10 DOWNING STREET

From the Private Secretary

Prime Minister

The Chancellor seeks approval for circulation of this Cabinet paper on Monday, for the Economic Cabinet on Thursday. Given the difficulties he is facing, particularly on public expenditure, it is even thinner than usual. An extended bilateral has been set aside for Wednesday to discuss the public expenditure prospect and the handling of the Cabinet meeting.

Agree circulation of this on Monday?

AT
8/2

Very thin - and a little on the complacent side.

Nevertheless - circulate

MT

5

Draft Cabinet Paper

ECONOMIC STRATEGY

Memorandum by the Chancellor of the Exchequer

We approach the Budget with the economy in reasonably good shape, despite the miners' strike, following another year of low inflation and steady growth. But, in the wake of the recent pressure on sterling, this is not a time to take any risks; but with unemployment still remaining stubbornly high I believe that, within the contraints of prudence, the focus this year should be on a budget for jobs.

Economic Prospects

2. 1984 was a good year for the world economy - the best since 1976 for output and trade. But with the return to a more normal growth rate in the United States 1985 is unlikely to be as good. Nevertheless, output growth in the major industrialised countries should average 3 per cent or so, with inflation staying below 5 per cent.

3. The UK economy has benefited from a strong rise in exports and 1985 should see further growth, broadly in line with world trade. Last year we saw a sharp rise in investment, especially in manufacturing, and further substantial increases are expected this year. With personal real incomes also continuing to rise, there is scope for consumer spending to rise by 2-3 per cent in 1985.

4. The economy has withstood the coal strike better than might have been expected. Nevertheless, the strike is calculated to have reduced output growth by 1 per cent in 1984: without it the economy could well have grown by 3½ per cent. On the assumption the strike is over soon, growth for 1985 should be over 3 per cent. However, North Sea oil production, which has been contributing nearly ½ per cent a year recently to the growth of total output, is now probably at or near its peak.

5. It looks as though the balance of payments on current account was in small surplus in 1984, despite the extra oil imports resulting from the coal strike. Once that is over, the current account should return to more substantial surplus for a time. Looking further ahead, the likely fall in the oil surplus will be partly offset by extra income from our increased stock of overseas assets. But there will be a continued need to improve our performance if British industry is to be competitive in world markets and at home.

6. Inflation has been running at around 5 per cent for the last two years; but the recent fall in the exchange rate, coupled with the effect on mortgage rates of the sharp rise in interest rates, will inevitably mean a modest increase in the RPI in the first half of 1985. However, with a gradual improvement in financial markets, and a steadier pound, the inflation rate should be falling again before the end of 1985 and into 1986.

7. There are two principal external worries. First, the US budget deficit remains a major uncertainty for world economic prospects and for financial markets generally; whilst the extent of the US Administration's proposed action suggests the problem will remain for some years ahead. Second, with the prospect of plentiful oil supplies, future oil prices also remain uncertain; a sharp fall in oil prices, or in the dollar, would pose a threat to our balance of payments and reduce tax revenues over the coming year.

8. At home, despite four years of continued recovery the high and still rising level of unemployment also remains a major source of worry. The growth in output has been accompanied, as we always expected, by some increase in employment; but with wage increases staying well ahead of prices - to a greater extent than in nearly all our competitors - progress towards lower unemployment has been slower than we would like. We must continue to do all we can to get this message across.

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

The Medium Term Financial Strategy

10. Last year colleagues agreed that the Medium Term Financial Strategy should, exceptionally, be extended to 1988-1989. The figures assumed that public spending in the years beyond the Survey would be held constant at the 1986-1987 level published in last year's White Paper. I see no reason for any further extension this year.

Borrowing

11. In the Autumn Statement the published forecast of the PSBR outturn for this year was put at £8½billion, £1¼billion more than the figure anticipated at the time of the Budget. This forecast assumed that the coal strike, to which the overrun is mostly attributable, would be over by the end of December.

12. At this stage of the year, the PSBR outturn is always difficult to forecast with any accuracy; as the difference between revenue and expenditure flows of approaching £200 billion, small changes on either side can have a significant effect on the net outcome. But, with the coal strike continuing and with other very serious pressures on the public expenditure planning total, there a real prospect that this year's PSBR will be substantially higher than that envisaged at the time of the Autumn Statement.

