
Financial Statement and Budget Report 1989-90

Return to an Order of the House of Commons dated 14 March 1989: for

*Copy of Financial Statement and Budget Report 1989-90
as laid before the House of Commons by
the Chancellor of the Exchequer when opening the Budget*

Treasury Chambers
14 March 1989

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Norman Lamont

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Table 1.1 The Budget measures¹

	£ million		yield(+)/cost(-)
	1989-90	1990-91	1990-91
	Changes from a non-indexed base	Changes from an indexed base	Changes from an indexed base
National insurance			
employee contributions reformed and reduced	- 980	- 980	- 2 800
Income tax			
personal allowances and basic rate limit indexed	- 1 465	—	—
car benefit scales increased	+ 160	+ 160	+ 200
Excise duties			
duty on unleaded petrol reduced, duty increased for 2 and 3 star petrol	- 40	- 95	- 170
vehicle excise duty for taxis, buses and some lorries increased	+ 40	+ 5	*
other duties unchanged	—	- 1 135	- 1 210
Value added tax			
non-domestic construction etc	+ 315	+ 315	+ 535
Life assurance tax regime reformed	- 20	- 20	+ 45
Corporation tax			
small companies' profits limits increased	*	*	- 35
Other tax changes	- 160	- 125	- 55
Pensioners' earnings limit abolished ²
Total	- 2 150	- 1 875	- 3 490

¹ These measures, and the basis of the costings shown, are described in detail in Chapter 4.

² Public expenditure cost of £190 million in 1989-90 and £375 million in 1990-91 will be met from the Reserve. See Chapter 5.

— = Nil.

* = Negligible.

... = Not applicable.

1 The Budget

1.01 The objective of the Government's economic policy is to defeat inflation and to maintain a vigorous and enterprising economy, with sustained growth of output and employment.

1.02 The Financial Statement and Budget Report (FSBR) supplements the Chancellor's Budget Statement. It presents the Medium Term Financial Strategy (MTFS); describes developments in the economy over the past year; provides forecasts to mid-1990; sets out the tax and national insurance proposals in the Budget; summarises the Government's spending plans; and gives forecasts for the public finances for the year ahead.

The Medium Term Financial Strategy

1.03 Chapter 2 describes the MTFS, which provides the framework for the Government's economic policy. The objectives of the MTFS and the central role of monetary policy have remained unchanged throughout the 1980s, a period of substantial economic progress. Monetary policy is designed to reduce money GDP growth and thus inflation over the medium term, with the ultimate objective of achieving stable prices; in this year's MTFS money GDP growth falls to around 5½ per cent over the next four years. Monetary policy is buttressed by a sound fiscal policy, with a substantial budget surplus in both 1988-89 and 1989-90; a gradual return to a balanced budget is intended over the medium term, with both taxes and public expenditure declining as a share of GDP. The MTFS is complemented by policies designed to improve the working of markets and the supply performance of the economy.

The economy

1.04 Chapter 3 describes the main developments in the economy in 1988 and the prospect until mid-1990. The economy grew strongly again in 1988, by 4½ per cent, with the largest fall in unemployment since the war. GDP is forecast to grow by a further 2½ per cent in 1989, though growth through the year will be lower than this. Inflation is forecast to be on a downward trend in the second half of 1989.

Tax and national insurance measures

1.05 Chapter 4 sets out the tax and national insurance proposals in the Budget. They include reform and reduction of employee national insurance contributions, indexation of the main income tax thresholds, improvements to personal equity plans and employee share schemes, reform of the taxation of life assurance, changes to the taxation of pensions and unit trusts, measures to promote unleaded petrol, and abolition of the earnings rule for pensioners. The measures are summarised in Table 1.1.

Public expenditure

1.06 Chapter 5 summarises the Government's spending plans, as set out in the public expenditure White Paper. This chapter also provides the latest estimate of the outturn for the public expenditure planning total in 1988-89

Public sector finances 1.07 Chapter 6 presents the complete financial picture for the public sector. The public sector debt repayment is forecast to be £14 billion in 1988–89. A further debt repayment of £14 billion is forecast for 1989–90, the same as in 1988–89. The forecast takes account of the measures in the Budget which are expected to reduce taxation and national insurance contributions by £1.9 billion, after adjusting for the net cost of indexing direct and indirect tax rates and allowances. Table 1.2 shows the main components of general government receipts and expenditures.

Table 1.2 The finances of the public sector¹

	£ billion				£ billion		
	1988–89		1989–90		1988–89		1989–90
	1988 Budget ²	Latest estimate	Forecast		1988 Budget ²	Latest estimate	Forecast
RECEIPTS				EXPENDITURE			
Inland Revenue:				Department			
Income tax	42.1	43.8	46.9	Social security	48.5	47.4	51.0
Corporation tax ³	19.8	18.4	22.4	Health	20.7	21.7	23.2
Petroleum revenue tax	1.2	1.3	1.4	Defence	19.2	19.0	20.1
Capital gains tax	2.0	2.4	2.1	Education and science	18.0	18.4	19.6
Inheritance tax	1.0	1.1	1.1	Home Office and legal departments	7.0	7.2	8.0
Stamp duties	2.0	2.3	2.4	Transport	5.1	4.8	5.4
Total Inland Revenue	68.0	69.3	76.3	Scotland	8.5	8.7	9.0
Customs and Excise:				Wales	3.5	3.6	3.8
Value added tax	26.2	27.5	30.0	Northern Ireland	5.1	5.6	5.5
Petrol, derv duties etc.	8.4	8.7	8.8	Other departments	22.8	21.2	23.1
Tobacco duties	5.0	5.0	5.1	Privatisation proceeds	–5.0	–7.0	–5.0
Alcohol duties	4.5	4.6	4.7	Reserve	3.5	—	3.5
Betting and gaming duties	0.9	0.9	1.0	Public expenditure planning total	156.9	150.6	167.1
Car tax	1.3	1.4	1.4				
Customs duties	1.6	1.7	1.8				
Agricultural levies	0.1	0.2	0.1				
Total Customs and Excise	47.9	49.9	52.9				
Vehicle excise duties	2.8	2.8	2.9				
Oil royalties	0.6	0.6	0.6				
Gas levy	0.4	0.4	0.4				
Local authority rates ⁴	19.0	18.9	20.6	General government gross debt interest	17.5	18.3	17.1
Other taxes and royalties	2.4	2.7	3.3	Other adjustments	8.6	10.2	10.1
Total taxes and royalties	141.2	144.6	156.9				
National insurance and other contributions	31.6	32.8	34.0				
Interest and dividends	5.6	6.6	7.0				
Gross trading surpluses and rent	3.5	3.0	3.3				
Other receipts	3.0	3.9	5.2				
General government receipts	185.0	190.9	206.4	General government expenditure	183.0	179.1	194.3

Receipts, expenditure and debt repayment

	£ billion		
	1988–89		1989–90
	1988 Budget ²	Latest estimate	Forecast
General government receipts	185.0	190.9	206.4
General government expenditure	183.0	179.1	194.3
General government debt repayment	2.0	11.8	12.1
Public corporations' market and overseas debt repayment	1.2	2.1	1.7
Public sector debt repayment	3.2	13.9	13.8

¹ In this and other tables constituent items may not add up to totals because of rounding.

² On current definitions.

³ Includes advance corporation tax (net of repayments):
— also includes North Sea corporation tax after ACT set off and corporation tax on gains.

⁴ In this and other tables community charge receipts in Scotland are included with local authority rates.

2 The Medium Term Financial Strategy

Development of the MTFS

2.01 This is the tenth occasion on which the Government has set out its Medium Term Financial Strategy (MTFS).

2.02 Since its inception in 1980 the MTFS has provided a nominal framework within which the Government pursues its objective of bringing down the rate of inflation. The MTFS has been complemented by policies designed to improve the working of markets and the supply performance of the economy. The objectives of the MTFS and the central role of monetary policy in reducing inflation have remained unchanged throughout the 1980s; but the precise form in which the nominal framework has been expressed and the indicators used in the assessment of monetary conditions have changed as the economy has itself evolved.

2.03 The original version of the MTFS specified the nominal framework in terms of broad money—the aggregate known at the time as £M3 and now simply as M3—which had shown a stable relationship with money GDP in the second half of the 1970s. M3 initially had two roles: it was used to describe the Government's strategic objective for growth of nominal magnitudes in the medium term; and to act as a target in the short term, and thus as a guide to setting interest rates. However, following the abolition of exchange controls and other measures of financial liberalisation the earlier relationship between broad money and money GDP changed. It became necessary to give more attention to money GDP itself and to take account of other monetary indicators in setting interest rates.

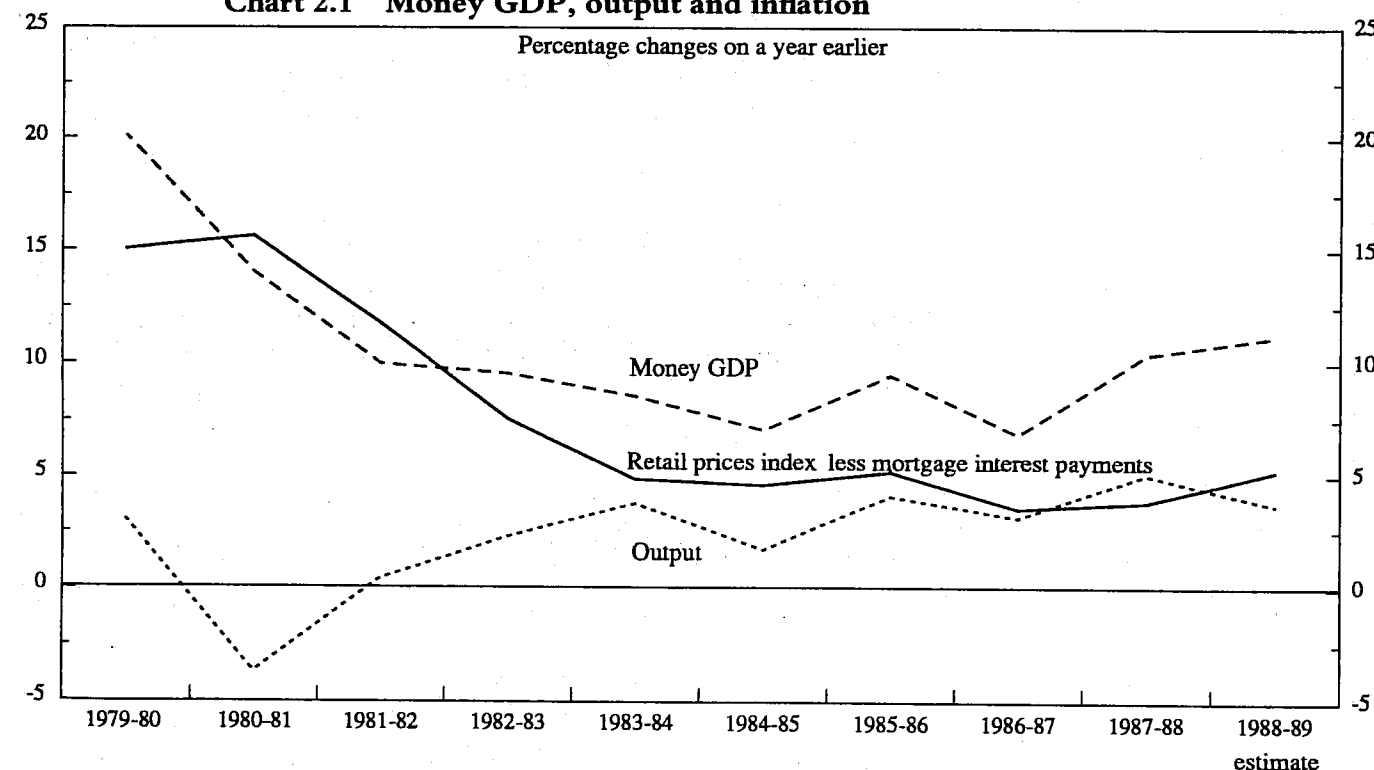
2.04 The nominal framework has been expressed in essentially its present form for the past six years. A medium term path for money GDP has been shown in all versions of the MTFS since 1982. M0 was introduced as a target aggregate in 1984, initially alongside M3, and since 1987 has been the only monetary aggregate for which a target range is given. The importance of the exchange rate in the assessment of monetary conditions was discussed in the 1982 MTFS, and restated regularly in subsequent versions.

2.05 Since the introduction of the MTFS, objectives for fiscal policy have been described in terms of the public sector borrowing requirement (which has now become a public sector debt repayment). With the PSBR at almost 5 per cent of GDP in 1979–80, a major reduction in the deficit was an essential component of the strategy in the early years of the MTFS. Since then, the public finances have been transformed and are now in substantial surplus; this has allowed the Government to move from a medium term objective of deficit reduction to a long term objective of a balanced budget

Economic performance since 1980

2.06 As a result of sound financial policies coupled with supply side reforms, substantial economic progress has been made during the 1980s. Inflation in recent years has been brought back to levels not experienced since the 1960s. The increase in the RPI excluding mortgage interest payments is likely to have averaged about 5 per cent in 1988–89, compared with over 15 per cent in the first year of the MTFS. The growth of GDP has averaged around 3 per cent a year since 1980–81, while productivity performance has improved sharply compared both with the UK's record in the second half of the 1970s and with the performance of other industrial countries. Latest figures put the workforce in employment almost 1½ million above its 1980–81 level and at an all time high. Industrial profitability has recovered to levels not seen for 20 years. The UK has acquired one of the largest stocks of net overseas assets of any country.

Chart 2.1 Money GDP, output and inflation



2.07 The early years of the MTFS saw a sharp decline in money GDP growth. Output fell in the first year but started to recover in 1981; as output accelerated money GDP growth settled down between about 7 and 9½ per cent a year. Since 1986, the growth of money GDP has risen somewhat, with higher output growth matched by an upward movement in inflation.

2.08 As in other industrial countries, recent growth of demand in the UK has been much stronger than expected; here this has occurred in the face of high real interest rates and a substantial tightening of fiscal policy. Private sector investment has surged—growing by about 30 per cent over the past two years. And several years of rising asset prices and increased consumer borrowing have helped to stimulate household expenditure. The collapse of stock market prices in October 1987 did not dampen demand in the way that had been widely expected.

Objective for money GDP

2.09 The Government's intention remains to bring down inflation further over a period of years and ultimately to achieve price stability. To this end it plans to reduce the rate of growth of money GDP over the medium term; monetary policy will be directed to achieving this. Money GDP growth in 1988–89 is estimated to have overshoot the path published in last year's MTFS by $3\frac{1}{2}$ percentage points; but current prospects, discussed in Chapter 3, are for a substantial slowdown in demand in 1989 and the first half of 1990, in part the result of the tightening of policy during 1988. Money GDP growth in 1989–90 is forecast to be just over 1 percentage point higher than envisaged in last year's MTFS.

2.10 It is the Government's policy not to accommodate inflationary impulses. To the extent that faster money GDP growth reflects supply side improvements it is sensible to raise the money GDP objective to accommodate the faster potential growth; but to the extent that faster growth of money GDP reflects only higher demand with no supply side improvement, the Government will take action designed to return to its planned path for money GDP growth over the medium term.

2.11 As compared with last year the Government has revised its view of the likely real growth rate over the medium term, taking account of a slower projected decline in oil output. The medium term trend in output growth consistent with declining inflation is now put at $2\frac{3}{4}$ per cent, compared with $2\frac{1}{2}$ per cent assumed last year; the medium term trend in non-oil output growth consistent with declining inflation is put at 3 per cent.

Table 2.1 Money GDP growth, output and inflation¹

	1988–89	1989–90	1990–91	1991–92	1992–93
Money GDP	11	$7\frac{3}{4}$	6	6	$5\frac{1}{2}$
Real GDP: non-oil	$4\frac{1}{2}$	$2\frac{1}{4}$	2	3	3
total	$3\frac{1}{2}$	$2\frac{1}{4}$	2	$2\frac{3}{4}$	$2\frac{3}{4}$
Inflation: GDP deflator	$7\frac{1}{4}$	$5\frac{1}{2}$	4	3	$2\frac{1}{2}$

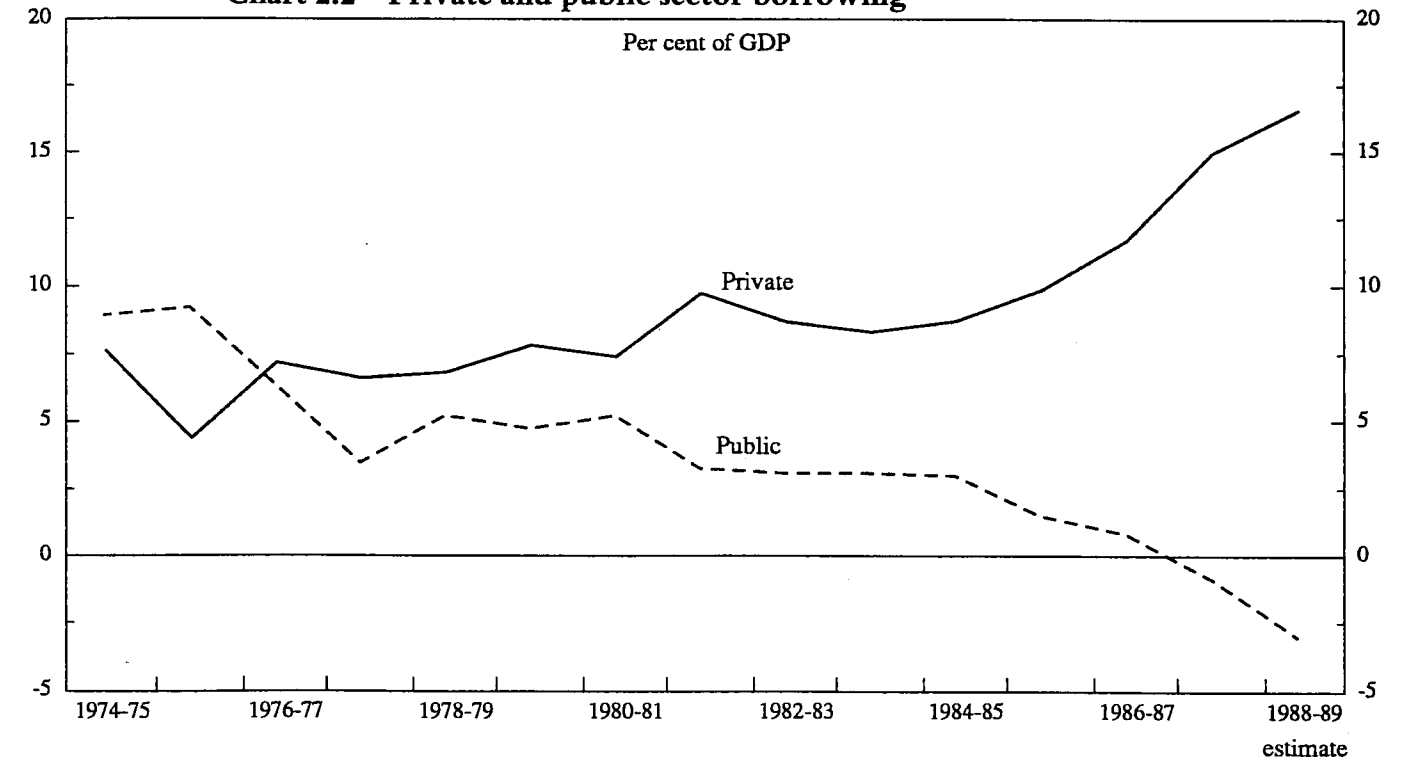
¹ Percentage changes on previous financial year. The figures for 1989–90 are forecasts; the figures for subsequent years show the Government's medium term objectives for money GDP and consistent assumptions for

output and inflation. The projections in the table make no allowance for any effect of the replacement of local authority domestic rates by the Community Charge on recorded growth in money GDP or the GDP deflator.

2.12 Table 2.1 sets out the Government's revised objectives for money GDP. The aim is to get back by 1991–92 onto the path implied by last year's money GDP objectives, after allowing for the higher trend output growth now assumed. The new path is intended to be consistent with reducing inflation to 3 per cent by 1991–92, as envisaged in last year's MTFS. There will inevitably be some fluctuation around the path for money GDP. Moreover the split between output and inflation implied by it is subject to unavoidable uncertainty; illustrative assumptions are shown in Table 2.1. Following two years of rapid growth, output is likely to grow somewhat less than trend in the next two years.

2.13 The flows of saving and investment in the economy over the medium term are also uncertain; and these inherent uncertainties are compounded at present by the discrepancies in the macroeconomic statistics discussed more fully in the annex to Chapter 3. In recent years the private sector as a whole appears to have moved from large surplus into substantial deficit, and this has led to the balance of payments current account moving into deficit despite the public sector's move into surplus. It seems likely that these trends will reverse themselves over the medium term, and the private sector's financial position is likely to move back into surplus. In particular, the personal debt/income ratio, which has been rising fast, should tend to stabilise, as borrowers and lenders become more cautious about allowing further increases: this will imply higher net personal saving.

Chart 2.2 Private and public sector borrowing



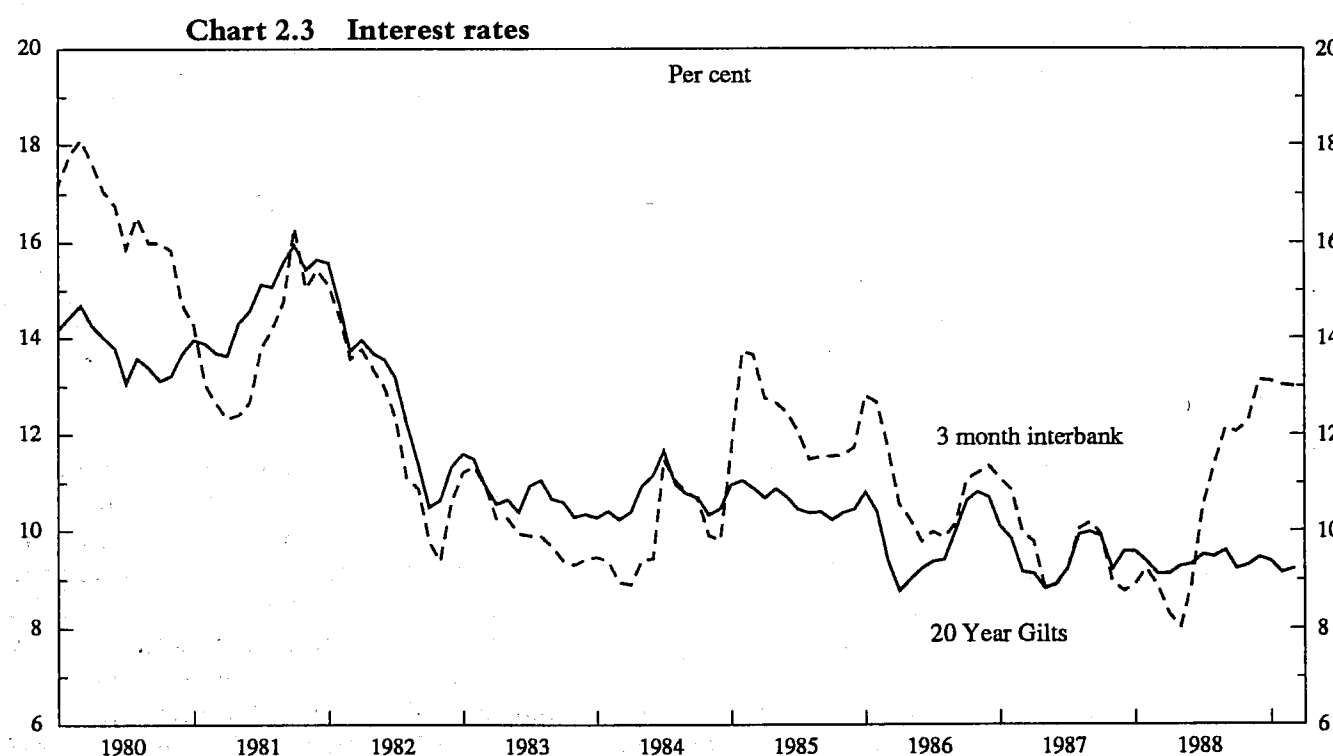
Monetary policy

2.14 The task of exerting downward pressure on inflation falls to monetary policy, conducted within a sound fiscal framework. Experience in the UK and elsewhere has shown that direct quantitative controls, once thought to be a possible instrument of monetary control, are not only inefficient and distortionary, and so undesirable, but also ineffective in today's sophisticated financial markets. Even a decade ago, markets were learning quickly how to circumvent such controls; their proficiency in doing so would be much greater now. The further liberalisation announced today, including the abolition of the Control of Borrowing Order (see box over page), removes one of the last vestiges of post-war controls on capital markets.

