform is a simple matter for the armchair critic, it is very much more difficult in practice. It is difficult technically and difficult politically - since any tax system, however it arose, creates powerful vested interests in favour of the status quo. Nor, indeed, is it right that change should be too violent. People have a right to expect a reasonable degree of stability in the framework within which they order their affairs. But stability should not mean immobility. That way lies national decline.

E4. So the tax-reforming Chancellor has to tread a careful path. That I have sought to do in this Budget.

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The proposals I shall be making today amount to a substantial and coherent package which will be of increasing benefit to the taxpayer and the economy as a whole in the years to come.

E5. I have been guided by four basic principles. First, the need to reduce tax rates where they are clearly too high. Second, the need to reduce or abolish unwarranted tax breaks. Third, the need to make life a little simpler for the taxpayer. And, fourth, the need to remove some manifest injustices from the system.

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F. INDEPENDENT TAXATION AND TAX PENALTIES ON MARRIAGE

F1. My first reform concerns the taxation of marriage.

F2. The present system for the taxation of married couples goes back 180 years. It taxes the income of a married woman as if it belonged to her husband. Quite simply, that is no longer acceptable.

F3. This is a matter on which there has already been extensive consultation. The time has come to take action.

F4. I therefore propose a major reform of personal taxation, with two objectives. First, to give married women the same privacy and independence in their tax affairs as everyone else. And second, to bring to an end the ways in which the tax system can penalise marriage.

F5. I have decided to introduce, at the earliest practicable date, April 1990, a completely new system of independent taxation.

F6. Under this new system, a husband and wife will be taxed independently, on income of all kinds. All taxpayers, male or female, married or single, will be

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entitled to the same personal allowance, which will be available against all income, whether from earnings, pensions or savings.

F7. In addition, there will be a married couple's allowance, equal to the difference under the present system between the married man's allowance and the single allowance. This new allowance will go in the first instance to the husband, so that his tax threshold does not fall. But if he does not have enough income to use it in full, he will be able to transfer any unused portion to his wife, to set against her income.

F8. This ensures that the tax system will continue to recognise marriage, as it should do. At the same time, from 1990 married women will pay their own tax, on the basis of their own income, and have their own tax return, when one is necessary. There will, of course, be nothing to stop married women from asking their husbands to handle their tax affairs, or vice versa, as before; and many will no doubt do so. But what matters is that, for the first time ever, married women will have the right to complete independence and privacy so far as tax is concerned.

F9. In the same way, a husband and wife will be taxed independently on any capital gains they may have, with an annual exemption each, instead of one between them, as

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now. But transfers of capital between husband and wife will continue to be entirely free of any liability to tax.

F10. As I have said, the new system will come into force in 1990. This is much sooner than would have been possible for most of the alternatives that have been canvassed. The necessary legislation will be contained in this year's Finance Bill. The cost of this historic reform, which for the first time ever gives a fair deal to married women, will be £550 million in 1990-91.

F11. I mentioned a few moments ago the tax penalties on marriage. It is clearly wrong that some couples should find themselves paying more tax, simply because they are married. I propose to put that right.

F12. Independent taxation by itself will remove the most common penalty - the taxation of a married woman's income at her husband's marginal rate. But there are other tax penalties on marriage, and I propose to abolish all of them. These changes need not await the introduction of Independent Taxation.

F13. Under the present system an unmarried couple can get twice as much mortgage interest relief as a married couple. This has attracted increasing - and justified - criticism. I propose to put a stop to it as from August

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this year. Thereafter, the £30,000 limit on mortgage interest relief will be related to the house or flat, irrespective of the number of borrowers. This was the solution put forward in the 1986 Green Paper on Personal Taxation, and it was widely welcomed. Existing mortgages will be unaffected.

F14. Another anomaly is that an unmarried couple with children can each claim the Additional Personal Allowance intended for single parents, and thus get more tax relief than a married couple in the same position. I propose to confine them to a single Additional Personal Allowance, with effect from April 1989.

F15. Thus this Budget will not only, for the first time ever, give married women a fair deal from the tax system. It will also eliminate, for all practical purposes, all the other tax penalties which, under the present system, can arise on marriage.