13. This is the second year running in which, largely because of unforeseen events, the PSBR has exceeded expectations. That is disappointing enough. But it must also be seen against the background of market doubts both at home and abroad about our determination to maintain downward pressure on inflation.

It is all the more essential, therefore, that our fiscal stance next year should be seen to reinforce the thrust of policy generally. This means, in my view, that we should aim to get back to the path for borrowing set out in last year's MTFS, which envisaged a PSBR of 2 per cent of GDP.

Fiscal position

14. As the result of the decisions we took in this year's public spending round, my room for manoeuvre in the Budget seems unlikely to be very large.

15. In the Autumn Statement I referred to the possibility of being able to make some tax reductions this year, on top of the £1¾ billion tax cuts which come through in 1985-86 as the result of measures included in last year's Budget. The autumn forecast put the prospective "fiscal adjustment", on the usual illustrative assumptions, at about £1½ billion - subject to the usual wide margin of error at that stage. That figure was over and above broad indexation of the excise duties and the income tax thresholds and bands, the effects of which are illustrated in Annex 2.

16. I have to say that the latest forecasts imply even less room for maneouvre. On the receipts side, as the result of changes in oil prices and in the dollar exchange rate, it seems likely now that oil revenues may be somewhat greater next year than had been forecast in the autumn. But there are already indications of even stronger upward pressures on public spending next year. I have already referred to the continuation of the coal strike which - even if it ended tomorrow - would still cast its shadow into the coming financial year; and other demand-led claims on the Reserve are already in prospect for 1985-86. Moreover, higher domestic interest rates are bound to increase the total of debt interest.

17. In short, I now envisage having only modest scope for any new measures in the Budget, after providing for indexation. This makes it all the more important to focus on measures which will increase the underlying efficiency of the economy, and which will be seen as encouraging greater employment and as improving the prospects for bringing down unemployment. By way of background, Annex 3 shows how the various taxes have moved in recent years.

Summary and Conclusions

18. In spite of the miners' strike, the economy has come through the last year reasonably well, and there are no signs of the recovery faltering. But recent weeks have underlined the importance of the strong dollar and uncertain oil prices, and reaffirmed the need to maintain confidence in our commitment to the defeat of inflation and to policies which will bring that about. To that end, we must do everything possible to keep within our public spending plans, and to bring the level of public borrowing back on to the downward path charted in the Medium Term Financial Strategy. Therein lies the only secure route to continuing non-inflationary growth, higher employment and an eventual end to rising unemployment.

19. Accordingly, I seek colleagues' views on the appropriate level of the PSBR for 1985-86 (paragraph 12), and on the broad shape of a Budget with an employment theme (paragraph 17)

(N.L.)

SELECTED ECONOMIC INDICATORS

	1979	1980	1981	1982	1983	1984	1985 (1)
World GDP, volume (per cent change)	3½	1	2	0	2½	5	3½
UK GDP, volume (per cent change)	2½	- 2½	- 1½	2	3	2½ (3½) (4)	3 (2½) (4)
Domestic demand, volume (including stockbuilding) (per cent change)	3½	- 3	- 1½	2½	4½	2 (2½) (4)	3 (2½) (4)
Retail prices Q4 (per cent change)	17½	15½	12	6	5	5	5
Interest rates (average 3-month interbank)	13½	16½	14	12½	10	10	13½ (2)
Current balance (£ billion)	- ½	3½	7	5	2½	½ (3) (4)	2 (3½) (4)
Unemployment (UK per cent excluding school leavers)	5	6½	10	11½	12	12½	12½ (3)
Sterling Index	87	96	95	90½	83	78½	71½ (2)

(1) Provisional pre-Budget figures.

(2) Early February

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

(4) Figure in brackets is adjusted for the estimated effect of the miners' strike.

n59sd

REVENUE EFFECTS OF TAX CHANGES

A. Direct Taxes: Indexation

The RPI increased in the year to December 1984 by 4.6 per cent. With indexation by this amount and statutory rounding, the figures for the main allowances and other thresholds would be:

Personal Allowances	1984-85	1985-86
	£	£
Single and wife's earned income allowance	2,005	2,105
Married allowance	3,155	3,305
Bands eg		
30% rate	0-15,400	0-16,200
60% rate	over 38,100	over 40,200

The total revenue costs of indexation of income tax (reflected in the forecast) are £860m in 1985-86, and £1,125m in a full year, at forecast 1985-86 prices and incomes.

