Duplicate destroyed 14/5

9

12 March 1980

PRIME MINISTER

Here are some comments on the points raised in your discussion with the Chancellor last Friday. I would like to have got it to you in time for your meeting with him this evening, but the PPB and Bournemouth preparations have put us rather behind.

1. WHAT ARE THE BUDGET'S OBJECTIVES?

1.1 The Budget must convey a clear message and sense of purpose. It must not appear to be a return to Healey-style ~~bickering~~. tinkering.

1.2 The main message must be the commitment, over time, to ending inflation. Our scope here is limited by our failure to de-index on an adequate scale in public expenditure.

1.3 The Budget must be seen as fair as well as firm. Its measures, its objectives, and measures we have already taken in the past, must all hang together coherently.

2. COMMENTS ON CHANCELLOR'S PROPOSALS TO DATE

2.1 For the above objectives, the most important of Geoffrey's proposals must be the proposal to set out a medium-term financial plan related to the PSBR and the growth of the money supply. It both demonstrates our commitment and also reminds people that the cure takes time. The Governor's objections last Friday don't add up to much. It's the old chicken-and-egg argument. The Government does not "take responsibility for continued slow growth", simply because it publishes its best forecasts on what will happen. When the Governor says that "wages might not accommodate to the declining monetary path" is he saying that it is better that we should not tell the operators in the economy too much about the path to which those wages have to accommodate? Is he forecasting the necessity for a freeze? Isn't a freeze more likely to be avoidable if the maximum information is given to ensure that behaviour within the economy is compatible with the monetary path? It's certainly true that we're finding it hard to stay within the existing one-year target - but is that surprising, with £18bn a year of auto-indexed public expenditure? This whole

?

exercise is presumably part of a bigger and properly worked out programme to get all that under control. Other colleagues may raise similar time-honoured objections, but they all amount to a sub-conscious desire to avoid announcing that you're going to try and do something difficult, in case you fail. And they completely overlook the effect of that announcement on, first steeling the Government's own resolve and, second, altering expectations in the economy.

2.2 You raised a number of points on Geoffrey's proposals. Here are some comments:

(a) Abolition of the reduced rate band may have undesirable distributional and incentive effects - though the latter are unavoidable if income tax is to be raised in real terms. Abolition would look divisive, especially since - I believe - the introduction of the reduced rate band followed a sustained campaign by the TUC.

(b) We believe there are compelling reasons of fairness, longer-term coherence and avoidance of anomalies in favour of some moves on fringe benefits. Any real increase in their taxation could be quite modest and therefore symbolic. (To abolish the reduced rate band of income tax and leave fringe benefits untouched would look very unfair when we are telling the country that we are going into some very rough weather.)

(c) Corporate liquidity indications look increasingly grim. I am sure Keith is right to press for reductions in NIS rather than the much slower and more indirect (and widely spread) benefits of a lower PSBR. Of course, pressure on the corporate sector to adjust to the harsh realities must be maintained, but there is a limit to how fast the adjustment can happen.

(d) We still feel that there is scope for extending the principle of partial de-indexation, though I realise that this would need fresh Cabinet consideration on public expenditure. There are two quite distinct purposes here. First, there is the need to reduce public expenditure in the short term. Second, but quite different, is the need to start the process of matching the deceleration of money incomes to the deceleration of our monetary growth. To date, our thinking has been quite misconceived. We have assumed that the monetary deceleration would start in the private sector, under pressure of unemployment and bankruptcies (despite the tenuous connection between the actions taken by fiercely-competing unions, and the results of those actions). Meanwhile, the rest of the system (public sector pay under Government influence, and social security payments under Government's complete control) have remained fully indexed! We have tackled it completely the wrong way round. Everything that Government pays out should have been immediately partially-indexed (we can't now undo the commitment on pensions, though even those could have been de-indexed rather less, for symbolic purposes, than other social security payments, as part of a really purposeful package to cut inflation). After that comes heavy pressure on the public sector and then finally the private sector or what's left of it. I found Ken Berrill's minute of 27 February very disappointing. It presumably reflects Gordon Downey's view, who was on the Wass group. The penny never really dropped with that group; the need for the "change of gear" didn't seem to be grasped; confusion between cutting public expenditure on one side, the monetary deceleration on the other, was total; and there was vigorous ~~defence of~~ resistance to anything less than full comparability in public sector pay! Another boat missed.

(e) If it's too late to do any more de-indexing, it might be possible to squeeze a little more tax out of the oil companies so that the de-indexation of Rooker-Wise could be brought into line with the de-indexation on unemployment benefits. It seems sensible that they should both be at 5% so as to establish the pattern of equal treatment for extending de-indexation, as I am sure we will have to do as we find inflation coming down too slowly.

3. WILL WE NEED SOMETHING MORE?

3.1 I made the points in 2.2 (d) to Geoffrey on 20 February but it was probably already too late for any new insights to be useful. The problem was that the indexation study took place so late that its results could not be properly digested and it is probably now being put away in the files as an academic exercise. The result is that the public expenditure cuts have not created enough manoeuvring space for anything but a tinkering Budget - redeemed, I hope, by a medium-term forecast. There must be a strong possibility that we will have to do something else on more Hayekian lines some time in the next year (ie along the lines of the "shock package" I suggested in January).

JH

JOHN HOSKYNS