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Ref. A09464

PRIME MINISTER

The Budget

The 3rd April Budget was of course a holding operation. A new Budget needs to be introduced as soon as possible. The longer it is delayed, the greater the revenue loss in the current year from any increases in indirect taxes. (Cuts in direct taxes can of course be backdated to the beginning of the financial year). Delay would leave little time for completion of the Finance Bill without cutting into the Summer Recess. The Treasury think 12th June is the earliest feasible date.

2. The Chancellor will no doubt let you have an early appreciation of short-term prospects. This will inevitably be based on a "neutral" forecast (i.e. reflecting continuation of existing policies) and will thus only provide a starting point for the new Government: a full and more detailed forecast will be ready in about 2-3 weeks after the election. The main features of the present forecast are:

13-14% earnings

11-12% prices

(i) Earnings and Prices: the outturn in the present round is likely to be about 13-14 per cent, in both public and private sectors. Prices will be rising by around 11-12 per cent during 1979. In 1980, without changes in policy, both pay and prices would be increasing at about the same level.

1½% growth

(ii) Growth. About 1½ per cent in 1979 and 1980, involving some rise in unemployment, but the current account remaining in balance in 1979 and moving into deficit in 1980.

£10b 79-80.

(iii) PSBR. Rising from about £8½ billion in 1978-79 to about £10 billion or a little more in 1979-80, and a further increase the following year. Company profits remaining low, but no widespread liquidity problem because of low stock building and downturn in investment.

(iv) Domestic and External Monetary Policy. Assuming that the 8-12 per cent monetary target range continues - see below - some increase in interest rates would be needed. The present upward movement in the exchange rate will probably be reversed later in the year.

Then target must be reduced.

3. Thus the overall picture in the short term on present policies is a rising rate of inflation and slow growth, leading to continued uncertainty and instability.

4. The main problems to be faced in framing the Budget are:

(a) The overall stance - demand management. With the economy still depressed, the conventional response in past years would have involved a mild budgetary stimulus. This year, until recently, the confidence factor seemed to rule this out. But sterling continues strong. In addition a Conservative Government with clear long-term policies on public expenditure can probably rely on confidence remaining high even if it decides to go for gentle expansion. So one of the first decisions the Chancellor will want to discuss with you is whether to aim at some stimulus to demand, or whether to offset the cuts in direct taxation completely with reductions on public expenditure and increases in indirect tax. Obviously you will not want to allow very much net stimulus until there have been real improvements on the 'supply' side of the economy; otherwise increased demand merely fuels inflation and sucks in additional imports. On the other hand you are relying on the direct tax cuts to produce the necessary dynamic improvements. So there is a chicken-and-egg problem here.

No

Yes

Agreed

(b) Money supply. Your policy - especially for pay and inflation in the private sector - depends on keeping tight control over the growth of money supply. You will want to balance this against the need for expansion. The previous Government was committed to keeping control over money supply (expressed as a 12-month target growth range of £M3, rolled forward every six months). The present published target runs to October 1979. The City expects the Chancellor to announce in the Budget a new target up to April 1980. In setting a new target the main elements are the PSBR, external policy (including intervention on the exchanges), interest rates and direct controls on the banking system. Here too a Conservative Government may have the advantage of greater market confidence: because it will be able to sell more gilts as a result,

Agreed. Expanding money supply does not necessarily go to expansion. Last time - went into property prices.

No it will probably be able to afford a slightly higher PSBR at least in the short term, for any given rate of money supply expansion. This may help a bit in finding room for net cuts in taxation.

(c) On the latest information, allowing for the Rooker-Wise indexation and published public expenditure plans, PSBR is likely in the current year to be around £10-£10.5 billion (5½ per cent of GDP). Its composition will be as important in many respects as its size, both for its direct monetary effects and its effect on market confidence. Despite the favourable factors mentioned in (b) above some reduction will be necessary to keep the money supply within the existing 8-12 per cent target range during 1979-80. You will need to judge what reduction is feasible in the current year, given the late date of the Budget, and how to balance tax changes and public expenditure to achieve this.

Agreed

(d) Direct taxation. Once the central budget judgment on the permissible size of the PSBR has been made, and a view taken on growth in the coming year, the problem is to balance cuts in personal taxation (beyond the Rooker-Wise indexation in the recent Finance Act, which is allowed for in the forecast) with increases in indirect taxes and cuts in public expenditure. The more you aim for cuts in personal tax the more of offsetting action you will need on indirect taxes and expenditure. Illustrative figures on possible cuts in direct tax are: reducing the top rate to 75 per cent, and revalorising the bands to April 1973 levels, would cost about £800 million in a full year, and £450 million in the current year; each penny off the basic rate of income tax has a revenue effect of about £½ billion; and to increase the main single and married personal allowances by, say, £50 and £100 respectively, on top of revalorisation, could cost about £600 million in a full year.

(e) Indirect taxation.

(i) VAT is the prime runner for raising new revenue. The options include harmonisation of the two rates at 10 per cent or 12½ per cent; or moving both rates up. Harmonisation at 10 per cent would bring in about £900 million in a full year and

£400 million in the current year and add 0.9 per cent to the RPI. Harmonisation at $12\frac{1}{2}$ per cent would bring in about £2250 million in a full year (£1200 million in the current year) and add 2.1 per cent to the RPI.

(ii) Specific duties. The options here are to increase (revalorise) the rates of the specific excise duties (alcohol, tobacco, petrol). Straight revalorisation to last year's level would yield about £400 million, and add 0.5 to the RPI. To return to 1977 levels would roughly double these figures. There is a good case on energy conservation grounds for increasing petrol tax anyway, particularly if you maintain the previous Government's decision to phase out VED in the next few years. There are good health arguments for putting more on alcohol and tobacco.

