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PART A

1989 BUDGET
CONSULTATIONS

2-3-89
13-3-89

6-2-89

Budget
consultations.

3

470

psp.bh/2.3cap2

BUDGET CONFIDENTIAL

FROM: D W RAYSON
DATE: 2 MARCH 1989

1. MR HARRIS
2. SIR P MIDDLETON
3. CHANCELLOR

Leonard Harris 2.3.89

cc: Treasury

Chief Secretary
Financial Secretary
Paymaster General
Sir T Burns
Mr Anson
Dame Anne Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Mr Luce
Mr Riley
Mr P Sedgwick
Mr Dixon
Mr Gilhooly
Mr Macpherson
Miss J C Simpson
Mrs Chaplin
Mr Tyrie
Mr Call
Mr Sheridan

Inland Revenue

Sir A Battishill
Mr Beighton
Mr Isaac
Mr Painter
Mr G Bush
Mr Corlett
Mr Kuczys
Mr Hinton

Customs and Excise

Mr Jefferson Smith

Thanks. The Finance Bill will need explicitly (either) to include provision for the cap or to include a regulation-making power, wh. can then be used for this purpose. I shd be grateful for advice on these two options in due course.

PENSIONS CAP: MPs AND OFFICE HOLDERS

1. I should have covered the position of MPs, the Speaker, the Lord Chancellor and the Prime Minister in my note of 28 February. I am sorry for the omission.

2. For MPs, there is power (following the Parliamentary Pensions Act 1987) to make regulations before the "appointed" day. None would currently be caught by the cap, but might be in future.

38-2-3

3. The pensions of the Office holders, (who are not part of the Parliamentary scheme) are governed by the Parliamentary Pensions Act 1972. There is no power to make regulations. Following the TSRB Report in 1988, it has been agreed that there should be primary legislation to amend the Act. A legislative spot has been agreed for 1989/90 but, if Parliamentary time permits, the Lord President would like to take it this session. The Bill could include provision for the cap.

D W Rayson

D W RAYSON
Superannuation Division

PM/89/005

THE PRIME MINISTER

Future of Hong Kong and Shanghai Banking Corporation

1. I am writing to seek your agreement and that of colleagues that I should authorise the Governor of Hong Kong to initiate discussions with the Hong Kong and Shanghai Banking Corporation (HSBC) about the Bank's future.

2. You will recall the detailed discussions that took place in November 1986 about the proposed merger between the HSBC and the Midland Bank. We decided that in view of the political impact that such a merger would have in Hong Kong and the penalties for Hong Kong of raising the issue with the Chinese at this stage, the proposal could not be allowed to go ahead. But we also recognised that the problem would not disappear and that the Government would be faced in due course with an attempt by the HSBC to secure its future. The considerations behind our decision were set out in Charles Powell's letter of 26 November, 1986.

/3.

3. In November 1987 we decided that we should raise no objections to an agreement between the HSBC and the Midland Bank whereby the HSBC acquired a 14.9% shareholding in the Midland Bank. That arrangement, which was described in detail in Tony Galsworthy's letter of 12 November 1987 to Charles Powell, fell within the limits of what we had previously told the Chairman of the HSBC would be acceptable to us in political terms, and which made very good sense in commercial and banking terms. Part of the agreement between the two banks was that the HSBC would not increase its stake for 3 years (ie until the end of 1990).

4. In the meantime, as we agreed in November 1986, we have authorised the Hong Kong Government to embark on a confidential dialogue with the Chinese Government about the banking and financial system of Hong Kong. Three rounds of detailed talks have been held, and we have passed to the Chinese side a series of papers on various aspects of Hong Kong's banking and finance system, including the role of the HSBC. This dialogue has gone well and the Chinese authorities have indicated that they value it. We believe that we are making good progress in this educative process; but it is clear from comments made by the Chinese to us during those meetings, and from the nervous Chinese reaction to the news of the acquisition by HSBC of a stake in Midland Bank, that they remain very sensitive indeed about the position of the HSBC in Hong Kong and would be resistant to any change in the <u>status quo</u>.

/5.

5. As we expected in 1986, however, the problem of the HSBC's future has not gone away. The management of the Bank are becoming increasingly concerned about the implications of its present position. The Chairman, Mr Purves, has recently spoken forcefully about the subject to Simon Glenarthur. In essence, the Bank's problem is that the approach of 1997 makes it increasingly vulnerable to adverse political and economic developments in Hong Kong and that it is therefore difficult for the Bank to develop a long term strategy. The Bank claims that the international financial community is becoming increasingly aware of the HSBC's potential vulnerability; and that it is already experiencing difficulty in obtaining a proper credit rating to facilitate its long term borrowings in the international market.

6. The advice of the Governor of Hong Kong is that these problems are genuine and must be taken seriously. He has also pointed out that the HSBC is about five times the size of the Exchange Fund, which is disproportionately large compared with the resources available to the Hong Kong Government (or the future Hong Kong Special Administrative Regional Government) to support the Bank if it ran into difficulties. The continuing expansion of the HSBC's business overseas will exacerbate the problem by increasing the contingent liability on the Hong Kong Government as the supervisory authority and lender of last resort.

/7.

7. The Governor believes that the time has now come to begin to tackle these problems. I fully share this view. The three year freeze on the further development of the HSBC's relationship with the Midland provides both a breathing space in which to begin working towards a solution and in effect a deadline by which such a solution must be found. Mr Purves' discussion with Simon Glenarthur is a clear signal to which I am sure we must respond. If we do not, there is a real risk that we would find ourselves forced to react to a unilateral move by the Bank in or before 1990; or alternatively that there could be a highly damaging crisis of confidence in the Bank as 1997 approaches.

8. The Governor envisages establishing a very restricted working group which would hold a series of discussions with the Bank in Hong Kong in strict secrecy. There would have to be a clear understanding that the assurances that Mr Purves has already given about no unilateral action without prior approval would be strictly adhered to; that in any solution the headquarters of the HSBC must remain in Hong Kong; and that the solution should not require an amendment to the existing HSBC Ordinance (such a change would have to be enacted by the Legislative Council, which would put the issue in the political arena in a very unhelpful way). The first aim of the dialogue would be to establish the Bank's current thinking about the future and to make

/clear

clear how we see the political dimension to the problem. In subsequent meetings the Governor would seek to establish possible strategies and a preferred option. It would be prudent to put down a marker at an early stage that any greater participation by HSBC in Midland or any other UK based bank, or any establishment of a holding company in London, will raise supervisory questions for the Bank of England which will require careful consideration.

9. It will be necessary at a later stage to tackle the problem with the Chinese. This will be a long and difficult task. But it would be premature to begin that process until we have a much clearer idea of what our preferred solution would be. In the view of the Governor, such a solution would almost certainly have to involve the HSBC becoming either a branch or a subsidiary of an entity based in London or one of the other main financial centres. But it would have to be clear that the HSBC itself, plus its Hong Kong assets and operations, would remain with their headquarters in Hong Kong.

10. I am keen that the Governor should initiate the dialogue with the HSBC as soon as possible. Mr Purves will be coming to London on 7 February and it would be desirable if the Governor could speak to him in Hong Kong before he leaves. I propose to instruct him to do so along the lines of the attached telegram.

/11.

SECRET (ORIEL)

11. I am copying this minute to the Chancellor of the Exchequer, the Governor of the Bank of England and to Sir Robin Butler.

(GEOFFREY HOWE)

Foreign and Commonwealth Office
3 February 1989

OUT TELEGRAM

Classification	Caveat	Precedence
SECRET	ORIEL / DEYOU	IMMEDIATE

ZCZC ZCZC
TC SECRET
CAVEAT ORIEL / DEYOU
FM FM FCO
TO TO IMMEDIATE HONG KONG
TELNO TELNO
OF OF 011015Z FEBRUARY 89
AND TO

INFO PRIORITY PEKING

FOLLOWING STRICTLY PERSONAL FOR GOVERNOR FROM PAUL, HKD

PEKING: STRICTLY PERSONAL FOR AMBASSADOR/MISS BAILES:

YOUR TELNOS 6 AND 7 AND PEKING TELNO 16: FUTURE OF THE HONG KONG AND SHANGHAI BANK

1. Ministers have considered the advice in your telegrams and your recommendation that the time has come to enter into detailed discussions with the Bank about its future.

2. Ministers accept that it would now be right ~~there is now no alternative~~ to open~~ing~~ up a dialogue with the Bank with a view to identifying possible solutions to the Bank's future. They agree that these discussions should take place in Hong Kong in the very restricted and secret format which you envisage. The aim of these discussions should be to establish the Bank's current thinking, while leaving them in no doubt about the importance we attach to the political dimension, both in terms of Hong Kong and China. They agree that the talks should begin on the basis of a clear

YYYY	Catchword: ARYAIG

File number	Dept	Drafted by (Block capitals)	Telephone no
MAIN	HKD	A R PAUL	270 2647

ADDITIONAL

NNNN

Authorised for despatch by:	Initials	Date/time

For COD use only	Comcen reference	Telegram number	Processed by

OUT TELEGRAM (CONT)

Classification	Caveat	Precedence
SECRET	ORIEL	IMMEDIATE

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understanding that the Bank would not take unilateral action without prior approval from HMG: that, in any solution, the headquarters of the Bank must remain in Hong Kong: and that any solution must not require an amendment to the HSBC Ordinance.

3. Ministers take the view that it would be unwise in the initial stages of the dialogue for you to put forward any specific suggestions about possible solutions. It would be preferable for such suggestions to come from the Bank, once we had made clear the political parameters in which a solution would have to be found. They should also be warned that the Bank of England will need to look very carefully at the supervisory implications of any solution involving greater participation in a UK bank or establishing a holding company in London.

