

## CHAPTER 9

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# 1981 - A TIGHT AND CONTROVERSIAL BUDGET

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### *Origins of the 1981 Budget*

IT WAS NOT THESE monetary conundrums but the Government's problems with the Budget deficit that lay behind the 1981 Budget, which defiantly raised the tax burden in a recession and provoked a notorious letter of protest to *The Times* from 364 economists. Yet its success in turning round sentiment and as a prelude to more than eight years of economic growth made it in retrospect seem climacteric. As a result there has been some myth-making and attempts to claim the credit. It is worth setting the record straight.

The Government did not set out with the deliberate intent of making a dramatic doctrinal challenge to economic orthodoxy or to the political faint-hearts in its own ranks. The 1981 Budget was essentially a response to the fiscal difficulties which had emerged in the financial year 1980-81. As that year progressed it became clear that the Budget deficit as measured by the PSBR was running well ahead of the £6 billion target set the previous March and embodied in the MTFS. By November 1980 it was apparent that the deficit would be at least £11.5 billion; and the eventual out-turn was £12.5 billion or 5.25 per cent of GDP (equivalent to some £30 billion in early 1990s terms).

Roughly half the overrun, which was largely on the public expenditure side, could be attributed to the recession. Although, in output terms, no deeper than forecast, it was accompanied by a much greater than expected rise in unemployment, and hence spending on social security benefits. It was also having a much more severe effect on the finances of the nationalized industries than had been predicted. But a good deal was also due to weaknesses in our system of public expenditure control, which I discuss in the next chapter.

In the circumstances it was clear that the forthcoming public spending round would need to be a very tough one. At the July 1980 Cabinet meeting on public expenditure, Geoffrey secured the agreement of Cabinet to a substantial reduction in the so-called public expenditure planning total for 1981-82. But when it came to the autumn public expenditure round of bilateral discussions between the Treasury and spending Ministers, the specific savings needed to achieve this overall reduction were not forthcoming. And even where they were, the success was short-lived. Patrick Jenkin, the Social Services Secretary, responsible for the biggest budget of all, argued that the only means by which he could find the savings demanded of him by the Treasury was by abandoning the annual uprating of pensions in line with inflation, an offer John Biffen, the Chief Secretary, gratefully accepted. The decision was subsequently overturned by Cabinet, as Patrick had no doubt expected it would be.

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This was an object lesson to Treasury Ministers in a standard spending Minister's ploy: the political boomerang offer. Subsequently, when I became Chancellor, I made a point of warning each of the four Chief Secretaries that served under me about it and of the importance of securing savings that would not be too politically difficult for Cabinet to swallow - not to mention the *sine qua non* of getting Margaret fully signed up before the matter ever went to Cabinet.

The public spending round for 1981-82 was particularly hard fought. Its final resolution required no fewer than three Cabinet meetings in the first half of November 1980, the first two of them devoted to nothing else. In the end, Geoffrey had to settle for an overall reduction, achieved principally by squeezing cash limits, of only half the figure the Cabinet had agreed in July. The outcome was manifestly inadequate, especially in view of the deteriorating fiscal position for 1980-81 and, in consequence, the steadily worsening outlook for 1981-82.

The position was clearly unacceptable, on a number of levels. The private sector, hard hit by the recession and the rising exchange rate, was increasingly resentful that the public sector appeared to be getting off relatively lightly - an argument with which Treasury Ministers had considerable sympathy. Quite apart from the manifest unfairness, the public sector was felt to be 'crowding out' the private sector: the precise reverse of what the Government had entered office to bring about. The argument was that high public spending, resulting in high public borrowing, pushed up interest rates, which in turn choked off private sector investment.

In retrospect I believe we overstated that effect. Short-term interest rates, which (apart from the level of stocks) have little direct bearing on private investment anyway, are determined not by the scale of the PSBR but by the needs of the Government's anti-inflation policy. Long-term interest rates, which have a direct impact on equity yields and thus on private investment decisions, are determined by the balance of supply and demand in the capital market. As the capital market was becoming increasingly a single global market, the public borrowing of any one country - with the important exception, because of its sheer size, of the United States - had a correspondingly diminished effect.

