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FROM: MISS M P WALLACE
DATE: 6 March 1989

PS/FINANCIAL SECRETARY

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PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
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Dame A Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Mr Sedgwick
Mr Riley
Mr A C S Allan
Mr Gieve
Mr Gilhooly
Mr Matthews
Mr Pickford
Mr Macpherson
Mr Michie
Miss Hay
Miss Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

Sir A Battishill - IR
Mr Beighton - IR
Mr Isaac - IR
Mr Painter - IR
Mr G Bush - IR
Mr C McNicol IR [+1]

Mr Unwin - C&E
Mr Jefferson Smith - C&E
Mr P R H Allen - C&E
Ms A French - C&E [+1]

Moira,
Comments on the 'tax on spending' section are shown in red.
Alison French
7/3

BUDGET STATEMENT: TAX SECTION

The Chancellor was most grateful to all those who commented on last week's version of the tax section (my minute of 27 February). I attach his latest version, with the amendments side-lined.

2. There are one or two specific points which you might like to note.

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(i) The Chancellor has decided, on balance, not to include Keith, so the Financial Secretary may want to mention it in his speech.

(ii) The Chancellor has also decided not to mention the consultative document on swaps in the Budget speech.

(iii) He has deleted the bulk of what was formerly paragraph 41 - the explanation of why other PEP modifications had been ruled out - but he feels this might usefully be developed for defensive briefing.

(iv) For the moment, he has retained a paragraph on deep discounted bonds, with the other CGT changes. But, depending on how he revises the first section of the speech, it is possible that these could be replaced by an allusion in a more general section on COBO.

3. He would be grateful if any further comments on this revise could reach me be close tomorrow, Tuesday 7 March.

MW

MOIRA WALLACE

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TAXPAYER CONFIDENTIALITY

Before I turn to my proposals for changes in taxation, I have one other change of a specific nature to announce.

2. As the House knows, the new official secrets legislation currently passing through Parliament is very much narrower in scope than the present Official Secrets Act. In particular, it does not cover information in the possession of either the Inland Revenue or Customs & Excise concerning the private affairs of specific taxpayers.

3. I am sure that the whole House will agree that it is essential for taxpayer confidentiality to be properly protected. I therefore propose to introduce provisions in this year's Finance Bill to ensure that it will continue to be 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.

4. I would only add that the need for this protection is in no sense a reflection on the probity and integrity of the members of those two Departments. Indeed, after nearly six years as Chancellor and more than eight years

as a Treasury Minister, I would like to take this opportunity to pay public tribute to the outstanding service I have consistently received from the officials of both Departments.

BUSINESS TAXATION

5. I now turn to taxation. As I have done on a number of previous occasions, I propose to divide this into three broad sections: the taxation of business, the taxation of savings, and the taxation of personal income and spending.

6. First, taxes on business.

7. Ever since the corporation tax reform I introduced in 1984, the rate of corporation tax for small companies, defined for this purpose as those with annual profits of less than £100,000, has been set at the basic rate of income tax, currently 25 per cent. Large companies, defined as those with profits of £1/2 million or more, pay the main rate of corporation tax of 35 per cent, one of the lowest rates of tax on company profits in the world. Between £100,000 and £½ million the effective rate of tax gradually rises from 25 to 35 per cent.

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8. I propose to keep the small companies rate in line with the basic rate of income tax for 1989-90 and to leave the main corporation tax rate unchanged . But I propose to increase the small companies' rate band substantially, by 50 per cent.

9. Thus the small companies' rate will apply to companies with profits of under £150,000, and the 35 per cent rate will only be reached at profits of £$^3/_4$ million. These changes will reduce the corporation tax burden for more than half of all those companies that do not already enjoy the benefit of the small companies rate.

10. I propose to increase the VAT threshold to £23,000, the maximum permitted under European Community law.

11. I also have to set the scales for the private use of company cars. This remains far and away the most widespread benefit in kind. When I doubled the car scales in last year's Budget, I made it clear that this still left it significantly undertaxed.

12. Accordingly, I propose to increase the car scales by one third for 1989-90. The yield from this will be £160 million in 1989-90 and £200 million in 1990-91. There will be no change in the fuel scales.

[13. There is one further tightening in the general area of employee benefits which I believe it right to make. There is an extra statutory concession which exempts from income tax additional housing costs paid by an employer when an existing employee moves to a higher cost area. This relief blunts the market forces which should be leading employers to relocate in lower cost areas, and I therefore propose that it should be withdrawn. Anyone who has moved, or entered into a commitment to move, before today will, however, continue to receive the relief. At the same time I propose to put on a proper statutory footing the more important and fully justified extra statutory concession exempting from tax payments made by an employer to cover an employee's inevitable moving costs when he is required to move house because of his job.]

14. Over the years I have received a steady stream of representations from business complaining about the long-standing tax treatment of foreign exchange gains and losses. I recognise that as business becomes more

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global this subject becomes increasingly important. However, I have to say that I find it one of the most intractable I have encountered. Certainly, there can be no question of any change in the present system until a number of crucial and complex issues have been satisfactorily resolved. I have therefore authorised the Inland Revenue to publish today a consultative document which explores those issues and examines the scope for reform.

15. Finally, I have two major simplifications to propose, both of which follow from the income tax reforms I introduced last Budget.

16. One of the many undesirable features of an income tax system with several higher rates was that since a taxpayer's marginal rate could well be very different in different years, the question of which year income was attributed to made a great deal of difference. To remove the scope for manipulation, the rule was that income was taxed in the year to which it related, on an accruals basis.

17. This is still the basis of Schedule E and poses no problem at all for the vast majority of employees, who are on PAYE. But for about half a million people,

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mainly directors, who do not receive their income in the year to which it formally relates, it causes untold complication, with needless form-filling long after the tax year is over. With only one higher rate of income tax, the potential for this abuse is gone. I therefore propose that income tax under Schedule E should in future be assessed on a receipts basis, with the simple principle that you pay the tax when you receive the income. Initially, this will have a transitional cost of £80 million, but in the long term it will yield both extra revenue and significant Inland Revenue staff savings.

18. The reduction in the top rate of income tax to 40 per cent in last year's Budget also enables me to make a major simplification of the tax treatment of that section of the small business sector known as close companies - generally, unquoted companies that are controlled by five or fewer people.

19. The rules for the so-called apportionment of close companies' income are notoriously complex, taking up some twenty pages of impenetrable legislation. These rules are no longer needed and I propose to abolish them. I believe that many [hundreds of thousands] of

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small businesses, and particularly family businesses, will welcome this substantial simplification.

20. I do, however, have to guard against the avoidance of tax on investment income by channelling it through a closely controlled investment company. Any such company which does not distribute most of its profits and other investment income will therefore be taxed at 40 per cent, equivalent to the higher rate of income tax.

TAXES ON SAVING

21. I now turn to the taxation of saving.

22. The sharp decline in the ratio of personal saving to personal income over the past two years in particular has led to even more discussion than usual of the merits of providing greater tax incentives for personal saving.

23. Certainly it is desirable that, over the medium-term, we generate as a nation a level of saving high enough to finance a high level of investment. But what matters in this context is not personal savings alone, but corporate savings too, which are running at historically high levels, and public sector savings,

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which have of course been boosted by the move to budget surplus.

24. Moreover, the fall in the personal savings ratio, which is of course measured in net terms, that is to say gross saving net of borrowing, has not occurred because gross saving has fallen; rather it is the result of the sharp increase in personal borrowing. And the appropriate remedy for that is to raise the cost of borrowing, and with it the return on saving, as we have done.

25. Above all, it is essential that tax reform is always seen in a medium-term, even a long-term time-scale. It is wholly inappropriate as an answer to what are essentially cyclical phenomena. In that context, the Government's policy is clear. It is to strengthen and deepen popular capitalism in Britain, by encouraging in particular wider share ownership.

26. The privatisation of the water and electricity industries is likely to provide a further impetus to popular capitalism over the next two years.

27. Meanwhile, I have a number of specific tax measures to announce today to the same end.

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28. Personal equity plans were first announced in my 1986 Budget, and started up in January 1987. As the House knows, those who invest in these plans pay no further tax at all, either on the dividends they receive or on any capital gains they may eventually make - indeed, there is no need for them to get involved with the Inland Revenue at all.

29. Personal equity plans got off to a good start, with over a quarter of a million investors, many who had never owned shares before, subscribing almost £$^1/_2$ billion between them in 1987.

30. Since then, however, the rate of growth has slowed down, not least as a result of the changed climate in the equity market since the October 1987 Stock Exchange crash.

31. So the time has come to improve and simplify PEPs and give them a new lease of life.

32. First, I propose to raise the annual limit on the overall amount that can be invested in a PEP from £3,000 to £4,800.

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33. Second, within that, I propose to raise substantially the amount that can be invested in unit trusts or investment trusts from £750 to £2,400 a year. Moreover, the requirement that the amount invested in unit or investment trusts should not exceed one-quarter of the total amount invested in a PEP will be dropped, and replaced simply by the requirement that, to qualify for investment through a PEP a unit or investment trust must invest wholly or mainly in UK equities.

34. Third, at present, only cash may be paid into a PEP. I propose that investors should also be permitted to place directly into a PEP shares obtained by subscribing to new equity issues, including privatisation issues.

35. Finally, I propose to make a number of important simplifications to the PEP rules so as to make the scheme more flexible, better directed to the needs of small and new investors, and cheaper to administer.

36. I am confident that the changes that I have announced today will enable personal equity plans to play an important part in stimulating individual ownership of British equity in the years ahead.

37. I also have a number of improvements to announce specifically designed to encourage employee share ownership.

38. It is a striking fact that the number of approved employee share schemes has risen from a mere 30 in 1979 to almost 1,600 today, involving 10,000 companies and benefiting some $1^3/_4$ million employees. At present the annual limits on the value of shares which can be given income tax-free to employees under all-employee profit-sharing schemes are £1,250 or 10 per cent of salary up to a ceiling of £5,000. I propose to raise these limits to £2,000 and £6,000 respectively.

39. Second, I propose to increase the monthly limit for contributions to all-employee save-as-you-earn share option schemes from £100 to £150, and at the same time to double the maximum discount from market value at which options may be granted from 10 per cent to 20 per cent.

40. Third, a number of my Hon. Friends have been concerned that current tax law may be inhibiting the development of employee share ownership plans, otherwise known as ESOPs. These are distinguished from ordinary approved employee share schemes by the fact that they

use a wider variety of finance, acquire more shares and tend to operate on a longer timescale. I propose to make it clear that companies' contributions to ESOPs qualify for corporation tax relief, provided they meet certain requirements designed to ensure that the employees acquire direct ownership of the shares within a reasonable time. I hope that this will encourage more British companies, particularly in the unquoted sector, to consider setting up ESOPs.

41. Those firms with employee share ownership schemes have no doubt that it helps to improve company performance, by giving the workforce a direct personal interest in its profitability and success. The same benefits can flow from profit related pay.

42. This was one of the reasons why, in my 1987 Budget, I introduced a tax relief to encourage its development. I have some improvements to make to this scheme, too.

43. First, as I have previously announced, I propose to abolish the restriction that, to qualify for the tax relief, profit-related pay must equal at least 5 per cent of total pay. Second, I propose to raise the limit on the annual amount of profit-related pay which can attract relief from £3,000 to £4,000.

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44. Third, I propose to enable employers to set up schemes for headquarters and other central units using the profits of the whole company or group for their profit calculations.

And fourth, to help share schemes and ESOPs as well as profit related pay, I propose ~~changing~~ to change the material interest rules which ~~be~~ may at present unnecessarily exclude employees from their schemes where they already benefit from a trust set up for employees.

45. Taken together, the package of measures I have announced to encourage wider share ownership in general, and employee share ownership in particular, will help to ensure that the idea of a share-owning democracy becomes ever more entrenched as a part of the British way of life.

46. I now turn to life assurance.

47. The tax regime for life assurance is <u>sui generis</u>. The present system dates back to the First World War and has developed over the years in a piecemeal way, leading to a state of affairs in which the incidence of tax is extremely uneven, with some successful life offices paying no tax at all.

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48. There is clearly a powerful case for reform, with a view to securing a tax regime which is more equitable both within the industry and as between life assurance and most other forms of savings. Accordingly, last July the Inland Revenue issued with my authority a major consultative document on the taxation of life assurance.

49. Since then, I have considered very carefully the representations the industry has made, and taken full account both of the changes to the regulation of life assurance proposed by the Securities and Investment Board under the Financial Services Act and the prospects for increased competition within the European Community after 1992. In the light of these factors, I have decided not to proceed with the more radical reforms canvassed in the consultative document. But I do have a number of important changes to propose, based for the most part on the general tax reform principle of seeking lower rates on a broader base.

50. First, many life offices run a pension business alongside their life assurance business, and they are not required to keep the two businesses separate for tax purposes. This enables them to set the unrelieved expenses of the pensions business against the income and gains of their life business, thus giving their life

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profits unduly favourable tax treatment. I propose to end this anomaly.

51. This change, which will come into force on 1 January 1990, will yield £155 million in 1990-91. The remainder of the changes I have to propose constitute a broadly balanced package which, because of the transitional provisions, will reduce the taxation of life assurance in 1990-91 by some £110 million.

52. I propose that the expenses incurred by life offices in attracting new business should continue to be fully deductible for tax purposes from the income and gains of life funds, but spread over a period of seven years rather than being deductible immediately, as now. To give the industry time to adjust, this change will be phased in gradually over the next four years, starting on 1 January, 1990.

53. There are certain other, even more technical matters raised in the consultative document which will require further discussion with the industry, and any legislative changes on these issues will have to wait for next year's Finance Bill.

54. But I can say here and now that I propose, as from 1 January 1990, to abolish Life Assurance Premium Duty. And I also propose, from the same date, to reduce the rate of tax payable on the income and gains of life offices, which at present stands at 35 per cent on unfranked investment income and 30 per cent on realised capital gains, to the basic rate of income tax.

55. The net revenue effect of this reform of the taxation of life assurance will be a cost of £20 million in 1989-90 and a yield of £45 million in 1990-91, rising somewhat in subsequent years.

56. But above all it will provide a more efficient and equitable tax regime for this most important industry.

57. Later this year, UK unit trusts will be able to compete freely in Europe and will face competition from analogous Community investment schemes here. At present, trusts investing in gilts or bonds face a tax disadvantage. They pay corporation tax at 35 per cent on their income but can pass on a credit of only the basic rate to their investor. So I propose that from 1 January 1990, as for life assurance companies, the corporation tax rate on unit trusts that come within the new European Community rules will be equal to the basic

rate of income tax. Their investors will then get full credit for all the tax the trusts pay.

58. I now turn to pensions.

59. Of all forms of savings, the most favourable tax treatment is that accorded to pension schemes. This is necessarily circumscribed by Inland Revenue rules.

60. But as a result, tax law has effectively come to set a limit on the overall pension someone can receive. This is neither desirable nor necessary. Accordingly, I propose to remove the obstacles in the way of employers setting up pension schemes to provide benefits above the tax limits. Such "top-up" schemes will carry no limit on benefits whatsoever, but, equally, will have no tax privileges. Thus, employers will henceforth be free to provide whatever pensions package they believe necessary to recruit and reward their employees.

61. This change enables me to deal with another anomaly in the existing tax reliefs for pensions; namely that there is no limit to them at all, in cash terms: the higher an individual's salary, the greater the pension they can have, and the more tax relief that goes with it. Of course, someone who receives a very

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high salary will expect a good pension. But given that one man's tax relief is another man's tax increase, and in the light of the income tax reforms I introduced last year, it is hard to justify a state of affairs in which the tax advantages of pension provision are effectively available with no upper limit whatever.

62. So long as the limits on tax relief effectively constrained total pension provision, it was not practicable to avoid this result. But dealing with the first anomaly makes it possible to act on the second.

63. I therefore propose to set a limit on the pensions which may be paid from tax-approved occupational schemes, based on earnings of £60,000 a year. I have deliberately set the ceiling at a level which will leave the vast majority of employees unaffected, and it will be subject to annual uprating in line with inflation. It will still be possible for a tax-approved occupational scheme to pay a pension of as much as £40,000 a year, of which up to £90,000 may be commuted for a tax-free lump sum.

64. The new ceiling will apply only to pension schemes set up, or to new members joining existing schemes, on or after today. And, as I have already said, there will

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now be complete freedom to provide benefits above the Inland Revenue limits, though without the tax advantages.

65. The introduction of this ceiling on tax relief also enables me to simplify and improve the rules for the majority of pension scheme members, in particular to improve the conditions under which people can take early retirement.

66. I also propose to simplify very substantially the rules concerning additional voluntary contributions or AVCs. In particular, the present requirements for free standing AVCs place a heavy administrative burden on employers at the point where an employee wants to start paying AVCs. In future, the necessary checks will be greatly reduced. In many cases employers will not need to be involved at all.

67. Furthermore, if AVC investments perform very well, occupational pensions may at present have to be reduced to keep total benefits within the permitted limits. I propose that in future any surplus AVC funds should be returned to employees, subject to a special tax charge. This will remove the penalty on good investment performance.

68. These changes should give a further impetus to saving through AVCs.

69. The most important development in the pensions field in recent years has undoubtedly been the introduction and success of personal pensions. Since July last year, a million people have already taken advantage of the new flexibility and opportunities these offer. I have two proposals today to make personal pensions still more attractive.

70. First, I propose to make it easier for people in personal pension schemes to manage their own investments. In general, pension savings have been highly institutionalised. There has been little opportunity for scheme members to be involved in the investment decisions taken on their behalf. I now propose to remove the obstacles to greater individual involvement in personal pension plans.

71. Second, I propose to increase substantially the annual limits, as a percentage of earnings, on contributions to personal pensions for those aged 35 and over. This will be of particular value to those running their own business, who are often unable to make

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contributions until later on in their working life. It will also improve the position of personal pensions in relation to occupational schemes. The new limits will be subject to an overall cash ceiling based on earnings of £60,000, corresponding to the new ceiling for occupational pensions, and similarly indexed.

72. These reforms build on, and complete, the pension measures I introduced in my 1987 Budget. They represent a significant deregulation which will allow more flexibility in a number of circumstances, while setting for the first time a reasonable limit on the tax relief available to any individual. They should give a boost, in particular, to saving through personal pensions and through AVCs.

73. The proposals I have announced for personal equity plans, for life assurance and for pensions amount to a significant further measure of tax reform, this time in the field of the taxation of saving.

74. But it should not be overlooked that a more far-reaching reform which I announced in last year's Budget, to come into effect in April 1990, may well have an even more marked effect in encouraging the growth of personal saving.

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75. I refer, of course, to Independent Taxation. For there can be little doubt that one of the greatest disincentives to saving in the present tax system is the treatment of the savings of married women. At present a wife's income from savings has to be disclosed to her husband and taxed at his marginal rate. Independent Taxation will change all that. In particular, those married women who have little or no earnings will in future be able to set their personal allowance against their savings income. Independent Taxation is a major reform. Preparations are well in hand for its introduction in April next year, and three new leaflets have just become available from Inland Revenue offices to explain all the main features of the new system.

TAXES ON SPENDING

76. I now turn to taxes on personal income and spending.

77. As the House knows Her Majesty's Government are obliged to implement the European Court's judgement that certain of our zero rates of VAT on supplies to business, notably on non-residential construction, are not lawful. This derives from the Court's

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certain transactions relating to land -

interpretation of the Community's Sixth VAT directive to - together with a number of minor changes in the VAT treatment of which the UK agreed in 1977. The necessary changes will be introduced in this year's Finance Bill, and draft clauses have already been published.

Minor property changes cd do with a mention.

×

78. In implementing the judgement I have sought to do as much as possible to minimise the burden. From 1 April VAT will be payable in respect of all non-residential construction unless carried out under ~~a contract~~ agreements entered into before the court ruling. And from 1 August landlords will have the option to tax rents, which means that in most cases no extra VAT will be paid at all.

×

(This is rather misleading - the £450m & £110m are the full year figures)

79. These measures ~~of mitigation~~ will reduce the burden of the construction changes on the private sector ~~from £450 million~~ to just £35 million in the first year rising to £110 million in ~~a full year~~ 1992-93. There will also be a first year yield of £~~xyz~~ 250 million from construction carried out by the public sector, which has been fully taken into account in the Public Expenditure plans already announced.

Without them, the yield from construction wd have been £450 million by 1992-93.

Do we need to quote this figure? It will not appear elsewhere and seems likely to provoke awkward rather than helpful comment

80. VAT will not be payable until July 1990 on water for industry or on fuel and power - and then only on business users above a specified threshold. Private households will remain zero rated.

