2 The 1981 Budget: how did it come about?

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The 1981 Budget has a mythological status in the history of Margaret Thatcher's premiership. It was highly controversial at the time because its contractionary stance went in the face of the conventional view that, in a deep recession, fiscal policy should be relaxed, not tightened. No fewer than 364 academic economists wrote to *The Times* arguing just that. Yet, on the surface at least, the critics were proved wrong. The economy started to recover in the quarter following the Budget announcements. Consequently, the improvement in Mrs Thatcher's political fortunes from 1981 onwards is often seen as stemming from this Budget. Whether in reality the Budget was responsible for the economic turnaround and recovery, or whether they happened in spite of the Budget, as has been argued, is addressed elsewhere in this volume.

The aim of this chapter is not to argue the merits and demerits of the Budget but to examine how it came about. What were the views of the key players in the run-up to the Budget – the Prime Minister and her advisers, and the Chancellor, his ministerial team, Special Advisers and top officials – and how were these played out?

The answers to these questions are of interest because they throw light on decision making at the highest level at a critical moment in the Thatcher premiership, and on the clash of economic ideas prevalent at the time. They can also illuminate an old debate about the Budget's 'paternity': who among the principal players can claim primary responsibility for the main Budget decisions?

The case for revisiting the 1981 Budget process

The 1981 Budget has already been the subject of many accounts. Several of the key participants have published their recollections of what happened: Margaret Thatcher herself, Sir Geoffrey Howe and Nigel Lawson in their respective memoirs; and Thatcher's two key advisers in the No. 10

Policy Unit, Alan Walters and John Hoskyns.[1] There have also been accounts by others, notably by Thatcher's biographers, Hugo Young, John Campbell, and Charles Moore, and by economic journalist William Keegan.[2]

The case for this further examination of the 1981 Budget process is twofold. First, many of the relevant papers, which were not available to earlier writers, are now in the public domain. Neither Howe nor Lawson would have had access to papers prepared by Thatcher's advisers, nor to their diaries, which are now in the Thatcher Foundation archive; and Thatcher, Walters and Hoskyns would not have had access to many of the Treasury papers. Second, all five were writing from their own particular perspective, and it is legitimate to ask whether their accounts are biased. Other writers had the disadvantage of not being directly involved, and only Moore had access to most of the papers.

I was the Prime Minister's Private Secretary for Economic Affairs at the time, on secondment from the Treasury. My job, amongst others, was to coordinate the briefing and advice that Mrs Thatcher received from the Treasury and from others in and outside government on economic and financial matters. I was the note taker at her meetings with Howe in the run-up to the 1981 Budget, and I was in close touch with the No. 10 Policy Unit advisers and with the Treasury team – ministers, their Special Advisers, and officials. I was thus in a good position to observe how the thinking on the Budget developed. Moreover, I had – and have – no particular axe to grind. My first loyalty was to the Prime Minister, but I also had an allegiance to the Treasury insofar as the latter was my 'home' department, and it was my responsibility to ensure that the Treasury's views were properly understood and considered by Thatcher.

I was in the middle ground in terms of economic philosophy. Originally trained as an economist with a definite Keynesian bias, by 1981 I was well conscious of the limitations of fiscal policy as a tool of demand management, particularly in times of high inflation. I had learnt this from having worked on macroeconomic policy at the Treasury in the mid-1970s, at the time of Britain's request for assistance from the International Monetary

[1] M. H. Thatcher, *The Downing Street years* (London, 1993); R. E. G. Howe, *Conflict of loyalty* (London, 1994); N. Lawson, *The view from No. 11: memoirs of a Tory radical* (London, 1992); A. A. Walters, *Britain's economic renaissance: Margaret Thatcher's reforms 1979–84* (Oxford, 1986); J. A. H. L. Hoskyns, *Just in time: inside the Thatcher revolution* (London, 2000).

[2] H. J. S. Young, *One of us: a biography of Margaret Thatcher* (London, 1989); J. Campbell, *Margaret Thatcher*, 2 vols. (London, 2000, 2003); C. H. Moore, *Margaret Thatcher: the authorized biography,* vol. I, *Not for turning* (London, 2013); W. J. G. Keegan, *Mrs Thatcher's economic experiment* (London, 1984).

Fund. Equally, while acknowledging that control of the money supply was necessary if inflation were to be contained, I was no believer in the sort of crude monetarism that posited a one-for-one link between the growth of one or other monetary aggregate and price inflation, or that the short-run impact of a monetary squeeze could be principally on prices with only a minimal effect on real activity. I was therefore well positioned to understand, and present, the different views on macroeconomic policy making that partly underlay the different views on how the Budget should be constructed. To the extent that my own views counted – which was not a lot compared with Walters and Hoskyns and the Treasury team – I tended to the more cautious line of the Treasury 'doves'.

But the differences were considerably less than has sometimes been described – especially by Walters and Hoskyns. Howe and Moore correctly aver that, at the political level (i.e. between Margaret Thatcher and Geoffrey Howe) the Treasury and No. 10 were never far apart; and there were at least two senior officials at the Treasury, Terry Burns and Peter Middleton, whose thinking was close to that of Walters. To the extent that differences of view did exist, they were as much within the Treasury, and within No. 10, as between the two. Moreover, the views of several of the key participants switched during the course of the ongoing discussions – not least Thatcher and Howe themselves.

Previous accounts

The most detailed account of what happened is provided by Hoskyns. It draws heavily on his diary and makes for fascinating reading. But it is inevitably one-sided – as well as incomplete, because, when he wrote his book, he did not have access to key Treasury papers. Hoskyns writes that 'the top Treasury officials were totally opposed to what we were suggesting'.[3] He goes on to say that 'the shape of the Budget first emerged at an advisers' meeting in my office on 21 January – and in the end, Margaret and Geoffrey took the outsiders' advice rather than Whitehall's'.[4] Thatcher in her account tends to support Hoskyns' view that it was due to pressure from the advisers and herself that the public sector borrowing requirement in the Budget came out in the way it did.

By contrast, according to Howe and Lawson, the Treasury were working towards a similar PSBR goal as the Prime Minister's advisers throughout the Budget process; and the final Budget decisions were Howe's, albeit endorsed by the Prime Minister. If he and the Treasury team

[3] Hoskyns, *Just in time*, 283. [4] Ibid., 285.

approached the final decisions less single-mindedly and with greater caution, it was because they weighed the pros and cons – both political and economic – more carefully. Hoskyns essentially takes the view that Howe and Lawson altered the story with the benefit of hindsight so that they could take principal credit for a successful Budget.

At the same time, it can be asked whether there is not an element of hindsight in the Hoskyns/Walters accounts. After the Budget decisions had finally been taken, Walters argued that the budgeted reduction in the PSBR was inadequate. In his book, he skates over this. In a footnote, he does say that he 'would have preferred to have a figure [for the PSBR] below £10 billion'.[5] But then he goes on to say: 'I am convinced that the total thrust of the 1981 Budget was substantially right.'[6] Possibly he changed his tune because the Budget was seen in retrospect to have been a success, and because the PSBR outcome for 1981/82 came out £2 billion lower than in the Budget forecast.

Moore provides the best-rounded account. He captures well the sense of crisis and gloom at No. 10 in the months preceding the Budget, and he gives a good idea of just how exceedingly difficult the discussions were. This was in part because of Thatcher, who found it hard to understand how and why, under her overall direction, things had gone so badly wrong. Although he was one of her closest political allies, she was starting to lose confidence in her Chancellor – though this was as nothing compared with her relations with the Governor of the Bank of England, Gordon Richardson.[7] Thatcher's and Howe's methods were also very different. Howe liked to ponder long and hard about the trade-offs and risks he faced. Thatcher was more intuitive in her approach, and was more inclined to make snap judgements. These factors did not make for easy or coherent debate between the two.

