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Econ Pol Budget

Nothing about Incentives !?

Prime Minister

MCS 19/1

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

I am very worried about this paper. I believe the way it is phrased will arouse opposition and it will be difficult to get Cabinet wholehearted support. There must be more emphasis on jobs !! Also the impression is given that [illegible] we [illegible] getting inflation the name of the game!

CABINET: 28 JANUARY

We spoke today about the discussion of economic strategy, and the Budget, which is due to take place in Cabinet on 28 January. I briefly described the reasons why I think it best that I should put round a paper in advance.

2. I fully recognise that there are risks in doing so. They perhaps fall into three categories. First, there is the risk of a leak; but a documentary leak is unlikely, and can be made more so by special handling procedures (which my Office have discussed with the Cabinet Office). They might include delaying circulation until next week. The chances of loose talk by colleagues are probably much the same whether or not a paper goes round: the best way of reducing them would be for you and I to stress on 28 January the market-sensitivity of the matters under discussion.

3. Secondly, it could be argued that circulating a paper increases the risk that we slide further down the road - which we are already on - towards Budget-making in Committee. I myself would not so argue; indeed it seems to me that colleagues are more likely to agree to keep off the grass in the succeeding six weeks if they are permitted a substantive discussion on 28 January. And this really means putting a paper round.

4. Thirdly, I have carefully considered, with Leon Brittan, whether the circulation of a paper is likely to increase or reduce the chances of colleagues' accepting our judgement about the appropriate size of the PSBR for next year. We both believe that the chances would be increased. Colleagues are well aware - from last year's Budget, from our October paper, and from the press passim (e.g. Sarah

The need of getting inflation in to have sound & continuing recovery, more jobs & [illegible] - not [illegible].

Hogg's piece in the latest Sunday Times, and this week's Economist) of the significance of the PSBR decision, and will expect to discuss figures. Some may start from the mistaken assumption that a figure similar to this year's £10½ billion would be supportable next year.

5. I attach the draft of the paper which I have in mind. You will see that my present, and necessarily provisional, judgement is that the right PSBR for next year will lie in the range of £7½ billion to about £9 billion. The interest rate argument would take us to the lower end: the arguments for tax relief point to the upper end. I suspect that a majority of our colleagues would be very resistant to the lower figure. Nevertheless, Leon Brittan and I think that the arguments for it should be drawn to their attention, and may help to convince them that going above about £9 billion is just not on.

6. Perhaps we could have a word about the draft at our meeting tomorrow evening?

7. Copies of this minute go to Leon Brittan and to Sir Robert Armstrong.

GH.

(G.H.)
19 January 1982

ECONOMIC STRATEGY

I shall be presenting our fourth Budget on 9 March.

Outlook for the Year Ahead

2. The latest forecasts predict continuing, though frustratingly slow, recovery in output, and a further fall in inflation, which should be at 10 per cent by the end of this year, and in single figures in 1983. Unemployment may continue to edge up in 1982, though at a diminishing pace, while industrial productivity should continue to rise. The general picture is one of continued recovery, with encouraging signs of real improvement in the economy. The forecast could of course be invalidated by events beyond our control, whether world-wide (e.g. American interest rates) or domestic (e.g. another serious setback on pay). [And it assumes that we hold to present policies.]

3. (The temptations to change course are obvious.) The level of unemployment is worrying (and we need to do more to convince people that there is no easy solution). We should all like to see the recovery quicken, and I recognise the case for doing something now to encourage our supporters, and the country. However it would be foolish to do this in such a way as to endanger the chances of further progress on inflation and further improvement in our industrial performance. In economic (e.g. on unemployment) as well as political terms, the gains, if any, from such a course would be short-term only, and it would risk throwing away the hard-won progress made in the last 2½ years.

