

Meeting on the Budget

You already have a note from the Policy Unit.

Douglas Wass has telephoned to suggest that the meeting should cover the following topics (and I think this fits in with the approach suggested by the Policy Unit):-

- (i) What PSBR should we be aiming for in 1981/82?

The Treasury's latest estimate on the conventional forecasting assumptions (i.e., revalorisation on indirect taxes and of direct tax thresholds) is for a PSBR of £13½ b. The forecast has now deteriorated by nearly £3 b. in the course of the last three weeks. You will want to ask what grounds we have for believing that it won't deteriorate further. (But there have been some years in which the Treasury have over-estimated the PSBR - usually, I think, when the economy has been coming out of recession. This happened in 1977/78: when the IMF came in November 1976, we were expecting a PSBR of about £10 b.: we took £1½ b. off the PSBR, and the final outcome was nearer £5 b.) Then discuss what PSBR would be desirable. To decide this, we really need to know what monetary target we are going for. The Treasury are not yet ready to go firm on this because of the unresolved question of how (i.e., M3 and/or other measures) the target should be expressed. But assuming the Treasury are still on 6-10% for M3, I judge that that would require a PSBR of no more than £10 b. as a maximum if there can be any confidence of interest rates falling. On the other hand, taking as much as £4 b. out of the economy may not be politically possible; and pace the Policy Unit, even if it is possible, the short term effect may arguably

be too deflationary. We need to consider carefully the trade-off between the deflation caused by interest rates not falling, and the deflation which would come from what the Policy Unit call "overkill". From a political point of view, getting the PSBR down from £3½ b. to £10 b. may simply not be possible - which brings us on to the main revenue options.

- (ii) What is the maximim RPI effect we can stomach?
 Revalorisation on the specific duties, which is already built into the forecast, adds 1% to the RPI. Twice revalorisation would add a further 1% to the RPI, and yield about £1 b. (The increases can of course be varied as between beer, tobacco, etc.: you get a good deal more revenue from beer for a given RPI impact than from tobacco or spirits. Thus, 1p on a pint of beer adds 0.1% to the RPI and yields £105 m. in a full year; 1p on a pack of cigarettes also adds 0.1% to the RPI, but yields only £40 m.) Your own feeling earlier this week was that a full 2% addition to the RPI was untenable politically; and, of course, the more we add to the RPI, the more difficult it is to achieve a given monetary target.
- (iii) How much do we do on thresholds?
 Rooker-Wise require 15%. The Treasury thinking is that we can't do less than 7½%; otherwise, quite apart from the disincentive effect, large numbers of additional people are brought into tax; and this means extra staff numbers. By raising thresholds by only 7½%, we save about £1 b. on the PSBR.
- (iv) Bank Levy
 The Chancellor's proposal would reduce the PSBR by £450 m.; he wants your endorsement of it, though I am

told that the Governor wants to make his own representations before a final decision is taken. One point we need to be clear on is what will be the monetary effect of the levy: I have been told that, while it reduces the PSBR, it will not have a beneficial effect on the money supply.

(v) VAT on imports

The Chancellor has sent in a minute (Flag A) arguing very strongly against: he argues that it would have a negligible effect on switching spending to domestic manufacturers, while at the same time it would be a substantial drain on corporate liquidity. A decision is needed today. If we were to do this, it would save £600 m. on the PSBR.

(vi) Industry Package

The Treasury have in mind some measures to help all of industry, in addition to the enterprise package (costing £200 m.) which is designed specifically for small businesses. They have in mind some minor measures such as helping on energy prices, which might cost about £250 m. But in view of the arithmetic set out above, and if we are to get the PSBR down even near £11 b., it seems doubtful whether we will be able to afford this. (There is one other revenue measure which the Treasury have up their sleeve: £250 m. from smoothing the receipts from VAT. In other words, they hope to be able to bring forward some of the VAT receipts from large traders from 1982/83.)

13 February, 1981.