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81. I have been particularly concerned about the impact of the European Court's ruling on charities. Unfortunately charities' business activities cannot lawfully be shielded from the effects of the ruling but I have been able to retain zero-rates for construction, water, fuel and power for all charities' non-business activities and for most ~~non-~~residential accommodation such as old people's homes, students hostels and hospices, as well as churches.

(not accommodation!)

82. In these special circumstances, I have considered whether there is anything further I can sensibly do to assist charities with their VAT bills. Accordingly, I propose to relieve charities from VAT on fund raising events, on sterilising equipment for medical use, and on classified advertising.

83. I also propose to relieve from car tax cars leased to the disabled. This is equivalent to a saving of about £40 on each vehicle leased to a disabled person. ~~[Add, if possible, statistics on benefit to individual.]~~

This wording has been carefully chosen! Exactly how the benefit per car wd be passed on to lessees is a matter for Motability.

84. But in general, I continue to believe that the best way of helping charitable causes through the tax system is by directly encouraging the act of charitable giving. The Payroll Giving Scheme, which I introduced in my 1986 Budget, has been growing steadily. Some

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3,400 schemes have now been set up, and over 100,000 employees are already participating, quite a few of them giving the full £240 annual limit. I now propose to double that limit to £480, or £40 a month.

85. But for the Payroll Giving Scheme to achieve its full potential, it is clearly necessary for the charities themselves, and others involved, to mount a major information and marketing campaign about it. I am particularly glad that my noble Friend, the Viscount Whitelaw, has agreed to become Chairman of the new Payroll Giving Association, which will co-ordinate efforts in this field.

86. I now turn to the excise duties.

87. The damage to the environment in general, and to child health in particular, from lead in the atmosphere, and the contribution of ordinary leaded petrol to this problem, is increasingly widely known. The government is committed to phasing out leaded petrol altogether, and in successive Budgets I have sought to assist this. I first introduced a tax differential in favour of unleaded petrol in 1987, and increased it last year. But although sales are undoubtedly rising, unleaded petrol still accounts for only some 5 per cent of total

petrol sales, even though two-thirds of the cars now on the road could use it, either without any adjustment or else with ~~a conversion~~ an adjustment costing only some £20 or so.

This is DoE's preferred terminology!

88. One of the problems is ignorance of the facts. Many motorists do not realise that their cars can already use unleaded petrol. Many others are unaware how modest the ~~conversion~~ adjustment cost is. Many are under the false impression that, if they do switch to unleaded petrol, their cars will no longer be able to use leaded petrol. Others wrongly imagine that their car's performance would suffer were they to use unleaded fuel.

89. It is clearly essential that these myths are rapidly dispelled. Meanwhile, I propose to take the opportunity of this Budget to increase still further the tax differential in favour of unleaded petrol, by reducing the tax on it by nearly fourpence a gallon. If this reduction is fully passed on to the customer - and I look to the oil companies to see that it is - it means that the price of unleaded petrol at the pump will ~~generally~~ typically be some ~~ninepence~~ nearly tenpence a gallon, or ~~twopence~~ just over twopence a litre, cheaper than four star leaded petrol. This will be one of the most substantial differentials between the

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price of leaded and unleaded petrol within the European Community.

90. But I do not intend to stop there. I also propose to raise the tax on two and three star petrol by roughly fourpence a gallon, so that the pump price of these grades will be as at least high as that of four star. This should encourage garages to phase out two star petrol, which is already down to about 6 per cent of the total market, thus enabling them to switch storage capacity ~~and in some cases a pump, too,~~ to unleaded petrol - quite apart from the incentive to the remaining two-star users to switch to unleaded fuel.

The differential between 2* & 4* is narrowing all the time, so it seems sensible to add 'at least'.

superfluous

91. I am confident that the duty changes I have announced, which will take effect from six o'clock this evening, will help to lead to a marked increased in the use of unleaded petrol over the next twelve months.

92. They will of course also lead to a loss of revenue of some £40 million in 1989-90. I propose to recoup this from Vehicle Excise Duty. A the present time a bus or a coach has to have 66 seats before it pays as much in Vehicle Excise Duty as a family car. I propose to rectify this anomaly by increasing the tax rates of this group of vehicles so that they cover their track costs.

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I also propose to increase the rates of duty for the heaviest non-articulated lorries, to put them on a more equal footing with articulated lorries. These changes will also simplify the system, reducing the number of separate rates of Vehicle Excise Duty from 220 to 70.

93. I have no further changes to propose this year in the rates of excise duty.

TAXATION OF INCOME

94. Nor do I propose any change this year to either the basic or higher rate of income tax.

95. Since I aligned the rates of income and capital gains tax in last year's Budget, it follows that I also propose no change this year in the capital gains tax rates. However, I do have a few changes to capital gains tax to propose.

96. With the advent of independent taxation from April 1990, married women will acquire their own capital gains tax threshold, so that a married couple will enjoy two such exemptions. In the light of this, I propose to maintain the capital gains tax threshold at £5,000 for 1989-90.

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97. Second, I propose to abolish the general holdover relief for gifts.

98. This was rightly introduced by my predecessor in 1980, when there was still capital transfer tax on lifetime gifts, in order to avoid a form of double taxation. But the tax on lifetime giving has since been abolished, and the relief is increasingly used as a simple form of tax avoidance.

99. But while the general holdover relief will go, I propose to retain it for gifts of business, farm and heritage assets, and also for all gifts to charities. And of course gifts between husband and wife will continue to be exempt.

100. In the case of gifts of personal belongings, these benefit from chattels relief, under which any items worth less than £3000 on disposal are entirely exempt from capital gains tax. I propose to double the chattels exemption limit for capital gains tax to £6000.

101. The last of these three capital gains tax proposals is to change the tax treatment of certain bonds so as to simplify the tax rules and prevent a loss

of yield by the use of indexation to create losses and the conversion of income into capital gains.

102. To return to income tax, I propose to raise all the main income tax thresholds and allowances by the statutory indexation factor of 6.8 per cent, rounded up. Thus the single person's allowance will rise by £180 to £2,785, and the married man's allowance will rise by £280 to £4,375. The basic rate limit will rise by £1,400 to £20,700.

103. The single age allowance will rise by £220 to £3,400, and the married age allowance by £350 to £5,385. The higher level of age allowance will rise by £230 to £3540 for a single person, and by £360 to £5565 for a married couple.

104. I propose a number of measures to help the elderly. In 1987 I introduced a new higher age allowance, for those over 80. I now propose to extend this to all aged 75 and over. This will take an additional 15,000 elderly single people and married couples out of tax altogether. As a result, three quarters of all those over 75 will not be liable to income tax at all.

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105. The income limit for the age allowance will rise by £800 to £11,400, again in line with indexation. However, I propose to reduce the rate at which the age allowance is withdrawn above this income limit. I propose that in future it should be withdrawn at the rate of £1 of allowance for each £2 of income above the limit, instead of the present withdrawal rate of £2 in every £3. This means that the marginal tax rate for those in the withdrawal band will be reduced to well below 40 per cent, thus meeting a large number of representations I received last year.

106. The Finance Bill will also include the provisions to establish the new tax relief for the over 60s health insurance premiums, which I announced to the House in January, and which will take effect from April next year, at a cost of £40 million in 1990-91.

107. I have one further change to make to help pensioners. Under the earnings rule, any pensioner who decides to continue to work after reaching the statutory retirement age has his or her pension docked at a rate of 50 per cent on every £1 earned between £75 and £79 a week, rising to 100 per cent for every £1 earned over £79 a week.

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108. The Manifesto on which we were first elected in 1979 acknowledged that it was wrong to discourage people who wished to work beyond retirement age in this way, and pledged that we would phase out this earnings rule.

109. That is precisely what we shall do. My Rt.Hon Friend the Secretary of State for Social Services and I have agreed that the pensioners' earnings rule should be abolished as from 2 October, the earliest practicable date. The necessary legislation will be included in the Social Security Bill currently before the House.

110. The cost to public expenditure will be £125 million in 1989-90, which will be entirely met from the Reserve. But the net cost of this measure will of course be reduced by the increased income tax payable on increased pensions.

111. Those who wish to defer taking their pension will, of course, remain entirely free to do so, and will continue to earn a higher pension in return.

112. I am sure the whole House will welcome this long overdue reform.

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113. If one were to adopt the so-called "duck test" now in vogue across the Atlantic, the pensioners' earnings rule would probably qualify as a tax, and I would now be able to claim to have abolished a sixth tax. But sound tax principles coupled with my innate modesty and natural reticence prevent me from doing so.

NATIONAL INSURANCE CONTRIBUTIONS

114. I have one further measure to propose.

115. It has long been a feature of the National Insurance system that, once people earn more than the lower earnings limit, which in 1989-90 will be £43, they have to pay National Insurance contributions at the same rate on the whole of their earnings up to the upper earnings limit. There are currently three different rates - 5 per cent and 7 per cent for those on low pay and the standard rate of 9 per cent,

116. The two reduced rates, which I introduced for both employers and employees in my 1985 Budget, cut the cost of employing the young and unskilled, among whom unemployment was then high and rising, and cut the

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burden of national insurance contributions on the very low paid. But the highly desirable reduction in the steep step at the lower earnings limit was at the expense of two small steps further up the earnings scale. This inevitably means that, at certain points on the income scale, people can still be worse off if they earn more. Their extra earnings take them from a lower rate band to a higher one, and they therefore lose more in National Insurance contributions than they gain in extra pay.

117. In agreement with my Rt Hon Friend the Secretary of State for Social Security, I now propose to complete my 1985 reform. For everyone who pays employee National Insurance contributions, I propose to reduce to only 2 per cent the rate of contributions on earnings up to and including the lower earnings limit. On earnings above that limit, there will be a single rate of 9 per cent, up to the upper earnings limit, which has already been set for 1989-90 at £325 a week.

118. This will abolish altogether the steps which at present exist at earnings, for 1989-90, of £75 and £115 a week. The step which has always existed at the lower earnings limit, where people first come into the National Insurance system, is the entry ticket to the

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full array of contributory benefits. As such, it is an essential feature of the contributory principle. But my proposals will further reduce this step very considerably, to only 86 pence a week in 1989-90.

119. There will be no change in the contributions payable by employers.

120. This reform will significantly reduce the burden of employees' National Insurance contributions across the board. For the lowest paid, that burden is now heavier than the burden of income tax. This is the most effective measure I can take to lighten it. For everyone on half average earnings or more, the reform will leave them £3 a week more of their own money; and most of the benefit will go to those below average earnings.

121. The chances will take effect from 1 October, the earliest practicable date. The cost will be some £1 billion in 1989-90 and £2,800 million in 1990-91. The necessary legislation will be included in the Social Security Bill currently before the House.

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122. The total additional cost of all the measures in this Budget, on an indexed basis, is under £2 billion in 1989-90 and £3$^{1}/_{2}$ billion in 1990-91.

[Peroration to follow]

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MPW/89/6

REF
COPY NO 42 OF 42. COPIES

FROM: MISS M P WALLACE
DATE: 6 March 1989

PS/FINANCIAL SECRETARY

PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Dame A Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Mr Sedgwick
Mr Riley
Mr A C S Allan
Mr Gieve
Mr Gilhooly
Mr Matthews
Mr Pickford
Mr Macpherson
Mr Michie
Miss Hay
Miss Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

Sir A Battishill - IR
Mr Beighton - IR
Mr Isaac - IR
Mr Painter - IR
Mr G Bush - IR
Mr C McNicol IR [+1]

Mr Unwin - C&E
Mr Jefferson Smith - C&E
Mr P R H Allen - C&E
Ms A French - C&E [+1]

BUDGET STATEMENT: TAX SECTION

The Chancellor was most grateful to all those who commented on last week's version of the tax section (my minute of 27 February). ... I attach his latest version, with the amendments side-lined.

2. There are one or two specific points which you might like to note.

(i) The Chancellor has decided, on balance, not to include Keith, so the Financial Secretary may want to mention it in his speech.

(ii) The Chancellor has also decided not to mention the consultative document on swaps in the Budget speech.

(iii) He has deleted the bulk of what was formerly paragraph 41 - the explanation of why other PEP modifications had been ruled out - but he feels this might usefully be developed for defensive briefing.

(iv) For the moment, he has retained a paragraph on deep discounted bonds, with the other CGT changes. But, depending on how he revises the first section of the speech, it is possible that these could be replaced by an allusion in a more general section on COBO.

3. He would be grateful if any further comments on this revise could reach me be close tomorrow, Tuesday 7 March.

MW.

MOIRA WALLACE

TAXPAYER CONFIDENTIALITY

Before I turn to my proposals for changes in taxation, I have one other change of a specific nature to announce.

2. As the House knows, the new official secrets legislation currently passing through Parliament is very much narrower in scope than the present Official Secrets Act. In particular, it does not cover information in the possession of either the Inland Revenue or Customs & Excise concerning the private affairs of specific taxpayers.

3. I am sure that the whole House will agree that it is essential for taxpayer confidentiality to be properly protected. I therefore propose to introduce provisions in this year's Finance Bill to ensure that it will continue to be 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.

4. I would only add that the need for this protection is in no sense a reflection on the probity and integrity of the members of those two Departments. Indeed, after nearly six years as Chancellor and more than eight years

as a Treasury Minister, I would like to take this opportunity to pay public tribute to the outstanding service I have consistently received from the officials of both Departments.

BUSINESS TAXATION

5. I now turn to taxation. As I have done on a number of previous occasions, I propose to divide this into three broad sections: the taxation of business, the taxation of savings, and the taxation of personal income and spending.

6. First, taxes on business.

7. Ever since the corporation tax reform I introduced in 1984, the rate of corporation tax for small companies, defined for this purpose as those with annual profits of less than £100,000, has been set at the basic rate of income tax, currently 25 per cent. Large companies, defined as those with profits of £$^1/_2$ million or more, pay the main rate of corporation tax of 35 per cent, one of the lowest rates of tax on company profits in the world. Between £100,000 and £½ million the effective rate of tax gradually rises from 25 to 35 per cent.

8. I propose to keep the small companies rate in line with the basic rate of income tax for 1989-90 and to leave the main corporation tax rate unchanged . But I propose to increase the small companies' rate band substantially, by 50 per cent.

9. Thus the small companies' rate will apply to companies with profits of under £150,000, and the 35 per cent rate will only be reached at profits of £$^3/_4$ million. These changes will reduce the corporation tax burden for more than half of all those companies that do not already enjoy the benefit of the small companies rate.

10. I propose to increase the VAT threshold to £23,600, the maximum permitted under European Community law.

11. I also have to set the scales for the private use of company cars. This remains far and away the most widespread benefit in kind. When I doubled the car scales in last year's Budget, I made it clear that this still left it significantly undertaxed.

12. Accordingly, I propose to increase the car scales by one third for 1989-90. The yield from this will be £160 million in 1989-90 and £200 million in 1990-91. There will be no change in the fuel scales.

13. There is one further tightening in the general area of employee benefits which I believe it right to make. There is an extra statutory concession which exempts from income tax additional housing costs paid by an employer when an existing employee moves to a higher cost area. This relief blunts the market forces which should be leading employers to relocate in lower cost areas, and I therefore propose that it should be withdrawn. Anyone who has moved, or entered into a commitment to move, before today will, however, continue to receive the relief. At the same time I propose to put on a proper statutory footing the more important and fully justified extra statutory concession exempting from tax payments made by an employer to cover an employee's inevitable moving costs when he is required to move house because of his job.

14. Over the years I have received a steady stream of representations from business complaining about the long-standing tax treatment of foreign exchange gains and losses. I recognise that as business becomes more

global this subject becomes increasingly important. However, I have to say that I find it one of the most intractable I have encountered. Certainly, there can be no question of any change in the present system until a number of crucial and complex issues have been satisfactorily resolved. I have therefore authorised the Inland Revenue to publish today a consultative document which explores those issues and examines the scope for reform.

15. Finally, I have two major simplifications to propose, both of which follow from the income tax reforms I introduced last Budget.

16. One of the many undesirable features of an income tax system with several higher rates was that since a taxpayer's marginal rate could well be very different in different years, the question of which year income was attributed to made a great deal of difference. To remove the scope for manipulation, the rule was that income was taxed in the year to which it related, on an accruals basis.

17. This is still the basis of Schedule E and poses no problem at all for the vast majority of employees, who are on PAYE. But for about half a million people,

mainly directors, who do not receive their income in the year to which it formally relates, it causes untold complication, with needless form-filling long after the tax year is over. With only one higher rate of income tax, the potential for this abuse is gone. I therefore propose that income tax under Schedule E should in future be assessed on a receipts basis, with the simple principle that you pay the tax when you receive the income. Initially, this will have a transitional cost of £80 million, but in the long term it will yield both extra revenue and significant Inland Revenue staff savings.

18. The reduction in the top rate of income tax to 40 per cent in last year's Budget also enables me to make a major simplification of the tax treatment of that section of the small business sector known as close companies - generally, unquoted companies that are controlled by five or fewer people.

19. The rules for the so-called apportionment of close companies' income are notoriously complex, taking up some twenty pages of impenetrable legislation. These rules are no longer needed and I propose to abolish them. I believe that many [hundreds of thousands] of

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small businesses, and particularly family businesses, will welcome this substantial simplification.

20. I do, however, have to guard against the avoidance of tax on investment income by channelling it through a closely controlled investment company. Any such company which does not distribute most of its profits and other investment income will therefore be taxed at 40 per cent, equivalent to the higher rate of income tax.

TAXES ON SAVING

21. I now turn to the taxation of saving.

22. The sharp decline in the ratio of personal saving to personal income over the past two years in particular has led to even more discussion than usual of the merits of providing greater tax incentives for personal saving.

23. Certainly it is desirable that, over the medium-term, we generate as a nation a level of saving high enough to finance a high level of investment. But what matters in this context is not personal savings alone, but corporate savings too, which are running at historically high levels, and public sector savings,

which have of course been boosted by the move to budget surplus.

24. Moreover, the fall in the personal savings ratio, which is of course measured in net terms, that is to say gross saving net of borrowing, has not occurred because gross saving has fallen; rather it is the result of the sharp increase in personal borrowing. And the appropriate remedy for that is to raise the cost of borrowing, and with it the return on saving, as we have done.

25. Above all, it is essential that tax reform is always seen in a medium-term, even a long-term time-scale. It is wholly inappropriate as an answer to what are essentially cyclical phenomena. In that context, the Government's policy is clear. It is to strengthen and deepen popular capitalism in Britain, by encouraging in particular wider share ownership.

26. The privatisation of the water and electricity industries is likely to provide a further impetus to popular capitalism over the next two years.

27. Meanwhile, I have a number of specific tax measures to announce today to the same end.

28. Personal equity plans were first announced in my 1986 Budget, and started up in January 1987. As the House knows, those who invest in these plans pay no further tax at all, either on the dividends they receive or on any capital gains they may eventually make - indeed, there is no need for them to get involved with the Inland Revenue at all.

29. Personal equity plans got off to a good start, with over a quarter of a million investors, many who had never owned shares before, subscribing almost £$^1/_2$ billion between them in 1987.

30. Since then, however, the rate of growth has slowed down, not least as a result of the changed climate in the equity market since the October 1987 Stock Exchange crash.

31. So the time has come to improve and simplify PEPs and give them a new lease of life.

32. First, I propose to raise the annual limit on the overall amount that can be invested in a PEP from £3,000 to £4,800.

33. Second, within that, I propose to raise substantially the amount that can be invested in unit trusts or investment trusts from £750 to £2,400 a year. Moreover, the requirement that the amount invested in unit or investment trusts should not exceed one-quarter of the total amount invested in a PEP will be dropped, and replaced simply by the requirement that, to qualify for investment through a PEP a unit or investment trust must invest wholly or mainly in UK equities.

34. Third, at present, only cash may be paid into a PEP. I propose that investors should also be permitted to place directly into a PEP shares obtained by subscribing to new equity issues, including privatisation issues.

35. Finally, I propose to make a number of important simplifications to the PEP rules so as to make the scheme more flexible, better directed to the needs of small and new investors, and cheaper to administer.

36. I am confident that the changes that I have announced today will enable personal equity plans to play an important part in stimulating individual ownership of British equity in the years ahead.

37. I also have a number of improvements to announce specifically designed to encourage employee share ownership.

38. It is a striking fact that the number of approved employee share schemes has risen from a mere 30 in 1979 to almost 1,600 today, involving 10,000 companies and benefiting some $1^3/_4$ million employees. At present the annual limits on the value of shares which can be given income tax-free to employees under all-employee profit-sharing schemes are £1,250 or 10 per cent of salary up to a ceiling of £5,000. I propose to raise these limits to £2,000 and £6,000 respectively.

