PRIME MINISTER

TOMORROW'S CABINET

You will be discussing tomorrow the macro-economic situation in advance of the Budget.

The press know that this is one of the items on the Cabinet agenda. We shall need to give out a line as soon as possible afterwards. It will be particularly important to do so because of the state of the pound.

Could I suggest that we say something on the lines of the following:

- the Chancellor today set out the background to the economic situation in the United Kingdom.

- Members of the Cabinet made their comments in advance of the Chancellor reaching his budget judgement.

- The Government ~~is resolved to maintain~~ wholeheartedly reaffirmed the central objectives of its strategy - ~~to hold down and reduce inflation.~~

BERNARD INGHAM

13 February 1985

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AT from John Redwood.

AT

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Editor **Brian Naylor**

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Advertisement manager **Simon Moore Brown**

Will pensions be taxed?

The latest kite to be flown by the government is a rumour that taxation rules for pensions are to be changed. Some heavy guns are trained on it. Trouble is they don't know what the real target is. So what are the Chancellor's likely intentions?

The rumours centre around his declared aim of tax neutrality between different types of investment, and an innocent sounding document produced last year by the Inland Revenue, 'Cost of Tax Reliefs for Pension Schemes: appropriate statistical approach'.

Ostensibly, the document sought to establish quite how much the present pensions allowances cost the Treasury as against a tax neutral system. In absolute terms the Revenue estimated that in 1983-84 employees' relief was worth £1·1bn on their own contributions and a further £1·1bn on their employers' contributions; and that the Treasury also lost £2·25bn by not taxing the income of pension funds (assuming 30 per cent tax) and £650m by not taxing lump sums.

Naturally to exact all those taxes would make pension investment highly unattractive — in fact kill the industry. But the Revenue suggested four (hypothetical, of course) tax neutral systems of pensions taxation against which the present system's cost could be measured. In doing so, it went straight to the heart of the present pensions debate: should pensions be treated as deferred pay or as savings out of taxed pay? And should they be subject to any degree of double taxation (that is, taxed within the fund and in the hand of the beneficiary)?

Today, pensions are pretty much treated as simple deferred pay — with the exception of the lump sum, which is tax free. The Chancellor is said to want to raise more revenue by switching to one of the other systems. That's not surprising — one could argue that the whole pensions industry was getting out of control. Look for a moment at the sheer growth of tax free pension funds. Back in 1980, when their assets amounted to just £110bn, Sir Geoffrey Howe told the National Association of Pension Funds that some pruning must be in order. Today a fair guess would be something over £200bn between private trustee funds (estimated by the NAPF at £120bn) and insurance company and managed funds (perhaps £80bn). Even using more conservative figures — say £175bn — and a relatively low yield to allow for the funds' heavy weighting in property — say 6 per cent — that suggests gross dividend income of £10½bn tax-free. Ripe for the picking.

Which form of taxation will the Chancellor choose? The administrative problems associated with treating pensions contributions as savings out of taxed pay are horrific and expensive. Taxing lump sums would be easy, but it's no vote winner and will raise relatively little money. (The Chancellor's promise that no one would be worse off for waiting on the Budget before retiring suggests that any action here will not be retrospective — at most the government would tax that part of the lump sum "earned" after the Budget.)

The plum is of course the pension fund's investment income. The Life Offices Association claims that a tax rate of 25 per cent on investment income and gains would involve a 75 per cent increase in contributions — as much as an 11 per cent increase in payroll costs to the employer. That of course would be offset against Corporation Tax and greatly reduce the net revenue to the Treasury.

But an alternative view is advanced by John Greener of investment advisers Richards Longstaff. On his calculations a 25 per cent tax on investment income would just be equivalent to at most a 1·75 per cent wealth tax on the funds. He points out too that only 30 to 40 per cent of the funds' balance sheets are accounted for by present assets. The remainder is made up of estimated future contributions. So the tax would not mean an automatic increase in funding — and the revenue raised would go towards cutting the basic rate of income from 30 tax to 25 per cent and would sweeten the pill of double taxation on pensions. Now that is a package you can sell.

CONFIDENTIAL
~~BUDGET SECRET~~

SPEAKING NOTE FOR MEETING WITH THE PRIME MINISTER

As we firm up our Budget estimates of expenditure, revenues and borrowing for 1985-86 we come right up against the problems we discussed at length with you at the 15 January seminar on public expenditure. Our assessment then was that it required optimistic assumptions to believe that the public expenditure planning total next year would not again overrun - for the third year running. The figures are still being refined, but the position has deteriorated significantly since the Public Expenditure White Paper was finalised in December: the Treasury's latest forecast is for an overrun of some £1¾ billion.

2. The main reasons for this very unwelcome assessment are overspending by local authorities - current and capital; higher interest rates; post-strike coal costs; higher social security payments (because the May RPI is likely to be higher than assumed, and higher take-up). And on top of this, outside the planning total, debt interest is also running higher because of higher interest rates.

3. The Chief Secretary's and my immediate response to this is to consider what we should propose to bring expenditure back on course. A 5 per cent Scargill surcharge on electricity would bring in £400 million. Action on gas prices (say a further 5 per cent on the increases already announced) another £250 million. Postponing the November 1985 social security uprating would save £500m. We could re-open (by, say, imposing some further across-the-board squeeze on non-pay cash limits) the autumn decisions on programmes generally.

4. This last possibility is not, in my view, a runner. Cash limits will already be under unprecedented pressure in 1985-86, in coping with higher pay and inflation than was envisaged when they were set. To squeeze them further would risk destroying cash-planning. We cannot afford to do that.

