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1989 BUDGET
BRIEF

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1989 BUDGET.
BRIEF

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BUDGET SECRET

COPY NO 1 OF 9

FROM: MRS JUDITH CHAPLIN
9th March 1989

CST
I'd be grateful if you could deal with this in the first instance, as you did last year. I have made a few comments on this draft in a number of places (in addition to comments at paragraphs [illegible]) [illegible]

CHANCELLOR

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Mr Tyrie
Mr Call

DRAFT BACKBENCH BRIEF

I attach a draft of the Budget Brief for Backbenchers. As they already have other briefing giving them the facts, I have tried to concentrate on the main measures with the reasons for the changes and bull points in the hope that the Brief will be useful to them not only for the Budget debates but also for any media discussion or in their constituencies.

2. I have included a small piece on public spending, particularly investment, as the Opposition are bound to argue for more.

3. I have also, therefore, left out a number of items: COBO, the ECJ items apart from those relating to charities, pre-trading expenditure, foreign exchange gains and losses and the Keith tax compliance legislation.

Main headlines

Budget surplus (debt repayment) of £14 billion.

Employee NICs cut in October — worth £3 a week to most

Pensioners' earnings rule abolished

No increase in excise duties on petrol, tobacco or alcohol — but a reduction in the tax on unleaded petrol

More tax relief for share ownership

JC

JUDITH CHAPLIN

A. SUMMARY

The Chancellor reaffirmed the prudent policies that have led to seven years of strong and steady growth:

- the control of inflation remains paramount; that requires a firm monetary policy

(This is not objective)

- ~~overall the total tax and NIC burden is broadly unchanged;~~

backed up by a sound fiscal policy:

- some [£15 4] billion of public sector debt was repaid in 1988-89 and a further repayment of [£12 4] billion is planned for 1988-89 90.
- with supply side reforms — including tax reductions & reforms — to promote enterprise

~~He announced further measures in a continuing programme of tax reform and reduction:~~

The main measures he announced in his Budget were:

Change sequence, as in numbers in red

1. - employee NICs are to be simplified and reduced. Everyone earning just under half average earnings and above will pay £3 a week less in contributions, with most of the benefit going to those below average earnings;

6. - taxation of pensions altered to increase flexibility and choice for employers and employees, while limiting the amount of tax relief available;

5. - taxation of life assurance made more effective and equitable within the industry;

Measures to help pensioners:

3.
- earnings rule abolished;
- enhanced age allowances for over-80s extended to all over 75;
- tax relief on premiums for private health insurance.

Further measures to encourage wider ownership:

4.
- extension and simplification of ~~PEPs~~ Personal Equity Plans (PEPs);
- improvement for employee share ownership schemes;
- encouragement of employee share ownership plans (ESOPs).

Would not be mention this at all op!?

2. The main excise duties are unchanged (but there is a further boost for unleaded petrol); the basic and higher rates of income tax remain at 25 per cent & 40 per cent respectively; tax thresholds are increased in line with inflation.

B. THE ECONOMY: RECORD AND POLICY

THE ECONOMY HAS BEEN TRANSFORMED

The economy has been transformed since 1979 as a result of the success of Conservative policies.

averaged over 3 per cent over the past

the longest period of steady growth since the War.

- Growth has [been sustained for] seven [successive] years [at an average 3¼ per cent]. [GDP is at its highest ever level, having risen by [4½] per cent in 1988.] It is forecast to rise by a further [2½] per cent in 1989-90.

- Inflation has averaged 5 per cent over the past five years. Under Labour the average was 15¼ per cent. It rose to ~~6.8~~ 7.5 per cent ~~at the end of 1988~~ in January and is likely to ~~rise~~ edge up a little further before resuming its downward trend in the second half of this year. It is forecast to fall to 5½ per cent by the end of 1989, and to 4½ per cent by 1990Q2.

- The Government is repaying debt, lifting the burden on future generations. Around [£15] 4 billion will have been repaid in 1988-89, and a further debt repayment of [£13] 4 billion is forecast for 1989-90. ~~equivalent to [£8] billion net of privatisation proceeds, the same as in 1988-89.~~ This will bring the total public sector debt to a lower level as a percentage of national output than it has been at any time since ~~before~~ the first world war.

Must make ex-MPs point. See Budget Speech.

- Unemployment has fallen for 30 months in a row, by over 1.1 million in total - the longest period of falling unemployment since the War. The UK unemployment rate is now below the EC average. More people are in work than ever before.

- Investment is booming, having grown [nearly] twice as fast as consumption over the past seven years. Total investment rose by [12] per cent in 1988, with manufacturing investment up 9¾ per cent. Investment intentions remain strong with further growth forecast for 1989.

Make point abt benefits of lower debt interest

- Industry remains strong. Manufacturing output is at its highest ever level and in the last two years growth has ~~consistently~~ exceeded 5 per cent. UK manufacturing productivity growth in the 1980s has been higher than all other major industrial countries and whole economy productivity growth has been second only to Japan's. Company profitability is the highest for 20 years.

- Exports. In the second half of 1988 the volume of exports of manufactures was 5 per cent higher than a year earlier, and is forecast to rise by 7 per cent in 1989, close to the projected growth of world trade.

- Imports rose faster than exports, by 13 per cent in 1988 reflecting the strength of domestic demand. Imports of capital and intermediate goods rose fastest, and this is expected to continue in 1989 although the slowdown in overall domestic demand means that total import growth will slow significantly.

- Living standards have risen at all income levels. A married man, with two children, on average earnings is over £45 a week better off in real terms now than in 1978-79 (up over 29 per cent). Under Labour real take-home pay rose by £1.

ECONOMIC POLICY

The Budget reaffirms the Government's sound financial policies of bearing down on inflation, controlling public spending and bringing the public sector into balance. It continues the process of tax reform and introduces further measures to remove distortions and regulations to improve the working of free markets.

Monetary policy which operates through the level of short-term interest rates remains, as it has always been, the key to controlling inflation. As inflationary pressures have re-emerged in the economy the Chancellor has raised short-term interest rates and, as he has made clear "Interest rates will stay as high as is needed for as long as is needed to get on top of inflation".

Well targeted policy. Because, for the first time ever, households are now net borrowers, higher interest rates will have their main effect precisely where they are needed - on consumer spending. They will not be popular with home owners but a return to rampant inflation would be far worse. There are already clear signs that the heat has gone out of the housing market and that retail spending is slowing.

Higher interest rates will also encourage savings - a more appropriate way of so doing than greater tax incentives. The personal savings ratio has fallen not because gross saving has fallen, but because personal borrowing has increased and raising the cost of borrowing and the return on saving will reverse the trend.

Business and interest rates. Interest rates will have their principal effect on consumer spending, not corporate spending. In contrast to the early 1980s when many British companies had high levels of debt relative to their equity value firms have reduced their reliance on borrowing. British companies' UK bank borrowing has fallen from 45 per cent of the market value of their equity in 1980 to 28 per cent at the end of 1987. Furthermore with profits at their highest level since 1969 many firms have retained profits available with which to finance expansion. They are therefore less sensitive to interest rate rises than they were. Furthermore, with the reduction in Government borrowing, the scope for industry to borrow long term is increased.

