PREM 19/2942

H.T.

SECRET

Part 19

Confidential filing

The 1990 Budget.

ECONOMIC POLICY.

Part 1: May 1979.

Part 19: Dec 1989.

Attachment folder.
Supply Estimates 1990-91
Financial Statement and Budget Report 90-91
January Forecast 1990. Pre notices

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
11-12-89							
~~22.12.89~~							
~~16.2.90.~~							
~~21.2.90~~							
~~27.2.90.~~							
~~7.3.90~~							
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17.5.90.							
PMRT							
CLOSED.							

PREM 19/2942

PART 19 ends:-

BP to HMT 17.5.90

PART 20 begins:-

SS/DT/ to Ch Exch 6.12.90.

Published Papers

The following published paper(s) enclosed on this file have been removed and destroyed. Copies may be found elsewhere in The National Archives.

1. Cm 980: Supply Estimates 1990-91 for the year ending 31 March 1991 – Summary and Guide
   HMSO, March 1990 [ISBN 0 10 109802 2]

2. House of Commons Paper No. 286: Financial Statement and Budget Report 1990-91
   HMSO, 20 March 1990 [ISBN 0 10 228690 6]

Signed Wayland Date 13 October 2016

PREM Records Team

FILE

VLS

C:/updates/economic/VAT.VLS
(Deb 5/5)

RESTRICTED

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

17 May 1990

VAT Registration Threshold

The Prime Minister was grateful for the Chancellor's minute of 15 May covering a note by Customs and Excise on the VAT registration threshold.

The Prime Minister is content that the Chancellor should pursue a further initiative to remove EC obstacles to setting a higher VAT threshold.

(BARRY H. POTTER)

John Gieve, Esq.,
H.M. Treasury.

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chex.ps/tt2/23 **RESTRICTED**

Prime Minister

The Chancellor proposes a further initiative to remove EC obstacles to setting a higher VAT threshold.

Content to proceed as he suggests?

TPP 16/5

Treasury Chambers, Parliament Street, SW1P 3AG
071-270 3000

PRIME MINISTER

VAT REGISTRATION THRESHOLD

At my party at No.11 on Budget evening you asked the Chairman of Customs & Excise, Brian Unwin, whether we could make a substantial further increase in the VAT registration threshold. Although he explained the constraints, he undertook to have another look at this.

2. The attached note by Customs summarises the current position and recommends a further political initiative on the threshold. I fear that it looks as if the prospect of agreement on flexibility to fix a higher threshold is pretty remote. But if we could achieve it, it would have considerable advantages. Not only would it enable us to increase our own threshold in real terms, with benefits both for small businesses and our own costs of administering VAT; but it would also end the threat of infraction proceedings that were initiated back in 1984 against our current threshold - a course which the Commission are currently showing renewed interest in pursuing.

3. I therefore agree that we should consider a new political initiative. Since our immediate priority must be to concentrate on settling the technical arrangements for the post 1992 VAT regime, I also agree that, on the question of timing, it would be better to pursue the matter later this year during the Italian Presidency. If you are content, I will consider the best options for an initiative.

4. Finally, I should add briefly that the technical proposals for the VAT and trade statistics regime for the post 1992 period presented by the Commission last week are generally very acceptable to us. Although there is an unwelcome proposal to change to an 'origin' system of collection in 1997 - which we shall seek to modify in negotiation - the proposed arrangements are very much on the lines we have been consistently advocating and should mean much less burden and bureaucracy for businesses.

John M.

[J.M.]
15 May 1990

VAT REGISTRATION THRESHOLD

Note by HM CUSTOMS AND EXCISE

Background

A VAT registration threshold has operated since 1973; its purpose was to limit the administrative costs for both traders and Customs. When the VAT 6th Directive was adopted in 1977, Article 24 permitted Member States whose threshold exceeded 5,000 ECUs to increase it only to maintain its value in real terms. This facility has been exploited in successive Budgets but the Commission have challenged our method of indexation and in 1984 issued a warning letter under Article 169 of the Treaty as the first step in infraction proceedings.

2. The basis of the Commission's claim is that indexation should be based on the threshold in force on the date of the Directive's adoption (17.5.77), whereas we have used the date of the introduction of the tax in the UK (1.4.73). We are thus already under threat of proceedings for our current threshold, and it follows that any increase beyond the annual budget revalorisation would be regarded as a clear breach of our Treaty obligations. Indeed, the Commission have already made warning noises about the simplifications in this year's Budget and we understand their lawyers are again looking at the possibility of pursuing infraction proceedings.

The Draft Small and Medium-Sized Enterprises Directive (SMED)

3. It is the existence of this draft directive that has probably caused the Commission to stay their hand so far. Following the Prime Minister's initiative in 1985 it was submitted to the Council in September 1986; it incorporates a minimum threshold of 10,000 ECUs with an optional higher threshold of 35,000 ECUs. Although it has been discussed several times at official level in Brussels, it has not been on the agenda since December 1988 and has remained dormant since then. It has singularly failed to attract the support of other Member States, all of whom except the UK and Ireland regard the optional higher threshold as too high.

4. We had hoped that the Irish might provide new impetus during their current Presidency but, despite pressure at official level, they have no plans to discuss SMED. They believe there is little prospect of agreement; and indeed the Brussels timetable is so heavily committed to Single Market issues that it is unlikely in any case that SMED would command any priority.

The UK threshold and 35,000 ECUs

5. Last year's threshold of £23,600 moved within and outside the 35,000 ECUs limit during the course of the year so we can expect the 1990-91 revalorised limit of £25,400, although currently (in our view) within, to be more vulnerable if and when the exchange rate improves. As and when discussions begin again in Brussels we shall, of course, argue strongly for revalorisation of the 35,000 ECUs proposal which is now out of date.

The way forward

6. We shall, as a matter of course, maintain strong pressure in Brussels and seek any opportunity of either reviving interest in the SMED itself or of using the forthcoming Commission VAT Single Market proposals as a vehicle for re-opening discussion on VAT

thresholds and small business measures generally. The Single Market proposals have now been unveiled and generally follow the line we have been advocating on the need to reduce burdens on business. The Commission has proposed high thresholds in at least two areas (statistics and mail order) and we should be able to build on this foundation. This suggests that the best routine way forward is to use our present (relatively high by Community standards) threshold to demonstrate our commitment in the Single Market to the least burdensome and bureaucratic system, and to show our partners that this system works perfectly well.

7. The question is, however, whether we can accelerate or short circuit this by a high level intervention either by the Chancellor (eg at ECOFIN) or by the Prime Minister. Although there is always a danger of it being used as a trade off against other negotiating points, a substantial further increase in the SMED threshold would provide the flexibility we currently lack in fixing the UK limit and would bring the infraction proceedings to an end. At official level it is doubtful whether we shall make any progress - at any rate for a long time to come - by continuing on the present path.

8. The timing of a political initiative is critical. For the reasons referred to above, progress is unlikely under the Irish Presidency and in any case our first priority must be to concentrate on settling the technical details of the new Single Market VAT and trade statistics systems. This suggests that, subject to developments, it would be best for the issue to be raised by the Chancellor or the Prime Minister during the Italian Presidency towards the end of the year.

14 May 1990

Andrew Turnbull
No 10.

Mr Owen

FOOTBALL: REDUCTION IN POOL BETTING DUTY

Lord Aberdare, Chairman of the Football Trust, is to write today to Football Club Chairmen and Trustees about the creation of a single Trust. I enclose drafts of his letter and the Trust's press release.

PAL

P A LEE

23 March 1990

cc Mr McDonald
Mr Turney) HO
Mr Bolton)
Mr Mortimer) Tsy
Mr Walker)
Mr Gaw - C & E
Mr McPherson - SO
Mr Baden
Mr Newsom

Prime Minister
To note that the Football Trust and its subsidiary the Football Ground Improvement Trust are being merged into a single body the Football Trust (1990). The football authorities think it better to create a unified body to handle both the Spot the Ball money and money diverted from the pool betting duty.

AT
23/3

FROM THE CHAIRMAN 23 March 1990

To the Chairmen of all clubs in the Football League, the Scottish Football League and the Irish Football League

I am writing to let you know that following the final report of Lord Justice Taylor some important changes are being made to our Trust arrangements.

For some time it has been apparent that the division in responsibilities between the Football Trust and the Football Grounds Improvement Trust has been the cause of some confusion within the game and outside it. This question has been given added point by the Taylor recommendations and by the Chancellor's welcome decision to reduce pool betting duty and to make the £100 million thus raised over the next five years available to the Football Trust. The implementation of the Taylor Report will require a unified coherent approach, not only because the Government is requiring that the contribution it is making should be channelled through the Football Trust, but also because Taylor's proposals for ground improvements and crowd control measures need to be seen in a single overall context, as will the relationship with the Football Licensing Authority, once that has been established.

Accordingly responsibility for helping clubs implement the Taylor report will be undertaken by a single trust. This will be The Football Trust (1990), which will have the same responsibilities as the existing Football Trust and FGIT. Its membership will be drawn from the same organisations which nominate trustees currently: the Football League, the Football Association, the Scottish Football League and the Scottish Football Association, the Professional Footballer's Association, the local authority associations, the chief police officers, and the pools. The only change is that the Football League is to nominate a third trustee: Tom Wharton will be the first such appointment and become a deputy chairman - he will chair an important new committee which will be responsible for grant aid policies in relation to the Taylor report and professional football.

Continued.../2

You will appreciate that it is too early yet to have determined our grant aid policies for the period ahead, but we have already made clear our intention that professional football should continue to expect to receive around 75 per cent of the funds that are made available through the Spotting-the-Ball competition organised by Littlewoods, Vernons and Zetters: on current forecasts that is worth something in excess of £7.5 million per annum. The money generated by the reduction in pool betting duty will be added to the total.

We believe that in future you will find it easier to deal with a single trust. On ground safety and improvement measures we shall continue to employ the services of consulting surveyors, Corderoy and Co. We shall of course do our best to be as helpful as possible, but I am sure you will understand that until we have had the chance fully to assess the implications of the Taylor Report for the Trust, it will be a little while before we inform you of any changes in our grant policy. Needless to say, all existing commitments entered into by either trust will be honoured.

I hope you find this letter helpful. If you would like further information, please come back to us.

Yours sincerely,

FROM THE CHAIRMAN

To All Trustees

23 March 1990

I am writing to let you know that following the final report of Lord Justice Taylor some important changes are being made to our Trust arrangements.

For some time it has been apparent that the division in responsibilities between the Football Trust and the Football Grounds Improvement Trust has been the cause of some confusion within the game and outside it, especially in government and political circles. This question has been given added point by the Taylor recommendations, and by the Chancellor's welcome decision to reduce pool betting duty and to make the £100 million thus raised over the next five years available to the Football Trust.

The implementation of the Taylor Report will require a unified coherent approach, not only because the Government is requiring that the contribution it is making should be channelled through the Football Trust, but also because Taylor's proposals for ground improvements and crowd control measures need to be seen in a single overall context, as will the relationship with the Football Licensing Authority, once that has been established.

Accordingly responsibility for helping clubs implement the Taylor report will be undertaken by a single trust. This will be The Football Trust (1990), which will have the same responsibilities as the existing Football Trust and FGIT. Its membership will be drawn from the same organisations which nominate trustees currently: the Football League, the Football Association, the Scottish Football League and the Scottish Football Association, the Professional Footballer's Association, the local authority associations, the chief police officers, and the pools. The only change is that the Football League is to nominate a third trustee: Tom Wharton will be the first such appointment and become a deputy chairman - he will chair an important new committee which will be responsible for grant aid policies in relation to the Taylor report and professional football. I shall chair a committee which will look after the needs of grassroots and community football and the semi- and non-professional clubs.

Continued.../2

We shall decide the membership of each committee in the weeks to come, and the Deputy Chairmen - Richard Faulkner and Tom Wharton - and I will be giving considerable thought to the sort of grant aid policies we should follow in the period ahead. We are making clear our intention that professional football should continue to receive around 75 per cent of the funds that are made available from Spotting-the-Ball: on current forecasts that is worth something in excess of £7.5 million per annum. The money generated by the reduction in pool betting duty will be added to the total.

I shall be writing to clubs in the Football League, and the Scottish and Irish leagues to tell them of these arrangements. On ground safety and improvement measures we intend to continue to employ the services of consulting surveyors, Corderoy and Co. We shall be strengthening the administration of the Trust to take account of our important new responsibilities, and I shall be in touch with you again about this in due course.

It will of course be necessary to complete a number of formalities before these new arrangements are fully established; in particular we and FGIT will need to transfer our assets and liabilities to the new Football Trust. For this reason we shall go ahead with our planned meeting at Walkden House on Monday 2 April. Papers will be prepared and sent out to you shortly.

Yours sincerely,

NEW FOOTBALL TRUST ARRANGEMENTS ANNOUNCED

Single body to assist response to Taylor Report

Important changes in the administration and organisation of the Football Trust were announced today. They are designed to assist the game in its response to the final report of Lord Justice Taylor, and with the administration of the substantial new funding announced by the Chancellor in his Budget on Tuesday. The work of the existing Football Trust and the Football Grounds Improvement Trust is being combined into a single body, to be known as The Football Trust (1990).

The membership of the new Football Trust will be drawn from the same organisations which have nominated trustees hitherto: the Football League, the Football Association, the Scottish Football League and the Scottish Football Association, the Professional Footballer's Association, the local authority associations, the chief police officers, and the pools. One change is that the Football League is to nominate a third trustee: the existing chairman of FGIT, Tom Wharton, will be the first such appointment, and he will chair an important committee which will be responsible for grant aid policies for the professsional game in relation to the Taylor Report.

The Chairman of the new Trust will be Lord Aberdare and the Deputy Chairmen will be Richard Faulkner and Tom Wharton. In a letter to clubs telling them of these new arrangements, Lord Aberdare confirms that it will be the trust's intention that the professional game should continue to receive around 75 per cent of the funds that are made available through the Spotting-the-Ball competition organised by Littlewoods, Vernons and Zetters. On current forecasts that is worth

something in excess of £7.5 million per annum. Added to this amount will be the money raised by the reduction in pool betting duty announced by the Chancellor: worth, on his calculation, £100 million in total over the next five years.

The needs of grassroots and community football, and of the semi- and non-professional clubs will continue to be looked after as generously as possible.

Continued.../2

Explaining the changes, Lord Aberdare writes: "For some time it has been apparent that the division in responsibilities between the Football Trust and the Football Grounds Improvement Trust has been the cause of some confusion. This question has been given added point by the Taylor recommendations, and by the Chancellor's welcome decision to reduce pool betting duty and to make the £100 million thus raised over the next five years available to the Football Trust. The implementation of the Taylor Report will require a unified coherent approach, not only because the Government is requiring that the contribution it is making should be channelled through the Football Trust, but also because Taylor's proposals for ground improvements and crowd control measures need to be seen in a single overall context, as will the relationship with the Football Licensing Authority, once that has been established".

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US REACTIONS TO THE UK BUDGET

SUMMARY

1. GENERALLY NEUTRAL REPORTING FOCUSED ON INFLATIONARY PROBLEMS AND CHANCELLOR'S PLEDGE TO MAINTAIN HIGH INTEREST RATES. LITTLE COVERAGE OF BUDGET DETAILS OTHER THAN MEASURES TO BOOST SAVINGS, A FAMILIAR US PREOCCUPATION. SOME COMMENTARY ON GOVERNMENT'S POLITICAL DIFFICULTIES THOUGH LESS EXTENSIVE THAN LAST YEAR. MIXED INTERPRETATION OF FINANCIAL MARKET RESPONSE.

DETAIL

2. BUDGET REPORTING IN THE QUALITY PRESS WAS LESS EXTENSIVE THAN LAST YEAR, WHEN THE BUDGET WAS AT TIMES USED AS A HOOK ON WHICH TO HANG STORIES ABOUT EMERGING ECONOMIC AND POLITICAL DIFFICULTIES. (THIS YEAR'S ARTICLES HAVE BEEN FAXED TO THE TREASURY PRESS OFFICE). THE GENERAL PERCEPTION WAS OF A CAUTIOUS BUDGET TAILORED TO MEET THE NATION'S ECONOMIC PROBLEMS. THE LATTER, PRIMARILY HIGH INFLATION AND INTEREST RATES AND A LARGE CURRENT ACCOUNT DEFICIT, WERE DESCRIBED IN FAIRLY NEUTRAL TERMS.

3. LITTLE DETAIL WAS PROVIDED ON INDIVIDUAL BUDGET MEASURES. HOWEVER, THE CHANCELLOR'S WARNING THAT INTEREST RATES WOULD REMAIN HIGH WAS WIDELY REPORTED, AS WAS THE PREDICTION THAT INFLATION WOULD RISE FURTHER BEFORE FALLING. OF THE SPECIFIC BUDGET MEASURES THOSE DESIGNED TO ENCOURAGE SAVINGS RECEIVED MOST COMMENT, IN PART BECAUSE LOW SAVING IS ALSO OF CONCERN IN THE US.

4. THE CHANCELLOR'S RESTATEMENT OF THE PRECONDITIONS FOR ENTRY INTO THE ERM WERE PICKED UP, AND THE WASHINGTON TIMES SUGGESTED THAT THE LACK OF A QUOTE CLEAR SIGNAL UNQUOTE FOR ENTRY INTO THE ERM DISAPPOINTED THE FINANCIAL MARKETS, DEPRESSING THE POUND. THE JOURNAL OF COMMERCE, BY CONTRAST, NOTED THAT BOTH SHARE PRICES AND THE POUND ENDED THE DAY HIGHER.

5. POLITICAL ASSESSMENT OF THE BUDGET SPEECH AND PACKAGE HAS

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BEEN LIMITED. HOWEVER, THE JOURNAL OF CONGRESS QUOTED ONE IMMEDIATE VERDICT AS BEING QUOTE A GOOD BUDGET POLITICALLY UNQUOTE, AND THAT MR KINNOCK GAVE THE BUDGET A QUOTE GRUDGING WELCOME (AS) THE FIRST SIGNS OF A LISTENING GOVERNMENT UNQUOTE. THE WALL STREET JOURNAL JUDGED THAT THE SAVINGS AND THE DAY-CARE MEASURES SHOULD BOOST THE GOVERNMENT'S POPULARITY.

COMMENT

6. ON BALANCE, THE BUDGET RECEIVED LIMITED BUT GENERALLY FAVOURABLE COVERAGE. CERTAINLY GIVEN THE PERCEIVED ECONOMIC AND POLITICAL DIFFICULTIES IN THE UK (INCLUDING THE POLL TAX WHICH HAS BEEN WIDELY REPORTED OF RECENT) THE PRESS COMMENT WAS PERHAPS MORE HELPFUL THAN MIGHT HAVE BEEN FEARED.

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THE BUDGET

in brief

Published by
The Treasury
20 March 1990

The Budget reaffirms prudent policies designed to achieve the Government's main objective of reducing inflation and improving the climate for output and jobs. It is primarily a Budget for savers. It is also a Budget for business, with particular help for small and medium-sized companies.

Savings and income

The Budget contains a number of **measures to help small savers,** whether the savings are held in the form of bank or building society accounts or invested in shares.

The Chancellor has provided for a new way of planned saving for all adults with **Tax Exempt Special Savings Accounts (TESSAs)**. Up to £3,000 can be put into a TESSA in the first year. After that the maximum is £1,800 a year up to the total of £9,000 over five years. It will be possible to withdraw interest as it accrues, but only up to the 'net of tax' level. At the end of the five years the depositor gets a bonus representing the money which would otherwise have gone in tax, provided none of the capital has been withdrawn. Depositors can withdraw capital at any time, but without tax relief. The relief is to take effect from January 1991, after full details have been agreed with the banks and building societies.

The **composite rate tax** on interest paid on bank and building society accounts will be abolished. This means that non tax-payers will no longer pay tax on interest on these accounts.

To encourage savings in the form of equities, the Chancellor has raised the annual limit on amounts which may be invested in **Personal Equity Plans (PEPs)** from £4,800 to £6,000. Within that, the limit on amounts invested in unit and investment trusts will be increased to £3,000. To help more investment trusts to qualify for inclusion, the requirement that 75 per cent of their portfolio should be in UK equities has been reduced to 50 per cent. The maximum that can be invested in any one year in trusts not satisfying this rule has been raised from £750 to £900. Since the introduction of PEPs in 1987 690,000 plans have been taken out, and £1,430 million invested.

Stamp duties on share transactions are to be abolished late in 1991–92 to coincide as far as possible with the introduction of paperless dealing. This will lower the cost of purchasing shares, encouraging wider share ownership, and enhance Britain's pre-eminence as a financial centre in an increasingly competitive international market. Already one in four adults owns shares.

The Chancellor has made a change to the rules governing **Employee Share Ownership Plans (ESOPs)**. Company owners, particularly in the unquoted sector, will be able to sell their shares to the workforce without incurring an immediate tax charge.

The main features

- Budget in surplus for the fourth successive year.
- Tax Exempt Special Savings Accounts (TESSAs) to allow adults to save free of all tax from 1 January 1991.
- Amount of savings people can have without losing all entitlement to income-related benefits increased substantially.
- Independent taxation of husband and wife effective on 6 April 1990.
- Non-taxpayers no longer to pay tax on interest from banks and building societies from 6 April 1991.
- Annual investment limit on Personal Equity Plans (PEPs) increased to £6,000 and further encouragement for Employee Share Ownership Plans (ESOPs).
- Stamp duties on shares to be abolished late in 1991–92, to coincide as far as possible with the introduction of paperless dealing.
- Basic and higher rates of income tax and basic rate limit unaltered, and main tax allowances increased in line with inflation. Blind person's tax allowance doubled to £1,080.
- 'Gift Aid' relief introduced for single donations of £600 to £5 million by individuals from October 1990, and matching relief for single donations by companies; limit on relief for charitable donations under payroll giving scheme increased to £600; and VAT reliefs for charities extended.
- Workplace nurseries provided by employers exempt from tax as a benefit in kind.
- Excise duties generally increased in line with inflation, but:
  - —duty on petrol up 10 per cent, a 15½p tax differential in favour of unleaded as against leaded. No increase in vehicle excise duty for cars;
  - —10 per cent increases in duty on cigarettes, cigars and spirits, but no change in duty on pipe tobacco.
- 2½ point reduction in pool betting duty—worth £100 million over five years—to provide funds to improve safety and comfort at football grounds.
- Company car scale charges increased by 20 per cent.

At present income-related benefits such as income support, family credit and community charge benefit are subject to a **capital rule**. So if someone claiming these benefits has savings above a certain level the benefit is reduced. There are also upper capital limits, above which benefit entitlement ceases. These limits are being increased from £6,000 to £8,000 for income support and family credit, and from £8,000 to £16,000 for housing and community charge benefit.

These measures together give personal savers a much fairer deal, and should in time encourage a resurgence in the traditional virtue of thrift.

Recent economic performance

During the 1980s Britain's economic performance has improved substantially. The last eight years have been an unprecedented period of strong, steady growth averaging over 3 per cent a year. Investment has grown more than twice as fast as consumption. Indeed investment in the UK has grown faster than in any other major European country. There has also been a dramatic improvement in manufacturing productivity growth, which has exceeded that of all other major industrialised countries during the 1980s.

But the record growth in investment was accompanied in recent years by rapid growth in consumer spending and borrowing. As a result total domestic demand and output grew at rates that could not be sustained. This above-trend growth resulted in a combination of rising inflation and a widening current account deficit.

As soon as the threat of higher inflation became clear, policy was tightened, and short-term interest rates have been in double figures for nearly two years. The tight policy stance has reduced the growth of demand and output, which moderated during 1989. Inflation remains high, but will in time fall in response to slower growth.

Economic policy

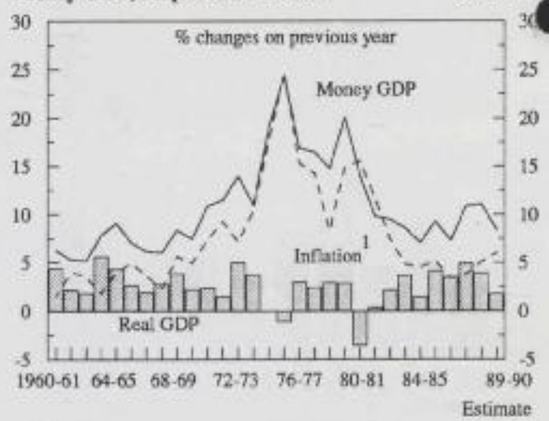
The Budget continues the policy which has been adopted since 1979, namely:

- A Medium Term Financial Strategy (MTFS) aimed at the defeat of inflation.
- Reforms in taxation and other fields to stimulate enterprise and to improve the supply side of the economy.

The key points of the MTFS are:

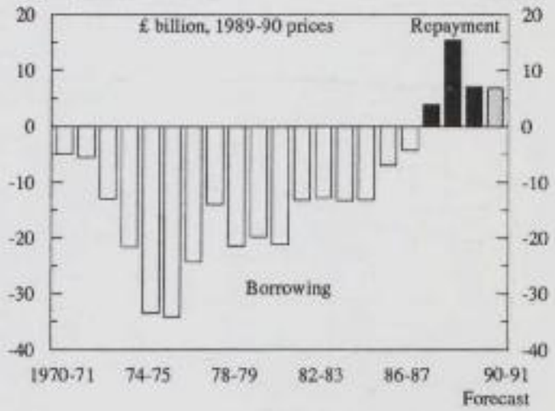
- The maintenance of tight monetary and fiscal policies in order to exert downward pressure on the cash value of national income, or money gross domestic product (GDP). The path for money GDP and an illustrative breakdown between real output and inflation are shown in table 1.
- Interest rates will be set as high as necessary to bring inflation down. A target growth range of 1–5 per cent has been set for the most reliable monetary indicator, M0.
- The Government will also take account of the evidence of other monetary aggregates, particularly the exchange rate and prices of assets.
- Following debt repayments of £7 billion in 1989–90 and 1990–91, there will be a gradual return to the longer-term objective of a balanced budget.

Money GDP, output and inflation — **Chart 1**



[1] RPI excluding mortgage interest payments from 1976-77. Earlier figures based on all-items RPI, when it did not include mortgage interest payments.

Government finances — **Chart 2**



The Government is committed to joining the **Exchange Rate Mechanism (ERM)** of the European Monetary System (EMS) when the level of UK inflation is significantly lower, there is capital liberalisation in the Community and real progress towards completion of the single market, freedom of financial services and strengthened competition policy. The MTFS is designed to reduce inflation and to sustain the anti-inflationary stance which ERM membership requires.

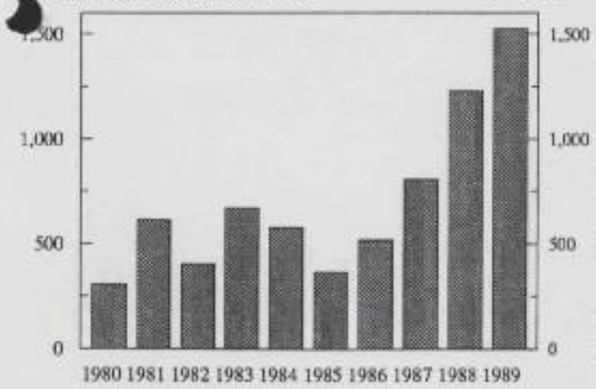
Table 1 Money GDP growth, output and inflation*

	1989–90	1990–91	1991–92	1992–93	1993–94
Money GDP	8½(8½)†	5¾(7½)†	6¾	6¼	5¾
Real GDP					
—Non North Sea	2½	1	2	2¾	2¾
—Total	1¾	1	2	2¾	2¾
Inflation (GDP deflator)	6¼(6½)†	4½(6½)†	4¾	3¼	3

* The figures for 1990–91 are forecasts. The figures for subsequent years represent the Government's medium term objectives for money GDP and assumptions for output and inflation.

† The figures in brackets adjust for the abolition of domestic rates.

New businesses each week* — **Chart 3**



* Start-ups net of closures based on VAT registration data

Saving — **Chart 4**

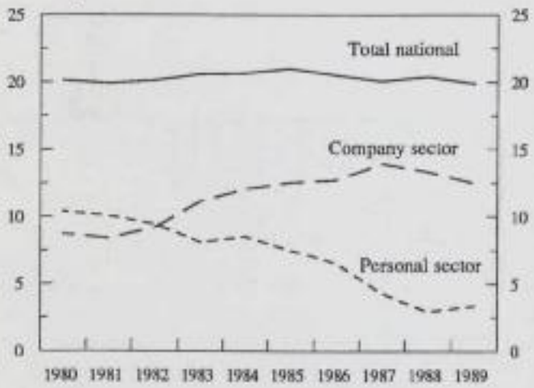


Table 2 Money supply

	1989–90 Forecast	1990–91	1991–92	1992–93	1993–94
M0 growth rate per cent	5½*	1 to 5	0 to 4	0 to 4	−1 to 3

* 1990–91 is a forecast. The figures for later years are illustrative.

Table 3 Public sector debt repayment*

	1989–90 Estimate	1990–91	1991–92	1992–93	1993–94
PSDR £ billion	7	7	3	0	0
PSDR per cent of GDP	1¼	1¼	½	0	0

* 1990–91 is a forecast. The figures for later years are illustrative.

Economic forecast

1990 is expected to be a year of slow growth as inflation is squeezed out of the economy.

Domestic demand is expected to fall by ½ per cent in real terms in 1990 while GDP is forecast to rise by 1 per cent. A lower growth rate is necessary given the excessive expansion in recent years. However, growth over the four years to 1990 will still have averaged 3 per cent if the forecast is met. Export prospects are particularly bright as British businesses are expected to continue making the most of the excellent opportunities in overseas markets.

RPI inflation will rise in the months ahead in response to a number of unfavourable factors, before falling later in the year. It is forecast to be 7¼ per cent in the fourth quarter. Thereafter it is expected to fall rapidly during 1991.

Table 4 Economic forecast

	1989 Estimate	1990 Forecast
	per cent change on previous year	
Consumers' expenditure	3¾	1¼
General government consumption	½	½
Fixed investment	4¾	−1¼
Change in stockbuilding (as per cent of GDP)	−¼	−1¼
Exports	4	7¼
Imports	7	1
Gross domestic product—total	2¼	1
—manufacturing	4¾	0
Balance-of-payments current account (£ billion)	−21	−15
Inflation—retail prices index (fourth quarter on fourth quarter)	7½	7¼
—GDP deflator at market prices (financial year)*	6½	6½
Money GDP at market prices (financial year)*	8½	7½
£ billion	519	558
PSDR (financial year)		
£ billion	7	7
per cent of GDP	1¼	1¼

* Adjusted for distortions arising from the abolition of domestic rates.

Public money 1989–90

Pence in every £1

Where it comes from		Where it goes	
Income tax	25	Social security	25½
National insurance contributions	16	Health	12
Value added tax	15	Education and science	12
Local authority rates and community charge	11	Defence	9½
Road fuel, alcohol and tobacco duties	10	Law, order and protective services	4½
Corporation tax	8	Transport	3
Capital taxes	3	Other services	18
Interest, dividends	3	Debt interest	9
Petroleum revenue tax and oil royalties	1	Debt repayment	3½
Other expenditure taxes	4	Other	3
Other	4		
Total	**100**		**100**

Income tax

Independent taxation was announced in the 1988 Budget and comes into effect on 6 April 1990. From this date all taxpayers, married and single, male and female, are taxed separately on their own income.

Every taxpayer will be entitled to a personal allowance which can be set against any type of income. Previously a married woman had no allowance to set against her income from savings and any state retirement pension paid to her on the basis of her husband's national insurance contributions. Now she can use her personal allowance against these forms of income.

The main **tax allowances and thresholds**, shown in table 6, have been increased in line with inflation. The blind person's allowance has been doubled from £540 to £1,080. There has been no change in **income tax rates** or the basic rate limit this year.

Business

The main corporation tax (CT) rate and the small companies rate are unchanged. But there are a number of measures to help companies, particularly small and medium sized ones:

- Comprehensive system of VAT relief for bad debts.
- Small companies' VAT threshold raised to £25,400, the maximum permitted under European Community law.
- The small companies' corporation tax limits are raised to £200,000 and £1 million. So companies will not be liable for CT at 35 per cent till their profits reach £1 million. For companies in a group, these limits apply to the profits of the group as a whole. These changes in the limits will reduce the burden of CT for around 20,000 companies.
- Tax relief granted for contributions to training and enterprise councils.
- Relief for expenditure on waste disposal sites.
- Annual limit for investment raised under Business Expansion Scheme increased to £750,000.

Table 5 Revenue effects of Budget measures

£ million*

	Yield +/Cost − 1990-91	1991-92
	Changes from indexed base	
Income tax		
basic rate limit unchanged	+220	+400
car benefit scales increased by 20 per cent	+160	+200
benefit of workplace nurseries exempted	−10	−10
Excise duties		
tobacco duties increased	+75	+85
petrol, derv and other oil duties increased	+175	+195
alcohol duties increased	+20	+25
vehicle excise duty on cars, buses etc unchanged, other vehicle excise duty changes	−210	−215
pool betting duty rate reduced	−20	−20
Tax Exempt Special Savings Accounts	−20	−200
Composite rate tax abolished	—	+550
Stamp duties on shares abolished	+5	−120
Corporation tax		
small companies' limits increased by a third	*	−25
relief for doubtful sovereign debt phased	*	+200
Value added tax		
bad debt relief / reform of registration rules	−35	−225
Other tax changes	+70	+115
Total	**+430**	**+955**

— = Nil
* = Negligible

Table 6 Income tax

	1989-90	1990-91*	Increase over 1989-90
Allowances (£)			
Single person's/personal	2,785	3,005	220
Married couple's		1,720	
Married man's/personal & married couple's	4,375	4,725	350
Additional personal & widow's bereavement	1,590	1,720	130
Single age/personal (65–74)	3,400	3,670	270
Single age/personal (75+)	3,540	3,820	280
Married couple's (65–74)		2,145	
Married couple's (75+)		2,185	
Married age/personal & married couple's (65–74)	5,385	5,815	430
Married age/personal & married couple's (75+)	5,565	6,005	440
Age-related income limit	11,400	12,300	900
Blind person's	540	1,080	540

* With independent taxation.

Football

In the light of the Taylor Report it is evident that football clubs must spend large sums to improve the safety and comfort of their grounds. Much of the expenditure required to meet the Taylor recommendations should be eligible for capital allowances or for full offset against tax. But this will not help the poorer clubs as few of them make any taxable profits.

Pool betting duty, currently at 42½ per cent, is to be reduced to 40 per cent, initially for five years, as long as the benefit of the cut is all channelled to the Football Trust to distribute for essential expenditure on safety and comfort at football league grounds.

Excise duties

Most excise duties are to rise in line with inflation. This will put 7p on a bottle of wine, and 2p on a pint of beer. However, the duties on spirits and cigarettes are to be increased by 10 per cent, putting 54p on a bottle of whisky and 10p on a packet of 20 cigarettes. The duty on pipe tobacco has not been changed.

The vehicle excise duty on cars is to be unchanged, but there will be increases in some lorry rates. Petrol duties will rise by 10 per cent. This will put 11p on a gallon of leaded petrol and 9p on unleaded, raising the tax differential in favour of unleaded to 15½p.

Charities

A new 'Gift Aid' relief is to be introduced from October 1990 for single donations of £600 to £5 million by individuals, with a similar relief for single donations by companies. The limit on relief for charitable donations under the payroll giving scheme is to be increased to £600. VAT reliefs for charities are to be further extended.

Workplace nurseries

The benefit in kind resulting from free provision at workplace nurseries and playgroups will be exempt from tax.

Car scale changes

Company car scale charges are to be increased by 20 per cent from 6 April 1990. Car fuel scales are unchanged.

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BUDGET SNAPSHOT

20 March 1990

1. PERSONAL TAXES

Income Tax - Independent taxation announced in the 1988 Budget giving women independence in tax matters introduced from 6 April 1990

Main Allowances and allowances for the over 65s increased in line with inflation (RPI was 7.7 per cent to December 1989). Tax reductions in pay packets on first day after 17 May.

No change in 25 per cent basic rate, 40 per cent higher rate or the basic rate limit (threshold for liability to the higher rate).

Allowances (£)	1989-90	1990-91
Personal	2,785[1]	3,005
Married Couples		1,720
Personal + Married Couples (PA + MCA)	4,375[2]	4,725
Additional Personal	1,590	1,720
Personal (aged 65-74)	3,400[3]	3,670
Married Couples (65-74)		2,145
PA + MCA (65-74)	5,385[4]	5,815
Personal (aged 75+)	3,540[3]	3,820
Married Couples (75+)		2,185
PA + MCA (75+)	5,565[4]	6,005

Allowances(£)	1989-90	1990-91
Income limit for over 65s	11,400	12,300
Threshold for 40 per cent rate	20,700	unchanged

(1) Single persons Allowance (2) Married Mans Allowance
(3) Age Allowance single (4) Age Allowance married

Blind person's Allowance doubled from £540 to £1,080, unused portion can be transferred to spouse.

Scale charges for private use of **company cars** raised by 20 per cent in 1990-91 compared with 1989-90. The 1989-90 scale charge of £1,850 on a 1.6 litre car travelling between 2,500 and 18,000 business miles will rise to £2,220. No change in car fuel scale charges.

Workplace nursery provision by an employer for an employee's children will be exempt from income tax as a benefit in kind.

2. TAXATION OF SAVINGS

Tax Exempt Special Savings Accounts (TESSAs) to be introduced; these will be five year investment plans in a bank or building society account in which up to £3,000 in the first year and £1,800 a year thereafter can be contributed within an overall limit of £9,000. Interest will accumulate tax free. Investment can be withdrawn after 5 years: early withdrawal of capital will mean loss of exemption. Relief effective from January 1991, but net-of-tax interest can be withdrawn during the five year period.

Composite Rate Tax abolished from April 1991. There will be arrangements under which non-taxpayers can receive interest free of tax. For taxpayers, basic rate tax will be deducted. Anyone not liable to tax who has had income tax deducted will be able to reclaim it.

Stamp Duty will be abolished on share transactions from a date in late 1991-92 to coincide as far as possible with the introduction of the Stock Exchange's new system for paperless transfer of shares.

Annual investment limit for **Personal Equity Plans (PEPS)** raised from £4,800 to £6,000.

Capital Gains Tax roll-over relief to be available for shares sold into **ESOPs (Employee Share Ownership Plans)**.

Authorised provision of **Save as Your Earn (SAYE)** contracts extended from building societies and Department of National Savings to banks.

Capital cut-off (the amount of savings above which people are ineligible for income related social security benefits) raised from £6,000 to £8,000 for income support and family credit, and from £8,000 to £16,000 for housing benefit and community charge benefit.

3. Excise Duties

Duties on cigarettes, hand rolling tobacco, cigars, petrol, derv and spirits raised by 10 per cent; on beer, wine and cider raised by 7.7 per cent in line with inflation: no increases on pipe tobacco.

	Duty Increase (percent)	Price effect (including VAT)
Beer	7.7	1.7p a pint
Wine	7.7	6.8p a 75cl bottle
Spirits	10.0	54.4p a 75cl bottle
Cider	7.7	0.9p a pint
(Alcohol duty increases apply from 6pm Budget Day)		
Cigarettes 20 kingsize	10.0	9.6p per packet
Cigars	10.0	4.8p per packet of small cigars
(Tobacco duty increases apply from midnight 22/23 March)		
Leaded petrol	10.0	10.7p a gallon
unleaded petrol	10.0	9.3p a gallon
Derv	10.0	9.0p a gallon
(hydrocarbon oil duty increases from 6pm on Budget Day)		

Vehicle Excise Duty (VED) - No change in £100 VED on cars and light vans.

RPI effect of duty changes: 0.53 per cent

Pool Betting Duty to be cut from 42½ per cent to 40 per cent for initial period of five years on condition that the pools promoters pass the full amount saved (some £100 million over five years) to the Football Trust for use in improving safety and conditions at football grounds.

4. TAXATION AND BUSINESS

Value Added Tax (VAT):-

Comprehensive system of VAT relief for bad debts

VAT registration requirements simplified.

Registration threshold (annual turnover below which traders are not obliged to register) up from £23,600 to £25,400.

No change in 15 per cent rate.

Corporation Tax - main rate remains at 35 per cent, small companies rate at 25 per cent.

Profits limit below which the 25 per cent rate applies raised from £150,000 to £200,000; the limit below which companies receive relief from the full 35 per cent rate raised from £750,000 to £1 million.

Annual limit for investment under **Business Expansion Scheme** raised from £500,000 to £750,000;

New arrangements for tax relief for banks' doubtful foreign sovereign debt to remove uncertainty and to spread the cost to the Exchequer of any further worsening of the prospects of recovering those debts.

Tax relief for expenditure on waste disposal sites.

Tax relief for contributions by businesses to Training and Enterprise Councils (TECs)

5. CHARITIES

Qualifying donations under the payroll giving scheme raised from £480 to £600 a year.

New income tax relief for single donations by individuals equal to or more than the payroll giving limit of £600 (Gift Aid).

VAT zero rating extended to waterborne ambulances, inshore rescue boats, and ancillary work on charities' advertising; further concessions on medical equipment (from 1 May).

6. CAPITAL GAINS TAX

Exempt amount held at £5,000 for individuals and at £2,500 for most trusts.

7. INHERITANCE TAX

Threshold increased in line with inflation from £118,000 to £128,000.

PRIME MINISTER

CHANCELLOR'S BUDGET PARTY

Like his predecessor, the Chancellor has invited you to the post-Budget party in Number 11 tomorrow evening.

Proceedings are due to start at about 2000. You should by then be back from your Audience. But you may prefer to delay going next door until, say, 2030. I will check while you are at the Audience how the timetable is running, and you can then decide on your return from the Palace what time to go through.

PAUL GRAY
19 March 1990

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PRIME MINISTER

BUDGET CABINET: 20 MARCH

As in the past, the Chancellor does not plan to hand round any pieces of paper at Cabinet tomorrow, but will simply give an oral presentation of his proposals.

After the Chancellor has spoken, you will want to give other members of Cabinet a chance to comment if they wish. I would imagine the package will be well received; it follows quite closely both the broad thrust and some of the detailed proposals suggested in the pre-Budget Cabinet discussion a month ago.

In summing up, you will want to stress:

(i) the warm welcome for the Budget package;

(ii) the essential need for total secrecy until 1530.

PAUL GRAY
19 March 1990

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~~BUDGET SECRET~~

CONFIDENTIAL

REF. NO. JGBS/47/90

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JS

FROM: JOHN GIEVE

DATE: 19 March 1990

SIR T BURNS

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir J Anson
Mr Scholar
Mr Wicks
Mr Monck
Mr Odling-Smee
Mr A J C Edwards
Mr Culpin
Mrs Lomax
Mr Peretz
Mr Riley
Mr Sedgwick
Mr Hibberd

Mr Mowl
Mr Owen
Mr O'Donnell
Miss O'Mara
Mr Grice
Mr Ritchie
Miss Wallace
Mr Deane
Miss James
Mrs Chaplin
Mr Tyrie
Mr Lightfoot

Sir A Battishill - IR
PS/IR

Mr Unwin - C&E
PS/C&E

Mr Gieg - No 10.

BUDGET SPEECH: ECONOMIC SECTION

The Chancellor was most grateful for the further comments he received on the draft I circulated on 15 March. He has reworked this section over the weekend and I attach the latest version [which contains further amendments to the version I circulated to a few people on Friday evening].

CONFIDENTIAL

~~BUDGET SECRET~~

2. He has made a number of minor drafting changes. I have sidelined the main changes (since the 15 March version). I would be grateful for comments by noon on Monday. In particular:

- would Mr Peretz check paragraph 40 on credit marketing;
- would Mr Ritchie check all the numbers and facts (including para 24);
- would Mr Sedgwick and Mr Riley check paragraphs 11-13 on the world.
- would Mr Monck check paras 60 & 61

JG

JOHN GIEVE

Draft 18 March 1990

DRAFT

BUDGET SPEECH

Mr Speaker, [the Government's economic policy/policy over the next year] has two main objectives.

2. The first is to again bring down inflation. Until that happens, we cannot reduce interest rates and keep them down.

3. The second is to enable this country to take the opportunities that exist in the 1990s. In Western Europe, the single market, a British concept, is nearly on us. And the whole of Eastern Europe, where there is great goodwill for Britain, has opened up in a most dramatic way. We need to make sure that British business can take advantage of these changes.

4. These two objectives are closely related. Unless we succeed in the first, we are unlikely to do so in the second.

5. So this Budget will take no risks with inflation. It will maintain a strong fiscal surplus.

6. It will, above all, be a budget for savers. It will provide a range of incentives to save and a novel incentive to give. It will bring the introduction of independent taxation for married women. It will introduce important new measures for business and keep up the pace of supply side reform. It will remove an old grievance from the tax system and make the social security system fairer. And it will abolish two taxes.

7. In framing by first Budget I have had the great advantage of following my RHF, Blaby who has left the public finances stronger than at any time [in living memory/ since Gladstone's time]. His record of tax reform, too, is one that few have matched in the past and few will match in future.

8. I will come to the detailed measures later. First, I wish to review the performance of the economy in 1989 and look at the prospects for 1990; I will then deal with monetary policy and public sector finances.

9. As usual, the Red Book, together with a number of Press Releases filling out the details of the Budget measures, will be available from the Vote Office as soon as I have sat down.

ECONOMIC PERFORMANCE AND PROSPECTS

10. First, the economic background.

11. 1989 saw continued buoyant growth in world trade despite some slow down in the growth of the major economies particularly in the United States. However increased inflation and fears of overheating in continental Europe led to increases in short-term interest rates in most major economies during the year. More recently we have seen a rise in long-term interest rates - particularly in Germany where uncertainty about the effects of monetary union has been an additional factor.

12. This tightening of monetary policy is likely to bring lower growth generally in 1990 than last year and, in due course a fall in inflation. We are likely, therefore, also to see a slower growth in world trade in the current year, although the astonishing developments in Eastern Europe improve the longer-term prospects.

13. The rise in interest rates also reflect [a fall in savings/a fall in savings relative to investment] that has been apparent in the '80s in all the leading economies. This fall is a matter for concern since it not only exacerbates inflationary pressures but also constrains the amount of

investment that can be financed. The fall has gone furthest in the US and the UK and has been reflected in current account deficits. While in Japan and Germany domestic savings have remained more than sufficient to finance their own investment. In the medium term the UK's savings and investment need to come back into line and it is certainly desirable that savings should rise rather than investment fall.

14. During the last year, business confidence in Britain has remained a good deal stronger than many expected. New businesses have outnumbered closures, by around 1,500 every week; a larger figure than we previously estimated and a record never before approached. Employment has continued to rise, and unemployment to fall. Almost 27 million men and women are in work today - a larger number than ever before and $1^1/_2$ million more than at the beginning of the '80s. Business investment has risen by a further 9 per cent in the last year, taking it to 15 per cent of national output - the highest level ever. And a great part of this investment has been financed from rising company profits. Profitability at the end of the eighties was at its highest for 20 years.

15. And now companies are profitable they have been investing in more than just plant and machinery. Their spending on research and development has also risen in real

terms by almost 50 per cent in the five years to 1988. They now spend over £500 million a year on R&D which is, of course, allowable against tax. Similarly in the 5 years up to 1989 the numbers of employees receiving training has increased by over 70 per cent.

16. These are all favourable developments which reflect well on businesses' preparation for the future. But recently they have been accompanied by the return of inflationary pressures. That, beyond any doubt, is the most urgent problem, before us today.

17. To a degree it is a problem common to all nations. Since its low point in 1986 and 1987 inflation has risen significantly throughout the Group of Seven - the leading economies of the Western world. But our affliction has been sharper. There are a number of reasons for this - some welcome and some not. The record rise in business investment is obviously welcome; but it has been accompanied by a similar growth in borrowing and in consumer spending. Thus investment has been rising but the savings to finance it have not.

18. This has led to excessive growth in domestic demand, a revival of inflationary pressures, and a current account

deficit, a good deal of which itself represents suppressed inflation.

19. Policy was therefore tightened, and interest rates have now been in double figures for 20 months. This tight monetary policy has been backed by large Budget surpluses throughout the last three years. So monetary and fiscal policy have acted together.

20. Squeezing out inflation is always difficult but there is now clear evidence that demand is slowing down. High Street sales are now only 2 per cent up on a year ago. The housing market has cooled off noticeably. New car and vehicle registrations are down. Business spending is slowing and import growth has been sharply reduced.

21. And as demand has fallen back so has output growth, to just over 2 per cent in 1989.

22. No one likes to see the economy slow but it is inevitable if we are to push inflation downwards. I now expect the economy to grow by only 1 per cent this year, compared with the above trend growth of $4^1/_2$ per cent in 1987 and 1988. The size of this fall shows the extent of the downward pressure on inflation. But growth should return in 1991 towards its sustainable rate of around $2^3/_4$ per cent.

23. I am confident that the period of low growth will be short-lived - not least because of the permanent improvements in the underlying economy in the 1980s. For example, investment has grown more than twice as fast as consumption over the last eight years. As this additional capacity comes fully into use inflationary pressures will lessen and more normal growth will resume. No one need have any doubt about that.

24. Last year also saw a record level of foreign direct investment into Britain. Overseas investors see the potential for investment in this country in 1990's. These investments are particularly welcome as they are in industrial sectors like cars and electronic goods where a high proportion of the output is usually exported. For example, Britain already runs a trade surplus in colour TVs, and by the mid-1990s we could well be in surplus again in cars.

25. This increased investment will enable British industry both to meet domestic demand and to respond to export opportunities. Indeed, that is already beginning to happen. The current account deficit for 1989 as a whole was a little over the £20 billion I forecast at the time of the Autumn Statement. But the deficit in the last 3 months was

substantially lower than in the previous quarter and, in particular, the manufacturing deficit is now improving. Exports have been growing faster than imports for at last [X] months.

26. The reason for this improvement is twofold. A year ago, rapidly expanding domestic demand sucked in imports to meet a market that domestic manufacturers could not supply. Moreover, that same demand absorbed British goods that would otherwise have been exported. This pattern is now reversing.

27. Exports are now growing rapidly, regaining the share of world markets they lost in 1988. Last year, the volume of exports of manufactures grew by $11^1/_2$ per cent - the highest recorded rate for nearly 20 years.

28. So, British industry is responding extremely well to export opportunities. The fact that they are doing so illustrates clearly that the present trade deficit is not caused by poor industrial competitiveness. It does result from excess demand and as that is reduced the current account deficit will fall - initially to £15 billion in 1990 and further thereafter.

29. But we cannot [yet] afford to relax policy notwithstanding the prospect of lower growth. The buoyancy of past demand

means that inflation has been far more stubborn than anyone expected. A significant fall is still some months away and a number of factors will ensure that the position will worsen noticeably before it improves. This will be reflected in the Retail Price Index during the next few months.

30. The largest single factor is the growth of some £4,000 million in local authority spending next year. This is mainly responsible for the expected growth of over 30 per cent in average community charges compared with domestic rates. This will add over 1 per cent to the RPI next month.

31. Similarly the further rise in mortgage rates last month will also increase the Retail Price Index. As a result, I now expect that RPI inflation may still be a little over 7 per cent by the fourth quarter of this year, compared to the $5^3/_4$ per cent I had previously forecast.

32. Beyond that - as these one-off increases drop out of the index and the lagged effect of monetary tightening builds up, I expect inflation to fall below 5 per cent during 1991.

33. To summarise, the economy - both consumption and investment - has been very resilient in recent years. Adjustment so far has been gradual. But this is not necessarily a good guide to the future. The gradual

adjustment may continue but equally the downturn may become quite sharp.

34. It is against this uncertain background that I must set monetary and fiscal policy, to which I now turn.

MONETARY POLICY

35. I want to deal with monetary policy and interest rates first for two reasons: because they are of great concern in the House and in the country and because as always they provide the key to progress on inflation.

36. And, I repeat, my first priority is to prevent inflation re-imposing itself. For inflation is immensely damaging socially as well as economically. It damages business by undermining planning and investment and it foments industrial strife. And socially, it penalises the weak. Those on fixed incomes see their savings eaten away and security and self-sufficiency destroyed. That was what happened in the 1970s it must not happen again.

37. I know that high interest rates are unpopular. They are generally most unpopular as they become most effective. They discourage spending and borrowing. They act directly on the things we have to influence if we are to get inflation down.

38. But interest rates are also the most flexible way of responding to what can be a rapidly changing situation. They can be raised quickly when necessary. And they can be reduced just as quickly when it is safe to do so.

39. In recent months I have looked carefully to see if there is an effective alternative to interest rates. Because I am very conscious of the burden they place on business and on individuals purchasing their own houses.

40. I know many people favour direct controls on lending, hire purchase and consumer credit. I do understand that. In particular, I understand the distaste many people feel for the widespread marketing of credit that is so evident today and that is characterised by indiscriminate mailshots encouraging people to borrow. I do believe the financial institutions would be wise to reconsider their policy and I hope that this will be one subject covered in the Code of Practice the banks are currently preparing in the wake of the Jack Report.

41. But having looked at the matter I have concluded that it is extremely unlikely that credit controls would work in the modern world in anything other than the very short-term. They were becoming less and less effective even before

exchange controls were abolished over ten years ago. Their main impact now would be to replace domestic borrowing with overseas borrowing. For these days it would be a simple matter for any High Street bank to arrange its lending through an overseas branch.

42. This, of course, applies to other countries too, and it is for this reason that governments of all persuasions throughout the Western world are abolishing credit controls and are relying on interest rates to control money - and thus inflation. The same is true of those countries in Eastern Europe who are seeking to join the Western system.

43. In recent years financial markets have become more open to competition and their behaviour has changed enormously. As a result monetary conditions have become more difficult to judge. This is one of the problems of financial deregulation but one that must be set against the great benefits it has brought.

44. So, although monetary policy remains the key to controlling inflation, it is not realistic to suppose that we can take decisions solely by reference to the way any one particular measure of money is growing. In a more sophisticated world, we must apply judgement and take into account the other evidence about monetary conditions that may

be available including for example the exchange rate and asset prices.

45. In recent weeks I have looked afresh at the role of monetary targets. Having done so, I am clear that it is sensible to maintain a target for narrow money, and that this is best measured by the familiar aggregate M0. Since this is essentially notes and coin, it clearly is not a comprehensive measure of money in all its uses. But it does have value as a proven indicator of transactions and has been a reliable guide for many years. For next year I have set the target range at 1 to 5 per cent. Although the growth of M0 has fallen from its earlier peaks, it is likely to start the year above the range and it may be some months before it falls within it.

46. In this re-examination of policy, I have also looked closely at the case for reintroducing a target for broad money. I can understand why some favour this. At times broad money has given a useful indication of the build up of inflationary pressure. The difficulty is that its message has always varied in quality: its growth can represent money that is about to be spent, or money that is very definitely being saved: savings which I wish to encourage as will become apparent later this afternoon. So, although we will

monitor M4 carefully, and give it weight in our decisions, I do not intend to set an target for the year ahead.

47. I have also reviewed whether there should be any changes in the Government's funding policy. The objectives must be to manage public debt in a way that supports monetary policy in bearing down on inflation, without distorting financial markets. I have concluded that in general policy should continue to be guided by the funding rule followed in recent years, with the public sector avoiding sustained under or overfunding. But I am also clear that in practice the rule cannot and should not be operated rigidly. In particular, in recent years there has been an increase in the size of the Treasury bill issue, largely as a result of a change in the financial position of local authorities. In the circumstances, the Government will if necessary adjust its funding operations, increasing gilt sales or reducing gilt purchases, to take account of this.

48. Progress on reducing inflation is also a vital pre-condition of our commitment to take sterling into the exchange rate mechanism of the European Monetary System. Our commitment to do so was set out at Madrid. It remains firm, and the conditions for entry remain unchanged.

49. When we join the exchange rate mechanism it will provide a new short term framework for interest rate decisions. But even then, no one should suppose it will bring a dispensation from the need for strong domestic monetary control. Indeed, quite the reverse. Commitment to the one will reinforce the commitment to the other.

50. To sum up, interest rate decisions will continue to be made on the basis of the growth of monetary aggregates, and a range of other evidence most notably the exchange rate. This matters because it provides important information about domestic monetary conditions - quite apart from having an effect on prices. Therefore I favour a strong exchange rate. But there is, as I have made clear, no single lodestar to guide us in monetary policy. Life would be simpler if there were but it just does not exist. So judgement is unavoidable.

51. And my judgement is that interest rates will stay high for some time to come. The moment I judge I can safely lower them, I will. But to reduce them prematurely only to increase them again would be extremely damaging. When I bring them down it will be because I believe they are likely to stay down.

52. In Chapter 2 of this year's Red Book I have provided a much longer and more comprehensive account than usual of how monetary policy, including funding policy, is to be operated over the years ahead. I hope this will be helpful to the House, and in particular to members of the Treasury and Civil Service Select Committee when they come to examine the Budget documents in detail.

FISCAL POLICY

53. Although monetary policy must play the main role in tackling inflation, a tight fiscal policy is also essential. It cannot do the work of monetary policy, but it can and must support it.

54. The dramatic improvement in the state of public finances over the last 10 years under the stewardships of my RHFs is an achievement of which they can be rightly proud. For decades successive Governments have spent more than they were prepared to raise honestly from taxation and made up the shortfall by borrowing. They left the bill to be picked up by future generations.

55. Over decades that bill mounted to very considerable levels. Today, just paying the interest on the accumulated debt accounts for 10p on income tax.

56. Over the past 10 years we have reversed that trend; and in the last three we have re-paid around £25 billion, reducing the burden of government debt to levels we have not seen since before the first world war.

57. The rewards of this repayment will be felt by future generations but they bring also an immediate benefit. As a result of the debt repayments we are saving over £2,500 million a year in debt interest. That is sufficient to meet the annual cost of around 150 district general hospitals.

58. The very large Budget surpluses in 1988 and 1989 owed much to cyclical factors. In the current year, as I indicated to the House some months ago, we expect the surplus to fall back. The position will remain uncertain until the year is complete but our best estimate is that the debt repayment this year will be around £7 billion.

59. This fall in the surplus owes less to the slowdown in growth than to a number of special factors. We have seen a fall in privatisation proceeds from the very high level achieved in 1988-89. There has also been a sharp and unwelcome increase in local authority spending. This has been particularly marked in their capital spending, as they

have sought to forestall the new controls which will take effect in April. As a direct result of this spending, we now expect the public expenditure planning total this year to be overshot by £$2^1/_4$ billion. The overshoot arises solely because of overspending by local authorities; central government expenditure remains well under control.

60. Another, but much more welcome, factor reducing the surplus has been the higher national insurance rebates that have resulted from the huge success of personal pensions. This extension of choice is a considerable tribute to my RHF, Sutton Coldfield. Over $3^1/_2$ million people have now been taken out personal pensions. As well as benefiting the individuals concerned, in the long-term this will reduce public spending. But it also reduces national insurance receipts, by £$2^1/_2$ billion this year.

61. Next year, some of these factors will not be repeated but we will see the effect of slower growth on the debt repayment. In particular corporation tax receipts are likely to be significantly lower, not least because of the higher investment of recent years which entitles businesses to higher allowances against tax. These allowances will be worth over £9 billion to companies next year. These cyclical factors will build further in subsequent years.

62. It is against the medium-term fiscal prospect that I have framed the Budget judgement; for fiscal policy is not a flexible instrument which should be altered to meet short-term contingencies. Fine tuning fiscal policy is not only disruptive to the public sector, business, and to taxpayers but its effects on the economy are both uncertain and often destablising.

63. Accordingly, I am budgeting next year for a further Public Sector Debt repayment of £7 billion - the same as this year. Looking further ahead, I expect our fiscal position to move towards the medium-term objective of a balanced budget, an objective I reaffirm today.

64. The overall effect of the Budget measures I announce today will be to tighten fiscal policy modestly by increasing the yield from taxation by £$^1/_2$ billion next year and just under £1 billion in 1991.

