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PART A

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PART A

BUDGET 1984 PRESENTATION

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PART A

84 Budget

Chief Economic Adviser to the Treasury

Presentation and Effects on

- Corporate Sector (TB)
- Financial Sector
- House Prices
- Equities
- RPI
- Financial Plans.

Budget 1984
Presentation

08

Budget ~~B~~

A62

CONFIDENTIAL

SIR TERRY BURNS

Thank you. I have spoken to Mr O-S about this. If we are operating on a firm MI basis I would be content to see the calculations on a "fiscal adjustment" basis. TB

FROM: C J RILEY
DATE: 13 January 1983

cc Mr Odling-Smee
Mr Battishill
Mr Ritchie

PRESENTATION OF EFFECTS OF FISCAL MEASURES IN RUN UP TO THE BUDGET

I attach (top only) some recent correspondence on the topic of the presentation of the effects of fiscal changes in the run-up to the Budget. We discussed this with CU yesterday, and Tony Battishill said that he might raise this issue 'in the margins' at Chevening. You might therefore like to be aware of what the debate is about.

2. The main problem is how to present the effects of individual fiscal changes in the scoresheets kept in the run-up to the Budget. We need a record of the individual effects of the various tax and expenditure measures under consideration, which can be set against the aggregate fiscal effect at which the Budget is aiming, in order to monitor progress in putting together a package which achieves this aggregate effect. The practice developed in presenting forecasts has been to present the aggregate fiscal effect in terms of the 'fiscal adjustment' required to meet a given PSBR target. The scoresheets kept in the run-up to previous Budgets have, however, recorded the fiscal effects of individual measures in terms of PSBR effects. This is a potential source of confusion, as it has not been widely appreciated that the fiscal adjustment is not the same thing as the gap between the 'no policy change' PSBR and the target PSBR.

3. We in MP have floated the idea that the scoresheets should record individual fiscal measures in terms of their effects on the fiscal adjustment, rather than their PSBR effects. This is the subject of the attached correspondence. The arguments about PSBR effects versus fiscal adjustment effects revolve to a large extent about how one sees the Budget arithmetic - as attempting to close a given fiscal adjustment, or as attempting to change a 'no policy

13/1

change' projection of the PSBR by £ x billion. Our suggestion of fiscal adjustment effects starts from the premiss that the presentation of the aggregate fiscal gap as a fiscal adjustment is now the standard, familiar one. It assumes that the decision on the post-budget PSBR is taken more or less independently of the make-up of the budget package.

4. If we were instead to opt for a presentation of scoresheets in terms of PSBR effects, as in previous years, then it would be desirable to set this alongside a target for the aggregate fiscal effect measured in terms of the difference between two PSBR's - the 'no tax change' one and the target one. This has implications for the presentation of the forecast.

CJR

C J RILEY

2/12/1

CONFIDENTIAL

FROM: ALLEN RITCHIE
12 JANUARY 1984

cc:

MR BATTISHILL

Mr Odling-Smee
Mr Riley
Mr Folger
Mr Davies
Mr Melliss
Mr Norgrove
Mr Bayoumi
Ms Goodman

PRESENTATION OF EFFECTS OF FISCAL CHANGES - PSBR OR FISCAL ADJUSTMENT?

In October, you and Mr Riley exchanged minutes about how the effects of fiscal changes might most usefully be presented on the score sheets which are produced in the run-up to the Budget. Mr Riley suggested then that it might be preferable to present fiscal options in terms of effects on the fiscal adjustment, as conventionally defined, rather than in terms of effects on the PSBR. We have not as yet resolved this issue.

2. For a given forecast, the fiscal adjustment is conventionally defined as the change in income tax measured in terms of revenue yield at incomes and prices in the forecast, which would be required to achieve the specific PSBR target imposed. In the run-up to the Budget, we are interested in how a given forecast is affected by various options for fiscal policy changes, usually tax changes. This starting forecast may be constructed with or without a fiscal adjustment. If it is constructed with a fiscal adjustment, then a view has to be taken as to the target PSBR path; the fiscal adjustment is then the change in income tax which would be required to achieve the target PSBR. It is these circumstances that a case can be made out for looking at fiscal options in terms of their effects on the fiscal adjustment, as the Budget package needs to be designed so as to achieve a fiscal

adjustment of zero. On the other hand, a starting forecast might be constructed without a fiscal adjustment. The Budget package then needs to be targetted at bringing about an adjustment between the forecast PSBR and the target PSBR. In this case, fisca options would seem best looked at in terms of their effects on the PSBR.

3. The effect on the fiscal adjustment from a given tax change will not be the same as the effect on the PSBR, because the latter is the ex-post change from all tax yields and expenditures deriving from the tax change. In the special case of a change in income tax, the effect on the fiscal adjustment will be equal to the direct revenue effect of that tax change, at ex-ante income and price levels. The difference between fiscal adjustment effect and PSBR effect will then reflect changes in tax revenues, including income tax, (and changes in expenditures, stemming, etc, from policy assumptions about cash limits) deriving from the economic effects of the income tax change.

4. The conventional definition of the fiscal adjustment in terms of an adjustment to income tax introduces a further complication into measuring the fiscal adjustment effect of changes in other taxes (or expenditures). The fiscal adjustment effect is now no longer necessarily equal to the direct revenue effect on the tax which is shifted, as the ratio of PSBR effect to revenue effect for that tax may be different from that for income tax. If these two ratios are different, then the direct revenue effect of the chang in income tax needed to offset the PSBR effect of the tax change under consideration will not be equal and opposite to the direct revenue effect on the tax shifted.

5. The fiscal adjustment effect of a given tax changes can be measured as follows:

$$\Delta \text{ FISADJ (TX)} = (a/_b). \quad \Delta \text{ REVENUE (TX)}$$

$$\text{where } a = \left(\frac{\Delta \text{REVENUE(TY)}}{\Delta \text{ PSBR(TY)}}\right)$$

$$\text{and } \quad b = \left(\frac{\Delta \text{REVENUE(TX)}}{\Delta \text{ PSBR (TX)}}\right);$$

Notation:-

FISADJ = fiscal adjustment effect;

REVENUE = direct revenue effect (at ex-ante incomes and prices)

PSBR = PSBR effect;

(TX) = tax under consideration;

(TY) = income tax

6. As well as the choice between PSBR effect or fiscal adjustment effect, or indeed direct revenue effect, in presenting the effects of fiscal changes, there is the more familiar choice as between monetary policy asumptions. In discussions among ourselves in MP, we have leaned towards the view that fiscal adjustments under fixed money supply should be the preferred candidate for the score-sheets. This reflects the way that we see this year's Budget scoresheets - as being largely concerned with arriving at a package which eliminates a given fiscal adjustment, without disturbing the existing broad lines of fiscal and monetary policy.

7. We need to take a decision on this soon. Inland Revenue have already asked for PSBR effects of income tax changes for their Chevening papers, and for advice on which monetary policy assumption to use. Can we discuss this at this afternoon's CU/MP meeting?

Allen Ritchie

13/13/10   fiscal policy box   CJR.

MR ODLING-SMEE

FROM: C J RILEY
DATE: 12 October 1983

cc Mr Cassell
Mr Evans
Mr Shields
Mrs Lomax
Mr Bell
Mr Gleed
Mr Ritchie
Mr Hibberd
Mr Patterson
Mr Ridlington
Mr A White

DEFINITION OF THE FISCAL ADJUSTMENT

Last year there was a correspondence between Rachel Lomax, Frank Cassell and Steven Bell (copies attached for top copy) about the appropriate definition of the fiscal adjustment and changes to it. Since this issue has arisen in the context of the annual review of National Insurance contributions, and given the wholesale staff changes in MP1, I am writing this note to draw attention to the issues involved and the approach currently adopted.

2. There seem to be three main alternatives for defining the fiscal adjustment:

(i) <u>Direct, full year, revenue effects</u>. This corresponds to full year figures in table 4.2 of the FSBR. It takes the values of macroeconomic variables such as GDP, prices and employment, as given,* but allows for all direct flow-backs to the public sector not associated with changes in macroeconomic variables (eg substitution effects, transactions within the public sector). It refers to a notional full year, in which revenues and expenditure have adjusted fully to the ruling levels of macro variables in the year in question.

(ii) <u>Direct revenue effects in the year in question</u>. This is the same as (i), except that the full year assumption is dropped.

(iii) <u>PSBR effect</u>. This allows for the indirect effects on the PSBR from changes in macro variables.

* At levels ruling <u>ex post</u>, ie <u>after</u> the fiscal adjustment.

3. Each of these definitions has advantages and disadvantages. The PSBR definition (iii) has the advantage that it is independent of the tax/expenditure category chosen for the fiscal adjustment. Given the forecast, the size of the fiscal adjustment is uniquely determined by the PSBR target. The disadvantage is that it does not give a clear indication of the size of the discretionary change necessary to achieve it. The relationship between the two depends not only on the scale of the macro-economic flow backs (and hence the model) but also on the policy basis on which these flow-backs are calculated (eg fixed interest rates or fixed money supply, the definition of money that is held fixed, assumptions about cash limits ...). Calculation of the effects of particular measures on the fiscal adjustment defined in this way would have to be based on full simulations or ready-reckoners, with all the presentational and other difficulties which these entail. Since this basis is not the one used in previous editions of the MTFS or in general reports on the forecast, there would clearly be a risk of some confusion if it were adopted now.

4. Option (ii) - direct effects in the year in question - is essentially the basis on which the MTFS and forecast numbers are presented. It is the only basis on which the fiscal adjustment equals the difference between the PSBR and the separate categories of revenue and expenditure for which explicit assumptions have been made - ie table 2.5 in the MTFS adds up. It is easier to relate to the size of the required discretionary change, and equals the <u>ex post</u> change in revenue/expenditure for the chosen instrument given the rest of the forecast. The disadvantage in this case is that the size of the fiscal adjustment depends on the tax/expenditure category chosen, though as long as it is a "typical" one this shouldn't be a serious problem. The effects of specific measures on the fiscal adjustment are straightforward to calculate unless the measure is very atypical. Given the degree of accuracy feasible in such calculations, one can simply quote the direct first year effect of the measure, making explicit allowance for the <u>relative</u> size of the macro-economic feed-backs only in extreme cases (eg public sector employment).

Except in extreme cases, the issue of what policy assumption to use in the calculation does not arise since the main macroeconomic variables would be broadly unchanged.

5. The advantages of presenting the numbers on a full year basis - option (i) - are surely not enough to offset the disadvantage that there would not be a clear link with the public sector accounts in the year in question. Moving to a PSBR basis is the only real option to the present approach, but the conceptual advantages would surely be outweighed by the practical difficulties and confusions which would undoubtedly occur. I propose, therefore, that we should stick with option (ii). If you or anyone else wish to object, could you please do so quickly.

CJR

C J RILEY

Mr Riley

1/21/10

AG B4: Budget 1984

FROM: C J RILEY

DATE: 20 OCTOBER 1983

MR BATTISHILL

cc: Mr Norgrove
Mr Odling Smee)
Mr Shields)
Mr Gleed) without
Mr Ritchie) attachment
Mr Evans)

PRESENTATION OF PACKAGES IN THE RUN-UP TO THE BUDGET

... As promised at this morning's meeting, I attach a copy of a recent note on the definition of the fiscal adjustment. The definition currently used in both forecasts and in previous editions of the MTFS makes no allowance for indirect effects on the PSBR via changes in macro-economic variables. It is perhaps worthwhile to consider what is the best method of presenting alternative packages in the run-up to the Budget.

2. My understanding is that the practice in previous budgets was to present score sheets giving the Revenue and PSBR effects of individual measures, and the whole package, at various stages of the decision-making process. But an alternative would presumably be to replace the PSBR effects by the effects on the fiscal adjustment, as conventionally defined. If the post-budget PSBR is agreed at a relatively early stage, and successive versions of the post-budget forecast are constructed on this basis, this may be a more helpful presentation. It would be easy to deduce from the score sheets how much fiscal adjustment is left, and approximately what scale of changes is necessary to eliminate it, for any given package. If, on the other hand, alternative packages would in practice lead to different post-budget PSBR figures, presentation of the PSBR figures alongside the Revenue figures makes more sense.

3. Although we are still some way from the Budget, it would be helpful to have comments on this issue. It has a bearing on how we should present the ready-reckoners which are prepared before the Budget process gets under way.

CJR

C J RILEY

FROM: A M W BATTISHILL
DATE: 28 October 1983

MR RILEY

cc Mr Odling-Smee
Mr Evans
Mr Shields
Mr Norgrove
Mr Gleed
Mr Ritchie

PRESENTATION OF PACKAGES IN THE RUN-UP TO THE BUDGET

I was extremely grateful for your minute of 20 October and for circulating your earlier note to Mr Odling-Smee about the definition of the fiscal adjustment.

2. With my Revenue and FP background I thought this was an area that I knew and understood. It is clear that I do not - and despite your detailed explanations I personally would welcome a small teach-in before we get much further down the Budget road. Perhaps we could fix something up sometime.

3. That said, Mr Odling-Smee's suggestion that the ready-reckoners should show both revenue and PSBR effects for the time being seems to me to be a sensible one if that can be done without adding too much to the work. However we approach the problem of next year's fiscal adjustment - and the process will begin in the next week or so - I think it most unlikely that we shall find ourselves conducting the Budget arithmetic after Christmas other than in PSBR terms. In short, I would expect the Chancellor to be aiming at a particular level of post-Budget PSBR, to which sucessive Budget decisions would be intended to lead. But that still leaves me less than totally sure that I understand how such a process would relate to any specific fiscal adjustment that one started from. Hence my wish for some more of your time.

AB/

A M W BATTISHILL

fiscal policy box

FROM: F CASSELL
DATE: 30 December 1982

MRS LOMAX

cc Mr Evans
Mr Shields
Mr Bell — 89/3.
Mr Gleed
Mr Melliss
Mr Mowl
Mr Parkinson

FISCAL ADJUSTMENT

The silence that has greeted your note of 16 November suggests that no one disagrees with the general proposition that the concept of the 'fiscal adjustment' as used in our forecasts and revenue projections is the change in the PSBR.

2. When the fiscal adjustment was introduced it was recognised that its size depended on the form it took. As I recall, some examples of this were given. This greatly complicated the exposition, however, and since we were generally dealing with fairly small margins we let this complication be lost in the rounding.

3. This was never entirely satisfactory and if we get to the position where we are showing large fiscal adjustments (albeit in rather distant years) the inconsistencies you point to could become too big to ignore.

4. I think the problem is largely presentational. The forecast print-outs - or at least those I generally look at - do not show the fiscal adjustment. Still less do they tell you what the PSBR would have been without it. I suggest that:

(i) The adjustment should be displayed more prominently.

(ii) It should be reported not in terms of "£xb of tax cuts" but of "tax cuts that add £xb to the PSBR".

(iii) The convention of assuming that the adjustment is made on personal income tax should be explicitly stated in both internal and external projections.

(iv) The footnote to Table 8 of the MTFS be looked at again to see if it can be improved (but note that it does not say that the plus sign means lower taxes or higher public expenditure "by that amount".....).

The first three suggestions should help in discussion of the forecast and its policy implications. The second in particular should help in packaging - where the cost of each element is nowadays scored in PSBR terms.

F CASSELL

fiscal policy box

A4

FROM: MR [illegible]
DATE: January 1983

MR [illegible]

cc Mr Cassell
Mr Evans
Mr Shields
Mr Gleed
Mr Melliss
Mr Mowl
Mr Parkinson

FISCAL ADJUSTMENT

I agree with you and Mrs Lomax that the issue is one of presentation but - despite my failure to respond to Mrs Lomax's earlier minute on this - I do not think that the 'fiscal adjustment' as used in our forecasts is best seen as the change in the PSBR. In numerical terms it is closer to a direct effect.

As programmed the fiscal adjustment is the amount by which taxes on employment income must be increased to achieve a given PSBR figure above the amount that would be generated at given (ie revalorised) tax rates and <u>actual</u> GDP, unemployment etc. It therefore incorporates second round effects only on direct taxes themselves, which are small. Direct costs typically exceed PSBR costs by 10-20% but the fiscal adjustment differs from the direct cost by less than 5%. If one raised the PSBR "goal" by £1 billion the fiscal adjustment would change by a greater amount. (Mr Gleed tells me that the difference would be 6% with M fixed and 14% with M free).

The fiscal adjustment is supposed to measure the room for tax cuts. Since these are invariably described in direct cost terms the current approach is adequate for the purpose. If, however, we emphasise the fiscal adjustment as the change in the PSBR there is a danger that commentators may conclude that it understates the room for tax cuts in direct cost terms. If we want to generate an informed discussion

Cassell

In this area, we need a table (in the FSBR?) showing how much a given fiscal adjustment translates into tax and programme changes into direct cost terms, though this may raise other problems.

S R Bell

S R BELL
MP1
Room 89/3
Ext 5521

fiscal policy box

FROM: MRS LOMAX
DATE: 16 November 1982

MR CASSELL

cc: Mr Evans
Mr Shields
Mr Bell
Mr Gleed
Mr Melliss
Mr Mowl
Mr Parkinson

FISCAL ADJUSTMENT

In the last few days the question has arisen as to what exactly the fiscal adjustment is. This is a rather tedious question, and distinctly de minimis if we are talking about numbers like £1 bn; nevertheless, now it has arisen, it may be worth getting straight. And, of course, it does matter once the adjustment reaches numbers like £5 bn.

2. The presentation of the fiscal adjustment as a single figure equally applicable to either tax or expenditure changes is only consistent with defining it as a PSBR effect. In practice, however, the way in which we calculate it makes it much more closely akin to a revenue effect. That is, it is the difference between the tax yield at constant rates and forecast levels of income and the tax yield needed to bring the PSBR to the level consistent with the assumed ratio.

3. This is technically the simplest way to do the calculation. But it has the disadvantage that the size of the fiscal adjustment depends on the tax/expenditure category to which it is allocated. This is because the relationship between revenue and PSBR effects differs and, as between tax and expenditure changes, quite widely. This reflects the fact that different fiscal changes have different effects on activity, employment, prices, the exchange rate etc. - with the result that, at least in principle, the nature of the final forecast also reflects the particular decision that has been taken about how to close the fiscal adjustment.

4. There is no getting away from this last point - but as long as the fiscal adjustment is relatively small, it probably doesn't matter very much. It is more tiresome to have to operate with a fiscal adjustment which is not defined as a PSBR effect, ie. which is conceptually a range, not a single number. For internal purposes, indeed, we have tended to forget about the technicalities and treat the fiscal adjustment as if it were a single number. The traditional description of the fiscal adjustment in the FSBR ("+ means lower taxes or higher public expenditure than assumed in lines 1 and 2") adopts a similarly cavalier approach.

5. Would it not be better to present and calculate the adjustment in the same way - as a PSBR effect? We could either simply convert the fiscal adjustment, as now calculated, into PSBR effect, using our ready reckoners (making offsetting adjustments to the expenditure/revenue totals, as applicable) or run a variant in which the PSBR ratio is unfixed. I can only see one disadvantage - that is, that the revenue and expenditure projections in lines 1 and 2 would, in principle, be calculated at marginally different levels of income, employment etc. from those shown in the forecast - (they would correspond to the figures in the PSBR - free variant). Against this, the fiscal adjustment would be defined in a way equally applicable to either revenue or expenditure changes, as we imply. What do people think?

RL

RACHEL LOMAX

17/251

FROM: J ODLING-SMEE
DATE: 25 OCTOBER 1983

file: Budget 1984
B4

MR RILEY

Mr Battishill
cc Mr Evans
Mr Shields
Mr Norgrove
Mr Gleed
Mr Ritchie

PRESENTATION OF PACKAGES IN THE RUN UP TO THE BUDGET

I suspect that it is too early to decide whether to present the packages in PSBR or in revenue terms. Much must depend on how firm the fiscal adjustment and/or the PSBR objective of the Government is at an early stage of the decision-making process. If the fiscal adjustment is firm, then revenue estimates would be better; but if the PSBR were firm, it might be better to present results in terms of the PSBR effects.

2. If I am correct, then I suggest that the ready reckoners that we prepare in advance of the budget process should show both revenue and the PSBR effects in a readily accessible form.

J O-S

J ODLING-SMEE

A53

CONFIDENTIAL

From: J ODLING-SMEE

6th January 1984

SIR TERENCE BURNS

cc Mr Evans
Mr Barber
Mr Riley
Mr Powell

NORTH SEA REVENUE AND THE PSBR

The attached table suggests what the change in the PSBR target should have been in the past and should be in the future on the assumption that all oil revenue in excess of the annual amount that can be consumed in perpetuity without altering the real value of the resource is saved rather than spent and vice versa. This is not necessarily the correct rule: one might, for example, want the extra permanent income to be divided between consumption and investment in such a way that the government should save more than the simple rule suggests so as to reduce interest rates and encourage productive private sector investment. Nevertheless it is a starting point.

2. The additional permanent income that North Sea oil provides the government is assumed to be 1.5% of GDP a year. This is derived by applying a real interest rate of 5% to the present value of economic rents (estimated by the Bank to be 60% of GDP), and dividing by two to obtain the government's share. Many of the assumptions involved in arriving at the answer could be altered.

3. As one would expect, the calculation shows that the PSBR could have been bigger than in the absence of oil in the 1970s, it should be smaller in the 1980s, and from sometime in the 1990s (or later) it can be bigger again. The PSBR this year and next should be lower by 1.5 percentage points than without oil, but it can rise (relative to what would have happened in the absence of oil) by about ½ percentage point over the next 5 years. Very little weight can be placed on absolute numbers, because they depend on the 1.5% permanent income assumption. But changes over time are not affected by this.

