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Prime Minister

PRIME MINISTER

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I thought it would be helpful to let you have my preliminary views on the prospects for the Budget before we meet tomorrow.

2. The economic and financial forecast which has been submitted to me presents me with something of a problem which I have not yet fully resolved. It predicts a larger drop in output in 1980 than any other forecasting body is expecting; but it suggests at the same time a smaller PSBR for 1980-81 than might be expected to correspond to the output path. I can see a number of reasons for supposing that output will not be as depressed as the Treasury forecast and the forecast I propose to publish on Budget Day will be more in line with what outsiders are saying. But I think it prudent to publish a PSBR which is not unduly optimistic. The figure we set as our target should be as low as we can get. But it should be regarded as a ceiling. I do not want to have to bring in supplementary fiscal measures this autumn because our estimates of the PSBR have been exceeded.

3. In approaching the Budget generally I have addressed myself to two main considerations. The first is the appropriate monetary stance for the coming year, and the PSBR that would be consistent with it. The second is the appropriate tax disposition within the given PSBR, bearing in mind in particular the need to achieve the right balance between the personal and the company sectors.

4. I shall be discussing the monetary stance further with the Governor but I think it unlikely that we shall be able to reduce the target range for £M3 over the chosen period below 7-11 per cent. I know that this will be a disappointment to you and I should explain why I do not think we should aim for a lower bracket. There is a risk that we will have significantly over-shot the range this financial year and we could not, without damage to our credibility, simply sweep this aside. I propose to affirm a commitment to bring the money supply growth back within the range by setting as the base the level of £M3 in June 1979 - as I did both at the time of the Budget last year and in the autumn when I rolled the target range forward. If I now roll forward the target range of 7-11 per cent p.a. to April 1981 with June 1979 as the base this is likely to imply a growth in the course of 1980-81 of only about 7 per cent or possibly even less. If we were to remove the corset and take into account the re-intermediation which would then occur, the permitted underlying growth would be even lower. Rates of monetary growth of these magnitudes could only be achieved, given the sort of PSBR which is feasible, at the risk of interest rates which are in my view out of the question.

i.e. before <u>any</u> revalorisation

5. Everything therefore argues for our going for the lowest PSBR we can reasonably secure. After the expenditure cuts we have obtained for 1980-81, <u>unchanged tax rates</u> would suggest a target PSBR of around £8½ billion - i.e. about the same figure as last year, but in real terms over £1 billion less. On any reasonable test a PSBR of £8-9 billion would represent a tight fiscal stance, given the downturn the economy will be experiencing, and I think that the market would so judge it. I should instinctively have liked to go for a lower figure, but I do not think I would be justified in <u>increasing</u> the burden of

taxation. We must bear in mind that even a Budget which keeps the burden of taxation where it now is would, given inflation, represent a net increase in the burden of tax compared with that which followed my 1979 Budget. No-one in the Treasury has been arguing for a PSBR less than £8 billion or more than £9 billion. I hope that you will agree that a figure in this range is about right.

6. My preliminary thinking as to how we should reshape the incidence of tax, within a broadly 'no change' Budget, runs on the following lines. To index all the specific income and expenditure tax points and rates would involve a reduction of income tax of some £2 billion and an increase in indirect taxes of some £1 billion - i.e. a net reduction of around £1 billion. We cannot afford this. So I propose to reduce the income tax cuts to about £1 billion and I shall achieve this mainly by abolishing the reduced rate band. (I shall in consequence have in equity to adjust the valorisation of the higher rate bands; I will explain this in detail later.) I have not yet decided how to distribute the £1 billion increase in indirect taxes, but in any case the RPI increase would be kept to about 1 per cent.

7. Within the business sector I can see a strong case for taking more off the North Sea oil companies and redistributing it to the non-oil sector. I hope to be able to do this by an increase in PRT to 70 per cent and other possibilities I am examining - which should yield some £½ billion in 1980-81 - and by using the proceeds to mitigate the effect which a fall in company stock levels would have on company tax liability next year (the so-called DIPS scheme) and possibly also to make some reduction in the national insurance surcharge. I shall also want to do something in the field of capital taxation on the lines of my minute to you of 12th December; and also to implement an enterprise package including the measures to help

small firms and to encourage wider share ownership that we have discussed in E Committee. The precise arithmetic of all these elements has still to be worked out, but I have it in mind to seek extra revenue by disallowing the offset to the VAT liabilities that traders may currently claim as a result of the VAT they bear in their petrol and derv purchases. As you know we disallow the VAT on business cars and it seems logical to do the same for motor fuel.

8. A Budget on the above lines would essentially be a consolidating Budget, with limited impact effect on the RPI. It would serve as a clear confirmation of our basic strategy - attacking inflation through tight monetary control - and would, I think, be well received by the markets.

9. As you know, however, I think the presentation will be greatly enhanced if it can be set in the context of the medium-term financial strategy we have discussed. This will offer the prospect of more substantial tax reductions when we have surmounted the next two very tight years. I understand that arrangements are being made to discuss this at Cabinet on 13th March and I shall be preparing a short paper for that purpose following further discussion with the Governor early next week.

The Chancellor is discussing this with the Governor on Monday.
TL 29/2

(G.H.)

29 February 1980