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CABINET

ECONOMIC STRATEGY

Memorandum by the Chancellor of the Exchequer

The approach to the 1986 Budget is inevitably dominated by the dramatic changes taking place in the oil market. The large price fall that has already occurred means a sharp reduction in prospective oil tax revenues.

2. The current North Sea oil price of \$17-18 per barrel is some 40 per cent below the end-November level - a change almost as great as the price increases of 1973 and 1979. It is hard in current circumstances to make a reliable judgment about the new level at which oil prices may settle. We therefore have to consider the Budget against the prospect not merely of greatly reduced oil revenues but also considerable uncertainty about how large the reduction will be.

3. Our current estimates suggests that if oil prices settle at \$15 a barrel our revenues from the North Sea will be reduced to £6 billion for the next financial year. This compares with receipts of £12 billion in 1984-85. In last year's Medium Term Financial Strategy (MTFS) we expected revenues of £11½ billion for 1986-87.

4. There has inevitably been some turmoil in financial markets as they have responded to the oil price change. Sterling has fallen by about 7½ per cent and there has been persistent upward pressure on short term interest rates. So far we have weathered the collapse in oil prices and consequent financial market turbulence pretty well - though it may not be over yet. In so doing we are helped both by the underlying strength of the economy, in terms of growth, inflation and the external account; and above all by the reputation we have acquired for sound and prudent policies.

FISCAL POSITION

5. Faced with this background my judgment is that we must approach the Budget with considerable caution. We must avoid going above the £7½ billion Public Sector Borrowing Requirement figure set out in last year's MTFS. Indeed there is a strong case for going below it, bearing in mind the proceeds of privatisation, estimated at £4¾ billion next year.

6. Much may change between now and Budget Day. Because non-oil revenues are now projected to be higher than expected I hope to be able to avoid a

net increase in taxes in the Budget. But there looks like being little, if any, scope for a net reduction in taxation. We should just meet the public expenditure planning total set for the current financial year. The need to cope successfully with the unprecedented situation which the oil price fall has created for the public finances underlines the importance of holding public spending next year similarly within the planning total we have announced.

ECONOMIC PROSPECTS

7. But while lower oil prices have a profound impact on what is possible in the Budget, they should not greatly affect our overall economic performance - although there will be significant changes within the economy. For the world as a whole, lower oil (and commodity) prices will have beneficial effects in 1986 on the oil-consuming countries. The forecast for the major industrialised countries is for the output growth averaging 3 per cent - a little better than achieved last year. Inflation will stay low: indeed in Germany and Japan it is likely to approach zero.

8. For the United Kingdom, the oil price fall has not caused me to revise my view that 1986 will be a further year of steady growth, at an annual rate of about 3 per cent, accompanied by declining inflation. Different parts of the economy will be affected in different ways by lower oil prices. While the oil sector will not do so well, manufacturing industry in particular should benefit considerably.

9. The United Kingdom economy is now in a stronger position to take advantage of the opportunities created by lower oil prices. The underlying improvement shows up in a number of indicators. Last year manufacturing productivity increased by a further 4 per cent. Since 1979 it has now grown at an average annual rate of $3\frac{3}{4}$ per cent. As the table below shows, our performance here compares very favourably with the recent past; and even with the majority of our principal overseas competitors.

Output per man hour in manufacturing
average annual growth rates, per cent

	1973-79	1979-85
United States	$1\frac{1}{2}$	$2\frac{1}{2}$
Japan	$6\frac{1}{2}$	$6\frac{1}{2}$
Germany	3	3
France	5	$3\frac{1}{2}$
United Kingdom	1	$3\frac{3}{4}$

10. Capital spending by business has generally been rising faster than output in recent years and further growth is expected in 1986, as a response to higher profits and continued expansion in output. Exports performed well in 1985: indeed, United Kingdom exporters increased their

share of world trade. The prospect is for continued export growth, albeit at a slower pace. Even after the fall in oil prices, another sizeable current account surplus is in prospect for 1986, helped by rising earnings from our increasing stock of overseas assets. (Our net overseas asset position is now second only to that of Japan.)

