

Ref. A086/496

PRIME MINISTER

Economic Strategy

(C(86) 5)

BACKGROUND

In C(86) 5, the Chancellor of the Exchequer seeks the views of his colleagues on the broad shape of his forthcoming Budget.

2. Although the Chancellor will take the views of his colleagues into account in preparing his Budget, he will not wish to be bound by them. He will also want to avoid any commitment to further collective discussion during the runup to the Budget on 18 March, although he will no doubt be willing to discuss particular points bilaterally with individual Ministers. The only exception to this is the proposed Green Paper on the Reform of Personal Taxation, which has already been discussed by the Ministers most closely concerned, and is to be considered by the Cabinet on 20 February.

3. The uncertainties about the economic outlook are probably greater than at any time in recent years:

a. Government revenue and exchange rates for sterling will be substantially affected by the course of oil prices. Oil prices have already fallen by 40 per cent in dollar terms from their levels last November (and are now less than half their level in sterling terms a year ago). The effect on Government revenue depends on how far the reduction in dollar realisations is offset by a fall in the value of sterling against the dollar. If oil prices and the pattern of exchange rates continued as at present, the direct

revenue loss as compared with expectations last year would be of the order of £5-6 billion, about £2-2½ billion of which is expected to be offset by higher revenues from other parts of the economy as a result of the lower oil prices and the continuing high increase in real incomes.

b. The exchange rate indices for sterling have fluctuated substantially over the last year; pessimistic expectations about oil prices were a factor in forcing sterling well down last winter, but a firmer oil market and the end of the miners' strike were reflected in a recovery of sterling last summer. Subsequently perceptions of the fundamental disequilibrium in the oil market have become clearer, as markets have realised that Saudi Arabia can no longer be relied on to act as swing producer in stabilising the world market. The recent history of sterling exchange rates is summarised in the following table:

Sterling Exchange Rate Indices

	<u>1985</u>				<u>1986</u>
	1st qtr	2nd qtr	3rd qtr	4th qtr	11 Feb
Exchange rate index	72.1	78.9	82.1	79.8	74.2
Index excluding US \$	81.1	87.9	90.0	85.5	78.1

Although there has been substantial depreciation of sterling, the fall in the exchange rate in recent weeks has been much smaller relative to the fall in oil prices than was the experience in late 1984; there is thus some evidence that financial markets are beginning to realise that the United Kingdom's dependence on oil is fairly limited, and



that the current account is likely to remain in surplus even if oil prices fell below the present level of \$16-17 per barrel.

c. Nevertheless the possibility of further sharp downward movement in sterling cannot be excluded if the markets lose confidence. This could result in further upward pressure on interest rates, with adverse effects on the level of United Kingdom economic activity and on the prospects for inflation. Unless OPEC are seen to be taking effective action to restrain oil production and so stabilise the world oil market, these uncertainties are likely to remain. And even if there are no further shocks, United Kingdom interest rates are likely to remain above 10 per cent throughout the next two years, implying real interest rates of 6-7 per cent, twice as high as in other major industrial countries.

d. Although the Government managed in the 1985 public expenditure round to hold to the planning totals previously announced, this was only achieved for 1986-87 and 1987-88 by taking credit for an additional £2 billion of receipts from asset sales in each year over and above the amounts allowed in the 1985 White Paper and by reducing the Reserve. Taking this into account, so as to compare like with like, the tightening last year of the Public Sector Borrowing Requirement (PSBR) as a proportion of the Gross Domestic Product (GDP) is likely in any event to be substantially reversed. This is illustrated in the following table:



	1984-85	1985-86	1986-87	1987-88	1988-89
1. PSBR (£ billion, as in 1985 Medium Term Financial Strategy)	10.5	7	7.5	7	7.5
2. PSBR as proportion of GDP(%)	3 ¹ / ₄	2	2	1 ³ / ₄	1 ³ / ₄
3. Receipts from asset sales (£ billion)	2.1	2.6	4.7	4.7	4.7
4. Adjusted PSBR (line 1 plus line 3) (£ billion)	12.6	9.6	12.2	11.7	12.2
5. Adjusted PSBR as proportion of GDP(%)	3.9	2.8	3.3	2.9	2.8

This point is unlikely to escape the attention of the financial commentators and markets.