4. Ministers attach importance to our continuing confidential dialogue with the Chinese on financial and banking matters in Hong Kong. This should continue to be helpful in educating the Chinese about the realities of Hong Kong and the Hong Kong and Shanghai Bank's position. But they do not think it would be desirable to explore, even tentatively, possible solutions until we ourselves have a much clearer idea of what form the solution is likely to take.

5. Please take an early opportunity to speak to Purves on the lines set out in paragraph 2 above.

HOWE

YYYYY

HD/HKD

/// PS

// PS/LORD GLENARTHUR

/ MR GILLMORE

MR MCLAREN

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OUT TELEGRAM (CONT)

Classification	Caveat	Precedence
SECRET	ORIEL	IMMEDIATE

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ADDITIONAL:
MR A LOEHNIS, BANK OF ENGLAND
MR D PERETZ, HM TREASURY
NNNN

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mg.22/docs/md.13 **SECRET AND PERSONAL (ORIEL)**

From : D L C Peretz
Date : 3 February 1989

Ch: content to write as proposed?
AF 3/2

OK

CHANCELLOR OF THE EXCHEQUER

cc Sir P Middleton
Mr Wicks
Mr Odling-Smee
Miss O'Mara

FUTURE OF HONG KONG AND SHANGHAI BANKING CORPORATION

You will remember the recent telegrams from the Governor of Hong Kong (telegram numbers 006 and 007 of 3 January).

2. The Foreign Secretary's minute of 3 February follows a meeting ten days ago between FCO, Bank of England and Treasury Officials. You will see the Foreign Secretary now accepts that the present position of the HSBC will not be sustainable in the run up to 1997. He proposes exploratory talks in Hong Kong to try to identify possible solutions that might be saleable to the Chinese.

3. As you yourself said of the earlier telegrams from the Hong Kong Governor, the Foreign Secretary's change of heart on this since 1986 is welcome, if belated.

4. I should just note there have been some other changes in position since 1986:-

(i) It is not at all clear that Midland would still be as interested in a full merger, were it on offer, as they were then.

(ii) The Bank of England have become more concerned than they were about the potential problems of supervising a bank holding company in London, with the Hong Kong and Shanghai Bank as one of its principal assets. They still think this will be manageable, but this explains the last sentence of paragraph 3 of the draft telegram.

5. I attach a draft minute for you to send to the Prime Minister, welcoming the Foreign Secretary's proposal, and noting that depending on what solutions the HSBC and Hong Kong Authorities between them manage to identify, we may need later on to review the preconditions laid down in the last sentence of paragraph 2 of the telegram.

DLCP

D L C PERETZ

DRAFT

PRIME MINISTER

FUTURE OF HONG KONG AND SHANGHAI BANKING CORPORATION

I very much welcome the initiative Geoffrey Howe proposes in his minute to you of 3 February. As you know, I have always ~~recognised~~ believed that the current position of the HSBC ~~is unlikely to~~ will not be sustainable as 1997 ~~draws closer~~ approaches. I am sure it is right, as proposed, to use the present breathing space to try to find a solution.

I do not think we should lay down, in advance, any absolute preconditions for an acceptable solution. We should take stock once we know what the options are. But I am content for the initial talks to take place on the basis described in the last sentence of paragraph 2 of the draft telegram attached to Geoffrey Howe's minute.

I am copying this minute to Geoffrey Howe, the Governor of the Bank of England, and Sir Robin Butler.

D C PERETZ

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

4 February 1989

CH/EXCHEQUER
REC. 06 FEB 1989 6/2
ACTION MR PERETZ
COPIES TO SIR P MIDDLETON
MR WICKS
MR ODLING-SMEE, MISS O'MARA

FUTURE OF THE HONG KONG AND SHANGHAI BANKING CORPORATION

The Foreign Secretary minuted to the Prime Minister on 3 February proposing that the Governor of Hong Kong should be authorised to open discussions with the Hong Kong and Shanghai Banking Corporation about the Bank's future. A telegram of instructions to the Governor was attached to the minute.

The Prime Minister agrees that the Governor should be instructed to open discussions. She does not think, however, that we can really circumscribe the discussions as much as paragraph 8 of the Foreign Secretary's minute proposes, at least not to the point of requiring acceptance of our conditions as the basis for opening discussions. The first of the conditions - that the Bank would not take unilateral action without prior approval from HMG - is as I recall already in operation and therefore only needs to be confirmed. But the other two conditions - that the Headquarters of the Bank must remain in Hong Kong and that any solution must not require an amendment to the HSBC Ordinance - might be expressed as aims rather than as absolute conditions for the opening of discussions.

This would require some amendment to paragraph 2 of the draft telegram of instructions. The fourth and fifth sentences might be changed to read:

> "We expect the Bank to maintain its commitment not to take any unilateral action without prior approval from HMG. You should also aim to secure their agreement that any solution must provide for the Headquarters of the Bank to remain in Hong Kong, and must not require an amendment to the HSBC Ordinance".

You may wish to consult Stephen Wall about this during the weekend. Subject to any points which he wants to raise, the telegram to Hong Kong can issue. I am at Chequers tomorrow if required.

I am copying this letter to Alex Allan (HM Treasury), John Foot~~ing~~ man (Bank of England) and to Sir Robin Butler.

CHARLES POWELL

The Resident Clerk,
Foreign and Commonwealth Office

fp.pk/BUDGET/Consultat.

COPY NO. 1 OF 29 COPIES

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BUDGET

Rc

FROM: N I MACPHERSON
DATE: 9 February 1989

1. MR CULPIN 9/2

2. CHANCELLOR

cc: Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Dame Anne Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Riley
Mr Sedgwick
Mr Gilhooly
Mr Matthews
Miss Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

Sir A Battishill)
Mr Beighton) IR
Mr Isaac)
Mr Painter)

Mr Unwin) C&E
Mr Jefferson Smith)

Ch,

Content?

JC 9/2

SECRET

B.L.O.

SECRET

BUDGET: CONSULTATION WITH OTHER MINISTERS

I attach a list of Budget measures on which we think you may need to consult colleagues. Not included are consultations with the Governor of the Bank of England, which are already in hand.

2. Are you content?

N I Macpherson

N I MACPHERSON

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BUDGET SECRET

CONSULTATION ON BUDGET MEASURES

PROPOSAL	CONSULTATIONS REQUIRED	ACTION
Unleaded petrol	Chancellor to talk to Mr Ridley first about general differential (mid February) and then about details (early March). Mr Parkinson and Mr Channon also to be informed.	Chancellor's office to set up meeting
Vehicle Excise Duty	Economic Secretary to write to Mr Bottomley about minor transport starters (mid February). Chancellor to write to Mr Channon about main VED rates by 20 February.	FP to provide drafts
Company cars	No need to consult Lord Young, but may want to anyway.	Depends on decisions
Pensions	Chancellor to talk to Lord Chancellor about effect of pension limits on judges.	Chancellor's office to set up meeting. S to provide briefing.
	Financial Secretary may need to consult Mr Maude on allowing people to run own personal pension schemes. Consultation going on at official level first.	IR
	No need to consult Mr Moore on pensions measures, but may want to anyway.	Depends on decisions
NICs and subsidised mortgages Also prob. [illegible]	Mr Moore to be consulted by late February, if decide to go ahead. Meetings with DSS would then take place at official level (end February onwards).	Depends on decisions
Oil taxation	Meeting between Economic Secretary and Mr Morrison (DEn) on incremental investment relief in mid February.	EST office to set up meeting
Rent a room	Chancellor may want to consult Mr Ridley, if decide to go ahead.	Depends on decisions
Unauthorised disclosure	Chancellor to write to Prime Minister (copies to Home Secretary, Mr Moore and Attorney General) in mid February.	IR/C&E to provide draft
Abolition of COBO	No decision on consultation, but Chancellor may want to write to Lord Young.	FIM to provide draft

Will [illegible] LDY then! [illegible] other matters ([illegible] Life Assce)

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PERSONAL AND BUDGET CONFIDENTIAL

FROM: A G TYRIE

DATE: 10 February 1989

Thanks. As you know, I reached the same conclusion as you, for much the same reasons, on the pensions wheeze.

CHANCELLOR

BUDGET OPTIONS

A summary of my thoughts following the discussion in Prayers!

2. The pensions wheeze. The upside is fairly straightforward:

- Taking the basic pension out of tax would be a big selling point in the election. It would also be an attraction to future pensioners.

- It is the only time I can remember the Revenue claiming we can get rid of some staff!

- It will get the order papers waving on budget day.

3. The downside, as we have discussed, revolves around the knock on effects in the benefit system and, to a lesser extent, in tax policy. On this it seems to me that there are four questions which we need to address:

- Would we be forced into uprating the basic pension?

  The demands would start for this on budget day but I think we could stick to our policy of uprating on prices if we were prepared to buy off opposition with further top-ups to the Lawson scheme. (After all, you could argue that the Lawson scheme was the right vehicle because, with the abolition of the earnings rule, any increase in the basic pension would give large dollops to the rich!)

  However, a side effect of any concession would be to highlight the extent to which exemption of the basic pension was a ramp for better off pensioners and that the majority were not gaining.

On the other hand, I wouldn't put it past Kinnock's ineptitude to welcome the move in his reply to your speech so warmly that he could not easily eat his words and subsequently claim that it was just a sop to the rich! Remember his warm reception for the extension of BES, which turned Hattersley purple!

- Would any benefits be dragged from taxed into untaxed status?

The obvious candidates here are widows' benefit and invalid care allowance. We might also come under pressure on unemployment benefit.