In charting the discussions within No. 10, and between the Treasury and No. 10, in the weeks before the Budget, Moore's reading of what happened is largely correct. Yet in one critical respect (of which more below) he is wrong; and this leads him to attach greater importance to Thatcher's role in the final decision making than it deserves.

[5] Walters, *Britain's economic renaissance*, 87. [6] Ibid., 88.

[7] Thatcher's relations with Richardson by this time were at rock bottom. She blamed him for failing to keep the money supply under control – albeit with only limited justification: the chosen aggregate, £M3, was notoriously difficult to control over the short term; the target for 1981/82 turned out to have been set far too low in view of structural changes affecting broad money (i.e. the ending of the 'corset'); and the £M3 overrun was partly due to the government's failure to meet its PSBR target and the lower than forecast level of activity. She also blamed him for being slow to accept the case for monetary base control. In addition, she had a general mistrust of the Bank of England, as an institution too close to its City clients and too far from her control.

Mrs Thatcher's advisers

Moore also fails to capture quite how fraught the relations between Thatcher and her advisers could be. On this, Hoskyns is a better guide – while Thatcher provides little sense of it at all. She rarely saw fit to ask for their views. Instead, it was they who constantly had to take the initiative in drawing issues to her attention and putting forward advice. Sometimes this was welcomed, at other times it was not. She blew hot and cold, on some occasions treating them as her closest confidants, at other times shutting them out altogether. The volatile nature of their relationship was all too evident in the 1981 Budget deliberations.

Hoskyns had worked with Thatcher in opposition as an occasional adviser, and after the 1979 election he became head of the Policy Unit at No. 10. Her relations with him were ambiguous. He was a former army officer and successful businessman, good-looking and charming. She had a high regard for his analytical capability, and for his economic vision and commitment to her cause. On the other hand, she found his thinking overly conceptual and systems-oriented, and insufficiently grounded in what she felt was practical. She didn't rate his political sense.[8]

Hoskyns, for his part, was frequently frustrated by her unwillingness to think strategically and logically, or to engage in serious debate. He saw the running of the country like the running of a very large company; she was less taken by the analogy. He was openly critical of her management and leadership style. She disliked the apocalyptic tone and rough language of some of his memos. She preferred the more guarded and respectful language of the civil service. And she didn't quite trust him and Walters to maintain her confidences. For all the devotion they showed to her personally, and their wish for her to succeed, she felt they shared too much information with colleagues outside No. 10. Hoskyns thought that her insistence on secrecy stifled useful debate.

Walters was a monetarist economist of great distinction, and his presence as adviser after January 1981 certainly accorded her ill-formed monetarist views greater weight and shifted the balance of power between No. 10 and the Treasury. Thatcher valued the clarity and freshness of his thinking, and his ability to take on the Treasury and the Bank of England. She also admired the fact that he had 'come a long way' – in some respects, a good deal further even than herself. His father, like hers, was a grocer, but – in stark contrast to Alfred Roberts – a communist.

[8] Hoskyns accepted that politics was not the Policy Unit's strong suit. In December 1980 he admitted that 'we are amateurs in the political field': J. A. H. L. Hoskyns, 'Government strategy', 19 December 1980, London, TNA, PREM 19/174, MTFW 113306.

Walters left school at age fifteen and initially worked as a machine operator in a shoe factory, before enrolling at his home-town university, Leicester, while she went from grammar school in Grantham to privileged Oxford. He later had a brilliant career as an academic economist in the United Kingdom and the United States.

Walters had a disarming self-confidence, which helped to give Mrs Thatcher renewed hope that a way forward to a sustainable recovery could be found. On the other hand, she considered him politically and bureaucratically naïve, and too much the academic economist, with insufficient understanding – because of his years spent in America – of the political problems she faced inside and outside her party.

One other adviser at No. 10 needs to be mentioned: political adviser David Wolfson. Scion of the Wolfson retail family, he had also worked for Thatcher in opposition. He worked closely with Hoskyns and Walters and provided a practical, common-sense and calming influence when, at times, calm and practicality were in short supply. Yet, as we will see, on the 1981 Budget his influence was anything but calming.[9]

Policy challenges

In what follows, I review the key papers – including the records I made of the Thatcher/Howe meetings – to see how the thinking of the two leaders and their respective advisers developed. In doing so, I examine the question of whether she and her advisers were instrumental in achieving the £10.5 billion PSBR in the Budget, or whether the Treasury team – ministers and officials – were heading for this level of PSBR anyway. The detailed chronology, especially in the final couple of weeks, is important for providing an objective answer to this question.

I focus principally on the Budget stance (i.e. the PSBR). But of course, as in any budget, there were numerous decisions to be taken on the composition of the measures to meet the chosen PSBR target, which in the end involved a PSBR reduction package of £4 billion, roughly equivalent to 1¾ per cent of GDP. These were entirely made up of tax increases, including substantial increases in indirect taxes and in income tax; an additional tax on North Sea oil production; and a special levy on bank deposits.[10] The discussions between the Treasury and No. 10

9 Wolfson's official title was 'Chief of Staff'. This was misleading, as no staff at No. 10 reported to, or through, him.

10 The additional tax on North Sea oil had in fact been announced in November 1980, so there was an element of double counting to make the Budget package appear tougher than it actually was.

regarding the particular tax increases were relatively painless, compared with the PSBR discussions. Agreement on most of them, including the controversial levy on bank deposits and the sizeable hike in indirect taxes, was reached without much difficulty. There was one exception: whether to raise the basic rate of income tax or whether to freeze the personal income tax allowances. The No. 10 advisers, with periodic support from Thatcher, strongly favoured the former; the Treasury team, after considerable internal debate, in the end favoured the latter.

There was one other particular theme running through the internal Treasury discussions throughout the winter months: the need to switch resources from wage and salary earners, who had been doing rather well through the recession provided they kept their jobs, to the increasingly loss-making corporate sector. This came to be known as the 'Burns–Middleton hypothesis'. The question was whether to use some of the revenue from increased personal taxes to help industry. In the end, it was decided not to give any significant breaks to the corporate sector and to use the bulk of the extra revenue to reduce the PSBR. (Companies did receive some help but this was limited to £200 million in stock relief.) Thatcher expressed a preference for giving priority to the PSBR reduction in view of the lower interest rates that she believed the latter would bring about and from which companies would benefit (though the Confederation of British Industry did not think much of this argument); but the issue did not feature prominently in their discussions. Basically, the issue was decided by Treasury ministers, albeit with Thatcher's support.[11]

To all the participants, it was clear by the second half of 1980 that economic policy was in a serious mess. The Medium-Term Financial Strategy, a four-year programme of gradual reductions in the PSBR and the growth of the money stock, had been launched with great fanfare as part of the 1980 Budget. Its aim was to provide a credible plan for bringing inflation down permanently and reducing the burden of government borrowing, and thereby create the conditions for restoring prosperity. By the autumn of 1980 it was abundantly clear that, in its first year, the MTFS was already seriously off track. The PSBR was running way over forecast, owing to extra spending on the nationalised industries, a disastrous public sector pay round and reduced revenues and higher social security payments resulting from worsening levels of economic activity.

[11] Amongst Treasury ministers, Lawson appears to have led the way in favouring a lower PSBR over tax breaks for the corporate sector. See, for example, his remarks in A. J. Wiggins, 'Note of a meeting held at No. 11 Downing Street on Tuesday, 27 January, 1981 at 9.30 am', 28 January 1981, private office files of Geoffrey Howe, MTFW 127452.