4. These numbers raise questions about the present and the future:-

(a) The Present

Have we reduced the PSBR by the full 1.5 (or whatever) percentage points that this rule suggests, compared with a no-oil

CONFIDENTIAL

NORTH SEA REVENUE AND THE PSBR

(% of GDP at MP)

	Total Government revenues from North Sea	Constant annual equivalent of Government revenues	Adjustment to PSBR target
1977-78	0.2	1.5	1.3
1978-79	0.3	1.5	1.2
1979-80	1.1	1.5	0.4
1980-81	1.7	1.5	-0.2
1981-82	2.5	1.5	-1.0
1982-83	2.8	1.5	-1.3
Forecasts			
1983-84	3.0	1.5	-1.5
1984-85	3.0	1.5	-1.5
1985-86	2.8	1.5	-1.3
1986-87	2.8	1.5	-1.3
1987-88	2.4	1.5	-0.9
1988-89	(2.4)	1.5	(-0.9)
Guesses			
1995	1.5	1.5	0.0
2000	0.5	1.5	1.0
2010+	0.0	1.5	1.5

FROM: F CASSELL
24 February 1984

CHANCELLOR

cc - Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr Battishill
Mr Lankester
Mr Monger
Mrs Lomax
Mr Pirie
Mr Allen
Mr Riley
Mr Ridley
Mr Lord
Mr Portillo
Mr Green) IR
Mr Beighton)
Mr Knox, C&E
PS/Governor) B/E
Mr George)

EFFECTS OF THE BUDGET ON THE FINANCIAL SECTOR

The attached paper reports the analysis we have been able to carry out on the effects of the Budget on the financial sector.

Its assessment - summarised in paragraphs 38-46 - is, I fear, extremely tentative, resting on highly uncertain assumptions about the reactions of institutions to a complex of fiscal changes, many of which interact.

The analysis, particularly of the effects on the banks, has benefited from discussion with the Bank. I suggest the paper might provide background material for your meetings with the Governor next week.

F CASSELL

THE EFFECT OF THE BUDGET ON FINANCIAL INSTITUTIONS

This note assesses how the various Budget measures will affect particular groups of financial institutions, in particular the banks and the building societies, and the financial sector as a whole. It focusses on the measures that will have a direct impact on the financial sector (or a strong indirect one, eg through their effect on leasing). It also looks at how the flow of funds between institutions, and among different securities, might be affected.

2. The main proposals that will affect the financial sector are:

- the composite rate scheme for taxing interest paid by banks;
- the consumer credit duty;
- a halving of the rate of stamp duty;
- changes in life assurance premiums relief;
- the changed tax arrangements for building societies (though the most important of these, the taxation of their gilts profits as trading income, is not a Budget measure);
- the package of measures to encourage the corporate bond market;
- the company tax package, which will strong affect bank profits through its effect on leasing.

The financial sector will also be affected indirectly by the Budget proposals as a whole, and in particular by the change in PAS, which is likely to generate additional demand for bank credit.

THE MEASURES

Composite rate

3. Though the change (on which the banks were consulted in confidence) is expected to be broadly revenue netrual, the banks have objected to it not only on points of principle - alleged injustice to non-taxpayers, for example - and dislike of the administrative burdens which it will impose on them, but mainly because of the fear it will cause them to lose deposits.

4. There are three main areas where there is some risk of loss of deposits:-

(a) Resident non-taxpayers. This is where the banks are perhaps most vulnerable, although even now their gross 7 day deposit rate is uncompetitive with the building societies net rate or the NSB investment account. Moreover the NSB investment account has withdrawal conditions which may not be attractive to non-taxpayers wishing to have their money on ready call.

(b) Resident taxpayers. Some of these may be jolted into action to seek a more attractive interest rate once banks have to quote a rate net rather than gross. Much depends on how banks and building societies respond competitively to the new situation.

(c) Non-residents. Though these deposits would not be subject to the composite rate, there is, some risk of withdrawals in cases where depositors are concerned about giving a certificate. But it should be noted that the proposed let-out for certificates of deposit and time deposits will provide an alternative to certification, and non-residents already have to provide certificates if they wish to avoid information about their interest being passed to the Revenue under s.17 Taxes Management Act.

5. The TSBs are particularly concerned about the proposal, because personal sector interest-bearing deposits fund a larger proportion of their balance sheet than is the case for other banks, and they believe they have a larger proportion of non-taxpaying customers.

6. The banks' crude calculation, on a static basis, estimates the loss of deposits at £3¾ billion. They argue that the cost of replacing this sum with wholesale money would be equivalent to a ¼ per cent increase in lending rates across the board, and that they would have to pass this on. The alternative response of raising 7 day deposit rates to compensate non-taxpayers for the composite rate tax they suffer would be more costly for the banks, because taxpayers would benefit as well as non-taxpayers. It would also be a bigger move than might strictly speaking be required to replace the loss of deposits. But if the banks acted in that way, the increase in lending rates required would then be 1½ per cent if it were concentrated on the personal sector alone, or as much as 2½ per cent if the increase was loaded on lending for personal consumption only.

7. These figures are almost certainly at the most unfavourable end of the range of possibilities. The banks' present 7 day "retail" deposit rate is so uncompetitive that there is likely to be substantial loss of these funds in any case. They assume National Savings rates would not be adjusted if there were a major flow in that direction. They also assume that building societies will not reduce their rates, or bid less strongly in the wholesale markets if they gain deposits from the banks. On more realistic assumptions - and given the way in which customer inertia and convenience seem to enable the banks to hold deposits at uncompetitive rates at present - we would be surprised if the banks' deposit loss as a result of the composite rate exceeded £1½ billion over the next two years.

8. Our own analysis assumes that £500 million would be lost from the banks' retail deposits in 1984-85 as the announcement jolts some depositors out of their previous inertia. Interest-bearing accounts of both taxpayers and non-taxpayers might be affected in this way. In 1985-86, when the composite rate comes into effect, the loss is put at £1 billion,

almost entirely from non-taxpayers (who are assumed to hold 15 per cent of the £28-30 billion of interest-bearing deposits covered by the proposal). The National Savings target is taken to be unaffected by this measure, so that NS rates are adjusted to secure the same inflow as intended before; the deposits lost to banks therefore go to building societies.

9. In practice, these flows are likely to lead to movements in interest rates which will reduce the size of the flows ex post. The banks are likely either to increase their retail deposit rates in order to bid back their lost deposits or to raise money on the wholesale market. The increased cost of funds to the banks - probably around £25 million - is likely to be passed on in lending rates. If the cost is spread across all forms of lending the effect on rates is very small - of the order of $^1/_{32}$ to $^1/_{16}$ per cent. The increased inflows to building societies will provide a downward pressure on their interest rates, given that they are already close to meeting the demand for mortgages.

Consumer Credit Duty

10. As now evisaged, this will apply to all loans to persons (other than those eligible for income tax relief - ie up to £30,000 of mortgage loans) and to be charged at an annual rate of 1 per cent on credit outstanding. Credit for which no charge is genuinely made will be excluded. The duty will be paid by banks and building societies (on their non-mortgage credit) and by a host - ? up to 50,000 - of other lenders (with a de minimis provision of £18,000).

11. It is estimated - very roughly - that the stock of such credit is about £20 billion. Much of this credit - eg personal loans from banks, HP contracts - is in fixed-rate form. The treatment of existing contracts is therefore a major question. The average maturity of such contracts is probably about 2 years. So if the duty does not begin to operate until 1 July 1985, ie 15½ months after the announcement in the 1984 Budget, well over half of the fixed rate credit should have been paid off by then.

12. With the tax collected in arrears, following a six-month duty period, the yield in 1985-86 would be low, even with (as Customs is planning) all the big lenders included in the first "stagger". Probably the net revenue yield is that year would be around £90 billion if existing fixed rate contracts were included and £75 billion if those contracts were excluded. The yield in a full year would be of the order of £200 million.

13. This duty is thus of only marginal significance in the monetary picture for the next two financial years. However, setting up the data system for the duty will involve lenders in additional reporting obligations, and the banks, building societies and finance houses will need to reprogramme their computers. For the banks in particular this requirement must be seen in the context of the imposition of the composite rate - and is one reason for preferring a fairly late starting date for the duty.

14. The duty is likely to be passed on by the credit granting institutions to their customers. There are no reliable estimates of the effect this will have on the demand for credit. Assuming, however, an eventual 2 per cent reduction in demand (in stock terms) for every one percentage point on the borrowing rate, implies that the stock of credit might fall by £400 million. About half of this might come through within one year. There is a danger of course that borrowers will switch from dutiable to non-dutiable credit, particularly mortgages. Equity withdrawal from housing might increase. The rise in the cost of credit is also likely to reduce personal consumption, as is the reduction in disposable income represented by increased tax payments. Finally it is worth noting that the credit institutions will get a temporary cash flow gain as the tax is paid to Customs in arrears.

Stamp duties

15. Almost half of the benefit that flows from the proposed halving in the rate of stamp duty will accrue to the "financial sector". Apart from the property companies, the main beneficiaries will be the investment dealing institutions together with the jobbing and

situation? If not, have we been following an equally acceptable rule? I suspect that we have not reduced the PSBR by as much as an optimal rule would suggest, but it is impossible to prove it.

(b) The Future

If we have not reduced the PSBR by enough so far, should we try to do more in future so as to leave post-oil generations their full share of the permanent income? Is that the justification for the suggestion in the Chevening paper that we need a lower PSBR in the near future so as to get down to a level from which no increase in other taxation will be required as the oil revenue runs down? If not, why does oil justify a lower PSBR in the future? - why not just allow the PSBR to rise by ½ percentage point on account of the reduction in oil revenue?

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broking firms who will benefit in an increase in the turnover of shares, estimated to be 20 per cent in 1984-85, 30 per cent in 1985-86.

16. The total direct revenue cost is estimated by about £435 million in 1984-85 and £515 million in 1985-86:

Lower Stamp Duty Payments by financial institutions 1985-86

	Land and buildings	Stocks and shares	Total
Banks	5	-	5
Insurance companies	30	35	65
Superannuation funds	15	60	75
Investment/unit trusts	-	25	25
Building societies	5	-	5
Property, etc companies	30	-	30
All financial institutions	85	120	205
Whole economy	360	155	515

The calculations above allow for the direct effects on revenue of the increase in activity but not for the increased profits (eg of jobbers and brokers, and estate agents) which will in turn be charged to income tax and corporation tax and can also lead to increased realised gains chargeable to CGT.

Life assurance premium relief

17. The withdrawal of premium relief on new policies taken out after Budget day (revenue yield of £90 million in 1984-85 and £240 million in 1985-86) will affect friendly societies, building societies and banks as well as life offices.

18. It is estimated that under the exsiting system of premium relief the life companies would have attracted new (qualifying) premium income in 1984-85 of £1¼ billion at an annual rate. Since the additional business would have built up through the year, actual new

premiums paid <u>in</u> 1984-85 would have been about half this, £0.6 billion (commission would further reduce the amount actually received by the life companies). In 1985-86 a full year's premium income on new 1984-85 business would have been received plus some premiums on new 1985-86 business - these two together would probably amount to about £2 billion. Thus the amount of institutional cash flow at risk from abolition of premium relief on new policies is probably around £0.6 billion in 1984-85 and £2 billion in 1985-86.

19. It is difficult to say how much of this new business the life companies would lose. There may be scope for redistributing business and for expanding into areas traditionally covered by other institutions - eg unit trusts. Abolition of relief increases the cost of premiums by about 17½ per cent. An elasticity of 2-2½ seems plausible - ie a 2-2½ per cent reduction in business results from each 1 per cent increase in cost. On this basis life companies' cash flow would fall by about £¼ billion in 1984-85 and £¾ billion in 1985-86. If the life offices were to cut back on their investments roughly in line with their existing portfolio proportion, their purchases of gilts would fall by about £70 million in 1984-85 and £220 million in 1985-86.

20. We have little idea about how persons might reallocate their portfolios, or whether they will increase or reduce their total saving. In our preliminary figuring we have assumed that persons will reallocate the reduced life assurance premium in the first instance as follows: 20 per cent higher spending, 35 per cent building societies, 15 per cent national savings, 10 per cent gilts, 20 per cent equities/unit trusts. All these figures are, however, guesses.

21. Much of the life companies' new premium income comes, however, from business (including annuity business) which does not currently qualify for tax relief. In 1982, the last year for which complete figures are available, total new premium income was £2.6 billion at an annual rate, of which only about one-third qualified for relief. Thus the greater part of the life companies' own business is not threatened by this measure. Moreover both

qualifying and non-qualifying business has been growing very rapidly in recent years, partly because of aggressive marketing, and the latter may act as a cushion for the loss of qualifying business.

22. Building societies (and banks) will probably lose commission to the extent that endowment policies (linked to mortgages) become less popular, but the effect is likely to be fairly limited in its impact. Both building societies and banks could gain to some degree if money currently going into qualifying life assurance policies were switched to deposit accounts with them. They will also benefit from the likely increase in repayment mortgages at the expense of endowment-linked mortgages.

<u>**Corporation tax package (including leading**</u>

23. The financial sector is likely to be one of the main immediate gainers from the corporation tax (CT) package, but for some institutions the effect on their tax payments will be strongly affected by changes in the attractiveness of leasing. It is not clear how this will be reflected in their accounts. Banks and finance houses in particular use leasing to reduce their immediate tax liabilities. This is worthwhile so long as capital allowances are more generous than economic depreciation.

24. The CT package, with its foreshadowing of future rates, will give a strong incentive to bring investment forward. In 1984-85, the real cost of capital to firms will actually be reduced. The effect of the reduction in allowances that can be claimed when investment is undertaken is outweighed by the prospect of a lower CT rate in later years when profits on the investment are being earned. But by the third year, when the allowances have been reduced by the full amount, the cost of capital will be higher.

25. The extent that actual investment decisions and supplies of investment goods can be brought forward is obviously limited, but the scope for advancing payments is considerable. The scale of these forestalling effects is very difficult to determine, but in 1984-85, they

could easily amount to £1-2 billion or even more, with perhaps slightly lower effects in 1985-86. Advancing payment, which is likely to account for the majority of the total effect, has the effect of reallocating funds between purchasers and suppliers of investment goods. The net effect of this alone is likely to increase bank lending; but the cash flow benefits to companies of lower stock-building and lower tax payments will work in the opposite direction.

26. The alterations to the CT regime significantly affect the incentive to leasing. This incentive will be increased in the first stage of the CT package, parallelling the reduced cost of capital to tax-paying (rather than tax exhausted) companies. But by the third year leasing will have become much less attractive. Short leases (ie less than 5 years) will then be attractive mainly to firms facing cash flow constraints and limits to their ability to borrow. The changes to investment will themselves affect the amount of leasing, but changes in the incentive to lease rather than buy will also alter the pattern of financing of investment which would have been undertaken anyway. Again the scale of effects is highly uncertain. We tentatively suggest that new leasing business may be about £½ billion higher than it would otherwise have been in 1984-85, little changed in 1985-86 and perhaps £1½ billion lower the following year. This compares with a total of about £3 billion of new leasing business in 1982. For any given total of investment there is likely to be a switch between leasing finance and bank borrowing. This will be mainly due to the greater cost of leasing finance compared with bank borrowing, but it will also reflect the fall in the number of tax exhausted companies as a result of the lower capital allowances. Bank borrowing is likely to be higher, but the net effect on £M3 may be small, since there will be offsetting changes in the banks' non-deposit liabilities. A simpified example of the effects of the CT changes on profitability of leasing is given in Annex A.

27. The precise extent and timing of the impact of the CT package on banks is impossible to estimate. Much depends on existing policies for the retention or release of deferred tax provisions (on which there is no great consistency among banks); on the pattern of existing

business (whether short or long lease); on how banks choose to respond to the new arrangements (by increasing the amount of leasing and by going for longer life equipment they may still be able to shelter profits under the reduced writing down allowances); and finally, perhaps most importantly in the short term, on whether the banks' auditors take the view that in the light of the changed tax regime it would be prudent to restore unprovided provisions against tax, perhaps by a charge to reserves.

28. The Bank have looked at the impact on the clearers and one major finance house on a "worst case" basis. This assumes either that all the unprovided potential deferred tax crystallises in payments to the Revenue or, alternatively that banks and their auditors choose to restore full provision against the possibility of the tax becoming payable. On this basis, the figures show a quite significant deterioration in the risk asset ratios of the clearers - on average from 6.8 per cent to 5.3 per cent. For the finance house the fall would be more substantial - almost a halving of the ratio. On these worst assumptions, the Bank's supervisors could face some difficult prudential judgements. From a quick look at the accounts of some Accepting Houses, it would appear that they would be relatively unscathed, since full provisions are generally maintained.

29. This is very much a worst case. Any unwinding of unprovided deferred tax will be phased over at least five years and in the first instance tax payments could be met from retained provisions. Moreover, since provisions have been set up on the basis of 52 per cent corporation tax, there will be greater capacity to meet future charges which crystallise but at a lower rates of tax.

National Insurance Surcharge

30. Abolition of NIS from August 1984 would have the following effects:

Cash flow loss (-) or gain (+) £m

	1984-85	1985-86
All businesses (private sector)	+460	+930
Banking, finance, insurance etc	+55	+100
of which: banks	(10)	(20)
building societies	(2)	(3)

Withdrawal of PAS for imports

31. This will accelerate payment of VAT on imports by about 1½ months. It is not a measure aimed at the financial sector, but will lead to some increase in their VAT payments in 1984-85. But this effect is not expected to be large.

Importers may finance part of the accelerated payments by borrowing from banks, which could be of the order of £400 million.

Corporate bond package

32. The package of measures (covering the tax treatment of deep discount stock, Eurobonds, acceptance credits and CGT exemption for fixed interest stock) have a small revenue cost (less than £20 million in 1985-86) and seem unlikely to have a very marked effect on the demand for bank loans. But they could encourage a marginal shift away from bank lending towards the raising of funds in capital markets, and thus a marginal shift away from clearing banks and others who do substantial lending on their own balance sheets towards merchant banks and stockbrokers who earn their living by organising capital issues. The same comment would apply to any measures to encourage the raising of equity finance as an alternative to bank borrowing.

Other measures

33. The Government's proposals to prevent UK residents avoiding income tax by investing in offshore roll-up funds or life assurance have already been published. The avoidance mechanism turns income into capital gains and the proposed legislation will treat the gains as income from January this year. The proposals will not lead to more tax being paid by financial institutions, since the charge is on investors. But the institutions are losing offshore business - it is estimated that about £1 billion have already moved out of offshore funds - and UK investment in many funds has plummeted. They are now developing alternative products which will qualify as distributing funds in an effort to recapture at least some of the money. All the main London banking groups, and some life assurance groups, have offshore funds under their management.

34. The tax-haven proposals - which would in some circumstances tax income of foreign subsidiaries of UK companies, usually where income is accumulated in a tax-haven have also been published and attracted widespread comment. The effect on the financial sector is difficult to predict. On insurance companies it is likely to be negligible. On banks there could be a few big cases. The total effect might be of the order of £5 million, compared with £100 million full-year estimate for the proposals as a whole (£25 million in 1985-86).

35. Individual TSBs are unincorporated associations. They are liable to corporation tax but, because they are not companies, they cannot quality for the reliefs for groups of companies (allowing, inter alia, losses in one company to be set against profits of another). The proposals is to treat the banks as companies for the purposes of these reliefs. The cost is estimated at £10 million in 1985-86. This proposal is another held over from the 1983 Finance Bill.

36. UK insurance companies currently treat insurance written by their overseas branches as zero-rated for VAT purposes. This enables them to recover more input tax than was ever intended or is justified. Withdrawal of VAT zero-rating for these supplies will cost the

insurance companies about £3-5 million a year. (The banking sector has not so far made any significant use of the existing legal provision, and so its withdrawal will add little to the cost).

37. Finally, the direct impact of the withdrawal of foreign emoluments deduction will be on employees of foreign institutions but to the extent that employers pick up their employees' additional tax bill there will be a measurable cost to foreign banks etc in London. It is estimated that perhaps 2000 (new) bank, etc employees first qualify for foreign emoluments deduction each year and that the "additional" tax bill for these people in 1984-85 would be of the order of £1 million. (The deduction will not be withdrawn for existing beneficiaries. The figure would be greater in later years, reaching perhaps £30 million per annum for all financial institutions. Some senior bank, etc executives will also be affected by the withdrawal of this foreign earnings deduction, and may seek compensation for this from their companies.

Summary and Assessment

38. Reaching a view about the overall impact of the various measures in the Budget on financial institutions is difficult. The estimated direct revenue, or cash flow, effects of particular proposals are shown in table 1 along with estimates of the likely ex ante effects on the flow of funds. This is highly simplified. Some of the most important effects occur indirectly and are not reflected in the table. But the table does indicate where the main immediate presures may arise.

39. Though the financial sector as a whole should gain substantially from the Budget, the gains will be unevenly distributed and the pattern of gainers and losers is likely to change from one year to another. It is also far from clear that the gains and losses as we would conventionally measure them will be reflected in the financial accounts of the particular institutions. As explained above, much will depend on how auditors decide that provisions for deferred taxation should be shown.

40. It seems clear that stock exchange firms and pension funds and investment and unit trusts should benefit from the Budget - particularly from the reductions in stamp duties. They will also gain from the corporate bond package, the abolition of NIS and in some cases also from the reduction in corporation tax.

41. For building societies the Budget itself is probably fairly neutral. The composite rate on the banks and the abolition of LAPR and the halving of stamp duty on transfers of property will all bring more business to their offices, though this may only build up slowly. As against this, the loss of LAPR will tend to squeeze margins and the consumer credit duty, which might apply to about 3 per cent of their mortgage lending (though a strongly rising portion), will raise around £20 million, when in force, though much of this would presumably be passed on to borrowers. However, these Budget effects need to be seen in the context also of the decision anounced on 23 February to tax their gains on gilt-edged as trading income (at CT rate). The cost of this to them is extremely difficult to estimate but it could be of the order of £150 million a year.

42. The net effect of all this on their rate structure could lead to a significant cut in the rates they offer to depositors. Give nthe effects of the gilts tax on their margins, this is unlikely to be reflected in an equivalent cut in the mortgage rate. There is little likelihood that the mortgage rate will actually be raised as a result of the Budget and other recent action by the authorities; the most likely outcome is that the fall that would probably have occurred quickly after the Budget will now be delayed. A fuller discussion of the effects on building societies is contained in Annex B.

