3.49

SECRET

Prime Minister 2

In addition to seeking your approval of these papers, the Chancellor would like to settle timing of distribution.

AT 31/1

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

31 January 1984

Public Expenditure
Pt 26

Andrew Turnbull Esq
10 Downing Street
LONDON SW1

Dear Andrew,

CABINET: 9 FEBRUARY

The Prime Minister and the Chancellor have agreed that it would make sense to consider in Cabinet on 9 February not only the overall economic position in the run up to the Budget, but also the issues of Capital and Current Expenditure, and Public Expenditure in the Longer Term. That means that we have three papers to circulate, and the Chancellor has had it very much in mind that the Prime Minister would wish to see, before her departure for Budapest, the three drafts. All three will therefore reach you today, so that the Prime Minister is in a position to discuss them, if she should so wish, at her meeting with the Chancellor tomorrow.

I enclose with this letter copies of the main Economic Strategy paper, and of the Long Term Public Expenditure paper.

The former is on similar lines to Sir Geoffrey Howe's paper of exactly a year ago, which was the basis of a satisfactory discussion in the comparable Cabinet. You will however note one significant innovation (at paras 12 and 13). Because it seems appropriate in the first MTFS of the new Parliament to set out a path for (the monetary aggregates and) the PSBR which covers a full five years, it is necessary to show public expenditure figures going beyond the ambit of the recent Survey and the forthcoming Public Expenditure White Paper. Although the figures for the extra two years can only be assumptions, the Chancellor thinks it right to seek collective approval for them.

The Long Term Public Expenditure paper is, as you will see, prepared on a very different basis from the 1982 exercise, and should not carry the same risks as that exercise did. There could indeed be criticism of the absence of Departmental programme figures in a Green Paper along the lines proposed, but the Chancellor believes that it is necessary to publish a discussion document, and that it would be better to face such criticism than to provide a detailed breakdown of expenditure forecasts, along 1982 lines. He would be happy to discuss this with the Prime Minister tomorrow.

The Capital/Current paper is being forwarded separately to you from the Chief Secretary's office this afternoon.

X The Prime Minister may wish to discuss tomorrow the timing for the circulation of papers to Cabinet. There seems no reason why the Capital/Current paper should not go round on Thursday, with the Long Term Public Expenditure paper (following on Friday.) But it would be in line with the recent precedents if the Economic Strategy paper was not circulated until next week.

Yours ever,
John Kerr.

J O KERR
Principal Private Secretary

DRAFT CABINET PAPER

ECONOMIC STRATEGY

Memorandum by the Chancellor of the Exchequer

The background to the Budget, which will set the tone for the remainder of this Parliament, is one of steady growth in output and continuing success on inflation. My aim will be to build on this, and on the progress made in my predecessor's Budgets.

Economic prospects

2. The recovery began in early 1981, ahead of the rest of the industrialised world, mainly as the result of falling inflation and lower interest rates. A year ago the Treasury forecast was of growth in output of some 2 per cent in 1983. Most outside forecasters saw this as optimistic. In fact growth has been around 3 per cent; while inflation has fallen more than expected, averaging 4½ per cent in 1983, the best performance since 1967. Numbers in work have been growing again for the first time since the recession began, with total employ ment, job vacancies, and overtime all up, and short time working at its lowest level for 4 years.

3. The prospects for the year ahead are also encouraging. The latest forecast suggests that output will grow by a further 3 per cent this year, and that inflation - after rising to about 5½ per cent in the early summer - will be down again to around 4½ per cent by the end of the year. CBI surveys and the CSO leading indicators confirm expectations of a continuing increase in activity, reinforcing the better prospect for jobs.

4. There remains 2 major external worries. First, the size of the US budget deficit continues to exert upward pressure on world interest rates, thus exacerbating the international debt problem, and it seems clear that adequate remedial action has been postponed until after the Presidential Election. Secondly, although the risk of a sharp fall in oil prices has receded a little, it has not disappeared: and such a fall, though in the long term helpful to world economic activity, would be distinctly unhelpful to our balance of payments and tax revenues in the coming year.

5. There is also a domestic risk. With company profits and job prospects improved, wage settlements could begin to creep up again, damaging competitiveness in foreign and domestic markets. We need to do all we can to ensure that this does not happen.

