

20 February 1981

PRIME MINISTER

BUDGET STRATEGY

It is, of course, easy for us to prescribe a tough Budget, when we don't personally have the responsibility for presenting it. Nevertheless, we believe that a Budget which fails to intercept the ominous trend in PSBR will spell the end of the Government's economic strategy; while a Budget which succeeds is not unsaleable and would set us on the right road for the next Election. Some comments:

1. PSBR IS ALREADY LOOKING WORSE

- 1.1 When we discussed Budget strategy with you last week, the Treasury team agreed with our forecast that the "present assumptions" PSBR of over £13bn would continue to get worse.
- 1.2 Since last week, it already looks as if we shall need about £200m more for NCB, and another £400m-odd for British Steel, depending on the £-DM rate. Another £150m has just cropped up for BT in the current year, and we understand that this will also mean more for 1981-2. If we assume more bad news on Rolls Royce, British Rail, British Leyland, ICL, public services pay, unemployment, the numbers are going to keep on growing.

2. MID-YEAR FUNDING CRISIS: CATASTROPHE OR OPPORTUNITY?

- 2.1 Last week, you and Geoffrey argued that a mid-year funding crisis would be an opportunity, not a problem, because it would allow us to make further cuts which would not otherwise be possible. In other words, the worse the problem, the more surely it would solve itself. Does our experience of PSBR overshoot in 1980/81, and the last round of cuts, bear that out?
- 2.2 We simply cannot see how a funding crisis could work out well in practice. Total failure of policy can't be good news. Colleagues will argue that your economic strategy, after three Budgets, has

finally come unstuck. The choice will then lie between a further increase in MLR (leading to more bankruptcies, even higher unemployment and yet greater PSBR strains as a result); or letting money supply take the strain which would once again be quickly reflected in increasing interest rates, as the market discounted accelerating inflation (which would, of course, come through as the Election approached). Cabinet would choose the latter course, when your own credibility was at its lowest.

- 2.3 LET US BE BLUNT. A BUDGET THAT CAUSES A MID-YEAR CRISIS MEANS CERTAIN FAILURE. IT IS WISHFUL THINKING TO IMAGINE THAT IT COULD BE AN OPPORTUNITY. BECAUSE CERTAIN FAILURE IS "UNTHINKABLE", WISHFUL THINKING TAKES OVER.

We believe there is an alternative strategy for success.

3. IF A TOUGHER BUDGET IS RIGHT, IT MUST BE SALEABLE

3.1 No It was the possibility of a hostile press reaction to a deflationary Budget which seemed to concern you most last week. But honest money requires an honest Budget. We believe that such a Budget would not be as difficult to sell as at first sight appears:

- (a) It should be presented as an enterprise/employment/recovery package. Everyone in work contributes to meet the heavy costs of recession. Public service pay and nationalised industries should bear their share of the blame. Social security costs are heavy, but that is what the welfare state is for at a time of recession. The key to recovery is the reduction of interest rates and, hopefully, the exchange rate. That is the only way that the business sector - the only provider of jobs that create rather than consume wealth - can begin to recover.
- (b) As you have already suggested, the withdrawal of the pit closure plan will inevitably affect the Budget. That is one of the pegs on which to hang a tougher Budget. It is a perfect opportunity - the opposite of a U-turn - for the Government to reassert authority and regain control of events. (Opinion research last summer showed that people do not regard sensible and necessary action as a U-turn. The only thing that would

be seen as a U-turn, the research showed, would be deliberate increases in public spending to win electoral popularity.)

- (c) The colleagues would have to accept a tough Budget, since they were not able to find more expenditure cuts, and they all know that industry must get lower interest rates and a lower exchange rate, if it is to recover.
- (d) We know, from the 1979 Budget, the likely RPI effect on the pay round if we load too much onto indirect taxes. And we know the "tax net" effects of too big a cut in Rooker-Wise. Increases in direct tax rates should not only be "thinkable"; they will also be seen as fair and honest in hard times.

3.2 We should not underestimate the maturity and commonsense of the public, back-benchers and commentators. If we ensure that they understand the box into which world recession, nationalised industry performance and public service pay have driven the Government over the past year, then they should welcome a Budget which points a way out of that box; a Budget which may appear deflationary in terms of consumption, but which allows early fall in interest rates and the exchange rate, a consequent recovery of business activity and thus a gradual unwinding of the whole tangle of recession-linked problems. Do we seriously think that, after proper explanation, back-benchers would revolt and force an early Election?

3.3 If we believe that this is the right way out of the maze, surely we can explain it, and keep on explaining it, until the commentators are persuaded. If we don't think that this is the right way, then of course that is another matter, but this was not the conclusion we seemed to reach during our discussions. The conclusion we reached was that it was the right thing to do but that it was politically impossible to do it.

4. THE BUDGET IS THE TURNING POINT

4.1 We remain convinced that this Budget is the turning point. Whichever way we go, it will be a rapidly self-fulfilling prophesy. If the Budget fails to take care of the PSBR, we shall be locked almost immediately into a vicious circle from which there will be no escape.

If it succeeds in intercepting the PSBR, even to the extent of over-kill, we shall be quickly into a virtuous circle of falling interest rates, restoration of confidence and renewed activity.

4.2 IN SHORT, WE BELIEVE THAT THE BUDGET PRESENTED ON 10 MARCH WILL LARGELY DETERMINE WHETHER WE WIN OR LOSE THE NEXT ELECTION.

We are copying this minute to Geoffrey and are, of course, available if you want to discuss it over the weekend.

ALAN WALTERS

DAVID WOLFSON

JOHN HOSKYNES