Investment. Business expansion is continuing. Private investment last year was at an all time record as a proportion of national output. Manufacturing investment is reckoned to have risen by some 9¾ per cent last year. Total investment in the UK is estimated to be up by at least 12 per cent in 1988, almost twice as fast as consumption.

Public sector investment. The Labour Party will urge additional spending on public investment. They choose to ignore the record of private investment and consider only public sector spending. Even there their record compares poorly.

Public sector capital spending is now running at around £25 billion a year. An additional £2¾ billion in 1989-90 will mean that total capital spending will be higher in real terms than in 1978-79, despite a deliberate policy of reducing the state's role in providing new housing. Under Labour capital spending fell 23 per cent in real terms.

Public spending. A key element of the Government's sound financial management is the control of public spending. Since 1982-83 public spending, expressed as a share of national income, has fallen by 7 percentage points - the largest and longest sustained fall since the war-time economy was unwound. It is now under 40 per cent of national income - the first time this has happened for over 20 years.

The Opposition will urge additional indiscriminate spending in order to improve the "supply side" of the economy. Within a tightly controlled overall sum, Government spending has been targeted to do precisely that with, for example, reductions in industrial subsidies and the restructuring of regional policy, and increases in infrastructure spending, education and training and the science budget. (For details of public expenditure see CRD brief on Public Expenditure White Paper 9th February 1989.)

Balance of Payments. The combination of high levels of investment and high consumer spending financed by borrowing has led to a current account deficit which is estimated to have been £14½ billion last year and is forecast to be the same level in the coming year. The current account deficit reflects an excess of domestic investment, which has risen sharply, over domestic saving, which has remained broadly unchanged, with capital inflows from the rest of the world filling the gap.

Capital inflows are financing high investment spending by the private sector which will add to productive capacity, thus boosting exports and displacing imports in the future. Meanwhile the deficit is readily financeable due to the recognition of the strength of the economy, the high level of UK net overseas assets and reserves at record levels.

<u>Public Sector Finances</u>. Unlike the 1960s and 1970s, the present current account deficit is not the counterpart of excessive government borrowing and spending. When the Government came to office in 1979 the public sector borrowing requirement (PSBR) was over 5 per cent of GDP, equivalent to some £25 billion in today's terms.

Government borrowing has been steadily reduced until in 1987-88 the PSBR was eliminated and the Government started to repay debt.

Last year the Public Sector Debt Repayment (PSDR) is likely to have been [£15] billion or [3] per cent of GDP. Even without privatisation proceeds the surplus would have been some [£8] billion. Total public debt as a proportion of GDP is lower than at any time since before the First World War. In 1989-90 the PSDR is forecast to be [£13] billion ~~or net of privatisation proceeds [£8] billion~~, the same as the current year.

The Government's longer-term aim is to balance its budget so that the State makes no claim on the savings of the private sector or on flows of finance from overseas. Then as GDP continues to rise, the ratio of public debt to GDP will continue to fall and with it the burden of debt interest. Not only will this lessen the burden on future generations, but at the same time, provided public expenditure continues to fall as a proportion of national output, it will allow a sustainable and progressive reduction in the burden of taxation.

C. CONTINUING REFORM

The Budget continues the Government's programme of reform:

has been

- ~~1984~~ Business Taxation reformed: capital allowances altered so that investment decisions based on commercial judgment not tax advantage; CT rates reduced substantially;

~~(and you went to sleep in 1985, 1986 & 1987??)~~ has been

- ~~1988~~ Personal Taxation reformed: IT reduced to only two rates at 25 per cent and 40 per cent; IHT rates reduced from four to one rate; CGT aligned with IT and gains rebased to 1982; announcement of independent taxation for husbands and wives (to come into force in 1990) ~~and end of tax penalties~~ on marriage;

In this Budget!

- ~~1989 Further Reform:~~ reform and reduction of National Insurance contributions, reform of taxation of ~~pensions~~, life assurance companies, [~~and unit trusts~~] and further measures to encourage wider share ownership. Abolition of pensioners' earnings rule.

changes to the taxation of pensions

National Insurance Contributions (NICs)

In his 1985 Budget the Chancellor reduced national insurance contributions for employees on low earnings by introducing two reduced rate bands. This cut the cost of employing young and unskilled workers and reduced the burden of NICs on the low paid. However, movement across the steps causes high marginal rates of tax.

From October 1 this system will be radically simplified so that:

- as now, those earning below the lower earnings limit (£43 per week in 1989-90) will pay no NICs;

- those earning £43 per week and above will pay a contribution of 2 per cent on earnings below £43 per week (86p) and 9 per cent on all earnings above £43 up to the upper earnings limit (£325 per week in 1989-90);

- this will give all employees earning just under half average earnings or more a gain of £3 per week. Most of the benefit will go to those below average earnings.

- it is right to keep a step at the lower earnings limit as the entry fee to one of the most comprehensive benefit systems in the world;

- there will be no change in employers' NICs.

Proposals to help pensioners

- The higher age allowance which is currently restricted to those over 80 will be extended to cover those aged 75 and over;

- The rate at which age allowance is withdrawn above the income limit of £11,400, will be reduced to £1 for each £2 of income, rather than the present £2 in every £3. This will remove the only remaining effective marginal rates over 40 per cent.

  In addition:

- tax relief will be available from April 1990 on premiums for private health insurance paid by or on behalf of those over 60;

- the pensioners' earnings rule is to be abolished. Pensioners who continue to work after retirement age will no longer have their pension reduced. This honours the commitment made in the 1979 Conservative Manifesto.

Income Tax

- no change in income tax rates;

- tax thresholds increased by 6.8 per cent in line with statutory indexation.

D. TAXATION OF SAVINGS

Pensions

The aim of the Government's policy on pensions is to give individuals more flexibility and choice in the way in which they provide for their retirement. The introduction of personal pensions was a major step in that direction and further substantial steps are now proposed.

Occupational Pensions Currently, if a pension scheme satisfies certain conditions about the benefit it pays, it will be approved by the Inland Revenue, in which case various tax reliefs apply to it. However, it is not possible for an employer to set up two schemes, one with tax relief and one without, if the combined benefits exceed the normal limits for tax approval. The result is that the limits on tax relief have come to determine the total pension an employee can receive and the form it takes.

In future:

- employers will be able to provide whatever pension they wish to recruit or reward their employees;

- there will be a limit on the total tax relief available. For new pension schemes or for new members joining existing schemes there will henceforth be a "cap" on tax relief based on earnings of £60,000 a year. This limit will be increased in line with inflation;

- there will be simplification of the tax rules for occupational pension schemes, particularly affecting those who leave or retire early.

Free-standing Additional Voluntary Contributions were introduced in October 1987 to give additional choice to employees. However currently providers have to check that the benefits provided, together with the employer's benefits, are not likely to exceed the maximum benefits allowed. If, despite checks, they do exceed these benefits on retirement the employer's scheme benefits must be cut back. Successful free-standing AVCs are therefore penalised.

In future:

- any excess will be returned to the employee subject to a tax charge which broadly corresponds to the tax relief received on contributions and on build-up of funds. Changes will also be made to reduce the administrative burden on employers.

Personal Pensions have been available to employees and the self-employed since July 1988. Already over a million personal pensions have been taken out.

