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David Wright (Personal)

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10 DOWNING STREET

From the Private Secretary

3 March 1980

Dear John,

As you know, the Chancellor called on the Prime Minister on Friday afternoon to outline his approach to the budget. They had before them his minute of 29 February.

The Chancellor said that the Treasury's pre-budget forecast was suggesting a rather larger fall in output in the coming year than most outside forecasters; at the same time, the forecast for the PSBR on the assumption of unchanged tax rates was approximately £8½ billion - which was perhaps rather lower than might have been expected from the output forecast. In the forecast to be published in the FSBR, he intended to show a less depressed output path in line with outside forecasters; but he did not think it would be right to be more optimistic about the PSBR. It would be better to show a PSBR target which could be met rather than be overly optimistic and run the risk of having to introduce supplementary fiscal measures in the autumn. As between the different sectors in the economy, the forecast was showing a substantial shift of resources into the oil sector and into the personal sector, and away from the non-oil corporate sector. This was reflected in a worsening of non-oil corporate liquidity. One of the objectives of the budget must be to reverse this shift.

As far as the monetary stance was concerned, he was proposing to roll forward the target range of 7-11% per annum to April 1981, with June 1979 remaining as the base. Given the likely overshooting of the target range for this financial year, a roll forward on these lines would represent as tight a stance as could be readily contemplated; on the other hand, to go for a more relaxed target would not be credible to the markets. He believed that a PSBR of £8-9 billion would be consistent with the 7-11% roll forward. Thus, in aggregate terms he was proposing a "no change" budget.

The Chancellor went on to explain that to index all the specific income and expenditure tax points and rates would involve a reduction of income tax of some £2 billion and an increase in indirect taxes of some £1 billion. £1 billion from indirect taxes would add about 1% to the RPI. He had yet to decide what combination of specific duty increases to go for; but he did not think it would be right to do more than this in total. Consequently, he was proposing to reduce the cuts in income tax to about £1 billion; and he intended to achieve

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this by abolishing the reduced rate band. In other words, there would be no going back on "Rooker-Wise", but people would enter tax at a 30% rate rather than a 25% rate. Low income earners would suffer proportionately more from this than higher income earners; and therefore to compensate for this, he intended to raise the higher tax thresholds by about 11% rather than by full indexation.

In order to provide some relief to the non-oil sector, he was hoping to raise some £½ billion by increasing PRT to 70% and possibly by advancing the oil companies' payments to some extent. He would use this money to reduce company tax liabilities arising from the recent fall in company stock levels resulting from the steel strike (the DIPS scheme), and also possibly to make some reduction in the national insurance surcharge.

In addition, he hoped to include about £50 million for the so called "enterprise package", perhaps £60 million by way of relief on capital taxes and some relief for voluntary service charities. He was also considering raising the starting point for Stamp Duty from £15,000 to £20,000 (though this would cost perhaps £80 million). To pay for these extra reliefs, he was considering raising additional revenue by disallowing the offset to the VAT liabilities that traders may currently claim as a result of the VAT they bear in their petrol and DERV purchases; and also reducing the relief on life insurance contributions from 17½% to 15%. In addition, he was considering raising taxes on fringe benefits - and in particular on business cars.

The Prime Minister gave her initial reactions to the Chancellor's proposals as follows:

i) She agreed that the monetary target should be rolled forward as proposed, and that the Chancellor should aim for a PSBR target of £8-9 billion. She also agreed that the increase in specific duties should not add more than 1% to the RPI.

ii) While she recognised that substantial savings were needed on the income tax front, she had certain doubts about abolishing the reduced rate band. She wondered whether this would be altogether consistent with the Government's announced aim of reducing the standard rate of tax to 25%; and she was worried about the distributional effects. She hoped the Chancellor would look very carefully at the latter point before reaching a final decision.

iii) As regards the proposal to reduce the national insurance surcharge, she wondered whether the business community might not prefer the alternative of a slightly lower PSBR and therefore lower interest rates.

iv) She was not altogther convinced that it would be right to give still further relief on business stocks, as seemed to be suggested by the DIPS scheme. In her view,

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the existing stock relief already gave companies an undesirable incentive to build up their stocks at the end of the tax year; the Chancellor's proposal would surely aggravate this.

v) She was glad to note that the Chancellor was not contemplating capital taxation reliefs on anything like the scale proposed in his minute of 12 December: for in the light of the forecast, there would clearly not be resources available in the coming year for implementing his original plans. On the other hand, she was attracted by the proposal for raising the starting point for Stamp Duty on house purchases.

vi) She was strongly against any increases in taxation of business cars. It seemed that middle managers, who benefited a great deal from the existing arrangements, had done relatively badly over the last year - taking into account the increase in mortgage rates; and to take action now would create considerable political difficulties.

The Chancellor made the following points in reply:

i) The distributional effect of abolishing the reduced rate band, provided it were accompanied by less than full indexation of the higher rate thresholds, would be more or less neutral. He would send the Prime Minister a note explaining this.

ii) He had not reached a final view on the national insurance surcharge, and he would certainly consider the point that a somewhat lower PSBR might be preferred by the business community.

iii) He had already given an indication in his speech to the Engineering Federation that he would be introducing the DIPS scheme. The scheme was intended to deal specifically with the problems caused by the steel strike, and it would operate in such a way as to benefit the manufacturing, and not the trading sector. He would send the Prime Minister a note explaining this.

iv) He hoped the Prime Minister would not completely rule out an increase in tax on fringe benefits. If nothing were done this year, their imputed value for tax purposes would fall further and further behind their real value; and this would mean increased anomalies and inequities. He would send a note setting out his proposals.

He would also send the Prime Minister a note on the specific duty options, and the note which Treasury officials had already prepared

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which showed the substantial shift of resources currently taking place out of manufacturing and into the oil and personal sectors.

Yours ever.

Tim Lankester.

John Wiggins, Esq.,
HM Treasury.

10 DOWNING STREET

John Hodges

PM

To see and

return pls.

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Tim (PM) R.

Returned with Sir Keith's letter attached. Thank you.

Andrew.

10 DOWNING STREET

Tim

Thank you very much.

MR. WHITMORE

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For you to see.

TPL

① David

To see

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② C.F.

3 March 1980