39. Second, I propose to increase the monthly limit for contributions to all-employee save-as-you-earn share option schemes from £100 to £150, and at the same time to double the maximum discount from market value at which options may be granted from 10 per cent to 20 per cent.

40. Third, a number of my Hon. Friends have been concerned that current tax law may be inhibiting the development of employee share ownership plans, otherwise known as ESOPs. These are distinguished from ordinary approved employee share schemes by the fact that they

use a wider variety of finance, acquire more shares and tend to operate on a longer timescale. I propose to make it clear that companies' contributions to ESOPs qualify for corporation tax relief, provided they meet certain requirements designed to ensure that the employees acquire direct ownership of the shares within a reasonable time. I hope that this will encourage more British companies, particularly in the unquoted sector, to consider setting up ESOPs.

41. Those firms with employee share ownership schemes have no doubt that it helps to improve company performance, by giving the workforce a direct personal interest in its profitability and success. The same benefits can flow from profit related pay.

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42. This was one of the reasons why, in my 1987 Budget, I introduced a tax relief to encourage its development. I have some improvements to make to this scheme, too.

43. First, as I have previously announced, I propose to abolish the restriction that, to qualify for the tax relief, profit-related pay must equal at least 5 per cent of total pay. Second, I propose to raise the limit on the annual amount of profit-related pay which can attract relief from £3,000 to £4,000.

44. Third, I propose to enable employers to set up schemes for headquarters and other central units using the profits of the whole company or group for their profit calculations. And fourth, to help share schemes and ESOPs as well as profit related pay, I propose ~~changing~~ to change the material interest rules which ~~be~~ may at present unnecessarily exclude employees from their schemes where they already benefit from a trust set up for employees.

45. Taken together, the package of measures I have announced to encourage wider share ownership in general, and employee share ownership in particular, will help to ensure that the idea of a share-owning democracy becomes ever more entrenched as a part of the British way of life.

46. I now turn to life assurance.

47. The tax regime for life assurance is sui generis. The present system dates back to the First World War and has developed over the years in a piecemeal way, leading to a state of affairs in which the incidence of tax is extremely uneven, with some successful life offices paying no tax at all.

48. There is clearly a powerful case for reform, with a view to securing a tax regime which is more equitable both within the industry and as between life assurance and most other forms of savings. Accordingly, last July the Inland Revenue issued with my authority a major consultative document on the taxation of life assurance.

49. Since then, I have considered very carefully the representations the industry has made, and taken full account both of the changes to the regulation of life assurance proposed by the Securities and Investment Board under the Financial Services Act and the prospects for increased competition within the European Community after 1992. In the light of these factors, I have decided not to proceed with the more radical reforms canvassed in the consultative document. But I do have a number of important changes to propose, based for the most part on the general tax reform principle of seeking lower rates on a broader base.

50. First, many life offices run a pension business alongside their life assurance business, and they are not required to keep the two businesses separate for tax purposes. This enables them to set the unrelieved expenses of the pensions business against the income and gains of their life business, thus giving their life

profits unduly favourable tax treatment. I propose to end this anomaly.

51. This change, which will come into force on 1 January 1990, will yield £155 million in 1990-91. The remainder of the changes I have to propose constitute a broadly balanced package which, because of the transitional provisions, will reduce the taxation of life assurance in 1990-91 by some £110 million.

52. I propose that the expenses incurred by life offices in attracting new business should continue to be fully deductible for tax purposes from the income and gains of life funds, but spread over a period of seven years rather than being deductible immediately, as now. To give the industry time to adjust, this change will be phased in gradually over the next four years, starting on 1 January, 1990.

53. There are certain other, even more technical matters raised in the consultative document which will require further discussion with the industry, and any legislative changes on these issues will have to wait for next year's Finance Bill.

54. But I can say here and now that I propose, as from 1 January 1990, to abolish Life Assurance Premium Duty. And I also propose, from the same date, to reduce the rate of tax payable on the income and gains of life offices, which at present stands at 35 per cent on unfranked investment income and 30 per cent on realised capital gains, to the basic rate of income tax.

55. The net revenue effect of this reform of the taxation of life assurance will be a cost of £20 million in 1989-90 and a yield of £45 million in 1990-91, rising somewhat in subsequent years.

56. But above all it will provide a more efficient and equitable tax regime for this most important industry.

57. Later this year, UK unit trusts will be able to compete freely in Europe and will face competition from analogous Community investment schemes here. At present, trusts investing in gilts or bonds face a tax disadvantage. They pay corporation tax at 35 per cent on their income but can pass on a credit of only the basic rate to their investor. So I propose that from 1 January 1990, as for life assurance companies, the corporation tax rate on unit trusts that come within the new European Community rules will be equal to the basic

75. I refer, of course, to Independent Taxation. For there can be little doubt that one of the greatest disincentives to saving in the present tax system is the treatment of the savings of married women. At present a wife's income from savings has to be disclosed to her husband and taxed at his marginal rate. Independent Taxation will change all that. In particular, those married women who have little or no earnings will in future be able to set their personal allowance against their savings income. Independent Taxation is a major reform. Preparations are well in hand for its introduction in April next year, and three new leaflets have just become available from Inland Revenue offices to explain all the main features of the new system.

TAXES ON SPENDING

76. I now turn to taxes on personal income and spending.

77. As the House knows Her Majesty's Government are obliged to implement the European Court's judgement that certain of our zero rates of VAT on supplies to business, notably on non-residential construction, are not lawful. This derives from the Court's

interpretation of the Community's Sixth VAT directive to which the UK agreed in 1977. The necessary changes will be introduced in this year's Finance Bill, and draft clause have already been published.

78. In implementing the judgement I have sought to do as much as possible to minimise the burden. From 1 April VAT will be payable in respect of all non-residential construction unless carried out under a contract entered into before the court ruling. And from 1 August landlords will have the option to tax rents, which mean that in most cases no extra VAT will be paid at all.

79. These measures of mitigation will reduce the burden on the private sector from £450 million to just £35 million in the first year rising to £110 million in a full year. There will also be a yield of £xyz million from the public sector, which has been fully taken into account in the Public Expenditure plans already announced.

80. VAT will not be payable until July 1990 on water for industry or on fuel and power - and then only on business users above a specified threshold. Private households will remain zero rated.

81. I have been particularly concerned about the impact of the European Court's ruling on charities. Unfortunately charities' business activities cannot lawfully be shielded from the effects of the ruling but I have been able to retain zero-rates for construction, water, fuel and power for all charities' non-business activities and for most non-residential accommodation such as old people's homes, students hostels and hospices as well as churches.

82. In these special circumstances, I have considered whether there is anything further I can sensibly do to assist charities with their VAT bills. Accordingly, I propose to relieve charities from VAT on fund raising events, on sterilising equipment for medical use, and on classified advertising.

83. I also propose to relieve from car tax cars leased to the disabled. [Add, if possible, statistics on benefit to individual.]

84. But in general, I continue to believe that the best way of helping charitable causes through the tax system is by directly encouraging the act of charitable giving. The Payroll Giving Scheme, which I introduced in my 1986 Budget, has been growing steadily. Some

3,400 schemes have now been set up, and over 100,000 employees are already participating, quite a few of them giving the full £240 annual limit. I now propose to double that limit to £480, or £40 a month.

85. But for the Payroll Giving Scheme to achieve its full potential, it is clearly necessary for the charities themselves, and others involved, to mount a major information and marketing campaign about it. I am particularly glad that my noble Friend, the Viscount Whitelaw, has agreed to become Chairman of the new Payroll Giving Association, which will co-ordinate efforts in this field.

86. I now turn to the excise duties.

87. The damage to the environment in general, and to child health in particular, from lead in the atmosphere, and the contribution of ordinary leaded petrol to this problem, is increasingly widely known. The government is committed to phasing out leaded petrol altogether, and in successive Budgets I have sought to assist this. I first introduced a tax differential in favour of unleaded petrol in 1987, and increased it last year. But although sales are undoubtedly rising, unleaded petrol still accounts for only some 5 per cent of total

petrol sales, even though two-thirds of the cars now on the road could use it, either without any adjustment or else with a conversion costing only some £20 or so.

88. One of the problems is ignorance of the facts. Many motorists do not realise that their cars can already use unleaded petrol. Many others are unaware how modest the conversion cost is. Many are under the false impression that, if they do switch to unleaded petrol, their cars will no longer be able to use leaded petrol. Others wrongly imagine that their car's performance would suffer were they to use unleaded fuel.

89. It is clearly essential that these myths are rapidly dispelled. Meanwhile, I propose to take the opportunity of this Budget to increase still further the tax differential in favour of unleaded petrol, by reducing the tax on it by nearly fourpence a gallon. If this reduction is fully passed on to the customer - and I look to the oil companies to see that it is - it means that the price of unleaded petrol at the pump will generally be some ninepence a gallon, or twopence a litre, cheaper than four star leaded petrol. This will be one of the most substantial differentials between the

price of leaded and unleaded petrol within the European Community.

90. But I do not intend to stop there. I also propose to raise the tax on two and three star petrol by roughly fourpence a gallon, so that the pump price of these grades will be as high as that of four star. This should encourage garages to phase out two star petrol, which is already down to about 6 per cent of the total market, thus enabling them to switch storage capacity and in some cases a pump, too, to unleaded petrol - quite apart from the incentive to the remaining two-star users to switch to unleaded fuel.

91. I am confident that the duty changes I have announced, which will take effect from six o'clock this evening, will help to lead to a marked increased in the use of unleaded petrol over the next twelve months.

92. They will of course also lead to a loss of revenue of some £40 million in 1989-90. I propose to recoup this from Vehicle Excise Duty. A the present time a bus or a coach has to have 66 seats before it pays as much in Vehicle Excise Duty as a family car. I propose to rectify this anomaly by increasing the tax rates of this group of vehicles so that they cover their track costs.

I also propose to increase the rates of duty for the heaviest non-articulated lorries, to put them on a more equal footing with articulated lorries. These changes will also simplify the system, reducing the number of separate rates of Vehicle Excise Duty from 220 to 70.

93. I have no further changes to propose this year in the rates of excise duty.

TAXATION OF INCOME

94. Nor do I propose any change this year to either the basic or higher rate of income tax.

95. Since I aligned the rates of income and capital gains tax in last year's Budget, it follows that I also propose no change this year in the capital gains tax rates. However, I do have a few changes to capital gains tax to propose.

96. With the advent of independent taxation from April 1990, married women will acquire their own capital gains tax threshold, so that a married couple will enjoy two such exemptions. In the light of this, I propose to maintain the capital gains tax threshold at £5,000 for 1989-90.

97. Second, I propose to abolish the general holdover relief for gifts.

98. This was rightly introduced by my predecessor in 1980, when there was still capital transfer tax on lifetime gifts, in order to avoid a form of double taxation. But the tax on lifetime giving has since been abolished, and the relief is increasingly used as a simple form of tax avoidance.

99. But while the general holdover relief will go, I propose to retain it for gifts of business, farm and heritage assets, and also for all gifts to charities. And of course gifts between husband and wife will continue to be exempt.

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of yield by the use of indexation to create losses and the conversion of income into capital gains.

102. To return to income tax, I propose to raise all the main income tax thresholds and allowances by the statutory indexation factor of 6.8 per cent, rounded up. Thus the single person's allowance will rise by £180 to £2,785, and the married man's allowance will rise by £280 to £4,375. The basic rate limit will rise by £1,400 to £20,700.

103. The single age allowance will rise by £220 to £3,400, and the married age allowance by £350 to £5,385. The higher level of age allowance will rise by £230 to £3540 for a single person, and by £360 to £5565 for a married couple.

104. I propose a number of measures to help the elderly. In 1987 I introduced a new higher age allowance, for those over 80. I now propose to extend this to all aged 75 and over. This will take an additional 15,000 elderly single people and married couples out of tax altogether. As a result, three quarters of all those over 75 will not be liable to income tax at all.

105. The income limit for the age allowance will rise by £800 to £11,400, again in line with indexation. However, I propose to reduce the rate at which the age allowance is withdrawn above this income limit. I propose that in future it should be withdrawn at the rate of £1 of allowance for each £2 of income above the limit, instead of the present withdrawal rate of £2 in every £3. This means that the marginal tax rate for those in the withdrawal band will be reduced to well below 40 per cent, thus meeting a large number of representations I received last year.

106. The Finance Bill will also include the provisions to establish the new tax relief for the over 60s health insurance premiums, which I announced to the House in January, and which will take effect from April next year, at a cost of £40 million in 1990-91.

107. I have one further change to make to help pensioners. Under the earnings rule, any pensioner who decides to continue to work after reaching the statutory retirement age has his or her pension docked at a rate of 50 per cent on every £1 earned between £75 and £79 a week, rising to 100 per cent for every £1 earned over £79 a week.

108. The Manifesto on which we were first elected in 1979 acknowledged that it was wrong to discourage people who wished to work beyond retirement age in this way, and pledged that we would phase out this earnings rule.

109. That is precisely what we shall do. My Rt.Hon Friend the Secretary of State for Social Services and I have agreed that the pensioners' earnings rule should be abolished as from 2 October, the earliest practicable date. The necessary legislation will be included in the Social Security Bill currently before the House.

110. The cost to public expenditure will be £125 million in 1989-90, which will be entirely met from the Reserve. But the net cost of this measure will of course be reduced by the increased income tax payable on increased pensions.

111. Those who wish to defer taking their pension will, of course, remain entirely free to do so, and will continue to earn a higher pension in return.

112. I am sure the whole House will welcome this long overdue reform.

MP

FST

FROM: FINANCIAL SECRETARY
DATE: 7 March 1989

Thanks. On balance, prefer to leave pensions note as is. Other pts taken on board.

annotated except pensions

CHANCELLOR

BUDGET STATEMENT: TAX SECTION

I had the following comments on the draft attached to Miss Wallace's minute of 6 March.

Para 14: I think it is important not to exaggerate the pressure for change in the tax treatment of foreign exchange gains and losses. It may create a rod for our own back. I doubt whether it is "a steady stream" of representations; better perhaps to say "a number". Moreover, the point should not be forgotten that many exchange gains and losses are already recognised in the tax system; and hedging, and other financial techniques, are readily available. There is a danger of getting this issue out of proportion;

Para 16: Amend the fourth line to "the question of when income was recognised..." and the seventh to "taxed in the year in which it was earned...";

Para 17: In the first line, insert "statutory" before basis; amend the fourth line to "income in the tax year in which it is earned..."; and in the eighth line, change "gone" to "substantially reduced";

Para 26: I wouldn't use the words "popular capitalism" near to water, "wider share ownership" would be better;

Para 36: "Wider share" instead of "individual";

Para 50: Change the last sentence to "the Life Offices themselves have accepted that this treatment is anomalous, and I propose to end it";

Para 60: I still think it sounds odd to have the "liberalisation" of pensions before the capping of tax relief. Indeed, the liberalisation makes little sense without the cap. Unless there is a cap, there is little incentive to make arrangements over and above the tax relieved limits. Furthermore, para 61 (the cap) follows more naturally from para 59 which deals with the very favourable tax treatment ofpensions;

Para 65: Couldn't we expand this a little?;

Para 70: Can't this be much more definite? It is a little imprecise;

Para 94 onwards: You are presumably following the tactic of previous budget speeches and teasing in order to surprise.

Para 94 ("no tax cuts") will disappoint, whereas para 114 onwards ("but NIC cuts") will surprise. However, there is a danger that the let-down in para 94 will be greater than the pick-up in para 114. Furthermore, people may not understand the NICs package so readily, so the whole Budget might seem (unnecessarily) an anti-climax. Might it not be advisable to add to para 94 "though I have some proposals to make later to NICS" in order to build up expectations.

In any case, why put part of the Income Tax section before CGT? Why not get CGT out of the way and then have Income Tax <u>and</u> NICs?

Para 102: "to return to income tax" after a break sounds curious. Surely it should go with para 94;

Para 106: One could make more of this if you wanted;

Para 116: Add "this is a genuine disincentive to overtime and to lower-paid workers generally".

R.C.M.S.

pp **NORMAN LAMONT**

chex.md/mw/29 BUDGET SECRET REF: MPW/BS/89/5

COPY NO 6 OF 34

FROM: MISS M P WALLACE
DATE: 7 March 1989

See my changes

SIR T BURNS

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Anson
Dame A Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Mrs Lomax
Mr H P Evans
Mr Peretz
Mr Riley
Mr Sedgwick
Mr A C S Allan
Mr Gieve
Mr Hibberd
Mr O'Donnell
Mr Pickford
Miss Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

Sir A Battishill IR
PS/IR

Mr Unwin C&E
PS/C&E

Ch/ PEM's comments marked.

NB Paul Gray rings to say PM has changed her plans for tomorrow, and will be passing through London to collect her boxes at 6.00 pm. They are not planning to send her another box until Sat) lunchtime.

Better to get this turned round early in the weekend, if poss, so we ought to aim for 6.00 tomorrow. I shall chase up remaining comments now so that does not delay us.

MPW.

BUDGET STATEMENT: ECONOMIC SECTION

The Chancellor was grateful for the comments he has had on ~~the~~ the version ~~circulated with my minute~~ ~~I attach the Chancellor's redraft~~ of the Economic section of the speech. He would be grateful for quick comments, if possible to reach me by lunchtime tomorrow, Wednesday 8 March.

circulated with my minute of 7 March. I may attach his revised version. He would be grateful ~~if~~ for any ~~further~~ final comments, to reach me by ~~1.00 pm~~ 12.30 pm tomorrow, ~~Th~~ Friday 10 March. He will be working further on it during

MPW

MOIRA WALLACE

40

PTO

before

a final version

the afternoon ~~at~~ sending ~~its~~ to

No 10 in the evening.

BUDGET SPEECH - FIRST SECTION

The background to this year's Budget is the overriding need to ~~bear~~ bring down ~~on~~ inflation, at a time when, throughout the world, it is edging up for the first time this decade.

2. It is only by doing this, whatever the short-term difficulties, that we will preserve the great gains we have made in this country over the past ten years, gains which offer so much hope for the future.

3. I shall begin, as usual, with the economic background to the Budget, I shall then deal with monetary policy and the public sector finances. Finally, I shall propose a number of measures to carry forward the process of tax reform.

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

5. The Government's first ten years in office have seen a transformation both in the way in which economic

policy is conducted, and in the results that have been achieved.

6. For the first time, economic policy has been set firmly and explicitly in a medium-term context. That means that we do not bend to every puff of wind that comes along: we resist the blandishments of those who urge reflation or deflation in automatic response to every new number that fashion dictates should assume special significance. We stand ready to act and act decisively promptly whenever inflationary pressures threaten to re-emerge. But that is within a general philosophy that the Government should set a sound medium-term financial framework and leave it to the private sector to operate with confidence within it.

7. The Government came to office with two central objectives: to defeat inflation, and to breathe new life into a moribund economy. Inflation is the fall in the value of money. It is is a disease of money; and monetary policy is its ~~only~~ cure. Fiscal policy ~~is used to~~ supports the monetary stance by bringing the public accounts into balance and keeping them there. ~~and~~ It thus completes the process of re-establishing sound money. And within the context of sound money, markets ~~had~~ have to be allowed to work again, and the enterprise culture restored, by the removal of unnecessary restrictions and controls, by the reform of

trade union law and promotion of all forms of capital ownership, and by the reform and reduction of taxation.

8. In the early years, the urgent task was to stamp out the inflationary forces that had raged in the '70s, and wrought so much economic and social havoc. Between 1974 and 1979 inflation averaged over 15 per cent. By 1983 we brought it down to 5 per cent, and that is what it has averaged since.

Both the new financial framework and the measures to improve supply performance were bound to take time before their full impact was felt

There was

9. It was not surprising that in those early years less ~~progress was made in~~ improv~~ing~~ the supply performance of the economy. But ~~once~~ as business and industry recognised the dramatic changes that were ~~occurring in the economic climate~~, they responded with vigour and confidence. As a result, we have experienced the longest period of sustained strong growth since records began. Indeed, output in the United Kingdom has grown faster than in all the major European nations during the '80s - a marked contrast to the previous two decades, when we were bottom of the league. And this growth has been based on a dramatic and sustained improvement in productivity, which in the economy as a whole has been second only to that of Japan among all the major nations during the '80s - and in manufacturing has exceeded that of Japan.

better mo They are better motivated

10. We have more people in work than ever before, and their living standards have improved beyond recognition.

11. But it is not just our economic performance over the past ten years that has been transformed: so have our prospects for the future. For over the past seven years, investment has grown very nearly twice as fast as consumption, and total business investment is now a higher proportion of GDP than ever before. And its quality has improved immeasurably, too: witness the dramatic improvement in profitability.

