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ft

12 February 1988

Paul Gray
No.10 Downing Street

Note

Passed on PM's comms
to Alex Allen.

RCCG

15/2

Dear Paul,

PAPER FOR ECONOMIC CABINET

... I attach the latest draft of the Chancellor's paper for Cabinet next Thursday. The Chancellor himself will be working on the draft over the weekend, before it is circulated on Monday. He would be grateful for any comments the Prime Minister may have.

Prime Minister

Yours
Alex

A C S ALLAN

I have raked minor
comments on paras. 7 and 11.
Otherwise this seems OK to me.
Contact?

RCCG

12/2

SECRET

PAPER FOR ECONOMIC CABINET

Eight years of steady and cautious financial policies have put the British economy in the strongest position we have enjoyed for many years. Provided that we stick to those policies, we shall be well placed to withstand any shocks which may lie ahead, particularly overseas, and should continue to enjoy a healthy growth rate with low inflation.

2. All in all, 1987 was a successful year for the British economy. The growth rate was probably a shade over 4 per cent, compared with the Budget forecast of 3 per cent. Unemployment fell by over half a million. Manufacturing productivity grew by about [6 per cent]. And, unlike in earlier periods of rapid growth, there was no resurgence of inflation.

3. Looked at in a longer term perspective, the performance of the economy also shows up well. It is not simply a matter of doing better than in the 1970s: it would have been appalling if we had not. But output in recent years has on average grown faster than in the 1950s and the 1960s; we have brought inflation back to its average level in the 1950s and 1960s; and

manufacturing productivity has grown at over 4½ per cent a year, compared with less than 3½ per cent in the 1950s and 1960s.

4. These achievements reflect the steady transformation which is taking place in the efficiency, enterprise and adaptability of all sectors of the economy. Our financial policies have given the private sector the room and the confidence to expand. And our supply-side policies have reduced the barriers which held British industry in check for far too long. It is clearly vital that we stick to the policies that have brought about this success.

Economic Prospects

5. This is especially true against world background that remains uncertain. Very large trade imbalances persist, especially between the US, Germany and Japan. And while we have recently seen somewhat more stable conditions in financial markets around the world, the dollar remains volatile and confidence in equity markets is fragile.

6. World growth in 1987 was close to what I forecast in the Budget last year. The GNP of the major seven industrial countries rose by 3 per cent. And industrial production in the G7 accelerated during the

year as net exports to the rest of the world improved. World trade in manufactures appears to have risen by 5 per cent, somewhat above the rate in the previous two years.

7. The latest indicators suggest that world activity remains fairly buoyant, particularly in Japan, the UK and (for the most part) the US. But the stock market collapse is likely to dampen demand in the US, and growth in Germany remains sluggish. We are likely to see GNP growth in the G7 slow down to perhaps $2\frac{1}{2}$ per cent in 1988. But there are risks that it could be less than that, particularly if there is further instability in world equity and foreign exchange markets.

The risks
are not all
one-way.
PRCG.

8. Nevertheless, we should see continued healthy growth in UK exports in 1988, though probably not as high as in 1987, when our non-oil exports grew by $7\frac{1}{2}$ per cent.

9. So far as UK domestic demand is concerned, we should see a further strong rise in investment growth; this is confirmed by the various surveys of business confidence and intentions carried out since the Stock Market collapse in October, which continue to indicate buoyant investment plans. Consumers' expenditure should grow a little less strongly in 1988, as the savings ratio picks up from its historically very low level in 1987.

If it does

10. With a steady growth of domestic demand and further strong growth in exports, I now expect 3 per cent growth in 1988 for the economy as a whole. As North sea production will be falling, this implies non-oil GDP growth of around $3\frac{1}{2}$ per cent. This should be sufficient to ensure a further fall in unemployment, though probably not at the rapid rate of the last 12 months. The prospects for a further fall in unemployment would clearly be better if pay settlements were more modest.

11. The deficit on the current account of the balance of payments in 1987 is now estimated at £2.7 billion - broadly in line with the £2½ billion deficit I forecast at the time of last year's Budget. With UK growth in 1988 once again exceeding that of the other major economies, and our surplus on all trade falling as North Sea oil output falls, a higher current account deficit is likely in 1988. But at less than 1 per cent of GDP it will be very much lower than the trade imbalances elsewhere, and we should have no difficulty in financing it. *but it is clearly a more favourable position to be in.*

*implies
no more
than £4 billion*

12. Inflation as measured by the Retail Price Index (RPI) crept up to just under $4\frac{1}{2}$ per cent in the third quarter of last year, but has since fallen back to under $3\frac{1}{2}$ per cent. These fluctuations largely mirror fluctuations in the mortgage rate, and the prospect is that the inflation rate should stay at around 4 per cent during 1988.

