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CABINET

ECONOMIC STRATEGY

Memorandum by the Chancellor of the Exchequer

We are now reaping the benefits of prudent monetary and fiscal policies. The economy is performing as well as that of any developed nation. Growth has been sustained at near to 3 per cent a year since 1981, one of our longest periods of expansion ever. It is in marked contrast to the record of the 1970s.

2. Yet the most remarkable feature of this expansion is that it has been achieved against a background of falling inflation and with improving competitiveness. Inflation has fallen from 16½ per cent at the end of 1980 to 3¾ per cent at the end of 1986. Manufacturing productivity has grown faster than in any of our major competitors. Provided we guard against a resurgence of inflation, and provided we maintain external and domestic confidence in our policies, the prospects for this year and next are good.

3. But the proviso is important. We have demonstrated convincingly that steady growth comes from pursuing a sound monetary and prudent fiscal policy set in a clear medium-term framework - and from resisting the temptation to inject fiscal stimuli which might provide short-term gains but spell long-term trouble. The overriding need in this Budget must be to do nothing which might put the favourable prospects which now lie before us at risk.

FISCAL PROSPECT

4. Last year's Budget was dominated by the sudden collapse of our oil revenues, which have fallen from £11½ billion in 1985-86 to an estimated £4½ billion in 1986-87. I introduced a cautious Budget which nevertheless contained sufficient by way of tax reduction to show our determination to stick with our policies. The Public Sector Borrowing Requirement (PSBR) was expected to be around £7 billion in 1986-87. This still seemed the most likely outcome at the time of the Autumn Statement. Since then, however, the tax gathering season has revealed a marked surge in non-oil revenues. This is not the result of stronger economic growth - the economy has performed in line with our projections. It is the consequence of higher than expected effective tax rates: as Table 1 of Annex 3 shows,

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non-North Sea tax as a proportion of non-North Sea Gross Domestic Product (GDP) is estimated to have risen from 37.1 per cent of GDP in 1985-86 to 37.4 per cent of GDP in 1986-87, contrary to our long-term policy of reducing the burden of taxation. As a result, the PSBR this year will, for the second year in succession, be lower than the Budget estimate.

5. This outturn inevitably affects the appropriate stance for 1987-88. Prudence is judged, in part, in relation to achievement. The economy is performing well both absolutely and relative to other countries, with a lower than expected PSBR. There is thus a strong case for setting next year's PSBR at a lower figure than the $1\frac{3}{4}$ per cent of GDP envisaged in the Medium Term Financial Strategy (MTFS). The last thing we should do is to take any unnecessary risks - or even to appear to be doing so.

6. Despite this, I still expect there to be scope for further tax reductions this year, although the substantial public expenditure increases we announced in the autumn have pre-empted the greater part of our fiscal scope. It will, however, be seen as a measure of the soundness of our policies that we shall be able to maintain public borrowing at a prudently low level despite both the sizeable additions we have made to public expenditure and the collapse of our oil revenues, and still find room for some further reduction in taxation.

ECONOMIC PROSPECTS

7. During 1986 our economic performance has been influenced by the difficulties the world economy experienced in adjusting to the sharp fall in oil prices. We have seen a strong growth of demand in all the industrial economies, including the United Kingdom. But the oil producers and other developing economies cut back their imports more than expected. As a result the industrialised countries experienced weak export demand in the early months of 1986. United Kingdom exports initially reflected this performance but have grown strongly since the middle of the year. By the fourth quarter of 1986 the volume of visible exports (excluding oil and erratics) was $9\frac{1}{2}$ per cent higher than a year earlier. This appears to have been a stronger performance than in any other major economy. As a result, manufacturing output grew rapidly in the second half of 1986, following pronounced weakness in the first half.

8. The growth of the United Kingdom's main overseas markets should be somewhat stronger in 1987 than in 1986. There are, however, risks that the outturn could be less favourable. Any prolonged turmoil in foreign exchange markets could lead to reactions that dampen demand and output in the major economies. It is also possible that developing countries and oil producers could import less from the developed economies than we now expect. Nor can we be sure that protection will be held at bay.

9. On the reasonable assumption, however, that demand for United Kingdom exports in 1987 grows more quickly than in 1986, the prospect is for continued strong export growth. But because non-oil imports have been growing rapidly and the surplus on oil trade has declined by £5 billion, there is likely to be a modest current account deficit of around $\frac{1}{2}$ per cent of GDP in 1987.

10. Domestic demand is expected to continue to expand steadily in 1987, and this, combined with vigorous export growth, should mean yet another year of 3 per cent growth for the economy as a whole. The composition of domestic demand growth is likely to be more balanced than last year, with slightly slower growth of consumers' expenditure and much stronger investment.

11. The continuing steady growth performance has contributed to a welcome fall in unemployment. Since August 1986 unemployment (United Kingdom seasonally adjusted, excluding school leavers) has fallen by 107,000. With 3 per cent growth in prospect, there is every chance of unemployment continuing to fall at a roughly similar rate throughout 1987. But the prospects would be even better if we could see a further slowdown in the rate of pay increases.