But the crowding-out thesis was in any case only part of the story. Another consideration which carried considerable weight, not least with the official Treasury at that time, was the belief that the burden needed to be shifted from companies, hard hit by high interest rates and a high exchange rate, to individuals, who benefited from the high exchange rate - provided they were in work. Yet a further important factor was that the Government's credibility in the financial markets clearly depended greatly on the extent to which it was seen to be taking the newly published MTFs seriously. And with the wayward behaviour of £M3, it was all the more important that the fiscal side of the MTFs - the declining path for public borrowing - should be observed.

Finally, of course, it was no bad thing to demonstrate to the Cabinet colleagues and to the country alike that failure to curb public spending, on which the Government had set such store, would mean higher taxes. Thus it was that on 24 November 1980, for the first and only time, the Thatcher Government came close to introducing a mini-Budget of the kind that had characterized the Healey Chancellorship and which we had resolved to eschew. Geoffrey Howe announced a percentage point increase in employees' National Insurance Contributions from 6.75 per cent to 7.75 per cent, to take effect from 1 April 1981. It was true, of course, that National Insurance Contribution rates were, for administrative reasons, always reviewed and announced in the autumn. But on this occasion Geoffrey also announced a new Supplementary Petroleum Duty (SPD) of 20 per cent of the gross return of each field to take effect from 1 January 1981, an impost which it was felt the prosperous North Sea oil industry could well afford. Each of these measures was expected to bring in an extra £1 billion in 1981-82.

To soften the blow the Government had announced three days earlier a £245 million package to increase various employment subsidies and launch a Community Enterprise programme. Less happily, there were

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further increases in aid to hospitalized enterprises in the state sector, notably British Leyland and British Steel, and in the External Financing Limits of the nationalized industries generally. On 24 November itself, MLR was reduced from 16 to 14 per cent.

While Geoffrey was announcing his measures to the House, I invited to my room at the Treasury, at his request, the chairmen of all the main oil companies operating in the North Sea, to inform them of the new impost which they would be asked to bear and why the Government felt justified in imposing it. I was flanked by a silent Hamish Gray, David Howell's number two as Minister of State for Energy, who was clearly unhappy at the tax and expected the chairmen to react angrily to it. In the end, the meeting went remarkably well, which made a favourable impression on Hamish, something that was to stand me in good stead when, less than a year later, I succeeded David Howell as Secretary of State for Energy and inherited Hamish as the most loyal of deputies.

The November measures had their expected favourable effects on financial confidence. Nevertheless the PSBR overrun continued unabated. As we embarked on the preparation for the 1981 Budget, it was clear that further increases in taxation would be required. The only question was how much, and where the burden should fall.

### *A Penchant for Company Cars*

One area that had long seemed to me an obvious candidate was the taxation of fringe benefits, better known as 'perks', and in particular the commonest perk of all, the company car, the use of which was grossly undertaxed. As long ago as July 1979, I had minuted Geoffrey:

The fringe benefit society and its proliferation of perks arose as the most effective way round (a) excessive marginal rates of tax and (b) the constraints of a formal incomes policy. Since we have largely eliminated (a) and are pledged to eschew (b), the need for perks (as a way of life) has disappeared and I believe we should launch a major attack on fringe benefits in next year's Finance Bill - and indeed trail it this year.

The prevalence of the company car, and the distortions and dishonesty inseparable from it, were a peculiarly British phenomenon. In the United States, where tax rates were never so high as to make remuneration in cash unattractive, and where - apart from a short-lived aberration during the Nixon Administration - incomes policies were unknown, the company car is a rarity. Largely, as a result of my minute, Geoffrey asked Peter Rees, the Minister of State, to look at this, and Peter had a series of meetings with enthusiastic Revenue officials, whose zeal was fortified by the virtual absence of the equivalent of the company car in the Civil Service and who duly advised on the most promising way ahead.

