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PART B

1989 BUDGET
BRIEF

8-3-89
8-3-89

14.3.89

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G1 EXCISE DUTY: MAIN POINTS

Customs and Excise and Department of Transport issuing Press Notices on Budget Day.

Other relevant briefs: GG1 Unleaded petrol
GG2 VED
JJ1 EC tax proposals
JJ6 International tax reform and comparisons

Brief contains A General
B Changes in individual duties
C Unchanged duties

A. GENERAL

Factual

(i) 1989 Budget

- No change in main excise duty rates.

- Only changes: Unleaded petrol (See GG1); package of lorry and 'Hackney Carriage' vehicle excise duty (VED) rates. (See GG2).

(ii) Earlier standstill Budgets:

- April 1970, March 1971, March 1972, April 1978 (apart from surcharge on high tar cigarettes), 'caretaker' Budget 1979, March 1987 (except for reduction in tax on unleaded petrol; some minor vehicle excise duty rates; abolition of on-course betting and gaming duty and increase in gaming machine licence duties)

(iii) Historical comparisons: see Annex.

(iv) Total Yield from all excise duties (including VED) £24.2 billion in 1989-90.

(v) Revalorisation (ie duties increased by 6.8 per cent in line with increase in RPI over 12 months to December 1988) would have produced following price increases (incl. VAT):

Beer	1.5p a pint
Table Wine	6.0p a 75cl bottle
Spirits	37.0p a 75cl bottle
Cigarettes	6.5p a packet of 20 KS
Leaded petrol	7.3p a gallon
Unleaded	6.5p a gallon
Derv	6.1p a gallon
VED	£6.80 a car

(vi) Revenue foregone by non-revalorisation (including VED) £1,225 million in 1989-90; £1,320 million in 1990-91.

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(vii) RPI impact effect of revalorisation would have been 0.47 per cent.

(viii) Representations:

- Tobacco industry supported by MPs with cigarette factories in their constituencies argued for freeze, or at most revalorisation. Tobacco Alliance (representing retailers) mounted campaign amongst members arguing for freeze;

- Drinks industry wanted no increase in duties and reduction in the duty on wine exceeding 15 degrees of alcoholic strength; also asked for increased duty deferment period (ie time between date duty falls due and actual payment);

- Spirits industry wanted all drinks taxed at same rate per degree of alcohol;

- Health lobbies (BMA, ASH) argued for significant increase in real level of tobacco taxation, in particular to dissuade young people from smoking;

- Increased tax differential in favour of unleaded petrol supported by Petrol Retailers Association and Freight Transport Association;

- Aviation manufacturers, traders and operators mounted campaign for abolition of duty on AVGAS, to reduce burden on commercial aviation.

(ix) International comparisons: See JJ6.

(x) EC harmonisation: Commission have proposed harmonisation of excise duty rates. At post-Budget 1989 duty levels, changes proposed would require reduction of about 15 per cent in tax on cigarettes; reduction of over 45 per cent in duty on spirits and over 85 per cent in duty on table wine; increase of about 8 per cent in duty on petrol and reduction of over 30 per cent in duty on derv. Government has already made clear that UK has major difficulties with proposals. Unanimity required for adoption (see JJ1).

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Positive

(i) Excise standstill of general benefit to economy by reducing inflationary expectations.

(ii) Buoyancy of Government revenues means other Budget measures can be financed without need for excise duty increases.

Defensive

(i) Return to fiscal fine-tuning of RPI. No. Tackling inflation is key priority. Not sensible to add unnecessarily to inflationary expectations when Government revenues buoyant.

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(ii) Revenue foregone through non-revalorisation could have been put to better use in certain areas of Government expenditure. General buoyancy of Government revenues means additional revenue from excise duties unnecessary. Tackling inflation is key priority.

(iii) Revalorisation used to be "sensible presumption'. Sensible starting point in Budget planning, but not immutable (nor statutory). Has to be examined against other factors, not least Government's overall economic strategy.

(iv) Standstill in first step in move towards EC harmonisation. Government does not consider harmonisation necessary for completion of single market. Has already made clear that UK has major difficulties with proposals.

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B. CHANGES IN INDIVIDUAL DUTIES

Factual

(i) Unleaded Petrol: See GG1

- Tax (duty and VAT) on unleaded petrol reduced by 0.8p a litre (3.6p a gallon) to give tax differential of 3.1p a litre (14.2p a gallon). Typical pump price differential over 4 star thereby increased from about 1.3p to 2p a litre (roughly 6p to 9p a gallon);

- higher rate of duty on 2 and 3 star introduced. Increases tax (duty and VAT) by 0.9p a litre (4.1p a gallon). Ensures price of 2/3 star at least in line with 4 star.

(ii) VED: See GG2

- Number of tax rates for "hackney carriages" - buses, coaches and taxis - cut from 60 to 5; for agricultural machines from 6 to 1, and for rigid HGV class from around 70 to about 60;

- Coach rates increased to cover track costs (wear and tear caused to roads);

- range of selective increases made in VED on rigid goods vehicles to bring total tax burden (VED and derv duty) more into line with articulated vehicles of similar weight.

Positive

(i) Unleaded Petrol: Budget measures will encourage sales of unleaded and help to achieve desirable environmental and health objectives (see GG1).

(ii) Vehicle Excise Duty: Major simplification of tax structure (see GG2).

Defensive

(i) Larger tax differential needed for unleaded petrol. No. Action elsewhere (increased publicity, wider availability, increasing numbers of cars able to use unleaded) will also encourage greater take up.

(ii) Future of unleaded differential. Differential will be reviewed each year as part of Budget planning.

(iii) Why increase coach VED costs? "Hackney carriage" tax class covered track costs (wear and tear on roads) for first time after last Budget increases, except buses and coaches. Coaches currently need 66 seats before pay even as much VED as family car.

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C. UNCHANGED DUTIES

Factual

(i) Tobacco

- Cigarette consumption likely to be marginally higher than if duty revalorised. Underlying trend now static or showing slight increase. In first three quarters of 1988 consumption up about 0.4 per cent on same period in 1987;

- Per capita cigarette consumption about average for EC;

- Cheap imported cigarettes in 1988 accounted for about 8.0 per cent of UK market, down from 9.6 per cent in 1986;

- Direct employment in UK tobacco industry down by over 50 per cent since 1979: reflects streamlined production methods and falling demand, resulting largely from real rice increases.

(ii) Alcohol

- 1989 Finance Bill measures

  (a) Prohibition on blending duty-paid wines extended to made-wines in anticipation of European Commission upholding complaint by Spanish sherry producers that UK blending rules discriminate against imported products by allowing British sherry made wine to secure lower duty burden. British sherry now increasingly produced without duty-paid blending.

  (b) legislation (Alcoholic Liquor Duties Act 1979) to be amended to ensure greater accuracy in determination of original gravity of beer for duty purposes.

- Alcohol consumption likely to be marginally higher than if duty revalorised;

- Per capita consumption lower than in all EC countries except Greece and Ireland;

- Ministerial Group on Alcohol Misuse has focussed over past year on social rather than fiscal measures as best means of tackling alcohol-related problems.

(iii) Hydrocarbon oils

- Consumption of petrol and derv in 1988 22.9 per cent and 13.5 per cent respectively above 1987 levels. Reflects continuing buoyancy of economy and growth in disposable incomes;

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- Revalorisation of all motor taxes would add about £285 million to business costs. Businesses account for about one third of petrol consumption and virtually all of derv;

- Minor oils at standstill since 1980 except duty on gas oil increased in 1986 to recoup revenue lost from abolition of duty on aviation kerosene (AVTUR) and lubricating oil.

(iv) VED

- No change in VED rates on cars, light vans and motor cycles.

(v) Other Excise Duties

- No change in betting and gaming duties;

- No change in duties on matches and mechanical lighters.

Positive

(i) Tobacco

- Duty on tobacco (including VAT) still up over 40 percent in real terms since May 1979. Fell in real terms under Labour Government, 1973-1979;

- Fall in real value of cigarette duty over 1988 will help UK industry to remain competitive in face of cheap imports and thereby help to safeguard jobs;

- Seventh successive standstill for pipe tobacco will benefit areas of high unemployment - 50 per cent produced in Northern Ireland - where most manufactured;

- Benefits small shopkeepers; newsagents, tobacconists, confectioners and other retailers;

- Positive action on health already taken by making available £6.6 million over three years for campaign aimed at discouraging smoking by teenagers.

(ii) Alcohol

- Consumption per capita lower than in all EC countries except Greece and Ireland;

- Fourth successive standstill for spirits duty, benefits industry, especially in Scotland, in which market still relatively fragile.

(iii) Hydrocarbon oils

- Standstill in petrol/derv duties and most VED means only about £20 million increase in business costs;

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- No increase in heavy oil duty benefits industrial users.

Defensive

(i) Maintain real level of duty on cigarettes because of health risks:

- Cigarette consumption given only marginal upward nudge by failure to revalorise. Consumption down since 1979 by over 20 per cent. Slowing of downward trend in smoking in 1988 largely due to growth in disposable incomes rather than to tax treatment;

- Recent trend for smokers to respond to duty increase by switch to lower priced, mainly imported, cigarettes, rather than to reduce or give up smoking, to detriment of UK industry;

- Standstill will help employment prospects in UK tobacco industry - factories in areas of high unemployment: eg Northern Ireland, Northern England, South Wales;

- Duty on cigarettes still second highest in EC (after Denmark).

(ii) Duty standstill on tobacco inconsistent with 'Europe Against Cancer' campaign: Chancellor's Budget judgement takes account of economic, employment and revenue considerations as well a health arguments. Positive action on education already being taken under 'Europe against Cancer' campaign.

(iii) Drinks duty standstill for third out of four years will encourage excessive consumption:

- great majority of consumers drink within sensible limits, whatever tax levels; consumption down 8.5 per cent since 1979;

- 1988 Budget measures gave worthwhile boost to low alcohol product;

- Beer consumption accounts for greater part of alcohol drunk in UK. Duty level (including VAT) still over 30 per cent higher in real terms than in May 1979;

- Duty on beer, spirits and fortified wine still higher than in all EC countries except Denmark and Ireland (and on table wine only higher in Ireland);

- Will encourage employment eg in Scotland where most whisky produced and about 80 per cent of jobs in spirits industry located;

- Duty (including VAT) on drinks overall up 5 per cent in real terms since May 1979 (see Annex);

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(iv) Extend period of duty deferment for wines and spirits: Not justified. Trade will benefit from standstill. Doubling period of deferment for all wines and spirits would cost about £270 million in year of introduction, about £465 million if extended to all drinks.

(v) Fairer if all drinks taxed according to alcoholic strength (spirits industry representations):

- Would result in loss of fiscal flexibility and could be administratively more expensive.

- As result of favourable treatment in past 5 Budgets, ratio of spirits duty to beer duty per litre of pure alcohol reduced from 2.7:1 in 1979 to 1.6:1 now.

(vi) Freeze inconsistent with Government's aim to shift balance from direct to indirect taxation. See CC3.

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ANNEX

CHANGE IN REAL VALUE OF THE DUTIES including VAT: 1979-1989

	Notes		Level off duty + VAT May 1979 (see Note 1)	Level of duty post-1989 Budget	Real change % (See note 2)
Beer	(3)	p/pint	8.1	21.7	31.8
Table Wine	(3)	p/75cl	57.9	88.3	-24.9
Spirits	(3)	£/75cl	3.38	5.44	-20.8
Tobacco	(3)&(4)	p/20KS	25.4	73.0	41.4
Leaded Petrol	(2 star		33.8	111.9	62.9
	(4 star		33.8	106.9	55.6
Unleaded Petrol			33.8	93.1	35.6
Derv	(3)&(6)	p/gal	37.8	90.4	17.7
VED	(7)	£/Car	50.00	100.0	-1.6
ALL DRINKS	(8)				5
ALL TOBACCO	(9)				40

Notes

(1) Includes VAT on the duty only, not total VAT on the good as that would depend on the total price.
(2) Based on RPI from April 1979 (last full month of Labour Government) to December 1988 (latest available).
(3) Rate of VAT 8 per cent in May 1979, 15 per cent in 1989
(4) Based on specific duty only: August 1979 figure used because duty restructured.
(5) Rate of VAT 12.5 per cent in May 1979, 15 per cent in 1989.
(6) Most users able to reclaim VAT.
(7) VAT not chargeable.
(8) Beer, all types of wines, spirits and cider.
(9) Cigarettes and minor tobacco duties.

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G2 VAT: MAIN POINTS (INCLUDING CAR TAX)

Customs and Excise issuing Press Notices on Budget Day

Other relevant briefs:

C3	Fiscal projections
CC3	Burden of taxation
FF1	VAT deregulation
GG3	VAT on non-domestic construction etc
GG4	R&D cars
JJ1	EC tax proposals
JJ2	Charities
JJ6	International comparisons

Factual

(i) Budget 1989 changes

(a) Implementation of European Court of Justice (ECJ) ruling on 21 June 1988, against UK zero-rating of:

- commercial construction and civil engineering;
- supplies of fuel and power to businesses;
- supplies to industry of water and sewerage services;
- supplies to employers of protective boots and helmets;
- news services other than those supplied direct to public or for production of zero-rated products eg newspapers;

and minor property changes (see GG3).

(b) Extension of reliefs for charities: (see JJ2)

- exemption for charity and certain other fund-raising events;
- extension of zero rate to medical sterilising equipment and certain classified advertising and other types of advertising.

(c) - VAT registration limit to be increased to £23,600 a year and £8,000 a quarter from 15 March 1989 and deregistration limit to be increased to £22,600 from 1 June (see FF1).

(d) Extension of relief to allow car manufacturers to reclaim input tax on unused cars imported or acquired for research and development purposes (see GG4).

(e) Existing extra-statutory reliefs from tax and duty for diplomats, members of international organisations and visiting forces to be put on statutory footing. Power to impose sanctions for breach of conditions of relief to be introduced.

(ii) No change in 15 per cent VAT rate.

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(iii) VAT yield: £29,920 million in 1989-90.

(iv) Major VAT changes under this Government:

1979: Single rate of 15 per cent (formerly standard and higher rates of 8 per cent and 12½ per cent).

1984: Scope widened to include hot take-away food and drink and building alterations; tax made payable at time of importation.

1985: Scope widened to include press advertising. Wide range of changes to VAT enforcement powers provided for as result of Keith Committee recommendations.

1987: Measures introduced to help small businesses - including cash and annual accounting schemes.

(v) Government policy and commitments

(a) Extension of VAT Base. During 1987 general election campaign, Prime Minister pledged Government would not impose VAT on food, fuel and power or young children's clothing and shoes. Re-iterated in Prime Minister's Questions: "we shall continue to have zero-rating on food, that is crucial. The question then arises about electricity, gas and fuel. It is not our intention to put VAT on those. If anyone tried to put VAT on children's clothes and shoes, they would never get it through the House" (OR vol 119 no 13 col 192, 7 July 1987).

Chancellor said in House "We made a number of pledges during the general election campaign on VAT. All those pledges will be honoured. As for any other matters, we shall stick to the convention, which I think is right, that statements are made at the time of the Budget and at no other time" (OR vol 123 no 52 col 371, 26 November 1987).

Pledges repeated on subsequent occasions and remains the position.

(b) During 1987 general election campaign Prime Minister said UK could not accept European Community (EC) proposals which restricted right to apply VAT zero rates. (Press Conference 29 May 1987). Frequently confirmed, eg by Economic Secretary in written reply "The Government's position, which has been repeated on numerous occasions, is that we are not prepared to accept proposals which would restrict our ability to apply VAT zero rates. Our position is safeguarded because changes to EC tax require unanimity' (OR vol 132 no 143 col 401, 3 May 1988).

(vi) EC tax proposals (see JJ1) Commission proposes VAT standard rate band of 14 to 20 per cent; and reduced rate band of 4 to 9 per cent as part of plans to complete internal market. No provision for UK to retain zero rate. But Commission has hinted at possibility of (temporary) derogations to Member States "in cases of particular difficulty".

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Proposals formally presented by Lord Cockfield on 16 November 1987 at ECOFIN. Chancellor put forward alternative, market based approach at ECOFIN Council in September 1988. Both approaches remain on table.

(vii) VAT rates in EC countries: See JJ6.

(viii) Effects of rate increase: A one percentage point increase (assuming 1 April start):

- would yield £1,300 million in 1989-90 (about £1,775 million in 1990-91);
- but extra revenue from further percentage point rises would decline proportionately, because expenditure on goods on which VAT was levied would fall. (Effect of percentage point decrease around same as increase);
- would have 0.45 per cent impact effect on RPI.

(ix) Car tax:

- 1989 Budget change: relief for vehicles leased to disabled (See JJ2);
- No change in rate: 10 per cent on wholesale price of all new cars and motorcycles;
- Yield: £1,415 million in 1989-90:
- Representations: Society of Motor Manufacturers and Traders (SMMT) no longer pushing for immediate abolition; looking for phased abolition by 1992. Few other representations.

Positive

(i) No increase in VAT rate.

(ii) Only major changes in scope arise from ECJ ruling. Based on ECJ's interpretation of Sixth VAT Directive. No appeal against judgement - UK has Treaty obligation to comply. Government has sought to minimise tax and compliance burden of ruling (See GG3).

(iii) Package of deregulatory measures offers significant relaxation of burdens of business (see FF1).

(iv) VAT reliefs for charities extended (See JJ2)

(v) Car tax relief introduced for vehicles leased to the disabled (See JJ2).

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Defensive

(i) Reduce VAT rate:

- Reduction inappropriate when Government policy has been to shift burden of taxation towards taxes on spending (see CC3);

- Cut in VAT rate would have high revenue cost: [see factual (viii)].

(ii) Reduce VAT rate rather than freeze excise duties: Government does not wish to use VAT rate as fiscal regulator. Has not changed VAT rate since 1979.

(iii) Raise VAT rate to curb spending: Government's priority to maintain downward pressure on inflation. Only effective way to do this is through movements in interest rates.

(iv) Widen VAT base to cover newspapers, housing, etc: Zero rate pledges on food, fuel and power, young children's clothing and footwear are firm commitments Government stands by. That apart other options kept open.

(v) EC tax approximation and future of zero rate:

- UK firm believer in benefits of Single Market. But has ensured (eg by keeping unanimity for changes in EC tax law) that national interests safeguarded.

- Approximation not essential to removal of fiscal frontier controls. Nor is abolition of zero rates: many zero-rated items not tradeable across frontiers (eg construction services, internal passenger transport).

- No tax on food (or other items) without UK's positive agreement.

(vi) Buoyant VAT revenue: (see C3).

(vii) Why no extension of bad debt relief/changes to default surcharge regime after reviews in 1988? Potentially costly measures; not top priority in prudent, cautious Budget.

(viii) Relax entry requirements for cash accounting. Scheme's operation now being reviewed. Current scheme required EC derogation which will constrain any future changes.

(ix) Abolish guarantee for VAT deferred at import (CBI, ABCC representations).

- significant amount of revenue at risk (£12.3 billion VAT collected at import in 1987-88.)

- enforcement action to recover bad debts would be time consuming and resource intensive.

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- under EC law, mandatory to provide guarantee to defer customs duties - practical to treat VAT in some way.

(x) Abolish VAT between registered traders: Working party, including trade representatives, carried out study and recommended against change. Would increase burden for retail sector and increase opportunities for evasion. Not permitted by EC legislation.

(xi) VAT visits system oppressive: No. VAT is self-assessed tax controlled by visits and verification in arrears at relatively infrequent intervals. Non-compliant and large traders visited more often.

(xii) Traders should be allowed to deduct compliance costs from VAT payments: returns and payments not required until one month after end of accounting period. On average traders have 2½ months to collect VAT charged before paid to Customs. Already allow traders with annual turnover below £250,000 to account for VAT:

- annually instead of quarterly and given extra month to fill in annual return

- on cash paid and received.

Deduction of compliance costs would require more stringent documentary requirements.

(xiii) Compliance costs too heavy: Independent report due shortly (Professor Sandford of Bath University). Government will consider carefully.

(xiv) Phase out car tax:

- Revenue from tax forecast to be £1,415 million in 1989-90, would have to be recouped elsewhere;

- Foreign penetration of car markets means large proportion of any increased demand would be met by imports;

- Government response to Trade and Industry Select Committee rejected Committee's recommendation to abolish: "The imposition of car tax has regard to a range of factors besides the particular circumstances and prospects of the UK based car manufacturing industry ..... Government does not at present consider that expansion of the UK industry is in any significant way held up by an insufficiency of domestic demand which has been at record levels in each of the past four years.

(xv) Diplomats, visiting forces etc being favoured at tax payers' expense. No. Such organisations have internationally agreed right to relief. Change relates only to legal basis of reliefs, not scope.

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BUDGET REPRESENTATIONS

Factual

PERSONAL TAXATION

Organisations

(i) Widespread support for increase in earnings threshold for taxing benefits-in-kind.

(ii) Representations from car companies and traders supported freeze or increase in line with inflation on car scales.

(iii) Some support eg. Institute of Directors, British Institute of Management, Union of Independent Companies for increase in personal allowances above statutory indexation.

(iv) Some support for increased tax incentives for PEPs: eg from stock Exchange, Wider Share Ownership Council, Centre for Policy Studies.

(v) Limited support for increased tax relief on personal savings.

(vi) Limited support for increase in MIRAS threshold.

Minor Organisations, MPs and members of the Public

(i) Widespread support for concessions for elderly, particularly increased age allowance and tax exemptions for pensioners' savings and pensions.

(ii) Considerable support for increased thresholds and personal allowances, particularly for low paid.

(iii) General support for tax incentives for saving.

(iv) Limited support for a reduction in basic rate tax but this almost equalled by support for freeze on basic rate.

(v) Some support by individual company car users, particularly travelling salesmen, for freeze in car scales - a smaller number supported a reduction.

(vi) Some support for increase in benefits-in-kind threshold, mainly from company car users.

(vii) Limited support for increase in MTR threshold.

CAPITAL GAINS TAX (CGT)

Organisations

(i) Some support for roll-over relief on sale of assets if reinvested.

(ii) Institute of Directors proposed a reduction in CGT rates.

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(iii) Some support for tapering instead of indexation.

Minor Organisations, MPs and members of the Public

(i) Limited support for a reduction in the rate of CGT.

INHERITANCE TAX (IHT)

Organisations

(i) Number of organisations including Institute of Directors, supported increase in threshold to between £200,000 and £250,000. Some proposed reduced rates.

(ii) The Landowners Group and Motor Agents both proposed abolition. The Small Business Bureau advocated abolition for unquoted businesses.

(iii) Royal Institute of Chartered Surveyors and Country Landowners Association favoured special treatment for sites of scientific interest.

Minor Organisations, MPs and members of the Public

(i) General support both for increase in threshold or abolition.

STAMP DUTY

Organisations

(i) Number of organisations including Stock Exchange and British Invisible Exports Council supported abolition on securities.

(ii) Some support for raising threshold on houses to £60,000.

Minor Organisations, MPs and members of the Public

(i) About equal support for an increase in the threshold on houses or abolition.

Business Taxation

Organisations

(i) General support for reduction in rate of Corporation Tax - the Association of British Chambers of Commerce suggested reduction of 2 per cent.

(ii) Some support, including National Chamber of Trade for increasing small companies' lower and upper thresholds.

(iii) Wider Share Ownership Council proposed revision of liability to Corporation tax for companies introducing approved profit sharing or SAYE schemes.

(iv) British Invisible Exports Council proposed relaxing treatment of unrelieved ACT.

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(v) Building Employees Federation proposed tax incentives for urban regeneration.

(vi) Association of Independent Businesses suggested raising Business Expansion Scheme limit to £1 million and extending limit for land/building companies to £250,000.

(vii) Association of British Chambers of Commerce and AIB proposed an easing of BES restrictions on relations and partners.

Minor Organisations, MPs and members of the Public

(i) Some support for a reduction in Corporation Tax.

CAPITAL ALLOWANCES

Organisations

(i) Number of organisations including Association of British Chambers of Commerce proposed extension to commercial buildings.

(ii) Several organisations advocated 100 per cent allowances on investment of up to £50,000.

(iii) Society of Conservative Accountants advocated 100 per cent allowance in year of acquisition for anti-pollution equipment.

(iv) General Council of British shipping proposed a 50 per cent first year allowance for ships.

(v) British Invisible Exports Council sought a reduction in conditions applying to writing-down allowance for export leases.

(vi) The National Farmers Union proposed the reinstatement of 100 per cent Agricultural Building Allowance.

Minor Organisations, MPs and members of the Public

(i) Some representations supporting an increase in capital allowances.

VALUE ADDED TAX (VAT)

Organisations

(i) Several organisations including Institute of Directors were against any extension of VAT.

(ii) Chartered Institute of Management Accountants proposed easing the rules for donations to educational establishments.

(iii) Association of Independent Businesses proposed extending the VAT payment period to 2 months.

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(iv) Joint Taxation Committee of the Construction Industries Group proposed a reduced rate of VAT for work on existing housing stock.

(v) Charities VAT and Tax Reform Group proposed relief from VAT for all medical equipment.

Minor Organisations, MPs and members of the Public

(i) General support against extending VAT to books and newspapers.

(ii) Some support for concessions to charities.

EXCISE DUTIES

Organisations

Tobacco - BMA, ASH and Health Education Authority proposed substantial increases in tobacco duty.

- Tobacco Advisory Council and Institute of Directors proposed freezing tobacco duty.

Alcohol - Representatives of drinks industry urged freeze or limited increase in duty, and proposed extension of duty deferment period from 4 to 8 weeks.

- Scotch Whisky Association proposed that all drinks should be taxed equally on basis of alcoholic strength.

Petrol - General support for significantly increased tax differential in favour of unleaded petrol.

VED - Some support for freezing VED rates.

Car Tax - Some support for abolition of special car tax.

Minor Organisations, MPs and members of the Public

(i) By far the greatest number of all Budget representations received were from those advocating an increase in tobacco duty.

(ii) Considerable number supported a freeze on tobacco duty (newsagents orchestrated campaign).

(iii) Some support for increasing duty on alcohol and reduction in duty on low alcohol beers and wines.

(iv) General support for further concessions for unleaded petrol.

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BB1 UK ECONOMY: RECENT DEVELOPMENTS

This brief includes:
- A Activity
- B Inflation
- C Labour Market

Other relevant briefs:
- B2 Statistical adjustments
- B1 Industry Act forecast of UK economy
- BB2 World economy and international comparisons
- BB3 Balance of payments, oil and competitiveness
- BB4 Manufacturing and industry
- CC3 Interest and exchange rates

A ACTIVITY

<u>Factual</u>

(i) GDP and components (1985 prices)

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	per cent changes on previous period		
	1981H1 to first 3 quarters of 1988 average annual rate	1988Q3 on 1988Q2	1988Q3 on 1987Q3
Consumers' expenditure*	3¾	2¼	6
General government consumption	1	-½	-½
Domestic demand	[+3¾]	[-¼]	[+3¼]
Fixed investment	5	-3¾	5¾
Exports of goods and services*	3¾	-½	-¼
Imports of goods and services*	7½	5¾	12½
GDP (A)	3	1¼	3½

* Q4 data also available - see below

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(ii) <u>Consumers' expenditure</u> Rose by 1½ per cent (preliminary estimate) between 1988Q3 and Q4 to level 5½ per cent higher than a year earlier. In 1988 as a whole up 6¼ per cent on 1987 following increase of 5½ per cent in 1987.

(iii) <u>GDP(O)</u> Flat (preliminary estimate) between 1988Q3 and Q4. But 3¼ per cent higher than a year earlier. In 1988 as a whole up 4½ per cent on 1987 following increase of 4¾ per cent in 1987.

(iv) <u>Industrial production</u>: See BB4.

(v) <u>Personal saving ratio</u>: Fallen from nearly 14 per cent in 1980 to 5 per cent in 1987 and 2½ per cent in the first three quarters of 1988.

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(vi) Latest indicators of demand

		Retail sales (1980=100)	Change in consumer credit (£ million per month)	EC/Gallup consumer confidence (balance)	Building Society (£ billion per month) lending	commitments
1987	Q3	131.5	264	7	1.2	3.1
	Q4	133.3	350	5	1.4	3.5
1988	Q1	135.3	322	5	1.8	4.5
	Q2	137.0	368	7	2.1	4.9
	Q3	139.2	364	2	2.4	4.3
	Q4	140.8	291	-7	1.9	3.7
	December	140.8	295	-12	1.7	3.3
	January	137.4	-	-12	1.9	3.3
	February		-	-11	-	-

In latest 3 months retail sales unchanged on previous 3 months, and 4½ per cent higher than year earlier.

(vii) Fixed investment: (see also BB4.)

	percentage changes 1988 Q3 on 1988Q2	1987Q3	1981Q1	1979H1	1979H1on 1974H1
Total fixed investment	-4	5½	43½	23½	1½

(viii) Trade volumes and current account: (See also BB3.)

- Current account deficit of £14.7 billion in 1988, around [3] per cent of GDP.
- Non-oil export volumes of goods (less erratics) in 1988 up 3½ per cent on 1987.
- Non-oil import volumes of goods (less erratics) in 1988 up 14 per cent on 1987.

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Positive

(i) Average annual growth likely to turn out at over 3 per cent in eight years to 1989, compared with 2 per cent annual growth in 1970s. Seven years to 1988 have seen combination of strong and steady growth not matched since War.

(ii) UK grown faster than all major EC countries since 1980. Contrast with previous two decades when UK bottom of league.

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(iii) Growth broadly based: Investment grown by [6¼] per cent a year since 1981 faster than consumption 3¼ per cent. Exports grown by 3¼ per cent a year. In 1989, both fixed investment and exports forecast to rise faster than consumer spending. (See also B1.)

(iv) Volume of total fixed investment at all time high in first three quarters of 1988, up 9 per cent on same period in 1987. CBI survey (January) and DTI investment intentions survey (December) report investment intentions remain strong. (See also B1)

Defensive

(i) Economy heading for hard landing: See B1.

(ii) No sign of consumer slowdown: No. Latest figures show retail sales in January 2½ per cent down on December and latest 3 months unchanged on previous 3 months. Consumer confidence at very low level. (See factual vi)

(iii) Growth slowing in 1989: See B1.

(iv) Investment falling?: Investment grew strongly in 1988 up [ ] on 1987. Investment intentions point to further strong growth in 1989. Quality of investment improved, as evidenced by strong productivity and profitability performance. (See also BB4).

(v) Personal saving ratio too low: Difficult to measure and subject to substantial and frequent revision. Falling personal saving ratio in recent years reflects greater confidence in future, with people having lower inflation expectations and higher wealth. In addition, employers' contributions to pension funds have fallen (treated in national accounts as personal saving). Companies' saving and public sector saving have risen leaving total saving broadly unchanged over 1980s.

X ~~(vi) Use of adjusted statistics. See brief B2.~~

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B INFLATION

Factual

(i) Retail price inflation

- Annual increase of 4.2 per cent in 1987 and 4.9 per cent in 1988.
- Rose from 3.3 per cent in January 1988 to 7.5 per cent in January 1989.
- Excluding mortgage payments, risen from 3.7 per cent in January 1988 to 5.0 per cent in July and 5.5 in January 1989.
- Rise in RPI inflation in recent months largely reflects higher mortgage rates, but underlying inflation has also edged up.

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(ii) Latest inflation figures (per cent change on year earlier)

	RPI	RPI excluding mortgage interest payments	TPI	Producer input prices	Produces output prices
November	6.4	5.1	4.4	4.4	4.9
December	6.8	5.1	4.8	4.7	4.9
January	7.5	5.5	5.6	5.7	5.3

(iii) GDP deflator (per cent change on year earlier)

1987	4.8
1988Q1 - Q3	6.0

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(iv) Underlying rate of increase in average earnings risen from 8½ per cent at start of 1988 to 8¾ per cent in December. Annual increase reached a peak of 9¼ per cent in late summer - fall since then reflects last year's high service sector settlements dropping out of the twelve month change.

(v) Unit wage and salary costs in whole economy rose by 5.7 per cent in year to 1988Q3. Part of the increase (- per cent) due to effects of lost output from the North Sea following Piper Alpha disaster. (See BB4 for manufacturing.)

Positive

(i) Retail price inflation averaged 5 per cent in past 5 years.

(ii) Tax and prices index (TPI) risen by 5.6 per cent in year to January means pay rise of about 5½ per cent would be sufficient to compensate an average taxpayer for price increases over past year.

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Defensive

(i) Inflation on upward trend: RPI inflation risen since early 1988, mainly because we - unlike most other industrial countries - include mortgage interest payments in our inflation measure. Annual increase in RPI excluding mortgage interest payments in a full 2 points below increase in all items RPI. But underlying inflation has also risen. RPI inflation forecast to rise a little further in [first half of 1989] before falling back to [5½] per cent in 1989 Q4 (see also B1.)

(ii) Earnings on upward trend: Certainly settlements rising faster than desirable and this threatens prospects for continued fall in unemployment. But recent rise in earnings growth also reflects performance related factors such as overtime and bonus payments, especially in manufacturing, which have been largely offset by growth in productivity.

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C LABOUR MARKET

Factual

(i) Summary of latest statistics

seasonally adjusted, GB, unless otherwise stated

	Level	Thousands Change on previous period	Change on previous year
Unemployment (UK): September			
Total (seasonally adjusted excluding school leavers)	1,988	-49	-531
- per cent of workforce	(7.0)		
'Headline Total' (not seasonally adjusted)	2,074	+28†	-648†
- per cent of workforce	(7.4)		
Long-term unemployment (over one year) (UK, unadjusted) January (quarterly series)	821	-64†	-279†
Youth unemployment (aged under 25) (UK, unadjusted) January (quarterly series)	596	-10.3†	-178
Unfilled vacancies (UK): January	229	-9	-22
Whole economy workforce in employment (GB): 1988Q3	25,807	+168	+731
Manufacturing employees (GB): December	5,154	+11	+37

† figures distorted by change in regulations for claimants under 18 (monthly change only slightly affected.)

(ii) Growth in labour force (GB)

Thousands	1985	1986	1987	1988	1989	2990
	+248	+171	+232	+335	+324*	+138*

* Department of Employment projections

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(iii) Industrial disputes (UK): December

	Latest 12-month period	Previous 12-month period	Annual average: 10 years to August 1987
Number of strikes	725	1,016	1,443
Working days lost (million)	3.8	3.5	10.3

(iv) January seasonally adjusted unemployment fell below 2 million for the first time since February 1981.

(v) Unemployment trend Average monthly fall in seasonally adjusted adult total of 47,000 during last six months.

(vi) Unemployment rate on standardised (ILO/OECD) definition: 7.3 per cent in December (latest figure) compared with, 7.2 per cent on UK definition (adult, seasonally adjusted) definition.

(vii) Effect on unemployment count of changes in regulations for under-18s. New benefit rules (effective from 12 September) mean that most under 18 year olds ineligible to claim Income Support. New seasonally adjusted series, restricted to those aged 18 and over, introduced with October figures. This is a full back series on consistent basis.

(viii) Manufacturing employment: Downward trend now leveled off. During 1988Q4 rose by 4,000. In 1988 as a whole vartually unchanged following fall of 33,000 in 1987. (See also BB4).

(ix) Stock of unfilled vacancies at Jobcentres: Fell by 9,000 in January to 229,000. Slight fall on year earlier but still high. Whole economy vacancies probably around 3 times as many in number.

(x) Results of 1988 Labour Force Survey: On ILO/OECD definition of unemployment - those without job, available for work and seeking work in previous 4 weeks

- on ILO/OECD definition, unemployment fell by 505,000 between spring 1987 and spring 1988, while claimant count fell by 540,000. The difference is well with in margin of survey error.
- 2.37 million unemployed in spring 1988 on ILO/OECD definition, 40,000 lower than claimant count;
- 790,000 claimants either working or not looking for work;
- but 750,000 non-claimants were looking for work in reference period;

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Positive

(i) Unemployment (seasonally adjusted adult) below 2 million for first time since February 1981.

- Fallen for thirty months in succession since July 1986, by 1.1 million in total; longest period of falling unemployment since War.

- Fallen by well over ½ million in year to January.

(ii) Unemployment rate fallen faster in UK than in any other major industrial country over past year. UK unemployment rate now well below EC average.

(iii) Unemployment rate fallen in all regions over past twelve months. Fallen fastest in West Midlands, and Wales, but large falls in all regions including Northern Ireland.

(iv) Long term unemployment fallen by record half million in two years to January 1989. Number of long-term unemployed falling faster than unemployment as whole in all regions of UK.

(v) Employment rising continuously for more than 5 years. Employees in employment increased in each of last 22 quarters, and by more than 1 million in total. Over 2¾ million jobs created since 1983, more than any other EC country.

(vi) Self employment risen in every year since 1979. Total increase over 1 million, or 60 per cent, getting on for seven times as much as in previous 20 years.

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Defensive

(i) Fall in unemployment count just due to Restart, availability testing and employment measures. No. Fall in unemployment due to strong growth in output and employment, built on success of Government's sound financial and economic policies, which have contributed to creation of 2¾ million new jobs since 1983. Number of people covered by employment/ training measures hardly changed overall in past year, and effect of administrative schemes difficult to identify but small in comparison with overall fall in unemployment.

(ii) Recorded fall in unemployment largely due to fiddled figures? No. On standardised ILO/OECD definition unemployment 7.3 per cent in December (latest figure) on UK definition 7.2 per cent (UK seasonally adjusted). ILO/OECD definition shows fall in unemployment of half a million between Spring 1987 and spring 1988 - very similar to fall in

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claimant count, level of unemployment also very similar to claimant count.

(iii) Changes to benefit regulations yet another fiddle to unemployment statistics. No changes in underlying method of counting number of unemployed. Some impact on count inevitable as result of changes in rules and arrangements for paying benefit, but cannot avoid these changes just to maintain continuity of statistics. No intention of hiding them or of

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giving misleading impression of trend in unemployment. Full back series on revised basis has been compiled.

(iv) Much of increase in employment part-time jobs for women. No. Over half of new jobs created since March 1983 full time. About half of increase in female employment since March 1983 is part time. Nothing wrong with this; benefits both employees and employers. Indicates flexibility of labour market that industry prepared to offer employment opportunities that suit women with young children.

(v) Model simulations show tax cuts produce fewer jobs than extra infrastructure spending. Model simulations of limited value, since do not allow for all relevant supply-side effects and thus full benefit for jobs in long run. Attempts to boost employment by more spending and borrowing lead only to higher inflation. Spending decisions must be based on own merits, not short-run effects on employment.

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BB2 INTERNATIONAL COMPARISONS AND WORLD ECONOMY

Other relevant briefs BB1 UK economy recent development
BB4 Industry and manufacturing

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Factual

Note: Figures for UK adjusted to produce more coherent accounts. ~~Adjusted figures in italics(see B2)~~

(i) Real GDP growth annual average percentage change

	1960-1970	1970-1980	1980-1988*	1986	1987	1988*
United Kingdom	**2.9**	**1.8**	**2.6**	**3.2**	**4½**	**4½**
United states	3.8	2.7	3.1	2.8	3.4	3.8
Japan	10.5	4.6	4.0	2.4	4.3	5¾
Germany	4.5	2.7	1.7	2.3	1.8	3.4
France	5.6	3.3	1.9	2.1	2.3	3½
Italy	5.7	3.1	2.1	2.9	3.1	3¾
Canada	5.2	4.6	3.2	3.2	4.0	4¼
Major 7	5.3	3.1	3.0	2.7	3.4	4¼
EC	4.7	2.9	2.1	2.6	2.8	3¾

* Includes OECD estimates for 1988 for Japan, France, Italy Canada major 7 and EC. FSBR estimate for UK.