43. The net effect on the banks will be very uneven. They will gain from the reduction in NIS - worth about £10 million to them in 1984-85 and up to £20 million in 1985-86. But they will lose from the imposition of the composite rate in that they are likely to see deposits (possibly around £1½ billion but this can only be a guess) switched to building societies that they will try to replace by bidding in the wholesale market. This might add about

£25 million to the cost of their funds. They would presumably pass this on in lending rates; if spread across all forms of lending the average rise would be less than 1/16th per cent. The other cost of the composite rate is the administrative one for them in reprogramming their computers; they complain that this will be a lengthy exercise and will involve them in substantial (but unquantified) additional staff costs. The consumer credit duty will have some marginal effect in reducing bank lending, but the net impact on bank profits is unlikely to be significant.

44. By far the most important changes affecting the banks stem from the corporation tax changes. This will dramatically change the attraction of the leasing operations they have previously been using to shelter their profits. In the first two years, 1984-85 and 1985-86, leasing is likely to be highly profitable and the banks will presumably try to increase their activity. Thereafter, as investment allowances fall to zero and the corporation tax rate comes down sharply, much leasing will cease to be profitable. It will be cheaper for tax-exhausted companies to borrow finance rather than to lease the equipment.

45. The clearing banks will then presumably begin paying substantial tax on their profits, at the lower CT rates envisaged. In the first two years, when leasing is still a good proposition, their trading profits may rise, but the effect on their disclosed profits will be strongly affected by whether the banks' auditors take the view that in the light of the new tax regime it would be prudent to restore provisions for deferred tax. On the "worst case" assumptions discussed above there would be quite a significant deterioration in the risk asset ratios of the clearers and, even more, in those of the specialist finance houses. By contrast with the clearing banks and finance houses, merchant banks should gain unequivocably from the Budget. They will be much less affected by the changes in leasing and will benefit from the increase in business resulting from lower stamp duties and the corporate bond package.

46. Looking at the likely effects of the Budget on particular <u>types of securities</u>, the general impression is that by reducing the incentives to prefer capital gains to income it

should be good for conventional gilts and bad for low coupon gilts (especially taken in conjunction with the change in building society taxation) and index-linked issues. The impact on the equity market is extremely difficult to foretell. It will take some time for the City to work out the full implications of the complex of measures. The main changes may be seen initially in adjustments of the structure of share prices, rather than in the overall level. But, over time, the Budget should substantially help company finances and this should be reflected in share prices.

24 February 1984

TABLE 1

DIRECT EFFECTS OF BUDGET MEASURES ON FINANCIAL INSTITUTIONS

(These only show where pressures may arise in the system - they do not show how the pressures are resolved by interest rate changes etc)

1984-85

Measure	Banks			Building Societies			Other Financial Institutions (a)		
	Tax Paid	Liabilities	Assets	Tax Paid	Liabilities	Assets	Tax Paid	Liabilities	Assets
Composite Rate	Neg	-500	-	Neg	400	-	Neg	-	-
Consumer Credit Duty	-	-	-55	-	-	-	-	-	Neg
Stamp Duty	-5	-	-	-5	-	-	-195	-	-
Life Assurance Premium Relief	-	-	-	-	90	-	-	-250	-
Company Tax Package (stock relief, capital allowance and CT rates)	(b)	(e)	[150] e	5	-	-	-35	-	-
NIS	-10	[175]	[-200]	-2	-	-	-43	-	-
PAS	(c)	-350	400	(c)	-	-	(c)	-	-
Corporate Bond Package	na	-	small fall	na	-	-	up to -20	-	-
Other Minor Measures (d)	na	-	-	na	-	-	-10 to -15	-	-

(a) Life Assurance Companies, pension funds, unit trusts etc
(b) Depends, inter alia, on how volume of leasing business is affected (see text)
(c) Cash flow loss of £40 million in 1984-85 but (continuing) interest rate cost would be much smaller
(d) Including tax havens, off shore funds and life assurance, TSBs, foreign investments deductions and treatment of VAT on financial sector supplies.
(e) Gross flows large but net effect may be small

TABLE 1
continued

DIRECT EFFECTS OF BUDGET MEASURES ON FINANCIAL INSTITUTIONS

(These only show where pressures may arise in the system - they do not show how the pressures are resolved by interest rate changes etc)

1985-86

Measure	Banks			Building Societies			Other Financial Institutions		
	Tax Paid	Liabilities	Assets	Tax Paid	Liabilities	Assets	Tax Paid	Liabilities	Assets
Composite Rate	Neg	-1000	-	Neg	800	-	Neg	-	-
Consumer Credit Duty	[75]	-	-210	[10]	-	small fall	[5]	-	Small fall
Stamp Duty	-5	-	-	-5	-	increase	-250	-	-
Life Assurance Premium Relief	-	-	-	-	280	-	-	-800	-
Company Tax Package (stock relief, capital allowance and CT rates)	(b)	(c)	(c)	-5	-	-	-110	-	-
NIS	up to -20	(d)	(d)	-3	-	-	-67	-	-
PAS	-	-	-	-	-	-	-	-	-
Corporate Bond Package	na	-	small fall	na	-	-	up to -20	-	-
Other Minor Measures	-	-	-	-	-	-	-10 to -15	-	-
Building Societies gilts profits(e)	-	-	-	[140] f	-	-	-	-	-

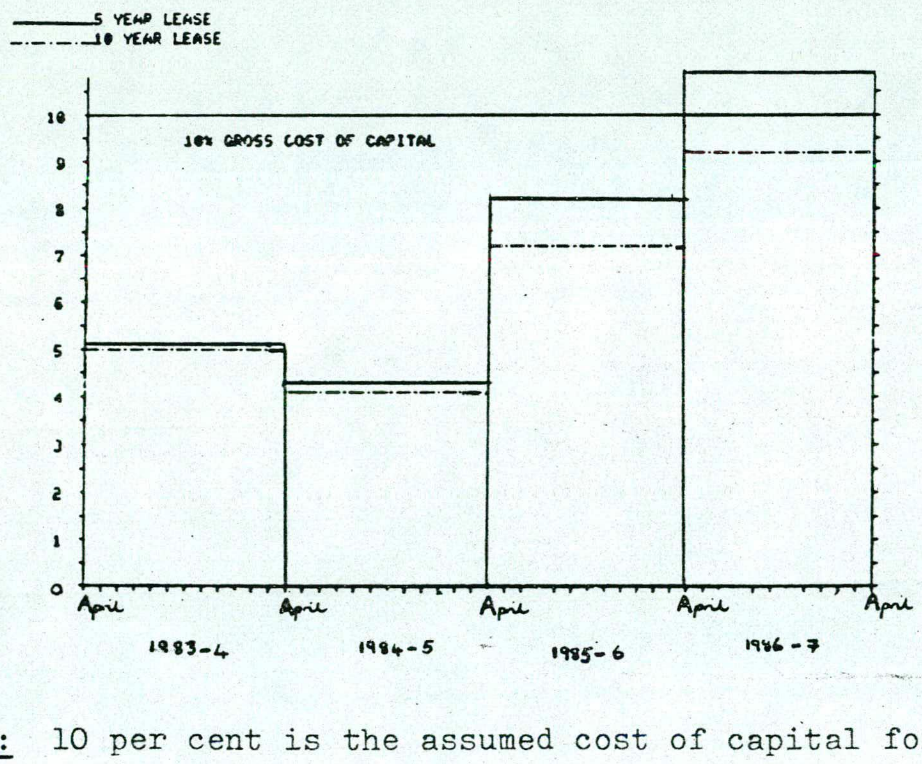
(a) and (b) as in previous table
(c) Gross flows large but net effect may be small
(d) Liabilities likely to rise and assets to fall
(e) Not Finance Bill
(f) This represents two years additional tax, all of which becomes payable in 1985-86

ANNEX: THE PROFITABILITY OF LEASING

Companies with insufficient taxable profits cannot take advantage of capital allowances and tax relief on the interest on money borrowed to finance investment. But lessors, mainly banks, with large taxable profits are able to purchase capital equipment, obtain the benefit of tax allowances and defer their tax liabilities until they receive rental payments from the lessees. These tax benefits to lessors are passed on to lessees in whole or in part in the form of lower rental payments. By this process tax exhausted companies are able to obtain finance for investment at only slightly higher rates than tax paying companies.

The phased removal of capital allowances removes one of the main incentives to leasing. Since the value of the allowances to lessors is much less they have to increase their rental charges to lessees. These leasing payments can be expressed as an implicit cost of capital. Chart 1 below shows how this implicit cost will be altered by the CT package. In the first year the fall in CT rates outweighs the effect of reduced allowances so the cost of leasing capital falls. However, in subsequent years the cost rises significantly and from 1986-87 onwards it will be cheaper to borrow directly from banks than to lease, at least for leases of up to 5 years duration.

POST TAX COST OF LEASING CAPITAL



Note: 10 per cent is the assumed cost of capital for banks.

ANNEX B

BUILDING SOCIETIES

Composite Rate: Building society deposits rise as a result of the first-round switch of deposits from the banks and the subsequent multiplier effects. Consequently, mortgage lending will increase (assuming that mortgage demand is not fully met before the change) and/or building society interest rates will decline. House prices are likely to rise.

Consumer Credit Duty: Because mortgage lending is exempt from the tax, at least for loans up to the £30,000 mortgage interest relief ceiling, there is likely to be some substitution from other forms of lending to the personal sector into building society mortgage lending. The purchase of a house is generally required in order to qualify for a building society loan, so that house prices are likely to be bid up. The increased demand for mortgage finance will put some upward pressure on building society interest rates.

Corporation tax rate: Margins will benefit in due course from the reduction in CT rate below the present special rate for building societies, but this lies a few years ahead. Small societies will benefit sooner from the reduction of the small companies rate.

LAPR abolition: This has similar effects on the building societies as the composite rate for banks in that there is a switch into building society shares which has a downward effect on building society interest rates and an upward effect on house prices. In addition, however, the net demand for mortgage loans is likely to fall, both because endowment mortgages will be more expensive and because any switching by mortgages into repayment mortgages will imply more rapid repayment of the outstanding stock of mortgages (although this latter effect is very small in the early years). Building society margins will be squeezed, perhaps by up to 0.1 per cent, because of the reduced commission from insurance companies and the reduced opportunites to charge premium interest rates on endowment mortgages.

BUDGET SECRET

Stamp duty on houses: The halving of stamp duty on transfers of property will increase the number of transactions and put upward pressure on house prices. To the extent that the reduction in stamp duty is capitalised in house prices, the demand for mortgages is likely to increase in order to maintain a constant gearing ratio, leading to upward pressure on building society rates.

NIS: Societies will benefit by about £2m in 1984-85 and £3m in 1985-86.

Taxation of gilts: This may have a significant effect on building society margins (of the order of ¼ per cent). It is not clear to what extent this would be taken, on the next adjustment of building society rates, in a higher mortgage rate or a lower share rate or a combination of both.

The table below indicates the direction of the main changes described above. It should be noted that the effects of items 1 and 2 are largely deferred until 1985-86; the effects of items 3 and 4 build up gradually; and the effect of item 5 comes through immediately in terms of societies' need to provide for the tax, although it is unlikely to fall due to payment until late in 1985-86.

BUDGET SECRET

EFFECTS OF MEASURES ON BUILDING SOCIETIES

		Supply of Deposits	Demand for Mortgages	Building Society Interest Rate Levels	Building Society Margins	House Prices
1.	Composite rate for banks	up	-	down	-	up
2.	Consumer credit tax	-	up	up	-	up
3.	Corporation tax rate	-	-	-	widened	-
4.	LAPR abolition	up	down	down	squeezed	up
5.	Stamp duty	-	up	up	-	up
6.	NIS abolition	-	-	-	widened	-
7.	Taxation of gilts gains	-	-	-	squeezed	-

-5 MAR 1984

BUDGET SECRET

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FROM: MISS J C SIMPSON

DATE: 2 March 1984

SIR T BURNS
SIR L AIREY
MR FRASER
MR MONCK
MR GREEN (IR)
MR ISAAC (IR)
MR KNOX (C&E)
MR MONGER
MR RIDLEY
MR HALL
MR PORTILLO

cc Chief Secretary
Financial Secretary
Minister of State
Economic Secretary
Sir P Middleton
Mr Cassell
Mr Battishill
Mr Lankester
Mr Folger
Mr R I G Allen
Mr G P Smith
Mr Martin
Mr Norgrove

ACTION ARISING FROM A MEETING HELD IN HM TREASURY ON THURSDAY 1 MARCH TO DISCUSS THE PRESENTATION OF THE BUDGET

A Corporate Sector

1. More work was needed to develop the argument that "investment profitability" was as important and valid as the traditional concept of "labour profitability".
[Sir T Burns]

2. Arguments and, if possible, examples should be prepared to refute claims that the revised pattern of capital allowances would lead to the abandoning of worthwhile projects.
[Mr Monck, consulting DTI as necessary]

3. Figures should be worked up to prove that the manufacturing sector would be a net gainer from the measures and that its interests were not being subordinated to those of the service sector.
[Mr Monck]

12. More work was required generally on the identification of the gainers and losers.

[Mr Monger]

13. A reassuring form of words needed to be devised for defensive response to questions like "what is the next candidate in extension of the VAT base". But this should not close any doors to future action.

[Mr Knox]

14. Precise information about foreign practice on LAPR was needed urgently.

[Mr Isaac]

C Financial Sector

15. Figures should be provided for the IR manpower savings from the introduction of the composite rate, including those that would otherwise be added by payment of interest on current accounts and the (hypothetical) cost of removing the composite rate from the building societies.

[Sir L Airey]

16. Proposed measures on foreign earnings would affect individuals particularly; they would be bound to arouse opposition and therefore detailed defensive briefing should be prepared.

[Mr Isaac]

17. A firm line on tax treatment of pensions (next candidate for reform?) was needed.

[Mr Monger]

D General

18. A list of individuals and organisations who would be prepared to come out in support of the Budget should be compiled, and steps taken to mobilise them to

4. The presentation of the timing balance between the revised capital allowances and the reduced CT rate needed further thought.
[Mr Monger]

5. Examples of the effects of the corporation tax measures should be provided, but not on the basis of the "tax wedges" approach used by the IFS and in some earlier discussions.
[Mr Green (IR)]

6. More work was needed to develop the theme that high profitability was the key to a buoyant economy cf the present position in the US.
[Sir T Burns]

7. Figures should be prepared to show the corporate sector had benefitted from the abolition of NIS, compared to the reduction in income tax which would have been possible otherwise.
[Mr Monger]

8. Figures were required on international comparisons on
(a) rates of tax on company profits overseas;
(b) rates of return on investment.
[Mr Monger]

9. The effects of the package on farmers needed to be explored urgently, and defensive briefing prepared.
[Mr Isaac]

B Personal Sector

10. More thought needed to be given to the defence of the extension of the VAT base. General impressions would be more valuable here than precise figures.
[Mr Fraser]

11. Specific figures were required for the number of widows taken out of tax by the increase in thresholds.
[Mr Isaac]

speak out at a suitable time.
[Mr Portillo]

19. A checklist should be prepared of things to be done after the Budget: a possible schedule for Ministerial meetings with key groups (including industry)
[Mr Battishill]

20. A checklist of key themes to establish in the first couple of days post-Budget.
[Mr Hall]

21. Consideration to be given to the press releases that would be necessary (beyond the standard tax etc ones).
[Mr Ridley]

JS

MISS J C SIMPSON

NFF A66

FROM: F CASSELL

2 March 1984

FINANCIAL SECRETARY

cc - PPS
Chief Secretary
Minister of State
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Battishill
~~Mr~~ Lankester
Mr Monger
Mr Sedgwick
Mrs Lomax
Mr Pirie
Mr Riley
Mr Ridley
Mr Lord
Mr Portillo
Mr Green, IR

EFFECTS OF THE BUDGET ON HOUSE PRICES

You asked if there was any way of quantifying, however tentatively, the likely effects of the Budget on house prices.

2. The Budget is likely to have an effect on house prices in two main ways . First, the income tax package and indirect tax measures will affect real personal disposable income, which partly determines the demand for houses. However, we think that the net effect on both real personal disposable income and house prices, though positive in both cases, is small. Secondly, the package of financial measures is likely to influence house prices both through changes in flows of funds to the building societies and through the change in stamp duty on transfers of property. All these effects are indirect, and so difficult to quantify. The remainder of this note looks at the three individual measures in the financial package that are most obviously related to the supply of housing finance or the demand for houses.

<u>Composite Rate</u>

3. The supply of deposits to the building societies increases both from the direct switch of deposits from the banks (estimated at £400 million in 1984-85 and £800 million in 1985-86) and from

84
3.

second-round credit-multiplier effects. If mortgage demand is not fully met before the change, the societies will be able to increase their lending, with some upward pressure on house prices. However, this effect will be moderated in so far as the increased mortgage lending leaks from the housing market in the form of equity withdrawal by persons.

4. If mortgage lending is in equilibrium before the change (ie there is no rationing), the increase in the supply of building society deposits might ultimately reduce building society interest rates, raising mortgage demand and the demand for houses. The equity withdrawal point is still valid, so the effect on house prices is again likely to be small. We think that the maximum effect of this measure on house prices is of the order of 1 per cent by 1985-86.

LAPR Abolition

5. Abolition of life assurance premium relief on new policies is estimated to increase building society inflows by £90 million in 1984-85 and £280 million in 1985-86, with some additional second-round multiplier effects. Similar arguments apply as in the case of the composite rate for banks, but the ultimate effect on house prices is much smaller because the ex ante building society inflows are smaller.

6. LAPR abolition also has two minor effects on the societies that might tend to push house prices downwards. Because endowment mortgages become more expensive, the cost of mortgages generally will be higher, whether the societies decide to spread the extra cost to repayment mortgages or not. Also, building societies are likely to lose some commission from insurance companies for arranging endowment mortgages (although they will receive more commission for mortgage protection policies on repayment mortgates) and their margins will be slimmed a little. There will be some upward pressure from these factors on the mortgage rate; this will reduce the demand for mortgages, with some downward effect on house prices.

7. These effects are all thought to be very small. Since they operate in opposing directions, the net outcome is probably negligible, although on balance we think that house prices are more likely to rise than to fall.

Stamp Duty

8. The stamp duty reduction on exchanges of property will increase the number of transactions. Part of the reduction is likely to be capitalised into house prices, but probably not all of it. A plausible estimate of the effect on house prices is that they might increase by about ½ per cent.

Conclusion

9. Bringing all the measures together, our best guess is that they might eventually lead house prices to increase by about 1-2 per cent. The stamp duty reduction could raise house prices fairly quickly, but the composite rate and LAPR abolition will work through to house prices over the next two years as building society inflows build up.

F CASSELL

Copy 7 of 22.

FROM: N MONCK
DATE: 5 March 1984

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr Bailey
Mr Byatt
Mr Cassell
Mr Battishill
Mr Lovell
Mr Folger
Mr Hall
Mr Lord
Mr Ridley
Mr Portillo

PS/Inland Revenue
PS/Customs and Excise
Mr Beighton - IR

THE BUDGET AND EQUITIES

I attach the note on this produced by the Bank. Since the note was drafted the Financial Times index for life assurance companies has fallen (about 6% on Thursday 1 March with a modest recovery on Friday).

2. The Bank's estimates for some individual companies is on the last page.

NM

N MONCK

1143

STOCK MARKET ASSESSMENT

Note by the Bank of England

1 The implications of the Budget for the equity market as a whole will not be easy for the market to appraise quickly. Differential effects on particular sectors such as life assurance and between different classes of companies - notably between those paying Mainstream Corporation Tax and those who do not - will be clearer than overall effects. Because of the complexity of the impact of the changes on the corporate sector the initial market reaction is likely to be significantly influenced by the presentation of the measures in the Budget speech.

Overall Sentiment

(1) The treatment of monetary policy in the Budget is probably sufficiently close to average market expectations for this section of the Budget not to affect overall sentiment.

(2) The net changes in Government revenue and in the cash flow of the corporate sector in 1984/5 resulting from Budget measures are so slight that they are not likely to have an impact on overall sentiment.

(3) In later years the changes in FYA and CT imply a reducing tax burden on the corporate sector. This implication is positive for equities but it is likely to be somewhat discounted.

(4) The temporary investment incentive in 1984/5 and 1985/6 resulting from the changes in FYA and CT will have a positive effect, outweighing the longer-term negative effect of the reduction in investment incentives.

2 The overall effect of sentiment is likely to be modestly positive.

Distributional Effects

3 The reduction in CT will be a major benefit to sectors and companies which pay substantial amounts of MCT - notably distribution and other services. Those companies which do not now pay MCT but have major investment programmes will suffer from the elimination of FYA's. The reduced opportunity to engage in leasing will be detrimental to all those who have found it advantageous - whether as lessors or as lessees. Those such as banks who have been large scale lessors will suffer considerably as they will have to restore provisions for deferred tax as well as starting to pay CT. The lessees who will be most affected will be young high-growth companies short of capital and tax-exhausted companies in capital-intensive sectors.

Sectoral Effects

(1) The abolition of LAPR will have a sharp negative impact on life insurance shares.

(2) Bank shares should rise overall since they have been sharply depressed by fears of a new bank tax, but the recovery will be limited by the need which banks will face to recreate deferred tax provision as a result of the prospective reduction in the availability of shelter from leasing.

(3) Engineering shares will suffer because few engineering companies are sufficiently profitable to benefit from lower CT. The generally reduced incentive to investment in later years will also be negative.

(4) Construction shares may suffer from reduced investment incentives.

(5) Importers will suffer from PAS.

(6) Shares in companies with a high proportion of overseas income will be marked down as their opportunity to repatriate profits without double taxation will be reduced.

Some Individual Companies

ICI	Little change, assuming that changes in tax on North Sea earnings are neutral.
GEC	Marked up due to reduced tax bill from lower CT rate which more than offsets loss of stock relief and lower FYA's.
BP	Little change assuming PRT/CT changes are neutral. There is little net benefit due to the high level of overseas earnings and large non-North Sea spending.
Commercial Union	Marked down due to loss of LAPR.
RTZ	Marked down because large overseas earnings prevent benefit of lower CT rate coming through.
ICL	Marked down on devaluation of tax losses brought forward.
Barclays Bank	Marked slightly up on absence of specific bank tax but rise restricted because of reduced scope for leasing and the need to recreate deferred tax provisions.
Lucas	Marked down, tax-exhausted.
Marks & Spencer	Marked up, tax paid and sufficiently profitable for loss of stock relief to be outweighed by reduction in CT.
Tube Investments	Marked down as losses brought forward are reduced in value.
Unilever	Marked slightly up. Loss of stock relief and reduced offset for overseas taxation offset by lower CT.

