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Ref. A084/440

PRIME MINISTER

Economic Strategy

(C(84) 5)

BACKGROUND

Flag A In C(84) 5, the Chancellor of the Exchequer seeks the views of his colleagues on the appropriate level of the Public Sector Borrowing Requirement (PSBR) in 1984-85 and the appropriate balance between different taxes in the 1984 Budget. He also seeks agreement to rolling forward the Medium Term Financial Strategy (MTFS) to 1988-89, with an assumption of public expenditure held constant in real terms after 1986-87 (the final year covered by the Public Expenditure White Paper, to be published on 16 February).

2. Although the Chancellor of the Exchequer will take the views of his colleagues into account in preparing his Budget, he will not wish to be bound by them. He will also want to avoid any commitment to further collective discussion during the run-up to the Budget on 13 March, though he will no doubt be willing to discuss particular points bilaterally with individual Ministers.

3. The main features of the economic background are that output has increased by some 3 per cent, compared with last year's forecast of 2 per cent. Inflation also fell more rapidly than was forecast, averaging 4½ per cent in 1983. Most labour market indicators have been moving more favourably than in recent years, though the January unemployment figures were less satisfactory than had been expected. The latest forecasts (which will be updated for publication at the time of the Budget) suggest that inflation will rise temporarily to about 5½ per cent in the early summer, but fall again to about 4½ per cent by the end of 1984; and that output will again rise by about 3 per cent.

C(84) 5 contains no forecast of unemployment (though Annex 1 suggests no reduction in 1984); but the paper suggests that the prospect for jobs is better than in the recent past.

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MAIN ISSUES

4. The main issues are:

(i) in relation to the forthcoming Budget:

PSBR.
Taxes
Promises?

(a) whether to aim at a slightly lower PSBR for 1984-85 than the present MTFS figure for that year of £8 billion, thus implying a broadly neutral Budget;

(b) what should be the balance of taxes within the 1984-85 Budget;

(c) how far it would be desirable to give any commitments regarding taxation in 1985-86;

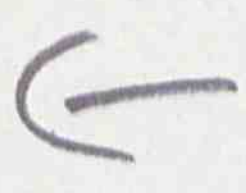
(ii) in relation to the MTFS:

(a) whether it should be rolled forward for a further three years up to and including 1988-89;

(b) whether for the last two years, for which public expenditure decisions have not yet been taken, the assumption should be that public expenditure will be held constant in real terms at the 1986-87 level.

The level of the PSBR in 1984-85

5. At this time last year the forecast for the PSBR in 1983-84, with tax changes confined to revalorisation, was £6 billion. The forecast at the time of the Budget, allowing for the actual tax changes, was £8.2 billion. Although the outturn for the year is still uncertain, a substantial overrun seems inevitable: the current expectation is that this year's PSBR will amount to some £10 billion, despite the measures taken in July 1983 to reduce the overrun.



6. The Chancellor of the Exchequer argues that this experience suggests that a cautious approach is needed for 1984-85. The main aim should be to hold to the current MTFS figure of £8 billion (equal to 2½ per cent of GDP). The Chancellor also suggests that the fact that asset sales are expected to make an unusually large contribution to reducing the PSBR in 1984-85 is a further reason for caution. Although he mentions no precise figure, he suggests

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that it would "probably be right, in terms of market confidence and hence interest rates, to aim for a slightly lower figure" than £8 billion.

7. Given this view of the appropriate PSBR for 1984-85, there will be little or no room for net reductions in taxation (though increases in prospective oil revenue make it unlikely that taxes will need to be increased - a possibility which was mentioned in the Autumn Statement). The Chancellor therefore has in mind a broadly neutral Budget.

8. Some members of the Cabinet may suggest that this is too cautious an approach, for one or more of the following reasons:

(a) Although an overrun in the 1983-84 PSBR seems certain, inflation has been lower and output higher than predicted. Might not a higher PSBR be tolerable in 1984-85 also?

(b) The Government is committed to reducing taxation as a means of strengthening the economy. Would it not be desirable to make the fastest possible progress in this direction?

(c) Industrial confidence may still be fragile; and the January unemployment figures may be an indication that the recovery could falter. Reductions in taxation would improve confidence.

