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PRIME MINISTER

THE BUDGET

High interest rates and the weakness of sterling have upset Budget plans. **Two clear themes are emerging: lowering the cost of employing people, and reforming capital taxes.**

Should it be a tough Budget?

Sterling shows there is no room for an easy Budget. We now have to err on the side of caution.

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Treasury are asking should we have a higher borrowing requirement, coupled with tight money and high interest rates; or a low borrowing requirement, and drive towards lower interest rates again?

A PSBR which is not credible means tearing up the rhetoric and the ambitions of many years.

To deliver lower interest rates with oil prices and sterling weak, the Budget has to show the MTFS/PSBR target can be hit. It's not enough to say again that expenditure will be kept under control. Budget planning should begin - if you want to pursue a tight PSBR, low interest rate policy - with spending cuts. A package of a net £500 million of spending cuts, after paying for the jobs measures that will be needed, should help restore market confidence and underline the basic spending realities. I attach the last list of targets where we offered some ideas on how this could be done.

Jobs

Nigel's thesis that rising real pay destroys jobs is right. But companies are too profitable and liquid for us to expect real wages to start falling on their own. There are four ways in which the Budget could help lower the costs of employment:

1. National Insurance. The Treasury have looked at a range of schemes. They favour restructuring the employer's National Insurance Contribution, which would mean at the lower end of the pay scales a reduction of, say, 2% in the employer cost, financed from the same tax on higher levels of pay.

   The earlier variants, which entailed raising the lower earnings limit for the employer contribution - so that people were taken completely out of employer National Insurance at the lower levels - would have a much bigger real and psychological impact; despite the sudden step caused by the lower earnings limit.

2. Raising tax thresholds. This is a vital part of the strategy. Making people better off at the net level is what counts, taking people out of the poverty and unemployment traps, and helping to reduce the pressure for higher gross pay.

The main problem is to find enough money within the spartan Budget now available to make a significant increase in thresholds.

If you wish to pursue this route - and we think you ought to - it probably means providing a specific tax relief for families with children, where the poverty and unemployment traps are worst. There are several possible schemes, and if the general principle appeals, one or more of these could be worked up. In the last week, all these ideas seem to have been destroyed as immediate runners by the sterling speculators.

Treasury may suggest a Green Paper on reform.

3. Expanding and amending the Community Programme. Providing work of community value to people on benefit would exert some downward pressure on wages, and is the cheapest way of cutting the unemployment total. You could:

a. Increase the existing Community Programme and include rule changes to widen it.
100,000 new jobs for £200 million (net PSBR cost).

b. Turn the Voluntary Projects Programme into another variant of the CP.
50,000 people off the register for £60 million.

c. Allow charity projects under the CP.
Creates an estimated 50,000 jobs for £70 million.

4. Youth Training Scheme

A full second-year YTS, retaining Supplementary Benefit - this apparently is cheaper than abolishing it! - would create a little under 200,000 new places at a net PSBR cost of £250-500 million. This has turned out to be much dearer than originally planned.

These jobs packages could take around 400,000 people off the register, at a net PSBR cost of £600-800 million by 1986/87. More work is needed on YTS costings and public expenditure offsets before a final decision can be taken.

The £15-30,000 a year people

The current thresholds for higher rate tax are too close together, and arguably there are too many bands. This group is politically very important, and a scheme to stretch and reduce the number of bands would be desirable.

Within the Treasury, several schemes have been examined and pigeon-holed. We believe they should be looked at again.

Capital taxation

Major reform of capital taxation has long been promised, but has still not been delivered. I believe Treasury are making good progress here.

Development Land Tax could be abolished - it now raises very little.

Capital Gains Tax can be simplified by increasing the tax-free sum further, or by scrapping indexation and choosing a new, more recent, base date for taxing gains.

Conclusion

We recommend:

a. A tough Budget which begins with net public expenditure reductions, to reassert the PSBR/MTFS path.

b. A budget for jobs which takes action through income tax thresholds, Special Employment Measures, and National Insurance, to lower the costs of employing people.

c. A combined package of YTS and CP that takes up to 400,000 people off the count.

d. A purposeful series of capital taxation reforms to honour pledges long made but never delivered.

We would stress that the events of the last 4 weeks should not allow the Budget to become timorous or unimaginative. It has never been more vital for the Chancellor and the Government that the Budget should be clear, purposeful, addressed to jobs, and pledged to lower interest rates and lower taxes.

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