
Financial Statement and Budget Report 1987-88

Return to an Order of the House of Commons dated 17 March 1987: for

*Copy of Financial Statement and Budget Report 1987-88
as laid before the House of Commons by
the Chancellor of the Exchequer when opening the Budget*

Treasury Chambers
17 March 1987

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Norman Lamont

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1 The Budget

Table 1.1 The Budget measures¹

	£ million		yield(+)/cost(-)
	1987-88	1988-89	1988-89
	Changes from a non-indexed base	Changes from an indexed base	Changes from an indexed base
Tax proposals			
Income tax			
basic rate ²	-2 200	-2 200	-2 820
personal allowances	-705	-10	-10
higher rate thresholds	-65	+40	+80
Excise duties			
oils	—	-240	-265
vehicle excise duty	+5	-90	-90
tobacco	—	-105	-110
alcohol	—	-105	-120
on-course betting duty	-20	-20	-20
gaming machine licence duty	+20	+20	+20
VAT			
partial exemption rules	+300	+300	+400
small business package	-115	-115	-60
other	-5	-5	+20
Inheritance tax	-90	-75	-170
Corporation tax			
small companies' rate	*	*	-45
capital gains	*	*	+60
dual resident companies	*	*	+125
payment dates	*	*	+100
Profit-related pay	*	*	-50
Pensions	*	*	-65
Other changes	-20	-20	+75
Total	-2 895	-2 625	-2 945

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

* = Negligible. — = nil.

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

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

1.02 The Financial Statement and Budget Report (FSBR) supplements the Chancellor's Budget Statement. It describes the Medium Term Financial Strategy (MTFS); outlines developments in the economy over the past year; provides forecasts to mid-1988; details the tax proposals in the Budget; summarises the Government's spending plans, and brings together the financial position of the public sector for the year ahead.

The Medium Term Financial Strategy

1.03 Chapter 2 describes the MTFS, which has been in place since 1980. It provides the framework for the Government's economic policies, which are designed to bring inflation down further and improve other aspects of the UK's economic performance. Monetary and fiscal policy is set to reduce the growth of money GDP, so bringing down inflation. The Budget contains new measures to encourage enterprise, efficiency and flexibility which will improve the prospect for output and jobs. Public expenditure is on a declining path as a percentage of GDP and taxes have again been reduced, as they have in each year since 1981.

Forecast

1.04 Chapter 3 describes the main developments in the economy in 1986 and the prospect until mid-1988. GDP is forecast to grow by 3 per cent in 1987, the sixth successive year of steady growth. A strong rise is forecast in investment, in manufacturing output and in non-oil exports. Inflation is forecast to be about 4 per cent in the fourth quarter of 1987. There are good prospects for a continuing decline in unemployment.

Tax measures

1.05 Chapter 4 sets out the tax proposals in the Budget. They include a reduction of 2p in the basic rate of income tax, a tax incentive to encourage the growth of profit-related pay, the introduction of a favourable tax regime for personal pensions, and a package of measures to lighten the burden on small businesses. Table 1.1 opposite summarises the effect of all these measures.

Public expenditure

1.06 Chapter 5 summarises the Government's spending plans for the next three years. The plans show a continuing fall in general government spending as a percentage of GDP. This chapter also provides the latest estimate of the outturn for the public expenditure planning total in 1986-87 and includes a comparison of outturn and plans for the different spending authorities.

Exchange control 1.07 The Government has decided to repeal the Exchange Control Act 1947.

Receipts and expenditure 1.08 Chapter 6 brings together the complete financial picture for the public sector. The public sector borrowing requirement (PSBR) for 1986-87 is forecast to be just over £4 billion, some £3 billion lower than indicated in the 1986 FSB. The PSBR for 1987-88 is forecast to be just under £4 billion or 1 per cent of GDP, £3 billion below the illustrative level in last year's MTFS. The Budget measures are expected to contribute a little over £2½ billion to the borrowing requirement, over and above the net cost of indexing tax rates and allowances. Table 1.2 summarises the sources of the receipts and the direction of expenditure.

Table 1.2 The finances of the public sector¹

	£ billion				£ billion		
	1986-87		1987-88		1986-87		1987-88
	1986 Budget ²	Latest estimate	Forecasts		1986 Budget ²	Latest estimate	Forecasts
RECEIPTS				EXPENDITURE			
Income tax	38.7	38.4	40.0	DHSS—social security	42.9	44.6	46.0
Corporation tax excluding North Sea ³	9.4	11.2	13.5	Defence	18.5	18.2	18.8
Capital taxes	2.8	2.7	3.3	DHSS—health and personal social services	17.7	18.0	19.1
Expenditure taxes:				Education and science	14.3	15.7	16.6
VAT	20.7	21.5	23.3	Home Office (and Lord Chancellor's Department)	5.6	5.8	6.2
local authority rates	15.6	15.5	16.9	Employment	3.7	3.8	4.0
petrol, derv, etc.	7.3	7.5	7.8	Other departments	36.6	38.3	39.4
spirits, beer, wine, etc.	4.4	4.2	4.3	Privatisation proceeds	-4.8	-4.4	-5.0
cigarettes and other tobacco	4.7	4.8	4.9	Reserve	4.5	—	3.5
stamp duties	1.4	1.8	2.1				
other	8.2	8.2	8.5	Public expenditure planning total	139.1	140.0	148.6
Total expenditure taxes	62.2	63.5	67.8				
North Sea revenues:							
North Sea corporation tax ⁴	2.7	2.7	1.4	General government gross debt interest	18.2	17.5	17.9
petroleum revenue tax	2.4	1.3	1.7	less public corporations' market and overseas borrowing	-0.4	-1.6	-0.8
oil royalties	1.0	0.9	0.8	Other national accounts adjustments	6.2	5.8	6.2
Total North Sea	6.1	4.8	3.9				
Other ⁵	-1.2	-1.2	-0.8				
Total taxes and royalties	117.9	119.4	127.8				
National insurance and other contributions	26.2	26.5	28.5				
Interest and dividend receipts	6.4	5.8	5.7				
Gross trading surpluses and rent	2.9	3.2	3.3				
Other	3.0	4.3	3.5				
General government receipts	156.4	159.2	168.8	General government expenditure	163.9	164.9	173.5

Difference between expenditure and revenue financed by borrowing:

	£ billion		
	1986-87		1987-88
	1986 Budget ²	Latest estimate	Forecast
General government expenditure	163.9	164.9	173.5
General government receipts	156.4	159.2	168.8
General government borrowing requirement	7.5	5.7	4.7
Public corporations' market and overseas borrowing	-0.4	-1.6	-0.8
Public sector borrowing requirement	7.1	4.1	3.9

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.

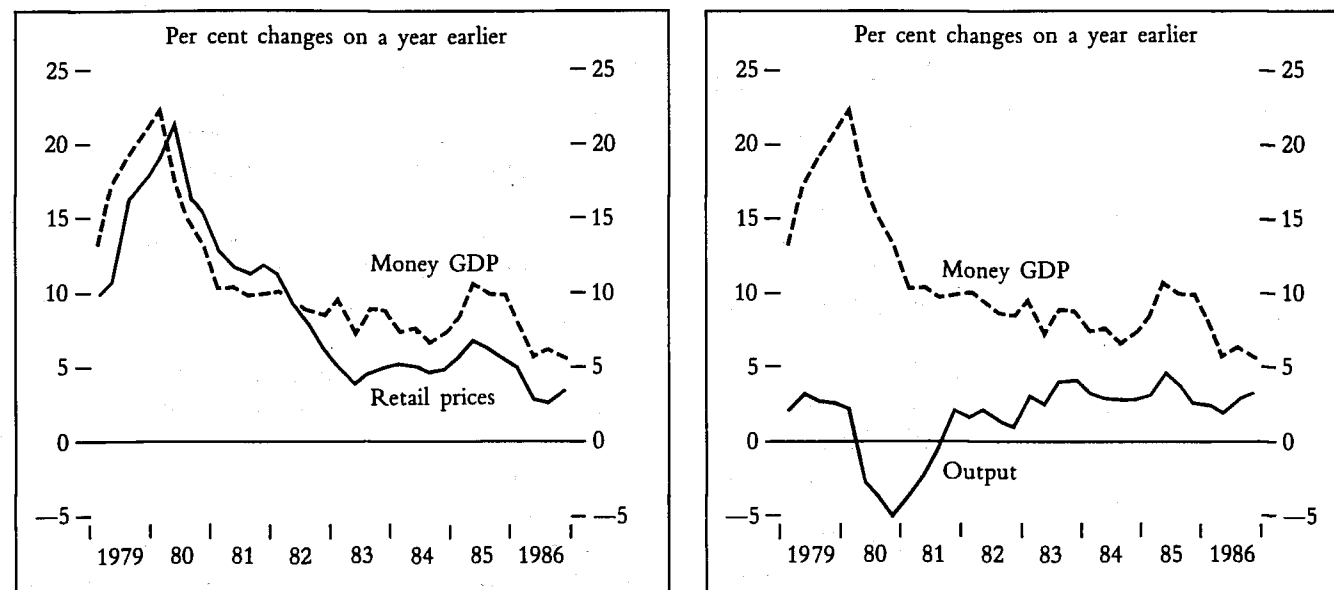
2 The Medium Term Financial Strategy

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. It is intended to bring inflation down further over a period of years, and ultimately to achieve price stability. It is complemented by policies designed further to improve other aspects of the UK's economic performance.

2.02 Economic policy is set in a nominal framework. Monetary and fiscal policies are designed to reduce the growth of money GDP, so bringing down inflation. They are complemented by policies to encourage enterprise, efficiency and flexibility. These policies improve the division of money GDP growth between output growth and inflation, and help the creation of jobs.

2.03 Over the past seven years, money GDP growth has come down from over 20 per cent to around 6 per cent. In real terms the economy has grown at approaching 3 per cent a year on average since 1981, with little variation in the growth rate from year to year. This has been achieved while inflation has come down sharply—from a peak of over 20 per cent in 1980 to 4 per cent now. Productivity is rising rapidly, at a rate which compares very favourably with our major competitors. The economy has weathered the fall in oil prices last year without disruption, and is about to embark on a seventh year of steady growth, combined with low inflation.

Chart 2.1 Money GDP output and inflation



Objectives and the framework of policy

Money GDP **2.04** Policy is directed at maintaining monetary conditions that will bring about a gradual reduction in the growth of money GDP over the medium term. In the short term there will inevitably be fluctuations, but the Government will aim to avoid departures in the medium term from the path set out in Table 2.1.

Table 2.1 Money GDP growth*

1986-87	1987-88	1988-89	1989-90	1990-91
6	7½	6½	6	5½

*Per cent change on previous financial year. See Table 2.3 for assumptions on output and inflation. The figure for 1987-88 is a forecast; and in subsequent years the figures describe the Government's broad medium term objectives.

2.05 The growth of money GDP in 1986-87 is expected to be somewhat below the 6½ per cent forecast at the time of the last Budget. The forecast for 1987-88, described in Chapter 3, is correspondingly higher than the 6½ per cent indicated last year. Over the two years to 1987-88 the growth rate is little changed. In the later years the growth of money GDP declines at the same rate as in last year's MTFS.

Instruments of policy **2.06** The Government sets monetary and fiscal policies to achieve monetary conditions which will deliver its objectives for money GDP. A declining path for money GDP growth, as in Table 2.1, requires firm monetary policies supported by low public sector borrowing.

2.07 Fiscal policy is reviewed each year at Budget time. Short-term interest rates, which can be varied more frequently, are the essential instrument of monetary policy. They will continue to be maintained at levels necessary to keep monetary conditions on track.

2.08 The authorities seek over each financial year to fund the PSBR fully, and no more, by sales of debt outside the monetary sector. This will continue to be the basis for funding policy.

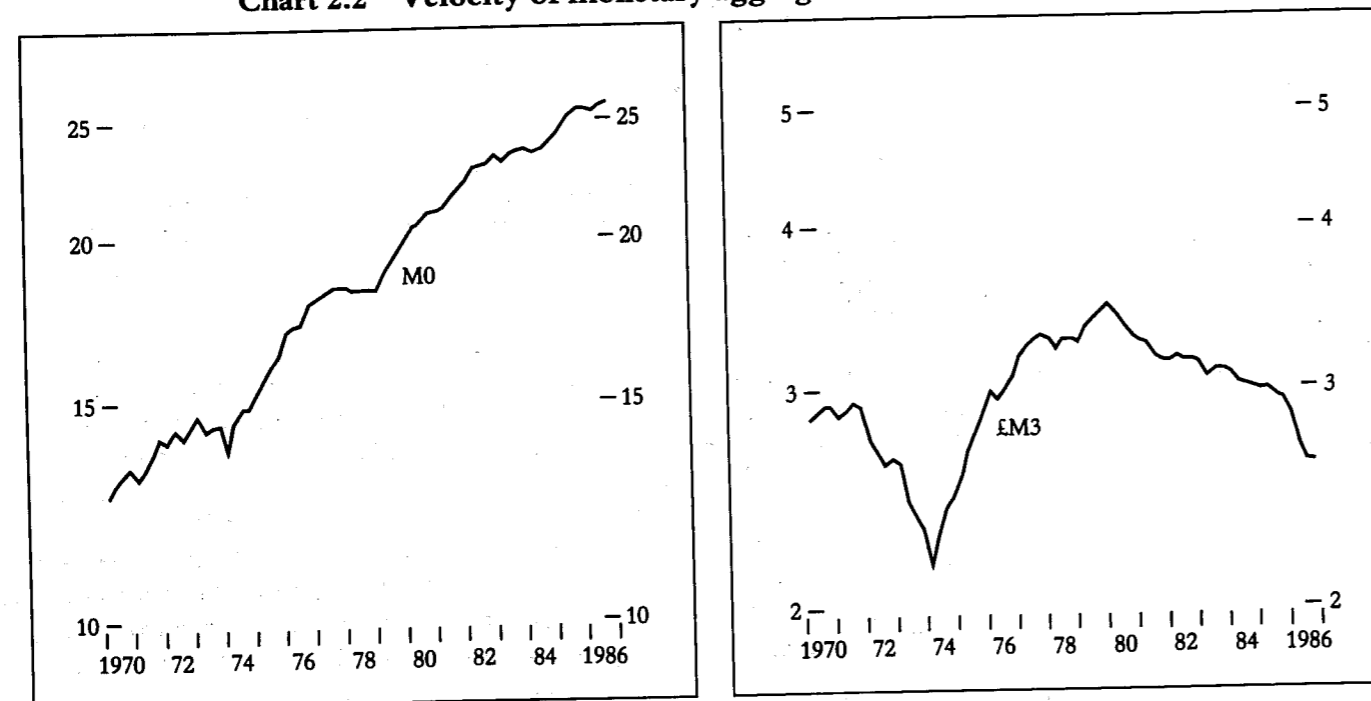
Monetary policy

2.09 Monetary conditions are assessed in the light of movements in narrow and broad money, and the behaviour of other financial indicators, in particular the exchange rate. There is no mechanical formula for taking these factors into account; a balance must be struck between the exchange rate and domestic monetary growth consistent with the Government's aims for money GDP and inflation.

2.10 Over the past two years, the dollar has depreciated substantially against most other major currencies. At a meeting of Finance Ministers and Central Bank Governors of six major industrial nations in Paris on 22 February, it was concluded that a period of stability would be desirable. Accordingly, the UK and other countries represented there agreed to co-operate closely to that end. The MTFS projections assume that there is no major change in either the sterling exchange rate index or the sterling/dollar exchange rate from year to year.

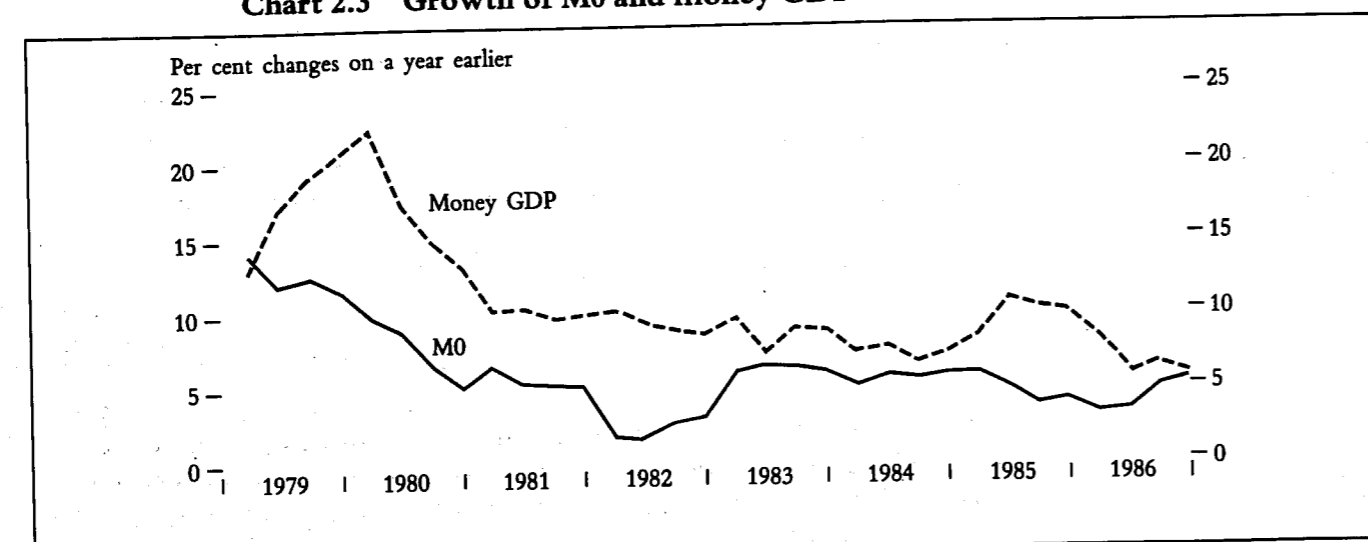
Narrow money 2.11 Last year's MTFS set out the properties desired of a target aggregate for narrow money. In particular it should have a stable relationship with money GDP. As Chart 2.2 shows, the velocity of M0 has grown relatively steadily over a long period of time. M0 has proved a reliable indicator of monetary conditions.

Chart 2.2 Velocity of monetary aggregates



2.12 In principle there is a case for moving to a wider measure of non-interest bearing money, such as the non-interest bearing component of M1. But the velocity of this aggregate exhibits considerable fluctuations which are currently exacerbated by the rapid growth of interest bearing sight deposits, and it is ultra-sensitive to interest rate changes. In these circumstances M0 remains the best choice of narrow aggregate for target purposes.

Chart 2.3 Growth of M0 and money GDP



2.13 The target range for M0 growth in 1987-88 is 2-6 per cent, unchanged from the range indicated in last year's MTFS. Ranges for the later years are illustrative, but show a decline consistent with the declining path for money GDP growth.

