

9(a-c)

PRIME MINISTER

BILATERAL WITH THE CHANCELLOR: 7 MARCH

You are seeing the Chancellor tomorrow evening at 1730. The Chancellor will have to leave by about 1930 for an evening engagement, but this means you have up to two hours with him to go through his latest thinking on the Budget.

He has this evening sent over the attached minute, which sets out the latest package and provides detailed notes on a number of aspects.

You will want to work through the whole of the note at tomorrow's meeting. But you may find it helpful to have the following quick thoughts.

The overall fiscal position

You need to start by agreeing on the overall budget judgment. The latest score-card is not greatly different from the earlier one you saw, and points to a cost in 1991-92 of some £365 million. The Chancellor suggests that this net cost needs to be reduced by some £300 million to bring it near to balance.

When we spoke the other evening you were minded to think some tightening of the package was essential. I think there is a strong case for doing a lot more than the Chancellor now proposes, bearing in mind that the score-card excludes the impact in 1991-92 of the lagged effects of the last two Budgets. As I understand it this will have an additional fiscal impact from next year of some £2½ billion. So even a balanced Budget this year will in reality lead to a loosening of fiscal policy, as compared with the current year, of that amount; a fact City commentators will not be slow to pick up.

I assume that at this stage you will not want to press the Chancellor to tighten the package to anything like the extent of £2½ billion. But if your main priority for the next 12-18 months

b

to provide conditions in which interest rates can come down you must err on the side of caution and have a tighter fiscal stance.

How to close the gap

In paragraph 7 of his note, the Chancellor identifies four main options for saving £300 million. He currently favours his option (d) involving a number of minor adjustments to indexation of income tax allowances.

The first issue to settle is whether you are content with only one of these four options or whether - given the argument above - you think it necessary to do more than that.

My own views are:

- it is silly to be cutting the CT rate by a small amount. You will get scarcely any credit and even fewer votes for it. And it just uses up some of the money you may want to have in reserve for next year. If you want to do anything on business taxation it would be far better to have a more generous package for raising ^{the threshold for} the small business CT rate (as far as I am aware there is no EC constraint here - that applies in the case of VAT thresholds);
- I know you were minded last week not to go for differentiated car tax but I think the Chancellor over-states the problems with this, bearing in mind the points raised in MISC 141 this morning;
- although I was initially attracted to the married couples option it does have the drawback of "hitting" families with only one income. If you wanted to freeze any of the income tax allowances it might be better to go for the basic rate limit which would also save some £400 million. One potential problem with that is hitting people with company cars, but to judge from the detailed notes which follow immediately after the score-card in the Chancellor's paper, I am not sure they would suffer any significant cash loss.

Excise duties

You may be tempted to cut back the duty increases further given the RPI worries. But I would argue strongly against doing so. It really would store up big problems for next year.

You will want to work carefully through the detailed notes annexed to the Chancellor's minute, in particular the capital limits for means-tested benefits. You will see that the Chancellor has now discussed the Community Charge issue with Tony Newton and proposes a 50 per cent increase in all the limits.

(PAUL GRAY)

BUDGET SECRET