Geoffrey, however, was a great believer in consultation before legis-lation, and he instructed the Inland Revenue to issue a consultative paper on the subject. This eventually arrived on Margaret's desk in August 1980 with a short covering note from Geoffrey recommending immediate publication. As soon as she had read it, she exploded. Her distaste for the Inland Revenue was reinforced by the advice she received from David Wolfson, a member of the Great Universal Stores family, and the then head of the Prime Minister's Political Office, who told her that were we to act on it, no businessman would vote for us again.

Margaret told her office to summon Geoffrey to her presence instantly, but he was on holiday in France. Her office then tried to get hold of Peter Rees, but she was unwilling to wait for him to make the journey from his home in Wales. As a result I was summoned to Number 10 from my rather less distant home in Leicestershire to be the unfortunate recipient of her wrath. After she had subsided, I agreed to instruct the Revenue to defer publication of a consultative document until Geoffrey had returned from France and she had had the opportunity to discuss it with him. When she did so, he agreed to bury the paper altogether, but nevertheless persisted on the substance in his usual dogged way.

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He insisted on a modest increase in the tax on perks in the 1981 Budget, largely on company cars and the petrol supplied for their use; and he froze the threshold over which benefits in kind became taxable. In law such benefits are taxable only in the hands of 'directors and higher paid employees', a formulation devised by an earlier Labour Government at the behest of the trade unions who did not want their own members' perks to be liable to tax. The definition of a higher paid employee was set afresh in each year's Finance Bill: when we took office in 1979, it was defined as those earning (including the taxable value of any perks received) in excess of £8,500 a year. We maintained the same nominal threshold, unindexed, throughout the Thatcher years, leading to a small but growing correspondence from those who, missing the point, understandably queried how somebody on well below average earnings could be classified as a 'higher paid employee'. But it fell to me, as Chancellor, to implement the significant attack on the undertaxation of the company car I had advocated in 1979.

### *Taxing the Banks*

Meanwhile, other avenues had to be explored in the desperate circumstances in which we found ourselves in 1981. Apart from North Sea oil, there was one other sector of the economy that was doing well while business and industry in general suffered: the banks. This was largely because, in those days, the banks enjoyed a substantial 'endowment' income from money kept in current accounts on which no interest was paid. Clearly the higher the level of lending rates, the greater this endowment income became.

In the circumstances, and somewhat in conflict with our non-interventionist philosophy, we decided to ask the banks to take over the responsibility for financing a proportion of the Government's fixed rate export credit scheme. This would involve the banks in assuming a financial liability which they could well afford. But the main attraction to the Treasury was that it would 'score' as a reduction in public expenditure. Whether it ought to score in purely economic arithmetic was beside the point at a time when a Government was fighting to maintain confidence in its budgetary strategy during the worst post-war recession to date and in the face of disaffection in its own ranks.

Geoffrey accordingly asked me, as Financial Secretary with delegated responsibility for the banks, to negotiate an agreement along these lines. I duly held a meeting at my room in the Treasury with Jeremy Morse, Chairman of Lloyds Bank, in his capacity as Chairman of the Committee of London Clearing Banks, at which I argued that, in return for their acquiescence, the banks, whose reputation among the hard pressed business community was not particularly favourable, would be able to promote themselves as public spirited and patriotic citizens helping the UK exporter. But I was not so naïve as to believe that this not particularly juicy carrot would suffice without some sort of stick as well, and accordingly agreed with Geoffrey that, if all else failed, we would have to impose some sort of additional taxation on the banks.

