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ECONOMIC POLICY

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The 1979 Budget

ECONOMIC POLICY

May 1979

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Published Papers

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

CBI Publication: Economic policy and Budget representations to the incoming Government, May 1979

Signed CAWayland Date 24 October 2009

PREM Records Team

CHANCELLOR OF THE EXCHEQUER

With the Compliments

of the

Chancellor of the Exchequer

Treasury Chambers,
Parliament Street,
S.W.1.

Covering Budget Secret

CHANCELLOR OF THE EXCHEQUER

11/6/79

With the Compliments
of the
Chancellor of the Exchequer's
Private Secretary

As announced: Corrected for typing errors in first copy.

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Economic Policy

INDEX

23

I INTRODUCTION

It is a little over five years since my predecessor, the rt. hon. Member for Leeds East, rose at this despatch box to present his first Budget. Like me, he did so within a very few weeks of his Party's success at a General Election. In compressing the huge and complex process of Budget-making into so short a time, he faced - as I have done - a formidable task.

I have received unstinting support not just from my fellow Treasury Ministers but from many people, of every rank, within the Treasury and the two Revenue Departments. But for their willingness to work far beyond the call of duty it would scarcely have been possible for me to present this Budget at all.

So I gladly echo my predecessor in acknowledging this assistance with a very real sense of gratitude.

I echo him too in saying that I approach my task - and I assure the House that I quote his very words - "in a mood of humility and trepidation".

/I say that

I say that not just because of the novelty of the experience - although that is daunting enough - but much more because of my sense of dismay at the disturbing familiarity of the occasion from the point of view of almost everybody else.

For, as the House will recall, this is the fourth Budget in the last fifteen years to be introduced by a new Chancellor in a new Government. The late Iain Macleod, alas, did not live long enough to be included in this series. Before me there was, in 1964, the present Leader of the Opposition; in 1970, my noble friend, Lord Barber; and in 1974, the rt. hon. Gentleman, the Member for Leeds East.

The depressingly familiar feature of the first Budget Speech of each of these three predecessors is that every one of them found cause to complain, with more or less justice, about the disagreeable nature of the economic estate that had come his way.

The House will understand, in light of the most recent evidence about inflationary trends, monetary growth, government borrowing and the deteriorating trade balance - not to mention the post-dated cheques for public sector pay that I found on arrival at the Treasury - that I am in no position to discontinue that tradition.

/II THE YEARS OF DECLINE

II THE YEARS OF DECLINE

For so many other facts tell the same story. Consumer spending rose last year, in percentage terms, by seven times as much as manufacturing output. We actually manufactured 4 per cent less goods in 1978 than in 1973. But the volume of manufactured imports went up by 13½ per cent. Though demand was rising strongly, and unemployment remained high, the economy was almost unable to increase supply. The current account of the balance of payments was barely in surplus last year, despite a massive contribution of £3½ billion from North Sea oil and gas. And well before the last Administration left office inflation was back on a rising trend. Although many price increases had been held behind the General Election dam, the rate of inflation in the six months to April - excluding seasonal foods - was running at no less than 12.3 per cent at an annual rate.

On that form and on the policies which brought it about, there is little reason to expect any improvement in the future. Productivity is rising less than half as fast as in the early 1970s. And there is no sign of any change for the better there. Last year's growth

/in demand

in demand could never have been sustained. For, as the trade figures make clear, it was largely met from imports. This is the main reason why the recent fall in unemployment was, in any event, likely to be reversed.

It would be easy to conclude that these difficulties are all the fault of the last administration. And certainly the party opposite bears a heavy responsibility. Labour Governments have, after all, been in office for eleven of the last fifteen years. Even so I want to consider our problems in an even longer perspective.

Only a quarter of a century ago - within the memory of almost every Member of this House - the people of the United Kingdom enjoyed higher living standards than the citizens of any of the larger countries of Europe. Amongst the free nations of the world, Britain was then second only to the United States in economic strength.

Not so today. For example, France and Germany's combined share of world trade in manufactured goods, which in 1954 was almost the same as Britain's alone, is now more than three times as large as ours. The French people now produce half as much again as we do. The Germans produce more than twice as much. And they are moving further ahead all the time.

./There has,

There has, of course, been plenty to say in mitigation of these developments. At least until recently, we have been able to claim a good record in most of those things that can be summed up in the phrase "the quality of life". But in the last few years, the hard facts of our relative decline have become increasingly plain. And the threat of absolute decline has gradually become very real. That is not a prospect I am prepared to accept. Nor, I believe, are the British people. They realise that we cannot for ever go on avoiding difficult choices in the fatal, and increasingly futile, quest for easy solutions.

/III INTERNATIONAL BACKGROUND

III INTERNATIONAL BACKGROUND

Naturally, as inhabitants of a country that has always been deeply involved in the international economy, we pay a great deal of attention to events outside our own country. But it would be very dangerous if preoccupation with this or that "world crisis" - "the oil crisis", "the dollar crisis", or whatever - led us to believe that our economic troubles could be blamed mainly on the outside world. The truth is that our troubles are very largely home-made. If we tackle them ourselves, then we can pull our own economy round, even in a world of slow growth. If we do nothing to change course, then nothing that happens beyond these shores can help us.

As it happens, the international environment is unlikely to give us any comfort in the years immediately ahead. Oil prices are now, on average, about 30 per cent higher than six months ago. This is one reason why growth in most countries is likely to be significantly lower than in 1978. So we clearly now need to do more about both conservation and supply of energy.

/For that reason

For that reason it will be an important subject for discussion at the next meeting of the European Council, and at the Economic Summit in Tokyo at the end of this month.

In this disturbed situation, the European Community can, and should, be a source of stability and of strength for its members. In one important area, however, present EEC policies are seriously hindering our efforts to help ourselves. The United Kingdom and Italy, which are among the poorer members of the Community, are transferring substantial resources to richer member states, chiefly through the Community Budget. We have already made it very clear to our partners that this cannot be allowed to continue. It is plainly unfair. And it is against the interests of the Community itself. We shall continue to press for an agreement which meets our case.

But, I repeat, progress internationally, whether on energy policy or within the Community, will not cure the deep-seated weaknesses of our own domestic economy.

/Nor will North

Nor will North Sea oil. Growing production will certainly put us in a better position than other countries, without oil of their own. But it must not be allowed to conceal the grim truth about what has been happening to the balance of our own trade, particularly in manufactured goods.

North Sea oil will itself do nothing to solve the problems on the supply side of our economy. Nor will it check inflation. Indeed, in some respects it may actually make matters worse, unless we correct some other aspects of policy which are at present working in the wrong direction.

/IV THE CAUSES OF DECLINE

IV THE CAUSES OF DECLINE

So we find ourselves, yet again, asking the question: how are we to check, and then reverse, the long decline? In particular, what can we, here in this House of Commons, do about it?

We do well to begin, I suggest, by acknowledging that there is a definite limit to our capacity, as politicians, to influence these things for the better. I suspect that that view is much more widely accepted outside this place than it is within.

I do not mean to be unkind to my predecessor when I invite the House, for a moment, to consider his experience. The Government of which he was a prominent member consistently behaved as if it was possible for Government to manage, indeed to plan, the economy, so as to promote efficiency and growth. The rt. hon. Gentleman, the Member for Leeds East, did this with notable enthusiasm. For in five years of office he introduced no less than 15 Budgets and economic "packages", and financed a wide range of policies in the name of "the regeneration of industry".

/But, at the

But, at the end of five years, he must ask himself, to what avail? Has the industrial strategy, as he conceived it, really transformed the outlook for British industry? Are we not driven to the conclusion that the notions of demand management, expanding public spending and "fine tuning" of the economy, have now been tested almost to destruction?

Certainly the rt. hon. Gentleman, the Leader of the Opposition, has come round to that view. For, as he said in a memorable speech on September 28th, 1976:

> "We used to think that you could just spend your way out of a recession and increase employment by cutting taxes and boosting Government spending. I tell you, in all candour", said the rt. hon. Gentleman, "that that option no longer exists..."

The rt. hon. Gentleman, the Member for Leeds East, has, in the event, been proclaiming the same conclusion. For he has throughout asserted the importance of monetary policy. He rightly began the practice of setting money supply targets. And he claimed to make his public spending plans accordingly. This means that I am able to approach my task this afternoon on this one, crucially important, piece of common ground: that the poor performance of the British economy in recent years has not been due to a shortage of demand. We are suffering from a growing series of failures on the supply side of the economy.

/V A NEW BEGINNING

V A NEW BEGINNING

It is our belief that many of these failures are themselves the result of actions and interventions by Government itself: laws that stand in the way of change and stifle enterprise; and, as important as anything, a structure of taxation that might have been designed to discourage innovation and punish success.

Of course, there are many other causes of our decline. That is not in dispute. But we believe that it is more sensible for Government to make those beneficent changes that are undoubtedly within its power than to preach the need for changes that lie well beyond its authority. Certainly, improvement remains unlikely unless we are prepared to change the laws and taxes to which I have referred.

This is why the British people are convinced, as we believe, that it is time for a new beginning. So, our strategy to check Britain's long-term economic decline, which has gathered pace in the last five years, is based on four principles.

We need to strengthen incentives, by allowing people to keep more of what they earn, so that hard

/work, talent

work, talent and ability are properly rewarded.

We need to enlarge freedom of choice for the individual by reducing the role of the state.

We need to reduce the burden of financing the public sector, so as to leave room for commerce and industry to prosper.

And we need to ensure, so far as possible, that those who take part in collective bargaining understand the consequences of their actions - for that is the way to promote a proper sense of responsibility.

These are simple principles. But they require substantial change in the way in which our economy is allowed to work.

The tax changes I shall propose today will be only the first step. They will take us a long way in the right direction.

/VI INFLATION

VI INFLATION

But they will not themselves be enough unless we also squeeze inflation out of the system. It is crucially important to re-establish sound money. We intend to achieve this through firm monetary discipline and fiscal policies consistent with it, including strict control over public expenditure.

Financial responsibility on the part of Government must be supported by responsibility elsewhere. People must understand and accept that the only basis for real increases in wages and salaries is an increase in national production. Higher pay without higher productivity can only lead to higher inflation and unemployment.

It is important for this to be fully understood by all those involved in wage negotiation. We shall be more than willing to consider better methods of ensuring that it is.

Given the monetary and fiscal policies to which we are firmly committed, irresponsibility is bound, as I have said, to threaten jobs. This indeed is the clear evidence of recent history, most plainly in the

/private sector

private sector.

Responsible bargaining necessarily means different things to different people and in different kinds of firms and industry. But on both sides of the table certain limitations must be recognised : in the public sector, what the rate payer and tax payer can afford; in industry, what the customer is prepared to pay, what the firm needs to invest, and what the pressure of competition demands; and, throughout the economy, the limits imposed by the need to control the money supply.

/VII MONETARY POLICY

VII MONETARY POLICY

As I have already observed, my predecessor was undoubtedly right to adopt a system of monetary targets. But his other policies were seldom consistent with his own monetary objectives. Thus, although monetary growth in 1978-79 as a whole was just within the target range of 8-12 per cent, it was growing in the second half of the year at an annual rate of almost 13 per cent. Moreover, the May figures, now becoming available, indicate that the underlying growth is still above the top of the range and, if anything, accelerating. One cause of this has been the alarming rate of central government borrowing: £2½ billion in April and May alone.

It is now clear that the public expenditure policies which we inherited would have made it quite impossible to meet the rt. hon. Gentleman's 8-12 per cent target without a further savage squeeze on the private sector, involving not just higher interest rates but a sharp increase in the total tax burden as well. Not for the first time, the levels of public spending and borrowing which he permitted were far too high to be compatible with his own monetary targets.

/Reluctantly,

Reluctantly, I shall myself be obliged to take painful action to correct that mistake.

We are committed to the progressive reduction of the rate of growth of the money supply. I therefore intend, despite the discouraging backcloth and as the first step in this process, to reduce the target range for the remainder of this year, 1979-80. The new target range, to apply to the growth of sterling M3 in the 10 months to the banking make-up day in April 1980, will therefore be an annual rate of 7 per cent - 11 per cent. I will roll the target forward by six months in the autumn.

Equally important, I intend to improve the way in which the monetary target is achieved. We need to rely less on curbing the private sector, and put more emphasis on fiscal restraint and economy by the public sector. This requires, as a first step, a significant reduction in the Public Sector Borrowing Requirement from the figure of around £10 billion that it would otherwise have reached this year.

There are, however, limits to what can be done in this Budget, with two and a half months of the financial

/year already

year already passed, to curtail the scale of public spending in the current year. This is indeed a severe handicap. I intend, even so, to reduce the public sector's financial needs enough to make it possible to achieve my monetary target with less restraint on the private sector.

But the fiscal measures which I am announcing today must inevitably take time to take effect. They cannot immediately reduce the seriously excessive monetary growth that we have inherited. Particularly given the continuing surge in bank lending, I have concluded that there is no option but to act directly to reduce that growth. It is not enough to speak of the importance of monetary policy, unless one is prepared to carry one's words into practice.

The Bank of England are accordingly rolling forward the Supplementary Deposit scheme, or "corset", by three months on the existing basis. In addition, the Bank are announcing this afternoon, an increase in their Minimum Lending Rate by 2 per cent to 14 per cent. I must make it very plain to the House that the necessity for this action ranks alongside the trade figures as entirely characteristic of the legacy of the last administration.

/I return now

I return now to consider the right size of the Public Sector Borrowing Requirement in the current year. As my predecessor found to his cost, this is a fickle and elusive statistic. That is why I offer my judgement of the scale of Government borrowing in 1979-80 with a degree of caution. Having said that, my best estimate is that the changes in taxation and public expenditure which I am announcing today will be sufficient to reduce the PSBR to £8¼ billion in the current year, as compared with the outturn of £9¼ billion for 1978-79. As a percentage of GDP, that will represent a reduction from over 5½ per cent last year to under 4½ per cent in the current year. The public sector deficit will also fall from 4½ to 3¾ per cent of GDP. These are important steps in the right direction. I intend to continue along this path in the years ahead.

It will no doubt be argued by some - although I do not think it can be so argued by my predecessor - that fiscal action to bring down the PSBR to the figure I have mentioned is unduly severe. And indeed the conventional forecasting arithmetic, which, in accordance with custom and statute, I am publishing in the Financial Statement, does suggest that the economy will show no growth in the period immediately ahead.

/But this

But this prospect, insofar as it can be viewed as a reliable prediction - which itself is open to doubt, cannot be taken to mean that the Budget is, in the traditional language of neo-Keynesian economists, perversely contractionary. To make this claim is to argue that an alternative course of fiscal policy would produce more growth and more employment. I believe this argument to be profoundly wrong.

To aim at a significantly higher Public Sector Borrowing Requirement - in other words to ease the stance of fiscal policy - would serve only to fuel the fire of inflation. In the end, we should have less growth, less employment, and even higher prices. Even the Leader of the Opposition must accept that, if he remembers what he said at Blackpool, nearly 3 years ago. It follows that any decline in economic activity which might, on a narrow view, be attributed to this Budget will be essentially the consequence of the economic situation which has made such measures inevitable, while inflation is being brought under firm control.

/VIII EXCHANGE CONTROL

VIII EXCHANGE CONTROL

I come now to my proposals. I propose to deal first with the question of exchange control.

Sterling is at present relatively strong, and I expect it to remain so. This strength flows partly from the realisation that, as a result of North Sea oil, the UK is better placed than most of our competitors to deal with present world oil problems. Moreover, our fiscal and monetary policies should maintain confidence in the currency. This is, therefore, an appropriate time to start dismantling our apparatus of controls on outward capital flows. Our present regime is more restrictive than that of any other major industrialised country. There is an overwhelming case, in this context as in others, for giving both companies and individuals wider freedom of choice. This should reduce the distortions and costs which controls are bound to impose on economic decisions. These costs bear particularly heavily on smaller companies.

We intend to move one step at a time. In this initial stage, the emphasis will be on direct investment overseas. Details are being made available in the Vote Office.

/The main

The main relaxation will be to make official exchange, to the extent of £5 million per project per year, freely available for new outward direct investment. This should allow the majority of UK firms who invest overseas all the sterling finance they are likely to want. The two-thirds rule, which restricts the re-investment of profits earned overseas, will be abolished. This greater freedom in the financing of direct investment abroad does not, as is sometimes feared, threaten jobs in the United Kingdom. The weight of evidence is that overseas investment generally strengthens our position in world export markets to the benefit of output and jobs in this country. Moreover, additional investment overseas today will yield an income that will stand us in good stead when the overseas earnings from North Sea oil begin to decline.

During the sterling crisis of 1976, the last Government stopped the use of sterling to finance third country trade. This restriction has placed British merchants at a disadvantage in international business and I am taking the opportunity to restore the facility to them as soon as the details can be worked out.

I have also decided that there should be some immediate easement of the controls affecting individuals. I am, therefore, making significant relaxations in the

/rules concerning

rules concerning travel and emigration allowances, overseas property, and cash gifts and payments to dependants. In the field of portfolio investment, I am taking two modest steps at this stage. I am abolishing the requirement to maintain 115 per cent cover for overseas portfolios financed by foreign currency borrowing; and official exchange will henceforth be available for meeting interest payments on such borrowing. The 1975 controls on gold coins will also be abolished.

As the House knows, the liberalisation of exchange controls is one of our obligations under the EEC Treaty. I have accordingly discussed with the Commission the decisions I am announcing today.

As time goes by, I intend to take further steps in the progressive dismantling of exchange control. The pace of relaxation will obviously be influenced by sterling's strength as well as by the speed with which we can solve the economic problems that face us.

In our external policy we have also to take account of our official external debts. These at present amount to 22 billion dollars - a massive increase on the 8 billion dollars which the previous Government inherited in 1974.

/It is our

It is our intention to reduce this burden of external debt substantially during the life of this Parliament.

/IX PUBLIC EXPENDITURE

IX PUBLIC EXPENDITURE

In order to reduce the borrowing requirement and the burden of direct taxation we must make savings in public spending and roll back the boundaries of the public sector. We are totally committed to improving standards in the public services. But that can only be achieved if the economy is strong. So that will be our first priority. Finance must determine expenditure, not expenditure finance. Substantial reductions in expenditure can and will be made in the remainder of this financial year.

First, as I made clear three weeks ago, we shall not raise the cash limits to cover prices higher than those provided for in the cash limits originally published for this year. On pay in the public services, while we will honour the commitments to the universities and the health authorities entered upon by our predecessors, in general we will limit the adjustment of the cash limits so that substantial offsetting economies will have to be found.

The need for substantial economies applies equally to local authority expenditure, where the Government's

/contribution is

contribution is made through the rate support grant. As I said three weeks ago, we shall take account of pay settlements in calculating the increase orders for the rate support grant, but we shall make a significant across-the-board reduction from the total so calculated. I can now tell the House that the reduction will be £300 million for England and Wales and £35 million for Scotland, out of total rate support grant expenditure of about £9 billion. These figures may have to be increased when we know the cost of further pay increases and will be finally determined in November, before the increase orders are made. In coming to this decision, a major factor has been how much in present circumstances it is reasonable for the taxpayer to contribute.

The cash limits on Departments and fringe bodies are being set to ensure that economies of 3 per cent are achieved on manpower costs this year, as announced by my hon. Friend the Minister of State in the Civil Service Department.

I estimate that this cash limits policy will reduce the volume of planned expenditure by about £1 billion at 1979 Survey prices.

On top of these reductions resulting from the

/policy on

policy on cash limits, my rt. hon. and hon. Friends have reviewed the plans for their Departments and the nationalised industries and have identified further specific reductions which are being made this year. The changes are listed in a notice to be issued by the Treasury today, and available in the Vote Office. Further details will be given by the Ministers concerned. But the House will want to know where the main reductions will be made. All figures are at 1979 Survey prices.

We are making an immediate start in reducing expenditure on industrial and employment subsidies. My rt. hon. Friend, the Secretary of State for Industry, is cutting expenditure on industrial support this year by £210 million. This will come mainly out of the provision for new projects by the Department of Industry and by the National Enterprise Board, and by imposition of a delay of 4 months in payments of approved claims for regional development grant. Support from the employment programmes is to be concentrated on the areas where unemployment is highest. Savings of over £170 million will be made in these programmes this year.

In the area for which my rt. hon. Friend the Secretary of State for Energy is responsible savings of over £320

/million are

million are being made this year in the finance for BNOC and the electricity, gas and coal industries. The industries have been asked to avoid so far as possible increases in fuel charges beyond those required to meet the cash limits announced by the previous Government.

My rt. hon. Friend, the Secretary of State for the Environment, is making savings of about £440 million from his programmes this year, mainly by scrapping the Community Land Act, deferring water authority investment and reducing the existing allocations to housing authorities.

As we have repeatedly made clear, it is not our intention to reduce spending on the Health Service. But we cannot ignore the fact that the contribution made by some health charges has greatly diminished in recent years. This applies especially to prescription charges, which have stood at their present level for eight years, during which prices have risen over 2½ times. It is therefore proposed to increase prescription charges to 45p. This will still leave them cheaper in real terms than they were in 1971, and the present wide range of exemptions covering children and the elderly amongst others will, of course, be maintained. Certain dental charges will also be increased. These changes

/will yield

will yield £34 million in 1979/80 for Great Britain as a whole.

My rt. hon. Friend, the Secretary of State for Education and Science, is reducing expenditure in those areas of the education and science programmes within the Government's direct control by about £55 million. We shall not add to the increase of 5p in the school meal charge which was planned by our predecessors for the autumn term.

The aid programme this year is being reduced by £50 million. Savings are also being made on the transport, trade and arts programmes.

My rt. hon. Friends, the Secretaries of State for Scotland, Wales and Northern Ireland are making comparable reductions in their own programmes.

In total these reductions amount to almost £1½ billion this year.

In addition, we do not intend to use as large a Contingency Reserve as provided for 1979-80 in the last Government's public expenditure White Paper.

/We have

We have decided to cut the Reserve by £250 million. Any further decision to add to the volume of programmes in the remainder of this year will be met from the balance of just over £250 million which will remain in the Reserve after today.

In two areas we are providing for increased expenditure - defence and pensions. An extra £100 million is being provided for the defence budget this year. This will enable essential projects in the equipment programme to go ahead. I shall return to the pensions improvements shortly.

As I have already indicated, we are only just embarking on our review of the plans we have inherited and of the scope for reducing the size of the public sector. But it is already clear that the scope for sales of assets is substantial.

Sales of state-owned assets to the private sector serve the immediate purpose of helping to reduce the excessive Public Sector Borrowing Requirement with which I was faced. This is all the more necessary this year, given the difficulty of cutting back public sector spending programmes once a year has already begun.

/But such

But such sales are not justified simply by the help they give to the short-term reduction of the PSBR. They are an essential part of our long-term programme for promoting the widest possible participation by the people in the ownership of British industry.

This objective - wider public ownership in the true meaning of the term - has implications not merely for the scale of our programme, but also for the methods of sale we shall adopt.

So far as this year's disposals are concerned, we must obviously retain flexibility on timing and on the precise mix of assets in order to ensure a fair price. I do not therefore propose to announce the details today. But I intend to ensure that the proceeds of sales in the current financial year will amount to some £1 billion and I have taken account of this in the Budget arithmetic. The biggest contribution to this total will come from the sale of a further part of the Government's shareholding in British Petroleum, where we shall be following the example set by the last administration.

In total I estimate that the economies I have announced will amount this year to about £3½ billion

/at 1979

at 1979 Survey prices and £4 billion at current prices. Yet given the scale of the problem we have inherited, I must look for a further contribution from indirect taxes to finance the first stage of our plans for the reduction of income tax.

Before turning to the first of my tax proposals, I must make it clear that today's Budget will only be able to deal with a small part of the Government's tax agenda. Coming, as we do, to a Finance Bill at this late stage in the year, there is a physical limit to the amount of legislation that can be proposed and enacted. We have been unable to deal with many important matters. There will be other opportunities to consider those. At this stage, we have concentrated on tax changes of strategic importance. I now turn to the first of these.

/X INDIRECT TAXATION

X INDIRECT TAXATION

We made it clear in our Manifesto that we intended to switch some of the tax burden from taxes on earnings to taxes on spending. This is the only way that we can restore incentives and make it more worthwhile to work; and at the same time increase the freedom of choice of the individual. We must make a start now.

I have reviewed the whole field of indirect taxation to decide where the increased revenue could best come from. There are many cogent arguments at this stage in favour of Value Added Tax.

First, large areas of consumer expenditure, in fact about half the total, are not chargeable to VAT. Food, children's clothes, heating and light, public transport, house prices and rents are all zero rated.

Second, poorer households tend to spend proportionately more of their income on such zero-rated goods. This means that, unlike most indirect taxes, VAT is not regressive.

/Third, by

Third, by comparison with taxes such as those on alcohol and tobacco, VAT is much more broadly based.

Fourth, there is a real opportunity for simplifying the operation of the tax by having one rate instead of two.

In his Speech on 22nd May, the rt. hon. Gentleman, the Member for Leeds East, seemed to favour increases in the surcharge on National Insurance contributions or in Advance Corporation Tax. The National Insurance Surcharge falls on the whole of British industry, including production for export, but not on imports. It is inferior in this respect to VAT, which falls on imports but not on exports. This is clearly significant in light of the latest trade figures. An increase in Advance Corporation Tax would damage the overall liquidity of industry at a particularly difficult time: by contrast an increase in VAT actually increases it.

For all these reasons my choice must fall on VAT. Moreover, the increase I make must be sufficient to provide for substantial and worthwhile reductions in income tax. I propose, therefore, that as from next Monday VAT should be charged at a new unified rate of 15 per cent.

/Allowing for

Allowing for the wide range of goods and services which are zero rated - and which will stay zero rated - the new rate I propose is equivalent to 8 per cent averaged over the whole of consumer expenditure. This is significantly less than the average in the European Community.

The yield from the increase to 15 per cent is estimated at £2035 million in 1979/80 and £4175 million in a full year. Thus it will provide scope for further direct tax reductions in later years. The relatively small size of the yield this year reflects the loss of over two months' revenue between April and the present, and the time lag allowed to traders before they pay over VAT receipts to the authorities - an average of over 3 months. I have referred to the helpful contribution this gap provides towards improving liquidity. For as these funds build up in traders' hands, they provide a substantial boost to the liquidity of the firms and companies concerned. Concern has been expressed that an increase in VAT could lead to some particular difficulties, for example in relation to telephone bills for calls made before the date of change. I am proposing transitional provisions to deal with this and some of the other problems in this field.

/The increase

The increase in VAT will, of course, add significantly to the point of sale prices of drink and tobacco. For example, the VAT increase will mean about an extra 28p on a bottle of whisky, approximately 2p on a pint of beer and 6p on a typical packet of 20 cigarettes. In these circumstances, I do not think it would be justifiable to make a separate increase in the excise duty on drink and tobacco this year.

I fully realise that this increase in Value Added Tax will result in a rise in prices - in fact a rise of about 3½ per cent in the Retail Price Index. This is, of course, a once-for-all effect. But there never will be a time when it is easy to effect the switch from direct to indirect taxes and the present moment is no exception. This much-needed reform has been postponed too long already.

The House should bear in mind that, as I have already indicated, VAT does not fall on a wide range of necessities. This means that the increase will fall less heavily on people in the lower income groups. And, as will be apparent when I come to my income tax proposals, I shall be leaving people with more money

/in their

in their pockets with which to pay the increased VAT. I appreciate, however, that those who are not liable to income tax, and I have in mind particularly many of those living on retirement pensions, will not benefit directly from my income tax proposals. This brings me to our proposals in the field of Social Security.

/XI SOCIAL SECURITY PAYMENTS

XI SOCIAL SECURITY PAYMENTS

The Government have decided to increase the standard rate of retirement pensions in November by £6.10 to £37.30 for a married couple and by £3.80 to £23.30 for a single person. These increases take full account of the underestimate which the last Government made of the actual rise in earnings between November 1977 and November 1978, and are well above the figures of £4 and £2.50 announced by the previous Government. Other social security benefits will also be increased, and my rt. hon. Friend, the Secretary of State for Social Services, will announce full details tomorrow.

This means that social security pensioners will be fully protected against the increase in prices. This is what is really important. But the extent to which we can afford to go further than this - to add improvements in real terms - must depend on the productive capacity of those in work.

Under the present rules, pensions are uprated on the basis of the movement in prices or earnings, whichever is the greater. The Government have decided, however, that for the future the requirement for the

/statutory uprating

statutory uprating of pensions should be based on price movements, and we shall be introducing legislation to this end. This will be a minimum requirement, and will fully protect the value of these pensions against price increases at all times, including those arising from indirect tax changes, such as I have just announced. Of course we want to be able to do more. I am confident that in time, as our economy improves, it will be possible to do more and ensure that pensioners share in the increase in national prosperity. That is one more reason why my other proposals today are so important. For they are intended to strengthen the productive capacity of the economy as a whole.

We also propose to improve certain other social security benefits. Child benefit went up by £1 per week only two months ago, and we do not propose a further increase this year. But single parent families face particular problems, and we propose that the one parent premium should go up from £2 to £2.50 next November. We also want to help the disabled. Mobility allowance will accordingly be increased from £10 to £12 in the autumn. And we shall, of course, honour our commitment to pay a Christmas bonus this year of £10.

/These measures

These measures overall are worth about £1,100 million in 1979-80 and £2,700 million in a full year. They are largely covered by the existing social security programme, and the balance has been charged to the Contingency Reserve. As the House knows, my general policy is to make substantial reductions in public expenditure. But the reductions in public expenditure must not be done in a way which bear unfairly on the more vulnerable members of society.

Our social security system has become far too complicated and it sometimes acts to reduce the incentive to work. The problem is widely recognised on both sides of this House. We are therefore studying a number of aspects of the social security system to see what can be done to simplify it. My rt. hon. Friend, the Secretary of State, is also putting in hand urgent measures to tighten up on abuse and fraud.

/XII TAXATION OF
OIL AND PETROLEUM

XII TAXATION OF OIL AND PETROLEUM

Hydrocarbon Oil Duties

I dealt earlier with the excise duties on tobacco and drink. The oil duties, however, raise wider issues. I have already mentioned the general case for measures which will help us to meet the growing and undoubted need to conserve oil. At a time when there is a worldwide shortage of crude oil it is essential that we should play our full part in achieving the 5 per cent reduction in consumption to which the previous Government rightly committed us.

I therefore propose to increase all the main oil duties this year. In the particular case of petrol, the VAT increase from 12½ per cent to 15 per cent will be smaller than for many other items. With this in mind I propose to increase the petrol duty by 7p a gallon - which will result in a total price change of about 10p a gallon. I also propose to increase the duty on derv by the same sum, 7p a gallon, and the duty on heavy oil other than derv, by ½p. I am not, however, increasing the duty for burning oil and for domestic paraffin, which is the oil used most commonly in the home, particularly by pensioners. The yield from these excise duty changes is estimated at an additional £525 million in a full

/year and

year and £400 million in 1979/80. The immediate increase in the RPI will be about a quarter of one per cent.

Vehicle Excise Duty

In view of the increase I am proposing in the road fuel duties I have decided to make no change in the rate of vehicle excise duty. Our predecessors announced their intention of abolishing the duty on petrol driven vehicles. As my rt. hon. Friend, the Minister of Transport has already said, we are reviewing the future of this duty and we shall announce our conclusions in due course. For heavier goods vehicles my rt. hon. Friend will be announcing plans for restructuring the form of this tax.

Car Leasing

Before I leave the subject of motor cars, there is a particular issue I need to deal with. There is a weakness in the present legislation on capital allowances which enables leased cars to avoid the special rules restricting allowances for business cars. This has resulted in a loss of tax which is currently running at about £175 million a year; and which could well rise to £200 million next year if I take no action. I propose to put this right with effect from today.

/Petroleum Revenue Tax

Petroleum Revenue Tax

I turn next to petroleum revenue tax. The previous Government announced last August that they proposed to increase this tax from 1st January 1979. These proposals were discussed very fully by the last Government with the industry and we ourselves have had representations about them, which we have carefully considered.

I have judged them now against the background of recent rises in the price of oil. On that basis, the original package of PRT proposals for giving the Government more revenue from the North Sea is now fully justified. There will accordingly be provisions in the Finance Bill to implement it. I also propose, however, to introduce some changes in the PRT expenditure rules for which the industry have been pressing for some time. And the British National Oil Corporation will no longer be exempted from PRT.

These proposals will increase the Government's revenue from the North Sea (at 1978 prices) by about £110 million this year, and by about £1800 million over the period to 1985.

/XIII BUSINESS TAXATION INCLUDING CAPITAL TAXATION

XIII BUSINESS TAXATION - INCLUDING CAPITAL TAXATION

Before I deal with the taxation of business profits, I propose to refer to the taxation of capital, a matter of vital interest to business as well as to individuals.

We made it clear in our Manifesto that we were determined to make the taxation of capital simpler and less oppressive. The objection to Capital Gains Tax in its present form is that most of the yield comes from paper gains arising from inflation. The tax is, therefore, a capricious and sometimes savage levy on the capital itself. The Capital Transfer Tax, despite the improvements secured in the last Parliament by constant pressure from the Conservative Benches, is oppressive, harmful to business, and a real deterrent to initiative and enterprise. It is perfectly natural that people should want to build up capital of their own and pass it on to their children; this is particularly true of the small business proprietor.

The issues involved in both of these taxes are difficult and complex. I have, therefore, decided that we should not attempt to deal with them in the coming Finance Bill - abbreviated as it is bound to be - but should press ahead with a thorough study, with a view

/to legislation

to legislation on all these matters at an early date. There is, however, one specific issue on which legislation is required in order to hold the present position: I propose to extend for a further two years the period for CTT transitional relief for capital distributions from discretionary trusts and to defer for two years the introduction of the periodic charge.

The Development Land Tax, however, is a very different matter and calls for immediate action. This tax has combined with the Community Land Act to prevent much worthwhile development and to increase unemployment in the construction industries. We have already said that we will repeal the Community Land Act. I propose now to deal with the Development Land Tax. In place of the present rates of 66⅔ per cent and 80 per cent, which the previous Government intended should rise to 100 per cent, I propose that Development Land Tax will in future be charged at a single rate of 60 per cent. The amount of development value which can be realised in a financial year without liability to Development Land Tax will be raised from £10,000 to £50,000. Both these changes take effect for disposals made on or after today.

I do not propose to make any further reductions in rate; and the generous increase in the exempt slice

/should mean

should mean that it will not need early revision. Owners of development land will, therefore, have no reason for holding back in the hope of further tax reductions. What I have said today should remove the major uncertainties which have been hanging over the market.

I now turn to the taxation of profits. A vigorous, profitable and expanding company sector is essential if we are to rebuild this country's prosperity. Profitability has dropped sharply in recent years and the rate of return on capital employed is now far too low. This is especially true of manufacturing industry.

Without higher profits we shall not see the new investment and jobs which are so urgently needed. Achieving those profits is very largely the task of management and work people. The Government can help or hinder them, and this is no time to add to the difficulties that they face by raising taxes on profits still further. Against that background I propose no change this year in the general system or in the rates of Corporation Tax. Nor would it be right to make any major changes in the system of company taxation without careful consultation in advance.

/Looking further

Looking further ahead, however, it is important that the tax system should take account of the effects of inflation on businesses, and do so in a way that is reasonably objective, equitable and simple to administer. The Government will therefore be reviewing this matter along with the accountancy profession's latest proposals for current cost accounting. I am arranging for the Inland Revenue to consult the accountancy profession and business later in the year.

I need however to deal now with the question of stock relief. The Finance Bill will include legislation to honour the undertaking which my predecessor gave last year, and which we supported, to write off the deferred tax liabilities arising from stock relief given for the first two years of the scheme -1973-74 and 1974-75; and thereafter to write off these liabilities in respect of each subsequent year, after they have been outstanding for six years.

In addition, following consultations which the Inland Revenue have had with industry, I am proposing two further changes in the stock relief scheme. I intend to reduce the profit restriction for unincorporated businesses from 15 per cent to 10 per cent; and all businesses will be given greater flexibility in the

/amount of relief

amount of relief that they can claim. Both these changes will be of particular benefit to small businesses.

Details of the stock relief and car leasing proposals will be given in Inland Revenue Notices which I am making available in the Vote Office.

I now come to dividend control. If industry is to flourish it needs not only adequate profits but a vigorous capital market to provide funds for investment and expansion. The control of dividends has now outlived its purpose. The control will accordingly come to an end when the existing legislation expires on 31st July.

We on this side of the House have consistently championed the cause of smaller businesses. So I also propose to raise this year the qualifying profit limits for the small companies rate of corporation tax - to the figures of £60,000 at the lower end and of £100,000 at the upper end. This will go some way further than is necessary to maintain their real value.

In the tax field, however, there is one measure that will do more than anything else to encourage smaller businesses -indeed businesses of every size. That is a major reduction in the burden of income tax.

/XIV INCOME TAX

XIV INCOME TAX

That brings me to the keystone of our policy. Excessive rates of income tax bear a heavy responsibility for the lack-lustre performance of the British economy. We need, therefore, to cut income tax at all levels. For the reasons I have already explained, I cannot do as much this year as I should have liked, and I cannot do as much as is needed. But, although it is only a first instalment, there should be no doubt in anyone's mind that this Budget marks a turning point.

I begin with the higher rates of tax. The upper rates no longer affect only those on very high incomes. They apply to senior executives and middle managers in industry and increasingly to skilled workers: as well as to professional people and the proprietors of small businesses. These are the people upon whom so many of our hopes for initiative, greater enterprise and national prosperity must depend.

It is universally recognised that the present top rate of 83 per cent on earned income is an absurdity. The rate of 98 per cent on investment income is even worse. Such rates bring in very little revenue. But

/they kill

they kill incentive and are patently unjust. Some members of the previous Government recognised this. But they did nothing about it. I now propose an overdue measure of reform. The top rate on earned income will be cut from the present 83 per cent to 60 per cent. This new top rate will apply to taxable income over £25,000. At the other end of the higher rate scale, the present threshold of £8,000 is too low. I propose raising it to £10,000. Even at this figure the starting point for taxation at higher rates will be no higher in real terms than it was in 1973. Between £10,000 and £25,000 I propose a new scale of rates less steeply progressive than the old scale.

The top rate of 60 per cent on earned income I now propose fulfils our commitment to reduce the top rate to the European average. For example, the top rate in France is 60 per cent. In Germany, it is 56 per cent. In the United States, it is only 50 per cent. The new top rate will still be reached at an income level which is lower and in some instances significantly lower than is common elsewhere. This is a matter to which we may need to return on a future occasion.

So, while the reductions I propose are substantial, they are no more than the circumstances require. They

/will still in

will still in general leave people in the top income groups more highly taxed than people in corresponding positions in other industrialised countries. We have to compete with such countries, not only in the sale of goods and services, but in attracting and retaining the talent required to run our industry efficiently and profitably and thereby provide the employment opportunities that our people so desperately need.

We have over the years spent too much time and effort trying to "level down". This is no good to anybody. It is much more important to have a successful and prosperous society. And we cannot have a successful and prosperous society without successful and prosperous individuals.

But it is not only at the top of the income range that the burden of income tax is particularly oppressive. The same is true for those on the lowest taxable incomes, where the tax system can help to ensure that some people are actually better off out of work. That is the importance of the tax thresholds, to which I turn next. The increases proposed in the April Finance Act, which were not of course implemented, were plainly inadequate. I propose to double these increases. This means that the amount a single person can earn tax-free will go up, not by

/£90, but by £180.

£90, but by £180. The married allowance will go up, not by £140, but by £280. A single person's tax-free earnings will thus go up by nearly £3.50 a week. The amount that a married man can earn tax-free will go up by £5.38 a week. And these increases in personal allowances are quite apart from the change that I have in mind for the basic rate of tax.

I have in fact three other changes to propose before I come to that. First, to help the elderly, the age allowance will be raised by £240 for the single person and £380 for the married person. These again are double the figures proposed in the April Finance Act. Last year the income limit for the full age allowance was £4,000. This year I propose raising it to £5,000, more than twice the increase proposed in the April Finance Act.

Second, I propose raising the threshold for the investment income surcharge. The justification for retaining the surcharge is itself debatable. Certainly there can be no argument but that it bites at far too low a level of income. Almost half the surcharge is paid by people over 65. This is moreover a tax which falls with particular severity on those who have had

/to make provision

to make provision for their retirement out of their savings and have no occupational pensions to fall back on. The undue severity of the tax was recognised by the previous Government. But they introduced no more than palliatives, in the form of a reduced rate applied to the first slice of income liable to the surcharge and a slightly higher threshold for those over 65. I propose instead to raise the threshold to £5,000 for everyone; the rate above that level will remain at 15 per cent. This approach combines a considerable simplication of the tax with a measure of justice that is long overdue.

Third, I propose to implement immediately our election pledge to war widows. Provision will be made in the Finance Bill to exempt their pensions entirely from tax.

I come finally to the basic rate. For the great majority of taxpayers - some 21 million in all - it is the basic rate which determines their tax liability. It is the basic rate (plus, of course, the National Insurance Contributions) which represents the deterrent effect of tax on additional earnings - whether those extra earnings come from overtime, or greater productivity,

/or reflect

or reflect greater skill or the rewards of promotion. Everywhere one meets complaint and criticism that income tax erodes differentials, reduces the rewards of skilled workers and discourages effort, initiative and responsibility. This year I propose taking a first and significant step to deal with these complaints by reducing the rate from 33 per cent to 30 per cent. Our long term aim should surely be to reduce the basic rate of income tax to no more than 25 per cent.

The total cost of these income tax reductions, including the cost of increases in personal allowances proposed in April but not implemented at the time, will be £4,540 million in a full year. The lion's share, no less than £3,460 million or over three-quarters of the total, represents the cost of increasing the personal allowances and reducing the basic rate. The cost this year of all the income tax changes will be £3,500 million.

As a result of the increase in the tax thresholds, 1.3 million people who would otherwise have paid tax this year will not be required to do so. The number of people paying tax at the higher rates would have been 1.2 million: This will be virtually halved, to 650,000. The number liable to the investment income

/surcharge will be

surcharge will be reduced to about a third of what it would have been -from 850,000 to 300,000. All these changes will simplify administration and reduce the work load on the Inland Revenue.

The changes in allowances will be implemented for most taxpayers on the first pay day after 12 July. The reduction in the rates of tax will be given effect as soon as new tax tables are ready in October.

A full year's income tax reductions will be received even though my Budget is being presented two months or more after the start of the year. On this basis the income tax changes mean that for the married couple where the husband earns £100 a week, which is close to average earnings, there will be an increase in take-home pay averaged over the remainder of the financial year of over £4 a week. The increases in VAT and petrol duty will increase average family expenditure by about £2.75. So that, taking both the direct and indirect tax changes into account, the average family will be about £1.30 per week better off. Similarly, where the husband earns £60 per week there will be a real gain of over 75p a week, while the position of the couple on £150 per week will improve by nearly £2 a week.

/These reductions

These reductions in the burden of income tax, which are as substantial as they are unprecedented, mean that wage and salary earners will have more money in their pockets to buy the goods and services they help to produce. True the prices of a good many of these goods and services will be increased by my tax proposals. But we have done everything we can to ensure that every family in the land will have more money coming in to pay the increased bills. And what is more, the choice of the way they spend their income will rest increasingly with people, and not with Government.

These changes represent only the first stage in the major reduction in the burden of direct taxation that we are determined to make.

I emphasize this point particularly for those who will be involved in pay bargaining in the year ahead. Take-home pay will be substantially increased by these unprecedented cuts in income tax. This will more than make good the price effects of higher spending taxes. Any further attempts to cover those price effects by higher pay claims will be utterly self-defeating. The money will simply not be there to finance higher pay as well as lower income tax. Any attempt to have it

/both ways will

both ways will simply end up by threatening jobs and putting firms - on whom jobs depend - out of business.

/XV CONCLUSION

XV .. CONCLUSION

This is why it is so important for this Budget to be considered as a whole.

I have stressed the urgent need for new policies to reverse the decline of the British economy. These start with our conviction that it is people not Governments who create prosperity. So this Budget seeks to reduce the role of Government. Government will spend less. Government will borrow less. This will lay the foundations for controlling inflation.

In today's world, higher prices for oil and petrol are inescapable. So too, in the short run, are the consequences of the inflation that has afflicted us for so long. Until that is controlled, some check to the growth of output and employment is unavoidable.

That underlines the other half of the Budget strategy. This is not a give-away Budget. Indeed, it is not in the power of Government to give anything away.

It is an opportunity Budget. The shift from taxes on income to taxes on spending will widen choice and

/improve incentives.

improve incentives. And above all, it will enlarge opportunities.

This Budget is designed to give the British people a greater opportunity than they have had for years to win a higher standard of living, for their country and for their families as well as for themselves.

I dare to believe they will respond to the opportunity that I have offered them today.

CH/EX. REF. NO. B(79)39 22

COPY NO. 1 OF 4 COPIES

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

9th June, 1979

Dear Tim,

I enclose a copy of the latest draft of the Chancellor's Budget Speech.

The Chancellor will be working on it again tomorrow but he thought the Prime Minister might care to see a copy in its present form at the weekend.

Yours ever,

Tony Battishill

(A.M.W. BATTISHILL)

T.P. Lankester, Esq.,

I INTRODUCTION

It is a little over five years since my predecessor, the rt. hon. Member for Leeds East, rose at this despatch box to present his first Budget. Like me, he did so within a very few weeks of his Party's success at a General Election. In compressing the huge and complex process of Budget-making into so short a time, he faced - as I have done - a formidable task.

