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PRIME MINISTER

BILATERAL WITH THE CHANCELLOR OF THE EXCHEQUER

I passed your comments on to the Chancellor's Office.

The Chancellor's objectives are to reassure the markets and to avoid tying his hands for the Budget. Your objectives are to reassure the markets, and to tie the Chancellor's hands so far as possible to a very prudent PSBR.

Terry Burns (to whom I have now spoken) thought your formulation would be helpful in the discussion tomorrow. He feels the present version is neither one thing nor the other: it will not reassure the markets, but at the same time it says enough that commentators and the Treasury Committee could cause a great deal of difficulty in pressing for explanations of what a meaningless paragraph really means.

Terry is, however, concerned about being tied too tightly to a particular PSBR for next year. He points out that circumstances can change, that there is a large margin of error on the PSBR forecast, and that the Government have all along said that the fiscal stance cannot be determined as early as the autumn. To give a PSBR figure now could lead to greater pressure for green budgets. However, he is not himself yet sure whether he will go for a formula along the lines you have proposed, or whether he will seek an alternative more general formula.

I understand that Peter Middleton has proposed a formula along the lines:

> "This means that taxes next year will be higher than they would otherwise have been."

That sounds like a tautology, but it does suggest that the Government will take the strain on taxation rather than on borrowing. So it is better than the Chancellor's version.

You could meet one of Terry Burns' concerns by leaving a small loophole, thus:

> "My best present assessment is that the Government's fiscal stance should remain as set out ..."

Other weaker versions would be:

(i) "We stand by the objectives and the figures for money and borrowing set out in this year's MTFS."

(ii) "The PSBR should be no more than the figure of $1^3/_4$% of GDP indicated in this year's MTFS."

(iii) "The PSBR next year should be about the same as the figure of $1^3/_4$% of GDP indicated in this year's MTFS."

However, none of these really meets the bill. I wonder whether the real problem is not the markets' belief that the Chancellor wishes to reduce taxation come what may. A clear statement along the following lines might help:

> "The PSBR next year will be set at a level which is consistent with the objectives and the financial policy set out in the medium term financial strategy. If that requires higher taxes, I shall not hesitate to increase them."

This would be consistent with a PSBR either higher or lower than the figure in the MTFS. But it would be worth making the point to the Chancellor that if this formula is adopted, you would not feel inhibited from arguing for a lower figure.

I understand that the question of the national health contribution has not yet been settled with Mr. Fowler.

A note on APRT should come across during the course of the morning.

DN

David Norgrove

3 November 1986

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FROM: A P HUDSON
DATE: 3 NOVEMBER 1986

PS/CHIEF SECRETARY

cc Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Scholar
Mr Turnbull
Mr Sedgwick
Miss O'Mara
Mr Culpin
Mr Gray
Miss Noble
Mr Pickering
Mr Cropper
Mr Tyrie
Mr Ross Goobey

AUTUMN STATEMENT

I attach the Chancellor's own draft of the Oral Statement.

2. The sections on detailed public expenditure measures are pending the Chief Secretary's views.

3. Please could I have comments and additional contributions by close tonight?

David
This is present draft
– likely to be substantially
amended @ meeting tomorrow.
Alex

APH

A P HUDSON

With permission, Mr Speaker, I should like to make a statement.

Cabinet today agreed the Government's public expenditure plans for the next three years.

In the normal course of events that would be followed by the publication of the printed Autumn Statement, accompanied by an Oral Statement to the House, next Tuesday.

For obvious reasons that is not possible this year.

So while the Autumn Statement will be printed in the normal way and laid before the House as soon as it reassembles next Wednesday, I thought it would be for the convenience of the House if I made my Oral Statement today.

This will cover all three of the key elements in the printed Statement: the Government's outline public expenditure plans for each of the next three years and the expected outturn for this year, proposals for next year's national insurance contributions, and the forecast of the economic prospects for 1987 required by the 1975 Industry Act.

Summary tables for both public expenditure and the economic forecast will be available from the Vote Office as soon as I have sat down. //P I turn first to the outturn for the current financial year, 1986-87.

The public expenditure planning total now looks likely to amount to some £140½bn // £1½bn, or a little over 1 per cent, more than was allowed for in this year's Public Expenditure White Paper. The main reason~~s~~ for this excess is an 8 per cent rise in the current spending of local authorities - far more than was provided for. However, two major items of public expenditure which lie outside the planning total, debt interest and the overseas borrowings of the nationalised industries, are likely to fall £1bn short of what was forecast at the time of the Budget, which reduces the overall expenditure overrun to about £½bn.

