PREM 19/700

PART 6

SECRET

M.T

CONFIDENTIAL FILING

The 1982 Budget.

Review of Corporation Tax & Stock

ECONOMIC.

POLICY.

PART 1 MAY 1979

PART 6 SEPTEMBER 1981

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~5-11-81~~							
~~10-11-81~~							
~~18-11-81~~							
~~23-11-81~~							
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3-~~12-81~~							
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~~27-1-82~~							
28·1·82							
ENDS							

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PART 6 ends:-

28.1.82

~~Mec to Sir Ray Pennock of 29/1/82.~~

PART 7 begins:-

RTA to CAW (A07304) of 1/2/82.

TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
C(82)1	26.1.82
CC(82) 3rd Conclusions, Minute 5	28.1.82

The documents listed above, which were enclosed on this file, have been removed and destroyed. Such documents are the responsibility of the Cabinet Office. When released they are available in the appropriate **CAB** (CABINET OFFICE) CLASSES

Signed CWayland Date 14 August 2012

PREM Records Team

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

27 January 1982

M. Pattison, Esq.,
Private Secretary,
10, Downing Street

Dear Mike,

ECONOMIC DEBATE: 28 JANUARY

I understand that the Opposition have put down the following Motion:-

"That this House believes that the Government's deflationary economic policies are the prime cause of the massive decline in output and the massive rise in unemployment from which we have suffered since May 1979; and that it is only through a major and planned expansion of production and demand that the nation can be put back to work."

The Chancellor assumes that an amendment should be tabled, and would be content with one along the following lines:-

P.T.O.

"[That this House] endorses the continuation of Government policies to reduce inflation, improve output, restore prosperity, and so create improved prospects for employment, on a lasting and sustainble basis; and welcomes the clear evidence that such policies are bringing success."

Copies of this letter go to David Heyhoe in the Lord President's Office, Murdo MacLean at No.12.

Yours ever,

J.O. KERR

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SECRET

Qa 05796

To: PRIME MINISTER

From: J R IBBS

27 January 1982

Economic Strategy - C(82)1

1. The second half of the Chancellor's paper invites views on where a possible tax cut might best be directed.

2. In my view the economic arguments are strongly in favour of a cut in National Insurance Surcharge (NIS). Annex 3 reminds us that the average real rate of return for all non-North Sea companies, let alone manufacturing, has come down to an appallingly low level (Table 4), while the tax burden has not fallen (Table 5). If they are to win their share of expanding markets companies will have to increase investment in new products and processes. Before they can expand investment they need a recovery in their profitability, and some reassurance to stimulate their confidence in future prospects. A cut in NIS would reduce the tax burden on companies and directly help their profits. Without better profits and more investment in the UK, an undue proportion of greater demand in home and overseas markets will be met by our competitors and will not help UK output or employment. On the other hand experience suggests that cuts in personal taxation may have limited helpful effect because of an increase in demand for imports.

3. The Chancellor refers to a risk of leakage into wages. I accept that there is some risk. But hard pressed companies themselves know all too well how necessary it is to use any profit improvement on investment to keep up with their competitors. Increasingly they are getting this message across to their workforce. There is obviously a timing point here. Fear of leakage to wages cannot be allowed indefinitely to restrict recovery of profits; this would ensure continued industrial decline.

4. There is a separate and equally strong case for cutting NIS, namely as an aid to employment. The immediate cause of unemployment is that companies cannot afford the costs of employing more people or are

uncompetitive because of employment costs. NIS is part of these costs and hence any cut (like a cut in real wages) will help to create more jobs. In this context because a cut in NIS would also help service industries it would be more helpful than a change limited to the manufacturing sector.

5. I am sending a copy of this minute to Sir Robert Armstrong only.

JRJ.

15

Ref: A07258

SECRET

PRIME MINISTER

Economic Strategy
(C(82) 1)

BACKGROUND

In C(82) 1 the Chancellor of the Exchequer seeks the views of Cabinet on the appropriate level of the Public Sector Borrowing Requirement (PSBR) in 1982-83 and on how any fiscal relief which proves practicable might be distributed between taxation measures directly affecting prices, reducing income tax and assisting companies.

2. He will take account of these views in preparing his Budget, but he will not wish to be bound by them either in terms of amounts or of the direction in any detail. He will want to avoid if possible any commitment to further collective discussion in the run-up to the Budget; although, as is the normal practice, he will be ready to discuss particular points bilaterally with individual Ministers (eg those on small firms, new technology and the construction industry made by the Secretary of State for Industry in his letter of 26th January copied to you and some other Ministers).

THE LEVEL OF THE PSBR IN 1982-83

3. The public expenditure discussions in the Autumn were on the basis that the Government should plan for a PSBR in 1982-83 not greater than the £9 billion foreseen at the time of the 1981 Budget. As explained in paragraph 6 of C(82) 1, the current forecast gives a provisional figure of 'rather less' than £9 billion; this is on the assumption that income tax thresholds and excise duties will both be increased in line with inflation (Annex 2 of C(82) 1 tabulates the effects on income tax allowances and on prices). By referring to a range of between £7 to £8 billion and £9 billion for the PSBR the Chancellor of the Exchequer implies that the scope for fiscal adjustment could be in the order of £1½ billion; as you will know but not the Cabinet generally, the present forecast on present policies is of a PSBR of £7½ billion. Against this background there are three broad options for planning for the PSBR in 1982-83.

4. First, the aim could be to plan for a PSBR of £7 to £8 billion. As the Chancellor points out in his paragraph 7, this would give the prospect of lower interest rates which would assist recovery and be helpful both to industry and to personal borrowers, including mortgagors. It would mean, however, forgoing the possibility of fiscal relief over and above revalorisation. As such, it is likely to be regarded by most members of Cabinet as unattractive.

5. Secondly, the PSBR could be higher than £9 billion so as to open the way to fiscal relief of more than the £1½ billion now in prospect. In his paragraph 8, the Chancellor of the Exchequer warns strongly against this course which could lead to higher interest rates, damage confidence, risk a fall in sterling and so have adverse consequences for inflation and for the prospects for recovery.

6. Thirdly, the Government could continue to plan for a PSBR in the order of £9 billion, and use some or all of the £1½ billion 'saving' which has now emerged for fiscal relief. This would add to the risks of higher interest rates; on the other hand, £9 billion is the figure the markets are broadly expecting and it would not be seen as reflationary (though some care would be necessary in explaining how the leeway for tax relief emerged).

THE FISCAL OPTIONS

7. Without getting tied to particular figures or to details, the Chancellor of the Exchequer would welcome views on how any relief which might turn out to be possible should be distributed.

8. Some Ministers may wish some of it to be allocated to additional public expenditure - to deal with problems emerging on particular programmes or to stimulate industrial activity by way of further capital expenditure or an increased programme of selective financial assistance to industry (e.g. the FLAG A. — Secretary of State for Industry proposes in his letter of 26th January, an "innovation package" costing £45 million in 1982-83). The Chancellor of the Exchequer is likely to argue strongly against this. The Public Expenditure White Paper, which will be published on Budget day, provides for a planning total in 1982-83 of £115.3 billion, including a contingency reserve of

£$2\frac{1}{4}$ billion. This planning total, which follows Cabinet's decisions in November, is about £5 billion higher than envisaged last year. Any further increase could be ill-received and represented as a weakening of the Government's stance on public expenditure. The Chancellor of the Exchequer will argue that it is better to help industry, and individuals, through the tax route. If increases on particular programmes were judged to be necessary they could be dealt with as claims on the contingency reserve. (The Chief Secretary is sending you the draft of the White Paper today, and asking you and members of the Cabinet for any comments by next Tuesday, 2nd February.)

9. If it is accepted that there should be no further increases in public expenditure - or that, at most, only a small part of the fiscal adjustment should take this form - the discussion then focuses on the tax options. There is a useful ready reckoner at Annex 5 of C(82) 1.

10. In looking at the possibilities for a tax relief package in the order of £1 - £$1\frac{1}{2}$ billion, and assuming that some of the total will be reserved for more detailed measures such as relief in capital taxes, the broad choice is between the following three categories, and permutations between them, of measures:

(i) directly affecting prices;

(ii) reducing income tax;

(iii) directly assisting companies.

Annex 4 sets out the broad consequences of each of these three categories of an illustrative £1 billion reduction. You will note that there is no difference in 1982-83 between them in terms of Gross Domestic Product and of numbers unemployed and not much difference in the following year.

11. In looking at the three categories Cabinet might bear in mind the following general points:

(i) A choice has to be made between the major options of 1p off the basic and higher rates of income tax (first year cost £910 million) and 1 percentage point off the National Insurance Surcharge (NIS) (first year effect £700 million).

(ii) The full year (1983-84) effect of 1 percentage point off NIS or VAT is markedly higher than that in the first year (1982-83); care must be taken not to reduce the room for manoeuvre in the 1983 Budget and, in particular, not to run a risk of having to retrench in that year.

(iii) "Helping individuals" and "helping companies" should not be seen as mutually exclusive alternatives. Companies will benefit from changes in personal taxation and in excise duties through increased demand, reduction in the Retail Price Index (RPI) and possibly, some reduction in the pressure for wage increases. But the benefits to companies of changes in personal taxation would come through to companies more slowly than changes in company taxation, and in more diffused form: companies would be less able to identify them, and would therefore feel less benefited than by changes in company taxation.

MEASURES DIRECTLY AFFECTING PRICES

12. The possibilities include less than full revalorisation of excise duties or a reduction in the rate of VAT. Advantages are:

(i) a reduction in the RPI, helpful to individuals and to companies (Annex 4 assumes that £1 billion less in indirect taxes would reduce the RPI by 0.7 per cent in 1982-83);

(ii) avoiding or reducing increases on tobacco and alcohol, and on petrol and derv (where there are special Parliamentary sensitivities to be taken into account, because of the effects on those who live in rural areas).

But:

(a) concessions on tobacco and alcohol will be criticised by others as a curious priority;

(b) energy conservation arguments point against real reductions in the duty on petrol.

REDUCTIONS IN INCOME TAX

13. Advantages:

(i) A rise in take home pay could help in wage negotiations.

(ii) Checks trend of growing total tax burden since 1978-79 - see Annex 3.

(iii) Helps with poverty trap and "why work" problems.

But not such a quick or direct help to industry as the third category and, if 1p is taken off each band, there is no room left for a major move on company tax burdens such as a reduction in NIS.

HELP FOR COMPANIES

14. Advantages:

(i) Boost to company profits and confidence, and welcome as a response by the Government to the views of industry.

(ii) Possibly welcome by persons (as well as by companies) as a move which could, over time, help employment and avoid more closures.

But:

(a) NIS relief, in particular, could leak into wages and could relax the pressure for productivity improvements.

(b) NIS relief benefits banks and North Sea sector which do not need it so much (less than $\frac{1}{3}$ of NIS payments are by manufacturing industry).

(c) Much more costly in full year 1983-84 than in 1982-83.

HANDLING

15. After the Chancellor of the Exchequer has introduced his paper it is likely that each member of the Cabinet will wish to speak. The two main questions before them are:

(i) What is their view on the PSBR for 1982-83.

(ii) How could any relief be best distributed between individuals and the company sector bearing in mind the main advantages and disadvantages of each category (paragraphs 13 to 14 above) and the need to take account of the impact on the 1983 Budget.

In practice it may not be possible to structure the discussion to deal with these two questions separately, and you may prefer to go round the table seeking the views of each Minister on both.

16. You might ask the Secretary of State for Industry to speak first so that the Cabinet can take account of his views on the needs of industry. You might call fairly early in the discussion on the Secretary of State for Social Services to advise on the relevance of the options to the social security programmes and on the Secretary of State for Employment to give his assessment of the impact of the options on wage bargaining and on the RPI. The Lord President and the Chief Whip may comment on the priorities as seen by backbench opinion (I have the impression that the Lord President may be reasonably content, if the Cabinet endorses the £9 billion target for the PSBR). You might bring the Chief Secretary in towards the end of the discussion to deal with any points on public expenditure and finally, before you sum up, ask the Chancellor of the Exchequer to give his general reactions to the discussion.

CONCLUSIONS

17. In summing up you will wish to reflect the consensus - or the balance of views - on the size of the PSBR in 1982-83 and on the options for distributing any relief. You will wish to make clear that the Chancellor of the Exchequer is not committed by the discussion to particular changes in his Budget and you will want to avoid any commitment to further general discussion by the Cabinet apart from the traditional discussion immediately preceding the Budget.

18. You might then record conclusions which:-

(i) invite the Chancellor of the Exchequer either to take account of the views expressed in discussion in his further work on the Budget or - if there is widespread pressure for a stronger formulation - to be broadly guided by your summing up of the discussion;

(ii) invite any Minister who has particular points on possible tax changes to discuss them directly with the Chancellor of the Exchequer or, in the case of public expenditure points, with the Chief Secretary.

RTA

Robert Armstrong

27th January 1982

JH 222

CONFIDENTIAL

Prime Minister A ②
MES 26/1

cc AD

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

26 January 1982

The Rt Hon Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
London SW1

Dear Geoffrey,

1982 BUDGET

Your Budget will be critical to the relationship between the Government and private industry. In 1979 industry was prepared to accept a tough period and there was widespread support for our policies. Three years later, there is general recognition that companies have become more efficient. Operating costs have been cut, productivity has improved, many restrictive practices have been abandoned. But private industry has achieved this at great cost in loss of output, closures and failures, while other sectors of the economy appear not to have suffered comparably. The continuing burden of the public sector on private industry in the form of the National Insurance Surcharge (NIS) and constantly rising local authority rates and nationalised industry charges (especially energy charges) is causing great resentment. Industry feels that the improvements it has made by its own efforts are being negated by others who have not borne the brunt. Inevitably the Government is blamed; and the result is we do not get the credit for the real achievements of our policies.

2 In recent months, of course, the position has improved. Output has increased and the worst of the recession is now past. I wish I could advise you that industrial recovery will now take its course without substantial new measures. Unfortunately, the situation and prospects do not allow me to do this. Profitability remains at or near a record low and there is no prospect of any substantial improvement. For all industry's efforts, only a third of the loss of competitiveness suffered in recent years has been recovered. British companies are in a weak position to face the challenge of new technology and the markets of the next decade.

3 I believe it would be right this year to allow full revalorisation of allowances and duties. You will also want to ensure that the Budget is seen as contributing to the imperative problem of unemployment. Measures which strengthen industry will, however, help to secure and promote employment in the long

term in addition to their immediate and direct effect. I believe that what I propose could be effectively presented in that light.

4 I believe we should aim for a package which can be presented as a £1½bn boost to industry in 1982/83. Clearly a package of such a size, in addition to the net effect of full revalorisation, would have important implications for the PSBR and the MTFS itself. You will no doubt be considering whether in current circumstances some short term flexibility can be applied to the PSBR without unduly adverse effects on interest rates. If there is room for such flexibility, I would most strongly urge that industry should get the benefit.

Reduction of Costs

5 Any stimulus must clearly be applied in a way calculated to minimise the effects on inflation. This points to action to reduce industry's costs forming the principal element of the package, and this accords with industry's need to become more profitable and competitive.

6 While rates and energy prices remain important sources of cost increases, I continue to believe that a 1½ point cut in the NIS should have overriding priority. A reduction in this Labour-imposed payroll tax can be presented as a measure helping employment. It should be helpful on the inflation front also. In present circumstances I believe only a small proportion (if any) of a cut would go through to wages. The bulk would be taken by companies to improve profits or keep prices below what they might otherwise be.

Small Firms and Enterprise

7 While reduction of industry's costs should be an important part of your package, I believe there should also be a more positive element. I wrote to you on 11 December with a list of suggestions for small firms and enterprise and we have since discussed this area. I believe we should look on these measures as a continuation of the positive side of the policy we have been operating since 1979.

8 In addition to the measures I listed in that letter, I believe we should follow previous practice in revalorising the VAT registration threshold and the small companies' rate of corporation tax.

9 Two further measures would be worth taking in this area:

i) The Business Start Up Scheme has been well received and attracted much interest as a radical development. It is too early to subject the scheme to comprehensive assessment. But I believe we should maintain the momentum of the scheme by increasing the £10,000 limit on qualifying investment. John MacGregor and I have received a number of representations to the effect that this limit is inhibiting interest in the scheme and is well below the sort of finance many start-ups need. An increase to £50,000 or even £100,000 has been proposed to me. You may not feel able to go that far. But an element of revalorisation would be justified on general grounds; and an increase to, say, £20,000 would also contain an element of "real" increase which would show we remain committed to the scheme's success.

I am also still being told that the scheme is surrounded with too many restrictions. I hope it will be possible to review the need for these again, particularly the denial of any benefit under the scheme to any employee or person connected with the company and the 30% limit on an individual investment.

ii) Small Workshops Scheme. My priority remains the extension on a permanent basis of the coverage of the schemes as proposed in my letter of 11 December. But we must also consider extension in time beyond the trial period which expires in March 1983. It would be appropriate to announce an extension now to give adequate notice to developers. Provided you can agree to the permanent wider coverage, I would be content to see the special 100% allowance lapse after March 1983 except for the very small end of the market. The latest official assessment shows continuing unsatisfied demand for units of 1250 square feet or less. I believe it would be reasonable to announce an extension of the 100% allowance for such units to March 1985.

10 You will be in a better position than I to cost the proposals in my letter of 11 December and the above items. I would tentatively put the 1982/83 cost of revenue foregone from industry at around £200m. It would not necessarily be right to regard the whole of the cost of the proposed CGT concessions, for example, as falling within an industrial package.

New Technology

11 Important as small firms are, I believe you should also devote a prominent section of your Budget to new technology. This is the fundamental challenge to the heart of British industry and must be the cornerstone of the positive side of our industrial policy. In Information Technology Year it would be right to use the Budget to show the Government's commitment.

12 I have already written to you (11 December) about the proposal to extend for a further two years the 100% allowance on

teletext sets purchased for rental. That move would be greatly welcomed by the industry and would be evidence of our clear determination to help it succeed.

13 In addition to this, Kenneth Baker has already discussed with you ideas for expanding our support for new technological developments, extending awareness of them throughout industry, and assisting (in a limited way) with their application. This is essentially "seedcorn" expenditure. The sums concerned are relatively modest, especially in 1982/83, but should have a high presentational value now and yield good returns for the country in later years. Our officials are discussing the details of a range of individually minor additions to expenditure. What I have in mind is that you might announce an increase of our support for new technology of some £300m over three years, with £45m falling in 1982/83. I attach a list of the kind of measures I have in mind, though it should not be regarded as definitive.

Construction

14 The construction industry is not my direct responsibility. But a stimulus to construction of, say, £¼bn would improve employment and would have beneficial consequential effects throughout industry. I very much hope you will be able to take measures to this end, with particular emphasis on maintenance work, eg on the sewerage system.

15 I am copying this letter to the Prime Minister, the Secretaries of State for the Environment, Scotland, Wales, Trade, Social Services, Energy and Employment, and to Sir Robert Armstrong.

Yours ever

Patrick

12

POSSIBLE MAKE-UP AND PES COSTS OF AN 'INNOVATION PACKAGE'

Measure	Possible costs of selective assistance over the three years 1982/83, 1983/84, 1984/85 (£M) Industry Act	S&T Act
A - Improved Production Techniques		
1 Small Firms Engineering Scheme (for buying machine tools etc)	4/6/7	
2 CAD/CAM Programme (for buying CAD/CAM equipment)	2/4/6	
3 Polys scheme for buying machine tools	1/1/1	
4 Flexible manufacturing Scheme (already largely provided for)		1/2/3
5 Extend Robots Scheme		3/8/12
B - Information Technology		
6 Improve software products scheme		2/3/5
7 Extend IT Centres		3/3/4
8 IT in Medicine		1/2/3
9 Research for Fifth Generation Computers		1/3/5
C - Electronics and their Applications		
10 CAD/CAT Scheme (for buying CA design and test facilities)	2/4/6	
11 Extend MAP		0/7/7
12 Demonstration of Advanced Instrumentation and Control		1/2/2
13 Electronics CAD/MAT (awareness, training, development of integrated systems, purchase of equipment) (already small provision)	2/4/6	0/1/2
14 Double allocation for Fibre-optics Scheme		0/7/7
15 Extend F.O Scheme for collaborative research		0/2/5
D - Various		
16 More Space (satellites) support		3/5/7
17 Components Industry Scheme for Improved Vehicle Economy	2/6/8	1/2/5
18 More public purchasing (offices of the future, etc)		0/2/5

Measure	Possible costs of selective assistance over the three years 1982/83, 1983/84, 1984/85 (£M) Industry Act	S&T Act
19 Increase grants in Energy Conservation Demonstration Project Scheme and new Heat Pumps Scheme		3/5/9
20 Quality and Standards		1/1/1
21 Widen guidelines of S.8 facility to cover computer software	0/1/1	
E - Changes in General Conditions of Support		
22 Increase maximum PPDS grant (eg from 25% to 40%)		10/25/40
23 Lower S.8 project cost limit (eg from £0.5m to £0.1m)	2/5/8	
	Total (IA) 15/31/43	Total (S&TA) 30/80/122

OVERALL TOTAL 45/110/165 (£M)

Secret and personal 13

(1)

10 DOWNING STREET

PM has seen
MCS 26/1

Prime Minister

At Ian Gow's suggestion I have put in two copies of this paper.

It seems much better to me. But it still lacks a paragraph on the political difficulty of the assumed duty revalorisation – eg. in the effect on petrol prices.

MCS 25/1

12

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

PRIME MINISTER

CABINET: 28 JANUARY

We spoke about the first draft, enclosed with my minute of 19 January, of the paper for discussion in Cabinet on 28 January. The attached revised version incorporates a number of helpful suggestions from Ian Gow; and includes some additional material on the fiscal options. The Annexes, and perhaps particularly Annex 4, are likely to be of some interest to our colleagues, and could perhaps whet the appetite for further Budget-making in Committee. I myself believe that colleagues are now looking for at least as much information as the paper and the Annexes would provide, and that it might be a mistake to try to give them less. But Annex 4 could be dropped if you would prefer this.

2. Subject to your views, I would propose to circulate the paper tomorrow. A copy of it, and of this minute, goes to Sir Robert Armstrong.

(G.H.)
25 January 1982

I shall be presenting our fourth Budget on 9th March.

Outlook for the year ahead

2. The latest forecasts predict continuing, though slow, recovery in output and a further fall in inflation, which should be at 10 per cent by the end of this year, and in single figures in 1983. Unemployment is likely to edge up a little further in 1982, though at a diminishing rate, while industrial productivity should continue to improve. The general picture is one of continuing recovery, with encouraging signs of real improvement in the economy. Annex 1 gives some figures showing the progress we have made to date. A continuation of this improvement could, of course, be invalidated by events beyond our control, whether world-wide (e.g. American interest rates) or domestic (e.g. a serious setback on pay).

3. Of course I continue to be deeply concerned about the level of unemployment. We should all like to get it down. But all previous attempts at artificially induced reflation have resulted, in the medium and longer term, in higher inflation and in higher unemployment. In political terms, any gains from another such attempt would be short-term and extremely limited. The probable impact on interest rates, the exchange rate and inflation would mean throwing away the hard-won progress of the past 2½ years - and lead to still higher levels of unemployment than those from which we are now suffering.

The right strategy

4. We must accordingly persevere in our present strategy, maintaining progress towards our key objectives: a continuing reduction in inflation; a continuing rise in output; a diminution of the (monopoly) public sector; and a strengthening of the free market economy. This is the way to secure a genuine improvement in the employment situation rather than a very small and short-lived change in the figures. The prospects are by no means poor. The rates of both wage and

good

price increases should continue to fall, with inflation down to 8 per cent or less by the end of 1983; and there should be faster growth of output in that year than in 1982.

5. For domestic and overseas confidence in the Government's strategy to be sustained we must have a credible financial framework. The markets will expect us to maintain downward pressure on the rate of monetary growth. This is crucial to confidence and to maintaining a reasonably steady exchange rate without cripplingly high interest rates. Our objectives for the period ahead will need to be expressed in terms of a number of aggregates, ~~and with more explicit reference to the exchange rate~~, rather than exclusively to £M3. If we were thought to have abandoned monetary and fiscal control, sterling would quickly prove fragile.

inflationary expectations including wage claims would explode and

Borrowing

6. Within this framework the size of the PSBR for next year is crucial. For the current year, we planned for a PSBR of £10½ billion and we are on course for this. For next year, the forecast (which may change substantially before March) gives a provisional figure of rather less than the £9 billion for which we thought it right to plan at the time of the last Budget. This forecast is based, as is customary, on the following assumptions:-

award

- (i) That public spending next year is at the level agreed in November - a planning total of £115 billion;
- (ii) That income tax thresholds will be increased in line with inflation ("Rooker-Wise");
- (iii) That excise duties will be similarly increased;
- (iv) That the tax structure and rates are in other respects unchanged.

Annex 2 shows what assumptions (ii) to (iv) mean in terms of cash increases in the allowances and price increases in the goods subject to specific duties. The impact on the PSBR of assumptions (ii) to (iv), taken together, is broadly neutral: the revenue lost through indexing the income tax allowances is nearly offset (in the first year) by the extra revenue produced by revalorisation of the specific duties.

7. The choice of the right PSBR for next year presents a problem. To go up to about £9 billion might give some limited room for modest tax reductions. But it would also involve risks for interest rates and the exchange rate. Since the last Budget the exchange rate has fallen considerably. Oil prices, which support it, have also fallen and we have had to face high interest rates. We could diminish some of these difficulties by planning for a PSBR of, say, £7 to £8 billion. We should then have a better prospect of lower interest rates, though they will probably still be uncomfortably high. For most people - industry and mortgagors alike - lower interest rates are an important objective. But we should not have any room for tax reductions, and the political difficulties are obvious.

8. The trade-off between interest rates and tax reliefs as a means of sustaining recovery is bound to be a matter of judgement - political as well as economic. But it is my belief, not least in the light of our experience of the last year, that to go for a PSBR <u>above</u> about £9 billion is likely to lead to higher interest rates than we now have, would affect confidence, and could risk so large a fall in sterling as to jeopardise the prospects of reducing inflation and impair - or even reverse - recovery.

<u>Fiscal options</u>

9. If some reductions in taxation should turn out to be possible, for the coming year, the main issue will be the balance to be struck between:-

(i) measures which would directly affect prices;

(ii) those which would reduce income tax; and

(iii) those which would directly assist companies.

Category (i) includes less than full revalorisation of excise duties, or a reduction in the rate of VAT. Category (ii) includes action to more than implement "Rooker-Wise" increases in tax allowances. The most obvious category (iii) measure would be a cut in National Insurance Surcharge.

10. The argument for category (i) changes is essentially political. We would avoid adding to the RPI: full revalorisation of the duties is assumed in the forecast. And we would avoid the unpopularity attaching to some individual increases: see the examples at Annex 2. But the more ground we give here, the less room we have for changes in categories (ii) or (iii), the case for which emerges clearly from the tables at Annex 3.

11. For the personal sector, an increase in tax allowances of 10 to 11 percentage points above inflation would be necessary to restore tax thresholds as a proportion of average earnings to their 1978-79 levels. An increase would bring benefits in wage bargaining; and would diminish the poverty trap and "why-work" problems. Assistance to the company sector is no less desirable, and category (iii) changes would have the most direct impact on companies' income, though at the risk of some leakage into wages. When second round effects are taken into account, the effects on employment, GDP and company incomes of all three categories are however very similar. Annex 4 sets out Treasury model estimates of the broad consequences of an illustrative £1 billion reduction, effected through measures falling into each of the three categories, while Annex 5 gives the revenue effects of certain specimen reductions.

Summary

12. All the signs are that our efforts to restore the economy to health are succeeding. Inflation is going down; output is going up; the rate of increase in unemployment is slackening. This Budget will be crucial. At this stage in the economic cycle previous governments have sacrificed sound finance for dubious electoral advantage. If we follow that pattern, we will risk losing all. The key for 1982-83 is the PSBR. Given high interest rates world-wide, there is an argument for going for a figure in the region of £7-8 billion but to achieve this could mean foregoing tax cuts altogether.

To go above about £9 billion would be popular politically in the short run; but it would imperil the exchange rate, interest rates, the conquest of inflation, our whole determination to create a sound economy and, in anything other than the very short-term, the creation of more real jobs. The choice for the PSBR seems to lie in a range which has £7 billion as the minimum and about £9 billion as the maximum.

13. If a figure towards the top of the range is chosen, the choice for tax reductions lies between the three categories listed at paragraph 10 above. Elements of all three might of course find a place in the final package.

14. I would welcome colleagues' views on 28 January on the two areas of choice outlined above.

G.H.

H.M. TREASURY
25 January 1982

SELECTED ECONOMIC INDICATORS, 1979-82

	1978 to 1979	1979 to 1980	1980 to 1981 (1)	1981 to 1982 (1)
[Percentage change]				
GDP (1975 prices)	+ 2	- 2	- 2	+ 1
Consumer prices (Q4)	+ 17½	+ 15½	+ 12	+ 10
Average earnings (Q4)	+ 18½	+ 19½	+ 12½	+ 7½ (3)
Exports of goods and services (1975 prices)	+ 2½	+ 1	- 5½	+ 2½
	1979	**1980**	**1981**	**1982**
Current balance (£bn)	- 1	+ 3	+ 6	+ 3
Unemployment (UK, %, narrow)	5½	7	10½	12 (3)
	1979-80	**1980-81**	**1981-82**	**1982-83**
Tax as % GDP (4)	30	31	33½	(6)
Public expenditure as % GDP (5)	41	43½	45	44
PSBR as % GDP	5	6	4	(6)

(1) Figures consistent with December 1981 Industry Act Forecast

(2) Forecasts from OECD Economic Outlook, December 1981

(3) Figures based on <u>assumptions</u> in December 1981 Government Actuary's Report relating to 1982-83 financial year

(4) Excluding NIC

(5) Including debt interest

(6) Depending on decisions to be made.