In the 1980 Budget, the PSBR had been forecast by the Treasury at £8½ billion. By November the forecast for 1980/81 was revised upwards to £11½ billion, an increase equivalent to 1½ per cent of GDP – and the eventual outturn was £13¼ billion. The monetary aggregate that the MTFS had chosen to target, £M3 (broad money), was running wildly over its target range owing to the ending of quantitative controls over the banks' deposit taking (the so-called 'corset') and other unforeseen factors, especially the overshooting of the PSBR. After peaking in May 1980, inflation was coming down; but other economic indicators were mainly negative. Company profits were being squeezed by high interest rates and by an impossibly high exchange rate; output was continuing to fall; and unemployment was rising inexorably. In the 1980 public spending 'round', the Treasury had been unable to rein back spending for 1981/82 and beyond on any significant scale. The government seemed unable to stem the haemorrhaging of taxpayers' money into the steel, coal and automobile industries. As a result, if the PSBR overrun in 1980/81 was to be reversed and brought back more in line with the MTFS in 1981/82, the main burden would have to be borne by tax increases – the opposite of what the government had been elected to deliver.

The policy challenges were therefore very considerable indeed. In particular, what could be done to revive the corporate sector's profitability? What could be done to bring down the exchange rate? And what could – and should – be done to restore the credibility of the MTFS with respect to the money supply and the PSBR?

The November 1980 mini-Budget

The Treasury did not wait until the 1981 Budget to address these issues. On 24 November 1980 Howe announced revenue increases amounting to £2 billion (about ¾ per cent of GDP), roughly half from an increase in employees' national insurance contributions (NICs) and the other half from an increase in petroleum revenue duty. (Denis Healey for the Labour opposition said that Howe should *increase* the PSBR by £7 billion in 1981/82.)[12] On the same day the Bank of England's Minimum Lending Rate was reduced by two percentage points in an attempt to assist industry and reduce the upward pressure on the exchange rate – and this despite the risk that it might further inflate £M3 and make gilt sales more difficult.

Both practically and philosophically, the November measures can be seen as a precursor of the 1981 Budget. Despite major concerns about the

[12] House of Commons debate (hereafter 'HC Deb.', as reported in Hansard), 24 November 1980, vol. 994, c209.

ongoing recession, action was taken to rein back the budget deficit rather than increase it, and one of the purposes was to make possible a cut in interest rates so as to restrain the upward pressure on the exchange rate.

Initially, there was no appetite among ministers for fiscal action ahead of the 1981 Budget. The Conservatives had come to power highly critical of Labour's frequent resort to mid-year fiscal corrections, or 'mini-budgets'. The Prime Minister and Treasury ministers alike were keen to see monetary growth brought under control, as well as a drop in the exchange rate. But they did not regard early action to reduce the PSBR as a priority. Thus, at a meeting on 22 September between Treasury officials and ministers to discuss the overall economic situation, Lawson is recorded as noting that tax increases might be necessary in the 1981 Budget, but that it would be 'undesirable for the Government to take hasty and perhaps inappropriate action now'.[13] Any announcements in his view should focus on other measures to reduce monetary growth – possible funding initiatives and even controls on credit. Howe did not show any enthusiasm for early fiscal action either, though he did authorise discussions to take place on a contingency basis for an increase in employees' national insurance contributions.[14] And there was no push from the Prime Minister or from the No. 10 Policy Unit for the early announcement of action to reduce the PSBR. Instead, as a way of directly curbing the upward pressure on sterling, Thatcher showed a passing interest in re-imposing exchange controls, only to be rebuffed by Howe.[15]

Treasury officials took a different view. At the 22 September meeting, the Permanent Secretary, Sir Douglas Wass, and the Second Permanent Secretary, Bill Ryrie, both argued that an early reduction in interest rates would be credible only if it was accompanied by the announcement of measures to reduce the PSBR.[16] It was this view – a clear foretaste of the logic behind the 1981 Budget – that in due course prevailed in Howe's 24

[13] A. J. Wiggins, 'Note of a meeting held in the Chancellor of the Exchequer's room, HM Treasury at 9.30 am on Monday, 22 September 1980', TNA, T386/544, MTFW 128330.

[14] Ibid.

[15] See chapter by Christopher Collins, 'Origins of the Budget in 1980', in this volume.

[16] A. J. Wiggins, 'Note of a meeting held in the Chancellor of the Exchequer's room, HM Treasury at 9.30 am on Monday, 22 September 1980', TNA, T386/544, MTFW 128330. It is ironic that the call for fiscal action came from two of the Treasury's so-called 'doves'. Neither Wass nor Ryrie ever found favour with Mrs Thatcher. She considered Wass tainted by his association with Labour's policies and by his lack of enthusiasm for the MTFS. As for Ryrie, she had clashed with him when she visited Washington as leader of the opposition in 1977 and he was the Treasury representative in Washington at the time. At a briefing meeting, he contradicted her on her analysis of American economic policy. They had another unsatisfactory meeting when she visited Washington as Prime Minister in 1979. When Ryrie returned to London in 1980 she undoubtedly held these two encounters against him, and as a result his career in the civil service effectively stalled.

November mini-Budget. Following the 22 September meeting, Ryrie told Kit McMahon, Deputy Governor of the Bank of England, that 'officials were more concerned about the PSBR and the necessity of fiscal action than ministers'.[17]

Howe naturally discussed the November measures with Thatcher, but, in contrast to the period immediately running up to the Budget, her advisers played no significant role. Alan Walters had not yet arrived at No. 10, and before his arrival the No. 10 Policy Unit did not get closely involved in macroeconomic policy. (Its main concerns prior to Walters' arrival were overall government strategy, public spending, the nationalised industries, and the trade unions and employment law.)

The Treasury's internal forecast of the PSBR for 1981/82 just prior to the November measures was 4½ per cent of GDP (about £11 billion), compared with 3 per cent (about £7½ billion) in the MTFS.[18] With the November measures, the PSBR forecast ought to have reduced to around £9 billion. By the middle of December, however, the forecast had deteriorated again to around £10½ billion.[19] So, unless there were to be a substantial adjustment to the MTFS projection to allow for cyclical factors, there would need to be further action in the upcoming Budget if the PSBR path was to be made consistent with the MTFS.

Donald Derx, an exceptionally knowledgeable official at the Department of Employment, suffered a similar fate, after clashing with her on the details of trade union law. See Moore, *Margaret Thatcher*, 424. (Thatcher was not averse to challenge; in fact, she enjoyed an argument. But it had to be on her terms, and preferably with individuals she already knew and trusted.) Both Wass and Ryrie were brilliant civil servants, loyal to the governments they served, and it was unfortunate and unfair that Thatcher never adequately appreciated them. Wass nonetheless saw out his term as Permanent Secretary. Ryrie took early retirement from the civil service and went on to serve with great distinction as head of the World Bank's private sector arm, the International Finance Corporation.

17 C. W. McMahon, 'Treasury thinking on economic policy', 25 September 1980, London, BOE, 7A134/16, MTFW 113082.

18 The PSBR forecast, prior to the November measures, is taken from a draft paper, 'The economic prospect and implications for policy', that the Treasury had intended to send to Thatcher around the end of October. A copy later found its way into Alan Walters' files at Churchill College, Cambridge. The paper argued for a PSBR reduction of £2.5 billion (compared with the £2 billion reduction achieved in the November measures). It explicitly ruled out a reduction – around £4 billion – of the size that would have been needed to get the PSBR back in line with the MTFS's 3 per cent of GDP, on the grounds that this would be too much in the light of the worsening recession. HM Treasury, 'Economic prospects and implications for policy', October 1980, Cambridge, Churchill Archives Centre (hereafter 'Churchill'), WTRS 1/1.

19 The mid-December forecast assumed a PSBR of £9 billion for 1981/82 (3¾ per cent of GDP) with a fiscal adjustment of £1 billion at 1978/79 prices (roughly £1.5 billion at 1981/82 prices) to achieve it: T. Burns, 'Medium term prospects and the fiscal adjustment', 16 December 1980, private office files of Geoffrey Howe, MTFW 127437.

Views of ministers, officials and advisers

This was the situation that faced the Treasury when Budget discussions started in earnest in January 1981. During January Walters arrived as Thatcher's economic adviser, and he immediately brought an additional consideration to bear. Bolstered by advice from Professor Jürg Niehans from Berne, he was convinced that the £M3 overrun was giving an entirely misleading impression of monetary laxity, and that monetary policy – as indicated by the high exchange rate and the slow growth of narrow money (M0 and M1) – was too tight.[20] The point was not entirely new: the Bank of England had been making it for months. But Walters' championing of it gave it immediate traction at No. 10. The priority had to be to get interest rates down further. This in Walters' view further strengthened the case for a tight budget, since an MLR cut would be credible to the markets only if the PSBR was brought back under control.

