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PRIME MINISTER

Cabinet: Economic Strategy

C(87) 2

BACKGROUND

In C(87) 2 the Chancellor of the Exchequer seeks the views of his colleagues on the broad shape of his forthcoming Budget.

2. Although the Chancellor of the Exchequer will take his colleagues' views 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 run up to the Budget on 17 March, although he will no doubt be willing to discuss particular points bilaterally with individual Ministers.

MAIN ISSUES

3. The main issues are:

- a. The level of the PSBR in 1987-88.
- b. The balance as between direct, indirect and company taxation.
- c. The nature of any fiscal changes.

The level of the PSBR in 1987-88

4. The 1986 Medium-Term Financial Strategy (MTFS) projected a PSBR of 1.75 per cent of GDP or £7 billion. This was consistent with a fiscal adjustment of £2 billion.

5. At the time of the 1986 MFTS, however, general Government expenditure was expected to be £170 billion in 1987-88. As a result of the outcome of the 1986 public expenditure round, it will now be £173.7 billion - an increase in expenditure of £3.7 billion.

6. This rise has, however, been offset by a bigger than expected increase in revenue. The Chancellor therefore said in the Autumn Statement that the PSBR in 1987-88 would still be held to 1.75 per cent of GDP. He now suggests that, in view of the likely lower than expected outturn in the present year, it should be smaller (though he does not specify a figure). The effect on the fiscal adjustment depends on just how buoyant revenues have been.

7. Colleagues may wish to discuss whether it is right to use the unexpected headroom to plan for a lower PSBR next year than in the 1986 MFTS. It would, of course, be at the expense of further tax cuts or spending. There are, however, four factors which argue for a very prudent approach:

a. Macro Economic Considerations

The balance of payments is more likely to deteriorate than improve, and the rate of inflation is likely to move upwards, during 1987; these consideration could be held to militate against over-large reductions in taxation (particularly personal taxation).

b. Treatment of Privatisation Proceeds

These are treated in effect as negative public expenditure, and their increase over the last few years has been important in holding down the apparent size of the PSBR. The public sector financial deficit (which, unlike the PSBR, does not take credit for privatisation proceeds) was actually forecast, in last year's Red Book, to increase from £10.2 billion in 1985-86 to £12.2 billion in 1986-87,

although the 1986-87 outturn will probably turn out to be lower than this. The markets are well aware of this underlying feature of the PSBR.

c. Size of the Reserve

The Reserve in 1986-87 was set at £4.4 billion but proved not to be enough. For 1987-88, however, it has been fixed at the even lower figure of £3.5 billion.

d. Oil Prices

Last year's Red Book assumed that they would be \$15 on average for the rest of 1986 and throughout 1987. This proved too high for much of 1986. Although the market price is now higher, oil prices remain a major source of uncertainty and could again fall.

The market's awareness of these points suggests that, other things being equal, it would be right to err on the side of caution in fixing the level of the PSBR.

The Balance between Direct, Indirect and Company Taxation

8. The first question is how the benefit of reduction in taxation should be shared between the company and personal sectors. The financial position of the company sector is now very strong, and with the completion of the 1984 reform of corporation tax, we now have the lowest rate of Corporation Tax of any major country. There is also a question whether lower corporate taxation would simply lead to higher pay. It may have done so in the past. On the face of it the case for substantial concessions to the company sector does not appear strong.

9. On the personal side, the Government's declared policy is to shift the balance from direct to indirect taxation. This could be achieved by widening the VAT base - ruled out by the Chancellor in 1985 for the rest of this Parliament; increasing

the rate of VAT - enormously controversial; or increasing excise duties by more than revalorization. Only the last seems a realistic possibility. The disadvantage is the impact effect on the RPI, which is already likely to drift upwards for the next few months. Revalorization of all excise duties, assuming 3.25 per cent inflation, would yield about £500 million and raise the RPI by 0.3 per cent. It is however already allowed for in the Budget calculations, so an increase above revalorization would be necessary to make more money available, than in those calculations, to reduce direct taxation.

The Nature of any Fiscal Change

10. The major questions are likely to be on the direct tax side. The biggest single choice is between action on:

i. The basic rate - every 1p off the basic rate would cost £1,100 million in 1987-88.

ii. Personal allowance - the Budget arithmetic already assumes that these are revalorized. Every £100 increase in the main personal allowance would cost about £570 million in 1987-88.

11. The arguments for increasing personal allowances more than required for revalorization are:

i. It could be represented as giving the biggest proportionate help to those on low incomes.

ii. It would do more than action on the basic rate for the poverty trap and unemployment trap.

iii. It would take people out of tax altogether.

12. The arguments for concentrating on the basic rate are:

- i. It would reduce the marginal rate, and so in principle improve incentives, for the 95 per cent of taxpayers who pay at the basic rate.
- ii. It would help towards the declared long-term aim of reducing the basic rate to 25 per cent.
- iii. It would, arguably, be more visible.

13. There is also the question of how much should be done at the higher rates. Arguments for action on the higher rates are:

- i. It is not expensive. Reducing all higher rates by 1p would cost only £65 million in 1987-88.
- ii. There is a worldwide movement towards reductions in top rates, not only in the USA (new top rate 28 per cent) but, for example, in Labour Australia and New Zealand (new top rates of 49 per cent and 48 per cent).

As against this, it is already possible to show that the Government's tax changes since 1979 have reduced the proportion of earnings paid in tax and NIC only for those on the highest incomes. Action on the top rates would reinforce this.

DISCUSSION AND CONCLUSIONS

14. After the Chancellor of the Exchequer has introduced his paper, you will wish to invite Ministers to comment. In you concluding remarks, however, you will wish to avoid any suggestion that the Chancellor is committed by the discussion to particular changes in his Budget. You may also wish to avoid any commitment to further discussion in Cabinet, other than in the traditional meeting immediately before 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.

Mr Woolley

Mr

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11 February 1987