Source: OECD, CSO, FSBR.

(ii) GDP levels (US dollars): 1987

	per capita ($ thousand)	total GDP ($ billion)
United Kingdom	**12.3**	**703**
United States	18.3	4473
Japan	13.2	1609
Germany	13.3	815
France	12.8	712
Italy*	12.25	703
Canada	17.2	442

* OECD have used Italian national figures, which include allowance for black economy and are doubtfully comparable with others.

Source: OECD, using purchasing power parities

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(iii) Investment growth (annual average percentage change)

	Whole Economy 1970-1980	Whole Economy 1980-1988**		Business* 1970-1980	Business* 1980-1988**§
United Kingdom	**0.4**	**[3.1]**	**United Kingdom**	**2.3**	**[5.7]**
Germany	1.4	0.7	United States	3.7	3.2
France	2.5	0.7	Japan	2.8	8.1
Italy	1.1	1.4	Germany	1.8	2.2
Belgium	2.2	-0.1	France	2.4	1.5
Luxembourg	2.7	0.1	Italy	2.0	1.7
Netherlands	0.2	1.7	Canada	7.5	4.1
Denmark	-0.8	1.6			
Ireland	5.9	-1.6	G7	3.3	4.2
Spain	1.6	3.7			
Portugal	3.7	2.4			
Greece	2.8	-1.4			
EC12	1.5	1.5			
G7	2.6	3.5			

* OECD definition of private non residential fixed capital formation. This includes investment of privatised companies which increases UK growth rate. Excluding privatised companies reduces UK figure but UK still has second fastest growth among G7.

** OECD estimates for 1988 except UK FSBR estimate.
*** OECD estimates for 1988

Source: OECD, CSO, HMT

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(iv) Manufacturing output (annual average percentage change)

	1974H1-1979H1	1979H1-1988*	1987-1988*
United Kingdom	-0.5	0.8	7.1
United States	3.6	2.7	6.0
Japan	1.9	4.0	9.7
Germany	1.2	1.4	7.0
France	0.7	0.3	5.5
Italy	1.0	1.7	4.5
Canada	2.3	2.4	5.9
Major 7	2.1	2.2	6.7

* Average of 1988Q1-Q3 for all countries except UK (average of whole year) and France (average of 1988Q1-Q2).

Source: OECD, CSO

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(v) Output per worker* (annual average percentage change)

	Manufacturing			Whole economy		
	1960-1970	1970-1980	1980-1988**	1960-1970	1970-1980	1980-1988***
United Kingdom	**3.0**	**1.6**	**5.3**	**2.4**	**1.3**	**2.7**
United States	3.4	3.0	4.0	2.0	0.3	1.2
Japan	8.8	5.3	3.1	9.0	3.7	2.9
Germany	4.1	3.2	2.5	4.3	2.8	1.8
France	6.6	4.1	3.0	5.0	3.1	2.0
Italy	5.9	3.5	3.5	6.2	2.5	2.0
Canada	4.0	3.2	3.4	2.5	1.0	1.4
Major 7	5.2	3.5	3.7	4.1	1.8	1.8

* Total manufacturing employment and total civilian employment.

** Average of 1988Q1-Q3 for all countries except UK (average of whole year) and France (average of 1988Q1-Q2).

*** Includes OECD estimate for 1988 except UK 1988 figure based on GDP(O) figures for 1988 and OECD estimate of employment growth.

Source: OECD, IMF, CSO

(vi) Employment* growth (annual average percentage change)

	1963-1970	1970-1980	1980-1988**	1987	1988**
United Kingdom	**0.1**	**0.2**	**0.1**	**1.7**	**2.1**
United States	2.2	2.4	1.8	2.6	2¼
Japan	1.5	0.8	1.0	1.0	1¾
Germany	-0.1	-0.1	-0.1	0.7	½
France	0.9	0.5	-0.1	0.0	½
Italy	-0.4	0.6	0.3	-0.2	¾
Canada	3.0	3.1	1.8	2.8	3½
Major 7	1.5	1.2	0.9	1.6	1¾

* Total civilian employment

** Includes OECD estimate for 1988.

Source: OECD, CSO

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(vii) Unemployment rates (OECD standardised, per cent of labour force)

	1974	1979	1983	1986	1987	1988	Latest (Jan 1989)
United Kingdom	**2.9**	**5.0**	**11.8**	**11.2**	**10.3**	**8.3**	**7.2**
United States	5.5	5.8	9.5	6.9	6.1	5.4	5.4
Japan	1.4	2.1	2.4	2.8	2.8	2.5	2.3***
Germany	1.6	3.2	8.0	6.4	6.2	6.2	5.9***
France	2.8	5.9	8.3	10.4	10.6	10.3	10.2***
Italy	5.3	7.6	9.3	10.9*	11.8*	na	na
Canada	5.3	7.4	11.8	9.5	8.8	7.7	7.5
Major 7	3.7	4.9	8.2	7.1	6.8	6.2	6.0**
EC (8 largest)*	2.9	5.6	10.5	10.9	10.7	10.2	9.9**

* OECD estimates
** November 1988
*** December 1988

Source: OECD

(viii) Consumer price inflation (percentage change on year earlier)

	December 1986	December 1987	January 1989
United Kingdom	**3.8**	**3.7**	**7.5**
United States	1.1	4.4	4.7
Japan	-0.4	0.5	0.9*
Germany	-1.1	1.0	2.5
France	2.1	3.1	3.3
Italy	4.1	5.1	5.7
Canada	4.1	4.2	4.3
Major 7	1.2	3.4	3.6*
EC	2.0	3.2	4.1*

* December 1988

Source: OECD

(ix) Relative inflation rates (average annual percentage change)

	Major Seven	EC(12)	UK	Difference UK-Major 7	UK-EC(12)
Feb 1974 - Apr 1979	9.0	11.0	15.4	6.4	4.4
May 1979	8.6	8.8	10.3	1.7	1.5
May 1979 - Dec 1988	5.5	7.3	7.6	2.1	0.3
June 1983 - Dec 1988	3.2	4.5	4.9	1.7	0.4
Dec 1988	3.6	4.1	6.8	3.2	2.7

Source: OECD

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(x) Current account balances ($ billion, % of GDP in brackets)

	1986		1987		1988	
United Kingdom	**0**	**(0)**	**-3**	**(-½)**	**-21**	**(-2½)**
United States	-139	(-3¼)	-154	(-3½)	-132	(-2¾)+
Japan	86	(4½)	87	(3½)	80	(2½)
Germany	39	(4½)	45	(4)	48	(4)
France	3	(½)	-5	(-½)	-6	(-½)+
Italy	3	(½)	-1	(0)	-4	(-½)+
Canada	-8	(-2)	-8	(-2)	-8	(-1¾)+

\+ OECD estimates

Source: OECD, CSO, FSBR

(xi) Short-term interest rates (annual average rates, per cent)

	--------Nominal*--------			---------Real**---------		
	1984-1988	**1988**	**27 Feb 1989**	**1984-1988**	**1988**	**27 Feb 1989**
United Kingdom	**10.6**	**10.3**	**13.3**	**5.6**	**5.2**	**5.4**
United States	7.9	7.8	10.1	4.3	3.5	5.2
Japan	5.4	4.6	4.7	4.3	4.0	3.8
Germany	4.9	4.3	6.9	3.7	3.1	4.3
France	9.1	7.9	9.6	4.4	5.0	6.1
Italy	13.6	11.3	12.5	6.1	6.0	6.4
Canada	9.5	9.5	12.2	5.1	5.3	7.6
Major 7	7.9	7.3	9.2	4.5	4.1	5.4

* 3-month money market rates
** nominal rates deflated by 12 month change in consumer price index

Source: Bank of England

(xii) General government financial balance (see CC2).

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(xiii) FSBR forecast for world economy similar to latest assessments from IMF, OECD:

		Estimate	---Forecast---	
Per cent change on a year earlier	**1987**	**1988**	**1989**	**1990H1**
Major 7:				
Real GNP	3¼	4¼	3	2½
Real domestic demand	3¾	4½	3¼	2½
Industrial production	3¼	6	4½	2½
Consumer prices	3	3¼	4	3½
World trade at constant prices:				
Total imports	5½	8½	6¼	5
Manufactures	7¾	10	8	5¾

Source: FSBR Table 3.1

(xiv) IMF, OECD forecasts for Major 7

	1987 (Actual)	1988	1989
Real GDP			
IMF	3.4	4¼	3
OECD	3.4	4¼	3¼
Inflation			
IMF	2.8	3¼	3½
OECD	3.2	3¼	3½
World Trade			
IMF	5¾	7½	5½
OECD	5.7	9	7½

Sources: OECD - Economic Outlook (December 1988)
IMF - World Economic Outlook (October 1988)

(xv) Recent developments in major 7:

(a) GDP growth of over 4 per cent in 1988 - faster than in 1987 (3.4 per cent). Sixth consecutive year of growth; average 1983-88 3½ per cent.

(b) Industrial production in November over 5 per cent higher than year earlier.

(c) Unemployment 1988 fifth consecutive year that unemployment fallen on average in major 7 countries.

(d) Average inflation picked up only slightly in second half of 1988 to 3.6 per cent in December, 0.4 per cent up on a year earlier.

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(xvi) Fiscal policies

(a) US Federal budget deficits outturns and projections

	Fiscal year			
	1987	1988	1989	1990
Outturns	149	155		
Forecasts				
- US administration			170.2	94.8
- Congressional Budget Office				141
Gramm Rudman Target				100

NB: Main reasons for different projections for 1990 are Administration's more optimistic growth and interest rate assumptions. Gramm-Rudman targets have +$10 billion leeway. (Administrations proposed $50 billion bail out of savings and loan industry will have limited cost on 1990 Budget as largely to be financed by new funding body.)

(b) Japan: Central government borrowing requirement expected to decline slightly as proportion of GDP.

(c) Germany: FY1988 Federal budget deficit DM35 billion. FY1989 budget deficit estimated to fall to DM28 billion partly due to increases in taxes on petrol, cigarettes and gas supplies.

(xvii) Monetary policies: Monetary policy tightened in all major countries except Japan in second half of 1988. Interest rates on average 2¼ percentage points above June levels.

(xviii) G7 meeting 2-3 February: G7 Finance Ministers met in Washington as part of ongoing G7 cooperation process. No communique issued but was opportunity for G7 Ministers to become better acquainted with new Bush administration and to discuss a range of international issues of mutual interest, in particular debt.

Positive

(i) 1988 sixth consecutive year of growth in major 7. FSBR forecast (also IMF and OECD) is for continued growth in 1989.

(ii) Major 7 inflation low in 1988 at about 3¼ per cent.

(iii) Unemployment now falling in most major economies. Unemployment rate fallen most in UK over past year.

(iv) World trade growth in 1988 fastest since 1984. Healthy growth to continue in 1989.

(v) UK GDP growth since 1980 highest among major EC countries. Contrast with previous two decades when UK bottom of EC growth league.

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(vi) UK standardised unemployment rate now below average of major EC countries.

(vii) UK manufacturing productivity growth since 1980 (also since 1979) highest among major seven countries; lowest in 1960s and 1970s.

(viii) UK whole economy productivity growth since 1980 only bettered by Japan of major countries. Contrasts with 1960s and 1970s when only US had worse record.

(ix) UK total investment growth fastest of EC since 1980.

(x) UK business investment growth second to Japan of Major 7 since 1980.

Defensive

(i) FSBR forecasts of world economic prospects too optimistic. No. FSBR forecast very similar to those of OECD and IMF.

(ii) World economic growth slowing down. Growth rate in 1988 exceptional. Some deceleration expected in 1989 to more sustainable rates.

(iii) World inflation speeding up. Only slight pick up in inflation expected in 1989. Prompt response of G7 governments shows that remain committed to anti-inflationary policies. Will not sacrifice progress already made on tackling inflation so far in 1980s.

(iv) International cooperation breaking down. No. G7 Finance Ministers met on 3 February. Process of cooperation has contributed to continuing good performance of world economy.

(v) Process of external adjustment has stalled. US deficit and Japanese surplus fell in 1988 in absolute terms and as percentage of GDP from their peak in 1987. As Chancellor said at IMF meetings in Berlin last September, no reason why current account balances should be zero if they reflect efficient distribution of world savings and investment.

(vi) US budget deficit forecast to rise in 1989. Yes. US administration has pledged itself to reduce budget deficit in 1990. We expect that pledge to be implemented.

(vii) Strength of dollar will slow process of adjustment of US external deficit. Dollar moved within relatively narrow range since Louvre. Recent strength of dollar a small movement in context. Important to concentrate on fundamentals not short term market conditions. Continued non inflationary growth in US, Japan and Germany combined with sound budgetary policy in US and further domestic demand growth in Japan and Germany will provide best background.

(viii) Interest rates rises threaten world prosperity. No. Prompt action on interest rates in 1988 was right response to contain inflationary pressures. Resurgence of inflation much greater threat to world prosperity. Nominal short term market rates currently only 1¼ points above average of last five years. Real short term market rates currently only 1 percentage point above average of last five years.

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(ix) UK current account deficit in 1988 larger as percentage of GDP than US deficit. See BB3.

(x) UK interest rates highest in major 7. Interest rates held at level required to maintain downward pressure on inflation.

(xi) UK inflation rate highest in major 7. UK inflation lower when mortgage interest payments excluded. UK inflation performance relative to average of G7 and EC countries was worse before 1979. (See also, B1, BB1)

(xii) Italy overtaken UK as world's fifth economic power. Not true. Latest OECD estimates for 1987 show UK GDP level with Italy. UK grew faster than Italy in 1988.

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BB3 BALANCE OF PAYMENTS

Other relevant briefs:
- B1 Industry Act forecast of UK economy
- BB1 UK economy: recent developments
- BB2 International comparisons and world economy
- BB4 Manufacturing and industry

Factual

(i) Recent developments:

£ billion

Balances	1988	1987 Q4	1988 Q1	Q2	Q3	Q4	Nov	Dec	Jan
Manufactures	-14.4	-2.5	-2.7	-3.4	-3.9	-4.4	-1.3	-1.3	-1.5
Oil	2.3	1.0	0.7	0.8	0.5	0.3	0.1	0.1	-0.7
Other goods	-8.5	-1.8	-2.0	2.0	-2.2	-2.2	-0.7	-0.7	0.1
Total visibles	-20.6	-3.3	-4.0	-4.5	-5.7	-6.3	-1.9	-1.8	-2.1
Invisibles	6.1*	1.3	1.0	1.8	2.1	1.2*	0.4*	0.4*	0.4*
Current account	-14.5	-2.0	-3.0	-2.8	-3.6	-5.1	-1.5	-1.3	-1.7

* Includes CSO projection for 1988Q4 and January 1989

- <u>1988 current account deficit</u> £14.5 billion, about 3 per cent of GDP.

- <u>Current account</u> deficit deteriorated in every quarter (bar one) since 1987Q2. Mainly reflects widening visible deficit, particularly for manufactures, but smaller invisibles surplus also contributed.

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(ii) Current account: recent trends and forecast.

£ billion

	1974-79	1980-86	1987	1988	FSBR Forecast 1989
Manufactures	4.0	-0.4	-7.5	-14.3	-16
Oil	-2.6	4.9	4.2	2.3	2
Other goods	-4.7	-5.9	-6.9	-8.3	-7
Invisibles	2.4	4.8	7.5	6.1	9
Current Balance	-0.9	3.4	-2.7	-14.3	-12

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(iii) Industry Act forecast

(a) 1988 current account deficit estimated to be £11½ billion compared with forecast of £4 billion in last year's Budget.

- Larger deficit than forecast in last year's FSBR mainly due to stronger than expected growth of imports; also lower oil surplus.

- Imports risen strongly reflecting buoyant domestic demand. Recent CBI Surveys show some industries facing capacity constraints and hence a greater part of domestic demand growth satisfied by imports.

- Oil surplus fell by £2 billion in 1988. Result of lower sterling oil prices, decline in production (mainly due to Piper Alpha disaster) and increase in home demand for oil.

(b) 1989 current account deficit forecast to be £11½ billion - same as 1988.

- Forecast of unchanged deficit consistent with imports growing more slowly than exports in 1989, as imports start 1989 from a much higher base level than exports i.e. exports have to grow faster than imports just to leave current account unchanged.

- Oil balance expected to fall further in 1989 reflecting temporary shutdowns in Brent and Fulmar fields.

(iv) Average of City forecasts shows unadjusted deficit of £14.2 billion in 1989.

(v) Exports and imports of goods (incl erratics): volumes

Percentage change

	1988Q4 on 1988Q3	**1988Q4 on 1987Q4**	**1988 on 1987**	**FSBR forecast: 1989 on 1988**
TOTAL (LESS OIL)				
Exports	1 (-2)	6½ (3)	4½ (2½)	7½
Imports	2 (1)	15½(14½)	15 (14½)	4
MANUFACTURES				
Exports	1 (2)	8½ (4)	6½ (4½)	7
Imports	1 (1½)	18 (17)	17½ (17)	na

NB: BOP basis, adjusted estimates in italics, unadjusted figures in brackets.

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(a) Non-oil export volumes erratically low in 1988Q1. But, risen strongly since as world trade has continued to expand. Manufactured export volumes forecast to rise by 7½ per cent in 1989, close to projected growth of world trade.

(b) Non-oil import volumes rose 15 per cent in 1988, reflecting strength of domestic demand and capacity shortages in some industries. Imports of capital and intermediate goods rose fastest (by 22 and 23 per cent respectively) with increase in growth of imports of consumer goods entirely attributable to passenger cars. Further high investment (import intensive) likely to sustain high levels of capital goods imports in 1989. But total import growth forecast to slow markedly as domestic demand slows and extra capacity becomes available from investment boom.

(vi) Terms of trade improved over past year with higher exchange rate more than offsetting falling oil prices. Non-oil terms of trade forecast to show small improvement in 1989 but oil terms of trade expected to improve considerably reflecting rise in North Sea premiums, following recent accidents.

(vii) Recent CBI Surveys. January Quarterly Survey showed export optimism at lowest level since July 1986. February Monthly Enquiry shows export order books subdued for fifth month running.

(viii) Invisibles surplus:

- Estimated to be £8½ billion in 1988, same as 1987.

- OECD Economic Outlook (December 1988) shows UK with largest nominal invisibles surplus in world in 1987.

- Rise in invisibles surplus in 1988 reflected an increase of £1 billion in net earnings from interest, profits and dividends partly offset by a lower surplus on services. Further rise of £½ billion forecast for 1989. Reflects an improvement in services balance and a further rise in net earnings from overseas.

(ix) Net overseas assets estimated at £90 billion at end 1987. Fall of £24 billion during 1987 largely due to revaluations following fall in US dollar. Follows several years of strong growth. Despite fall, only Japan has higher level of net assets. (1988........)

(x) Balancing item averaged £7¾ billion in past four years and was more than £12 billion in first three quarters of 1988. Positive balancing item reflects either better current account than recorded or unrecorded net capital inflows; most likely a combination of both.

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(xi) UK cost competitiveness

		Sterling exchange rate index (1985 = 100)	Relative unit labour costs in manufacturing in common currencies* (1985 = 100)
1986		91.5	91.0
1987		90.1	88.7
1988		95.5	-
1987	Q3	90.5	88.6
	Q4	92.7	92.1
1988	Q1	93.4	92.4
	Q2	96.7	95.4
	Q3	95.2	92.6
	Q4	96.7	98.4

*NB: fall implies improvement in competitiveness

- Manufacturing unit labour costs in UK rose slightly faster in 1988 than 1987; productivity growth not fully offsetting continuing high level of pay increases. Unit labour costs in other major countries grew on average at similar rate to UK. But sterling appreciation resulted in rise in UK's relative unit labour costs.

- Cost competitiveness still more favourable than 1985 before fall in oil prices.

- Forecast assumes exchange rate remains close to recent levels.

- Restraint of unit costs in industry's own hands - key to improved competitiveness.

(xii) Oil Prices

		North Sea average $/bl	Brent Spot Price $/bl	Brent Spot Price £/bl
1985		27.3	27.0	20.8
1986		14.2	14.2	9.7
1987		17.9	18.4	11.2
1987	Q3	19.0	19.1	11.8
	Q4	17.9	18.0	10.3
1988	Q1	16.0	15.9	8.8
	Q2	16.4	16.3	8.9
	Q3	14.6	14.2	8.4
	Q4	13.9	13.7	7.6
March [ ]		[ ]	[ ]	[ ]

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(xiii) Prospects for oil prices

(a) Forward prices on March 1989 $ per barrel)

	April	May	November
West Texas Intermediate	18.5	17.9	16.6
Brent	16.7	16.2	-

(b) Budget forecast assumes North Sea oil price remains close to recent levels, (average of last 4 months).

(c) Average of City forecasts $15.2 per barrel in 1989.

(xiv) North Sea output

(a) Production in 1988, 114 million tonnes. Forecast to fall in 1989 mainly as result of accidents in North Sea (Piper Alpha, Fulmar and Brent D Fields)

(b) Effect on current account. Oil surplus fell from £4.2 billion in 1987 to £2.3 billion 1988. Accident estimated to have worsened current account by upto £½ billion in 1988 impact on 1989 could be as great.

(c) Falling oil output likely to reduce GDP growth by around ½ per cent in 1989.

(d) North Sea investment remained level in 1988. Forecast to rise by 43 per cent in real terms in 1989 (37 per cent excluding accident effects).

(xv) North Sea revenue

	1987-88	1988-89	1989-90	1990-91	1991-92
1987 FSBR	3.9	4	4	4	na
1987 Autumn Statement	4.5	na	na	na	na
1988 FSBR	4.7	3.3	3	3	3
1988 Autumn Statement	4.7	3.3	na	na	na
1989 FSBR	4.7	3.2	2.7	2.4	2.7

(xvi) North Sea tax ready reckoner. If oil price $1 higher in 1989 then government receipts increased by £210 million in 1989-90 (£270 million in full year). If oil production 1 million tonnes higher in 1989 then Government receipts increased by £35 million in 1989-90 (£40 million in full year).

Positive

(i) Export volumes of goods (less oil) up 4½ per cent in 1988. Forecast growth of 7½ per cent in 1989.

(ii) Manufacturing industry continues to perform well. In second half of 1988 adjusted volume of exports of manufactures up 6½ per cent on a year earlier.

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(iii) Current account in cumulative surplus of over £21 billion 1980-1987 inclusive, reflecting strength of invisibles earnings and oil balance.

(iv) Current account deficit reflects financing needs of private not public sector, in contrast to deficits of 1960s and 1970s.

(v) Strength of capital inflows reflects confidence in UK as place to invest both because of good profitability prospects for UK industry and Government's sound fiscal and monetary stance.

(vi) UK net overseas assets estimated at £90 billion at end 1987, bettered only by Japan.

(vii) UK unit labour costs expected to rise only slightly in 1988 reflecting strong growth in manufacturing productivity. Continued good performance in industry's own hands.

Defensive

(i) Why does current account deficit not fall in 1989? Value of exports of goods now lower than imports; relatively faster growth of exports therefore required just to keep deficit unchanged. Also oil balance adversely affected by recent North Sea accidents.

(ii) How can current account deficit be unchanged between 1988 and 1989 when domestic demand is forecast to grow at about the same rate as GDP? Reflects improvement in terms of trade and larger surplus on interest, profits and dividends.

(iii) Continuing large deficits will diminish confidence in sterling. No reason why they should. Markets recognise Government's strong fiscal stance and commitment to firm monetary policy.

(iv) Growth in manufactured imports in 1988 dominated by consumer goods? No, only about one quarter of growth in value of manufactured imports (less erractics) between 1987 and 1988 accounted for by consumer goods (including cars) with 22 per cent capital goods and remainder intermediates and semi-manufactures.

(v) Current account deficit unsustainable. There are many examples around world of deficits or surpluses persisting for considerable period, eg recent sustained imbalances of US, Japan and Germany. Reflects worldwide move to deregulation of capital markets, development of wide range of new financial instruments and massive growth of mobile capital. Hence,not surprising imbalances have emerged; would be more surprising if in each country domestic savings equalled domestic investment and capital inflows matched capital outflows.

(vi) Dependent on world capital markets to finance current account deficit. In modern world, Governments dependent on capital markets whether current account in deficit or not. Chancellor has noted that this is an 'excellent discipline' for any country. Encourages pursuit of sound, anti-inflationary policies. Government's firm fiscal and monetary policies meet this requirement. Confidence in economy will thereby be maintained and ensure deficit can be readily financed.

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(vii) Capital inflows not long term, but short term and speculative, therefore likely to reverse. Large positive balancing item over past few years and in first half of 1988 show that figures subject to much uncertainty. Inflows take many forms. Impossible to disentangle. But common element is confidence in the UK economy.

(viii) Current account deficit has reached US proportions. No similarity between underlying UK and US positions. US deficit, now in fifth year at 3 per cent or so of GDP, associated with large and persistent US Government fiscal deficit. Stance of UK policy altogether different, with fiscal surplus; UK current account deficit reflects excess of private sector investment over private sector saving.

(ix) Current account estimate misleading given size of balancing item. Very likely. Balancing item averaged +£6 billion in past five years and over +£12 billion in first 3 quarters of 1988. Positive balancing item reflects either better current account than recorded or unrecorded net capital inflows most likely combination of both.

(x) CSO's reported view (Director of CSO to TCSC 1 February) that current account deficit overstated by only £1½-£2 billion. Current balance has a history of upward revision over time reflecting changes to estimates of invisibles trade. Figure of £1½-2 billion based on these past revisions. But large sustained positive balancing item over recent years means that some large capital inflows or current account credits have not been picked-up despite revisions.

(xi) Current account deficit could be reduced by depreciation of sterling. Restraint of unit costs - which is in industry's own hands - key to improved competitiveness. Not Government policy to depreciate exchange rate to try to increase UK competitiveness.

(xii) Deterioration in cost competitiveness since late 1970s. Narrow measures of competitiveness misleading because overwhelmingly dependent on exchange rate movements; on this basis Japan is country that has really become uncompetitive.

(xiii) Forecast deterioration in competitiveness makes 1989 deficit look optimistic? Competitiveness not only factor affecting forecast of current account. Some components, IPD, transfers, and some services, not affected by changes in competitiveness. Forecast slowing of domestic demand growth likely to be far bigger influence on current account in 1989.

(xiv) Does lack of estimate of net overseas assets in FSBR hide the fact that assets dwindling as a result of deficit? No. In last 3 years balancing items have amounted to over £40 billion, reflecting unknown mixture of unrecorded net exports and unidentified capital inflows. In these circumstances not sensible yet to give an estimate of net asset position, but stock undoubtedly substantial. (Estimate for end 1988 to be published in Pink Book in September.)

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BB4 MANUFACTURING AND INDUSTRY

Other relevant briefs: B1 Industry Act forecast of UK economy
BB1 UK economy: recent developments
BB3 Balance of payments, oil and competitiveness

Factual

(i) Manufacturing output

1988Q4 on				percentage changes	
1988Q3	1987Q4	1981H1	1979H1	1988 on 1987	1979H1 on 1974H1
+½	+7	+30¼	+10¼	+7¼	-2½

(a) In 1988Q4 up 10 per cent on 1979H1 peak and 4 per cent above 1974Q2 previous all time peak.

(b) FSBR forecast: growth of [ ] per cent in 1989.

(ii) Industrial production (manufacturing plus energy and water supply)

1988Q4 on				percentage changes	
1988Q3	1987Q4	1981H1	1979H1	1988 on 1987	1979H1 on 1974H1
-¼	+2½	+25¼	+12	+3¾	+10¾

(i) Output of construction industry

1988Q3 on				percentage changes	
1988Q2	1987Q3	1981H1	1979H1	1987 on 1986	1979H1 on 1974H1
-¼	+5¾	+39½	+25	+7¾	-4½

(ii) Share of manufacturing in national income: Fallen from 28½ per cent in 1979 to 24 per cent in 1987. (Also fell from 30½ per cent to 28½ per cent between 1974 and 1979.)

(iii) Manufacturing investment (including leased assets)

1988Q4 on				percentage changes	
1988Q3	1987Q4	1983Q1 (trough)	1979H1	1988 on 1987	1979H1 on 1974H1
-4	+5	+51¼	-3½	+9¾	+8¾

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(a) CBI's January Quarterly Trends Survey shows investment intentions in plant and machinery remain strong. Balance of firms expected to increase capital expenditure over next year at same level as October Survey; one of highest since 1977. DTI Investment Intentions Survey also expects strong growth in 1989.

(b) FSBR forecast: a rise of [ ] per cent in 1989.

(iv) DTI Investment Intentions Survey (December)

percentage change on year earlier

Real expenditure on investment	**1989**
Manufacturing (incl. leased assets)	+11
Construction, Distribution and Selected Service Industries (excl. assets leased to manufactures)	+9
Industrial investment	+10

- FSBR forecast: Business investment expected to rise by [ ] per cent in 1989.

(v) Manufacturing employment:
GB, manufacturing employees

average monthly change ('000)

March 1974 to June 1979	-10
June 1979 to June 1983	-35
June 1983 to December 1988	-4

actual change (quarter on quarter) ('000)

1987	Q1	-31
	Q2	+25
	Q3	+11
	Q4	+28
1988	Q1	+34
	Q2	-2
	Q3	+1
	Q4	+4

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(vi) Manufacturing productivity

percentage change at annual rate

output per person employed

1988Q4 on 1987Q4	1988 on 1987	1988H2 on 1979H1	1979H1 on 1974H1
+6	+5¼	+4¼	+1¼

(vii) Unit wage and salary costs in manufacturing

	Average earnings growth	Productivity growth	Growth in unit wage and salary costs
1987	+8	+6½	+1½
1988	+8½	+5¼	+3
1988Q3	+8¼	+6¼	+2
Q4	+8¾	+6	+2½

- FSBR forecast: unit labour costs in manufacturing are expected to rise by [ ] per cent in 1989.

(viii) Manufacturing prices: Producer output prices (excluding food, drink and tobacco) rose 4¾ per cent in 1988 compared with 4½ per cent in 1987.

(ix) Manufacturing trade (see also BB3)

(a) UK moved into deficit on manufacturing trade balance for first time in 1983. Deficit of £7½ billion in 1987 and £14½ billion in 1988. Deficit of £1½ billion in January 1989.

- FSBR forecast: deficit of [ ] billion in 1989

(b) Manufacturing: trade volumes (excluding erratics)

percentage changes

	3 months to January on previous 3 months	3 months to January on a year earlier	3 months to January on 1979H1	1988 on 1987	1979H1 on 1974H1
Exports	+½	+6½	+38½	+5	+11½
Imports	+4½	+17	+119½	+17½	+39

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(x) Profitability

Net (pre-tax) rates of return (per cent)

	Industrial and Commercial Companies excluding North Sea	**Manufacturing**
1981	2.8	2.3
1985	7.2	6.4
1986	8.9	7.5
1987	10.2	9.2

Source: DTI

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(xi) Profits (Non-North Sea Industrial and Commercial Companies)

	Profits (net of stock appreciation) £ billion	**percentage change on year earlier**
1982	21.3	24.2
1983	24.7	15.9
1984	28.0	13.5
1985	38.0	35.5
1986	46.1	21.4
1987	55.2	19.8
1988 Q1	16.0	23.2
Q2	15.5	14.7
Q3	17.2	16.9

NOTE: Since privatisation, British Telecom, British Gas, British Airways and British Airports Authority have boosted recorded figures.

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(xii) Order books

(a) Orders for new construction in 1988Q4 up 23 per cent on a year earlier. In 1988 as a whole up 5 per cent on 1987. 1987 distorted by Channel Tunnel.

(b) CBI February Enquiry found balances on total order books fell back sharply. Export order books picked up slightly. Both still at historically high levels.

(xiii) CBI Quarterly Industrial Trends Survey (January): Optimism down. Order books also down, but still above normal. Investment intentions strong. Some easing of capacity constraints expected over next four months.

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(xiv) CBI Monthly Trends Enquiry (February). Total order books series down again, but export order books show slight recovery. Reflects slowing demand. Output expectations remain strong.

Positive

(i) Manufacturing output

- In 1988 as a whole output grew by 7 per cent - more than in any year since 1973 - to reach its highest ever level.
- In 1988Q4 up 7 per cent on a year earlier.
- At highest ever level, 10 per cent above 1979H1 peak and 4 per cent above 1974Q2 previous all-time peak.

(ii) Industrial production passed 1979 peak in 1985 and continued growth since. Up 2½ per cent in year to 1988Q4.

(iii) Construction output at highest level since 1973.

(iv) Strong manufacturing investment growth in 1988 10 per cent up on 1987, and with likely upward revisions to figures, could be even higher.

(v) Manufacturing productivity: Increased by 5¼ per cent a year since 1980 - fastest growth of all major industrialised countries. Contrasts with 1960s and 1970s when bottom of international league table. Underlying growth now appears to be higher than rate experienced in the 1960s.

(vi) Unit labour costs in manufacturing rose only slightly in 1988 but still marginally faster than average of those in other major industrial countries.

(vii) UK manufactured export volumes: Rose 5½ per cent in 1988 to highest recorded level. In 3 months to January up 6½ per cent on year earlier. [After decades of decline UK's volume share has changed little since 1981.] Improved performance forecast to continue in 1989.

(viii) Manufacturing profitability risen every year since 1981 and grew particularly strongly in 1987. Over 9 per cent in 1987, highest level for about twenty years, and 4 times level recorded in 1981. Higher in 1986 and 1987 than at any time between 1974 and 1979.

(ix) Non-North Sea company profitability rose for the sixth successive year in 1987, back to levels not seen for about twenty years. With continued strong profit growth likely in 1988 expected to improve further.

(x) CBI Quarterly Industrial Trends Survey (January): Investment intentions remain strong, and easing of capacity constraints expected.

(xi) Business starts exceeded stops by around 500 a week between 1979 and 1987, and around 900 a week during 1987. Latest figures for 1988 show net start up averaged over 1,000 a week.

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Defensive

(i) Manufacturing output still only just back to 1979 level?

- Manufacturing output at highest ever level. In 1988Q4 10 per cent above 1979H1 peak and 4 per cent above 1974Q2 previous all-time peak.

- Manufacturing output growing strongly, up 7 per cent in year to 1988Q4.

- Output fell between 1974 and 1979.

(ii) Share of manufacturing in total output

- In industrial countries, long-term process of economic development generally associated with decline in relative importance of manufacturing. Declining since early 1960s in UK.

- But manufacturing output forecast to grow faster than total non-North Sea GDP in 1989.

(iii) Role of manufacturing in economy: Important that manufacturing thrives and is profitable. But UK also needs a strong service sector that now contributes more than twice much to output and nearly three times as much to employment.

(iv) Manufacturing investment down under this Government: Now growing well. In 1988 as a whole up 10 per cent on 1987. Not just quantity; but also quality. Improvement in quality evidenced by strong profitability and productivity performance.

(v) Investment figures in 1988Q4 show investment growth slowing? Estimates show manufacturing investment in 1988Q4 down 4 per cent on 1988Q3, but up 5 per cent on year earlier. In 1988 as whole up 10 per cent on 1987. Figures disappointing, but provisional estimates unreliable. Long history of upward revisions, sometimes substantial. CSO Director, in evidence to TCSC, pointed to inherent difficulties in making reliable estimates of investment in recent past. Recent CBI and DTI Surveys are consistent with strong growth in second half of 1988. They point to buoyant investment prospects in 1989.

(vi) Industry about to hit capacity constraints:

- CBI's January Quarterly Survey shows expectations of easing capacity constraints. 88 per cent of firms say current fixed capacity at least adequate to meet expected demand over next year.

- FSBR forecast: growth [ ] per cent. (See also B1).

(vii) Manufacturing employment down under this Government:

- Long established trend; peaked as far back as 1965.

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- Experience shared by all Western industrial nations (except Japan). Inevitable result of structural changes in modern economy.

- Average monthly fall since 1983 less than average monthly fall under Labour Government. CBI on basis of January survey report favourable trend in manufacturing employment set to continue.

(viii) Manufacturing employment fallen proportionately more under this Government than in other countries: Result of over-manning and inefficiency in 1970s. Fall in UK exaggerated by reclassification of some jobs from manufacturing to services.

(ix) Manufacturing trade deficit large and [forecast to rise further.]

- Deficit reflects strong growth of UK domestic demand and activity in 1987 and 1988; import growth should slow significantly in 1989 as domestic demand decelerates and as extra capacity becomes available following investment boom.

- A large part of import growth relates to capital, semi-manufactured and intermediate goods, reflecting rising UK output and investment.

- Export volumes (excluding erratics) up 6½ per cent over past year. [After decades of decline, UK's share of world trade has changed little since 1981.] (See also BB3.)

(x) Trade deficit best indicator of manufacturing performance: Ignores good performance of output, profitability, productivity and exports.

(xi) Manufacturing competitiveness: Manufacturing unit labour costs in the UK risen only slightly over past year, but still marginally faster than average of those in other major industrial countries. Nonetheless , most of large gain in labour cost competitiveness in 1986 has been maintained.

(xii) British industry less competitive now than in 1978? Misleading to look at competitiveness too narrowly. Supply performance of UK manufacturing industry much improved since late 1970s due to rise in underlying growth of UK productivity and improvement in no-price factors such as delivery dates, quality and reliability. [Demonstrated by UK maintaining share of world trade in manufactures since 1981, following decades of decline.]

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(xiii) Reform of business rates means higher rate bills for many businesses? New Uniform Business Rate, to be introduced in April 1990, will mean more consistent and predictable rate bills with increases limited to RPI. Overall yield of business rates to remain broadly constant in real terms. But change to new system and revaluation inevitably mean substantial increases for some properties and reductions for others. Transitional arrangements give businesses time to adjust.

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CC1 INTEREST AND EXCHANGE RATES

This brief contains: A Interest rates
B Exchange rate

Other relevant brief: C1 MTFS: Strategy
C2 Monetary policy and funding

A INTEREST RATES

Factual

(i) Recent UK nominal rates

	Base rate	3 month interbank	10 year gilt	20 year gilt
Current rates (23 February 1989) (* close 22 February)	13	13 1/8	9.8*	9.2*
1 November 1988 (Autumn Statement)	12	12 1/16	9.6	9.1
15 March 1988 (Budget Day)	9	8¾	9.1	9.1

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(ii) **Recent rates movements**

	Bank base rates*	Mortgage rates (major lenders)
February 1 1988	9	10.1 - 10.5
March 17	8½	10.1 - 10.5
April 8	8	10.1 - 10.5
May 17	7½	9.5 - 9.8
June 2	8	9.5 - 9.8
June 6	8½	9.5 - 9.8
June 22	9	9.5 - 9.8
June 28	9½	9.5 - 9.8
July 4	10	9.5 - 9.8
July 18	10½	9.5 - 9.8
August 8	11	11.5
August 25	12	11.5
November 25	13	12.75
February 24	13	13.5 - 13.75

Historical movements

	per cent
1974 (10 October)	11½
1979 (3 May)	12
1983 (9 June)	10
1987 (11 June)	9

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* Date when Bank of England changed dealing rates. Base rates moved on next working day.