Table 2.2 Growth of M0*

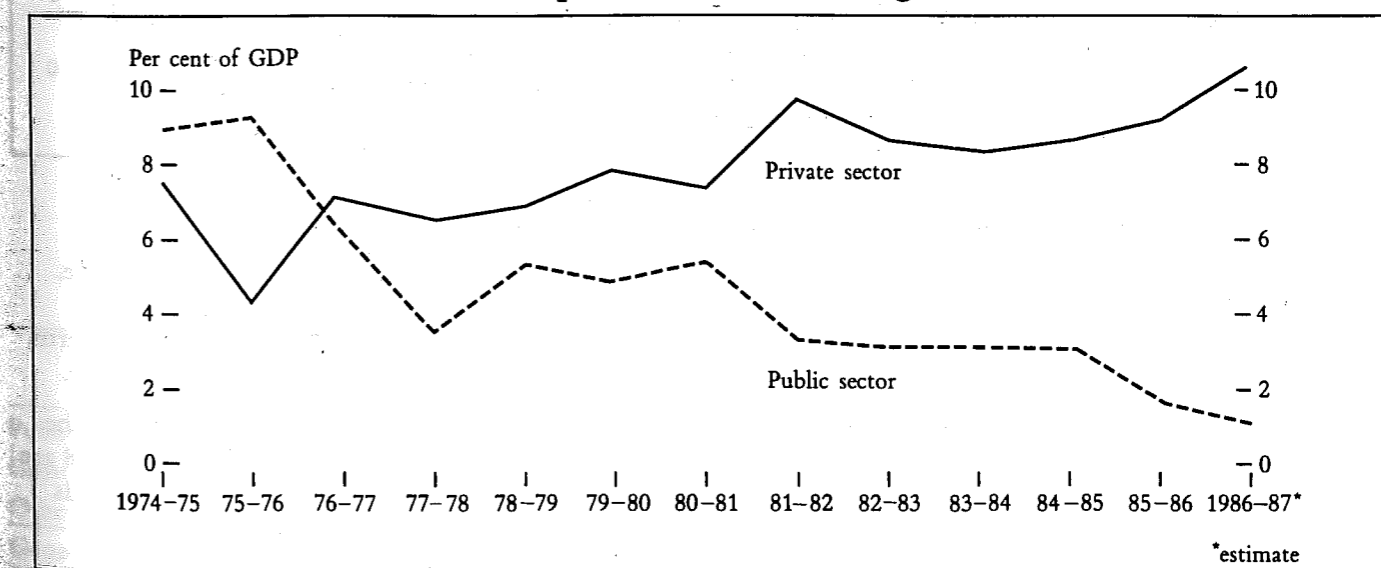
1986-87	1987-88	1988-89	1989-90	1990-91
4	2-6	1-5	1-5	0-4

*1986-87: per cent change on previous financial year. 1987-88: target range. 1988-1989 onwards: illustrative ranges.

2.14 If the underlying growth of M0 threatens to move significantly outside its target range in 1987-88 there is a presumption that the Government will take action on interest rates unless other indicators clearly suggest that monetary conditions remain satisfactory.

Broad money 2.15 Broad money has been growing considerably faster than money GDP in recent years. In part this has reflected high real interest rates, which have added to the attractiveness of financial assets in general; and the end of overfunding in 1985 has also contributed. But perhaps most important, the increasing competition in financial markets in recent years has led to rapid growth of private sector liquidity and borrowing. Private sector borrowing has been rising and is now over 10 per cent of GDP (Chart 2.4). It has clearly contributed more than public borrowing to upward pressure on real interest rates. These trends are likely to persist, so that broad money growth may continue at around its recent rate, well in excess of the growth rate of money GDP.

Chart 2.4 Public and private sector borrowing



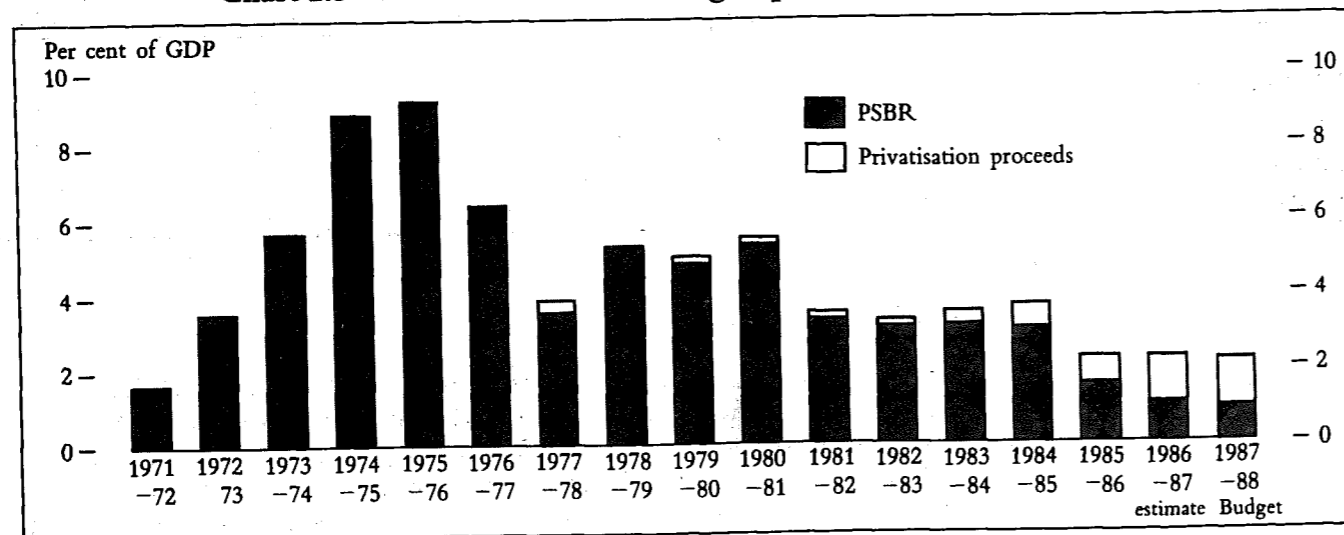
2.16 The 1986 Building Societies Act marks a further step in the evolving status of building societies. As their behaviour becomes closer to that of banks, wider aggregates which include building society liabilities are likely to continue to be slightly less erratic than £M3.

2.17 Both the Chancellor and the Governor of the Bank of England have drawn attention to the increasing difficulties in interpreting changes in broad money. With rapid and pervasive changes in financial practices, there is no simple relationship between broad money growth and money GDP. For this reason, the Government has decided that there should be no formal target for broad money in 1987–88. But the rate of growth of broad money cannot be ignored, and the Government will continue to take it into account in assessing monetary conditions.

Fiscal policy

2.18 The PSBR in 1986–87 is expected to be about 1 per cent of GDP. This is appreciably less than was set at the time of last year's Budget, in spite of lower oil revenues. After remaining at about 3½ per cent of GDP between 1981–82 and 1984–85, the PSBR was reduced sharply in 1985–86 and has come down further in 1986–87. As Chart 2.5 shows, even if privatisation proceeds are added back, it has been lower as a share of GDP in the past two years than at any time since 1971–72.

Chart 2.5 Public sector borrowing requirement and privatisation proceeds



The PSBR path

2.19 As usual, the fiscal projections for the next four years set out in Tables 2.4–6 take account of the composition of receipts and expenditure. The path of the PSBR is below that shown in last year's MTFs. The buoyancy of revenues has enabled the Government to achieve its long term objective for the PSBR sooner than would otherwise have been the case.

2.20 The PSBR for 1987–88 is set at £4 billion, or 1 per cent of GDP, the same as the expected outturn in 1986–87. North Sea revenues in 1987–88 are forecast at about £4 billion, slightly lower than in 1986–87. The proceeds from the Government's privatisation programme are expected to be £5 billion, as set out in the Autumn Statement.

2.21 The PSBR is projected to remain at 1 per cent of GDP thereafter. If privatisation proceeds are added back the ratio gradually falls from 2½ per cent in 1987–88 to 2 per cent in the final year. The PSBR to be set in future Budgets for the year ahead will as usual be reviewed in the light of circumstances at the time.

Assumptions 2.22 For the period to 1989–90, the public expenditure projections in Table 2.4 follow the plans set out in the public expenditure White Paper (Cm 56). It is provisionally assumed that the planning total will grow by 1 per cent in real terms in 1990–91. Decisions on the planning total for that year will be taken in the 1987 Survey. The definition of revenue in Table 2.5 is based on the conventional assumptions of constant 1987–88 tax and national insurance contribution rates, and allowances and thresholds indexed from the proposed 1987–88 levels. All changes proposed in the Budget are taken into account.

2.23 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 average \$15 a barrel in 1987–88, and thereafter to remain broadly unchanged in real terms.

Table 2.3 Output and inflation assumptions

	Percentage change on previous financial year				
	1986–87	1987–88	1988–89	1989–90	1990–91
Real GDP					
Non-North Sea	3	3	2½	2½	2½
Total	3	3	2½	2½	2½
Inflation					
GDP deflator	3	4½	4	3½	3

Public expenditure

2.24 Continued restraint in public spending is a vital element of the Government's economic strategy. General government expenditure has fallen steadily as a proportion of GDP from its peak of over 46 per cent in 1982–83. The plans in the White Paper imply a continuing fall in this ratio. This will enable a low level of borrowing to be combined with reductions in the burden of taxation, so improving motivation, efficiency and employment. Public expenditure is considered more fully in Chapter 5.

Table 2.4 General government expenditure

	£ billion, cash					
	1985–86	1986–87	1987–88	1988–89	1989–90	1990–91
Public expenditure planning total ¹	133.6	140	149	154	162	168
Gross debt interest	17.6	17	18	18	19	19
Other adjustments ²	7.5	7	7	8	8	8
General government expenditure³	158.8	165	174	180	188	196
of which						
Privatisation proceeds ⁴	–2.7	–4½	–5	–5	–5	–5

¹ For 1985–86 to 1989–90, the figures are taken from Table 5.1. The planning total is assumed to grow by 1% in real terms in 1990–91.
² See paragraph 5.04.

³ General government expenditure, and its components, are rounded to the nearest £1 billion from 1986–87 onwards.
⁴ See the public expenditure White Paper (Cm 56), Table 1.6. Proceeds are assumed to be the same in cash terms in 1990–91 as in 1989–90.

Revenue

2.25 Over the period as a whole, non-North Sea revenues are assumed to grow broadly in line with non-North Sea money GDP. Government revenues from the North Sea, however, are expected to remain more or less unchanged in cash terms, having fallen sharply in 1986-87. Thus total general government receipts are projected to increase somewhat less than money GDP.

Table 2.5 General government receipts

	£ billion, cash					
	1985-86	1986-87	1987-88	1988-89	1989-90	1990-91
Taxes on incomes, expenditure and capital	114.4	119	128	136	144	152
National insurance and other contributions	24.7	27	28	30	32	34
Interest and dividends	6.5	6	6	6	6	6
Other receipts	6.7	7	7	6	6	6
Accruals adjustment	-0.5	—	—	—	-1	-1
General government receipts¹	151.9	159	169	178	187	197
of which						
North Sea tax ²	11.4	5	4	4	4	4

¹ General government receipts, and its components, are rounded to the nearest £1 billion from 1986-87 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 footnote 3 to Table 6B.3.

Public sector borrowing

2.26 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.

2.27 Changes since the 1986 MTFS are discussed in the Annex to this Chapter.

Table 2.6 Public sector borrowing¹

	£ billion, cash					
	1985-86	1986-87	1987-88	1988-89	1989-90	1990-91
General government expenditure	158.8	165	174	180	188	196
General government receipts	151.9	159	169	178	187	197
Fiscal adjustment from previous years ²	—	—	—	—	3	5
Annual fiscal adjustment ²	—	—	—	3	2	2
GGBR	6.9	6	5	5	6	6
Public corporations' market and overseas borrowing	-1.1	-2	-1	-1	-1	-1
PSBR	5.8	4	4	4	5	5
Money GDP at market prices	360	382	411	437	464	489
PSBR as per cent of GDP	1.6	1	1	1	1	1

¹ Rounded to the nearest £1 billion from 1986-87 onwards. Further details for 1986-87 and 1987-88 are provided in Tables 1.2 and 6.7.

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

Conclusion

2.28 Events both at home and abroad may modify some of the assumptions on which the projections have been based. But the Government is committed to maintaining progress towards lower inflation, lower public expenditure as a share of GDP and lower taxes in the medium term. The MTFS provides the framework within which the financial policies to achieve this are set.

Annex to Chapter 2

Changes since the 1986 MTFS

Money GDP 2A.1 The growth rate of money GDP in 1986-87 is expected to be somewhat lower than envisaged in last year's MTFS, with a smaller increase in the GDP deflator. A bounce-back is projected in 1987-88 leaving money GDP growth over the two years to 1987-88 much as projected last year. After 1987-88, inflation and money GDP growth are $\frac{1}{2}$ point higher than assumed last year, though declining at the same rate. The projection of output growth is unchanged.

Table 2A.1 Money GDP growth

Differences from 1986 MTFS projections, percentage points				
1986-87	1987-88	1988-89	1989-90	
- $\frac{3}{4}$	+1	+ $\frac{1}{2}$	+ $\frac{1}{2}$	

Monetary aggregates 2A.2 The growth of M0 in 1986-87 is expected to be at the centre of its target range. The target range for 1987-88 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			
	1986-87	1987-88	1988-89	1989-90
1987 MTFS	4	2-6	1-5	1-5
1986 MTFS	2-6	2-6	1-5	1-5

Fiscal projections 2A.3 Table 2A.3 shows changes in the fiscal projections since the 1986 FSBP, after allowance for classification changes. Additional information on 1986-87 is given in Chapter 6.

Expenditure 2A.4 The expected overspend on the planning total in 1986-87 is described in Chapter 5. The planning totals for 1987-88 onwards are as in the public expenditure White Paper (Cm 56), which incorporate higher figures than assumed last year. General government expenditure is rather higher in 1986-87 than projected last year, partly because of the higher planning total and partly because of a change in the level and pattern of public corporations' borrowing. Within a reduced level of total borrowing, they borrowed more from the government and less from the market and overseas than projected last year. From 1987-88 onwards, the higher levels of general government expenditure are due to higher planning totals.

Receipts 2A.5 The reduction in North Sea revenues in 1986-87 is due to last summer's fall in dollar oil prices. Little change on last year's projections is expected in later years. Other taxes are higher throughout the period, reflecting their buoyancy in 1986-87 and the path of non-North Sea money GDP.

Table 2A.3 Revenue and expenditure¹

	Changes from 1986 MTFS projections £ billion				
	1985-86	1986-87	1987-88	1988-89	1989-90
Expenditure					
1 Planning total	-0.2	+1	+4 $\frac{1}{2}$	+5 $\frac{1}{2}$	+8
2 Other ^{2,5}	+0.8	—	-1 $\frac{1}{2}$	- $\frac{1}{2}$	—
3 General government expenditure	+0.6	+1	+3$\frac{1}{2}$	+5	+8
Receipts³					
4 North Sea taxes	-0.1	-1 $\frac{1}{2}$	—	- $\frac{1}{2}$	—
5 Other taxes and contributions	+1.8	+3 $\frac{1}{2}$	+4 $\frac{1}{2}$	+5 $\frac{1}{2}$	+6 $\frac{1}{2}$
6 Other ²	+0.1	+1	—	-1	-1 $\frac{1}{2}$
7 General government receipts	+1.8	+3	+4$\frac{1}{2}$	+4	+5
8 Implied cumulative fiscal adjustment ⁴	—	—	-2	-3	-4 $\frac{1}{2}$
9 Public corporations' market and overseas borrowing ⁵	+0.1	-1	—	- $\frac{1}{2}$	- $\frac{1}{2}$
10 PSBR	-1.1	-3	-3	-2$\frac{1}{2}$	-2

¹ Rounded to the nearest $\frac{1}{2}$ billion from 1986-87 onwards. Classification changes since the 1986 FSBP add about $\frac{1}{2}$ billion a year to both expenditure and receipts. The main change is in respect of the treatment of central government VAT refunds.

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 6B.3.

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 1988

Summary

Demand and activity 3.01 The economy has been growing at around 3 per cent since last spring as exports have recovered strongly. For 1986 as a whole, recorded GDP growth was about 2½ per cent. A substantial rise in investment and non-oil exports is forecast for 1987, and GDP is expected to grow by 3 per cent, with manufacturing output rising slightly faster.

Labour market 3.02 Employment has continued to grow, particularly since the middle of 1986. There has been a reversal of the previous rising trend in unemployment, and there are good prospects for a continuing decline this year.

Inflation 3.03 Inflation fell last year to 3½ per cent, its lowest level for nearly 20 years. During 1987, inflation may rise temporarily to a little over 4½ per cent, as last year's movements in petrol prices and in mortgage interest rates affect the year-on-year comparisons. But it is expected to fall back to around 4 per cent by the fourth quarter.

World economy 3.04 Output in the major industrial countries has been rising by 2½–3 per cent a year since 1984, and is likely to continue at that rate in 1987. Imports by developing countries (other than oil exporters) should rise this year. Markets for UK exports of manufactures may grow a little faster in 1987 than in 1986.

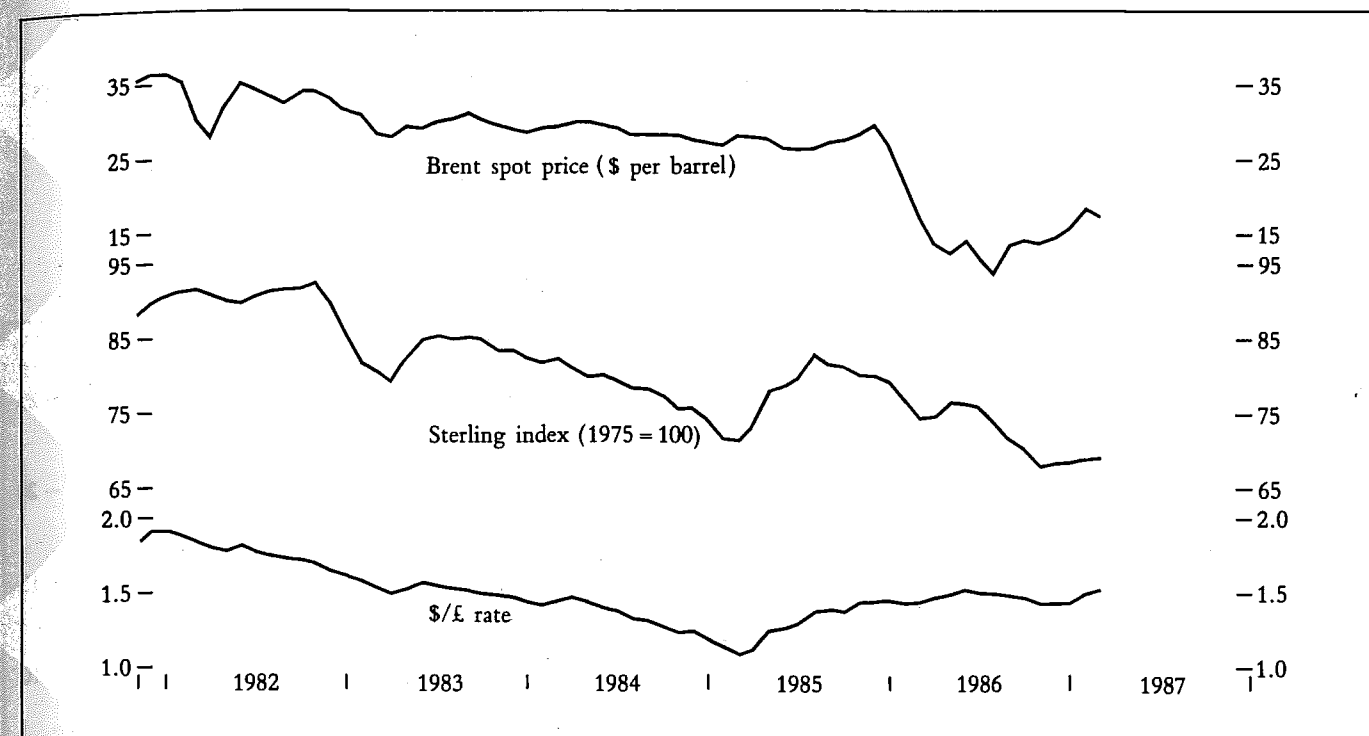
UK trade and the current account 3.05 Following the fall in oil prices a year ago, the current account of the balance of payments recorded a deficit of around £1 billion in 1986. Both export and import volumes rose sharply in the second half of last year. A further relatively modest current account deficit of £2½ billion (some ½ per cent of GDP) is forecast for 1987.

