

cc
Mr Woffson
Mr Stone

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PRIME MINISTER

I have already mentioned to you in a general way how my thinking on the Budget has been developing. To meet the 12th June deadline I must now firm up several important decisions without further delay, and I must do so with your support. I have therefore set out below the considerations most relevant to those decisions.

2. Even taking full credit for the latest proposals for cuts (not yet agreed by colleagues) we shall have a very tough task in cutting this year's PSBR back to £8bn. This will be a very substantial reduction, both absolutely and in real terms, on the outturn for 1978-79, which is now thought likely to be around £9 bn, well above Denis Healey's target. We have also to allow for the likelihood that the new short-term forecast (due later this week) will predict a PSBR for 1979-80 (on pre-Budget policies) lying between £10 bn and £11 bn, rather than the £10 bn we now assume.

3. On the tax front we have identified in broad terms a package of income tax cuts which constitutes an irreducible minimum. Its principal features are

(1) cutting the basic rate to 30%, and the higher rates to 60% maximum;

(2) a modest but significant improvement in the allowances over and above the provisions of the caretaker Finance Act.

4. We have deferred "buying out" the 25% reduced rate band until next year, and set our face firmly against a number of other

/smaller

BUDGET SECRET



smaller but highly desirable changes. The principal details are set out in the attached table, though it must be stressed that the costings are provisional and subject to revision when the forecast is available. (I can explain when we meet the other smaller changes which we have in mind - some of which are important in terms of presentation and confidence).

5. As you will know from last Thursday's Cabinet, we have now taken an extremely firm line on public spending for 1979-80, and I do not think that there are more economies of any significance to be found if we can secure what we have bid for.

6. On the indirect tax front the position is tough but, I believe, manageable. Even if this week's new forecast does not worsen the PSBR arithmetic, the minimum direct tax package can only be financed with a 15% VAT rate. This is crucial and equally important for next year. The only margin turns on whether or not we increase the duty on drink and tobacco, both of which have a heavy weight in the price index, together with the other specific duties. If they are included, the immediate impact of the indirect tax changes on the RPI is about 4.3%. If not, it is just over 3½%. We need to balance this difference against the importance of reducing the PSBR by the extra £200 million that is involved.

7. Looking beyond the mechanics and arithmetic of the proposals is still difficult. But one or two points are already clear. On conventional economic arithmetic the impact of our measures would be deemed to be quite severely contractionary. But insofar as any Government - including a Labour one - would have had to cut the PSBR back to circa £8.5 bn, any responsible Budget at this juncture would tend to have a contractionary effect. I intend of course to stress this point in the course of my Budget speech. But I think that, in contrast to a Labour Government, we would expect to see our Budget lead to an improvement in confidence at home and

/abroad



abroad, amongst both consumers and investors. This should lead to a more favourable outcome.

8. Furthermore, one must allow something on the plus side for the impact on the "supply side" of the economy of an important first step towards getting right our tax structure and incentives. No one can know quite how much that intangible but vital consideration is worth, or when it will come into effect. But it is no less relevant for that.

9. Finally there is the question of confidence in our policies in the longer term. If I can give really firm and convincing indications in my Budget speech of the Government's ability and determination to get public spending and borrowing down and to control the money supply in the longer term, then the response of the economy should be swifter and more positive. This points, of course, to the extreme importance of our securing early agreement from our colleagues to the need for longer run economies on the scale we shall be putting forward in this Thursday's Cabinet discussion of the medium-term public spending survey.

A handwritten signature in dark ink, appearing to be "G. Howe".

(GEOFFREY HOWE)

21st May 1979.

Direct Tax

Increase* in single and married allowances by £120 and £190 respectively, together with corresponding age allowance increases

Reduction in basic rate to 30p +£2,790

Improvements in higher rate structure and top rate 60%

Investment income surcharge:
single threshold of £5,000

Public Expenditure

Cash limits squeeze on prices and pay (assumed £720 million reduction in volume of central Government spending).

RSG cut of £300m (assumed £100m reduction in volume of LAs spending).

Specific cuts of £1.3 bn. -£3,000 0.4%

Contingency reserve cut
of £250 million.

Sales of assets of £1 bn.

Indirect Tax

VAT at 15%

15% increase in petrol duty. /

10% increase in specific
duties except VED -£1750 4.3%

Alternatively

As above, but excluding drink
and tobacco -£1550 3.6%

* Including Caretaker Finance Act increases.

(Note: These figures are rough estimates based on the use of current ready reckoners and assuming a floating exchange rate and unchanged monetary growth).