At this point, there was no one amongst the top Treasury officials who believed there was any option but to reduce the PSBR. They had already shown this by taking the initiative in proposing the revenue package in November. But, not surprisingly, there were differences of opinion as to how much it should be reduced. Too much of a reduction could put an excessive squeeze on economic activity at a time when the economy was still in deep recession and there was no certainty of an upturn; and inflation was already falling quite rapidly, so there was little need for further downward pressure. Too small a reduction would fail to impress the markets, make it impossible to reduce MLR, risk a funding crisis and make it difficult to restore credibility to the MTFS. It was a fine judgement where to draw the line, bearing in mind also what was politically feasible. Howe needed to hear both sides of the argument – and he did. As he says in his memoirs, the Treasury was not a monolith.[21]

The balance of opinion amongst the top Treasury officials was on the side of caution (i.e. what Hoskyns described as 'underkill'). Wass and Ryrie were in this camp, as were Brian Unwin, the Under Secretary in charge of budget coordination, and Howe's Principal Private Secretary, John Wiggins. These officials may have had personal doubts – and Wass certainly did – about the monetarist philosophy as embodied in the MTFS; but the record suggests that they repressed those doubts and provided the best possible advice, as they saw it, within the framework

[20] Niehans was brought in as a consultant on Walters' advice and paid for by private Conservative supporters.
[21] Howe, *Conflict of loyalty*, 200.

of the MTFS. If they showed caution, it was because – with the key MTFS targets quickly proving untenable – they were worried about the impact on the real economy of trying to re-establish them too quickly.

There were two prominent officials who took a more hawkish line on the PSBR, however. The Chief Economic Adviser, Terry Burns, was one of the intellectual architects of the MTFS from his time as professor at the London Business School, and he was close to Walters in terms of monetarist philosophy. Peter Middleton, the Deputy Secretary in charge of monetary policy (and later to succeed Wass as Permanent Secretary), was of a more pragmatic bent, seeing a significant lowering of the PSBR as an essential precondition for getting the money supply back under control and for lower interest rates.

But the views of the 'doves' and the 'hawks' among Treasury officials on what the PSBR for 1981/82 should be were never very far apart. Judging from the Treasury papers, they never diverged by more than £1 billion, less than ½ per cent of GDP, even as the PSBR forecast worsened. In short, the differences within the Treasury official team were not that significant, and were well within the margin of error in forecasting the PSBR.[22] By the same token – insofar as the 'hawks' in the Treasury held similar views to Walters' – the differences between the 'doves' in the Treasury and the No. 10 advisers, except in the latter's more excitable moments, were not very significant either. Conceptually, the relatively small differences essentially turned on how much adjustment should be made to the MTFS projection to allow for the worse than previously projected economic outlook. Even Walters accepted that a significant adjustment needed to be made – which is why his views were not that different from the official Treasury view.

At the start of the Budget discussions, the range of views amongst the Treasury political team was rather greater. Shortly before Christmas 1980 Howe asked his ministerial colleagues and Special Advisers for their first 'sighting shots' on the Budget. They came back with a range of answers. At one end were the Economic Secretary, Peter Rees, and the Treasury minister in the Lords, Arthur Cockfield, who suggested little or no fiscal adjustment at all. In the middle were the Chief Secretary, John Biffen, the Financial Secretary, Nigel Lawson, and Special Adviser Adam Ridley, who suggested an adjustment so as to bring the PSBR down to around 3½ per cent of GDP, half a percentage point above the MTFS number. At the

[22] The average error in forecasting the PSBR one year ahead in the 1970s was about 1.5 per cent of GDP (£3.5 billion in 1981 prices). See *FSBR 1981–82* (London, 1981), 28, tab. 10.

other extreme was Special Adviser Peter Cropper, who suggested a PSBR of 2½ per cent of GDP – well below the MTFS number.[23]

Howe was famously collegiate in terms of wanting to hear and ponder the views of his Treasury colleagues and advisers. To others outside the Treasury, including Thatcher, his decision making seemed unnecessarily tortuous – especially if it meant shifting his position from one day to another, as happened with the 1981 Budget. What it did mean, however, was that – once he had made up his mind – every possible angle had been covered.

Among his ministerial colleagues, Howe relied more than any other on Lawson. Lawson, who would succeed Howe as Chancellor of the Exchequer in 1983, was only a Minister of State, whereas Biffen was a member of the Cabinet. But Biffen, though a Thatcherite politically, had been opposed to the MTFS, and in his role as Chief Secretary he was held partly responsible for failing to curb public spending. Moreover, in early January 1981 he was moved sideways to become Secretary of State for Trade. His successor as Chief Secretary, Leon Brittan, though a close friend and confidant of Howe, had limited financial experience or expertise. Lawson, by contrast, could rightly consider himself the political progenitor of the MTFS, and he had a strong track record as an advocate and exponent of neoliberal economics in opposition and then as a Treasury minister. Not surprisingly, when it came to the 1981 Budget, he was consistently hawkish on the PSBR.

Like others, Lawson saw the reduction in the PSBR as essential for restoring credibility to the MTFS, and thereby to improving market expectations with regard to inflation and private investment. All the participants in the Budget discussions believed that a lower PSBR, assuming the reduction was large enough, should allow a reduction in interest rates. Lawson subsequently wrote that the link between the PSBR and interest rates was overstated.[24] He has also claimed that he didn't think much of the argument at the time. In fact, it is not obvious from the Treasury records that his view was different from the consensus Treasury view – namely that, while a lower PSBR would not

[23] Principal Private Secretary John Wiggins advised the Chancellor that 'I doubt the merits of going for a notably tighter fiscal policy next year than our current stance would suggest': A. J. Wiggins, '1981 budget', 18 December 1980, private office files of Geoffrey Howe, MTFW 127445.

[24] Lawson writes that 'short term interest rates. . .are determined not by the scale of the PSBR but by the needs of the government's anti-inflation policy'. He goes on to argue that, 'as the capital market was becoming increasingly a single global market, the public borrowing of any one country – with the important exception, because of its sheer size, of the United States – had a correspondingly diminished effect': Lawson, *The view from No. 11*, 90.

automatically lead to lower interest rates, a lower PSBR was more likely to be compatible with lower interest rates than a higher PSBR. Thus, in a post-Budget statement, he said of Labour's spending plans that, with unchanged monetary targets, 'the effect of borrowing more would be higher interest rates'.[25] Nonetheless, insofar as he understood these things better than most, he may well have been concerned that Thatcher and Howe were placing too much emphasis on the PSBR/interest rate link per se, rather than the effect of a lower PSBR on expectations more generally.[26]

At No. 10, Walters and Hoskyns, along with Wolfson, were consistently on the side of 'overkill'. They were partly influenced by what they saw as the Treasury's consistent tendency to underestimate the PSBR. This was certainly true of 1980/81, though in the 1970s the Treasury had in fact as often overestimated as underestimated it.

Hoskyns viewed the PSBR through the lens of the systems analyst as a 'stabilisation' issue: he believed that without a serious reduction in government borrowing, and preferably its eventual elimination, the economy would never stabilise. He wanted to maximise the PSBR reduction so as to impress the markets and restore credibility to the government's economic strategy and stability in the economy.

Walters approached the problem as a macroeconomist. With the level of PSBR in prospect, he believed that the confidence effect for the private sector of a very tight Budget, along with lower interest rates, would outweigh any direct deflationary impact. As prescribed in the MTFS, there had to be a progressive reduction in the structural deficit; but he was prepared to accept some adjustment to the PSBR projections in the MTFS to take into account cyclical factors.[27] For both Hoskyns and Walters, the link between a lower PSBR and lower interest rates and a lower exchange rate was crucial. They were less interested in the link between the PSBR and £M3 because the latter, in their view, was largely discredited as a monetary indicator.

