SM/87/85

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INFORMATION

April 6, 1987

To: Members of the Executive Board

From: The Secretary

Subject: United Kingdom - The 1987 Budget

Attached for the information of the Executive Directors is a paper on the 1987 budget of the United Kingdom, which was prepared at the request of a number of Executive Directors during the discussion of the staff report for the 1986 Article IV consultation with the United Kingdom, at Executive Board Meetings 87/31 and 87/32 (2/24/87).

Mr. Hadjimichael (ext. 8794) is available to answer technical or factual questions relating to this paper.

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INTERNATIONAL MONETARY FUND

UNITED KINGDOM

The 1987 Budget

Prepared by the European Department

Approved by L. A. Whittome

April 6, 1987

1. Overview

The budget for fiscal year 1987/88 (year ending March) was presented on March 17, 1987. As a result of the buoyancy of non-oil tax receipts, the estimated outturn for the public sector borrowing requirement (PSBR) for 1986/87 has been revised downward to £4 billion (1 percent of GDP), compared with the budget target of £7 billion and the outturn of £5.8 billion (1.6 percent of GDP) in 1985/86 (Table 1). This is the second successive year that the PSBR significantly undershot its target. Even if privatization proceeds were to be excluded, the PSBR amounted in 1986/87 to the equivalent of 2.3 percent of GDP, the lowest level since 1971/72. The strong growth in non-oil tax receipts, which is in part cyclical in nature but reflects also a permanent increase in corporate profit tax revenue, left room for both tax cuts and a reduction in the PSBR in the budget for 1987/88. In the event, the Chancellor of the Exchequer decided to "err on the side of prudence and caution" and provided for a PSBR of £4 billion (1 percent of GDP) in 1987/88. This is £3 billion lower than indicated in the Medium-Term Financial Strategy (MTFS) of 1986 1/ and lower than had generally been anticipated. At the same time, the budget provided, as expected, for a reduction of 2 percentage points to 27 percent in the basic rate of personal income tax and for some other measures of tax relief at a total cost of about £2.6 billion.

The budget for 1987/88 includes also an outline of the Government's Medium-Term Financial Strategy for the period ahead. The new MTFS postulates a deceleration in the growth of nominal GDP to 5 1/2 percent by 1990/91, and incorporates a target range of 2-6 percent for the growth in narrow money (MO) in 1987/88, with gradually declining illustrative ranges thereafter. In view of the difficulties in

1/ The MTFS of March 1986 provided for an illustrative target for the PSBR in 1987/88 of £7 billion (1 3/4 percent of GDP). In his Autumn Statement of November 1986, the Chancellor reaffirmed the Government's commitment to achieving this target, despite the £4.7 billion increase in public spending provided for 1987/88 in the revised government expenditure plans.

forecasting changes in the velocity of broad money, no explicit target range has been set for the growth in £M3 in 1987/88, but the Government would continue to take into account developments in broad money in assessing monetary conditions. To support monetary policy, the PSBR would henceforth be maintained at the equivalent of 1 percent of GDP, thus below the path indicated for the PSBR in last year's MTFS. The buoyancy of non-oil tax revenue has enabled the Government to achieve its long-term objective for the PSBR sooner than otherwise would have been the case.

The budget has been received favorably by the financial markets. The base interest rate, which had been raised by 1 percentage point to 11 percent in October 1986 and allowed to fall by 1/2 percentage point in early March 1987, was reduced by a further 1/2 percentage point one day after the budget. In anticipation of further declines in domestic interest rates, mortgage rates were also lowered by 1 percentage point on March 20, 1987. The effective exchange rate of the pound sterling had firmed prior to the budget and on March 31, 1987 was at a level 4.5 percent higher than in December 1986.

Section 2 of this note outlines the revised economic forecast included in the budget, while Section 3 describes briefly the main tax measures announced for 1987/88. 1/ Section 4 outlines the new MTFS, and Section 5 provides a staff appraisal.

2. Revised economic forecasts

Developments in 1986 and the official forecasts (based on the *Autumn Statement* of November 1986) for 1987 were described in the staff report for the 1986 Article IV consultation with the United Kingdom (SM/87/25, 1/28/87). The revised forecasts for 1987 included in the budget documents differ somewhat from those of the *Autumn Statement* in that they project a stronger pickup in real gross fixed investment, a higher rate of growth in the volume of exports of goods and services, a slightly higher rate of inflation, and a larger external current account deficit (Table 2). In particular, real gross fixed investment and the volume of total exports are now both expected to rise by 4 percent, compared with increases of 2 1/2 percent and 3 percent, respectively, previously anticipated. A slower growth in real government consumption and a higher growth in the volume of imports of goods and services is forecast, however, leaving the rate of growth of real GDP unchanged at 3 percent. Retail price inflation is now expected to continue to edge upward, rising temporarily to over 4 1/2 percent by mid-1987 before falling to 4 percent by the end of the year, a rate one quarter of 1 percentage point higher than projected in the *Autumn Statement*.