Further measures liberalising the financial markets

The removal of controls in financial markets since 1979 has contributed to greater competition and efficiency in the allocation of capital. Further liberalisation was announced in the Budget. The Control of Borrowing Order (COBO), which, with its antecedents, goes back to the immediate post-War period, is to be revoked and its parent legislation repealed. A General Consent has been issued by the Treasury, which means that it will no longer be necessary for new issuers (other than local authorities) to obtain the Bank of England's consent to the timing of their issues. The Bank will no longer operate a new issues queue in the equity and bond markets. COBO itself will remain in place, solely for local authorities, only until new controls on their borrowing, contained in the Local Government and Housing Bill, come into force. The regulatory regime for sterling commercial paper and short-term corporate bonds is also to be significantly liberalised, creating a single regime for sterling paper with an initial maturity of up to 5 years. In addition, the restrictions preventing certain borrowers, including foreign sovereigns and private companies, from making sterling issues in this maturity range will be removed.

2.15 Here, as in other countries, monetary policy is implemented by changing the level of short-term interest rates. The process of financial liberalisation has increased the power of interest rates as a policy instrument. They can now fulfil their function as the price of money and credit unhampered by quantitative controls. At the same time, the rise in borrowing and holdings of liquidity, which followed liberalisation, means that interest rates now act on a wider base.

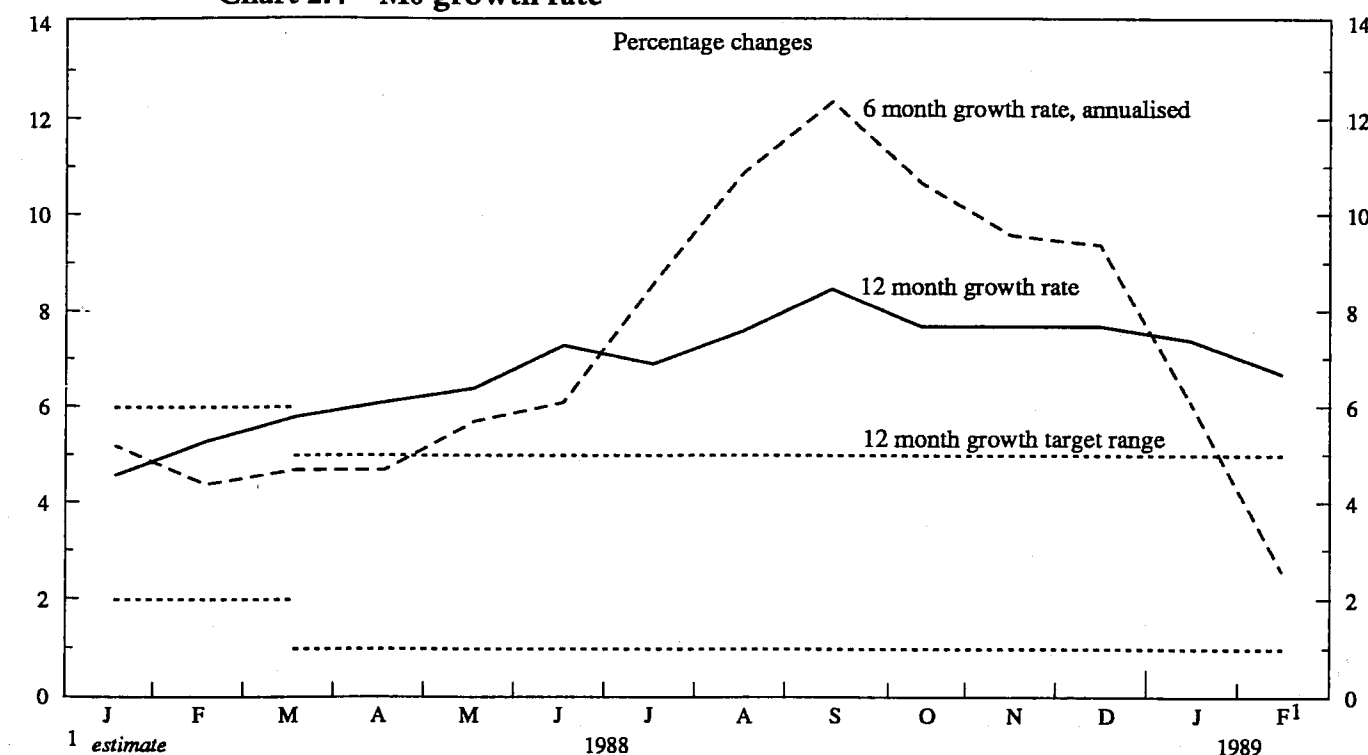


2.16 Decisions about interest rates are made on the basis of a comprehensive assessment of monetary conditions. The evidence of a range of indicators has to be appraised and balanced. But the assessment gives particular weight to the behaviour of narrow money in relation to its target range and to the exchange rate. Attention is also paid to the behaviour of broad money or liquidity. Short-term interest rates fell from 9 per cent in early 1988 to touch $7\frac{1}{2}$ per cent for a fortnight in May. Thereafter they were raised steadily to reach 13 per cent by the end of November, where they have remained.

2.17 Longer term interest rates have been stable despite the rise in short rates. 20 year gilts yields have fluctuated between around 9 and $9\frac{1}{2}$ per cent throughout the past year, and currently stand near the middle of this range. This relative stability has been a feature of recent years. Since the sharp decline in 1982, the trend in long rates has been gently downwards, with only minor fluctuations.

2.18 Narrow money, as measured by M0, has continued to have a reliable and predictable relationship with money GDP. Reflecting the higher growth of money GDP, the 12 month growth rate of M0 has been above the target range throughout 1988–89. M0 grew particularly rapidly between March and September last year, but has slowed sharply since the autumn in response to the higher interest rates in the second half of 1988. Its estimated annualised growth over the last six months seasonally adjusted is under 3 per cent, the lowest since the middle of 1987.

Chart 2.4 M0 growth rate



2.19 For 1989–90, a target range for M0 of 1–5 per cent has been set, the same as the illustrative range for that year in last year's MTFs. Measured by the 12 month growth rate, it is likely to begin the year above the target

range. But as the deceleration over recent months continues, it will come back within it. The ranges given in Table 2.2 for later years are illustrative and show a steady fall consistent with the declining path for money GDP growth.

Table 2.2 Growth of M0¹

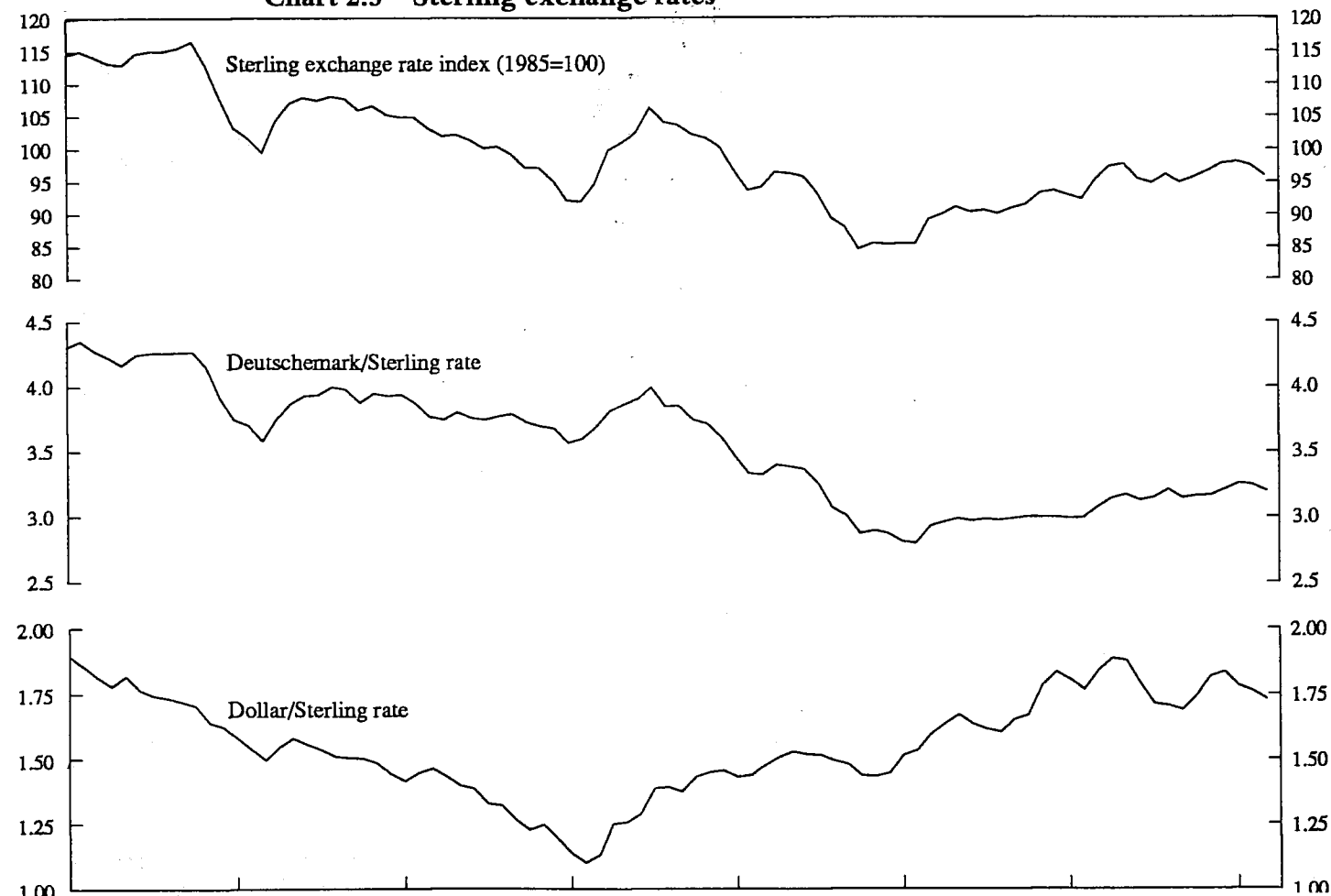
1988-89	1989-90	1990-91	1991-92	1992-93
7	1 to 5	0 to 4	0 to 4	-1 to 3

¹ 1988-89: forecast percentage change on previous financial year;
1989-90: target range for 12 month growth rate; 1990-91 onwards: illustrative ranges.

2.20 The exchange rate is a key influence upon, and a key indicator of, monetary conditions. It has to be considered together with all the evidence of domestic indicators in making monetary policy decisions. Monetary policy has the overriding task of defeating inflation: the Government is accordingly not prepared to accommodate increases in domestic costs by exchange rate depreciation. Sterling has risen slightly against the deutschmark over the past year. The dollar has also risen against the deutschmark, though it has shown little change against the yen.

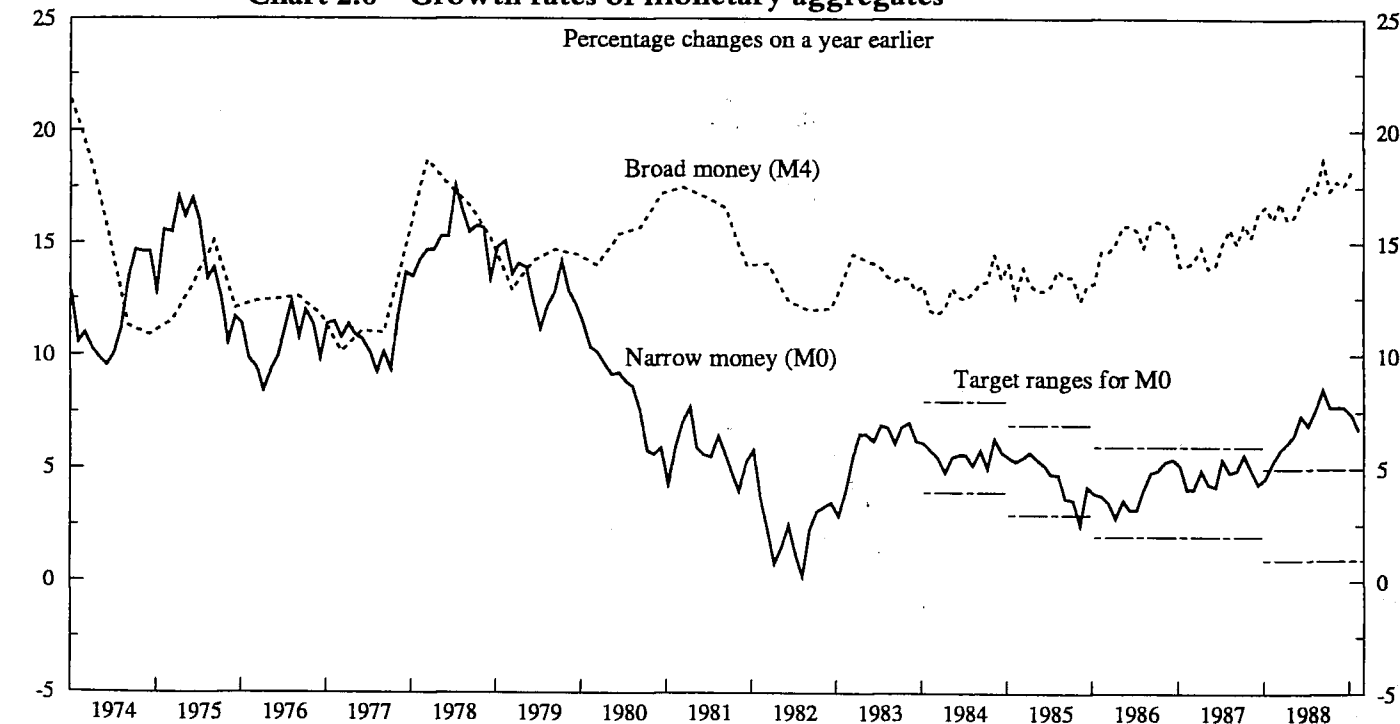
2.21 Exchange rates are also important in international economic relationships. The improved co-operation between the G7 countries, who share a common counter-inflationary objective, has been clearly beneficial to the international community.

Chart 2.5 Sterling exchange rates



2.22 In assessing monetary conditions, the interpretation of broad money, or liquidity, requires considerable judgment. There have been significant changes in the relationship between broad money and spending over the years. Because it is used as a store of value as well as for transactions purposes, what matters so far as subsequent inflationary pressure is concerned is not its growth rate alone but the extent to which people are prepared to hold interest-bearing money balances rather than to spend them.

Chart 2.6 Growth rates of monetary aggregates



Funding policy

2.23 The Government will continue to conduct its own financial affairs so as to have a broadly neutral impact on liquidity. That is embodied in the policy of funding 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. Should this total be negative, then 'unfunding' will be required; that is, the authorities will make purchases of debt. Gilts bought in by the Bank of England are normally held in its Issue Department. The Government is taking powers in this year's Finance Bill to enable the National Loans Fund to acquire these gilts for cancellation.

2.24 Now that the public sector is repaying debt it is possible to devote more attention to the structure of the remaining debt, both to secure lower expected servicing costs and to improve the quality of debt by reducing reliance on borrowing in the form of liquid instruments. Attention will also be paid to smoothing the profile of redemptions. The reverse auction conducted in January 1989, the first of its kind, enabled the authorities to make substantial purchases of gilts maturing in 1989-90, a year when maturities will be particularly heavy.

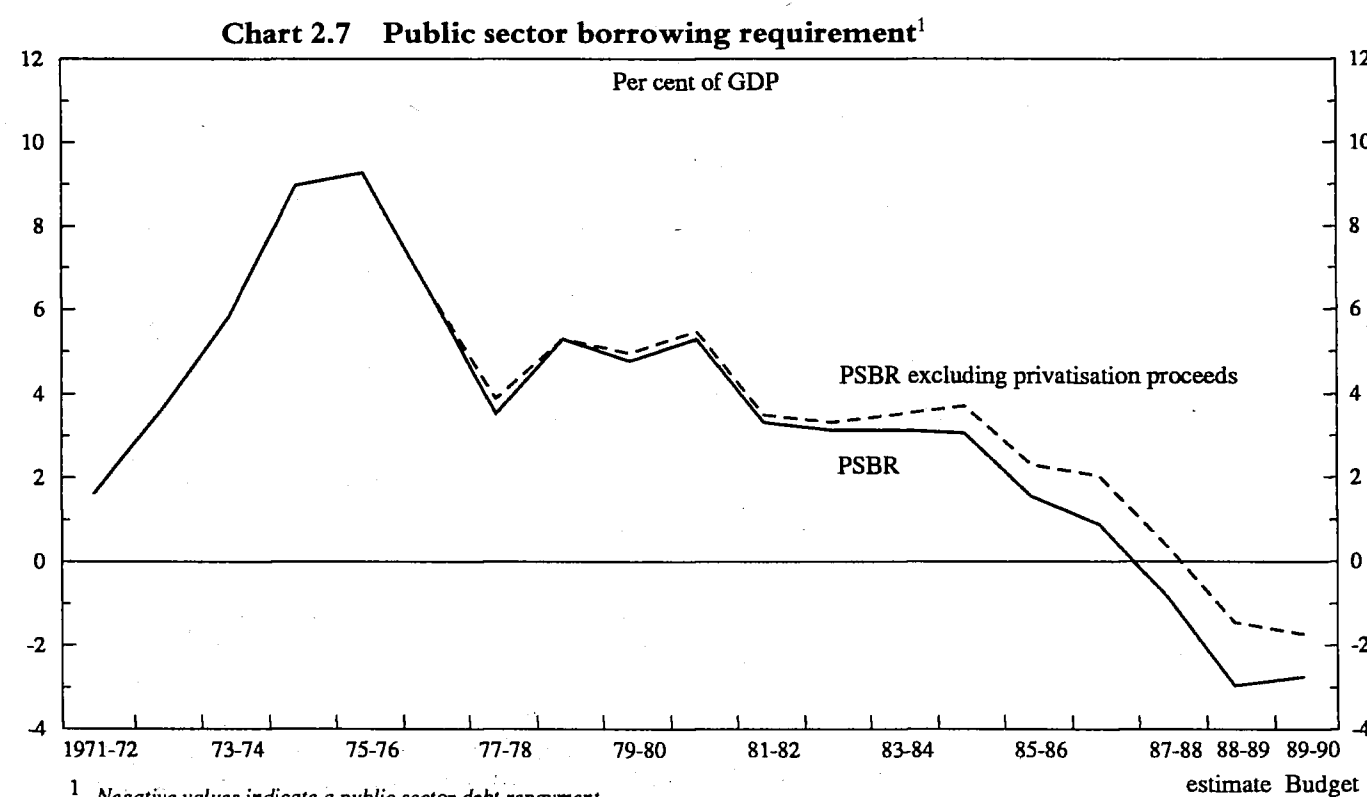
2.25 In general, however, the Government decides what types and maturity of debt to repurchase or issue, depending on current relativities and expected future yields. In 1988-89, the Government took the view that, on this basis, its longer term debt looked relatively expensive borrowing. Accordingly,

much of the buying-in of conventional gilts required by the full fund policy was of longer maturity issues, so as to secure greater future debt interest savings. The fact that the Government has been a net repurchaser of long term debt and the emergence of a downward sloping yield curve have created favourable conditions for longer term borrowing by the private sector. The increasing volume of fixed rate sterling borrowing by companies has been a welcome development.

2.26 Indexed debt has the advantage of reducing uncertainty, for both the Government and investors, about future real yields. In circumstances when the Government believes it will reduce inflation in a way that is not yet fully reflected in market yields, index-linked borrowing becomes particularly attractive to the Government as compared with conventional gilts. Net sales of indexed gilts continued in 1988–89, despite the reduction in total gilts outstanding, and about one eighth of all gilts outstanding are now in indexed form.

Fiscal policy

2.27 It is now expected that the net repayment of debt in 1988–89 will total about £14 billion (3 per cent of GDP), compared with a forecast in last year's Budget of £3 billion. Even allowing for the fact that privatisation proceeds are now expected to be some £2 billion higher than forecast a year ago, this means that the fiscal stance has been considerably tighter than planned, reflecting in large part the strength of economic activity which has both boosted tax revenues and depressed public expenditure.



2.28 The long term objective of fiscal policy remains a balanced budget. This provides a clear and simple rule, with a good historical pedigree. It constitutes a firm buttress for monetary policy in the struggle against inflation, while enabling the burden of public debt, and with it debt interest, steadily to diminish as a proportion of the economy as a whole. And it means that as public expenditure declines as a share of GDP, so too can the burden of taxation.

2.29 The Government intends to move gradually from the present surplus towards a balanced budget over the medium term. The PSDR for 1989–90 has been set at £14 billion, the same as in 1988–89. The projected PSDR path thereafter is shown in Table 2.7. As usual, the PSDR to be set in future Budgets will be reviewed in the light of circumstances at the time; as tax rates are set on the basis of medium to longer term objectives the PSDR will tend to be increased by GDP growth above trend, and to be reduced by below trend GDP growth.

Public expenditure

2.30 The Government's objective for expenditure is to maintain a downward trend over the medium term in the ratio of general government expenditure to GDP. Firm control of public expenditure, coupled with the strength of economic activity has caused the ratio of GGE excluding privatisation proceeds to GDP to fall by over 7 percentage points since 1982–83. This is the largest and most sustained fall since the immediate post-war period and it has brought the ratio back to levels not experienced since the mid 1960s. The Government is determined to build on this achievement.

Table 2.3 General government expenditure (excluding privatisation proceeds) as a per cent of money GDP¹

1963–64	36½	1973–74	42½	1983–84	45½
1964–65	35½	1974–75	48	1984–85	46½
1965–66	37½	1975–76	48½	1985–86	44½
1966–67	38½	1976–77	46	1986–87	43½
1967–68	42½	1977–78	42½	1987–88	41½
1968–69	40½	1978–79	43½	1988–89	39½
1969–70	40½	1979–80	43½	1989–90	39½
1970–71	40½	1980–81	46	1990–91	39
1971–72	41	1981–82	46½	1991–92	38½
1972–73	41	1982–83	46½	1992–93	38

¹ 1988–89: latest estimate; 1989–90: forecast; 1990–91 onwards: MTFS projections.

2.31 Projections of government expenditure are shown in Table 2.4. For the period to 1991–92, they incorporate the public expenditure plans shown in the public expenditure White Paper (Cm 601–621); the projections of gross debt interest payments and other adjustments are consistent with the latest economic projections and assumptions. It is provisionally assumed that general government expenditure will grow by 1 per cent in real terms in 1992–93; decisions will be taken in the 1990 Summer.

Table 2.4 General government expenditure¹

	£ billion, cash					
	1987-88	1988-89	1989-90	1990-91	1991-92	1992-93
Public expenditure planning total ²	145.7	151	167	179	192	200
Gross debt interest	17.7	18½	17	15½	14½	14
Other adjustments	8.4	10	10	10½	9½	9½
General government expenditure³	171.9	179	194	205	216	224
Privatisation proceeds	5.1	7	5	5	5	5
General government expenditure excluding privatisation proceeds	177.0	186	199	210	221	229

¹ For 1987-88 to 1991-92, the figures are taken from Table 5.1.

² Existing definition; as proposed in Cm 441, a new definition of the planning total will be introduced in the 1989 Survey.

³ General government expenditure, and its components, are rounded to the nearest £1 billion from 1988-89 onwards; except for debt interest and other adjustments which are rounded to the nearest £½ billion, as in Chapter 5. General government expenditure is assumed to grow by 1% in real terms in 1992-93.

Revenue

2.32 The Government's objectives for taxation are to reduce tax rates and bring down the tax burden. Much progress has been made in reducing rates and reforming the structure of the tax system; and the tax burden has fallen from the peak of 1981-82. The Government's success in bringing down the share of public expenditure has so far been reflected mainly in the emergence of a budget surplus. But moving back towards a balanced budget over the medium term should enable continued public expenditure restraint to be reflected in a gradual fall in the tax burden.

Table 2.5 Non-oil taxes and national insurance contributions as a per cent of non-oil money GDP¹

1963-64	29	1973-74	33½	1983-84	37½
1964-65	29½	1974-75	35½	1984-85	37½
1965-66	31½	1975-76	36½	1985-86	37½
1966-67	32	1976-77	36	1986-87	37½
1967-68	33½	1977-78	35	1987-88	37½
1968-69	35½	1978-79	34½	1988-89	37½
1969-70	36½	1979-80	35	1989-90	37½
1970-71	36½	1980-81	36½	1990-91	36½
1971-72	34½	1981-82	38½	1991-92	36
1972-73	32½	1982-83	38½	1992-93	35½

¹ 1988-89: latest estimate; 1989-90: forecast; 1990-91 onwards: MTFs projections (after fiscal adjustment).

2.33 The growth in government revenues over the medium term will depend on the growth of incomes, spending and prices, as well as on policy decisions. Government revenues from the North Sea are projected to decline relative to money GDP as oil output falls. After taking account of the tax reductions announced in the Budget, non-North Sea revenues are also projected to grow at a little under the rate of growth of non-oil money GDP.

Table 2.6 General government receipts

	£ billion, cash					
	1987-88	1988-89	1989-90	1990-91	1991-92	1992-93
Taxes on incomes, expenditure and capital	132.8	145	157	164	172	179
National insurance and other contributions	29.1	33	34	35	37	39
Interest and dividends	6.2	7	7	7	7	6
Other receipts	5.8	7	8	8	9	9
General government receipts¹	173.8	191	206	214	225	233
of which						
North Sea tax ²	4.7	3	3	3	3	3

¹ General government receipts, and its components, are rounded to the nearest £1 billion from 1988-89 onwards.

² Royalties, petroleum revenue tax (including advance payments) and corporation tax from North Sea oil and gas production (before advance corporation tax set off). This does not correspond exactly to tax receipts in the same financial year in respect of North Sea production.

