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CABINET

ECONOMIC STRATEGY

Memorandum by the Chancellor of the Exchequer

1. I shall be presenting our fourth Budget on 9 March.

OUTLOOK FOR THE YEAR AHEAD

2. The latest forecasts predict continuing, though slow, recovery in output and a further fall in inflation, which should be at 10 per cent by the end of this year, and in single figures in 1983. Unemployment is likely to edge up a little further in 1982, though at a diminishing rate, while industrial productivity should continue to improve. The general picture is one of continuing recovery, with encouraging signs of real improvement in the economy. Annex 1 gives some figures showing the progress we have made to date. A continuation of this improvement could, of course, be invalidated by events beyond our control, whether world-wide (eg American interest rates) or domestic (eg a serious setback on pay).

3. Of course I continue to be deeply concerned about the level of unemployment. We should all like to get it down. But all previous attempts at artificially induced reflation have resulted, in the medium and longer term, in higher inflation and in higher unemployment. In political terms, any gains from another such attempt would be short-term and extremely limited. The probable impact on interest rates, the exchange rate and inflation would mean throwing away the hard-won progress of the past  $2\frac{1}{2}$  years - and lead to still higher levels of unemployment than those from which we are now suffering.

THE RIGHT STRATEGY

4. We must accordingly persevere in our present strategy, maintaining progress towards our key objectives: a continuing reduction in inflation; a continuing rise in output; a diminution of the monopoly public sector; and a strengthening of the free market economy. This is the way to secure a genuine improvement in the employment situation rather than a very small and short-lived change in the figures. The prospects are now good. The rates of both wage and price increases should continue to fall, with inflation down to 8 per cent or less by the end of 1983; and there should be faster growth of output in that year than in 1982.

5. For domestic and overseas confidence in the Government's strategy to be sustained we must have a credible financial framework. The markets will expect us to maintain downward pressure on the rate of monetary growth. This is crucial to confidence, to maintaining a reasonably steady exchange rate without crippling high interest rates, and hence to the defeat of inflation. Our objectives for the period ahead will need to be expressed in terms of a number of aggregates, and with more explicit reference to the exchange rate, rather than exclusively to £M3. But if we were thought to have abandoned monetary and fiscal control, sterling would quickly come under pressure.

#### BORROWING

6. Within this framework the size of the Public Sector Borrowing Requirement (PSBR) for next year is crucial. For the current year, we planned for a PSBR of £10½ billion and we are on course for this. For next year, the forecast (which may change substantially before March) gives a provisional figure of rather less than the £9 billion for which we thought it right to plan at the time of the last Budget. This forecast is based, as is customary, on the following assumptions:-

- i. That public spending next year is at the level agreed in November - a planning total of £115 billion.
- ii. That income tax thresholds will be increased in line with inflation ("Rooker-Wise").
- iii. That excise duties will be similarly increased.
- iv. That the tax structure and rates are in other respects unchanged.

Annex 2 shows what assumptions ii. to iv. mean in terms of cash increases in the allowances and price increases in the goods subject to specific duties. The impact on the PSBR of assumptions ii. to iv., taken together, is broadly neutral: the revenue lost through indexing the income tax allowances is nearly offset (in the first year) by the extra revenue produced by revalorisation of the specific duties.

7. The choice of the right PSBR for next year presents a problem. To go up to about £9 billion might give some limited room for modest tax reductions. But it would also involve risks for interest rates and the exchange rate. Since the last Budget the exchange rate has fallen considerably. Oil prices, which support it, have also fallen and we have had to face high interest rates. We could diminish some of these difficulties by planning for a PSBR of, say, £7 to £8 billion. We should then have a better prospect of lower interest rates, though they will probably still be uncomfortably high. For most people - industry and mortgagors alike - lower interest rates are an important objective. But we should not have any room for tax reductions, and the political difficulties are obvious.

