
Financial Statement and Budget Report 1988-89

Return to an Order of the House of Commons dated 15 March 1988: for

*Copy of Financial Statement and Budget Report 1988-89
as laid before the House of Commons by
the Chancellor of the Exchequer when opening the Budget*

Treasury Chambers }
15 March 1988 }

Norman Lamont

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1 The Budget

Table 1.1 The Budget measures¹

	£ million		yield(+)/cost(-)
	1988-89	1989-90	1989-90
	Changes from a non-indexed base	Changes from an indexed base	Changes from an indexed base
Income tax			
personal allowances double indexed	- 1 375	- 690	- 895
basic rate limit double indexed	- 155	- 75	- 125
basic rate reduced to 25p ²	- 2 570	- 2 570	- 3 200
higher rates above 40p abolished	- 1 025	- 965	- 2 070
car benefit scales doubled	+ 260	+ 260	+ 310
home improvement loans relief abolished	+ 80	+ 80	+ 200
covenants and maintenance	+ 35	+ 35	+ 100
Capital gains tax			
tax rebased to 1982	*	*	- 55
annual exemption reduced to £5 000	*	*	+ 15
gains charged at income tax rates	+ 70	+ 70	+ 65
Independent taxation³	*	*	- 20
Inheritance tax			
flat rate of 40 per cent above £110 000	- 120	- 100	- 200
Corporation tax			
tax on capital gains rebased to 1982	- 25	- 25	- 235
small companies' rate reduced to 25p	*	*	- 50
Capital duty abolished⁴	- 90	- 90	- 100
Excise duties			
petrol and derv	+ 350	+ 100	+ 65
vehicle excise duty	+ 20	- 80	- 90
tobacco	+ 100	*	- 5
alcohol	+ 105	*	- 10
Other tax changes	+ 65	+ 65	+ 135
Total	- 4 275	- 3 985	- 6 165

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

² Figures include the effect of the consequential change in the rate of advance corporation tax.

³ The cost of independent taxation, which is introduced in 1990-91, is explained in note 36 in the annex to Chapter 4.

⁴ Figures include the cost of abolishing unit trust instrument duty.
* = Negligible.

The Medium Term Financial Strategy

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-1989; sets out the tax proposals in the Budget; summarises the Government's spending plans; and gives forecasts for the public finances for the year ahead.

1.03 Chapter 2 describes the MTFS, which provides the framework for the Government's economic policy. Monetary policies are designed to keep the growth of money GDP on a downward trend over the medium term, so bringing down inflation. This year's MTFS provides for a balanced budget over the medium term, with both taxes and public expenditure declining as a share of GDP. It is complemented by supply side policies, including new measures in the Budget, designed to encourage enterprise, efficiency and flexibility and thus the growth of output and employment.

The economy

1.04 Chapter 3 describes the main developments in the economy in 1987 and the prospect until mid-1989. The economy grew strongly in 1987, with the largest fall in unemployment since the war. GDP is forecast to grow by a further 3 per cent in 1988, with particularly strong growth in business investment. Inflation should remain low and unemployment continue to fall.

Tax measures

1.05 Chapter 4 sets out the tax proposals in the Budget. They continue the Government's programme of tax reduction and reform. They include an increase in personal allowances, a reduction in the basic rate of income tax of 2p to 25p, the abolition of all higher rates of income tax above 40 per cent, and the introduction in 1990-91 of the independent taxation of husband and wife. Other measures include reforms of capital gains tax, inheritance tax and the tax treatment of covenants and maintenance. 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 1987-88.

Public sector finances

1.07 Chapter 6 presents the complete financial picture for the public sector. There is expected to be a budget surplus of around £3 billion in 1987-88, only the second surplus since the beginning of the 1950s. A further surplus of around £3 billion is envisaged for 1988-89, with a balanced budget thereafter. This takes account of the tax proposals in the Budget which are expected to reduce taxation by £4 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		
	1987-88		1988-89		1987-88		1988-89
	1987 Budget ²	Latest estimate	Forecast		1987 Budget ²	Latest estimate	Forecast
RECEIPTS				EXPENDITURE			
Income tax	40.0	41.5	42.1	DHSS—social security	46.0	46.3	48.5
Corporation tax excluding North Sea ³	13.5	13.7	17.3	DHSS—health and personal social services	19.1	19.7	20.7
Capital taxes	3.3	3.7	4.7	Defence	18.8	18.6	19.2
Expenditure taxes:				Education and science	16.6	17.1	18.0
VAT	23.3	24.1	26.2	Scotland, Wales and Northern Ireland	16.0	16.3	17.1
local authority rates	16.9	16.9	19.0	Other departments	33.6	33.0	34.9
petrol, derv, etc.	7.8	7.8	8.4	Privatisation proceeds	-5.0	-5.0	-5.0
cigarettes and other tobacco	4.9	4.8	5.0	Reserve	3.5	—	3.5
spirits, beer, wine, etc.	4.3	4.4	4.5				
stamp duties	2.1	2.4	2.0	Public expenditure planning			
other	8.5	8.9	9.4	total	148.6	146.0	156.8
Total expenditure taxes	67.8	69.3	74.4				
North Sea revenues:							
North Sea corporation tax ⁴	1.4	1.4	1.5				
petroleum revenue tax	1.7	2.3	1.2				
oil royalties	0.8	1.0	0.6				
Total North Sea	3.9	4.7	3.3	General government gross			
Other ⁵	-0.8	-0.6	-0.7	debt interest	17.9	17.5	17.5
Total taxes and royalties	127.8	132.3	141.2	Other adjustments	7.0	8.3	8.6
National insurance and other contributions	28.5	28.7	31.6				
Interest and dividend receipts	5.7	6.3	5.6				
Gross trading surpluses and rent	3.3	3.0	3.5				
Other	3.5	3.4	2.9				
General government receipts	168.8	173.7	184.9	General government expenditure	173.5	171.8	182.9

Expenditure, receipts and borrowing⁶

	£ billion		
	1987-88		1988-89
	1987 Budget ²	Latest estimate	Forecast
General government expenditure	173.5	171.8	182.9
General government receipts	168.8	173.7	184.9
General government borrowing requirement	4.7	-1.9	-2.0
Public corporations' market and overseas borrowing	-0.8	-1.2	-1.2
Public sector borrowing requirement	3.9	-3.1	-3.2

¹ In these and other tables, constituent items may not add up to totals because of rounding.² On current definitions.³ Including advance corporation tax but excluding corporation tax on capital gains.⁴ Before advance corporation tax set off. See footnote ³ to Table 6B.3.⁵ Adjustments for advance corporation tax set off against North Sea corporation tax plus accruals adjustment.⁶ Net borrowing: positive; net debt repayment: negative.

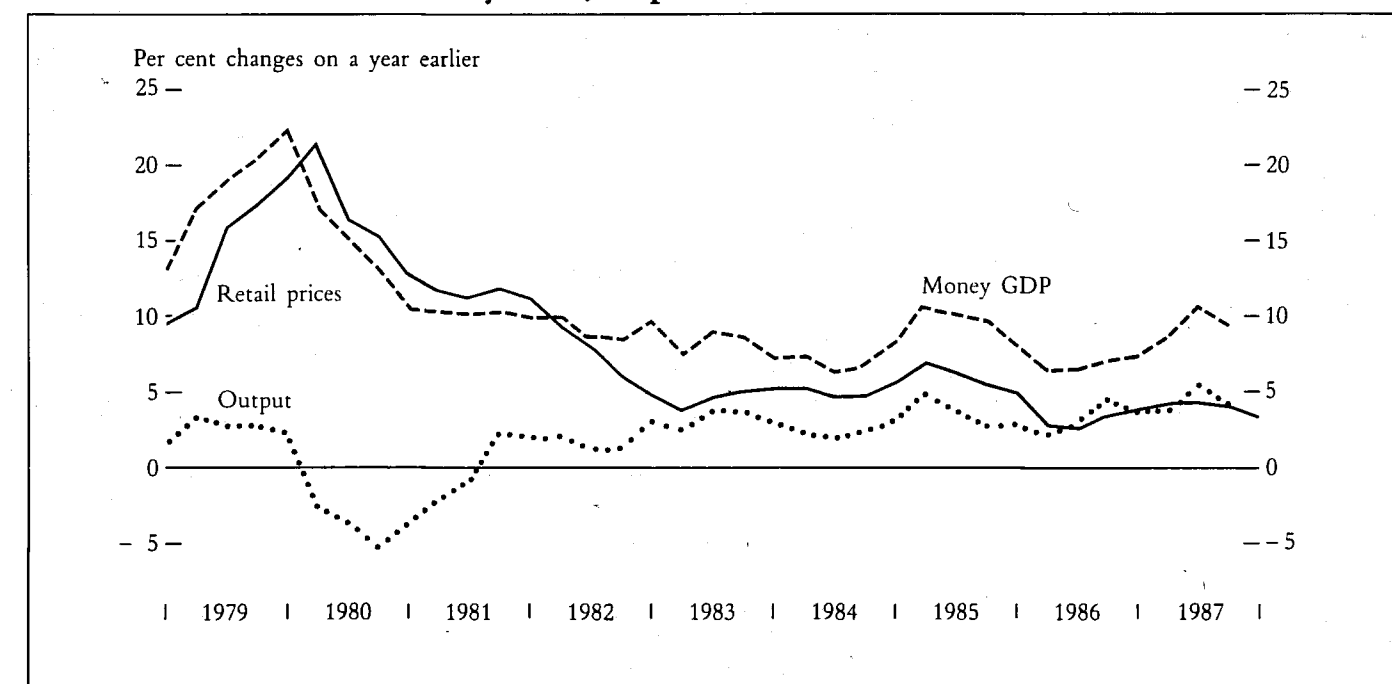
2 The Medium Term Financial Strategy

2.01 The Medium Term Financial Strategy (MTFS) continues to provide the framework for the Government's economic policy, as it has done since 1980.

2.02 It is intended to bring inflation down further over a period of years, and ultimately to achieve price stability. Accordingly, economic policy is set in a nominal framework. Monetary and fiscal policies are designed to keep the growth of money GDP on a downward trend over the medium term. The MTFS is complemented by policies to improve the working of markets and the supply side of the economy. By encouraging enterprise, efficiency and flexibility, these policies improve the division of money GDP growth between output growth and inflation, thus assisting the creation of jobs.

2.03 Money GDP growth has come down from over 20 per cent at the start of 1980 to under 10 per cent last year. At the same time retail price inflation has fallen from over 20 per cent at its peak in 1980 to 4 per cent last year. In real terms the economy has grown steadily at 3½ per cent a year on average since 1983, and is set for a further year of growth at around 3 per cent, with inflation approaching 4 per cent.

Chart 2.1 Money GDP, output and inflation



Objectives and the framework of policy

2.04 Monetary and fiscal policy is directed at maintaining conditions that will bring about a gradual reduction in the growth of money GDP over the medium term. Table 2.1 shows the intended medium term path for money GDP, although there will inevitably be fluctuations around it in the short term.

Table 2.1 Money GDP growth¹

1987-88	1988-89	1989-90	1990-91	1991-92
9½	7½	6½	6	5½

¹ Per cent changes on previous financial year. See Table 2.3 for assumptions on output and inflation. The figure for 1988-89 is a forecast; the figures for subsequent years describe the Government's broad medium term objectives.

2.05 Money GDP growth is expected to be around 9½ per cent in 1987-88, higher than forecast in last year's FSBR. The division of money GDP growth between output growth and inflation was better than forecast, a further sign of improvement in the supply performance of the economy. Output growth is currently estimated at 1½ percentage points above last year's forecast; inflation (as measured by the GDP deflator) is estimated to have been about ½ percentage point higher than forecast.

2.06 For 1988-89, money GDP growth is forecast to be 7½ per cent. Real growth is forecast to slow down from its 1987-88 level. The current forecast for the increase in the GDP deflator in 1988-89 is a little above the projection in last year's MTFS.

2.07 For the later years, the growth of money GDP is projected to decline at much the same rate as envisaged last year. The medium term growth projection for the economy as a whole is unchanged from last year's MTFS, as is the medium term decline in inflation.

Monetary policy

2.08 A declining path for money GDP growth requires a reduction in monetary growth over the medium term. For M0, which has continued to be a reliable indicator of monetary conditions, the Government is setting a target range for 1988-89 of 1-5 per cent. This is the same as indicated in last year's MTFS. The ranges given in Table 2.2 for later years are illustrative, but show a steady fall consistent with the declining path for money GDP growth.

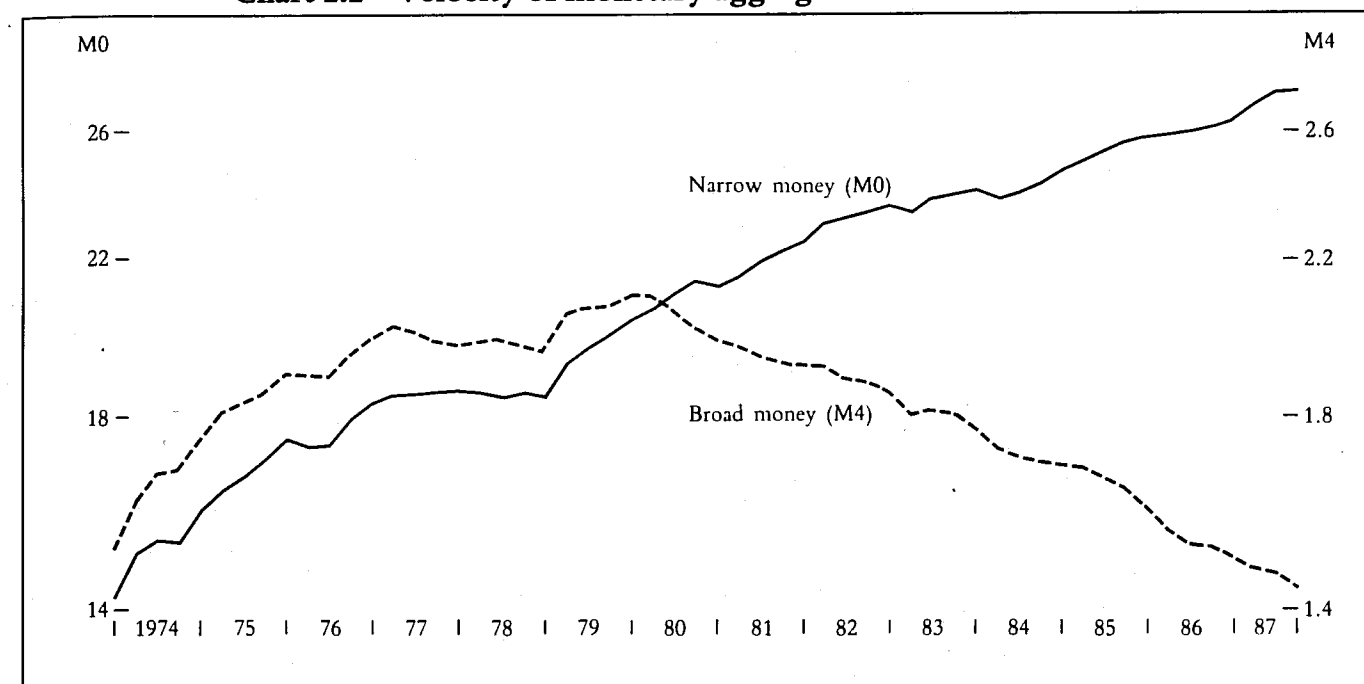
Table 2.2 Growth of M0¹

1987-88	1988-89	1989-90	1990-91	1991-92
5	1-5	1-5	0-4	0-4

¹ Per cent changes on previous financial year.

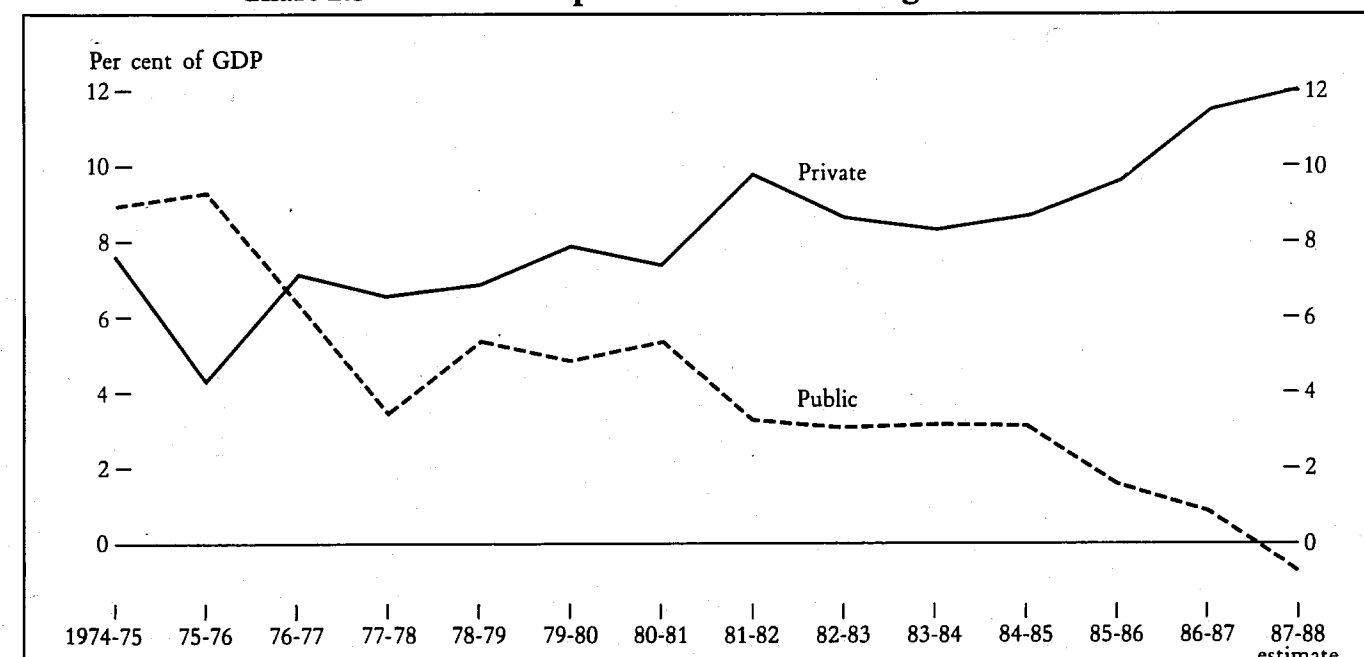
2.09 While, as last year, there is no explicit target range for broad money, the assessment of monetary conditions continues to take broad money, or liquidity, into account.

Chart 2.2 Velocity of monetary aggregates



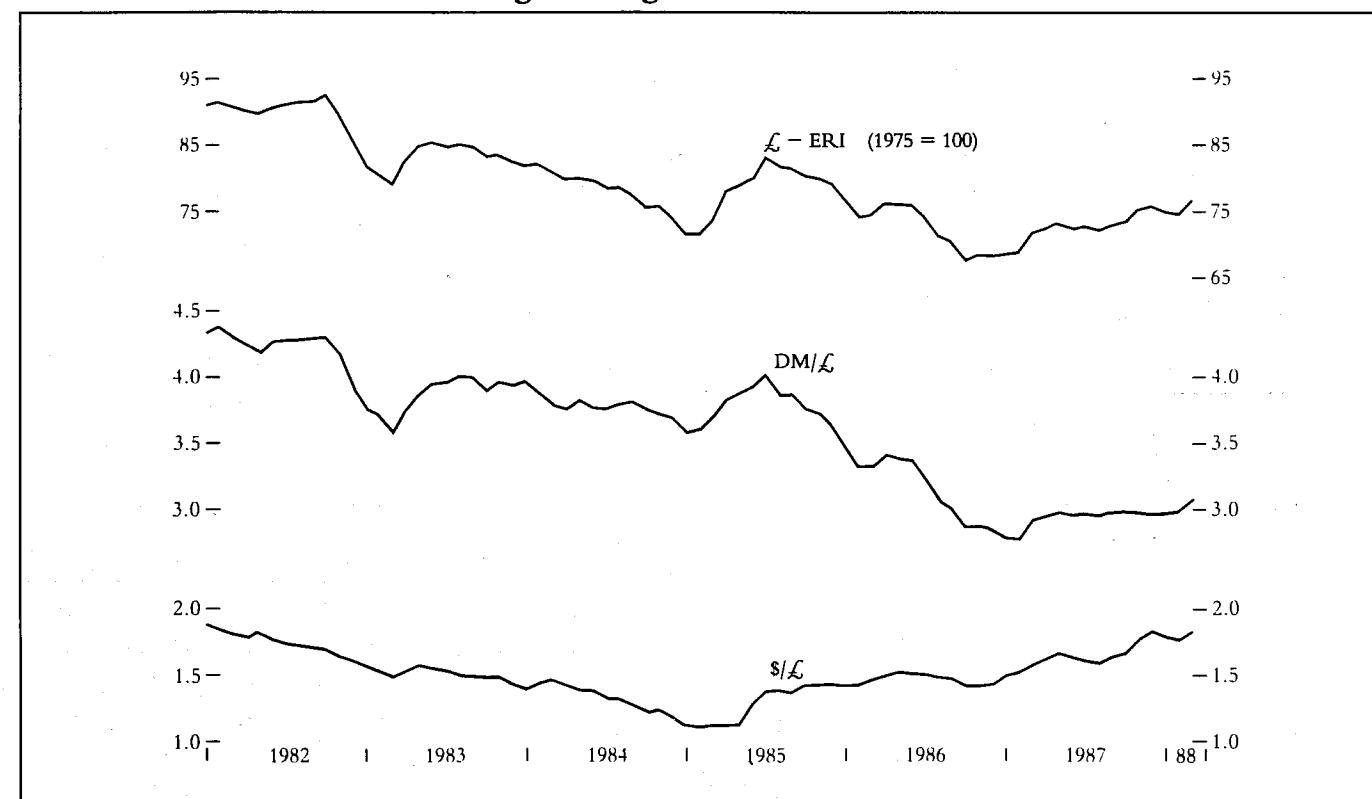
2.10 With the increasing overlap between activities of banks and building societies, it is sensible to concentrate on measures of broad money that include deposits held with both. The authorities will seek to fund the net total of maturing debt, the PSBR, and any underlying change in foreign exchange reserves, by sales of debt outside the banking and building society sectors.