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BUDGET**G. BUSINESS TAXATION**

G1. I turn now to business taxation.

G2. The major reform of business taxation, which I introduced in 1984, and which was completed in 1986, has given us one of the lowest Corporation Tax rates in the world. This has encouraged overseas companies to invest in Britain and, most important of all, has greatly improved the quality of investment by British firms. It is a crucial part of an environment in which company profitability has recovered to its highest level for some twenty years. It has succeeded in its objectives.

G3. I do not therefore propose any further changes to the structure of Corporation Tax. And the main Corporation Tax rate for 1988-89 will be unchanged at 35 per cent.

G4. But I do have some changes to propose to specific aspects of business taxation.

G5. British exporters have done extremely well in recent years, thanks to major improvements in efficiency and quality. But no exporter could honestly claim that his success hinges on the fact that the cost of entertaining

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overseas customers is tax deductible, whereas business entertainment generally is not. I therefore propose to simplify the system by making all business entertainment non-deductible for tax purposes, including for VAT.

G6. In conjunction with my rt. hon. Friend the Secretary of State for Energy, I propose to restructure the tax regime for the new generation of Southern basin and onshore fields, so as to relate tax liability more closely to profitability. Accordingly, my rt hon Friend will shortly be bringing forward legislation to abolish royalties, from 1 July, for all such fields. At the same time, I propose to reduce the Petroleum Revenue Tax oil allowance for these fields. This will mean the end of royalties for all future fields.

G7. The 1986 Building Societies Act gives Building Societies the power to convert themselves into companies, if they so wish. At present, however, they would face a heavy, and unintended, tax charge if they did so. I propose to rectify this.

G8. I have two changes to propose to the tax arrangements for Lloyd's. The first meets the only point Lloyd's have raised on last year's legislation on reinsurance to close. The second will benefit both Lloyd's and the Inland Revenue by simplifying the administrative arrangements for taxing Lloyd's members.

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G9. I also propose to simplify the Section 482 rules for companies who wish to migrate overseas, so as to bring them broadly into line with most of our major competitors. In future, companies will be resident in the UK if they are incorporated here. Subject to that, instead of having to ask for Treasury consent, companies will be free to migrate, provided only that they pay their tax first.

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G10. I now turn to a number of proposals to give further help to small businesses and new businesses, whose encouragement is a central theme of Government policy. The rate of new business formation, net of failures, has averaged 500 a week since 1979. This shows beyond any doubt the continuing vigour of this sector, which is such an important source of enterprise, innovation, and new jobs.

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G11. Many new businesses have been greatly assisted by the Business Expansion Scheme, which has now been running for nearly five years. During that time it has enabled new and expanding companies to raise equity finance amounting to some £150 million a year.

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G12. However, the rapid growth of the venture capital market since 1983 has meant that companies seeking relatively large amounts of equity investment can now

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raise these readily, while smaller companies looking for more modest amounts can still find it difficult to do so.

G13. To improve the targeting of the BES, I therefore propose to introduce a limit of half a million pounds on the amount any company can raise under the scheme in any one year. Investment should thus be better directed at the smaller and newer businesses, particularly those outside the South-East of England, which can still find it hard to raise equity finance in other ways. In the special circumstances of the ship chartering industry, however, the limit will be £5 million.

G14. I have one further proposal affecting the Business Expansion Scheme.

G15. One of the key reasons for our economic transformation has been the reform of the supply side of the economy.

G16. The tax relief I introduced last year for profit-related pay will, in time, help to increase pay flexibility and improve the working of the labour market. But if successful firms are to expand further, and create still more jobs, we also have to make it easier for people to move to where the new jobs are.

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G17. For years, the shortage of private rented accommodation has been an obstacle to labour mobility. The Government's proposals to deregulate new rents are already going through the House. Deregulation will, over time, substantially increase the supply of housing for rent. But this will not happen overnight, and there is a case for a special incentive to speed up the process in the early years.

G18. I therefore propose to extend the Business Expansion Scheme to include companies specialising in the letting of residential property on the new assured tenancy basis.

G19. The BES is well suited to this task. Since full tax relief is given immediately, it should bring forward new investment straight away. And we will be building on success.