12. So the outlook is good, provided we remain firm in our resolve to get on top of inflation.

13. A year ago, in the aftermath of the worldwide stock market crash, it looked as if there would be some slowing down from the rapid growth of 1987. In fact that was not to be.

14. It now looks appears ~~as if~~ that we had in 1988 a second successive year of growth at $4^{1}/_{2}$ per cent - the first time this has happened [since the War/for 30 years] - with unemployment falling by half a million to well below the European average. [This means, incidentally,

that we have had six successive years of growth at 3 per cent or better, the first time this has ever occurred.]

15. Manufacturing output grew particularly rapidly, by more than 7 per cent, to a level well above the previous peak reached as far back as the first half of 1974.

But there was also a rapid expansion in the economy in money terms.

16. ~~But~~ total domestic demand ~~also~~ grew by some 7 per cent, faster than the economy's capacity to supply, mainly because of the boom in industrial investment, in itself a welcome event, but also because of continued strong growth in consumer spending. This last was financed to an unprecedented degree by borrowing, overwhelmingly mortgage borrowing. Of all borrowing by households, almost 85 per cent is accounted for by mortgages compared with under 5 per cent by credit cards.

This may not quite be the right deadline - but it looks a bit disjointed at present from the monetary section of the speech

[illegible] but OK grammar

17. Inevitably this led to renewed inflationary pressure. To some extent this was relieved by a sharp rise in imports, and hence in the deficit in current account of the balance of payments. This is officially recorded as having reached £14$^{3}/_{4}$ billion in 1988, although given the £15$^{1}/_{4}$ billion positive balancing item (another name for errors and omissions) the true figure is almost certainly less than this. More important - for whatever

the true figure, it is undoubtedly large, and a sharp increase on the deficit recorded in 1987 after seven successive years of surplus - it is one that, given sound policies can readily be financed.

18. Unlike previous current account deficits we have known in this country, it does not reflect a budget deficit, but rather the excess of private sector investment over total private savings. And this is something that will in due course correct itself.

19. But this there has ~~also~~ been some pick up in recorded inflation. Excluding the distorting effect of mortgage interest payments, the RPI, which rose by $5^1/_4$ per cent in 1983, increased by $4^1/_2$ per cent last year. But the rate picked up markedly through the year, and the most recent figure is $5^1/_2$ per cent.

20. Moreover this pick up in inflation appears to be a worldwide trend. Indeed, over the past six months, the rate of inflation excluding mortgage payments has probably risen by slightly less than inflation in the rest of the G7.

21. In any event, it ~~soon~~ became clear that it was necessary to tighten monetary policy sharply. And this meant by ~~the only effective means of~~ raising short-term interest

rates, which ~~and this~~ was duly done, starting last June. I repeat what I have stated clearly on a number of previous occasions: interest rates will stay as high as is needed for as long as is needed to get on top of inflation. Nor am I prepared to allow the struggle against inflation to be undermined by exchange rate depreciation.

22. I am of course keenly conscious of the effects of the rise in interest rates on borrowers, particularly home owners. But however unwelcome high interest rates are, they are infinitely preferable to the damage that would be done by high inflation.

23. There are now increasing signs that the determined action already taken is having the desired effect. The housing boom that played such a large part in the events of last year has ? (largely) subsided. Monetary growth, particularly as measured by the target aggregate, M0, is slowing has slowed down appreciably. And retail sales, too, seem to have levelled off over the past three months, presaging a gradual recovery in the personal savings ratio.

24. The outlook for 1989 is for inflation to rise a little further to something approaching 8 per cent as

recorded by the RPI (although excluding mortgage interest payments the rate is forecast to remain ~~well~~ below 6 per cent) before falling back in the second half of the year to $5^1/_2$ per cent in the fourth quarter and perhaps $4^1/_2$ per cent in the second quarter of 1990.

25. A slow down in real growth is probably inevitable as we get inflation back onto a downward path - indeed, it has almost certainly already begun to happen. Overall growth is forecast to fall from the $4^1/_2$ per cent recorded last year to 2 per cent this year, with domestic demand growth also at 2 per cent. Within this, investment is once again forecast to grow faster than consumption. The current account deficit is forecast to remain at roughly the same level as this year's.

26. But the question of how "soft" or "hard" the landing is as we get the economy back on track is not a matter for Government, nor is it a sensible objective of economic policy. The Government's policy is to reduce inflation by acting, through monetary policy, to bring down the growth of ~~the money supply and~~ GDP in money terms. The extent to which, over the short term, this is reflected in a reduction in inflation, and the extent to which it is reflected in a growth in real output, is up to business and industry.

27. In a free economy, it is up to them to ensure that the temporary rise in inflation during the first half of this year does not lead to an unwarranted rise in pay and other costs. Any failure by industry to control its costs will only make the necessary reduction in the growth of nominal GDP more painful for them and others, not least in terms of employment prospects.

28. But over the medium-term, it is clear from experience over the past ten years that it ~~is~~ these policies will bring inflation ~~that will~~ come down, ~~while~~ and steady growth will resume. Indeed, ~~it is clear~~ that over anything but the very short term, the use of fiscal and monetary policy to promote growth merely leads to inflation; whereas the use of macroeconomic policy to curb inflation, when coupled with the right supply side policies, produces real growth.

Monetary policy

29. Monetary policy, to which I now turn, plays and must always play, the central role in the battle against inflation. It is at the very heart of the medium-term financial strategy, the 10th Edition of which I am publishing today.

30. I have already described the monetary tightening that has taken place over the past nine months. This has lead to a sharp deceleration in the rate of growth of the target aggregate, M0, although for 1988-89 as a whole it is likely to have grown at some [2] percentage points above its target range.

31. For 1989-90, the target range will be 1-5 per cent, as envisaged in last year' MTFS. Although starting the year above the top of that range, its very low growth over the past six months - some $2^1/_2$ per cent at an annualised rate - suggests that it ~~will soon~~ is on track to come back well within it; the task will then be to keep it there. The exchange rate is also of particular importance in the conduct of monetary policy. The Government's clear commitment not to accommodate increases in domestic costs by exchange rate depreciation remains a key safeguard against inflation. ~~It~~ This has ~~recently~~ been demonstrated both by the level of interest rates and in the markets by our readiness to make use of the massive reserves we have accumulated. In this context, we will continue to work with our G7 partners to maintain the exchange rate stability that has been a feature of the past two years.

This gives a bit more emphasis to the exchange rate than I should like in relation to M0

32. As for the past [three] years, there is no target for the growth of broad money, or liquidity, but it will continue to be taken into account.

I don't think this is needed again

33. Short-term interest rates remain the essential instrument of monetary policy. As I have already indicated, the battle against inflation is paramount, and there can therefore be no question of any premature reduction in interest rates.

34. Meanwhile, I am today adding one more entry to the long list of financial controls which we have swept away during our term of office. The last surviving relic of the post-War apparatus for the direction of capital by the State is the Control of Borrowing Order which since 1946 has involved first the Treasury then the Bank of England in giving consents for equity and bond issues in the capital markets. The Treasury has today made a General Consent under the Control of Borrowing Order 1958, so that it will no longer be necessary for those who wish to make capital market issues to obtain the Bank of England's consent to the timing of such issues; and we will, as soon as possible, revoke the Order itself and repeal the legislation on which it depends, the 1946 Borrowing (Control and Guarantees) Act.

35. The sterling capital market has in recent times been going through a period of considerable adjustment,

as the Government has changed from being a large issuer to a large purchaser of its own debt. I will have more to say about that in a moment. The abolition of the Control of Borrowing Order will remove an unnecessary and bureaucratic restriction on issuers of capital as they move into the space formerly occupied by the Government when it was a borrower.

<u>Public Sector finances</u>

36. When we first took office the public sector borrowing requirement was almost 6 per cent of GDP - equivalent to some £[30] billion in today's terms.

37. This was steadily reduced over the years as a deliberate act of policy, until, by 1987-88, the PSBR had been eliminated altogether and we started to repay the national debt.

38. Accordingly, last year I budgeted for a further Public Sector Debt Repayment, or PSDR, of some £3 billion. In the event, it looks like turning out five times as large, at £15 billion, or 3 per cent of GDP. Even if there had been no privatisation proceeds at all, the public finances would still be in surplus, to the tune of some £8 billion.

39. Nothing like this has ever been achieved since the War. And no other major country enjoys a comparable budget surplus. It has not been easy, even though we were assisted in the year now ending by a combination of an extra £2 billion of privatisation proceeds, and by the exceptional buoyancy of the economy, which both boosted tax receipts and reduced public expenditure well below the planned level. As a result, total public debt as a proportion of GDP is now lower than at any time since before the First World War.

40. Moreover, the substantial repayment of public debt over the past two years has permanently reduced the burden of debt servicing, both now and for future generations. For the coming year, for example, the debt repayments of the last two years mean that debt interest costs are lower by £[X] billion a year. Indeed, debt reduction on this scale means that in this year's Finance Bill I shall have to take a new power, not needed before, to enable gilts to be acquired by the NLF, for cancellation.

41. The dramatic improvement in the United Kingdom's public finances has also provided a welcome opportunity to devote more attention to the structure of the debt

that remains. Now that the Government has become a net purchaser of debt, it has become possible to tailor repayment policy so as to reduce future interest costs, and to improve the quality of outstanding Government debt by relying less on the more liquid borrowing instruments.

42. Similarly it has proved possible to restructure part of the Government's foreign currency debt, launching an innovative and cost-effective programme of Treasury Bills denominated in ecu. The first experimental six-monthly tenders for these bills have proved extremely successful, and I can today inform the House that the programme will be continuing, at a level of around ecu $2^1/_2$ billion. [What period?]

43. In last year's Budget Speech , I set out the principle of a balanced budget as a proper objective of fiscal policy.

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

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

44. It is a rule that ensures that, as GDP continues to rise, the ratio of public debt to GDP continues to fall, and with it the burden of debt interest. It ensures, too, that the State makes no claim either on the savings of the private sector or on flows of finance from overseas. But to go further than this, and seek to achieve the maximum possible repayment of public debt, would be neither economically sensible, nor consistent with the Government's policy, as it would mean deferring for a very long time the prospect now before us of a sustainable and progressive reduction in the burden of taxation.

45. So I reaffirm the principle of the balanced budget. However, given the substantial surplus we now have, the path of prudence and caution is clearly to return to balance not overnight, but gradually, over a period of years. Thus we can expect to have a number of further years of debt repayment ahead of us. Moreover, given the particular uncertainties there are at the present time, I believe it would be right to budget for 1989-90 for a surplus similar to that secured in the

year now ending, after adjusting for the change in privatisation proceeds: that is to say, a further public sector debt repayment, or PSDR, of some £13 billion. What this means is that it will not be possible in this Budget to reduce the burden of taxation that is to say, to reduce taxation as a share of GDP.

chex.md/mw/29 BUDGET SECRET REF: MPW/BS/89/5

COPY NO 6a OF 34

FROM: MISS M P WALLACE
DATE: 7 March 1989

See my changes

SIR T BURNS

Alex: to see and return to me.
Top sent to Ch.

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Anson
Dame A Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Mrs Lomax
Mr H P Evans
Mr Peretz
Mr Riley
Mr Sedgwick
Mr A C S Allan
Mr Gieve
Mr Hibberd
Mr O'Donnell
Mr Pickford
Miss Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

Sir A Battishill IR
PS/IR

Mr Unwin C&E
PS/C&E

BUDGET STATEMENT: ECONOMIC SECTION

I attach the Chancellor's redraft of the Economic section of the speech. He would be grateful for quick comments, if possible to reach me by lunchtime tomorrow, Wednesday 8 March.

MPW.

40

MOIRA WALLACE

BUDGET SPEECH - FIRST SECTION

The background to this year's Budget is the overriding need to ~~bear~~ bring down ~~on~~ inflation, at a time when, throughout the world, it is edging up for the first time this decade.

2. It is only by doing this, whatever the short-term difficulties, that we will preserve the great gains we have made in this country over the past ten years, gains which offer so much hope for the future.

3. I shall begin, as usual, with the economic background to the Budget, I shall then deal with monetary policy and the public sector finances. Finally, I shall propose a number of measures to carry forward the process of tax reform.

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5. The Government's first ten years in office have seen a transformation both in the way in which economic

policy is conducted, and in the results that have been achieved.

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trade union law and promotion of all forms of capital ownership, and by the reform and reduction of taxation.

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Both the new financial framework and the measures to improve supply performance were bound to take time before their full impact was felt

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that we have had six successive years of growth at 3 per cent or better, the first time this has ever occurred.]

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But there was also a rapid expansion in the economy in money terms.

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Looks a bit mid-ish but OK I think

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rates, ~~and this~~ which was duly done, starting last June. I repeat what I have stated clearly on a number of previous occasions: interest rates will stay as high as is needed for as long as is needed to get on top of inflation. Nor am I prepared to allow the struggle against inflation to be undermined by exchange rate depreciation.

22. I am of course keenly conscious of the effects of the rise in interest rates on borrowers, particularly home owners. But however unwelcome high interest rates are, they are infinitely preferable to the damage that would be done by high inflation.

23. There are now increasing signs that the determined action already taken is having the desired effect. The housing boom that played such a large part in the events of last year has (largely)? subsided. Monetary growth, particularly as measured by the target aggregate, M0, ~~is strong~~ has slowed down appreciably. And retail sales, too, seem to have levelled off over the past three months, presaging a gradual recovery in the personal savings ratio.

24. The outlook for 1989 is for inflation to rise a little further to something approaching 8 per cent as

recorded by the RPI (although excluding mortgage interest payments the rate is forecast to remain ~~well~~ below 6 per cent) before falling back in the second half of the year to $5^1/_2$ per cent in the fourth quarter and perhaps $4^1/_2$ per cent in the second quarter of 1990.

25. A slow down in real growth is probably inevitable as we get inflation back onto a downward path - indeed, it has almost certainly already begun to happen. Overall growth is forecast to fall from the $4^1/_2$ per cent recorded last year to 2 per cent this year, with domestic demand growth also at 2 per cent. Within this, investment is once again forecast to grow faster than consumption. The current account deficit is forecast to remain at roughly the same level as this year's.

26. But the question of how "soft" or "hard" the landing is as we get the economy back on track is not a matter for Government, nor is it a sensible objective of economic policy. The Government's policy is to reduce inflation by acting, through monetary policy, to bring ~~the money supply and~~ down the growth of GDP in money terms. The extent to which, over the short term, this is reflected in a reduction in inflation, and the extent to which it is reflected in a growth in real output, is up to business, and industry.

27. In a free economy, it is up to them to ensure that the temporary rise in inflation during the first half of this year does not lead to an unwarranted rise in pay and other costs. Any failure by industry to control its costs will only make the necessary reduction in the growth of nominal GDP more painful for them and others, not least in terms of employment prospects.

28. But over the medium-term, it is clear from experience over the past ten years that it these policies will bring ~~is~~ inflation ~~that will~~ come down, and ~~while~~ steady growth will resume. Indeed, ~~it is clear that~~ that over anything but the very short term, the use of fiscal and monetary policy to promote growth merely leads to inflation; whereas the use of macroeconomic policy to curb inflation, when coupled with the right supply side policies, produces real growth.

Monetary policy

29. Monetary policy, to which I now turn, plays and must always play, the central role in the battle against inflation. It is at the very heart of the medium-term financial strategy, the 10th Edition of which I am publishing today.

30. I have already described the monetary tightening that has taken place over the past nine months. This has lead to a sharp deceleration in the rate of growth of the target aggregate, M0, although for 1988-89 as a whole it is likely to have grown at some [2] percentage points above its target range.

31. For 1989-90, the target range will be 1-5 per cent, as envisaged in last year' MTFS. Although starting the year above the top of that range, its very low growth over the past six months - some $2^1/_2$ per cent at an annualised rate - suggests that it ~~will soon~~ is on track to come back well within it; the task will then be to keep it there. The exchange rate is also of particular importance in the conduct of monetary policy. The Government's clear commitment not to accommodate increases in domestic costs by exchange rate depreciation remains a key safeguard against inflation. ~~It~~ This has ~~recently~~ been demonstrated both by the level of interest rates and in the markets by our readiness to make use of the massive reserves we have accumulated. In this context, we will continue to work with our G7 partners to maintain the exchange rate stability that has been a feature of the past two years.

This gives a bit more emphasis to the exch rate than I should like in relation to MO ?.

32. As for the past [three] years, there is no target for the growth of broad money, or liquidity, but it will continue to be taken into account.

I don't think this is needed again

33. Short-term interest rates remain the essential instrument of monetary policy. As I have already indicated, the battle against inflation is paramount, and there can therefore be no question of any premature reduction in interest rates.

34. Meanwhile, I am today adding one more entry to the long list of financial controls which we have swept away during our term of office. The last surviving relic of the post-War apparatus for the direction of capital by the State is the Control of Borrowing Order which since 1946 has involved first the Treasury then the Bank of England in giving consents for equity and bond issues in the capital markets. The Treasury has today made a General Consent under the Control of Borrowing Order 1958, so that it will no longer be necessary for those who wish to make capital market issues to obtain the Bank of England's consent to the timing of such issues; and we will, as soon as possible, revoke the Order itself and repeal the legislation on which it depends, the 1946 Borrowing (Control and Guarantees) Act.

35. The sterling capital market has in recent times been going through a period of considerable adjustment,

as the Government has changed from being a large issuer to a large purchaser of its own debt. I will have more to say about that in a moment. The abolition of the Control of Borrowing Order will remove an unnecessary and bureaucratic restriction on issuers of capital as they move into the space formerly occupied by the Government when it was a borrower.

Public Sector finances

36. When we first took office the public sector borrowing requirement was almost 6 per cent of GDP - equivalent to some £[30] billion in today's terms.

37. This was steadily reduced over the years as a deliberate act of policy, until, by 1987-88, the PSBR had been eliminated altogether and we started to repay the national debt.

38. Accordingly, last year I budgeted for a further Public Sector Debt Repayment, or PSDR, of some £3 billion. In the event, it looks like turning out five times as large, at £15 billion, or 3 per cent of GDP. Even if there had been no privatisation proceeds at all, the public finances would still be in surplus, to the tune of some £8 billion.

39. Nothing like this has ever been achieved since the War. And no other major country enjoys a comparable budget surplus. It has not been easy, even though we were assisted in the year now ending by a combination of an extra £2 billion of privatisation proceeds, and by the exceptional buoyancy of the economy, which both boosted tax receipts and reduced public expenditure well below the planned level. As a result, total public debt as a proportion of GDP is now lower than at any time since before the First World War.

40. Moreover, the substantial repayment of public debt over the past two years has permanently reduced the burden of debt servicing, both now and for future generations. For the coming year, for example, the debt repayments of the last two years mean that debt interest costs are lower by £[X] billion a year. Indeed, debt reduction on this scale means that in this year's Finance Bill I shall have to take a new power, not needed before, to enable gilts to be acquired by the NLF, for cancellation.

41. The dramatic improvement in the United Kingdom's public finances has also provided a welcome opportunity to devote more attention to the structure of the debt

that remains. Now that the Government has become a net purchaser of debt, it has become possible to tailor repayment policy so as to reduce future interest costs, and to improve the quality of outstanding Government debt by relying less on the more liquid borrowing instruments.

42. Similarly it has proved possible to restructure part of the Government's foreign currency debt, launching an innovative and cost-effective programme of Treasury Bills denominated in ecu. The first experimental six-monthly tenders for these bills have proved extremely successful, and I can today inform the House that the programme will be continuing, at a level of around ecu $2^1/_2$ billion. [What period?]

43. In last year's Budget Speech , I set out the principle of a balanced budget as a proper objective of fiscal policy.

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

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

44. It is a rule that ensures that, as GDP continues to rise, the ratio of public debt to GDP continues to fall, and with it the burden of debt interest. It ensures, too, that the State makes no claim either on the savings of the private sector or on flows of finance from overseas. But to go further than this, and seek to achieve the maximum possible repayment of public debt, would be neither economically sensible, nor consistent with the Government's policy, as it would mean deferring for a very long time the prospect now before us of a sustainable and progressive reduction in the burden of taxation.