12. Since the end of the 1985-86 pause we have seen a further surge in productivity, particularly in manufacturing industry. This builds on the good productivity performance achieved by British industry throughout the 1980s, when by comparison with other developed economies, United Kingdom productivity growth has been considerably better than in the 1960s and the 1970s. Indeed, in terms of output per head in manufacturing industry, we have done better since 1979 than any other member of the Summit Seven, as the following table shows:

OUTPUT PER HEAD IN THE MAJOR 7 INDUSTRIALISED COUNTRIES
(average annual percentage change)

	<u>Manufacturing</u>			<u>Whole Economy</u>		
	1964-73	1973-79	1979-86H1	1964-73	1973-79	1979-86H1
United States	3.4	3.5	2.3	1.6	0.2	0.7
Japan	9.8	4.0	2.7	7.4	2.9	2.8
Germany	3.9	3.3	2.3	4.2	2.9	1.4
France	5.4	3.0	2.5	4.5	2.8	1.5
Italy	5.5	2.4	2.4	5.6	1.7	1.0
Canada	4.3	2.5	3.0	2.5	0.5	0.6
United Kingdom	3.8	0.7	3.5	2.7	1.1	1.8
G7 Average	5.0	3.2	2.5	3.5	1.5	1.3

13. For 1986 as a whole, inflation as measured by the Retail Price Index (RPI) averaged 3.4 per cent - the lowest annual figure since 1967. Since the 1983 Election most of the short-term swings in the monthly RPI have mirrored changes in the mortgage interest rate. For example, the monthly lows of 3.7 per cent in 1983 and 2.4 per cent in 1986 coincided with falling mortgage rates, while the monthly high of 7 per cent in 1985 reflected a rising mortgage rate. With no further change in mortgage rates, the RPI is likely to edge gradually upwards from the latest published figure of 3.7 per cent during the first half of this year before falling back to around 4 per cent by the fourth quarter. This pattern is largely the result of the mortgage rate increase at the end of last year, coupled with the effect on the 12-month comparison of the temporary dip in petrol prices last summer.

14. The recent and prospective performance on inflation is in historical terms a good one, and one that we can point to with some satisfaction. But most other major industrial countries have still lower levels of inflation, and it remains important that we continue to give the highest priority to keeping inflation on an unambiguously downward underlying trend.

SUMMARY AND CONCLUSIONS

15. Output growth last year was close to its average rate since 1981 of 3 per cent a year; and a further 3 per cent growth is expected this year. This compares well with other major countries. Unemployment seems set to fall in 1987. Inflation is rising a bit - though from the somewhat artificially low rates recorded in the middle of last year. Markets will be paying close attention to this and perhaps also to the prospects for the current account of the balance of payments. It is in both our short-term and medium-term interests to play safe, with relatively modest tax reductions and a PSBR below the level envisaged in the MTFS.

16. I would welcome colleagues' views on the Budget against the background of the fiscal and economic prospects I have outlined.

N L

Treasury Chambers

10 February 1987.

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ANNEX 1

	1979	1980	1981	1982	1983	1984	1985	1986	1987 ⁽¹⁾
World GNP, ⁽²⁾ in major 7 economies (per cent change)	3½	1	1½	-½	3	4½	3	2½	3
UK GDP, ⁽²⁾ (per cent change)	2½	-2½	-1	1½	3½	3	3½	3	3
Domestic demand, ⁽²⁾ (per cent change)	4	-3	-1½	2	4½	2½	3	3½	3½
Retail prices Q4 (per cent change on a year earlier)	17½	15½	12	6	5	5	5½	3½	4
Interest rates (average 3-month interbank)	13½	16½	14	12½	10	10	12	11	11 ⁽³⁾
Unemployment (UK, per cent of working population excluding school leavers)	4½	5½	8½	10	11	11	11½	11½	10½
Sterling Index	87	96	95	90½	83	78½	78	73	68½ ⁽³⁾

(1) Provisional pre-Budget figures.

(2) At constant prices.

(3) February 4.

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ANNEX 2: DIRECT EFFECTS OF TAX CHANGES

A. Direct Taxes: Indexation

The RPI increased in the year to December 1986 by 3.7 per cent. With indexation by this amount and statutory rounding, the figures for the main allowances and other thresholds would be:

<u>Personal allowances</u>	<u>1986-87</u>	<u>1987-88</u>
Single and wife's earned income allowance	2,335	2,425
Married allowance	3,655	3,795
 <u>Bands, eg:</u>		
29% rate	0-17,200	0-17,800
60% rate	over 41,200	over 42,900

The total revenue costs of indexation of income tax (included in the forecast) are £800 million in 1987-88 and £1,080 million in 1988-89.