G20. The limit for this type of investment will be £5 million a year for any one company. *[But since the relief is specifically designed to provide an extra stimulus in the early years of deregulation, it will run only for investments made before the end of 1993.]*

G21. This change will powerfully reinforce the impact of decontrol in reviving the private rented sector of housing in Britain.

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G22. In last year's Budget I raised the ceiling for capital gains tax retirement relief from £100,000 of gain to £125,000. But I believe it is necessary to do more to help the small businessman whose wealth is tied up in his business and who is faced with the disincentive of a heavy capital gains tax bill when he sells up on retirement. I therefore propose to extend capital gains tax retirement relief so that, on top of the exemption, half of any gain between £125,000 and £500,000 will also be completely free of tax.

G22A. While on the subject of capital gains tax, I propose to extend rollover relief to a group of assets whose common characteristic is that they did not exist when the present list of qualifying assets was drawn up. They are milk quotas, potato quotas, satellites and spacecraft. I know that this will be warmly welcomed in the farming and extra-terrestrial communities alike.

G23. Lastly, on the small business front, I propose to increase the VAT threshold to £22,100, the maximum permitted under existing European Community Law.

G24. Throughout my time as Chancellor, I have been on the look-out for taxes to abolish. Abolition is clearly the simplest variety of reform. I have already abolished the National Insurance surcharge, the Investment Income

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surcharge, Development Land Tax, and the tax on lifetime gifts.

G25. At present, companies have to pay a Capital Duty of 1 per cent whenever they raise new capital - whenever, for example, a new company is formed or an existing company sells new shares to the public. This is undesirable on two counts. It is a burden on companies who need to secure external finance for expansion. And it discriminates against equity capital as compared with debt finance and bank borrowing.

G26. Capital Duty is a relatively recent impost which had to be introduced in 1973 in compliance with our obligations under European Community Law. But the relevant Community Directive has now been amended. Accordingly, I propose to abolish Capital Duty with effect from midnight tonight.

G27. At the same time, I propose to get rid of the Unit Trust Instrument Duty, a similar though much less substantial tax, which is levied at the rate of $\frac{1}{4}$ per cent on all property put into a unit trust. I know the unit trust movement will welcome this minor relief, and I trust the benefit will be fully passed on to investors.

Does this mean "property" as you understand it (if so OK) or is it Revenue good ledger?

G28. The cost of abolishing these two taxes will be of the order of £100 million in 1988-89. Not counting minor

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imposts, the demise of Capital Duty brings the number of taxes I have abolished up to five: an average of one a Budget.

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BUDGET**H. COVENANTS AND MAINTENANCE**

H1. I now turn to an important area of personal taxation which is ripe for reform and simplification: the taxation of payments made under deeds of covenant and maintenance arrangements.

H2. Covenants to charity will be wholly unaffected by the changes I am about to propose.

H3. Other covenants, and maintenance arrangements, are essentially ways of transferring income from one individual to another, usually from one member of a family to another, whether it is a parent or grandparent covenanting to a child, or a husband paying maintenance to an ex-wife. Most financial transfers that take place within families are rightly and properly outside the scope of the tax system altogether. I propose, as far as is practicable, to take covenants and maintenance out as well. This will greatly simplify an unnecessarily complex part of the tax system.

H4. First, covenants. Charitable covenants apart, I propose to take all new covenants made by individuals on or after today out of the tax system altogether. In other words, people receiving payments under covenants will not be liable to tax on them, and those making the

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payments will not be able to claim tax relief on them.

The tax treatment of existing covenants will continue unchanged.

H5. The largest single group of people affected by this change will be students, together with their parents, many of whom nowadays choose to make their contribution to the student maintenance grant by covenant. This has arisen as an unintended by-product of the reduction in 1970 of the legal age of majority from 21 to 18.

*"~~What~~
tax relief
on them?"*

H6. As I have already indicated, those who have already made such covenants will continue to benefit from them. For new students, the parental contribution to the maintenance grant will be assessed on a new and more generous scale, to reflect the withdrawal of tax relief on new covenants. My rt hon Friend the Secretary of State for Education and Science will be publishing the new scale tomorrow.