At present we argue that there are two basic kinds of benefit: "income maintenance" benefits on the one hand, such as retirement pension, invalid care allowance and unemployment benefit. These are taxed. On the other hand there are "cost replacement benefits" designed for particular needs and circumstances: for example, child benefit, mobility allowance and attendance allowance. These three are untaxed.

On balance I think we could just about sustain this distinction. We would simply say that pensioners are a special case. We would have to remove widows' benefit from taxation but apart from that I think we would be ok.

But we would, I think, lose the opportunity to tax invalidity benefit at some future stage. This is an obvious anomaly, being an "income maintenance" benefit, which should be taxed, but isn't. The tax foregone on that would be in the region of £100 - £200 million. (Any attempt to tax child benefit for the foreseeable future is a lost cause, so I think we can ignore that.)

- Is the number of losers sustainable?

  The number of these hops around a lot and was reduced by nearly two-thirds in Brian Mace's note earlier this week. Abolition of the earnings rule should help. We can't answer this without more detail but most of the losers are only losers for a short time.

- Could we ride out the argument that we've blown a hole in our own policy of targeting?

  Our line would have to be that the benefit system is the right vehicle for targeting, not the tax system. We use the tax system to raise revenue with as little distortive effects as possible. Public finances are now strong enough to make pensioners a special case. That, combined with our determination to get bureaucracy off the backs of pensioners, had led us to take this decision.

  But no amount of restatement of general principles such as those could cover up for the fact that the policy of targeting had been put into reverse. We would undoubtedly be faced by nasty examples of exactly how much rich pensioners had gained. I hear the pundits saying: "Now we know what Lawson really meant by targeting last year". Higher rate tax payers could, of course, be gaining 40% relief on the basic pension.

4. <u>Conclusion</u>

Annoyingly, I think that this reform and attendant simplification is something which will be much easier to do when the basic pension is an even smaller proportion of average earnings than it is now! For the moment, reluctantly, I think the risks are just too great.

5. A penny off versus thresholds

I think we have just got to work on educating the backbenchers to realise that thresholds don't help people at the bottom end, in comparison with a penny off, remotely as much as they think. The main points to get across are:

- The cross over point for single gainers is about £7,500, around half average earnings.

- At the bottom end, the reform of the social security system means that there is substantial off set, I think up to 100% on income support, for tax reductions. The benefit system, not the tax system, is the right way to target help there.

- Higher rate tax payers gain at the 40% rate from an increase in thresholds, ie, an increase in thresholds is equivalent to taking a chunk of higher rate income out of taxation altogether. (Against that, it is worth pointing out that whereas a penny off gives about £330 million to higher rate tax payers, the equivalent amount spent on thresholds gives higher rate tax payers only £175 million.)

6. Apart from the annoying problem of educating backbenchers, all the political points (and economic arguments - incentives etc) point to a penny off. You know all the arguments: George Young hit the nail on the head!

7. A penny off even with 13% interest rates?

I think the choice is between a penny off or nothing. That decision hinges on the perception of the economic climate a month hence. Fortunately, with the basic rate cut, we don't need to take a decision until the last minute. You are familiar with all the arguments:

- Does a penny off send the wrong signal at a time when interest rates are supposed to be telling us to tighten our belts? On the other hand, would it to any extent prove that the Government repudiated totally the suggestion that last year's tax cuts had anything much to do with the consumer boom over the past 12 months?

- Do we need to take a penny off this year? There are still two pre-election budgets to go. As long as we get below 25 pence the credibility of our 20 pence commitment would be intact, now that we have fulfilled the 25 pence pledge made at the last election.

8. Of course, no-one can tell how soon interest rates can come down. For what it's worth, I regretted the move from 12% to 13%, although it is easy to say that now. If there are no high profile tax cuts in the budget (ie nothing on pensions, NICs, thresholds or rates) I can easily imagine it being written up as an austerity signal, (as a £15 billion debt repayment should!). That might bring forward the date at which interest rates could be brought down.

pp RJ.
A G TYRIE

COPY NO. 12 OF 29

BUDGET SECRET
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FROM: J M G TAYLOR
DATE: 13 February 1989

BUDGET

MR MACPHERSON

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Dame A Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Mr Riley
Mr Sedgwick
Mr Gilhooly
Mr Matthews
Miss Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

Sir A Battishill IR
Mr Beighton IR
Mr Isaac IR
Mr Painter IR

Mr Unwin C&E
Mr Jefferson Smith C&E

Mr J M G Taylor

I am sure that the Chancellor is right about life assurance & COBO. We will pick the COBO point up in our submission to him on it.

MCS 14/2

SECRET

B.L.O.

BUDGET: CONSULTATION WITH OTHER MINISTERS

The Chancellor was grateful for your note of 9 February.

2. He has commented that he will probably also need to consult Mr Moore about the earnings rule. He will inform Lord Young about the abolition of COBO when he sees him on other matters (which he suspects should include life assurance).

3. He is otherwise content with the list.

J M G TAYLOR

SECRET

38/CDR

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FROM: J M G TAYLOR
DATE: 13 February 1989

MR MACPHERSON

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Dame A Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Mr Riley
Mr Sedgwick
Mr Gilhooly
Mr Matthews
Miss Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

Sir A Battishill IR
Mr Beighton IR
Mr Isaac IR
Mr Painter IR

Mr Unwin C&E
Mr Jefferson Smith C&E

BUDGET: CONSULTATION WITH OTHER MINISTERS

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J M G TAYLOR

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FROM: J M G TAYLOR
DATE: 13 February 1989

BUDGET

MR MACPHERSON

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Dame A Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Mr Riley
Mr Sedgwick
Mr Gilhooly
Mr Matthews
Miss Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

Sir A Battishill IR
Mr Beighton IR
Mr Isaac IR
Mr Painter IR

Mr Unwin C&E
Mr Jefferson Smith C&E

SECRET

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J M G TAYLOR

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REF NO.
COPY NO. 15 OF 15 .

FROM: J M G TAYLOR /BS/89/7

MR MACE - IR

cc PS/Financial Secretary
Sir P Middleton
Mr Scholar
Mr Culpin
Mr Gilhooly
Mr Matthews
Mrs Chaplin

Sir A Battishill - IR
Mr Painter - IR
Mr Bush - IR
Mr Lewis - IR

BASIC RATE AND CAR SCALES

The Chancellor would be grateful for a short note setting out the distributional effects of the following options:

(i) 1p off the basic rate, and a 50 per cent increase in the car scales;

(ii) 1p off the basic rate, and a 40 per cent increase in the car scales;

(iii) nothing off the basic rate, and a 20 per cent increase in the car scales (as in the Scorecard).

J M G TAYLOR

BILATS

Mr Ridley) — Post E(A) Thurs 2/3.

) — 3.45pm Thurs. 2/3.

Mr J Moore) This week

Lord Young) — 10.40 am Wed 1/3.

Mr Younger) — 8.45 Tues 7/3.

Next week.

Mr Hurd) — 2.45 Wed 8/3.

(15 mins + each)

-20.

582-6516

CHANCELLOR OF THE EXCHEQUER

HONI SOIT QUI MAL Y PENSE

50% w/drawal from 75 - 79 → 100% through

(Spend-it c [illegible] = Unworking)

Ch

Do you feel you need to see John Moore again about NICs, now package has firmed up? Or is it OK for Paul to tell Anne Bowtell?

A

I had better 8.00 tomorrow: 15 mins will do.

rc 1989/14.2.01

BUDGET CONFIDENTIAL

FROM: ROBERT CULPIN
DATE: 14 February 1989

CHANCELLOR

cc: Sir Peter Middleton
Mr Scholar
Mr Gilhooly
Mr Matthews

Ch/
Shall we commission 'X'?

Yes, but Budget 3 options: ① 1p off + 50% ② 1p off + 40% ③ non off + 20% (as per scorecard)

CONTINGENCY PLANNING

It might be prudent to decide soon how much further you would raise the car scales if, nearer the Budget, you decide either to reduce the basic rate or to raise the allowances in real terms.

2. The Scorecard has a 20 per cent increase. If you were to take a penny off the basic rate, it might be possible to raise this to 50 per cent. That would be the same cash increase as last year. It would demonstrate a certain consistency of purpose (which seems to be quite widely expected) and be consistent with yesterday's decision to put all our benefit eggs, for the time being, into the car basket. But it would clearly be the upper limit; and it might, in the event, look harsher than you want to be.

3. I raise this now because we cannot give you a detailed analysis of the distributional effects. That requires a Revenue submission; and if you want to look at the options, it would be sensible to commission it fairly soon. You might, for example, start by asking for a short note on a penny off and a 50 per cent increase, and invite the Revenue to illustrate alternatives if they wish. That would give you a benchmark without requiring the Revenue to produce strings of permutations.

X

RC

ROBERT CULPIN

COPY NO. 4 OF 5 .

FROM: A C S ALLAN
DATE: 22 February 1989

pps

MR McINTYRE cc Mr Culpin

BILATERAL WITH MR MOORE

As you know, the Chancellor spoke to Mr Moore yesterday. He gave me the following debrief.

2. Mr Moore was very happy in principle (not surprising!) and gave the Chancellor a copy (attached) of work he had had done, which you may have seen before. One of the options - which Mr Moore liked best - was the lower line on Chart C, which is very like our Option 4, the difference being that the contribution is fixed at the entry fee of £2.15 until £67 a week, after which all up to the UEL is charged at 9 per cent (£67 is the point, the Chancellor thinks, where this system produces no losers). This is a wrinkle on the Culpin alternative; but it is more complicated and the Chancellor sees little to commend it.

