

CAB 128/108

MOST CONFIDENTIAL RECORD

CM(93) 31st Conclusions

Tuesday 19 October 1993

ECONOMIC PROSPECTS

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MOST CONFIDENTIAL RECORD
TO
CM(93) 31st Conclusions

ECONOMIC
PROSPECTS

The Cabinet considered a memorandum by the Chancellor of the Exchequer (CP(93)10) on economic prospects in the run up to the Unified Budget on 30 November.

THE CHANCELLOR OF THE EXCHEQUER said that economic recovery now appeared to be soundly established. The latest forecast put growth in Gross Domestic Product (GDP) at 2 per cent in 1993 and 3 per cent in 1994. However uncertainties remained, and recovery was not uniform from month to month or across all sectors. Public confidence in continued economic growth fluctuated accordingly. The world economic background had been weaker than expected. Although the current statistics on European Community (EC) trade were unreliable, it was clear that European activity remained particularly depressed. But the position on competitiveness was encouraging. Unit wage costs had fallen by 1 per cent over the year (and by 2 per cent in manufacturing). Consumer confidence remained high and recent pessimism about the sustainability of the recovery had been exaggerated. Inflation performance continued to be encouraging, with underlying inflation at just over 3 per cent despite the depreciation of sterling. Some upward inflationary pressures remained including the impact of tax changes announced in the March Budget but still to take full effect, and increases in the Council Tax. Nonetheless, the prospects were good that underlying inflation could remain within the 1-4 per cent target range for the next 18 months. There had also been a welcome decline in unemployment although significant sustained falls were unlikely over the coming months. The best forecast remained that the Public Sector Borrowing Requirement (PSBR) would remain unacceptably high at some £50 billion in 1993-94. It was essential to bring this total down and under firm control quickly. It was unlikely that this task could be achieved through economic recovery alone. It was most important to meet the Survey remit for public expenditure. The increases in tax and National Insurance Contributions announced in the March Budget would in sum be equivalent to 1-1.5 per cent of GDP. However it might prove necessary to raise further revenue as part of the Unified Budget in order to ensure prudent management of public finances. The prospects therefore were for a sombre Budget.

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In discussion the following main points were made:

(a) sustaining the economic recovery was a key priority. Some indicators suggested that recovery was firmly established. The employment figures were for example more encouraging than had been expected, and consumer confidence remained buoyant. However, some sectors (in particular housing and construction) had not shared in the recovery and the economies of the EC Member States were likely to remain depressed. There were signs of concern in the business community that the recovery could stall. Industry was still operating with substantial spare capacity. Recent experience in the United States suggested that Government intervention had been necessary to sustain economic recovery there. There was a case for including some measures which would give a fillip to industry, particularly in science and high technology. More generally, some of the available statistics were not clear cut or reliable;

(b) the best working assumption was that the PSBR would be some £50 billion in the current year. PSBR forecasts were not reliable, and economic recovery might serve to reduce the total from the forecasts for the current and subsequent years. But it would be unwise to plan on the basis of a figure lower than £50 billion which, at 8 per cent of GDP, was unacceptably high. The need to reduce the PSBR was increasingly understood by the public. Tackling the PSBR would also help to bolster business confidence and was a necessary condition for room for manoeuvre on interest rates. Unless action was taken now, it would not be possible to bring the deficit under control in the life of the current Parliament;

(c) there were unlikely to be major upward pressures on inflation over the next year and beyond. But some rise was likely and the impact of the tax changes announced in the March Budget would have their peak effect on inflation around April 1994. There was some evidence that unemployment could be expected to decline gently, perhaps at the rate of 5-7,000 per month on average. But the total would remain high and a recent survey had found that nearly 50 per cent of those in employment felt their jobs were at risk;

(d) the Unified Budget would need to strike the right balance in bringing public finances under proper control without endangering a sustained economic recovery. The Budget and its presentation should seek to enhance the confidence of business and the public more generally. Policy priorities should include jobs and competitiveness.

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Substantial tax increases could hinder economic recovery, while a reduction in interest rates at the right time could have a beneficial effect. Businessmen and the public might be prepared to accept some increases in taxes in order to preserve the provision of essential public services (including those within the defence field). It was for consideration whether the Chancellor might brief Cabinet colleagues in advance of the Budget announcement so that they could secure the support of Government backbenchers for measures that might otherwise cause difficulties in Parliament;

(e) if tax increases proved necessary in the Budget, they should be kept to the minimum. Tax increases could have knock-on effects for inflation and the level of benefit expenditure. Tax loopholes should be closed where possible. It was politically unattractive to raise direct taxation and in particular rates of income tax;

(f) some groups merited particular attention, including pensioners and those on relatively low incomes but not entitled to benefits ("the nearly poor"). The upratings to apply from the following April would be based on the exceptionally low rate of inflation in the previous September. There was a risk that Government policy could serve to penalise thrifty pensioners. They often had to meet large bills for residential or other forms of care while the less thrifty were able to draw on benefits and other publicly funded support. It was however difficult for Government to help the "nearly poor" who were not eligible for benefits and, since they paid relatively little tax, could not be helped through further tax relief;

