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CABINET

MOST CONFIDENTIAL RECORD
TO
CC(82) 3rd Conclusions, Minute 5

Thursday 28 January 1982

ECONOMIC STRATEGY

Previous Reference: CC(81) 33rd Conclusions, Minute 5

The Cabinet considered a memorandum by the Chancellor of the Exchequer (C(82) 1) on the Government's economic strategy and its implications for the preparation of his forthcoming Budget on 9 March.

THE CHANCELLOR OF THE EXCHEQUER said that the latest forecasts predicted continuing, though slow, recovery in output and a further fall in inflation. Unemployment was likely to edge up a little further in 1982, though at a diminishing rate, while industrial productivity should continue to improve. The general picture was one of continuing recovery, with encouraging signs of real improvement in the economy, though this could be invalidated by events beyond the Government's control such as high interest rates in the United States of America or a serious set-back on pay. For the recovery to continue, and to secure a genuine improvement in the employment situation, it was essential to persevere with the present economic strategy. For domestic and overseas confidence in the strategy to be sustained, the financial framework had to be credible. Within this framework the size of the Public Sector Borrowing Requirement (PSBR) for 1982-83 was crucial. The present forecast, which could change substantially before March, gave a provisional figure of rather less than the £9 billion for which the Government had planned at the time of the 1981 Budget. This forecast was based on the assumptions that public spending next year would be at the level agreed by Cabinet in November - a planning total of about £115 billion; and that income tax thresholds and excise duties would be increased in line with inflation, but that the tax structure and rates were in other respects unchanged. He would now welcome the views of the Cabinet on what might be the appropriate size of the PSBR in 1982-83 and, if some reductions in taxation should turn out to be possible, how these might be distributed.

In considering the size of the PSBR, a balance had to be struck between the objectives of bringing about lower interest rates and, where possible, making tax reductions, To plan for a PSBR of, say, £7 - £8 billion would give a better prospect for lower interest rates which would be helpful to industry and to people with mortgages; it would not, however, leave any room for tax reductions, apart from those changes already assumed in the forecasts. On the other hand, to go for a PSBR above about £9 billion was likely to lead to higher interest rates than now, to affect the confidence of the financial markets, and to risk so large a fall in sterling as to jeopardise the prospects of reducing inflation and to impair, or even reverse, recovery.

In so far as tax reductions were possible, the choice was broadly between measures which would directly affect prices, those which would reduce income tax, and those which would directly assist companies; though elements of all three could be included in the final Budget package and he would also be considering a number of other smaller items, as well as the structure of the North Sea tax regime. Measures to affect prices could include less than full revalorisation of excise duties or a reduction in the rate of Value Added Tax; such changes would avoid additions to the Retail Price Index. For the personal sector, an increase in tax allowance 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 companies would have the most direct impact on companies' income, though at the risk of some leakage into wages; the main proposal which had been canvassed was for a reduction in the National Insurance Surcharge (NIS).

In discussion the following were the main points made:-

a. It was generally agreed that the aim should be to maintain the Government's broad economic strategy; any radical departure now, in search of benefits which could be only short-lived, would be damaging to the Government's credibility and deeply disappointing to its supporters. The 1982 Budget should be seen as a development of present policy. Its aim should be to give confidence and hope to industry, to the public generally, and to the Government's supporters.

b. It would be a mistake to go too far in offering tax and other reliefs in the coming Budget. Something should be kept in hand to deal with difficulties which could emerge later in the year. The right course was to leave room for progress in later Budgets in which there could be further tax reductions. It was particularly important to avoid the mistake of going so far in the 1982 Budget that retrenchment might be necessary in 1983. The Government should not put at risk the public's sense of its competence in the handling of the economy through a period of great difficulty and recession. It would be important to be sure that measures included in the Finance Bill would be supported in the House of Commons and, in particular, to avoid any which might have to be withdrawn through lack of support from Conservative Members of Parliament. Care should be taken in the remaining weeks before the Budget not to arouse over optimistic expectations of its contents.

c. It was generally agreed that it would be better to make tax reductions rather than to plan for a PSBR as low as £7 - £8 billion in the hope of bringing about lower interest rates. Tax reductions offered a more certain, and visible, benefit than the possible reduction of interest rates. The Government could influence the level of interest rates only to a limited extent; the effect on interest rates of a lower PSBR could be more than offset by other factors such as high interest rates in other countries, notably in the United States of America.

d. A number of Ministers thought that it would be right to plan for a PSBR of up to £9 billion. This should allow for tax reductions; it should also avoid putting at risk the recovery of the economy, and the prospects for continuing export led growth, by going so high as to lose the confidence of the financial markets in the Government's economic policy.

e. Some Ministers thought that the PSBR should be somewhat higher - perhaps £10 - £11 billion - and that this would not undermine market confidence, provided that the PSBR was no higher as a percentage of Gross Domestic Product than in previous years. The financial markets might be encouraged to accept borrowing at this level if the PSBR were reclassified to distinguish public sector borrowing to finance capital and productive investment, or possibly to exclude some of such borrowing from the PSBR; on the other hand, the markets might discount such reclassification, and any review of the definition of the PSBR could lead to the inclusion of some types of borrowing at present outside its scope. It was further suggested that, if a high PSBR led to instability in the exchange rate, this might be met by the United Kingdom deciding to participate in the exchange rate mechanism of the European Monetary System.