Assumptions 3.06 The forecast for the UK assumes that fiscal and monetary policies are set within the framework of the MTFS. It makes the conventional assumption of an oil price of \$15 a barrel, as in last year's forecast, and assumes that the exchange rate will remain close to its current level.

Financial conditions

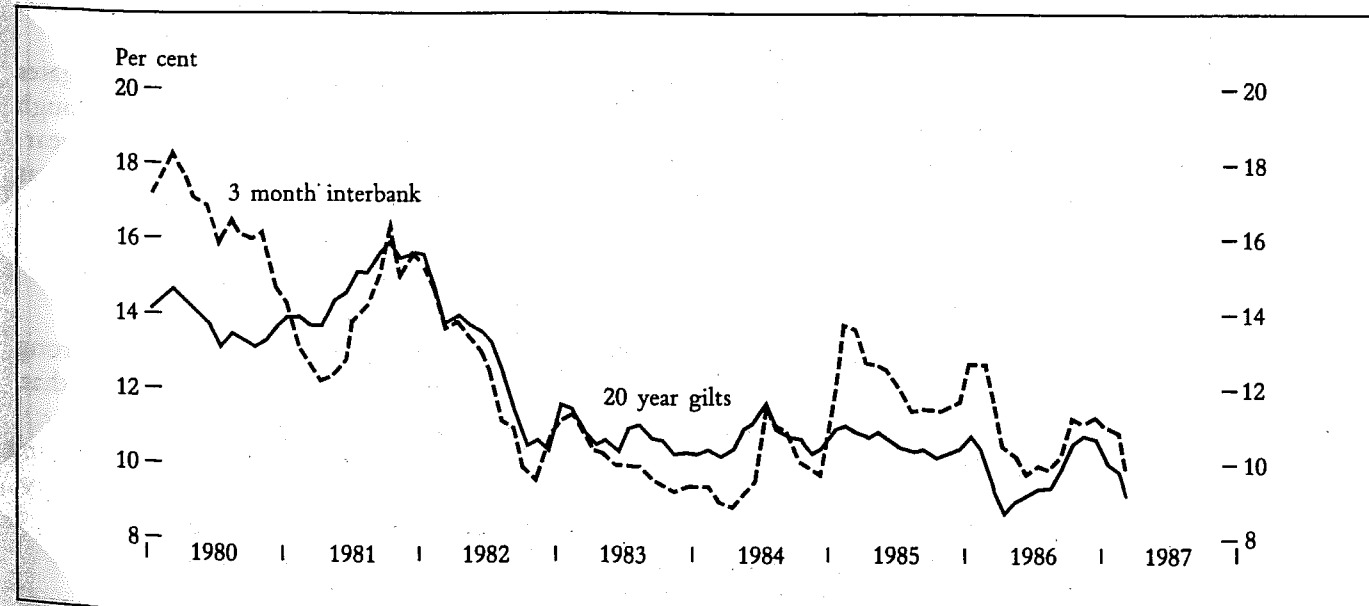
Exchange rates 3.07 The dollar fell further during 1986, particularly against the deutschemark and the yen. These changes will, over time, help to reduce the size of the US current account deficit and the Japanese and German surpluses. As paragraph 2.10 above explained, Finance Ministers of six of the leading industrialised nations agreed last month to seek a period of stability in exchange rates. Sterling fell in the summer of 1986, in the wake of the fall in the oil price (Chart 3.1). It remained steady between October and mid-February, but has since strengthened.

Chart 3.1 Exchange rate and oil prices



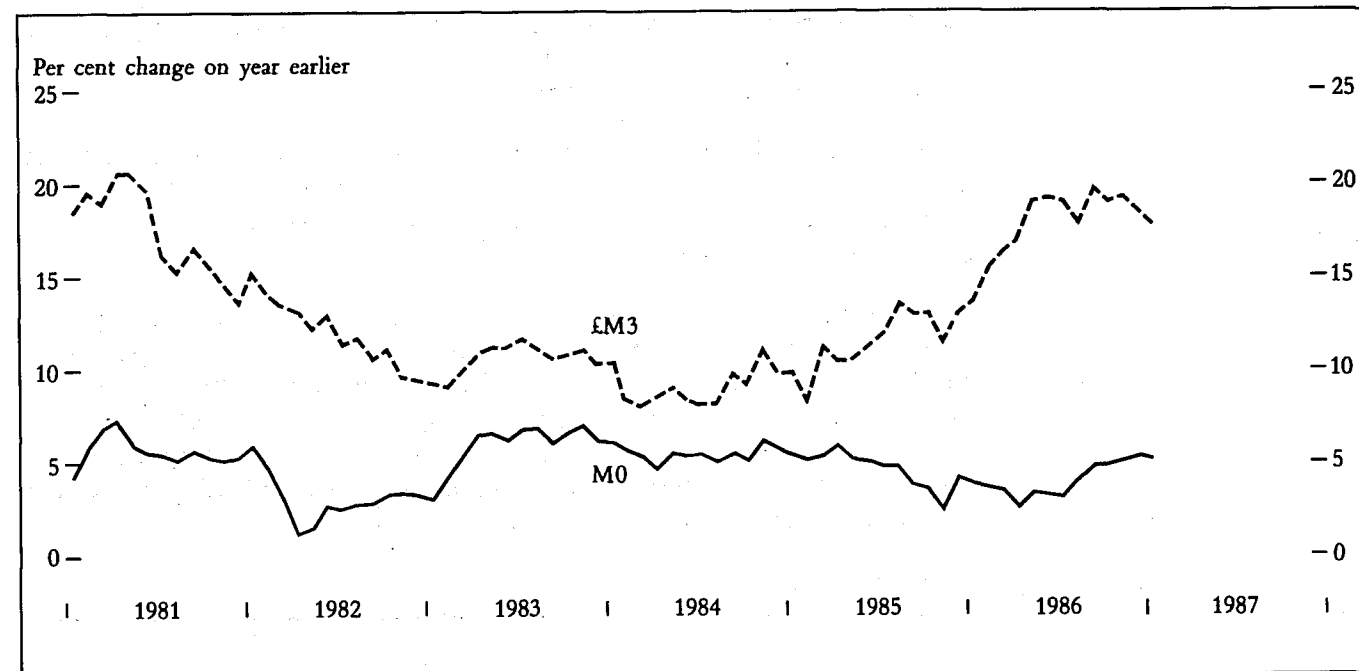
Interest rates 3.08 Short-term interest rates in the UK, which rose to nearly 13 per cent in January 1986, fell last spring to around 10 per cent. But with sterling weakening in the summer and autumn and with M0 also indicating an easing of monetary conditions, interest rates were raised to 11 per cent in October; they remained around that level until early March, but have since fallen. Rates in several overseas countries have also been reduced in recent months. Longer-term rates in the UK followed the same broad profile as short-term rates during 1986, falling sharply in the spring and rising in the autumn. In recent weeks they have fallen again, to below 10 per cent.

Chart 3.2 Interest rates in the UK



Narrow money 3.09 M0 growth was below the centre of its 2–6 per cent target range in the early months of 1986–87 (Chart 3.3). Its growth quickened from August onwards, reflecting both the falls in interest rates in the spring and the buoyant growth of personal incomes, and moved into the upper half of its target range. More recently it has fallen back again to the middle of its target range.

Chart 3.3 Growth rates of monetary aggregates



Broad money 3.10 The growth of £M3 rose to 18 per cent in the early months of 1986–87 and has since remained at about that level. This is some 3 points above the top of its target range, which in turn was set well above the growth of money GDP. Holdings of bank deposits by companies and financial institutions have grown particularly rapidly. The wider aggregates that include building societies' liabilities have grown more slowly, although also at a rate well in excess of the growth of money GDP: the year-on-year growth of PSL2 has been about 13–14 per cent in recent months. Credit has continued to grow strongly, reflecting at least partly the pace of financial innovation and liberalisation.

3.11 The growth of broad money must be seen in the context of the strong growth of private sector wealth and strongly positive real interest rates that have made financial assets attractive to hold. Increased competition in financial markets has narrowed the margins between borrowing and lending rates and this has led persons and companies to build up both their liquidity and their borrowing. The considerable increase in liquidity since 1980 appears to have been willingly held, and has been accompanied by lower inflation.

World economy

Recent developments

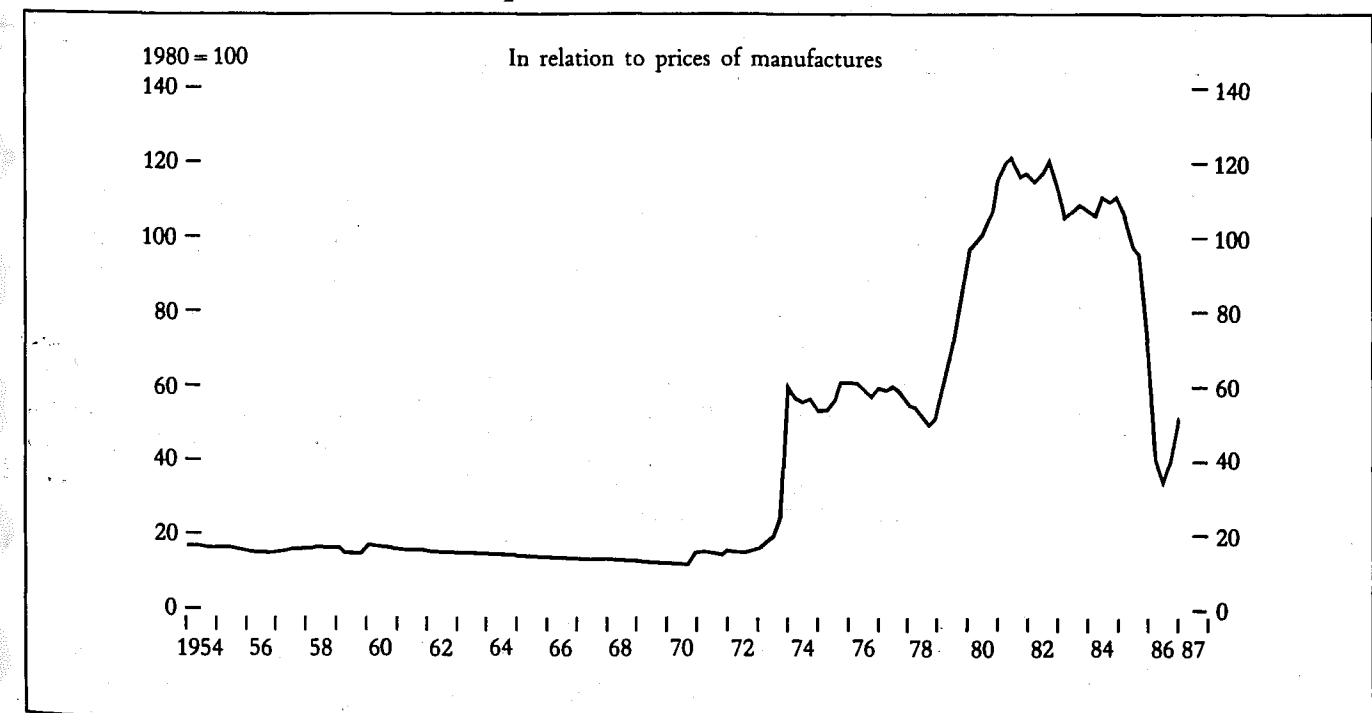
3.12 The world economy has been strongly influenced by the fall in oil and other commodity prices, and by the substantial depreciation of the dollar. Lower import prices have helped to reduce inflation in the industrialised countries and stimulated faster growth in real domestic demand. But developing countries—and oil producers in particular—have suffered a sharp deterioration in their terms of trade.

3.13 Real GNP in the seven largest OECD countries grew by about 2½ per cent in 1986. Domestic demand grew rather faster, at 3½–4 per cent, with large rises in household incomes and consumers' expenditure. Inflation fell further; and average consumer prices in the seven major countries increased by only 2 per cent in 1986.

3.14 Despite the buoyancy of domestic demand in these countries, industrial production has grown only slowly. This has been largely a result of weak export demand, particularly from developing countries, and relatively sluggish growth in investment.

3.15 The changes in exchange rates over the last two years are already beginning to have significant effects on trade volumes; but these have not yet been enough to overcome the terms of trade effects (the "J-curve"). As a result, the trade imbalances between the major countries remain large. The surpluses in Japan and Germany have continued to grow, though more slowly; and there has been little sign yet of any substantial reduction in the US current account deficit.

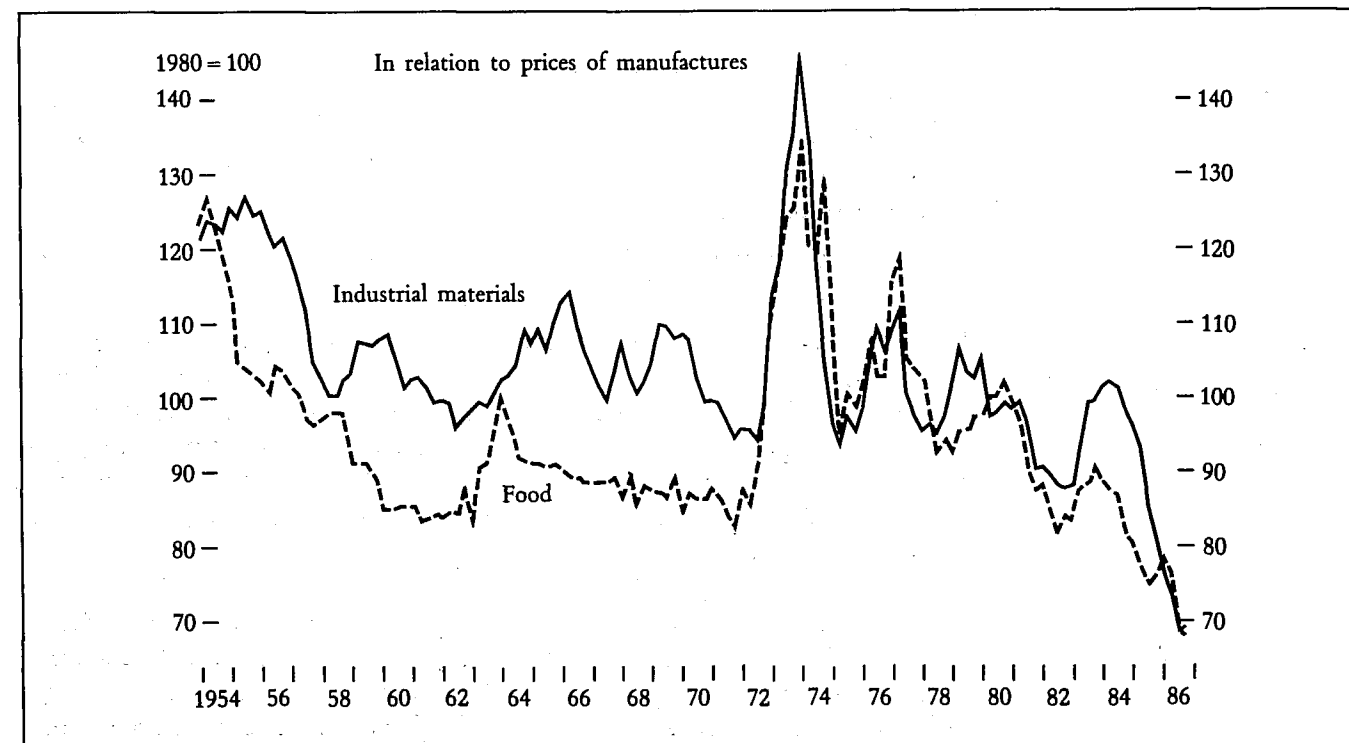
Chart 3.4 Real oil price



3.16 Oil prices fell below \$10 per barrel last summer, but rose in the second half of the year following the OPEC meeting in December. They have recently traded in a range of \$15–\$18 a barrel. Food and industrial materials

prices also fell sharply through most of last year, although they recovered slightly in the autumn. Charts 3.4 and 3.5 show past movements in real commodity prices, highlighting the extent of the recent falls.

Chart 3.5 Real commodity prices



3.17 World import volumes are thought to have grown by more than 5 per cent during 1986. This is somewhat faster than in 1985, largely because of a rise in oil trade as the major oil companies rebuilt their stocks. Developed countries' exports of manufactures rose by only 3 per cent as buoyant domestic demand in industrialised countries was partially offset by cuts in developing countries' imports.

Prospects 3.18 The outlook for oil prices remains uncertain. The forecast below is based on the assumption that North Sea oil prices average \$15 per barrel in 1987–88. Non-oil commodity prices may remain low, with food prices held down by the large surpluses of agricultural production. With rising activity in the major economies, industrial material prices may recover slightly from their current low levels.

3.19 Table 3.1 shows the forecasts for activity and inflation in the major seven industrialised countries, and for world trade. Inflation is expected to remain low, though it may rise a little from last year's level. In the US inflation may increase slightly as the effects of the fall in the dollar feed through, but the corresponding appreciation of the yen and deutschmark should mean that prices in Japan and Germany rise only very slowly, if at all.

Table 3.1 World economy

	Per cent changes on a year earlier			
	1985	Estimate 1986	Forecasts 1987	1988 H1
<i>Major Seven countries¹:</i>				
Real GNP	3	2½	2½	3
Real domestic demand	3	3½	3	3½
Industrial production	3	1	2½	4½
Consumer prices	4	2	2½	2½
<i>World trade, at constant prices</i>				
Total imports	3½	5½	3½	4½
Trade in manufactures ²	4	2½	3½	4

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

² Developed countries' exports weighted by UK markets.

3.20 These changes in exchange rates and inflation will affect domestic demand and output. In Japan and Germany they are likely to strengthen domestic demand but weaken export demand; in the US, the opposite effects are likely. In aggregate, domestic demand in the major industrial countries is likely to grow less strongly than in 1986. But GNP growth should be much the same, and industrial production should grow rather faster, helped by a recovery in exports.

3.21 World trade in manufactures is forecast to grow rather more quickly in 1987 than in 1986, though the pattern may be uneven. Import demand in the US is likely to slow down considerably, and oil producers are likely to cut back their imports further. But imports by Japan and Germany are expected to increase rapidly. Imports by non-oil developing countries seem likely to rise faster in 1987, after showing little change in 1986; despite continuing debt problems for some of these countries, commodity prices and hence export earnings are expected to strengthen during 1987. Growth in total world trade in 1987 is likely to be slower than in 1986, largely because the rebuilding of oil stocks is not expected to continue.

UK trade and the balance of payments

3.22 The UK's competitiveness improved markedly during 1986. Productivity rose fast and the growth of unit labour costs was only a little above that of our main competitors. As a result, the lower exchange rate was almost entirely reflected in improved competitiveness (Table 3.2). Most of the gain in competitiveness seems likely to be maintained over the year ahead.

Table 3.2 The exchange rate and competitiveness

	Sterling index (1975 = 100)	Relative unit labour costs* (1980 = 100)
1984 Q4	75	80
1985 Q4	80	86
1986 Q4	68	72

* Ratio of UK manufacturing costs to those overseas.

Trade prices and the terms of trade (excluding oil)

3.23 Prices of most imports rose during 1986, as the effects of the depreciation of sterling more than offset generally weak world prices. Export prices also rose, as exporters took advantage of sterling's decline to improve profit margins. Excluding oil, the terms of trade for goods worsened slightly between 1985 and 1986. Little further change seems likely in 1987.

Table 3.3 Visible trade

	Per cent changes on previous year					
	All goods			Goods less oil and erratic items		
	Export volume	Import volume	Terms of trade*	Export volume	Import volume	Terms of trade*
1985	5½	3½	1½	7	4	1½
1986	3½	6	-5½	2½	6	-1
1987 Forecast	4	7	0	6	8	½

*The ratio of UK export average values to import average values.