In future:

- contribution limits for members over 35 will be more generous;

- it will be easier for those with personal pensions to direct where their fund is invested;

- at the same time, as with occupational pensions, a limit will be placed on tax relief which will not be available for contributions related to earnings in excess of £60,000. This will also be increased annually in line with inflation.

Life Assurance

A consultative document on the taxation of life assurance was issued in June 1988. Following consultations with the industry it is proposed that:

- life offices will be required to keep their pensions business separate from their life assurance business;

- the expenses of attracting new business will be deductible for tax purposes over a period of seven years rather than immediately (this will be phased in over four years starting in 1990);

- income and capital gains attributable to policy holders will be taxed at the basic rate of income tax instead of 35 per cent and 30 per cent respectively;

- Life Assurance ~~Premium~~ Policy Duty will be abolished from 1 January 1990.

The tax treatment of life assurance premiums and policy benefits in the hands of individuals will be unchanged. Consultation will continue on a number of more technical issues for inclusion in the 1990 Finance Bill.

The proposals remove the distortions of the previous system whilst recognising the unique nature of the industry. There will be parity of treatment between life offices and other financial institutions and a fairer distribution of the overall tax burden on the industry between one life office and another. The proposals recognise the need for the industry to remain competitive within the European Community.

<u>Unit Trusts</u>

Under a European Community directive, collective investment vehicles that are UCITS (Undertakings for Collective Investment in Transferable Securities) will be able to market their shares or units throughout the EC from October 1989. A new tax regime is to be introduced which will enable them to compete more effectively with their European competitors. The main features are:

- A reduction in the corporation tax rate from 35 per cent to the basic rate of income tax (25 per cent). This will remove any UK tax charge on a trust which cannot be credited to unit holders.

- Relief for management expenses and interest on borrowings permitted under Securities and Investment Board regulations.

E. WIDER SHARE OWNERSHIP

The Budget encourages wider share ownership. Already the number of share owners has nearly trebled since 1979 with nine million adults, over 20 per cent of the adult population, owning shares. About 1¾ million employees own shares or options over shares in the companies for which they work, giving them a direct personal interest in the profitability and success of their companies. There have been improvements in approved share schemes in eight out of the last nine Budgets. Further improvements are proposed to encourage personal equity plans, employee share schemes and employee share ownership plans.

Personal Equity Plans (PEPs)

PEPs were introduced in the 1986 Budget to encourage investment in shares in UK companies. It is estimated that over 385,000 plans have been taken out, with total investment approaching £700 million. Changes are now proposed that will make them more attractive to investors - particularly smaller investors - by giving greater flexibility. At the same time simplification will keep down plan managers' costs and their charge to investors.

The main changes are:

- the annual investment limit is to be increased from £3,000 to £4,800; the annual investment limit for investment in authorised unit trust and investment trusts is to be raised to £2,400;

- the scheme will be better targeted with a new requirement that unit or investment trusts within PEPs must invest mainly in UK equities;

- a facility will be introduced to allow new issue shares, including future privatisation issues, to be brought within plans;

- significant simplifications are to be made to the administration of the scheme.

Approved All Employee Share Schemes

- annual limits on 1978 Finance Act approved employee share schemes are to be increased to £2,000 or 10 per cent of pay up to a limit of £6,000;

- the monthly limit for 1980 Finance Act SAYE schemes is to be increased from £100 to £150.

Employee Share Ownership Plans (ESOPs)

Various tax reliefs are already available in connection with trusts set up to run approved employee share schemes under legislation introduced in the Finance Act 1978. But some companies wish to encourage employee share ownership through ESOP trusts which have different requirements. They may:

- borrow to acquire their shares;

- need to hold shares for a longer period than the maximum eighteen months permitted under the 1978 scheme;

- wish to distribute larger amounts of shares to employees than is possible under the 1978 scheme;

- in the case of unquoted companies wish to provide a market for the company's shares for the benefit of employees.

The Budget clarifies that tax relief is available for payments by companies to ESOP trusts set up to distribute shares to the company's employees provided certain conditions are met. Key features of the qualifying conditions will be that shares must be distributed to employees within a maximum of seven years of their acquisition by the trust and on an all employee similar terms basis. A number of ESOPs have already been set up and it is hoped that this relief will encourage additional employee share ownership, particularly in unquoted companies.

Profit Related Pay

Profit related pay also encourages employee involvement in the companies in which they work. A range of improvements to the tax relief for PRP are proposed:

- the upper limit on PRP which can qualify for tax relief is to increase from £3,000 to £4,000;
- employers will be able to set up schemes for headquarters units with PRP based on the profits of the whole undertaking;
- the requirement for PRP to equal at least 5 per cent of employees' pay if profits remain the same is to be abolished; certain alterations will be allowed to be made to registered PRP schemes without loss of tax relief;
- the administration and operation of tax relief for PRP is to be improved.

F. BUSINESS TAXATION

Corporation Tax Rates

The main and small companies rates of corporation tax will be unchanged, but the profit limits will be raised:

- the 25 per cent rate will apply to firms with profits under £150,000, up from £100,000;
- the 35 per cent rate will apply to firms with profits over £¾ million - up from £½ million;
- between these rates, as now, intermediate rates will be payable.

Close Companies

As top rates of taxation are reduced, there is less incentive to avoid tax, allowing major simplification of the tax system. It is therefore proposed to abolish close company apportionment. (This involves taxing individuals on the undistributed income of close companies in which they have an interest.)

This will be of particular benefit to small family businesses and will dispense with 20 pages of legislation.

To prevent abuse, there will be a corporation tax rate of 40 per cent (equivalent to the higher rate of tax) on close investment companies unless they distribute a certain proportion of their profits.

Assessment of Earnings

It is proposed that income tax under Schedule E will no longer be assessed on the amount earned in a tax year, but on the amount received in the tax year.

- This will not affect the great majority of employees who are already taxed on earnings received in the tax year.

- It will be a major simplification for directors and other employees receiving bonuses or commission who often receive pay some time after the year for which it is earned.

- For these people it will reduce the complexity and delay in settling their tax bills.

Benefits in Kind

- the benefit of private use of a company car is still significantly under taxed even after the car scales were doubled in last year's Budget. It is proposed that they will be increased by a third in 1989-90.

G. CHARITIES

European Court Judgment

In implementing the European Court's judgement affecting certain UK VAT zero rates, the Government has sought to minimise the burden of tax and compliance particularly in relation to charities. They cannot be wholly shielded because many of them have activities which constitute "business" for VAT purposes, but construction, water, fuel and power for charities' non-business activities will remain zero-rated. Accommodation such as old people's homes, student hostels and hospices will therefore be zero-rated. (See CRD Brief: European Court of Justice VAT Zero Judgement February 6th 1988.)

VAT

Zero rating is to be extended to a number of further items for charities, for example, for advertising in most publications when the advertisement is to raise money for or make known the objects of the charity, and for supplies made by charities in connection with fund-raising events.

Motability

Cars leased to the disabled by Motability (which are already exempt from VAT) are to be relieved of car tax.

Payroll Giving

Since payroll giving to charity was introduced in the 1987 Budget, 3,400 employers have set up schemes and 100,000 employees are contributing, of whom about 17 per cent are contributing the maximum amount. £1 million was collected this way in 1987-88.