[wordcount = 3,736] complete

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REF. NO. MW/90/29

COPY NO. 48 OF 48

FROM: MISS M P WALLACE

DATE: 19 March 1990

MR CULPIN (FP)

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Sir J Anson
Mr Wicks
Mr Monck
Mr Odling-Smee
Mr Scholar
Mr Hardcastle
Mr A J C Edwards
Mr Riley
Mr Sedgwick
Mr Peretz
Mr Gieve
Mr Gilhooly
Mr Matthews
Mr Mowl
Mr O'Donnell
Mr Ritchie
Miss J C Simpson
Mr Deane
Miss James
Mr Macpherson
Miss Massie
Mr A Walker
Mrs Chaplin
Mr Tyrie
Mr Lightfoot

Sir A Battishill - IR
Mr Isaac - IR
Mr Painter - IR
Mr Beighton - IR
Mr Bush - IR
Mr McNicol - IR (+1)

Mr Unwin - C&E
Mrs Strachan - C&E
Mr W Parker - C&E
Mr P Collins - C&E (+1)

BUDGET SPEECH: TAXATION SECTION

The Chancellor was grateful for comments on the last version of the Taxation Section, circulated with my minute of 15 March.

... I now attach his latest version, with the main amendments side-lined. In particular, he has re-written the Capital Disregards section extensively. You will also see that he has added a peroration, on which he would like views.

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2. There are a number of blanks and square brackets to be filled in. In addition, the Chancellor would be grateful for advice on the following points:

(i) can we mention the Scots in the passage on TECs? If so, could the Revenue please provide a sentence or two;

(ii) he would like, if possible, one more explanatory sentence on life-assurance;

(iii) he feels the National Savings paragraph is rather thrown away, and it disrupts the link from CRT to the opening paragraph TESSA. Can anyone see any solutions to this?

3. Could advice on these points and all other final comments please reach me by 12.30 pm today, Monday.

B.L.O.

MPW.

MOIRA WALLACE

PS Extracts from this, as before, go to interested HMT divisions.

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TAXATION SECTION

I now come to the detailed measures in this year's Budget. And I shall begin with the taxation of business.

2. Everyone in this country benefits from the success of British enterprise. Tax reform cannot create success but it can help and encourage it.

VAT

3. Within the tight fiscal position I judge necessary, I am able to make some changes that should help small and medium sized companies.

4. Cash flow is particularly important to new and growing companies of this size. To improve it, therefore, I have two measures that should help.

5. At present, traders pay Value Added Tax on all their sales, even if their customers do not actually pay the bill. They can only claim VAT relief for a bad debt when the debtor has been declared formally insolvent. As a result, the

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trader - who has dealt in good faith - can be out of pocket, in some cases for years, and often for large sums.

6. This has long been resented by businesses and the time has come to deal with it. I therefore propose that from April next year all debts which are over 2 years old and written off in the trader's accounts will qualify automatically for relief from VAT. This will be worth some £150 million to business next year.

7. I also propose to help smaller companies by simplifying the rules for traders registering for VAT. At present whether or not you have to register depends on quarterly and annual turnover thresholds. You only have to say this to realise how difficult it is. Businesses also have to peer into the future to see if these limits might possibly be exceeded within the next year.

8. This complication is unnecessary. So as from today, I propose a simple rule for VAT registration. This will be based on actual turnover in the preceding 12 months and not unknown turnover in the distant future. It will bring certainty and simplicity in place of uncertainty and complexity. And for businesses it has a second benefit: because they will, in general, register later than they

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otherwise would have, it will save them £35 million in 1990-91 and £75 million the year after.

9. I have two further VAT changes. First, I propose to increase the VAT threshold to £25,400, a modest sum, but the maximum permitted under European Community law.

10. The second change will affect companies which provide accommodation for their own Directors. As things stand, the company can deduct the VAT they pay on this, for something that is more a fringe benefit than a legitimate business cost. Frankly I do not believe this generous treatment is justified. I therefore propose that VAT paid on Directors' accommodation should no longer be deductible. This will take effect from [April 5 this year].

CORPORATION TAX

11. I also have some changes to Corporation Tax. While the main rate of corporation tax will remain at 35 per cent, I propose to reduce the burden of tax for companies with only small and medium sized profits.

12. At present companies with profits below £150,000 pay a reduced rate of Corporation Tax of 25 per cent. I propose to raise this ceiling by one third, to £200,000. This amounts

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to a doubling in two years of the profits levels for the reduced rate, and will mean all profits below £200,000 will be taxed at the minimum rate. This will be of special benefit to smaller growing companies.

13. For companies with profits above this limit, the average rate of tax gradually rises until their profits reach the upper profits limit of £$^3/_4$ million a year. I propose to raise this limit, again by a third, to £1 million. This means that no single company will be liable for the full rate of Corporation Tax until its profits reach £1 million a year. These changes mean we will have the most favourable structure of corporation tax rates companies anywhere in the EC [? or in the G7 group of industrial nations. Please check].

TRAINING

14. I also have one specific tax change to help training.

15. One of the most welcome features of the last few years has been the massive amounts of money being invested in training throughout the economy by both large and small firms. The latest estimates suggest this has now risen to some £20 billion a year.

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16. All companies' expenditure on training is, of course, tax allowable, and in addition the Government is spending £2$^{1}/_{2}$ billion a year on training programmes. [The total support give by the Exchequer to training therefore now amounts to £X billion.] Over £2 billion of this will in future be spent through Training and Enterprise Councils or TECs, most of which will be coming into operation over the next year.

17. I have no doubt that TECs will do much to improve training in skills and that we shall see the benefits of this in future. They give employers a genuine opportunity to determine their own needs and will provide generous cash and tax help to meet them.

18. The Government has already promised to match local business donations to TECs pound for pound within certain limits. I now propose to encourage business to maximise the money they put into training by providing tax relief on business donations to TECs for five years until April 1995. I propose to extend the same concession to local enterprise agencies until the same date.

Mention the Scots?

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STAMP DUTY

19. My next announcement has implications for one in four of the adult population. For that is the number of people - nearly 11 million people - who now own shares in the UK. That remarkable figure - a new record - is published today in the annual Stock Exchange Survey of share ownership.

20. Over the next few months, the Stock Exchange will be taking crucial decisions on their plans for a new share-dealing system, affectionately known as TAURUS. This will cut costs and eliminate paper forms, and provide a modern computerised system for transferring shares. Decisions on the design of the new systems for TAURUS will have to be taken shortly. We need, therefore, to decide what stamp duty regime to apply to paperless transactions.

21. As we approach 1992 we can expect even sharper international competition in financial services, much of it from other European centres. Competitive and practical arguments point in the same direction. I have therefore decided to abolish stamp duty on securities late in 1991-92 to coincide as far as possible with the introduction of paperless dealing. [Add one sentence on SDRT.]

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22. Both the abolition of the tax and the introduction of a more modern dealing system will help to secure the UK's position as a leading financial centre in an increasingly competitive world market. They will also reduce transaction costs and permit higher returns for 11 million holders of occupational pension schemes, $3^1/_2$ million personal pension holders as well as the many millions of people who hold life assurance policies or unit trusts. It will also be of particular benefit to small shareholders.

[paras reversed]

23. The assumption in the Red Book is that abolition will be at the end of 1991, at a revenue cost of £120 million in 1991-92. This date will be subject to confirmation later when I have fuller information about the progress of TAURUS. However, although there is some flexibility about the timing, there is no doubt whatsoever about the decision to abolish stamp duty on shares. I have made the announcement now for two reasons: to remove uncertainty and make clear that there is no need to plan for stamp duty within TAURUS. I should add, for the avoidance of doubt, that stamp duty on land and property will be unaffected by this measure.

LIFE ASSURANCE

24. The Finance Bill will also include a number of measures on Life Assurance, announced by my HF the Financial Secretary

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last December. These measures which flow from the changes in the 1989 Finance Act followed extensive consultation with the industry. They put the taxation of life-assurance companies' unit trust holdings on a sounder footing and make a number of technical improvements. They will yield £50 million in 1990-91.

BANKS

25. I also have a measure to announce which will clarify the tax regime for banks.

26. Tax relief is rightly available to banks as it is to other lenders for bad and doubtful debts. But it has given rise to two problems. First, in recent years the banks have increased very substantially the amounts written off for their lending to Third World countries. That has been widely welcomed, but sudden increases do have an adverse impact on the public finances. Over time, the tax cost of the 1989 increases could amount to going on for £1 billion.

27. Second, although the principle is clear, it is less clear how to implement it in practice. This is because the relief available depends on the extent to which the debts are estimated to be irrecoverable - and that is often far from clear-cut. This difficulty is magnified when the debts in

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question are those of sovereign nations rather than individuals or firms.

28. This is an extremely unsatisfactory position for the banks, for the Inland Revenue, and for the taxpayer. I have therefore decided to resolve it, and remove the uncertainties in the present law. Banks will continue to be able to offset their losses on sovereign loans fully against tax, but under a clearer mechanism than previously, which will be broadly based on the Bank of England's present guidelines. There will be a limit on future increases in the cost of this tax relief between years.

29. For next year, banks' tax relief on such provisions will be limited to the same high proportion of debts as this mechanism indicates for 1989. Thereafter, the ceiling will be increased in steps of 5 per cent a year, so that the banks will, in time, get all the tax relief to which they are entitled. If the banks sell their debt to a third party and crystallise their losses, their tax relief on them will be similarly phased. But where the debt is sold back to the foreign state, to reduce its debt once and for all, then tax relief on that loss will be available in full and immediately.

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30. This measure produces a yield of around £200 million in 1991-92, compared with what might be expected if I took no action. This will unwind in later years.

TAXES ON SPENDING

31. I now turn to taxes on spending. Given the need to keep a tight fiscal position, I have decided that, taken as a whole, the excise duties must rise broadly in line with inflation. Within that overall constraint, however, I have some modest adjustments to make.

32. First, Vehicle Excise Duty. I propose a number of changes in VED to remove anomalies in the taxation of different types of lorries. These changes will also dramatically reduce the present vast number of different VED rates. Last year's Budget removed 80 different VED rates, and I propose to eliminate a further 188 today. This will greatly simplify the system.

33. Vehicle Excise Duty on cars - the tax disc - will be unchanged once again this year at £100. Nor will there be any change in VED for public or private sector buses, coaches, taxis and many lorries.

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34. I will recoup the cost of this by increasing petrol and DERV duties by rather more than strict revalorisation would justify. These will rise by 10 per cent. This will add 9p to a gallon of DERV and almost 11 pence to a gallon of leaded petrol.

35. For unleaded petrol the cash increase will be smaller at around 9 pence per gallon. This will widen the tax differential even further in favour of unleaded petrol. This will now amount to almost 16 pence a gallon. The market share of unleaded petrol has increased fivefold, to 30 per cent, since the changes in the last Budget. I hope and expect to see it increase even further.

36. For alcohol, with one exception, I propose to raise the duties in line with inflation. This will put 7p on a bottle of table wine, but only tuppence on a pint of beer. Spirits, however, have enjoyed a duty standstill since 1985. I propose therefore an increase of 10 per cent, which will increase the price of a bottle of spirits by 54p.

37. Cigarettes also were not increased last year. This year I propose a 10 per cent increase in duty, which will put 10p on a packet of 20. The duty on cigars will rise similarly and will add 5p to the cost of a packet of five small cigars. But I do not this year propose any increase in duty on pipe

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tobacco. This at least will be one measure which will command the support of the Leader of the Opposition.

FOOTBALL

38. I now turn to football.

39. The tragedies at Bradford and Hillsborough Football grounds shocked us all. The Report by Lord Justice Taylor made recommendations to improve comfort and safety in our football league grounds over the next ten years.

40. Implementing the programme of work envisaged in the Taylor Report will place a significant burden on football clubs, which many of them will find extremely hard to bear. For many are in a very weak financial position, and only a handful are profitable. I recognise this problem, but I believe there is an acceptable way to overcome it. The first priority is to ensure that vital improvements in safety and comfort can be made. And the second is to avert what would otherwise be the closure of many of our grounds. If we help football now, I am confident football will contribute itself to the improvements in facilities that are necessary.

41. Let me say first that much of the expenditure required to meet the Taylor recommendations is eligible for capital

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allowances or for full offset against tax. I know there has been some confusion about this, and I have asked the Inland Revenue to provide urgent guidance to clarify the tax position.

42. But tax allowances cannot help where there is no profit to set costs against. This is the case with many clubs. I have therefore reviewed the rate of Pool Betting Duty - the tax which is paid by the pools companies on the stakes they receive. This currently stands at $42^1/_2$ per cent. I propose to reduce it to 40 per cent on the clear understanding that the full amount saved is passed by the pools promoters to the Football Trust, and is used by them to improve the safety and comfort of fans at English and Scottish football league grounds.

43. I am confident that such an arrangement can be negotiated with the pools promoters and the football authorities. Provided that we do so, the duty will be reduced, in the first instance for 5 years. At the end of that period, we shall review the position again.

44. This reduction will yield around £100 million for football over five years. This is in addition to the £75 million that the Football Trust have already said will be available over the next ten years. These sums represent very

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large contributions towards making sure that football league clubs can implement the Taylor recommendations and bring their grounds up to the safety standards both we - and they - want to see.

45. Millions of people watch football every year. With better and safer grounds I hope many more will join them.

INCOME TAX

46. Next, I deal with income tax.

47. I have no change to announce to either the basic or the higher rate of tax. They will remain at 25p and 40p respectively. But I do re-affirm our objective of moving towards a basic rate of 20p when it is possible to do so.

48. I turn now to personal tax allowances. This year I do propose to uprate the main income tax allowances by the statutory indexation factor of 7.7 per cent, rounded up.

49. The personal allowance will rise by £220 to £3,005. The new married couple's allowance will be set at £1,720, as will the additional personal allowance for single parents, and the widow's bereavement allowance. But the basic rate limit, the level at which higher rate liability begins, will be

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unchanged, at £20,700 of taxable income. [This means a married man with 2 children and a mortgage of £30,000 would begin to pay higher rate tax at £X.]

50. The allowances for the elderly will similarly be fully uprated in line with inflation. For those aged 65 to 74, the personal allowance goes up by £270 to £3,670 and the married couples' allowance by £160 to £2,145. For those aged 75 and over, the personal allowance goes up by £280 to £3,820 and the married couples' allowance will rise to £2,185. The income limit for these allowances will also be fully indexed to £12,300. [Add thought that this necessary to keep marginal rates below 40 per cent? Check.]

51. I also propose to raise the IHT threshold by £10,000 to £128,000 in line with inflation.

52. The Capital Gains Tax exemption - that is, the amount of Capital Gains free of tax in one year - currently stands at £5,000. However, from April, the introduction of independent taxation means married couples will be entitled to not one but two exempt amounts rather than having to share one between them as at present. I have therefore decided to leave the exempt amount at £5,000 per person and £10,000 for a married couple.

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COMPANY CARS

53. I also have to set the scales for the taxation of the private use of company cars. The tax treatment of this benefit remains generous, though less so than previously, as a result of the significant increases in these scales in recent Budgets. I therefore propose an increase - but a smaller one than in previous years, at 20 per cent. The yield from this will be £160 million in 1990-91. There will be no change in the fuel scales.

BLIND ALLOWANCE

54. In the tax system there is one allowance - the tax allowance for the blind - that although anomalous has long been accepted as a proper recognition of the special difficulties faced by blind people. The allowance is modest, but welcome, at £540 a year. I propose to make it less modest and more welcome, and double it. Next year it will stand at £1,080.

WORKPLACE NURSERIES

55. Before I leave income tax, I have a supply side measure to announce, which will help the labour market to work better.

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56. We have always made it clear that it is not for the Government to encourage or discourage women with children to go out to work. That is rightly a decision for them to take, and one in which the Government would be wise not to interfere.

57. But it is undeniable that an increasing number of mothers do want to return to work. And many employers - in private industry, and in public services such as health and education - are keen to encourage them to do so.

58. However, at present, if an employer provides a nursery for his staff in order to recruit and retain skilled people, any employee who benefits and who earns more than £8,500 a year is required to pay tax on the assessed value of the benefit in kind. Many employers have argued that this has created recruitment difficulties for them, and many women see this as an obstacle to the growth of childcare provision and a positive disincentive to return to work.

59. For these reasons, therefore, I have decided to exempt the value of workplace nurseries and playgroups from taxation as a benefit in kind. This will take effect from 6 April this year.

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CHARITIES

60. I indicated at the beginning of this speech that this Budget would include incentives both to save and to give. I will come to saving in a moment, but I want to deal with giving first.

61. We are by instinct a generous nation to causes that appeal to us. The tax system already offers a great deal of help to charities. It offers reliefs on their income and on their expenditure. And it provides incentives to encourage charitable giving. There is a relief for charitable covenants that has now been in operation for many years, and is worth nearly £200 million to charities every year. The arrangements for charities and donors who wish to give through charitable covenants are not, however, as simple as they might be and the Inland Revenue will therefore today be issuing new guidance to simplify them.

62. Since 1987 relief for covenants has been complemented by the payroll giving scheme, a very user-friendly way to relieve regular giving from tax. This scheme has been doing well since its launch and I now propose to increase the annual limit from £480 to £600.

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63. These reliefs are focused mainly on regular giving, which is of great importance to charities. But they are ill-suited to encourage the one-off gift which, for a variety of reasons, many people find more convenient. Over the years, this has been a persistent source of concern to charities. This year, I propose to go some way to meet those concerns.

64. I propose a Gift Aid scheme which for the first time will give tax relief for large single money donations. It is simply not practical to operate a relief for all small one-off gift. And in any event, such a relief might undermine regular giving through the payroll scheme and covenants, which are very important to some Charities. The lower qualifying limit for Gift Aid will therefore be £600 per donation - the new ceiling for payroll giving. The relief will be available on one-off gifts up to an annual ceiling of £5 million per individual donor. The tax relief will be reclaimable by the Charity, and payable to them at basic rate. [As with covenants, the higher rate relief is due to the donor - check.]

65. This relief, which will apply to gifts by both individuals and companies, will come into operation from 1st October this year. I am confident that it will maintain and strengthen the growth of charitable giving, and I very

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much hope that charities will promote it actively. It will, of course, be open to the whole range of registered charities from social causes to those whose activities are devoted to the arts.

66. I have one measure to help charities. This is a package of further new VAT reliefs giving help especially to organisations engaged in sea rescue, medical care and research. These will come into effect on 1 May and give an additional benefit of about £5 million a year to charitable work. Full details are set out in a Customs and Excise press release than is issued today.

SAVINGS

67. I now turn to the taxation of savings where I have a number of measures to announce. As I do so I am conscious that the majority of personal savings are the fruits of earnings which have already been taxed.

68. I start with saving in shares.

69. The development of the personal equity plan, which stands to the immense credit of my RHF, Blaby, has been an important boost for share-ownership. I am pleased to report to the House that last year was a record one for PEPs, with

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over 300,000 plans taken out, to the value of some £750 million.

70. To build on this success I propose to raise the overall annual limit on investment in PEPs by a quarter, from £4,800 to £6,000. Within that, the annual limit on investment in unit and investment trusts will be increased by the same percentage, to £3,000.

71. I am also sympathetic to the problems investment and unit trusts face in qualifying for PEP treatment. This arises from the requirement that 75 per cent of their portfolio should be invested in ordinary UK equities. I propose therefore to relax this rule, to 50 per cent. I also propose to raise the PEP limit for those trusts that do not satisfy this rule, from the present £750 to £900.

72. Last year, my RHF put employee share-ownership plans, or ESOPs, as they are known, on the statute book. ESOPs are a vehicle for giving employees a direct stake in the business for which they work. I believe they are an attractive option and deserve further encouragement. One impediment to their growth has been that the transfer of shares to the workforce can mean that the company owner faces an immediate tax charge. To prevent this happening I propose to introduce a rollover relief from capital gains tax for sales of shares to

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ESOPs. I believe this will remove an obstacle to the development of ESOPs and give this form of employee share ownership the fillip it deserves.

INDEPENDENT TAXATION

73. In a moment, I will turn to some new and significant tax changes for savers. But first, I wish to turn to a reform which was announced in the 1988 Budget and comes into effect next month - independent taxation for women. There is too little understanding yet of what this change will mean. It will fundamentally change the financial affairs of women.

74. At present the taxation of married women's income is wholly inconsistent with their role in society. In tax law their income is still considered to belong to their husbands. The effect of this is twofold. It denies married women any privacy or independence in tax matters. And too often it results in heavier taxation than is fair. Frankly it is time for this system to go, and go it will from April.

75. In future, a husband and wife will be taxed entirely separately. Every married woman will have a tax allowance of her own to set against her income - whether this income is from earnings, pension or savings.

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76. Three and three quarter million people will gain, of whom 2 million have incomes of less than £5,000 a year. One million elderly married couples will pay less tax, with 200,000 pensioner couples taken out of tax altogether.

77. No one will be sorry to see the old system go. One of its worst features was its treatment of the savings of married women. Whether they had other income or not, the interest on their savings was added to their husband's income and taxed at his rate. This was a clear penalty on thrift. But from April all that will end. This may well be the area where the reform has its greatest effect and will be most welcomed.

COMPOSITE RATE TAX

78. However, independent taxation has thrown into sharp relief another aspect of the tax system that affects all savers, and which no longer deserves to survive.

79. Some women will see the benefit of independent taxation automatically, if they have their money invested in national savings, or other accounts which pay interest gross of tax. But many women, particularly those with only small savings, prefer to save with High Street banks or building societies. And so, frankly, do many other small savers. For all these

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savers, income tax - or rather a proxy for it, the so-called composite rate - is deducted before the interest ever gets to the saver, and whether or not the saver is liable to pay tax.

80. Composite rate tax was introduced originally in 1894, and put on the statute book in 1951. It currently stands at just under 22 per cent. It is deducted at source. It cannot be reclaimed in any circumstances. This means that basic rate taxpayers gain by 3 per cent - the difference between the composite rate and the basic rate of income tax, which is what they should pay. And it means that non-taxpayers are worse off by 22 per cent.

81. The attraction of composite rate has always been that it allows small amounts of tax to be collected with ease from very large numbers of people. It is very convenient and very cost-effective. But the fact remains that with CRT, we tax people on low incomes who should not be taxed.

different order

82. It has, of course, always been possible for these people to avoid taxation, by saving in accounts that pay interest gross or where tax can be reclaimed. But the convenience of using banks and building societies has meant that they have not done so.

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83. The scale of the problem is compelling. Once Independent Taxation is implemented there will be 14 million people - nearly one quarter of the population - who have savings income that does not merit taxation, but which will be taxed under present legislation.

84. They include some 5 million married women with little or no other income of their own, 4 million pensioners, $2^1/_2$ million other adults, and $2^1/_2$ million children with small savings accounts - often funded with small gifts of money from grandparents, or savings from pocket money.

85. There is no way out of this problem other than to abolish composite rate tax entirely. This I propose to do with effect from 6 April 1991, the earliest practicable date. From then on tax will fall on those who should pay it, and will not fall on those who should not pay it.

86. We shall discuss with the banks and building societies how to effect this change. I envisage a scheme of self-certification that will allow non-taxpayers to be paid their interest without deduction of tax. For other savers, tax will continue to be deducted at source, but at basic rate. However, unlike composite rate tax any tax deducted will be reclaimable by any non-taxpayers who, for any reason, may not have been able to self-certify for gross payment.

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87. This change will reduce significantly the amount of tax paid by millions of married women, pensioners, children, and others with small savings. It will relieve them of tax which they should never pay. And by removing the penalty of composite rate tax it will play an important part in encouraging the savings habit.

NATIONAL SAVINGS

88. Meanwhile, I am announcing today a 1 per cent increase in the interest rates paid on National Savings Investment Account and Income Bonds where interest is already paid gross. This too will help encourage saving, particularly by non-taxpayers. The Department for National Savings will also be introducing later this year a new Series of the [popular] Capital Bond, with simpler arrangements for paying tax on interest.

TESSA

89. However, as well as removing the tax impost for non-taxpayers, I do wish to do more to encourage the saving habit among taxpayers - all of them.

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90. In the 11 years we have been in office, a series of Budgets have removed penal rates of tax, abolished the investment income surcharge and introduced important new schemes to encourage saving and investment. I intend now to build further on those measures. And that means going beyond the incentives to saving that we have built up so far. These schemes have been immensely successful in spreading share ownership, and will continue to be so in the future. But I now want to extend savings incentives to the mass of ordinary taxpaying savers - and potential savers - who prefer to put their money in the familiar security of High Street banks and building societies.

91. My next measure is addressed precisely to them. I propose to introduce a wholly new tax incentive which will reward saving and encourage people to build up a stock of capital.

92. The scheme will work as follows. Every adult will be entitled to one Tax Exempt Special Savings Account, TESSA for short. This account can be held at any bank or building society. The essence of the scheme is to encourage people to save regularly over a 5 year period. The incentive for them to do so is that all the interest earned on their capital will be entirely free of tax, provided only that the capital itself is left undisturbed over the 5 years.

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93. The annual limit on the amount that can be invested will be £1,800, or £150 a month. In the first year, anyone who has capital that they are willing to tie up for longer can put this money in their account from the outset, up to a limit of £3,000. But the overall limit of £9,000 for the whole plan applies nonetheless.

94. To cope with the circumstances of many small savers - particularly pensioners - who use the interest on their savings for their everyday expenses, it will be possible to withdraw interest as it accrues, but only up to the net-of-tax level. At the end of the 5 years, the depositor then gets a bonus representing the money which would otherwise have gone in tax. The depositor will get this provided none of the capital has been withdrawn before the five years is up. They can, of course, withdraw the capital at any time, but without tax relief. [Should we add: It will, of course, be possible for the banks and building societies to offer additional bonuses for term deposits, but that is a matter for them.]

95. This scheme is convenient, flexible and simple. It extends PEP treatment to ordinary savings. It caters for those who want to save monthly, annually, or in irregular amounts. It represents a substantial incentive to save, and

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I am confident that TESSA will play its part in reviving the culture of thrift. I also believe it is both desirable and fair to reduce tax on small savings.

96. This new relief will be available from next January. Its cost will depend on take-up but could be around £200 million in the first full year, rising in the longer-term.

CAPITAL DISREGARDS

97. This Budget has contained a whole range of savings incentives. It has done so because I believe it is economically right to encourage savings. And because I believe also it is socially right - not least because of the independence and security it offers to savers as they build up capital of their own. But there is little point in encouraging savings if you leave in the system an over severe penalty for doing so. I turn therefore, to the social security system, and what has become known as the capital disregard rule.

98. As the House knows, people with more than a certain level of savings - £6,000 in the case of income support and family credit and £8,000 in the case of housing benefit and community charge benefit, become completely ineligible for

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all means-tested benefits, however low their weekly or monthly income may be.

99. This rule is widely resented as a penalty on thrift and self-provision. This is strongly felt by elderly people who have some capital but who use the interest on it for living expenses, and cannot afford to run it down. They also face the problem that, having retired, they are less able to replace their savings, which they see as essential for the security.

100. Although there must, of course, be some upper limit for benefits, I understand why people do not want to lose their nest egg. I have therefore reviewed the present limits, with my RHF, the Secretary of State for Social Services, and have decided that they should be raised.

101. The limit for income support and family credit will rise from £6,000 to £8,000. But the problem is most acute for ~~from~~ housing benefit and community charge benefit. I propose therefore to increase the capital cut-offs for both of these benefits from £8,000 to £16,000. The new limit will apply both to couples and to single people [so that widows and widowers will not face the loss of their social security help at a time when it may be most needed]. This measure will benefit around $^{1}/_{4}$ million people in all two thirds of them

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pensioners, who are at present wholly excluded from benefit. It will cost £120 million next year which will be met from the Reserve and will not increase the public expenditure totals.

102. To avoid delay, my RHF is laying the necessary regulations today so that limits will be increased when benefits are uprated at the beginning of April. He will discuss the operational implications of this change with local authorities immediately.

PERORATION

103. Mr Speaker, that concludes the package of measures I have to announce.

104. The Budget I have presented today takes no risks with inflation. It further strengthens the public finances. Where it has raised taxation, it has done so in the right way. It is firm but fair. It will be accompanied by tight monetary policy until inflation turns down.

105. It has re-affirmed our intention to the ERM. It has made sweeping changes to the taxation of savings. It has removed unfair impositions in the tax and social security systems. It ushers in a better deal for women. It has

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offered help to charities and sport. It has abolished two taxes and reduced the tax burden on growing companies.

106. It is the right Budget for this year, and it sets the right course for the '90s.

107. I commend it to the House, and the country.

[wordcount = 6,178] complete

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From the Private Secretary

Note

P.M. ~~also~~ spoke to the Chancellor on the telephone on 17/3 and gave him various helpful comments.

PREG 18/3

PRIME MINISTER

As promised I attach:

- the draft Budget speech in 2 sections
- the scorecard and forecast summary.

I have marked one or two quick thoughts on the text. The Chancellor is aiming to finalise it (at home) on Sunday afternoon. So it would help to get any comments before then. He will, however, be out of touch on Saturday morning.

There are 2 options:

① You could ring the Chancellor from Chequers, then both of you will have the text in front of you.

② You could ring me before you go to Chequers. I won't have the text, but you could give me paragraph references. I would then pass them on to the Chancellor on his office later in the day.

PREG
16/3

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Draft 16 March 1990

DRAFT

BUDGET SPEECH

Does it? Surely bringing down inflation is the main objective?

[Mr Speaker] The Government's economic policy has two main objectives.

2. The first is to bring down inflation. Until that happens, we will not be able to reduce interest rates and keep them down.

3. The second is to enable this country to take the opportunities of the 1990s. In Western Europe, the single market is nearly on us and the whole of Eastern Europe has opened up in a most dramatic way. I wish to see British business take advantage of these changes.

4. These two objectives are closely related. Unless we succeed in the first, we are unlikely to do so in the second.

5. So this Budget will take no risks with inflation. It will maintain a strong fiscal surplus.

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6. It will, above all, be a budget for savers. It will provide new incentives to save and to give. It will bring the introduction of independent taxation for married women. It will introduce important new measures for business. It will keep up the pace of supply side reform. It will remove an old grievance from the tax system and make the social security system fairer. And it will abolish two taxes.

7. I will come to the detailed measures later. First, I wish to review the performance of the economy in 1989 and preview the prospects for 1990; I will then deal with monetary policy and public sector finances.

8. As usual, the Red Book, together with a number of Press Releases filling out the details of the Budget measures, will be available from the Vote Office as soon as I have sat down.

ECONOMIC PERFORMANCE AND PROSPECTS

9. First, the economic background.

10. 1989 saw continued buoyant growth in world trade despite some slow down in the growth of the major economies particularly in the United States. However increased inflation and fears of overheating in continental Europe led to increases in short-term interest rates in most major

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economies during the year and, more recently, a rise in long-term interest rate particularly in Germany where uncertainty about the effects of monetary union has been an additional factor.

11. This tightening of monetary policy is likely to bring lower growth in 1990 than in 1989 and, in due course a fall in inflation. We are likely, therefore, also to see a slower growth in world trade in the current year, although the exciting developments in Eastern Europe improve the longer-term prospects.

12. In this country during the last year, business confidence has been a good deal stronger than many expected. New businesses have outnumbered closures, by around 1,500 every week, a record never before approached. Employment has continued to rise, and unemployment to fall. Almost 27 million of our fellow citizens are in work today - a larger number than ever before and $1^1/_2$ million more than at the beginning of the '80s. Business investment has risen by a further 9 per cent in the last year, taking it to 15 per cent of national output - the highest level ever.

13. And companies have not just been investing in plant and machinery. Their spending on research and development has also risen in real terms by almost 50 per cent in the

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five years to 1988. They now spend over £500 million a year of their own money on R&D. Similarly in the 5 years up to 1989 the numbers of employees receiving training has increased by over 70 per cent.

14. These are all favourable developments but recently they have been accompanied by the return of inflationary pressures. That, beyond any doubt, is the most urgent problem, before us today.

15. To a degree it is a problem common to all nations. Throughout the Group of Seven leading economies of the Western world inflation has risen significantly since its low point in 1986 and 1987. But our affliction has been sharper. It has arisen from a combination of reasons - some welcome and some not. The record rise in business investment is obviously welcome; but it has been accompanied by a similar growth in borrowing and in consumer spending. Thus investment has been rising but the savings to finance it have not.

16. This has led to excessive growth in domestic demand, a revival of inflationary pressures, and a current account deficit, a good deal of which itself represents suppressed inflation.

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17. As soon as these developments became clear, policy was tightened, and interest rates have now been in double figures for 20 months. This tight monetary policy has been backed by large Budget surpluses throughout the last three years. So monetary and fiscal policy have acted together.

When?

See 1981-83

18. Squeezing out inflation is always a slow business and this occasion is proving no exception. But there is now clear evidence that demand is slowing down. High Street sales are now only 2 per cent up on a year ago. The housing market has cooled off noticeably. New car and vehicle registrations are down. Business spending is slowing and import growth has almost come to a halt. been sharply reduced.

19. And as demand has fallen back, output growth has fallen also, to just over 2 per cent in 1989.

20. No one likes to see the economy slow but it is inevitable if we are to push inflation downwards. I now expect the economy to grow by only 1 per cent this year, compared with the above trend growth of $4^1/_2$ per cent in 1987 and 1988. This single statistic shows the extent of the downward pressure on inflation. But growth should return in 1991 towards its sustainable rate of around $2^3/_4$ per cent.

does it

But inflation will not have fallen far enough by then.

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21. I am confident that the period of low growth will be short-lived because of the permanent improvements in the underlying economy in the 1980s. Investment has grown more than twice as fast as consumption over the last eight years. As this additional capacity is fully utilised inflationary pressures will lessen and more normal growth will resume. No one need have any doubt about that.

but from a very different base.

22. Last year also saw a record level of foreign direct investment into Britain. These investments are particularly welcome as they are in industrial sectors like cars and electronic goods where a high proportion of the output is usually exported. For example, I wonder how many people realise that Britain now runs a trade surplus in colour TVs.

But does a trade deficit in so much due.

23. This increased capacity will enable British industry to meet domestic demand and to respond to export opportunities. Indeed, that is already beginning to happen. The current account deficit for 1989 as a whole was a little over the £20 billion I forecast at the time of the Autumn Statement. But the deficit in the last 3 months was substantially lower than in the previous quarter and, in particular, the manufacturing deficit is now improving. Exports have been growing faster than imports for at last [X] months.

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24. The reason for this improvement is twofold. A year ago, rapidly expanding domestic demand sucked in imports to meet a market that domestic manufacturers could not supply. Moreover, that same demand absorbed British goods that would otherwise have been exported. This pattern is now reversing.

25. Exports are now growing rapidly, regaining the share of world markets they lost in 1988. Last year, the volume of exports of manufactures grew by $11^1/_2$ per cent - the highest recorded rate for nearly 20 years.

26. It is encouraging - though not surprising - to see British industry responding so well to export opportunities. And it illustrates clearly that the deficit is not caused by poor industrial competitiveness. The primary problem has been excess demand and as that is reduced the current account will improve. I expect the deficit to fall to £15 billion in 1990 and further thereafter.

I fear this will give rise to hollow laughter

a colossal figure

27. But notwithstanding the prospect of lower growth we cannot afford to relax policy. The buoyancy of past demand means that inflation has been far more stubborn than anyone expected. A significant fall is still some months away and a number of factors will ensure that the position will worsen noticeably before it improves. This will be reflected in the Retail Price Index during the next few months.

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28. The largest single factor is the growth of some £4 billion in local authority spending next year. This is mainly responsible for the expected growth of over 30 per cent in average community charges compared with domestic rates, which will add over 1 per cent to the RPI next month.

29. Similarly the further rise in mortgage rates last month will also increase the Retail Price Index. As a result, I now expect that RPI inflation may still be a little over 7 per cent by the fourth quarter of this year, compared to the $5^3/_4$ per cent I had previously forecast.

30. Beyond that - as these one-off increases drop out of the index and the effect of monetary tightening builds up, I expect inflation to fall below 5 per cent during 1991.

31. To summarise, the economy - both consumption and investment - has been very resilient in recent years. Adjustment so far has been gradual. But this is not necessarily a good guide to the future. The gradual adjustment may continue but equally the turnaround may become quite sharp.

down but
i.e. down?
or up?

I wonder whether it is wise to say this.

32. I do not propose to pretend certainty where there can be none. I am only too well aware that it is against an

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uncertain background that I must set monetary and fiscal policy, to which I now turn.

MONETARY POLICY

33. I want to deal with monetary policy and interest rates first for two reasons: because they are of great concern in the House and in the country and because as always they provide the key to progress on inflation.

34. I know that high interest rates are unpopular. But they are most unpopular as they become most effective. They discourage spending and borrowing. They act directly on the things we have to influence if we are to get inflation down.

35. Interest rates are also the most flexible way of responding to what can be a rapidly changing situation. They can be raised quickly when necessary. And they can be relaxed just as quickly when it is safe to do so.

36. In recent months I have looked carefully to see if there is an effective alternative to interest rates. Many people, I know, favour direct controls on bank lending, hire purchase and consumer credit. But [~~apart from their inherent undesirability and unfairness~~,] it is extremely unlikely that they would work in the modern world. They were becoming less

It is the nature to hit many you so hard

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and less effective even before exchange controls were abolished over ten years ago. Their main impact now would be to replace domestic borrowing with overseas borrowing. For these days it would be a simple matter for any High Street bank to arrange its lending through an overseas branch.

37. It is for this reason that governments of all persuasions throughout the Western world are abolishing credit controls and are relying on interest rates to control money and thus inflation. The same is true of those in Eastern Europe who are seeking to join the Western system.

38. But as financial markets have become more open to competition their behaviour has changed enormously. They have become harder to read and that has made monetary conditions more difficult to judge as well. This is one of the consequences of financial deregulation which has brought great benefits as well as some problems.

Not for the Germans & French or Dutch.

39. So, although monetary policy remains the key to controlling inflation, it is not realistic to suppose that we can take decisions solely by reference to the way any one particular measure of money is growing. In a more sophisticated world, we must apply judgement and take into account the other evidence about monetary conditions that may be available .

I would expect you then to go on to that. Other evidence — but you don't see overall

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? Go straight to para 43.

Paras 40. para 41 & 42 para 45

40. Inflationary pressures will always be with us. Whether they originate in international circumstance or domestic behaviour, they are not easy to suppress. But faced with such pressures what we can do is to seek to bring the inflation rate back onto a downward path. That is the objective of the Medium Term Financial Strategy I am publishing today.

41. Progress on reducing inflation is as essential for social reasons as it is for the economy. It is also a vital pre-condition of our taking sterling into the exchange rate mechanism of the European Monetary System. Our commitment to do so was set out at Madrid, it remains firm, and the conditions for entry remain unchanged.

NB

42. In due course, joining the exchange rate mechanism will provide a new short term framework for interest rate decisions. But even then, no one should suppose it will bring a dispensation from the need for - strong domestic monetary control. Indeed, quite the reverse. Commitment to the one will reinforce the commitment to the other.

43. In recent weeks I have re-examined the role of monetary targets. I have concluded that it is sensible to maintain a target for narrow money, and that this is best measured by

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the familiar aggregate M0. Since this is essentially notes and coin, it clearly is not a comprehensive measure of money in all its uses. But it does have value as a proven indicator of transactions and has been a reliable guide for many years. For next year I have set the target range at 1 to 5 per cent. Although the growth of M0 has fallen from its earlier peaks, it is likely to start the year above the range and it may be some months before it falls within it.

44. I have also examined closely the case for reintroducing a target for broad money. I can understand why some favour this. At times broad money has given a useful indication of the build up of inflationary pressure. The difficulty is that its message has always varied in quality: its growth can represent money that is about to be spent, or money that is very definitely being saved: savings which I wish to encourage as will become apparent later in my speech. So, although we will monitor M4 carefully, and give it weight in our decisions, I do not intend to set an target for the year ahead.

45. Finally I have reviewed whether there should be any changes in the Government's funding policy. The objectives must be to manage public debt in a way that supports monetary policy, without distorting financial markets. I have concluded that in general policy should continue to be guided

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by the funding rule followed in recent years, with the public sector avoiding sustained under or overfunding. But in practice the rule cannot and should not be operated rigidly. In particular, in recent years there has been an increase in the size of the Treasury bill issue, largely as a result of a change in the financial position of local authorities. In the circumstances, the Government will if necessary adjust its funding operations, increasing gilt sales or reducing gilt purchases, to take account of this.

46. To sum up, interest rate decisions will continue to be made on the basis of the growth of monetary aggregates, and a range of other evidence most notably the exchange rate. This matters because it provides important information about domestic monetary conditions - quite apart from having a direct effect on prices. But there is, as I have made clear, no single lodestar to guide us in monetary policy. Life would be simpler if there were but it just does not exist. So judgement is unavoidable.

NB

Not always. Spectacular rise in prices to induce to keep them market

47. And for now the judgement must remain this: I judge that interest rates ~~must~~ will stay high for some time to come. The moment I judge I can safely lower them, I will. But to reduce them prematurely only to increase them again would be extremely damaging. When I bring them down it will be because I believe they are likely to stay down.

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48. In Chapter 2 of this year's Red Book I have provided a much longer and more comprehensive account than usual of how monetary policy, including funding policy, is to be operated over the years ahead. I hope this will be helpful to the House, and in particular to members of the Treasury and Civil Service Select Committee when they come to examine the Budget documents in detail.

FISCAL POLICY

49. Although monetary policy must play the main role in tackling inflation, a tight fiscal policy is also essential. It cannot do the work of monetary policy, but it can and must support it.

50. The dramatic improvement in the state of public finances over the last 10 years under the stewardships of my RHFs is an achievement of which they can be rightly proud. For decades successive Governments have spent more than they were prepared to raise honestly from taxation and made up the shortfall by borrowing. They left the bill to be picked up by future generations.

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51. Over decades that bill mounted to very considerable levels. Today, just paying the interest on the accumulated debt accounts for 10p on income tax.

52. Over the past 10 years we have reversed that trend; and in the last three we have re-paid around £25 billion, reducing the burden of government debt to levels we have not seen since before the first world war.

53. The rewards of this repayment will be felt by future generations but they bring also an immediate benefit. As a result of the debt repayments we are saving over £2,500 million a year in debt interest. That is sufficient to meet the annual cost of 150 district general hospitals.

54. The very large Budget surpluses in 1988 and 1989 owed much to cyclical factors. In the current year, as I indicated to the House some months ago, we expect the surplus to fall back. The position is still uncertain, as it usually is at this time of year, but our best estimate is that the debt repayment this year will be around £7 billion. £9.6m

55. This fall in the surplus owes less to the slowdown in growth than to a number of special factors. We have seen a fall in privatisation proceeds from the very high level achieved in 1988-89. There has also been a sharp and

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unwelcome increase in local authority spending. This has been particularly marked in their capital spending, as they have sought to forestall the new controls which will take effect in April. As a result, we now expect the public expenditure planning total this year to be overshot by £$2^1/_4$ billion. The overshoot arises solely because of overspending by local authorities; central government expenditure remains well under control.

56. Another, but much more welcome, factor reducing the surplus has been the higher national insurance rebates that have resulted from the huge success of personal pensions. This extension of choice is a considerable tribute to my RHF, Sutton Coldfield. Over $3^1/_2$ million people have now been taken out personal pensions. As well as benefiting the individuals concerned, in the long-term this will reduce public spending. But it also reduces national insurance receipts, by £$2^1/_2$ billion this year.

57. Next year, some of these factors will not be repeated but we will see the effect of slower growth on the debt repayment. In particular corporation tax receipts are likely to be significantly lower, not least because of the higher investment of recent years which entitles businesses to higher allowances against tax. These allowances will be

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worth over £9 billion to companies next year. These cyclical factors will build further in subsequent years.

58. It is against the medium-term fiscal prospect that I have framed the Budget judgement; for fiscal policy is not a flexible instrument which should be altered to meet short-term contingencies. Fine tuning fiscal policy is not only disruptive to the public sector, business, and to taxpayers but its effects on the economy are both uncertain and often destablising.

59. Accordingly, I am budgeting next year for a further Public Sector Debt repayment of £7 billion - the same as this year. Looking further ahead, I expect our fiscal position to move towards the medium-term objective of a balanced budget, an objective I reaffirm today.

60. The overall effect of the Budget measures I announce today will be to maintain a tight fiscal policy, modestly increasing the yield from taxation by approaching £$^1/_2$ billion next year and just under £1 billion in the year after that.

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REF. NO. MW/90/27
COPY NO. 1 OF 16.

cc: Mr Gray (No.10) (2)
Mr O'Donnell (6)
Mr Ritchie (3)

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MPW 16/3

DRAFT: 16.03.1990
CLOSE OF PLAY

TAXATION SECTION

I now come to the detailed measures in this year's Budget. And I shall begin with the taxation of business.

2. Everyone in this country benefits from the success of British enterprise. Tax reform cannot create success but it can help it, and encourage it.

VAT

3. Within the tight fiscal position I judge necessary, I am able to make some changes that should help small and medium sized companies.

4. Cash flow is particularly important to companies of this size. To improve it, therefore, I have two measures that should help.

5. At present, traders pay Value Added Tax on all their sales, even if their customers do not actually pay the bill. They can only claim VAT relief for a bad debt when the debtor has been declared formally insolvent. As a result, the

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trader - who has dealt in good faith - can be out of pocket, in some cases for years, and often for large sums.

6. This has long been resented by businesses and the time has come to deal with it. I therefore propose that from April next year all debts which are over 2 years old and written off in the trader's accounts will qualify automatically for relief from VAT. This will be worth some £150 million to business next year.

7. I also propose to help smaller companies by simplifying the rules for traders registering for VAT. At present whether or not you have to register depends on quarterly and annual turnover thresholds. You only have to say this to realise how difficult it is. Businesses also have to peer into the future to see if these limits might possibly be exceeded within the next year. This complication is unnecessary. So as from today, I propose a simple rule for VAT registration. This will be based on actual turnover in the preceding 12 months and not unknown turnover in the distant future. It will bring certainty and simplicity in place of uncertainty and complexity. Because businesses will, in general, register later than they otherwise would have, it will save them £35 million in 1990-91 and £75 million the year after.

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8. I have two further VAT changes. First, I propose to increase the VAT threshold to £25,400, a modest sum, but the maximum permitted under European Community law.

9. The second change will affect companies which provide accommodation for their own Directors. As things stand, the firm can deduct the VAT they pay on this, for something that is more a fringe benefit than a legitimate business cost. Frankly I do not believe this generous treatment is justified. I therefore propose that VAT paid on Directors' accommodation should no longer be deductible. This will take effect from [April 5 this year].

CORPORATION TAX

10. I also have some changes to Corporation Tax. While the main rate of corporation tax will remain at 35 per cent, I have some changes to propose that will reduce the burden of tax for small companies.

11. At present companies with profits below £150,000 pay a reduced rate of Corporation Tax of 25 per cent. For the coming financial year, I propose to raise this ceiling by one third, to £200,000. This amounts to a doubling in two years of the profits levels for the reduced rate, and will be of special benefit to smaller growing companies.

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12. For companies with profits above this limit, the average rate of tax gradually rises until they reach the upper profits limit of £$^3/_4$ million a year. I propose to widen this intermediate band by raising the upper profits limit, again by a third, to £1 million. This means that no single company will be liable for the full rate of Corporation Tax until its profits reach £1 million a year. This represents the most favourable structure of tax rates for small companies anywhere in the EC.

TRAINING

13. I also have one specific tax change to help training.

14. One of the most welcome features of the last few years has been the massive amounts of money being invested in training throughout the economy. Indeed, the latest estimates put this at some £20 billion a year.

15. All companies' expenditure on training is, of course, tax allowable, and in addition the Government is spending £2$^1/_2$ billion a year on training programmes. Over £2 billion of this will in future be spent through TECs, most of which will be coming into operation over the next year.

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16. I believe that TECs will do much to improve training in this country, and I have no doubt that we shall see the benefits in years to come. They will give the private sector a new opportunity to determine its own needs, contribute to them, and receive generous cash and tax help to meet them.

17. The Government has undertaken to match local business donations to TECs pound for pound within certain limits. I now propose to encourage business to put more money into training by giving tax relief on business donations to TECs for five years until April 1995. And I propose to extend the same concession to local enterprise agencies until the same date.

STAMP DUTY

18. My next announcement has implications for one in four of the adult population. For that is the number of people - nearly 11 million people - who own shares in the UK today, a new record.

19. Over the next few months, the Stock Exchange will be taking crucial decisions on their plans for a new share-dealing system, affectionately known as TAURUS. This will cut costs and eliminate paper forms, and provide a modern computerised system for transferring shares.

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Decisions on the design of the new systems for TAURUS will have to be taken shortly. We need, therefore, to decide what stamp duty regime to apply to paperless transactions.

20. As we approach 1992 we can expect even sharper international competition in financial services, much of it from other European centres. Competitive and practical arguments point in the same direction. I have therefore decided to abolish stamp duty on securities late in 1991-92 to coincide as far as possible with the introduction of paperless dealing.

21. The assumption in the Red Book is that abolition will be at the end of 1991, at a revenue cost of £120 million in 1991-92. This date will be subject to confirmation later when I have fuller information about the progress of TAURUS. However, although there is some flexibility about the timing, there is no doubt about the decision to abolish stamp duty on shares. I have made the announcement now to remove uncertainty and make clear that there is no need to plan for stamp duty within TAURUS. I should add, for the avoidance of doubt, that stamp duty on land and property will be unaffected by this measure.

22. Both the abolition of the tax and the introduction of a more modern dealing system will help to secure the UK's

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position as a financial centre in an increasingly competitive global market. Furthermore, by reducing transaction costs they will permit higher returns for 11 million holders of occupational pension schemes, the $3^1/_2$ million personal pension holders as well as the many millions of people who hold life assurance policies or unit trusts. It will also be of particular benefit to small shareholders.

LIFE ASSURANCE

23. The Finance Bill will also include a number of measures on Life Assurance, announced by my HF the Financial Secretary last December, which flow from the changes in the 1989 Finance Act. The measures followed extensive consultation with the industry. They put the taxation of life-assurance companies' unit trust holdings on a sounder footing and make a number of technical improvements. They will yield £50 million in 1990-91.

BANKS

24. I also have a measure to announce which will clarify the tax regime for banks.

25. Tax relief is rightly available to banks as it is to other lenders for bad and doubtful debts. But it has given

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rise to two problems. First, in recent years the banks have increased very substantially the amounts written off for their lending to Third World countries. That has been widely welcomed, but sudden increases do have an adverse impact on the public finances. Over time, the tax cost of the 1989 increases could amount to going on for £1 billion.

26. Second, although the principle is clear, it is less clear how to implement it in practice. This is because the relief available depends on the extent to which the debts are estimated to be irrecoverable - and that is often far from clear-cut. This difficulty is magnified when the debts in question are those of sovereign nations rather than individuals or firms.

27. This is an unsatisfactory position for the banks, for the Inland Revenue, and for the taxpayer. I have therefore decided to resolve it, and remove the uncertainties in the present law. Banks will continue to be able to offset their losses on sovereign loans fully against tax, but under a clearer mechanism than previously; and there will be a limit on future increases in the cost of this tax relief.

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28. For next year, banks' tax relief on such provisions will be limited to the same high proportion of debts as this mechanism indicates for 1989. Thereafter, the ceiling will be increased in steps of

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5 per cent a year, so that the banks will, in time, get all the tax relief which they are due. If the banks sell their debt to a third party and crystallise their losses, their tax relief on them will be similarly phased. But where the debt is sold back to the foreign state, to reduce its debt once and for all, then tax relief on that loss will be available in full and immediately.

29. This measure produces a cash flow yield of around £200 million in 1991-92, compared with what might be expected if I took no action. This will unwind in later years.

TAXES ON SPENDING

30. I now turn to taxes on spending. Given the need to keep a tight fiscal position, my judgement is that, taken as a whole, the excise duties must rise broadly in line with inflation. Within that overall constraint, however, I have some modest adjustments to make.

31. First, Vehicle Excise Duty. I propose a number of changes in VED to remove anomalies in the taxation of different types of lorries. These changes will also further reduce the number of different VED rates. Last year's Budget removed 80 different VED rates, and I propose to eliminate a

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further 188 today. This will greatly simplify the system, but will by no means perfect it.

32. Vehicle Excise Duty on cars - the tax disc - will be unchanged once again this year at £100. Nor will there by any change in VED for buses, coaches, taxis and many lorries.

33. I will recoup the cost of this by increasing petrol and DERV duties by rather more than strict revalorisation would justify. These will rise by 10 per cent. This will add 9p to a gallon of DERV and almost 11 pence to a gallon of leaded petrol.

34. For unleaded petrol the cash increase will be smaller at around 9 pence per gallon. This will widen the tax differential in favour of unleaded still further, to almost 16 pence a gallon. The market share of unleaded petrol has increased fivefold, to 30 per cent, since the changes in the last Budget. I hope and expect to see it increase even further.

35. For alcohol, with one exception, I propose to raise the duties in line with inflation. This will put 7p on a bottle of table wine, but only tuppence on a pint of beer. Spirits, however, have enjoyed a duty standstill since 1985. I

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propose therefore an increase of 10 per cent, which will increase the price of a bottle of spirits by 54p.

36. I propose also a 10 per cent increase in duty for cigarettes, which will put 10p on a packet of 20. The duty on cigars will rise similarly and will add 5p to the cost of a packet of five small cigars. But I do not this year propose any increase in duty on pipe tobacco. This at least will be one measure which will command the support of the Leader of the Opposition.

FOOTBALL

37. I now turn to football.

38. The tragedies at Bradford and Hillsborough Football grounds shocked us all. The Report by Lord Justice Taylor made recommendations to improve comfort and safety in our football league grounds over the next ten years.

39. Implementing the programme of work envisaged in the Taylor Report will place a significant burden on football clubs, which many of them will find extremely hard to bear. For many are in a very weak financial position, and only a handful are profitable. I recognise this problem, but I believe there is an acceptable way to overcome it. The first

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priority is to ensure that vital improvements in safety and comfort can be made. And the second is to avert what would otherwise be the closure of many of our grounds. If we help football now, I believe football will be able to help itself in future.

40. Let me say first that much of the expenditure required to meet the Taylor recommendations is eligible for capital allowances or for full offset against tax. But there is still some confusion in this area, and I have asked the Inland Revenue to provide urgent guidance to clarify the tax position.

41. But tax allowances cannot help where there is no profit to set costs against. I have therefore reviewed the rate of Pool Betting Duty the tax which is paid by the pools companies on the stakes they receive. This currently stands at $42^1/_2$ per cent. I propose to reduce it to 40 per cent on the clear understanding that the full amount saved is passed by the pools promoters to the Football Trust, and is used by them to improve the safety and comfort of fans at English and Scottish football league grounds.

42. I am confident that such an arrangement can be negotiated with the pools promoters and the football authorities. Provided that we do so, the duty will be

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reduced, in the first instance for 5 years. At the end of that period, we shall review the position again.

43. This reduction will yield around £100 million for football over five years. It will be added to the £75 million which the Football Trust have said will be available over the next ten years. These sums represent very significant contributions to ensuring that football league clubs bring their grounds up to the safety standards we all want to see.

44. Millions of people watch football every year. With better and safer grounds I hope they will continue to do so, and that many more will join them.

INCOME TAX

45. Next, I deal with income tax.

46. I have no change to announce to either the basic or the higher rate of tax. They will remain at 25p and 40p respectively. I re-affirm our objective of a basic rate of 20p, but I can make no move towards it this year.

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47. However, I do propose to uprate the main income tax allowances by the statutory indexation factor of 7.7 per cent, rounded up.

48. The personal allowance will rise by £220 to £3,005. The new married couple's allowance will be set at £1,720, as will the additional personal allowance for single parents, and the widow's bereavement allowance. But the basic rate limit, the level at which higher rate liability begins, will be unchanged, at £20,700 of taxable income.

49. The allowances for the elderly will be fully uprated in line with inflation. For those aged 65 to 74, the personal allowance goes up by £270 to £3,670 and the married couples' allowance by £160 to £2,145. For those aged 75 and over, the personal allowance goes up by £280 to £3,820 and the married couples' allowance will be £2,185. The income limit for these allowances also rises by 7.7 per cent to £12,300.

50. I also propose to raise the IHT threshold by £10,000 to £128,000 in line with inflation.

51. I do not propose to increase the Capital Gains tax exemption from its present level of £5,000 [this year]. However, the introduction of independent taxation means married couples will benefit from two exempt amounts

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totalling £10,000 a year, rather than having to share one between them as at present.

COMPANY CARS

52. I also have to set the scales for the taxation of the private use of company cars. The tax treatment of this benefit remains generous, though less so than previously, as a result of the significant increases in these scales in recent Budgets. I therefore propose an increase - but a smaller one than in previous years, at 20 per cent. The yield from this will be £160 million in 1990-91. There will be no change in the fuel scales.

BLIND ALLOWANCE

53. In the tax system there is one allowance - the tax allowance for the blind - that although anomalous has long been accepted as a proper recognition of the special difficulties faced by blind people. The allowance is modest, but welcome, at £540 a year. I propose to make it less modest and more welcome, and double it to £1,080.

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WORKPLACE NURSERIES

54. Before I leave income tax, I have a supply side measure to announce, which will help the labour market to work better.

55. We have always made it clear that it is not for the Government to encourage or discourage women with children to go out to work. That is rightly a decision for the parents to take, and one in which the Government should not interfere.

56. But it is undeniable that an increasing number of mothers do want to return to work. And many employers - in private industry, and in public services such as health and education - are keen to encourage them to do so.

57. However, at present, if an employer provides a nursery for his staff in order to recruit and retain skilled people, any employee who benefits and who earns more than £8,500 a year is required to pay tax on the assessed value of the benefit in kind. Many employers have argued that this has created recruitment difficulties for them, and many women see this as a positive disincentive to return to work.

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58. For these reasons, therefore, I have decided to exempt the value of workplace nurseries and playgroups from taxation as a benefit in kind. This will take effect from 6 April this year.

59. I accept the view of many businesses that this will give extra impetus to the trend for employers to invest in good quality nursery provision for their staff. And it has the additional advantage that it will make the tax system a little bit simpler for employers and the Inland Revenue to administer.

CHARITIES

60. I indicated at the beginning of this speech that this Budget would include incentives both to save and to give. I will come to saving in a moment, but I want to deal with giving first.

61. We are by instinct a generous nation to causes that appeal to us. The tax system already offers a great deal of help to charities. It offers reliefs on their income and expenditure. And it provides incentives to encourage charitable giving. There is a relief for charitable covenants that has now been in operation for many years, and is worth nearly £200 million to charities every year. The

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Inland Revenue are today issuing new guidance to help charities and donors who wish to give through charitable covenants.

62. Since 1987 relief for covenants has been complemented by the payroll giving scheme, a very user-friendly way to relieve regular giving from tax. This scheme has been doing well since its launch and I now propose to increase the annual limit from £480 to £600.

63. These reliefs are focused mainly on regular giving, which is of great importance to charities. But they are ill-suited to encourage the one-off gift which, for a variety of reasons, many people find more convenient. Over the years, this has been a persistent source of concern to charities. This year, I propose to go some way to meet those concerns.

64. I propose a Gift Aid which will give tax relief for large single money donations. It is not practical to operate a relief for all small one-off gifts. Nor do I wish to undermine regular giving through payroll giving and covenants. [Initially], therefore, the lower qualifying limit will be £600 per donation, although relief will be available on individual gifts up to an annual ceiling of £5 million per donor.

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65. This new relief, which will apply to gifts by both individuals and companies, will come into operation from 1st October this year. I am confident that it will maintain and strengthen the growth of charitable giving, and I very much hope that charities will promote it actively.

66. Before I leave the subject of charities I should also mention a package of further VAT reliefs giving help especially to organisations engaged in sea rescue and medical care and research. They will come into effect on 1 May and give an additional benefit of about £5 million a year to charitable work. Full details are set out in a Customs and Excise press release being issued today.

