PRIME MINISTER

BILATERAL WITH THE CHANCELLOR

There is a great deal to discuss and I do hope you will be able to finish your meeting with Paul Nitze fairly promptly.

I suggest you start with the question of intervention. You will want to make it clear to the Chancellor that you will be reluctant to see a reduction in interest rates before we have recouped a good part and preferable all of the reserves we have lost during this financial year. (I hope to be able to let you have figures for the change in the reserves for the meeting.)

The Tsy now say (with apologies) there was a decrease.

The Chancellor may say that in calendar 1986 we showed a net increase. But he cannot keep changing the period for comparison. During last autumn the evening market report showed the change in reserves from 1 July 1986. When you put him under pressure about the size of that loss he changed the date to 1 April. He should not seek to change it again.

The Chancellor may also say that you are exaggerating the importance of the size of the reserves. But if that is the case, why has he undertaken two huge dollar borrowing operations?

Another argument may be that the markets have been thin and prices have been moving up without much business. I think you can say robustly to him that you do not believe it. It does not square with reports in the newspapers. Nor does it square with the scale of trading in London's financial markets even on a so-called quiet day.

This could lead naturally into a discussion of the G5 (the Chancellor's minute is enclosed). There is natural scepticism about whether the agreement will have any effect on the exchange markets if it is seriously tested, and quite likely it will fail. But I do myself think that this may be part of a gradual movement towards exchange rate management even amongst the three major countries, spurred on by the difficulty of targeting monetary aggregates in the major economies and by the wild gyrations of the last few years. The process is slow and we shall only see the pattern with hindsight.

You will want to discuss with the Chancellor whether you should send a personal message to President Reagan about Italy and the G5.

The main item for discussion is the Budget.

The PSBR for 1986/87 is now forecast at £4.3 billion. This has not caused the forecasters to change their figure for 1987/88. I suspect they are erring on the side of caution.

The best news is that the Chancellor has provisionally decided to reduce the scale of his tax package from £2.9 billion to £2.6 billion and to reduce the 1986/87 PSBR from £4.3 billion to £4 billion.

The measures he has in mind are as follows:-

(i) 2p. off the basic rate, with a narrowing of the higher rate bands as last year in order to remove the extra benefit for higher taxpayers;

(ii) No revalorisation of any of the specific duties (with the result that there is a net shift towards indirect taxation: the reduction in indirect taxation is less than the reduction in direct taxation);

(iii) Revalorisation of the basic rate allowance by 3.7 per cent as provided for in Rooker-Wise, rather than the 5 per cent the Chancellor had earlier mentioned. (This is the main source of the reduction in the size of the package.)

The remaining changes are relatively small:-

(iv) VAT avoidance measures, as announced in December;

(v) VAT cash accounting for small businesses which will help them, for example by in effect giving them relief for bad debts;

(vi) Profit related pay at a more generous rate than envisaged in the Green Paper;

(vii) Measures on personal pensions and additional voluntary contributions;

(viii) Measures to prevent abuse of pension rules e.g. on lump sums and final salaries;

(ix) Increase and simplication of the inheritance tax thresholds (cost £70 million in 1987/88);

(x) Simplification of capital gains tax, including taxation of corporate capital gains as income; ACT set-off will be allowed;

(xi) Anti-avoidance measures to tackle dual residence companies and tax avoidance by banks;

(xii) A small liberalisation of the business expansion scheme to help avoid the way in which schemes bunch towards the end of the financial year;

(xiii) A couple of small changes on North Sea oil tax, including a small measure of cross-field set-off (where some expenditure on one field can be offset against tax accrued on another);

(xiv) An extra age allowances for the over 80s;

(xv) A concession to help training not related to the specific job being done by the person concerned;

(xvi) Abolition of on-course betting duty (this will also help the Tote).

There are no measures at all which directly increase public expenditure. (I do not know whether any have indirect effects.)

The Chancellor will need at some stage to agree his proposals on the MTFS with you.

This all assumes the Chancellor has no surprises up his sleeve which even Treasury officials as yet know nothing about.

David Norgrove

24 February 1987