8a

COPY NO. 20 OF 24 COPIES

Ch/Ex. Ref. No. B(81) 21

NOTE OF A MEETING HELD IN THE CHANCELLOR OF THE EXCHEQUER'S ROOM, H.M. TREASURY ON WEDNESDAY, 25 FEBRUARY 1981 AT 9.30 A.M.

Present:

Chancellor of the Exchequer (In the Chair)
Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
Sir D Wass
Mr Burns
Mr Ryrie
Mr Middleton
Mr Unwin
Mr Ridley
Mr Cropper
Mr Cardona

THE FISCAL STANCE

The Chancellor expressed his renewed concern about the trend in the PSBR for 1981-82. It appeared that income tax revenue might fall below the level hitherto indicated by the Treasury forecasters, while there would be some further additions to expenditure, particularly in respect of the financing of the coal industry. As a result the PSBR seemed to be moving inexorably towards £12 billion. There was much criticism that the Government's strategy was being gravely damaged by spending £l hundreds of millions in additional aid to the nationalised industries; but it appeared that there was no immediate scope for offsetting reductions in other areas of public expenditure. A fresh cash limit squeeze would have its main impact on private sector firms supplying public authorities, while a reduction in social security benefits could save relatively little in 1981-82. The Secretary of State for Industry and some of the Prime Minister's advisers favoured further taxation:

/was there not a

was there not a case for looking again at the possibility of increasing the basic rate of income tax?

2. The possibility was canvassed in discussion of waiting until the summer to see whether further action was required. If some kind of funding crisis materialised, there would be a better prospect of securing crash reductions in public expenditure. Equally, the indirect tax regulator powers would be available, and these could provide the Government with whatever additional revenue might be needed. Meanwhile an increase in the basic rate of income tax would not of itself provide sufficient of a safety margin to give Ministers a firm assurance that developments in the PSBR would not have an adverse impact on interest rates and funding at some stage.

3. It was noted, however, that the decision on the fiscal stance depended to a considerable extent on the Government's intentions about the movement of interest rates over the next three to four months. If reductions were to be made, then the risks of this course would be substantially increased with a PSBR approaching £12 billion. In these circumstances it would be increasingly difficult to make interest rate reductions credible.

4. Mr Unwin suggested that the margins of error in the figures were such that it would not be unreasonable for the Government to publish a PSBR forecast not far above £11 billion despite the difficulties with the miners. Some of the extra financing costs for coal might perhaps have to be found from the contingency reserve, although the balance of opinion was that it would not be possible to find the whole amount in this way. If it were decided not to change previous decisions on taxation, the fact that the contingency reserve would have been substantially pre-empted would constitute a strong argument for Treasury Ministers to resist any new claim

/from spending Ministers.

from spending Ministers. The question was also raised whether an increase in the basic rate would in practice be regarded with much favour by the financial markets. The disincentive effects, and the psychological damage to the Government's strategy would be considerable. On the other hand, it was generally felt that if no further fiscal action were taken, it would not be possible to reduce MLR by more than 1 per cent in the Budget; and there would then be little prospect of interest rates remaining on a downward trend thereafter. A further possibility suggested was to collect an additional 1p on the basic rate on a provisional basis, with the prospect that if things went well the Finance Bill might be amended in July to restore the basic rate to its present level; however, this would be administratively cumbersome, and it was doubtful whether the position would be clear enough for a new decision to be taken before the Finance Bill had completed its progress through Parliament.

5. Two further approaches to reducing the PSBR were canvassed: advancing the payment of VAT on imports, and a more radical approach to income tax involving full revalorisation of the thresholds and bands, coupled with a 3p increase in both basic and higher rates. The Chancellor thought that VAT on imports, quite apart from the adverse effect on industrial costs, would not represent a satisfactory response to a continuing problem; the containment of the 1981-82 PSBR would then be unduly dependent on once-for-all changes - the levy on the banks had the same characteristics. It was noted that the more radical approach to income tax would make the overall balance of the Budget less regressive, and would be better on the whole in relation to the "Why Work question" problem; but the effect on incentives was thought to be an overriding objection.