SAVINGS

67. I now turn to the taxation of savings. As I do so I am conscious that the majority of personal savings are the fruits of earnings which have already been taxed.

68. I start with saving in shares.

69. The development of the personal equity plan, which stands to the credit of my predecessor, has been an important boost for share-ownership. Last year was a record one for

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PEPs, with over 300,000 plans taken out, to the value of some £750 million.

70. To build on this success I propose to raise the overall annual limit on investment in PEPs by a quarter, from £4,800 to £6,000. Within that, the annual limit on investment in unit and investment trusts will be increased by the same percentage, to £3,000.

71. I am also sympathetic to the problems investment and unit trusts face in qualifying for PEP treatment, as a result of the requirement that 75 per cent of their portfolio should be invested in ordinary UK equities. I propose therefore to relax this rule, to 50 per cent. I also propose to raise the PEP limit for those [unit and investment] trusts that do not satisfy this rule, from the present £750 to £900.

72. Last year, my RHF put employee share-ownership plans, or ESOPs, as they are known, on the statute book. ESOPs are a vehicle for giving employees a direct stake in the business for which they work. I believe they are an attractive option and deserve further encouragement. I therefore propose to introduce a rollover relief from capital gains tax for sales of shares to ESOPs. This will enable company owners, particularly in the unquoted sector, to transfer their shares to their workforce without themselves incurring an immediate

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tax charge. I believe this will remove an impediment to the development of ESOPs and give this form of employee share ownership the fillip it deserves.

INDEPENDENT TAXATION

73. In a moment, I will turn to some new and significant tax changes for savers. But first, I wish to turn to a reform which was announced in the 1988 Budget and comes into effect next month - independent taxation for women. There is too little understanding of what this change will mean. But it will fundamentally change the financial affairs of women.

74. At present the taxation of married women's income is wholly inconsistent with their role in society. In tax law their income is still considered to belong to their husbands. The effect of this is twofold. It denies married women any privacy or independence in tax matters. And too often it results in heavier taxation than is fair. Frankly it is time for this system to go, and go it will from April.

75. In future, a husband and wife will be taxed entirely separately. Every married woman will have a tax allowance of her own to set against her income - whether this income is from earnings, pension or savings.

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76. Three and three quarter million people will gain, of whom 2 million have incomes of less than £5,000 a year. One million elderly married couples will pay less tax, with 200,000 pensioner couples taken out of tax altogether.

77. No one will be sorry to see the old system go. One of its worst features was its treatment of the savings of married women. Whether they had other income or not, the interest on their savings was added to their husband's income and taxed at his rate. This was a clear penalty on thrift. But from April all that will end. This may well be the area where the reform has its greatest effect and will be most welcomed.

COMPOSITE RATE TAX

78. However, it has thrown into sharp relief another aspect of the tax system that affects all savers, and which no longer deserves to survive.

79. Some women will see the benefit of independent taxation automatically, if they have their money invested in national savings, or other accounts which pay interest gross of tax. However, many women, particularly those with only small savings, prefer to save with High Street banks or building societies. And so, frankly, do many other small savers. For

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all these savers, income tax - or rather a proxy for it, the so-called composite rate - is deducted [before it ever gets to the saver, and] whether or not the saver is liable to pay tax.

80. Composite rate tax was introduced originally in 1894, and put on the statute book in 1951. It currently stands at just under 22 per cent. It is deducted at source. It cannot be reclaimed in any circumstances. This means that basic rate taxpayers gain a little - currently 3 per cent, compared with what they should pay - and non-taxpayers are worse off by 22 per cent.

81. The attraction of composite rate is that it allows small amounts of tax to be collected with ease from large numbers of people. It is very convenient and very cost-effective. But the fact remains that with CRT, we tax people on low incomes who should not be taxed.

82. The scale of this is compelling. Once Independent Taxation is implemented there will be 14 million people - nearly one quarter of the population - who have savings income that does not merit taxation, but which will be taxed under present legislation.

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83. They include some 5 million married women with little or no other income of their own, 4 million pensioners, $2^1/_2$ million other adults, and $2^1/_2$ million children with small savings accounts - often funded with small gifts of money from grandparents, or savings from pocket money.

84. It has, of course, always been possible for these people to avoid taxation, by saving in accounts that pay interest gross or where tax can be reclaimed. But the convenience of using banks and building societies has meant that they have not done so.

85. There is no way out of this problem other than to abolish composite rate tax entirely. This I propose to do with effect from 6 April 1991, the earliest practicable date. From then on tax will fall on those who should pay it, and will not fall on those who should not pay it.

86. We shall discuss with the banks and building societies how to effect this change. I envisage a scheme of self-certification that will allow non-taxpayers to be paid gross. For other savers, tax at basic rate will be deducted at source. Unlike composite rate tax it will be reclaimable by any non-taxpayers who, for any reason, may not have been able to self-certify for gross payment.

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87. This change will reduce significantly the amount of tax paid by many married women, pensioners, children, and others with small savings. It will relieve them of tax which they should never pay. And by removing the penalty of composite rate tax it will play an important part in encouraging the savings habit.

NATIONAL SAVINGS

88. Meanwhile, I am announcing today a 1 per cent increase in the interest rates paid on National Savings Investment Account and Income Bonds, where interest is already paid gross of tax. This too will help encourage saving, particularly by non-taxpayers. The Department for National Savings will also be introducing later this year a new Series of the Capital Bond, with simpler arrangements for paying tax on interest.

TESSA

89. However, I want to do more encourage the saving habit among taxpayers - all of them. In the 11 years we have been in office, a series of Budgets have removed penal rates of tax, abolished the investment income surcharge and introduced important new schemes to encourage saving and investment. I intend to build on those measures today. And that means

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going beyond the incentives to saving that we have built up over the last 10 years. These schemes have been immensely successful in spreading share ownership, and will continue to be so in the future. But I now want to extend savings incentives to the mass of ordinary taxpaying savers - and potential savers - who prefer to put their money in their High Street banks and building societies.

90. My next measure is addressed precisely to them. I propose to introduce a wholly new tax incentive which will reward saving and encourage people to build up a stock of capital.

91. The scheme will work as follows. Every adult will be entitled to one Tax Exempt Special Savings Account, TESSA for short. This account can be held at any bank or building society. The essence of the scheme is to encourage people to save regularly over a 5 year period. The incentive for them to do so is that all the interest earned on their capital will be entirely free of tax, provided only that the capital is left undisturbed over the 5 years.

92. The annual limit on the amount that can be invested will be £1,800, or £150 a month. In the first year, anyone who has capital that they are willing to tie up for longer can put this money in their account from the outset, up to a

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limit of £3,000. But the overall limit of £9,000 for the whole plan applies nonetheless.

93. To cope with the circumstances of many small savers - particularly pensioners - who use the interest on their savings for their everyday expenses, it will be possible to withdraw interest as it accrues, but only up to the net-of-tax level. At the end of the 5 years, the depositor then gets a bonus representing the money which would otherwise have gone in tax. The depositor will get this provided none of the capital has been withdrawn before the five years is up. They can, of course, withdraw the capital at any time, but without tax relief.

94. This scheme is convenient, flexible and simple. It caters for those who want to save monthly, annually, or in irregular amounts. I believe it represents a substantial incentive to save, and I am confident that TESSA will play its part in reviving the culture of thrift. I also believe it is both desirable and fair to reduce tax on small savings.

95. This new relief will be available from next January. Its cost will depend on take-up but could be around £200 million in the first full year, rising significantly in the longer-term.

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CAPITAL DISREGARDS

96. This Budget has contained a number of savings measures. I turn now to the removal of a savings disincentive.

97. As the House knows, the income-related benefits - housing benefit, community charge benefit, income support and family credit - are subject to a capital rule. Above a certain level of capital - £6,000 in the case of income support and family credit, and £8,000 in the case of housing benefit and community charge benefit, the claimant becomes completely ineligible for assistance, however low their income may be.

98. Many people resent this rule because they believe it represents a penalty on thrift and self-provision. They ask why they should save when, by doing so, they lose benefits to which they would otherwise have been entitled. This is particularly felt by elderly people who have to run down their capital, and having retired are less able to replenish it. A further problem that has arisen is that the Community Charge is an individual charge, but married couples have their capital aggregated to determine their benefit entitlement.

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99. There must, of course, be some upper limit, for benefits must be directed where they are most needed. But I have reviewed the present limits, together with my RHS, SoS ...., and have decided that they should be raised.

100. I therefore propose to raise the capital limit at which benefit is extinguished for those on income support or family credit from £6,000 to £8,000. But the principal grievance is felt in respect of the capital limits for housing benefit and community charge benefit. I therefore propose to increase the capital cut-offs for these help from £8,000 to £16,000. This measure will benefit around $^{1}/_{4}$ million people in all, two thirds of them pensioners, who are at present excluded from benefit.

£6,000 per single pensioner?

101. Mr RHF is laying the necessary regulations today so that the limits will be increased when benefits are uprated at the beginning of April [1 April for housing and community charge benefits and 9 April for family credit and income support.] Although there is no statutory requirement to consult the local authorities about increases in the capital limits for housing and community charge benefits, my RHF will, of course, be discussing with them the implementation of these changes straightaway. The public expenditure cost will be some £120 million a year from 1990-91, which will be met from

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the Reserve and not add to the overall planned spending totals.

PERORATION

[To follow.]

[wordcount = 5,669] complete

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Table 1.1 The Budget measures[1]

	£ million		yield(+)/cost(−)
	1990–91		1991–92
	Changes from a non-indexed base	Changes from an indexed base	Changes from an indexed base
Income tax			
~~age-related allowances increased by 10%~~	[redacted]	[redacted]	[redacted]
~~other~~ main allowances ~~and basic rate limit~~ indexed	−[redacted] 1495	+220	+400
car benefit scales increased by 20%	+160	+160	+200
childcare: benefits ~~of multiple-member~~ for employees exempted	−10	−10	−10
Excise duties			
tobacco duties increased	+330	+[redacted] 75	+[redacted] 85
petrol, derv and other oils duties increased	+795	+175	+195
alcohol duties increased	+310	+20	+25
vehicle excise duty on cars, buses etc unchanged	—	−185	−190
other vehicle excise duty changes	+15	−25	−25
pool betting duty rate reduced	−20	−20	−20
Tax Exempt Special Savings Accounts	−20	−20	−200
Composite rate tax abolished	—	—	+5[redacted] 50
Stamp duty on shares abolished	+5	+5	−120
Corporation tax			
small companies' limits increased by a third	*	*	−25
relief for domestic sovereign debt ~~provisions~~ phased	*	*	+200
Value added tax			
bad debt relief	—	—	−150
reform of registration rules	−35	−35	−75
Other tax changes	+[redacted]55	+7[redacted]0	+[redacted] 115
Capital limits raised for income-related benefits[2]	...	...	...
Total	+[redacted] +70	+430 +[redacted]	+[redacted]

[1] *The tax measures, and the basis of the costings shown, are described in detail in Chapter 4.*

[2] *See Chapter 5. Public expenditure costs of £[redacted] million in 1990–91 [redacted] will be met from the Reserve.*

around 120 from

− = *Nil.*
* = *Negligible.*
... = *Not applicable.*

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14.III

3 The economy: recent developments and prospects to mid-1991

case number first 9 paras 3.01, 3.02 etc etc

Summary

1 3.1 GDP is forecast to grow by ~~2~~ per cent in 1990, following above trend growth for three years. RPI inflation should begin to fall ~~in~~ the end of 1990, reaching 5 per cent by mid-1991. by

in the non-oil economy

Assumptions 3.2 The forecast assumes that fiscal and monetary policies are operated within the framework of the Medium Term Financial Strategy (MTFS). It assumes that both North Sea oil prices and sterling remain close to recent levels. The public sector debt repayment (PSDR) is forecast to be about £7 billion in 1989–90 and ~~£3½ billion~~ in 1990–91.

both

Demand and activity 3.3 GDP growth slowed to 2¼ per cent in 1989, partly because of a large fall in North Sea oil output. Growth of consumers' expenditure slowed markedly through 1989 and fixed investment ~~probably~~ flattened off ~~in mid-year.~~ But exports accelerated sharply in the second half of 1989, while import growth fell.

3.4 Domestic demand is forecast to ~~be lower~~ fall in 1990 ~~than in 1989.~~ But this is likely to be offset by strong growth in net exports, and GDP is forecast to rise by ~~2~~ per cent. 1 5

Inflation 3.5 ~~Total~~ Retail price inflation was 7½ per cent in the fourth quarter of 1989; excluding mortgage interest payments it was 6 per cent. Total RPI inflation is expected to rise further in the coming months, before falling to 7 per cent by the fourth quarter of 1990 in response to the continued slow-down in the economy. It is forecast to fall to ~~4½~~ per cent by mid-1991 and further thereafter. 1/4 5

Trade and current account 3.6 The current account deficit was nearly £21 billion in 1989, ~~but began~~ It has begun to fall in ~~the closing~~ months ~~of the year.~~ It is forecast to ~~fall to~~ be £1~~2~~ billion in 1990. 5

recent and

Labour market 3.7 Employment has continued to rise rapidly, while unemployment has fallen. With a forecast of low output growth, unemployment could level off in the coming months and may rise, although much depends on the behaviour of wage bargainers.

World economy 3.8 Growth of world trade and GNP slowed in 1989, but both were still above the trends for the 1970s and 1980s. ~~A further slight slowing down is forecast for 1990.~~ Inflation in the major economies picked up in 1989 and is now generally as high as or higher than a year ago. It is forecast to moderate ~~very~~ slightly in 1990.

They are forecast to slow further in 1990

Table 3.10 Economic prospects: summary

	Percentage changes on a year earlier unless otherwise stated			
		Forecast		Average errors from past forecasts[1]
	1989	1990	1991 H1	
GDP and domestic demand at constant prices				
Domestic demand	3¼	−½	¾	1¼
of which:				
Consumers' expenditure	3¼	1¼	¾	1¼
General government consumption	¼	¼	¾	1
Fixed investment	4¼	−1¼	−¾	3¼
Change in stockbuilding (as percent of GDP)	−¼	−1¼	¼	¼
Exports of goods and services	4	7¼	5½	1½
Imports of goods and services	7	1¼	3	2¾
Gross domestic product (average measure)	2¼	1	1½	¼
Manufacturing output	4¼	0	¼	1¾
Balance of payments current account (£ billion)	−21	−15	−12[3]	5¼
Inflation				
Retail price index (Q4 on Q4)	7¼	7¼	5[4]	1¼
GDP deflator at market prices (financial year)[2]	6¼ (6½)	4½ (6½)		¾
Money GDP at market prices (financial year)[2]	8¼ (8½)	5¼ (7½)		1½
£ billion	51¼ (51½)	54⅛ (55½)		
PSDR (financial year)				
£ billion	7	7		3¼
per cent of GDP	1¼	1¼		¼

[1] *The errors relate to the average differences (on either side of the central figure) between FSBR Industry Act Forecasts and outturn over the last ten years, and apply to the forecasts for 1990.*
[2] *The figures in brackets adjust for the distortion to money GDP and the GDP deflator arising from the abolition of domestic rates. This is explained in the box on page xx.*
[3] *At an annual rate.*
[4] *Q2 on Q2.*

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NOTE FOR THE RECORD

MTFS AND ECONOMIC FORECASTS

I discussed with the Prime Minister this morning reactions to my minute of 14 March. She agreed that:

- paragraph 2.43 of the draft MTFS on intervention should be allowed to stand.

- the MTFS material on the ERM should, as currently drafted, continue to focus on the Madrid formula and should not make specific reference to the new implications of German reunificatIon. But she wished the number of passages on the ERM to be reduced from three to two.

- it would be acceptable for the RPI forecast for 1990 Q4 to be increased from 7 per cent to 7 1/4 per cent.

I subsequently discussed all this with John Gieve in the Chancellor's office. He agreed to put to the Chancellor the proposition that the material currently in paragraph 2.10 of the draft MTFS should be merged into paragraph 2.22; and that the last sentence of paragraph 2.57 should be brought forward to the end of paragraph 2.56.

PAUL GRAY
15 March 1990
c:\economic\mtfs (kk)

16

PRIME MINISTER

MTFS AND ECONOMIC FORECASTS

You saw last night the minute from the Chancellor (flag A) spelling out key elements from the MTFS and economic forecast. You did not have a chance to go through this with the Chancellor at this afternoon's bilateral.

You may therefore like to take a further look tonight. In the light of what the Chancellor told you this afternoon about the latest forecasts he is now considering, but has not yet firmly decided on, some amendments to the key figures. I have marked these in red on the table at the end of flag A.

You may also want to go through this evening the latest draft of the MTFS itself (flag B). Its style has been substantially changed, and is considerably more expansive than in the past. Key passages I suggest you look at are:

- paras 2.10, 2.22 and 2.57 on the ERM — no mention of the unemployment caused by inflation! Wonder whether we should give such prominence to this.
- para 2.37 on the exchange rate
- para 2.43 on intervention — do we need this at all
- para 2.44 and the following box on credit controls
- para 2.49 on public expenditure
- para 2.51 on the tax burden
- para 2.53 on the PSDR.

Finally, you may also like to glance at the letter from Tony Newton (flag C) concerning the latest package on capital limits. I am minuting your agreement this afternoon to figures of £16,000 for community charge benefit and housing benefit, and £8,000 for income support and family credit.

Are there any comments you want me to give the Chancellor on the MTFS and economic forecast material?

See above

PAUL GRAY

14 March 1990

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COPY NO. 1 OF 18 .

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

PRIME MINISTER

I thought it might be helpful to let you know the state of play on the economic forecast and the MTFS before our meeting on Wednesday. We are not yet in a position to take final decisions on the numbers - since we are still waiting for information on RPI inflation, trade and the public finances in February - but my provisional decisions are set out below .

The economic forecast

2. The current forecast is realistic without being unduly gloomy. It is summarised in the attached table and summary page from the FSBR. It shows that 1990 will be an uncomfortable year, with relatively low growth and little progress on inflation. But it will show a pick up in growth and a significant fall in inflation in the first half of 1991.

3. The outlook for demand and activity has changed little since the picture given in my paper for Cabinet in February. I am proposing to publish a figure of $^{3}/_{4}$ per cent for GDP growth in 1990, with a pick up to $1^{1}/_{4}$ per cent in the first half of 1991. A period of below-trend growth is inevitable if we are to get inflation down, and while the Treasury's forecast is somewhat below the consensus of outside forecasts I believe that it is reasonable. In the past we have tended to underestimate the extent of cyclical swings in the economy.

6

4. The immediate prospect for inflation has become rather worse in recent weeks. The high levels of community charge being set by local authorities and the rise in the mortgage rate will add to RPI inflation. My current proposal is to publish a forecast of 7 per cent for RPI inflation in the fourth quarter of 1990, while making clear that a sharp rise is to be expected in the next few months. This is an uncomfortable message, but I am satisfied that publishing a lower inflation forecast would strain credibility in the light of the poor figures we are likely to see in the next few months. But the forecast is for a considerable improvement to 5 per cent inflation (and falling) by mid-1991.

5. The current account forecast for 1990 is, at £14 billion, marginally lower than that published in the Autumn Statement. A further fall, to £12 billion at an annual rate, is forecast for the first half of 1991. This is in line with the consensus of outside forecasts.

The MTFS

6. The Red Book will also restate the MTFS. The essence of the strategy will, of course, remain unchanged. But I propose to give a rather fuller statement of the way we conduct policy, and the reasons behind it, than has been the practice in recent versions. I think this is essential if we are to enhance the credibility of our approach.

7. At the centre of the MTFS is the commitment to defeat inflation. This will be restated in unequivocal terms, and I propose to show a path for money GDP growth consistent with bringing inflation down to 3 per cent by 1993-94. I believe that this is a credible objective which is within our grasp if we pursue our policies with determination.

C

Ellis

89-90	90-91	91-92	92-93	93-94
7	6	2	0	0

PSR

ie the fiscal stance:
- annual
- cumulative

1	1	1
1	2	3

Fiscal policy

8. The position on fiscal policy remains essentially as set out in my minute to you last week, although here again the numbers are subject to further change. I propose to restate the longer term objective of a balanced budget, with a medium term path as we discussed last week.

9. The GGE ratios we publish will inevitably be somewhat higher than in the public expenditure White Paper, given the increases in local authority expenditure we now expect in 1990-91. But we will show a downward trend in the medium term consistent with the cash figures for the planning total agreed in the Survey.

Monetary policy

10. I propose to include a fairly extended description of our approach to monetary policy in this year's MTFS. It will as usual make clear that monetary policy has to be in the forefront of the battle to conquer inflation, with support from a firm fiscal policy. It will explain our approach to setting monetary targets, and the factors we take into account in setting interest rates. And there will be detailed sections on funding policy, reserve asset ratios and the measurement of broad money.

11. I propose to retain the present approach to monetary targets. The only formal target will be for narrow money, as measured by MO, but I shall make clear that we also take account of the exchange rate, broad money, and other indicators in setting interest rates.

12. The underlying growth of MO has been outside its target range throughout the current financial year. Having fallen through much of 1989, it has if anything edged up again since the autumn and now stands at nearly $6^1/_2$ per cent. I therefore propose to set a

target range of 1-5 per cent for 1990-91, the same as in 1989-90, and I expect to see the growth rate come down within the range by the autumn. The proposed range is one point higher than the 0-4 per cent range foreshadowed in last year's MTFS, reflecting the higher path of money GDP growth which we now envisage. I see little prospect of MO growth falling below 4 per cent during 1990.

13. I have looked in some detail at the arguments for setting a target for broad money, as we used to do. But I am convinced that this would not be appropriate. Although we have observed a reasonably stable trend in M4 velocity in the 1980s, there are good reasons for thinking that this might not continue in the 1990s given the probable turnround in the relationship between asset prices and incomes.

14. Finally, the MTFS will contain a statement of our intention to join the ERM when the Madrid conditions are satisfied. It is made clear that this will not be a substitute for the MTFS, but rather a complement to it. The Government will continue to conduct its monetary policy within the MTFS framework.

John M.

[J.M.]

13 March 1990

3 The economy: recent developments and prospects to mid-1991

Summary

3.1 GDP is forecast to grow by ¾ per cent in 1990, following above trend growth for three years. RPI inflation should begin to fall at the end of 1990, reaching 5 per cent by mid-1991.

Assumptions

3.2 The forecast assumes that fiscal and monetary policies are operated within the framework of the Medium Term Financial Strategy (MTFS). It assumes that both North Sea oil prices and sterling remain close to recent levels. The public sector debt repayment (PSDR) is forecast to be about £7 billion in 1989–90 and £6 billion in 1990–91.

Demand and activity

3.3 GDP growth slowed to 2¼ per cent in 1989, partly because of a large fall in North Sea oil output. Growth of consumers' expenditure slowed markedly through 1989 and fixed investment probably flattened off in mid-year. But exports accelerated sharply in the second half of 1989, while import growth fell.

3.4 Domestic demand is forecast to be lower in 1990 than in 1989. But this is likely to be offset by strong growth in net exports and GDP is forecast to rise by ¾ per cent.

Inflation

3.5 Total retail price inflation was 7½ per cent in the fourth quarter of 1989; excluding mortgage interest payments it was 6 per cent. Total RPI inflation is expected to rise further in the coming months, before falling to 7 per cent by the fourth quarter of 1990 in response to the continued slow-down in the economy. It is forecast to fall to ~~4½~~ 5 per cent by mid-1991 and further thereafter.

Trade and current account

3.6 The current account deficit was nearly £21 billion in 1989, but began to fall in the closing months of the year. It is forecast to fall to £14 billion in 1990.

Labour market

3.7 Employment has continued to rise rapidly, while unemployment has fallen. With a forecast of low output growth, unemployment could level off in the coming months and may rise, although much depends on the behaviour of wage bargainers.

World economy

3.8 Growth of world trade and GNP slowed in 1989, but both were still above the trends for the 1970s and 1980s. A further slight slowing down is forecast for 1990. Inflation in the major economies picked up in 1989 and is now generally as high as or higher than a year ago. It is forecast to moderate very slightly in 1990.

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Table 3.10 Economic prospects: summary

	Percentage changes on a year earlier unless otherwise stated			
		Forecast		Average errors from past forecasts[1]
	1989	1990	1991 H1	
GDP and domestic demand at constant prices				
Domestic demand	3¼	−¾	1	1¼
of which:				
Consumers' expenditure	3¾	¾	1	1¼
General government consumption	½	½	2½	1
Fixed investment	4¾	−1¼	−1¼	3¼
Change in stockbuilding (as percent of GDP)	−¼	−1¼	¼	½
Exports of goods and services	4	7¼	4½	1½
Imports of goods and services	7	1¼	3¼	2¾
Gross domestic product (average measure)	2¼	≠1	1¼	¾
Manufacturing output	4¾	0	¾	1¾
Balance of payments current account (£ billion)	−21	~~−17~~ −15	−12[3]	3½
Inflation				
Retail price index (Q4 on Q4)	7½	~~7~~ 7¼	5[4]	1¼
GDP deflator at market prices (financial year)[2]	6¼(6¼)	4 (6)		1
Money GDP at market prices (financial year)[2]	8¼(8¼)	5 (7)		1½
£ billion	517 (518)	541 (552)		
PSDR (financial year)				
£ billion	7	≠7		3½
per cent of GDP	1¼	1		½

[1] *The errors relate to the average differences (on either side of the central figure) between FSBR Industry Act Forecasts and outturn over the last ten years, and apply to the forecasts for 1990.*
[2] *The figures in brackets adjust for the distortion to money GDP and the GDP deflator arising from the abolition of domestic rates. This is explained in the box on page xx.*
[3] *At an annual rate.*
[4] *Q2 on Q2.*

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PRIME MINISTER

BILATERAL WITH THE CHANCELLOR: 14 MARCH

Although you had a long talk with the Chancellor last night, I am assuming that you still wish to have the normal weekly bilateral with him which had already been fixed for tomorrow afternoon.

You agreed the final shape of the Budget package at lunch time. So there is nothing further to discuss on the Budget measures per se.

But you will want to consider the various other key announcements that accompany the measures, in particular the economic forecast and the MTFS. The attached minute from the Chancellor addresses those aspects.

I suggest you work through this note at tomorrow's bilateral. As regards the forecast, the most important point is the inflation forecast; you will see the Chancellor proposes a figure of 7 per cent for the 1990 Q4 RPI, compared with 5 3/4 per cent at the time of the Autumn Statement.

As regards the MTFS, you have already seen the proposed fiscal projections, which I have annotated at paragraph 8 of the Chancellor's minute. The main aspect you will want to consider now is what is to be said about monetary policy. This is covered in paragraphs 10-14 of the Chancellor's note.

You will want to note in particular the target range for MO, and the handling of the ERM. The Chancellor has not at this stage attached a full draft of the MTFS; I am told this is still being actively worked on. But you will want to ask the Chancellor for a sight of it by, say, Thursday night, so that you have a chance to look at it before the end of the week while there is still time to offer detailed comments.

I have also suggested to the Chancellor's Office that, like his predecessor, he may want to show you over the weekend a draft of the Budget Speech itself.

PG Pcl.

13 March 1990

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file 13

BUDGET SECRET

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

13 March 1990

Dear John,

THE BUDGET PACKAGE

The Prime Minister was grateful for the Chancellor's further minute of 13 March. She agrees with his proposal, which she regards as the best solution.

Yours,
Paul

PAUL GRAY

John Gieve, Esq.,
HM Treasury.

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12(a-b)

REF NO. J6/90/20
COPY NO. 1 OF 5

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

Prime Minister
Content?
Yes - the best solution
PREG 13/7

PRIME MINISTER

I have been reflecting further on the balance of the Budget. There is a case for some further tightening if only to affect the appearance of the Budget and improve its reception in the markets.

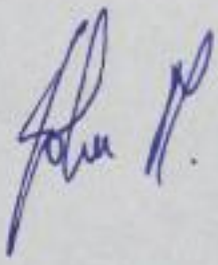
2. I have considered again, therefore, the best way of raising a little more revenue in the coming two years. As you know, all the options have disadvantages but the best is to freeze the basic rate limit. This currently stands at £20,700 of taxable income. Taking account of personal allowances and mortgage relief, people typically start paying higher rate tax at gross incomes of between £25,000 and £30,000. The effect of freezing the limit will be to increase the numbers paying higher rate tax and to reduce the gains to higher rate payers compared with full indexation by about £4.62 a week. It will also produce a number of cash losers especially when combined with the increase in company car scales that we are planning.

3. It will add £215 million to the yield of the Budget in 1990-91 and £390 million in 1991-92 giving overall effects of +£390 million and +£880 million respectively.

4. Politically the change is not attractive but there is no painless solution and I am satisfied that this is the best

b.

available option. Subject to any comments you have, therefore, I plan to make the change and will instruct the Inland Revenue accordingly at lunchtime.



[J.M.]

13 March 1990

11(a-b) A

PRIME MINISTER

STANCE OF FISCAL POLICY

The outcome of your meeting with the Chancellor is that he is aiming at a Budget which raises taxes (from an indexed base) by about £170 million in 1990-91 with little change in 1991-92 discounting the cash flow effect, of perhaps £500 million, of the composite rate abolition which is reversed the following year. This will leave published PSBRs of around £7 billion in 1990-91 and £6 billion in 1991-92, falling to £2 billion by 1992-93, and

Since that meeting:

(i) the pound has fallen sharply;

(ii) the retail sales figures for February have become available. The latter show a rise of 2.4 per cent to a new record. Even when using three month averages, the latest three months are 1.3 per cent up on the previous three.

In my view, the effect of these developments is to make a Budget that was barely tight enough, into one which is too lax. I suspect that the foreign exchange markets may not react sharply to the retail sales figures as people wil be reluctant to go very short of Sterling when it is possible that the Budget the following week may change perceptions for the better, but if the Budget when it is revealed is seen as weak, there could be a reaction at that stage. There is already a perception that the Government has already gone as far as it dare on interest rates. A no change Budget will indicate that it has reached the same position on taxation. It will have shot its bolt on both fronts and the economy will be left to come right on its own or not at all.

I think you should ask the Chancellor to reassess the position and to consider going for a net tax increase of around £1 billion, probably by not indexing fully.

At present spending is being restrained by cutting the purchasing power of those who have borrowed. It does so, however, by putting the strain heavily on this group while leaving those who are net depositors better off. The policy works only because the depositors tend to spend less than the borrowers.

By tightening fiscal policy, the restraint is spread more widely. This will bring forward the time when the interest rate can be relaxed. In my view, it would be wrong to relieve borrowers by raising mortgage interest relief

(a) because this is a net loosening of fiscal policy when tightening is called for;

(b) it encourages borrowing on the security of property and makes the conduct of monetary policy even more difficult;

(c) it drives up the price of houses relative to other goods when they are already much too high.

The argument against a tighter budget is that one should not put too much weight on one month's retail figures (I don't, and base the argument on three months) and that there are other indicators which point to slowing down, such as the very small fall in unemployment and the fall in car sales. But if demand falls off faster than expected, you will get an easing in inflationary pressure and can then bring forward the reduction in interest rates, which is the object of the exercise. In short, if you err on the restrictive side on fiscal policy, you can correct on the monetary side; but if you err on the lax side on fiscal policy, it is much more difficult to correct by putting interest rates up.

AT

ANDREW TURNBULL

9 March 1990

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10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

7 March 1990

1990 BUDGET

The Prime Minister was most grateful for the Chancellor's minute of 6 March and attachments, which they discussed at their bilateral this evening.

It was agreed that, as indicated in paragraph 7 of the Chancellor's minute, it was necessary to reduce the net cost of the present package in 1991-92 by some £300 million from the figure set out in the scorecard. Following discussion of the options for achieving this, it was agreed that the best approach would be to drop the earlier proposal to reduce the main rate of Corporation Tax by 1 per cent. Apart from that change, the Budget package should be as set out in the scorecard; the changes in excise duties should not be adjusted to reflect the possibilities in paragraph 13 of the Chancellor's minute.

I am writing to you separately about one detailed point concerning the capital limits for means tested benefits.

PAUL GRAY

John Gieve, Esq.
H.M. Treasury

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10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

7 March 1990

MEANS TESTED BENEFITS: CAPITAL LIMITS

The Prime Minister was grateful for the Chancellor's note on this subject, which they discussed at their bilateral this evening.

Following discussion, it was agreed that the Chancellor should proceed on the basis of Option A. As regards the date of implementation, the Prime Minister said that she regarded it as essential to backdate to April 1990 the change for Community Charge Benefit and, if at all possible, to do the same for Housing Benefit.

I am copying this letter to Stuart Lord (Department of Social Security).

PAUL GRAY

DTS

John Gieve, Esq.
H.M. Treasury

FROM: D I SPARKES
DATE: 6 March 1990

MR HUTSON (Parliamentary)

cc Sir P Middleton
Sir T Burns
Sir J Anson
Mr Scholar
Mr Culpin
Mr Gieve
Miss Wallace

Sir A Battishill - IR

Mr Unwin - C&E

Mr Gray - No.10

BUDGET DAY: OFFICIAL BOX

Could you please let the House authorities know that the following people will be occupying the official Box for the duration of the Chancellor's Budget Statement, and Mr Kinnock's reply, on Tuesday, 20 March:

1. Sir P Middleton
2. Sir T Burns
3. Sir J Anson
4. Mr M Scholar
5. Mr R Culpin
6. Mr J Gieve
7. Miss M Wallace
8. Sir A Battishill (Inland Revenue)
9. Mr B Unwin (Customs & Excise)
10. Mr P Gray (No.10).

Please would all the above check that they are in possession of a valid Palace of Westminster pass.

3. I will let you have in due course a list of people who will be covering the Box for the rest of Budget Day and the subsequent three days of the Debate.

D.C.

DUNCAN SPARKES

9(a-c)

PRIME MINISTER

BILATERAL WITH THE CHANCELLOR: 7 MARCH

You are seeing the Chancellor tomorrow evening at 1730. The Chancellor will have to leave by about 1930 for an evening engagement, but this means you have up to two hours with him to go through his latest thinking on the Budget.

He has this evening sent over the attached minute, which sets out the latest package and provides detailed notes on a number of aspects.

You will want to work through the whole of the note at tomorrow's meeting. But you may find it helpful to have the following quick thoughts.

The overall fiscal position

You need to start by agreeing on the overall budget judgment. The latest score-card is not greatly different from the earlier one you saw, and points to a cost in 1991-92 of some £365 million. The Chancellor suggests that this net cost needs to be reduced by some £300 million to bring it near to balance.

When we spoke the other evening you were minded to think some tightening of the package was essential. I think there is a strong case for doing a lot more than the Chancellor now proposes, bearing in mind that the score-card excludes the impact in 1991-92 of the lagged effects of the last two Budgets. As I understand it this will have an additional fiscal impact from next year of some £2½ billion. So even a balanced Budget this year will in reality lead to a loosening of fiscal policy, as compared with the current year, of that amount; a fact City commentators will not be slow to pick up.

I assume that at this stage you will not want to press the Chancellor to tighten the package to anything like the extent of £2½ billion. But if your main priority for the next 12-18 months

b

s to provide conditions in which interest rates can come down you must err on the side of caution and have a tighter fiscal stance.

How to close the gap

In paragraph 7 of his note, the Chancellor identifies four main options for saving £300 million. He currently favours his option (d) involving a number of minor adjustments to indexation of income tax allowances.

The first issue to settle is whether you are content with only one of these four options or whether - given the argument above - you think it necessary to do more than that.

My own views are:

- it is silly to be cutting the CT rate by a small amount. You will get scarcely any credit and even fewer votes for it. And it just uses up some of the money you may want to have in reserve for next year. If you want to do anything on business taxation it would be far better to have a more generous package for raising the threshold for the small business CT rate (as far as I am aware there is no EC constraint here - that applies in the case of VAT thresholds);

- I know you were minded last week not to go for differentiated car tax but I think the Chancellor over-states the problems with this, bearing in mind the points raised in MISC 141 this morning;

- although I was initially attracted to the married couples option it does have the drawback of "hitting" families with only one income. If you wanted to freeze any of the income tax allowances it might be better to go for the basic rate limit which would also save some £400 million. One potential problem with that is hitting people with company cars, but to judge from the detailed notes which follow immediately after the score-card in the Chancellor's paper, I am not sure they would suffer any significant cash loss.

If you are looking to save money, another option to look at is the proposed abolition of Stamp Duty. The Chancellor does not mention this, and presumably thinks that, given the introduction of paper-less transactions, it has to be done. But I am not sure it makes sense to declare it in this year's Budget arithmetic. Although the 1991-92 cost is only £120 million it rises to nearly a billion pounds a year in later years. Would it be better to stay silent on the subject this year and keep the money in the "fiscal adjustment" line (as you will see from paragraph 6 of the Chancellor's minute the available fiscal adjustment figures are extremely small).

Excise duties

You will see from paragraphs 12-13 of the Chancellor's minute that the latest news on RPI prospects has deteriorated further. He therefore proposes trimming back slightly on the excise duty increases. His minor adjustments seem sensible, and apparently would widen the differential of unleaded petrol.

You may be tempted to cut back the duty increases further given the RPI worries. But I would argue strongly against doing so. It really would store up big problems for next year.

Other issues

You will want to work carefully through the detailed notes annexed to the Chancellor's minute, in particular the capital limits for means-tested benefits. You will see that the Chancellor has now discussed the Community Charge issue with Tony Newton and proposes a 50 per cent increase in all the limits.

The last of the annexes covers the various savings measures. The Chancellor seems to have met your earlier comments on both timing and substance in relation to both small savings accounts and CRT.

PGG.

(PAUL GRAY)
6 March 1990

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8(a-e)

BUDGET

PRIME MINISTER

SECRET

1990 BUDGET

It may be helpful before our meeting on Wednesday if I set out more fully my current thinking on the Budget. I attach the latest Scorecard together with explanatory notes and longer annexes on capital limits, sovereign debt provision, charities, and saving.

B.L.O. SECRET

Fiscal Prospect

2. I have reviewed carefully the fiscal prospect for the year ahead and beyond. As you know we know expect a much lower PSDR both this year and next than we had previously forecast. Our current forecasts are for £7 billion in the current financial year and £6 billion next year.

3. In the current year, the undershoot reflects a number of special factors, notably: the reduction in privatisation proceeds (£3 billion), the unexpected success of personal pensions (£2½ billion), and overspending by local authorities in anticipation of the capital controls (£2 billion). While these factors will not apply next year, we will begin to see the effects of the economic cycle, particularly on corporation tax and expenditure. We will also see a further build up in the cost of the 1988 and 1989 Budgets (£2½ billion).

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4. I need not stress how uncertain these projections are. The average error on our forecasts for the year ahead is in the region of £4 billion and some of the independent forecasters are expecting a higher debt repayment.

5. Projections beyond next year are even more uncertain. For what its worth our economists' central guess is set out below. It would be wrong to put too much weight on these. Nonetheless the figures do bring home how little room for manoeuvre we may have in the next few years if, as I think we should, we continue to aim for a balanced Budget in the medium-term.

The PSDR in the medium term

	1989-90	1990-91	1991-92	1992-93	1993-94
£ billion	7	6	-1	-2	-1
% of GDP	1½	1	- ¼	- ¼	-

6. These projections are on the basis of a forecast that we will overshoot our expenditure plans. When we publish projections in the FSBR we will show expenditure figures consistent with the plans. Given the uncertainties, I think it would be wrong to show a net borrowing requirement so I propose to publish the following

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(assuming £5 billion of privatisation proceeds in each year from 1990-91):

£ billion

	1989-90	1990-91	1991-92	1992-93	1993-94
PSDR	7	6	2	0	0
after fiscal adjustment:					
- annual			1	1	1
- cumulative			1	2	3

Budget Arithmetic

7. I have reconsidered the Budget package in the light of this prospect. I am not inclined to make substantial changes. We have long set fiscal policy on the basis of medium-term trends and I think a substantial tax increase would give quite the wrong message politically as well as being of questionable effect economically. However, I am persuaded that the package should contribute and be seen to contribute to a resolute anti--inflationary policy. For that reason, I think we need to reduce the net cost in 1991-92 by some £300 million from the figure set out in the Scorecard. There are four main options:

90-91

(a) introducing a progressive structure of car tax;

(b) freezing the married couples' allowance;

(c) not cutting the corporation tax rate; and

(d) a combination of minor adjustments namely increasing the married couples' allowance and basic rate limit by 5 per cent rather than 7.7 per cent and not over-indexing the age allowances.

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8. A case can be made for the first option. Customs and Department of Transport are satisfied that a graduated car tax ranging from 7½ per cent on the most fuel-efficient cars to 15 per cent on the least fuel-efficient would be feasible and could raise some £250 million in 1991-92. We could present it as a green measure and much of the cost would fall on imports and on companies. On balance, however, I am not attracted to this approach, at any rate this year when the Midlands is already having to adjust to a slowdown in growth, the car industry is about to face an unwelcome MMC investigation into UK car prices and we wish to bring voluntary restraints on Japanese imports to an early end. I suspect the measure would provoke more criticism both in the industry and in parts of the Party than would be justified by its modest yield. We may, however, want to come back to it next year in the light of the environment White Paper.

9. I am also inclined to reject option (b). Although the married couples' allowance is something of an anomaly and there is a case for letting it wither on the wine, I don't think this is the year to start. The allowance is of most importance to couples with only one income, some of whom will be facing substantial increases in Community Charge.

10. Dropping the Corporation Tax reduction would clearly deal with the arithmetic neatly but I still see considerable attractions in making this a Budget for business as well as for savers. The reduction would also make clear that we still intend to reduce tax rates in the medium-term and that our policy is to aim for low rates on a broad base (rather than, for example, the pre-1984 Corporation Tax system which offered high allowances at a high rate).

11. That would point to the last option but I would like to discuss the matter with you before reaching a decision.

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Excise Duties

12. In the light of the truly appalling news on local authority budgets, we now expect the RPI to rise in April above 8½ per cent. I have considered, therefore, whether we should hold down excise duties. I am still of the view that we should broadly uprate the duties and do a little more on cigarettes and petrol. With hindsight, our decision last year to freeze the duties won us very little relief in the short-term and has made our position both on inflation and the fiscal balance appreciably more difficult this year. I am most concerned that we should not make our job in 1991 any harder. If we under-index the duties this year we will unavoidably be obliged to do so again next year and that will further restrict the scope for reductions in direct tax rates; indeed it could remove them. I was encouraged in this view by the almost unanimous support for raising the duties at Cabinet two weeks ago. Moreover if we did under-index we would have to show a lower PSDR in 1990-91 and 1991-92 unless we freeze personal tax allowances. Neither is attractive.

13. However, if we decide on option (d) above, we would raise extra revenue in 1990-91 as well as 1991-92 and on that basis, I think it would be worth amending the package to some extent: for example by indexing the duty on spirits (instead of increasing by 10 per cent as I had proposed) and also for increasing the duty on unleaded petrol by 7.7 per cent rather than 10 per cent. That will edge down the RPI effect a little and be welcome both to the whisky industry and our Scottish colleagues and to the environmental lobby.

John M.

JOHN MAJOR

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DIRECT EFFECTS OF BUDGET MEASURES

	£ million		yield (+)/cost (-)
	1990-91		1991-92
	Changes from a non-indexed base	Changes from an indexed base	Changes from an indexed base
1. Index income tax allowances	- 1690	nil	nil
2. 10% on age allowances	- 35	- 35	- 50
3. 20% on car scales	+ 160	+ 160	+ 200
4. Excise duties	+ 1425	+ 35	+ 65
BUSINESS			
5. 1% off main CT rate	- neg	- neg	- 315
6. Raise small companies' CT thresholds by a third	- neg	- neg	- 25
7. VAT: bad debt relief, simpler registration rules	- 35	- 35	- 225
SAVINGS			
8. Tax exempt special savings account	- 40	- 40	- 210
9. Abolish composite rate tax from 6/4/91	nil	nil	*
10. Abolish stamp duty on shares from introduction of TAURUS (assume 1/1/92)	+ neg	+ neg	- 120
11. PEPs, ESOPs etc	- neg	- neg	- neg
OTHER			
12. Phase relief on banks' sovereign debt provisioning	neg	neg	+ 200
13. Relief for workplace nurseries	- 10	- 10	- 10
14. Life assurance	+ 90	+ 50	+ 100
15. Relief for charities	- 5	- 5	- 5
16. Other	- 5	+ 30	+ 30
17. TOTAL	- 185	+ 150	- 365
18. Raise capital disregards for community charge benefit etc	- 95	- 95	- 95

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* Uncertain cash flow yield : see note 8

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BUDGET

N O T E S

Figures show cost (-) or yield (+) in £ million unless otherwise indicated.
Indexation 7.7 per cent.

SECRET

1. Index income tax allowances

Cash gain, in £ per week:

	Single	Married
Basic rate taxpayer		
under 65	1.06	1.68
age 65-74	1.30	2.07
over 75	1.35	2.12
Higher rate taxpayer	6.31	7.31

B.L.O.

Variants

	1990-91		1991-92
Increase basic rate limit by 5%	+ 65	+ 65	+ 110
Increase married couple's allowance by 5%	+ 115	+ 115	+ 145
Freeze basic rate limit	+ 215	+ 215	+ 390
Freeze married couple's allowance	+ 300	+ 300	+ 405

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2. 10% on age allowances

Table shows extra cost, on top of indexation in line 1. Aged income limit raised by 10%.

Extra cash gain, in £ per week:

	Single	Married
Basic rate taxpayer		
aged 65-74	0.34	0.53
over 75	0.38	0.63
Higher rate taxpayer	0.00	0.00

3. Increase car scales by 20 per cent

Cash cost, in £ per week, to typical Cavalier driver:

Basic rate taxpayer	1.78
Higher rate taxpayer	2.84

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4. Excise Duties

10% increase in petrol, derv, spirits and cigarette duties; freeze VED for cars, and duty on pipe tobacco; half-index VED for lorries; 2½ percentage point reduction in pool betting duty; index rest.

	Price rise (pence)	1990-91 non-indexed base	1990-91 indexed base	1991-92 indexed base	RPI impact effect
Cigarettes	9.6	+ 320	+ 75	+ 85	0.18
Cigars	3.7	+ 5	nil	nil	0.01
Pipe tobacco	nil	+ nil	- 5	- 5	0.00
Leaded petrol					
gallon	10.7	+ 400	+ 90	+ 85	0.13
litre	2.4				
Unleaded petrol					
gallon	9.3	+ 235	+ 55	+ 75	0.04
litre	2.0				
Derv					
gallon	9.0	+ 145	+ 30	+ 35	0.01
litre	2.0				
Beer (pint)	1.7	+ 155	nil	nil	0.07
Wine (75cl bottle)	6.8	+ 50	nil	nil	0.06
Spirits (bottle)	54.4	+ 100	+ 20	+ 25	0.05
Cider (pint)	0.9	+ 5	nil	nil	0.00
Other oils	neg	+ 15	nil	nil	0.00
VED: cars	nil	nil	- 180	- 185	0.00
other (see below)	neg	+ 15	- 30	- 30	0.00
Pool betting duty	nil	- 20	- 20	- 20	0.00
TOTAL		**+ 1425**	**+ 35**	**+ 65**	**0.55**

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Very roughly, raises price of:

20 king size cigarettes costing	£1.60	to £1.70	(6¼ per cent)
gallon of leaded petrol costing	£1.80	to £1.91	(6 per cent)
(litre	40p	to 42½p)	
gallon of unleaded petrol costing	£1.66	to £1.75	(5½ per cent)
(litre	37p	to 39p)	
gallon of derv costing	£1.70	to £1.79	(5¼ per cent)
(litre	38p	to 40p)	
pint of beer costing	£1	to £1.02	(2 per cent)
bottle of spirits costing	£8	to £8.54	(6¾ per cent).

Widens unleaded/leaded tax differential from 14.2p to 15.6p a gallon, 3.1p to 3.4p a litre.

Assumes take-up of unleaded petrol rises from 29½% in January 1990 to 40% in 1990-91 and 50% in 1991-92.

Variants:

Index unleaded petrol:	reduces yield by	- 55	- 75
Index spirits:	reduces yield by	- 20	- 25

5. <u>1% off main corporation tax rate</u>

Assumes start date 1 April 1990.

6. <u>CT: raise small companies' threshold</u>

From 1 April 1990:

- small companies' CT rate of 25 per cent available on profits up to £200,000 (instead of £150,000)
- benefit not fully withdrawn until profits £1 million (instead of £750,000).

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7. VAT: bad debt relief, simpler registration rules

Costs against indexed base:

		1990-91	1991-92
(i)	bad debt relief	nil	- 150
(ii)	simplification of registration rules	- 35	- 75

8. Abolish composite rate tax from 6/4/91

In principle revenue neutral. In practice, likely to be cash flow yield in 1991-92, as most bank and building society savers have to pay basic rate of tax on interest receipts instead of (lower) composite rate. Cash flow cost in 1992-93, as tax refunds paid to non-taxpayers, more non-taxpayers allowed interest gross, etc. Orders of magnitude very uncertain.

9. Tax exempt special savings account

Assumes:

(i) scheme starts January 1991;

(ii) cumulative limit of £9,000 over 5 years;

(iii) limit on investment £3,000 in first year, then £1,800 a year (£150 a month);

(v) initial interest rate 12 per cent, falling by stages to 7 per cent by 1994-95 in line with MTFS projections.

10. Abolish stamp duty on shares from introduction of TAURUS (assume 1/1/92)

Cost of order of -900 in 1992-93, -950 in 1993-94.

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11. PEPs, ESOPs etc

	1990-91		1991-92
	non-indexed base	indexed base	indexed base
PEPs: increase limits	- neg	- neg	- neg
PEPs: investment trusts	- neg	- neg	- neg
ESOPs: CGT relief	nil	nil	- neg

PEP limits rise from

- £4,800 to £6,000 for total annual investment
- £2,400 to £3,000 for unit and investment trust element
- £750 to £900 for unit and investment trusts which do not satisfy UK equities test.

Investment trusts: for inclusion in PEPs, only 50% of trusts' portfolio, instead of 75% as now, need be invested in UK equities.

ESOPs: CGT rollover relief for sales of shares to ESOP trusts.

Further savings measure in line 18.

12. Banks' sovereign debt provisioning

Yield assumes that there will be a gradual worsening of sovereign debt repayment prospects; and that tax relief on banks' provisions is phased in two ways:

(i) relief for 1990 provisions will be capped at 1989 levels, as determined by the Bank of England matrix in new statutory form. Relief for 1991 provisions will be capped at 1989 levels increased by 5 percentage points;

(ii) tax relief on debt sales will be phased analogously, or over 5 years.

13. Relief for workplace nurseries

Details being sorted out.

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14. Life assurance

Already announced.

Life assurance companies gain of the order of 50, from 1992-93, from abolition of stamp duty.

15. Charities

Breakdown:

	1990-91		1991-92
New VAT reliefs	- 5	- 5	- 5
Relief for one-off donations	-neg	-neg	-neg
Raise payroll giving limit to £600	nil	nil	-neg

Cost of relief for one-off donations assumes basic rate relief available to charities for donations of £600 or more up to limit of £5 million a year. Cost of -5 in 1992-93.

SECRET

16. Other

E.g. raise BES limit from £500,000 to £750,000; freeze annual exempt amount for CGT (which doubles for married couples with independent taxation); remove VAT relief from company accommodation provided for directors: double blind person's allowance.

B.L.O.

17. Total

Cost in 1992-93 just over -1,500.

18. Raise capital disregards

Housing benefit and community charge benefit: from £8,000 to £12,000.

Income support and family credit: from £6,000 to £9,000.

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MEANS-TESTED BENEFITS: CAPITAL LIMITS

I promised you a note on my proposal that the upper capital limits should be increased. I have now discussed this with Tony Newton. (I am sorry the note is so long but this matter is very complex.)

2. There are, of course, many different options. Details of three of them are set out in the annex.

3. Option A would involve a 50 per cent increase in all the limits. It would cost about £60 million in 1990-91, if the change in the community charge benefit limit only were made retrospective. The full year cost would be £90 million. There would be around 130,000 gainers, including 80,000 pensioners. Among the gainers would be 50,000 couples, so that 180,000 individuals in all would gain.

4. I know that you are concerned at the justification for higher limits in income support and family credit. But I think it would be difficult to defend leaving these limits unchanged at £6,000 while increasing the limits for housing and community charge benefits. In principle, there is no reason why we should help people up to a certain amount of capital with their housing costs and community charge bills but not with their other living expenses. And income support is a benefit which goes to many pensioners and disabled people as well as those who are unemployed, while family credit is, of course, an in-work benefit for those on low incomes.

5. This is the argument for Option B in the annex - a £10,000 limit for all the benefits, costing £100 million in a full year. However, Option A better meets our political objectives, in providing for a larger increase in the community charge benefit limit.

6. Tony and I have considered carefully the possibility of a higher limit for couples in community charge benefit (for example

on the lines of Option C in the annex). This has some attractions and would seem an appropriate response to the introduction of the community charge, which is a personal liability. However, upon examination, it has significant disadvantages too:

(a) If we conceded a higher couples limit in community charge benefit, we might well be pressed to do the same in the other benefits, at further substantial cost.

(b) Unless the rules for taking into account assumed income from capital were relaxed, a great many couples at the upper end of the new range (say at £15,000 or £16,000) would not benefit. However, relaxing these rules would help all those with capital above £3,000 and so add substantially to the cost of the change.

(c) The computer operations of most local authorities are programmed to deal with housing and community charge benefits on the same basis, with common rules for capital and income. It would be a major task to re-programme to provide for different treatment of capital, especially if we were also to introduce a new limit for couples.

(d) For this reason, it is unlikely that a higher limit for couples only in community charge benefit could be achieved by a large number of authorities in the course of 1990-91; we would have to wait until April 1991.

(e) We would be faced with some difficult cases of widows (and widowers) who would lose all their benefit entitlement on the death of their spouse, because the single person's limit would then apply. If only community charge benefit were affected, this would probably be defensible. But some people would also lose significant amounts of housing benefit, if the rules for the two benefits remained the same.

(f) Much of the present political pressure comes from widows with just over £8,000, who would not benefit from a couple's limit equivalent to £8,000 per person.

(g) Some of the pressure for a separate couple's limit comes from those who see an inconsistency between independent taxation and the fact that a couple's capital is jointly assessing in community charge benefit. We could only fully meet this point by providing that each partner in a couple should have a separate capital limit. This would breach the key principle that means-tested benefits are assessed for couples on the basis of joint incomes and capital. Departing from this principle would, of course, be extremely expensive. If we introduced a higher limit for couples while retaining joint assessment, we would then be pressed to bring in separate limits. I think we must maintain the position that it is right to treat taxes and benefits differently.

7. Option A would avoid these problems and would, in practice, provide more help to couples than to single people with the same income and capital. This is, of course, our intention, and there are two reasons for this. First, the income taper which reduces benefit entitlement (15p for each extra £1 of net income in the case of community charge benefit) does not start to operate for couples until a higher level of income than for single people. Second, community charge benefit pays for up to 80 per cent of the charges people actually pay, so that where two charges are payable entitlements will be higher for any given level of income and capital.

8. Having discussed these options in detail, Tony and I think that, on balance, a 50 per cent increase in all the limits (Option A) would be the most effective way of meeting our objectives - to encourage savings, while continuing to target help on those who need it most, and to provide additional help for people, especially pensioners, who are faced with high community charge bills. Another important consideration is that it could be

implemented by October, with the possibility of backdating the community charge increase to April. Other more complicated options (involving, for example, a separate higher limit for couples) might be feasible for some local authorities by October, but Tony is clear that a sufficiently large number of authorities would be unable to make such changes that we could not safely propose them.

9. The Chief Secretary has agreed that the first year cost of £60 million in 1990-91 (assuming retrospection for community charge benefit only) could be met from the Reserve.

10. Tony and I have discussed how far these changes could be backdated to 1 April. Changes to benefit rules are not normally backdated. And in administrative terms, exact backdating would be immensely difficult because in many cases, claimants' circumstances (eg levels of income and capital) will have changed in the intervening period. However, Tony believes that it would be possible for local authorities to apply a rough and ready retrospection of the increase in the community charge benefit limit. This could be done by making lump sum payments in October, which would be based on claimants' entitlements at that time. Although some claimants' personal circumstances may change between April and October, their community charges will (except in any capped authorities) be fixed over that period.

11. I think we need to give further urgent consideration to this point. Although there would be some presentational attractions in retrospection for community charge benefit, there might be anomalies which would be hard to defend. For example, some claimants might be entitled to benefit during April to September but not in October; they would get no benefit in respect of the earlier period. I am also uneasy as to whether we could defend retrospection for community charge benefit only and not the other benefits.

12. However, the main conclusion which Tony and I have reached is that I should announce in my Budget Statement a 50 per cent increase in the upper capital limits, as in Option A. I would welcome your views, following which Tony and I will consult further on the timing of implementation and, in particular, on how far the community charge change should be made retrospective.

13. I am sending a copy of this note to Tony Newton.

ANNEX

CAPITAL LIMITS: OPTIONS

Option A

	Current limit	Proposed
Income support/ family credit	£6,000	£9,000
Housing benefit/ community charge benefit	£8,000	£12,000

Cost: £90 million in full year
Gainers: 130,000 single people and couples.

Option B

	Current limit	Proposed
Income support/ family credit	£6,000	£10,000
Housing benefit/ community charge benefit	£8,000	£10,000

Cost: £100 million in full year

Gainers: 105,000 single people and couples

Option C

	Current limit	Proposed
Income support/ family credit	£6,000	£8,000
Housing benefit	£8,000	£10,000
Community charge benefit (single)	£8,000	£10,000
Community charge benefit (couples)	£8,000	£15,000

Cost: £75 million in full year

Gainers: 120,000 single people and couples.

Note: It is assumed that the existing lower capital limit of £3,000 (ie below which capital is ignored) is retained for all benefits. Costs exclude extra administration costs still to be agreed.

TAX RELIEF ON BANKS' SOVEREIGN DEBT LOSSES

Since the mid-1980s the banks have been making increasing provisions against their sovereign lending to third world countries, as the prospect that these loans will be repaid has receded. At the same time the Inland Revenue have been discussing with the banks, but have so far failed to reach agreement with them, about what tax relief may be allowed against these provisions. Tax relief of the order of £2-3 billion or so is at stake if the debts go wholly bad. I have concluded that I must act in the Budget to protect the Exchequer from excessive or premature tax relief, and to bring more certainty to the tax treatment of such provisioning.

2. The law at present is rather cryptic. It says that tax relief is available for bad debts and for doubtful debts to the extent to which they are estimated to be doubtful. But because a country cannot go bankrupt it is difficult to demonstrate that its debts are bad; and hard to reach an objective estimate of how doubtful they are.

3. The Inland Revenue have tried to deal with this difficulty by conducting their discussions with the banks around the Bank of England's matrix, which is an analytical tool used by the Bank to encourage the banks to make the prudential provision for such lending which is required by the Banking Act.

4. The Revenue have had partial success. But the banks have not yet come to an agreement with them and there is a real risk that the courts could find much higher amounts of tax relief are due under existing law. The prospect of repayment of these debts continues to recede and a step-change for the worse, such as we have seen in 1989, is always a possibility. That carries an unacceptable and unpredictable risk for the Exchequer.

5. I have accordingly decided to legislate in the 1990 Finance Bill to remove the uncertainties in the present law and to provide

for a planned phasing of this tax relief. Banks' tax relief will be capped in 1990 at 1989 levels as determined by the Bank of England's matrix in new statutory form; and in 1991 at a level 5 per cent above that, in 1992 10 per cent above and so on. If the banks sell their debt and crystallise their losses their tax relief on those losses will generally be similarly phased. Because we were forecasting a more rapid build-up of tax relief this change generates a tax yield of around £200m in 1991-92 and smaller amounts thereafter; this will unwind later on.

