

PRIME MINISTER

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cc. Mr. Sanders

You asked how much we would have to increase income tax or VAT in the absence of the public expenditure "cuts" for 1980/81.

The "cuts" on the plans inherited from Labour come to about £4 billion. (The precise amount will depend upon final decisions on gas and electricity pricing: the total will probably end up £2-300 million short of £4 billion.)

The £4 billion is at "1979 Survey Prices" - i.e. November 1978 prices. After allowing for inflation between then and 1980, the alternative of tax increases works out as follows:

- There would have to be a 9p increase on the basic income tax rate, or
- VAT would have to be increased to 26 per cent.

The additional revenue from a VAT increase in the first year is considerably less than in a full year. This explains partly why it has to be so large. (If one could have a Finance Bill in January with a VAT increase then, then the necessary increase to offset £4 billion of expenditure would be 8 per cent rather than 11 per cent.)

The Treasury are doing some further work on these figures for the Chancellor's and the Chief Secretary's use at their Press Conference after the publication of the Public Expenditure White Paper. They will, for example, refine them further to show what would have to be the VAT increase to keep the money supply on target. To satisfy this objective, the VAT increase would have to be even higher than shown above. This is because - pound for pound - a

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reduction in public expenditure is better for the money supply than a VAT increase. The reason for this is that public expenditure reductions have a more depressing effect on activity, and VAT increases - by raising prices - to some extent increase the demand for money.

I am sure you will not want to get into this kind of refinement. However, it would be a good thing if you were to use the same arithmetic as Treasury Ministers. If possible, therefore, it would be best to keep off this kind of comparison until the Chancellor and Mr. Biffen have considered the calculations themselves. Since the White Paper showing the £4 billion "cuts" will not be published until next week, you will probably want to avoid any reference (explicit or implicit) to the £4 billion. Until then, anyway.

T. P. LANKESTER

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