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Prime Minister
I have warned the Treasury that you will want to raise the points in Sir John Hunt's note. This paper presses again for going all the way to 15% on VAT.
TL 24/5

PRIME MINISTER

When we discussed the Budget yesterday you expressed concern about the likely impact on prices of the proposals described in my minute of 21st May. You asked for more information about the inflation prospect and the impact on it of different Budget packages. This minute does that and examines the consequences of the various alternatives.

2. I must start with income tax. We are committed to substantial income tax reductions. The Budget in this respect will be seen as a test of our resolution to implement commitments we have entered upon in Opposition. The minimum changes required in my judgement are as follows:

3. To cut the basic rate to 30 per cent.

To cut the top rate to 60 per cent on income over £25,000.

To increase the single and married allowances by £120 and £190 respectively (including the £90 and £140 included in the caretaker Finance Act)

The cost of these changes in 1979/80 is around £3.1 billion (£3.9 billion in a full year). Together with other less costly improvements (eg. for old people and on investment income) the cost this year to the PSBR is about £2.8 billion. And if it were possible to do more than this on the thresholds the package would be better-balanced, particularly in relaton to those at the bottom of the income scale.

This is gross cost. PSBR cost is lower because of flow-backs

4. It is clearly right that we must look to finance cuts in income tax by cuts in public expenditure. The proposals agreed

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in Cabinet amount to about £3.4 billion in 1979/80, including £1 billion from sales of assets. It is critical to the Budget arithmetic that Colleagues deliver these cuts in full.

5. The PSBR for 1979/80 is currently forecast on unchanged policies at about £10¼ billion. The net effect of our intended public expenditure cuts and of the income tax reductions (including the minor reliefs) would reduce this figure to around £10 billion. This contrasts with our target reduction to at least £8 billion.

6. We can only attain this objective by increasing indirect taxes, as we have said we would. This will put up prices. Before any Budget changes the RPI is forecast to rise to about 13 per cent by the end of this year. The choice is between adding to that figure or falling well short of our PSBR target; or, of course, doing much less than we want in reducing income tax. These are the variables. I can see no other alternatives.

7. An increase in VAT to a unified 15 per cent, coupled with a 15 per cent increase on petrol duty and a 10 per cent increase on other specific duties would just about close the gap. We would be in sight of a £8 billion PSBR, perhaps just a little more. But the RPI would increase by 4.3 per cent on this account. (I ignore any other small increase which might arise from putting up charges). The same package, but omitting increases in the duty on tobacco and drink, would reduce the price increase to 3.6 per cent. But the PSBR would be £0.2 billion higher.

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8. A 12½ per cent VAT would reduce the RPI increase to 2.9 per cent, if coupled with a 10 per cent increase in the

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specific duties (15 per cent on petrol). But this would increase the PSBR by £½ billion to over £8½ billion. Excluding any increase on drink and tobacco would reduce the RPI increase even further, to 2.3 per cent, but increase the PSBR by another £0.2 billion.

9. Lastly, a 10 per cent VAT would reduce the RPI increase to 1.6 per cent, coupled with a 10 per cent increase in specific duties (15 per cent on petrol). This would increase the PSBR by a full £1 billion, compared with a 15 per cent VAT - to a figure over £9 billion. In short, it is simply not possible to make worthwhile income tax reductions and keep the PSBR to around £8 billion without a 15 per cent VAT. With a 12½ per cent rate income tax expectations would be sadly disappointed; with only a 10 per cent rate we could scarcely make a start.

10. That said, with the year on year rate of increase in average earnings likely to be around 15% at the end of the year, I do not under-rate the significance of adding 3½-4 per cent to an already rising RPI.

11. But a comparison between gross earnings and prices gives an incomplete and distorted picture. What matters is a comparison between take home pay and prices, and everyone would be securing substantial income tax cuts. Such a package would be presented as giving greater personal choice. This message may be easier to get across if the switch to indirect taxation is immediate and ambitious than with a more muted version.

