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Ref. A085/492

PRIME MINISTER

Economic Strategy

FLAG A (C(85) 4)

BACKGROUND

In C(85) 4, the Chancellor of the Exchequer seeks the views of his colleagues on the appropriate level of the Public Sector Borrowing Requirement (PSBR) in 1985-86, and on the broad shape of a Budget with an employment theme.

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 19 March, though he will no doubt be willing to discuss particular points bilaterally with individual Ministers.

3. There are a number of major uncertainties about economic trends, which make preparation of this year's Budget unusually difficult:

a. The outlook for oil prices and the sterling exchange rate remains clouded. Since last summer the fall in the pound/dollar exchange rate has been greater than the reduction in the realised dollar price of North Sea oil, so that oil revenues have exceeded earlier forecasts, and are projected to continue to do so. A further fall in the dollar price of oil, or a sharp recovery of sterling against the dollar, could have a substantial effect on the Budget arithmetic.



- b. The miners' strike reduced output by 1 per cent in 1984, as well as reducing the current account surplus by £2½ billion. An early end to the strike would have a favourable direct impact on UK output and the trade balance, and seems likely also to have a favourable impact on the financial and foreign exchange markets.
- c. Recent movements in the sterling exchange rates and in UK interest rates have been greater than the forecasters would have expected. There has probably been some over-reaction in the markets, which could well be corrected at some point during the next few months. Meanwhile, however, the effect of these movements is bad for inflation, and their reversal within a given time-scale cannot be relied on; it is perhaps noteworthy that the pound/dollar rate has not yet responded to the tightening of the market (spot prices for North Sea oil have risen by \$1.50-2.00 a barrel over the last two weeks). The prospect substantially depends on the course of US fiscal and monetary policy, and on worldwide market sentiment toward the dollar; neither can readily be predicted.
- d. Private sector pay settlements during the current wage round have so far been about half a per cent higher than last year, and unit labour costs have been rising. No significant public sector settlements have yet been concluded, but the indications are that it will be difficult to prevent an increase above last year's levels. This could add to the difficulty of public expenditure control.
4. Despite these uncertainties, the performance of the UK economy has in a number of ways been reasonably good. The increase in Gross Domestic Product (GDP) in 1984, at 2½ per cent, compares with last year's forecast of 3 per cent; allowing for the impact of the miners' strike, underlying growth may have



been somewhat higher than expected. The current balance has remained in surplus despite the deterioration on oil account caused by the strike. Inflation has remained at or below 5 per cent despite the continuing depreciation of sterling (where the effective exchange rate index has fallen from 90½ in 1982 to about 71 today). Company profits and cash flow have remained relatively good, and the outlook is for rising industrial investment despite recent increases in interest rates. But the trend in unemployment has remained stubbornly upwards, despite the sharp slow-down in productivity growth.

MAIN ISSUES

5. The main issues are:

- a. the level of the PSBR in 1985-86;
- b. the balance as between personal, indirect and company taxation;
- c. the nature of any fiscal adjustment, bearing in mind the Chancellor's objective of presenting a "Budget for jobs".

The level of the PSBR in 1985-86

6. At the time of the 1984 Budget, the forecast of the PSBR for 1984-85 was about £7.25 billion (with the Budget changes having a broadly neutral effect on the financial year immediately ahead). The Chancellor's Autumn Statement - on the assumption that the miners' strike would be over by the end of 1984 - put the figure at £8.5 billion. It is clear that the out-turn will be substantially greater, with borrowing approaching the 1983-84 level of £10 billion. A substantial part of the excess is directly attributable to the miners' strike, but there are indications from recent experience that



the Treasury model may be tending to understate the PSBR: this factor would tend to reinforce the Chancellor's judgment that the objective should be to return to the Medium Term Financial Strategy (MTFS) path of holding the PSBR to 2 per cent of GDP, or about £7 billion.

7. Some Ministers may put forward arguments on the following lines in favour of a more relaxed fiscal stance:

a. US experience has combined vigorous real growth, continuing low inflation, a high PSBR, and an appreciating exchange rate. The attractions of a dynamic economy, and of the high interest rates required to finance public borrowing, have outweighed any adverse impact of the high PSBR and current account deficit. While the UK cannot expect fully to emulate the US example, the market response to expansionary Budget measures clearly perceived to encourage growth and enterprise might be quite favourable.

b. Reducing the PSBR to 2 per cent of GDP would represent a sharp contractionary move as compared with the 1984-85 situation, when the PSBR is likely to be around 3 per cent of GDP. The UK economy has absorbed this year's overshoot without excessive damage.

c. The eventual success of the Government's policies in revitalising the UK economy depends on their attracting and retaining the widest possible public support. Support could be increased by giving more people a feeling that the battle was being won.

8. The Chancellor may draw on some of the following arguments in reply:

a. Domestic demand, including both private consumption and investment, is projected to grow by 3 per cent in real



terms, on the basis of a "neutral" Budget (ie allowing only for the indexation of direct and indirect taxes).

b. The underlying fiscal stance to which the bulk of the economy has adjusted is that which excludes the impact of the miners' strike.

c. Upward pressures on public expenditure, particularly if the strike were to drag on, could prove very difficult to contain.

d. The $\text{£}\frac{1}{2}$ billion increase projected between 1984-85 and 1985-86 in receipts from special sales of public sector assets implies some underlying relaxation in fiscal stance not reflected in the PSBR numbers.

e. Adverse market reactions to a perceived fiscal relaxation - if they were to materialise - could have very damaging effects on inflation and on confidence in future UK economic growth.