The Right Balance

4. So we must stick broadly to our present course, maintaining progress towards our key objectives: a continued reduction in inflation and a continued rise in output. We should see the rates of both wage and price increases falling, with inflation down to 8 per cent or less by the end of 1983; and there should be faster growth of output in that year. A more ambitious approach on inflation in the coming year would risk choking off the rise in output, while a much more reflationary stance could

jeopardise the exchange rate and would mean inflation again taking off, and interest rates rising still further.

5. This balance has to be struck within a credible financial framework, involving control of monetary growth. The markets will expect us to maintain downward pressure on the growth of the various aggregates. This is crucial to confidence, and to the chances of a reasonably steady exchange rate without cripplingly high interest rates: if we were thought to have abandoned monetary and fiscal control, sterling would quickly prove fragile. It may be necessary to formulate our monetary objectives for the period ahead in terms relating to a number of aggregates, and with more explicit reference to the exchange rate, rather than exclusively to £M3. But what we must not do is discard the discipline.

Borrowing

6. Within this framework, the size of the Public Sector Borrowing Requirement for next year will be very important. For the current year we looked for a PSBR of £10½ billion, and we are on course for this. For next year the forecast (which may of course change substantially before March), gives a provisional figure of some £7½ billion on "present policies". This includes the assumption that income tax thresholds would be increased in line with inflation - and this year we must do our utmost to do this - and that excise duties would be similarly increased - which might cause some trouble in the House. But there clearly is a strong case for holding to £7½ billion: it should offer a prospect of interest rates which, though still uncomfortably high, would not be out of line with those world-wide, and would not unduly constrain recovery.

7. We were looking at the time of the last Budget for a PSBR of up to £9 billion for 1982-83. This would give a prospect of some further tax reductions, but on the other hand involve greater risks to market confidence, and hence to interest rates and the exchange rate. Since the last Budget, the exchange

rate has fallen considerably, oil prices - which support it - have also fallen, and we have had to face higher interest rates.

8. The trade-off between interest rates and tax relief is ultimately a matter for judgement. But it is my belief, not least in the light of our experience over the last year, that to go for a PSBR above about £9 billion could lead to still higher interest rates, would affect confidence, and would thus seriously risk so large a fall in sterling as to jeopardise the prospects of reducing inflation, and impair - or even reverse - recovery. We could engender a general loss of confidence.

9. If some tax reductions are possible, I shall have to consider the balance to be struck between the claims of the company sector and those of the personal sector. I shall be ready to discuss this on 28 January. Better prospects for later years have a habit of evaporating as they approach, but at this stage it looks as though there should be some scope for further tax reductions in 1983-84, providing public expenditure is kept under control.

Summary

10. The signs are that our efforts to restore the economy to health are working. Inflation and output are moving in the right direction, and the rate of increase in unemployment is slackening. This Budget will be crucial. To lose our nerve would be to risk losing all. The key is the 1982-83 PSBR. Given high interest rates world-wide, there is an argument for going below £7½ billion, but the measures to achieve this are not on politically. To go above about £9 billion would of course be politically easy, but, as seen now, economically very hazardous, particularly in terms of exchange and interest rates.

11. I would welcome my colleagues' views on these issues on 28 January.

G.H.

HM TREASURY
19 January 1982

SECRET

I shall be presenting our fourth Budget on 9th March.

1. Outlook for the year ahead

The latest forecasts predict continuing, though slow, recovery in output and a further fall in inflation, which should be at 10% by the end of this year, and in single figures in 1983. Unemployment is likely to increase slightly in the first half of 1982, though at a diminishing rate; while industrial productivity should continue to increase. The general picture is one of continuing recovery, with encouraging signs of real improvement in the economy. This forecast could, of course, be invalidated by events beyond our control, whether world-wide (eg American interest rates) or domestic (eg another serious set-back on pay).

2. Of course I continue to be deeply concerned about the level of unemployment. My colleagues know that there is no easy solution. We should all like economic recovery to quicken and unemployment to fall.