2 March 1984

- 2 MAR 1984

BUDGET: SECRET

COPY NO 6 OF 24 COPIES

E 3

FROM: ADAM RIDLEY
5 March 1984

MISS SIMPSON

Can I have all these together?

cc CST
FST
MST
EST
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Monck
Mr Battishill
Mr Lankester
Mr Monger
Mr R I G Allen
Mr Folger
Mr Hall
Mr Portillo
Mr G P Smith
Mr Martin
Mr Norgrove
Sir L Airey }
Mr Green } I/R
Mr Isaac }
Mr Fraser } C&E
Mr Knox }

F

BUDGET PRESENTATION: BUSINESS SECTOR ISSUES

The last item in the conclusions of the Chancellor's meeting of March 1 which you circulated on March 2 records that I am to consider what press release(s) would be needed beyond the standard ones on particular tax measures. I have discussed this at some length with Messrs Folger and Allen, and it may be helpful to others if I note what seems to us to be the best way to proceed:

(1) The basic need now is to prepare a fairly all-embracing release which sets out the philosophy and reasoning behind the measures proposed for business and enterprise, and then goes on to explain how the main measures fit in with that approach.

(2) This will have to be started de novo, though obviously it will draw on the many valuable bits of work to hand, such as the draft press release at the back of the Financial Secretary's minute of February 24 to the Chancellor on

presentation, and the material in the front part of the Economic Secretary's piece of the same date, and the (shortly-to-be-circulated) first draft of EB's overall Budget Brief.

(3) In addition nearly every other piece of work commissioned at last Thursday's meeting will be relevant to this exercise. [Can copy recipients please keep Messrs Folger, Allen and myself in touch with their work as it progresses? Even rough first drafts will be very helpful.]

(4) It will not be possible for me at this stage to devote much time to considering whether further press releases might be called for beyond this special general one. I shall assume that EB, CU and appropriate ministerial private offices are keeping a close eye on this issue. However it would be most helpful if I could be sent drafts of business-related press releases as they emerge during the week.

2. Mr Allen and I would hope to be able to submit a very rough first draft to the Chancellor and others tomorrow night so that we can establish clearly agreement on how to proceed later in the week, when the Chancellor himself will be pre-occupied with the speech.

AM

A N RIDLEY

BUDGET SECRET

-6 MAR 1984

FROM: A M ELLIS
DATE: 6 March 1984

MR ISAAC - IR
MR LANKESTER
MR BRYCE - IR
MRS LOMAX
MR WATTS
MR WILLETTS
MR RIDLEY
MR PORTILLO

cc PS/Chancellor
PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State
Sir P Middleton
Mr Cassell
Mr Battishill
Mr Folger
Mr R I G Allen
Mr Hall
Mr G P Smith
Mr Martin
Mr Norgrove

P

BUDGET PRESENTATION AND WINDING SPEECH: FINANCIAL SECTOR

The Economic Secretary held a meeting to discuss the presentation of Budget measures affecting the financial sector in the light of last week's Overview meeting.

2. It was agreed that Mrs Lomax's minute of 29 February should be re-drafted to corporate the comments made at the meeting. [Mrs Lomax].

3. It was agreed that Section V (handling post-Budget presentation) should be detatched from the paper and that Mr Portillo, in the context of his consideration of "bodies and persons to be contacted" (Mr Portillo's minute of 2 March) should also consider how best to contact them, drawing on the suggestions in Section V. [Mr Portillo]

4. In addition to the factual material already gathered on impact of Budget measures on the financial sector, the Economic Secretary asked for details on the following five items:

i. LAPR: the precise criteria for qualification for premium relief under current legislation; the precise criteria for qualification after the Budget; an account (quantified where appropriate) of factors that have led to a growth of non-qualifying life assurance business; a list of specific interest groups (eg independent schools) whose interests will be directly affected by the proposals; any information on the claim by the LOA reported in Saturday's Times that the IR had given a commitment that "there would be a year's notice of any change in the rate". [Mr Isaac]

ii. Capital Markets:a list of the measures the Government has already taken to improve capital markets in recent years together with a brief (and where appropriate quantified) note of recent developments in capital markets; [Mr Willetts]

iii. LIFFE:a note, containing defensive briefing and background, on all the Budget measures affecting LIFFE, as soon as decisions are taken on Mr Bryce's minute of 1 March; [Mr Bryce]

iv. Leasing:a quantative analysis of the leasing market by customer and dealer; [Mrs Lomax]

v. Interest Rates:a list of current interest rates in the personal savings sector (building societies media; national savings instruments and bank deposit accounts and interest bearing current accounts); [Mr Watts].

Budget Debate

5. Although it is not certain whether the Financial Secretary of the Economic Secretary will wind on the second day of the Budget Debate, it was agreed that the material in the revised version of Mrs Lomax's

paper should be worked up into "building blocks" suitable for incorporation into a winding speech. [Mr Lankester, Mrs Lomax].

6. The Economic Secretary would be grateful for this material (with the exception of that in paragraph 4iii and paragraph 6) by close of play Thursday.

A M ELLIS

6.11

- 6 MAR 1984

BUDGET SECRET

CH/EX REF. NO. B(84)468

FROM: MISS J C SIMPSON

DATE: 6 March 1984

cc PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State
PS/Economic Secretary
Sir P Middleton
Sir L Airey
Mr Fraser
Sir T Burns
Mr Littler
Mr Bailey
Mr Cassell
Mr Monck
Mr Battishill
Mr Evans
Mr Monger
Mr Odling-Smee
Mr Ridley
Mr Hall
Mr Lord

MR PORTILLO

BUDGET PRESENTATION: BODIES AND PERSONS TO BE CONTACTED

The Chancellor has seen your minute of 2 March, and has commented that he does not see many friends among the list that you have provided.

2. He has suggested that the Country Landowners Association will applaud the abolition of IIS, and that it must be possible to identify many people and companies who have made representations during the last few months who will applaud the stock options proposals. He has also suggested that the Financial Times, the Sunday Times and maybe the Economist will like the overall shape of the Budget, and that even the Daily Telegraph may also come out in its favour.

B

MISS J C SIMPSON

7 MAR 1984

BUDGET - SECRET

COPY NO 6. OF 33

FROM : M D X PORTILLO
DATE : 7 MARCH 1984

CHANCELLOR

cc Chief Secretary
Financial Secretary
Minister of State
Economic Secretary
Sir P Middleton
Sir L Airey
Mr Fraser
Sir T Burns
Mr Littler
Mr Bailey
Mr Cassell
Mr Monck
Mr Battishill
Mr Evans
Mr Monger
Mr Odling-Smee
Mr Ridley
Mr Hall
Mr Lord
Mr Crawley

f

BUDGET PRESENTATION : BODIES AND PERSONS TO BE CONTACTED

I am grateful for responses to my minute of 2 March. I now attach a draft list of the major bodies and "important" persons to be contacted after the Budget.

2. My preliminary conclusions are:

a) There is no difficulty in finding supporters on NIS, IIS, stock options, VAT on imports, stamp duty etc. The big question is who, apart from Lord Weinstock and Sir Clive Sinclair, will support company tax reform? We have very little idea. In a couple of cases (eg IOD, ABCC) we may need to ring our friends there after the Budget and find out who our likely friends are. But a list of big CT payers from the Revenue might help now (it may already have been commissioned).

b) We need to divide these names in several ways. There are those who must be approached by Ministers

78

or Sir Peter Middleton; and those who can be contacted by officials (including IDT) and advisers. There are those who could go on the media that evening to put in a good word, and others, whether supporters or not, who must be seen at some time soon after, but not immediately.

c) A good impression can be made by contacting people before, during or after the Budget to tell them that a Minister will want to speak to them. That may forestall a number from being too outspokenly critical. The technique is applicable to MPs too.

3. Peter Makeham is now doing some work on who sees whom when, with this list in mind.

4. It would be helpful if IDT could find out who on current plans is going to be on television and radio on Budget Day. On the day, IDT may find this list helpful in recommending to BBC and ITV whom to invite to appear.

5. Preparing this list has made me think again about the problem of how to present the oil tax changes: whether to brief on the benefit to oil from the CT package. If we do not brief even off the record to UKOOA, there is a danger that the initial reaction will be hostile. That might not cause any lasting damage, but it would be better to avoid it. I think we may need to give an unattributable nod and a wink.

MP

M D X PORTILLO

BUDGET - SECRET

BUDGET PRESENTATION : BODIES AND PERSONS TO BE CONTACTED

Body/Person	Attitude
CBI	
Sir Campbell Fraser Sir Terence Becket Sir James Cleminson President's Committee Committee Chairmen (see lists Annex 1 & 2)	Reform : will vary NIS : welcome VAT on imps:"rushed decision" Stamp duty: welcome Thresholds: "too much" VAT base: uncertain Share options : welcome IIS : welcome
Institute of Directors	
Walter Goldsmith Barry Bracewell-Milnes Bruce Sutherland Graham Mather (for advice on supporters)	Reform : will vary NIS : abolition unnecessary VAT on imps: unknown Stamp duty : welcome? CTT : welcome Thresholds : welcome (why not rates too?) Share options:welcome IIS : welcome?
Association of British Chambers	
Sir David Nicholson John Risk John Ackers Bruce Sutherland (see IOD) Tony Newsome Mr David Nicholson (for advice on supporters)	Reform: uncertain VAT base: unwelcome? Thresholds: welcome Share options:welcome IIS : welcome CTT : welcome

BUDGET - SECRET

Association of Independent Businesses

J B M Donnellan

Reform : uncertain
Thresholds: welcome(why not rates too?)
Share options: welcome
Stamp duty : welcome?
NIS : welcome
LAPR : welcome
VAT base : unwelcome?

National Federation of Self-Employed

Bernard Juby

Stock relief : unwelcome
VAT base : unwelcome
IIS : welcome
NIS : welcome

Union of Independent Companies

Bill Poeton

Consultative Committee of Accountancy Bodies

Reform : welcome

Institute of Chartered Accountants:

Reform : welcome

Eddie Ray - Spicer & Pegler

Reform : welcome

Lord Weinstock - GEC

Reform : welcome

Sir Clive Sinclair - Sinclair

Reform : welcome
Stock Options : welcome

BUDGET - SECRET

George Copeman - Wider Share Ownership Council

Stock Options : welcome
IIS : welcome

Dr Herman Hauser - Acorn Computers
(spoke at PM's technology conf)

Stock Options : welcome

Building Societies Association - Herbert Walden

Composite rate : welcome
LAPR : welcome

Life Offices Association

LAPR : unwelcome

Industrial Life Offices Association

LAPR : unwelcome

Friendly Societies

Stock Exchange - Sir Nicholas Goodison

Stamp duty : welcome
IIS : welcome

Law Society

Stamp duty : welcome

Law Society (Scotland)

Stamp duty : welcome

The Big four banks

Reform : unwelcome (leasing)

NFBTE

Stamp duty : welcome
VAT base : unwelcome

Age Concern	Unsatisfied
Child Poverty Action Group	Unsatisfied
UKOOA: George Band	Welcome (when understood)
BRINDEX: Dr Colin Phipps	Welcome (when undersood)
UKOITC : A E Willingale	Welcome (when understood)
Sir John Hoskyns	
Sir John Sparrow	
Sir Hector Laing	
Mr Bond - GEC	
Lord Hanson	
Institute for Fiscal Studies - John Kay	
Institute of Economic Affairs - Lord Harris	

Country Landowners Association	IIS : welcome
Clive Thornton - Mirror Group	Composite rate : welcome Reform : welcome? Stamp duty : welcome? VAT base : unwelcome
Financial Times	General welcome Reform :welcome
Economist	General welcome (but wrong reform?)
Sunday Times	
Andrew Neil Roger Eglin Lionel Barber John Huxley	General welcome? Cable :welcome
Standard	
Neil Collins	General welcome
Daily Telegraph	
Bill Deedes	General welcome
Financial Weekly	Unknown
Accountancy	Unknown
Accountancy Age	Unknown
Investors Chronicle	Unknown

MPs	Special Interest	Attitude
Sir William Clark	Backbench Committee	Mixed?
Terence Higgins	Select Committee	Mixed?
Anthony Beaumont-Dark	Select/Backbench Committees	Mixed
Peter Hordern		Mixed?
David Howell	PSBR etc	Mixed?
Cecil Parkinson	Business in general Stock Options	Generally in favour?
Tim Eggar	Oil, LTPE, Tax reform	Generally in favour?
Peter Lilley	Oil, PSBR	Generally in favour?
Michael Grylls	Small business Institute of Directors Backbench Industry Committee	Generally in favour?
John Hannam	Backbench Energy Committee Oil	Mixed
Nick Budgen	LTPE Select Committee	Mixed
Nigel Forman	Backbench Committee, Tax reform	Generally in favour
John Selwyn-Gummer	Conservative Party Chairman	-
William Powell (Corby)	Publicity in Liverpool on pipe tobacco duty?	-

CBI PRESIDENT'S COMMITTEE

Sir Campbell Fraser	President
Sir Terry Becket	Secretary-General
Sir Austin Bide	Glaxo/BL
Sir Richard Butler	National Farmers Union
Sir James Cleminson	Reckitt & Colman (Pres.designate)
Sir Ken Corfield	STC
Ron Dearing	PO
Ken Durham	Unilever
Sir Michael Edwards	ICL
H C Franklin	Chairman - Regional Council
Anthony Fraser	SMMT
J G Gaddes	BEAMA
John Gough	Chairman - Regional Council
Sir John Greenborough	(Shortly Ch. Fin.Cmttee)
Sir Arnold Hall	Hawker-Siddeley
John Harvey-Jones	ICI
Sir Alex Jarratt	Reed International
C F Jeanes	Chairman - Regional Council
Sir Emmanuel Kaye	Lansing Bagnall
Derek Kingsbury	Fairey Holdings
Sir Ian Morrow	Hambros
Norman Payne	BAA
Sir Austin Pearce	BAe
I H Philips	Chairman - Regional Council
John Raisman	Shell UK Ltd
Sir John Read	TSB
Dr Malcom Skillicorn	GKN
Alan Stote	Smaller Firms Council
Charles Tidbury	Whitbread
Sir Peter Walters	BP

CBI : CHAIRMEN OF COMMITTEES

Rt Hon The Viscount Colville - British Electric Traction Company
K Durham - Unilever
Sir James Cleminson MC DL - Rickitt & Colman
V G Paige CBE - National Freight Consortium
Sir Alex Jarratt - Reed International
M H Vogel - Air Products Ltd
R I Lindsell - ICI
J M Raisman CBE - Shell UK
Sir John Read - TSB
Sir Austin Pearce CBE - British Aerospace
W J Bartlett - British Paper and Board Industry Federation
D J Flunder MC VRD - No known company connection
R Halstead CBE - Beecham
H P Parry - Amey Roadstone
D J Kingsbury - Fairey Holdings
J M Peake - Baker Perkins Holdings
Sir Campbell Fraser
I D Gardiner - The Electronic Engineering Association
J Charman - ICI
Sir Austin Bide - Glaxo
R J Roots - Fords
A E C Stote - BTS Group
A E Willingale - BP
L S Payne - Sainsbury's

- 8 MAR 1984

FROM: H M GRIFFITHS
7 March 1984

cc PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State
PS/Economic Secretary
Sir P Middleton
PS/Customs & Excise
Mr Know - C&E

7/3

1. MR MONGER

2. CHANCELLOR OF THE EXCHEQUER

PRESENTATION OF THE BUDGET MEASURES TO THE EC COMMISSION

I attach a draft minute you may like to send to the Foreign Secretary in reply to his minute of 2 March concerning the presentation of the Budget measures to the EC Commission.

H M GRIFFITHS

DRAFT MINUTE TO THE FOREIGN AND COMMONWEALTH SECRETARY

14TH VAT DIRECTIVE (DEFERRED PAYMENT OF VAT)

Thank you for your minute of 2 March.

I have been very conscious of the need for particular care this year in presenting the Budget measures to the EC Commission and have made plans accordingly.

First, I intend to send a personal note to Christopher Tugendhat, to be delivered on Budget day (I shall of course let you have a copy). Secondly, I am arranging for Mr Knox, a deputy chairman of Customs and Excise, to be in Brussels on 13 March. He will be in touch with your officials about the arrangements for his visit. I have it in mind that Mr Knox should go over the relevant Budget measures in detail with the Director-General in charge of tax matters and also call on the Director-General for customs to explain the background to the new arrangements for VAT on imports. Thirdly the Chairman of Customs and Excise will write to his fellow Director-General of Customs in the other EC countries on the matter of VAT on imports.

I would hope that in this way we can avoid any misunderstanding in Brussels. On the other hand, I do not think we need be unduly apologetic. The Commission should have no reason to complain about my proposals on beer and wine, which will comply fully with the Court judgement. They will, of course, be disappointed about VAT on imports; but I shall make it clear in the Speech, and in my note to Christopher Tugendhat, that I am prepared to revert to the present system if and when our partners agree to adapt the Commission's proposal. As for the VAT threshold for small businesses, I doubt if the Commission - who have yet to raise this with us at a high level - will be greatly surprised by the line I intend to take.

FEV1a

- 7 MAR 1984

BUDGET CONFIDENTIAL

FROM: A. M. BAILEY

7th March, 1984.

MR. SCHOLAR

c.c. Chief Secretary
Sir P. Middleton
Mr. Battishill
Mr. Odling-Smee
Mr. Norgrove
Mr. Perfect
Mr. Ridley
Mr. Lord
Mr. Portillo

BUDGET BRIEFING: LTPE (BRIEF E3)

I have two comments on the defensive part of this briefing (circulated by Mr. Folger yesterday):

(i) The answer to question (iii) - "Why no options for reductions?" - is a bit thin; I suggest adding:

"Where radical options need to be explored, the right way to do so is to set up a "fundamental review" [Budget Speech G4], such as Mr. Fowler is undertaking into pensions".

(ii) The last sentence in the answer to (v) on tax cuts seems to me wrong, in suggesting that all of "resultant higher output" (from the "virtuous circle") can be applied either to higher spending or to lower taxes (and in that order, inviting the question why some of the 1½ per cent or 2 per cent growth might not equally be applied to "improved public services"). I suggest ending the sentence:
".... resultant higher output will make it possible either to improve public services or reduce taxes further".

A. M. BAILEY

32

BUDGET SECRET

NFA66

SIR TERENCE BURNS

FROM: ALLEN RITCHIE
DATE: 7 March 1984

cc Mr Riley

DIRECT RPI EFFECTS AND REVENUE YIELDS OF BUDGET MEASURES

The table you requested is set out below. All comparisons are from a non-indexed base.

Measure	RPI Impact (%)	Revenue Yield (£M) 1984-85	Revenue Yield (£M) Full Year
Tobacco Duties	+ 0.14	130	135
Alcoholic Drinks Duties	+ 0.08	140	145
Vehicle Excise Duties	+ 0.05	110	110
Petrol, Derv, etc.	+ 0.12	265 (a)	265 (a)
VAT on newspapers, etc	+ 0.21	225	300
VAT on takeaway food	+ 0.12	125	200
VAT on alterations to buildings	0.0	250	450
TOTALS	+ 0.72	1240 (b)	1610 (b)

Notes
(a) of which petrol = £225m.
(b) Totals include gaming duties [worth - £5m in 1984-85, + £5m full year]

Allen Ritchie

ALLEN RITCHIE
MP1

2C8/3

7.29

BUDGET SECRET

CH/EX REF. NO. B(650)84

FROM: MISS M O'MARA

DATE: 13 March 1984

cc PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State
PS/Economic Secretary
Sir P Middleton
Sir Terence Burns
Mr Cassell
Mr Monck
Mr Battishill
Mr Evans
Mr Lankester
Mr Odling-Smee
Mr Sedgwick
Mrs Lomax
Mr Riley
Mr Mowl
Mr Ridley

MR BURGNER

THE BUDGET & FINANCIAL FLOWS

The Chancellor has seen your minute of 12 March and agrees with the treatment you propose.

MOM

MISS M O'MARA

4.38/3

FROM: M C SCHOLAR
8 March 1984

PS/CHANCELLOR OF THE EXCHEQUER

cc: PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State
PS/Economic Secretary
Sir Peter Middleton
Sir T Burns
Mr Bailey
Mr Anson
Mr Cassell
Mr Byatt
Mr Monck
Mr Battishill
Mr Odling-Smee
Mr Monger
Mr Hart
Mr Riley
Mr Folger
Mr Norgrove
Mr Ridley
Mr Portillo

Simon
Re substitute

PRESENTATION OF BUDGET MEASURES

I shall be grateful if you will substitute the attached for the first page of the note which I circulated last night.

MCS

M C SCHOLAR

E3 GREEN PAPER: THE NEXT TEN YEARS: PUBLIC EXPENDITURE AND TAXATION INTO THE 1990's

Factual

(i) Green Paper is a contribution by the government to the current debate on the longer term.

(ii) contains no decisions or forecasts, but sets a framework within which issues can be discussed.

(iii) documents growth of public spending and taxation over past 20 years, setting changes in last 5 years within a longer term trend.

(iv) discusses pressures for higher spending in the years up to 1993-94.

(v) assumes GDP growth at 2¼% a year up to 1988-89 (as in MTFS), thereafter at either 2% or 1½% a year up to 1993-94; but makes no assumptions about the rate of the decline in unemployment over the period, or about the growth in personal incomes.

(vi) concludes that, on the illustrative framework of the Green Paper, tax burden will be brought back to its early 1970's level only if public expenditure is held at broadly its present level in real terms right up to 1993-94; and that

(vii) public expenditure growth of 1% in real terms after 1988-89 would mean tax burden only just below its 1978-79 level even after ten years of growth in the economy at about 2 per cent a year - still less to its level in early 1960's.

Positive

(i) Increases in public spending - and taxation - over many years partly a result of governments concentrating upon individual programme needs rather than a long-run view of what can be afforded in aggregate. Green Paper adopts latter-top-down-approach.

(ii) Green Paper analysis of past trends in tax and expenditure vindicates the government's view that finance must determine expenditure, not expenditure finance.