*? a bit too
replacement
Yes - the trend
will be increasing
for 2-3 years in
succession.*

Not
Compared with
the EC
average.

13. Our recent record of sustained low inflation is impressive when compared with the UK's earlier experience at times of rapid growth. But many of our major competitors have still lower inflation rates, and we must continue to give the highest priority to getting our inflation rate down further during the course of this Parliament.

Fiscal Prospects

14. Last year I introduced a cautious Budget which, despite a cut of 2p in the basic rate of income tax, was expected to produce a PSBR inclusive of privatisation proceeds of just under £4 billion (1 per cent of GDP), somewhat less than had been previously envisaged. In the event, the public finances in the current financial year are turning out to be considerably stronger than I expected. It now seems likely that the PSBR will be negative - ie there will be a Budget surplus - for the first time since 1969-70.

15. The major reason for the improvement in public finances has been a faster growth in tax revenues than we had foreseen. This has meant that, despite the tax reductions in the Budget, the share of non-North Sea taxes in GDP has increased. In fact, the tax burden has now risen in each of the last 2 years, and is nearly 4 percentage points higher than it was in 1978-79.

16. I am convinced that we must continue to follow a cautious fiscal policy. With the uncertainties ahead - and with UK demand remaining buoyant at a time when growth elsewhere is sluggish - this means that we should aim for a PSBR well below the level envisaged in the ^{MTEF} MSTF: indeed, I believe I should budget for a modest surplus.

17. But even on this basis there should be some scope to lower tax rates again this year. Indeed, unless we do so, fiscal drag will ensure that the non-North Sea tax burden rises yet again next year. But there are clearly limits to how much can be done while still maintaining the sound financial policies which have been the cornerstone of our success.

Summary and Conclusions

18. Output growth last year was well above the 3 per cent average we have enjoyed since 1981, but is likely to be closer to that average this year. This will still be well above the growth rate in most other major countries. Unemployment is likely to continue to fall, although more slowly than in 1987. Inflation should remain steady at about 4 per cent.

19. But there are considerable risks and uncertainties, especially on the international front. We must therefore

once again play safe, to ensure that in the coming year, as in the past, we are buttressed by sound and strong public finances. That means that tax reductions must be limited to a scale that enables us to secure a further year of Budget surplus.

20. I would welcome colleagues' views on the Budget against the background of the fiscal and economic prospect I have outlined.

I fear
that some
may respond
to this
invitation by
demanding
increased expenditure.

ANNEX 1

	1980	1981	1982	1983	1984	1985	1986	1987	1988(1)
World GNP, (2) in major 7 economies (per cent change)	1	1½	-½	3	5	3	2½	3	2½
UK GDP, (2) (per cent change)	-2½	-1	1½	3½	2½	3½	3	4½	3
Domestic demand, (2) (per cent change)	-3	-1½	2	4½	3	3	4	4	4½
Retail prices Q4 (per cent change) on a year earlier	15½	12	6	5	5	5½	3½	4	4
Interest rates (average 3-month interbank)	16½	14	12½	10	10	12	11	9½	9 (3)
Unemployment (UK, per cent of working population excluding school leavers)	5½	8½	10	11	11	11½	11½	10½	9
Sterling Index	96	95	90½	83	78½	78	73	72½	74½ (3)

(1) Provisional pre-Budget figures.

(2) At constant prices.

(3) February 2.

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ANNEX 2: DIRECT EFFECTS OF TAX CHANGES

A. Direct Taxes: Indexation

The RPI increased in the year to December 1987 by 3.7 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>1987-88</u>	<u>1988-89</u>
Single and wife's earned income allowance	2,425	2,515
Married allowance	3,795	3,945

Bands, eg:

29% rate	0-17,900	0-18,600
60% rate	over 41,200	over 42,800

The total revenue costs of indexation of income tax (included in the forecast) are £840 million in 1988-89 and £1,370 million in 1989-90.

