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PRIME MINISTER

BUDGET STRATEGY

1. THE POSITION WE START FROM

1.1 We have had a very severe monetary squeeze. This has had beneficial effects on efficiency and attitudes in the private sector, but industry can't stand the present exchange rate and MLR much longer.

1.2 Public expenditure has risen as a result of the lower activity caused by the squeeze. Every time we look at projected spending and PSBR, they get worse. We MUST assume there is worse to come, and budget accordingly. But we can not do much to cut spending further during 1981-2.

2. THE BUDGET'S STRATEGIC OBJECTIVES

2.1 This Budget will set the stage for the next Election. We can avert massive short-term damage to industry, and get, given a 2-year lead time, the main indicators (output, unemployment) moving in the right direction by late 1983. This is good management, not panic vote-buying.

2.2 The key is to get MLR down with the exchange rate hopefully following it down. How can we ensure that this is possible?

3. CHOICE OF BUDGET STRATEGY

3.1 The choice is between a Budget which takes the latest PSBR forecasts at face value (we call this optimism) and a Budget which assumes that PSBR projections will get worse (realism).

3.2 The penalties for erring too far on the side of optimism will be fatal, economically and electorally. Those from erring on the side of realism are, by comparison, trivial.

3.3 If we pursue an optimistic policy it is likely that we will face a mid-summer funding crisis, with a desperate attempt at further cuts, splits in Cabinet, trivial savings to show for it, and finally a further rise in MLR and then the exchange rate. This will lead to yet lower activity, higher unemployment and PSBR, which will no

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longer be reversible before the Election. The credibility of MTFS and Geoffrey himself will be destroyed and your own position undermined. It will be claimed "you have used your strategy and failed: let us now reflate".

3.4 This reflationary alternative would be to let money supply finance the gap. This would exacerbate inflation just as we run up to the next Election.

3.5 The choice between realism and optimism is like the choice about where to cut a firebreak to stop a forest fire. Do you do it 5 miles back, sacrificing 5 miles of forest to be sure that you save the nearby town? Or do you cut it 1 mile back, hoping only to sacrifice 1 mile of forest, but recognising that if you have misjudged the fire speed, you've lost the town? You choose the strategy which makes the worst outcome least likely. WE HAVE NO CHOICE BUT TO GO FOR REALISM.

4. RECOMMENDED STRATEGY

4.1 We should plot on a piece of paper, over time, the recent series of public expenditure and PSBR forecasts. We should then project their own "growth trend line". (This is standard business practice.) This will then quantify our experience over the recent past.

4.2 We should then design a Budget to reduce this realistic PSBR to a level compatible with declining MLR. The Budget itself has to deliver a certain revenue against a given expenditure. Let us decide the amount of that revenue. Then let us determine the best way of collecting it. The consequences of not collecting enough revenue would be so damaging that we ought to consider even the most unpalatable measures (eg increases in direct taxes).

4.3 The costs of our realistic budget giving rise to overkill are relatively small, and in any case they could be quickly offset by reductions in interest rates.

4.4 We do not believe that a realistic Budget would be hard to sell. We have a number of ideas about how to do it.

/5. CONCLUSION

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All the evidence and past Policy Unit papers show a familiar Treasury pattern: underkill; too little and too late; hoping things won't get worse, despite all the evidence; and resulting failure to get ahead of the problem. This is the story of the 1979 Budget and the 1980 Budget. The 1981 Budget is absolutely the last chance for realism to take over from wishful thinking.

AAW
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