In a series of meetings, Morse insisted that there was no way the banks could justify to their shareholders taking over the financing of fixed-rate credit to exporters. I hinted that the alternative would be some form of special tax on the banks. Morse, assuming that I was bluffing, declared that that would be the lesser evil, since the banks would not have any problems with their shareholders in that event. For good measure, however, he wrote to Margaret to complain about this threat - a singularly pointless exercise, since Margaret had no love for the banks, regarded Morse himself as a neo-Keynesian 'wet', and had been kept fully on side by Geoffrey about the work I had asked Treasury officials to do on a scheme to extract a contribution from the banks towards solving the pressing PSBR problem.

A once-for-all bank levy of 2.5 per cent of the value of non-interest bearing bank deposits on the eve of the Budget was duly announced as part of the 1981 Budget on 10 March, to bring in some £400 million of additional revenue. It caused some disquiet on our own benches, notably on the grounds of retrospection. This

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was the least valid objection of all. For if the date on which the levy was based had been later, it would have been a simple matter for the banks to decide to pay a modest rate of interest on current accounts, even on a purely temporary basis, thus reducing the yield from the levy to zero. Happily, there was only one resignation on the issue, that of Tim Renton, at the time PPS to John Biffen. As for the other bank chairmen, their anger at the Government was matched by their criticism of Morse for mishandling the situation on their behalf: it appeared that he had told them of the fixed-rate export credit proposal, but they had not been aware of the likely alternative.

### *Biting the Tax Bullet*

Even with this source of revenue on top of the one percentage point increase in National Insurance contributions and the new Supplementary Petroleum Duty, the prospective PSBR gap remained a yawning one. Geoffrey believed in a collegiate approach to Budget making, holding a series of meetings with the other Treasury Ministers as well as his top Treasury, Inland Revenue and Customs and Excise officials and the special advisers present. We were determined not to reverse the income tax cuts we had introduced in 1979, but felt that VAT at 15 per cent was as high as it could go. With businesses hard hit by recession, there was no question of any increase in Corporation Tax: instead some modest reliefs were required. We were thus left with the excise duties on alcoholic drinks, tobacco, petrol and derv, all of which we decided to increase by double the amounts required to keep pace with inflation.

But as Budget meeting followed Budget meeting, it became clear that this was not enough. In an atmosphere of mounting gloom, the economist then responsible for the Treasury's short-term forecasting would give his latest estimate of the current year's PSBR and his latest forecast of the PSBR for 1981-82. Each set of figures he produced was worse than the previous one. Towards the end of February when the final Budget decisions had to be taken, the prospective PSBR for 1981-82, even taking into account the increase in National Insurance contributions, but before any Budget measures, was forecast to be £14 billion. Not only was the sheer size alarming; but it meant that the PSBR was still rising at time when the Government's policy, newly enshrined in the MTFs, was to bring it down substantially.

Meanwhile, at a meeting at Chequers in January, Geoffrey Howe had warned Margaret of the serious deterioration in the public finances and of his sombre conclusion that he would have to do whatever was necessary to get the 1981-82 PSBR down to at most some £10 billion. She was not amused. She was even less amused in February, when he informed her that the picture was even worse and that he would have to raise taxes in the forthcoming Budget by £3.5 billion. She convened a meeting at Number 10, at which her new personal economic adviser, Alan Walters, who had taken office at the beginning of the year, was also present. Walters strongly supported Geoffrey's analysis, adding that, in his view, the increase in taxation should if anything be even larger - say £4 billion. Margaret responded angrily that she had not been elected to put up taxes; but eventually and with a heavy heart agreed to a Budget that would increase taxation on the scale recommended both by her Chancellor and her economic adviser, on the clear understanding that this would permit a significant reduction in interest rates.

To bridge the gap that remained even after the substantial real increase in the excise duties, it was clear that we would have to bite the bullet and raise the burden of income tax. But we remained - rightly - determined not to reverse the 1979 cut in the basic rate. This meant acting on the personal allowances. Initially it looked as if we could meet our target by confining the increase in the allowances to half that required by the indexation formula. But as the forecasts deteriorated, it became apparent that we would not be able to increase the allowances at all for 1981-82.