ANNEX 2

THE EFFECTS OF 12.2% INCREASE IN TAX ALLOWANCE ETC (ie INDEXATION)

Income tax: levels of allowances etc.

	1981-82 £	1982-83 (1) £
Single and wife's earned income allowance	1,375	1,543
Married allowance	2,145	2,407
Additional personal allowance	770	864
Single age allowance	1,820	2,042
Married age allowance	2,895	3,248
Age allowance income limit	5,900	6,620
Basic rate band	11,250	12,623
40% rate band width	1,999	2,244
Investment income surcharge exemption	5,500	6,171

The reductions in income tax payments for basic rate taxpayers with personal allowances increased by 12.2 per cent in 1982-83 rather than remaining at 1981-82 levels would be as follows:-

	£ per annum	£ per week
Single person	50.50	1.00
Married couple (husband only working)	78.50	1.50
Married couple (both working and earning more than personal allowance)	129.00	2.50
Single-parent family	78.50	1.50

As long as the tax units are basic rate taxpayers under both sets of allowances, the cash benefits do not vary with income levels.

Indirect taxes: price changes (2)

	Typical price effect
Pint of beer	2p
75cl bottle of table wine	10p
75cl bottle of sherry	13p
Bottle of Whisky	55-60p
Gallon of petrol	9p
Gallon of derv	7½p (6½p net of VAT)
20 king size cigarettes	7p
VED (1 year)	£ 10

Notes

(1) Does not include rounding up required by statute

(2) Inclusive of VAT, except VED

ANNEX 3

TAX: BACKGROUND FACTS

Total taxation

1. Since the Government came to power total taxation as a proportion of GDP has risen by nearly 6 percentage points. The figures are as follows:-

Table 1: Total taxation* as % of GDP (market prices)

1978-79	34.5
1979-80	35.8
1980-81	37.3
1981-82 (forecast)	40.3

(*Including national insurance contributions and local authority rates.)

Personal taxation

2. Calculations here have to take account of national insurance contributions as well as income tax changes. The following table shows the present position:

Table 2: Income tax and national insurance contributions as a percentage of gross earnings

Married*

	½ average earnings	Average earnings	2 average earnings
1978-79	16.4	28.0	31.6
1979-80	16.4	26.4	28.9
1980-81	18.2	27.5	29.9
1981-82 (forecast)	21.1	29.4	32.4

(* Wife not working: the couple are assumed to have no children, to avoid distortion of the figures from the abolition of child tax allowances.)

By 1982-83 the employees' national insurance contribution will be 2½ percentage points higher than in 1978-79. Even with the indexation of allowances assumed in the forecast, in 1982-83 income tax and national insurance contributions as a percentage of gross earnings will increase for all family types over 1981-82 levels

3. The main income tax reason for this change has been our inability to make any change in personal allowances last year, so that tax thresholds have fallen as follows:-

Table 3: Personal allowances as a percentage of average earnings

	Single	Married
1978-79	20.1	31.3
1979-80	20.2	31.4
1980-81	19.8	30.8
1981-82	17.8	27.7

(Real net incomes are of course higher than in 1978-79. The increase in the proportion of gross earnings taken in tax partly reflects the fact that earnings have risen faster than prices.)

Company sector

4. Real rates of return have been falling since the early 1960s:

Table 4: Percentage Real Rates of Return[1]

	Industrial and commercial companies excluding North Sea	Manufacturing companies
1960	13.3	13.3
1965	11.3	10.6
1970	8.7	7.5
1975	5.2	3.9
1979	5.0	3.6
1980	3.0	2.0
1981 (estimated)	2.2	n.a.

[1] Gross operating surplus less stock appreciation and capital consumption at replacement cost as a percentage of net capital stock of fixed assets (excluding land) at replacement cost plus value of stock.

Real interest rates are now above real rates of return.

5. But the tax burden on companies has not fallen:-

Table 5: Tax paid by industrial and commercial companies (excluding North Sea)

£ billion

	Taxes on companies' income (3)	Employers[1] NIC and NIS	Rates[2]	Total	Total in constant prices(4)
1978	2.8	4.3	1.7	8.8	8.8
1979	2.7	5.4	1.9	10.1	8.9
1980	3.2	6.5	2.4	12.1	9.1
1981(estimated)	3.2	7.2	2.9	13.3	9.1

(1) estimates of proportion paid by industrial and commercial companies

(2) includes North Sea and unincorporated business

(3) includes mainstream corporation tax, ACT, and tax on company investment income

(4) deflated by total final expenditure deflator (1978 = 100)

6. Comparing Tables 4 and 5 shows companies' ability to pay falling, but the demands made on them virtually constant.

CONFIDENTIAL ANNEX 4

Estimated consequences of an illustrative £1 billion tax reduction, effected by category (1), (2) or (3) measures

	Category	1982-83	1983-84
PSBR (£b)	(1)	(	0.7
	(2)	(1.0	0.8
	(3)	(	1.0
GDP (%)	(1)	0.2	0.5
	(2)	0.2	0.4
	(3)	0.2	0.5
Unemployment (000s)	(1)	-15	-50
	(2)	-15	-40
	(3)	-15	-60
Real Personal Disposable Income (%)	(1)	0.7	0.7
	(2)	0.6	0.6
	(3)	0.4	0.8
Companies' Disposable Income (£m)	(1)	1.0	1.3
	(2)	0.9	1.1
	(3)	1.4	1.8
Inflation (change in RPI) (%) (Q4 on Q4)	(1)	-0.4	0.2
	(2)	0.1	0.3
	(3)	-	0.3

Note: These illustrative estimates have been made using the Treasury model, which - like other economic models has great difficulty in dealing with the effect of changing expectations in financial markets upon interest rates and the exchange rate, and in turn with their effects on company behaviour. This limitation must be borne firmly in mind, for the actual effect of fiscal changes depends crucially on market reactions.

ANNEX 5

BASIC TAX READY-RECKONER

Illustrative revenue effects(1) of tax changes: £ million

	First year	Full year
Change basic rate by 1p	875	950
Change each higher rate by 1p	35	70
Change single and wife's earned income allowance by £100	315	390
Change married allowance by £100	275	340
Change corporation tax rate by 1 percentage point	40	70
Change NIS rate by 1 percentage point	700	1,160
Pint of beer: 1p change in duty	95	95
75cl bottle of table wine and sherry: 10p change in duty	35	35
Bottle of whisky: 30p change in duty	35	35
Gallon of petrol: 2p change in duty	110	110
Gallon of derv: 2p change in duty	30	30
Packet of cigarettes: 1p change in price (with equivalent increase in other tobacco products)	40	40
VAT: 1 percentage point change in rate	490	650
VED: £1 change in car licence	16	16
Car tax: change rate by 1 percentage point	50	65

Notes

(1) Income tax figures calculated on assumption of statutory indexation. This has first year cost of £1.6 billion and a full year cost of £2.1 billion. With early March Budget, first and full year effects of changes in indirect taxes are broadly similar.

11

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

PRIME MINISTER

CABINET: 28 JANUARY

We spoke about the first draft, enclosed with my minute of 19 January, of the paper for discussion in Cabinet on 28 January. The attached revised version incorporates a number of helpful suggestions from Ian Gow; and includes some additional material on the fiscal options. The Annexes, and perhaps particularly Annex 4, are likely to be of some interest to our colleagues, and could perhaps whet the appetite for further Budget-making in Committee. I myself believe that colleagues are now looking for at least as much information as the paper and the Annexes would provide, and that it might be a mistake to try to give them less. But Annex 4 could be dropped if you would prefer this.

2. Subject to your views, I would propose to circulate the paper tomorrow. A copy of it, and of this minute, goes to Sir Robert Armstrong.

(G.H.)
25 January 1982

I shall be presenting our fourth Budget on 9th March.

Outlook for the year ahead

2. The latest forecasts predict continuing, though slow, recovery in output and a further fall in inflation, which should be at 10 per cent by the end of this year, and in single figures in 1983. Unemployment is likely to edge up a little further in 1982, though at a diminishing rate, while industrial productivity should continue to improve. The general picture is one of continuing recovery, with encouraging signs of real improvement in the economy. Annex 1 gives some figures showing the progress we have made to date. A continuation of this improvement could, of course, be invalidated by events beyond our control, whether world-wide (e.g. American interest rates) or domestic (e.g. a serious setback on pay).

3. Of course I continue to be deeply concerned about the level of unemployment. We should all like to get it down. But all previous attempts at artificially induced reflation have resulted, in the medium and longer term, in higher inflation and in higher unemployment. In political terms, any gains from another such attempt would be short-term and extremely limited. The probable impact on interest rates, the exchange rate and inflation would mean throwing away the hard-won progress of the past 2½ years - and lead to still higher levels of unemployment than those from which we are now suffering.

The right strategy

4. We must accordingly persevere in our present strategy, maintaining progress towards our key objectives: a continuing reduction in inflation; a continuing rise in output; a diminution of the monopoly public sector; and a strengthening of the free market economy. This is the way to secure a genuine improvement in the employment situation rather than a very small and short-lived change in the figures. The prospects are by no means poor. The rates of both wage and

price increases should continue to fall, with inflation down to 8 per cent or less by the end of 1983; and there should be faster growth of output in that year than in 1982.

5. For domestic and overseas confidence in the Government's strategy to be sustained we must have a credible financial framework. The markets will expect us to maintain downward pressure on the rate of monetary growth. This is ESSENTIAL ~~crucial~~ NOT ONLY ~~to~~ confidence and ~~to maintaining~~ a reasonably steady exchange rate without cripplingly high interest rates. Our objectives for the period ahead will need to be expressed in terms of a number of aggregates, and with more explicit reference to the exchange rate, rather than exclusively to £M3. If we were thought to have abandoned monetary and fiscal control, sterling would quickly prove fragile.

TO THE DEFEAT OF INFLATION BUT ALSO TO MAINTAINING

Borrowing

6. Within this framework the size of the PSBR for next year is crucial. For the current year, we planned for a PSBR of £10½ billion and we are on course for this. For next year, the forecast (which may change substantially before March) gives a provisional figure of rather less than the £9 billion for which we thought it right to plan at the time of the last Budget. This forecast is based, as is customary, on the following assumptions:-

(i) That public spending next year is at the level agreed in November - a planning total of £115 billion;

(ii) That income tax thresholds will be increased in line with inflation ("Rooker-Wise");

(iii) That excise duties will be similarly increased;

(iv) That the tax structure and rates are in other respects unchanged.

Annex 2 shows what assumptions (ii) to (iv) mean in terms of cash increases in the allowances and price increases in the goods subject to specific duties. The impact on the PSBR of assumptions (ii) to (iv), taken together, is broadly neutral: the revenue lost through indexing the income tax allowances is nearly offset (in the first year) by the extra revenue produced by revalorisation of the specific duties.

7. The choice of the right PSBR for next year presents a problem. To go up to about £9 billion might give some limited room for modest tax reductions. But it would also involve risks for interest rates and the exchange rate. Since the last Budget the exchange rate has fallen considerably. Oil prices, which support it, have also fallen and we have had to face high interest rates. We could diminish some of these difficulties by planning for a PSBR of, say, £7 to £8 billion. We should then have a better prospect of lower interest rates, though they will probably still be uncomfortably high. For most people - industry and mortgagors alike - lower interest rates are an important objective. But we should not have any room for tax reductions, and the political difficulties are obvious.

8. The trade-off between interest rates and tax reliefs as a means of sustaining recovery is bound to be a matter of judgement - political as well as economic. But it is my belief, not least in the light of our experience of the last year, that to go for a PSBR above about £9 billion is likely to lead to higher interest rates than we now have, would affect confidence, and could risk so large a fall in sterling as to jeopardise the prospects of reducing inflation and impair - or even reverse - recovery.

Fiscal options

9. If some reductions in taxation should turn out to be possible, for the coming year, the main issue will be the balance to be struck between:-

(i) measures which would directly affect prices;
(ii) those which would reduce income tax; and
(iii) those which would directly assist companies.

? Category (i) includes less than full revalorisation of excise duties, or a reduction in the rate of VAT. Category (ii) includes action to more than implement "Rooker-Wise" increases in tax allowances. The most obvious category (iii) measure would be a cut in National Insurance Surcharge.

10. The argument for category (i) changes is essentially political. We would avoid adding to the RPI: full revalorisation of the duties is assumed in the forecast. And we would avoid the unpopularity attaching to some individual increases: see the examples at Annex 2. But the more ground we give here, the less room we have for changes in categories (ii) or (iii), the case for which emerges clearly from the tables at Annex 3.

11. For the personal sector, an increase in tax allowances of 10 to 11 percentage points above inflation would be necessary ? to restore tax thresholds as a proportion of average earnings to their 1978-79 levels. An increase would bring benefits in wage bargaining; and would diminish the poverty trap and "why-work" problems. Assistance to the company sector is no less desirable, and category (iii) changes would have the most direct impact on companies' income, though at the risk of some leakage into wages. When second round effects are taken into account, the effects on employment, GDP and company incomes of all three categories are however very similar. Annex 4 sets out Treasury model estimates of the broad consequences of an illustrative £1 billion reduction, effected through measures falling into each of the three categories, while Annex 5 gives the revenue effects of certain specimen reductions.

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To go above about £9 billion would be popular politically in the short run; but it would imperil the exchange rate, interest rates, the conquest of inflation, our whole determination to create a sound economy and, in anything other than the very short-term, the creation of more real jobs. The choice for the PSBR ~~seems to~~ lies in a range which has £7 billion as the minimum and ~~about~~ £9 billion as the maximum.

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14. I would welcome colleagues' views on 28 January on the two areas of choice outlined above.

G.H.

H.M. TREASURY
25 January 1982

SELECTED ECONOMIC INDICATORS, 1979-82

	1978 to 1979	1979 to 1980	1980 to 1981 (1)	1981 to 1982 (1)
[Percentage change]				
GDP (1975 prices)	+ 2	- 2	- 2	+ 1
Consumer prices (Q4)	+ 17½	+ 15½	+ 12	+ 10
Average earnings (Q4)	+ 18½	+ 19½	+ 12½	+ 7½[3]
Exports of goods and services (1975 prices)	+ 2½	+ 1	- 5½	+ 2½
	1979	**1980**	**1981**	**1982**
Current balance (£bn)	- 1	+ 3	+ 6	+ 3
Unemployment (UK, %, narrow)	5½	7	10½	12[3]
	1979-80	**1980-81**	**1981-82**	**1982-83**
Tax as % GDP (4)	30	31	33½	(6)
Public expenditure as % GDP (5)	41	43½	45	44
PSBR as % GDP	5	6	4	(6)

(1) Figures consistent with December 1981 Industry Act Forecast

(2) Forecasts from OECD Economic Outlook, December 1981

(3) Figures based on assumptions in December 1981 Government Actuary's Report relating to 1982-83 financial year

(4) Excluding NIC

(5) Including debt interest

(6) Depending on decisions to be made.

ANNEX 2

THE EFFECTS OF 12.2% INCREASE IN TAX ALLOWANCE ETC (ie INDEXATION)

Income tax: levels of allowances etc.

	1981-82 £	1982-83[1] £
Single and wife's earned income allowance	1,375	1,543
Married allowance	2,145	2,407
Additional personal allowance	770	864
Single age allowance	1,820	2,042
Married age allowance	2,895	3,248
Age allowance income limit	5,900	6,620
Basic rate band	11,250	12,623
40% rate band width	1,999	2,244
Investment income surcharge exemption	5,500	6,171

The reductions in income tax payments for basic rate taxpayers with personal allowances increased by 12.2 per cent in 1982-83 rather than remaining at 1981-82 levels would be as follows:-

	£ per annum	£ per week
Single person	50.50	1.00
Married couple (husband only working)	78.50	1.50
Married couple (both working and earning more than personal allowance)	129.00	2.50
Single-parent family	78.50	1.50

As long as the tax units are basic rate taxpayers under both sets of allowances, the cash benefits do not vary with income levels.

Indirect taxes: price changes [2]

	Typical price effect
Pint of beer	2p
75cl bottle of table wine	10p
75cl bottle of sherry	13p
Bottle of Whisky	55-60p
Gallon of petrol	9p
Gallon of derv	7½p (6½p net of [illegible]
20 king size cigarettes	7p
VED (1 year)	£ 10

Notes

(1) Does not include rounding up required by statute

ANNEX 3

TAX: BACKGROUND FACTS

Total taxation

1. Since the Government came to power total taxation as a proportion of GDP has risen by nearly 6 percentage points. The figures are as follows:-

Table 1: Total taxation* as % of GDP (market prices)

1978-79	34.5
1979-80	35.8
1980-81	37.3
1981-82 (forecast)	40.3

(*Including national insurance contributions and local authority rates.)

Personal taxation

2. Calculations here have to take account of national insurance contributions as well as income tax changes. The following table shows the present position:

Table 2: Income tax and national insurance contributions as a percentage of gross earnings

Married*

	½ average earnings	Average earnings	2 average earnings
1978-79	16.4	28.0	31.6
1979-80	16.4	26.4	28.9
1980-81	18.2	27.5	29.9
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(* Wife not working: the couple are assumed to have no children, to avoid distortion of the figures from the abolition of child tax allowances.)

By 1982-83 the employees' national insurance contribution will be 2½ percentage points higher than in 1978-79. Even with the indexation of allowances assumed in the forecast, in 1982-83 income tax and national insurance contributions as a percentage of gross earnings will increase for all family types over 1981-82 levels

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	Single	Married
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1981-82	17.8	27.7

(Real net incomes are of course higher than in 1978-79. The increase in the proportion of gross earnings taken in tax partly reflects the fact that earnings have risen faster than prices.)

Company sector

4. Real rates of return have been falling since the early 1960s:

Table 4: Percentage Real Rates of Return[1]

	Industrial and commercial companies excluding North Sea	Manufacturing companies
1960	13.3	13.3
1965	11.3	10.6
1970	8.7	7.5
1975	5.2	3.9
1979	5.0	3.6
1980	3.0	2.0
1981 (estimated)	2.2	n.a.

[1] Gross operating surplus less stock appreciation and capital consumption at replacement cost as a percentage of net capital stock of fixed assets (excluding land) at replacement cost plus value of stock.

Real interest rates are now above real rates of return.

5. But the tax burden on companies has not fallen:-

Table 5: Tax paid by industrial and commercial companies (excluding North Sea)

£ billion

	Taxes on companies' income (3)	Employers[1] NIC and NIS	Rates[2]	Total	Total in constant prices(4)
1978	2.8	4.3	1.7	8.8	8.8
1979	2.7	5.4	1.9	10.1	8.9
1980	3.2	6.5	2.4	12.1	9.1
1981(estimated)	3.2	7.2	2.9	13.3	9.1

(1) estimates of proportion paid by industrial and commercial companies

(2) includes North Sea and unincorporated business

(3) includes mainstream corporation tax, ACT, and tax on company investment income

(4) deflated by total final expenditure deflator (1978 = 100)

6. Comparing Tables 4 and 5 shows companies' ability to pay falling, but the demands made on them virtually constant.

Estimated consequences of an illustrative £1 billion tax reduction, effected by category (1), (2) or (3) measures

	Category	1982-83	1983-84
PSBR (£b)	(1)	(	0.7
	(2)	(1.0	0.8
	(3)	(	1.0
GDP (%)	(1)	0.2	0.5
	(2)	0.2	0.4
	(3)	0.2	0.5
Unemployment (000s)	(1)	-15	-50
	(2)	-15	-40
	(3)	-15	-60
Real Personal Disposable Income (%)	(1)	0.7	0.7
	(2)	0.6	0.6
	(3)	0.4	0.8
Companies' Disposable Income (£m)	(1)	1.0	1.3
	(2)	0.9	1.1
	(3)	1.4	1.8
Inflation (change in RPI) (%) (Q4 on Q4)	(1)	-0.4	0.2
	(2)	0.1	0.3
	(3)	-	0.3

Note: These illustrative estimates have been made using the Treasury model, which - like other economic models has great difficulty in dealing with the effect of changing expectations in financial markets upon interest rates and the exchange rate, and in turn with their effects on company behaviour. This limitation must be borne firmly in mind, for the actual effect of fiscal changes depends crucially on market reactions.

BASIC TAX READY-RECKONER

Illustrative revenue effects[1] of tax changes: £ million

	First year	Full year
Change basic rate by 1p	875	950
Change each higher rate by 1p	35	70
Change single and wife's earned income allowance by £100	315	390
Change married allowance by £100	275	340
Change corporation tax rate by 1 percentage point	40	70
Change NIS rate by 1 percentage point	700	1,160
Pint of beer: 1p change in duty	95	95
75cl bottle of table wine and sherry: 10p change in duty	35	35
Bottle of whisky: 30p change in duty	35	35
Gallon of petrol: 2p change in duty	110	110
Gallon of derv: 2p change in duty	30	30
Packet of cigarettes: 1p change in price (with equivalent increase in other tobacco products)	40	40
VAT: 1 percentage point change in rate	490	650
VED: £1 change in car licence	16	16
Car tax: change rate by 1 percentage point	50	65

Notes

(1) Income tax figures calculated on assumption of statutory indexation. This has first year cost of £1.6 billion and a full year cost of £2.1 billion. With early March Budget, first and full year effects of changes in indirect taxes are broadly similar.

10a

FROM: E P KEMP
22 JANUARY 1982

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State (C)
Minister of State (L)
Sir Douglas Wass
Mr Burns
Sir Kenneth Couzens
Sir Anthony Rawlinson
Mr Ryrie
Mr Byatt
Mr Barratt
Mr Middleton
Mr Quinlan
Mr Battishill
Mr Cassell
Mr Evans
Mr Monger
Mr Mountfield
Mr Allen
Mrs Gilmore
Mr Norgrove
Mr Bush
Mr Ridley
Mr Harris

CABINET 28 JANUARY - ECONOMIC STRATEGY - BRIEF

The paper Cabinet will discuss on 28 January is your own. At the time of dictating this brief it is still undergoing some last minute changes, but we thought it better to get this brief forward to you before the weekend so you can consider it and discuss it with us if need be well before next Thursday.

2. The Cabinet discussion on 28 January represents the third in the series of "macro-economic discussions", and is arguably by far the most important. Amongst other things, it seeks to fulfil what appears to be the general wish of Cabinet colleagues that they should to some extent at least be taken into the Budget-making process. Discussion will be difficult, not helped by the fact that the Press appears to be well aware that it is taking place, and you and the

Chief Secretary will, that same afternoon and evening, be speaking in the House in the Debate on economic strategy.

Objectives

3. Your objectives in respect of your pre-Budget paper are, in broad terms, fourfold :-

a. To seek your colleagues' views on the general stance of fiscal policy for 1982-83 - that is, in plain language, to ascertain what they think if not about the sort of absolute PSBR level which might be sought for 1982-83, at least various levels of tax "give away" which might be possible.

b. To ascertain your colleagues' views on how any "give away" might be distributed eg as between measures benefiting the personal sector and measures benefiting company sector.

c. To avoid any firm commitment to being bound to any view taken, your furthest position being an agreement that you would take account of the views expressed subject always to reserving your right to modifying your position if circumstances required it before the Budget.

d. To avoid any request for further collective consultation in the period in the run up to the Budget (obviously apart from bilateral consultation on particular points with individual colleagues).

Speaking Notes

4. I attach flags A and B speaking notes which you may like to use in connection with objectives (a) and (b) above. Although these are not independent of each other (because one way to use any slack for the benefit of industry is not to go for any tax reduction at all but simply keep the PSBR lower than it would otherwise be, thus help keep interest rates lower than they would otherwise be)

it seems preferable if possible to try to arrange the discussion so that (a) and (b) - considerations relating to the PSBR and size of total tax relief, on the one hand, and how any such tax relief might be distributed, on the other - should be kept separate in peoples' minds. Flag C is the index to a bundle of separate notes, mostly defensive, on the large number of points which may come up in discussion.

<u>The principal arguments - the size of the PSBR and any reliefs</u>

5. Your paper discusses your views on next year's PSBR. You argue that for reasons of market confidence, which translates itself primarily into the need to try to keep interest rates down, the upper end is about £9 billion. From the point of view of interest rates etc, a lower figure would however be preferable - you quote £7-£8 billion, but you point out that this would not give any room for tax reductions and the political difficulties are obvious. For any given level of PSBR, of course, the size of the tax reductions that are possible depends on what the economic forecast shows the PSBR to come out to on the basis of conventional revalorisation. As your paper says, the provisional figure we have is rather less than £9 billion. It looks as though, therefore, a PSBR of £9 billion would certainly give some room for tax reductions over and above the revalorisation assumed (which itself involves a give away of a net £300 million or thereabouts in 1982-83). A forecast of £8 billion would give scope for real reductions over and above revalorisation of £1 billion, on the basis of a £9 billion PSBR, or about £1.3* billion in cash terms. On the other hand on the basis of the lower end of your PSBR range no real scope for reduction would be possible at all.

6. Arguments you may like to use include the following :-

a. To go further than £9 billion takes unacceptable risks on interest rates, and would also involve going above the figure mentioned for 1982-83 in last year's MTFS, which is also the figure that has got into some public circulation.

*This is a mongrel figure comprising PSBR cost (£1 bn) and revenue cost £0.3 bn). Because of feedback, revenue costs are bigger than PSBR costs for any given decision. Presentationally, it is likely that any "give away" will be measured and described on the bigger revenue costs basis.

b. To stay within the £9 billion shows consistency, while to go above it could imply in the eyes of the markets an undesirable step towards relaxation.

c. In any case regardless of the forecast there is a limit to the amount of "give away" that can be contemplated. At some stage it would have to be retained and used to help on the interest rate front. It is a matter for judgment what this limit is (and there will no doubt be those around the table who will argue that there is a downward limit as well as an upward one). The point is that the size of the tax reductions given (whether over and above revalorisation or including the cost of revalorisation) will be taken by many as a measure of the "stimulus" (or, misleadingly, "reflation") which you are apply to the economy, and these people will compare this figure with the various other figures which others have been clamouring for. The competing packages are a mixed bag, not always fully or accurately costed. But it is surely the case that if you started getting above say £1½ billion real or £2 billion cash,* then the figure starts to look comparable with some of these alternative suggestions, and, in the eyes of the markets and politically, the Government could be thought to be getting into "U-turn" country. So something of this order must be the upper limit.

d. Finally it is necessary to keep an eye on the Budget for 1983 - perhaps the last of this Parliament; real reductions greater than around £1½ billion start to eat dangerously into possible slack for next year, the more so because any estimate now of next year's slack must be particularly tentative and at risk notably on the possibility of the 1983-84 public expenditure figures not holding. It would obviously be very desirable to have something in hand for 1983-84, and per contra very undesirable to risk being forced in that Budget either to have to increase taxes or take risks on interest rates; this points to some restraint now.

* See footnote to p.3.

These arguments point to sticking to a PSBR not bigger than £9 billion, and real tax reductions not more than, say, £1½ billion (cash equivalent about £1.8 billion).*

<u>The principal arguments - how any reductions might be distributed (b) above.</u>

7. Your paper spells out the broad possibilities. Briefly, the main choice lies between helping in the first place individuals (either through measures which directly affect prices or measures which reduce income tax) or companies. Immediately, operating on tax thresholds does best for individuals while operating on eg NIS or corporation tax does best for companies, with operating on the indirect taxes benefiting both (and of course, in a big sort of way, the RPI). But as Annex 4 of your paper shows, when the second round effects are taken into account this is not so obvious; money given to individuals works through and helps companies, while each of the alternative approaches gives very much the same result as far as GDP and unemployment. Another strand is the effect on wage bargaining, where while opinions can vary, reduction in direct tax should help while reduction in NIS might work in the opposite direction. And as well as economic, the arguments here are to a great extent political; for instance has the time now come to try to put right at least to some extent the way in which the burden of taxation on the individual has increased since the Election, contrary to the Manifesto promise; or would this be seen as "irresponsible" so that the main benefit should be overtly and in the first instance directed towards companies? Your colleagues will no doubt have a number of views on all this.

8. Some of your colleagues may make a case for more detailed perhaps cheaper measures - for instance enterprise, industrial, "caring", and so on packages. You could say that certainly you would hope that if there is to be an overall relief some amounts could be reserved for worthy less expensive causes (an example in your own field might be some relief in capital taxes). Obviously, however, to the extent this was done what could be done elsewhere would be that much less. Without actually soliciting a flood of Budget representations from your colleagues, you may like to say that if any individual Minister has ideas, you will be glad to know of them as quickly as possible.

* See footnote to p.3.

9. There may be some suggestions that some of any fiscal adjustment should be taken out by way of additional public expenditure. You will want to oppose this strongly. Detailed briefs J and K below gives some arguments. In short, the public expenditure decisions were taken, and so far as possible the books were closed, in December, and announcement made. To re-open them with second thoughts on policy would look feeble and indecisive. In addition, this Government was not elected to increase public expenditure; the December statement already had to add £5 billion for next year to the plans, and it is most undesirable to go any further in the wrong direction. And finally, in terms of the Government's longer-term strategy public expenditure measures are, economically speaking, not the best way of getting inflation down and output up; they are (and would be seen as) of the nature of short-term expediency.

The Annexes to your paper

10. These are largely background, and should not cause much comment. Annex 1 however, does give an interesting - and generally encouraging - picture of how the economy is evolving.

