

PRIME MINISTER

Economic Strategy  
(C(83) 5)

BACKGROUND

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In C(83) 5, the Chancellor of the Exchequer seeks the views of his colleagues on the size of the Public Sector Borrowing Requirement (PSBR) in 1983-84; and on how any reductions in taxation that he may be able to make in his Budget should be allocated between measures to reduce income tax, measures to assist companies, and measures to reduce prices.

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 15th March, though he will be willing to discuss particular points bilaterally with individual Ministers.

3. The main features of the economic background are that inflation has fallen much faster than expected a year ago: the latest annual figure is 5.4 per cent, compared with a forecast of about 10 per cent before the 1982 Budget. Interest rates are significantly lower. Output is forecast to grow in 1983 by about 2 per cent. But the exchange rate has depreciated significantly; and later in the year this will produce, at least temporarily, an increase in inflation. Unemployment is likely to continue to grow, but at a much slower rate than in 1982. The key figures are set out in Annex 1 to C(83) 5.

The Level of the PSBR in 1983-84

4. The Chancellor of the Exchequer may not want to be too specific about the figures at the Cabinet meeting. As you know, the present forecasts indicate a PSBR in 1983-84 of about £6 billion if tax changes are confined to revalorisation. The medium term financial strategy implies a PSBR of about  $2\frac{3}{4}$  per cent of Gross Domestic Product, or some £8 billion; and this would be in line with the indications given at the time of the 1982 Budget. On

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this basis, there is room for a fiscal adjustment of about £2 billion. The Chancellor of the Exchequer says (paragraph 9 of C(83) 5) that his preliminary view is that it would be a mistake to publish a forecast 1983-84 PSBR above £8 billion. There are indeed arguments for greater caution, which he may wish to deploy:

- (a) The markets are volatile. It would be dangerous to risk losing confidence and provoking a further substantial decline in the exchange rate.
- (b) Inflation is likely to rise again temporarily in the not too distant future. It will be important to do nothing which might add to inflationary pressures and, in particular, to try to keep interest rates down.
- (c) Although there are obvious political attractions in a larger fiscal adjustment, one of the Government's strongest points is its consistency of purpose and prudent management.

5. A further point that must be borne in mind is the effect of any fiscal adjustment on the PSBR in 1984-85. It would be dangerous to pre-empt now too much of the room for manoeuvre in that year. Moreover, the Financial Statement and Budget Report this year will have to include an estimate of the size of the fiscal adjustment in 1984-85: the Government would be strongly criticised if that estimate was unexpectedly low.

6. Clearly all these arguments will apply with greater force to any suggestion that the PSBR should be higher than £8 billion.

#### The Fiscal Options

7. To the extent that the scope for relaxation is used to reduce taxes, should the reductions mainly benefit persons or companies? Should they be concentrated on direct taxation, or used to affect prices through reduced indirect taxation? Are there individual measures which are particularly attractive or unattractive?

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Persons or Companies?

8. Pound-for-Pound, reductions in personal and company taxation have broadly similar economic effects. Reductions in personal taxation may help companies through increased demand or lower wage claims; reductions in company taxation may help people by increasing employment opportunities.

9. The main points which the Cabinet will wish to consider are as follows:

- (a) Recent fiscal measures - particularly the successive reductions in the National Insurance Surcharge (NIS) and last year's loading of the increase in National Insurance Contributions on to employees - have benefited companies rather than persons.
- (b) The depreciation in the exchange rate will help more companies than it damages; the resulting higher inflation will hit persons.
- (c) The Government is exposed to criticism (as Table 2 in Annex 3 to C(83) 5 brings out) for not having done more to reduce the burden of personal taxation.
- (d) On the other hand, company profits are still very low (Table 4 in Annex 3), and the industrial base fragile: the recent revisions in the estimated numbers of people in employment have thrown doubt on previous estimates of gains in productivity over the past few years.

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Direct or Indirect Taxation?

10. The main arguments affecting the choice between direct and indirect taxation are as follows:

- (a) In favour of reductions in indirect taxation is the fact that inflation is likely to turn upwards, at least temporarily. A reduction in indirect taxation would at least partly offset the effect of this on the Retail Price Index (RPI).
- (b) But even a reduction of 0.5 per cent in the RPI would cost some £600 million a year. To achieve a sufficiently large reduction to avoid any upsurge in inflation could use up the whole of the room for fiscal adjustment.

  
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- (c) It would look odd to devote substantial sums to reducing the real burden of taxation on drink or tobacco, though the case for containing the rise in other forms of indirect taxation may be stronger.
- (d) The Government is committed to shifting the burden of taxation away from direct taxation.

