



SECRET

PRIME MINISTEREconomic Strategy
(C(82) 1)

BACKGROUND

In C(82) 1 the Chancellor of the Exchequer seeks the views of Cabinet on the appropriate level of the Public Sector Borrowing Requirement (PSBR) in 1982-83 and on how any fiscal relief which proves practicable might be distributed between taxation measures directly affecting prices, reducing income tax and assisting companies.

2. He will take account of these views in preparing his Budget, but he will not wish to be bound by them either in terms of amounts or of the direction in any detail. He will want to avoid if possible any commitment to further collective discussion in the run-up to the Budget; although, as is the normal practice, he will be ready to discuss particular points bilaterally with individual Ministers (eg those on small firms, new technology and the construction industry made by the Secretary of State for Industry in his letter of 26th January copied to you and some other Ministers).

THE LEVEL OF THE PSBR IN 1982-83

3. The public expenditure discussions in the Autumn were on the basis that the Government should plan for a PSBR in 1982-83 not greater than the £9 billion foreseen at the time of the 1981 Budget. As explained in paragraph 6 of C(82) 1, the current forecast gives a provisional figure of 'rather less' than £9 billion; this is on the assumption that income tax thresholds and excise duties will both be increased in line with inflation (Annex 2 of C(82) 1 tabulates the effects on income tax allowances and on prices). By referring to a range of between £7 to £8 billion and £9 billion for the PSBR the Chancellor of the Exchequer implies that the scope for fiscal adjustment could be in the order of £1½ billion; as you will know but not the Cabinet generally, the present forecast on present policies is of a PSBR of £7½ billion. Against this background there are three broad options for planning for the PSBR in 1982-83.



SECRET

4. First, the aim could be to plan for a PSBR of £7 to £8 billion. As the Chancellor points out in his paragraph 7, this would give the prospect of lower interest rates which would assist recovery and be helpful both to industry and to personal borrowers, including mortgagors. It would mean, however, forgoing the possibility of fiscal relief over and above revalorisation. As such, it is likely to be regarded by most members of Cabinet as unattractive.

5. Secondly, the PSBR could be higher than £9 billion so as to open the way to fiscal relief of more than the £1½ billion now in prospect. In his paragraph 8, the Chancellor of the Exchequer warns strongly against this course which could lead to higher interest rates, damage confidence, risk a fall in sterling and so have adverse consequences for inflation and for the prospects for recovery.

6. Thirdly, the Government could continue to plan for a PSBR in the order of £9 billion, and use some or all of the £1½ billion 'saving' which has now emerged for fiscal relief. This would add to the risks of higher interest rates; on the other hand, £9 billion is the figure the markets are broadly expecting and it would not be seen as reflationary (though some care would be necessary in explaining how the leeway for tax relief emerged).

THE FISCAL OPTIONS

7. Without getting tied to particular figures or to details, the Chancellor of the Exchequer would welcome views on how any relief which might turn out to be possible should be distributed.

8. Some Ministers may wish some of it to be allocated to additional public expenditure - to deal with problems emerging on particular programmes or to stimulate industrial activity by way of further capital expenditure or an increased programme of selective financial assistance to industry (e.g. the

FLAG A. -

Secretary of State for Industry proposes in his letter of 26th January, an "innovation package" costing £45 million in 1982-83). The Chancellor of the Exchequer is likely to argue strongly against this. The Public Expenditure White Paper, which will be published on Budget day, provides for a planning total in 1982-83 of £115.3 billion, including a contingency reserve of



SECRET

£2¼ billion. This planning total, which follows Cabinet's decisions in November, is about £5 billion higher than envisaged last year. Any further increase could be ill-received and represented as a weakening of the Government's stance on public expenditure. The Chancellor of the Exchequer will argue that it is better to help industry, and individuals, through the tax route. If increases on particular programmes were judged to be necessary they could be dealt with as claims on the contingency reserve. (The Chief Secretary is sending you the draft of the White Paper today, and asking you and members of the Cabinet for any comments by next Tuesday, 2nd February.)

9. If it is accepted that there should be no further increases in public expenditure - or that, at most, only a small part of the fiscal adjustment should take this form - the discussion then focuses on the tax options. There is a useful ready reckoner at Annex 5 of C(82) 1.

10. In looking at the possibilities for a tax relief package in the order of £1 - £1½ billion, and assuming that some of the total will be reserved for more detailed measures such as relief in capital taxes, the broad choice is between the following three categories, and permutations between them, of measures:

- (i) directly affecting prices; =
- (ii) reducing income tax; =
- (iii) directly assisting companies. =

Annex 4 sets out the broad consequences of each of these three categories of an illustrative £1 billion reduction. You will note that there is no difference in 1982-83 between them in terms of Gross Domestic Product and of numbers unemployed and not much difference in the following year.