Visible trade volumes (goods other than oil and erratics)

3.24 The forecast for visible trade is summarised in Table 3.3.

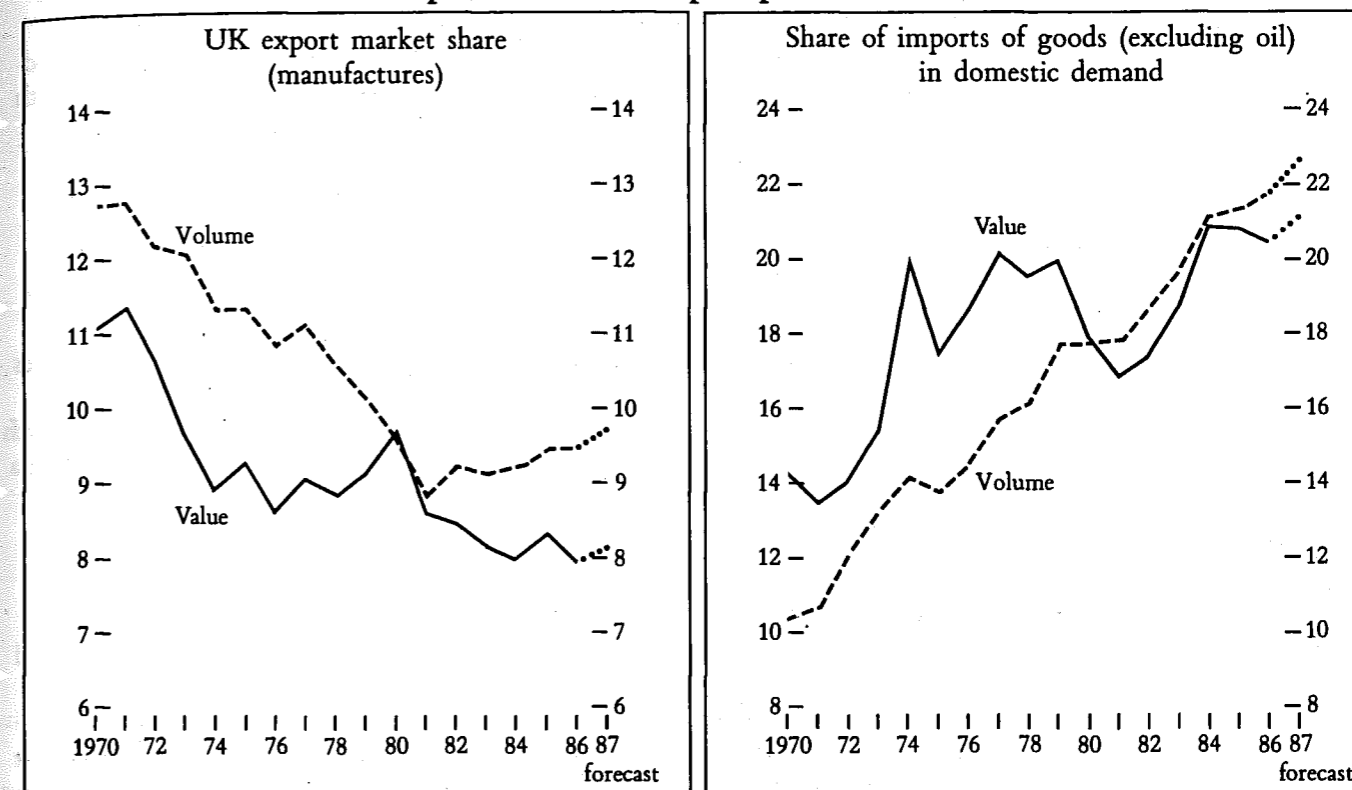
3.25 Exports of manufactures have been growing strongly in recent months. Growth had flattened in the final months of 1985 and exports fell briefly in early 1986, in common with those of other main manufacturing countries. But since then they have recovered strongly, and in the three months to January were 6 per cent above their level a year earlier. With rising world trade and the continued benefits of improved competitiveness, manufactured exports should show further strong growth in 1987. Exports of non-manufactures rose rapidly last year, mainly as a result of exceptionally high grain exports (demand for UK grain exports was strong, partly reflecting drought in Southern Europe); grain exports are unlikely to continue at these levels in 1987. Total exports should grow by about 6 per cent, compared with 2½ per cent in 1986.

3.26 UK manufactured export volumes appear to have maintained their share of developed countries' exports in 1986. This reinforces the previous evidence, illustrated in Chart 3.6, that the declining trend in share of developed countries' exports over the decades up to 1981 has ended.

3.27 Non-oil imports were flat in the early part of 1986, but then rose sharply in the second half of the year. More recently, the rate of growth has moderated. Imports are likely to continue to rise in 1987 as domestic activity expands, though improved competitiveness should slow the rate of growth. Non-manufactured imports rose rapidly in 1986, partly reflecting increased imports of foodstuffs; this effect is unlikely to continue in 1987. In total, imports of goods other than oil are forecast to rise by 5 per cent between the second halves of 1986 and 1987.

Oil trade

3.28 Britain's surplus on oil trade halved from £8 billion in 1985 to £4 billion in 1986, reflecting the sharp fall in world oil prices and some decline in the volume of net oil exports. North Sea production in 1987 is likely to be somewhat lower than in 1986 and the oil trade surplus slightly smaller.

Chart 3.6 Export shares and import penetration**Invisibles**

3.29 The surplus on invisibles rose in 1986. Net receipts of interest, profits and dividends (IPD) rose particularly rapidly as a result of the lower payments abroad by North Sea companies and an increase in the surplus on other earnings. The surplus on services fell in 1986, largely due to lower net earnings from tourism. The deficit on transfers was abnormally low last year, reflecting the size and timing of government transactions with the European Community.

3.30 The surplus on invisibles is forecast to show a further rise in 1987 with the pound's depreciation during last year helping to increase the sterling value of the earnings on the UK's large stock of foreign assets. The surpluses on services should also benefit from the improvement in UK competitiveness. These higher earnings should more than offset an increase in the transfers deficit to a more normal level.

Current account

3.31 The current account recorded a £1 billion deficit in 1986 following a surplus of £3 billion in 1985. Lower net oil earnings and an increased deficit on trade in manufactures more than offset an improvement in invisibles. The forecast for 1987 is for a current account deficit of £2½ billion. Details are given in Table 3.4.

Table 3.4 Current account

	£ billion				
	Manufactures	Oil	Other goods	Invisibles	Current balance
1985	-3	8	-7½	5	3
1986	-5½	4	-7	7	-1
1987 Forecast	-8	4	-7	8½	-2½

3.32 The UK's stock of net overseas assets is thought to have risen by the end of 1986 to about £110 billion (equivalent to 28 per cent of GDP: its highest recorded level since the war) compared with £80 billion at the end of 1985. The increase in the sterling value of assets reflects both the strength of world stock markets and the depreciation of sterling last year.

Demand and activity

3.33 The UK economy continued its steady growth in 1986. But there are uncertainties over the precise estimates of the rate of growth, given the differences between the three separate estimates of GDP (based on measures of expenditure, income and output). The output figures—generally recognised as the most reliable short-term indication—show non-oil growth of over 3 per cent between the end of 1985 and the end of 1986, following a brief pause in late 1985.

3.34 As in other industrial countries, consumers' expenditure in the UK grew strongly in 1986 as inflation fell and real incomes rose. UK exports were weak in the first half of the year, but recovered strongly in the second half. Imports had been depressed in the first half of the year but also rose sharply in the second half as the economy gained momentum, with particularly marked rises in imports of capital goods. Output growth in the service industries exceeded growth of manufacturing output for the year as a whole; but manufacturing output rose by over 2 per cent between the two halves of the year as exports recovered.

Personal sector expenditure

3.35 Real personal disposable income is estimated to have risen by about 4 per cent in 1986, and consumers' expenditure by over 4½ per cent. This implies some further fall in the personal savings ratio which has been declining throughout most of the 1980s. One reason is that with lower inflation households have needed to make less provision for the erosion of their past savings. Another factor has been a decline in the growth of employers' contributions to pension funds as a result of the surpluses that many funds have been showing, reinforced by the provisions of the 1986 Finance Act: these contributions are treated in the national accounts as a part of personal income and saving. The buoyancy of consumers' spending may also owe something to the strength of the stock market. In spite of the fall in the savings ratio, higher asset prices and lower inflation have contributed to an increase of over 50 per cent in persons' net holdings of financial assets since the end of 1983.

3.36 Real personal disposable income is forecast to rise by around 3½ per cent in 1987. This is slightly less than in 1986 and reflects some narrowing of the gap between earnings growth and inflation. Though there may be some further decline in the savings ratio, consumers' expenditure is expected to grow more slowly than in 1986, at a little under 4 per cent.

3.37 The housing market was buoyant in 1986, and private housing investment, both in new dwellings and in improvements to existing dwellings, grew strongly during the course of the year. Private housing

starts were about 8½ per cent higher than in 1985; in Greater London, where the largest increases in house prices have been recorded, private housing starts in 1986 were almost 40 per cent up on a year earlier. These higher starts should be reflected in completions and investment in new dwellings during 1987; private housing investment may rise by around 10 per cent in the year as a whole.

Company incomes and expenditure

3.38 The rate of return earned by non-North Sea industrial and commercial companies (ICCs) continued to rise last year; gross trading profits earned in the North Sea fell by more than half. The outlook for companies is favourable, but further substantial rises in profitability will probably have to depend less on depressed world prices of inputs of materials and fuels, and more on firms containing the costs that are under their own control.

3.39 Company sector spending was relatively weak in 1986. North Sea investment has been falling in the face of sharply lower profits. Onshore business investment was affected by the bringing forward of capital spending into 1985 ahead of the final stage of the changes in capital allowances announced in the 1984 Budget.

3.40 The prospects are for investment to grow rapidly this year. The DTI investment intentions survey published last December pointed to growth in non-North Sea business investment of about 6 per cent, continuing into 1988. The latest quarterly CBI survey of industrial trends indicated a pick up in investment in manufacturing industry, and the forecast assumes that the DTI's intentions survey projections will be broadly realised. Table 3.5 provides details of the forecast for total investment and its components.

Table 3.5 Gross fixed domestic capital formation

	£ billion at 1980 prices	Per cent changes on a year earlier		
		1985	1986	Forecast 1987
Business ¹	30.5	4	-3	4
Private dwellings ²	9.3	-1	9	8
General government	6.6	-5	7	-1
Total fixed investment	46.3	2	½	4

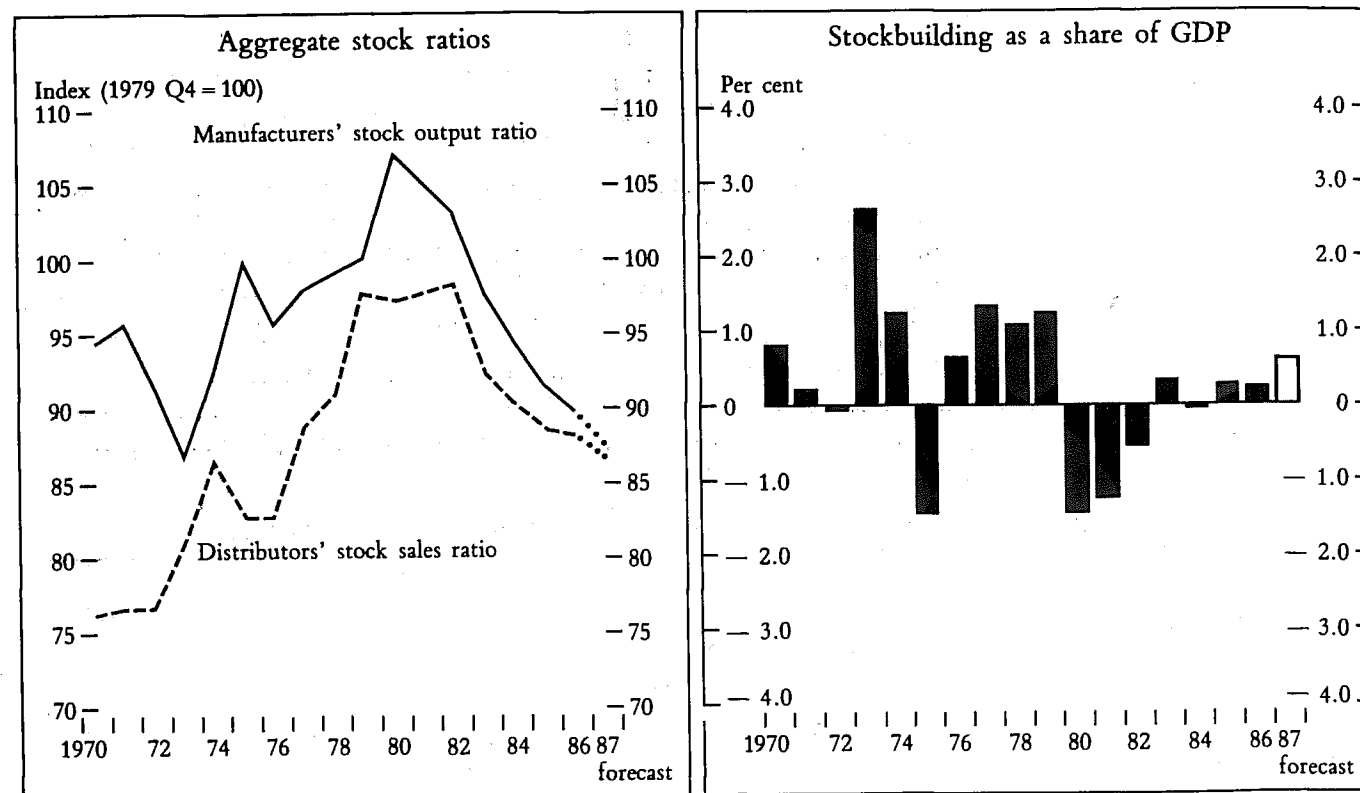
¹Includes investment by public corporations

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

3.41 The economy's stock output ratio fell in 1986 for the sixth successive year. It appears that manufacturers ran down stocks; and though distributors' stock levels rose, the increase was a small one in relation to the increase in the volume of sales. The latest quarterly CBI survey suggested that manufacturers may not now be intending to reduce their stocks of raw materials much further, possibly because of the firmer trend in raw material prices in recent months. An additional source of destocking in 1986 was the exceptionally high exports of grain which reduced the stocks held by the Intervention Board for Agricultural Produce (IBAP).

3.42 Stockbuilding is likely to make a positive contribution to growth in 1987, although the forecast is for only a small rise in stocks by the standards of most years in the 1970s (Chart 3.7), and there is likely to be a further fall in the stock output ratio for the whole economy.

Chart 3.7 Stockbuilding



Prospects for demand and activity

3.43 The forecast is for a further year of steady growth in 1987. GDP is expected to grow by 3 per cent, around the rate at which it was growing in the latter part of 1986. Exports and investment are forecast to grow strongly, offsetting some slowing down in consumer spending. The prospects for demand and activity are summarised in Table 3.6.

Table 3.6 Domestic demand and GDP

	Per cent changes on a year earlier ¹ (constant prices)		
	Forecasts		
	1986	1987	1988 H1
Domestic demand	3	3½	3
Exports of goods and services	3 (3)	4 (5)	2 (4)
Imports of goods and services	6 (5½)	6 (7)	2½ (3)
Domestic production: GDP ²	2½	3	2½

¹ Non-oil shown in brackets.

² Average measure.

3.44 The recovery in manufacturing output seen in the second half of 1986 is forecast to continue, helped by rising exports (Table 3.7). Construction output also rose quite strongly during 1986, and should benefit further from the expected strength of private investment in buildings during 1987.

Table 3.7 Real output

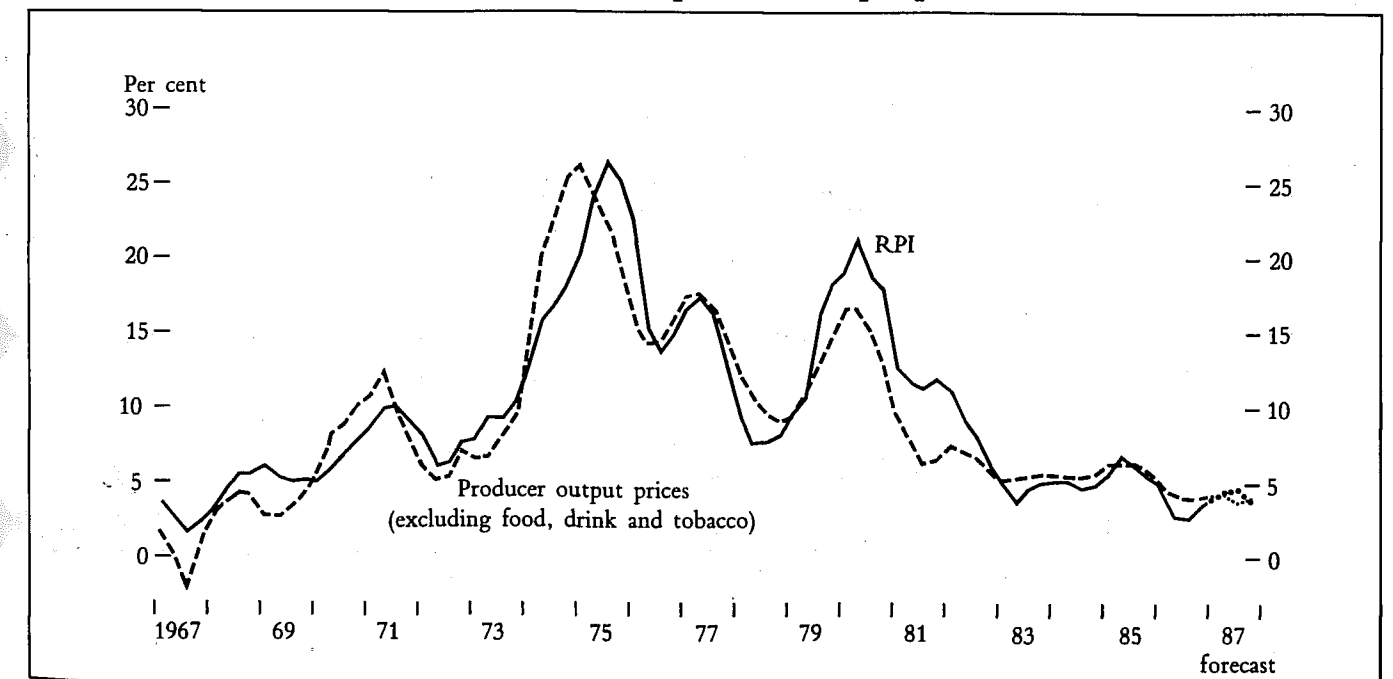
	Per cent changes on a year earlier		
	Forecasts		
	1986	1987	1988 H1
GDP	2½	3	2½
Non-North Sea output	2½	3½	3
Manufacturing output	½	4	3

Inflation

3.45 Both retail and producer output price inflation remain close to the lowest levels experienced since the 1960s (Chart 3.8). The RPI rose by 3½ per cent in 1986, compared to a rise of 6 per cent in 1985. The annual inflation rate reached a low point of 2.4 per cent in July and August: most of its subsequent rise has reflected changes in mortgage interest rates.

3.46 The rate of increase of producer output prices has also fallen significantly since the start of 1986, although it has started to edge up again recently, reflecting in part the fall in sterling that took place during the summer and early autumn.

