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CABINET

ECONOMIC STRATEGY

Memorandum by the Chancellor of the Exchequer

BACKGROUND

1. The background to our Fifth Budget, to be presented on 15 March, is one of expectations of modest growth in the world economy in 1983, as the long-delayed recovery begins. The need to maintain prudent fiscal and monetary policies, as the foundation for rebuilding sustainable growth, is fully recognised by most countries.

2. But there are two major uncertainties. First, the scale and speed of recovery must depend on developments in the United States economy, and especially on whether the United States Administration can convincingly tackle the problem of mounting federal deficits, and thus create both improved confidence and scope for further reductions in interest rates. Second, the future movement of oil prices is uncertain. A substantial reduction of approximately 7 per cent is already assumed in our forecasts, with effects broadly helpful to the level of world economic activity and inflation, marginally unhelpful to the United Kingdom balance of payments and public revenue. But we cannot rule out a considerably sharper fall.

3. In the United Kingdom we can this year expect growth of real demand, perhaps at around 3 to 4 per cent in volume terms, compared to 2½ per cent in 1982. Competitiveness has continued to improve, but not enough to prevent some of this "leaking" overseas. Thus the forecast is for growth of output of only 2 per cent this year. This is, however, a better prospect than was foreseen in the Autumn Statement, and (for the second successive year) slightly above the average of the major industrial economies - growth in Japan may be a little faster, whereas in Europe it may be rather slower. Here, as abroad, unemployment is likely to continue to increase, at least for some time, but improved growth and better profitability should ensure that the rise is much slower than in 1982. Inflation, now at 5.4 per cent, is down to less than half the rate of a year ago, with further improvements still to come, before sterling's recent fall produces a slight upturn later in the year. Interest rates also dropped steeply over the year, from 16 per cent in autumn 1981 to 9 per cent last autumn, 11 per cent now.

4. Annex 1 sets out some of the key figures. The 1983 column, being based on early forecasts, is of course subject to a number of uncertainties. There will be a further forecast at Budget time.

THE STRATEGY

5. Against this background the basic aims of the Budget must be:

(a) to avoid setting at risk the gains on inflation and interest rates which have resulted from past Budget restraint;

(b) to sustain and advance the domestic recovery, preferably by measures to encourage output, and so improve employment opportunities; and

(c) to provide the maximum tax reductions consistent with (a), and targetted with (b) in mind.

BORROWING

6. In the 1982 Budget we envisaged a 1982/83 Public Sector Borrowing Requirement (PSBR) of 3½ per cent of Gross Domestic Product (GDP), or £9.5 billion, and we currently expect to undershoot this figure. For next year, the Medium Term Financial Strategy (MTFS) suggests that we should aim for 2.75 per cent of GDP, or £8 billion. The present forecast (which assumes - as is customary - that income tax thresholds and excise duties are increased in line with inflation) suggests that this would permit a rather higher "fiscal adjustment" - ie higher spending or lower taxes - than the £1 billion indicated in the Autumn Statement.

7. As the difference between two very substantial figures (revenue and expenditure totals) the PSBR is of course particularly hard to forecast accurately. This year's likely shortfall partly reflects the fact that the real oil price, and hence North Sea revenue, has not fallen as anticipated in 1982 Budget decisions. But the odds are that it will fall further.

8. In coming to a final view of the PSBR for 1983/84 for which we should aim, I shall have to consider the trade-off between tax relief and action which would help to bring interest rates down further. (The International Monetary Fund team, in their preliminary report on their recent visit, drew attention to the need for continued restraint on the PSBR "to ensure that its financing will not place undue upward pressure on interest rates.") Equally, I have to consider the effect that any given PSBR, as well as any deviation from the figures we have already published, might have on market perceptions, and on public opinion generally. In particular, we need to avoid encouraging further sterling depreciation, given its impact on inflation. Sterling's recent fall makes relaxation of fiscal and monetary conditions less justifiable to the markets; and should reduce pressure for such relaxation, for it will benefit industry, and hence putput and employment.

9. My preliminary view is that it would be a mistake to publish a forecast 1983/84 PSBR above the £8 billion suggested in the MTFS and the Autumn Statement.

FISCAL OPTIONS

10. As noted above (paragraph 6), the current forecast suggests however that, without risking the adverse market reactions which could follow an increase in forecast borrowing, we could have more scope than the Autumn Statment suggested for tax reductions over and above revalorisation. As last year, the main issue is the balance to be struck between:

i. measures which reduce income tax; and

ii. measures which would directly assist companies.

