part . A .

Begins: 4/3/81
Ends: 21/3/81

PO -CH /GH/0057

PART A

Chancellor's (Howe) ~~Appearance Before~~

CHANCELLORS APPEARANCE BEFORE THE TREASURY AND CIVIL SERVIVE SELECT COMMITTEE

Disposal Directions: 25 Years

25/7/85.

PO -CH /GH/0057
PART A

4/3/81. pwp 1

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
Sir Douglas Wass
Mr Burns
Sir Kenneth Couzens
Sir Anthony Rawlinson
Mr Ryrie
Mr Middleton
Mr Britton
Mr Cassell
Mr Evans
Mr Monck
Mr R I G Allen
Mrs Gilmore
Mrs Lomax
Mr Riley
Mrs Stamler
Mr Turnbull
Mr H J Davies
Mr Shields
Mr Aaronson
Mr Folger
Mr Springthorpe (Parly)
Mr Lennon
Mr Ridley
Mr Cropper

PS/Governor - Bank of England

TREASURY COMMITTEE MONETARY REPORT: BRIEFING

The Treasury Committee's Monetary Report will be published (with a press conference) at noon tomorrow. CFR's have already gone out (copies are being distributed within the Treasury separately) so that the Press "heavies" will almost certainly give the Report advance coverage tomorrow morning.

2. I attach briefing that we have prepared. The spadework has been done by Mr Shields, but it reflects discussion with Mr Burns and others. It is in three sections:-

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- A summary of the Report;
- Some "bull points" to use;
- Further defensive briefing.

3. In a sense the strength of the Report lies in the fact that it has no strongly defined position so that there is a bit of something in it for everyone. The two most potentially damaging areas are the doubt cast in Chapter 8 on the causal relationship from monetary growth to inflation (though the Committee remain basically agnostic on this); and the strictures in the same Chapter on the costs of reducing inflation by restrictive monetary policy. The main weaknesses of the Report are (as in previous reports) the absence of any coherent alternative strategy; the failure to assess the costs of not attacking inflation by some such strategy as the Government are pursuing; and the sheer wetness of the Report on a number of issues (eg on the exchange rate where the analysis ends simply with an exhortation to the Government to keep methods of influencing the rate under review). All these points are covered in the briefing.

Reactions tomorrow

4. We shall need to decide tomorrow what sort of profile to adopt. If we are allowed to, a low profile would be better. We do not wish to contribute to enhancing the Report's status; and you will not in any case want to be drawn into anticipating in any way next week's Budget statement. But I suspect that it may be difficult to maintain this, particularly if a vigorous press conference follows prominent background coverage in tomorrow morning's papers. In this case you will need to consider in the course of the morning whether you (or, say, the Financial Secretary) should make any comment on the record; and whether Mrs Gilmore or others should intensify press briefing through the usual channels. We can make a first judgement when we see tomorrow morning's press. We can then consider further in the light of the press conference at which we shall have representatives.

Prime Minister's Question Time

5. The Prime Minister will also require briefing for Question Time tomorrow afternoon. If you agree, I think it might be useful if this note and the briefing went over to No 10 tonight. Again, if circumstances allow it would be better for the Prime Minister herself to maintain a fairly low profile. She will (quite justifiably) be able to claim not to have had time to read the Report; and she will not want to anticipate the Budget (though without implying that the Budget will necessarily address itself specifically to the Report). But, if pressed, the Prime Minister might also find it necessary to draw on some of this briefing and to deal with the Report in fairly robust terms. In particular both she and you would obviously want to make it absolutely clear that the publication of this Report does not mean that there will be any change of policy (perhaps adding that the Report seems to contain a good deal of misunderstanding of present policies - witness the ill-founded criticisms of the rigidity of the MTFS).

6. If the briefing is sent to No 10 it might be helpful if we were to make further contact with Mr Lankester around lunchtime tomorrow in the light of the morning's developments.

Official Government reply

7. We shall also need to consider in due course whether there should be a formal written Government reply. We are not obliged to do so. We could, for example, argue that the Budget Speech and speeches during the Budget Debate contained as much reply as the Government intended to give. But I suggest we keep the options open and consider this again after the Budget. We may decide that it is positively in our interests to put some further written comments on the record.

Report agreed with the Treasury?

8. I understand that Mr Du Cann has claimed that the Report was agreed with the Treasury. This seems to be the same kind of canard

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that he more or less perpetrated last summer. If it comes up publicly, it should be emphatically denied. As you know, the Report was sent to us by the Committee in draft in the usual way with a request for purely factual comments. Our opinions were not sought and in sending our comments I made it clear in writing that this did not imply in any way Treasury agreement to the opinions or judgements in the Report.