Particular Measures

11. There is a very wide range of possible changes which could be mentioned in the Cabinet's discussion. There is a useful ready reckoner of revenue effects in Annex 4 to C(83) 5. The particular pressures most likely to be discussed are the following:

Income Tax: Basic Rate or Allowances?

The arguments in C(83) 5 seem to point to increasing income tax allowances and thresholds. It may be suggested that it would be better to reduce the basic rate. But to reduce the basic rate by only 1p would cost nearly £1 billion in a full year. The same money would permit an increase in allowances (or allowances and thresholds) of 5 to 6 per cent.

NIS

From April 1983 the rate of NIS will be 1½ per cent.

If there is to be a further reduction, the choice may lie between ½ per cent and 1½ per cent (ie abolition): the reduction of 1 per cent would leave the rate at a derisory ½ per cent. Abolition would cost £1.2 billion in a full year.

Corporation Tax

The main rate of corporation tax is 52 per cent. A 2 per cent reduction would cost £230 million in a full year. It might have useful psychological significance, but, because of the generous allowances available, the incidence of corporation tax is very uneven. Reductions in it are not a way of helping the generality of companies.

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Petrol Tax

Particularly in the light of Parliamentary difficulties last year, some of your colleagues may suggest that petrol tax should not be fully revalorised. Halving the increase needed for revalorisation would cost about £100 million.

Public Expenditure

12. It may be suggested that part of the fiscal adjustment should be used to increase public expenditure. I understand that the Chancellor of the Exchequer is discussing various packages with the Ministers directly concerned. The costs of these packages are modest and can probably be found from the Contingency Reserve (ie within the Government's overall spending plans). But more ambitious suggestions may be put forward: for example, for a large programme of public works. If so, you will wish the Cabinet to consider the following:

- (a) The Government has gained a good deal of credit for not increasing its spending plans for 1983-84 between expenditure reviews. Does it want to put that credit at risk?
- (b) If there is to be no increase in public expenditure overall, major new programmes would require off-setting savings. Are those savings available?
- (c) Programmes of public works take a long time to mount. If one could be mounted now (and there are no definite proposals in view), could it take effect quickly enough to be useful?

13. One possible complication is on the social security front. The Ministerial Group on Social Security Issues (MISC 88) is recommending to the Cabinet that the November 1983 uprating of social security benefits should be adjusted downwards by 2 per cent to take partial account of the 2.7 per cent overshoot in the November 1982 uprating. I understand that this is already broadly allowed for in the Chancellor's calculations. But the Cabinet will not consider the recommendations from MISC 88 until

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17th February; and if the decision then were to be in favour of a significantly smaller adjustment, the Budget calculations could be affected. There is however no need to discuss this unless one of your colleagues raises the point.

HANDLING

14. After the Chancellor of the Exchequer has introduced his memorandum, each member of the Cabinet is likely to want to speak. The main questions are:

- (i) What should the PSBR be for 1983-84?
- (ii) How should any fiscal adjustment be distributed as between persons and companies and as between direct and indirect taxation?
- (iii) Should any significant part of the adjustment be devoted to additional public expenditure?

In practice, it will be difficult to keep these issues separate; and you will probably find it convenient to go round the table seeking the views of each of your colleagues on the whole range.

15. You will probably wish to ask the Secretary of State for Industry to speak early in the discussion, so that the Cabinet can take account of his views on the needs of industry. The Secretary of State for Employment may have views on the likely effects on different tax options on wage bargaining. The Lord President of the Council and the Chief Whip can advise on back-bench opinion. The Chief Secretary, Treasury will be able to deal with any public expenditure points.

16. Before you sum up, you may wish to ask the Chancellor of the Exchequer to give his general reactions to the discussion.

CONCLUSIONS

17. In summing up, you will wish to reflect the balance of views on the size of the PSBR in 1983-84 and on the options for allocating any fiscal adjustment. You will wish to make clear that the Chancellor of the Exchequer is not committed by the discussion to particular changes in his Budget and you will want to avoid any commitment to further general discussion by the Cabinet, apart from the traditional meeting immediately preceding the Budget.



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18. You might then record conclusions which:

- (i) Invite the Chancellor of the Exchequer either to take account of the views expressed in discussion in his further work in the Budget or, if there is widespread pressure for a stronger formulation, to be broadly guided by your summing up.
- (ii) Invite any Minister who has particular points on possible tax changes to discuss them directly with the Chancellor of the Exchequer or, in the case of public expenditure points, with the Chief Secretary.

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2nd February 1983