9. Present indications are that a neutral Budget would result in a PSBR for 1985-86 of around $\text{£}6\text{-}6\frac{1}{2}$ billion, ie that there would still be room for some small fiscal adjustment within the $\text{£}7$ billion implicit in the MTFs figure of 2 per cent of GDP, but less than the $\text{£}1\frac{1}{2}$ billion contemplated last autumn. It might be reasonable to aim on balance for the $\text{£}7$ billion figure, accepting some risk of it being overshot because of the miners' strike and other public expenditure pressures.



Balance between taxes

10. The main elements in last year's Budget were:

- a. a real (ie beyond indexation) increase in income tax allowances and thresholds costing about £1 billion in 1984-85 and £1½ billion in a full year;
- b. corporation tax changes, reducing capital allowances and tax rates on a broadly self-balancing basis;
- c. halving of Stamp Duty, at an annual cost of around £½ billion;
- d. abolition of the national insurance surcharge (NIS) paid by employers, from 1 October 1984, costing £0.3 billion in 1984-85 and nearly £1 billion in a full year;
- e. widening the VAT base and a real increase in excise duties, yielding £0.6 billion in 1984-85 and £0.9 billion in a full year;
- f. a once-for-all change in the timing of VAT payments, yielding £1.2 billion in 1984-85 but nothing thereafter.

11. The Government's objective of revitalising the economy might be thought to suggest further moves to reduce the burden of taxation on companies. However, with the abolition of NIS and the change in the structure of corporation tax (which removed the bias in favour of capital rather than labour-intensive production methods), the scope for further major structural shifts is limited. It is perhaps significant that neither the Secretary of State for Trade and Industry nor the Minister without Portfolio have in their pre-Budget letters to the Chancellor suggested any changes in business taxation



which would have a major macro-economic impact. There could still be advantage in a further shift from direct to indirect taxes, which has been a feature of the Government's policy; such a move would in principle add to the resources at the Chancellor's disposal to increase tax allowances and thresholds by more than indexation, but it would have the disadvantage of increasing the rate of inflation at a time of stronger upward pressure from recent exchange rate and interest rate movements. Meanwhile the prospect is that last year's Budget changes will in any event put £1.7 billion more into taxpayers' pockets in 1985-86 than would have happened had that Budget been confined to simple indexation of direct and indirect taxes. It would clearly be desirable to reduce the burden of direct taxes (including national insurance contributions); payments of direct taxes as a proportion of gross earnings are projected to remain well above the proportions current in 1978-79 for all except those on twice average earnings and above. But the present high proportion of incomes taken in taxes reflects in large measure the need to finance benefits for 2 million additional unemployed since 1979 and their dependents in a non-inflationary way.

A Budget for jobs

12. The Chancellor does not say what he has in mind in terms of specific measures to encourage employment. These could fall into five broad areas:

- a. Specific measures - each costing a comparatively small amount - to encourage particular activities or industrial sectors (examples might be some extension of the loan guarantee scheme, amendments to the Business Expansion Scheme, charging only the basic rate of income tax on undrawn profits of unincorporated traders).



b. Tax changes to encourage employers to take on additional - probably lower paid - workers. (The change in the contribution structure put forward for consideration by MISC 111 could have something of this effect, but there is unlikely to be scope for any further general reduction in employers' national insurance contributions following the abolition of NIS.)

c. Tax changes to increase incentives to work and alleviate the poverty trap. Such changes would involve real increases in tax thresholds, so as to reduce the marginal tax rates faced by lower paid workers as their incomes rise and their entitlement to welfare benefits tapers away.

d. Expenditure changes to reduce the impact of the poverty trap. Here again the work of MISC 111 is relevant. An increase in Child Benefit not matched by an increase in Supplementary Benefit children's scales would have the effect of directing help towards the families of people in lower paid work.

e. Expenditure changes which directly reduce unemployment. Extension of youth training opportunities (currently under discussion in MISC 107) might be an example of this. Permitting some increase in numbers employed in lower-paid, and low resource consuming, public sector work, where employment, supervision and materials costs were not very much more than entitlement to social security benefit, might in principle be another; but in practice the scope for this (other than in the context of youth training) is likely to be very limited indeed.



Medium Term Financial Strategy

13. The Chancellor (paragraph 10 of C(85) 4) essentially proposes adhering to the MTFs as already formulated, but without extending it beyond 1988-89. The Government's public expenditure plans continue to provide for expenditure to be held constant in real terms at the level projected for 1986-87; and monetary targets would be maintained on the basis established last year. With all the uncertainties surrounding the present economic situation, there seems to be nothing to be gained by extending the time horizon beyond four years; but equally there is every reason to stick to the MTFs as it is now, in order to maintain confidence in the Government's determination to achieve its objectives.

HANDLING

14. After the Chancellor of the Exchequer has introduced his memorandum, you may wish to divide the discussion into two parts:

- i. the overall fiscal stance, and the size of the 1985-86 PSBR;
- ii. the more detailed shape of the Budget, and the relevance of the jobs theme to particular possible measures.

You may wish to ask the Chancellor of the Exchequer to respond separately to each part of the discussion.

CONCLUSIONS

15. 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.

16. 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.

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ROBERT ARMSTRONG

13 February 1985