B. Indirect Taxes: Indexation

The effects of 3.7 per cent revalorisation of the excise duties (including VAT effects) are as follows:

<u>VAT inclusive price change</u>	<u>Yield in</u> <u>1987-88</u>	<u>RPI impact</u>
	<u>£m</u>	<u>£m</u>
Beer 0.8p/pint	60	0.04
Wine 2.9p/70cl light wine	20	0.02
Spirits 20.1p/bottle	25	0.03
Tobacco 3.4p/20 king size	95	0.10
Petrol 3.7p/gallon	185	0.09
Derv 3.2p/gallon	40	neg.
VED £3.7/car	<u>95</u>	<u>0.03</u>
Overall effect, including minor duties (included in forecast)	<u>525</u>	<u>0.31</u>

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C. Ready Reckoners: Illustrative Tax Changes

	<u>1987-88</u>	<u>£ million</u> <u>1988-89</u>
INCOME TAX		
<u>Allowances and Thresholds</u>		
1% above indexation on all statutory allowances	175	230
1% above indexation on all statutory allowances and thresholds	200	275
<u>Rates</u>		
Change in basic rate of 1p	1,100	1,400
CORPORATION TAX		
Change in main rate of 1 percentage point	230	400
Change in small companies' rate of 1 percentage point	20	35
VALUE ADDED TAX		
Change in VAT rate of 1 percentage point ⁽¹⁾	860	1,215

⁽¹⁾ A 1% change in the VAT rate would change the RPI by 0.5%

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ANNEX 3: THE TAX BURDEN

Since the Government came to power total taxes and NICs as a proportion of GDP at market prices have risen by about 4 percentage points, though the ratio has fallen from its peak in 1981-82. The decline in 1986-87 reflects North Sea revenues (down from 3.2% to 1.3% of GDP).

Table 1

Taxation* as a % of GDP (market prices)

	Total	Non-North Sea taxes as % of Non-North Sea GDP
1978-79	33.8	34.1
1979-80	35.2	35.2
1980-81	36.4	36.2
1981-82	39.3	38.8
1982-83	39.1	38.4
1983-84	38.6	37.9
1984-85	39.1	37.8
1985-86	38.6	37.1
1986-87 (estimate)	38.0	37.4
1987-88 (assuming indexation)	38.7	38.3

*Including NICs and local authority rates

Personal Sector

2. Despite reductions in income tax, total personal taxes (direct and indirect, including employees' NICs and domestic rates) in 1986-87 are about £20 billion higher in real terms (ie 1986-87 prices) than they were in 1978-79. For income tax and national insurance contributions the following table shows how the proportion of gross pay they represent rose up to 1981-82, particularly for the low paid:

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Table 2

Income Tax and NICs as a % of Gross Earnings*

	$\frac{1}{2}$ average earnings	average earnings	2 average earnings
1978-79	16.0	27.8	31.4
1981-82	20.8	29.3	32.2
1982-83	20.8	29.8	32.3
1983-84	20.1	29.6	31.7
1984-85	19.3	29.2	31.5
1985-86	18.9	29.0	31.5
1986-87 (estimate)	18.9	28.4	30.9
1987-88 (indexation)	19.4	28.7	31.1

*Adult male earnings (all occupations). Married couple, wife not working: the couple are assumed to have no children, to avoid distortion of the figures from the abolition of child tax allowances.

3. These figures reflect the rise in the standard employees' NIC rate from 6½% to 9%. The lower rates introduced in the 1985 Finance Act do not affect the cases shown. So far as income tax is concerned, personal allowances have increased by about 22% in real terms since 1978-79, slightly faster than earnings. The basic rate has been reduced from 33p to 29p, but the 25p reduced rate band has been abolished.

4. As the table shows, indexation of allowances in the Budget would lead to a slight rise in the proportion of incomes taken in tax and NICs. This is because earnings are assumed to rise by 6½% compared with the indexation percentage of 3.7%.

5. Following the sharp rise in corporation tax receipts this year, total taxes paid by businesses (outside the North Sea) are now slightly higher as a percentage of GDP than in 1978-79. Within this total, the major change has been a fall in employers' NICs and NIS as a percentage of GDP, offset by increases in corporation tax, business rates and 'other' taxes as the following table shows:

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Table 3

Taxes Paid by Businesses fbn in 1986-87 Prices

(figures in brackets are % of GDP)

	Corporation Tax ¹	Taxes on self employment incomes	Employers' NICs and NIS	Rates	Other ²	Total
1978-79	7.4 (2.2)	2.5 (0.7)	10.3 (3.1)	4.9 (1.5)	3.8 (1.1)	28.8 (8.6)
1986-87 (estimate)	11.2 (2.9)	2.9 (0.8)	8.7 (2.3)	6.7 (1.7)	5.4 (1.4)	34.9 (9.1)

¹Excludes North Sea, but includes ACT

²VED, car tax, road fuel duty, duty on rebated oils, capital taxes