H7. One desirable side-effect of this reform is that future students will no longer be deterred from taking vacation jobs because their covenant income has already absorbed their personal allowance.

H8. Student covenants apart, there will be no compensation for the loss of tax advantage arising from these proposals. But once rates of income tax are set at

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reasonable levels, this is precisely the sort of tax shelter it is right to dispense with.

H9. Next, maintenance. Here, too, we tax the recipient, only to give tax relief to the payer. The present rules can be complex and confusing for people going through separation and divorce. The tax system ought to intrude as little as possible, though it is reasonable that there should be some recognition of the fact that an ex-husband is continuing to support his ex-wife, or vice versa.

H10. Accordingly, I propose that, for new maintenance arrangements, recipients will not be liable to any tax whatever on maintenance payments. Relief to the payer will be restricted to payments to a separated or divorced spouse, up to a limit equal to the difference between the married and single allowances.

H11. For existing maintenance arrangements, the present rules will continue to apply in 1988-89, except that a separated or divorced spouse will be exempt from tax on receipts up to the difference between the married and single allowances. Full relief will continue for all those who are making payments under existing Court Orders or agreements. The same protection will also apply to those who have already applied for Court Orders, provided these are made by 30 June. From April 1989 there will be special transitional rules to continue protection for existing arrangements.

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H12. While the transitional provisions are inevitably somewhat complex, the new system will be very much simpler than the old, for all concerned. It will reduce the tax relief that can be obtained by the better-off payers of large amounts of maintenance, but for most couples the ex-husband will continue to enjoy full tax relief while the ex-wife will not be taxed.

H13. The reform of the tax treatment of maintenance I am proposing today will also remove one of the lesser known tax penalties on marriage. At present, an unmarried couple can make large payments either between themselves or to their young children, and get tax relief that would not have been available had they been married. My proposed reform will put an end to that.

H14. As I have said, this reform and simplification of the taxation of covenants and maintenance in no way affects covenants to charity. Indeed, I have a proposal to help charities further.

H15. The payroll giving scheme has now been running for nearly a year. I am glad that so many employers have already set up schemes, and I hope as many employees as possible will take advantage of them. In order to give further encouragement to charitable giving, and to assist the growth of the payroll giving scheme, I propose to double the annual limit on tax-allowable donations under the scheme to £240, or £20 a month.

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J. TAXES ON SPENDING

J1. I now turn to the taxation of spending.

J2. I have no major change to propose to the coverage of Value Added Tax, which will remain at 15 per cent.

J3. I propose to raise the excise duties as a whole broadly in line with inflation, but to make some modest adjustments within the total. The duty on cigarettes and hand-rolling tobacco will be increased, by the equivalent, including VAT, of between threepence and fourpence for a packet of 20 cigarettes. This will take effect from midnight on Thursday. The duty on a packet of five small cigars will rise by twopence, but that on pipe tobacco will remain unchanged.

J4. As to the alcohol duties, I propose increases which, including VAT, will put about a penny on the price of a pint of average-strength beer and cider, fourpence on a bottle of table wine, and sixpence on a bottle of sparkling or fortified wine. There will once again be no increase in the duty on spirits. These changes will take effect from 6 o'clock tonight.

J5. The existing duty structure is inhibiting sales of drinks known as 'coolers' which are mixtures of an alcoholic drink and a soft drink. I propose to introduce

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new lower rates of duty for these products, so as to encourage the young in particular to change to drinks with a lower alcohol content. For the same reason, I propose from 1 October to abolish the minimum duty charge on beer, which will encourage the promotion of low-alcohol beers.

just under?

J6. I propose once again to leave the main rates of Vehicle Excise Duty unchanged. To recover the revenue forgone, I propose increases in petrol and derv duty over and above the rate of inflation, which, including VAT, will raise the price of petrol by between fivepence and sixpence a gallon, and that of derv by less than fivepence a gallon. These changes will take effect from 6 o'clock tonight.

J7. In my Budget last year, I sought to promote the use of lead-free petrol, with all the environmental benefits it brings, by introducing a duty differential in its favour. As a result, the number of garages selling lead-free petrol has more than trebled. But consumption remains disappointingly low.