Public sector borrowing

2.34 The projections of government expenditure receipts are brought together in Table 2.7 to provide projections of the general government borrowing requirement (GGBR), the PSBR and the fiscal adjustment.

2.35 Changes since the 1988 MTFs are discussed in the annex to this chapter.

Table 2.7 Public sector debt repayment¹

	£ billion, cash					
	1987-88	1988-89	1989-90	1990-91	1991-92	1992-93
General government receipts	173.8	191	206	214	225	233
General government expenditure	171.9	179	194	205	216	224
Fiscal adjustment from previous years ²	—	—	—	—	1	3
Annual fiscal adjustment ²	—	—	—	1	2	3
GGDR	2.0	12	12	8	6	3
Public corporations' market and overseas debt repayment	1.5	2	2	2	0	0
PSDR	3.5	14	14	10	6	3
Money GDP at market prices ³	426	472	509	539	571	603
PSDR as per cent of GDP	¾	3	2½	1¾	1	½

¹ Rounded to the nearest £1 billion from 1988-89 onwards. Further details for 1988-89 and 1989-90 are provided in Tables 1.2 and 6.9

² Means lower taxes or higher expenditure than assumed in lines 1 and 2.

³ On the same basis as in Table 2.1.

Conclusion

2.36 This tenth issue of the MTFs has reviewed the greatly improved economic record of the 1980s. It has reaffirmed the Government's commitment to reducing inflation and to the policy of lower taxes and lower public spending as a share of GDP. The MTFs provides the financial framework within which the policies to achieve the Government's objectives are set.

Annex to Chapter 2

Changes since the 1988 MTFS

Money GDP 2A.1 The growth rate of money GDP is expected to be higher in both 1988–89 and 1989–90 than envisaged in last year's MTFS, with growth in the GDP deflator $2\frac{3}{4}$ percentage points higher in 1988–89 and $1\frac{1}{2}$ points higher in 1989–90. Inflation is projected to get back to last year's path by 1991–92. The projected trend in output growth over the medium term in the whole economy is $\frac{1}{4}$ percentage point higher than in last year's MTFS, reflecting a slower decline in oil output.

Table 2A.1 Money GDP growth

Differences from 1988 MTFS projections, percentage points				
1988–89	1989–90	1990–91	1991–92	
+ $3\frac{1}{2}$	+ $1\frac{1}{4}$	0	+ $\frac{1}{2}$	

Monetary aggregates 2A.2 M0 has moved above its target range during 1988–89 but it has been growing more slowly since the autumn. The target range for 1989–90 is the same as the illustrative range given last year. The illustrative ranges for subsequent years are also the same.

Table 2A.2 Growth of M0

	Percentage changes on a year earlier			
	1988–89	1989–90	1990–91	1991–92
1989 MTFS	7	1–5	0–4	0–4
1988 MTFS	1–5	1–5	0–4	0–4

Fiscal projections 2A.3 Table 2A.3 shows changes in the fiscal projections since the 1988 FSBR. Additional information on 1988–89 is given in Chapter 6.

Expenditure 2A.4 The undershoot on the planning total in 1988–89 is described in Chapter 5. The planning totals for 1989–90 onwards are as in the public expenditure White Paper (Cm 601–621), which incorporates higher figures for 1990–91 and 1991–92 than assumed last year. The general government expenditure figures for the future have also been revised up since last year; but to a lesser extent in 1991–92 than the planning total, as the path for the PSDR now assumed implies lower debt interest payments.

Receipts 2A.5 Revenues in 1988–89 have been much higher than forecast, in large part reflecting higher money GDP growth in both 1987–88 and 1988–89. Because there is some lag before changes in money GDP are fully reflected in tax payments, the buoyancy of the economy over the last year will still be contributing to the growth of revenues in 1989–90. In spite of the effect of the Piper Alpha and other accidents on oil output, North Sea revenues in 1988–89 were almost exactly as forecast. The projections of North Sea revenues for later years are little changed from the 1988 MTFS

Table 2A.3 Revenue and expenditure¹

	Changes from 1988 MTFS projections, £ billion				
	1987–88	1988–89	1989–90	1990–91	1991–92
<i>Expenditure</i>					
1 Planning total	– $\frac{1}{2}$	– 6	0	+ $3\frac{1}{2}$	+ $7\frac{1}{2}$
2 Other ²	+ $\frac{1}{2}$	+ $2\frac{1}{2}$	+ $1\frac{1}{2}$	0	– 1
3 General government expenditure	0	– 4	+ $1\frac{1}{2}$	+ $3\frac{1}{2}$	+ $6\frac{1}{2}$
<i>Receipts³</i>					
4 North Sea taxes	0	0	0	0	+ $\frac{1}{2}$
5 Other taxes and contributions	+ 1	+ $4\frac{1}{2}$	+ $7\frac{1}{2}$	+ $5\frac{1}{2}$	+ $6\frac{1}{2}$
6 Other ²	– 1	+ $1\frac{1}{2}$	+ 3	+ $3\frac{1}{2}$	+ 4
7 General government receipts	0	+ 6	+ 11	+ 9	+ $10\frac{1}{2}$
8 Implied cumulative fiscal adjustment ⁴	—	—	– $3\frac{1}{2}$	– $3\frac{1}{2}$	– $2\frac{1}{2}$
9 Public corporations' market and overseas debt repayment	+ $\frac{1}{2}$	+ 1	+ $\frac{1}{2}$	+ 1	– $\frac{1}{2}$
10 PSDR	+ $\frac{1}{2}$	+ $10\frac{1}{2}$	+ 14	+ 10	+ 6

¹ Rounded to the nearest £ $\frac{1}{2}$ billion. The above changes include the effect of classification changes made since the 1988 FSBR. Within expenditure they are largely offsetting. In 1987–88 classification changes reduce receipts by £0.2 billion.

² Includes changes in debt interest and other items.

³ The allocation of tax receipts between North Sea and other is affected by the treatment of advance corporation tax set off.

⁴ Line 8 = lines 9–10–3+7.

3 The economy: recent developments and prospects to mid-1990

Summary

3.01 GDP is forecast to grow by $2\frac{1}{2}$ per cent in 1989; this is below the average of recent years and comes after two years of above average growth. RPI inflation should fall to $5\frac{1}{2}$ per cent by the end of the year.

Demand and activity 3.02 GDP is estimated to have risen by $4\frac{1}{2}$ per cent in 1988. Domestic demand rose by $6\frac{1}{2}$ per cent, with investment rising by 12 per cent and consumption by $6\frac{1}{2}$ per cent. Business investment is forecast to continue to grow strongly this year, and consumer spending to slow sharply. For 1989 as a whole total domestic demand is forecast to rise by $2\frac{1}{2}$ per cent. GDP growth in 1989 is forecast at $2\frac{1}{2}$ per cent (3 per cent for non-oil GDP), with growth through the year at 2 per cent.

Inflation 3.03 Retail prices rose by $6\frac{1}{2}$ per cent in the year to the fourth quarter of 1988. RPI inflation is forecast to fall to $5\frac{1}{2}$ per cent by the fourth quarter of this year and to $4\frac{1}{2}$ per cent by the middle of 1990.

Labour market 3.04 Employment has risen sharply over the past year to an all time high. Unemployment fell by 530,000 in the year to January, but is most unlikely to continue falling at the same rapid rate in 1989.

World economy 3.05 GNP growth in the main industrial economies was about 4 per cent last year; it is forecast to ease to 3 per cent in 1989. World trade in manufactures rose by 10 per cent in 1988, and is forecast to rise a further 8 per cent this year.

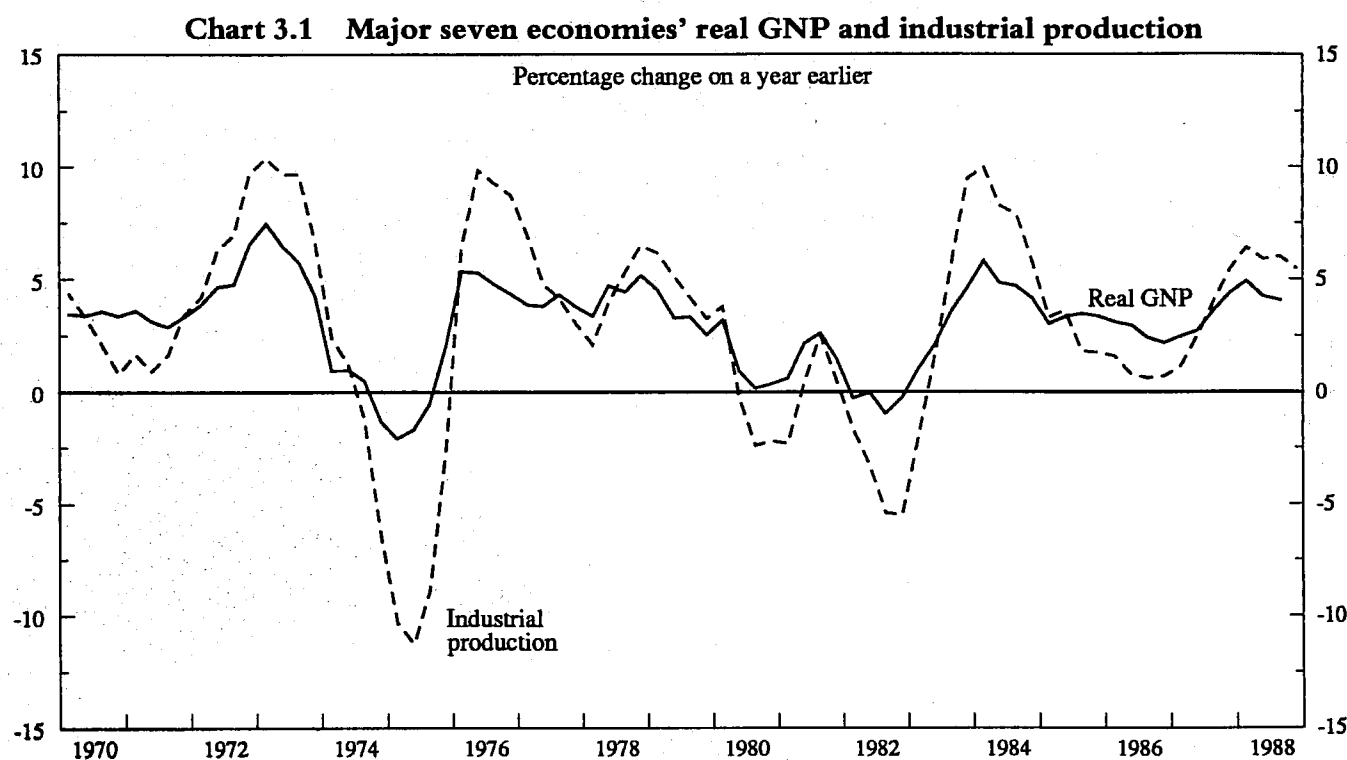
UK trade and current account 3.06 After a sluggish start in early 1988 export volumes of manufactures picked up quickly; in the second half of 1988 they were 5 per cent higher than a year earlier. Import volumes rose even more rapidly, boosted by strong domestic demand, especially business investment. The current account moved into large deficit in 1988; it is forecast to show a deficit in 1989 similar to that in 1988, and to fall thereafter.

Assumptions 3.07 The forecast assumes that fiscal and monetary policy are operated within the framework of the Medium Term Financial Strategy. It assumes that North Sea oil prices and the exchange rate remain close to recent levels.

There have been major inconsistencies in the recorded national and sectoral accounts. For its assessment of recent developments the Treasury has used the latest CSO data, which incorporate some substantial revisions to previous published estimates. The annex to this chapter assesses the latest data. The CSO will publish a full set of national accounts on March 17, which will include some description of these revisions.

World economy

Recent developments 3.08 Real GNP in the major seven economies is estimated to have grown by 4 per cent in 1988, compared with 3½ per cent in the previous year and an average growth of 3½ per cent a year from 1982 to 1987. Domestic demand grew at about the same rate as GNP in 1988. Growth was particularly strong in Japan and the US in the first half of the year.



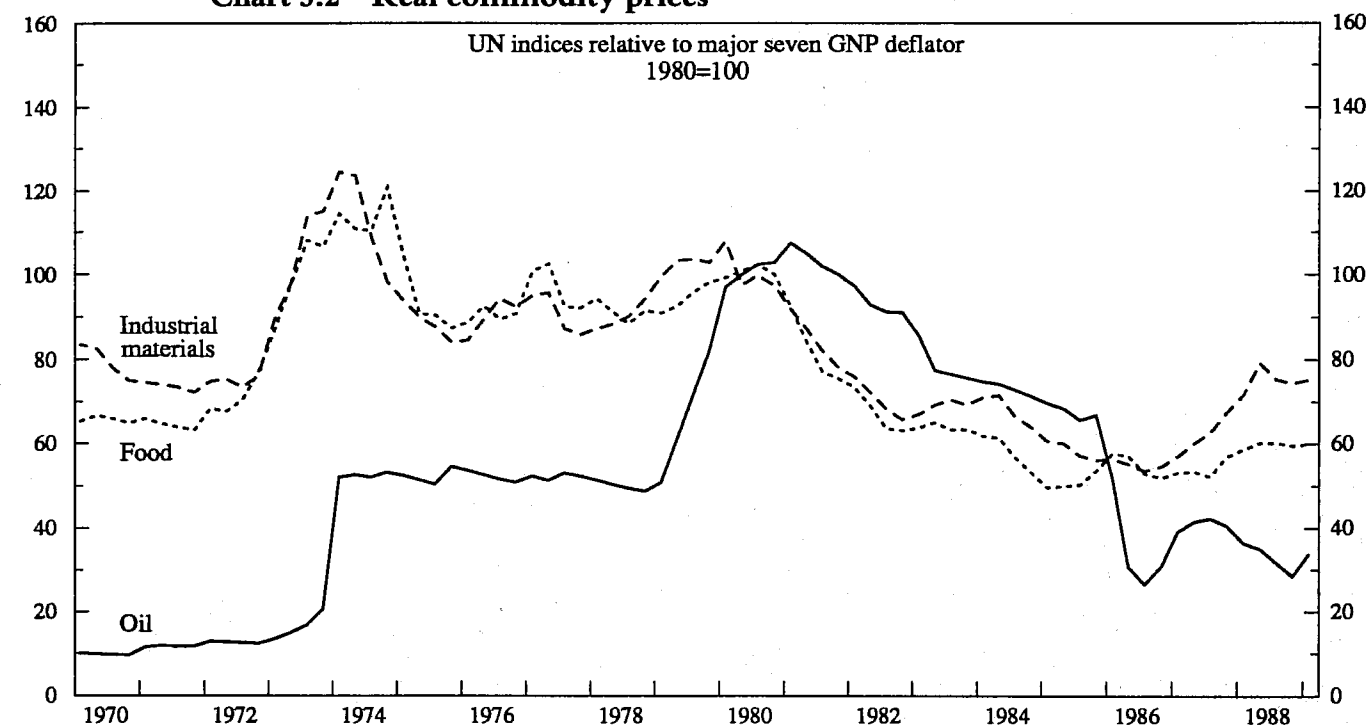
3.09 Business investment grew rapidly in all the major seven countries in 1988 (averaging almost 12 per cent); and export growth was also strong (over 9 per cent). Investment was boosted by rising profitability, increased capacity utilisation and high levels of business confidence. Growth in private consumption was about 3½ per cent, little changed on 1987.

3.10 World trade in manufactures was boosted in 1988 by high investment, and probably grew by around 10 per cent, the fastest annual growth rate since 1984.

3.11 Capacity utilisation in manufacturing rose strongly in 1988, to levels at or above the previous peaks reached in 1979 and 1980. Unemployment fell significantly in North America and the UK.

3.12 Non-oil commodity prices, particularly of industrial materials and metals, rose sharply in the first half of 1988. After significant falls from the mid-year peak they have risen again in recent months. Oil prices drifted downward for much of 1988 but have firmed since November.

Chart 3.2 Real commodity prices



3.13 In the fourth quarter of 1988 consumer price inflation averaged 3½ per cent in the major industrial countries, slightly higher than a year earlier. But there have been some recent indications of increased inflationary pressures. Interest rates have risen since the spring of last year in all major seven economies except Japan. For major countries as a whole the average increase was about 2 percentage points.

3.14 Continued progress in reducing current account imbalances was made in early 1988, with significant reductions in both the US deficit and Japanese surplus. But little or no further progress was made in the second half of the year.

Forecast 3.15 Table 3.1 shows the forecast for activity and inflation in the major seven countries, and for world trade.

Table 3.1 World economy

	Percentage changes on previous year			
	1987	Estimate 1988	Forecasts 1989	1990 H1
<i>Major seven countries¹</i>				
Real GNP	3½	4	3	2½
Real domestic demand	4	4½	3	2½
Industrial production	3½	6	4½	2½
Consumer prices	3	3½	4½	3½
<i>World trade, at constant prices</i>				
Total imports	5½	8½	6	5
Trade in manufactures	7½	10	8	5½

3.16 GNP growth is expected to slow through 1989 as the investment cycle passes its peak and as the effects of tighter monetary policy work through. The forecast growth of 3 per cent is close to estimates of productive potential. The slowdown is expected to be more marked in North America than in Continental Europe.

3.17 Growth of world trade in manufactures is expected to slow to about $5\frac{1}{2}$ per cent by mid-1990, still above the trend rate for the period 1973 to 1987.

3.18 The forecast slowdown in world economic growth suggests that recent commodity price inflation should abate; commodity prices are forecast to remain constant in real terms. With world demand slowing, consumer price inflation in the major seven economies is forecast to fall back from $4\frac{1}{4}$ per cent in 1989 to about $3\frac{3}{4}$ per cent by mid-1990.

3.19 Little further progress is expected in reducing the current account imbalances in nominal terms in 1989.

UK trade and the balance of payments

Relative costs and prices **3.20** UK manufacturing unit labour costs rose by $2\frac{1}{2}$ per cent in 1988, a little more than in 1987; productivity growth did not fully offset a continuing high level of pay increases. Unit labour costs in the other major countries fell slightly on average. This, together with sterling's appreciation, resulted in a rise in the UK's relative unit labour costs. But cost competitiveness still remains more favourable than in 1985, before the fall in world oil prices. The maintenance of competitiveness in the year ahead will depend on success in restraining unit cost increases.

Table 3.2 The exchange rate and cost competitiveness

	Sterling index (1985 = 100)	Relative unit labour costs (1985 = 100)
1985 Q4	101.4	104.0
1986 Q4	85.1	83.2
1987 Q4	92.7	93.6
1988 Q4	96.7	98.3

Trade volumes (goods other than oil) **3.21** After erratically low figures in the first quarter of 1988, the volume of UK manufactured exports has since risen strongly as world trade has continued to expand. In the second half of 1988 the volume of exports of manufactures was 5 per cent higher than a year earlier. Manufactured export volumes are forecast to rise by $7\frac{1}{2}$ per cent in 1989, close to the projected growth of world trade. A slightly faster rate of growth is forecast for non-manufactured exports.

Chart 3.3 UK share of world trade in manufactures

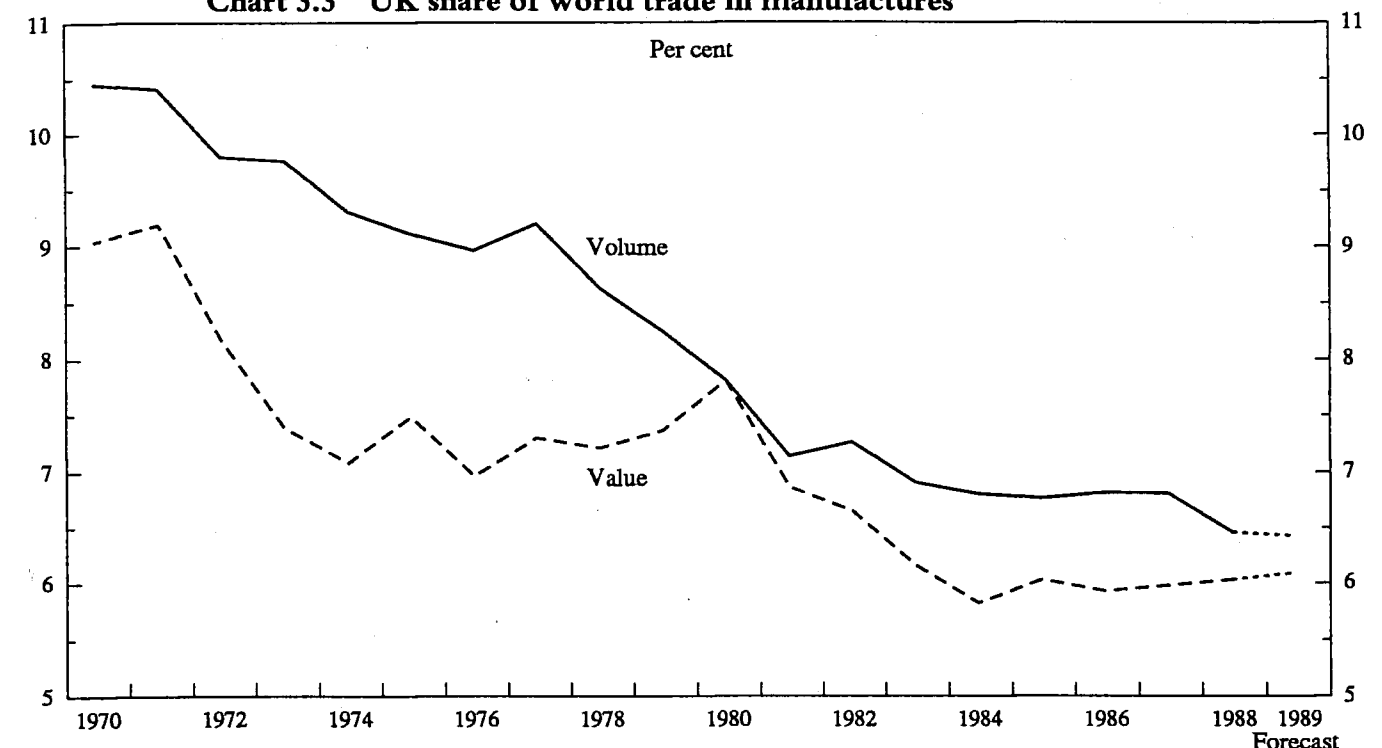


Table 3.3 Visible trade

	Percentage changes on previous year					
	All goods			Goods less oil		
	Export volume	Import volume	Terms of trade ¹	Export volume	Import volume	Terms of trade ¹
1987	5	7	1	$6\frac{1}{2}$	8	1
1988	$-\frac{1}{2}$	13	2	3	$14\frac{1}{2}$	$2\frac{1}{2}$
1989 Forecast	$5\frac{1}{2}$	$5\frac{1}{2}$	$1\frac{1}{2}$	$7\frac{1}{2}$	$4\frac{1}{2}$	$-\frac{1}{2}$

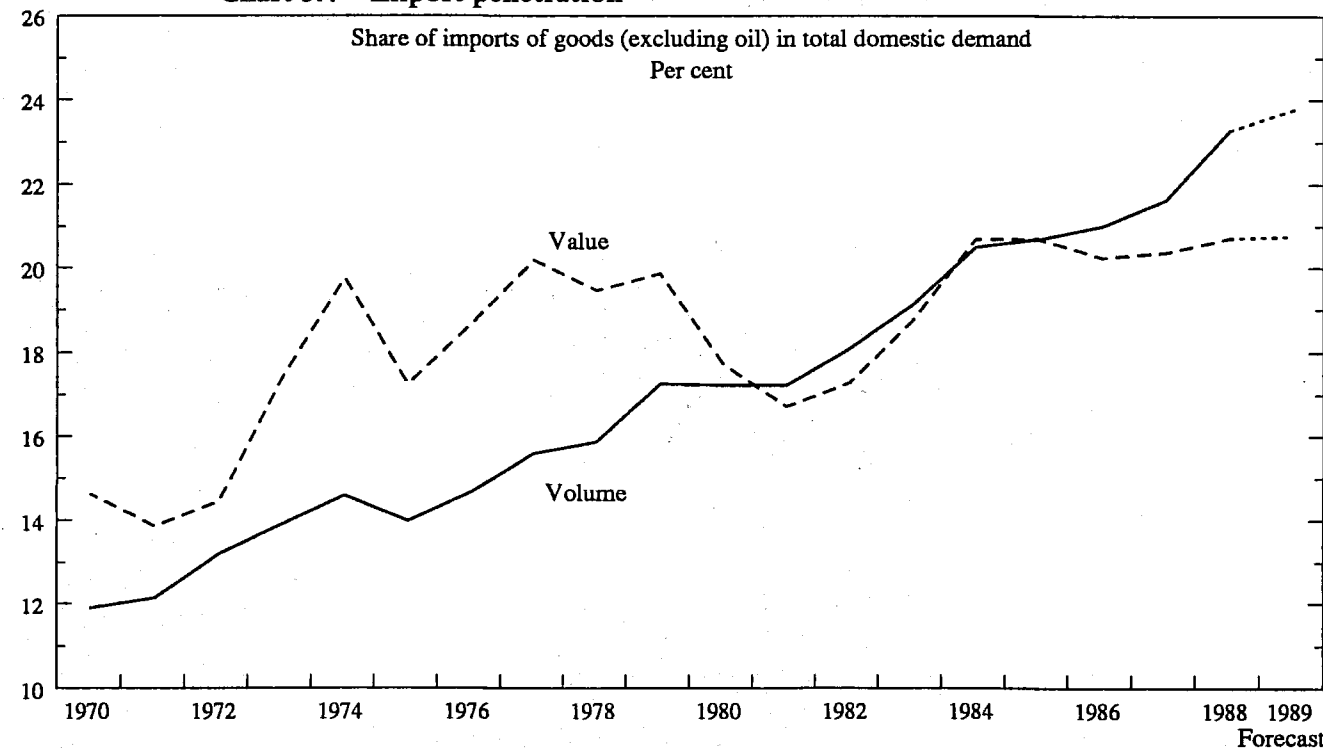
¹ Ratio of export average values to import average values.