To encourage further giving the amount on which tax relief will be available is to be doubled from £240 to £480 a year.

H. EXCISE DUTIES

Unleaded Petrol

The Government is committed to phasing out leaded petrol altogether and in the last two Budgets the Chancellor has introduced a tax differential in favour of unleaded petrol. Sales are rising fast but unleaded petrol still accounts for less than 5 per cent of total sales, even though two-thirds of cars could use it either without adjustment or else with a conversion cost of only some £20 or so. In order to encourage more people to switch to unleaded petrol:

- tax on unleaded petrol has been reduced by 3.6p a gallon;

- tax on two and three star petrol will be increased by 4p a gallon to bring it into line with four star;

- four star leaded and DERV duty remain unchanged.

If the tax differential is passed on there should be a difference between unleaded petrol and leaded petrol of nearly 10p a gallon, or 2p a litre, at the pump.

Tobacco and alcohol

As with four-star leaded petrol and DERV, (There will be no change in the excise duties on tobacco and alcohol this year. ~~[illegible]~~ At the present juncture it would be folly to do anything that might ~~boost~~ worsen inflationary expectations.

(Any need to give a line to backbenchers?)

I. OTHER MEASURES

Reform of Capital Gains Tax Rules for Gifts

Currently the tax on any gain accrued up to the date of the gift of an asset can normally be deferred until the recipient disposes of the asset. One of the original reasons for introducing this deferral was the existence of the simultaneous charge to capital transfer tax. As there is now no tax on life-time giving that rationale no longer applies. In addition the capital gains tax deferral has come to be used widely to eliminate the tax charge on gains. It is therefore proposed to abolish the deferral.

It will be retained however for gifts of:

- business assets (including unquoted shares in trading companies and holding companies of trading companies)
- heritage property
- heritage maintenance funds
- charities and political parties
- between husband and wife and
- on which there is an immediate charge to inheritance tax.

Chattels Exemption

Goods worth less than £3,000 are exempt from CGT on disposal. It is proposed to double this limit to £6,000.

J. CONFIDENTIALITY

The Official Secrets Bill currently before Parliament is narrower in scope than the present Official Secrets Act. It does not cover information in the possession of either the Inland Revenue or Customs & Excise. It is essential that the confidentiality of taxpayers' affairs is protected and it is therefore proposed to introduce provisions in the Finance Bill which will make it a criminal offence for officials or former officials of either of the Revenue Departments to reveal information about the private affairs of a specific taxpayer.

COPY NO 1 OF 26

pa/jp

NOTE OF A MEETING IN THE CHANCELLOR'S ROOM
HM TREASURY, AT 5.00PM ON THURSDAY 9 MARCH 1989

Present: Chancellor
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Riley
Mr Sedgwick
Mr S J Davies
Mr Gieve
Mr Mowl

FINALISING THE BUDGET ARITHMETIC

After some discussion the following points were agreed

(i) The PSDR forecast should be £14 billion in both 1989/89 and 1989/90 (the unrounded figures would be £13.9 billion and £13.8 billion respectively).

(ii) The presentation in Chapter 6 should be changed to show the tax burden rounded to the nearest ¼ per cent. The non-oil tax burden would be shown as 37½ per cent in both 1988/89 and 1989/90 (subject to any final changes in the money GDP forecast).

(iii) The MTFS path for the PSDR should be 14/10/6/3. The fiscal adjustments would be 1/2/3. The tax burden pre-fiscal adjustment would be 37½/37/36¾/36¼ and post-fiscal adjustment 37½/36¾/36¼/35¼, though the precise rounding of the numbers for 1991-92 and 1992-93 might change.

(iv) GDP growth in 1989 would be forecast at about 2.3 per cent. In Chapter 3 this would be described as 'around 2½ per cent' (the unrounded figure could be calculated from the detailed figures in the tables). The equivalent figure for non-oil GDP growth would be 3 per cent. Growth of GDP through the year would be forecast ~~as~~ at 2 per cent.

(v) The current account deficit forecast for the first half of 1989 should be £12 billion at an annual rate.

ACSA

A C S ALLAN
9 March 1989

<u>Distribution</u>

Those present
PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Anson
Mr Wicks
Mr Culpin
Mr Peretz
Mrs Lomax
Mr Hibberd
Mr Pickford
Miss Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

Chancellor cc Mr Grieve

Sir Terence Burns suggested that you might find it helpful to look at this before today's 5 o'clock meeting on the PSDR. The first estimate of the PSDR in February follows shortly.

Colin Mowl 9/3

COPY NO: 12 12 COPIES +1 +2 +3 +4 +5

FROM: COLIN MOWL
DATE: 9 March 1989

SIR T BURNS

cc Sir P. Middleton
Mr Anson
Mr Scholar
Mr Sedgwick
Mr Riley
Mrs Lomax
Mrs Butler
Mr MacAuslan
Mr S J Davies
Mr Patterson

FINALISING THE BUDGET ARITHMETIC

We spoke this morning about the Chancellor's wish to show PSDRs of £14 billion in both 1988-89 and 1989-90 and no rise in the non-oil tax burden (compared with a best forecast of a 0.3 per cent rise). I attach a table which attempts to meet these constraints given the current, not yet final, money GDP numbers.

2. The main problem has been reconciling the PSDR and tax burden constraints with GEP's wish to have a falling GGE ratio and the same £ billion GGE figures from 1990-91 onwards as in the PEWP.

3. But I think the attached table meets all the constraints. I have discussed the public expenditure figures with Mr MacAuslan and Mrs Butler and they are content, given the present money GDP figures. I have not discussed with Stephen Davies whether all this poses problems for the fiscal adjustment etc.

4. The second table shows how the figures proposed for publication differ from the central forecasts. The main changes are:-

- a reduction in debt interest of £0.6 billion;

- a reduction in non-oil taxes of £0.8 billion;

- an increase in other receipts of £1.0 billion.

5. The main problem with the plausibility of the proposed figures is the rise of £0.6 billion in "other receipts" in 1989-90. We may just about get away with this. The rise in the accruals adjustment

is genuine. It is mainly the result of increases in the NIC and indexed gilt accruals adjustments. The former reflects the fact that the reforms reduce accruals more than receipts. The IG adjustment reflects the fact that uplift on IGs (included in debt interest) is forecast to rise but will not be paid until the IGs are redeemed.

6. You may wish to discuss. But it looks to me that as though we can proceed in the way the Chancellor wants. The main remaining uncertainties are the money GDP figures and the February PSDR.

Colin Mowl.