11. We ought of course also to consider measures which would directly affect prices. But I should be inclined to give these a rather lower priority. Not to revalorise indirect taxes is expensive: Annex 2 shows that it would cost over £0.5 billion, substantially using up our room for manoeuvre. Moreover, since inflation is low, the effect on prices of full revalorisation across the board is relatively small (less than 0.5 per cent on the Retail Price Index). It may be right to consider partial exemptions for individual duties, but the general presumption must I think be to go for revalorisation. Cuts in VAT would make little economic or political sense.

12. Annex 3 sets out some background on how personal and corporate taxation have moved and Annex 4 shows the revenue effects of changes in the main taxes. Points to consider include the following:

i. the case for increasing income tax thresholds over and above Rooker/Wise is strong. Our record on personal taxation (taking National Insurance contributions into account) is not good, as Annex 3 shows. A significant increase in thresholds could well bring benefits in wage bargaining, and would help alleviate the poverty and unemployment traps;

ii. the most obvious ways of giving direct help to industry are a further reduction in the National Insurance Surcharge (NIS) - which would follow the pattern of the last Budget - or a reduction in Corporation Tax - the only main tax rate which we have not reduced. Clearly we want to help encourage improvements in competitiveness and the rebuilding of companies' profit margins. On the other hand, companies are already benefitting from the further percentage point cut in NIS, announced in the Autumn Statement, and from falls in both interest rates and the exchange rate.

13. In some respects it is a mistake to distinguish too sharply the case for particular forms of tax reduction. When second round effects are taken into account the medium-term consequences of different forms may often be strikingly similar (eg for unemployment, GDP and company income). But I would welcome colleagues' views on the right balance between the two categories of possible general fiscal action.

14. The Budget will also include, as last year, packages of smaller measures targetted to help particular areas of industry or particularly deserving groups. I shall be in touch separately with individual colleagues concerned.

SUMMARY AND CONCLUSION

15. The recovery we expected last year has been delayed (though less here than in many countries abroad), but we expect significant real growth this year (and more than in the Organisation for Economic Co-operation and Development as a whole). We should maintain policies designed to combat inflation and improve competitiveness, and so promote faster growth and hence employment, on a secure and sustainable basis.

16. This approach is not inconsistent with real tax reductions, as the last Budget demonstrated.

17. I would welcome colleagues' views on all these matters on 3 February.

G H

Treasury Chambers

1 February 1983

CONFIDENTIAL

ANNEX 1

SELECTED ECONOMIC INDICATORS, 1979 TO 1983

	1979	1980	1981	1982	1983(1)
World GDP, volume (per cent change)	+3½	+1½	+1½	-1	+1 to +2
UK GDP, volume (per cent change)	+2	-2½	-2½	+½	+1½ to +2½
Domestic demand, volume (including stockbuilding) (per cent change)	+4	-3	-1½	+2½	+3 to +4
Retail prices Q4 (per cent change)	+17½	+15½	+12	+6	about 6½
Interest rates (average 3-month interbank)	14	16½	14	12½	11½ (5)
Current balance (£ billion)	-1	+3	+6	+4½	+1 to +3
Unemployment (UK, per cent, narrow, new definition)	5	6½	10	12	13 (2)

TAX AND PUBLIC EXPENDITURE 1979-80 TO 1983-84

	1979-80	1980-81	1981-82	1982-83	1983-84
Tax and NIC as percentage of GDP	36	37½	40½	40	-(4)
Public expenditure as percentage of GDP(3)	41	43	44½	44	43½
PSBR as percentage of GDP	5	6	4	3	-(4)

Notes:

(1) Provisional pre-Budget figures.
(2) Not a forecast. Figures based on assumptions in PEWP
(3) Including debt interest. PEWP figures.
(4) Depending on decisions to be made.
(5) On 25 January.

ANNEX 2

TAXATION: Effects of Indexation

DIRECT TAXES

The Retail Price Index increased in the year to December 1982 by 5.4 per cent. With indexation by this amount and statutory rounding, the figures for the main allowances and other thresholds would be:

Personal Allowances	1982-83	1983-84
	£	£
Single and wife's earned income allowance	1,565	1,655
Married allowance	2,445	2,585
Bands eg		
30% rate	1-12,800	1-13,500
60% rate	over 31,500	over 33,500
Investment Income Surcharge threshold	6,250	6,600

The total revenue costs of indexation (reflected in the forecast) are £845m in 1983-84, £1,080 m in a full year at forecast 1983-84 prices and incomes.

INDIRECT TAXES

Excise duties: increases based on 5.4% revalorisation with rounded price changes including VAT effects

	Typical price change	Revenue (a) £m	RPI impact effect %
Beer	1 pence/pint	90	0.1
Wine	5½ pence/75 cl light wine	25	neg
Spirits	25 pence/bottle	25	0.05
Tobacco	3½ pence/20 KS	115	0.15
Petrol	4½ pence/gallon	210	0.1
Derv	3½ pence/gallon	45	nil
VED	£5 car licence	90	0.05
Increased revenue (reflected in the forecast)		600	0.5 (b)

(a) First and full year revenue effects are largely identical

(b) RPI effects do not sum because of rounding.