(iii) Increases in the burden of tax over many years have had serious impact on UK economic performance - and thus on capacity to sustain and improve public services.

(iv) Green Paper provides illustrative bench-marks against which to judge

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(P)

FROM: P MAKEHAM
DATE: 9 MARCH 1984

1. MR BATTISHILL ~~/~~ Note below.

2. CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Minister of State
Economic Secretary
Sir Peter Middleton
Sir Lawrence Airey
Mr Fraser
Sir Terence Burns
Mr Littler
Mr Bailey
Mr Byatt
Mr Cassell
Mr Monck
Mr Evans
Mr Lovell
Mr Monger
Mr Odling-Smee
Mr Ridley
Mr Hall
Mr Lord
Mr Crawley
Mr Portillo

Sir PM

Do you need to spk to Sir TB about post-Budget contacts?

Did you spk. to him already about X?

D Howard 13/3

Action

No

BUDGET PRESENTATION

I attach a possible schedule for meetings and other contacts with key groups and individuals to provide a basis for a concerted programme of action after the Budget. I have drawn on the list of contacts drawn up by Mr Portillo.

2. There appear to be two objectives. First, to influence the immediate response which will be reported by the media. Second, to influence the more considered views of key groups.

3. There are some people who should be contacted immediately after the Budget speech. A suggested list of those to be approached is given in Annex 1 and includes:

- personal (telephone) contact with individuals who may favour reforms and who could be quoted in the Press
- contact with key industrialists, who are representative of the most influential groups, to invite them to post Budget meetings. Arrangements are already in hand to provide a brief for the CBI which Mr Monck is submitting this evening, and for the Financial Secretary to write to North Sea Oil groups. A brief for the IOD could also be prepared. More

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extensive briefing for the North Sea Oil groups should be considered to forestall criticism of the effect of CT changes.

4. Meetings and contacts with other important representative groups could be initiated in Budget week. The groups which should be seen together with possible Ministerial coverage are indicated in Annex 2. We are also trying to identify high corporation taxpayers who would be likely to welcome the package.* Ministerial meetings with selected MPs with Ministers could perhaps be supplemented by the PPSs and Advisers contacting other members. There may be some advantage in officials contacting the IFS (who have a link with the Economist) to brief them immediately after the Budget on the effects of the company tax measures.

*Now attached, Annex 5

5. Speaking engagements will provide an opportunity to present Budget themes and respond to criticisms. The current speech programme is set out in Annex 3 and details of non-Treasury Minister speaking engagements in Annex 4:

- you are addressing the Conservative Central Council (24 March) and Manchester Industrialists/Lennox-Boyd constituency (30 March);
- we suggested previously that IFS might be approached to provide a suitable platform for a speech on the long term public expenditure Green Paper;
- the FST has three speaking engagements just after the Budget and the CST and MST have engagements in the week starting 26 March;
- you may wish to consider approaching some non Treasury Ministers about the possibility of including Budget themes in speeches on which officials could provide briefing. Mr Monck is already supplying briefing to Mr Jenkin for a speech on 15 March. Other possible suitable occasions include Mr Jenkin's visit to Liverpool on 16 March, Mr Tebbit's speech to the Finance Houses Association on 27 March, and perhaps one of Mr King's March engagements.

6. IDT will be putting up a submission on media arrangements.

Peter Makeham

P MAKEHAM

Potentially this is a pretty extensive programme of contacts, and you will want to discuss with other Treasury Ministers how to divide up the targets between you. But I hope the suggested programme, on which we have had considerable help from Mr Portillo, provides the basis for a discussion on Monday.

AMWB

A M W BATTISHILL

CONF[illegible]ENTIAL

ANNEX 1

CONTACTS IMMEDIATELY AFTER THE BUDGET

Name	Form of contact	By whom
1. People who may favour reforms		
Lord Weinstock	Telephone	Chancellor
Sir Clive Sinclair	Telephone	FST
Eddie Ray (Spicer and Pegler)	Telephone	Mr Issac - IR
George Copeman (Wider Share Ownership Council)	Telephone	FST/EST
Sir Hector Laing	Telephone	FST(EST)
Peter Gifford (Country Landowners Association)	Telephone	CST
2. Most influential groups		
CBI		
	Meeting to be offered by Chancellor's office at end of Budget speech	Chancellor's office
Sir Campbell Fraser Sir Terry Beckett Sir James Cleminson Ken Durham (Chairman Economic Committee)	In addition consider personal contact with selected CBI members	?Chancellor
Institute of Directors		
	Meeting to be offered by Chancellor's office at end of Budget speech)	Chancellor's office
Walter Goldsmith Bruce Sutherland Barry Bracewell-Milnes	In addition consider personal contact with selected IOD members	Chancellor FST/EST
Graham Mather	Telephone	Mr Portillo

4. City and other contacts

Sam Brittan	Chancellor
Lord Harris?	Chancellor
Gordon Pepper	Officials ?Sir P Middleton
Paul Neild	Officials ?Sir T Burns
Tim Congdon	Officials ?Sir T Burns

ANNEX 2

CONTACTS AFTER BUDGET DAY

Group	Minister
1. Meetings with other representative groups	
Life Offices Association	Chancellor
Industrial Life Offices Association	Chancellor
[British Insurance Association]	
Association of British Chambers of Commerce	CST
EEF	Chancellor
NFBTE	CST
London Clearing Banks	FST/EST
Consultative Committee of Accountancy Bodies	FST/EST
Union of Independent Companies	FST
Association of Independent Businesses	MST
National Federation of Self Employed	MST
Building Societies Association	EST
Friendly Societies Liaison Committee	EST
[SMMT - asked for post Budget meeting: wait to see if they follow up]	
2. Telephone contacts with individuals	
Stock Exchange - Sir Nicholas Goodison	Chancellor
Dr Herman Hauser - Acorn Computers	FST
Lord Hanson	FST or EST
Sir John Sparow	EST or FST
Sir Kenneth Bond	FST
3. MPs	
To be contacted personally	
Edward du Cann	Chancellor
Terence Higgins	Chancellor
Sir William Clark	Chancellor
David Howell	Chancellor
Peter Hordern	Chancellor
Cecil Parkinson	Chancellor
Nick Budgen	CST or MST
Anthony Beaumont Dark	CST or MST
John Browne	CST or MST
Roger Freeman	CST or MST
Ralph Howell	CST or MST
John Townend	CST or MST
Michael Grylls	FST or MST
Tim Eggar	FST or EST
Peter Lilley	FST or EST
Nigel Forman	FST or EST
John Hannam	FST or EST
William Powell (Corby)	Special Adviser telephone contact
Lord Bruce Gardyne	Chancellor
John Selwyn Gummer?	Chancellor

North Sea Oil interests

UKOOA	Letter arranged	FST
	Background brief by telephone?	IR or Mr Portillo
	Meeting?	FST
BRINDEX UKIOTC	Copy of letter to UKOOA	FST
	Background brief by telephone?	IR

ANNEX 3

MINISTERIAL SPEAKING ENGAGEMENTS AS AT 8 MARCH 1984

DATE 1984	MINISTER CHX	OTHERS	OFFICIAL SPEECHES AND MEDIA APPEARANCES*	PARTY SPEECHES
MARCH				
Week 12-18				
Tues 13	CHX		**Budget**	
Thurs 15	CHX		*Jimmy Young	
Sat 17		FST		Esher C A
Sun 18	CHX		*Weekend World	
Week 19-25				
Wed 21		FST	Westminster Ind Brief	
Thurs 22		FST	Croydon Soc Ch Acc	
Sat 24	CHX			Cons Central Council
Week 26-01 Apr				
Wed 28		CST		Carshalton CA
Fri 30		MST	Devon Soc of Accountants	
Fri 30	CHX		Manchester Industrialists	
Fri 30	CHX			M Lennox-Boyd MP
APRIL				
Week 2-8				
Tues 3	CHX		1900 Club	
Wed 4		CST		Cons Small Business
Fri 6	CHX		British Shoe Corp	
Fri 6	CHX			Claybrooke Rectory
Week 9-15				
Mon 09	CHX		**Internat. Assoc. Energy Economists**	
Tues 10		FST	Assoc Ec Reps London	
Tues 10		MST	Drinks Marketing Club	
Wed 11		CST	Royal Coll Defence	
Thurs 12		CST		Cons Ind Fund
Thurs 12		FST		Pimlico C C
Week 16-22				
Mon 16	CHX			CPC (City)
Tues 17		FST	IOD	
Wed 18	CHX		EEF	
Week 23-29				
Week 30 - 6 May				
Mon 30		CST		Westminster YC

ANNEX 4

FROM: MISS M O'MARA
DATE: 8 March 1984

MR MAKEHAM

cc Mr Battishill

NON-TREASURY POST-BUDGET MINISTERIAL SPEECHES

You asked if I could discover whether those of the Chancellor's colleagues most directly affected by the Budget were making any major speeches in the immediate post-Budget period. The position is as follows:

<u>Secretary of State for Trade and Industry</u>

27 March-speech to Finance Houses Association

<u>Secretary of State for the Environment</u>

15 March-speech at Placemakers Luncheon (Mr Monck is already supplying briefing)

16 March-Liverpool tour. Speech to a group of Liverpool businessmen.

20 March-speech to Central and Local Government Show

<u>Secretary of State for Employment</u>

14 March-speech to Conservative Women's National Committee
22 March-speech to Women's National Commission Conference
29 March-speech to Westminster Chamber of Commerce

<u>Secretary of State for Energy</u>

14 March-speech to Industrial Council for Wales

20 March-speech to Midland Industrialists' Advisory Council

21 March-speech to All Party Group for Energy Studies

2. We are also trying to establish whether the Home Secretary has any speaking engagements in the near future for which he is likely to pick an economic theme. I will let you know when we hear from his office.

MOM

MISS M O'MARA

ANNEX 5

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C J Farrow
Assistant Director
01-601 4657

BANK OF ENGLAND
Threadneedle Street
London
EC2R 8AH

9 March 1984

N J Monck Esq
H M Treasury
Parliament Street
London SW1P 3AG

Dear Nick,

As agreed I enclose two schedules which we have compiled from Datastream:-

1 Large companies which pay large amounts of Corporation Tax, tabulated to include an effective tax rate;

2 Large companies with irrecoverable ACT, which may be assumed not to benefit from a reduction in CT. In some cases the companies have substantial other tax liabilities. Where the ACT liability appears to result from double-taxation relief on overseas earnings this has been noted.

Yours

Kit

COMPANIES WHO PAY CORPORATION TAX OF OVER £10m LAST YEAR (after double tax relief)

COMPANY NAME	LATEST PRICE	MARKET VALUE	TOTAL SALES	PRE-TAX PROFITS INC. ASSOCS	* CORPORATION TAX	DOUBLE TAX RELIE	NET CT / PRETAX PROFITS
BRIT. PETROLEUM	425.0	7749.5	34583.0	2305.0	338.0	241.0	4.2%
GENERAL ELEC.	186.0	5102.9	4626.0	670.4	223.6	7.4	32.2%
MARKS & SPENCER	241.0	3171.9	2505.5	237.4	78.6		33.1%
CONSD. GOLDFIELDS	597.0	1117.2	760.4	89.7	73.3	48.1	28.1%
UNILEVER	925.0	1693.4	13215.7	761.5	73.0	45.5	3.6%
PLESSEY	226.0	1633.1	1074.8	146.6	68.5	7.7	41.4%
IMPERIAL GROUP	144.0	1040.8	4381.5	188.8	68.0	0.9	35.5%
DISTILLERS	257.0	933.3	1127.2	209.1	67.1	3.8	30.3%
BASS	326.0	1053.0	1988.4	161.4	60.6		37.5%
GRAND METROPLTN.	348.0	2109.6	4468.8	295.3	49.9	4.2	15.5%
GLAXO HLDGS.	807.0	2970.9	1027.5	192.7	47.9	3.7	22.9%
RACAL ELECTRONIC	210.0	1122.7	762.2	114.3	44.7		39.1%
ALLIED-LYONS	154.0	997.5	2176.0	144.6	44.2	7.7	25.2%
SEARS HOLDINGS	83.0	1116.9	1596.7	110.1	43.4	1.1	38.4%
BOOTS	163.0	1185.4	1670.0	125.6	41.7	3.9	30.1%
RIO TINTO-ZINC	657.0	2027.7	3680.4	341.0	40.4	17.6	6.4%
GT. UNIV. STORES	598.0	1476.9	2037.6	201.4	37.2	8.3	14.3%
PILKINGTON BROS	300.0	508.3	1021.6	76.0	36.1	22.1	18.4%
ASSD. DAIRIES GRP	150.0	981.6	1519.1	78.4	35.1		28.8%
THORN EMI	657.0	1147.7	2715.9	122.0	31.6		25.9%
CABLE & WIRELESS	343.0	1543.5	403.3	146.2	28.3	13.7	10.0%
TARMAC	482.0	654.1	988.4	68.7	27.8		40.5%
REED INT.	412.0	487.2	1809.0	74.1	25.0	1.2	32.1%
SAINSBURY, J	478.0	1650.6	2305.9	100.2	24.8		24.7%
HAWKER SIDDELEY	398.0	784.3	1407.0	123.0	24.8	2.2	18.4%
STD. TEL. & CABLES	328.0	1066.0	628.5	61.3	24.0	0.0	39.2%
WHITBREAD 'A'	148.0	566.1	1001.9	80.0	23.0		28.7%
RECKITT & COLMAN	443.0	546.9	901.3	76.3	20.6	9.9	14.0%
GRANADA GROUP'A'	210.0	329.6	521.1	43.5	19.5		44.8%
BRIT. HOME STORES	214.0	442.5	502.7	48.9	19.0		38.8%
GUINNESS, ARTHUR	155.0	273.5	872.4	69.2	18.3	7.3	15.9%
B. P. B. INDUSTRIES	266.0	505.7	465.8	65.4	18.1	2.4	24.0%
REDLAND	277.0	580.1	799.1	60.0	18.0	4.0	23.3%
ASSD. BRIT. FOODS	174.0	692.8	3366.0	146.5	17.8	3.7	9.6%
BARRATT DEV.	162.0	288.3	512.9	52.2	17.6		33.7%
TESCO	178.0	600.3	2404.0	53.5	16.3		30.5%
RMC GROUP	426.0	373.5	924.9	42.3	16.0	4.0	28.4%
ROWNTREE MACK.	246.0	389.6	770.5	50.5	15.7		31.1%
BURTON GROUP	235.0	406.2	299.2	38.8	15.5		39.9%
SCOT. & NEWCASTLE	113.5	320.1	641.8	41.1	15.0		36.5%
ENG. CHINA CLAYS	224.0	363.2	490.2	46.4	14.5	0.5	30.1%
KWIK SAVE DISCT.	172.0	258.8	556.2	27.5	13.3		48.4%
UNIGATE	125.0	275.3	1662.0	46.1	12.5	0.3	26.5%
COALITE GROUP	192.0	165.1	415.9	25.5	11.5	0.3	43.4%
HOUSE OF FRASER	270.0	415.2	876.7	30.9	10.9		35.3%
HABITAT M'CARE	314.0	332.1	317.2	25.1	10.8		} 43.0%
SMITH, W. H. 'A'	136.0	237.1	871.3	25.2	10.8		
HEPWORTH CERAMIC	148.0	232.9	298.8	24.6	10.6	0.0	43.1%
BELL, ARTHUR&SONS	158.0	176.2	246.7	31.3	10.5		33.5%
					£2012.3m	472.5	

* Probably including CT paid abroad.

Mostly from Accounts for 1982 calendar year or 1982/83 financial year.

£2012.3m
472.5
net CT £1539.8m

Companies with Irrecoverable ACT and Turnover over £200m.
(i.e. effectively had tax losses)

COMPANY NAME	LATEST PRICE	MARKET VALUE	TOTAL SALES	PRE-TAX PROFITS INC. ASSOCS	CORPOR-ATION TAX	DTR	IRRECOVERABLE A. C. T.
B. A. T. INDS	188.0	2743.5	11507.0	856.0	156.0	138.0	28.0
IMP. CHEM. INDS	576.0	3522.5	5368.0	579.0	32.0	23.0	54.0
PEN. &ORIENT. DFD	296.0	421.5	4205.6	32.7	1.3	0.8	5.5
DALGETY	444.0	344.8	2842.0	48.9	10.4	2.6	1.9
BERISFORD, S. &W.	194.0	371.4	2729.2	54.7	0.0	–	7.1
LONRHO	142.0	372.7	2336.1	72.8	2.3	2.2	9.5
BRIT. AEROSPACE	224.0	448.0	2053.0	-15.3	0.0	–	7.3
COURTAULDS	130.0	473.6	1906.0	63.3	8.5	7.3	3.6
GUEST, KEEN	217.0	479.3	1892.0	53.2	11.5	4.7	6.4
TATE & LYLE	390.0	266.3	1783.7	58.2	8.8	4.9	1.3
BEECHAM GROUP	315.0	2269.4	1702.4	237.1	50.0	29.8	11.4
BOC GROUP	277.0	1072.7	1701.6	114.8	24.8	14.9	10.2
INCHCAPE	333.0	282.3	1697.4	50.3	12.1	7.7	2.7
BICC	275.0	521.7	1654.9	101.7	12.1	9.1	6.2
RANKS, HOVIS	89.0	248.6	1636.9	40.7	5.4	1.8	2.4
CADBURY SCHWEPPS	132.0	586.7	1577.8	89.7	11.3	5.8	4.5
BOWATER CORP.	250.0	401.7	1566.0	72.5	8.1	4.2	4.0
DUNLOP	43.0	61.8	1525.0	-5.0		–	4.0
ULTRAMAR	692.0	934.2	1513.3	181.3	21.4	21.4	3.0
METAL BOX	344.0	259.8	1394.3	52.5	6.0	6.2	3.2
LUCAS INDUSTRIES	202.0	183.1	1217.0	20.1	13.7	3.9	3.3
UNITED BISCUITS	147.0	465.6	1205.2	68.4	9.9	–	1.9
HANSON TRUST	186.0	1255.9	1148.3	60.4	-0.3	–	5.0
TI GROUP	276.0	163.7	1095.6	-1.5	1.7	1.3	1.7
JOHNSON, MATTHEY	273.0	363.7	1044.8	38.0	2.1	2.1	5.5
GILL & DUFFUS	190.0	125.1	1006.0	12.9	0.3	0.3	1.9
TRUSTHOUSE FORTE	209.0	814.6	963.1	69.3	12.0	1.9	3.2
BROOKE BOND	82.0	255.4	913.7	47.9	11.4	7.4	3.1
DEE CORPORATION	510.0	302.2	910.1	16.0	0.7	–	3.4
NTHN ENG. INDS	86.0	186.9	867.0	39.6	4.7	1.4	3.0
COATS PATONS	104.5	289.1	856.2	77.3	15.6	14.1	3.6
ICL	73.0	328.6	846.5	46.3	0.0	–	3.2
FITCH LOVELL	170.0	116.6	804.1	12.6	2.2	–	1.3
BLUE CIRCLE INDS	440.0	510.8	785.2	106.5	8.7	4.7	4.5
PEARSON, S. &SON	426.0	399.0	718.5	59.9	8.2	4.0	2.2
OCEAN TRANSPORT	123.0	138.7	714.8	12.8	0.2	0.2	3.1
DAVY CORP.	70.0	66.1	708.0	6.4	3.4	1.0	1.4
DEBENHAMS	155.0	211.3	676.4	17.7	0.0	–	1.5
VICKERS	160.0	146.5	656.1	22.7	1.6		3.4
IMI	75.0	201.6	633.0	28.8	3.9	–	4.0
DRG	133.0	111.3	579.6	12.5	1.6	1.2	2.1
DELTA GROUP	79.0	113.0	508.0	19.2	8.6	2.9	1.3
GLYNWED	149.0	124.8	444.3	13.7	4.4	2.3	3.6
TOOTAL GROUP	45.5	80.6	401.2	14.9	1.9	1.6	1.8
FOSECO MINSEP	169.0	137.7	333.1	14.1	0.3	0.3	2.5
KENNING MOTOR	122.0	51.4	326.4	11.8	3.0	0.9	1.4
CRODA INT.	114.0	129.2	307.1	14.3	2.1	–	2.3
CRODA INT. DFD	80.0	129.2	307.1	14.3	2.1	–	2.3
COOKSON GROUP	301.0	143.3	289.3	11.5	1.3	0.8	1.3
L. C. P. HDGS.	96.0	61.7	277.5	4.1	-0.3	–	1.2
FISONS	753.0	337.3	235.1	21.0	2.2	2.2	2.0
DE LA RUE	625.0	237.9	225.9	31.6	5.7	4.8	3.7

FOR AN EXPLANATION OF OPTIONAL FACILITIES TO STORE THIS LIST SEE NEXT PAGE

FROM: F CASSELL
9 March 1984

ECONOMIC SECRETARY

cc - Chancellor
Chief Secretary
Financial Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr Battishill
Mr Lankester
Mr Odling-Smee
Mr Evans
Mr Sedgwick
Mr Mowl
Mr Riley
Mrs Lomax
Mr Ridley

THE BUDGET AND FINANCIAL FLOWS

We have been trying to assess the likely effect of the Budget on flows of funds through the financial system. This carries further the work on estimating the impact on financial institutions I reported on 24 February. Mercifully, it has not thrown up any major surprises that would lead us to change the conclusions then reached. Nor has it materially reduced the uncertainty. I would suggest that the estimates in this note, and the post-Budget prospect to which they give rise, would form a useful background to your next funding meeting.

Basis of the Estimates

2. The first problem to be faced in assessing the effects of the Budget is to decide what the world would have been like if there had been no Budget. With the MTFS, unchanged fiscal policy may involve quite substantial changes in tax rates (or public expenditure) to keep the PSBR on its medium-term track. For this reason in forecasting we now build in whatever fiscal adjustments are required to deliver the PSBR path (and conventionally assume that those adjustments take the form of changes in personal income tax). For the sort of exercise we are engaged on here, this would

not be the right point of departure. So we have started from a base with no tax changes beyond indexation. Most of the numbers in this note are <u>differences</u> from that base.