3. Mr Moore has already deferred the report stage of the Social Security Bill to after Easter (probably 13 April or thereabouts); he did this when the Chancellor told him of the proposal on the pensioners' earnings rule.

4. He was nervous about who needed to know at DSS. He felt he had to tell Partridge, and of course Ann Boatell; he told the Chancellor he would consult her on who, if anyone, else needed to know pre-Budget. He subsequently 'phoned the Chancellor to say that the additional person should indeed be Michael Lloyd, as you had suggested.

ACSA

A C S ALLAN

Annex 2 (d)

SMOOTHING OPTIONS - REMOVING CLIFF EDGES

The current structure of National Insurance contributions produces a number of "cliff-edges", where a small rise in earnings can result in a jump in the level of contributions which more than offsets the original increase in earnings. The reason these cliff-edges occur is that when earners cross a threshold from a lower-rate NIC band to a higher one the higher rate is immediately applied to all their earnings, not just to earnings above the threshold. Chart A illustrates the current NIC structure for employees, showing the contributions payable at various earnings levels. Three cliff-edges are apparent :

* at the LEL (£43pw in 1989-90), contributions of £2.15pw become payable for the first time

* at £75pw, the 7% rate begins to apply and contributions jump by £1.50pw

* at £115pw, the 9% rate begins to apply and contributions jump by £2.30pw

Options for smoothing.

Smoothing-out the cliff-edges requires a structure similar to that used for income tax, where contribution rates apply only to earnings above certain threshold levels. There are a number of different ways in which this might be achieved.

(i) **Chart B** shows two schemes. The lower line illustrates a scheme that removes all the cliff-edges and gives a smooth rise in contributions from the LEL. This is achieved by levying contributions at 14.375% on earnings between the LEL and £115pw. This rate is chosen so that when earnings reach £115pw, the amount payable is the same as under the current scheme. For those earning more than £115pw the current system is retained, with the 9% rate payable on total earnings.

i.e : Scheme I

Earnings	Contributions
Under £43pw	Nil
£43 to £115pw	14.375% of any earnings above £43pw
£115pw to UEL	9% of total earnings
Over UEL	9% of UEL

The scheme produces both gainers (mostly just above the LEL) and losers (mostly between £80 and £115pw). It has not yet been costed but total contribution revenue might be broadly similar to that from the current structure. Eliminating losers would require a cut in the basic rate, which would be expensive.

The upper line in Chart B shows a similar scheme, except that it retains a minimum level of contributions. The line shown here retains the current starting-point (£2.15 or 5% at £43pw). Contributions are then payable at 11.4% on the portion of earnings above the LEL. Again, this rate is chosen so that contributions revert to the current level at earnings of £115pw.

i.e : Scheme II

Earnings	Contributions
Under £43pw	Nil
£43 to £115pw	£2.15 plus 11.4% of any earnings above £43pw
£115pw to UEL	9% of total earnings
Over UEL	9% of UEL

Such a scheme clearly raises more revenue than the existing structure, and therefore produces losses for all those currently paying NICs at 5% or 7%.

(ii) **Chart C** shows a scheme which alters the contribution structure across the whole earnings range. There is a minimum contribution at the LEL (shown as £2.15 here), contributions are then charged at a single rate on earnings above the LEL. Those earning just above the LEL continue to pay the minimum amount until their calculated contributions exceed the minimum. The lower line, which retains a 9% contributions rate shows the following scheme :

Scheme III

Earnings	Contributions
Under £43pw	Nil
£43 to £67pw	£2.15
£67 to UEL	9% of earnings above £43pw
Over UEL	9% of earnings between £43 and UEL

The scheme always lies below the current contribution structure and would be very expensive.

The higher dotted line shows a scheme with a higher contribution rate. For illustration, an 11% rate is shown here. The structure of the scheme is the same except that the flat rate minimum contribution stops slightly earlier with a higher contribution rate. Those earning under £225 pw all gain, with the biggest gains between £75 and £90pw and between £115 and £175pw. The lost revenue is recouped from those earning above £250pw; those above the UEL pay an extra £1.80pw.

Again, this scheme has not yet been costed but a rate of about 11% - perhaps slightly lower - might be broadly revenue neutral.

The UEL could be increased by £43pw to offset effect of free earnings band - this would eliminate gains for the highest earners.

(iii) **Chart D** illustrates a scheme along the lines suggested by IFS. The main change from the schemes shown in (ii) above is that the UEL is abolished, so contributions continue to increase on earnings above £325pw. The line shown here also has no minimum contribution at the LEL. It could be adapted to include a minimum contribution, but without the sort of contributions "stand-still" in (ii) above that would mean losses for some of the lowest earners. The contribution rate shown - on earnings above the LEL - is 10.4% (which ensures that all those below the UEL pay less than at present and all those above the UEL pay more). The structure of the scheme is this :

i.e : Scheme IV

Earnings	Contributions
Under £43pw	Nil
£43 and over	10.4% of any earnings above £43pw

The net effect on contribution revenue is difficult to predict [probably net loss of revenue].

CHART A. CURRENT NATIONAL INSURANCE CONTRIBUTIONS (Employees, 1989-90)

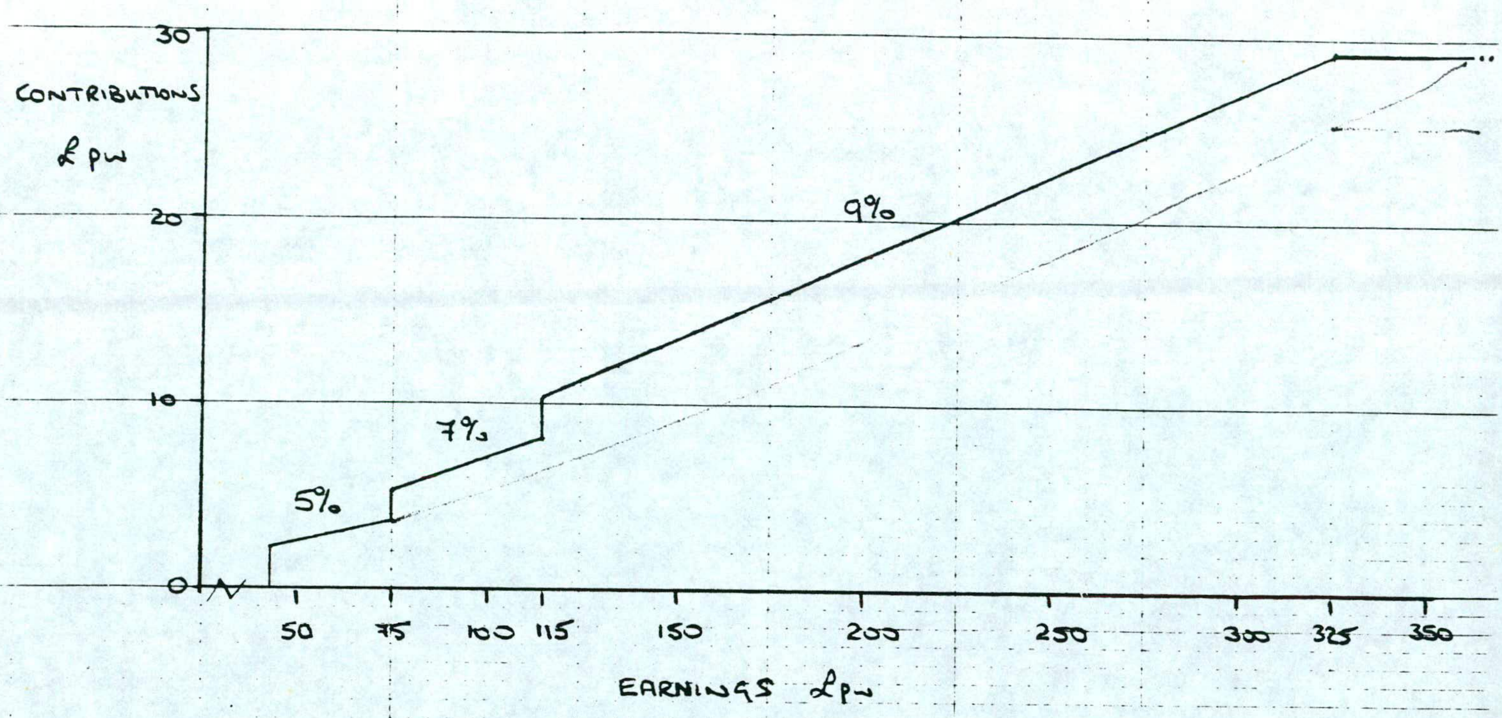
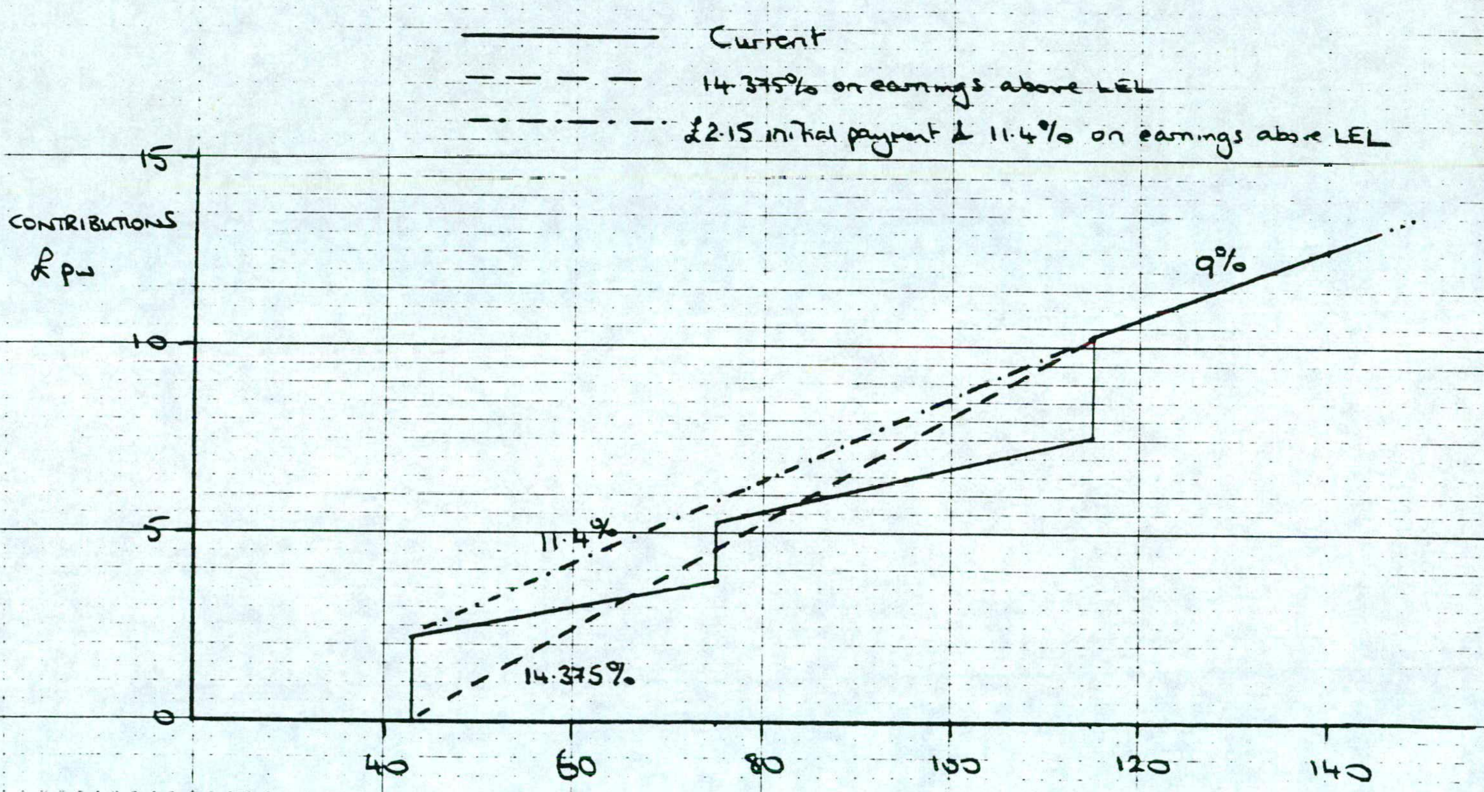