11. This year is likely to see a significant rise in consumer spending. This reflects rapid growth in real disposable incomes - itself a result of the high level of wage settlements in 1984-85 and the reduction in inflation expected this year. Earnings are currently rising at or over 7½ per cent. With inflation likely to fall to 4 per cent this year, the average employee's pay may rise by some 4 per cent in real terms during 1986.

12. However, this excessive earnings growth remains the chief threat to jobs. Despite five years of continuous output growth, and a growth in the number of people in work of over 600,000 since the last election, which I expect to continue, unemployment is unlikely to show much of a reduction while wages rise so far ahead of prices. The plain fact is that, despite our very good productivity record, United Kingdom unit labour costs have been increasing much more rapidly than those of our competitors.

13. Annex 1 sets out key figures from the forecast. Annexes 2 and 3 set out the revenue effects of selected tax changes, together with a note on the tax burden.

SUMMARY AND CONCLUSIONS

14. The dramatic change in oil prices has had a major - and adverse - impact on the public finances; but I very much hope that, thanks to the sound financial policies we have been following, it will prove possible to avoid raising taxes overall in the Budget. The impact of lower oil prices on the United Kingdom economy as a whole is more neutral. I expect to see continuing steady growth for the sixth year in succession; and lower inflation. This is a measure of the strength of our underlying economic performance.

15. I seek colleagues' views on the appropriate shape of the Budget in the light of the circumstances I have outlined.

N L

Treasury Chambers

11 February 1986

SELECTED ECONOMIC INDICATORS

	1979	1980	1981	1982	1983	1984	1985	(1) 1986
(2) World GNP, in major 7 economies (per cent change)	3½	1	1½	- ½	2½	4½	2½	3
(2) UK GDP, (per cent change)	2½	- 2½	- 1½	2	3½	2½	3½	3
(2) Domestic demand, (per cent change)	4	- 3½	- 2	2½	4½	2½	2	3½
Retail prices Q4 (per cent change)	17½	15½	12	6	5	5	5½	4
Interest rates (average 3-month interbank)	13½	16½	14	12½	10	10	12	(3) 13
Current balance (£ billion)	- ½	3	6	4	3	1	3½	3½
Unemployment (UK, per cent excluding school leavers)	5	6	9½	11	12	12½	13	(4) 13
Sterling Index	87	96	95	90½	83	78½	78	(3) 74½
Oil prices,\$, North Sea	20½	34½	37½	33	30	29½	27½	(5) 17½

(1) Provisional pre-Budget figures.

(2) At constant prices.

(3) February 7.

(4) Not a forecast. Figures based on assumptions in PEWP.

(5) Brent price for delivery in March, as of February 7.

REVENUE EFFECTS OF TAX CHANGES

A. Direct Taxes: Indexation

The RPI increased in the year to December 1985 by 5.7 per cent. With indexation by this amount and statutory rounding, the figures for the main allowances and other thresholds would be:

<u>Personal allowances</u>	<u>1985-86</u>	<u>1986-87</u>
	£	£
Single and wife's earned income allowance	2205	2335
Married allowance	3455	3655
<u>Bands eg</u>		
30% rate	0-16200	0-17200
60%	over 40200	over 42700

The total revenue costs of indexation of income tax (reflected in the forecast) are £1140m in 1986-87, and £1490m in a full year, at forecast 1986-87 prices and incomes.

B Indirect Taxes: Indexation

The effects of 5.7 per cent revalorisation of the exercise duties (including VAT effects, price changes rounded) are as follows:

Typical Price Change		Revenue effect	
		(1986-87 prices) £m	RPI impact £m
Beer	1p/pint	100	0.07
Wine	5p/70cl light wine	20	0.02
Spirits	31p/bottle	45	0.04
Tobacco	5p/20 King size	150	0.14
Petrol	5p/gallon	260	0.13
Derv	5p/gallon	65	nil
VED	£5/car	<u>100</u>	<u>0.05</u>
Overall effect (reflected in forecast)		<u>740</u>	<u>0.45</u>

Note: First year and full year revenue effects are virtually identical.