1/ Revised government expenditure plans for 1986/87 and the subsequent three fiscal years were announced in the *Autumn Statement* of November 1986 and were summarized in SM/87/25 (1/28/87) and SM/87/32 (2/10/87).

Nonetheless, the lower pay settlements in manufacturing recorded in recent months are expected to lead to a slower growth in average earnings and, combined with a marked growth in productivity, to a rise of only 1 1/2 percent in unit labor costs, compared with an increase of 2 1/2 percent previously forecast.

Following the revision of the external current account deficit in 1986 from £0.2 billion reported earlier to £1.1 billion (1/4 percent of GDP), as a result of a sizable downward revision of the surplus on net invisibles (due largely to lower earnings on U.K. direct investment overseas), the current account deficit in 1987 is now forecast to widen to £2 1/2 billion (1/2 percent of GDP), £1 billion higher than projected in the Autumn Statement. The price of oil in 1987 is assumed to remain on average at US$15 per barrel.

3. Tax measures

The main tax measures announced in the budget for 1987/88 included, in addition to the cut in the basic rate of income tax, the indexation of the main income tax allowances; the introduction of a tax incentive to encourage the spread of profit-related pay schemes; a reduction in the corporation tax rate for small businesses; modifications of the VAT system to assist small businesses; and measures to encourage personal pensions. In contrast to the practice of previous budgets, the budget did not adjust the excise duties on tobacco and beverages and other specific duties for inflation (at a total cost of £545 million in 1987/88 (Table 3)). 1/ More details on the proposed tax measures are provided below:

a. Income tax

In his budget speech, the Chancellor reaffirmed the Government's objective of reducing the basic rate of income tax to 25 percent but pointed out that, given the decision to seek a further lowering of the PSBR, this objective could not be achieved in the 1987 budget. Nonetheless, the budget provided, effective May 17, for a further reduction of 2 percentage points in the basic rate to 27 percent (costing £1.9 billion in 1987/88 and £2.7 billion in 1988/89 from an indexed base). 2/ In addition, the main income tax personal allowances will be raised by 3.7 percent, the inflation rate in the year to December 1986, in line with statutory provisions. The lower income bracket for the 40 percent marginal tax rate will also be raised in line with inflation, while that for the 45 percent rate will be raised by

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1/ Had the excise duties on tobacco and beverages been raised in line with inflation to maintain their real value, it is estimated that their impact on the retail price index would have been an increase of less than 1/2 percentage point.

2/ The indexed base assumes that income tax allowances and income tax brackets are raised in line with inflation.

only 1 percent. The income brackets for the three highest marginal tax rates, however, will remain unchanged. Allowances for those aged 80 years or more and for the blind will also be increased.

b. Profit-related pay

A new income tax relief will be introduced to encourage the spreading of profit-related pay (PRP) schemes, along the lines proposed in a Green Paper issued in mid-1986 with only one major change. Half of the profit-related pay of an employee on a PRP scheme meeting certain conditions will be exempt from his income tax (compared with only 25 percent proposed by the Green Paper), up to a maximum limit of £3,000 per year or 20 percent of total taxable pay, whichever is lower.

c. Business taxation

The business tax reform introduced in the budget of 1984, entailing inter alia a phased decline in the corporation tax rate from 52 percent to 35 percent, came fully into effect in April 1986. The main corporation tax rate will be maintained in 1987/88 at 35 percent (lower than in any other major industrial country). The tax rate for small businesses, however, will be lowered by 2 percentage points to 27 percent, in line with the reduction in the basic rate of personal income tax. The budget also introduced several measures of simplification and rationalization of the corporation tax system, involving mainly the treatment of capital gains.

To assist the North Sea oil sector, the budget provided for two additional petroleum revenue tax reliefs, designed to encourage the development of certain new oil fields and research into U.K. oil exploration.

d. Value-added tax

The VAT rate will remain at 15 percent. The registration threshold will be raised to the maximum level permitted under European Community law, while the registration period will be extended from 10 days to 30 days. The rules of the VAT system will also be simplified and modified to assist small businesses. In particular, small businesses with an annual turnover of less than £250,000 (over half of all traders registered for VAT) will be given the option of (1) accounting for VAT on the basis of payments received and paid (effective October 1987 and subject to the approval of the EC), i.e., qualified traders will have no liability to pay VAT until they themselves have been paid by their customers; and (2) accounting for VAT on an annual basis instead of the present requirement for quarterly returns (with effect from the summer of 1988).

e. Taxation of savings

Complementing the reforms of social security introduced with the Social Security Acts of 1985 and 1986, the budget contains a package of proposals to encourage a wider spreading of personal pensions. A new tax regime for personal pensions (i.e., pensions taken out by an individual independently of his employer and of the State Earnings-Related Pension Scheme) will be introduced with effect from January 1988. Under the new regime, personal pensions will be given the same favorable tax treatment as currently enjoyed by retirement annuities. In addition, to encourage a wider spread of occupational pension schemes, employers will be able to set up simplified schemes with greater scope for transferring pensions between different types of schemes, thereby enhancing labor mobility; members of occupational pension schemes will be allowed to make additional voluntary contributions within existing tax relief limits to separate plans of their own choice outside their employer's scheme.