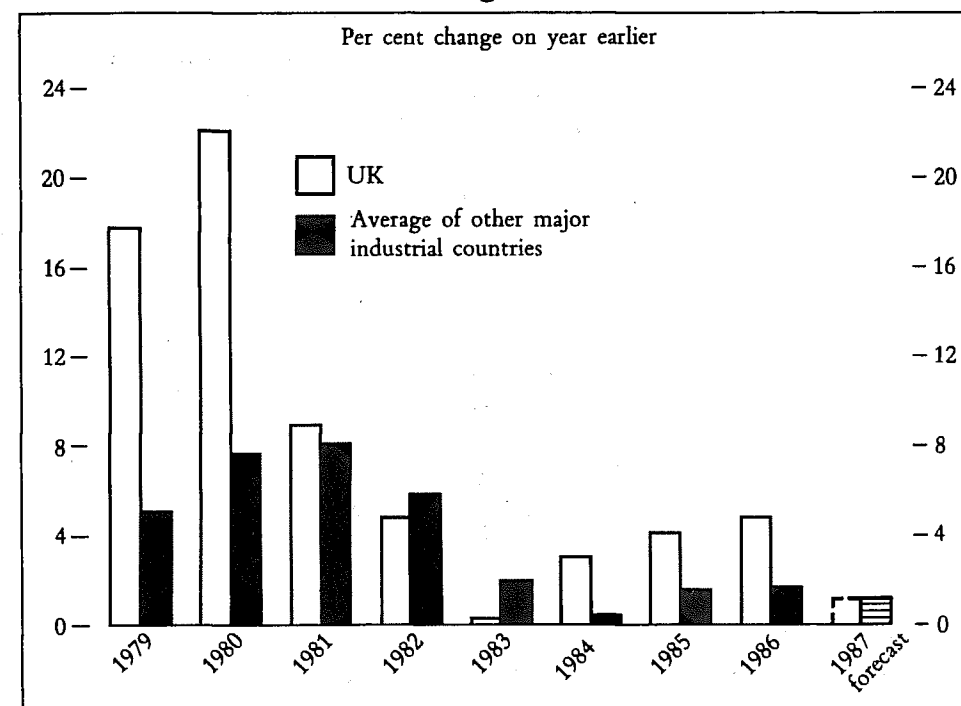
Chart 3.8 Annual increases in producer output prices and the RPI



3.47 Pay increases in the private sector have fallen slightly in recent months. Settlements in manufacturing industry recorded by the CBI have shown a fall of about 1½ per cent since 1985, although settlements in the private sector as a whole, including those outside manufacturing, may have fallen by less than this. This decline in pay settlements has not yet been reflected in lower recorded growth in average earnings. The current annual rate of growth of earnings reflects settlements made over the whole of the last year (the majority of them still dating from the period when settlements were running at a higher rate than they now are), and is also affected by overtime working, which has risen slightly since the second quarter of 1986.

3.48 In spite of the continuing relatively fast growth of earnings, unit labour costs in manufacturing have probably changed only a little since the first quarter of 1986 as productivity has risen sharply. Between 1985 and 1986 unit labour costs in manufacturing rose by about 5 per cent. Chart 3.9 shows recent and forecast movements in UK labour costs in relation to those of other major industrial countries. For the first time since 1983 unit labour costs in manufacturing in the UK are expected in 1987 to rise no faster than those in the other major industrial nations.

Chart 3.9 Unit labour costs in manufacturing



Prospects 3.49 The lower pay settlements recorded in recent months should lead to lower growth in earnings. Nevertheless employees will enjoy a further substantial rise in real earnings in 1987. The high rate of productivity growth currently being recorded should contain the growth in unit labour costs to below 4 per cent for the non-oil private sector as a whole, and to around 1½ per cent for manufacturing industry.

Table 3.8 Costs in manufacturing

	Per cent changes on a year earlier			
	Unit labour costs	Cost of materials and fuels ¹	Estimated total costs ²	Output prices ¹
1984	3	8½	5	5½
1985	4	4½	4½	6½
1986	5	-10½	0	4½
1987 Forecast	1½	3	2	4

¹ Producer prices excluding food, drink and tobacco.

² Including costs of bought in services.

3.50 The figures in Table 3.8 suggest that profit margins in manufacturing have widened markedly in recent years. It seems likely that industry will hold on to the gains it made last year with the help of falling input costs, and profit margins may widen further during 1987 given the forecast low growth in unit labour costs. In the longer run the higher level of profitability should lead to more investment, greater capacity, higher productivity, and hence lower inflationary pressure.

3.51 The year-on-year rate of inflation is likely to continue to edge up over the next few months, perhaps rising temporarily to a little over 4½ per cent. This will mainly reflect the relative movements in 1986 and 1987 of petrol prices (which fell during the first half of 1986 to a low point in July and early August) and mortgage interest rates. But inflation should then fall back in the second half of the year, to around 4 per cent in the fourth quarter (for details, see Table 3.9). The tax and price index (TPI) is expected to show a much smaller increase than the RPI during 1987, peaking at around 3 per cent during the summer, and probably falling to around 2 per cent by the fourth quarter.

Table 3.9 Retail prices index

	Weight in 1986	Per cent changes on a year earlier		
		1986 Q4	Forecasts	
			1987 Q4	1988 Q2
Food	18½	3½	2½	3
Nationalised industries*	6	3½	2	5
Housing	14½	7	9	7
Other	61	2½	3½	3½
Total	100	3½	4	4

* Includes water.

3.52 The GDP deflator measures the price of domestic value added—principally unit labour costs and profits per unit of output—and excludes import prices. It is sensitive to movements in North Sea profits, which may have fallen by more than half in the current financial year: as a result the deflator for GDP at market prices may have risen by only 3 per cent in 1986–87. Given the assumption of a \$15 oil price and with the further rise in non-North Sea profits now foreseen, the GDP deflator may rise rather faster in 1987–88 than in the previous year, perhaps by around 4½ per cent.

Productivity and the labour market

3.53 Results from the 1984 Census of Employment became available in December. These showed that the change in the number of employees since the last Census in 1981 had been very close to provisional estimates based on the results of successive Labour Force Surveys. Results from the 1986 Labour Force Survey have led to minor upward revisions to figures for employees, and to a downward revision to the figure for growth in self-employment

between mid 1985 and mid 1986. Growth since March 1983 in the employed labour force in Great Britain is now estimated at 1,040,000. Table 3.10 shows changes in employment over the last three years for which figures are available.

Table 3.10 Employment

	Thousands, change in GB seasonally adjusted				
	Employees in employment		Self-employed	HM Forces	Total in employment
	Male	Female			
September 1983 to September 1984	-23	+190	+235	+3	+406
September 1984 to September 1985	+47	+196	+90	-2	+330
September 1985 to September 1986	-25	+126	+38*	-3	+136

* Figure for self-employment growth since June 1986 is a projection based on self-employment growth over the previous five years.

3.54 Growth in employment averaged only about 20,000 a quarter in the first half of 1986, reflecting the period of sluggish output growth at the end of 1985 and in early 1986. The third quarter saw employment growing at almost three times this rate as the economy quickened again. Recent monthly figures for manufacturing employment point to a further pick up in total employment growth in the fourth quarter.

3.55 While confirming earlier figures for the total number of employees the Census results show some differences from the previous figures in the composition of changes in employment. Full-time female employment has risen by much more, and part-time female employment by much less than previously estimated; employment outside manufacturing has risen more than previously thought while manufacturing employment has shown a corresponding greater decline. The estimate of productivity growth in manufacturing since the 1979 cyclical peak has been raised by about $\frac{1}{2}$ per cent a year on average. Underlying growth in manufacturing productivity now seems to be back to the rate experienced in the 1960s.

Table 3.11 Output per head of the employed labour force

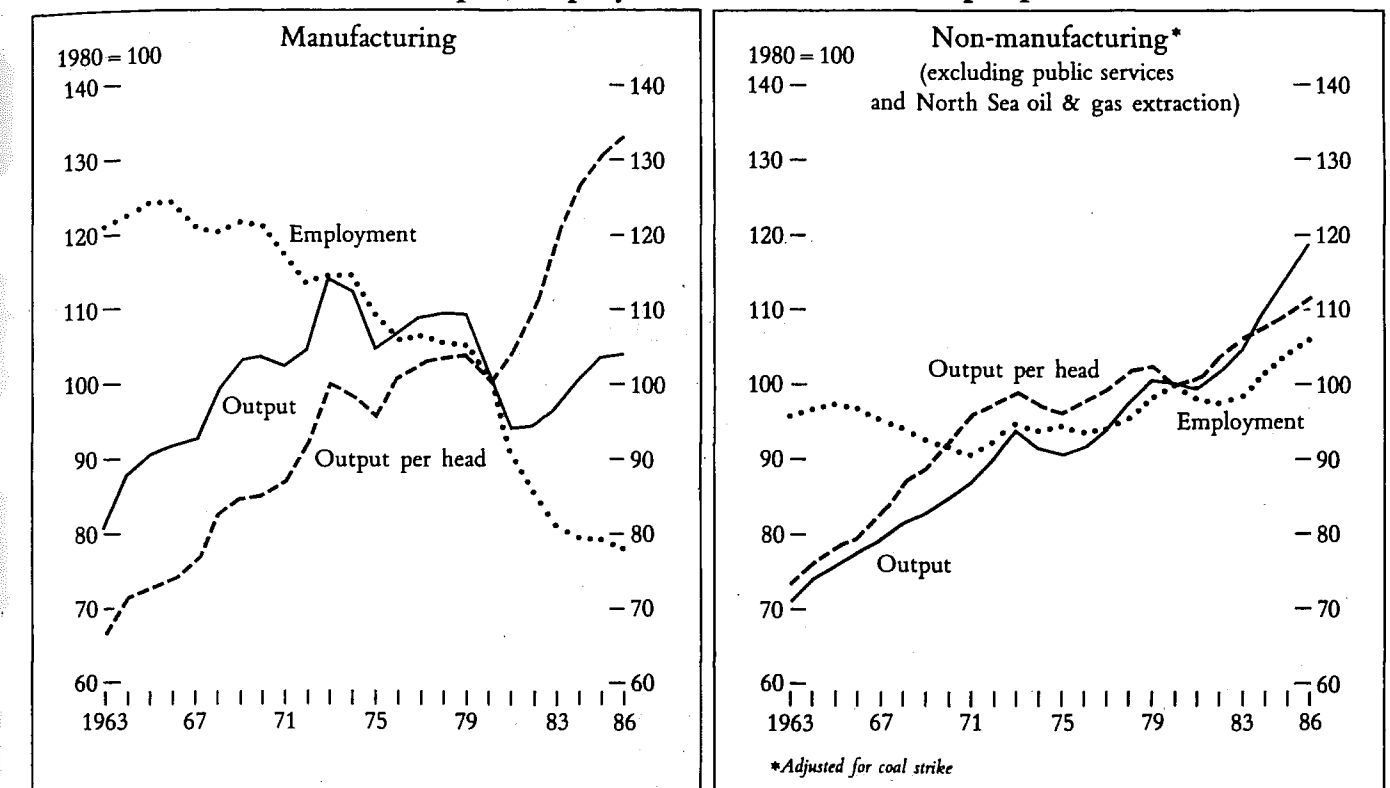
	Per cent changes					
	Annual averages			1983 Q4 to 1984 Q4 ¹	1984 Q4 ¹ to 1985 Q4	1985 Q4 to 1986 Q4 ³
	1964-73	1973-79	1979-86			
Manufacturing	3 $\frac{1}{2}$	$\frac{3}{4}$	3 $\frac{1}{2}$	3 $\frac{1}{4}$	2 $\frac{1}{4}$	4 $\frac{1}{2}$
Non-manufacturing ²	3	$\frac{1}{2}$	1 $\frac{1}{4}$	1 $\frac{3}{4}$	1 $\frac{1}{4}$	2 $\frac{3}{4}$
Whole economy	2 $\frac{3}{4}$	1 $\frac{1}{4}$	2	2	1	2 $\frac{1}{2}$
Non-North Sea economy	2 $\frac{3}{4}$	$\frac{1}{2}$	1 $\frac{3}{4}$	2	1 $\frac{1}{4}$	2 $\frac{3}{4}$

¹ Figures for 1984 Q4 are adjusted for the estimated effect of the coal strike.

² Excludes public services and North Sea oil and gas extraction.

³ Partly forecast.

Chart 3.10 Output, employed labour force and output per head



Unemployment **3.56** Seasonally adjusted adult unemployment in the United Kingdom fell by over 100,000 in the six months to January, the largest six month fall since 1973. The continued strength of the UK economy means that employment growth is likely to pick up further during the next year, and the outlook for a continuing fall in unemployment is promising. The training and counselling measures announced and implemented over the past year are helping the long term unemployed in particular. A sustained major reduction in unemployment will continue to depend on moderation in pay settlements.

Forecast and outturn

3.57 Table 3.12 compares the main elements of the forecast published in the 1986 FSBR with the outturn or latest estimate:

Table 3.12 Forecast and outturn

	1986 FSBR forecast	Latest estimate/forecast	Average errors from past forecasts
Total gross domestic product; per cent change between 1985 and 1986	3	2 $\frac{1}{2}$	$\frac{3}{4}$
RPI: per cent increase between the fourth quarters of 1985 and 1986	3 $\frac{1}{2}$	3 $\frac{1}{2}$ *	1 $\frac{1}{2}$
Money GDP, per cent change between 1985-86 and 1986-87	6 $\frac{3}{4}$	6	1 $\frac{1}{4}$
Current account of the balance of payments in 1986, £ billion	3 $\frac{1}{2}$	-1*	3
PSBR, financial year 1986-87, £ billion	7	4	5

* Outturn

3.58 Inflation in the fourth quarter of 1986 was in line with the forecast made a year ago. GDP growth has probably been a little below forecast, although the data on which latest estimates for 1986 are based are still very uncertain. Non-oil tax revenues have grown faster than forecast, and the PSBR in 1986–87 is likely to turn out about £3 billion below last year's forecast. The largest error made last year was on the current account; the main factors here were that growth in UK export markets turned out well below what had been expected a year ago while the terms of trade worsened more than forecast.

3.59 This year's forecast is summarised in Table 3.13.

Risks and uncertainties

3.60 No forecast is complete without an indication of error margins. Table 3.13 sets out the average errors from past forecasts, 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 3.13 The prospects: summary

	Forecast	Average errors from past forecasts ¹
Output and expenditure at constant 1980 prices	per cent changes 1986 to 1987	percentage points
Domestic demand	3½	¾
of which:		
consumers' expenditure	4	1
general government consumption	1	1
fixed investment	4	2¼
change in stockbuilding (as per cent of level of GDP)	½	¾
Exports of goods and services	4	2½
Imports of goods and services	6	2½
Gross domestic product: total	3	¾
: manufacturing	4	2
Inflation		
Retail prices index	per cent changes	
1986Q4 to 1987Q4	4	1½
1987Q2 to 1988Q2	4	2¼
Deflator for GDP at market prices	per cent changes on a year earlier	
Financial year 1986-87	3	¾
Financial year 1987-88	4½	1¾
Money GDP at market prices	per cent changes on a year earlier	
Financial year 1986-87	6	1¼
Financial year 1987-88	7½	1½
Balance of payments on current account	£ billion	
1987	- 2½	3
1988 first half (at an annual rate)	- 2	3½
PSBR	£ billion ²	
Financial year 1986-87	4 (1%)	1 (¼%)
Financial year 1987-88	4 (1%)	5 (1¼%)

¹ The errors relate to the average differences (on either side of the central figure) between forecast and outturn. The method of calculating these errors has been explained in earlier publications and government forecasts (see Economic Progress Report June 1981). The calculations of average errors are based on forecasts made between 1975 and 1985. The errors are after adjustment for the effects of major changes in fiscal policy that were not allowed for in the forecasts.

² Per cent of GDP at market prices shown in brackets.

Table 3.14 Constant price forecasts of expenditure, imports and gross domestic product*

£ 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
1982	138.3	49.6	39.4	63.3	-1.1	289.4	59.5	30.4	0.4	199.9	100.3
1983	143.6	50.5	41.7	64.7	0.7	301.2	62.8	31.5	-0.2	206.7	103.7
1984	146.7	50.9	45.5	69.1	-0.1	312.1	68.6	32.6	1.8	212.7	106.7
1985	152.0	51.0	46.3	73.1	0.6	323.0	70.7	34.0	1.4	219.8	110.2
1986	159.2	51.6	46.6	75.3	0.6	333.2	74.8	35.0	2.1	225.5	113.1
1987	165.2	52.1	48.4	78.4	1.4	345.5	79.4	36.3	2.4	232.2	116.5
1985 H1	75.0	25.5	23.3	36.7	0.4	161.0	35.2	16.7	0.5	109.5	109.9
H2	76.9	25.5	23.0	36.4	0.2	162.0	35.5	17.2	0.9	110.2	110.6
1986 H1	78.6	25.5	23.3	36.7	0.4	164.5	35.9	17.2	0.6	112.0	112.3
H2	80.6	26.0	23.3	38.7	0.2	168.8	39.0	17.8	1.5	113.5	113.9
1987 H1	81.9	26.0	24.0	39.0	0.6	171.6	39.3	18.0	1.2	115.5	115.8
H2	83.3	26.1	24.4	39.5	0.7	173.9	40.1	18.3	1.2	116.7	117.1
1988 H1	84.9	26.2	24.7	39.7	0.6	176.3	40.3	18.6	1.1	118.5	118.9
Per cent changes											
1984 to 1985	3½	0	2	6	—	3½	3	4	—	3½	3½
1985 to 1986	4½	1	½	3	—	3	6	3	—	2½	2½
1986 to 1987	4	1	4	4	—	3½	6	4	—	3	3
1987 H1 to 1988 H1	3½	1	3	2	—	2½	2½	3	—	2½	2½

* GDP figures in the table are based on "compromise" estimates of gross domestic product, reflecting, for the past, average movements in constant price expenditure, output and income estimates of GDP. Percentage changes are calculated from

unrounded levels and then rounded to half per cent. Figures for 1987 H1 and beyond are forecasts. Figures for periods up to the end of 1986 are based mainly on the national accounts published earlier (covering periods up to 1986 Q3)

and incorporate some revised and later data and forecasts. A full set of national accounts, to end 1986, will be published by the CSO on 20 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 basic rate of income tax will be reduced to 27 per cent.

4.03 The main income tax personal allowances will be increased in line with the statutory indexation provisions (based on the increase of 3.7 per cent in the RPI in the year to December 1986). This will mean that:

the single person's and wife's earned income allowances will rise from £2 335 to £2 425;

the married allowance will rise from £3 655 to £3 795;

the age allowance will rise from £2 850 to £2 960 (single) and from £4 505 to £4 675 (married) and the income limit from £9 400 to £9 800;

the additional personal allowance and widow's bereavement allowance will rise from £1 320 to £1 370.

4.04 For those aged 80 and over the age allowance will be increased by twice the amount due under statutory indexation to £3 070 (single) and £4 845 (married).

4.05 The allowance for the blind will be increased from £360 to £540.

4.06 The higher rates of income tax will be charged as follows:

Rate of tax per cent	Taxable income £
40	17 901-20 400
45	20 401-25 400
50	25 401-33 300
55	33 301-41 200
60	over 41 200

4.07 Car benefit scale charges will be increased by 10 per cent from 6 April 1988.

Profit-related pay **4.08** An income tax relief will be introduced for employees in profit-related pay (PRP) schemes which meet certain conditions and which have been registered with the Inland Revenue. The maximum amount of PRP eligible for relief will be £3 000, or 20 per cent of total PAYE pay, whichever is lower. Relief will be given on half the eligible amount.

Excise duties 4.09 The duty on unleaded petrol will be reduced by the equivalent of about 5p a gallon (including VAT).

4.10 On-course betting duty will be abolished.

4.11 The rates of duty on gaming machine licences will be increased by between 25 and 28 per cent.

Vehicle excise duty 4.12 The rates of duty on farmers' heavy goods vehicles over 7.5 tonnes will be increased by between 5 and 34 per cent. The rates of duty for trade licences will be increased to £85 for cars and £17 for motor cycles. A new taxation class will be created for recovery vehicles. The duty rate will be £50.

