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PRIME MINISTER

THE BUDGET

I thought it would be helpful to let you have a brief account of my preliminary thoughts on how I see the Budget shaping up. I have still a good way to go before I come to my decisions, but the key problems and choices are becoming clearer.

Present problems

2. One of the most difficult tasks I face is to re-establish credibility in our monetary and public expenditure objectives. This overshadows all other considerations. As you know, the PSBR this year seems likely to come out at between £12½ and £14 billion, compared with the £8½ billion forecast in last year's Budget: and between February 1980 and January 1981 the adjusted growth of £M3 at an annual rate is likely to be just under 19 per cent, compared with a target of 9 per cent<sup>+</sup> - 2 per cent

At the same time, the public expenditure plans we shall be publishing on Budget Day are substantially higher than those we committed ourselves to last year. My Budget must be seen to be relevant to these unfavourable and unfortunate developments.

3. I believe that I can only re-establish confidence by bringing in a rather tough Budget even though there are some grounds for thinking that our policies are working well. The inflation outlook for instance continues to be encouraging, and strong pressures remain on industry to keep its costs down. We must not however relax in our fight against inflation and this means persevering with a tight fiscal and monetary policy.



4. The present forecast (which assumes indexation of the personal tax allowances and of the specific duties, and takes account of the new system of stock relief and the measures announced last November - the 1 per cent increase in employees' national insurance contribution and the new tax on North Sea income, each producing £1 billion in 1981-2) gives a PSBR next year in the region of £11 billion (nearly 4½ per cent of GDP). This compares with the implied medium term strategy figure of around £7½ billion (some 3 per cent of GDP). Taking into account the extent of the recession, the external pressure exercised by the exchange rate and the need to re-establish confidence, I judge that we should aim for a PSBR somewhat below £10 billion. This would be in the range commentators in the City and elsewhere now seem to expect. But it means looking for a net reduction in the Budget of perhaps £1 - 1½ billion compared with the outlook on present policy.
5. I should stress that the PSBR forecast could, of course, change further and the figures quoted above are necessarily subject to this.
6. To secure a reduction of £1½ billion in the PSBR I should ideally like to have a further reduction in public expenditure. I am continuing to think about the scope for this, but I am not hopeful of being able to formulate any proposals that would be acceptable to the Cabinet, given the long struggle we had last autumn to get to where we are now.
7. This means that I shall probably have to look principally to increased taxation. In addressing myself to the question where I should find the sums I need I must bear in mind an important change in the distribution of income which took place in 1980. The combination of a high exchange rate and a sharp fall in domestic demand has reduced the real income of the company sector and increased that of persons. For example, personal disposable income last year increased by over 17 per cent in money terms, whereas that of non-oil companies fell by more than



20 per cent. With the exchange rate as likely as not to remain at a high level, there is therefore a very strong case for making no net increase in the fiscal burden borne by business. Indeed there is a powerful case to be made for actually reducing the tax burden on businesses, even though this would effectively mean a pro tanto increase in personal taxation.

8. Before addressing myself to the question of what extra taxation I can impose on the personal sector, I have to bear in mind the effects of the increase in employees' national insurance contributions (NIC) which will operate from the beginning of April. This will be a most useful addition to revenue next year; but, equally, it is bound to limit my freedom of manoeuvre to increase the 'real' burden of income tax as well.

#### Income tax and the specific duties

9. We have ruled out an increase in the basic rate of income tax. Some abatement of the full indexation of the personal allowances seems unavoidable however. Full indexation would be just over 15 per cent (the increase in prices during 1980). The very minimum we can do, I think, is  $6\frac{1}{2}$  per cent, which would be sufficient to preserve "clear water" between the tax threshold and the widows' pension. This would save about £1.1 billion off the forecast PSBR. I should like, however, to do more than this if at all possible, and I am at present thinking in terms of a threshold increase of 9 or 10 per cent - which would reduce the PSBR saving to about £0.6 billion. As it is, the NIC change from April means that most people will lose more in extra contributions than they gain from any degree of revalorisation of personal allowances that I could contemplate this year. We need to keep this loss as low as we sensibly can even though in some ways it is the inevitable consequence of the excessive growth of personal sector incomes over the past year.

10. So far as the specific duties are concerned the present forecast already allows for full revalorisation which has an initial RPI impact (already allowed for in the forecasts) of about



1 per cent. Depending on how it is possible to weight the package - bearing in mind in particular the adverse effect on the cash flow of businesses arising from increases in the fuel duties - I would not want to rule out  $1\frac{1}{2}$  times or even perhaps 2 times revalorisation, which would have a further RPI impact of around  $\frac{1}{2}$ -1 per cent and would reduce the 1981-82 PSBR by £0.75 -1 billion.

#### Relief for companies

11. Increases in personal taxation (direct and indirect) of this scale - with a combined PSBR reduction of about £ $1\frac{1}{2}$  billion - would not offer any significant scope for a reduction in company taxation consistently with the objective of reducing the PSBR by £1 billion or more. I am anxious to include some further enterprise measures and to reduce the capital taxes on the lines of the minute I sent you recently. Beyond that I do not think I can provide more than about £ $\frac{1}{2}$  billion at the most for the coming year, even if I shade down the size of the PSBR reduction I am aiming at. For planning purposes I am assuming that most of the extra revenue will have to come mainly from the personal sector, along the lines already described.

12. There is a difficult judgement also on how most effectively to give the relief to companies that we can afford. The choice of instruments is restricted, and each has its disadvantages. There is universal pressure for a reduction in the NIS. Further relief (i.e. over and above the measures on stock relief and capital taxation) of about £ $\frac{1}{2}$  billion for companies would just about allow a 1 per cent reduction from October (or a smaller reduction combined with other measures); a larger package of about £ $\frac{1}{2}$  billion would permit a reduction of 2 per cent from October (or, again, a smaller NIS reduction plus other measures).

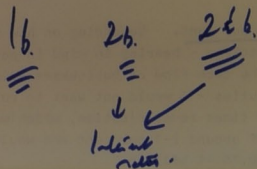
13. I am not myself greatly attracted to reducing the NIS. Although the costs this year would be modest, the full year cost is much greater (a 1 per cent reduction would add some



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PSBR. - Int. = Exchange Rate = level of Interest = Money =

£0.7 billion and a 2 per cent reduction nearly £1 billion to the PSBR in 1982-83); and the relief would be indiscriminate, with a risk that some of it might go quickly into wages. However, some reduction would undoubtedly be popular with industry, which attaches greater importance to help with costs than with profits, and it would be well received by the CBI in particular.

14. Of the other possible reliefs I have been concentrating on corporation tax and heavy fuel oil duty. Both have disadvantages. A corporation tax reduction would only benefit the one-third of companies currently paying any corporation tax. As for the heavy fuel oil duty, the terms of the British Gas Corporation's contract for buying gas from the Norwegian sector of the Frigg field are such that the price they pay rises automatically in the event of any reduction in the level of our duty. As a result the PSBR cost, and the resource loss to the UK, far outweigh the reduction in duty, and any conceivable benefit for industry. Despite its obvious attractions from some points of view, I have reluctantly concluded that we must rule it out as an option this year.

Monetary targets

15. I am still thinking about the form in which I should present my target for the monetary aggregates next year. The course charted by the MTFs would imply a 3M target of 8 per cent. But I may want to consider targeting on other variables, at any rate for the determination of short term interest rates. I shall minute you separately about this, in the light of the discussions I am currently engaged in on monetary control.

(G.H.)  
5 February 1981