But all previous attempts at artificially induced reflation have resulted, in the medium and in the longer term, in higher unemployment and in higher inflation. In terms of employment, and in political terms, the gains brought about by reflation, if any, would be short-term and extremely limited only. The impact on interest rates, inflation and, very probably the exchange rate would mean throwing away the hard won progress of the past 2½ years, and would inevitably lead to still higher levels of unemployment than those from which we are now suffering.

3. The right strategy

We must accordingly persevere in our present strategy, maintaining progress towards our key objectives; a continuing reduction in inflation; a continuing rise in output; a diminution of the monopoly public sector; and a strengthening of the free market economy. This is the way to secure a genuine improvement in the employment situation rather than a very small and short-lived change in the figures. The prospects are by no means poor. The rates of both wage and price increases should continue to fall with inflation down to 8% or less by the end of 1983; and there should be faster growth of output in that year than in 1982.

4. For domestic and overseas confidence in the Government's strategy to be sustained we must have a credible financial framework. This, in turn, involves controlling monetary growth. The markets will expect us to maintain downward pressure on the growth of the various aggregates. This is crucial to confidence and to maintaining a reasonably steady exchange rate without cripplingly high interest rates. If we were thought to have abandoned monetary and fiscal control, sterling would quickly prove fragile. Our monetary objectives for the period ahead will need to take account of a number of aggregates and with more explicit reference to the exchange rate, rather than exclusively to £ M3. But we must maintain the basic concept of monetary discipline.

5. Borrowing

Within this framework the size of the PSBR for next year is crucial. For the current year, we planned a PSBR of £10½ billion and we are on course for this. For next year, the forecast (which may change substantially before March) gives a provisional figure of rather less than the £9 billion anticipated at the time of the last Budget. That figure assumes that income tax threshholds would be increased in line with inflation and this year, in order to increase incentives and diminish the why work problem, this is the least that we can do (the cost is £ _____). It also assumes that excise duties would be similarly increased - although that may cause some difficulty in the House. Restraining next year's borrowing to £7½ billion would offer a prospect of lower interest rates which would at least not obstruct recovery and which would be lower than if borrowing was allowed to exceed that figure. Even so, they would still be uncomfortably high. For most people - industry and mortgagors alike - lower interest rates are a primary objective. But it is obviously possible to offer some fiscal relief as well. We do not yet know how far we shall have room to manoevre or balance our choice between lower interest rates and tax relief.

6. At the time of the last Budget, we were anticipating a PSBR of up to £9 billion for 1982/83. A figure of that magnitude might give room for limited tax reductions. But it would also involve risks to market confidence and hence to interest rates and the exchange rate. Since the last Budget, the exchange rate has fallen considerably. Oil prices which support it have also fallen and we have had to face even higher interest rates.

7. The trade off between interest rates and tax reliefs as a means of sustaining recovery is bound to be a matter of judgement. But it is my belief, not least in the light of our experience of the last year, that to go for a PSBR above about £9 billion is likely to lead to still higher interest rates, could affect confidence and could risk so large a fall in sterling as to jeopardise the prospects of reducing inflation and impair - or even reverse - recovery.

8. If some reductions in taxation should turn out to be possible, for the coming year, I shall have to consider the balance to be struck between the claims of the company sector and those of the personal sector. I shall welcome the advice of colleagues about this. Better prospects for later years have a habit of evaporating as they approach. However, at this stage, it looks as if there should be some scope for tax reductions in 1983/84 provided public expenditure is kept under control.

9. All the signs are that our efforts to restore the economy to health are succeeding. Inflation is going down; output is going up; the rate of increase in unemployment is slackening. This Budget will be crucial. At this stage in the economic cycle previous governments have sacrificed economic rectitude for presumed electoral advantage.

If we lose our nerve now, we will risk losing all. The key for 1982/83 is the PSBR. Given high interest rates world-wide, there is an argument for going below £7½ billion; but the measures required to achieve this are politically impossible. To go above about £9 billion would be easy politically; but it would imperil the exchange rate, interest rates, the conquest of inflation, our whole determination to create a sound economy and, in anything other than the very short-term, the creation of more real jobs.