45. So I reaffirm the principle of the balanced budget. However, given the substantial surplus we now have, the path of prudence and caution is clearly to return to balance not overnight, but gradually, over a period of years. Thus we can expect to have a number of further years of debt repayment ahead of us. Moreover, given the particular uncertainties there are at the present time, I believe it would be right to budget for 1989-90 for a surplus similar to that secured in the

year now ending, after adjusting for the change in privatisation proceeds: that is to say, a further public sector debt repayment, or PSDR, of some £13 billion. What this means is that it will not be possible in this Budget to reduce the burden of taxation that is to say, to reduce taxation as a share of GDP.

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COPY NO 19 OF 34

2nd 3

FROM: MISS M P WALLACE
DATE: 7 March 1989

SIR T BURNS

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Anson
Dame A Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Mrs Lomax
Mr H P Evans
Mr Peretz
Mr Riley
Mr Sedgwick
Mr A C S Allan
Mr Gieve
Mr Hibberd
Mr O'Donnell
Mr Pickford
Miss Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

Sir A Battishill IR
PS/IR

Mr Unwin C&E
PS/C&E

Ch

A few comments.

One slight re-ordering, to COBO.

One omission: funding policy.

Shouldn't you say something about this, in particular that we will not achieve a full unfund this year but will carry underunfund to next year when maturities heavy? If so, shall I draft a paragraph?

AA

BUDGET STATEMENT: ECONOMIC SECTION

I attach the Chancellor's redraft of the Economic section of the speech. He would be grateful for quick comments, if possible to reach me by lunchtime tomorrow, Wednesday 8 March.

MPW.

MOIRA WALLACE

chex.ps/mw/13

BUDGET SPEECH - FIRST SECTION

The background to this year's Budget is the overriding need to bear down on inflation, at a time when, throughout the world, it is edging up for the first time this decade. (? surely edged up in 87, admittedly post oil price collapse in 86)

2. It is only by doing this, whatever the short-term difficulties, that we will preserve and build on the great gains we have made in this country over the past ten years, [gains which offer so much hope for the future.] (sounds a bit placatory)

3. I shall begin, as usual, with the economic background to the Budget, I shall then deal with monetary policy and the public sector finances. Finally, I shall propose a number of measures to carry forward the process of tax reform.

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

5. The Government's first ten years in office have seen a transformation both in the way in which economic

policy is conducted, and in the results that have been achieved.

6. For the first time, economic policy has been set firmly and explicitly in a medium-term context. That means that we do not bend to every puff of wind that comes along: we resist the blandishments of those who urge reflation or deflation in automatic response to every new number that fashion dictates should assume special significance. We do of course stand ready to act and act promptly whenever inflationary pressures threaten to re-emerge. But that is within a general philosophy that the Government should set a sound medium-term financial framework and leave it to the private sector to operate with confidence within it.

7. The Government came to office with two central objectives: to defeat inflation, and to breathe new life into a moribund economy. And two central policies to achieve those objectives: monetary policy and supply side reforms. For inflation is a disease of money; and monetary policy is its only cure. It had, of course, to be buttressed by a tight fiscal policy [is used] to bring the public accounts into balance and keep them there, and thus complete the process of re-establishing sound money. [And] within the context of sound money, markets had to be allowed to work again, and the enterprise culture restored, by the removal of unnecessary restrictions and controls, by the reform of

trade union law and promotion of all forms of capital ownership, and by the reform and reduction of taxation.

8. In the early years, the urgent task was to stamp out the inflationary ~~forces~~ fires that had raged in the '70s, and wrought so much economic and social havoc. Between 1974 and 1979 inflation averaged over 15 per cent. By 1983 we brought it down to 5 per cent, and that is what it has averaged since.

9. It was not surprising that in those early years less progress was made in improving the supply performance of the economy. But once business and industry recognised the dramatic changes that were occurring in the economic climate, they responded with vigour and confidence. As a result, we have experienced the longest period of sustained strong growth since records began. Indeed, output in the United Kingdom has grown faster than in all the major European nations during the '80s - a marked contrast to the previous two decades, when we were bottom of the league. And this growth has been based on a dramatic and sustained improvement in productivity growth, which in the economy as a whole has been second only to that of Japan among all the major nations during the '80s - and in manufacturing has exceeded that of Japan.

10. We have more people in work than ever before, and their living standards have improved beyond recognition.

11. But it is not just our economic performance over the past ten years that has been transformed: so have our prospects for the future. For over the past seven years, investment has grown very nearly twice as fast as consumption, and total business investment is now a higher proportion of GDP than ever before. And its quality has improved immeasurably, too: witness the dramatic improvement in profitability.

12. So the outlook is good, provided we remain firm in our resolve to get on top of inflation.

13. A year ago, in the aftermath of the worldwide stock market crash, it looked as if there would be some slowing down from the rapid growth of 1987. In fact that was not to be.

14. It now looks as if we had in 1988 a second successive year of growth at $4^1/_2$ per cent - the first time this has happened [since the War/for 30 years] - with unemployment falling by half a million to well below the European average. [This means, incidentally,

that we have had six successive years of growth at 3 per cent or better, the first time this has ever occurred.]

15. Manufacturing output grew particularly rapidly, by more than 7 per cent, to a level well above the previous peak reached as far back as the first half of 1974.

16. But total domestic demand also grew by some 7 per cent, faster than the economy's capacity to supply, mainly because of the boom in industrial investment, in itself a welcome event, but also because of continued strong growth in consumer spending. This last was financed to an unprecedented degree by borrowing, overwhelmingly mortgage borrowing. Of all borrowing by households, almost 85 per cent is accounted for by mortgages compared with under 5 per cent by credit cards.

17. Inevitably this led to renewed inflationary pressure. To some extent this was relieved by a sharp rise in imports, and hence a large deficit in the current account of the balance of payments. This is officially recorded as having reached £14 3/4 billion in 1988, although given the £15 1/4 billion positive balancing item (another name for errors and omissions) the true figure is almost certainly less than this. More important - for whatever

the true figure, it is undoubtedly large, and a sharp increase on the deficit recorded in 1987 after seven successive years of surplus - it is one that, given sound policies can readily be financed.

18. Unlike previous current account deficits we have known in this country, it does not reflect a budget deficit, but rather the excess of private sector investment over total private savings. And this is something that will in due course correct itself.

19. But there has also been some pick up in recorded inflation. Excluding the distorting effect of mortgage interest payments, the RPI, [which rose by $5^1/_4$ per cent in 1983,] increased by $4^1/_2$ per cent last year. [much the same as the average over the previous five years] But the rate picked up markedly through the year, and the most recent figure is $5^1/_2$ per cent.

20. Moreover this pick up in inflation appears to be a worldwide trend. Indeed, over the past six months, the rate of inflation excluding mortgage payments has probably risen by slightly less in the UK than inflation in the rest of the G7.

21. In any event, it soon became clear that it was necessary to tighten monetary policy sharply, by the only effective means of raising short-term interest

rates, and this was duly done, starting last June. I repeat what I have stated clearly on a number of previous occasions: interest rates will stay as high as is needed for as long as is needed to get on top of inflation. Nor am I prepared to allow the struggle against inflation to be undermined by exchange rate depreciation. Quite simply, I am not prepared to take any risks with inflation.

I think I'd stick @ this & not say explicitly "if they have to go up they go up".

22. I am of course keenly conscious of the effects of the rise in interest rates on borrowers, particularly home owners. But however unwelcome high interest rates are, they are infinitely preferable to the damage that would be done by high inflation.

23. There are now increasing signs that the determined action already taken is having the desired effect. The housing boom that played such a large part in the events of last year has largely subsided. Monetary growth, particularly as measured by the target aggregate, M0, has slowed down appreciably. And retail sales, too, seem to have levelled off over the past three months, presaging a gradual recovery in the personal savings ratio.

24. The outlook for 1989 is for inflation to rise a little further in the next few months to ~~something approaching~~ close to 8 per cent as

(it could be 8%)

recorded by the RPI (although excluding mortgage interest payments the rate is forecast to remain well below 6 per cent) before falling back in the second half of the year to $5^1/_2$ per cent in the fourth quarter and perhaps $4^1/_2$ per cent in the second quarter of 1990.

25. A slow down in real growth is probably inevitable as we get inflation back onto a downward path - indeed, it has almost certainly already begun to happen. Overall growth is forecast to fall from the $4^1/_2$ per cent recorded last year to 2 per cent this year, with domestic demand growth also at 2 per cent. Within this, investment is once again forecast to grow faster than consumption. The current account deficit is forecast to remain at roughly the same level as this year's.

I don't think you should complicate this with oil/non-oil

26. But the question of how "soft" or "hard" the landing is as we get the economy back on track is not a matter for Government, nor is it a sensible objective of economic policy. The Government's policy is to reduce inflation by acting, through monetary policy, to bring down the growth of GDP in money terms. The extent to which, over the short term, this is reflected in a reduction in inflation, and the extent to which it is reflected in a growth in real output, is up to business and industry.

27. In a free economy, it is up to them to ensure that the temporary rise in inflation during the first half of this year does not lead to an unwarranted rise in pay and other costs. Any failure by industry to control its costs will only make the necessary reduction in the growth of nominal GDP more painful, not least in terms of employment prospects.

28. But over the medium-term, it is clear from experience over the past ten years that it is inflation that will come down, while steady growth will resume. Indeed, it is clear that over anything but the very short term, the use of fiscal and monetary policy to promote growth merely leads to inflation; whereas the use of macroeconomic policy to curb inflation, when coupled with the right supply side policies, produces real growth.

Monetary policy

29. Monetary policy, to which I now turn, [plays and must always play, the central role in the battle against inflation. It] is at the very heart of the medium-term financial strategy, the 10th Edition of which I am publishing today.

repetitive?

30. I have already described the monetary tightening that has taken place over the past nine months. This has lead to a sharp deceleration in the rate of growth of the target aggregate, M0, although for 1988-89 as a whole it is likely to have grown at some [2] percentage points above its target range.

31. For 1989-90, the target range will be 1-5 per cent, as envisaged in last year' MTFS. Although starting the year above the top of that range, its very low growth over the past six months - some $2^1/_2$ per cent at an annualised rate - suggests that it will soon come back within it. // The exchange rate is also of particular importance in the conduct of monetary policy. The Government's clear commitment not to accommodate increases in domestic costs by exchange rate depreciation remains a key safeguard against inflation. It has recently been demonstrated in the markets by our readiness to make use of the massive reserves we have accumulated. In this context, we will continue to work with our G7 partners to maintain the exchange rate stability that has been a feature of the past two years.

Para

32. As for the past [three] years, there is no target for the growth of broad money, or liquidity, but it will continue to be taken into account in assessing monetary conditions.

33. Short-term interest rates remain the essential instrument of monetary policy. As I have already indicated, the battle against inflation is paramount, and there can therefore be no question of any premature reduction in interest rates.

repetitive

34. Meanwhile, I am also today adding one more entry to the long list of financial controls which we have swept away during our term of office. The last surviving relic of the post-War apparatus for the direction of capital by the State is the Control of Borrowing Order which since 1946 has involved first the Treasury then the Bank of England in giving consents for equity and bond issues in the capital markets. The Treasury has today made a General Consent under the Control of Borrowing Order 1958, so that it will no longer be necessary for those who wish to make capital market issues to obtain the Bank of England's consent to the timing of such issues; and we will, as soon as possible, revoke the Order itself and repeal the legislation on which it depends, the 1946 Borrowing (Control and Guarantees) Act.

I'd move all this to after para 42.

35. The sterling capital market has in recent times been going through a period of considerable adjustment,

as the Government has changed from being a large issuer to a large purchaser of its own debt. I will have more to say about that in a moment. The abolition of the Control of Borrowing Order will remove an unnecessary and bureaucratic restriction on issuers of capital as they move into the space formerly occupied by the Government when it was a borrower.

Public Sector finances

36. I now turn to fiscal policy. When we first took office the public sector borrowing requirement was almost 6 per cent of GDP - equivalent to some £[30] billion in today's terms.

37. This was steadily reduced over the years as a deliberate act of policy, until, by 1987-88, the PSBR had been eliminated altogether and we started to repay the national debt.

38. Accordingly, last year I budgeted for a further Public Sector Debt Repayment, or PSDR, of some £3 billion. In the event, it looks like turning out five times as large, at £15 billion, or 3 per cent of GDP. Even if there had been no privatisation proceeds at all, the public finances would still be in surplus, to the tune of some £8 billion.

This sounds unnecessarily feeble.
Even though no statistics, it
surely must have been way before
the War that we last ran large surpluses?
(certainly not in 30s?)

39. Nothing like this has ever been achieved since the War. And no other major country enjoys a comparable budget surplus. It has not been easy, even though we were assisted in the year now ending by a combination of an extra £2 billion of privatisation proceeds, and by the exceptional buoyancy of the economy, which both boosted tax receipts and reduced public expenditure well below the planned level. As a result, total public debt as a proportion of GDP is now lower than at any time since before the First World War.

40. Moreover, the substantial repayment of public debt over the past two years has permanently reduced the burden of debt servicing, both now and for future generations. For the coming year, for example, the debt repayments of the last two years mean that debt interest costs are lower by £[X] billion a year. Indeed, debt reduction on this scale means that in this year's Finance Bill I shall have to take a new power, not needed before, to enable gilts to be acquired by the NLF, for cancellation.

41. The dramatic improvement in the United Kingdom's public finances has also provided a welcome opportunity to devote more attention to the structure of the debt

that remains. Now that the Government has become a net purchaser of debt, it has become possible to tailor repayment policy so as to reduce future interest costs, and to improve the quality of outstanding Government debt by relying less on the more liquid borrowing instruments.

42. Similarly it has proved possible to restructure part of the Government's foreign currency debt, launching an innovative and cost-effective programme of Treasury Bills denominated in ecu. The first experimental six-monthly tenders for these bills have proved extremely successful, and I can today inform the House that the programme will be continuing, at a level of around ecu $2^1/_2$ billion. [What period?]

COBO in here.

43. In last year's Budget Speech , I set out the principle of a balanced budget as a proper objective of fiscal policy:

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

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

44. It is a rule that ensures that, as GDP continues to rise, the ratio of public debt to GDP continues to fall, and with it the burden of debt interest. It ensures, too, that the State makes no claim either on the savings of the private sector or on flows of finance from overseas. But to go further than this, and seek to achieve the maximum possible repayment of public debt, would be neither economically sensible, nor consistent with the Government's policy, as it would mean deferring for a very long time the prospect now before us of a sustainable and progressive reduction in the burden of taxation.

45. So I reaffirm the principle of the balanced budget. However, given the substantial surplus we now have, the path of prudence and caution is clearly to return to balance not overnight, but gradually, over a period of years. Thus we can expect to have a number of further years of debt repayment ahead of us. Moreover, given the particular uncertainties there are at the present time, I believe it would be right to budget for 1989-90 for a surplus similar to that secured in the

year now ending, after adjusting for the change in privatisation proceeds: that is to say, a further public sector debt repayment, or PSDR, of some £13 billion. What this means is that it will not be possible in this Budget to reduce the burden of taxation, that is to say, to reduce taxation as a share of GDP.

chex.md/mw/29 **BUDGET SECRET** REF: MPW/BS/89/5

COPY NO 26 OF 34

FROM: MISS M P WALLACE
DATE: 7 March 1989

SIR T BURNS

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Anson
Dame A Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Mrs Lomax
Mr H P Evans
Mr Peretz
Mr Riley
Mr Sedgwick
Mr A C S Allan
Mr Gieve
Mr Hibberd
Mr O'Donnell
Mr Pickford
Miss Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

Sir A Battishill IR
PS/IR

Mr Unwin C&E
PS/C&E

i. In general, this is rather downbeat compared with earlier speeches, particularly at the outset. I have suggested some more bouncy stuff for the early pages.

ii. The customary warning that ~~it~~ we could still catch a nasty virus from overseas is missing this year. I think we need a paragraph saying that we're on the right tracks but must be vigilant in spotting trouble from abroad.

BUDGET STATEMENT: ECONOMIC SECTION

I attach the Chancellor's redraft of the Economic section of the speech. He would be grateful for quick comments, if possible to reach me by lunchtime tomorrow, Wednesday 8 March.

MPW.

19/3.

MOIRA WALLACE

chex.ps/mw/13

BUDGET SPEECH - FIRST SECTION

That is the background to every budget!

~~The background to this year's Budget is the overriding need to bear down on inflation, at a time when,~~ [throughout the world, ~~it~~ inflation is edging up for the first time this decade.] Our paramount objective is to ~~bear down on inflation~~ bring downward pressure to bear on inflation.

2. It is only by doing this~~, whatever the short-term difficulties,~~ that we will preserve the great gains we have made in this country over the past ten years, gains which offer so much hope for the future.

3. I shall begin, as usual, with the economic background to the Budget, I shall then deal with monetary policy and the public sector finances. Finally, I shall propose a number of measures to carry forward the process of tax reform.

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

5. The Government's first ten years in office have seen a transformation ~~both in the way in which economic~~ in the economy ~~with~~ reflected in record levels of output, employment, and a sustained rise in living standards. Quite simply, the policies we have pursued these past ten years are working. We will stick with them.

~~policy is conducted, and in the results that have been achieved.~~

6. ~~For the first time,~~ economic policy is now ~~has been~~ set firmly and explicitly in a medium-term context. That means that we do not bend to every puff of wind that comes along: we resist the blandishments of those who urge reflation or deflation in automatic response to every new number that fashion dictates should assume special significance. We stand ready to act and act promptly whenever inflationary pressures threaten to re-emerge. But that is within a general philosophy that the Government should set a sound medium-term financial framework and leave it to the private sector to operate with confidence within it.

7. The Government came to office with two central objectives: to defeat inflation, and to breathe new life into a moribund economy. Inflation is a disease of money; and monetary policy is its only cure. ~~Fiscal policy is used~~ The best contribution fiscal policy can make is to bring the public accounts into balance and keep them there, and thus ~~complete~~ assist the process of re-establishing sound money. And within the context of sound money and a prudent fiscal framework, markets had to be allowed to work again, and the enterprise culture restored, by the removal of unnecessary restrictions and controls, by the reform of

trade union law and promotion of all forms of capital ownership, and by the reform and reduction of taxation.

8. In the early years, the urgent task was to stamp out the inflationary forces that had raged in the '70s, and wrought so much economic and social havoc. Between 1974 and 1979 inflation averaged over 15 per cent. By 1983, under the stewardship of my RHF [G. Howe], we brought it down to 5 per cent, and that is what it has averaged since.

Tribute to Howe?

9. It was not surprising that in those early years less progress was made in improving the supply performance of the economy. But once business and industry recognised that we meant what we said, and saw the benefits of the dramatic changes that were occurring in the economic climate, they responded with vigour and confidence. As a result, we have experienced the longest period of sustained strong growth since records began. Indeed, output in the United Kingdom has grown faster than in all the major European nations during the '80s - a marked contrast to the previous two decades, when we were bottom of the league. And this growth has been based on a dramatic and sustained improvement in productivity, the key measure of competitiveness. ~~which~~ In the economy as a whole productivity has been second only to that of Japan among all the major nations during the '80s - and in manufacturing has exceeded that of Japan.

10. We have more people in work than ever before, and their living standards have improved beyond recognition.

11. But it is not just our economic performance over the past ten years that has been transformed: so have our prospects for the future. For over the past seven years, investment has grown very nearly twice as fast as consumption, and total business investment is now a higher proportion of GDP than ever before. And its quality has improved immeasurably, too: witness the dramatic improvement in profitability.

The best measure of ~~this~~ our prospects is investment - which ~~which makes for the~~ increases our productive potential for the future. ~~Greater Higher investment will make~~

~~Profits~~ Higher productivity and investment will lead to ~~higher~~ greater competition and higher profits - a self reinforcing process ~~which will greatly strengthen~~ that had eluded British industry for so long.

12. ~~So the outlook is good, provided we remain firm in our resolve to get on top of inflation.~~

V. downbeat.

13. A year ago, in the aftermath of the worldwide stock market crash, it looked as if there would be some slowing down from the rapid growth of 1987, both at home + abroad. In fact ~~that was not to be.~~ everyone underestimated the underlying strength of the world's leading economies.

14. It now looks as if we had in 1988 a second successive year of growth at $4^1/_2$ per cent - the first time this has happened [since the War/for 30 years] - with unemployment falling by half a million to well below the European average. [This means, incidentally,

Larry - Moira.

Provided we remain firm on inflation the ~~our~~ prospects ~~for~~ of many more years of sustained improvement are ~~within our grasp~~.

that we have had six successive years of growth at 3 per cent or better, the first time this has ever occurred. ½

15. Manufacturing output grew particularly rapidly, by more than 7 per cent, to a level well above the previous peak reached as far back as the first half of 1974.