4. Medium-term financial strategy

The assumptions and the revised illustrative projections of the new MTFS for the period to 1990/91 are shown in Table 1. The growth in nominal GDP in 1986/87 is now expected to be below the 6 3/4 percent forecast made at the time of the last budget. The nominal GDP growth of 7 1/2 percent forecast for 1987/88 is higher than the 6 1/2 percent growth indicated in last year's MTFS. Over the two years to 1987/88, however, the growth in nominal GDP is in line with previous expectations. It is projected to decline steadily to 5 1/2 percent by 1990/91, comprising an annual output growth of 2 1/2 percent and a gradual slowdown in inflation (GDP deflator) to 3 percent. The new MTFS continues to provide gradually declining illustrative target ranges for the growth in MO, but explicit target ranges for the growth in £M3 have been discontinued.

The fiscal projections for the next four fiscal years take into account changes in the composition of receipts and expenditure. For the period to 1989/90, the public expenditure projections are based on the public expenditure plans announced in November 1986. For 1990/91, public spending is provisionally assumed to increase by about 1 percent in real terms. These projections are consistent with a continuing fall in the ratio of general government expenditure to GDP. Revenue projections are based on the conventional assumptions of constant 1987/88 rates of tax and national insurance contributions, with indexed tax allowances and thresholds. Over the period as a whole, non-North Sea revenues are assumed to grow broadly in line with non-North Sea money GDP. North Sea oil revenues, however, are assumed to remain roughly unchanged in nominal terms after their sharp fall in 1986/87. Oil prices are assumed to average US$15 per barrel in 1987 and thereafter to remain roughly unchanged in real terms. Overall, the PSBR is projected to stabilize at the equivalent of 1 percent of GDP. Adjusted for the nonpermanent component of oil revenue and for privatization proceeds, the PSBR would fall from 2 3/4 percent of GDP in 1986/87 to 2 1/4 percent by 1990/91. The authorities intend to fund the PSBR fully (with no overfunding) by sales of debt to the nonbank sector. The fiscal projections include fiscal adjustments of £3 billion in 1988/89 and £2 billion in each of the subsequent two years which could be used for additional tax cuts.

5. Staff appraisal

The staff welcomes the U.K. authorities' decision to use the main part of the increase in non-oil revenue above earlier projections for FY 1987/88 in order to reduce the PSBR by £3 billion (one quarter of 1 percent of GDP) below the target set in last year's budget. This is in line with the views expressed by Executive Directors on the occasion of the 1986 Article IV consultation (EBM/87/32). As the staff had expected, the lower deficit has allowed a reduction in interest rates which should help support investment and, by checking the recent effective appreciation of sterling, export activity. On a cyclically adjusted basis, and taking into account the projected increase in privatization receipts, the budget seems to provide a moderate stimulus to the economy. Although both expenditure and the deficit are projected to decline in 1987/88 in relation to GDP, even greater restraint on public spending and lower PSBR might have permitted a faster decline in interest rates and a more stable effective exchange rate for sterling, which would have had advantages given the projected deterioration in the current account of the balance of payments.

Table 1. United Kingdom: Summary of the Budget for 1987/88 and the Medium-Term Financial Strategy 1/

(In billions of pounds sterling or in percent)

	1985/86	1986/87	1987/88	1988/89	1989/90	1990/91
	Actual	Estimate	Budget forecasts	Illustrative projections		
Nominal GDP growth	9.6	6	7 1/2	6 1/2	6	5 1/2
Real GDP growth	3.3	3	3	2 1/2	2 1/2	2 1/2
Growth in GDP deflator	6.1	3	4 1/2	4	3 1/2	3
Growth in monetary aggregates						
MO	3.6	4	2-6	1-5	1-5	0-4
Sterling M3	16.3	...				
Public expenditure planning total	133.6	140	149	154	162	168
Gross debt interest	17.6	17	18	18	19	19
Other adjustments	7.5	8	7	8	8	8
General government expenditure	158.8	165	174	180	188	196
(In percent of GDP)	(44.0)	(43 1/4)	(42 1/4)	(41 1/4)	(40 1/4)	(40)
Of which:						
Privatization proceeds 2/	-2.7	-4.7	-5	-5	-5	-5
General government receipts	151.9	159	169	178	187	197
Of which:						
North Sea oil revenue	11.4	5	4	4	4	4
Fiscal adjustment from previous years	--	--	--	--	3	5
Annual fiscal adjustment 3/	--	--	--	3	2	2
General government borrowing requirement	6.9	6	5	5	6	6
Public corporations' market and overseas borrowing	-1.1	-2	-1	-1	-1	-1
Public sector borrowing requirement	5.8	4	4	4	5	5
(In percent of GDP)	(1.6)	(1)	(1)	(1)	(1)	(1)
Memorandum item:						
Adjusted PSBR 4/	17.4	10.5	10.2	10.0	10.8	10.7
(In percent of GDP)	(4.8)	(2 3/4)	(2 1/2)	(2 1/4)	(2 1/4)	(2 1/4)