Chart 2.3 Private and public sector borrowing



2.11 Interest rate decisions are based on a comprehensive assessment of monetary conditions so as to maintain downward pressure on inflation. Increases in domestic costs will not be accommodated either by monetary expansion or by exchange rate depreciation. Exchange rates play a central role in both domestic monetary decisions and international policy co-operation. In their communique of 23 December the Finance Ministers and Central Bank Governors of the seven major industrialised countries re-emphasised their common interest in more stable exchange rates.

Chart 2.4 Sterling exchange rates



Fiscal policy

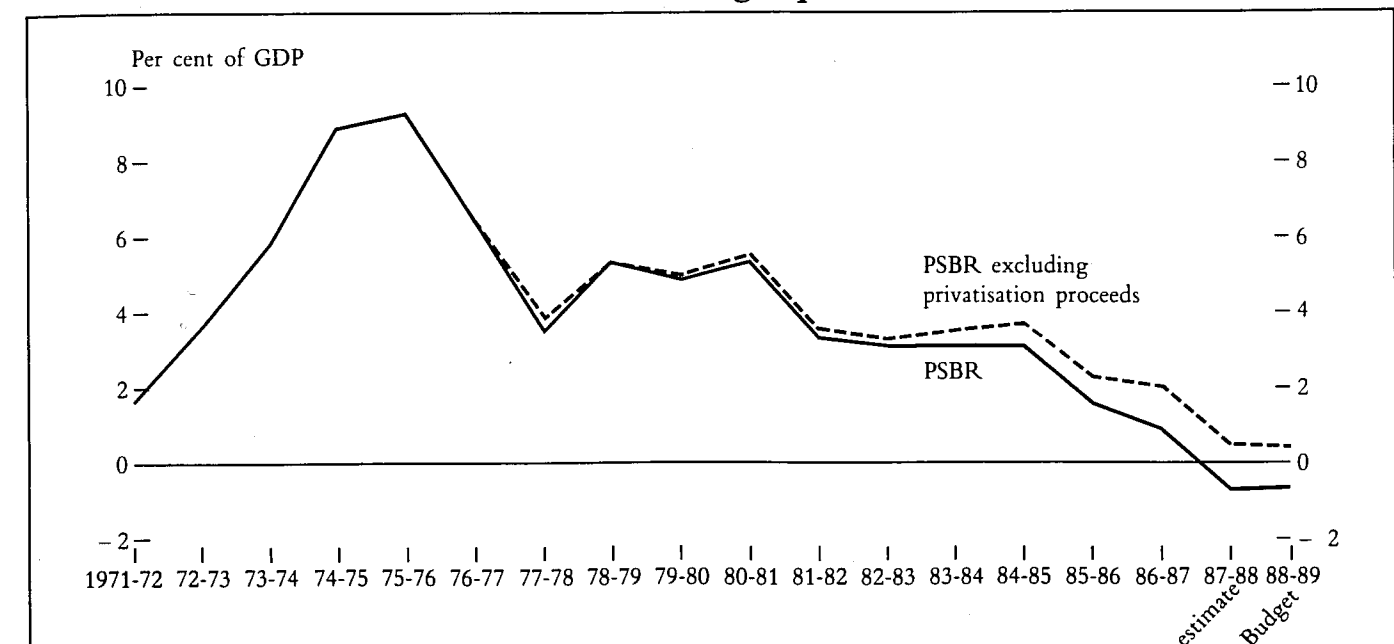
2.12 It is now expected that there will be a net repayment of public sector debt in 1987–88, compared with a borrowing requirement of around 1 per cent of GDP forecast a year ago. This is only the second time since the early 1950s that there has been a budget surplus. Even if there had been no privatisation proceeds at all, the PSBR would have been under $\frac{1}{2}$ per cent of GDP, smaller than in any year since 1969–70.

The PSBR path **2.13** The PSBR is now assumed to be zero over the medium term: a balanced budget. This is a prudent and cautious level and can be maintained over the medium term. It also provides a clear and simple rule, with a good historical pedigree. In practice, there are likely to be fluctuations around this level from year to year. A PSBR of zero on the basis of current privatisation plans implies a PSBR of only 1 per cent of GDP in the absence of privatisation proceeds.

2.14 The recent strength of the economy and the buoyancy of government revenue have led to a budget surplus over the last year; and without the tax

forecasts, a surplus of some £7 billion in 1988–89. Continuing the gradualist approach which has always been a characteristic of the MTFS, only part of this room for tax reductions has been used. The PSBR for 1988–89 has been set at minus £3 billion, the same as the expected outturn in 1987–88. The PSBR to be set in future Budgets will as usual be reviewed in the light of circumstances at the time.

Chart 2.5 Public sector borrowing requirement



Assumptions **2.15** For the period to 1990–91, the public expenditure projections in Table 2.4 incorporate the public expenditure plans shown in the public expenditure White Paper (Cm 288); gross debt interest payments are lower than projected in the White Paper, reflecting lower government borrowing, while other adjustments are a little higher. It is provisionally assumed that general government expenditure will grow by 1 per cent in real terms in 1991–92. Decisions on expenditure in 1991–92 will be taken in the 1988 Survey.

2.16 The assumptions about output growth and inflation that underlie the revenue projections are shown in Table 2.3. They are consistent with the figures for money GDP growth in Table 2.1. Oil prices are assumed to remain close to recent levels in 1988–89 and thereafter to remain broadly unchanged in real terms.

Table 2.3 Output and inflation assumptions

	Per cent changes on previous financial year				
	1987–88	1988–89	1989–90	1990–91	1991–92
Real GDP					
Non-North Sea	5	3½	3	3	3
Total	4½	3	2½	2½	2½
Inflation					
GDP deflator	5	4½	4	3½	3

Public expenditure

2.17 Continued restraint in total public spending is a vital element of the Government's economic strategy. Reductions in borrowing and hence in the burden of debt interest, coupled with strong economic growth, are helping the Government to increase spending on priority programmes while at the same time achieving its objective of reducing public expenditure as a proportion of national income. This in turn is creating room for reductions in taxation, helping to improve further the performance of the supply side of the economy. Public expenditure is considered more fully in Chapter 5.

Table 2.4 General government expenditure

	£ billion, cash					
	1986-87	1987-88	1988-89	1989-90	1990-91	1991-92
Public expenditure planning total ¹	139.2	146	157	167	176	184
Gross debt interest	17.6	17	17	17	17	16
Other adjustments	8.2	8	9	9	9	9
General government expenditure²	165.0	172	183	193	202	210
Privatisation proceeds	4.4	5	5	5	5	5
General government expenditure excluding privatisation proceeds	169.4	177	188	198	207	215

¹ For 1986-87 to 1990-91, the figures are taken from Table 5.1.

² General government expenditure, and its components, are rounded to the nearest £1 billion from 1987-88 onwards. General government expenditure is assumed to grow by 1% in real terms in 1991-92.

Revenue

2.18 The growth in government revenues in cash terms over the medium term will depend on the growth of incomes, spending and prices, as well as on policy decisions. On the unchanged policy assumptions set out above, general government receipts are expected to increase somewhat less than money GDP. 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 projected to grow at a little under the rate of growth of non-oil money GDP.

Table 2.5 General government receipts

	£ billion, cash					
	1986-87	1987-88	1988-89	1989-90	1990-91	1991-92
Taxes on incomes, expenditure and capital	120.1	132	141	150	158	165
National insurance and other contributions	26.6	29	32	34	36	38
Interest and dividends	6.0	6	6	5	5	4
Other receipts	7.5	6	6	7	7	7
General government receipts¹	160.1	174	185	195	205	214
of which						
North Sea tax ²	4.8	5	3	3	3	3

¹ General government receipts, and its components, are rounded to the nearest £1 billion from 1987-88 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. See

Public sector borrowing

2.19 The projections of government expenditure and receipts are brought together in Table 2.6 to provide projections of the general government borrowing requirement (GGBR), the PSBR and the fiscal adjustment.

2.20 Changes since the 1987 MTFS are discussed in the Annex to this chapter.

Table 2.6 Public sector borrowing¹

	£ billion, cash					
	1986-87	1987-88	1988-89	1989-90	1990-91	1991-92
General government expenditure	165.0	172	183	193	202	210
General government receipts	160.1	174	185	195	205	214
Fiscal adjustment from previous years ²	—	—	—	—	3	4
Annual fiscal adjustment ²	—	—	—	3	1	1
GGBR	4.9	-2	-2	1	1	1
Public corporations' market and overseas borrowing	-1.5	-1	-1	-1	-1	-1
PSBR	3.4	-3	-3	0	0	0
Money GDP at market prices	386	424	456	486	516	545
PSBR as per cent of GDP	0.9	-0.7	-0.7	0	0	0

¹ Net borrowing: positive; net debt repayment: negative. Rounded to the nearest £1 billion from 1987-88 onwards. Further details for 1987-88 and 1988-89 are provided in Tables 1.2 and 6.7.

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

Conclusion

2.21 The strength of the economy coupled with fiscal prudence has enabled the Government to achieve a balanced budget on a sustainable basis. The Government remains committed to continuing with the policies which have helped to bring this about, and to maintaining the progress in the medium term towards lower inflation, coupled with lower taxes and public spending as a share of GDP. The MTFS provides the financial framework within which the policies to achieve these objectives are set.

Annex to Chapter 2

Changes since the 1987 MTFS

Money GDP 2A.1 The growth rate of money GDP is expected to be higher in both 1987–88 and 1988–89 than envisaged in last year's MTFS, with growth in the GDP deflator $\frac{1}{2}$ percentage point higher in both years. Thereafter inflation is projected to decline at the same rate as last year. The projection of output growth over the medium term in the whole economy is unchanged from last year's MTFS.

Table 2A.1 Money GDP growth

Differences from 1987 MTFS projections, percentage points				
1987–88	1988–89	1989–90	1990–91	
+2 $\frac{1}{4}$	+1	+ $\frac{1}{2}$	+ $\frac{1}{2}$	

Monetary aggregates 2A.2 The growth of M0 in 1987–88 has been within its target range throughout the year. The target range for 1988–89 is the same as the illustrative range given last year. The illustrative ranges for subsequent years are also the same.

Table 2A.2 The growth of M0

	Per cent changes on a year earlier			
	1987–88	1988–89	1989–90	1990–91
1988 MTFS	5	1–5	1–5	0–4
1987 MTFS	2–6	1–5	1–5	0–4

Fiscal projections 2A.3 Table 2A.3 shows changes in the fiscal projections since the 1987 FSBR. Additional information on 1987–88 is given in Chapter 6.

Expenditure 2A.4 The undershoot on the planning total in 1987–88 is described in Chapter 5. The planning total for 1988–89 onwards is as in the public expenditure White Paper (Cm 288), which incorporates higher figures than assumed last year. The general government expenditure figures for the future have also been revised up; but to a lesser extent than the planning total, as the lower path now adopted for the PSBR implies substantially lower debt interest payments.

Receipts 2A.5 Revenues in 1987–88 have been much higher than forecast, in large part reflecting higher money GDP growth in both 1986–87 and 1987–88. Because of the lag between accruals and payments of taxes on corporate profits, the buoyancy of the economy over the last year will still be contributing to the growth of revenues in 1988–89. North Sea revenues in 1987–88 were higher than forecast, as the oil price for much of the year was well above the assumed level of \$15 a barrel. On the assumption that oil prices remain close to recent levels, oil revenues in 1988–89 are now forecast to be lower than projected a year ago.

Table 2A.3 Revenue and expenditure¹

	Changes from 1987 MTFS projections, £ billion				
	1986–87	1987–88	1988–89	1989–90	1990–91
<i>Expenditure</i>					
1 Planning total	–1	–2 $\frac{1}{2}$	+2 $\frac{1}{2}$	+5 $\frac{1}{2}$	+8
2 Other ^{2,5}	+1	+1	0	–1	–2
3 General government expenditure	0	–1$\frac{1}{2}$	+2$\frac{1}{2}$	+4$\frac{1}{2}$	+6
<i>Receipts³</i>					
4 North Sea taxes	0	+1	– $\frac{1}{2}$	–1	–1
5 Other taxes and contributions	+1	+4	+7	+8 $\frac{1}{2}$	+9
6 Other ²	0	0	0	+ $\frac{1}{2}$	0
7 General government receipts	+1	+5	+6$\frac{1}{2}$	+7$\frac{1}{2}$	+8
8 Implied cumulative fiscal adjustment ⁴	—	—	–3	–1 $\frac{1}{2}$	–3
9 Public corporations' market and overseas borrowing ⁵	0	– $\frac{1}{2}$	0	0	+ $\frac{1}{2}$
10 PSBR	–$\frac{1}{2}$	–7	–7	–5	–5

¹ Rounded to the nearest £ $\frac{1}{2}$ billion. Classification changes since the 1987 FSBR are included but their effect on both expenditure and receipts is small.

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. See footnote 3 to Table 6B3.

⁴ Line 8 = lines 10–9–3+7.

⁵ Public corporations' market and overseas borrowing is included in the planning total and in the PSBR, but not in general government expenditure. Changes in it are therefore deducted in line 2 and added back in line 9.

3 The economy: recent developments and prospects to mid-1989

Summary

3.01 Growth should be around 3 per cent in 1988, close to the average rate over the last six years, but significantly below the $4\frac{1}{2}$ per cent growth in 1987. Inflation is expected to remain low and there are good prospects for a further fall in unemployment.

Demand and activity **3.02** The economy grew strongly in 1987, with GDP growth of $4\frac{1}{2}$ per cent and manufacturing output growth of $5\frac{1}{2}$ per cent. Domestic demand rose by 4 per cent, the same as in 1986. It is expected to rise at a similar rate in 1988, with slightly slower growth of consumer spending being offset by markedly faster growth of investment. GDP is forecast to grow by 3 per cent ($3\frac{1}{2}$ per cent for non-oil GDP).

Inflation **3.03** Retail price inflation averaged just over 4 per cent in 1987. It fell to $3\frac{1}{4}$ per cent in January 1988, but is forecast to return to 4 per cent in the fourth quarter of 1988.

Labour market **3.04** Employment has risen strongly over the past year, with unemployment falling by half a million—the largest decline since the war. Unemployment should continue to fall this year.

World economy **3.05** GNP in the main industrial economies grew by about 3 per cent last year. In 1988 growth could ease slightly to $2\frac{1}{2}$ per cent. Industrial production picked up strongly during 1987. Associated with this were faster growth in trade in manufactures and some recovery in industrial materials prices. World trade in manufactures appears to have grown by about $5\frac{1}{2}$ per cent in 1987 and should grow by a similar amount this year.

UK trade and current account **3.06** Both export and import volumes grew rapidly last year: some moderation in growth is likely in 1988. Following recent revisions to the surplus on invisibles the current account is now estimated to have been in deficit by a little over £1½ billion in 1987. A deficit of £4 billion (less than 1 per cent of GDP) is forecast for 1988.

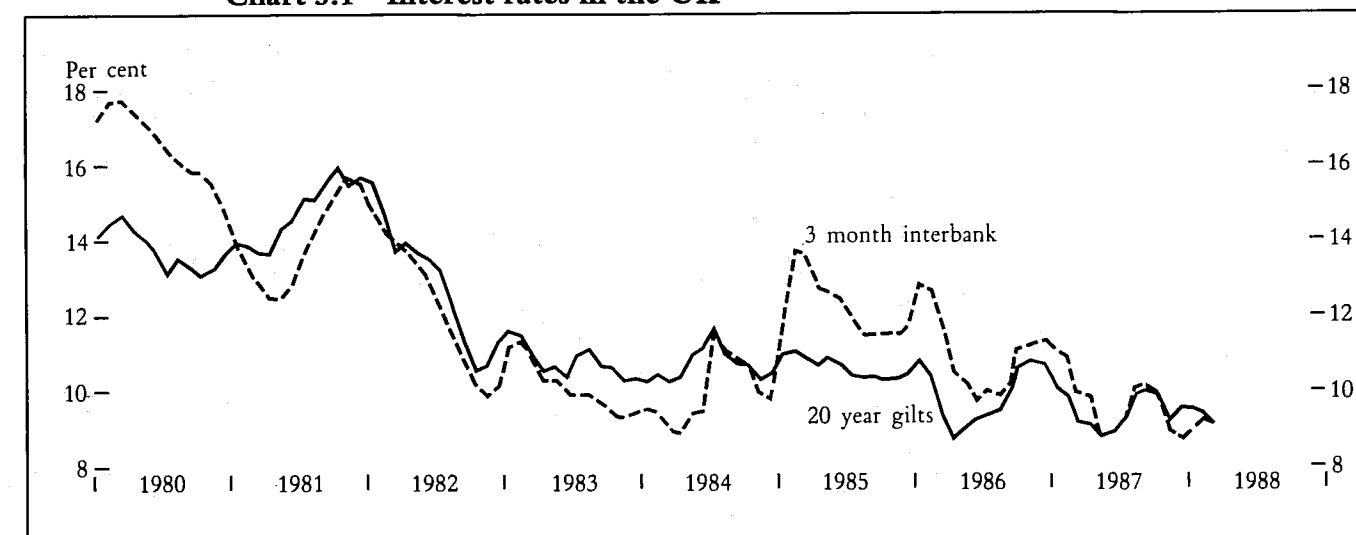
Assumptions **3.07** The forecast assumes that fiscal and monetary policies are operated within the framework of the Medium Term Financial Strategy. It assumes

Financial conditions

Exchange rates **3.08** Sterling has shown considerable stability against the deutschemark over the past year. There was an inflow of \$20 billion into the Reserves in the year to February. Following the Louvre accord, the dollar remained stable against the major currencies for much of 1987, before falling further towards the end of the year. It has risen slightly in the early months of 1988, in the wake of the G7 statement just before Christmas and improved US trade figures.

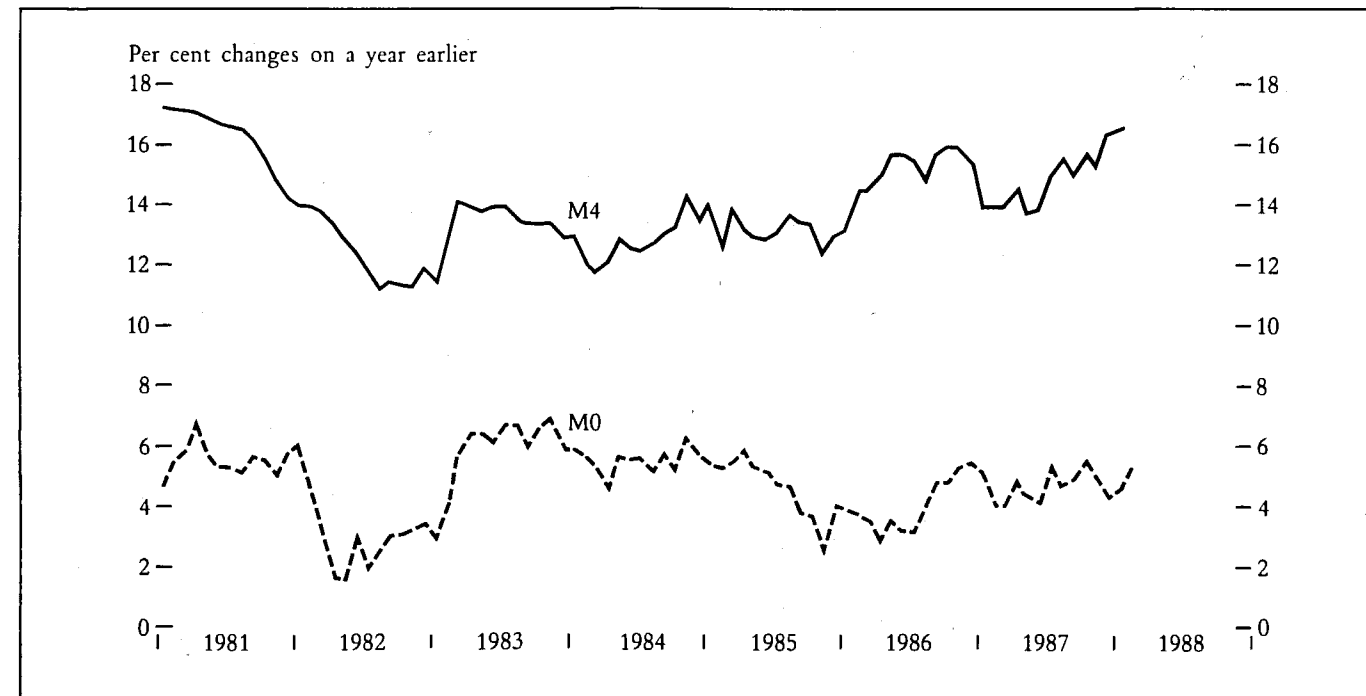
Interest rates **3.09** Short-term interest rates in the UK fell from 11 per cent at the beginning of 1987 to 9 per cent in July. They rose to 10 per cent in August, but came down again to $8\frac{1}{2}$ per cent in the immediate aftermath of October's stock market collapse. Following the restoration of more settled markets earlier this year, short-term interest rates returned to around 9 per cent. Longer term interest rates have followed a similar profile to short-term rates, but with smaller fluctuations. In the most recent period they, too, have been around 9 per cent.