3.22 The rise in non-oil imports, by $14\frac{1}{2}$ per cent in 1988, was much faster than that of exports, reflecting the strength of domestic demand and capacity shortages in some industries. Imports of capital and intermediate goods rose fastest; the increase in the growth of imports of consumer goods in 1988 was entirely attributable to passenger cars. Further high investment is likely to sustain continued high levels of capital goods imports in 1989. Nonetheless the slowdown in overall domestic demand and the extra capacity available from the current investment boom means that import growth is forecast to slow significantly in 1989, to around 5 per cent.

Table 3.4 Growth of import volumes by category of manufactured goods

	Percentage changes on previous year		
	1986	1987	1988
Consumer goods	9	7	17
Capital goods	-1	$10\frac{1}{2}$	22
Intermediate goods	9	13	23
Semi-manufactured goods	6	10	12

Chart 3.4 Import penetration



Oil trade 3.23 The oil trade surplus fell by just under £2 billion in 1988, to £2½ billion. This was a result of lower oil prices, a decline in production (mainly due to the Piper Alpha disaster), and increased domestic demand for oil. The temporary shutdowns in the Brent and Fulmar fields are expected to contribute to a further fall in production in 1989. Production is forecast to rise a little from mid-1989 as output recovers from the effects of the accidents. The oil trade surplus is forecast to fall again in 1989 to £2 billion, mainly as a result of the fall in production in the first half of the year.

Trade prices and the terms of trade 3.24 The terms of trade have improved somewhat over the past year, with the higher exchange rate more than offsetting the effects of falling oil prices. No significant change is forecast in the non-oil terms of trade this year, although the oil terms of trade may improve considerably, since the temporary shortage of North Sea quality crude, following the various accidents, is likely to raise its premium over other crudes.

Invisibles 3.25 The surplus on invisibles is provisionally estimated to have fallen by £1½ billion to £6 billion in 1988. This was mainly due to a decline in the surplus on services, offset to some extent by higher net receipts of interest, profits and dividends (IPD). The invisibles surplus is forecast to be £7 billion in 1989 as projected improvements in the services and IPD balances are partly offset by increased net transfers overseas, largely the result of higher net contributions to the European Community budget.

Current account 3.26 The current account is estimated to have been in deficit by £14½ billion in 1988. However, the deficit may be overstated to some extent given the magnitude of the balancing item. (The balancing item is the difference between the balances on the current and capital accounts.) The deterioration relative to the forecast in last year's FSBR was mainly due to the unexpected strength of domestic demand, particularly investment, combined with very high levels of capacity utilisation in some industries.

Table 3.5 Current account

	£ billion					Balancing item
	Manufactures	Other	Oil	Invisibles	Current balance	
1987	-7½	-7	4	7½	-3	12½
1988	-14½	-8½	2½	6	-14½	15
1989 forecast	-15½	-8	2	7	-14½	

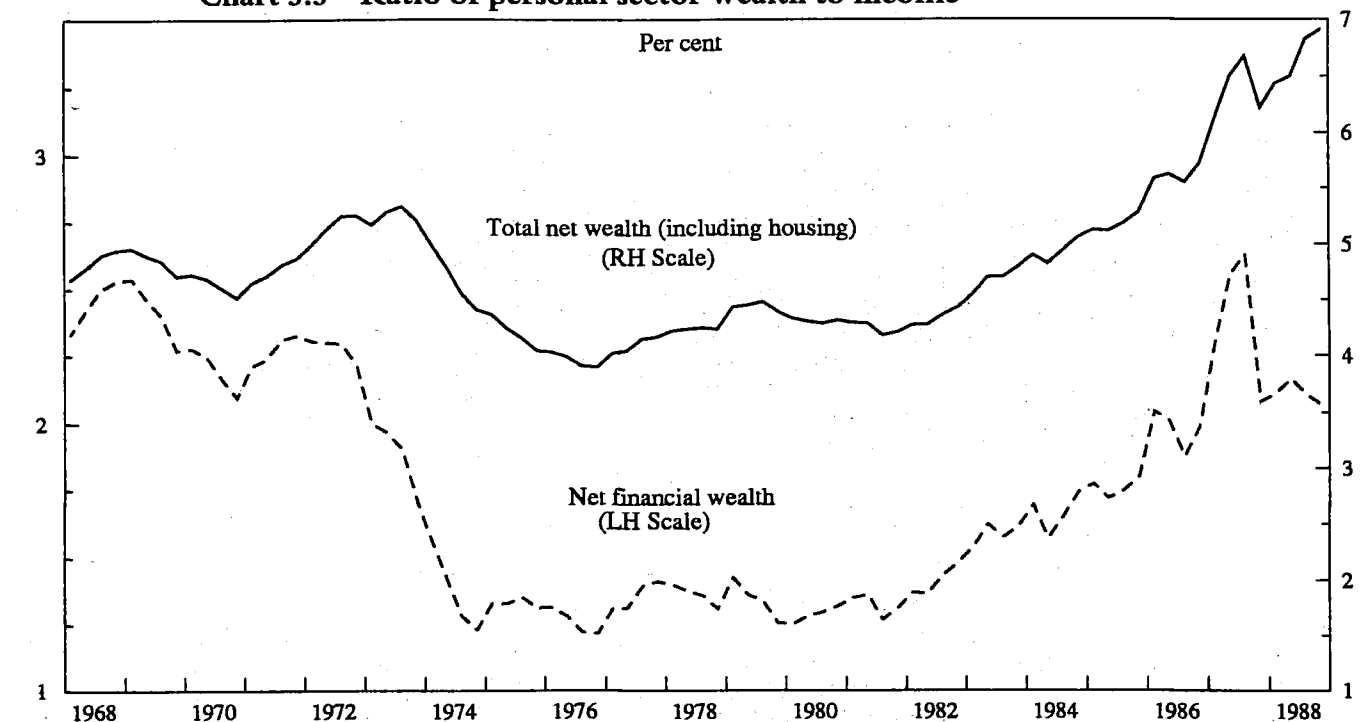
3.27 Though the current account deficit is expected to fall from recent levels with the slowdown in growth of domestic demand, the recorded deficit for 1989 as a whole is forecast to be unchanged.

Demand and Activity

3.28 The economy probably grew by 4½ per cent in 1988. Growth was strong throughout the non-oil economy; manufacturing output rose by 7 per cent, construction output by 7 per cent and output of the service industries by 5 per cent. Problems with recent estimates of the expenditure measure of GDP mean that recorded growth in domestic demand in 1988, at 6½ per cent, may be an underestimate.

Personal sector expenditure 3.29 Consumer spending is estimated to have risen by 6½ per cent in 1988, a little faster than in 1987, and the personal sector saving ratio once again fell. The fall in the personal sector saving ratio in recent years is probably due to a number of factors. First, there has undoubtedly been greater consumer confidence as a result of sustained growth, falling unemployment and rising wealth. Second, greater wealth itself (especially housing wealth) has led to a perceived need for lower savings relative to income. Finally, financial deregulation and innovation has led to greater competition in credit markets, enabling people to borrow more relative to income.

Chart 3.5 Ratio of personal sector wealth to income



3.30 Consumer spending is forecast to rise much more slowly this year than last, growing by 2 per cent between the second half of 1988 and the second half of 1989. The slowdown in retail spending growth in recent months indicates that personal spending is already moderating. The household sector is now a substantial net payer of interest. Higher interest rates are likely to reduce new borrowing and increase saving. The personal sector saving ratio is forecast to recover slowly.

3.31 The housing market was particularly buoyant in the first half of 1988. But there are now clear signs that it is easing. Building society mortgage lending commitments have fallen markedly from the high levels of last summer, and there is increasing evidence that house prices in the South East have stopped rising. House price inflation is likely to be very low through 1989, and total private housing investment is expected to decline.

Company expenditure and incomes

3.32 Business investment rose sharply in 1988, by 14½ per cent. A strong surge in investment is consistent with expectations outlined in CBI Surveys and DTI Investment Intentions Surveys. The same surveys point to further strong growth in 1989. Over the past 7 years total investment has grown over twice as fast as total consumption.

Table 3.6 Gross domestic fixed capital formation

	Weights in 1987	Percentage changes on previous year	
		1988	Forecast 1989
Business ^{1,3}	66	14½	8
Private dwellings etc ²	21	11	-5½
General government ³	13	1	3
Total fixed investment	100	12	4½

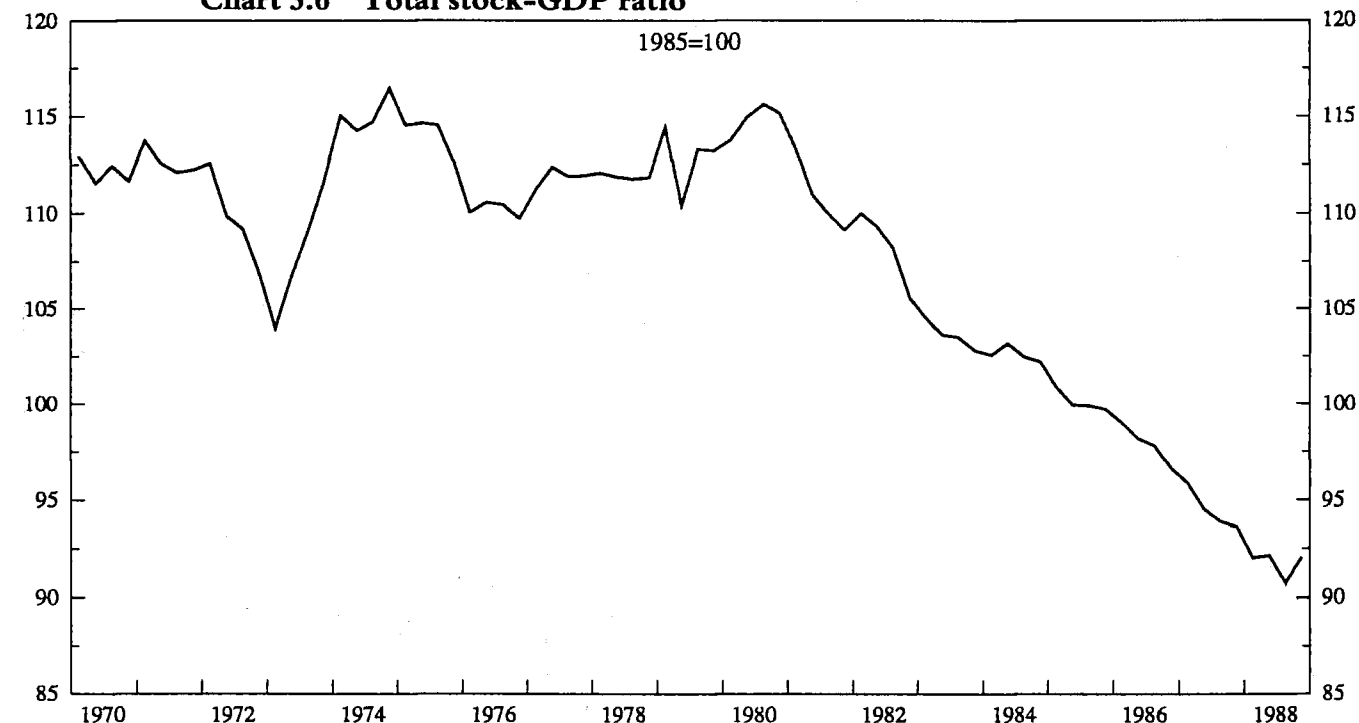
¹includes investment by public corporations;

²includes purchases less sales of land and existing buildings for the whole economy;

³excludes purchases less sales of land and existing buildings.

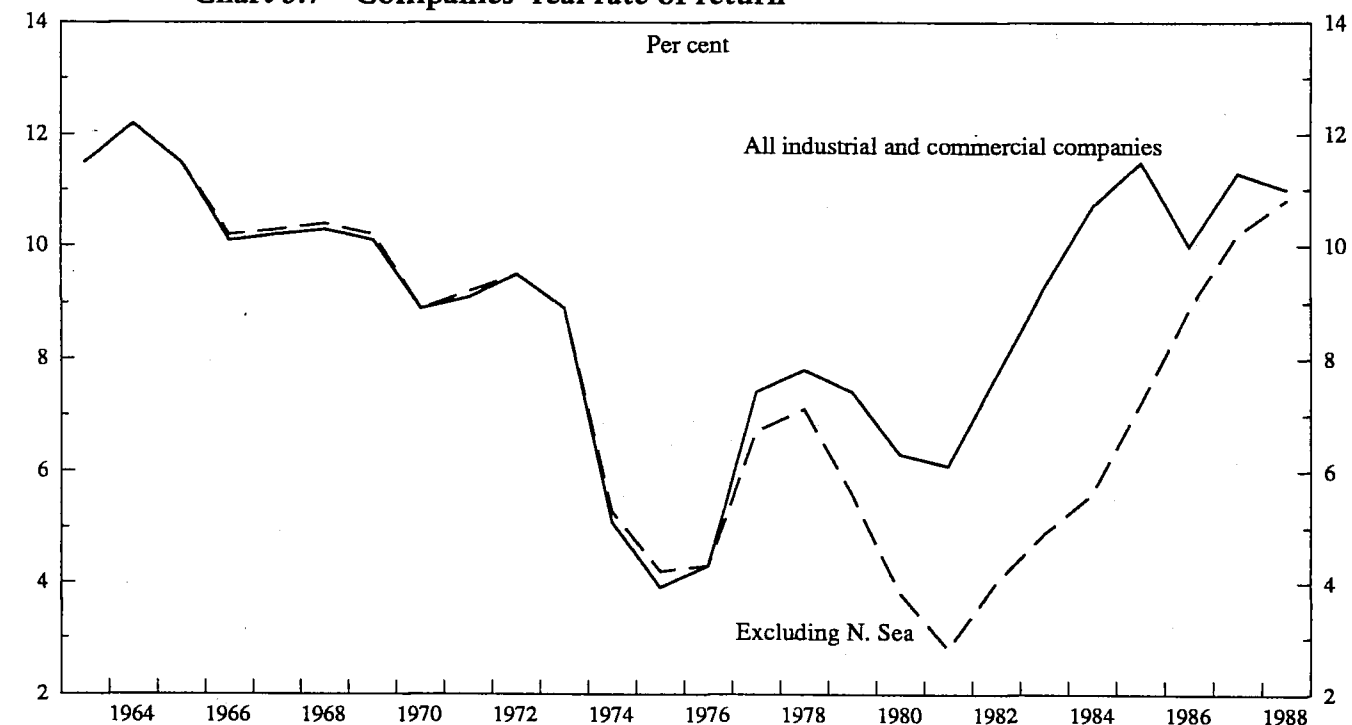
3.33 Stockbuilding is estimated to have been greater in the second half of 1988 than in the first half. But it is likely to be lower in 1989, with some destocking in the second half, as the growth of domestic demand slows down. The long run downward trend in the total stock-GDP ratio is expected to continue.

Chart 3.6 Total stock-GDP ratio



3.34 Non-North Sea industrial and commercial company sector profits (net of stock appreciation) are estimated to have risen by about 20 per cent in 1988; since 1984 profits have risen on average by 22 per cent a year. In 1988, the rate of return of non-North Sea industrial and commercial companies rose for the seventh successive year. Manufacturing profit margins rose strongly.

Chart 3.7 Companies' real rate of return



Saving and investment 3.35 Table 3.7 shows that, as a share of GDP, total saving has remained unchanged since 1986, with rising company and public sector saving offsetting falling personal sector saving.

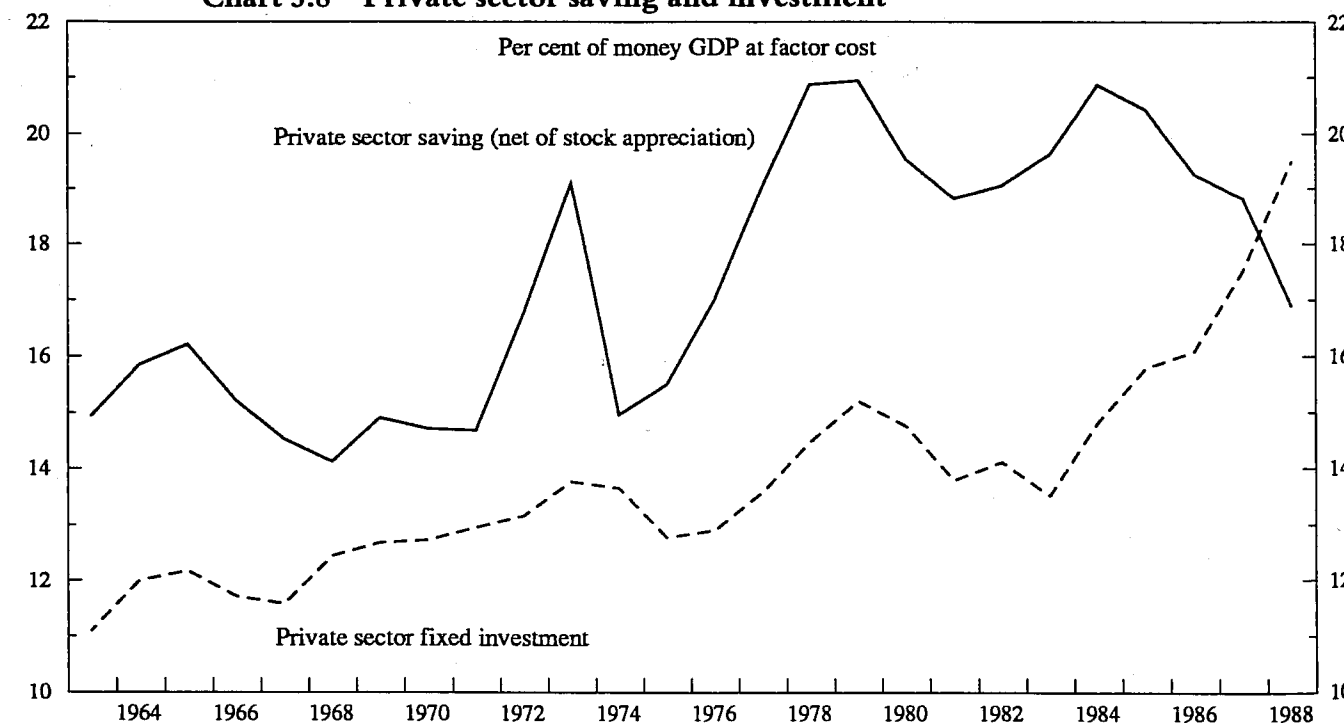
Table 3.7 Saving¹

	Per cent of GDP at factor cost				
	Personal sector	Company sector	Total private	Public sector	Total national
1985	7.5	12.9	20.4	1.0	21.4
1986	5.6	13.6	19.2	1.3	20.6
1987	3.6	15.2	18.8	1.6	20.4
1988	1.6	15.3	16.9	3.7	20.6

¹ Published CSO data to 1988Q3.

3.36 The fall in private sector saving since 1985 has come at the same time as a steep rise in private sector investment. The result has been an increased call on overseas savings and hence a current account deficit.

Chart 3.8 Private sector saving and investment



Prospects for demand and activity

3.37 Growth of domestic demand is forecast to fall sharply from a recorded 6½ per cent in 1988 to 2½ per cent in 1989, because of the slowdown in consumption and investment growth and some destocking. Domestic demand is forecast to rise by only 1½ per cent between the second halves of 1988 and 1989. GDP is forecast to rise by 2½ per cent in 1989, and 2 per cent between the second half of 1988 and the second half of 1989. Declining

North Sea production and the temporary effects of recent accidents may reduce GDP growth by ½ per cent in 1989, but the recovery from these accidents is forecast to produce higher growth of total GDP than of non-oil GDP in the year to the first half of 1990. Manufacturing output is forecast to grow slightly less than non-oil GDP through 1989, following two years of very rapid growth in 1987 and 1988.

Table 3.8 Domestic demand and GDP

	Percentage changes on a year earlier		
	1988	Forecast 1989	1990 H1
Domestic demand	6½	2½	1½
Exports of goods and services ¹	-1 (1½)	4½ (6)	7 (6)
Imports of goods and services ¹	12 (13½)	4½ (4)	3 (3)
GDP ^{1,2}	4½ (5)	2½ (3)	2½ (2)
Manufacturing production	7	3½	1½

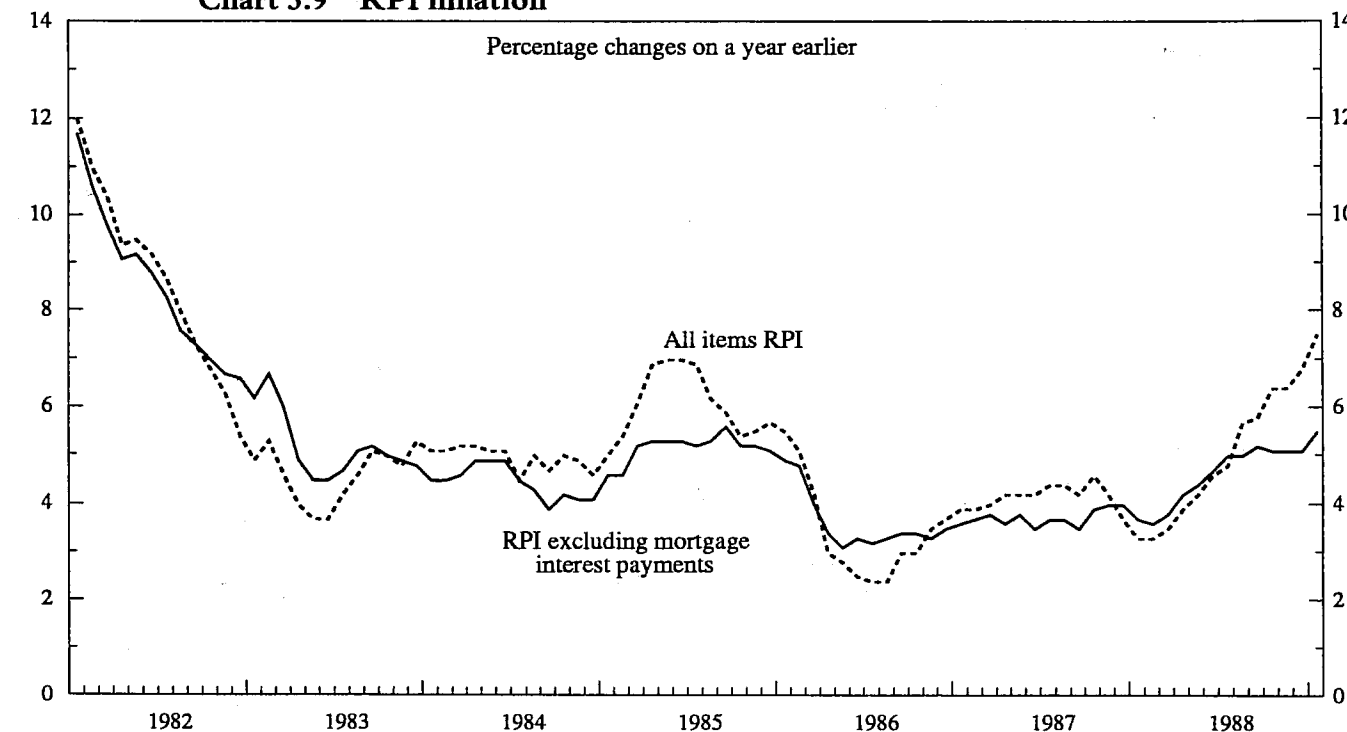
¹ Non-oil shown in brackets.

² Compromise measure.