COLIN MOWL

psf.sp.cm.tabs.012

FIGURES* PROPOSED FOR PUBLICATION

	1988-89	1989-90	1990-91	1991-92	1992-93
Planning total	150.6	167.1	179.4	191.6	199.8
Debt interest	18.3	17.0	15.0	14.7	14.0
Other adjustments	10.2	10.1	10.5	9.5	9.7
GGE	179.1	194.2	204.9	215.8	223.5
(GGE excluding privatisation proceeds)	(186.1)	(199.2)	(209.9)	(220.8)	(228.5)
Taxes and NICs	177.4	190.9			
(of which: Non-oil Oil)	(174.2) (3.2)	(188.0) (2.9)			
Interest and dividends	6.6	6.9			
Other receipts	6.6	7.2			
Accruals adjustment	0.3	1.3			
General government receipts	190.9	206.3			
GGDR	11.8	12.1			
PCMOD	2.2	1.7			
PSDR	14.0	13.8			
Money GDP (% increase)	472.6 (11.0)	509.2 (7.7)	539.8 (6.0)	571.5 (5.9)	602.9 (5.5)
Non-oil GDP	466.1	502.1			
GGE (excluding privatisation proceeds) ratio %	39.4 (39½)	39.3 (39¼)	38.9 (39)	38.6 (38¾)	37.9 (38)
Non-oil tax burden %	37.4	37.4			
Total tax burden %	37.5	37.5			
PSDR %	3.0	2.7			
PSDR excluding privatisation proceeds %	1.5	1.7			

* figures from 1990-91 onwards will be rounded in FSBR.

psf.sp.cm.tabs.012

DIFFERENCES FROM CENTRAL VIEW.

	1988-89	1989-90	1990-91	1991-92	1992-93
Planning total	—	+0.5			
Debt interest	+0.1	-0.6			
Other adjustments	+0.1	-0.3			
GGE	+0.2	-0.4			
GGE excluding privatisation proceeds	+0.2				
Taxes and NICs	—	-0.7			
of which: Non-oil		(-0.8)			
Oil		(+0.1)			
Interest and dividends	-0.1	+0.2			
Other receipts	-0.1	+1.0			
Accruals adjustment	—	+0.1			
General government receipts	-0.2	+0.3			
GGDR	-0.4	+0.7			
PCMOD	—	-0.4			
PSDR	-0.4	+0.4			
Money GDP					
Non-oil GDP					
GGE (excluding privatisation proceeds) ratio %					
Non-oil tax burden %					
Total tax burden %					

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COPY NO 3 OF 11

FROM J F GILHOOLY

DATE: 10 March 1989

MR PICKFORD

cc PS/Chancellor
PS/Financial Secretary
PS/Economic Secretary
Mr Scholar
Mr Culpin
Mr Riley
Miss Hay
Mr Michie

1989 BUDGET BRIEF : DRAFT

I return (top copy only) the Budget brief, with amendments marked. I have clipped the pages with the no amendments on them.

2. Mostly, the changes are details or typos. But there are more substantive points on:

The last page of A.1 and C.2.4

Do we want the regional message put so starkly? I reads as if the Government is out to get the South East.

The last page of A.2, G.2 and GG2.12

All need a Q & A explicitly on domestic water supply.

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Page 4 of Brief D.2

Bit too ferocious and committal about future increases in company car scales.

G.1, page 7

Needs to cover questions about cost to NHS of increased smoking and drinking

Charts annexed to DD8

Heading or footnote needed to make clear whether marginal £1 of extra earnings underlies the calculations.

3. You already have FP's list of Questions and Answers. But we need an answer to:

Why didn't you abolish Stamp Duty

(I will send separately);

and also something on the implications for savings of tax burden on company sector and personal sector of CSO ET article (about which we have spoken separately).

J F GILHOOLY

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x.pj/jc/10.3.2

BUDGET SECRET

COPY NO 1 OF 11

FROM: MRS JUDITH CHAPLIN
10th March 1989

PS

CHANCELLOR

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Mr Culpin
Mr Gieve
Mr Tyrie
Mr Call

NB There must be a clear theme tax savings which gives the key measures in the 1987 the substantial boost, the new pensions allowances, together with reaffirmation of 20p basic rate target

DRAFT BACKBENCH BRIEF

I attach a revised draft of the Budget Brief for backbenchers. Your comments have been incorporated and so have the changes suggested by the Chief Secretary.

2. It has a new summary, the order of some of the sections has been altered and they have been shortened where possible.

3. It is about the same length now as last year's brief, except that it has a section on economic policy which was not included last year. It is difficult to shorten that section as it is explanatory rather than bull points. I have discussed it with the Chief Secretary and he thinks that as it is likely that, as you have said, the debate will concentrate on this aspect of the Budget the section should be left in.

JC

JUDITH CHAPLIN

Ch
Judith will need this back on Monday - you can have a word @ Prayers.
AA

Step the Commons pressure

MAIN HEADLINES

A. ~~SUMMARY~~

Public sector

- ~~Debt repayment of £[14] billion in~~ both 1988-89 and 1989-90 ~~further massive repayment in the coming year~~;

- employees' NICs to be reduced (in October) with a gain of £3 a week for all earning half average earnings and above;

- no change in income tax rates but tax allowances and ~~thresholds~~ basic rate remains increased in line with inflation;

- ~~enhanced age allowance for over 80s extended to all over 75;~~

- pensioners' earnings rule abolished;

- further ~~tax relief for~~ measures to encourage share ownership: ~~PEPs~~ Personal Equity Plans (PEPs), employee share schemes and ~~ESOPs;~~ Employee Share Ownership plans (ESOPs).

- ~~changes in taxation of pensions and life assurance;~~

- no increase in excise duties on alcohol, tobacco and most petrol;

- ~~duty~~ tax on unleaded petrol cut to make ~~it~~ the pump price nearly [10p] a gallon cheaper than leaded — the second biggest tax differential in EC;

last year was 4½ per cent, and

strong and

this century.

B. THE ECONOMY: RECORD AND POLICY

The economy has been transformed since 1979 as a result of the success of Conservative policies.

- Growth has averaged over 3 per cent over the past seven years, the longest ~~largest~~ period of steady growth ~~since the war~~. It is forecast to ~~rise by a further~~ [2] ½ per cent in 1989-90.

slow down to

- Inflation has averaged 5 per cent over the past five years. Under Labour the average was own 15¼ per cent. It rose to 7.5 per cent in January and is likely to edge up a little further before falling back ~~resuming its downward trend~~ in the second half of this year. Excluding the distorting effect of mortgage interest payments, the RPI rose by 4½ per cent in 1988 and by 5½ per cent in the year to January 1989. ~~[last year, much the same as the average over the previous five years. But the rate increased significantly through the year, and now stands at 5½ per cent.]~~ ~~[Inflation (including MIR)]~~ is forecast to fall to 5½ per cent by the end of 1989, and to 4½ per cent by 1990Q2.

- The Government is repaying debt, lifting the burden on future generations. Around [£14] billion will have been repaid in 1988-89, and a further debt repayment of [£14] billion is forecast for 1989-90. The debt repayments of the last two years mean that net debt interest costs will be lower by £1¾ billion a year. Total public sector debt is now at a lower level as a percentage of national output than it has been at any time since the first world war.

- Unemployment has fallen for 30 months in a row, by over 1.1 million in total - the longest period of falling unemployment since the War. More people are now in work than ever before.

- Investment is booming, having grown ~~[nearly]~~ twice as fast as consumption over the past seven years. Total investment rose by [12] per cent in 1988, with manufacturing investment up 9¾ per cent. Investment intentions remain strong with further growth forecast for 1989.

healthy

Each of

- Industry remains strong. Manufacturing output is at its highest ever level and in Each of the last two years its growth has exceeded 5 per cent. UK manufacturing productivity growth in the 1980s has been higher than all other major industrial countries and whole economy productivity growth has been second only to Japan's. Company profitability is the highest for more than 20 years.