Something needed here on unemployment which will be in Ministers minds after Thursdays figures
AT

6. Provided it does not, the change already apparent in the pattern of our recovery should continue. Initially the recovery arose principally from an end to de-stocking, and rising domestic consumption. This year we expect continuing growth in consumer spending, higher industrial investment, especially in manufacturing, and a further increase in housing investment. But a greater contribution to recovery should come from overseas demand. Export growth of some 5 per cent this year should help to ensure a continuing surplus on the balance of payments, and the export recovery is already showing in recent trade figures.

7. Annex 1 sets out some of the key figures. Those for this year are based on early forecasts; a further and firmer forecast will be published as usual at Budget time.

Economic Strategy: The MTFS

8. We have shown that it is possible to achieve falling inflation and steady growth, without resort to the fiscal boost which simply fuelled inflation in the past. Getting inflation down was indeed an essential precondition for durable recovery. In the world at large our current performance is seen as demonstrating the success of firm financial policies, and the importance of cutting back on borrowing. I am convinced that we must hold to the strategy. It is now bringing results, and to change it would risk throwing away all that has been achieved.

9. The present Medium Term Financial Strategy, set out in last year's Red Book, extends only to 1985-86. I believe that we should this year publish projections covering the remainder of this Parliament. The benefits, for expectations and market confidence, of setting out a clear medium term path, providing an assurance of a stable monetary and financial framework, need no repetition.

10. Lower inflation, both as a desirable end in itself, and as a source of higher growth and more jobs, must remain our objective. I do not under- estimate what has already been achieved, but even 5 per cent inflation would have seemed worryingly high in the 1950s and 1960s, and is still well above the rates prevailing among our main competitors, the Americans, Germans and Japanese. So fiscal and monetary policy must be designed to achieve a continuing gradual decline in inflation through this Parliament, with price stability as our ultimate objective.

11. This means that monetary growth has to be brought down, and preferably without the enforced recourse to higher interest rates which has been a distinct and growing possibility in recent months. So we must aim for lower Government borrowing. The PSBR as a share of GDP came down from 5½ per cent in 1978-79 to 3½ per cent in 1981-82, but we have since registered no further downward progress. I believe that the MTFS path must show a significant further fall. to what?

12. In successive MTFSs we have shown a path for the PSBR deriving from assumptions about future revenue and expenditure. The expenditure figures have been in line with those in the most recent Public Expenditure White Paper. For a 5 year MTFS, we would this year have to show expenditure figures going 2 years beyond those covered in the 1983 survey and hence in the forthcoming White Paper. I believe that the assumption at this stage should be that expenditure is held constant in real terms at the level for 1986-87 which resulted from this year's Survey: the different status of the additional 2 years' figures would of course be signalled in the text; and final decisions on the 1987-88 and 1988-89 figures will of course remain to be taken in subsequent surveys.

13. On this basis, I seek colleagues agreement to the principle of rolling-forward the MTFS for 5 years, and to using for the final 2 years the assumption of rolling-forward the 1986-87 public expenditure figure constant in real terms.

Borrowing: 1983-84 and 1984-85

14. The published autumn forecast of the outturn 1983-84 PSBR was £10 billion: £1.8 billion above the target set by my predecessor. But for the measures we took in July to rein back spending, the increase would have been larger.

15. As the difference between two very substantial figures (revenue and expenditure totals) the outturn PSBR is of course particularly hard to forecast accurately. With more help from Departments, I hope our performance this year will be better than last year's. But I can at present say no more than that the latest expectation is still of an outturn of around £10 billion.

16. It will be important for market confidence, and the credibility of our policy generally, that this year's overshoot should be seen not to carry forward into next year. We need, as a minimum, to be seen to be getting back to the path for borrowing set out in last year's MTFS, where a PSBR of £8 billion was envisaged for 1984-85.

17. There are in fact powerful arguments for aiming for a lower figure. We are at the stage of the cycle when output rises above the long term trend. We also face the possibility of a gradual decline in North Sea oil revenues after next year. And, in judging the appropriate 1984-85 PSBR, we have to take into account sizeable privatisation plans of some £2 billion a year. While asset sales are rightly treated as diminishing public expenditure, and

hence the PSBR, they produce less downward impact on interest rates; and the pressures on the financial markets need to be taken into account in judging the appropriate level for the PSBR.

18. For all these reasons, I am clear that it would be wrong to provide for a PSBR next year higher than the £8 billion envisaged for 1984-85 at the time of last year's Budget; and it may well be prudent, in terms of market confidence and hence interest rates, to aim for a slightly lower figure.

Fiscal options

19. I warned in the autumn that I foresaw no room this year for tax reductions over and above broad indexation, and the autumn forecast in fact implied a small tax increase, on conventional assumptions.