J8. Accordingly, I propose to double the duty differential in its favour by exempting it altogether from the duty increase I have just announced for leaded petrol. This means that, despite the higher production costs, the pump price of unleaded petrol should in future

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be below that of ordinary 2-star petrol. I very much hope the petrol companies will now reinforce this concession by vigorously promoting the use of lead-free petrol.

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K. TAXES ON CAPITAL

K1. I now turn to taxes on capital.

K2. The emergence of the capital-owning democracy has been one of the most remarkable features of the 1980s.

Encouraged by Government policy, more than $2\frac{1}{2}$ million families have bought their homes, bringing the total to nearly two households in three. And our proposals for personal pensions, which come in to effect in July, will give a new dimension to pension ownership.

K3. But the most dramatic change has been in share ownership. In last year's Budget, I announced the results of a joint Treasury/Stock Exchange survey of the number of shareholders in this country. This revealed that some $8\frac{1}{2}$ million people - one adult in five - owned shares, about three times the number in 1979.

K4. A similar survey has been carried out this year. Despite all the stories of people taking quick profits on privatisation shares, and despite the stock market collapse, the results show that the number of individual shareholders has if anything risen further over the past 12 months, to very nearly 9 million. This illustrates in a quite remarkable fashion how wider share ownership is now taking root.

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K5. I have two proposals to encourage share ownership still further to announce today.

K6. First, Personal Equity Plans are off to a successful start. Over a quarter of a million people took out PEPs in 1987, and subscribed nearly £ $\frac{1}{2}$ billion between them.

To give further encouragement to this form of investment, I propose to increase the annual limit from £2,400 to £3,000. The new higher limit will apply to all plans taken out this year.

K7. Second, measures to encourage employee share ownership have featured in seven out of the last eight Budgets. As a result, the number of approved all-employee share schemes has risen from 30 in 1979 to over 1400 today, involving well over 10,000 companies, and providing shares and options for well over 1 $\frac{1}{2}$ million employees.

K8. Following extensive consultation, including the publication of draft clauses, I propose to relax the provisions of Section 79 of the 1972 Finance Act. This will make it easier for companies to provide shares to their employees outside the approved schemes without giving rise to an undue charge to tax. This will be of particular benefit to subsidiary companies and their employees.

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K9. In previous Budgets I have already substantially reformed the taxation of capital, with the replacement of Capital Transfer Tax by Inheritance Tax. But I believe this process can and should be taken further. Last year, I reduced the number of inheritance tax rates from seven to four. This year, I propose to simplify the tax still further by levying it at a flat rate of 40 per cent.

K10. At the same time I propose to raise the threshold from £90,000 to £110,000.

K11. The increase in the threshold will reduce the number of estates liable to tax by a quarter, allowing many more people to inherit the family home free of tax. And the flat rate of 40 per cent means that for the family business, enjoying 50 per cent business relief, the effective rate of tax can never exceed 20 per cent, one of the lowest inheritance tax rates in the industrialised world.

K12. The cost of these changes will be £100 million in 1988-89.

K13. Lastly, Capital Gains Tax. Strictly speaking, this should not be a tax on the original capital at all. Nor is it, so far as gains which have arisen since 1982 are concerned, thanks to the indexation provisions introduced by my predecessor in 1982, and extended in my 1985 Budget.

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K14. But for gains that arose before 1982, the tax falls largely on purely paper profits resulting from the rampant inflation of the 'seventies. In other words, it bites deeply, and capriciously, into the capital itself.

K15. This has long been recognised as manifestly unjust. Indeed, from the time I first entered this House I have argued that Capital Gains Tax should fall only on real gains, and not on paper gains. I have therefore looked hard to see if the indexation provisions could be applied right back to the inception of the tax in 1965. Unfortunately, they cannot. The necessary information is in many cases no longer available.

K16. Accordingly, I have decided to bring the base date for the tax forward from 1965 to 1982. That is to say, for all disposals on or after 6 April, that part of any capital gain which arose before April 1982 will be exempt from tax altogether, for individuals and companies alike.

K17. This Budget thus ends once and for all the injustice of taxing purely inflationary gains. This will benefit the economy by unlocking assets which have been virtually sterilised because of the penal tax that would have arisen on any sale. And it will help many small businessmen and farmers in particular.