Like him, I have received unstinting support not just from my fellow Treasury Ministers but from many people, of every rank, within the Treasury and the two Revenue Departments. But for the willingness of all these people to work far beyond a sense of duty it would scarcely have been possible for me to present this Budget at all.

So I gladly echo my predecessor in acknowledging

/this assistance

this assistance with a very real sense of gratitude.

I echo him too in saying that I approach my task - and I assure the House that I quote his very words - "in a mood of humility and trepidation".

I say that not just because of the novelty of the experience for me - although that is daunting enough - but much more because of my sense of dismay at the disturbing familiarity of the occasion from the point of view of almost everybody else.

For, as the House will recall, this is the fourth Budget in the last fifteen years to be introduced by a new Chancellor in a new Government. The late Iain Macleod, alas, did not survive long enough to be included in this series. Before myself there was, in 1964, the present Leader of the Opposition; in 1970, my noble friend, Lord Barber; and in 1974, the rt. hon.

/Gentleman, the

Gentleman, the Member for Leeds East.

The depressingly familiar feature of the first Budget Speech of each of these three predecessors is that every one of them found cause to complain, with more or less justice, about the disagreeable nature of the economic estate that had come his way.

The House will understand, in light of the figures published last Friday, which showed that the current account of the balance of payments in the first four months of this year was no less than £1½ billion in deficit, that I see every reason to take the same view as my predecessors.

/II THE YEARS OF DECLINE

II THE YEARS OF DECLINE

For so many of the facts tell the same story. Consumer spending rose last year, in percentage terms, by seven times as much as manufacturing output. We actually manufactured 4 per cent less goods in 1978 than in 1973. But the volume of manufactured imports went up last year by 13½ per cent. When demand was rising strongly, the economy had almost lost its capacity to increase supply. The current account of the balance of payments was barely in surplus last year, despite a massive contribution of £3½ billion from North Sea oil. Meanwhile, the pre-tax real rates of return on capital had fallen to less than half their level in the 1960s. And well before the last Administration left office inflation was back on a rising trend. The April figure for the RPI of 10.1 per cent told much less than the whole truth about their legacy.

/On that form,

On that form, and on the policies which brought it about, there is little reason to expect any improvement in the future. In many ways indeed, the prospect is more gloomy than the immediate past. Productivity is rising only about half as fast as in the early 1970s. And there is no sign of any change for the better there. Last year's growth in demand - founded, as it was, on growing consumption - could never have been sustained. For, as the trade figures make clear, it was largely met from imports. This is perhaps the main reason why the recent fall in unemployment was, in any event, likely to be reversed. It is little wonder that those who work in British industry are so deeply worried about their future.

It would be too easy to conclude that these problems are all the fault of the last administration. But I want to place the last five years in a rather longer perspective.

/Only a quarter

Only a quarter of a century ago - within the memory of almost every Member of this House - the people of the United Kingdom still enjoyed higher living standards than the citizens of any of the larger countries of Europe. Amongst the free nations of the world, Britain was then second only to the United States in economic strength.

Of course, we have not stood still since then. But others, like Germany and France, have achieved a great deal more. By now they have far outstripped us, and are moving further ahead all the time.

For example, their combined share of world trade in manufactured goods, which in 1954 was almost the same as ours alone, is now more than three times as large as ours. The French now produce half as much again as we do, while the Germans produce more than twice as much.

There has, of course, been plenty to say in mitigation or explanation of these developments. At least until recently, we have been able to claim a good record in most of those things that can be summed up in the phrase "the quality of life". But in the last few years, the hard facts of our relative decline have become increasingly plain. And the threat of absolute decline has gradually become very real.

/ III INTERNATIONAL BACKGROUND

III INTERNATIONAL BACKGROUND

Now as inhabitants of a country that has always been deeply involved in the international economy, we naturally pay a great deal of attention to events outside our own country. And, since the Yom Kippur war in 1973, scarcely a day has passed without press, radio or television telling us, in one way or another, that the world economy is in crisis. That may well be so. But it would be very dangerous if preoccupation with "the oil crisis", "the dollar crisis", or with this or that "Common Market crisis" led us to believe that our economic troubles could be blamed mainly on the outside world. That could all too easily suggest either that we should be rescued simply by a return of the world economy to its former buoyancy; or that if the world were to continue in the economic doldrums,

/we should not

we should not be able to put much right here at home. The truth is that our troubles are very largely home-made. If we tackle them ourselves, then we can pull our own economy round, even in a world of slow growth. If we do nothing to change course, then nothing that happens beyond these shores can help us.

As it happens, the international environment is unlikely to give us any comfort in the years immediately ahead. Oil, in particular, is once again a problem. With the cut in Iranian production market conditions have become very tight. Oil prices are now, on average, about 30 per cent higher than six months ago. This is one reason why inflation is now rising in most countries and why growth is likely to be significantly lower than in 1978. In these circumstances, we clearly now need to do more

/about both

about both conservation and supply of energy. We must achieve the oil saving objectives to which we are committed internationally. Some of the measures I shall be announcing later will help us to do so.

The energy problem can, of course, be mitigated by co-operation among the major consumer countries. For that reason it will be an important subject for discussion at the next meeting of the European Council, and at the Economic Summit in Tokyo at the end of this month. We have to recognise that there is both a short-term and a long-term problem in matching available oil supplies to the demands which a growing world economy is bound to make.

In this disturbed situation, the European Community can, and should, be a source of stability and of strength for its members. In one important

/area, however,

BUDGET - SECRET

area, however, present EEC policies are seriously hindering our efforts to help ourselves. At present the United Kingdom and Italy, which are among the poorer members of the Community, are transferring substantial resources, chiefly through the Community Budget, to richer member states. We have already made it very clear to our partners that this situation cannot be allowed to continue. It is plainly unfair. And it is against the interests of the Community itself, which cannot expect to progress on such an insecure foundation. I am confident that our view of this problem is becoming more fully understood by our partners. Upon the basis of this understanding, we shall continue to press for an agreement which meets the United Kingdom case.

But, I repeat, progress internationally, whether on energy policy or within the Community, will not

/cure the

cure the deep-seated weaknesses of our own domestic economy.

Nor will North Sea oil. Growing production from the North Sea may shield us, to some extent, from the transfer of income which other countries, without their own oil, are bound to suffer as prices rise. But this protection must not be allowed to shield us from the truth about what has been happening to the balance of our own trade, particularly in manufactured goods.

North Sea oil will itself do nothing to solve the problems on the supply side of our economy. Nor will it check inflation. Indeed, in some respects it may actually make matters worse, unless we correct some other aspects of policy which are at present working in the wrong direction. The moral once again is that it is for us now to take the

/decisive action

deçisive action that is needed to put our own house in order.

/ IV THE CAUSES OF DECLINE

IV THE CAUSES OF DECLINE

So we find ourselves, yet again, asking the question: how are we to check, and then reverse, the long decline? In particular, what can we, here in this House of Commons, do about it?

We do well to begin, I suggest, by acknowledging that there is a definite limit to our capacity, as politicians, to influence these things for the better. I suspect that that view is much more widely accepted outside this place than it is within.

I do not mean to be unkind to my predecessor when I invite the House, for a moment, to consider his example. The Government of which he was a distinguished member firmly believed that it was possible for Government to manage, indeed to plan, the economy, so as to promote efficiency and growth. The rt. hon. Gentleman, the

/Member for Leeds East,

BUDGET - SECRET

Member for Leeds East, espoused this belief with enthusiasm. For in five years of office he introduced no less than 15 Budgets and economic "packages", and financed a wide range of policies in the name of "the regeneration of industry".

But, at the end of five years, he must ask himself, to what avail? Has the industrial strategy, as he conceived it, really transformed the outlook for British industry? Are we not driven to the conclusion that the notions of demand management, expanding public spending and "fine tuning" (as it has come to be known), have now been tested almost to destruction?

Certainly the rt. hon. Gentleman, the Leader of the Opposition, has come round to that view. For, as he said in a memorable speech on September , 1976:

/"We used to think

"We used to think that you could just spend your way out of a recession and increase employment by cutting taxes and boosting Government spending. I tell you, in all candour", said the rt. hon. Gentleman, "that that option no longer exists and that, insofar as it ever did exist, it worked by injecting inflation into the economy.. And each time that happened the average level of unemployment has risen. Higher inflation, followed by higher unemployment", concluded the rt. hon. Gentleman, "that is the history of the last twenty years."

The rt. hon. Gentleman, the Member for Leeds East, has, in the event, been proclaiming the same conclusion. For he has throughout asserted the importance of monetary policy. He rightly began the practice of setting money supply targets. And he has claimed to make his public spending plans accordingly. This means that I am able to approach my task this afternoon on this one, crucially important, piece of common ground. For I can agree with my two Labour predecessors in this House, that the poor performance of the British economy in recent years has not

/been due to

been due to a shortage of demand. We are suffering from a growing series of failures on what is known as the supply side of the economy.

/ V A FRESH APPROACH

V A FRESH APPROACH

It is our belief that many of these failures are themselves the result of actions and interventions by Government itself: laws that stand in the way of change and stifle enterprise; and, as important as anything, a structure of taxation that might have been especially designed to discourage innovation and punish success.

So we are convinced that an entirely fresh approach is necessary if we are to check the long-term economic decline, which has gathered pace in the last five years.

Our strategy is based on four principles.

We need to strengthen financial incentives, by allowing people to keep more of what they earn, so that hard work pays, talent and ability are appreciated, and success is rewarded.

/We need to

BUDGET - SECRET

• We need to enlarge freedom of choice by reducing the role of the state and enlarging that of the individual.

We need to reduce the burden of financing the public sector, and its impact on the rest of the economy, to a level which will leave room for commerce and industry to prosper.

Which is [illegible]?

And we need to ensure, so far as possible, that those who play any part in the process of collective bargaining are obliged to live with the consequences of their actions - for that is the way to promote a proper sense of responsibility.

These are simple principles. But they require substantial change in the way in which our economy is allowed to work. They require us to remove the constraints and discouragement of recent years. Only

/in this way

in this way can we revive the motivation of businessmen, managers and the many other key individuals on whom we depend to produce genuine new jobs and the wealth that will be needed to improve public and social services.

The tax changes I shall propose today will be only the first step. But they will take us a long way in the new direction that is essential.

/ VI INFLATION

VI INFLATION

These policies will not, of course, succeed unless we are at the same time squeezing inflation out of the system. It is crucially important to re-establish sound money. We intend to achieve this through firm monetary discipline and fiscal policies consistent with it, including strict control over public expenditure. Financial discipline must begin at home. It will apply therefore as rigorously to the public sector as it does to the private sector. And it will be sustained.

Financial responsibility on the part of Government must be supported by a corresponding acceptance of responsibility elsewhere. People must understand and accept that the only basis for real increases in wages and salaries is an increase

M.P's pay?!

in national production. Higher pay that is not accompanied by higher productivity can only lead to higher inflation and unemployment.

This is the crucial reason for moderation, ? realism and responsibility in pay bargaining. It is important for this to be fully understood by all those involved in wage negotiation. We shall be more than willing to consider better methods of ensuring that it is.

In recent years people's sense of responsibility has too often been undermined on both sides of industry, frequently as a result of formal pay policies imposed by Government. Responsibility cannot thrive unless it is accompanied by freedom and flexibility - and this is what we are offering. Given the monetary and fiscal policies to which we are firmly committed, irresponsibility is bound, as I have said, to threaten the destruction of jobs, as to some extent it has done in the past.

Responsible bargaining necessarily means different things to different people and in different kinds of firms and industry. But on both sides of the table certain limitations must be recognised: in the public sector, what the rate payer and tax payer can afford; in industry, what the customer is prepared to pay, what the firm needs to invest, and what the pressure of competition demands; and, throughout the economy, the limits imposed by the need to control the money supply.

/ VII MONETARY POLICY

VII MONETARY POLICY

As I have already observed, my predecessor was undoubtedly right to adopt a system of monetary targets. But his other policies were seldom consistent with his own monetary objectives. Thus, although monetary growth in 1978-79 as a whole was just within the target range of 8-12 per cent, it was growing in the second half of the year at an annual rate of almost 13 per cent. Moreover, the May figures, now becoming available, indicate that the underlying growth is still above the top range and, if anything, accelerating. One cause of this has been the high rate of central government borrowing: £2½ billion in April and May.

It is now clear that the public expenditure policies which we inherited would have made it quite impossible to meet the rt. hon. Gentleman's 8-12 per cent target without a further savage squeeze on the private sector, involving

/both a sharp

both a sharp increase in the total tax burden and even higher interest rates. Not for the first time, the levels of public spending and borrowing which he permitted were far too high to be compatible with his own monetary targets.

I shall myself be obliged to take painful action to correct that mistake.

We are committed to the progressive reduction of the rate of growth of the money supply. I therefore intend, as the first step in this process, to make a modest change in the target range for the remainder of this year, 1979-80. The new target range, to apply to the growth of sterling M3 in the 10 months to the banking make-up day in April 1980, will therefore be an annual rate of 7 per cent - 11 per cent. I will roll the target forward by six months in the autumn.

Equally important, I intend to shift progressively the balance in the way in which the monetary target is achieved from an excessive reliance on interest rates and curbs on the private sector to a greater emphasis on fiscal restraint and economy by the public sector. This requires, as a first step, a significant reduction in the Public Sector Borrowing Requirement from the figure of around £10 billion that it would otherwise have reached this year.

/There are, however,

. There are, however, limits to what can be done in this Budget, with two and a half months of the financial year already passed, to curtail the scale of public spending in the current year. This is indeed a severe handicap. But I intend, even so, to reduce the public sector's financial needs enough to make it possible to achieve my monetary target in due course, with less restraint on the private sector.

But the fiscal measures which I am announcing today must inevitably take time to take effect. They cannot immediately reduce the seriously excessive monetary growth that I have inherited. Particularly given the continuing surge in bank lending, I have concluded that I have no option but to act directly to reduce that growth. It is not enough to speak of the importance of monetary policy, unless one is prepared to carry one's words into practice.

The Bank of England are accordingly rolling forward the Supplementary Deposit scheme, or "corset", by three months on the existing basis. In addition, the Bank are announcing this afternoon, an increase in their Minimum Lending Rate by [2 per cent] to [14 per cent]. I must make it very plain to the House that the necessity for this action ranks alongside the trade figures as entirely characteristic of the legacy of the last administration.

I return now to consider the right size of the Public Sector Borrowing Requirement in the current year. As my predecessor found to his cost, this is a fickle and elusive statistic. That is why I offer my judgement of the scale of Government borrowing in 1979-80 with a degree of diffidence. Having said that, my best estimate is that the changes in taxation and public expenditure which I am announcing today will be sufficient to reduce the PSBR to £8¼ billion in the current year, as compared with the outturn of £9¼ billion for 1978-79 and a forecast of £ x billion on the previous govt's policies for the current year. As a percentage of GDP, that will represent a reduction of over 5½ per cent last year to under 4½ per cent in the current year. That is an important step in the right direction. But it is only the first. I intend to continue along this path in the years ahead.

Would it not be advisable to compare it here with the current year's forecast on previous policies?

/It will no doubt

Why not ... this?

. It will no doubt be argued by some - although I do not think it can be so argued by my predecessor - that fiscal action to bring down the PSBR to the figure I have mentioned is unduly severe. And indeed the conventional forecasting arithmetic, which, in accordance with custom and statute, I am publishing in the Financial Statement, does suggest that the economy will show no growth in the period immediately ahead.

But this prospect, insofar as it can be viewed as a reliable prediction, cannot be taken to mean that the Budget is, in the by now traditional language of Keynesian economists, too contractionary. To make this claim is to argue that an alternative course of fiscal policy would produce more growth and more employment. I believe this argument to be profoundly wrong.

To aim at a significantly higher Public Sector Borrowing Requirement - in other words to ease the stance

/of fiscal policy

of fiscal policy - would be likely to fuel the fire of inflation and worsen the balance of payments. In the end, we should have less growth, less employment, a bigger deficit and a faster rate of growth of prices. From the quotation I made earlier of the Leader of the Opposition, I believe that he too fully supports this analysis. It follows that any decline in economic activity which might, on a narrow view, be attributed to this Budget will in reality not have been caused by the Budget but by the economic situation which has made such measures inevitable, while inflation is brought under firm control.

VIII EXCHANGE CONTROL

I come now to my proposals. I propose to deal first with the question of exchange control.

Sterling is at present relatively strong, and I expect it to remain so. This strength flows partly from the realisation that, as a result of North Sea oil, the UK is better placed than most of our competitors to deal with present world oil problems. Our fiscal and monetary policies should maintain confidence in the currency. This is, therefore, an appropriate time to start dismantling our apparatus of controls on outward capital flows. Our present régime is more restrictive than in any other major industrialised country. There is an overwhelming case, in this context as in others, for giving both companies and individuals wider freedom of choice. This should reduce the distortions and costs which controls are bound

/to impose

to impose on economic decisions. These costs bear particularly heavily on smaller companies.

We intend to move one step at a time, and, in this initial stage, we are placing emphasis on direct investment overseas. Details are being made available in the Vote Office.

I have decided that the main relaxation should be for access to official exchange up to £5 million per project per year to be freely permitted for new outward direct investment. This should allow the majority of UK firms who invest overseas all the sterling finance they are likely to want. The two-thirds rule, which restricts the re-investment of profits earned overseas, will be abolished. This greater freedom in the financing of direct investment abroad does not, as is sometimes feared, threaten jobs in the United Kingdom. The weight of evidence

/is that overseas

is, that overseas investment generally strengthens our position in world export markets to the benefit of output and jobs in this country. Moreover, additional investment overseas today will yield an income that will stand us in good stead when the overseas earnings from North Sea oil begin to decline.

During the sterling crisis of 1976, the last Government stopped the use of sterling to finance third country trade. This restriction has placed British merchants at a disadvantage in international business and I am taking the opportunity to restore the facility to them as soon as the details can be worked out.

I have also decided that there should be some immediate easement of the controls affecting individuals. I am, therefore, making significant relaxations in the rules concerning travel and emigration allowances,

/overseas property,

overseas property, and cash gifts and payments to dependants. In the field of portfolio investment, I am taking two modest steps at this stage. I am abolishing the requirement to maintain 115 per cent cover for overseas portfolios financed by foreign currency borrowing; and official exchange will henceforth be available for meeting interest payments on such borrowing. The 1975 controls on gold coins will also be abolished.

As the House knows, the liberalisation of exchange controls is one of our obligations under the EEC Treaty. I have accordingly consulted the Commission about the decisions I am announcing today.

As time goes by, I intend to take further steps in the progressive dismantling of exchange control. The pace of relaxation will obviously be influenced by sterling's strength as well as by the speed with which

/we can solve

we can solve the economic problems that face us.

In our external policy we have also to take account of our official external debts. These at present amount to 22 billion dollars - a massive increase on the 8 billion dollars which the previous Government inherited in 1974. It is our intention to reduce this burden of external debt substantially during the life of this Parliament.

/ IX PUBLIC EXPENDITURE

IX. PUBLIC EXPENDITURE

In order to reduce the borrowing requirement and the burden of direct taxation we must make savings in public spending and draw back the boundaries of the public sector. We are as committed as any Government to a high standard of public services. But these can only be achieved if the economy is strong. So our first priority must be to strengthen the economy - to reduce inflation and to restore incentives. Finance must determine expenditure, not expenditure finance. Substantial reductions in expenditure can and will be made in the remainder of this financial year.

First, as I made clear three weeks ago, we shall not raise the cash limits to cover higher prices than those provided for in the cash limits originally published for this year. On pay in the public

/services, while

BUDGET - SECRET

services, while we will honour the commitments to the universities and the health authorities entered upon by our predecessors, in general we will limit the adjustment of the cash limits so that substantial offsetting economies will have to be found.

The need for substantial economies applies to local authority expenditure, where the Government's contribution is made through the rate support grant. As I said three weeks ago, we shall take account of pay settlements in calculating the increase orders for the rate support grant, but we shall make a significant across-the-board reduction from the total so calculated. I can now tell the House that the reduction will be £300 million for England and Wales and £35 million for Scotland. These figures may have to be increased when we know the cost of further pay increases and will be finally

From £7,000 m? whole

/determined in

determined in November, before the increase orders are made. In coming to this decision, a major factor has been how much in present circumstances it is reasonable for the taxpayer to contribute.

The cash limits on Departments and fringe bodies are being set to ensure that economies of 9 3 per cent are achieved on manpower costs this year, as announced by my hon. Friend the Minister of State, Civil Service Department.

I estimate that this cash limits policy will reduce the volume of planned expenditure by about £1 billion at 1979 Survey prices.

On top of these reductions resulting from the policy on cash limits, my rt. hon. and hon. Friends have reviewed the plans for their Departments and the nationalised industries and have identified

/further specific

further specific reductions which are being made this year. The changes are listed in a notice to be issued by the Treasury today, and available in the Vote Office. Further details will be given by the Ministers concerned. But the House will want to know where the main reductions will be made. All figures are at 1979 Survey prices.

We are making an immediate start in reducing expenditure on industrial and employment subsidies. My rt. hon. Friend, the Secretary of State for Industry, is cutting expenditure on industrial support this year by £210 million. This will come out of the provision for new projects by the Department of Industry and by the National Enterprise Board, and by imposition of a delay of 4 months in payments of approved claims for regional development grant. Support for employment programmes is to be

From what to what

/concentrated on

concentrated on the areas where unemployment is highest. So that savings of over £170 million will be made this year.

In the area for which my rt. hon. Friend the Secretary of State for Energy is responsible savings of over £320 million are being made this year in the finance for BNOC and the electricity, gas and coal industries. The industries have been asked to avoid so far as possible increases in fuel charges beyond those required to meet the cash limits announced by the previous Government.

My rt. hon. Friend, the Secretary of State for the Environment, is making savings of about £440 million from his programmes this year, mainly by scrapping the Community Land Act, deferring water authority investment and reducing the existing

/allocations to

allocations to housing authorities.

As we have repeatedly made clear, it is not our intention to reduce spending on the Health Service. But we cannot ignore the fact that the contribution made by some health charges has greatly diminished in recent years. This applies especially to prescription charges, which have stood at their present level for eight years, during which prices have risen over 2½ times. It is therefore proposed to increase prescription charges to 45p. This will still leave them cheaper in real terms than they were in 1971, and the present wide range of exemptions covering children and the elderly amongst others will, of course, be maintained. Certain dental charges will also be increased. These changes will yield £34 million in 1979/80 for Great Britain as a whole.

/My rt. hon. Friend,

My rt. hon. Friend, the Secretary of State for Education and Science, is reducing expenditure in those areas of the education and science programmes within the Government's direct control by about £55 million. We shall not add to the increase of 5p in the school meal charge which was planned by our predecessors for the autumn term.

The aid programme this year is being reduced by £50 million. Savings are also being made on the transport, trade and arts programmes.

My rt. hon. Friends, the Secretaries of State for Scotland, Wales and Northern Ireland are making comparable reductions in their own programmes.

In total these reductions amount to over £1½ billion this year.

/In addition,

BUDGET - SECRET

In addition, we do not intend to use as large a Contingency Reserve as provided for 1979-80 in the last Government's public expenditure White Paper.

We have decided to cut the Reserve by £250 million. Any further decision to add to the volume of programmes in the remainder of this year will be met from the balance of just over £250 million remaining in the Reserve.

In two areas we are providing for increased expenditure - defence and pensions. An extra £100 million is being provided for the defence budget this year. This will enable essential projects in the equipment programme to go ahead. I shall return to the pensions improvements shortly.

As I have already indicated, we are only just

/embarking on our

embarking on our review of the plans we have inherited and of the scope for reducing the size of the public sector. But it is already clear that the scope for sales of assets is substantial.

Sales of state-owned assets to the private sector serve the immediate purpose of helping to reduce the excessive Public Sector Borrowing Requirement with which I was faced. This is all the more necessary this year, given the great difficulty of cutting back public sector spending programmes once the year has already begun.

But such sales are not justified simply by the help they give to the short-term reduction of the PSBR. They are an essential part of our long-term programme of promoting the widest possible participation by the people in the ownership of British industry.

This objective - wider public ownership in the true meaning of the term - has implications not merely for the scale of our programme, but also for the methods of sale we shall adopt.

So far as this year's disposals are concerned, we must obviously retain flexibility on timing and on the precise mix of assets in order to ensure a fair price. I do not therefore propose to announce the details today. But I intend to ensure that the proceeds of sales in the current financial year will amount to some £1 billion and I have taken account of this in the Budget arithmetic. The biggest contribution to this total will come from the sale of a further part of the Government's shareholding in British Petroleum, where we shall be following the example set by the last administration in 1979. (

/In total I

In total I estimate that the economies I have announced will amount to about £3½ billion at 1979 Survey prices and £4 billion at current prices. Yet given the scale of the problem we have inherited, I must look for a further contribution from indirect taxes to finance the first stage of our plans for the reduction of income tax.

/ X INDIRECT TAXATION

X INDIRECT TAXATION

We made it clear in our Manifesto that we intended to switch some of the tax burden from taxes on earnings to taxes on spending. This is the only way that we can restore incentives and make it more worthwhile to work; and at the same time increase the freedom of choice of the individual. We must make a start now.

I have reviewed the whole field of indirect taxation to decide where the increased revenue could best come from. There are many cogent arguments at this stage in favour of the VAT.

First, large areas of consumer expenditure, in fact about half the total, are not chargeable to VAT. Food, children's clothes, heating and light, housing and public transport are all zero rated.

/Second people

Second, people with bigger incomes tend to spend proportionately more on goods liable to VAT. This means that, unlike most indirect taxes, the VAT is not regressive.

Third, by comparison with taxes such as those on alcohol and tobacco, the VAT is much more broadly based.

Fourth, there is a real opportunity for simplifying the operation of the tax by having one rate instead of two.

In his Speech on 22nd May, the rt. hon. Gentleman the Member for Leeds East seemed to favour increases in the surcharge on National Insurance contributions or in Advance Corporation Tax. The National Insurance Surcharge falls on the whole of British industry, including

/production for export,

production for export, but not on imports. It is inferior in this respect to VAT, which falls on imports but not on exports. This is clearly significant in light of the latest trade figures. An increase in Advance Corporation Tax would seriously damage the overall liquidity of industry at a particularly difficult time: in contrast an increase in VAT actually increases it.

For all these reasons my choice must fall on the VAT. Moreover, the increase I make must be sufficient to provide for substantial and worthwhile reductions in income tax. I propose, therefore, that as from next Monday VAT should be charged at a new unified rate of 15 per cent.

Allowing for the wide range of goods and services which are zero rated - and which will stay zero rated - the new rate I propose is equivalent to 8 per cent

/averaged over

averaged over the whole of consumer expenditure. This is significantly less than the average in the European Community.

The yield from the increase to 15 per cent is estimated at £2035 million in 1979/80 and £4175 million in a full year. Thus it will provide scope for further direct tax reductions in later years. The relatively small size of the yield this year reflects the loss of over two months' revenue between April and the present, and the time lag allowed to traders before they pay over VAT receipts to the authorities - an average of over 3 months. I have referred to the helpful contribution this gap provides towards improving liquidity. For as these funds build up in traders' hands, they provide a substantial boost to the liquidity of the firms and companies concerned. Concern has been expressed that

/an increase

an increase in VAT would apply to telephone bills for calls made before the date of change. I am proposing transitional provisions to deal with this and some of the other problems in this field.

The sharp increase in VAT will, of course, add significantly to the point of sale prices of drink and tobacco. For example the VAT increase will mean about an extra 28p on a bottle of spirits, 2p on a pint of beer and 6p on a typical packet of 20 cigarettes. In these circumstances, I do not think it would be justifiable to make a separate increase in the excise duties on drink and tobacco this year.

I fully realise that this increase in Value Added Tax will result in a rise in prices - in fact a rise of about 3½ per cent in the Retail Price Index. This is, of course, a once-for-all effect. But there never was a

/time when it

time when it was going to be easy to effect the switch from direct to indirect taxes and the present moment is no exception. The action has been postponed too long already. Indeed, the former administration actually made matters worse at one moment when it cut the basic rate of VAT from 10 per cent to 8 per cent in a period when it was actually raising income tax. We are, therefore, proposing to deal with this overdue reform boldly and forthwith.

The House should bear in mind that, as I have already indicated, VAT does not fall on a wide range of necessities. This means that the increase will fall less heavily on people in the lower income groups. And, as will be apparent when I come to my income tax proposals, we shall be leaving people with more money in their pockets which will enable them to pay the increased VAT.

I appreciate that those who are not liable to income tax, and I have in mind particularly many of those living on retirement pensions, will not benefit from my income tax proposals. So this brings me to our proposals in the field of Social Security.

/ XI SOCIAL SECURITY PAYMENTS

XI SOCIAL SECURITY PAYMENTS

We have decided to increase the standard rate of retirement pensions in November by £6.10 to £37.30 for a married couple and by £3.80 to £23.30 for a single person. As we promised, these increases take full account of the underestimate which the last Government made of the actual rise in earnings between November 1977 and November 1978, and are well above the figures of £4 and £2.50 announced by the previous Government. Other social security benefits will also be increased, and my rt. hon. Friend, the Secretary of State for Social Services, will announce full details tomorrow.

This means that National Insurance pensioners and other beneficiaries will be fully protected against the forecast increase in prices. This is what is really important. But the extent to which we can afford to go

/further than this -

further than this - to add improvements in real terms - must depend on the productive capacity of those in work.

Under the present rules pensions are uprated on the basis of the movement in prices or earnings, whichever is the greater. The Government have decided, however, that for the future the requirement for the statutory uprating of pensions should be based on price movements, and we shall be introducing legislation to this end. This will be a minimum requirement, and will fully protect the value of these pensions against price increases at all times, including those arising from indirect taxes such as I have just announced. Of course we want to be able to do more. I am confident that in time, as our economy improves, it will be possible to do more and ensure that pensioners share in the increase in national prosperity. That is one more reason why my other proposals today are so important. For they are intended to strengthen the productive capacity of the economy as a whole.

The change will make no difference this year since the forecast rise in prices for the year to November is greater than the increase in earnings expected over the same period. The figures I have just mentioned fully reflect this forecast price increase.

We also propose to improve certain other social security benefits. Child benefit went up by £1 per week only two months ago, and a further increase this year is not justified. But single parent families face particular problems, and we propose that the one parent premium should go up from £2 to £2.50 next November. We also want to help the disabled. Mobility allowance will accordingly be increased from £10 to £12 in the autumn.

And we shall, of course, honour our commitment to pay a Christmas bonus this year of £10.

These measures overall will cost about £1100 million in 1979/80 and £2700 million in a full year. As the House knows, my general policy is to make substantial reductions in public expenditure. But the reductions in public expenditure must not be done in a way which bear unfairly on the more vulnerable members of society.

/Our social security

[Our social security system has become far too complicated and it sometimes acts to reduce the incentive to work. The problem is widely recognised on both sides of this House. We are therefore studying a number of aspects of the social security system to see what can be done to simplify it. My rt. hon. Friend, the Secretary of State, is also putting in hand urgent measures to tighten up on abuse and fraud.]

/ XII. TAXATION OF OIL AND PETROLEUM

XII TAXATION OF OIL AND PETROLEUM

Hydrocarbon Oil Duties

I dealt earlier with the excise duties on tobacco and drink. The oil duties, however, raise wider issues. I have already indicated my intention to announce measures which will help us to meet the growing and undoubted need to conserve oil. At a time when there is a worldwide shortage of crude oil it is essential that we should play our full part in achieving the 5 per cent reduction in consumption to which the previous Government rightly committed us.

I therefore propose to increase all the main oil duties this year. In the particular case of petrol, the VAT increase from 12½ per cent to 15 per cent will be smaller than for many other items. With this in mind I propose to increase the petrol duty by about 23 per cent -

/7p a gallon -

7p a gallon - which will result in a total price change of about 10p a gallon. I also propose to increase the duty on derv by the same sum, 7p per gallon, and the duty on heavy oil other than derv, by ½p, that is by about 20 per cent. I am not, however, increasing the duty for burning oil and for domestic paraffin, which is the oil used most commonly in the home, particularly by pensioners. The yield from these excise duty changes is estimated at an additional £525 million in a full year and £400 million in 1979/80. The immediate increase in the RPI will be about a quarter of one per cent.

Vehicle Excise Duty

In view of the increase I am proposing in the road fuel duties I have decided to make no change in the rate of vehicle excise duty. Our predecessors announced their intention of abolishing the duty on petrol driven vehicles.

/As my rt. hon. Friend

As my rt. hon. Friend, the Minister of Transport has already said, we are reviewing the future of this duty and we shall announce our conclusions in due course. For heavier goods vehicles my rt. hon. Friend will be announcing plans for restructuring the form of this tax.

Car Leasing

Before I leave the subject of motor cars, there is a particular issue I need to deal with. There is a weakness in the present legislation on capital allowances which enables leased cars to avoid the special rules restricting allowances for business cars. This has resulted in a loss of tax which is currently running at about £175 million a year; and which could well rise to £200 million next year if I take no action. I propose to put this right with effect from today.

/Petroleum Revenue Tax

Petroleum Revenue Tax

I turn next to petroleum revenue tax. The previous Government announced last August that they proposed to increase this tax from 1st January 1979. These proposals were discussed very fully by the last Government with the industry and we ourselves have had representations about them, which we have carefully considered.

Although we did not oppose them at the time, I am not sure that, when the proposals were announced, they were wholly justified in their intended aim of securing a fairer balance in sharing the proceeds from our oil resources. Companies cannot be expected to invest in the North Sea unless the return they get from successful development rewards them commensurately for the risks they have taken and which we are continuing to look to them to take. But judged against the recent developments in the world oil situation I consider that the package of

/PRT proposals

PRT proposals for increasing the Government's take from the North Sea is now fully justified. There will accordingly be provisions in the Finance Bill to implement it. I also propose, however, to introduce some changes in the PRT expenditure rules for which the industry have been pressing for some time. Moreover, the British National Oil Corporation will no longer be exempted from PRT.

These proposals will increase the Government's revenue from the North Sea by about £110 million in the year 1979/80, and by about £1800 million to 1985.

/ XIII BUSINESS TAXATION - INCLUDING CAPITAL TAXATION

XIII BUSINESS TAXATION - INCLUDING CAPITAL TAXATION

Before I deal with the taxation of business profits, I propose to refer to the taxation of capital, a matter of vital interest to business as well as to individuals.

We made it clear in our Manifesto that we were determined to make the taxation of capital simpler and less oppressive. The objection to Capital Gains Tax in its present form is that most of the yield comes from paper gains arising from inflation. The tax is, therefore, simply a levy on the capital itself. The Capital Transfer Tax, despite the improvements we were able to secure in the last Parliament by constant pressure from our Benches, is oppressive, harmful to business, and a real deterrent to initiative and enterprise. It is perfectly natural that people should want to build

/up capital

up capital of their own and pass it on to their children; this is particularly true of the small business proprietor.

The issues involved in both of these taxes are difficult and complex. We need more time to study them and devise the best solutions. I have therefore decided that we should not attempt to legislate in the coming Finance Bill, but should press ahead with a thorough study, with a view to legislating at the earliest possible date. There is however one specific issue on which legislation is required in order to hold the present position: I propose to extend for a further two years the period for CTT transitional relief for capital distributions from discretionary trusts and to defer for two years the introduction of the periodic charge.

The Development Land Tax, however, is a very

/different matter

different matter and calls for immediate action. This tax has combined with the Community Land Act to prevent much worthwhile development and to increase unemployment in the construction industries. We have already said that we will repeal the Community Land Act. I propose now to deal with the Development Land Tax. In place of the present rates of 66⅔ per cent and 80 per cent, which the previous Government intended should rise to 100 per cent, I propose that Development Land Tax will in future be charged at a single rate of 60 per cent. The amount of development value which can be realised in a financial year without liability to Development Land Tax will be raised from £10,000 to £50,000. Both these changes take effect for disposals made on or after today.

I do not propose to make any further reductions

/in rate;

in rate; and the generous increase in the exempt slice should mean that it will not need early revision. Owners of development land will, therefore, have no reason for holding back in the hope of further tax reductions. What I have said today should remove the major uncertainties which have been hanging over the market.

I now turn to the taxation of profits. A vigorous, profitable and expanding company sector is essential if we are to rebuild this country's prosperity. Profitability has dropped sharply in recent years and the rate of return on capital employed is now far too low. This is especially true of manufacturing industry.

Without higher profits we shall not see the new investment and jobs which are so urgently needed. Achieving those profits is very largely the task of

/management and

management and work people. The Government can help or hinder them, and this is no time to add to the difficulties that they face by raising taxes on profits still further. Against that background I propose no change this year in the general system or in the rates of Corporation Tax. Nor would it be right to make any major changes in the system of taxation without careful consultation in advance.

Looking further ahead, however, it is important that the tax system should take account of the effects of inflation on businesses, and do so in a way that is reasonably objective, equitable and simple to administer. The Government will therefore be reviewing a number of aspects of the present system, at the same time as the accountancy profession's latest proposals for current cost accounting. I am arranging for the Inland Revenue to consult the accountancy profession and business later in the year.

I need however to deal now with the question of stock relief. The Finance Bill will include legislation to honour the undertaking which my predecessor gave last year, and which we on this side of the House supported, to write off the deferred tax liabilities arising from stock relief given for the first two years of the scheme - 1973-74 and 1974-75; and to write off these liabilities in respect of subsequent years successively, after an interval of six years.

In addition, following consultations which the Inland Revenue have had with industry, I am proposing two further changes in the stock relief scheme. I intend to reduce the profit restriction for unincorporated businesses from 15 per cent to 10 per cent; and all businesses will be given greater flexibility in the amount of relief that they can claim. Both these changes will be of particular benefit to small businesses.

Details of the stock relief and car leasing proposals will be given in Inland Revenue Press Notices which I am making available in the Vote Office.

I now come to dividend control. If industry is to flourish it needs not only adequate profits but a vigorous capital market to provide funds for investment and expansion. The control of dividends has now outlived its purpose. The control will accordingly come to an end when the existing legislation expires on 31st July.

We on this side of the House have consistently championed the cause of smaller businesses. So I also propose to raise this year the profit limits for the small companies rate of corporation tax - to the figure of £60,000 at the lower end and of £100,000 at the upper end. This will go some way further than is necessary to maintain their real value. In the tax field, however there is one measure that will do more than anything else to encourage the contribution that smaller businesses - indeed businesses of every size - can make to enterprise, innovation and employment. That is, a major reduction in the burden of income tax. [I will come to that in due course.)

BUDGET - SECRET

XIV INCOME TAX

I now come to the income tax reductions, which are the keystone of my policy. The excessive levels of income tax bear a heavy responsibility for the lack-lustre performance of the British economy. We need, therefore, to cut income tax at all levels. For the reasons I have already explained, I cannot do as much this year as I should have liked, and I cannot do as much as is needed. But, although it contains only the first instalment of income tax changes which we shall bring forward in the future, I wish to leave no doubt in anyone's mind that this Budget marks a real turning point.

Would it not be better to begin with the lower

I begin with the higher rates of tax. The upper rates no longer affect only those on very high incomes. They apply to senior executives and middle managers in industry and frequently to skilled workers: as well as to professional people and the proprietors of small

/businesses

businesses. These are the people upon whom most of our hopes for initiative, greater enterprise and national prosperity must depend.

It is universally recognised that the present top rate of 83 per cent on earned income is an absurdity. The rate of 98 per cent on investment income is even worse. Such rates bring in very little revenue. But they act as a severe disincentive and are a patent injustice. Some members of the previous Government recognised this. But they did nothing about it. I propose an overdue measure of reform. The top rate will be cut from the present 83 per cent to 60 per cent. This new top rate will apply to taxable income over £25,000. At the other end of the higher rate scale, the present threshold of £8,000 is too low. I propose raising it to £10,000. Even at this figure it will be less in real terms than it was in 1973. In between I propose a new scale of rates less steeply progressive than the old scale.

The top rate of 60 per cent on earned income I now propose fulfils our commitment to reduce the top rate to the European average. The top rate in France is 60 per cent. In Germany, it is 56 per cent. In the United States, it is only 50 per cent. The new top rate will still be reached at an income level which is lower and in some instances significantly lower than is common elsewhere. This is a matter to which we may need to return on a future occasion.

So, while the reductions I propose are substantial, they are no more than the circumstances require. They will still in general leave people in the top income groups more highly taxed than people in corresponding positions in other industrialised countries. We have to compete with such countries, not only in the sale of goods and services, but in attracting and retaining

/the talent required

the talent required to run our industry efficiently and profitably and thereby provide the employment opportunities that our people so desperately need.

We have over the years spent too much time and effort trying to "level down". This is no good to anybody. It is much more important to have a prosperous society. And we cannot have a prosperous society unless we are prepared to have some prosperous people.

But it is not only at the top of the income range that the burden of income tax is particularly oppressive. The same is true for those on the lowest taxable incomes. That is the importance of the tax thresholds, to which I turn next. The increases proposed in the April Finance Act, which were not of course implemented, were not sufficient. I propose to double these increases. This means that the amount a single person can earn tax-free

/will go up

will go up, not by £90, but by £180. The married allowance will go up, not by £140, but by £280. A single person's tax-free earnings will thus go up by nearly £3.50 a week, and if he is paying tax at the basic rate he will get a full £1 a week extra in his pay packet. The amount that a married man can earn tax-free will go up by £5.38 a week; and if he is paying tax at the basic rate, he will find an extra £1.78 a week in his pay packet. This is quite apart from the consequences of any further changes that I have to propose.

I have in fact three other changes to propose before I come to the basic rate of income tax. First, to help the elderly, the age allowance will be raised by £240 for the single person and £380 for the married person. These again are double the figures proposed in the April Finance Act. Last year the limit for the full allowance was £4,000. This year I propose raising it to £5,000, more

/than twice the

than twice the increase proposed in the April Finance Act.

Second, I propose raising the threshold for the investment income surcharge. The justification for retaining the surcharge is itself debatable. Certainly there can be no argument but that it bites at far too low a level of income. Almost half the surcharge is paid by people over 65. This is moreover a tax which falls with particular severity on those who have had to make provision for their retirement out of their savings and have no occupational pensions to fall back on. The undue severity of the tax was recognised by the previous Government by introducing what were no more than palliatives in the form of a reduced rate applied to the first slice of income liable to the surcharge and a slightly higher threshold for those over 65. We propose instead to raise the threshold to £5,000 for everyone; the rate above that level will remain at 15 per cent. This approach combines a considerable simplication of the tax with a measure of justice that is long overdue.

Third, we propose implementing our election pledge to war widows. Provision will be made in the Finance Bill to exempt their pensions entirely from tax.

I come finally to the basic rate. For the great majority of taxpayers - some 21 million in all - it is the basic rate which determines the tax liability. It is the basic rate which is also the marginal rate falling on additional earnings whether they come from overtime, or greater productivity, or reflect greater skill or the rewards of promotion. Everywhere one meets complaint and criticism that income tax erodes differentials, reduces the rewards of skilled workers and discourages effort,

/initiative and

initiative and responsibility. This year I propose taking a first and significant step to deal with these complaints by reducing the rate from 33 per cent to 30 per cent. Nothing less than this would provide both the incentive we need and the conviction that we really mean business. [My long term aim is to reduce the basic rate of income tax to 25 per cent.]

The total cost of these income tax reductions, including the cost of increases in personal allowances proposed in April but not implemented at the time, will be £4,540 million in a full year. The lion's share, no less than £3,460 million or over three-quarters of the total, represents the cost of increasing the personal allowances and reducing the basic rate. The cost this year of all the income tax changes will be £3,500 million.

/As a result

As a result of the increase in the tax thresholds, 1.3 million people who would otherwise have paid tax this year will not be required to do so. The number of people paying tax at the higher rates would have been 1.2 million: the number will be virtually halved to 650,000. The number liable to the investment income surcharge will be reduced to about a third of what it would have been - from 850,000 to 300,000. All the changes will simplify administration and reduce the work load on the Inland Revenue.

The changes in allowances will be implemented for most taxpayers on the first pay day after 12th July. The reduction in the rates of tax will be given effect as soon as new tax tables are ready in October.

/A full year's

BUDGET - SECRET

A full year's income tax reductions will be received even though my Budget is being presented two months or more after the start of the year. On this basis the income tax changes mean that for the married couple where the husband earns £100 a week, which is close to average earnings, there will be an increase in take-home pay averaged over the remainder of the financial year of over £4 a week. The increases in VAT and petrol duty will increase family expenditure by about £2.75. So that, taking both the direct and indirect tax changes into account, the family will be about £1.30 per week better off. Similarly, where the husband earns £60 per week there will be a real gain of over 75p a week, while the position of the couple on £150 per week will improve by nearly £2 a week.

~~That~~ So there can be no question of ~~union~~ wage bargainers arguing that they need more for their members to compensate for VAT increases

/These reductions

These reductions in the burden of income tax, which are as substantial as they are unprecedented, mean that wage and salary earners will have more money in their pockets to buy the goods and services they help to produce. True the prices of a good many of these goods and services will be increased by my tax proposals. But we have done everything we can to ensure that every family in the land will have more money coming in to pay the increased bills, and with some to spare. And what is more, the choice of the way they spend their higher income will rest increasingly with them, and not with the Government.