e. Strong upward pressure is likely to remain on public expenditure programmes. Local authority expenditure will remain a problem (with increases in local rates a significant element in expected future inflation). Pressure for catching up increases in public service wages is likely to be increasingly difficult to resist, as the settlement for local authority manual workers and the interim



settlement for teachers has demonstrated. Pressure is likely also in the central Government area, where the cash-limited amounts provided for departmental running costs seem unlikely to be sufficient to finance a settlement at or above the lower quartile point for movements in private sector pay (the basis of the long-term pay agreement rejected by the Civil Service unions). Overall there will clearly be pressure on the Reserve: there will certainly be no underspend.

f. The beneficial impact of lower oil prices on United Kingdom inflation seems likely to be roughly offset by that of the consequent reduction in the exchange rates. Inflation is expected to remain at about 4 per cent over the next two years whatever the level of oil prices. This reflects the continuing increases in United Kingdom unit labour costs faster than those in other industrial countries; the growth in average earnings has remained at about $7\frac{1}{2}$ per cent a year for the economy as a whole, despite the prospect of inflation falling from 5.7 per cent now to around 4 per cent later in the year. There is, however, no sign of a significant acceleration in the growth of private sector earnings - this year's problems are more in the public services sector.

4. Despite these uncertainties, the overall performance of the United Kingdom economy has continued to be reasonably good, with growth at an underlying rate of about 3 per cent likely to be maintained through 1986 (but with some slow-down in prospect thereafter), and with manufacturing productivity continuing to increase by about 4 per cent a year. The company sector (other than companies in the North Sea) is making good profits, and business investment is continuing to grow. Lower oil prices will give an appreciable stimulus to the world economy and to world trade, so adding to demand for United Kingdom exports and countering the direct income loss sustained by the United Kingdom

economy. Although the United Kingdom benefits relatively less from lower oil prices than Japan and Germany, the overall impact on United Kingdom economic activity and employment (if not on real disposable incomes) is likely to be positive. Nevertheless there seems to be no prospect of any significant reduction in unemployment below the current level of about 13 per cent.

MAIN ISSUES

5. The main issues are:

- a. the level of the PSBR in 1986-87;
- b. the balance as between personal, indirect and company taxation;
- c. the nature of any fiscal changes.

The level of the PSBR in 1986-87

6. The latest Treasury expectation, despite the fall in oil prices, is that the PSBR outturn for 1985-86 will be close to the £7 billion estimate given in last year's Budget; this is a slightly better position than expected at the time of the Autumn Statement, when the PSBR was put at £8 billion. Last year's Medium Term Financial Strategy (MTFS) projected a PSBR for 1986-87 of about £7½ billion, or 2 per cent of GDP, together with a "fiscal adjustment" of £3¼ billion. As already noted, however, this assumed privatisation receipts £2 billion below those now expected (£4¾ billion), so that this reflects an underlying relaxation in the Government's fiscal stance.

7. The forecast of the PSBR for 1986-87 is much affected by oil prices. If we could rely on oil prices remaining at \$20 per barrel throughout the year, "present policies" (ie allowing for indexation of tax allowances and of excise duties) would indicate

a PSBR in the region of £5-6 billion (after taking credit for the additional privatisation receipts). But if oil prices were \$15 a barrel, the PSBR would be in the region of £7 billion, so eliminating any significant scope for a fiscal adjustment if the MTFS figure of £7½ billion is adhered to. The Chancellor of the Exchequer, having regard to the downside risks to which the economy will remain exposed, and the underlying policy relaxation already made, suggests that it would be prudent to aim at a PSBR a little below the £7½ billion in the 1985 MTFS; it is very hard to see any argument for a more adventurous fiscal stance. The Government will want to make it clear both domestically and internationally that, by maintaining prudent policies, it is capable of withstanding the "reverse" shock of rapidly falling oil prices. If the evolution of oil prices produced a substantial improvement in the Government's revenue prospects, and it was possible to have confidence that the improvement would be sustained, it would always be possible to review the fiscal stance later in the spring. It would be much easier then to relax the stance than the reverse.

Balance between taxes

8. Last year's Budget, apart from the restructuring of national insurance contributions to encourage the employment of more lower-paid people, went a little way beyond straight indexation of both direct and indirect taxes (with real increases in indirect taxes more than balanced by real increases in income tax allowances and thresholds, resulting in a net reduction in revenue from an indexed base of about £½ billion). Following the change in the structure of corporation tax, the abolition of the employer's national insurance surcharge, and the increasing extension of the principle of indexation into the area of capital taxes, there is little scope for further changes in tax structure as a means of encouraging the revitalisation of the economy.

