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TO
CC(83) 3rd Conclusions, Minute 5

Thursday 3 February 1983

ECONOMIC STRATEGY

The Cabinet considered a memorandum by the Chancellor of the Exchequer (C(83) 5) on economic strategy.

THE CHANCELLOR OF THE EXCHEQUER said that the background to the Budget, to be presented on 15 March, was one of expectations of modest growth in the world economy. Recovery had been delayed in 1982, partly because of the difficulties experienced by the United States and West German economies and partly because of retrenchment by major debtor countries such as Nigeria and Mexico. Inflation and interest rates were, however, declining; and real demand was likely to expand in 1983. There were two main uncertainties. First, the scale and speed of recovery would depend on developments in the United States economy: it would be necessary for the Administration to tackle convincingly the problem of the mounting federal budget deficit in order to improve confidence and allow scope for reductions in interest rates. Secondly, the future movement of oil prices was uncertain. A moderate decline in the price of oil would be broadly helpful to world economic activity and inflation, and had little effect on the United Kingdom's balance of payments and public revenue. A sharp decline could however have adverse effects.

The 1982 Budget had envisaged a Public Sector Borrowing Requirement (PSBR) in 1982-83 of about £9.5 billion; the outturn was likely to be less. For 1983-84, the Medium Term Financial Strategy suggested a PSBR of about £8 billion. A higher figure would have little effect on activity and employment in the short term, but could seriously impair confidence, especially in the present state of uncertainty in the markets. His preliminary view was that it would be a mistake to publish a forecast PSBR for 1983-84 of higher than £8 billion. A figure of £8 billion would allow some scope for tax reductions besides the revalorisation of allowances and bands assumed in the economic forecasts. On indirect taxes, he would be reluctant to forgo a substantial measure of revalorisation. Full revalorisation would yield some £600 million a year but add only about 0.5 per cent to the Retail Price Index. There might, however, be a case for limiting the increase in petrol tax in order to protect rural areas. To the extent that direct taxes were reduced, it would be necessary to decide between the claims of industry and the personal sector. The Confederation of British Industry (CBI) were pressing strongly for relief through the abolition of the National Insurance Surcharge (NIS). It was undoubtedly desirable to encourage improvements in competitiveness and the rebuilding of companies' profit margins. Companies were, however, already benefiting from the previous reductions in NIS, and from falls in interest rates and the exchange rate. There was a stronger case for increasing income tax thresholds beyond the amount needed for revalorisation. This would be welcome to many of the Government's supporters, and would be appropriate in view of the Government's inability to reduce the burden of direct taxation to the extent that it had hoped to be able to do when it took office. A significant increase in the thresholds could well bring benefits in wage bargaining, and would help alleviate the poverty and unemployment traps.

Finally, he hoped that the Budget could include, as in 1982, packages of smaller measures targeted to help particular areas of the industry or deserving groups. He would be in touch separately with the Ministers concerned.

The following main points were made in discussion -

a. The Chancellor of the Exchequer was to be congratulated on the steadiness with which he had maintained the course of the Government's financial and economic strategy. This was the main reason why the Government now had useful freedom of fiscal manoeuvre. It would be politically and economically disastrous if the Government appeared to be departing now from the course which had been set.

b. It could be argued that, without departing from the Government's underlying policies, it would be possible to allow the PSBR in 1983-84 to be rather higher than the Chancellor of the Exchequer had suggested. A PSBR of £8 billion would be low in comparison with the average of industrialised countries; and the previous forecasts which had included it had assumed a rather higher level of economic activity than now seemed likely. It was improbable that the markets would react adversely if the PSBR were kept below £9 billion. On the other hand, there were great uncertainties, as C(83) 5 brought out, in the economic forecasts and in the current economic situation. These and other considerations argued for erring on the side of caution in the Budget. It would be better to be cautious in the spring and relax if appropriate later, than to relax too far in the spring and be obliged to retrench later. A further consideration was that real interest rates were at an exceptionally high level. Reductions in them would encourage industrial investment and new housebuilding, which were the keys to sound economic growth. The level of mortgage interest rates was also of central importance to many families. All these arguments told in favour of a cautious policy in respect of the PSBR.