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(iii) 3 month nominal and real interest rates in G7 countries

	Nominal	Real(1)	Inflation
US	9.6	4.9	4.5
Japan	4.6	3.7	0.9
Germany	6.7	4.1	2.5
France	9.5	6.2	3.1
Italy	12.5	6.4	5.7
Canada	11.7	7.1	4.3
UK	**13.1**	**5.2**	**7.5**
Average	8.9	4.9	3.6

(1) Deflated by latest Consumer Price Index

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(iv) Comparison of Labour and Conservative Government interest rate records

		Interest rate				Mortgage rate[1]	
		Short Term[2]		Long Term[3]			
		High	Low	High	Low	High	Low
L	1974	12.5	11.5	17.2	13.7	11	11
A	1975	12	9.75	16.0	13.4	11	11
B	1976	15	9	16.0	13.5	12.25	10.5
O	1977	14.25	5	14.5	11.0	12.25	9.5
U	1978	12.5	6.5	13.2	11.1	11.75	8.5
R	1979 (to May)	14	12	13.9	11.7	11.75	11.75
C							
O							
N	1979 (from May)	17	12	14.7	12.3	15	11.75
S	1980	17	14	14.7	13.1	15	14
E	1981	16	12	16.0	13.6	15	13
R	1982	14.5	9	15.6	10.5	15	10
V	1983	11	9	11.6	10.3	11.25	10
A	1984	12	8.5	11.7	10.2	12.9	10.25
T	1985	14	9.5	11.7	10.2	14	11.9
I	1986	12.5	10	10.8	8.8	12.75	11
V	1987	11	8.5	10.1	8.8	12.5	10
E	1988/89	13	7.5	9.6	9.1	13.75	9.80
Labour high/low		15	5	17.2	11.0	12¼	8.5
Conservative high/low		17	7.5	16.0	8.8	15	9.8
Labour average[4]		10.7		13.7		10.75	
Conservative average[4]		12.2		11.5		12.6	

(1) Monthly average from November 1984 when cartel ended.
(2) Minimum Lending Rate (MLR) until 1980; base rate 1981 onwards.
(3) 20 year gilt yield. Figures for 1974-5 are averages of end-week rates and from 1976 are averages of daily rates.
(4) Average inflation rate: Labour Government 15.5 per cent, Conservative Government 7.2 per cent.

Defensive

(i) When will interest rates fall? When justified by monetary conditions.

(ii) Interest rates bearing excessive burden in adjustment process? No. Inflation is a monetary phenomenon and has to be cured by monetary

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policy i.e. vigorous use of interest rates. Interest rates worked when Government took office and again as recently as 1985. Will work again now.

(iii) Increases in interest rates will not restrain demand for consumer credit? See C2.

(iv) Why not impose controls on lending? Bring bank hire purchase controls or corset? See C2.

(v) UK nominal rates above those of major competitors? Level reflects number of factors, including fact that UK inflation still higher than in other G7 countries. Reductions in interest rates only made when justified by monetary conditions.

(vi) UK real rates above those of major competitors? Real interest rates bound to move higher when base rates have increased 5½ per cent since beginning of June 1988. Reflects Government's determination to keep downward pressure on inflation.

(vii) Interest rate increases damage industry? Companies now in far stronger financial position than for very long time hence firms much less dependent on borrowing and therefore less sensitive to short term interest rate changes. Industry performing very well (manufacturing output still growing at annual rate of about 7 per cent). Has much more to fear from resurgence of inflation than rise in interest rates. 1 per cent extra on interest rates, even if sustained for whole year, costs industry far less than 1 per cent rise in pay settlements.

(viii) Higher interest rates curb investment? Higher interest rates will principally affect consumer spending, not corporate spending.

- Business investment in 1988 as a whole up almost 15 per cent on 1987. Forecast to rise a further 10 per cent in 1989.

- Most larger firms can borrow long term and long term rates have risen very little. Now Government no longer making demands on gilt market excellent opportunities for other borrowers, particularly for long term fixed interest debt.

- But even for those smaller businesses dependent on bank borrowing and adversely affected in short term, resurgence of inflation more likely to damage investment then a period of higher interest rates.

(ix) Higher mortgage rates will lead to rise in repossessions? Repossession not in interest of lenders. Most will make arrangements for temporary problems. As Building Societies Association say in general increase in interest rates does not change a good borrower into a potential possession case.

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Latest BSA Survey shows repossessions in second half of 1988 35 per cent down on first half of year and 43 per cent below same period in 1987 (although building societies did report increase in "short arrears" which reflects period over which mortgage rates increased.) But main causes of mortgage problems are unemployment, matrimonial problems and financial mismanagement.

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B EXCHANGE RATE

Factual

(i) Exchange rate movements

	Opening level 2.03.89	General Election 3.5.79	All-time £ low against $ 26.2.85	Paris Accord 20.02.87	Budget 1988 15.03.88	Autumn Statement 01.11.88
		per cent change to 2 March				
Sterling						
£ ERI (1985=100)	95.3	10.9	4.8	11.3	-0.9	-0.2
$/£	1.7247	-16.9	66.5	12.9	-7.2	1.5
DM/£	3.1643	-19.8	-12.4	13.4	2.4	0.4
Yen/£	220.62	-52.7	-18.9	-6.0	-6.5	-0.3
Dollar						
$ ERI (1985=100)	67.2	-3.7	-40.6	-7.4	4.5	0.5
DM/$	1.8347	3.6	88.9	-0.4	-9.4	2.0
Yen/$	127.90	75.7	104.2	20.0	-0.7	1.3

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(ii) Sterling all-time lows:

ERI	83.7	(8 October 1986),
$	1.036	(26 February 1985),
DM	2.7349	(28 January 1987)

(iii) Recent £ Highs

ERI	98.7	(6 December 1988)
$	1.9065	(18 April 1988)
DM	3.2915	(1 February 1989)

(iv) Dollar all-time lows

ERI	63.3	(30 October 1988)
DM	1.5620	(4 January 1988)
Yen	120.25	(4 January 1988)

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(v) Exchange rate comparisons

		Highs		Lows	
Labour					
(March 1974- April 1979)	£ERI	138.2	(May 1974)	92.2	(October 1976)
	$/£	2.43	(March 1975)	1.57	(October 1976)
	DM/£	6.24	(March 1974)	3.62	(October 1978)
Conservative					
(May 1979 to date)	£ERI	131.9	(January 1981)	83.7*	(October 1986)
	$/£	2.45	(November 1980)	1.035*	(February 1985)
	DM/£	5.07	(January 1981)	2.735*	(January 1987)

* all time low

(vi) Reserves and official debt comparisons

		Gross reserves		Total official debt	$ billion
Labour					
(March 1974-	High	21.9	(March 1979)	25.5	(December 1977)
April 1979)	Low	4.1	(December 1976)	8.7	(March 1974)
Conservative					
(May 1979	High	51.7	(January 1989)	22.0	(May 1979)
to date)	Low	14.0	(May 1985)	11.0	(September 1984)

- Current total official debt: $15.8 billion at end-1988 (source: 'Financial Statistics; February 1989).

- Reserves in February: Underlying rise of $29 million, total fall of $22 million, giving a level of just below $51.7 billion at end-February.

- Change in reserves over 1988: Rise of $4.5 billion (10 per cent increase). Change over 1989 to date: fall of $2 million.

(vii) EC capital liberalisation proposals. Directive providing for complete removal of exchange controls adopted on 24 June 1988. Germany, Netherlands and Denmark fully liberalised, like UK. Other member states have until mid-1990 to remove all exchange controls, except for Ireland, Spain, Greece and Portugal which must remove all controls by 1992 (with the possibility of a further extension to 1995 for the last two).

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(viii) Delors Committee European Council 27/28 June 1988 set up Committee, comprising European Central Bank Governors and experts under chairmanship of President Delors, to study and propose concrete stages leading to economic and monetary union. Committee to report to European Council meeting in Madrid in June, with prior discussion in ECOFIN.

(ix) UK ECU Treasury Bill programme: Bills similar in form to sterling Treasury Bills, but denominated and payable in ECU. Range of maturities offered at tender; one, three and six months. Total size of programme to date ECU 2,150 million. Last of initial series of tenders on Budget Day. [In Budget Speech, Chancellor announced extension of programme [detail].]

(x) Exchange rate assumption for Budget forecast: Forecast assumes exchange rate remains close to recent levels.

Positive

(i) ECU Treasury Bill programme [Chancellor announced continuation of programme in Budget Speech [detail]]. Programme has been great success. Tenders to date have all been substantially oversubscribed at all three maturities.

(ii) Reserves: At record level, around $51½ billion, $29 billion more than in May 1979, and $47 billion more than their all time low in December 1976.

Defensive

(i) Government targeting £/DM, £/$ rate or £ ERI? Never focus exclusively on single indicator when setting monetary policy. Exchange rate is one of these indicators but look at various measures of level of sterling, (though as 1992 approaches, clear that exchange rate against other European currencies will become increasingly important).

(ii) Exchange rate fall. Government has taken action to bear down on inflation. Will resist any tendency for sterling to depreciate.

(iii) Recent fall in sterling suggests market confidence weakening? No. Government's commitment to firm monetary policy unchanged. Bound to be fluctuation in exchange rates from week to week. Current exchange rates similar to [- in fact slightly higher -] than in September and October.

(iv) "Hot money" rather than long term investment financing current account deficit? In today's global market difficult to tell what is short-term and what is long term, what is "hot money" and what is not. What matters is whether conditions in place within country make it hospitable home for investment. Depends upon whole framework of economic policies, not just short term interest rates. Government's prudent fiscal stance and commitment to firm monetary policy well understood by markets.

(v) Current account position means Government should let exchange rate fall? Policy of depreciation would be wholly inappropriate. Present deficit associated partly with high investment spending by private sector. Contrast with experience in 1960s and 1970s when current account deficit

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associated with public sector deficit. Private investment is adding to productive capacity; will boost exports and displace imports in future. Evidence that interest rate rises since summer beginning to have effect particularly in housing market and retail sector though full impact not yet being felt. (See also BB3.)

(vi) <u>Bank of England intervening recently</u>? Never discuss details.

(vii) <u>Sterling's participation in exchange rate mechanism (ERM)</u> Matter kept under continual review. As Chancellor said in House, 26 January (OR vol 145, No 36, Col 1162), UK will join when Government considers time is appropriate.

(viii) <u>Membership of ERM would have avoided need for higher interest rates</u>? Joining ERM would <u>not</u> be soft option. Countries in ERM change their interest rates too.

(ix) <u>Membership of ERM would have prevented sterling's recent fluctuations</u> Impossible to say. Countries within ERM engage in realignments from time to time. And ERM membership has no bearing on £/$ fluctuations.

(x) <u>Capital liberalisation will undermine ERM</u>? No. Plenty of pressures on ERM earlier this decade but mechanism survived them. May lead to greater monetary co-operation among member states or further modifications to mechanism along lines set out in Basle/Nyborg agreement of September 1987 but no reason to suspect collapse.

(xi) <u>Review of composition of ECU by September 1989 will adversely affect success of ECU Treasury Bill programme</u>?: Market demand for UK ECU Treasury Bills remains healthy. No reason why review should adversely affect new programme.

(xii) <u>Proposals for European Central Bank and common European currency/Economic and Monetary Union (EMU)</u>? Chancellor said in Royal Institute of International Affairs speech, 25 January, clear that EMU implied nothing less than European Government and political union - not on agenda now, nor for foreseeable future. Important to set sights on practical steps needed to implement Single Market by 1992 - removing barriers to free movement of people, goods, services and capital. In that context, EMU is essentially damaging diversion.

(xiii) <u>Amendment needed to Treaty of Rome to pave way for EMU</u>? In Royal Institute of International Affairs speech, 25 January, Chancellor said neither British Government nor British Parliament would be prepared to accept further Treaty amendment.

<u>Contact point</u>: B Nelson (MG1) 270 5558

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CC2 PUBLIC SECTOR STATISTICS: HISTORICAL TRENDS AND INTERNATIONAL COMPARISONS

A PUBLIC SECTOR BORROWING: HISTORICAL TRENDS

	PSBR			PSBR excluding privatisation proceeds		Public sector Financial Deficit (PSFD)	
	Cash £ billion	Real terms (1987-88 prices) £ billion	Ratio to GDP (per cent)	Cash £ billion	Ratio to GDP (per cent)	Cash £ billion	Ratio to GDP (per cent)
1948	not av	not av	not av	not av	not av	-0.3	-2¼
1949	not av	not av	not av	not av	not av	-0.3	-2½
1950	not av	not av	not av	not av	not av	-0.4	-2¾
1951	not av	not av	not av	not av	not av	0.2	1½
1952	0.8	8.6	5	0.8	5	0.6	3½
1953	0.6	6.2	3½	0.6	3½	0.7	4
1954	0.4	3.9	2	0.4	2	0.4	2½
1955	0.5	4.7	2½	0.5	2½	0.4	2
1956	0.6	5.4	2¾	0.6	2¾	0.5	2½
1957	0.5	4.4	2¼	0.5	2¼	0.5	2½
1958	0.5	4.3	2	0.5	2	0.4	2
1959	0.6	4.9	2¼	0.6	2¼	0.6	2¼
1960	0.7	6.0	2¾	0.7	2¾	0.7	2½
1961	0.7	5.8	2½	0.7	2½	0.7	2½
1962	0.5	4.3	1¾	0.5	1¾	0.5	1¾
1963	0.8	6.4	2½	0.8	2½	0.8	2½
1963-64	1.0	8.0	3¼	1.0	3¼	1.1	3¼
1964-65	0.9	6.8	2¾	0.9	2¾	0.8	1¾
1965-66	0.9	6.7	2½	0.9	2½	0.6	1¾
1966-67	1.1	7.8	3	1.1	3	1.0	2¾
1967-68	2.0	13.4	5	2.0	5	1.7	4¼
1968-69	0.4	2.3	¾	0.4	¾	0.4	¾
1969-70	-0.6	-3.6	-1¼	-0.6	-1¼	-0.8	-1¾
1970-71	0.8	4.3	1½	0.8	1½	-0.2	-½
1971-72	1.0	4.9	1¾	1.0	1¾	0.7	1¼
1972-73	2.4	11.4	3½	2.4	3½	2.0	3
1973-74	4.3	19.1	5¾	4.3	5¾	3.5	4¾
1974-75	8.0	29.4	9	8.0	9	6.0	6¾
1975-76	10.3	30.1	9¼	10.3	9¼	8.1	7¼
1976-77	8.3	21.5	6½	8.3	6½	7.4	5¾
1977-78	5.3	12.1	3½	5.9	4	6.6	4¼
1978-79	9.2	18.8	5¼	9.2	5¼	8.3	4¾
Avge 74-75 to 78-79	**8.2**	**22.4**	**6¾**	**8.3**	**6¾**	**7.3**	**5¾**
1979-80	9.9	17.4	4¾	10.3	5	8.1	4
1980-81	12.5	11.6	5¼	12.9	5½	11.6	5
1981-82	8.6	5.5	3¼	9.1	3½	5.5	2
1982-83	8.9	8.4	3¼	9.4	3¼	8.4	3
1983-84	9.7	11.7	3¼	10.9	3½	11.7	3¾
1984-85(1)	10.1	13.4	3	12.3	3¾	13.4	4
1985-86(1)	5.7	6.2	1½	8.4	2¼	7.5	2
1986-87	3.4	3.6	1	7.9	2	8.7	2¼
1987-88	-3.5	-3.5	-¾	1.6	½	1.4	¼
Avg 79-80 to 87-88	**7.3**	**8.2**	**2¾**	**9.2**	**3¼**	**8.5**	**3**
1988-89 estimated outturn	-14.0	-13.1	-3	-9.0	-2	-7.5	-1½
1989-90 (Budget forecast)	-12.0	-10.7	-2¼	-7.0	-1¼	-7.5	-1½

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(1) If adjusted for coal strike, PSBR and PSFD ratios to GDP roughly 0.9 per cent lower in 1984-85 and 0.2 per cent lower in 1985-86.

(i) Error on PSBR forecasts for year ahead: Average absolute error on past PSBR forecasts made at Budget time:

- over last 10 years*: about ¾ per cent of GDP, equivalent to around £4 billion in 1988-89.

- over last 5 years*: about 1 per cent of GDP, equivalent to around £4¼ billion in 1988-89.

* ending with Budget forecast for 1987-88.

	FSBR (£ billion)	Outturn+ (£ billion)	Difference (£ billion)	As percentage of GDP
1975-76	9.1	10.6	1.5	1.4
1976-77	12.0	8.5	-3.5	-2.6
1977-78	8.5	5.6	-2.9	-1.9
1978-79	8.5	9.2	0.7	0.4
1979-80	8.3	9.9	1.6	0.8
1980-81	8.5	13.2	4.7	2.0
1981-82	10.6	8.8	-1.8	-0.7
1982-83	9.5	9.1	-0.4	-0.1
1983-84	8.2	9.7	1.5	0.5
1984-85	7.2	10.1	2.9	0.9
1985-86	7.1	5.7	-1.4	-0.4
1986-87	7.1	3.4	-3.7	-1.0
1987-88	3.9	-3.5	-7.4	-1.7
1988-89	-3.2	-14.0(f)	-10.8	-2.3

\+ Up to 1983-84, PSBR outturns based on definitions then in use (slightly different from current definition).
(f) Forecast

(ii) Relationship between public sector financial balance and PSDR in 1988-89 and 1989-90

	1988-89	1989-90
Public sector financial balance (+ = surplus)	+7.5	+7.5
Privatisation proceeds	+7.0	+5.0
Other Adjustments*	-0.5	-0.5
PSDR	+14.0	+12.0

* including net lending and accruals adjustments.

(iii) PSFD, unlike PSBR, is not wholly measure of cash transactions because certain components are measured on an accruals basis. PSFD figures also less timely and more subject to revision. In recent years PSFD higher than PSBR, mainly because PSFD excludes privatisation proceeds. Privatisation proceeds reduce PSBR/GDP ratio by around one per cent each year.

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B GENERAL GOVERNMENT EXPENDITURE AND DEBT INTEREST: HISTORICAL TRENDS

(i) General government expenditure in cash, real terms and as a percentage of GDP

	General government expenditure			General government expenditure (excluding privatisation proceeds)		
	Cash (£billion)	Real terms[1] (£billion)	per cent of GDP	Cash (£billion)	Real terms[1] (£billion)	per cent of GDP
1963-64	11.3	88.0	36¼	11.3	88.0	36¼
1964-65	12.3	91.2	35¾	12.3	91.2	35¾
1965-66	13.6	96.5	37¼	13.6	96.5	37¼
1966-67	15.1	102.5	38¾	15.1	102.5	38¾
1967-68	17.5	115.3	42¼	17.5	115.3	42¼
1968-69	18.2	114.9	40¾	18.2	114.9	40¾
1969-70	19.3	115.7	40¼	19.3	115.7	40¼
1970-71	21.6	119.5	40¾	21.6	119.5	40¾
1971-72	24.4	123.3	41	24.4	123.3	41
1972-73	27.6	129.6	41	27.6	129.6	41
1973-74	32.0	140.5	42¾	32.0	140.5	42¾
1974-75	42.9	157.4	48	42.9	157.4	48
1975-76	53.8	157.4	48½	53.8	157.4	48½
1976-77	59.6	153.9	46	59.6	153.9	46
1977-78	63.9	145.0	42¼	64.4	146.2	42¾
1978-79	75.0	153.4	43¼	75.0	153.4	43¼
1979-80	90.0	157.9	43¼	90.3	158.5	43½
1980-81	108.6	160.7	46	109.0	161.3	46
1981-82	120.5	162.6	46¼	121.0	163.2	46½
1982-83	132.6	167.0	46½	133.1	167.7	46¾
1983-84	140.4	169.1	45½	141.6	170.5	45¾
1984-85	150.6	172.8	45½	152.8	175.3	46¼
1985-86	158.2	172.1	43¾	160.9	175.1	44½
1986-87	164.5	173.0	42½	168.9	177.7	43¾
1987-88	171.7	171.7	40¼	176.9	176.9	41½
1988-89[2]	178.8	166.9	37¾	185.8	173.5	39¼
1989-90[3]	193.5	171.9	38	198.5	176.3	39
1990-91[3]	205	175	38	210	180	39
1991-92[3]	216	179	37¾	221	183	38½
1992-93[3]	228	184	37¼	233	188	38½

Source: HM Treasury, using CSO data for historical figures on general government expenditure (GGE) and GDP.

(1) Cash figures adjusted to 1987-88 price levels by excluding effect of general inflation as measured by GDP deflator at market prices.

(2) Estimated outturn

(3) Budget forecast

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(ii) Inter-government comparisons

GGE excluding privatisation proceeds as percentage of GDP

Labour	1963-64 to 1969-70	Up from 36¼ to 40¼
Conservative	1969-70 to 1973-74	Up from 40¼ to 42¾
Labour	1973-74 to 1978-79	Up from 42¾ to 43¼
Conservative	**1978-79 to 1988-89**	**Down from 43¼ to 39¼**

(iii) General government debt interest

	General government gross debt interest		General government net debt interest	
	Cash £ billion	per cent of GDP	Cash £ billion	per cent of GDP
1963-64	1.2	4	0.8	2½
1964-65	1.3	3¾	0.8	2½
1965-66	1.4	3¾	0.9	2¼
1966-67	1.5	3¾	0.9	2¼
1967-68	1.7	4	1.0	2½
1968-69	1.8	4	1.1	2½
1969-70	1.9	4	1.1	2¼
1970-71	2.0	3¾	1.1	2
1971-72	2.2	3¾	1.1	1¾
1972-73	2.3	3½	1.1	1½
1973-74	2.9	4	1.5	2
1974-75	3.6	4	1.8	2
1975-76	4.5	4	2.4	2¼
1976-77	5.6	4¼	3.2	2½
1977-78	6.4	4¼	3.9	2½
1978-79	7.6	4½	4.8	2¾
1979-80	9.4	4½	6.0	3
1980-81	11.4	4¾	7.3	3
1981-82	13.3	5 (peak)	8.6	3¼ (peak)
1982-83	13.9	4¾	8.5	3
1983-84	14.5	4¾	9.5	3
1984-85	16.1	4¾	10.9	3¼
1985-86	17.6	5	11.2	3
1986-87	17.5	4½	11.5	3
1987-88	17.7	4¼	11.6	2¾
1988-89 Estimated Outturn	18.3	3¾	11.5	2½
1989-90 Budget forecast	18.2	3½	11.2	2¼
1990-91 Budget forecast	16	3	10	1¾
1991-92 Budget forecast	15	2½	9	1½
1992-93 Budget forecast	14	2¼	8	1½

Positive

(i) Debt interest payments in 1988-89: As percentage of GDP, expected to be lowest since 1972-73 (gross) and 1977-78 (net) and expected to fall further in future years.

(ii) Reduced burden since 1978-79. If PSBR as a share of GDP had remained at its 1978-79 level, cumulative borrowing would by now be some £90 billion higher than outturn with increased debt servicing costs in the present year of over £9 billion.

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(iii) Reduced burden since 1985-86. Gross debt interest payments as a share of GDP down by 1¼ of a per cent between 1985-86 and 1988-89 equivalent to saving of just under £6 billion.

Defensive

(i) Why has lower level of borrowing not produced bigger reductions in interest payments? Takes time for lower borrowing to affect interest payments - in 1988-89 higher inflation (increasing servicing of indexed debt) is an offset, and interest rates are also higher.

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C NATIONAL DEBT AND NET PUBLIC SECTOR DEBT

End-March	NATIONAL DEBT Cash £ billion	Ratio to GDP (per cent)	NET PUBLIC SECTOR DEBT Cash £billion	Ratio to GDP (per cent)
1855	0.8	105.0		
1860	0.8	98.7		
1865	0.8	81.4		
1870	0.8	71.5		
1875	0.8	59.0		
1880	0.8	58.0		
1885	0.7	57.2		
1890	0.7	47.4		
1895	0.7	42.6		
1900	0.6	32.3		
1905	0.8	36.7		
1910	0.7	31.9		
1915	1.1	35.3		
1920	7.5	125.9		
1925	7.6	164.6		
1930	7.6	161.6		
1935	6.8	143.3		
1940	7.9	105.0		
1945	21.4	217.3		
1950	25.8	199.5		
1955	26.9	141.0		
1960	27.7	107.1		
1961	28.3	103.0		
1962	28.7	99.4		
1963	29.8	98.7		
1964	30.2	91.4		
1965	30.4	85.0		
1966	31.3	82.0		
1967	32.0	79.4		
1968	34.2	79.3		
1969	34.0	72.8		
1970	33.1	65.2		
1971	33.4	59.3		
1972	35.8	57.0		
1973	37.2	51.5		
1974	40.5	50.4		
1975	46.5	46.6	59.5	59.6
1976	56.6	47.2	71.8	60.0
1977	67.2	47.8	81.3	57.9
1978	79.2	48.8	87.9	54.2
1979	86.9	46.1	95.3	50.6
1980	95.6	42.7	102.1	45.6
1981	113.3	45.6	116.5	46.9
1982	118.6	43.5	127.2	46.7
1983	128.2	43.3	135.0	45.5
1984	143.1	45.0	147.3	46.2
1985	158.3	45.7	160.7	46.4
1986	171.6	46.0	166.8	44.8
1987	185.7	45.9	171.1	42.3
1988	197.3	44.3	171.3	38.6
1989 (forecast)			157	31½

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(1) GDP centred on 31 March for 1959 to 1988, calendar year GDP used prior to 1959.

(2) Sources

GDP: 1946 to 1988 CSO
GDP: 1855 to 1945 Feinstein
National Debt and Net Public Sector Debt: Bank of England Quarterly Bulletin

(ii) Why focus on net public sector debt and not national debt? Net public sector debt is nowadays a more useful measure of public sector indebtedness than the traditional measure. Net public sector debt is a stock analogue of the flow represented by the PSBR/PSDR. Also net public sector debt covers all of the public sector, whereas the National Debt covers only central government.

Positive

(i) Net public sector debt as a percent of GDP forecast at end-March 1989 to be lowest since 1975 when records began. Relative to GDP the stock of government debt is now lower than at any point since before the First World War.

Defensive

(i) Why hasn't net public sector debt fallen as PSDR? Net public sector debt did not fall between March 1987 and March 1988 even though the PSDR was £3½ billion for several reasons, for example: Changes in exchange rates affect value of foreign currency liabilities and assets independently of transactions.

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D INTERNATIONAL COMPARISONS

NB International comparisons of public sector financial balances and borrowing requirements and expenditure made difficult by differences in coverage of public sector accounts. Usually comparisons employ general government (central and local government and social security funds) but even these require caution.

(i) General government financial deficits as percentage of GDP (deficit shown as plus)

Calendar year	**1979**	**1983**	**1985**	**1986**	**1987**	**1988** (1)	**1989** (1)
UK	**3.3**	**3.6**	**2.7**	**2.4**	**1.5**	**-½**	**-1¼**
US (2)	-0.5	3.8	3.3	3.4	2.3	1¾	1½
Japan (2)	4.7	3.7	0.8	1.1	0.3	¼	¼
West Germany (2)	2.5	2.5	1.1	1.3	1.7	2	1¼
France	0.7	3.2	2.8	2.9	2.5	1½	1¾
Italy	10.1	10.7	12.5	11.4	10.5	10	9½
Canada	2.0	6.9	7.0	5.4	4.6	3¼	3½
Total of above countries (G7)	1.7	4.1	3.3	3.3	2.5	2	1¾
Total EC (3)	3.7	5.3	5.2	4.7	4.2	3¾	3½
Total OECD (4)	1.8	4.2	3.4	3.3	2.5	2	1¾

(1) OECD estimates and forecasts on stated policies as of Autumn 1988, except for UK where 1988 is latest CSO estimate of outturn and 1989 is Treasury forecast for 1989-90 consistent with FSBR.

(2) As percentage of GNP.

(3) EC(8) before 1980. EC(12) after 1980.

(4) Covers 17 of 24 members.

Source: OECD 'Economic Outlook'; December 1988
EC Annual Economic Report; December 1988

NB: General government ratio for US is lower than the often quoted Federal deficit (3.5 per cent in fiscal 1987) because of state government surpluses. Japan's general government deficit is also much lower than its central government deficit because of a surplus on social security funds. For UK, PSBR is lower than general government financial deficit, partly because of asset sales.

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(ii) Net general government debt(1) as percentage of GDP*

	1975	1979	1983	1987+	1988+
UK	**57**	**48**	**46**	**43**	**39**
US++	25	20	25	30	30
Japan++	-2	15	26	26	25
Germany++	1	12	21	23	24
France	10	14	20	27	27
Italy	52	55	69	89	92
Canada	4	11	21	36	37
G7 average	20	22	28	33	33

(1) Net of financial assets.

* rounded to nearest 1 per cent
\+ OECD estimate for 1987, forecast for 1988 on stated policies as of autumn 1988.
++ as percentage of GNP

Source: OECD Economic Outlook: December 1988

(ii) Expenditure of general government as percentage of GDP

	1981	1982	1983	1984	1985	1986
United Kingdom	**48**	**47**	**47**	**48**	**47**	**46**
United States++	34	37	37	36	37	37
Japan++	34	34	34	33	33	33
Germany++	49	49	48	48	47	47
France	49	50	51	52	52	52
Italy	46	48	49	50	51	51
Total EC	48	49	50	50	50	49
OECD	40	41	42	41	41	41

\+ rounded to nearest 1 per cent
++ as percentage of GNP

Source: OECD "Economic Outlook: December 1988.

Coverage: International comparisons of expenditure of general government based on OECD definitions. OECD concept of "total outlays" broadly similar to GGE excluding privatisation proceeds but also excludes net lending (negative for much of the period) and includes imputed contributions for unfunded employee pension schemes.

Positive

(i) UK general government budget position in 1988 (as percentage of GDP)

- stronger than other G7 countries

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- Contrasts with 1979 when UK deficit double average of G7 countries.

(ii) UK's net public debt has fallen as percentage of GDP since 1979. Contrasts with all other G7 countries where percentage has risen since 1979.

(iii) UK general government expenditure as percentage of GDP below that of other major European countries in recent years.

(iv) Gap between UK general government expenditure as percentage of GDP and that of US and Japan now smaller than in 1981.

Defensive

(i) UK public expenditure a lower share of GDP than in other EC countries, public expenditure should be raised. No. [PSF to supply].

(ii) OECD figures for UK not declining as fast as GGE/GDP ratio. OECD figures do not include reduction in net lending or rise in privatisation proceeds, and only go to 1986. OECD figures now well out of date.

Contact points: P Patterson (PSF) 270 5029 (PSBR)
Miss C Summerfield (GEP3) 270 5640 (General Government Expenditure)
Mrs H F Wright (PSF) 270 5069 (Debt and Debt Interest)
D Ramsden (IF2) 270 5548 and D Deaton (GEP3) 270 5337 (International comparisons)

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CC2 PUBLIC SECTOR STATISTICS: HISTORICAL TRENDS AND INTERNATIONAL COMPARISONS

A PUBLIC SECTOR BORROWING: HISTORICAL TRENDS

	PSBR			PSBR excluding privatisation proceeds		Public sector Financial Deficit (PSFD)	
	Cash £ billion	Real terms (1987-88 prices) £ billion	Ratio to GDP (per cent)	Cash £ billion	Ratio to GDP (per cent)	Cash £ billion	Ratio to GDP (per cent)
1948	not av	not av	not av	not av	not av	-0.3	-2¼
1949	not av	not av	not av	not av	not av	-0.3	-2½
1950	not av	not av	not av	not av	not av	-0.4	-2¾
1951	not av	not av	not av	not av	not av	0.2	1½
1952	0.8	8.6	5	0.8	5	0.6	3½
1953	0.6	6.2	3½	0.6	3½	0.7	4
1954	0.4	3.9	2	0.4	2	0.4	2½
1955	0.5	4.7	2½	0.5	2½	0.4	2
1956	0.6	5.4	2¾	0.6	2¾	0.5	2½
1957	0.5	4.4	2¼	0.5	2¼	0.5	2½
1958	0.5	4.3	2	0.5	2	0.4	2
1959	0.6	4.9	2¼	0.6	2¼	0.6	2¼
1960	0.7	6.0	2¾	0.7	2¾	0.7	2½
1961	0.7	5.8	2½	0.7	2½	0.7	2½
1962	0.5	4.3	1¾	0.5	1¾	0.5	1¾
1963	0.8	6.4	2½	0.8	2½	0.8	2½
1963-64	1.0	8.0	3¼	1.0	3¼	1.1	3¼
1964-65	0.9	6.8	2¾	0.9	2¾	0.8	1¾
1965-66	0.9	6.7	2½	0.9	2½	0.6	1¾
1966-67	1.1	7.8	3	1.1	3	1.0	2¾
1967-68	2.0	13.4	5	2.0	5	1.7	4¼
1968-69	0.4	2.3	¾	0.4	¾	0.4	¾
1969-70	-0.6	-3.6	-1¼	-0.6	-1¼	-0.8	-1¾
1970-71	0.8	4.3	1½	0.8	1½	-0.2	-½
1971-72	1.0	4.9	1¾	1.0	1¾	0.7	1¼
1972-73	2.4	11.4	3½	2.4	3½	2.0	3
1973-74	4.3	19.1	5¾	4.3	5¾	3.5	4¾
1974-75	8.0	29.4	9	8.0	9	6.0	6¾
1975-76	10.3	30.1	9¼	10.3	9¼	8.1	7¼
1976-77	8.3	21.5	6½	8.3	6½	7.4	5¾
1977-78	5.3	12.1	3½	5.9	4	6.6	4¼
1978-79	9.2	18.8	5¼	9.2	5¼	8.3	4¾
Avge 74-75 to78-79	8.2	22.4	6¾	8.3	6¾	7.3	5¾
1979-80	9.9	17.4	4¾	10.3	5	8.1	4
1980-81	12.5	11.6	5¼	12.9	5½	11.6	5
1981-82	8.6	5.5	3¼	9.1	3½	5.5	2
1982-83	8.9	8.4	3¼	9.4	3¼	8.4	3
1983-84	9.7	11.7	3¼	10.9	3½	11.7	3¾
1984-85(1)	10.1	13.4	3	12.3	3¾	13.4	4
1985-86(1)	5.7	6.2	1½	8.4	2¼	7.5	2
1986-87	3.4	3.6	1	7.9	2	8.7	2¼
1987-88	-3.5	-3.5	-¾	1.6	½	1.4	¼
Avg 79-80 to87-88	7.3	8.2	2¾	9.2	3¼	8.5	3
1988-89 estimated outturn	-14.0	-13.1	-3	-9.0	-2	-7.5	-1½
1989-90 (Budget forecast)	-12.0	-10.7	-2¼	-7.0	-1¼	-7.5	-1½

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CC3 BURDEN OF TAXATION

Note: This brief covers <u>tax burden as proportion of GDP</u>; Brief [D7] (Effects of tax, National Insurance Contributions and social security reforms on living standards) covers <u>personal taxation as proportion of income</u>.

Other relevant briefs:
- C1 MTFS: Strategy
- C3 Fiscal policy
- C4 PSDR: 1988-88 and 1989-90
- [HH1 International tax comparisons]

<u>Factual</u>

Note: Table 2, 3 and 4 show taxes and NICs on an accruals basis. They differ from FSBR table 1.2 which shows taxes on a <u>receipts</u> basis, but NICs on an accruals basis.

(i) <u>Taxation as a proportion of GDP</u>

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Table 1: Total taxation (including local authority (LA) rates) and NICs as percentage of GDP (at market prices)

	Total, incl North Sea taxes	North Sea (1) taxes	Non-North Sea taxes and NICs as per cent of non-North Sea GDP
1970-71	36.1	0	36.1
1974-75	35.7	0	35.7
1978-79	33.9	0.3	34.2
1979-80	35.1	1.1	35.2
1980-81	36.4	1.7	36.2
1981-82	39.3	2.5	38.7
1982-83	39.0	2.8	38.2
1983-84	38.6	2.9	37.8
1984-85	39.2	3.7	37.9
1985-86	38.5	3.1	37.1
1986-87	38.1	1.2	37.6
1987-88	37.9	1.1	37.7
1988-89 (estimate)	37.4	0.7	37.3
1989-90 (forecast)	37.2	0.5	37.3

(1) Includes North Sea corporation tax before ACT set off.

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Table 2: Breakdown as percentage of GDP (at market prices)

	1978-79	1987-88	1988-89 (estimate)	1989-90 (forecast)
Income tax	11.1	9.8	9.2	9.3
Employees' NICs	2.4	3.3	3.3	3.0
Sub-total	13.4	13.1	12.5	12.3
Corporation tax (non-North Sea)	2.2	3.3	3.5	3.8
North Sea taxes(1)	0.3	1.1	0.7	0.5
Other(2)	0.0	-0.2	-0.2	-0.1
Capital taxes	0.5	0.9	1.1	1.0
Employers' NICs and NIS	4.8	3.5	3.7	3.7
LA rates	3.4	4.0	4.0	4.0
Taxes on expenditure(3)	9.3	12.3	12.2	11.9
Total	**33.9**	**37.9**	**37.4**	**37.2**

(1) Includes North Sea corporation tax before ACT set off.
(2) Includes North Sea ACT set off and royalties accruals adjustment.
(3) Includes VAT, excise duties, stamp duties, vehicle excise duty etc.

Main points

(a) Sharp rise in total tax burden 1978-79 to 1981-82 (to highest ever level), reflecting recession and need to reduce PSBR. 1981-82 to 1988-89 burden fell by 2 percentage points including North Sea; excluding North Sea it fell by 1½ percentage points.

(b) Since 1978-79:

- Income tax and employees' NICs together fell by nearly 1 percentage point as proportion of GDP

- Corporation tax rose as proportion of GDP reflecting rising profitability of UK industry

- Expenditure taxes as proportion of GDP up by 3 percentage points, mainly owing to VAT increase in 1979.

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(c) Effects of Budget

- Burden of all taxes excluding North Sea measured as proportion of non-North Sea GDP unchanged between 1988-89 and 1989-90.

- Overall tax burden expected to fall slightly between 1988-89 and 1989-90; increased Corporation Tax revenues and effect of real fiscal drag on income tax more than offset by effects of 1988 and 1989 Budget measures and lower North Sea tax revenues.

(ii) Taxes in real terms

Table 3: Taxes in real terms (1987-88 prices)

£ billion

	1978-79	1987-88	1988-89 (estimate)	1989-90 (forecast)
Income tax	37.4	39.9	39.0	40.1
Employees' NICs	8.0	13.4	13.7	13.1
Sub-total	45.4	53.2	52.7	53.2
Non-North Sea Corporation tax	7.4	13.2	14.8	16.4
North Sea taxes(1)	1.1	4.5	2.8	2.3
Other(2)	0.1	-0.9	-0.6	-0.3
Capital taxes	1.6	3.6	4.6	4.4
Employers' NICs and NIS	16.3	14.3	15.5	16.2
LA rates	11.4	16.2	16.8	17.3
Taxes on expenditure(3)	31.2	50.2	51.6	51.4
Total	114.5	154.3	158.2	160.9

(1) Includes North Sea corporation tax before ACT set off
(2) Includes North Sea ACT set off and royalties accruals adjustment
(3) Includes VAT, excise duties, stamp duties, vehicle excise duty etc.