Mrs Thatcher was drawn instinctively to their general point of view, though she attached more importance than they did to the link between

[25] N. Lawson, 'The Budget Judgement', 12 March 1981, Oxford, Christ Church College, Lawson MSS, MTFW 128044.

[26] The distinction was slightly academic, for, while there was no mechanistic link between the PSBR and interest rates except under very restrictive conditions, an improvement in market expectations brought about by a reduced PSBR was likely to result in lower interest rates.

[27] Walters writes that 'the policy of increasing the 1980 projected deficits by some 1.25 to 1.75 percent [of GDP] does not seem outrageously perverse. On the contrary, it appears to be in the appropriate ballpark.' Walters, *Britain's economic renaissance*, 82.

the PSBR and £M3, which – despite her interest in monetary base control – she was not ready yet to jettison. She and her Chancellor had invested too much political capital in the control of broad money as a means of controlling inflation.

There was also Robin Ibbs, head of the Central Policy Review Staff in the Cabinet Office. Ibbs was a senior executive at Imperial Chemical Industries (ICI), one of Britain's largest trading companies, on secondment to the government. He had a better idea than anyone else with access to Thatcher of the damage that the high exchange rate was doing to business. He was not part of the inner circle dealing with the Budget; but he nonetheless took every opportunity to argue that action had to be taken in the Budget to help the company sector and, in particular, to bring the exchange rate down. He doubted whether a reduction in interest rates made possible by the Budget would reduce the level of sterling sufficiently. The situation was so urgent that he favoured targeting the exchange rate and 'flexing' the monetary target as necessary.[28] Thatcher sympathised with his view that sterling had to come down, but a switch to targeting the exchange rate was anathema to the prevailing monetarist philosophy. Ibbs' was a lone voice in government on this issue at the time, and his proposal received no serious consideration.

Countdown to the Budget

On 17 January 1981 Thatcher held a special meeting with her advisers and with Howe and Burns and others from her inner political circle at Chequers. At this meeting, Howe warned of the worsened prospects for the PSBR (£11 billion, with the real possibility of further upward revision), and the need for a tough budget.[29] Walters and Hoskyns believed that the PSBR forecast would only get worse, which – unless it was dealt with – would produce a major economic crisis and in due course electoral

[28] In a letter to Howe dated 6 February 1981, Ibbs argued that a 10 per cent depreciation of sterling was needed – to bring the rate back to where it had been in early 1980. He suggested 'a system of monetary targets which could be temporarily flexed to eliminate unacceptable exchange rate changes whilst still retaining confidence in the basic monetarist approach'. It is doubtful whether commentators or the markets would have seen this as consistent with 'the basic monetarist approach': J. R. Ibbs, 'The 1981 Budget', 6 February 1981, TNA, PREM 19/438, MTFW 113992.

[29] I was not present and there were no minutes of the meeting. Hoskyns and Howe describe the discussion in broad outline. The PSBR forecast of £11 billion mentioned here is the figure mentioned by Burns at the meeting with the Governor of the Bank of England on 22 January: A. J. Wiggins, 'Note of a meeting held at 11, Downing Street at 8.30 am on Thursday, 22 January, 1981', 22 January 1981, BOE, 7A133/3, MTFW 117373; Hoskyns, *Just in time*, 260–1; Howe, *Conflict of loyalty*, 200–2.

defeat. From that moment they made it their principal goal to ensure a budget that would bring about the maximum possible reduction in the PSBR.

Howe met with the Governor of the Bank of England on 22 January. He revealed the same worsening story on the PSBR and the need for contractionary action in the Budget. The Governor told Howe that the Bank were more pessimistic than the Treasury about the economic outlook and 'questioned whether – in the light of the recessionary prospect – it would be appropriate to tighten both fiscal and monetary [sic] policy'.[30] At this and other meetings in the run-up to the Budget, Richardson and his Bank of England colleagues were clearly on the side of the 'doves'.[31]

On 27 January Howe held a meeting with his ministerial team plus officials and Special Advisers. Wass started the meeting by telling Howe that 'officials were generally agreed that a net contraction of around £1.5 billion would be sensible'.[32] The aim would be to deliver a PSBR of between 4 and 4½ per cent of GDP (around £10 billion), and thus a downward path from the 5½ per cent of GDP now likely for 1980/81. Lawson is recorded as saying that the markets would be very pleased with a figure of £10 billion provided they believed it. Howe concluded that the PSBR reduction should be a minimum of £1½ billion.[33]

Howe followed this meeting up with a note to the Prime Minister on 5 February. He reminded her that the PSBR forecast (which assumed full indexation of personal tax allowances and specific duties plus the £2 billion of revenue measures announced in November) was about £11 billion, compared with around £7½ billion implied in the MTFS. 'Taking into account the extent of the recession,' he wrote, he would be aiming for a PSBR 'somewhat below £10 billion' with a PSBR reduction package amounting to £1 to 1½ billion.[34] On seeing this note, Walters advised the Prime Minister that it would be better to plan on a PSBR reduction of £2 billion rather than £1½ billion, in order to reduce the

30 There is no mention of anyone at the meeting suggesting a tightening of monetary policy: A. J. Wiggins, 'Note of a meeting held at 11, Downing Street at 8.30 am on Thursday, 22 January, 1981', 22 January 1981, BOE, 7A133/3, MTFW 117373.

31 Howe says no one ever explained to him why the Governor failed to provide his customary 'Budget judgement' letter. With their views so out of line with the views of the Treasury team, Howe perhaps should not have been surprised that the Governor did not bother to send in formal advice on the 'Budget judgement'. Richardson met him again and again in the weeks running up to the Budget; Howe was hardly left in the dark as to what he thought. Howe, *Conflict of loyalty*, 204.

32 A. J. Wiggins, 'Note of a meeting held at No. 11 Downing Street on Tuesday, 27 January, 1981 at 9.30 am', 28 January 1981, private office files of Geoffrey Howe, MTFW 127452.

33 Ibid.

34 'R. E. G. Howe to Prime Minister', 5 February 1981, TNA, PREM 19/438, MTFW 113990.

funding burden further and improve the prospects for bringing down interest rates and the exchange rate.[35]

On 10 February Howe had the first of five meetings with Thatcher in which they discussed the Budget stance and the PSBR. Wass and Burns were also present for the Treasury, and so were Walters and Wolfson. Howe revealed that the PSBR forecast had now jumped to £13 billion, so, to bring the PSBR back to below £10 billion would be extremely difficult. Burns said it would be hard to defend a PSBR any higher than £10 to 10½ billion. They discussed the main options for bringing in more revenue. Howe had ruled out the practical feasibility of expenditure cuts at this late stage for 1981/82 and the political feasibility of an increase in income tax rates. (This would have meant putting into reverse one of the main planks of his first Budget, in 1979.) He had to rule out any increase in tax on the corporate sector (apart from the oil producers) because of its poor financial state; if anything, he would wish to offer the sector some tax reliefs. The main options he was left with, bearing in mind that he was already intending a special levy on bank deposits and the additional tax on North Sea oil production announced in the November mini-Budget, were increasing indirect taxes by more than inflation and limiting the increase in personal income tax allowances to perhaps only 6 per cent, compared with over 15 per cent if there were to be full indexation.[36]

Thatcher responded that the greatest priority was to improve industrial activity, which meant reducing the PSBR to enable a reduction in interest rates and the exchange rate.[37] Walters followed up with a note to Thatcher warning that the PSBR forecast could well rise further, and that therefore there was a real risk that the Budget measures would be inadequate – requiring a mini-Budget later or leading to a funding crisis.[38] He and Hoskyns and Wolfson met with Thatcher later that night to ram home the point. They thought they had succeeded. But then, the next day, Hoskyns was dismayed to hear that she scarcely seemed to remember what they had discussed.[39] In the wake of this, Hoskyns, Walters and Wolfson sent Thatcher another note warning of the dangers ahead and

[35] 'A. A. Walters to Prime Minister', 6 February 1981, TNA, PREM 19/438, MTFW 113994.