3. The second problem is to make a workable assumption about monetary policy. Ideally, this would be that, starting from a base in which the aggregates are growing within their target ranges, interest rates adjust to keep those aggregates at their base levels. This assumption is usually known as 'fixed money supply'; it is the one generally adopted in the forecasts. But it greatly complicates the task of tracking flows of funds through the system. The interest rate changes would lead to large feed-back effects that would make it difficult to see what was happening. So in constructing our flow of funds matrix we have assumed that interest rates (not monetary aggregates) are fixed. This is purely so that we can describe the monetary effects of the fiscal changes with greater clarity - it does not imply that we think policy should allow the monetary aggregates to move in that way.

4. This assumption means that in the calculations described below the Budget is not quite neutral in its effect on the PSBR. It reduces the PSBR by about £200 million in 1984-85. This is consistent with neutrality in the "score card" terms, where a weighted money supply is fixed. Our analysis implies that the net effect of the Budget will be to put (<u>slight</u>) upward pressure on this weighted money supply, and therefore - when this is offset on interest rates (so increasing the PSBR). But the monetary assumption underlying the score card embraces several aggregates, including PSL2. The weight given to PSL2 in assessing monetary conditions is crucial, since there is likely to be a substantial increase in building society deposits as a result of the Budget. In terms of the target aggregates M0 and £M3 alone, the broad effect of the Budget on interest rates is probably neutral.

5. These implications need to be seen in relation to the base forecast that foresaw a gradual decline in both short and long interest rates over the next two years. That picture remains

broadly unchanged, but within it the Budget is likely to lead to changes in the structure of relative interest rates, with building society rates and those offered on National Savings falling in relation to bank rates and gilt-edged yields. The reasons for this are explained below.

6. All the figures are, of course, highly uncertain. In many cases they are no more than plausible guesses. This is always true in financial forecasting, but it is given added force on this occasion by the absence of any past experience to call on in estimating the effects of some of the measures.

THE MAJOR MEASURES

7. The major Budget measures have been divided into four broad groups:

i. Corporate Tax Package, comprising the abolition of NIS, changes to investment allowances and corporation tax rates, the abolition of stock relief and changes to North Sea taxes.

ii. "Financial" Package, comprising introduction of the composite rate for banks, abolition of life assurance premium relief, reductions in stamp duty; VAT on imports is also included in this group.

iii. Income Tax, comprising changes to personal income tax.

iv. VAT, comprising the extension of the VAT base.

8. Each of these groups is first analysed separately and the effects of the total package obtained by summing the parts. This makes it easier to see why the total effect on certain variables might be zero even though we know that individual measures have potentially large effects on those variables.

9. A simulation on the Treasury model was run for each of the four groups and the resulting changes in sector financial surpluses

and deficits provide the starting point for the flow of funds analysis. These financial surpluses and deficits are (broadly!) the excess of the sector's saving over its expenditure on physical assets (fixed capital and stocks). Changes in them are not a measure of the financial gain or loss to the sector as a result of the Budget. The profitability of companies might be substantially increased by tax cuts, but their financial balance would worsen if this led to an even bigger increase in their investment. So what the changes in Table A below show is how much more the sector can lend to, or needs to borrow from, other sectors as a result of the Budget. For comparison, the effects on the PSBR are also shown.

TABLE A

SUMMARY OF EFFECTS OF BUDGET ON FINANCIAL SURPLUSES AND DEFICITS

£ million

	Overseas	Persons	ICCs	OFIs	Banks	Public Sector	PSBR*
1984-85							
Corporate Tax	500	100	400	-350	-50	- 600	500
Financial	50	- 50	100	150	0	- 250	- 900
Income Tax	550	300	-100	0	0	- 750	750
VAT	-200	-250	-350	0	0	800	- 550
Minor			negligible				
Total	900	100	50	-200	-50	- 800	- 200
1985-86							
Corporate Tax	650	200	350	-150	0	-1050	1100
Financial	250	-250	-100	200	0	- 100	150
Income Tax	450	500	- 50	-100	0	- 800	800
VAT	-550	-100	-100	50	0	700	- 750
Minor			negligible				
Total	800	350	100	50	0	-1300	1300

NB Assumes fixed interest rates.

+ indicates higher surplus or smaller deficit

- indicates smaller surplus or higher deficit

*The marked difference between the change in the public sector's financial deficit (PSFD) and the change in the PSBR in 1984-85 reflects mainly VAT on imports (which is counted as a change in the timing of payments and so as an "accruals adjustment" outside the PSFD).

10. It will be seen that the Budget leads to a substantial increase in the financial deficit of the public sector and a marked worsening in the external current account (which is the mirror image of the overseas sector's surplus). Among the domestic sectors, persons and industrial and commercial companies (ICCs) see their financial position improve while financial institutions (banks and OFIs) see theirs worsen. However, the contrast between ICCs and OFIs is almost certainly exaggerated in these figures since much of the increase in investment is assumed to be financed by leasing and so is allocated to OFIs. The broad picture is that the main counterpart of the bigger public sector deficit is in a worsened external current account. Since we assume that the exchange rate is freely floating, the worsening of the current account is matched by capital inflows, at a lower exchange rate.

Corporate Tax Package

11. The CT package, including abolition of NIS, has a mildly expansionary impact on the economy (rising to an increase of ¼ per cent in real GDP by 1986-87). Real disposable incomes and average earnings rise slightly (less than ½ per cent) while prices and the exchange rate are marginally lower (the latter reflecting the increased demand for imported investment goods).

12. The main economic effect of the package in 1984-85 is to stimulate investment, and leasing. In total, investment spending is assumed to rise by £1.5 billion, of which £1 billion represents "financial forestalling" (ie accelerating payment)*. A third of this increased investment expenditure is assumed to be financed within the company sector itself (companies buying capital goods making payments to companies producing capital goods); a further third is assumed to be financed by additional bank lending to the company sector; the remaining third is assumed to be financed from other sources (notably running down liquid assets or borrowing abroad).

13. Much of the bank lending is channelled, directly or indirectly, through leasing. It has been assumed that leasing increases by

*Since this paper was drafted, these figures have each been revised down by £250 million, but this would not significantly affect the assessment presented here.

£400 million in 1984-85. About three-quarters of this rise shows up as bank lending to OFIs as it is carried out by bank subsidiaries that are outside the monetary sector. Around 10 per cent is carried out by institutions within the monetary sector and this shows up as lower NDLs (ie a lower financial surplus for banks). The remainder (15 per cent) is assumed to be carried out by companies, which in turn affects their bank borrowing. These effects become minor in 1985-86, as leasing is then assumed to be only slightly above the level it would otherwise have been.

14. While these higher investment outlays reduce companies' financial surplus, two other parts of the package go the other way - NIS and the abolition of stock relief, which reduces stockbuilding.

15. In 1985-86 companies are again in higher financial surplus as they continue to run down their stocks. They are assumed to invest an extra £300 million, and increase leasing by £100 million. Financial forestalling accounts for a further £300 million expenditure. Even so, companies should be able to reduce their bank borrowing.

Financial Package

16. The effects of these measures on the real economy and inflation are tiny. Real GDP is slightly higher, mainly because of the reduction in stamp duty, and retail prices are unchanged. Consumer prices fall slightly, however, because stamp duty is counted as a tax on consumer spending.

17. The changes to the surpluses and deficits in 1984-85 are fairly small. The public sector deficit increases because loss of stamp duty revenue outweighs the extra income tax from abolition of premium relief. The extra revenue from imposing VAT on imports scores as a change in the accruals adjustment, outside the PSFD. This is the main reason why, ex post, the PSBR falls by £900 million despite an increase in the public deficit. The counterparts to the latter are a smaller deficit for the overseas sector (ie a lower current account surplus), lower personal surplus - partly due to higher housing investment - and improved positions for ICCs and OFIs. The latter arises from a cut-back in property investment by

life companies, whose cash flow is reduced by the abolition of premium relief on new policies. The effects are somewhat larger in 1985-86, particularly for the overseas sector, and the pattern roughly the same, except that ICCs financial balance deteriorates slightly instead of improving.

18. Most of the effects on financial transactions are familiar from the discussion of the direct effects in my paper of 24 February (Effects of the Budget on the Financial Sector). For the composite rate the main direct effect is a shift by the personal sector out of bank deposits into building society deposits and National Savings. The direct reduction in bank deposits is assumed to be £500 million in 1984-85 and £1000 million in 1985-86. The ex post effects on bank deposits of the composite rate, however, are lower, and on building society deposits larger, than these direct effects, because building societies lend back the higher inflow to persons, who re-deposit with banks and building societies.

19. The process of increased intermediation by the building societies can only take place at unchanged interest rates if there is an unsatisfied demand for mortgages at existing interest rates. This may well be the case, but it is less evidently so than it was. In practice, these flows between banks and building societies would be likely to induce changes in relative interest rates - with building society rates shading down and bank rates edging up. But these effects cannot readily be allowed for in our matrices (which assume fixed interest rates). We return to this point later when looking at the effects of the Budget as a whole.

20. Abolition of premium relief is assumed to reduce inflows to life assurance and pension funds by £250 million in 1984-85 and £800 million in 1985-86. The reduction in stamp duty reduces the institutions' administrative costs and hence increases their surplus available for investment. The cut in stamp duty makes itself felt mainly by increasing the personal surplus and by improving the climate for ICCs capital issues, so reducing their need for bank finance.

21. The imposition of VAT on imports takes funds out of ICCs in 1984-85. This does not show up as a reduction in ICCs financial surplus, however, because it does not change their total VAT liability but only the timing of payments. ICCs are assumed to finance the earlier payment of tax by receiving more import credit (£400 million), borrowing more from banks (£400 million) and running down their liquid assets, mainly bank deposits (again £400 million).

Income Tax

22. This is a straightforward tax change, GDP is increased by $\frac{1}{4}$-$\frac{1}{2}$ per cent by 1985-86, and prices rise (as a result of a lower exchange rate). The public sector deficit is increased, the main counterparts being higher overseas and personal sector surpluses.

23. The financial effects are fairly obvious. Persons spread their higher surplus between building societies, bank deposits and public sector debt, mainly national savings. The higher building society inflows allow higher mortgage lending. Persons also borrow more from banks, as they gear up to their higher after-tax income. ICCs borrow more in 1984-85 to finance their higher deficit. OFIs other than building societies are not greatly affected.

VAT

24. The widening of the VAT base raises prices and this depresses demand and output. By 1985-86 real GDP is about $\frac{1}{4}$ per cent lower. The public sector financial balance improves and those of the overseas, personal and ICC sectors deteriorate. Persons borrow more from banks and reduce their holdings of financial assets. ICCs also borrow more from banks, though the extent to which this is necessary is moderated in 1984-85 by a cash flow gain from the accruals adjustment (since VAT is paid over after a lag). Bank lending to the private sector is higher in 1984-85 partly because higher prices lead to more borrowing.

OVERALL PICTURE

25. Tables B-G appended summarise the effects of the Budget as a whole on key financial variables and sectors.

26. Table B shows the effects on financial institutions other than banks and building societies. This is a key sector for Government financing. The total resources of these institutions available for investment in financial assets are little changed in 1984-85. Extra leasing investment is financed by bank borrowing. Although the financial package reduces inflows to life assurance and pension funds, these institutions gain funds from the income tax package. However, this seems to be largely through bank borrowing. Either way, the numbers are fairly small and the Budget has little overall impact in 1984-85.

27. The effects are bigger in the following year and are dominated by reduced inflows to life assurance. The institutions reduce their purchases of gilts and overseas assets almost equally, by around £100 million.

28. Table C shows the effects on building societies. The inflow to the societies is considerably higher in both years, by over £1 billion in 1984 and £2.5 billion in 1985-86. Some 80 per cent of this is assumed to be lent in the form of mortgages, the rest being split equally between bank deposits and gilts. The main question is whether building societies will be able and willing to do the extra lending at unchanged interest rates. They will almost certainly be willing - in the provisional post-Budget forecast their gross lending in 1984 was below the £23 billion mentioned publicly by the BSA. The big question is whether the extra demand for mortgages would be forthcoming at unchanged interest rates. The estimates in Table C assume that although disequilibrium in the mortgage market is less than it was, it is still significant, particularly following the increase in the limit for mortgage interest relief last year and the opportunities for equity withdrawal. So while there might therefore be a fall in building society interest rates relative to other rates, it would be probably fairly small.

Banks and Money Market Assistance

29. Tables D and E show what we think might happen to bank balancesheets and money market flows as a result of the Budget as a whole. They suggest that despite the shadow of the composite rate and the rundown of company deposits to finance higher investment spending and accelerated VAT payments, there is, overall, only a small fall in deposits in 1984-85. As noted above, this partly depends on the assumption that the building societies can on-lend to persons at existing interest rates most of the deposits they receive; for the rest, banks gain deposits as a result of the corporate tax and income tax packages.

30. But if the Budget leaves their deposits little changed it is likely to generate additional demand for bank lending. This demand can only be met, within the monetary guidelines, by a combination of over-funding and bill purchases by the authorities. The banks lend an additional £850 million as advances, but have to sell £1 billion of bills to the Issue Department. In other words, the Budget gives rise to an extra £1 billion of money market assistance.

31. This is a very important implication of the analysis, because it is superimposed upon a base forecast that had money market assistance continuing to rise. This raises a difficult policy question: if the financial system has to rely on continual increases in official purchases of bills is the fall in the PSBR a misleading indicator of the public sector's demands on the financial markets? Continued money market assistance, year after year, would make it hard to resist the argument that these transactions should be scored 'above-the-line' as contributing to the PSBR, not as "financing" it.

32. In 1985-86 bank deposits in total are actually higher, and with demand for loans falling, money market assistance is lower.

33. Tables F and G show the estimated effects on the counterparts of £M3 and PSL2 respectively, again at unchanged interest rates. £M3 is virtually unchanged over the two years. In 1984-85 a combination of over-funding (a lower PSBR, higher debt sales) and

negative externals broadly offset higher bank lending. In 1985-86 £M3 increases by £250 million, reflecting in part the higher PSBR. PSL2 is higher in both years, by over £½ billion in 1984-85 and £2 billion in 1985-86 - equivalent in that latter year to 1½ per cent of the stock of PSL2. The Budget accentuates therefore the recent tendency of PSL2 to grow faster than £M3. This divergence would, however, be moderated if building society rates fall in relation to bank rates.

The Post-Budget Prospect

34. The post-Budget prospect that we face is therefore broadly that summarised in Mr Mowl's submission of 27 February. The main features as now seen are:-

(£ billion unless otherwise stated)	1983-84	1984-85	1985-86
PSBR	9.9	7.2	7.0
Net sales of public sector debt to non-bank private sector:-			
a. gilts	10.0	6.3	5.6
b. National Savings	3.1	3.0	3.0
c. Other	- 1.6	- 0.8	- 0.4
Changes in bank £ lending to private sector	13.9	14.9	14.4
Change in building society mortgage lending (gross)	19.6	21.9	23.0
Change in MO (%)	6	6½	5½
Change in £M3 (%)	10	9	8
Change in PSL2 (%)	13½	10½	9½
Over-funding	1.7	1.4	1.2
Money Market Assistance	1.5	1.3	1.9
3-month inter-bank rate %	9¾	8¾	7¾
20 year gilts rate %	10½	9¼	8¾
Mortgage rate %	11	10½	9¾
Effective Exchange rate	83½	83½	83½

35. An outcome of this sort would, on the whole, be acceptable - but it is worrying that it has to rely so much on over-funding and money market assistance. Of the obvious risks perhaps the two

greatest are that bank lending will rise more than is now forecast and that the exchange rate will weaken. Either of these could put the fall in interest rates in jeopardy.

9 March 1984

BUDGET SECRET

TABLE B

CHANGES TO OFIs SOURCES AND USES - EXCLUDING BUILDING SOCIETIES

£million

Sources of Funds

	Bank Borrowing	Unit Trust Inflows	Life Ass, Pension Fund Inflows	Other	Financial Surplus	Total Sources
1984-85						
Corporate Tax	300	-	-	-	-400	-100
Financial	-	-	-100	-	200	100
Income Tax	50	-	50	-	-	100
VAT	-	-	-	-		-
Minor						
Total	350	-	-50	-	-200	100
1985-86						
Corporate Tax	50	-	50	-	-150	-50
Financial	50	50	-600	-	200	-300
Income Tax	100	-	100	-50	-100	50
VAT	-	-	-	-	50	50
Minor						
Total	200	50	-450	-50	-	-250

Use of Funds

	Bank Deposits	LA Temp Debt	LA Long Debt	Gilts	UK Company Securities	Overseas Assets	Other Assets
1984-85							
Corporate Tax	50	-	-	200	-150	-200	-
Financial	-	-	-	50	100	-50	-
Income Tax	50	-	-	100	-	-50	-
VAT	-	-	-	-50	-	50	-
Minor							
Total	100	-	-	300	-50	-250	-
1985-86							
Corporate Tax	50	-	-	100	-100	-100	-
Financial	-	-	-	-200	-50	-50	-
Income Tax	50	-	-	100	-	-100	-
VAT	-50	-	-	-100	50	150	-
Minor							
Total	50	-	-	-100	-100	-100	-

TABLE C

CHANGE TO BUILDING SOCIETIES SOURCES AND USES

£million

Source of Funds

	Bank Borrowing	Shares and Deposits	Other	Financial Deficit	Total Sources
1984-85					
Corporate Tax	-	250	-	-	250
Financial	-	700	-	-	700
Income Tax	-	500	-	-	500
VAT	-	-300	-	-	-300
Minor					
Total	-	1150	-	-	1150
1985-86					
Corporate Tax	-	350	-	-	350
Financial	-20	1800	-	-	1800
Income Tax	-	600	-	-	600
VAT	-	-250	-	-	-250
Minor					
Total	-20	2500	-	-	2500

Use of Funds

	Bank Deposits	LA Temp Debt	LA Long Debt	Gilts	Mortgages	Total Assets
1984-85						
Corporate Tax	-	-	-	50	200	250
Financial	50	-	-	100	550	700
Income Tax	50	-	-	50	400	500
VAT	-	-	-	-	-200	-300
Minor						
Total	100			200	950	1150
1985-86						
Corporate Tax	-	-	-	50	300	350
Financial	150	-	-	200	1450	1800
Income Tax	50	-	-	50	500	600
VAT	-	-	-	-50	-200	-250
Minor						
Total	200			250	2050	2500

TABLE D

CHANGES TO BANKS' BALANCE SHEET

£million

	Liabilities		Assets			
	Deposits	Non-Deposit Liabs.	Total Advances	Less Issue Dept holdings of bills	=	On Balance Sheet Loans
1984-85						
Corporate Tax	400	-50	300	-50		350
Financial	-900	-	150	1050		900
Income Tax	450	-	200	-250		450
VAT	-200	-	200	400		-200
Minor						
Total	-250	-50	850	1150		-300
1985-86						
Corporate Tax	550	-	-250	-800		550
Financial	-450	-	-250	200		-450
Income Tax	500	-	150	-350		500
VAT	-350	-	100	450		-350
Minor						
Total	250	-	-250	-500		250

MONEY MARKET INFLUENCES

TABLE E

	Gilt Sales	National Savings	Other	CGBR*	Market Assistance	Over Funding
1984-85						
Corporate Tax	400	50	-	-500	-50	-100
Financial	50	100	-	900	1050	1100
Income Tax	250	150	50	-750	-300	-350
VAT	-100	-50	-	550	400	400
Minor						
Total	600	250	50	200	1100	1050
1985-86						
Corporate Tax	250	100	-50	-1100	-800	-900
Financial	100	250	-	-150	200	200
Income Tax	200	150	100	-800	-350	-400
VAT	-200	-50	-50	750	450	400
Minor						
Total	350	450	0	-1300	-500	-700

* increase minus

TABLE F

EFFECTS ON STERLING M3 AND COUNTERPARTS

£million

	PSBR	Gilts	National Savings	Other Debt	Bank Lending	Externals	NDLs	£M3
1984-85								
Corporate Tax	500	300	50	0	400	-300	- 50	300
Financial	-900	100	100	0	150	150	0	-800
Income Tax	750	200	150	0	300	-250	0	450
VAT	-550	-100	-100	0	150	50	0	-150
Minor								
Total	-200	500	200	0	1000	-350	- 50	-200
1985-86								
Corporate Tax	1100	200	100	-100	-100	-350	0	450
Financial	150	100	250	0	-150	- 50	0	-400
Income Tax	800	150	150	0	100	-150	0	450
VAT	-750	-150	-100	0	50	200	0	-250
Minor								
Total	1300	300	400	-100	-100	-350	0	250

EFFECTS ON PSL2

TABLE G

	£M3	Other	B. Soc. Component	National Savings Component	Less B. Soc. Bk Deps	PSL2
1984-85						
Corporate Tax	300	-	200	-	-	500
Financial	-800	-	550	50	100	-300
Income Tax	450	-	400	50	50	850
VAT	-150	-	-250	0	- 50	-350
Minor						
Total	-200	-	900	100	100	700
1985-86						
Corporate Tax	450	-100	300	50	50	650
Financial	-400	-	1450	50	150	950
Income Tax	450	-	450	50	50	900
VAT	-250	-	-200	0	0	-450
Minor						
Total	250	-100	2000	150	250	2050

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CONFIDENTIAL

From: T Burns

Date: 9 March 1984

Chief Secretary
Financial Secretary
Minister of State
Economic Secretary
Sir P Middleton
Mr Cassell
Mr Battishill
Mr Evans
Mr Odling Smee
Mr Folger
Mr Allen
Mr Smee
Mr Smith
Mr Norgrove

Mr Ridley
Mr Lord
Mr Portillo

CHANCELLOR

PRESENTATION OF THE BUDGET: CORPORATE SECTOR

I attach two notes on the corporate sector relating to points raised at last week's overview meeting on presentation. The first deals with the argument that investment productivity is as important and valid as the traditional concept of labour productivity. The second presents some fairly recent figures for profitability to compare recent trends in the UK and US.

TB

T Burns

COMPANY TAXATION: THE IMPORTANCE OF INVESTMENT PRODUCTIVITY

Traditionally, the most common productivity measure has been that of labour productivity. This note argues that investment (capital) productivity is just as important and valid a measure as labour productivity and suggests why, as a measure, it has been less frequently employed.