TAX: BACKGROUND FACTS

Total taxation

1. Since the Government came to power total taxation as a proportion of GDP has risen by over 5 percentage points. The figures are as follows:-

Table 1:

Total taxation* as a % of GDP (market prices)

1978-79	34.4
1979-80	36.0
1980-81	37.3
1981-82	40.3
1982-83 (forecast)	40.2
1983-84 (assuming indexation)	about 40

(*Including National Insurance Contributions and local authority rates)

Personal taxation

2. To restore personal taxes (direct and indirect) to the same proportion of personal income as in 1978-79 would require reductions of some £9 billion. For income tax and national insurance the following table gives an idea of how the proportion of gross pay they represent has risen, particularly for the low paid:-

Table 2

Income tax and National Insurance Contributions as a percentage of gross earnings

	Married*		
	½ average earnings	Average earnings	2 average earnings
1978-79	16.4	28.0	31.6
1979-80	16.4	26.4	28.9
1980-81	18.2	27.5	29.9
1981-82	21.1	29.4	32.4
1982-83 (forecast)	21.3	30.0	32.5
1983-84 (assuming indexation)	21.7	30.3	32.8

(*Wife not working: the couple are assumed to have no children, to avoid distortion of the figures from the abolition of child tax allowances.)

In 1983-84 the employees' National Insurance Contribution will be 2½ percentage points higher than in 1978-79. Even with the indexation of allowances assumed in the forecast, in 1983-84 income tax and National Insurance Contributions as a percentage of gross earnings would increase for all family types over 1982-83 levels because of the rise in NIC announced in the Autumn Statement.

3. Because we were unable to make any change in personal allowances in 1981 tax thresholds have not risen as fast as prices since we came to office, and more slowly still than earnings:

Table 3

Personal allowances as a percentage of average earnings

	Single	Married
1978-79	20.1	31.3
1979-80	20.1	31.4
1980-81	19.8	30.9
1981-82	17.8	27.8
1982-83 (forecast)	18.6	29.1

Real net incomes are, however, higher than in 1978-79. The increase in the proportion of gross earnings taken in tax partly reflects the fact that earnings have risen faster than prices.

Company sector

4. Real rates of return have been falling since the early 1960s:

Table 4:

Net pre-tax real rates of returns

	Industrial and commercial companies excluding North Sea	Manufacturing companies
1960	13.2	13.2
1965	11.2	10.6
1970	8.7	7.5
1975	4.9	3.5
1979	5.3	4.3
1980	4.0	3.4
1981	3.2	2.1
1982 (estimated)	3.8	n.a.

Real interest rates are now above real rates of return.

5. But the tax burden on companies has not fallen:-

Table 5

Tax paid by industrial and commercial companies
(excluding North Sea)

£ billion

	Taxes on companies' income(3)	Employers(1) NIC and NIS	Rates(2)	Total	Total in constant prices(4)
1978	2.8	4.3	2.3	9.4	9.4
1979	2.8	5.4	2.5	10.7	9.4
1980	3.2	6.5	3.2	12.9	9.7
1981	3.6	7.0	4.0	14.6	10.0
1982 (estimated)	4.4	7.1	4.7	16.2	10.2

(1) Estimates of proportion paid by industrial and commercial companies

(2) Includes North Sea and unincorporated business.

(3) Includes mainstream corporation tax, ACT, and tax on company investment income.

(4) Deflated by total final expenditure deflator (1978 = 100).

6. Comparing Tables 4 and 5 shows that companies' ability to pay is falling, but that the demands made on them are rising.

REA · RECKONER: **Illustrative Tax Changes**

£ million at forecast 1983-84 income levels

	Direct Revenue Effect	
	1983-84	Full Year
INCOME TAX		
Allowances and Thresholds		
1% above indexation on allowances and Thresholds	140	180
1% above indexation on allowances only	130	160
Rates		
Change basic rate by 1p	850	965
Investment Income Surcharge		
Change threshold by 10% points	1	18
CORPORATION TAX		
Change main rate by 1 percentage point	65	115
Change small companies' rate by 1 percentage point	10	15

OTHER TAXES

	First year cost/yield	Full Year	RPI
Car tax: reduce from 10 to 5 per cent from 1 April 1983	240	325	-0.2
VAT: 1 per cent change	500	690	1.5
NIS: ½ per cent off from August 1983	200	400	
abolition of 1½ per cent rate from August 1983	650	1200	
(Assuming recovery from public sector)			

EXCISE DUTIES

The costs and effects of specimen changes in alcohol, tobacco and petrol etc can be seen from Annex 2.