B. Indirect Taxes: Indexation

The effects of 4.6 per cent revalorisation of the exercise duties (including VAT effects, price changes rounded) are as follows:

	Typical Price Change	Revenue effect (85-86 prices) £m	RPI impact %
Beer	1p/pint	80	0.05
Wine	3½p/75cl light wine	15	neg
Spirits	25p/bottle	30	0.05
Tobacco	4p/20 King size	130	0.15
Petrol	4p/gallon	205	0.1
Derv	3½p/gallon	50	nil
VED	£5/car	100	0.05
Overall effect (reflected in forecast)		610	0.4

Note: First year and full year revenue effects are virtually identica

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C. Ready Reckoner: Illustrative Tax Changes

£ million at forecast 1985-86 income levels[1]

	1985-86	Full Year
INCOME TAX		
Allowances and Thresholds		
1% above indexation on all statutory allowances	160	200
1% above indexation on all statutory allowances and thresholds	175	225
Rates		
Change basic rate by 1p	1070	1150
CORPORATION TAX		
Change main rate by 1 percentage point	135	235
Change small companies' rate by 1 percentage point	15	30
OTHER TAXES		
Change VAT rate by 1 percentage point[1]	625	840

(1) Direct revenue effects. For CT (which is collected one year in arrears) the figures are based on 1984-85 income levels.

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

ANNEX 3

THE TAX BURDEN

Since the Government came to power total taxes and NICs as a proportion of GDP at market prices has risen by over 5 percentage points, though the ratio has remained virtually unchanged since 1981-82. The figures are as follows:

Table 1

Total taxation* as a % of GDP (market prices)

1978-79	33.9
1979-80	35.2
1980-81	36.4
1981-82	39.1
1982-83	39.0
1983-84	38.8
1984-85 (estimate)	39.2
1985-86 (assuming indexation)	39.1

*Including NICs and local authority rates.

Personal sector

2. Despite reductions in income tax, total personal taxes (direct and indirect, including employees' NIC and domestic rates) are about £13 billion higher in real terms 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 has risen, particularly for the low paid:

Table 2

Income tax and NICs as a % of gross earnings*

	½ 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 (estimate)	19.2	29.1	31.5
1985-86 (indexation)	19.6	29.3	31.7

* 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 employees' NIC rate from 6% to 9%. So far as income tax is concerned, personal allowances have increased 16% in real terms since 1978-79 and have roughly kept pace with earnings. The basic rate has been reduced 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 assumed to rise by 7% compared with the indexation percentage of 4.6%.

Company Sector

5. The last two years have seen a strong recovery in company sector profitability though the rate of return remains well below the level in the early 1960s (figures for manufacturing alone are not available for 1984):

Table 4

Net pre-tax real rates of return

	Industrial and commercial companies excluding North Sea	Manufacturing companies
1960	11.2	14.0
1965	9.8	16.5
1970	7.9	8.0
1975	4.3	3.1
1978	6.8	6.3
1979	4.9	4.2
1980	3.7	3.3
1981	3.4	3.1
1982	4.3	4.2
1983	5.5	5.3
1984 (estimate)	6.8	n.a.

Source DTI.

Since 1978-79 total taxes paid by businesses (outside the North

Sea) have fallen slightly as a percentage of GDP. Within this total, the major change has been a fall in employers' NIC and NIS as a percentage of GDP, partially offset by an increase in business rates, as the following table shows:

Taxes paid by businesses £bn in 1984/5 prices
(figures in brackets are %s of GDP)

	Corporation tax[1]	Taxes on self employment incomes	Employer's NIC and NIS	Rates	Other[2]	Total
1978-79	6.7	2.2	9.3	4.5	3.5	26.2
	(2.2)	(0.7)	(3.1)	(1.5)	(1.1)	(8.6)
1984-85	6.6	2.5	8.0	5.5	4.2	27.0
	(2.1)	(0.7)	(2.5)	(1.7)	(1.3)	(8.3)

1. Excludes North Sea, but includes ACT.

2. VED, car tax, road fuel duty, duty on rebated oils, capital taxes.