Sources: H.M. Treasury, Financial Statement and Budget Report 1987/88, March 1987; and staff estimates.

1/ Based on official definitions for public expenditure aggregates.
2/ In official statistics, privatization proceeds are treated as negative expenditure.
3/ Annual fiscal adjustment can be used to either lower government receipts and/or raise government expenditure.
4/ PSBR plus the nonpermanent component of North Sea oil rvenue plus privatization proceeds; staff estimates.

Table 2. United Kingdom: Selected Economic Indicators

	1985 Actual	1986 Revised estimates	1987 Autumn Statement forecasts	1987 Budget forecasts
	(Annual percentage changes)			
Aggregate demand and output 1/				
Private consumption	3.6	4 1/2	4	4
Government consumption	0.2	1	1 1/2	1
Gross domestic fixed investment	1.8	1/2	2 1/2	4
Changes in stocks 2/	0.3	—	1/2	1/2
Domestic demand	2.8	3 1/4	3 1/2	3 1/2
Exports of goods and services	5.8	3	3	4
Imports of goods and services	3.0	6	4 1/2	6
Foreign balance 2/	0.9	-1	-1/2	-3/4
GDP (average estimate) 3/	3.3	2 1/2	3	3
Manufacturing output	3.1	1/2	4	4
Prices and costs				
Retail prices 4/	5.5	3 1/2	3 3/4	4
Producer prices in manufacturing	5.5	4 1/2	3 1/2	4
Unit labor costs in manufacturing	4.2	5	2 1/2	1 1/2
Balance of payments				
Export volume				
All goods	5.5	3.7	3	4
Non-oil goods 5/	7.0	2.4	5 1/2	6
Import volume				
All goods	3.4	6.3	5	7
Non-oil goods 5/	4.0	5.8	6 1/2	8
Terms of trade 6/				
All goods	1 1/2	-5 1/2	1/2	--
Non-oil goods 5/	1 1/2	-1	-1/2	1/2
	(In billions of pounds sterling)			
Trade balance	-2.2	-8.3	-10 1/2	-11
Of which:				
Oil	8.1	4.2	3 1/2	4
Manufactures	-3	-5 1/2	-7 1/2	-8
Other goods	-7 1/2	-7	-6 1/2	-7
Net invisibles	5.1	7.2	9	8 1/2
Current account balance	2.9	-1.1	-1 1/2	-2 1/2
(In percent of GDP)	(0.8)	(-0.3)	(-1/4)	(-1/2)

Sources: H.M. Treasury, Autumn Statement, November 1986, and Financial Statement and Budget Report 1987/88, March 1987; and Central Statistical Office, Economic Trends.

1/ In constant 1980 prices.
2/ Contribution to growth of GDP.
3/ At factor costs.
4/ Percentage change in the year to the fourth quarter.
5/ Excluding erratic items.
6/ Ratio of U.K. export average values to import average values.

Table 3. United Kingdom: Estimated Direct Effect on Receipts of the Tax Measures Announced in the Budget for 1987/88

(In millions of pounds sterling)

	1987/88		1988/89
	Changes from a non-indexed base 1/	Changes from an indexed base 2/	Changes from an indexed base 2/
Income tax	-2,680	-1,880	-2,640
Reduction of 2 p. in basic rate	-1,910	-1,910	-2,690
Increases in the main allowances	-695	--	--
Changes in higher rate thresholds (net)	-5	40	80
Profit-related pay	--	--	-50
Other changes	-70	-10	20
Corporation tax and capital gains tax	-310	-310	80
Reduction in the tax rate for small businesses	--	--	-60
Other changes	-310	-310	140
Inheritance tax	-90	-75	-170
Value-added tax	180	180	360
Excise duties	5	-545	-590
Other	--	5	5
Total effects	-2,895	-2,625	-2,955

Source: H.M. Treasury, Financial Statement and Budget Report 1987/88, March 1987.

1/ Income tax allowances and income tax brackets held constant in nominal terms.
2/ Income tax allowances and income tax brackets raised in line with inflation.