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LONDON SW1A 2AA

From the Private Secretary

18 October 1990

Dear John,

PRIME MINISTER'S MEETING WITH THE CHANCELLOR: 17 OCTOBER

The Prime Minister and the Chancellor held their regular weekly bilateral yesterday.

I should be grateful if you would ensure that this letter is seen only by those with a strict need to know.

The Chancellor reported on the PES negotiations. Only two main programmes were now outstanding: defence, where in particular a third year settlement had not yet been concluded, and education, where the gap had now been substantially narrowed. (Later in the evening the education programme was settled bilaterally with the Chief Secretary.) It now looked as though the addition to the planning total for 1991-92 would be a little below the £10 billion figure indicated earlier by the Chief Secretary. There was some presentational attraction in keeping the total to just below £200 billion. But that might not be practical: officials were however examining the scope for appropriate minor adjustments to the figures including setting the reserve a little lower than originally planned.

In striking such a tough overall settlement, it had inevitably been necessary to make some hard judgements. Particularly difficult decisions had had to be made on the social security budget. A revision to Child Benefit which would give an additional £1 per week to the first child was proposed. This could prove controversial. The package proposed was also designed to give more to certain priority groups: this had been paid for by taking further the progressive privatisation of Statutory Sick Pay (SSP). This would add to employers' costs; but this would be offset by changes to National Insurance Contribution employers' rates. Other steps on NICs were also planned however, such as under-indexation of the thresholds: in total there would be a gain to the PSDR of around £180 million with the cost falling on employers. The proposal on SSP would require primary legislation. The Chief Secretary had agreed to the package on the strict understanding that if the legislation proved unachievable, the Social Security Secretary would find corresponding savings on his programmes elsewhere.

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The Chancellor said that the next Treasury economic forecast would be ready shortly. The Treasury's central forecast would be sent to the Prime Minister. There was considerable room for varying assumptions on certain economic variables. The published forecast was likely to show positive but very slow growth in 1991. The RPI forecast for 1991 Q4 would be set at 5½ per cent: this was a little above the Treasury's best guess, but would discourage early expectations of interest rate reductions. On the latest central projections unemployment would be as high as 2 million next year. For the published forecast a stylised assumption of interest rate reductions would be adopted. In practice, the Chancellor did not expect the next reduction in interest rates until around the turn of the year.

The worrying feature of the latest forecast was the prospective deterioration in public finances. For 1990-91 a PSDR of £4 billion was projected; the PSDR would fall to £1 billion in 1991-92. But thereafter a sharp deterioration to a PSBR of around £9 billion in 1992-93 was projected. This reflected lower VAT receipts; the effect of abolishing the composite rate for the building societies; the lagged effect of Corporation Tax receipts which reflected low growth and low profits; and generally depressed revenue from all asset-related and profit-related taxes.

Treasury forecasters had also carried out a simulation of the impact on the economy of a war in the Gulf. Much would depend of course upon the length and cost of any hostilities. But a short, if brutal, conflict was likely to have only a short-term impact on the RPI.

The Chancellor said he had been giving thought to the development of the Government's family policies on taxation and child benefit. For next year, a provisional decision had been taken to increase child benefit only for the first child. And, given the tight overall fiscal position, there were constraints on any radical reforms in the tax field.

But it was not clear that the present balance between child benefit and the extra tax allowances for married couples was appropriate. Nor was it evident that, within the tax system itself, the present married couples allowance made much sense. There were arguments in favour of a wide range of reforms to both child benefit and tax allowances which would need to be considered further.

The separate taxation of husbands and wives had been widely welcomed. But some women were disappointed that the married couples allowance was nearly always paid to the husband. Moreover, it was not obvious why a family comprising two earners and two children should be given larger tax allowances than a family comprising one working adult and two children - especially when the woman was unable to take up work while looking after small children. The married couples allowance could be seen as a surrogate for a family tax allowance; but if so it was not well-directed under present arrangements.

One approach which had been floated would be to create a care costs tax allowance to encourage more mothers to go out to work. Others believed this was undesirable; instead the tax arrangements should make it easier for women to stay at home and look after young children. Another approach might be not to index the married couples allowance this year, but to concentrate any room for manoeuvre on single allowances - though it would then be logical to do more through child benefit. A further approach which might be investigated was a rise in NICs which would then be reflected in higher child support - again through child benefit. But that in turn raised issues of inter-generational equity - by shifting the balance in paying for family support from general taxation (which was partly funded by pensioners) to NICs (which was wholly funded by the working population).

It was agreed that these were difficult issues: the Chancellor would give further thought to the options and report back to the Prime Minister as appropriate.

More generally the Chancellor indicated that his thinking on the budget had not developed very far at this early stage. Ideas included an increase above inflation in tax allowances; a lower increase in tax allowances and a new low starting rate for income tax; a "Greenery" package, for example to encourage the use of diesel rather than petrol; and a possible additional tax on the oil companies.

Finally, the Chancellor raised the implications of the Barber/Guardian Royal Exchange case in the European Court. As the Prime Minister was aware this had a potentially enormous impact on the Exchequer. The Chancellor saw wider economic attractions in raising the retirement age. This might be achieved over a number of years without for example prejudicing the expectations of those over 40. The Prime Minister agreed there were attractions in raising the retirement age. The next step would be the paper promised from the Social Security Secretary.

Yours ever,

Barry

BARRY H. POTTER

John Gieve, Esq.,
HM Treasury.