- Exports. In the second half of 1988 the volume of exports of manufactures was 5 per cent higher than a year earlier, and is forecast to rise by 7½ per cent in 1989, close to the projected growth of world trade.

- Imports rose considerably faster than exports, by 13 per cent in 1988, reflecting the strength of domestic demand. Imports of capital and intermediate goods rose fastest, and this is expected to continue in 1989 although the slowdown in overall domestic demand and extra capacity in British industry means that total import growth ~~will~~ should slow significantly.

- Living standards have risen at all income levels. A married man, with two children, on average earnings is over £45 a week better off in real terms now than in 1978-79 (up over 29 per cent). Under Labour real take-home pay rose by £1.

ECONOMIC POLICY

This is a cautious Budget. It

~~The Budget~~ reaffirms the Government's ~~sound financial~~ well tried policies: a firm monetary policy to bear down on inflation, buttressed by a balanced budget (for the first time in substantial surplus). ~~of bearing down on inflation, controlling public spending and bringing the public sector into balance.~~ It continues the process of tax reform and introduces further measures to remove distortions and regulations to improve the working of ~~free~~ markets.

Monetary policy, which operates through the level of short-term interest rates remains, as in all other modern economies ~~it has always been~~, the key to controlling inflation. As inflationary pressures have re-emerged, both in the UK and other countries ~~in the economy~~ the Chancellor has raised short-term interest rates substantially and, as he has made clear "Interest rates will stay as high as is needed for as long as is needed to get on top of inflation".

Well targeted policy. Because, for the first time ever, households are now net borrowers, high interest rates will have their main effect precisely where they are needed - on consumer spending. They will not be popular with home owners but a return to rampant inflation would be far worse. There are already clear signs that the heat has gone out of the housing market and that retail spending ~~is slowing~~ has levelled off.

High interest rates will also discourage borrowing and encourage saving~~s~~ - a more appropriate way of so doing than greater tax incentives. The personal saving~~s~~ ratio has fallen not because gross saving has fallen, but because personal borrowing has increased. ~~and raising the cost of borrowing and the return on saving will reverse the trend.~~

Business and interest rates. Interest rates will have their principal effect on consumer spending, not corporate spending. In contrast to the early 1980s when many British companies had high levels of debt relative to their equity value, firms have reduced their reliance on borrowing. And, with profitability at ~~their~~ its highest level ~~since 1969~~ for over 20 years, many firms have retained profits available with which to finance expansion. They are therefore less affected by interest rate rises than they were. Furthermore, with the reduction in Government borrowing, the scope for industry to borrow long term is increased. Long term interest rates are well below short overnight rates.

10

Investment. Boom. ~~Business~~ Expansion is continuing. Business ~~Private~~ investment last year was at an all time record as a proportion of national output. Manufacturing investment is reckoned to have risen by ~~some~~ almost 9¾ per cent last year. Total investment in the UK is estimated to be up by at least 12 per cent in 1988, almost twice as fast as consumption.

Public sector investment. The Labour Party ~~demand more~~ ~~will urge additional spending on public investment. They choose to~~ ignore the record of private investment and ~~consider only public sector~~ spending. Even there ~~their~~ Labour's record compares poorly.

demand more public investment.

Public sector capital spending is now running at ~~around £25~~ nearly £26 billion a year. An additional £2¾ billion in 1989-90 will mean that total capital spending will be higher in real terms than in 1978-79, despite a deliberate policy of reducing the state's role in providing new housing. Under Labour capital spending fell 23 per cent in real terms.

Public spending. A key element of the Government's sound financial management is the control of public spending. Since 1982-83 public spending, expressed as a share of national income, has fallen by over 7 percentage points - the largest and longest sustained fall since the war-time economy was unwound. It is now under 40 per cent of national income - the first time this has happened for over 20 years.

~~The Opposition will urge additional indiscriminate spending in order to improve the "supply side" of the economy. Within a tightly controlled overall sum, Government spending has been targeted to do precisely that with, for example, reductions in industrial subsidies and the restructuring of regional policy, and increases in infrastructure spending, education and training and the science budget. (For details of public expenditure see CRD brief on Public Expenditure White Paper 9th February 1989.)~~

Balance of Payments. The combination of high levels of investment and high consumer spending financed by borrowing has led to a reported current account deficit ~~which is estimated to~~ of ~~have been~~ £14½

At the same time economic success has allowed the Government to set priorities for public spending, and significant increases in spending have been made on vital areas such as health, road and rail, and law and order.

The very high level of the so called balancing item (£15 billion 1988) suggests that the true current account deficit is rather less than this.

billion last year and is forecast to be the same level ~~in the~~ this ~~coming~~ year. The current account deficit reflects an excess of domestic investment, which has risen sharply, over domestic saving, which has remained broadly unchanged, with capital inflows from the rest of the world filling the gap.

Capital inflows are financing high investment spending by the private sector which will add to productive capacity, thus boosting exports and displacing imports in the future. Meanwhile the deficit is readily financeable ~~due to the~~ given sound policies, worldwide recognition of the strength of the UK economy, the high level of UK net overseas assets and reserves at record levels.

<u>Public Sector Finances</u>. Unlike the 1960s and 1970s, the present current account deficit is not the counterpart of excessive government borrowing and spending. When the Government came to office in 1979 the public sector borrowing requirement (PSBR) was over 5 per cent of GDP, equivalent to some £25 billion in today's terms.

Government borrowing has been steadily reduced until in 1987-88 the PSBR was eliminated and the Government started to repay debt.

turn on at

~~Last year~~ For the financial year now ending the Public Sector Debt Repayment (PSDR) is likely to ~~have been~~ [£14] billion or [3] per cent of GDP. Even without any privatisation proceeds ~~the~~ that implies a Budget surplus ~~would have been~~ of some [£7] billion. Total public debt as a proportion of GDP is lower than at any time since ~~before~~ the First World War. In 1989-90 the PSDR is forecast to be [£14] billion, the same as the current year.

The Government's ~~longer-term aim~~ objective is to balance its budget so that the State makes no claim on the savings of the private sector or on flows of finance from overseas. Then as GDP continues to rise, the ratio of public debt to GDP will continue to fall and with it the burden of debt interest. Not only will this lessen the burden on future generations, but at the same time, provided public expenditure continues to fall as a proportion of national output, it will allow a sustainable and progressive reduction in the burden of taxation.

multi-rate Capital Transfer Tax abolished and replaced by a flat rate Inheritance Tax with a high threshold;

Spell out

C. CONTINUING REFORM

The Budget continues the Government's programme of reform:

Business taxation has already been reformed, with capital allowances altered so that investment decisions are based on commercial judgment not tax advantage and CT rates reduced substantially. Personal taxation has been reformed: IT reduced to only two rates at 25 per cent and 40 per cent; ~~IHT rates reduced from four to one rate~~; CGT aligned with IT and gains rebased to 1982; ~~announcement of~~ independent taxation for husbands and wives ~~and end of tax penalties on marriage~~. to start next year.

In this Budget: reform of reduction of National Insurance contributions, reform of taxation of life assurance companies, pension taxation changed and further measures to encourage wider share ownership. Abolition of pensioners' earnings rule.