6. The banks will complain about this change but it is a less severe outcome than some of them have feared. We can argue that no change has been made to the principle that tax relief is available for bad and doubtful debts, and that the peculiarity of this lending and its scale requires clarification of the law in order to protect the Exchequer. On the international front my assessment is that this change will cause us some, but not unmanageable, difficulty, and that some will welcome it.

THE BUDGET : CHARITIES

This annex deals with my proposed measures to help charities this year

2. First, I want to give a boost to large one-off donations to charities, by giving income tax relief on them. David Waddington and Richard Luce have suggested that this would be helpful, and the charities have been pressing for it. I think we need this to fill a gap in the reliefs for charitable giving: regular donors can use either the payroll giving scheme or covenants; but the covenant system is ill-suited to encourage large gifts by the better-off.

3. What I propose is a scheme where a charity can claim back basic rate tax on large donations. The reason for giving the relief to the charity rather than to the donor is that the entire benefit will go to charity even if the donor does not increase his donations. (The danger of giving relief to donors is that they may pocket the tax relief without increasing their donation). Charities could then encourage further giving by saying "for every donation you give, we can claim an extra 33 per cent from the tax man". I would not - exceptionally - give higher rate tax relief here as that would complicate the scheme.

4. I have still to settle the details of the scheme, including the limits of the relief. I want a minimum amount on the size of donations which attract relief, because giving relief for millions of small donations would be prohibitively costly, both to the Exchequer and in administration. I am proposing to set this lower limit at £600 per donation.

5. I should also like an upper limit which would set a maximum on what the Exchequer would be prepared to contribute. I nevertheless have in mind a fairly high limit of £5 million.

6. The gross cost of this, depending on the take-up, might be about £15 million; but some of this may be offset by a reduction in the use of covenants, in which case the net cost would fall to about £5 million. (The reasons for the modest cost is the high threshold of £600.)

7. The remaining measures I propose for charities are :

- increase the payroll giving limit from £480 a year to £600 a year (ie an amount equal to the minimum for tax-relieved one-off donations);

- extend zero rates of VAT to ancillary work for charities' advertising, waterborne ambulances and in-shore rescue boats; and further extend the concessions for medical equipment (you will recall that European obligations prevent us from exempting charities from VAT entirely);

- introduce measures to simplify covenants further.

I am also considering relaxations in the existing provisions for relief for charitable donations by companies.

8. The cost of these measures will be about £6 million. So overall, the charities' package will have a gross cost of around £20 million in the first full year.

SAVINGS MEASURES

This annex describes the Budget proposals on savings.

Tax exempt small savings accounts.

2. The first measure is a new tax-exempt special savings account (TESSA, for short), to encourage and reward the saving habit among ordinary people. It will be a savings account, to be available from January 1991, into which individuals will be able to make contributions over 5 years. I particularly wish to encourage the banks and building societies to offer facilities for regular contractual saving in a TESSA, but the scheme will be sufficiently flexible to permit saving on a more ad hoc or intermittent basis. The interest will be completely free of both basic and higher rate tax provided no capital withdrawals are made until the end of 5 years. But withdrawal of interest will be allowed.

3. While I particularly want to attract the small saver, I have chosen not to make the limits on the amounts that can be saved too restrictive: £9,000 in total over five years, with an annual maximum of £1,800 (£150 per month). During the first year, however, investment of up to £3,000 will be permitted to allow pensioners, in particular, to invest a slightly larger lump sum initially if they wish, and draw on the interest. It will also encourage others to invest small lump sums they receive, perhaps on bonuses from their job or an inheritance.

4. I expect this scheme to be very popular with small savers, and to signal strongly our commitment to longer-term saving. If the banks and building societies rise to the challenge - as I expect they will - take-up could be significant. It is always difficult to make accurate projections for new schemes like this, but I would not be surprised to see it building up to, say,

5 million accounts over a few years. On this basis, the annual cost could then be £500 million or more a year.

5. Much of the initial investment will come from switching out of existing bank, building society and National Savings accounts. I see no problem here. Some may also come from investors choosing a TESSA rather than other forms of saving, including life assurance companies. Life offices will not welcome this, particularly as a package of measures we announced in December (primarily aimed at preventing life companies getting tax free capital gains) will have some cost for them. But the package was discussed in advance with the life industry, and they recognised that the capital gains loophole would have to be closed.

6. This will be the first time that ordinary savers will have been able to save in the High Street with banks and building societies (their preferred vehicles) and avoid tax on modest savings.

Composite rate tax on deposit interest.

7. As you know, at present, nearly 15 million people pay CRT who are not really liable for tax at all. Apart from the fact that this is unfair, Independent Taxation would make it very apparent and I am sure we have to have to take action. (If we do not, much of these savings will go off-shore and there will be a growing public perception of the unfairness of the present system.) To deal with this, the second significant savings measure is the abolition of composite rate tax (CRT) on bank and building society accounts. Like you, I want to see this implemented as quickly as possible, so that it will help non-taxpayers (including those who become non-taxpayers as a result of independent taxation) from the earliest possible date.

8. I am still discussing the practical details with the Revenue but I hope that it will prove possible to abolish CRT from April 1991. From that date, banks and building societies would

deduct tax at the basic rate on deposit interest. So the rate would rise from 22 per cent to 25 per cent for taxpayers, unless we cut the basic rate next year.

9. To achieve that, we shall need

- to work up with the banks and building societies special arrangements to enable as many as possible of the 15 million or so non-taxpayers to receive their interest gross; and

- to put the Inland Revenue in a position to repay tax to all those who do not or cannot take advantage of those special arrangements.

10. This is a big programme to be achieved in a very short time. There will be a significant cost (and some risk) in getting the new arrangements up and running. We shall need to explore with the banks and building societies how best to meet the 1991 timetable.

11. In Exchequer terms, the abolition should be more or less self-balancing over time, with a small net loss of revenue from taxpayers transferring assets to their non-taxpaying spouses (and perhaps other relations). But initially, differences in the timing of tax payments could give a yield of perhaps £800 million in 1991-92, which would be largely unwound in 1992-93 as the cost of repayments to non-taxpayers built up. The exact figures will depend on the number of non-taxpayers receiving payments gross.

12. All this is bound to require extra civil servants in the Inland Revenue and more office accommodation. While I shall of course keep the numbers down as far as is reasonably possible, I think a substantial increase is a price we have to pay.

Other measures

13. I am proposing a number of more modest savings measures:

(i) **Personal equity plans (PEPs)**: The annual investment limit is to be raised from £4,800 to £6,000 for 1990-91. Within that overall level, the limit for investment in unit or investment trusts will be raised from £2,400 to £3,000. I also propose to relax the requirement that to qualify, unit and investment trusts must themselves invest at least 75 per cent in UK equities: the figure will be reduced to 50 per cent.

(ii) I propose to raise the **capital disregards** for means tested benefits, including the community charge benefit. I am minuting you separately about this.

(iii) I am giving capital gains tax relief on transfers of shares into employee share ownership plan (ESOP) trusts. The effect will be that someone selling shares to the trust will be able to use the proceeds to buy another asset and will be able to defer tax on any gain until that asset is disposed of. We legislated a statutory framework for corporation tax relief for company contributions to ESOPs last year, but so far no one has taken this up. I believe that this new relief is needed to get things moving.

(iv) We have spoken about the **friendly societies tax-exempt limit**. I plan to increase it so that policies with premiums of £150 will be exempt (the present limit is £100). I shall, of course, want to review the tax treatment of friendly societies again when we have decided what to do about the powers and regulation of friendly societies

(v) I want to extend to banks the ability to offer **SAYE share contracts**. These contracts, which require regular savings over 5 years, are often linked to approved share option schemes. At present, only the Department for National Savings and building societies can operate them; but the banks have pressed to be able to offer them - they point out that it looks odd if, for the purpose of the bank's own share option scheme, employees have to save through a building society or DNS. And this measure fits well with the general thrust of savings package.

chex.ps/ds/1

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

NBPM
Press
2/3

1 March 1990

Brian Mower Esq
Director of Information
Home Office
Queen Anne's Gate
LONDON
SW1H 9AT

Dear Mr Mower,

BUDGET DAY PRESS NOTICES

As you will be aware, the Chancellor will be making his Budget Statement on Tuesday, 20 March. In handling press notices, we propose to follow the arrangements of previous years under which all press notices, including those issued by Departments other than the Chancellor's, are collated by the Treasury and issued as a package both to the press and to the House.

You will no doubt be considering whether your Department wishes to issue any press notices on Budget Day. I would be grateful if you would let Kate Gaseltine here (270 5666) know your intentions, the subject matter of any notices you will be producing, and a contact point (name and telephone number, together with a proxy) for any subsequent enquiry on each notice, by close on Monday, 12 March. All press notices should, of course, be cleared in draft with the appropriate divisions in the Treasury as early as possible.

We will need 1,990 copies of each press notice. These should be sent to Mr A T Flindell in our Committee Section (Room 30/G, Treasury Chambers) packaged in three sets numbering 170, 670 and 1,150 copies respectively. If you are issuing more than one press notice they should be packaged separately and clearly labelled.

In order to make the collation process easier, each notice should be hole-punched one inch from the top, one inch in from the left.

If any press notice is of more than one page in length it should be stapled.

You will appreciate that the Treasury will be collating an enormous volume of papers over the weekend before the Budget. As a consequence, it is essential that copies of press notices reach Mr Flindell by midday on Friday, 16 March, and preferably beforehand. I would be grateful if you would make meeting this deadline your personal responsibility.

I am writing in similar terms to other Chief Press Officers and have sent copies of this letter to Bernard Ingham (no.10), Paul Gray (No.10), the Private Secretaries of other Cabinet Ministers, and Trevor Woolley (Cabinet Office).

Yours sincerely,

Duncan Sparkes

DUNCAN SPARKES
Assistant Private Secretary

FILE KK

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

27 February 1990

Dear John,

COMPOSITE RATE TAX

The Prime Minister has noticed that over recent weeks there has been heavy press coverage on the implications of the introduction of independent taxation for investments where interest is paid net of tax. She is concerned about the possible implications of large-scale switches of investments by those married women who will in future have unused personal tax allowances including, for example, switches to offshore investments. She would therefore be grateful for an updated report from the Chancellor on how quickly it would be possible to introduce changes to remove non-tax payers from tax liability on investments currently covered by the composite rate tax arrangements.

Yours

Paul

(PAUL GRAY)

John Gieve, Esq.,
HM Treasury.

KK

PERSONAL

PRIME MINISTER

CABINET DISCUSSION OF BUDGET PROSPECTS

You discussed the handling with the Chancellor this afternoon.

You will want to start by inviting the Chancellor to introduce his paper.

Order of subsequent interventions

As agreed this afternoon, I have alerted the Lord President's Office that you would like him to speak first, and Messrs. Waddington and Wakeham's Offices that you will probably want to bring them in towards the end.

You will then want to judge the order in which to call others to speak. You may find it helpful to have the following two lists to hand; the expected strong supporters are on the left.

Howe	Walker (1)	Rifkind Sc.
(3) Parkinson	Hurd	Waddington H
(5) MacGregor	Mackay	Hogg Mo.
Ridley	Howard	
Brooke	Patten	
King	Baker (2)	L.P.S.
Wakeham	Gummer (8)	Lord Sc.
(7) Waddington	Rifkind (6)	
Lamont	Clarke (4)	For. Sec.
	Newton	N.I.
	Belstead	Soc Sec
		Trade Sec
		Energy

In summing up, you will want to stress that the absolute priority is bringing down inflation; hence the need to remain prudent and cautious.

Finally, you will need to agree the form of words to be used by Bernard, as follows:

"The Cabinet today held the usual pre-Budget economic discussion. They reaffirmed the economic strategy and the central objective of bringing down inflation, and agreed that economic policy should remain prudent and cautious."

PG

21 February 1990

jd c:pre-budget

chex.ps/jg2/40

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

20 February 1990

P R C Gray Esq
Private Secretary to
Prime Minister
10 Downing Street
LONDON
SW1

Note

Discussed and agreed by PM and Chancellor at their bilateral on 21/2. Subsequently agreed by Cabinet at the end of their discussion on 22/2, and then issued by the No. 10 Press Office.

PRCG 22/2

Dear Paul

CABINET ON 22 FEBRUARY

The Chancellor has been giving some thought to what should be said to the press about tomorrow's Cabinet discussion about the economy. He suggests that No.10 Press Office should say (as last year):

> "The Cabinet today held the usual pre-Budget economic discussion. They reaffirmed the economic strategy and the central objective of bringing down inflation, and agreed that economic policy should remain prudent and cautious."

If the Prime Minister agrees with this, perhaps you could pass on the above form of words to Bernard Ingham.

Yours

JG

JOHN GIEVE
Principal Private Secretary

20.02. 10 11 12 1 2 3 4 5 6 7 8 9 PM 90

6

Note

CF - pc.

Passed on PM's comments to John Grieve.

PRC6 19/2

PRIME MINISTER

ECONOMIC STRATEGY PAPER FOR CABINET

Next Thursday's Cabinet will include the usual pre-budget discussion. I now attach a draft paper the Chancellor proposes to circulate to Cabinet colleagues on Monday. This follows broadly the shape of earlier years. The point that will attract most attention is the inclusion in paragraphs 2 and 16 of an explicit acknowledgement that the annual RPI figures are likely to move above 8 per cent again during the Spring. For the rest, the paper includes nothing very surprising.

I have marked a couple of minor comments on the first page of the draft. But, assuming you are content for the over 8 per cent forecast to be included, the rest of the drafting seems OK to me.

You will see the Chancellor is planning to add as an Annex to the paper the note you saw earlier in the week, giving a preliminary assessment of the impact of Germany Monetary Union.

i) Content for the Chancellor to circulate his paper on this basis?

Yes

Or

ii) Any further comments you want to pass on?

I think he is too optimistic about the current account deficit

PRC6.

PAUL GRAY

16 FEBRUARY 1990

(1)

(2) One is left with an uncomfortable feeling that everyone else knows how to keep down inflation, and we don't. Are there many figures more reliable than ours? Our forecasts have been totally wrong.

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chex.ps/jg2/34 covering SECRET

S (A J)

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

16 February 1990

P R C Gray Esq
Private Secretary to
Prime Minister
10 Downing Street
LONDON
SW1

Dear Paul

ECONOMIC STRATEGY PAPER FOR CABINET

... I attach a copy of the draft Memorandum by the Chancellor for Cabinet next week. Subject to any comments that the Prime Minister may have, and to the addition of a fourth annex on the Economic Implications of German Monetary Union, the Chancellor would propose to circulate this to colleagues on Monday.

Yours,

JG.

JOHN GIEVE
Principal Private Secretary

B

ECONOMIC STRATEGY

Memorandum by the Chancellor of the Exchequer

Introduction

Following the exceptional growth in 1987 and 1988, we saw a slowdown last year in both consumer demand and business investment. However, demand proved more resilient than we expected at this time last year. The current account deficit rose in 1989; RPI inflation remained stuck at 7½ per cent or more (around 6 per cent excluding mortgage interest payments); and in the labour market, earnings growth increased and unemployment continued to fall. As a result we were obliged to raise interest rates by a further 2 per cent.

2. Recent figures for retail sales, trade, and both business and consumer confidence provide further evidence that demand is slowing down; and the foreign exchange and money markets have been steady. The tightening of policy is clearly working. Our central forecast is that, provided we keep policy tight, we will see a further slowdown this year with a reduction in the current account deficit and, in due course, an easing in inflation. This is in line with most outside forecasts. But there nevertheless remains considerable uncertainty; growth in the monetary aggregates, for example, remains uncomfortably high and there is always a danger of market turbulence. Moreover, the ~~rate of inflation~~ RPI is bound to rise in the next few months and remain high until well into the Autumn. The prospect for 1990 is therefore an unappealing combination of low growth, possibly rising unemployment, and little progress on inflation. But as long as we avoid the temptation to relax policy too quickly, we should see inflation coming down at the end of the year and during 1991, and a recovery in output growth.

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3. In the circumstances, I am sure that we must maintain a cautious approach in the Budget as well as in monetary policy, while continuing our policies to improve the efficiency and flexibility of the economy. If we do so I have no doubt that our economic performance over the next decade can be at least as successful as in the 1980s, and probably more so.

The world economy

4. The world economy grew rapidly in 1988 and 1989, but GNP and world trade have been slowing during 1989 in response to higher interest rates worldwide. Within the Group of Seven growth has slowed most in North America, while in West Germany and other European economies activity has remained strong throughout 1989. G7 growth is expected to slow a little further in 1990, though the scale of the slowdown is likely to be modest when compared with the downswings of the 1970s and early 1980s - a soft landing. Events in Eastern Europe will tend to boost world trade and output, but are unlikely to have significant effects in the short term.

5. Consumer price inflation has risen in all G7 economies, but remains on average some way below underlying inflation in the UK. Because monetary policy is now tighter worldwide than in 1988, and GNP growth is forecast to ease, consumer price inflation in the G7 should fall gradually over the coming year, from 4½ per cent now to 3½ per cent by the end of the year. Real non-oil commodity prices fell during 1989, and a further small fall may occur this year: in contrast oil prices rose during 1989 and the beginning of this year.

Demand, output, and unemployment

6. In the UK, domestic demand - the sum of consumption, fixed investment and stockbuilding - grew by 5¼ per cent on average in the four years to 1989. Over the same period non-oil GDP grew by over 4¼ per cent. Growth in both domestic demand and GDP at such

D

rates is some way above the growth of productive capacity in the economy, and faster than over any four year period since the war.

7. Growth on this scale was in part the result of an investment boom. Business investment grew rapidly from the mid-1980s, and by over 10 per cent in each of the last three years. A higher rate of return on capital, now back to its highest level for over twenty years, and the creation of an environment that encourages enterprise, contributed to this remarkable surge in investment, which is already enhancing the supply potential of the economy. While we expected investment and productivity to benefit from our policies, no-one expected a boom on the scale that actually occurred.

8. Consumer spending has also grown very rapidly - by over 5 per cent per annum on average over the four years to 1989. The confidence generated by rising wealth and incomes since the early 1980s has been reflected in a sharp reduction in the saving ratio, associated with higher borrowing. Consumers are in a better position to arrange their spending and borrowing as they wish, now that the controls on the financial system in place until the 1970s have been lifted.

9. A sharp slowdown in demand was clearly necessary after this period of excessive growth and the inflationary pressures thus generated. Recently there have been some welcome signs that this adjustment is indeed occurring. Consumer spending has slowed, and in the last three months the volume of retail sales was only 1½ per cent higher than a year earlier. It looks as if business investment may have peaked in the middle of 1989. Industrial output has also slowed down, and capacity constraints have eased.

10. Domestic demand may well fall a little in 1990. Consumers' expenditure is forecast to follow the trend of recent months, rising only very slowly as the personal sector adjusts further to high interest rates. The end of the housing boom should be an important restraining influence. Companies are likely to trim

their stocks and cut their capital expenditure by a modest amount. After so powerful an investment boom it is not at all surprising that in the very short term some retrenchment is likely.

11. While domestic demand may fall slightly, net exports should continue to grow strongly, sustaining the growth of output. I have no reason to change the forecast of GDP growth I made in the Autumn Statement - just under 1 per cent. GDP growth at this rate would in normal circumstances lead to a rise in unemployment. But while the monthly path for unemployment could be on a rising trend during much of the year, unemployment may be lower on average in 1990 than in 1989.

12. The precise timing and extent of any rise in unemployment will depend crucially on how companies react to high wage demands. They already face a difficult financial position. With a tight policy stance they will have limited scope for passing on cost increases in higher prices. If they allow wages and unit labour costs to accelerate, many are likely to face a severe squeeze later in the year, which in turn could lead to sharper cutbacks in employment, investment, and stocks.

13. Clearly there is great uncertainty attaching to forecasts for growth and unemployment when the economy is at a turning point. It looks as if GDP growth will moderate without the level of GDP actually falling. But the uncertainties are such that it is not possible to rule out a fall in output over a short period. We must continue to stress the need for pay restraint, and to exercise it ourselves in the public sector.

Inflation and the current account

14. The excessive growth of demand and output until early 1989 caused considerable strain in the economy, with serious capacity constraints emerging in a number of industries and rising inflationary pressure. One symptom was the current account deficit of just over £20 billion in 1989. Another was the most

unwelcome rise in RPI inflation - to over 8 per cent between April and July last year. While the inclusion of mortgage interest payments in the RPI makes it a distorted measure of underlying consumer price inflation, the latter also rose - to just over 6 per cent.

15. We cannot be content with an underlying inflation rate of over 6 per cent. The fact that RPI inflation has consistently been below the levels recorded under the last Labour government is small consolation in either economic or political terms. Our performance is still markedly worse than our major overseas competitors. We remain committed to the further reduction of inflation, and any rise in it, however modest by historical standards, requires a firm policy response.

16. RPI inflation is likely to rise to over 8 per cent in the next month or so and is unlikely to come down very far until well into the autumn. One contributory factor is the recent rise in mortgage rates. And a number of special factors, of which the introduction of the community charge at unjustifiably high rates is the most notable, will also add to inflation over this period. (Conversely as they fall out of the 12 month comparisons these factors will tend to depress the rate of inflation in Spring 1991.) A tight policy stance always takes time to influence underlying price and wage inflation, and there could be an uncomfortable period during 1990 while output growth appears to be very low without any apparent progress on inflation. However, by the end of the year, and during 1991, the tight policy stance should be seen to be having the desired results, and both underlying and recorded RPI inflation should be on a downward trend.

17. Progress is likely to be quicker in reducing the current account deficit. Companies have clearly already switched production to overseas markets as domestic demand and capacity constraints have eased; exports of non-oil goods have risen by 15 per cent over the last year. Because world trade growth is

G

likely to fall a little, export growth may be somewhat slower over the coming year than in recent months; but it should nevertheless remain higher than import growth which has already fallen sharply. As a result the prospect is for a substantial fall in the current account deficit in 1990, broadly in line with the Autumn Statement forecast of £15 billion.

Monetary developments

18. Concern about inflationary pressures and the slow response of the economy to the tightening of policy, together with political uncertainties at the end of 1989 and a strong deutschemark, led to a fall in the sterling index of just over 10 per cent during 1989. Recently sterling has firmed, and returned to the level of last Autumn. But that is still over 8 cent below its level at the beginning of 1989. This has added to upward pressure on costs and prices. Growth of MO has been above its target range since April 1988; and broad money (M4) and credit have continued to grow rapidly.

19. Against this background, monetary policy was tightened during 1989, with two increases of 1 per cent in the general level of short-term interest rates. Mortgage rates also rose during 1989, and have risen further in the last few days to a level nearer their normal relationship with base rates. (The most recent increase in mortgage rates will not immediately affect those whose monthly payments are fixed under annual schemes and have already been set for 1990.) Unpopular as these rises have been, they are having their desired effect, with an adjustment in the housing market a necessary part of the process of restraining domestic demand. We shall have to keep interest rates high until inflation is clearly back on a downward track; it would be folly to lower them prematurely and then be forced to raise them again.

H

Public finances

20. It now looks as if the PSDR for 1989-90 will be a good deal lower than the £12½ billion I forecast in the Autumn Statement, which was itself below the £14 billion expected at budget time and the £14½ billion recorded last year. There are a number of factors behind the shortfall: on the expenditure side, the outturn is expected to be over £2 billion higher than planned, with privatisation proceeds lower than expected, and a surge in capital expenditure and borrowing by local authorities seeking to forestall the tighter controls that will apply next year; and on the revenue side, corporate tax payments have been lower, and - as a result of our policy on personal pensions - rebates have been a little under £2 billion higher than expected. These adverse influences have been offset only partially by higher income tax receipts than expected.

21. Looking forward to 1990-91, there are a number of factors which will tend to reduce the PSDR further. Some tax changes announced in earlier Budgets have not yet had their full effect: independent taxation, which was announced in the 1988 Budget, comes into effect in April; and PSDR will reflect the full year effect of the reform of National Insurance Contributions which came into effect last October. At the same time, the cyclical slowdown in the economy will reduce the growth of tax revenue, particularly from companies, and increase the upward pressure on public expenditure. I expect to see a smaller surplus in 1990-91 than this year, and a quicker fall from budget surplus to budget balance than envisaged in last year's MTFS.

Conclusion

22. After two years in which the economy had been growing at an unsustainably rapid rate, there are now clear signs of a slowdown. This is to be expected, and indeed welcomed prior to the resumption of steady growth. Already the current account deficit is showing signs of falling.

I

23. But progress on inflation will be slower. If we are to succeed in getting inflation down, fiscal policy must support monetary policy. This means a cautious Budget, with little if any scope for reducing tax rates or other reliefs.

24. I have endeavoured to set out all the difficulties before us in this paper. But I see no need for excessive pessimism. By next year I do expect a lower trade gap, lower inflation and rising growth. But that does depend on our policies this year.

25. I would welcome colleagues' views on the Budget in the light of the fiscal and economic prospects which I have outlined.

... 26. As background, I attach the three usual annexes on the economic record and prospect, the direct effects of tax changes, and the public finances and the tax burden. I have added an annex this year on the economic implications of German monetary union.

b

ANNEX 1

	1981	1982	1983	1984	1985	1986	1987	1988	1989 latest estimate	1990[1] Forecast	10 year average
World GNP,[2] in major 7 economies (per cent change)	1½	-½	3	5	3½	2½	3½	4½	3½	3	3
UK GDP[2] (per cent change)	-1	1¾	3½	1¾	4	3¼	4½	4½	2¾	¾	2½
Domestic demand[2]	-1½	2¼	4¾	2½	2¾	4¼	5½	7½	4	-1	3
Retail prices Q4 (per cent change on a year earlier)	12	6	5	5	5½	3½	4	6½	7½	6½	6
Interest rates (average 3-month interbank)	14	12½	10	10	12	11	9½	10½	14	15⅛[3]	
Unemployment (UK, per cent of working population excluding school leavers)	8½	10	10¾	10¾	11	11¼	10¼	8¼	6½	6¼	
Sterling index	118½	113	104½	100	99½	91½	90	95½	92½	89½[3]	
memorandum items											
Non-Oil GDP	-1½	1	3¼	1½	4	3½	5	5	3¾		
Consumers expenditure	0	1	4¼	1¾	3¾	5½	6	7	4¼		
Business investment	-9	2¾	3	10¼	7½	-½	10¾	17½	10½		

[1] *Provisional pre-Budget figures*

[2] *At constant prices*

[3] *February 12*

ANNEX 2 : DIRECT EFFECTS OF TAX CHANGES

A. Direct Taxes : Indexation

The RPI increased in the year to December 1989 by 7.7 per cent. With indexation by this amount and statutory rounding, the figures for the main allowances and income tax bands, and their equivalents this year, would be:

	1989-90	1990-91	
Personal allowance	2,785	3,005	220
Married couple's allowance	1,590	1,720	130
Tax rate bands			
25% rate	20,700	22,300	
40% rate	over 20,700	over 22,300	

The total revenue cost of indexation of income tax (included in the forecast) is £1,670 million in 1990-91.

B. Indirect Taxes : Indexation

The effects of 7.7 per cent revalorisation of the excise duties (including VAT effects) are as follows:

VAT inclusive price change		Yield in 1990-91 £m	RPI impact % points
Beer	1.7p/pint	160	0.07
Wine	6.8p/75cl light wine	55	0.06
Spirits	41.9p/bottle	80	0.04
Tobacco	7.4p/20 king size	265	0.16
Leaded Petrol	8.2p/gallon	305	0.14
Unleaded Petrol	7.1p/gallon	175	neg
Derv	7.0p/gallon	110	0.01
VED	£7.70/car	180	0.06
Overall effect, (including minor duties)		1400	0.55 (1)

(1) Figures do not sum due to rounding.

C. Ready Reckoners : Illustrative Tax Changes

	£ million 1990-91	1991-92
INCOME TAX		
Allowances and Thresholds		
1% above indexation on all statutory allowances	180	250
1% above indexation on all statutory allowances and basic rate limit	205	295
Rates		
Change basic rate by 1p	1,500	1,900
Change higher rate by 1p	130	270
CORPORATION TAX		
Change in main rate of 1 percentage point	390	570
Change in small companies' rate of 1 percentage point	35	45
VALUE ADDED TAX		
Change in VAT rate of 1 percentage point[1]	1,515	2,070

[1] A 1% change in the VAT rate would change the RPI by 0.48%.

ANNEX 3 : PUBLIC FINANCES AND THE TAX BURDEN

Taxation, Expenditure and Borrowing

Since the Government first took office, total taxes and NICs have risen by 3½ percentage points of GDP, though the ratio has fallen from its peak in 1981-82. This has enabled us to make net repayments of government debt in the last three years.

Table 1

Overall Taxation, Expenditure and Borrowing
(percentage of GDP at market prices)

	Non-North Sea Taxes plus NICs (as per cent of non-North Sea GDP)	Total Taxes plus NICs	General Government Expenditure (excluding) privatisation proceeds)	PSBR
1978-79	34.1	33.8	43.2	5.3
1979-80	35.0	35.0	43.4	4.8
1980-81	36.1	36.2	45.9	5.3
1981-82	38.6	39.3	46.5	3.3
1982-83	38.1	38.8	46.7	3.1
1983-84	37.6	38.4	45.8	3.1
1984-85	37.7	39.1	46.1	3.1
1985-86	37.0	38.5	44.4	1.5
1986-87	37.4	37.9	43.5	0.9
1987-88	37.6	37.9	41.3	-0.8
1988-89	37.1	37.3	39.0	-3.0

Personal Taxation

Despite reductions in income tax, total personal taxes (direct and indirect, including employees' NICs and domestic rates) in 1989-90 are over £30 billion higher in real terms (ie 1989-90 prices) than they were in 1978-79. For income tax and national insurance contributions the following table shows how the proportion of gross pay they represent rose up to 1981-82:

Table 2

Income Tax and NICs as a per cent of Gross Earnings*

	½ average earnings	average earnings	2 average earnings
1978-79	16.0	27.8	31.4
1981-82	20.8	29.3	32.2
1982-83	20.8	29.8	32.3
1983-84	20.1	29.6	31.7
1984-85	19.3	29.2	31.5
1985-86	18.9	29.0	31.5
1986-87	18.9	28.5	30.9
1987-88	19.1	27.6	29.9
1988-89	18.6	26.3	28.3
1989-90 (estimate)	17.9	26.0	28.3
1990-91 (indexation)	16.9	25.5	28.1

These figures reflect the rise in the standard employees' NIC rate from 6½ per cent to 9 per cent followed by the cut in the rate on earnings below the LEL to 2 per cent in 1989. The lower rates introduced in the 1985 Finance Act do not affect the cases shown. So far as income tax is concerned, personal allowances have increased by about 24 per cent in real terms since 1978-79, slightly less than earnings. The basic rate has been reduced from 33p to 25p.

Average earnings have of course increased by substantially more than prices since 1978-79. So a married man on average earnings has seen his real take-home pay rise by £54 per week. The increase for a married man on half average earnings has been £26 per week, and on twice average earnings £110 per week.

As the table shows, indexation of allowances in the Budget, with no reduction in the basic rate, would lead to a slight fall in the proportion of incomes taken in tax and NICs. This is because 1990-91 sees the effect of the October 1989 NIC reform throughout the year, whereas the financial year average figure given for 1989-90

*Adult male earnings (all occupations). Married couple, wife not working: the couple are assumed to have no children, to avoid distortion of the figures from the abolition of child tax allowances.

includes half a year of the old system. If the post-October figure were looked at for 1989-90, indexation would lead to a very slight rise in the proportion of incomes taken in tax and NICs. This is because earnings are assumed to rise by more than the increase in tax thresholds, which is indexed to changes in prices.

Business Taxation

Following the sharp rise in corporation tax receipts since 1983-84, as a result of the substantial recovery in company profits, total taxes paid by businesses (outside the North Sea) are now higher as a percentage of GDP than in 1978-79. The rise in total taxes on business as a share of GDP was made up of a large rise in corporation tax and smaller rises in other taxes; employers' NICs and NIS fell.

Table 3

Tax paid by Businesses £bn in 1988-89 prices
(figures in brackets are per cent of GDP)

	Corporation Tax[1]	Taxes on self employment incomes	Employers' NICs and NIS	Rates	Other[2]	Total
1978-79	8.4	2.8	13.6	5.5	4.3	34.6
	(2.2)	(0.7)	(3.6)	(1.4)	(1.1)	(9.1)
1989-90 (forecast)	18.0	4.6	13.0	8.4	7.5	51.4
	(3.7)	(0.9)	(2.7)	(1.7)	(1.5)	(10.5)

[1] Excludes North Sea, but includes ACT

[2] VED, car tax, road fuel duty, duty on rebated oils, capital taxes

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BUDGET - SECRET

4 (a-e)

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

PRIME MINISTER

INITIAL BUDGET DISCUSSION WITH CHANCELLOR : 8 FEBRUARY

You are seeing the Chancellor for an hour tomorrow evening when he will unveil his present Budget thinking. He wants to see you privately, but he plans to hand over to you an aide-memoire.

2. I have obtained strictly privately from the Chancellor's office the attached draft of the aide-memoire, so that you have advance warning of what he will say. The Chancellor does not know that either you or I have seen it, so please do not reveal you had any advance warning of its contents.

Overall Stance

3. The summary table at the back of the paper shows this would be a broadly neutral Budget, though with a modest net cost (£300m) in 1991-92.

4. Is that the right stance? I see no case for any looser

BUDGET SECRET

(2)

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From the Private Secretary

stance; the main question is should it be tighter? If late in the year the Budget looked to have been too tight you can always lower Tax and NICs then loosen monetary policy - but not vice versa.

5. Worth considering slight under-indexing of the main tax allowances, eg 5% rather than some 7½% implied by indexation?

Company Cars

6. With no major tax give-aways a further swipe at company cars implies net losses for eg middle-income taxpayers with cars. That may be the justification for only a further 20% increase in scale charges; other arguments would point to a bigger jump. What residual untaxed benefit would be left after 20%?

Excise Duties

7. The overall package seems to be slightly less than indexation, and is ~~[illegible]~~ allowed for in the latest Treasury forecast.

Several questions:

- should ~~[illegible]~~ spirits be more than indexed, as proposed for petrol and cigarettes?
- why not widen further the unleaded petrol gap ~~[illegible]~~ (particularly given the absence of many "green" measures)?

BUDGET - SECRET (3)

C

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LONDON SW1A 2AA

From the Private Secretary

VAT

8. The VAT bad debt relief etc. package seems quite expensive in 1991-92 (£225m.). Is that justified or necessary?

Corporation Tax

9. Is it worth spending £315m. in 1991-92 for 1% off the main CT rate? Wouldn't it be better to be more generous in raising the small companies rate?

Environment

10. If we're going for differentiated car tax, is it worth also looking again at scrapping VED and putting the tax all on petrol?

Savings

11. Abolishing the composite rate arrangements for banks and building societies would be popular for non-taxpayers - particularly the new class of pensioner wives with unused tax allowances. But: (1) it reverses the decision taken on banks in the early 1980s.

(2) what are the Inland Revenue manpower implications?

BUDGET - SECRET

(4)

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10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

12. The new ~~[illegible]~~ tax-free contractual savings and five-year savings plans look quite useful complements to SAYE and PEPs to cater for regular savers who are not interested in equities.

13. Could higher capital disregards for ~~[illegible]~~ social security be brought into effect for 1990-91 community charge payments? But, if so, is this the most sensible way of targetting extra help?

14. You will see the Chancellor has responded to your doubts about a credit tax.

Sovereign Debt

15. Does the tax shelf limit have to be as high as 50% if the Chancellor is worried about the implied tax loss this year. Against that, a tougher regime than the Labour Bank of England matrix would undoubtedly be interpreted as the response to your "fuzzing with fury" over student loans.

BUDGET - SECRET

(5)

10 DOWNING STREET
LONDON SW1A 2AA

From the Private Secretary

Charities

16. You asked the Chancellor to consider tax relief for one-off gifts (the Ulrichsen proposal). A Green Paper this year, rather than firm proposals, seems sensible.

Football

17. You will want to consider the balance between carrot and stick.

Other

18. Raising the limit on exempt Friendly Society savings is another idea you asked the Chancellor to look at. Is £150 high enough?

MTFS

19. The paper is silent on this. If the Chancellor does not raise this you might ask him for his latest thinking in the light of the seminar discussion.

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AIDE MEMOIRE ON BUDGET

Income Tax and NICs

No change in income tax rates.

Indexation of personal and married couples allowances, probably some over indexation of age allowances.

No change to NICs.

Company Cars

Car scales (which determine the amount of taxable benefit from company cars) to be increased by 20 per cent, following increases of 100 per cent and 33 per cent in last two years.

Excise Duties

Broad indexation of excise duties. VED and duty on cider, cigars and pipe tobacco frozen; petrol duty and cigarettes duty raised by 10 per cent. Unleaded/leaded differential will widen automatically by 1½ pence a gallon. The impact on the RPI in April will be a little over 0.5 per cent, (which is already in the forecast).

VAT

No change to VAT rate or coverage.

To help business, provide relief from VAT for bad debts, simplify the registration rules for VAT, and raise the registration threshold to the maximum permitted by EC Laws

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Corporation Tax

Reduce Corporation Tax main rate by one per cent to 34 per cent. How much?

Increase thresholds for the small companies rate from £150,000 and £750,000 to £200,000 and £1m benefiting 35 per cent of the 50,000 companies currently paying tax at the main CT rate.

Environment

Apart from the rise in the leaded to unleaded petrol differential, considering the scope for differentiating car tax to bear more heavily on less fuel efficient cars. Not attracted to other measures, for example tax incentives for catalytic converters.

Savings

Considering the abolition of Composite Rate Tax from 1 April 1992 thus allowing many married women with incomes below the tax threshold to benefit from independent taxation.

Introduce a new contractual savings scheme from January 1991 with a monthly savings limit of £250 allowing people to avoid tax on savings income where they save regularly over five years. Over several years the takeup is likely to increase and the cost will grow to, perhaps, £150m. Unlike SAYE, the schemes will be run by Banks and Building Societies.

Also examining, the possibility of a five year savings plan with an annual limit of £3,000. This would enable capital and interest to build up tax free and encourage people inheriting or otherwise coming into small capital sums to save for a prolonged period. The cost could rise to £150m in due course.

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Exploring also the possibility of exempting interest on small savings accounts (for example exempting up to £100 of interest for each taxpayer). This would be more expensive than the other schemes but could have presentational advantages and also reduce the administrative cost of abolishing CRT.

Abolish Stamp Duty on shares from 1 April 1992. Announcement and legislation needed now to enable the Stock Exchange's new paperless transaction system to be planned and implemented on this basis. Essential to maintain City's competitive position as other countries abolish their duties.

Raise the PEP limits from £4,800 to £6,000 and within that the limit on investments in unit and investment trusts from £2,400 to £3,000. Also change rules to allow inclusion in PEP of investment trusts with 50 per cent of their portfolios in the UK rather than 75 per cent as now.

Provide CGT rollover relief for sales of shares to ESOP trusts.

Raise the capital disregards for certain social security benefits (currently £6,000 for income support and £8,000 for community charge benefit and housing benefit). A number of options still under consideration; one would be to raise the limits of pensioners only (or couples only).

Considered the possibility of imposing a credit tax in order to discourage borrowing but decided against. (This would be necessary in the next Parliament - though unattractive).

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Sovereign Debt Provisions

Limit tax relief on banks doubtful sovereign lending at 50 per cent of total exposure (broadly the figure suggested by the Bank of England's revised matrix). This will bring certainty on the tax due (Inland Revenue are still discussing with the banks the relief for 1987 and 1988) and will detach the tax relief from the Bank's decisions on prudential provisioning. It would allow the Government to phase in the cost of further provision over a period of 7 years. (This year we have a most unwelcome tax loss of around £½ billion).

Charities

Increase the payroll giving limit.

Considering the desirability of issuing a Green Paper on providing tax relief for one-off gifts.

Football

Exploring the possibility of a package of measures to help football grounds meet the recommendations of the Taylor Report:

(a) clarify eligibility of ground improvements for capital allowances;

(b) reduce Pool Betting Duty from 42½ per cent to 40 per cent on condition that the 2½ per cent is passed to the Football Trust to be used in ground improvements;

(c) possibly, introduce a levy on transfer fees.

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Other Proposals

Other proposals include:

(i) implementation of the second tranche of life assurance reforms (already announced in January);

(ii) indexing the thresholds for IHT and CGT.

(iii) increasing the limit on the exempt Friendly Society savings from £100 to £150 (annual premium).

7 February 1990

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DIRECT EFFECTS OF BUDGET MEASURES

	£ million		yield (+)/cost (-)
	1990-91		1991-92
	Changes from a non-indexed base	Changes from an indexed base	Changes from an indexed base
1. Index income tax allowances	- 1670	nil	nil
2. 10% on age allowances	- 50	- 50	- 70
3. Increase car scales by 20 per cent	+ 160	+ 160	+ 200
4. Excise duties	+ 1430	+ 30	+ 50
BUSINESS			
5. 1% off main corporation tax rate	- neg	- neg	- 315
6. CT: raise small companies thresholds to £200,000 and £1 million	- neg	- neg	- 25
7. VAT: bad debt relief, simpler registration rules	- 35	- 35	- 225
SAVINGS			
8. Contractual tax-exempt savings scheme	- neg	- neg	- 25
9. Ten year savings plan	- neg	- neg	- 20
10. Abolish stamp duty on shares from introduction of TAURUS (assume 1/1/92)	+ 10	+ 10	- 90
11. PEPs, ESOPs etc	- neg	- neg	- neg
OTHER			
12. Limit relief on banks' sovereign debt provisioning	nil	nil	+ 120
13. Life assurance: already announced	+ 50	+ 50	+ 95
14. Other starters	- 25	+ 5	nil
15. **TOTAL**	- 130	+ 170	- 305
16. Raise capital disregards for community charge benefit etc	- 15	- 15	- 30

7 February 1990

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2 The Medium Term Financial Strategy

2.01 The central objective of the Medium Term Financial Strategy (MTFS) is the defeat of inflation.

2.02 The rise in inflation in the post-war period was put into reverse in the 1980s. This was done by maintaining tight monetary and fiscal policies, complemented by structural policies to improve the responsiveness and flexibility of markets. That remains the right approach to economic policy and the one the Government will follow in the 1990s.

2.03 ~~It will do so because~~ Inflation damages the economy by increasing uncertainty, discouraging investment and reducing profitability. It brings conflict into industrial relations and reduces confidence in the management of the economy, at home and abroad. Action to maintain the soundness of the currency remains a prime duty of government.

2.04 The social effects of inflation are no less destructive. Inflation redistributes income and wealth arbitrarily and capriciously. It discourages saving and is a disincentive to those who wish prudently to provide for their retirement. It bears most heavily on the people least able to protect themselves.

2.05 The MTFS will remain the centrepiece of the Government's economic policy. It will continue to be accompanied by policies which encourage enterprise, flexibility and efficiency, and thus promote the growth of output and the creation of jobs.

2.06 All major western governments have increasingly followed these policies in recent years, giving primacy to the drive against inflation. And the means of controlling inflation are fundamentally the same in all countries, whatever their institutional structure. They are based on an effective monetary policy supported by a firm fiscal policy. No other methods have been successful.

2.07 These policies do not guarantee a permanent low rate of inflation. Unforeseen events at home or overseas can cause ~~some price rises~~ pressures which may lead to a rise in the general price level—as happened with the increase in oil prices in 1973 and 1979. At other times a prudent policy decision taken for the right reasons on a balance of risks can have unforeseen consequences for inflation. But maintenance of sound monetary policies will always require corrective action to be taken, to reverse the rise in inflation and set it on a downward trend.

2.08 This is the course which monetary policy has followed in the United Kingdom over the past decade. It brought inflation down sharply from the high levels of the 1970s, and was set to bring about a further reduction until the renewed resurgence of inflationary pressures in 1987 and 1988. The Government's response to this renewed threat was to tighten monetary policy sharply.

2.09 The Government is determined to bring about a decisive fall in the rate of inflation. But it is not enough simply to state this. It is important for the Government to say clearly how it intends to operate monetary policy, now and in the future, and to set itself realistic objectives which, with determination, will be achieved. In this way the whole economy can work with the grain of the Government's counter-inflation policy.

move to para 2.22

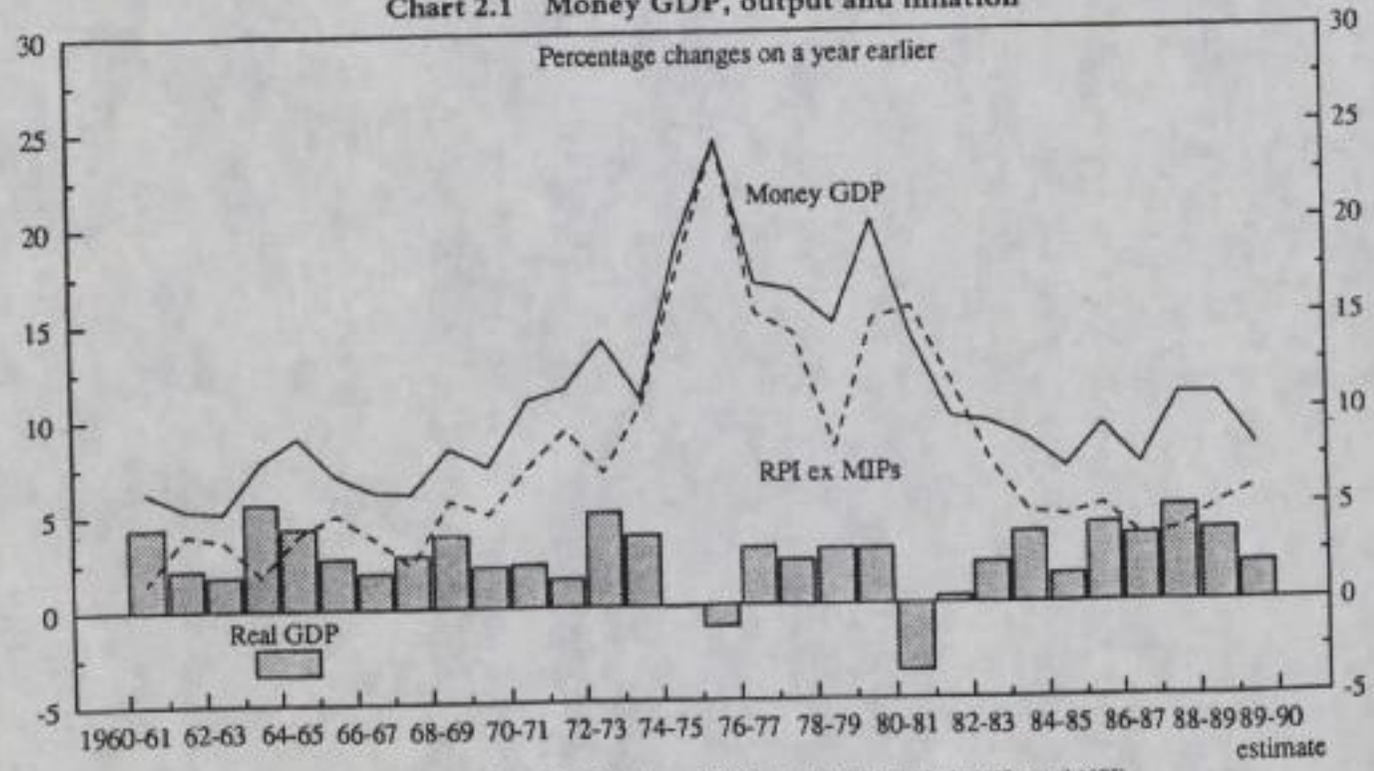
2.10 The Government has committed itself to join the exchange rate mechanism (ERM) of the European Monetary System when the level of UK inflation is significantly lower, there is capital liberalisation in the Community and real progress has been made towards completion of the single market, freedom of financial services and strengthened competition policy. It remains committed to that. But membership is a complement to, and not a substitute for, an effective monetary policy. A medium term financial strategy, which follows the principles set out in this chapter is required both to reduce inflation and to sustain the anti-inflationary stance which ERM membership requires.

2.11 The following sections set out the Government's economic policy in more detail, explain how monetary and fiscal policies have been formulated, and how the Government determines day-to-day decisions about interest rates.

Money GDP and inflation

2.12 The rate of growth of money GDP has averaged some 10 per cent a year over the last three years. This is much too high. The Government's strategy is to keep policy tight enough to secure a much lower rate of growth in money GDP over the next few years. This should bring about a substantial fall in inflation.

Chart 2.1 Money GDP, output and inflation



Note: Before 1975–76 all-items RPI (which did not include MIPs until 1975)

2.13 Chart 2.1 illustrates the close relationship between growth in money GDP and inflation over the last 30 years. Sharp changes in money GDP growth are often associated in the short term with changes in output. But sustained differences in rates of growth of money GDP are reflected in inflation rather than real growth. The extent of the short-term impact on output depends on how well markets work. The labour market is particularly important in this respect: if labour costs continue to rise fast well after policy has been tightened, that is bound to result in lost output and higher unemployment.

2.14 The period covered by the MTFS is being rolled forward this year to end in 1993–94: Table 2.1 shows the Government's objective for money GDP growth over this period. Real GDP growth is forecast at ¾ per cent in 1990–91 (more details are given in chapter 3), but is expected to recover the following year. For 1992–93 and the following year output growth is projected at 2¾ per cent, the same trend as assumed in last year's MTFS. The easing of capacity-utilisation that the forecast implies should mean much more moderate inflationary pressures over the medium term.

Table 2.1 Money GDP growth, output and inflation[1]

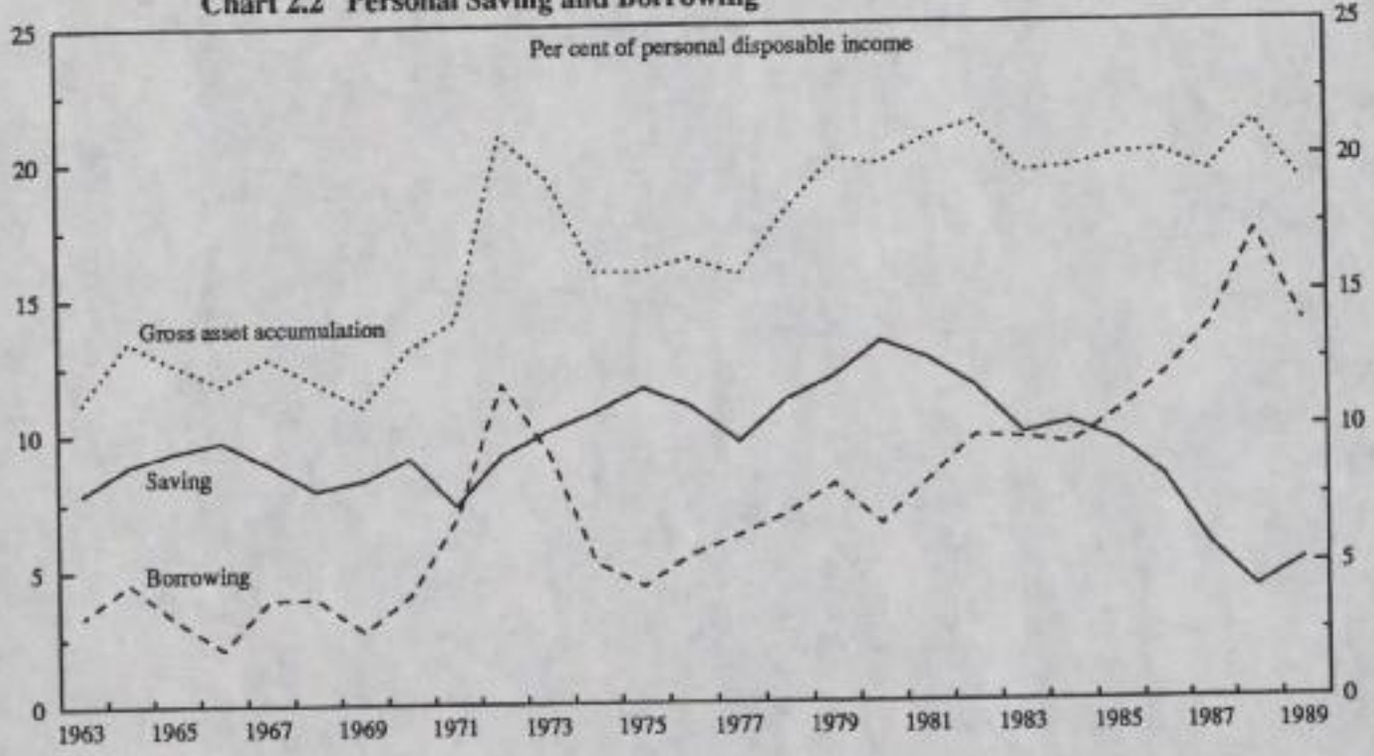
	1989–90[2]	1990–91[2]	1991–92	1992–93	1993–94
Money GDP	**8¼(8¼)**	**5(7)**	**6½**	**6¼**	**5¾**
Real GDP:					
Non-North Sea	2½	¾	2	2¾	2¾
total	2	¾	2	2¾	2¾
Inflation:					
GDP deflator	5¾(6)	4(6)	4½	3½	3

[1] *Percentage changes on previous financial year. The figures for 1990–91 are forecasts; the figures for subsequent years show the Government's medium term objectives for money GDP and consistent assumptions for output and inflation.*

[2] *The figures in brackets for money GDP growth and the GDP deflator adjust for the distortion arising from the abolition of domestic rates. This is explained in the box on page XX.*

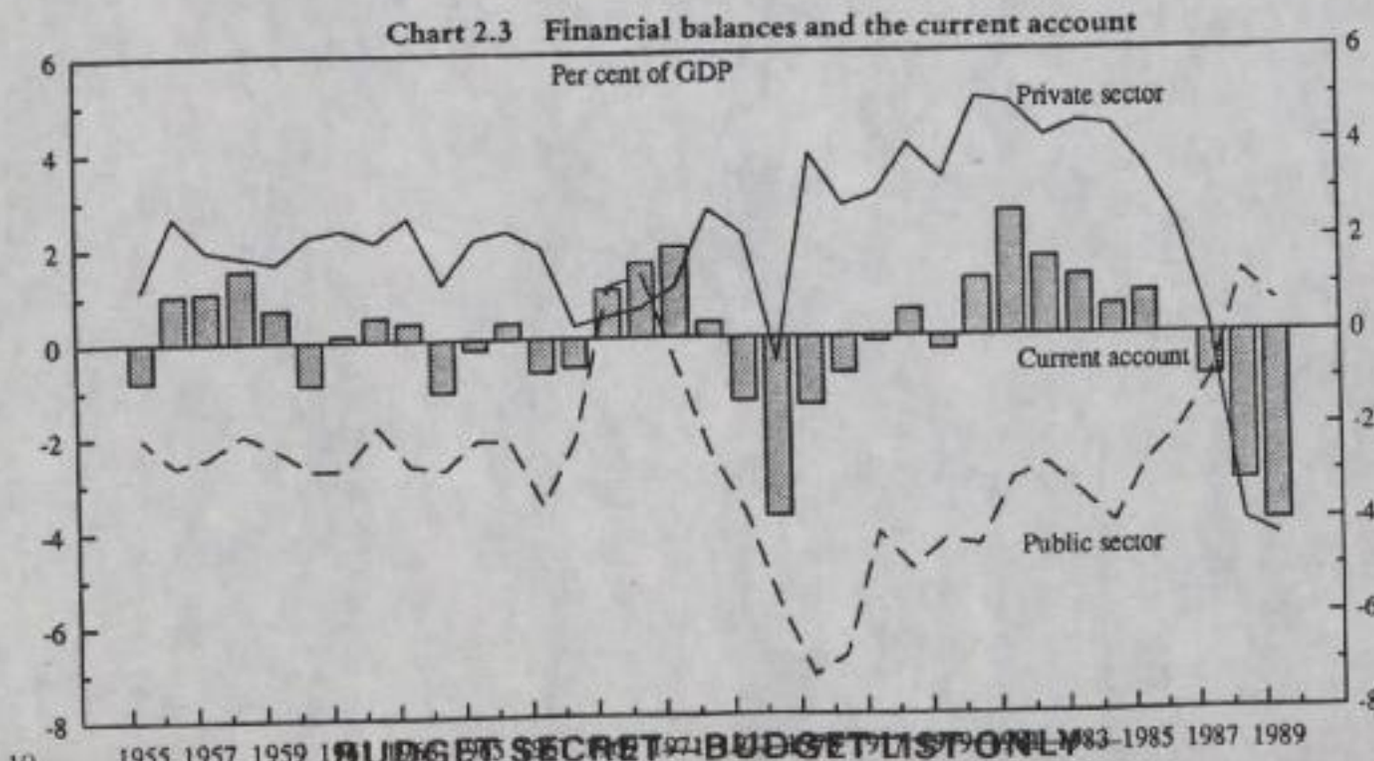
2.15 The main factors in the high demand growth of recent years have been a boom in business investment and buoyant consumers' expenditure. Business investment rose to over 15 per cent of GDP in 1989, the highest proportion ever. The personal saving ratio has fallen sharply since 1985, associated with higher borrowing.

Chart 2.2 Personal Saving and Borrowing



2.16 The private sector as a whole has moved from saving more than it invests (a financial surplus of more than 2 per cent of GDP as recently as 1986) to investing much more than it saves (preliminary estimates suggest a financial deficit of about 4 per cent of GDP in 1989). The extent of this change is without any precedent, at least in the period since the First World War. The recent excess of investment over saving is being financed, in effect, by borrowing from the rest of the world; in other words, it means a large current account deficit on the balance of payments.

Chart 2.3 Financial balances and the current account



2.17 Manufacturing investment reached a new record level in 1989 after growth averaging 8 per cent a year since 1983; total business investment rose by over 40 per cent in the three years to 1989. Published statistics show an unsustainable rate of increase in stocks in 1989. The prospects are for some fall in total domestic investment (including stockbuilding) as a share of GDP over the next few years, while saving should rise as the effects of financial liberalisation and past increases in asset prices become weaker. This means that the private sector financial deficit will contract, perhaps quite sharply, and the balance of payments current account will improve in spite of the public sector moving back towards budget balance.

The policy framework

2.18 The function of macroeconomic policy is to create a non-inflationary climate, and the function of supply side policies is to encourage individuals and companies to make the most of it. The economy is now much more flexible than it was ten years ago, following a series of reforms that have reduced distortions and improved the way markets work.

2.19 Reductions in marginal rates of taxation have increased incentives to work and save, and improved the quality of investment. The extension of owner occupation, the revival of the private rental market, and the introduction of more flexible pension arrangements are helping labour mobility; while employment and trades union law reforms have facilitated more efficient use of the labour force and the creation of new jobs. The deregulation of financial markets (although adding to the problems of monetary control) and the privatisation programme have contributed to improved performance in the industries directly affected and more widely. Youth training has been extended, and major reforms of education are in progress.

2.20 Tight monetary and fiscal policies are both needed to defeat inflation. Inflation is a monetary problem and so monetary policy has to be in the forefront of the battle to conquer it. A firm fiscal policy must complement and support the monetary stance.

2.21 Frequent large changes to fiscal policy instruments are harmful to supply performance and potentially destabilising. So it is best to take a medium term view about the appropriate contribution of fiscal policy, not to use it to offset temporary fluctuations in private demand. These considerations do not apply with the same force to monetary policy, which can therefore be used more flexibly to make shorter term adjustments to the policy stance.

2.22 It is, of course, the Government's firm intention to join the Exchange Rate Mechanism of the European Monetary System. But membership of the ERM is not a substitute for firm monetary policy. They are complements, with the commitment to the one reinforcing the commitment to the other. Most members of the Exchange Rate Mechanism have their own monetary targets. Likewise the British Government will continue to conduct its monetary policy within the MTFS framework.

Para 2.10

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Monetary policy

2.23 The essential instrument of monetary policy is the level of short term interest rates. So it is the authorities' job to set interest rates in such a way that the Government's objectives for inflation are achieved. But, as the following paragraphs explain, monetary policy is complex and the authorities' task is far from mechanical.