B. Indirect Taxes: Indexation

The effects of 3.7 per cent revalorisation of the excise duties (including VAT effects) are as follows:

<u>VAT inclusive price change</u>		<u>Yield in</u> <u>1987-88</u> <u>£m</u>	<u>RPI impact</u> <u>% points</u>
Beer	0.8p/pint	60	0.04
Wine	3.1p/75cl light wine	20	0.02
Spirits	20.1p/bottle	25	0.03
Tobacco	3.4p/20 king size	100	0.09
Petrol	3.7p/gallon	195	0.07
Derv	3.2p/gallon	50	neg.
VED	£3.7/car	<u>100</u>	<u>0.03</u>
Overall effect, including minor duties (included in forecast)		<u>550</u>	<u>0.28</u>

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C. Ready Reckoners: Illustrative Tax Changes

	<u>1988-89</u>	<u>£ million</u> <u>1989-90</u>
INCOME TAX		
<u>Allowances and Thresholds</u>		
1% above indexation on all statutory allowances	185	240
1% above indexation on all statutory allowances and thresholds	215	295
<u>Rates</u>		
Change in basic rate of 1p	1,250	1,600
CORPORATION TAX		
Change in main rate of 1 percentage point	360	560
Change in small companies' rate of 1 percentage point	25	45
VALUE ADDED TAX		
Change in VAT rate of 1 percentage point ⁽¹⁾	940	1,310

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

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ANNEX 3: PUBLIC FINANCES AND THE TAX BURDEN

Taxation, Expenditure and Borrowing

Since the Government came to power total taxes and NICs have risen by over 4 percentage points of GDP, though the ratio has fallen from its peak in 1981-82. General government expenditure has fallen by more since then, permitting a significant reduction in borrowing.

Table 1

Overall Taxation, Expenditure and Borrowing
(percentage of GDP at market prices)

	Non-North Sea Taxes plus NICs (as per cent of non-North Sea GDP)	Total Taxes plus NICs	General Government Expenditure (excluding privatisation proceeds)	PSBR
1978-79	34.1	33.8	43.2	5.3
1979-80	35.2	35.1	43.4	4.8
1980-81	36.1	36.3	46.0	5.4
1981-82	38.7	39.4	46.5	3.3
1982-83	38.2	38.9	46.8	3.1
1983-84	37.8	38.5	45.9	3.2
1984-85	37.8	39.1	46.2	3.1
1985-86	37.0	38.5	44.5	1.6
1986-87	37.4	37.9	43.9	0.9

Personal Taxation

2. Despite reductions in income tax, total personal taxes (direct and indirect, including employees' NICs and domestic rates) in 1987-88 are about £24 billion higher in real terms (ie 1987-88 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 rose up to 1981-82, particularly for the low paid:

Table 2Income 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	18.9	29.0	31.5
1986-87	18.9	28.5	30.9
1987-88 (estimate)	18.9	27.4	29.7
1988-89 (indexation)	19.3	27.6	30.0

*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.

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 about 22% in real terms since 1978-79, slightly less than earnings. The basic rate has been reduced from 33p to 27p, but the 25p reduced rate band has been abolished.

4. As the table shows, indexation of allowances in the Budget would lead to a slight rise in the proportion of incomes taken in tax and NICs. This is because earnings are assumed to rise by more than the increase in tax thresholds, which is indexed to changes in prices.

Business Taxation

5. Following the sharp rise in corporation tax receipts over the past two years, total taxes paid by businesses (outside the North Sea) are now higher as a percentage of GDP than in 1978-79. Within this total, the major change has been a fall in employers' NICs and NIS as a percentage of GDP, offset by increases in corporation tax, business rates and 'other' taxes as the following table shows:

Table 3Taxes paid by Businesses fbn in 1987 88 prices

(figures in brackets are % of GDP)

	Corporation Tax ¹	Taxes on self employment incomes	Employers' NICs and NIS	Rates	Other ²	Total
1978-79	7.7	2.6	12.6	5.1	4.0	32.1
	(2.2)	(0.7)	(3.6)	(1.4)	(1.1)	(9.1)
1987-88 (estimate)	15.2	3.3	11.3	7.2	5.9	43.0
	(3.6)	(0.8)	(2.7)	(1.7)	(1.4)	(10.1)

¹Excludes North Sea, but includes ACT²VED, car tax, road fuel duty, duty on rebated oils, capital taxes