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Changes in taxes on persons in 1989-90 compared to indexed 1978-79 regime

	£ billion
Income tax	-22
Employees' NICs	+5
Indirect taxes on persons (excluding LA rates)	+12
Total	-5

Effects of Budget: Changes in taxes on persons in 1989-90 compared to indexed 1988-89 regime

	£ billion
Income tax	0
Employees' NIC	0
Indirect taxes on persons (excluding LA rates)	-1
Total	-1

* All income tax changes, including [ ], excluding changes in ACT

Main points

(a) Total tax revenue up by over £46 billion in real terms since 1978-79 because economy has grown. 1989-90 tax revenue, after Budget changes, over £2½ billion higher in real terms than 1988-89.

(b) Increase in NICs since 1978-79 have financed pensions and benefits to unemployed.

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(iii) Balance of Taxation

Table 4: Balance of taxation

	Per cent of total taxes and NICs 1978-79	1987-88	1988-89 (estimate)	1989-90 (forecast)
Income tax	32.7	25.9	24.6	24.9
Employees' NICs	7.0	8.7	8.7	8.2
Sub total	39.7	34.5	33.3	33.1
Corporation tax (Non-north sea)	6.5	8.6	10.2	8.8
North Sea taxes(1)	1.0	2.9	1.8	1.4
Other(2)	0.1	-0.6	-0.4	-0.2
Capital taxes	1.4	2.3	2.8	2.8
Total direct	**48.6**	**47.7**	**47.0**	**47.2**
Employers' NICs and NIS	14.1	9.3	10.1	10.1
LA rates	9.9	10.5	10.8	10.8
Taxes on expenditure(3)	27.5	32.5	32.0	31.9
Total indirect	**51.4**	**52.3**	**53.0**	**52.8**

(1) Includes North Sea corporation tax before ACT set off.
(2) Includes North Sea ACT set off and royalties accruals adjustment.
(3) Includes VAT, excise duties, stamp duties, vehicle excise duty, etc.

Main points

(a) Since 1978-79

- Direct tax share has fallen;
- Share of taxes on personal incomes has fallen even more;
- Share of expenditure taxes has risen; reflects explicit Government objective to switch taxation from earnings to spending to encourage enterprise and increase freedom of choice.

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(b) Effects of this Budget in 1989-90 (relative to indexed base):

- Balance between direct and indirect taxes little changed: [ ] cut but indirect taxes [ ].

- Share of taxes on personal incomes little changed.

(iv) 1989-90 compared with 1988-89:

- Non-North Sea tax burden as proportion of non-North Sea GDP, unchanged.

- Compared with indexed 1988-89 regime, total burden on persons in 1989-90 down by [£1] billion, because [ ] burden reduced.

- Balance between direct and indirect taxes little changed.

(v) Burden of tax over medium term: See C3.

(vi) International comparisons: See HH1.

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Contact point: P L Patterson (PSF) 270 5029

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CC4 DEREGULATION OF CAPITAL MARKETS

Treasury Issuing General Consent and Press Notices on Budget Day.

Bank of England issuing Market Notice and Press Notice on Budget Day. Inland Revenue issuing press notice.

Other Relevant Briefs: C2 Monetary Policy and Funding

Brief contains: A Sterling comercial paper and short term corporate bonds

B Control of Borrowing Order 1958 (COBO)

C. Deep discounted securities

A STERLING COMMERCIAL PAPER AND SHORT TERM CORPORATE BONDS

Factual

Current regime

Currently two separate Banking Act regimes in places for short term corporate sterling debt instruments:

(i) Sterling Commercial Paper (SCP)

- 7 days to 1 year maturity;
- minimum denomination £500,000;
- companies must have net assets of £50 million.

(ii) Short Term Corporate Bonds (STCB)

- 1 year to 5 years maturity;
- minimum denomination £100,000;
- companies must have net assets of £50 million.
- Prospectus requirement for each issue

New regime

New, combined SCP/STCB regime will cover instruments with:

- 7 days to 5 years maturity;
- minimum denomination £100,000;
- companies must have net assets of £25 million.
- no prospectus reqirement

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Eligible issuers will be expanded to include:

- Foreign sovereigns and parastatals;
- Private companies and non-UK listed companies, which satisfy appropriate disclosure requirements.
- Banks and building societies.

Timing

Details of new arrangements set out in Market Notice published 14 March by Bank of England. [Issues of this type of security also subject to regulation under Companies Act, which is due to be replaced later this year by regulations under Part V of Financial Services Act.] Changes to SCP regime to be made as soon as possible, STCB regime will be brought into line when [Companies Bill receive Royal Assent].

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Positive

- Provides simpler and more logical framework, encompassing greater range of borrowers;
- Removes anomalous distinctions between 0-1 year and 1-5 year sterling paper;
- Will encourage companies to issue in 1-5 year market, by removing prospectus requirements.
- More eligible issuers, and simpler procedures, should create a more active and liquid market.

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Defensive

(i) Companies will be flooded out of market by new issuers (foreign sovereigns)? No evidence. Companies should still be able to borrow on attractive terms, and more issuers should improve depth and liquidity of market, to benefit of all issuers.

(ii) £100,000 minimum denomination too low? No. Pitched high enough to exclude non-professional investors. Minimum denomination for corporate bonds has always been £100,000. And consistent with Financial Services Act definition of wholesale offering.

(iii) Prospectuses needed for investor protection? No. These are professional markets. Continuing disclosure obligations should be sufficient. Minimum assets requirements ensures only substantial companies can make issues.

(iv) Why not make all changes now? Companies Act will have to be amended before companies will be able to make issues in 1-5 yr maturity without a prospectus. Not right to retain restriction on companies only, so making changes for issues under one year now, and for 1 to 5 years when Companies Act amendment comes into force.

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B CONTROL OF BORROWING ORDER 1958 (COBO)

__Factual__

__Current regime__:

- Currently new issues in sterling of £3 million or more require timing consent from Bank of England.

- Last vestige of post war regime controlling capital markets.

__New regime__:

- General Consent under COBO coming into effect on Budget day removes requirement to apply for timing consent, from all except local authorities. Hence queue no longer operated by Bank.

- Controls on local authority borrowing under COBO to remain in place until carried into local authority legislation (April 1990). Then COBO revoked fully, and parent legislation (Borrowing (Control and Guarantees) Act 1946) repealed.

- General Consent will have effect of removing restrictions on issue of deep discount bonds by foreign public sector borrowers.

__Timing__:

- Requirement to apply for timing consent lifted immediately. COBO to be revoked after Part IV of Local Government and Housing Bill comes into effect 1 April 1990.

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__Positive__

(i) Abolition of COBO sweeps away last vestige of post war apparatus for direction of capital by state.

(ii) Important deregulatory measure - frees markets and underlines Government's confidence in London's future as financial centre.

__Defensive__

(i) __Abolition of COBO will increase borrowing on sterling capital markets?__ No - not used to control __volume__ of new issues, only __timing__.

(ii) __Abolition of queue will mean clashes in new issues?__ Wrong for state to impose restrictions of this sort. It is for market to decide if it wants voluntary mechanism for preventing clashes.

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(iii) Abolishing queue with immediate effect will cause new issue clashes? Government believes markets able to respond flexibly to such changes.

(iv) Why maintain COBO for local authorities? COBO continues to serve useful function in control of local authority borrowing. When new, comprehensive, regime in Local Government and Housing Bill takes effect in 1990, COBO no longer needed for this purpose and will be revoked.

Contact point: A J Sharples (FIM2) 270 4482

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C DEEP DISCOUNTED SECURITIES

Inland Revenue and Treasury issuing Press Notice on Budget Day. See also brief on Capital Markets Deregulation.

Factual

New rules needed because of abolition of new issues queue for sterling bonds and equities. Different rules for variable and non-variable securities.

Non-variable securities

(i) New rules extend existing taxation treatment of yield from deep discounted corporate bonds to yield from similar securities issued by non-corporate sector (Government and other public sector bonds). On disposal or redemption investor will be charged income tax on accrued discount. Any balance of gain or loss taxed as capital gains (unless exempt from CGT as qualifying corporate bond). Existing issues of deep discounted gilts continue to be taxed as present.

(ii) New rules apply to disposals on or after Budget Day.

(iii) Deep discount defined as more than ½ point discount per year (or more than 15 points overall).

Variable securities

(i) Where total discount to redemption cannot be determined at time of issue because of variable features (eg no fixed date of redemption or return index linked) but can exceed ½ point per year or 15 points overall, whole uplift (difference between cost and sale or redemption proceeds) to be taxed as income. Index linked securities which carry commercial rate of interest and issued for more than five years are excluded from new rules, subject to certain conditions about nature of index linking.

(ii) New rules apply to disposals on or after Budget Day of variable securities issued by both corporate and non-corporate sector.

Positive

(i) Aligns tax treatment of corporate and non-corporate deep discounted securities. Non-discriminatory between sterling and foreign currency issues.

(ii) Provides opportunity for non-corporate sector to offer similar terms to corporate sector.

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Defensive

Why treat variable issues differently?

Impossible to apply non-variable rules to variable securities. But benefit of non-variable regime available to all issuers provided securities have fixed features. Also new regime provides consistent treatment irrespective of issuer, and clears up doubts about treatment of index linked securities.

Contact point: B O'Connor (Inland Revenue) 438 (GTN 3541) 6218

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CC5 **GILTS AND NATIONAL SAVINGS**

This brief includes:

A NLF purchases of gilts
B Gilt redemption procedures
C Small estates
D Winding up Redemption Annuities Account
E National Savings - removal of minimum interest rate
F National Savings - restriction of deposits to personal savers.

Other relevant briefs: C2

A. POWER TO USE NLF MONEY TO BUY GILTS FROM BANK OF ENGLAND ISSUE DEPARTMENT

[This measure will be mentioned in [Budget Speech and the] FSBR.]

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Factual

(i) According to Government's full fund rule, Bank of England currently has to buy in gilts, not issue them. These gilts are held in Bank's Issue Department. But Issue Department assets provide backing for note issue and finite in size - currently around £16 billion. Finance Bill will include clause to allow Treasury to use NLF money to buy gilts from Issue Department ahead of redemption for immediate cancellation.

(ii) When gilts are cancelled, national debt reduced immediately.

Positive

Need for measure reflects Government's prudent fiscal stance, with large repayments of debt in 1987-88 and 1988-89.

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Defensive

(i) How will this power be used? Timing, prices, particular stocks and amounts involved will be agreed between Bank and Treasury. Market sensitive to reveal further information.

(ii) Why use NLF and not voted money? Money from issues of stock goes into NLF and payment of dividends and final redemption money comes from it. So sensible to use NLF for this purpose.

(iii) Costs? Once gilts have been bought in by Issue Department, only cost is insignificant amount for administration.

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B. **GILT REDEMPTION PROCEDURES**

[This measure will not be referred to in Budget Speech, or supporting documentation. Will only become apparent when Finance Bill published.]

Factual

(i) Finance Bill will amend section 47 of the Finance Act 1942 (power to make regulations about transfer and registration of Government stocks) to allow regulations to be made concerning redemptions. Intention is to lay regulations streamlining gilt redemption procedures.

(ii) At present, under Finance Act 1921 and Government Stock (Redemption) Regulations 1924, Bank (as gilt registrars) issue form about 3 months prior to redemption date to sole or first named holder on each account with notice to other holders. This must be signed by all holders and returned with stock certificate before redemption payment can be made. Intention is to legislate to allow Bank to write to sole or first named holder saying that unless instructions signed by all holders given, on appropriate form, warrant will automatically be sent to address registered with Bank for sole or first named holder. Explanatory notice will be issued to joint holders.

Positive

(i) Expected to save around £70,000 per year and administratively simpler for gilt holders (especially those with joint holdings) as well as the Bank.

Defensive

(i) Gilt holder moved and failed to notify Bank? Responsibility of holder to tell Bank he has moved.

(ii) Disincentive to payment direct into bank account? No. Holders will only have to return form, as at present.

(iii) Open to abuse by first named holder? No. Explanatory note will be issued to joint holders, who always able to object.

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C. SMALL ESTATES

[This measure will not be referred to in Budget Speech or supporting documentation. It will only become apparent when Finance Bill published.]

Factual

(i) Finance Bill will amend section 47 of Finance Act 1942 (power to make regulations about transfer and registration of Government Stocks) to allow regulations to be made enabling Bank to transfer stock on their books (up to a specified market value) in name of deceased person into another name, without requiring probate.

(ii) Intention is to align as far as possible Bank's powers with those of DNS for stocks held on National Savings Stock Register (NSSR). DNS have statutory power to dispense with probate for holdings of gilts with market value of less than £5,000. Bank do not, and can only avoid asking for probate, even if not required for other purposes, by transferring stocks to NSSR. Administratively complex, appears illogical to stockholders and not all stocks can be held on NSSR.

Positive

(i) Minor savings in administrative costs for Bank and DNS.

(ii) Will benefit estates concerned, since no need now to secure probate simply to deal with small holdings of gilts.

(iii) Removes apparent presentational illogicality.

Defensive

(i) Flouting proper legal process for Bank to transfer ownership without probate? No. Bank will only act in cases where inheritance is absolutely clear and where probate not required for any other purpose. Simply following DNS precedent which has applied since 1925 (limit increased from £500 to £5000 in August 1975) and in any event used now for holdings on Bank's register transferred to NSSR.

(ii) Why only Bank of England and not Bank of Ireland? [For use only if pressed] Different considerations apply to Bank of Ireland, and they are not pressing for the change. Therefore best to avoid measures with implications for Irish law on administration of estates.

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D. **WINDING UP REDEMPTION ANNUITIES ACCOUNT (Following redemption of 3 per cent Redemption Stock 1986-1996 on 1 October 1988)**

[This measure will not be referred to in the Budget Speech or supporting documentation Will only become apparent when Finance Bill is published.]

Factual

(i) Measure winds up an obscure Government account. 3 per cent Redemption Stock 1986-96 issued as compensation to tithe owners who, by the Tithe Act 1936, lost ancient and statutory rights to tithes. Intention was stock issue should be self-financed by payments from tithe payers, and annual grant from Consolidated Fund (lately £0.3 million) representing savings to Exchequer from abolition of tithes. All transactions effected by Redemption Annuities Account, which met interest cost of stock, and passed over surplus to separate Sinking Fund.

(ii) As arrangements were to be self financing 3 per cent Redemption 1986-96 was redeemed as soon as adequate funds in Sinking Fund - ie 1 October 1988. Nonetheless, some surplus inevitable (impractical to redeem except on 6 monthly interest payment dates). But surplus relatively minor (£2 million). Sinking Fund already been closed (and had no residual balance); RAA now has no further purpose.

(iii) New powers will enable surplus on RAA to be paid into Consolidated Fund immediately before RAA is closed. Also enables various repeals, including removing need for annual contribution from Consolidated Fund to RAA.

Positive

(i) This measure tidies up Government accounts.

(ii) Entirely consistent with spirit of 1936 Tithe Act, and Ministerial statements at time that Government would not profit by acting as intermediary in resolving tithe problem. Had Government redeemed on 1 October 1996 (last possible date), RAA would have had surplus of £35-40 million, clearly inconsistent with Government's previous statements.

Defensive

(i) Why pay surplus to Consolidated Fund (1936 Act required only that Parliament determined what to do with surplus)? Only practical solution - stockholders have benefited from earliest possible redemption; tithe payers no longer traceable.

(ii) Does surplus mean redemption of the 3 per cent of the Redemption Stock was delayed? No. Stock redeemed at earliest opportunity. Inevitably some small balance on RAA.

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E. NATIONAL SAVINGS ORDINARY ACCOUNT - REMOVAL OF MINIMUM INTEREST RATE OF 2½ PER CENT

[This measure will not be referred to in Budget speech or supporting documentation. Will not become apparent until Finance Bill is published.]

Factual

(i) Section 5 of National Savings Bank Act 1971 provides that interest rates on Ordinary Account deposits may be determined by Treasury, and specified by Order, subject to a minimum of 2½ per cent. Finance Bill will replace those arrangements, so that interest rates (including a nil rate) will in future be determined by Director of Savings, with Treasury consent, with notice given in Gazettes.

Positive

This change will bring Ordinary Account into line with practices for all other National Savings products. In no other case is a minimum interest rate stipulated in legislation, or change to terms notified in statutory instrument.

Defensive

(i) This is no way to encourage personal saving? Government wants to encourage saving among all sections of community. That doesn't mean promoting all National Savings products. Want National Savings in funds investors will leave untouched for a number of years. Ordinary Account is instant access product, which has no priority as funding instrument.

(ii) Do you intend to stop paying interest entirely? Rates for 1989 already announced, and will not be changed. No decision taken on interest rate structure thereafter.

(iii) Paving way for abolition of Ordinary Account? No such plans. Government has no power to abolish Ordinary Account. That will require further primary legislation - extensive amendment to National Savings Bank Act 1971.

(iv) Further swipe at small savers, eg pensioners and children? No. Unlikely that depositors see Ordinary Account as savings account - much closer to instant access account. Those who wish to save small sums with National Savings would do much better with Investment Account (10.75 per cent gross at 1 months notice). For those who wish to deposit less than £5, banks, building societies and Girobank (at Post Offices) offer facilities, including higher interest than Ordinary Account. Significant that Ordinary Account business has been declining for many years.

(v) Will take more business away from sub-Postmasters? Expect any loss of business on National Savings to be [largely] offset by gains on Girobank.

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(vi) <u>Government's approach to Ordinary Account mean and vindictive</u>? No. Ordinary Account operation expensive - £130 million a year for administration and interest. Average cost of each transaction well over £1. Essential to ensure it is run efficiently and economically.

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F. NATIONAL SAVINGS ORDINARY AND INVESTMENT ACCOUNTS: RESTRICTION OF DEPOSITS TO PERSONAL SAVERS

[This measure will not be referred to in Budget speech or supporting documentation. Will not become apparent until Finance Bill is published.]

Factual

(i) Clause widens Section 2 of National Savings Bank Act 1971 to permit the Treasury by Order to restrict classes of persons who may open accounts with National Savings Bank. Intention is to make an Order restricting deposits to personal savers. This will rule out "collective" accounts, eg in name of companies, institutions, clubs, societies, religious orders etc. But all existing accounts of this type will continue to operate.

Positive

(i) Given Government's need to borrow less overall, yet stimulate personal savings, National Savings can now concentrate on attracting money from the personal sector.

Defensive

(i) When will Government make an Order under this Clause? Not decided, but the power will be available from 1 October, provided clause passed.

(ii) Which classes of persons will be covered? Government intends to restrict investments to personal savers.

(ii) Discriminates against charities and non-profit making organisations who will be denied interest gross of tax? No. Existing accounts can continue. New accounts will not be available, but charities and all other organisations not classified as companies for tax purposes can get gross payment of interest from banks and building societies, linked to money market rates.

(iii) Why only acting on Ordinary and Investment Account? Other products are not governed by legislation, so this kind of stipulation can be made in prospectus. Gradually extending concept across ranges of products. Already applies to Capital Bond introduced in January, and has always applied to Premium Bonds.

(iv) When will Government extend restriction to Income Bonds? It is intended to do this in due course.

Contact point: C Ryding (MG1) 270 4612 for A, B and C
R Devereux (FIMI) 270 4648 for D
I Rich (MG1) 270 4679 for E and F

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DD2 INDEPENDENT TAXATION

Brief contains: A: Savings
B: Special Issue of Tax Returns
C: New Leaflets

A. SAVINGS

Factual

(i) Independent Taxation (which applies from 6 April 1990) abolishes rule which treats wife's income as husband's for tax purposes:

Means wife will

- be taxed separately on all her income including savings income.
- no longer have to disclose her income to her husband.
- have her own personal allowance to set against her income.

Positive

(i) Independent Taxation will encourage saving - gives married women privacy for their savings income and considerably reduces overall tax on married women's investment income by comparison with present system.

Defensive

(i) Married women cannot recover tax deducted from building society interest? Bank and building society interest subject to composite rate arrangements. Tax deducted not refundable in any circumstances. Married women treated in same way as other people.

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B. SPECIAL ISSUE OF TAX RETURNS

Factual

(i) To help divide income and tax reliefs correctly between husbands and wives for new system, Inland Revenue issuing about 1 million extra tax returns in April 1989, mostly to married men over 65. Returns sent to those who do not normally receive them will include special note explaining why one sent this year.

Positive

(i) Preparations for smooth introduction of Independent Taxation already well in hand. Inland Revenue issuing extra tax returns to couples where the husband/wife split of income and tax reliefs might otherwise be in doubt.

(ii) Poster campaign in post offices, libraries and day centres to explain about special issue of returns. Financial Secretary to write to all MPs in April with further details, and other interested bodies will receive full information.

(iii) Recognise that those not used to receiving tax returns may find it daunting. Each extra return will include a note explaining why it has been sent. Tax office staff always available to help with any questions.

Defensive

(i) Extra returns being issued to test whether taxpayers not used to them can fill them in?/to test whether Revenue staff can cope with extra work?/to discover tax evasion? No. Inland Revenue not in business of creating unnecessary work for taxpayers or themselves. Extra returns sent only where necessary to establish correct position for introduction of new system. (Always possible that some previously undisclosed income might come to light - but not the aim of the exercise.)

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C. NEW LEAFLETS

Inland Revenue issuing Press Release on Budget Day.

Factual

(i) 3 new leaflets describing new system available in Tax Offices by Budget Day:

- Independent Taxation - A guide for Married Couples (IR 80).
- Independent Taxation - A guide for Pensioners (IR 81).
- Independent Taxation - A guide for Husbands on a low income (IR 82).

Positive

(i) Publicity for Independent Taxation taken very seriously. New leaflets only one aspect of major campaign which will gather strength throughout the year ready for introduction of new system in April 1990.

Contact point: B A Mace (IR) 438 (GTN 3541) 6546
or P Wardle (IR (GTN 3541) 7349.

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DD3 **TAX RELIEF FOR PRIVATE MEDICAL INSURANCE**

Factual

(i) Government announced in White Paper "Working for Patients" (Cm 555) published 31 January 1989, new income tax relief on premiums for private medical insurance for those aged 60 and over.

(ii) Legislation introducing relief in Finance Bill 1989. Relief to take effect from April 1990.

(iii) Main features of relief:-

- basic rate relief by deduction at source (like MIRAS scheme for mortgages - goes to non-taxpayers as well as taxpayers);
- higher rate relief, where due, to be given by tax office, eg by adjustment to PAYE code.
- available both where premiums paid by insured person or someone else (eg relative) on their behalf;

(iv) Details of relief still to be finalised. Inland Revenue consulting medical insurance industry.

(v) Cost of relief: Nil 1989-90; £40 million 1990-91. In subsequent years costs likely to rise as more over 60s encouraged by relief to take out medical insurance.

(vi) Approximate numbers of over-60s with cover now:-

- 300,000 individual policyholders (compared with 800,000 aged under 60).

Total over-60s covered (including dependants): 600,000-700,000 (about 5 per cent of 12 million people over 60).

(vii) Background figures (millions: increase over previous year shown in brackets):

		1985		1986		1987	
(a)	Overall number of subscribers	2.33	(+2.2%)	2.45	(+5.3%)	2.54	(+3.8%)
	Overall number of people covered by private medical insurance	5.03	(+1.6%)	5.25	(+4.3%)	5.34	(+1.7%)
	Number of company provided policies included in above figures	1.24	(n/a)	1.35	(+9.3%)	1.43	(+5.4%)

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(b) Typical policy premiums (1988):

Age group	Full policy(£)	Budget policy(£)
Up to 29 years	240	100
30-54	270	140
55-69	380	220
70+	680	350

Positive

(i) Relief needed because members of company medical insurance schemes usually lose benefit on retirement. Need to provide help for those who wish to continue with medical insurance when their income falls and premiums rise.

(ii) Relief for under 60s paying premiums for over-60s encourages younger people to provide, eg for older relatives, while reducing burden on NHS.

Defensive

(i) Why not wider relief? Unnecessary; number of people covered by private medical insurance grown significantly in recent years, especially where insurance cover provided by employers. Special tax reliefs should always be avoided except where case for them can be clearly made out.

(ii) Should have spent money on NHS rather than give tax relief. Public Expenditure White Paper (published 30 January 1989) shows largest increase in resources ever made available to NHS: £2.5 billion 1989-90, and over £2.5 billion 1990-91. Measures announced in White Paper "Working for Patients" ensure patients will benefit from better, more responsive and efficient NHS.

(iii) Subsidy for those with private medical insurance already. Relatively few over-60s among current medical policyholders. People often leave private medical insurance schemes on retirement because of rising premiums and decrease in income.

(iv) Favours wealthy. Relief aimed at those who can no longer afford full cost of premiums.

(v) Why relief at marginal rate? In line with general approach that tax reliefs given at taxpayer's marginal rate.

(vi) Relief for those who pay for operations direct out of own resources? Not necessary: already good market in paying direct.

Contact point: A J Walker (IR) 438 (GTN 3541) 7237

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DD4: SCHEDULE E: RECEIPTS BASIS

Inland Revenue issuing Press Release on Budget Day

Factual

(i) Basis of assessment under Schedule E for earnings of employees and directors to be changed from earnings for the year to earnings received in the year - with effect from 6 April 1989.

(ii) Present position: most employees receive in the tax year broadly what they earn for that year - change will not affect them. Minority - around ½ million, mostly directors - receive remuneration after year for which it is earned: need to sort out what income relates to which year - assessment required annually on earnings, or non-statutory accounts, basis.

(iii) New system will mean for everyone tax due will be based on earnings received in year - brings into line basis of assessment and basis of collection under PAYE.

(iv) Yield £50 million from 1992-93 onwards, after transitional costs of £80 million in 1989-90, £60 million in 1990-91 and yield of £10 million in 1991-92.

(v) Staff saving 175 by 1992-83, after small initial staff cost for work on transitional provisions.

Positive

(i) Continues Government's programme of tax reform - significant simplification - aligns basis of assessment with basis of collection - easier for taxpayers to understand.

(ii) Reduction in compliance burden, mainly for directors.

(iii) Speedier settlement of directors' tax liabilities - fewer, and simpler assessments needed.

(iv) Increased Revenue efficiency by enabling IR to drop unproductive work - improvement in Schedule E assessing arrears.

(v) Eventual yield of £50 million and staff savings of 175.

Defensive

(i) Proposal unfairly target directors? Not so. Change results in fairer system - easier and less burdensome for directors.

(ii) Proposals will result in losers? Precise impact will vary between taxpayers, but few if any will lose in cash terms. Scope for tax planning under accounts basis removed.

(iii) Will there be transitional provisions/anti-avoidance provisions? Yes - wait for Finance Bill.

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(iv) Will bunching of receipts take people into higher rate? Bunching could happen under old system. Less of a problem now, with broad basic rate band and only one higher rate of 40 per cent.

(v) Employees able to minimise tax bills by arranging in which year to receive income? Most employees don't have control over when pay received. Directors can minimise tax bills now by voting remuneration for different periods. Less worthwhile now with broad basic rate band and only one higher rate.

(vi) Why no consultation? Government agrees consultation can be valuable in appropriate cases - but basic proposal straightforward. Proposed definition of receipt takes account of responses to Keith consultations on definition of payment for PAYE purposes - decided important to obtain benefits of this simplification measure without delay which would inevitably result from consultation.

(vii) Why not also introduce current year basis for Schedule D? More complex. Although good case in principle, finding precise form for CY basis and means of getting there acceptable to taxpayers, practitioners and Revenue, without unacceptable cost, far from straightforward.

Contact points: I Fraser (IR) 438 (GTN 3541) 6818
or J Payne (IR) 438 (GTN 3541) 7211

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DD5 REFORM OF TAX RELIEFS FOR RELOCATION COSTS

Inland Revenue issuing Press Notice on Budget Day.

Factual

(i) At present two extra-statutory reliefs for employees who move house with their jobs:

(a) ESC A67 - relief for contributions by employers (up to prescribed maximum) to additional housing costs, eg extra mortgage interest and rent, incurred by employees moved to more expensive housing areas. Maximum changes in line with civil service Additional Housing Costs Allowance maximum total amount currently payable - £21,210 from 1 February 1989.

(b) ESC A5 (a) and (b) - exempts from tax benefit of removal expenses, eg legal, estate agency fees, moving furniture, paid for or reimbursed to employees.

(ii) With effect from 6 April 1989

(a) ESC A67 (additional housing costs) withdrawn.

(b) ESC A5 (a) and (b) (removal expenses) withdrawn but replaced by new statutory relief. New relief broadly mirrors concessionary arrangements, but not entirely. Payments for capital losses in future taxable. Categories of removal expenses covered area:

- costs of selling and buying new property eg legal fees, stamp duty, estate agents fees
- costs of removing or storing furniture and effects
- extra travelling and subsistence costs
- bridging loan interest
- costs related to provision of replacement effects eg carpets and curtains, not suitable for removal to new home or use at new location.

(iii) Concessionary relief retained on transitional basis for payments made after 6 April 1989 where

(a) Under ESC A67

- housing costs subsidies already in payment before 6 April;
- employee committed to move before 6 April and starts new job by 1 July 1989 provided all conditions for relief under ESC satisfied.

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In transitional period maximum amount payable tax free frozen at limit applying on 6 April 1989.

(b) Under ESC A5 (a) and (b) in relation to capital losses met by employer. To qualify employees must be committed to move before 6 April and start new job by 1 July 1989.

(iv) Yield from withdrawing relief for housing costs subsidies (ESC A67) - estimated at £5 million in 1989-90 and £30 million in 1990-91. Once transitional relief expired full year yield tentatively estimated at up to £100 million. Annually, about 50,000 employees receive additional housing costs payments.

(v) Annual costs of relief for removal expenses (ESC A5 (a) and (b)) tentatively estimated at £200 million. 180,000 employees move each year with their jobs and receive tax exempt payments.

(vi) Revenue staff cost negligible.

Positive

(i) Withdrawal of relief for additional housing costs will remove any contribution it made to

- artificial blunting of market pressures on employers to relocate to cheaper housing areas.
- house price pressures in South East and other expensive housing areas
- house price differentials between South East and UK generally

(ii) New statutory relief for removal expenses preserves genuine tax incentive for job mobility between all parts of country

(iii) Transitional arrangements will help ensure employees committed to job move at 6 April do not lose out.

(iv) Legislating relief for removal expenses (ESC A5) will answer requests (by CBI and others) for greater certainty and clarity in scope of relief.

Defensive

(i) Withdrawal of relief will reduce job mobility? No. Relief for additional housing costs payments only available for employees moving jobs with existing employers. So relief does not help new job mobility now.

Also, estimated that more than 50 per cent of employees moving house with their jobs get no help with costs from employers.

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(ii) Withdrawal of relief for additional housing costs will only have marginal affect on house prices? Difficult to estimate. But Government believe it wrong in principle to continue a tax relief which has this effect of increasing housing pressures in already expensive areas. (Contrast: mortgage interest relief - neutral geographically).

(iii) Withdrawal of relief will add to employers costs? Depends. Most employers unaffected either because they do not relocate or they do not subsidise employees' costs. Employers costs will rise where payments increased to cover extra tax payable by employee.

(iv) Company relocation plans affected? Not if moving away from South East or other expensive areas. Withdrawn relief only applies where extra costs stem from move to more expensive housing areas.

(v) Transitional arrangements not generous enough? Arrangements will ensure relief not withdrawn retrospectively. 3 month period in which to start job in new area should mean all employees committed to moves by 6 April will retain old relief.

(vi) Why withdraw relief for capital losses under removal expenses relief? In principle, income tax relief should not be available for capital losses on houses however they arise.

(vii) Why not give relief for employees own costs? Too expensive - could double cost (currently £200 million) of relief for removal expenses. Well outside normal Schedule E expenses rule - "wholly, exclusively and necessarily in the performance of the duties". (Large compliance and administration costs for employers and Inland Revenue).

(viii) Why no consultation with employers representatives? Already know that CBI and others want further relaxations in removal reliefs so reaction to withdrawal predictable. But legislation for removals expenses will improve clarity of present concessionary relief, while preserving it largely intact.

(ix) Will add to employers compliance burden? Unlikely and, if so, only marginally. Where appropriate, payments will be taxed under PAYE. Taxable benefits should be returned on either form P9D or P11D after year end. (Compliance Cost Assessment available from IR.)

Contact point: C R Massingale (IR) 438 (GTN 3541) 6303
S S Wilcox (IR) 438 (GTN 3541) 6383

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DD6 - PROFIT RELATED PAY (PRP)

Other briefs: DD11 - Material Interest

Inland Revenue issuing Press Release on Budget Day.

Factual

(i) PRP part of employee's pay linked to profits of business. Income tax relief on half of PRP up to 20 per cent of pay or £3,000 if less, for PRP paid under registered schemes.

(ii) Changes in PRP

(a) Increase in cash limit on tax-relieved PRP from £3,000 to £4,000 (maximum relief increased from £375 to £500 for basic rate taxpayer; from £600 to £800 for higher rate taxpayer). Effective for PRP payments made for profit periods beginning 1 April or after.

(b) Employers enabled to set up schemes for central (eg headquarters) employment units with PRP based on profits of whole business.

(c) Minor changes to improve PRP operation and administration:

- facility for profit and loss accounts to exclude employer's NIC relating to PRP (to ease accounting complexity);
- option to continue scheme after death of scheme employer;
- remuneration of certain excluded employees defined;
- secondary tax recovery power against PAYE employer if scheme employer outside UK.

(d) Changes already announced:

- requirement dropped for schemes registered after 3 February 1989 that PRP be at least 5 per cent of employee's pay if profits unchanged ("5 per cent test")
- certain alterations to scheme rules permitted from 10 October 1988;

(iii) Revenue cost: £10 million in 1989-90 and £15 million in 1990-91.

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Positive

(i) Likely to increase take-up of PRP. Meets variety of representations.

(ii) Widens choice of starting level of PRP. Admits employers who wish to start lower and build-up.

(iii) Simplifies PRP (notably by abolishing "5 per cent test"), while increasing flexibility (eg 'headquarters' units).

Defensive

(i) Take-up disappointing? No. Encouraging for new initiative. Compares favourably with early employee share scheme take-up. [ ] schemes registered to end-February - [ ] live schemes.

(ii) PRP difficult to understand? Apparent complexity due to great flexibility. Revised Revenue Guidance Notes widely welcomed. Small average size of schemes already registered suggests difficulties exaggerated.

(iii) No advantage to employers? Advantage to both employers and employees. Flexible wage costs and improved industrial relations.

(iv) PRP costly to set up and operate Depends how introduced. Costs normally tax-deductible.

Contact points: J D Farmer (IR) 438 (GTN 3541) 7652
Ms J Fairfield (IR) 438 (GTN 3541) 7763

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DD7 GIFTS, TRUSTS AND OTHER SETTLEMENTS: INCOME TAX

Other relevant brief: DD2 Independent Taxation.

Inland Revenue issuing Press Notice on Budget Day.

Factual

(i) Present position

- Wife's investment income taxed as husband's until 1989-90 but as her own from 1990-91.

- Settlement income treated as settlor's if settlor can benefit or if spouse can benefit, from capital or income. In some cases, income still treated as beneficiary's for basic rate - tax paid by trustees can be reclaimed.

(ii) Budget proposes three changes:

(a) Income from simple, outright gifts between husband and wife to be taxed as recipient's from 6 April 1990.

(b) Pensions allocated (under certain statutory pension schemes) to husband or wife in return for pensioner giving up part of own pension to be taxed as partner's income, not pensioner's, from 6 April 1990.

(c) Trusts and other settlements: if income treated as settlor's for higher rate purposes, will always be treated as his for basic rate also, and no longer as beneficiary's.

(iii) Income from gift between husband and wife which falls short of complete transfer of income and capital (such as trust under which either husband or wife benefits) taxed as donor's.

Positive

(i) Treats husband and wife as independent.

(ii) Recognises every day type of gift between husband and wife. No need for couples to keep track of such gifts for tax purposes. Where control of capital passes, right that tax on income follows.

(iii) Puts pensions allocated under certain statutory schemes on same footing as National Insurance pensions awarded by virtue of spouse's contributions.

(iv) Denies tax advantages to more sophisticated arrangements - eg transfer of income without losing control of capital.

(v) Stops trusts being used by wealthy to obtain tax advantages not available through covenants following reform in 1988.

(vi) Fulfils commitment given by Financial Secretary in 1988 - OR Standing Committee A 23 June 1988 cols 623-4.

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Defensive

(i) Taxation only truly independent if benefit to settlor's spouse ignored altogether. Would be going too far. Wealthy could minimise tax by transferring investment income to low rate taxpayers (eg children or non-working spouse) whilst keeping capital within family.

(ii) Are changes retrospective? No:

- Gifts between husband and wife, allocation of pensions: new rules take effect from 1990-91 whenever gift or allocation made.

- Trust income paid to settlor's spouse: new rules take effect from 1990-91 whenever trust made. Will generally continue present treatment of taxing income as husband's.

- Other trust income: new rules only apply to trusts made on or after Budget day.

(iii) Why no other changes to trust taxation? Other matters mentioned by Financial Secretary in 1988 are under review.

Contact points: B A Mace (IR) 438 (GTN 3541) 6546 - Independent Taxation
R D Golding (IR) 438 (GTN 3541) 7509 - other aspects

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DD8 EFFECTS ON INCENTIVES AND TRAPS

Other relevant briefs: D4 Effects of income tax, NIC and indirect tax changes on living standards.
D5 National Insurance Contributions.
Pre-Budget Brief N.

__Factual__

(i) __Budget Measures__

(a) Main personal allowances indexed for non-aged.

(b) Under __pre-reform regime for NICs__, employees with an increase in earnings which takes them across one of the thresholds at £43 per week, £75 per week and £115 per week would pay additional NICs of £2.15 per week, £1.50 per week and £2.30 per week respectively. Implied marginal effective tax rates for small pay increases well in excess of 100 per cent. (See chart showing marginal income tax and NIC rates, before and after reform).

(c) __Reform of employee NICs__ will from October 1989 eliminate the steps at £75 and £115 per week, and reduce that at £43 per week by £1.29 to 86 pence. No changes being made to employers' NICs, so steps remain at £43, £75 and £115 p.w.

(d) At present there are some x employees with earnings less than £5 below £43 per week, y employees with earnings less than £5 below £75 per week and z employees with earnings less than £5 below £115 per week. A major disincentive for them to work and earn more has been removed by the NIC reform.

(e) __Pensioners earnings limit__ abated State retirement pension by 50p for every pound earned between £75 and £79 p.w. by individuals eligible for the pension and pound for pound thereafter. A severe disincentive for older people to work more hours and earn more, but no data available which would permit us to estimate the number discouraged from working as a result. Some 200,000 chose the alternative option of deferring their pension in return for a higher pension on their eventual retirement.