Summary

11. As I say, your principal objective is to get your colleagues' acquiescence of your working to a PSBR of not more than £9 billion in 1982-83. It seems reasonable to hope that you would succeed, given the prospect you can hold out of associating this with some real tax reductions. In a sense this is a situation which gives everyone a prize. Seen from the City, a PSBR of £9 billion should represent a continuation of existing policies and should not damage confidence too much. Seen domestically, there are real tax reductions in prospect, which will not be unpopular. How such a position is eventually presented eg in the Budget speech may need some adroitness. But the argument you might be able to adopt is that this is not in fact "reflation", assuming one defines reflation as going for a PSBR beyond what can reasonably be afforded, on a sort of "dash for growth" argument. The Borrowing Requirement remains at a responsible level, and the tax reductions available are the first fruits of the Government's economic strategy over the last 2½ years.

12. You may wish to discuss this brief with us.

EPK

E P KEMP

LIST OF BRIEFS

BRIEF

RECENT ECONOMIC SITUATION [See also Annex 1 of the Cabinet Paper]

Positive

(i) Evidence points to turning point in 1H 1981 - clearly shown by CSO cyclical indicators and consensus of independent forecasters.

(ii) Output now rising - total up ⅔ per cent in 3Q over 2Q 1981. Manufacturing and construction output up 2½ per cent. Destocking much reduced.

(iii) Exports held up well under difficult conditions of sluggish world trade and earlier losses in competitiveness. In 3 months to November non-oil exports some 4 per cent up on average 1980 level.

(iv) Current account remains in surplus.

(v) Labour market indicators improving.

- average hours worked increased during 1981 (4 per cent) as short time sharply cut (down by ¾) and overtime recovered.
- total hours worked stabilised (employment continues to decline).
- vacancies picked up during 2H 1981 (from very low level).
- unemployment increasing much less slowly - only about ⅓ of a year earlier (4Q 1980, 115,000 pm cf 4Q 1981 36,000 pm - 43,000 pm allowing for new benefit arrangements for over 60s)

Defensive

Unemployment continues to rise - rate of increase much reduced, other labour market indicators improving. See also briefing (to be provided) on January figures.

November manufacturing output disappointing - smooth monthly profile unlikely. Allowing for BL and Ford disputes index remained above September level.

Imports increased very rapidly - but from a very depressed level. Reflects slower destocking and recovery in output.

Investment weak - No further decline since Q1 1981. Fall concentrated in housing. Plant and machinery investment held up. 10 per cent higher in 1H 1981 than two years earlier.

BRIEF B

THE FORECAST

(i) Latest Treasury forecast sent to Chancellor on 26 January.

(ii) Based on conventional assumptions about tax indexation in the 1982 Budget; and on sticking to public expenditure totals.

(iii) Summary of forecast attached - NOT FOR USE.

(iv) In general, forecast is close to published Industry Act Forecast, and to interim Treasury forecast of 7 January.

Main points of forecast

(i) Recovery continues in 1982, and should strengthen in 1983.

(ii) Growth of exports - which performed appreciably better than expected in 1981 - should help to sustain economic recovery, as well as end of de-stocking. Current account still in large surplus.

(iii) Inflation lower in 1982, and again in 1983 which should see single figure rate.

(iv) Path of interest rates depends partly on US rates - but the prospect of a falling PSBR and falling inflation suggest possibilities of falls in interest rates, consistently with rates of monetary growth significantly below those in past two years.

	Industry Act Forecast	Latest Treasury Internal Forecast
Output, per cent change between 1981 and 1982	+ 1	+ 1¼
Inflation, per cent change between end 1981 and 1982	+10	+ 9½-10
Current Account, balance of payments, £bn	+ 3	+ 4

BRIEF C

READY RECKONERS

Annex 4 shows effects of illustrative tax changes, each of which increase PSBR by £1bn in 1982/83.

Changes are:-

Category (1):- no revalorisation of specific duties (incl VED on cars) (NB Not VAT).

Category (2):- Personal allowances: an increase of 10 per cent points (above full revalorisation allowed for in forecast).

Category (3):- Cut in National Insurance Surcharge of approx 2 per cent points (implemented from July 1982).

2. These are extreme cases prepared to bring out the various effects, not proposed Budget packages.

3. Table assumes no change in interest rates: so money supply is about ¾-1% higher than with £7-8bn PSBR. If interest rates were higher with £9 billion PSBR (so monetary growth was the same as with PSBR of £7-8 billion) tax cuts would have much less effect on output (and none at all after 2-3 years).

4. Lower specific duties (category (1)) is best for inflation. Higher personal allowances may help reduce wage pressures. Lower NIS may be partly passed on in lower prices: but could also leak into higher wages.

5. NIS does most to help companies: but all tax cuts boost company incomes indirectly. Lower NIS also indirectly boosts real personal disposable incomes.

6. Tax cuts have similar effects on output and employment (though not inflation) taking account of second round effects.

UNEMPLOYMENT AND OUTPUT PROSPECTS BRIEF D

Factual: Recent developments and immediate prospects

1. Output. Bottom of recession passed in first half of 1981. Sure signs of recovery seen in last six months:

- manufacturing output grew by over 2 per cent in the third quarter and GDP by ½ per cent:

- short-time working dropped dramatically: October level less than one-quarter that of January 1981.

- destocking in the third quarter of 1981 only at one fifth of rate in first half.

Output likely to continue to rise (although moderately) through 1982 and show over 1 per cent increase year-on-year. Helped by recent improvements in productivity and competitiveness and the end of destocking, but unlikely to be very fast because of continued impact of high real interest rates and falls in real personal disposable income. Effects of strikes, cold weather etc should be short-lived.

2. Unemployment. Even taking account of January's figure, recent monthly increases in seasonally-adjusted unemployment have been much lower than at the end of 1980 or early 1981 - roughly half the rate of increase. But "wide" unemployment now just over 3 million. See table at end of brief for recent figures. Prospects are probably for some further increases in unemployment in the near future, but unemployment forecasts are notoriously uncertain.

Positive

3. Longer term prospects for unemployment. Much depends on our success in reducing inflation, as basis for sustained economic growth.

Need for restraint on wage demands and improved productivity.

4. Better output prospects in medium term. Growth of 1 per cent in 1982 should be followed by sustained growth in medium term:

- Better growth in the world economy.

- Falling nominal interest rates, resulting from control of the PSBR and decelerating inflation, to help investment.

- Falling wage and price inflation will improve our international competitiveness and hence trade performance.

- Falling inflation will mean that individuals will have to save less to maintain the real value of their savings and so they will spend more.

5. Lower PSBR in the medium term. Output growth will increase tax receipts and reduce expenditure on unemployment benefit, and improve the financial position of the nationalised industries. North Sea revenue will be rising fast. Therefore as long as we retain strict control of public expenditure there is the prospect of a fall in public sector borrowing in the medium term both in money terms, and as a share of national income. This will help to bring down nominal interest rates, further benefiting the PSBR.

Defensive

6. 3 million a critical figure. The magnitude of January's rise reflects abnormal weather in addition to the normal seasonal increase. Underlying rate of increase, once adjustment made for special factors, has not increased. Vacancies still improving.

7. Interest rates still too high. Interest rate increases last year were necessary to restrain monetary growth and protect the exchange rate to maintain progress in bringing down inflation. Reduction of inflation vital if we are to secure prospects for sustained long term growth.

8. <u>Forecasts of unemployment</u>? Forecasts notoriously unreliable. For purposes of public expenditure planning, GAD <u>assumed</u> a level of <u>GB</u> wholly unemployed of 2.9 million in 1981-82 and in 1982-83 and subsequent years.

9. <u>Output prospects still as gloomy as 1981 MTFS</u>? The 1981 FSBR projections of government receipts, expenditure and borrowing <u>assumed</u> an average output growth of ½% per annum for the whole period 1980 to 1985. Latest projections suggest just over 1 per cent growth in 1982 and perhaps stronger performance in 1983 and 1984. Given growth of nominal income - "the national cash limit" - prospects for output depend crucially on how fast prices, and more particularly earnings, decelerate.

Background Note H: UK Unemployment

Unemployment Levels

	Wholly Unemployed (excluding school leavers s.a.)		Total including school leavers ("wide") (unadjusted)	
	Millions	Percentage of working population	Millions	Percentage of working population
1980 December	2.14	(8.8)	2.2	(9.3)
1981 October	2.73	(11.3)	2.99	(12.4)
November	2.76	(11.4)	2.95	(12.4)
December	2.78	(11.5)	2.94	(12.2)
1982 January	2.83	(11.7)	3.07	(12.7)

Increase in Unemployment 1981-82

	(monthly averages) Thousands
Mid January to Mid April	75
Mid April to Mid July	43
Mid July to Mid October	49
Mid October to Mid January	33

Unemployment Projections

The assumptions used in recent projections have been as follows:

	GB unemployment including school leavers (millions)	
	Government Actuary's Report (December 1981)	PEWP (March 1981)
1982-83	2.9	2.7
1983-84	2.9	2.7

INFLATION

BRIEF E

Factual

1. Retail prices rose by 12 per cent in the year to December 1981 (the same as for the year to November).

2. January RPI may be adversely affected by the recent bad weather, but little change expected in 12 per cent inflation rate.

3. The outlook for early 1982 is for very little change in the annual rate of inflation. Later in the year it should drop below the 1981 trough (10.9 per cent). By 1982 Q4 the Industry Act Forecast looked to an annual rate of increase in the RPI of 10 per cent. A reduction to single-figure inflation is expected in 1983.

4. General government procurement prices are expected to grow by 9 per cent in financial year 1982-83, in line with the price factor used in planning expenditure.

Positive

1. Inflation on a rising trend when we took office. It has come down from 22 per cent in the early part of last year to around 12 per cent now. Recent months have been somewhat less encouraging, but downward trend will be renewed soon.

2. This has been achieved without prices and incomes policies and without building in a serious threat of a future explosion.

Defensive

1. The recent increases in inflation have been disappointing, but special factors (the mortgage rate increase, effects of sterling depreciation) have been unhelpful. There is a firm prospect of resumed progress soon.

BRIEF F

PRODUCTIVITY

1975 = 100

Factual	Output per head: Whole Economy	Output per head: Manufacturing	Output per person hour: Manufacturing
1979 Q2 (last cyclical peak)	111.4	108.6	111.1
1980 Q4 (cyclical trough)	108.1	103.1	106.9
1981 Q3	n/a *[Q2 = 110.1]	113.2	115.0
per cent change			
Q3 1981 on Q2 1979	[Q2 =-1.2]*	4.2	3.5
Q3 1981 on Q4 1980	[Q2 = 1.8]*	9.8 N.B.	7.6

*As output rose and employment fell in 3Q the 3Q figure will show a significant rise. The 2Q figures are therefore underestimates.

Positive

(i) Productivity increased sharply during 1981 especially in manufacturing. Previous cyclical peaks have been passed.

(ii) Widespread reports of strenuous efforts to improve efficiency perhaps now beginning to show up in the figures.

(iii) Productivity gain plus moderation in settlements have resulted in very little rise in manufacturers' unit wage costs - up only 4 per cent in year to September.

Defensive

Improvement is just cyclical bounceback

Normal for productivity to decline in recession as employment response lags - but decline less than previous experience indicated. Productivity now above previous 1979 cyclical peak.

BRIEF G

PAY

Factual

The cumulative average for private sector settlements monitored by the Department of Employment in the pay round so far has now fallen to just over 6½ per cent. The corresponding figure for the public sector is 12 per cent, but this is still dominated by the police settlement in September (13.2 per cent).

2. The cumulative average for the economy as a whole is just over 7 per cent. Just under 15 per cent of employees monitored by the Department have reached settlements.

3. The miners have accepted 7.4 per cent in earnings (presented as 9.3 per cent on basic rates), water workers 8.8 per cent, oil tanker drivers 8.1 per cent. Low settlements include national engineering agreement (5.1 per cent), British Leyland (4½-5 per cent), clothing industry (5 per cent), motor vehicle retail and repair (4½ per cent).

Positive

1. Clear decleration in this pay round

Average level of settlements was 9 per cent in the last pay round. In this round 9 per cent is emerging as the upper end of the range, with settlements ranging down to 4 per cent and below. Few settlements in double figures.

2. Government objectives still intact

Even groups with most scope for damaging industrial action (miners, water workers, oil tanker drivers) are settling well within single figures, if rather on the high side. The 6.9 per cent offer to the local authority manuals was regrettable. But no reason why the Government should not continue to approach public service pay on the basis of the 4 per cent pay factor.

Defensive

1. Pay settlements higher than assumed?

Some are certainly higher than we would have wished. But no serious pay threat to the strategy at this stage. The need is to press hard for low settlements in the public services. CBI report that the bulk of settlements in manufacturing this round have been in the 4 to 6 per cent range.

2. Intolerable squeeze on living standards?

The great majority of settlements are well below the rate of inflation, and they are being voluntarily accepted by workforces. Much greater realism about the short-term prosepcts for living standards, and about the need to earn them. Personal living standards grew by 17½ per cent in the 3 years 1977-80: downward correction from this unsustainable level now inevitable, and little of it had occurred by the start of this pay round (less than 2 per cent down in first 9 months of 1981 compared with same period of 1980).

3. Incomes policy

A sharp decleration was achieved in the last pay round (from 18 per cent settlements in the round before that to 9 per cent), and a further marked deceleration (to 6½ per cent so far in the private sector) is being achieved now. Doubtful whether incomes policy could have done any better even if the grave problems of norms, enforcement, public acceptability, and union acquiescence could have been overcome, quite apart from the economic distortion which would have resulted.

Brief H

EXCHANGE RATE AND COMPETITIVENESS

1. Why did the exchange rate fall so far in 1981?

Between January and October 1981 sterling fell by 23% against the dollar (from $2.40 to $1.84), by 14% against the deutschemark (from DM 4.82 to DM 4.15) and by 14% in effective terms (from 102 to 88). Reasons for decline include:

- fall in oil price
- high interest rates in US and latterly in Europe
- also perhaps some fear in the autumn of weakening of UK government resolve against inflation.

Since October sterling has staged a modest recovery and currently stands at $1.88 DM 4.33 and an effective rate of 91.2 . This recovery owes something to the rise in UK interest rates since September; but sterling has also benefited from evidence of the Government's continued resolve on economic policy; and more recently from the better industrial news (miners).

2. Support the rate by greater intervention rather than interest rates

Experience here and elsewhere shows intervention ineffective, except in very short-term. Can even attract speculation. Most effective support for the pound that the Government can offer is to show continued determination to cut inflation and pursue responsible econimic policies.

3. An exchange rate target/join EMS e.r.m

(Hard to adopt an independent target publicly without joining EMS e.r.m). Membership of the EMS is itself would not stabilise the exchange rate: exchange rate stability will only flow from the successful pursuit of counter-inflation policy. In addition:

- would put a European label on the prompt adjustments in interest rates and fiscal policy required whenever sterling came under pressure;
- some loss of the flexibility presently available to us of permitting the exchange rate to take part of the strain of international adjustment.

A balance of risks. But must doubt our ability to hold sterling to any target in some circumstances. Remember it is a petro-currency and responds to changing expectations in the oil markets - whether the price is rising or falling - by moving in a contrary direction to other currencies; and is an internationally traded currency, like the DM, and subject to market pressures of a different kind from the other EMS currencies, which find it easier to keep up (or down) with the DM.

4. Should exchange controls be reimposed?

Abolition of exchange contols an important part of policy of reducing bureaucracy and freeing the economy. Experience had shown that their effect on the exchange rate was very limited. In particular they could not prevent substantial pressure from changes in leading and lagging on trade payments or investment by non-residents. The abolition of exchange controls helped UK industry by allowing long pent-up outflows that helped keep the exchange rate lower than it would otherwise be at a time when it was subject to strong oil-related upward pressures.

5. Effect of fall in the exchange rate on the RPI?

Some 20% of a fall in the exchange rate may be reflected in the RPI within a year. On that basis the 10% fall in sterling's effective exchange rate in 1981 would add 2% to this year's RPI. Therefore it is important to maintain current policies to moderate growth of wages, public spending, and the money supply and to encourage improvements in productivity.

6. Fall in the exchange rate help exporters to regain cost competitiveness?

There is now some evidence that UK unit labour costs are rising more slowly than those of our competitors, due to faster growth in productivity and the more moderate growth in wages. This suggests competitiveness may be improving even before the 10 per cent fall in the effective exchange rate is allowed for. Most of the extensive loss of competitiveness suffered in 1979-80 was due to a failure by companies to contain their cost increases. Seeking further falls in the exchange rate will add to those costs. The only long term path to improved competitiveness is to continue to confine cost increases and improve productivity.

MONETARY POLICY BRIEF I

Factual - see attached table for details of monetary aggregates(1) and UK/international interest rates.

(i) Over the past year £M3 has grown by 13.5 per cent; M1 has grown by only 7.8 per cent; PSL2 has grown by 11.5 per cent. After allowing for effects of Civil Service strike, growth of £M3 is probably above the target range.

(ii) Bank lending has been growing very rapidly. Stock outstanding at mid-November was 22 per cent higher than a year earlier. Personal lending growing very rapidly, up 42 per cent on a year earlier.

(iii) At time of Budget, our interest rates were broadly in line with average for other industrial countries. As our rates fell and rates abroad rose, UK rates were up to 3 per cent lower. In Nov/Dec that was reversed, and our rates rose to be about 2½ per cent higher. Subsequently, US rates have risen while UK rates have fallen, leaving our rates now roughly 1½ per cent higher than the average for other industrial countries.

Positive

(i) Tough fiscal decisions in Budget enabled us to hold our interest rates below those abroad for much of summer, though as rates abroad rose we were not able to sustain the advantage. But without that tight Budget our rates could now be even higher.

(ii) An updated version of MTFS containing financial guidelines for money and the PSBR will be presented in Budget. Central theme of MTFS, that fiscal policy must be consistent with monetary policy, is gaining wide acceptance around the world.

Defensive

(i) Why did interest rates have to rise from their 1981 Budget levels
Immediate reasons were pressure on sterling and rapid growth of bank lending. But important to note that overseas rates had bee rising since the spring, and while Budget measures enabled us to prevent our rates being pulled up for some months, deterioration in domestic monetary conditions required a rise to keep the money supply under control.

(1) figures relate to the new monetary sector

(ii). Isn't it just exchange rates which are determining interest rates and if so why the concern about the PSBR?

No. Exchange rate is one factor to be taken into account along with domestic monetary situation, especially recent rapid growth in bank lending to the private sector. US rates not sole determinant of UK rates. Can have lower rates here if prospects for inflation improve and PSBR is contained.

(iii) What will be the monetary target for next year?

Am still considering the form and level of the financial guidelines in the MTFS. Essential to look at behaviour of different aggregates - so am considering the case for providing figures for several aggregates in addition to £M3. Too early to say what precise figures may be, but our latest work on velocity trends indicates that rather higher figures than in last MTFS may be consistent with maintaining downward pressure on inflation.

(iv) Don't the narrow aggregates give a better guide to monetary tightness?

Growth in narrow aggregates more affected than £M3 by fluctuation in interest rates (higher rates imply lower growth). In practice, interest rates are determined with reference to a range of indicators including the exchange rate.

(v) Isn't £M3 a misleading guide? (eg rise in bank lending for house purchase)

Aware of need to take account of structural changes which could inflate £M3 without adding to inflationary pressures. Extent to which lending for house purchase by banks represents substitution for lending by building societies is borne in mind in interpreting £M3. But indications are that some of bank lending has been additional, not just in substitution, and as such constitutes a risk to inflation.

(vi) Do we have a consistent framework for interest decisions?

Yes. Aim has been to exert steady downward pressure on monetary conditions and thus on inflationary pressures. Interest rates adjusted in the framework. As set out in 1981 Budget, interest rates are determined with reference to a range of financial indicators including the exchange rate.

(vii) MTFS and monetary targets discredited?

It is necessary to set our policy decisions in a medium term framework for operation of the economy. Essence of our approach is not so much in particular series of figures, but in assurance it gives of Government's determination to reduce inflation. Only in this way can we give wage bargainers the the right message.

(viii) Why not allow PSBR to rise, to accommodate tax cuts in the budget?

Effect of tax cuts on output would be largely offset by consequences of the rise in interest rates necessary to contain monetary growth - both the direct effect of raising industry's costs and the indirect loss of competitiveness due to rise in exchange rate.

(ix) What if we make room for tax cuts by allowing PSBR to rise, but keep interest rates fixed?

Rise in real output would be accompanied by rise in inflation resulting from rise in money supply and fall in exchange rate.

MONETARY POLICY

(i) Monetary growth (annual rate)

Per cent

	MO	M1	£M3	M3	PSL2
Change over:-					
Target period - Feb/Dec	2.9	8.6	15.3	19.9	12.1
Last 12 months - to Dec	4.8	7.8	13.5	19.2	11.5

(ii) International Interest rates (3 months)

	UK	US	Germany	France	Japan	Italy	Canadian	World Basket
Mar	12.6	14.5	13.8	12.7	7.9	18.6	16.9	13.8
April	12.3	15.2	13.2	13.1	6.8	20.0	17.3	13.8
May	12.4	18.0	13.1	16.3	7.2	20.1	18.6	15.8
June	12.7	17.0	13.1	19.0	7.4	20.6	19.2	15.9
July	13.8	17.6	12.9	17.7	7.2	21.0	19.4	15.9
Aug	14.2	17.8	12.9	17.5	7.2	21.2	21.9	16.0
Sept	14.9	16.5	12.4	18.0	7.3	21.4	20.2	15.5
Oct	16.4	15.0	11.7	16.9	7.1	21.2	18.8	14.4
Nov	15.0	12.0	11.1	15.5	7.1	21.4	16.4	12.7
Dec	15.6	12.9	10.8	15.3	6.6	21.0	15.9	12.9
25 Jan	14.8	14.6	10.2	15.2	6.4	21.6	15.2	13.2

We have announced a planning total of £115 billion for 1982-83 (the 2 December statement). We should stick as closely to this as possible. /By 28 January, we shall know what total has gone to Cabinet with the Public Expenditure White Paper: it could be £115.5 billion or even more./ To use up any room for manoeuvre by increasing public expenditure would be quite the wrong thing to do both economically and politically.

- Economically, our aim must be to help industry, while keeping costs down. This means reducing taxation, whether corporate or personal. To add to public expenditure might look like a good short term expedient. But it does nothing to cut costs. The whole experience of the UK, as in many other countries, is that the growth of public spending tends to weaken the industrial and commercial basis which pays for it. At best, extra public spending is likely to create jobs which are not sustainable; at worst it is likely to increase unemployment rather than to reduce it.

- Politically, this Government came into Office with the objective of reducing public expenditure, not of increasing it. The Government is already under attack from some of its supporters for failure to reduce public expenditure as promised and for repeated failures to adhere to the original reductions in plans. Extra public spending has vitiated our objectives on taxation. We should be criticised (by some) if not of by all if the total were increased further and substantially within 3 months of announcements of our plans. Certainly to add to them at this stage would not give the impression of an administration with no clear idea of where it is heading.

Defensive

Operationally, we have finalised the figures for 1982-83 for the White Paper - there is virtually no time left for changes. However, it would be possible to publish a slightly different figures in the FSBR to take account of late decisions. Governments have done so in the past. But it looks bad, against the political arguments stated above. We should stick to our published plans.

Background

If the Chancellor eventually decides to make small increases in spending in the Budget eg by spending more on the disabled rather than by the tax route, it should come out of the Contingency Reserve, rather than adding to the overall total. The public expenditure side would advise strongly against any such increases. The programmes for 1982-83 have been settled and were published in December subject to only such adjustments as would bring the total to £115bn. Additions are not only undesirable in themselves but would weaken our case against other spending departments (like the Home Office) where we are at present insisting on offsetting savings to any fresh bids. And of course charging such items to the Contingency Reserve, rather than to the fiscal adjustment, means that they have no reflationary effect since the forecast assumes that the Reserve is more or less fully spent.

Public Expenditure White Paper

Cabinet colleagues should have received from the Chief Secretary, before Cabinet, a draft of Part 1 of the PEWP. They might raise points on it, although the Chief Secretary will merely have asked for comments in writing.

Any general points raised could usefully be got out of the way on 28 January (the following Cabinet, 4 February, would be too late). But if specific points on individual Departments are raised, you are advised to suggest that they could best be dealt with in correspondence or bilateral discussion.

K

PARTICULAR ITEMS OF PUBLIC EXPENDITURE

1. Shortfall on unpledged benefits
2. Child Benefit
3. Energy price subsidies
4. Department of Industry expenditure proposals
5. Agriculture
6. Asset disposals
7. Construction

These briefs cover the major items of direct departmental interest which have been raised or may be raised by particular colleagues. Budget representations on more general matters relating to taxation etc are covered passim in your briefs. Minor items (workshops scheme and the like) are not Cabinet material. Indeed in principle departmental spending proposals should not be discussed tomorrow.

K.1

THE SHORTFALL ON UNPLEDGED BENEFITS

Line to take

Cabinet agreed that we should not restore the 2 per cent shortfall on the unpledged benefits and Chancellor announced the decision on 2 December. No specific commitment given to review that decision though, because the November 1982 uprating will not be known until the Budget, impression given that Government will reconsider at Budget time. This a matter to be considered further between Chancellor and Secretary of State for Social Services.* The merits which led the Cabinet to decide not to restore shortfall are unchanged. The cost would be £180 million in a full year. The benefits are, for the most part, short-term and restoration of shortfall means very little since the population on benefit in November 1982 would be very different from that receiving the benefit in November 1980. Third, we expect those in work to take a cut in their living standards in the next financial year; we have already done more for those out of work by giving them a guarantee of price protection from November 1982 to November 1982. The case for doing more and restoring shortfall is thin.

Background

2 The shortfall in question is the amount by which the actual movement of prices from November 1980 to November 1981 (12 per cent) was below the forecast made at Budget time (10 per cent) on which the upratings for November 1981 were based. The actual upratings were 9 per cent because of the decision to take back 1 per cent over-provision in the previous uprating.

3 The cost of making good the 2 per cent shortfall is shown in the table below.

---

*We understand that Mr Fowler will be writing shortly, perhaps before Cabinet, to say that in his view it is not now practical to restore the shortfall. But DHSS think he is unlikely to copy his letter round.

	1982-83	Full year (1983-84)
Unemployment benefit	11	35
Sickness, injury and maternity allowance	5	10
Supplementary allowance		
- short-term rate	16	45
- long-term rate	6	15
Child benefit	25	65
Family Income Supplement	2	6
Mobility Allowance	2	4
	67	180

K. 2

CHILD BENEFIT

Line to take

Child benefit was treated in the PES discussions as an unpledged benefit. In other words it was assumed it would receive an uprating to cover the movement of prices from November 1981 to November 1982, but that there should be no attempt to restore any shortfall between last year's uprating and the movement of prices from November 1980 to November 1981. We all recognise however that the rate of child benefit has an importance in the Budgetary context as one of the components of family income. It is therefore proposed to discuss this further with the Secretary of State for Social Services in the Budget context.

Background

2 The rate of child benefit is £5.25 p.w. The increase announced last Budget was just over 10 per cent (in contrast to the 9 per cent increase for other benefits and the freezing of tax allowances). There will be a number of considerations in setting the rate payable from November 1982. They include the post-Budget expectation of price movements from November 1981 to November 1982; the actual increase in tax allowances decided on in the Budget (simple Rooker-Wise would be about 12 per cent - the price movement for the calendar year 1981); the political pressures (CPAG are pressing for at least 60p; a number of Conservative backbenchers take their tune from CPAG); and the fact that increases are usually to reasonably round numbers of £p. The attached table shows what the public expenditure impact of likely increases would be, and further material on the real value of child benefit etc is also attached.

Defensive

In the context of discussion on category (ii) measures as discussed in the main paper (giving the bulk of any fiscal relief by way of increase in income tax thresholds over and above straight Rooker/Wise) Treasury Ministers may be pressed for an undertaking that if they went down this path child benefit would also be increased as appropriate beyond straight revalorisation, in order to avoid the position of people with children falling behind those without children. Treasury Ministers will want to be cautious on this; increasing child benefit over the odds is an expensive business, and it could be argued that following last year, when the benefit went up although income tax allowances did not, some reversal this year would be only fair. But this Cabinet is not the place to settle this; Treasury Ministers may simply like to say that they will bear the point in mind when they consider the matter with the Secretary of State for Social Services in the Budget context.

CHILD BENEFIT

Rate	Increase		Public expenditure full year (compared with current programme)	Comment
£p	£p	%	£m	
5.50	25	4.8	-168	
5.75	50	9.5	- 18)	The nearest to the PES assumption of 10%
5.80	55	10.5	+ 18)	
5.85	60	11.4	+ 50	The CPAG "minimum"
5.90	65	12.3	+ 80	This would more than "restore shortfall" on the basis of a 10% price forecast. It would equal a "Rooker-Wise" provision on tax allowances
5.95	70	13.3	+115	
6.00	75	14.3	+150	

CONFIDENTIAL FROM Mr C D Butler
DATE 27 January 1982

27/1

1 MR MONGER

2 CHANCELLOR

cc attached for

Chief Secretary
Financial Secretary
Minister of State C
Minister of State L
Sir A Rawlinson
Mr Barratt

cc Mr Battishill
Mr Kemp
Miss Peirson
Mr A J White
Mr Norgrove
Mr Aaronson
PS/IR
Mr Spence - IR
SS1
Spare

CABINET: CHILD BENEFIT

You asked for some background information on the movement of child benefit since the Government took office including comparisons with changes in family incomes.

2 The attached tables show:

(i) The rates of child benefit at the time of upratings and comparisons with the RPI;

(ii) the same information expressed at financial year averages;

(iii) the changes in the tax and NIC burden on families with children compared with single people and childless couples.