16. But total domestic demand also grew by some 7 per cent, faster than the economy's capacity to supply, mainly because of the boom in industrial investment, in itself a welcome event, but also because of continued strong growth in consumer spending. This last was financed to an unprecedented degree by borrowing, overwhelmingly mortgage borrowing. Of all borrowing by households, almost 85 per cent is accounted for by mortgages compared with under 5 per cent by credit cards.

Isn't it under 3%, excluding charge card use?

Do we need to say # (even tho' it's true) that we have swapped some inflation for a higher deficit?

17. Inevitably this led to renewed inflationary pressure. To some extent ~~this was relieved by~~ excess demand fed through into a sharp rise in imports, and hence in the current account of the balance of payments. This is officially recorded as having reached £$14^3/_4$ billion in 1988, although given the £$15^1/_4$ billion positive balancing item (another name for errors and omissions) the true figure is almost certainly less than this, but still large. More important ~~- for whatever~~, whatever the true figure,

~~the true figure, it is undoubtedly large, and a sharp increase on the deficit recorded in 1987~~ it comes after after seven successive years of surplus. ~~It is~~ and ~~one that,~~ The deficit, given sound policies, can readily be financed.

18. The deficit stands in marked contrast to ~~Unlike~~ previous current account deficits we have known in this country. Unlike these it does not reflect a budget deficit, but rather the excess of private sector investment over total private savings. It is therefore a private sector phenomenon. And this is something that will in due course correct itself.

19. But there has also been some pick up in recorded inflation. Excluding the distorting effect of mortgage interest payments, the RPI, which rose by $5^1/_4$ per cent in 1983, increased by $4^1/_2$ per cent last year. But the rate picked up markedly through the year, and the most recent figure is $5^1/_2$ per cent.

20. Moreover this pick up in inflation appears to be a worldwide trend. Indeed, over the past six months, the rate of inflation excluding mortgage payments has probably risen by slightly less than inflation in the rest of the G7.

21. In any event, it soon became clear that it was necessary to tighten monetary policy sharply, by the only effective means of raising short-term interest

rates, and this was duly done, starting last June. I repeat what I have stated clearly on a number of previous occasions: interest rates will stay as high as is needed for as long as is needed to get on top of inflation. Nor am I prepared to allow the struggle against inflation to be undermined by exchange rate depreciation.

22. I am of course keenly conscious of the effects of the rise in interest rates on borrowers, particularly home owners. But however unwelcome high interest rates are, they are infinitely preferable to the damage that would be done by high inflation.

23. There are now increasing signs that the determined action already taken is having the desired effect. The housing boom that played such a large part in the events of last year has largely subsided. Monetary growth, particularly as measured by the target aggregate, M0, has slowed down appreciably. And retail sales, too, seem to have levelled off over the past three months, presaging a gradual recovery in the personal savings ratio.

24. The outlook for 1989 is for inflation to rise a little further to something approaching 8 per cent as

recorded by the RPI (although excluding mortgage interest payments the rate is forecast to remain well below 6 per cent) before falling back in the second half of the year to $5^1/_2$ per cent in the fourth quarter and perhaps $4^1/_2$ per cent in the second quarter of 1990.

25. A slow down in real growth is probably inevitable as we get inflation back onto a downward path - indeed, it has almost certainly already begun to happen. Overall growth is forecast to fall from the $4^1/_2$ per cent recorded last year to 2 per cent this year, with domestic demand growth also at 2 per cent. Within this, investment is once again forecast to grow faster than consumption. The current account deficit is forecast to remain at roughly the same level as this year's.

26. But the question of how "soft" or "hard" the landing is as we get the economy back on track is not a matter for Government, nor is it a sensible objective of economic policy. The Government's policy is to reduce inflation by acting, through monetary policy, to bring down the growth of GDP in money terms. The extent to which, over the short term, this is reflected in a reduction in inflation, and the extent to which it is reflected in a growth in real output, is up to business and industry.

27. In a free economy, it is up to them to ensure that the temporary rise in inflation during the first half of this year does not lead to an unwarranted rise in pay and other costs. Any failure by industry to control its costs will only make the necessary reduction in the growth of nominal GDP more painful, not least in terms of employment prospects.

28. But over the medium-term, it is clear from experience over the past ten years that it is inflation that will come down, while steady growth will resume. Indeed, it is clear that over anything but the very short term, the use of fiscal and monetary policy to promote growth merely leads to inflation; whereas the use of macroeconomic policy to curb inflation, when coupled with the right supply side policies, produces real growth.

Condensed, but v. effective.

<u>Monetary policy</u>

29. Monetary policy, to which I now turn, plays and must always play, the central role in the battle against inflation. It is at the very heart of the medium-term financial strategy, the 10th Edition of which I am publishing today.

30. I have already described the monetary tightening that has taken place over the past nine months. This has lead to a sharp deceleration in the rate of growth of the target aggregate, M0, although for 1988-89 as a whole it is likely to have grown at some [2] percentage points above its target range.

31. For 1989-90, the target range will be 1-5 per cent, as envisaged in last year' MTFS. Although starting the year above the top of that range, its very low growth over the past six months - some $2^1/_2$ per cent at an annualised rate - suggests that it will soon come back within it. The exchange rate is also of particular importance in the conduct of monetary policy. The Government's clear commitment not to accommodate increases in domestic costs by exchange rate depreciation remains a key safeguard against inflation. It has recently been demonstrated in the markets by our readiness to make use of the massive reserves we have accumulated. In this context, we will continue to work with our G7 partners to maintain the exchange rate stability that has been a feature of the past two years.

32. As for the past [three] years, there is no target for the growth of broad money, or liquidity, but it will continue to be taken into account.

33. Short-term interest rates remain the essential instrument of monetary policy. As I have already indicated, the battle against inflation is paramount, and there can therefore be no question of any premature reduction in interest rates.

34. Meanwhile, I am today adding one more entry to the long list of financial controls which we have swept away during our term of office. The last surviving relic of the post-War apparatus for the direction of capital by the State is the Control of Borrowing Order which since 1946 has involved first the Treasury then the Bank of England in giving consents for equity and bond issues in the capital markets. The Treasury has today made a General Consent under the Control of Borrowing Order 1958, so that it will no longer be necessary for those who wish to make capital market issues to obtain the Bank of England's consent to the timing of such issues; and we will, as soon as possible, revoke the Order itself and repeal the legislation on which it depends, the 1946 Borrowing (Control and Guarantees) Act.

35. The sterling capital market has in recent times been going through a period of considerable adjustment,

as the Government has changed from being a large issuer to a large purchaser of its own debt. I will have more to say about that in a moment. The abolition of the Control of Borrowing Order will remove an unnecessary and bureaucratic restriction on issuers of capital as they move into the space formerly occupied by the Government when it was a borrower.

Public Sector finances

36. When we first took office the public sector borrowing requirement was almost 6 per cent of GDP - equivalent to some £[30] billion in today's terms.

37. This was steadily reduced over the years as a deliberate act of policy, until, by 1987-88, the PSBR had been eliminated altogether and we started to repay the national debt.

38. Accordingly, last year I budgeted for a further Public Sector Debt Repayment, or PSDR, of some £3 billion. In the event, it looks like turning out five times as large, at £15 billion, or 3 per cent of GDP. Even if there had been no privatisation proceeds at all, the public finances would still be in surplus, to the tune of some £8 billion.

39. Nothing like this has ever been achieved since the War. And no other major country enjoys a comparable budget surplus. It has not been easy, even though we were assisted in the year now ending by a combination of an extra £2 billion of privatisation proceeds, and by the exceptional buoyancy of the economy, which both boosted tax receipts and reduced public expenditure well below the planned level. As a result, total public debt as a proportion of GDP is now lower than at any time since before the First World War.

40. Moreover, the substantial repayment of public debt over the past two years has permanently reduced the burden of debt servicing, both now and for future generations. For the coming year, for example, the debt repayments of the last two years mean that debt interest costs are lower by £[X] billion a year. Indeed, debt reduction on this scale means that in this year's Finance Bill I shall have to take a new power, not needed before, to enable gilts to be acquired by the NLF, for cancellation.

needs a little more explanation.

41. The dramatic improvement in the United Kingdom's public finances has also provided a welcome opportunity to devote more attention to the structure of the debt

that remains. Now that the Government has become a net purchaser of debt, it has become possible to tailor repayment policy so as to reduce future interest costs, and to improve the quality of outstanding Government debt by relying less on the more liquid borrowing instruments.

42. Similarly it has proved possible to restructure part of the Government's foreign currency debt, launching an innovative and cost-effective programme of Treasury Bills denominated in ecu. The first experimental six-monthly tenders for these bills have proved extremely successful, and I can today inform the House that the programme will be continuing, at a level of around ecu $2^1/_2$ billion. [What period?]

43. In last year's Budget Speech , I set out the principle of a balanced budget as a proper objective of fiscal policy.

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

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

44. It is a rule that ensures that, as GDP continues to rise, the ratio of public debt to GDP continues to fall, and with it the burden of debt interest. It ensures, too, that the State makes no claim either on the savings of the private sector or on flows of finance from overseas. But to go further than this, and seek to achieve the maximum possible repayment of public debt, would be neither economically sensible, nor consistent with the Government's policy, as it would mean deferring for a very long time the prospect now before us of a sustainable and progressive reduction in the burden of taxation.

45. So I reaffirm the principle of the balanced budget. However, given the substantial surplus we now have, the path of prudence and caution is clearly to return to balance not overnight, but gradually, over a period of years. Thus we can expect to have a number of further years of debt repayment ahead of us. Moreover, given the particular uncertainties there are at the present time, I believe it would be right to budget for 1989-90 for a surplus similar to that secured in the

year now ending, after adjusting for the change in privatisation proceeds: that is to say, a further public sector debt repayment, or PSDR, of some £13 billion. What this means is that it will not be possible in this Budget to reduce the burden of taxation that is to say, to reduce taxation as a share of GDP.

chex.md/mw/29 BUDGET SECRET REF: MPW/BS/89/5

COPY NO 27 OF 34

FROM: MISS M P WALLACE
DATE: 7 March 1989

SIR T BURNS

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Anson
Dame A Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Mrs Lomax
Mr H P Evans
Mr Peretz
Mr Riley
Mr Sedgwick
Mr A C S Allan
Mr Gieve
Mr Hibberd
Mr O'Donnell
Mr Pickford
Miss Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

Sir A Battishill IR
PS/IR

Mr Unwin C&E
PS/C&E

MC

BUDGET STATEMENT: ECONOMIC SECTION

I attach the Chancellor's redraft of the Economic section of the speech. He would be grateful for quick comments, if possible to reach me by <u>lunchtime tomorrow, Wednesday 8 March</u>.

MPW.

33+

MOIRA WALLACE

BUDGET SPEECH - FIRST SECTION

The background to this year's Budget is the overriding need to bear down on inflation, at a time when, throughout the world, it is edging up for the first time this decade.

2. It is only by doing this, whatever the short-term difficulties, that we will preserve the great gains we have made in this country over the past ten years, gains which offer so much hope for the future.

3. I shall begin, as usual, with the economic background to the Budget, I shall then deal with monetary policy and the public sector finances. Finally, I shall propose a number of measures to carry forward the process of tax reform.

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

5. The Government's first ten years in office have seen a transformation both in the way in which economic

Only upon the ~~successful~~ foundation created by success there can a government build its programme for the future.

policy is conducted, and in the results that have been achieved.

6. For the first time, economic policy has been set firmly and explicitly in a medium-term context. That means that we do not bend to every puff of wind that comes along: we resist the blandishments of those who urge reflation or deflation in automatic response to every new number that fashion dictates should assume special significance. We stand ready to act and act promptly whenever inflationary pressures threaten to re-emerge. But that is within a general philosophy that the Government should set a sound medium-term financial framework and leave it to the private sector to operate with confidence within it.

whether inside or outside this House.
(a Tone?)

7. The Government came to office with two central objectives: to defeat inflation, and to breathe new life into a moribund economy. Inflation is a disease of money; and monetary policy is its only cure. Fiscal policy is used to bring the public accounts into balance and keep them there, and thus complete the process of re-establishing sound money. And within the context of sound money, markets had to be allowed to work again, and the enterprise culture restored, by the removal of unnecessary restrictions and controls, by the reform of

trade union law and promotion of all forms of capital ownership, and by the reform and reduction of taxation.

8. In the early years, the urgent task was to stamp out the inflationary forces that had raged in the '70s, and wrought so much economic and social havoc. Between 1974 and 1979 inflation averaged over 15 per cent. By 1983 we brought it down to 5 per cent, and that is what it has averaged since.

9. It was not surprising that in those early years less progress was made in improving the supply performance of the economy. But once business and industry recognised the dramatic changes that were occurring in the economic climate, they responded with vigour and confidence. As a result, we have experienced the longest period of sustained strong growth since records began. Indeed, output in the United Kingdom has grown faster than in all the other major European nations during the '80s - a marked contrast to the previous two decades, when we were bottom of the league. And this growth has been based on a dramatic and sustained improvement in productivity, which in the economy as a whole has been second only to that of Japan among all the major nations during the '80s - and in manufacturing has exceeded that of Japan.

10. We have more people in work than ever before, and their living standards have improved beyond recognition.

11. But it is not just our economic performance over the past ten years that has been transformed: so have our prospects for the future. For over the past seven years, investment has grown very nearly twice as fast as consumption, and total business investment is now a higher proportion of GDP than ever before. And its quality has improved immeasurably, too: witness the dramatic improvement in profitability.

12. So the outlook is good, provided we remain firm in our resolve to get on top of inflation.

13. A year ago, in the aftermath of the worldwide stock market crash, it looked as if there would be some slowing down from the rapid growth of 1987. In fact that was not to be.

14. It now looks as if we had in 1988 a second successive year of growth at $4^{1}/_{2}$ per cent - the first time this has happened [since the War/for 30 years] - with unemployment falling by half a million to well below the European average. [This means, incidentally,

that we have had six successive years of growth at 3 per cent or better, the first time this has ~~ever~~ occurred.] Since records began.

15. Manufacturing output grew particularly rapidly, by more than 7 per cent, to a level well above the previous peak reached as far back as the first half of 1974.

16. But total domestic demand also grew by some 7 per cent, and faster than the economy's capacity to supply, mainly because of the boom in industrial investment, in itself a welcome event, but also because of continued strong growth in consumer spending. This last was financed to an unprecedented degree by borrowing, overwhelmingly mortgage borrowing. Of all borrowing by households, almost 85 per cent is accounted for by mortgages compared with under 5 per cent by credit cards.

17. Inevitably this led to renewed inflationary pressure. To some extent this was relieved by a sharp rise in imports, and hence in the current account of the balance of payments. This is officially recorded as having reached £14$^3/_4$ billion in 1988, although given the £15$^1/_4$ billion positive balancing item (another name for errors and omissions) the true figure is almost certainly less than this. More important - for whatever

the true figure, it is undoubtedly large, and a sharp increase on the deficit recorded in 1987 after seven successive years of surplus - it is one that, given sound policies can readily be financed.

18. Unlike previous current account deficits we have known in this country, it does not reflect a budget deficit, but rather the excess of private sector investment over total private savings. And this is something that will in due course correct itself.

19. But there has also been some pick up in recorded inflation. Excluding the distorting effect of mortgage interest payments, the RPI, which rose by $5^{1}/_{4}$ per cent in 1983, increased by $4^{1}/_{2}$ per cent last year. But the rate picked up slightly markedly through the year, and the most recent figure is $5^{1}/_{2}$ per cent.

hardly a marked pick up?

20. Moreover this pick up in inflation appears to be a worldwide trend. Indeed, over the past six months, the rate of inflation excluding mortgage payments has probably risen by slightly less than inflation in the rest of the G7.

21. In any event, it soon became clear that it was necessary to tighten monetary policy sharply, by the only effective means of raising short-term interest

rates, and this was duly done, starting last June. I repeat what I have stated clearly on a number of previous occasions: interest rates will stay as high as is needed for as long as is needed to get on top of inflation. Nor am I prepared to allow the struggle against inflation to be undermined by exchange rate depreciation.

22. I am of course keenly conscious of the effects of the rise in interest rates on borrowers, particularly home owners. But however unwelcome high interest rates are, they are infinitely preferable to the damage that would be done by high inflation.

23. There are now increasing signs that the determined action already taken is having the desired effect. The housing boom that played such a large part in the events of last year has largely subsided. Monetary growth, particularly as measured by the target aggregate, M0, has slowed down appreciably. And retail sales, too, seem to have levelled off over the past three months, presaging a gradual recovery in the personal savings ratio.

24. The outlook for 1989 is for inflation to rise a little further to something approaching 8 per cent as

recorded by the RPI (although excluding mortgage interest payments the rate is forecast to remain well below 6 per cent) before falling back in the second half of the year to $5^1/_2$ per cent in the fourth quarter and perhaps $4^1/_2$ per cent in the second quarter of 1990.

25. A slow down in real growth is probably inevitable as we get inflation back onto a downward path - indeed, it has almost certainly already begun to happen. Overall growth is forecast to fall from the $4^1/_2$ per cent recorded last year to 2 per cent this year, with domestic demand growth also at 2 per cent. Within this, investment is once again forecast to grow faster than consumption. The current account deficit is forecast to remain at roughly the same level as this year's.

26. But the question of how "soft" or "hard" the landing is as we get the economy back on track is not ~~a~~ ultimately ~~matter for~~ in the hands of the Government, ~~nor is it a sensible objective of economic policy.~~ The Government's policy is to reduce inflation by acting, through monetary policy, to bring down the growth of GDP in money terms. The extent to which, over the short term, this is reflected in a reduction in inflation, and the extent to which it is reflected in a growth in real output, is up to business and industry.

27. In a free economy, it is up to them to ensure that the temporary rise in inflation during the first half of this year does not lead to an unwarranted rise in pay and other costs. Any failure by industry to control its costs will only make the necessary reduction in the growth of nominal GDP more painful, not least in terms of employment prospects.

28. But over the medium-term, it is clear from experience over the past ten years that it is inflation that will come down, while steady growth will resume. Indeed, it is clear that over anything but the very short term, the use of fiscal and monetary policy to promote growth merely leads to inflation; whereas the use of macroeconomic policy to curb inflation, when coupled with the right supply side policies, produces real growth. This basic pt. was disputed by 364 economists in late 1981. They said our policies could not deliver growth. Well we've had rather more than 364 consecutive weeks of steady and significant growth.

Monetary policy

29. Monetary policy, to which I now turn, plays and must always play, the central role in the battle against inflation. It is at the very heart of the medium-term financial strategy, the 10th Edition of which I am publishing today.

30. I have already described the monetary tightening that has taken place over the past nine months. This has lead to a sharp deceleration in the rate of growth of the target aggregate, M0, although for 1988-89 as a whole it is likely to have grown at some [2] percentage points above its target range.

31. For 1989-90, the target range will be 1-5 per cent, as envisaged in last year' MTFS. Although starting the year above the top of that range, its very low growth over the past six months - some $2^{1}/_{2}$ per cent at an annualised rate - suggests that it will soon come back within it. The exchange rate is also of particular importance in the conduct of monetary policy. The Government's clear commitment not to accommodate increases in domestic costs by exchange rate depreciation remains a key safeguard against inflation. It has recently been demonstrated in the markets by our readiness to make use of the massive reserves we have accumulated. In this context, we will continue to work with our G7 partners to maintain the exchange rate stability that has been a feature of the past two years.

32. As for the past [three] years, there is no target for the growth of broad money, or liquidity, but it will continue to be taken into account.

33. Short-term interest rates remain the essential instrument of monetary policy. As I have already indicated, the battle against inflation is paramount, and there can therefore be no question of any premature reduction in interest rates.

34. Meanwhile, I am today adding one more entry to the long list of financial controls which we have swept away during our term of office. The last surviving relic of the post-War apparatus for the direction of capital by the State is the Control of Borrowing Order which since 1946 has involved first the Treasury then the Bank of England in giving consents for equity and bond issues in the capital markets. The Treasury has today made a General Consent under the Control of Borrowing Order 1958, so that it will no longer be necessary for those who wish to make capital market issues to obtain the Bank of England's consent to the timing of such issues; and we will, as soon as possible, revoke the Order itself and repeal the legislation on which it depends, the 1946 Borrowing (Control and Guarantees) Act.

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<u>**Public Sector finances**</u>

36. When we first took office the public sector borrowing requirement was almost 6 per cent of GDP - equivalent to some £[30] billion in today's terms.

37. This was steadily reduced over the years as a deliberate act of policy, until, by 1987-88, the PSBR had been eliminated altogether and we started to repay the national debt.