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K18. At present, the first £6,600 a year of capital gain is tax free. The relatively high level of this threshold stems from the substantial increase my predecessor made in 1982, explicitly as rough and ready partial compensation for the continued taxation of pre-1982 paper gains. Now that I have taken pre-1982 gains out of tax altogether, I propose to reduce the capital gains tax threshold to £5,000. It should also be borne in mind that, with the introduction of independent taxation in 1990, a husband and wife will each have their own threshold for capital gains tax as well as for income tax.

K19. Rebasing the tax so as to produce a fully indexed system makes it possible to bring the taxation of gains closer to that of income. In principle, there is little economic difference between income and capital gains, and many people effectively have the option of choosing to a significant extent which to receive. And, insofar as there is a difference, it is by no means clear why one should be taxed more heavily than the other. Taxing them at different rates distorts investment decisions and inevitably creates a major tax avoidance industry.

K20. Moreover, at present, with capital gains taxed at 30 per cent for everybody, higher rate taxpayers face a lower - sometimes much lower - rate of tax on gains than on investment income, while basic rate taxpayers face a

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higher rate of tax on gains than on income. This contrast is hard to justify.

K21. I therefore propose a fundamental reform. Subject to the new base date, capital gains will continue to be worked out as now, with the present exemptions and reliefs. In particular, the principal private residence will remain tax-free. But the indexed gain will be taxed at the income tax rate that would apply if it were the taxpayer's marginal slice of income. In other words, I propose in future to apply the same rate of tax to income and capital gains alike.

K22. These changes will not take effect until 6 April.

K23. Taxing capital gains at income tax rates makes for greater neutrality in the tax system. It is what we now do for companies. And it is also the practice in the United States, with the big difference that there they have neither indexation relief nor a separate capital gains tax threshold.

K24. The changes I have announced represent a thoroughgoing reform of capital gains tax which will benefit the economy and eradicate a major injustice. They will sharply reduce the damaging effects of the tax, while ensuring that capital gains remain properly taxed and the yield of income tax adequately protected.

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K25. They are expected to cost £210 million in 1989-90.

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L. INCOME TAX

L1. Finally, I turn to income tax.

L2. The way to a strong economy is to boost incentives and enterprise. And, that means, among other things, keeping income tax as low as possible.

L3. Income tax has now been reduced in each of the last six Budgets - the first time this has ever occurred. And the strength of the economy over that period speaks for itself.

L4. However, reforming Income Tax is not simply a matter of cutting the rates. I also have to look at all the various allowances and reliefs to ensure that they are still justified.

L5. With this in mind, I have a number of proposals to announce.

L6. First, forestry. I accept that the tax system should recognise the special characteristics of forestry, where it can take anything up to a hundred years between the costs of planting and the income from selling the felled timber.

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L7. But the present system cannot be justified. It enables top rate taxpayers in particular to shelter other income from tax, by setting it against expenditure on forestry, while the proceeds from any eventual sale are effectively tax free.

L8. The time has come to bring it to an end. I propose to do so by the simple expedient of taking commercial woodlands out of the income tax system altogether. That is to say, as from today, and subject to transitional provisions, expenditure on commercial woodlands will no longer be allowed as a deduction for income tax and corporation tax. But, equally, receipts from the sale of trees or felled timber will no longer be liable to tax.

L9. It is, perhaps, a measure of the absurdity of the present system that the exemption of commercial woodlands from tax will, in time, actually increase tax revenues by over £10 million a year.

L10. At the same time, in order to further the Government's objectives for the rural areas, I have agreed with my rt hon. Friends who have responsibilities for forestry and the environment that, in parallel, there should be increases in planting grants. Full details of the new grant scheme will be announced next week.

L11. The net effect of these changes will be to end an unacceptable form of tax shelter; to simplify the tax

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system, abolishing the archaic Schedule B in its entirety; and to enable the Government to secure its forestry objectives with proper regard for the environment, including a better balance between broad-leaved trees and conifers.

L12. One of the legacies of the years of penal top tax rates is the complicated special relief for large redundancy payments. This is no longer justified. I propose to increase the exemption limit for these payments from £25,000 to £30,000, and to abolish the additional relief for larger amounts.