[36] Following the 1977 so-called Rooker–Wise amendment, personal allowances were automatically indexed to inflation unless countermanded by Parliament.

[37] T. P. Lankester, 'Note for the record', 10 February 1981, TNA, PREM 19/438, MTFW 113996.

[38] A. A. Walters, 'The Budget, etc.', 10 February 1981, TNA, PREM 19/438, MTFW 113997.

[39] Hoskyns, *Just in time*, 269–70.

pressing again for a tough budget. They later found she hadn't bothered to read it.[40]

In briefing Thatcher for her next meeting with Howe, on 13 February, I advised that the PSBR forecast had risen yet again – to £13¾ billion. I suggested that it would be necessary to get the PSBR down to £10 billion to justify any reduction in MLR; but I also warned that the 'short-term effect [of such a large PSBR reduction] may arguably be too deflationary. We need to consider carefully the trade-off between the deflation caused by interest rates not falling, and the deflation which would come from what the Policy Unit call "over-kill".'[41]

At the meeting itself, Howe told Thatcher that he did not think it would be possible, given the new PSBR forecast, to reduce the PSBR below £11¼ to £11½ billion. Ideally, it might be desirable to reduce it below £11 billion, but he did not believe it was politically feasible. Walters intervened to say that the markets would be disappointed by a PSBR of £11 billion, and therefore there was the strong likelihood that Howe's measures would be insufficient. He didn't believe a PSBR of £10 billion would be any more deflationary than a PSBR of £11 billion, because the latter would be worse for expectations. He urged that consideration be given to raising the basic rate of income tax by one or two percentage points. Although no final decisions were taken, Thatcher indicated that she agreed with Howe that the package he was proposing was the most that was politically sustainable.[42] It was after this meeting that, according to Walters, she screamed at him: 'You are just an academic and you don't know what the political implications [of tax rises] are.'[43]

Hoskyns and Walters were sufficiently shocked by this turn of events that they began seriously to consider resigning. They felt that Howe and Thatcher were in 'self-denial' and that their advice was having no effect.[44]

But the story was by no means over yet. Four days later, on Tuesday 17 February, Howe came to see Thatcher again. I was the only other person present. Howe said that he was now seriously thinking of raising the basic rate of income tax by one percentage point and raising the personal allowances by 10 per cent rather than the 6 per cent he had earlier suggested. This combination would be fairer and would bring in some additional useful revenue. Thatcher said she was now 'veering towards the view that a PSBR of less than £11 billion was essential'; and, if there was extra

[40] Ibid., 271–3.
[41] T. P. Lankester, 'Meeting on the Budget', 13 February 1981, TNA, PREM 19/438, MTFW 114003.
[42] T. P. Lankester, 'Note for the record', 13 February 1981, TNA, PREM 19/438, MTFW 114002.
[43] Moore, *Margaret Thatcher*, 625. [44] Hoskyns, *Just in time*, 273.

revenue in his new proposals, she was willing to contemplate a basic rate increase.[45]

For some reason, Hoskyns and Walters were unaware that this meeting was taking place. Possibly Thatcher had already told me that they were no longer to be invited to her Budget meetings (see below), or it may have been because it was unscheduled, taking place immediately after an important statement in the House of Commons on the coal industry (the government had just caved in to the demands of the miners' union), which both Thatcher and Howe would have been present for.

My record of the 17 February meeting is dated that same day, and it was copied to Walters and Hoskyns.[46] But, for some reason, they ignored it; or perhaps they didn't fully appreciate the shift in Thatcher's and Howe's position from reading my note. Walters' diary records hearing about the meeting for the first time from me orally on 23 February.[47] I told him they had reached a provisional understanding on the need for an increase in the basic rate. I also, according to the diary, reported that Thatcher had told Howe that he had to get the PSBR below £11 billion, or 'you are for the chop'. The following day, 24 February, Walters passed on this information to Hoskyns, who described in his diary what he heard as 'an amazing *volte face*' on the part of Thatcher. He wrote: 'So our onslaught bears fruit at last?'[48]

The volte-face Hoskyns is talking about is clearly with reference to the Thatcher/Howe meeting on 17 February. Moore confusingly links it to the next meeting between Thatcher and Howe, on 24 February – in relation to which the remark makes no sense (as we shall see below).

My report that Thatcher had instructed Howe to reduce the PSBR or else he was for the 'chop' has become part of the 1981 Budget folklore.[49] I was likely exaggerating, or Walters was putting his own spin on what I said, for there is nothing in my record of the meeting to give any inkling – even allowing for the sanitised language of an official note – that she threatened him in this way: the essence is that they were both moving towards a PSBR of less than £11 billion. If she did use the word 'chop',

[45] T. P. Lankester, 'Note for the record', 17 February 1981, TNA, PREM 19/438, MTFW 114007.

[46] Ibid. Their names are shown as copy recipients. At some point Walters clearly read it, since there is a manuscript 'Wow' in the margin of his copy in his personal files at Churchill College. T. P. Lankester, 'Note for the record', 17 February 1981, Churchill, WTRS 1/5.

[47] A. A. Walters, 'Diary entry', 23 February 1981, Churchill, WTRS 3/1/1, MTFW 128827.

[48] Hoskyns, *Just in time*, 276–7.

[49] See, for example, Howe, *Conflict of loyalty*, 203.

which would have been uncharacteristic, it was probably out of exasperation with the political dilemma they both faced.

In the light of Thatcher's meeting with Howe on 17 February, she might have expected a note from Hoskyns and his colleagues acknowledging hers and Howe's change of heart on the PSBR and the basic rate. Instead, she got the opposite. On Friday 20 February the three advisers sent her a roughly worded memo warning that 'the present budget strategy leads to disaster'.[50] They pressed once again for a 'tough budget' – to include an increase in income tax rates, which would be seen as 'fair and honest in hard times', in preference to holding down the personal allowances. The memo didn't make clear how tough a Budget they now had in mind. Walters had been arguing for a PSBR in the region of £10 billion. Even if they still believed that Howe was aiming for a PSBR of around £11 billion, the difference was hardly sufficient to justify the memo's apocalyptic language. Or were they now suggesting an even tougher Budget?

Judging by her scant jottings on the memo, Mrs Thatcher wasn't pleased.[51] She must have been even less pleased when the advisers, having received no response to their Friday memo, sent her a further memo after the weekend with a copy of their earlier memo attached, warning that 'this is the eleventh hour, but it is still possible to choose a budget that gives some chance of success'.[52]

While Hoskyns and his colleagues, in apparent ignorance of the Thatcher/Howe meeting of 17 February, were firing off their singularly inappropriate weekend missiles, Howe was in fact changing his mind yet again. On the evening of Monday 23 February he sent Thatcher a note outlining his latest thinking: no increase in the basic rate after all, increasing personal allowances by only half the rate of inflation (i.e. by about 8 per cent), raising indirect taxes (other than value added tax) by twice the rate of inflation, and a PSBR of £11¼ billion.[53] In other words, this was a complete reversal of the position he had proposed on 17 February, and a reversion more or less to where he had been on 13 February.