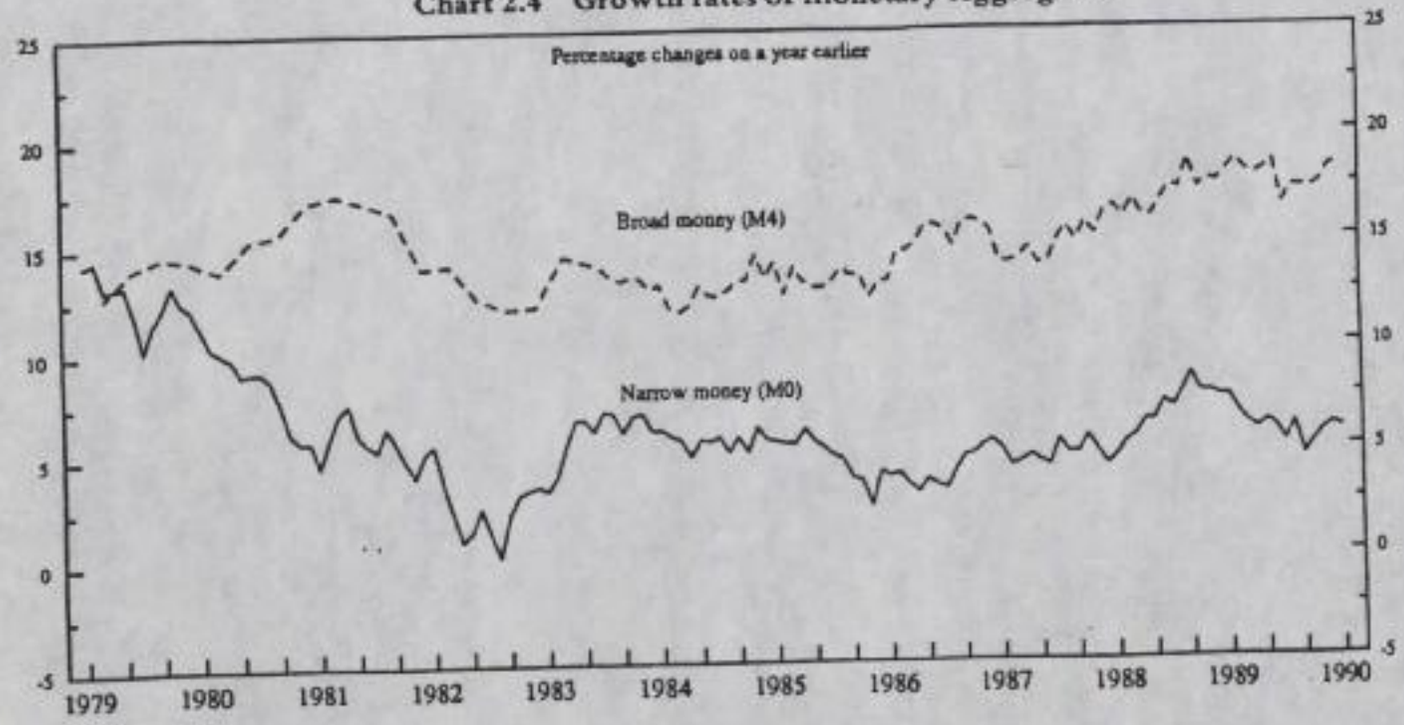
Money and inflation

2.24 ~~Sustained~~ Inflation occurs when monetary growth is excessive: "too much money chasing too few goods" is a traditional and accurate characterisation. That is why the rate at which money is growing is an essential concern of economic policy.

2.25 In contrast to most other economic statistics, accurate data on all of the monetary aggregates are available quite quickly after the period to which they relate. But there is no unique measure of money, and the various aggregates—narrow ones such as M0 and wider ones like M4—rarely grow at the same rate. Nor should they be expected to do so. They have differing relationships with inflation and each has to be assessed, along with other relevant indicators, to build up the picture of what is happening to monetary conditions.

2.26 The underlying point is that growth in the money stock need not be inflationary. It may in part reflect real growth in the economy, and in part long term trends in people's financial behaviour. Moreover, ~~especially in the case of the broad aggregates, growth~~ it may be caused by an increase in savings rather than a build up of money likely to be spent and hence of inflationary pressure.

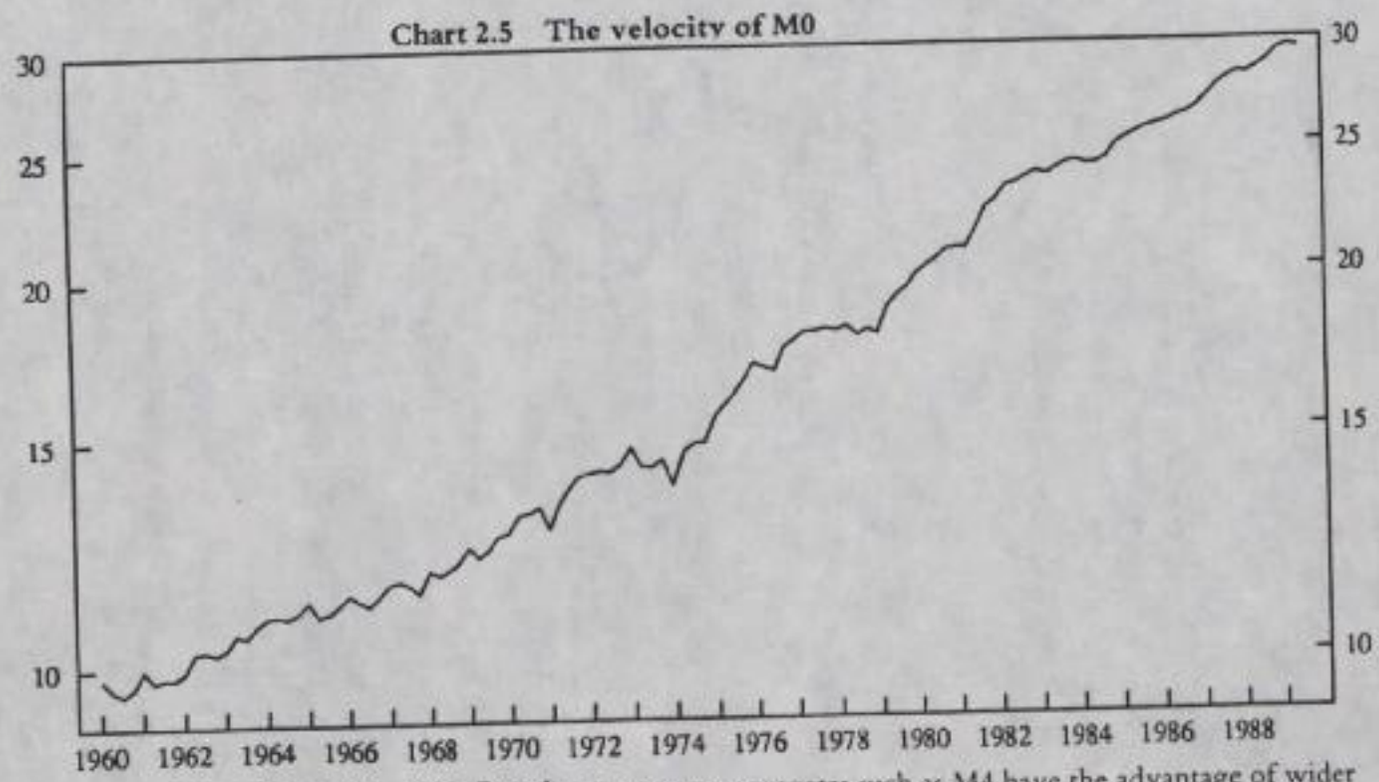
Chart 2.4 Growth rates of monetary Aggregates



Narrow money

2.27 Narrow money, best measured by M0, has a simpler relationship with money GDP and inflation than have wider aggregates. It tends to be used predominantly for transactions purposes rather than as a home for savings, so that one of the complications ~~associated~~ with interpreting broad money does not arise. M0 cannot claim to be a comprehensive measure of transactions balances. But the pervasive use of notes and coin, which constitute 99 per cent of M0, for making transactions means that M0 has demonstrated a close relationship with money GDP over a period of 40 years or more. Its velocity has grown in a steady and reasonably predictable way, ~~no doubt~~ reflecting a fairly steady rate of change in the way people make payments. M0 has thus proved a timely and generally dependable indicator of current monetary conditions. Because other indicators are available only with a delay and often subject to revision, this is valuable information to have.

Chart 2.5 The velocity of M0



Broad money

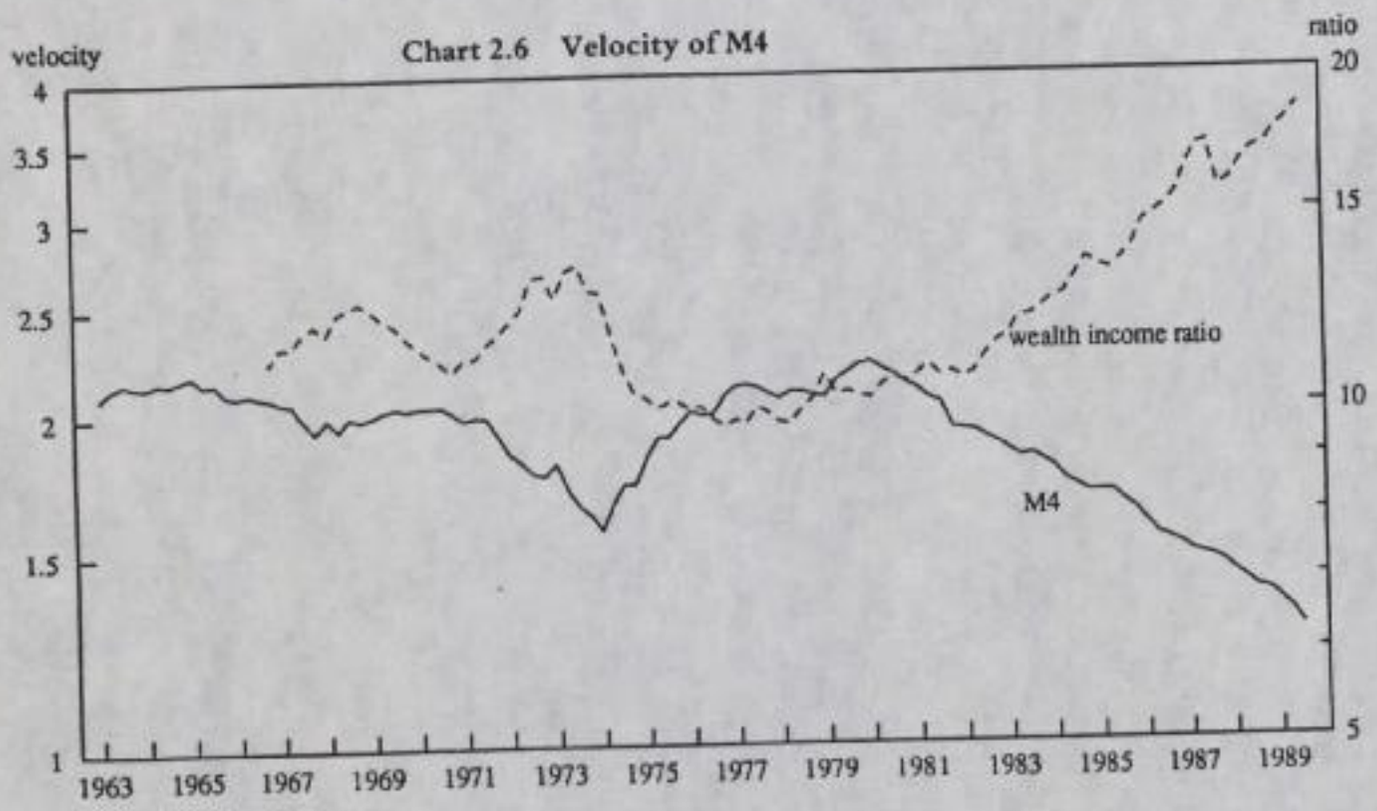
2.28 Broader monetary aggregates such as M4 have the advantage of wider coverage. They embrace financial instruments like bank and building society accounts which, while excluded from M0, possess most of the characteristics of money. So the authorities monitor M4 and the other broad aggregates closely. But experience shows that the relationship between broad money growth and inflation is complex and variable.

2.29 An ~~observed~~ increase in broad money may, or may not, foreshadow an increase in inflation, depending upon why it occurs. If it reflects only a rise in firmly held savings, there will be no increase in inflationary pressures. On the other hand, if it represents an unstable build up of purchasing power, about to be spent on goods and services in excess of the economy's ability to produce them, that will be clearly inflationary. The important point is that the growth rate of broad money and liquidity alone does not indicate clearly the degree of inflationary pressure: it is necessary to interpret it carefully in the light of other information.

2.30 Experience backs up this analysis. Relatively rapid growth in broad money was consistent throughout the 1980s with much lower levels of inflation. For the most part, the build up of this money has consisted of firmly held savings. Savers have enjoyed a much better return in the 1980s, after the low or negative real interest rates of the 1970s. While the saving ratio has fallen, this reflects a rise in borrowing rather than a fall in gross asset acquisition. Wealth has grown rapidly and it is natural that people should wish to hold a proportion of this as interest bearing money.

2.31 The relationship between inflation and money GDP on the one hand and broad money and liquidity on the other has not been steady or predictable. Taking M4 as the measure of broad money, its velocity—the ratio of money GDP to M4—has changed erratically over time, in a way which mirrors the relationship between wealth and income.

Chart 2.6 Velocity of M4



2.32 That said, since the early 1980s the decline in velocity ~~alone~~ has been ~~proceeded at a~~ relatively steady ~~pace~~. If it were possible to rely on this trend continuing, there would be a basis for setting a new target range for broad money. It seems likely, however, that the fall in velocity is explained in some measure by the unusually rapid growth of wealth ~~generally, in the 1980s, at a faster pace than incomes have risen~~. In the economy's present position, it is doubtful if the upward trend in the ratio of wealth to income will continue. This ~~That~~ uncertainty ~~, therefore, applies~~ comes ever to the future velocity of broad money as well.

Measuring broad money and liquidity

Broad money and liquidity are among the inputs into the assessment of monetary conditions, and it is important that they are measured in a way which enables all relevant information to be taken fully into account. To date the authorities have tended to concentrate on measures of sterling liquidity held only by residents, added up to form an aggregate—M4 and, before that, M3.

A number of developments have made it necessary to have regard to the behaviour of other forms of liquidity measure. The increasing integration of financial markets across national boundaries, for example, makes it the more important to take account of non-residents' holdings of sterling liquidity, and of residents' holdings both of non-sterling liquidity and of sterling held outside the UK. At the same time, there is increasing interest in the divergence frequently to be seen in the behaviour of the money holdings of the different sectors of the UK economy—households and companies of various kinds.

This all means that coverage and presentation of the monetary statistics must adapt to keep pace with changes in the markets. The Bank of England will, in the next few days, publish a discussion paper dealing with these questions, and inviting comments on the statistical issues to be faced.

Credit **2.33** There are similar problems ~~to those with broad money arise~~ in interpreting credit growth. If one individual borrows from another, the borrower has a debt and the lender acquires an asset in the form of the borrower's obligation eventually to repay this. But if the lender is content to regard this asset as a home for his savings, the credit he has extended will not be inflationary. Corresponding to the borrower's spending the money advanced to him, the lender will be abstaining from spending to the same degree. Only if the lender tries to spend his asset, adding to the spending by the borrower, will there be any upward pressure on prices.

2.34 None of this is to deny that broad money and credit growth are important indicators. The growth of liquidity and credit since 1987 has been too fast, as is clear from the rise in inflation. Mortgage lending has been particularly buoyant until recently, with associated upward pressure on house prices. But changes in these indicators need to be interpreted carefully alongside other evidence to see what they imply about inflationary pressures, and therefore for decisions on interest rates.

Monetary targets **2.35** The Government therefore will continue to set a target for M0, as a yardstick for its monetary policy. A target range of [redacted] per cent is being set for M0 in 1990-91, the same as ~~the illustrative range for 1990-91 set out~~ in 1989-~~last year's MTFS~~. Although ~~[redacted]~~ the 12-month growth rate has fallen from earlier peak levels, it is likely to finish this financial year above the ~~current target~~ range, and it may be some months ~~There will be a period~~ before it falls within ~~next year's lower target corridor.~~ it.

Table 2.2 Growth of M0[1]

1989–90	1990–91	1991–92	1992–93	1993–94
[5¾]	1 ~~½~~ to ~~1~~ 5	0 to 4	0 ~~½~~ to ~~½~~ 4	−1 to 3

[1] *1989–90: forecast percentage change on previous financial year;*
1990–91: target range for (seasonally adjusted) 12 month growth rate;
1991–92 onwards: illustrative ranges.

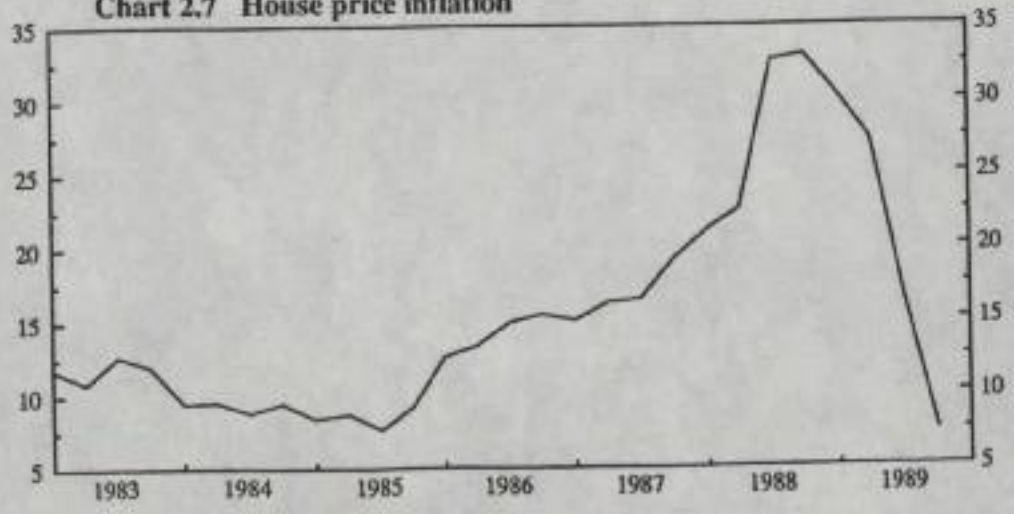
2.36 As to broad money, it would be unwise at present to reintroduce a target range given the uncertainty about its future velocity trend.

Other factors bearing on the assessment of monetary conditions

2.37 A range of other indicators supplement the evidence of the monetary aggregates in the interpretation of monetary conditions. What is happening to the exchange rate is particularly important. If people were to feel that they had too much sterling and tried to reduce their holdings, this would be likely to show up quickly in downward pressure on sterling. More generally, a perceived loosening in the policy stance might ~~blow~~ show up in this way. Other factors, which may have little to do with domestic monetary conditions, also affect its behaviour, so that the exchange rate is not an infallible guide to the tightness of monetary policy. But appraised carefully with other evidence, the exchange rate is a sensitive and timely indicator. Moreover, it can also play a direct part in raising inflation; a lower pound tends to lead to higher import prices in sterling terms as well as giving more headroom for domestic producers to pass on increased costs. A higher pound has the opposite effect. No government can therefore be indifferent to the exchange rate, though in setting interest rates it would be wrong to give undue weight to the minor short-run fluctuations that are inevitable in any financial market.

2.38 Amongst other indicators, the authorities pay close attention to the behaviour of asset prices. Sharp rises in house prices, in particular, and the consequent increase in housing wealth played an important role in the unexpectedly strong demand of recent years. With the increased access to credit that financial liberalisation has brought, people were more easily able to turn their housing "equity" into spending power. The flattening out of house prices over the last year is a welcome development in this respect, following the progressive tightening of monetary policy.

Chart 2.7 House price inflation



2.39 Information relating to the level of economic activity and to the behaviour of inflation itself must also be taken into account, though the indicators are generally available only with a delay. Evidence relating to future behaviour—intentions survey data, for example, or confidence indicators—is monitored closely.

2.40 Assessing monetary conditions—deciding whether the monetary stance is appropriately tight or whether a change is required—involves balancing up all of the ~~some of~~ factors discussed in the previous paragraphs. This cannot be a mechanical process and, inevitably, judgement is required.

Implementing monetary policy

2.41 While assessing monetary conditions is a complex task, implementing changes in the monetary stance is in principle simple. Interest rates are the price of money and credit. Changing the price is the best method of influencing the degree of monetary tightness.

2.42 The level of interest rates affects the economy in a wide variety of ways. Higher interest rates increase the reward for saving while raising the cost of borrowing. There are also cash flow effects; higher interest rates for example reduce the spending power of borrowers after they have paid their interest charges (and increase the incomes of savers). Interest rates also influence asset values and thus the level of wealth. Again, a rise in interest rates will make sterling more attractive than it would otherwise be compared to other currencies, thus raising the exchange rate, leading to downward pressure on domestic costs. Some of these channels are more important than others and not all work in the same direction. Nevertheless, the net effect is that raising interest rates constitutes a powerful way of tightening the monetary stance. Lowering interest rates has the opposite effect.

2.43 Used as a short term instrument, official intervention in the foreign exchanges can also be of value. By buying or selling foreign currency for sterling, as appropriate, the authorities can affect the supply and demand for sterling, and hence the exchange rate, in the short term. Intervention can also on occasion be used to signal the authorities' future intentions, at times dampening or preventing inappropriate and unnecessary movements in sterling. In the longer run intervention is likely to have only modest effects, unless combined with a change in the level of interest rates; but it can be a useful short term tactical weapon.

2.44 In principle, an alternative to using interest rates to regulate monetary conditions would be to return to some form of direct credit control. But such controls undermine the ~~free market~~ price mechanism ~~for~~ credit that the interest rate represents. That would lead to distortions and inefficiencies and poor resource allocation which would be clearly undesirable. They would also be unfair: some would obtain the credit they wanted; others would find themselves rationed. But, more fundamentally, in today's developed and sophisticated financial markets, and without the support of exchange controls, credit controls would be almost impossible to work except in the very short term. For all these reasons, the trend in those major countries that still have credit controls is towards dismantling them. The Government sees no advantage and many disadvantages in swimming against the tide. There is no going back to the relatively controlled and regulated economy of earlier years.

Reserve Asset Ratios

Because interest rates are the essential instrument of monetary policy, the monetary authorities must be in a position to exercise a high degree of influence over their movements. That means they need to ensure that the financial system is dependent on funds provided by the central bank so that its own lending rate is transmitted more widely into market rates.

To achieve this result, a number of other countries—France or Germany for example—impose minimum reserve asset ratios on their banks. The operation of the ratio increases the banking system's need for funds from the central bank, and thereby helps to ensure that market rates will reflect the rate of interest at which the central bank provides the supply. Only the central bank can meet these needs. It is thus mistaken to see reserve requirements as an alternative monetary instrument to interest rates. In particular, reserve requirements do not serve as a direct credit control. Rather they provide a means whereby official influence on interest rates is made effective.

In the United Kingdom, benefiting from our well developed money markets, the authorities have in recent years been able to exercise this control simply and flexibly by varying the size of market purchases of bills and the weekly Treasury Bill tender. This avoids the distortions that are often inherent in reserve asset ratios.

Funding policy

2.45 Funding policy—the way that the Government finances its own operations—must support monetary policy in attaining the objectives for inflation. The Government will continue to arrange the public sector's financial affairs in accordance with this principle, at the same time financing the public sector so as to minimise any distortion to the financial system. Annex A of this chapter discusses funding policy in more detail.

Fiscal policy

2.46 A budget surplus is expected for 1989–90, the third successive year that the Government has repaid debt. However the PSDR is now estimated at £7 billion, about half what was forecast a year ago. Almost £1 billion of this reduction reflects lower privatisation proceeds. Local authorities' capital spending has increased by about £2 billion more than expected, and an unexpectedly large take-up of personal pensions reduced national insurance contributions by almost £2 billion. These changes taken together account for most of the shortfall in the PSDR compared with last year's forecast.

2.47 The PSDR is set to fall slightly to £6 billion in 1990–91. While there will be a reversal of some of the factors that explain the 1989–90 shortfall, this will be more than offset by the effects of lower growth in 1990–91 (¾ per cent now forecast, some 2 percentage points below trend). The Government has made clear in the past that it sets tax rates on the basis of medium to long-term considerations, and will not normally change them to offset cyclical swings in the PSDR.

2.48 Fiscal policy will remain tight, and so play an important part in bringing inflation down. The PSDR path now projected is shown in table 2.7; the Government's balanced budget objective is expected to be reached in 1992–93. The projections imply that the ratio of net public sector debt to GDP, which has fallen by more than a third in the last five years, will show a further substantial decline over the medium term; so there will be a further fall in the burden of debt interest payments.

Public expenditure

2.49 The Government's objective for public spending is that over time it should take a declining share of national income, while value for money is improved. The ratio of GGE excluding privatisation proceeds to GDP has fallen by almost 8 percentage points since 1982–83; over half the fall took place during the period of fast economic growth between 1986–87 and 1988–89. As economic growth moderates, the ratio may show a temporary rise, even after adjusting for the distortion arising from the abolition of domestic rates which will raise the published ratio by about ¾ percentage point. Thereafter a continuing decline in the ratio is projected.

Table 2.3 General government expenditure (excluding privatisation proceeds) as a per cent of money GDP[1, 2]

1964–65	35¾	1974–75	48	1984–85	46
1965–66	37¼	1975–76	48½	1985–86	44½
1966–67	38¾	1976–77	46	1986–87	43½
1967–68	42¼	1977–78	42¾	1987–88	41¼
1968–69	40¾	1978–79	43¼	1988–89	38¾
1969–70	40¼	1979–80	43½	1989–90	39¼ (39½)
1970–71	40¾	1980–81	46	1990–91	40¼ (39½)
1971–72	41	1981–82	46½	1991–92	39½ (38¾)
1972–73	41	1982–83	46¾	1992–93	39¼ (38½)
1973–74	42¾	1983–84	45¾	1993–94	39 (38¼)

[1] *1989–90: latest estimate; 1990–91: forecast; 1991–92 onwards: MTFS projections.*
[2] *Ratios in brackets adjust for the distortion arising from the abolition of domestic rates. This is explained in the box on page xx.*

Figures

2.50 Projections of government expenditure are shown in table 2.4. For the period to 1992–93, ~~they~~ incorporate the public expenditure plans shown in the public expenditure White Paper (Cm 1001–1021) ~~which have been held unchanged~~. The projections of local authorities' self-financed expenditure (outside the planning total) have been increased to take account of the sharp real growth in their spending in 1990–91 indicated by recent information about their budgets ~~(see paragraph 5.03)~~. The new projections of gross debt interest payments and accounting adjustments are consistent with the latest economic projections and assumptions. For 1993–94 it is provisionally assumed that general government expenditure will grow by 1¾ per cent in real terms; expenditure plans will be settled in future surveys.

which are explained further in chapter 5,

Table 2.4 General government expenditure[1]

	£ billion, cash					
	1988–89	1989–90	1990–91	1991–92	1992–93	1993–94
Public expenditure planning total	145·5	162	179	192	203	215
Local authorities' self-financed expenditure[2]	10·2	13½	13½	13½	14½	14½
Central government debt interest	17·5	18	17	15½	14½	14
Accounting adjustments	4·9	4	3½	3½	4½	5
General government expenditure[3, 4]	**178·1**	**198**	**213**	**224**	**237**	**248**
Privatisation proceeds	7·1	4	5	5	5	5
General government expenditure excluding privatisation proceeds	**185·2**	**202**	**218**	**229**	**242**	**253**

[1] *For 1988–89 to 1992–93, the figures are taken from chapter 5.*
[2] *See footnote to table 5.1.*
[3] *General government expenditure, privatisation proceeds and the public expenditure planning total are rounded to the nearest £1 billion from 1989–90 onwards; local authorities' self-financed expenditure, debt interest and accounting adjustments are rounded to the nearest £½ billion, as in Chapter 5. General government expenditure excluding privatisation proceeds is assumed to grow by 1½ per cent in real terms in 1993–94.*
[4] *General government expenditure includes debt interest payments to other sectors as follows (£ billion):*

1988–89	*18·0*	*1991–92*	*16*
1989–90	*18½*	*1992–93*	*15*
1990–91	*18*	*1993–94*	*14½*

Revenue

2.51 The Government's objectives for taxation are to reduce tax rates and bring down tax as a percentage of GDP. Much progress has been made in reducing tax rates and reforming the structure of the tax system, and the ratio of tax to GDP has fallen from the peak of 1981–82. In the second half of the 1980s the ratio was broadly unchanged, in spite of substantial cuts in tax rates, reflecting in part cyclical increases in revenue. The rise in the ratio compared with the end of the 1970s reflects the elimination of borrowing: expenditure is now more than covered by taxation and other government receipts.

Table 2.5 Non-oil taxes, national insurance contributions and the community charge as a per cent of non-oil money GDP[1,2]

1964–65	29½	1974–75	35½	1984–85	37¾
1965–66	31¼	1975–76	36	1985–86	37
1966–67	32	1976–77	36	1986–87	37½
1967–68	33¼	1977–78	35	1987–88	37½
1968–69	35¼	1978–79	34	1988–89	37
1969–70	37	1979–80	35	1989–90	37 (37)
1970–71	36¼	1980–81	36	1990–91	37¾ (37)
1971–72	36¾	1981–82	38½	1991–92	36¾ (36)
1972–73	32½	1982–83	38	1992–93	36½ (35¾)
1973–74	33¼	1983–84	37½	1993–94	36½ (36)

[1] *1989–90: latest estimate; 1990–91: forecast; 1991–92 onwards: MTFS projections (after fiscal adjustment).*
[2] *Ratios in brackets adjust for the distortion arising from the abolition of domestic rates. This is explained in the box on page xx.*

2.52 The growth in government revenues over the medium term will depend on the growth of incomes, spending and prices. It will also depend on policy decisions, including measures announced in this year's Budget and other measures that will be implemented over the period, such as the introduction of independent taxation for husbands and wives. Taking

account of these factors, non-North Sea revenues may rise less fast than money GDP after 1990–91, even before allowing for any tax cuts in future Budgets. North Sea revenues are not expected to change much over the medium term.

Table 2.6 General government receipts

	£ billion, cash					
	1988–89	1989–90	1990–91	1991–92	1992–93	1993–94
Taxes on incomes, expenditure and capital[1]	144·7	158	169	175	185	195
National insurance and other contributions	33·0	33	36	38	40	43
Interest and dividends	6·5	7	6	7	7	6
Other receipts	5·5	6	7	7	7	7
General government receipts[2]	**189·7**	**204**	**218**	**227**	**239**	**251**
of which North Sea revenues	3·2	3	3	3	3	3

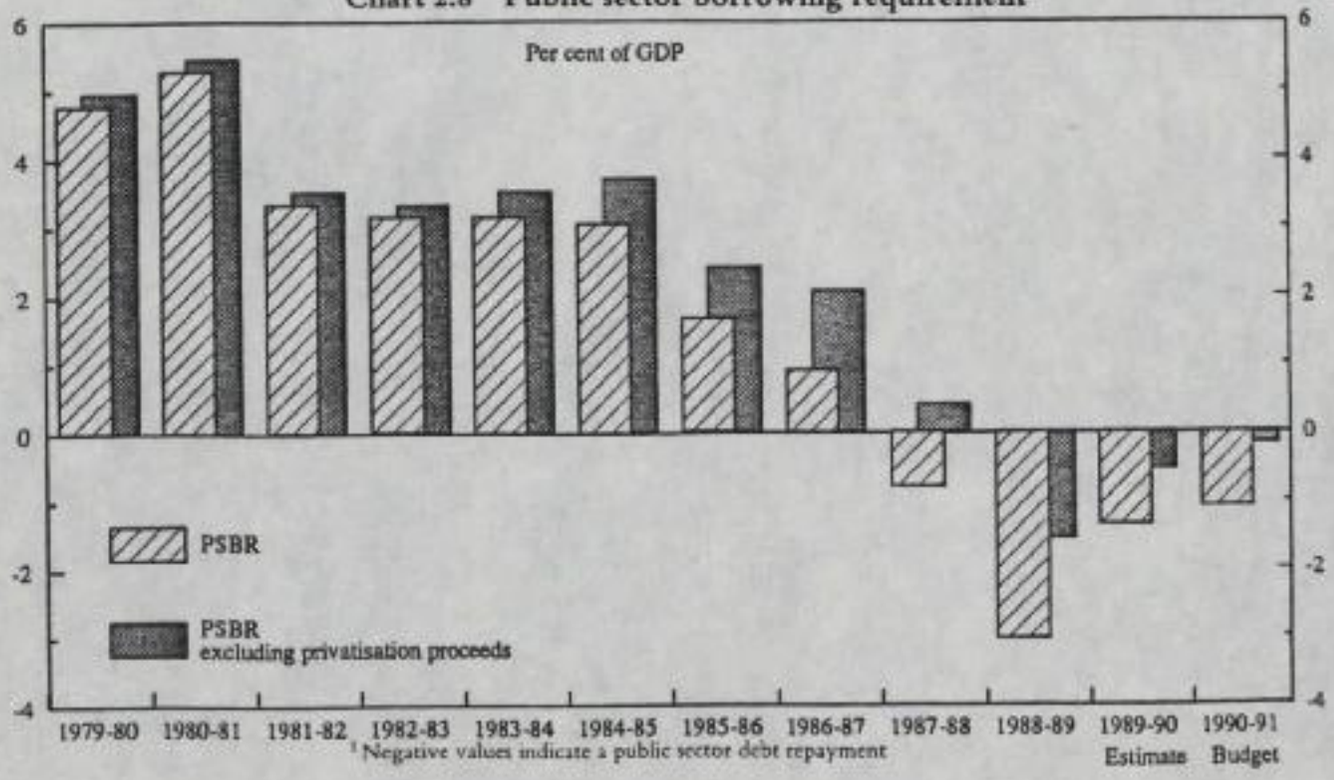
[1] *Includes the community charge from 1989–90 onwards.*
[2] *General government receipts, and its components, are rounded to the nearest £1 billion from 1989–90 onwards.*

Public sector debt repayment

2.53 The projections of government expenditure receipts are brought together in Table 2.7 to provide projections of the general government debt repayment (GGDR), the PSDR and the fiscal adjustment.

2.54 Changes since the 1989 MTFS are discussed in annex B of this chapter.

Chart 2.8 Public sector borrowing requirement[1]



[1] Negative values indicate a public sector debt repayment

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Table 2.7 Public sector debt repayment

	£ billion, cash					
	1988–89	1989–90	1990–91	1991–92	1992–93	1993–94
General government receipts	189·7	204	218	227	239	251
General government expenditure	178·1	198	213	224	237	248
Fiscal adjustment from previous years[1]	—	—	—	—	1	2
Annual fiscal adjustment[2]	—	—	—	1	1	1
GGDR	**11·5**	**6**	**5**	**2**	**0**	**0**
Public corporations' market and overseas debt repayment	3·0	1	1	0	0	0
PSDR	**14·5**	**7**	**6**	**2**	**0**	**0**
Money GDP at market prices[3]	476·7	515 (516)	544 (555)	580 (592)	616 (628)	652 (665)
PSDR as per cent of GDP	**3**	**1½**	**1**	**½**	**0**	**0**

[1] *Rounded to the nearest £1 billion from 1989–90 onwards. Further details for 1990–91 are provided in Tables 1.2 and 6.9*

[2] *Means lower taxes or higher expenditure than assumed in lines 1 and 2.*

[3] *Figures in brackets adjust for the distortion arising from the abolition of domestic rates. This is explained in the box on page xx.*

Summary

2.55 This chapter has discussed the Government's economic policy intentions and reaffirmed the Government's determination to bring inflation down.

2.56 There have been clear signs in recent months that the economy has been slowing down under the influence of tight monetary and fiscal policies, and it is likely to grow at well below its sustainable rate over the next year. Against this background inflation should fall sharply. The period of slow growth is also likely to see a contraction of the recent large budget surplus. Tight monetary and fiscal policies will be maintained over the period covered by the MTFS so as to achieve the deceleration in money GDP set out in table 2.1.

2.57 The Government will continue to set a target for M0. It is not setting a target for broad money, but as in the past will take a range of indicators, including the exchange rate, into account in assessing monetary conditions. The Government sees membership of the Exchange Rate Mechanism of the EMS, once its conditions have been met, as complementary to the MTFS policy framework.

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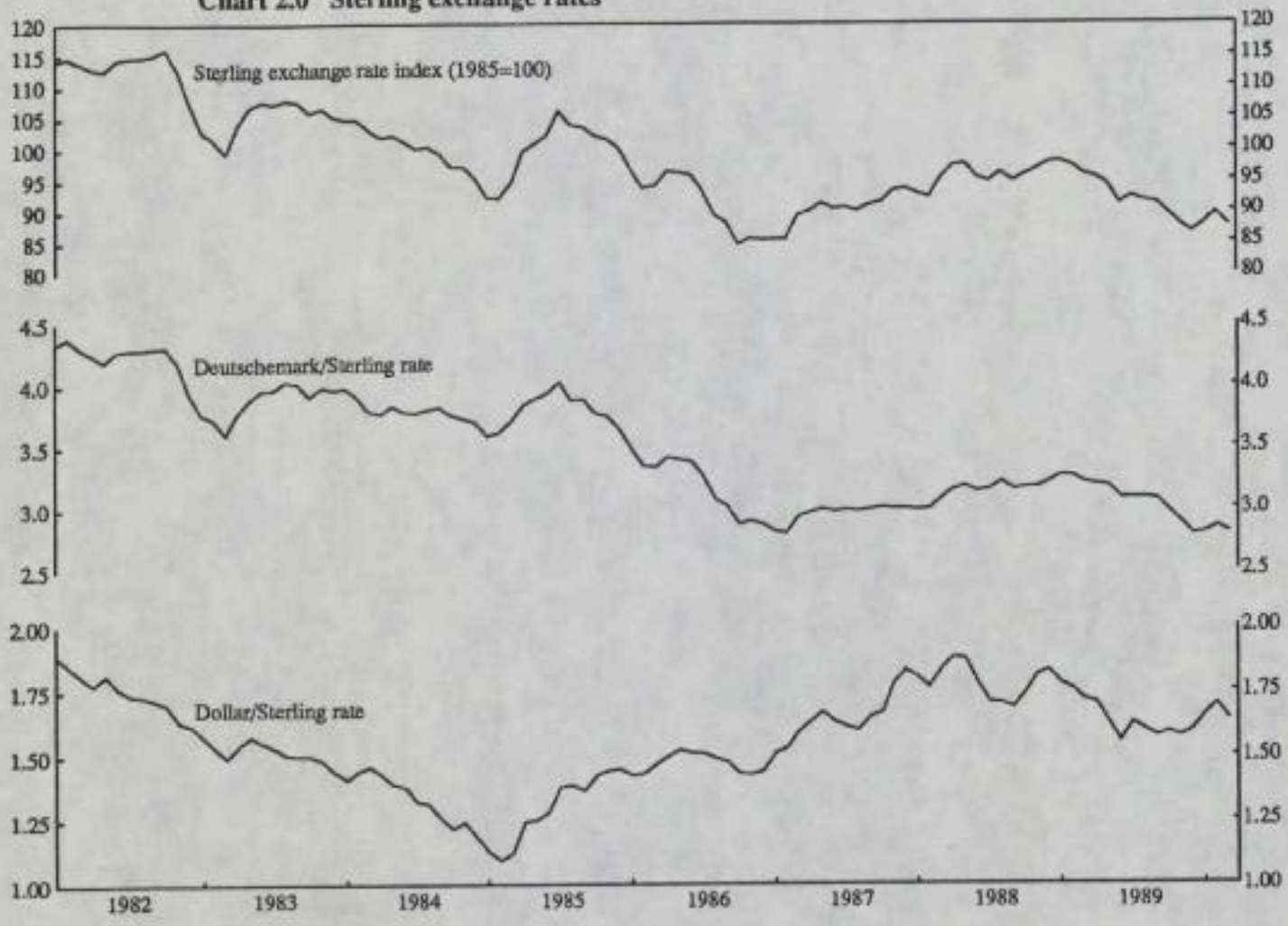
Chart 2.0 Sterling exchange rates



(for possible insertion after para. 2.37)

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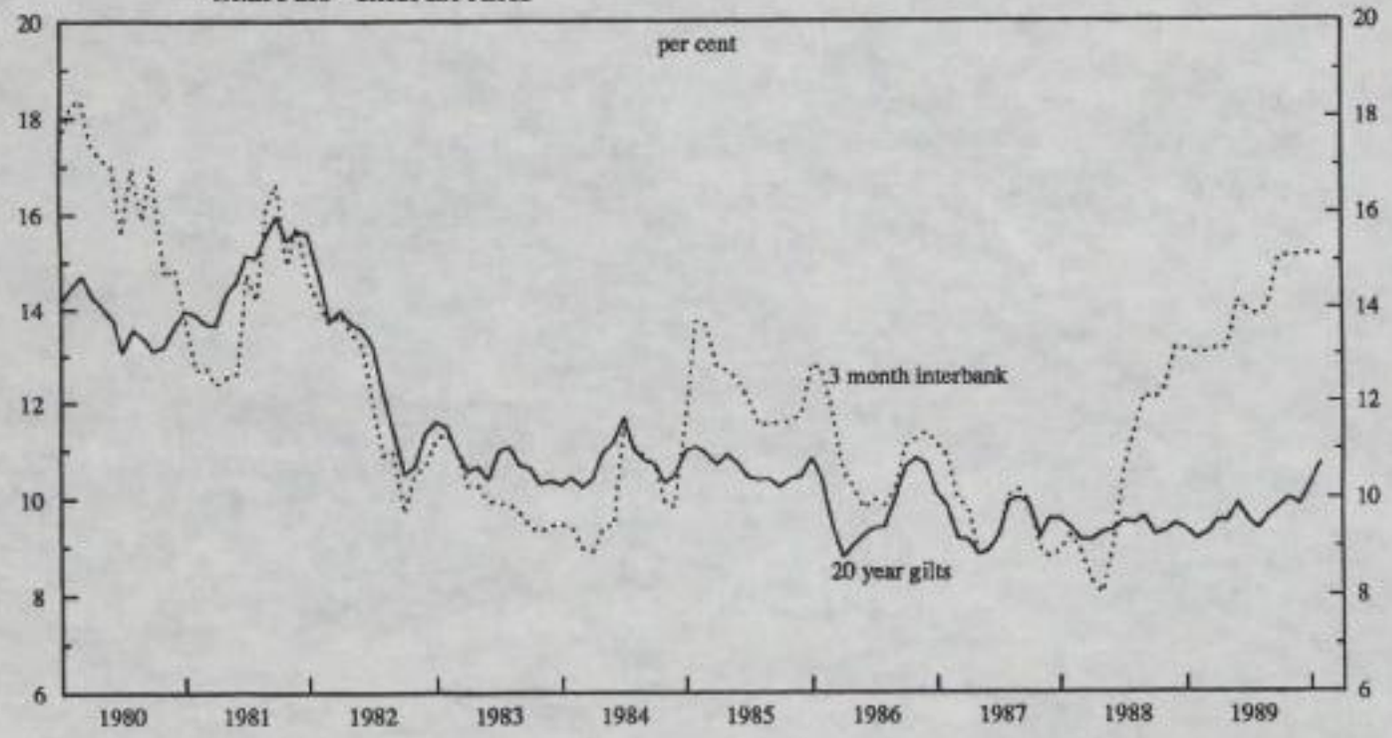
Chart 2.0 Interest rates



(for possible insertion after para 2.42)

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Annex B to Chapter 2

Changes since the 1989 MTFS

Money GDP

2B.1 After adjusting for the distortion arising from the abolition of domestic rates, the growth rate of money GDP is expected to be a little higher in both 1989–90 and 1990–91 than envisaged in last year's MTFS, with growth in the GDP deflator ¾ percentage point higher in 1989–90 and 2 points higher in 1990–91. Inflation is projected to remain above last year's path but with the difference from last year falling to 1 percentage point by 1992–93. The projected trend in output growth over the medium term in the whole economy is the same as in last year's MTFS.

Table 2B.1 **Money GDP growth**

Differences from 1989 MTFS projections, percentage points			
1989–90[1]	1990–91[1]	1991–92	1992–93
+½ (+½)	−½ (+1½)	+½	+¼

[1] *Figures in brackets show the comparison after adjusting for the distortion arising from the abolition of domestic rates (see the box on page xx).*

in 1989-90, 1 percentage point higher than

Monetary aggregates

2B.2 M0 growth has from earlier peak levels declined but has remained above its target range. The target range for 1990–91 is the same as the illustrative range given last year. ~~The illustrative ranges for subsequent years are also the same.~~ Illustrative target ranges for future years have also been adjusted.

Table 2B.2 **Growth of M0**

	Percentage changes on a year earlier			
	1989–90	1990–91	1991–92	1992–93
1990 MTFS	5¼	0 to 4	0 to 4	−1 to 3
1989 MTFS	1 to 5	1 ~~0~~ to ~~1~~5	0 to 4	0 ~~1~~ to ~~1~~4

Fiscal projections

2B.3 Table 2B.3 shows changes in the fiscal projections since the 1989 FSBR. Additional information on 1989–90 is given in Chapter 6.

Expenditure

2B.4 The planning total outturn in 1989–90 is discussed in Chapter 5. The planning totals for 1990–91 onwards are as in the public expenditure White Paper (Cm 1001–1021); this year's MTFS is the first to show the planning total on its new definition. The cash general government expenditure figures for the future have been revised up since last year.

Receipts

2B.5 Revenues in 1989–90 have in total been somewhat lower than forecast. Income tax receipts were higher, but corporation tax receipts were lower, as were National Insurance contributions, reflecting about £2 billion more personal pension rebates than forecast. Revenues over the next two years or so will be affected by growth in the economy falling below the rate assumed in the 1989 MTFS. The revenue projections this year for the first time reflect the introduction of the Community Charge.

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Table 2B.3 Revenue and expenditure[1]

	Changes from 1989 MTFS projections, £ billion				
	1988–89	1989–90	1990–91	1991–92	1992–93
1 General government expenditure	**−1**	**+4**	**+7½**	**+8**	**+13**
Receipts[2]					
2 North Sea taxes	0	0	0	0	0
3 Other taxes and contributions	+½	0	+5½	+4	+7
4 Other[3]	−1½	−2½	−2	−1	−½
5 General government receipts	**−1**	**−2½**	**+4**	**+2½**	**+6½**
6 Implied cumulative fiscal adjustment[4]	—	—	−½	−1½	−3½
7 Public corporations' market and overseas debt repayment	+1	−½	−1	0	0
8 PSDR	**+½**	**−7**	**−4**	**−4**	**−3**

[1] *Rounded to the nearest £½ billion. There have been no significant classification changes made since the 1989 FSBR.*
[2] *The allocation of tax receipts between North Sea and other is affected by the treatment of advance corporation tax set off.*
[3] *Includes changes in debt interest and other items.*
[4] *Line 6 = lines 7 − 8 − 1 + 5.*

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Annex A to Chapter 2

Funding policy

2A.1 Funding policy determines how the public sector manages its debt. When there is a PSDR, decisions have to be made about how to use the surplus : what debts to repay, or what financial assets to buy. When there is a PSBR decisions have to be made about how the deficit is to be financed. Despite the substantial debt repayment of recent years, and the consequent fall in the ratio of debt to GDP (see chapter 6 for more details), gross public sector debt still amounts to around £190 billion. Public debt thus remains of significant size in relation to financial flows in the economy, and its management is clearly of considerable importance.

Underlying principles

2A.2 Three principles underlie the Government's funding policy:

(a) it must support and complement monetary policy in pursuit of the Government's objectives for inflation;

(b) subject to (a) it should operate in a way which avoids distorting to financial markets.

(c) subject to (a) and (b) it should be conducted at least cost and risk.

The funding rule

2A.3 In recent years, the implementation of the first two of these principles has been embodied in the " full fund " rule that:

" The authorities will seek to fund the net total of maturing debt, the PSBR and any underlying increase in the foreign exchange reserves by sales of debt outside the banking and building society sectors. "

2A.4 The monetary policy rationale for the rule is as follows. If the public sector spends more than it receives, so that it has a borrowing requirement, then funding policy should ensure that this is not financed by an addition to private sector money holdings. In particular the rule ensures that the PSBR is financed by means other than any increase in issue of notes and coin. It also means that the direct effect of a PSBR on broad money is neutralised, with none of it financed by net borrowing from banks and building societies.

2A.5 These same considerations apply exactly in reverse when, as now, the public sector is in surplus. " Unfunding " in that case offsets the effect the surplus would otherwise have on narrow and broad money.

Redrafted paragraphs attached.

2A.6 Policy as it has been operated in recent years has therefore been designed to ensure that over time the potential effect of public sector borrowing or debt repayment on broad and narrow money has been offset. Operation of the full fund rule has also helped meet the second objective in paragraph 2A.2, limiting any distortions caused to the capital markets. If net sales of debt were greater than needed to fund the public sector's net borrowing needs—as they were for a period in the early 1980s—then the excess borrowing has to be recycled into a build up in the public sector's holdings of financial assets, such as commercial bills.

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2A.7 The operation of such a rule gives guidance to the markets as to how much debt the authorities can be expected to issue, or redeem, in relation to the development of the public finances generally. That increases the degree of market certainty, to the benefit both of investors in Government debt and of the Government.

Application of the rule in practice

2A.8 The funding rule cannot be applied rigidly. The aim has always been to achieve full funding over each financial year as a whole. Within the financial year, temporary under- or over-funding has occurred, depending on conditions at the time. The authorities have not regarded it as sensible to offset the effect on sterling liquidity of foreign exchange intervention operations by funding that intervention immediately or necessarily even within the financial year in which it occurs.

Money market position

2A.9 The authorities must also ensure that funding operations do not lead to money market conditions that complicate the arrangements for setting short-term interest rates—the essential instrument of monetary policy. In 1985 these arrangements were beginning to be undermined by the size of the authorities' holdings of bills, the "bill mountain" which reached a peak of over £17 billion. At that time market holdings of Treasury bills were only just above £1 billion. Since then, official holdings of commercial bills have fallen to [£5 billion] and market holdings of Treasury bills increased to [£10 billion].

2A.10 The main reason for this change in the money market position has been a swing in the position of the local authorities. Over the period since 1985, local authorities as a group have borrowed large amounts from the central government, through the Public Works Loan Board (PWLB), while at the same time putting capital receipts and other funds into the money market by repaying bank loans, and increasing their deposits with banks and building societies. A second factor tending to ease the money market position, and hence requiring an increase in the Treasury bill issue, has been the scale of net gilt sales in recent years by banks and building societies.

2A.11 The change in the local authority position may have related in part to measures taken in the early 1980s to ease the terms and conditions of borrowing from the PWLB, partly with the aim of reducing the scale of money market shortages at the time. The money market position is now very different. The Chancellor therefore announced on 15 February a range of measures intended to limit borrowing from the PWLB, particularly where authorities have investments available with which to finance their capital expenditure.

2A.12 This change should in due course allow a reduction in the size of the Treasury bill issue. But if necessary in the meantime the Government will adjust its funding operations, increasing gilt sales or reducing gilts purchases, so as to prevent an excessive increase in the Treasury bill issue. This would involve a departure from the funding rule.

Other considerations bearing on funding decisions

2A.13 The general point is that no funding policy rule could provide a comprehensive guide to a sensible funding policy. Just as monetary policy itself cannot be a mechanical process, so the authorities must bear in mind a number of considerations in their funding strategy. The factors mentioned in paragraphs 2A.8–12 above may require temporary or longer-term departures from the funding policy rule followed in recent years. There are other considerations that affect the way public debt is managed, but which do not imply any departure from the overall guideline. In particular :

(i) because the underlying intention is that the public sector does not finance itself by creating money, the authorities need to ensure that funding is not concentrated in very short term debt, where the public liabilities concerned have

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some of the attributes of money and liquidity, even where these liabilities are not sold to banks and building societies. Treasury Bills, which have such characteristics, no longer count as funding, even when sold to others than banks or building societies.

(ii) due regard must also be given to expected servicing costs. If the Government's medium and long term view of interest and inflation rates differs from that of the market as a whole, there will be implications for the type and maturity of debt that the Government wishes to issue or purchase;

(iii) but, equally, reducing risk is important both for the Government and investors. The existence of a range of maturities for debt issued in the past is helpful in this respect. Indexed debt also has the advantage of reducing uncertainty, for both the borrower and investor, about future real yields, and the proportion of gilts in indexed form has risen steadily since 1981;

(iv) because over the longer term the Government will have continuing borrowing or refinancing needs, it is in the general interest that the gilts market retains adequate capacity and liquidity. The series of conversion operations designed to enhance market liquidity have proceeded well and they will be continued.

2A.14 Such considerations do not always point in the same direction and some must be given heavier weight than others in determining funding decisions.

~~Conclusion~~ **2A.15** Funding operations will continue to be guided by the full fund rule, as they have been over the past few years. But the authorities will be prepared to depart from what the rule formally would require when circumstances warrant it. That will require, as it has in the past, the exercise of judgement by the authorities—a judgement that will be based on the underlying principles set out in paragraph 2.

2A.5. In the early 1980s, the authorities went beyond this policy of full funding. They deliberately "overfunded", that is issued more debt than the Government needed to fund its borrowing requirement, in an attempt to reduce the growth of broad money. But experience showed the shortcomings of this policy. With sales of debt greater than the public sector's net borrowing needs, the excess had to be re-cycled into a build up in the public sector's holdings of financial assets, such as commercial bills. Rather than proving of practical benefit, sustained overfunding made monetary policy increasingly difficult to operate. It also created undesirable distortions in the financial markets, discriminating in particular against long term private sector borrowing for investment.

2A.6. So, in summary, policy as it has been operated in recent years has been designed to ensure that over time the potential effect of public sector borrowing or debt repayment on broad and narrow money has been offset. Operation of the full fund rule has also helped meet the second objective in paragraph 2A.2, limiting any distortions to the capital markets. This applies whether the public sector is in deficit or surplus. When there is a surplus, as now, the rule requires the public sector to repay debt - "unfunding". The alternative of using the surplus to acquire assets would amount to overfunding which, if sustained, would have the same adverse effects as in the early 1980s.

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10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

1 February 1990

Dear John,

SEMINAR ON ECONOMIC PROSPECTS

The Prime Minister held a seminar on 30 January to discuss the latest economic position and prospects and the appropriate policy stance. Those present were the Chancellor, the Economic Secretary, Sir Terence Burns and Mr. Michael Scholar. The papers before the meeting were the Treasury's January 1990 economic forecast, and the annotated agenda supplied with your letter of Friday 26 January.

I should be grateful if you would ensure that this record is seen only by a strictly limited number of people.

In discussion of the present economic position the following main points were made:

(i) There was now clear evidence that the desired aims from the tightening of policy were being achieved. Despite the monthly jump in December the volume of retail sales compared with a year ago was now sluggish, and indicators of consumer confidence were low. The housing market was very weak. Imports had slowed down considerably, and this was particularly noticeable for basic materials and capital equipment. The profile of industrial production had flattened and the latest intentions survey from the CBI pointed to the volume of investment being broadly flat. All in all the rapid growth of demand seen from 1987 to early 1989 had now been contained, and the large private sector financial deficit was probably beginning to turn.

(ii) The effect of this slow down was also to be seen in the latest figures and prospects for the PSDR. The surplus was now falling quite sharply and might in the event be only some £8 billion in the current financial year, falling to some £5 billion on present policies in 1990-91. To a substantial extent the position this year reflected special factors, in particular the higher than expected take up of personal pensions and further growth in local authority expenditure: taken together these factors had an impact of some

£4 billion. Corporation tax proceeds had fallen more than expected in December, but first signs were that this may have been largely reversed in January. In 1990-91 the main factor underlying a further fall in the PSBR would be the cyclical impact of a slowing economy, reversing the factors which in 1987 and 1988 had led to a much sharper growth of the surplus than anticipated. It seemed that changes in the public sector financial position, in either direction, were more highly geared to levels of economic activity than was generally recognised or allowed for.

(iii) Recent company news indicated that there had been substantial over-confidence in the retail sector, with acquisitions at high prices that could not be justified once the rapid growth of demand had fallen off. In this respect there were similarities with 1973. It could also be expected that the tighter financial position of the retail sector would again have knock on consequences for the commercial property market.

(iv) It was possible that house prices could still fall substantially further, given that the ratio of house prices to average earnings was still at a historically high level. There were, however, considerable regional variations in house price trends, and these were mirrored in similar variations in retail sales trends.

(v) The rate of fall in unemployment had slowed in recent months in response to the lower growth in demand. Although the precise timing was uncertain it seemed inevitable that unemployment would start to rise again before too long.

(vi) Although the majority of the indicators pointed to a broadly satisfactory response to tightening of policy there were still some major problem areas. In particular it was both disappointing and puzzling that the growth of M0 continued to be in excess of the target range, with the broader aggregates and lending also continuing to grow at a high rate. It was difficult to understand why M0 had been so slow to respond, although one explanation might be that the greater availability of cash dispensers was increasing the use of cash rather than alternative means of payment. But the temptation to regard the high growth of M0 and the broader aggregates as due to some unexplained and benign special factors should be resisted; the money figures were amongst the economic statistics that could be most accurately measured. It was also noticeable that mortgage lending continued to rise month-by-month even though the volume of house transactions was very low; this was because much of the borrowing was remortgaging and second mortgages with the funds being used for consumption purposes. There had been a major revolution in the easy availability of finance secured on housing over a short period; Alan Greenspan had suggested that the UK was experiencing

within the space of just a few years the sort of developments that had taken place over some 7-8 years in the United States. For all these reasons there were continuing grounds for concern about whether inflationary pressures had yet been contained; as long as the high growth of monetary aggregates continued, it would be right to remain cautious about the stance of policy.

(vii) This was reinforced by the latest prospects for inflation. The January forecast showed that there was now little expectation of significant progress in reducing the 12-monthly growth of the RPI during the course of 1990.

Discussion then turned to the implications of the present position and the forecast for the stance of policy. The main points raised were:

(a) There was a strong case for seeking to maintain a broadly balanced budget and for avoiding intentionally moving back into a position of net public sector borrowing. The assessment of a balanced budget was most appropriately made on the basis of the PSBR excluding privatisation proceeds. On that definition it appeared that a position of budget balance was already close to being reached.

(b) There were a number of arguments that pointed to the conclusion that the present overall stance of economic policy was not tight enough. As indicated in the earlier discussion the figures for the monetary aggregate were worrying, and it was reasonable to conclude that inadequate notice had been taken in the past of the signals they were giving. A substantial number of mortgage holders had yet to face up to the cash flow consequences of higher interest rates because of yearly lags in the adjustment of monthly payments; however even when the process had fully adjusted the intense competition amongst mortgage lenders meant that most mortgage borrowers were in practice paying significantly below 15 per cent. The same was true of business borrowing, which was generally tax deductible. The fact that many businesses still seemed willing to agree to large wage increases suggested there must still be considerable slack in business finances.

(c) Even though effective borrowing rates for many people could be below 15 per cent, there was no doubt that monetary policy had been greatly tightened since mid 1988, and it was therefore surprising that it had not had a greater effect. This prompted the question whether the normal mechanisms for transmitting the impact of tighter monetary policy were breaking down. It was important to bear in mind however that over recent years there had been major structural changes in the financial markets consequent on deregulation and the removal of controls. When policy instruments had

included direct controls and other rationing devices, these mechanisms provided a considerable reinforcement to the impact of a higher price of money via interest rates. Following deregulation this was no longer the position and full reliance therefore fell on interest rates. The implication was that, for a given overall tightening of policy, it might now be necessary to pull the interest rate lever harder. That said it remained important not to underestimate the effects that monetary tightening had had over the last year.