C. Ready Reckoner: Illustrative Tax Changes

	£ million at forecast 1986-87 income levels	
	<u>1986-87</u>	<u>Full Year</u>
INCOME TAX		
<u>Allowances and Thresholds</u>		
1% above indexation on all statutory allowances	210	175
1% above indexation on all statutory allowances and thresholds	245	190
<u>Rates</u>		
Change basic rate by 1p	1175	975
CORPORATION TAX		
Change main rate by 1 percentage point	180	310
Change small companies' rate by 1 percentage point	16	30
OTHER TAXES		
Change VAT rate by 1 percentage point ⁽¹⁾	700 ⁽²⁾	925

(1) A 1% change in the VAT rate would change the RPI by 0.5%.

(2) Provisional forecast

THE TAX BURDEN

Since the Government came to power total taxes and NICs as a proportion of GDP at market has risen by about 5 percentage points, though the ratio has fallen slightly since 1981-82. The figures are as follows:

Table 1

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

1978-79	33.9
1979-80	35.2
1980-81	36.4
1981-82	39.3
1982-83	39.1
1983-84	38.6
1984-85	39.2
1985-86 (estimate)	38.7
1986-87 (assuming indexation)	38.6

* Including NICs and the local authority rates.

Personal sector

2. Despite reductions in income tax, total personal taxes (direct and indirect, including employees' NIC and domestic rates) in 1985-86 are about £15 billion higher in real terms (ie 1985-86 prices) than they were in 1978-79. For income tax and national insurance contributions the following table shows how the proportion of gross pay they represent has risen, particularly for the low paid:

Table 2

Income tax and NICs as a % of gross earnings*

	$\frac{1}{2}$ average earnings	Average earnings	2 average earnings
1978-79	16.0	27.8	31.4
1981-82	20.8	29.3	32.2
1982-83	20.8	29.8	32.3
1983-84	20.1	29.6	31.7
1984-85	19.3	29.2	31.5
1985-86 (estimate)	19.0	29.0	31.5
1986-87 (indexation)	19.3	29.1	31.7

* Adult male earnings (all occupations). Married couple, wife not working: the couple are assumed to have no children, to avoid distortion of the figures from the abolition of child tax allowances.

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3. These figures reflect the rise in the standard employees' NIC rate from 6½% to 9%. The lower rates introduced in the 1985 Finance Act do not affect the cases shown. So far as income tax is concerned, personal allowances have increased by over 19% in real terms since 1978-79 and have increased slightly faster than earnings. The basic rate has been reduced from 33p to 30p, but the 25p reduced rate band has been abolished.

4. As the table shows, indexation of allowances in the Budget would lead to a very slight rise in the proportion of incomes taken in tax and NIC. This is because earnings are assumed to rise by 7% compared with the indexation percentage of 5.7%.

5. Since 1978-79 total taxes paid by businesses (outside the North Sea) have fallen slightly as a percentage of GDP. Within this total, the major change has been a fall in employers' NIC and NIS as a percentage of GDP, partially offset by an increase in business rates, and 'other' taxes as the following table shows:

Taxes paid by businesses £bn in 1985-86 prices
(figures in brackets are %s of GDP)

	Corporation tax ¹	Taxes on self employment incomes	Employers' NIC and NIS	Rates	Other ²	Total
1978-79	7.1 (2.2)	2.4 (0.7)	9.9 (3.1)	4.7 (1.4)	3.7 (1.1)	27.7 (8.6)
1985-86 (estimate)	8.2 (2.3)	3.1 (0.9)	8.0 (2.2)	5.9 (1.7)	4.8 (1.4)	30.0 (8.4)

1. Excludes North Sea, but includes ACT

2. VED, car tax, road fuel duty, duty on rebated oils, capital taxes.