

BUDGET

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From the Private Secretary

24 May 1979

Dear Tony,

The Prime Minister held a meeting at 1800 hours this evening with the Chancellor of the Exchequer and the Chief Secretary to discuss the Budget. They had before them the Chancellor's further minute of 23 May.

The Prime Minister said that she remained extremely worried about the price consequences of the Chancellor's proposals, and the effect they might have on pay negotiations in the coming winter. She wondered whether there were not other ways of meeting the Chancellor's objectives on the income tax front than through increasing VAT to 15 per cent. In particular, there seemed no reason why the income tax reliefs could not be made effective from Budget Day rather than being backdated to the beginning of the financial year. Taxpayers would not expect such backdating and the revenue savings would be very substantial. The revenue savings would be about sufficient to enable the VAT increase to be confined to 12½ per cent. It appeared from the figures attached to the Chancellor's minute as if the taxpayer would be getting considerably more in tax relief than he would be paying out in higher indirect taxes. She recognised that there were administrative difficulties, but it ought to be possible to overcome them. The Prime Minister went on to ask whether all the options for raising revenue had been fully considered. One possibility which she had in mind was the replacement of the VAT element in the petrol tax by a straight duty: this would bring in

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additional revenue because there would be no VAT offset on business purchases and the RPI effect would be small.

The Chancellor said that, in his view, making the tax reliefs effective from Budget Day, and not backdating them, raised insuperable difficulties. Not to backdate them would destroy the cumulative method on which the PAYE system was based. As for the argument that the taxpayer appeared to be getting back more than he would be paying in indirect taxes, the Chancellor explained that this was not so in terms of purchasing power. Because of the three-month lag in VAT collection, much more had to be given to the taxpayer in tax reliefs in year one than the revenue which would accrue to the exchequer in order to leave his real disposable income roughly unchanged. It was therefore essential to increase VAT to 15 per cent if his income tax objectives were to be met. In any case, a 15 per cent rate of VAT would be needed in 1980/81, and it could well be more difficult politically to raise the rate again in the second year than it was to move straight to 15 per cent immediately. He had considered various other revenue raising options, including increasing Advance Corporation Tax. But he had concluded that ACT was not a runner because company liquidity, notwithstanding the short run cash flow improvement resulting from the VAT increase, would remain tight; and although he was willing to consider the possibilities further, he did not think there was much likelihood of finding significant additional revenue without either affecting the RPI or damaging business confidence (as would happen, for example, if the NIS were increased again). In order to mitigate the RPI effects, he was disposed not to increase the specific duties on alcohol and tobacco: revalorisation of these duties would reduce the PSBR by only £200 million, while they would increase the RPI by 0.6 per cent. In this way, the price rises in the Budget would be confined to the VAT increase and the increase in petrol duty, and the total

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effect would be 3.6 per cent - which would be marginally less than the 3½ per cent RPI effect of Mr. Healey's first Budget. This excluded any increases in prescription and school meal charges; in order to keep within the 3½ per cent margin, he thought there was a strong case for not announcing any such increases in the Budget.

The Chief Secretary added that the switch to indirect taxes which the Chancellor was proposing was essential to his overall strategy - both in terms of achieving his minimum income tax objectives and in terms of keeping the PSBR within reasonable limits in 1980/81. There was of course a risk that there would be industrial repercussions, and the industrial situation in the winter would not be easy; but in his view the Government was more likely to face industrial trouble in its second and third years of office. Hence, it was better to get the large price increase out of the way early. Once a VAT rate at 15 per cent had been achieved, there would be no need to raise VAT again in the life of the present Parliament; the only further indirect tax increases that would be needed would be the revalorisation of specific duties. A further argument for making the major shift to indirect taxes was that this would result in less tax evasion. Although the immediate effect of the Budget would be inflationary, the overall Budget stance was decidedly deflationary; and indeed on the conventional presentation, the Budget would be shown as having a significant contractionary effect on the economy. The Chancellor said that in presenting this it would be necessary to point out that, with the current prospects for the PSBR, any Budget - whether presented by a Conservative or Labour administration - would have had to be deflationary.

The Prime Minister then asked whether the Chancellor was satisfied with the PSBR forecast. She understood that there was a wide margin of error in it, and wondered

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whether the Chancellor was happy with the underlying assumptions. The Chancellor replied that there was indeed a wide margin of error, but he was reasonably satisfied that the forecasters had done a good job. He would be considering whether there was any possibility of adjusting the forecast down, but he did not think there was much scope for this. As for the correct size of the PSBR, he was subject to conflicting advice. On the one hand, there were those who were pressing him to go back on his pre-election commitment; on the other hand, it was clear that even with a PSBR of just under £8½ billion, there was a real risk that interest rates would stay high. On the whole, he felt it essential to aim for a PSBR below £8½ billion. The Prime Minister agreed.

Summing up, the Prime Minister said that she reluctantly agreed to the Chancellor's main proposals. This would mean increasing VAT to 15 per cent and increasing petrol duty by 15 per cent, and excluding any increases on tobacco and drink. At the same time, it would be worth forgoing any increase in prescription charges and any increase in the school meal charge over and above that announced by the previous administration. The Department of Education and the Department of Health and Social Security would have to find offsetting savings to meet the Chief Secretary's public expenditure requirements. The Chancellor should consider the possibility of any further measures which would bring in revenue without affecting the RPI - including replacing VAT on petrol with a higher petrol duty still. These could be used to provide further improvements in the income tax package.

Tom

Tim Latham

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