5. If you believe that any of the other options are worth trying for, the Chief Secretary and I will go for them as hard as we are able to do. But I must tell you that both Peter Rees and I have, regretfully, concluded that we would do better to save our fire until the Survey. [-except, perhaps on the Scargill surcharge, which we agreed in principle last July-]

6. But I do not think that we can leave the public expenditure figures where they are. Another overrun would be bad for confidence, and bad for control.

7. I propose, therefore, that we should add £2 billion to the Reserve and thus to the planning total. Any lesser figure would be unacceptably exposed to the risk of itself being overrun. In addition, to be realistic, we should add a further £½ billion, outside the planning total, for debt interest.

8. In order to present a credible path for later years - which are no less at risk of being overrun on the latest forecasts - I believe that additions of £2½ billion (£2 billion on the reserve, and £½ billion on debt interest) should also be made to the White Paper totals for each of the forward years. [We shall also need to add further sums, rising to, say, £½ billion, to cover whatever we decide is needed for new special employment measures.]

9. The presentation of these increases would be of critical importance. There would be no surprise in the markets at a higher expenditure path to take account of post-coal strike costs and higher interest rates and inflation; and markets would see these increases as a recognition that our public spending numbers, which they know are deliberately held low in order to put spending Departments under maximum pressure, had got too far out of line with reality. We would, obviously, need to avoid, for markets and spending colleagues alike, any implication that we were, as a result of policy and substantively, increasing public expenditure.

10. The fact is that even these revised spending targets will themselves be desperately hard to hit. We shall need tough decisions on social security, defence, energy prices and the rest of the list we discussed at your recent seminar. The 1985 Survey will be of at least the same order of difficulty as the 1984 Survey. Without the additions I am suggesting it would be totally impossible.

HANDLING

11. The addition for 1985-86 must, clearly, be made at the time of the Budget. I believe that the later-year additions, too, would best be made in the Budget and MTFS context. That is the right point in the cycle to decide these matters and to present them to Cabinet. The alternative of a further upward revision at the time of the Survey would get us the worst of all worlds.

12. The proposal is to make additions to the Reserves, not to colleagues' programmes. But, they will need to be consulted, and I do not think that I could leave that to the eve-of-Budget Cabinet. If you agree, therefore, I will mention it orally tomorrow, saying no more, given the risk of a leak, than that our latest forecast suggests that we will need to make significant additions to the planning totals and the Reserve in order to present a credible MTFS.

13. There is a further, Parliamentary complication. Peter Rees will be giving evidence to the Treasury Committee on Monday on the Public Expenditure White Paper. If we decide to add to White Paper totals he will need, without giving too much away, to give some indication that in our preparations for the Budget we are reassessing the realism of the planning totals.

IMPLICATIONS FOR THE BUDGET

14. Parliamentary and market expectations are that we will have £1½ billion (as in the Autumn Statement) - or, after recent events in the markets, less - to play with in the Budget - but on the assumption of the expenditure figure in the White Paper. In fact, as you know, our £1½ billion figure already rested on our concealed assumption that the public expenditure planning total would run £1½ billion or so higher than plan. Even on the higher prospect for public expenditure, the forecasts are still indicating a fiscal adjustment of around £1½ billion, within a £7 bn PSBR - as I indicated a fortnight ago.

15. But we have a problem of public presentation with these figures. Taken by itself, announcing a £2 billion increase in the planning total will be assumed to use up more than the available room for manoeuvre, implying an increase in taxes or borrowing. A large tax package on top of this would stretch the credibility of the Budget arithmetic to breaking point - unless we at the same time announced a higher PSBR. But higher expenditure, higher borrowing, and lower taxes would add up to an irresponsible Budget in most people's - and certainly the markets' - eyes.

16. I have considered the possibility of detaching the expenditure decision from the Budget by an earlier announcement - say in the Public Expenditure White Paper debate on 7 March. But the commentators and the Treasury Committee would immediately add together the two figures on Budget Day, so we would be no further forward. Furthermore, a public expenditure announcement on these lines could worry the markets and would make a very awkward setting for the Budget: it would be widely assumed that a tax-raising Budget must follow, and any disappointment of that expectation would lead to charges of fiscal irresponsibility.

17. My present thinking, therefore, is that these increases should be made, as estimating changes, in the Budget, together with corresponding (and genuine) estimating increases on the revenue side and to give ourselves a good margin of safety to maintain credibility. But I shall need to scale down somewhat the ideas I was earlier contemplating for tax and employment measures: I envisage something less than £1 billion net to play with for next year. That figuring implies a PSBR of around £7 billion - the 2 per cent of GDP envisaged in last year's MTFS.

18. This all adds up to a fairly tough Budget - tougher than many of our supporters would hope for. But public spending is running higher than planned, and we must keep on trying to bring it home to colleagues - including those on the backbenches - that, for as long as this continues, the prospect of serious relief from the burden of taxation will steadily recede.

£ billion

	1985 Public Expenditure White Paper		Proposed 1985 Budget*	
	Cash	Real terms	Cash	Real terms
1983/84	120.3	125.0	120.3	125.0
1984/85	129.6	129.6	129.6	129.6
1985/86	132.1	125.2	134.1	127.1
1986/87	136.7	124.0	138.7	125.8
1987/88	141.5	124.0	143.5	125.8

* special employment measures included within £2 billion additions

£ billion

	1985 Public Expenditure White Paper		Proposed 1985 Budget*	
	Cash	Real terms	Cash	Real terms
1983/84	120.3	125.0	120.3	125.0
1984/85	129.6	129.6	129.6	129.6
1985/86	132.1	125.2	134.2	127.2
1986/87	136.7	124.0	139.3	126.3
1987/88	141.5	124.0	144.1	126.3

* SEMs added to the £2 billion additions