38. Accordingly, last year I budgeted for a further Public Sector Debt Repayment, or PSDR, of some £3 billion. In the event, it looks like turning out five times as large, at £15 billion, or 3 per cent of GDP. Even if there had been no privatisation proceeds at all, the public finances would still be in surplus, to the tune of some £8 billion.

39. Nothing like this has ever been achieved since the War. And no other major country enjoys a comparable budget surplus. It has not been easy, even though we were assisted in the year now ending by a combination of an extra £2 billion of privatisation proceeds, and by the exceptional buoyancy of the economy, which both boosted tax receipts and reduced public expenditure well below the planned level. As a result, total public debt as a proportion of GDP is now lower than at any time since before the First World War.

40. Moreover, the substantial repayment of public debt over the past two years has permanently reduced the burden of debt servicing, both now and for future generations. For the coming year, for example, the debt repayments of the last two years mean that debt interest costs are lower by £[X] billion a year. Indeed, debt reduction on this scale means that in this year's Finance Bill I shall have to take a new power, not needed before, to enable gilts to be acquired by the NLF, for cancellation.

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42. Similarly it has proved possible to restructure part of the Government's foreign currency debt, launching an innovative and cost-effective programme of Treasury Bills denominated in ecu. The first experimental six-monthly tenders for these bills have proved extremely successful, and I can today inform the House that the programme will be continuing, at a level of around ecu $2^1/_2$ billion. [What period?]

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

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

44. It is a rule that ensures that, as GDP continues to rise, the ratio of public debt to GDP continues to fall, and with it the burden of debt interest. It ensures, too, that the State makes no claim either on the savings of the private sector or on flows of finance from overseas. But to go further than this, and seek to achieve the maximum possible repayment of public debt, would be neither economically sensible, nor consistent with the Government's policy, as it would mean deferring for a very long time the prospect now before us of a sustainable and progressive reduction in the burden of taxation.

45. So I reaffirm the principle of the balanced budget. However, given the substantial surplus we now have, the path of prudence and caution is clearly to return to balance not overnight, but gradually, over a period of years. Thus we can expect to have a number of further years of debt repayment ahead of us. Moreover, given the particular uncertainties there are at the present time, I believe it would be right to budget for 1989-90 for a surplus similar to that secured in the

year now ending, after adjusting for the change in privatisation proceeds: that is to say, a further public sector debt repayment, or PSDR, of some £13 billion. What this means is that it will not be possible in this Budget to reduce the burden of taxation that is to say, to reduce taxation as a share of GDP.

ANNOTATED

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REF: MPW/BS/89/5

COPY NO 34 OF 34

MASTER

FROM: MISS M P WALLACE
DATE: 7 March 1989

ANNOTATED

SIR T BURNS

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Anson
Dame A Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Mrs Lomax
Mr H P Evans
Mr Peretz
Mr Riley
Mr Sedgwick
Mr A C S Allan
Mr Gieve
Mr Hibberd
Mr O'Donnell
Mr Pickford
Miss Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

Sir A Battishill IR
PS/IR

Mr Unwin C&E
PS/C&E

Ch/
as usual ~ clean version, annotated one, and some of the key minutes. Comments in pencil are mine,* those in ink are others.

mpw

BUDGET STATEMENT: ECONOMIC SECTION

I attach the Chancellor's redraft of the Economic section of the speech. He would be grateful for quick comments, if possible to reach me by lunchtime tomorrow, Wednesday 8 March.

MPW.

MOIRA WALLACE

MCS
new 1

"This year's Budget comes at a time of concern, worldwide and at home, that the forces of inflation are beginning to gain ground again for the first time this decade. Against this background we must be more than ever vigilant, and more than ever resolute in our efforts to combat inflation, whenever and wherever it occurs.

2. It is only by doing this ..."

See JChaplin's note

Sounds too new. a late convert etc.

BUDGET SPEECH - FIRST SECTION

See MCS suggestion opposite

The background to this year's Budget is the overriding need to bear down on inflation, at a time when, [throughout the world] in most countries it is edging up for the first time this decade. [Not true, says Sedgwick see chart in his minute]

AT
JG
2. It is only by doing this, [whatever the short-term difficulties] that we will ~~preserve~~ take forward the great gains we have made in this country over the past ten years, gains

mpw [which offer so much hope] that have built a sound foundation for the future.

3. I shall begin, as usual, with the economic background to the Budget, I shall then deal with monetary policy and the public sector finances. Finally, I shall propose a number of measures to carry forward the process of tax reform.

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

5. The Government's first ten years in office have seen a transformation [both in the way in which economic]

in economy policy. We have transformed the way it

mpw is conducted. So not surprisingly the results ~~have~~ too have been transformed.

AGT in economy, reflected in X, Y, Z. Quite simply policies have pursued are working. We will stick with them.

policy is conducted, and in the results that have been achieved.

a Government ~~has~~ made it quite clear that it would

and that

would be

6. For the first time, economic policy ~~has~~ ~~been~~ set firmly and explicitly in a medium-term context. That means that ~~we do~~ not bend to every puff of wind that comes along: we resist the blandishments of those who urge reflation or deflation in automatic response to every new number that fashion dictates should assume special significance. We stand ready to act and act promptly whenever inflationary pressures threaten to re-emerge. But that is within a ~~general~~ basic philosophy that the Government should set a sound medium-term financial framework, and leave it to ~~the private sector~~ them to operate with confidence within it.

so that the private sector knows where it stands

The latest fluctuation in the latest fashionable number.

Cavalier? JC

Govt also ready to act on change in indicators.

7. The Government came to office with two central objectives: to defeat inflation, and to breathe new life into a moribund economy. Inflation is a disease of money; and monetary policy is its only cure. Fiscal policy is used to bring the public accounts into balance and keep them there, and thus [complete] the process of re-establishing sound money. And [within the context of sound money] markets had to be allowed to work again, and the enterprise culture restored, by the removal of unnecessary restrictions and controls, by the reform of

Also have clear idea of how to achieve them

the correct medicine

MCS: provide vital support for

DLCP JG

Too precise - CJR, JC

Redraft: F.P. is used to support M.P., limiting burden of debt of the economy + Govt's claim on nation's savings.

trade union law and promotion of all forms of capital ownership, and by the reform and reduction of taxation.

8. In the early years, the urgent task was to stamp out the inflationary ~~forces~~ fires that had raged in the '70s, and wrought so much economic and social havoc. Between 1974 and 1979 inflation averaged over 15 per cent. [By 1983 we brought it down to 5 per cent, and that is what it has averaged since.]

CJR: own goal, no further progress. "Over last 6 yrs it has averaged 5%"

AGT under stewardship of RHF Sir GH

9. It was not surprising that in those early years [less progress was made in improving] we saw no immediate results in our efforts to improve the supply performance of the economy. But once business and industry recognised the dramatic changes that were occurring in the economic climate, they responded with vigour and confidence. As a result, we have experienced the longest period of [sustained] strong and steady growth since records began. Indeed, output in the United Kingdom has grown faster than in all the major European nations during the '80s - a marked contrast to the previous two decades, when we were bottom of the league. And this growth has been based on a dramatic and sustained improvement in productivity, which ~~in~~ for the economy as a whole has been second only to that of Japan among all the major nations during the '80s. [and] In manufacturing it has even exceeded that of Japan.

MES

healthy?

AGT that we meant what we said and saw

PNS

radical?

? ×

AGT the key measure of competitiveness

JC Add something on supply side miracle - see her minute.

Sounds a bit cold - case for expanding JG.

10. We have more people in work than ever before, and their living standards have improved beyond recognition.

Add 1000 new firms a wk.

11. But it is not just our economic performance over the past ten years that has been transformed: so have our prospects for the future. For over the past seven years, [investment has grown [very nearly twice as fast as consumption, [JC: creating capacity ~~needed to meet future~~ demand] and total business investment is now a higher proportion of GDP than ever before. And its quality has improved immeasurably, too: [witness the dramatic improvement in profitability.]

SJP: may be better than this now

CJR: companies now investing because it is profitable to do so, not because of the subsidies offered to them

12. So the outlook is good, provided we remain firm in our resolve to get on top of inflation.

[Add that we do?]

[V. downbeat - AGT]

Any link required

13. A year ago, in the aftermath of the worldwide stock market crash, it looked as if there would be some slowing down from the rapid growth of 1987. In fact that was not to be.

JC: resilience underestimated by all?

14. It now looks as if we had in 1988 a second successive year of growth at $4^1/_2$ per cent - the first time this has happened [since the War/for 30 years] - with unemployment falling by half a million to well below the European average. [This means, incidentally,

"Unscrambling the composition of this growth is clouded by the large inconsistencies that have appeared in our macroeconomic statistics. The expenditure components of GDP grew by only 2½ per cent in 1988. There have also been enormous discrepancies, or balancing items, in the main sectoral accounts, adding to the difficulties involved in interpreting the behaviour in particular sectors. Domestic demand is estimated to have grown by some 6½ per cent, faster....".

PNS

16

averaging over

that we have had six successive years of growth ~~at~~ 3 per cent ~~[or better, the first time this has ever occurred.]~~

SJP → "or 4 successive years of growth at 3 per cent or better, the first time this has ever occurred."

15. Manufacturing output grew particularly rapidly, by more than 7 per cent, to a level well above the previous peak which was ~~[reached]~~ as far back as the first half of 1974. [only 4% - PNS]

PNS: add something on £ rapey stats - see opposite.

16. But total domestic demand also grew by some 7 per cent, which was faster than the economy's capacity to supply, mainly because of the reflected boom in industrial investment, in itself a welcome event, but also because of continued strong growth in consumer spending. This last was financed to an unprecedented degree by borrowing, overwhelmingly mortgage borrowing. Of all borrowing by households, almost 85 per cent is accounted for by mortgages compared with under 5 per cent by credit cards.

YG
JG (to shorten)

MCS agrees ↓ sticks out a little here.

/ what?

17. Inevitably this led to renewed inflationary pressure. To some extent this was eased ~~[relieved]~~ by a sharp rise in imports, and hence in the deficit on the current account of the balance of payments. This is officially recorded as having reached ~~£14~~$^3/_4$ billion in 1988, although given the ~~£15$^1/_4$~~ billion positive balancing item [(another name for errors and omissions)], the true figure is almost certainly less than this. But ~~[More important - for]~~ whatever

AGT dislikes X
JG
£4.½ } SJP
£16 billion }

which may well mean we've been under recording exports + over recording imports

LBS

MCS
new 19
+20

"19. But there has also been some increase in inflation, at home and worldwide. Indeed, the rate of inflation in the rest of the Group of 7 major industrialised countries has, over the past six months, risen slightly more rapidly than in Britain, if we exclude, as all the other countries except Canada do, mortgage interest payments from the comparison. On this basis the RPI, which rose by 5¼ per cent in 1983, increased by 4½ per cent last year; but the rate picked up markedly throughout the year, and the most recent figure is 5½ per cent."

the true figure, it is undoubtedly large, and a sharp increase on the deficit recorded in 1987 after seven successive years of surplus. The most important thing is ~~it is one~~ that, given sound policies we can readily ~~be~~ finance~~d~~ it.

AGT

18. The deficit stands in marked contrast to ~~Unlike~~ previous current account deficits [we have known in] this country has known, it [does not reflect] is not the result of a budget deficit, but rather the excess of private sector investment over total private savings. And this is something that will in due course correct itself.

See MCS suggestion opposite.

reference to 1983 confuses as it stands. Expand to bring out point?

19. But there has also been some pick up in recorded inflation. Excluding the distorting effect of mortgage interest payments, the RPI, which rose by $5^1/_4$ per cent in 1983, increased by $4^1/_2$ per cent last year. But ~~the rate~~ inflation picked up markedly through the year, and the most recent figure is $5^1/_2$ per cent.

see PNS caveats and HPE's

I wd omit – "tortured"

20. Moreover this [pick up in inflation] appears to be part of a worldwide trend. Indeed, over the past six months, the UK rate of inflation [excluding mortgage payments] has probably risen by slightly less than inflation in the rest of the G7.

21. In any event, it soon became clear that it was necessary to tighten monetary policy sharply, by the

MCS

only effective means, of raising short-term interest rates, and this ~~was~~ I duly ~~done~~ did, starting last June. I repeat what I have stated clearly on a number of previous occasions: interest rates will stay as high as is needed for as long as is needed to get on top of inflation. Nor am I prepared to allow [the struggle] our achievements in the battle against inflation to be undermined by exchange rate depreciation.

JG prefers in §33

MCS: cd drop comes later

22. I am of course keenly conscious of the effects of the rise in interest rates on borrowers, particularly home owners. But however unwelcome high interest rates are, they are infinitely preferable to the damage that would be done by high inflation.

JC: add: unpopular because targetted + working

23. There are now increasing signs that the determined action [already] we have taken is having the desired effect. The housing boom that played such a large part in the events of last year has largely subsided. Monetary growth, particularly as measured by the target aggregate, M0, has slowed down ~~appreciably~~ sharply. And retail sales, too, seem to have levelled off over the past three [four] months, presaging a gradual recovery in the personal savings ratio.

JC: sticks out - technical.

MCS

JG - will have Feb prov by then.

24. The outlook for 1989 is for inflation to rise a little further to [something approaching] 8 per cent as

caution - cf last figure

JG and PNS

nor in FSBR (PNS)

the House won't hear the brackets - cd be confusing.

recorded by the RPI (although excluding mortgage interest payments the rate is forecast to remain well below 6 per cent) ~~before~~ The RPI should then fall~~ing~~ back in the second half of the year to $5^1/_2$ per cent in the fourth quarter and perhaps $4^1/_2$ per cent in the second quarter of 1990.

MCS suggests omit sentence in brackets

JC: add good news on investment intentions, and why industry not destroyed by higher IR.

JG

25. A slow down in real growth is [probably] inevitable as we get inflation back onto a downward path - indeed, it has almost certainly already begun to happen. Overall growth is forecast to fall from the $4^1/_2$ per cent recorded last year to 2 per cent this year, with domestic demand growth also at 2 per cent. Within this, investment is once again forecast to grow faster than consumption. The current account deficit is forecast to remain at [roughly] the same level as ~~this~~ last year's.

SJP × PNS

Delete or amend - see CST note
Omit: MCS

JG

JG

26. [But the question of how "soft" or "hard" the landing is as we get the economy back on track is not a matter ~~for~~ Government can determine, nor is it a sensible objective of economic policy.] What The Government's ~~policy~~ can + is determined to do is to reduce inflation by acting, through monetary policy, to bring down the growth of GDP in money terms. The extent to which, over the short term, this is reflected in a reduction in inflation, and the extent to which it is reflected in a growth in real output, is up to business and industry.

abroad in cost & quality of service

JC: it is essential that business + ind do not allow

27. [In a free economy, it is up to them to ensure that the temporary rise in inflation during the first half of this year does not lead to an] unwarranted rises in pay and other costs. Any failure by industry to control its costs will only make the necessary reduction in the growth of nominal GDP more painful, not least in terms of employment prospects. But I am confident they will meet challenge for man'l in Brit industry is better motivated than ever & know central importance of matching comp from

JG

~~[illegible]~~

MCS

JC thinks this not quite right See her note.

28. But over the medium-term, it is clear from experience over the past ten years that with our policies, it is inflation that will come down, while steady growth will resume. Indeed, [it is clear] that over anything but the very short term, the use of fiscal and monetary policy to promote growth merely leads to inflation; whereas the use of macroeconomic policy to curb inflation, when coupled with the right supply side policies, produces real growth.

AGT says "condensed but effective"

Monetary policy

29. Monetary policy, to which I now turn, plays and must always play, the central role in the battle against inflation. It is at the very heart of the medium-term financial strategy, the 10th Edition of which I am publishing today.

SJP DLCP ×

30. I have already described the monetary tightening that has taken place over the past nine months. This has lead to a sharp deceleration in the rate of growth of the target aggregate, M0, although [for] on average during 1988-89 [as a whole] it [is likely to have grown at] has been some [~~2~~] 2½ percentage points above its target range.

MTFS says "under 3"

31. For 1989-90, the target range will be 1-5 per cent, as envisaged in last year' MTFS. Although starting the year above the top of that range, its very low growth over the past six months - some $2^1/_2$ per cent at an annualised rate - suggests that it will soon come back within it. ¶ The exchange rate is also of particular importance in the conduct of monetary policy. The Government's clear commitment not to accommodate increases in domestic costs by exchange rate depreciation remains a key safeguard against inflation. [It has recently been demonstrated in the markets by our readiness to make use of the] massive reserves We have accumulated and are ready to make use of them. In this context, we will continue to work with our G7 partners to maintain the exchange rate stability that has been a feature of the past two years.

DLCP

MCS

32. As for the past [three] years, there is no target for the growth of broad money, or liquidity, but it will continue to be taken into account.

I see no need to set a target for it.

CST - sounds dismissive

Or if you want something shorter you could model it on the section we put in the note for the Queen ~~(attached)~~. below.

I shall be announcing on Budget day a substantial liberalisation of the London sterling capital market. I am abolishing the queue for bond and equity issues which has been operated by the Bank of England since 1946, opening up the market for sterling paper and at the same time simplifying its regulatory regime. I am also making some consequential changes in the taxation of deep discount and other bonds. Taken together all these changes ~~should~~ will give greater flexibility to those who issue capital in London; and wider choice to those who invest here.

JG: omit

Is there a better link eg. interest rates the right weapon; not controls; which I reject;

33. Short-term interest rates remain the essential instrument of monetary policy. As I have already indicated, the battle against inflation is paramount, and there can therefore be no question of any premature reduction in interest rates.

34. Meanwhile, I am today adding one more entry to the long list of financial controls which we have swept away during our term of office. The last surviving relic of the post-War apparatus for the direction of capital by the State is the Control of Borrowing Order which since 1946 has involved first the Treasury then the Bank of England in giving consents for equity and bond issues in the capital markets. The Treasury has today made a General Consent under the Control of Borrowing Order 1958, so that it will no longer be necessary for those who wish to make capital market issues to obtain the Bank of England's consent to the timing of such issues; and we will, as soon as possible, revoke the Order itself and repeal the legislation on which it depends, the 1946 Borrowing (Control and Guarantees) Act.

happy not to mention LAs? SJP

35. The sterling capital market has in recent times been going through a period of considerable adjustment,

as the Government has changed from being a large issuer to a large purchaser of its own debt. I will have more to say about that in a moment. The abolition of the Control of Borrowing Order will remove an unnecessary and bureaucratic restriction on issuers of capital as they move into the space formerly occupied by the Government when it was a borrower.

MCS wants to reinsert sterling cap mkts, opposite.

Public Sector finances

36. When we first took office the public sector [SJP-78-9] borrowing requirement was ~~almost 6~~ over 5 per cent of GDP - equivalent to some £[~~30~~] 25 billion in today's terms.

37. This was steadily reduced over the years as a deliberate act of policy, until, by 1987-88, the PSBR had been eliminated altogether and we [started to repay DLCP the national debt] had a debt repayment.

38. Accordingly, last year I budgeted for a further Public Sector Debt Repayment, or PSDR, of some £3 billion. In the event, it looks like turning out C.M. five times as large, at £~~15~~ 14 billion, or 3 per cent of GDP. Even if there had been no privatisation proceeds at all, the public finances would still be in surplus, to the tune of some £~~8~~ 7 billion.

[PSFD Late 40s
- 2 1/4 / 2 3/4 GDP]

for 40 yrs

CM 39. Nothing like this has ever been achieved [since the War]. And no other major country enjoys a comparable budget surplus. It has not been easy, even though we have been this
JG were assisted in the year now ending by a combination of an extra £2 billion of privatisation proceeds, and by the exceptional buoyancy of the economy, which both boosted tax receipts and reduced public expenditure well below the planned level. [As a result,] total public debt government CM
MCS as a proportion of GDP is now lower than at any time
JG since [before] the First World War.

net
DLCP 40. Moreover, the substantial repayment of public debt over the past two years has permanently reduced the burden of debt servicing, both now and for future generations. For the coming year, for example, the debt net
DLCP repayments of the last two years mean that debt interest will be about 1 3/4 continuing
CM | DLCP costs are lower by £[X] billion a year. Indeed, debt reduction on this scale means that in this year's be taking
Finance Bill I shall [have to take] a new power, not with money from
unclear - AGT. needed before, to enable gilts to be acquired by the NLF, for cancellation.

[See ACSA's separate piece on funding behind]

41. The dramatic improvement in the United Kingdom's public finances has also provided a welcome opportunity to devote more attention to the structure of the debt

See Peretz redraft opposite.

that remains. Now that the Government has become a net purchaser of debt, it has become possible to tailor repayment policy so as to reduce future interest costs, and to improve the quality of ~~outstanding~~ remaining Government debt by relying less on the more liquid borrowing instruments.