L13. Next, benefits in kind - perhaps better known as perks. One of the biggest tax-induced distortions in the economy today is the growing tendency to provide remuneration in kind rather than in cash. It must be right to move towards a system of lower taxes all round and fewer tax breaks of this kind.

L14. Far and away the most widespread benefit in kind is the company car, which is substantially undertaxed. Independent studies, based on figures supplied by the AA, suggest that an employee with a typical company car may be taxed on only about a quarter of its true value.

L15. This discrepancy is too great to be allowed to continue. On the other hand, the scale of the undertaxation is so great that it cannot be put right in

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a single year. But in a Budget when I am able to reduce tax rates, there is a strong case for a substantial increase in the taxation of these benefits. I therefore propose to double the car scales for 1988-89. This increase replaces the 10 per cent increase which I had already announced for 1988-89. The yield will be £260 million in 1988-89.

L16. The scales for the taxation of car fuel adequately reflect the value of the benefit, and I propose to leave them unchanged for 1988-89.

L17. However, the taxation of the benefit of free car parking threatens to become an administrative nightmare. I propose to exempt this particular benefit from tax altogether.

L18. Next, mortgage interest relief. This Government is committed to the further spread of home ownership. Mortgage interest relief has an important role to play in achieving that aim.

L19. However, in addition to the decision to apply the £30,000 limit to the house or flat, which I have already announced, and which will remove the most widely-resented tax penalty on marriage, I have a further reform to propose in this area.

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L20. This concerns the parallel tax relief for home improvement loans. Most of these loans are for fittings such as double glazing, and have played a significant part in the recent growth of consumer credit without in any way contributing to the expansion of home ownership. This may be partly due to the substantial scope for abuse, as loans ostensibly taken out for home improvements are used for other purposes, a matter which was the subject of a recent report from the Public Accounts Committee.

L21. I propose, therefore, to end tax relief for all new home improvement loans taken out after 5 April. Existing home improvement loans will be unaffected. This is expected to yield £80 million in 1988-89.

L22. Finally, I turn to income tax itself.

L23. The statutory indexation formula means that I should increase all the principal income tax allowances and bands by the increase in the RPI over the year to last December, or 3.7 per cent, rounded up. I propose to do more than that; indeed twice as much.

L24. Thus the single allowance will go up not by £90, as required by indexation, but by £180, to £2605; and the married allowance will go up not by £150 but by £300, to £4095. The additional personal allowance and widow's bereavement allowance will thus rise by £120 to £1490.

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Similarly the single age allowance will rise by £220 to £3180 and the married age allowance by £360 to £5035. The higher allowances for taxpayers aged 80 and over, which I introduced in the last Budget, will correspondingly be increased by £240 and £360 to £3310 and £5205 respectively, and the new age allowance income limit will be £10,600. The upper limit of taxable income for the basic rate band will be increased to £19,300.

L25. The increases I have just announced mean that the basic tax thresholds will be fully 25 per cent higher, in real terms, than they were in 1978-79, Labour's last year. Indeed, the married man's tax threshold will be at its highest level in real terms for nearly half a century.

L26. Given these substantial increases in the main allowances, I am taking the opportunity to simplify the system by abolishing three minor personal allowances which have been unchanged, in cash terms, for over twenty years: the housekeeper allowance, the dependent relative allowance, and the son's or daughter's services allowance.

L27. In our general election manifesto last year, we committed ourselves to reducing the basic rate of income tax to 25 pence in the £ as soon as it was prudent to do so. This pledge followed a reduction of twopence in the £ to 27 pence in last year's Budget.

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L28. At the time, this was regarded with some scepticism, not to say cynicism, by the Opposition, who no doubt recalled that Labour Governments used to reduce tax only in front of an election, and at all other times increased it. Indeed, shortly before last year's Budget the rt hon Gentleman the deputy leader of the Labour Party said this:

"I must advise the Chancellor of something that he already knows: whichever party wins the general election, the tax cuts he makes in this Budget will be reversed."