Chart 3.1 Interest rates in the UK



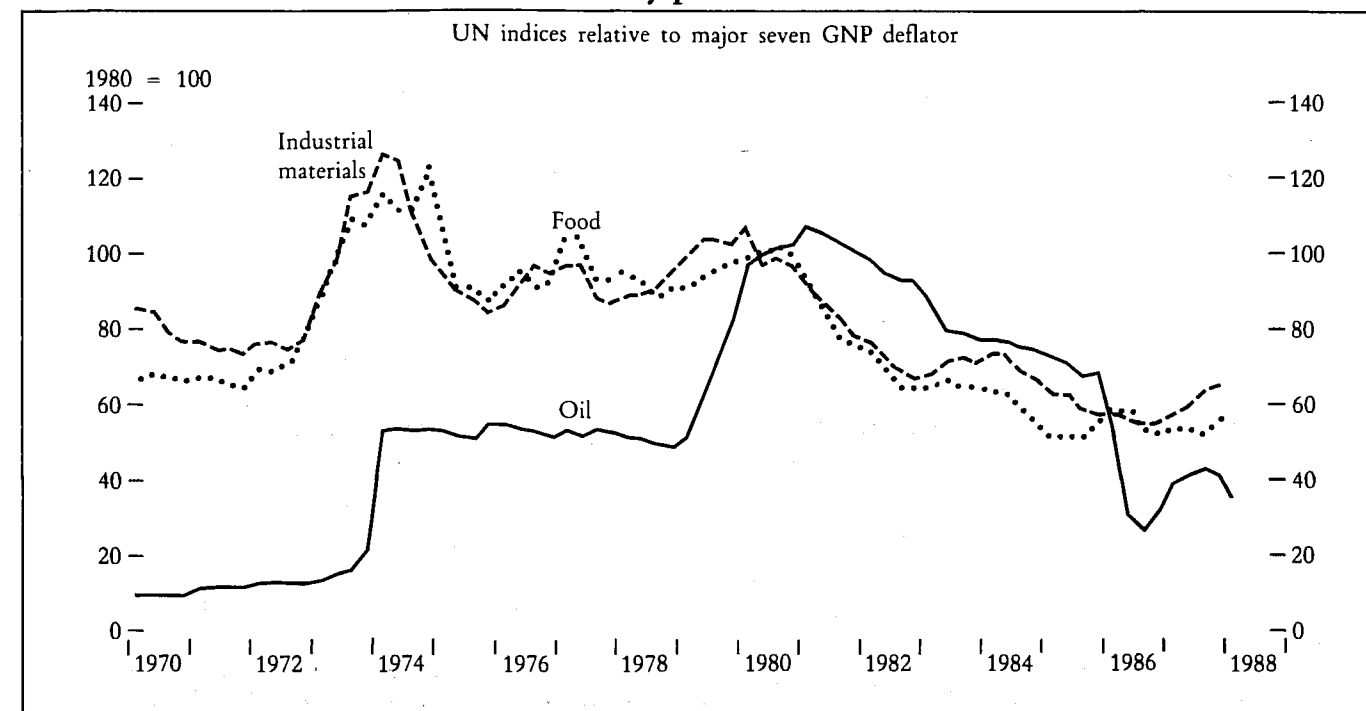
Narrow money **3.10** M0 growth, which fell in early 1987, rose rapidly in the summer reflecting lower interest rates. It may move to the top of, or outside, its 1–5 per cent target range in the early part of the financial year before coming back within it.

Broad money **3.11** M4, which includes the liabilities of both banks and building societies, has grown at close to $16\frac{1}{2}$ per cent over the past year. As in recent years, there has been a sharp fall in its velocity

Chart 3.2 Growth rates of monetary aggregates


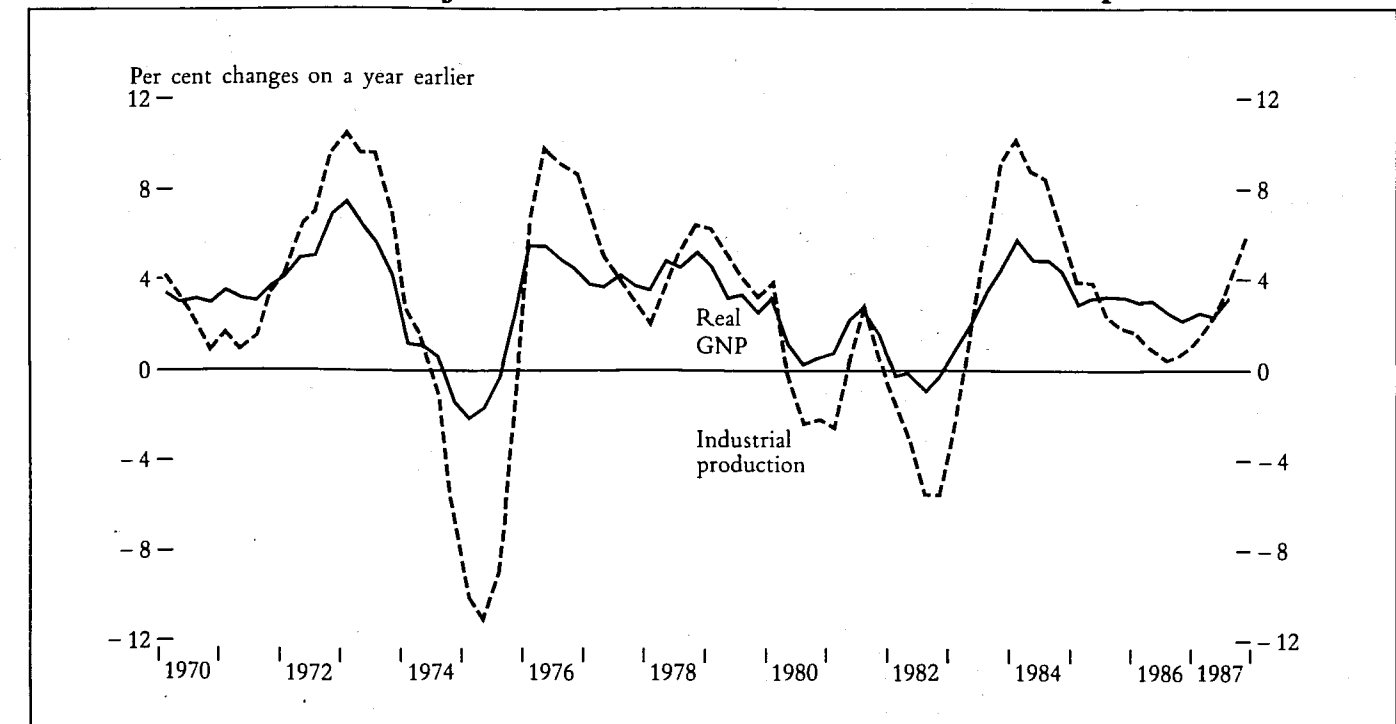
World economy

Recent developments 3.12 Output growth in the industrialised countries strengthened in the second half of 1987, particularly in North America and Japan. Real GNP in the major seven OECD countries is estimated to have increased by 3 per cent in 1987, marginally faster than in 1986.

Chart 3.3 Real commodity prices


3.13 Substantial falls in import prices in 1986—notably for oil, but also for many other primary commodities—were partly reversed in 1987. Oil prices recovered from their low point of the summer of 1986, but have weakened in recent months. Prices of other industrial materials rose as world activity picked up. Nevertheless, consumer price inflation in the major economies has remained low. In Japan and Germany, the appreciation of their currencies meant that inflation was close to zero. But in the US, consumer price inflation rose to 4½ per cent at the end of 1987.

3.14 The improved terms of trade for developing countries boosted the exports of the major industrialised countries and helped to strengthen business investment. This more than offset some slowdown in the growth of real personal incomes and consumer spending. As a result industrial production has been particularly buoyant; industrial output in the major seven OECD economies was over 5 per cent higher in December 1987 than a year earlier.

Chart 3.4 Major seven economies' real GNP and industrial production


3.15 Equity prices in the US and most other countries continued to rise in the first part of 1987, reaching an all-time high in a number of countries around mid-year. In large part, the subsequent fall in equity prices can be seen as a correction, even though the scale and sharpness of the fall in October were unprecedented. Prompt action by the monetary authorities in the major countries to reduce interest rates and provide sufficient liquidity helped to prevent a major collapse of confidence.

3.16 In the United States, domestic demand growth, which had averaged 5½ per cent a year between 1983 and 1986, slowed to 2½ per cent in 1987: as a

result, the growth of import volumes has also slowed. US export volumes are now responding strongly to the massive depreciation of the dollar from its 1985 peak; by the fourth quarter of last year they were 17 per cent higher than a year earlier. These favourable movements in trade volumes were, for much of 1987, offset in money terms by the effects of the dollar's fall. But more recent figures have suggested some decline in the US trade deficit.

3.17 A two year phase of relatively slow growth in Japan ended in the spring of 1987 as exports stopped falling and domestic demand picked up sharply. But in Germany both real domestic demand and GNP grew slowly in 1987. The current account surpluses of both Japan and Germany fell slightly in relation to their GNP in 1987, with that of Japan falling rather faster.

3.18 World import volumes are estimated to have grown by more than 4 per cent in 1987. This is slightly lower than in 1986, when there was a substantial rise in oil trade as stocks were rebuilt. The growth of trade in manufactures in 1987—provisionally estimated at about 5½ per cent—picked up substantially, helped by the continued buoyancy of domestic demand in the major seven countries and by increased demand from the rest of the world.

Prospects 3.19 Table 3.1 shows the forecast for activity and inflation in the major seven OECD countries, and for world trade. In aggregate, real GNP in the major seven countries is expected to grow a little less strongly in 1988 than in 1987, though industrial production should remain buoyant. Inflation is likely to stay low.

Table 3.1 World economy

	Per cent changes on a year earlier			
	1986	Estimate 1987	Forecast 1988	1989 H1
<i>Major seven countries¹</i>				
Real GNP	2½	3	2½	2
Real domestic demand	3½	3	2½	2
Industrial production	1	3½	4½	3
Consumer prices	2	2½	3	3
<i>World trade, at constant prices</i>				
Total imports	5	4½	4½	3½
Trade in manufactures	2	5½	5	3½

¹ US, Japan, Germany, UK, France, Italy and Canada.

3.20 As a result of the continued strength of industrial activity, some further modest rise in non-food commodity prices is expected during 1988. Food prices, however, are likely to be held down by continued over-supply, encouraged by high levels of support in many countries. The forecast is based on the assumption that North Sea oil prices remain close to recent levels.

3.21 Imports by industrial countries are expected to grow less rapidly than in 1986 and 1987. However, imports by non-oil developing countries will

be helped by stronger commodity prices, and hence export earnings. Total world trade in 1988 is forecast to grow at close to the rate experienced in 1987.

UK trade and the balance of payments

Relative costs and prices 3.22 In the UK, unit labour costs in manufacturing rose only slightly in 1987, at a similar rate to the average in the other major economies, with rapid productivity growth largely offsetting a continuing high level of pay increases (Chart 3.11). Despite some appreciation of sterling, the UK's cost competitiveness 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 continuing to restrain unit cost increases.

Table 3.2 The exchange rate and cost competitiveness

	Sterling index (1975 = 100)	Relative unit labour costs ¹ (1980 = 100)
1985 Q4	80	88
1986 Q4	68	71
1987 Q4	75	80

¹ Ratio of UK manufacturing sector's costs to those overseas.

Trade volumes (goods other than oil) 3.23 Non-oil export volumes rose by 7 per cent in 1987. Manufactured exports rose particularly strongly, reflecting renewed growth in world trade and the UK's strong competitive position. Non-oil export volumes are forecast to rise in 1988 by a further 5 per cent.

3.24 The UK increased its share of world trade in manufactures slightly in 1987 (Chart 3.5). Its volume share has remained broadly stable since 1981, in marked contrast to the previous long-term decline. This improved performance is forecast to continue in 1988.

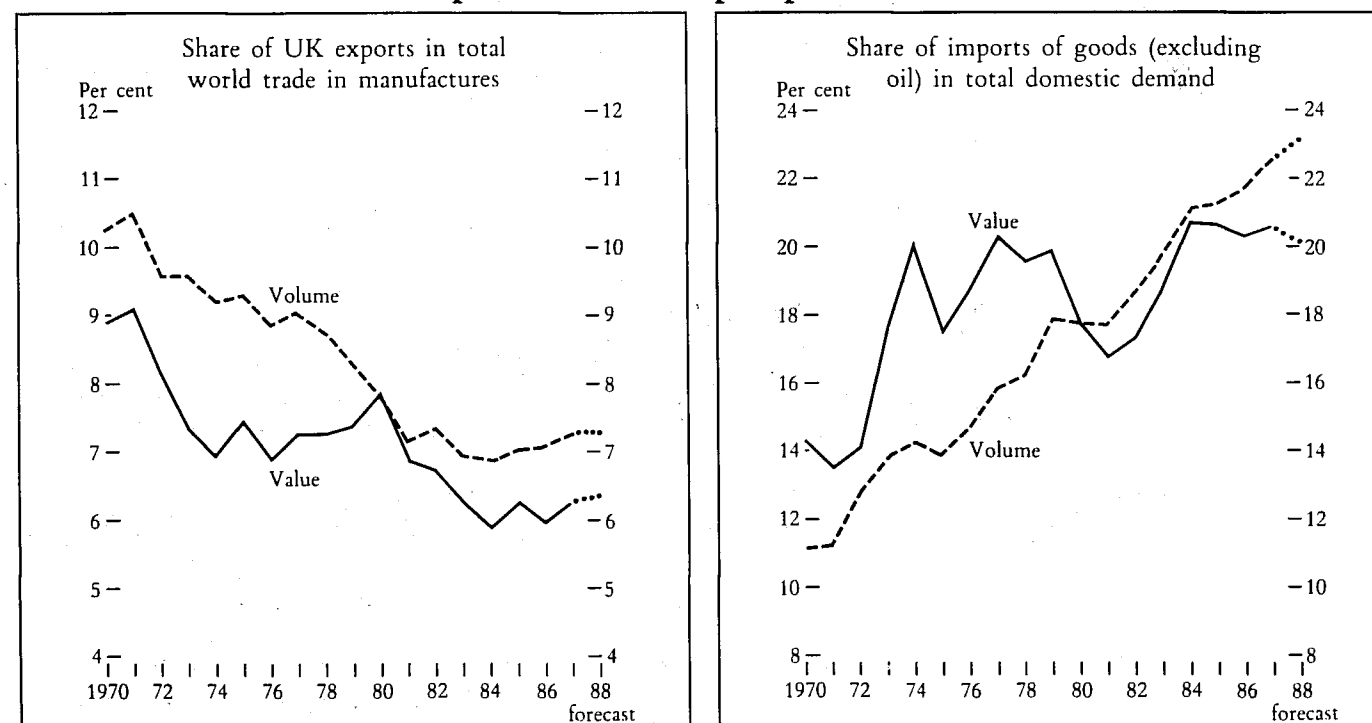
Table 3.3 Visible trade

	Per cent 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
1986	3½	6½	-5½	4	5½	-½
1987	5½	7½	1½	7	8½	1½
1988 Forecast	3½	7	1	5	7	1½

¹ Ratio of UK export average values to import average values.

3.25 Non-oil import volumes fell unexpectedly in early 1987, but rose during the rest of the year, and were 8½ per cent higher than in 1986. The increases were widespread, with higher imports of materials and capital goods reflecting the strong growth of UK production, stocks and investment. Consumer goods imports also rose in response to the rise in consumer spending. The volume of imports is forecast to rise less rapidly through the year ahead as output growth slows.

Chart 3.5 Export shares and import penetration



Oil trade 3.26 There was a surplus on oil trade of £4 billion in 1987, little changed from 1986. Higher oil prices and a fall in domestic demand for oil more than offset a decline in North Sea production. In 1988, oil production is likely to be below its 1987 level, close to the centre of the Department of Energy's projected output range, while domestic demand for oil may rise modestly. The oil trade surplus is expected to fall by £1½ billion, to about £2½ billion.

Trade prices and the terms of trade 3.27 The terms of trade, which fell in 1986 as oil prices declined, improved again in 1987 as oil prices firmed and as sterling's appreciation offset some rise in world commodity prices in the latter part of the year. Little further change in the terms of trade is assumed during the rest of 1988.

Invisibles and overseas assets 3.28 The latest estimate for the surplus on invisibles in 1987, at £8 billion, is slightly below the outturn in 1986, with increased transfers to the European Community being only partly offset by higher net earnings from services and from the UK's net overseas assets. The invisibles surplus seems likely to rise a little in 1988, partly because of lower net payments abroad by North Sea oil companies.

3.29 The value of the UK's stock of net overseas assets is provisionally estimated to have been about £90 billion at the end of 1987, some £20 billion down on end-1986. This decline is largely due to the fall in world equity markets and in the sterling value of UK assets in North America following the fall in the US dollar.

Current account 3.30 The current account deficit is estimated to have been a little over £1½ billion in 1987. The improvement over the forecast in last year's FSBR was mainly due to the unexpected strength of exports of manufactures. A deficit of £4 billion (less than 1 per cent of GDP) is forecast for 1988, largely as a result of the projected decline in the oil surplus. The deficit on non-oil trade is forecast to show little further change from the level in the second half of 1987.

Table 3.4 Current account

	£ billion				
	Manufactures	Oil	Other goods	Invisibles	Current balance
1986	-5½	4	-7	8½	0
1987	-6½	4	-7½	8	-1½
1988 Forecast	-8½	2½	-6½	8½	-4

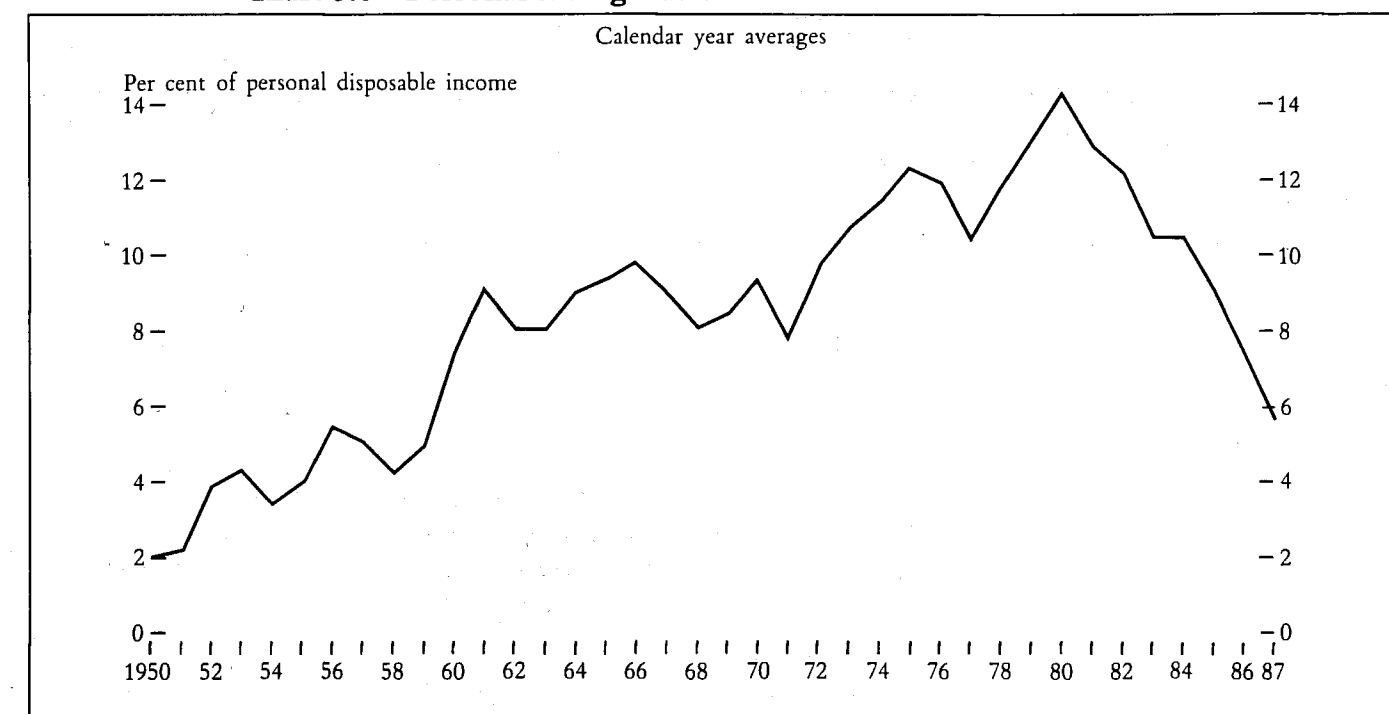
Demand and activity

3.31 The UK economy grew by 4½ per cent in 1987. Growth was strong throughout the non-oil economy: manufacturing output rose by 5½ per cent, construction output by 8½ per cent and output of the service industries by 5½ per cent.