On the revenue side, the North Sea tax take is likely to be even lower, by about £1bn, than I envisaged at the time of the Budget, largely because for a long period the oil price has been below the $15 a barrel level on which the Budget arithmetic was explicitly based.

This shortfall, however, is more than offset by the continuing buoyancy of non-oil revenues, in particular VAT and Corporation Tax, which now look likely to exceed the Budget forecast by £1½bn. This would imply an overall revenue overrun of about £½bn, the same as the projected expenditure overrun.

At the same time I have one tax change to announce.

The collapse of the oil price has led to a sharp cutback in investment activity in the North Sea, with inevitable consequences for the UK offshore supplies industry both in Scotland and the North of England.

Against this background the Government is conducting a review of the North Sea fiscal regime, and I shall be announcing my conclusions in the light of that review in the Budget.

But given the current difficulties of the offshore supplies industry, there is one change I believe it right to make the change without further delay.

I propose, on a carefully targeted basis, to accelerate the arrangements for the repayment to the oil companies of Advance Petroleum Revenue Tax due to them.

The details of this change, which will require legislation early in the new Session of Parliament, are set out in a Press Notice the Inland Revenue will be issuing as soon as I have sat down.

The new arrangements will result in a loss of revenue this financial year of some £300m, which will of course be fully recouped over the next three years.

Taking this into account, the Public Sector Borrowing Requirement for the current year is now forecast to be about £7½bn, slightly above the £7bn figure which I set in the Budget.

I turn now to the public expenditure plans for the next three years. This year, for the fourth successive year, public spending is set to decline as a proportion of national output.

And this remains true even before deducting the proceeds of privatisation.

The Government is determined to ensure that this trend continues: to see to it that total public spending, even without taking account of privatisation proceeds, continues to decline as a percentage of GDP. The plans I am about to announce secure that objective. But within this overall constraint the Government has felt it right, in the context of its policy priorities, to allow an increase in the previously announced planning totals for 1987-88 and 1988-89.

The new totals have been set at £148½bn for 1987-88 and £154½bn in 1988-89, an increase of £4½bn and £5½bn respectively.

For 1989-90 the planning total has been set at £XYZbn.

Compared with the forecast outturn for 1986-87, these totals suggest an average growth of public spending of a shade over 1 per cent a year in real terms, well within the prospective growth of the economy as a whole.

As usual, these totals incorporate estimates for the proceeds of privatisation. Last year I increased the estimate of these proceeds very substantially to £4¾bn in each of the three Survey years, a figure which I expect to be duly achieved this year.

Although the privatisation programme is now moving ahead more strongly than ever before, I have decided to make only a modest further addition to this estimate, bringing it to £5bn in each of the next three years.

The new planning totals also contain substantial reserves, rising from £3½bn in 1987-88 to £7½bn in 1989-90.

[These are larger than in any previous survey with the exception of last year's, when, exceptionally, local authority provision was artificially set at the same cash figure for all three years and special allowance had to be made for this in setting the reserves.]

The public expenditure increases I have announced allow us to make realistic provision both for local authority current expenditure, over which the Government has no direct control, and for demand-led programmes such as social security, while still leaving scope for increased spending on services to which the Government attaches particular priority.

But before referring to some of the more important changes, let me make one thing absolutely clear.

There can be no question of allowing the projected increases in public expenditure over the next three years to undermine the prudence of the Government's overall fiscal stance, either next year or subsequently.

The Government's fiscal stance will remain as set out in the medium-term financial strategy published at the time of this year's Budget, that is, the PSBR for 87-88 will be at or below 1¾% of GDP.

Pending CST's views

[The largest increase comes on local authority current spending, where provision for 1987-88 and 1988-89 had previously been set at the same cash level as in 1986-87, pending further decisions. Full account has now been taken of likely future levels of spending, and this has meant an increase of £4bn in provision for 1987-88. Over half of this increase is for education, including the new proposals on pay and conditions of service for teachers announced last week. A further major portion of the increase is for the police. In subsequent years provision has been set so as to grow [broadly in line with] inflation.

In addition to the increased provision for the cost of education in schools contained within local authority current spending, there will be additional provision for universities of £60m in 1987-88 and £70m in 1988-89.

Spending on the health service will be increased by £310m in 1987-88 with further increases in subsequent years. Combined with the resources increasingly being generated by greater efficiency, this will not only meet the growing demands on the health service but will allow it to improve services.

