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PRIME MINISTER

ECONOMIC STRATEGY

1. I attended this morning the Chancellor's first discussion on economic strategy with his colleagues and senior officials. A number of interesting points emerged in the subsequent discussion, of which the most important are noted below.

2. Public Expenditure and the PSBR

The PSBR, as you know, is presently reckoned to be around £10bn. However, it is not entirely clear whether this figure makes full allowance for recent revisions in the estimated cost of existing policies or for the consequences of public sector pay settlements likely to arise from the activities of the Comparability Commission. The Treasury are investigating urgently to see how fully these factors have been allowed for in their estimate, and we shall no doubt know the answer beforelong. I am not myself satisfied yet that the £10bn figure reflects accurately the true present position.

3. Timing of Income Tax Changes

There was some discussion of the very important issue of whether one could in some sense bring reductions in income tax into force part of the way through the present financial year. The Inland Revenue stressed, as might be expected, the difficulties of doing this. They are, no doubt, very considerable, but it will be interesting to see what they amount to. I understood the meeting to conclude that the Revenue would be producing a submission on this matter, which I believe Tim Lankester has already been investigating at your request. From a policy point of view, there seemed to be enormous advantages in starting the cuts half-way through the year, if it can be undertaken without undue technical difficulties.

4. Charges

You will remember that the Chancellor was inclined not to push too hard with increases in school meal or prescription charges if there was to be a substantial increase in VAT. Clearly, this is a matter on which it is not essential to make an instant decision. My impression from the discussion is that there is a very strong case for moving on both fronts. After all, the previous Secretary of State for Education had proposed a

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10p increase in school meal charges last autumn, and prescription charges have not been increased for many years. When the exemptions are taken into account, the impact on the needy does not emerge as the serious issue which many feel it to be.

5. Capital Gains Tax

As I intimated to you the other day, there are a number of very serious problems involved in indexing or tapering Capital Gains Tax. In terms of the burden on what should be a short Finance Bill, dealing with CGT could well turn out to be unjustifiably onerous unless a simple method can be found for the time being. This the Chancellor is keen to do.

6. The RPI

There was some discussion of the possibility of supplementing the RPI with an index which takes into account cuts in direct taxes. Such an index could, as you know, come very close to being an index of the standard of living. The Treasury pointed out that to compile such an index accurately is not likely to be easy at the moment, since the present index of the RPDI is produced quarterly and in arrears. The Treasury will shortly be given some papers which we did on this issue while in Opposition. My own instinct is that we shall not get very far with this in the short run, and that the best way to proceed in presenting the effects of the budget to the public will be to prepare tables for specimen families showing the overall impact of price and income tax changes attributable to the budget.

7. Taxation of Short-Term Benefits

There was insufficient time to discuss this issue more than in passing. The initial judgment was that it would be a matter for year two. The technical complexities involved in this operation are, by any standards, very considerable and Lord Cockfield will be examining them with the Revenue in the near future.

8. General Observation

Some quick jottings on the back of an envelope suggest to me that, even if the £10bn PSBR forecast proves to be correct, the greatest difficulties will arise on the expenditure side. For that reason, I would advise extreme caution in the very short run before taking any decisions which involve increased expenditure over and above what we have committed ourselves to in the Manifesto. In particular, we should be cautious

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in establishing the preliminary guidelines for the revision of Cash Limits to deal with pay and price increases. I understand that you and the Chancellor felt yesterday that it would be appropriate to "squeeze" Cash Limits by about 2%. I would recommend that, if it is not too late, no final decision be made on this until the basic budgetary arithmetic is a little clearer than at present. It may well turn out that, almost regardless of the apparent practical difficulties, a slightly tighter rein may be needed.

MR

ADAM RIDLEY
9 May 1979

*Adam. Thawson - this is
most helpful
ant*