6. Mr Burns argued that the Budget as yet did not sufficiently

/confront the problem

confront the problem presented by the large increase in public expenditure as compared with previous plans; expenditure in cost terms in 1981-82 was now likely to be £6 billion higher than had been envisaged in the 1980 MTFS - but additional revenues would amount to only about £4 billion. Unless action were taken which offered a better prospect of a substantial reduction in interest rates, the Budget would mean disappointed expectations for industry as well as unpopular increases in taxes for the personal sector. Mr Ryrie and Mr Unwin, however, thought it would be better not to make the fiscal stance more restrictive; they suggested that a PSBR in the region £11¼-11½ should be shown, with the immediate reduction in MLR restricted to 1 per cent. This course would certainly involve some risks, but there was no entirely satisfactory way out of a difficult situation. To the extent that the exchange rate moved down somewhat, relatively higher interest rates would be less of a problem for UK industry.

7. Mr Burns again urged the case for action in the Budget rather than later; if monetary developments through the first half of 1981 proved adverse, there would be a risk of a resurgence in inflation, to which "regulator" increases in indirect taxes would not be an appropriate response, since they would increase both the RPI and the demand for money. On the other hand, if the PSBR could be reduced to about £10½ billion, Mr Burns thought it would be reasonable to make a 2 per cent reduction in MLR in the Budget.

8. The Minister of State (L) said he saw no circumstances in which it would be appropriate to increase the basic rate of income tax. If the Government had to have more revenue, it would be better to leave tax thresholds and bands where they currently were in money terms - despite sophisticated discussion in Parliament and the Press,

/people still saw

people still saw increases in tax thresholds as implying a reduction in tax, even if the reduction were not enough to offset the rising real burden due to inflation. If there were no revalorisation of income tax, the CTT thresholds would have to be left where they were, and it might be appropriate to look again at the level of child benefit. There would undoubtedly be a problem arising from the disappearance of clear water between benefit levels and tax thresholds but this should not prove insuperable; the Inland Revenue could absorb a good deal of this by increasing their administrative tolerances. The Financial Secretary and Sir Douglas Wass agreed with the Minister of State (L) about the choice between tax thresholds and an increase in the basic rate; and it was noted that the Conservative Central Office had taken the same view.

9. In further discussion there was a wide measure of agreement among Ministers with the Minister of State (L)'s approach. Action now to contain the PSBR would put the Government somewhat less at risk from newly emerging public expenditure overruns; if, on the other hand, the situation were to deteriorate markedly following inadequate action in the Budget, then the remedial action which would be needed later would have to be greater and therefore more unpopular. In general the Budget would carry greater conviction if it included what would clearly be a harsh decision on income tax, and Treasury Ministers' hands would be strengthened in asking their spending colleagues for expenditure cuts.

10. The question was raised, if income tax and CTT thresholds were unchanged, what other elements of the business and enterprise package would also have to be omitted. The preliminary view was that the other CTT changes - the annual exemption, 10 year accumulation, life-time scale and the agricultural package - could probably be retained; there was relatively little revenue at stake in the near

/future, and the

future, and the agricultural changes incorporated useful measures against tax avoidance. Similarly it appeared that the CGT roll-over relief could be retained, on the basis that this was being presented as self-financing.

11. It was noted in further discussion that more thought would need to be given to the treatment of the additional financing for the coal industry, and the measures to reduce energy prices. On the face of things it would be odd to regard the energy price changes (up to £150 million), which were known with certainty, as a charge on the Contingency Reserve, while the extra costs of coal financing - which were not precisely known at this stage - were shown explicitly in the arithmetic as affecting the PSBR.

12. The Chancellor, summing up the discussion, said Treasury Ministers favoured leaving income tax and CTT thresholds and bands where they were, thus reducing the PSBR by approaching £1 billion. This course would offer a far better prospect of validating a 2 per cent reduction in MLR as part of the Budget. In effect this implied a trade off between 7½ per cent revalorisation of tax allowances and a further immediate reduction in interest rates of 1 per cent. In view of the urgent need to help the business sector, it seemed better to follow the course which gave a better prospect of lower interest rates.

13. Following the meeting the Chancellor discussed the new proposals on income tax and CTT with the Prime Minister. She gave her agreement to them.

JW

A J WIGGINS

25 February 1981

Distribution:

Those present
Sir A Rawlinson
Mr Battishill
Mr Bridgeman
Mr Britton
Mr Monck
PS/Inland Revenue
PS/Customs & Excise
Mr T P Lankester - No.10 (Personal)