3 You may also be interested to see tables prepared by CPAG - but based on Government information - showing

(iv) changes in tax "break-even" points (the point at which, taking account of tax-free benefits, the family unit becomes a net payer of tax);

(v) value of child support for basic rate taxpayers since 1946.

4 The CPAG memorandum sent to you on 18 January of course makes all the points attacking the record on child benefit. The positive points might be summarised:

(i) The 1981 Budget announced a 10.5% increase in CB; above the expected movement of prices (10%), and the benefit uprating (9%), and compared with no change in the personal allowance;

(ii) on a financial year basis the level is just above the CB/CTA real level in 1978-79;

(iii) on a comparison of tax break-even points married couples with children fared less badly between 1980-81 and 1981-82 than single people or childless couples.

CDB

C D BUTLER

	Nov 78	April 79	Nov 79	Nov 80	Nov 81	Nov 82* (estimate)
1. Child Benefit: cash value	3.00	4.00	4.00	4.75	5.25	5.80
RPI	202.5	214.2	237.7	274.1	306.9	337.6
Child Benefit: real value (index)	100	126.1	113.6	117.0	115.5	116.0
Child Benefit plus value of child tax allowance in 1978-79 (index of real value)	100	104.0	93.8	96.7	95.4	95.7

*assuming 10% movement of RPI

2. Table 1 using Financial Year averages

	78/9	79/80	80/1	81/2
Child Benefit: cash value	2.57	4.00	4.27	4.94
Child Benefit: real value (index)	100	132.6	122.7	126.8
Child Benefit plus child tax allowance (index of real value)	100	106.3	98.4	101.7

3. Burden of Income Tax plus NIC allowing for Child Benefit as a percentage of gross earnings for a man on average earnings

	Per cents				Percentage Change
	78/9	79/80	80/1	81/2	78/9 to 81/2
Married couple, 2 children (one earner)	21.2	19.2	21.1	22.8	+ 7.5
Married couple, no children (two earners)	20.1	19.7	21.6	24.1	+ 19.9
Single person	31.7	29.8	30.8	32.4	+ 2.2

Table Five: Value of child support for each child in standard rate tax-paying families expressed at November 1981 prices £

Date	Children under age 11: 1st child	2nd child	3rd and subsequent children	Children aged 11-15: 1st child	2nd child	3rd and subsequent children
August 1946	4.52	6.20	6.20	4.52	6.20	6.20
April 1950	4.84	6.34	6.34	4.84	6.34	6.34
April 1955	5.93	7.88	7.88	5.93	7.88	7.88
April 1960	4.70	6.40	6.84	5.83	7.59	8.03
April 1964	4.77	6.27	6.71	5.77	7.38	7.71
April 1965	4.78	6.26	6.57	5.84	7.26	7.62
April 1966	4.62	6.04	6.35	5.63	7.00	7.36
April 1967	4.48	5.86	6.16	5.47	6.80	7.15
April 1968	4.29	5.38	5.66	5.24	6.32	6.61
April 1969	4.07	5.32	5.63	4.96	6.21	6.53
April 1970	3.85	5.04	5.33	4.70	5.88	6.18
April 1971	4.49	5.69	5.96	5.18	6.42	6.69
April 1972	4.22	5.35	5.60	4.88	6.04	6.30
April 1973	3.83	4.80	5.03	4.53	5.46	5.70
April 1974	4.40	5.21	5.38	5.06	5.82	6.05
April 1975	3.85	5.33	5.33	4.40	5.90	5.90
April 1976	4.04	5.30	5.30	4.50	5.76	5.76
April 1977	3.88	4.44	4.44	4.27	4.84	4.84
April 1978	4.62	4.62	4.62	4.99	4.99	4.99
April 1979	5.73	5.73	5.73	5.73	5.73	5.73
Nov 1980	5.32	5.32	5.32	5.32	5.32	5.32
Nov 1981	5.25	5.25	5.25	5.25	5.25	5.25

Note: Child support equals the combined value of child tax allowances after clawback and family allowances/child benefit.

Source: House of Commons Hansard, vol 14, 7 December 1981, cols 303-4

Child benefit has been increased by 31.3 per cent since May 1979 compared with a 51.8 per cent increase in the retirement pension.[15] Table Six shows how, over a longer period, the position of children has deteriorated relative to that of pensioners. Child support for a two child family is now equal to little more than a fifth of the pension rate for a couple, whereas in the 1950s, it stood at nearly three-fifths of that rate. The point of the comparison is not to argue that the pension is overgenerous but to demonstrate how the balance in the financial support provided by the community for two different dependent groups has shifted dramatically in the space of a couple of decades. As far as we know this shift against children was not the result of a deliberate act of policy; rather it reflects years of neglect of children at a time when the needs of pensioners were, rightly, receiving greater public recognition than previously.

Table Three: Changes in tax break-even points 1949/50 to 1981/82. Index at 1949/50 prices and as % of average male manual earnings

(1949/50 = 100)

Tax year	Single person		Childless couple		Couple + 2 children*		Couple + 4 children**	
	Index	As % of male manual earnings	Index	As % of male manual earnings	Index	As % of male manual earnings	Index	As % of male manual earnings
1949/50	100	39.4	100	62.8	100	122.7	100	185.6
1959/60	95.2	27.4	99.1	45.7	114.9	103.5	133.1	181.1
1969/70	112.3	25.4	103.9	37.3	96.7	68.0	103.3	109.8
1970/71	134.2	28.7	120.2	41.0	96.5	64.4	98.1	98.9
1971/72	122.6	25.8	109.9	37.0	98.9	65.0	104.5	103.8
1972/73	161.6	32.1	132.2	41.8	107.5	66.4	107.7	100.5
1973/74	147.3	28.0	120.2	36.5	97.4	57.6	97.1	87.0
1974/75	131.5	24.2	114.2	33.5	93.6	53.8	92.6	80.4
1975/76	113.7	21.5	100.9	30.4	82.6	48.7	82.1	73.0
1976/77	107.5	20.7	99.6	30.5	83.5	50.1	82.7	75.0
1977/78	121.2	24.9	117.2	36.8	90.8	58.1	84.4	78.4
1978/79	117.1	21.8	114.2	34.0	103.7	60.4	96.5	84.9
1979/80	119.2	21.9	116.3	34.1	109.2	62.5	102.3	88.6
1980/81	121.2	22.6	118.5	35.3	102.2	59.7	95.3	84.1
1981/82	108.2	20.3	106.0	31.7	97.4	57.0	93.0	82.3

* 2 children aged under 11, ** 2 children aged under 11, 1 aged 11-15, 1 aged 16 or over.

Source: Inland Revenue Statistics, 1980, Tables 2A1, 2 & 3;
House of Commons Hansard, Vol 14, 11 December 1981, cols 508-510

K.3

ENERGY PRICE SUBSIDIES

If Ministers press for energy price subsidies, we recommend the following line:

"The November report of the NEDC Task Force shows clearly that there is no general energy pricing problem compared with Europe. Most industrial gas consumers have a clear price advantage over the Continent. Electricity prices, even for intensive users, are broadly in line.

It is clear, however, that there are electricity price disparities with France and with some users in Germany. MISC 56 agreed in the Summer that some limited help should be offered to these consumers. But despite considerable work, Departments have been unable to devise a scheme which was compatible with the industry's statutory "no undue preference" requirement and Community obligations.

The Secretary of State for Energy has recently received the Electricity Council's review of the Bulk Supply Tariff. I will be discussing this with him shortly. The 1981 Budget included some £40m help for large electricity consumers and I have not ruled out the possibility of further help in the forthcoming Budget. But the technical and legal difficulties which made it so difficult to implement the MISC 56 decisions pose formidable problems.

Any general help for electricity bill would be enormously expensive. For example, prices based on short run marginal cost would lose the industry some £1.2bn in revenue a year; and would provide little help to the intensive user whose prices are already near SRMC.

K.4

DEPARTMENT OF INDUSTRY EXPENDITURE PROPOSALS

The Secretary of State for Industry is expected to propose additional expenditure of:

1982-83	1983-84	1984-85
£45 million	£110 million	£165 million

A breakdown of these figures, which cover some 23 separate proposals, is attached.

2 All the additional expenditure proposed is in the high technology area. It is to support schemes for promoting the awareness and use of computer-aided design and manufacture, robotics, microprocessors, opto-electronics and other advanced technology.

3 A group under Mr Quinlan is preparing a paper on "Industrial Innovation" for the Chancellor's Health of Industry Group which is now scheduled to meet on 2 February. This paper will look at these and other possible measures to promote innovation.

4 The attitude of Treasury officials is basically not unfavourable to a certain amount of additional expenditure in this area. The introduction of new technologies can produce very great increases in productivity and is essential if Britain's competitiveness is to be maintained. But any additional expenditure would make the position on the Contingency Reserve more difficult.

5 In discussion with the Department of Industry, Treasury officials have taken the view that any addition for this purpose should be offset by savings on less effective forms of assistance to industry. But in practice Regional Development Grants are the only part of the DOI budget on which they could hope to achieve savings of this size, and as Treasury Ministers know even the small cut agreed in the last public expenditure round has failed to be delivered.

6 We judge that Mr Jenkin's bid is deliberately ambitious and consider that (if Treasury Ministers are prepared to accept any addition to public expenditure) a useful impetus could be given to innovation by an additional allocation of:

1982-83	1983-84	1984-85
£30 million	£50 million	£50 million

7. If Mr Jenkin raises this at Cabinet we recommend that Treasury Ministers give no commitment but agree to consider the proposals and discuss them with him in the near future. They will not want to refer explicitly to the Health of Industry Group, knowledge of which is confined to the participant Departments.

DOI EXPENDITURE BIDS

	1982-83	1983-84	1984-85
Small firms engineering scheme, numerically controlled tools, computer aided design and manufacture	11	21	27
Information technology, fifth generation computers	7	11	17
Electronics applications, MAP, advanced instrumentation and control, fibre optics	5	27	35
Various items, including space, components industry scheme, office of the future, energy conservation demonstration projects	10	22	36
Increase maximum PPDS grant and reduce the minimum project size for S8 assistance	12	30	48
Total (rounded)	45	110	165

Divided between:

Industry Act	15	31	43
Science and Technology Act	30	80	122

K. S

AGRICULTURE

(a) Extension of agricultural capital grants to plant and machinery

Mr Walker put forward a bid in last year's PES for an extra £30m a year to extend the coverage of existing agricultural capital grants to plant and machinery. Resist - this was rejected by MISC 62; too expensive; and capital grants for agriculture already generous compared with those available for industry.

(b) Marginal lands survey

Agriculture Ministers are considering proposals to extend the boundaries of the Less Favoured Areas, which benefit from payment of Hill Livestock Compensatory Allowances and preferential rates of capital grant. Possible costs - of the order of £10m a year. Resist - evidence justifying extension of the boundaries is extremely weak; not possible to justify such a measure when Assisted Area Boundaries for payment of regional development grant are to be severely contracted in August.

(c) Financial assistance to UK fishing fleet

Mr Walker has £24m in 1982-3 available to spend on restructuring the UK fishing fleet, if agreement is reached on a Common Fisheries Policy. But if no agreement is reached on the CFP early this year, he will probably want to make available a third tranche of purely national assistance as in 1980-81 and 1981-82. He may well bid for more than £24m for this purpose. Line to take:

> any decision on this premature until it is clear the current efforts to re-start the negotiations on the CFP are unlikely to lead to an early agreement. [If pressed] prepared to consider when it becomes clear that the CFP negotiations have become deadlocked.

(d) Marketing initiative

Mr Walker bid for additional expenditure of £2m in 1982-3, £4m in 1983-4 and £6m in 1984-5 to improve the marketing of UK agricultural output. This was rejected in the PE survey by MISC 62. But the Chancellor has indicated some sympathy with the objectives of this expenditure. We suggest this could be considered, but only if concessions to other spending Ministers are contemplated.

(e) Emergency aid to farmers following bad weather

So far Agriculture Ministers have stoutly defended the usual line that bad weather is one of the normal risks inherent in farming for which the Government does not give compensation. But the Secretary of State for Wales in particular may want to argue that this year's emergency was exceptionally severe and justifies some Government assistance, eg in the form of a contribution to any relief fund set up by the NFU. The EC Commission have now offered £0.8 million to help individuals affected by the disaster. Farmers will get their share of this. No evidence that more is needed.

K. 6

CABINET 28 JANUARY: BRIEF ON ASSET DISPOSALS

General treatment of asset disposals

All receipts from disposals of public sector assets not credited to individual programmes are scored to the special sales of assets line shown in Table 1.1 of the draft public expenditure White Paper. These special sales count as negative offsets to planned expenditure and thus reduce the planning total and PSBR. Most, but not all, of the past and planned receipts are associated with privatisation measures (eg sales of majority Government shareholdings); other flows arising from such measures (eg lost public sector receipts) are also taken account in the calculation of special asset sales total, if they have not been taken on board elsewhere.

The figures

The figures in the special asset sales line (line5) of Table 1.1 have been based on a simple summation of the estimated receipts from individual disposals, but with two refinements :

(i) Half the receipts from the sale of Britoil projected for 1982-83 have been spread into 1983-84.

(ii) Half the receipts from the sale of BGC's offshore oil assets projected for 1983-84 have been spread into 1984-85 (some BGC receipts are also projected for 1984-85 - these have similarly been partly spread into 1985-86).

In addition, the figures have been rounded. The following table summarises the approach that has so far been adopted. Sir Anthony Rawlinson's submission of 25 January sets out the case for this in relation to BNOC.

Estimated receipts from special disposals, £ million

	1981-82	1982-83	1983-84	1984-85
Latest estimate (25 January 1982) of aggregate net receipts from individual disposals.	35	820	446	578
of which from sale of Britoil shares in 1982-83	-	750	-	-*
of which from sale of BGC oil assets (Wytch Farm in 1981-82, offshore assets in 1983-84 and 1984-85)	150	-	300	345
Net receipts after 'spreading' half of Britoil and BGC offshore asset proceeds.	35	445	671	556
Rounded figure in Table 1.1, line 5.	50	500	600	600

*Purely as a working assumption, the aggregate figure for 1984-85 includes an additional £200m from a possible further sale of Britoil shares. We have also assumed, in each of the last two years, 'miscellaneous' sales totalling £100m.

Line to take: (i) General

The asset disposals programme as a whole is crucially dependent on receipts from the sale of Britoil shares and BGC offshore oil assets. It remains the Government's policy to achieve these in 1982-83 and 1983-84/1984-85 respectively. But the figures in line 5 of Table 1.1 are intended to be estimates, not targets. It would be wrong to allow the Government's public spending plans to be excessively influenced by disposals which remain highly uncertain.

[On the question of spreading BNOC receipts between 1982-83 and 1983-84, Treasury Ministers will wish to avoid being drawn into debate in advance of final decisions. If Mr Lawson raises the issue, as we understand he might, his points should simply be noted.]

The following paragraphs give a line to take on the valuation of the main individual assets that might be mentioned. The figures are summarised in the Annex to this brief.

Line to take: (ii) Britoil

The arithmetic assumes that proceeds from the disposal of 51 per cent of the equity in Britoil will amount to £750m. The valuation reflects a study by Rothschilds of the likely market rating of Britoil. It is based on future profitability and dividend yield, to which the market attaches more weight than to asset value. At this stage, obviously, it represents only a preliminary judgement, and the actual proceeds will depend on market conditions. Stock-brokers' estimates, which have been reported in the press, are on a different basis - they represent discounted cash flow valuations of BNOC's oil assets. The higher valuations appear to have been based on a lower discount rate than appears realistic (we would use a figure of 10 per cent real; the higher end of Wood Mackenzie's range is based on a 5 per cent real discount rate, and Phillips and Drew's estimate appears to be based on a discount rate of 10 per cent nominal, the result being discounted by a further 20 per cent). [Defensive: The timing of the receipts from the Britoil disposal is uncertain. First, the issue may be delayed by adverse market conditions. Secondly, it is possible that the issue would be in partly-paid form, to spread the load on financial markets.]

Line to take: (iii) Wytch Farm

The PEWP figure is £150m in 1981-82. The Secretary of State is trying hard to achieve this in 1981-82, but for reasons the Treasury has recognised it may slip. The figure of £150m is not out of line with brokers' estimates. BGC have suggested, as reported in the Financial Times of 11 January, that the figure may be as high as £400m. We have not yet seen a detailed analysis of this, but think it is probably misleading - it attaches as much weight to possible reserves as to proven reserves, and uses an unrealistically low discount rate of 5 per cent real. Adjusting BGC's calculations to a more realistic basis would produce a result close to the PEWP figure.

Line to take: (iv) BGC Offshore Oil Assets

The PEWP figures are £300m in 1983-84 and £345m in 1984-85. These are based on estimates by BGC. We now understand from the Department of Energy that these figures may be on the high side, and that the proceeds are likely to be of the order to £500m in total. This lower estimate is comparable with Wood Mackenzie's figures, but substantially higher than Phillips and Drew's. Phillips and Drew seem to be much more pessimistic than Wood Mackenzie about one particular field. The Department of Energy are due to provide a full assessment of the valuation shortly, after they have received a report from their financial advisers. Until this is received, it is not possible to explain more fully the divergence between the valuations.

COMPARISON OF ESTIMATED PROCEEDS FROM DISPOSALS

1. Britoil

Assumption in PEWP

Year	Amount	
1982-83	375	
1983-84	375	
		750 - for 51%
1984-85	200 - for further tranche of shares	

Estimate by Phillips and Drew (P&D) November 1981

Year	Amount
1982-83*	900 (for 51%)

Estimate by Wood Mackenzie 30 July 1981

Year	Amount
1982-83	800-1200

* These commentators recognised that the issue might need to be spread over a period, perhaps by an issue in partly-paid form.

2. BGC - Wytch Farm

Assumption in PEWP

Year	Amount
1981-82	150

Range of estimates reported in "Financial Times", 18 December 1981

125-180

Figure reported in "Financial "Times", 11 January 1982

400

3. BGC - North Sea oilfields

Assumption in PEWP

Year	Amount
1983-84	300*
1984-85	345*

*Preliminary figures from BGC which may be revised downwards to c. £500 million in total.

Estimate by Phillips and Drew, November 1981

360

Estimate by Wood Mackenzie, 30 July 1981

425-540

K.7

CONSTRUCTION PACKAGE

I Tax measures to help the construction industry

1. A number of tax proposals aimed at helping the construction industry are under consideration.

2. Several involve capital allowances available against corporation tax. These can be expensive. Introducing capital allowances for commercial building could build up to an annual cost of about £1 billion. Increasing the existing allowance on industrial buildings from 75% to 100% would build up in cost to about £70 million a year.

3. In other cases the "construction industry" argument appears to be used to bolster the case for tax changes that would probably be of relatively little benefit to the industry - such as raising the £25,000 ceiling on mortage interest relief.

4. Mr Heseltine has suggested special reliefs for the inner cities. Another possibility is relief for private rent housing. On development land tax, at your recent meeting Treasury Ministers were disinclined to any action in this budget.

5. We shall be reporting shortly to Treasury Ministers on all these. There do seem to be some tax elements for a construction package, but it is fair to say that the industry is more interested in additional expenditure, rather than tax relief.

II Public expenditure measures

6. The general brief on public expenditure argues against any further increase in expenditure programmes. Moreover:-

i) Constructinn packages in the past have always been found to have their effect at least a year late; it takes time to get projects underway.

ii) Public expenditure on construction is anyway expected to rise by more than 9% between 1981-82 and 1982-83, to nearly £10½ billion.

iii) Number of houses started and improved in 1982-83 should be higher than in 1981-82 (see below) and there should be a slight increase in work done on water and sewerage projects.

7. Mr Heseltine may mention his proposed paper for E Committee on private sector finance for increased construction investment. Agreed remit attached. Aim is to report by end February - suggest leave discussion until then. (See also paragraph 10 below.)

8. Mr Heseltine may suggest extra resources for construction in inner cities. On housing, see below. On other inner city expenditure,

- Mr Heseltine has already announced considerable expansion in urban programme and in reclamation and development works by UDCs (offset by savings elsewhere in his programmes). Not clear further provision could usefully be spent in short term.

- Scarman report noted that a lot of money already spent on inner cities without apparently achieving much. Ineffective management of programme is being investigated by Mr Heseltine's task force; should wait for results before expanding programme, or risk wasting more money.

- Specifically agreed at Ministerial meeting on 23 September that substantial extra resources for inner cities should wait for firm proposals from Merseyside team.

9. On water and sewerage, Mr Heseltine might seek to have cuts restored. But he has acknowledged that recent keen tender prices mean cuts will have little or no effect on volume of work done, which likely to be slightly higher in 1982-83 than 1981-82.

10. Mr Heseltine may mention his recent proposal for massive, privately-financed sewerage treatment project on Mersey. (DOE due to come back on details.) Seems unlikely he can attract finance on basis which will allow project to score as private sector. He may now agree and seek extra public

expenditure for it. But project cannot start until 1984.

11. On housing, Mr Heseltine may push for

i) new public investment in inner cities, particularly to attract new private investment;

ii) need to promote new investment in private rented housing to improve labour mobility and to reduce pressure on public sector.

But general prospects for housebuilders already good: numbers of new private house starts in 1981 were well up on 1980 and still rising, and likely to go on rising. And

- on (i) above, agreed plans already allow for a real increase in gross housing capital spending in 1982-83; the first real increase, year on year, for seven years. Mr Heseltine has had option of increasing allocations to inner city authorities, and has done so in some cases.

- on (ii) above, DOE and Treasury officials have just completed study which suggests difficult to achieve major improvement in state of private rented market without substantial tax reliefs/ investment grants or rent deregulation: report will be submitted to you shortly. You might take note of Mr Heseltine's views; and agree that the state of private rented housing is subject on which further discussion is needed in light of report by officials.

12. On roads, particularly slow to get going; and keen tender prices mean cuts in 1982-83 plans will have little or no effect on previously planned mileage.

THE CONSTRUCTION INDUSTRY - DRAFT REMIT

The Secretary of State for the Environment, in conjunction with the Chief Secretary, Treasury, is invited to submit a paper which considers the direct involvement of market finance in construction projects in the public sector. The paper should take into account the effects of any such funding on the Government's wider economic policies, including the aim of limiting the extent of the public sector and the growth of the money supply and total nominal expenditure. It should also consider how market finance might be raised under conditions of fair competition with the private sector and how far the greater cost of market finance would be justified by additional pressure for better performance in each case. The paper should set out the various initiatives of this kind which have been taken or are being considered, including also schemes where a small amount of public expenditure or public guarantees might be used to attract additional private investment and make recommendations as to what further initiatives might be proceeded with.

The paper should be submitted to E Committee not later than the end of February.

Factual

Government's tax objectives, as stated in the Manifesto, included :

"Switch to some extent from taxes on earnings to taxes on spending".

"Cut income tax at all levels" and, in particular, "cut the absurdly high marginal rates of tax both at the bottom and top of the income scale".

"Tax thresholds to be raised to "let the low-paid out of the tax net altogether".

In short, the central thrust of stated objectives is to reduce the burden of taxation, to increase incentives to work and invest so as to promote growth and increased employment.

2. But since the Government took office :-

(i) total non-North Sea tax burden has increased - from about 35% of GDP to over 40%;

(ii) starting point for income tax is now lower in real terms - for married men down from 31% to under 28% of average earnings. And starting point for basic rate tax has been significantly reduced by the abolition of the lower band. Real improvement in thresholds has occurred only for the three highest rates of tax;

(iii) rate of employees' NIC has been raised $1\frac{1}{4}$ points to $7\frac{3}{4}$%. And employers' rate is up by $\frac{1}{4}$%;

(iv) no significant reduction in the general burden of business taxes - Corporation Tax still at 52% and NIS at $3\frac{1}{2}$%;

Thus at present falling a long way short of Manifesto commitments and of achieving the reduced levels of taxation which are essential to improve economic performance. Indeed, at risk of being judged a Government of higher rather than lower taxation.

Positive

Balance between companies and persons - will be looking at this very carefully. The increases in national insurance contributions announced in November were geared to minimise any further burdens on companies. The nominal yield of NIS and employers' NIC is expected to rise by about 7 per cent in 1982-83; about 1 percentage from the increase in the earnings limits and the remainder from increases in earnings. In real terms the burden of NIS and employers' NIC is expected to fall in 1982-83 for the second year running.

2. Cuts in taxes on persons help companies through higher demand for products. Differences in benefits to companies between cutting NIS and raising income tax threshold is not as great as often thought.

3. Strong case for raising the income tax starting point. Only way the low paid can be taken out of tax. The most important factor in the "why work" syndrome. Valuable incentive and supply side effects: wider gap between income in and out of work will help reduce unemployment. But action here expensive: indexation of income tax - already assumed and only maintaining real value of thresholds - will cost about £1.6 billion in 1982-83, while to restore the 15 per cent real fall caused by non-indexation in the 1981 Budget wou ld cost an additional £2 billion in 1982-83.

4. Concerned about the profitability and financial position of companies, with real rate of return down to 2 per cent from over 10 per cent in the 1960s while personal sector income has risen steeply up to 1980, and personal sector spending maintained in 1980 and 1981 while company sector spending fell sharply. Possibilities for action here include cutting corporation tax and NIS. A reduction in NIS would:

(i) reduce labour costs, assist profitability and competitiveness, and have some benefit on prices;
(ii) encourage employers to take on labour;

But it is expensive - a 1 per cent reduction would cost £900 million in revenue in a full year (after taking account of saving in NIS paid by local and central Government). Risk that it would leak in part into higher wages. Cuts in Corporation Tax would be slower working, only of benefit to the 40 per cent of companies regularly paying corporation tax but less likely to leak in higher wages.

5. Want to take further measures to stimulate enterprise. Already done a great deal, and considering further action.

6. Want to look again at capital taxes. Strong body of opinion in favour of action to stop capital gains tax being charged on inflationary gains.

7. On the specific duties - drink, tobacco, petrol etc - revalorisation would point to increases of 2p on a pint of beer, 9p on a gallon of petrol and 7p on 20 cigarettes. Add about 1 point to RPI. Not wedded to revalorisation. Will take account of state of industries and political pressure (eg on petrol).

8. North Sea oil - industry wants change in tax structure and a substantial reduction in tax take. Discussing with Secretary of State.

[See also paper on fiscal options submitted by Mr Kemp on 22 January.]

Facts

MTFS

The illustrative medium-term projection for the PSBR contained in last year's Budget Report was as follows:-

1981-82	1982-83	1983-84	
$4\frac{1}{2}$	$3\frac{1}{4}$	2	PSBR as a % of money GDP

This figure for 1981-82 is equivalent to £$10\frac{1}{2}$ billion and $3\frac{1}{4}$ per cent for next year is likely to imply a cash figure of around £9 billion.
On course for 1981-82 figure of £$10\frac{1}{2}$ billion.

Civil Service dispute:

- revenue still outstanding is rather less than £3 billion
- forecast effect on PSBR this year about £$\frac{1}{2}$ to £$\frac{3}{4}$ billion. Largely due to higher debt interest costs. Effect on tax revenue this year broadly neutral.
- about £1 billion delayed tax payments still to come in 1982-83 (offsetting net loss in revenue in 1980-81). [To be treated like any other tax receipt. No reason here to add to £9 billion - £1 billion already taken into account.]

Cyclically adjusted PSBR

Facts

A number of commentators have adjusted the PSBR for the estimated effect of the recession (eg Kellner, OECD, NIESR) and concluded that current fiscal policy is excessively tight. But they all get different answers: no uniquely correct way of doing these calculations (as pointed out in February 1981 EPR article, Treasury Working Paper No 1.).

Main Points

- Last year the PSBR was raised by £3 billion above the planned figure on account of the recession.
- But quite wrong to suggest that the cyclically adjusted PSBR is the appropriate measure of fiscal stance. It is the taxes that people actually pay and expenditure that is actually paid out that affect demand, not some hypothetical calculation of what they would be in other circumstances.

- Also wrong to suggest that government should hold cyclically adjusted PSBR constant. This would be inconsistent with "steady but not excessive downward pressure" needed to reduce inflation.

- Main criterion for judging the appropriate size of PSBR is ease with which it can be financed without strain on interest rates. If the demand for money falls in a recession the PSBR can be raised within the monetary guidelines without putting up interest rates. That is why we raised the planned PSBR last year. We have to fund the actual not the cyclically adjusted PSBR.

- Cyclical adjustments based on "full employment" assume that unemployment could be cut merely by reflating output.

- Agree that PSBR not invariant to composition of tax changes. Decision not yet taken: but Chancellor will take account as necessary.

Rise in unemployment not just due to recession. Unemployment is a bad cyclical indicator.

WHY DOES A £9 BILLION PSBR LEAVE ROOM FOR TAX CUTS, DESPITE A P/E PLANNING TOTAL OF £115 BILLION?

Factual

(i) The October 20 Cabinet paper said that "we cannot plan at this stage for a 1982-83 PSBR larger than some £9 billion", and that even a planning total of £113.5 billion as proposed by Treasury Ministers would "certainly make it quite impossible to hold out any reliable hope of tax reductions".

(ii) The planning total agreed was some £115 billion. Colleagues may question how it is now possible to talk about tax reductions.

Defensive

(i) Forecasts of the PSBR are notoriously liable to error: the PSBR is a small difference between two very large numbers.

(ii) Nearly four months have passed since the figures used in the October paper were put together: only small changes in the prospects are needed to produce the improvement in the borrowing prospect now foreseen.

(iii) Even to go to £9 billion would involve risks to interest rates. The world interest rate prospect is no better than it was in October.

IF PRESSED

(iv) Our central estimate of the PSBR consistent with £113.5 billion was somewhat less than £9 billion; but the PSBR was not the main issue in October.

(v) The PSBR picture was (and is) complicated by the effects of the Civil Service strike. There may be about £1 billion delayed tax receipts to come in 1982-83.