2. Output depends on the use of both capital and labour, and, for a given factor supply, the level of output depends on the efficiency with which both these factors are employed. Moreover simple measures of labour productivity - output divided by numbers employed or man-hours - will be influenced by the amount and quality of capital employed, just as a simple measure of capital prductivity will be influenced by the amount and quality of labour. The two measures are interdependent. There is no à priori reason to stress labour rather than capital productivity: a profit maximising firm will seek to use both as efficiently as possible.

3. Capital productivity has not been totally neglected. Total factor productivity measures, which look at the productivity of both labour and capital have a long history: and capital productivity is often approached obliquely eg via the rate of return on investment or the level of profits. Nevertheless labour productivity has been the more commonly used measure in comparative productivity studies. One reason for this is that it is easier to measure in physical terms. For comparative purposes, it is often difficult, at a firm level, to evaluate the relative quantities of capital employed; and at an aggregate level there are considerable doubts as to the reliability of capital stock figures. Another reason for the stress on labour productivity is the belief that there is more scope for increasing growth through changes in labour productivity than in capital productivity. This reflects two factors: one, the post-war belief that labour was the scarce factor and the major constraint on growth; the other that, as the best technology and the capital embodying it is relatively freely traded on world markets, in the absence of other distortions international differences in the productivity of capital might be considerably less than differences in the productivity of labour.

/4...

4. Many of the factors that contribute to low labour productivity also apply to capital productivity. There are, however, some factors which affect capital uniquely; for instance investment incentives distort the capital-labour mix and the asset-distribution of investment, and this may be reflected in low capital productivity. There is evidence that the UK has a high capital stock per worker, especially in manufacturing, and that its stock is more plant and machinery intensive than that in other countries. Moreover, the rate of return on investment, the incremental output associated with new investment and the output per unit of capital are very low compared to those in other western countries. (Mr Monk's submission, "Company Tax and Investment" of March 2 summarized the evidence on the low productivity of UK investment).

5. Given that there seeems to be considerable scope for improvement in capital productivity in the UK, and given that we may be in a period when capital not labour is the scarce factor, it is important to adopt policies which raise the productivity of capital by improving the "quality" of investment.

FROM: H P EVANS

DATE: 8 March 1984

cc Mr Byatt
Mr Odling-Smee
Mr Horton
Mr Owen

SIR TERENCE BURNS

PRESENTATION OF THE BUDGET : CORPORATE SECTOR

You asked for some briefing on the theme that

> "More work was needed to develop the theme that high profitability was the key to a buoyant cf the present position in the US".

2. Mr Owen and Mr Horton have dug out some fairly recent figures for profitability. I attach at A an extract from the September EPR, and at B a minute and table prepared by Mr Owen. The figures for 1982 (even) are not published and there could well be changes. A group under Mr Byatt is looking into the measurement problems in the UK in this area.

3. While the precise figures are very uncertain, the general trends in the last couple of years in the UK and the US are familiar. Profitability is recovering in both countries, earlier but more steady in the UK and from a lower base.

4. Points to make:

i. Profitability has declined, in most countries, since the fifties and sixties.

ii. The decline in the UK has been greater, and to a lower level, particularly in manufacturing.

1023

iii. The cyclical decline in the period 1980-81 is now being reversed, but there is some way to go - above all in manufacturing in the UK - before we reach the average of the seventies (even).

iv. The extent of the decline in UK output in the period 1979-81, especially in the manufacturing sector, owed much to the fall in profitability.

v. Rising profitability, accompanied by rising employment, is a feature of the recovery in both the UK and the US. A rise in profitability is a vital part of the recovery process, bringing with it increased spending and employment.

HPE

H P EVANS

Table 4

Average absolute forecasting errors

1972-73 to 1982-83

	Budget forecast for year ahead	Summer internal	Autumn internal	Autumn published	Winter internal	Budget forecast for year finishing
As a % of GDP at market prices	1.6	1.3	1.0	0.9	0.4	0.3
In 1982-83 prices (£bn)	4.4	3.6	2.7	2.5	1.0	0.9

one per cent of GDP (see 3(a) and 3(c)).

The bottom part of the table shows that in-year forecasts made in the autumn have been less subject to error in recent years — helped no doubt by more up-to-date statistics.

A tentative conclusion is that the turbulent and inflationary years of the mid-seventies, with the introduction of cash limits in 1976-77, were more difficult to forecast, and the errors were large. Over the last five years, with more control, more experience of forecasting and better statistics in this area, errors were probably smaller than they would otherwise have been. However, one must be cautious about trends over short periods.

Table 5

Published PSBR forecasts

		Number of years	Average absolute error (% of GDP)
Budget forecasts for year ahead			
1. Whole period	**1967-68 to 1982-83**	**16**	**1.4**
of which:			
2. (a) First half	1967-68 to 1974-75	8	1.3
(b) Second half	1975-76 to 1982-83	8	1.4
or of which:			
3. (a) First period	1967-68 to 1973-74	7	0.8
(b) Second period	1974-75 to 1977-78	4	2.9
(c) Third period	1978-79 to 1982-83	5	0.9
Autumn forecasts for current year			
4. Whole period	**1976-1982**	**7**	**0.9**
of which:			
5. (a) First half	1976-78	3	1.3
(b) Second half	1979-82	4	0.6

Analysis of forecasts and errors

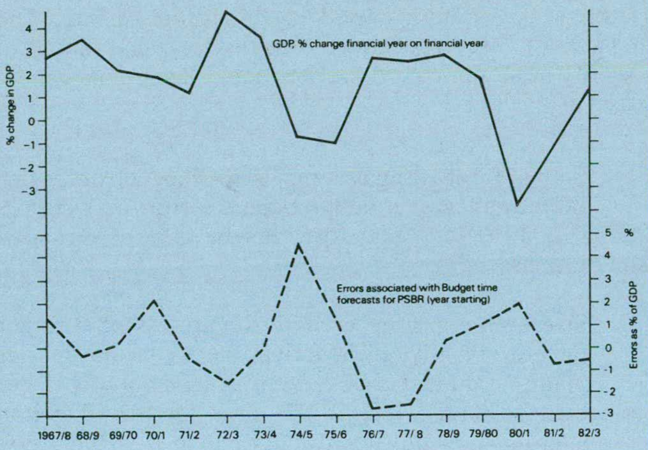
A number of observations can be made about PSBR forecasting errors. For instance, a clear correlation seems to exist between the direction of the errors and the economic cycle. Forecasts made at times when GDP has been rising have tended to show negative errors — that is the PSBR has tended to emerge lower than forecast in an upswing — while forecasts made when GDP was falling below trend have tended to show positive errors. Chart 2 compares movements in the economic cycle with Red Book forecast errors on the PSBR in the forthcoming year. The top line shows annual growth rates of GDP (by financial year) and the bottom shows PSBR forecasting errors as a per cent of money GDP. The chart suggests, at least since the early seventies, some correlation with the economic cycle.

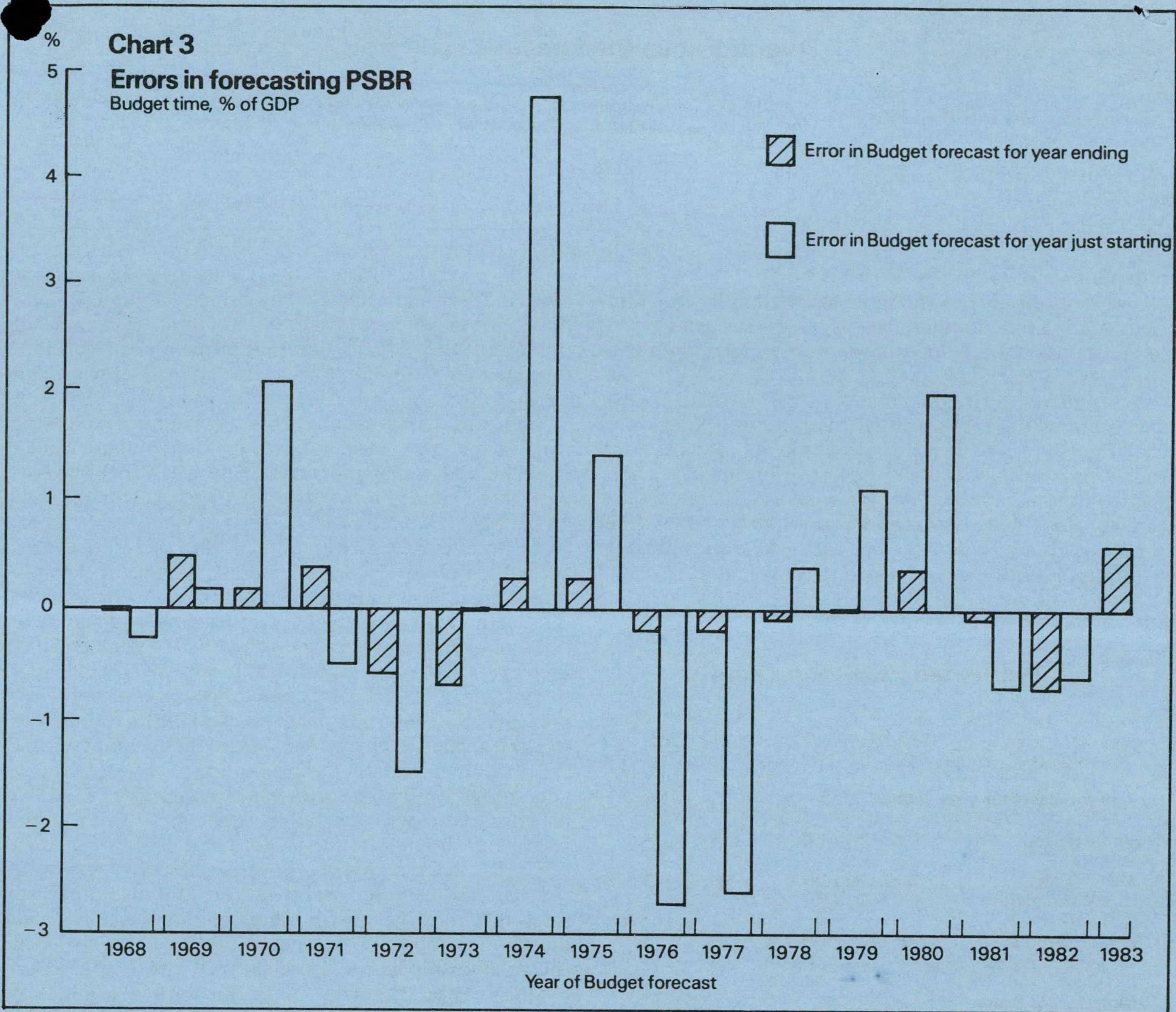
There is good reason to expect the PSBR to show a cyclical pattern. In an economic recovery, unemployment is typically falling, implying lower social security benefit expenditure, whilst employment and spending are rising, thereby increasing tax receipts. A lower PSBR is therefore natural in recovery and a higher one in recession. If the forecasting errors themselves show a cyclical nature, this suggests poor forecasts of GDP itself or else an inability to model precisely the relationship between GDP and the PSBR at different stages of the cycle. An example of the latter might be the different propensities of unemployed people to register for social security in upswings and downswings.

Some analysis has been carried out within the Treasury with a view to establishing whether either of these factors could help to explain the cyclical nature of PSBR forecasting errors. Errors in Budget-time forecasts for the year ahead were assumed to depend on growth rates of output, errors in unemployment and GDP forecasts, and a measure of the relative price of general government expenditure. Simple tests suggested that, since errors in forecasts of GDP and unemployment themselves did not appear to be significant factors in explaining PSBR forecast errors, then the major source of difficulty was the modelling of the influence of cyclical factors. This suggests, not unexpectedly, that the risks of getting the PSBR too high or too low depend in part on the state of the economy and on the prices of government consumption relative to prices in general (if the public sector raises wages relative to the private sector or if the public sector has to pay more, relative to the private sector, for the goods it buys, then the PSBR will tend to rise).

It can also be noted that the errors in Budget forecasts relating to the year just finishing tend to be in the same direction as those for the year ahead. Chart 3 shows that this relationship has held in all years but two. The reason for this may be that errors in the Budget-time estimate of the PSBR outturn in the year just finishing will carry through into the forthcoming year simply because the latter is heavily dependent on the former; many of the projections for income and expenditure items for the year ahead are based on estimates for the current year. Positive forecasting errors in the year just finishing tend to be associated with (larger) positive forecasting errors in the forthcoming financial year.

Chart 2
The economic cycle and PSBR forecasting errors





Conclusions

The main instruments of fiscal policy are normally set in the Budget, usually close to the start of the financial year. The fiscal system was not designed for tight control over all cash receipts or the total of cash spending; setting tax rates is not the same thing as determining tax revenues, and large parts of public expenditure are demand-determined. Decision-making requires the best possible forecasts of the PSBR and other fiscal measures, as well as an appreciation of the inevitable imprecision of such forecasts. Advances have nevertheless been made in recent years in the methods used in PSBR forecasting. The analysis of forecasts reported in this note has aimed to identify systematic errors. The main conclusions can be listed as follows:

(1) **Sign of forecasting errors.** On average, errors in one direction have tended to balance errors in the opposite direction. The forecasts have been, broadly, unbiased.

(2) **Size of forecasting errors.** Regardless of whether they are positive or negative, the errors in forecasts made at Budget time have averaged about 1½ per cent of GDP. This is the basis for the £4 billion average (absolute) error quoted in the Red Book this year.

(3) **Performance over time.** Extra resources have gone into data gathering, analysis and PSBR forecasting in recent years. The record suggests signs of improvement in both Budget-time and autumn forecasts over the last 8 to 10 years. If the average were based on the last five years only, the error quoted in (2) would fall to about £2½ billion.

(4) **Errors in the PSBR getting larger in cash terms.** In 1974-75, an error in the PSBR of 1½ per cent of GDP represented £1¼ billion, in 1983-84 about £4 billion.

(5) **Causes of errors.** For periods of six or twelve months ahead errors in the economic forecast (for example, of prices or output) have not generally been the principle cause of errors in the PSBR — even though these seem to be related to the state of the economic cycle. Identified errors have generally involved more detailed judgements about public sector accounts — the extent of cash underspending the take-up of social security benefits, payments of corporation tax and so on.

(6) **Improvements throughout the year.** In general, and not surprisingly, forecasts get more accurate as we go through the year, though there have been exceptions. Even at Budget time, near or after the end of the year, errors amount on average to about 1/3 per cent of GDP, equivalent to nearly £1 billion.

Monthly economic assessment

Based on statistics† published up to 7 September 1983.

- **Output in the second quarter was around two per cent higher than a year ago though little changed from its first quarter level.**
- **The recovery is being reflected in the labour market.**
- **Unit wage and salary costs in manufacturing show only a small rise.**
- **Non-oil import volumes have changed little in recent months following a significant rise at the beginning of the year. Non-oil export volumes have been erratic.**
- **Monetary growth eased in July and August, with private sector borrowing moderating.**

Financial developments

The large increases in **M1** and **sterling M3** in the banking month of June appear to have been erratic. In July M1 fell by 0.4 per cent, while sterling M3 increased by only 0.8 per cent, about the same as the private sector liquidity measure, **PSL2.** The provisional August figures confirmed this picture — M1 is estimated to have increased ¾-1 per cent, sterling M3 by only ¼ per cent, and PSL 2 by ¾ per cent. Annualised growth rates since the beginning of the financial year have therefore declined but remain above the Government's target range for the year as a whole, mainly reflecting the large public sector contribution early in the period. Sterling lending to the private sector increased only slightly in the banking month of July, unwinding the high increase in the month before. The public sector contribution to the growth of money was also small.

Domestic **financial markets** remained steady in August. The three-month interbank rate remained around 9¾ per cent, while the twelve-month rate declined by about ¼ per cent to 10½ per cent. Very long-term interest rates, measured by yields on conventional gilt-edged stock, came down by about the same amount.

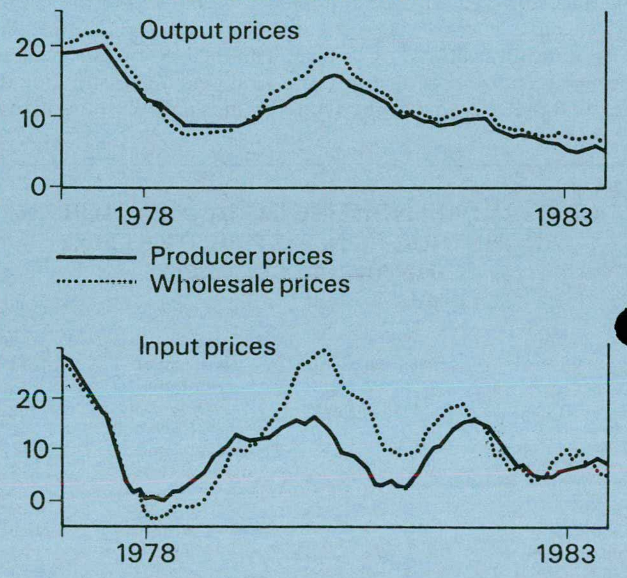
In the four months April to July 1983 the **central government borrowing requirement** totalled £6.4 billion*, compared with £3.8 billion* for the same period last year. Of this increase of £2.6 billion, lending by central government to local authorities and public corporations was £1.9 billion higher than in April-July 1982. The **public sector borrowing requirement** was £3.9 billion* in the second quarter of 1983. Seasonally adjusted it was £1.9 billion, but this figure also needs to be interpreted carefully given the large irregular items affecting the PSBR[1].

As in July, **sterling** traded mostly on the sidelines during August, generally easier against the strengthening dollar, but on balance little changed in effective terms after rising to a high point of 85.9 on 22 August, its highest level since 10 June. The **US dollar** continued to be the main focus of market attention throughout the month, rising to a 9½ year high against the Deutschemark on 11 August — some 8 per cent higher than year ago. This reflected continued market expectations of higher US interest rates, and the decision by the Bundesbank Council not to raise West German interest rates.

Producer prices

The **producer price index**, published for the first time in August, is the result of a number of changes made to the former wholesale price index. The new name reflects more precisely the index's purpose and conforms with established international practice. The index has been rebased onto 1980 = 100 and adopts the new 1980 version of the Standard Industrial Classification[2]. The main impact of reclassification on the price indices arises from the inclusion of mineral oil refining in a new grouping of energy industries and its consequent exclusion from the new definition of manufacturing. Hence petroleum products replace crude oil as a component of the **input index** and no longer feature in the output index. In addition petroleum products have a smaller weight in the input index and this has contributed to reducing the volatility of the data (as can be seen in chart 1 which compares the twelve-monthly changes of the new indices with their old wholesale price counterparts). The quality of the **output price** series may have improved since there was evidence that recorded wholesale price inflation had recently been overstating the increase in actual prices charged, as the petroleum product index is based on list rather than discount prices (the latter are not readily available). The exclusion of petroleum products from the output series dampens recorded inflation following the 1979 oil price rise.

Chart 1 Wholesale and producer prices
(12 monthly % changes)



In the twelve months to August producer output prices rose by 5.4 per cent* with input prices rising by 8.0 per cent*. The corresponding figures last August were 7.4 per cent* and 4.6 per cent* respectively.

Retail prices and labour costs

Retail prices rose by ½ per cent* between June and July, largely because of the higher mortgage rate announced in June and increases in petrol prices. As the index was broadly unchanged between the same two months last year the twelve-monthly increase rose from 3.7 per cent to 4.2 per cent. As the

[1] See the first article in this issue and the article on seasonal adjustment published in the *Economic Progress Report*, March 1983.
[2] Rebasing and reclassification is affecting a number of key economic statistics (see *Economic Trends*, March 1983) and it is hoped that a brief explanation and analysis will be given in next month's *Economic Progress Report*.

†Figures are seasonally adjusted unless marked *

A

Table

INTERNATIONAL COMPARISONS OF PROFITABILITY 1955—1981

*Pre-tax rate of return to fixed capital** *per cent*

	Non-financial corporations				Manufacturing industry			
	UK	US	Japan	France	UK	US	Canada	West Germany
Averages for years†								
1955-58	13	17	na	na	17	27	23	39
1959-62	12	17	na	11	16	26	19	31
1963-67	11	22	na	12	14	34	18	22
1968-71	9	17	na	14	11	24	15	23
1972-75	6	14	18	13	8	20	17	17
1976-80	6	14	15	9	6	18	14	16
Years								
1980	5	12	15	8	4	12	15	14
1981	5	13	14	7	2	12	14	na

*Net of stock appreciation and capital consumption.
†Apart from the first, which is governed by availability of data, the groupings of the years are related to the cycles in UK rates of return. Figures for other countries for the same years may cover more or less than a complete cycle and in this sense can only provide a broad comparison with the UK.
Note: For further details, see *British Business*, 19 August 1983, pp 22-23.

index remained flat until September last year the twelve-monthly inflation rate is likely to rise further.

The underlying twelve-monthly increase in whole economy **average earnings** was 7 per cent in June. Although well ahead of price inflation, earnings are now rising at a consistently lower rate than at any time since 1967. **Manufacturers' unit wage and salary costs** have risen much less — about 2½ per cent in the year to the second quarter of 1983 — reflecting above average productivity growth of 5½ per cent (see chart 2). This is the lowest increase for over 16 years and would be even smaller if changes in labour taxes (including the recent cuts in the national insurance surcharge) were incorporated in these statistics.[3]

Company profitability

Recently published international comparisons show that pre-tax real **rates of return** on fixed capital (net of stock appreciation and capital consumption) have generally been on a long-term downward trend in the major industrialised countries (see table 1). In recent years it would appear that Japan and the United States have had the highest rates of return for non-financial corporations, followed by France, with the UK lowest. In manufacturing, rates of return in the UK appear to be substantially below those in Canada, the United States and West Germany.[4]

Table 2

CAPITAL EXPENDITURE IN MANUFACTURING, CONSTRUCTION, DISTRIBUTION AND FINANCIAL SECTORS

£ billion, 1980 prices, seasonally adjusted

	Manufacturing* (including leased assets)	Construction, distribition and financial sectors (excluding assets leased to manufacturers)	Total
1979	8.2	8.7	16.8
1980	7.3	8.5	15.8
1981	5.8	8.5	14.2
1982	5.5	9.4	14.8
1982 H1	2.8	4.6	7.3
H2	2.7	4.8	7.5
1983 H1	2.5	4.9	7.4

*Revised definition.

