SUBJECT

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NOTE FOR THE RECORD

The Prime Minister held a meeting this morning with the Chancellor of the Exchequer, Sir Douglas Wass, Mr. Burns, Mr. Wolfson and Mr. Walters to discuss the Budget strategy.

The Chancellor said that his minute of 5 February had indicated a PSBR for 1981/82, on existing policies, in the region of £11 billion. It had suggested that the objective should be to secure a reduction of £1½ billion so as to bring the PSBR back to £9½ - 10 billion. The PSBR forecast had now been updated, and the estimate was now for a figure of £13 billion. On this basis, and assuming the right policy was to achieve a PSBR of £9½ - 10 billion, his budgetary task was going to be extremely difficult. He had ruled out raising income tax rates. Consequently, the only possibilities for raising tax were through holding back the increase in thresholds and through raising indirect taxes (though he had also ruled out raising VAT). He had hoped to raise thresholds by 10 per cent, but in view of the latest PSBR forecast, it looked as if only a 6 per cent increase would be possible. As regards indirect taxes, the Treasury were considering two main options: one would raise the RPI by 1¾ per cent, the other by 2 per cent. Again, in view of the PSBR forecast it might be necessary to go for the higher figure. Then there was the question of how much revenue should be switched to the corporate sector. He believed that an enterprise package amounting to about £250 million would be psychologically very valuable. As for a reduction in the National Insurance Surcharge, he was still undecided. The CBI were pressing strongly for this, and the first year cost of a 1 per cent reduction would be only about £300 million. On the other hand, the full year cost had to be considered, and also the fact that part of the benefit would go the banks and other service industries. In addition, industry might prefer a lower PSBR, and the improved prospect for interest rates which would follow.

/ In discussion

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In discussion the following points were made:

(i) The Prime Minister said that the first priority must be to improve industrial activity; and in her view, this meant giving priority to a reduction in interest rates which would also have a salutary effect in getting down the exchange rate. If there were to be a choice between a reduction in the NIS and a lower PSBR, she would go for the latter.

(ii) The Prime Minister suggested that, if help was to be given to industry, a reduction in the heavy fuel oil duty should be considered. The Chancellor explained that he had considered this option, but a major drawback was the fact that - according to the Department of Energy - a good deal of the revenue would, because of the terms of the FRIGG contract, accrue to the Norwegians. He was exploring this further with Mr. Howell.

(iii) The Prime Minister suggested that, faced with the prospect of a 2 per cent addition to the RPI as a result of indirect tax increases, the Cabinet would prefer further public expenditure cuts. The Chancellor indicated that he did not believe that, at this stage, further cuts would be possible. It was going to be difficult enough to stay within the cash limits already agreed. At the same time, it was a regrettable fact that colleagues did not seem to fully understand the enormous burden of Government spending on pay. The central Government pay bill was forecast to increase by 10 per cent in 1981/82, and this was a major cause of the PSBR problem.

/ (iv)

(iv) The Prime Minister asked about the proposal to speed up VAT payments on imports: she thought that the extra revenue from this would be very useful. The Chancellor said that a final decision on this still had to be taken. It would yield a sizeable benefit for the PSBR in year 1; on the other hand, it would impose an undesirable burden on the corporate sector at a time when the aim should be to ease industry's cash flow. He was likely to decide against.

(v) The Prime Minister suggested that a further increase in the National Insurance contribution of employees should be considered. The Chancellor said that this would require new legislation, but in any case he did not believe it was a runner coming on top of the one per cent increase already in train.

(vi) Mr. Burns said that it would be hard to defend a PSBR any higher than £10-10½ billion. This was the highest figure consistent with the PSBR projection in the MTFS after making allowance for the lower level of activity now forecast.

The meeting then turned to a discussion of monetary policy. The Chancellor said that, for the sake of the credibility of the strategy, M3 would have to continue to be the target variable for the medium term. But he would indicate in his Budget Speech that the authorities would be looking at other monetary aggregates as well in future. (Whatever the disadvantages of M3, he had concluded - following discussions his officials had had with outside experts - that it could not simply be abandoned.) He would also say that they would be moving as fast as they sensibly could in the direction of monetary base control.

/ The Prime Minister

The Prime Minister urged the Chancellor to go further than this, and announce a concrete plan for moving to monetary base control.

Mr. Burns said that, even if there was greater focus in the coming year on the narrower aggregates, there was still a significant risk of conflict between the different policy objectives. If M3 and the narrower aggregates were to be contained within the MTFS target, there was a risk that interest rates would have to go up; and this would put upward pressure on the exchange rate. He was concerned that the authorities should maintain a tight grip on monetary policy: in the last six months there had been a significant relaxation, as evidenced by the acceleration of all the aggregates; there was a danger that, if this was not curbed, inflation would start to rise again. Mr. Walters suggested that, insofar as the growth of the monetary base had been very modest until recently, there might be a case for allowing it to grow rather more quickly in the year ahead.

Finally, there was a short discussion of the immediate prospect of an MLR cut. The Chancellor said that he had now concluded that an MLR reduction in the Budget itself would be untenable because of the relatively high PSBR forecast. If there was to be a cut, it would have to be either this Thursday or next. An early reduction could not be justified in terms of the money supply figures; it could only be on the basis of the lower rate of inflation (now expected to be just over 13 per cent for January), and the need to moderate the exchange rate. Mr. Burns added that a cut in MLR might help to reduce M3, but it would tend to push up the narrow aggregates. The Chancellor said that Treasury officials were doing further work on the possible justification of an MLR cut. The Prime Minister said that, if there were to be a cut before the Budget, in her view it would be better to do it this Thursday rather than next.

10 February 1981

FILE

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BUDGET SECRET

MF

~~bc~~ Mr. Wolfson
Mr. Walters
D Wright

10 DOWNING STREET

From the Private Secretary

10 February 1981

Dear John,

As I told you, no decisions were taken at the Prime Minister's meeting with the Chancellor and others this morning. However, you may still like to have a copy of my note of the meeting. This is enclosed.

Yours ever,

Tim Lankester.

A. J. Wiggins, Esq.,
H.M. Treasury.

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