These changes represent only the first stage in the major reduction in the burden of direct taxation that we are determined to make. The <u>net</u> effects of my proposals as a whole - and not simply the immediate effects on prices of some of them - should be studied carefully, particularly

/by those who

by those who will be involved in pay bargaining.

+ unnecessary

It would be not only foolish, but positively damaging to the nation as a whole, as well as to the individual's own self-interest, if an attempt were made to recover by excessive pay claims what has already been more than made good by these unprecedented reductions in income tax.

SECRET

21

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

8th June, 1979

Dear Tim,

TRADE FIGURES AND EXCHANGE MARKET INTERVENTION BEFORE THE BUDGET

The Prime Minister expressed an interest in the approach to exchange market intervention which the Bank of England will ~~be adopting~~, in the period between the publication of the trade figures at 3.30 pm today and the Budget on Tuesday afternoon. The Chancellor has asked me to let you know the tactics which the Bank intend to follow, and which he has approved.

We start from the probability that the trade figures we shall publish are significantly worse than the market is expecting. The main market activity is likely to be in New York on Friday, where there will be several hours trading after the publication of the figures in London; and in London and elsewhere on Monday. We would not expect much activity on Tuesday ahead of the Budget.

We intend in principle to let the rate take the strain. There is no question of trying to dig in or peg on any particular rate. We would want to avoid large erratic movements resulting from speculation in a thin market. But, on the other hand we would not want the idea to take hold that we wished to take advantage of this opportunity to get the rate down. The Bank would naturally have to show its presence in the market, but would also allow the rate to fall, adjusting intervention progressively with the extent of the fall.

I am copying this letter to John Beverly .

Yours ever,

Mat

This is hardly illuminating! M.A. HALL

T. L. Lankester, Esq.,

MT.

SECRET

20

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

PM accepts.

In the light of the minutes about the Budget and the forecasts which I sent you at the weekend you asked, I believe, whether any part of the PRT which is expected to be paid in 1980-81 can be brought forward into the current financial year.

2. The short answer is that it could be done; by shortening the interval between the end of the period for which the PRT is chargeable and the date when it falls due for payment from 4 months to (say) 12 weeks - which would be about the absolute minimum that seems feasible - a further £m650 would be brought into 1979-80.

3. But shortening this "payment period" might well be seen as such a transparent device for altering cash flow in the Government's favour, that - coming on top of the necessarily large element in the Budget for asset-disposals - it might actually reduce, not strengthen, market confidence in the total Budget package.

4. Moreover, though this might be regarded as a secondary argument, the change would be sure to provoke a hostile reaction from the companies, bearing in mind the proposed stiffening of the PRT regime as a whole. There also would be significant administrative difficulties for the Revenue and for the companies.

5. Fortunately, as you know, I now consider it possible to achieve my tax and financial objectives for 1979-80 within the budgetary package I described to you. In all the circumstances,

SECRET

therefore, I think it best not to make this PRT change now, but to leave it for consideration for 1980-81, when the financial position may be very tight if we are to achieve further reductions in income tax. I have asked the Inland Revenue to consider the scope for accelerating payment against this time-table.

G.H.

(G.H.)

7 June, 1979

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

7 June 1979

Dear Andrew,

PRESS NOTICES RELATING TO THE BUDGET

I asked in my letter of 21st May for you and copy recipients to let me know of any press notices which you proposed to issue on Budget Day. I am grateful for the information which has been provided to us, which we have used to make up a consolidated list of such notices.

I also set out in that letter the arrangements to be followed for the copying and distribution of these notices. These still stand. However, it seems that one or two Departments may not have their notices ready in time for 750 copies to be with the Treasury Parliamentary Section by 3.30 p.m. on Monday 11th June. If this deadline cannot be met, these copies should be sent direct to the Deliverer of the Vote in the House instead. Although this will unfortunately increase the Deliverer's collating task, it should help to reduce the risk of unnecessary delay.

We should also be grateful if any early copies of drafts which become available could be sent direct to Mr. S. Locke in Central Unit, Room 117/2, Treasury Chambers, Parliament Street, S.W.1. telephone 233 8652. It would be helpful, too, if he could be kept informed of any problems which seem likely to arise.

I am copying this letter to the Private Secretaries to all other members of the Cabinet.

Yours ever

John Nelson.

(JOHN NELSON)
Private Secretary

Private Secretary
Secretary of State for Industry

BUDGET SECRET

Econ Pol 19

CH/EX. REF. NO. B(79)36

COPY NO. 1 OF 10 COPIES

Treasury Chambers, Parliament Street, SWIP 3AG

01-233 3000

PRIME MINISTER

RATE SUPPORT GRANT 1979-80

We agreed in Cabinet last month that an across the board cut in the current year's RSG cash limit for England and Wales of at least £300 million should be made, with a corresponding reduction for Scotland. But we reached this decision before negotiations on teachers' pay had recognised that the amount of the abatement might need to be increased when the size of this settlement was known. Following your Private Secretary's letter of 21st May, I did not quantify the size of the reduction we had in mind in my speech during the Debate on the Address.

2. However, I think it would be right for me to reveal the figures in my Budget speech, since this is an essential part of our strategy on cash limits and public expenditure reductions in the current year. It is important that the local authorities should be informed as soon as possible of the size of the grant reductions we intend to make, if they are to take action to achieve significant economies in the current year. This is a point which the local authority associations have stressed in recent discussions in the Consultative Council and in the Convention of Scottish Local Authorities.

/3. I have

BUDGET SECRET

3. I have considered with Michael Heseltine and George Younger whether the reduction of £300 million for England and Wales, and the corresponding sum of £35 million for Scotland, should be increased because of the teachers' settlement, as Cabinet envisaged might be necessary. We have concluded that it would be right to adhere for the present to these figures, on the grounds that the first stage of the teachers' settlement was along the lines of the offer approved by Cabinet and that abatements of this size will represent a substantial financial constraint on local government. But I propose to announce that we will keep our options open on the possibility of making further reductions if they should be required in the light of the settlement reached for local authority white collar grades, the comparability awards by the Clegg Commission for the manuals, and the further settlement due in November for the manuals. We shall need to reach a final decision on the size of the abatement before the RSG Increase Orders are made at the end of this year.

4. Michael Heseltine and George Younger are content for me to deal with these reductions in the Budget Speech. I propose to do so in terms of the attached draft paragraph. I should be grateful for your agreement.

5. I am copying this minute to the Home Secretary, the Secretaries of State for the Environment, Education, Social Services, Scotland, Wales and Transport, and to Sir John Hunt.

(G.H.)
7 June, 1979

CONFIDENTIAL

A

DRAFT PARAGRAPH FOR BUDGET SPEECH

RSG CASH LIMIT CUT

"The need for substantial economies applies to local authority expenditure, where the Government's contribution is made through the Rate Support Grant. As I said three weeks ago, we shall take account of pay settlements in calculating the Increase Orders for the Rate Support Grant, but we shall make a significant across-the-board reduction from the total thus calculated. I can now tell the House that the reduction will be £300 million for England and Wales and £35 million for Scotland. These figures may have to be increased when we know the cost of further pay increases and will be finally determined in November before the Increase Orders are made. In coming to this decision a major factor has been how much in present circumstances it is reasonable for the tax-payer to contribute."

Econ. Policy

CONFIDENTIAL

CF - Pls. ensure we get one copy of this on Tuesday morning. I have told Treasury we expect this.
T

PRIVATE SECRETARIES/PRIME MINISTER
LORD PRESIDENT
FOREIGN SECRETARY
HOME SECRETARY
ENERGY SECRETARY
INDUSTRY SECRETARY
EMPLOYMENT SECRETARY
TRADE SECRETARY

AGRICULTURE,FISHERIES & FOOD MINISTER

BUDGET BRIEFING

One copy of the background briefing for the Budget will be despatched to you immediately the Budget Statement has been made.

2. Because of the pressure on Treasury resources in producing a variety of documents for the Budget, we shall not hold stocks of spares. It would be helpful if you foresee a use for this document within your Department, eg by your Information Division, if you could make appropriate arrangements for taking your own further copies from the one we shall send you.

3. You may prefer to arrange to collect your copy rather than await delivery; if so, please advise me on 233-3298 and I will arrange for it to be left at our Enquiry Room for collection after 5 pm on Budget Day by your messenger.

G. Way.

G WAY
EB DIVISION
7 June 1979

HM TREASURY
PARLIAMENT STREET
LONDON SW1P 3AG

BUDGET - SECRET

Econ Policy 18 JS

10 DOWNING STREET

From the Private Secretary

6 June 1979

Dear Tony,

PRESCRIPTION CHARGES

The Prime Minister has considered the Chancellor's minute of 5 June in which he proposes that prescription charges should be raised to 50p, rather than to 45p as agreed in E Committee last Friday.

The Prime Minister considers that 45p is the right figure and that going to 50p would be just too much. In any case, the Prime Minister thinks it a very bad precedent to go back on a firm decision taken at E Committee.

I am sending copies of this letter to the Private Secretaries to the members of E Committee, to Don Brereton (Department of Health and Social Security) and to Martin Vile (Cabinet Office).

Yours ever,

Tim L.

A.M.W. Battishill, Esq.,
HM Treasury.

10 DOWNING STREET

From the Private Secretary

6 June 1979

Thank you for your letter of 5 June about background briefing on the Budget, which could be made available to MPs.

I have shown this to the Prime Minister, and she has confirmed that she would like the "snap-shot" made available to all MPs with the necessary number of copies placed in the Vote Office, and a copy in the Library of the House as well. She has also commented that it is most important that copies of the press notices are available to MPs; but I understand from your letter that they would be in any case.

I am sending a copy of this letter to Martin Hall (HM Treasury) and Richard Prescott (Paymaster General's Office).

T. P. LANKESTER

P.G. Davies, Esq.,
H.M. Treasury.

KRB

17 1

BUDGET SECRET

CH/EX. REF. NO. B(79)32
COPY NO. 1 OF 18 COPIES

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

Prime Minister
Are you content with 50p ?

PRIME MINISTER

I think 45p. was the right figure and 50p is just too much. Moreover I don't like going back on a firm decision reached in committee. MT

6/6

I have been thinking about the decision we took on Friday to increase prescription charges in the Budget to 45p.

2. I am sure it is right to put up the charge. My only anxiety is whether 45p is - or will look like - the right figure. In terms of maintaining the value of the charge since it was fixed in 1971, it should be about 56p or 57p. We have, sensibly enough, rejected the idea of such mathematical precision.

3. Having said that, would not the round sum of 50p seem much more natural if we have to have this sort of increase?

4. I feel sure it would arouse no more protest than 45p, which will look like an odd figure to have plucked out of the air. Indeed, 50p might conceivably arouse less protest simply because patients and dispensary staff alike will be saved the bother of dealing with 5p change. (Least important of all, in this presentational context, 50p would bring in an estimated further £5 million in this very difficult year.) I should like to suggest, even at this late stage, that we go for 50p rather than 45p after all.

5. I am copying this to colleagues on E Committee, Patrick Jenkin and to Sir John Hunt.

G.

(G.H.)

5 June, 1979

BUDGET SECRET

1

Prime Minister

Treasury say they will be hard-pressed to provide the summary of the speech and the 'snap-shot'. (They have limited reproduction facilities, and these documents cannot be finalised until pretty late). I think the 'snap-shot' (Flag B) is the more useful. Shall I arrange for the Vote Office (and Library) to get copies of that?

TL 5/6

cc Mr James

H M Treasury

Parliament Street London SW1P 3AG

Switchboard 01-233 3000

Direct Dialling 01-233 3443

P G Davies
Press Secretary and
Head of Information Division

Mr Tim Lankester
Private Secretary
10 Downing Street
London SW1

5 June 1979

Dear Tim,

BACKGROUND BRIEFING ON THE BUDGET

You spoke to me yesterday about the Prime Minister's wish that MPs should be provided with "background briefing" on the Budget at least as full as that received by the press.

We in the Treasury - that is, IDT, EB and Parliamentary Section - supply no background briefing on the Budget to the press in advance of the event. Nor does the Privy Council Office.

Immediately after the Chancellor has made his Budget Statement, MPs and the press alike receive the standard documents, namely the Red Book (FSBR), White Paper material and press notices. All that the press gets but MPs don't is a summary of the Budget speech, the 'snapshot' (a summary of the Summary) and the full text of the speech. We could not undertake to provide Members with the speech in full because this would strain our facilities beyond breaking point: but, if the Prime Minister wished, we could arrange for 700 copies of the summary or the snapshot to be placed in the Vote Office along with the documents already provided.

Flag A

Flag B

Yours ever,

Peter

P G DAVIES

The important things are the press notices which are quite detailed. They usually spell out the effects of any changes giving quite extensive figures. I don't think the summary speech is necessary. The 'snap-shot' would be useful.

M.

cc

Mr Hall
Mr Ridley
Mr Cropper
Mr Unwin
Mr Bottrill
Mr Dyer
Mr Chambers
Mr Godfrey
Mr Prescott - Privy Council Office

A I.D.T. Ref.

SECRET TILL CHANCELLOR'S STATEMENT 11 APRIL 1978

SUMMARY OF THE BUDGET SPEECH: 11 April 1978

Note: This is a working document. It summarises the main points of the Budget speech, but does not give the exact words or definitions except where "quotes" are marked. The purpose is to help journalists and others get hold of the main points of the speech in the shortest possible time. More detailed information is contained in the Financial Statement and Budget Report. A shorter "snapshot" of the main points is also available immediately the Chancellor finishes his speech.

SECTION A - BRITAIN AND WORLD ECONOMY

Worst world recession since 30s. Britain entered it with unbalanced economy.

Better balance now. Current account much better. Financial position transformed. Inflation and interest rates down. Money supply under control. Exceptionally high reserves. Real personal income up 5% in 4th quarter, 1977 - biggest quarterly rise for nearly 6 years. But no adequate growth of output. Unemployment still intolerably high.

First purpose of Budget to encourage economic activity so as to get unemployment moving further down.

No country can solve its problems on its own, and world outlook leaves much to be desired. World trade rose only 3½% last year. Problem made worse by uneven sharing of oil consuming countries' deficits.

Action needed on world scale. Leaders of 7 leading world economies agreed on concerted approach to 5 main problems. Council of European Community did so on Saturday.

"This Budget represents a British contribution towards that common effort as well as meeting our national needs".

SECRET TILL CHANCELLOR'S STATEMENT 11 APRIL 1978

SECTION B - THE BALANCE OF PAYMENTS AND OVERSEAS DEBT

Most of our overseas debt due for repayment 1979-84. Not sensible to pay off all this solely from current account surpluses over 6 or 7 years, adding to world current account imbalance problem and restricting expansion of British economy.

Aim therefore to combine net yearly repayment of debt with new borrowing to spread the maturities.

Now paying large amounts ahead of time.

Already about $1bn market loans being repaid early.

Already $1bn prepayment to IMF. Further $1bn to be repaid to IMF. Total to IMF $2bn. Total early repayments $3bn. Further $1bn normal repayments in 1978. New borrowing to lengthen repayment period. Since last October about $630m borrowed from European Investment Bank and Coal & Steel Community. Now British Government bond issue in New York - $350m in 7 and 15 year tranches. "Triple A" credit rating - highest possible.

SECRET TILL CHANCELLOR'S STATEMENT 11.4.78

SECTION C - THE FIGHT AGAINST UNEMPLOYMENT

Aim: reduce intolerable level by "stimulating demand in ways which create jobs at home without refuelling inflation"

Special employment measures already taken or announced should have provided 400,000 jobs or training placed by March 1979. Unemployment falling slowly for last 6 months although workforce increasing 170,000 a year.

Need for new jobs, particularly in manufacturing. Budget stimulus, by itself, will not necessarily achieve this. Need for British industry to produce and sell goods to satisfy increased demand - otherwise extra demand creates new jobs abroad instead and set inflation going again.

Two things clear.

1. Key to growth and jobs is improvement in industrial performance.

2. Budget, like October measures, must be part of programme for steady growth sustainable over many years.

SECRET TILL CHANCELLOR'S STATEMENT 11.4.78

SECTION D - IMPROVING INDUSTRIAL PERFORMANCE

If British goods are to meet extra demand from this Budget, must ensure British industry's products more competitive in design, delivery and price. This is main objective of Industrial Strategy backed by Government, TUC and CBI.

Main responsibility is in the workplace. Government encouraging right climate through industrial assistance, training etc. Industry to have first priority in all policies, eg. education and local planning

Special role of small companies - prime source of innovation and prime role in creating new jobs, regenerating inner cities and countryside. Special attention in Budget.

Improvement in industrial performance overriding objective, but must take time. Meanwhile counter-inflation policy vital for price competitiveness; both monetary policy and moderation in pay negotiations vital. Moderation helped by Government controlling prices, avoiding unnecessary increases in indirect tax and cutting income tax. But main responsibility remains with pay negotiators.

SECTION E - THE CURRENT PROSPECT

Two judgements needed for deciding size of stimulus:

1. On rate at which our industry can meet increased demand competitively.

2. On likely development of economy without stimulus - large margin of error in economic forecasts.

But some trends fairly clear.

Likely increases in living standards, consumption, private investment, public spending and (more difficult to forecast) exports point to possible 2-2½% growth in coming year without Budget stimulus.

Extra increase in demand we can afford depends critically on inflation outlook which depends on monetary control and wage cost outlook.

Annual inflation rate down to 7% by Spring or early Summer and - barring catastrophe - likely to remain fairly steady at that level for rest of this year - about average rate for most industrial countries and lower than some foreign competitors'.

SECRET TILL CHANCELLOR'S STATEMENT 11 APRIL 1978

SECTION F - MONETARY POLICY

Will continue to have central role.

£M3 grew by only ½% in March and M1 slightly less - trend of monetary growth back into desired range after expected jump in January. Figure for 1977-78 probably just above 9-13% range, but exceptional inflows of foreign currency last year - corrected last October.

£M3 the main focus. Rolling targets to be adopted - target rolling forward every 6 months to allow regular reassessment and modification of target if needed. Eg lower target in Autumn if counter-inflation policy develops as hoped.

£M3 target range for 1978/79 to be 8-12% DCE level below £6bn. Target will provide both for lower inflation and increase in economic growth. Ample room for increase in bank lending to industry.

Rate of monetary growth inevitably irregular. Probably greater in first half of 1978/79 than in year as a whole.

MLR raisedfrom 6½% to 7½% today. Short-term interest rates had become out of line with US and euro-dollar rates, in light of recent developments in exchange markets.

SECRET TILL CHANCELLOR'S STATEMENT 11 APRIL 1978

SECTION G PAY AND PRICES

Within framework of monetary policy, co-operation from employers and unions needed to keep inflation falling and keep industry competitive.

Not easy to achieve. Cannot rely on further appreciation of £ or fall in world prices.

Earnings growth still higher than most competitors' and productivity lower. Lower increases in wage costs needed than in current year. Without that, no hope of lower prices and more jobs, whatever size of Budget boost.

Discussions to start with both sides of industry on counter-inflation policies.

Success in fighting inflation gives reasonable grounds for confidence on further progress.

SECTION H - THE SIZE AND NATURE OF THE STIMULUS

Judgement assumes continued progress on counter-inflation. Size of stimulus also depends on its nature - can be larger if designed to improve industrial performance and strengthen counter-inflation.

Measures designed to support industrial strategy through: Direct help for business, especially small firms and Strengthening incentives at all levels.

Counter-inflation: Tax cuts increasing real incomes should encourage moderation in pay settlements.

And

Measures must help relieve poverty, fight unemployment, improve social services and achieve fairer society.

Measures designed to achieve objectives, THEREFORE £2½bn full year STIMULUS. Satisfied this will not refuel inflation or overstrain productive capacity. Will add ¾% to growth of GDP.

Resulting Public Sector Borrowing Requirement (PSBR) for 1978/79: £8½bn. Below ceiling given* to IMF (£8.6bn). This equals 5¼% of GDP. General Government financial deficit (central and local Government) 4% of GDP - no higher than in Germany.

PSBR to be financed may be good deal higher than £5.7bn estimated outturn for 1977/78.

But increase counter-balanced by less need to sell gilts to offset domestic effects of foreign inflows.

cont'd

Funding helped by sales of Certificates of Tax Deposit and National Savings. New NS issue announced today with tax-free yield of just under 6.8% a year over 4-year life. Maximum holding £2,000. Forecast need for gilt sales about same value as last 2 years, smaller in relation to institutional funds available. Foresee no difficulty in financing 1978/79 PSBR.

Now for Budget measures themselves.

SECTION I - PUBLIC EXPENDITURE

Public expenditure White Paper already provides for extra £400 for construction, over £300m for increased child benefit and uprating of social security benefits in 1978/9.

PENSIONS to go up £3.20 to £31.20 for married couples and £2.00 to £19.50 for single people in November - rise of over 4 per cent in real terms - about 20 per cent under this Government. Cost around £500m in 1978/79 and £1,300m in full year.

£750 contingency reserve for 1978/79(at 1977 prices). Large part allocated now:

JOBS, HEALTH AND SCHOOLS

£156m for EMPLOYMENT MEASURES in 1978/79 (already announced).

(Further £144m in 1979/80 already announced).

All specific employment measures will have provided about 400,000 jobs or training places by March 1979.

£50m for HEALTH SERVICE

Full use of new hospitals, cutting waiting lists, care for elderly and handicapped, extra 400 kidney machines etc.

£40m for SCHOOL AND COLLEGE BUILDING.
Extra funds for teacher retraining in "shortage subjects"

£20m for ENVIRONMENTAL SERVICES

including country factories and coastline preservation.

Further sums for LAW AND ORDER, areas affected by STEEL CLOSURES, SEA DEFENCES and ENERGY SAVING by industry and private houses.

HELP FOR FAMILY BUDGETS

£68m to cancel SCHOOL MEAL price increase and provide FREE SCHOOL MILK for 7-11 year olds - EEC subsidy for this.

SECRET TILL CHANCELLOR'S STATEMENT 11 APRIL 1978

CHILD BENEFIT to go up to £4 for each child in April 1979 from higher level of £2.30 reached this April. As first instalment, increase to £3 per child, plus doubling of single parent premium for first child to £2, in November 1978 at a cost of £165m in 1978/79.

Right for Government to have taken now main extra spending decisions for year. Just under £200m remains in contingency reserve and any unexpected spending this year must be met from this.

Growth of public spending to be contained within expected growth of economy in future years.

SECRET TILL CHANCELLOR'S STATEMENT 11 APRIL 1978

SECTION J - TAX AND BUSINESSES

Now come to tax proposals. A major purpose: adjust taxes to help improve industrial performance.

Business tax system gives generous incentives to new investment. Stock relief scheme of immense value.

Business needs tax stability. NO CHANGE IN 52% RATE OF CORPORATION TAX OR INVESTMENT INCENTIVES.

STOCK RELIEF SCHEME TO CONTINUE INDEFINITELY until permanent scheme based on inflation accounting can be brought in. If no progress by next year, will legislate to write-off balance of first two years relief; similar relief on balance remaining after 6 year period.

Easing of tax on SMALL BUSINESSES can give significant improvement in performance. Big Capital Transfer Tax concessions announced in October.

Profits limit for 42% rate of CORPORATION TAX raised from £40,000 to £50,000. Limit for marginal relief up from £65,000 to £85,000.

Small businessman to be able TO SET OFF LOSSES in early years of unincorporated business against income received in previous years (INCOME TAX).

SELF-EMPLOYED and PARTNERS living here and WORKING ABROAD to get income tax relief.

CAPITAL GAINS TAX [CGT] on gift within a family or to employees to be deferred until assets sold. Losses on loans and guarantees to qualify for CGT relief. Limit for retirement relief from CGT raised from £20,000 to £50,000.

REGISTRATION THRESHOLD for VAT raised from £7,500 to £10,000. Relief from VAT for BAD DEBTS where debtor insolvent. Further proposals to help small businesses being considered.

FARMERS to be able to AVERAGE incomes for income tax purposes over 2 years if incomes vary by 30% or more between 2 years. Reasons: weather problems; capital-intensive industry. Farm BUILDING ALLOWANCE in first year RAISED TO 30%.

Capital allowance for new HOTELS or extensions - 20% INITIAL ALLOWANCE PLUS 4 % ANNUAL ALLOWANCE. Important for invisible export earnings.

PROFIT-SHARING scheme will make employees eligible for up to £500 of shares tax free. Improve industrial relations. Stimulate growth. Details in Finance Bill.

Indexation or tapering of CAPITAL GAINS TAX (CGT) too complicated, and unfair to fixed-interest investors. To ease burden on small investors, individuals' CAPITAL GAINS UP TO £1,000 a year to be EXEMPT from CGT. Gains between £1,000 and £5,000 to be charged at 15% instead of 30%. Marginal relief up to £9,500. Effective from 6 April 1977.

4 artificial TAX AVOIDANCE schemes to be stopped. Need to ensure no similar schemes marketed in future. So provisions on COMMODITY FUTURE schemes to be backdated to 6 April 1976.

Those on LAND SALES WITH RIGHT TO REPURCHASE backdated to 3 December 1976.

Provisions on DISCRETIONARY TRUSTS and ASSOCIATED ENDOWMENT AND LIFE TERM POLICIES effective from today.

SECTION K - TAX AND INDIVIDUALS

General tax burden in Britain well within international average. But proportion of income tax in total revenue still too high in spite of recent cuts. Cuts in income tax responsible for almost all the £2½bn stimulus.

Some Members want much bigger cuts, offset by higher indirect taxation. Some sympathy in principle. But does not make sense at critical point in fight against inflation for Government deliberately to raise prices.

Therefore, INDIRECT TAXES generally UNCHANGED, with one small exception. EXTRA DUTY ON CIGARETTES WITH TAR YIELD OF 20 MG OR MORE, to discourage high-tar cigarette smoking. If fully passed on in prices, could raise price of 20 qualifying cigarettes by about 7p. 15 per cent of cigarettes affected. Not designed primarily to raise revenue. Could bring in £25m in full year. Effect on RPI negligible.

Employers' NATIONAL INSURANCE contributions and payroll tax lower than in most EEC countries. But too soon to increase SURCHARGE when unemployment major problem. Would increase costs and prices. NO CHANGE.

Measures announced so far leave £2.4bn for income tax cuts. Objectives: increase incentives and promote social justice. Second phase of process begun last autumn.

Thresholds already more than indexed last October, a year earlier than due. (From 6April 1977). Rate at which people enter tax too high - highest in world. Low-paid no better off in work than on dole - no economic or social sense in that.

LOWER RATE OF 25 PER CENT TAX ON FIRST £750 of taxable income . 25 per cent becomes marginal rate for 4 million people. Impact of poverty trap less severe. £1.30 a week less tax for anyone paying tax on £750 or more. Hope to extend lower-rate band in future.

Still necessary to raise thresholds as far as possible above pension etc level; to take more people out of tax altogether; and see that father's pay packet not reduced by cut in child tax allowances - even though already more than offset by higher child benefit paid to wife. Therefore married allowance raised twice as much as single.

PERSONAL ALLOWANCES RAISED

Single (and wife's earned income)	up £ 40	to	£ 985
Married (and single parents)	up £ 80	to	£1,535
Age allowance - single	up £ 50	to	£1,300
Age allowance - married	up £100	to	£2,075
Age allowance income limit	up £500	to	£4,000

Revenue cost: full year	25 per cent band:	£1,600m
	Thresholds:	£ 550m
	Total	£2,150

360,000 people who would have paid tax this year will not now do so.

Thresholds for HIGHER RATES not indexed last October. If not done now, people with 1½ times average earnings would start paying higher rate.

UPPER LIMIT OF BASIC RATE RAISED FROM £6,000 to £7,000. Married man on £8,500 pays no higher rate tax even if no allowances other than personal.

450,000 who would have been paying higher rate tax will not now do so.

Advantage to highly skilled workers, middle managers etc. Further changes in higher bands to give following structure:

NEW TAX BANDS

TAXABLE INCOME (£)	TAX (%)	TAXABLE INCOME (£)	TAX (%)
0- 750	25	11,500-13,000	60
750- 7,000	34	13,000-15,000	65
7,000- 8,000	40	15,000-17,500	70
8,000- 9,000	45	17,500-23,000	75
9,000-10,000	50	Over 23,000 (instead of 21,000)	83
10,000-11,500	55		

Similar case for raising thresholds for INVESTMENT INCOME SURCHARGE.

NEW THRESHOLDS

	10% surcharge starts at	15% surcharge starts at
People under 65	£1,700 (£1,500 at present)	£2,250 (£2,000 at present)

Raised in line with prices.

SECRET TILL CHANCELLOR'S STATEMENT 11 APRIL 1978

65's and over	£2,500 (£2,000)	£3,000 (£2,500)

More than indexed. Nearly half surcharge payers are over 65 and 2/3 of these have incomes below higher-rate threshold. Help for elderly with fairly modest income from savings.

MAINTENANCE PAYMENTS TO BE WHOLLY EXEMPT FROM SURCHARGE from 6 April 1978.

Personal allowance tax cuts to be paid under PAYE from 1st pay day after 10 May, backdated to 6 April. Refund of £1.30, then 26p a week less tax for single people and earning wives earning over £19 a week.
Refund of £2.60, then 52p a week less tax for married men earning over £30 a week.
Tax rate tax cuts to be paid from mid-July, backdated to 6 April.

25 per cent rate gives refund of up to £18, then up to £1.30 a week less tax.

SECRET TILL CHANCELLOR'S STATEMENT 11.4.78

SECTION L - LIVING STANDARDS AND PAY

Man on £75 a week with wife and 2 children gets extra £1.82 in pay packet as result of this Budget. Second phase of process started in October when he got extra £1.05 a week.

Including last October's measures, new child benefit and tax allowances and increased national insurance contributions, the £75-a-week family is £3.32 better off. With the child benefit increase in November, the family will be £4.72 better off a week.

With a 10% pay rise, the £75 a week family's standard of living will be up nearly 6% between August 1977 and August 1978 (current pay round). The £50-a-week family's living standard goes up nearly 7½%. Single man on £75 nearly 5% better off, on £50 a week over 6% better of.

Modest increases in earnings should ensure living standards continue to rise over year ahead without unduly increasing industrial costs. Best possible recipe for industrial success. Only recipe for curing unemployment.

I.D.T. Ref.
B
E

SECRET TILL END OF BUDGET SPEECH

BUDGET SNAPSHOT 1978

This brief Budget summary gives the main points only. Figures are in round terms and relate to revenue estimates for full year throughout.

BACKGROUND

Worst world slump since 1930s. World unemployment high and trade low. International action needed if world growth to recover.

Britain well placed to play part in this. Financial position transformed by recent painful measures. North Sea oil and success of pay/prices and monetary policies help to allow stimulus.

Key to growth and jobs: improvement in industry's competitive performance. Continued moderation in pay and prices and firm monetary policy vital.

BUDGET AIMS

Help fight unemployment by boosting demand in ways which create jobs in Britain without new inflation. British industry must be able to supply extra demand, otherwise imports rise and jobs created abroad. Growth must be sustainable for years ahead.

Measures designed to support industrial strategy through: Direct encouragement for business through tax cuts. Cuts also aimed at encouraging moderation in pay settlements. Pay rises through tax cuts don't raise costs and prices. Straight pay rises do. Special help for small businesses.

Measures further designed to assist economic objectives by raising living standards, relieving poverty, improving social services and achieving fairer society.

SIZE OF BUDGET BOOST

£2½bn. This should not refuel inflation or exceed our industry's ability to supply extra demand. PSBR for 1978/79 forecast at £8½bn - under ceiling given to IMF. Equals 5¼% of national output. Almost all £2½bn goes on income tax cuts.

EFFECT ON LIVING STANDARDS

Married man with 2 children on £75 a week gets extra £1.82 in pay packet from income tax cuts. Taking in the October cuts, and this April's changes in child benefit, tax allowances and N.I. contributions, the family is £3.32 better off. (£4.72 in November 1978). If man has a 10% pay rise in Stage 3 the family living standard will be up nearly 6% between August 1977 and August 1978 after allowing for price increases. Similar family man on £50 a week is £3.50 a week better off - rise in living standard of nearly 7½% in real terms.

Single people nearly 5% better off (£75); over 6% better off (£50)

THE BUDGET TAX MEASURES

INDIRECT TAX

HIGHER-TAR CIGARETTES

Special health duty on higher tar cigarettes from 4 September.

Could add 7p on 20 higher-tar cigarettes.

Yield: £25m. RPI effect negligible.

NO CHANGE in VAT rate and other indirect taxes. Aim: No unecessary rise in prices.

PERSONAL TAXES

INCOME TAX

PERSONAL ALLOWANCES

People under 65

Married (and single parent). Up £80 to £1,535 (5.5%)
Single (and wives with jobs). Up £40 to £985 (4.2%) Cost: £510m

65s and over (age allowance)

Married: Up £100 to £2,075 (5.1%)

Single: Up £ 50 to £1,300 (4%)

Income ceiling to qualify for age allowance: up from £3,500 to £4,000. Cost: £70m

Take-home pay rise - up to 52p a week for married (under 65), up to 26p for single. Should reach PAYE pay packets by mid-May, backdated to 6April.

New tax thresholds (per week): £29.52 (married) £33.37 (married with 2 children under 11); £18.94 (single); £25 (single 65+); £39.90 (married couple 65+).

Number taken out of tax: 360,000

NEW LOWER RATE BAND OF 25% ON FIRST £750 OF TAXABLE INCOME. Applies to all taxpayers including wives with jobs. 4 million taxpayers will no longer pay any tax at 34%. Married man with 2 children will start paying 34% at about £48 a week.

Everyone paying tax on £750 or more will benefit by £1.32 a week. (£2.64 for working couples). Cut to reach PAYE pay packets mid-July. Refund back to 6 April about £18.

Special effect. Big cut in "poverty surtax" for those in poverty trap who lose means-tested benefits and pay tax as earnings rise. Cost £1,570m

CHILD TAX ALLOWANCES (CTA)

Being replaced by child benefit. Cuts this year to £100 (under 11s), £135 (11-16s), £165 (16s+). (Already announced)

People with children living overseas to keep present (1976/77) levels of CTA: £300 (under 11s), £335 (11-16s), £365 (16s+). Special arrangements for widows, students, children with mobility allowances etc.

HIGHER RATE TAX

Threshold for 40% tax raised from £6,000 to £7,000 taxable income.

About 450,000 people kept(or taken) out of all higher rate tax. Threshold more than indexed.

All further higher rate thresholds also raised, with some changes in size of income bands. Top rate (83%) to start at £23,000 instead of £21,000.

Aim: improve incentives, compensate for past price rises. Cost: £210m

NO CHANGE IN BASIC RATE - 34%

INVESTMENT INCOME SURCHARGE

People under 65

Exemption limit raised by £200 to £1,700 (indexed). Next £550 (instead of £500) - surcharge 10%. Income over £2,250 (instead of £2,000) - surcharge 15%.

65s and over

Exemption limit raised by £500 to £2,500 (more than indexed). Next £500 - surcharge 10%. Income over £3,000 (instead of £2,500) - surcharge 15%. (Nearly half of all surcharge payers are over 65, and two-thirds of these have incomes below the higher rate threshold).

Aim: fair to index both types of income tax threshold. Help elderly with modest savings. Cost £31m

Maintenance payments (for divorced wives or for children)

To be entirely exempt from investment income surcharge. Cost £1m

SELF-EMPLOYED

25% of earnings free of tax for work done abroad - comparable with employees - if minimum of 60 days a year spent working abroad. Could benefit about 40,000 people.

Aim: fairer treatment of self-employed at "sharp end" of exporting etc. Cost: about £10m

FARMERS

To be able to pay tax on average profits over two years. Reason: big fluctuations in profits because of weather etc. Could help about 200,000 farmers. Possible Cost: £10m

Capital allowances for farm buildings increased.

Aim: encourage farm investment and building jobs. Cost: about £20m

Farmers also benefit from small business reliefs.

NORTH SEA DIVERS

To be taxed as self-employed Cost: £1m

PROFIT SHARING

Income tax concession from 6 April 1979 to encourage profit-sharing. Tax-free shares for employees. Up to £500 worth a year from 6 April 1979. Details in Finance Bill.

Aim: improve industrial relations and output. Cost £25m in 1979/80. Could reach £100m

CAPITAL GAINS TAX

Capital gains up to £1,000 a year to be exempt. Next £5,000 of gains taxable at 15% instead of 30%. Tapering relief from full 30% up to £9,500. Change backdated to 6 April 1977. Present rules exempting sales up to £1,000 etc. scrapped.

Aim: help small investors against effect of inflation. Cost: £15m in 1978/79 rising to £65m in 1981/82

Unit and Investment Trusts
Tax on their capital gains reduced from 17½% to 10% from 1 April 1977.

Aim: help for small investors. Cost: £7m in 1978/79, rising to £11m

BUSINESS TAXES

SMALL BUSINESSES

Limit for reduced rate of corporation tax - 42% - raised from £40,000 to £50,000 profits.

Limit for tapered reduced rate up from £65,000 to £85,000. Cost:£32m

Capital gains tax reliefs on gifts of assets and losses on loans. Limit for retirement relief up from £20,000 to £50,000. Cost: £10m

Capital transfer tax concessions to help employees' trusts and workers' co-operatives. Cost:£10m

Income tax reliefs for losses made by those just setting up a business. Cost: £5m

Threshold for VAT registration raised from £7,500 to £10,000. VAT relief for bad debts if debtors insolvent. VAT forms etc. simplified. Cost: about £15m

Aim: to encourage small businesses to expand and create jobs

See also: FARMERS, SELF-EMPLOYED, CAPITAL GAINS TAX and HOTELS.

ALL FIRMS

Stock relief. Extended for another year and to continue indefinitely. Promise of legislation next year to write off deferred tax if inflation-accounting rules not agreed.

Corporation tax: 52%. No change. Need for stability.

HOTELS

New capital allowance 20% first year, 4% annual, on new hotels and extensions.
Aim: help tourism, jobs and construction industry. Cost:about £15m

TAX AVOIDANCE

Four artificial devices to be blocked using: discretionary trusts, associated life policies, sale of land with right to repurchase and commodity futures schemes. Last 2 backdated to December 1976 and April 1976. Warning already given.

SPENDING MEASURES

ALREADY ALLOWED FOR IN MAIN SPENDING PLANS

Pensions to go up in November by:

£3.20 to £31.20 for married couple. £2.00 to £19.50 for single.

Real value increase: over 4%. Total real increase since 1973: over 20%.

NEW MEASURES MET FROM CONTINGENCY RESERVE (of £750m for 1978/79)

Child benefit

Benefit to go up from £2.30 per week to £4 for all children in April 1979.

As first instalment, benefit to go up 70p to £3 in November 1978 and single parent premium doubled again to £2 in November. Cost this year: about £165m

Other family support

Extra £68m for cancellation of autumn school meal price rise and for free school milk for 7 -11s (plus EEC subsidy)

Employment measures (already announced)

£156m in 1978/79. £144m in 1979/80. Will protect or provide 400,000 jobs etc

Health Service

Extra £50m for full use of new hospitals, cutting waiting lists, care for elderly and handicapped, extra 400 kidney machines, etc.

Education

Extra £40m for building work on schools and colleges.

Extra provision for teacher retraining in certain subjects.

Environment

Extra £20m mainly for country factories and coastline.

Other

Extra provision for prisons, police, magistrates' courts and probation, areas affected by steel closures, sea defences, and energy saving in industry and homes (insulation).

Nearly £200m remains in contingency reserve. Any further increase in planned spending this year will come out of this.

Note: spending increases not part of £2½bn Budget boost to economy as total spending plans (including contingency reserve) not increased.

FINANCIAL MEASURES

Overseas

Repayment of $1bn to IMF already arranged. Further $1bn to be repaid to IMF. Total early repayment is $3bn. Total foreign debt repayment 1977 and 1978: $4bn. Debt repayment programme to be spread earlier and later than "hump" years 1979/84. As part of this, 7 and 15 year HMG bond issue in New York, $350m.

Home

Money supply growth target for 1978/79: 8-12%. Government has shown its determination to exert firm control. "Rolling targets" to be used, to make trend clearer and allow revision every six months. Could be tighter in Autumn if successful pay policy.

New (17th) issue of National Savings Certificates in June. £2,000 maximum holding. Will help finance PSBR and control money supply.

Minimum repayments for retailers' credit and Barclaycard and Access scrapped, along with £30 cash borrowing limit.

E N D

BUDGET- SECRET

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10 DOWNING STREET

From the Private Secretary 4 June 1979

The Prime Minister was grateful for the Chancellor's minute of 1 June in which he set out his main Budget proposals. This is to confirm that she is content with them.

The Prime Minister has also considered the Chancellor's minute of 1 June concerning VAT on petrol. She is content to accept the Chancellor's judgement on this matter, though she has noted that he intends to instruct officials to give it more detailed consideration after the Budget for possible action either next year or, if the energy supply situation should seriously deteriorate, later this year.

The Prime Minister was also grateful for the Chancellor's note, and the accompanying papers by officials, on the forecast.

T. P. LANKESTER

Tony Battishill, Esq.,
HM Treasury.

BUDGET - SECRET

NB 2nd carbon shredded MSH 4/6.

WOODROW WYATT

BRITAIN'S MOST INFLUENTIAL COLUMNIST

Why we have to wait for the Tories' tax bonanza

THE Tories' first Budget on June 12 cannot be a bonanza.

Denis Healey, the former Labour Chancellor, admitted in the Commons the week before last that once again he had got his sums wrong.

Originally he had publicly promised not to borrow more than £8·5 billion in the current financial year.

That was to cover the difference between taxation collected and what the Labour Government were actually spending.

What Mr. Healey didn't tell us before polling day but tells us now, is that the Labour Government had set a course to borrow not £8.5 billion but £10.5 billion.

This limits the tax concessions which can be made by some £2,000 million.

The Tory Government declare their determination to cut dramatically public borrowing and extravagance in public spending. But they can't do it by Budget day.

However, the new Chancellor, Sir Geoffrey Howe, should point the tax-cut direction he means to follow during the next four years.

Without losing more than £250 million revenue he could reduce the penal rates of taxation at the top immediately.

That would bring us into line with every other country similar to ourselves.

Sir Geoffrey could also at once release hundreds of thousands of the lowest-paid from paying income tax at all.

But the biggest and most important wedge in the middle cannot yet have income tax cuts of the size they deserve. They would reduce the revenue from taxation by thousands of millions of pounds.

But there should be some cuts and a switch from income tax to VAT, even at the risk of elevating the cost of living.

Sir Geoffrey should promise that the big cuts will arrive next April and the April after.

That is, if the Tories stick firmly to their intention that we should live within our means. That is what they have promised and that is what they must do.

Nevertheless, if I were Sir Geoffrey I would, even as early as June 12, incline ever so slightly towards boldness.

The more he contrives to reduce the general rate of income tax for the majority, the more enthusiasm there will be to earn more by greater output.

Next year we will be self-sufficient in oil. The world oil price rises, though making some difficulties for us, also make North Sea oil much more valuable.

That is an insurance against our having to run for rescue to the International Monetary Fund, as the Labour Government did.

Sir Geoffrey cannot exactly push the boat out, but he can begin to put it into the water.

☐ **PLEASE don't be too bored to vote on Thursday for the new European Parliament.**

As the first international democratic election ever held, it is an exciting event.

About 180 million people of different nationalities and languages are entitled to vote.

They will elect members who can begin to have a practical democratic control over the European Economic Commission.

It's not sensible to complain about things you don't like from Brussels if you don't vote.

You should examine closely the credentials of your candidates. If, from whatever Party, they are hostile to the European Economic Community (Common Market) don't vote for them. The right way to get reforms to suit Britain is to elect people who believe in the EEC.

Sir Nicholas Henderson, formerly Ambassador in Paris and now to be Ambassador in America, is a shrewd observer.

He was correct in his memorandum, leaked to the Press yesterday, when he said that Britain doesn't count much in Europe today.

We can put that right only by wholehearted participation in the EEC. And by our industrial performance.

☐ **THE Italians are little interested in their general election.**

The Christian Democrats and the growing Radical Party will do better. The Communists will do worse.

How's that if Italy is as poor as she's supposed to be?

In Southern Italy there is great poverty but strong support for the Roman Catholic Church. In the North people are even more prosperous than the official statistics show.

Earnings from moonlighting jobs and trade on which there are no taxes paid and no records kept are estimated at 30 per cent. of the national output.

Most of Italy is thus doing very nicely, and will carry on after the election the same as before.

☐ **I WAS in a handsome, spacious factory near Turin, Italy, last week.**

It makes printing machinery, is owned by Fiat and employs 1,300.

The canteen serves splendid subsidised three-course meals, with three choices for each course, all for 18p. They would cost at least £2 outside. And you can have a fourth course for 1½p.

Even the wine is only 3p a quarter bottle.

The management happily eat these bargain meals alongside the shop-floor workers.

But Prince Charles, an advocate of this practice, will be sad to learn that this does not seem to improve industrial relations. Union notices all over the factory gave instructions for holding half-hour strikes by each department in rotation.

Of course, if the workers (average take-home pay £80 to £90 a week) went on *complete* strike, they would lose those marvellous meals.

■ **THE Americans are usually generous and anxious to help. That is why their decision to subsidise oil imports is so startling. Pulling more oil into the USA will increase the world oil shortage and world oil prices still more. Instead, America should cut her oil consumption by doubling the price of petrol. It would still be cheaper than in Europe.**

A bad example for the people

THERE is dangerous talk about a hefty salary increase for MPs. That would be a dreadful example for the nation.

