

File A 9

c.c. Master Set
cc Mr Hoskyns



10 DOWNING STREET

From the Private Secretary

B/F 29.5.79

22 May 1979

Dear Tony,

The Prime Minister and the Chancellor of the Exchequer had a general discussion about the Budget prospects at 1000 hours this morning. They had before them the Chancellor's minute of 21 May. The Prime Minister and the Chancellor spoke privately for part of the meeting; the following points came up while I was present.

The Chancellor explained that the changes which he was proposing on the indirect tax front, accompanied by the £3 billion saving on public expenditure, were the minimum needed if he were to move decisively on direct taxes. In particular, anything less than 15% on VAT would effectively rule out any major change this year on income tax: it would not be possible to make the radical improvements in the higher rate structure unless the standard rate were also reduced to 30 or 31p. Moving VAT no higher than 12½% would not only lose a significant amount of revenue, it would also mean a lost opportunity politically - once the VAT rate was raised to 12½%, it might well be difficult to move it higher in subsequent years. The Chancellor emphasised that the Budget arithmetic was very tight. The package outlined in his minute would only get the PSBR down to nearly £8 billion if the pre-Budget forecast turned out to be about £10 billion; the forecast, which was due in the next few days, could well turn out higher than £10 billion. There was a possibility that asset sales could be raised to £1¼ billion rather than the £1 billion mentioned in his note. On the other hand, it was open to question whether the specific duties on drink and tobacco should be increased: increases on these items would have a large price impact in relation to the revenue which they would bring in.

The Prime Minister said that she was concerned about the price impact of the Chancellor's proposals. An increase in the RPI of around 4%, which would be the result of what the Chancellor was proposing, would mean that the inflation rate would be increasing by about double what it had been at the end of last year; and although much of the increase was attributable to the current pay round for which the Government could not be blamed, there would still be accusations that the RPI had doubled in the Government's first year of office. There was a clear risk, in the Prime

/Minister's view

BUDGET SECRET

Minister's view, that the very large RPI effect of the Chancellor's proposals would have a damaging impact on next winter's pay negotiations; and it could possibly result in the reopening of some of this year's pay settlements. Also, the larger the RPI effect of the Budget, the larger would have to be the uprating of pensions and other long term benefits; and this would add to public expenditure. (In reply to the latter point, the Chancellor explained that social security upratings had been netted off in his calculations.)

More generally, the Prime Minister wondered whether it was necessary or wise to try to achieve all of the Government's objectives on the income tax front in the first year. It might be better to concentrate on cutting public expenditure, curbing the rate of inflation and getting the overall balance of the economy right in the first year - with major reductions in income tax being left to the second. She referred in this context to the Budgets of 1952 and 1953. Mr. Butler's first Budget had been a tough one, and it was only in his second Budget that he had introduced major reductions in income tax and other incentives to the business community.

Before taking a final view on the overall strategy proposed by the Chancellor, the Prime Minister said that she would like to see an analysis of the inflation prospect. This should show the forecast for the RPI before the Budget, and the additions to the forecast which different Budget packages would involve. It should also take into account explicitly the various price increases which are currently in the pipeline, for example, bread, milk, gas, electricity and the likely increase in petrol prices. The Prime Minister understands that these increases alone would add 0.9% to the RPI. I would be grateful if you could let me have an analysis on these lines as soon as possible.

Ann em.

Tim Lalor.

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