CHART B.



18

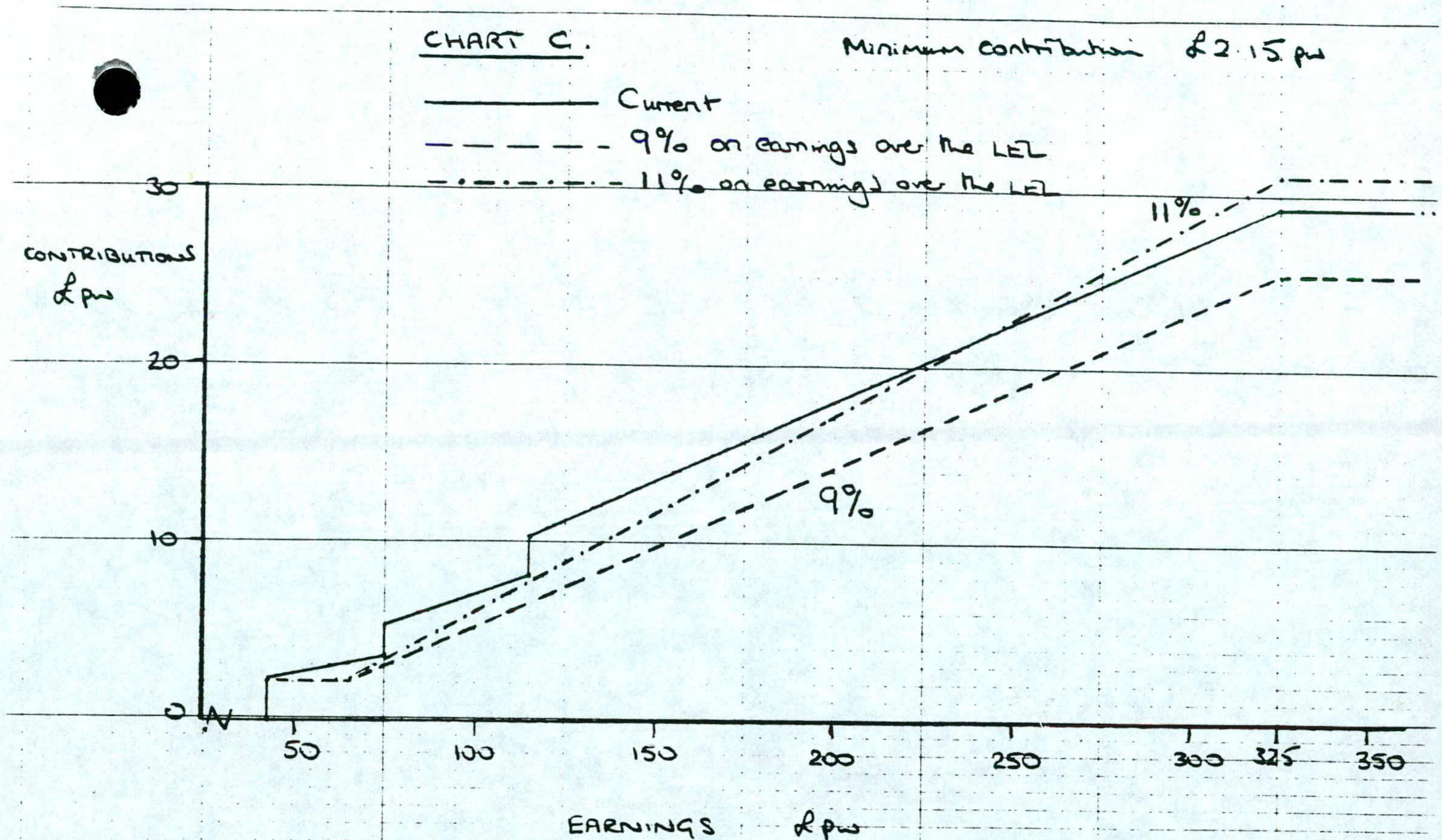


CHART C.
Minimum contribution £2.15 pw
Current
9% on earnings over the LEL
11% on earnings over the LEL
11%
9%
CONTRIBUTIONS £pw
0
10
20
30
50
100
150
200
250
300
325
350
EARNINGS £pw

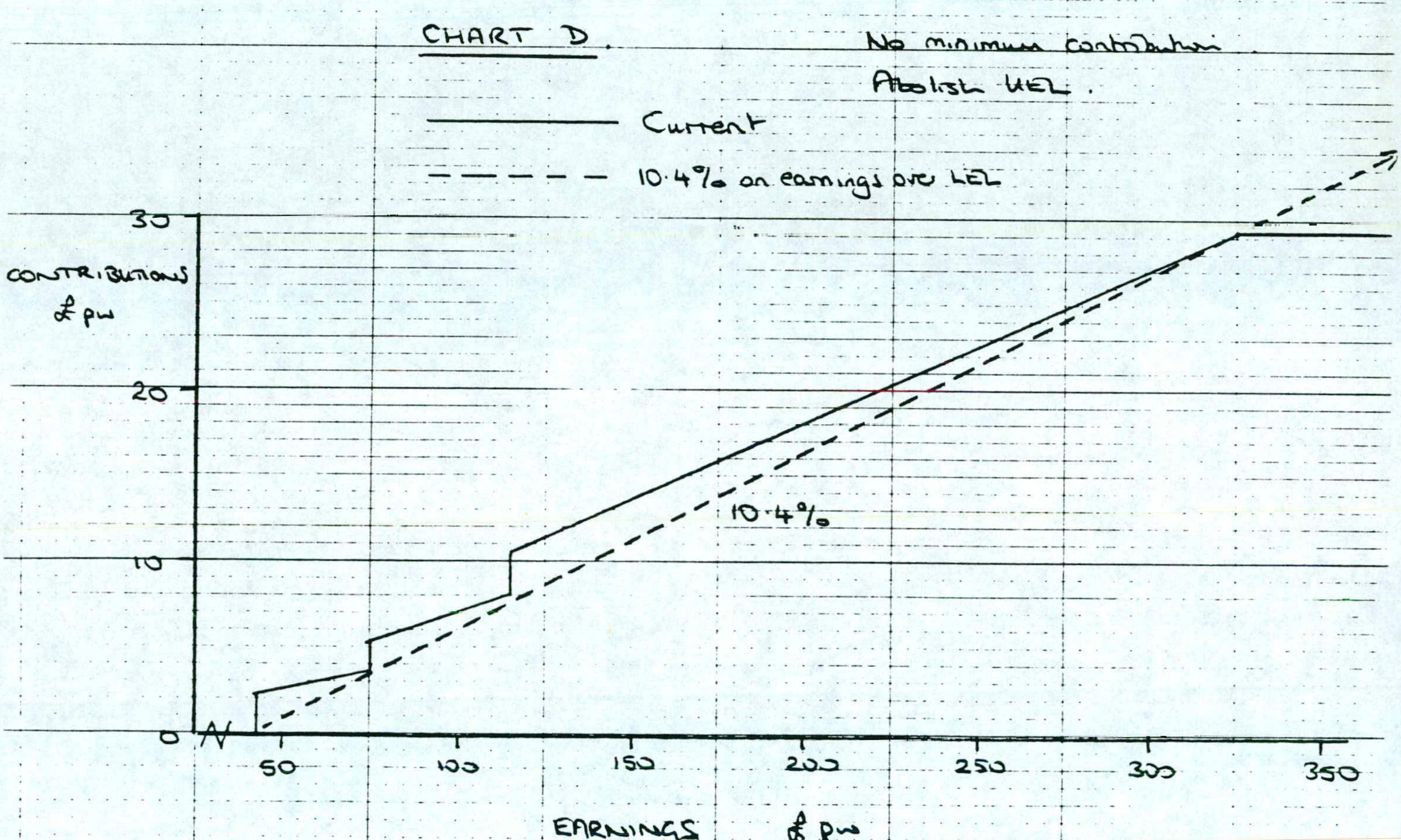


CHART D.
No minimum contribution.
Abolish UEL.
Current
10.4% on earnings over LEL
10.4%
CONTRIBUTIONS £pw
0
10
20
30
50
100
150
200
250
300
350
EARNINGS £pw