MPs should be allowed to keep up with inflation but no more. Their duties are very light.

If MPs want more money, they should do second jobs. That was the advice of the great Labour leader, Herbert Morrison.

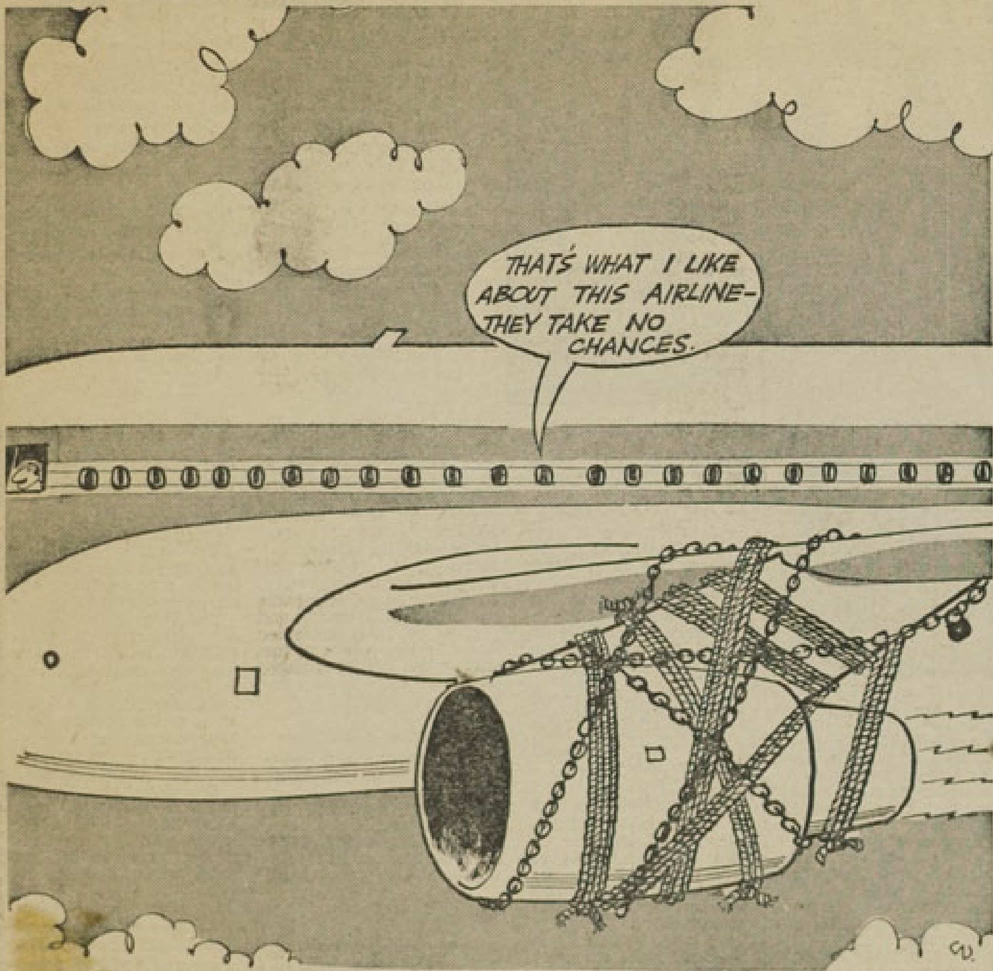
He thought having some work outside kept MPs more in touch with ordinary people's problems.

It is Ministers who have a real job to do who are grossly underpaid.

No Minister of Cabinet rank should have less than £25,000 a year. No Minister of State should have less than £17,500.

Jobs with similar responsibilities in industry pay far more than that.

KEITH WAITE ON SUNDAY



HOW HARD UP

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Prime Minister
The arguments seem to me finely balanced. Are you content to accept the Chancellor's judgement?
TL 1/6

PRIME MINISTER

Accept Chancellor's judgment. MT

VAT ON PETROL

At our discussion on 24th May you asked me to examine ways of increasing the revenue paid on the purchase of petrol for business use, by for example replacing the VAT element with a higher rate of specific duty. I find there are great difficulties in achieving what you want in this way but that effectively the same result can be secured by introducing a "blocking" provision to prevent the deduction of VAT on petrol for business use. Any such provision could not, in this context, extend to VAT on diesel road fuel (derv) because of its importance for industrial costs.

2. It would be technically possible to introduce a "blocking" provision as a Budget measure, to take effect (by Order) on Monday 18th June together with the VAT increase to 15 per cent. It would have to cover all petrol used by businesses: there could be no halfway house - for example, we could not block VAT deduction only in respect of the Budget increase from 12½ per cent to 15 per cent. There might be some difficulties with the EEC, but these could probably be surmounted. The effect of the measure would be to raise additional revenue of about £250 million in a full year and £125 million in 1979/80. The RPI would increase by about 0.2 per cent over time and total UK petrol consumption might be reduced by up to 2 per cent a year in the long run.

4. However, there would be a number of disadvantages:-

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(i) The revenue gain from the proposal would be reflected in an addition to business costs. This would not be limited to expenditure on petrol for cars, but would extend to other business expenditure on petrol - for example, delivery vans and taxis (which amount to about one-third of all "business use" of petrol). The effect would be very selective and would no doubt give rise to many not unreasonable complaints. We shall be adding to business costs through the 7p excise duty increases for petrol and derv and through the extra VAT on new cars (the subject of an existing blocking Order). I do not think it would be right to do more at this stage - necessarily in a very random fashion.

(ii) By altering the balance of taxation between petrol and derv, the measure could have a potentially serious effect on the UK car market. As you know, the outlook for our car manufacturing industry is already poor, and we ought not to risk further damage by straining the traditional loyalty of the company car market to British manufacturers. At present, virtually no diesel cars are manufactured in the UK, but output has been increasing elsewhere, especially in France and Germany.

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I am satisfied that a selective (petrol only) increase of this kind could induce a significant switch to diesel cars, with a consequent increase in the volume of imports.

(iii) Criticism could also be levelled at us on the grounds that the move was much too much of a leap in the dark. We often spoke out in Opposition against ill-considered proposals brought forward in a hurry. I would not like us to be tarred with the same brush. (The blocking Order on cars, to which I have referred above, was part of the original structure of VAT which was the subject of widespread consultation over a long period.)

5. These disadvantages seem to me considerably to outweigh the revenue and energy conservation attractions of the proposal. I have therefore decided not to include the proposal in my forthcoming Budget. Nevertheless, we must clearly expect the energy supply situation to remain tight for some time to come, and there could well be a case in the longer term for a blocking Order (quite possibly applying to Derv as well as to petrol). I propose therefore to instruct officials to give it detailed consideration after the Budget, for possible action either next year or, if the energy supply situation should seriously deteriorate, later this year

G.H.

(G.H.)
1 June, 1979

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Prime Minister
This is in line with what you agreed with the Chancellor last week. Are you content?
TL 1/6

PRIME MINISTER

Yes. Unhappy re it.

Following our discussion a week ago I have now more or less settled the main budget proposals and I thought it would be helpful to let you have a summary of them this weekend. For operational reasons it was necessary to settle the indirect tax changes by last night and, subject to the comments below, I hope it will not be necessary to make any further significant changes in the package.

2. I have framed the proposals in the light of the updated National Income Forecast which became available this week. I am sending a copy of this to you under a separate covering note. The forecast will, however, need to be revised over the weekend to take account of the latest information both on the economy and on the package itself. If, as is possible, this leads to some upward revision to the forecast of the PSBR, I shall need to consider some adjustment to the income tax proposals. I hope this will not be necessary; but I shall want to settle this by Monday evening if we are to be able to meet the timetable for producing the necessary Budget documentation.

3. The main constituents of the package may be summarised as follows:-

Direct tax: I am planning to do a little more on the thresholds than was included in the "minimum" package in my minute to you of 23 May. This will give the package a better balance and in particular

Flag A

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help those lower down the income scale. More specifically, the main income tax reductions proposed are:-

- a 3p cut in the basic rate to 30 per cent
- a cut in the top rate to 60 per cent on taxable income over £25,000, with a first higher rate band of £2,000 at 40 per cent starting at £10,000;
- increases in the single and married allowances of £180 and £280 respectively over the 1978-79 levels - double the increases under indexation provisions of the caretaker Finance Act.

The total cost of these changes in 1979-80, together with related increases in the age allowances and other less costly improvements (eg on investment incomes), is estimated at about £3.6 billion (£4.5 billion in a full year). I am also proposing some smaller changes in corporate taxation (eg on stock relief and to help small companies). The base rate and structure of corporation tax will, however, remain unchanged.

Indirect tax: As we agreed last week, VAT will be increased to a unified rate of 15 per cent and I am proposing increases in the duty on petrol and derv of 7p a gallon (a duty increase of about 23 per cent on petrol and 20 per cent on derv). The duties

Separate note on petrol VAT is attached
TL

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on alcohol and tobacco will remain unchanged, as we also agreed. These increases will yield about £2.3 billion this year (£4.1 billion in a full year) and have an impact effect of about 3 3/4 per cent to the RPI.

Public expenditure: Subject to the developments at E Committee this morning of which you are aware, the package will be as agreed by Cabinet, including the reductions in specific progammes and sales of assets that we discussed yesterday. The outlook for prices following the Budget will mean that the cash limits squeeze will be somewhat greater than colleagues have so far been led to expect: the Chief Secretary and I are considering the implications of this. The effect of the increase in prescription charges to 45p, and of additional price increases by the nationalised industries due to the package, will be to add about 0.3 per cent to the RPI by the middle of next year by which time it should once again be on a downward path. In my Budget statement I shall give some account of all the main expenditure cuts; I am sure the House will expect this.

4. There are two other tax measures I should mention. First, there is general agreement that the present rate of Development Land Tax is too high and is reducing the supply of development land and acting as a brake on the building and construction industries. I am therefore proposing to

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to reduce the rate to 60 per cent and to raise the exemption to £50,000. This should assist the release of development land and lighten the burden of tax. Second, we have inherited our predecessor's decision to increase petroleum revenue tax from 1st January. With some modifications I propose to implement this. It seems right in present circumstances, when we are seeking to reduce the burden of direct taxation, to look to the North Sea for a larger revenue contribution.

5. I hope that this combination of measures will enable me to publish in the Industry Act forecast, which will be contained in the Financial Statement and Budget Report, a PSBR forecast for this year of £8¼ billion. This will be within our PSBR target. But if any substantial upward revision proves necessary, I shall, as indicated above, consider an offsetting revision to the income tax proposals. But even if this does prove necessary, the increases in the thresholds should still be very substantial.

G.H.

(G.H.)
1 June, 1979

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Thank you so. [illegible]

Prime Minister - To note
(I suggest you read the summary at Flag A) ~~[illegible]~~
TL 1/6
[illegible]

PRIME MINISTER

I think you will want to see the latest Treasury forecast which has recently been completed. The forecast uses post-Budget policy assumptions, though the package incorporated is now somewhat out-of-date. In particular, we now expect a rather smaller impact on the RPI, which is now likely to show a rise of 17 per cent rather than 17¾ per cent for the fourth quarter of 1979. (In most other respects the forecast will not be materially affected.) You should know that the usual tables in the FSBR will go on to show the prospect of a substantial fall in the year-on-year inflation rate by the third quarter of 1980.

2. The prospect is obviously an uncomfortable one in many respects. As I have observed in my separate note on the Budget package, I shall ensure that the final package enables us to display a PSBR forecast for 1979-80 of £8¼ billion; i.e. below Denis Healey's target. But the consequence is inevitably a discouraging one in the short-term both for output (and therefore employment) as well as for prices. There are, however, a number of considerations which should help to de-fuse the impact of these figures. Far and away the most important is the fact that any Budget - from any Government - at this time would have had to be "deflationary". Certainly Denis Healey will not be able to deny that to achieve his own stated PSBR target of £8½ billion (let alone to increase tax allowances beyond the provisions in the April Finance Act) he would equally have had to introduce a contractionary Budget.

3. We must accept that the increases in indirect taxes - and to a lesser extent some of the public expenditure measures - have an

adverse impact on prices. We now put this at about $3\frac{1}{4}$ per cent. By the middle of next year there may be about another 0.3 per cent from the effects of higher nationalised industry prices and the increase in prescription charges. (I do not include the nationalised industry price increases required which are happening anyway, simply to meet the previous Government's cash limits.) The increase arising from the Budget is, of course, only a comparatively small part of what is happening. There is not much we can do immediately about the underlying $12\frac{1}{2}$ per cent. It is fair to say that most of this is the inevitable consequence of the failure of the last Government's policies, of unavoidable developments in the world in general (especially oil prices) and of several specific decisions on which we can defend our policy on merit. Our general theme must remain that firm monetary and fiscal policy is the surest way to get inflation down; but that there is bound to be an uncomfortable interval before this policy achieves results.

The Chancellor will let us know his conclusion on Monday
TL

4. On output, the gloomy prospect for the immediate future is an inevitable implication of our pre-lunch conversation and of the policies which we believe should set the economy on the right path for the longer term. The net effect of these measures according to normal national income forecasting procedures (as used in the Treasury and by most other practitioners) is bound to be deflationary in the short-term. While we appreciate that conventional forecasting methods fail to pick up many of the beneficial effects of these policies it is clear that these effects take time; particularly insofar as improvement in the underlying supply side performance of the economy is concerned. I have ensured that the forecasts make some allowance for the favourable effects of our policies on consumer and business confidence. We can also argue that by making a substantial part of our package consist of asset disposals (£1.2 billion this year) - measures

which the Opposition would reject on doctrinal grounds - we are helping to achieve a low PSBR at much less cost to the economy.

G.H.

(G.H.)

R/1 June 1979

BUDGET - SECRET

cc Chief Secretary
Financial Secretary
Minister of State(L)
Minister of State(C)
PCC Members
MEG Members
Mr Ridley
Miss Brown
Mr Evans
Mrs Lomax
Mr Riley
Mr Sedgwick

CHANCELLOR OF THE EXCHEQUER

ECONOMIC PROSPECTS TO 1980-81

I attach the revised Treasury National Income Forecast, of which you will have seen a preview on Tuesday.

2 Further to my comments on the preview we now calculate that if the Budget assumptions used for the forecast were changed to those of the higher indirect tax version of the "second sighting shot" the 1979-80 PSBR would come down by nearly £200 million to £8¼ billion. If the further squeeze on cash limits consequent on the higher price forecast is fully reflected in policy, this could bring the PSBR figure down to a little above £8 billion. This of course is the most stringent interpretation possible. It assumes, for example, that the most RPI-expensive tax option is adopted, that all of the £1 billion of asset disposals score for PSBR purposes and that the planned expenditure cuts and reduced contingency reserve are held without any concessions.

JRS

J R SHEPHERD
24 May 1979

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ECONOMIC PROSPECTS TO 1980-81

May 1979 Forecast

Introduction and Summary

This forecast is constructed on a provisional post-Budget basis. The Budget assumption was based on the package available to us on May 17th. Adjustments to the forecast to reflect a more recent Budget package are being made separately. The policy assumptions are listed fully in paragraphs 5-11. The expenditure package assumed was somewhat arbitrary and is not therefore described in great detail. Apart from the Budget itself the general approach in determining the assumptions was to take account of firm decisions by the new Government (eg those on armed forces pay and on the Price Commission) but not to attempt to predict specific future decisions. It was, however, assumed that there would be further expenditure cuts in 1980-81 sufficient to keep the planned level of expenditure at the reduced 1979-80 figure. No further tax changes (apart from indexation for inflation) were assumed for 1980-81.

2 Other key policy assumptions include the growth of £M3 in 1979-80 towards the centre of a 7-11% target range. In 1980-81 monetary policy remains restrictive in that it does not accommodate the rise in money incomes, but in the light of the large PSBR which is indicated in the forecast it was not thought appropriate to try to keep the growth of £M3 to around 9% or less by means of sharply rising interest rates. The exchange rate is assumed to be determined by market forces, with no net intervention by the authorities. Debt repayment continues and a package of exchange controls involving outflows of around £1 billion is included. Pay was projected on the basis of the going rate in the present pay round, guesses at the outcome of public sector comparability agreements and very tentative estimates of an underlying relationship between pay, prices, taxation and the pressure of demand.

3 A numerical summary of the forecast is set out in the table on page 4. None of these numbers should be taken too literally. Margins of error are always large and there are a number of factors - notably the scale of the Budget measures and the associated rise in consumer prices, and the exceptionally unfavourable level of international competitiveness - which add to the uncertainties on this occasion. Paragraph 33-37 attempt some quantification of the margins of error. It is helpful to think of the forecast as amounting to a limited number of propositions, containing only a minimum of numbers, which can be put forward with a reasonable degree of confidence. Much more detailed arithmetic is necessary in compiling the forecasts and some of the detail is useful for specific purposes. But for most general uses the detailed tables annexed to this note should not be taken as indicating more than these general propositions imply. Thus the forecast indicates,

(1) The UK economy is likely to move further into recession. The volume of GDP is unlikely to rise much and is more likely to fall from the level reached in the second half of 1978. Manufacturing output may fall significantly.

(2) Unemployment is expected to increase.

(3) Earnings increases for the economy as a whole may remain at around 14% in the current pay round, perhaps accelerating slightly in 1979/80 when comparability agreements will mean higher increases for the public services.

(4) With oil prices rising sharply the exchange rate beginning to turn down and some domestic factors (eg rates) adding to inflation, retail price inflation well into double figures could be expected this year even in the absence of Budget measures. Allowing for the Budget an RPI increase of approaching 18% is foreseen between the beginning and end of this year. Next year the increase will fall back (on our policy assumptions), perhaps to 13% or a little over.

(5) The PSBR forecast for 1979-80 of some £8½ billion is still rather above the Government's objective. Interest rates rise above their present levels in order to keep the growth of £M3 towards the centre of the 7-11% range. In 1980-81, in the absence of fiscal

action going beyond the further expenditure cuts assumed, the PSBR could rise by more than in proportion to nominal GDP (perhaps to a level of about £10 billion) and a tight monetary target could be very difficult to achieve without substantial rises in interest rates.

(6) The depressed economy and the continued build-up of oil production should keep the current account in balance or modest surplus. But (excluding oil) the volume balance of exports compared with imports will probably worsen further this year with no prospect of recovery in 1980.

(7) Though the timing of exchange rate movements is very difficult to foresee, the effective rate is likely to fall back from its current particularly high level over the full period of the forecast. The rate could hold fairly firm during 1979 but show a more marked fall next year as, among other things, the unsatisfactory fiscal and monetary background for 1980-81 begins to emerge. Despite a fall in the exchange rate, cost and price competitiveness are likely to remain unfavourable by the standards of the recent past, contributing to the difficulties of manufacturing industry.

(8) Poor international competitiveness, depressed activity and high interest rates are expected to worsen the financial position of industrial companies. No major liquidity crisis is foreseen, but profitability may be very low and the prospect must be a discouraging one for investment and stockbuilding despite possibly favourable effects of Government policy on longer term expectations.

4 The remainder of this paper lists the policy assumptions in more detail, explains some of the key forecasting judgments involved and indicates both the particular uncertainties and the general margins of error attaching to forecasts of this kind. The attached tables provide a selection of the more detailed numerical work incorporated in the forecast. The financial forecasts are being covered in a separate note.

May assessment: summary of forecast

PERCENTAGE CHANGES ON A YEAR EARLIER

Gross Domestic Product (volume)

2nd half 1978	3.0
2nd half 1979	-0.4
1st half 1980	-1.0
2nd half 1980	-0.8

Manufacturing Production

2nd half 1978	1.1
2nd half 1979	-1.1
1st half 1980	-1.8
2nd half 1980	-2.0

Average earnings

3rd quarter 1978	14.2
3rd quarter 1979	14.1
3rd quarter 1980	15.8

Retail price index

4th quarter 1978	8.1
4th quarter 1979	17.8
2nd quarter 1980	18.5
4th quarter 1980	13.3

LEVELS

Current balance (£ billion)

1978	0.3
1979	0.4
1980	0.1

PSBR (£ billion)

1978-79 9.3 (5.6% of market price GDP)
1979-80 8.4 (4.4% of market price GDP)
1980-81 10.0 (4.6% of market price GDP)

Effective exchange rate (December 1971 = 100)

4th quarter 1978	62.7
4th quarter 1979	64.9
4th quarter 1980	61.9

Labour cost competitiveness: (increase implies worsening of competitiveness)

4th quarter 1978	93.6
4th quarter 1979	103.5
4th quarter 1980	105.1

Interest Rates	Short Rates	Long Rates	Mortgage Rate
Average 1978-79	10¾	13	9¾
Average 1979-80	12¼	13	11¾
Average 1980-81	12¾	14½	11¾

POLICY ASSUMPTIONS

5 The choice of Budget assumptions, as explained in Sir Douglas Wass's submission of May 16, was constrained by the deadline for completing the forecast. It took account of preliminary information about Cabinet decisions on 17th, but not of any details. The main features of the assumptions are set out below. Their relevance is mainly to aid comparison with later assumptions or decisions.

Taxation

6 The basis of the tax package assumed was Mr Unwin's first "sighting shot" as set out in his minute of 10 May. But the Inland Revenue measures other than income tax, which were comparatively small, were excluded. For income tax a downward adjustment of £500 million was made to the full year cost of £3175 million; the difference was attributed to lower levels of the main personal allowances.

7 For indirect taxation we again started with the package in Mr Unwin's minute (based on 15% VAT and 10% in most of the main duties). The adjustments were to exclude VED changes on cars and to assume 4½p on petrol and Derv. This left the full year yield at very close to £4300 million.

Public expenditure

8 For public expendiure we assumed the following differences from the previous Government's White Paper. The additional £1500 million of cuts in 1980-81 reflected the somewhat arbitrary assumption that planned expenditure volumes would be held flat between the two years.

Differences from White Paper (Cmnd 7439)

£ million at 1979 Survey prices

	1979-80	1980-81
Cash limits (pay and prices) and subsequent consolidation	-600	-600
Programme cuts	-1200	-2200
Contingency reserve	-300	-800
Disposal of assets	-750	-750
	-2850	-4350

9 All of these asset disposals have been assumed to affect the PSBR. Some possible candidates would not have this effect. This applies primarily to sales of shares in a concern which remains in the public sector (eg British Airways). In this case the sale of shares would be regarded as a financing transaction. The PSBR effects, but not the precise monetary effects, would be much the same if £750 million out of the total package of disposals of £1000 million was directly relevant to the PSBR. In addition RSG cuts of £300 million were assumed in each year.

Monetary Policy

10 For 1979-80 it is assumed that £M3 is held close to the centre of a 7-11% target range. For 1980-81 monetary policy remains restrictive in that the rise in money supply does not accommodate the rise in money incomes. But given the size of the PSBR forecast it was not thought appropriate at this stage to assume strict consistency with a low monetary target. This would lead to a forecast of sharply rising interest rates.

Exchange rate policy

11 The exchange rate is assumed to be determined by market forces, with no net intervention by the authorities. A package of exchange controls mainly affecting direct investment is assumed leading to outflows of the order of £1 billion in each year. Debt repayment continues, totalling some $2.2 billion in 1979 and $1 billion in 1980.

NOTES ON MAJOR FORECASTING ISSUES

Earnings (Table 3)

12 Pay settlements in the private sector have been averaging 11-12% in the present pay round. But the earnings figures confirm that it is right to allow for "wage drift", and the growth rate of earnings is probably still around 14%; very similar to the previous pay round. In the present pay round and, to a far greater extent, in the 1979/80 pay round earnings in the public services will be boosted by the effects of comparability agreements. In cases where we now have no direct evidence on the size of comparability awards they have been assumed to average 10%, though these are taken to come on top of "normal" increases for the 1979/80 pay round; the latter are taken to be about 3% lower (in terms of earnings rather than settlements) than private sector increases in the same period. Between the financial years 1978-79 and 1979-80 average earnings in the public service sector are forecast to rise by about 17½%; in 1980-81 the increase is put at 19%.

13 One of the crucial judgments is the extent to which these increases in public services pay encourage leap-frogging demands from the private sector. We are predicting some element of this, though we have not made it a major feature of the forecast. We have also taken account of the high and rising level of unemployment and of the pressures to restore differentials or relativities after a period of pay guidelines. Private sector and nationalised industry earnings increases are forecast to average around 15% in the 1979/80 pay round.

Prices (Tables 4 and 5)

14 Even without the Budget the prospect was for some further increase in the rate of inflation this year. The increase compared with a year ago has already reached 10% and by the end of this year could have reached around 12½%. This acceleration is partly the consequence of a number of particularly favourable factors last year; notably roughly stable import prices for food and basic materials, reflecting the strength of sterling and the weakness of commodity prices. Although

sterling has remained very strong so far some depreciation from the current high level seems likely, oil prices have risen sharply and there have been signs of firmer trends in commodity prices, though we are not forecasting sharp increases. There are also some domestic factors (eg local authority rates) tending to raise prices faster this year and we think there may be some tendency for producers to increase their mark-ups. The latter point is clearly debatable, in such a depressed economy, but the Price Commission may well have exercised a deterrent effect on price increases in a small number of cases, and financial pressures on the company sector could also encourage a sense of urgency in passing on cost increases. But only a small effect (½% on mainly cost-determined prices) has been allowed for these factors. The Budget (including nearly ½% for public sector charges and prices as well as indirect taxation) is thought to add rather over 4½% to the RPI by the end of this year, leading to a total increase approaching 18%. During 1980 the increase is forecast to fall back to around 13%, which bears a roughly normal relationship with the level of private sector pay settlements.

<u>Demand and output</u> (Tables 1 and 2)

15 On a post-Budget basis all categories of demand except exports are forecast to show small falls over the year ending in the first half of 1980. There is little change in total final expenditure over this period but the continuing upward trend in the propensity to import implies a small fall of 1% in GDP. The forecast shows almost unchanged GDP between the two halves of 1980 and the downward movement is concentrated on the period in which the Budget has its initial impact.

16 The main reasons for the decline in output are the Budget itself and the adverse movement in the volume balance of trade, which reflects a rather depressed world outlook and the unfavourable level of UK competitiveness. In addition, private sector investment was probably reaching a cyclical peak, quite apart from the prospects for output and interest rates.

<u>Personal consumption</u> (Table 6)

17 Apart from its effects on real personal disposable incomes a tax stimulus to consumer prices reduces the real value of existing savings in money-denominated assets; there is evidence that this encourages consumers to save in order to re-establish the real value of existing savings. For this reason the fall in the personal savings ratio after the Budget is likely to be fairly small and the impact on personal consumption to be correspondingly large. The savings ratio is forecast to dip slightly in the second half of this year but nevertheless to stay close to the historically high figure of 15% throughout the forecast period. The ratio of wealth to income will also remain low compared with earlier years. Personal consumption falls following the Budget but the path is essentially fairly flat throughout 1979 and 1980.

<u>Private investment and stockbuilding</u> (Tables 8 and 9)

18 The basic investment forecasts owe a great deal to the investment intentions surveys though it is fairly clear that the respondents did not allow for as sharp a downturn in activity as appears in the post-Budget forecast. There is some (highly fallible) econometric evidence on the scale and pace at which investment responds to output. The evidence on interest rates and other financial factors is even weaker, but monetary conditions in the forecast are bound to be unfavourable to both investment and stockbuilding. We have substantially discounted the econometric estimates of the effects of the Budget, partly on the grounds that the effects on general confidence in the longer term may be less unfavourable than is suggested by the short term effects on output. Stockbuilding, however, seems likely to become negative by 1980 since the starting position was one of high stocks in relation to output, particularly for manufacturing, and high nominal interest rates are foreseen. A decline in stockbuilding is therefore likely to reinforce the primary factors pushing down output over the period.

<u>The company sector</u>

19 The prospect is unfavourable both to company profitability and to the financial balances of the company sector as a whole. One indicator is the falling profits (net of stock appreciation) for non-oil companies from 8% of GDP in 1978 to 5½% in 1980 (Table 11). Another is the company sector's financial deficit (excluding both the North Sea and the financial sector) of around £4 billion (some 2½% of factor cost GDP) both in 1979 and in 1980. This deficit has built up gradually from a comparatively trivial level in 1975 and 1976.

20 The extent to which this may involve inadequate liquidity or serious financing problems will be explored in the financial forecasts. At this stage it does not look as if any severe financing crisis will be involved, though inevitably the depressed general outlook may bring difficulties to some companies. When combined with high interest rates the situation cannot be one in which companies are attracted to risk-taking or to large commitment of resources. We have forecast that companies' pricing policy will lean somewhat towards achieving increased profitability, despite the low level of activity, though we have not pushed this very far. We would also expect efforts to economise in stocks and to minimise "labour hoarding".

THE PUBLIC SECTOR

Expenditure

21 The assumptions on cuts in public expenditure are set out earlier in this note. These together with the public expenditure plans in the January 1979 White Paper and the latest information from the survey provide the basis for forecasting the volume of expenditure - though for those elements dependent on economic developments (debt interest, social security benefits, housing subsidies, nationalised industries' borrowing) the forecast of expenditure is based on the development of the economy as seen in this forecast. For other elements of public expenditure, the forecast is constructed by taking the programmes, adding in the (cut) contingency reserve allocated between economic categories, and making allowances for shortfalls in many areas: the programme cuts and cash limit squeezes are expected to lead to a lower than normal level of shortfall. It should be noted that, quite apart from the difficulties of making consistent comparisons between two sets of statistical systems and price bases (theCSO's national accounts and the Public Expenditure Survey), there are major uncertainties over the future level of under or over spending by departments, local authorities and public corporations. In practice much depends on the attitudes of managers in the public sector and so the past relationship between spending plans and outturn has been highly variable.

22 The volume of public expenditure on goods and services (table 7) is forecast to remain at about the same level in 1979-80 and 1980-81 as in 1978-79. At current prices the increases are about 17% in each year, with similar figures for public expenditure in total at current prices, mainly affecting large increases in public sector pay.

Revenues

23 Public sector receipts are forecast by type in considerable detail, with the Revenue departments and their tax models the main source of information. The revenue forecasts take account of the policy assumptions, and of the growing revenue (an additional £0.8 billion in 1979-80 and a further £0.7 billion in 1980-81) from North Sea oil.

Company taxes are the most complicated and the most difficult to forecast: revenues are sluggish in 1980-81 because of the poor profit position in 1979 and because ACT receipts are particularly high in 1979-80 following the ending of dividend control and the resulting large rise in dividends.

Public sector accounts

24 In 1978-79 the PSBR is now estimated at £9¼ billion, the increase of nearly £4 billion on the previous year reflecting a sharp rise in the volume of public expenditure, and the direct tax cuts in the 1978 budget, as well as the absence of some special factors (including sale of BP shares, and a switch to the banks of export credit refinance) affecting 1977-78.

25 Forecasts of the public sector financial deficits and the PSBR are set out below:

	£ billion			
	1977-78	1978-79	1979-80	1980-81
Financial deficits				
Central government	3.3	5.1	4.1	6.7
Local authorities	1.4	1.0	1.2	1.3
Public corporations	1.1	1.3	1.9	1.2
Total deficit	5.8	7.4	7.2	9.2
PSBR: £bn	5.5	9.3	8.4	10.0
As % of GDP at market prices	3.8	5.6	4.4	4.6

BUDGET SECRET

26 In 1979-80 the deflationary effects of the budget are partly offset by the cost of comparability wage payments and by the increased borrowing of many of the public corporations as their price rises fail to keep pace with their cost increases. On a pre-budget basis (the Budget is defined as including both Rooker-Wise and the full cash limit squeeze) the PSBR in 1979-80 would be a little over £10 billion.

27 In 1980-81 the PSBR stays at about the same percentage of GDP (4½%), despite the extra expenditure cuts assumed, because of the main impact of comparability payments, and because non North/Sea company tax payments rise very little (mainly because of the poor profit outlook for 1979 which affects receipts in 1980-81).

28 The margins of error on PSBR forecasts suggest that the forecast for 1979-80 should be regarded as being in the range £6-11 billion. (The estimate of the PSBR in 1978-79 has been revised up by over £1 billion since November.)

External trade (Tables 14, 15 and 18)

29 A note on world economic prospects has already been circulated (see also table 12). Prospects for the growth in activity of the main industrial countries are poor, with GNP growth falling to below 3% by 1980. The pattern of expansion, however, with little growth in the US and a recovery in some small OECD countries should be favourable to UK exports, and we are forecasting that imports of manufactures in the UK's markets rise by around 4% this year and 5 to 6% in 1980. We are also nowadays comparatively optimistic about the UK's trend loss of share in trade in manufactures; we would now put the growth rate of UK exports about 3% a year below that of total trade. But this year's rise in the exchange rate (see table 16) appears to mean an increase compared with 1978 of approaching 10% in the UK unit labour costs relative to its competitors. No improvement is foreseen in 1980 and, allowing for time lags, the impact of adverse competitiveness will be felt more fully in 1980 than this year and will reduce the growth of exports by some 2-3%. The implication is very little change in the volume of UK exports of manufactures either this year of next.

30 The reduction in demand will do a great deal to curb the growth of imports and we foresee falls in the volume of imports of food and basic materials as well as oil. But imports of manufactures will again be adversely affected by unfavourable trends in competitiveness as well as by a continuing trend towards increasing import penetration of the UK market. The perhaps surprisingly large forecast for total imports of goods and services this year (over 4% above 1978) is a reflection of these trends and of the particularly sharp increase in manufactured imports which took place between the two halves of 1978. The forecast growth of total imports from now on is much smaller (1½% between 1979 and 1980). It should also be noted that most of the future benefits from higher oil production are projected as increased exports rather than reduced imports.

31 The forecast has been prepared without any useable trade figures since the beginning of 1979, and with serious distortions to the final quarter of 1978. Inevitably the prospective arrival of these figures could lead to a significant reassessment.

<u>The current account</u> (Table 13)

32 The forecast of a continuing rough balance in the current account involves a number of divergent trends. The visible balance of trade in oil moves from a deficit of £2 billion in 1978 to a small surplus in 1980. Apart from oil the visible balance deriorates by about £1½ billion over the same two-year period as a result of the volume movements referred to above. The terms of trade (Table 17) improve by around 3% this year reflecting the strength of sterling and greatly mitigate the effect of a worsening real (non-oil) balance. The invisible balance is likely to deteriorate, even though the surplus for services should increase. This is partly a reflection of higher Government transfers (notably EEC contributions) and partly a deterioration in the IPD account of which a significant part is a counterpart of the improved oil balance; ie profits due to overseas companies operating in the North Sea.

Margins of error

33 The forecasts presented in this note are our best estimates of what is likely to happen, on the given assumptions about government policies. But these point forecasts are, of course, the centre of a wide range and it is essential to know something about the size of the range, and the chances of the outcome falling within it.

34 Those who prepare forecasts and those who use forecasts are aware in a general way that large uncertainties attach to eg the balance of payments and to the PSBR, both of which represent the difference between very large flows. Forecasters are also aware that in particular forecasts, some elements (such as oil prices in the current forecast) are especially uncertain. While such factors need to be stressed at the time of each forecast, a more general treatment of margins of error is available from the record of past official forecasts. After making allowances for unanticipated fiscal policy changes, the outturn (for a number of key variables) is compared with the forecast over a period of 5-10 years. The average forecasting errors (regardless of sign) are then calculated: some of the results are shown below. These are average errors: the errors in some years were larger.

	Average forecasting error in second half year of forecasting period
GDP (per cent)	2.0
Current account of balance of payments (percentage of current price GDP)	1.5
Retail price index (percentage change on year previously)	3.4

35 Calculations of PSBR errors are not available on the same basis, but over the period 1967-77 PSBR forecasts published at Budget time for the year immediately ahead had an average error of 1.7% of GDP. In 1979-80 that is equivalent to £2½ billion.

36 It is natural to make a judgment from past errors on the size of likely errors in the present forecast, but with changes in the world and in forecasting methods errors in present forecasts may well be rather different from those in the past. But in general these provide a crude guide to the margins of error.

37 Areas of this forecast which are especially uncertain include: the extent of the oil price rise, and the impact upon the world economy; the consequences on trade flows of very unfavourable UK competitiveness; the effect of the Budget and associated measures (its calculated impact on GDP is the biggest for any Budget over at least the last ten years).

TABLE 1 SUMMARY OF EXPENDITURE

BUDGE SECRET

AT 1975 PRICES, SEASONALLY ADJUSTED
UNDERLYING AND FORECAST

		1 CONS EXPDT	2 PUBLIC CONS	3 EXPENDITURE INV (1)	4 TOTAL (1)	5 PRIVATE INV (2)	6 EXPORTS GOODS + SERVICE	7 INV STOCKS (3)	8 TOTAL FINAL EXPDT	9 IMPORTS GOODS + SERVICE	10 FACTOR COST ADJ	11 GDP AT FACTOR COST
£ MILLION 1975		63365	22962	9025	31987	11513	26942	-1627	132201	29628	10453	92377
INDEX NUMBERS 1975 = 100												
1977	I	96.4	101.3	83.4	96.3	105.4	115.1	723	104.2	106.4	102.5	104.1
	II	100.3	101.5	80.3	95.5	112.8	118.8	255	105.6	102.6	104.8	105.7
1978	I	103.4	102.9	75.3	95.1	119.9	117.9	570	107.9	108.8	109.3	107.2
	II	106.1	102.9	73.3	94.6	119.8	121.2	391	109.5	110.1	109.7	108.9
1979	I	107.5	104.6	73.7	95.9	120.6	120.9	89	110.0	113.2	110.3	108.9
	II	107.3	103.8	72.2	94.9	121.0	122.7	118	110.1	115.0	110.1	108.5
1980	I	107.1	103.7	72.6	95.0	118.8	124.2	-135	109.8	115.7	110.1	107.8
	II	107.5	103.8	73.0	95.2	115.3	125.1	-218	109.8	116.0	110.6	107.6
PERCENTAGE CHANGES ON A YEAR EARLIER												
1978	I	5.2	1.6	-9.7	-1.2	13.8	2.4		3.6	2.2	6.7	2.9
	II	5.8	1.4	-8.7	-1.0	6.2	2.1		3.7	7.3	4.7	3.0
1979	I	3.9	1.7	-2.1	0.9	0.6	2.6		1.9	4.1	0.9	1.6
	II	1.1	0.9	-1.5	0.4	1.0	1.2		0.6	4.5	0.4	-0.4
1980	I	-0.4	-0.9	-1.5	-1.0	-1.5	2.7		-0.2	2.2	-0.2	-1.0
	II	0.2	-0.0	1.2	.2	-4.7	2.0		-0.3	0.8	0.5	-0.8

(1) INCL B.S.C. AND PART OF SHIPBUILDING + AIRCRAFT MAN. FROM 1977QTR1
(2) EXCL B.S.C. AND OTHER PUBLIC SECT MAN. (FROM 1977QTR1 PART OF SHIPBUILDING AND AIRCRAFT IS EXCLUDED)

BUDG SECRET

TABLE 2 SUMMARY OF EXPENDITURE

BUDGET SECRET

AT 1975 PRICES, SEASONALLY ADJUSTED
UNDERLYING AND FORECAST £ MILLION

	1 CONS EXPDT	2 PUBLIC AUTH CONS	3 FIXED INV	4 EXPORTS GOODS + SERVICE	5 INV STOCKS	6 COMPR ADJ	7 TOTAL FINAL EXPDT	8 IMPORTS GOODS + SERVICE	9 FACTOR COST ADT	10 GDP AT FACTOR COST	11 GDP INDEX 1975=100
1977	62954	23263	19946	31509	978	-569	138670	30336	10629	96936	104.9
1978	66397	23626	20506	32208	961	-664	143698	31763	11445	99826	108.1
1979	68059	23937	20494	32316	207	-480	145513	33130	11519	100384	108.7
1980	68021	23832	20047	33588	-353	-480	145135	33624	11538	99493	107.7
1977 QTR 1	15622	5771	4858	7714	431	7	34396	7687	2708	24008	104.0
QTR 2	15551	5856	4972	7792	292	19	34465	7754	2646	24084	104.3
QTR 3	15876	5807	5029	8172	-71	-239	34813	7580	2730	24264	105.1
QTR 4	15905	5845	5087	7331	326	-356	34994	7315	2743	24580	106.4
1978 QTR 1	16296	5923	5169	7917	291	-230	35596	7997	2865	24504	106.1
QTR 2	16407	5887	5133	7959	279	-105	35745	7787	2849	25004	108.3
QTR 3	16858	5873	5124	8198	301	-187	36354	8081	2881	25205	109.1
QTR 4	16756	5942	5080	8134	90	-142	36002	7896	2849	25113	108.7
1979 QTR 1	16944	5963	5087	8008	147	-120	36169	8188	2861	25000	108.3
QTR 2	17115	6030	5164	8284	-58	-120	36555	8244	2904	25287	109.5
QTR 3	17035	5971	5101	8273	66	-120	36446	8356	2882	25088	108.6
QTR 4	16965	5952	5122	8250	52	-120	36341	8340	2872	25009	108.3
1980 QTR 1	17006	5960	5087	8349	-40	-120	36362	8402	2882	24958	108.1
QTR 2	16931	5949	5029	8385	-95	-120	36199	8388	2873	24818	107.5
QTR 3	17030	5956	4982	8414	-112	-120	36270	8409	2888	24853	107.6
QTR 4	17054	5965	4949	8438	-106	-120	36300	8423	2893	24864	107.7
1981 QTR 1	17125	5977	4866	8468	-68	-120	36368	8475	2900	24873	107.7

BUDGET SECRET

MAY 20

TABLE 3 WAGE AND SALARY BILL (1) BUDGET SECRET

SEASONALLY ADJUSTED
RECORDED AND FORECAST

	1	2	3	4	5	6	7	8	9	10
	PERCENTAGE	CHANGES	ON THE	PREVIOUS		YEAR		1975 = 100		£M.
	AVERAGE	WAGES AND SALARIES			RL DISP	W + S	W + S	AVERAGE	W + S	W + S
	TOTAL	PUBLIC	PRIVATE	CYC.PRIV	AVW+S(3)	EARNRS	BILL	W + S	EARNERS	BILL
1977	9.1	7.1	9.7	9.5	-4.2	0.5	9.7	124.8	99.8	75023
1978	13.0	11.7	13.3	13.6	5.7	0.3	13.3	141.0	100.1	85015
1979	13.9	14.4	13.8	14.1	1.3	0.2	14.1	160.6	100.2	97014
1980	15.9	20.4	14.7	15.1	0.1	-1.6	14.1	186.2	98.6	110655
1977 QTR 1	10.3	10.0	10.4	8.9	-5.6	0.4	10.7	120.5	99.7	18101
QTR 2	9.2	6.7	9.9	9.4	-6.2	0.6	9.8	123.4	99.8	18556
QTR 3	7.8	6.3	8.3	8.4	-6.5	0.6	8.5	125.6	99.8	18889
QTR 4	9.3	5.5	10.4	11.1	1.9	0.4	9.8	129.6	99.8	19477
1978 QTR 1	10.5	9.5	10.6	11.9	3.2	0.1	10.7	133.2	99.8	20033
QTR 2	13.7	11.2	14.4	14.8	7.1	0.2	13.9	140.3	99.9	21128
QTR 3	14.2	11.7	14.9	14.8	8.5	0.3	14.6	143.5	100.1	21638
QTR 4	13.4	14.3	13.1	13.1	4.0	0.6	14.1	146.9	100.4	22216
1979 QTR 1	12.7	9.4	13.7	13.6	4.8	0.6	13.4	150.1	100.4	22720
QTR 2	13.9	14.7	13.6	13.8	3.5	0.6	14.5	159.8	100.5	24189
QTR 3	14.1	15.9	13.6	14.2	-0.3	0.1	14.2	163.7	100.2	24707
QTR 4	15.0	17.3	14.3	14.7	-2.4	-0.6	14.3	168.9	99.8	25398
1980 QTR 1	17.1	21.5	15.9	16.0	-0.5	-1.0	15.9	175.8	99.4	26328
QTR 2	15.1	21.8	13.1	13.6	-0.5	-1.7	13.1	183.8	98.6	27361
QTR 3	15.8	19.0	14.9	15.4	-0.5	-1.9	13.6	189.6	98.3	28074
QTR 4	15.9	19.4	14.9	15.2	2.0	-1.9	13.6	195.7	98.0	28892
1981 QTR 1	15.4	17.1	14.9	15.2	1.2	-1.7	13.5	202.8	97.7	29870

(1) THE WAGE AND SALARY BILL AND AVERAGE WAGE AND SALARY FIGURES
IN THIS TABLE INCLUDE FORCES PAY
(2) PUBLIC REFERS TO NON-TRADING PUBLIC AUTH. AND PRIVATE TO THE REST
(3) THIS MEASURE OF REAL TAKE-HOME PAY IS DEFLATED BY THE RETAIL PRICES INDEX