8. The trade-off between interest rates and tax reliefs as a means of sustaining recovery is bound to be a matter of judgment - political as well as economic. But it is my belief, not least in the light of our experience of the last year, that to go for a PSBR above about £9 billion is likely to lead to higher interest rates than we now have, would affect confidence, and could risk so large a fall in sterling as to jeopardise the prospects of reducing inflation and impair - or even reverse - recovery.

#### FISCAL OPTIONS

9. If some reductions in taxation should turn out to be possible, for the coming year, the main issue will be the balance to be struck between:-

- i. measures which would directly affect prices;
- ii. those which would reduce income tax; and
- iii. those which would directly assist companies.

Category i. includes less than full revalorisation of excise duties, or a reduction in the rate of Value Added Tax (VAT). Category ii. includes action to more than implement "Rooker-Wise" increases in tax allowances. The most obvious category iii. measure would be a cut in National Insurance Surcharge.

10. The argument for category i. changes is essentially political. We would avoid adding to the Retail Price Index (RPI): full revalorisation of the duties is assumed in the forecast. And we would avoid the unpopularity attaching to some individual increases: Annex 2 lists some, including petrol. But the more ground we give here, the less room we have for changes in categories ii. or iii., the case for which emerges clearly from the tables in Annex 3.

11. For the personal sector, an increase in tax allowances of 10 to 11 percentage points above inflation would be necessary to restore tax thresholds as a proportion of average earnings to their 1978-79 levels. An increase would bring benefits in wage bargaining; and would diminish the poverty trap and "why-work" problems. Assistance to the company sector is no less desirable, and category iii. changes would have the most direct impact on companies' income, though at the risk of some leakage into wages. When second round effects are taken into account, the effects on employment, Gross Domestic Product (GDP) and company incomes of all three categories are however very similar. Annex 4 sets out Treasury model estimates of the broad consequences of an illustrative £1 billion reduction, effected through measures falling into each of the three categories, while Annex 5 gives the revenue effects of certain specimen reductions.

## SUMMARY

12. All the signs are that our efforts to restore the economy to health are succeeding. Inflation is coming down; output is going up; the rate of increase in unemployment is slackening. This Budget will be crucial. At this stage in the economic cycle previous governments have sacrificed sound finance for dubious electoral advantage. If we follow that pattern, we will risk losing all. The key for 1982-83 is the PSBR. Given high interest rates world-wide, there is an argument for going for a figure in the region of £7-8 billion but to achieve this could mean foregoing tax cuts altogether. To go above about £9 billion would be popular politically in the short run; but it would imperil the exchange rate, interest rates, the conquest of inflation, our whole determination to create a sound economy and, in everything other than the very short-term, the creation of more real jobs. The choice for the PSBR lies in a range which has £7 billion as the minimum and about £9 billion as the maximum.

13. If a figure towards the top of the range is chosen, the main choice for tax reductions lies between the three categories listed at paragraph 10 above. Elements of all three might of course find a place in the final package. I am, naturally, considering a number of other smaller items, as well as the structure of the North Sea tax regime.

14. I would welcome colleagues' views on all these matters on 28 January.

G H

Treasury Chambers

26 January 1982

## SELECTED ECONOMIC INDICATORS, 1979-82

	1978 to 1979	1979 to 1980	1980 to 1981 (1)	1981 to 1982 (1)
[Percentage change]				
GDP (1975 prices)	+ 2	- 2	- 2	+ 1
Consumer prices (Q4)	+ 17½	+ 15½	+ 12	+ 10
Average earnings (Q4)	+ 18½	+ 19½	+ 12½	+ 7½ <sup>(3)</sup>
Exports of goods and services (1975 prices)	+ 2½	+ 1	- 5½	+ 2½
	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>
Current balance (£bn)	- 1	+ 3	+ 6	+ 3
Unemployment (UK, %, narrow)	5½	7	10½	12 <sup>(3)</sup>
	<u>1979-80</u>	<u>1980-81</u>	<u>1981-82</u>	<u>1982-83</u>
Tax as % GDP (4)	30	31	33½	(6)
Public expenditure as % GDP (5)	41	43½	45	44
PSBR as % GDP	5	6	4	(6)

- (1) Figures consistent with December 1981 Industry Act Forecast
- (2) Forecasts from OECD Economic Outlook, December 1981
- (3) Figures based on assumptions in December 1981 Government Actuary's Report relating to 1982-83 financial year
- (4) Excluding NIC
- (5) Including debt interest
- (6) Depending on decisions to be made.