Copy 1 of 9

FROM: N I MACPHERSON
DATE: 28 February 1989

1. MR GILHOOLY 28/2
2. CHANCELLOR

cc: Financial Secretary
Sir P Middleton
Mr Scholar
Mr Culpin

PS/IR

MEETING WITH LORD YOUNG ON BUDGET

You are meeting Lord Young tomorrow to inform him of a number of Budget measures.

2. You need to mention the capital markets package. You do not need to mention life assurance, car scales or stamp duty but you may want to anyway. Details are set out below.

(a) Capital Markets Package

This consists of:

- Abolition of the new issues queues for bonds and equities; from 12 March it will no longer be necessary for issuers to obtain the Bank of England's consent to the timing of sterling issues.

- The establishment of a unified regime for sterling issues of up to 5 years, by bringing the short-term corporate bond regime into line with that for sterling commercial paper.

- An extension of the categories of institution that can issue sterling paper of less than 5 years, to include private companies, companies listed on non-UK Stock Exchanges, sovereign and parastatal bodies.

- A simplification of the tax regime for sterling corporate bonds, abolishing the distinction between qualifying and non-qualifying corporate bonds. In future all sterling corporate bonds will be exempt from capital gains tax.

- Extension of the tax regime for non-variable deep discount bond issues by companies to cover issues by the UK Government, overseas sovereigns and parastatals. This will mean that the tax treatment of deep discount bonds in the hands of the investor will be independent of type of issuer.

Taken together these changes constitute a major liberalisation in the operation of London's capital markets, giving issuers greater flexibility, and giving investors wider choice, and more straightforward tax treatment.

(b) Life Assurance

In December Lord Young wrote expressing concern about the more favourable tax regime applying to life assurance in Europe and arguing against radical reform. You may wish to indicate that the Budget proposals take account of the European dimension and that the tax advantage of continental countries are offset by (and are only possible as a result of) severe regulatory restrictions including the type of assets which can be held by life companies

In June 1988 the Inland Revenue issued a consultative document on the taxation of life assurance.

The document put forward three main options for change:

(a) For "unit linked" business only, to tax the income and gains of individual policy holders by reference to their own tax circumstances.

(b) To replace the current regime with a special tax regime ("Schedule X") specifically designed for life assurance and formulated on actuarial principles.

(c) To reform the current "I minus E" base to remedy defects and close loopholes.

In Budget will announce decision to reform the (I-E) base.

Approach favoured by vast majority of representations.

The following measures will take effect from 1 January 1990.

- the tax rate on life office income and capital gains attributable to policy holders will be reduced to the basic rate (from 35% and 30% respectively).

- life assurance policy duty will be abolished.

- pension business expenses will be deductible only from pension business profits.

- other changes to produce a fairer measure of pension business profits.

- acquisition expenses will continue to be fully deductible but relief will be spread over 7 years, rather than given immediately as now. To give the industry time to adjust this change will be phased in gradually over the next four years.

Certain other, even more technical issues raised in Consultation document require further discussion with industry. Any legislative change will have to wait for next year's Finance Bill.

Pension measures will yield £155 million in 1990-91. Once the system is mature, the remaining measures will constitute a broadly balanced package of lower rates on a broader base.

(c) Car Scales

In his Budget Representations, Lord Young argued for restraint in pushing up car scales to protect "middle managers".

The current proposal is for an increase in car scales of one third. You may want to tell Lord Young that you are raising car scales in real terms, but that you intend to keep losers to a minimum. [Mentioning the specific increase will either give the game away on the extent of NIC/tax reductions or result in further complaints about the fate of middle managers].

(d) Stamp duty

Lord Young asked for abolition of stamp duty on share transactions (along with abolition of the stamp duty reserve tax) in his Representations.

You may want to tell him that abolition is going ahead, almost certainly from 1 April 1990.

N. I. Macpherson

N I MACPHERSON

rc 1989/28.2.02

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COPY NO 1 OF 10 COPIES

Thanks: Annotated ~

FROM: ROBERT CULPIN
DATE: 28 February 1989

CHANCELLOR

cc: Sir Peter Middleton
Mr Scholar
Mr Gilhooly
Mr Macpherson
Mrs Chaplin
Mr Tyrie
Mr Call

Ch/ Some of this note is overtaken by events. We have fixed bilats with Messrs Clarke, Rifkind, Younger, + Hurd, apart from those arranged with Ld Young, Mr Ridley + Mr Moore.
JT 28/2

At WR to get there: Better start @ 10.30 a.m.

BUDGET SECRET

BUDGET CONSULTATIONS

It might be sensible to take stock of your consultations with Ministerial colleagues.

2. Consultations are in hand on VED, the earnings rule, national insurance contributions, oil taxation, judges' and other public service pensions, taxpayer confidentiality, the ITV levy, and the sale of number-plates; and you are going to write to Lord Young about the capital markets package. I imagine you might want a further word with Mr Moore about his subjects. That apart, I think this leaves three main questions.

Poss. unnecessary, after tomorrow's meeting.

Meeting fixed ✓

B.L.O. SECRET

3. First, you agreed earlier that you would mention your decision on unleaded petrol to Mr Ridley, and possibly Mr Parkinson and/or Mr Channon. Are you now ready to do that? If so, do you wish to see all three Ministers, or only Mr Ridley? And do you want to say only that you will make unleaded 2p a litre cheaper than 4 star, and 2 star at least as expensive, or that you will do this entirely by reducing the tax on unleaded, without indexing the duty on leaded?

Mr Ridley

The former

You are already seeing Mr Ridley (3.45 pm on 2/3)

SECRET

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Yes 4. Second, do you want to mention to Lord Young company cars, life assurance, and/or stamp duty, in addition to the capital markets package? — Briefing on all these is in the folder

Yes 5. Third, do you want to tell Mr Ridley that you are not proceeding with rent-a-room? His officials have asked if they should put out a supporting press notice. We have stonewalled.

RC

ROBERT CULPIN

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CHANCELLOR OF THE EXCHEQUER

HONI SOIT QUI MAL Y PENSE

Clarke.
2.50 7 March.

Rifkind;
3.00pm 8 March

Bilaterals
next week.

chex.rm/jmt1/71 **BUDGET SECRET**

COPY NO 17 OF 18 COPIES

FROM: J M G TAYLOR
DATE: 28 February 1989

MR MACPHERSON

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Scholar
Mr Culpin
Mr Gilhooly
Miss Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

PS/IR
PS/C&E

BUDGET: CONSULTATION WITH OTHER MINISTERS

The Chancellor will be having a series of bilateral meetings with colleagues to let them know about the Budget proposals in their areas of responsibility. The meetings, and subjects, are:

(i) Lord Young. Meeting at 10.40am on Wednesday 1 March. Subjects: Life assurance, company cars, COBO.

(ii) Mr Ridley. Meeting on Thursday 2 March, am (after EA). Subjects: Unleaded petrol, public service pensions (local authority staff).

Mr Clarke

(iii) Mr Moore. Meeting in margins of Cabinet on Thursday 2 March. Subjects: NICs, pensions ~~(including public service pensions - NHS staff)~~.

Mr Rifkind

(iv) Mr Younger. Meeting at 8.45am on Tuesday 7 March. Subject: Public service pensions (armed forces).

(v) Mr Hurd. Meeting at 2.45pm on Wednesday 8 March.
Subject: Public service pensions (police).

3. I should be most grateful if you could provide a short aide memoire for each of these meetings.

J M G TAYLOR

COPY NO 18 OF 18 COPIES

FROM: J M G TAYLOR
DATE: 28 February 1989

MR MACPHERSON

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Scholar
Mr Culpin
Mr Gilhooly
Miss Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

PS/IR
PS/C&E

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Subjects: NICs, pensions (including public service pensions - NHS staff).

(iv) Mr Younger. Meeting at 8.45am on Tuesday 7 March.
Subject: Public service pensions (armed forces).

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Subject: Public service pensions (police).

3. I should be most grateful if you could provide a short aide memoire for each of these meetings.

J M G TAYLOR

FROM: J M G TAYLOR
DATE: 1 March 1989

MR MACPHERSON

cc Financial Secretary
Sir P Middleton
Mr Scholar
Mr Culpin
Mr Gilhooly

MEETING WITH LORD YOUNG ON BUDGET

The Chancellor was grateful for your note of 28 February.

J M G TAYLOR

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REF NO. JMGT/89/1
COPY NO. 10 OF 11.