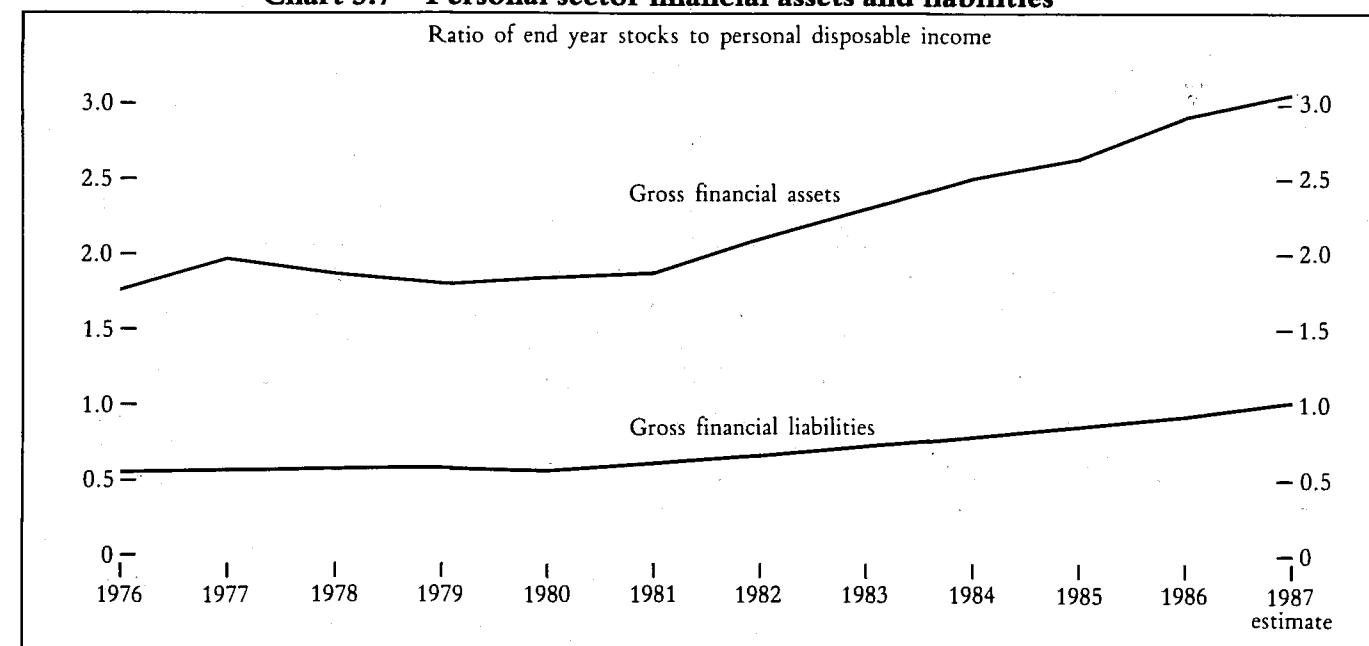
Personal sector expenditure 3.32 Consumers' expenditure is now estimated to have risen by 5 per cent in 1987, less than in 1986. This was faster than the 3½ per cent growth in real personal disposable income, and the savings ratio once again fell.

3.33 A number of factors could account for the decline in the savings ratio in recent years. Inflation has been at a low level not experienced since the 1960s. Recent increases in real house prices, and in equity prices to October 1987, may also have contributed. And many employers have taken so-called holidays on their contributions to employees' pension funds; these score as reduced personal saving.

Chart 3.6 Personal savings ratio



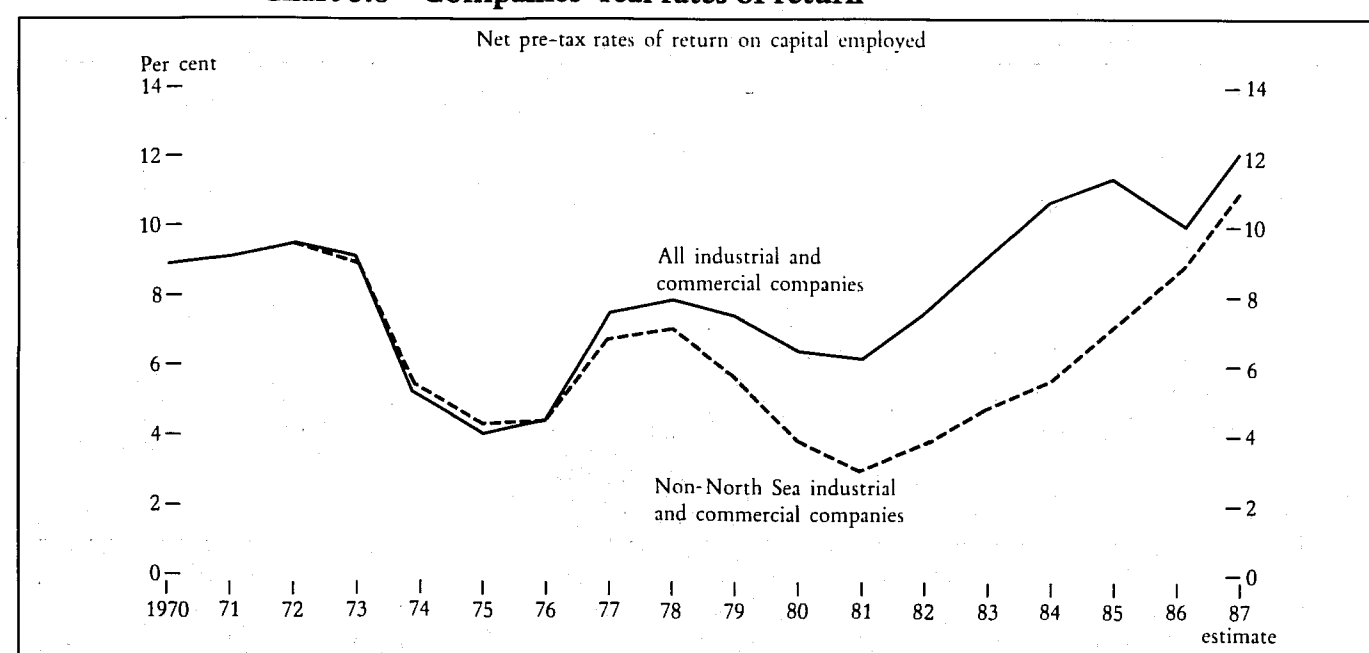
3.34 Personal borrowing rose further during 1987, in large part reflecting increased mortgage borrowing. But personal sector financial assets showed a larger increase despite the October share price fall (Chart 3.7).

Chart 3.7 Personal sector financial assets and liabilities


3.35 Consumers' expenditure is forecast to increase by 4 per cent in 1988 and the savings ratio is expected to bounce back a little. Persons' investment in dwellings could rise by around 3½ per cent in 1988, rather more slowly than over the last two years.

Company incomes and expenditure

3.36 Non-North Sea industrial and commercial companies' profits (net of stock appreciation) rose sharply in 1987, by over 20 per cent. The rate of return of non-North Sea industrial and commercial companies was around 11 per cent—the highest level for about 20 years. Manufacturing profitability grew particularly strongly.

Chart 3.8 Companies' real rates of return


3.37 Current estimates suggest that manufacturing investment grew by 3½ per cent last year, while total non-oil business investment grew by 6 per cent. The latest DTI Investment Intentions Survey indicated a strong pick-up in manufacturing investment growth, to about 11 per cent in 1988. The January CBI Industrial Trends Survey, the first full enquiry since the fall in share prices, confirms that prospect, with a near record balance of manufacturing firms expecting to increase investment. On the basis of the DTI Survey, further steady growth is expected in non-manufacturing business investment. This outlook for company investment is consistent with the recent and prospective buoyancy in output, real profitability and company finances, and it will add to industrial capacity. North Sea investment fell in 1987 and is expected to show little change in 1988.

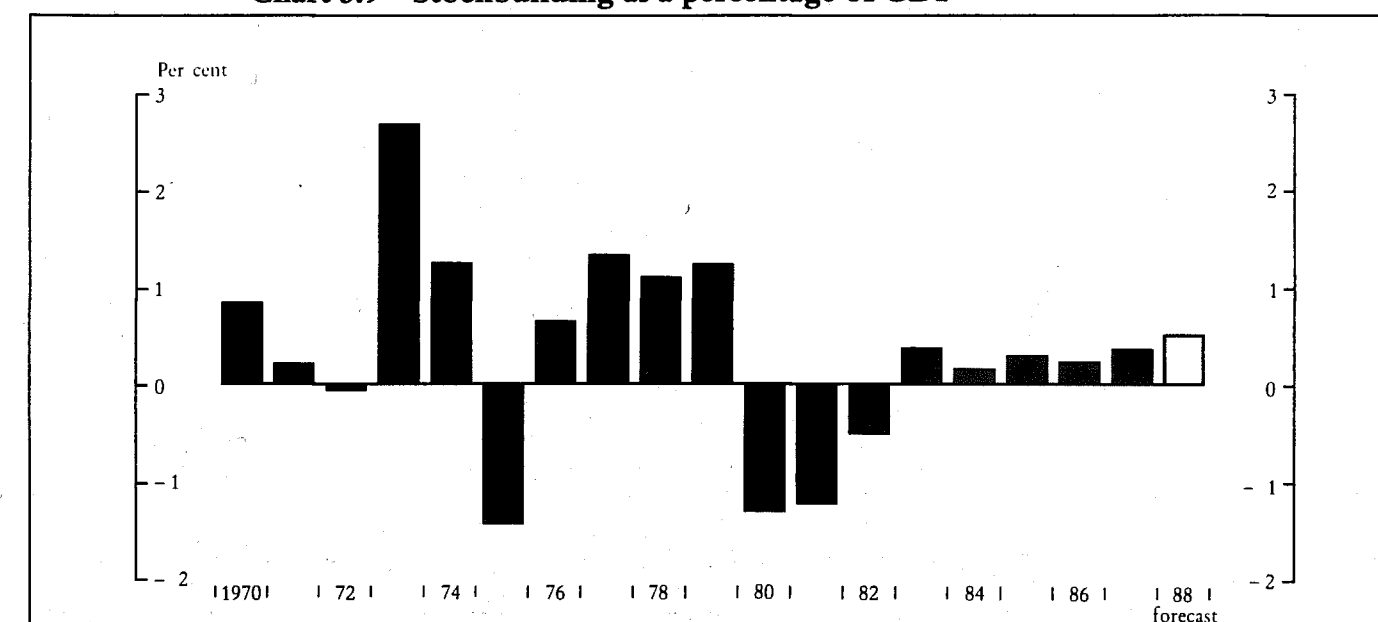
Table 3.5 Gross fixed domestic capital formation

	£ billion at 1980 prices	Per cent changes on previous year		
		1986	1987	Forecast 1988
Business ¹	29.8	-3	4	9
of which: non-oil business	27.8	-2	6	9
manufacturing	7.1	-5	3½	11½
Private dwellings ²	9.5	7	5½	2
General government	6.9	4	-1	1½
Total fixed investment	46.2	-½	3½	6½

¹Includes investment by public corporations.

²Includes purchase less sales of land by persons, companies and public corporations, other than purchases of council houses.

3.38 Despite a rise in stocks in 1987, stock-output and stock-sales ratios continued their trend decline of the last eight years. These downward trends are expected to continue in 1988, though, as last year, there is still likely to be modest stockbuilding.

Chart 3.9 Stockbuilding as a percentage of GDP


Prospects for demand and activity

3.39 GDP growth is likely to moderate to around 3 per cent ($3\frac{1}{2}$ per cent excluding oil) in 1988, close to the 1981–87 average. Domestic demand is forecast to rise at around the same rate in 1988 as in 1987; some slowdown in consumer spending should be offset by buoyant investment. But declining North Sea output may reduce GDP growth by around $\frac{1}{2}$ per cent. Manufacturing output is expected to rise faster than non-oil GDP in 1988, as it did in 1987.

Table 3.6 Domestic demand and GDP

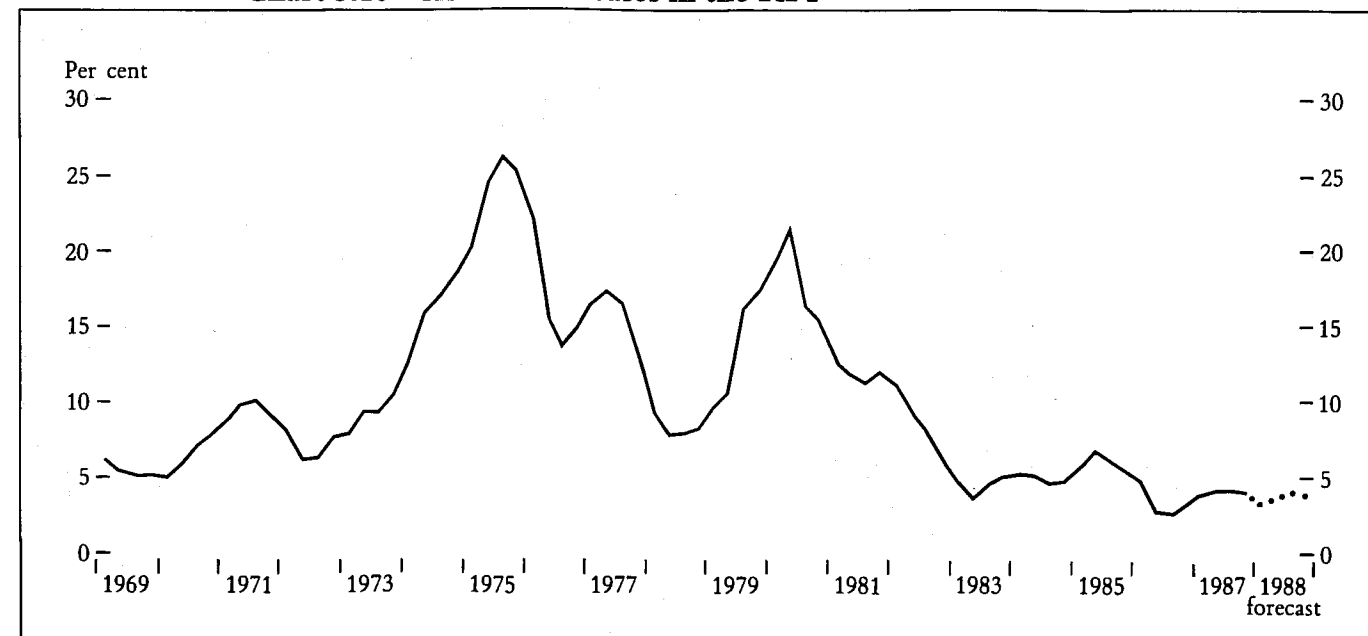
	Per cent changes on a year earlier		
	1987	Forecast	1989 H1
Domestic demand	4	4	3
Exports of goods and services ¹	$5\frac{1}{2}$ ($6\frac{1}{2}$)	3 (4)	2 ($3\frac{1}{2}$)
Imports of goods and services ¹	$7\frac{1}{2}$ ($8\frac{1}{2}$)	$6\frac{1}{2}$ (6)	4 (4)
GDP ^{1,2}	$4\frac{1}{2}$ (5)	3 ($3\frac{1}{2}$)	$2\frac{1}{2}$ (3)
Manufacturing production	$5\frac{1}{2}$	5	$3\frac{1}{2}$

¹ Non-oil shown in brackets.

² Average measure.

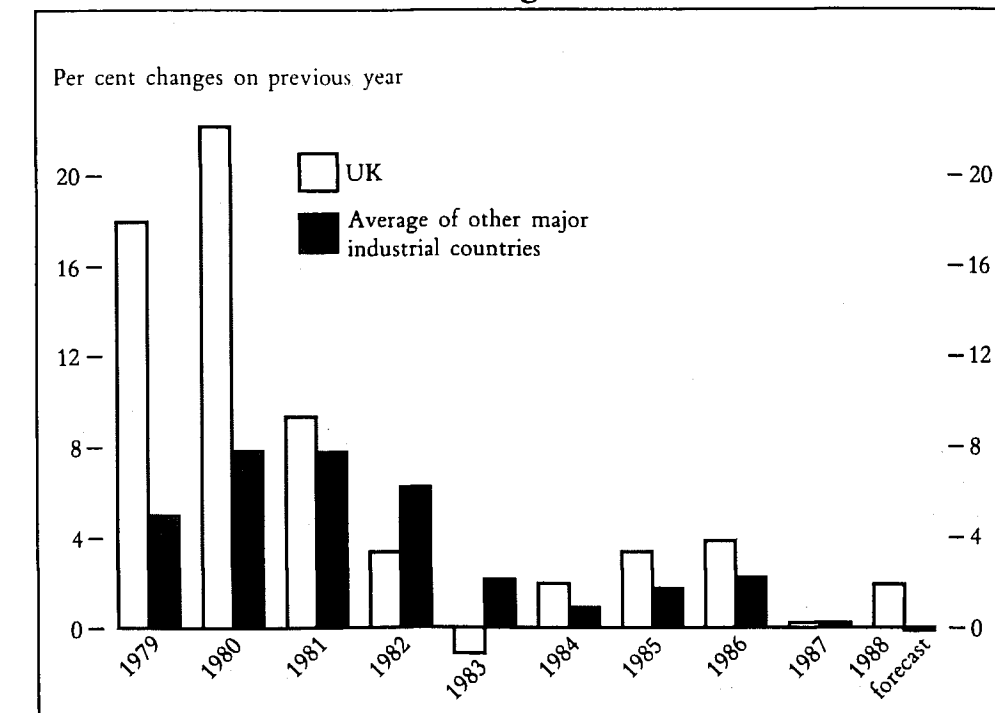
Inflation

3.40 The annual rate of inflation as measured by the RPI was 4.1 per cent in 1987Q4, in line with the forecasts in the 1987 FSBP and Autumn Statement. The average rate for 1987 as a whole was 4.2 per cent. Last year was the first time in 23 years that inflation was lower than the growth of GDP.

Chart 3.10 Annual increases in the RPI

3.41 Pay settlements in manufacturing industry recorded by the CBI show a fall of about 1 percentage point between the 1985–86 and 1986–87 pay rounds. There was a similar picture in the services sector. Whole economy

underlying average earnings, boosted by record overtime working in manufacturing, rose by $7\frac{1}{2}$ per cent in 1987. But unit labour costs in manufacturing were broadly unchanged in 1987, reflecting a sharp increase in labour productivity.

Chart 3.11 Unit labour costs in manufacturing

Prospects 3.42 It is difficult to discern a reliable trend in recent private sector pay settlements. They have been markedly lower than the recent high growth in earnings, which reflects record overtime working and bonus payments. Recent data suggest that settlements may turn out a little higher in 1988 than in 1987, but overtime working (and overtime earnings) should fall as economic growth moves back closer to trend.

3.43 In 1987 rapid growth in productivity meant that manufacturing unit labour costs rose only fractionally, in line with other major industrial countries. Continued growth in underlying productivity should mean that manufacturing unit labour costs grow only slowly in 1988, though in other major industrialised countries no unit labour cost growth at all is forecast.

Table 3.7 Costs in manufacturing

	Per cent changes on previous year			
	Unit labour costs	Cost of materials and fuel ¹	Estimated total unit costs ²	Output prices ¹
1986	4	-11	$-\frac{1}{2}$	$4\frac{1}{2}$
1987	0	5	$1\frac{1}{2}$	$4\frac{1}{2}$
1988 Forecast	2	$-1\frac{1}{2}$	1	$4\frac{1}{2}$

¹ Producer prices excluding food, drink and tobacco industries.

² Including costs of bought-in services.

3.44 Manufacturers' profit margins rose significantly in 1987 for the third year in succession. There may be further increases in 1988 if producers take some advantage of falling import costs to raise profits, as they did in 1986. Over the longer term, high profitability should lead to continued growth in investment, capacity and productivity. Together these should enhance prospects for controlling industrial costs.

3.45 Retail price inflation has come down in the first quarter of 1988, aided by lower import costs and recent cuts in mortgage interest rates. It may edge up a little, partly as a result of the Budget proposals and the effects of local authority rate increases. There will also be some real increases in nationalised industry prices following a decline in real terms over the past three years. The RPI is forecast to rise by 4 per cent in the year to the fourth quarter of 1988. With substantial cuts in income tax, the tax and price index (TPI) will rise more slowly than the RPI during 1988. By the fourth quarter of 1988 it is likely to be $1\frac{3}{4}$ per cent higher than a year earlier.

Table 3.8 Retail prices index

	Weight in 1987	Per cent changes on a year earlier		
		1987 Q4	Forecast 1988 Q4	1989 Q2
Food	16 $\frac{1}{2}$	3 $\frac{1}{2}$	2	2 $\frac{1}{2}$
Nationalised industries	6	2 $\frac{1}{4}$	6 $\frac{1}{2}$	5 $\frac{3}{4}$
Housing	15	7	6 $\frac{3}{4}$	8 $\frac{1}{4}$
Other	62 $\frac{1}{2}$	3 $\frac{3}{4}$	3 $\frac{1}{2}$	3 $\frac{1}{2}$
Total	100	4	4	4

3.46 The GDP deflator measures the price of domestic value added—principally unit labour costs and profits per unit of output. It does not include import prices. The GDP deflator at market prices is estimated to have risen by 5 per cent in 1987–88, following an increase of 3 per cent in 1986–87. The higher rate of increase in 1987–88 is largely accounted for by a recovery in North Sea profits, which had fallen by over 50 per cent in 1986–87 following the sharp fall in oil prices. The GDP deflator is forecast to rise by $4\frac{1}{2}$ per cent in 1988–89.

Productivity and the labour market

3.47 Preliminary estimates suggest that the employed labour force in Great Britain rose sharply during 1987; in the year to September 1987 it is estimated to have risen by 460,000. Self-employment has grown particularly strongly, as many more people have taken advantage of the opportunities offered by the buoyant economic climate. Total employment has risen by over 1 $\frac{1}{4}$ million since March 1983.

Table 3.9 Changes in employment

	Thousands, seasonally adjusted, GB				
	Employees in employment		Self-employed	HM Forces	Employed labour force
	Male	Female			
September 1984 to September 1985	+ 55	+ 193	+ 90	– 2	+ 336
September 1985 to September 1986	– 82	+ 148	+ 71	– 3	+ 134
September 1986 to September 1987	+ 24	+ 234	+ 207 ¹	– 4	+ 461

¹ Figures for self-employment after June 1987 are projections based on self-employment growth over the previous six years.