## THE EFFECTS OF 12.2% INCREASE IN TAX ALLOWANCE ETC (ie INDEXATION)

Income tax: levels of allowances etc.

	<u>1981-82</u> £	<u>1982-83</u> <sup>(1)</sup> £
Single and wife's earned income allowance	1,375	1,543
Married allowance	2,145	2,407
Additional personal allowance	770	864
Single age allowance	1,820	2,042
Married age allowance	2,895	3,248
Age allowance income limit	5,900	6,620
Basic rate band	11,250	12,623
40% rate band width	1,999	2,244
Investment income surcharge exemption	5,500	6,171

The reductions in income tax payments for basic rate taxpayers with personal allowances increased by 12.2 per cent in 1982-83 rather than remaining at 1981-82 levels would be as follows:-

	£ per annum	£ per week
Single person	50.50	1.00
Married couple (husband only working)	78.50	1.50
Married couple (both working and earning more than personal allowance)	129.00	2.50
Single-parent family	78.50	1.50

As long as the tax units are basic rate taxpayers under both sets of allowances, the cash benefits do not vary with income levels.

Indirect taxes: price changes (2)

	Typical price effect
Pint of beer	2p
75cl bottle of table wine	10p
75cl bottle of sherry	13p
Bottle of Whisky	55-60p
Gallon of petrol	9p
Gallon of derv	7½p (6½p net of VAT)
20 king size cigarettes	7p
VED (1 year)	£ 10

Notes

(1) Does not include rounding up required by statute

(2) Inclusive of VAT, except VED

## TAX: BACKGROUND FACTS

Total taxation

1. Since the Government came to power total taxation as a proportion of GDP has risen by nearly 6 percentage points. The figures are as follows:-

1978-79	34.5
1979-80	35.8
1980-81	37.3
1981-82 (forecast)	40.3

(\*Including national insurance contributions and local authority rates.)

Personal taxation

2. Calculations here have to take account of national insurance contributions as well as income tax changes. The following table shows the present position:

Table 2: Income tax and national insurance contributions as a percentage of gross earnings

	<u>Married*</u>		
	$\frac{1}{2}$ average earnings	Average earnings	2 average earnings
1978-79	16.4	28.0	31.6
1979-80	16.4	26.4	28.9
1980-81	18.2	27.5	29.9
1981-82 (forecast)	21.1	29.4	32.4

(\* Wife not working: the couple are assumed to have no children, to avoid distortion of the figures from the abolition of child tax allowances.)

By 1982-83 the employees' national insurance contribution will be 2½ percentage points higher than in 1978-79. Even with the indexation of allowances assumed in the forecast, in 1982-83 income tax and national insurance contributions as a percentage of gross earnings will increase for all family types over 1961-62 levels

3. The main income tax reason for this change has been our inability to make any change in personal allowances last year, so that tax thresholds have fallen as follows:-

Table 3: Personal allowances as a percentage of average earnings

	<u>Single</u>	<u>Married</u>
1978-79	20.1	31.3
1979-80	20.2	31.4
1980-81	19.8	30.8
1981-82	17.8	27.7

(Real net incomes are of course higher than in 1978-79. The increase in the proportion of gross earnings taken in tax partly reflects the fact that earnings have risen faster than prices.)