DLCP

MCS

42. Similarly it has proved possible to restructure part of the Government's foreign currency debt, launching an innovative and cost-effective programme of Treasury Bills denominated and payable in ecu. The ~~first~~ initial series of [experimental] six-monthly tenders for these bills has proved extremely successful, and I can today inform the House that [the programme will be continuing, at a level of around ecu $2^1/_2$ billion. [What period?]]

this is an innovation we plan to continue [Bank]

43. In last year's Budget Speech , I set out the principle of a balanced budget as a proper objective of fiscal policy.

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

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

44. It is a rule that ensures that, as GDP continues to rise, the ratio of public debt to GDP continues to fall, and with it the burden of debt interest. It ensures, too, that the State makes no claim either on the savings of the private sector or on flows of finance from overseas. But to go further than this, and seek to achieve the maximum possible repayment of public debt, [would be neither economically sensible, nor consistent with the Government's policy, as it would mean deferring for a very long time the prospect now before us of a sustainable and progressive reduction in the burden of taxation.]

unnecessarily dismissive, lost big a signal of tax JG.

JG → in the long term. Building up surplus not an end in itself. No case for raising more rev. than need as permanent policy

45. So I reaffirm the principle of the balanced budget. However, given the substantial surplus we now have, the path of prudence and caution is clearly to return to balance not overnight, but gradually, over a period of years. Thus we can expect to have a number of further years of debt repayment ahead of us. Moreover, given the particular uncertainties there are at the present time, I believe it would be right to budget for 1989-90 for a surplus similar to that secured in the

year now ending, after adjusting for the change in privatisation proceeds: that is to say, a further public sector debt repayment, or PSDR, of some £13 billion. What this means is that it will not be possible in this Budget to reduce the burden of

JG taxation that is to say, to reduce taxation and NICs as a share of GDP.

[I dislike this]

chex.ps/mw/13

cc PEM
TB

BUDGET - SECRET

BUDGET SPEECH - FIRST SECTION

The background to this year's Budget is the continuing need to combat inflation, at a time when, throughout the world, it is unmistakably edging up again.

2. It is only by doing this, whatever the short-term difficulties, that we can be sure of ~~pursuing~~ preserving the great gains we have made in this country over the past ten years, gains which offer the prospect of an even better future.

3. I shall begin, as usual, with the economic background to the Budget, I shall then deal with monetary policy and the public sector finances. Finally, I shall propose a number of measures to carry forward the process of tax reform.

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

5. The Government's first ten years in office have seen a transformation both in the way in which economic policy is conducted, and in the results that have been achieved.

BUDGET - SECRET

6. For the first time, economic policy has been set firmly and explicitly in a medium-term context. We stand ready to act and act decisively whenever inflationary pressures threaten to re-emerge. But that is within the basic philosophy that the Government should set a sound medium-term financial framework and leave the private sector free to operate with confidence within it.

7. The Government came to office with two central objectives ~~and~~ — to defeat inflation, and to breathe new life into a moribund economy — and a ~~clean~~ clear idea of how to ~~advise~~ achieve them. Inflation is a disease of money; and monetary policy is its cure. Fiscal policy is used to bring the public accounts into balance and keep them there, and thus provide vital support for the process of re-establishing sound money. Within the context of sound money, markets have to be allowed to work again, and the enterprise culture restored, by the removal of unnecessary restrictions and controls, by the reform of trade union law and promotion of all forms of capital ownership, and by the reform and reduction of taxation.

8. Our first and most urgent task was to stamp out the inflationary fires that had raged in the '70s, and wrought so much economic and social havoc. Between 1974

BUDGET - SECRET

and 1979 inflation averaged over 15 per cent. Over the past six years, it has averaged under 5 per cent.

9. On the supply side, once business and industry recognised the fundamental changes that were taking place, they responded to the new economic climate with vigour and confidence. As a result, we have experienced the longest period of strong and steady growth since records began. Indeed, output in the United Kingdom has grown faster than in all the other main European nations during the '80s - a marked contrast to the previous two decades, when we were bottom of the league. And this growth has been based on a dramatic and sustained improvement in productivity, which for the economy as a whole has been second only to that of Japan among all the major nations during the '80s. In manufacturing it has exceeded that of Japan.

10. In Britain today we have more people in work than ever before, they are better motivated, and their living standards have improved beyond recognition.

11. But it is not just our economic performance over the past ten years that has been transformed: so have our prospects for the future. For over the past seven years, investment has grown twice as fast as

consumption, creating the increased capacity necessary to meet future demand. Total business investment is now a higher proportion of GDP than ever before. And its quality has improved immeasurably, too; as has the quality of British management. Hence the dramatic and long overdue improvement in company profits. And the total number of businesses is growing at the rate of 1,000 companies a week.

12. So the outlook is good, provided we remain firm in our resolve to get on top of inflation. And at least on this side of the House, we do.

13. A year ago, in the aftermath of the worldwide stock market crash, it looked as if there would be some slowing down from the rapid growth of 1987. In fact that was not to be.

14. It now appears that we had in 1988 a second successive year of growth at $4^1/_2$ per cent - the first time this has happened [since the War/for 30 years] - with unemployment falling by half a million to well below the European average. This means, incidentally, that we have had four successive years of growth at 3 per cent or better, the first time this has ever occurred.

BUDGET - SECRET

15. Manufacturing output grew particularly rapidly, by more than 7 per cent, to a level well above the previous peak reached as far back as the first half of 1974.

16. But total domestic demand probably also grew by getting on for 7 per cent, considerably faster than the economy's capacity to supply, mainly because of the boom in industrial investment, in itself a welcome event, but also because of continued strong growth in consumer spending. This last was financed to an unprecedented degree by borrowing, overwhelmingly mortgage borrowing. Of all borrowing by households, almost 85 per cent is accounted for by mortgages compared with under 5 per cent by credit cards.

17. Inevitably the rapid growth of total spending led to renewed inflationary pressure. To some extent this STET was diverted into a sharp rise in imports, and hence ~~in~~ into the deficit on the current account of the balance of payments. This is officially recorded as having reached [£$14\frac{3}{4}$] billion in 1988, although given the [£$15\frac{1}{4}$] billion positive balancing item - another name for errors and omissions - the truc figure is almost certainly less than this. But whatever the true figure,

BUDGET - SECRET

it is undoubtedly large, and a sharp increase on the deficit recorded in 1987 after seven successive years of surplus.

18. But given sound policies it can readily be financed. Moreover, unlike previous current account deficits we have known in this country, it reflects not a budget deficit, but rather the excess of private sector investment over total private savings. And this is something that will in due course correct itself.

19. But there has also been some pick up in recorded inflation. Excluding the distorting effect of mortgage interest payments, the RPI rose by $4^1/_2$ per cent 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 $5^1/_2$ per cent.

20. Moreover this pick up in inflation appears to be a worldwide trend. Taking the seven major industrial nations as a whole, inflation is now at its highest level for some three years, and still heading upwards.

21. In the UK, as in a number of other countries, it became clear that it was necessary to tighten monetary

BUDGET - SECRET

policy sharply. This meant raising short-term interest rates, which I duly did, starting last June.

22. I am of course keenly conscious of the difficulties for many borrowers, particularly home owners, caused by the rise in interest rates. But however unwelcome high interest rates are, they are infinitely preferable to the damage that would be done by high inflation.

23. There are now increasing signs that the determined action I have taken is having the desired effect. The housing boom that played such a large part in the events of last year has subsided. Monetary growth has slowed down appreciably. And retail sales, too, seem to have levelled off over the past four months, presaging a gradual recovery in the personal savings ratio.

24. Thc outlook for 1989 is for inflation to rise a little further, from $7^1/_2$ per cent including mortgage interest payments to close to 8 per cent, before falling back in the second half of the year to $5^1/_2$ per cent in the fourth quarter and perhaps $4^1/_2$ per cent in the second quarter of 1990.

25. A slowdown in real growth is inevitable as we get inflation back onto a downward path - indeed, it has almost certainly already begun to happen. Overall growth is forecast to fall from the $4^1/_2$ per cent recorded last year to 2 per cent this year, with domestic demand growth also at 2 per cent. Within this, investment, which is holding up well, is once again forecast to grow faster than consumption. The current account deficit is forecast to remain at the same level as last year.

26. But the question of just how "soft" or "hard" the landing is as we get the economy back on track, is not in the hands of Government alone. The Government's task is to reduce inflation by acting, through monetary policy, to bring down the growth of GDP in money terms. The extent to which, over the short term, this is reflected in a reduction in inflation, and the extent to which it is reflected in slower output growth, is up to business and industry.

27. The better industry succeeds in controlling its pay and other costs, the less painful the necessary reduction in the growth of nominal GDP will be, not least in terms of employment prospects.

28. But over the medium-term, it is clear from our experience over the past ten years that the policy we are pursuing will bring inflation down, and steady growth will resume. Indeed, over anything but the very short term, the use of fiscal and monetary policy to promote growth merely leads to inflation; whereas the use of macroeconomic policy to curb inflation, when coupled with the right supply side policies, produces real growth.

Monetary policy

29. Monetary policy, to which I now turn, plays and must always play, the central role in the battle against inflation. It is at the very heart of the medium-term financial strategy, the tenth edition of which I am publishing today.

30. I have described the monetary tightening that has taken place over the past nine months. This has already led to a sharp deceleration in the rate of growth of the target aggregate, M0.

31. For 1989-90, the target range for MO will be 1-5 per cent, as envisaged in last year' MTFS. Although starting the year above the top of that range, its very

BUDGET - SECRET

low growth over the past six months - under 3 per cent at an annualised rate - suggests that it will fairly soon come back within it. As for the past [three] years, there is no target for the growth of broad money, or liquidity, but I will continue to take it into account in assessing monetary conditions.

32. The exchange rate is of particular importance in the conduct of monetary policy. The Government's clear commitment not to accommodate increases in domestic costs by exchange rate depreciation remains a key safeguard against inflation. This has been demonstrated both by the level of interest rates and by our readiness to use the massive reserves we have accumulated. In this context, we will continue to work with our G7 partners to maintain the exchange rate stability that has been a feature of the past two years.

33. Short-term interest rates remain the essential instrument of monetary policy. I repeat what I have stated clearly on a number of previous occasions: interest rates will stay as high as is needed for as long as is needed to get on top of inflation.

BUDGET - SECRET

Public Sector finances

34. I now turn to fiscal policy. When we first took office the public sector borrowing requirement was over 5 per cent of GDP - equivalent to more than £25 billion in today's terms.

35. This was steadily reduced over the years as a deliberate act of policy, until, by 1987-88, the PSBR had been eliminated altogether and we started to repay the national debt.

36. Accordingly, last year I budgeted for a further Public Sector Debt Repayment, or PSDR, of some £3 billion. In the event, it looks like turning out almost five times as large, at £14 billion, or 3 per cent of GDP. Even if there had been no privatisation proceeds at all, the public finances would still be in surplus, to the tune of some £7 billion.

37. Nothing like this has ever been achieved in the past 40 years. And no other major country enjoys a comparable budget surplus. It has not been easy, even though we have been assisted in this in the year now ending by the exceptional buoyancy of the economy, which both boosted tax receipts and reduced public expenditure

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well below the planned level. As a result, Government debt as a proportion of GDP is now lower than at any time since the First World War.

38. Moreover, the substantial net repayment of public debt over the past two years has permanently reduced the burden of debt servicing, both now and for future generations. For the coming year, for example, the debt repayments of the last two years mean that net debt interest costs will be lower by some £1$^{3}/_{4}$ billion a year. This saving is being put to good use.

X

39. The objective of funding policy remains unchanged: to achieve a full fund of the Government's borrowing requirement, which nowadays translates into using the Budget surplus to buy back an equivalent amount of Government debt. With the PSDR this year likely to be considerably larger than earlier expected, it may not be practicable to buy back sufficient debt to meet the funding rule this financial year, in spite of innovations such as a reverse gilt auction. The undershoot will therefore be carried forward into the next financial year. Because there are unusually heavy

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maturities of gilt-edged stock in 1989-90, this is unlikely to require any major change in the rate at which the Bank of England purchases gilts.

40. The dramatic improvement in the United Kingdom's public finances has also provided a welcome opportunity to devote more attention to the structure of the debt that remains. We will continue to seek both to minimise the cost of servicing the Government's domestic debt and to improve its quality by relying less on the more liquid borrowing instruments.

41. We have also been able to restructure part of the Government's foreign currency debt, launching an innovative and cost-effective programme of Treasury Bills denominated and payable in ecu. The first series of six monthly tenders for these bills has proved very successful, and this is an innovation we plan to continue.

42. Meanwhile, I am today adding one more entry to the long list of financial controls which we have swept away during our term of office. The last surviving relic of the post-War apparatus for the direction of capital by the State is the Control of Borrowing Order, which since 1946 has involved first the Treasury and then the Bank

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of England in giving consents for equity and bond issues in the capital markets. The Treasury has today made a General Consent under the Control of Borrowing Order 1958, so that it will no longer be necessary for those who wish to make capital market issues to obtain the Bank of England's consent to the timing of such issues; and we will, as soon as possible, revoke the Order itself and repeal the legislation on which it depends, the 1946 Borrowing (Control and Guarantees) Act.

43. The sterling capital market has in recent times been going through a period of considerable adjustment, as the Government has changed from being a large issuer to a large purchaser of its own debt. I will have more to say about that in a moment. The abolition of the Control of Borrowing Order will remove an unnecessary and bureaucratic restriction on issuers of capital as they move into the space formerly occupied by the Government when it was a borrower.

44. This new freedom will be enhanced by a further, important, set of derogatorily measures for the sterling capital market which are being promulgated today in notices issued by the Bank of England. These measures will open up the market for sterling paper of less than

5 years' maturity by extending the range of institutions which can make such issues; and they will create a unified regime for all these issues.

45. Taken together the changes I have described constitute a major liberalisation of the arrangements for London's capital markets. They will give greater flexibility to issues and wider choice to investors.

46. In last year's Budget Speech , I set out the principle of a balanced budget as a proper objective of fiscal policy, in these terms:

> "A balanced budget is a valuable discipline for the medium term. It represents security for the present and an investment for the future. Having achieved it, I intend to stick to it. In other words, henceforth a zero PSBR will be the norm. This provides a clear and simple rule, with a good historical pedigree."

47. It is a rule that ensures that, as GDP continues to rise, the ratio of public debt to GDP continues to fall, and with it the burden of debt interest. It ensures, too, that the State makes no claim either on the savings of the private sector or on flows of finance

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from overseas. But to go further than this, and seek to achieve the maximum possible repayment of public debt, would not be consistent with the Government's policy, as it would mean deferring for a very long time the benefits of a reduction in the burden of taxation.

48. So I reaffirm the principle of the balanced budget. However, given the substantial surplus we now have, the path of prudence and caution is clearly to return to balance not overnight, but gradually, over a period of years. Thus we can expect to have a number of further years of debt repayment ahead of us. Moreover, given the particular uncertainties there are at the present time, I believe it would be right to budget for 1989-90 for a surplus similar to that secured in the year now ending; in other words, a further public sector debt repayment, or PSDR, of some £14 billion. What this means is that it will not be possible in this Budget to reduce the burden of taxation; that is to say, to reduce taxation as a share of GDP.

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covering BUDGET SECRET: L BLO

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Central Division

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COPY NO 1 of 8

Miss M P Wallace
Room 13/2
Chancellor's Office
HM Treasury

7 March 1989

IR

Dear Moira

BUDGET STATEMENT: TAX SECTION

Thank you for copying your submission of 6 March and the Chancellor's latest version of the Speech and, once again, for the extra copy.

I am returning to you copy 33 of your note. As before, textual suggestions have been annotated in red and explanatory comments, where necessary, in blue.

Some of our suggestions need slightly fuller comments and these are on the attached sheet.

I am copying this letter, without the annotated Speech, to Revenue recipients of your note and to Steve McManus.

Yours
Charles.

C S McNICOL

BUDGET STATEMENT: 6 MARCH 1989 VERSION

Paragraphs 16 and 17: Schedule E - receipts basis

We are not sure that, if pressed, we could sustain the argument that the "several higher rates" of tax necessitated an accruals basis for Schedule E. (The existing Schedule E basis of assessment was, in fact, introduced because of the change to PAYE. And there are other types of income not taxed on an accruals basis.) Hence the suggested recasting.

Paragraphs 18 and 19: Close company legislation

You asked us to check the reference in paragraph 19 to "many hundreds of thousands".

In principle, all close companies (getting on for about 900,000) are potentially within the apportionment rules. But the great majority of these are not liable to apportionment mainly because trading income is no longer apportionable and small family companies tend to distribute their income as remuneration or dividends. It is the non-distributors of investment income and those making certain interest payments and annual payments that are caught by the present rules.

I have suggested how it might be incorporated, or we can drop.

But the complexity of the apportionment rules has given rise to complaints, and there has been pressure for their modification and, since last year's Budget, their abolition. So the point that abolition of apportionment will be welcomed is worth making and we suggest it might be done as indicated on the draft.

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Paragraph 38: Employee share schemes

We would be inclined to omit the reference to the number of companies involved because:-

- the figure is a rough estimate;
- in practice it means very little (a scheme may involve one company with 10,000 employees, or 1,000 companies in a group covering the same number of employees);
- in any event, the figure is very stale. (It was used in 1986 in relation to 1,000 schemes and in January 1988 in relation to 1,400 schemes.)

Paragraph 40: ESOPs

I understand that FIM may have some input to this paragraph: you may wish to touch base with them.

No they haven't - M.

Paragraphs 49 et seq: Life Assurance

A number of points.

Paragraph 49: While, of the consultative document options, Option B has clearly been rejected, I gather that, following a meeting chaired by the Financial Secretary, the Budget Day Press Release will indicate that Option A is not off the table altogether. One solution might be, in line 8, to refer to "reform" rather than "reforms".

Paragraph 50: As indicated last time, "pension business" is part of a company's life business. "Entirely" is appropriate because, even under the present regime, companies have to keep the two businesses separate for some purposes.

Paragraphs 51 and 54: It is important, for the sake of accuracy, that these additions, which we suggested last time, are made. As it stands, paragraph 54 especially, is misleading.

Trusts

As indicated on the draft, we think this short additional piece should go in. Since the measures are in part triggered by Independent Taxation, that part of the Speech seems the best place.

Paragraph 85: Payroll giving

I gather that Malcolm Buckler in the Paymaster General's Office is making enquiries about the status of this announcement. I suggest you liaise with him. (As of now, we do not know what the precise position is.)

Sorry. Still pursuing. PMG commented last time but did ~~[illegible]~~ not comment on this point then.

M.

mg.ee/dlcp/8.3-pps

CONFIDENTIAL

From : D L C Peretz
Date : 8 March 1989

PPS

cc PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Riley
Mr Gieve
Miss O'Mara
Mr Pickford
Mr Chaplin

BUDGET SPEECH : FUNDING POLICY

I attach a paragraph on the lines you commissioned earlier today.

2. I have tried to avoid use of the word "unfund", which always strikes me as somewhat inelegant. (I suppose 'under unfunding' is best kept for other occasions!)

3. I have also avoided giving any figures for the likely size of the overfund to be carried forward to next year. If we gave a range it would be something like £0-£4 billion. Even leaving aside uncertainties about the PSDR itself, uncertainties about the scale of bank/building society purchases/sales of gilts in February and March, and about intervention over the rest of this month, mean that it is not impossible that we will end up with something quite close to a full fund, and equally that we could be as far out in the other direction from our present central estimate of overfunding for the year of about £2 billion. This central figure of course also assumes that the Bank will be able to continue to make good progress in buying in over the next 3 weeks.

Ch

I offer a less technical version

DLCP

D L C PERETZ

AA

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FROM: A C S ALLAN
DATE: 8 March 1989

MR PERETZ

cc PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Riley
Mr Gieve
Miss O'Mara
Mr Pickford
Mrs Chaplin

BUDGET SPEECH: FUNDING POLICY

The Chancellor feels it would be worth including a paragraph on funding policy in the Budget Speech. This would restate that our policy is a full unfund, but that the rapid increase in the PSDR has made it impracticable to achieve this this financial year. As a result some £X to £Y billion will be carried forward to the next financial year, when maturities are particularly heavy so that there will not be any major change of gear in the rate of gross purchases.

2. I should be grateful for a draft paragraph <u>by close of play tonight</u>.

ACSA

A C S ALLAN