FROM: J M G TAYLOR

DATE: 1 March 1989

MR CULPIN

cc Sir P Middleton
Mr Scholar
Mr Gilhooly
Mr Macpherson
Mrs Chaplin
Mr Tyrie
Mr Call

BUDGET CONSULTATIONS

The Chancellor was grateful for your note of 28 February.

2. We have arranged a series of bilaterals as follows:

(i) Lord Young. Meeting this morning.
Subjects: company cars, life assurance, stamp duty, capital markets package;

(ii) Mr Moore. Meeting in margins of Cabinet on Thursday 2 March.
Subjects: NICs, pensions;

(iii) Mr Ridley. Meeting at 3.45pm on Thursday 2 March.
Subjects: unleaded petrol, public service pensions (local authority staff). (The Chancellor does not plan to see Mr Parkinson or Mr Channon about unleaded petrol; he will say only to Mr Ridley that he will make unleaded 2p a litre cheaper than 4 star, and 2 star at least as expensive. He will also tell Mr Ridley that he is not proceeding with rent-a-room);

(iv) Mr Clarke. Meeting at 2.50pm on 7 March.
Subject: public service pensions (NHS staff);

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(v) Mr Younger. Meeting at 8.45am on Tuesday 7 March.
Subject: public service pensions (Armed Forces);

(vi) Mr Hurd. Meeting at 2.45pm on 8 March.
Subject: public service pensions (Police);

(vii) Mr Rifkind. Meeting at 3.00pm on 8 March.
Subject: public service pensions (Scottish Judiciary).

3. I should be most grateful if you could arrange for a short aide memoire to be provided for each meeting. (I have spoken to Mr Macpherson about this).

J M G TAYLOR

Can/seexpl

COPY NO. 25 OF 26.

FROM: A C S ALLAN
DATE: 6 March 1989

MR SPEEDY

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Mr Monck
Mr Scholar
Mr Culpin
Mr Riley
Mr Sedgwick
Mr Gieve
Mr Gilhooly
Mr McIntyre
Mr Mowl
Mr Macpherson
Mrs Chaplin
Mr Tyrie
Mr Call

PS/IR

BUDGET CHANGES AND THE NATIONAL INSURANCE FUND

X The Chancellor was grateful for your minute of 3 March. He would be grateful for the Chief Secretary's views. His initial comments were that it need not be all that awkward to present a "cut" in the NHS allocation, given that we have never made anything of the increases in the NHS allocation in recent years, nor did anyone else. He is attracted to the ingenious option 2 (a zero employee's NHS allocation on earnings up to the LEL).

ACSA

A C S ALLAN

chex.rm/jmt/6 BUDGET CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 6 March 1989

MR RAYSON

cc Chief Secretary
Financial Secretary
Paymaster General
Sir P Middleton
Sir T Burns
Mr Anson
Dame A Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Mr Luce
Mr Riley
Mr Sedgwick
Mr Dixon
Mr Gilhooly
Mr Macpherson
Miss Simpson
Mrs Chaplin
Mr Tyrie
Mr Call
Mr Sheridan
Mr L J Harris

Sir A Battishill - IR
Mr Beighton - IR
Mr Isaac - IR
Mr Painter - IR
Mr Bush - IR
Mr Corlett - IR
Mr Kuczys - IR
Mr Hinton - IR

Mr Jefferson Smith - C&E

PENSIONS CAP: MPs AND OFFICE HOLDERS

The Chancellor was grateful for your note of 2 March.

2. He has commented that the forthcoming Bill will need either explicitly to include provision for the cap, or to include a

regulation making power, which could then be used for this purpose. He would be grateful for advice on these two options, in due course.

J M G TAYLOR

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COPY NO. 14 OF 15.

BUDGET

FROM: A C S ALLAN

DATE: 10 March 1989

MR C J RILEY

cc Mr Wicks
Mr Scholar
Mr Culpin
Mr Sedgwick
Mr S Davies
Mr Gieve
Mr Gilhooly
Mr Matthews
Mr Pickford
Miss Simpson
Mr Tyrie

SECRET

NOTE FOR THE QUEEN AND OVERSEAS POSTS

... The Chancellor was grateful for your minute of 7 March. I attach a revised version with his comments incorporated. I should be grateful for any comments by noon on Monday at the latest.

ACSA

A C S ALLAN

B.L.O.

SECRET

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1989 BUDGET: SUMMARY OF MAIN POINTS

The background to this year's Budget is one in which the United Kingdom has enjoyed two years of exceptionally strong growth. With high investment, rapid productivity growth and a major improvement in profitability, the UK is very well placed to build on the achievements of recent years. But the rapid expansion in the last two years has produced some build-up of inflationary pressures, and monetary policy has been tightened sharply since last summer to deal with that. This year's Budget therefore adopts a continued prudent and cautious approach to financial policy, and the Chancellor is budgeting for a further massive repayment of public sector debt. But this is combined with further reforms and reductions in taxation and national insurance contributions to improve the supply side of the economy and continue the transformation of Britain's economic performance.

2. The main points are:-

- a public sector debt repayment of [£14 billion] in 1989-90, the same as the outturn for 1988-89, with gradual movement back towards a balanced budget over the medium term;

- a major reform of employees' national insurance contributions, with reductions of £3 a week for most employees;

- no change in income tax rates, tax thresholds increased in line with inflation;

- measures to help the elderly, including abolition of the pensioners' earnings rule and improvements in age allowances;

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- a reduction in the duty on unleaded petrol, designed to produce a pump price differential of getting on for 10p a gallon (over 2p a litre) with 4 star leaded;
- no change in the main excise duties;
- new tax incentives for share ownership, including major improvements to Personal Equity Plans;
- reform of the taxation of life assurance companies and some changes to the tax regime for occupational and personal pensions.

Economic background

3. The 1980s have seen major improvements in the performance of the British economy. Since 1983 inflation has averaged under 5 per cent, compared with over 15 per cent between 1974 and 1979. At the same time we have had an unprecedented seven years of steady, sustainable growth averaging in excess of 3 per cent a year. Output has grown faster in the 1980s than in all other main European countries, whereas the UK was at the bottom of the league in each of the previous two decades.

4. In 1988 total output grew by some 4½ per cent, faster than forecast a year ago. This is the first time for at least 40 years that there have been two successive years of growth above 4 per cent. Manufacturing output has grown particularly rapidly, by over 7 per cent in 1988 following 5½ per cent in 1987. Unemployment has fallen by over half a million in the past year, more than in any other major country. We now have more people in work than ever before.

5. Over the past seven years investment has grown very nearly twice as fast as consumption, and total business investment is now

a higher proportion of national income than ever before. And investment has grown particularly strongly over the last two years. Over the 1980s as a whole, investment has grown faster than in any other of the main European economies. There has been a dramatic and sustained improvement in productivity growth, which in manufacturing has exceeded that of all other major nations during the '80s.

6. With consumers' expenditure also extremely buoyant, domestic demand probably grew by about 7 per cent in 1988, faster than the economy's capacity to supply. This has led to an increase in inflationary pressures and a widening in the current account deficit. The RPI has grown by about 7½ per cent over the last year, though the underlying inflation rate (excluding mortgage interest payments) currently stands at about 5½ per cent; published figures put the current account deficit at around £14½ billion in 1988, but with a very large positive balancing item in the external accounts this may well overstate the true deficit.

7. Since the Summer, monetary policy, which must necessarily play the key role in combating inflation, has been tightened sharply to deal with the emerging inflationary pressures, and some slowdown in real growth is probably inevitable while inflation is being brought firmly back onto a downward path. Following two years of above average growth, the Chancellor expects growth to be somewhat below trend over the coming year. But even so, GDP in 1989 is forecast to be 2½ per cent higher in 1989 than in 1988, with the non-oil economy up by 3 per cent, though growth in the course of 1989 is forecast to be rather less than this, at 2 per cent. Business investment is forecast to continue growing strongly, with a rise of 10 per cent. Inflation as recorded by the RPI is forecast to come down to 5½ per cent by the end of the year and 4½ per cent by the middle of 1990.

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8. The slowdown in domestic demand should lead in due course to an improvement in the current account. But this is unlikely to occur quickly; continued buoyancy of investment will add to imports of capital goods for the time being, and it will take some time before the additions to industrial capacity feed through into better trade performance. The current account deficit is thus forecast to be the same as in 1988.

Budget strategy

9. The medium term financial strategy continues to provide the framework for the Government's macroeconomic policy, and this is the tenth occasion on which it has been set out in the FSBR. Although the precise form in which the strategy has been expressed has changed as the economy has itself evolved, the essential objectives remain the same. The overriding aim is to bring down inflation by reducing the growth of money GDP, and ultimately to achieve price stability.

10. Short term interest rates will be held at whatever level is necessary, for as long as necessary, to get on top of inflation. Decisions on interest rates will continue to be based on a comprehensive assessment of monetary conditions, in which particular weight is given to the behaviour of MO and the exchange rate. The Chancellor is setting a target range of 1-5 per cent for the growth of MO in 1989-90; the 12 month growth rate is likely to begin the year above this range, but as the deceleration over recent months continues it should fairly soon come back within it.

11. In its early years of office, one of the Government's main objectives was to bring down the rate of Government borrowing. Now the public finances have been completely transformed, with the budget in surplus for the last two years. It seems likely that

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the outturn in 1988-89 will be a debt repayment of £14 billion. No other major country enjoys a comparable surplus.

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32. The Chancellor is introducing a number of specific tax measures to encourage further widening of share ownership.

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35. The Chancellor will also make various improvements and simplifications to the rules applying to Profit Related Pay.

36. Together these measures will further stimulate wider share ownership and the greater identification of employees with the companies for which they work.

