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Prime Minister
Useful background for Cabinet discussion of public expenditure.
CDP 2/X

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Dear Charles,

FISCAL POLICIES IN OTHER MAJOR COUNTRIES

The Prime Minister may be interested in a brief round up of the latest budget plans in the major industrialised countries whose governments are following policies of fiscal restraint. The last couple of months have seen some important policy statements from the US, Japan, Germany, France and the Netherlands.

A key feature is continuing expenditure restraint in an effort to curb budget deficits further and, particularly in Europe, to make room for tax cuts. The tight fiscal stance continues in Japan despite considerable pressure for some relaxation.

The budget resolution for 1986 agreed by the US Congress over the summer cuts planned expenditure by about $55 billion to produce an estimated Federal deficit of $178 billion in fiscal 1986 (4¾ per cent of GNP) compared to this year's deficit of $211 billion (5½ per cent). There are no major tax increases. Congress is now considering the Appropriation Bills needed to implement the Resolution and it remains to be seen whether all the proposed cuts will be achieved. Jim Baker's best guess is that they will end up with $40 - $45 billion of genuine cuts, of which some $30 billion will be in the defence budget.

The Administration's projections of a sharply declining Federal deficit in the next few years (2 per cent of GNP by 1988) depend on their optimistic assumptions of future output growth and on achieving further expenditure cuts. It is thus far from clear that the Federal deficit is yet firmly established on a downward path.

The 1986 German budget continues the government's commitment to budgetary consolidation by holding the cash increase in expenditure to 2½ per cent. Capital expenditure and subsidies to industry are to be cut. Public expenditure will fall slightly as a proportion of GNP. The budget deficit is to be held at last year's level of DM 25 billion. Past success in reducing the deficit is seen as allowing scope for some income tax cuts worth around ½ per cent of GNP next year.

Japan's draft fiscal 1986 budget continues the tight fiscal stance adopted in recent years. At this stage it seeks cash cuts of 10 per cent in most areas of expenditure except defence and overseas aid. These initial budget intentions are usually revised considerably but the scale of reduction can be taken as a broad indication of the government's determination to lower the budget deficit further as a percentage of GNP. There remains a risk that this determination may undo the other measures which they promised in the G5 communique.

The French draft central government budget for 1986 seeks to contain the increase in expenditure to under 4 per cent, compared with the government's highly optimistic inflation assumption of 3½ per cent for next year, in order to maintain the central government deficit at 3 per cent of GDP, while providing room for some FF 10 billion of tax cuts (just under £1 billion). Spending on defence, research and education is to increase slightly in real terms but this is offset by cuts in subsidies, particularly to nationalised firms and in the state's contribution to social security costs. The latter, however, reduces the deficit of the central government but not that of the government sector as a whole.

After a period of marked fiscal retrenchment the Dutch 1986 budget plans further but more moderate expenditure restraint. The freeze in money terms of social security benefits, family allowances and public service salaries is to continue. But employee and employer social security contributions are to be cut and corporate taxes reduced slightly. Forthcoming elections in May next year have led the government to pause in its efforts to reduce the budget deficit as a proportion of GNP though further restraint seems probable thereafter.

I am copying this to Len Appleyard (FCO).

Yours ever
Rachel

RACHEL LOMAX
Principal Private Secretary