3.48 Productivity has also been growing strongly. In 1987 manufacturing productivity rose by almost 7 per cent. In the year to 1987Q3 (the latest period for which comparable data are available) UK manufacturing productivity rose faster than in any other major industrial country. It has now risen by an average of 4 per cent per annum since 1979. Underlying growth in labour productivity in manufacturing industry may now be higher than in the 1960s. This has been accompanied recently by a substantial improvement in capital productivity. Non-manufacturing output per man hour has risen by about 2 per cent a year since 1979, and by about 2 $\frac{1}{2}$ per cent a year since 1983. Output per head has grown less than this, reflecting the large rise in part-time employment.

Chart 3.12 Output and productivity

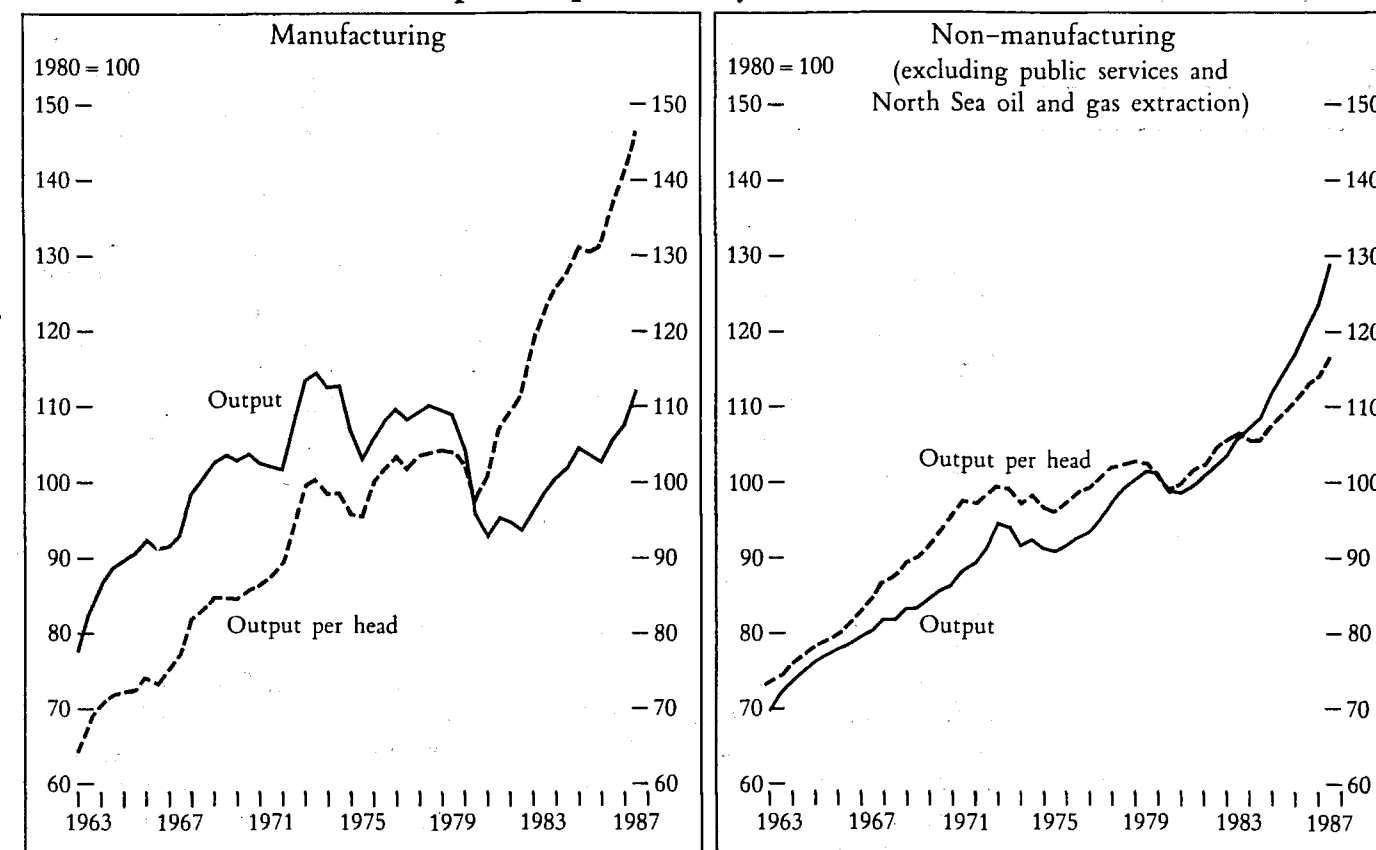


Table 3.10 Output per head of the employed labour force

	Per cent changes					
	Annual averages			1984 Q4	1985 Q4	1986 Q4
	1964-73	1973-79	1979-87	to 1985 Q4	to 1986 Q4	to 1987 Q4 ²
Manufacturing	3 $\frac{3}{4}$	$\frac{3}{4}$	4	2 $\frac{1}{4}$	6 $\frac{1}{2}$	6 $\frac{1}{4}$
Non-manufacturing ¹	3	$\frac{1}{2}$	1 $\frac{1}{2}$	3 $\frac{1}{2}$	3 $\frac{1}{2}$	3 $\frac{1}{2}$
Whole economy	2 $\frac{3}{4}$	1 $\frac{1}{4}$	2	2 $\frac{1}{4}$	3 $\frac{1}{4}$	3 $\frac{1}{4}$
Non-North Sea economy	2 $\frac{3}{4}$	$\frac{1}{2}$	2	2 $\frac{1}{2}$	3 $\frac{1}{2}$	3 $\frac{1}{2}$

¹Excludes public services and North Sea oil and gas extraction.²Partly forecast.

Unemployment 3.49 Seasonally adjusted adult unemployment in the UK has fallen in each of the last eighteen months. It has now come down by almost 650,000 since July 1986. Over the same period long term unemployment (over one year's duration) has fallen by around 250,000. The improved trend in unemployment has been mainly the result of strong growth of output and employment. Unemployment should continue to fall in the year ahead. But excessive pay settlements would threaten further progress.

Forecast and outturn

3.50 Table 3.11 compares the main elements of the forecast published in the 1987 FSBR with the outturn or latest estimate.

Table 3.11 Forecast and outturn

	1987 FSBR forecast	Outturn or latest estimate	Average errors from past forecasts
GDP (per cent change between 1986 and 1987)	3	4 $\frac{1}{2}$	$\frac{3}{4}$
RPI (per cent change between the fourth quarters of 1986 and 1987)	4	4	1
Money GDP (per cent change between 1986-87 and 1987-88)	7 $\frac{1}{2}$	9 $\frac{3}{4}$	1 $\frac{1}{2}$
Current account of the balance of payments (1987, £ billion)	-2 $\frac{1}{2}$	-1 $\frac{1}{2}$	3
PSBR (1987-88, £ billion)	4	-3	4

3.51 Inflation in the fourth quarter of 1987 was in line with the forecast made a year ago while the current account deficit is now estimated to have been smaller than forecast. Although the data on which the latest estimates of GDP in 1987 are based are liable to revision, it is clear that both money and real GDP growth have been stronger than forecast. The PSBR in 1987-88 is likely to turn out about £7 billion lower than last year's forecast. This error—which is higher than the average error on past forecasts—reflects a combination of lower than expected general government expenditure and, in particular, higher than forecast tax revenues. This is discussed in more detail in Chapter 6.

3.52 This year's forecast is summarised in Table 3.12

Risks and uncertainties

3.53 No forecast is complete without an indication of error margins. Table 3.12 sets out the average errors from FSBR forecasts over the past ten years, alongside the forecasts themselves. These average errors provide an indication of possible errors in the current forecast. Those items which represent the relatively small balance between large flows in either direction are particularly subject to error. For example, the flows on either side of the PSBR, including the revenues of the public corporations, are about £200 billion; and for the current account of the balance of payments exceed £150 billion.

Table 3.12 The prospects: summary

	Forecast		Average errors from past forecasts ¹
	1986 to 1987	1987 to 1988	
Output and expenditure at constant 1980 prices			
Domestic demand			
of which:			
consumers' expenditure	4	4	1
general government consumption	5	4	1
fixed investment	1	1	1
change in stockbuilding (as per cent of level of GDP)	3½	6½	2½
Exports of goods and services	0	0	½
Imports of goods and services	5½	3	2
Gross domestic product: total	7½	6½	2½
manufacturing	4½	3	½
	5½	5	1½
Inflation			
Retail prices index			
1987 Q4 to 1988 Q4			
1988 Q2 to 1989 Q2			
	4		1
GDP deflator at market prices			
Financial year 1987-88	5		2
Financial year 1988-89	4½		1
Money GDP at market prices			
Financial year 1987-88			
Financial year 1988-89			
	424 (9½)		1½
	456 (7½)		1½
Balance of payments current account			
1988			
1989 first half (at an annual rate)			
	-4		3
	-4		4½
PSBR			
Financial year 1987-88			
Financial year 1988-89			
	-3 (-½)		1 (½)
	-3 (-½)		4 (1)

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.

² Per cent change on previous financial year in brackets; average error shown relates to the forecast of the percentage change.

³ Per cent of GDP at market prices shown in brackets.

Table 3.13 Gross domestic product and its components¹

£ billion at 1980 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 statistical adjustment	Gross domestic product at factor cost	GDP index (average estimate) 1980 = 100
1983	144.5	50.5	41.6	64.4	0.7	301.8	62.6	31.6	0.1	207.7	104.0
1984	147.7	51.0	45.0	68.9	0.3	312.8	68.7	32.7	1.3	212.7	106.5
1985	153.4	51.0	46.3	73.0	0.7	324.3	70.6	33.8	0.6	220.5	110.4
1986	162.6	51.6	46.2	75.3	0.6	336.2	75.1	35.5	1.4	227.1	113.7
1987	171.0	52.2	47.8	79.5	0.8	351.4	80.7	37.5	3.8	236.9	118.7
1988	178.3	52.7	51.0	81.9	1.3	365.1	86.0	39.1	4.4	244.4	122.4
1986 H1	80.3	25.7	22.7	36.8	0.4	165.9	36.1	17.5	0.4	112.6	112.8
H2	82.3	25.9	23.5	38.5	0.2	170.3	38.9	18.0	1.0	114.5	114.6
1987 H1	83.8	25.9	23.4	39.1	-0.2	172.0	38.5	18.3	1.7	116.9	117.1
H2	87.2	26.3	24.4	40.5	1.0	179.4	42.3	19.2	2.1	120.0	120.2
1988 H1	88.5	26.3	25.2	40.8	0.5	181.3	42.3	19.4	2.1	121.7	121.9
H2	89.7	26.4	25.8	41.1	0.7	183.8	43.7	19.7	2.2	122.7	122.9
1989 H1	91.3	26.6	26.4	41.7	0.7	186.7	44.1	19.9	2.2	124.9	125.1
Per cent changes											
1985 to 1986	6	1	-½	3	—	3½	6½	5	—	3	3
1986 to 1987	5	1	3½	5½	—	4½	7½	6	—	4½	4½
1987 to 1988	4	1	6½	3	—	4	6½	4	—	3	3
1988 H1 to 1989 H1	3	1	5	2	—	3	4	2½	—	2½	2½

¹ The GDP figures are averages of constant price expenditure, output and income estimates of GDP. Percentage changes are calculated from unrounded levels and then rounded to the nearest

half per cent. Figures for 1988 H1 and beyond are forecasts. Figures for periods to the end of 1987 are based in part on the published national accounts (to 1987 Q3) and in part on

revised and later data and forecasts. A full set of national accounts to end-1987 will be published by the CSO on 18 March.

4 The Budget tax proposals

4.01 The main tax 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 personal allowances and the limit of the basic rate band will be increased by twice the amounts due under the statutory indexation provisions (based on the increase of 3.7 per cent in the RPI in the year to December 1987). This will mean that:

the single person's and wife's earned income allowances will rise by £180 from £2 425 to £2 605;

the married allowance will rise by £300 from £3 795 to £4 095;

the additional personal allowance and widow's bereavement allowance will rise by £120 from £1 370 to £1 490;

the age allowance for those aged 65 to 79 will rise by £220 from £2 960 to £3 180 (single) and by £360 from £4 675 to £5 035 (married);

the age allowance for those aged 80 and over will rise by £240 from £3 070 to £3 310 (single) and by £360 from £4 845 to £5 205 (married);

the income limit for age allowance will rise by £800 from £9 800 to £10 600;

the basic rate limit will rise from £17 900 to £19 300 of taxable income.

4.03 The dependent relative allowance, the housekeeper allowance and the allowance for the services of a son or daughter will be abolished.

4.04 From 6 April 1989 an unmarried couple will not be entitled to more than one additional personal allowance.

4.05 The basic rate of income tax will be reduced to 25 per cent.

4.06 There will be a single higher rate of income tax of 40 per cent.

Life assurance premium relief **4.07** The rate of premium relief for life assurance policies taken out before 14 March 1984 will be reduced to 12½ per cent from 6 April 1989.

Benefits in kind **4.08** Car benefit scale charges for 1988–89 will be set at twice their 1987–88 levels.

Mortgage interest relief **4.09** For loans taken out from 1 August 1988, tax relief will be limited to the interest on £30 000 per residence, regardless of the number of borrowers. Relief on new loans for home improvements will be abolished from 6 April 1988. So will relief on new loans for the purchase of residences for dependent relatives and divorced or separated spouses.

- Covenants** 4.10 The tax treatment of covenants will be reformed and simplified. Non-charitable covenants made by individuals on or after Budget day will no longer attract tax relief, and income from such covenants will not be taxable in the hands of the recipient. Covenants to charities will not be affected, nor will non-charitable covenants made before Budget day.
- Charitable giving** 4.11 The limit on charitable donations qualifying for tax relief under the payroll giving scheme will be doubled from £120 to £240 a year from 1988-89.
- Maintenance payments** 4.12 The tax treatment of maintenance payments will be reformed. People who receive maintenance payments under new arrangements will not be liable to tax on their receipts; the person making the maintenance payments will get tax relief only for payments to a divorced or separated spouse, up to a limit of £1 490. Relief for existing maintenance arrangements will be preserved, and all divorced or separated spouses will be able to receive up to £1 490 of existing maintenance payments free of tax.
- Personal Equity Plans** 4.13 The annual limit on investment in a Personal Equity Plan will be increased from £2 400 to £3 000.
- Employee share schemes** 4.14 Following consultation last year, the income tax charge on unapproved employee share schemes under Section 79 of the Finance Act 1972 will be eased.
- Lloyd's** 4.15 The present administrative arrangements for taxing members of Lloyd's will be simplified.
- 4.16 The legislation on Lloyd's reinsurance to close will be modified to give relief to Lloyd's members who leave syndicates at the end of the underwriting year.
- Trusts** 4.17 The additional rate of income tax charged on discretionary and accumulation trusts will be reduced from 18 per cent to 10 per cent.
- Capital gains** 4.18 The base date for capital gains will be brought forward from 6 April 1965 to 31 March 1982; in general, only gains or losses accrued since 1982 will be brought into account for tax. This change will also apply to companies' gains. The present indexation provisions will continue to apply to gains accruing from 31 March 1982.
- 4.19 The capital gains tax annual exempt amount for 1988-89 will be reduced to £5 000 in the case of individuals and £2 500 in the case of most trusts.
- 4.20 Gains, after deduction of the exempt amount and allowing for rebasing to 1982 and indexation, will be added to income and taxed at income tax rates (as if they were the marginal slice of income).
- 4.21 From 6 April 1988, 50 per cent of gains between £125 000 and £500 000 will qualify for retirement relief, subject to the general conditions for the relief.

- Inheritance tax** 4.22 From Budget day, the threshold for inheritance tax will be increased from £90 000 to £110 000. Chargeable transfers above this amount will be taxed at a flat rate of 40 per cent. The £100 000 limit on the amount that can be given to a political party without incurring inheritance tax will be abolished.
- Business tax** 4.23 The small companies' rate of corporation tax will be reduced to 25 per cent for the financial year 1988.
- 4.24 The rate of advance corporation tax (ACT) for 1988-89 will go down automatically to 1/3rd as a consequence of the reduction in the basic rate of income tax.
- 4.25 The main rate of corporation tax for the financial year 1988 will be 35 per cent.
- 4.26 In common with other business entertainment, the cost of entertaining overseas customers will no longer be an allowable business expense for tax purposes. This change will take effect from Budget day, except for commitments entered into before that date. From 1 August 1988 the VAT paid by businesses on this entertainment will no longer be deductible.
- 4.27 A number of changes will be made to prevent tax charges arising on the conversion of building societies into public limited companies.
- Business Expansion Scheme** 4.28 Investment in private rented housing will be encouraged by extending the Business Expansion Scheme to give relief on investment in companies providing rented housing under the new assured tenancy scheme.
- 4.29 A general limit of £500 000 will be set on relief under the Business Expansion Scheme for total investment in any one company in any period of twelve months, with a higher limit of £5 million for investment in qualifying companies providing private rented housing or letting ships on charter.
- Forestry** 4.30 Income from the occupation of commercial woodlands will be removed from the scope of income tax and corporation tax.
- Oil taxation** 4.31 The oil allowance for petroleum revenue tax (PRT) will be reduced to 100 000 tonnes per chargeable period for all Southern Basin and onshore fields given development consent on or after 1 April 1982. (At the same time the Secretary of State for Energy proposes to abolish royalty payments for these fields.)
- 4.32 A new capital gains relief will be provided for disposals of oil licence interests in undeveloped areas wherever the consideration includes a work programme or another licence interest.
- Company residence and migration** 4.33 Section 482(1) (a) and (b) of the Taxes Act 1970 will be repealed with effect from Budget day. In future companies will be resident for tax purposes in the United Kingdom if incorporated here, or centrally managed and controlled here. UK incorporated companies wishing to move their business abroad, or non-UK incorporated companies moving their residence abroad may do so without consent if they pay the tax due (including tax on accrued capital gains).

Stamp duties 4.34 Capital duty and unit trust instrument duty will be abolished with effect from midnight on Budget day.

VAT 4.35 From 16 March 1988 the registration limits will become £22 100 per annum and £7 500 per quarter.

4.36 The provision for applying VAT to confectionery will be amended, with the main effect of taxing all cereal bars at the standard rate.

Excise duties 4.37 The duties on beer and wines will rise by the equivalent of 1p on a typical pint of beer, just under 4p on a bottle of table wine, and just over 6p on a bottle of sherry (all inclusive of VAT). The duty on spirits will remain unchanged. The minimum duty charge for beer will be abolished and provision will be made for restructuring the duties on lower strength mixed drinks.

4.38 The duty on leaded petrol will be increased by the equivalent of 5½p a gallon (inclusive of VAT). The duty on unleaded petrol will remain unchanged so that the tax differential in favour of unleaded petrol will increase to nearly 11p a gallon. The duty on derv will rise by the equivalent of just under 5p a gallon (inclusive of VAT).

4.39 The specific duties on cigarettes, hand-rolling tobacco and cigars will rise by the equivalent of just over 3p on a packet of 20 cigarettes and nearly 2p on a packet of 5 small cigars (inclusive of VAT). The duty on pipe tobacco will remain unchanged.

Tax administration 4.40 The VAT civil penalty system, introduced in 1985, has been reviewed and various easements are proposed.

4.41 In the light of recommendations by the Keith Committee, changes will be made:

- to encourage people to notify the Inland Revenue if they are liable to tax;
- to improve the information powers of the Inland Revenue;
- to charge interest where payment to the Inland Revenue of income tax deducted by employers is delayed beyond the end of the tax year.

Independent taxation 4.42 A new system of taxation for married couples will be introduced in 1990. The details are set out in the box opposite.

Independent taxation for married couples

The present system of taxing husbands and wives, under which a married woman's income is treated in law as if it belonged to her husband, has been unchanged since the earliest days of income tax. Green Papers published in 1980 and 1986 have considered how the system might be reformed. There is general agreement that the present law is no longer acceptable, and wide support for an early change to a new and more up-to-date system.

A major reform of the system is therefore proposed to give husbands and wives independence and privacy in their tax affairs and remove the tax penalties on marriage which can occur under the present system. The new system will be introduced from 6 April 1990 to allow time for the necessary preparations.

From 6 April 1990, husbands and wives will be taxed independently on their income and chargeable capital gains. This will mean that:

husband and wife will become independent taxpayers each with their own allowances and basic rate band to set against their own income (from whatever source); each will be responsible for handling their own tax affairs with the Inland Revenue;

every taxpayer will be entitled to a personal allowance, equivalent to the allowance for single people under the present system;

there will be a new married couple's allowance (based on the difference under the present system between the married allowance and the single allowance). This will be set first against the husband's income, but any unused amount may be transferred to the wife;

married women will qualify in their own right for the higher levels of personal allowance for taxpayers aged 65–79 and those aged 80 and over. Higher levels of married couple's allowance will apply where either partner in a couple is aged 65–79 (or aged 80 and over);

there will be transitional protection for the small number of couples whose allowances would be reduced as a result of the change to the new system;

a husband's and wife's capital gains will be taxed independently; each partner will be entitled to the same exempt amount as a single person;

the existing exemptions from capital gains tax and inheritance tax on transfers of capital between husband and wife will continue; and

it will be possible to abolish a number of provisions, including the wife's earnings election and separate assessment.