(vi) In October we did not take credit for this tax spillover. The figures in the 28 January paper do. Could be argued that unwise to use this temporary bonus to cut tax rates, especially when the interest rate outlook is still so gloomy. This points ideally to choosing a PSBR of less than £9 billion now. But need also to recognise the case for action on the tax front at this stage.

WHY REFLATION NOT SENSIBLE

Facts

Estimates of effects depend crucially on unquantifiable factors eg confidence in financial markets.

- No shortage of monetary demand: in 1970s money income rose 20 times faster than real output. In the last 2 years money income has risen by 20 per cent, real output fell 5 per cent [NB These relationships do not necessarily apply to marginal increases in money spending especially in short term]

- Recent packages put forward by advocates of reflation frequently show relatively small effect on unemployment eg: National Institute £5 billion reflation reduces unemployment by 150-300,000 after five years; Blake/ ITEM (The Times) £4-6 billion package unemployment down by 133,000 after 3 years; NIESR see falling exchange rate (no comment on interest rates); Blake/ITEM see higher interest rates (no comment on exchange rate).

- PSBR plans raised by £3 billion this year on account of recession

- Government has taken steps to help particularly hard-pressed groups (Summer measures, young people, training etc)

- General recognition by developed countries of need to restrain budget deficits

- Government strategy designed to secure sustainable improvement in output by cutting inflation

Defensive

- Reflation through extra capital expenditure not exempt from effects on interest rates and inflation which erode away the benefits to employment. Higher intere rates and inflation hit other forms of investment.

- Why not a little reflation? Room for this depends critically on the level of interest rates required to finance the resulting PSBR. Even moderate (or "selective") reflation has only transitory benefits if it means higher interest rates. Always a risk that reflation will be misinterpreted as major change in direction. That would be damaging to confidence, exchange rate and could undo progress on inflation so far.

TAX CUT/INTEREST RATE TRADEOFF

Positive

1. Level of the PSBR affects the level of interest rates. With a PSBR of £7-8 billion, we would use available room for manoeuvre to help on interest rates. With a PSBR of £9 billion, that room would be used to reduce taxes.

2. As a broad rule of thumb, with PSBR of £9 billion (through lower taxes) interest rates might be ½-1 per cent higher in 1982-83, compared with what they would be with a PSBR of £7 - 8 billion and the same rate of monetary growth. But precise effects depend on nature of tax cuts. Price reducing tax cuts have less effect on interest rates than cuts in income tax.

3. Tax cuts are better for output than lower interest rates but only for a few years.

4. Lower customs duties or lower NIS might be a bit better for inflation, than lower interest rates. but only for a year or so. Lower income tax might be slightly worse for inflation, even in the short run.

Defensive

1. PSBR is not the only influence on interest rates. But we cannot do much about world interest rates. We can do something about the PSBR.

2. With a higher PSBR this year, UK interest rates would have been even higher. If we had held down interest rates when world interest rates rose, the exchange rate would have fallen more steeply. That would have damaged inflation.

MISUNDERSTANDINGS WHICH AROSE ON OCTOBER 20

This brief deals with misunderstandings that arose out of the calculations in Annex B of the Cabinet paper for October 20.

Q. Expenditure on Publc Service Manpower an Aunt Sally?

Not true. The Annex examined this case as being the most favourable to those who argue that reflation is self-financing. Other, more realistic cases are even less favourable to self-financing.

Q. Cost per Job Figures Unrealistically High?

The calculations in Annex B of the October 20 Cabinet Paper implied a net PSBR cost of £6,450 for getting one person off the unemployment register. For procurement expenditure the cost was even higher at £20,000. These figures may appear high but:-

- they relate to changes in unemployment. The associated change in employment is normally larger because some of the newly employed will not previously have registered as being unemployed;

- there is a lag between increases in expenditure and reductions in unemployment;
- some of the expenditure will "leak" into imports and savings.

SUMMARY OF REFLATIONARY PACKAGES

[Figures are gross costs unless otherwise stated; price bases are indicated where known.]

Note: Figures could be compared with the £1½ billion "Ch/Ex package"

CBI

£6 billion net fiscal stimulus spread over four years ("Will to Win" March 1981; amplified in "Agenda for Recovery" September 1981). More public sector investment; further aid to industry; abolition of NIS; their capital taxation; employment measures.

TUC

£24 billion programme spread over five years ("Reconstruction of Britain" August 1981). Emphasis on house building, road, rail, inner cities and other public works.

[Leak of TUC annual Economic Review 1982 in FT, Times, suggests reflationary package of over £6 billion for 1982-83 will be sought in next Budget.]

Conservative Backbenchers

1. "Blue Chips" £4-5 billion per year extra public spending over two years plus £2 billion cut in NIS ("Changing Gear" October 1981).

2. Sir Ian Gilmour £5 billion fiscal package for 1982-83 (speech, October 1981). NIS cuts, £½ billion extra capital spending and "Layard" subsidies to employers.

SDP

1. Roy Jenkins: £2-3 billion over two years (most in first year) extra public spending on employment subsidies; SEMs; more public sector investment in environment, etc. (Warrington, July 1981).

2. Horam: £5 billion fiscal package in 1981-82 prices (speech October 1981). Extra public sector investment; cuts in NIS and VAT. Tax cuts partly conditional on further pay moderation.

3. Shirley Williams: package including £2-3 billion extra sector investment plus new training measures, cuts in NIS, etc. Not fully costed but probably in region of £5 billion in 1982-83. (Crosby, November 1981).

Liberals

£9 billion programme spread over three years ("A Chance to Work" January 1982; updates "10-point Plan" published January 1981). Claim PSBR cost only £3 billion. Package includes extra public sector investment on environment, regions and nationalised industries; and new training and employment measures.

BANK OF ENGLAND AND CBI VIEWS

(i) Bank of England

The Governor's views will carry weight with different colleagues to different degrees. You might say if asked, or volunteer if appropriate, that the Governor sees

- over-riding need to keep up the pressure to reduce inflation;
- important to give no indication to markets of any relaxation of policy that would indicate a significant deviation from underlying objectives;
- room for manoeuvre therefore limited;
- might be best to have low PSBR to help interest rates, but reduction in inflation by tax cuts could be better way;
- favours tax cuts to help prices and costs
- [if asked] Governor believes that in context of maintaining firm financial policies might be feasible to introduce measures raising PSBR by up to £2 billion so long as concentrated on tax changes which reduce prices and costs.

You might in general draw attention to Governor's view of the delicate state of market confidence in relation to interest rates and exchange rate, and the risks. On composition of tax cuts, Governor's arguments certainly need to be taken into account alongside other arguments eg on role of cuts in personal tax to help incentives and atmosphere for the next pay round.

(ii) CBI

Have not yet published their formal representations. But in summary, they want:-

- NIS cut 2%;
- 15% business derating;
- lower interest rates;
- £1 billion on extra public sector capital investment by 1983-84;
- cuts in public spending, particularly manpower (including local authorities and NHS);
- action on energy costs;
- changes in CGT and CTT;
- various other more minor changes;
- CBI do not want very large expansion in demand because effect on exchange rate and interest rates; vast majority of CBI members feel that they will be best able to take advantage of extra demand for their product if any expansion is not so rapid as to put at risk the success that they have achieved in controlling their own costs.

You might say:-

- you have not yet examined these proposals in detail;
- if the whole of any freedom of manoeuvre were devoted to companies, might be able to go a good way to meet the CBI; but
- persons also have good claims;
- will be discussing their proposals with the CBI;
- [if asked] CBI calculate the cost of their proposals at £1.8bn on the PSBR in 1982-83. Probably an unrealistic calculation, but shows CBI broadly in line with Treasury assessment of what might prudently be spent;
- [if pressed] CBI suggest PSBR in 1982-83 of £11-12bn, up from their forecast on unchanged policies of £9-10bn. On this you might say that in many ways it is the <u>change</u> not the <u>level</u> which matters and CBI members don't want a very large expansion in demand (see above).

OTHER COUNTRIES' POLICIES

Factual

(i) Firm action by governments in major 7 industrial countries held budget deficits down to 2½ per cent of GDP last year (same as 1980), in spite of tendency for recession to increase them (See Table 1).

(ii) Extra spending on benefits to unemployed together with increased cost of debt service due to higher interest rates had to be offset by savings on public spending and in some cases by higher taxes.

(iii) OECD Secretariat calculates that about two-thirds of its 24 members announced lower public spending plans and half raised taxes. Some did both.

(iv) Prospects for 1982 are that firm action will again on average hold major countries budget deficits in check. Particularl determined action by Japan and Germany to reduce deficits will offset tendency for increases in U.S and France.

(v) Outlook for US deficit in FY 1983 [to be added in light of President Reagan's State of Union message 26 January]. If increased US government borrowing collides with tight monetary policy and sends interest rates back to record levels, then the sounder our position is, the less closely we shall have to follow them up.

(vi) Monetary targets in many countries being set so as not to accommodate inflation.

Positive

(i) Prospect is for modest growth of major countries' output this year. Industry Act Forecast of 1 per cent by UK is close to OECD forecast for Germany, Canada and Italy and above US. General agreement that to force the pace of recovery would do more harm than good. Despite this, total OECD output expected to be growing at annual rate of 2½-3 per cent by latter half of 1982 and to continue at same rate into 1983.

(ii) Consumer price inflation down to 10 per cent in major countries last year, compared to peak rate of 13 per cent in 1980. Further decline expected this year.

(iii) Wide measure of agreement revealed at Ottawa and IMF meetings that countries should persevere with firm monetary and fiscal policies, and not be pushed into damaging reflation.

Defensive

(i) Firm policies have caused recession? Not true. They have helped OECD countries weather 1979-80 oil price shock better than 1973-74 episode. GDP rose by 1-1½ per cent in both 1980 and 1981. Contrast fall in 1975.

(ii) French reflation successful: we should copy? French, too, have now recognised inflationary dangers. Have frozen F Fr 15 billion of public investment and introduced counter-inflationary measures (eg wages and prices policy).

(iii) True that Germans are considering 'employment' programme but this will not be French socialist style 'job creation' and work-sharing. Likely to be investment incentives financed by higher taxes. German commitment to curbing financial deficit demonstrated impressively in 1982 budget-making. [Review in light of Chancellor Schmidt's possible statement, 27 January].

(iv) Higher unemployment and lower output in UK compared with other majors not caused by tighter fiscal and monetary policies, but by our weaker condition when second oil shock hit us. OECD expect unemployment to grow in all major economies except Japan in 1982, some at higher rate than UK.

(v) Examples of individual countries raising particular spending programmes? Different countries have different priorities and scope for public spending.

TABLE 1

General government financial balances
in the major seven OECD countries
1978-1982

Surplus (+) or deficit (-) as percentage of nominal GNP/GDP

	1978	1979	1980	1981	1982
UNITED STATES	0	+0.5	-1.2	-0.7	-1.3
JAPAN	-5.5	-4.7	-4.1	-3.6	-2.0
GERMANY	-2.7	-2.9	-3.4	-4.4	-4.0
FRANCE	-1.8	-0.6	+0.4	-2.4	-2.7
ITALY	-9.7	-9.4	-7.8	-9.4	-9.7
CANADA	-3.1	-1.9	-2.1	-0.1	-0.2
UNITED KINGDOM	-4.3	-3.2	-3.5	-2.3	-1.4
Total of above countries	-2.5	-1.9	-2.5	-2.5	-2.4

NB The figures in this table need to be handled with particular caution. On the one hand, they show that the UK succeeded in reducing its general government deficit in 1981, to a level below the average of the major seven. On the other, the very low UK figure for 1982 could be used by those arguing for a very large measure of reflation. In the latter context it should be noted that the general government deficit is much smaller than the PSBR in the UK (and other countries, notably France), because it excludes lending to public corporations and to the private sector (eg local authority loans for house purchase) and other financial transactions./CONFIDENTIAL: current forecast of UK PSBR is:

1981-2: 4% of GNP
1982-3: 2¾% of GNP

TABLE 2

OECD Projection of Growth of real GNP
(Percentage changes from previous period)

	1980	1981	1982
UNITED STATES	-0.2	1¾	-½
JAPAN	4.2	3¾	3¾
GERMANY	1.8	-1	1½
FRANCE	1.2	½	2½
ITALY	4.0	0	1
CANADA	0	3	1
UNITED KINGDOM[1]	-1.8	-2	¼
Total of above countries	1.0	1¼	1
Total OECD	1.2	1¼	1¼

1. Industry Act Forecast predicts 1% growth in 1982.

TABLE 3

OECD caloulation of Private Consumption Deflator.
(Percentage changes from previous period)

	Average 1969 to 1979	1980	1981	1982
UNITED STATES	6.3	10.2	8¼	7½
JAPAN	8.6	7.1	4¼	4½
GERMANY	4.9	5.4	5¾	4¼
FRANCE	8.5	13.5	13½	13¾
ITALY	13.1	20.4	19¼	16
CANADA	7.0	10.5	11½	11½
UNITED KINGDOM	12.2	16.0	11	10½
Total of above countries	7.4	10.6	9	8½
Total OECD	7.7	11.0	9½	8¾

TABLE 4

Projections of Unemployment (Definitions, historical statistics and forecasts are all national, not OECD).

	1980	1981	1982
UNEMPLOYMENT RATES (% OF LABOUR FORCE)			
UNITED STATES	7.2	7½	9
JAPAN	2.0	2¼	2¼
GERMANY	3.4	5	6
FRANCE	6.3	7½	8½
ITALY	7.6	8¼	9
CANADA	7.5	7½	8¼
UNITED KINGDOM	7.0	10½	12
Total of above countries	5.7	6½	7½
OECD Europe	7.0	8¾	9¾
Total OECD	6.2	7¼	8

	1980	1981	1982
UNEMPLOYMENT LEVELS (MILLIONS)			
NORTH AMERICA	8.4	9	10¾
OECD EUROPE	11.4	14¼	16
MAJOR FOUR EUROPEAN COUNTRIES	5.9	7¾	8¾
TOTAL OECD	21.4	25	28¼

WHY INFLATION MUST BE CONTROLLED

1. <u>Controlling inflation no longer vital, unemployment is the more important issue</u>

Reduction in inflation necessary to secure a <u>sustained</u> increase in output and employment. Experience shows that policies that attempt to "buy" jobs with more inflation do not work: rise in employment is small and rapid rise in inflation would quickly eliminate it.

2. <u>Why can't we live with 10% inflation?</u>

   - Difficult for most people, particularly pensioners, to cope with inflation.
   - Inflation is unpopular and inequitable.
   - All the evidence suggests that the only <u>stable</u> rate of inflation is a low one.

3. <u>Inflation and investment</u>

High inflation discourages new investment and innovation. With high nominal interest rates companies are reluctant to issue long-term fixed interest debt: if inflation should fall they would be left to pay cripplingly high real interest rates. To borrow large amounts short term, on the other hand, increases the risk of bankruptcy, especially as high nominal interest rates worsen cash flow.

4. <u>Inflation and the Market Mechanism</u>

Improving industrial performance by encouraging markets to be more open and flexible is a major goal. But inflation obscures the market signals provided by movements in <u>relative</u> prices, and therefore impedes the proper operation of markets.

5. <u>Inflation and Savings</u>

Savers cannot be sure they have provided adequately for their future. Inflation redistributes wealth in an arbitrary way. It also distorts the choice of savers of where they place their savings encouraging funds to be placed in inflation "hedges" rather than int business enterprises.

MP Division

"NATIONAL CASH LIMIT" AND CROWDING OUT

1. "National cash limit". Not a precise concept, but a helpful way of thinking about the need to restrain nominal incomes in total if inflation is to be brought low. Our aim is to raise the share of output, within the national cash limit, and to reduce the share of inflation.

2. Private sector to finance more public sector projects? Yes, so long as the schemes are linked to performance. However in so far as increased borrowing leads to increased expenditure, it can be inflationary whoever does the financing.

3. Capital investment counter-inflationary? Eventually yes, if it really pays off. But short term effects on interest rates etc much the same as for any other form of government expenditure.

4. "Crowding out" could be a result of government policy? Yes, to some extent. But that is a necessary consequence of the attempt to control nominal income, and thus lay the basis for sustainable growth.

5. How does money income relate to the money supply? Money supply policy presupposes a relationship to money incomes. Behind the control of money, we are seeking to reduce the growth in nominal income and expenditure. A consequence is that if inflation is to be brought under control, we can only finance additional expenditure by a reduction in expenditure elsewhere: new financing devices will generally not change the nature of the economic constraints.

CU Division

R

EFFECT OF TAX CHANGES ON DISPOSABLE INCOME

The following are the changes in weekly disposable income resulting from:-

(i) revalorisation of income tax allowances and thresholds;
(ii) an additional increase of 15 percentage points in allowances;
(iii) from the changes in national insurance contributions already announced.

Single Person

	(A) Revalorisation (12% increase in allowances and thresholds)	(B) Allowances increased 15 points above revalorisation (not thresholds)	(C) NIC Increases	(D) Net (A + C)	(E) Net (B + C)
Half average earnings	+ 0.95	+ 2.14	- 0.81	+ 0.14	+ 1.33
Average earnings	+ 0.95	+ 2.14	- 1.62	- 0.67	+ 0.52
Twice average earnings	+ 5.56	+ 7.34	- 3.75	+ 1.81	+ 3.59

Married Couple (with or without children)

	(A)	(B)	(C)	(D)	(E)
Half average earnings	+ 1.49	+ 3.34	- 0.81	+ 0.68	+ 2.53
Average earnings	+ 1.49	+ 3.34	- 1.62	- 0.13	+ 1.72
Twice average earnings	+ 5.97	+ 8.45	- 3.75	+ 2.22	+ 4.70

On this basis simple revalorisation would leave people on average earnings slightly worse off after taking account of the NIC increase.

All figures are in £ per week. A plus sign indicates an increase in disposable income.

10

Econ Pol
Budget

Nothing about Incentives !?

Prime Minister

MLS 19/1

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

PRIME MINISTER

I am very worried about this paper. I believe the way it is phrased will arouse resentment and opposition and it will be difficult to get Cabinet wholehearted support. There must be more emphasis on jobs !! Also the impression is given in places that the more we get inflation the more we choke off recovery!

CABINET: 28 JANUARY

We spoke today about the discussion of economic strategy, and the Budget, which is due to take place in Cabinet on 28 January. I briefly described the reasons why I think it best that I should put round a paper in advance.

2. I fully recognise that there are risks in doing so. They perhaps fall into three categories. First, there is the risk of a leak; but a documentary leak is unlikely, and can be made more so by special handling procedures (which my Office have discussed with the Cabinet Office). They might include delaying circulation until next week. The chances of loose talk by colleagues are probably much the same whether or not a paper goes round: the best way of reducing them would be for you and I to stress on 28 January the market-sensitivity of the matters under discussion.

3. Secondly, it could be argued that circulating a paper increases the risk that we slide further down the road - which we are already on - towards Budget-making in Committee. I myself would not so argue; indeed it seems to me that colleagues are more likely to agree to keep off the grass in the succeeding six weeks if they are permitted a substantive discussion on 28 January. And this really means putting a paper round.

4. Thirdly, I have carefully considered, with Leon Brittan, whether the circulation of a paper is likely to increase or reduce the chances of colleagues' accepting our judgement about the appropriate size of the PSBR for next year. We both believe that the chances would be increased. Colleagues are well aware - from last year's Budget, from our October paper, and from the press passim (e.g. Sarah

The point of getting inflation down is to have sound and continuing recovery, more jobs and stability - more so.

Hogg's piece in the latest Sunday Times, and this week's Economist) of the significance of the PSBR decision, and will expect to discuss figures. Some may start from the mistaken assumption that a figure similar to this year's £10½ billion would be supportable next year.

.... 5. I attach the draft of the paper which I have in mind. You will see that my present, and necessarily provisional, judgement is that the right PSBR for next year will lie in the range of £7½ billion to about £9 billion. The interest rate argument would take us to the lower end: the arguments for tax relief point to the upper end. I suspect that a majority of our colleagues would be very resistant to the lower figure. Nevertheless, Leon Brittan and I think that the arguments for it should be drawn to their attention, and may help to convince them that going above about £9 billion is just not on.

6. Perhaps we could have a word about the draft at our meeting tomorrow evening?

7. Copies of this minute go to Leon Brittan and to Sir Robert Armstrong.

G.H.

(G.H.)

19 January 1982

ECONOMIC STRATEGY

I shall be presenting our fourth Budget on 9 March.

Outlook for the Year Ahead

2. The latest forecasts predict continuing, though frustratingly slow, recovery in output, and a further fall in inflation, which should be at 10 per cent by the end of this year, and in single figures in 1983. Unemployment may continue to edge up in 1982, though at a diminishing pace, while industrial productivity should continue to rise. The general picture is one of continued recovery, with encouraging signs of real improvement in the economy. The forecast could of course be invalidated by events beyond our control, whether world-wide (e.g. American interest rates) or domestic (e.g. another serious setback on pay). [And it assumes that we hold to present policies.]

3. (The temptations to change course are obvious.) The level of unemployment is worrying (and we need to do more to convince people that there is no easy solution). We should all like to see the recovery quicken, and I recognise the case for doing something now to encourage our supporters, and the country. However it would be foolish to do this in such a way as to endanger the chances of further progress on inflation and further improvement in our industrial performance. In economic (e.g. on unemployment) as well as political terms, the gains, if any, from such a course would be short-term only, and it would risk throwing away the hard-won progress made in the last 2½ years.

The Right Balance

4. So we must stick broadly to our present course, maintaining progress towards our key objectives: a continued reduction in inflation and a continued rise in output. We should see the rates of both wage and price increases falling, with inflation down to 8 per cent or less by the end of 1983; and there should be faster growth of output in that year. A more ambitious approach on inflation in the coming year would risk choking off the rise in output, while a much more reflationary stance could

jeopardise the exchange rate and would mean inflation again taking off, and interest rates rising still further.

5. This balance has to be struck within a credible financial framework, involving control of monetary growth. The markets will expect us to maintain downward pressure on the growth of the various aggregates. This is crucial to confidence, and to the chances of a reasonably steady exchange rate without cripplingly high interest rates: if we were thought to have abandoned monetary and fiscal control, sterling would quickly prove fragile. It may be necessary to formulate our monetary objectives for the period ahead in terms relating to a number of aggregates, and with more explicit reference to the exchange rate, rather than exclusively to £M3. But what we must not do is discard the discipline.

<u>Borrowing</u>

6. Within this framework, the size of the Public Sector Borrowing Requirement for next year will be very important. For the current year we looked for a PSBR of £10½ billion, and we are on course for this. For next year the forecast (which may of course change substantially before March), gives a provisional figure of some £7½ billion on "present policies". This includes the assumption that income tax thresholds would be increased in line with inflation - and this year we must do our utmost to do this - and that excise duties would be similarly increased - which might cause some trouble in the House. But there clearly is a strong case for holding to £7½ billion: it should offer a prospect of interest rates which, though still uncomfortably high, would not be out of line with those world-wide, and would not unduly constrain recovery.

7. We were looking at the time of the last Budget for a PSBR of up to £9 billion for 1982-83. This would give a prospect of some further tax reductions, but on the other hand involve greater risks to market confidence, and hence to interest rates and the exchange rate. Since the last Budget, the exchange

rate has fallen considerably, oil prices - which support it - have also fallen, and we have had to face higher interest rates.

8. The trade-off between interest rates and tax relief is ultimately a matter for judgement. But it is my belief, not least in the light of our experience over the last year, that to go for a PSBR above about £9 billion could lead to still higher interest rates, would affect confidence, and would thus seriously risk so large a fall in sterling as to jeopardise the prospects of reducing inflation, and impair - or even reverse - recovery. We could engender a general loss of confidence.

9. If some tax reductions are possible, I shall have to consider the balance to be struck between the claims of the company sector and those of the personal sector. I shall be ready to discuss this on 28 January. Better prospects for later years have a habit of evaporating as they approach, but at this stage it looks as though there should be some scope for further tax reductions in 1983-84, providing public expenditure is kept under control.

Summary

10. The signs are that our efforts to restore the economy to health are working. Inflation and output are moving in the right direction, and the rate of increase in unemployment is slackening. This Budget will be crucial. To lose our nerve would be to risk losing all. The key is the 1982-83 PSBR. Given high interest rates world-wide, there is an argument for going below £7½ billion, but the measures to achieve this are not on politically. To go above about £9 billion would of course be politically easy, but, as seen now, economically very hazardous, particularly in terms of exchange and interest rates.

11. I would welcome my colleagues' views on these issues on 28 January.

G.H.

HM TREASURY
19 January 1982

SECRET

I shall be presenting our fourth Budget on 9th March.

1. Outlook for the year ahead

The latest forecasts predict continuing, though slow, recovery in output and a further fall in inflation, which should be at 10% by the end of this year, and in single figures in 1983. Unemployment is likely to increase slightly in the first half of 1982, though at a diminishing rate; while industrial productivity should continue to increase. The general picture is one of continuing recovery, with encouraging signs of real improvement in the economy. This forecast could, of course, be invalidated by events beyond our control, whether world-wide (eg American interest rates) or domestic (eg another serious set-back on pay).

2. Of course I continue to be deeply concerned about the level of unemployment. My colleagues know that there is no easy solution. We should all like economic recovery to quicken and unemployment to fall.

But all previous attempts at artificially induced reflation have resulted, in the medium and in the longer term, in higher unemployment and in higher inflation. In terms of employment, and in political terms, the gains brought about by reflation, if any, would be short-term and extremely limited only. The impact on interest rates, inflation and, very probably the exchange rate would mean throwing away the hard won progress of the past 2½ years, and would inevitably lead to still higher levels of unemployment than those from which we are now suffering.

3. The right strategy

We must accordingly persevere in our present strategy, maintaining progress towards our key objectives; a continuing reduction in inflation; a continuing rise in output; a diminution of the monopoly public sector; and a strengthening of the free market economy. This is the way to secure a genuine improvement in the employment situation rather than a very small and short-lived change in the figures. The prospects are by no means poor. The rates of both wage and price increases should continue to fall with inflation down to 8% or less by the end of 1983; and there should be faster growth of output in that year than in 1982.

4. For domestic and overseas confidence in the Government's strategy to be sustained we must have a credible financial framework. This, in turn, involves controlling monetary growth. The markets will expect us to maintain downward pressure on the growth of the various aggregates. This is crucial to confidence and to maintaining a reasonably steady exchange rate without cripplingly high interest rates. If we were thought to have abandoned monetary and fiscal control, sterling would quickly prove fragile. Our monetary objectives for the period ahead will need to take account of a number of aggregates and with more explicit reference to the exchange rate, rather than exclusively to £ M3. But we must maintain the basic concept of monetary discipline.

5. Borrowing

Within this framework the size of the PSBR for next year is crucial. For the current year, we planned a PSBR of £10½ billion and we are on course for this. For next year, the forecast (which may change substantially before March) gives a provisional figure of rather less than the £9 billion anticipated at the time of the last Budget. That figure assumes that income tax threshholds would be increased in line with inflation and this year, in order to increase incentives and diminish the why work problem, this is the least that we can do (the cost is £ _____). It also assumes that excise duties would be similarly increased - although that may cause some difficulty in the House. Restraining next year's borrowing to £7½ billion would offer a prospect of lower interest rates which would at least not obstruct recovery and which would be lower than if borrowing was allowed to exceed that figure. Even so, they would still be uncomfortably high. For most people - industry and mortgagors alike - lower interest rates are a primary objective. But it is obviously possible to offer some fiscal relief as well. We do not yet know how far we shall have room to manoevre or balance our choice between lower interest rates and tax relief.

6. At the time of the last Budget, we were anticipating a PSBR of up to £9 billion for 1982/83. A figure of that magnitude might give room for limited tax reductions. But it would also involve risks to market confidence and hence to interest rates and the exchange rate. Since the last Budget, the exchange rate has fallen considerably. Oil prices which support it have also fallen and we have had to face even higher interest rates.

7. The trade off between interest rates and tax reliefs as a means of sustaining recovery is bound to be a matter of judgement. But it is my belief, not least in the light of our experience of the last year, that to go for a PSBR above about £9 billion is likely to lead to still higher interest rates, could affect confidence and could risk so large a fall in sterling as to jeopardise the prospects of reducing inflation and impair - or even reverse - recovery.

8. If some reductions in taxation should turn out to be possible, for the coming year, I shall have to consider the balance to be struck between the claims of the company sector and those of the personal sector. I shall welcome the advice of colleagues about this. Better prospects for later years have a habit of evaporating as they approach. However, at this stage, it looks as if there should be some scope for tax reductions in 1983/84 provided public expenditure is kept under control.

9. All the signs are that our efforts to restore the economy to health are succeeding. Inflation is going down; output is going up; the rate of increase in unemployment is slackening. This Budget will be crucial. At this stage in the economic cycle previous governments have sacrificed economic rectitude for presumed electoral advantage.

If we lose our nerve now, we will risk losing all. The key for 1982/83 is the PSBR. Given high interest rates world-wide, there is an argument for going below £7½ billion; but the measures required to achieve this are politically impossible. To go above about £9 billion would be easy politically; but it would imperil the exchange rate, interest rates, the conquest of inflation, our whole determination to create a sound economy and, in anything other than the very short-term, the creation of more real jobs.

Econ Pol

2

10 DOWNING STREET

MS

Prime Minister

To see the kind of speculation which is beginning already.

The scene is of a "dry" PSBR of £9 billion and a "wet" one of £11 billion. The press are already onto the "£1 billion" of delayed tax payments and the receipts from BNOC sale which will be a windfall to the 1982-83 PSBR.