Company sector

4. Real rates of return have been falling since the early 1960s:

Table 4: Percentage Real Rates of Return <sup>(1)</sup>

	<u>Industrial and commercial companies excluding North Sea</u>	<u>Manufacturing companies</u>
1960	13.3	13.3
1965	11.3	10.6
1970	8.7	7.5
1975	5.2	3.9
1978	5.0	3.6
1980	3.0	2.0
1981 (estimated)	2.2	n.a.

(1) Gross operating surplus less stock appreciation and capital consumption at replacement cost as a percentage of net capital stock of fixed assets (excluding land) at replacement cost plus value of stock.



Real interest rates are now above real rates of return.

5. But the tax burden on companies has not fallen:-

Table 5: Tax paid by industrial and commercial companies (excluding North Sea)  
£ billion

	<u>Taxes on companies' income (3)</u>	<u>Employers' NIC and NIS</u> <sup>(1)</sup>	<u>Rates</u> <sup>(2)</sup>	<u>Total</u>	<u>Total in constant prices</u> <sup>(4)</sup>
1978	2.8	4.3	1.7	8.8	8.8
1979	2.7	5.4	1.9	10.1	8.9
1980	3.2	6.5	2.4	12.1	9.1
1981(estmated)	3.2	7.2	2.9	13.3	9.1

(1) estimates of proportion paid by industrial and commercial companies

(2) includes North Sea and unincorporated business

(3) includes mainstream corporation tax, ACT, and tax on company investment income

(4) deflated by total final expenditure deflator (1978 = 100)

6. Comparing Tables 4 and 5 shows companies' ability to pay falling, but the demands made on them virtually constant.

Estimated consequences of an illustrative £1 billion tax reduction, effected  
by category (1), (2) or (3) measures

	<u>Category</u>	<u>1982-83</u>	<u>1983-84</u>
PSBR (£b)	(1)	(	0.7
	(2)	(1.0	0.8
	(3)	(	1.1
GDP (%)	(1)	0.2	0.5
	(2)	0.2	0.4
	(3)	0.2	0.5
Unemployment (000s)	(1)	-15	-50
	(2)	-15	-40
	(3)	-15	-60
Real Personal Disposable Income (%)	(1)	0.7	0.7
	(2)	0.6	0.6
	(3)	0.3	0.7
Industrial and Commercial Companies Disposable Income (£b)	(1)	0.9	1.3
	(2)	0.9	1.2
	(3)	1.4	1.9
Inflation (change in RPI) (%) (Q4 on Q4)	(1)	-0.7	0.1
	(2)	0.1	0.3
	(3)	0.1	0.2

Note: These illustrative estimates have been made using the Treasury model, which - like other economic models - has great difficulty in dealing with the effect of changing expectations in financial markets upon interest rates and the exchange rate, and in turn with their effects on company behaviour. This limitation must be borne firmly in mind, for the actual effect of fiscal changes depends crucially on market reactions.

## BASIC TAX READY-RECKONER

Illustrative revenue effects<sup>(1)</sup> of tax changes: £ million

	First year	Full year
Change basic rate by 1p	875	950
Change each higher rate by 1p	35	70
Change single and wife's earned income allowance by £100	315	390
Change married allowance by £100	275	340
Change corporation tax rate by 1 percentage point	40	70
Change NIS rate by 1 percentage point	700	1,160
Pint of beer: 1p change in duty	95	95
75cl bottle of table wine and sherry: 10p change in duty	35	35
Bottle of whisky: 30p change in duty	35	35
Gallon of petrol: 2p change in duty	110	110
Gallon of derv: 2p change in duty	30	30
Packet of cigarettes: 1p change in price (with equivalent increase in other tobacco products)	40	40
VAT: 1 percentage point change in rate	490	650
VED: £1 change in car licence	16	16
Car tax: change rate by 1 percentage point	50	65

Notes

- (1) Income tax figures calculated on assumption of statutory indexation. This has first year cost of £1.6 billion and a full year cost of £2.1 billion. With early March Budget, first and full year effects of changes in indirect taxes are broadly similar.