National Insurance Contributions (NICs). In his 1985 Budget the Chancellor reduced both employers' and employees' national insurance contributions for ~~employees~~ those on low earnings by introducing two reduced rate bands. This cut the cost of employing young and unskilled workers and reduced the burden of NICs on the low paid. However, for the employee, movement ~~across the steps~~ from one rate to the next causes high marginal rates of tax.

From October ~~1 this system~~ employees' NICs will be radically simplified so that:

- as now, those earning below the lower earnings limit (£43 per week in 1989-90) will pay no NICs;

- those earning £43 per week and above will pay a contribution of 2 per cent on earnings below £43 per week (86p) and 9 per cent on all earnings above £43 up to the upper earnings limit (£325 per week in 1989-90);

- <u>this will give all employees earning just under half average earnings or more a gain of £3 per week. Most of the benefit will go to those below average earnings</u>.

- it is right to keep a step at the lower earnings limit as the entry fee to one of the most comprehensive benefit systems in the world;

- there will be no change in employers' NICs.

<u>Proposals to help pensioners</u>

- the <u>pensioners' earnings rule</u> is to be abolished. This honours the commitment made in the 1979 Conservative Manifesto. Pensioners who continue to work after retirement age will no longer have their pension reduced;

- The ~~higher~~ more generous age allowance which is currently restricted to those over 80 will be extended to cover those aged 75 and over;

- The rate at which age allowance is withdrawn above the income limit of £11,400, will be reduced to £1 for each £2 of income, rather than the present £2 in every £3. This will remove the only remaining ~~effective~~ marginal rate over 40 per cent;

- tax relief will be available from April 1990 on premiums for private health insurance paid by or on behalf of those over 60.

Str understanding of savings from here on

~~D.~~ F. OTHER TAXATION OF SAVINGS

Pensions. The aim of the Government's policy on pensions is to give individuals more flexibility and choice in the way in which they provide for their retirement. The introduction of personal pensions was a major step in that direction and further substantial steps are now proposed.

Occupational Pensions Currently, if a pension scheme satisfies certain conditions about the benefit it pays, it will be approved by the Inland Revenue, in which case various tax reliefs apply to it. ~~However, it is not possible for an employer to set up two schemes, one with tax relief and one without, if the combined benefits exceed the normal limits for tax approval.~~ The result is that the limits on tax relief have come to determine the total pension an employee can receive and the form it takes.

In future:

- employers will be able to provide whatever total pension they wish to ~~to recruit or~~ reward their employees;

- but there will be a limit on the total tax relief available. For new pension schemes or for new members joining existing schemes there will henceforth be a "cap" on tax relief based on earnings of £60,000 a year. This limit will be increased in line with inflation;

- there will be simplification of the tax rules for occupational pension schemes, particularly affecting those who leave or retire early.

Free-standing Additional Voluntary Contributions were introduced in October 1987 to give additional choice to employees. However if the benefits provided, together with the employer's benefits, exceed the maximum allowed, the employer's scheme benefits must be cut back. Successful free-standing AVCs are therefore penalised.

In future:

- any excess will be returned to the employee subject to a tax charge;

- the administrative burden on employers will be reduced.

<u>Personal Pensions</u> have been available to employees and the self-employed since July 1988. Already over a million personal pensions have been taken out.

In future:

to personal pensions (for those

- contribution limits ~~for members~~ over 35 will be more generous;

- it will be easier for those with personal pensions to direct where their fund is invested;

- at the same time, as with occupational pensions, a limit will be placed on tax relief which will not be available for contributions related to earnings in excess of £60,000. This will ~~also~~ be increased annually in line with inflation.

<u>Life Assurance</u>. A consultative document on the taxation of life assurance was issued in June 1988. Following consultations with the industry it is proposed that:

- life offices will be required to keep their pensions business separate from their life assurance business;

- the expenses of attracting new business will be deductible for tax purposes over a period of seven years rather than immediately (this will be phased in over four years starting in 1990);

- income and capital gains attributable to policy holders will be taxed at the basic rate of income tax instead of 35 per cent and 30 per cent respectively;

- Life Assurance Policy Duty will be abolished from 1 January 1990.

The tax treatment of life assurance premiums and policy benefits in the hands of individuals will be unchanged. Consultation will continue on a number of more technical issues for inclusion in the 1990 Finance Bill.

Unit Trusts. A new tax regime is to be introduced which will enable unit trusts to compete more effectively in Europe. The main features are:

- A reduction in the corporation tax rate from 35 per cent to the basic rate of income tax (25 per cent). This will remove any UK tax charge on a trust which cannot be credited to unit holders.

- Relief for management expenses and interest on borrowings.

E. WIDER SHARE OWNERSHIP

The Budget further encourages wider share ownership. Already the number of share owners has nearly trebled since 1979 with nine million adults, over 20 per cent of the adult population, owning shares. About 1¾ million employees own shares or options over shares in the companies for which they work, giving them a direct personal interest in the profitability and success of their companies. Further changes are proposed to encourage personal equity plans, employee share schemes and employee share ownership plans.

Personal Equity Plans (PEPs). PEPs were introduced in the 1986 Budget to encourage investment in shares in UK companies. It is estimated that over 385,000 plans have been taken out, with total investment approaching £700 million. Changes are now proposed that will make them more attractive to investors - particularly smaller investors - by giving greater flexibility. At the same time simplification will keep down plan managers' costs and their charge to investors.

The main changes are:

- the annual investment limit is to be increased from £3,000 to £4,800; the annual investment limit for investment in authorised unit trust and investment trusts is to be raised to £2,400;

- with unit trusts and investment trusts given a much stronger role in PEPs, they will be required to ~~the scheme will be better targeted with a new requirement that unit or investment trusts within PEPs must~~ invest mainly in UK equities;

I can see why it's put like this here, but it made me pause

- a facility will be introduced to allow new issue shares, including future privatisation issues, to be brought within plans;

- significant simplifications are to be made to the administration of the scheme.

<u>Approved All Employee Share Schemes</u>

- annual limits on 1978 Finance Act approved employee share schemes are to be increased to £2,000 or 10 per cent of pay up to a limit of £6,000;

- the monthly limit for 1980 Finance Act SAYE schemes is to be increased from £100 to £150.

<u>Employee Share Ownership Plans</u> (ESOPs). ESOPs operate differently from trusts set up to run approved employee share schemes under Finance Act 1978 legislation. They may:

- borrow to acquire their shares;

- need to hold shares for a longer period than the maximum eighteen months permitted under the 1978 scheme;

- wish to distribute larger amounts of shares to employees than is possible under the 1978 scheme;

- in the case of unquoted companies wish to provide a market for the company's shares for the benefit of employees.

The Budget clarifies that tax relief is available for payments by companies to ESOP trusts set up to distribute shares to the company's employees provided certain conditions are met. A number of ESOPs have already been set up and it is hoped that this relief will encourage additional employee share ownership, particularly in unquoted companies.

Profit Related Pay. Profit related pay also encourages employee involvement in the companies in which they work. A range of improvements to the tax relief for PRP are proposed:

- the upper limit on PRP which can qualify for tax relief is to increase from £3,000 to £4,000;

- employers will be able to set up schemes for headquarters units with PRP based on the profits of the whole undertaking;

- the requirement for PRP to equal at least 5 per cent of employees' pay if profits remain the same is to be abolished;

- the administration and operation of tax relief for PRP is to be improved.

