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Budget.

NOTE FOR THE RECORD

c.c. Mr. Wolfson
Mr. Ryder
Mr. Stowe
Mr. Hoskyns

The Prime Minister had a short meeting with Mr. Adam Ridley at 1830 yesterday to discuss the Budget.

Mr. Ridley expressed great anxiety about the Budget prospects. The PSBR was currently forecast at £10 billion for 1979/80; but a new forecast was due on 23 May and could well show a higher figure. In order to get the PSBR down to £8 billion, it would therefore be necessary to find expenditure savings and/or indirect tax increases amounting to at least £2 billion; and some £100 millions of additional savings would be needed to finance the planned reductions in income tax. The Treasury's options for reducing public expenditure so far amounted to only £800 million. They were assuming £800 million from sale of public sector assets; and the rest - on their current thinking - would have to be raised by indirect tax increases.

This approached raised at least two major problems. Firstly, it was doubtful whether the markets would fully count the revenue which would be raised by selling off assets. The markets were now more sophisticated than they had been in 1976 when the Labour Government had sold off the BP shares; and they would be looking at the public sector deficit (i.e. the difference between expenditure and tax revenue) as well as the PSBR. There was a good reason for this: the sale of assets, while raising revenue, would not improve the real resource balance of the economy, and insofar as the institutions substituted purchases of public sector assets for purchases of gilts, there would be no reduction in the growth of the money supply.

Secondly, the substantial increases in indirect taxes which were implied would give a sharp boost to the RPI. Together with increases in nationalised industry prices, the increases in indirect taxes could lead to a once-and-for-all jump of 3% in the RPI later in the summer. Notwithstanding the Conservative pledge to switch taxes from direct to indirect, this would lead

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to major criticism. It would seem inconsistent with the Government's objective of tackling inflation. Moreover, the critics would focus on the net income position of typical families (as the Labour Party had done during the campaign).

Mr. Ridley said that all this pointed, in his view, to much greater emphasis being given to public expenditure cuts. It would be very helpful if the Prime Minister would give Treasury Ministers and the Cabinet generally a strong lead in this direction. In the absence of cuts well in excess of £800 million which were currently proposed by the Treasury, there was a grave danger that the Budget would fail to satisfy both the markets and the Government's supporters in the country. One aspect of public expenditure in the coming year was of course the awards arising from the referencesto the Clegg Commission. Although their size was uncertain, there was little doubt that they would result in heavy extra expenditure. Assuming the Government was not going to revoke the existing references, this pointed to the Government putting in very strong evidence to the Commission as soon as possible. There would also need to be great care in allowing further references to go to the Commission.

Mr. Ridley went on to say that the Budget would be better received in the financial press and by the markets if it were accompanied by a clear and strong commitment to major spending economies in the 2-5 years ahead - preferably with the Prime Minister's endorsement; and also by a commitment to re-examine other means of monetary control such as the monetary base.

The Prime Minister made the following comments:

i. She agreed that there was room for anxiety, and in particular that it was essential to achieve greater expenditure cuts than the Treasury were at present envisaging. Sne would make this clear to Cabinet on Thursday. But she thought that Mr. Ridley was perhaps over-emphasising the market's reaction to the sale of assets: if presented properly, and as part of a good overall package, they could play a significant part in the Budget.

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ii. The Prime Minister said that a £8 billion PSBR was an absolute maximum; the Chancellor should be aiming for £7.5 billion.

iii. The Prime Minister said that one of the advantages of switching from direct to indirect taxes would be that there would be less tax evasion. At present, large amounts of income tax were not being paid, whereas there was less scope for evasion on the indirect tax side. She wondered whether it might not be worth offering an amnesty to those who had evaded their tax obligations on condition that they paid up within a certain time, with stiffer penalties to follow if they did not. She understood that the Italian Government had adopted such a policy quite successfully, although the amounts at stake there were no doubt far greater.

iv. The Prime Minister said that she too was very worried about the Clegg awards. She hoped to strengthen the Commission with some hard liners (and had asked the Chancellor's views on various names); she also hoped to call in Professor Clegg to express her worries to him in person. She was keen that the Government evidence should be put to the Commission as soon as possible (after Cabinet had considered it on Thursday); she had already indicated that the evidence should ask the Commission to take into account supply and demand considerations, as well as the overall economic effect of particular awards.

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16 May 1979