(f) __Budget abolished earnings limit from October 1989__. Those eligible for State retirement pension will receive their full pension entitlement however much they earn. Option to defer will be kept.

(ii) __Poverty trap__

(a) Situation where working families with low incomes face high effective marginal rates (ie increases in gross earnings produce small increases or even decreases in net income) as a result of combined effect of income tax, NICs and

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withdrawal of means-tested benefits. Commonly defined as effective marginal rates in excess of 70 per cent.

(b) Latest published estimates of numbers of working families with very high combined marginal rates are:

Table 1 Combined marginal income tax, NIC and benefit withdrawal rates, 1988-89 (1)

	Working heads of tax units
100 per cent or more	0
90 - 100 per cent	45,000
80 - 90 per cent	300,000
70 - 80 per cent	170,000
Total over 70 per cent	515,000

(1) Figures do not allow for the NIC steps, which could by themselves produce marginal rates over 100 per cent if a rise in earnings led to one of the steps being crossed.

Source: OR 25 March 1988, col 244. Most recently reproduced as table 15.15 of chapter 15 of the January 1989 Public Expenditure White PaPER.

(c) Note, however, that these estimates ignore the effects of the NIC steps - see (i) (b) above and chart - and thus understate the scale of the trap.

(d) On other hand quoted marginal rules may overstate the problem. Family Credit awards ran for 6 months, so incentive to earn more in short run not affected.

(e) Main way for people to get out of proverty trap is to raise their net income sufficiently to float them off means-tested benefits.

(iii) Unemployment trap

(a) Situation where net income out-of-work is close to or even greater than net income in work. Conventional measure of this is ratio of out of work to in-work net income - "replacement ratio". Unemployment trap commonly defined as replacement ratios above 80 per cent.

(b) Difficult to define numbers precisely because of need to measure potential earnings of those currently unemployed - obviously a hypothetical number. Easier, but not particularly meaningful, to work out figures for working families. DSS estimate that only 20,000 working families have ratios over 100 per cent.

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Positive

(i) NIC reform removes a major distortion affecting the lower paid. Eliminates the highest potential marginal effective tax rates in the system. Eases both proverty and unemployment traps.

(ii) Abolition of earnings limit eliminates penal disincentive for people over retirement age to earn more than £75 per week.

(iii) More gradual withdrawal rate for age allowance reduces marginal income tax rate for some 120,000 aged tax ;units from $41^2/_3$ per cent to 37½ per cent.

Defensive

(i) Not enough attention to alleviating traps? Should not overestimate size of problem. Numbers in worst part of the traps is small. Best long term solution is to pull people out of traps by productivity growth, leading to rising real earnings for those in work and reducing need for means-tested benefits.

(ii) NICs reform does nothing to improve incentives for those earning more than £115 per week (who still face marginal NIC rate, contracted-in, of 9 per cent). Reform reduces major distortions affecting work incentives for many earning less than £115 per week. Leaves combined income tax & NIC rate unchanged at 34 per cent for all between £115 and £325 per week.

(iii) Marginal NIC rates raised for those earning less than £115 pw. Rise small - from 5 or 7 per cent to 9 per cent - and unlikely to have any significant distribution affects, as lower marginal rates only applied if employee's pay remained below next step of £75 or £115 pw: in affect trapping employees and deterring them from undertaking more demanding jobs. Beneficial incentive affects of reducing the LEL step and abolishing the other steps will be more important in long run.

(iv) Why no reform of employer NICs? No particular incentive problem with employers' NICs. More urgent to tackle employee side.

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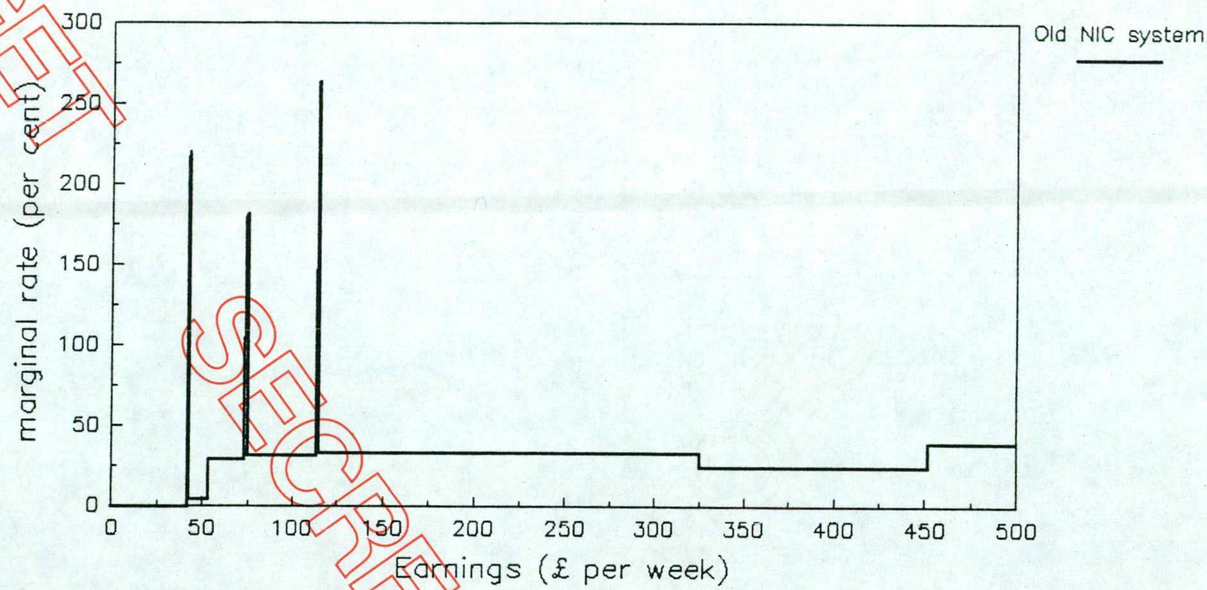
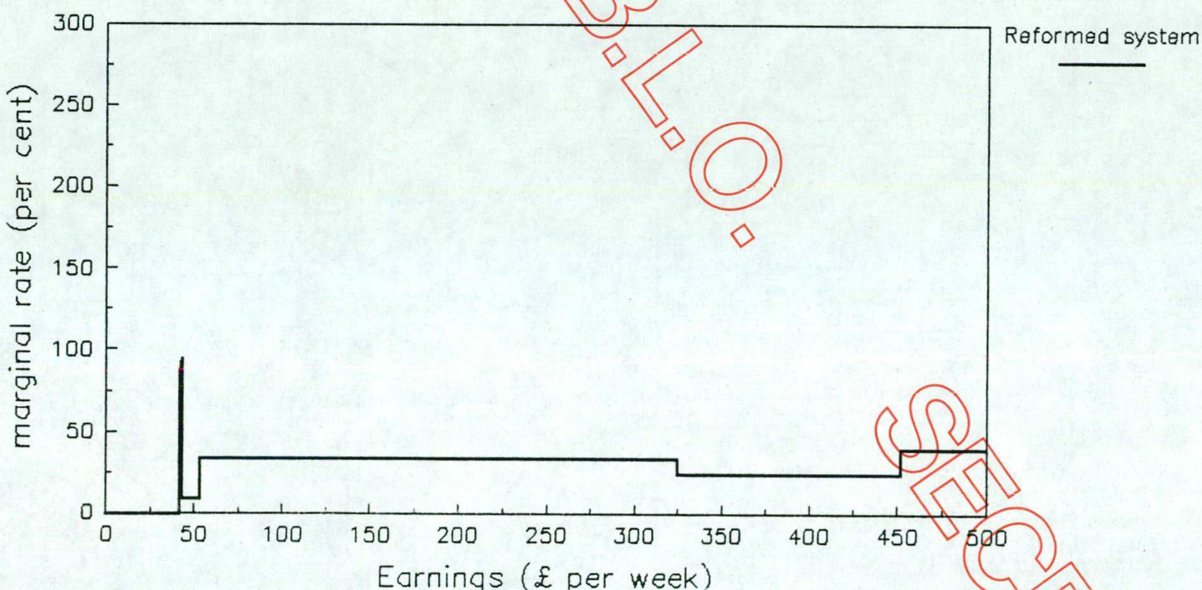
Marginal Income tax and NIC rates
Single Person



Assumes no allowances or reliefs other than the personal allowances

Marginal Income tax and NIC rates
Single Person



Assumes no allowances or reliefs other than the personal allowances

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DD9: CAPITAL GAINS - MINOR CHANGES

Other relevant briefs: CC4 Abolition of COBO
D3 Capital gains tax

This brief contains:
A Chattels exemption
B Bonds
C Gifts to Housing Associations
D Rebasing - Technical changes

Inland Revenue issuing Press Notices on Budget Day on all these changes.

A. CHATTELS EXEMPTION

Factual

Chattels exemption raised: gains on chattels worth less than £6,000 will be exempt and losses on such chattels will not be allowable. (Marginal relief above this figure). Present exemption £3,000. Negligible effect on yield.

Positive

(i) Increase cuts out cases involving trivial gains.

Defensive

(i) Takes away some people's losses. True: but losses will be usually small, and cost of computing them will often outweigh their tax benefit.

(ii) Why increase exemption when general CGT annual exemption being frozen? Chattels exemption not raised since 1982. Increase a compliance and administrative simplification at negligible cost to Exchequer.

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B BONDS

Factual

(i) All sterling non-convertible bonds will be exempted from capital gains charge, instead of just some as at present.

(ii) Foreign currency and convertible deep discount bonds within new regime (see brief CC4) also exempted.

(iii) Prevents sizeable revenue loss.

Positive

(i) Removes scope for using indexation to create tax losses.

(ii) Creates more level playing field between different types of bond.

Defensive

(i) Why not done in 1985, when most sterling bonds exempted? Action precipitated by

- recent developments in tax planning (creation of bonds designed to give UK investors tax loss)
- abolition of Control of Borrowing Order (see brief CC4).

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C GIFTS TO HOUSING ASSOCIATIONS

Factual

(i) Donor of land and buildings to Housing Association will not face CGT charge by reference to market value at date of gift.

(ii) Cost: negligible

(iii) Equivalent relief being introduced for Inheritance Tax.

Positive

(i) Removes unjustified charge on some gifts to Housing Associations.

(ii) Will encourage wealthy landowners to give land, or sell it cheap, to Housing Associations which can then provide cheaper housing.

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D. REBASING - TECHNICAL CHANGES

Factual

(i) Minor technical changes to 1988 provisions for rebasing capital gains charge to 1982.

(ii) Cost: negligible

Positive

(i) Changes will ensure benefits of rebasing flow through in certain recondite situations.

Defensive

(i) Should have got it right in 1988. Changes affect only very small number of unusual cases. Difficulties only identified since 1988 Finance Act.

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DD10 INHERITANCE TAX (IHT): MINOR CHANGES

Inland Revenue issuing Press Notices on Budget Day on all these changes (C jointly with CGT).

Brief contains:
- A. Threshold and Rate
- B. Instruments of Variation
- C. Gift to Housing Associations

Other relevant brief: DD9 (part C) - CGT: Gifts to Housing Associations.

A. THRESHOLD AND RATE

Factual

(i) From 6 April 1989

- Threshold to be increased in line with Retail Prices Index (RPI) from £110,000 to £118,000 (statutory indexation).

(ii) Immediately chargeable lifetime transfers continue to be charged at half death rate of 40 per cent.

(iii) Estimated to be around 23,500 taxpaying estates in 1989-90, compared with 27,500 if threshold not increased in line with RPI. Around 38,000 in 1978-79, and 24,000 in 1988-89 (1988 Budget forecast 20,000).

(iv) CTT/IHT yield:

	£ million	
1987-88	1,070	
1988-89	1,080	(1988 Budget forecast 1,000)
1989-90	1,110	

(v) Costs of statutory indexation (£118,000 threshold)

	£ million
1989-90	35
1990-91	70
Full year	80

Positive

(i) Threshold more than 2½ times higher in real terms than in 1975-76 or in 1978-79.

(ii) Flat rate of 40 per cent combined with generous relief for business property means lower effective rate on UK estates with substantial business assets than in most competitor countries.

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Defensive

(i) Burden still harsher in real terms than in 1975: Changes since 1979, particularly exemption of lifetime transfers, make direct comparisons misleading. Even so, not true for smaller estates up to about £200,000 nor for estates above about £300,000, but even on those between £200,000 and £300,000, burden reduced compared to 1978-79.

(ii) Tax now payable on modest estates: Threshold increases particularly beneficial to small estates through complete removal from tax. Threshold now almost 165 per cent higher in real terms than in 1975-76, equivalent to a reduction of 52,500 smaller taxpaying estates. Tax on £125,000 estate only £2,800 (instead of £6,000 in 1988-89) and payable by 10 annual instalments to extent attributable to land, including housing.

(iii) Threshold lagging behind rise in house prices? Yes but threshold increased this year by more than 7 per cent. Combined increases over last three years [from £71,000 in 1986-87 to £118,000 in 1989-90] total 66 per cent. On average house value equals less than half of value of estates above the threshold up to £150,000 and even less thereafter.

(iv) Why not 100 per cent business relief? Existing business property relief [50 per cent for unincorporated businesses and unquoted shareholdings of more than 25 per cent; 30 per cent smaller unquoted shareholdings] mean *effective* rate on major holdings in family business less than 20 per cent - among lowest of main Western economies.

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B. INSTRUMENTS OF VARIATION

Factual

(i) Present rules give, at parties' election, retrospective effect to rearrangements made by beneficiaries within 2 years of death for any purpose.

(ii) From Royal Assent re-arrangements of death estates by beneficiaries which have retrospective effect for IHT purposes will be limited to those making adequate provision for dependants.

(iii) In addition rearrangements will continue to have retrospective effect when effected by:

- disclaimer of benefits under wills, intestacies or Scottish legal rights; or
- Court Orders making adequate provision for dependants; or
- beneficiaries making adequate provision for dependants which could be ordered by Courts.

(iv) Yield: £5 million 1989-90; £15 million 1990-91.

Positive

(i) Wider provision no longer needed (originally made to give time for adjustment of wills to take account of (then) new spouse exemption).

(ii) Closes loophole which is increasingly being exploited since abolition of immediate charge on lifetime transfer in 1986.

(iii) Genuine hardship for surviving spouse and other dependants can still be relieved.

(iv) Ends unproductive use of scarce, skilled staff resources.

Defensive

(i) Disadvantages for estates where wills drawn up before change? New rules apply only to deaths after Royal Assent - gives time to adapt; and preserves facility to enable beneficiaries to make adequate provision for dependants without involving Courts.

(ii) Main losers are modest taxpaying estates? No. Present provisions mainly used by wealthy for tax planning purposes. Main asset in modest estates is usually house which tends to be jointly owned and passes by survivorship to spouse and so exempt.

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C. GIFTS TO HOUSING ASSOCIATIONS

Factual

(i) From Budget Day gifts of land to Housing Associations will normally be exempt from IHT.

(ii) Cost: negligible.

(iii) Equivalent relief being introduced for Capital Gains Tax (see Brief DD9C).

Positive

(i) Removes unnecessary charge on sales at under value or gifts to Housing Associations which are not charities.

(ii) Encourages landowners to give land, or sell it cheaply, to Housing Associations which can then provide cheaper housing to low-income families.

Defensive

Why not extend new exemption to gifts of leasehold interests out of the landlord's freehold interest? New provision will exempt gifts of land to Housing Associations on same basis as present IHT exemption for gifts to charities. No justification for treating gifts to Housing Associations more favourably than gifts to charities.

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DD11 EMPLOYEES MATERIAL INTEREST TEST

Other relevant briefs: EE3 Employee Shares Schemes
EE4 Employee Share Ownership Plans
DD6 Profit-Related Pay

Inland Revenue issuing Press Notices on Budget Day.

Factual

(i) At present employee with material interest in company may not participate in, or benefit from tax reliefs associated with, registered profit-related pay (PRP) or approved employee share schemes (ESS). Individual with material interest eligible for close company interest relief. Employee has material interest if he together with his associates owns or controls more than specified percentage of ordinary shares (10 per cent for PRP; 25 per cent for all employee share schemes; 10 per cent for discretionary employee share schemes). Associates include trustees of trust in which employee interested.

(ii) Proposed relaxation to material interest tests for PRP and ESS no no longer counts trustees as associates provided certain conditions met. Same change (tightening) will be made to interest relief provision.

(iii) Conditions include:

- trust must be for all or most employees (may also benefit former employees, relatives, dependents, charities);

- once employee has material interest (from either his own or his non-trust associates' share-holding or benefits from shares) trustees his associate from then on.

(iv) Changes effective for PRP and ESS from Royal Assent, but trust distributions made on or after 14 March 1989 will count in deciding whether trust holding to be excluded in reckoning employee's material interest. Changes for interest relief will apply to loans made after Royal Assent, and trust distributions made after Royal Assent will count in deciding whether trust holding to be excluded in reckoning individual's material interest.

(v) Revenue cost negligible in 1989-90 and up to £5 million in 1990-91 and 1991-92.

Positive

(i) Enables some companies unable at present to introduce PRP or ESS schemes to do so. Meets concern expressed at 1988 Committee Stage.

(ii) Employees with only remote interest in company but barred from PRP or ESS by interest in trust will now be able to benefit from tax reliefs for PRP or ESS.

(iii) Eases introduction of Employee Share Ownership Plans - see brief EE4.

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Defensive

(i) Increased risk of abuse? Slightly increased. Outweighed by advantages of allowing companies with acceptable employee benefit trusts to introduce PRP or ESS.

(ii) All trusts satisfy conditions? Trusts vary considerably. Impossible to introduce relaxation covering all trusts without unduly increasing risk of abuse or more complex legislation.

(iii) Why tighten interest relief? Result of changes to ESS. Avoids inconsistency of allowing employee (a) to participate in ESS because he does not have material interest, and (b) also to qualify for interest relief because he does. Only very few cases likely to be affected.

(iv) Greater complexity/compliance burden for employers? No significant problem foreseen.

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DD12 MORTGAGE INTEREST RELIEF

Factual

Mortgage interest relief limit £30,000 for 1989-90.

(i) Unchanged since 1983-84 increase from £25,000.

(ii) Since 1 August 1988 £30,000 limit applied to residence instead of individual or married couple. Transitional relief continues on old basis for life of pre-August 1988 loans if more favourable.

(iii) For most home purchasers relief given at source (MIRAS) rather than through tax codes.

(iv) Cost of mortgage interest relief in 1988-89 estimated at £5.5 billion.

(v) Statutory indexation does not apply to limit for mortgage interest relief; has to be set each year.

(vi) Indexation in line with RPI increase (in £25,000 ceiling) since June 1979 would produce limit of £50,000; since last increase (1983 Budget) £38,000.

(vii) Cost of housing Average UK house price purchased through building society £52,100 (1988 Q4).

(viii) Average new mortgages from building societies £30,700 (first time buyers), £37,600 (others); from banks £34,000 (first time buyers) £41,200 (others).

(ix) Between 1978-79 and 1988-89 mortgage interest relief increased by £4.4 billion from £1.1 billion to £5.5 billion. About £2.5 billion attributable to growth in average mortgages outstanding; remaining £1.9 billion mainly attributable to increased number of mortgagors, after taking account of increased value of average mortgages. (Since 1983-84 cost includes cost of relief for mortgages previously under option mortgage scheme).

(x) Direct revenue yield if mortgage interest relief restricted to basic rate: £330 million in 1988-89.

Positive

(i) Mortgage interest relief helps 9.1 million home buyers in 1988-89.

(ii) Owner occupation at highest ever level: just under 65 per cent of all dwellings in UK in 1988-89.

Defensive

(i) Why no increase in limit? Limit reviewed every year; need to balance against competing claims. Unchanged limit focuses relief at lower

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end. Those with larger mortgages still benefit from relief on £30,000. 83 per cent (average for 1988-89) of mortgages still £30,000 or less.

(ii) Relief should be given at basic rate only No. Fair and right that relief allowed at rate tax paid, particularly given overall limit. Restriction would draw more people into higher rate.

(iii) Relief should be abolished Government fully committed to provide relief to help people to buy their own homes. Withdrawal would adversely affect over 9 million households.

(iv) Relief distorts housing market Many factors affect house prices.

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DD13 ABOLITION OF PENSIONERS' EARNINGS RULE

Factual

(i) Retirement pensioners' earnings rule to be abolished from 1 October 1989. 12 hour limit on pensioners' working week also to be abolished. Parliament will be asked to approve necessary provisions, which will be added to current Social Security Bill.

(ii) Rule affects men aged 65-69 and women aged 60-64. From 1 October will be able to claim basic retirement pension and SERPS, irrespective of earned income.

(iii) Right to defer receipt of pension, with increments of 7½ per cent for each year deferred, will be retained.

(iv) Currently, 200,000 defer receipt of pension because of rule. Another 2,500 have pensions reduced by operation of rule.

(v) Public expenditure cost of abolition: £190 million in 1989-90, £375 million in 1990-91. Net Exchequer cost, allowing for tax on additional pensions £170 million in 1989-90 and £265 million in 1990-91.

(vi) Long term net cost of abolition will decline as need to pay increments on pension falls.

(vii) Earnings limit has stood at £75 since 1985.

(viii) Conservative manifestos of 1979 and 1983 pledged abolition of earnings rule.

Positive

(i) Fulfils long-standing commitment to abolish earnings rule.

(ii) Removes penalty against elderly people wishing to work.

(iii) Increases their choice and flexibility, which will be helpful to them and economy generally.

(iv) Strengthens contributory principle. Means that pension entitlements earned thrfough NICs no longer delayed.

(v) Another simplification of social security system, with eventual savings in DSS administrative costs of £[ ] million a year.

Defensive

(i) Full year net cost of £375 million compared with extra £195 million spent on poorer pensioners. Long-term cost will be much lower as need to pay increments on pensions is reduced. People earning over £75 a week not necessarily rich.

(ii) Contrary to policy of targeting help on worst-off. No conflict between targeting benefits on poor pensioners and removing penalties which discourage pensioners from working.

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(iii) Better to spend extra money on enhancing basic retirement pension. Government is committed to maintaining value of retirement pension by uprating in line with inflation. Will continue to honour this pledge in full. Abolishing earnings rule will enable those pensioners who want to go on working to increase their incomes, which will benefit economy generally.

(iv) Why encourage elderly to stay in jobs at time of high unemployment? Level of unemployment has fallen sharply, partly because Government has removed controls and restrictions in economy. Ending pensioners' earnings rule part of same strategy and should therefore help to improve economic performance.

(v) Why not abolish other earnings rules? Retirement pension special case. Entitlement built up through NICs on lifetime earnings. No implication for other earnings rules.

(vi) Why not abolished earlier (given 1979 manifesto commitment)? Initial public expenditure cost substantial. But can now be afforded, thanks to huge improvement in public finances.

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EE2 PERSONAL EQUITY PLANS (PEPs)

Other relevant briefs: E1 Savings
EE6 Wider share ownership

Inland Revenue issuing Press Notice on Budget Day (also Inland Revenue press notice issued 11 January 1989).

Factual

(i) PEPs announced Budget 1986, introduced January 1987, as vehicle to encourage investment in UK equities. PEPs offer:

- exemption from capital gins tax on gains;

- income tax relief on dividends.

(ii) PEPs run by plan managers. Investors have no contact with Inland Revenue. 189 plan managers currently registered.

(iii) At present investment in any calendar year permitted:

- up to £3,000 in total; within which:

- up to £540 (or 25 per cent of total investment, if greater) in investment trusts or authoritised unit trusts.

(iv) Take-up

1987	1988	Total to 31.12.88
270,000	115,000	385,000

(v) Significant reform from 6 April 1989:

(a) Investment limits raised:

- £4,800 overall; of which:

- £2,400 in investment trusts or authorised unit trusts.

(b) Unit and investment trusts within PEPs to invest at least 75 per cent in UK equities from 6 April 1990;

(c) Facility to be introduced to allow new issue shares (including privatisation issues) to be brought within plans;

(d) Significant simplifications for plan managers:

- minimum (1-year) holding period to be abolished;

- plan year to be moved from calendar to fiscal year. Next plan year begins 6 April 1989. Anyone with plan taken out since January 1989 will be able to take out another plan from 6 April;

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- "cash rules", limiting amount of cash held in plan, to be abolished. Instead, interest arising on cash to be subject to composite rate tax;

- plan managers no longer to be required to submit application forms to Inland Revenue for approval;

- amount of information required from plan managers by Inland Revenue to be reduced;

- relaxation of rule preventing switch from investment in shares to unit or investment trusts. Switching to be allowed up to half value of portfolio.

(vi) Transitional provisions. If desired, new rules need not apply to existing (unreformed) plans until 1 January 1990; and restrictions on unit/investment trusts apply only from 6 April 1990.

(vii) Change already announced (11 January 1989) to allow tax relief on dividends even when taken out of plan. (Previously only reinvested dividends attracted relief.)

(viii) Representations for change

- give front-end-loaded relief similar to Loi Monory in France (Centre for Policy Shares; many plan managers; British Bankers Association);

- Allow full investment in investment trust shares (Association of Investment Trust Companies);

- Allow full investment in unit trusts (Unit Trust Association);

- Simplify administration (all plan managers);

- Give ration of tax-free dividends (Barclayshare).]

(ix) £5 million 1989-90; £10 million 1990-91; rising to £30 million after 5 years.

Positive

(i) PEPs simple and cheap way of owning shares. Now even better.

(ii) Raised investment limits make PEPs more attractive: encourage broader spread of equities.

(iii) Raised unit/investment trust limit will encourage smaller investors to enter equity market. Will help managers reduce costs and make schemes attractive to mass market.

(iv) Opportunity to bring privatisation and other new issues within PEPs real encouragement for new or small shareholders.

(v) Major package of changes improves flexibility for investor and plan manager alike.

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(vi) Simplifications cut red tape and will help keep plan managers' costs - and therefore charges - to minimum. Meets representations from plan managers.

(vii) New rule that unit/investment trusts must invest 75 per cent in UK equities meets objective of targeting scheme on investment in British companies.

(viii) Reform will lead to greater take-up over medium term; but precise level depends on, eg, market conditions.

Defensive

(i) Give front-end relief. No need for subsidy: objectives achieved within existing framework. Front-end relief would complicate scheme and increase costs.

(ii) "Loi Monory" better approach? No:

- Loi Monory now abandoned by French. Replaced by retirement plan and relief for investment in new companies. UK already has generous reliefs for pension provision (eg occupational and personal pensions) and for enterprise investment (eg Business Expansion Scheme);

- would encourage recycling of investment in order to get tax relief several times using same money;

- would be more complex (eg minimum holding period, clawback provisions for early withdrawal): would be move away from simplifications announced in Budget;

- in contrast, PEPs run with grain of tax system: extensive red tape not needed.

(iii) Too little, too late. No. Package constitutes significant improvement. Reduced take-up in 1988 due largely to market conditions following 1987 Stock Market Crash. Even so, 15,000 plans taken out. Take-up likely to increase in medium term.

(iv) Reforms benefit existing shareholders rather than first-timers. Package designed to encourage existing shareholders to make further investment, as well as to encourage new shareholders. Increase in attractiveness of unit/investment trust PEPs should encourage more first-timers.

(v) Abolition of minimum holding period disincentive to long-term saving. No. Structure of tax reliefs (which increase in value with length of holding) encourages long-term saving. Abolition of holding period gives reduction in costs and red tape.

(vi) Raising unit/investment trust limit conflicts with policy of direct share ownership. No. Still real incentive for direct share ownership. But Government recognises unit and investment trusts good vehicle for first-time investment. Headroom between £2,400 and £4,800

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allows direct ownership on top of unit/investment trust holdings. Maintains aim of encouraging investment in UK companies, but in different way.

(vii) Plan managers' costs too high - eat up benefits of tax relief. Simplifications will help keep costs - and charges - to minimum.

(viii) Start date (6 April 1989) too soon for plan managers to adjust. Plan managers have choice of continuing on existing basis until end 1989.

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EE3 APPROVED EMPLOYEE SHARE SCHEMES

Other relevant brief: EE6 widerr Share Ownership

Inland Revenue issuing Press Notice on Budget Day

Factual

Income tax reliefs for employee participants in approved employee share schemes. Number of approved share schemes (at 31 December 1988):

780 all-employee profit-sharing schemes (FA 1978)

787 all-employee SAYE-related share option schemes (FA 1980)

3,617 discretionary share option schemes (FA 1984)

1989 Budget changes

(i) Annual limit on shares given to individual employees under approved profit-sharing scheme increased from £1,250, or 10 per cent of salary subject to £5,000 ceiling, to £2,000, or 10 per cent of salary subject to £6,000 ceiling (effective 6 April 1989).

(ii) (a) Monthly savings limit under approved SAYE-related share option scheme increased from £100 to £150 (effective by Treasury Order from an early date after Royal Assent).

(b) Statutory limit on share price discount at which options may be offered to employees under these schemes increased from 10 per cent to 20 per cent (effective Royal Assent).

Positive

(i) Now over 1,500 all-employee schemes approved, against 30 in 1979.

(ii) Over 1.75 million employees already given shares or options over shares under all-employee schemes, with initial market value over £4 billion.

(iii) Improvements in 9 of last 10 Budgets.

(iv) Present changes underline Government commitment to all-employee schemes.

(v) Inland Revenue leaflets and booklets on approved employee share schemes to be revised and updated.

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Defensive

(i) Increases a reaction to slackening interest in employee share schemes? Appeal of all approved schemes remains at encouragingly high level.

Scheme approvals	All-employee	Discretionary
1985-87 (average)	196	911
1988	163	850

In 1987-88 alone, under all-employee schemes, nearly 1 million employees received shares or options over shares worth over £1 billion.

(ii) Companies should be obliged to operate all-employee schemes if they operate a discretionary scheme? No evidence that popularity of discretionary schemes has affected spread or operation of all-employee schemes. Companies value freedom to choose which schemes to operate to best suit own circumstances.

(iii) 1988 CGT changes eliminated tax advantages of approved schemes? No evidence of diminished interest. Significant advantages remain (eg CGT charge only when shares sold; continues to benefit from annual £5,000 CGT exemption).

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EE4 EMPLOYEE SHARE OWNERSHIP PLANS (ESOPS)

Other relevant brief: DD11 Employee's material interest tests

Inland Revenue issuing Press Notice on Budget Day

Factual

Hitherto no express tax reliefs for ESOPs, though, depending on circumstances, companies and employees concerned may qualify for CT and IT relief under other provisions.

1989 Budget changes

(i) CT relief for company contributions to ESOP trusts which meet certain conditions eg purpose (to pass shares to individual employees), nature of trustees and beneficiaries, trust function, distribution of shares to all employees on similar terms within 7 years etc.

(ii) Relaxation of material interest test for approved employee share scheme purposes (see DD11) lowers barrier to ESOP participation by employees.

Positive

(i) New initiative helps companies to provide employees with share interest by providing certainty of CT relief for company contributions to ESOP trust, on conditions securing individual employee share ownership within reasonable time.

(ii) Likely to be of particular help to small, unquoted (perhaps family) companies hitherto unable or unwilling to meet conditions for introduction/operation of approved employee share schemes.

(iii) Proposals designed to avoid weaknesses perceived in US ESOPs arrangements (eg use in lieu of employee retirement benefit plans, use as 'poison pill' defence against take-overs, entrenchment of existing management, protracted collective (not individual) employee share ownership).

Defensive

(i) Tax reliefs do not go far enough? Dozen ESOPs already set up without express reliefs. Present initiative confirms Government sympathy for ESOPs by meeting principal demand of ESOP lobbies - certainty of CT relief.

(ii) Good idea spoilt by excessive concern with abuse-prevention, too demanding conditions for ESOP trust? Government concerned to encourage real individual employee share ownership, not collective employee interests or arrangements primarily benefiting companies or owners (eg financing advantage or entrenchment of existing management/ownership). Regard paid to US experience.

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(iii) Provide income tax reliefs for employee acquisition from ESOPs? If shares distributed by ESOP through approved employee share scheme - as many ESOP proponents envisage - employees will not normally be liable to income tax charge.

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- personal tax aspects

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EE5 EMPLOYEE PRIORITY IN PUBLIC SHARE OFFERS

Inland Revenue issued Press Notices on 11 October 1988 and 22 February 1989.

Factual

(i) Government announced 11 October 1988 technical improvements to present (FA 1988) legislation exempting from income tax benefit that can arise if employees given priority allocations in public offers of shares. Changes:

a. extend exemption to priority benefit in offers to employees at discount to public offer price (discount itself remains taxable);

b. increase (to 40 per cent) the 10 per cent limit on employee priority allocations under individual elements of public offer arrangements, while retaining overall 10 per cent limit on total employee priority measured against total public offer arrangements for shares in question.

(ii) Draft clause published 22 February 1989; changes take effect from 11 October 1988.

Positive

Sensible relaxation of legislation introduced in 1988 to encourage employees' stake in their companies.

Defensive

(i) Designed to help only privatisations? No. Changes applicable to, and will help, private as well as public sector flotations.

(ii) Comments received since 11 October/22 February announcements? None.

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EE7 PENSIONS

Inland Revenue issuing Press Notice on Budget Day.

Factual

(i) Major pensions package covering:

(a) occupational pensions

(b) Additional Voluntary Contributions (AVCs)

(c) personal pensions

(ii) Occupational pensions

(a) Inland Revenue benefit limits no longer absolute limit on pensions. Employers will be able to set up "top up" schemes to pay pensions above tax approval limits - but without tax privileges.

(b) Changes in rules for tax approved schemes:

- Cap on tax privileged benefits, based on earnings of £60,000. So limit on pension £40,000; limit on tax-free lump £90,000. Cap to be indexed to prices. At present, only limit is on lump sum - £150,000.

- Simpler, more generous, early retirement benefit limit. Will allow 'two-thirds final salary' benefit after 20 years service on retirement after age 50. At present, pension cut back on proportionate basis where employees retire before scheme normal pension age.

- New simpler lump sum rule. Tax free lump sums to be better of 3/80th final salary for each year's service or 2.25 times pension (before commutation).

(c) Implementation

Changes in rules for tax approved schemes take effect immediately for new schemes but from 1 June 1989 for new members of existing schemes. "Top-up" schemes may be set up from August 1989.

(iii) AVCs

(a) New tax rules for AVCs (both those paid to employer's scheme and to own free-standing AVC plan). Excess contributions no longer go to waste, but returned at retirement, less a tax charge. Charge on scheme administrator at 35 per cent (to offset relief given for contributions and tax free build-up). No further liability for basic rate taxpayers, but higher rate chargeable where appropriate.

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(b) New rules make possible much simpler administration of free-standing AVCs - especially for employers' schemes - at times when AVCs paid. Inland Revenue to discuss plans for simplification with pension industry.

(c) Start date August 1989.

(iv) Personal Pensions (PPs)

(a) Cap on contributions (not benefits) based on £60,000 earnings

(b) Higher age related contribution limits for those over 35 to help bridge gap with good occupational schemes

(c) New tax-free lump sum rule: 25 per cent of total fund excluding 'protected rights' from DSS "minimum contributions" to PP schemes contracted-out of State Earnings Related Pension Scheme. £150,000 ceiling on PP lump sums lifted.

(d) New flexibility for individuals to direct investment of their personal fund.

(e) Start date 6 April 1989, for (a) and (b); May 1989 for (d); August 1989 for (c).

(v) Cost of overall package broadly neutral. Yield from cap on tax privileged benefits offset by cost of more generous early retirement rule and higher personal pension contribution limits.

Positive

(i) Simplification: a major package of simplification to pensions tax rules, including -

(a) very much easier to take out freestanding AVCs, with much less involvement by employer (in many cases no need for employer to be involved at all until retirement) - meets numerous representations;

(b) very much simpler to calculate allowable benefits where, eg, early retirement involved.

(ii) Deregulation: Inland Revenue rules no longer determine maximum benefits; employers free to make whatever pension arrangements they want, without jeopardising tax approval of existing scheme, (but without additional tax relief). Includes (for example) new flexibility for employers on "fast accrual" for late entrants. Burden on employers of dealing with freestanding AVC requests greatly reduced.

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(iii) Personal Pensions receive a triple boost:

(a) significantly higher percentage contribution limits (subject to £60,000 ceiling on earnings) for older contributors - especially helpful for self-employed building up businesses;

(b) new, better, way of calculating 25 per cent lump sum (meets industry representations and in most cases more generous); and no need for £150,000 lump sum cap;

(c) new opportunity for individuals with personal pensions to decide how their money is invested.

(iv) Fairer: £60,000 earnings cap limits relief available to very high earners; other changes improve position of ordinary scheme members.

Defensive

(i) Breaks "Green Paper" pledge? [1985 Budget Speech]. No. Similar to changes made in 1987. No change to basic tax treatment of pensions.

(ii) £60,000 cap penalises high earners? No. Employers will be free to provide "top-up" pensions, without additional tax relief, if they wish. Normal for savings tax reliefs to have a cash limit (cf PEPS, BES, mortgage interest). And cap makes it possible to simplify and improve rules for vast majority.

(iii) Personal Pensions given unfair advantage? [higher contribution limits as percentage of earnings; no cap on benefits.] Redresses balance between personal pensions and best occupational schemes for senior employees.

(iv) Freestanding AVCs still burdensome for employers? [Employers will still be responsible for checking total benefits at retirement]. Only final employer can review overall position at retirement. But in future no pre-retirement checks, and only very simple (in many cases no) checks required when freestanding AVCs taken out. Revenue to discuss details with pensions industry.

(v) Why over-ride scheme rules? [Finance Bill legislation will change rules of pension schemes.] Did this in 1987. Easier for pension schemes and Inland Revenue: no need to change rules of individual schemes and re-submit them for tax approval. Schemes can opt not to have rules changed (and so lose tax approval).

(vi) Will changes apply to public services? Yes. (NB for technical reasons, changes in public service scheme rules require separate legislation, not Finance Bill over-ride. Follows 1987 precedent.)

(vii) Will public sector have top-up schemes? Government will have regard to good employer practice. Precise form of top up schemes to be decided in light of emerging private sector practice.

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(viii) Does any of this affect MPs (and Ministers)? MPs will be affected in exactly the same as others.

(ix) Burdensome for employers to run separate top-up schemes? Doubt it. In foreseeable future likely that top-up schemes will be offered only to key employees. And no extra work if employers choose to set up unfunded top-up schemes.

(x) Unfair to have earlier start date for new schemes? No. Employers with existing schemes need time to decide how new rules will affect them in view of new flexibilities open to them. On the other hand, new schemes will be set up in the knowledge of Budget proposals.

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D Rayson (HMT) 270 4535 public services:

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EE9 UNIT TRUSTS

Inland Revenue issuing Press Notice on Budget Day.

Factual

(i) At present authorised unit trusts other than gilt trusts (which invest only in UK interest bearing securities) pay corporation tax (CT) at 35 per cent. Relief for management expenses and interest paid. Gilt trusts pay basic rate income tax (now 25 per cent) but do not get the two reliefs.

(ii) New tax regime from 1 January 1990 for unit trusts freely marketable in EC under UCITS directive. Builds on present CT system for most authorised unit trusts and

(a) brings in new lower rate equal to income tax basic rate.

(b) gives relief for management expenses and for interest on loans up to ceiling permitted by SIB.

