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CONFIDENTIAL.

PRIME MINISTER To see also John Redwood's note attached.

PUBLIC EXPENDITURE

At his meeting early today the Chancellor reported that expenditure in 1985/86 and in later years was likely to be significantly over the planning total. In addition debt interest was expected to be about £½b. The existing figures were no longer credible and the government was faced with the choice of validating them by expenditure cuts or publishing higher figures. The Chancellor concluded that, with the possible exception of a Scargill surcharge, none of the options for reigning back explained within the planning totals was feasible eg higher gas prices, postponing the social security uprating or a further squeeze on cash limits as had been done in July 1983. He concluded reluctantly that the right course was to add £2b to the planning total and £½b to debt interest (Even though higher revenues would, however, make it possible to achieve the existing PSBR objectives, this confession of failure on public expenditure will be difficult to present to financial markets. But soldiering on with the present figures is not an option).

Containing expenditure within these higher totals would be extremely difficult but he felt that the best ground for the next survey was to start with higher figures and then higher, but realistic, figures and then go hard for major savings. The attached table shows what the new figures would look like.

While he proposes to put the general picture to colleagues he will not be specific about figures. You may like to see the speaking note which has been prepared for him.

AT

Andrew Turnbull
13 February 1985

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£ 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

This makes no provision for whatever is decided on SEM's which could add a further £0.5 billion by 1987-88.

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SPEAKING NOTE FOR CABINET

Public Expenditure

Public expenditure pressures remain intense, both for this year and next. In Parliament we are faced with a succession of lobbies urging ever higher spending on each and all of us. For this year the Treasury's latest assessment is of a significantly larger overshoot on the planning total than we published in January's Public Expenditure White Paper - indeed, an overshoot some way beyond what can reasonably be attributed to the cost of the coal strike.

For the future, the prospects for public expenditure have also worsened since the White Paper was finalised, before Christmas. Higher interest rates will affect a number of programmes. Debt interest projections are up £½ billion or so. The mortgage rate increases are likely to mean a higher RPI, and so increases in the social security programme. Financial markets are, of course, well aware of all this, and the credibility of the White Paper plans is under the spotlight.

As the forecasts are firmed up and refined in the weeks up to the Budget we shall be reassessing the realism of the White Paper expenditure figures, for 1985-86 and for the later years. My present thinking is that, to avoid the damage of another overspend next year, we need to start off the year with a higher Reserve. That will mean a higher planning total, and, if we are to present a realistic MTFS, additions of a similar order of magnitude in 1986-87 and 1987-88.

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(For use if pressed)

Why is higher Reserve needed?

Very difficult to estimate required size of Reserve - by definition trying to allow for the unknown.

But since £3 billion figure for 1985-86 set during last Survey assessment of likely pressures has increased.

- no provision has been allowed for post-coal strike costs. Not now a question of whether there will be costs in 1985-86 and later years, but of how large they will be. Size will depend on decisions yet to be taken.

- even without coal strike costs 1984-85 Reserve now looks likely to be overspent. Hope some pressures will be less intensive in future, eg LA current and capital; but calls on Reserve still likely to be substantial. Hope social security forecasts are better than in past, but continuing threat for both prices and take-up.

Lombard

Don't let VAT kill off jobs

By Samuel Brittan

The most cost - effective measure that could be taken to promote employment might well be the raising of the ceiling for exemption from VAT, which is now on a turnover of £18,500 in the UK, to £50,000 pa or, far better, to £100,000.

Such a concession would lift one of the most important single obstacles to the expansion of self-employment and very small businesses. It is this area which provides the greatest opportunities for people to meet unsatisfied demand and price themselves into jobs without having to face head-on the question of the union rate.

VAT exemption would also discourage the black economy—not by clamping down on it but by making it white—and would stimulate the provision of a great variety of personal household services which are still difficult to obtain economically in spite of the existence of more than 3m unemployed.

A concession would cost very little. VAT on turnover below £50,000 brought the Chancellor only £550m in 1983-84, or 3½ per cent of total VAT yield; and a substantial fraction of that sum would have gone in collection costs.

The exemption of very small businesses would not, of course, deprive the Customs and Excise of revenues arising from their activities. For they would not be "zero rated" and would have to pay VAT on bought-in supplies and services.

For this reason some small traders might opt to stay in the VAT system where they would receive rebates for VAT they had already paid; but many other businesses, especially in services and among entirely new enterprises, would undoubtedly prefer to stay out.

It is not just the saving in tax. Among the array of start-up costs and heavy paper work which discourages both young people and mature adults from setting out on their own, the complexities of VAT are near the head of the list.

Moreover, I have often been told that while the Inland Revenue goes out of its way to help the new and inexperienced businessman, the VAT authorities are said to adopt a daunting and adversarial approach.

What then is the objection to lifting the VAT ceiling? Some larger traders would complain of "unfair competition." But the main obstacle is the sixth EEC Directive on VAT of 1977 which restricts the rise in exemption limits to no more than indexation against inflation.

One is prompted to ask: are EEC directives made for Man or is Man made for EEC directives? There is no way by which the existence of a higher ceiling for VAT in one country than in others could distort trade or competition. An exempt trader has no more nor less incentive to buy home products rather than imports than one subject to VAT. Harmonisation for harmonisation's sake is the curse of the Community.

One possible minor distortion could occur in frontier areas where shoppers might pop across to buy in countries with higher exemption limits. This may explain why the UK and Ireland, which have no land frontiers with the rest of the EEC, argue for higher exemption limits. But it also suggests that the directive is particularly ludicrous for these countries.

Harmonised limits are not necessary for "own resources" contributions to the EEC Budget, which are based on the yields of a hypothetical standardised VAT rather than the tax actually collected.

If the British Government raised its VAT limit, it could ask for an *ex post* waiver. Or more simply the Commission could use its political discretion not to bring a court case. There are surely grounds enough to treat high unemployment as a state of emergency which different countries must tackle by the (non-protectionist) measures most suitable to their own circumstances.

A court case against new VAT exemption limits would hardly accord with the Commission's own efforts.

If the going gets rough, attention can always be drawn to the far more serious distortions brought about by back door industrial subsidies, which only survive because member governments such as Britain turn an eye, which is now blind, but need not be so for ever.

Normally, EEC members should play by the rules, but when the latter are absurd and job destroying, the higher duty is to find ways around them.