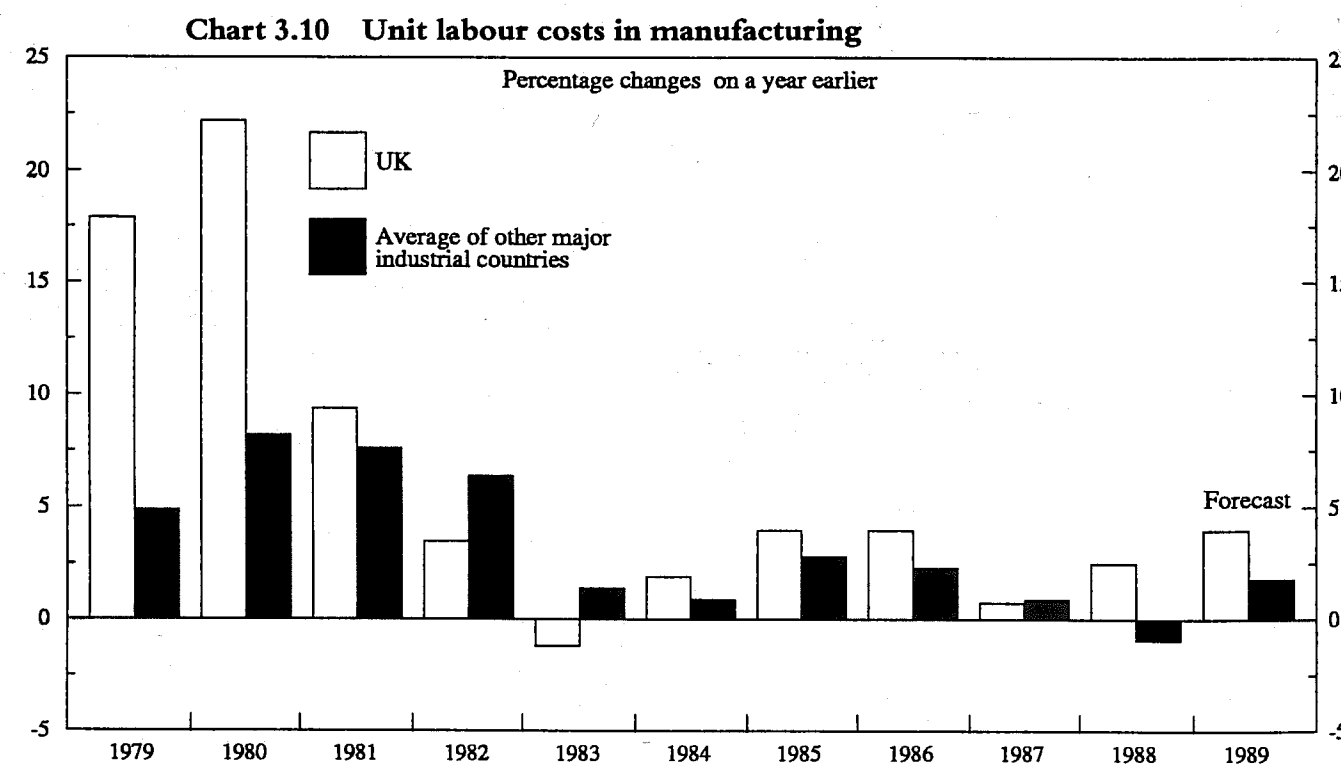
Inflation

3.38 The annual rate of retail price inflation was 6½ per cent in the fourth quarter of 1988, a little higher than forecast in the Autumn Statement. Excluding mortgage interest payments, RPI inflation was 5 per cent.

Chart 3.9 RPI inflation



3.39 According to CBI data, pay settlements in manufacturing are estimated to have risen to just under 7 per cent in the fourth quarter of 1988, about 1 per cent higher than a year earlier, with service sector settlements slightly higher. Average earnings rose by $8\frac{3}{4}$ per cent in the year to December, with earnings in manufacturing boosted by continued high overtime. Unit labour costs in manufacturing are estimated to have risen by $2\frac{1}{2}$ per cent in 1988. UK manufacturing industry's profit margins increased significantly again in 1988, for the sixth year running. Margins are unlikely to continue to grow during 1989, given the forecast deceleration in domestic demand and activity.

**Table 3.9 Costs in manufacturing**

	Percentage changes on previous year			
	Unit labour costs	Cost of materials and fuel ¹	Estimated total unit costs ²	Output prices ¹
1987	$\frac{3}{4}$	5	$1\frac{3}{4}$	$4\frac{1}{4}$
1988 Partly forecast	$2\frac{1}{2}$	$4\frac{3}{4}$	$2\frac{1}{4}$	$4\frac{3}{4}$
1989 Forecast	4	$5\frac{1}{4}$	$4\frac{1}{4}$	$5\frac{1}{2}$

¹ Producer prices excluding food, drink and tobacco industries.² Including costs of bought-in goods services.

3.40 Retail price inflation is likely to moderate to $5\frac{1}{2}$ per cent by the final quarter of 1989 as the effects of past increases in mortgage interest rates start to drop out and as retailers' profit margins are squeezed following the deceleration in consumer demand.

Table 3.10 Retail prices index

	Weight in 1988	Percentage changes on previous year		
		1988Q4	Forecasts 1989Q4	1990Q2
Food	$16\frac{1}{4}$	4	$4\frac{1}{4}$	4
Nationalised industries	$5\frac{1}{2}$	$7\frac{1}{2}$	7	6
Housing	$15\frac{1}{4}$	$16\frac{1}{2}$	$10\frac{1}{2}$	$3\frac{3}{4}$
Other	63	$4\frac{3}{4}$	$4\frac{1}{2}$	$4\frac{1}{2}$
Total	100	$6\frac{1}{2}$	$5\frac{1}{2}$	$4\frac{1}{2}$

3.41 The GDP deflator, which measures the price of domestic value added (principally unit labour costs and profits per unit of output), is forecast to have risen by $7\frac{1}{4}$ per cent in 1988–89 and to rise by $5\frac{1}{2}$ per cent in 1989–90. The rise in the GDP deflator in 1988–89 has been boosted by changes in the composition of GDP.

Productivity and the labour market

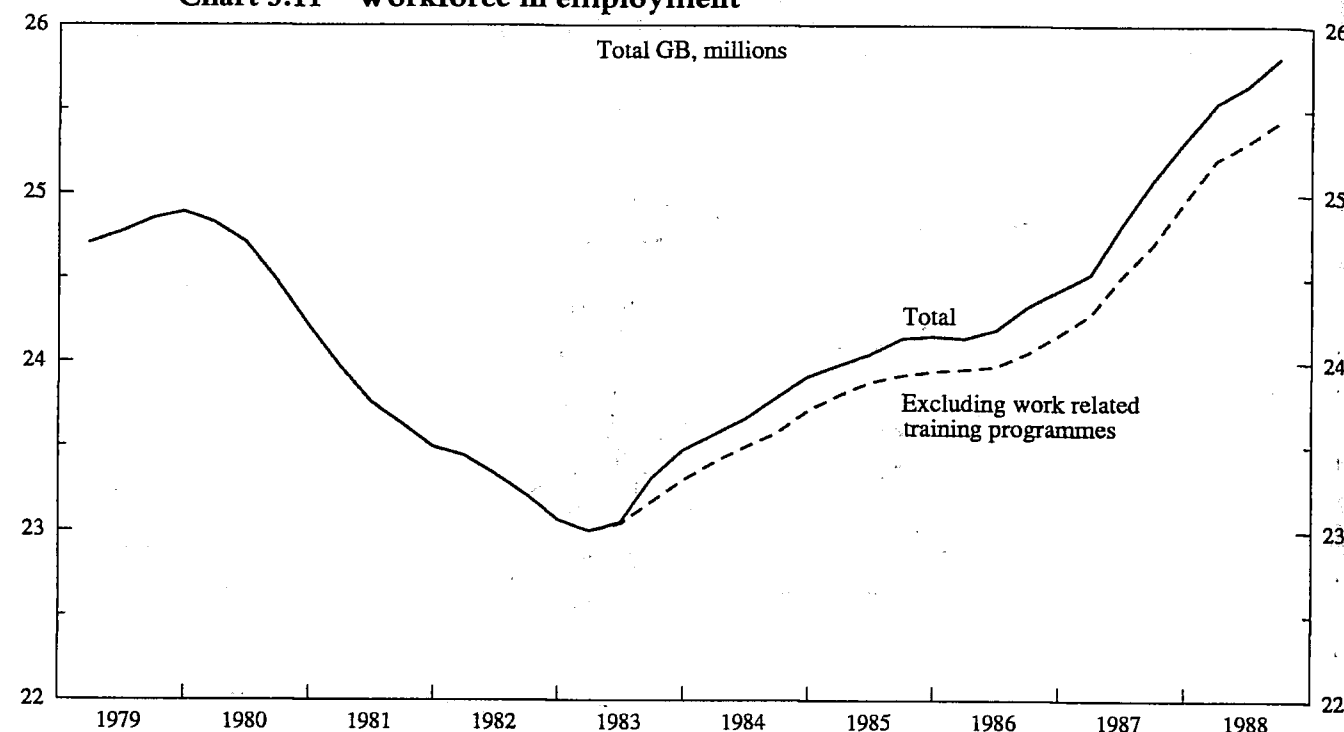
3.42 Latest estimates show that the workforce in employment including those on training programmes rose by 1.5 million in the two years to September 1988 and 2.8 million since March 1983. Excluding those on training programmes, the increase was 1.4 million in the two years to September 1988 and 2.4 million since March 1983.

Table 3.11 Changes in employment

	Thousands, seasonally adjusted, GB				
	Employees in employment		Self-employed	HM forces	Workforce in employment
	Male	Female			
September 1985 to September 1986	-82	+148	+71	-3	+188
September 1986 to September 1987	+145	+307	+207	-4	+754
September 1987 to September 1988	+245	+362	+125 ¹	-4	+731

¹ Figures for self-employment after June 1988 are projections based on self-employment growth since 1981.

Chart 3.11 Workforce in employment



3.43 Productivity continued to rise strongly in 1988. Manufacturing productivity has risen on average by $5\frac{1}{4}$ per cent a year since 1980, higher even than in the 1960s. Output per head in manufacturing industry has risen faster in the 1980s than in any other major industrialised economy and whole economy productivity growth has been second only to Japan's.

Table 3.12 Output per head of the employed labour force

	Annual average percentage changes		
	1960-70	1970-80	1980-88
Manufacturing	3	$1\frac{1}{2}$	$5\frac{1}{4}$
Non-oil economy	$2\frac{1}{2}$	1	$2\frac{1}{4}$ *
Whole economy	$2\frac{1}{2}$	$1\frac{1}{4}$	$2\frac{1}{2}$ *

* Partly forecast

Unemployment **3.44** By January 1988, seasonally adjusted unemployment in the UK had fallen for 30 successive months, by over a million in total. This is the longest and largest sustained fall in unemployment since the war. The fall in unemployment over the past year is mainly attributable to the strong growth of output and employment.

Forecast and Outturn

3.45 Table 3.13 compares the main elements of the forecast published in the 1988 FSBR with the outturn or latest estimate.

Table 3.13 Forecast and outturn

	1988 FSBR forecast	Outturn or latest estimate	Average errors from past forecasts
GDP (percentage change between 1987 and 1988)	3	$4\frac{1}{2}$ *	1
RPI (percentage change between the fourth quarters of 1987 and 1988)	4	$6\frac{1}{2}$	1
Money GDP (percentage change between 1987-88 and 1988-89)	$7\frac{1}{2}$	11	$1\frac{1}{2}$
Current account of the balance of payments (1988, £ billion)	-4	-14 $\frac{1}{2}$	3
PSDR (1988-89 £ billion)	3	14	4

* Compromise measure of GDP.

3.46 Recorded RPI inflation in the fourth quarter of 1988 was higher than forecast a year ago mainly because of increases in interest rates in the second half of the year. The latest national accounts show that real and money GDP growth were both stronger than forecast: the extent of the forecast error could alter with revisions to data. The current account deficit was also larger than forecast, mainly because of the continued buoyancy of domestic demand, especially business investment, and associated capacity constraints in some sectors. The PSDR is likely to turn out substantially higher than forecast a year ago, reflecting lower government expenditure than projected and greater buoyancy of tax revenues arising from faster than expected growth.

3.47 Table 3.14 summarises this year's forecast, and shows average errors from past forecasts. The inconsistencies in the recorded data for 1988 mean that there is probably a wider error margin than usual around the forecasts.

Table 3.14 Economic prospects: summary

Percentage changes on previous year unless otherwise stated				
	Forecast			Average errors from past forecasts ¹
	1988	1989	1990 H1	
GDP and domestic demand at constant prices				
Domestic demand	6½	2½	1½	1
of which:				
Consumers' expenditure	6½	3½	2	1
General government consumption	½	½	1	1
Fixed investment	12	4½	3	3
Change in stockbuilding (as per cent of GDP)	½	-½	-½	½
Exports of goods and services	-1	4½	7	2
Imports of goods and services	12	4½	3	2½
Gross domestic product (compromise measure)	4½	2½	2½	1
Manufacturing output	7	3½	1½	1½
Balance of payments current account (£ billion)	-14½	-14½	-12½	3½
Inflation				
Retail price index (Q4 on Q4)	6½	5½	4½	1
GDP deflator at market prices (financial year) ⁴	7½	5½		1
Money GDP at market prices (financial year)⁴				
£ billion	11	7½		1½
	472	509		
PSDR (financial year)				
£ billion	14	14		4½
per cent of GDP	3	2½		¾

¹ The errors relate to the average differences (on either side of the central figure) between FSBR forecasts and outcome over the last ten years, and apply to the forecasts for 1989.

² At an annual rate

³ Q2 on Q2.

⁴ On the same basis as in Table 2.1, partly forecast.

Table 3.15 Gross domestic product and its components¹

£ billion at 1985 prices, seasonally adjusted											
	Consumers' expenditure	General government consumption	Total fixed investment	Exports of goods and services	Change in stocks	Total final expenditure	Less imports of goods and services	Less adjustment to factor cost	Plus compromise adjustment	GDP at factor cost (compromise measure)	GDP index 1985 = 100
1984	207.9	73.9	58.1	97.0	1.1	438.0	96.7	48.5	1.2	294.0	96.4
1985	215.5	74.0	60.3	102.8	0.6	453.1	99.2	49.5	0.5	304.9	100.0
1986	227.8	75.4	61.3	106.6	0.7	471.7	105.5	51.9	-0.4	314.0	103.0
1987	240.1	76.2	66.4	112.4	0.9	495.9	113.4	54.8	0.2	328.0	107.6
1988	255.6	76.6	74.2	111.2	1.9	519.6	126.9	56.4	5.8	342.1	112.2
1989	264.1	77.1	77.6	116.3	-0.2	534.9	132.7	58.1	5.8	349.9	114.7
1987 H1	117.6	37.7	32.1	55.7	0.0	243.2	54.5	26.8	0.0	161.8	106.1
H2	122.5	38.5	34.2	56.7	0.9	252.8	58.8	28.0	0.2	166.2	109.0
1988 H1	125.9	38.2	36.6	55.9	0.6	257.3	61.2	27.9	1.4	169.7	111.3
H2	129.7	38.4	37.6	55.3	1.3	262.3	65.7	28.5	4.4	172.5	113.1
1989 H1	131.6	38.5	38.3	57.1	0.2	265.7	65.8	28.9	2.9	173.9	114.1
H2	132.5	38.6	39.2	59.2	-0.4	269.1	66.9	29.2	2.9	175.9	115.4
1990 H1	133.9	38.8	39.4	61.0	-0.6	272.5	67.6	29.5	2.9	178.2	116.9
Percentage change on previous year ²											
1987	5½	1	8½	5½	0	5	7½	5½	0	4½	4½
1988	6½	½	12	-1	½	5	12	3	1½	4½	4½
1989	3½	½	4½	4½	-½	3	4½	3	0	2½	2½
1990 H1	2	1	3	7	-½	2½	3	2	0	2½	2½

¹ The compromise GDP figures to 1987 are unweighted averages of constant price expenditure, output and income estimates of GDP. Growth in 1988 is based on the output measure.

Percentage changes are calculated from unrounded levels and then rounded to the nearest half per cent. The annex to this chapter assesses the recorded data.

² For stockbuilding and the compromise adjustment, changes are as a percentage of GDP.

Annex to Chapter 3

National and sectoral accounts

3A.1 The Autumn Statement explained that, because of problems with the statistics, it has become increasingly difficult to assess the development of the economy in the recent past. The alternative measures of GDP have shown different growth rates between years and different paths within years. There have been very large balancing items in the sectoral accounts, and the data are subject to large revisions.

3A.2 The figures for the past in this chapter are the CSO's latest estimates; there may be further small changes before the full set of national accounts is published on 17 March. Revisions to the figures for 1986, 1987 and 1988 have reduced the difference between the various measures of GDP.

Table 3A.1 Gross domestic product: 1985 prices, seasonally adjusted

	1985 = 100			
	Expenditure	Output	Income	Compromise*
1987	107.7	107.8	107.2	107.6
1988	110.5	112.4	112.0	112.2
1987 H1	106.3	106.1	105.9	106.1
H2	109.0	109.4	108.6	109.0
1988 H1	110.5	111.5	111.8	111.3
H2	110.4	113.3	112.2	113.1
Growth rates				
percentage change on a year earlier				
1987	4.3	4.7	4.4	4.5
1988	2.6	4.3	4.5	4.3
1988 H1	4.0	5.0	5.6	4.9
H2	1.2	3.6	3.4	3.8

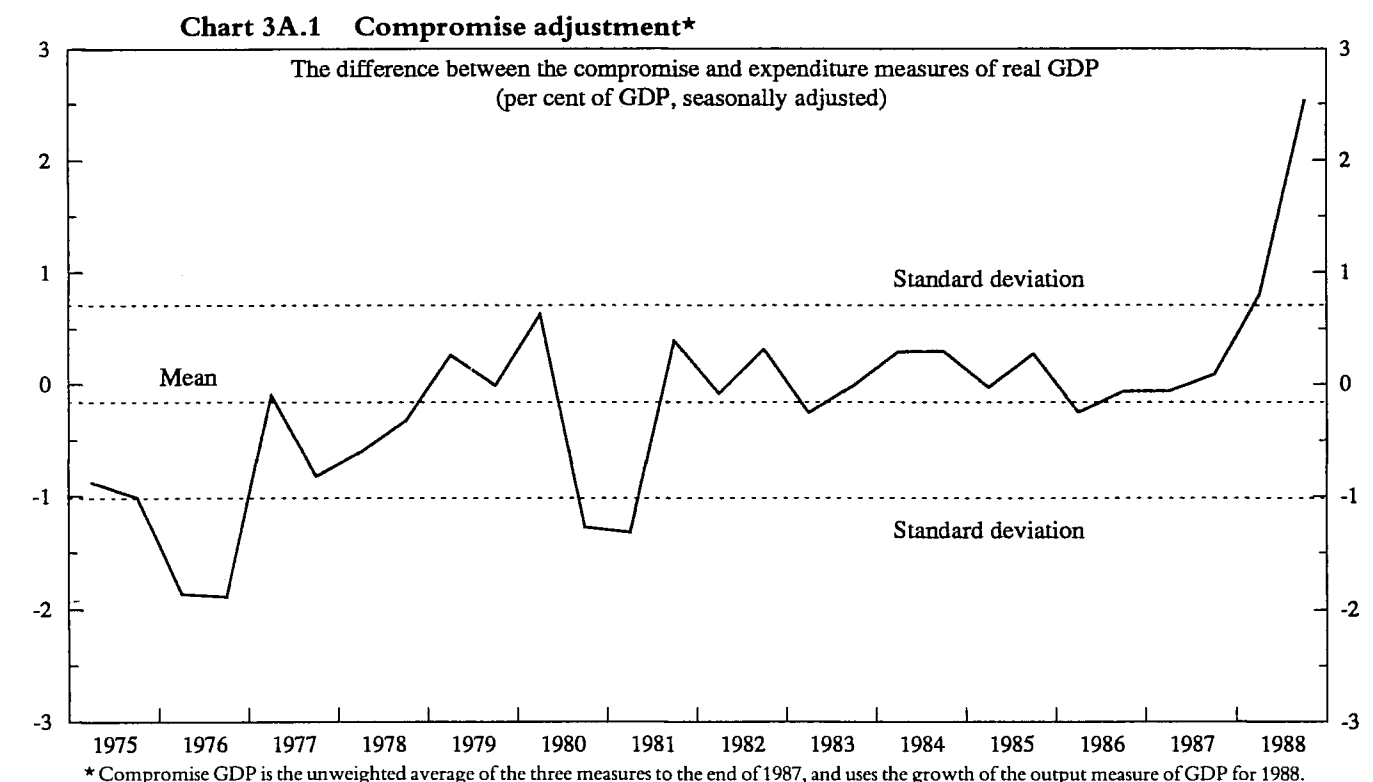
* Compromise GDP is the unweighted average of the three measures to the end of 1987, and uses the growth of the output measure of GDP for 1988.

3A.4 There have been unusually large upward revisions to the expenditure measure of GDP and some of its components since the last set of national accounts was published in December. For the first three quarters of 1988 the expenditure measure of GDP has been revised up by £3 billion, over 1 per cent. This is more than accounted for by fixed investment which has been revised up by £3½ billion (6½ per cent). Fixed investment is now estimated to have grown by 8½ per cent in 1987 and 12 per cent in 1988. Following these revisions the path of investment is more consistent with the high level of imports of capital and intermediate goods.

3A.5 Despite the revisions, there are still problems with the statistics in 1988. The expenditure measure of GDP is estimated to have grown significantly less rapidly than the output or income measures—especially in the second half of the year. In this forecast a compromise measure of GDP is used, and is estimated to have grown by 4½ per cent in 1988, in line with the output measure. This judgement is based on the widely accepted view that the output measure of GDP is the most reliable measure of recent activity, and is consistent with the other indicators of activity including CBI surveys.

3A.6 The income measure of GDP grew by a similar amount in 1988, although its path through the year was more erratic. In contrast, the expenditure measure of GDP is estimated to have grown by only 2½ per cent.

3A.7 The difference between the estimated growth of the compromise measure of GDP and the expenditure measure is shown as the compromise adjustment in Table 3.15. Chart 3.A1 shows the difference between the expenditure measure of GDP and compromise GDP. The difference for 1988 is still at an unusually high level.



3A.8 A full set of sectoral accounts that are consistent with the revised national accounts will be published in April. Until then it will not be possible to assess whether there has been any reduction in the very large balancing items for recent years in certain sectoral accounts, notably those for the personal sector and for industrial and commercial companies. (The balancing item for any sector is the difference between the sector's financial surplus/deficit as measured by the national accounts and as measured by the financial accounts.) Large inconsistencies remain in the accounts for the overseas sector. In the last three years there have been substantial, positive balancing items, rising to over £15 billion in 1988 on the latest data (Table 3.5). These represent an unknown combination of unrecorded net exports and unidentified capital inflows. To the extent that the balancing items consist of unrecorded net exports, the published figures overstate the actual current account deficits.

4 The Budget tax and national insurance proposals

4.01 The main tax and national insurance changes proposed in the Budget are summarised below. A full list of changes is given in Table 4.1.

Income tax **4.02** The main income tax thresholds will be increased in line with the statutory indexation provisions (based on the increase of 6.8 per cent in the RPI in the year to December 1988); the higher level of age allowance currently given to those aged 80 and over will be extended to those aged 75 and over. This will mean that:

the single person's and wife's earned income allowances will rise from £2 605 to £2 785;

the married allowance will rise from £4 095 to £4 375;

the additional personal allowance and widow's bereavement allowance will rise from £1 490 to £1 590;

the age allowance for those aged 65 to 74 will rise from £3 180 to £3 400 (single) and from £5 035 to £5 385 (married);

the age allowance for those aged 75 and over will rise from £3 180 (for single people aged under 80) and from £3 310 (for single people aged 80 and over) to £3 540; and from £5 035 (for married couples aged under 80) and from £5 205 (for married couples aged 80 and over) to £5 565;

the income limit for the age allowances will rise from £10 600 to £11 400;

the basic rate limit will rise from £19 300 to £20 700 of taxable income.

4.03 The age allowance withdrawal rate will be reduced from £2 of allowances for each £3 of income to £1 of allowances for each £2 of income above the income limit of £11 400. This means that the marginal tax rate for someone with income in the withdrawal band will fall from nearly 42 per cent to 37½ per cent.

Benefits in kind **4.04** Car benefit scale charges will be increased by one third from 6 April 1989.

Private medical insurance **4.05** Income tax relief will be given from 6 April 1990 on private medical insurance premiums for those aged 60 and over.

Charitable giving **4.06** The limit on charitable donations qualifying for tax relief under the payroll giving scheme will be doubled from £240 to £480 a year from 6 April 1989.

Schedule E assessment **4.07** The basis of assessment for Schedule E (remuneration of employees and directors) will be changed from accruals to receipts. Bringing the systems of assessment and collection (PAYE) into line will simplify the taxation of the half million directors and employees not already in practice taxed on the receipts basis.