L29. The time has come to put the rt hon Gentleman out of his misery. So far from reversing the 1987 Budget tax reductions, I propose to take this, the first opportunity since the general election, to fulfil our manifesto pledge. The basic rate of income tax for 1988-89 will be 25 pence in the pound.

L30. The small companies' rate of corporation tax will similarly be reduced to 25 per cent. This means that the basic rate of income tax, and the corporation tax rate for small companies, will both be at their lowest level since the War.

L31. Life Assurance premium relief remains in place for policies taken out before the 1984 Budget. It has traditionally been given at half the basic rate of income tax. I therefore propose to reduce it from 15 per cent

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to 12½ per cent. But, to give life offices time to adjust, this change will not take effect until 6 April 1989.

L32. I also propose to reduce the additional rate which applies to the income of discretionary trusts and for certain other purposes from 18 per cent to 10 per cent.

L33. It is now nine years since my predecessor, in his first Budget in 1979, reduced the top rate of tax from the absurd 83 per cent that prevailed under Labour to 60 per cent, where it has remained ever since.

L34. At that time, this was broadly in line with the European average for the top rate of tax. It is now one of the highest. And not only do the majority of European countries now have a top rate of tax below 60 per cent, but in the English-speaking countries outside Europe - not only the United States and Canada, but Labour Australia and New Zealand, too - the top rate is now below 50 per cent, sometimes well below.

L35. The reason for the worldwide trend towards lower top rates of tax is clear. Excessive rates of income tax destroy enterprise, encourage avoidance, and drive talent to more hospitable shores overseas. As a result, so far from raising additional revenue, over time they actually raise less.

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L36. By contrast, a reduction in the top rates of income tax can, over time, result in a higher, not a lower, yield to the Exchequer. Despite the substantial reduction in the top rate of tax in 1979, and the subsequent abolition of the investment income surcharge in 1984, the top five per cent of taxpayers today contribute a third as much again in real terms as they did in 1978-79, Labour's last year; while the remaining 95 per cent of taxpayers pay slightly less in real terms.

L37. After nine years at 60 per cent I believe the time has come to make a further reduction in the top rate of income tax. At present there are no fewer than five higher rates of income tax: 40 per cent, 45 per cent, 50 per cent, 55 per cent, and 60 per cent. I propose to abolish all the higher rates of tax above 40 per cent.

L38. This major reform will leave us with one of the simplest systems of income tax in the world, consisting of a basic rate of 25 per cent and a single higher rate of 40 per cent. And, indeed, a system of personal taxation in which there is no rate anywhere in excess of 40 per cent.

L39. I believe that 40 per cent is an acceptable top rate of tax. But, bearing in mind that the basic rate of income tax is also the starting rate, 25 per cent is still too high.

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L40. Since we first took office in 1979, we have reduced the basic rate of income tax from 33 per cent - one third - to 25 per cent - a quarter. Our aim should now be to get it down to a fifth - a rate of 20 pence in the pound - as soon as we prudently and sensibly can.

L41. Meanwhile, I have today been able to reduce income tax at all levels, with increases in both the personal allowances and the basic rate limit, and reductions in both the basic and higher rates. The tax reduction for a married man on average earnings will be worth nearly £5 a week. The changes will take effect under PAYE on the first pay day after 14 June. They will cost £4 $\frac{1}{4}$ billion in 1988-89 over and above statutory indexation, of which three quarters represents the cost of increasing tax thresholds and reducing the basic rate.

L42. The total cost of all the measures in this year's Budget, again on an indexed basis, is a shade under £4 billion.

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M. PERORATION

M1. Mr Deputy Speaker, in this Budget, I have reaffirmed the prudent policies which have brought us unprecedented economic strength. I have announced a radical reform of the taxation of marriage, which for the first time ever will give married women a fair deal from the tax system. I have eliminated the long-standing injustice of taxing inflationary gains, and abolished a fifth tax. I have radically reformed the structure of personal taxation, so that there is no rate anywhere in the system in excess of 40 per cent.

M2. After an Autumn Statement which substantially increased public spending in priority areas, I have once again cut the basic rate of income tax, fulfilling our manifesto pledge of a basic rate of 25 pence in the £ and setting a new target of 20 pence in the £.

M3. And I have balanced the Budget.

M4. I commend this Budget to the House.

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