G. ~~F.~~ BUSINESS TAXATION

Corporation Tax Rates. The main and small companies rates of corporation tax will be unchanged, but the profit limits will be raised:

- the 25 per cent rate will apply to firms with profits under £150,000, up from £100,000;

- the 35 per cent rate will apply to firms with profits over ~~£¾ million~~ £750,000 - up from ~~£½ million~~ £500,000;

- between these rates, as now, intermediate rates will be payable.

Close Companies. As top rates of taxation are reduced, there is less incentive to avoid tax, allowing major simplification of the tax system. It is therefore proposed to abolish close company apportionment. (This involves taxing individuals on the undistributed income of close companies in which they have an interest.)

This will be of particular benefit to small family businesses and will dispense with 20 pages of legislation.

To prevent abuse, there will be a corporation tax rate of 40 per cent (equivalent to the higher rate of tax) on close investment companies unless they distribute a certain proportion of their profits.

Assessment of Earnings. It is proposed that income tax under Schedule E will no longer be assessed on the amount earned in a tax year, but on the amount received in the tax year.

- This will not affect the great majority of employees who are already taxed on earnings received in the tax year.

- It will be a major simplification for directors and other employees receiving bonuses or commission who often receive pay some time after the year for which it is earned.

- For these people it will reduce the complexity and delay in settling their tax bills.

Benefits in Kind

- the benefit of private use of a company car is still significantly under taxed even after the car scales were doubled in last year's Budget. It is proposed that they ~~will~~ be increased by a third in 1989-90.

H. ~~G.~~ CHARITIES

European Court Judgment. In implementing the European Court's judgement affecting certain UK VAT zero rates, the Government has sought to minimise the burden of tax and compliance particularly in relation to charities. They cannot be wholly shielded because many of them have activities which constitute "business" for VAT purposes, but construction, water, fuel and power for charities' non-business activities will remain zero-rated. Accommodation such as old people's homes, student hostels and hospices will therefore be zero-rated. (See CRD Brief: European Court of Justice VAT Zero Judgement February 6th 1988.)

VAT. Zero rating is to be extended to a number of further items for charities, ~~for example, for advertising in most publications when the advertisement is to raise money for or make known the objects of the charity, and for supplies made by charities in connection with fund-raising events.~~

Motability. Cars leased to the disabled by Motability (which are already exempt from VAT) are to be relieved of car tax.

Payroll Giving. Since payroll giving to charity was introduced in the 1987 Budget, 3,400 employers have set up schemes and 100,000 employees are contributing, of whom about 17 per cent are contributing the maximum amount. £1 million was collected this way in 1987-88.

To encourage further giving the amount on which tax relief will be available is to be doubled from £240 to £480 a year.

D. ~~H.~~ EXCISE DUTIES

Unleaded Petrol. The Government is committed to phasing out leaded petrol altogether and in the last two Budgets the Chancellor has introduced a tax differential in favour of unleaded petrol. Sales are rising fast but unleaded petrol still accounts for less than 5 per cent of total sales, even though two-thirds of cars

- classified advertising for charitable purposes;
- fund raising events run by charities (and political parties and trade unions);
- autoclaves etc.

could use it either without adjustment or else with a small conversion cost. In order to encourage more people to switch to unleaded petrol:

- tax on unleaded petrol has been reduced by 3.6p a gallon;

- tax on two and three star petrol will be increased by 4p a gallon to bring it into line with four star;

- four star leaded and DERV duty remain unchanged.

If the tax differential is passed on there should be a difference between unleaded petrol and leaded petrol of nearly 10p a gallon, or 2p a litre, at the pump.

X Other Excise Duties ~~Tobacco, alcohol and leaded petrol~~. As with ~~un~~leaded petrol and DERV there will be no change in the excise duties on tobacco and alcohol this year. At the present juncture it ~~would be folly~~ is clearly desirable to ~~do anything that might worsen~~ avoid adversely affecting inflationary expectations.

I. OTHER MEASURES

? ~~Reform of~~ Capital Gains Tax Rules for Gifts. Currently the tax on any gain accrued up to the date of the gift of an asset can normally be deferred until the recipient disposes of the asset. One of the original reasons for introducing this deferral was the existence of the simultaneous charge to capital transfer tax. As there is now no tax on life-time giving that rationale no longer applies. In addition the capital gains tax deferral has come to be used widely to eliminate the tax charge on gains. It is therefore proposed to abolish the deferral.

It will be retained however for gifts of:

- business assets (including unquoted shares in trading companies and holding companies of trading companies)

- heritage property

- heritage maintenance funds

- charities and political parties

- between husband and wife and

- on which there is an immediate charge to inheritance tax.

Not told

Chattels Exemption. Goods worth less than £3,000 are exempt from CGT on disposal. It is proposed to double this limit to £6,000.

Confidentiality. The Official Secrets Bill currently before Parliament is narrower in scope than the present Official Secrets Act. It does not cover information in the possession of either the Inland Revenue or Customs & Excise. It is essential that the confidentiality of taxpayers' affairs is protected and it is therefore proposed to introduce provisions in the Finance Bill which will make it a criminal offence for officials or former officials of either of the Revenue Departments to reveal information about the private affairs of a specific taxpayer.

est.ld/james/10 Mar/pscx

BUDGET SECRET

Copy no 1 of 8

ECONOMIC SECRETARY TO THE TREASURY

FROM: S M A JAMES
DATE: 10 MARCH 1989

PS/CHANCELLOR

cc: Chief Secretary
Financial Secretary
Paymaster General
Mrs Chaplin
Mr Tyrie
Mr Call

BACKBENCH BRIEF

The Economic Secretary has seen Mrs Chaplin's revised draft circulated today. He has the following comments:

(i) Page 1, end of final tiret, add " - second biggest tax differential in EC";

(ii) Economic Policy

- paragraph 2, redraft first sentence: "Monetary policy which operates through short term interest rates remains, as in all other modern economies, the key to controlling inflation.". 2nd sentence, after "reemerged" insert "both in the UK (and other countries)" and delete "in the economy";

- paragraph 3,"They will not be popular" redraft to express sympathy as in the standard letters;

Overtaken

- paragraph 4, line 4, delete "and";

- page 5, paragraph 1: heading to read "Investment Boom";

- page 5, paragraph 2: delete "will urge ... choose to". Delete "consider ... spending" and insert "demand more public investment". Replace "their record" with "Labour's record";

- page 5, final paragraph, insert "reported" before "current account deficit". Delete "which ... been" and insert "of".

(iii) G **<u>Charities, VAT</u>**: Replace "for example ... fund-raising events" with 3 tirets as follows:

"- classified advertising for charitable purposes

- fund raising events run by charities (and political parties and trade unions)

- autoclaves [etc]."

<u>Motability</u>: add after "car tax" "(10% of cars' wholesale value)".

(iv) H **<u>Excise Duties</u>**

yes

- <u>Unleaded Petrol</u> - <u>is</u> there a commitment to phasing out leaded petrol altogether?

- <u>Tobacco etc</u> - replace heading with "<u>Other Excise Duties</u>".

S M A JAMES
Private Secretary