(d) If monetary policy was tightened further it would lead to major economic and political difficulties. The impact of high interest rates tended to be concentrated on particular, politically sensitive, groups such as mortgage holders and small businesses. With that in mind it was highly desirable to strain against pressures for any further interest rate increase. But if the monetary indicators continued to be unfavourable this possibility could not be absolutely ruled out.

(e) One possible means to reinforce the impact of interest rate policy would be the introduction of a consumer credit tax. Its advantage was that it could be targeted on particular groups or types of borrowing. There was however a major presentational drawback in the introduction of a new tax.

(f) One of the major difficulties with higher interest rates was the short term adverse impact on the RPI. It was essential once the RPI began significantly to be reduced to look again at the arrangements for calculating the RPI, including the advisory committee system. The present conventions were full of anomalies and unjustified assumptions, and these needed to be challenged. One possible solution in the longer term was to move towards adopting a common OECD or EC approach. A more immediate problem was the impact on the RPI of the introduction of the community charge. At an earlier stage the Government had gone along with the approach of including the community charge in the RPI (unlike rates), mainly because of worries over the likely cost of having to redeem index linked gilts (at a possible cost of some £3 billion) if the community charge was excluded from the index. But the logic for including the community charge was extremely weak, and the nonsense of this approach was under-lined by the fact that an inconsistent approach was being used by the national income statisticians in measuring GDP. It might not be possible at this stage to change the basic decisions to include the community charge in the RPI and to exclude from it credit for community charge rebates; however it was essential to make an early approach to the RPIAC to look at the treatment of the community charge transitional relief scheme. This had been introduced since the original RPIAC decision, and no effort should be spared in seeking to persuade the Committee that transitional relief should be taken into

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account in the index so that the RPI more closely measured the net payments being faced by charge payers.

(g) If some tightening of economic policy was judged appropriate, it might be preferable to tighten the fiscal rather than the monetary position. In this context a key issue would be the Budget decision about the revalorisation of excise duties. It was now clear that it had been a mistake in 1989 not to revalorise; and if that decision was to be repeated this year an impossible position could be faced in 1991 given the worries that would then be expressed about the RPI impact of higher excise duties. Following the decisions in recent years to increase indirect taxes less than the rate of inflation there was a strong case for more than indexing them this year; indeed some duties were now 30 per cent lower in real terms than in 1979. On the other hand, given the latest RPI prospect set out in the January forecast, to more than index this year would have obvious draw-backs.

(h) One potential weakening of the fiscal stance would arise if it was necessary, in view of Stock Exchange developments, to reduce Stamp Duty. But as a result of delays in the planned introduction of Taurus the implementation of fiscal changes following the start of paper-less transitions might not be necessary in 1990-91.

(i) Further consideration needed to be given to the tax treatment of fixed investment. One potential problem area was short life or high technology investment; there was already a short life asset scheme which was thought to provide more generous tax treatment than the actual writing down periods that businesses use, but this was certainly an issue that could be looked at again. A wider possibility would be to consider a more general change in tax allowances so that capital investment could be written off much more rapidly for tax purposes than its actual period of use; in effect to use the tax system to subsidise investment. The attraction of such an approach was the importance, following several years of strong growth in fixed investment, to ensure that this record was maintained and that the UK's productivity performance relative to Germany and other strong competitor countries was improved. On the other hand if tax allowances were significantly increased that could pre-empt the possibility of lower corporation tax rates in later years; it might therefore be better to focus on the longer term aim of tax rate reduction and leave businesses to reach their investment decisions on the basis of purely business rather than tax reasons.

(j) A key issue for the Budget and for economic management more generally was the need to reach a view on an acceptable rate of inflation in the near term. There was general agreement that by mid-1991 the inflation

rate must be brought down to 5 per cent or less. On one view it would be necessary to administer a sharp policy shock to deliver such an objective. On the other hand it was felt that shock treatment could have very serious adverse economic and political effects, and it would therefore be highly desirable to achieve the lower inflation objective by a steadier application of policy instruments.

(k) The existing MTFS targets had now lost credibility. If the MTFS approach was to be maintained it was essential the targets set at Budget time to be realistic. But equally it was necessary to take action which would give the MTFS a new stamp and a new credibility. Hitherto the MTFS had set targets for interim policy objectives, but not for inflation itself. It was therefore for consideration whether there would be advantage in setting a medium term target for the reduction of inflation to a specified rate by, say, 1993-94. This might provide the means of giving the MTFS credibility, and it would provide an excellent discipline for the conduct of the policy over a period of years. On the other setting a precise inflation target was a high risk strategy and a hostage to fortune particularly when, following recent experience, there were doubts about exactly how it would be achieved. On this view the necessary pre-requisite to any such targeting would be to get the rate of inflation down further first. On the other hand if some new ingredient could not be introduced into the MTFS it might be better to drop the whole approach; simply to roll forward the existing MTFS with higher numbers could lack credibility. Against that, to drop the MTFS and replace it with nothing would provide a very bad signal for the markets. A further alterative might be to consider setting a shorter time-frame on the MTFS than had been done in the past, and to reinforce this with non-quantified intentions for the future. Given these conflicting considerations it was not possible at this stage to reach a final decision on the role and nature of the MTFS in this year's Budget; it would need to take into account the latest available pre-Budget information on the monetary and other indicators.

(l) It would be necessary in the Budget documentation to include a form of words about UK entry into the Exchange Rate Mechanism. There was a strong case for sticking closely to the post-Madrid formula; any other approach would raise difficult questions. It would also be desirable to say as little as possible about exchange rate policy, perhaps relying on the phrase that the Government favoured a strong pound, and to focus heavily on past exchange rate developments rather than speculating about the future.

(m) Outside the Budget context it would be necessary to consider carefully the approach to

9.

possible ERM entry over the months ahead. The UK was now committed to entry unless there was some further dramatic development, for example in the context of the IGC next winter. A key issue on possible timing of entry would be the profile of UK inflation, and against the background of the latest forecast it may well be that the UK would not join before the next January election. If the UK was to enter the mechanism before the election then there was a strong case for ensuring this was at least 4-6 months in advance of the election itself, in order to allow for the markets to settle down; it was likely that there would be an initial period of turbulence. An essential pre-requisite to entry would be reasonable assurance that sterling would stay steady if UK interest rates were significantly lower; and an assessment that lower UK interest rates would not undermine the necessary tightness of domestic economic conditions. All these considerations pointed to reviewing the position reached towards the end of 1990 which, given the current RPI profile, was the earliest date that entry could be contemplated. In the meantime it seemed likely to be appropriate to keep interest rates at or close to present levels.

Yours,
Paul

(PAUL GRAY)

John Gieve, Esq.,
HM Treasury.

PRIME MINISTER

SEMINAR WITH THE TREASURY: 30 JANUARY

Next Tuesday evening you are having a pre-Budget seminar with the Chancellor and some of his Treasury team. We are starting at 1745 and Sherry will be preparing some supper at 2000.

The Treasury team will be:

Chancellor of the Exchequer
Richard Ryder
Terry Burns
Michael Scholar

Peter Middleton will not be there as he is still on his honeymoon. Andrew and I will also be present; Brian Griffiths cannot come because he is in America next week.

I suggest the aim of the seminar is not to get into the detail of the Chancellor's Budget ideas. Rather your aim should be to assess where the economy now is, what are the short-term prospects, and what should be the broad policy stance. You told the Chancellor a couple of weeks ago you would like to carry forward discussion of the ERM, but I suggest that issue should be left until well on into the meeting.

The main paper for the meeting is the annotated agenda below, which the Treasury have prepared. They have also sent over this evening the detailed January Economic Forecast which has just been completed; this is a background document but you may find it helpful to go through it to familiarise yourself with some of the detail.

PAUL GRAY
26 January 1990
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Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

26 January 1990

Paul Gray Esq
Private Secretary to the
Prime Minister
10 Downing Street
LONDON
SW1A 2AA

Dear Paul

see attached folder.

... I enclose three copies of the new Treasury forecast and a note that we have prepared as the basis for discussion at the Prime Minister's seminar on Tuesday.

Yours
JG.

JOHN GIEVE

COPY NO. 12

January Forecast 1990

HM TREASURY
JANUARY, 1990

TREASURY ECONOMIC FORECAST
JANUARY 1990

Chapter 1 provides a full self-contained account of the major features of the January economic forecast. Readers interested in more detailed discussion of the judgements and uncertainties underlying the forecast can find the relevant material in the chapters on the separate aspects of the forecast.

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Table 1.1 Summary of the forecast

Percentage changes on a year earlier unless otherwise stated

	FSBR 1989	October Internal	Autumn Statement	January Internal
GDP VOLUME				
(non-oil in brackets)				
1988	4.3 (5.1)	4.3 (5.1)	4.3 (5.1)	4.4 (5.1)
1989	2.3 (2.8)	2.0 (3.1)	1.9 (3.1)	2.7 (3.8)
1990	2.1 (1.9)	0.4 (-0.1)	1.3 (0.8)	0.8 (0.4)
1991	2.6 (2.7)	2.3 (0.5)	1.8 (2.0)	1.3 (1.6)
DOMESTIC DEMAND				
1988	6.5	7.3	7.3	7.4
1989	2.5	3.4	3.7	4.0
1990	1.3	-0.9	-0.1	-0.9
1991	1.8	2.0	1.6	1.3
RPI				
(ex MIPs in brackets)				
1988 Q4	6.6 (5.2)	6.5 (5.2)	6.5 (5.2)	6.5 (5.1)
1989 Q4	5.6 (5.1)	7.4 (5.8)	7.6 (6.1)	7.6 (6.1)
1990 Q4	3.3 (3.7)	6.5 (5.9)	5.8 (5.5)	6.7 (6.0)
1991 Q4	2.8 (3.1)	4.0 (4.2)	3.9 (4.0)	4.1 (4.7)
GDP DEFLATOR*				
1988-89	7.2	7.0	7.0	6.9
1989-90	5.4	6.8	6.9	6.0
1990-91	3.9	5.7	5.0	5.4
1991-92	3.0	4.9	4.9	5.2
MONEY GDP*				
1988-89	11.0	10.8	10.8	10.9
1989-90	7.8	8.6	8.6	8.7
1990-91	5.9	6.5	6.8	5.9
1991-92	5.9	7.4	6.6	7.0
BASE INTEREST RATES				
(%)				
1988 Q4	12.4	12.4	12.4	12.4
1989 Q4	12.0	15.0	15.0	15.0
1990 Q4	10.0	14.0	14.0	14.5
1991 Q4	8.5	12.5	12.5	12.5
MO				
1988-89	7.2	7.1	7.1	7.1
1989-90	3.6	5.4	5.3	5.8
1990-91	2.7	3.7	4.0	4.3
1991-92	2.4	3.1	3.3	3.0
STERLING INDEX				
1988 Q4	96.7	96.7	96.7	96.7
1989 Q4	95.3	90.0	89.0	88.0
1990 Q4	93.8	90.0	89.0	86.4
1991 Q4	92.9	90.0	89.0	85.0
CURRENT BALANCE £bn				
1988	-14.7	-14.6	-14.6	-14.7
1989	-14.5	-18.9	-20.2	-20.5
1990	-12.1	-13.4	-14.8	-14.0
1991	-8.6	-10.2	-10.7	-12.3
PSDR				
(Fiscal adjustments in brackets)				
1988-89	13.9 (0)	14.4 (0)	14.3 (0)	14.4 (0)
1989-90	13.8 (0)	13.3 (0)	12.6 (0)	8.0 (0)
1990-91	10.0 (1.0)	9.5 (1.0)	10.0 (1.0)	5.0 (0)
1991-92	6.0 (2.0)	3.1 (1.0)		-1.1 (0)

**On the Autumn Statement basis - see footnote to Table 1.4*

CHAPTER 1: THE JANUARY FORECAST

1.1 Table 1.1 summarises the forecast and compares it with the FSBR, October and Autumn Statement forecasts. **GDP growth** is expected to turn out at 2¾ per cent in 1989, faster than we expected in the October and Autumn Statement forecasts (both about 2 per cent). Despite this, the main message of the latest forecast is that **demand prospects** for 1990 are still likely to be as weak as foreseen in October, and more depressed than in the published Autumn Statement forecast. The prospect for **retail price inflation** through 1990 has worsened notably since the Autumn Statement, but recent favourable trends in visible trade point to a slightly better prospect for the **current account**. **Fiscal prospects** for both the current year and next have deteriorated quite sharply.

Demand and output

1.2 Table 1.2 summarises the forecast for demand and output.

Table 1.2 GDP and domestic demand at constant 1985 prices

	Percentage changes on a year earlier			
	1988	1989	1990	1991
Domestic Demand	7.4	4.0	-0.9	1.3
of which:				
Consumers' expenditure	6.9	4.3	0.8	1.4
Public authorities' consumption	0.4	0.1	0.9	1.4
Fixed investment	13.7	7.1	-1.3	-0.4
Change in stockbuilding (per cent of GDP)	0.8	0.0	-1.6	0.3
Exports of goods and services	0.8	5.2	6.0	3.3
Imports of goods and services	12.4	8.6	-0.1	3.1
Gross domestic product	4.4	2.7	0.8	1.3
Non-North sea GDP	5.1	3.8	0.4	1.6
Manufacturing output	7.1	4.6	-0.5	2.1

1.3 **Consumer spending** clearly slowed in 1989 in response to high interest rates. The slow-down is most evident in **retail sales** and in depressed **demand for new cars** since September. Retail sales recovered unexpectedly sharply in December, up 2¼ per cent on November. But we do not believe this indicates a more sustained recovery. Rather, it probably reflects some spending delayed from November (which was very low) and some advance of planned January spending in response to an earlier than usual start to winter sales. Early indicators for January are consistent with this view.

1.4 **Consumer confidence** fell more sharply than expected in October in response to the last interest rate increase and remained weak in November and December . However, it recovered somewhat in January. With a further ½ per cent rise in mortgage rates assumed to occur in April (reflecting recent building society warnings of the need to restore margins if base rates do not fall before then), confidence may be further depressed in the spring. Against this background, and the prospect of rising unemployment later in the year, consumer spending is projected to grow slowly in 1990 and 1991 (¾ and 1½ per cent respectively).

1.5 **Companies' real spending** remained strong in 1989, with **business investment** likely to have risen by 10-11 per cent (after an average increase of 14 per cent a year in 1987 and 1988), though it seems to have flattened in recent quarters. There was also further strong **stockbuilding**.

1.6 **Industrial and commercial company sector finances,** however, weakened much more than expected in 1989. With the slow-down in growth during 1989, and the rise in unit labour costs, companies' **real rates of return** are likely to have flattened off - though still at high levels by the standards of the 1970s and early 1980s. The rapid growth in company spending (investment and stockbuilding) over the last two years has led to large **financial deficits** by industrial and commercial companies in 1988 and 1989. Although the data are uncertain, they suggest that the deficit in 1989 is likely to have been the largest since the war; and two years of such deficit are unprecedented over the last 40 years. Companies' **net liquidity** has also deteriorated sharply over the last two years, to historically very low levels.

1.7 Industrial and commercial companies will continue to face a difficult financial outlook in 1990, with a further slackening of demand growth and falling capacity utilisation in prospect. As is usual in a cyclical slow-down, companies are likely to try to improve their financial position by cutting back on their spending and employment. However, their reactions could be more muted than in previous periods of financial squeeze. Financial deregulation has probably led to greater willingness by companies to borrow to see them through temporary disturbances, while financial institutions are also more willing to lend. Even so, business spending is likely to be more depressed in 1990 than we expected in October, with **business investment** falling slightly (down nearly 1 per cent) and **destocking** of over £2 billion. Business investment could fall a further 1 per cent in 1991.

1.8 **Exports of goods** are currently growing significantly faster than imports in volume terms. Falling capacity utilisation in the domestic consumer and intermediate goods sectors (especially cars) has resulted in an apparent switch of production to satisfy export markets rather than domestic demand. Import growth took more time to respond, though there is now clear evidence of quite a sharp slow-down. These improving trends in trade are expected to continue, and net exports are likely to make a more significant contribution to GDP growth than we foresaw in October.

1.9 **In summary,** personal spending and business investment are both projected to be weaker in 1990 than we expected in October. However public authorities' consumption could be a little stronger. Together with less destocking than we previously forecast, this implies the same outlook for domestic demand in 1990, down nearly 1 per cent, as we

saw in the October forecast. Even so, GDP is likely to rise a little faster in 1990 (¾ per cent) than we expected in October (½ per cent). This reflects a greater contribution from net exports. Growth of GDP picks up in 1991, but only to a fairly muted 1¼ per cent.

1.10 In 1988 and 1989 the private sector (persons and companies) ran sharply increasing financial deficits. This contrasts with a long previous history of the private sector running financial surpluses. The slide into deficit resulted from the unprecedented combination of **falling** savings and **rising** investment (savings and investment usually rise and fall together). The counterpart to recently rising private sector deficits has been a sharp deterioration in the current account deficit. There are already signs that the private sector deficit was turning round during 1989. With both the personal and company sectors reining in on expenditure in the forecast, this process is expected to continue and the deficit comes down significantly through the next two years, from 4¼ per cent of GDP in 1989 to ¾ per cent in 1991.

Pay and Inflation

1.11 **Private sector pay settlements** are likely to continue at recent fairly high levels in the first three quarters of 1990 as retail price inflation stays well above 7 per cent. Some downward pressure may emerge later as inflation begins to moderate and as firms take a more stringent approach to pay bargaining against the background of declining profit margins, a tight financial position, and rising unemployment. Private sector pay settlements are expected to average 8¼ per cent in the 1989-90 pay round and 7 per cent in the 1990-91 pay round. **Underlying average earnings growth** should abate both with the slow-down in pay settlements and as overtime and performance related bonuses come down in line with sluggish demand and output. Whole economy underlying earnings are expected to rise by 9¼ per cent in 1990 and 8½ per cent in 1991.

1.12 Developments on both **producer output and retail price inflation** in the final quarter of 1989 were in line with the Autumn Statement forecast, with some emerging evidence that margins are already being squeezed by slackening demand growth and rising unit labour costs.

1.13 The prospects for **RPI inflation** through 1990 have, however, deteriorated since the Autumn Statement. The lack of any marked progress on inflation during 1990 mainly reflects:

- higher and surprisingly sustained food price inflation, which may take some time to abate (it may even pick up further in the immediate months ahead);
- a lower average level of the exchange rate;
- a high assumed starting level for the community charge - now put at nearly £330 per head compared to £317 assumed in the October internal forecast and £305 in the Autumn Statement;
- an assumed ½ per cent rise in mortgage rates from the beginning of April and;

- the assumed revalorisation of specific duties and excise taxes in the 1990 budget (after no revalorisation in the 1989 budget).

These factors should be partly, but only partly, offset by a substantial squeeze on profit margins. Moreover, the prospect for food price inflation is highly uncertain. Since it has risen much more sharply than we expected, and is still difficult to explain, there must be a chance that it will subside more quickly than we have currently allowed.

1.14 But overall we expect **RPI inflation** to rise to 7¾ per cent in the second and third quarters of this year, before moderating to 6¾ per cent by 1990Q4 as interest rates come down. The **underlying RPI inflation rate (ie excluding mortgage interest payments)** is likely to rise to 6 ¼ per cent for most of the summer under the influence of rents, community charge, etc. It falls to 6 per cent by 1990Q4 as the decline in marketed retail price inflation begins to offset these factors. Inflation abates sharply through 1991 with further falls in interest rates and sustained slow growth in demand.

Table 1.3 Inflation

	Percentage changes on a year earlier		
	Manufacturers producers output prices[1]	RPI less mortgage interest payments	Total RPI
1988Q4	5.0	5.1	6.5
1989Q2	5.4	6.0	8.2
1989Q4	5.5	6.1	7.6
1990Q2	5.0	6.3	7.8
1990Q4	4.3	6.0	6.7
1991Q2	3.9	4.9	4.7
1991Q4	3.9	4.7	4.1

[1]*less food, drink and tobacco*

Money GDP

1.15 Recorded **money GDP** in the first half of 1989-90 was 9¾ per cent up on a year earlier. For 1989-90 as a whole we expect money GDP growth of a little under 9 per cent, down from 11 per cent last year. Money GDP growth in 1990-91 is expected to weaken further to 6 per cent, mainly because of lower real growth. But it may rebound somewhat thereafter as output itself recovers.

Table 1.4 Money GDP and the GDP deflator[1]

	Percentage changes on a year earlier					
	Money GDP			GDP Deflator		
	FSBR	Autumn Statement	January Forecast	FSBR	Autumn Statement	January Forecast
1988-89	11.0	10.8	10.9	7.2	7.0	6.9
1989-90	7.8	8.6	8.7	5.4	6.9	6.0
1990-91	5.9	6.8	5.9	3.9	5.0	5.4
1991-92	5.9	6.6	7.0	3.0	4.9	5.2

[1] *These are calculated on the Autumn Statement basis, ie not allowing for the introduction of the community charge in England and Wales.*

The balance of payments

1.16 The **current account deficit** in 1989 was close to the Autumn Statement forecast of £20 billion. **Visible trade** performance was better than expected, with exports continuing to rise strongly in the final months of the year and imports showing clear signs of slowing in response to slower domestic demand growth. However, the **invisibles balance** in 1989 seems to have been much weaker than expected because of high net transfers overseas (mainly net contributions to the EC) and a sharp drop in the net earnings on overseas assets.

1.17 The current account deficit is still forecast to fall sharply, to around £14 billion in 1990 - slightly below the Autumn Statement forecast - even though, in the light of the recent weakness, we are now much more cautious about the prospects for a recovery in invisibles. The visibles balance is forecast to improve substantially as growth in domestic demand and imports fall. Export growth is likely to slow from the exceptional rate recorded in 1989, as world trade growth eases. But the **UK share of world trade in manufactures** may rise a little further, following the strong recovery in 1989, as reductions in capacity utilisation continue to allow firms to divert production to overseas markets. The North Sea oil price is assumed to fall back from its recent high level, to an average of just over $18 a barrel in 1990 - only slightly above the average in 1989. But the oil trade balance is likely to be higher in 1990 than in 1989, because of the recovery in oil production.

1.18 In 1991 exports of manufactures are forecast to grow in line with world trade, but import growth may pick up as domestic demand growth begins to recover. The current account deficit is expected to fall further, but only to £12½ billion - 2 per cent of GDP.

Table 1.5 Current account

	£ billion					
	Manu-factures	Oil	Other goods	Total visibles	Invisibles	Current balance
1988	-14.9	2.8	-8.7	-20.8	6.2	-14.7
1989	-16.1	1.3	-8.4	-23.2	2.6	-20.5
1990	-11.6	2.0	-7.9	-17.4	3.4	-14.0
1991	-11.1	1.5	-8.3	-17.8	5.6	-12.3

Monetary policy and conditions

1.19 Inflation remains well above the 1989 MTFS path throughout the forecast period and money GDP growth falls only briefly to the MTFS path in 1990-91, before rising in 1991-92. Against this background of a relatively slow inflation response to tight policy, the forecast assumes that **short term interest rates** will need to remain high - base rates are assumed to stay at 15 per cent until the beginning of the fourth quarter of 1990, and then fall slowly.

1.20 Even with rates remaining high relative to other G7 countries, some further downward pressure on the **exchange rate** seems likely. The forecast assumes a fall in the sterling index, from its present level, of 2 per cent a year over the next 2 years. This is consistent with a stable rate against the dollar, and a fall against the Deutschemark to 2.76 by the end of 1990, slightly above the lowest level reached in recent weeks. The fall in sterling is in line with the inflation differential between the UK and other G7 countries, implying a **constant real exchange rate**.

1.21 Sustained high interest rates and the slowdown in money GDP growth are likely to bring **M0 growth** down within its 0-4 target range for 1990-91 by the second half of the financial year, and keep it in the upper half of its range in 1991-92.

Public finances

1.22 The PSDR for 1989-90 is forecast to be £8 billion, compared with £12½ billion in the Autumn Statement. The downward revision largely reflects a shortfall in corporation tax receipts and higher borrowing by local authorities. There are still considerable uncertainties about the outcome, particularly about the level of receipts in the peak tax collecting month of January and the size of the surge in spending in March. The average error on forecasts made at this time of year is nearly £2 billion, and the largest single error was £3 billion.

Table 1.6 PSDR

	£ billion			
	1988-89	1989-90	1990-91	1991-92
PSDR	14.4	8.0	5.0	-1.1
PSDR excluding privatisation proceeds	7.4	3.8	0	-6.1
PSDR less all asset sales	1.8	-1.8	-4.5	-10.6

1.23 On the assumption that taxes are revalorised and indexed in the Budget, the PSDR is forecast to fall further in 1990-91 to around £5 billion. This largely reflects the slow-down in the economy, although the introduction of independent taxation and the full year effect of NICs' reform also contribute.

1.24 The share of taxes and national insurance contributions (NICs) in GDP is forecast to rise marginally in 1990-91, with a fall in the share of corporation tax more than offset by rises in the shares of income tax and domestic rates/community charge. The rising

share of income tax reflects the continued buoyancy of wages and salaries. In 1991-92 with wages and salaries growing at the same rate as money GDP and the share of corporation tax continuing to fall, the share of total taxes and NICs in GDP is forecast to fall.

Table 1.7 Ratios of public expenditure, receipts and debt repayment to money GDP

	Per cent			
	1988-89	1989-90	1990-91	1991-92
GGE (excl.priv.proceeds).	39.0	38.9	39.6	39.7
Non-oil taxes and NICs[1]	37.1	36.6	36.7	36.0
PSDR	3.0	1.6	0.9	-0.2

[1] *as share of non-oil money GDP*

1.25 The ratio of GGE (excluding privatisation proceeds) to GDP is forecast to rise by ¾ per cent in 1990-91 and to be broadly unchanged in 1991-92.

Risks and uncertainties

1.26 The prospects for growth in 1990 are particularly uncertain. On the one hand, we have persistently under-predicted the growth in domestic demand (both consumer and business spending) over the past three years. According to latest data, domestic demand has turned out faster in 1989 even than we perceived in October or in the Autumn Statement. This tendency may continue. There must, therefore, be a risk that domestic demand and activity will continue to be quite buoyant, with the private sector remaining in substantial deficit, despite sustained tight monetary and fiscal policies. If so, the improvement in the current account may be less than we are forecasting. And the pressure on firms to cut profit margins will be reduced, so that progress on reducing inflation may be slower than expected.

1.27 On the other hand, just as we tend to underpredict growth in periods of rapidly rising activity, so we may overstate growth when the economy is slowing fairly sharply and the private sector has to adjust to tightening financial constraints. In this case the current account deficit and inflation may both fall more sharply than forecast.

1.28 The uncertainty about the cyclical position of the economy over the next year carries over into the fiscal outlook. It is always difficult to forecast the public finances when the economy is changing gear; in the past, the tendency has been to underestimate cyclical effects on the PSDR. Uncertainties about the current and recent levels of profits and investment in particular pose major problems for forecasting corporation tax receipts. In addition there are considerable uncertainties stemming from the introduction of a new regime for local authority finance and of independent taxation.

CHAPTER 2 : THE WORLD ECONOMY

Policy

2.1 **Nominal interest rates** outside the US rose in stages through 1989. Average G7 rates are now at their highest level since 1984. The forecast assumes that they will remain at around present levels until the end of 1990. Thereafter lower inflation allows Japan and Germany, followed by France and Italy, to reduce rates by 1 to 1½ percentage points by the end of 1991. Real interest rates remain higher than in any year in the 1980s. **Real effective exchange rates** are assumed to remain constant at about end 1989 levels. Overall, some tightening of **fiscal policy** is assumed. Small reductions in the US Federal deficit are expected in 1990 and 1991, after three years in which the outturn remained around $150bn.

Forecast

Table 2.1 **Summary of world forecast**

	Percentage changes on a year earlier			
		Forecast		
	1988	1989	1990	1991
G7 activity and inflation				
Real GNP	4.5	3.4	2 ½	2 ¾
Domestic demand	4.7	3.4	2 ½	2 ½
Industrial production	6.0	4.1	2 ¾	3
Consumer prices	3.3	4.6	4	3 ¼
Trade				
Total world trade	8.4	7.4	5 ¼	5
World trade in manufactures	9.6	8.4	6	5 ½

Activity 2.2 **G7 GNP** growth in 1989 was about 3½ per cent, with North America and the UK being weaker than Japan and Continental Europe. **G7 GNP** growth is forecast to reach a trough of about 2½ per cent around the end of 1990. A slow recovery, led by the US and Canada, starts in the second half of 1991. Growth of **private consumption** continues steadily at just under 3 per cent, but **business investment** weakens sharply. **Capacity utilization** eases back to about the same levels as in 1986 and 1987. **World trade** is forecast to grow by a little over 5 per cent a year, still quite brisk but well down on the 1988 and 1989 average of about 8 per cent.

Inflation 2.3 **Oil prices** are now falling back from the early January peak, and for 1990 prices are assumed to average $18 pb (Brent), about $½pb up on last year. **Non-oil commodity prices** weakened through 1989, but are expected to remain close to current levels in 1990, ie falling slightly in real terms. Latest data on **G7 consumer price inflation** reveal little

evidence of a sustained slowdown yet; it remained at about 4½ to 4¾ per cent late last year. But inflation is expected to drop back to about 3½ per cent by the end of this year and 3¼ per cent in 1991, a little higher than the 3 per cent average over 1984-88

Current balances

2.4 The US and Japanese **current account balances** were smaller than expected in 1989, in the US mainly because of valuation effects and slower growth relative to elsewhere. Over the forecast, the US deficit and Japanese surplus are expected to increase again, but only slightly as a share of GNP. The forecast of the German current account surplus is influenced by immigration from the East which raises domestic demand. The forecast surplus in both years is similar to the 1989 outturn.

Chart 2.1 G7 interest rates and inflation

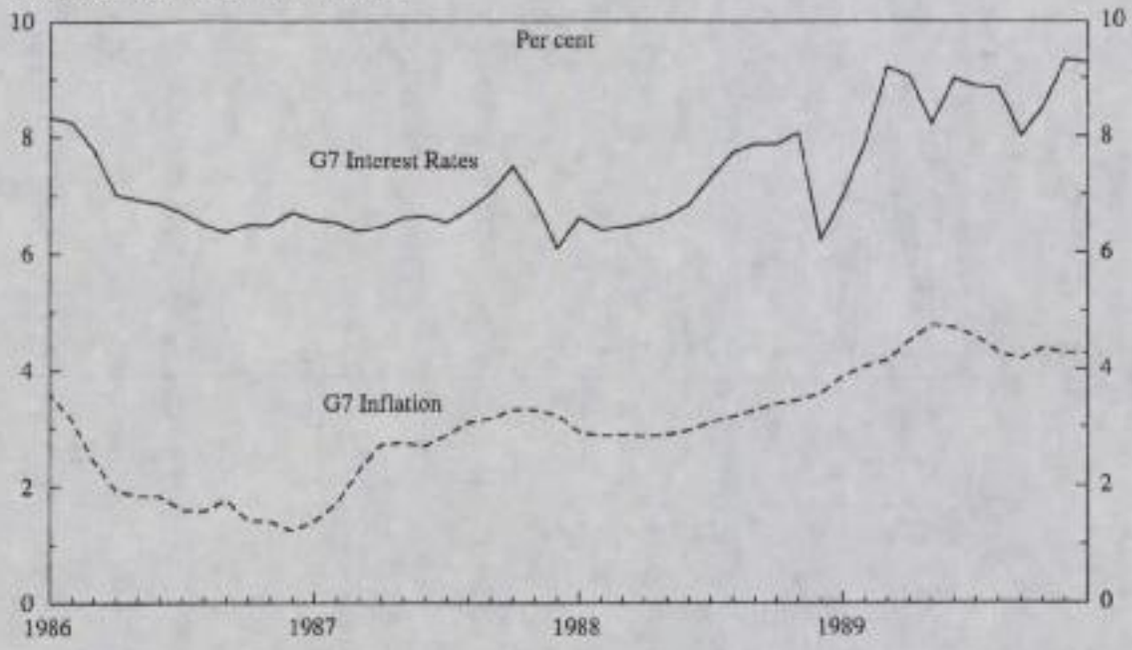


Chart 2.2 Total world trade and G7 industrial production

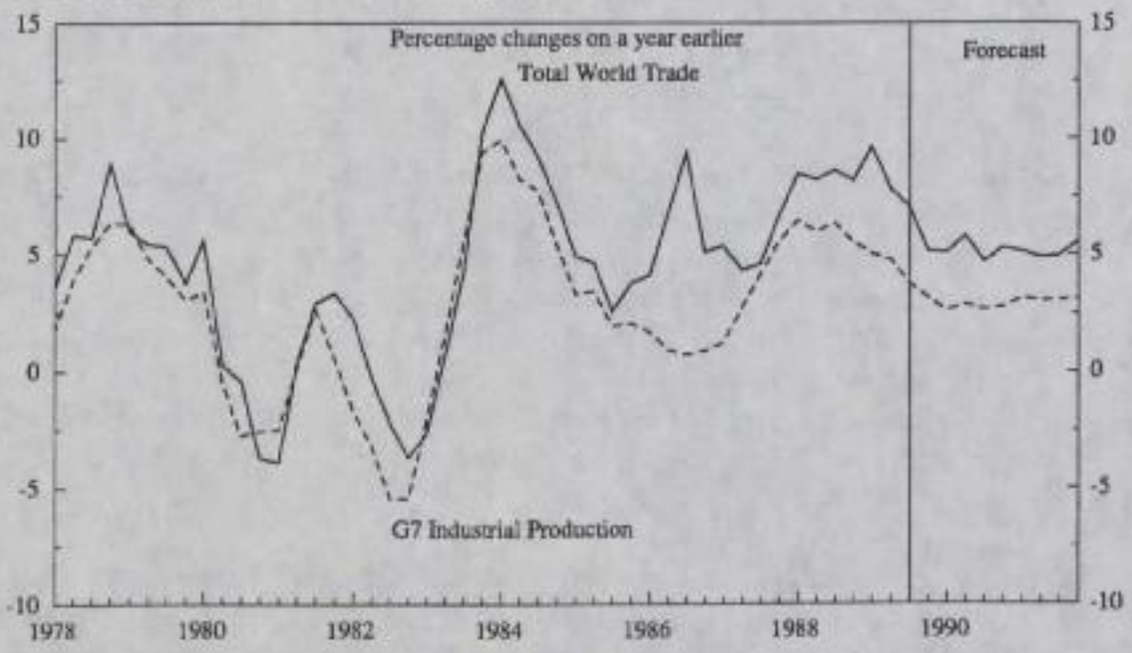


Chart 2.3 Real commodity prices*

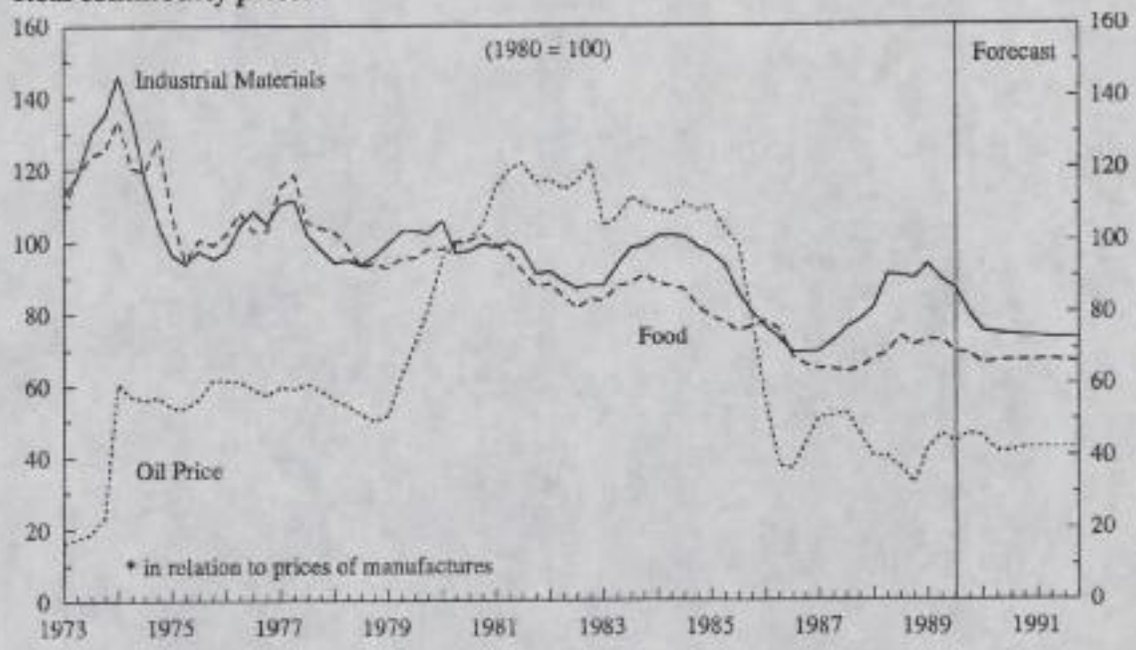
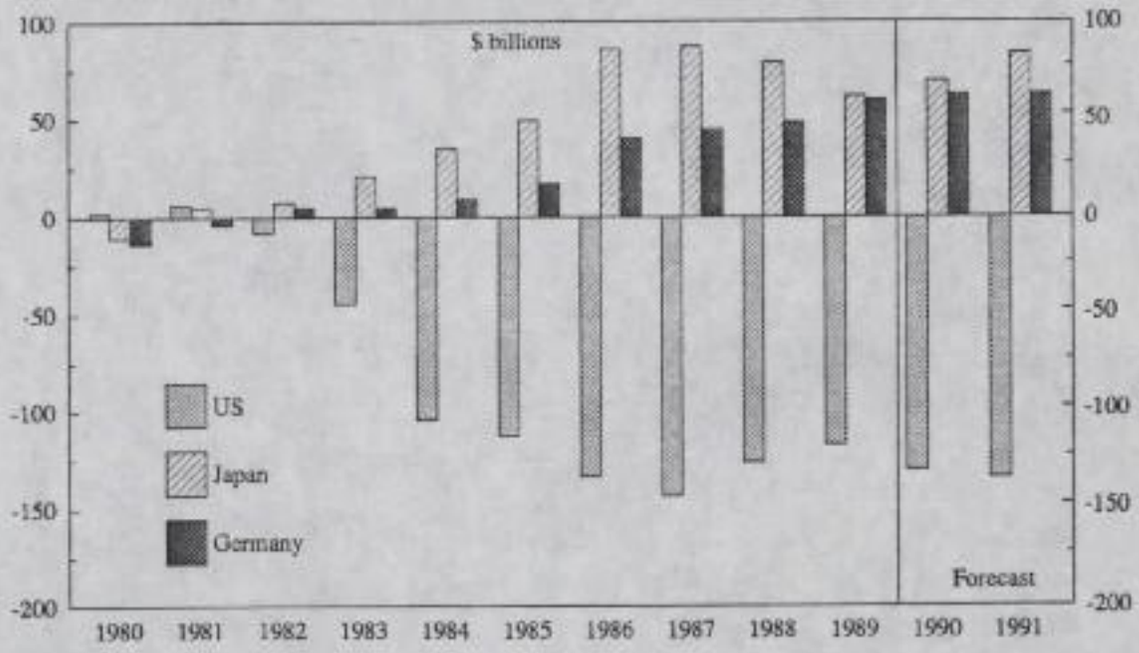


Chart 2.4 Current account inbalances



CHAPTER 3 : PERSONAL SECTOR

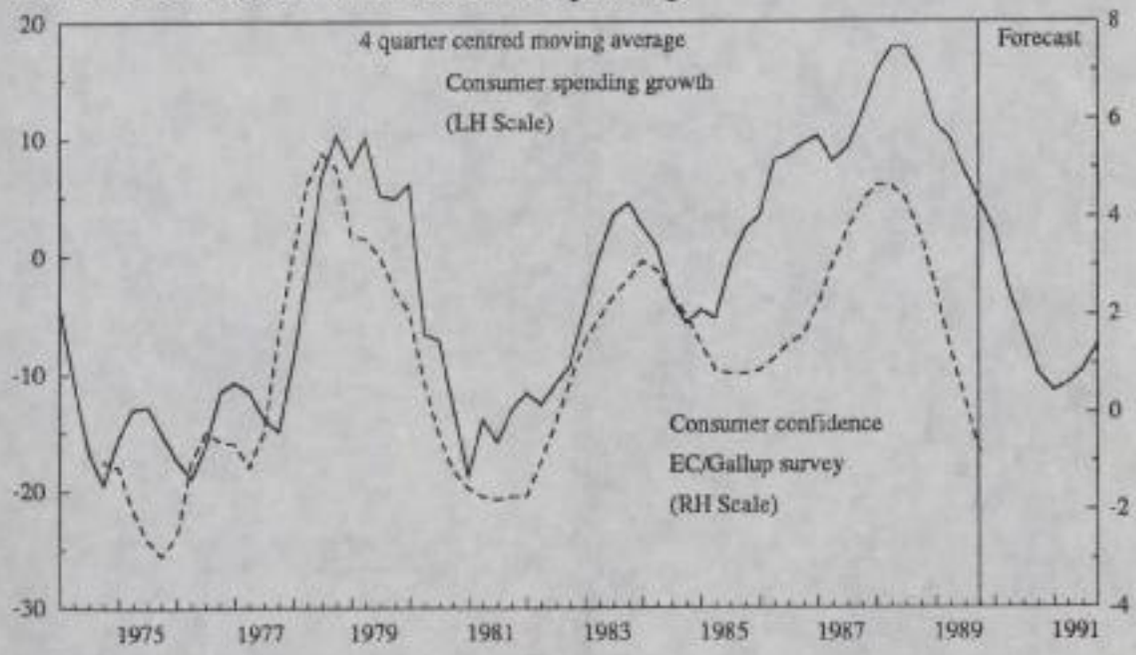
Consumer spending

3.1 **Retail sales** volume growth fell sharply through 1989 (despite the rise in December), from an annual growth rate of 3.8 per cent in the first three months of the year to 1.2 per cent in the final quarter - one of the smallest annual increases since mid-1982. The 2 per cent jump in December may reflect deferred expenditure from November, when expenditure was very low, and an unusually early start to the January clearance sales. **Spending on cars** took longer to slow down than retail sales, but the trend in new car registrations is now also clearly downward.

3.2 According to latest estimates, total consumers' expenditure rose 4¼ per cent in 1989 (though the data contain some upward adjustments by CSO - see **Annex B**). Consumer spending was unchanged between the second and third quarters of 1989, but the first estimate for 1989Q4 shows a rise of 1-1¼ per cent on the third quarter. However, this latest estimate is highly provisional, and is based on little actual data apart from retail sales and new car registration figures.

3.3 **Consumer confidence**, usually a fairly reliable indicator of short-term consumer spending prospects, fell very sharply in October, after the last interest rate increase. It recovered in January but remains at historically low levels. Consumer confidence is expected to remain depressed in the next couple of months. However, it is likely to fall further in April if the assumed ½ per cent rise in mortgage rates materialises. This points to a fairly depressed short-term outlook for personal spending.

Chart 3.1 Consumer confidence and real consumer spending



3.4 Other factors point in the same direction for 1990 as a whole. **Real personal disposable income (RPDI)** is likely to rise by only 1 per cent in 1990 and 2¼ per cent in 1991. This comes after average growth of 5 per cent a year in 1988 and 1989. Incomes are squeezed by a sharp fall in dividend growth and a rise in net interest payments, mainly

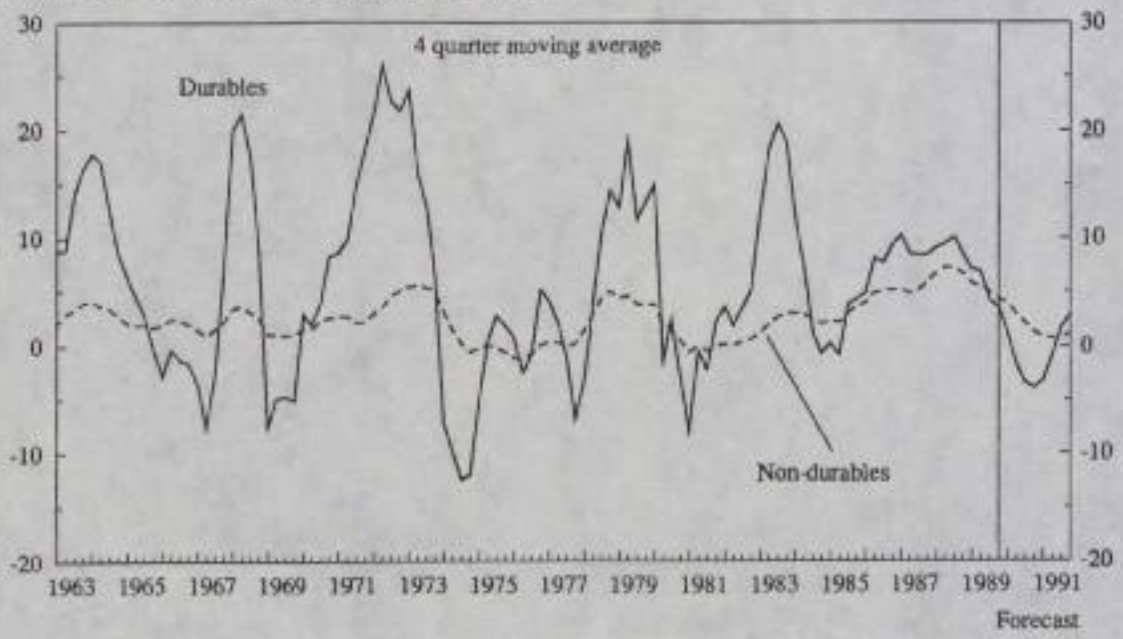
mortgage interest. Moreover, the wealth of households is expected to fall, especially with a further drop in house prices. The sharp rise in wealth, particularly housing wealth, between 1986 and 1988 is thought to be a major factor behind the recent protracted consumer boom. Conversely, therefore, the fall in wealth may well exert a fairly powerful constraining influence this year and next.

Table 3.1 Real consumer spending, RPDI and the saving ratio

	Percentage changes on a year earlier				
	Consumer Spending			RPDI	Saving Ratio
	Total	Durables	Non-Durables		%
1988	6.9	8.5	6.7	5.4	4.4
1989	4.3	3.5	4.4	4.6	4.6
1990	0.8	-3.9	1.3	0.9	4.7
1991	1.4	2.9	1.3	2.3	5.6

3.5 Personal consumption is forecast to grow by only ¾ per cent in 1990, and by a fairly slow 1½ per cent in 1991. Spending on **durables** could be more depressed; it is forecast to fall by nearly 4 per cent in 1990. However, this is less of a fall than we might normally expect. One of the surprising features of the recent consumer boom is that spending on durables has been much less buoyant (though more protracted) than in previous cycles. It is spending on non-durables that mainly accounts for the recent exceptional strength of consumer demand (**Chart 3.2**). The **personal saving ratio** recovers a little from around 4½ per cent in 1988 and 1989 to nearly 6 per cent by the end of 1991 (**Chart 3.4**).

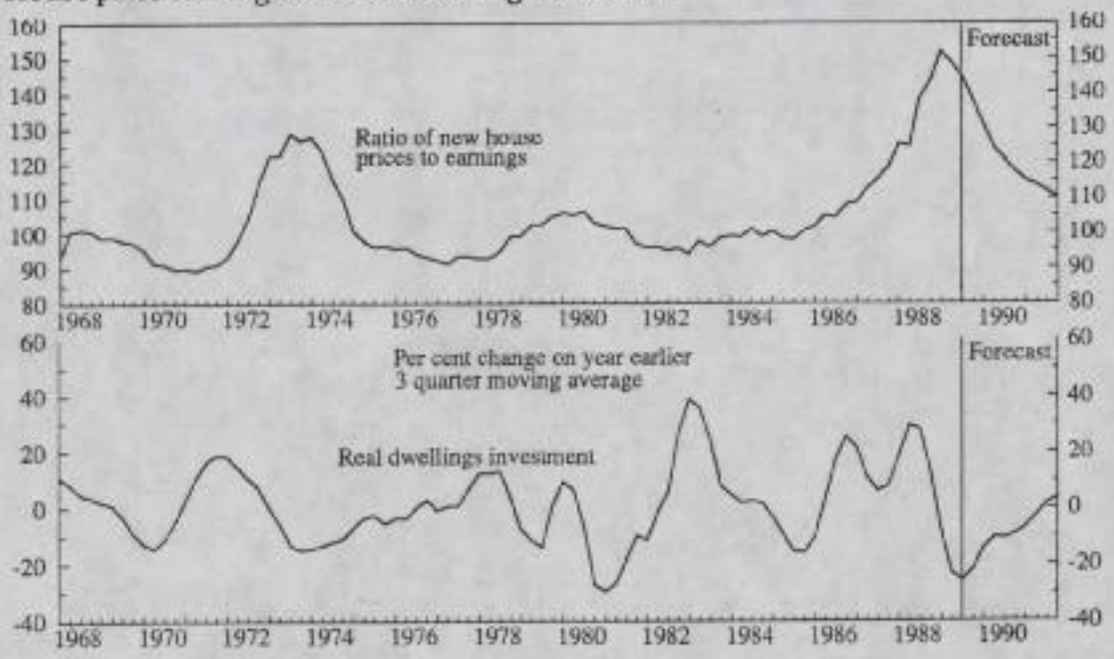
Chart 3.2 Durables and non-durables growth cycles



Housing market 3.6 The housing market has continued to weaken, with total **housing investment** (new dwellings and improvements) nearly 8 per cent lower in the first three quarters of 1989 than in the same period of 1988. And nominal house prices continue to fall; the **Halifax house price index** (seasonally adjusted) fell for the seventh consecutive month in December to stand less than 3 per cent above its December 1988 level.

3.7 It is likely that the housing market will be further depressed in 1990, with a forecast 7 per cent fall in **house prices** in the year to 1990Q4 and only a small rise in the following year. **Investment in dwellings** is expected to fall by nearly 5 per cent in 1990, and to begin to recover only in the second half of 1991.

Chart 3.3 House price earnings ratio and housing investment



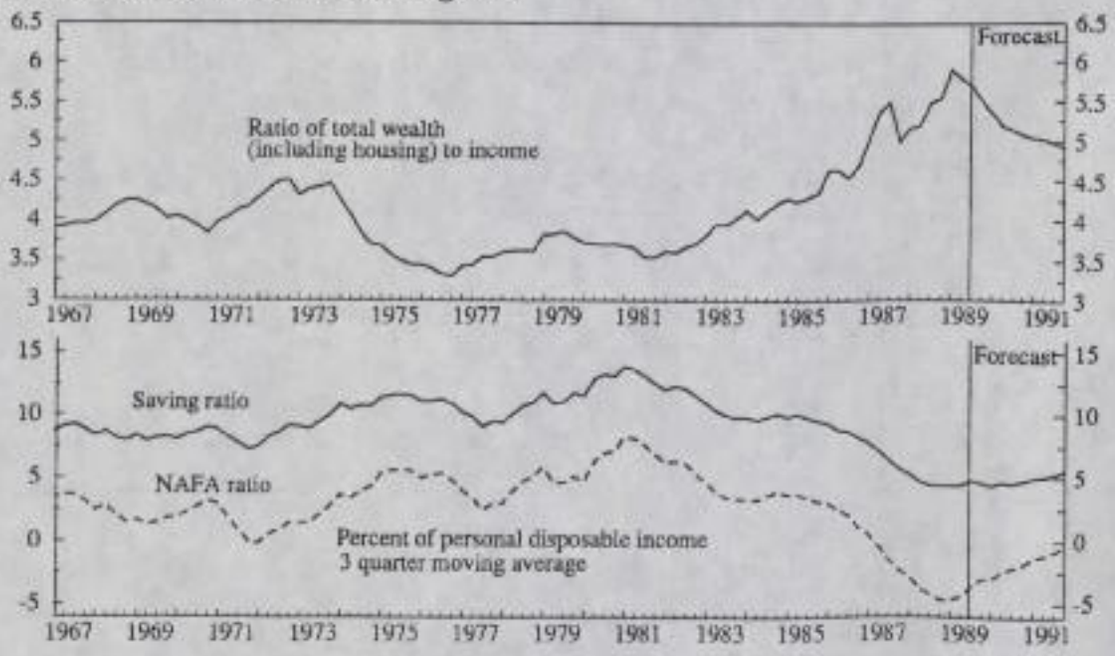
Personal sector financial position

3.8 The personal sector faces a tight financial position; its **financial deficit** increased to over 3 per cent of GDP in 1988 and, even with a fall in investment spending and slower growth in consumption, it is estimated to have been close to 2 per cent of GDP in 1989. The sharp cutback in expenditure, both consumption and investment, in 1990 and 1991 is insufficient to eliminate the deficit completely, though it is much reduced as a share of GDP. The ratio of **personal sector wealth** (including housing wealth) to income is forecast to fall in 1990 and 1991 as a result of lower house and share prices. Even so, total wealth-income ratios remain at historically very high levels (1987 and 1988 apart) in the forecast period.

Risks and uncertainties

3.9 As always, there is considerable uncertainty about the prospects for consumers' expenditure. We risk underestimating the resilience of consumer demand yet again. As we have said, personal sector wealth, though falling over the next two years, remains historically high. Borrowing capacity is likely to remain strong therefore, and consumers may be prepared to increase their borrowing further to sustain more buoyant consumption than we foresee. If they do, however, they will increase their interest burden and simply may defer adjustment to a later date. On the other hand we may well be overstating likely personal spending. Consumers may perceive a greater need to adjust than we have allowed for, with a tight financial prospect and interest payments likely to make a large and rising prior claim on income. It is quite possible that we have not given sufficient weight to the recent low levels consumer confidence and the prospect of a sharp drop in house prices. In that event, there is every chance that consumer spending will take a sharper knock than we expect in 1990, and recover more slowly in 1991.

Chart 3.4 Personal sector wealth and saving ratio



CHAPTER 4 : COMPANY SECTOR

4.1 Latest estimates of business investment and stockbuilding include considerable upward adjustments by the CSO (see **Annex B**). While there must be some uncertainty about recent developments, it seems clear that business spending remained strong in 1989. **Business investment** is likely to have risen by 10½ per cent in 1989, though it levelled off in mid-year (**Chart 4.1**). More recent indicators, such as commercial vehicle registrations, suggest that it may have fallen in the fourth quarter.

4.2 **Stockbuilding** continued at a rapid pace in 1989, as it did in 1988. The rise in stockbuilding over the last two years has led to a steep reversal of the downward trend in the stock:output ratio evident between 1980 and 1987(**Chart 4.2**). Some rise in the stock:output ratio is entirely plausible. It is possible that firms may have been taken by surprise by the strength of demand in 1987 and early 1988. They may, therefore, have had to run stocks down more than they desired relative to output, and to have rebuilt them to more optimal levels subsequently. Even so, there may still be an involuntary aspect to the most recent stockbuilding data. Firms may again have been surprised, this time by the extent of the slow-down in demand, and accumulated more stocks than they expected.

4.3 With the slow-down in demand, high interest rates and an emerging squeeze on profit margins, **industrial and commercial companies (ICCs) financial position** deteriorated markedly in 1989. Growth in non-oil **ICCs profits** (and total income) slowed sharply, after exceptionally strong growth, averaging close to 18 per cent a year between 1981 and 1988. As a result, their **real rate of return** probably stabilised in 1989, albeit at high levels not seen since the late 1960s (**Chart 4.3**). But with continued strong growth in dividend and interest payments, and buoyant investment and stockbuilding, ICCs ran an unprecedentedly large **financial deficit** last year (**Chart 4.4**), the second successive year of financial deficit. **ICCs net liquidity** (net liquidity largely represents companies' bank deposits less their bank borrowing) also deteriorated sharply in 1989, reflecting both the large deficit and a large number of take-overs financed by cash (**Chart 4.5**).

4.4 Industrial and commercial companies continue to face a very difficult financial outlook in the next two years with:

- sluggish demand prospects;
- a further, perhaps intensifying, squeeze on margins;
- falling real rates of return (**Chart 4.3**);
- declining liquidity (**Chart 4.5**) and;
- falling capacity utilisation.

4.5 These developments will clearly colour the prospects for real spending in investment and stockbuilding. As they usually do in a period of sharp slowdown, firms are likely to try to defend their financial position by cutting back on spending and shaking out labour. However, their reaction may be less strenuous than in previous periods of retrenchment. Financial deregulation has led to marked changes in the financial environment. For example, banks and financial institutions are now much more willing to lend for long term purposes, such as investment, than during the 1960s and 1970s. Companies' retained profits, the main source of investment finance in earlier decades, are therefore likely to be much less of a constraint now than then.

4.6 Even so, some slow-down in business spending is still likely. Recent CBI surveys (including the survey to be published on January 30) point to a fall in manufacturing confidence and a marked decline in expected investment authorisations over the next year, especially in new buildings. There is evidence from chambers of commerce and the Institute of Directors which also indicate a significant weakening of business sentiment. Against this background, **total business investment** is projected to fall by 1 per cent in 1990 and 1991 (**Chart 4.1**). It is prevented from falling further by extensive investment by public corporations, particularly the transport industries. **Manufacturing investment**, which is usually much more cyclical than other sectors, is likely to fall 7.5 per cent in 1990 and 5 per cent in 1991.

Table 4.1 Gross domestic fixed capital formation

	Percentage changes on previous year					
	1986	1987	1988	1989	1990	1991
Business[1]	-0.5	10.8	17.6	10.4	-1.0	-1.0
of which:						
North Sea	-11.9	-22.5	-3.4	10.7	30.2	-3.5
Manufacturing	-6.0	5.1	11.7	9.0	-7.5	-5.0
Private non-manufacturing[2]	5.2	21.1	23.2	11.1	-1.7	-0.3
Private Dwellings[3]	10.5	6.5	10.3	-6.8	-4.7	0.4
General Government[4]	4.5	1.2	-0.1	17.9	-5.1	1.7
Total Investment	2.1	8.5	13.7	7.1	-1.3	-0.4

[1] *includes public corporations*
[2] *excludes effects of privatisation*
[3] *includes purchases less sales of land and existing buildings for whole economy*
[4] *excludes purchases less sales of land and existing buildings*

4.7 Companies are also expected to **destock** on a fairly large scale. This implies some resumption of the downward trend in the stock:GDP ratio, though from a much higher level than implied by the trend from 1980 to 1987 (**Chart 4.2**).

