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- 1. Mr Wilson *AW 16/2*
- 2. Sir R Butler *RSB*

G W Monger 16/2/88

*GD*  
*16/2*

PRIME MINISTER

Economic Strategy

C(88)3

*with PG?*

**BACKGROUND**

In C(88)3 the Chancellor of the Exchequer seeks the views of his colleagues on the broad shape of his forthcoming Budget.

2. Although the Chancellor of the Exchequer will take his colleagues' views into account in preparing his Budget, he will not wish to be bound by them. He will also want to avoid any commitment to further collective discussion during the run-up to the Budget on 15 March, although he will no doubt be willing to discuss particular points bilaterally with individual Ministers.

3. The main issues which might arise are:

- a. The prospects for the economy, as shown by the new forecasts mentioned in C(88) 3.
- b. The level of the PSBR in 1988-89. The Chancellor proposes to budget for a modest surplus.
- c. The balance between public expenditure increases and tax cuts.
- d. Where tax reductions might be made: the balance between company and personal taxation, priorities within personal taxation, and tax reform.

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Prospects for the economy

4. The Chancellor presents a generally optimistic picture for 1988, with substantial growth, a continued fall in unemployment, and no rise in inflation.

5. But there are some ambiguous or worrying signs:

a. Growth in 1988 is expected to be faster than forecast in the Autumn Statement: the forecast for GDP is 3%, as against 2 1/2% in the A S, and for domestic demand 4% as against 3 1/2%. The risk of coming up against capacity constraints will be greater.

b. This growth will be faster than in the other major countries of the world, which is forecast at 2 1/2%, and possibly less if there is further market instability. International uncertainties remain a major problem.

c. As a result there will be a further deterioration, for the third successive year, in the balance of payments. C(88)3 does not give an exact forecast, but implies a current account deficit of around £4 billion.

d. Although the inflation rate is forecast to remain steady at 4% a year, this will leave inflation well above the OECD average.

6. There is no discussion of prospects for the growth of credit or the increase in earnings. You may want to deduce from all this the need for caution in deciding the fiscal stance in 1988.

Level of the PSBR

7. The Chancellor proposes to budget for a modest surplus. Some Ministers could question this, perhaps on the ground that last year's Medium Term Financial Strategy envisaged a borrowing requirement of £4 billion. You may want to resist this because international uncertainties and worries about domestic overheating

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(para 5 above) show the need for caution. Moreover, since there will be a surplus this year, any move into deficit next year would be an easing of the fiscal stance which would be very inappropriate in present circumstances and might be taken badly by the markets.

#### Public expenditure and tax cuts

8. The Chancellor says that even with a budget surplus there would be 'some scope' for reducing tax rates, although he does not say exactly how much. Some Ministers might be disposed to argue that more of the money available should be used to raise public expenditure, for example on health.

9. You will probably not want to encourage any such discussion but if necessary it could be pointed out that:

a. The Government has only recently settled and announced its public expenditure plans for 1988-89.

b. The Chancellor's paper shows that non-North Sea taxes plus (NICs) are a higher proportion of non-North Sea GDP than when the Government came to office (37.4% in 1986-87 as against 34.1% in 1978-79). The Government is committed by the Manifesto to 'reduce the burden of taxation'.

National  
Insurance  
Contributions

c. For the man on average earnings, tax and NICs take about the same proportion of his earnings now as when the Government came to office (27.4% in 1987-88 as against 27.8% in 1978-79). For those on half average earnings (student nurses are an example) the tax and NIC take has substantially increased under this Government (18.9% from 16.0%).

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Distribution of tax cuts

10. On the distribution of tax cuts, the first question is how the benefit should be shared between the company and personal sectors.

The financial position of the company sector is now strong and we have the lowest rate of Corporation Tax of any major country.

There is also a danger that lower corporate taxation would simply lead to higher pay, as it may have done in the past.

11. As to reductions in personal tax, the first choice is between action on:

i. The basic rate. Every 1p off the basic rate would cost £1,250m in 1988-89; and on

ii. Personal allowances. The Budget arithmetic already assumes revalorisation. Every £100 increase in the main personal allowances would cost £580m in 1988-89.

12. The arguments for an increase in personal allowances more than required for revalorisation are:

i. It could be represented as giving the biggest proportionate help to those on low incomes.

ii. It would do more than action on the basic rate for the poverty and unemployment traps.

iii. It would take people out of tax altogether. This would also reduce the Inland Revenue's manpower needs.

13. The arguments for concentrating on the basic rate are:

i. It would reduce the marginal rate, and so in principle improve incentives, for the 95% of taxpayers who pay at the basic rate.

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ii. It would achieve, or help towards, the Manifesto commitment of reducing the basic rate to 25%.

iii. It would be more visible.

14. There is also the question of how much should be done at the higher rates. This need not be very expensive and would follow a worldwide move to reduce top rates (US top rate 28%, Australia 49%, New Zealand 46%). On the other hand, Table 2 in Annex 3 to the paper shows that those with above average incomes have already enjoyed the biggest proportionate fall in tax and NICs since 1978-9.

15. Finally, there are the possibilities for tax reform, in particular broadening the base by eliminating special reliefs, simplifying the system and allowing a cut in rates. Cabinet last year were interested in this and the Government said in the Manifesto that it would continue the process of tax reform. But the Chancellor will not want to go into the possibilities in detail.

#### DISCUSSION AND CONCLUSIONS

16. After the Chancellor of the Exchequer has introduced his paper, you will wish to invite Ministers to comment. In your concluding remarks, however, you will wish to avoid any suggestion that the Chancellor is committed by the discussion to particular changes in his Budget. You ~~may~~<sup>will</sup> also wish to avoid any commitment to further discussion in Cabinet, other than in the traditional meeting immediately before the Budget.

17. You might ~~then~~<sup>therefore</sup> record conclusions which:

- a. Invite the Chancellor of the Exchequer to take account of the views expressed in discussion in his further work on the Budget.

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- b. Invite any Minister who has particular points on possible tax changes to discuss them directly with the Chancellor of the Exchequer.

FRB

ROBIN BUTLER

Cabinet Office  
16 February 1988

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