No manufacturing net rate of return is available for Japan but their gross rates are considerably higher than those of other countries despite being much lower since 1975 than before. However, comparisons of levels between countries must be treated with considerable caution given the problems in measuring and comparing capital stock. Moreover, these figures are based on average rates of return on existing capital and may be a misleading guide to prospective rates on new investment.

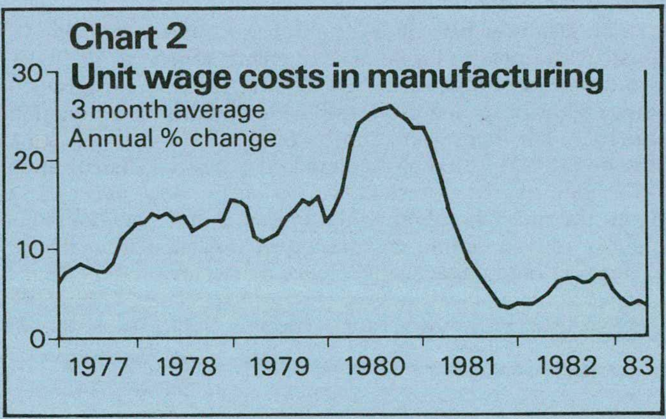
Demand

Real **domestic demand** in the first quarter of 1983 was nearly 4 per cent higher than a year earlier, with the turnround in stock-building contributing to the particularly fast growth in that quarter. Export demand has been much weaker so that **total demand** rose by less — 3 per cent — over the same period. **Consumer spending** has been notably strong and is estimated to have risen 4½ per cent in the year to the second quarter. Retail sales in July were similar to their second quarter average and in the May-July period were some 6 per cent higher than a year earlier. New car registrations have been particularly buoyant and in August may have been 15-20 per cent* higher than last year's record level.

Information about other components of domestic demand in the second quarter is limited. **Fixed investment** for manufacturing, construction, distribution and financial sectors — accounting for about 40 per cent of economy-wide investment — was virtually unchanged between the first and second quarters and was at much the same levels as a year ago (see table 2). Manufacturing investment rose in the second quarter and investment intentions surveys suggest it may continue to increase slowly this year. Overall **stocks** held by manufacturers and distributors changed little in the first half of 1983, after being run down in the previous six months (see table 3).

Trade and balance of payments

The **current account** surplus in 1982 has been revised upwards from £4 billion to £5½ billion, some £2½ billion arising in the last quarter. In the first half of this year the current account was around £½ billion in surplus. **Non-oil imports** rose significantly at the beginning of 1983 but now appear to have flattened out at



[3] In November 1982 the Government announced that for 1983-84 the NIS rate would be cut to 1½ per cent. Special arrangements were made to enable half of the cut to be brought forward into 1982-83. In this year's Budget it was announced that the rate would be reduced again — to 1 per cent from August 1983.

[4] Although based on different definitions, more recent information for the UK suggests that manufacturing rates of return have improved in 1982 (to 3¼ per cent from 2¼ per cent in 1981 — see *Bank of England Quarterly Bulletin*, June 1983, pp 232-239).

YC

(B)

FROM: DAVID OWEN

DATE: 7 MARCH 1984

MR EVANS

cc Mr Shields
Mr Horton

BUDGET PRESENTATION : CORPORATE SECTOR

You asked me to update the profitability figures from the September 1983 EPR (Table attached). These figures were taken from British Business 19 August 1983 and are based on OECD calculations together with Department of Commerce information for the US. The calcualtions are based, as far as possible, on a standard definition, using national accounts information submitted in a standardised form to OECD and the UN. Unfortunately the OECD calculations for 1982 will not be available until June. Moira O'Connor (DTI) felt that, in the absence of these figures, it would not be practicable to update the table using the non-standard information available from individual country sources - at least not in time for the Budget.

2. However I have, with Mr Horton's help, attempted to use these sources to get estimates for the US and UK - these are attached. There seem to be insufficient data available from other countries even to attempt estimates. The methods I have used are very crude, and I would not have thought the figures should be quoted though they probably reflect the trends accurately. For the US I have taken figures for corporate profits (net of stock appreciation and capital consumption) as a proportion of gross domestic project of non-financial corporate business - these are available up to 1983(3) - and assumed that profitability has changed by the same proportion since 1981. This involves the assumption that the capital output ratio has remained constant over this period. For the UK I have taken published estimates of net pre tax rate of return for 1982. These are not on the same basis as the EPR figures so once again I have taken the 1981 EPR figure as a base and rescaled the 1982 figures appropriately. The 1983 figure for non-financial companies is based on our forecast for all ICCS.

David Owen

DAVID OWEN
EA1

International Comparisons of Profitability

(update of Table from September 1983 EPR)

Pre tax net rate of return to fixed capital

Years		Non Financial Corporations UK	Non Financial Corporations US	Manufacturing UK	
1976-80	published data	6	14	6	
1980		5	12	4	
1981		5	13	2	(4)+
1982	Estimates not published	6	11	4	
1983		7*	15**		

* Based on Treasury forecast for All ICCs.

** Estimate based on first 3 quarters.

\+ Revised figure based on revisions to published official series since September 1982. No estimates for 1983 available

NF A66

Ch/Ex Ref No B.(84)619

FROM: MISS M O'MARA
DATE: 12 MARCH 1984

PS/Economic Secretary

cc PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Battishill
Mr Evans
Mr Lankester
Mr Odling-Smee
Mr Sedgwick
Mrs Lomax
Mr Riley
Mr Mowl
Mr Ridley

THE BUDGET AND FINANCIAL FLOWS

The Chancellor has seen Mr Cassell's minutes of 9 March. He has enquired how the nationalised industries are affected by the CT package and has asked whether their EFLs should be adjusted. He would like urgent analysis and advice on this point.

MOM

MISS M O'MARA

NF A66

FROM: T U BURGNER
12 March 1984

CHANCELLOR

cc: Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir Peter Middleton
Sir Terence Burns
Mr Cassell
Mr Monck
Mr Battishill
Mr HP Evans
Mr Lankester
Mr Odling-Smee
Mr Sedgwick
Mrs Lomax
Mr Riley
Mr Mowl
Mr Ridley

THE BUDGET & FINANCIAL FLOWS

You have asked (Miss O'Mara's minute of today) how the nationalised industries are affected by the CT package and whether their EFLs should be adjusted.

2. We do not think that there is any need to adjust NI EFLs on this account. The only element in the CT package which will affect NI cash flows in 1984-85 is the reduction in the rate from 52 to 50 per cent. The effect is very small. Most of the industries will not pay tax at all. For those that do the tax bill is in aggregate expected to be below £200 million. So there is less than £8 million involved in total in 1984-85.

3. The other elements in the CT package - the further reduction from 50 to 45 per cent, the change to tax allowances, and the abolition of stock relief - will not affect cash flows before 1985-86. The effect will show up in the 1984 IFR and will be taken into account in setting EFLs for 1985-86 in the autumn.

TB

T U BURGNER

401/3

(F)

Sir PM - to see
D Brand 12/3

FROM: T U BURGNER
12 March 1984

CHANCELLOR

cc: Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir Peter Middleton
Sir Terence Burns
Mr Cassell
Mr Monck
Mr Battishill
Mr HP Evans
Mr Lankester
Mr Odling-Smee
Mr Sedgwick
Mrs Lomax
Mr Riley
Mr Mowl
Mr Ridley

THE BUDGET & FINANCIAL FLOWS

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TB

T U BURGNER

13 MAR 1984

CONFIDENTIAL (P)

Sir PM - to see
D Howard 13/3

FRom: C H SMEE
Dare: 12 March 1984

MISS SIMPSON

cc PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Battishill
Mr Evans
Mr Odling-Smee
Mr Folger
Mr Allen
Mr Smith
Mr Norgrove
Mr Ridley
Mr Lord
Mr Portillo
Mr Byatt
Mr Monck
Mr Monger
Mr Hall

PRESENTATION OF THE BUDGET: CORPORATE SECTOR

The Chancellor asked that useful figures should be extracted and circulated to substantiate the points in para 4 of the note on the importance of investment productivity, which was attached to Sir T Burns' minute of 9 March.

2. The relevant tables are attached:-

Table 1 shows that in 1980 in manufacturing the net capital stock per worker was higher in UK than in Germany, France or USA - looking at the economy as a whole capital stock per worker is larger in UK than in France and USA, but not Germany (the source for the figures used for this table and the other tables is OECD).

Table 2 shows ICORs and ICORs adjusted for changes in employment. The figures (which have been revised and differ from those circulated under cover of Mr Monck's minute of 2 March) show that over the period 1973-79 UK performed worse than Germany and France on all measures. If the labour adjustment is made UK does somewhat better than USA (but not if the straight ICOR is used). Canada seems to perform better than UK in manufacturing but not for the economy as a whole. (A high ICOR shows that a lot of capital is associated with the change in output; conversely a low ICOR means that extra output can be achieved with relatively little increase in capital; a negative ICOR means that output has fallen even though capital has increased.)

CONFIDENTIAL

Table 3 shows that output per unit of capital stock is, for manufacturing, low in UK as compared to Germany, France or USA. If figures for the whole economy are taken UK seems to be on a par with Germany, but to be inferior to both USA and France.

C H Smee

TABLE 1

NET CAPITAL STOCK PER WORKER* 1980

	Whole economy	Manufacturing
UK	100	100
Germany	120	60
France	50	80
USA	80	80

*Converted to $ at OECD PPP rates

TABLE 2

ICORs, 1973-79 (wrong, see minute of 13/3, from Hartley below)

	Whole economy		Manufacturing	
	ICOR	ICOR(L)	ICOR	ICOR(L)
UK	5.6	6.1	negative	16.6
Germany	3.1	2.8	0.2	0.1
France	1.5	1.6	1.0	0.9
USA	1.7	negative	1.5	negative
Canada	1.9	negative	1.9	2.6

TABLE 3

OUTPUT PER UNIT OF CAPITAL* 1980

	Whole economy	Manufacturing
UK	100	100
USA	170	270
Germany	110	250
France	260	230

*converted to $ at OECD PPP rates

13 MAR 1984

CNOFIDENTIAL

From: N J HARTLEY
Date: 13 March 1984

P

MISS SIMPSON

cc PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State
PS/Economic Secretary
~~Sir~~ P Middleton
Sir T Burns
Mr Cassell
Mr Byatt
Mr Monck
Mr Battishill
Mr Monger
Mr Evans
Mr Odling- Smee
Mr Hall
Mr Folger
Mr Smee
Mr Allen
Mr Smith
Mr Norgrove
Mr Ridley
Mr Lord
Mr Portillo

PRESENTATION OF THE BUDGET: CORPORATE SECTOR

I am afraid there was a mistake in the table of ICORs circulated under cover of Mr Smee's minute of 12 March. The ICOR(L)s for USA and Canada should not have been shown as negative. The UK is now shown to perform worse than the other countries on all measures. The correct table is:-

ICORSs, 1973-79

	Whole economy		Manufacturing	
	ICOR	ICOR(L)	ICOR	ICOR(L)
UK	5.6	6.1	negative	16.6
Germany	3.1	2.8	0.2	0.1
France	1.5	1.6	1.0	0.9
USA	1.7	4.2	1.5	2.1
Canada	1.9	8.4	1.9	2.6

N J Hartley

N J Hartley

fle

MINISTER OF STATE TREASURY

FROM: APS/Minister of State
DATE: 12 March 1984

PS/CHANCELLOR OF THE EXCHEQUER

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Sir Peter Middleton
Mr Monger
Mr Griffiths
PS/Customs & Excise
Mr Knox - C&E

PRESENTATION OF THE BUDGET MEASURES TO THE EC COMMISSION

The Minister of State has seen Mr Griffiths' minute of 7 March and has commented that the attached draft minute to the Foreign Secretary seems fine.

Debbie McCambridge

MISS D C McCAMBRIDGE

BUDGET SECRET

12 MAR 1984

CH/EX REF NO BC84/G22.

FROM: MISS M O'MARA

DATE: 12 March 1984

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Minister of State
PS/Economic Secretary
Sir P Middleton
Mr Bailey
Mr Cassell
Mr Monck
Mr Battishill
Mr Lovell
Mr Monger
Mr R I G Allen
Mr Lord

PS/IR
Mr Beighton - IR

Mr Graham - Parly Counsel

SHIPPING: MR RIDLEY'S LETTER OF 7 MARCH

The Chancellor has seen the Financial Secretary's suggestion that he might write to Mr Ridley (your minute of 9 March). He agrees and would be grateful if the Inland Revenue could submit a draft which he might send after the Budget.

Mary

MISS M O'MARA

21

12 MAR 1984

CONFIDENTIAL

Sir T M - to see
D Broad 12/3
Pre-budget

FROM: MISS J C SIMPSON
DATE: 12 March 1984

SIR T BURNS

cc PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State
PS/Economic Secretary
Sir P Middleton
Mr Cassell
Mr Battishill
Mr Evans
Mr Odling-Smee
Mr Folger
Mr Allen
Mr Smee
Mr Smith
Mr Norgrove
Mr Ridley
Mr Lord
Mr Portillo

PRESENTATION OF THE BUDGET: CORPORATE SECTOR

The Chancellor has seen and was grateful for the two notes attached to your minute of 9 March. He has asked that useful figures should be extracted and circulated to substantiate the points in paragraph 4 of the note on the importance of investment productivity: ie that the UK has a high capital stock per worker, and that the incremental output associated with new investment and the output per unit of capital are very low compared to those in other western countries.

JS

MISS J C SIMPSON

FROM: T U BURGNER
12 March 1984

1 FINANCIAL SECRETARY

2 CHANCELLOR

cc: Chief Secretary
Economic Secretary
Minister of State
Sir Peter Middleton
Mr Bailey
Mr Monck
Mr Lovell
Mr Grimstone
Mr Robson
Mr RH Wilson
Mr Palmer
Mr Halligan
Mr Portillo

TIMETABLE FOR GOVERNMENT SALES IN 1984

Mr Tebbit's recent letter about Jaguar privatisation proposes that since 1 May is now no longer possible for flotation, 24 July should be assumed for planning purposes. You (Financial Secretary) have questioned whether we are happy with this in view of the proximity to a BT flotation (assumed to be late October or November).

2. On the face of it since DTI are responsible for both BT and Jaguar, this is a problem for them. However it seems that Mr Tebbit's letter reflects the views only of officials involved in the Jaguar privatisation and is not necessarily a coordinated DTI view. Officials concerned with BT are expressing anxiety, although whether this will lead to a further letter from Mr Tebbit is not clear.

3. On the basis that a sale of Jaguar goes ahead, sales planned for 1984-85 currently stand as follows:

		£m	
around 9 April	ABP	50	(secondary sale)
11-29 June	Enterprise Oil	250 ?	(value uncertain)
24 July	Jaguar	200	
October/November	Telecom	4,000	(£1,500m on first call)
20 November	Unipart	100	(method of sale & timing under discussion with DTI)
Early 1985	BA	1,000	(only £500m on first call)
date uncertain	BAe	90	(under discussion with DTI)

If all these sales took place the total of asset sales would be nearer £2¼bn than the £2bn in the recent White Paper. That is not a reason for going slow, but it shows that there is flexibility in the programme within existing public expenditure targets.

4. It is probably unnecessary to consider BAe and Unipart further at this stage. This programme could not comfortably accommodate sales of BAe shares until after British Telecom i.e. until early 1985. In the meantime the desirability of a sale of shares in the near future is disputed by DTI. In the case of Unipart, the provisional date held by the Bank has not been agreed with us and we would regard a public share offer so close to BT as undesirable. In practice Unipart may well be a trade sale, so that different considerations would apply. Again this is all for further discussion with DTI.

5. The key pre-BT sales are therefore ABP, Enterprise Oil and Jaguar. Of these, Enterprise Oil and Jaguar have both slipped, the former from April to second half June, the latter from May to second half July. So although the quantity of possible sales has not changed, the timing profile has moved closer to BT.

6. One further general question affecting Enterprise Oil and possibly Jaguar is the applicability in the UK of certain EC Directives concerning Stock Exchange listing. The question is currently receiving urgent consideration: the Attorney General has written to Mr Tebbit. The timing of Enterprise Oil and subsequent privatisations could be affected. Specific advice will be offered once the position is clarified. For the present it is sensible to assume that the programme remains in place.

7. Kleinwort, Benson have expressed considerable concern at the insertion of the Jaguar sale between Enterprise Oil and BT. Their main argument is that the market is not at present expecting a sale of Jaguar between Enterprise Oil and BT and that this succession of sales by the Government may have detrimental consequences for the reception of BT. Kleinworts' argument is not about market capacity

(on which see paragraph 8(i) below) but about market psychology. Given that there has been consistent Press publicity about Jaguar being sold in Spring/summer and a recent statement by Mr Tebbit in Parliament that a decision on Jaguar privatisation would be announced as soon as possible, Kleinworts' reaction is surprising. We think it possible that in conducting discussions with financial institutions in recent months Kleinworts may have been somewhat too categorical about the Government programme in the months before BT and they are worried about the damage to their credibility. Nevertheless their worries cannot be ignored.

8. The Bank are also concerned about the programme but on rather different grounds. Their main worry is that in committing itself to a sale of BT in one go, Kleinworts are straining the capacity of the market and risk achieving an unacceptably low price for HMG. There are some very real worries here which we are probing with Kleinworts and we will be advising Ministers at a later stage. But in terms of the sales other than BT the Bank's arguments are 3-fold:

(i) Market capacity: in addition to BT there is now a very full corporate queue, already totalling £1.5bn between now and the end of 1984. The chances are that the total of non-BT issues will be equal to the high figures reached last year.

It is difficult to attach much importance to the Bank's arguments about capacity when a decision e.g. to hold back the sale of Jaguar would lead the Bank to fill the gap with more private sector issues. The Bank's worries about capacity are probably a reflection of their more general worries about BT.

(ii) Repercussions: the Bank argue that failure in any of the preceding sales (ABP, Enterprise Oil or Jaguar) will have an adverse effect on BT, whereas success would not produce similar benefits.

We accept that there is something in this argument - the market's reaction to success and failure appears to be asymmetrical - but it is a matter of judgment how far the ABP, Enterprise Oil, Jaguar and BT sales (all very different businesses) will affect each other. And some risks of this kind must be taken unless we are to stop all sales until we have sold BT.

(iii) Distraction: the Bank believe that it is important during the run-up to the BT sale, when there will be a growing volume of synchronised and random publicity, that the market should not be distracted by other Government sales. Kleinworts would undoubtedly support this view.

Again one would not wish to discount it entirely, but it is difficult to believe that the various publicity and funding weapons that will be used to promote BT will not keep the BT sale near the centre of the market's attention.

9. In sum, therefore, the Government's two principal advisers are concerned about the weight of the privatisation programme pre-BT, and in particular about Jaguar, although neither regards this as more than a contributory factor to the intrinsic difficulty of selling sufficient BT shares. There appear to be two main options for the Government: either to decide now not to go ahead with one or more pre-BT sales; or to continue planning on the assumption that all sales will take place but to be prepared to pull a sale subsequently if there appears a real danger of prejudicing BT. Unforeseen events may in any case conspire to prevent one or other sale taking place:

- ABP - The Department are working hard for a sale in early April although the fallback of sale in early May remains for the time being. The Bank suggest postponing this sale, because ABP is already privatised and because the market is not expecting it. But it is difficult to believe that a sale as small as £50m in April can have any real effect on BT in the autumn.

- Enterprise Oil - The main risks to the Enterprise Oil sale at present are the EC Directives (referred to above) and the threat of excess world oil supplies in the summer which could weaken oil shares. Postponement until 1985 would not be straightforward. Enterprise Oil will want to expand and diversify in ways that would be difficult while it was in the public sector; and the management team might well become restless.

- Jaguar - Postponement would probably mean a lengthy delay in order to avoid a share sale coinciding with the launch of a new model. Again the EC Directive may cause a postponement, but the dangers are less than for Enterprise Oil.

Conclusion

10. The programme of sales in the first half of 1984-85 is heavy and both Kleinworts and the Bank are concerned about the impact on BT. The main problems about selling BT are intrinsic to the decision to sell 50 per cent of the equity in one go; but a heavy Government programme of sales up to the summer period may add somewhat to the difficulties.

11. It is a matter of judgment whether deliberate action should be taken to thin out the programme. If something were to go, it should either be Enterprise Oil or Jaguar. My own view shared by most of PE is that it would be premature to do so. In addition we ought to be clear that Unipart (unless a trade sale) should not take place before or immediately around the Telecom sale; and any further sale of BAe shares should not be before early 1985.

12. Mr Wilson, however, is concerned at the risks for the sale of BT and BA. Both are likely to be unprecedently large by past standards. BT is the big problem but if it is not successfully overcome this could prejudice the prospects for BA. The sale of BT will require the investing institutions to adjust their portfolios in one go to accommodate a significant new weight in the share index. They will regard this as a major challenge. Their willingness to rise to it could be seriously impaired if any view gained currency, rightly or wrongly, that the Government was overburdening the market

with its total programme of sales. For these reasons Mr Wilson would prefer to see a measure of deliberate caution about Government sales in the mid-summer period.

13. If however you accept my advice (i.e. to continue to plan to sell ABP, Enterprise Oil and Jaguar in advance of BT) you will want to review the position from time to time, and certainly after each sale has taken place. IA are putting up separate advice on Mr Tebbit's letter concerning Jaguar.

TB

T U BURGNER

12 MAR 1984

Ch/Ex Ref No B.(84)619

FROM: MISS M O'MARA
DATE: 12 MARCH 1984

PS/Economic Secretary

cc PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Battishill
Mr Evans
Mr Lankester
Mr Odling-Smee
Mr Sedgwick
Mrs Lomax
Mr Riley
Mr Mowl
Mr Ridley

THE BUDGET AND FINANCIAL FLOWS

The Chancellor has seen Mr Cassell's minutes of 9 March. He has enquired how the nationalised industries are affected by the CT package and has asked whether their EFLs should be adjusted. He would like urgent analysis and advice on this point.

MOM

MISS M O'MARA