- Employee share ownership plans (ESOPs)** 4.08 Tax relief will be given for payments by companies to qualifying ESOP trusts.
- Approved employee share schemes** 4.09 The annual limit for individual participation in the 1978 all-employee share scheme will be increased to £2 000 or—if greater—10 per cent of pay up to a maximum of £6 000. The 1980 SAYE share option scheme limit will be increased from £100 to £150 per month. The maximum discount from the share price at which options may be granted under these schemes will be doubled to 20 per cent.
- Profit-related pay** 4.10 The cash ceiling on the amount of profit-related pay attracting tax relief will be increased to £4 000. A number of other changes will simplify and improve the PRP rules.
- Personal equity plans** 4.11 The annual limit on investment in Personal Equity Plans will be increased from £3 000 to £4 800. The annual limit on investment in unit and investment trusts will be increased to £2 400, irrespective of other holdings. Investment in unit and investment trusts will be restricted to trusts which invest mainly in UK equities. The PEP rules will be greatly simplified.
- Pensions** 4.12 A number of changes will be made to the taxation of pensions. In the case of occupational pensions:
- employers will be able to set up “top-up” schemes for their employees, with no limits on benefits, but without special tax reliefs;
 - a limit will be placed on pensions paid from tax-approved schemes, based on earnings of £60 000 a year. This is consistent with a tax-privileged pension of up to £40 000 a year or maximum tax free lump sum of up to £90 000. The limit will be indexed to prices;
 - the rules for tax-approved pensions, particularly affecting those who take early retirement, will be simplified and improved.
- These changes will apply to schemes set up on or after Budget day and to new members joining existing schemes on or after 1 June 1989.
- 4.13 New simplified rules will be introduced for monitoring additional voluntary contributions. Any surplus contributions made will be returned to employees, subject to a special tax charge.
- 4.14 Annual contribution limits for personal pension schemes will be increased as a percentage of earnings, subject to an overall cash limit based on the £60 000 earnings limit for occupational schemes.
- Life assurance** 4.15 The tax regime for life assurance companies will be reformed. The main changes, to be introduced from 1 January 1990, are:
- pension and general annuity business expenses will be deductible only from pension or general annuity business profits;
 - relief for expenses of acquiring new life assurance business (other than pension or general annuity business) will be spread over seven years: this change will be phased in gradually over four years;
 - the rate of tax charged on income and capital gains attributable to policy holders will be reduced to a rate equal to the basic rate of income tax (25 per cent);
 - life assurance policy duty will be abolished.

- Unit trusts** 4.16 A new tax regime will be introduced from 1 January 1990 for unit trusts investing in transferable securities which are freely marketable throughout the European Community under the UCITS directive. The rate of corporation tax charged on their income will be reduced to a rate equal to the basic rate of income tax (25 per cent).
- COBO and deep discounted bonds** 4.17 The new issues queue will be abolished by a general consent under the Control of Borrowing Order and the regime for deep discounted bonds, including certain index-linked bonds, will be amended with effect from Budget day.
- Business taxation** 4.18 The profits limit for the small companies' corporation tax rate of 25 per cent for financial year 1989 will be raised from £100 000 to £150 000 and the limit for marginal relief will be raised from £500 000 to £750 000.
- 4.19 The main rate of corporation tax for the financial year 1989 will be 35 per cent.
- 4.20 The apportionment rules for close companies will be abolished. Special provisions including a corporation tax rate equal to the higher rate of income tax (40 per cent) will be introduced for close investment companies which distribute less than a specified percentage of their profits.
- Capital gains tax** 4.21 The capital gains tax annual exempt amount will remain at £5 000 in the case of individuals and £2 500 in the case of most trusts.
- 4.22 The disposal value limit below which chattels are exempt from charges on capital gains will be doubled from £3 000 to £6 000.
- 4.23 Capital gains tax deferral on lifetime gifts will be restricted to certain types of gift—in particular, gifts of business, farm and heritage assets, gifts on which there is an immediate charge to inheritance tax, and gifts to charity.
- Inheritance tax** 4.24 From 6 April 1989 the threshold for inheritance tax will be increased in line with the statutory indexation provisions from £110 000 to £118 000.
- VAT and car tax** 4.25 From 15 March 1989 the VAT registration limits will be raised to £23 600 a year and £8 000 a quarter.
- 4.26 To comply with the European Court judgment of 21 June 1988 certain previously zero rated goods and services will be subject to VAT at the standard rate. As announced on 6 February, the regime will aim to minimise the tax and compliance burden.
- 4.27 Non-residential construction and property development will be liable to VAT from 1 April 1989 with transitional relief for prior contractual commitments. Landlords will be given the option to tax rents of non-residential buildings from 1 August 1989. VAT will also be applied from 1 April 1989 to news services, and to protective boots and helmets supplied to employers; and from 1 July 1990 it will be applied to fuel and power supplied to businesses, and to water and sewerage services supplied to industry.

4.28 VAT relief for charities will be extended to charity fund-raising events, certain types of advertising and medical sterilising equipment. Cars purchased for leasing to the disabled will be relieved of car tax.

Excise duty **4.29** The duty on unleaded petrol will be reduced by the equivalent of just under 1p a litre (nearly 4p a gallon) including VAT. A higher rate of duty will be introduced on 2 and 3 star leaded petrol. This will add nearly 1p a litre (4p a gallon) including VAT to the tax charged on these grades.

ITV levy **4.30** From 1 January 1990, the additional payments made by ITV programme contractors will be assessed on a mixture of net advertising revenue and profits.

Tax administration **4.31** In the light of recommendations by the Keith Committee, measures are proposed to:

simplify and update the system of interest and monetary penalties for tax offences;

revise the Inland Revenue's powers to obtain information about a taxpayer under enquiry, to allow questions to be put to the taxpayer and to provide the taxpayer with greater safeguards;

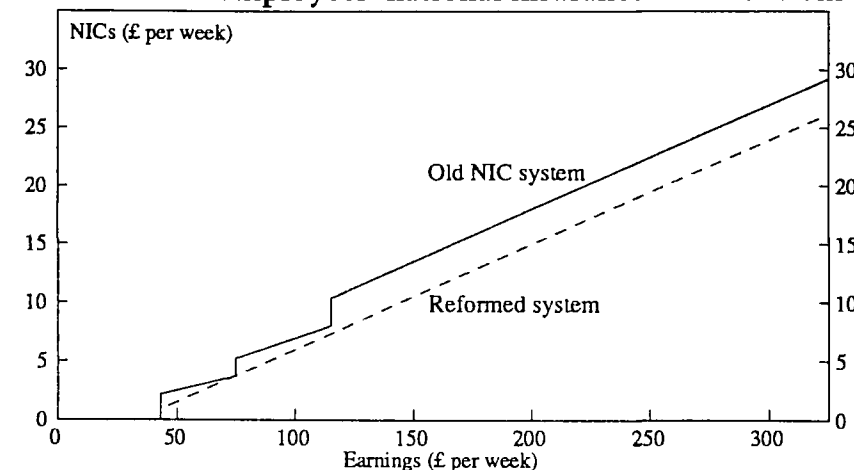
amend the Inland Revenue's search powers to provide greater protection for the taxpayer;

improve compliance by employers in filing end of year returns of PAYE and NIC deductions.

Tax confidentiality **4.32** Criminal sanctions will be provided against unlawful disclosure of information relating to a taxpayer by employees or former employees of the Inland Revenue and Customs and Excise.

National insurance **4.33** From 5 October, the structure of employees' national insurance contributions will be reformed. Employees will pay Class 1 contributions equal to 2 per cent of earnings up to the lower earnings limit (£43 a week in 1989-90) and 9 per cent of earnings above the lower earnings limit, up to the upper earnings limit (£325 a week in 1989-90). Those earning below the lower earnings limit will continue to pay no Class 1 contributions.

Chart 4.1 Reform of employees' national insurance contributions



4.34 From 1 October the rule whereby state retirement pensioners earning more than £75 a week have their pensions reduced, and those earning over £120 a week have their pension abated entirely, will be abolished. The public expenditure cost of abolition will be about £190 million in 1989-90 and £375 million in 1990-91. This cost will be met from the Reserve, and is therefore not included in Table 4.1. (Nor does Table 4.1 include the increased tax revenue that will flow from the changes, £20 million in 1989-90 and £110 million in 1990-91.)

4.35 These changes to national insurance contributions and the pensioners' earnings rule will be included in the Social Security Bill now before Parliament.

Table 4.1 Direct effects of changes in taxation and national insurance

See Annex 4 paragraph numbers	£ million		
	Estimated effect on receipts in: 1989-90		1990-91
	Changes from a non-indexed base	Changes from an indexed base	Changes from an indexed base
INLAND REVENUE			
Income tax			
1 Increase of £180 in single allowance and of £280 in married allowance	-1 130	—	—
2 Increase of £100 in additional personal allowance and widow's bereavement allowance	-10	—	—
3 Increase in age allowances in line with statutory indexation	-100	—	—
4 Extension of higher age allowance for those aged 80 and over to those aged 75 and over	-10	-10	-15
5 Increase of £800 in income limit for age allowance	-15	—	—
6 Reduction in age allowance withdrawal rate	-5	-5	-5
7 Increase of £1 400 in basic rate limit to £20 700	-210	—	—
8 Fringe benefits—one third increase in car benefit scales	+160	+160	+200
9 Tax relief for private medical insurance for those aged 60 or over	—	—	-40
10 Pension schemes—amendments to tax rules	*	*	*
11 Payroll giving to charities—increase in donation limit to £480 a year	*	*	*
12 Membership covenants to heritage charities	-5	-5	-10
13 Liberalisation of profit-related pay legislation	-10	-10	-15
14 Increase in approved employee share limits	*	*	*
15 Employee priority in public offer of shares	*	*	*
16 Changes in material interest tests	*	*	-5
17 Abolition of tax relief on new loans to buy Business Expansion Scheme shares	*	*	+5
18 Schedule E—change to receipts basis of assessment	-80	-80	-60
19 Changes in settlements provisions where settlor or spouse can benefit	*	*	*
20 Tax deductible from tax credit payments to US companies	—	—	—
Income tax and corporation tax			
21 Life assurance companies—pensions measures	—	—	+155
22 Life assurance companies—acquisition costs and rate reduction	—	—	-30
23 Abolition of close company apportionment	*	*	*
24 Capital allowances—safety at sports grounds and miscellaneous amendments	*	*	*
25 Extension of relief for pre-trading expenditure	*	*	*
26 Subcontractor tax scheme—reduction in paperwork requirements	—	—	—
Income tax and capital gains tax			
27 Personal Equity Plans—increase in limits etc.	-5	-5	-10
Income tax, corporation tax and capital gains tax			
28 Keith committee—administrative changes	*	*	*
29 Deep discounted bonds—taxation of uplift as income	—	—	+15
30 Tax charge on switching investments in offshore funds	*	*	*
Corporation tax			
31 Increase in profits limits for small companies rate and marginal relief	*	*	-35
32 Reduction in tax rate for certain unit trusts	—	—	*
33 Relief for payments to ESOP trusts	*	*	*
34 Advance corporation tax amendments	*	*	*
35 Sale of subsidiaries	*	*	*
Capital gains tax			
36 No change in annual exempt amount	—	*	+10
37 Restriction of gifts relief	*	*	+25
38 Change in the rules for Lloyd's underwriters—stock lending	—	—	*

* = Negligible — = Nil

Table 4.1 Direct effects of changes in taxation and national insurance—continued

See Annex 4 paragraph numbers	£ million		
	Estimated effect on receipts in: 1989-90		1990-91
	Changes from a non-indexed base	Changes from an indexed base	Changes from an indexed base
Capital gains tax and corporation tax			
39 UK branches of foreign businesses—changes affecting capital gains	*	*	*
40 Technical changes associated with rebasing of capital gains	*	*	*
41 Increase in capital gains chattels exemption to £6 000	*	*	*
42 Exemption of certain bonds from charges on capital gains	*	*	*
Capital gains tax and inheritance tax			
43 Gifts to housing associations	*	*	*
Inheritance tax			
44 Increase of £8 000 in threshold	-35	—	—
45 Changes in rules for varying dispositions on death	+5	+5	+15
Stamp duties			
46 Abolition of life assurance policy duty	-20	-20	-80
TOTAL INLAND REVENUE	-1 470	+30	+120
CUSTOMS AND EXCISE			
Value added tax			
47 Increase in registration limit	*	*	*
48 Revised tax regime for construction, buildings and land	+310	+310	+440
49 Change in liability of news services	+5	+5	+5
50 Change in liability of certain protective boots and helmets	*	*	*
51 Change in liability of certain supplies of fuel and power	—	—	+90
52 Change in liability of certain water and sewerage services	—	—	*
53 Reliefs for charities	-5	-5	-5
54 Relief for research and development cars	*	*	-5
55 Self-supplies—input tax	*	*	*
Car tax			
56 Relief for vehicles leased to disabled	-10	-10	-10
Excise duties			
57 Reduction in duty on unleaded petrol	-35	-65	-135
58 Increase in duty on 2 star and 3 star petrol	-5	-30	-35
59 No change in rate of duty on 4 star petrol etc.	—	-385	-395
60 No change in rate of duty on derv	—	-95	-105
61 No change in rate of duty on minor oils	—	-10	-10
62 No change in rates of tobacco products duties	—	-235	-250
63 No change in rate of spirits duty	—	-65	-70
64 No change in rate of beer duty	—	-140	-155
65 No change in rate of duty on cider and perry	—	-5	-5
66 No change in rate of duty on wine and made-wine	—	-45	-50
67 Restriction on blending of duty-paid made-wine	*	*	*
68 Determination of original gravity of beer	*	*	*
69 Relief from duty and tax for diplomats etc.	—	—	—
TOTAL CUSTOMS AND EXCISE	+260	-775	-695
Vehicle excise duty			
70 Increase in VED rates for taxis, buses and coaches	+20	+20	+20
71 Increase in VED rates for certain lorries and other vehicles	+20	-15	-20
72 No change in VED on cars, light vans and main lorry rates	—	-155	-170
TOTAL VED	+40	-150	-170

* = Negligible — = Nil

Table 4.1 Direct effects of changes in taxation and national insurance—*continued*

See Annex 4 paragraph numbers	£ million		
	Estimated effect on receipts in: 1989–90		1990–91
	Changes from a non-indexed base	Changes from an indexed base	Changes from an indexed base
Other			
73 ITV levy re-basing	—	—	+ 45
74 Sale of vehicle registration marks	*	*	+ 10
75 Unauthorised disclosure of confidential information	—	—	—
TOTAL OTHER	*	*	+ 55
TOTAL CHANGES IN TAXATION	– 1 170	– 895	– 690
National insurance contributions			
76 Employee contributions reformed and reduced	– 980	– 980	– 2 800
TOTAL CHANGES TO NATIONAL INSURANCE CONTRIBUTIONS	– 980	– 980	– 2 800
TOTAL BUDGET CHANGES	– 2 150	– 1 875	– 3 490

* = Negligible — = Nil

Annex to Chapter 4

Explanatory notes to Table 4.1

Table 4.1 gives the direct effects of changes in taxation. Estimates are rounded to the nearest £5 million. "Negligible" means less than £3 million.

The direct effect of a tax change is the difference between the yield of tax which would arise on the basis of the rates of tax, allowances, etc prevailing before the Budget (the pre-Budget regime) and the yield after the changes proposed in the Budget (the post-Budget regime). The difference in yield is generally calculated by applying the pre- and post-Budget regimes to the same tax base. This base is the post-Budget base—that is, the levels of income, consumption, profits, etc forecast for future years on the assumption that all the measures proposed in the Budget take effect.

Tax changes may cause changes in taxpayers' behaviour, which in turn can alter the tax base and hence revenue. The direct effects are estimated subject to the constraint that, in general, total incomes and total expenditure are fixed at their post-Budget levels. Thus the estimates in the table do not include income effects—that is, effects arising solely from the impact of changes in taxes on disposable incomes. Nor do they include the effects of changes in the tax base arising from changes in pre-tax incomes, the general level of prices or other macro-economic variables which may result from the proposed tax change. But other behavioural effects are taken into account where it is thought that they will have a significant effect on the yield.

For Customs and Excise taxes and duties, all the estimates of yield incorporate the effects of the tax changes on relative prices and associated changes in the pattern of consumers' expenditure. Aggregate income and consumers' expenditure at factor cost are assumed not to change. This is a slight modification of previous practice in which nominal consumers' expenditure at market prices, rather than at factor cost, was held constant. Examples where behavioural effects are taken into account for Inland Revenue taxes include changes involving the take-up of a new or modified relief.

The post-Budget forecast of each tax given in Table 1.2 takes account of all the effects of the measures announced in the Budget, and not just the direct effects included in Table 4.1.

The figures in the first column of Table 4.1 show the direct effect of the Budget proposals on receipts in 1989–90. Budget proposals are compared with a non-indexed base—that is, with the pre-Budget regime of allowances, thresholds and rates of duty at 1988–89 levels.

The figures in the second column show the direct effect of the Budget proposals on receipts in 1989–90, measured against an indexed base. The indexed base for 1989–90 is obtained by increasing 1988–89 allowances, thresholds and rates of duty by 6.8 per cent, the increase in the RPI over the year to December 1988.

The figures in the third column show the direct effect on receipts in 1990–91, also measured against an indexed base. For this comparison, both the Budget proposals and the indexed base for 1989–90 have been further indexed by the forecast movement in the RPI between the fourth quarters of 1988 and 1989 (shown in Table 3.14).

The remainder of this annex provides a commentary on the Budget proposals in Table 4.1; the paragraph numbers refer to the lines in this table. Additional information is provided for those proposals where the effect on tax liabilities in the first complete year to which the change applies (full year effect) is substantially different from the effect on receipts in either 1989-90 or 1990-91; or where the impact of the proposal is expected to build up over a period of years.

Income tax

1 to 5 The increases in the main income tax allowances are in line with the statutory indexation provisions (based on the increase of 6.8 per cent in the RPI in the year to December 1988). The higher level of age allowance currently given to those aged 80 and over will be extended to those aged 75 and over.

6 The age allowance withdrawal rate will be reduced from £2 of allowances for each £3 of income to £1 of allowances for each £2 of income above the income limit of £11 400.

7 The increase in the basic rate limit is in line with the statutory indexation provisions.

8 For 1989-90 the scales for taxing car benefits will be increased by one third from their 1988-89 levels. The estimated yield takes account of behavioural effects.

9 Tax relief will be available (with basic rate relief given at source) for eligible premiums paid in 1990-91 and subsequent years for private medical insurance for those aged 60 and over. The cost for 1990-91 assumes an increase in take-up in the region of 10 per cent as a result of the new relief. Eventual costs will depend, among other things, on the extent to which medical insurance for the over-60s is promoted and taken up.

10 The amendments to the tax rules for pension schemes will mean that:

for tax-approved schemes, earnings over £60 000 a year will be ignored for the purpose of calculating benefits (consistent with a maximum pension of £40 000, or tax-free lump sum of £90 000). Other amendments will be made to the tax rules to improve early retirement benefits, to allow a two-thirds final salary pension on retirement after 20 years' service between ages 50 and 70 and to simplify calculation of tax-free lump sums. These changes apply to new schemes set up on or after 14 March 1989 and to new members joining existing schemes on or after 1 June 1989;

employers will be able to set up top-up schemes with no limits on benefits, but without tax privileges such as tax-free investment build-up;

new rules will allow surplus voluntary contributions to be returned to the member instead of reducing benefits from the employer's scheme. The voluntary scheme will deduct a 35 per cent charge from the refund to recoup the tax advantages enjoyed on contributions and build-up. There will be a further liability on higher rate taxpayers;

changes will be made to the personal pensions tax rules to increase from 6 April 1989 the age-related contribution limits. The increased limit will be subject to the £60 000 earnings cap. And the rules for calculating tax-free lump sums will be simplified.

These measures are expected to have a broadly neutral revenue effect in the early years.

11 The limit on charitable donations qualifying for relief under payroll deduction schemes will be increased from £240 to £480 a year from April 1989. The cost will depend on take-up.

12 The conditions for relief for charitable covenants will be relaxed so that where a member of a heritage charity is given free or cheap entry to view the charity's property, that benefit will not disqualify the covenant payments from relief. The cost will depend on take-up.

13 The main amendments to the profit-related pay (PRP) legislation will:

abolish the "5 per cent test" on a PRP scheme's eligibility for registration;

increase to £4 000 the cash limit on the amount of PRP attracting tax relief;

allow scheme employers to alter, subject to conditions, the rules of PRP schemes already registered; and

enable PRP schemes to be registered for certain employment units using the profits of the whole business rather than of the employment unit itself.

The cost will depend on take-up.

14 The annual limit on the value of shares which may be given to an employee under an approved all-employee profit-sharing share scheme will be increased, with effect from 6 April 1989, from £1 250 (or 10 per cent of pay up to a maximum of £5 000) to £2 000 (or 10 per cent of pay up to £6 000). The limit on monthly savings made by an employee under an approved savings-related share option scheme will be increased, from a day to be appointed, from £100 to £150. The maximum discount on the share price at which options may be granted under these schemes will be increased from 10 per cent to 20 per cent. The use of consortium shares in an approved employee share scheme will be extended to include the shares of any member of a consortium owning 5 per cent or more of the company's ordinary share capital in place of the previous 15 per cent limit.

15 There will be relaxations in the conditions under which income tax relief is given to employees who benefit by virtue of their employment from priority in applying for a public offer of shares.

16 Changes will be made in the material interest tests relating to an employee's eligibility to participate in an approved employee share scheme or a registered profit-related pay scheme, and an individual's entitlement to close company interest relief. Subject to certain conditions, shares held by a trust of which the employee is a beneficiary will be disregarded when reckoning whether he has material interest.

17 Relief for interest on loans to acquire Business Expansion Scheme shares on or after 14 March 1989 will be abolished.

18 From 6 April 1989 Schedule E emoluments will be assessed for the year in which they are received instead of the year for which they are earned. There will be a transitional cost, but from 1992-93 when the transition is complete, there will be an annual yield of about £50 million.

19 A change will be made to the provisions which treat certain settlement income as the settlor's for higher rate tax purposes to ensure that income from outright gifts between husband and wife will be treated under Independent Taxation as the income of the recipient of the gift. For certain other settlements the present provisions will be extended to the basic rate, producing a small revenue yield.

20 Legislation will be introduced to make clear the amount of UK tax that is deductible from UK tax credits to which non-residents may be entitled under a double taxation convention. This measure will prevent a potential Exchequer loss of about £15 million a year.

Income tax and corporation tax

21 From 1 January 1990, life assurance companies will be allowed to set relief for the expenses of pension, general annuity and other life assurance business only against their respective profits. There will be other measures to align the tax treatment of pension profits more closely with industry accounting practice. The yield in 1990-91 and the immediately following years is reduced by the carry-forward of unrelieved expenses from past years. The long term yield is expected to be around £4 billion a year.

22. Other changes will be made from 1 January 1990 to the rules for taxing life assurance companies: in particular, to spread over seven years the relief for the costs of acquiring new business (other than pension and general annuity business), subject to transitional arrangements in the first four years; and to reduce the corporation tax rate on income and capital gains attributable to policy holders to 25 per cent. The impact of these measures in 1990-91 and subsequent years is affected by the proposed transitional arrangements. The long-run effect is expected to be broadly revenue-neutral.

23 The apportionment rules for close companies will be abolished. A higher rate of corporation tax equal to the higher rate of income tax of 40 per cent will be introduced for close investment companies which distribute less than a specified percentage of their profits. A close investment company will no longer get tax relief for interest payments, annual payments or management expenses unless these would have been deductible if paid by an individual.

24 The legislation relating to capital allowances for safety expenditure at sports grounds will be amended from 1 January 1989 to take account of the extension of safety certificate requirements to regulated stands at undesignated sports grounds. Minor amendments will be made to the capital allowances legislation to correct defects and anomalies in advance of the consolidation of that legislation.

25 The period for which relief may be available for business expenditure incurred before a trade begins will be increased from three to five years. The cost of this proposal will take some years to build up and could amount to tens of millions of pounds.

26 Subject to consultation, the paperwork requirements of the scheme for subcontractors in the construction industry will be reduced.

Income tax and capital gains tax

27 The main changes are:

- an increase in the overall annual limit on investment in a Personal Equity Plan to £4 800;
- within that an increase in the limit for investment in authorised unit trusts and investment trusts to £2 400, coupled with a new requirement that the trust must invest mostly in UK equities;
- significant simplifications for plan managers; and
- the facility for new share issues to be brought within plans.

The costs assume take-up in the region of 400 000 in the first full year. The cost is likely to reach £30 million after five years.

Income tax, corporation tax and capital gains tax

28 In the light of recommendations of the Keith Committee, administrative changes will be made:

- to update the system of monetary penalties for tax offences in line with inflation and remove obsolete penalties;
- to introduce a uniform time limit of 20 years for recovery of tax lost through default;
- to allow taxpayers further time to claim reliefs where an Inspector discovers that further tax is due;
- to revise the Inland Revenue's powers to obtain information about a taxpayer under enquiry, to allow questions to be put to the taxpayer, provide greater safeguards for the taxpayer and protect audit papers and tax advice from disclosure by his accountant;
- to amend the Inland Revenue's search powers to provide greater safeguards for the taxpayer.

to create a new criminal offence for the deliberate destruction of documents called for under the Inland Revenue's information powers;

to change the filing date for returns of PAYE and NIC deductions by employers from 19 April to 19 May, tighten up the penalties for late filing gradually over a period of years, leading to the introduction of automatic penalties for all late filing (but not before 1995).

The effect on revenue in subsequent years is expected to be small.

29 From Budget day the existing corporate deep discount legislation in Schedule 4 ICTA 1988 will be widened to include non-variable deep discounted securities issued by non-corporate borrowers. On a sale or redemption the accrued discount will be taxed as income. Any excess or shortfall will be taxed as a capital gain or loss unless the security is exempt from capital gains tax as a qualifying corporate bond. Where deep discounted securities have variable features so that the precise accrued discount at any particular time cannot be determined in advance (including certain index-linked bonds), the whole of the uplift between cost price and sale or redemption price will be taxed as income. The eventual yield is uncertain but is estimated at around £50 million.