Inheritance tax 4.13 From Budget day the threshold will be increased from £71 000 to £90 000 and the number of chargeable bands reduced from seven to four. The new scale will be as follows:

Rate of tax per cent	Band of chargeable value £000
0	0- 90
30	90-140
40	140-220
50	220-330
60	Over 330

4.14 Lifetime gifts of "interests in possession" in settled property will be exempt from inheritance tax if the donor survives for seven years. Measures against abuse will be incorporated.

4.15 Trust property in which there is an interest in possession will not be taxed on the death of a life tenant if the property is put into a heritage maintenance fund not later than two years after the death.

4.16 Property accepted in lieu of tax may be valued at the date of the offer, and interest will cease to accrue on that date, at the option of the offeror.

4.17 From Budget day, the rate of business relief on transfers of holdings of more than 25 per cent (other than control holdings) in unquoted companies will be increased from 30 to 50 per cent. Companies whose shares are traded on the Unlisted Securities Market will from Budget day be treated for inheritance tax purposes in the same way as companies with a full listing on the Stock Exchange.

Business taxation 4.18 The small companies' rate of corporation tax will be reduced to 27 per cent. The rate of advance corporation tax (ACT) will go down automatically to 27/73rds as a consequence of the reduction in the basic rate of income tax. The main rate of corporation tax for the financial year 1987 will be 35 per cent.

4.19 All companies, building societies and other bodies chargeable to corporation tax will become liable, after a phasing-in period, to pay the tax nine months after the end of the accounting period for which the tax is due.

4.20 From Budget day there will be changes in the tax treatment of companies' capital gains. They will be taxed without adjustment, other than the indexation that applies to post-1982 gains, at the rates of corporation tax applying to other profits (including, where appropriate, the small companies' rate) and credit for payment of ACT will be allowed against liability to tax on them.

4.21 From 1 April 1987 credit for any foreign withholding tax actually paid or deemed to be paid on interest received by banks on any new loan made by them to a non-resident will be allowed only against corporation tax due on the profit from that loan. This rule will apply to existing loans with effect from 1 April 1988.

4.22 From 1 April 1987 dual resident companies will not be allowed a double deduction for interest payments. This change will not apply to trading companies.

4.23 Legislation will be introduced for a new scheme, known as Pay and File, to streamline the assessment and collection of corporation tax. The scheme will be implemented when the necessary computerisation is complete.

Oil taxation 4.24 Two relaxations to the expenditure relief rules are proposed:

companies may elect to have up to 10 per cent of the costs of developing certain new fields set against their petroleum revenue tax (PRT) liabilities on existing fields;

certain research expenditure which is not specifically related to a particular oil field may after three years be set against PRT liabilities in any field.

A minor technical change is also proposed to the rules for allocating oil allowance.

4.25 One effect of Section 16 of the Oil Taxation Act 1975 is to restrict the ability of oil companies to set off payment of ACT against tax due on ring-fence profits. It is proposed that such companies should be allowed limited carry-back of surrendered ACT. It will also be possible for a 50/50 joint venture to surrender ACT to a ring-fence company owned by the venture.

4.26 Where an oil extraction company uses the issue of preference shares to raise capital which is not used for oil extraction purposes, there will be restrictions in the extent to which ACT paid on certain dividends on those preference shares can be set off by the company against ring-fence profits.

Business Expansion Scheme

4.27 Two changes will be made to the Business Expansion Scheme:

for investments made in the first half of the tax year, the investor will be able to opt for part of the relief to be given for the previous year;

the rules governing the special relief for film production will be relaxed.

Pensions 4.28 In the light of the reform of social security, a new tax regime for personal pensions (ie pensions taken out by an individual independently of his employer) will be introduced, to replace and extend the present, broadly similar, legislation for retirement annuities. The new regime will come into effect next year. The main features will be:

- benefits based on the actual return from invested contributions (money purchase);
- no limits on pension benefits;
- a tax-free lump sum, subject to a limit;
- annual contributions limited to 17.5 per cent of earnings (more for people over 50) with employers free to contribute within the limit;
- tax relief for contributions, tax exemption for fund income and gains.

4.29 Employees will be able to contract-out of the State Earnings Related Pension Scheme (SERPS) by joining a personal pension scheme, to which the DHSS will pay a minimum contribution.

4.30 Employers will be able to establish simplified occupational schemes which may be "final salary" or "defined contribution". Under the new social security rules, the latter may be "contracted out money purchase" schemes.

4.31 There will be greater transferability between different types of pension arrangements.

4.32 Members of occupational pension schemes will be able to pay additional voluntary contributions—on which tax relief will be available up to the present limits—to arrangements outside their employer's scheme.

4.33 A number of changes in current pensions law and practice will be made, to counter certain types of exploitation, particularly by high earners. These include:

- a limit on lump sums of £150 000;
- changes in the rules on "final salary" for pension purposes;
- changes in the rules relating to accelerated accrual of benefits.

Training 4.34 Employees who are about to change their jobs will be exempted from income tax on the cost of training in new work skills provided by their employer.

Employee share schemes 4.35 The 1980 and 1984 employee share option schemes will be changed to make it possible, in the event of a takeover, for participants to exchange their existing share options for options over shares in the acquiring company.

Capital gains tax 4.36 The capital gains tax annual exempt amount is to be increased in accordance with the statutory indexation provisions from £6 300 to £6 600 in the case of individuals, and from £3 150 to £3 300 in the case of most trusts.

4.37 The ceiling for retirement relief will be raised from £100 000 to £125 000.

Lloyd's: reinsurance to close 4.38 Legislation is proposed to bring the tax treatment of members of Lloyd's into line with the normal tax treatment of provisions for outstanding liabilities made by ordinary insurance companies and of comparable provisions made by other financial traders. These proposals will affect the tax treatment of Lloyd's reinsurance to close and will first apply to premiums payable in respect of the 1985 Lloyd's account closing at 31 December 1987.

PAYE and subcontractor schemes 4.39 Changes will be made to the PAYE and subcontractor deduction schemes, including the charging of interest where formal assessments have had to be made of tax deducted under these schemes. This follows recommendations of the Keith Committee.

VAT 4.40 From 18 March 1987 the registration limits will become £21 300 per annum and £7 250 per quarter.

4.41 Subject to the Government's obtaining the necessary derogation from the European Community, businesses with annual turnover below £250 000 are to be given the option of accounting for VAT on the basis of payments received and made. This optional system of cash accounting is intended to come into effect on 1 October 1987.

4.42 An optional system of annual accounting for VAT is to be introduced with advance payments based normally on the previous year's tax so that businesses with annual turnover below £250 000 would need to send only one return to Customs each year.

4.43 The period within which businesses must notify and be registered for VAT will be extended to 30 days.

4.44 The simpler VAT schemes for retailers will be made available for use by many more small and medium-sized businesses.

4.45 The rules on VAT input tax deduction by partly exempt traders are to be revised so as to curb tax avoidance and to prevent distortion of competition.

4.46 VAT relief for charities will be extended to certain welfare vehicles used by hospices to transport the terminally ill; to specialised location and identification equipment used by rescue and first aid services; to goods donated for export by a charity for relief of distress or animal welfare; to installing or adapting bathroom, washroom or lavatory facilities for the handicapped in charity residential homes; and to drugs and chemicals directly used by a charity in medical care or research.

Table 4.1 Direct effects of changes in taxation

See Annex 4 paragraph numbers	£ million		
	Estimated effect on receipts in:		
	1987-88	1988-89	1988-89
	Changes from a non-indexed base	Changes from an indexed base	Changes from an indexed base
INLAND REVENUE			
Income tax			
1 Reduction of 2p in basic rate	-1 910	-1 910	-2 690
2 Increase in single allowance of £90 and married allowance of £140	-610	—	—
3 Increase in additional personal allowance and widow's bereavement allowance of £50	-5	—	—
4 Increase in age allowance of £110 (single) and £170 (married) and income limit of £400	-80	—	—
5 Further increase in age allowance of £110 (single) and £170 (married) for those aged 80 and over	-10	-10	-10
6 Increase in blind person's allowance of £180	*	*	*
7 Increase in basic rate limit of £700 to £17 900	-60	—	—
8 Changes to further higher rate thresholds	-5	+40	+80
9 Profit-related pay	*	*	-50
10 Fringe benefits—car scale	—	—	+30
11 Income support paid to the unemployed and to strikers	—	—	*
12 Approved employee share schemes—takeovers	*	*	*
13 Payroll giving to charities—increase in donation limit to £120 a year	*	*	*
14 Legislation on Lloyd's reinsurance to close	—	—	†
15 Apportionment of income etc of close companies	*	*	*
16 Foreign partnerships—removal of possible anomaly	*	*	*
Income tax and capital gains tax			
17 Business Expansion Scheme changes	-5	-5	-5
18 Amendment to offshore fund rules	*	*	*
Income tax and corporation tax			
19 Personal pensions	*	*	-25
20 Other pensions changes	*	*	-40
21 Friendly societies	*	*	*
22 Keith Committee—PAYE and subcontractors	+5	+5	+45
23 Interest payments between related companies	*	*	*
24 Increase in exemption limits for trade union provident funds	*	*	*
25 Capital allowances—extension of assured tenancies relief	*	*	*
26 Relief for the costs of training	*	*	*
Income tax, corporation tax and capital gains tax			
27 Securities—Financial Services Act consequential	—	—	—
Income tax, corporation tax, capital gains tax, inheritance tax and stamp duties			
28 Unit trusts—Financial Services Act consequential	—	—	—
Corporation tax			
29 Reduction in rate of ACT to 27/73rds of the amount of the distribution	-290	-290	-130
30 Reduction in small companies' rate to 27 per cent	*	*	-45
31 Harmonisation of payment dates for corporation tax	*	*	+100
32 Taxation of indexed gains in full at normal corporation tax rates	*	*	+80
33 ACT set-off against tax on companies' gains	*	*	-20
34 Dual resident companies—non-allowance of double deduction	*	*	+125
35 Foreign withholding tax on interest received by banks	*	*	+20
36 Relaxation of set-off of surrendered ACT against ring fence profits	-20	-20	-20
37 ACT set-off against ring fence profits (certain preference share dividends)	—	—	+15
38 Building societies—groups of companies and capital gains	*	*	*
39 Pay and File	—	—	—
40 Amendment to controlled foreign companies legislation	+10	+10	+10
Corporation tax and capital gains tax			
41 Financial futures and traded options	—	—	*

* = Negligible — = Nil † Details of measure subject to consultation, so no estimate possible at present.

Table 4.1 Direct effects of changes in taxation—continued

	£ million		
	Estimated effect on receipts in:		
	1987-88	1988-89	1988-89
	Changes from a non-indexed base	Changes from an indexed base	Changes from an indexed base
Oil taxation			
42 10 per cent cross field allowance	-5	-5	-15
43 Petroleum revenue tax relief for certain research expenditure	—	—	—
44 Oil allowance—final adjustments	*	*	*
Capital gains tax			
45 Indexation of annual exempt amount	—	—	—
46 Retirement relief	—	—	*
Inheritance tax			
47 Changes to rates and bands	-90	-75	-170
48 Business relief and Unlisted Securities Market	*	*	*
49 Abolition of lifetime charge on interest in possession trust property	*	*	*
50 Heritage maintenance funds	*	*	*
51 Property accepted in lieu of tax	*	*	*
Stamp duties			
52 Changes to stamp duties and the reserve tax	*	*	*
TOTAL INLAND REVENUE	-3 080	-2 265	-2 720
CUSTOMS AND EXCISE			
Value added tax			
53 Revised treatment of tour operators' margins	—	—	+20
54 New rules on deduction of input tax by partly exempt traders	+300	+300	+400
55 Cash accounting for small businesses	-100	-100	-10
56 Increase in registration limits	*	—	—
57 Revised registration requirements	-15	-15	-25
58 Annual accounting for small businesses	—	—	-25
59 Simplified retail schemes	—	—	—
60 Removal of loophole on imported services	*	*	+5
61 Reliefs for charities	-5	-5	-5
Excise duties			
62 No change in rate of spirits duty	—	-25	-30
63 No change in rate of beer duty	—	-60	-70
64 No change in rate of duty on cider and perry	—	*	*
65 No change in rates of wine and made-wine duties	—	-20	-20
66 No change in rates of duty on petrol etc	—	-190	-210
67 No change in rate of duty on derv	—	-50	-55
68 No change in rates of minor oil duties	—	-5	-5
69 No change in rates of tobacco products duties	—	-105	-110
70 Duty differential in favour of unleaded petrol	*	*	*
71 Abolition of on-course betting duty	-20	-20	-20
72 Increase in rates of gaming machine licence duty	+20	+20	+20
TOTAL CUSTOMS AND EXCISE	+180	-275	-140
Vehicle excise duty			
73 No change in VED on car, light van and main lorry rates	—	-95	-100
74 Increases in certain other VED rates	+5	+5	+5
75 Recovery vehicles	*	*	*
76 VED enforcement measures	*	*	+5
Other			
77 Bus fuel grants	—	+5	+5
TOTAL VED AND OTHER	+5	-85	-85
TOTAL CHANGES IN TAXATION	-2 895	-2 625	-2 945

* = Negligible — = Nil

Annex to Chapter 4

How the figures in Table 4.1 have been calculated

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 rates of tax, allowances, etc prevailing before the Budget (the pre-Budget regime) and the yield after the changes proposed in the Budget (the post-Budget regime).

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 behavioural changes can be directly attributed to the change in tax.

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 1987–88 or 1988–89; 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 1987–88. Budget proposals are compared with a non-indexed base—that is, with the pre-Budget regime of allowances, thresholds and rates of duty at 1986–87 money levels.

The figures in the second column show the direct effect of the Budget proposals on receipts in 1987–88, measured against an indexed base. The indexed base for 1987–88 is obtained by increasing 1986–87 allowances, thresholds and rates of duty by 3.7 per cent, the increase in the RPI over the year to December 1986.

The figures in the third column show the direct effect on receipts in 1988–89, also measured against an indexed base. For this comparison, both the Budget proposals and the indexed base for 1987–88 have been further indexed by the forecast movement in the RPI between the fourth quarters of 1986 and 1987 (shown in Table 3.13).

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

are, of course, taken into account in estimating the impact of the tax change on the 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.

Table 4.1 does not include certain measures announced and implemented before Budget day. These are the amendment of the material interest test for approved employee share schemes and other purposes, tax relief for the cost of seconding employees to educational bodies, the tax treatment of invalid care allowance paid to married women, and changes in the pricing and valuation rules for petroleum revenue tax. These measures are reflected in the baseline for costing the effect of tax changes 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 The basic rate will be reduced from 29 per cent to 27 per cent. The cost figures in the table for this item assume that the changes in items 2–7 have been made first. They include the saving in public expenditure on 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 29 of Table 4.1.
 - 2 The single person's allowance and the wife's maximum earned income relief will be increased from £2 335 to £2 425 and the married allowance from £3 655 to £3 795.
 - 3 The additional personal allowance and widow's bereavement allowance will be increased from £1 320 to £1 370.
 - 4 The age allowance will be increased for the single person from £2 850 to £2 960 and for the married from £4 505 to £4 675; the age allowance income limit will be increased from £9 400 to £9 800.
 - 5 There will be a new, higher level of age allowance for those aged 80 or over. The allowance will be £3 070 for the single person and £4 845 for the married.
 - 6 The blind person's allowance will be increased from £360 to £540. This will cost about £2 million per year.
 - 7 The basic rate limit will be increased to £17 900.
 - 8 The threshold for the 45 per cent higher rate will be raised by £200 to £20 400. The thresholds for the 50 per cent, 55 per cent and 60 per cent rates will remain at £25 400, £33 300 and £41 200 respectively.
 - 9 One half of profit-related pay (PRP) paid to a private sector employee under a registered scheme will be relieved from income tax, subject to the lower of two annual limits: where the total PRP exceeds 20 per cent of total PAYE pay, PRP will be regarded for tax relief purposes as limited to that amount, and the maximum annual amount of PRP which may be taken into account will be £3 000. The cost will depend on take-up. It is likely to build up substantially as tax relief becomes payable on more schemes, and PRP becomes a higher proportion of total pay.
 - 10 For 1988–89, the scale for taxing car benefits in respect of company cars provided for directors, and for employees whose remuneration is at a rate of £8 500 a year or more, will be increased by 10 per cent. No change is proposed for 1988–89 to the scale charges for car fuel benefit, also—from 6 April 1987—used for VAT purposes.

11 Legislation providing for the taxation of supplementary benefit paid to the unemployed and to strikers will be amended to reflect the replacement in 1988 of supplementary benefit by income support.

12 Approved savings-related or discretionary share option schemes will be permitted to enable directors and employees, when their company is taken over, to exchange their existing options for options over shares in the acquiring company.

13 The limit on charitable donations qualifying for relief under payroll deduction schemes will be increased to £120 from April 1987.

14 The tax treatment of Lloyd's reinsurance to close will be made consistent with the treatment of provisions for outstanding liabilities made by insurance companies and comparable provisions made by other financial traders. The legislation will first take effect for the Lloyd's 1985 Account which closes at the end of 1987. This is assessable for the year 1985-86, the tax for which does not become payable until 1 January and 1 July 1989. The estimate of receipts depends on the details of the new arrangements, which are still to be established.

15 The Inland Revenue's powers to apportion the income and annual payments of a close company to its participators will be made obligatory (a recent Court case held that they were discretionary).

16 A possible anomaly in the law relating to the taxation of foreign partnerships will be removed to prevent substantial potential revenue loss.

Income tax and capital gains tax

17 Relief under the Business Expansion Scheme for investments made in the first half of the tax year will, in part, be able to be claimed against the income of the previous tax year. The special relief for film production, which requires the company to be producing films throughout the three year qualifying period, will be relaxed so that the requirement can be satisfied by the distribution of films produced in this period.

18 The Revenue will be given a limited discretion in certifying offshore funds as distributing funds.

Income tax and corporation tax

19 A new tax regime for personal pensions will be introduced to replace and extend the present, broadly similar, legislation for retirement annuities. The estimated cost assumes an initial take-up of 200 000 rising to 400 000 by April 1989.

20 The changes proposed for pensions include some tightening up to guard against exploitation of the tax reliefs and some relaxations, in particular to allow members of occupational schemes to pay additional voluntary contributions to pension plans outside their employer's scheme ("freestanding AVCs"). The estimated overall cost of the package assumes an initial take-up of freestanding AVCs of 250 000 and includes a modest yield from the tightening up measures.

21 A change is proposed in the limit applicable to tax exempt life or endowment business carried on by friendly societies. The present limit of £750 gross sum assured will be changed to £100 annual premium.

22 The PAYE and subcontractor deduction schemes will be slightly amended. In particular, from April 1988 there will be an interest charge where PAYE tax, or an amount that should have been paid under deduction by a contractor, has to be formally determined. The yields shown result largely from earlier payments of tax due.

23 Where certain interest is paid between companies which are members of a group or under common control, it will be treated in all cases as being paid and received on the same day. Without this measure there could be widespread avoidance.

24 The exemption limits for trade union provident funds will be increased from £2 400 to £3 000 (for lump sums) and from £500 to £625 (for annuities).

25 Capital allowances for construction costs of properties provided for letting on assured tenancy terms by "approved bodies" were introduced in 1982 for a period of five years ending 31 March 1987. That period will be extended by a further five years ending 31 March 1992.

26 With effect from 6 April 1987, training costs borne by an employer to equip with new work skills a worker who is to leave his present employment will normally no longer be treated as taxable on the employee and the circumstances in which such costs will be allowed in computing the employer's taxable profits will be correspondingly widened.

Income tax, corporation tax and capital gains tax

27 Legislation will enable securities quoted on new Recognised Investment Exchanges to be treated in the same way as comparable securities quoted on the Stock Exchange.

Income tax, corporation tax, capital gains tax, inheritance tax and stamp duties.

28 Changes in the tax rules for unit trusts are necessary to cater for the definitional and regulatory changes relating to unit trusts introduced in the Financial Services Act.