MCS 18/1

Secrets of the Budget

Revealed: the policies, the facts and the figures on which the Chancellor will be making up his mind over the next crucial weeks

BRITAIN'S budget process is as antiquated as the famous dispatch case from which the chancellor's decisions will be produced in March. When, in the dim past, there was little or no inflation, tax changes were rare — and the mere possibility had to be kept a deathly secret until budget day. Now tax rates and allowances have to be changed every spring to keep pace with inflation, and are widely anticipated — everyone stocks up with booze and petrol.

Yet as the budget discussions begin in January, the Treasury still becomes neurotically secretive. Last year even the cabinet, to its anger, had only a few hours' warning of the chancellor's budget plans. Parliament, expected simply to rubber-stamp them, is also becoming increasingly restive.

Tomorrow the important Treasury select committee of the Commons will put its weight behind demands for reform of this terrible old British system. MPs, ministers — even a former head of the Treasury, the late Lord Armstrong — have demanded that the chancellor publish a "draft budget" earlier in the year, showing the Treasury's forecasts of the public sector's finances and the cost of various options open to him.

Outside the closed minds and closed doors of the Treasury, the Institute for Fiscal Studies is uniquely qualified to provide this illumination. For the first time director John Kay and senior research officer Nick Morris have used their tax model, with the help of the London Business School, stockbroker L. Messel's and Co, and accountants Thomson McClintock, to produce full calculations of the public sector's accounts, the cost of tax changes and the likely economic consequences in the same detail as the tables which will eventually appear in the chancellor's "red book" on budget day. And they have done so for alternative budgets —summarised above right—representing the "dry" and "wet" differences of economic opinion in the Tory party.

● For the first time, you can enter the pre-budget debate armed with the kind of detailed figures the chancellor and his officials are now discussing behind closed doors. John Kay and Nick Morris of the Institute for Fiscal Studies have constructed a unique model of the British tax system, and The Sunday Times has commissioned them to produce the first authoritative set of draft budget calculations ever published.

Report by Sarah Hogg

These budgets have been prepared in meticulous detail—they make allowance for likely small changes in corporation tax (raising the limit for small businesses); in stamp duty (raising the threshold); in capital gains tax; and in all the small personal allowances and higher-rate tax bands likely to change whenever the main allowances or rates are altered. But it is decisions on these basic taxes that cost the chancellor big money.

The dry option assumes Mrs Thatcher and Sir Geoffrey Howe stick as close as they dare to their declared aim of cutting the public sector deficit. Because the calculations by Kay and Morris suggest the chancellor has a little more headroom than he is presently letting on, this dry budget actually produces a figure for the all-important public sector borrowing requirement (PSBR) of only about £9 bn, even though it contains some political sweeteners.

Personal tax allowances are increased in line with inflation, and the 3½% surcharge on employers' national insurance is cut to 2½%. All social security benefits (including 50p on child benefit) are inflation-proofed. But excise duties are also put up (adding 0.6% to the retail price index), and employees' national insurance goes up, as announced in December. And though the chancellor does agree to make good the unintended 2% "real cut" in unemployment pay last year, both this and higher-than-planned public pay rises have to come out of the contingency reserve, with no net increase in public spending plans.

For his dry budget, the chancellor could announce a PSBR much in line with the £9 bn implied by his latest version of his medium-term financial strategy (see table 1). This, however would be a little bit of a cheat. He will have a windfall next year of nearly £1 bn of tax which should have been paid in 1981-82, but was delayed by the civil service dispute. And he will be raising once-for-all cash with sales of the equity on the British National Oil Corporation. Deducting both these benefits, the underlying PSBR is shown by the bottom line of the balance sheet table. However, the chancellor could persuasively argue that the line above matters more—because this is the sum he will actually have to raise in the markets to pay his way.

The tax increases and decreases in the dry budget roughly cancel out for 1982-83, partly because the national insurance surcharge cut could not be enacted until July (the computers take months to digest it). The full-year effects and mildly reflationary.

The wet budget, by contrast, "gives away" a total of over £5 billion in tax cuts and extra public spending, including these full-year effects.

Even so, the PSBR, at the end of the balance sheet is only about £11 billion. This is partly because of the windfalls described above. It is also because a proportion of the tax give-aways or public spending increases announced by chancellors inevitably find their way back to his coffers in the shape of taxes on goods bought with the money, on incomes earned producing these goods, and so on, along the economic chain.

Of course the chancellor will be discussing other options than the two spelt out in detail here. But they are carefully chosen to represent his most urgent priorities. However "dry" he intends to be, MPs will revolt if he does not put up tax allowances in line with inflation—after all, he failed to increase them at all last year.

Tories are demanding some help for battered British industry—and a cut in the insurance surcharge has long been top of both the Confederation of British Industry and the Treasury list of priorities.

If he can afford, or is pushed, to be "wetter," an extra increase in income tax allowances is the favourite option—because it would make up for some of last year's failure to index allowances, reduce the "poverty trap" for the low-paid and reduce work for the Inland Revenue by taking more people out of the tax net altogether.

By contrast, a cut in the basic tax rate would simply mean collecting less tax from just as many taxpayers. But it would put the government a step along the road towards the 25% basic income tax rate which was its target in 1979. A one-point cut (to 29%) would cost about the same as the extra 5% on allowances provided in our wet budget, and have much the same economic effects, so build-your-own-budget addicts can safely swap these two bricks in their argument.

The different consequences of the two budgets are shown in the final table. The wet budget produces better results for output (and also reduces unemployment by about 200,000). This is partly because the £1½bn extra public spending assumed in the dry budget goes largely on job-creation schemes — rather than on, say, public sector pay settlements way above the government's 4% target. It is also because of the good effects of an extra 1½% off the national insurance surcharge. This, too, explains why inflation is predicted to be a little lower after a wet budget — the cut in the surcharge lowers industrialists' prices.

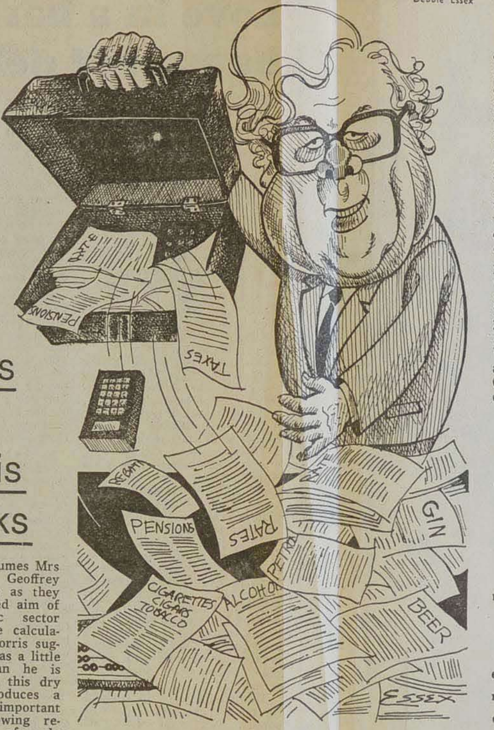
The chancellor could instead attack prices directly either by cutting VAT or by failing to increase excise duties. But the first would be a huge U-turn on the VAT increase of 1979; and the second is an option more likely to be saved for a quick price fix before a general election.

The downside of the wet option is its possible effect on interest rates and the exchange rate. In both these forecasts it is assumed that the exchange rate remains constant. But with the balance of payments turning sour, another bout of sterling weakness (threatening more inflation) and the necessity to keep British interest rates up to or above high world levels are what the chancellor most fears from a reflationary budget. His task is to present as low a PSBR figure as possible for City and international consumption while "giving away" the £2bn—£3bn demanded by even moderate rebels.

Kay and Morris's calculations suggest he may have room to do this. But there is one area where they point out they may be a little more optimistic than the figures actually being put before the Chancellor. This is the all-important question of the government's take from the North Sea. The Treasury is notoriously more pessimistic than private analysts.

A different question mark hangs over the trading position of the nationalised industries. Kay and Morris have been less optimistic than the latest plans published by the Treasury. They still wonder whether the forecast is pessimistic enough. The nationalised industries have been the graveyard of government hopes and intentions over the past two years.

Full details from Institute for Fiscal Studies, 1 Castle Lane, London, SW1.



Debbie Essex

THE POLICY CHOICES

"Dry" Budget: Broadly no change. About £2.5 bn. is "given away" by 1% cut in employers' national insurance surcharge and 12% rise in personal income tax allowances (bringing single man's allowance to £1,530 a year and married man's to £2,390). But this is recouped by 1% rise in employees' national insurance already announced, plus 12% rise in excise duties All social security benefits raised in line with forecast inflation, plus 2% to make up for last year's underestimate.

"Wet" Budget: Reflationary. About £4 bn. "given away" (or over £5 bn. in a full year). Personal tax allowances up 17% (bringing single man's allowance to £1,600 and married man's to £2,500); national insurance surcharge on employers cut 2½%. Public expenditure raised £1½ billion above published plans. Social security benefits raised fully in line with inflation, and extra job-creation schemes introduced. Cost of all this partly offset (as in "dry" option).

THE BALANCE SHEET

	1981-82	1982-83 "Dry"	1982-83 "Wet"
General government		£ million	
Current receipts:			
Taxes on income	37,726	41,182	41,246
National insurance (including surcharge)	20,668	22,447	21,513
Taxes on expenditure	41,614	46,203	46,551
Other	9,262	10,127	10,294
Total receipts	109,270	119,959	119,604
minus Current expenditure:			
Goods and services	53,265	56,799	58,630
Capital consumption	1,980	2,150	2,150
Subsidies	4,438	5,809	5,809
Interest	14,036	14,613	14,840
Current grants	33,940	36,937	36,545
Total expenditure	107,659	116,308	117,974
equals Current balance	1,611	3,651	1,630
Capital receipts	1,685	1,830	1,830
minus Capital expenditure	7,290	7,737	7,756
equals Capital balance	−5,605	−5,907	−5,926
GOVERNMENT FINANCIAL DEFICIT	−3,994	−2,256	−4,296
Public corporations			
Internal funds and capital receipts	5,629	6,664	6,868
minus Capital expenditure	9,137	9,987	10,032
equals PUBLIC CORPORATIONS' DEFICIT	−3,508	−3,323	−3,165
TOTAL PUBLIC SECTOR'S FINANCIAL DEFICIT	−7,502	−5,579	−7,461
and Financial transactions	−2,736	−3,550	−3,550
equals PUBLIC SECTOR BORROWING REQUIREMENT (PSBR)	−10,238	−9,129	−11,011
PSBR excluding BNOC sales and £1 billion tax held over	−9,988	−10,829	−12,711

WHAT THE CHANGES WILL COST (−) OR YIELD (+)

	"Dry" 1982-83*	"Wet" 1982-83*
INLAND REVENUE		
Increases in personal allowances	−1,350	−1,975
Increases in age, investment income and blind allowances	−74	−131
Increase in higher-rate thresholds	−70	−163
Increase in small companies' limits	−24	−24
NATIONAL INSURANCE		
Increase in employees' contributions	+1,203	+1,173
Increase in self-employed rates	+20	+20
Decrease in employers' surcharge	−837	−2,208
CUSTOMS AND EXCISE		
Increase in VAT limits	−6	−6
Light oil, (petrol up 8p a gallon)	+250	+251
Heavy oil, (diesel up 8p a gallon)	+74	+75
Tobacco, (7p on 20 cigarettes)	+130	+147
Spirits, (50p on a bottle of whisky)	+48	+52
Beer etc., (up 1½p a pint)	+135	+135
Wine, (up 8p a bottle)	+37	+40
Car licences, etc., up £10	+225	+225
TOTAL TAX CHANGES	−239	−2,389

* The costs and yields shown are for the financial year 1982-83 only. The "full-year" effects of these tax changes are much greater—partly because the full effects of changes in income tax allowances are only felt in the second year, and partly because it is assumed that the national insurance surcharge cannot be reduced until July. For the "Dry" and "Wet" budgets respectively, the net full-year effects of all these tax changes are calculated to be —£1,002m and —£3,947m respectively.

THE ECONOMIC CONSEQUENCES

GDP (% change, 1981 to 1982, at constant prices)	1.5	2.3
Public sector borowing requirement as % of GDP (1982-83)	3.2	3.8
Retail prices (% change, average 1982 on 1981)	10.0	9.9
Unemployment (average 1982 in millions)	3.0	2.8
Money suply: Sterling M3 (% change at annual rate) 1st quarter 1982-2nd quarter 1983	12.8	14.1
Balance of payments on current account (£ billion, 1982)	−3.5	−3.7

Source: simulations on LBS model

PRIVY COUNCIL OFFICE

WHITEHALL. LONDON SW1A 2AT

12 January 1982

Dear John,

BUDGET DAY ANNOUNCEMENT

Thank you for your letter of 6 January. The Lord President is content to proceed as proposed and we will make the necessary arrangements in consultation with the Chief Whip's office.

I am copying this letter to the recipients of yours.

Yours ever,

David

D C R HEYHOE
Private Secretary

J O Kerr Esq
Principal Private Secretary
to the Chancellor of the Exchequer
Treasury Chambers
Parliament Street

CONFIDENTIAL

Prime Minister

Econ Pol 2

There has been quite a lot of press speculation about an early-March Budget.

MCS 6/1

CHANCELLOR OF THE EXCHEQUER

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

6 January 1982

cc: PS/CST
PS/FST
PS/EST
PS/MST L
Sir D Wass
Sir A Rawlinson
Sir K Couzens
Mr Ryrie
Mr Burns
Mr Allen
Mrs Gilmore
Mr Martin
Mr Salveson
Mr Norgrove
PS/Customs
PS/IR
Mr Ridley
Mr Cropper
Mr Harris
Mr Kemp
Mr Bush

D C R Heyhoe Esq.
Private Secretary to the
Lord President

Told Ch/Ex and Jill Rutter MCS 8/1

Agreed MT

Dear David,

BUDGET DAY ANNOUNCEMENT

The Chancellor and the Prime Minister have been planning on 9 March as the date of the Budget. The date should probably now be announced, and the Chancellor is inclined to think that it might be right, as last year, to do so in the First Business Statement after the Recess - which we understand to be Thursday, 21 January. Perhaps you could let me know whether Mr Pym agrees? (The normal form is, I understand, for the announcement to be made in reply to a question by the Leader of the Opposition, who is prompted in advance by the Chief Whip).

Copies of this letter go to Michael Scholar at No 10 and to Murdo Maclean in the Chief Whip's Office.

Yours ever,

John Kerr.

J.O. KERR
Principal Private Secretary

Econ Pol

BF

10 DOWNING STREET

Michael

Many thanks.

I have told Robert Armstrong.

I also agreed with him that we would not show this item on the forward agenda for Cabinet meetings.

FERB 4.i.82

Clive

(1) The PM + Chancellor agreed today that there shd be a macroeconomic discussion at Cabinet on 28 Jan (see attached note). The Chancellor will put round a highly general paper (which tells Cabinet nothing they don't know already): he will then expand on this, giving some numbers, orally. They also agreed that EMS shd be discussed at the same Cabinet.

Will you tell Sir R Armstrong's office, or shall I?

(2) I shall not be in before lunch on Monday - but will be available at home if required.

MCS 31/12

10 DOWNING STREET

PRIME MINISTER

The Chancellor would like to talk to you about the next Cabinet discussion on the approach to the Budget - see his minute below. He is aware of your reaction to the proposal he made in it.

He would then like to go on to a tour d'horizon of the economic field. Finally, he would like to spend a few minutes on a private political discussion.

MAP

30 December 1981

1

Prime Minister

Agree to a discussion on 28 January?

MES 24/12

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

PRIME MINISTER

APPROACH TO THE BUDGET

We are, as you know, working towards a Budget date of 9 March and I would envisage that this should be announced fairly soon after the Recess.

2. I have been considering the timing of the next macro-economic discussion in Cabinet. Since the last Budget we have now had two such discussions, in June and in October. I have all along thought that we might aim for a third in January, and I still believe that a discussion next month could in fact prove helpful. 28 January would seem the best date.

3. I would expect at that time to be able to describe the prospects to Cabinet colleagues in broad terms on the basis of an updated economic forecast. It would not be appropriate to enter into discussion then about detailed Budgetary measures - and indeed the basis for that would not by then be fully available, because there will be another forecast before the Budget - but colleagues will expect, and I would want them to have, an opportunity to register their views on the overall approach to the Budget. At a later stage I might discuss with particular colleagues aspects which might directly affect their departmental interests.

4. If you agree with this approach I shall circulate a paper to Cabinet by 21 January for discussion on 28 January.

No - it will leak. Can we not have a factual presentation - followed by discussion not

5. I am copying this minute to Sir Robert Armstrong.

GH

G.H.

23 December 1981

PV90

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

11 December 1981

MCS 6 Dec 9/R

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
London SW1

Dear Geoffrey,

CORPORATION TAX GREEN PAPER

Thank you for your letter of 3 December.

I am grateful to you for agreeing to the majority of the suggestions I made on the Green Paper and I confirm that I am content with the draft concluding passage you enclosed with your letter.

I am also grateful for the assurance you have given me and I shall be writing to you shortly with suggestions for your next Budget. These suggestions are likely to include some of the points my Department raised in the context of the Green Paper.

I am disappointed you do not feel able to remove the reference to a possible 6 year cut-off for unused capital allowances. I still believe that this reference will lead to the very uncertainty in industry we are anxious to prevent. If you retain the reference - and I accept that completeness may require it - I believe the case is strengthened for your making a statement along the lines you say you are considering. I believe such a statement would be important in obtaining a good response from industry to the Green Paper. I should be grateful for an opportunity to see beforehand the text of what you propose to say.

I am copying this letter to the Prime Minister, Peter Carrington, Francis Pym, Peter Walker, Michael Heseltine, John Biffen, Nigel Lawson, Jim Prior, George Younger, Nicholas Edwards and to Robin Ibbs (CPRS).

Yours ever

Patrick

1 DEC 1981

11 12 1 2 3 4 5 6 7 8 9 10

File VB

Econ Pol

10 DOWNING STREET

From the Private Secretary 9 December 1981

Dear John,

Budget Papers

The Prime Minister has been having some preliminary thoughts about Budget security. She is most anxious that there should be no leak of the 1982 Budget and wishes circulation of papers to be as restricted as possible to that end. Within No. 10 Downing Street she has decided that the only people besides herself to see Budget papers should be: Mr. Whitmore, myself, Mr. Hoskyns and Mr. Walters. We would be grateful if you would send simply one copy here addressed to me; I will make only one copy of this which will be shared between Messrs. Hoskyns and Walters.

I would be grateful if you would let me know in due course what Budget security arrangements you are proposing for this year.

Yours sincerely,

Michael Scholar

John Kerr, Esq.,
H.M. Treasury.

CONFIDENTIAL

Econ Pol
2pm

MAP

Treasury Chambers, Parliament Street, SWIP 3AG

N P M Huxtable Esq
Private Secretary to the Lord President
Privy Council Office
Whitehall
LONDON
SW1A 2AT

9 December 1981

Dear Nick,

CORPORATION TAX GREEN PAPER

Thank you for your letter of 8 December.

In compliance with the wishes of the Prime Minister and the Lord President we will defer publication of the Green Paper until 7 January 1982.

I am copying this letter to Richard Riley (Department of Industry), Mike Pattison (No 10) and Gerry Spence (CPRS).

Yours,

Peter

P A MICHAEL
Private Secretary

CONFIDENTIAL

cc Mr. Walters
~~Mr.~~ Scholar

Done MES

Michael
Can you pl make sure that the Tsy do indeed send all papers to you + do not send any direct to Mr Walters.
Thks
Tim

MR. HOSKYNS

Budget papers

As you know, the Prime Minister has modified her earlier instructions about the circulation of budget papers inside No. 10 and has decided that you should be included among those authorised to see them. She has, however, said that in order to keep to an absolute minimum the number of copies made of such papers, she would be grateful if you and Mr. Walters would share the same copy.

Mr. Scholar, to whom the Treasury will send budget papers in the first instance, will make the necessary arrangements.

C. A. WHITMORE

7 December 1981

CONFIDENTIAL

PRIVY COUNCIL OFFICE
WHITEHALL. LONDON SW1A 2AT

8th December 1981

1 MCS to see
2. AA

MAP 9/XII

Dear Peter

When we spoke yesterday, I explained that next week is an especially busy one in terms of the numbers and importance of Government announcements which are due to be made. For this reason, the Prime Minister and the Lord President of the Council took the view when they met yesterday that it would be preferable for the Corporation Tax Green Paper to be issued early in the New Year: this would result in less congestion and would ensure that the Green Paper will receive the attention it merits.

I am copying this letter to Richard Riley (Department of Industry), Mike Pattison (No 10) and Gerry Spence (CPRS).

Yours sincerely

N P M HUXTABLE
Private Secretary

P Michael Esq
Private Secretary to the
Minister of State (Lords) Treasury
Treasury Chambers
Parliament Street

3 pp

cc AW
AD ✓
JV
BI

(2)

MINISTER OF STATE (LORDS)
TREASURY

Prime Minister

MLS 4/12

I should be inclined to have more than 2 days' between the Green Papers.

MT

Treasury Chambers, Parliament Street, SWIP 3AG

Rt Hon Francis Pym MC MP
Lord President of the Council
Privy Council Office
Whitehall
SW1A 2AT

4 December 1981

✓ MAP 9/XII

Dear Francis,

As you know, Geoffrey Howe is anxious to publish before Christmas the long-awaited Green Paper on Corporation Tax. At present, we are aiming for publication on Thursday 17 December. I should be most grateful if you could confirm that this is acceptable to you, and that it does not clash with any other Government announcement likely to be made at the same time.

2. In particular, I am conscious that we ought to allow a reasonable interval - say a minimum of 48 hours - between the publication of this Green Paper and the publication of the proposed Green Paper on Rates. I hope that this will not prove a problem. My present understanding is that the Green Paper on Rates will be published on Tuesday 15 December.

3. I am sending copies of this letter to Patrick Jenkin, Robin Ibbs and No.10.

Yours,
Arthur.

LORD COCKFIELD

Prime Minister

Econ Pol

MCS 4/12

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

3 December 1981

The Rt. Hon. Patrick Jenkin, MP.,
Secretary of State for Industry

Dear Patrick

CORPORATION TAX GREEN PAPER

I am most grateful for your prompt and constructive response to the draft Green Paper which I sent to you on 12 November.

I am glad to think that - though we cannot hope to please everyone - you feel that we have got the balance about right.

You raise 5 important points in your letter.

First, as you know, I share your anxiety that we should not cause unnecessary uncertainty in industry; and I see that Peter Walker has made the same point. But these considerations point in the direction of publication not postponement. Publication of the Green Paper has repeatedly been promised - I have referred to the matter in each of my Budget Speeches. Delay in publication has already attracted much criticism and if we were to postpone it further now the inevitable result would be to create speculation and uncertainty.

The vital thing is to emphasise that the Government will propose no major change in the structure of business taxation, without further full consultation, and without general consensus that the balance of advantage is in favour of change. The draft Green Paper makes this clear in both the opening and the concluding Chapters. I am considering whether it would be helpful to accompany the Green Paper with a short statement at the time of publication. If so, this is one of the points which I would want to emphasise again.

Second, both you and Peter Rees have suggested that it might help to include a short passage indicating

> "certain broad key questions against which comment might be framed".

/This is

... This is a very helpful suggestion and I attach the text of a new paragraph which I intend to add for this purpose to the concluding Chapter.

Third, you mention that the Green Paper does not discuss some points which have been raised in correspondence between officials. I agree that it is difficult to know precisely where to draw the line in a paper of this kind. On balance, we thought it best to concentrate on changes which affected the general structure of business taxation. However, I agree that it would be useful to include something further about small workshops, and my officials will be in touch with yours accordingly about a possible draft text.

I can of course give you the assurance you ask, that I would not regard any question as being ruled out of consideration between us in the normal way, merely by reason of the fact that it was covered or not covered in the Green Paper.

Fourth, you ask whether it is really necessary to canvass in Chapter 14 the possibility of a 6-year cut off for carrying forward unused allowances. Certainly the point is a sensitive one. But the underlying reality is formidable: a £30 billion overhang of unused tax losses, accumulating at £5 billion per annum. Frankly, I think it would be unrealistic, if the Green Paper were to discuss only ways in which we could add to the Exchequer cost of this "overhang", or allow companies to cash it more quickly; and the relevant Chapter 14 of the draft Green Paper would accordingly appear unbalanced, if we did not say something about ways in which we could to some extent safeguard the yield of revenue, when company profits recover.

You express a particular fear that for an individual company the very suggestion of this possibility in the Green Paper

> "could have potentially very serious financial implications, including reducing the company's sales value in certain cases".

If I may say so, the possibility that unused tax losses could affect the value of a company's shares in the market does itself illustrate the artificiality of the situation with which we are dealing. However, even leaving that aside, the Green Paper draws attention to the fact that the analogous provisions on stock relief in this year's Finance Act did not affect existing tax losses but only losses accruing after a future date. On this basis, I do not think that a market problem would really arise.

Fifth, both you and Peter Rees suggest that it might be helpful to put in a deadline for comment on the paper. My initial reaction had been to give no deadline of this kind. As you suggest, I was anxious to avoid the impression that the Government were embarking

/on some

on some kind of phased "programme" of tax changes. On reflection, however, I agree that people are bound to ask this question. I propose therefore to ask for at least initial comments by end-September 1982. We could do this at the same time as we emphasise your first point - that there will be no change without consensus.

Finally, may I thank Peter Rees for his redraft of paragraph 15.65 on hotels. I am happy to accept that.

I am sending copies of this letter to the Prime Minister, Peter Carrington, Francis Pym, Peter Walker, Michael Heseltine, John Biffen, Nigel Lawson, Jim Prior, George Younger, Nicholas Edwards and to Robin Ibbs (CPRS).

Yours

Geoffrey

GEOFFREY HOWE

PART V

CHAPTER 17

CONCLUSION

17.1 This Green Paper discusses the main suggestions which have been put forward in recent years for changing the present system of company taxation. The discussion covers a very wide spectrum of issues, ranging from the fundamental question of whether companies should be taxed at all, across the radical suggestions for major changes in the structure of the corporation tax to the much narrower, but still important, possibility of simply increasing (or reducing) the reliefs available within the existing system.

17.2 The discussion raises questions about the structure of company taxation: should it continue to be (broadly) commercial profits, adjusted as necessary to meet the special requirements of the tax system; should it base itself more closely on commercial accounts, including the latest developments in current cost accounting and other accounting standards; or should it break loose from commercial accounts, and look to some quite different base, such as for example the flow of funds? At many points, the discussion also raises important questions abou the objective of the tax system: should it in general seek to give further support and encouragement to selected sectors of business - for example through investment incentives; or should it in general tend to neutrality, encouraging capital to flow freely to where it would earn the highest pre-tax returns to the nation?

17.3 For the reasons given in Chapter 3, the discussion proceeds on the assumption that any changes would have to be made on a revenue-neutral basis and financed from within the corporate sector. This is a point of great importance. Many of the changes advocated involve such large sums of revenue that there would be little prospect of them being implemented if the Exchequer had to find the money to finance them: while if they were introduced on a revenue-neutral basis their effect would be to increase the tax substantially on some sectors, and on some companies, to pay for the reductions in tax on other sectors and on other companies. Some proposals such as the adoption of CCA for tax purposes would themselves have this kind of redistributive effect. It is a matter of critical importance whether redistributive effects of this kind would be acceptable.

17.4 It is important that the case for change should be considered against the workings and effects of the present system. Some of the criticisms which have been made need to be

B1

2pp

DEPARTMENT OF TRADE
1 VICTORIA STREET
LONDON SW1H OET

TELEPHONE DIRECT LINE 01 215 5144
SWITCHBOARD 01 215 7877

(2)

From the
Minister for Trade

Prime Minister

MES 4/12

The Rt Hon Sir Geoffrey Howe MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street

30 November 1981

Dear Geoffrey

FUTURE OF CORPORATION TAX

Thank you for copying to me your draft Green Paper on possible changes to the structure of Corporation Tax which you sent Patrick Jenkin on 12 November.

I should first like to say that I welcome the open and exploratory nature of the draft paper: I can well appreciate the drafting difficulties involved in ensuring a neutral approach to the wide range of proposals discussed. I know you are looking for comments which will not upset the balanced structure of the paper, and it is in this spirit which I would like to put forward the following proposals.

Indeed, my first request is that the tone of the passage on capital allowances for hotels could be altered, if only not to provoke the hotel lobby. I attach a redraft of paragraph 15.65 which ought, by changing just a few words, avoid creating the impression that we have prejudged this issue against any extension of allowances in a forthcoming Budget.

Apart from this 'Departmental' point, may I make a more general suggestion. Because the Green Paper will cover many proposals in some detail, I think we should signpost the various possible tax strategies which any future corporation tax reform might follow. We should, I think, specifically mention the importance of corporate

.../...

REVISED PARAGRAPH 15.65

"Suggestions are frequently made that the initial allowance should be increased, and in particular that hotels should qualify for the same relief as industrial buildings. In general, however, it is possible that hotels have a longer life than industrial buildings, and this would tend to point to depreciation allowances being spread over a longer period. Moreover, though an increase in the hotel allowance would diminish the difference between hotels and industrial buildings, it would at the same time heighten the preferential treatment already given to qualifying hotels as compared with other types of commercial buildings and accommodation unless capital allowances were extended to commercial buildings generally".*

* amendments underlined

RESTRICTED

Econ Pol
Budget

30 November, 1981.

Taxation of Benefits in Kind - Free Petrol

The Prime Minister was grateful for the Chancellor's minute of 24 November whose contents she has carefully noted.

M. C. SCHOLAR

John Kerr, Esq.,
HM Treasury.