9. This leaves the possibility of reductions in direct taxation, balanced - if the conjuncture requires this - by increases in indirect taxes. There remains a clear case for transferring relatively more of the burden on to indirect taxes; but increases in indirect taxes have effects both on the price level and on inflationary expectations, and it must be questionable whether it would be prudent to make any substantial move in this direction this year, given that United Kingdom inflation - even assuming no adverse shocks in the financial and foreign exchange markets - will remain higher than in other major industrial countries. In the longer run, of course, holding the rate of growth of public expenditure below that of the GDP should make possible real reductions in direct taxes without any need for compensating increases in indirect taxes.

The nature of any fiscal changes

10. Last year's Budget had an employment theme, and contained some substantial expenditure proposals on youth training and the Community Programme. These expenditures are only now beginning to take effect, and we know of no proposals for substantial new expenditures, or major changes in particular taxes, which might serve as the basis for a comparable theme for the 1986 Budget. Numbers of detailed suggestions have, of course, been made, and the Chancellor can be expected to pursue these as appropriate with the colleagues concerned. One area which has been a particular focus of attention has been the possibility of widening tax exemptions for gifts to charities (including those associated with the arts) - but the sums at issue here are relatively small.

11. In the absence of any immediate eye-catching proposals, rather more attention may be focused on the Chancellor's proposed Green Paper on the introduction of transferable income tax allowances. Following this morning's meeting you have agreed to a substantive discussion of this issue in Cabinet on 20 February,

on the basis of a draft text to be circulated by the Chancellor; it would therefore be better to avoid any detailed discussion on this occasion.

Medium Term Financial Strategy

12. The Chancellor does not mention the MTFS, or its extension to 1989-90, except in the context of assessing the size of the 1986-87 PSBR. A cautious and steady approach to both fiscal and monetary policy, which has underlaid successive restatements of the MTFS, has undoubtedly played a part in enabling the United Kingdom economy to resist economic shocks as well as it has; commentators have foreseen very serious consequences for the economy resulting from the prospective fall in oil revenues as North Sea output declines, but the effect of recent market changes has been that half of that reduction is already being sustained. It will no doubt be sensible to reconfirm the Government's medium-term approach to public expenditure and the PSBR; but it is less clear what should be said about monetary policy if the Chancellor gives no hint of his thinking on this. Until recently a steady reduction in the annual target ranges for growth in some of the principal monetary aggregates had been an important element in the MTFS; but the experience of the current financial year, when the growth of M0 has fallen below the target range, when that of £M3 (and other wider aggregates) has far exceeded the target range, and when real interest rates have been maintained at unprecedentedly high levels, has suggested that changes in the monetary aggregates alone may not be reliable as guideposts for steering the economy. In his Autumn Statement the Chancellor said that "monetary policy will continue to be directed towards sustaining further downward pressure on the growth of money GDP and hence on inflation, as in the MTFS, and that short-term interest rates will be set so that the paths of the monetary aggregates and the exchange rate are consistent with this objective". The statement in effect put the £M3 target into abeyance, acknowledging that "the range did not allow for the

continued downward trend in velocity associated with financial liberalisation and positive real interest rates". The Chancellor is presumably considering what to say about future monetary targets, and about the management of monetary and exchange rate policy; the Cabinet are unlikely to want to discuss this in any detail, but the Chancellor might be asked how he considers policy can best be structured to contribute towards the Government's objectives of stability and lower inflation.

HANDLING

13. After the Chancellor of the Exchequer has introduced his memorandum, you may wish to divide the discussion into two parts:

- i. the overall fiscal stance, and the size of the 1985-86 PSBR;
- ii. any points on the more detailed shape of the Budget.

You may wish to ask the Chancellor of the Exchequer to respond separately to each part of the discussion.

CONCLUSIONS

14. In your concluding remarks you will wish to avoid any suggestion that the Chancellor of the Exchequer is committed by the discussion to particular changes in his Budget, and to avoid any commitment to further general discussion by the Cabinet, apart from the discussion on 20 February of the reform of personal taxation and the traditional meeting immediately preceding the Budget.

15. You might then record conclusions which:



- a. invite the Chancellor of the Exchequer to take account of the views expressed in discussion in his further work on the Budget;
- b. invite any Minister who has particular points on possible tax changes to discuss them directly with the Chancellor of the Exchequer.

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for

ROBERT ARMSTRONG

12 February 1986