(c) Companies liable to CT on income from unit trusts, but get credit for basic rate tax paid by trust.

(iii) UCITS directive covers unit trusts investing in transferable securities (equities and bonds) but not unit trusts investing in property, futures and options, deposits (ie money funds). These outside new legislation.

Positive

(i) Reduce tax bill on unit trust investment by £20 million.

(ii) Removes all UK tax charge which cannot be credited against unit holders' own tax.

(iii) Removes tax penalty on gilt trusts and others with investments in bonds enabling them to compete more effectively with their continental counterparts.

(iv) Simple system building on existing regime.

Defensive

(i) Why not full transparency like Europe? Administratively very complex given different withholding tax arrangements on different sources of income. New system provides main benefit sought by unit trust industry.

(ii) Why not include other authorised unit trusts/investment trusts? Neither they nor continental counterparts directly affected by UCITS directive. Investment trusts frequently heavily geared and would lose badly from restriction of interest relief to level permitted for unit trusts.

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[(iii) Why restrict tax relief on interest?. Individuals investing direct cannot get tax relief for interest on borrowing to purchase investments; right therefore not to allow interest relief to unit trusts except in special cases: hedging currency risk and borrowing for mismatches in cashflow. (Relief for BES investments similarly being withdrawn (see FF5).]

(iv) Why delay start until 1 January 1990 New life assurance regime starts then. Very short delay from 1 October 1989 (when UCITS directive operative) avoids penalty on life companies or complex transitional provisions.

(v) Why not allow payment of unit trusts' distributions gross (as in Luxembourg)? Administratively complex as gives need for extra assessments on UK unit holders. Could lead to downward competitive spiral in withholding tax rates. Would not affect tax bill of honest investor.

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EE10 UMBRELLA FUNDS

Inland Revenue issuing Press Notice on Budget Day.

Factual

(i) At present switches within offshore funds not taxable but switches within UK unit trusts are.

(ii) Proposal to align treatment by taxing switches in all umbrella collective investment vehicles.

Positive

(i) Creates level playing field for switches in all umbrella funds.

Defensive

(i) Why no earlier action? Use of offshore umbrella funds recently increased.

(ii) Why no action on offshore (non-unit) trusts? Trusts being reviewed as a whole. Cannot anticipate outcome of review.

(iii) Offshore fund legislation now unnecessary with same IT/CGT rates CGT has significant advantages over IT (eg indexation, annual exemption) therefore legislation still necessary.

(iv) Why no action on offshore life policies ("investment bonds"). Treatment of offshore life policies to be subject of further consultation with life industry.

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FF1 VAT AND BUSINESSES

Customs and Excise issuing Press Notices on Budget Day.

Other relevant briefs: G2 VAT: Main points
JJ6 Staffing

CHANGES IN VAT REGISTRATION AND DEREGISTRATION THRESHOLDS

Factual

(i) Registration threshold (below which small businesses not required to register): raised from £22,100 to £23,600 a year. Previous quarterly limit of £7,500 taxable turnover raised to £8,000.

(ii) Deregistration threshold (for voluntary deregistration of small businesses) raised from £21,100 to £22,600 a year for estimated future turnover.

(iii) Effective date:

- Registration limits change effective 15 March 1989
- Deregistration limits change effective 1 June 1989.

(iv) Cost: Negligible.

(v) EC law: Threshold increases maximum permitted within present EC restrictions. But following Prime Minister's initiative in March 1985 European Council, EC Commission produced draft VAT Directive on small and medium-sized enterprises (SMEs). Proposals include mandatory lower threshold of 10,000 ECU and optional higher threshold of 35,000 ECU (about £22,950); now overtaken by revised UK threshold above. Government will continue to argue vigorously in Brussels for higher optional threshold and greater flexibility.

(vi) Representations: Many trade associations argue for threshold of £50,000 or £100,000 but others, eg Building Employers' Federation, want lower or nil threshold.

(vii) Finance Act 1985 implemented number of recommendations of independent Keith Committee including civil penalties for registration and deregistration defaults.

Positive

(i) Increases help to small businesses by

- keeping new businesses out of VAT net longer;
- enabling further 31,000 traders to deregister if wish.

(ii) Thresholds increased each year since 1979 to maintain real value since introduction in 1973.

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(iii) Threshold increases maximum permissible under EC law (Sixth VAT Directive) which allows maintenance of real value, but no more.

(iv) Helps avoid increases in Customs manpower.

Defensive

(i) Raise threshold to £50,000 or £100,000: Increase above revalorisation would breach legal obligations under Sixth VAT Directive. Government will continue to argue vigorously in Brussels for greater flexibility.

(ii) Abolish or reduce threshold substantially: Would discourage growth of enterprise and new businesses; impose VAT burden on very small businesses for minimal revenue return; and require substantial increase in Customs manpower.

(iii) Special nil or reduced threshold for construction industry (representation by eg Building Employers' Federation): Not justified. Would destroy advantages of uniform threshold for all traders, increase complexity of tax and add to Customs and Excise manpower and administrative costs.

(iv) Make deregistration limit change effective immediately: Delay allows time for potential applicants for deregistration to consider their position and apply to their local VAT offices. While application being processed, traders must continue to charge and account for VAT.

(v) Bring deregistration threshold into line with registration threshold: Difference of £1000 necessary to prevent businesses deregistering on grounds of diminished turnover having to re-register almost immediately through having to increase prices to offset loss of input tax credit.

(vi) EC Commission believes UK exemption limit already too high: [FOR USE ONLY IF PRESSED]: UK has exchanged views with Commission about correctness of UK interpretation of Sixth VAT Directive. Rests with Commission to decide whether to pursue further. Pursuit unlikely pending discussions on draft SMEs Directive.

(vii) Simplify registration requirements further: Arrangements kept under review. Changes made as and when appropriate.

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FF2 SMALL COMPANIES' CORPORATION TAX

Inland Revenue issuing Press Notice on Budget Day.

Factual

(i) 1989 Budget sets small companies' CT rate for financial year 1989 (ie year ending 31 March 1990) at 25 per cent in line with income tax basic rate.

(ii) 1989 Budget increases profits limits for small companies' rate and associated marginal relief by 50 per cent. New small companies' profits limit £150,000 (previously £100,000). New marginal relief profits limits £750,000 (previously £500,000). Marginal rate in taper band (profits between £150,000 and £750,000) remains at 37.5 per cent - gradually withdraws benefit of small companies' rate but average rate always below 35 per cent.

(iii) Small companies' rate reduced in 1984 from 38 per cent to 30 per cent and subsequently brought down in line with basic rate. Rate reduced by 13 percentage points to 25 per cent (financial year 1988) in six years.

(iv) Cost of increasing profits limits:

1989-90	Negligible
1990-91	£35 million
full year	£55 million

(v) Profits limits unchanged since financial year 1982.

Positive

(i) Increase in profits limits helps small companies. More pay tax at small companies rate and more companies benefit from marginal relief. Over 20,000 companies will pay less tax.

Defensive

(i) Profits limits should have been raised before. Changes in earlier years concentrated on bringing down CT rate. Small companies' rate down from 38 per cent in 1983 to 25 per cent in 1988.

(ii) Increase in profits limits should have been higher. Increase is 50 per cent, which is more than revalorisation (since 1982 40 per cent increase in RPI).

(iii) Why no cut in small companies' rate? Not right to reduce rate for companies below rate borne by most unincorporated businesses (basic rate).

(iv) Why not all company profits taxed at 25 per cent below a certain level and excess at 35 per cent? Would benefit large companies most - present system targets benefit on small companies.

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FF3 CLOSE COMPANIES

Inland Revenue issuing Press Notice on Budget Day.

Factual

(i) A "close company" is one controlled by, usually, five or fewer people.

(ii) Undistributed income of a close company can be 'apportioned' to its shareholders and taxed as if they had received a dividend. Various exclusions and relief (since 1980, trading income of trading companies not apportioned).

(iii) Other apportionment powers counteract various tax advantages from using a close company (eg tax relief for interest on loans to buy investments).

(iv) All apportionment powers to be abolished for accounting periods starting after 31 March 1989.

(v) Replaced by special tax regime for close investment companies (CICs) does not apply to trading companies generally, but does apply to dealers in land, shares or securities.

(vi) CIC pays Corporation Tax at 40 per cent unless distributes 85 per cent of its profits (70 per cent if income mainly from property or trading). Dividends received (less dividends paid) included in profits.

(vii) Rules to prevent tax advantage from paying dividends to children etc with unused tax allowances.

(viii) No tax relief for interest payments, management expenses etc of CIC (unless an individual would get tax relief).

(ix) Negligible effect on tax yield in 1989-90 and 1990-91.

Positive

(i) Abolition of apportionment removes burden from hundreds of thousands of small incorporated businesses. Replacement legislation much simpler and affects only investment companies (normal rules apply to other companies).

Defensive

(i) Why abolish apportionment. Legislation highly complicated and troublesome. Such complications no longer needed as result of 1988 cuts in income tax rates.

(ii) Why replace apportionment. To prevent individuals using CICs to avoid higher rate income tax and obtain tax relief for interest on borrowings.

(iii) Will lead to increased avoidance No. New regime for close investment companies usually at least as effective as apportionment.

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(iv) Will penalise property companies No. 40 per cent corporation tax payable only if retain more than 30 per cent of profits. Should allow sufficient retentions to fund future repairs.

(v) Hits existing companies Can avoid higher rate of corporation tax by distributing 85/70 per cent of profits. Undistributed profits currently apportioned.

(vi) Apportionment does not apply to capital gains Legacy from when all capital gains taxed at 30 per cent. Right to tax undistributed capital gains of CIC at 40 per cent (same rate as paid by higher rate taxpayer).

(vii) Apportionment does not apply to management expenses Individual investor gets no tax relief for expenses of managing investments - no reason why CIC should.

(viii) Personal investments can be put into a trading company Trading company must exist mainly for trading and trading income must exceed investment income. But no reason why trading company should not have some investment income - may be used for the trade.

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FF5 BUSINESS EXPANSION SCHEME (BES)

Inland Revenue issuing Press Notice on Budget Day.

Factual

(i) 1989 Budget contains proposal to prevent interest relief on loans used to buy BES shares.

(ii) BES offers income tax relief to individuals investing up to £40,000 a year in new full-risk equity of unquoted UK companies with which investor not connected. Most trades eligible plus, since 1988, letting residential property on assured tenancies.

(iii) At present investors can get interest relief on borrowings to buy shares in BES company if BES company is close company (broadly company controlled by five or fewer shareholders) ie two tax reliefs available for same purchase of shares.

(iv) Both reliefs always available but only this year large numbers involved. Of £200 million finance raised by BES companies April 1988-mid-February 1989 more than £70 million raised using both reliefs. Expected to be much higher by end of tax year.

(v) Savings from withdrawal of interest relief. Uncertain but negligible in 1989-90, around £5 million in 1990-91.

(vi) Scheme great success, as illustrated by take up figures:

1983-86: 2,156 companies raised £408 million;

1986-87: £167 million raised;

1987-88: £175 million likely to have been raised;

1988-89: Expected to be in range £300 million to £400 million (nearly all for assured tenancies).

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Positive

(i) Two tax reliefs for same purchase of shares excessive. Proposal not likely to discourage much investment in private rented housing - will primarily discourage setting up of large numbers of commercially inefficient small companies.

Defensive

(i) Restriction should have been made earlier. Only in last few months has substantial use been made of interest relief in combination with BES issues.

(ii) Interest relief encourages extra BES investment from those without available cash resources. Investment might well have been made anyway. And not cost-effective to give excessive tax relief.

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(iii) Investors already committed to borrowing, expecting interest relief will be hit by change if shares not issued before Budget Day. Widely known that changes like this can take place on Budget Day. Potential investors should take this into account.

(iv) Extension of BES to private renting companies and £500,000 ceiling for conventional BES companies has killed conventional BES. No. Expected reduced amount of investment in conventional BES companies this year because of £500,000 ceiling. Now targeted on smaller companies which need BES to raise equity finance.

(v) £500,000 ceiling should be raised. Above £500,000 thriving venture capital industry typically can supply finance. Much below £500,000 less likely. Government monitoring developments.

(vi) Why £5 million ceiling for shipping and private rented housing companies? Important to encourage provision of UK-registered ships (condition of relief). In early years of deregulation of rents, tax incentive needed to attract investment.

(vii) Scheme should be extended to owners of business and employees. Large deadweight cost and risk of abuse. BES designed for outside investors not actively involved in running business.

(viii) BES companies, especially private rented housing BES companies, involve little risk. All BES investments risky. Some BES companies have failed - others highly successful. Private rented housing BES companies offer less chance of really high returns while reduced chance that all investment lost. But rents and property values uncertain.

(ix) BES creates few jobs. BES is not job-creation measure. But resulting economic activity will create jobs in BES companies and elsewhere.

(x) Properties let at market rents so why give tax relief? Years of rent control discouraged potential landlords. Deregulation will in due course rectify this. BES relief providing stimulus to attract early investment. In longer-term relief should not be necessary (so relief available for only five years).

(xi) BES relief for property development normally excluded. Yes, because companies could obtain finance without BES relief. But new relief needed to encourage provision of rented property in early years of deregulation - no contradiction.

(xii) If rent paid by housing benefit there will be double subsidy. Subsidies to different people for different reasons. No. conflict.

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FF6 PRE-TRADING EXPENDITURE

Factual

(i) Increases from 3 years to 5 years period within which certain pre-trading expenditure qualifies for tax relief. Relief given once trading starts.

(ii) Relief applies to all trades, professions and vocations.

(iii) Extended limit will apply to those who start to trade on or after 1 April 1989

(iv) Cost: Negligible at first: building up in later years to perhaps tens of millions.

Positive

(i) Reflects Government's continuing policy of encouraging enterprise.

(ii) Meets representations that 3 year limit unduly restrictive, particularly for large scale infrastructure projects with long lead times.

(iii) Will help to encourage private sector involvement in major construction projects.

Defensive

(i) Why need for time limit? Some restriction on period for qualifying expenditure needed to restrict relief to expenditure connected with the eventual trade.

(ii) Special relief for Eurotunnel/breach of Anglo-French agreement on no hidden subsidies? Not a special relief for Eurotunnel. Change applies to all traders but of course will benefit any large ventures. Representations from number of sources that present 3 year limit too short.

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FF7 ACT ON OWNERSHIP CHANGES

Inland Revenue issuing Press Notice on Budget Day.

<u>Factual</u>

(i) Advance corporation tax (ACT) payable on dividends. Rate linked to basic rate of income tax. ACT set against company's liability to corporation tax (CT) on its profits. Any surplus ACT can be carried forward indefinitely or carried back for up to six years. ACT can be surrendered to a subsidiary company to set against its CT liability.

(ii) Surplus surrendered ACT lost if company ceases to be subsidiary of surrendering company. In future, will not be lost if both companies remain in same group.

(iii) Surplus ACT (and trading losses) lost if change of ownership of company <u>and</u> major change in business within 3 years. Rules will be tightened.

(iv) ACT does not have to be paid on intra-group dividends - nor does income tax have to be deducted from interest payments. Same applies to a consortium. Rules will be tightened to ensure genuine group/consortium relationship.

(v) Will ensure that interest payable on increased CT liability resulting from surrender of ACT (company has up to six years to surrender CT - its CT liability may increase as a result).

(vi) Change (ii) applies to accounting periods ending on or after Budget day. Other changes apply from start of Budget day.

(vii) Negligible effect on tax yield.

<u>Positive</u>

(i) Removes unnecessary restriction (Factual ii) but safeguards against avoidance.

<u>Defensive</u>

(i) <u>Will restrict use of ACT</u> Won't prevent normal use. Necessary to safeguard against <u>sale</u> of ACT (and trading losses).

(ii) <u>Should be able to sell ACT/trading losses</u> No. Tax reliefs integral part of tax systems affecting single taxpayer (or group of companies). Sale of surplus reliefs unjustified.

(iii) <u>Companies with surplus ACT are penalised</u> Dividends carry a tax credit which is paid to pension funds etc. If ACT not charged Exchequer would pay out tax it had not received.

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(iv) <u>Companies should be able to set double taxation reliefs against ACT/pay dividends free of ACT</u> No. ACT system carefully considered before introduced in 1972. Recognised that companies with large overseas incomes might generate surplus ACT. Necessary to ensure that UK corporation tax is paid to frank UK tax credit to shareholders.

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FF8 CAPITAL ALLOWANCES: MINOR CHANGES

This brief contains A Pre-consolidation changes
B Sports grounds

A. PRE-CONSOLIDATION CHANGES

Inland Revenue issuing Press Notice on Budget Day

Factual

(i) Capital Allowance Consolidation Bill to be introduced later this year. Last consolidated 1968.

(ii) Budget proposes to correct defects and anomalies in existing rules in advance of consolidation.

(iii) Main changes proposed:

(a) to allow contributor relief on contributions to capital expenditure where he or recipient engaged in profession or vocation (at present, only trades qualify);

(b) to restrict recipient's allowance to net outlay where contributor gets relief as trading expense or is exempt;

(c) to amend rules on sales of patent rights between "connected" parties to allow purchaser relief where no disposal value brought to account by vendor;

(d) to rationalise rules against double relief.

Positive

(i) Changes assist consolidation and create simpler more coherent code.

(ii) Meets call for contributor to get relief where profession or vocation also involved.

(iii) Meets call for relief where company purchases patent rights from non-resident parent.

(iv) Rationalisation of double allowance rules simplifies system. Gives taxpayer choice of allowance.

Defensive

(i) Why restrict relief to recipient of contribution? Right to give relief on net outlay only. Prevents potential double relief.

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B. SPORTS GROUNDS

Inland Revenue issuing Press Notice on Budget Day.

Factual

(i) Sports Grounds. Home Office Safety Certificate requirements extended 1 January 1989 to "regulated stands" (normally covered stands for 500 or more spectators) at undesignated sports grounds following Popplewell recommendation.

(ii) Existing capital allowance for safety expenditure confined to designated sports grounds. Proposed to extend tax allowance to bring into line with Home Office legislation.

Positive

(i) Right to extend existing tax relief to safety expenditure on smaller stands at smaller grounds.

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FF9 SUBCONTRACTOR TAX SCHEME: CONSULTATION ON REDUCED REQUIREMENTS

Inland Revenue issuing Press Notice and Consultative Document on Budget Day.

Factual

(i) Special scheme for subcontractors in construction industry. Those running business, with good tax record, get "714" exemption certificate and pay tax under normal Sch D/CT rules. Most must provide "715" vouchers when paid. Vouchers basis of Inland Revenue computer cross-checks. Uncertificated subcontractors paid under [25 per cent deduction].

(ii) Following Efficiency Scrutiny of scheme, Inland Revenue issuing consultative document on some aspects of scheme procedures. This covers eg letting subcontractors list small payments on one voucher rather than a series, quicker procedures for issuing scheme documentation.

(iii) Subject to results of consultation, regulations could be laid this year, to come into force from April 1990.

Positive

(i) Aim of proposals deregulation and minimisation of paperwork for industry and Revenue.

(ii) Some extra safeguards against fraud proposed (eg upper limit on amount on a voucher, faster submission of those vouchers still needed).

Defensive

(i) Consultative document the only result of Scrutiny? No. Scrutiny produced recommendations for internal procedures: no need to consult industry on those. Ministers still considering some other recommendations. For reasons for tax security, scrutiny report will not be published.

(ii) Size of cut in paperwork? Depends on proportion of small payments made under continuing contracts; but with over 6 million vouchers a year, could be sizeable.

(iii) Extent of subcontractor fraud? Much smaller than if no special scheme existed.

(iii) European dimension? 1992? Proposals in document would apply equally to all EC firms.

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FF10 LLOYD'S

Inland Revenue issuing Press Release on Budget Day.

Brief contains: A Stock lending: extension to Lloyd's underwriters

B Amendments to regulations

A. STOCK LENDING: EXTENSION TO LLOYD'S UNDERWRITERS

Factual

(i) New rules will treat stock lent by Lloyd's as remaining part of Lloyd's premium trust funds

(ii) This will enable Board of Inland Revenue to approve lending arrangements for Lloyd's, under which loans can be made without giving rises to CGT or accrued income liabilities as a result of transfers under the arrangement.

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Positive

(i) Will give Lloyd's members opportunity to earn fees by stock lending.

(ii) Will improve liquidity of markets in some stocks, particularly the gilts market, by providing a new source of stock available for borrowing by market makers.

Defensive

(i) Will not affect tax bill of Lloyd's members in respect of the stock.

(ii) Fees earned by Lloyd's will be liable to tax.

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B. AMENDMENTS TO REGULATIONS

Factual

(i) Amendments to powers to make regulations about the administrative arrangements for Lloyd's - to correct minor errors in earlier legislation.

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FF11 ITV LEVY

Home Office issuing Press Notice on Budget Day.

Factual

(i) Levy for 1 January 1990 to 31 December 1992 based three quarters on revenue, one quarter on profits.

(ii) Revenue levy 10.5 per cent of net advertising revenue (NAR) above £15 million. Contribution to Fourth Channel (17 per cent of NAR) is levy deductible.

(iii) Profits levy will be 22.5 per cent of profits above £2 million.

(iv) Overall yield broadly the same as would have arisen under the pre-1986 arrangements.

	pre 1986 system	existing system	£ million proposed system
1985	29		
1986		67	
1987		87	
1990-92	[210]	[155]	210

(v) Levy to be reviewed if NAR grows less than inflation.

		Revenue	Costs

(vi) Pre 1986 system: 66.7 per cent of domestic profits above £650,000.

(vii) Present system: 45 per cent of domestic profits plus 22.5 per cent of overseas profits, above £850,000.

(viii) Post - 1992: Broadcasting White Paper announced levy would be on advertising revenue, and progressive.

(ix) Objectives of levy: to cream off monopoly profits on TV advertising.

Positive

(i) Proposals will encourage cost - consciousness. Switch to a largely revenue-based system increases incentive to control costs, by reducing marginal rate, from 78 per cent (pre-1986) and 64 per cent (existing system), to 55 per cent on revenue and 50 per cent on costs.

(ii) Proposed levy will raise extra £50 million a year. The PAC criticised the present levy for not raising as much as the pre-1986 system would have done. The proposed system should do so.

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Defensive

(i) ITV companies' post-levy profits will be reduced. Post levy profits (+84 per cent 1985 to 1987) have outpaced those of industrial and commercial companies. Increasing yield will give Exchequer a fairer share.

	Levy yield	Post levy ITV profits	£ million 1987 prices Gross trading profits of firms in UK
1985	31	89	64
1986	70	142	59
1987	87	164	69
% increase 1985-87		+84%	+8%

(ii) Levy rates too high. Proposed marginal rates lower than now. Yield similar to pre-1986 system.

(iii) Forecast increases in revenue and costs unrealistic. Forecast increases in revenue take account of competition from satellites. Real growth in costs allowed for, despite incentives to control costs by new levy structure and auctions for future 1992 franchises.

(iv) Why tax overseas sales? Introduced to reduce marginal rate on domestic profits. Will be abolished once pure revenue levy introduced in 1993.

(v) ITN news subscription should be exempted Exempting ITN subscriptions from revenue levy would reduce incentive to control costs. ITV post-levy profits expected to grow so finance for ITN not endangered.

(vi) ITV companies face restructuring costs Restructuring underway now should be complete by end 1989 so can be set against current profits levy. Should mean savings in 1990-92.

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FF13 FOREIGN EXCHANGE GAINS AND LOSSES

Inland Revenue issuing Press Notice and Consultative Document on Budget Day.

Factual

(i) No change proposed in Budget.

(ii) Inland Revenue issued Statement of Practice (SP) February 1987 setting out current tax treatment of exchange rate fluctuations.

(iii) Representations for legislative reform from group of nine representative bodies July 1987.

(iv) Consultative document examines scope for comprehensive reform and considers:

- when exchange differences should be taxed or relieved;
- how they should be recognised;
- rules necessary to protect Exchequer from potential costs and abuse.

Inland Revenue inviting comments (by 30 September 1989) on matters discussed.

Positive

(i) Ministers recognise limitations of present system. Possibility of major legislative reform not ruled out if workable and acceptable scheme can be devised.

(ii) Document responds to representations. Taking forward consultative process. Government would welcome ideas for way forward.

Defensive

(i) SP does not meet companies' needs. Statement goes as far as possible within existing law. Useful and practical guide.

(ii) Why no legislation in 1989 Finance Bill? Complex issue. Wrong to rush into legislation. As widely recognised, many difficult problems to solve and document invites suggestions.

(iii) Government not serious about reform. Not this. Seeking scheme that is workable in practice, acceptable to business and without unacceptable Exchequer costs. Document also discusses alternative (limited) solutions to specific problems.

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(iii) Why pursue Woolworth appeal (Exchange losses on loans claimed as revenue deductions)? Not inconsistent to clarify current law on capital borrowing. Court of Appeal test unsatisfactory solution.

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GG1 MEASURES TO PROMOTE UNLEADED PETROL

Customs and Excise issuing Press Notice on Budget Day

Other relevant brief: G1 Excise duties

<u>Factual</u>

(i) <u>Budget measures</u>

- duty on unleaded <u>reduced</u>;
- <u>higher rate</u> of duty on 2 and 3 star petrol introduced;
- <u>no change</u> in duty on other (ie 4 star) petrol or derv.

(ii) <u>Duty changes</u> (including VAT):

		pence	%
2 star leaded	a litre	0.9	+3.8
	a gallon	+4.1	
unleaded	a litre	-0.8	
	a gallon	-3.6	-3.8

(iii) <u>Differentials</u> in favour of unleaded over 4 star leaded petrol:

		Pre-Budget	Post-Budget
		--------pence-------	
<u>Tax</u> (duty and VAT)	a litre	2.3	3.1
	a gallon	10.6	14.2
<u>Price</u> (assuming full duty reduction passed on)	a litre	1.3	2.0
	a gallon	6.0	9.0

Price differential lower than tax differential because of higher production costs of unleaded.

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(iv) Post-Budget duties and typical prices (based on prices as at [15 January]):

		Retail Selling Price (RSP)	Duty	VAT	Tax as % of RSP
			--------pence-------		
4 star	leaded				
	a litre	37.1	20.4	4.8	
	a gallon	168.8	92.9	22.0	68.1
2 star	leaded				
	a litre	37.5	21.2	4.9	
	a gallon	170.3	96.5	22.2	69.7
unleaded					
	a litre	35.3	17.7	4.6	
	a gallon	160.6	80.5	20.9	63.1

(v) Revenue cost of duty changes: £40 million in 1989-90 and £100 million in 1990-91.

(vi) Effective date: Both changes apply to oil delivered from refineries and bonded warehouses from 6pm on 14 March 1989.

(vii) Revalorisation (at 6.8 per cent) would have increased tax (duty plus VAT) on leaded petrol by 1.6p a litre (7.3p a gallon); unleaded petrol by 1.4p a litre (6.5p a gallon).

(viii) Availability of unleaded petrol: Around 4300 garages (22 per cent) sold unleaded at end January. Since 1 January number growing at about 250 a week.

(ix) Cars able to use unleaded 10 per cent of cars, 80 per cent of motorcycles on road at present are able to use unleaded without adjustment. Another 55 per cent could use unleaded after (usually) minor, inexpensive adjustment to ignition timing. 80 per cent of new cars sold can run on either; 28 per cent without adjustment. By 1 October 1990 all new cars must run on unleaded.

(x) Health: 80 per cent of lead in air comes from petrol. Increasing evidence that lead damages nervous system and development of children's brains at low as well as high concentrations.

(xi) Policy of successive governments over past 15 years to reduce exposure of population to lead in environment. Duty differential in favour of lead-free petrol one element of this policy. Government also taking action to raise public awareness of unleaded, eg Department of Trade and Industry changed Price Marking (Petrol) Order to allow garages to display prices in litres only, leaving more room to display unleaded price; Department of Environment working in conjunction with groups like CLEAR (the Campaign for Lead Free Air) to promote unleaded petrol.

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Positive

(i) Budget measures will speed up shift to unleaded. 2 star and unleaded close substitutes: some ¾ million motorists use 2 and 3 star and can switch to unleaded without adjustment. Positive action to secure worthwhile environmental and health benefits.

(ii) Will further help to satisfy EC Directive that lead-free fuel be widely available from October 1989.

(iii) Increased differential has widespread support from oil industry, car manufacturers and environmental lobby.

(iv) Tax differential in favour of unleaded now second highest (behind Denmark) in EC.

Defensive

(i) Differential in favour of unleaded not high enough. No. Tax differential second highest in EC. Price differential only one of number of factors influencing take-up of unleaded.

(ii) Wrong to promote unleaded petrol because inferior product. No. Recent 'Which?' report found no significant loss in performance.

(iii) Ban leaded 2 star petrol, as in Germany. Would not achieve same dramatic results, because German market structure and oil industry unlike those in UK. (In Germany about 40 per cent of cars use 2 star, in UK only 5-10 per cent).

(iv) Higher rate of duty on 2 star unnecessary as market share already low and diminishing. Higher rate of duty will speed shift away from leaded petrol.

(v) Unfair on two star users whose cars cannot be adjusted to unleaded. Only small minority of older cars affected. Reasonable to give priority to environmental/health benefits of unleaded petrol.

(vi) UK car industry not ready for unleaded petrol - another boost for foreign manufacturers. Plenty of notice given. Most UK makes at least capable of modification to run on unleaded petrol. Necessary to encourage shift to unleaded petrol further.

(vii) Cost of adjustment makes switching uneconomic. No. For most cars, adjustment only costs £15 - 20. Easily recouped over average year's motoring (8,000 - 10,000 miles).

(viii) Low availability of unleaded makes switching unattractive: No. Over 4,300 (22 per cent) garages already stock unleaded. Number growing each week. Cars adjusted to unleaded can run on either if necessary.

(ix) Oil companies will pocket some of increased differential. Existing price differentials reflect higher production costs of unleaded. Chancellor has made clear [in Budget Speech] that expects full benefit of increased differential to be passed on to consumers.

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(x) Further incentives to oil companies not needed. Market share of unleaded remains low. Increased differential aimed more at motorists than oil companies.

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GG2 VEHICLE EXCISE DUTY

Department of Transport issuing Press Notice on Budget Day.

Other relevant brief: G1 Excise Duties

<u>Factual</u>

(i) No change in duty rates, except:

- increase of around 10 per cent in rates of VED on 14 weight bands of rigid heavy goods vehicles (from 15 March).

- increase from £1,600 to £3,100 for "Special Types" heavy vehicles used for abnormal and indivisible loads - bringing the rate in line with maximum rate for heaviest HGV (from 15 March).

- <u>Simplification</u> of 'Hackney Carriage' tax structure. Tax bands reduced from over 60 to five. Taxis to pay £100, same as cars (90 per cent increase). Increases of up to 370 per cent in rates of buses and coaches bringing group as a whole to track cost coverage. (from 15 March).

Trade licences increased by 17 per cent. Final leg of three-phase increase started in 1986 (From 15 March).

(ii) <u>Simplification</u> of Agricultural Machine classes by merging six classes into one. (From 15 March).

(iii) Automatic penalties for those <u>convicted</u> of acquiring tax disc using dishonoured cheque. (From 30 September).

(iv) Clearer definition of functions which may be undertaken by vehicles licenced in concessionary <u>Recovery Vehicle</u> class.

(v) <u>RPI impact of VED changes</u>: negligible.

(vi) <u>Revenue yield from Budget changes</u>: £40 million in 1989-90 and £40 million in 1990-91.

(vii) <u>Total yield of VED</u>: £2,880 million in 1989-90.

- If all VED rates revalorised would have increased revenue yield by £190 million in 1989-90 (£140 million from cars and light vans, and £50 million from other vehicles).

(viii) <u>In 1989-90 estimated (at current rates) that:-</u>

- lorries share of road track costs (cost of building, maintaining and policing roads) will be £1,310 million.

- lorries share of total motoring taxation will be £1,740 million (£1,200 million fuel duty and £540 million VED).

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- excess taxation of £430 million in 1989-90 compares with excess of £405 million in 1988-89.

(ix) Scale of VED evasion

- 4 per cent of total revenue (DTp survey, December 1984) (equivalent to £110 million in 1988-89).
- In 1987-88 more than 900,000 offence reports followed up; 183,000 prosecutions; 173,000 cases settled out of court; revenue recovered £23.6 million - more than twice the amount recovered five years ago.

(x) Government position is that it would not abolish VED unless benefits clearly outweigh disadvantages. Then Financial Secretary said (24 October 1985 OR Vol 84 col 488) "possible alternative forms of taxation have been examined but none has been found preferable to the form that we have, even with its acknowledged disadvantages".

(xi) Rises in rates for heaviest rigids continue process of bringing excess of taxes over costs for heavy rigids more into line with articulated lorries of similar weight.

(xii) "Special Types" shortfall in track costs coverage highlighted by NAO report on regulation of heavy lorries (1987). DTp Survey showed "Special Types" cause at least as much road wear as heaviest HGV; increase brings to same rate as heaviest HGV.

Positive

(i) No VED increase for most vehicles.

(ii) Fourth year of standstill for most vehicles.

(iii) Standstill for artics may help hauliers to obtain international business in the face of competition from foreign hauliers.

(iv) Simplified Hackney structure by eliminating 56 tax bands. Increases ensure all new bands of buses and coaches cover track costs.

(v) 'Special Types' contributing more to track cost coverage. Excess of taxation over track costs for rigid vehicles increased closer to that for articulated lorries. Some simplification of the HGV tax bands also.

(vi) New 'Special Machine' class combines 6 tax classes (500,000 vehicles), removes many restrictions on use, makes administration easier, allows more operators to claim concessions.

(vii) Dishonoured cheques - new measure closes a loophole which allowed deliberate form of evasion.

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Defensive

(i) 'Hackney Carriage' increases result in increased fares and more congestion on roads? Policy is that all vehicles should cover track costs, and increases will ensure all classes of buses and coaches do that. VED not a significant part of operators' overheads. Direct effect on fares negligible.

(ii) Why should there be any excess tax? Policy is that tax (VED and fuel duty) should at least cover road track costs. Excess reflects social and environmental factors as well as fiscal considerations.

(iii) Lorries should be taxed more? Every group of lorries ('Special types' are still being monitored) more than covers its track costs in fuel duty and VED. Social and environmental costs reflected in taxation over and above road track costs.

(iv) VED widely evaded: better abolished? Government does not take evasion lightly. Dishonoured cheques provision will plug important loophole. Replacement of VED with petrol duty would mean increase of 40p per gallon, raising costs to essential high mileage and business users.

(v) Will Government abolish VED? Not unless benefits clearly outweigh disadvantages.

(vi) UK hauliers heaviest taxed in Europe: EC proposals lead to reductions? EC directive proposes that taxation must at least cover track costs. UK unique in doing so - others must aim for this. Government committed to improving position of UK hauliers - bringing about rise in rates of competitors will achieve that. Also UK businesses have favourable direct tax regime - UK has lowest rate of Corporation Tax in EC (equal with Spain).

(vii) Increase for 'Special Types' exorbitant? Policy is all vehicles should cover track costs. PAC report insisted on need to remove indefensible low rate. 1988 Survey confirmed they give rise to costs at least as high as heaviest HGV.

(viii) Why increase Trade Licences? Part of long term objective set in 1986 to bring in line with rate for similar vehicles.

(ix) Private Finance for Roads? Keen to encourage where more cost-effective or would provide new types of facilities. Department of Transport evaluating results of recent consultations with Finance sector and Construction Industry.

(x) Imposition of tolls on existing roads? No plans to do so.

(xi) Introduce road pricing? No plans to do so.

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GG3 VAT ON NON-DOMESTIC CONSTRUCTION ETC

Other relevant briefs:
- G2 VAT: main points
- HH3 International tax reforms and comparisons
- JJ1 EC tax proposals
- JJ2 Charities
- JJ6 Staffing

Brief contains:
- A Infraction proceedings - general
- B Construction, buildings and land
- C Fuel and power
- D Water and sewerage services
- E News services
- F Protective boots and helmets
- G Charities

A. INFRACTION PROCEEDINGS - GENERAL

Factual

(i) European Commission took first step towards infraction proceedings against Ireland and UK in 1981. Contended zero rating of items challenged incompatible with Sixth VAT Directive because not "for clearly defined social reasons and for benefit of final consumer". Government vigorously disputed contention before European Court of Justice (ECJ).

(ii) Items under challenge were

- construction of buildings (supplies other than to final consumers "within a social policy");
- fuel and power (supplies to businesses);
- sewerage services and water (supplies to industry);
- news services (all supplies);
- protective clothing and footwear (supplies to employers); and
- animal feeding stuffs, seeds, live animals yielding food for consumption (all supplies).

Commission did not challenge zero rating of food in shops, young childrens" clothing and shoes, fuel and power supplied to domestic consumers.

(iii) ECJ gave judgment on 21 June 1988. Found against UK's zero rating of

- commercial construction and civil engineering;
- supplies of fuel and power to businesses;
- supplies of water and sewerage services to industry;
- supplies of protective boots and helmets to employers; and

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- news services other than those supplied direct to public or for production of zero rated products eg newspapers.

(iv) Economic Secretary announced key decisions on construction in oral statement to House on 21 June 1988 (OR 21 June 1988 vol. 135 no. 170 col. 957-8) (see section B).

(v) After extensive consultation, Economic Secretary announced measures to implement judgment on 6 February. Early announcement to allow maximum time for technical consideration of draft clauses. Economic Secretary stated "our aim has been to implement the ruling in a way which, while respecting the terms of the judgement, minimises the burden of tax and compliance" (OR 6 February vol 146 no 45 col W548). Also announced other minor changes in liability of construction and property (see section B).

(vi) Revenue effect: Total yield expected to be £315 million in 1989-90 and £540 million in 1990-91. Of total, only £55 million in 1989-90 and £100 million in 1990-91 to accrue from private sector. Remainder falls on public sector costs, mainly VAT on capital building projects. Compensating adjustment has already been made to relevant capital expenditure provisions.

(vii) RPI effect: No impact effect on RPI, because no direct effect on prices to final consumers.

(viii) Own resources: Not affected. Payments to EC take account of both zero rated and standard rated supplies.

(ix) EC comparisons: Only UK, Ireland and Portugal have extensive zero rating. Items zero rated in UK generally taxed at reduced rates in other Member States.

(x) No connection with tax approximation proposals. (see brief JJ1).

Positive

(i) Government defended case vigorously before ECJ and won on most important element - continued zero-rating for housing.

(ii) Care taken to implement judgment in way which minimises burden of tax and compliance.

(iii) ECJ decision implemented in full.

(iv) Government gave maximum possible time for consultation by announcing decisions on day of judgment itself. Now opportunity for full technical consideration of law by announcing changes early (6 February).

(v) All possible steps taken, within terms of judgment, to mitigate effect on charities.

(vi) Government stands by pledges on VAT zero rating (see brief G2).

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Defensive

(i) Government allowing EC to dictate domestic tax policy. As EC Member State, UK has Treaty obligation to respect ECJ's ruling on interpretation of Community law. General principle of zero rating maintained.

(ii) Commission could use infraction proceedings to abolish other zero ratings. Bulk of zero rates (eg food, young chilren's clothing, housing) clearly within existing law, as interpreted by ECJ. Government fully able to determine policies within existing law.