Chart 4.1 **Business investment**

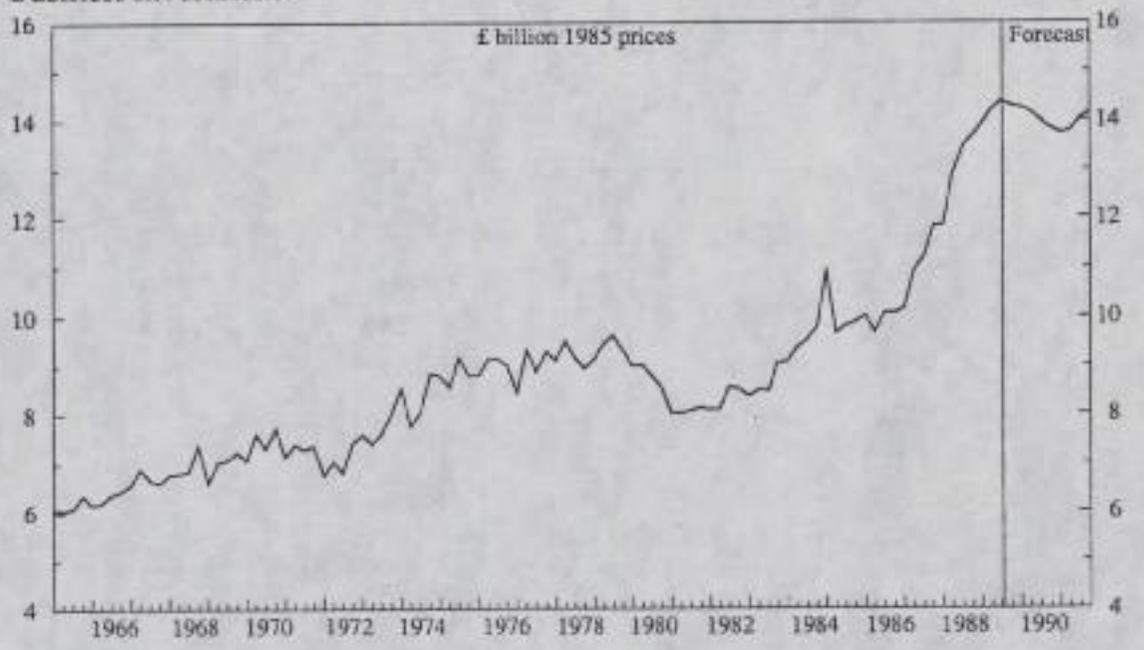
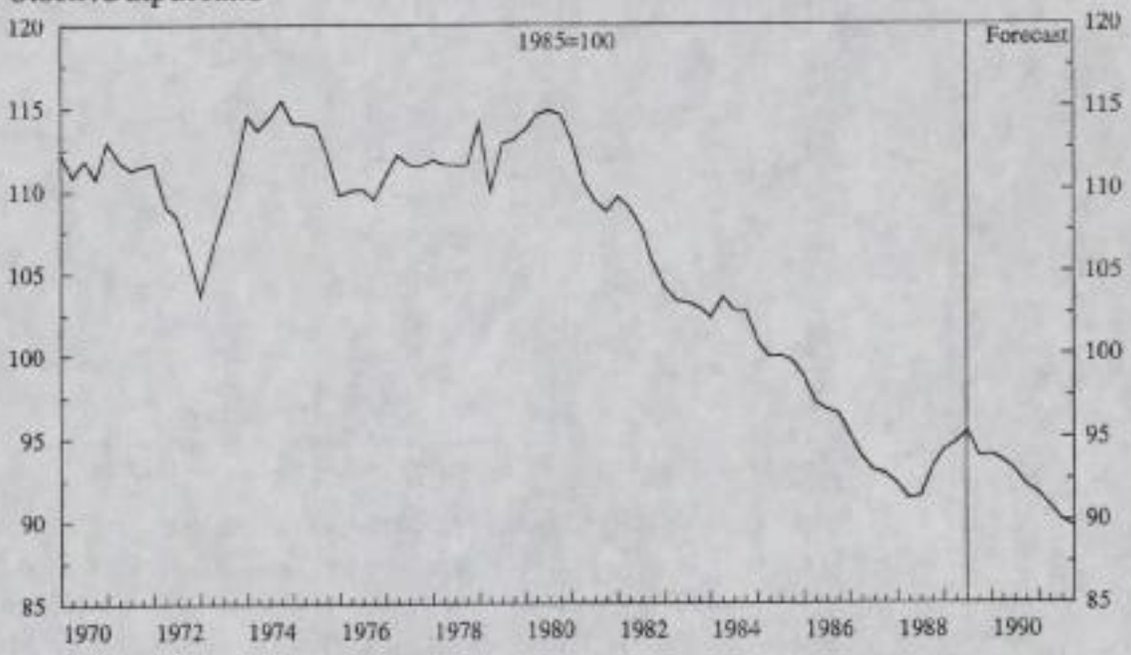


Chart 4.2 **Stock :Output ratio**



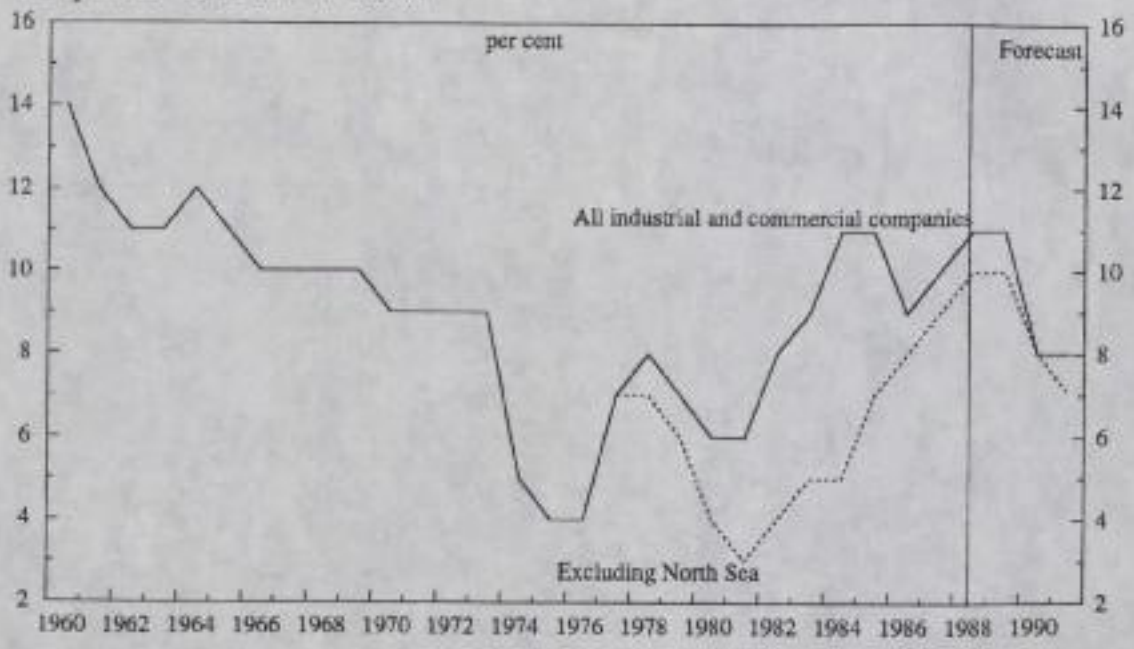
4.8 Despite this retrenchment in spending, industrial and commercial companies are projected to remain in **deficit** throughout 1990 and 1991, though the deficit does decline (**Chart 4.4**). Four years of financial deficits is unprecendented since the war. The **net liquidity ratio** (net liquidity as a proportion of total final expenditure) continues to deteriorate to unprecedentedly low levels (**Chart 4.5**). And **income gearing** (interest payments as a share of income) rises further in 1990 before moderating slightly thereafter(**Chart 4.6**).

Table 4.2 Profit shares and rates of return

	Per cent			
	Total	Non-oil	Non-oil (excl-privatised) companies	Net rate of return on assets, non-oil ICCs [1]
1986	14.4	12.2	11.1	8.0
1987	16.0	13.7	11.9	9.0
1988	16.2	14.8	12.8	10.0
1989	16.1	14.8	12.8	10.0
1990	14.9	13.5	11.4	8.0
1991	15.4	14.1	11.1	7.0

[1] *Excluding companies to be privatised*

Chart 4.3 Companies ' real rates of return



Risks and uncertainties

4.9 It is always difficult to gauge companies reactions to emerging financial problems with any confidence. We may have been too pessimistic about the need for retrenchment. Certainly, there are not the same widespread public signs of distress that we witnessed in previous periods of financial stress such as 1974 or 1980, although producers and retailers of domestic electrical appliances and furniture are becoming more vociferous about their particular plight (all associated with recent declining housing turnover). Companies in general, however, may be prepared to sustain spending more than we foresee by further borrowing, especially if they perceive the slowdown in economic activity to be fairly short lived. On the other hand, once companies have perceived a need to adjust, they usually do so very rapidly. Previous financial deficits, for example, have usually been eliminated within a year. Various survey evidence points to weakening confidence and some retrenchment of investment and employment. Moreover, financial institutions may begin to show some reluctance to increase lending significantly to companies with high and rising income gearing. We may not have given enough weight to these factors, and adjustment could be more severe than we currently expect.

Chart 4.4 All ICCs' NAFA and borrowing requirement (share of TFE)

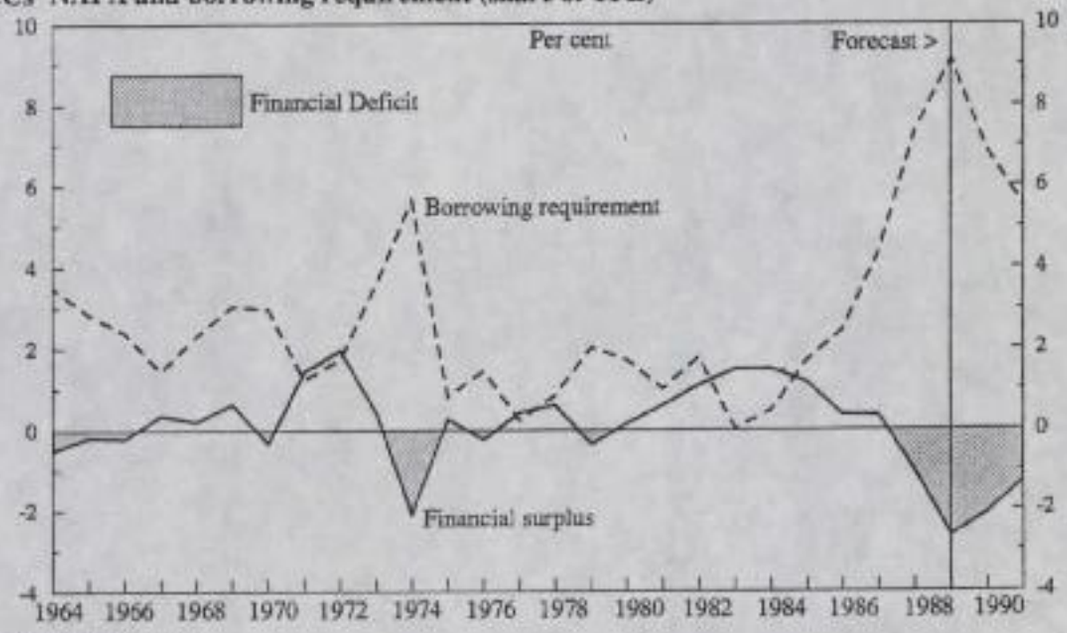


Chart 4.5 ICC's liquidity ratios *

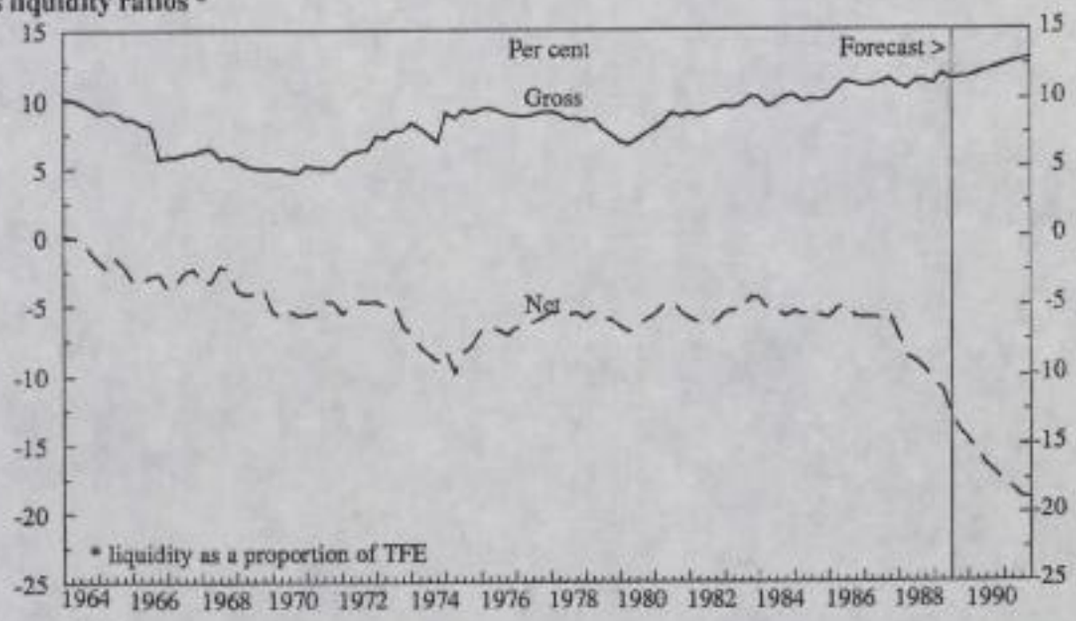
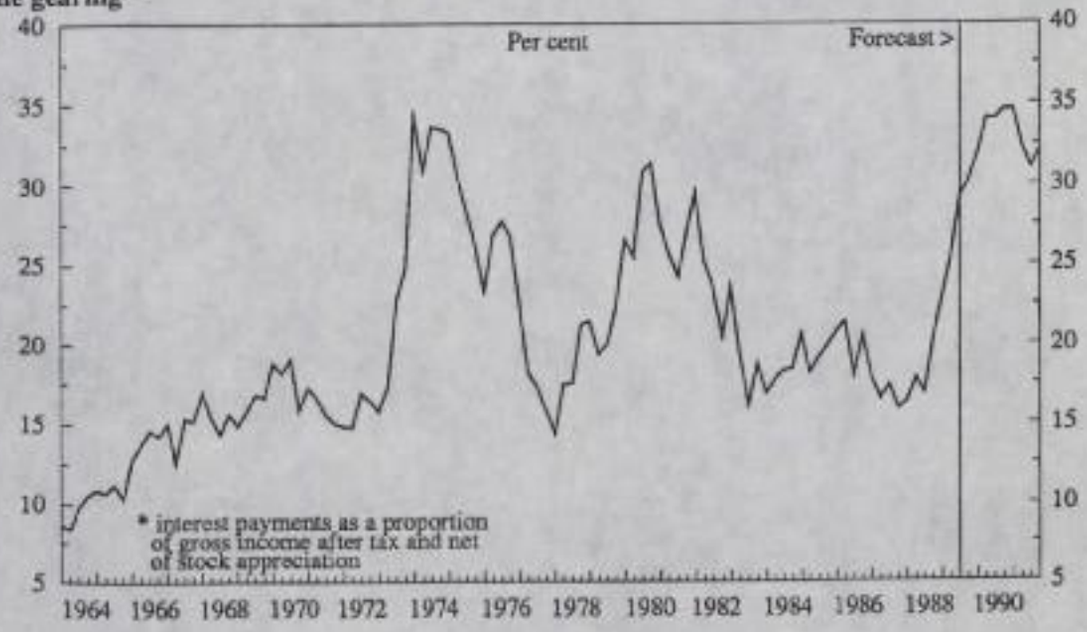


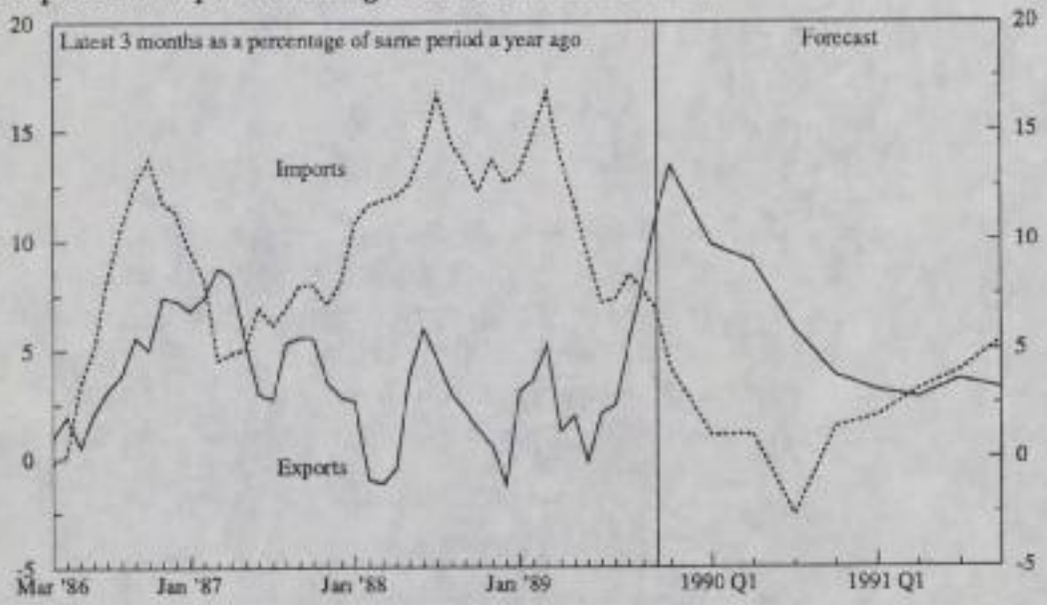
Chart 4.6 Income gearing*



CHAPTER 5: TRADE AND THE BALANCE OF PAYMENTS

Summary 5.1 The outturn for the **current account deficit** in 1989 is likely to be just over £20 billion, close to the Autumn Statement forecast but £6 billion higher than the 1988 deficit. The current account deficit increased between the first and third quarters of 1989, largely reflecting a deterioration in **invisibles**. However the **visibles balance** and the current account have improved in every month since July, as export growth has picked up and import growth has responded to slower domestic demand growth (**Chart 5.1**).

Chart 5.1 Export and import volume growth (total visible trade)



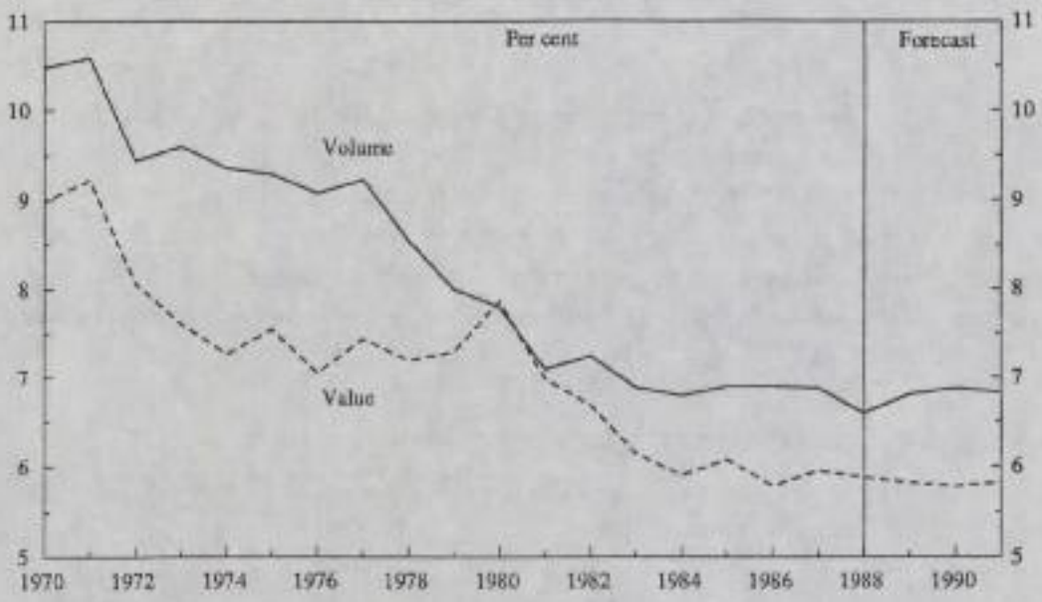
5.2 Export volumes were growing substantially faster than import volumes by the end of 1989, and this gap is projected to remain wide in 1990, before narrowing during 1991 as domestic demand growth recovers. The current account is forecast to fall to £14 billion in 1990 and £12½ billion in 1991, helped by a slow recovery in the invisibles surplus.

Non-oil trade 5.3 **Manufactured export volumes** grew by 12 per cent in 1989, nearly regaining the share of world trade lost in 1988. Exports have been helped by the easing of capacity pressures, which held back growth in 1988.

5.4 **Competitiveness** deteriorated sharply in 1988 but was unchanged in 1989, as exchange rate depreciation offset the effect of rapid UK unit labour cost growth. Despite further projected growth in unit labour costs relative to our competitors, the assumed exchange rate depreciation should be sufficient to maintain competitiveness close to its average 1989 level. Exports of manufactures are therefore forecast to grow in line with world trade on average over the next two years (**Chart 5.2**). The tendency for UK

exports to lose share slightly on average is offset in the forecast by a further easing of capacity constraints, particularly in 1990.

Chart 5.2 UK share of world trade in manufactures



5.5 **Manufactured import volumes** rose by 11½ per cent in 1989. But growth slowed through the year, and the underlying trend seems to have levelled out in the second half of the year. With falling domestic demand forecast in 1990, import volume growth is expected to be less than ½ per cent. It should recover in 1991, but remain below the growth of manufactured export volumes. **Imports of non-manufactures** could fall in 1990, reflecting in particular cuts in imports of basic materials as firms destock.

Table 5.1 Non-oil trade volumes

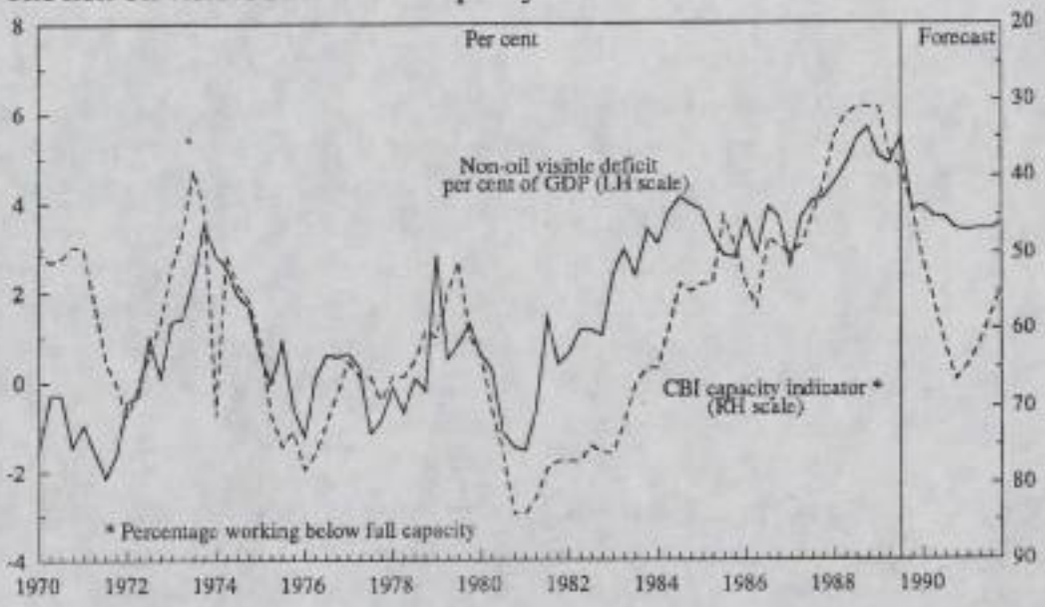
per cent changes on previous year

	Exports			Imports		
	Manufactures	Non manufactures	Total non-oil	Manufactures	Non manufactures	Total non-oil
1987	7.6	5.0	6.9	10.0	1.6	8.2
1988	5.1	-5.7	3.3	16.7	5.0	14.2
1989	11.9	11.1	11.8	11.5	2.0	9.5
1990	7.2	5.5	7.0	0.2	-1.9	0.2
1991	4.8	4.1	4.7	3.2	1.9	3.7

5.6 The **non-oil terms of trade** - export prices relative to import prices - are projected to remain constant at around their recent level. This is in line with experience in the 1980s, when substantial movements in the exchange rate had no long run impact on the terms of trade.

5.7 The **non-oil visible balance** is therefore forecast to improve sharply in 1990, reflecting the favourable trade volume movements. The improvement in the balance is consistent with the likely path of capacity utilisation, which eases further in 1990 as the economy continues to slow (**Chart 5.3**).

Chart 5.3 The non-oil visible balance and capacity utilisation



North Sea oil

5.8 **Oil production** and the oil trade balance recovered strongly in the second half of 1989 from the effects of accidents. This recovery is expected to continue over the next few months, before the slow downward trend in production resumes. However the projected level of production in 1991 and later years has been revised down again, compared to recent forecasts, to allow for longer shutdowns for safety and maintenance work which now look increasingly likely.

5.9 **North Sea oil prices** have recently been over $21 a barrel but have now fallen back to $19-20. They are forecast to average $19½ a barrel in the first quarter before falling further to average $18-18½ in 1990 and 1991 - only slightly higher than in 1989. The **oil trade balance** is forecast to rise from £1½ billion in 1989 to £2 billion in 1990, before falling back to £ 1½ billion in 1991. This mainly reflects the changes in oil production. **Domestic demand for oil** is likely to rise only sluggishly, restrained by slow economic growth.

Invisibles

5.10 On present estimates the invisibles surplus has fallen sharply from £6 billion in 1988 to £ 2½ billion in 1989, (though the first complete estimate for 1989 will not be published until early March, and revisions to past data could alter this picture significantly). The services balance has begun to recover, following a fall in 1988. But

Table 5.2 The invisibles balance

£ billion

	Services	Interest profits and dividends	Transfers	**Total invisibles**	Invisibles as % GDP
1987	5.7	4.8	-3.4	7.1	1.7
1988	4.2	5.5	-3.5	6.2	1.3
1989	4.5	2.8	-4.6	2.6	0.5
1990	5.5	2.4	-4.4	3.4	0.6
1991	6.8	3.3	-4.5	5.6	1.0

the transfers deficit rose, reflecting higher net contributions to the EC, and net earnings from interest profits and dividends (IPD) fell to around half the 1988 level.

5.11 In the light of the recent invisibles data, which were much weaker than expected, we have become more cautious about the prospects for a recovery. The invisibles surplus is expected to rise by only £1 billion, to £3½ billion, in 1990. This compares with a rise of £2 billion (to £6 billion) in the Autumn Statement forecast and £3 billion in the October internal forecast. The **services balance** is expected to continue its recent recovery, but more gradually than previously thought. The travel balance in particular is responding more slowly than expected to lower growth in consumers' expenditure, and net earnings of financial services could be hit in the months ahead by high insurance payouts in the US following recent disasters.

5.12 The deterioration in the **IPD surplus** during 1989 mainly reflects the servicing of strong sterling borrowing at high interest rates, required to finance the large current account deficit and net outflows of direct and portfolio investment. There is little prospect of any substantial improvement in IPD while these factors persist, though a small rise in the surplus is forecast in 1991, as sterling interest rates fall.

5.13 The fall in net earnings on overseas assets has occurred despite a probable rise in the measured level of **net overseas assets** during 1989 - from £88 billion at end-1988 to an estimated £114 billion at end-1989. The rise is more than accounted for by favourable revaluations, as world stock markets rose and sterling fell, boosting the sterling value of foreign currency assets. (Measured in foreign currencies, our net assets probably changed very little during 1989). Revaluations are forecast to be much smaller over the next two years, but sufficient to offset the effect of continued net capital inflows, so that identified net overseas assets may continue to rise slowly. However the large balancing items in the overseas accounts, which are assumed to continue, imply that CSO estimates, and consequently the forecast, may overstate the true level of net overseas assets.

5.14 The **transfers deficit** is likely to be a little lower in 1990 than in 1989. Net EC contributions should fall from £2¼ billion to £1¾ billion, with a particularly marked fall in EC contributions in the first half of 1990.

CHAPTER 6 : PRICES AND EARNINGS

Producer prices

6.1 **Producer output price inflation (excluding food, drink and tobacco)** was stable at around 5½ per cent throughout 1989. With unit labour costs picking up sharply in the second half of last year, profit margins have probably been squeezed recently. This pressure on margins is likely to continue - even intensify - in 1990, as companies face very sluggish demand growth and strong foreign competition. **Producer price inflation** is therefore expected to fall to 4¼ per cent by 1990Q4. It falls only slightly further, to 4 per cent, by the end of 1991, with rising import and fuel costs partly offsetting the beneficial effects of moderating unit labour cost inflation and sustained pressure on margins.

Table 6.1 Costs and prices in manufacturing

	Percentage changes on a year earlier			
	Unit labour costs	Costs of materials and fuels	Estimated total costs	Domestic producer output prices[1]
1987 Q4	3.1	5.1	2.0	4.8
1988 Q4	2.2	5.1	2.9	5.0
1989 Q4	4.5	4.3	5.5	5.5
1990 Q4	6.1	1.8	5.1	4.3
1991 Q4	4.0	4.8	4.2	3.9

[1] *Excluding food, drink and tobacco*

Retail prices

6.2 The **all-items RPI inflation rate** peaked in May/June at 8.3 per cent. It has fallen since to 7.7 per cent, largely because the effect of mortgage interest rate increases in late 1988 have dropped out of the calculation. The **underlying RPI inflation rate, excluding mortgage interest payments**, rose from 5.7 per cent in August to a steady 6.1 per cent throughout October-December. This largely reflected the continued acceleration of **food prices**, which began around April but gathered pace from the summer. Food price inflation averaged 3½ per cent in 1988 but rose from 4.2 per cent in March to 7.5 per cent in December, adding about 0.6 per cent to the underlying inflation rate. Annex A details the factors behind these developments in food prices

6.3 The prospects for RPI inflation through 1990 (see **Table 6.2**) are dominated by a number of unfavourable influences:

- Rapid food price inflation in the immediate months ahead; it may rise to 7.6 per cent in the first quarter of 1990 before falling sharply to 5 per cent by 1990Q4.
- Rising utilities' prices, including an assumed 12¾ per cent increase in water charges and a 9 per cent increase in electricity prices from April.
- A 26¼ per cent increase in the community charge/rates indicator, compared to 20½ per cent in October. This is based on an average community charge of

£329. But there is still a wide range of possible outcomes. CPIFA has recently forecast £344.

- A 10 per cent increase from April 1990 in local authority rents (which dominate the rents component of the RPI).
- The assumed revalorisation of excise duties in the 1990 Budget. Because there was no revalorisation in the 1989 Budget, this effect will add about ½ per cent to the index from April.
- An assumed ½ point rise in average building society mortgage rates from the beginning of April.

6.4 Food prices apart, these factors are mainly the result of administered, or quasi-administered, price changes (LA rents, community charge, utilities, revalorisation etc.). They clearly impart considerable inertia to the inflation prospect. Their impact may be partly moderated, but only partly, by a sustained squeeze on margins in the marketed retail sector.

Table 6.2 Evolution and Prospects for RPI Inflation

		percentage changes on a year earlier					
	Weight[1]	1986Q4	1987Q4	1988Q4	1989Q4	1990Q4	1991Q4
Housing	%						
MIPs	6.0	4.2	6.4	36.4	32.6	17.2	-4.0
Rent	3.2	6.1	6.2	8.3	9.5	8.7	6.7
Rates/Community[2] Charge	4.2	13.6	7.7	8.4	9.6	26.2	7.2
Other	3.4	5.1	5.4	9.3	9.4	6.3	7.7
Utilities							
Electricity	2.6	0.8	-0.6	8.6	6.5	9.0	6.4
Water	0.7	8.1	6.9	8.1	12.7	12.6	12.0
Gas	2.2	1.4	-4.5	6.0	3.4	2.8	3.9
Other	1.3	7.0	5.6	4.9	6.8	7.6	7.1
"Retailed" Prices							
Food	15.4	3.2	3.4	3.9	7.4	5.0	4.0
Petrol	3.4	-12.6	1.3	-0.2	7.7	4.9	4.5
Other	57.6	4.0	4.3	4.8	4.9	4.4	4.2
Total	76.4	2.9	4.0	4.4	5.6	4.5	4.2
Total RPI Inflation	100	3.4	4.1	6.5	7.6	6.7	4.1
Total RPI Inflation excl MIPs	94	3.4	4.0	5.1	6.1	6.0	4.7

[1] *weights at Jan 1989*
[2] *includes 3.5 per cent for 'index household effect', worth about 0.15 per cent on all-items*

6.5 Overall, **all-items RPI inflation** is likely to rise to a local peak of almost 8 per cent in April before falling to 6¾ per cent in 1990Q4 as interest rates start to decline later in the year. (**Table 6.3** presents the expected monthly inflation profile through 1990.) Underlying inflation rises to 6¼ per cent in 1990Q2 before falling to 6 per cent in 1990Q4 (the same as 1989Q4). The fall in underlying inflation is the result of sharply declining

food price inflation and a fall in other marketed retail price inflation (from 5 per cent in 1989Q4 to about 4½ per cent in 1990Q4). Inflation moderates more quickly through 1991. The all-items RPI inflation rate falls to 4 per cent by 1991Q4, reflecting the steady fall in interest rates. Underlying inflation falls to about 4¾ per cent.

Table 6.3 Monthly profile for RPI inflation

	Percentage changes on a year earlier			
	All items RPI		RPI excluding mortgage interest payments	
	January	October	January	October
1989				
October	7.3	7.1	6.1	5.9
November	7.7	7.7	6.1	5.9
December	7.7	7.6	6.1	5.8
1990				
January	7.5	7.4	5.9	5.8
February	7.2	7.2	5.8	5.6
March	7.1	7.1	5.6	5.5
April	7.9	7.5	6.5	6.1
May	7.7	7.5	6.2	5.9
June	7.7	7.5	6.2	6.0
July	7.8	7.4	6.3	6.0
August	7.8	7.3	6.3	6.0
September	7.6	7.3	6.2	6.0
October	7.4	7.1	6.1	5.9
November	6.5	6.4	5.9	5.9
December	6.4	6.2	5.8	5.8

Wage settlements and earnings

6.6 Private sector settlements have averaged 8-8¼ per cent so far in the 1989-90 pay round, compared with 7¼ per cent for 1988-89. The cost of living appears to be the dominant factor behind the rise in settlements in the private sector, though the need to recruit and retain labour is also an important influence, particularly in the service sector. **Whole economy underlying average earnings growth** was flat at 9¼ per cent in November, having risen by ¼ per cent in both September and October. The recent pick up in average earnings reflects high settlements agreed last summer and autumn, but has been attenuated by declining overtime and bonus payments as the economy has slowed. **Public sector underlying earnings** growth also picked up towards the end of 1989.

6.7 With the headline RPI inflation rate forecast to remain high for the first three quarters of 1990, we are unlikely to see any significant reduction in **private sector settlements** until late 1990. Settlements are then expected to moderate in response to falling inflation, rising unemployment, and greater resistance from employers in the face of a poor financial prospect. Overall, **private sector settlements** are expected to average 8¼ in the 1989-90 pay round, falling to 7 per cent in 1990-91. With overtime falling, earnings drift is expected to continue to decline, but **private sector**

underlying earnings growth may still average 9¼ per cent in 1990 moderating to 8¼ per cent in 1991.

Table 6.4 **Settlements and earnings**

	Contributions to changes on a year earlier				
	1987 Q3	1988 Q3	1989 Q3	1990 Q3	1991 Q3
Private sector					
Settlements: *current*	5.3	5.7	7.8	8.0	6.2
12 month average	5.2	5.8	7.3	8.2	6.9
Drift	2.8	2.8	1.8	1.2	1.2
Underlying average earnings	8.0	8.6	9.1	9.4	8.1
Public sector					
Underlying average earnings	6.8	11.0	7.9	9.3	8.5
Whole economy					
Underlying average earnings	7.8	9.2	8.9	9.4	8.2

6.8 Public sector underlying earnings are expected to grow in line with the private sector through 1990. Thereafter, some recovery in the public sector/private sector earnings differential is expected, implying whole economy underlying earnings growth of 8 ½ per cent in 1991 as a whole.

The GDP deflator

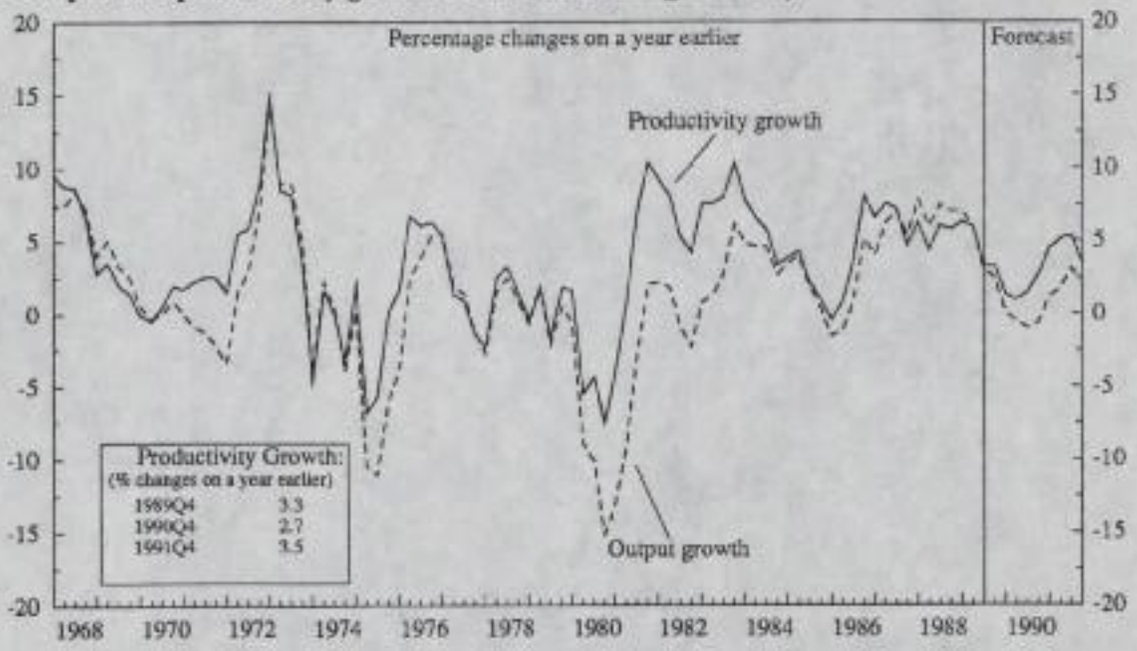
6.9 The **market price GDP deflator** is now estimated to have risen by 6.9 per cent in 1988-89. We expect it to rise by 6 per cent in 1989-90 and by 5½ per cent in 1990-91 on the Autumn Statement basis (ie, making no allowance for the effect of the introduction of the community charge in England and Wales).

CHAPTER 7 : LABOUR MARKET

Employment and productivity

7.1 **Manufacturing employment** increased by an estimated 1¾ per cent between 1987Q1 and 1989Q3. This was much slower than the growth of output, and productivity rose at an annual average rate of 5.5 per cent over the same period. Since then manufacturing employment has started to fall as output growth has moderated, and productivity growth has also slowed. Productivity normally follows the cycle in output, because employers typically take some time to adjust their labour forces to changes in output. With much slower output growth in prospect in 1990 and 1991, manufacturing employment may fall more sharply, especially if, as we assume, employers shake-out labour to defend their financial position and improve unit labour cost performance. Productivity may rise by only 1½ per cent in 1990, picking up to 4½ per cent in 1991 as output growth recovers and firms continue to shake-out labour (**Chart 7.1**).

Chart 7.1 Output and productivity growth in manufacturing industry



7.2 Employment in the **private non-manufacturing sector** increased by 1¾ million or 12.1 per cent, between 1985Q1 and 1989Q2. Productivity growth has slowed from 4 per cent in 1986 (an exceptionally fast rate) to around 1¾ per cent currently (a bit low by historic standards). For much the same reasons as in the manufacturing sector, employment may start to fall soon. Productivity growth may be close to zero in 1990 before recovering with output growth and some further labour shake-out in 1991.

Unemployment

7.3 Strong employment growth has resulted in large falls in unemployment. However, the trend fall in unemployment is now clearly slowing from 38 thousand a month in the first half of 1989, to 20 thousand a month in the latest three months. With total employment expected to fall by 250,000 between end-1989 and mid-1991, and some rise in labour supply, unemployment is expected to start rising from 1.6 million in mid-1990, to 2.0 million by mid-1991. It rises to 2.1 million by end-1991 (**Chart 7.2**).

Chart 7.2 Unemployment

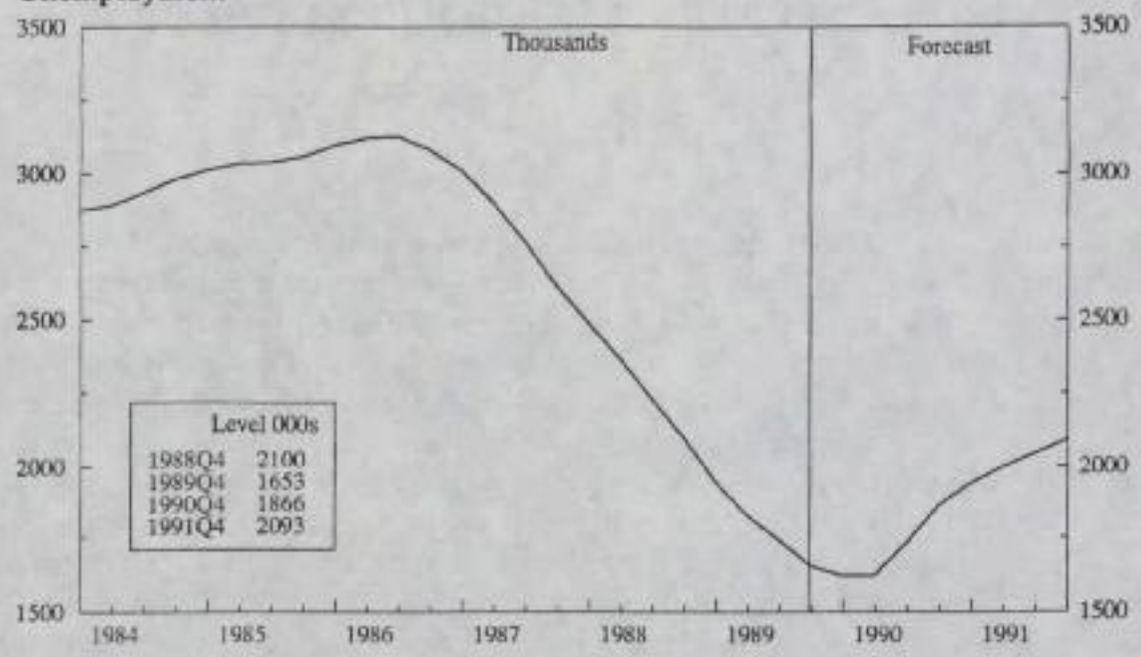
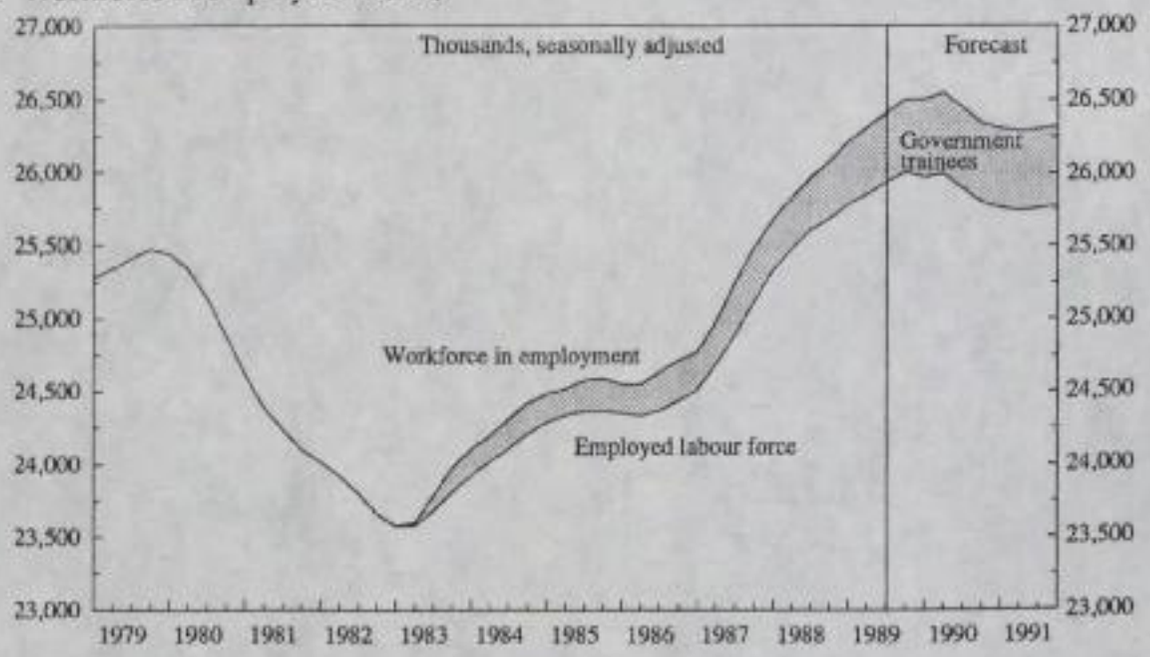


Chart 7.3 Workforce in employment (UK)



CHAPTER 8: MONETARY CONDITIONS

Exchange rates 8.1 The **sterling index** has fallen nearly 10 per cent since it peaked in the first quarter of 1989. The forecast assumes a **constant real exchange rate** at around its recent level. This means that the sterling index falls in line with the differential between UK and other G7 countries' inflation, forecast to be about 2 percent in 1990 and 1991. This is consistent with little change in the $/£ rate, and a small fall against the DM.

Table 8.1 Exchange rates and interest rates

	Sterling index (1985=100)	$/£	DM/£	Base rates
1987Q4	92.7	1.75	2.99	9.2
1988Q4	96.7	1.79	3.18	12.4
1989Q4	88.0	1.58	2.88	15.0
25 Jan	87.9	1.66	2.80	15.0
1990Q4	86.4	1.65	2.76	14.5
1991Q4	85.0	1.65	2.68	12.5

Interest rates 8.2 Inflation remains well above the MTFS path throughout the forecast. We have therefore assumed **interest rates** will need to remain high to maintain downward pressure on inflation. Base rates stay at 15 per cent until the beginning of the fourth quarter of 1990, and then fall ½ point a quarter through to the end of 1991-92. With world rates forecast to fall only very slowly, the **interest rate differential** begins to narrow in 1991. However it remains high by historical standards (**Chart 8.1**) and should be sufficient to attract the substantial inflows from overseas required to finance both the current account deficit and direct and portfolio capital outflows.

Chart 8.1 Sterling exchange rate and interest rate differential

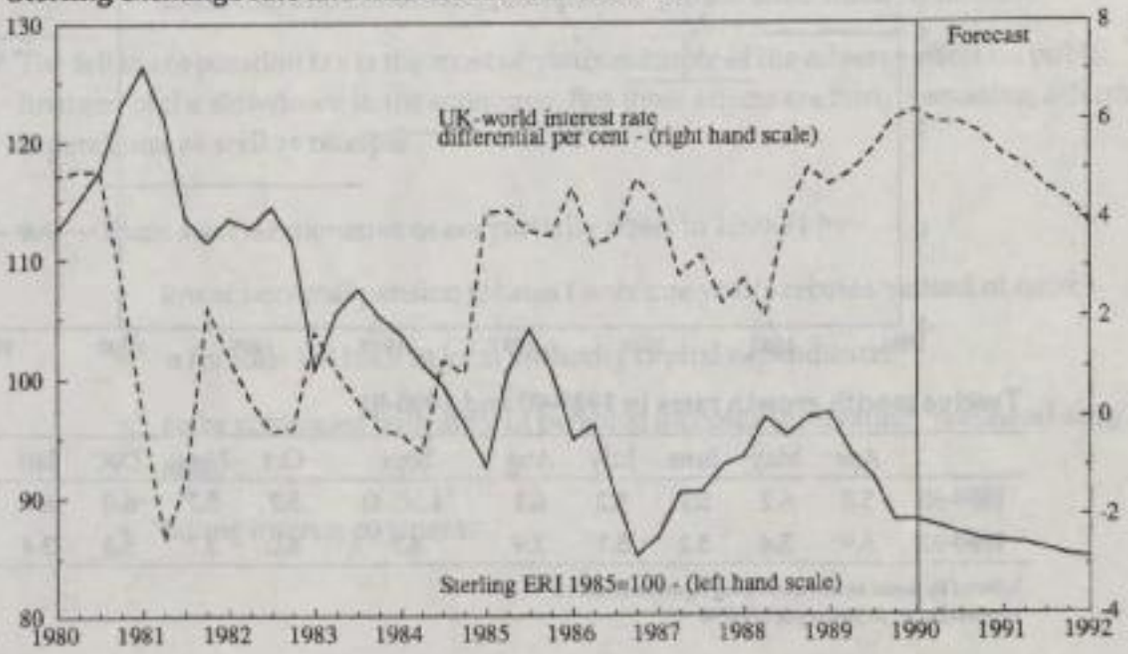
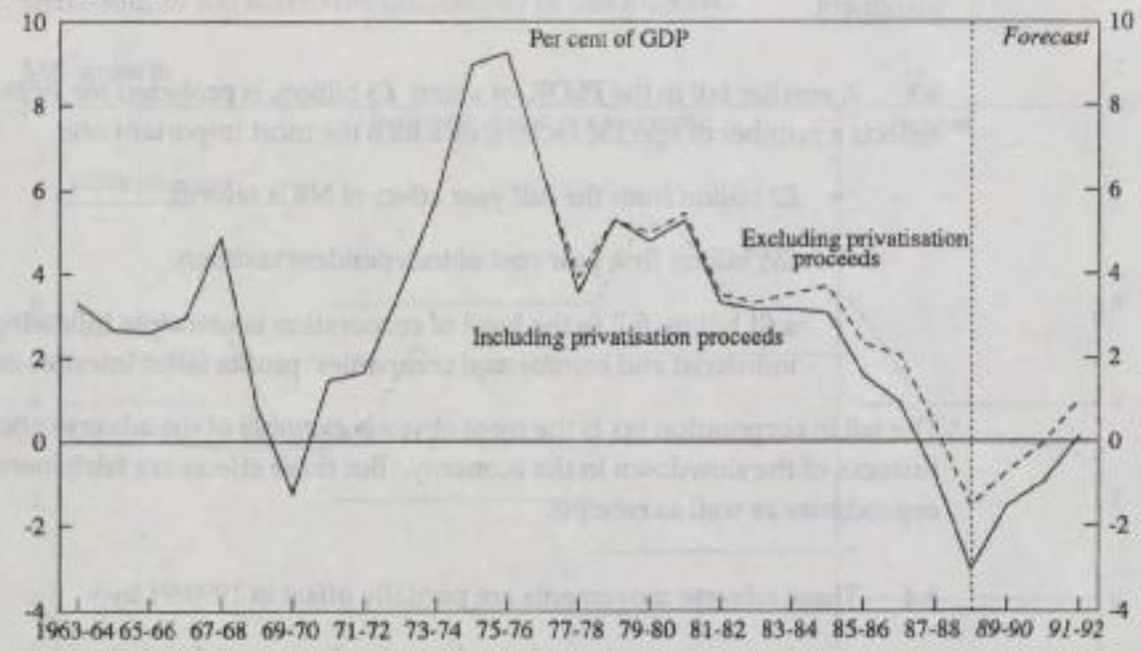


Table 9.1 Expenditure, receipts and debt repayment

	£billion					
	1988-89	1989-90			1990-91	1991-92
	Outturn	1989 FSBR	Autumn Statement	January Forecast	January Forecast	January Forecast
General government expenditure	178.8	194.3	196.3	197.7	212.4	228.4
General government receipts	190.2	206.4	206.9	204.3	216.5	227.1
Fiscal adjustment	-	-	-	-	0	0
General government debt repayment	11.5	12.1	10.6	6.6	4.1	-1.3
Public corporations' market and overseas debt repayment	3.0	1.7	1.9	1.4	0.9	0.2
PSDR	**14.4**	**13.8**	**12.6**	**8.0**	**5.0**	**-1.1**
(as per cent of GDP)	(3)	(2¾)	(2½)	(1½)	(1)	(-¼)
PSDR excluding privatisation proceeds	**7.4**	**8.8**	**8.3**	**3.8**	**0**	**-6.1**
(as per cent of GDP)	(1½)	(1¾)	(1½)	(¾)	(0)	(-1)

Chart 9.1 PSDR ratios



Public expenditure

9.5 GGE in 1989-90 is expected to be £1¼ billion higher than estimated in the (forthcoming) PEWP, due to higher estimates of both the planning total (old and new) and debt interest.

9.6 In 1990-91 GGE is £2 billion higher than in the 1990 PEWP as a result of:-

- £½billion overspend on the new planning total;
- £½ billion increase in local authority self-financed expenditure and;

- £1½ billion increase in central government debt interest, reflecting both the carry forward of a higher level of interest payments in 1989-90 and lower levels of debt repayment.

A small reduction in accounting adjustments partially offsets these increases.

Table 9.2 New planning total and GGE

	£billion					
	1989-90		1990-91		1991-92	
	1990 PEWP	Forecast	1990 PEWP	Forecast	1990 PEWP	Forecast
New planning total	161.9	162.4	179.0	179.5	192.3	197.6
Local authority self-financed expenditure	13.1	13.7	11.8	12.4	11.9	11.6
CG debt interest	17.3	17.8	15.3	16.7	14.1	15.7
Accounting adjustments	4.2	3.8	4.3	3.8	3.8	3.4
GGE	196.4	197.7	210.4	212.4	222.2	228.4

9.7 The main claims on the Reserve next year are expected to come from:

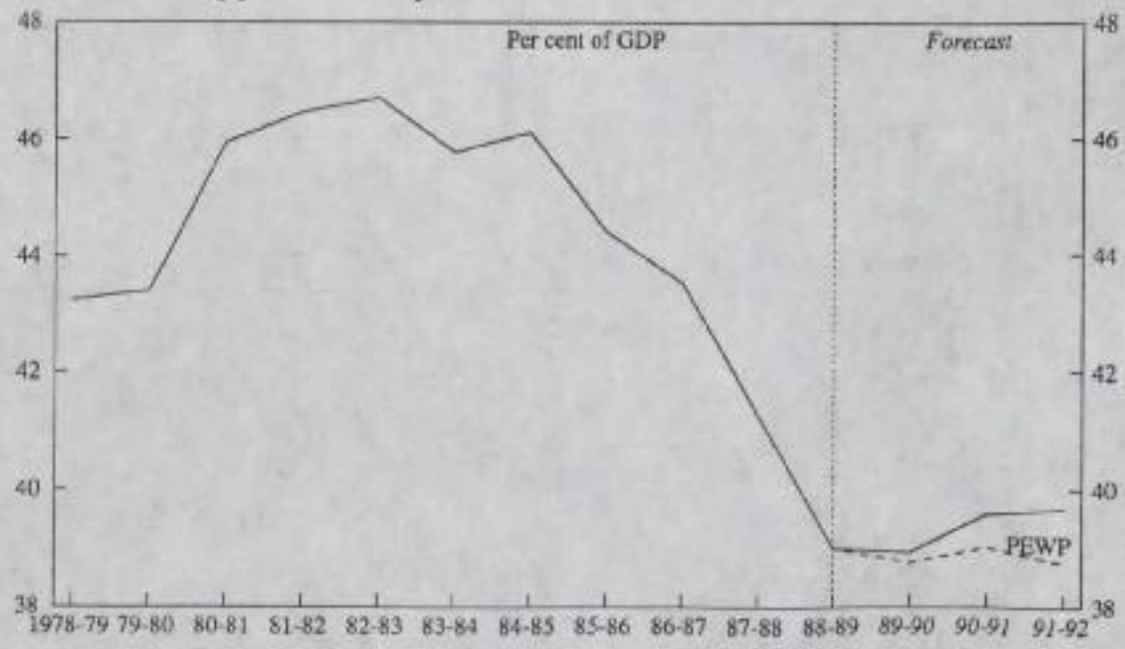
- central government pay, where the upward pressures could go wider than review body awards;
- community charge benefit grant where a forecast community charge per head of £329 compares with £274 underlying the published plans, and adds £½ billion to expenditure and;
- nationalised industries, where the adverse effect on profits of the slowdown in the economy is superimposed on top of structural problems for industries such as British Coal.

Apart from community charge benefit, social security may not absorb much, if any, of the Reserve next year. Benefit rates are fixed and unemployment in the forecast, though rising, is **below** the level assumed in the 1990 PEWP. In 1991-92 however forecast upratings and unemployment are above PEWP levels, directly adding £1 billion to spending.

9.8 The upward revision from the PEWP to the forecast of local authority spending is consistent with early indications about the level of budgets set by individual authorities for next year.

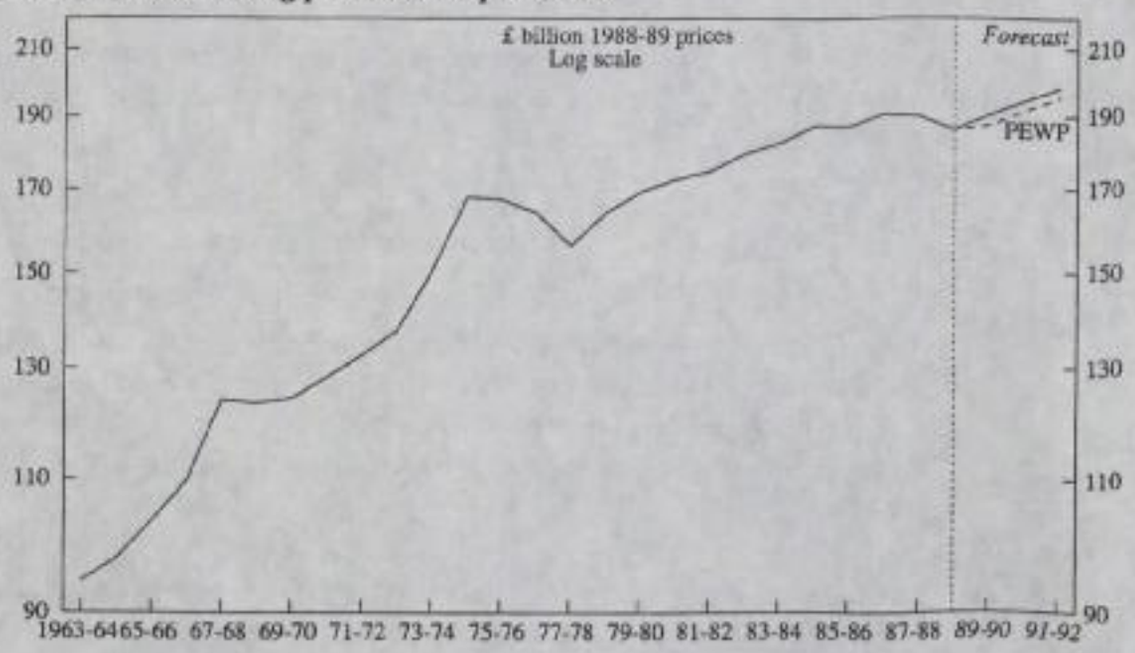
9.9 The upward revision to GGE in 1989-90 means that the GGE ratio (excluding privatisation proceeds) is now forecast to be unchanged from its 1988-89 level at 39 per cent, compared with a fall of ¼ per cent in the PEWP. Moreover the forecast rise in the GGE ratio in 1990-91 is ¾ per cent, compared with ¼ per cent in the PEWP. This is the result of a higher cash figure for GGE and slower growth of money GDP (all money GDP figures in this chapter treat the community charge in the same way as in the Autumn Statement). A tiny rise in the ratio is forecast for 1991-92.

Chart 9.2 GGE (excluding privatisation proceeds) ratio



9.10 Although money GDP is forecast to increase **less** than in the PEWP, the GDP deflator is forecast to rise **more** - ie the shortfall in money GDP is more than accounted for by a shortfall in output. The higher level of GGE in cash terms in the forecast more than compensates however for the higher prices and the forecast of spending in real terms is _ **above** the PEWP.