20. There has since been a welcome improvement in the fiscal prospect for 1984-85. Increases in oil production, and a higher forecast sterling oil price, now lead to an expectation of higher oil revenues. The risk of my having to put taxes up in March now seems slight, and unless circumstances change significantly in the next 6 weeks, my intention will be to keep taxes overall broadly unchanged in real terms next year, after providing for indexation (the effects of which are illustrated in Annex 2).

21. The prospect is for real tax reductions in 1985-86, but it would be rash to bring them forward to the coming year on any significant scale, given the obvious uncertainties, and the importance of being seen to get borrowing back under firm control. It may nevertheless be right to consider this year measures with costs falling in 1985-86.

22. A broadly neutral Budget does not of course necessarily preclude changes in particular taxes, or some shift in the balance between those paid by individuals and by companies. (Annex 3 shows how taxes have moved over recent years.) Striking the right balance is never easy, though in economic terms the importance of the choice can be exaggerated, since over a period of years the consequences for output, inflation, and employment are very similar.

Summary and Conclusion

23. The recovery has been faster than we expected; and is set to continue. It shows the value of sound financial policies consistently applied. We need to keep strictly to our public spending plans, and keep borrowing moving down in support of firm monetary targets. That is the right way to keep inflation low, and sustain growth, thus further improving the prospects for jobs. It is also the only way to the tax reductions in later years which we all wish to see, and which are necessary to improve the performance of the economy in the longer term.

24. I accordingly:

a. seek colleagues' agreement to the rolling-forward of the MTFS up to 1988-89 (with an assumption of public expenditure remaining constant in real terms after 1986-87 (paragraph 13);

b. seek colleagues' views on the appropriate level of the PSBR for 1984-85 (paragraph 18), and the appropriate balance between the different taxes in a broadly neutral 1984 Budget (paragraph 22).

ANNEX 1

Selected Economic Indicators

	1979	1980	1981	1982	1983	1984(1)
World GDP, volume (per cent change)	3	1	2	0	2½	4
UK GDP, volume (per cent change)	2½	-2½	-1½	2	3	3
Domestic demand, volume (including stockbuilding) (per cent change)	3½	-3½	-1½	3	4½	3-4
Retail prices Q4 (per cent change)	17½	15½	12	6	5	4-5
Interest rates (average 3-month interbank)	13½	16½	14	12½	10	9½(2)
Current balance (£ billion)	-½	3	6½	5½	2	1-2
Unemployment (UK per cent narrow definition)	5	6½	10	11½	12½	12½(3)

Tax and Public Expenditure as % of GDP

	1978-79	1979-80	1980-81	1981-82	1982-83	1983-84	1984-85
Tax and NIC	34	35½	37	39½	39½	39	-(4)
Public Expenditure(5)	40½	40½	42½	44	43½	(43)(6)	(42)(6)
PSBR	5½	5	5½	3½	3½	3½	-(4)

(1) Provisional pre-Budget figures.

(2) End-January.

(3) Not a forecast. Figures based on assumptions in PEWP.

(4) Depending on decisions to be made.

(5) Including debt interest. PEWP figures.

(6) Confidential until publication of the Public Expenditure White Paper.

CONFIDENTIAL

ANNEX 2

TAXATION: Effects of Indexation

DIRECT TAXES

The Retail Price Index increased in the year to December 1983 by 5.3 per cent. With indexation by this amount and statutory rounding, the figures for the main allowances and other thresholds would be:-

Personal Allowances	1983-84 £	1984-85 £
Single and wife's earned income allowance	1785	1885
Married allowance	2795	2945
Bands eg		
30% rate	0-14600	0-15400
60% rate	over 36000	over 38100
Investment Income Surcharge threshold	7100	7500

The total revenue costs of indexation of income tax (reflected in the forecast) are £875m in 1984-85, £1130m in a full year at forecast 1984-85 prices and incomes

INDIRECT TAXES

Excise duties: increases based on 5.3 per cent revalorisation with rounded price changes including VAT effects:

	Typical price change	Revenue (a) (84-85 prices) £m	RPI impact effect %
Beer	1 pence/pint	95	0.1
Wine	5 pence/75 cl light wine	25	neg
Spirits	28 pence/bottle	28	0.05
Tobacco	3½ pence/20KS	115	0.15
Petrol	4½ pence/gallon	225	0.1
Derv	4 pence/gallon	50	nil
VED	£5/car	90	0.05
Increased revenue (reflected in forecast)		628	0.4(b)

(a) First and full year revenue effects are largely identical.