(g) there was an attractive case in principle for tightening personal tax allowances and relief as a means of reducing the PSBR. Substantial savings were available, for example of the order of £5 billion if the rate for personal tax allowances were restricted to 20 per cent. Although the decision in the March Budget to reduce tax relief on mortgage interest payments had yet to take full effect, there had been little outcry at the announcement. A further possibility for savings was greater recourse to means testing of benefits (including perhaps entitlement to the basic pension). Such steps might appeal to the general public on grounds of fairness in that the financially better-off would be seen to be making a proportionate contribution to tackling the deficit;

(h) on the other hand, in practice the Government had already relied to a considerable extent on changes to tax allowances and reliefs as a means of raising finance (more so than on changes to indirect taxation). The full effect of the

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March Budget on allowances and reliefs, and on National Insurance Contributions which were to rise by 1 per cent, had yet to be felt. While there was a strong case in principle for reducing relief on mortgage interest payments, the effect could be to hinder a recovery in the housing market;

(i) there would inevitably be increases in the Council Tax. This would help to encourage a sense of responsibility among local authorities. But the immediate scope for such increases was limited without provoking difficulties in Parliament and more widely;

(j) if tax increases proved inevitable, indirect taxation was a more attractive area than the rates of direct taxation. One option was to introduce a second rate of Value Added Tax (VAT) beneath the current rate of 17.5 per cent. The current rate was arguably too high to impose on items where VAT currently did not apply. On the other hand, differential rates would encourage lobbying in favour of items taxed at the higher rate to be moved to the lower;

(k) a further possibility was to widen the VAT base. A strong case could be made for extending VAT to newspapers and magazines. The current price-cutting round indicated scope for introducing VAT on newspapers, while the magazines market was particularly buoyant. On the other hand, adverse reaction was likely among the printed media and reading public. The Newspaper Society had estimated that some 250 local newspapers would collapse. VAT on books was a further option, although this was likely to be more controversial. Transport fares were a further option, but the resulting price increases would not be popular with the travelling public, could damage privatisation prospects and could cause difficulties for some domestic airline and other transport companies;

(l) additional duties on tobacco, alcohol and motoring should be considered closely. Further duties on alcohol could however serve to widen the existing price differential between drinks sold in the United Kingdom and on the Continent, and hence encourage purchases abroad for bringing into this country. Increased taxation on motoring might depress the vehicle sales of domestic producers, who were currently performing better than their Continental counterparts;

(m) compensation for the introduction of VAT on domestic fuel remained to be resolved. Compensation would add significantly to public expenditure (thus offsetting in part the additional revenues secured). Full compensation for

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pensioners and others in receipt of benefit could cost over £1 billion. On the other hand, there was a strong case for providing a substantial element of compensation for those who would be hardest hit by the tax change. The issue was of key concern to many Government supporters;

(n) it was vital to meet the Public Expenditure Survey remit. Otherwise the PSBR would not be brought under control and confidence in the Government's determination to manage the public finances sensibly would be severely damaged;

(o) tight restraint on provision for public sector pay continued to be essential to meet the Survey remit. Although as a result difficulties on pay lay ahead, they would have to be faced resolutely. The remit on public sector pay in effect meant that increases in the coming round would have to be beneath the level of inflation, and there was a case for relieving pressure by a freeze on recruitment. The March Budget tax changes would depress take-home pay, and their effects would be fully felt around April 1994, when there would be a bunching of pay settlement dates and inflation was likely to be increasing. Public servants might prove less amenable to low pay settlements against a background of diminishing job security;

(p) capital expenditure was an important component of economic recovery. While there had been some successes, joint ventures between the public and private sectors had come forward less quickly than had been hoped. Ministers should impress upon their Departments the importance of the Private Finance Initiative. There was very considerable scope for raising the level of capital investment in this way, with a genuine transfer of risk to the private sector. A depressed construction market tended to depress the level of confidence elsewhere in the economy. The Business Expansion Scheme, which was coming to an end, offered a possible model for encouraging joint financing, including the use of bonds and tax relief;

(q) there was a case for Budget measures to enable lone parents to resume work (in which respect the United Kingdom compared badly with other countries) and to enhance training and qualifications.

THE PRIME MINISTER said that the discussion had underlined the importance of a Unified Budget which enabled the economic recovery to continue while securing effective control of public finances. A range of views had been expressed on economic prospects and measures that might be adopted, and the Chancellor would take them into account in drawing up

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his Budget. The Survey remit had to be met. Some tax increases might also prove necessary. Once the policy had been settled, it would be essential for the Government to be seen to stand together in support of the Budget strategy. Meanwhile, Ministers should ensure that the substance of the discussion remained confidential.

The Cabinet -

Took Note, with approval of the Prime Minister's summing up of their discussion.

Cabinet Office

19 October 1993