Thatcher and Howe met again the following day (24 February), with only Wass and me in attendance. Implausibly, Thatcher writes in her memoirs that Walters was absent because he was 'engaged on some

50 A. A. Walters, D. Wolfson and J. A. H. L. Hoskyns, 'Budget strategy', 20 February 1981, TNA, PREM 19/439, MTFW 114016.
51 Ibid.
52 'A. A. Walters, J. A. H. L. Hoskyns and D. Wolfson to Prime Minister', 23 February 1981, Churchill, WTRS 1/3.
53 'R. E. G. Howe to Prime Minister', 23 February 1981, TNA, PREM 19/439, MTFW 114018.

other business'.[54] The truth is that I had been instructed by her not to invite him. I did not know precisely why at the time. I knew she was getting tired of Hoskyns' and Walters' pressuring her but I wasn't aware of their 20 and 23 February memos (which hadn't been copied to me) and how badly she must have taken them. These memos, and the fact that she felt that she was well aware of the economic arguments, and that the decisions were now essentially political, were almost certainly the reasons why she didn't want Walters or Hoskyns at the meeting. The fact that she allowed Howe to bring Wass with him made their exclusion all the more galling. Hoskyns writes despairingly of the secrecy that had overtaken the No. 10 deliberations.

At the meeting, she said she was dismayed that Howe was proposing once more a PSBR as high as £11¼ billion. She pressed for a PSBR of £10½ billion, which she suggested was the maximum figure that could justify any reduction in MLR. She argued that an increase in the basic rate could be justified on account of the increased spending on the National Coal Board and the British Steel Corporation, which somehow had to be paid for. Howe responded that he and his ministerial colleagues at the Treasury had concluded that an increase in the basic rate was not politically feasible.

My record of the meeting says that she 'remained concerned at the risks that the Chancellor was taking, but she was prepared to accept his political judgement that an increase in the basic rate was not possible'.[55] They then went on to discuss various suggestions from Thatcher on how to raise more revenue from indirect taxes, none of which were feasible. Although the record does not explicitly say so, my clear memory is that the meeting finished with Thatcher assenting – albeit reluctantly – to a PSBR of £11¼ billion. She did not believe she could push Howe any further. Moore writes that 'her point about the lower PSBR stood'.[56] But in what sense did it stand? Both Howe and Thatcher wanted a lower PSBR, but Howe did not think it possible and Thatcher did not insist on it.

I informed Hoskyns, Walters and Wolfson of what had happened. They were pleased that Thatcher had at least attempted to persuade Howe of the need for a PSBR below £11 billion, and of the case for an increase in the basic rate, but they were equally disappointed that she had not prevailed. Walters called on her early the following morning to double-check. According to Walters, she told him that she had told Howe that he had to take £3.5 billion off the PSBR (i.e. to reach a figure of £10.5 billion); and,

54 Thatcher, *The Downing Street years*, 136.
55 'T. P. Lankester to A. J. Wiggins', 24 February 1981, TNA, PREM 19/439.
56 Moore, *Margaret Thatcher*, 626.

when he pressed whether she was sure, she answered: 'Of course I'm sure. That's what you want, isn't it?'[57] The account in her memoirs is consistent with this when she writes: 'I told him [Walters] that I had insisted on the lower PSBR he wanted. But I still did not quite know how Geoffrey would react.'[58]

The reality, as my official record of the meeting shows, is that she did not tell Howe he had to take £3½ billion off. She had reluctantly gone along with a smaller reduction. She was either too upset or too embarrassed to tell Walters what had really happened.

After hearing the disappointing outcome of the 24 February meeting, Wolfson drafted what was, for him, an uncharacteristically brutal memo to Thatcher, in which he accused her of 'self delusion'.[59] He wrote that the 'political judgement is your own', that she would be held responsible by 'the City, the Country and the Colleagues' if there were a funding crisis, and that failure to act would be bordering on 'Criminal Liability' if the country were a company.[60] 'Does the Chancellor really hope to fool all of the people all of the time? Do you?'[61] The tone was so rough that Mrs Thatcher's principal Private Secretary, Clive Whitmore, who had not been much involved in the discussions to date, felt he had to intervene and show it to her in private. When she read it she was so incensed she tore it up. She had had enough of her advisers: she was not going to press their views on Howe any further.

While this was going on at No. 10 on the morning of 25 February, Howe had called an early meeting with his ministerial colleagues and senior officials at the Treasury. He said he had thought further overnight and had decided it was too risky to go for a PSBR of £11¼ billion, especially if the object was to reduce MLR by two percentage points. Perhaps he was influenced by Sir Keith Joseph, the Secretary of State for Industry, who had been briefed by Hoskyns the evening beforehand and had, according to Hoskyns, gone on to see Howe later.[62] In any event, Howe was now minded to go for a PSBR of £10.5 billion after all.

The ensuing discussion focused on two issues. First, officials suggested that Howe had a choice: he could either go for a PSBR of £11¼ billion and an MLR reduction of one percentage point, or a PSBR of £10½ billion and an MLR reduction of two percentage points. Treasury officials were divided: Ryrie and Unwin argued for the former on the grounds that it

[57] Ibid. [58] Thatcher, *The Downing Street years*, 136.
[59] 'D. Wolfson to Prime Minister', 25 February 1981, Churchill, HOSK 2/273, MTFW 127996.
[60] Ibid. [emphasis in original]. [61] Ibid.
[62] Howe has no recollection of meeting Joseph: telephone interview with Lord Howe, 6 August 2013.

would be less deflationary, Burns and Middleton for the latter (the opinion of Wass is not recorded). The other ministers and Howe's Special Adviser, Ridley, favoured £10.5 billion. This is what Howe decided – and, subject to further discussion with the Bank of England, a two percentage point MLR cut. Second, they had to decide how to finance this further PSBR reduction. Other options having been ruled out by now, there were only two possibilities: increasing the basic income tax rate by 1p or freezing the personal allowances. The former was less regressive (i.e. the burden would be spread more evenly and would be better from the point of view of making it worthwhile for people at the bottom end to seek work), but politically more difficult. All the ministers present, with Wass's support, agreed that freezing the allowances was easier to present than raising the basic rate; the latter would patently be seen as a tax rise whereas, with the former, nominal taxes would not be affected.[63] Lawson's preference in favour of freezing the allowances over any increase in the basic rate may have particularly influenced Howe, since it was he (Lawson) who from the Conservative benches had strongly supported the Rooker–Wise amendment in 1977; and he would therefore be especially prone to criticism if the allowances were not raised in line with inflation.

With the Treasury meeting concluded, Howe asked to see the Prime Minister, so that he could inform her before she left for the United States in the afternoon. He came over in the late morning. It was a strange meeting. Thatcher's mind was on other things: a speech she had to make at lunchtime to the Parliamentary and Scientific Committee, and her preparations for America and her first meetings with President Ronald Reagan following his recent election. Howe told her of his decisions on the PSBR and on the income tax allowances. She neither congratulated him on the former nor demurred on the latter. The official record (by me) simply says that she 'was content'.[64] It seemed she almost no longer wanted to know: it was now his Budget, despite the fact that she had been deeply engaged in Budget discussions with him for weeks. Perhaps she wanted ownership of the Budget now to be entirely his – even though no one would believe it – in case it all went badly wrong.

Mrs Thatcher instructed me not to tell her three advisers of this final turnaround.[65] She probably didn't want any further argument with them;

63 A. J. Wiggins, 'Note of a meeting held in the Chancellor of the Exchequer's room, HM Treasury on Wednesday, 25 February 1981 at 9.30 am', 25 February 1981, TNA, T388/231, MTFW 127482.

64 T. P. Lankester, 'Note for the record', 2 March 1981, TNA, PREM 19/439, MTFW 114024.

65 Although I informed them orally, this probably explains why – unusually – I did not write a note of the meeting until several days later.

for, although the PSBR had come out more or less their way, they weren't going to be happy with the decision to freeze the allowances. And by this time she was becoming paranoiac about keeping the Budget decisions secret: she was worried they would leak the information to like-minded colleagues in yet another effort to secure what they wanted.

I ignored her instruction and told them. To deny them the information after all their involvement to date seemed to me ridiculous; it wasn't the way they should be treated; and it would have made our working relations in the office, which to date had always been friendly and harmonious, impossible.