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39. The Chancellor will make an important deregulatory change to occupational pensions, allowing employers to pay pensions beyond the Inland Revenue limits without, as at present, loss of tax relief for the entire pension scheme; but at the same time he will place a limit on the maximum size of tax-privileged pensions and tax free lump sums, based on a salary of £60,000 a year indexed to inflation. These changes will apply to new pension schemes and new members of existing pension schemes: existing members will not be affected. The Chancellor is increasing the tax-free contributions which people aged over 35 can make to buy personal pensions, subject to the same earnings cap as for occupational pensions.

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41. The Chancellor will also include in the Finance Bill provisions for fairer and more effective enforcement on Inland Revenue taxes; and to restore criminal sanctions against Revenue or Customs officials who reveal information about the private affairs of taxpayers.

Summary

42. The Budget continues the economic policies which have brought about the transformation of UK economic performance over the last decade. It introduces a major reform of, and reduction in, employees' national insurance contributions. At the same time,

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the Chancellor has budgeted for a substantial Public Sector Debt Repayment in the year ahead.

chex.ps/aa/60

REF NO.
COPY NO. 13 OF 15.

FROM: A C S ALLAN
DATE: 13 March 1989

MR C J RILEY

cc Mr Wicks
Mr Scholar
Mr Culpin
Mr Sedgwick
Mr S Davies
Mr Gieve
Mr Gilhooly
Mr Matthews
Mr Pickford
Miss Simpson
Mr Tyrie

NOTE FOR THE QUEEN AND OVERSEAS POSTS

... The Chancellor was grateful for the further comments from you and others on the draft I circulated on Friday. I attach the final version. I should be grateful if you could arrange for it to be dispatched to Posts once the Chancellor has sat down.

ACSA

A C S ALLAN

SECRET

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1989 BUDGET: SUMMARY OF MAIN POINTS

The background to this year's Budget is one in which the United Kingdom has enjoyed two years of exceptionally strong growth. With high investment, rapid productivity growth and a major improvement in profitability, the UK is very well placed to build on the achievements of recent years. But the rapid expansion in the last two years has produced some build-up of inflationary pressures, and monetary policy has been tightened sharply since last summer to deal with that. This year's Budget therefore adopts a continued prudent and cautious approach to financial policy, and the Chancellor is budgeting for a further massive repayment of public sector debt. But this is combined with further reforms and reductions in taxation and national insurance contributions to improve the supply side of the economy and continue the transformation of Britain's economic performance.

2. The main points are:-

- a public sector debt repayment of £14 billion in 1989-90, the same as the outturn for 1988-89, with gradual movement back towards a balanced budget over the medium term;

- a major reform of employees' national insurance contributions, with reductions of £3 a week for most employees;

- no change in income tax rates, tax thresholds increased in line with inflation;

- measures to help the elderly, including abolition of the pensioners' earnings rule and improvements in age allowances;

- a reduction in the duty on unleaded petrol, designed to produce a pump price differential of getting on for 10p a gallon (over 2p a litre) with 4 star leaded;

- no change in the main excise duties;

- new tax incentives for share ownership, including major improvements to Personal Equity Plans;

- reform of the taxation of life assurance companies and some changes to the tax regime for occupational and personal pensions.

Economic background

3. The 1980s have seen major improvements in the performance of the British economy. Since 1983 inflation has averaged 5 per cent, compared with over 15 per cent between 1974 and 1979. At the same time we have had an unprecedented seven years of steady growth averaging in excess of 3 per cent a year. Output has grown faster in the 1980s than in all other main European countries, whereas the UK was at the bottom of the league in each of the previous two decades.

4. In 1988 total output grew by some 4½ per cent, faster than forecast a year ago. This is the first time for a generation that there have been two successive years of growth above 4 per cent. Manufacturing output has grown particularly rapidly, by over 7 per cent in 1988 following 5½ per cent in 1987. Unemployment has fallen by over half a million in the past year, more than in any other major country. We now have more people in work than ever before.

5. Over the past seven years investment has grown more than twice as fast as consumption, and total business investment is now a higher proportion of national income than ever before. And investment has grown particularly strongly over the last two years. Over the 1980s as a whole, investment has grown faster than in any other of the main European economies. There has been a dramatic and sustained improvement in productivity growth, which

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in manufacturing has exceeded that of all other major nations during the '80s.

6. With consumers' expenditure also extremely buoyant, domestic demand probably grew by almost 7 per cent in 1988, faster than the economy's capacity to supply. This has led to an increase in inflationary pressures and a widening in the current account deficit. The RPI has grown by 7½ per cent over the past year, though the underlying inflation rate (excluding mortgage interest payments) currently stands at 5½ per cent; published figures put the current account deficit at around £14½ billion in 1988, but with a very large positive balancing item in the external accounts this may well overstate the true deficit.

7. Since the Summer, monetary policy, which must necessarily play the key role in combating inflation, has been tightened sharply to deal with the emerging inflationary pressures. Some slowdown in real growth is probably inevitable while inflation is being brought firmly back onto a downward path. Following two years of above average growth, the Chancellor expects growth to be somewhat below trend over the coming year: it is forecast at about 2 per cent from now until the beginning of 1990. But even so, GDP in 1989 as a whole is forecast to be 2½ per cent higher than in 1988, with the non-oil economy up by 3 per cent. Business investment is forecast to continue growing strongly, with a rise of 8 per cent. Inflation as recorded by the RPI is forecast to come down to 5½ per cent by the end of the year and 4½ per cent by the middle of 1990.

8. The slowdown in domestic demand should lead in due course to an improvement in the current account. But this is unlikely to occur quickly; continued buoyancy of investment will add to imports of capital goods for the time being, and it will take some time before the additions to industrial capacity feed through into better trade performance. The current account deficit this year is thus forecast to be the same as in 1988.

Budget strategy

9. The medium term financial strategy continues to provide the framework for the Government's macroeconomic policy, and this is the tenth occasion on which it has been set out in the FSBR. Although the precise form in which the strategy has been expressed has changed as the economy has itself evolved, the essential objectives remain the same. The overriding aim is to bring down inflation by reducing the growth of money GDP, and ultimately to achieve price stability.

10. Short term interest rates will be held at whatever level is necessary, for as long as necessary, to get on top of inflation. Decisions on interest rates will continue to be based on a comprehensive assessment of monetary conditions, in which particular weight is given to the behaviour of M0 and the exchange rate. The Chancellor is setting a target range of 1-5 per cent for the growth of M0 in 1989-90; the 12 month growth rate is likely to begin the year above this range, but as the deceleration over recent months continues it should fairly soon come back within it.

11. In its early years of office, one of the Government's main objectives was to bring down the rate of Government borrowing. Now the public finances have been completely transformed, with the budget in surplus for the last two years. It seems likely that the outturn in 1988-89 will be a debt repayment of £14 billion. No other major country enjoys a comparable surplus.

12. Although the longer term aim of fiscal policy is a balanced budget, the Chancellor believes that this should be approached gradually. The Chancellor has thus budgeted for a further substantial PSDR of almost £14 billion in 1989-90, before moving gradually back towards budget balance over the medium term.

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Written pre phone call ✓

Spoken to JM. V. happy at proposal (not surprising!). Hansard has a copy (Dillon) of work he has done (we may have seen this before). One of the options – which is listed first (see the first line on chart C) is v. like our option 4(a), the difference being that the contribution is frozen at the entry fee of £2.15 ~~a week~~ a week after until £67 a week ~~...~~ then all up for VAT & charges @ 9% (£67 is the point I think where their system produces no losers). Complicated, though somewhat Calpratesque, & I see little

N

to command it.

2. He has already deferred the ~~8~~ report stage of the Bill to after Easter (Comms 13 April or thereabouts) – he did this when I told him of the ~~C~~ to rule proposal.

3. He is nervous about who needs to know @ DSS. He feels he has to tell Partridge, & of course Ann Bowtell; he will consult her on who, if anyone, else needs to know pre-Budget, & come back to me on this before going any further.

M.

Ch

Main points to make

(1) Definitely planning to do NIC reform.
- keep step at LEL (probably 5%); entry fee
- abolish higher steps; single threshold to 9% (probably at £75pw)
- perhaps raise UEL (not decided yet); if so, consider UPL implications.

(2) Officials here (McIntyre + Speedy) consulting GAD in strict Budget secrecy to refine costings, especially of SERPs implications of raise UEL

(3) Willing to authorise them to consult two <u>named</u> DSS officials, on same terms. Probably <u>Anne Boatell</u> and <u>Michael Lloyd</u> (his boss, <u>Steve Hewitt</u> is too new)

CHANCELLOR OF THE EXCHEQUER

(4) V helpful if Report Stage of SS bill could be delayed until after Easter. Ask her to find suitable pretext.

AH

chex.ps/jmt2/86 **SECRET (ORIEL)**

Sir P Middleton
Mr Wicks
Mr Odling-Smee
Mr Peretz
Miss O'Mara

PLP

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

PRIME MINISTER

FUTURE OF HONG KONG AND SHANGHAI BANKING CORPORATION

I very much welcome the initiative Geoffrey Howe proposes in his minute to you of 3 February. As you know, I have always believed that the current position of the HSBC will not be sustainable as 1997 approaches. I am sure it is right, as proposed, to use the present breathing space to try to find a solution.

I do not think we should lay down, in advance, any absolute preconditions for an acceptable solution. We should take stock once we know what the options are. But I am content for the initial talks to take place on the basis described in the last sentence of paragraph 2 of the draft telegram attached to Geoffrey Howe's minute.

I am copying this minute to Geoffrey Howe, the Governor of the Bank of England, and Sir Robin Butler.

Duncan Sparkes
p.p. **[N.L.]**

6 February 1989