BUDGET- SECRET

BUDGET- SECRET

TABLE 4 RETAIL PRICES INDEX AND CONSUMERS EXPENDITURE DEFLATOR

RECORDED AND FORECAST

	1	2	3	4	5	6	7	8	9	10	11	12
	RETAIL PRICES INDEX JANUARY 1974=100					PERCENTAGE CHANGES OVER LAST YEAR FOR RETAIL PRICE INDEX AND COMPONENTS					CONS.EXPD.DEFLATOR (SEAS. ADJ.)	
WEIGHTS(1)	FOOD 221	HOUSING 131	NAT.IND. 78	OTHER 570	TOTAL 1000	FOOD	HOUSING	NAT.IND.	OTHER	TOTAL	INDEX 1975=100	P-C CH ON PREV.YEAR
1977	190.3	161.8	208.1	179.6	182.0	19.0	13.0	12.3	15.6	15.8	132.7	14.8
1978	203.8	173.3	227.2	195.7	197.0	7.1	7.1	9.2	9.0	8.3	144.2	8.6
1979	227.3	207.3	245.7	224.0	224.2	11.5	19.6	8.1	14.5	13.6	163.1	13.1
1980	256.2	240.5	283.2	261.3	259.2	12.7	16.1	15.3	16.7	15.6	188.0	15.3
1977 QTR 1	184.7	154.8	198.9	170.7	174.1	22.0	14.2	14.8	14.9	16.5	126.8	15.2
QTR 2	191.1	165.0	207.5	178.4	181.9	21.8	15.3	13.3	16.7	17.4	131.7	16.3
QTR 3	192.1	164.1	210.9	182.8	184.7	21.0	13.5	11.0	16.2	16.5	135.4	15.7
QTR 4	193.3	163.5	215.3	186.5	187.4	11.9	9.2	10.4	14.7	13.0	137.1	12.3
1978 QTR 1	197.3	162.9	221.1	190.1	190.6	6.8	5.2	11.2	11.4	9.5	139.9	10.3
QTR 2	203.8	171.2	226.0	194.2	195.8	6.7	3.8	8.9	8.9	7.6	142.4	8.1
QTR 3	206.2	176.8	230.2	197.3	199.2	7.3	7.7	9.2	7.9	7.9	145.9	7.7
QTR 4	208.0	182.4	231.7	201.1	202.6	7.6	11.6	7.6	7.8	8.1	148.4	8.3
1979 QTR 1	218.8	191.5	235.3	205.4	208.9	10.9	17.6	6.4	8.0	9.6	151.9	8.5
QTR 2	225.0	206.4	238.8	213.8	217.3	10.4	20.5	5.7	10.1	11.0	158.6	11.4
QTR 3	229.7	213.3	248.9	235.0	232.1	11.4	20.6	8.1	19.1	16.5	168.9	15.8
QTR 4	235.8	217.9	259.6	241.8	238.7	13.4	19.5	12.1	20.2	17.8	173.0	16.6
1980 QTR 1	244.5	221.1	263.7	247.9	244.9	11.7	15.4	12.1	20.7	17.2	178.0	17.2
QTR 2	254.0	242.6	281.6	256.9	257.5	12.9	17.5	17.9	21.1	18.5	186.3	17.4
QTR 3	259.9	247.1	289.3	265.9	263.9	13.1	15.9	16.2	13.1	13.7	191.7	13.5
QTR 4	266.5	251.4	298.4	272.6	270.5	13.0	15.4	14.9	12.7	13.3	195.9	13.2
1981 QTR 1	275.4	256.5	309.7	279.9	278.2	12.6	16.1	17.4	12.9	13.6	201.9	13.5

(1) THESE WEIGHTS ARE APPLICABLE TO INDICES BASED ON JANUARY 1974 = 100
THE PUBLISHED WEIGHTS ARE APPLICABLE TO INDICES BASED ON JANUARY 1978 = 100

BUDGET-SECRET

MAY 20

BUDGET-SECRET

TABLE 5 EXPENDITURE PRICE DEFLATORS

PRICE INDICES AND THEIR PERCENTAGE CHANGES ON A YEAR EARLIER

	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
	CONSUMERS EXPENDITURE		PUBLIC AUTH CONSUMPTION		FIXED INVESTMENT		EXPORTS OF GDS AND SERVICES		TOTAL FINAL EXPENDITURE		IMPORTS OF GOODS AND SERVICES		GDP AT FACTOR COST		GDP AT MARKET PRICES	
	INDEX	P-C	INDEX	P-C	INDEX	P-C	INDEX	P-C	INDEX	P-C	INDEX	P-C	INDEX	P-C	INDEX	P-C
1977	132.8	0.0	125.2	0.0	129.4	0.0	138.1	0.0	132.2	0.0	139.7	0.0	126.9	0.0	130.2	0.0
1978	144.2	8.6	138.2	10.3	142.7	10.2	147.4	6.7	143.7	8.6	144.1	3.1	140.1	10.4	143.5	10.3
1979	163.1	13.1	157.8	14.2	160.5	12.5	161.6	9.6	161.5	12.4	152.1	5.5	156.1	11.5	164.3	14.5
1980	188.0	15.3	187.6	18.8	184.9	15.2	178.3	10.3	185.2	14.7	167.9	10.4	179.3	14.8	190.6	16.0
1977/78	136.1	0.0	128.5	0.0	132.8	0.0	140.5	0.0	135.4	0.0	140.5	0.0	130.4	0.0	134.0	16.0
1978/79	147.2	8.2	141.1	9.8	145.8	9.8	150.3	7.0	146.7	8.4	146.3	4.1	142.5	9.3	146.9	9.7
1979/80	169.6	15.2	165.1	17.1	166.8	14.3	165.6	10.1	167.5	14.2	155.4	6.2	162.1	13.7	171.2	16.5
1980/81	194.0	14.4	194.8	18.0	190.9	14.5	182.9	10.5	191.1	14.1	172.1	10.8	185.3	14.4	197.0	15.1
1978 QTR 1	139.9	10.3	133.6	11.0	137.8	11.2	143.2	7.4	138.9	9.9	140.5	2.1	135.9	11.2	138.5	12.3
QTR 2	142.4	8.1	136.1	9.5	140.9	10.0	146.6	6.5	142.0	8.1	144.5	3.8	138.0	10.2	141.3	9.5
QTR 3	145.9	7.7	140.0	9.5	144.5	9.6	148.1	6.0	145.2	7.4	145.2	3.1	141.7	9.4	145.2	8.6
QTR 4	148.4	8.3	143.0	11.3	147.5	10.5	151.5	7.0	148.5	9.2	146.4	3.5	144.6	10.7	149.1	10.8
1979 QTR 1	151.9	8.5	145.1	8.6	150.6	9.3	155.2	8.4	151.3	8.9	148.9	6.0	145.7	7.3	152.0	9.8
QTR 2	158.6	11.4	155.1	14.0	156.9	11.4	159.7	8.9	158.0	11.3	149.8	3.7	154.8	12.2	160.5	13.5
QTR 3	168.9	15.8	163.1	16.4	164.4	13.8	163.9	10.6	166.2	14.5	153.1	5.5	159.7	12.7	170.1	17.2
QTR 4	173.0	16.6	168.1	17.6	170.2	15.4	167.2	10.4	170.5	14.8	156.5	7.0	164.3	13.6	174.7	17.2
1980 QTR 1	178.0	17.2	174.3	20.1	175.6	16.6	171.4	10.5	175.6	16.0	161.9	8.7	169.6	16.4	179.7	18.2
QTR 2	186.3	17.4	186.8	20.5	182.2	16.1	176.9	10.8	183.7	16.2	167.8	12.0	176.8	14.2	188.6	17.5
QTR 3	191.7	13.5	191.1	17.2	188.1	14.4	180.3	10.9	188.5	13.5	169.1	10.5	182.9	14.5	194.5	14.3
QTR 4	195.9	13.2	197.9	17.7	193.9	13.9	184.3	10.2	193.3	13.4	172.8	10.4	187.9	14.4	199.6	14.2
1981 QTR 1	201.9	13.5	203.3	16.6	199.8	13.8	190.0	10.8	199.1	13.4	178.5	10.3	193.7	14.2	205.5	14.4

BUDGET-SECRET

MAY 20

TABLE 6 CONSUMERS EXPENDITURE

BUDGET-SECRET

	1	2	3	4	5	6	7	8	9	10	11
	REAL CONSMR EXP. TOTAL	DUR-ABLES	NONDUR-ABLES	REAL PERSNL DISP. INC.	SAVINGS RATIO	CONSMR PRICE INDEX	% CHANGES ON PREVIOUS YEAR OF: CONSUMPTION TOTAL	DUR-ABLES	NONDUR-ABLES	PERSNL DISP. INC.	CONSMR PRICES
1977	62954	5114	57840	72955	13.71	132.7	-0.9	-4.6	-0.6	12.8	14.8
1978	66397	6021	60376	77572	14.41	144.2	5.5	17.7	4.4	15.5	8.6
1979	68059	6151	61907	80221	15.16	163.1	2.5	2.2	2.5	16.9	13.1
1980	68021	5902	62119	80247	15.23	188.0	-0.1	-4.1	0.3	15.3	15.3
1977/78	63628	5261	58367	73318	13.22	136.0	0.4	-1.7	0.6	12.9	13.6
1978/79	67045	6107	60938	79246	15.40	147.1	5.4	16.1	4.4	16.9	8.2
1979/80	68121	6136	61984	80078	14.93	169.6	1.6	0.5	1.7	16.4	15.3
1980/81	68140	5861	62278	80343	15.19	194.0	0.0	-4.5	0.5	14.7	14.3
1977 QTR 1	15622	1297	14325	18216	14.24	126.8	-0.9	-0.8	-0.9	12.2	15.2
QTR 2	15551	1225	14326	17966	13.44	131.7	-1.8	-6.6	-1.4	12.9	16.3
QTR 3	15876	1334	14542	18028	11.94	135.4	-0.4	-1.5	-0.3	10.8	15.7
QTR 4	15905	1258	14647	18745	15.15	137.1	-0.6	-9.4	0.2	15.2	12.3
1978 QTR 1	16296	1444	14852	18579	12.29	139.9	4.3	11.3	3.7	12.5	10.3
QTR 2	16487	1501	14986	19441	15.20	142.4	6.0	22.5	4.6	17.0	8.1
QTR 3	16858	1594	15264	19640	14.16	145.9	6.2	19.5	5.0	17.4	7.7
QTR 4	16756	1482	15274	19912	15.85	148.4	5.4	17.8	4.3	15.0	8.3
1979 QTR 1	16944	1530	15414	20253	16.34	151.9	4.0	6.0	3.8	18.3	8.5
QTR 2	17115	1588	15527	20158	15.10	158.6	3.6	5.8	3.6	15.5	11.4
QTR 3	17035	1508	15526	19934	14.54	168.9	1.0	-5.4	1.7	17.5	15.8
QTR 4	16965	1525	15440	19876	14.65	173.0	1.2	2.9	1.1	16.3	16.6
1980 QTR 1	17006	1515	15491	20110	15.43	178.0	0.4	-1.0	0.5	16.4	17.2
QTR 2	16931	1467	15464	20087	15.71	186.3	-1.1	-7.6	-0.4	17.0	17.4
QTR 3	17030	1448	15582	19923	14.52	191.7	-0.0	-4.0	0.4	13.5	13.5
QTR 4	17054	1472	15582	20127	15.27	195.9	0.5	-3.5	0.9	14.6	13.2
1981 QTR 1	17125	1474	15650	20206	15.25	201.9	0.7	-2.7	1.0	14.0	13.5

BUDGET-SECRET

MAY 20

TABLE 7 PUBLIC EXPENDITURE ON GOODS A[illegible] BUDGET-SECRET

AT 1975 PRICES, SEASONALLY ADJUSTED
UNDERLYING AND FORECAST £ MILLION

	1	2	3	4	5	6	7	8	9	10
	---PUBLIC			INVESTMENT			---	CONSUMPTION		
	LAND	DWELL	LOCAL AUTH	CENTRAL GOVNMT	PUBLIC CORP	STEEL	TOTAL INC STEEL	LOCAL AUTH	CENTRAL GOVNMT	TOTAL PUBLIC EXPEND
1977	156	1849	1143	966	2914	358	7390	9857	13426	30673
1978	-120	1621	1183	996	2911	217	6708	9983	13643	30334
1979	28	1467	1136	911	2858	185	6585	10252	13685	30522
1980	-4	1422	1158	933	2880	135	6574	10190	13642	30406
1977/78	123	1782	1091	930	2892	325	7143	9894	13541	30573
1978/79	-110	1553	1198	873	2936	195	6645	10042	13644	30331
1979/80	21	1473	1131	913	2855	190	6563	10240	13675	30498
1980/81	-10	1412	1164	946	2896	180	6568	10177	13672	30437
1977 QTR 1	36	467	327	289	712	100	1951	2474	3297	7722
QTR 2	66	457	264	219	718	90	1814	2475	3383	7672
QTR 3	36	454	275	225	765	80	1835	2444	3363	7642
QTR 4	20	451	277	235	719	88	1790	2464	3381	7635
1978 QTR 1	1	420	275	251	690	67	1704	2511	3412	7627
QTR 2	0	364	291	218	741	61	1695	2480	3407	7582
QTR 3	-33	443	302	207	733	46	1698	2468	3405	7571
QTR 4	-88	374	315	220	747	43	1611	2524	3418	7553
1979 QTR 1	11	352	290	228	715	45	1641	2570	3413	7624
QTR 2	10	367	285	231	723	50	1666	2565	3465	7716
QTR 3	4	369	280	225	709	45	1632	2559	3412	7603
QTR 4	3	359	281	227	711	45	1626	2558	3394	7578
1980 QTR 1	4	356	285	230	712	50	1639	2558	3402	7599
QTR 2	-3	356	291	230	720	45	1639	2544	3405	7588
QTR 3	-3	355	291	234	723	45	1645	2544	3412	7601
QTR 4	-2	353	291	239	725	45	1651	2544	3421	7616
1981 QTR 1	-2	348	291	243	728	45	1653	2545	3432	7630

BUDGET-SECRET

TABLE 8 FIXED INVESTMENT - PRIVATE AND TOTALS

BUDGET - SECRET

AT 1975 PRICES, SEASONALLY ADJUSTED
UNDERLYING AND FORECAST £ MILLION

	1	2	3	4	5	6	7	8	9	10
	P R I V A T E									
	DWELL	MANUFAC -TURE(1)	SHIPS +AIR TR	DISTB + SERVICES	NORTH SEA	MISC	TOTAL PRIV(1)	TOTAL PUB(2)	GRAND TOTAL	MANUFAC -TURE TOTAL
1977	1992	3163	390	4016	1593	1402	12556	7390	19946	3930
1978	2296	3560	253	4346	1584	1759	13798	6708	20506	4061
1979	2227	3686	300	4559	1508	1629	13909	6585	20494	4129
1980	2278	3293	300	4662	1257	1683	13473	6574	20047	3739
1977 QTR 1	421	745	124	926	347	344	2907	1951	4858	951
QTR 2	492	760	108	981	461	316	3158	1814	4972	969
QTR 3	535	813	78	1034	372	362	3194	1835	5029	990
QTR 4	544	825	80	1075	393	380	3297	1790	5087	1020
1978 QTR 1	614	838	124	1075	406	408	3465	1704	5169	989
QTR 2	566	884	59	1090	401	418	3438	1695	5133	1028
QTR 3	551	918	59	1078	372	448	3426	1698	5124	1027
QTR 4	545	920	11	1103	405	485	3469	1611	5080	1022
1979 QTR 1	539	927	75	1093	412	400	3446	1641	5087	1035
QTR 2	549	931	75	1131	407	405	3498	1686	5184	1049
QTR 3	564	922	75	1160	337	411	3469	1632	5101	1030
QTR 4	575	906	75	1175	352	413	3496	1626	5122	1015
1980 QTR 1	581	864	75	1170	345	413	3448	1639	5087	983
QTR 2	578	818	75	1163	334	422	3390	1639	5029	927
QTR 3	564	808	75	1162	304	424	3337	1645	4982	917
QTR 4	555	803	75	1167	274	424	3298	1651	4949	912
1981 QTR 1	544	767	75	1155	248	424	3213	1653	4866	876

(1) EXCLUDING BSC AND OTHER PUBLIC SECTOR MANUFACTURING: FROM 1977Q3 THE STATE OWNED PART OF THE SHIPBUILDING AND AEROSPACE INDUSTRIES IS EXCLUDED

(2) INCLUDES BRITISH STEEL THROUGHOUT - BRITISH AEROSPACE FROM 1977Q2 AND BRITISH SHIPBUILDERS FROM 1977Q3

BUDGET - SECRET

MAY 20

TABLE 9 STOCKBUILDING

BUDGET-SECRET

SEASONALLY ADJUSTED

	1	2	3	4	5	6	7	8
		--- MANUFACTURER'S DISTRIBUTERS ---					-- TOTAL --	
	STOCK-BLDING	STOCK/OUTPUT 1975=100	CNSMPTN GOODS STOCK-BLDING	STOCK/SALES 1975=100	MATERIALS STOCK-BLDING	OTHER STOCK-BLDING	STOCK-BLDING	STOCK/GDP 1975=100
1977	443	97.1	187	105.0	100	241	979	96.6
1978	595	99.0	321	100.4	-2	47	961	96.4
1979	-210	100.3	254	101.6	9	152	205	97.0
1980	-533	100.2	65	104.8	-36	80	-353	97.5
1977 QTR 1	234	95.4	171	103.9	27	-3	429	96.7
QTR 2	97	97.4	49	109.3	134	12	292	97.3
QTR 3	-4	97.3	-54	102.7	-84	74	-68	96.3
QTR 4	116	98.5	21	104.3	31	158	326	96.0
1978 QTR 1	39	99.0	125	101.8	18	109	291	97.1
QTR 2	271	97.4	60	100.9	-14	-58	279	95.9
QTR 3	174	98.2	72	98.2	27	28	301	96.0
QTR 4	111	101.3	44	100.6	-33	-32	90	96.6
1979 QTR 1	34	102.0	85	100.5	-11	38	146	97.4
QTR 2	-148	99.0	63	100.1	-5	31	-59	96.1
QTR 3	-46	100.0	52	102.4	9	51	66	97.1
QTR 4	-50	100.4	54	103.4	16	32	52	97.5
1980 QTR 1	-111	100.7	33	103.9	11	27	-40	97.6
QTR 2	-146	100.6	19	105.3	5	26	-96	97.9
QTR 3	-143	100.0	7	105.2	12	13	-111	97.5
QTR 4	-133	99.6	6	104.8	7	14	-106	97.1
1981 QTR 1	-93	99.4	8	104.6	3	12	-70	96.9

BUDGET-SECRET

BUDGET-SECRET

TABLE 10 EMPLOYMENT AND UNEMPLOYMENT IN U.K.

	1	2	3	4	5	6	7	8
	EMPLOYMENT					UNEMPLOYMENT		
	PUBLIC (1)	PRIVATE(1) MANUF	OTHER(2)	TOTAL	LABOUR SUPPLY	WIDE(3) UNADJ	NARROW,ADJ(3)	
	000'S	000'S	000'S	000'S		000'S	000'S	P-C
1977	4994	7354	12509	24857	26433	1463	1378	5.7
1978	5024	7311	12590	24925	26524	1475	1375	5.6
1979	5101	7205	12660	24966	26611	1430	1348	5.5
1980	5068	7049	12475	24592	26710	1705	1605	6.6
1977 QTR 1	5013	7339	12490	24842	26367	1418	1330	5.5
QTR 2	4999	7371	12493	24863	26443	1395	1341	5.5
QTR 3	4973	7369	12524	24866	26454	1622	1415	5.8
QTR 4	4992	7338	12529	24859	26469	1499	1428	5.9
1978 QTR 1	5015	7338	12519	24872	26484	1506	1409	5.8
QTR 2	5021	7327	12551	24899	26507	1428	1373	5.6
QTR 3	5015	7309	12610	24934	26536	1571	1381	5.7
QTR 4	5047	7272	12680	24999	26569	1395	1340	5.5
1979 QTR 1	5078	7248	12689	25015	26584	1437	1351	5.5
QTR 2	5107	7230	12690	25027	26597	1355	1312	5.4
QTR 3	5115	7188	12654	24957	26619	1499	1339	5.5
QTR 4	5107	7155	12609	24871	26647	1430	1393	5.7
1980 QTR 1	5105	7114	12558	24777	26667	1553	1456	6.0
QTR 2	5064	7071	12499	24634	26690	1603	1547	6.4
QTR 3	5054	7023	12441	24518	26724	1846	1657	6.8
QTR 4	5050	6990	12405	24445	26762	1821	1764	7.3
1981 QTR 1	5060	6960	12371	24391	26782	1982	1864	7.6

(1) PUBLIC EQUALS NON TRADING PUBLIC SECTOR,PRIVATE EQUALS REST
(2) INCLUDES NORTH SEA OIL AND GAS EMPLOYMENT
(3) NARROW EXCLUDES SCHOOL LEAVERS,WIDE INCLUDES THEM

BUDGET-SECRET

This must be
[illegible] 2 million

BUDGET SECRET

TABLE 11 FACTOR INCOMES - SHARES

PERCENTAGE OF TOTAL DOMESTIC INCOME NET OF STOCK APPRECIATION

	1 INCOME FROM EMPL-OYMENT	2 INCOME FROM SELF EMPLMT.	3 ..NET COMPANY NON-OIL	4 PROFITS.. OIL	5 PUBLIC CORP.ETC NET SUR-PLUSES	6 RENT	7 TOTAL DOMST. INCOME (1)
1977	69.6	8.7	8.0	1.4	4.0	8.1	100.0
1978	69.7	8.8	8.1	1.6	3.8	8.0	100.0
1979	70.7	8.8	6.4	2.5	3.4	8.2	100.0
1980	70.9	8.9	5.4	3.0	3.6	8.2	100.0
1977 QTR 1	70.9	8.5	7.2	1.4	3.9	8.2	100.0
QTR 2	69.9	8.6	7.9	1.5	4.1	8.1	100.0
QTR 3	69.4	8.8	8.0	1.4	4.3	8.0	100.0
QTR 4	69.2	9.1	8.7	1.3	3.6	8.0	100.0
1978 QTR 1	69.3	8.9	8.5	1.6	3.7	8.0	100.0
QTR 2	70.0	8.8	7.7	1.6	3.9	7.9	100.0
QTR 3	69.4	8.8	8.5	1.6	3.7	8.0	100.0
QTR 4	69.8	8.7	7.9	1.7	3.8	8.1	100.0
1979 QTR 1	71.3	8.9	5.9	2.0	3.5	8.5	100.0
QTR 2	70.6	8.8	6.8	2.3	3.3	8.1	100.0
QTR 3	70.5	8.9	6.5	2.7	3.4	8.1	100.0
QTR 4	70.6	8.8	6.2	2.8	3.4	8.1	100.0
1980 QTR 1	71.0	8.9	5.9	2.9	3.1	8.1	100.0
QTR 2	71.3	9.1	4.7	3.0	3.7	8.2	100.0
QTR 3	70.5	9.0	5.6	3.0	3.6	8.1	100.0
QTR 4	70.8	8.9	5.2	3.0	3.9	8.2	100.0
1981 QTR 1	71.2	8.8	4.7	3.1	4.1	8.2	100.0

(1) NET OF STOCK APPRECIATION

BUDGET-SECRET

BUDGET-SECRET

TABLE 12 WORLD ECONOMIC VARIABLES

	1	2	3	4	5	6	7	8	9	10	11	12
	- -UK WEIGHTED (DOL)- -				WORLD INDUST -RIAL PRODN	- COMMODITY PRICES (DOL)-				INDEX OF CAP PRICES (UA)	UK WTD COMMO- DITIES	TERMS OF TRADE
	WORLD TRADE MANUFS	COMPRS EXPORT PRICES	COMPRS WHSALE PRICES	COMPRS UNIT LABOUR		FOOD (SEE BELOW)	AGRIC. NON-FOOD	METAL ORES	NON-FERROUS METALS			
1977	117	109	112	110	112	120	124	104	117	133	119.7	109.5
1978	120	126	130	129	116	122	131	105	126	146	124.7	98.9
1979	125	140	143	141	122	129	145	119	149	148	137.6	98.3
1980	132	155	158	156	125	139	160	129	164	150	150.0	97.1
77/76%CH	5.1	8.5	9.6	9.0	3.1	14.6	10.5	2.3	7.6	10.0	11.0	2.3
78/77%CH	3.0	15.4	15.8	17.1	3.6	1.7	5.9	1.4	7.9	10.0	4.2	-9.6
79/78%CH	4.1	11.0	10.4	9.6	4.7	5.9	11.1	12.8	18.1	1.6	10.3	-0.6
80/79%CH	5.7	10.4	10.2	10.6	2.5	7.5	10.1	8.7	9.7	1.0	9.0	-1.2
1977 QTR 1	116	106	108	106	112	120	126	105	120	127	121.2	113.9
QTR 2	116	108	111	108	112	127	133	104	117	132	126.2	117.4
QTR 3	117	110	113	111	112	116	118	102	114	136	115.4	104.8
QTR 4	118	113	116	115	112	117	117	103	117	137	115.9	102.3
1978 QTR 1	118	119	122	121	113	122	122	102	119	145	120.0	101.0
QTR 2	120	123	125	124	115	121	129	102	120	147	122.6	100.0
QTR 3	119	129	133	132	117	120	133	105	129	147	125.3	97.3
QTR 4	123	134	138	138	119	125	139	111	137	147	131.2	97.7
1979 QTR 1	122	136	140	139	121	127	142	119	153	148	135.9	99.8
QTR 2	124	136	140	138	121	125	144	118	151	150	135.8	99.7
QTR 3	126	141	144	142	122	130	145	118	146	148	137.1	97.1
QTR 4	128	146	148	147	122	135	150	120	147	148	141.5	96.7
1980 QTR 1	129	150	152	151	123	138	153	123	152	149	144.7	96.5
QTR 2	131	153	156	155	124	138	156	127	160	151	148.2	96.7
QTR 3	133	156	159	158	125	139	162	131	168	150	151.8	97.6
QTR 4	136	159	163	161	126	141	167	134	175	150	155.4	97.6
1981 QTR 1	138	163	167	166	128	142	169	138	161	151	157.9	96.7

COLUMN 6 IS FOOD WEIGHTED BY UK IMPORTS FROM NON-EEC COUNTRIES

BUDGET-SECRET

TABLE 13 BALANCE OF PAYMENTS

BUDGET - SECRET

AT CURRENT PRICES, SEASONALLY ADJUSTED
UNDERLYING AND FORECAST £ MILLION *

	1 EXPORT GOODS	2 IMPORT GOODS	3 VISIB BAL	4 EXPORT SERV	5 IMPORT SERV	6 BAL SERV	7 BAL TRANSF	8 BAL IPD	9 INVIS BAL	10 CURRENT BALANCE	11 CURRENT BALANCE DOLLRS(1)	12 CONTRIB NS OIL (2)
1977	32147	33891	-1744	11373	8498	2875	-1225	392	2042	298	520	1935
1978	35432	36606	-1174	12034	9170	2864	-1987	552	1424	255	489	2416
1979	39656	40343	-687	13361	10050	3311	-2251	63	1123	436	889	3914
1980	44800	45068	-268	15075	11392	3683	-2606	-454	363	95	190	4958
1977 QTR 1	7520	8466	-946	2765	2111	654	-273	137	518	-426	-733	392
QTR 2	7921	8700	-779	2805	2098	757	-287	62	492	-297	-510	512
QTR 3	8531	8534	-3	2889	2138	751	-334	100	525	522	905	522
QTR 4	8175	8191	-16	2914	2151	763	-331	65	517	501	908	508
1978 QTR 1	8409	9004	-595	2925	2231	694	-548	109	255	-340	-655	493
QTR 2	8752	8925	-173	2917	2326	591	-440	168	319	146	267	610
QTR 3	9051	9418	-367	3092	2312	780	-535	173	418	51	98	615
QTR 4	9220	9259	-39	3100	2301	799	-464	102	437	398	790	696
1979 QTR 1	9238	9772	-534	3191	2424	767	-477	32	322	-212	-427	798
QTR 2	9951	9881	70	3280	2467	813	-506	56	363	433	884	919
QTR 3	10153	10248	-95	3405	2544	861	-618	5	248	153	313	1058
QTR 4	10314	10442	-128	3485	2615	870	-650	-30	190	62	128	1137
1980 QTR 1	10719	10868	-149	3595	2738	857	-665	-66	126	-23	-47	1191
QTR 2	11097	11214	-117	3741	2860	881	-726	-105	50	-67	-134	1240
QTR 3	11350	11363	-13	3821	2860	961	-744	-120	97	84	171	1243
QTR 4	11634	11623	11	3918	2934	984	-731	-163	90	101	205	1283
1981 QTR 1	12044	12081	-37	4047	3050	997	-801	-199	-3	-40	-79	1324

(1) N.B. COLUMN 11 IN U.S. DOLLAR MILLIONS

(2) VALUE OF N.S. OIL PRODUCTION LESS IPD DEBITS

BUDGET - SECRET

TABLE 14 EXPORTS OF GOODS AT 1975 PRICES

BUDGET - SECRET

£ MILLION,1975 PRICES

	1 ADJUST MANUF	2 SHIPS + AIRCRFT	3 PREC STONES	4 PRIOR ADJUST	5 RESI- DUAL	6 TOTAL MANUF	7 FUEL	8 NON- MANUF	9 SECTION 9	10 RESI- DUAL	11 TOTAL OTS	12 BOP ADJUST	13 TOTAL BOP
1977	17258	1079	1287	0	0	19624	1367	2293	694	-7	23971	-835	23136
1978	17800	859	1311	0	0	19970	1726	2637	720	4	25057	-1148	23909
1979	17768	899	1372	0	0	20039	2313	2570	735	2	25659	-1163	24496
1980	17760	947	1440	0	0	20147	3048	2578	754	2	26529	-1188	25341
1977 QTR 1	4225	210	307	0	0	4742	327	573	169	1	5812	-173	5639
QTR 2	4289	242	368	0	0	4899	350	556	183	-8	5980	-253	5727
QTR 3	4455	394	263	0	0	5112	383	591	168	-8	6246	-183	6063
QTR 4	4289	233	349	0	0	4871	307	573	174	8	5933	-226	5707
1978 QTR 1	4376	229	333	0	0	4938	370	651	164	-2	6121	-302	5819
QTR 2	4372	238	319	0	0	4929	420	666	180	-24	6171	-225	5946
QTR 3	4541	188	312	0	0	5041	473	656	173	19	6362	-290	6072
QTR 4	4511	204	347	0	0	5062	463	664	203	11	6403	-331	6072
1979 QTR 1	4319	212	323	0	0	4854	538	648	182	1	6223	-303	5920
QTR 2	4547	229	351	0	0	5127	515	660	183	0	6485	-290	6195
QTR 3	4470	229	349	0	0	5048	612	635	184	1	6480	-284	6196
QTR 4	4432	229	349	0	0	5010	648	627	186	0	6471	-286	6185
1980 QTR 1	4442	232	354	0	0	5028	726	634	186	1	6575	-290	6285
QTR 2	4449	235	357	0	0	5041	750	641	188	-1	6619	-295	6324
QTR 3	4440	238	362	0	0	5040	774	649	189	1	6653	-299	6354
QTR 4	4429	242	367	0	0	5038	798	654	191	1	6682	-304	6378
1981 QTR 1	4418	246	374	0	0	5038	818	662	193	0	6711	-309	6402

BUDGET - SECRET

MAY 20

TABLE 15 IMPORTS OF GOODS AT 1975 PRICES (OTS) BUDGET-SECRET

£ MILLION, 1975 PRICES

SITC	1 FOOD ETC 0 + 1	2 FUEL OIL	3 FUEL COAL +GAS	4 FUEL TOTAL 3	5 BASIC MATER. 2 + 4	6 SEMI-MANUFACTURES PR.ST. +SILV	7 SEMI-MANUFACTURES OTHER	8 SEMI-MANUFACTURES TOTAL 5 + 6	9 FINISHED MANUFACTURES CAPIT. GOODS	10 FINISHED MANUFACTURES CONS. GOODS	11 FINISHED MANUFACTURES OTHER	12 FINISHED MANUFACTURES SHIPS + AIR	13 FINISHED MANUFACTURES RESID -UAL	14 FINISHED MANUFACTURES TOTAL 7 + 8	15 MISC. 9	16 RESID -UAL	17 TOTAL 0 - 9
1977	4415	3420	150	3570	2571	1132	5957	7090	2140	3035	2371	650	0	8196	742	-3	26581
1978	4396	3293	188	3481	2630	1251	6783	8033	2537	3411	2697	658	0	9303	794	-6	28633
1979	4310	3003	265	3268	2537	1324	7174	8498	2632	3913	2887	760	1	10393	613	-1	29618
1980	4260	2989	268	3257	2419	1391	7107	8498	2952	4268	3000	794	0	11014	622	0	30070
1977 QTR 1	1137	904	23	927	684	215	1501	1718	527	741	591	164	4	2027	96	62	6651
QTR 2	1148	890	43	933	625	368	1457	1825	516	740	588	172	9	2025	366	-32	6890
QTR 3	1120	828	33	861	635	226	1533	1760	560	766	596	168	-5	2085	129	31	6621
QTR 4	1010	798	51	849	627	323	1466	1787	537	788	596	146	-8	2059	151	-64	6419
1978 QTR 1	1099	871	40	911	658	315	1641	1959	599	802	658	199	9	2267	96	83	7073
QTR 2	1094	718	54	772	662	275	1648	1927	637	819	673	166	2	2297	464	-52	7164
QTR 3	1130	865	22	887	644	355	1728	2077	630	901	674	133	-5	2333	139	40	7250
QTR 4	1073	839	72	911	666	306	1766	2072	671	889	692	160	-6	2406	95	-77	7146
1979 QTR 1	1079	814	66	880	535	325	1778	2103	675	939	697	183	0	2494	139	-1	7329
QTR 2	1061	706	66	772	644	329	1804	2133	703	973	723	188	0	2587	150	0	7367
QTR 3	1079	738	67	805	636	333	1809	2142	716	991	735	193	1	2636	176	1	7475
QTR 4	1071	745	66	811	622	337	1783	2120	738	1010	732	196	0	2676	148	-1	7447
1980 QTR 1	1069	771	67	838	615	341	1780	2121	736	1040	740	197	0	2713	146	0	7502
QTR 2	1063	765	67	832	605	345	1765	2110	729	1051	740	198	-1	2717	156	0	7483
QTR 3	1066	738	67	805	602	350	1772	2122	739	1077	754	199	0	2769	170	0	7534
QTR 4	1062	715	67	782	597	355	1790	2145	748	1100	766	200	1	2815	150	0	7551
1981 QTR 1	1062	710	64	774	593	361	1810	2171	742	1122	779	201	0	2844	150	1	7595

BUDGET-SECRET

TABLE 16 EXCHANGE RATES AND COMPETITIVENESS

BUDGET SECRET

	1	2	3	4	5	6	7	8	9	10
	...EXCHANGE RATES...			-- COMPETITIVENESS OF GOODS --						
				- EXPORTS OF MANUFAC. -		WHOLESALE PRICES/IMP. PRICES				
	EFFECTIVE EXCH.RATE	EX. COMP WTD. RATE	DOLLAR/£ EXCH.RATE	PRICE COMPET	REL.UNIT LAB.COST	REL.WHS. PRICES	OTHER S-MANUF	CONSUM GOODS	CAPIT GOODS	OTH.FIN. MAN(1).
1977	62.12	60.375	1.745	102.76	88.52	96.96	100.66	88.47	99.60	88.99
1978	63.00	59.375	1.920	107.56	93.18	100.77	101.74	87.96	102.95	94.46
1979	65.12	60.663	2.045	112.03	101.90	107.41	104.35	91.10	107.44	99.01
1980	62.14	56.874	2.021	110.04	103.15	108.14	105.14	92.43	108.20	99.46
1977 QTR 1	61.80	60.430	1.714	98.66	86.10	93.80	98.89	86.05	98.16	87.52
QTR 2	61.60	60.060	1.719	102.07	87.50	95.98	98.92	88.31	99.79	88.66
QTR 3	61.80	59.860	1.735	103.36	87.70	97.49	101.47	89.26	100.34	88.59
QTR 4	63.30	61.150	1.814	106.95	90.60	100.57	103.52	90.39	101.28	91.25
1978 QTR 1	65.40	62.230	1.928	110.29	94.70	104.32	104.71	91.31	103.71	94.90
QTR 2	61.50	58.370	1.836	104.06	91.90	98.45	102.35	87.59	102.82	93.52
QTR 3	62.40	58.540	1.932	107.22	92.50	99.90	102.04	87.52	102.92	93.92
QTR 4	62.70	58.360	1.985	109.74	93.63	100.41	96.08	85.60	102.38	95.52
1979 QTR 1	63.90	59.491	2.015	111.17	96.75	103.77	102.88	88.48	105.11	97.61
QTR 2	66.50	62.310	2.045	113.82	104.26	108.20	104.11	91.33	107.96	99.23
QTR 3	65.22	60.786	2.051	111.99	103.13	108.47	104.99	92.16	108.41	99.65
QTR 4	64.66	60.062	2.068	111.12	103.47	109.22	105.45	92.57	108.36	99.60
1980 QTR 1	62.79	57.895	2.023	108.85	101.64	107.19	105.30	91.70	107.34	98.67
QTR 2	61.29	56.261	1.991	108.16	101.15	106.08	104.68	91.24	106.81	98.17
QTR 3	62.57	57.068	2.041	111.77	104.56	109.57	105.18	93.39	109.32	100.48
QTR 4	61.91	56.274	2.030	111.39	105.06	109.74	105.41	93.45	109.39	100.55
1981 QTR 1	60.50	54.751	2.000	110.43	104.69	108.69	105.13	93.03	108.90	100.09

(1) EXCLUDING SHIPS AND AIRCRAFT

BUDGET SECRET

BUDGET-SECRET

TABLE17 TERMS OF TRADE

INDICES 1975 = 100

	1	2	3	4	5	6	7	8	9	10	11	12
	--- G O O D S ---			- S E R V I C E S -			- - T O TAL - -			UVI GOODS EXCLUDING FUEL		
	EXPORTS DEFLATR	IMPORTS DEFLATR	TERMS OF TRADE	EXPORTS DEFLATR	IMPORTS DEFLATR	TERMS OF TRADE	EXPRTS DEFLATR	IMPRTS DEFLATR	TERMS OF TRADE	EXPORTS	IMPORTS	TERMS OF TRADE
1977	138.9	139.2	99.8	135.8	141.0	95.8	138.1	139.7	98.8	142.5	138.9	102.6
1978	148.2	143.2	103.5	145.0	147.8	98.1	147.4	144.1	102.3	155.9	145.0	107.5
1979	161.9	151.0	107.2	160.6	156.9	102.4	161.6	152.1	106.2	168.8	152.7	110.5
1980	176.8	166.5	106.1	182.8	173.5	105.3	178.3	167.9	106.2	185.2	168.9	109.6
1977 QTR 1	133.4	137.1	97.3	133.3	133.5	95.5	133.3	137.6	96.9	135.7	135.4	100.3
QTR 2	138.3	138.6	99.8	135.8	141.9	95.7	137.7	139.3	98.8	141.7	138.7	102.2
QTR 3	140.7	140.2	100.4	137.0	143.4	95.5	139.7	140.8	99.3	145.3	140.8	103.2
QTR 4	143.2	141.1	101.5	137.2	142.5	96.3	141.6	141.4	100.2	147.4	140.7	104.8
1978 QTR 1	144.5	139.6	103.4	139.4	143.4	97.2	143.2	140.5	101.9	149.9	139.9	107.2
QTR 2	147.2	143.4	102.7	144.9	148.9	97.3	146.6	144.5	101.5	153.6	144.6	106.3
QTR 3	149.1	144.4	103.2	145.4	148.1	98.2	148.1	145.2	102.0	157.9	146.5	107.8
QTR 4	151.6	145.3	104.5	150.3	150.9	99.6	151.5	146.4	103.5	162.0	149.0	108.7
1979 QTR 1	156.0	147.8	105.6	152.8	153.7	99.4	155.2	148.9	104.2	165.3	151.2	109.3
QTR 2	160.6	148.6	108.1	157.0	154.6	101.5	159.7	149.8	106.6	167.0	150.5	110.9
QTR 3	163.9	152.0	107.8	163.9	157.8	103.9	163.9	153.1	107.1	169.8	152.8	111.1
QTR 4	166.8	155.4	107.3	168.7	161.3	104.6	167.2	156.6	106.8	173.1	156.3	110.7
1980 QTR 1	170.5	160.7	106.1	174.1	167.0	104.3	171.4	161.9	105.9	177.6	162.1	109.6
QTR 2	175.5	166.5	105.4	181.4	172.9	104.9	176.9	167.8	105.5	183.3	168.4	108.8
QTR 3	178.6	167.7	106.5	185.4	175.2	105.8	180.3	169.1	106.6	187.6	170.4	110.1
QTR 4	182.4	171.3	106.5	190.2	179.1	106.2	184.3	172.8	106.7	192.2	174.7	110.0
1981 QTR 1	188.1	177.0	106.3	195.8	184.7	106.0	190.0	176.5	106.4	198.4	180.8	109.7

BUDGET SECRET

MAY 20

TABLE 18 BALANCE OF RESOURCES

BUDGET - SECRET

AT 1975 PRICES, £ MILLION

	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
										--EXCLUDING ALL FUEL--			IN THE ABSENCE OF N. S. OIL(1)		
	EXPORTS OF GOODS	IMPORTS OF GOODS	VISIBLE BALANCE	EXPORTS SERV.S	IMPORTS SERV.S	BALANCE SERV.S	TOTAL EXPORT	TOTAL IMPORT	BALANCE RESOURCE	EXPORT GOODS	IMPORT GOODS	VISIBLE BALANCE	EXPORT GOODS	IMPORT GOODS	VISIBLE BALANCE
1977	23136	24344	-1208	8373	5992	2381	31509	30336	1173 .	21769	21066	703 .	22518	25125	-2607
1978	23909	25559	-1650	8299	6204	2095	32208	31763	445 .	22183	22364	-181 .	22991	26626	-3635
1979	24496	26723	-2227	8321	6406	1915	32816	33130	-314 .	22183	23723	-1540 .	22853	27872	-5019
1980	25341	27060	-1719	8246	6565	1681	33588	33624	-36 .	22293	24069	-1776 .	23160	28339	-5179
1977 QTR 1	5639	6174	-535	2075	1513	562	7714	7687	27 .	5312	5323	-11 .	5506	6323	-817
QTR 2	5727	6276	-549	2065	1478	587	7792	7754	38 .	5377	5419	-42 .	5567	6477	-910
QTR 3	6063	6089	-26	2109	1491	618	8172	7580	592 .	5680	5298	382 .	5896	6296	-400
QTR 4	5707	5805	-98	2124	1510	614	7831	7315	516 .	5400	5025	375 .	5547	6028	-481
1978 QTR 1	5819	6441	-622	2098	1556	542	7917	7997	-80 .	5449	5604	-155 .	5613	6650	-1032
QTR 2	5946	6225	-279	2013	1562	451	7959	7787	172 .	5526	5516	10 .	5721	6488	-767
QTR 3	6072	6520	-448	2126	1561	565	8198	8081	117 .	5599	5705	-106 .	5819	6774	-955
QTR 4	6072	6373	-301	2062	1525	537	8134	7898	236 .	5609	5536	73 .	5831	6713	-882
1979 QTR 1	5920	6611	-691	2088	1577	511	8008	8188	-180 .	5382	5803	-421 .	5574	6915	-1341
QTR 2	6195	6649	-454	2090	1595	495	8284	8244	40 .	5680	5940	-260 .	5822	6940	-1118
QTR 3	6196	6744	-548	2077	1613	464	8273	8356	-83 .	5584	6005	-421 .	5752	7015	-1263
QTR 4	6185	6719	-534	2066	1621	445	8250	8340	-90 .	5537	5974	-437 .	5704	7000	-1296
1980 QTR 1	6285	6763	-478	2065	1640	425	8349	8402	-53 .	5559	5993	-434 .	5775	7061	-1286
QTR 2	6324	6735	-411	2061	1654	407	8385	8388	-3 .	5574	5971	-397 .	5791	7048	-1257
QTR 3	6354	6777	-423	2060	1633	427	8414	8409	5 .	5580	6037	-457 .	5797	7103	-1306
QTR 4	6378	6785	-407	2060	1638	422	8436	8423	15 .	5580	6067	-487 .	5796	7126	-1330
1981 QTR 1	6402	6824	-422	2066	1651	415	8466	8475	-7 .	5584	6113	-529 .	5801	7161	-1360

(1) VISIBLE BALANCE OF RESOURCES LESS CONTRIBUTION OF NS OIL PRODUCTION

BUDGET - SECRET

6

Chancellor of the Exchequer

cc PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State
Circulation list below

THE FINANCIAL FORECASTS: MAY 1979

1. The preview of the forecast attached to Mr Shepherd's minute of 23 May summarised the prospects for the money supply, interest rates and the exchange rate. Complex judgements are however involved, and the two attached reports - dealing with external and domestic financial flows - attempt to give a more comprehensive account. They have been prepared in collaboration with the Bank of England and are of course consistent with the rest of the short term forecast of which they are an integral part.

2. There are a number of points of particular importance to which I might draw attention.

Uncertainties

3. Forecasting financial flows is a hazardous business. We may hope to predict the direction of movements, but we should count ourselves very fortunate if we got the timing and scale of market fluctuations right. Quarterly changes in interest rates and the exchange rate shown in the forecast are no more than broad indications of our judgement about underlying trends. The one thing we can be quite sure of in practice is that markets will be much more volatile reflecting short term swings in confidence.