As the main architect of the indexation provisions, I had no hesitation in supporting this course of action. Indeed I volunteered to take the Finance Bill clause setting aside indexation of the personal allowances

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through the committee stage on the floor of the House myself, which I duly did. Although Michael Foot and others called for my resignation, I had little difficulty in reminding the House that the whole purpose of my Amendment to the Rooker-Wise Amendment in 1977 (already described in Chapter 2) had been to make it clear that indexation, although the presumption, was not automatic. Under the pre-1977 system the maintenance of the existing allowances for a further year in unchanged cash terms would have required no Finance Bill legislation whatever. It was only because of the Rooker-Wise-Lawson Amendment that the Government had to come out in the open and treat the non-indexation of the allowances as a tax increase, raising £2 billion of additional revenue, and could no longer increase the tax burden by stealth.

### *The Fiscal Arithmetic*

The overall increase in taxation on the fully indexed basis nowadays employed, although not at that time, was £4.5 billion. Adding back the increase in employees' national insurance contributions, the increase was well over £5 billion or around 2 per cent of GDP, equivalent to some £12 billion in terms of the early 1990s. The projected effect was to reduce the PSBR from the then estimated 6 per cent of GDP in 1980-81 to 4.25 per cent of GDP, or £10.5 billion, in 1981-82. In the event, the out-turn was considerably better, at £8.5 billion. We thus more than achieved our target. If we had had more accurate forecasts, we might well have done less, and not felt it necessary to freeze the personal allowances. But this might have been a mixed blessing. For the Budget might then not have made the salutary public impact that it did, and our long-term aim of sharply reducing the Budget deficit might have taken longer to achieve.

### THE 1981 BUDGET (Figures are on an indexed basis)

Estimated PSBR outcome, 1980-81	£13.5b (final outcome £12.5b)
Expected PSBR, 1981-82 before Budget measures	£14.5b
Effect of Budget measures:	
- Non-indexation of income tax allowances & thresholds	-£1.9b
- Increase in Excise Duties above indexation	-£1.2b
- Oil tax increases & other	-£1.2b
- Expenditure changes	+£0.3b
Forecast PSBR, 1981-82	-£4.0b
Actual outcome	£10.5b

### *The Political Row*

To introduce a tax-raising Budget on this scale in the depth of the recession was inevitably highly controversial. At the Cabinet of Tuesday, 10 March, at which Geoffrey unveiled the Budget to his colleagues, he was roundly attacked by the usual wets: Jim Prior, Peter Walker, Ian Gilmour - all of whom subsequently claimed that they had toyed with the idea of resignation. Margaret knew full well that the Cabinet would be a difficult one and had armed herself with a concession - in future there would be a pre-Budget discussion of Budget strategy in January or February of each year, and there would be a further Cabinet discussion of economic policy each July, in advance of the annual spending round. These innovations were duly implemented and no doubt Jim Prior, in particular, felt he had gained something of value. But from my own experience as Chancellor I can confirm that these concessions in no way derogated in practice from the sovereignty of the Chancellor of the day over the Budget, subject only to the need to carry the Prime Minister with him.

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Among our own back-benchers, the focus of discontent was on the specific measures rather than on the economic doctrines supposedly violated by the Budget. Somewhat surprisingly they homed in on the increase in the duty on petrol. Advised by Michael Jopling, the Chief Whip, that we would have difficulty in getting the relevant Finance Bill clause through the House, we decided to offer a limited concession. We would go ahead with the petrol duty increase as proposed - we needed the money - but we would make the far less costly sacrifice of confining the increase in the duty on fuel for diesel engined road vehicles ('derv') to no more than that required to keep pace with inflation. We argued that this concession would have a directly beneficial impact on business costs. At the same time Geoffrey austere made it clear that he would have to recoup the revenue lost by the derv concession elsewhere, which he duly did by moving an amendment to increase the tobacco duty still further, adding a further 3 pence, making an extra 17 pence in all, to a packet of twenty cigarettes. Such is the success of the anti-smoking lobby that the tobacco duty is the one tax where an increase commands more friends than enemies in the House of Commons. Thus was the back-bench rebellion against the 1981 Budget overcome, without any alteration whatever to the overall Budget arithmetic.