c. A few members of the Cabinet took the view that any reduction in taxation should mainly benefit industry. The United Kingdom's industrial base was still weak. Strengthening it, and improving competitiveness, was the only satisfactory long-term solution to the problem of unemployment, which was bound to assume increasing political and social importance. One possibility would be to make a further reduction in the rate of NIS, as an earnest of the Government's intention ultimately to abolish it. But there were grounds for believing that the CBI's arguments in favour of this course reflected their difficulties in reaching agreement among their members rather than the true needs and wishes of individual companies. Moreover the fall in the exchange rate was now helping to make industry more competitive. It might be better to devise schemes of increasing capital investment, particularly in the West Midlands and other parts of the country which had been particularly hard hit by unemployment.

An alternative way of helping businesses, which could have some presentational advantage at relatively small cost, would be to reduce corporation tax.

d. Most members of the Cabinet, however, took the view that priority should be given to reductions in personal taxation, and to increasing income tax thresholds, rather than to reducing tax rates. Many workers on relatively low earnings paid surprisingly large amounts of income tax. Unless early action was taken to put this right the problem could become intractable for a long time. Raising tax thresholds would help to alleviate the problems of the poverty trap and the lack of incentive to take a job rather than rely on social security benefits. If possible, it would similarly be desirable to make a substantial increaase in the rate of child benefit.

e. On this occasion it would be desirable to make a striking improvement in one major area of the tax system rather than dissipate the effect by spreading the reductions over several areas. It would also be important, however, to supplement the major measures with an imaginative package of minor measures such as had featured in the 1982 Budget. These need not cost much, but could have a stimulating effect out of all proportion to their cost. Attractive possibilities were developments of the Enterprise Allowance Scheme and the Small Engineering Firms Investment Scheme. The latter could be particularly helpful to firms in areas such as the West Midlands, which had suffered an extremely sharp decline in comparison to their previous history. It might also be desirable to devote resources to alleviating unemployment, which was certain to continue to increase for some time to come, through such measures as the Temporary Short-Time Working Compensation Scheme, the Job Release Scheme, and improved youth training. There should also be a more imaginative and helpful attitude to fiscal measures, such as stock-option schemes, designed to encourage entrepreneurship.

f. It was open to doubt whether it would be possible to mount a scheme to increase public investment, as had been suggested in discussion, which would be economically justified and have sufficiently early effects to be useful. It was however regrettable that the undershoot in the PSBR for 1982-83 was partly the result of an unintended shortfall in capital expenditure in the public sector. Every effort should be made to prevent this from happening again in 1983-84.

g. The reduction in the oil price might have serious effects on the profitability of marginal fields on the United Kingdom Continental Shelf. It might be necessary to adjust the relevant financial regime in order to ensure that marginal fields continued to be exploited and developed.

h. There was some concern about the price of petrol, particularly in rural areas, and this should be borne in mind in considering the revalorisation of the relevant duties. Limiting the increase in the duty on DERV could in particular have beneficial consequences for industrial and agricultural costs. On the other hand rural areas had benefited from the greater prosperity of agriculture, as compared with industry.

i. Much attention had been given in the media to complaints about the rating of empty industrial and commercial premises. There were, for example, reports of roofs being removed from new buildings in order to avoid the payment of local rates. There might be scope for fiscal reliefs in this area. However, the factual basis for the reports was doubtful. The matter was under examination by the Secretary of State for the Environment and the other Ministers concerned.

THE PRIME MINISTER, summing up the discussion, said that there was general agreement on the assessment of the situation, on the outlook for the future and on the course to be followed.

The Cabinet -

Invited the Chancellor of the Exchequer to take account of the discussion in preparing his forthcoming Budget.

Cabinet Office

7 February 1983