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PRIME MINISTER

31 January 1986

BUDGET ISSUES

Your meeting with the Chancellor can begin by surveying the state of the economy and the forecast. The basic message is encouraging - more so than a lot of the outside forecasts. We can hope for continuing buoyant growth (maybe 3% in 1986 and 2% in 1987). Inflation might remain steady at about 4%. The crucial policy questions boil down to how tight a monetary policy you want and how loose a fiscal policy.

There are four big issues for the meeting:

A. Monetary Policy

B. PSBR

C. Income Tax Cuts: Rates v. Allowances

D. Other Taxes

A. Monetary Policy

Broad money cannot be ignored. The City still cares about it. Moreover, it measures the dry tinderwood in the economy - the money available to be spent and fuel inflation unless real interest rates stay high. So the Chancellor is likely to want to publish a target for Sterling M_3 or some variant of it, and we recommend you agree to this.

But you could press the Chancellor on what happens if broad money overshoots its target figure during next year: what will he do to convince the market that the target is taken seriously by the Government?

Narrow money is more important. M_0 has a good track record as an indicator of inflation. It responds well to increases in interest rates. If inflation is to come down to 3% or less, it is crucial that the published ranges over the next 2 years show reduced numbers, eg 1-5% for 1986/87 and 0-4% for 1987/88.

All this means that we are in for a further period of high interest rates. There is little prospect of a fall in the cost of mortgages.

B. PSBR

FISCAL STANCE IN 1985 BUDGET £bn

	1985-6	1986-7	1987-8	1988-9
PSBR	7	7.5	7	7.5
Fiscal Adjustment		3.5	3	3
Asset Sales	2.5	2	2	2

The Treasury now expect the PSBR to turn out at around £7 billion for 1985-86. This is good news. It is better than the £8 billion estimate in the Autumn Statement. The market expects an even higher number.

There have been two big changes since the 1985 Budget.

The fall in the oil price cuts our oil revenues dramatically:

		£bn
	1986-7	1987-8
1985 Budget forecast	11.5	9.5
Reduction assuming oil at $20 per barrel	-3.5	-3.0

The sale of BGC has whacked up receipts from asset sales:

		£bn
	1986-7	1987-8
1985 Budget	2	2
Now planned	4.5	4.25

The key issue is whether you keep to the target of £7.5 billion, counting asset sales as negative expenditure. This might permit about £2 billion of tax cuts next year. Alternatively, we could be cautious because of the higher asset sales and go for a tight PSBR of £5.5 billion without any net tax cuts. A compromise of £6.5 billion would allow the Chancellor net tax cuts of £1 billion.

The Chancellor's instinct may be to go for tax cuts of around £2 billion and a PSBR of about £7.5 billion. The arguments in favour are:

a. The lower oil price and reduced revenues are temporary and erratic. Our North Sea oil revenue assumption is now on the pessimistic side.

b. The PSBR target set out in the last Budget was on the low side. The PSBR could still be falling as a percentage of GDP. The famous tough Budget of 1981 gave us a PSBR in 1981-82 that was 3.3% of GDP. Even after counting back asset sales, a PSBR of £7.5 billion in 1986-87 would be about 2.75% of GDP.

The arguments for a more cautious approach are:

a. Lower oil prices are like a tax cut - but unfortunately the Chancellor doesn't get the credit.

b. It would be a brave forecaster who offered to predict with near certainty the future course of the oil price.

c. We must not let a loose fiscal policy expose us to the risk of high inflation or the loss of City confidence.

The total size of the British economy is approaching £400 billion. So a change in the PSBR of £1 billion either way isn't going to make that much difference. It's well within the margin of error of the Treasury forecast. We would be prepared to see a PSBR of £7.5 billion, provided that monetary policy is tight to keep inflation down and keep City confidence. Moreover, that little bit extra on the PSBR enables the Chancellor to be more adventurous in changing the tax system.

C. Income Tax Cuts: Rates v. Allowances

The economic argument is between a large change in the marginal rate of tax for a small number of people (allowances) versus a small change in the marginal rate for a large number of people (rates). The effects on the overall economy are much the same in either case.

Therefore the choice must be made on political grounds. Allowances have become a trifle dull, whereas rates may excite more people. In any case, further big changes in allowances can legitimately be delayed until after the Green Paper on tax reform. However, the back-benches appear to want to carry on upping the allowances.

The Policy Unit view has been consistently to favour a cut in the basic rate. If you could get income tax down to 28p in this Budget, and push it down further to 25p in 1987, you would really have something to show the electorate. But a 1p reduction might look rather feeble. So if you want to reduce the rate, it has to be by 2p, and we are again driven to accept that the PSBR should be at around £7 billion. This might give a fiscal adjustment of about £1.5 billion, with maybe another £0.5 billion coming from indirect taxes - notably petrol duty.

D. Other Taxes

You could press the Chancellor for his ideas here.

The morass of CGT and CTT must be looked at again. At the moment, we get the worst of all possible worlds. They don't raise much money - CTT doesn't raise much more than the death duties which it replaced. But they remain very unpopular because they are so complicated. We recommend a major simplification lubricated by further reductions in the total burden of these capital taxes.

The tax reliefs for pension funds remain a scandal. They are sitting on huge untaxed surpluses which Roy Hattersley can direct into every bankrupt company without future pensioners so much as noticing. The big obstacle to reform is the Chancellor's promise last year that he would only act after consulting. But he could argue that circumstances had changed, and begin with, say, a specially reduced rate of CGT levied on gains accruing within funds.

Now that Norman Fowler is going to give everyone a right to a personal pension, the tax system needs to reinforce this right, rather than undermine it. In particular, there should be some tax relief for people who wish to save towards a personal pension on top of their normal occupational scheme. The American evidence is that this is the best way of building up personal property-ownership. The Revenue are producing a consultation document in the Autumn. You could press the Chancellor to make it positive so that he can claim some advance credit for it in his Budget speech.

Another lesson from America is the enormous volume of private charity stimulated by generous tax reliefs. There is a strong tide running in favour of a better tax régime for companies' charitable activities.

Conclusion

Our proposals hang together.

First, set a tight monetary policy. We recommend that you insist on:

a broad money figure in the MTFS;

a lower target range for M_0.

Provided that monetary policy carries on the fight against inflation, we believe that a PSBR of £7 -7.5 billion need not be imprudent. Moreover, it enables the Chancellor to be much more bold on tax reform.

A PSBR of £7 billion gives a fiscal adjustment of about £1.5 billion. With higher indirect taxes of £500 million, this could finance a tax cut in the basic rate of 2p.

The Chancellor should also use any extra room for manoeuvre for some reforms in capital taxes and a generous tax régime for personal pensions and charities.

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