(b) RPI effects do not sum because of rounding.

ADY RECKONER: Illustrative Tax Changes

	£ million at forecast 1984-85 income levels Direct Revenue Effect	
	1984-85	Full Year
INCOME TAX		
Allowances and Thresholds		
1% above or below indexation on allowances and thresholds	162	201
1% above or below indexation on allowances only	145	177
Rates		
Change basic rate by 1p	950	1025
Investment Income Surcharge		
Change threshold by £500	1	18
CORPORATION TAX		
Change main rate by 1 percentage point	100	170
Change small companies' rate by 1 percentage point	10	18

OTHER TAXES

	First year cost/yield	Full Year	RPI
VAT: 1 per cent change	550	740	0.5
NIS: 1 per cent change from August	450	850	
(Assuming recovery from public sector)			

EXCISE DUTIES

The costs and effects of specimen changes in alcohol, tobacco and petrol etc are on the previous page.

ANNEX 3

BACKGROUND FACTS

Tax burden

1. Since the Government came to power total taxation as a proportion of GDP at market prices has risen by over 5 percentage points reaching a peak in 1981-82, since when it has declined slightly. The figures are as follows:

Table 1

	Total taxation* as a % of GDP (market prices)	
	1978-79	34.1
	1979-80	35.4
	1980-81	36.8
	1981-82	39.7
	1982-83	39.6
	1983-84 (estimate)	38.8
Confidential	1984-85 (forecast**)	38.9

i.e. no progress after an improvement in 1983-84.

* Including National Insurance Contributions and local authority rates
** Makes the usual conventional assumptions that the income tax thresholds and allowances and the specific duties are indexed and that the PSBR is as indicated in the 1983 MTFS.

Personal taxation

2. Despite reductions in income tax, total personal taxes (direct and indirect) are some £10bn higher than they would be under the 1978-79 tax regime (suitably indexed). For income tax and national insurance the following table gives an idea of how the proportion of gross pay they represent has risen, particularly for the low paid:-

Table 2

Income tax and National Insurance Contributions (NICs) as a percentage of gross earnings

Married*

	½ average earnings	Average earnings	2 average earnings
1978-79	16.4	28.0	31.6
1981-82	21.1	29.4	32.4
1982-83	21.1	29.9	32.4
1983-84 (forecast)	20.2	29.6	31.7
1984-85 (assuming indexation)	20.4	29.7	31.8

(* Wife not working: the couple are assumed to have no children, to avoid distortion of the figures from abolition of child tax allowances.)

3. These figures reflect the rise in the employees' NIC rate from 6½ per cent to 9 per cent. So far as income tax is concerned, personal allowances have increased 6 per cent in real terms since 1978-79 and just about kept pace with earnings. The basic rate is down from 33p to 30p, but the 25p reduced rate band has been abolished.

4. As the table shows, indexation of allowances in the Budget would lead to a very slight rise in the proportion of incomes taken in tax and NIC. This is because earnings are forecast to rise by 6½ per cent, slightly more than the indexation percentage (5.3 per cent).

Company sector

5. Real rates of return have been falling since the early 1960s:

Table 4

Net pre-tax real rates of return

	Industrial and commercial companies excluding North Sea	Manufacturing companies
1960	13.5	13.5
1965	11.0	9.8
1970	8.6	7.6
1975	4.5	3.0
1979	5.7	4.1
1980	4.4	3.8
1981	4.0	3.5
1982	4.3	3.6
1983 (estimate)	6.4	na

Last year saw a strong recovery in company profits (reflected in the figures above) though the rate of return remains below the level seen in 1978 (7.5 per cent). (Figures for manufacturing alone are not yet available.)

( ) During the last Parliament total taxes paid by businesses (outside the North Sea) fell slightly as a percentage of GDP. But within this total NIS and corporation tax fell while business rates rose, as the following table shows:

Table 4

Taxes paid by businesses £bn (excl North Sea)
(figures in brackets are % of GDP)

	CT	Self-employed income tax	NIS	NIC	Rates	Others[1]	Total
1978-79	3.9 (2.3)	1.2 (0.7)	1.3 (0.8)	4.0 (2.3)	2.5 (1.5)	2.3 (1.3)	15.2 (8.9)
1983-84	5.1 (1.7)	2.3 (0.7)	0.9 (0.3)	6.9 (2.3)	5.5 (1.8)	4.4 (1.4)	25.1 (8.3)

[1]Petrol and derv duty, VED, capital taxes, etc.