Corporation tax

29 As a consequence of the reduction in the basic rate, the rate of advance corporation tax (ACT) for 1987-88 will be 27/73rds of the amount of the distribution. This reduction in ACT will be balanced by an increase in the subsequent liability to mainstream corporation tax.

30 The small companies' rate of corporation tax for the financial year 1987 will be reduced to 27 per cent.

31 All companies, building societies and other bodies chargeable to corporation tax will be liable to pay the tax nine months after the end of each accounting period. For individual companies etc. the change will be phased in over a period of up to three years. The yield in 1988-89 represents a bringing forward of payment dates from 1989-90.

32 Under present law capital gains by companies are reduced by one-seventh before being charged to corporation tax at 35 per cent. Gains realised from Budget day will cease to be reduced. Instead they will be taxed in full (with indexation allowance) at normal corporation tax rates. For small companies, the small companies' rate will apply to gains. The yield represents the difference between receipts at the level of capital gains before the change and receipts at the level of capital gains expected as a result of the change.

33 Credit for the payment of ACT will be allowed against liability for tax on gains realised from Budget day. The cost shown against this measure is extremely tentative.

34 Dual resident companies are companies which are simultaneously resident in two countries. It is proposed that, unless they are trading companies, they should no longer enjoy a deduction in both countries for the interest which they pay.

35 The rules for calculating banks' taxable income from making a loan to a non-resident will be changed so that any tax credit for foreign withholding tax paid or deemed to be paid on the interest they receive may be offset only against UK tax due on the turn on that loan. The yield will build up over time to about £60 million by 1990-91.

36 An effect of Section 16 of the Oil Taxation Act 1975 will be mitigated by allowing limited carry back of ACT surrendered to a ring fence subsidiary by its parent (initially restricted by a monetary ceiling of £10 million per company), or, in the case of a company owned by a consortium which is a 50/50 joint venture, by allowing surrender of ACT to the ring fence consortium company. Provision will be made to prevent the carrying back of ACT giving rise to repayment of ACT under certain repealed provisions.

37 ACT in respect of dividends paid on or after Budget day on certain preference shares where the capital raised has not been used for ring fence purposes will no longer be available for set-off against corporation tax on ring fence profits. Without this measure, there could have been widespread avoidance of the ring fence provisions, possibly costing tens of £million.

38 The capital gains provisions for groups of companies will be amended to include building societies.

39 Under Pay and File companies will estimate and pay their corporation tax on the normal due date without the need for the Inland Revenue to make estimated assessments. Interest will run from the normal due date on tax paid late by the company and on tax repaid to the company. Returns will be due twelve months after the accounting period with automatic penalties for delay. This measure will not be implemented before 1992.

40 The legislation affecting controlled foreign companies is to be amended to prevent avoidance of a UK tax charge on dividends. Without this provision, there could be a significant loss of tax.

Corporation tax and capital gains tax

41 The provisions concerned with financial futures dealt in on recognised futures exchanges and with traded options will be amended.

Oil taxation

42 Up to 10 per cent of expenditure incurred in developing certain new oil fields will be allowed against a participator's PRT liability in another field. The cost could build up to £40 million in 1989-90, and to £80 million in 1990-91.

43 Research expenditure will be allowed against a participator's PRT liability in any field if, three years after it is incurred, it has not yet become allowable for any field. No cost therefore arises until 1990-91, when it will amount to about £30 million, and £25 million thereafter (taking account of CT clawback).

44 The scope for redistributing oil allowance amongst participators, in order to correct imbalances, will be extended. The cumulative total of oil allowance will be unchanged.

Capital gains tax

45 The capital gains tax annual exempt amount is to be increased in accordance with the statutory indexation provisions from £6 300 to £6 600 in the case of individuals, and from £3 150 to £3 300 in the case of most trusts.

46 The limit for retirement relief will be increased from £100 000 to £125 000.

Inheritance tax

47 The estimated full year cost for the proposed rate structure in paragraph 4.13 attributable to transfers in 1987-88 is £220 million, measured against the indexed base.

48 The rate of relief on transfers of holdings of more than 25 per cent and up to 50 per cent in unquoted companies is to be increased from 30 to 50 per cent from Budget day. Minority holdings in Unlisted Securities Market companies will no longer qualify for business relief, but shares in such companies will be treated for all inheritance tax purposes like shares in companies with a full listing. The revenue effect of these changes is likely to be broadly neutral.

49 (a) The charge on transfers made by individuals to interest in possession trusts on or after 17 March 1987 and more than seven years before the death of the transferor will be abolished.

(b) The charge on termination of an interest in possession in settled property in favour of another individual on or after 17 March 1987 and more than seven years before the death of the person beneficially entitled to the interest will be abolished.

(c) An alternative basis will be provided for determining the rate of charge on the termination of an interest in possession in settled property in favour of a discretionary trust on or after 17 March 1987.

50 (a) Inheritance tax will not be payable in respect of settled property on the death on or after 17 March 1987 of a person beneficially entitled to an interest in possession in that property if the property becomes subject to the trusts of a qualifying heritage maintenance fund within two years (or if a Court Order is needed, within three years) after the death.

(b) The charge where property formerly subject to an interest in possession leaves a heritage maintenance fund will be altered: if the tax given up when the property entered the maintenance fund was tax on the termination of an interest in possession, the exit charge will be based on the cumulated chargeable transfers of the person whose interest was terminated.

51 (a) The tax satisfied by acceptance of pre-eminent heritage property in lieu of inheritance tax may be calculated, at the option of the offeror, by reference to the value of the property at the date of the offer instead of the value at the date of acceptance.

(b) Where this option is selected, the tax will be regarded as having been paid on the date of the offer and so will not bear interest after that date.

Stamp duties

52 Certain technical changes are proposed to the legislation governing stamp duties and the reserve tax.

VAT

53 The gross margins earned by tour operators on sales of tours within the European Community will be brought within the scope of VAT with effect from 1 April 1988.

54 The law will be changed to strengthen the rules relating to the deduction of input tax by partly exempt traders; and to exempt the underwriting of, and making of arrangements for, capital issues.

55 Businesses with annual turnover below £250 000 will have the option of accounting for VAT on the basis of payments made and received. It is intended that this system should be introduced on 1 October 1987.

56 The registration limit will be increased to £21 300 per annum and £7 250 per quarter.

57 The time allowed to notify for registration will be extended to 30 days, and it will be made easier to deregister.

58 Businesses with annual turnover below £250 000 will have the option of making a single VAT return each year (instead of the present four) with nine advance payments based normally on the VAT paid in the previous year. This system will be introduced in the second half of 1988. Certain recommendations of the Keith Committee which were due to be implemented in 1988 will, as a result, be deferred until 1989. The cost of deferral will be £25 million in 1988-89 and some £50 million to £75 million in 1989-90.

59 The special schemes for retailers are to be improved and changed in a number of ways.

60 The law will be changed to prevent the avoidance of tax on imported services by exempt businesses.

61 VAT relief for charities will be extended to certain welfare vehicles used by hospices to transport the terminally ill; to specialised location and identification equipment used by rescue and first aid services; to goods donated for export by a charity for relief of distress or animal welfare; to installing or adapting bathroom, washroom or lavatory facilities for the handicapped in charity residential homes; and to drugs and chemicals directly used by a charity in medical care or research.

Excise duties 62-69 There will be no changes in the duties on alcoholic drinks, tobacco products and most hydrocarbon oils.

70 The duty on unleaded petrol will be reduced by 5p a gallon (inclusive of consequential VAT).

71 The duty on bets placed on-course at horse and greyhound racetracks will be abolished.

72 The rates of gaming machine licence duty will be increased as follows:

for 5p "amusement with prizes" machines by £30

for 10p "amusement with prizes" machines by £75

for 5p jackpot machines by £75

for 10p jackpot machines by £210

The amount of refund on surrender of a licence will be increased and the arrangements for collecting the duty will be changed.

Vehicle excise duties 73 There will be no change in the duties on cars, light vans, taxis, buses, coaches, motor cycles and most lorries.

74 The concessionary rates of duty for farmers' heavy goods vehicles over 7.5 tonnes will be increased by varying amounts as the final stage in the process of bringing them into line with the proportion of average mileage covered by these vehicles on public roads. From 1 January 1988 the rate of duty for trade licences will be increased to £85 for cars and £17 for motor cycles, as the second stage in the process of increasing these rates to the rates for ordinary licences for cars and motor cycles between 150cc and 250cc, respectively.

75 From 1 January 1988 a new taxation class will be created for recovery vehicles. The rate of duty will be set at £50.

76 The law will be amended so that, on conviction for VED evasion, the courts will be required to order payment of all back duty due from that offender from the expiry of the last licence or date of acquisition of the vehicle, without regard for any non-use of the vehicle during the period. The maximum penalty for failure to return a licence, issued against a cheque that is subsequently dishonoured, will be increased.

Other 77 There will be no change in bus fuel grant.

5 Public expenditure

Public spending plans 5.01 The 1987 public expenditure White Paper (Cm 56) set out plans for public spending for the next three years and provided the basis for the more detailed Supply Estimates, cash limits and other spending controls for 1987-88. These plans are summarised in Table 5.1. The Budget makes no change to them.

Changes since previous Budget 5.02 Since the last FSBR, extra funds have been allocated to priority services including education, health and law and order. The estimated costs of some demand-led programmes, such as social security, have also risen.

Table 5.1 Public expenditure

	£ billion				
	1985-86 Outturn	1986-87 Estimated outturn	1987-88 Plans	1988-89 Plans	1989-90 Plans
Department					
DHSS - social security	41.5	44.6	46.0	47.5	49.3
Defence	18.0	18.2	18.8	19.0	19.5
DHSS - health and personal social services	16.6	18.0	19.1	19.9	20.8
Education and science	14.5	15.7	16.6	17.4	17.8
Home Office (and Lord Chancellor's Department)	5.3	5.8	6.2	6.4	6.6
Employment	3.4	3.8	4.0	4.2	4.3
Other departments	37.1	38.3	39.4	39.4	40.7
Privatisation proceeds	-2.7	-4.4	-5.0	-5.0	-5.0
Reserve			3.5	5.5	7.5
Public expenditure planning total	133.6	140.0	148.6	154.2	161.5
General government gross debt interest*	17.6	17.5	17.9	18	19
Other adjustments*	7.5	7.4	7.0	8	8
General government expenditure*	158.8	164.9	173.5	180	188
Planning total in real terms (base year 1985-86)	133.6	135.8	137.9	137.6	139.2
General government expenditure as a percentage of GDP	44	43	42½	41½	40½

* 1988-89 and 1989-90 figures rounded to nearest £1 billion.

Public spending trends 5.03 The plans show a further fall in general government spending as a percentage of GDP in each of the next three years (see Table 5.1); this would still be the case even without any proceeds from privatisation. By 1989-90, the percentage should be back to the level of the early seventies. This reflects the Government's continued objective of reducing steadily the state's share of the nation's income.

5.04 General government expenditure covers spending by central government and local authorities. It is the key public spending aggregate used in the Medium Term Financial Strategy. The main difference between general government expenditure and the planning total is the inclusion in the former of gross debt interest, amounting to some £18 billion in 1987-88. There are also a number of other definitional differences and adjustments, which are described in the Annex to Part 2 of the 1987 public expenditure White Paper. In 1987-88, these adjustments account for a further £7 billion.

1986-87 outturn 5.05 The latest estimates, which still remain subject to some uncertainty, suggest that the planning total outturn in 1986-87 is likely to be about £140.0 billion, £0.9 billion above the plans shown in the 1986 public expenditure White Paper and the 1986 Budget. The details are shown in Table 5.2.

Table 5.2 Comparison of plans and estimated outturn for 1986-87

	1986-87 £ billion		
	Plans ¹	Estimated outturn	Outturn minus plans
Central government ²	102.6	105.0	+ 2.4
Local authority ²	35.2	38.1	+ 3.0
of which:			
relevant expenditure	27.0	29.4	+ 2.5
other current	4.5	4.8	+ 0.3
capital	3.7	3.8	+ 0.2
Nationalised industries and other public corporations	1.6	1.3	- 0.3
Privatisation proceeds	- 4.8	- 4.4	+ 0.4
Reserve	4.5		- 4.5
Public expenditure planning total	139.1	140.0	+ 0.9

¹ Plans from The Government's Expenditure Plans 1986-87 to 1988-89, Cmd 9702, adjusted for classification changes.

² Excluding finance for nationalised industries and other public corporations.

5.06 The major changes between plans and estimated outturn are:

an increase of £3.0 billion in local authority expenditure including an overrun of £2.5 billion on expenditure relevant for Aggregate Exchequer Grant (relevant expenditure);

an increase in social security expenditure of £1.7 billion;

additional equity of £0.7 billion in Rover Group to meet debt and restructuring costs associated with disposal of their trucks and bus businesses.

The additions to programmes amount to some £5.0 billion and, together with a shortfall of £0.4 billion on privatisation proceeds, exceed the Reserve of £4.5 billion. The consequent overrun on the planning total amounts to about £0.9 billion.

Table 5.3 Public expenditure by spending authority

	£ billion				
	1985-86 Outturn	1986-87 Estimated outturn	1987-88 Plans	1988-89 Plans	1989-90 Plans
Central government*	98.5	105.0	108.3	111.2	115.7
of which:					
Voted in Estimates	71.3	74.5	76.3	78.7	81.1
other	27.1	30.5	32.0	32.5	34.6
Local authorities*	35.2	38.1	40.2	41.1	42.4
of which:					
relevant expenditure	26.9	29.4	31.0	32.2	33.1
other current	4.5	4.8	4.9	4.9	5.2
capital	3.9	3.8	4.3	4.0	4.1
Nationalised industries	1.7	0.5	0.7	0.3	- 0.1
Other public corporations	0.9	0.9	1.0	1.0	1.1
Privatisation proceeds	- 2.7	- 4.4	- 5.0	- 5.0	- 5.0
Reserve			3.5	5.5	7.5
Public expenditure planning total	133.6	140.0	148.6	154.2	161.5

*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 of the total. Table 5.3 gives outturn figures for the last two years and the plans as published in the public expenditure White Paper.

Supply Estimates 5.08 For 1987–88, 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 1987–88 for which the Government is seeking Parliamentary approval is shown in Table 5.4. The main Estimates for 1987–88 are published in a series of booklets on 17 March 1987 with a Summary and Guide (Cm 94) 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 £104.5 billion included in the Supply Estimates, £78.8 billion is direct public expenditure. The remaining £25.6 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. Just over 60 per cent of the money voted in Estimates is subject to cash limits, which provide the Government with greater control over its cash expenditure during the financial year.

Table 5.4 Supply expenditure

	£ billion		1986–87	1987–88
	1985–86			
	Expected outturn in 1986 Budget	Final outturn	Expected outturn	Provision
Main Supply Estimates	96.0	96.0	99.1	104.5
Supplementaries and net under-spending	2.0	2.1	2.8	
Total Supply expenditure	98.1	98.1	101.9	
(public expenditure element)	(74.9)	(75.0)	(77.3)	

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 1987–88, together with new estimates of outturn in 1986–87. 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 borrowing

	£ billion			
	1985–86	1986–87		1987–88
	Outturn	1986 Budget★	Latest estimate	Forecast
General government expenditure	158.8	163.9	164.9	173.5
General government receipts	151.9	156.4	159.2	168.8
General government borrowing requirement	6.9	7.5	5.7	4.7
Public corporations' market and overseas borrowing	− 1.1	− 0.4	− 1.6	− 0.8
Public sector borrowing requirement	5.8	7.1	4.1	3.9

* On current definitions.

6.02 The PSBR is now estimated to be about £4 billion in 1986–87, compared with the forecast of £7 billion made a year ago. The PSBR is also forecast to be about £4 billion in 1987–88.

Public sector's finances: three-fold analysis 6.03 The public sector's finances can be analysed in a number of different ways:

by type or activity, showing on the one hand the different types of receipts (income taxes, corporation taxes, capital taxes, expenditure taxes, North Sea revenues, and so on); and on the other hand the spending (on social security, defence, health, education and so on) financed by those receipts and by borrowing;

by sector, showing the authority which undertakes the financing or spending: central government, local authorities or public corporations;

by economic category, showing, for example, whether the receipts and spending are current or capital transactions and whether current spending is on goods and services or transfer payments.

6.04 This three-fold analysis of the public sector's finances is analogous to the three-fold presentation of public spending that has become an established feature of the public expenditure White Paper (see paragraph 13 of Cm 56-I). The rest of this chapter sets out these three analyses in detail.

Public sector's finances: analysis by type or activity

6.05 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 public sector borrowing requirement (PSBR), is derived from those two totals. This derivation is repeated in Table 6.1.

Receipts 6.06 The Autumn Statement said that general government receipts in 1986-87 were likely to be higher than forecast in the 1986 Budget. The size of the overshoot now appears to be greater than envisaged then. Total general government receipts are now estimated to be £2½ billion higher than the 1986 Budget forecast, despite a shortfall of £1¼ billion in oil receipts. As Table 1.2 shows, non-North Sea corporation tax (£1½ billion) and VAT (£¾ billion) account for most of the additional receipts. Stamp duties account for nearly a further £½ billion.

6.07 The shortfall in oil revenues mainly reflects lower than assumed oil prices in 1986 and the £0.3 billion repayment of advance petroleum revenue tax announced in the Autumn Statement. Oil revenues are now estimated to have fallen from £11½ billion in 1985-86 to £4¾ billion in 1986-87. They are forecast to fall further to £4 billion in 1987-88. This reduction is more than accounted for by lower receipts of North Sea corporation tax. This reflects the fall in oil prices in 1986, as corporation tax is paid with a lag.

6.08 The forecast of oil revenues is based on the assumption of an average oil price of \$15 a barrel and also assumes that the exchange rate will remain close to its current level. Oil production is forecast to fall slightly in 1987. A \$1 a barrel difference in the oil price in 1987 would change revenues by about £350 million in 1987-88 and £400 million in a full year. A change of 1 million tonnes in oil production in 1987, spread evenly across fields, would alter revenues by about £45 million in 1987-88 and £50 million in a full year.

6.09 The 1986 Budget expected total non-oil receipts to rise a little less than the projected rise in non-oil money GDP. They are now estimated to have risen slightly more, by 9¾ per cent, compared with an estimated 9 per cent rise in non-oil money GDP. Corporation tax receipts in 1986-87 largely depend on profits and other income earned in calendar year 1985. On currently available data non-North Sea company incomes rose strongly in 1985. The rise, however, is insufficient to explain the whole of the increase in corporation tax receipts. One possibility is that current estimates understate the full rise in company income. Another possibility is that the distribution of total income growth among individual companies was such that less use was made of capital allowances and other tax offsets than the forecast implied. The greater than expected buoyancy of VAT is partly attributable to total consumer spending rising a little faster than forecast, but also reflects a change in the composition of consumption towards spending on goods and services subject to VAT.

6.10 In 1987-88 both total and non-oil money GDP are forecast to increase at much the same rate, about 7½ per cent. Non-oil receipts are forecast to rise by nearly 7 per cent, after taking account of the Budget proposals. As Table 1.2 shows there is within this overall increase:

a further rise, of 21 per cent, in receipts of corporation tax (excluding North Sea mainstream corporation tax). This reflects continued growth of company incomes in 1986;

a 4 per cent increase in receipts from income tax—lower than the increase in personal incomes, reflecting the income tax reductions announced in the Budget;

an 8½ per cent increase in VAT receipts, following an 11 per cent increase in 1986-87. The rate of increase in consumer spending on goods and services subject to VAT is forecast to be lower in 1987-88 than in 1986-87;

an 8½ per cent increase in net local authority rate income, a smaller increase than in 1986-87;

a 3 per cent increase in revenue from excise duties.