30 A tax charge will be imposed on UK investors on gains when they switch holdings within an offshore fund.

Corporation tax

31 The profits limit for the small companies' corporation tax rate of 25 per cent for financial year 1989 will be raised from £100 000 to £150 000 and the limit for marginal relief will be raised from £500 000 to £750 000.

32 From 1 January 1990 all unit trusts that are UCITS (Undertakings for Collective Investment in Transferable Securities) under the relevant European Communities legislation will be subject to corporation tax on their income at a rate of 25 per cent. The cost will rise to about £20 million from 1991-92 onwards.

33 Payments made by a company to an ESOP trust will be deductible in calculating its corporation tax liability where the trust meets conditions aimed at ensuring the distribution of shares in the company to all of its employees, on similar terms, within a reasonable time.

34 Various minor changes will be made to the advance corporation tax (ACT) rules concerning a company which is part of a group or consortium.

35 Measures will be introduced to counter avoidance of tax on disposals of subsidiaries in ways which could cause a substantial loss of tax.

Capital gains tax

36 The capital gains tax annual exempt amount will remain at £5 000 in the case of individuals and £2 500 in the case of most trusts.

37 Capital gains tax gifts relief (which allows deferral on gifts) will be restricted to certain types of gift, the main categories being gifts of business, farm and heritage assets and gifts on which there is an immediate charge to inheritance tax. The revenue yield in 1991-92 is estimated at £40 million. The change will not affect gifts to charities or between spouses.

38 The capital gains tax rules and rules about the transfer of securities applying to assets held by Lloyd's underwriters in their premiums trust funds will be amended to facilitate stock lending to market makers.

Capital gains tax and corporation tax

39 Changes will be made to the rules for the taxation of capital gains of foreign businesses with UK branches or agencies or with operations on the UK continental shelf. The main effect will be to counter possible developments which could lead to a significant loss of tax.

- Capital gains tax and inheritance tax**
- Inheritance tax**
- Stamp duties**
- Value added tax**
- Car tax**
- Excise duties**
- 40 Technical changes will be made in relation to the application of the provisions in the Finance Act 1988 for rebasing the taxation of capital gains to 1982 in certain special situations.
- 41 Chattels with a disposal value of less than £3 000 are exempt from charges on capital gains. The limit will be doubled to £6 000.
- 42 Certain sterling bonds will be exempted from capital gains tax and corporation tax on gains. The main effect will be to counter use of the indexation allowance in ways which could cause a significant loss of tax.
- 43 Gifts of land to registered housing associations will qualify for capital gains tax deferral and inheritance tax exemption.
- 44 The estimated full year cost of indexation attributable to taxable estates in 1989-90 is £80 million.
- 45 The facility for varying the disposition of a deceased person's assets with effect for inheritance tax will be limited to those variations making adequate provision for his or her dependants.
- 46 Life assurance policy duty will be abolished from 1 January 1990. The cost in 1990-91 takes account of the consequential change in corporation tax liability.
- 47 From 15 March 1989, the registration limits will become £23 600 a year and £8 000 a quarter.
- 48 From 1 April 1989, VAT will be applied at the standard rate to the construction and sale of new non-residential buildings. Transitional relief will allow zero rating to continue for certain developments where legal commitments had been entered into before 21 June 1988. From 1 August 1989, landlords will be able to opt to charge tax on their non-residential rents and sales of used buildings and VAT at the standard rate will be applied in limited circumstances to building land where this is necessary to ensure fair competition. Tenants whose landlords opt to tax existing leases will pay tax on only half of the rent in the first year. The phasing in period will be five years where the tenant is a charity.
- 49 From 1 April 1989, VAT will be applied at the standard rate to news services (but not newspapers).
- 50 From 1 April 1989, VAT will be applied at the standard rate to protective boots and helmets supplied to employers.
- 51 From 1 July 1990, VAT will be applied at the standard rate to fuel and power supplied to businesses.
- 52 From 1 July 1990, VAT will be applied at the standard rate to water and sewerage services supplied to industry.
- 53 From 1 April 1989, VAT relief for charities will be extended to charity and certain other fund-raising events, medical sterilising equipment and classified and certain other types of advertising.
- 54 From 1 August 1989, all cars used by manufacturers for research and development purposes will be relieved of VAT.
- 55 From Royal Assent, Customs and Excise will be given the power to determine, by regulation, the correct attribution of input tax in respect of self-supplies of goods and services.
- 56 From 1 April 1989, vehicles purchased for leasing to the disabled will be relieved of car tax.
- 57 The duty on unleaded petrol will be reduced by the equivalent of 0.8p a litre (3.6p a gallon) including VAT.

- 58 A higher rate of duty will be introduced on two and three star leaded petrol. This will add 0.9p a litre (4.1p a gallon) including VAT to the tax charged on these grades. Despite the increase in duty, the revenue effect of this change is negative as a result of expected switching from two and three star to unleaded petrol.
- 59-66 There will be no change in the rates of duty on other hydrocarbon oils, alcoholic drinks and tobacco products.
- 67 The duty arrangements for made-wine will be brought into line with those applicable to wine of fresh grapes by prohibiting duty-paid blending.
- 68 The rules for determining the original gravity of beer for duty purposes will be clarified.
- 69 Statutory provision will be made for a number of duty and tax reliefs currently granted to diplomats, members of international organisations and visiting forces by means of extra-statutory class concessions. A power to impose sanctions for breaching the conditions of the reliefs will be introduced.
- Vehicle excise duties**
- 70 From 15 March 1989, the number of duty rates for coaches and buses will be reduced from over sixty to five and rates will be increased; duty rates will also be increased for taxis.
- 71 From 15 March 1989, the rates of duty on certain rigid lorries will be increased to bring them more into line with rates for articulated vehicles of similar gross weight. The rate of duty for special types capable of carrying very long, wide or heavy loads will be increased to £3 100.
- 72 There will be no change in the duties on cars, light vans, motor cycles and most lorries.
- Other**
- 73 From 1 January 1990, the additional payments made by ITV programme contractors will be assessed on a mixture of net advertising revenue and profits.
- 74 A pilot scheme making certain vehicle registration marks available for sale to the public will begin in December 1989.
- 75 Criminal sanctions will be provided against unlawful disclosure of information relating to a taxpayer by employees or former employees of the Inland Revenue and Customs and Excise.
- National insurance contributions**
- 76 From 5 October 1989, employees will pay Class 1 contributions equal to 2 per cent of earnings up to the lower earnings limit (£43 a week in 1989-90) and 9 per cent of earnings above the lower earnings limit, up to the upper earnings limit (£325 a week in 1989-90). Those earning below the lower earnings limit will continue to pay no Class 1 contributions.

5 Public expenditure

5.01 The Government's expenditure plans for the next three years were set out in the 1988 Autumn Statement (HC 695) and in detail in the 1989 public expenditure White Paper (Cm 601-621). They are summarised in Table 5.1.

Changes since previous Budget **5.02** The planning total for 1989-90 remains unchanged from the level shown in the last FSBP; the planning total for 1990-91 has been increased by £3.3 billion. In both years, extra resources have been provided to meet the Government's priorities, including substantial additional sums for health, law and order, defence and roads. Provision for local authority current spending and the UK's net contribution to the European Communities is also higher.

Table 5.1 Public expenditure

	£ billion				
	1987-88 Outturn	1988-89 Estimated outturn	1989-90 Plans	1990-91 Plans	1991-92 Plans
Department					
Social security	46.3	47.4	51.0	55.3	58.7
Health	19.7	21.7	23.2	24.4	25.4
Defence	18.9	19.0	20.1	21.2	22.1
Education and science	17.1	18.4	19.6	20.2	20.8
Home Office and legal departments	6.5	7.2	8.0	8.4	8.6
Transport	4.6	4.8	5.4	5.5	5.7
Scotland	8.1	8.7	9.0	9.1	9.7
Wales	3.3	3.6	3.8	3.9	4.0
Northern Ireland	4.9	5.6	5.5	5.7	5.9
Other departments	21.6	21.2	23.1	23.7	25.3
Privatisation proceeds	-5.1	-7.0	-5.0	-5.0	-5.0
Reserve			3.5	7.0	10.5
Public expenditure planning total	145.7	150.6	167.1	179.4	191.6
General government gross debt interest ¹	17.7	18.3	17.1	15½	14½
Other adjustments ¹	8.4	10.2	10.1	10½	9½
General government expenditure	171.9	179.1	194.3	205	216
General government expenditure excluding privatisation proceeds:					
in real terms (base year 1987-88) ²	177.0	173.5	176.4	179	183
as a per cent of GDP	41½	39½	39½	39	38½

¹ 1990-91 and 1991-92 figures rounded to nearest £½ billion.

² Using GDP deflator and money GDP on the same basis as in Table 2.1

5 Public expenditure

Public spending trends **5.03** General government spending, excluding privatisation proceeds, has fallen from 46½ per cent of GDP in 1982-83 to 39½ per cent in 1988-89. The expenditure plans to 1991-92 are consistent with the Government's policy of reducing the share of national income taken by total government spending. The move to Budget surplus has reduced the burden of debt interest, and the fall in unemployment has made savings possible in the social security, employment and training programmes. These savings, together with higher housing receipts and reduced agricultural market support, have made room for increases in priority programmes within the declining trend of total expenditure relative to national income.

Budget consequences **5.04** The public expenditure cost of abolishing the earnings rule for state retirement pensioners (£190 million in 1989-90 and £375 million in 1990-91) will be charged to the Reserve, and will not add to planning totals. The public expenditure cost of extending VAT to non-residential construction and property development was incorporated in the plans set out in the 1989 public expenditure White Paper.

1988-89 outturn **5.05** The latest estimate of the outturn for the planning total in 1988-89, which is still subject to some uncertainty, suggests that it is likely to be £150.6 billion, £6.3 billion below the plans shown in the 1988 public expenditure White Paper and the 1988 Budget (of which £2 billion represents increased privatisation proceeds) and £2.8 billion below the outturn figure shown in the 1989 public expenditure White Paper. A breakdown is shown in Table 5.2.

Table 5.2 Comparison of plans and estimated outturn for 1988-89

	£ billion		
	Plans ¹	Estimated outturn	Outturn minus plans
Central government ²	114.3	114.4	+0.1
Local authority ²	42.6	42.9	+0.3
of which:			
relevant expenditure	33.2	34.5	+1.2
other current	5.4	5.3	-0.1
capital	4.0	3.1	-0.9
Nationalised industries and other public corporations	1.4	0.3	-1.1
Privatisation proceeds	-5.0	-7.0	-2.0
Reserve	3.5		-3.5
Public expenditure planning total	156.9	150.6	-6.3

¹ Plans from The Government's Expenditure Plans 1988-89 to 1990-91 (Cm 288), adjusted for classification changes.

² Excluding finance for nationalised industries and other public corporations

5.06 The major changes in 1988–89 between programme plans in the 1988 White Paper and the estimated outturn are:

central government: increases arising from pay settlements for NHS Review Body groups (£0.9 billion), a capital grant of £0.5 billion associated with the sale of Rover to BAe and finance for an initial recapitalisation of Shorts Brothers prior to privatisation (£0.4 billion), are largely offset by reductions in social security expenditure (£1.0 billion) due to the fall in unemployment; lower payments by the Intervention Board for Agricultural Produce (£0.4 billion) and lower expenditure on employment programmes (£0.4 billion);

local authorities: an overspend of £1.2 billion on planned current expenditure and a net underspend of £0.9 billion on capital expenditure, reflecting higher gross spending (£1.2 billion) offset by higher receipts (£2.1 billion);

nationalised industries and other public corporations: an underspend of £1.1 billion mainly by the electricity supply industry (£0.6 billion, reflecting latest information on timing of tax payments), British Steel (£0.3 billion, due to higher profitability prior to privatisation) and British Rail (£0.3 billion, mainly due to buoyant passenger income).

Table 5.3 Public expenditure by spending authority

	£ billion				
	1987–88 Outturn	1988–89 Estimated outturn	1989–90 Plans	1990–91 Plans	1991–92 Plans
Central government ¹	109.4	114.4	123.7	131.2	136.9
of which:					
Voted in Estimates	76.9	80.9	86.9	92.2	96.4
other	32.5	33.5	36.8	39.0	40.5
Local authorities ¹	40.7	42.9	44.0	45.5	47.1
of which:					
relevant expenditure	32.0	34.5	35.2	36.5	37.5
other current	5.1	5.3	6.2	6.7	7.1
capital	3.6	3.1	2.6	2.4	2.5
Nationalised industries	0.3	–0.1	—	–0.4	1.0 ²
Other public corporations	0.5	0.5	0.9	1.0	1.1
Privatisation proceeds	–5.1	–7.0	–5.0	–5.0	–5.0
Reserve			3.5	7.0	10.5
Public expenditure planning total	145.7	150.6	167.1	179.4	191.6

¹ Excluding finance for nationalised industries and other public corporations.

² The increase in 1991–92 reflects the disappearance from the public expenditure figures, following privatisation, of the substantial negative external finance of the electricity industry.

Public expenditure by spending authority

5.07 Central government spending makes up about three quarters of the planning total. About 70 per cent of this is voted by Parliament through the annual Supply Estimates and covers the expenditure of government departments for their own activities as well as their funding of other bodies

such as the National Health Service. Most of the remainder consists of social security payments paid out of the National Insurance Fund. Spending by local authorities accounts for about one quarter of public expenditure. Nationalised industries and other public corporations account for the remainder of the total. Table 5.3 gives outturn figures for the last two years and the plans as published in the public expenditure White Paper.

Supply Estimates 5.08 For 1989–90, the plans set out in the public expenditure White Paper have now been translated, where appropriate, into detailed control totals in Supply Estimates. The total Estimates provision for 1989–90 for which the Government is seeking Parliamentary approval is shown in Table 5.4. The main Estimates for 1989–90 are published in a series of booklets on 14 March 1989 with a Summary and Guide (Cm 633) which summarises the Estimates and explains how they relate to the public expenditure planning total. It also describes the Supply procedure.

5.09 Of the £116.5 billion included in the Supply Estimates, £90.1 billion is direct public expenditure. The remaining £26.3 billion does not feature directly as public expenditure because it consists of grants to local authorities and finance for other bodies whose spending is counted as public expenditure. About 60 per cent of the money voted in Estimates is subject to cash limits, which provide the Government with greater control over its cash expenditure during the financial year.

Table 5.4 Supply expenditure

	£ billion		1988–89	1989–90
	1987–88			
	Expected outturn in 1988 Budget	Final outturn	Expected outturn	Provision
Main Supply Estimates	104.5	104.5	108.3	116.5
Supplementaries and net underspending	0.9	1.0	2.4	
Total Supply expenditure	105.3	105.5	110.7	
Public expenditure element	79.5	79.6	85.0	

6 The public sector's finances

6.01 This chapter brings together revenue and spending and provides an analysis and forecast of the public sector's overall financial position in 1989–90, together with some explanation of the main differences between estimated outturn in 1988–89 and last year's forecast.

Debt repayment 6.02 The latest estimate is for a public sector debt repayment (PSDR) of £14 billion in 1988–89, equivalent to 3 per cent of GDP, or £7 billion excluding privatisation proceeds. Even this last figure represents a larger net repayment as a proportion of GDP than in any year since the beginning of the 1950s—the earliest date for which comparable figures are available. Both the public sector financial balance and the general government financial balance are also estimated to be in substantial surplus in 1988–89.

6.03 The forecast is for a further substantial PSDR of around £14 billion in 1989–90, about the same as in 1988–89. Excluding privatisation proceeds the PSDR in 1989–90 is forecast to be some £2 billion higher than in 1988–89.

Table 6.1 Public sector debt repayment

	1987–88	1988–89	1989–90
	Outturn	1988 Budget	Latest estimate
Public sector debt repayment			
£ billion	3.5	3.2	13.9
per cent of GDP	$\frac{3}{4}$	$\frac{3}{4}$	3
PSDR excluding privatisation proceeds			
£ billion	–1.6	–1.8	6.9
per cent of GDP	$-\frac{1}{2}$	$-\frac{1}{2}$	$1\frac{1}{2}$

6.04 The stock of net public sector debt has fallen from over 50 per cent of money GDP in 1979 to 38 per cent (£171 billion) at the end of 1987–88. It is forecast to be about £157 billion, or 32 per cent of GDP, at the end of 1988–89. Relative to GDP the stock of government debt is now lower than at any point since the First World War. There should be a further large fall in net public sector debt in 1989–90, in both nominal terms and as a per cent of GDP.

Changes since last Budget

6.05 The PSDR in 1988–89 is now estimated to be £10 $\frac{1}{2}$ billion higher than forecast in last year's Budget. As Table 6.2 shows, the higher net repayment comes roughly equally from higher receipts and lower expenditure, including £2 billion additional privatisation proceeds (see Table 1.2 for a detailed comparison of the components). Much of the extra receipts reflects the higher than forecast growth of money GDP. Higher growth has also contributed to the lower than forecast expenditure, primarily through lower spending on social security and improved finances of public corporations.

Table 6.2 Changes to receipts, expenditure and debt repayment since 1988 Budget¹

	£ billion	
	1987–88	1988–89
<i>Receipts</i>		
Taxes, royalties and national insurance contributions	+0.9	+4.6
Other receipts	–0.8	+1.3
Total receipts	+0.1	+5.9
<i>Expenditure</i>		
Privatisation proceeds	–0.1	–2.0
Other general government	+0.2	–1.9
Public corporations' market and overseas finance	–0.4	–0.9
Total expenditure	–0.3	–4.9
PSDR	+0.4	+10.7

¹ + higher receipts, higher expenditure, or higher debt repayment;
– lower receipts or lower expenditure.

6.06 The main contributors to the higher than expected receipts in 1988–89 are income tax (£1 $\frac{3}{4}$ billion), national insurance contributions (£1 $\frac{1}{4}$ billion), VAT (£1 $\frac{1}{4}$ billion) and interest receipts (£1 billion). The first two largely reflect higher total wages and salaries. Higher VAT receipts are the result of faster growth of consumer spending in total and a change in its composition towards those goods and services which are subject to VAT.

6.07 Corporation tax receipts again rose strongly in 1988–89 but not by as much as forecast. Within the total, advance corporation tax (ACT) receipts were higher than forecast, reflecting high dividend payments in 1988, but other corporation tax receipts rose much less than expected. The latter is likely to be mainly the result of lower profits and higher investment in 1987 than shown by the recorded figures available at the time of the last Budget.

6.08 Privatisation proceeds were £2 billion higher than projected at the time of the last Budget. Expenditure excluding privatisation proceeds was lower than forecast, largely as a result of lower social security expenditure and higher local authority capital receipts.

6.09 The public sector's finances can be analysed in a number of different ways: by type or activity, by sector and by economic category. The rest of this chapter sets out these three analyses in detail.

Public sector's finances: analysis by type or activity

6.10 Table 1.2 analyses the public sector's finances by type or activity. The main receipts of general government (ie central plus local government) are grouped according to the kind of activity which gives rise to them, while spending is shown by department, as in Chapter 5 and in the public expenditure White Paper.

Receipts 6.11 General government receipts are estimated to have risen by nearly 10 per cent in 1988–89, a little less than the growth of money GDP. They are forecast to rise by about 8 per cent in 1989–90, a little more than the forecast growth of money GDP.

6.12 Within general government receipts North Sea revenues fell sharply in 1988–89, as forecast. They are forecast to fall further in 1989–90, by about 10 per cent, mainly the delayed effect on corporation tax of falling profits in earlier years. Oil production is expected to be lower in 1989 than in 1988, due mainly to the continued effect of the Piper Alpha disaster and accidents in the Fulmar and Brent fields. The forecast assumes that North Sea oil prices will remain close to recent levels. PRT receipts are forecast to be slightly higher in 1989–90, despite the projected fall in production because there were repayments of advance PRT in 1988–89 and none are forecast for 1989–90.

Table 6.3 North Sea revenues

	£ billion			
	1987–88	1988–89		1989–90
	Outturn	1988 Budget	Latest estimate	Forecast
North Sea corporation tax ¹	1.4	1.5	1.3	0.8
Petroleum revenue tax ²	2.3	1.2	1.3	1.4
Oil royalties	1.0	0.6	0.6	0.6
Total North Sea revenues	4.7	3.3	3.2	2.9
¹ Before ACT set off of:	0.7	0.8	0.8	0.5

² Includes advance petroleum revenue tax

6.13 Excluding North Sea revenues general government receipts rose by 11 per cent in 1988–89 and are forecast to rise by about 8½ per cent in 1989–90. Within the overall increase forecast for 1989–90 there is:

a 7 per cent increase in income tax receipts;

a 23 per cent increase in receipts of corporation tax (including ACT but excluding North Sea mainstream corporation tax), with ACT growing more slowly than the rest;

a 9½ per cent increase in VAT receipts;

little change in receipts from the excise duties on petrol, tobacco and alcohol;

an 8½ per cent increase in local authorities' net receipts of rates (and community charge in Scotland);

a 3½ per cent increase in national insurance contributions, after allowing for the reforms to employees' contributions announced in the Budget.

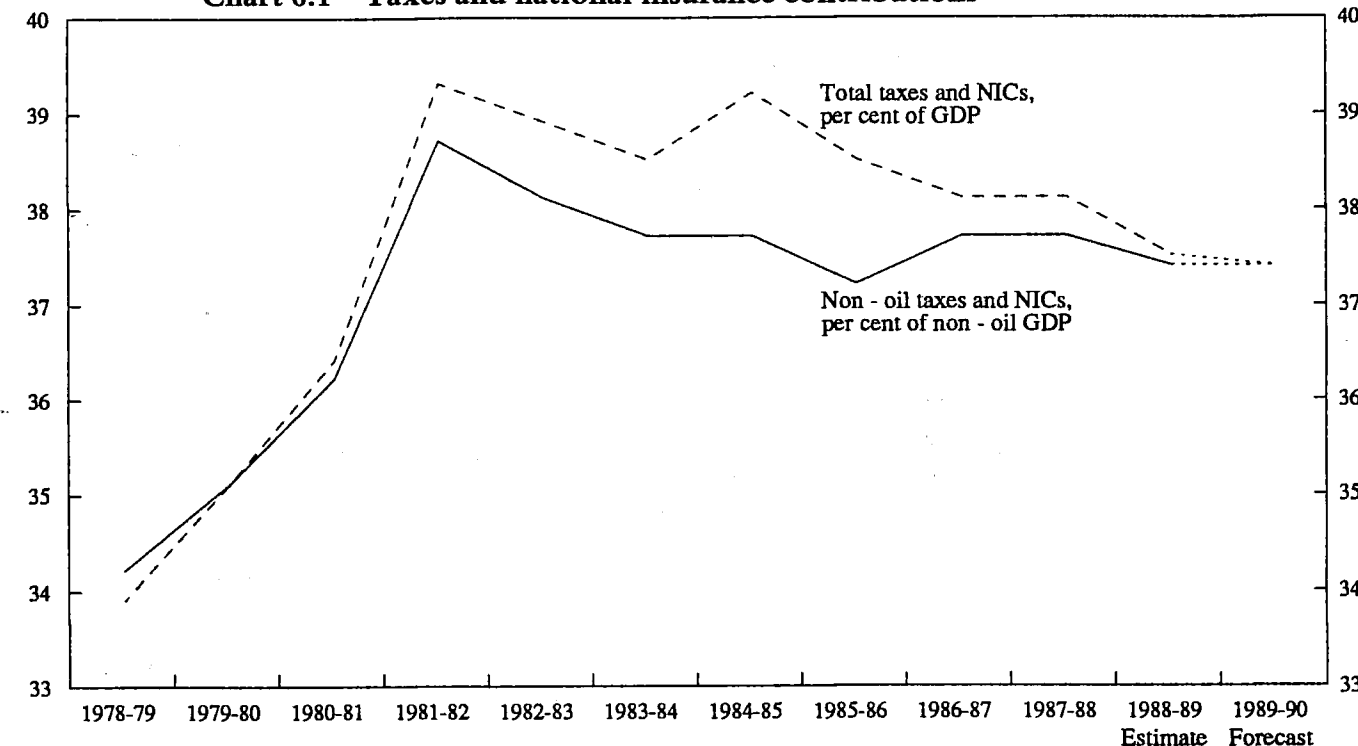
Taxes as a share of GDP

6.14 Table 6.4 shows taxes and national insurance contributions (NICs) as a per cent of GDP. Both the total and non-oil percentages are estimated to have fallen in 1988–89, by a half and a quarter percentage point respectively, compared with forecasts of no change in last year's Budget.