(iii) UK being singled out. No. Ireland also challenged - and condemned by ECJ - on zero rating. All Member States have been challenged on VAT matters.

(iv) Judgment implemented with undue haste. No. UK under Treaty obligation to implement ECJ ruling. Timing reflects need to avoid prolonged uncertainty about changes and ability of industries to adjust. Delaying too long would open UK to further infraction proceedings.

(v) Could have applied reduced rate instead of standard rate to items affected by ruling. Reduced rate complex, and costly, for both business and Government. Ruled out by Economic Secretary in statement to House on 21 June 1988 (OR 21 June vol. 135 no. 170 col. 959).

(vi) Package too complex, will lead to mistakes and administrative burdens. No. Government aim has been to minimise burden of tax and compliance.

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B. CONSTRUCTION, BUILDINGS AND LAND

Factual

(i) ECJ ruled that zero rates for industrial and commercial buildings and community and civil engineering works not compatible with Sixth VAT Directive because supplies not made to final consumers. Zero rating for housing acceptable.

(ii) Still zero rated after Budget changes:

- new dwellings, ie individual houses, flats etc;

- most new communal residential buildings (eg old people's homes, hospices, student accommodation);

- new buildings used by charities for non-business activities (includes new churches); and

- approved alterations to listed buildings, where use to which buildings put would qualify for zero rating of newly constructed building.

(iii) Standard rated

- new buildings except those still zero rated:

- new civil engineering works (with minor exceptions eg work to create permanent residential caravan parks);

- demolition services (except those supplied under contract for construction of new zero rated buildings);

- work done to existing buildings or civil engineering works (except approved alterations to qualifying listed buildings);

- self-supply of building services valued at over £100,000 for construction of new building for use by business and for works which increase floor area by 10 per cent or more.

(iv) Use of land to build new standard rated buildings or civil engineering works to be taxed at standard rate as self-supply, in limited circumstances (subject to EC derogation under Article 27 of Sixth VAT Directive). (Effect is to tax building land, where both zero and standard rated buildings may be built, in most efficient way).

(v) Letting of land, buildings or civil engineering works on land will generally be exempt.

(vi) Landlords' option to tax rents: Owners and landlords will, subject to certain conditions, have option to tax rents on building-by-building basis at standard rate. Option also to apply to sale of existing buildings, civil engineering works, agricultural land and other land which otherwise exempt. (Effect is to allow landlords to recover

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input tax paid on purchase of standard rated buildings and other relevant purchases).

(vii) Special transitional reliefs

- zero rating to continue for sale or construction of buildings or civil engineering works, with time of supply after 1 April 1989, but where sale or construction agreed, in writing and for a price, before 21 June 1988;

- zero rating to continue for sale or construction, before 21 June 1993, of buildings or civil engineering works where developer was under binding legal obligation to proceed and had planning permission before 21 June 1988; and

- tenants whose landlords opt to tax existing leases from 1 August 1989 will pay tax on only half of rent for first year and on full amount in year two. For charities, VAT will be phased in over 5 years.

(viii) Minor property changes: Changes announced on 6 February included several changes from existing provisions for construction and property not directly linked to ECJ judgement. Relevant changes are

- materials etc used in construction of zero rated buildings only qualify for zero rating when supplied to recipient of zero rated building services;

- dwelling accommodation acquired only for holiday purposes (eg time-share) to be standard rated;

- payments of rent and service charges under long lease to become exempt;

- supply of rented accommodation in caravan or houseboat to be exempt unless it is holiday accommodation, in which case it is standard rated;

- provision of holiday accommodation in tents provided and put up by site operator and letting of pitches in caravan parks (except those for permanent residential caravans) to be standard-rated;

- provision of facilities (eg boxes and executive suites) at sports stadia and places of entertainment to be standard-rated;

- freehold disposals of fishing and shooting rights to be standard rated.

(ix) Effective dates:

- new commercial construction and civil engineering etc standard rated from 1 April 1989;

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- standard rating of land for new standard rated buildings etc effective from 1 August 1989;
- letting of buildings etc exempt from 1 April 1989;
- option to tax effective from 1 August 1989;
- minor property changes effective from 1 April 1989.

(x) Revenue yield: (£ million)

	1989-90			1990-91		
	Private sector	**Public sector**	**Total**	**Private sector**	**Public sector**	**Total**
New Construction	15	250	**265**	20	325	**345**
Option to tax rent	20	10	**30**	40	35	**75**
Minor property changes	15	neg	**15**	20	neg	**20**
Total	50	260	**310**	80	360	**440**

(xi) No RPI impact effect.

Positive

(i) Zero-rating retained for construction of housing, thanks to Government's vigorous defence before ECJ.

(ii) Zero-rating also retained for construction of buildings for charitable and most communal residential uses (including churches, sheltered housing, and student residences).

(iii) All four of mitigating measures asked for by trade given.

- start date delayed until 1 April, together with full consultation;
- relief for existing commitments in form of legally binding obligation by day of ECJ judgment;
- protection of public sector projects - local and health authorities able to reclaim VAT paid out; increased funding elsewhere totalling £250 million;
- option to tax granted, and extended to agricultural and other land. Reduces full year tax burden of judgement on private sector from £450 million to £110 million in 1989-90.

(iv) Additional mitigation in form of phasing in of option to tax.

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Defensive

(i) Package too complex and burdensome; better to stick with zero-rating. Treaty obligations oblige UK to implement ECJ judgment. Mitigation, especially option to tax, offsets most of extra cost.

(ii) Exempt traders (banks, other financial services, bookmakers) should not have to bear full burden of option to tax. Natural consequence of exempt status. Relief impossible without either drastic cut in benefit of option to tax or substantial administrative problems.

(iii) No zero-rating for hospitals, schools, village halls. Judgment explicitly ruled out zero-rating for private hospitals and schools (except boarding houses). Judgment interpreted as generously as possible and maximum allowable mitigation given.

(iv) Denying relief for charities' business activities niggardly and administratively burdensome. Zero rate for business activities would risk further infraction case. VAT on business activities reclaimable under normal rules.

(v) New rules will have adverse effect on listed buildings. For zero-rated buildings, current rules will continue to apply. Elsewhere, if landlord opts to tax, VAT on all work to listed buildings reclaimable - worthwhile improvement on old regime of zero rating for approved alterations only.

(vi) Relief for existing commitments too restrictive: damaging to inner city development. Line has to be drawn if implementation date not to be undermined. Clarity and objectivity essential, and achieved, under chosen relief.

(vii) Landlord should not have unfettered right to impose tax. Option is very substantial ongoing benefit for landlords, major way of reducing impact of judgement. No extra burden for most tenants (domestic tenants exempt, taxable tenants can reclaim tax). Landlords should be willing to discuss with tenants, but tenant's veto would greatly reduce usefulness of option.

(viii) Introduce new liabilities and option on same date. New liabilities foreseeable since judgment; delay beyond 1 April would give rise to economic distortion (feast and famine). Option to tax is new. Right to give extra time to prepare, and ensure full Parliamentary discussion before implementation.

(ix) Domestic accommodation included in agricultural estates should be subject to option to tax with land. In vigorously, successfully, contesting ECJ case on domestic building, Government already reaffirmed principle that taxation of housing unacceptable. Tax on domestic accommodation could not be reclaimable.

(x) Option should be by tenancy, not by building. Administratively complicated for both traders and officials, and would make effective 'policing' impossible.

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(xi) Self-supply where trader does own building work is unnecessary or burdensome. Routine repairs and minor works not affected; only substantial work worth £100,000 or more. Blocks possible avoidance loophole. Operates as deterrent even if rarely invoked.

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C. **FUEL AND POWER**

Factual

(i) ECJ ruled zero rating of supplies to businesses not compatible with Sixth VAT Directive.

(ii) Still zero rated after Budget changes:

- fuel and power used by domestic consumers (including communal residential homes, hospices, school and student boarding accommodation, self-catering holiday accommodation) and by charities for non-business purposes;

- small deliveries of coal, oil and liquified petroleum gas regardless of whether for business or non-business use. (Discussions continuing about de minimis system depending on size of delivery for gas and electricity);

- all wood, peat and charcoal sold as fuel;

- mixed zero rated and standard rated supplies, eg where one electricity meter serves both shop (standard rated) and flat (zero rated), and where zero rated element is 60 per cent or more of total. If zero rated element less than 60 per cent, supply to be apportioned.

(iii) Standard rated

- all other supplies of fuel and power. (Effect is that, for many supplies, rate of VAT charged will depend on status of consumer).

(iv) Effective date of standard rating: 1 July 1990

(v) Revenue yield: £95 million in 1990-91, £180 million in full year. Of full year total, some £150 million will accrue from public sector.

(vi) No RPI impact effect because no direct effect on prices to final consumers.

Positive

(i) Government has kept pledge not to impose VAT on domestic gas and electricity.

(ii) Supplies to charities for non-business activities still zero rated.

(iii) Judgment implemented with minimum administrative burden for suppliers.

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Defensive

(i) VAT on fuel and power costly to businesses. No. Most businesses able to recover tax. Many small businesses will still benefit from zero rating of small quantities of fuel.

(ii) Charging VAT according to status of customer complicated to operate. Consultation with interested parties means have fairest workable solution within terms of ECJ judgment.

(iii) Risk of further infraction proceedings. Terms of judgment carefully considered.

(iv) First step to taxing all fuel and power. No. Pledge on domestic gas and electricity is firm commitment by which Government stands.

(v) Implementation date too delayed. No. Earlier date would be very difficult for fuel and power industries to implement. No risk of 'feast and famine' that determined early start on construction.

(vi) Implementation date too early. No. Longer delay would bring threat of further infraction proceedings.

(vii) Implications for privatisation of electricity. None.

(viii) Delay in start date just sop to privatisation. No. Later start date recognises greater complexity of system where rate charged (zero or 15 per cent) depends on status of customer, not nature of supply.

Contact points: D Barrett (Customs and Excise) 382 (GTN 3913) 5387
W Hoggett (Customs and Excise) 382 (GTN 3913) 5393

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D. **WATER AND SEWERAGE SERVICES**

Factual

(i) ECJ ruled that zero rating of water and sewerage services supplied to industry not compatible with Sixth VAT Directive.

(ii) Standard rated after Budget changes:

- all supplies to industry of services of emptying cesspools, septic tanks etc for business purposes;

- all supplies of water to industry.

Industry defined as activity described in Divisions 1 to 5 of 1980 Edition of Standard Industrial Classification (ie energy and water supply; mining; manufacture of metals, minerals, chemicals, metal goods, engineering and vehicles; other manufacturing; construction).

(iii) Zero rated:

- all other supplies of water and sewerage services.

(iv) Effective date for standard rating: 1 July 1990.

(v) Revenue yield: Negligible in 1989-90 and 1990-91.

(vi) No RPI impact effect.

Positive

(i) Judgment implemented with minimum burdens on water/sewerage industries.

(ii) Zero rating maintained for supplies to commerce and domestic consumers.

(iii) Ample time given for industry to implement changes.

Defensive

(i) Implications for water privatisation. None.

(ii) "Industry" defined too widely/narrowly. No. Changes implement letter of judgment. Wider definition would add substantially to burdens on water industry and customs.

(iii) Interpretation of "industry" open to further challenge by Commission. Have interpreted term in light of decision. "Industry" not defined in UK or EC law.

(iv) Implementation date too delayed. No. Earlier date would be very difficult for industry to implement. No risk of 'feast and famine' which determined early start on construction.

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(v) Implementation date too early. No. Longer delay would bring threat of further infraction proceedings.

(vi) First step towards taxation of all water and sewerage services. Government position on zero rating perfectly clear (see G2).

Contact points: D C Hewett (Customs and Excise) 382 (GTN 3913) 5406
A R Ruston (Customs and Excise) 382 (GTN 3913) 5413

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E. NEWS SERVICES

Factual

(i) ECJ ruled zero rating of news services supplied to businesses which do not themselves make zero rated supplies not compatible with Sixth VAT Directive.

(ii) Standard rated after Budget changes:

- all supplies of news services (mainly supplied by news agencies like Reuters and Press Association).

(iii) No continued zero rating for news services.

(iv) Effective date for standard rating: 1 April 1989.

(v) Revenue yield: £5 million in 1989-90 and 1990-91.

(vi) No RPI impact effect.

Positive

(i) Most straight forward solution. Preferable for suppliers because avoids need to operate different VAT rates in parallel.

(ii) Main users, eg newspapers, able to recover VAT on news services.

Defensive

(i) Changes go beyond ECJ decision. Simplest, least administratively burdensome solution for suppliers.

(ii) Unfair to private users of news services. Affects only small proportion of public. Unlikely to figure largely in household budgets.

(iii) First step to taxing newspapers. Entirely separate issue.

(iv) Implementation too early. No. Accounting and other problems are relatively straightforward (unlike fuel and power and water where rate depends on customer's status). No reason to delay.

Contact points: D Barrett (Customs and Excise) 382 (GTN 3913) 5387
W Hoggett (Customs and Excise) 382 (GTN 3913) 5394

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F. **PROTECTIVE BOOTS AND HELMETS**

Factual

(i) ECJ ruled that zero rating of protective boots and helmets supplied to employers not compatible with Sixth VAT Directive.

(ii) Standard rated after Budget changes:

- all supplies to employers for use by employees;
- all supplies of services in respect of protective boots and helmets supplied to employers for use by employees.

(iii) Zero-rated

- all supplies to anyone other than employer

(iv) Effective date for standard rating: 1 April 1989

(v) Revenue yield: Negligible.

(vi) No RPI impact effect.

Positive

(i) Judgment implemented with minimum burden on suppliers.

(ii) Supplies to individuals for own use still zero rated.

(iii) Judgment fully implemented.

Defensive

(i) Identification of user (employer/employee) complicated for suppliers. No. Most supplies made by manufacturers or wholesalers direct to industry and in more than single pair lots.

(ii) Implementation date too early. No. Timetable will not cause problems for suppliers or buyers.

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Contact points: D C Hewett (Customs and Excise) 382 (GTN 3913) 5406
G R Burgess (Customs and Excise) 382 (GTN 3913) 5376

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G. CHARITIES

Factual

(i) In written answer to PQ on 6 February, Economic Secretary said "[in implementing the judgment)] we have had particular regard to the potential impact on charities. I regret they cannot be wholly shielded because many of them have activities which constitute "business" for VAT purposes and therefore come within the ambit of the judgment. But we have done as much as we can to safeguard their position. "(OR 6 February vol 146 no 45 col W548).

(ii) Effects of judgement on charities

- retain zero rating of fuel and power, new construction supplied for residential and/or non-business purposes;
- landlords not allowed to opt to tax rent from charities' non-business buildings other than offices;
- tax on charities' rents, where landlords do opt to tax, phased in over 5 years (2 years for other tenants).

[NB. Non-business activities include eg provision of subsidised homes for disabled and elderly; lifeboat and mountain rescue services; religious activities of churches. Business activities of large charities, eg. sale of Christmas cards/merchandise, often VAT registered so able to reclaim VAT charged to them].

Positive

(i) Government done all possible to mitigate effect of judgement on charities.

(ii) Charities" non-business activities largely shielded from effects of judgment.

Defensive

(i) No right of veto over landlords' option to tax rents. Generous concessions already made. Further special treatment would unacceptably complicate administration of tax, create distortions.

(ii) Village halls unfairly penalised. Lettings constitute 'business' within wide definition of domestic/EC law. Discussions continuing to see if can find ways of mitigating effects of judgment eg moving to voluntary contributions rather than compulsory charges, opting to tax lettings.

Contact points: D Barrett (Customs and Excise) 382 (GTN 3913) 5387
I R monk (Customs and Excise) 382 (GTN 3923) 5390

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GG4 VAT: RESEARCH AND DEVELOPMENT (R&D) CARS

Customs and Excise Issuing Press Notice on Budget Day

Factual

(i) Existing arrangements: When car manufacturer uses own cars for R&D purposes, VAT is not chargeable. But VAT is chargeable where car manufacturer imports or acquires other cars for R&D purposes. Relief for manufacturers' own cars provided since 1973.

(ii) Revised arrangements: All unused cars imported or acquired by car manufacturers for R&D purposes will be relieved of VAT. Change will be made by Treasury Order.

(iii) Effective date: 1 August 1989.

(iv) Revenue cost: Negligible in 1989-90 and £5 million in 1990-91

(v) EC Commission advised UK that present arrangements discriminatory and contrary to Article 95 of Treaty of Rome. Threat of infraction proceedings no action taken.

Positive

(i) Provides additional VAT relief for car manufacturers using new cars for research and development purposes.

(ii) Puts all new cars used for R&D purposes on equal VAT basis.

(iii) Simplifies administration for businesses and Customs

(iv) Removes artificial constraint on European-wide rationalisation of production and research activities.

Defensive

(i) Widen relief to include car component manufacturers. No evidence this sector needs relief. Would be open to abuse.

(ii) Will encourage imports Negligible impact. Change will remove artificial constraint on efficient allocation of production and research resources in EC market.

Contact points: I Walton (Customs and Excise) 382 (GTN 3913) 5295
G Elander (Customs and Excise) 382 (GTN 3913) 5313

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HH1 UNAUTHORISED DISCLOSURE OF INFORMATION

Press Notice issued by Inland Revenue and Customs and Excise on 23 February 1989. Further Press Notice issuing on Budget Day.

Factual

(i) Finance Bill 1989 provision to safeguard private and confidential information held by Inland Revenue (IR) and Customs and Excise (CE) against wrongful disclosure. Preserves possibility of criminal sanction for most serious cases. Applies to employees (past and present).

(ii) Existing arrangements: Any breach of confidentiality subject to disciplinary action under Civil Service code, up to and including dismissal. Prosecution possible under Official Secrets Act (OSA).

(iii) Prosecution option will not be preserved by Official Secrets Bill (OSB) currently before Parliament.

(iv) Scope of new provision: Covers information relating to identifiable persons and businesses for purposes of assessing and collecting taxes and duties but not policy and Budget papers, Departmental instructions, etc, nor information obtained by CE in respect of import/export of restricted/prohibited goods (eg drugs, weapons, rabid animals, etc).

(v) Penalties: As for OSA, maximum penalty for unauthorised disclosure of 2 years' imprisonment.

(vi) Announcement: Made to House by Home Office Minister on 22 February, during Report Stage of OSB. (OR vol 147 no 55 col 1075).

(vii) Effective date: On repeal of OSA.

Positive

(i) Public has right to expect personal information to be kept private. New measure maintains proper confidentiality for individuals and businesses.

(ii) Applies only to personal information: not catch-all like 1911 OSA.

Defensive

(i) IR and CE staff being singled out: No. Over 130 criminal measures against unlawful disclosure already in place (eg census information, legal aid information). Parliament and Courts have already recognised special nature of Revenue Departments' confidentiality.

(ii) No need for criminal sanction, Civil Service discipline code enough: True in most cases, but cannot discipline ex-employees. And criminal sanction needed for most serious cases where dismissal not punishment enough.

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(iii) No protection for information on CE's non-tax functions: Inappropriate to Finance Bill. Much would relate to other criminal offences such as drug smuggling and, at times, would involve international co-operation so would fall within provisions of OSB, Clauses 3 and 4.

Contact points:
R A Hutton (Inland Revenue) 438 (GTN 3541) 6544
M H Gledhill (Inland Revenue) 438 (GTN 3541) 7614
R S Brisley (Customs and Excise) 382 (GTN 3913) 5722

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HH2 KEITH

Inland Revenue issuing Press Notice on Budget Day.

Other relevant briefs: F1 Effect of Budget on Business
FF1 VAT Deregulation

Brief contains: A Background

B Inland Revenue: Measures to modernise compliance system

A. BACKGROUND

(i) Independent Committee, chaired by Lord Keith of Kinkel, set up by Government in July 1980 to review tax enforcement powers of Inland Revenue and Customs and Excise. Report (Volumes 1 and 2 - on income tax, capital gains tax, corporation tax, VAT), published 1983, made far-reaching recommendations for future administration of tax compliance and enforcement regimes. Bulk of VAT recommendations implemented in Finance Act 1985. Vol 3 (development land tax, petroleum revenue tax, capital transfer tax, stamp duties) published January 1984: consultation continuing. Vol 4 (covering excise, customs, car tax) published February 1985, followed by public consultation. Government considering most appropriate way forward.

(ii) Consultation:

(a) Extensive consultation 1983-1986 informed changes to VAT regimes made 1985-88 and changes in some IT and CT regimes 1987-88.

(b) Second Inland Revenue consultative paper July 1988 - revised proposals for rest of Keith. Well received. Proposals in this Budget complete Government's programme of legislation on Keith for income tax, capital gains tax and corporation tax - except appeals.

(c) Further consultative paper promised on administration and conduct of appeals.

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B. INLAND REVENUE: MEASURES TO MODERNISE COMPLIANCE SYSTEM

Factual

(i) Package of proposals to modernise and simplify administrative framework of compliance system:

(a) Simple, updated, streamlined penalties for tax offences.

(b) Automatic penalties for late end of year returns by employers (PAYE, NIC and subcontractor's deductions). Full implementation not before 1995. Gradual tightening up in interim.

(c) Simple, open system for setting Revenue interest rates; clear interest rules.

(d) 20 year time limit for assessing tax offenders.

(e) Wider rights for tax payers to claim further reliefs where Revenue discovers further tax due.

(f) Modernise Revenue information powers, giving greater safeguards to taxpayer and protection for accountants broadly equivalent to that for lawyers.

(g) Criminal penalty for intentional destruction of documents called for under Revenue's information powers.

(h) Restrict Revenue search powers, giving greater safeguards to taxpayer in line with police and VAT search powers.

(j) Clearer rules for seizure of goods to meet tax debts Revenue priority reduced in line with Insolvency At 1985.

(ii) Package implements recommendations of Keith Committee, modified in light of consultations.

(iii) Yield/Cost negligible/unquantifiable. Proposals simplify/update framework for compliance, pave way for measures to encourage better voluntary compliance and better use of Revenue resources.

Positive

(i) Right that people pay correct amount of tax - particularly better-off who have benefited from cuts in tax rates. Right that Revenue should be able to catch, and deal effectively with, tax evaders. Ensures that honest do not bear unfair share of tax burden. In 1987-88 Revenue recovered £2 billion from compliance activities, equivalent to 1.25 p off basic rate of income tax. But more could be done. Black economy estimated at 6-8 percent of GDP and tax loss of around £5 billion.

(ii) Unprecedented degree of consultation with representative bodies and public.

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(iii) Overwhelming support for proposals. Nearly all responses broadly content, most specifically commended overall approach and changes made, many commended consultative process.

(iv) Keith recommendations designed to provide proper balance between taxpayer's rights and obligations, and between powers of Revenue and safeguards for taxpayers. Some recommendations criticised as getting balance wrong. Responses to consultations generally agree revised proposals improve on Keith balance, achieve fair and proper balance overall.

(v) Automatic penalties for late end of year returns from employers of PAYE/NIC and subcontractor's deductions, will encourage employers to make returns to Revenue at correct time. End of year return necessary for Revenue to check employer has paid tax deducted to Revenue, and to check employees' tax position and repay if overpaid. Completes compliance package for employers (measures on interest in 1987 and 1988 Finance Acts). Large amounts of tax at stake. Criticism, by Public Accounts Committee and others, of loss to Exchequer caused by delay in payment.

Defensive

(i) Revenue has too much power already. Keith Committee concluded otherwise. Not enough power to track down, and deal effectively with, evaders. But also more rights for tax payers needed.

(ii) New penalties give Revenue too big a stick Keith concluded otherwise. Maximum penalties as recommended by Keith. Some are lower than before (100 per cent maximum, rather than 200 per cent). Others uprated in line with inflation, to restore to value when last set in 1960. Most penalties fully-mitigable, can be less than maximum down to nil according to seriousness of offence. All penalties ultimately subject to independent judicial review.

(iii) Why not extend legal professional privilege as recommended by Keith?

(a) Keith recommended balanced reform - restrict legal privilege by override, extend privilege with override to accountants.

(b) Lawyers firmly opposed to override - threat to civil liberties.

(c) Override widely seen as much greater threat to civil liberties than not extending privilege to accountants.

(d) But accountants are being given protection broadly equivalent to lawyer's privilege.

(iv) Why no new right of appeal for taxpayer against Revenue information notice?

(a) At present, oversight by independent Commissioners or, exceptionally, Board of Inland Revenue in every case before notice can be issued.

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(b) Keith recommended replacement by new right of appeal to Commissioners <u>for taxpayer and Revenue</u>.

(c) New right of appeal would give <u>limited</u> oversight after notice is issued, and needed for <u>override</u> (which Government has dropped).

(d) Generally agreed, better protection for taxpayer if oversight remains <u>universal and before</u> notice is issued.

(e) Oversight <u>both before</u> and <u>after</u> (ie appeal) would put <u>unreasonable</u> burden on Revenue and Commissioners.

(f) <u>Taxpayer has adequate rights of appeal</u> already - directly by judicial review or indirectly by non-compliance and appeal against penalty if Revenue pursue.

(v) <u>Why no compensation to third party for providing information</u>?

Would breach general principle - citizen's duty to comply with statutory obligations. Keith recommended limited breach for information from unconnected third parties. Linked to Keith recommendation for increasing amount of information Revenue can obtain from third parties, which Government has rejected.

<u>**Contact point**</u>: D L Shaw (IR) 438 (GTN 3541) 6300

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HH3 STAFFING IMPLICATIONS OF BUDGET

Brief contains: A Staffing implications for Customs and Excise
B Staffing implications for Inland Revenue

A. STAFFING IMPLICATIONS FOR CUSTOMS AND EXCISE

Other relevant brief: GG3 VAT on non-domestic construction etc.

Factual

(i) Changes broadly neutral except for implementation of European Court of Justice (ECJ) judgment on zero rates needs 170 extra staff by 1991. (See GG3).

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Positive

(i) 430 more staff agreed in 1988 PES for Customs and Excise in 1989-90 includes provision for ECJ judgment - to be targeted at Department's top priorities, prevention of drugs smuggling and effective collection of VAT. Effectiveness of staff in all areas being enhanced by improvements in support eg from computer systems and training.

Defensive

(i) Why such large increases from ECJ judgment? Increases are minimum needed to cope with complex changes to VAT base and with special steps taken by Government to minimise the impact of judgment in business.

Contact point: M J Eland (Customs and Excise) 382 (GTN 3913) 5431

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B. STAFFING IMPLICATIONS FOR INLAND REVENUE

Other relevant briefs: DD3 Tax relief for private medical insurance
DD4 Schedule E receipts basis

Factual

Net effect of Budget changes in next 2 years increased staff requirement of 25 in 1989-90 and 140 in 1990-91. The longer term effect will be a reduced requirement of about 80 (from 1992-93). But some offsetting increase in requirement because of changes in taxpayer population (around 60 in full year). Net reduction in requirement of about 20 by 1992-93.

Main components

	Full year (i.e. once effects have worked through)
- schedule E receipts basis (see DD4)	175 fewer staff (but staff cost in transitional year (1990-91) of 40)
- relief for premiums for over 60s (see DD3) medical insurance	45 more staff
- no change in CGT exemption limit	25 more staff

Positive

(ii) Reduced longer-term Revenue staff requirement of about 20 from Budget as a whole.

(iii) Process of reform and simplification reduces staff needs - 175 for Schedule E receipts basis.

Defensive

(i) More staff for Revenue in 1989-90, 1990-91 Yes, but mainly as result of transitional work. Budget package gives reduced requirement in longer-term.

(ii) What about independent taxation - staff intensive: Yes, new work inevitable when large number of married women become taxpayers in own right, but short term Budget increases will not affect preparatory work to be carried out in 1989-90.

Contact points: J Boyce (Inland Revenue) 438 (GTN 3541) 7155

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JJ1 EUROPEAN COMMUNITY (EC) TAX PROPOSALS

Other relevant briefs: G1 Excise Duties
G2 VAT: main points
HH1 International tax reforms and comparisons

A. INDIRECT TAXES

Factual

(i) Commission White Paper, published June 1985, proposed "approximation" of indirect tax rates in EC as part of plan to achieve completion of single market by 1992.

(ii) Tax proposals remitted by Milan European Council (June 1985) to Council of Economic and Finance Ministers (ECOFIN) for consideration. Following report by officials, ECOFIN asked Commission to produce detailed proposals by 1 April 1987. Commission finally agreed detailed proposals July 1987, presented to ECOFIN, 16 November 1987.

(iii) Commission propose

- VAT standard rate band of 14 to 20 per cent, including young children's clothing and footwear (now zero-rated in UK);

- VAT reduced rate band of 4 to 9 per cent, covering foodstuffs; domestic heating and lighting; water; pharmaceuticals; books, newspapers and periodicals; passenger transport (all covered by UK zero rate);

- ending of VAT zero-rating of exports from one member state to another. Clearing house to be set up to redistribute VAT revenues from where they are collected so that they accrue - as at present - to the country where products are consumed.

- rates of major excise duties (alcoholic drinks; tobacco products; hydrocarbon oils) to be harmonised (see brief G1).

(iv) Derogations: Commission recognised sensitivity of certain issues, eg VAT zero-rates for some member states and has expressed a willingness to agree to them, but no derogations included in proposals.

(v) Unanimity requirement: Under Article 17 of Single European Act all tax measures require unanimous agreement.

(vi) Timetable of discussions: At informal ECOFIN in May 1988, Chancellor said he had objections of principle to the Commission's proposals and promised to prepare paper setting out alternative approach to completion of single market without need for centrally-imposed tax approximation. Paper presented and discussed at ECOFIN in September. Main features:

- progressive reduction of (and ultimate removal of) fiscal frontier controls;

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- easing of restrictions on cross-border shopping by increasing duty-paid allowances (except alcohol and tobacco where relaxation limited on health grounds); and

- no centrally-determined approximation of indirect tax rates.

Both UK and Commission approaches remain on table. Commission agreed to reconsider its proposals in light of comments made at meeting and held bilateral meetings with Member States late last year. In report to ECOFIN in December, Lord Cockfield hinted at possibility for greater flexibility but said this was for Member States to decide. Procedural issues currently being considered by Committee of Permanent Representative (COREPER).

(vii) <u>Election Commitments</u> (see brief G2): During 1987 general election campaign, Prime Minister pledged Government would not impose VAT on food, fuel and power or young children's clothing and shoes; nor could UK accept EC proposals which restricted right to apply VAT zero rates. Chancellor in written reply reporting on November 1987 ECOFIN, "I made it clear that the United Kingdom would not permit to come into force any proposals that in any way conflicted with pledges Her Majesty's Government has given concerning the United Kingdom's zero rates of VAT" (OR 20 November 1987 vol 122 no 48 col 704).

(viii) <u>Revenue</u>: if Commission package adopted as drafted (with 4 per cent VAT on items in reduced rate, 15 per cent on rest) revenue from VAT would increase by about £3 billion in full year. (Excise proposals would produce offsetting loss to revenue of about £2.5 billion).

(ix) <u>Charities</u> Oxfam launched major campaign against EC Commission's proposals which would lead to VAT being charged on donated goods sold in charity shops. Other organisations starting to show concern.

<u>Positive</u>

(i) <u>Tax approximation</u>: UK determined to make real progress towards removing fiscal frontiers by 1993; believes benefits can be achieved without centrally-imposed approximation. Chancellor's paper outlined alternative market-based approach: avoids major difficulties associated with Commission's proposals - Member States remain free to set own tax rates, including zero rates, without need for complex and fraud-prone clearing house system.

(ii) <u>Zero-rate</u>: Cannot be abolished in face of UK opposition. Clear commitments already given.

<u>Defensive</u>

(i) <u>Anything other than Commission proposals inconsistent with Single European Act</u>: No. Treaty requires harmonisation only to 'extent necessary' to complete single market. UK believes Commission's bureaucratic proposals unnecessary.

(ii) <u>Loss of Sovereignty</u>: Position perfectly clear - will reject proposals restricting UK's ability to use zero rating.

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(iii) Use of 'veto': No question of 'veto'. Proposals require unanimity and are unacceptable as drafted, not just to UK but to most Member States.

(iv) Derogations: Too early to say how discussions will go; but commitments quite clear.

(v) If do not agree to approximation, other Member States could act to exclude UK from benefits of internal market: Agreement on EC tax proposals has to be unanimous, so not clear how proposals could come into force if one or more Member States against them. UK's commitment to single market not in doubt, but will be achieved through reasoned discussion not through imposed solutions or threats of exclusion.

(vi) If UK given derogations, would not benefit fully from single market: Discussions between Member States at early stage - wrong to anticipate outcome. UK committed to single market, but how this best achieved is matter for discussion between Member States.

(vii) EC likely to impose tax harmonisation proposals through European Court of Justice: No. Infraction cases concern interpretation of Directives already agreed by all Member States. Tax approximation requires new law which cannot be adopted without agreement of all, including UK. And Single European Act declaration (on Article 8A - which defines 'single market') makes clear that 1992 is political not legal commitment.

(viii) EC likely to impose VAT on donated goods sold retail in charity shops: No. Although no specific commitment made, UK will not accept EC proposals which restrict right to apply zero rate. Agreement on EC tax proposals must be unanimous.

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DIRECT TAXES

B. PROPOSAL FOR WITHHOLDING TAX ON INTEREST PAYMENTS

Factual

(i) Council Directive on liberalisation of capital movements requires Commission to submit proposals to eliminate or reduce risks of distortion, tax avoidance and tax evasion linked to national systems for the taxation of savings. Council required to take position on proposals by 30 June 1989.

(ii) Commission has proposed tax at minimum rate of 15 per cent to be withheld from payments of interest by Community residents.

(iii) Commission proposals allow for optional exemptions eg where interest received constitutes "commercial and industrial" income of recipient.

(iv) Application of bilateral double taxation treaties may provide for lower rate of withholding tax.

(v) Tax to be refunded if recipient's marginal tax rate in state of residence is less than 15 per cent.

(vi) Tax paid to individuals "home" state irrespective of where interest generated.

Positive

UK views proposals as:

(i) Damaging - Capital could be driven outside Community, including exempt capital because investors will not comply with administrative burden of establishing exemption.

(ii) Unnecessary - No evidence that removing exchange controls increases evasion. In any event evaders would simply go to third countries.

(iii) Ineffective - Will create greatly increased administrative burden on tax administrations and payers of interest with no increase in tax yield.

Defensive

(i) Why not seek more acceptable proposal? UK agreed on without prejudice basis to take part in high level discussions to clarify technical details of proposal.

(ii) What is link between capital liberalisation and introduction of withholding tax? There is no link between obligations to liberalise capital movements and the adoption of any tax measures.

(iii) Will UK be outvoted? No. The Council has to act unanimously in introducing any tax measures.

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(iv) <u>Is UK alone in opposing proposal</u>? No. Several other member States have fundamental objections and, like UK, are participating in high level discussions on a "without prejudice" basis.

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C. TAX RULES FOR EUROPEAN INTEREST GROUPING (EEIG)

Factual

(i) EEIG new form of undertaking to encourage cooperation across frontiers within European Community.

(ii) Intended to facilitate common, non-profit making support activities (for example research or marketing) between businesses in different Member States.

(iii) European Council Regulation creating EEIG adopted 25 July 1985 takes effect 1 July 1989.

(iv) Company Law rules will be effective from 1 July 1989 and are embodied in Secondary Legislation (DTI responsibility) now expected to be published March 1989.

(v) Tax rules will also be effective from 1 July 1989 but not enacted until 1990.

Positive

(i) Underlying principle of taxation of EEIG already clear from EC Regulation. EEIG will be fiscally transparent. Any profits will be taxable and losses will be allowable only at level of its members.

(ii) Detailed tax rules to ensure fiscal transparency for EEIGs and provide consistency with existing tax rules for companies, partnerships and individuals will be discussed with interested parties before enactment in 1990.

Defensive

(iii) Why tax rules not in place by 1 July 1989? EEIG cannot exist before 1 July 1989. First year trading cannot end until 30 June 1990 at earliest.

(iv) Why not consult interested parties before? Tax rules could not be made before company law rules in place. Consultative period between publication of company law rules and publication of detailed tax rules will be helpful to prospective users of EEIGs.

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D. OTHER DIRECT TAX PROPOSALS

Factual

(i) Commission White Paper on approximation of indirect tax rates (June 1985) promised White Paper on harmonisation of direct taxes. This has never been published. Instead Commission has concentrated on individual measures of harmonisation.

(ii) Current measures comprise:

(a) Three proposals on tax measures for promoting co-operation between undertakings from different Member States ("mergers", "parent companies/subsidiaries", "arbitration procedure").

(b) Proposal for strengthening the Mutual Assistance Directive.

(c) "Preliminary Draft Proposal" on Harmonisation of Rules for determining taxable profits of undertakings.

(iii) None of these proposals is ready for adoption.

(iv) Details

(a) (1) Mergers. First submitted 1969. Has been discussed on many occasions in Council Working Parties and COREPER. Its objective is to remove tax obstacles (esp. capital gains tax) on mergers etc of companies across Community borders.

(2) Parent companies/subsidiaries. First submitted 1969. Has also been discussed on many occasions in Council Working parties and COREPER. Its objective is to harmonise tax rules for dividends paid from subsidiary company in one Member State to parent company in another.

(3) Arbitration Procedure. First submitted 1976 as directive. Has also been discussed (as a convention) on many occasions as 1 and 2 above. Its objective is to ensure that transfer pricing adjustments affecting profits of associated undertakings in different Member States would not result in double taxation.

(b) Mutual Assistance Directive. Adopted in 1977, extended to VAT 1979. Provides for exchanges of information on tax matters between Member States.

New Proposal (1989) to strengthen powers to obtain information linked with capital liberalisation and current proposal on withholding tax on savings. Discussions continuing in Council Working Party.

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(c) <u>Harmonisation of rules</u> for determining taxable profits of undertakings. Preliminary proposal produced in March 1988 as partial substitute for lack of promised White Paper. Commission are reconsidering following discussion with Member States.

<u>**Positive**</u>

(a) <u>Mergers etc</u>. Some technical points needing resolution are being discussed in Working Party. UK broadly in favour subject to satisfactory resolution of these points.

(b) <u>Mutual Assistance Directive</u>. Under active consideration at Working Party level.

(c) <u>Harmonisation of Corporation Tax Rules</u>. Commission are to produce some revised proposals.

<u>**Defensive**</u>

(a) <u>Mergers etc</u>. Will have only marginal effect on UK companies which have displayed little interest. Other Member States (notably Germany) have problems.

(b) <u>Mutual Assistance Directive</u>. UK considers unnecessary and not consequent upon capital liberalisation. There are also resource problems.

(c) <u>Harmonisation of CT rules</u>. Case for harmonisation has not been made out. Such convergence as is necessary will come through operation of market forces.

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JJ2 CHARITIES

Other relevant briefs: G2 VAT: Main popints
GG3 VAT on non-domestic construction etc

Brief contains A. Payroll giving - increase in relief
B. Covenanted membership subscription
C. VAT and charities - effect of ECJ judgement - minor measures.
D. Car tax relief for vehicles leased to disabled

A. PAYROLL GIVING

Inland Revenue issuing Press Release on Budget Day

Factual

(i) - Payroll giving scheme announced in 1986 Budget, started 6 April 1987.