11. In looking at the three categories Cabinet might bear in mind the following general points:

- (i) A choice has to be made between the major options of 1p off the basic and higher rates of income tax (first year cost £910 million) and 1 percentage point off the National Insurance Surcharge (NIS) (first year effect £700 million).



SECRET

- (ii) The full year (1983-84) effect of 1 percentage point off NIS or VAT is markedly higher than that in the first year (1982-83); care must be taken not to reduce the room for manoeuvre in the 1983 Budget and, in particular, not to run a risk of having to retrench in that year.
- (iii) "Helping individuals" and "helping companies" should not be seen as mutually exclusive alternatives. Companies will benefit from changes in personal taxation and in excise duties through increased demand, reduction in the Retail Price Index (RPI) and possibly, some reduction in the pressure for wage increases. But the benefits to companies of changes in personal taxation would come through to companies more slowly than changes in company taxation, and in more diffused form: companies would be less able to identify them, and would therefore feel less benefited than by changes in company taxation.

MEASURES DIRECTLY AFFECTING PRICES

12. The possibilities include less than full revalorisation of excise duties or a reduction in the rate of VAT. Advantages are:

- (i) a reduction in the RPI, helpful to individuals and to companies (Annex 4 assumes that £1 billion less in indirect taxes would reduce the RPI by 0.7 per cent in 1982-83);
- (ii) avoiding or reducing increases on tobacco and alcohol, and on petrol and derv (where there are special Parliamentary sensitivities to be taken into account, because of the effects on those who live in rural areas).

But:

- (a) concessions on tobacco and alcohol will be criticised by others as a curious priority;
- (b) energy conservation arguments point against real reductions in the duty on petrol.

REDUCTIONS IN INCOME TAX

13. Advantages:

- (i) A rise in take home pay could help in wage negotiations.
- (ii) Checks trend of growing total tax burden since 1978-79 - see Annex 3.
- (iii) Helps with poverty trap and "why work" problems.

But not such a quick or direct help to industry as the third category and, if lp is taken off each band, there is no room left for a major move on company tax burdens such as a reduction in NIS.

HELP FOR COMPANIES

14. Advantages:

- (i) Boost to company profits and confidence, and welcome as a response by the Government to the views of industry.
- (ii) Possibly welcome by persons (as well as by companies) as a move which could, over time, help employment and avoid more closures.

But:

- (a) NIS relief, in particular, could leak into wages and could relax the pressure for productivity improvements.
- (b) NIS relief benefits banks and North Sea sector which do not need it so much (less than $\frac{1}{3}$ of NIS payments are by manufacturing industry).
- (c) Much more costly in full year 1983-84 than in 1982-83.

HANDLING

15. After the Chancellor of the Exchequer has introduced his paper it is likely that each member of the Cabinet will wish to speak. The two main questions before them are:

- (i) What is their view on the PSBR for 1982-83.
- (ii) How could any relief be best distributed between individuals and the company sector bearing in mind the main advantages and disadvantages of each category (paragraphs 13 to 14 above) and the need to take account of the impact on the 1983 Budget.



SECRET

In practice it may not be possible to structure the discussion to deal with these two questions separately, and you may prefer to go round the table seeking the views of each Minister on both.

16. You might ask the Secretary of State for Industry to speak first so that the Cabinet can take account of his views on the needs of industry. You might call fairly early in the discussion on the Secretary of State for Social Services to advise on the relevance of the options to the social security programmes and on the Secretary of State for Employment to give his assessment of the impact of the options on wage bargaining and on the RPI. The Lord President and the Chief Whip may comment on the priorities as seen by backbench opinion (I have the impression that the Lord President may be reasonably content, if the Cabinet endorses the £9 billion target for the PSBR). You might bring the Chief Secretary in towards the end of the discussion to deal with any points on public expenditure and finally, before you sum up, ask the Chancellor of the Exchequer to give his general reactions to the discussion.

CONCLUSIONS

17. In summing up you will wish to reflect the consensus - or the balance of views - on the size of the PSBR in 1982-83 and on the options for distributing any relief. You will wish to make clear that the Chancellor of the Exchequer is not committed by the discussion to particular changes in his Budget and you will want to avoid any commitment to further general discussion by the Cabinet apart from the traditional discussion immediately preceding the Budget.

18. You might then record conclusions which:-

- (i) invite the Chancellor of the Exchequer either to take account of the views expressed in discussion in his further work on the Budget or - if there is widespread pressure for a stronger formulation - to be broadly guided by your summing up of the discussion;
- (ii) invite any Minister who has particular points on possible tax changes to discuss them directly with the Chancellor of the Exchequer or, in the case of public expenditure points, with the Chief Secretary.

Robert Armstrong

27th January 1982