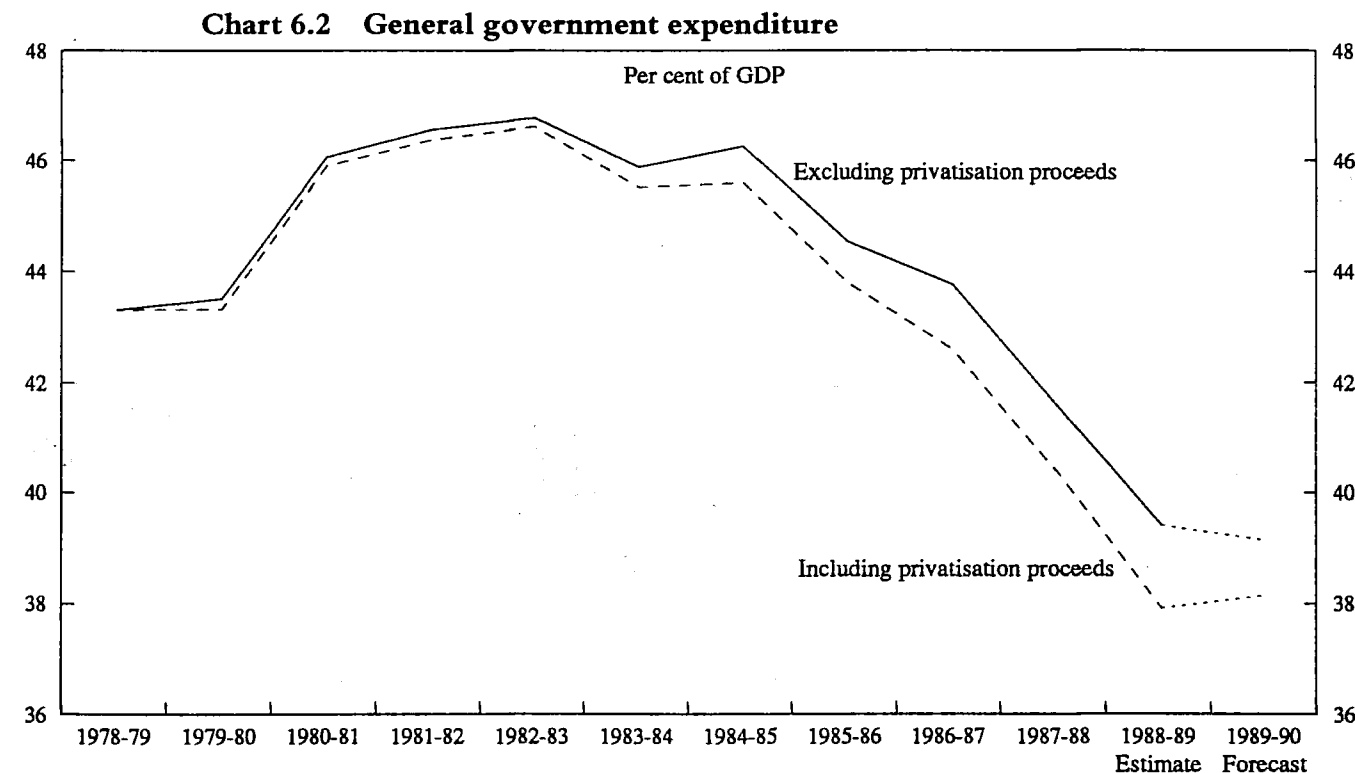
Table 6.4 Taxes and national insurance contributions as a per cent of GDP

	1983–84	1984–85	1985–86	1986–87	1987–88	1988–89 Latest estimate	1989–90 Forecast
Total taxes and NICs as a share of total GDP	38½	39¼	38½	38	38	37½	37½
Non-oil taxes and NICs as a share of non-oil GDP	37¾	37¾	37¼	37¼	37¼	37½	37½

6.15 The forecast is for total and non-oil taxes and NICs to be the same as percentages of GDP in 1989–90 as in 1988–89. In other words, the changes in the Budget merely offset real fiscal drag—the tendency for average tax rates to rise in a progressive tax system indexed to prices.

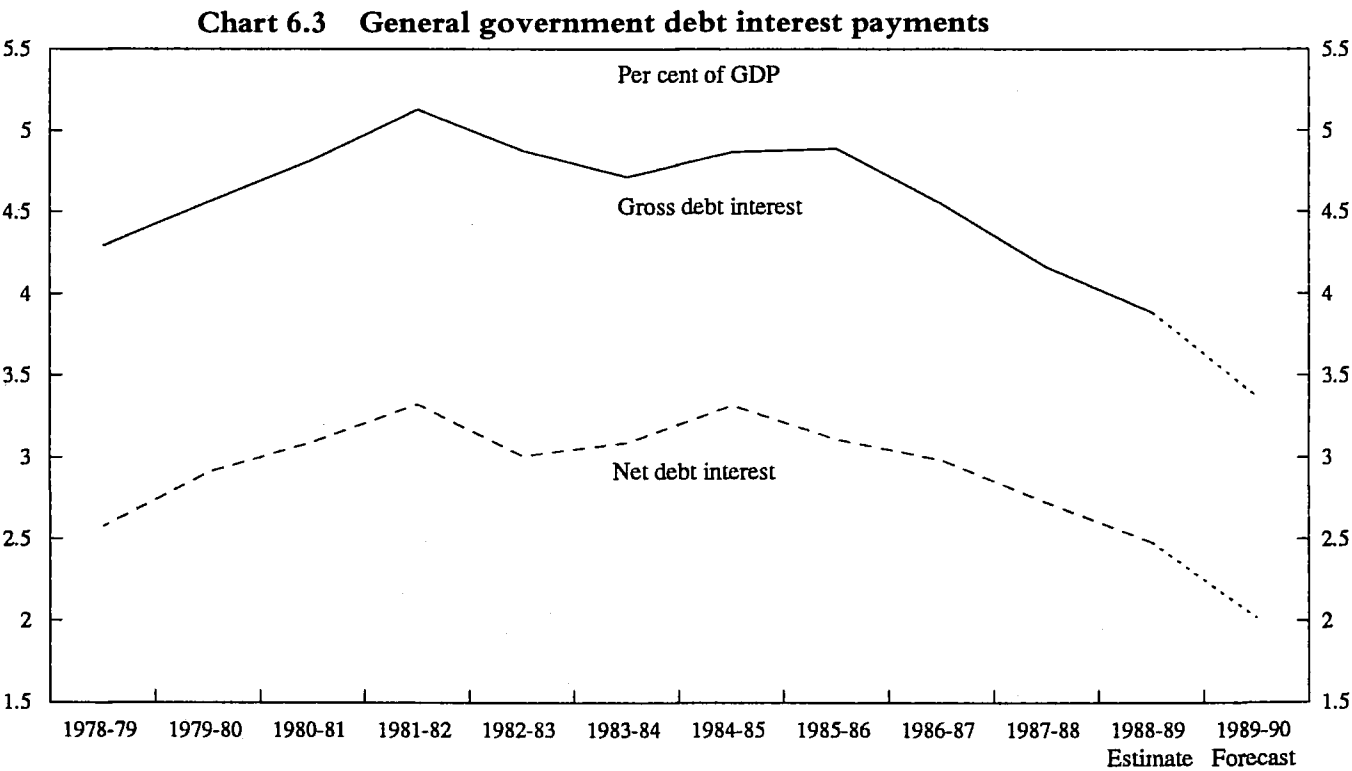
Chart 6.1 Taxes and national insurance contributions

Expenditure 6.16 General government expenditure (GGE) excluding privatisation proceeds is now estimated to have increased by about 5 per cent in 1988–89, and is forecast to rise by 7 per cent in 1989–90, below the growth of money GDP in both years. The ratio of GGE excluding privatisation proceeds to money GDP is therefore expected to fall in both years, as illustrated in Chart 6.2.

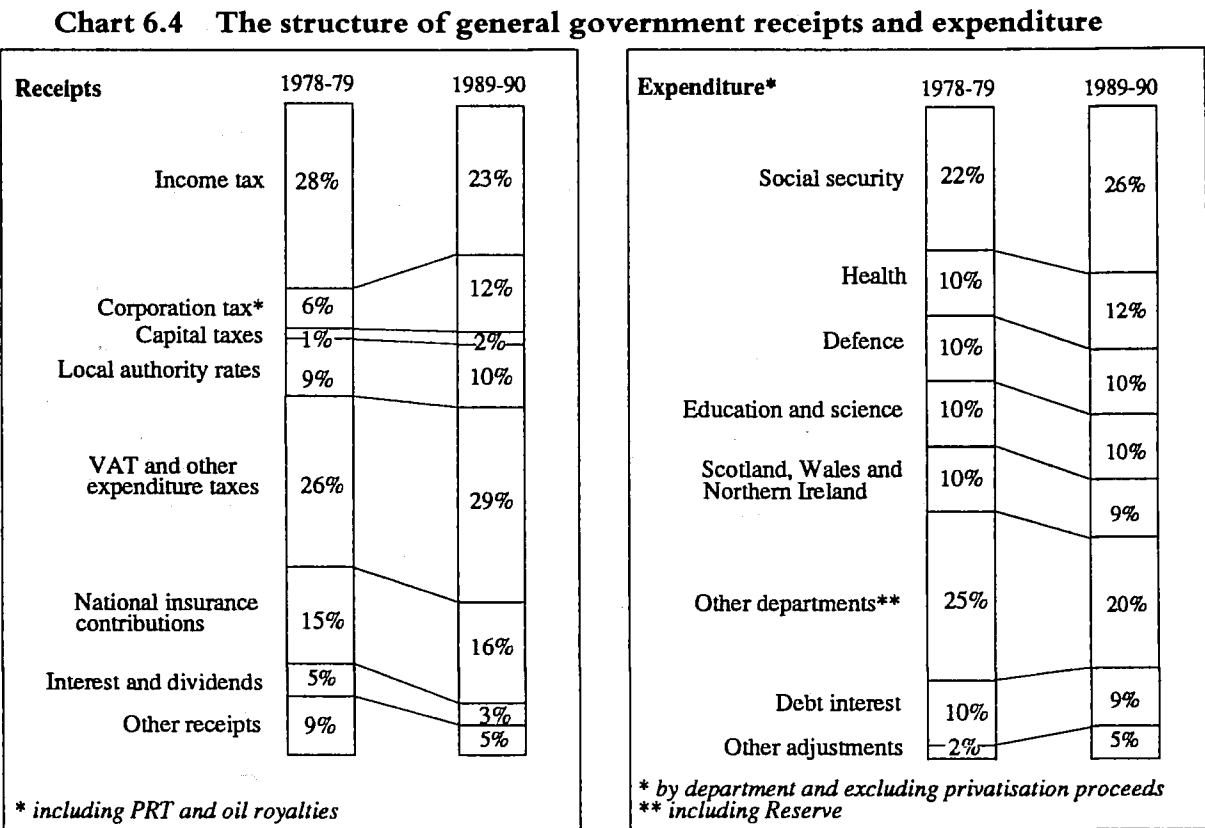


6.17 Within GGE, gross debt interest payments rose in cash terms in 1988–89 partly because of higher interest rates and inflation (which raises the cost of servicing indexed debt). Net debt repayment reduces interest payments, other things being equal, but not immediately; and because of the rise in the foreign exchange reserves and other short-term assets in 1987–88 and early 1988–89 some of the effect has come through initially as higher interest receipts. Interest and dividend receipts rose by £½ billion in 1988–89, despite a fall in the dividend element following the sale of the Government's remaining shareholding in BP.

6.18 Debt interest payments are forecast to fall substantially in 1989–90, against a background of a further rise in interest and dividend receipts.



6.19 Chart 6.4 shows the changes in the structure of general government receipts and expenditure which have taken place since 1978–79.



Public sector's finances: analysis by sector

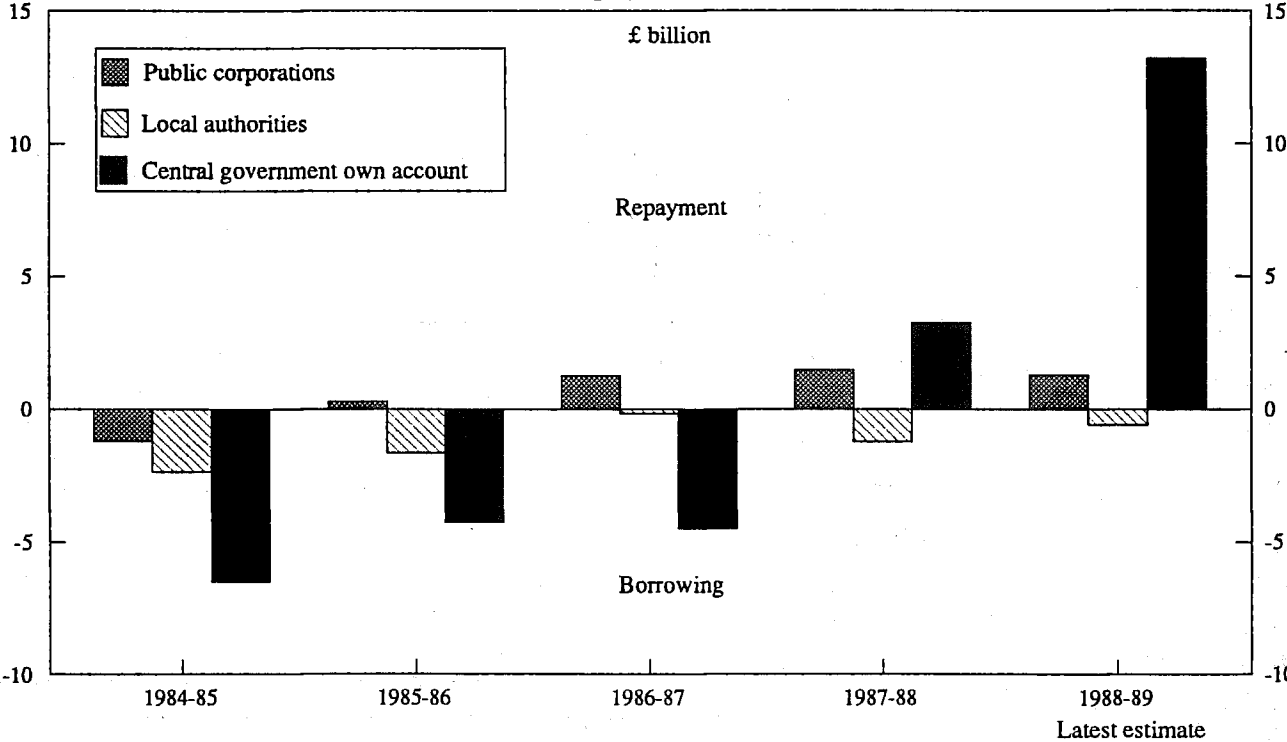
6.20 Table 6.5 shows net debt repayment in 1987-88 and 1988-89 by central government, local authorities and public corporations.

Table 6.5 Public sector debt repayment

	£ billion	
	1987-88 Outturn	1988-89 Latest estimate
1 Central government debt repayment on own account	3.2	13.2
2 Local authority debt repayment	-1.2	-0.6
3 of which to: central government	-4.1	-5.5
4 market and overseas	2.9	4.9
5 Public corporations' debt repayment	1.5	1.3
6 of which to: central government	0.0	-0.8
7 market and overseas	1.5	2.1
8 Public sector debt repayment	3.5	13.9
Central government debt repayment (lines 1 + 3 + 6)	-0.9	6.9

6.21 The PSDR in the first ten months of 1988-89 was £15.5 billion, substantially higher than in the same period of 1987-88, both including and excluding privatisation proceeds. The greater part of the increase was on central government own account. Taking into account both further privatisation proceeds of about £1 billion due in March and the well established pattern of high borrowing in March, the forecast for 1988-89 as a whole is a public sector debt repayment of £14 billion.

Chart 6.5 Public sector debt repayment by sector



6.22 Tables 6.6 to 6.8 show estimated outturns and forecasts of receipts and expenditure in 1988-89 and 1989-90 for each of the three sectors. Expenditure in 1989-90 does not include an allocation of the Reserve, although the forecast of the PSDR assumes that the Reserve is fully spent.

Central government

6.23 Central government expenditure in Table 6.6 includes grants and subsidies to local authorities and public corporations (including nationalised industries), which are included in the receipts of those sectors, shown in Tables 6.7 and 6.8. The forecast large rise in 1989-90 in net lending etc is mainly the result of a lower level of privatisation proceeds and higher capital grants to local authorities.

Table 6.6 Central government transactions

	£ billion		
	1987-88 Outturn	1988-89 Latest estimate	1989-90 Forecast ¹
<i>Receipts</i>			
Taxes and royalties	115.9	125.7	136.3
National insurance and other contributions	29.1	32.8	34.0
Other	10.4	11.5	13.3
Total receipts	155.3	170.0	183.6
<i>Expenditure</i>			
Current expenditure on goods and services	52.5	57.0	61.2
Current grants and subsidies	80.9	80.3	86.9
Interest	17.1	17.7	17.0
Net lending ² , capital expenditure, and cash expenditure on company securities	1.6	1.8	6.3
Total expenditure	152.1	156.7	171.4
Consolidated Fund revenues	123.0	135.1	141.9

¹Excluding any allocation from the Reserve.
²Excluding lending to local authorities and public corporations.

Local authorities

6.24 Local authority current receipts consist primarily of rate income (and, in Scotland, community charge income) plus grants from central government. The forecast increase in income (net of rebates) between 1988-89 and 1989-90 takes account of available information about rate decisions by local authorities, additions to rateable value, and the announced levels of community charge in Scotland. The forecast of expenditure in 1989-90 is lower than it would otherwise have been because of the transfer of polytechnics from the local authority to the private sector.

6.25 From information available about the first ten months it looks as if the local authority borrowing requirement will turn out to be rather lower in 1988-89 than in 1987-88, partly due to lower net capital spending as a result of rising capital receipts.

Table 6.7 Local authority transactions

	£ billion		
	1987-88 Outturn	1988-89 Latest estimate	1989-90 Forecast ¹
<i>Receipts</i>			
Rates and community charge ²	17.0	18.9	20.6
Rate and revenue support grant	12.5	12.7	13.0
Other grants from central government	12.0	12.2	15.0
Other	5.3	6.1	6.7
Total receipts	46.8	50.0	55.2
<i>Expenditure</i>			
Current expenditure on goods and services	34.4	36.6	37.1
Current grants and subsidies	5.5	5.9	6.8
Interest	4.4	4.7	4.5
Net lending and capital expenditure	3.7	3.3	3.1
Total expenditure	48.0	50.6	51.5
¹ Excluding any allocation from the Reserve.			
² Net of rebates:	1.8	1.5	1.7

Public corporations 6.26 Table 6.8 shows public corporations' transactions. The public corporations' receipts include subsidies and capital grants from central and local government. Changes in public corporations' income and expenditure from one year to another are affected by privatisations which involve re-classifying privatised industries from the public to the private sector in the national accounts. For example the 12 per cent increase in gross trading surplus in 1988-89 would have been larger had British Steel not been excluded in the last quarter, following its privatisation.

Table 6.8 Public corporations' transactions

	£ billion		
	1987-88 Outturn	1988-89 Latest estimate	1989-90 Forecast ¹
<i>Receipts</i>			
Gross trading surplus (including subsidies)	6.8	7.6	8.1
Other	2.4	2.1	2.7
Total receipts	9.2	9.7	10.8
<i>Expenditure</i>			
Interest, dividends and taxes on income	3.1	3.0	3.5
Net lending and capital expenditure	4.6	5.4	6.0
Total expenditure	7.7	8.5	9.5
<i>Public corporations' contribution to planning total:</i>			
nationalised industries' external finance	0.3	-0.1	0.0
other public corporations	0.5	0.5	0.9

¹ Excluding any allocation from the Reserve

Public sector's finances: analysis by economic category

6.27. The full analysis of receipts and expenditure by economic category is shown in Table 6.9, with a breakdown between central government, local authorities and public corporations. This analysis, which distinguishes between current and capital transactions (and within the latter between physical and financial investment), shows the derivation of the public sector financial surplus. The financial surplus, unlike the PSDR, is not wholly a measure of cash transactions because certain items above line 24 in Table 6.9, for example some taxes included in lines 1 and 2, are measured on an accruals basis. An accruals adjustment is accordingly made in line 28.

6.28. The unallocated Reserve is assumed to be on current spending items or physical capital formation ie in transactions that fall above the financial surplus line. In practice allocations from the Reserve can affect financial transactions (lines 25 to 29).

Table 6.9 Public sector transactions by sub-sector and economic category

		£ billion				
		1988-89 Latest estimate				
		General government			Public corpora- tions	Public sector
		Central govern- ment	Local authori- ties	Total		
	Line ¹					
<i>Current and capital receipts</i>						
Taxes on income, and oil royalties	1	62.7	—	62.7	-0.1	62.6
Taxes on expenditure	2	57.8	18.9	76.8	—	76.8
Taxes on capital	3	5.1	—	5.1	—	5.1
National insurance and other contributions	4	32.8	—	32.8	—	32.8
Gross trading surplus	5	-0.5	0.4	-0.1	7.6	7.6
Rent and miscellaneous current transfers	6	0.4	3.1	3.5	0.5	4.0
Interest and dividends from private sector and abroad	7	3.4	1.2	4.6	0.7	5.2
Interest and dividends within public sector	8	6.0	-4.0	2.1	-2.1	—
Imputed charge for non-trading capital consumption	9	1.3	1.6	2.9	—	2.9
Capital transfers from private sector	10	—	—	—	0.2	0.2
Total receipts	11	169.1	21.2	190.3	6.9	197.1
<i>Current and capital expenditure</i>						
Current expenditure on goods and services	12	57.0	36.6	93.6	—	93.6
Subsidies	13	4.1	1.0	5.1	—	5.1
Current grants to personal sector	14	49.2	5.0	54.2	—	54.2
Current grants paid abroad	15	3.0	—	3.0	—	3.0
Current grants within public sector	16	23.9	-23.9	—	—	—
Debt interest	17	17.7	0.6	18.3	0.6	18.9
Gross domestic fixed capital formation	18	3.8	2.8	6.5	4.9	11.5
Increase in stocks	19	-0.3	—	-0.3	0.4	0.1
Capital grants to private sector	20	3.1	0.7	3.8	0.1	3.9
Capital grants within public sector	21	1.8	-1.0	0.8	-0.8	—
Total expenditure	22	163.3	21.7	185.0	5.3	190.2
Unallocated Reserve	23	—	—	—	—	—
Financial surplus	24	5.8	-0.5	5.3	1.6	6.9
<i>Financial transactions</i>						
Net lending to private sector and abroad	25	0.5	-0.2	0.3	—	0.3
Cash expenditure on company securities (including privatisation proceeds)	26	-7.1	0.1	-7.0	—	-7.1
Transactions concerning certain public sector pension schemes	27	-0.7	—	-0.7	—	-0.7
Accruals adjustments	28	-0.1	-0.2	-0.3	—	-0.3
Miscellaneous financial transactions	29	—	0.5	0.4	0.3	0.8
Debt repayment	30	13.2	-0.6	12.6	1.3	13.9

¹ Financial surplus (line 24) = receipts (line 11) - expenditure (line 22) - Reserve (line 23).
Debt repayment (line 30) = financial surplus (line 24) - financial transactions (lines 25 to 29).

² Including community charge in Scotland.

	£ billion 1989-90 Forecast					
	General government			Public corpora- tions	Public sector	
Line ¹	Central govern- ment	Local authori- ties	Total			
						<i>Current and capital receipts</i>
1	69.6	—	69.6	-0.6	69.0	Taxes on income, and oil royalties
2	61.4	20.6	82.0	—	82.0	Taxes on expenditure ²
3	5.3	—	5.3	—	5.3	Taxes on capital
4	34.0	—	34.0	—	34.0	National insurance and other contributions
5	-0.5	0.4	—	8.1	8.1	Gross trading surplus
6	0.5	3.2	3.7	0.6	4.3	Rent and miscellaneous current transfers
7	3.4	1.5	4.9	0.6	5.5	Interest and dividends from private sector and abroad
8	6.4	-4.3	2.2	-2.2	—	Interest and dividends within public sector
9	1.4	1.7	3.1	—	3.1	Imputed charge for non-trading capital consumption
10	—	—	—	0.2	0.2	Capital transfers from private sector
11	181.6	23.1	204.7	6.7	211.5	Total receipts
						<i>Current and capital expenditure</i>
12	61.2	37.1	98.3	—	98.3	Current expenditure on goods and services
13	4.6	0.9	5.5	—	5.5	Subsidies
14	52.9	5.8	58.7	—	58.7	Current grants to personal sector
15	4.0	—	4.0	—	4.0	Current grants paid abroad
16	25.5	-25.5	—	—	—	Current grants within public sector
17	17.0	0.1	17.1	0.4	17.5	Debt interest
18	5.1	2.5	7.6	5.7	13.4	Gross domestic fixed capital formation
19	-0.3	—	-0.3	0.2	-0.1	Increase in stocks
20	2.4	0.7	3.1	0.1	3.3	Capital grants to private sector
21	3.6	-2.5	1.1	-1.1	—	Capital grants within public sector
22	176.0	19.2	195.3	5.3	200.6	Total expenditure
23					3.5	Unallocated Reserve
24					7.3	Financial surplus
						<i>Financial transactions</i>
25	0.4	-0.2	0.2	—	0.2	Net lending to private sector and abroad
26	-5.0	—	-5.0	—	-5.0	Cash expenditure on company securities (including privatisation proceeds)
27	-0.5	—	-0.5	—	-0.5	Transactions concerning certain public sector pension schemes
28	-1.0	-0.2	-1.2	—	-1.2	Accruals adjustments
29	-0.4	0.5	—	0.1	0.1	Miscellaneous financial transactions
30					13.8	Debt repayment