In addition to enjoying the benefits of substantially higher receipts from council house sales - nearly £1bn over the three years - housing investment will be increased by £225m in 1987-88. This will sustain the rising trend of spending on renovation and improvements and provide extra resources for the housing associations.

In the light of this year's experience, £1¾bn has been added to next year's provision for social security, most of which represents greater take-up of existing means-tested benefits.

For defence, the provision remains as planned in the last White Paper after allowing for minor changes, including a reduction in the estimated cost of the Falklands deployment. The defence programme will continue to benefit from the substantial real growth in previous years and the wide-ranging action to improve efficiency and value for money.]

A summary table setting out the figures for each programme will be available in the Vote Office as soon as I have sat down, and further details of these and other changes will be contained in the printed Autumn Statement which will be published as soon as the House returns next week. In addition, full details, together with information on running costs and manpower, will be given in the public expenditure White Paper early in the New Year.

I now turn to National Insurance contributions. The Government have conducted the usual Autumn review of contributions in the light of advice from the Government Actuary on the prospective income and expenditure of the national insurance fund, and taking account of the benefit uprating which my Rt Hon Friend the Secretary of State for Social Services announced on 22 October.

The lower earnings limit will be increased next April to £39 a week, in line with the single person's pension, and the upper earnings limit will be similarly raised to £295 a week. The limits for the reduced rate bands which I announced in last year's Budget will also be increased again in April, but by proportionately larger amounts. Thus the upper limit for the 5 per cent and 7 per cent bands will be raised to £65 a week and £100 a week respectively, and the upper limit for the 9 per cent rate for employers will be raised to £150 a week. The taxpayer's contribution to the National Insurance Fund - the so-called Treasury Supplement - will be reduced by 2 per cent to 7 per cent, but this will not require any change in contribution rates. Thus the main Class I contribution rates will once again remain unchanged at 9 per cent for employees and 10.45 per cent for employers.

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Finally, I turn to the Industry Act Forecast.

Both growth and inflation have turned out to be slightly lower this year than I envisaged at the time of the Budget.

x Growth now looks like turning out at 2½ per cent, against a Budget forecast of 3 per cent, and inflation in the Fourth Quarter of this year now looks likely to be 3¼ per cent, against the Budget forecast of 3½ per cent. The principal reason for this slower growth has been the disappointing performance of exports, which were hard hit by the cutback in spending by OPEC and other primary producers affected by the sharp fall in commodity prices in general and the oil price in particular. These are export markets of particular importance to the UK.

Combined with a halving in the value of our own oil exports, this has meant a significant deterioration in the current account of the balance of payments, a surplus of from £Xbn in 1985 - and a cumulative surplus of £YZbn over the six years from 1980 to 1985 inclusive - to a forecast of broad balance for 1986.

Looking ahead to 1987 the prospects are generally encouraging. While the inescapable adjustment of the exchange rate to the oil price collapse has now taken place, it will inevitably take time before the full benefits come through in higher non-oil exports and reduced import penetration at home.

This means we can expect the current account of the balance of payments to go into deficit next year, for the first time since 1979, to the tune of some £1½bn.

Even so, exports are forecast to rise next year by 3 per cent, compared with an increase of only 1 per cent this year, with manufacturing output, in consequence, up by 4 per cent. And with domestic demand continuing to expand at the same rate as this year, the economy overall is likely to grow by a further 3 per cent next year - the sixth successive year of growth at 3 per cent or thereabouts, and into the seventh.

Recorded inflation is likely to edge up a little, to 3¾ per cent in the Fourth Quarter of 1987.

This is [entirely/almost entirely] due to the effect on the RPI of the timing of mortgage rate changes, and the Government's commitment to a monetary policy that will squeeze out inflation remains unabated.

Meanwhile the likelihood of faster growth next year, coming at a time when unemployment already appears to have stopped rising, suggests that the prospects for some fall in unemployment are now more promising than at any previous time this decade.

But this promise could still be frustrated by

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excessive pay settlements. // The full text of the Autumn forecast is to be published today and is now available in the Vote Office.

It will, of course, also be included in the printed Autumn Statement next week.

Mr Speaker, the strategy we have followed since 1979 has brought inflation down to the lowest level for two decades, combined with sustained growth and steadily rising living standards.

This is a combination that has eluded successive Governments for a generation. We have brought it about by the determined pursuit of free markets and sound money.

And that is what we will stick to.