Hoskyns' and Walters' reaction was ambivalent. After hearing from me what Howe had decided, Hoskyns still believed there was a good chance there would be a funding crisis within six months.[66] The following week, though, he writes, 'It was now, to our great relief, becoming clear that the Budget was going to be as tough as we had hoped it would be.'[67]

In his diary on 25 February, Walters wrote that 'at least the PSBR will be about right'.[68] Yet, in the same diary entry, he described the Budget decisions as 'stupid politically, indefensible morally and economically'. On that same day, after a lunch in the City, he wrote to Howe that, for the City, a 'really satisfactory figure for the PSBR would be £7 billion'.[69] And, on the following day, he wrote to Wass in the following terms: 'I have seen neither evidence nor arguments to suggest that the present proposals are not very much a case of too little and the wrong kind. The consequences are likely to appear in crisis measures after a few months.'[70] He went on to say that, 'with this Budget, I would think it desirable not to move MLR at all'.[71] If MLR had to be reduced, the reduction should not be more than one percentage point.[72] In his diary, he wrote that he had told Middleton that he thought the Budget had 'all the seeds of disaster'.[73]

The Treasury team were put out, if not baffled, by Walters' late démarche. It was an intensely worrying time at the department: no one could be absolutely confident that they had got the Budget right. To have Walters sniping from the wings, after Howe and Thatcher had now agreed

[66] Hoskyns, *Just in time*, 278. [67] Ibid., 280.
[68] A. A. Walters, 'Diary entry', 25 February 1981. Churchill, WTRS 3/1/1, MTFW 114204.
[69] Howe, *Conflict of loyalty*, 203.
[70] 'A. A. Walters to D. W. G. Wass', 26 February 1981, TNA, PREM 19/439, MTFW 114026.
[71] Ibid. [72] Ibid.
[73] A. A. Walters, 'Diary entry', 26 February 1981. Churchill, WTRS 3/1/1, MTFW 114204.

on a budget stance more or less in line with his previously stated views, was hardly helpful.

What were the reasons for these contradictory signals from Hoskyns and Walters? For Hoskyns, it seems to have taken a little time for him to realise that the Budget had come out more or less as he had wanted. Or perhaps he was worried that Howe would do yet another about-turn just ahead of Budget day? As for Walters, one possible explanation for his contradictory posture and colourful language is that he was thoroughly fed up with the final twists and turns, and with his exclusion from the final discussions. Another possibility is that he was genuinely torn between what he believed would be acceptable to the markets and what he thought was right in terms of macroeconomic theory. The figure of £7 billion he had mentioned to Howe after his lunch in the City was approximately the figure implied by the MTFS. It was this figure that less sophisticated market practitioners had their eye on, whereas the figure of around £10 billion, which he had been supporting in the Budget discussions, was consistent with allowing for a 1¼ per cent cyclical adjustment – an upward revision that, in his book, he later wrote was 'in response to the deep recession, and was entirely consistent with the medium term framework'.[74] In objecting to the Budget decisions on moral and political grounds, he was presumably referring to the freezing of personal allowances in preference to an increase in the basic rate. Considering that the distributional impact was not vastly different, calling the decision 'stupid politically' and 'indefensible morally' was perhaps the sort of hyperbole for which a diarist can be forgiven. Yet unlike many economists of a Conservative persuasion, perhaps reflecting his own personal background, Walters did care about equity.

Following Howe's meeting with Thatcher on 25 February, the main elements in the Budget were fixed. There then followed within the Treasury considerable debate on how to present the figures. It was decided – so as to make it the more credible with the financial markets – to make the Budget look even tougher than it actually was. This was achieved by the unusual ploy of including in the Budget arithmetic the revenue from the supplementary petroleum duty announced in November 1980. The latter, up until then, had been included in the pre-Budget revenue forecast. By taking it out, the pre-Budget PSBR forecast went up to £14.5 billion, and the total Budget measures could be presented, with some

[74] Walters, *Britain's economic renaissance*, 81. In his post-Budget statement referred to earlier, Lawson had taken a similar line. He justified the £10.5 billion PSBR on the grounds that the MTFS target for the PSBR required an adjustment of £3 billion on account because of the 'extra severity of the recession': Lawson, 'The Budget Judgement'.

other minor adjustments, as amounting to a PSBR cut of £4 billion.[75] It is doubtful whether many market practitioners were taken in by this presentational gambit. What they were most interested in was the post-Budget PSBR forecast of £10.5 billion and whether there were steps in place to achieve it. As it turned out, there were: the actual PSBR for 1981/82 came out at £8.5 billion.

The Budget's paternity

We come back to the question: how much was the final Budget judgement due to Thatcher and her advisers at No. 10?

There is no doubt at all that the No. 10 advisers pressed consistently for a low PSBR, and that their voice had influence both with the Prime Minister and with the Treasury. Hoskyns certainly thought he and Walters had influenced Howe. After Howe's final meeting with Thatcher on 25 February before she left for America, Hoskyns wrote in his diary: 'I think Geoffrey came because our barrage of notes is affecting him'.[76] But it was not their voice, nor the Prime Minister's, that ultimately determined the Budget stance. As the Treasury papers show, the official Treasury was by no means monolithic on the Budget. Burns and Middleton were effectively in the same camp as Walters; and so were Lawson and Howe's own Special Advisers, Cropper and Ridley; and, when it came to Howe's final meeting with officials on 25 February, the 'doves' among the Treasury officials were only £¾ billion apart from the 'hawks' – a relatively small amount given the margin of error in the forecasting. Howe himself wanted a tough Budget. If he – and, indeed, Thatcher – appeared at times less hawkish than the No. 10 advisers, it was because they were more mindful of the political difficulties of imposing a really tight Budget.

Thatcher, as I have shown, did not force Howe to accept a £10.5 billion PSBR. She certainly pressed him in that direction over several meetings; but, like Howe, she also veered backwards and forwards on whether this was politically feasible. At their penultimate meeting, on 24 February, she went along with his judgement that £10.5 billion was impossible. The volte-face the next day was his decision and was not due to renewed pressure from her. It is straining the record for Moore to write, as he does, that she 'found ways to get Howe to accept it'.[77]

75 This was net of £320 million of extra spending on the nationalised industries, which was decided in early March 1981. Full details of the Budget measures, their costings and their impact on the PSBR can be found in the *FSBR 1981–82*.

76 Hoskyns, *Just in time*, 277. 77 Moore, *Margaret Thatcher*, 627.

On the composition of the Budget measures, Mrs Thatcher and her advisers were unsuccessful. They – and she, intermittently – would have preferred an increase in the basic rate instead of freezing the allowances. (Quite why she preferred the former was something of a puzzle – since she had not shown much interest in the fairness or unfairness factor in Howe's previous Budgets, and raising the basic rate was clearly worse in presentational terms. Probably, it was out of deference to Walters.) Howe decided to freeze the allowances; and Thatcher did not attempt to get him to change his decision.

Finally, there is the question of who called the shots on the related decision on whether the Budget should be accompanied by a reduction in MLR. The Treasury team, with the possible exception of Lawson (see above), believed that an important rationale for a tight Budget was to achieve a cut in MLR. Thatcher was determined to achieve a reduction; it was the pay-off that made a tough Budget politically feasible. The markets were expecting it. The Governor of the Bank of England supported it. Walters did not; although he believed in the link between the PSBR and interest rates, his view was that a PSBR of £10.5 billion wasn't low enough to justify a reduction.

MLR was reduced by 2 percentage points on Budget day to 12 per cent, and this helped to temper the political and media row that inevitably followed the Budget announcements. But, as Walters had warned, the reduction proved excessive. In the autumn of 1981, amid worries that sterling was falling too far and that private credit demand was rising too rapidly, MLR was allowed to climb back to 15.125 per cent. Walters thought they had overreacted, putting at risk the fragile recovery. Not for the first or last time, Walters found himself at odds with the Treasury.[78]

[78] Walters, *Britain's economic renaissance*, 148. His most famous falling-out with the Treasury was in 1989, when he got into a public spat with Lawson over exchange rate policy, leading first to Lawson's resignation and then his own.