Table 4.1 Direct effects of changes in taxation

See Annex 4 paragraph numbers	£ million		
	Estimated effect on receipts in:		
	1988-89	1989-90	1989-90
	Changes from a non-indexed base	Changes from an indexed base	Changes from an indexed base
INLAND REVENUE			
Income tax			
1 Increase in single allowance of £180 and married allowance of £300	-1 245	-625	-810
2 Increase in additional personal allowance and widow's bereavement allowance of £120	-15	-5	-10
3 Increase in age allowance of £220 (single) and £360 (married) for those aged 65 to 79	-90	-45	-55
4 Increase in age allowance of £240 (single) and £360 (married) for those aged 80 and over	-15	-10	-10
5 Increase in income limit for age allowance of £800	-10	-5	-10
6 Increase in basic rate limit of £1 400 to £19 300	-155	-75	-125
7 Abolition of minor personal allowances	+10	+10	+10
8 Restriction on additional personal allowance for unmarried couples	—	—	+5
9 Reduction of 2p in basic rate	-2 190	-2 190	-3 000
10 Abolition of higher rates of income tax above 40p	-1 025	-965	-2 070
11 Reduction in relief on life assurance premiums	—	—	+70
12 Fringe benefits—car benefit scales	+260	+260	+310
13 Fringe benefits—car parking space	-5	-5	-5
14 Mortgage interest relief ceiling applied to residence	*	*	+25
15 Abolition of tax relief on new home improvement loans	+80	+80	+200
16 Abolition of tax relief on new loans for homes for dependent relatives and divorced or separated spouses	*	*	*
17 Abolition of tax relief on new non-charitable covenants	+45	+45	+105
18 Payroll giving to charities—increase in donation limit to £240 a year	*	*	*
19 Change in rules for maintenance payments	-10	-10	-5
20 Change in additional rate on discretionary trusts	-5	-5	-10
21 Lloyd's—reform of administrative arrangements	—	—	*
22 Lloyd's reinsurance to close—relief for leavers	*	*	*
23 Unapproved employee share schemes—relaxation of charge	*	*	*
24 Employee priority in public offer of shares	*	*	*
25 Approved FA 1984 employee share option schemes—restricted shares	*	*	*
26 Assessing procedure for Schedule D	—	—	—
27 Redundancy payments—change to scale of charge	*	*	*
28 Withdrawal of top-slicing relief for tax charged on premiums for leases, etc	*	*	*
29 Amendment to tax treatment of overseas interest and dividends	*	*	*
Capital gains tax			
30 Rebasing capital gains of individuals and trusts to March 1982	*	*	-55
31 Annual exempt amount reduced to £5 000	*	*	+15
32 Charging gains of individuals and trusts at income tax rates	+70	+70	+65
33 Retirement relief	*	*	-10
34 Building and co-operative society shares	*	*	*
35 Homes provided for dependent relatives	—	—	*
Income tax and capital gains tax			
36 Independent taxation of income and chargeable capital gains of husband and wife from 1990-91	*	*	-20 ¹
37 Business Expansion Scheme—limit on relief	+5	+5	+25
36 Business Expansion Scheme—private rented housing	*	*	-40
39 Personal Equity Plans—increase in limit	*	*	-5

* = Negligible — = Nil

¹ Allows for some postponement of realisation of gains by married couples (see annex note 36)

Table 4.1 Direct effects of changes in taxation—continued

See Annex 4 paragraph numbers	£ million		
	Estimated effect on receipts in:		
	1988-89	1989-90	1989-90
	Changes from a non-indexed base	Changes from an indexed base	Changes from an indexed base
Income tax and corporation tax			
40 Rebasing capital gains of companies to March 1982	-25	-25	-235
41 Forestry—removal of commercial woodlands from scope of tax	—	—	*
42 Refunds of employee pension contributions	+15	+15	+15
43 Occupational pensions—minor amendments	—	—	—
44 End of year interest on PAYE and subcontractors deductions	—	—	—
45 Capital allowances—exempt persons	—	—	—
46 Capital allowances—safety at sports grounds	*	*	*
47 Capital allowances—abolition of quarantine premises relief	*	*	*
48 Withdrawal of relief for business entertainment of overseas customers	*	*	+5
Corporation tax			
49 Reduction in small companies' rate to 25 per cent	*	*	-50
50 Reduction in rate of ACT to 1/3rd of the amount of the distribution	-380	-380	-200
51 Company residence and migration—new rules	—	—	—
52 Definition of an investment trust	—	—	—
53 Indexation allowance—intra-group transactions	—	—	—
54 Intra-group share exchanges	—	—	—
55 Capital allowances—assured tenancies relief	—	—	—
Corporation tax and capital gains tax			
56 Rollover relief for satellites, spacecraft, milk quotas and potato quotas	*	*	-5
Income tax, corporation tax and capital gains tax			
57 Keith Committee administrative changes	+10	+10	+20
Income tax, corporation tax, capital gains tax and stamp duties			
58 Conversion of building societies into public limited companies—changes in tax rules	—	—	—
Oil taxation			
59 Reduction in PRT oil allowances for certain fields	+30	+30	+25
60 New capital gains relief for certain oil licence disposals	-5	-5	-5
61 PRT relief for certain tariff-related costs	—	—	—
Inheritance tax			
62 Increase of £20 000 in threshold and change to 40 per cent flat rate	-120	-100	-200
63 Abolition of limit on gifts to political parties	*	*	*
Stamp duties			
64 Abolition of capital duty and unit trust instrument duty	-90	-90	-100
65 Stamp duty and reserve tax on paired shares	—	—	—
TOTAL INLAND REVENUE	-4 860	-4 015	-6 140
CUSTOMS AND EXCISE			
Value added tax			
66 Change in liability of certain confectionery	+5	+5	+10
67 Keith Committee—review of civil penalties	*	*	*
68 Increase in registration limits	*	*	*
69 Revised registration requirements	*	*	*
70 Revision of approved self-billing arrangements	+5	+5	+5
71 Revised treatment of business entertainment for overseas customers	*	*	*
Excise duties			
72 No change in rate of spirits duty	—	-25	-25
73 Increase in rate of beer duty	+75	+15	+15
74 Abolition of minimum duty charge for beer	*	*	*
75 Increase in rate of duty on cider and perry	+5	+5	*

* = Negligible — = Nil

Table 4.1 Direct effects of changes in taxation—*continued*

See Annex 4 paragraph numbers	£ million		
	Estimated effect on receipts in: 1988–89		1989–90
	Changes from a non-indexed base	Changes from an indexed base	Changes from an indexed base
Excise duties—<i>continued</i>			
76 Increases in rates of wine and made-wine duties	+ 25	+ 5	*
77 Revised duty regime for lower strength mixed drinks	*	*	*
78 Changes in rates of duty on petrol, etc.	+ 275	+ 80	+ 50
79 Increase in rate of duty on derv	+ 75	+ 25	+ 25
80 No change in rates of minor oil duties	—	— 5	— 10
81 Increase in rates of duties on cigarettes, hand-rolling tobacco and cigars	+ 100	—	—
82 No change in rate of duty on pipe tobacco	—	*	— 5
TOTAL CUSTOMS AND EXCISE	+ 565	+ 110	+ 65
Vehicle excise duty			
83 No change in VED on cars, light vans and in main lorry rates	—	— 100	— 110
84 Increase in certain other VED rates	+ 20	+ 20	+ 20
85 New VED class for exceptional loads	*	*	*
TOTAL VED	+ 20	— 80	— 90
TOTAL CHANGES IN TAXATION	— 4 275	— 3 985	— 6 165

* = 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 the tax which would arise on the basis of the rate 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).

For Inland Revenue taxes (and VED) the difference in yield for each tax is generally calculated by applying the pre- and post-Budget tax regimes to the same tax base. This base is the post-Budget base—that is the levels of income, profits, etc forecast for future years on the assumption that all the measures proposed in the Budget take effect. In certain cases, however, the difference in yield also takes account of changes in taxpayers' behaviour arising from the tax change where these changes can be directly attributed to the change in tax. For example, the estimates of the cost or yield of the capital gains tax changes allow for the likely effects on the volume and timing of disposals.

For Customs and Excise taxes and duties, the calculation takes into account, where possible, the effect of the tax change on the pattern of consumers' expenditure and the resulting impact on other expenditure taxes but makes no allowance for secondary effects: in particular, it is assumed that total consumers' expenditure does not change. A fuller description of the methodology is in *Economic Trends*, March 1980.

Table 4.1 shows the expected change in receipts of tax resulting from the Budget proposals. Additional information is provided in the commentary below 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 1988–89 or 1989–90; or where the impact of the proposal is expected to build up over a period of years.

The figures in the first column of Table 4.1 show the direct effect of the Budget proposals on receipts in 1988–89. Budget proposals are compared with a non-indexed base—that is, with the pre-Budget regime of allowances, thresholds and rates of duty at 1987–88 levels.

The figures in the second column show the direct effect of the Budget proposals on receipts in 1988–89, measured against an indexed base. The indexed base for 1988–89 is obtained by increasing 1987–88 allowances, thresholds and rates of duty by 3.7 per cent, the increase in the RPI over the year to December 1987.

The figures in the third column show the direct effect on receipts in 1989–90, also measured against an indexed base. For this comparison, both the Budget proposals and the indexed base for 1988–89 have been further indexed by the forecast movement in the RPI between the fourth quarters of 1987 and 1988 (shown in Table 3.12).

The estimates shown in Table 4.1 do not reflect changes in the tax base arising from changes in money incomes and in the general level of prices and other economic variables which may result from the proposed tax change. These secondary effects

PSBR. The base for the post-Budget forecast of each tax (given in Table 6B.3) takes account of the effects, direct and secondary, of all the measures announced in the Budget.

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.

- Income tax**
- 1 to 5** The increases in the main personal allowances are twice those due under statutory indexation (based on the increase of 3.7 per cent in the RPI in the year to December 1987).
- 6** The basic rate limit will rise by £1 400 from £17 900 to £19 300, twice the amount due under statutory indexation.
- 7** The dependent relative allowance, housekeeper allowance and the allowance for the services of a son or daughter will be abolished.
- 8** From 6 April 1989, an unmarried couple will not be entitled to more than one additional personal allowance.
- 9** The basic rate will be reduced to 25 per cent. This item includes the saving in mortgage interest relief to those below the tax threshold. The effect of the consequential change in the rate of advance corporation tax (ACT) is shown in line 50 of Table 4.1.
- 10** There will be a single higher rate of 40 per cent.
- 11** Following the reductions in the basic rate of income tax in successive Budgets, the rate of relief for life assurance premiums on policies taken out before 14 March 1984 will be reduced from 15 per cent to 12.5 per cent from 6 April 1989. The starting date is to allow life offices time to make the necessary preparations. This item includes the saving in life assurance premium relief to those below the tax threshold.
- 12** For 1988–89 the scale for taxing car benefits for directors and “higher paid” employees will be double the 1987–88 levels. The previously announced scales for 1988–89 will not apply. The estimated yield is based on the difference between the tax payable on the new scales and the tax payable if 1987–88 scales had applied.
- 13** The provision of a car parking space at work for the use of directors or higher-paid employees will be exempt from tax from 6 April 1988.
- 14** For loans taken out from 1 August 1988, tax relief for two or more people borrowing to buy the same property as their only or main residence will be limited to the interest on £30 000 in total for the residence.
- 15** Relief for new loans for home improvement will be abolished from 6 April 1988. Relief for loans for the purchase or improvement of let property is not affected.
- 16** Relief for new loans for the purchase of residences for dependent relatives and divorced or separated spouses will be abolished from 6 April 1988.
- 17** Non-charitable covenants made on or after Budget day by individuals will no longer be effective for tax purposes. The change is estimated to yield £160 million in 1990–91 and £175 million in 1991–92. There will be parallel changes in the student grant system (see paragraph 5.04).
- 18** The limit on charitable donations qualifying for tax relief under payroll giving schemes will be increased to £240 a year from 6 April 1988.
- 19** The new tax regime for maintenance payments will mean that:
- for payments under new maintenance arrangements, relief will be restricted to payments to a divorced or separated spouse, up to a limit equal to the difference between the married and single allowances (£1 490 for 1988–89). Recipients will

for existing maintenance arrangements, in 1988–89 the present rules will continue to apply except that a divorced or separated spouse will be exempt from tax on the first £1 490 of maintenance received (after grossing up at the basic rate where tax has been deducted by the payer). From 1989–90, all payments will be made gross; and relief for the payer will be limited to the amount which qualified for relief in 1988–89. The tax liability on the recipient will be limited to the amount taxable in 1988–89; and a divorced or separated spouse will be exempt from tax on an amount up to the difference between the single and married allowances.

The changes are estimated to yield £5 million in 1990–91 and £15 million in 1991–92.

20 The additional rate of income tax charged on the income of discretionary and accumulation trusts will be reduced from 18 per cent to 10 per cent for 1988–89. The full year cost is £15 million.

21 The administrative arrangements for the assessment and collection of tax from members of Lloyd's will be reformed. The legislation will first take effect for the Lloyd's 1986 Account, which closes at the end of 1988.

22 The legislation on Lloyd's reinsurance to close (RIC) will be modified so that it will not apply to Lloyd's members who ceased membership of a syndicate at the end of the underwriting year, and are therefore not members of the syndicate to which the relevant RIC premium is paid. The legislation will first take effect for the Lloyd's 1985 Account, which closed at the end of 1987. This is the first year to which the 1987 legislation on Lloyd's RIC will apply.

23 The rules (Section 79 Finance Act 1972) governing unapproved employee share schemes will be relaxed with effect from 26 October 1987 (when draft clauses were published for consultation).

24 Any benefit resulting from priority in applying for a public offer of shares given to employees by virtue of their employment will, subject to certain conditions, be exempt from income tax.

25 Changes will be made to the approved discretionary share option legislation to enable employees to borrow to purchase their option shares without losing tax relief.

26 Legislation will be introduced to ensure that the Inland Revenue continue to have power to make an income tax assessment, on certain types of income assessable on the current year basis, in the course of the year in which the income arises.

27 The limit below which redundancy and certain other lump sum payments are exempt from income tax will be increased from £25 000 to £30 000. The reduced rates of tax which apply to the next £50 000 of such payments will be abolished.

28 The top-slicing relief which applies to the tax charged on premiums for leases and certain other payments will be withdrawn.

29 The definition of a recognised clearing system will be amended and the deduction of tax rules will be extended to collecting agents obtaining payment of overseas interest and dividends in the UK.

Capital gains tax

30 The base date for capital gains tax (and for corporation tax on gains—see 40 below) will be changed from 6 April 1965 to 31 March 1982. There will be provisions to ensure that this change will never produce greater taxable gains or tax losses than the present system. The total cost of rebasing may build up for several years; but it will eventually decline as the stock of assets acquired before March 1982 falls. Estimates of cost, including the measures described in 31, 32 and 40 below, take account of the likely effect of the changes on the volume and timing of disposals.

31 The capital gains tax annual exempt amount will be reduced to £5 000 in the case of individuals and £2 500 in the case of most trusts. The revenue yield in 1990–91 is estimated at £35 million. The cost of allowing separate annual exempt amounts for husbands and wives from 1990–91 is not included in these figures but at 36 below.

32 From 1988–89, the capital gains of individuals and trusts will be taxed at income tax rates, that is as if they formed the marginal slice of income. The revenue yield in 1990–91 is estimated at £75 million. Until the introduction of independent taxation in 1990–91, the gains of married couples will be taxed as if they were the marginal slice of the husband's income.

33 Retirement relief currently exempts business gains up to £125 000, subject to certain qualifying conditions. From 6 April 1988, half of any business gains between £125 000 and £500 000 will also be exempt, subject to the same conditions.

34 From 4 July 1987, disposals of shares in building and co-operative societies will not qualify for indexation relief.

35 From 6 April 1988, the capital gains tax exemption for homes provided for dependent relatives will be abolished. There will be special provisions to ensure that exemption continues where a dwelling would have qualified for this exemption on a disposal before 1988–89.

Income tax and capital gains tax

36 The new system of independent taxation for husbands and wives will apply from 1990–91. For income tax, the revenue costs in 1990–91 and 1991–92 (based on the existing distribution of income and capital between husbands and wives) are estimated at £500 million and £1 billion respectively. For capital gains tax, the prospect of independent taxation may lead some couples to defer disposals until the new arrangements are in place; and the figure for 1989–90 in Table 4.1 reflects this. Costs for capital gains tax in 1990–91 and 1991–92 are estimated at £50 million and £45 million respectively. The estimates are inevitably subject to considerable uncertainty.

37 A general limit of £500 000 will be set on the total amount of investment in any one company in any period of 12 months qualifying for relief under the Business Expansion Scheme, with a higher limit of £5 million for investment in qualifying companies letting ships on charter. The estimated revenue effects depend on take up and are highly uncertain.

38 Relief under the Business Expansion Scheme will be made available for investment in companies providing private rented housing under the new assured tenancy scheme. A limit of £5 million will apply to qualifying investment in these companies. The estimated revenue costs depend on take up and are highly uncertain.

39 The annual limit on investment in a Personal Equity Plan will be raised from £2 400 to £3 000. At the same time, the amount which may be held in cash will be increased from £240 to £300 (or, in each case, 10 per cent of total market value of a plan). And the amount which may be invested in a unit trust or investment trust will rise from £420 to £540 (or, if greater, 25 per cent of total investment). The changes will apply from calendar year 1988.

Income tax and corporation tax

40 The base date for corporation tax on gains will be changed from 6 April 1965 to 31 March 1982 (see 30 above).

41 Schedule B will be abolished with effect from 1988–89. With effect from 15 March 1988 (subject to transitional provisions extending to 5 April 1993) the right of occupiers of commercial woodlands to elect to be assessed to tax on their profits or losses under Schedule D will be abolished. The eventual net annual revenue saving is estimated at over £10 million. In parallel there will be increases in

42 The rate of tax on refunds of employee pension contributions will be increased from 10 per cent to 20 per cent.

43 Minor amendments are to be made to the 1987 legislation which dealt with exploitation of tax reliefs for pensions.

44 Interest will be charged where an employer or contractor delays payment to the Inland Revenue of amounts deducted under the PAYE or subcontractor deduction schemes beyond 19 April immediately following the deduction year. This interest charge will not be introduced before 1992.

45 The rules for calculating industrial buildings allowance following a sale and those for transfers of machinery or plant between connected persons will be amended to prevent excessive relief where one person is not chargeable to tax in the United Kingdom. These changes will prevent a potential Exchequer loss of up to £150 million in 1991–92 with a diminishing effect in later years.

46 The legislation relating to capital allowances for safety expenditure at sports grounds will be amended from 1 January 1988 to take account of changes to the Safety at Sports Grounds Act 1975.

47 Capital allowances on expenditure at certain quarantine premises will be abolished from 16 March 1988.

48 The relief for the costs incurred by a business in entertaining overseas customers will be withdrawn. The yield from the VAT change is at 71.

Corporation tax

49 The small companies' rate of corporation tax for the financial year 1988 will be reduced to 25 per cent.

50 As a consequence of the reduction in the basic rate of income tax, the rate of advance corporation tax (ACT) for 1988–89 will be 1/3rd of the amount of the distribution. The reduction in ACT will be balanced by an increase in the subsequent liability to mainstream corporation tax.

51 The rules for company residence and migration will be changed. In future companies will be resident for tax purposes if they are incorporated in the UK or are centrally managed and controlled here. UK incorporated companies will be able to transfer their business abroad and non-UK incorporated companies will be able to transfer their residence abroad—in both cases without requiring Treasury consent—on providing for the payment of any tax due, including tax on accrued capital gains.

52 The Finance (No 2) Act 1987 repealed part of the definition of an investment trust. The full definition will be reinstated, and the legislation will include provision to ensure that the repeal was never effective.

53 The indexation allowance will be denied or restricted on disposal of certain intra-group debts and shareholdings. This provision counters use of the indexation allowance in ways which could artificially cause a significant loss of tax.

54 As a result of a recent court ruling, share exchanges by companies in the same group can now give rise to capital gains or losses being taxed or allowed more than once. The legislation will be amended so as to remove that anomaly.

55 Capital allowances in respect of properties let on assured tenancy terms by "approved bodies" will come to an end when the Housing Bill takes effect. Changes will be made to the capital allowances legislation to ensure that relief for past years is not withdrawn and to provide transitional arrangements in respect of expenditure already incurred.

