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Prime Minister

You should read this before your meeting with the Chancellor at 6 pm tomorrow. It raises some important questions.* The Chancellor will be sending you his own promised paper first thing tomorrow.

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BUDGET SECRET

Ref. A09625

PRIME MINISTER

* Which I have mentioned to the Treasury.

The Budget

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I have seen Mr. Lankester's account, in his letter of 22nd May to the Chancellor's office, of the discussion you had on Tuesday with the Chancellor about the Budget. I understand that your talk with the Chancellor is to be resumed tomorrow evening and I should like to offer these comments.

2. Your objectives are clear. You want to reduce the PSBR and the rate of growth in money supply to restrain inflation; you want to reduce the share of ~~national~~ income absorbed by the public sector, and thus release more for the private sector; you want to shift the burden of taxation from direct to indirect taxes in order to provide the economy with a new dynamic; and you want to do these things without putting up the RPI, through tax changes, more than is necessary.

3. My worry is that the Treasury, in its approach to these objectives, is in danger of getting too boxed in between the conflicting desiderata, in the light of their latest forecasts, and that the casualty is likely to be the cuts in direct taxation on which your broad economic strategy fundamentally depends. Whatever the economists may say, a Budget largely confined to cutting public expenditure and the PSBR and raising VAT would not only be a great disappointment to the voters (who don't understand PSBR and the money supply anyway) but would wrong foot your basic strategy in the critical first 12 months of your Administration. Might I therefore suggest that in your talk with the Chancellor you seek to explore each of the main elements in the equation and probe whether the Treasury could not be more inventive. Thus:-

(a) The PSBR: Of course the level of the PSBR is important and of course you want to get it below Mr. Healey's target if you can. But the Treasury forecast is not inscribed on tablets of stone. It is a forecast and there is a wholly legitimate area of uncertainty about the figures. How far has the Chancellor probed the arithmetic and what probabilities attach to the single central forecast coming from the Treasury computer? How critical are the assumptions built in to the forecast and what sensitivities attach to them?

(b) Secondly, the Budget arithmetic for this year, and particularly the PSBR outcome, is much affected by the fact of a late Budget which will inevitably reduce substantially the yield of any increased indirect taxes in the present financial year - whereas cuts in direct taxes date back to the beginning of the financial year. Is it necessary or reasonable to try and make good the shortfall of revenue during the financial year itself? The markets would readily understand the problem and a distinction could properly be drawn between the borrowing needed for the year as a whole and the annual rate of borrowing which would be needed once increased rates of indirect tax had come into effect. The Government's self-evident determination to cut public expenditure and to constrain the rate of growth in money supply would reinforce the market's readiness to regard the extra borrowings needed for April to June this year as a special, non-recurring factor.

(c) The RPI: It is inevitable and accepted that a Budget which switches the burden of taxation from direct to indirect taxes will put up the RPI. The question is not whether but by how much and in what forms. Mr. Lankester's record of your conversation with the Chancellor suggests that he saw the main weight of the increase in indirect taxes being placed on VAT and he argued that this had a lesser RPI effect than raising money by increasing Excise duties. We do not have the full facts available to us to evaluate this argument but such information as we have suggests that it can easily be exaggerated. For example the effect on the RPI of raising £100 million by increased duties on tobacco, alcohol and petrol rather than by VAT may well be significantly less than 0.1 per cent on the Index. You may want to press the Chancellor for the facts because Excise duties have a presentational advantage over VAT in that taxation in this form has worthy secondary objectives - reduced health risks, energy conservation, etc. - and can be defended - and accepted by public opinion - on these grounds.

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(d) Alternative sources of revenue: It may be unfair to infer from the record of your conversation that the Treasury's mind is over-concentrated on VAT and the Excise duties. But there are other ways of raising money which do not all have the same RPI consequences as these classic sources. Thus, despite pre-election commitments the National Insurance surcharge does provide a relatively painless way of raising a lot of money. It has of course other serious disadvantages, e.g. it is a direct tax on business and employment, but need a temporary increase be ruled out as a bridge to a future where significant savings in public expenditure will have been achieved? Again, in a Budget which really cut income tax it might be relatively easy and acceptable to toughen the tax treatment of non-monetary income like company cars. Could useful sums of money be clawed back here? Another possibility would be to replace the VAT element in the petrol tax by a straight duty (the point being that a substantial amount of petrol is bought on company account and thus has the VAT element offset even when used for private purposes. The need for energy conservation would provide a good public reason for the change).

12 £600

Another way - although you reacted against it in your first days in office - would be to put up the price of gas to the domestic

£500 RPI

consumer (OPEC is already ensuring that industrial gas consumers will have to pay more as the price of gas to them is oil-related). And if one really wanted to widen the tax base the application of VAT to all fuels could be readily justified by the difficult international oil situation and the obvious need for energy conservation. And there are other taxes like Petroleum Revenue Tax, levied on North Sea oil production, where OPEC may be giving us useful room for manoeuvre.

(e) Extra savings in public expenditure: You will know by the end of the month how successful the Chief Secretary has been in saving money this year. But you will have heard Mr. Healey's speech in the House yesterday when he outlined in some detail the elements which would have found a place in his Budget had he had the opportunity to introduce it. Two of them in particular involved quite a lot of money, yet may not figure in the

Chief Secretary's list. These are the deferment of payment of Regional Development Grant and the switch of part of ECGD cover from the public sector to private sources. Faced with such propositions the Treasury purists would no doubt argue (correctly) that "savings" of this kind are not real. The resources involved in the ECGD cover would still be needed and companies, paid late on their RDG claims, would simply borrow from the banks against their known entitlement. But the cosmetic effects on the PSBR could be useful - and again more acceptable to the market against the background of the Government's general policies.

(f) Presentation: The ways in which tax changes are made and presented are as important as their content. At one level the Chancellor could perhaps make up for deficiencies in what he is able to do this year by making firm promises about his intentions next year. No Chancellor likes tying his hands too much but the dynamic effect you are seeking might be at least partly achieved by firm commitments on future tax rates. At another level it might (though the revenue and legislative problems could be insuperable) be possible to promise further downward adjustments in tax to take effect later this year. At yet another level there could be mileage in splitting the "standard rate" band of income tax in two with tax levied at 30 per cent on the lower part and 35 per cent on the upper. The size of the bands would be adjusted to whatever the Chancellor feels he can afford but at least most taxpayers under this system would find their marginal rate of tax reduced to 30 per cent and even those paying 35 per cent would be better off than they are now. An incidental advantage of such a change - which would leave us with a logical progression of tax rates in 5p steps from 25p to 75p - would be to escape from the tyranny of the sheer size of the present standard rate band (currently £7,250 million) where a 1p change (which does not sound much) costs £400 million. With a fixed progression of rates much finer adjustments would be possible through alterations in the size of the bands of income to which they apply.

4. I do not advocate all of the changes outlined in this minute but I think it would be well worth probing whether the constraints are quite as tight as the Treasury are saying.

(John Hunt)

23rd May, 1979