9. Against that, the Chancellor of the Exchequer can be expected to make the following points:

(a) The monetary effects of an excessive PSBR take time to show themselves: it would be wrong to draw conclusions from experience in the current year.

(b) Inflation is forecast to increase temporarily in the earlier part of 1984; there are also some signs of an upturn in wage settlements. Higher inflation, coupled with a higher planned figure for the PSBR, could arouse fears that the Government was reversing its policies. This would have serious adverse effects on confidence.

(c) United States interest rates are high and seem likely to stay so. If we run a high PSBR, there will be further

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not be easy to accommodate in a "broadly neutral" Budget. Moreover the cost in a full year would be £850 million and this would affect the room for manoeuvre in 1985-86.

Direct and indirect taxation

13. The main arguments affecting the balance between direct and indirect taxation are as follows:

- (a) Inflation is likely to turn upwards, at least temporarily. A reduction in indirect taxation would at least partly offset the effects of this on the Retail Price Index (RPI).
- (b) But to achieve a worthwhile reduction in the rate of inflation by reductions in indirect taxation within a broadly neutral Budget would require substantial offsetting increases in direct taxation. (Each half per cent reduction in the RPI by this means would cost about £750 million in a full year.)
- (c) The Government's longer-term policy is to shift the burden of taxation away from direct taxation.

1985-86

→ } 14. Paragraph 21 of C(84) 5 says that if the Government holds to its public expenditure plans "the prospect is for worthwhile tax reductions in 1985-86". The paragraph also suggests that it may be possible to consider for the 1984 Budget some measures reducing the burden of taxation in the 1985-86 Budget.

15. The Cabinet may wish to ask the Chancellor of the Exchequer for a fuller indication of what he has in mind here. Does he, for example, have in mind tax changes with small cost in 1984-85, but a significantly larger full year or second year cost? Does he intend to foreshadow in the 1984 Budget a measure such as abolition of the NIS from April 1985? Such an approach would help meet the points mentioned in paragraph 8 above - in particular, the case for fostering industrial confidence by reductions in taxation - while maintaining the Government's financial strategy. On the other hand, it would restrict the room for manoeuvre next year.

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Medium Term Financial Strategy

16. The existing MTFS extends only as far as 1985-86. It is logical that it should be extended to 1988-89 to cover the full possible lifetime of the present Parliament. The Chancellor will not wish to involve his colleagues in the technical details of the monetary targets. However, he will wish to secure their endorsement of one of the implications of the approach he wishes to adopt - that public expenditure should be held constant in real terms after 1986-87. (Broadly speaking, it is already being held constant in real terms over the three years 1984-85 to 1986-87 covered by the latest Public Expenditure White Paper.)

17. Some Ministers may feel that the Chancellor is seeking to anticipate decisions on the public expenditure planning totals for 1987-88 and 1988-89 which would normally fall to be taken in the 1984 and 1985 Public Expenditure Surveys. His reply would be that these are merely assumptions, that this would be made clear in the statement, and that the decisions will remain to be taken in the normal way in due course. It would however be realistic to recognise that these assumptions will be taken as an indication that the Government does not intend public expenditure to increase in real terms during the remainder of this Parliament. Such an indication would be consistent with the Government's declared aim of reducing taxation while also continuing to reduce borrowing, interest rates and inflation.

HANDLING

18. It may be convenient to divide the discussion into two main parts: the first concentrating on the 1984 Budget and the second on the extension of the MTFS.

19. After the Chancellor of the Exchequer has introduced his memorandum, you will probably wish to go round the table asking all members for their views on the 1984 Budget. After this discussion, you might then ask whether any members of the Cabinet wish to comment on the Chancellor's suggestions regarding the MTFS. You may then wish to ask the Chancellor of the Exchequer to give his general reactions to the discussion.

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CONCLUSIONS

20. In your concluding remarks you will wish to avoid any suggestion that the Chancellor of the Exchequer is committed by the discussion to particular changes in his Budget, and to avoid any commitment to further general discussion by the Cabinet, apart from the traditional meeting immediately preceding the Budget.

21. You might then record conclusions which:

- (i) invite the Chancellor of the Exchequer to take account of the views expressed in discussion in his further work on the Budget;
- (ii) invite any Minister who has particular points on possible tax changes to discuss them directly with the Chancellor of the Exchequer.

RIA

ROBERT ARMSTRONG

8 February 1984

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