### *The Economic Row*

The most memorable reaction to the 1981 Budget came not from the world of elected politicians, but from academics, in the shape of a round-robin letter signed by no fewer than 364 economists (one for every day in the year save Christmas day). Its text, published in *The Times* of 30 March 1981 read:

We who are all present or retired members of the economic staff of British universities, are convinced that:

There is no basis in economic theory or supporting evidence for the Government's belief that by deflating demand they will bring inflation permanently under control and thereby introduce an automatic recovery in output and employment;

Present policies will deepen the depression, erode the industrial base of our economy and threaten its social and political stability;

There are alternative policies;

The time has come to reject monetarist policies and consider which alternative offers the best hope of sustained recovery.

The statement was prepared and circulated in the universities by two Cambridge economics professors, Frank Hahn and Robert Neild, on 13 March. The signatories included five former chief economic advisers to the Government - Robert Hall, Alec Cairncross, Bryan Hopkin, Kenneth Berrill, and Terry Burns' immediate predecessor, Fred Atkinson.

Their timing was exquisite. The economy embarked on a prolonged phase of vigorous growth almost from the moment the letter was published. So far from launching the economy on a self-perpetuating downward spiral, the Budget was a prelude to eight years of uninterrupted growth and left our economic critics bewildered and discredited.\* It brought public borrowing back on track, and rescued the fiscal side of the MTFs. The one achievement it did not secure was the one that Margaret Thatcher and in particular Alan Walters had seen as its *raison d'être*: the 2 per cent cut in interest rates (to 12 per cent the day after the Budget). This had to be reversed within six months and interest rates were raised a further two percentage points to 16 per cent in October of the same year, to halt a run on the pound.

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\* Output touched bottom in the first quarter of 1981; and in the year to the first quarter of 1982, real GDP began its recovery, rising by 1.8 per cent. In the eight years 1981-9 it grew by an average of 3.2 per cent per annum. (The turning point in employment came a little later, in the first quarter of 1983, and in unemployment not until the third quarter of 1986.) The figures are average estimates of GDP at constant factor cost. Back series for quarterly data are taken from the Annual Supplement to Economic Trends.

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In the course of time the 1981 Budget came to be seen almost as a political equivalent of the Battle of Britain: the Thatcher Government's finest hour; its most widely acknowledged success and a turning point in its political fortunes. Hence the myth-making and attempts to claim the credit.

But the truth is beyond dispute. As Geoffrey was later to declare his 1991 IFS Lecture:

There has sprung up a myth about the paternity of those difficult Budget judgements, the implication being that the 1981 Budget was somehow 'made in No. 10' against Treasury advice. Those Budget judgements were in fact fashioned by the Chancellor of the Exchequer with the help of Treasury Ministers and on the strength of Treasury advice.

### *Inflation Starts to Fall*

What really mattered, of course, was that the policy was working. The RPI, in its customary way, moved in fits and starts. Its year on year increase reached a peak of 21.9 per cent in May 1980. It then fell sharply to 16.9 per cent in July when the VAT increase dropped out of the annual comparison, and then more gradually to 13 per cent in January 1981 and 12 per cent in April. It fluctuated around that level during the rest of 1981 before plunging decisively to 5 per cent by the end of 1982.

Other indicators gave a smoother picture of what was happening. Producer output price inflation peaked at 14 per cent in 1980 and was down to 9.5 per cent in 1981 and 7.7 per cent in 1982. Average earnings moved in line with this, falling from a peak annual increase of over 20 per cent in 1980 to 13 per cent in 1981 and 9.5 per cent in 1982. The battle against inflation was being won.