Take them to 2's.

Petrol will go up because of V.A.T.

(iii) National Insurance surcharge. Sir Geoffrey Howe virtually ruled this one out in the Budget debate. The earliest date a change announced in a June Budget could take effect is the beginning of October.

No change.

(iv) Nationalised Industry prices. These have much the same effect as indirect taxes. Some increases will be needed anyway to achieve even the published targets for nationalised industry borrowing. (See below under 'public expenditure'). If you want to go further, the main candidates are probably gas prices (dealt with in the separate brief on energy) and postal/telecommunications charges.

No

(f) Public Expenditure. There are two main problems: some inevitable (mainly statutory) increases in expenditure on social security side (allowed for in the forecast) and the long-term search for structural changes leading to real reductions. Notes on each one:-

(i) The normal uprating of social security benefits next November had been built into the forecast, and administrative action is already in hand. To delay it would have made it impossible to pay out on time. The previous Government were also committed to a

50p increase in child benefit in November which would cost about £100 million this year and £300 million in a full year. It is not allowed for in the forecast. There is no immediate pressure for any other changes, though there may be small concessions (e.g. the pre-1945 widows) which you will want to make. There is no statutory obligation to increase child benefit, but the uprating of the main national insurance benefits is required annually under existing legislation.

(ii) On the generality of public expenditure, you are committed to large and early cuts. The Treasury will be suggesting a possible 1979-80 package to the Chancellor, and he will probably want to put it to Cabinet very soon. It is likely to involve a mixture of policy changes, sales of assets, and trimming of the Contingency Reserve for the rest of the year. You will obviously need an early Cabinet discussion on this. The immediate question is how much saving you can secure in time for the Budget.

(g) Cash limits for the rest of the year. You have made it clear that cash limits will be one of the main weapons used by the Government to control expenditure, and by implication to maintain restraint in the public sector. Since their introduction cash limits have worked well as a control: but those for this year have already been increased, and corresponding RSG support promised, to allow for those public sector settlements which had been reached for various local authorities groups during February and March. Otherwise, the cash limits have been maintained at the level assumed in January. They will therefore come under increasing pressure during the year both from pay and price increases over and above the assumed levels. In the Health Service and in central Government, to maintain the level of cash limits in the face of approved pay increases implies a volume squeeze on expenditure. You are committed to implementing in full the recommendations of the Armed Forces Pay Review Body, and this will impose a similar squeeze on MOD

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expenditure unless you are prepared to increase their cash limits. Yes
There is a similar problem in the nationalised industries, where the PSBR forecast assumes that their borrowing is held constant, and that the extra cost of recent pay settlements, over and above the original forecast assumptions will be met by increased prices or reduced investment. You will need an early paper from the Treasury on all this so that the Ministers concerned (most of the Cabinet) can agree together on the line to be taken.

5. To sum up, you will need:

(i) An early discussion with the Chancellor about the main shape of the Budget.

(ii) Probably - though this is for you to decide - a general discussion in a Ministerial Economic Strategy Committee and/or Cabinet on the same theme. - especially on P.E. cuts.

(iii) At least a first round of specific decisions by Cabinet about public expenditure cuts (though a fully worked out strategy for public expenditure in the longer term is unlikely to be feasible before 12th June).

(iv) Specific decisions by Cabinet about nationalised industry borrowing (and thus prices and investment) for the remainder of the year.

4/5

(John Hunt)

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File T

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b.c. Mr. Ridley
Mr. Wolfson
Mr. Ryder

Econ Pol

10 DOWNING STREET

From the Private Secretary

MR. VILE

The Prime Minister has now had an opportunity to consider Sir John Hunt's brief of 4 May on the Budget. She has made the following comments:

(i) On the overall stance on demand management, the Prime Minister's view is that we should not be aiming at any stimulus to demand, and that cuts in direct taxation will have to be completely off-set by reductions in public expenditure and increases in indirect tax. She believes that there can be no scope for a stimulus to demand until we see real improvements on the supply side of the economy.

(ii) The Prime Minister fully agrees that we must keep tight control over the growth of money supply. She has commented: "Expanding money supply does not necessarily go to expansion. Last time it went into property prices." If, as the brief suggests, some increase in interest rates will be needed to keep the monetary aggregate within the existing 8 - 12% target, she believes that the target will have to be reduced. The Prime Minister does not go along with the view that the Conservative Administration, because it may be able to sell more gilts as a result of greater market confidence, may be able to afford "slightly higher PSBR".

The PM must have meant that the PSBR will have to be reduced
TL. 8/5

(iii) The Prime Minister has commented that there should be no change in the National Insurance surcharge in the Budget.

/(iv) On

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(iv) On nationalised industry prices, she is disinclined to raise gas prices further.

(v) On cash limits, the brief says that the Government are committed to implementing in full the recommendations of the armed forces pay review body and that "this will impose a squeeze on MOD expenditure unless you are prepared to increase their cash limits". The Prime Minister has commented that in this case, we should be prepared to increase the cash limit.

The Prime Minister has noted Sir John Hunt's summing up. She has already had an informal discussion with the Chancellor about the Budget (I enclose a note on some of the points which they covered); and she would like to have a collective discussion on the Budget, as Sir John Hunt suggests. This discussion should include consideration of expenditure cuts. The Prime Minister has not taken a view as yet on whether this should be in MES Committee or in Cabinet (or in both).

T. P. LANKESTER

8 May 1979