RESTRICTED

With the Compliments

of the

Secretary of State

Scottish Office,
Dover House,
Whitehall,
London, S.W.1 A 2AU

B1

Prime Minister (2)

MCS 4/12

SCOTTISH OFFICE
WHITEHALL, LONDON SW1A 2AU

The Rt Hon Sir Geoffrey Howe QC MP
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

27 November 1981

Dear Chancellor

with MCS

Thank you for copying to me your draft Green Paper on possible changes in the basic structure of corporation tax. The Paper demonstrates very clearly the devastating effects which inflation can have on real company profits. Clearly our continuing fight against inflation remains the most significant single factor in easing the pressure facing the corporate sector in the next few years.

I fully endorse your proposals to publish the Green Paper on a consultative basis, although I am a little concerned about the de-stabilising effect that such a consultative document could have on investment decisions particularly in the manufacturing sector if certain of the proposals were carried through. Presentationally, therefore, I think that we have to get the message very clearly across about the basis on which the paper is being issued and our intention to seek a consensus view before making any radical change to the corporation tax system.

Clearly it will take some time to analyse the effects of the many different tax systems outlined in the Green Paper on the areas for which I am responsible in Scotland. In particular I am thinking of the possible effects on our regional policies, the employment mix between manufacturing and service industry and the effect on multi-nationals which operate within a variety of tax systems. However, given that legislation is unlikely to follow during the life of the present Parliament, we shall have time to consider these and other issues in some depth.

I am copying this letter to the recipients of yours.

yours sincerely

M Stewart (Miss).

(Approved by the Secretary
of State and signed in
his absence.)

JH 964

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

27 November 1981

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
London SW1

Dear Geoffrey,

CORPORATION TAX

Thank you for your letter of 12 November with the draft Green Paper on Corporation Tax.

2 May I say straight away that I think this is an admirable draft. The wide range and neutrality or "Green-ness" of it seem to me just what is needed. Subject to the points I make below, the broad coverage and balance of it seem well-judged in present circumstances.

3 While I am sure the broad thrust is right, there are certain dangers for industry in publishing a paper of this kind and I think we need to do all we can to minimise them. The first danger is that the very width and neutrality of the paper may cause damaging uncertainty in industry about the nature and timing of any tax changes. As you say, there is value in stability and uncertainty about whether and when there will be changes can be as destabilising as change itself.

4 The second danger is that while a long and no doubt controversial debate is likely to arise over the radical options in the first part of the paper, desirable improvements to the existing system will get overlooked. This is perhaps a point for the Government to watch particularly closely. While I would agree with you that no consensus has emerged on fundamental changes (will it ever?) I believe there is already widespread agreement that the corporate tax system needs to take better account of inflation and that improvements could be made to the system of allowances.

5 I should like to make two suggestions which may help to minimise these dangers. The first is that without changing the

"Green" character of the paper you might consider including in it certain broad key questions against which comment might be framed. This might be done in the introduction to the Green Paper and could possibly include a reference to the fact that the paper is not intended to deal with some of the other factors affecting industry, such as the National Insurance Surcharge or rates. This would, I think, help the CBI and other representative bodies who will need to consult members and might also lead to more useful and better-structured comments.

6 My second suggestion is that you consider including a deadline for comment in the paper. I appreciate that you may think it inappropriate to appear to be embarking on a phased programme, particularly in relation to the wide-ranging options in the first part of the paper. Nevertheless, on balance, I believe a deadline would help to reduce the risk of a prolonged period of debate and uncertainty. Again, there is the practical point that it would help representative bodies.

7 Turning to the coverage of the final part of the paper, I am glad to see that the draft covers the majority of the points my colleagues here were anxious to see included. There are, however, some important ommissions from the discussion, including:

(i) widening the coverage of the small workshops allowance and/or giving the allowance by reference to use of building rather than trade of user. (I wrote to you about this myself on 17 November);

(ii) some additional ways of mitigating the problem of unused allowances;

(iii) possible improvements to the allowances for pre-trading expenditure.

You may prefer to deal with these separately from the Green Paper, perhaps on a shorter time-scale. If so, I should be content. But I should like to be assured that they are being considered in whatever may be their appropriate context.

8 There is also the question of regional allowances for commercial buildings which you may think should be discussed in the Green Paper but, in my view, this is more appropriate to a review of regional policy generally.

9 Finally, a small point in the context of the whole but one which illustrates my general concern about the creation of uncertainty for industry. Is it really necessary to canvas at paragraph 14.45 the possiblity of a 6 year cut off for carrying forward unused allowances? This apparently innocent sentence is

SECRETARY OF STATE FOR INDUSTRY

likely to create considerable alarm in industry and for an individual company its very appearance in the Green Paper could of course have potentially serious financial implications, including reducing the company's sales value in certain cases. I would hope you could reconsider the need for this possibility to be mentioned.

10 I am copying this letter to the Prime Minister, Peter Carrington, Francis Pym, Peter Walker, Michael Heseltine, John Biffen, Nigel Lawson, Jim Prior, George Younger, Nicholas Edwards and to Robin Ibbs (CPRS).

Yours ever

Patrick

Prime Minister (4)

MINISTRY OF AGRICULTURE, FISHERIES AND FOOD
WHITEHALL PLACE, LONDON SW1A 2HH

MCS 27/11

From the Minister

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
London SW1P 3AG

27 November 1981

MA

Thank you for copying to me your letter to Patrick Jenkin of 12 November, enclosing a copy of the draft Green Paper on corporation tax.

with MCS

May I say first of all that I entirely share your view that industries should not be faced with the upheaval of a fundamental adjustment to the tax system unless there is a clear justification for embarking on such a course. Although I appreciate your reasons for producing an exploratory paper my concern is that companies and their professional advisers, who are hard pressed to cope with the present economic difficulties, will not be in a position to give the Green Paper the attention it deserves. Publication of the paper would itself create further uncertainty which could affect future investment decisions and the prospects of recovery. I shall be interested to see the views of colleagues on this point but I do have reservations about launching such an initiative at the present time.

As you know only a very small percentage of farming businesses are incorporated and the main agricultural interests in the paper appear to be in the reference to the agricultural buildings allowance and the "small companies" rate of corporation tax. Changes in corporation tax, however, could affect the unincorporated sector in a number of ways. They would be likely to affect the choice of business form and they could influence the general allocation of resources and competitive positions within the economy. For this reason and because of the effect any changes could have on the food and drink manufacturing and distributive trades I am concerned that we should take the views of industry at a time when it is able to give proper consideration to the implications of the options which are put forward. At this stage I am not convinced that this would be the case.

/Copies of ...

Prime Minister

Copies of this letter go to the Prime Minister, Peter Carrington, Francis Pym, Michael Heseltine, Patrick Jenkin, John Biffen, Nigel Lawson, Jim Prior, George Younger and Nicholas Edwards and Robin Ibbs at the CPRS.

PETER WALKER

27 NOV

Econ Pol 9

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

25 November 1981

The Rt. Hon. Patrick Jenkin MP
Secretary of State for Industry

Dear Patrick

NATIONAL INSURANCE CONTRIBUTIONS

Thank you for your letter of 24 November.

I am glad you are prepared to go along with the kind of changes in National Insurance Contributions which I proposed in my minute to the Prime Minister of 17 November. You will see from my further minute today that Norman Fowler and I are now putting forward proposals that are slightly different, but not in their effect upon employers.

I recognise that private sector employers will still pay more next year than this year in National Insurance Contributions and NIS. But, as you are aware, by loading the whole of the increase in contribution rates onto employees, our proposals are designed to minimise the additional burden that will be placed on employers. Even with the extra NIC and NIS they will be paying, the burden on private sector employers will decline in real terms.

Nevertheless, I quite see why you suggest that I should allocate the benefit that will accrue to the PSBR as a result of these proposals to a reduction in the NIS with effect from next April. But I am afraid that I could not agree to that. As you know, the public expenditure outlook is now considerably worse than I foresaw when we discussed these matters in Cabinet on 20 October. Even if we had been able to achieve the totals I suggested, there would still have been a risk of my having to announce tax increases in the next Budget. That risk is now considerably greater. I am afraid therefore that there can be no question of my committing myself now, in advance of other tax decisions, to a reduction in the NIS. As I have said, I am prepared to look at this again at Budget time but that is as far as I can go now.

/As to your

SECRET

As to your suggestion that we should take powers in the National Insurance Bill to reduce the NIS rate by subordinate legislation, my officials and yours are as you know considering this urgently today, in consultation with DHSS officials.

Copies of this letter go to the other recipients of yours.

GEOFFREY HOWE

25 NOV 1981

8

Ref: A06097

PRIME MINISTER

National Insurance Contributions

BACKGROUND

The Chancellor of the Exchequer proposes:

(a) an increase in the employee's national insurance contribution (NIC) rate by one percentage point, to 8.75 per cent;

(b) an increase from £200 to £220 in the upper earnings limit, the maximum amount of weekly pay on which the NIC and national insurance surcharge (NIS) are levied.

2. These changes would take effect in April 1982; would yield, gross, rather more than £1,100 million next year, and would:

(i) permit the Redundancy Fund to stay within its statutory borrowing limit;

(ii) allow an increase of 0.1 per cent in the contribution to the Health Service, which the Secretary of State for Social Services proposed as an alternative to cuts in Health Service expenditure;

(iii) prevent the National Insurance Fund from going into deficit next year;

(iv) provide a surplus of £250 million for the National Insurance Fund in 1982-83 - the net gain to the PSBR from these changes after allowing for outgoings from the Fund next year. The Chancellor proposes an equivalent reduction in the Treasury supplement to the Fund - an accounting device to reduce the PSBR without a surplus accruing in the Fund.

3. Primary legislation is needed to increase the NIC by more than 0.25 per cent. The Chancellor proposes that the Government should introduce a bill next week for enactment before the end of January.

4. The Chancellor has decided that he cannot now announce a reduction in the NIS. If he does so in the Budget the NIS could probably be reduced in July 1982.

MAIN ISSUES

5. Two points are likely to concern some Ministers. First, there is the impact on employers. Though the Chancellor proposes no increase in the employers' contributions rate, raising the upper earnings limit means that employers must pay more (NIC and NIS) in respect of any employee earning more than £200 a week. The cost to employers will be about £120 million next year - in addition to the £550 million extra they will have to pay as a result of probable increases in earnings. The Secretary of State for Industry may argue (as he has in a letter of 24 November to the Chancellor of the Exchequer) that this increase should be offset by a reduction in the NIS, which the Chancellor should announce now. Secondly, there is the impact on pay bargaining, to which the Secretary of State for Employment referred in his minute to you of 18 November.

Flag B

6. The Chancellor of the Exchequer may argue in reply on the following lines:

a. There is little room for manoeuvre. Most of the increase in contributions is necessary to ensure that the National Insurance Fund stays in broad balance, as the law requires; and to avoid legislation to increase the Redundancy Fund's borrowing limit. The net gain to the PSBR is small: £250 million. A smaller increase in employee contributions means either more from employers or a larger PSBR.

b. It is not clear how much wage settlements will be affected by changes in employee's contributions or the upper earnings limit; but the alternatives (higher PSBR or taxation) might well have effects which were even less desirable.

Flag C

7. The Secretary of State for Industry may suggest (as in his letter of 24 November) that the National Insurance Bill should provide that the NIS can be reduced by secondary legislation: primary legislation is necessary at the moment. If he does, he could be invited to pursue the matter with the Chancellor of the Exchequer in correspondence. (The answer may be that the NIS is a tax: a provision of the sort Mr Jenkin proposes would have to be included in a Finance Bill).

HANDLING

8. After the Chancellor has introduced his proposals you will want to invite comments from the Secretary of State for Social Services (who agreed to these proposals at your meeting on 23 November); the Secretary of State for Employment; the Secretary of State for Industry; the Lord President (on the legislative timetable); and other colleagues.

CONCLUSIONS

9. You will want to record the Cabinet's decision on the Chancellor's proposals and any points of detail which the Ministers concerned must sort out.

10. On the assumption that the Chancellor's proposals are endorsed it will be for the Chancellor and the Secretary of State for Social Services, in consultation with other colleagues as necessary, to agree on the terms and timing of an announcement; and the Secretary of State for Social Services, who will have to introduce the National Insurance Bill that will be necessary, to discuss its handling with the business managers.

RtA

25 November 1981

7

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

PRIME MINISTER

NATIONAL INSURANCE CONTRIBUTION

We need to make our annual decision about the increases needed to the National Insurance Contribution (NIC). I have been considering this with the Secretary of State for Social Services and this minute contains our joint proposals.

2. Our starting-point is the Government Actuary's forthcoming report on the National Insurance Fund. This will show a deficit for the Fund next year unless the NIC is increased substantially. At the same time an increase in the allocation to the Redundancy Fund (RF) will be necessary if the RF is not to exceed its statutory borrowing limit during 1982-83. Action to increase the NIC is therefore required by the state of the Funds. It will also help with the general financial prospects for next year.

3. I have already decided that I cannot now announce a reduction in National Insurance Surcharge (NIS) from next April. Private sector employers are likely to have to pay an extra £550 million next year compared with this year in NIC and NIS simply because of the rise in earnings. As much as possible of the additional fund income should therefore come from employees rather than employers.

4. We therefore propose:

(i) A rise in the employees' rate by 1 per cent, from 7.75 per cent to 8.75 per cent with no rise in the employers' rate. This will increase the NIC for the worker on average earnings in 1982-83 by £1.60 a week.

(ii) A rise in the Upper Earnings Limit (UEL) from £200 to £220 a week, the maximum allowed under current legislation. The NIC is a flat rate percentage between the Lower Earnings Limit (which will rise to £29.50 in line with the basic pension) and the UEL. Raising the UEL will mean, with the 1 per cent increase in rates, that the contribution paid by the man earning £220 a week or more will rise by £3.75 a week. It will mean additional costs for private sector employers, through NIC and NIS, of £120 million.

5. These proposals will:-

(i) Enable an increase of 0.35 per cent in the allocation to the RF, so ensuring that it keeps within its borrowing limit.

(ii) Allow an increase in the allocation to the National Health Service (NHS) of 0.1 per cent, as proposed by the Secretary of State for Social Services.

(iii) Provide a surplus of £250 million for the National Insurance Fund in 1982-83. We must aim at a surplus of £170 million to keep for the PSBR the savings from taking 1 per cent off the uprating of benefits this November to recover the overshoot last year. The surplus can however be removed by a deduction, from 14.5 per cent to 13 per cent, in the supplement which the Treasury pay into the Fund.

6. Legislation is required for an increase in either the employees' or the employer's contribution of more than 0.25 per cent, and is therefore unavoidable. It needs to be passed by the end of January, which means, subject to the views of the business managers, that the Bill should be introduced as soon as possible and no later than next week. The announcement should preferably be linked with the intended announcement about public expenditure programmes for 1982-83.

8. To sum up, I recommend:

(i) An increase in the employees' NIC rate by 1 per cent.

(ii) An increase in the UEL from £200 to £220.

(iii) A reduction in the Treasury Supplement by 1½ per cent.

A Bill should be introduced accordingly. It could also provide for the extra payments into the RF to be made by the employees; at present all payments into this Fund come from the employers.

9. Copies of this minute go to our Cabinet colleagues, and to Sir Robert Armstrong.

G.H.

25 November 1981

SUBJECT

cc Master

cc CSO ✓
DHSS ✓
CO

6

10 DOWNING STREET

From the Private Secretary

24 November 1981

Dear John,

Social Security expenditure and National Insurance contributions

The Prime Minister held an informal meeting yesterday evening with the Chancellor of the Exchequer, the Secretary of State for Social Services and the Chief Secretary to consider what should be put before Thursday's Cabinet in relation to decisions about social security expenditure and national insurance contributions.

The Secretary of State and the Chief Secretary briefly reported the position that they had reached on social security matters. The two issues on which they had reached no agreement were the changes which the Treasury had proposed to the Christmas bonus arrangements for 1982, and proposed abatement of the unpledged benefits at their next uprating. The Secretary of State said that he found very considerable difficulty with both of these proposals. He had dropped his claim for a restoration of the 2% shortfall this year on the unpledged benefits, and he expected much Parliamentary opposition on this front. He would also face considerable difficulties in taking the new national insurance contributions bill through Parliament. The Chief Secretary had suggested as an alternative the possibility of postponing by up to three weeks the date of the 1982 uprating, which would generate savings of £150 million in 1982/83 and £90 million a year in 1983/84 and 1984/85. But this too would face the same Parliamentary difficulties, since primary legislation would be required. His view was that it was simply not possible to achieve the desired savings by either of these three routes.

After further discussion it was agreed that there would need to be an increase in contributions to the national insurance fund of 1.0 percentage points, rather than the 0.85 percentage points canvassed in the Chancellor's minute to the Prime Minister of 17 November. The Chancellor should circulate a paper to Cabinet for discussion on Thursday 26 November. The emphasis of the paper should be heavily on the need to balance the national insurance fund. It was agreed that these increases should be loaded on the employee and not on the employer.

/ On this basis

SECRET

On this basis it was agreed that there should be no changes in the arrangements for the 1982 Christmas bonuses, and that there should be no abatement of the uprating of the unpledged benefits. The Secretary of State withdrew all his earlier proposals in relation to invalidity benefit. The aim would be to announce the national insurance decisions together with the public expenditure decisions in general on Wednesday 2 December, if it were not possible to do so on Monday 30 November. It would then be possible to introduce a new national insurance contributions bill immediately.

The Prime Minister is particularly concerned to ensure that there should be no leak of these decisions, and I would accordingly be grateful if you would see to it that as few people as possible are informed.

I am sending copies of this letter to Terry Mathews (Chief Secretary's Office), Don Brereton (Department of Health and Social Security) and David Wright (Cabinet Office).

Yours sincerely,

Michael Scholar

John Kerr, Esq.,
H.M. Treasury.

JU754 TOTAL COPIES 15

COPY No. 2 SECRET

Prime Minister 2ppS (2)

Now overtaken - if Cabinet agree.

MLS 24/11

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

24 November 1981

The Rt Hon Sir Geoffrey Howe QC MP
HM Treasury
Parliament Street
London SW1

Dear Geoffrey,

NATIONAL INSURANCE CONTRIBUTIONS

Thank you for sending me a copy of your minute to the Prime Minister of 17 November.

2 I can confirm that I am prepared to accept the changes in National Insurance Contributions you propose, that is, no change to the employers' rates of contribution and an increase in the upper earnings limit to £220. I should of course have preferred no increase in this limit but I accept that the situation we are in requires it.

3 Nevertheless, I am greatly concerned at the additional burden we shall be imposing on industry in this way and I believe we must search for offsetting benefits elsewhere. Your minute makes clear that employers' costs will be increased by £120 million next year as a result of your proposal, in addition to an expected increase of £570 million on their national insurance bill arising mainly from the rise in earnings. These figures include an estimated £210 million increase in the burden of the National Insurance Surcharge (NIS). There is great pressure to reduce the NIS and you have, I believe, accepted the economic case for doing so as soon as resources permit. I do not think, therefore, that we should allow the burden to increase by £210 million, £40 million of which would arise directly from the proposed increase in the NIC upper earnings limit.

4 The annex to your minute makes clear that if we follow the option you propose there will be a benefit of £500 million to the PSBR compared with the forecast. I believe there is a strong case for allocating this benefit to industry in the form of a cut of half a point in the NIS, to offset the increase in the NI burden that would otherwise take place. Naturally I would hope that by next spring you will feel able to go further and make the full 1½ point cut I have previously suggested. I understand your reluctance to announce any NIS reduction now, but in view of the extra cost of NIC falling on industry next year, I still believe that a cut in NIS of at least half a point should be announced at the time of the NIC announcement. You could then start from that basis when you review the matter before the Budget as you have undertaken to do.

SECRET

SECRET

5 I will not repeat here the detailed case for reducing the NIS which we have discussed before. The basic point is that by reducing industry's costs the reduction would be the most helpful contribution the Government can make to the vital objective of improving industry's competitiveness. It goes without saying, of course, that any increase in the NIS burden will work against that objective, at a time when, through considerable efforts, industry itself is at last beginning to improve its competitiveness.

6 In conclusion, I should like to raise a procedural point about an NIS reduction. As we know, it takes a considerable time to implement a reduction and I am anxious that, when the time comes, any delay on the Government side should be kept to an absolute minimum. At present primary legislation is required to reduce the NIS rate. I wonder if there is a case for taking powers in the National Insurance Bill to reduce the rate of NIS by subordinate legislation? That should save time later on, and I doubt if it would prove controversial. I hope you and Norman Fowler will consider this.

7 I am copying this letter to the Prime Minister, Norman Fowler, Norman Tebbit and to Sir Robert Armstrong.

Yours ever
Patrick

SECRET

CC AD
AW.

(2)

Prime Minister

To note.

MCS 26/11

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

PRIME MINISTER

TAXATION OF BENEFITS IN KIND - FREE PETROL

In my minute of 8 July (see PE5) I told you of my proposal to bring all petrol provided for directors and higher-paid employees into charge to tax from April 1982. Legislation providing for a scale charge was included in this year's Finance Act.

2. As I told you last week a related proposal to require employers providing car and petrol benefits to apply PAYE directly aroused strong opposition from employers' representatives and I have decided to postpone for a year any change in the method by which tax on these benefits is collected. Now, after further consideration, I have decided that it would be wise to postpone also the introduction of the scale charge on petrol. This is partly because, without the proposed change in the method of collection, little or none of the 1982/83 tax could have been collected in that year, and partly because to attempt to collect that tax even in later years under the existing method would have entailed additional staff costs at a time when it is a major part of our strategy to cut Civil Service numbers. Indeed the proposed change in the method of collection was conceived primarily as a cost-cutting measure.

3. I am sure both these decisions will be welcomed by employers, particularly the Institute of Directors and the CBI, and I have asked them to co-operate with Inland Revenue officials in the search for new, economical methods of taxing these benefits.

(G.H.)

24 November 1981

JS

tcan Pd

10 DOWNING STREET

From the Private Secretary

23 November 1981

TAXATION OF FRINGE BENEFITS

The Prime Minister has seen and noted the Chancellor's minute of 17 November, in which he recorded his conclusion that it would be unwise to proceed with the implementation of the draft Inland Revenue Regulations on a change in the method of taxing car benefits.

M. C. SCHOLAR

Miss Jill Rutter,
HM Treasury.

Mr Griffiths.

MR SALVESON

cc Mr C D Butler

REVIEW OF NATIONAL INSURANCE CONTRIBUTIONS

I understand No 10 have asked for a background note on the forthcoming annual review of National Insurance Contributions and the accompanying Government Actuary's report.

2. There is nothing that can be said at this time about the outcome of that review, which is not yet complete, or, indeed, anything too specific about the timing. The Prime Minister has herself already received a minute from the Chancellor outlining the changes he would like to make. But I assume the note for which you are now asking is for immediate public consumption.

3. The attached background note simply, therefore, sets the scene for the current review and gives no clear indication of what is likely to happen.

MJWu

pp. A J WHITE
19 November 1981

ANNUAL REVIEW OF NATIONAL INSURANCE CONTRIBUTIONS

The present level of Class I National Insurance Contributions are:-

Employees - 7.75 percent
Employers - 10.2 percent

In addition employers pay the National Insurance Surcharge for 3.5 percent, making their total contribution 13.7 percent.

2. The upper and lower earnings limits relevant for levying these contributions are, currently, £27 per week and £200 per week. Contributions are not levied on earnings below the lower earnings limit, but once that level is reached contributions are levied on all earnings from the first pound up to £200.

3. The Secretary of State for Social Services is due to announce shortly the earnings limits and contributions rates for 1982-83. This announcement would normally be before the end of November but could slip slightly to the first few days in December. The main purpose of any changes would be to seek to ensure that the National Insurance Fund would be in broad balance in the next financial year. The Government Actuary will publish a Report on the changes and their effect on the Fund when these changes are announced.

4. There are two sorts of changes which can be made. First, changes in the earnings limits and, second, changes in the rates. The earnings limits would normally change. The lower earnings limit is linked to the level of the pension and, on that basis, can be expected to increase from £27 to £29.50. The upper earnings limit has to be between $6\frac{1}{2}$ and $7\frac{1}{2}$ times the lower earnings limit, which implies a range of about £190 to £220.

5. Changes in the rates of contribution will depend on the expected balance of the Fund <u>before</u> such changes are made. It is already clear that, largely because of increased unemployment, some deficit on the Fund for 1982-83 is likely and, therefore, that some increase in rates is not unlikely. The points of particular interest will be the size of any increase in rates

and how it is distributed between employees and employers.

6. Last year a 1 per cent increase in rates was placed solely on employees (whose rate went up from 6.75 to 7.75 per cent). This was done in order to avoid placing an additional burden on employers. Some additional cash burden on employers is inevitable since increased earnings mean increased payments of National Insurance Contributions and National Insurance surcharge. Any increase in the upper earnings limit would also place an additional burden on employers. The Government will, however, continue to be aware of the need to limit the additional burden on employers.

7. There are, in addition, Class II and Class IV Contributions, levied on the self-employed and Class III Contributions which are voluntary. These can be expected to change in line with changes in the employee and employer Class I Contributions.

8. There is nothing more that can be said, at this time, about changes to earnings limits and changes, if any, to contribution rates.

SECRET

4

Prime Minister

This has just come in.

Mr Tebbit agrees to the Chancellor's NIC proposals.

MCS 19/11

PRIME MINISTER

In his minute of yesterday the Chancellor advocates that most of the increase in next year's National Insurance Contribution should fall on the employee, including the increase of 0.35% in the Employment Protection Allocation which has always hitherto been paid by the employer.

As indicated in paragraph 6 of the minute, I think we must accept that such a step will make it more difficult to secure a satisfactory outcome to the current pay round and employers will be pressed hard in negotiations to settle the higher. To the extent that such pressures cannot be resisted some employers may come to bear the additional costs. We need also to recognise the effects on the forthcoming miners' ballot which has been delayed.

But I recognise the arguments against imposing a greater load on employers, and by his proposal to make a sizeable increase in the upper earnings limit the Chancellor has limited the increase payable by workers on average incomes and has thus gone some way to meet my point. I would not therefore wish to oppose his scheme.

I am copying this minute to the recipients of the Chancellor's minute.

NT

N T

18 November 1981

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000 18 November 1981

Michael Scholar Esq
Private Secretary
Prime Minister's Office
No.10 Downing Street
LONDON SW1

Dear Michael,

NATIONAL INSURANCE CONTRIBUTIONS

I regret there was a typing error in the Chancellor's minute of 17 November to the Prime Minister about national insurance contributions. In line 8 on page 3 "employer" should read "employee".

I am copying this letter to Don Brereton, Richard Dykes, Ian Ellison and David Wright.

Yours ever
Peter

P S JENKINS
Private Secretary

SECRET

Seen by the Prime Minister 19/11
MCS.

PRIME MINISTER

Papers on NIC and NIS

You were concerned about the wide circulation of Alan Walters' note to you of 13 November, given its sensitivity and the fact that the Chancellor's note was copied only to Sir Robert Armstrong.

You asked for a list of everyone to whom these documents are being copied and all who see them. Within No.10 Downing Street the following people saw either the Chancellor's minute or Alan Walters':-

Mr. Scholar
Mr. Wolfson
Mr. Hoskyns
Mr. Duguid
Mrs. Padwick
Mr. Walters
Mr. Davies-Jones
Neill Mitchell
Steve Pike
Charlotte Stevens
Alan Logan
David Collins
Andrew Coombes
Steve Geary
Duty clerks
Jan Crean
Trevor Garrett
Filing clerks

No one outside No.10 Downing Street saw Alan's note. The Chancellor's minute was seen by the Cabinet Office people listed in Mr. Wright's minute to me of 18 November. The Chancellor's minute would also of course have been seen by a number of people in the Treasury.

If the Chancellor had classified his minute "Budget - Secret" the number of people who would have seen it would have been drastically reduced. Within No.10 it would have been seen only by Alan Walters and me, and perhaps Clive Whitmore. He did not so classify it because he does not regard it as a Budget Secret, as can be seen from the wider distribution he has given to his later minute on the

/ same

same subject, of 17 November. In view of this, I do not myself think that Alan Walters gave too wide a distribution to his note, particularly since I understand that there have been discussions within the Policy Unit about the NIC and NIS.

As to the substance of the matter, I suggest that you discuss the Chancellor's two minutes with him at your regular meeting with him at 0945 tomorrow morning. You will see from Alan Walters' note to me of 18 November that he supports the Chancellor's proposals, both in order to maintain the soundness actuarily of the Fund; and also because he thinks it is a useful pre-emptive strike for a smaller PSBR. He, however, does not accept the Treasury assumption that by loading the NIC onto employees rather than employers the employment effect is minimised. Alan thinks it important to argue this out with the Treasury, to prevent them putting forward wrong headed proposals in the future. You may wish to suggest to the Chancellor tomorrow that Alan discusses the issue with the Treasury people concerned.

The Treasury have not been able to give me notice of any issues which the Chancellor will wish to raise at tomorrow's meeting.

MCS

18 November, 1981.

SECRET

3

MR. SCHOLAR

Prime Minister

MCS 18/11

NATIONAL INSURANCE CONTRIBUTIONS

I feel I may have been a bit elliptical in my last memo to the Prime Minister dated 13 November on this subject. May I make my position clear?

I support the Chancellor's proposal to increase the National Insurance Contribution by 1% on "constitutional grounds". The rules of the Fund require it to be actuarily sound. The 1% increase is required for this purpose.

I also accept, but am less convinced by, the argument that there must be considerable room for manoeuvre before the Budget. I believe that the National Insurance Contribution is not a good tax because it does have probably a greater effect on employment than most other alternative taxes.