- Corporation tax and capital gains tax** 56 Rollover relief will be extended to satellites and spacecraft from 28 July 1987 and to milk quotas and potato quotas from 30 October 1987.
- Income tax, corporation tax and capital gains tax** 57 There are a number of administrative changes arising out of the Keith Committee recommendations:
- the present flat rate penalty for failure to notify liability to tax will be replaced by a fully mitigable penalty up to the amount of tax unpaid;
 - the Inland Revenue's power to call for returns of information will be extended to details (where relevant for tax) of payments for services by Government departments, grants or subsidies paid out of public funds and the names of licence holders;
 - the Inland Revenue's power to call for documents relating to taxpayers suspected of avoidance or evasion will be extended to include the Department for National Savings, and, in order to identify taxpayers suspected of serious default, to documents relating to taxpayers whose identity is not known to the Inland Revenue;
 - the Inland Revenue will be allowed the same access to records held on computer as it is allowed to records held on paper.
- The estimated yield of these measures is inevitably uncertain.
- Income tax, corporation tax, capital gains tax and stamp duties** 58 Changes in the tax rules concerning the conversion of building societies into public limited companies are necessary in order to prevent unintended tax charges arising.
- Oil taxation** 59 The PRT oil allowance for Southern Basin and onshore fields given development consent on or after 1 April 1982 is to be reduced to 100 000 tonnes per chargeable period, with a cumulative total of 2 million tonnes. The yield figures in Table 4.1 relate to this proposal only. At the same time, it is proposed to abolish royalties on these fields. These two measures have a cumulative cost of around £50 million in the first five years (in part because it is estimated that they will accelerate certain developments), but in the long run they are expected to be broadly revenue neutral.
- 60 For disposals of oil licences in undeveloped areas where the consideration includes a work programme or another licence interest, that work programme or other licence interest will be deemed to have a nil value.
- 61 All tariff-related expenditure incurred by an asset owner will be allowed against his PRT liability on tariff income arising from third party use of those assets, even though his principal field has ceased production. No cost will arise until after fields owning assets used by others cease production.
- Inheritance tax** 62 The estimated full year cost attributable to taxable estates in 1988-89 is £220 million measured against an indexed base.
- 63 The £100 000 exemption limit on gifts to political parties made on or within one year of death is abolished from Budget day.
- Stamp duties** 64 Capital duty will not be payable on transactions completed after 15 March 1988. Unit trust instrument duty will not be payable on instruments executed after 15 March 1988, nor on property put into an existing trust after that date.
- 65 Changes are proposed to stamp duties and the reserve tax on shares in a UK and a non-UK company where the shares are paired and can only be transferred as a unit.
- Value added tax** 66 The taxing provision relating to confectionery will be amended, with the main effect of taxing all cereal bars at the standard rate from 1 May 1988.
- 67 Amendments will be made to the civil penalty system including the introduction of a time-related penalty for late registration; the halving of daily penalties; changes to the rules about eligibility to repayment supplement; and

- 68 From 16 March 1988, the registration limits will become £22 100 per annum and £7 500 per quarter.
- 69 The rules for registration of voluntary and intending traders will be simplified and restrictions and conditions removed.
- 70 From Royal Assent, where a taxable person issues himself with an invoice under the terms of an approved self-billing arrangement, he will be responsible for determining the correct VAT liability.
- 71 From 1 August 1988, VAT incurred by businesses on entertaining foreign customers will no longer be deductible, bringing it into line with the treatment of VAT on other business entertainment.
- Excise duties** 72 There will be no change in the rate of duty on spirits.
- 73 The duty on typical beer will be increased by 4.7 per cent, equivalent to 1p a pint (inclusive of VAT).
- 74 From 1 October 1988, beer duty will be charged on the basis of £0.90 a hectolitre for every degree by which the original gravity of the beer exceeds 1 000°.
- 75 The duty on cider and perry will be increased by 9.7 per cent, equivalent to 1p a pint (inclusive of VAT).
- 76 The duties on wine and made-wine will be increased by 4.5 per cent, equivalent to 3.8p on a 75cl bottle of still wine, 5.9p on a 70cl bottle of sparkling wine, 6.1p on a 70cl bottle of sherry and 7.1p on a 70cl bottle of port (all inclusive of VAT).
- 77 Lower strength mixed drinks, not exceeding 5.5 per cent alcohol, will be dutied according to their alcoholic strength on a scale proportionate to table wine duty.
- 78 The duty on leaded petrol will be increased by 5.5 per cent, equivalent to 5½p a gallon (inclusive of VAT). The duty on unleaded petrol will remain unchanged so that the tax differential in favour of unleaded petrol will rise to 10.6p a gallon. The rate of duty on aviation gasoline and gas for road fuel will remain half that of leaded petrol.
- 79 The duty on derv will be increased by 5.5 per cent, equivalent to 4.7p a gallon (inclusive of VAT). Bus fuel grants to certain bus service operators will automatically be increased to compensate them for the increase in duty on derv.
- 80 There will be no change in the rates of duty on gas oil and fuel oil.
- 81 The specific duties on cigarettes, hand-rolling tobacco and cigars will be increased by 3.7 per cent, equivalent to 3.4p on a packet of 20 cigarettes, 5.3p on a 25 gram packet of hand-rolling tobacco and 1.9p on a packet of 5 small cigars (all inclusive of VAT).
- 82 The duty on pipe tobacco will be unchanged.
- Vehicle excise duties** 83 There will be no change in the duties on cars, light vans, motor cycles, buses, coaches and most lorries.
- 84 From 16 March 1988, the rates of duty for the heaviest rigid lorries will rise by about 10 per cent bringing them more into line with rates for articulated vehicles of similar gross weight.
- 85 From 1 June 1988, a new tax class will be introduced for heavy goods vehicles (special types) capable of carrying very long, wide or heavy loads. The rate of VED for these special types will be raised to £1 600.

5 Public expenditure

5.01 The Government's expenditure plans were set out in the public expenditure White Paper (Cm 288). They are summarised in Table 5.1. The Budget makes no change to these plans, apart from two consequences of the tax proposals, described in paragraph 5.04.

Changes since previous Budget **5.02** Since the last FSBR, extra resources have been allocated to priority services such as health, education, law and order, defence and inner cities. Provision for social security and local authority current spending has also been increased.

Table 5.1 Public expenditure

	£ billion				
	1986-87 Outturn	1987-88 Estimated outturn	1988-89 Plans	1989-90 Plans	1990-91 Plans
Department					
DHSS – social security	44.4	46.3	48.5	51.1	53.6
DHSS – health and personal social services	17.9	19.7	20.7	21.7	22.7
Defence	18.1	18.6	19.2	20.0	20.6
Education and science	15.7	17.1	18.0	18.6	19.2
Scotland, Wales and Northern Ireland	15.4	16.3	17.1	17.5	17.9
Other departments	32.0	33.0	34.9	36.2	36.7
Privatisation proceeds	-4.4	-5.0	-5.0	-5.0	-5.0
Reserve			3.5	7.0	10.5
Public expenditure planning total	139.2	146.0	156.8	167.1	176.1
General government gross debt interest ¹	17.6	17.5	17.5	17	17
Other adjustments ¹	8.2	8.3	8.6	9	9
General government expenditure¹	165.0	171.8	182.9	193	202
General government expenditure excluding privatisation proceeds:					
in real terms (base year 1986-87)	169.4	168.5	171.3	174	175
as a percentage of GDP	43$\frac{3}{4}$	41$\frac{3}{4}$	41$\frac{1}{4}$	40$\frac{3}{4}$	40

¹ 1989-90 and 1990-91 figures rounded to nearest £1 billion.

Public spending trends 5.03 The reductions in the burden of debt interest, in unemployment and in subsidies to industry are helping to make room for priority services while maintaining the Government's policy of reducing the share of national income taken by public expenditure. General government spending excluding privatisation proceeds has fallen from 46 $\frac{3}{4}$ per cent of GDP in 1982-83 to 41 $\frac{3}{4}$ per cent now. This fall is planned to continue.

Budget consequential 5.04 In parallel with the abolition of tax relief on new covenants between individuals, including covenants to students (see paragraph 4.10), the parental contribution scale is being revised for new students. This will cost some £15 million in 1988-89, rising to £60 million in 1991-92. In parallel with the change in the tax treatment of forestry (see paragraph 4.30) there will be increases in planting grants for commercial woodlands estimated to cost about £4 million in 1988-89 rising to £8 million in 1991-92. The expenditure arising from these changes will be charged to the Reserve and will not add to the planning totals.

1987-88 outturn 5.05 The latest estimates for the outturn for the planning total in 1987-88, which are still subject to some uncertainty, suggest that it is likely to be £146.0 billion, £2.6 billion below the plans shown in the 1987 public expenditure White Paper and the 1987 Budget and £1.3 billion below the outturn figure shown in the 1988 public expenditure White Paper. A breakdown is shown in Table 5.2. Of the Reserve of £3.5 billion, only £0.9 billion has been required to meet additions to departmental programmes.

Table 5.2 Comparison of plans and estimated outturn for 1987-88

	1987-88 £ billion		
	Plans ¹	Estimated outturn	Outturn minus plans
Central government ²	108.3	109.2	+0.8
Local authority ²	40.2	40.9	+0.7
of which:			
relevant expenditure	31.0	32.2	+1.2
other current	4.9	5.1	+0.1
capital	4.3	3.7	-0.6
Nationalised industries and other public corporations	1.6	1.0	-0.6
Privatisation proceeds	-5.0	-5.0	
Reserve	3.5		-3.5
Public expenditure planning total	148.6	146.0	-2.6

¹ The Government's Expenditure Plans 1987-88 to 1989-90 (Cm 56), adjusted for classification changes.

5.06 The major changes between programme plans and estimated outturn for the different spending authorities are:

a net increase of £0.8 billion in central government expenditure: higher net payments to the European Communities (£0.8 billion) are expected, partly offset by lower payments by the Intervention Board for Agricultural Produce (£0.2 billion); and there has been an increase of £0.5 billion in DHSS expenditure on health, two-thirds of which reflects the 1987 nurses' and doctors' and dentists' pay settlements;

an overspend of £1.3 billion on the plans for local authority current expenditure;

a net underspend of £0.6 billion on local authority capital expenditure, reflecting £0.4 billion higher gross spending, more than offset by £1.0 billion higher capital receipts;

an improvement of £0.6 billion in the figures for nationalised industries and other public corporations, due principally to higher profitability of British Steel (£0.4 billion) and the effect of increased capital receipts from new towns (£0.2 billion).

Table 5.3 Public expenditure by spending authority

	£ billion				
	1986-87 Outturn	1987-88 Estimated outturn	1988-89 Plans	1989-90 Plans	1990-91 Plans
Central government ¹	104.6	109.2	114.2	120.2	124.7
of which:					
Voted in Estimates	74.0	76.6	81.0	84.6	87.6
other	30.6	32.5	33.2	35.6	37.1
Local authorities ¹	37.9	40.9	42.6	44.0	45.2
of which:					
relevant expenditure	29.4	32.2	33.2	34.3	35.4
other current	4.8	5.1	5.4	5.7	5.9
capital	3.7	3.7	4.0	4.0	3.9
Nationalised industries	0.4	0.4	0.7	0.0	-0.4
Other public corporations	0.8	0.6	0.8	1.0	1.0
Privatisation proceeds	-4.4	-5.0	-5.0	-5.0	-5.0
Reserve			3.5	7.0	10.5
Public expenditure planning total	139.2	146.0	156.8	167.1	176.1

¹ Excluding finance for nationalised industries and other public corporations.

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. Table 5.3 gives outturn figures for the last two years and the

Supply Estimates 5.08 For 1988–89, 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 1988–89 for which the Government is seeking Parliamentary approval is shown in Table 5.4. The main Estimates for 1988–89 are published in a series of booklets on 15 March 1988 with a Summary and Guide (Cm 328) which explains the Supply procedure and summarises the Estimates. It also explains how they relate to the public expenditure planning total.

5.09 Of the £108.3 billion included in the Supply Estimates, £83.0 billion is direct public expenditure. The remaining £25.3 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 two-thirds 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		1987–88 Expected outturn	1988–89 Provision
	1986–87	1987–88 Final outturn		
	Expected outturn in 1987 Budget			
Main Supply Estimates	99.1	99.1	104.5	108.3
Supplementaries and net underspending	2.8	2.4	0.9	
Total Supply expenditure	101.9	101.5	105.3	
Public expenditure element	77.3	76.9	79.5	

6 The public sector's finances

The scope of this chapter 6.01 This chapter brings together revenue (discussed in Chapter 4) and spending (in Chapter 5), and provides an analysis and forecast of the public sector's finances in 1988–89, together with estimates of outturn in 1987–88. It also comments on the main features of the public sector's finances in those two years, including the most important changes that have taken place since last year's projections. Table 6.1 is a summary.

Table 6.1 Public expenditure, receipts and borrowing¹

	£ billion			
	1986-87	1987-88		1988-89
	Outturn	1987 Budget	Latest estimate	Forecast
General government expenditure	165.0	173.5	171.8	182.9
General government receipts	160.1	168.8	173.7	184.9
General government borrowing requirement	4.9	4.7	-1.9	-2.0
Public corporations' market and overseas borrowing	-1.5	-0.8	-1.2	-1.2
Public sector borrowing requirement	3.4	3.9	-3.1	-3.2
PSBR as per cent of GDP	$\frac{3}{4}$	1	$-\frac{3}{4}$	$-\frac{3}{4}$
PSBR excluding privatisation proceeds	7.8	8.9	1.9	1.8
as per cent of GDP	2	$2\frac{1}{4}$	$\frac{1}{2}$	$\frac{1}{2}$

¹Net borrowing: positive; net debt repayment: negative.

6.02 There is now estimated to be a negative public sector borrowing requirement, ie a budget surplus, of about £3 billion in 1987–88. This net repayment of debt compares with the forecast of a borrowing requirement of £4 billion made a year ago. This will be the first budget surplus since 1969–70 and only the second since the beginning of the 1950s. A budget surplus of about £3 billion is forecast for 1988–89.

6.03 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

6.04 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. Its bottom line, the PSBR, is derived from those

- Receipts** **6.05** General government receipts in 1987–88 are now projected to exceed the 1987 Budget forecast by nearly £5 billion. As Table 1.2 shows, most components of general government receipts are likely to be higher than originally forecast. The main contributors to the extra receipts are income tax (£1½ billion), VAT (£1 billion), and North Sea revenues (£¾ billion).
- 6.06** Additional income tax receipts are mainly the result of the stronger growth of the economy and higher incomes. VAT receipts have increased by more in 1987–88 than would have been expected from the recorded increase in total consumer spending. The higher than expected oil revenues in 1987–88 are largely the result of a higher dollar oil price than assumed last year.
- 6.07** General government receipts, including interest and dividend receipts, are forecast to rise by 6½ per cent in 1988–89, following an estimated 8½ per cent increase in 1987–88. This is less than the rate of growth forecast for money GDP. Without the Budget measures, however, forecast growth in receipts would be about 1 percentage point above that of money GDP.
- 6.08** Oil revenues, which in the event in 1987–88 were only slightly below the 1986–87 level, are forecast to fall by about £1½ billion in 1988–89 as a result of both a lower average oil price and lower production. The forecast assumes that North Sea oil prices will remain close to recent levels. Oil production is assumed to fall in 1988 to a level close to the centre of the Department of Energy's range. A \$1 a barrel difference in the average oil price in 1988 would change revenues by about £270 million in 1988–89 and £330 million in a full year. A change of 1 million tonnes in oil production in 1988, spread evenly across fields, would alter revenues by about £35 million in 1988–89 and £45 million in a full year.
- 6.09** Non-oil receipts are forecast to rise by 7 per cent in 1988–89. As can be seen from Table 1.2 there is within this overall increase:
- a 1½ per cent increase in income tax receipts—lower than the expected increase in personal incomes, reflecting the income tax reductions in the Budget;
 - a further rise of 26 per cent in receipts of corporation tax (including ACT but excluding North Sea mainstream corporation tax). This reflects continued growth in company profits in 1987;
 - a 28 per cent rise in capital taxes, mainly reflecting rising asset prices in earlier years;
 - an 8½ per cent increase in VAT, close to the forecast increase in consumers' expenditure;
 - a 6 per cent increase in the excise duties on petrol, tobacco and alcohol, a little below the increase in consumers' expenditure reflecting the trend decline in the share of these items in the total;
 - a fall in stamp duties following the fall in stock market turnover, and the abolition of capital duty and unit trust instrument duty in the Budget.

6.10 Table 6.2 shows taxes (including rates) and national insurance contributions (NICs) as a percentage of GDP. Non-oil taxes have risen as a percentage of non-oil GDP in each of the last two years; they are forecast to remain unchanged in 1988–89. Without the Budget measures the 1988–89 figure would have been a full percentage point higher.

Table 6.2 Taxes and national insurance contributions as a percentage of GDP

	1982–83	1983–84	1984–85	1985–86	1986–87	1987–88 Latest estimate	1988–89 Forecast
Total taxes and NICs as a share of total money GDP	38.9	38.6	39.2	38.5	38.0	37.9	37.9
Non-oil taxes and NICs as a share of non-oil money GDP	38.2	37.8	37.9	37.0	37.5	37.7	37.7

- Expenditure** **6.11** General government expenditure is now forecast to be £171¾ billion in 1987–88, £1¼ billion lower than in the 1987 Budget forecast. The outturn for the planning total is expected to be £2½ billion lower than in the original plans, and gross debt interest payments nearly £½ billion lower than forecast.

6.12 General government expenditure is expected to rise by 6½ per cent in 1988–89, to about £183 billion. The planning total, at £156.8 billion, is as published in the public expenditure White Paper (Cm 288). General government gross debt interest payments in 1988–89 are now forecast to be lower than projected in the White Paper as a result of the marked reduction in the PSBR.

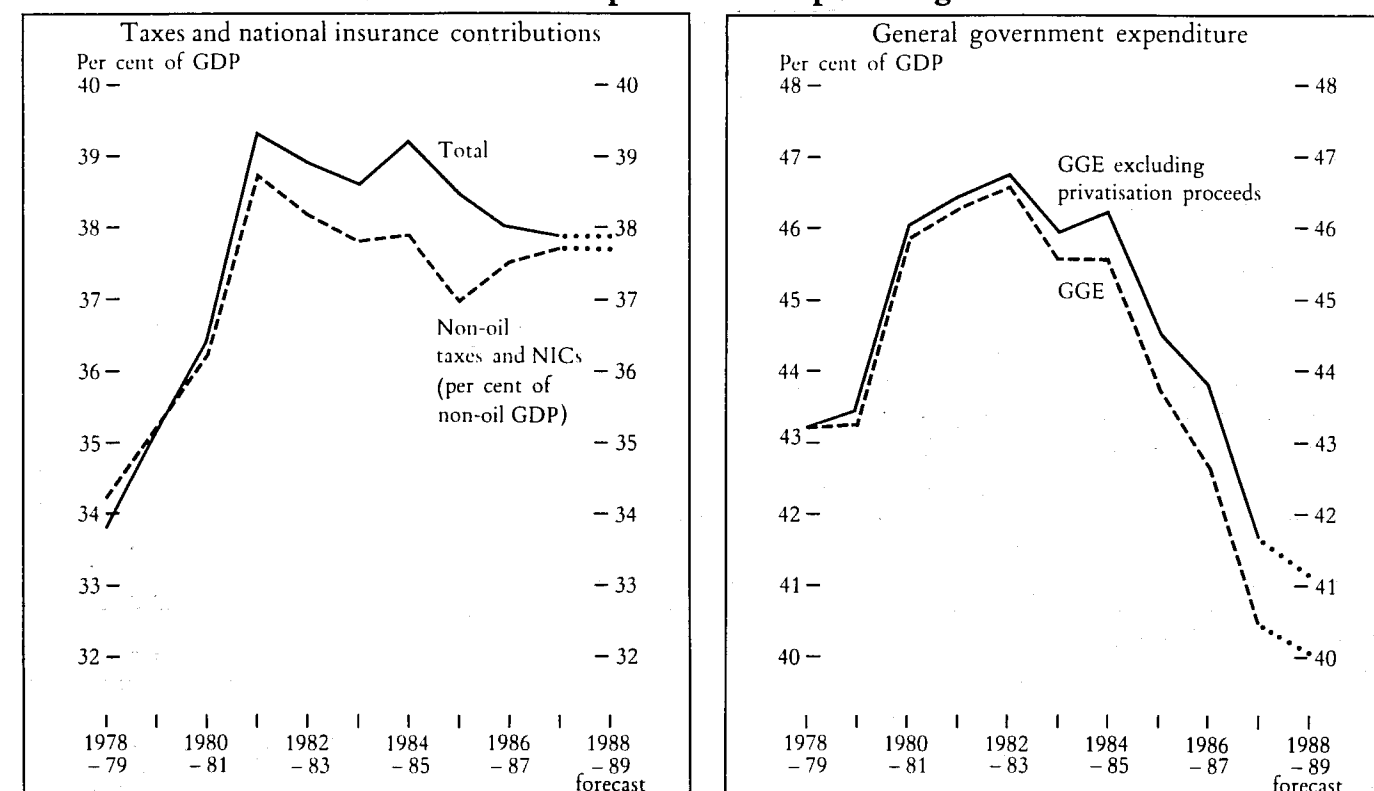
- Borrowing** **6.13** The difference between general government receipts and expenditure is the general government borrowing requirement (GGBR), as shown in Table 6.1. As general government lending to public corporations is included in general government expenditure, the GGBR together with public corporations' market and overseas borrowing gives the PSBR.

6.14 There was a substantial budget surplus in the first ten months of 1987–88. Excluding privatisation proceeds the PSBR was some £5½ billion lower than in the same period of 1986–87. This reduction in borrowing was more than accounted for by lower central government own account borrowing. Local authority borrowing has been higher than in 1986–87 and public corporations' borrowing little changed. Taking into account the well established pattern of relatively high borrowing in March, the forecast for 1987–88 as a whole is a budget surplus of about £3 billion, or ¾ per cent of GDP.