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12. It is true that the perceived rate of inflation will suffer an immediate shock, but this will not then be repeated month after month. By September or October there would be substantial tax rebates coming just at a critical period for wage bargaining, or the formulation of prospective wage claims. At what will be the most difficult period for wage negotiation, the Budget price increase will be in the past. Against that background, we must consider whether an extra one or two per cent on the RPI on top of what would be necessary anyway would make a critical difference to the climate for earnings in the next pay round. This can only be a matter of judgement, but I see no reason to suppose that this would make a critical difference in the sense of crossing some threshold of danger. In my judgement, this Budget provides our only opportunity to make a radical switch from direct to indirect taxation and thus honour the commitment on which our credibility depends. Coupled with firm monetary policies, one or two additional points on the RPI should not be decisive.

13. I hope we may have an early opportunity to talk this through. I am sorry to burden you with more figures (in the attached tables), but I am rapidly approaching the administrative deadline for a decision on the indirect taxes. The necessary printing timetable requires identification of a limited range of options by the weekend and final choices by the end of 31st May.

G. H.

(GEOFFREY HOWE)

23 May 1979

	PSBR 1979-80 (£million)	RPI impact effect
Direct Tax		
Increase* in single and married allowances by £120 and £190 respectively, together with corresponding age allowance increases		
Reduction in basic rate to 30p	+£2,790	
Improvements in higher rate structure and top rate 60%		
Investment income surcharge: single threshold of £5,000		
Public Expenditure		
Cash limits squeeze on prices and pay (assumed £720 million reduction in volume of central Government spending).		
RSG cut of £300m (assumed £100m reduction in volume of LAs spending).		
Specific cuts of £1.3 bn.	-£3,000	0.4%
Contingency reserve cut of £250 million.		
Sales of assets of £1 bn.		
Indirect Tax		
VAT at 15%		
15% increase in petrol duty.		
10% increase in specific duties except VED	-£1750	4.3%
Alternatively		
As above, but excluding drink and tobacco	-£1550	3.6%

*. Including Caretaker Finance Act increases.

(Note: These figures are rough estimates based on the use of current ready reckoners and assuming a floating exchange rate and unchanged monetary growth).

	PSBR 1979-80 (£ million)	RPI impact effect
Direct Tax		
Increase* in single and married allowances by £120 and £190 respectively, together with corresponding age allowance increases		
Reduction in basic rate to 30p	+£2,790	
Improvements in higher rate structure and top rate 60%		
Investment income surcharge: single threshold of £5,000		
Public Expenditure		
Cash limits squeeze on prices and pay (assumed £630 million reduction in volume of central Government spending)		
RSG cut of £300m (assumed £100 m reduction in volume of LAs spending).	-£2920	0.4%
Specific cuts of £1.3 bn		
Contingency reserve cut of £250 million		
Sales of assets of £1 bn		
Indirect Tax		
VAT at 12½%		
15% increase in petrol duty	-£1,265	2.9%
10% increase in specific duties except VED		
Alternatively		
As above, but excluding drink and tobacco	-£1060	2.3%

* Including Caretaker Finance Act increases.

(Note: These figures are rough estimates based on the use of current ready reckoners and assuming a floating exchange rate and unchanged monetary growth).

	PRBR 1979-80 (£ million)	RPI impact effect
Direct Tax		
Increase* in single and married allowances by £120 and £190 respectively, together with corresponding age allowance increases		
Reduction in basic rate to 30p	+£2,790	
Improvements in higher rate structure and top rate 60%		
Investment income surcharge: single threshold of £5,000		
Public Expenditure		
Cash limits squeeze on prices and pay (assumed £540 million reduction in volume of central Government spending)	-£2,830	0.4%
RSG cut of £300m (assumed £100m reduction in volume of LAs spending).		
Specific cuts of £1.3 bn		
Contingency reserve cut of £250 million		
Sales of assets of £1 bn		
Indirect Tax		
VAT at 10%		
15% increase in petrol duty	- £750	1.6%
10% increase in specific duties except VED on cars.		

*Including Caretaker Finance Act increases.

(Note: These figures are very rough estimates of the orders of magnitude based on the use of current ready reckoners and assuming a floating exchange rate and unchanged monetary growth).