4. Markets, particularly the foreign exchange markets, are influenced by developments in the UK relative to those in the rest of the world. Events in Iran are likely to be a continuing source of uncertainty. The repercussions of these events on the oil market, set against our increasing self sufficiency, has caused the rest of the world to take a favourable view of the prospects for sterling. The situation is still murky, and it can

set up expectations which override - at least for a time - other influences.

Initial Impact of the Budget on the Markets

5. The starting point is one in which according to our normal yardsticks the exchange rate is if anything on the high side. Interest rates on the other hand, while high in comparison with other countries, are probably on the low side when the relatively rapid monetary growth of the last six months and the prospects for inflation before the Budget are compared with the present monetary target The markets are however looking forward to the Budget package and some of its effect will have been already discounted. We have assumed that the package of measures will not be a disappointment and will maintain confidence. The exchange rate remains firm at its current high level and domestic interest rates do not react adversely to the immediate price raising effect of the Budget. But there will undoubtedly be some surprise about the size of the indirect tax increases and concern about its impact on prices; this may give rise to worries about its effects on the labour markets. There may thus be conflicting initial reactions in the market which we have not attempted to incorporate in the forecast.

The Stance of Monetary Policy

6. Monetary policy in 1979-80 is very tight, with the targeted growth of the money stock set at about half the growth in money incomes. Even though there may be a favourable market reaction to the Budget, it is difficult to imagine that this tightness can be achieved without some increase in interest rates from their present levels. The growth of the money stock increases in 1980-81 not because there is any suggestion that the Government will be content with such a stance. But with a wide monetary aggregate, monetary and fiscal policy have to be considered together. The PSBR is forecast to rise significantly and it did not seem realistic to assume that policy would be directed towards attempting to achieve a target centring on 9% or less by interest rate increases alone. So we adopted the holding assumption of

keeping the growth of the money stock below the forecast rise in money national income.

Publication

7. Though there is a verbal description of the exchange rate and monetary assumptions, it has not been customary to publish any numbers in respect of financial variables in the various Industry Act forecasts.

Banking Months

8. Monetary targets are set and monitored in banking months. There is no reason why the banking month figures should be greatly different from the calendar month figures shown in this forecast, but we shall have to check this further when the final Budget package is available.

PM.

P E MIDDLETON
24 May 1979

Enc

Circulation List

PCC Members

Mr Bridgeman
Mr Shepherd
Mr Cassell
Mr Hancock
Mrs Hedley-Miller
Mr Unwin
Mr Dixon
Mrs Lomax
Mr Riley
Mr Turnbull
Mr Odling-Smee
Mr Evans
Mr Sedgwick
Mr Ridley
Mr Bell
Mr Spencer

Mr Denham
Mr Allan
Mr R Butt
Mr Williams

B/Eng:
Mr Fforde
Mr Dow
Mr McMahon
Mr Page
Mr Walker
Mr Dicks-Mireaux
Mr Goodhart
Mr Townend
Mr D Green
Mr D Sheppard

THE EXCHANGE RATE AND CAPITAL FLOWS FORECAST

Introduction and Summary

The exchange rate and external capital flows forecast forms the main link between the income expenditure and domestic financial forecasts. It is prepared in conjunction with these other forecasts and reflects the assumptions and judgments that underlie them. Both for this reason, and because the behaviour of financial markets is at best imperfectly understood, forecasts in this area are subject to a very wide margin of uncertainty. While it may often be possible to give a broad indication of the likely direction of change over a year or two, it is extremely difficult to predict quarter-to-quarter movements in either exchange rates or capital flows with any reasonable degree of accuracy. Subject to this qualification, the forecasts, which are prepared with the help of our econometric model of capital flows,* reflect our best judgment about the likely course of events over the next two years, given the assumptions about policy and world developments which underpin the rest of the forecasting exercise.

2. The forecasts have been prepared on the assumption that the exchange rate will effectively be determined by market forces, and that there will be no sustained one-way official intervention in the foreign exchange market. The predicted exchange rate path rests on a detailed consideration of the factors influencing balance of payments flows on both current and capital account. Trade and other current account flows are described elsewhere. This report discusses the financial and confidence factors influencing capital flows, as well as analysing the implications of the rest of the forecasts for the exchange rate.

3. The forecast is summarised in table 1. Details of official financing and debt repayment are shown in table 2 and the exchange rate forecast, both in effective terms and against the dollar and other major currencies, is shown in table 3. The forecast suggests that

*Described in Treasury Working Paper No 8, Part II sterling will remain broadly stable in effective terms, in the range 64-66, for the rest of 1979, falling back slightly to about 61-63 in the following year.

RECENT DEVELOPMENTS

4. Sterling was relatively quiet in the second half of 1978: there was little net intervention by the authorities, and the effective rate was fairly steady at about 62½. The current account was in small surplus, matched by a modest outflow on capital account. This year, since the revolution in Iran, sterling has been in much heavier demand, partly reflecting relatively high UK interest rates but chiefly because the markets have taken the view that the UK is better placed than other major countries to withstand the shock of a substantial increase in oil prices.

5. Until 4 April, the authorities attempted to limit sterling's appreciation but despite purchases of $2 billion, the effective rate rose by 4 per cent compared with end-1978. Since early April the Bank has allowed greater movement in the rate both ways and intervention has been on a more modest scale, totalling only about $½ billion; there has been little net change in the level of 66½ reached then. We have no detailed information about balance of payments flows after the fourth quarter of last year; but the domestic banking statistics suggest that there has been a significant build up in private sterling balances. It seems unlikely that the non-bank private sector has been a net buyer of sterling.

POLICY ASSUMPTIONS

6. The exchange rate forecast reflects all the assumptions about fiscal and domestic monetary policy that underlie the rest of the forecasts: the most important additional assumption about policy concerns the scale of official intervention* in the foreign exchange market. We have assumed that, on balance, this is zero over the forecast period. Other policy assumptions which are particularly relevant to this part of the forecast are summarised below.

*As measured by the balance for official financing. This includes both the Bank of England's market and off-market transactions (other than for official debt repayment).

Debt repayment

7. We assume net official debt repayment of about $2 billion in 1979 and nearly $1 billion in 1980, financed by running down the reserves. Since we have maturing debts of over $2 billion in 1980 and $3 billion in 1981, this means we shall have a substantial continuing programme of new borrowing by HMG and public sector bodies. Full details are shown in table 2.

Exchange control

8. We have assumed that the Budget will include a substantial step towards relaxing the present exchange control regime. The precise changes follow closely those discussed in the submissions put forward by the Treasury and the Bank. The most important are: a £5 million annual ration for overseas direct investment; permission for UK merchants to use sterling to finance third country trade; an extension to two months in the holding period for foreign currency deposits. Against the background of the demand for sterling envisaged in this report, the ex ante impact on capital flows is likely to be of the order of £1 billion a year, largely in the form of a financing switch from foreign currency to sterling. Ex post, the effect will be felt on the exchange rate, rather than the balance of payments, given our assumption that the exchange rate is free to adjust to market pressures.

RELATED FORECASTS

9. The exchange rate and capital flows forecasts reflect developments foreseen elsewhere in the NIF, the domestic financial forecast and in the WEP. The features of those forecasts which are particularly relevant are summarised below.

Other currencies

10. Forecasts of the dollar and other major currencies are taken from the WEP report. The recovery of the dollar that took place in the early part of this year is not expected to go any further, and both the yen and the mark are forecast to appreciate in real terms, while the dollar shows some real depreciation, in line with

past trends. Exchange rates between members of the European Monetary System are assumed to remain within the currently agreed bands for a further year, with a general realignment in mid-1980. The UK is not assumed to join the EMS.

Monetary developments

11. Movements in sterling M3 relative to monetary growth in other major countries are thought to have an important influence on expectations about the future course of sterling. Forecasts for overseas money supplies (summarised in table 4) are based on the outlook for individual economies contained in the WEP report. The weighted basket of overseas money supplies, which is dominated by the US, is expected to grow by 11 per cent between the first quarters of 1979 and 1980, and 11½ per cent over the following year. In the UK, the domestic financial forecasts show sterling M3 growing at about 9 per cent in 1979/80 and about 10½ per cent in 1980/81.

Interest rates

12. Changes in domestic interest rates relative to foreign rates have a direct effect on capital flows. Foreign interest rates are forecast together with overseas monetary growth, on the basis of the WEP. Full details are shown in table 4. In the US, we assume some modest further upward movement in rates, with 3-month CDs peaking just short of 10½ per cent in the current quarter. Thereafter, rates are assumed to ease back gradually as activity slackens. German and Japanese interest rates may show some further rise this year, but fall back a little next year as their currencies harden. On average, overseas rates are likely to remain firm this year, with the weighted basket falling by only about ½ percentage point during 1980. The domestic financial forecast shows UK rates rising this year and continuing at a high level throughout the forecast period. Interest rate differentials, at both the long and short end, are expected to move somewhat in the UK's favour.

Relative wage costs

13. The relatively fast growth in the UK's trend unit labour costs, compared with our main competitors, will have a direct effect on trade flows. We also think that it will have an influence on expectations about sterling. The rise in UK wage costs is expected to exceed that in competitor countries, measured in domestic currencies, by about 8 percentage points in both 1979 and 1980.

Current account

14. The current account is expected to remain in modest surplus over the forecast period. This is at a time of rapidly rising North Sea oil production. The contribution of North Sea oil to the current account rises from £2.4 billion in 1978 to nearly £5 billion in 1980; by implication, therefore, the balance on other transactions is in very substantial deficit.

THE EXCHANGE RATE FORECAST

15. The effective exchange is expected to fall back from the current exceptionally high level over the forecast period. While the timing of the fall is inevitably highly uncertain, we are expecting the rate to remain above 64 this year, and to fall back quite sharply at the beginning of 1980. This is likely to be consistent with some fall against the dollar, though we are not expecting the rate to dip significantly below $2 over the forecast period. If the deutschemark and the yen strengthen, as foreseen in the WEP, the fall may be steeper against these currencies next year; and, as table 3 shows, sterling may depreciate slightly more against the European unit of account (equals the ECU) than it does in effective terms.

Exchange rate determination

16. The forecast assumes that the exchange rate is determined by market forces. Broadly, this means that the exchange rate is assumed to adjust to clear any incipient deficit or surplus on the balance of payments. In the short run many balance of payments flows are relatively insensitive to the current exchange rate. The main effect of a change in the rate is felt on short term

flows, which respond rapidly to changes in the expected return on holding sterling. So, for example, if underlying balance of payments flows are in deficit, the exchange rate must depreciate sufficiently to persuade those undertaking foreign exchange transactions that the prospects for future gains are at least somewhat more than they were. How much the exchange rate has to move to achieve this result depends both on how market operators form their expectations, and on how responsive short term flows are to changes in these expectations. At the same time, the resulting exchange rate path will also depend on anything and everything that, under a fixed exchange rate, would be reflected in movements in the official reserves - relative prices, the level of activity, world trade, and relative interest rates, as well as expectations about the future course of sterling.

Exchange rate expectations

17. The forecast incorporates our best judgment about how market operators will view the prospects for sterling over the next two years. We assume they form their views partly with regard to the prevailing level of the exchange rate, and partly with regard to the 'fundamentals', that is, some notion of the appropriate sustainable level for sterling under present circumstances. Relevant factors which we assume they consider are the UK's monetary growth rate relative to that in her major competitors, taking account of the UK's relatively slow growth rate and adverse productivity record, and movements in relative wage costs. In recent months, the market has clearly also been impressed by the UK's favourable energy position vis-a-vis other major countries: formally we have taken account of this by assuming operators expect the real exchange rate to appreciate as the real oil price rises.

18. Quantification of all these factors is extremely difficult; but it seems likely that sterling is currently somewhat over-valued in relation to the factors mentioned above. For the future, the trend of market sentiment may depend on how much weight is attached to purely monetary factors, as against forecast developments on the pay front; the latter is likely to be a much

more bearish factor than the former. Our forecasts are based on the even handed assumption that monetary growth rates and relative wage costs receive roughly equal weight. On this view, any deterioration in confidence this year may primarily reflect a view that at 66½ sterling is somewhat overvalued. By 1980, the 'fundamentals' may, on balance, be suggesting to the market that sterling should be on a slight downward trend.

CAPITAL FLOWS FORECAST

19. The forecasts for capital flows are summarised below and shown in more detail in table 6.

	£ billion		
	1978/9	1979/80	1980/81
Net private investment	-	-0.9	-0.9
(Memo: ex ante impact of relaxing exchange controls on outward direct investment)	-	(-0.7)	(-0.8)
Net trade credit	-0.2	-0.3	-0.3
of which: fixed rate export credit	-0.4	-0.1	-0.1
Net oil flows	+0.2	+0.3	-0.3
of which: to finance North Sea development	+0.5	+0.5	+0.3
Other	-1.1	+0.4	+1.2
(Memo: ex ante impact of relaxing exchange controls other than on direct investment)	-	(-0.2)	(-0.2)
TOTAL	-1.0	-0.4	-0.3

These forecasts must be interpreted in the light of the exchange rate forecast discussed above. When the exchange rate is allowed to float freely, short term flows will largely reflect developments elsewhere in the balance of payments. If there is a deficit on current account or 'autonomous' capital flows, it must be offset by a matching capital inflow, and the exchange rate will fall until the expected return from holding sterling is high enough to bring one about. If confidence weakens this is likely to be reflected in a sharper deterioration in the exchange rate rather than short term outflows (though in practice the Government may prefer to change the amount of official intervention to brake a fall in the rate).

Private investment

20. The balance on private sector investment (which includes all identified transactions between related companies, excluding oil companies), is expected to deteriorate by about £½ billion, mainly as a result of the relaxation of controls to be announced in the Budget. Inward investment is likely to grow strongly, after falling back slightly last year, as interest rate differentials widen in favour of sterling, and as total portfolios expand. We have assumed that sales of public sector assets will generate additional inward investment of about £150 million over the period.

Trade credit

21. The major trade credit flow has historically arisen from ECGD fixed rate business which, until recently was a large and growing claim on the balance of payments. The switch to foreign currency financing is only now, two years after its inception, beginning to have a significant impact on the capital account. The effect of financing fixed rate credit in ~~sterling~~ foreign currency is to bring forward the benefit to the balance of payments of exports sold under the scheme, albeit at some cost in invisible earnings. The outflow from credits financed in sterling, which was over £600 million in 1976/77 is forecast to be no more than £140 million in 1979/80 and less than £100 million in 1980/81. These figures reflect the very high proportion of ECGD advances which has been agreed in foreign currency over the last two years; for the future we have assumed, in line with the latest forecasts of public expenditure, that roughly 70 per cent of ECGD's future business will be done in foreign currency rather than sterling.

Oil flows

22. In recent years, the financing of exploration and development expenditure in the North Sea has had a major impact on the capital account. Both non-UK and UK companies have brought in foreign funds on a large scale for this purpose. With oil production and revenues building up over the next few years, companies will need to bring in much less external finance, especially if, as seems likely, capital expenditure declines slightly. A more detailed discussion of how the financing of North Sea operations has and will affect the balance of payments is given in the Annex.

Short term flows

23. Short term flows (which include movements in private and non-OPEC official sterling balances, as well as changes in the banks' net foreign currency position, and the balancing item) are in principle likely to be directly influenced by interest rates which, together with exchange rate expectations, determine the expected return on holding sterling; but, like changes in confidence, changes in interest rates will have their effecton the exchange rate rather than recorded flows, if the authorities are not intervening. As explained earlier, the balance on short term flows is largely the mirror image of the balance on other current and capital account transactions if the exchange rate is flexible. The forecast suggests that, despite the small surplus on current account, a modest continuing inflow of short term funds will be needed to offset the adverse balance on other capital flows, due both to the turnround on oil flows to finance the North Sea, and to the relaxation of exchange controls.

24.5.79

ANNEX

NORTH SEA OIL FINANCIAL FLOWS

The financial flows generated by the North Sea programme have been and will continue to be an important influence on the balance of payments. This Annex gives a summary of flows in the past, and describes in more detail our forecasts of future flows.

Recent developments

2. It is only in the last two years that oil production has begun to build up and oil companies have begun to generate revenues to finance some of their heavy expenditure. Capital expenditure in developing the fields now in production or likely to be in production shortly grew from £700 million in 1974 to over £2 billion in 1976. North Sea production was very small in these years and as a result companies financed most of their investment by borrowing. Private take before interest (a rough measure of cash flow) was substantially negative over this period.

3. A high proportion of expenditure has been, and continues to be, financed from overseas.* Foreign companies either borrowed foreign currency or brought in overseas capital and many UK companies borrowed in the eurodollar market through UK banks. Probably no more than 10 per cent of the capital expenditure of foreign companies has been financed in sterling.

4. As a result there have been substantial capital inflows which totalled over £1 billion a year in 1975-77. In 1978, the inflow was rather smaller, at around £600 million, as an increase in cash flow reduced the need for some companies to bring in funds from overseas.

5. Profits earned by non-UK companies on their North Sea operations, a debit in the current account of the balance of payments, have so far been small. There were small losses up

*See Bank of England Quarterly Bulletin : March 1979 to 1976 and the profits due abroad in 1977 and 1978 were only £300-400 million; in 1978 they were depressed by the fall in the sterling price of oil.

Forecasts of flows over the next two years

6. There is likely to be a substantial change in the pattern of flows over the next few years. As North Sea production builds up towards its' peak in the early 1980s so oil companies will begin to earn substantial revenues and, after a lag, will begin to pay substantial amounts in tax. Capital expenditure is likely to start to fall in real terms as the first round of field developments are completed. Private 'take' before interest is likely to grow rapidly, reaching nearly £3 billion in 1980.

7. It is unlikely that much of this surplus will remain in sterling in the UK. Some will be earmarked to service the foreign currency debt which has been built up; most of the remainder is likely to be invested overseas. Multinational oil companies operate by using revenues generated in one part of the world to finance exploration and development elsewhere; they have, for instance, substantial commitments in Mexico and in Australia. Their scope for investment in the UK is limited: there is already some over-capacity in refining and in parts of the chemicals sector.

8. This argument applies equally to UK multinational oil companies (Shell and BP) as it does to foreign companies such as Esso. Some of the smaller UK companies who have a stake in the North Sea might use their profits to finance investment in the United Kingdom, but many might want to use the opportunity, to the extent that exchange control rules permit, to explore for raw materials elsewhere.

9. Our forecasts reflect the judgment that the bulk of the surplus funds will be invested overseas, though an allowance has been made for some build up of short-term UK assets in anticipation of future tax payments. Table 1 summarises the assumptions about the use of the private take from the North Sea which underly our forecasts of capital flows. The corresponding forecasts of IPD

debits and of inward and outward investment flows are shown in table 2. The balance of payments conventions are that profits earned in the North Sea by foreign companies are recorded as a debit in the current account whether or not they are remitted abroad: if they are retained in the UK, an offsetting capital account inflow will be recorded. On the same conventions, profits earned by UK companies only affect the balance of payments if the funds are invested overseas. The forecast suggests that the total impact of these financial flows on the balance of payments will turn round from being positive in 1978 to being substantially negative in 1979 and 1980. Against this, the visible trade balance will be benefiting substantially from lower net imports of oil, so that the net contribution of the North Sea oil programme to the balance of payments willbe positive and growing.

SECRET

TABLE 1 : SUMMARY OF FORECAST

not seasonally adjusted

	Current Balance £m	Capital Flows £m	Balance for official financing £m	Net official borrowing	Change in reserves £m	Reserve level * (end-period) $bn	MEMO ITEM Sterling effective rate
1978	254	-1380	-1126	-1202	-2328	15.7	63.0
1979	437	563	1000	- 851	149	20.5 *	65.1
1980	90	- 440	- 350	- 338	- 688	19.1	62.1
1978/79	382	-1031	- 649	- 990	-1639	21.5	62.6
1979/80	624	- 424	200	- 885	- 685	19.1	64.9
1980/81	78	- 278	- 200	- 225	- 425	19.3	61.6
1978Q1	-583	756	173	- 218	- 45	20.3	65.4
Q2	204	-1698	-1494	- 531	-2025	16.5	61.5
Q3	173	37	210	- 155	55	16.5	62.4
Q4	460	- 475	- 15	- 296	- 311	15.7	62.7
1979Q1	-455	-1105	650	- 8	642	21.5*	63.9
Q2	491	- 141	350	- 695	- 345	20.8	66.5
Q3	275	- 275	0	- 155	- 155	20.5	65.2
Q4	126	- 126	0	8	8	20.5	64.9
1980Q1	-268	118	- 150	- 43	- 193	20.1	62.8
Q2	- 10	- 190	- 200	- 303	- 503	19.1	61.3
Q3	206	- 206	0	- 43	- 43	19.0	62.6
Q4	162	- 162	0	52	52	19.1	61.9
1980Q1	-280	280	0	69	69	19.3	60.5

* The gold reserves were revalued during 1979 Q1

TABLE 2 : OFFICIAL FINANCING

Ø million

	IMF Repayments	HMG Borrowing	HMG Repayments	Under exchange cover scheme PS Borrowing	Under exchange cover scheme PS Repayments	Total net official financing	North American Repayments	Repayments of uncovered borrowing	Total net borrwing A+B+C
						A	B	C	
1978	-1977	351	0	-703		-2329	-131	-348	-2808
1979	-1247	500	0	2719	-3713	-1741	-259	-204	-2204
1980	- 324	500	0	1036	-1887	- 675	-138	-188	-1001
1978/79	-1977	351	0	-298		-1924	-131	-331	-2386
1979/80	-1328	500	0	2353	-3338	-1813	-259	-109	-2181
1980/81	- 324	500	0	1447	-2069	- 446	-138	-201	- 785
1978 Q1	0	0	0	-422		- 422	0	-123	- 545
Q2	- 927	351	0	-400		- 976	- 11	- 32	-1019
Q3	- 50	0	0	-251		- 301	0	- 18	- 319
Q4	-1000	0	0	+370	-	- 630	-120	-175	-925
1979 Q1	0	0	0	625	- 642	- 17	0	-106	- 123
Q2	-1085	0	0	698	-1035	-1422	- 11	- 27	-1460
Q3	- 81	0	0	698	- 936	- 319	-125	- 8	- 452
Q4	- 81	500	0	698	-1100	+ 17	-123	- 63	- 169
1980 Q1	- 81	0	0	259	- 267	- 89	0	- 11	- 100
Q2	- 81	0	0	259	- 782	- 704	- 12	- 21	- 637
Q3	- 81	0	0	259	- 266	- 88	0	- 9	- 97
Q4	- 81	500	0	259	- 572	+ 106	-126	-147	- 167
1981 Q1	- 81	0	0	670	- 449	+ 140	0	- 24	+ 116

SECRET

TABLE 3 : EXCHANGE RATES AND UK COMPETITIVENESS

	STERLING EXCHANGE RATES							US Dollar effective rate	UK competitiveness Relative Unit labour costs
	£ effective rate	EUA/£	S/£	DM/£	F.Fr/£	Lira/£	Yen/£		
1978	63.0	1.51	1.92	3.85	8.65	1629	403	86.7	93.2
1979	65.1	1.50	2.05	3.77	8.68	1706	423	84.2	101.9
1980	62.1	1.41	2.02	3.43	8.40	1696	393	80.6	103.2
1978/79	62.6	1.49	1.95	3.79	8.51	1637	390	85.4	93.7
1979/80	64.9	1.49	2.05	3.73	8.60	1693	424	83.5	103.2
1980/81	61.6	1.39	2.02	3.34	8.45	1717	384	79.9	103.9
%1978-1979	3.3	-0.7	6.7	-2.1	0.3	4.7	5.0	-2.9	9.3
%1979-1980	-4.6	-6.0	-1.5	-9.1	-3.8	-0.6	-7.9	-4.3	1.3
1978 1	65.4	1.56	1.93	4.00	9.17	1662	458	89.1	94.7
2	61.5	1.49	1.84	3.81	8.45	1584	405	89.4	91.9
3	62.4	1.51	1.93	3.87	8.46	1617	372	84.8	92.5
4	62.7	1.48	1.99	3.73	8.52	1652	378	83.3	93.6
1979 1	63.9	1.49	2.02	3.74	8.60	1693	406	84.3	96.8
2	66.5	1.53	2.05	3.83	8.83	1729	440	85.5	104.3
3	65.2	1.50	2.05	3.79	8.73	1708	423	84.1	103.1
4	64.9	1.48	2.07	3.72	8.57	1695	424	82.7	103.5
1980 1	62.8	1.43	2.02	3.56	8.26	1638	407	81.7	101.8
2	61.3	1.39	1.99	3.44	8.01	1616	393	80.9	101.2
3	62.6	1.41	2.04	3.38	8.68	1763	390	80.2	104.6
4	61.9	1.40	2.03	3.32	8.64	1765	382	79.7	105.1
1981 1	60.5	1.36	2.00	3.20	8.48	1724	371	78.9	104.7

TABLE 4 : INTEREST RATES AND MONEY SUPPLIES

	INTEREST RATES (% pa)								MONEY SUPPLIES (% growth during period)				
	UK short rate (3-mth interbank)	Overseas short rates				Long rates			UK £M3	Overseas money supplies			
		Weighted basket*	3-mth Eurodollar	Germany	Japan	UK*	US			Weighted basket*	US	Germany	Japan
1978	9.3	7.2	8.8	3.0	2.5	11.1	8.9						
1979	12.4	8.6	11.1	5.3	3.6	11.5	9.5						
1980	12.8	8.2	10.1	5.0	4.3	12.7	9.5						
1978/79	10.8	7.5	9.8	3.5	2.5	11.5	9.1		11.6		7	12¼	12
1979/80	12.4	8.6	11.0	5.4	4.2	11.7	9.5		9.4	11	9	9	12
1980/81	12.8	8.1	9.9	5.0	4.1	12.7	9.5		10.5	11½	10	9¼	11
1978 1	6.6	6.8	7.5	2.6	2.5	9.9	8.5						
2	9.1	6.8	8.1	2.7	2.5	11.1	8.8						
3	9.7	7.1	9.0	3.0	2.5	11.5	8.8						
4	11.6	8.1	11.1	3.6	2.5	11.8	9.3						
1979 1	12.7	8.1	10.95	4.7	2.5	11.7	9.5						
2	11.8	8.6	11.4	5.7	3.25	10.5	9.5						
3	12.3	8.7	11.2	5.7	3.75	11.2	9.5						
4	12.8	8.5	10.7	5.25	5.0	12.5	9.5						
1980 1	12.8	8.5	10.5	5.0	4.75	12.7	9.5						
2	12.8	8.4	10.5	5.0	4.3	12.7	9.5						
3	12.8	8.1	10.0	5.0	4.0	12.7	9.5						
4	12.8	7.9	9.5	5.0	4.0	12.7	9.5						
1981 1	12.8	7.9	9.5	5.0	4.0	12.7	9.5						

Footnotes: The weighted basket comprises six major overseas economies, including the US, Germany and Japan. UK long rate is 3½ per cent War Loan

TABLE 30 CAPITAL ACCOUNT

CURRENT PRICES NOT SEASONALLY ADJUSTED
£ MILLION

	1 CURR. BAL.	2 SHORT TERM FLOWS	3 INWARD INVEST -MENT	4 OUTWARD INVEST -MENT	5 EXPORT COMMCL.	6 CREDIT IDENT. L-T	7 COMM. IMPORT CREDIT	8 NORTH SEA FLOWS	9 OTHER CAPITAL FLOWS	10 TOTAL CAPITAL FLOWS	11 BAL FOR OFFICL FINANCE	12 PSA INF ETC	13 RESERVE CHANGE STERLING	14 RESERVE CHANGE DOLLARS
1977	295	5244	1699	-1457	-57	-591	41	594	1602	7063	7361	2226	9587	16707
1978	254	-249	1495	-1333	-262	-419	102	662	-1467	-1300	-1126	-1202	-2328	-4319
1979	407	1412	1679	-1507	-254	-179	150	561	-1221	563	1000	-351	149	284
1980	90	910	2122	-1669	-343	-90	170	301	-1539	-440	-350	-336	-666	-1376
1976/77	-1590	2163	1217	-1722	-499	-603	270	627	-34	1208	-382	3203	2821	4857
1977/78	270	3627	1601	-1335	-321	-564	11	704	1505	5343	5621	724	6345	11140
1978/79	362	556	1478	-1369	-23	-414	222	569	-2390	-1031	-649	-992	-1641	-2938
1979/80	624	449	1729	-1674	-332	-139	159	501	-1099	-424	200	-666	-686	-1400
1980/81	76	1007	8212	-1942	-354	-82	177	260	-1581	-278	-200	-224	-424	-844
1977 QTR 1	-563	1902	495	-453	22	-131	56	53	537	2476	1913	1283	3196	5478
QTR 2	-327	602	500	-351	-115	-136	-50	102	681	1235	908	250	1158	1990
QTR 3	592	1002	429	-310	63	-135	-13	194	105	2016	2608	618	3226	5599
QTR 4	596	1076	275	-353	-47	-189	54	242	277	1336	1932	73	2005	3638
1978 QTR 1	-563	265	457	-324	-242	-104	20	223	440	756	173	-218	-45	-89
QTR 2	204	-1114	344	-302	-222	-160	72	86	-402	-1698	-1494	-531	-2025	-3718
QTR 3	173	405	304	-312	116	-142	-10	171	-536	37	210	-155	55	104
QTR 4	403	105	391	-395	66	-53	100	200	-969	-475	-15	-296	-311	-617
1979 QTR 1	-455	1350	439	-360	-3	-69	60	129	-463	1105	650	-3	642	1293
QTR 2	451	-9	410	-436	-166	-20	33	146	-101	-141	350	-695	-345	-706
QTR 3	275	-51	393	-293	5	-30	34	126	-360	-275	0	-155	-155	-319
QTR 4	125	61	437	-464	-90	-40	20	158	-296	-126	0	8	3	17
1980 QTR 1	-200	420	489	-447	-81	-49	49	70	-341	110	-150	-43	-193	-392
QTR 2	-10	139	524	-406	-102	-7	40	72	-394	-190	-200	-303	-503	-1002
QTR 3	205	30	543	-472	-42	-15	32	82	-384	-206	0	-43	-43	-88
QTR 4	102	190	580	-462	-115	-25	45	74	-418	-162	0	52	52	106
1981 QTR 1	-260	643	579	-526	-92	-25	50	28	-364	200	0	69	69	140

NORTH SEA OIL AND GAS : PRIVATE TAKE - Sources and uses

All companies £m

	1975	1977	1978	1979	1980
Sources					
1. Value of oil and gas production	300	2500	3400	5500	7400
2. less operating costs, royalties	200	700	800	1200	1600
3. less tax payments	0	0	100	700	1300
4. less capital expenditure in North Sea	1400	2000	2200	2300	2200
5. less income accruing to public sector (BGC & BNOC)	0	100	100	100	200
equals Private take before interest	-1300	- 100	200	1200	2100
Uses					
1. Net borrowing (repayment +) : Sterling	-300	-200	-200	0	100
Foreign currency	-1500	-700	-1100	-500	100
2. Interest & dividend paid : abroad	100	200	300	400	700
in UK	100	200	300	400	400
3. Working capital and sterling assets in UK	0	100	200	300	400
4. Onshore investment by UK firms	300	300	400	500	300
5. Overseas investment by UK firms	0	0	300	100	100
equals Private take before interest	-1300	-100	200	1200	2100

Notes

i. Borrowing in foreign currency includes funds borrowed from overseas parents or subsidiaries

ii. Onshore investment by UK firms is not necessarily additional to that which might otherwise have taken place

iii. Foreign firms are assumed to remit all surpluses abroad as dividends: some may then be re-invested onshore in the UK.

THE DOMESTIC FINANCIAL FORECAST: MAY 1979

Introduction and Recent Developments

1. The Financial Forecast is prepared simultaneously with the forecasts of the 'real' economy (the NIF) and External Capital Flows. Given assumptions about the stance of monetary policy it provides a picture of the development of financial flows, the monetary aggregates and accompanying interest rates consistent with these other forecasts. The forecast covers the period up to the end of 1980-81, although for the second year the forecast must be regarded as extremely tentative.

2. In 1978-79, on a banking month basis, the growth in £M3 was within the previous government's target range of 8-12%, although at 11.4% it was towards the top end. In the six months to the end of banking April, however, £M3 grew at an annual rate of nearly 13%. The relatively fast growth over this period occurred in spite of very high gilt sales, particularly in the early months of this year, and in large part reflected very rapid growth of bank lending to the private sector. The latter may have been partly due to the industrial disruption earlier in the year and may therefore be reversed in future months. Central government borrowing was also high in this six month period, partly reflecting the industrial action by civil servants, but despite the strength of sterling the external adjustments to the money supply were on balance negative.

3. Short term interest rates rose substantially in the autumn of last year, but are now at much the same level as they were at the beginning of this year, having risen substantially in January and then fallen back. Rates at the long end, however, are now lower than at any time since last spring, with the result that the yield gap between 3-month rates and the rate on 20 year gilts is now virtually zero.

Policy Assumptions and the Rest of the Forecast

4. Some features of the rest of the forecast which have an important bearing on the Financial Forecast are summarised in table 1 at the end of this report. Among the more important are the following:

a) GDP at current market prices is forecast to grow by 18% in 1979-80 and by 14% in 1980-81. Even measuring GDP at factor cost - ie ignoring net indirect tax changes - the growth rate is over 16% in 1979-80.

b) Real GDP falls until mid-1980 and then rises only very slightly. The price level, however, rises sharply between the second and third quarters of this year as indirect taxes increase, and partly as a result total final expenditure prices are forecast to rise during 1979-80 by 16%. In the second year the increase is slightly lower at about 13%.

c) The PSBR is forecast to be £8½ billion in 1979-80, rising to about £10 billion in 1980-81. The corresponding figures for the Public Sector's Financial Deficit (PSFD) are about £7 billion in 1979-80 and about £9 billion in the following year. In this context it is worth noting that the disposal of assets allowed for in the forecast is assumed to reduce the PSBR in both years but not to affect the PSFD. On the other hand the increase in VAT in 1979-80 reduces the PSFD in that year by more than the PSBR as a result of the lag in collection.

d) The current account is forecast to be in modest surplus (just over £½ billion) in 1979-80 and to be roughly in balance in the following year.

e) The forecast assumes that the exchange rate is determined largely by market forces, with little intervention by the authorities. A package of exchange controls worth around

£1 billion a year *ex ante* is included, but this is offset *ex post* by current and capital account inflows. The exchange rate is forecast to fall modestly in both financial years.

5. The Financial Forecast assumes that the Supplementary Special Deposits (SSD) scheme does not 'bite'. Indeed, artificial disintermediation resulting from the operation of the scheme so far is assumed to be reversed over the forecast period.

6. Monetary policy is assumed to be geared to restricting the growth of £M3 to a range 7-11% in 1979-80 and that in practice the authorities aim for the centre of the range. This is a very restrictive monetary stance. Monetary growth is only about half the growth of current price GDP over this period, implying a very considerable increase in the velocity of circulation. The restrictiveness of monetary policy can also be measured by comparing the growth of £M3 with the growth of total private sector net financial wealth induced by the financial surpluses which emerge from the rest of the forecast*. In this sense as the table below shows monetary policy in 1979-80 appears slightly less restrictive than the comparison with GDP suggests, but still £M3 is being constrained to grow less than the *ex ante* growth of private sector portfolios. In 1980-81 we have assumed that the stance of monetary policy remains tight but, as shown in the table, monetary growth is assumed to rise slightly above 9% in order to avoid further rises in interest rates.

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*Net financial wealth of the private sector measures that sector's cumulated financial surpluses adjusted for the effect of changes in long term interest rates on the market value of existing fixed interest debt. When assessing the tightness of monetary policy *ex ante*, however, it is appropriate to focus on the growth of net wealth adjusted for the impact of the interest rate changes required to validate the policy.

	Growth of GDP at current market prices (%)	Growth of Private Sector Net Financial Wealth adjusted for interest rate changes (%)	Growth of £M3 (%)*
1978-79	15.1	13.1	11.8
1979-80	18.1	12.2	9.4
1980-81	14.0	13.4	10.6

Interest Rates

7. It is assumed in the forecast that the policies pursued by the monetary authorities will ensure that interest rates are at levels appropriate to the target growth of £M3 in 1979-80. Given the tightness of the policy stance assumed this means that both long and short term interest rates have to rise from current levels during 1979-80, but thereafter no further rise is projected. The forecast is summarised in table 2 at the end of the report. Short rates are forecast to rise by about 1 percentage point to 12¾% by the end of 1979 and then to remain at that level. Long rates are forecast to rise by around 2 percentage points to 14%. At both the short and the long end of the maturity spectrum, therefore, differences between nominal interest rates and the inflation rate over the previous year are expected to be either negative or only very slightly positive. The rise in competing interest rates over the forecast period has been assumed not to be sufficient to force the building societies to raise their mortgage and share rates, although some slight rise cannot be ruled out.

8. It is necessary for interest rates to rise during the remainder of 1979-80, in spite of a fall in the PSBR, because of

*Figures for the growth of £M3 quoted in this table are on a calendar quarter basis and therefore the figure for 1978-79 differs slightly from that quoted in paragraph 2.

the very tight monetary stance assumed in the forecast. Essentially, the demand for money at <u>given</u> interest rates is forecast to rise faster than permitted by the monetary target. In this context three points are worth noting. First, the substantial rise in the price level which is forecast to occur in that year, partly as a result of Budget changes, will tend to raise bank lending to the private sector at a given level of interest rates. This will be matched by increases in the private sector's demand for financial assets generally, including money. Second, although the PSBR declines in 1979-80 the PSFD declines only slightly, and current account surplus is slightly greater than in the previous year. The private sector's financial surplus is identically equal to the sum of the financial deficits of the overseas sector (the current account surplus) and the public sector (the PSFD), and it is therefore the forecast of these two items combined which is relevant to the growth of private sector net financial wealth and thus the demand for money and other financial assets. As the table above shows the forecast of private sector surpluses contributes to <u>ex ante</u> growth of net financial wealth in excess of the target rate of monetary growth. And third, the target rate of monetary growth assumed in the forecast is, of course, lower than the targets in previous years. Assuming the new target is achieved, this in itself requires interest rates to rise for given growth in the determinants of the demand for money such as incomes, prices and net financial wealth.

9. The fact that long rates are forecast to rise by more than short rates reflects the fact that the current situation in which the yield gap between, say, 3 month and 20 year rates is virtually zero is exceptional. Reverse yield gaps can be experienced in periods when interest rate expectations are lower in the long run than in the short run, but interest rates expectations for the next few years are particularly important and given the tightness of monetary policy which financial market participants are likely to be expecting it seems reasonable to forecast the re-emergence of a small positive yield gap.

10. The precise quarterly path of interest rates in the next year is, of course, extremely uncertain. Much will depend on the reaction of the markets to the Budget. The quarterly path in table 2 should not therefore be invested with too much significance: the forecast has concentrated on the underlying level of interest rates required to validate the Government's monetary target for 1979-80 and has not attempted to allow for short run 'confidence' effects. Also the forecast has made no special allowance for expectational effects resulting from the structure of the Budget package assumed.

The Forecast of Financial Flows

11. The forecast of £M3 and its counterparts is summarised in the table below.

£M3 AND ITS COUNTERPARTS (£ billion)

	1978-79	1979-80	1980-81
PSBR	9.2	8.5	10.1
Less sales of public sector debt to the non-bank private sector	- 9.0	-8.3	- 8.2
Plus bank lending to:			
private sector	6.5	5.4	5.3
overseas	0.4	0.8	0.6
DCE	7.1	6.4	7.7
External factors	- 0.6	-0.4	- 0.5
Less increase in banks' non-deposit liabilities, etc	- 1.1	-1.1	- 1.2
Change in £M3	5.5	4.9	6.0
% change in £M3	11.8	9.4	10.6

The elements of the forecast are described in the paragraphs which follow.

(a) Debt Sales

12. Given the interest rates described above and the forecast growth of private sector net financial wealth, the forecast of gilt sales (including some local authority long-term debt) to the non-bank private sector is just under £6 billion in 1979-80 - slightly less than the sales achieved in 1978-79. The figures show a further small fall in 1980-81. Nevertheless the forecast sales are still very substantial and ensure that the share of gilts in the private sector's total portfolio of financial assets, which has risen sharply in recent years, is maintained at around the present level.

13. The reductions in sales are attributable to two main factors: increased competition from the equity market and the 'overhang' effect of the recent heavy sales of gilts. The supply of new equities available to the institutions is expected to be around £2 billion in 1979-80 (of which £750 million represents the sale of public sector assets) compared with under £500m in 1978-79. This increase in the supply of equities can be expected to reduce the institutional demand for gilts at given interest rates. The second depressing factor reflects the view that the sharp rise in the proportion of gilts in private sector portfolios in recent years cannot be expected to continue indefinitely, and in fact may make further sales more difficult to achieve. In consequence, a rise in long rates is considered necessary to maintain broadly the same level of gilt sales. Expectational factors due to either the temporary increase in inflation resulting from the assumed increase in indirect taxes in the Budget, or anticipation of the increase in interest rates in the forecast are not expected to exert a depressing effect on gilt sales.

14. Sales of other public sector debt are forecast to continue to make a useful contribution to funding the PSBR. The more ambitious policy for the sale of National Savings Certificates is assumed to

be continued and extended in the forecast period. We have assumed no long run adverse impact on inflows into National Savings as a result of the strike at DNS, given that generous recompense is likely to be paid to savers. Inflows to National Savings are put at over £1.5 billion in 1979-80 (much the same as in 1978-79) and rather more in 1980-81. The figures imply that National Savings will account for almost 12% of the personal sector surplus and represent a slowly increasing share of total personal sector liquid assets.

15. Holdings of Certificates of Tax Deposit are forecast to increase in line with the pattern of accruals and payments of tax liabilities (particularly PRT); this requires that the yield on CTDs is kept fully competitive with that on other money market instruments. Non-bank holdings of local authority deposits and Treasury bills are sensitive to interest rate differentials and are particularly difficult to forecast. Our best guess is a moderate take up of Treasury bills and local authority temporary debt.

(b) Bank lending in sterling

16. In 1978-79 bank lending to domestic residents rose rapidly. Total lending to the private sector increased by some 20% (over £6 billion in money terms) with all three sectors (ie persons, industrial and commercial companies (ICCs) and the institutions) showing rapid growth. The bulk of the increase in lending to persons is explicable in terms of the growth in incomes over the year (personal disposable income in 1979 Q1 was about 18% higher than in 1978 Q1). Some part of the additional lending to industrial and commercial companies probably reflects the deterioration in their financial position as investment increased whilst profits grew more slowly and the opportunities for capital issues were limited. The industrial disruption during the winter and the delay in VAT repayments will have added to the financial difficulties of the company sector. But the exceptionally rapid growth of lending in the early months of this year probably cannot be attributed entirely to these factors.

17. Whilst clearly it is possible that the recent rapid increases in bank lending mark a change in underlying behaviour, the forecast foresees a slowdown in the growth of total bank lending as increases in interest rates reduce the demand for credit and the large outstanding stock at the beginning of the period (some of which is thought to represent temporary borrowing to finance the effects of industrial disruption) reduces the need for additional bank credit. For companies the slowing down is expected to be mitigated by the reintermediation of the £650 million or so of commercial bills held outside the banking system, and the assumed increase in sterling borrowing following the relaxation of exchange controls. Total bank lending is forecast to grow by 14% in 1979-80 and 12% in 1980-81. The equivalent flow figures are £5.4 billion and £5.3 billion.

18. The historically low rate of growth in sterling lending overseas in 1978-79 is continued in the forecast period as an increasing proportion of fixed rate export credit is financed in foreign currencies.

(c) External factors

19. Given the assumption of broadly zero foreign exchange market intervention, external flows have a limited direct effect on £M3 over the forecast period. The figures for external adjustments to the money supply in the table above mainly reflect offsets to sterling lending overseas and aid, which are included in DCE but not in the money supply.

The Growth of other Monetary Aggregates

20. M1 has grown substantially faster than £M3 in the last two financial years, but given the increases in interest rates expected, our central forecast is for M1 to grow at more or less the same rate as £M3 in both years. Given our forecast of Building Society Shares and Deposits, wider monetary aggregates such as M5 may grow somewhat faster than £M3.

Implications of the Forecast for Individual Sectors

(a) Life Assurance and Pension Funds

21. The forecast of gilts purchases by the institutions in 1979-80 and 1980-81 consistent with the overall gilts sales forecast would appear to be attainable without straining portfolio positions. In recent years the institutions have been investing an historically high proportion of newly accruing funds in gilts. This has increased the share of gilts in their portfolios from under 20% on average at the end of 1975 to nearly 30% at the end of March 1978. We are forecasting that a lower proportion of newly accruing funds will be invested in gilts in 1979-80 and 1980-81, which appears unobjectionable for the reasons outlined in paragraph 13 above. Given fairly neutral assumptions about movements in share prices this implies relatively little change in the share of gilts in the institutions' portfolios in both years.

(b) Building Societies

22. The deterioration in the relative competitive position of the building societies is not expected to be sufficient to necessitate a rise in share and mortgage rates from their present levels of 8% and 11¾% respectively. On this basis we would expect shares and deposits to increase by 15% in 1979-80 and 1980-81. With the stock of mortgages outstanding forecast to rise only slightly faster than this the liquidity ratio changes little from its present level of 18.4%. Given repayments, gross advances are put at about £9 billion in 1979-80 and nearly £11 billion in 1980-81.