- Employees get tax relief on gifts to charity deducted from pay.

- Original limit £100 a year (Finance Act 1986). Increased to £120 in 1987 Budget; £240 in 1988 Budget.

(ii) From 1989-90 tax relief limit doubled from £240 a year to £480 a year (£40 a month).

(iii) Cost of increase depends on take-up but likely to be very small at outset and build up overtime.

(iv) So far 16 agencies running schemes. Over [3,400] employers' schemes with 100,000 individual participants.

(v) Facility available to over 400,000 Civil servants.

Positive

(i) Increase in limit doubles present limit on donations; allows £40 a month or £8 a week.

(ii) Enables higher paid employees to give substantially more. CAF (Charities Aid Foundation) say 17 per cent of new participants in their schemes are giving maximum amount.

(iii) Shows Government fully committed to success of scheme.

(iv) Covenanted giving increased by nearly [60] per cent and bequests to charity by [140] per cent from [1978] to [1985].

(v) Following proposal at seminar last Summer (attended by Chancellor and Home Secretary) Payroll Giving Association has been set up. Will promote payroll giving drawing on experience of agencies, employers, charities and donors.

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<u>Defensive</u>

(i) <u>Increase of £240 too low</u>: For most people £240 generous. But increase allows those at limit to give more.

(ii) <u>Government should do more to promote schemes</u>: For charities to encourage donors to join up (see also (vi) above).

(iii) <u>Are Ministers participating in payroll giving</u>. Ask them.

(iv) <u>Should have relief for one-off gifts to charities</u>. No evidence that need encourage spontaneous giving - good public record on e.g. famine relief appeals. Existing reliefs encourage long-term commitment which benefits charities in planning programmes etc.

(v) <u>Extend scheme to self employed</u>: Administration costs kept down by making use of PAYE machinery. This does not cover self-employed. Extension in effect similar to one-off gifts - see (iv) above.

<u>Contact point</u>: E Fletcher (Inland Revenue) 438 (GTN 3541) 7784

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B COVENANTED MEMBERSHIP SUBSCRIPTION

Inland Revenue issuing Press Release on Budget Day

Factual

(i) At present person making convenanted gift to charity deducts basic rate income tax and charity can claim refund of tax; but where convenanted payment is membership subscription given in return for benefit provided by charity, tax repayment refused, unless available benefit is less than 25 per cent of subscription.

(ii) There have been some problems in applying the rule where members are allowed free entry to view charity property, and this benefit could be worth more than 25 per cent of subscription. Legal advice now shows relief should be withdrawn in these circumstances.

(iii) Proposal allows charities whose membership is open to general public and whose sole or main purpose is preservation of property or conservation of wild life for public benefit to ignore benefit of free entry to members (and family members) to view property when claiming tax refunds on convenanted subscriptions.

(iv) Applies to convenant payments due on or after Budget Day.

Positive

(i) Clears up the current problems with cases where free entry is allowed to members.

(ii) Allows heritage and conservation charities to offer members free or cheap entry to view charity property or collections without loss of charity tax relief.

Defensive

(i) Other types of charity with convenanting members should be allowed to offer them benefits without losing tax relief (eg arts charities giving discounts on concert tickets)? Distinction between discounts on tickets for performances, which are more valuable and tangible, and free entry to view a historic house or museum which charity is aiming to preserve permanently for public benefit.

(ii) Other benefits (eg free literature) should also be ignored. No. These will be considered under existing law. No reason why they should get special tax relief. Practice of allowing benefit up to 25 per cent already allows relatively modest benefits to be ignored.

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C VAT RELIEFS FOR CHARITIES

Customs and Excise issuing Press Notice on Budget Day

Other relevant briefs: G2 VAT - main points
GG3 VAT on non-domestic construction etc

Factual

(i) Measures in 1989 Budget

(a) VAT zero rate extended to

- autoclaves (large sterilising machines used in medical laboratories) and other sterilising equipment used in medical research, diagnosis or treatment by medical research charities and certain other non-profit-making bodies; and

- advertisements placed by charity for educational or fund-raising purposes in single issue brochures, programmes and leaflets, on posters or in classified sections of newspaper, journals or periodicals. (Non-classified advertising in newspapers and periodicals already zero-rated.)

(b) VAT exemption extended to

- fund-raising events by charities and certain other non-profit making organisations eg political parties, trades unions.

(ii) Effective date: 1 April 1989.

(iii) Revenue Costs: Total costs of package unlikely to exceed £5 million in 1989-90 and 1990-91. Most of cost relates to fund-raising exemption.

(iv) European Court of Justice judgement on VAT zero rates (see GG3)

- In written answer to PQ on 6 February, Economic Secretary said "[in implementing the judgement] we have had particular regard to the potential impact on charities. I regret they cannot be wholly shielded because many of them have activities which constitute "business" for VAT purposes and therefore come within the ambit of the judgement. But we have done as much as we can to safeguard their position" (OR 6 February vol.146 no.45 col.548-50)

- Effects of judgement on charities:

  retain zero rating of eg fuel and power, new construction, supplied for non-business purposes;

  landlords not allowed to opt to tax rent from charities' non-business buildings other than offices;

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tax on charities' rents, where landlords do opt to tax, phased in over 5 years (2 years for other tenants).

(v) Representations: (items underlined are contained in Budget package)

- Charities VAT and Tax Reform Group (CVTRG) again submitted 'shopping list' of points of concern/additional reliefs. In particular, asked for

  continued zero rating of new construction for non-business purposes;

  right of veto over landlord's option to tax rents;

  commitment to retain zero rating in context of EC Commission's tax approximation proposals;

  VAT exemption for fund-raising events;

  relief for certain building alterations;

  extension of relief for advertising;

  relief for all equipment used in medical research, especially autoclaves;

  relief for wireless for the bedridden.

- Oxfam launched major campaign against EC Commission's tax approximation proposals which would lead to VAT being charged on donated goods sold retail in charity shops.

Positive

(i) Exemption of fund-raising events is worthwhile extension of VAT reliefs for charities. Of benefit to wide range of major charities.

(ii) Changes meet three of CVTRG's longstanding requests.

(iii) Charities' non-business activities largely shielded from effects of ECJ judgement.

(iv) Present Government has substantially extended VAT reliefs for charities since 1979 (eg welfare vehicles for transporting handicapped in 1984; medicinal products for charities caring for people or animals in 1986).

Defensive

(i) No general relief from VAT for charities. Carefully and sympathetically considered by Government on many occasions but

- would benefit most charities which spend most, regardless of purpose of expenditure. Government have preferred to

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concentrate resources available on direct tax incentives to charitable giving (eg Payroll Giving Scheme) which reflect charities' popular support;

- contrary to Sixth VAT Directive. No other EC country gives general relief from VAT to charities;

- expensive both in terms of revenue (over £100 million) and administration.

(ii) Extend VAT zero-rating to other goods and services currently standard-rated (eg. building alterations for social welfare charities). Sixth VAT Directive only allows marginal adjustments to existing zero-rates.

(iii) No relief for hospital broadcasting equipment/wireless for bedridden. Present relief confined to talking books/newspapers/wireless sets/recording equipment for blind - by analogy with zero rating for books and newspapers for sighted. Hospital patients/bedridden not cut off in same way from these sources of information/entertainment. Difficult to draw borderlines for relief between worthy causes; will always have hard cases which fall wrong side of the line.

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D CAR TAX RELIEF FOR VEHICLES LEASED TO DISABLED

Customs and Excise issuing Press Notice on Budget Day.

Other relevant briefs: G2 VAT - main points.

Factual

(i) Existing arrangements: Cars leased to disabled are relieved of VAT, but bear car tax, where

- car is leased for no less than 3 years;
- disabled person received mobility allowance or mobility supplement; and
- lessor's business consists mainly of providing cars to disabled.

(ii) Revised arrangements: Vehicles relieved of VAT to be relieved of car tax too.

(iii) Effective date: 1 April 1989.

(iv) Revenue cost: £10 million in 1989-90 and £10 million in 1990-91.

(v) Practical effect: Traders registered for car tax, will not charge lessor car tax when conditions of relief fulfilled. Should reduce initial charge to disabled when leasing car.

(vi) Other existing reliefs:

- cars adapted for carriage of disabled in wheelchair are relieved of VAT and car tax;
- cars used exclusively by disabled person receiving mobility allowance or mobility supplement are exempt from vehicle excise duty.

Positive

(i) Reduced financial burden on disabled who cannot use public transport. Up to 30,000 a year may eventually benefit.

(ii) Reduced costs makes leasing car more accessible to disabled.

(iii) Useful addition to package of reliefs introduced over several years.

Defensive

(i) Bring into effect immediately. Time needed for consultation. Trade distortions of delay minimal in context of overall car sales.

(ii) Relax 3 year minimum lease requirements: No. Shorter period would allow cars to enter, and compete with, tax paid market too soon.

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(iii) Relieve cars bought by/for disabled. Impractical. Relieved cars could not be controlled once bought. Could be resold and compete unfairly with tax-paid market.

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ANNEX

OTHER MEASURES IMPLEMENTED BY THE GOVERNMENT TO HELP CHARITIES.

(i) Reduced the period of charitable convenants qualifying for tax relief from "over 6" to "over 3" years; (1980).

(ii) Introduced higher rate income tax relief for charitable convenants with a £3,000 limit (1980); increased the qualifying limit to £5,000 (1983); and to £10,000 (1985); and abolished the limit completely in 1986.

(iii) Raised the capital transfer tax exemption limit for gifts to charities on or within one year of death from £100,000 to £200,000 (1980) and then to £250,000 (1982) before abolishing the limit completely in 1983;

(iv) Provided reduced rate relief, a complete exemption from stamp duty for all transfers to charities, whether by sale or gift (1982).

(v) Given tax relief for employee costs met by a company during a period of secondment to a charity (1983), and extended that to all employers (1984)

(vi) Introduced relief for single donations by non-close companies (1986).

(vii) Extended the range of specialised goods and services eligible for VAT relief when acquired by charities (eg medicinal products (1986) welfare vehicles for disabled (1984)).

(viii) The 1988 Local Government Finance Act also provides for charities to be relieved of at minimum 80 per cent of their business rates due.

(ix) It is estimated that the total amount of tax repaid to charities in respect of income from which tax has been deducted increased £150 million in 1978-79 to some £400 million in 1987-88; this was itself an increase of £60 million compared with 1986-87.

(x) The Government provides substantial support in grants as well as in tax relief. The total level of grants increased by over 90 per cent in real terms between 1979-80 and 1986-87 when it stood at £1,173 million.

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JJ3 PERSONAL RESIDENCE

Factual

(i) Consultative document issued in July 1988 suggested:

(a) introducing new rules for determining individual residence for tax purposes in UK;

(b) bringing taxation of foreign domiciled residents (broadly, those with roots abroad) more into line with that of UK domiciled residents; and

(c) introducing measures to counter various avoidance devices in residence field (eg avoiding CGT by short absence abroad).

(ii) Present residence rules can be complex and uneven in impact; lack firm statutory basis. Document suggested moving to objective test based on counting days of presence in UK.

(iii) Foreign domiciled residents currently enjoy favourable tax regime since their foreign income only taxable to extent that remitted here. Even this limited basis easy to avoid. Document suggested either taxing worldwide income (with special provisions for short term residents) or strengthening present remittance basis.

(iv) Over 200 responses received. No clear consensus. Measure of support for simplifying residence rules; and some recognition of weaknesses in remittance basis. But considerable concern about worldwide income approach (particularly from Greek and associated shipping interests). Argued that taxing worldwide income would deter foreigners from coming to UK and drive others out, with consequent loss of economic activity here.

(v) No mention of review in Budget Statement. (Confidential until after Financial Secretary's speech in Budget debate: Financial Secretary will announce no action in 1989; further consideration being given to issues; but worldwide income approach for non-UK domiciled foreigners ruled out).

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For use before the Financial Secretary's's Budget debate speech

(i) Does no announcement in Budget Statement mean no legislation in 1989? No legislation planned for 1989. Ministers may refer to this matter during Budget debates.

For use after the Financial Secretary's Budget debate speech

Positive

(i) Decision to drop worldwide income approach meets widespread concern about possible prejudice to UK's position as major international centre.

(ii) Further consideration of issues meets calls not to act precipitately on matter that goes to heart of tax system.

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Defensive

(i) Why delay introducing new residence rules? Cannot consider rules in isolation from possible changes in basis of taxation of residents.

(ii) Why drop worldwide income approach for foreigners? Worldwide income approach only one possibility floated in document. Risk that, despite lower tax rates, would make UK less attractive to international business community. And would mean high compliance burden, relative to yield, for foreign executives in UK for only a few years.

(iii) Why no action in 1989 on avoidance identified in document? Scale and nature of appropriate measures depends on what action taken regarding residence rules and basis of taxation. Will not hesitate to introduce specific measures if evidence of increasing abuse.

(iv) Should drop action on consultative document completely? Not appropriate. Widely accepted as area worthy of consideration for reform.

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JJ4 DOUBLE TAXATION: TAX CREDITS

Inland Revenue issued Press Notice on 25 October 1988

Factual

(i) Double taxation: tax credits Government announced (25 October 1988- OR Vol 139 no 203 col 129) inclusion of legislation in 1989 Finance Bill to make clear amount of UK tax deductible from UK tax credits to which non-residents may be entitled under a double taxation convention - on aggregate of dividend and tax credit payable, not paid.

(ii) Follows adverse decision of High Court on interpretation of UK/US double taxation convention in Union Texas Petroleum Corporation v Critchley

(ii) Legislation retrospective: but will allow Union Texas to keep fruits of victory.

(iii) Yield: Nil, but large potential loss if action not taken.

Positive

(i) Restores position to what it was intended to be.

Defensive

(i) Why retrospection? To avoid companies seeking repayment of UK tax already paid on basis of what the law was thought to be at the time.

(ii) Overrides UK/US convention Merely restores position to what it was intended and understood by parties to be.

(iii) Discriminates against US residents or companies No. Legislation in general terms. No question of discrimination against US residents. No US company worse off than when treaty signed and ratified.

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JJ6 INTERNATIONAL TAX REFORM AND COMPARISONS

Brief contains: A International tax reform
B International tax comparisons

A. INTERNATIONAL TAX REFORM

Factual

1. GENERAL

(i) - Many developed countries implementing or planning reform.

- Generally following UK lead in reducing rates of direct tax (especially top rates), reducing the number of tax rates and broadening tax base by removing or reducing tax reliefs and shelters which distort decisions.

(ii) Top rates of income tax already reduced or proposed to be reduced including, where appropriate, state/local income tax at typical rates.

	Top rate in 1979 (per cent)	Present top rate (per cent)	Proposed top rate (per cent)
UK	98 (1)	40	
Australia	61	49	
Belgium	76.3	76.8	59.4
Canada (eg Ontario)	62	44	
France	60	56.8	
Germany	56	56	53 (wef 1.1.90)
Ireland	60	58	56
Italy	77.4 (2)	68.1 (2)	58.1 (2)
Japan	93	65	
Luxembourg	57	56	
Netherlands	72	72	60
New Zealand	60	33	
Norway	71	44	
Portugal	80	40	
Spain	66	56	
Sweden	86	75	60
USA (eg California)	76	35 (3)	

(1) including investment income surcharge
(2) lower rate applies for employment income
(3) effective marginal rate 39 per cent for some.

Note: Some countries (eg Japan, New Zealand) following UK lead by switching from direct to indirect taxes.

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2. INDIVIDUAL COUNTRIES

(i) USA

a. Comprehensive Tax Reform Act passed 1986.

b. Overall revenue neutral; but switch in burden from individuals (down 6.1 per cent on average) to companies.

c. 15 rate bands for individuals reduced to 2 in 1988 (15 per cent and 28 per cent). But effective marginal rate of 33 per cent for some. Additional state taxes increase rate eg California combined top rate 35 per cent (39 per cent in effective 33 per cent Federal tax band).

d. Corporation tax rates reduced. From 1 July 1987 5 rate bands reduced to 3, with top rate down from 46 to 34 per cent.

e. Capital gains treated as ordinary income for both companies and individuals. Tax on a net capital gain for individuals guaranteed by law not to exceed 28 per cent.

f. Many reliefs removed or reduced: investment credits abolished; deductions for interest, state sales taxes, medical expenses and individual retirement accounts reduced.

g. But remaining reliefs still extensive compared with UK: no action on pensions: mortgage interest relief available without limit on two houses.

h. Complex minimum taxes on both individuals and companies tightened up.

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(ii) Canada

a. Reforms effective from July 1988.

b. Income tax for individuals: 10 rate bands reduced to 3 with top rate of 29 per cent (higher effective top rate when provincial tax added - eg 44 per cent effective top rate in Ontario). Minimum tax introduced and many personal exemptions and deductions converted to tax credits.

c. Corporation tax: main rate reduced to 28 per cent plus provincial tax eg Ontario 15 per cent. Depreciation allowances reduced and many shelters eliminated.

d. Capital gains: Portion of capital gains which is subject to tax increased from one half to three-quarters by 1990.

e. Sales tax increased. Further reforms will replace existing federal sales tax with a broad-based multi-stage sales tax similar to VAT.

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(iii) Japan

a. Further reforms enacted 1988 to take effect from 1 April 1989.

b. Income tax for individuals: top national rate reduced to 50 per cent, 12 rate bands reduced to 5. Top rate inhabitants tax down to 15 per cent.

c. Corporate tax: rate reduced to 40 per cent (37.5 per cent in 1990). Reduced rate on income distributed as divided to be phased out by 1990.

d. Indirect tax system reformed. Ad valorem duty on liquor replaced by a tax based on volume. Commodity tax rate on cars, previously up to 23 per cent of the shipping price, will be replaced by a 3 per cent (6 per cent until March 1992) consumption tax on the retail price of cars.

(iv) Australia

a. Reforms introduced in 1986 became effective 1987.

b. Income tax for individuals: rates reduced, with top rate down to 49 per cent and 6 rate bands reduced to 5. Further reductions promised.

c. Tax base broadened by abolition of some personal rebates and of deductions for entertainment expenses. New fringe benefit tax imposed on employers.

d. Capital gains taxed at income rates.

e. Corporation tax: imputation system introduced removing double taxation of dividends.

(v) New Zealand

a. Reforms effective from October 1988.

b. Income tax for individuals: 5 rate bands reduced to 2 with 33 per cent top rate, 24 per cent lower rate from 1 April 1989. Many reliefs abolished eg house purchase, life assurance premiums. Deductions for most employment-related expenses abolished.

c. Corporation tax: rate reduced from 48 to 28 per cent. Partial imputation system introduced.

(vi) Federal Republic of Germany

a. Reforms to take effect from 1 January 1990.

b. Income tax for individuals: top rate reduced from 56 to 53 per cent, lowest rate down from 22 to 19 per cent. Lower

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maximum tax rate threshold. Increased allowance for dependent children.

c. Corporation tax: rate to be reduced from 56 to 50 per cent. Radical reform of corporate and business tax system promised after elections in 1990.

d. Overall direct taxes being reduced; only partly offset by indirect tax increases.

e. Withholding tax on interest: effective 1 January 1989, 10 per cent tax on interest from bonds and debt instruments and from deposits with resident banks and savings institutions.

(vii) France

a. Income tax for individuals: top rate reduced to 56.8 per cent in 1986.

b. Widespread VAT reductions.

c. New wealth tax introduced which taxes earnings and savings over 4 million francs (£318,000) at rates ranging from 0.5 to 1.1 per cent

d. Further reforms promised aimed at simplification of the tax system and harmonization within EC.

(viii) Ireland

a. Major reforms of tax collection and enforcement introduced.

b. Income tax for individuals: standard rate tax band of 35 per cent widened and reduction proposed to 32 per cent.

c. Corporation tax: rate to be reduced from 47 per cent to 43 per cent.

d. Government committed to further reforms aimed at broadening the tax base.

Positive

(i) UK top income tax rate lower than most OECD countries. Makes UK more attractive to international businessmen and executives.

(ii) UK started first: 1979 switch from direct to indirect tax; 1984 business tax reform; successive Budgets have reduced rates, removed distorting reliefs.

(iii) US still has more shelters in some areas than UK eg mortgage interest on first and second home without limit.

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Defensive

(i) Comprehensive US type package only effective method of reform: US needed comprehensive reform because so many likely losers if done piecemeal. Major UK achievement in tax reform since 1979. Upheaval of comprehensive package can impose uncertainty and serious learning costs on Government, taxpayer and advisers. Starting from different point in UK. "Root and branch" approach not necessarily best.

(ii) UK should follow US example of abolishing tax shelters. Significant tax shelters abolished, eg by change in treatment of capital gains, and forestry measure. But UK never had substantial shelters which US reform removed.

- US reform revenue neutral overall. But better approach would be to use tax receipts to reduce budget deficit (as UK did). Also, UK Government long-term objective to reduce overall tax burden.

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B INTERNATIONAL TAX COMPARISONS

Warning

International comparisons can be misleading because:

a. statistics hide different underlying tax systems and economic conditions, and different-sized public sectors, in different countries;

b. countries can be selected to support virtually any argument;

c. OECD statistics used in some tables in this brief not necessarily comparable with classification used in other briefs;

d. latest figures for most countries are 1986 - UK position improved since then.

1. OVERALL BURDEN AND BALANCE OF TAXATION

Factual

(See Tables 1, 2 and 3 at Annex.)

(i) UK burden falling (by 1 per cent in 1987, further fall of ½ per cent expected in 1988); only Norway and Finland had greater fall in 1987.

(ii) Total UK burden of tax and social security contributions as percentage of GDP (Table 1)

- just below EC average;
- comparable with West Germany;
- well below Denmark, France and Netherlands; but much higher than US and Japan.

(iii) UK direct taxes as percentage of GDP (Table 2)

- higher than US, Japan and France; but below Germany and EC average and close to OECD average.

(iv) UK indirect taxes as percentage of GDP (Table 2).

- higher than US, Japan and Germany but below EC average and well below France.

(v) UK direct taxes as proportion of total tax in UK (Table 3)

- just below EC average.
- well below Germany, Japan and US.

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(vi) On make-up of total burden (table 3)

- UK taxes on personal incomes slightly above EC unweighted average. Employees' SSCs below EC unweighted average.

- UK taxes on corporate income above EC unweighted average, but well below Japan. (NB UK figures distorted by North Sea tax receipts).

- taxes on goods and services just below EC unweighted average but well above US and Japan.

Positive

(i) UK total tax burden falling (from 39 per cent in 1986, to 38 per cent in 1987, and [37.5] per cent in 1988). Fall greater than nearly all other countries [figures not available for many].

(ii) In 1986 UK tax burden less than EC unweighted average and close to OECD unweighted average; significantly lower than France, Netherlands and Denmark. (Table 1).

(iii) Tax burden on industry (tax on corporate income plus employers' SSCs) as proportion of tax lower than most major industrial countries. (Table 3).

(iv) UK's main corporation tax rate (35 per cent) one of lowest of any major industrial country. (The effective US rate is much higher than the national rate of 34 per cent when state tax is added.)

Defensive

(i) UK burdens still too high - much higher than US, Japan. Government objective to lower tax burden when prudent to do so.

(ii) Burden on consumers relatively high: Taxes on goods and services certainly higher than US, Japan. But about average for EC. Government's long-term policy remains to reduce taxes on earnings to give greater freedom of choice.

2. **INCOME TAX AND SOCIAL SECURITY CONTRIBUTIONS**

Factual

(See Tables 4, 5 and 6 at Annex).

(i) UK thresholds

- in middle of range compared with other developed countries;

- single and married thresholds higher than Italy, Denmark and Australia.

- but lower than USA, France, Japan; (Table 4).

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(ii) UK starting tax rate: (25 per cent)

- still higher than all countries in table except Denmark.

- but combined tax/SSC rate nearer average (Table 4).

(iii) UK maximum rate: (40 per cent)

- lower than all countries in table except USA (Table 5);

(iv) At UK £15,000 and £30,000 earnings level: Marginal rate of tax and tax plus SSC at lower end of range of rates (Table 6).

Positive

(i) Basic rate cuts have brought starting rate of tax and marginal rate at average income more into line with US and lower than many overseas competitors.

(ii) UK tax thresholds compare favourably with number of countries (eg Italy, Denmark, Australia).

Defensive

(i) High UK starting rate

- accept still high by international standards

- objective to reduce basic rate to 20 per cent when prudent to do so

- basic rate band very wide (marginal rate for 94 per cent UK taxpayers); low starting rates in other countries usually marginal rate for very few taxpayers

- UK SSC rates about average; combined burden in UK lower than average.

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Table 1

Total taxes and social security contributions as per cent of GDP at market prices.

	1986	1987(1)	Change
Finland	38.4	36.6	-1.8
Norway	49.8	48.3	-1.5
United Kingdom	39.0	38.0	-1.0
Switzerland	32.6	32.0	-0.6
Austria	42.6	42.2	-0.4
Canada	33.2	33.0	-0.2
Irish Republic	40.2	40.1	-0.1
FR Germany	37.5	37.6	+0.1
France	44.2	44.7	+0.5
Denmark	50.6	51.8	+1.2
Netherlands	45.5	47.3	+1.8
Sweden	53.5	55.8	+2.3
Spain	30.4	32.8	+2.4
Australia	31.4	not av	
Italy	36.2	not av	
Japan	28.8	not av	
USA	28.9	not av	
EC unweighted average	40.0	not av	
G7 unweighted average	35.4	not av	
OECD unweighted average	38.1	not av	

(1) Latest available figures.

Source: OECD Revenue Statistics (Tables 1, 109) and OECD Economic Trends January 1989.

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Table 2

Breakdown of taxes and social security contributions as percentage of GDP at market prices, 1986(1)

	UK	France	West Germany	Italy	EC Average(2)	Canada	Japan	US	Australia	Denmark	Netherlands
Taxes on personal Income	10.9	5.7	10.7	n/a	11.2	12.5	7.2	10.2	14.6	24.2	9.3
Employees' social security contributions (incl self employed)	3.4	6.7	6.7	3.5	5.2	1.7	3.6	3.6	0.0	0.9	11.4
Corporate Taxes(3)	4.0	2.3	2.2	n/a	3.0	2.7	6.0	2.0	2.8	3.1	3.3
Wealth and Inheritance Taxes	0.3	0.4	0.5	0.1	0.5	0.3	0.4	0.2	0.1	0.5	0.4
Total direct	18.6	15.1	20.1	n/a	19.9	17.2	17.2	16.0	17.5	28.7	24.4
Employers' social security contributions and pay-roll taxes	3.6	13.0	7.2	9.1	6.7	2.9	5.0	5.0	1.8	0.8	7.8
Goods and services	12.1	13.0	9.5	8.9	13.0	9.8	3.8	5.1	9.6	17.9	11.8
Other Indirect Taxes (incl rates and stamp duties)	4.8	2.8	0.6	0.8	1.6	3.3	2.8	2.7	2.5	1.9	1.3
Total Indirect	20.5	28.8	17.3	18.8	21.3	16.0	11.6	12.8	13.9	20.6	20.9

(1) Latest year for which International comparisons available.
(2) Unweighted average excluding Italy and Portugal for which disaggregated figures are not available for 1986
(3) Including North Sea taxes and ACT.
Source: OECD Revenue Statistics.

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Table 3

Balance of total taxes and social security contributions (SSCs) 1986[1]

	UK	France	West Germany	Italy	EC Average[2]	Canada	Japan	US	Australia	Denmark	Netherlands
Taxes on personal Income	27.9	13.0	28.6	n/a	26.4	37.5	25.1	35.4	46.6	47.8	20.3
Employees' social security contributions (incl self employed)	8.7	15.4	18.1	9.7	12.8	4.9	12.4	12.5	0.0	1.8	25.1
Corporate Taxes[3]	10.3	5.1	6.0	n/a	7.2	8.2	20.7	7.0	9.0	6.2	7.3
Wealth and Inheritance Taxes	0.7	1.4	1.3	0.2	1.2	0.8	1.5	0.8	0.1	1.0	0.9
Total direct	47.6	34.9	54.0	47.9	47.7	51.4	59.7	55.7	55.7	56.8	53.6
Employers' social security contributions and payroll taxes	9.1	29.4	19.1	25.1	16.7	8.7	17.4	17.3	5.9	1.7	17.2
Goods and services	30.9	29.4	25.2	24.6	31.7	29.7	13.4	17.7	30.5	35.4	26.0
Other Indirect Taxes (incl rates and stamp duties)	12.3	6.3	1.7	2.4	3.7	9.5	8.8	9.3	8.0	3.8	2.9
Total Indirect	52.3	65.1	46.0	52.1	52.1	47.9	39.6	44.3	44.4	40.9	46.1

(1) Latest year for which International comparisons available.
(2) Unweighted average, excluding Portugal and Italy.
(3) Including North Sea taxes and ACT.

Source: OECD Revenue Statistics

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Table 4[1] **Starting tax rate, combined tax/social security contribution (SSC) rate, and threshold**

Single Person	Tax rate[1] (per cent)	Tax and SSC rate (per cent)	Income Tax Threshold[1]
UK (1988-89)	25	34	£2,605
Australia (1988-89)	24	24	£2,125
Denmark (1988)[2]	51	51	£1,978
France (1989)	19	34	£4,567
FR Germany (1989)	22	40	£1,926
Italy (1988)	22	31	£2,550
Japan (1989)[2] [3]	15	26	£2,938
Netherlands (1989)	14	28	£2,557
USA (1989)[2]	15	23	£2,948
Married without children			
UK	25	34	£4,095
Australia	24	24	£3,567
Denmark[2]	51	51	£3,602
France	14	29	£7,064
FR Germany	22	40	£3,321
Italy	22	31	£3,589
Japan[2] [3]	15	26	£5,840
Netherlands	14	28	£4,730
USA[2]	15	23	£5,318
Married with two children			
UK	25	34	£4,095
Australia	24	24	£3,913
Denmark[2]	51	51	£3,602
France	14	29	£9,905
FR Germany	22	40	£4,805
Italy	22	31	£3,986
Japan[2] [3]	15	26	£9,221
Netherlands	14	28	£4,730
USA[2]	15	23	£7,630

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1. Figures relate to years indicated (latest available), and take account of minimum deductions and other flat-rate reliefs. Thresholds converted using latest estimated purchasing power parities (PPP), which is a better measure than exchange rates which can be volatile. Income of married couple treated as wholly of husband.

2. Includes local income tax at typical rates (for Japan: rates applying in most areas; for Denmark: Copenhagen; for USA: California).

3. Japan: 1989 rates generally used for national income tax (following enactment of tax reform), but 1988 rates for local tax.

Sources: Inland Revenue: estimates based on latest known information.

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Table 5[1] Maximum (marginal) tax rate on employment income and threshold

Single person	Tax rate per cent	Tax and SSC rate per cent	Threshold for maximum tax rate
UK (1988-89)	40	40	£21,905
Australia (1988-89)	49	50	£14,583
Denmark (1988)[2]	68	68	£12,335
France (1989)	57	65	£38,529
FR Germany (1989)	56	56	£33,446
Italy (1988)	62	62	£250,510
Japan[2] [3]	65	66	£68,276
Netherlands (1989)	72	72	£62,966
USA (1989)	37	45	£15,617
Married without children			
UK	40	40	£23,395
Australia	49	50	£14,583
Denmark[2]	68	68	£15,929
France	57	63	£75,214
FR Germany	56	56	£66,486
Italy	62	62	£250,510
Japan[2]	65	66	£70,385
Netherlands	72	72	£64,820
USA[2]	37	37	£31,235
Married with two children			
UK	40	40	£23,395
Australia[4]	49	50	£14,583
Denmark[2]	68	68	£15,929
France	57	63	£75,214
FR Germany	56	56	£67,712
Italy	62	62	£250,510
Japan[2]	65	66	£72,494
Netherlands	72	72	£64,820
USA[2]	37	37	£31,235

Notes

1. Figures relate to years indicated (latest available), and take account of minimum deductions and other flat-rate reliefs. Thresholds converted using latest estimated purchasing power parities (PPP), which is a better measure than exchange rates which can be volatile. Income of married couple treated as wholly of husband.

2. Includes local income tax at typical rates (for Japan: rates applying in most areas; for Denmark: Copenhagen; for USA: California).

3. Japan: 1989 rates generally used for national income tax (following enactment of tax reform), but 1988 rates for local tax.

4. Australia: Medicare levy shown as SSC - Type contribution.

Source:
Inland Revenue: estimates based on latest known information.

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Table 6[1]: Marginal rate of tax, and tax plus SSC, on employment incomes of £15,000 and £30,000

	Income Tax per cent			Tax and SSC per cent		
A. £15,000	Single	Married	Married 2 children	Single	Married	Married 2 children
UK (1988-89)	25	25	25	34	34	34
Australia (1988-89[4]	49	49	49	50	50	50
Denmark (1988)[2]	68	64	64	68	64	64
France (1989)	36	26	17	48	38	29
FR Germany (1989)	44	28	26	56	39	38
Italy (1988)	34	34	34	42	42	42
Japan[2][3]	21	20	20	32	31	31
Netherlands (1989)	41	32	32	66	57	57
USA (1989)[2]	36	19	19	44	30	30
B. £30,000						
UK	40	40	40	40	40	40
Australia[4]	49	49	49	50	50	50
Denmark[2]	68	68	68	68	68	68
France[5]	55	37	37	67	49	49
FR Germany[6]	56	48	48	56	48	48
Italy[5]	41	41	41	41	41	41
Japan[2][3][5]	44	44	34	45	45	35
Netherlands[5]	66	60	60	66	60	60
USA[2][6]	39	36	36	39	36	36

Notes

1. Figures relate to years indicated (latest available), and take account of minimum deductions and other flat-rate reliefs. Thresholds converted using latest estimated purchasing power parities (PPP), which is a better measure than exchange rates which can be volatile. Income of married couple treated as wholly of husband.
2. Includes local income tax at typical rates (for Japan: rates applying in most areas; for Denmark: Copenhagen; for USA: California).
3. Japan: 1989 rates generally used for national income tax (following enactment of tax reform), but 1988 rates for local tax.
4. Australia: Medicare levy shown as SSC - type contribution
5. Maximum tax rate not reached.
6. Maximum tax rate not reached for married taxpayer.

Source: Inland Revenue: estimates based on latest known information

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VAT AND EXCISE DUTIES

Factual

(i) Excise duty and VAT on premium petrol at 1 March 1989. Total tax (duty and VAT) as percentage of retail selling price lower than all countries except Belgium, Germany, Luxembourg and Spain.

(ii) Excise duty and VAT on derv at 1 March 1989. Total tax (duty and VAT) as percentage of retail selling price average for EC.

(iii) Other countries with tax differential in favour of unleaded petrol: Belgium, Denmark, Germany, Greece, Ireland, Luxembourg, Netherlands, Switzerland, Finland, Norway and Sweden. (See Table 8 at Annex).

(iv) Excise duty on beer, wines and spirits at 1 March 1989. Duty on beer, fortified wine and spirits in UK is higher than in all countries except Denmark and Ireland. Only Ireland has a higher duty on table wine.

(v) Excise duty and VAT on cigarettes at 1 March 1989. Duty second highest (after Denmark). Total tax (duty and VAT) on 20 cigarettes in most popular category as percentage of retail selling price about average for EC.

(vi) VAT rates see Table 7

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Positive

(i) Standard rate of VAT in UK lower than most in EC.

(ii) UK (with Ireland and Portugal) has zero rates on wide variety of goods and services.

(iii) UK has higher tax differential (including VAT) in favour of unleaded petrol than all other EC Member States with the exception of Denmark.

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Defensive

(i) UK duties generally higher than rest of EC. Yes, but VAT relatively low.

Contact point: Ms A French (Customs and Excise) 3913 5059.

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Table 7: VAT rates for UK and other EC Countries at 1 March 1989

	Standard per cent	Luxury per cent	Reduced per cent	Coverage of zero-rating as percentage of total consumers' expenditure	Effective VAT rate 1985 (Total tax as percentage of final consumption expenditure)[a]
UK	15	-	-	25 (including a wide variety of goods and services)	10.0
Belgium	19	25,33[b]	1,6,17	Minimal	11.6
Denmark	22	-	-	Minimal	18.1
France	18.6	28	2.1,5.5	Nil	13.8
West Germany	14	-	7	Nil	10.5
Greece	16	36	6	Details not available	n/a
Ireland	25	-	2,5,10	25% (including a wide variety of goods and services)	14.2
Italy	19	38	2,9	Minimal	9.5
Luxembourg	12	-	3,6	Nil	11.2
Netherlands	18.5	-	6	Nil	12.4
Portugal[c]	17,12	30,21	8,6	Variety of goods including food	n/a
Spain	12	33	6	Minimal	n/a

(a) Latest year for which international comparison available.

(b) Higher rate includes 8 per cent luxury tax and applies to restricted selection of goods including jewellery, arms, furs, perfumes and cosmetics.

(c) Lower rates apply in autonomous regions of the Azores and Madeira Archipelagoes.

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Table 8: Tax Differentials in favour of unleaded petrol over 4 star leaded petrol in EC Member States

MEMBER STATES	TAX DIFFERENTIAL (including VAT)	
	pence/GALLONS	pence/LITRES
Denmark	17.54	3.86
UK	14.16	3.12
Germany	12.67	2.79
Netherlands	9.93	2.18
Belgium	8.30	1.83
Luxembourg	7.44	1.64
Greece	4.24	0.93
Ireland	3.72	0.82

Exchange rates as at 16 January 1989

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JJ7 SWAPS

Other relevant brief: FF13 Foreign Exchange Gains & Losses

Inland Revenue issuing Press Notice and Consultative Document on Budget Day.

Factual

(i) Existing Revenue practice allows recurrent swap fees (ie excluding initial arrangement fees) to be deducted for corporation tax. Tax must be deducted from fees unless paid to or by UK bank.

(ii) Consultative document published on Budget Day proposes legislative scheme to replace existing practice. Proposals would remove requirement to deduct tax from swap fees whether payment made to UK bank or otherwise. Would also give relief for initial arrangement fees.

(iii) Pending outcome of consultations, existing concessionary practice extended (from Budget Day) to allow relief for payments made gross to or by UK swaps dealers.

Positive

(i) Proposals in consultative document will

- simplify and codify tax treatment of swaps
- give more freedom to swaps market by removing need for use of banks as intermediaries
- cater for use of swaps by non-corporate taxpayers
- allow relief for initial fees

(ii) Extended concession has immediate effect in removing discrimination between banks and other swaps dealers.

(iii) Both will make London more attractive as centre for financial business.

Defensive

(i) Restrictions proposed in consultative document will not affect ordinary commercial swaps. Necessary to protect Exchequer from artificially contrived swaps.

(ii) Problems about mismatches in tax treatment of capital sums exchanged in currency swaps dealt with in consultative document on foreign exchange gains and losses (see FF13).

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(iii) Relevant to Hammersmith and Fulham? No, because local authorities exempt from tax. Tax system merely provides for proper tax consequences if people invest in swaps; does not encourage use in inappropriate circumstances.

Contact point: A G Nield (IR) 438 (GTN 3541) 6412
or J W Calder (IR) (IR) 438 (GTN 3541) 6206

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