f. In considering how any financial relief might be distributed, it was generally agreed that the emphasis should be on giving help to companies rather than to individuals. While there were now signs of economic recovery, there was still a long way to go, and it was important to take steps to strengthen the country's industrial and commercial base. This, rather than reductions in the real rate of personal taxation, was the best way to respond to the problem of unemployment and to open up the prospect of creating jobs.

g. It was generally agreed that income tax thresholds should be increased in 1982-83 in line with inflation ("Rooker-Wise"). It was suggested that the Chancellor of the Exchequer should not seek to make good in the 1982 Budget the effects of not indexing thresholds in 1981-82, but that some relatively modest changes in personal allowances, over and above "Rooker-Wise" might be considered for the 1982 Budget. Further changes in personal taxation should be left for consideration in the 1983 Budget.

h. It was agreed that, with the exception of petrol and derv, indirect taxes should be fully revalorised. It would be helpful to industry and to rural communities if any increases in the tax on petrol and derv were less than full revalorisation; it was unlikely that a majority in the House of Commons would support a measure to increase the price of a gallon of petrol by 9p, which would be the effect of full revalorisation.

i. Opinion was divided on whether the main measure to help industry should be a reduction in the NIS. Some Ministers wished priority to be given to this reduction: the public were resentful of what they saw as a tax on employment, at a time when 3 million people were unemployed; and it would be warmly welcomed by industry as a response by the Government to their representations. These Ministers doubted whether in present circumstances any significant part of the benefit would be passed on in the form of wages rather than used to restore profitability and to increase investment and output. Other Ministers thought that a reduction in the NIS would be misdirected: less than one-third of NIS payments were made by manufacturing industry and much of the benefit would go to the banking and North Sea oil sectors whose needs were relatively less pressing. Unless steps were taken to prevent it, some of the benefit would also go to local authorities and nationalised industries. The trade unions would be likely to seize the opportunity of the reduction to reinforce their claims for higher increases than otherwise in the coming round of wage negotiations; the result could be that much of the benefit would be taken up by wage increases.

j. It would be better not to devote any further substantial resources to large programmes of public sector capital investment which would be slow in fruition and in helping to reduce unemployment. A better course would be to consider measures to stimulate, and to accelerate, investment in selected sectors by offering time-limited financial incentives which would be available for, say, investment undertaken in the next two years. In particular, there was support for measures to stimulate a programme of house improvement: this work was labour intensive, and so would be useful in reducing unemployment; a programme could take effect quickly; and it would be seen as a positive and necessary measure to restore the quality of the country's housing stock which was rapidly deteriorating in a number of areas. Proposals for investment by the nationalised industries showing a satisfactory return should not be held back by capital rationing; cash planning systems in the public sector should be operated so that capital programmes did not suffer and were able to benefit from underspending elsewhere.

k. It would however in general be better for any new assistance to particular sectors of industry to be given by way of tax reductions rather than increased public expenditure. Although some public expenditure had the effect of helping the private sector, this point was not generally and readily perceived; and it was important that the Government should not be criticised for appearing to preside over an inexorably, expanding public sector.

l. Further consideration should be given to proposals for private sector participation in public sector projects, such as the roads programme. There were possibilities for using public sector money in partnership with private sector finance, for example in house building, with a very beneficial gearing effect in the sense that a relatively small injection of public sector money could lead to a considerable investment programme. The Secretary of State for the Environment, in consultation with the Chief Secretary, Treasury, would shortly be making proposals to the Ministerial Committee on Economic Strategy on the possibilities for the direct involvement of market finance in construction projects in the public sector.

m. Although it had so far proved impossible to work out a practicable scheme, it would be helpful if there could be some reduction in industrial energy costs. The Secretary of State for Energy would shortly be making proposals to the Chancellor of the Exchequer on electricity prices for large industrial users. The Secretary of State for Industry had put proposals to the Chancellor of the Exchequer for measures to help small firms, to stimulate enterprise, and to encourage the development of new technology.

n. In considering the measures in the 1982 Budget, account should be taken of their impact on the coming round of wage negotiations. Most wage earners were seeing their personal disposal incomes reduced by increases in tax, national insurance, rates and fuel bills; about two-thirds of trade unionists lived in council houses and they were faced with rent increases too. This would increase the pressure for higher wage increases in the coming pay round. In the public sector, where cash limits operated, it could indirectly lead to cuts in capital expenditure to compensate for increased wage costs. Consideration should be given to the possibility of influencing wage bargaining in selected sectors of private industry; for example, it might be indicated that if the construction industry were to settle at a relatively modest level of wage increases, the Government would then be willing to introduce tax allowances which would stimulate activity, and employment, in the industry.

THE PRIME MINISTER, summing up the discussion, said that the Cabinet recognised that the Chancellor of the Exchequer would have to determine both the main budgetary judgment and the details of budgetary measures in the light of the situation and prospect as they appeared nearer the time. The discussion had shown that the Cabinet agreed that it would be right to continue on the broad strategy which the Government had followed hitherto. It was essential not to put at risk the objective of reducing inflation; within that the aim should be to enable the country to take advantage of the prospects of recovery.

The Cabinet -

1. Took note, with approval, of the Prime Minister's summing up of their discussion.

2. Invited the Chancellor of the Exchequer to take account of the views expressed and the points made in discussion in the preparation of his forthcoming Budget.

Cabinet Office

28 January 1982