(c) The Banks

23. The combination in 1979-80 of high gilt sales and a significant growth in bank lending puts the banks under some reserve asset pressure. Looked at another way, bank lending to the public sector (which can take the form of reserve assets) is limited, but bank lending to the private sector (which the banks need reserve assets

to back) is significant: the banks get squeezed from both sides. In this respect the period 1979-80 is similar to 1979 Q1 and we have assumed that the official assistance to the markets given in that period would be repeated in 1979-80. It is difficult to forecast the reserve asset position of the banks with any degree of accuracy and the projected timing of any pressure is inevitably fairly arbitrary. We would interpret our forecast as suggesting that the authorities will need to provide some measure of relief to the markets at various times during the year.

(d) Industrial and Commercial Companies

24. Although the figures are not yet available it seems likely that the very heavy borrowing from banks enabled industrial and commercial companies to increase their stock of liquid assets in relation to nominal final expenditure (the gross liquid assets ratio) during 1978-79. In contrast, their net liquidity position (after adjusting for bank borrowing) may have deteriorated. In 1979-80, the forecast of a slowdown in bank lending to ICCs means that the gross liquidity ratio falls back sharply but the net position stays broadly constant. A detailed analysis has not been made for 1980-81 but it is unlikely that the position would improve in that year. The basic difficulties stem from a level of profitability which is insufficient to finance even the very low levels of investment and stockbuilding contained in the forecast.

TABLE 1: THE REST OF THE FORECAST

	Percentage Changes Calendar Q1 on a Year Earlier						£ billion			Net Acquisition of Financial Assets		
	GDP at 1975 Prices	GDP at current market prices	Real Personal Disposable Income	RPI	Total Final Expenditure Prices	Effective Exchange Rate	Balance for Official Financing	PSBR	Current Balance	Persons	Industrial and Commercial Companies	Total Private Sector
1977-78	2.1	15.1	2.0	9.5	10.3	5.8	5.6	5.6	0.4	7.7	-1.5	4.7
1978-79	2.0	11.8	9.0	9.6	8.3	-2.3	D-0.7	9.2	0.4	11.4	-3.5	6.9
1979-80	-0.2	18.1	0.7	17.2	14.9	-1.7	+0.2	8.5	0.6	13.1	-3.6	7.2
1980-81	-0.3	14.0	0.5	13.6	13.0	-3.7	-0.2	10.0	0.1	15.4	-3.9	8.6

TABLE 2: INTEREST RATES

	Short Rates	Long Rates	Mortgage Rate
1978 Q1	6.6	11.5	8.7
Q2	9.1	12.7	8.5
Q3	9.7	12.6	9.3
Q4	11.6	13.1	9.8
1979 Q1	12.7	13.4	11.8
Q2	11.8	11.8	
Q3	12.3	12.5	
Q4	12.8	13.8	
1980 Q1		14.0	
Q2			
Q3			
Q4			
1981 Q1			

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PERSONAL AND SECRET

Econ Pol

DEPARTMENT OF INDUSTRY
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Secretary of State for Industry

13

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
Whitehall
London SW1

31 May 1979

Dear Geoffrey,

P 1/6

We had a word the other night about the betting and gaming duties, which you said could not yield more than about £40 million increase in the forthcoming budget. This is not a subject in which I have either Departmental or personal expertise, but as I understand it there are three main objections to raising very large amounts of money by this means:

(a) the duty on the pools is already at 40% of stake money and could not be increased significantly without affecting business.

(b) Significant increases in the betting duty itself would drive the business underground, and hence be self-defeating.

(c) In any case, decisions have yet to be taken on the various taxation recommendations of the Royal Commission on Gambling, and substantial increases in the rates of the existing duties would preempt those structural decisions.

I understand the force of (a), and am not competent to judge the significance of (b). On (c), however, I feel most strongly that the structure and interests of the betting industry should not be subordinated to the vastly more important interests of industry at large and manufacturing industry in particular. I have myself put forward in the wider interest of the economy substantial proposals which run counter to the interests of industry - cuts in direct assistance and regional support, increases in VAT and specific duties, and my proposal for an ACT surcharge. I should feel badly if industry in general had to bear these heavy burdens merely in order to protect the betting industry or to avoid the minor embarrassment of pre-empting decisions on the Royal Commission.

I am copying this letter to the Prime Minister.

Yours, Keith

THE BOARD ROOM
INLAND REVENUE
SOMERSET HOUSE

25 May 1979

T P Lankester Esq
Private Secretary
10 Downing Street

Dear Tim,

In the Debate on the Address on 15 May (OR Col 77), the Prime Minister referred to "a pensioner of 64, with an income of £25 a week ... paying £1.50 a week in income tax under a Labour Government.

It is quite possible that the Prime Minister had in mind the circumstances of a particular case where these figures arose. In general, however, a single person under 65 with £25 a week income would have paid £1.51 a week income tax during the tax year 1978/79. (The fact that there are the same figures in £1.15 and £1.51 leaves open the possibility of a typographical error.) The personal tax allowances in the caretaker Finance Act are not required to be implemented before August but would reduce that tax bill for the year by £22.50 to give a weekly deduction of £1.08. But these are, of course, subject to the coming Budget.

I am copying this to Tony Battishill in the Chancellor of the Exchequer's office.

Yours sincerely,

Robin

R B Willis

Private Secretary

BUDGET

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bcc Slowe Econ. Pol. 12 VLB HS
Wolfson
John Hunt
J. Hoskyns.

10 DOWNING STREET

From the Private Secretary

24 May 1979

Dear Tony,

The Prime Minister held a meeting at 1800 hours this evening with the Chancellor of the Exchequer and the Chief Secretary to discuss the Budget. They had before them the Chancellor's further minute of 23 May.

The Prime Minister said that she remained extremely worried about the price consequences of the Chancellor's proposals, and the effect they might have on pay negotiations in the coming winter. She wondered whether there were not other ways of meeting the Chancellor's objectives on the income tax front than through increasing VAT to 15 per cent. In particular, there seemed no reason why the income tax reliefs could not be made effective from Budget Day rather than being backdated to the beginning of the financial year. Taxpayers would not expect such backdating and the revenue savings would be very substantial. The revenue savings would be about sufficient to enable the VAT increase to be confined to 12½ per cent. It appeared from the figures attached to the Chancellor's minute as if the taxpayer would be getting considerably more in tax relief than he would be paying out in higher indirect taxes. She recognised that there were administrative difficulties, but it ought to be possible to overcome them. The Prime Minister went on to ask whether all the options for raising revenue had been fully considered. One possibility which she had in mind was the replacement of the VAT element in the petrol tax by a straight duty: this would bring in

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additional revenue because there would be no VAT offset on business purchases and the RPI effect would be small.

The Chancellor said that, in his view, making the tax reliefs effective from Budget Day, and not backdating them, raised insuperable difficulties. Not to backdate them would destroy the cumulative method on which the PAYE system was based. As for the argument that the taxpayer appeared to be getting back more than he would be paying in indirect taxes, the Chancellor explained that this was not so in terms of purchasing power. Because of the three-month lag in VAT collection, much more had to be given to the taxpayer in tax reliefs in year one than the revenue which would accrue to the exchequer in order to leave his real disposable income roughly unchanged. It was therefore essential to increase VAT to 15 per cent if his income tax objectives were to be met. In any case, a 15 per cent rate of VAT would be needed in 1980/81, and it could well be more difficult politically to raise the rate again in the second year than it was to move straight to 15 per cent immediately. He had considered various other revenue raising options, including increasing Advance Corporation Tax. But he had concluded that ACT was not a runner because company liquidity, notwithstanding the short run cash flow improvement resulting from the VAT increase, would remain tight; and although he was willing to consider the possibilities further, he did not think there was much likelihood of finding significant additional revenue without either affecting the RPI or damaging business confidence (as would happen, for example, if the NIS were increased again). In order to mitigate the RPI effects, he was disposed not to increase the specific duties on alcohol and tobacco: revalorisation of these duties would reduce the PSBR by only £200 million, while they would increase the RPI by 0.6 per cent. In this way, the price rises in the Budget would be confined to the VAT increase and the increase in petrol duty, and the total

/ effect would be

effect would be 3.6 per cent - which would be marginally less than the 3¾ per cent RPI effect of Mr. Healey's first Budget. This excluded any increases in prescription and school meal charges; in order to keep within the 3¾ per cent margin, he thought there was a strong case for not announcing any such increases in the Budget.

The Chief Secretary added that the switch to indirect taxes which the Chancellor was proposing was essential to his overall strategy - both in terms of achieving his minimum income tax objectives and in terms of keeping the PSBR within reasonable limits in 1980/81. There was of course a risk that there would be industrial repercussions, and the industrial situation in the winter would not be easy; but in his view the Government was more likely to face industrial trouble in its second and third years of office. Hence, it was better to get the large price increase out of the way early. Once a VAT rate at 15 per cent had been achieved, there would be no need to raise VAT again in the life of the present Parliament; the only further indirect tax increases that would be needed would be the revalorisation of specific duties. A further argument for making the major shift to indirect taxes was that this would result in less tax evasion. Although the immediate effect of the Budget would be inflationary, the overall Budget stance was decidedly deflationary; and indeed on the conventional presentation, the Budget would be shown as having a significant contractionary effect on the economy. The Chancellor said that in presenting this it would be necessary to point out that, with the current prospects for the PSBR, any Budget - whether presented by a Conservative or Labour administration - would have had to be deflationary.

The Prime Minister then asked whether the Chancellor was satisfied with the PSBR forecast. She understood that there was a wide margin of error in it, and wondered

/ whether the

whether the Chancellor was happy with the underlying assumptions. The Chancellor replied that there was indeed a wide margin of error, but he was reasonably satisfied that the forecasters had done a good job. He would be considering whether there was any possibility of adjusting the forecast down, but he did not think there was much scope for this. As for the correct size of the PSBR, he was subject to conflicting advice. On the one hand, there were those who were pressing him to go back on his pre-election commitment; on the other hand, it was clear that even with a PSBR of just under £8½ billion, there was a real risk that interest rates would stay high. On the whole, he felt it essential to aim for a PSBR below £8½ billion. The Prime Minister agreed.

Summing up, the Prime Minister said that she reluctantly agreed to the Chancellor's main proposals. This would mean increasing VAT to 15 per cent and increasing petrol duty by 15 per cent, and excluding any increases on tobacco and drink. At the same time, it would be worth forgoing any increase in prescription charges and any increase in the school meal charge over and above that announced by the previous administration. The Department of Education and the Department of Health and Social Security would have to find offsetting savings to meet the Chief Secretary's public expenditure requirements. The Chancellor should consider the possibility of any further measures which would bring in revenue without affecting the RPI - including replacing VAT on petrol with a higher petrol duty still. These could be used to provide further improvements in the income tax package.

Yours ever,

Tim Lankester.

A. M. W. Battishill, Esq.,
H.M. Treasury.

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Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

PRIME MINISTER

When we discussed the Budget yesterday you expressed concern about the likely impact on prices of the proposals described in my minute of 21st May. You asked for more information about the inflation prospect and the impact on it of different Budget packages. This minute does that and examines the consequences of the various alternatives.

2. I must start with income tax. We are committed to substantial income tax reductions. The Budget in this respect will be seen as a test of our resolution to implement commitments we have entered upon in Opposition. The minimum changes required in my judgement are as follows:

3. To cut the basic rate to 30 per cent.

To cut the top rate to 60 per cent on income over £25,000.

To increase the single and married allowances by £120 and £190 respectively (including the £90 and £140 included in the caretaker Finance Act)

The cost of these changes in 1979/80 is around £3.1 billion (£3.9 billion in a full year). Together with other less costly improvements (eg. for old people and on investment income) the cost this year to the PSBR is about £2.8 billion. And if it were possible to do more than this on the thresholds the package would be better-balanced, particularly in relaton to those at the bottom of the income scale.

4. It is clearly right that we must look to finance cuts in income tax by cuts in public expenditure. The proposals agreed

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in Cabinet amount to about £3.4 billion in 1979/80, including £1 billion from sales of assets. It is critical to the Budget arithmetic that Colleagues deliver these cuts in full.

5. The PSBR for 1979/80 is currently forecast on unchanged policies at about £10¼ billion. The net effect of our intended public expenditure cuts and of the income tax reductions (including the minor reliefs) would reduce this figure to around £10 billion. This contrasts with our target reduction to at least £8 billion.

6. We can only attain this objective by increasing indirect taxes, as we have said we would. This will put up prices. Before any Budget changes the RPI is forecast to rise to about 13 per cent by the end of this year. The choice is between adding to that figure or falling well short of our PSBR target; or, of course, doing much less than we want in reducing income tax. These are the variables. I can see no other alternatives.

7. An increase in VAT to a unified 15 per cent, coupled with a 15 per cent increase on petrol duty and a 10 per cent increase on other specific duties would just about close the gap. We would be in sight of a £8 billion PSBR, perhaps just a little more. But the RPI would increase by 4.3 per cent on this account. (I ignore any other small increase which might arise from putting up charges). The same package, but omitting increases in the duty on tobacco and drink, would reduce the price increase to 3.6 per cent. But the PSBR would be £0.2 billion higher.

17.3

8. A 12½ per cent VAT would reduce the RPI increase to 2.9 per cent, if coupled with a 10 per cent increase in the

3

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01-233 3000

specific duties (15 per cent on petrol). But this would increase the PSBR by £½ billion to over £8½ billion. Excluding any increase on drink and tobacco would reduce the RPI increase even further, to 2.3 per cent, but increase the PSBR by another £0.2 billion.

9. Lastly, a 10 per cent VAT would reduce the RPI increase to 1.6 per cent, coupled with a 10 per cent increase in specific duties (15 per cent on petrol). This would increase the PSBR by a full £1 billion, compared with a 15 per cent VAT - to a figure over £9 billion. In short, it is simply not possible to make worthwhile income tax reductions and keep the PSBR to around £8 billion without a 15 per cent VAT. With a 12½ per cent rate income tax expectations would be sadly disappointed; with only a 10 per cent rate we could scarcely make a start.

10. That said, with the year on year rate of increase in average earnings likely to be around 15% at the end of the year, I do not under-rate the significance of adding 3½-4 per cent to an already rising RPI.

11. But a comparison between gross earnings and prices gives an incomplete and distorted picture. What matters is a comparison between take home pay and prices, and everyone would be securing substantial income tax cuts. Such a package would be presented as giving greater personal choice. This message may be easier to get across if the switch to indirect taxation is immediate and ambitious than with a more muted version.

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01-233 3000

12. It is true that the perceived rate of inflation will suffer an immediate shock, but this will not then be repeated month after month. By September or October there would be substantial tax rebates coming just at a critical period for wage bargaining, or the formulation of prospective wage claims. At what will be the most difficult period for wage negotiation, the Budget price increase will be in the past. Against that background, we must consider whether an extra one or two per cent on the RPI on top of what would be necessary anyway would make a critical difference to the climate for earnings in the next pay round. This can only be a matter of judgement, but I see no reason to suppose that this would make a critical difference in the sense of crossing some threshold of danger. In my judgement, this Budget provides our only opportunity to make a radical switch from direct to indirect taxation and thus honour the commitment on which our credibility depends. Coupled with firm monetary policies, one or two additional points on the RPI should not be decisive.

13. I hope we may have an early opportunity to talk this through. I am sorry to burden you with more figures (in the attached tables), but I am rapidly approaching the administrative deadline for a decision on the indirect taxes. The necessary printing timetable requires identification of a limited range of options by the weekend and final choices by the end of 31st May.

G. H.

(GEOFFREY HOWE)

23 May 1979

	PSBR 1979-80 (£million)	RPI impact effect
Direct Tax		
Increase* in single and married allowances by £120 and £190 respectively, together with corresponding age allowance increases		
Reduction in basic rate to 30p	+£2,790	
Improvements in higher rate structure and top rate 60%		
Investment income surcharge: single threshold of £5,000		
Public Expenditure		
Cash limits squeeze on prices and pay (assumed £720 million reduction in volume of central Government spending).		
RSG cut of £300m (assumed £100m reduction in volume of LAs spending).		
Specific cuts of £1.3 bn.	-£3,000	0.4%
Contingency reserve cut of £250 million.		
Sales of assets of £1 bn.		
Indirect Tax		
VAT at 15%		
15% increase in petrol duty.		
10% increase in specific duties except VED	-£1750	4.3%
Alternatively		
As above, but excluding drink and tobacco	-£1550	3.6%

*. Including Caretaker Finance Act increases.

(Note: These figures are rough estimates based on the use of current ready reckoners and assuming a floating exchange rate and unchanged monetary growth).

	PSBR 1979-80 (£ million)	RPI impact effect
Direct Tax		
Increase* in single and married allowances by £120 and £190 respectively, together with corresponding age allowance increases		
Reduction in basic rate to 30p	+£2,790	
Improvements in higher rate structure and top rate 60%		
Investment income surcharge: single threshold of £5,000		
Public Expenditure		
Cash limits squeeze on prices and pay (assumed £630 million reduction in volume of central Government spending)		
RSG cut of £300m (assumed £100 m reduction in volume of LAs spending).	-£2920	0.4%
Specific cuts of £1.3 bn		
Contingency reserve cut of £250 million		
Sales of assets of £1 bn		
Indirect Tax		
VAT at 12½%		
15% increase in petrol duty	-£1,265	2.9%
10% increase in specific duties except VED		
Alternatively		
As above, but excluding drink and tobacco	-£1060	2.3%

* Including Caretaker Finance Act increases.

(Note: These figures are rough estimates based on the use of current ready reckoners and assuming a floating exchange rate and unchanged monetary growth).

	PRBR 1979-80 (£ million)	RPI impact effect
Direct Tax		
Increase* in single and married allowances by £120 and £190 respectively, together with corresponding age allowance increases		
Reduction in basic rate to 30p	+£2,790	
Improvements in higher rate structure and top rate 60%		
Investment income surcharge: single threshold of £5,000		
Public Expenditure		
Cash limits squeeze on prices and pay (assumed £540 million reduction in volume of central Government spending)	-£2,830	0.4%
RSG cut of £300m (assumed £100m reduction in volume of LAs spending).		
Specific cuts of £1.3 bn		
Contingency reserve cut of £250 million		
Sales of assets of £1 bn		
Indirect Tax		
VAT at 10%		
15% increase in petrol duty	- £750	1.6%
10% increase in specific duties except VED on cars.		

*Including Caretaker Finance Act increases.

(Note: These figures are very rough estimates of the orders of magnitude based on the use of current ready reckoners and assuming a floating exchange rate and unchanged monetary growth).

110

Prime Minister

You should read this before your meeting with the Chancellor at 6 pm tomorrow. It raises some important questions.* The Chancellor will be sending you his own promised paper first thing tomorrow. TL 23/5

BUDGET SECRET

Ref. A09625

PRIME MINISTER

* Which I have mentioned to the Treasury.

The Budget

Flag A

I have seen Mr. Lankester's account, in his letter of 22nd May to the Chancellor's office, of the discussion you had on Tuesday with the Chancellor about the Budget. I understand that your talk with the Chancellor is to be resumed tomorrow evening and I should like to offer these comments.

2. Your objectives are clear. You want to reduce the PSBR and the rate of growth in money supply to restrain inflation; you want to reduce the share of ~~national~~ income absorbed by the public sector, and thus release more for the private sector; you want to shift the burden of taxation from direct to indirect taxes in order to provide the economy with a new dynamic; and you want to do these things without putting up the RPI, through tax changes, more than is necessary.

3. My worry is that the Treasury, in its approach to these objectives, is in danger of getting too boxed in between the conflicting desiderata, in the light of their latest forecasts, and that the casualty is likely to be the cuts in direct taxation on which your broad economic strategy fundamentally depends. Whatever the economists may say, a Budget largely confined to cutting public expenditure and the PSBR and raising VAT would not only be a great disappointment to the voters (who don't understand PSBR and the money supply anyway) but would wrong foot your basic strategy in the critical first 12 months of your Administration. Might I therefore suggest that in your talk with the Chancellor you seek to explore each of the main elements in the equation and probe whether the Treasury could not be more inventive. Thus:-

(a) The PSBR: Of course the level of the PSBR is important and of course you want to get it below Mr. Healey's target if you can. But the Treasury forecast is not inscribed on tablets of stone. It is a forecast and there is a wholly legitimate area of uncertainty about the figures. How far has the Chancellor probed the arithmetic and what probabilities attach to the single central forecast coming from the Treasury computer? How critical are the assumptions built in to the forecast and what sensitivities attach to them?

(b) Secondly, the Budget arithmetic for this year, and particularly the PSBR outcome, is much affected by the fact of a late Budget which will inevitably reduce substantially the yield of any increased indirect taxes in the present financial year - whereas cuts in direct taxes date back to the beginning of the financial year. Is it necessary or reasonable to try and make good the shortfall of revenue during the financial year itself? The markets would readily understand the problem and a distinction could properly be drawn between the borrowing needed for the year as a whole and the annual rate of borrowing which would be needed once increased rates of indirect tax had come into effect. The Government's self-evident determination to cut public expenditure and to constrain the rate of growth in money supply would reinforce the market's readiness to regard the extra borrowings needed for April to June this year as a special, non-recurring factor.

(c) The RPI: It is inevitable and accepted that a Budget which switches the burden of taxation from direct to indirect taxes will put up the RPI. The question is not whether but by how much and in what forms. Mr. Lankester's record of your conversation with the Chancellor suggests that he saw the main weight of the increase in indirect taxes being placed on VAT and he argued that this had a lesser RPI effect than raising money by increasing Excise duties. We do not have the full facts available to us to evaluate this argument but such information as we have suggests that it can easily be exaggerated. For example the effect on the RPI of raising £100 million by increased duties on tobacco, alcohol and petrol rather than by VAT may well be significantly less than

12 p/£1000

0.1 per cent on the Index. You may want to press the Chancellor for the facts because Excise duties have a presentational advantage over VAT

0.1

in that taxation in this form has worthy secondary objectives - reduced health risks, energy conservation, etc. - and can be defended - and accepted by public opinion - on these grounds.

(d) Alternative sources of revenue: It may be unfair to infer from the record of your conversation that the Treasury's mind is over-concentrated on VAT and the Excise duties. But there are other ways of raising money which do not all have the same RPI consequences as these classic sources. Thus, despite pre-election commitments the National Insurance surcharge does provide a relatively painless way of raising a lot of money. It has of course other serious disadvantages, e.g. it is a direct tax on business and employment, but need a temporary increase be ruled out as a bridge to a future where significant savings in public expenditure will have been achieved? Again, in a Budget which really cut income tax it might be relatively easy and acceptable to toughen the tax treatment of non-monetary income like company cars. Could useful sums of money be clawed back here? Another possibility would be to replace the VAT element in the petrol tax by a straight duty (the point being that a substantial amount of petrol is bought on company account and thus has the VAT element offset even when used for private purposes. The need for energy conservation would provide a good public reason for the change). Another way - although you reacted against it in your first days in office - would be to put up the price of gas to the domestic

12 £600

£1500

RPI consumer (OPEC is already ensuring that industrial gas consumers will have to pay more as the price of gas to them is oil-related). And if one really wanted to widen the tax base the application of VAT to all fuels could be readily justified by the difficult international oil situation and the obvious need for energy conservation. And there are other taxes like Petroleum Revenue Tax, levied on North Sea oil production, where OPEC may be giving us useful room for manoeuvre.

(e) Extra savings in public expenditure: You will know by the end of the month how successful the Chief Secretary has been in saving money this year. But you will have heard Mr. Healey's speech in the House yesterday when he outlined in some detail the elements which would have found a place in his Budget had he had the opportunity to introduce it. Two of them in particular involved quite a lot of money, yet may not figure in the

Chief Secretary's list. These are the deferment of payment of Regional Development Grant and the switch of part of ECGD cover from the public sector to private sources. Faced with such propositions the Treasury purists would no doubt argue (correctly) that "savings" of this kind are not real. The resources involved in the ECGD cover would still be needed and companies, paid late on their RDG claims, would simply borrow from the banks against their known entitlement. But the cosmetic effects on the PSBR could be useful - and again more acceptable to the market against the background of the Government's general policies.

(f) Presentation: The ways in which tax changes are made and presented are as important as their content. At one level the Chancellor could perhaps make up for deficiencies in what he is able to do this year by making firm promises about his intentions next year. No Chancellor like s tying his hands too much but the dynamic effect you are seeking might be at least partly achieved by firm commitments on future tax rates. At another level it might (though the revenue and legislative problems could be insuperable) be possible to promise further downward adjustments in tax to take effect later this year. At yet another level there could be mileage in splitting the "standard rate" band of income tax in two with tax levied at 30 per cent on the lower part and 35 per cent on the upper. The size of the bands would be adjusted to whatever the Chancellor feels he can afford but at least most taxpayers under this system would find their marginal rate of tax reduced to 30 per cent and even those paying 35 per cent would be better off than they are now. An incidental advantage of such a change - which would leave us with a logical progression of tax rates in 5p steps from 25p to 75p - would be to escape from the tyranny of the sheer size of the present standard rate band (currently £7,250 million) where a lp change (which does not sound much) costs £400 million. With a fixed progression of rates much finer adjustments would be possible through alterations in the size of the bands of income to which they apply.

.12.-2^{30}

4. I do not advocate all of the changes outlined in this minute but I think it would be well worth probing whether the constraints are quite as tight as the Treasury are saying.

Stephen Smith

(John Hunt)

23rd May, 1979

Prime Minister 2
For information
R
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RECORD OF A MEETING HELD IN THE TREASURY
AT 4.30 P.M. ON WEDNESDAY, 23RD MAY, 1979

Present:

Chancellor of the Exchequer
Minister of State (Commons)
Minister of State (Lords)
Sir Anthony Rawlinson
Sir Lawrence Airey
Mr. Littler
Mr. Lovell
Mr. P.G. Davies
Mr. Cropper
Mr. Gracey, Inland Revenue
Mr. Ian Stewart, M.P.
Mr. H.P. Greenborough
Sir Raymond Pennock
Sir John Methven
Sir Adrian Cadbury
Mr. A. Lord
Sir Donald MacDougall
Mr. D.R. Glynn
Mr. E.A.J. Rayner

CONFEDERATION OF BRITISH INDUSTRY: BUDGET REPRESENTATIONS

Mr. Greenborough introduced the CBI's Budget representations; they were summarised in the enclosure to Sir John Methven's letter to the Chancellor of the Exchequer of 11th May, which brought up to date the representations the CBI had made in February. Mr. Greenborough said the CBI welcomed the general thrust of the Chancellor's speech on 22 May. He had been right to emphasise the sombre prospects for the world economy. The CBI still recommended a "broadly neutral" Budget. In their view, the risks of accelerating inflation ruled out any stimulus to demand; equally, the already poor growth prospects argued strongly against a deflationary Budget. As a general strategy, the CBI favoured cuts in direct taxation, financed by reductions in public expenditure. If strictly necessary, indirect taxes could be increased by up to £1 billion. The construction industry would be badly affected by further cuts in the Government's plans for capital expenditure. The CBI had not taken account in their calculations of the possible sale of Government assets. As a preliminary view, they saw merit in some of the Government's propposals, e.g. disposal of some of the NEBs holdings and of land.

2. The CBI welcomed the Government's intention to abolish the Price Commission. Their recommended medium term strategy proposed further measures aimed at restoring competitiveness and adequate levels of profitability. The main elements of this were:- no further real increase in public expenditure; further reductions in direct taxation on companies and individuals, reform of the structure for determining pay, abolition of exchange controls and dividend controls, and, of course, no increase in the national insurance surcharge. Mr. Greenborough thought annual growth of 3½-4 per cent was a desirable target, but recognised that the CBI's Budget proposals would not help significantly in the short term to achieve it. But the CBI welcomed the Government's intention to create the conditions for responsible risk taking by businessmen, and recognised that the forthcoming Budget would be an important signal to businessmen generally.

3. The Chancellor of the Exchequer said that he had studied carefully the CBI's written representations. He felt however that he must emphasise the necessarily packed Budget timetable. The lateness of the date also meant that the Finance Bill would have to be comparatively brief, and the revenue benefit from increases in indirect taxation much less than for a full year. He thought the phrase "broadly neutral" was ambiguous. Whilst the first round demand effects might be strictly neutral, a shift in the pattern of taxation could have a sharply stimulatory effect, whatever the strict Budget arithmetic. Sir John Methven took the Chancellor's point on "neutrality"; but the CBI meant by this a Budget which neither raised nor lowered the level of aggregate demand in the first instance. The Government's task must be to establish the right climate; it would then be for managers to respond. In the CBI's view, reductions in direct

taxation were the most important element. But the poor prospects for growth and the high and increasing level of inflation made it difficult to make a really significant impact in this year's Budget. The CBI's emphasis was therefore on a strategy for the medium term,but it was psychologically very important, particularly for small businesses, that the top maximum income tax rate should be cut at once to 60 per cent, not in a smaller step to 75 per cent. In the longer term, personal taxation should be reduced by some 30 per cent. On an inflation adjusted basis, the CBI calculated that profitability had been some 4½ per cent on average in 1978. They expected it to be only 3½ per cent this year, and also estimated that unit cost competiveness had worsened by some 15 to 20 per cent over the last two years. This underlined the merit of abolishing the Price Commission, and the argument for not increasing the NIS. Inflation was a serious worry. An increase in VAT to a 10 per cent unified rate would add 1 to 1½ per cent to the RPI this would bring the RPI to 12 to 13 per cent by the end of the year. If VAT went to 12½ per cent, a further 1¼ per cent would be added to the RPI. The rise in oil prices was having an equally serious effect. If the inflation rate rose above 15 per cent, it would be extremely difficult to keep earnings down to an acceptable level in the next pay round. This was why the CBI regarded increases in indirect taxes to pay for direct tax cuts as a last resort; and in any event not to be invoked beyond a total increase of £1 billion. The determination of earnings was a continuing problem, which the CBI would like to discuss with the Government at an early opportunity.

4. Sir Adrian Cadbury added that the exchange rate was one of the factors which had been affecting competiveness. Sterling had appreciated by 5.3 per cent in effective terms this year. He also emphasised the importance of continuity in the Government's policies and the need to pursue consistently medium term objectives. He would add BP shares to the list of assets which the

Government might usefully dispose of. He wished to emphasise two points from earlier discussion; dividend controls should be removed, and cuts in public expenditure should take full account of the precarious state of the construction industry. He also considered that there was no longer a case for maintaining exchange controls.

5. The Chancellor of the Exchequer said that the Government wished to consider carefully its future role in the determination of pay. They would be glad to take up the CBI's offer of discussions "fairly shortly". As for dividend controls, he would say only that they were not immortal. The CBI had said that their own Budget scenario suggested a PSBR of £8½ billion. What would be the impact of this on interest rates? Sir Adrian Cadbury said that if adherence to strict monetary targets implied higher interest rates, business would accept this. Sir John Methven commented that the figure of £8½ billion took no account of the sale of assets. Sir Lawrence Airey pointed out that such sales would reduce the PSBR, but would not necessarily relieve the pressure on monetary targets.

6. The Chancellor of the Exchequer said that the Government was considering its policy on exchange controls. The shape and timing of any package required careful thought. He detected two strands of thoughts in the CBI's view on the exchange rate - varying degrees of stress were placed on the benefits to competiveness of a weak exchange rate, and the benefits on the prices front of a strong rate. Sir Adrian Cadbury referred to a recent survey by Peter Oppenheimer; 67 per cent of those who replied said that the relative prices of their products compared with overseas competitors were an important consideration. In his view, the relaxation of exchange control would be the best means of achieving the right exchange rate. Sir John Methven commented that views on the exchange rate varied from sector to sector of industry. The Chancellor of the Exchequer said there was a need to work for wider understanding

of the benefits of relaxing exchange controls on the part of the TUC. Sir Adrian Cadbury thought that on the theoretical plane the TUC now accepted the arguments for relaxation. But there was a political block. Sir John Methven said that there was now significantly less pressure from the TUC for generalised import controls. Sir Raymond Pennock added that, whilst ICI's export volume had increased by 7 per cent, the value had fallen by 1 per cent.

7. The Chancellor of the Exchequer said that he well understood the need for a powerful signal in the Budget on the top rates of income tax. But it was politically very difficult to make such a gesture towards the higher paid, without offering something to the rest of those who paid income tax. He also took the point that public expenditure must be the quarry of first resort to finance cuts in direct taxation. But the more capital expenditure was left alone, the more difficult it was to find sufficient savings. There was an inherent problem in switching from direct to indirect taxes. Even in a period of low or very low inflation, a shift from direct to indirect taxes would cause the RPI to increase. If attention continued to focus on pre-tax wages, this increase would tend to be reflected in the next pay round. Unless the Government were bold, anxiety about the RPI effects could be a permanent obstacle to change. Clearly radical change in this area carried a price tag. But the solution was surely to concentrate on net post tax earnings. Sir John Methven said that in his view, expectations about inflation were the prime influence on pay bargaining. In his experience, at the lower levels of earnings, tax cuts had had no significant effect on bargaining. But a start in cutting direct taxation had to be made somewhere. It was the managers who were the engines of change; and in any case, the cost of cutting the top rates of income tax would be negligible. Such a policy could even increase revenue. It would cut sharply the amount of time and effort

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spent on tax avoidance. The Chancellor of the Exchequer said he thought that even at the lower end of the earnings scale, there was a learning curve, and that it was increasingly take-home pay with which pay bargainers were concerned. Mr. Alan Lord still felt, however, that the less the cut in direct taxation had to be carried on indirect taxes, and hence by the RPI, the better. It was therefore helpful to sell assets in this first year as a once and for all measure. The Chancellor said there were two aspects to asset sales; the PSBR effect was obviously important, but such sales were also useful in themselves, to the extent that they restored competition and balance in the market.

8. Before bringing the meeting to a close, the Chancellor asked the CBI if they had any clear view on why unemployment was falling. Sir Donald MacDougall said that this trend was not clearly understood. Various factors might be at work - output higher than recorded, movement of married women out of employment, but no on to the unemployment register, further erosion of productivity; the CBI would welcome a continuing exchange of ideas on this.

MAH.

(M.A. HALL)
29th May, 1979

31 MAY 1979

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PS/Secretary of State, Industry

PS/P.M.

H. M. TREASURY

Parliament Street, London SW1P 3AG, Press Office: 01-233-3415
Telex 262405

PLEASE NOTE EMBARGO

NOTE FOR PUBLICATION, BROADCAST OR USE ON CLUB TAPES BEFORE 15.30 HOURS WEDNESDAY 23 MAY 1979

BUDGET PROCEDURES EXPLAINED

The leading article in the May issue of Economic Progress Report helps to set the scene for the forthcoming Budget on 12 June by explaining some of the procedures involved in Budget-making. The article also sets out for the record the provisions of the April Finance Act.

Forecasting world economic developments

As part of its regular short-term economic forecasts the Treasury makes an assessment of the prospects for the world economy. An article on pages 4 - 5 describes how this assessment is prepared with the help of an econometric model. The current version of this model is shortly to be published as a Treasury Working Paper.

Monthly economic assessment

The Treasury's latest monthly economic assessment is on pages 5 - 8.

Economic indicators

A table containing the most recent figures for the main economic indicators is included on page 7.

PRESS OFFICE
H M TREASURY
PARLIAMENT STREET
LONDON SW1P 3AG
01-233 3415

80/79

NOTES TO EDITORS

1. Economic Progress Report is published every month by the Treasury. It contains articles on economic subjects, analysing or giving background to Government economic policy, together with the Treasury's assessment of the economic situation and a table and charts of economic indicators.
2. There was no April 1979 issue of Economic Progress Report on account of the recent general election.

HANSARD EXTRACT: 22.5.79.
column 881.

The right hon. and learned Gentleman told us that if he is to carry out his election promises and make these cuts in income tax he will have to raise £5 billion in all. He told us that he will do so by increasing taxes on what we buy, or by cutting public expenditure, or both. Why has he apparently ruled out increases in other taxes? For example, what about company taxation? He has given a firm undertaking not to increase the national insurance surcharge, but why not increase advance corporation tax? He could get really substantial help here and, of course, ACT is levied only on companies that distribute dividends. There should be a lot more of them if the right hon. and learned Gentleman carries out his promise to reduce or abolish the control of dividends in his current Budget.

c.c. Master Set
cc Mr Hoskyns

File A 9

10 DOWNING STREET

From the Private Secretary

B/F 29.5.79

22 May 1979

Dear Tony.

The Prime Minister and the Chancellor of the Exchequer had a general discussion about the Budget prospects at 1000 hours this morning. They had before them the Chancellor's minute of 21 May. The Prime Minister and the Chancellor spoke privately for part of the meeting; the following points came up while I was present.

The Chancellor explained that the changes which he was proposing on the indirect tax front, accompanied by the £3 billion saving on public expenditure, were the minimum needed if he were to move decisively on direct taxes. In particular, anything less than 15% on VAT would effectively rule out any major change this year on income tax: it would not be possible to make the radical improvements in the higher rate structure unless the standard rate were also reduced to 30 or 31p. Moving VAT no higher than 12½% would not only lose a significant amount of revenue, it would also mean a lost opportunity politically - once the VAT rate was raised to 12½%, it might well be difficult to move it higher in subsequent years. The Chancellor emphasised that the Budget arithmetic was very tight. The package outlined in his minute would only get the PSBR down to nearly £8 billion if the pre-Budget forecast turned out to be about £10 billion; the forecast, which was due in the next few days, could well turn out higher than £10 billion. There was a possibility that asset sales could be raised to £1¼ billion rather than the £1 billion mentioned in his note. On the other hand, it was open to question whether the specific duties on drink and tobacco should be increased: increases on these items would have a large price impact in relation to the revenue which they would bring in.

The Prime Minister said that she was concerned about the price impact of the Chancellor's proposals. An increase in the RPI of around 4%, which would be the result of what the Chancellor was proposing, would mean that the inflation rate would be increasing by about double what it had been at the end of last year; and although much of the increase was attributable to the current pay round for which the Government could not be blamed, there would still be accusations that the RPI had doubled in the Government's first year of office. There was a clear risk, in the Prime

/Minister's view

Minister's view, that the very large RPI effect of the Chancellor's proposals would have a damaging impact on next winter's pay negotiations; and it could possibly result in the reopening of some of this year's pay settlements. Also, the larger the RPI effect of the Budget, the larger would have to be the uprating of pensions and other long term benefits; and this would add to public expenditure. (In reply to the latter point, the Chancellor explained that social security upratings had been netted off in his calculations.)

More generally, the Prime Minister wondered whether it was necessary or wise to try to achieve all of the Government's objectives on the income tax front in the first year. It might be better to concentrate on cutting public expenditure, curbing the rate of inflation and getting the overall balance of the economy right in the first year - with major reductions in income tax being left to the second. She referred in this context to the Budgets of 1952 and 1953. Mr. Butler's first Budget had been a tough one, and it was only in his second Budget that he had introduced major reductions in income tax and other incentives to the business community.

Before taking a final view on the overall strategy proposed by the Chancellor, the Prime Minister said that she would like to see an analysis of the inflation prospect. This should show the forecast for the RPI before the Budget, and the additions to the forecast which different Budget packages would involve. It should also take into account explicitly the various price increases which are currently in the pipeline, for example, bread, milk, gas, electricity and the likely increase in petrol prices. The Prime Minister understands that these increases alone would add 0.9% to the RPI. I would be grateful if you could let me have an analysis on these lines as soon as possible.

Yours ever,

Tim Lankester.

A.M.W. Battishill, Esq.,
H.M. Treasury.

Mr Jones

Nothing from No 10 I assume.

TL 22/5

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

21st May, 1979

Mr. Lankester

On all past form – no. Nil return this year

26/5/79

Dear Andrew,

PRESS NOTICES RELATING TO THE BUDGET

I am writing to seek your co-operation in dealing with press releases relating to the Budget.

I should be grateful if you and other recipients of this letter would let me know NOT LATER than Tuesday, 5th June of:-

(a) any proposed press notices;

(b) contact point for each press notice.

Also I should be grateful if you and, where appropriate, other recipients would ensure that 400 copies of each such press notice are sent to Mrs. M. Robertson in the Chancellor of the Exchequer's Office, H.M. Treasury, Parliament Street, S.W.1. by 9.00 a.m. (earlier if possible) on Tuesday, 12th June.

In addition, the Treasury Parliamentary Clerk should be sent 750 copies of those press notices which it is decided should be placed in the Vote Office. These should be sent direct to the Treasury Parliament Section, Room 128/2nd Floor, H.M. Treasury, Parliament Street, S.W.1. The deadline for their delivery, as they need to be collated into sets, is 3.30 p.m. on Monday, 11th June.

I am copying this note to the Private Secretaries of all Cabinet Ministers.

Yours ever

A J Nelson

(A. J. NELSON)
Private Secretary

A. Duguid, Esq

BUDGET SECRET

A 8

ok.
Mr Wolfson
Mr Strauss

CH/EX. REF NO. B(79)11

COPY NO. 1 of . 3 COPIES

PRIME MINISTER

I have already mentioned to you in a general way how my thinking on the Budget has been developing. To meet the 12th June deadline I must now firm up several important decisions without further delay, and I must do so with your support. I have therefore set out below the considerations most relevant to those decisions.

2. Even taking full credit for the latest proposals for cuts (not yet agreed by colleagues) we shall have a very tough task in cutting this year's PSBR back to £8bn. This will be a very substantial reduction, both absolutely and in real terms, on the outturn for 1978-79, which is now thought likely to be around £9 bn, well above Denis Healey's target. We have also to allow for the likelihood that the new short-term forecast (due later this week) will predict a PSBR for 1979-80 (on pre-Budget policies) lying between £10 bn and £11 bn, rather than the £10 bn we now assume.

3. On the tax front we have identified in broad terms a package of income tax cuts which constitutes an irreducible minimum. Its principal features are

(1) cutting the basic rate to 30%, and the higher rates to 60% maximum;

(2) a modest but significant improvement in the allowances over and above the provisions of the caretaker Finance Act.

4. We have deferred "buying out" the 25% reduced rate band until next year, and set our face firmly against a number of other

/smaller

smaller but highly desirable changes. The principal details are set out in the attached table, though it must be stressed that the costings are provisional and subject to revision when the forecast is available. (I can explain when we meet the other smaller changes which we have in mind - some of which are important in terms of presentation and confidence).

5. As you will know from last Thursday's Cabinet, we have now taken an extremely firm line on public spending for 1979-80, and I do not think that there are more economies of any significance to be found if we can secure what we have bid for.

6. On the indirect tax front the position is tough but, I believe, manageable. Even if this week's new forecast does not worsen the PSBR arithmetic, the minimum direct tax package can only be financed with a 15% VAT rate. This is crucial and equally important for next year. The only margin turns on whether or not we increase the duty on drink and tobacco, both of which have a heavy weight in the price index, together with the other specific duties. If they are included, the immediate impact of the indirect tax changes on the RPI is about 4.3%. If not, it is just over 3½%. We need to balance this difference against the importance of reducing the PSBR by the extra £200 million that is involved.

7. Looking beyond the mechanics and arithmetic of the proposals is still difficult. But one or two points are already clear. On conventional economic arithmetic the impact of our measures would be deemed to be quite severely contractionary. But insofar as <u>any</u> Government - including a Labour one - would have had to cut the PSBR back to circa £8.5 bn, <u>any</u> responsible Budget at this juncture would tend to have a contractionary effect. I intend of course to stress this point in the course of my Budget speech. But I think that, in contrast to a Labour Government, we would expect to see our Budget lead to an improvement in confidence at home and

/abroad

abroad, amongst both consumers and investors. This should lead to a more favourable outcome.

8. Furthermore, one must allow something on the plus side for the impact on the "supply side" of the economy of an important first step towards getting right our tax structure and incentives. No one can know quite how much that intangible but vital consideration is worth, or when it will come into effect. But it is no less relevant for that.

9. Finally there is the question of confidence in our policies in the longer term. If I can give really firm and convincing indications in my Budget speech of the Government's ability and determination to get public spending and borrowing down and to control the money supply in the longer term, then the response of the economy should be swifter and more positive. This points, of course, to the extreme importance of our securing early agreement from our colleagues to the need for longer run economies on the scale we shall be putting forward in this Thursday's Cabinet discussion of the medium-term public spending survey.

(GEOFFREY HOWE)
21st May 1979.

	PSBR 1979-80 (£million)	RPI impact effect
Direct Tax		
Increase* in single and married allowances by £120 and £190 respectively, together with corresponding age allowance increases		
Reduction in basic rate to 30p	+£2,790	
Improvements in higher rate structure and top rate 60%		
Investment income surcharge: single threshold of £5,000		
Public Expenditure		
Cash limits squeeze on prices and pay (assumed £720 million reduction in volume of central Government spending).		
RSG cut of £300m (assumed £100m reduction in volume of LAs spending).		
Specific cuts of £1.3 bn.	-£3,000	0.4%
Contingency reserve cut of £250 million.		
Sales of assets of £1 bn.		
Indirect Tax		
VAT at 15%		
15% increase in petrol duty.		/.
10% increase in specific duties except VED	-£1750	4.3%
Alternatively		
As above, but excluding drink and tobacco	-£1550	3.6%

* Including Caretaker Finance Act increases.

(Note: These figures are rough estimates based on the use of current ready reckoners and assuming a floating exchange rate and unchanged monetary growth).