My memorandum was meant to warn against using what I believe is the Chancellor's false analysis in order to "help industry" at the expense of the personal sector. For example, it might be argued that a decrease in the National Insurance Surcharge, urged on us by the CBI, and a corresponding increase in the National Insurance Contribution would transfer money from the personal to the business sector. My analysis shows that such a proposition is wrong. We would be imposing these administrative burdens to no purpose.

AW

18 November 1981

ALAN WALTERS

SECRET

Ref. A06013

MR SCHOLAR

National Insurance Contribution

I understand that you have asked to know by this evening who in the Cabinet Office saw the Chancellor of the Exchequer's minute of 12 November to the Prime Minister about the National Insurance contribution.

2. The minute was seen by Sir Robert Armstrong and four members of his Private Office, namely myself, Mr Hilton, Mr Cloke and one of our Secretaries who sent copies to Mr Ibbs (Head of the CPRS), Mr Gregson (Deputy Secretary, Economic Secretariat) and Mr Moore (Under-Secretary, Economic Secretariat). The copies sent to Mr Gregson and Mr Moore were seen by their respective Secretaries and one was also shown to Mr Bostock (Principal, Economic Secretariat). The minute was copied to these people firstly since it is customary to send to the CPRS a copy of correspondence reaching the Cabinet Office on economic questions and secondly to the Economic Secretariat since the item is due to come up at Cabinet shortly.

3. Within the CPRS, the minute was seen by Mr Ibbs and the three members of his office (Mr Spence, Mrs Wharram and Miss Medwell). Three copies were made and circulated as follows: to the Deputy Head of the CPRS and the Chief Economist (Mr Bailey and Dr Rickard); one to Mr Wasserman, Mr Thompson and Miss Mackay and one to Mr Cornish. These members of the CPRS were shown the document because of their involvement with work on economic policy and benefits. Their copies would have passed through the hands of their Secretaries.

D J Wright

D J WRIGHT

18 November 1981

File AH

ccs Mr Walters
Mr Hoskyns
Mr Wolfson

Econ Pol
Budget

10 DOWNING STREET

From the Principal Private Secretary

17 November 1981

Dear John,

We spoke at the end of last week about Alan Walters's involvement in the preparation of the Budget, and I told you that the Prime Minister would like him to participate on the same basis as last year. This means that he should receive all Budget papers and be invited to the appropriate meetings in the Treasury.

You have since let me know that this arrangement is acceptable to the Chancellor of the Exchequer.

Yours ever,

Clive Whitmore.

John Kerr Esq.,
H M Treasury.

AH

0%

cc Alan Walters

2

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

Prime Minister

I suggest you discuss with the Chancellor at your meeting tomorrow.

* Alan Walters agrees with the Chancellor's proposal, but does not accept the assumption at X that it hurts employment more if the increase is loaded on to the employers rather than the employees.

Shall I suggest he discusses with the Treasury?

MCS 18/11

PRIME MINISTER

* see attached minute.

NATIONAL INSURANCE CONTRIBUTIONS

The Secretary of State for Social Services and I have been considering the rates and earnings levels of National Insurance Contributions payable from April 1982. This minute has been agreed with Norman Fowler although as you will see we have not agreed a proposal. We have also had discussions with the Secretaries of State for Industry and for Employment.

2. The questions at issue have to be seen against the background of our current discussions on public expenditure. These are not yet completed, but it is apparent that the public expenditure totals will be well above those which I proposed in my paper (C(81)50) which we discussed on 20 October.

3. I have already minuted you about my fears that we shall be forced into tax increases in the next Budget, and I have decided that I cannot now announce a reduction in the National Insurance Surcharge to take effect from next April. I shall look at this again at Budget time but any change could then take effect only in the summer at the earliest. In my judgement we cannot allow National Insurance Contributions to increase less than we had assumed, and ideally should look for more. Combining these features we need to look for the maximum tolerable increase in contribution income over and above what we had assumed, with such increase coming as far as possible from employees, so as to spare employers unnecessary extra burdens. X

.... 3. I attach a note by officials which gives the necessary facts and figures. There are three elements:

- We need an increase in contributions in order first to balance the NI Fund, and a further increase if we are to retain for the PSBR the savings that flow from the 1 per cent abatement in benefit savings, for which we have already legislated. The effective range is between 0.35 and 0.70 percentage points depending on whether we go for balance or something more and on the upper earnings limit chosen.

- We need an increase in the allocation to the Redundancy Fund of at least 0.35 percentage points if it is not to exceed its statutory borrowing powers.

- The Secretary of State for Social Services wishes to increase the Health element of the contribution by 0.1 percentage points.

4. An important conclusion is that if we made no changes, the resulting deficit on the NI Fund for 1982-83 would be some £700 million more than has been assumed in our forecasts so far, even before any decisions are taken on public expenditure. The minimum necessary increase is above the level which can be achieved within the existing statutory framework. In my view we could only avoid legislation at the expense of either worsening our PSBR objective or imposing a disproportionate burden on employers. I regard neither as acceptable.

5. That means that we must legislate to increase NI contributions, and in my judgement on much the same pattern as last year's Social Security Contributions Bill, putting the main share of the burden on the employee.

6. I recognise that this will be difficult in relation to our desire to limit the growth of earnings. The Secretary of State

for Employment has drawn particular attention to the effects on wage bargaining of this measure and of rising real local authority rents. I am therefore prepared to accept an increase in the upper earnings limit to £220, despite the additional burden it involves for employers (an extra £120 million in NIC and NIS for private sector employers in addition to the £550 million they can expect to pay solely as a result of the increase in earnings). This means that the additional contribution for the employee will be 0.85 per cent - an extra £1.38 a week for the man on average earnings - though the effect on take-home pay would be eased if I were able in the Budget to raise income tax personal allowance in line with inflation.

7. This will enable us to balance the NI Fund and contain the deficit on the Redundancy Fund. I am willing to allow the 0.1 per cent increase in the Health element of the contribution as an alternative to at least part of the surplus on the NI Fund that would otherwise be required to obtain the savings in benefit expenditure. It will also involve the employee paying for the Redundancy Fund Allocation. But I think so long as we are clear about the reasons for this I see no presentational difficulty. The Secretary of State for Social Services will also be making proposals for the self-employed.

8. The Secretary of State has expressed grave reservations about making sharp increases in NI Contributions at the same time as he is being asked, in the public expenditure context, to consider abating next year's uprating of social security benefits. He thinks this combination of factors will make it difficult to carry through the necessary social security legislation.

9. You may want to see this discussed further among the Ministers most directly concerned, and it may be right to bring in the business managers at that stage. Timetable pressures mean that the legislation must be introduced in the week beginning 30 November,

to be through the Commons by the Christmas Recess and receive Royal Assent by the end of January. We need also to keep an eye on the relationship to an announcement about public expenditure. Subject to your views, I suggest that we should put the options to Cabinet, and if necessary dispense with the normal discussion in Legislation Committee.

10. I am sending copies of this minute to the Secretaries of State for Social Services, Employment and Industry, and to Sir Robert Armstrong.

Peter Jenkins

for (G.H.)

17th November 1981

(Approved by the Chancellor of the Exchequer and signed in his absence).

(7)

POSSIBLE INCREASES IN NATIONAL INSURANCE CONTRIBUTIONS

Note by officials in the Treasury, Department of Health and Social Security and Department of Employment

Introduction

1 The Government has to review the National Insurance contributions (NIC) payable from 1 April 1982. Four questions are involved:

(i) the increase in rates and/or earnings limits necessary to provide income to the National Insurance Fund either to balance exactly expected expenditure or to provide to the PSBR the expenditure savings which flow from the 1% abatement in benefits in November 1981 (estimated at £170 million).

(ii) the increase in allocation from the employers contribution (within the overall rate) necessary to prevent the Rundndancy Fund from exceeding its statutory borrowing powers (£300 million). If the allocation were to be increased without an effect on the NIF this would involve an increase in rates, whether of employer or employee.

(iii) the Secretary of State for Social Services has proposed an increase in the allocation to the NHS of 0.1 per cent.

(iv) the distribution of the increases between employers and employees and between the rate and the earnings limits. There will be subordinate decisions to take on the rates for the self-employed and non-employed.

The present position on rates and earnings limits

2 The standard rate contributions are at present as follows:

	National Insurance Fund	National Health Service	Employment Protection allocation	Total
Employer	9.4%	0.6%	0.2%	10.2%
Employee	7.1%	0.65%	-	7.75%
TOTAL				17.95%

In addition the rate of NI Surcharge paid to the Consolidated Fund is 3.5% on employers.

3 The lower earnings limit is £27 a week, and the upper earnings limit £200 a week. The LEL will rise to about £29.50 next year, and all calculations in this note assume that this happens. The UEL could stay at £200; the maximum possible increase under current legislation would in practice be £220.

National Insurance Fund

4 The Government Actuary has provided the following calculation of the increase required in the contribution to the NI Fund on assumptions given to him with Ministers' approval of earnings, prices and unemployment. (The figures are for increases in the employees' rate, assuming no change in the employers' rate, but if the increases were to be shared between employers and employees the total for the two together would be approximately the same.)

	Required increases for 1982-83	
	To provide a Surplus of £170m in Fund	To maintain balance in Fund
UEL £200	0.69	0.54
UEL £210	0.57	0.41
UEL £220	0.49	0.33

5 Even if the employers' rate did not change, extra costs would fall on private sector employers from raising the UEL, as follows:

	NIC	NIS	Total £m
£210	48	22	70
£220	80	40	120

These figures are additional to increases in private sector employers' costs next year, resulting mainly from the rise in earnings, of £400 million on the NIC and £170 million on the NIS.

6 The expenditure savings that result from the 1% abatement in benefits at November 1981 can be secured for the Consolidated Fund by a reduction of one percentage point in the Treasury Supplement to the National Insurance Fund.

Redundancy Fund

7 An Order is now before Parliament to increase the Fund's borrowing power to £300 million. Any further increase would require primary legislation. The deficit is expected to be some £265 million by March 1982 and without special action might well rise to £519 million by March 1983. Increases in the EPA of the following order would produce extra revenue as shown below, resulting in deficits in March 1983 also as shown.

	Extra revenue during 1982-83	Deficit in March 1983 £m
0.3%	306	198
0.35%	360	142
0.4%	412	86

In the DE view 0.3% is the minimum increase in allocation needed and carries some risk of borrowing limits being exceeded. An increase of 0.35 reduces that risk and makes a start on reducing the deficit in Fund from the beginning of the financial year. These figures are for increases in the employers' contribution. Increases in the employees' contribution would have to be 0.03 percentage points higher in each case to yield the same extra revenue.

8 These figures assume no special measures to adjust expenditure by the Fund. The following measures could be considered:

(a) Reduction of the statutory scale of redundancy payments. Primary legislation would be required. A cut of 10% would save £34 million in 1982-83.

(b) Reduction of the Fund's contribution to employers' redundancy payments from the current 41%. A reduction to 35% would be the maximum possible under the current legislation; it would require an affirmative Order. The saving would be some £43 million in 1982-83.

9 An alternative would be to increase the Fund's borrowing limit. A rise to £600 million would be necessary to avoid any change in contributions. Primary legislation would be required.

10 Under current legislation, contributions to the Redundancy Fund are paid only by the employer. If the objective was to avoid any increase in employers' costs, it would be possible to raise their contribution to the Redundancy Fund and make an offsetting reduction in their contribution to the National Insurance Fund. An alternative would be to legislate to provide for employees to contribute to the Redundancy Fund.

National Health Service

11 The Secretary of State for Social Services has proposed an increase of 0.1 per cent in the NHS allocation. This is the most that can be done without primary legislation.

Legislative Position

12 Under existing legislation there is a limit to the increase that may be made in either employee or employer contributions of 0.25 per cent each. The effects of such a maximum increase in the rate combined with the maximum UEL are shown as Option 1 of the attached table. Thus, to achieve a balance on the NI Fund even without a surplus, to prevent the Redundancy Fund from exceeding statutory borrowing powers and to increase the NHS allocation, would require legislation.

Alternative Options

15 The other options in the attached table show the effects of

- Option 2: the increase necessary in the employees rate alone sufficient to put the NI Fund in surplus of £70 million, to prevent the Redundancy Fund from exceeding borrowing powers and to increase the NHS allocation by 0.1 per cent keeping the UEL at £200.
- Option 3: the increase necessary to provide the same result as Option 2 but with the UEL increased to £220.
- Option 4: as Option 3 but with the increase in contribution rates split equally between employer and employee.

Effects of different options for changes in NI contribution rates and earnings limits

	Increase in rates: employer base 10.2%	Increase in rates: employee 7.75%	UEL	Additional burden: employer(1) NIC	Additional burden: employer(1) NIS	Additional burden: employee NIC	Effects on NI Fund in 1982-83 deficit(-) or surplus(+)	Direct effects on PSBR in 82-83 (compared with forecast)(2)
	%	%	£ pw	£m	£m	£m		£m
Option								
1 Effects of changes in rates and earnings limits to maximum within permissible legislation assuming 0.35% from employers to RF and 0.1% from employees to NHS	0.25	0.25	220	280	40	330	-310	- 50
2 Increase in rates necessary to keep RF within statutory borrowing limits, to provide 0.1% to NHS and retain for Consolidated Fund savings in benefit expenditure using only change in employee rate	Nil	1.05	200	Nil	Nil	1010	+70	-450
3 As 2 but with UEL increased to £220	Nil	0.85	220	80	40	920	+80	-500
4 As 3, but with increase in contribution rates split equally between employer and employee	0.40	0.40	220	400	40	480	+60	-300

(1) Central and local government employers excluded

(2) Direct effect on PSBR before second round effects on tax receipts and benefit payments etc are taken into account. The total effect on the PSBR for Option 2 for example would be roughly £420m (compared with forecasts).

For comparison, a 1 per cent reduction in NIS would have a direct cost to the PSBR in 1982-83 of £800m if reduced from April, £550m if reduced from July, £300 million if reduced from October.

CONFIDENTIAL

Prime Minister

To note.

MCS 20/11

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

PRIME MINISTER

MT

TAXATION OF FRINGE BENEFITS

see pt 4 file

In my minute of 3 February I referred to my proposal to change the method of taxing car benefits from 6 April 1982. Instead of being taken into account in the PAYE code, the value of car (and petrol) benefits was to be included by the employer in taxable pay. The purpose of this was to save Inland Revenue staff.

2. The Inland Revenue have produced draft Regulations covering the details of the scheme and held a number of meetings with employers' representatives. In the light of employers' reactions I have now decided that it would be unwise to prodceed with the implementation of those Regulations and have asked the Inland Revenue in consultation with employers to look again for ways of reducing their staff costs in this area. This decision will be announced in reply to a written Parliamentary Question [the proposed text is attached].

Jim Rutter

pp (G.H.)

17 November 1981

Seen and approved by the Chancellor of the Exchequer and signed in his absence

CONFIDENTIAL

TEXT OF PARLIAMENTARY QUESTION

Con - Hertfordshire South West

MR RICHARD PAGE: To ask Mr Chancellor of the Exchequer, what are the cost savings to the Inland Revenue of changing the basis of collecting tax on car and fuel benefits to PAYE and how these savings are made up.

REPLY

The proposals in the Finance Act 1981 requiring employers to apply PAYE to car and car fuel benefits from April 1982 would have made possible a reduction in Inland Revenue staff numbers of about 150. However, in the light of a number of representations received about the difficulties the regulations would have created for employers the Government have decided to postpone the introduction of any change for one year. Amending legislation to this effect will be included in the next Finance Bill. The Inland Revenue will continue to discuss with employers' representatives ways of overcoming the problems that have been identified and of achieving worthwhile staff savings in this area.

CC Mr G P Smith
Mr Aaronson
FP
DEU

MR STUBBINGTON

CHANGES IN TAXES AND RATES BURDEN ON TYPICAL HOUSEHOLD

I attach a table which answers your request of Friday evening. You asked for comparisons to be made between:-

(i) the gross earnings
(ii) the tax payments
(iii) the rates payments; and
(iv) the RPI

All except the last, for a household on average earnings with two children and wife not working as in the Jack Straw example, between May 1979 and now.

2. I have interpreted May 1979 to 1978/79 mainly for the reason that if it is wished to use the tax regime ruling in 1978/79 as the base (as is implied in the choice of May 1979), then it is more appropriate to take the rates payments for 1978/79 also. We are unhappy about identifying families' tax bills for individual months since they fall due upon the income of a full year.

2a. The table shows an increase in rates payments of some 77 per cent over the period. Measuring the increase is not however straightforward. The figure given is based on estimates of expenditure on rates (from FES) at different earnings levels. There are of course no figures available for actual rates payments by household type and at different earnings levels - payments obviously depend on the type of housing occupied. But the average domestic rate payment across all households has grown faster, at least in England. Between 1978/79 and 1981/82 the average domestic rates payments per household in England rose by over 93 per cent (DOE figure).

3. You will see also that the table distinguishes between income tax payments taking account of and excluding the effects of child tax allowances which were still in existence in 1979. The fairer comparison is between the tax figures excluding child tax allowances since, then the CTA structure was admantled at April 1979, the money equivalent of the CTA was notionally incorporated into the child benefit, which, in part, accounts for the very large increase in CB between 1978-79. Note that the figures for child benefit are those for the average amount of CB payable to a two-children family over the financial year - they are thus a weighted average of the pre- and post-November rates multiplied by two.

RICHARD SMITH
16 November 1981

SS EARNINGS, TAX AND RATES PAYMENTS FOR TWO-CHILDREN HOUSEHOLD, N-WORKING WIFE

	£ per week		%
	1978/79	1981/82 f	% Change
RPI (15 Jan 74 = 100)	201.66	303.88	50.7
Gross earnings	94.42	148.67	57.5
Income Tax	18.99	32.22	69.7
/Income Tax (excluding child tax allowances)7	/20.267	/32.227	/59.07
NICs	6.14	11.52	87.6
CB o	5.14	9.87	92.0
Net, incl CB	74.43	114.80	54.2
Indirect taxes (personal, excluding rates)			(82.6)*
Rates			(77.2)*
Income tax and NICs			74.1
/Income tax, excluding CTAs, plus NICs7			/65.77
Income tax, NICs, and personal indirect taxes			76.2
/Income tax, excluding CTAs, plus NICs and personal indirect taxes7			/69.87

o Average rates for financial years, multiplied by two.

* based on estimates derived from Family Expenditure Survey data.

f part-forecast.

I take it that no Budget figures are ever taken out of the office. No

No - there are 605 many documents about already

Prime Minister

SECRET

13 November 1981

ALAN WALTERS

PRIME MINISTER

Shall I ask the Treasury for their comments: assuming they accept Alan's theoretical analysis, are they arguing that practical considerations justify their proposal?

MCS 13/11

NIC AND NIS - THE CHANCELLOR'S PROPOSALS OF 12 NOVEMBER

1. I agree with the Chancellor's proposal that the NIC be raised - and about 1 per cent seems correct.

2. Some of the arguments that are used by the Chancellor, however, seem to me to be incorrect and inconsistent with basic analysis.

3. The Chancellor urges an increase in the NIC because, as distinct from NIS, the NICs are paid primarily by employees rather than employers. Consequently, he argues, the burden would fall on employees rather than firms.

4. That is not correct. Under competitive conditions it does not matter who pays the tax; the burden or incidence of any tax is completely independent of how it is collected (administrative problems and cost aside). Analogously, it would not matter if the brewer, the retailer or the drinker actually paid the same tax on beer. The burden and incidence would not be affected.

5. The question "who bears the burden" of a tax on employment depends entirely on the extent to which the employers find it profitable to reduce employment and the degree to which workers respond by varying, if at all, their job-acceptance-(real) wages.

6. Probably the most frequently asserted assumption about the latter is that there is an infinitely elastic supply of labour at the going real wage. Variations in the demand for labour, at least over the range we are considering and with the present level of unemployed, will then have no effect on the real wage rate. In this case, the volume of employment will fall and business, and the newly unemployed, will bear the burden of the tax. If the employees' NIC is increased then gross real wage rates will rise pari passu but real wages, excluding the NIC increase, will be constant. If the employers' NIS is increased, then although real wage rates, both gross and net, remain the same, profits are reduced by the NIS to exactly the same extent. Whether we use NIC or NIS is irrelevant.

/7. There are

SECRET

7. There are a number of alternative views about the wage-employment supply process which we could explore. But they all amount broadly to the same proposition: the greater the response of the supply of labour to different wage rates the more will those with jobs bear the burden. Correspondingly the smaller the effect on both employment and profits.

8. I am inclined to think that the caracature of paragraph 6 is rather more consistent with the evidence than that in paragraph 7. (But the fact that it is also the common prejudice should give us cause to be sceptical). In other words imposing an increased NIC or NIS will not much reduce real take-home wage. The real wage paid out by industry rises almost as much as the NIC or NIS increase. Business then bears the substantial burden of the tax.

AW

ALAN WALTERS

cc Mr. Wolfson
Mr. Hoskyns
Mr. Duguid
Mr. Scholar

– why? A copy of the original minute went only to Sir Robert Armstrong?

May I have a list of everyone to whom these documents are being copied and all who see them? I will then discuss with the Chancellor.

SECRET

Prime Minister

The Chancellor has not yet secured his colleagues' agreement to this proposal and is minuting you simply to keep you in touch. Unless, therefore, you think this on the wrong track you need only note at this stage.

MES 12/11

SECRET

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

12 November 1981

PRIME MINISTER

I mentioned to you on Tuesday the issue of an increase in the National Insurance Contribution (NIC). This minute describes how matters now stand. The NIC is of course the immediate responsibility of Norman Fowler. I am still discussing with him what should be done, and I hope that we can put proposals to you more formally within a few days.

2. The starting point is that the Government Actuary's report will show that a substantial increase is necessary in the NIC to balance the National Insurance Fund. An increase will also be needed in the allocation to the Redundancy Fund to avoid a growing deficit in that Fund. We therefore need to take some action, and we have to decide the best form for it to take.

3. I believe we must keep in mind the two principles mentioned in the last paragraph of my minute of 27 October. First, we need to secure maximum flexibility on the PSBR., The prospects for public expenditure next year are bad. Everyone will want to see income tax allowances at least raised in line with inflation next year. We do not want to add to inflationary pressures by further real increases in taxes on spending. It therefore makes sense to look for a substantial rise in NIC to provide room for manoeuvre on the PSBR. Secondly, any additional burden we impose on industry should be as small as possible. Private sector employers are likely to pay an additional £550 million next year (a 5 per cent increase on this year) in NIC and NIS, without any change at all in their

rates or in the earnings limits, simply because of the increase in earnings. We are under pressure to help employers by reducing the rate of NIS but it is at present very uncertain that we shall be able to do so. It is therefore desirable for the increase in the NIC to fall as far as possible on employees' contributions.

4. While my consultations with Norman Fowler are not yet complete, my present view is that an increase in the employees' rate of about 1 per cent, and no change in the employers' rate, would be right. The increase would be justified by reference to the prospective deficits in the National Insurance and Redundancy Funds. The rise in weekly payments next year by the employee on average earnings would be about £1.60. At the same time we could make a small increase in the Upper Earnings Limit from its present £200. If it rose to £210 (compared with the £220 possible within the legislation), the additional burden falling on private sector employers next year through the NIC and NIS would be about £70million. The improvement to next year's PSBR resulting from such a package would be about £400-£500 million compared with our forecast.

5. In my minute of 27 October I mentioned that primary legislation, which would need to be passed by the end of January, would probably be necessary. Any increase above 0.25 per cent in either employees' or employers' contributions would require such legislation. So I shall press ahead with my talks with Norman Fowler, and bring in Patrick Jenkin and Norman Tebbit as soon as possible, so that we are in a position soon to produce firm proposals, and start consultations with the business managers.

6. A copy of this minute goes to Sir Robert Armstrong.

(G.H.)

12 November 1981

cc Mr. Hoskyns
Mr. Wolfson

MR. WHITMORE

THE BUDGET

I believe shortly the Budget process will be set in motion. I assume that the process will be similar to that which we pursued last year: I shall receive all Budget documents and be invited to the appropriate Treasury meetings.

Agreed MT.

AW

12 November 1981 ALAN WALTERS

Prime Minister.

I am sure that you will want Mr Walters to be involved in exactly the same way as last year. If that is agreed, I will mention it to the Chancellor's office.

[illegible] 12.xi.

CONFIDENTIAL

vb

Econ Pol

10 November 1981

Date of the 1982 Budget

The Prime Minister was grateful for the Chancellor's minute of 29 October, which suggested 9 March as Budget Day 1982.

The Prime Minister has noted that the unemployment figures will be published on 23 February and 23 March 1982; and that the RPI figures will be published on 19 February and 19 March 1982. Against this background, she is content with 9 March as Budget Day.

MCS

John Kerr, Esq.,
H.M. Treasury

CONFIDENTIAL

1

PRIME MINISTER

Budget Day 1982: 9 March?

You asked the dates of the regular monthly unemployment and inflation figures around 9 March. They are:

Unemployment figures: 23 February & 23 March
RPI figures: 19 February & 19 March

Content with 9 March for Budget Day?

MCS

Yes

9 November 1981

(1)

10 DOWNING STREET

Prime Minister

Budget Day

You asked when the inflation and unemployment figures are to be published.

The Government Actuary's Report and the Industry Act forecast will be published around Nov 30th (I have told the Treasury to make sure they're not published on or before Nov 26 - Crosby!)

The next date when such assumptions get published is in the Public Expenditure

OVER

White Paper, planned to be published on Budget Day.

Content with 9 March for Budget Day?

MCS 6/11

The regular monthly unemployment & inflation figures – are they on that day – or the week before or after?

M

(1)

Mr Walters

Prime Minister

Content with 9 March for the Budget?

MCS 4/11

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

When are the inflation and unemployment figures published?

PRIME MINISTER

DATE OF 1982 BUDGET

I have been giving some thought to the timing of the 1982 Budget in the light of last year's experience and the decisions that will need to be taken in the coming months. I am asking my Departments provisionally to plan for Budget Day on 9 March. An early Budget has significant revenue advantages and, as importantly, gives us an early opportunity to take whatever measures we deem necessary in pursuit of our economic strategy. It will also allow the Chief Whip and Leader of the House the maximum flexibility in arranging what looks likely to be a crowded Parliamentary timetable. We may well, for example, wish to plan an early passage of the Finance Bill through the Commons to avoid the problems that nearly beset us in the Lords this year.

2. I am assuming that as in the past two years we will be publishing the Public Expenditure White Paper on Budget Day. This has been widely welcomed by commentators. It strengthens the desirability of taking public expenditure decisions in good time this autumn. A significant slippage could put the 9 March date at risk. And our room for manoeuvre is not great. March 16 appears to be ruled out because of a likely State visit and March 30 because of your absence at the European Council. That leaves 23 March which would be neither as desirable or

convenient as 9 March. Further delay would, because of Easter, put the Budget back to 20 April with the attendant loss of indirect tax revenue and difficulties for the Parliamentary timetable.

3. All this points to 9 March. Of course, no final decision is needed until the New Year and unforeseen circumstances may change the balance of advantage. But it would be helpful to know that you are content with a planning date of 9 March.

(G.H.)

29 October 1981

DSS

File

10 DOWNING STREET

From the Private Secretary

7 September 1981

DATE OF 1982 BUDGET

You sent us a copy of your letter of 4 September asking for reactions to various possible dates for the 1982 Budget.

The Prime Minister's preference, like the Chancellor, would be for 9 March. 16 March would be inconvenient because of a likely State Visit; 23 March would be inconvenient because Mrs. Gandhi will probably be in London; and 30 March would not be appropriate because the Prime Minister will be in Belgium for the European Council. 20 April would be possible.

I am sending copies of this letter to Murdo Maclean (Chief Whip's Office) and to David Heyhoe (Office of the Leader of the House).

T. P. LANKESTER

H. J. Bush, Esq.,
H. M. Treasury.

MR. LANKESTER

1982 Budget

The 9th of March would be the date that suits the Prime Minister best. Would you like to reply to Harry Bush?

Just for your information, 16 March is probably going to be the State Visit of Sultan Qaboos; 23 March Mrs Gandhi will be in London; the Prime Minister will be in Belgium for the European Council on 30 March; and 20 April is free but the week after the Easter Recess and therefore I suspect not a very good date to choose. But I have pencilled in Tuesday 9 March and Tuesday 20 April.

CP.

7 September 1981

Treasury Chambers
Parliament Street London SW1P 3AG

Telex 262405 Telephone Direct Line 01-233
Switchboard 01-233 3000

R Birch Esq
Private Secretary to the
Leader of the House
Privy Council Office
Whitehall
LONDON SW1

Your reference

Our reference

Date

4 September 1981

Dear Mr Birch

DATE OF 1982 BUDGET

As part of our planning of the sequence of economic decisions and announcements over the next six months we have been giving some thought here to the date of the 1982 Budget. The purpose of this letter is, as far as is possible at this early stage, to obtain clearance from yourself and those to whom I am copying th letter, for possible Budget dates bearing in mind (for example) the requirements of the parliamentary timetable and the management of Government business (including the Budget debates); the Prime Minister's diary on Budget day and during the Budget debates; and (cf the Archbishop's enthronement) functions which may require Ministerial attendance.

2. In line with the practice of early Budgets in the last two years, the Chancellor has expressed a preference for 9 March. However, while we are about it, it would be as well to check on other possibilities: namely 16 March, 23 March, 30 March and 20 April.

3. I should be grateful for a reply by 25 September if possible.

4. I am copying this letter to Mr Maclean (Chief Whip's Office) and Miss C M Stephens (No 10).

Yours sincerely,

Harry Bush

H J BUSH

4 SEP 1981

PART 5. ends:-

Th to Treasury 10.7.81

PART 6 begins:-

Treasury Chancellor to P/S CDL