6.11 Table 6.2 shows taxes (including rates) and national insurance contributions as a percentage of GDP. While, overall, the percentage is estimated to have fallen in 1986-87 and is forecast to fall a little further in 1987-88, non-oil taxes are estimated to have risen in 1986-87 as a percentage of non-oil GDP, and are likely to increase marginally in 1987-88.

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

	1981-82	1982-83	1983-84	1984-85	1985-86	1986-87 Latest estimate	1987-88 Forecast
Total taxes and NICs as a share of total money GDP	39.4	39.2	38.6	39.1	38.6	38.2	38.0
Non-oil taxes and NICs as a share of non-oil money GDP	38.8	38.4	37.9	37.8	37.2	37.7	37.8

Expenditure 6.12 Total general government expenditure is expected to be £165 billion in 1986-87, a little higher than in the Autumn Statement and public expenditure White Paper, and £1 billion higher than in the 1986 Budget forecast. There are two main reasons for the overspend compared with the Budget forecast. First, as explained in Chapter 5, the planning total is expected to be about £1 billion higher than planned. Secondly within public corporations' external financing requirement, a component of the planning total, public corporations have met a higher proportion by government borrowing and a smaller proportion by market and overseas borrowing. Partially offsetting these factors is an estimated £¾ billion reduction in the forecast of general government debt interest payments.

6.13 General government expenditure is expected to rise by 5 per cent in 1987-88, to £173½ billion. The planning total, at £148.6 billion, is the same as in the public expenditure White Paper. General government gross debt interest payments are forecast to rise a little in 1987-88.

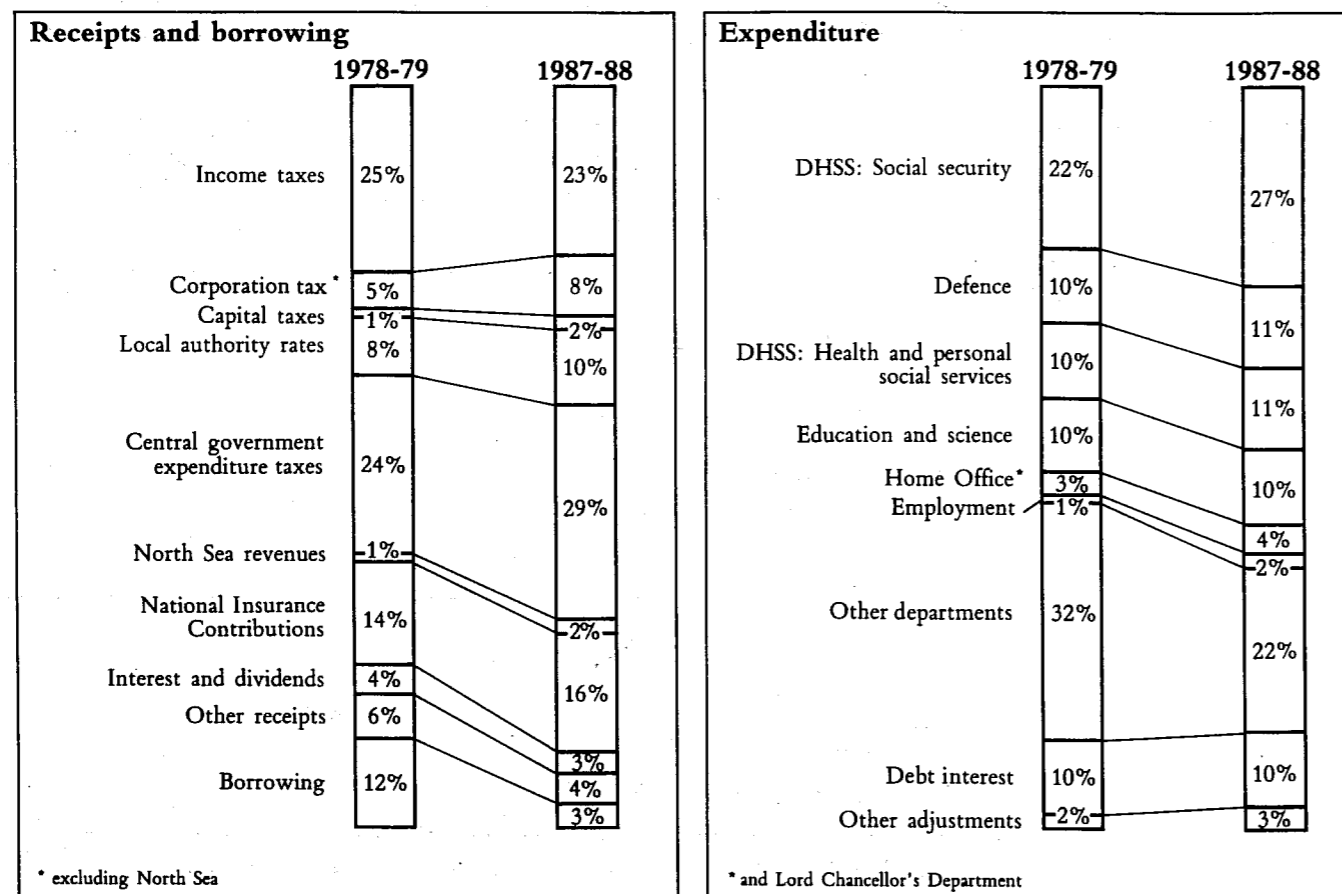
Borrowing 6.14 The difference between general government receipts and expenditure is the general government borrowing requirement (GGBR), as shown in Table 6.1. As general government lending to public corporations is included in general government expenditure, the GGBR together with public corporations' market and overseas borrowing, gives the PSBR.

6.15 A year ago the PSBR in 1986-87 was forecast at £7.1 billion. Borrowing in the eleven months to February is provisionally estimated to have been £0.1 billion. Borrowing in March is always relatively high. Central government expenditure is likely to be unusually high this March as a result of transactions related to the Rover Group, while revenue is expected to be less than last year, with lower receipts from the North Sea, as a result of the fall in oil prices. Local authority borrowing is always high in the closing weeks of the financial year. The latest estimate of the outturn for the PSBR in 1986-87 as a whole is £4.1 billion, or 1 per cent of money GDP.

6.16 The PSBR in 1987-88 is also forecast to be about £4 billion, or 1 per cent of money GDP.

6.17 Chart 6.1 shows the significant changes in the structure of general government receipts and expenditure which have taken place since 1978-79.

Chart 6.1 The structure of receipts and expenditure



Public sector's finances: analysis by sector

6.18 The PSBR may also be analysed by the authority or sector which will be undertaking (or repaying) the borrowing: central government, local authorities and public corporations. Table 6.3 shows the sectoral composition of the PSBR in 1986-87, in summary form.

Table 6.3 Public sector borrowing requirement

	£ billion	
	1985-86 Outturn	1986-87 Latest estimate
1 Central government borrowing on own account	4.1	5.0
2 Local authority borrowing from central government	5.7	4.9
3 Local authority borrowing from market and overseas	-4.1	-4.4
4 Total local authority borrowing	1.7	0.5
5 Public corporations' borrowing from central government	1.1	0.2
6 Public corporations' borrowing from market and overseas	-1.1	-1.6
7 Total public corporations' borrowing	0.0	-1.4
8 Public sector borrowing requirement	5.8	4.1
Memorandum item:—		
Central government borrowing requirement (lines 1 + 2 + 5)	10.9	10.0

6.19 Tables 6.4 to 6.6 show estimated outturns and forecasts of receipts and expenditure in 1986-87 and 1987-88 for each of the three sectors. These tables include some of the analysis by economic category in Table 6.7. Expenditure in 1987-88 does not include the Reserve, which has not been allocated. The forecast of the PSBR assumes however 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 Tables 6.5 and 6.6.

Table 6.4 Central government transactions

	£ billion		
	1985-86 Outturn	1986-87 Latest estimate	1987-88 Forecast
Receipts			
Taxes and royalties	100.8	103.9	110.9
National insurance and other contributions	24.5	26.5	28.5
Other	9.7	10.7	10.4
Total receipts	135.0	141.1	149.8
Expenditure			
Current expenditure on goods and services	46.6	49.4	52.0
Current grants and subsidies	72.1	77.1	79.4
Interest	16.1	16.5	17.2
Net lending and capital expenditure, excluding on-lending to local authorities and public corporations	4.3	3.1	2.6
Total expenditure	139.1	146.1	151.3*

*Excluding any allocation from the Reserve

Local authorities 6.21 Local authority receipts consist primarily of rate income plus grants from central government. The forecast increase in net rate income between 1986-87 and 1987-88 takes account of available information about rate decisions by local authorities and additions to rateable value.

6.22 The local authority borrowing requirement (LABR) in the first eleven months of 1986-87 is provisionally estimated to have been a net repayment of £0.7 billion. The estimated outturn for the year as a whole is borrowing of £0.5 billion. This estimate takes account of the usual high level of borrowing in March. If the estimated outturn is correct, and the margin of error surrounding the forecast is inevitably very large, the LABR in 1986-87 will be over £1 billion lower than in 1985-86. This fall in borrowing appears to have been the result of current receipts rising more than current expenditure and a small fall in net capital spending. In 1986-87, as in 1985-86, local authorities replaced substantial amounts of market and overseas borrowing by borrowing from the central government.

Table 6.5 Local authority transactions

	£ billion		
	1985-86 Outturn	1986-87 Latest estimate	1987-88 Forecast
<i>Receipts</i>			
Rates (net of rate rebates) ¹	13.8	15.5	16.9
Rate support grant	11.2	11.8	12.2
Other grants from central government	10.1	11.4	12.6
Other	5.6	6.0	5.8
Total receipts	40.7	44.8	47.5
<i>Expenditure</i>			
Current expenditure on goods and services	28.6	31.3	33.1
Current grants and subsidies	5.3	5.7	5.6
Interest	4.4	4.4	4.4
Net lending and capital expenditure	4.3	3.9	4.2
Total expenditure	42.5	45.3	47.3²
¹ Memo: Rate rebates	1.6	1.7	1.9

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 planning total. Changes from one year to another are affected by privatisations. During the course of 1986-87 British Gas and British Airways were privatised and ceased to be classified as public corporations.

Table 6.6 Public corporations' transactions

	£ billion		
	1985-86 Outturn	1986-87 Latest estimate	1987-88 Forecast
<i>Receipts</i>			
Gross trading surplus (including subsidies)	8.1	7.0	7.0
Other	2.0	3.6	2.4
Total receipts	10.1	10.6	9.4
<i>Expenditure</i>			
Interest, dividends and taxes on income	4.3	3.7	3.5
Net lending and capital expenditure	5.8	5.5	5.0
Total expenditure	10.1	9.2	8.5*

* Excluding any allocation from the Reserve

6.24 Public corporations' borrowing requirement in the first eleven months of 1986-87 is provisionally estimated at a net repayment of £1.4 billion. The estimated outturn for the year as a whole is also a net repayment of £1.4 billion, compared with a nil borrowing requirement in 1985-86.

Public sector's finances: analysis by economic category

6.25 The transactions leading up to the PSBR may also be analysed by economic category (some details of which are given in Tables 6.4 to 6.6 above). This analysis 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 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 surplus/deficit line. In practice allocations from the Reserve can affect financial transactions (lines 25 to 29). For example expenditure in 1986-87 associated with Rover Group is classified as cash expenditure on company securities and appears in line 26.

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

	Line ²	£ billion ¹			Public corpora- tions	Public sector
		1986-87 Latest estimates				
		General government				
		Central govern- ment	Local authori- ties	Total		
<i>Current and capital receipts</i>						
Taxes on income, and oil royalties	1	53.2	—	53.2	-0.1	53.1
Taxes on expenditure	2	48.0	15.5	63.5	—	63.5
Taxes on capital	3	2.7	—	2.7	—	2.7
National insurance and other contributions	4	26.5	—	26.5	—	26.5
Gross trading surplus	5	-0.3	0.4	0.1	7.0	7.1
Rent and miscellaneous current transfers	6	0.2	3.1	3.3	0.5	3.8
Interest and dividends from private sector and abroad	7	2.7	0.7	3.4	0.8	4.1
Interest and dividends within public sector	8	5.8	-3.3	2.4	-2.4	—
Imputed charge for non-trading capital consumption	9	1.0	1.4	2.4	—	2.4
Capital transfers from private sector	10	—	—	—	0.2	0.2
Total receipts	11	139.8	17.8	157.6	6.0	163.5
<i>Current and capital expenditure</i>						
Current expenditure on goods and services	12	-49.4	-31.3	-80.7	—	-80.7
Subsidies	13	-5.1	-1.2	-6.3	—	-6.3
Current grants to personal sector	14	-46.6	-4.5	-51.1	—	-51.1
Current grants paid abroad	15	-3.1	—	-3.1	—	-3.1
Current grants within public sector	16	-22.3	22.3	—	—	—
Debt interest	17	-16.5	-0.9	-17.5	-0.8	-18.3
Gross domestic fixed capital formation	18	-3.3	-3.6	-7.0	-5.3	-12.3
Increase in stocks	19	0.1	—	0.1	0.1	0.2
Capital grants to private sector	20	-2.2	-0.6	-2.9	-0.1	-3.0
Capital grants within public sector	21	-1.5	0.9	-0.6	0.6	—
Total expenditure	22	-149.9	-19.0	-168.9	-5.6	-174.5
Unallocated Reserve	23	—	—	—	—	—
Financial surplus/deficit	24	-10.2	-1.2	-11.3	0.4	-11.0
<i>Financial transactions</i>						
Net lending to private sector and abroad	25	-0.2	0.4	0.2	-0.2	—
Cash expenditure on company securities (net) (including privatisation proceeds)	26	4.0	—	4.0	—	4.0
Transactions concerning certain public sector pension schemes	27	0.8	—	0.8	—	0.8
Accruals adjustments	28	0.1	—	0.1	—	0.1
Miscellaneous financial transactions	29	0.5	0.3	0.7	1.2	2.0
Borrowing requirement	30	5.0	0.5	5.5	-1.4	4.1

¹ Sign convention: receipts positive, payments negative.² Relationship between lines: (24) = (11) + (22) + (23)
(30) = -(24 to 29)

£ billion ¹						
1987-88 Forecasts						
General government				Public corpora- tions	Public sector	
Line ²	Central govern- ment	Local authori- ties	Total			
<i>Current and capital receipts</i>						
1	56.8	—	56.8	-0.1	56.6	Taxes on income, and oil royalties
2	50.9	16.9	67.8	—	67.8	Taxes on expenditure
3	3.3	—	3.3	—	3.3	Taxes on capital
4	28.5	—	28.5	—	28.5	National insurance and other contributions
5	-0.3	0.5	0.2	7.0	7.1	Gross trading surplus
6	0.3	3.1	3.4	0.5	3.9	Rent and miscellaneous current transfers
7	2.9	0.6	3.5	0.7	4.2	Interest and dividends from private sector and abroad
8	5.9	-3.7	2.2	-2.2	—	Interest and dividends within public sector
9	1.1	1.5	2.5	—	2.5	Imputed charge for non-trading capital consumption
10	—	—	—	0.3	0.3	Capital transfers from private sector
11	149.2	18.9	168.1	6.1	174.2	Total receipts
<i>Current and capital expenditure</i>						
12	-52.0	-33.1	-85.1	—	-85.1	Current expenditure on goods and services
13	-5.1	-1.0	-6.1	—	-6.1	Subsidies
14	-47.8	-4.6	-52.4	—	-52.4	Current grants to personal sector
15	-2.9	—	-2.9	—	-2.9	Current grants paid abroad
16	-23.6	23.6	—	—	—	Current grants within public sector
17	-17.2	-0.6	-17.9	-0.9	-18.7	Debt interest
18	-3.5	-3.6	-7.1	-4.6	-11.6	Gross domestic fixed capital formation
19	-0.2	—	-0.2	-0.1	-0.3	Increase in stocks
20	-2.0	-0.7	-2.8	-0.1	-2.9	Capital grants to private sector
21	-1.7	1.1	-0.6	0.6	—	Capital grants within public sector
22	-156.1	-18.9	-175.0	-5.0	-180.1	Total expenditure
23					-3.5	Unallocated Reserve
24					-9.4	Financial surplus/deficit
<i>Financial transactions</i>						
25	-0.2	0.2	—	-0.2	-0.2	Net lending to private sector and abroad
26	5.0	—	5.0	—	5.0	Cash expenditure on company securities (net) (including privatisation proceeds)
27	0.5	—	0.5	—	0.5	Transactions concerning certain public sector pension schemes
28	-0.1	—	—	—	—	Accruals adjustments
29	0.3	—	0.2	—	0.2	Miscellaneous financial transactions
30					3.9	Borrowing requirement

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 as the sum of 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 and 3.12 to 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 1986–87 will accordingly be published on April 16. The first national accounts outturns for 1986–87 will appear in the June issue of Financial Statistics, including supplementary Table 13 which is based on Table 6.7.

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 1986–87 latest estimate
<i>Consolidated Fund</i>	
Revenue (Table 6B.3)	111.1
Expenditure (Table 6B.2)	– 116.2
Deficit met from National Loans Fund	– 5.1
<i>National Loans Fund (Table 6B.4)</i>	
Receipts	15.6
Payments	– 25.4
Total net borrowing by the National Loans Fund	– 9.8
Other funds and accounts (net)	– 0.2
Central government borrowing requirement* (Table 6.3)	– 10.0

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

Table 6B.2 Consolidated Fund expenditure

	£ million 1986–87 latest estimate
Supply issues ¹	101 900
<i>Standing services</i>	
Payment to the National Loans Fund in respect of service of the national debt	8 900
Northern Ireland—share of taxes etc.	2 000
Payments to the European Communities ²	3 300
Other services	110
Total standing services	14 300
Total Consolidated Fund expenditure	116 200

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.

²£500 million was paid to the European Communities from Supply Issues instead of Standing Services.

Table 6B.3 Consolidated Fund revenue

	£ million		
	1986-87		1987-88
	1986 Budget	Latest estimate	Forecast
<i>Inland Revenue</i>			
Income tax ¹	38 500	38 300	39 900
Corporation tax ²³	11 700	13 400	15 000
Petroleum revenue tax ⁴	2 400	1 260	1 680
Capital gains tax	1 050	1 050	1 300
Development land tax	35	55	20
Inheritance tax ⁵	910	990	1 100
Stamp duties	1 430	1 840	2 100
Total Inland Revenue	56 000	56 900	61 100
<i>Customs and Excise</i>			
Value added tax	20 700	21 500	23 300
Petrol, derv etc.	7 300	7 500	7 800
Cigarettes and other tobacco	4 700	4 700	4 800
Spirits, beer, wine, cider and perry	4 400	4 200	4 300
Betting and gaming	800	760	800
Car tax	980	980	1 100
Other excise duties	20	20	20
EC own resources ⁶			
Customs duties, etc.	1 300	1 290	1 350
Agricultural levies	160	220	230
Total Customs and Excise	40 400	41 200	43 800
Vehicle excise duties ⁷	2 500	2 500	2 600
Gas levy	500	520	490
Broadcasting receiving licences	1 000	1 010	1 030
Interest and dividends	840	870	1 020
Other ⁸	7 400	8 100	7 600
Total Consolidated Fund revenue	108 600	111 100	117 500

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 payments of 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 (see Table 1.2).

Table 6B.4 National Loans Fund receipts and payments

	£ million 1986-87 Latest estimate
<i>Receipts</i>	
Interest on loans, profits of the Issue Department of the Bank of England, etc.	6 700
Service of the National Debt—balance met from the Consolidated Fund	8 900
Total receipts	15 600
<i>Payments</i>	
Service of the National Debt:	
interest	15 400
management and expenses	170
Total service of the National Debt	15 600
Loans to:	
nationalised industries	- 390
other public corporations	120
local authorities	4 900
private sector and within central government	100
Total National Loans Fund lending*	4 700
Consolidated Fund deficit	5 100
Total payments	25 400

*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).