BUDGET - SECRET

7

PM seen

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB
TELEPHONE DIRECT LINE 01-212 3301
SWITCHBOARD 01-212 7676

Secretary of State for Industry

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer

1 - Chancellor
2 - P.M.
3 - Secretary
4 - [illegible]
5 - [illegible]
6 - [illegible]
7 - PS/SOS

18 May 1979

TOTAL COPIES 7

COPY No. 2

Dear Geoffrey.

It may be helpful to you, as you consider the contents of your Budget, to have a note of the industrial priorities as I see them.

It is clear that substantial measures are needed simply to cut PSBR back to an acceptable level in 1979/80 - especially as we are starting some way in to the financial year, and as some of our own first decisions will increase public expenditure.

However, I believe most strongly that we must, in addition to this, make a dramatic beginning to our programme of cutting income tax. This belief is founded on the view that only a major initial package, that will take people's breath away by its very boldness, will stand a chance of making a real change in attitudes on which the whole of our strategy depends.

Moreover, to undertake these two tasks - both of which have to be done in the lifetime of this Parliament - will involve major surgery: we need to get that started now, in a substantial way, with the impetus of the election still strong and backed by a bold set of income tax cuts that are seen as part and parcel of the same process.

I think the scale of what I have in mind may be a good deal more than the public and the press are expecting: I regard that as an advantage. If I illustrate my suggestions with numbers, you will I know appreciate that the figuring and the details are very crude.

I start from the proposition that we must cut the target growth £M3 from the present 8 to 12% for 1979/80 down to 7 to 11%, and announce our intention to set subsequent annual targets progressively lower than that; and that consistent with that approach, we should aim for a PSBR in 1979/80 of no more than £8 billion. Taking account of demand effects and offsetting increases in public expenditure, I imagine you will need to be looking for revenue, disposals or public expenditure savings of at least £2½ billion, simply to meet that objective.

/....2

In addition, I believe we need to implement in this Budget at least the following on income tax cuts:

- abolish all rates above 60%
- reduce the basic rate by 3p
- increase personal allowances by about £150 (in addition to the Rooker Wise amendments) to make a significant contribution to tackling the "poverty gap"
- increase the width of the higher rate bands - say by £1000 for the basic rate band and £500 for each subsequent band.

The cost of these measures, together with the need to cut the PSBR, must add up to something like £5½ billion in 1979/80, to be raised by other means. My suggestions to meet this requirement are as follows:

- something over £2½ billion from public expenditure cuts and disposals taken together. I believe that more can be done on each of these than is currently suggested, and I am sure that we must approach the question of disposals in particular with the utmost vigour. We can make our contribution in the Department of Industry's field, but the lion's share must come from the sale of a substantial part of the BP shareholding.
- A standardised rate of VAT of 15%
- Revalorisation of the specific duties (apart from heavy oil duty and perhaps derv) by the effect of inflation since the 1978 Budget. I do not favour increasing the heavy fuel oil duty in line with inflation: our duty is already virtually the highest in Europe, and I see no point in making our contribution to global energy conservation in a form which burdens our industrial costs. I would also favour reversing the present bias against derv, and a declaration that we intend to maintain a bias in its favour in future on grounds of its relative energy efficiency.
- Double the yield on betting and gaming (though inevitably less on the pools and more on other forms of gambling).
- A 50% surcharge on ACT for two years, which would give additional revenue in year 1 (1979/80), reversed in year 3 (1981/2). I am most conscious that despite, or perhaps because, of the precedent for doing this in 1974, such a step would be heartily disliked by industry especially at a time of pressure on company finance, and that it runs counter to our general policies. I would propose, however, that it should be presented openly and honestly as a one year emergency measure to make possible steps on income tax that will have a most reinvigorating effect on industry and the economy.

/....3

These measures taken together would, I am told, have an RPI effect of nearly 6% before taking into account the beneficial effects of the tighter monetary control; and I am told they might have a demand effect equivalent to a 3% reduction in GDP. If these effects are likely they could prove too repercussive for our general purposes, and my Department is seriously concerned that we might be forced to back-track later in the year. On this I have two comments to make: first, it would obviously be better to substitute for part of those tax increases which have the most RPI and demand impact other methods of raising revenue which have less RPI and demand consequences. I am not competent to judge whether say £500-£700m could be shifted off the VAT increase, for instance, on to a number of individually smaller methods of raising that amount of revenue with less demand and RPI effects. By such means the RPI effect might be limited to 3% or 4% and the demand effect to 2%. If such means could be found I would prefer to use them in addition to a VAT increase which could then be limited to 12½%. I am quite sure, knowing you, that you will have long ago initiated the search for all such means.

Secondly, I am not sure that in estimating the demand effects conventional forecasting methods sufficiently allow for the stimulus of income tax cuts on the scale envisaged.

I believe we should also make a start in reducing capital taxation, and phasing out the investment income surcharge, both of which would be relatively cheap. These are included for convenience - though they are by no means wholly small firms measures - in the attached annex about small firms taxation.

Finally, I hope you will feel able to include a group of measures to help small firms. I know you will be under pressure to limit the legislative content of the Budget, given the time available before the Finance Bill must be introduced. David Mitchell has prepared some proposals, which will be familiar to John Biffen from his time as spokesman on small firms matters. I have suggested in the annex to this letter a number of steps which could be taken at once with minimal legislative content - changing rates, thresholds etc - and at limited cost; and a list of further matters to be considered for early action thereafter. I should like to propose that you also include in your statement a reaffirmation of the need to reduce the tax burden on small firms, and an undertaking to review the field thoroughly in the coming months including the best way of securing "tax neutrality" for direct equity investment in small firms. We might then invite officials of the interested departments to undertake such a review, taking into account at the same time the recent Wilson Committee report and the representations being made by various bodies about it, to which we shall have to respond in due course.

I shall be happy to discuss these suggestions with you if that would be helpful. In view of the importance of the subject, I am copying this letter to the Prime Minister.

Ever, Keith

ANNEX

SMALL FIRMS PROPOSALS

A. Proposals for the Budget

1 i) A significant rise in the lower and upper limits for the small companies rate of corporation tax and for marginal relief to say, £100,000 and £150,000.

ii) An extension of the period over which first year allowances can be carried back from 3 years to 5 years.

iii) A commitment to phase out the investment income surcharge over a period of 2/3 years.

iv) An extension of the period during which interest on loans taken out before 1974, for the purchase of shares and direct investment where the individual spends less than 75% of his time on the affairs of the business, can continue to qualify, from April 1980, pending a review of policy on interest relief generally.

v) An increase in the capital transfer tax threshold, to, say, £50,000, the starting point of each taxable band and the annual exemption, to, say, £5,000.

vi) An increase in the VAT registration limit to the maximum permitted under the EEC directive, £11,500.

/ vii)

BUDGET - SECRET

ANNEX

vii) A reduction in the rate of development land tax to, say, 50 per cent, making clear that there will be no further downward movement.

viii) The introduction of comprehensive VAT relief for bad debts.

ix) The writing-off of deferred tax liabilities arising from stock relief, but at a faster rate for unincorporated businesses.

x) A commitment to review the conditions attached to the issue of 714 certificates to sub-contractors in the construction industry.

xi) No further relaxation of the thresholds for apportionment of the income of a close company without consultation.

B. Proposals for further consideration

2 i) The introduction of tax reliefs for equity investment in small companies.

/ ii)

ANNEX

ii) A reduction of the restrictions on the amounts that self-employed individuals can set aside for pension arrangements and deduct for tax purposes.

iii) An examination of ways in which the capital transfer tax burden can be reduced further to enable successful small firms to be passed intact to the next generation.

iv) Further changes to the Capital Gains Tax Code to ensure it adequately takes account of inflation.

v) A general examination of the effect of the present corporation tax system on small companies.

15 May 1979

SECRET

Budget. 6

NOTE FOR THE RECORD

c.c. Mr. Wolfson
Mr..Ryder
Mr. Stowe
Mr. Hoskyns

The Prime Minister had a short meeting with Mr. Adam Ridley at 1830 yesterday to discuss the Budget.

Mr. Ridley expressed great anxiety about the Budget prospects. The PSBR was currently forecast at £10 billion for 1979/80; but a new forecast was due on 23 May and could well show a higher figure. In order to get the PSBR down to £8 billion, it would therefore be necessary to find expenditure savings and/or indirect tax increases amounting to at least £2 billion; and some £100 millions of additional savings would be needed to finance the planned reductions in income tax. The Treasury's options for reducing public expenditure so far amounted to only £800 million. They were assuming £800 million from sale of public sector assets; and the rest - on their current thinking - would have to be raised by indirect tax increases.

This approached raised at least two major problems. Firstly, it was doubtful whether the markets would fully count the revenue which would be raised by selling off assets. The markets were now more sophisticated than they had been in 1976 when the Labour Government had sold off the BP shares; and they would be looking at the public sector deficit (i.e. the difference between expenditure and tax revenue) as well as the PSBR. There was a good reason for this: the sale of assets, while raising revenue, would not improve the real resource balance of the economy, and insofar as the institutions substituted purchases of public sector assets for purchases of gilts, there would be no reduction in the growth of the money supply.

Secondly, the substantial increases in indirect taxes which were implied would give a sharp boost to the RPI. Together with increases in nationalised industry prices, the increases in indirect taxes could lead to a once-and-for-all jump of 3% in the RPI later in the summer. Notwithstanding the Conservative pledge to switch taxes from direct to indirect, this would lead

/to major

SECRET

to major criticism. It would seem inconsistent with the Government's objective of tackling inflation. Moreover, the critics would focus on the net income position of typical families (as the Labour Party had done during the campaign).

Mr. Ridley said that all this pointed, in his view, to much greater emphasis being given to public expenditure cuts. It would be very helpful if the Prime Minister would give Treasury Ministers and the Cabinet generally a strong lead in this direction. In the absence of cuts well in excess of £800 million which were currently proposed by the Treasury, there was a grave danger that the Budget would fail to satisfy both the markets and the Government's supporters in the country. One aspect of public expenditure in the coming year was of course the awards arising from the referencesto the Clegg Commission. Although their size was uncertain, there was little doubt that they would result in heavy extra expenditure. Assuming the Government was not going to revoke the existing references, this pointed to the Government putting in very strong evidence to the Commission as soon as possible. There would also need to be great care in allowing further references to go to the Commission.

Mr. Ridley went on to say that the Budget would be better received in the financial press and by the markets if it were accompanied by a clear and strong commitment to major spending economies in the 2-5 years ahead - preferably with the Prime Minister's endorsement; and also by a commitment to re-examine other means of monetary control such as the monetary base.

The Prime Minister made the following comments:

i. She agreed that there was room for anxiety, and in particular that it was essential to achieve greater expenditure cuts than the Treasury were at present envisaging. Sne would make this clear to Cabinet on Thursday. But she thought that Mr. Ridley was perhaps over-emphasising the market's reaction to the sale of assets: if presented properly, and as part of a good overall package, they could play a significant part in the Budget.

/ii.

ii. The Prime Minister said that a £8 billion PSBR was an absolute maximum; the Chancellor should be aiming for £7.5 billion.

iii. The Prime Minister said that one of the advantages of switching from direct to indirect taxes would be that there would be less tax evasion. At present, large amounts of income tax were not being paid, whereas there was less scope for evasion on the indirect tax side. She wondered whether it might not be worth offering an amnesty to those who had evaded their tax obligations on condition that they paid up within a certain time, with stiffer penalties to follow if they did not. She understood that the Italian Government had adopted such a policy quite successfully, although the amounts at stake there were no doubt far greater.

iv. The Prime Minister said that she too was very worried about the Clegg awards. She hoped to strengthen the Commission with some hard liners (and had asked the Chancellor's views on various names); she also hoped to call in Professor Clegg to express her worries to him in person. She was keen that the Government evidence should be put to the Commission as soon as possible (after Cabinet had considered it on Thursday); she had already indicated that the evidence should ask the Commission to take into account supply and demand considerations, as well as the overall economic effect of particular awards.

TL

16 May 1979

Original on:
Econ Pol:
Public Expenditure

SECRET

MR. CARTLEDGE

5

NOTE FOR THE RECORD

The Prime Minister held a meeting with Treasury Ministers and senior Treasury officials at 1630 today. Attached is a list of those who were present.

The Prime Minister said that she was dissatisfied with the two papers - C(79)4 and 5 - which the Treasury had put forward for Cabinet on public expenditure. The Treasury approach, as set out in these papers, was not nearly tough enough. The Budget arithmetic would require substantially greater cuts than the Treasury had put forward if the twin objectives of getting the PSBR down and substantially reducing income tax without raising indirect taxes unduly were to be met. In her view, the Chancellor should be aiming to reduce the PSBR to £7.5 billion in 1979/80 - rather less than the £8 billion which he was apparently thinking of. As for indirect taxes, she was extremely perturbed at the prospect of having to increase VAT to 15%. This would mean a sudden jump in the RPI of at least 3%. The result could be catastrophic for the next pay round, and she would far rather find the necssary savings for the direct cuts by a smaller increase in indirect taxes and larger public expenditure cuts. Within the cuts proposed by the Treasury, too much involved increases in charges - which would also show up on the RPI. The Treasury's method of trying to obtain cuts also seemed unsatisfactory: instead of proposing cuts in specific items, which individual Ministers would be bound to argue against, it would have been better to have proposed overall amounts by which Departments would have to find cuts - leaving it to them to find cuts in particular items. The Prime Ministers said that she was sure that there was enormous waste in most departments. Although the proposed squeeze on cash limits would get rid of some of this, the broader approach to the cutting exercise which she would have preferred would have forced departments to look further at the waste problem.

/The Prime Minister

SECRET

The Prime Minister went on to say that she thought the sale of assets could provide a significant contribution to getting the PSBR down - though it would only find favour with the markets if the rest of the Budget package was right. It would be necessary to press ahead with early legislation to achieve the desired sales. If it was not possible to provide for this in the Finance Bill, then consideration should be given to preparing an Omnibus Bill covering different types of assets which the Government intended to sell off.

More generally, the Prime Minister said that it was essential to get the overall strategy right from the start. This must involve large public expenditure cuts this year leading on to more substantial reductions in later years; a lower growth in the money supply (she would favour a new target for M3 in the range of 7 to 10% rather than 7 to 11% which the Chancellor was presently considering); and lower interest rates.

The following conclusions were reached on the conclusions in C(79)4, and it was agreed that the Prime Minister, the Chancellor and the Chief Secretary would try to get agreement in Cabinet on these lines:-

(a) On i, if Ministers failed to agree the cuts proposed for their Departments in the annex, they should undertake to find cuts from within their programmes of at least equal amounts - and these should be postively identified.

(b) The RSG should be reduced by £300m., not £200m.

(c) On iii, the aim should be to raise at least £1,000m from selling assets.

/(d)

(d) Conclusions iv and v on the Contingency Reserves should be accepted, but it should be made clearer what these meant - i.e. the Contingency Reserve will be cut, it will then be held, and the reduced figure will only be drawn against with the authority of Cabinet.

(e) Ministers should be asked to find additional savings of £400m in 1979/80.

Likewise, the following conclusions were reached on C(79)5:-

(a) Ministers should endorse conclusion i.- i.e. the published cash limits should not be adjusted to cover higher price increases. (Sir Anthony Rawlinson had said earlier that if VAT were not increased to 15%, then there might well be a case for reducing the published cash limits.)

(b) On ii, there should be no automatic adjustment of the cash limits of the RSG to cover the Government share of local authority settlements. However, if the £300m in the RSG noted above were achieved, there would be a stronger case for upward adjustment on account of pay settlements (the Prime Minister made it clear that she was still not convinced that the Government should agree to increase the RSG to cover its share of the teachers' settlement).

(c) Conclusion iii on the adjustment of the cash limit for universities and the National Health Service should be accepted.

/(d)

(d) On iv, fringe bodies would have to be treated very strictly - and this meant at least following the cuts in staff costs which the Prime Minister proposed for the Civil Service.

(e) The conclusion on the nationalised industries should be accepted.

Other Points

The Prime Minister said that she was not convinced there was so little scope for cutting the aid programme for 1979/80. She did not believe that so much was contractually committed as the Treasury paper implied. She asked that a paper should be prepared spelling out precisely the UK's existing aid commitments.

The Prime Minister said that the paper by the Secretary of State for Employment on pay - C(79)6 - should not be taken in Cabinet tomorrow. The paper was thoroughly deficient on content, and it would be quite wrong for Cabinet to take it without an accompanying paper by the Treasury who were in the lead on pay. She suggested that the Treasury produce a paper which should then be taken - along with Mr. Prior's paper - in E Committee.

T.P. LANKESTER

16 May 1979

cc Sir John Hunt
Mr. Stowe
Mr. Wolfson
Mr. Ryder
Mr. Hoskyns
Mr. Cartledge

SECRET

Prime Minister

Chancellor of the Exchequer

Chief Secretary

Financial Secretary

Minister of State (Mr. Rees)

Sir Douglas Wass

Sir Anthony Rawlinson

Sir Lawrence Airey

Mr. Ken Couzens

Sir Fred Atkinson

Sir John Hunt

Mr. Ken Stowe

Mr. David Wolfson

Mr. Tim Lankester

SECRET

PRIME MINISTER

The following will be at this meeting:

The Chancellor

Mr. Biffen

Mr. Lawson

Mr. Rees

Sir Douglas Wass

Sir Anthony Rawlinson (Second Permanent Secretary in charge of public expenditure)

Sir Lawrence Airey (in charge of the domestic economic sector)

Mr. Ken Couzens (in charge of the overseas sector)

Sir Fred Atkinson (Chief Economic Adviser and Head of the Government Economic Service)

Sir John Hunt

Lord Cockfield has cried off because he is representing the Government in the Debate in the Lords.

TL.

16 May 1979

SECRET

Budget file

4

R 17/5

Problems

1. Even the modest income tax-cutting programme envisaged requires us to "give away" £2½bn in year 1 (£3.2bn subsequently in a full year).

2. The PSBR is currently put by the Treasury at £10bn and by outside commentators. Initial anxieties that this is an underestimate have been partly dispelled. But a new forecast, due on May 23rd, is bound (almost) to lead to a higher estimate.... And the new Treasury estimate would have to be published in the Red Book.

3. Furthermore, the date of the revised forecast is so late that it would make a considered amendment to the proposed budgetary package very difficult within the period up to the Budget. In particular the scope for a further round of Departmental discussions on expenditure would be almost zero. So the new forecast could well blow the Budget off course, unless the Budgetary arithmetic could be adjusted to contain a lot of room for manoeuvre.

4. The expenditure economies in 1979/80 currently being bid for need to amount to at least £2bn merely to reduce the PSBR as at present forecast to an acceptable level. In addition, a little more (say a few £100 million) is almost certainly needed to provide room for manoeuvre for the tax changes.

5. In the event, Treasury bids for 1979/80 economies below current expenditure levels are only some £1.5bn or so, of which only about half really counts, the other half being disposals of assets. While valuable in their own right, these latter do nothing to help the balance of the economy, to ease the inconsistency between a high public sector financial deficit and a tight monetary policy,

or to lower interest rates. About £1.2bn of further economies seems needed in year 1 even to meet the minimal objective of getting the PSBR down to £8bn. And more still would be needed to provide the extra "few £100m" mentioned in 4 above, to ease the tax changes in.

6. To put the same point a different way, when the present package of (hoped-for) 1979/80 economies and tax changes is put together, the projected PSBR comes down only from £10bn to a little over £9bn. If the economies cannot be obtained, or the forecast worsens, the projected budgetary arithmetic would be even worse.

7. That is not all. Responsible commentators who set the tone will look at trends in the PSD more than PSBR. The present package would almost certainly raise the PSD substantially, both in £ at current prices and as a proportion of GDP. It will, on present calculations, be mercilessly criticised. And it would almost certainly only be compatible with a 7-11% monetary target if very high interest rates were considered acceptable.

8. On a quite different front, the internal composition of the fiscal side of the package seems, on initial analysis, to threaten a position in which any tabulation by income group of the effect of the Budget on the position of families will show all except the richest appearing to do badly from the Budget changes, even when the effects of the first 1979 Finance Act are included. This is part of the case (if presentational tricks are impossible, or to be eschewed on grounds of principle) for having more expenditure savings available than currently planned. Only then can one "float off" the tax package without leaving people afraid of being worse off, or arousing dangerously higher inflationary expectations.

9. There is also lurking in the background the question of monetary policy. If the whole package is considered "incredible" in terms of its PSD impact, the problems of managing the Gilts market could become swiftly unmanageable.

10. Finally one must consider the short run RPI impact on top of the much higher underlying rate of inflation than envisaged last autumn.

SOLUTIONS

11. The position is, then, very unsatisfactory; ineed one might almost say it threatens to be impossible. What, then is to be done? The alternatives are as follows. They can be crudely classified into five groups of proposals, under the headings:

- Expenditure
- Revenue
- Targets
- Monetary policy
- Timing.

12. On the expenditure front one could look for more economies. Obvious areas to go for would be:

- more policy changes
- less recruitment
- moraroria on procurement
- action to diminish or delay awards under the Clegg references and related settlements [currently due to cost £1,250m this past financial year alone, and much more in every full year hereafter].
- tougher cash limits, not least on the LAs and the NIs
- lower debt interest (by means, probably, of new financing instruments and some debt conversion)
- the whole social security complex, which cries out for long term treatment.

13. On the revenue front one might go for

- higher charges
- an energy tax (Gas in practise) and higher coal and electricity prices, thus permitting lower NI cash limits
- bigger increases in the excises, VED etc.

14. One might also reconsider the principal targets which constrain the package. These would be:

- the tax package - could one cut income taxes less?
- the PSBR - could one tolerate a higher figure, particularly if at the same time one could get the PSD lower than in 1978/79 as a GDP percentage.

15. Raising the PSBR target could only by considered in the context of a broader presentation of budgetary and expenditure strategy which buttressed long run confidence from several angles, and enabled the markets to swallow the bitter pill of a very difficult 6-12 months by holding out the vision of a promised land by Budget 2. The chief ingredients of this broader framework would probably be

- a clear and credible (ie PM endorsed) commitment to major spending of economies in years 2-5, eg getting firmly back to the 1977/8 outturn by year 3 or 4
- a commitment to study other means of monetary control, such as the monetary base
- a major innovation in the instruments of Government borrowing such as extensive use of index linking and conversion of outstanding borrowing.

This would need to be done as part of a Budget which did not arouse inflationary expectations enough to alarm the markets.

16. Other avenues to explore might include

- the proposal to delay the tax cuts until late in the financial year
- a decision to publish the old NIF forecast in the Red Book, unless that due on May 23rd is "better" than the present one.

OTHER ISSUES

17. The information currently available about the economic prospect and the effects of the budgetary package need to be supplemented in the following respects with

(a) a full presentation of the contribution, if any to public spending economies in year 1 of the decisions made or expected on cash limits;

(b) an assessment of the internal consistency of an £8bn PSBR, a 7-11% monetary target and the pattern of interest rates they would jointly imply;

(c) an estimate of the path of the RPI over the next 6-12 months implied by current fiscal proposals and the possible increases foreseen in Nationalised Industry prices etc;

(d) a "mock-up" of the Red Book forecast, taking the present NIF as modified by the latest Treasury estimates of the macro-affects of the overall package;

(e) an analysis of the effects of the proposed package on the PSF Deficit (as well as PSBR) in £bn and as GDP shares;

(f) an early indication from the Inland Revenue as to whether these are insurmountable problems in cutting in some taxes in the middle of the financial year.

18. Finally there needs to be very careful consideration of the timing of the present short-term forecast, due at the moment on May 23rd. On the face of it, there is an overwhelming case for advancing it, suppressing it or delaying it by at least a month.

Confederation of British Industry
News Release

21 Tothill Street London SW1H 9LP Telephone 01-930 6711 Telex 21332

P.34.79

NOT TO BE PUBLISHED OR QUOTED BEFORE 11.30 HOURS ON MONDAY 14 MAY, 1979.

INCOME TAX CUTS SHOULD BE GOVERNMENT'S FIRST PRIORITY

CBI'S BUDGET ADVICE TO NEW CHANCELLOR

The first priority of the new Government must be to reduce income tax to the fullest extent possible. That is the advice given to Sir Geoffrey Howe, the Chancellor of the Exchequer, today (Monday 14 May) by the Confederation of British Industry in its representations on the tax changes businessmen would like to see in his first Budget.

The CBI calls for:

* a cut of 1p in the basic rate of income tax from 33p to 32p in the £
* a reduction in the top rate of tax on earned income from 83p to 60p in the £
* substantial increases in the starting points and a widening of the bands at which the higher rates of income tax are payable
* a ten per cent increase in personal allowances (including the indexation already provided for in the caretaker Budget)

These cuts, and other changes proposed by the CBI, would cost £1,000 million in the present tax year and £1,675 million in a full year. This money should be found by cuts in the Government's spending plans and, if this is not possible or acceptable, by increases in indirect taxes - for example standardising VAT at 10 per cent and other indirect taxes could be raised to yield up to a further £500 million, says the CBI.

..../2

REDUCE SPENDING PLANS

Since the CBI presented its Budget proposals to the last Government in February, new information has suggested there may be a greater possibility of cash limits reducing planned Government expenditure during 1979-80. There may thus be a better chance within a public sector borrowing requirement of £8,500 million of making these tax cuts without the £1,000 million increases in indirect taxes envisaged.

The CBI's recommendation in February of a broadly neutral Budget still stands. "There has been no lessening of inflationary pressures and dangers, so that we cannot advocate an expansionary Budget.

Nor is there any stronger case than there was before for a Budget designed to depress the level of activity. Profits remain very low; unemployment is likely to start to rise and - with some important exceptions - lack of demand remains the most important factor limiting output by industry and commerce", says the CBI. Sterling is considerably stronger and at its present level manufacturing unit labour costs are some 15 to 20 per cent higher in relation to our overseas competitors than they were two years ago.

"The change of Government means that potential economies in Government spending plans can be looked at with a fresh political will and this will be all the more necessary in view of the new Government's commitment to increased expenditure in certain areas." Economies of £1,000 million to £1,500 million - about 2 per cent of the total-should be made in planned spending in 1979-80 so that Government spending is no higher this year than last and is held in real terms to approximately the same level as in 1976-77.

SELL GOVERNMENT ASSETS

"We would welcome a programme for selling certain Government assets provided that sales affecting businesses are only made after full consultation with those concerned and without damage to the business. We recognise that such a programme may take time to plan and implement", says the CBI. "We emphasise the need for fully competitive pricing in the public sector industries".

..../3

There is no economic justification whatsoever for the present level of tax rates. Britain's top rate of 83 per cent on earned income, reached at £26,000 a year compares with a top rate on earned income of 56 per cent in Germany which is not reached until an income of about £70,000 a year. When in Opposition, present Ministers said our top rate should be cut to the European average, which they put at 57 per cent.

It is also indefensible that at the lowest levels of income, even after the "Rooker-Wise" increases in personal allowances, single people should start to pay income tax on wages of barely £20 a week and that a married man earning £50 a week should have to pay over £4.50 of this to the Inland Revenue on top of his National Insurance contribution of £3.25.

NEW INCENTIVES

Reducing the burden of income tax would improve individual incentives, making it more worthwhile for people to acquire and use improved skills and take on increased responsibilities. Effective differentials would widen, without inflationary pay increases, so helping employers to recruit and retain skilled workers. Take-home pay would be improved, reducing the pressure for inflationary pay increases. It would be more worthwhile to take the risks involved in setting up and expanding a small business. Gifted and successful people would no longer have powerful tax incentives to leave the country or disincentives to return. The insidious increase in illicit payments and the decline in tax morality generally could be halted and reversed. Investment in companies by individuals would be encouraged because the post-tax return would be greater.

The CBI remains strongly opposed to the employers' National Insurance surcharge on the grounds that it reduces employment, worsens the balance of payments, raises price increases and squeezes profits. For many the rate of contributions has risen from 8½ per cent in March 1977 to 13½ per cent now. The CBI welcomed the recognition by Sir Geoffrey Howe in March this year that "it would be an act of grotesque folly for the Government at this stage to increase the burden of taxation on industry by increasing the National Insurance surcharge".

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COMMITMENT TO MORE TAX CUTS

The CBI says that at least as important as anything that can be achieved in the Government's first Budget will be the indication of medium-term policy which the Chancellor gives. It calls for a firm commitment to reduce the overall burden of income tax by 30 per cent over the next two or three years, to reduce the top rate on earned income to 50 per cent, and for the basic rate to be cut to 30p in the £ (or less if the 25 per cent lower rate is abolished).

The CBI says that the tax burden on companies is far too high. While the revenue from corporation tax amounted to £4,000 million in 1978-79 the total tax paid by companies, including corporation tax, NIS, employers' social security contributions, and rates, was over £11,000 million. There should be a commitment to reduce the burden on companies, a renewal of the promise given in the 1972 Budget to ensure stability of investment incentives, and the maintenance of the stock relief system pending the introduction of a permanent inflation accounting system.

ABOLISH PRICE COMMISSION

Outlining other economic policies which would be helpful, the CBI says that the level of profits, the main incentive and source of finance for expansion and investment, needs to be raised very substantially and the Government should accept firm responsibility for establishing the conditions in which this is possible. Smaller firms must be given a fairer deal. The Price Commission should be abolished at once. So should dividend controls. Company accounts should be reformed to adjust for inflation.

The CBI's Budget document says that it seems likely that a high exchange rate may prove a constraint on growth, especially in view of the loss of cost competitiveness over the past two years. There is need to press ahead with measures to moderate pay settlements and raise productivity. The National Insurance surcharge, which is a tax on exports and in effect a subsidy on imports, should at the very least be drastically reduced at the earliest possible opportunity.

There is absolutely no case for retaining exchange controls on investment abroad. These may be artificially holding the exchange rate above its true market level and thus eroding our industrial and commercial base and at the same time inhibiting the building up of assets abroad, the income from which would help to cushion the adverse effects on the balance of payments when North Sea oil production begins to decline.

Full details of CBI's Budget representations are given in the attached document.

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ERRATA

Page 22

The first paragraph under the heading PROFITABILITY should read:

> The level of profits - the main incentive and source of finance for expansion and investment - needs to be raised very substantially.

Page 28

The fourth paragraph of the CONCLUSION should read:

> It is disturbing that, at a time when we are enjoying the growing benefits of North Sea oil, the prospects for growth have deteriorated. One important reason has been the growing loss of cost and price competitiveness during the past couple of years. We also suffer from lack of competitiveness in other forms, including ability to deliver - and on time - what customers want at home and abroad.

Econ. Policy

1

1. ~~Bdgt~~ MS
I have told the Treasury.
2. p.a.

TL 11/5

PRIME MINISTER

Announcement of the Budget date

You told Ken Stowe that you had it in mind to announce the Budget date (12 June) in your speech in the debate on the Address.

The normal way of announcing the Budget date is for the Leader of the House to do it in his Thursday business statement - in reply to an arranged PQ from the Leader of the Opposition. However, the Treasury can see no reason why you yourself should not announce it if you so wish.

Will you announce it? Or shall we leave it to the Leader of the House - i.e. next Thursday?

Leave it to the Leader of the House. I just wanted it known as soon as possible.

TL.

MG

10 May 1979

SECRET

File T

3

b.c. Mr. Ridley
Mr. Wolfson
Mr. Ryder

Econ Pol

10 DOWNING STREET

From the Private Secretary

MR. VILE

The Prime Minister has now had an opportunity to consider Sir John Hunt's brief of 4 May on the Budget. She has made the following comments:

(i) On the overall stance on demand management, the Prime Minister's view is that we should not be aiming at any stimulus to demand, and that cuts in direct taxation will have to be completely off-set by reductions in public expenditure and increases in indirect tax. She believes that there can be no scope for a stimulus to demand until we see real improvements on the supply side of the economy.

(ii) The Prime Minister fully agrees that we must keep tight control over the growth of money supply. She has commented: "Expanding money supply does not necessarily go to expansion. Last time it went into property prices." If, as the brief suggests, some increase in interest rates will be needed to keep the monetary aggregate within the existing 8 - 12% target, she believes that the target will have to be reduced. The Prime Minister does not go along with the view that the Conservative Administration, because it may be able to sell more gilts as a result of greater market confidence, may be able to afford "slightly higher PSBR".

The PM must have meant that the PSBR will have to be reduced TL. 8/5

(iii) The Prime Minister has commented that there should be no change in the National Insurance surcharge in the Budget.

/(iv) On

SECRET

(iv) On nationalised industry prices, she is disinclined to raise gas prices further.

(v) On cash limits, the brief says that the Government are committed to implementing in full the recommendations of the armed forces pay review body and that "this will impose a squeeze on MOD expenditure unless you are prepared to increase their cash limits". The Prime Minister has commented that in this case, we should be prepared to increase the cash limit.

The Prime Minister has noted Sir John Hunt's summing up. She has already had an informal discussion with the Chancellor about the Budget (I enclose a note on some of the points which they covered); and she would like to have a collective discussion on the Budget, as Sir John Hunt suggests. This discussion should include consideration of expenditure cuts. The Prime Minister has not taken a view as yet on whether this should be in MES Committee or in Cabinet (or in both).

T. P. LANKESTER

8 May 1979

SECRET

cc Master set.

2

c. Mr. Stowe
Mr. Ridley
Mr. Wolfson
Mr. Ryder
Mr. Cartledge

NOTE FOR THE RECORD

The Prime Minister called me and Mr. Ridley in to the latter part of a meeting which she had with the Chancellor of the Exchequer this evening. While we were present, the following points were made.

i) The Prime Minister raised the question of whether it was necessary to back-date to the beginning of this financial year direct tax cuts in the Budget. She understood that there could be administrative difficulties in achieving this - the Inland Revenue would no doubt complain about the extra work load. Nonetheless, it was vital that there should be no back-dating. In this way, there would be revenue savings, and the tax cuts would not look significantly less than if there was full back-dating. The Chancellor agreed to follow this up.

ii) The Prime Minister said that, in her view, the sale of assets could make a very useful contribution to getting the PSBR down. She had particularly in mind the sale of derelict land. She thought Irwin Bellow would be able to provide good advice on this. Mr. Ridley pointed out that too much dependence on sale of assets to finance PSBR reductions would be bad for confidence. The Prime Minister agreed that a balance was needed as between this and other measures.

iii) The Prime Minister said that the Budget, in her view, should not involve any stimulation of the economy. It was essential to secure a signficant reduction in PSBR and also to reduce the growth of the monetary aggregates.

iv) As regards public expenditure cuts, the Prime Minister said that Departments should not be told what particular activities to cut but rather to make reductions of particular amounts: thus, it would be for spending Ministers to decide where to cut. However, it would still be necessary for them to consult with colleagues on the political aspects.

SECRET

/ v) The Chancellor

v) The Chancellor said that inflation was likely to rise over the next six months even in the absence of any increases in indirect tax. The Prime Minister said that in view of this, and if there were to be increases in VAT, it would be important to maintain a high exchange rate. The Chancellor mentioned the worries which the CBI had expressed about the growing price uncompetitiveness of some areas of industry as a result of sterling's strength. The cheapening of imports of raw materials was of course a benefit from having a high exchange rate; but a high exchange rate also meant cheaper imports of manufactured goods.

vi) The Prime Minister questioned whether any immediate decisions were required on EMS. The Chancellor replied that no immediate decisions were required. It would be best to leave over the question of joining the exchange rate regime until the review which the EMS members had agreed for September. He hoped to insert a sentence in The Queen's Speech on EMS which would imply a neutral position for the time being. The Prime Minister could take the same line in her discussions with Chancellor Schmidt later this week. In addition, there was the question of whether we should deposit 20 per cent of our reserves with the European Monetary Cooporation Fund and receive ecus in return. On the face of it, this was only a paper transaction; and it could be done without any difficulty.

vii) The Prime Minister said that she hoped that the Finance Bill would be short and straightforward. The Chancellor said that he hoped it would be but there were certain tax changes which could involve a significant number of clauses. He mentioned changes in CGT to allow for the effect of inflation. On this, he proposed to go for either indexation or tapering, whichever proved simpler. The Prime Minister said that she would prefer tapering. Mr. Ridley said that the Chancellor's ideas for changing stock relief could also involve complex drafting.

/ viii). The Prime Minister

viii) The Prime Minister raised the question of raising the £25,000 cut-off point for income tax relief on mortgages. She thought that this cut-off was holding back the housing market above a certain level. The Chancellor said that he would prefer to remove the surcharge on stamp duty for purchases above £15,000. This would be no less popular, and by reducing the fixed cost of housing transactions, it would help to improve mobility. The Prime Minister agreed that the Chancellor should try to find the extra revenue to make this change.

T.L.

7 May 1979

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SECRET

Ref. A09464

PRIME MINISTER

The Budget

The 3rd April Budget was of course a holding operation. A new Budget needs to be introduced as soon as possible. The longer it is delayed, the greater the revenue loss in the current year from any increases in indirect taxes. (Cuts in direct taxes can of course be backdated to the beginning of the financial year). Delay would leave little time for completion of the Finance Bill without cutting into the Summer Recess. The Treasury think 12th June is the earliest feasible date.

2. The Chancellor will no doubt let you have an early appreciation of short-term prospects. This will inevitably be based on a "neutral" forecast (i.e. reflecting continuation of existing policies) and will thus only provide a starting point for the new Government: a full and more detailed forecast will be ready in about 2-3 weeks after the election. The main features of the present forecast are:

13-14% earnings

(i) Earnings and Prices: the outturn in the present round is likely to be about 13-14 per cent, in both public and private sectors. Prices will be rising by around 11-12 per cent during 1979. In 1980, without changes in policy, both pay and prices would be increasing at about the same level.

11-12% prices

1½% growth

(ii) Growth. About $1\frac{1}{2}$ per cent in 1979 and 1980, involving some rise in unemployment, but the current account remaining in balance in 1979 and moving into deficit in 1980.

£10b 79-80.

(iii) PSBR. Rising from about £$8\frac{1}{2}$ billion in 1978-79 to about £10 billion or a little more in 1979-80, and a further increase the following year. Company profits remaining low, but no widespread liquidity problem because of low stock building and downturn in investment.

Then target must be reduced.

(iv) Domestic and External Monetary Policy. Assuming that the 8-12 per cent monetary target range continues - see below - some increase in interest rates would be needed. The present upward movement in the exchange rate will probably be reversed later in the year.

3. Thus the overall picture in the short term on present policies is a rising rate of inflation and slow growth, leading to continued uncertainty and instability.

4. The main problems to be faced in framing the Budget are:

(a) The overall stance - demand management. With the economy still depressed, the conventional response in past years would have involved a mild budgetary stimulus. This year, until recently, the confidence factor seemed to rule this out. But sterling continues strong. In addition a Conservative Government with clear long-term policies on public expenditure can probably rely on confidence remaining high even if it decides to go for gentle expansion. So one of the first decisions the Chancellor will want to discuss with you is whether to aim at some stimulus to demand, or whether to offset the cuts in direct taxation completely with reductions on public expenditure and increases in indirect tax. Obviously you will not want to allow very much net stimulus until there have been real improvements on the 'supply' side of the economy; otherwise increased demand merely fuels inflation and sucks in additional imports. On the other hand you are relying on the direct tax cuts to produce the necessary dynamic improvements. So there is a chicken-and-egg problem here.

No
Yes
Agreed

(b) Money supply. Your policy - especially for pay and inflation in the private sector - depends on keeping tight control over the growth of money supply. You will want to balance this against the need for expansion. The previous Government was committed to keeping control over money supply (expressed as a 12-month target growth range of £M3, rolled forward every six months). The present published target runs to October 1979. The City expects the Chancellor to announce in the Budget a new target up to April 1980. In setting a new target the main elements are the PSBR, external policy (including intervention on the exchanges), interest rates and direct controls on the banking system. Here too a Conservative Government may have the advantage of greater market confidence: because it will be able to sell more gilts as a result,

Agreed

Expanding money supply does not necessarily go to expansion. - but leaks into property prices.

No it will probably be able to afford a slightly higher PSBR at least in the short term, for any given rate of money supply expansion. This may help a bit in finding room for net cuts in taxation.

(c) On the latest information, allowing for the Rooker-Wise indexation and published public expenditure plans, PSBR is likely in the current year to be around £10-£10.5 billion ($5\frac{1}{2}$ per cent of GDP). Its composition will be as important in many respects as its size, both for its direct monetary effects and its effect on market confidence. Despite the favourable factors mentioned in (b) above some reduction will be necessary to keep the money supply within the existing 8-12 per cent target range during 1979-80. You will need to judge what reduction is feasible in the current year, given the late date of the Budget, and how to balance tax changes and public expenditure to achieve this.

Agreed

(d) Direct taxation. Once the central budget judgment on the permissible size of the PSBR has been made, and a view taken on growth in the coming year, the problem is to balance cuts in personal taxation (beyond the Rooker-Wise indexation in the recent Finance Act, which is allowed for in the forecast) with increases in indirect taxes and cuts in public expenditure. The more you aim for cuts in personal tax the more of offsetting action you will need on indirect taxes and expenditure. Illustrative figures on possible cuts in direct tax are: reducing the top rate to 75 per cent, and revalorising the bands to April 1973 levels, would cost about £800 million in a full year, and £450 million in the current year; each penny off the basic rate of income tax has a revenue effect of about £$\frac{1}{2}$ billion; and to increase the main single and married personal allowances by, say, £50 and £100 respectively, on top of revalorisation, could cost about £600 million in a full year.

(e) Indirect taxation.

(i) VAT is the prime runner for raising new revenue. The options include harmonisation of the two rates at 10 per cent or $12\frac{1}{2}$ per cent; or moving both rates up. Harmonisation at 10 per cent would bring in about £900 million in a full year and

£400 million in the current year and add 0.9 per cent to the RPI. Harmonisation at 12½ per cent would bring in about £2250 million in a full year (£1200 million in the current year) and add 2.1 per cent to the RPI.

(ii) Specific duties. The options here are to increase (revalorise) the rates of the specific excise duties (alcohol, tobacco, petrol). Straight revalorisation to last year's level would yield about £400 million, and add 0.5 to the RPI. To return to 1977 levels would roughly double these figures. There is a good case on energy conservation grounds for increasing petrol tax anyway, particularly if you maintain the previous Government's decision to phase out VED in the next few years. There are good health arguments for putting more on alcohol and tobacco.

Take them to 78's.

Petrol will go up because of V.A.T.

(iii) National Insurance surcharge. Sir Geoffrey Howe virtually ruled this one out in the Budget debate. The earliest date a change announced in a June Budget could take effect is the beginning of October.

No change.

(iv) Nationalised Industry prices. These have much the same effect as indirect taxes. Some increases will be needed anyway to achieve even the published targets for nationalised industry borrowing. (See below under 'public expenditure'). If you want to go further, the main candidates are probably gas prices (dealt with in the separate brief on energy) and postal/telecommunications charges.

No

(f) Public Expenditure. There are two main problems: some inevitable (mainly statutory) increases in expenditure on social security side (allowed for in the forecast) and the long-term search for structural changes leading to real reductions. Notes on each one:-

(i) The normal uprating of social security benefits next November had been built into the forecast, and administrative action is already in hand. To delay it would have made it impossible to pay out on time. The previous Government were also committed to a

50p increase in child benefit in November which would cost about £100 million this year and £300 million in a full year. It is not allowed for in the forecast. There is no immediate pressure for any other changes, though there may be small concessions (e.g. the pre-1945 widows) which you will want to make. There is no statutory obligation to increase child benefit, but the uprating of the main national insurance benefits is required annually under existing legislation.

(ii) On the generality of public expenditure, you are committed to large and early cuts. The Treasury will be suggesting a possible 1979-80 package to the Chancellor, and he will probably want to put it to Cabinet very soon. It is likely to involve a mixture of policy changes, sales of assets, and trimming of the Contingency Reserve for the rest of the year. You will obviously need an early Cabinet discussion on this. The immediate question is how much saving you can secure in time for the Budget.

(g) Cash limits for the rest of the year. You have made it clear that cash limits will be one of the main weapons used by the Government to control expenditure, and by implication to maintain restraint in the public sector. Since their introduction cash limits have worked well as a control: but those for this year have already been increased, and corresponding RSG support promised, to allow for those public sector settlements which had been reached for various local authorities groups during February and March. Otherwise, the cash limits have been maintained at the level assumed in January. They will therefore come under increasing pressure during the year both from pay and price increases over and above the assumed levels. In the Health Service and in central Government, to maintain the level of cash limits in the face of approved pay increases implies a volume squeeze on expenditure. You are committed to implementing in full the recommendations of the Armed Forces Pay Review Body, and this will impose a similar squeeze on MOD expenditure unless you are prepared to increase their cash limits. Yes

There is a similar problem in the nationalised industries, where the PSBR forecast assumes that their borrowing is held constant, and that the extra cost of recent pay settlements, over and above the original forecast assumptions will be met by increased prices or reduced investment. You will need an early paper from the Treasury on all this so that the Ministers concerned (most of the Cabinet) can agree together on the line to be taken.

5. To sum up, you will need:

(i) An early discussion with the Chancellor about the main shape of the Budget.

(ii) Probably - though this is for you to decide - a general discussion in a Ministerial Economic Strategy Committee and/or Cabinet on the same theme. - especially on P.E cuts.

(iii) At least a first round of specific decisions by Cabinet about public expenditure cuts (though a fully worked out strategy for public expenditure in the longer term is unlikely to be feasible before 12th June).

(iv) Specific decisions by Cabinet about nationalised industry borrowing (and thus prices and investment) for the remainder of the year.

[illegible] 4/5

(John Hunt)

END

Filmed at the National Archives (TNA) in London

February 2010