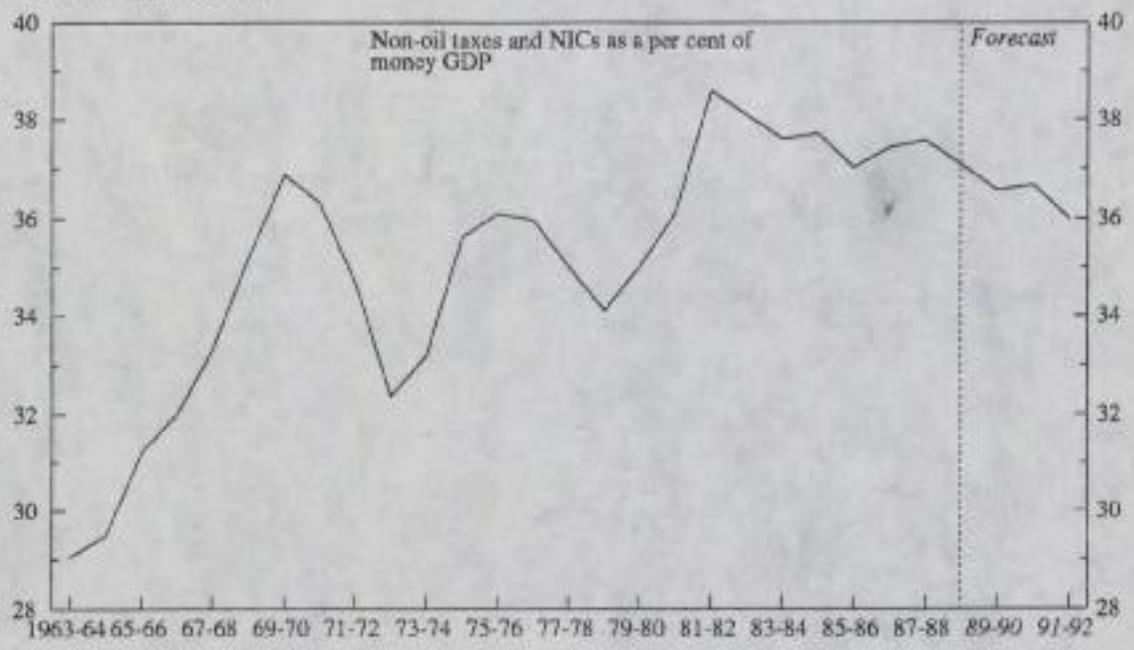
Chart 9.3 Real GGE (excluding privatisation proceeds)



Receipts **9.11** The growth of general government receipts appears to have slowed in 1989-90, and to be below that of money GDP. Within the total, income tax and corporation tax are growing relatively quickly and taxes on expenditure relatively slowly. This fits with the familiar picture of continued rapid growth of personal incomes and a slowdown in the growth of personal spending. The slow growth of expenditure taxes also partly reflects the non-revalorisation of the excise duties in the last Budget.

9.12 The continued buoyancy of corporation tax receipts is not surprising as, given the payments lags, receipts in 1989-90 reflect:

Chart 9.4 Non-oil tax burden



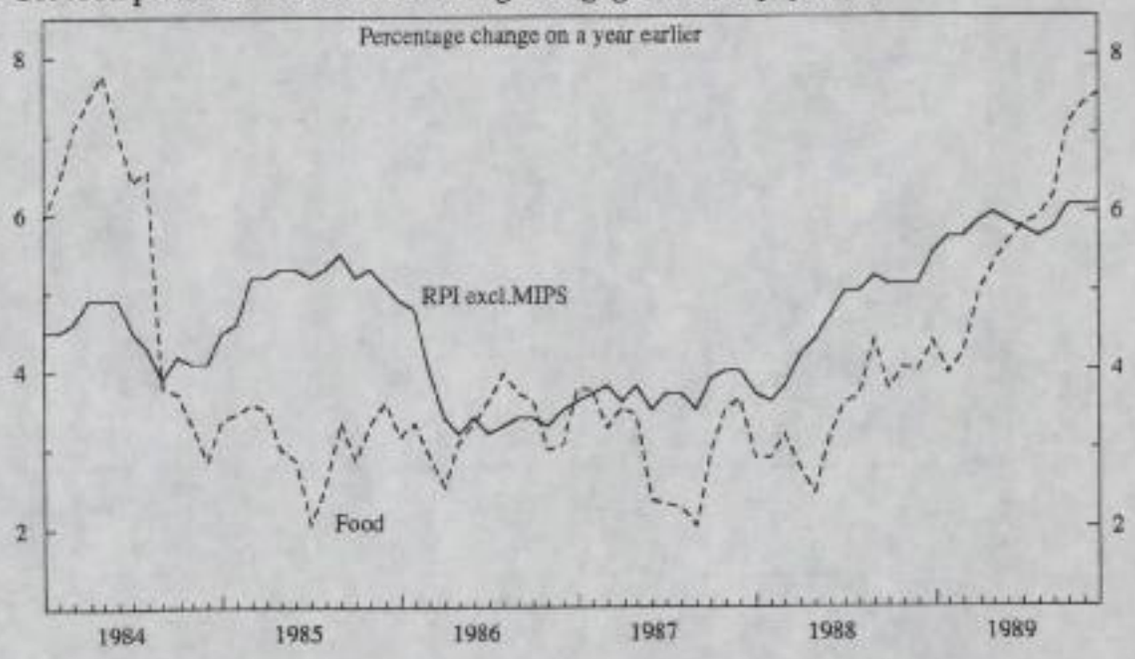
ANNEX A: THE EVOLUTION AND PROSPECTS FOR FOOD PRICE INFLATION

A.1 This annex examines the factors behind the rise in UK food price inflation in 1989 and discusses the outlook for food prices to 1991Q4.

Recent developments

A.2 The rate of growth of the **food component of the RPI** was fairly steady from the middle of 1984 to the beginning of 1989 at between 2 and 4 per cent. However, domestic food price inflation picked up through 1989 from 4.2 per cent in March to 7.5 per cent in December, adding 0.6 per cent to the underlying RPI inflation rate excluding mortgage interest payments (**Chart A1**).

Chart A1 UK food prices and the RPI excluding mortgage interest payments



A.3 The sharp rise in UK food price inflation through 1989 took most people by surprise. One factor has been sharply rising world prices of **pork** and **bacon.** This has been due to the so-called "hog-cycle". Producers cut back their herds or left the industry in response to low prices in 1988. But demand in 1989 subsequently outstripped the reduced supply and prices have consequently risen. **Tea** and **sugar** prices have also been strong recently.

A.4 Even so, **world food prices** in general have been very weak. For example, measured in dollar terms, aggregate world food prices in 1989Q4 were around 4¼ per cent lower than a year earlier. This fall in large part has reflected the effects of the recovery of **cattle supplies** after the US drought of 1988 on beef and dairy prices; the weakness of **coffee** prices following the suspension of export quotas; and the weakness of **cocoa** prices in the face of widespread over-production. The important question to

address is therefore why lower beef, dairy, coffee, and cocoa prices have not fed through to UK retail food prices.

A.5 A key factor is the **Common Agricultural Policy.** The CAP effectively insulates EC market prices from the wide movements that occur in many world prices, including beef and dairy prices. As **Chart A2** shows, UK food price inflation has remained fairly steady in recent years in the face of swings in world food price inflation from minus to plus 20 per cent. And the increase in food price inflation throughout the EC in 1989 - albeit from a generally lower base - suggests that the CAP has tended to hold up food prices in 1989.

Chart A2 UK and world food price inflation

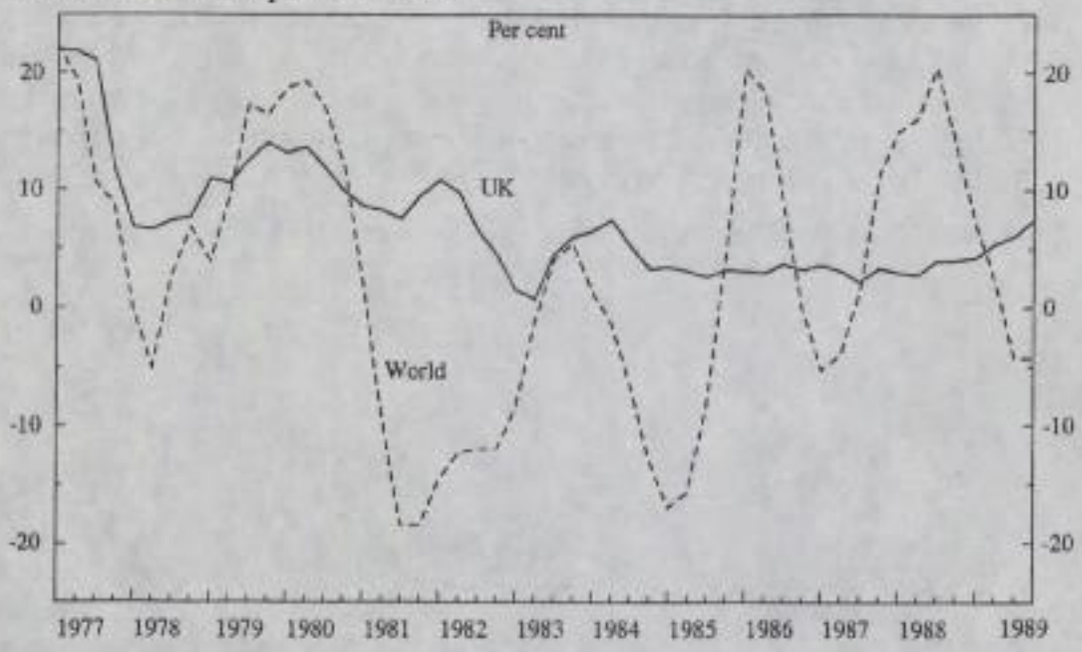


Table A1 Food price inflation in the EC in 1989

	Per cent					
	UK	W Germany	France	Italy	Spain	EC
January	4.4	1.6	3.2	4.9	6.9	3.6
February	4.0	1.6	3.2	5.5	6.5	3.8
March	4.2	1.7	3.5	6.1	6.5	4.0
April	5.0	1.9	3.8	6.4	7.9	4.4
May	5.3	2.2	4.1	6.7	8.2	4.6
June	5.6	2.1	4.2	6.7	9.0	4.7
July	5.9	2.4	4.5	6.6	9.2	5.1
August	5.9	2.4	4.8	6.5	6.5	5.0
September	6.2	2.8	4.9	6.3	7.2	5.1
October	7.1	3.1	5.1	-	7.9	5.5
November	7.4	2.7	5.2	-	8.6	5.5
December	7.5	-	-	-	-	-

A.6 There are, however, a number of products that are not covered by the CAP, including, in particular, **coffee** and **cocoa**. While, for example, world coffee prices fell by almost 40 per cent in the second half of 1989, UK retail coffee prices in December were 5½ per cent higher than a year earlier.

A.7 The UK market for coffee is dominated by two large manufacturers, Nestle and Maxwell House (General Foods). Together they account for about three quarters of the retail market. Nestle - the market leaders - currently face very high interest payments following their expensive takeover of Rowntree Mackintosh. They may therefore have been prepared to accept some loss of market share to their competitors rather than cut their prices and risk a 'price war'. Nestle's position in the confectionery market may also explain why falling cocoa prices have not been reflected in the price of chocolates etc. But the recent rises in sugar prices may have been an important factor as well.

A.8 The operation of the CAP and the uncompetitive behaviour of coffee and confectionery manufacturers together may largely explain why falling world food prices have not been reflected in falling UK retail food prices. However, they are not sufficient to explain the increase in prices through 1989. And neither can it be explained by rapidly rising real demand for food. Real consumers' expenditure on food in 1989 is provisionally estimated to have been less than 1 per cent up on 1988, against an increase in total consumers' expenditure of 4¼ per cent.

A.9 It would appear that food price inflation in the UK (and in the EC in general) has risen because of a number of special factors. For example in the UK :

- The supply of many seasonal food products has been reduced by last year's **dry weather**, especially fresh fruits and vegetables. In December, seasonal food prices were 9.5 per cent higher than a year earlier, with potatoes over 24 per cent up and fresh vegetables 13¾ per cent up.
- Two devaluations in the **green pound** - one in January last year and another in the late summer - will have raised market prices, although MAFF do not estimate their effect to have been large.
- Changes in the **support regime** for beef led farmers to market their stock early and switch some to export markets, reducing domestic supplies of beef.

Prospects

A.10 The outlook for food price inflation is very uncertain. **World food prices** are expected to remain fairly flat through 1990 and 1991. Dramatic falls in prices, such as occurred to coffee and cocoa in 1989, are unlikely. However, stocks of coffee remain high and it will be several years before the required adjustment of supply begins to allow a return to more normal prices for these key commodities. In the absence of further climatic disorders, slowing but still rapid world growth is unlikely to provide any significant impetus to prices of other foods in either direction.

A.11 In the very short term, we expect **UK food price inflation** to rise to 7.6 per cent in 1990Q1. Thereafter, some of the factors which pushed up food prices in 1989 are likely to unwind quickly. There is already also some evidence that pork and bacon prices may

have peaked and that the "hog-cycle" is moving into a downswing again. And coffee manufacturers have just announced cuts of over 10 per cent in their prices.

A.12 However, these effects will probably be partly offset by a further devaluation of the green pound, phased in from the start of the second quarter, which could well be larger than recent devaluations. Moreover, though the effects of the changes in the support regime for beef can be expected to have worked themselves out quite soon, similar changes to the support regime for sheep meat are likely to push up lamb prices from 1 January. And retail tea prices may have not yet fully adjusted to the recent increases in the world price of tea.

A.13 But overall, with the growth of consumer demand forecast to be weak over the next two years and, in particular, the supply of seasonal fruit and vegetables likely to recover from the spring (assuming more normal weather than in 1989), we expect UK food price inflation to fall sharply this year, to 5 per cent in 1990Q4. It is expected to moderate further thereafter, to 4 per cent by 1991Q4.

Table A2 Prospects for food prices

	Percentage changes on a year earlier					
			Forecast			
	1989 Q2	1989 Q4	1990 Q2	1990 Q4	1991 Q2	1991 Q4
World	2.3	-4.3	-1.1	2.2	3.2	2.1
UK	5.4	7.4	6.8	5.0	4.4	4.0

ANNEX B: RECENT NATIONAL ACCOUNTS DATA

B.1 The forecast was based on the third quarter GDP numbers, published on 20 December. They included a radical re-evaluation of the statistical adjustments to the components of the expenditure measure of GDP,GDP(E). **Table B1** sets out the latest adjustments, and compares them with those included in the second quarter GDP figures published in September. In the first three quarters of 1989, the new adjustments amount to over 2½ per cent of GDP.

Table B1 National accounts statistical adjustments

	£million at 1985 prices					
	Latest			Published in September press notice		
	1987	1988	1989 Q1-Q3	1987	1988	1989H1
Consumers expenditure	1500	3080	3750	0	1318	681
GDFCF	0	850	1470	0	850	440
Stockbuilding	0	1240	2410	0	1230	2316
Net exports	0	520	430	0	520	280
GDP (E)	**1500**	**5690**	**8060**	**0**	**3918**	**3717**
Adjustments to GDP(E) as per cent of GDP (market prices)	0.4	1.4	2.6	0	1.0	1.8

B.2 The latest figures put much more of the statistical adjustment on consumer spending than in the September press notice, when proportionately the largest adjustment in 1989 was allocated to stockbuilding. However given the size of the required adjustment it looked increasingly implausible to load so much on to stockbuilding. It was not supported by evidence from the CBI's surveys of manufacturers, distributors and retailers, and implied an unbelievable rise in stock-output ratios. The CSO give no particular rationale for allocating the adjustment to consumers' expenditure, other than that as the largest single component of GDP(E) it is more readily able to absorb such a large adjustment.

B.3 By themselves, the new adjustments have worsened the sectoral balancing items. The increase in consumers' expenditure has made the personal sector balancing item even larger, whilst the reduction in stockbuilding has made the industrial and commercial companies' balancing item even more negative.

B.4 Despite some improvements to the measurement of certain categories of expenditure, such as the supply-side estimates of investment, growth in GDP(E) as measured by the raw data continues to fall well short of growth in the output measure, GDP(O) - see **Table B2**.

Table B2 Expenditure and output estimates of GDP

		percentage changes on a year earlier			
		GDP(E)		GDP(O)	Difference between GDP(O) and measured GDP(E) (% points)
		Published	Measured[1]		
1988	Q1	5.3	3.6	5.7	1.9
	Q2	4.1	4.7	4.7	0.0
	Q3	3.7	0.6	4.1	3.5
	Q4	3.2	2.3	3.5	1.2
1989	Q1	2.9	0.8	3.0	2.2
	Q2	2.7	-0.2	2.7	2.9
	Q3	2.0	1.4	1.9	0.5

[1] *ie before statistical adjustments*

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BACKGROUND

Present Position

1. Indicators since the Autumn Statement confirm a weak outlook for personal and business sector demand: -

- retail sales have been sluggish (despite the high figure for December);

- consumer confidence declined sharply in October, and stayed low until January when it recovered much of the previous loss;

- the housing market - which made a major contribution to the overheating - is now very weak with falling prices and housing starts;

- the emergence of a huge company sector financial deficit - previously only matched in 1974 and 1980 when they were followed by large reductions of stocks and investment;

- investment intentions have weakened - one possible indicator is commercial vehicle registration which are well down on earlier levels.

2. Surprisingly, however, monetary indicators have been slow to adjust:-

- MO growth has been stuck a little above its target range for the past 6 months. We have yet to see the full effects of the tightening of monetary policy on MO, but in the past MO growth has been 3 to 4 per cent less than money GDP growth. There are no obvious reasons why the gap should have narrowed;

- M4 growth continues at 16-20 per cent; bank lending remains very buoyant;

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- the exchange rate has fallen by 10 per cent over the past year and is 5 per cent below its 1986-88 average level (although it has bounced back in recent weeks from its low point).

3. Inflation has been disappointing in recent months - the inflation rate ex-MIPS, at 6.1 per cent, is higher than its mid summer level. One important feature has been the rapid growth of food prices - also evident in other EC countries.

4. At last there are clear signs of some improvement in the trade figures - often a precursor of lower inflationary pressure:-

- exports continue to grow rapidly;

- import growth has slowed and the level of imports is relatively unchanged over the past 6 months.

The invisible surplus has fallen sharply over the past two years reflecting an adverse travel balance, a growing deficit on transfers and high interest payments on overseas investment in the UK - but it should improve as consumer demand weakens and interest rates (eventually) fall back.

5. The large Public Sector Debt Repayment in recent years has been heavily influenced by the cycle. In 1987 and 1988 rapid growth meant buoyant taxes - particularly corporation tax - and a declining public expenditure ratio. This year it appears that the PSDR may be down to £8 billion from £14 billion last year. We believe this largely reflects some big one-off items - the lower privatisation proceeds (£3 billion), a high take-up of private pensions (£2½ billion) and a surge in local authority capital expenditure (£2 billion) before the change of regime.

The Outlook

6. The main features of the forecast are as follows:

- slow growth in 1990. GDP may grow by less than 1 per cent - with non oil GDP about flat;

- a marked reduction in the current account deficit with exports holding their share of world trade and import growth declining in line with domestic demand;

- a vanishing PSDR; as the beneficial cyclical effects unwind the surplus may be down from about £8 billion this year to £5 billion next in the absence of budget measures. Excluding privatisation proceeds, general Government Expenditure may rise from 39 per cent of GDP this year to 39¾ per cent next year;

- not much progress on inflation in 1990 which will be adversely affected by special factors: local authorities setting the community charge at a high level compared to previous rate levels; high mortgage rates; rapid growth of nationalised industry prices; the depreciation of sterling during 1989.

- there should be a sharp improvement in the headline RPI figure next year as some of these factors fall out of the 12 month comparison. The underlying rate may not improve much during this year but should decline from the end of this year onwards.

7. The forecast is highly uncertain. The big question is the speed at which private sector expenditure adjusts to its deficit and higher interest rates:

- consumption has risen very rapidly in recent years. With high debt/income ratio and debt service burdens will be pressures to reduce spending. But consumers always resistant to efforts to curb spending;

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- big uncertainty about response by companies to company sector deficit.

We have underestimated strength of demand in recent years. This may continue - or it may be reversed faster than we expect.

QUESTIONS FOR POLICY

8. Is the prospect for inflation acceptable? Some points to note:

- there is a substantial lag between policy action and inflation coming down;

- there is a lot of uncertainty about the timing of lower inflation;

- in the short run inflation is affected by a number of non-monetary factors eg mortgage rates, public sector prices, food prices;

- getting inflation down probably means a period of slow output growth.

9. Is policy tight enough to satisfy objectives? Or is there a concern that policy may be too tight?

- Forecast suggests policy may be tight enough to get inflation below 5 per cent by mid 1991; meanwhile we face a prolonged period before then of inflation at a higher level; and, of course, the forecast is subject to a margin of error;

- biggest worry is the unsatisfactory growth of money supply on various definitions. MO growth is too high. And broad money growth is showing few signs of falling;

- the inflation outlook could be undermined by exchange rate depreciation in face of continuing current account deficit;

- there is no way of avoiding the risk of policy being too tight. If we want to make sure of getting inflation down there has to be an equal chance of undershooting and overshooting objectives;

- if activity does weaken more rapidly than expected then we are always in a position to reduce interest rates.

10. What can we do to make the MTFS more credible?

- the record on sticking to the MTFS has been poor. Instead of reducing the growth of money GDP it has gone up. We have a target for MO but hardly ever let it trigger interest rate changes. We say we believe in a firm exchange rate but it has fallen by 10 per cent over the past year;

No - we didn't - we say we prefer a stable £.

- this suggests our best chance of achieving credibility is to set realistic objectives; stick to the monetary indicators we have chosen; and do not look for excuses for unpalatable figures;

- the biggest weakness in monetary control procedures is the interaction of bank and building society lending with the housing market. Rising house prices interact with lending to create bubbles of feast and famine;

- there may be a case for setting an explicit inflation objective for the medium term - say 1993-4. It would commit the Government to achieving it which could increase credibility. Inflation is the ultimate target of monetary policy; it is easily understood and it would be seen as an important commitment. The dangers are that it would risk pressure to manipulate prices by subsidy, etc; it could be missed because of shocks

outside our control; and it would be difficult to choose a target that was simultaneously challenging and realistic.

11. Should we change approach to monetary policy?

- no case for dropping MO target. Problem, if anything, has been failure to take sufficient notice;

- dangerous to set M4 target; no way of controlling it; and cannot tell if reflects desire to spend or distress borrowing. But need to continue to take into account;

- continue to take account of what the exchange rate seems to be telling us about monetary conditions and future inflation;

- case for monitoring money GDP more closely to check against message from MO and other monetary indicators.

12. Should we change approach to fiscal policy?

- continue medium term perspective;

- must continue to support monetary policy;

- cannot target PSDR in individual years as fluctuates so much with output;

- continue to aim for budget balance over the medium term. In year of rapid growth expect a surplus; and a smaller surplus or deficit in year of weak growth.

13. What is the case for tightening fiscal policy?

- there is already some easing of fiscal policy built into the system via the introduction of independent taxation and the full year affects of changes in National Insurance announced in the last Budget;

9

- medium term prospect is for elimination of PSDR;

- it would help confidence in the market (which may see the declining PSDR as a fiscal weakening) and may improve prospect for lower interest rates;

- would speed up reduction in current account;

- would spread counter-inflationary pressures more widely.

14. Is there a case for a repeat of 1981?

- Then we were happy (even eager) to see a lower exchange rate. No longer the case;

- danger now that sharp tightening would look as if determined to reduce interest rates which might weaken sterling;

- would be set back to ambitions for lower taxes with adverse supply side consequences.

15. How do we deal with the commitment to join ERM?

- Economically, we need to be satisfied that the exchange rate is at a level that can be sustained for some time to come; at a reasonable interest rate.

- that requires us to be satisfied that the economy has adjusted sufficiently to permit a reduction in interest rates without undermining domestic monetary conditions as credible membership of ERM will produce pressures to narrow differential;

- political considerations include the timing of entry in relation to the IGC and the next election.

Clearly the conditions are not satisfied at the moment. When they will be depends on how rapidly the policies in place have their effects.

26 January 1990

2 E.D. PM 90

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070

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

19 January 1990

Murdo MacLean Esq
PS/Chief Whip
12 Downing Street
LONDON SW1

DM
I've dealt this.
ARCG
19/1

Dear Murdo,

AUTUMN STATEMENT DEBATE: 23 JANUARY

... I attach the Motion the Chancellor has approved for Tuesday's Debate.

Copies go to Paul Gray (No.10), and Tim Sutton (Lord President's Office).

Yours,

Moira

MOIRA WALLACE

"That this House approves the Autumn Statement presented by Mr Chancellor of the Exchequer on 15 November 1989; welcomes the continuing reduction in the share of national income taken by public expenditure, and the provision of substantial extra resources for priority areas;congratulates Her Majesty's Government on its policies of sound financial discipline and supply side improvement which have been the foundation of record growth of employment, investment, and business formation; and commends the Government's determination to maintain downward pressure on inflation and to bring further improvements in economic performance."

The Prime Minister
Mr Chancellor of the Exchequer
Mr Secretary Hurd
Mr Secretary Waddington
Mr Secretary Walker
Mr Norman Lamont

19.0 1969

O/O

CCPS

FROM THE SECRETARY OF STATE

2 MARSHAM STREET LONDON SW1P 3EB
TELEPHONE 01-276 3000

CONFIDENTIAL

Rt Hon John Major MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
LONDON SW1

Cf - pc
RCC
22/12

My Ref.

Your Ref.

MT

21 DEC 1989

Prime Minister
To note this budget operation which seeks to build on the fiscal concession agreed at the 2 meetings you held with colleagues in summer 1988.

Dear John

SHIPPING AND THE 1990 BUDGET

RCC
22/12

You will be expecting my views on the strength of the case submitted to you by the General Council of British Shipping in connection with next year's budget.

After a decade of very low investment, the United Kingdom merchant fleet is now looking decidely old. Probably for the first time this century, the average age of the British vessel - at some 13½ years -is now higher than the world average. I find it disturbing that against the background of a now buoyant market and with our competitors freely re-equipping themselves with efficient modern tonnage, our companies' investment comes nowhere near the level necessary to replace existing stock.

The problem has of course been addressed before. Some very modest measures of assistance were adopted in the Merchant Shipping Act 1988, to give some encouragement to owners to make more use of British crews. These have had some effect on the recruitment of officers; but the impact on the profit and loss account of the companies has been negligible and the new recruits in many companies remain rightly sceptical about the prospects of their employers continuing to operate ships beyond the short term. Since the last collective discussion of the issue some 18 months ago, more and more countries have taken steps to ensure that their shipowners are in a position to reinvest. The latest example is the Netherlands, where seafarers' tax and social security payments are now diverted to their employers.

We shall obviously press the Commission very hard to ensure that the state aids which member states are introducing are consistent with their Treaty obligations. However, there is such a widespread sense of the strategic importance of national fleets that this must be one area where our efforts to get state aids abolished are going to make less impact than we would wish. The recent debates in the Council of Ministers on the Commission's

proposals for "Positive Measures" for shipping have made that abundantly clear. Unless we are prepared to see British shipping continue its steady decline we would be wise to consider what further help we can give our owners while minimising the call on public funds.

The industry's main request is for 100% depreciation allowance. This would of course improve the viability of projects and stimulate reinvestment. But I would support you in being extremely reluctant to make such a conspicuous exception to the neutral tax regime which was introduced in 1984.

I feel that there is an altogether stronger case for rollover relief of balancing charges. Peter Lilley will have heard the arguments himself from the GCBS in their presentation to him on 7 December. I hope that you and he will be persuaded that the proceeds from the sale of a ship should be exempted from corporation tax provided that they are invested in a new or second-hand ship within a period of 3 years. If you found it necessary to restrict the benefit to the purchase of ships for the UK register, I would not disagree. The introduction of rollover relief for shipping could, in my view, be defended as being consistent with our general fiscal policies by reference to the peculiarly mobile nature of shipping investment and it would reflect practice that is now extremely common amongst the maritime countries.

I would also like to propose two rather more technical changes which would also be helpful to the industry. Although there have been some successes, the Business Expansion Scheme has not really caught on for shipping projects. The main reason may well be the competition from assured tenancy schemes. But many owners believe that a further important factor is the restriction of the scheme to one year charters at a time when the proportion of charters over one year is rising. I would be grateful if you would take a look at this.

This was agreed do you recall in June 1988. AHCG.

Second, I believe that there is scope for improving the current Foreign Earnings Deduction Scheme. A change was made in the 1988 Finance Act so as to allow seafarers who stay in the UK for 90 days or less to recover the tax paid on their overseas earnings. If the seafarer is in the United Kingdom for over 90 days, the seafarer is fully liable for tax. It now seems clear that the "cliff edge" effect is frustrating our objective of helping maintain an adequate supply of British seafarers, important to us on defence grounds. With that aim in view, I would like to propose therefore a more graduated scheme, which provides for some relief for those seafarers who spend more than the prescribed period in the UK.

Before making these proposals to you, I considered carefully the outcome of collective discussion in June 1988. It was agreed then that if the Merchant Shipping Act measures and the adjustment in the Foreign Earnings Deduction had insufficient impact to take care of the supply of ships for defence purposes we might need to consider legislation to allow payment of a special premium to owners suitably crewed of ships in short supply. The NATO study of supply and demand was going to help us assess the position.

Quite apart from the difficulties associated with primary legislation I am not sure that this would be the most cost-effective way of shoring up our commercial shipping resources. Nor do I believe we have previously given anything like enough weight to the contribution which British shipping makes to the balance of payments and to sustaining London as a world centre for the service industries. These considerations lead me to the conclusion that the right course is to seek early adjustments to the fiscal regime.

If you feel that any of my suggestions need further discussion before you can adopt them I shall be very glad to meet you, with other colleagues as necessary.

I am copying this letter to the Prime Minister, Douglas Hurd, Tom King, Nicholas Ridley and Sir Robin Butler.

Yours ever
Cecil

CECIL PARKINSON

DEFENCE
Future UK D of POL
Pt 4

21 12 PM 89

Howell Harris Hughes cc CF file
Thank you. I'm not troubling the PM with these papers at this stage, but will keep your thoughts in mind for post-Christmas.

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PAUL GRAY

14 December 1989 PRC6 14/12

1990 BUDGET - THE D T I SUBMISSION

1. Mr Ridley's letter to the Chancellor of ~~11~~ 13 December makes a number of suggestions which would be very welcome to London financial markets.

2. He would like to abolish stamp duty and points out that it now represents 75 per cent of the transaction costs on the biggest deals. German and French stamp duties are likely to go and London risks becoming uncompetitive.

3. The London market in futures and options is under-developed because non-tax paying investors like pension funds are not able to use these derivatives because profits may be taxed as "trading" rather than "investment". New definitions are needed because otherwise firms which want to reduce risks in this way will do so in Paris. The same point extends to the new breed of pooled vehicles investing in futures and options - the DTI will authorise them but they will have no takers in London unless new rules can be hammered out.

4. Mr Ridley gives strong support to the proposals of the Unit Trust Association for changes in the taxation of unit trusts to make them more attractive to non-residents and companies. Here again, European-based trusts will otherwise swamp the market because their tax regulations are less restrictive.

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5. On wider share ownership, Mr Ridley's suggestion that stamp duty be abolished is clearly important, but he also urges a substantial increase in the annual gains tax allowance together with an increase in the maximum amounts which may be invested in Personal Equity Plans. This forms part of the whole process of "levelling the playing field", and would help to arrest the decline in the proportion of shares owned by individuals and, in so doing, contribute to the liquidity of markets.

Howell Harris Hughes

HOWELL HARRIS HUGHES

chex.dc/jg/67

CONFIDENTIAL

Rogue ~~Prime Minister~~

NBM 14/12

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

13 December 1989

Andrew Turnbull Esq
PS/Prime Minister
10 Downing Street
LONDON
SW1

Dear Andrew

DATE OF THE 1990 BUDGET

The Prime Minister may wish to be aware that the Chancellor is aiming to present his Budget next year on 20 March. I understand that the date does not cause difficulties for the Prime Minister or for the Palace. Following the pattern of recent years, the Chancellor plans to announce the date of the Budget during his speech opening the Autumn Statement debate in January.

Yours

JG.

JOHN GIEVE
Principal Private Secretary

13.12. 1989

dti

the department for Enterprise

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cc PM

80

The Rt. Hon. Nicholas Ridley MP
Secretary of State for Trade and Industry

Rt Hon John Major MP
Chancellor of The Exchequer
HM Treasury
Parliament Street
LONDON
SW1P 3AG

NBPM
RLCG
11/12

Department of
Trade and Industry

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London SW1H 0ET

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Direct line 215 5422
Our ref PE4AHO
Your ref
Date 11 December 1989

Dear John

1990 BUDGET

I am writing in good time before the 1990 Budget, to give you my views on the overall fiscal strategy which I consider would best promote the long term interests of business; and to make a number of suggestions for tax changes which I believe would strengthen the supply performance of the economy.

You stressed, in presenting the Autumn Statement, that fiscal policy would remain tight, notwithstanding the modest increase in planned public expenditure in 1990-91. I am sure that this is right; I believe that for business, the most important objectives of the Budget, and indeed of macroeconomic policy generally, should be a lower rate of inflation, and the reductions in interest rates which that will in time make possible. I do not think that further reductions in personal taxation should be a priority for 1990; and I would support an increase in real terms in indirect taxes, and specifically in the main excise duties, if that is necessary to balance the reductions in business taxes which I favour, while keeping the overall fiscal stance tight.

I have considered carefully the arguments in favour of more generous capital allowances, particularly for plant and machinery. After two years of rapid growth in industrial investment, the rate of increase is now forecast to slow down or even to go into reverse in 1990 and 1991, just when industry needs to be equipping itself for 1992. To tackle this problem, I would favour an increase from 25% to 35% in the rate of writing down allowances for plant and machinery bought or leased from next April. There would be little or no cost in 1990-91; I understand that the cost would be approximately £1.2bn in 1991-92 rising to £1.9bn in 1993-94.

Recycled Paper

If you are unable to accommodate a change of this magnitude in your overall Budget strategy, I have a more limited suggestion. The present system for writing down the value of capital investment for tax purposes may not fully reflect the speed with which some of the key equipment needed to update our manufacturing systems is itself evolving rapidly, and the modernisation of a number of our industries is constrained by supply problems in this area. I have in mind particularly equipment for the production and testing of electronic components and microprocessors. I should therefore like to suggest an improvement in the present writing down arrangements for short life assets. Where a taxpayer nominates an item of plant or machinery as a short life asset, and the nomination is accepted by the Inland Revenue, he should be permitted to claim a 35% writing down allowance, on a straight line basis; and the present arrangement should be retained whereby the outstanding balance of the cost, less any realisation on disposal, is written off when the asset is scrapped or sold. If necessary to combat avoidance, these special provisions could be limited to the category of assets mentioned above.

I have also considered the case put to me for a cut in the main rate of corporation tax. The CBI argue for this strongly, now that the yield of corporation tax is over £20bn a year, and the financial position of companies is less strong than it was. But the increased yield of corporation tax is due overwhelmingly to the return of companies to reasonable levels of profit; and the overall tax burden on companies in the UK, including social security contributions as well as corporate tax, compares favourably with that in most other industrial countries. Levels of company taxation abroad are falling, and we must ensure that we are not left behind in this process. But for the moment the tax rate in the UK remains competitive, and I see no strong case for a reduction this year. I assume, however, that if you did decide to reduce the basic rate of personal taxation, you would, as on previous occasions, extend the reduction to the "small companies" rate of corporation tax.

My other main proposal is that the Stamp Duty of ½% on all securities transactions should be abolished. Stamp Duty now represents 75% of transaction cost for the largest securities transactions. It is becoming a real threat to the competitive pre-eminence of the London securities market in the European time zone. The German authorities have announced there intention to abolish their equivalent tax, and similar moves are expected in the Netherlands and in France. There is also a practical reason for abolishing Stamp Duty on securities transactions in the next Budget. Significant private sector resources are about to be devoted to updating the mechanics of share transfers. It would be wasteful for these to have to

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the department for Enterprise

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accommodate the collection of Stamp Duty if that is to disappear soon anyway. I recognise that this change would be expensive, at a cost of some £750m a year; but I believe that the benefits of maintaining London's lead as a financial centre are fully commensurate with the cost.

The low level of turnover at which traders are required to register for VAT is a continuing source of unnecessary aggravation to small businesses. I would therefore urge you to increase the registration threshold by the maximum amount permitted by the Sixth VAT Directive, as has been done in every recent Budget. There is, as I am sure you agree, a strong case on merit for a very much larger increase. I hope that you will make renewed efforts to persuade your colleagues in other member states of the benefits this would bring to smaller businesses throughout the Community.

As you know there has been a good deal of recent discussion of the use of fiscal measures and other market mechanisms as instruments of environmental policy. I am sure that this will remain an important topic in the medium term; and we shall need to look critically at initiatives which might work to the disadvantage of the UK's relatively energy intensive industries. I have no general proposal in this area. But I should like to make one specific point.

This relates to tax incentives for the early introduction of cars fitted with catalytic convertors. We have dropped our objection to the use by other member states of tax incentives for this purpose. But it is important that we should continue to resist proposals for such incentives here. The manufacturers are already moving as fast as they can, so there would be a lot of deadweight; and insofar as tax incentives did affect purchasing decisions, overseas manufacturers, whose development of convertors is more advanced, would benefit disproportionately.

I have a number of more detailed and technical proposals. These cover the capital gains of unincorporated traders; wider share ownership; the taxation of futures, options and unit trusts; the administration of VAT; and the taxation of company cars. They are set out in the enclosed memorandum.

I am copying this letter to the Prime Minister and Norman Fowler.

Yours ever

Nigel

Recycled Paper

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DTI PROPOSALS FOR ACTION IN THE 1990 BUDGET

CAPITAL GAINS OF UNINCORPORATED BUSINESSES

1 Companies are able to set off trading losses from one accounting period against capital gains arising in the same period or in the previous twelve months. But there is no provision for unincorporated traders to set off trading losses against capital gains for tax purposes. This creates a distortion to the disadvantage of unincorporated traders for which there is no economic justification and which should be removed. It is accepted that any relief must be restricted to gains arising on disposals of business assets. This can be achieved if the definition of qualifying assets used for CGT roll-over relief is also used to define the gains which can be set off against trading losses. It is therefore proposed that the trading losses of an unincorporated trader should be able to be set off pound for pound against capital gains realised on the disposal of business assets.

WIDER SHARE OWNERSHIP

2 It is suggested that further fiscal measures should be introduced which would promote personal saving, particularly in the form of wider individual share ownership. Three specific measures are suggested, which are not mutually exclusive.

i) **Personal Equity Plans.** The maximum amount which an individual may invest each year in a PEP should be increased substantially from the present level of £4,800.

ii) **Capital Gains Tax.** A substantial increase in the personal exempt amount, now £5,000, would increase the relative attraction of individual share ownership to reasonably substantial private investors, since a far higher proportion of "switches" within an individual portfolio would escape CGT.

iii) **Stamp Duty.** It would make individual equity ownership more attractive to private investors if Stamp Duty were abolished on all securities transactions of less than £5,000 value. At that level, abolition would reduce transaction costs by about a quarter, and go far to redress the balance of advantage now enjoyed by collective investments. Given the present structure of dealing charges, and the administrative burden involved, the "unbundling" of larger transactions would not be a major source of avoidance.

TAXATION OF FUTURES AND OPTIONS

3 The present tax treatment of futures and options (FAO's) creates a degree of uncertainty for some important categories of investing institutions which inhibits their use of FAOs to pursue systematic strategies to reduce risk. This uncertainty arises because proceeds from FAO transactions received by pension funds, unit trusts, and investment trusts may be classed as trading income (and thus subject to Schedule D Case I treatment) rather than investment income (and thus subject to CGT, from which they are exempt). The Inland Revenue's view on what transactions constitute investment (as opposed to trading) for tax purposes effectively limits them to FAO contracts undertaken to hedge specific risks on specific assets. In practice this prevents pension funds etc pursuing systematic strategies (for example based on stock index futures or options) to reduce the risks that arise from wider movements in the market. If the Revenue take a similarly restrictive view in relation to on-shore FAO funds when these are authorised by the DTI (probably early next year), the viability of these funds will be seriously reduced.

4 This limitation on the institutional use of the London FAO markets reduces their competitiveness against, in particular, their French equivalent, the MATIF (which poses an increasingly serious competitive threat to LIFFE in any event). If imposed on authorised FAOs, it will drive this category of business either to Paris or off-shore. It is therefore proposed that Treasury Ministers should use the 1990 Finance Act to ensure that investment strategies using FAOs either to hedge specific risks within an investment portfolio or to reduce a general risk to a portfolio should be treateed as investment activity for tax purposes.

UNIT TRUSTS

5 The 1989 Budget contained important changes in the taxation of unit trusts, which will enable UK resident unit trusts to compete more effectively with trusts based overseas. UK-based unit trusts are now well placed to compete for the business of individual UK resident taxpayers. But unit holders who are resident abroad, or who are companies, still face a tax regime on their holdings which is less favourable than those in some other countries, and this is likely to limit the ability of UK based unit trusts to market their products to such customers and thus to remain fully competitive in Europe. The Unit Trust Association (UTA) has submitted detailed proposals intended to remove this problem at an estimated cost of £15 million year. It is hoped that the UTA proposals will receive sympathetic consideration.

6 It is also proposed that money funds, which cannot be marketed throughout Europe under the UCITS Directive, should nevertheless be afforded the same treatment as UCITS so as to remain competitive within the UK. Without this, the authorisation of these funds in the UK is likely to be ineffective.

VAT THRESHOLD

7 It is understood that Treasury Ministers are seriously considering a substantial simplification of the rule requiring traders to register for VAT when their quarterly turnover exceeds specified limits, or when they expect their annual turnover to exceed the annual registration threshold. The proposal under consideration is understood to be that traders should be required to register only when their annual turnover actually exceeds the annual threshold. This would greatly ease the administrative burden on small businesses of monitoring and record keeping; and it would give businesses reaching the turnover threshold the benefit of up to nine months additional VAT free trading. The cost is estimated at £80-100m a year. It is proposed that this helpful simplification should be introduced in the 1990 Budget.

VAT REGISTRATION PERIOD

8 Traders are required to register for VAT within thirty days, once they exceed the registration threshold. Many small businesses have accounting systems which cannot reliably establish turnover in a previous period within thirty days, and they may unwittingly exceed the time limit and become liable for heavy and automatic penalties. The administrative burden would be substantially eased if the time limit for VAT registration were extended from 30 days to 60 days.

VAT BAD DEBT RELIEF

9 Bad debt relief should be given within the VAT system without the need for formally declared insolvency. Such relief could be effected <u>either</u> by providing annual relief based on the traders/companies' annual accounts, where the bad debt write-off and provision figures would be available and could be reconciled back to the accounts (Inland Revenue accepted procedure); <u>or</u> providing quarterly relief based on information supplied by the trader, with provision for adjustment following the completion of the trader's annual accounts.

VAT DEFAULT SURCHARGE

10 Where a trader habitually makes late VAT returns he is liable to a default surcharge which increases in steps over time to a maximum of 30% of VAT paid late. The severity, and the non-discretionary nature, of the penalties have long been a source of complaint from small business, and Customs and Excise are understood to have reviewed the operation of the surcharge. It is hoped that a way can be found of mitigating the impact of the default surcharge on small businesses, without removing the incentive to timely compliance.

COMPANY CARS

11 In each of the last two Budgets, car benefit scales have been increased well above the rate of inflation. But the scales still fall some way short of reflecting true value to the individual of a company car. If and when the stage is reached where an individual is assessed for income tax on the full economic value of the benefit of a company car, discrimination against passenger cars in the operation of corporation tax and VAT should also cease. This would involve abolishing the annual limit of £2,000 on the writing down allowance on a company car; and ending the rule that input VAT on the purchase of passenger cars cannot be offset against output tax on sales. Once a company car ceased to be a tax efficient perk, and cars were bought by companies for business reasons, there would be no case for treating the company's expenditure on cars less favourably than its expenditure on other business assets.

file to
c: NIF

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

MR. WILSON

NATIONAL INSURANCE FUND

Thank you for your minute of today's date about which we subsequently spoke. This is to confirm that I agree with the points you propose to put to Mr. Partridge, and that in addition I think the Department of Social Security should be urged to set out in much more detail the underlying reasons for the trends now foreseen in the finances of the NIF. One point in particular that does not seem to me so far to have been adequately described is exactly what impact the larger than expected take-up of personal pensions is having. I don't see how the Prime Minister can be expected to take a considered view on the possible options for change without adequate analysis of the nature of the underlying problems.

PG

6 December 1989.

KC

COVERING CONFIDENTIAL

CABINET OFFICE
P .....5151.....
6 DEC 1989
FILING INSTRUCTIONS
FILE NO. .....

DEPARTMENT OF SOCIAL SECURITY
Richmond House, 79 Whitehall, London SW1A 2NS
Telephone 01-210 5543

From the Permanent Secretary
M.J.A.Partridge CB

4 December 1989

Dear Richard,

Thank you for your understanding of my S.o.S.'s position on the NI Fund. Simply to raise contribution rate flexibilities in the Bill without full consideration by colleagues would concern him considerably, given the political attention and controversy this would generate for the Government's handling of fiscal matters as well as the social security aspects.

He would like to be sure that colleagues have considered this complex

of issues carefully before he goes ahead with his Bill. He has had the enclosed paper prepared for E(A) on 13 December, which we are seeking to clear urgently with the Chancellor, who may have views.

Meanwhile, you may wish to have an advance sight, and it might be helpful if we could discuss it later this week (? with Andrew Turnbull) so that the secretariat are seized of the implications of a paper we have sought to keep short.

Yours ever,

Michael

Richard Wilson.

CONFIDENTIAL

Miss Dudley APS/S of S

From: Mr S G Hewitt C1
Date: 4 December 1989

Copies: Mr Willis PS/M of S
Ms Edwards PS/PS (C)
Mr Lowe PS/PS (L)
Mr Griffiths PS/PS
Mrs Bowtell SSPG
Mrs Firth SS (C)
Mrs Woods FD
Mr Clark FD1C
Mr Epsom C1A

NI FUND

I attach:

* A revised draft paper
* A draft letter to the private secretaries to the Chancellor of the Exchequer and the Secretary of State for Health

As we discussed, you will hold on to this material until Mr Partridge has discussed the matter again with colleagues in the Cabinet Office.

S Hewitt

S G Hewitt
Room 824
Friars House
Ext 23207

CONFIDENTIAL

Introduction

1. On 23 November, the Committee considered my memorandum E(A)(89)(31) about the management of the National Insurance Fund. I was asked to consult with the Chancellor of the Exchequer and the Secretary of State for Health and provide a further paper on options for managing the Fund.

The National Insurance Fund

2. The structure of the Fund is described at Annex 1. Because contributions are earnings related and benefits (except SERPS) are price indexed, a surplus has hitherto built up in the Fund allowing us to reduce, and eventually to abolish, the Treasury Supplement; gradually to increase the NHS allocation; and, at the last Budget, to decrease contributions for employees. But the unexpectedly high take up of personal pensions and the costs of rebates and incentives associated with the initiative means that the Fund will be exhausted by 1991/92 unless remedial action is taken.

3. Forecasts on the state of the Fund are produced by the Government Actuary using economic assumptions provided by the Treasury. By law, the Fund must not be allowed to go into deficit. In addition, the Actuary recommends that a minimum balance (currently 16.7% or sufficient to meet about 2 months' benefit) should be maintained at all times. The Fund has no borrowing powers: nor can contribution rates be increased quickly. Moreover, the Treasury Supplement has been abolished. The minimum balance is therefore essential to cope with short term fluctuations in income and/or expenditure. It would be imprudent to reduce this minimum balance and given current uncertainties about the future number of personal pensions the Actuary would, if anything, be likely to recommend an increase in the current level. This would, of course, exacerbate our present difficulties.

Options

4. This paper examines the scope for solving the Fund's problems through a reduction in outgoings or an increase in income.

Outgoings

5. Expenditure from the Fund includes three items which are non-contributory namely industrial injuries benefits (IIB), statutory sick pay and maternity pay (SSP/SMP) and the NHS allocation.

Industrial Injuries Benefits

6. Industrial injuries benefits are not statutorily contributory since they do not have specific contribution conditions. However recipients are required to have been in employment. II Benefits are currently financed from the NI Fund; being non-contributory however it might be more appropriate to make them and associated administrative costs a charge on the Consolidated Fund. This would reduce expenditure from the NI Fund by about £500 million a year.

SSP/SMP

7. The same considerations apply to SSP/SMP although the practical arrangements for paying these benefits makes their treatment rather different. At the moment, employers are responsible for meeting these benefits but they recoup their costs by adjusting their monthly national insurance contribution payments. It would be administratively difficult both for employers and the Inland Revenue and undesirable in principle (because that would be hypothecation of tax) to change to a system whereby the costs of these benefits were recouped through reductions in PAYE tax. But the burden could be shifted on to the Consolidated Fund by the introduction of a

special vote to the NI Fund. This would be worth more than £1 billion a year. It could however be portrayed by the Opposition as a revival of the Treasury Supplement.

Administrative Costs

8. The Fund traditionally bears the administrative costs relating to the NI contributions received and benefits paid out. Expenditure from the fund could be reduced by about £1 billion a year by transferring these costs to the Consolidated Fund. This would require primary legislation and could be presentationally difficult because it would undermine the status of the Fund as a self sufficient source of finance for the relevant payments. I do not find such an approach to be attractive.

NHS Allocation

9. The extent of the NHS allocation in recent years is shown at Annex 2. The allocation is currently about £4 billion or 16% of NHS spending.

10. Colleagues have decided that the allocation should be retained. It is the one device which allows us to vary the Fund's balance without changing contribution or benefit rates. For presentational reasons, it would be extremely difficult to reduce the allocation to zero. At present, the size of the allocation can only be altered by 0.1% each year. An increase in the permitted level of annual variations from 0.1% to 0.2% would give greater flexibility in the management of the Fund. This would, of course, require primary legislation.

National Insurance Contributions

11. The only other possibility is to increase contribution rates. To eliminate the projected deficit, it would be necessary to increase primary and secondary contributions by about 0.5% from April 1991 and, again, by a similar margin in April 1992. A small reduction might be necessary the following year but the rates for 1993/94 would still be higher than now. Such increases would be unpopular especially as they could only be justified as a way of paying for some peoples' personal pensions. And there could be an indirect effect on inflation with employers trying to pass on their increased costs to consumers and employees pressing for higher wage settlements.

12. At present, the main contribution rates can only be varied by 0.25% a year by way of secondary legislation. New powers could be taken to increase this margin to, say, 0.5%. As with the NHS allocation, this would provide greater flexibility although we would need to be ready to defend the change.

Discussion

13. If we are looking for a single measure to cure the Fund's problems it will be necessary either to increase contributions progressively by around 1%; or reduce the NHS allocation to zero. Both would have considerable presentational drawbacks.

14. An alternative would be to remove expenditure on IIB and SSP/SMP. This would improve the balance in the Fund to the point where only limited additional action would be necessary on contribution rates and the NHS allocation. Such additional action could be taken within existing legislative provision. Nevertheless, new powers on contribution rates and the allocation - even if they were not used in full - would greatly increase our flexibility in futher years and help to put the Fund on a sounder footing.

Conclusion

15. I propose to include a package of measures in my next Bill aimed at solving the Fund's present difficulties and providing much greater room for manoeuvre. This package would include the removal of expenditure on IIB and SSP/SMP; and powers to vary contribution rates by up to 0.5% a year, and the NHS allocation by 0.2% a year. I believe this could be presented as a logical and acceptable reform of the NI Fund.

16. Colleagues are invited to agree such an approach.

CONFIDENTIAL

DRAFT LETTER TO THE PRIVATE SECRETARY TO THE CHANCELLOR OF THE EXCHEQUER

NI FUND

At the meeting of E(A) on 23 November, my Secretary of State was asked to produce a further paper on options for managing the NI Fund. I attach a draft of such a paper and should be grateful to know whether the Chancellor of the Exchequer is content with the conclusions it reaches.

From the DSS point of view, there is now some urgency in this matter, since any new measures designed to cure the Fund's problems will have to be included in our forthcoming Bill. We therefore need to circulate an agreed paper as quickly as possible.

A copy of this letter goes to [ ] at the Department of Health. I should be grateful if he could let me have any comments on the draft which his Secretary of State would care to make.

ANNEX 1

THE NATIONAL INSURANCE FUND

GENERAL

1. The National Insurance Scheme operates on a contributory principle whereby contributions paid by employers and employees are compulsory and go towards the cost of benefits which are paid subject only to the fulfilment of qualifying conditions. This principle is reflected by the existence of a separate Fund where contributions and benefits are set out quite separately from general tax income and Consolidated Fund expenditure.

The National Insurance Fund has effectively never been financed on an actuarial, but on on a pay-as-you-go, basis from contributions, now mainly earnings-related, and interest on investments. This means that current contributions pay for current benefits.

THE NATIONAL INSURANCE FUND

2. A working balance is provided

a. to finance advances, mainly to the Post Office and Girobank, to meet benefit expenditure; and

b. to cushion against changes in the forecast levels of income and expenditure.

and thus ensure that sufficient money is always available to meet the cost of benefits. This is essential because the Fund has no borrowing powers from which to meet any shortfall.

3. The Government Actuary has considered what risk margins it would be prudent to allow for the various items of income and outgo in the light of recent experience of the operation of the Fund. These risk margins reflect variations both in the actuarially estimated factors and in the working economic assumptions. On balance, the Actuary has recommended a minimum working balance of one-sixth of the year's estimated benefit expenditure.

THE ROLE OF THE GOVERNMENT ACTUARY

4. The Social Security Act 1975 (sections 121(1) and 124(3)) provide that whenever the Secretary of State lays before Parliament the draft of any Order which proposes a re-rating of contributions or an increase in benefit rates, he must simultaneously lay before the House a copy of a report by the Government Actuary which shows the Actuary's opinion of the likely effects on the National Insurance Fund. These opinions are published as House of Commons Command Papers.

MANAGEMENT OF THE FUND

5. Under section 133(3) of the 1975 Act, the assets of the Fund are invested by the National Debt Commissioners. The Commissioners are required by statute to invest in Government stocks. Some £1.5 to £2 billion is held in liquid funds to meet current needs and the remainder in a range of stock maturing over the next 20 years.

6. In the final analysis after taking account of interest on investments the Government must ensure that contribution rates are set at a level to finance projected outgoings rrom the Fund and to maintain the prudent balance as recommended by the Government Actuary.

7. The Government has recently taken steps to reduce future liabilities by encouraging contributors to opt out of the State Earnings Related Pension Scheme (SERPS) and by making changes in that scheme to reduce its future costs. However, the immediate effect of these changes has been to reduce the income of the Fund in short-term.

FD3A

ANNEX 2

NHS Allocation from NI Fund

Year	Percentage Employee*	Allocation Employer*	Amount Allocated to NHS £ million	Percentage of total NHS Finance
79/80	0.4%	0.6%	877	9.6%
80/81	0.4%	0.6%	989	8.2%
81/82	0.65%	0.6%	1,257	9.4%
82/83	0.75%	0.6%	1,662	11.3%
83/84	0.75%	0.6%	1,708	11.0%
84/85	0.75%	0.6%	1,848	11.1%
85/86	0.75%	0.6%	1,945	11.0%
86/87	0.75%	0.6%	2,220	11.7%
87/88	0.85%	0.7%	2,471	13.0%
88/89	0.95%	0.8%	3,372	14.5%
89/90	1.05%	0.9%	4,068	16.2%

* The NHS allocation is a percentage of the relevant earnings - eg if the NI Contribution rate is 9% of earnings, and the allocation rate is 1.05%, 7.95% goes to the NI Fund and 1.05% to the NHS.

From: R T J Wilson
6 December 1989

P 03589

MR GRAY

NATIONAL INSURANCE FUND

1. I mentioned to you the draft paper, following up the recent discussion in E(A) about the National Insurance Fund, which Mr Newton wants to put forward to E(A) for discussion on 13 December. Michael Partridge has now let me see a draft: see copy attached.

2. The specific proposals which Mr Newton wishes to put forward seem not unreasonable as a response to the immediate problems facing the Fund. I am however concerned about three aspects of the paper which if you agree I am minded to put to Mr Partridge:

i. the Prime Minister's comments suggested to me that she wanted a much more fundamental look at the Fund than this paper provides. At the very least I think Mr Newton ought to flag up this point and specifically acknowledge that the paper deals only with the short term;

ii. allied to this, Mr Newton ought also to explain why the short-term problem has to be dealt with now, in advance of any more fundamental analysis. To some extent this is answered in paragraph 3, but the paragraph needs to be recast, expanded a little and should include a reference to the legislative timetable;

iii. the paper ought also to say clearly whether the steps proposed will be adequate to solve the problems of the Fund. Paragraph 14 makes a rather guarded statement about "limited additional action" which needs to be spelt out.

3. Perhaps we could have a word?

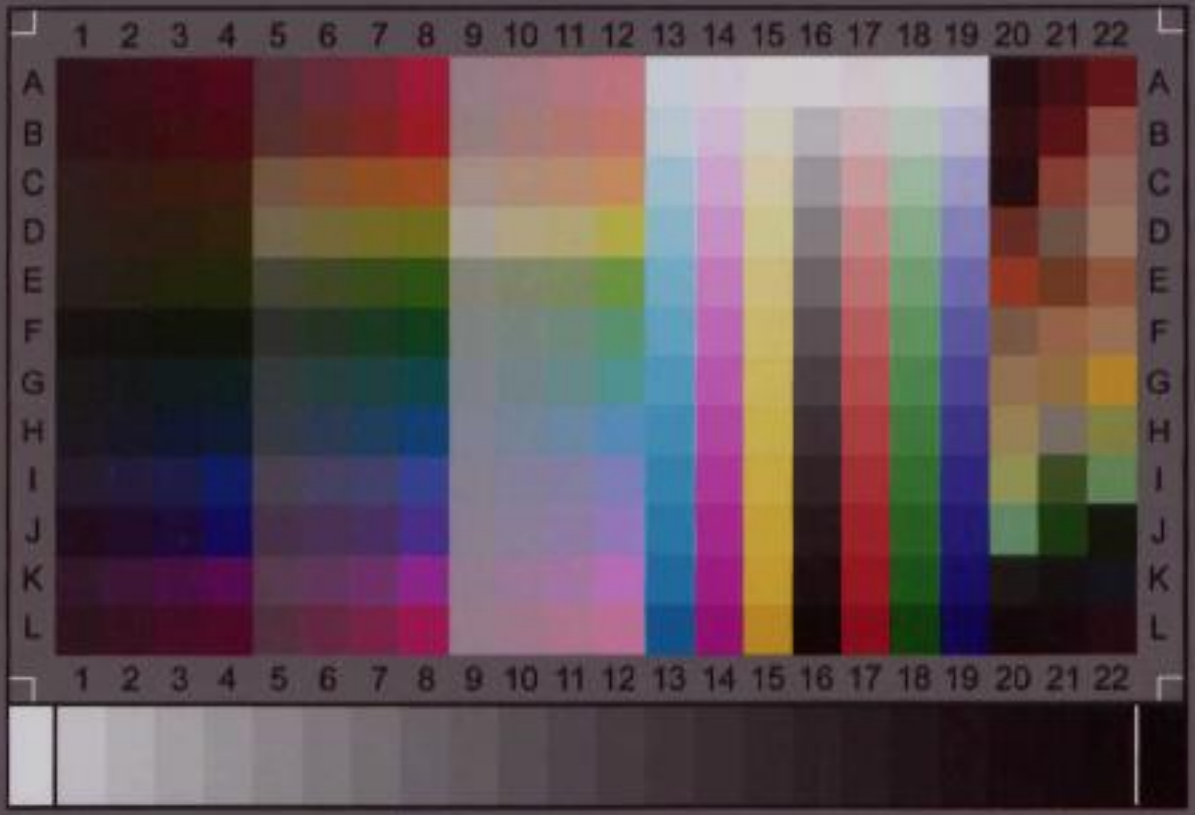
6/12

PART 18 ends:-

AT to PM 22-11.

PART 19 begins:-

R. Wilson to PM 6.12-89



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