6.15 A further budget surplus of about £3 billion, or ¾ per cent of GDP, is forecast for 1988–89.

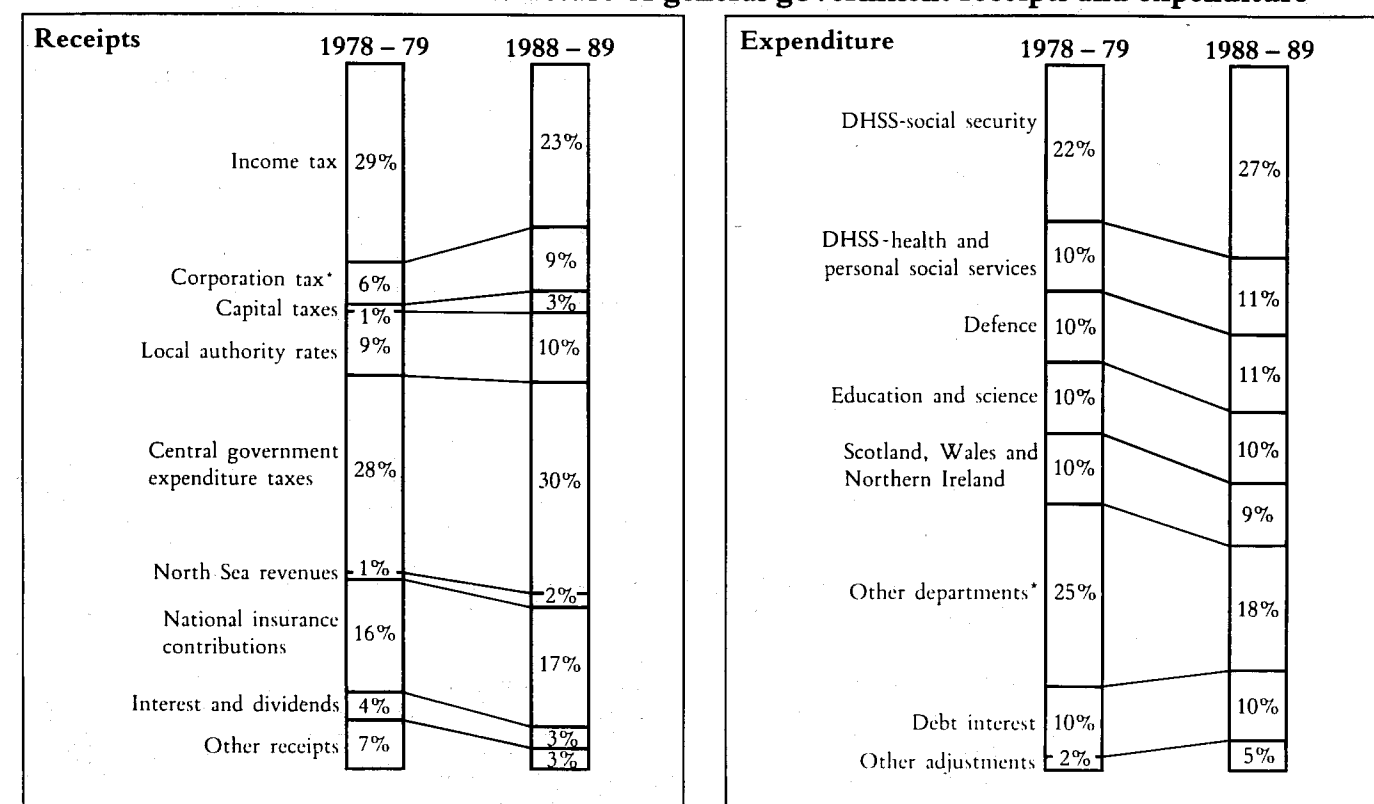
- Trends in receipts and expenditure** **6.16** Chart 6.1 shows trends in taxes and expenditure as percentages of GDP. Revenues from non-oil taxes and national insurance contributions fell as a percentage of non-oil GDP between 1981–82 and 1985–86, but since then they have been rising. The percentage is forecast to remain unchanged in 1988–89. The ratio of general government expenditure (excluding privatisation proceeds) to GDP has fallen every year since 1982–83 except for a small rise in 1984–85 as a result of the coal strike; it is forecast to fall

Chart 6.1 Taxes and expenditure as a percentage of GDP



6.17 Chart 6.2 shows the significant changes in the structure of general government receipts and expenditure which have taken place since 1978-79.

Chart 6.2 The structure of general government receipts and expenditure



Public sector's finances: analysis by sector

6.18 Table 6.3 shows net borrowing in 1986-87 and 1987-88 by central government, local authorities and public corporations.

Table 6.3 Public sector borrowing requirement

	£ billion	
	1986-87 Outturn	1987-88 Latest estimate
1 Central government borrowing on own account	4.5	-3.2
2 Local authority borrowing from central government	5.9	5.2
3 Local authority borrowing from market and overseas	-5.6	-3.7
4 Total local authority borrowing	0.2	1.5
5 Public corporations' borrowing from central government	0.1	-0.2
6 Public corporations' borrowing from market and overseas	-1.5	-1.2
7 Total public corporations' borrowing	-1.4	-1.4
8 Public sector borrowing requirement	3.4	-3.1
Central government borrowing requirement (lines 1 + 2 + 5)	10.5	1.7

6.19 Tables 6.4 to 6.6 show estimated outturns and forecasts of receipts and expenditure in 1987-88 and 1988-89 for each of the three sectors. These tables include some of the analysis by economic category in Table 6.7. Expenditure in 1988-89 does not include an allocation of the Reserve, although the forecast of the PSBR assumes that the Reserve is fully spent.

Central government

6.20 Central government spending includes grants and subsidies to local authorities and public corporations (including nationalised industries), which are included in the receipts of those sectors, shown in Table 6.5 and 6.6.

Table 6.4 Central government transactions

	£ billion		
	1986-87 Outturn	1987-88 Latest estimate	1988-89 Forecast
Receipts			
Taxes and royalties	104.6	115.3	122.1
National insurance and other contributions	26.6	28.7	31.6
Other	10.5	11.6	11.3
Total receipts	141.7	155.6	165.0
Expenditure			
Current expenditure on goods and services	49.4	52.9	55.8
Current grants and subsidies	77.4	80.5	82.6
Interest	16.5	17.0	17.0
Net lending ¹ , capital expenditure, and cash expenditure on company securities	2.9	2.0	3.2
Total expenditure	146.2	152.4	158.5²

¹Excluding lending to local authorities and public corporations.

Local authorities 6.21 Local authority receipts consist primarily of rate income plus grants from central government. The forecast increase in rate income (net of rate rebates) between 1987–88 and 1988–89 takes account of available information about rate decisions by local authorities, additions to rateable value, and changes to the system of rate rebates introduced by the Social Security Act 1986.

6.22 The local authority borrowing requirement (LABR) fell sharply in 1986–87 to £½ billion, from £1½ billion in 1985–86. The LABR in the first ten months of 1987–88 was higher than in the same period of 1986–87 and it seems likely that borrowing in the year as a whole will be well above that in 1986–87, although still below the levels of some earlier years. The estimates of local authority receipts and expenditure do not fully explain the LABR in 1986–87 and 1987–88 (other receipts in Table 6.5 and miscellaneous financial transactions in Table 6.7 include a balancing item).

Table 6.5 Local authority transactions

	£ billion		
	1986–87 Outturn	1987–88 Latest estimate	1988–89 Forecast
<i>Receipts</i>			
Rates (net of rate rebates) ¹	15.6	16.9	19.0
Rate support grant	11.8	12.6	13.3
Other grants from central government	11.0	12.0	12.4
Other	6.4	4.9	5.1
Total receipts	44.8	46.5	49.9
<i>Expenditure</i>			
Current expenditure on goods and services	31.3	34.3	35.6
Current grants and subsidies	5.4	5.8	6.0
Interest	4.4	4.3	4.7
Net lending and capital expenditure	4.0	3.6	4.1
Total expenditure	45.1	48.0	50.4²
¹ Rate rebates.	1.7	1.9	1.6

² Excluding any allocation from the Reserve.

Public corporations 6.23 Table 6.6 shows public corporations' transactions. The public corporations' receipts include subsidies and capital grants from central and local government. For the nationalised industries (and the majority of other public corporations) their net external finance, ie their borrowing plus subsidies and grants, is included in the public expenditure planning total. Public corporations' net external financing requirement, and not their borrowing requirement (PCBR), is the best measure of the public corporations' total contribution to the PSBR, because it includes, in addition to borrowing, subsidies and grants provided by central government which

Table 6.6 Public corporations' transactions

	£ billion	
	1986–87 Outturn	1987–88 Latest estimate
<i>Receipts</i>		
Gross trading surplus (including subsidies)	7.4	7.0
Other	2.9	2.2
Total receipts	10.2	9.2
<i>Expenditure</i>		
Interest, dividends and taxes on income	3.3	3.1
Net lending and capital expenditure	5.5	4.7
Total expenditure	8.8	7.8
<i>Public corporations' contribution to planning total:</i>		
nationalised industries' external finance	0.4	0.4
other public corporations	0.8	0.6

¹ Excluding any allocation from the Reserve

6.24 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, although Table 6.6 shows a fall in gross trading surplus in 1987–88, the gross trading surplus of those industries remaining in the public sector rose strongly in 1987–88. The underlying buoyancy of the gross trading surplus is a major reason why the PCBR is estimated to have risen only slightly between 1986–87 and 1987–88, despite the inclusion in 1986–87 figures of negative net borrowing by corporations now in the private sector.

Public sector's finances: analysis by economic category

6.25 The full analysis of receipts and expenditure by economic category is shown in Table 6.7, 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's financial deficit. The financial deficit, unlike the PSBR, is not wholly a measure of cash transactions because certain items above line 24 in Table 6.7, 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.

6.26 The unallocated Reserve is assumed to be used up by spending on current items or physical capital formation ie in transactions that fall above the financial deficit line. In practice allocations from the Reserve can also be used for financial transactions (lines 25 to 29).

Table 6.7 Public sector transactions by sub-sector and economic category

£ billion						
1987-88 Latest estimate						
General government					Public corporations	Public sector
	Central government	Local authorities	Total			
Line ¹						
<i>Current and capital receipts</i>						
Taxes on income, and oil royalties	1	59.3	—	59.3	-0.2	59.1
Taxes on expenditure	2	52.3	16.9	69.3	—	69.3
Taxes on capital	3	3.7	—	3.7	—	3.7
National insurance and other contributions	4	28.7	—	28.7	—	28.7
Gross trading surplus	5	-0.6	0.4	-0.2	7.0	6.8
Rent and miscellaneous current transfers	6	0.3	3.1	3.4	0.5	3.9
Interest and dividends from private sector and abroad	7	3.3	0.9	4.2	0.6	4.8
Interest and dividends within public sector	8	5.8	-3.7	2.1	-2.1	—
Imputed charge for non-trading capital consumption	9	1.2	1.6	2.8	—	2.8
Capital transfers from private sector	10	—	—	—	0.1	0.1
Total receipts	11	154.0	19.3	173.3	6.1	179.3
<i>Current and capital expenditure</i>						
Current expenditure on goods and services	12	52.9	34.3	87.2	—	87.2
Subsidies	13	5.2	1.0	6.2	—	6.2
Current grants to personal sector	14	48.2	4.7	52.9	—	52.9
Current grants paid abroad	15	3.5	—	3.5	—	3.5
Current grants within public sector	16	23.6	-23.6	—	—	—
Debt interest	17	17.0	0.5	17.5	0.6	18.0
Gross domestic fixed capital formation	18	3.6	3.6	7.3	4.5	11.8
Increase in stocks	19	-0.2	—	-0.2	—	-0.1
Capital grants to private sector	20	1.8	0.6	2.5	0.1	2.5
Capital grants within public sector	21	1.7	-1.0	0.7	-0.7	—
Total expenditure	22	157.4	20.2	177.6	4.5	182.2
Unallocated Reserve	23	—	—	—	—	—
Financial deficit²	24	3.4	0.9	4.4	-1.5	2.8
<i>Financial transactions</i>						
Net lending to private sector and abroad	25	0.3	-0.6	-0.3	0.1	-0.2
Cash expenditure on company securities (including privatisation proceeds)	26	-5.4	—	-5.4	—	-5.4
Transactions concerning certain public sector pension schemes	27	-0.6	—	-0.6	—	-0.6
Accruals adjustments	28	-0.5	0.2	-0.3	—	-0.3
Miscellaneous financial transactions	29	-0.5	1.1	0.5	0.1	0.7
Borrowing requirement²	30	-3.2	1.5	-1.7	-1.4	-3.1

¹ Financial deficit (line 24) = expenditure (line 22) + Reserve (line 23) — receipts (line 11).

Borrowing requirement (line 30) = financial deficit (line 24) + financial transactions (lines 25 to 29).

² Financial deficit and borrowing requirement: positive; financial surplus and net debt repayment: negative.

£ billion						
1988-89 Forecast						
General government				Public corporations	Public sector	
Line ¹	Central government	Local authorities	Total			
<i>Current and capital receipts</i>						
1	62.0	—	62.0	-0.7	61.3	Taxes on income, and oil royalties
2	55.4	19.0	74.4	—	74.4	Taxes on expenditure
3	4.7	—	4.7	—	4.7	Taxes on capital
4	31.6	—	31.6	—	31.6	National insurance and other contributions
5	—	0.5	0.5	7.5	8.0	Gross trading surplus
6	0.4	3.0	3.3	0.6	3.9	Rent and miscellaneous current transfers
7	2.7	0.9	3.6	0.7	4.3	Interest and dividends from private sector and abroad
8	6.1	-4.1	2.0	-2.0	—	Interest and dividends within public sector
9	1.3	1.6	2.9	—	2.9	Imputed charge for non-trading capital consumption
10	—	—	—	0.2	0.2	Capital transfers from private sector
11	164.1	21.0	185.1	6.3	191.4	Total receipts
<i>Current and capital expenditure</i>						
12	55.8	35.6	91.3	—	91.3	Current expenditure on goods and services
13	4.6	0.9	5.5	—	5.5	Subsidies
14	50.5	5.0	55.5	—	55.5	Current grants to personal sector
15	2.9	—	2.9	—	2.9	Current grants paid abroad
16	24.6	-24.6	—	—	—	Current grants within public sector
17	17.0	0.5	17.5	0.7	18.2	Debt interest
18	3.9	3.7	7.7	5.4	13.0	Gross domestic fixed capital formation
19	0.1	—	0.1	0.1	0.2	Increase in stocks
20	1.9	0.7	2.6	0.1	2.6	Capital grants to private sector
21	1.8	-1.1	0.7	-0.7	—	Capital grants within public sector
22	163.0	20.7	183.8	5.6	189.3	Total expenditure
23					3.5	Unallocated Reserve
24					1.4	Financial deficit²
<i>Financial transactions</i>						
25	0.5	-0.3	0.2	0.1	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	-0.7	—	-0.7	—	-0.7	Transactions concerning certain public sector pension schemes
28	-0.2	—	-0.2	—	-0.3	Accruals adjustments
29	0.1	1.0	1.1	—	1.1	Miscellaneous financial transactions
30					-3.2	Borrowing requirement²

Annex to Chapter 6

Part A: relationship between tables in Chapter 6, and with Table 1.2; and outturn data

Relationship between tables

6A.1 Table 6.7 is based on the definitions used to compile the national accounts. In order to show the financial deficit for each sector, lending and other financial transactions are separated from the analysis of receipts and expenditure in lines 1–23 and shown in lines 25–29. These lines show the relationship between the financial deficit (line 24) and the borrowing requirement for each sector (line 30).

6A.2 Tables 6.4–6.6 are summary versions of the sectoral columns of Table 6.7. The information in Table 6.7 is rearranged so that, for example, central government grants to local authorities (which appear as negative expenditure in the local authorities column of Table 6.7, lines 16 and 21) appear as receipts in Table 6.5. Interest paid by local authorities to central government (which appears as negative receipts in the local authorities column of Table 6.7, line 8) appears as expenditure in Table 6.5. Finally, lending and other financial transactions (lines 25–29 of Table 6.7) are included in the receipts and expenditure of Tables 6.4–6.6.

6A.3 Table 1.2 in Chapter 1 uses the same information as Table 6.7, but again rearranges it. To derive general government expenditure, it starts by giving a departmental breakdown of the public expenditure planning total: that includes not only general government expenditure items in the third column of Table 6.7 (including the “financial transactions” in lines 25–26), but also borrowing or capital expenditure by public corporations in the fourth column. General government expenditure as shown in Table 1.2 is then obtained by adding general government debt interest from the third column of Table 6.7 and the national accounts adjustments already included in Table 6.7, and deducting public corporations’ borrowing from the market and from overseas.

6A.4 Alternatively, general government expenditure in Table 1.2 (and Table 2.4) can be obtained from lines 22, 23, 25 and 26 (third column) in Table 6.7 and on-lending to public corporations in Table 6.3.

6A.5 To derive general government receipts, Table 1.2 takes the receipts shown in the third column of Table 6.7 (lines 11, 27, 28 and 29) and rearranges them according to the type of activity which gives rise to them. For example, oil revenues comprise North Sea corporation tax and petroleum revenue tax (included in “taxes on income” in Table 6.7) plus oil royalties. The sub-total “total taxes and royalties” is the same as the first line of Table 2.5 in Chapter 2.

Outturn data

6A.6 Outturns for the PSBR and the statutory central government accounts (as in Tables 6B.1–4 in Part B of the Annex) are compiled monthly and published by press notice 12 working days after the end of the month and then in more detail in Tables 2.5, 3.12 and 3.16 of the following issue of Financial Statistics. Details of the PSBR on national accounts definitions, as in Table 6.7, are compiled quarterly and published in sections 2 to 5 of Financial Statistics three months after the end of the quarter.

6A.7 The first outturn for the PSBR in 1987–88 will accordingly be published on 20 April. The first national accounts outturns for 1987–88 will appear in the June issue of Financial Statistics

Part B: central government transactions

Commentary on the tables

6B.1 The tables in Part B of this Annex are confined to central government transactions, and are based on the statutory funds and accounts. Their relationship to the accounts of central government on a national accounts basis (as in Table 6.4) is described in the Financial Statistics Explanatory Handbook (1987 edition, p38). The receipts and payments in the Part B tables are all shown on a cash basis, not accrued. Table 1.2, however, shows the main categories of taxes on an accrued basis as in the national accounts: for instance the item “income tax” in Table 1.2 differs slightly from “income tax” in Table 6B.3.

Table 6B.1 Summary of central government transactions

	£ billion 1987–88 latest estimate
<i>Consolidated Fund</i>	
Revenue (Table 6B.3)	123.2
Expenditure (Table 6B.2)	121.0
<i>National Loans Fund (Table 6B.4)</i>	
Receipts	16.7
Payments	21.7
Surplus transferred from Consolidated Fund	2.2
Total net borrowing by the National Loans Fund	2.9
Surplus on other funds and accounts (net)	1.1
Central government borrowing requirement¹ (Table 6.3)	1.7

¹Including borrowing for on-lending to local authorities and public corporations.

Table 6B.2 Consolidated Fund expenditure

	£ million 1987–88 latest estimate
Supply Issues ¹	105 100
<i>Standing services</i>	
Payment to the National Loans Fund in respect of service of the national debt	9 800
Northern Ireland—share of taxes etc.	2 220
Payments to the European Communities	3 770
Other services	100
Total standing services	15 900
Total Consolidated Fund expenditure	121 000

¹Supply Issues are monies paid from the Consolidated Fund to departments’ cash accounts with the Paymaster General for spending on Supply. Supply expenditure (see Table 5.4) equates closely to total Supply Issues in most years, although there may sometimes be slight timing differences between the two.

Table 6B.3 Consolidated Fund revenue

	£ million		
	1987-88		1988-89
	1987 Budget	Latest estimate	Forecast
<i>Inland Revenue</i>			
Income tax ¹	39 900	41 400	42 100
Corporation tax ^{2 3}	15 000	15 600	19 800
Petroleum revenue tax ⁴	1 680	2 330	1 180
Capital gains tax	1 300	1 350	1 950
Development land tax	20	25	10
Inheritance tax ⁵	1 100	1 070	1 000
Stamp duties	2 100	2 440	1 950
Total Inland Revenue	61 100	64 200	68 000
<i>Customs and Excise</i>			
Value added tax	23 300	24 100	26 200
Petrol, derv, etc.	7 800	7 800	8 400
Cigarettes and other tobacco	4 800	4 800	5 000
Spirits, beer, wine, cider and perry	4 300	4 400	4 500
Betting and gaming	800	810	890
Car tax	1 100	1 150	1 260
Other excise duties	20	20	20
EC own resources ⁶			
Customs duties, etc.	1 350	1 470	1 550
Agricultural levies	230	190	120
Total Customs and Excise	43 800	44 700	47 900
Vehicle excise duties ⁷	2 600	2 700	2 770
Gas levy	490	500	420
Broadcasting receiving licences	1 030	1 030	1 140
Interest and dividends	1 020	1 080	680
Other ⁸	7 600	9 100	7 300
Total Consolidated Fund revenue	117 500	123 200	128 200

¹ See paragraph 6B.1.² Includes advance corporation tax (net of repayments)³ North Sea corporation tax of which satisfied by setting off ACT

Liability to corporation tax arising in respect of North Sea production may be satisfied by setting off ACT arising on dividends paid in previous periods in respect of both onshore and offshore activities. Dividends and ACT associated with North Sea activities alone cannot be identified.

⁴ Includes advance petroleum revenue tax.⁵ Includes estate duty and capital transfer tax.⁶ Customs duties and agricultural levies are accountable to the European Communities as 'own resources'; actual payments to the Communities are recorded in Table 6B.2.⁷ Includes driving licence receipts.⁸ Includes the 10 per cent of 'own resources' refunded by the European Communities to meet the costs of collection, privatisation proceeds and oil royalties.

Table 6B.4 National Loans Fund receipts and payments

	£ million 1987-88 Latest estimate
<i>Receipts</i>	
Interest on loans, profits of the Issue Department of the Bank of England, etc.	6 800
Service of the National Debt—balance met from the Consolidated Fund	9 800
Total receipts	16 700
<i>Payments</i>	
Service of the National Debt:	
interest	16 500
management and expenses	170
Total service of the National Debt	16 700
Loans to:	
nationalised industries	-180
other public corporations	-170
local authorities	5 200
private sector and within central government	180
Total National Loans Fund lending¹	5 000
Total payments	21 700

¹ On-lending to local authorities and public corporations in Table 6.3 includes, in addition to National Loans Fund lending, net lending from other funds and accounts (mainly Supply Issues in Table 6B.2).