J B UNWIN
4 March 1981

SELECT COMMITTEE MONETARY REPORT: SUMMARY

There are two main themes in the Report:-

i) scepticism about the causal relationship from monetary growth to inflation; and

ii) a rejection of a policy based on inflexible targets for a single monetary aggregate (particularly £M3) set for a period of years.

On the positive side, however, the Report:-

i) "welcomes the Government's readiness to announce medium and longer term objectives which express its policy intentions"; and

ii) it does not offer any specific policy alternatives.

Its general thrust is that economic policy should be conducted in a more eclectic, pragmatic way. It recommends that more attention should be paid in a counter-inflationary policy to the possible short-term costs in terms of lost output and to movements in the exchange rate.

Two additional aspects of the Report which might attract particular attention are:

i) the doubts it casts on the relationship between the PSBR and £M3; and

ii) the theoretical possibility it raises that policy directed at maintaining the monetary target could amplify rather than dampen fluctuations in economic activity.

The final chapter of the Report is entitled "summary and conclusions" and it provides a succinct chapter-by-chapter review of the main Report, including direct quotes from the relevant chapters. In brief, the arguments are as follows:-

Chapters 1 and 2: Introduction and "Method of Enquiry"

These chapters set the scene for an analytical review of the Government's objectives and ways in which the methods adopted for achievement of these objectives can be subject to empirical testing. In fact, however, very little empirical evidence was

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provided to the Committee except by the Treasury (and this was treated rather grudgingly in the Report.)

Chapter 3: The Conduct of the Government's Monetary Policy

It is accepted that although the £M3 target in 1980/81 overshot by a long way, the Government did make strong efforts to achieve it and monetary conditions remained tight throughout the period. There is also implicit agreement that it was right for the Government not to go further in the autumn in terms of cutting the PSBR or keeping interest rates higher.

Chapter 4: Principal views about main issues of Monetary Policy

The following useful (although somewhat expedient) classifications are provided of the views put to the Committee, divided into four "schools of thought":-

(i) New Classical (eg Minford, exponents of rational expectations);
(ii) Gradualists (eg Laidler, Friedman);
(iii) Pragmatists (eg Tobin, Bundesbank); and
(iv) Anti-Monetarists (eg Kaldor).

There is also a balanced summary of the evidence put to the Committee by the Treasury on behalf of the Government.

Chapter 5: Objectives, Targets and Indicators

The distinction between intermediate targets and indicators is spelt out. The credibility of an intermediate target in terms of its relationship to the Government's ultimate objective and the Government's power to control it are seen as crucial factors. Tobin and the Bundesbank are quoted in support of monetary targets being made "conditional" on measures of international competitiveness although it is acknowledged that whilst an "unconditional" target that had to be abandoned repeatedly would damage credibility, so would a "conditional" target if it became a licence for unpredictable reversals of policy.

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Chapter 6: Money, Interest Rates and PSBR

This Chapter, although acknowledging carefully the impact of interest rates on the relationship between the PSBR and the money supply in the short term, is very sceptical about the constraints imposed on the PSBR by the money supply and the effect of using discretionary changes in the PSBR to meet a £M3 target. It quotes Treasury papers and many outside witnesses in evidence of the diversity of relationships which can exist between changes in the PSBR and £M3 (depending on the origin of the change in the PSBR) and points out that action taken to correct deviations of £M3 from target may counterbalance the moderating effect that the automatic stabilisers in the PSBR would otherwise have during a recession. It notes, however, that the Authorities did not take action of this kind in 1980/81 itself.

Chapter 7: Monetary Policy, Exchange Rate and International Competitiveness

Various possible influences on the nominal and real exchange rate over the last two years are examined. North Sea Oil is identified as probably an important factor, but monetary policy (in its conduct and perception) is thought to have been an important direct and indirect influence. It is also suggested that external factors and the recent re-emergence of sterling as a financial asset have perhaps given a boost to sterling which may not be sustained. Although direct controls are unlikely to be effective, some tactic which would allow some pressure to be taken off sterling is thought to be a useful element of policy. The possibility is raised of taking some account of both the money supply and the exchange rate, as well as the objective of inflation, in setting monetary instruments. A recommendation is also made that revenue from North Sea Oil should be used to facilitate structural change.

Chapter 8: Money, Output and Inflation

Considerable doubt is cast on the causal relationship from growth in the money supply to inflation, although the summary does carefully speak of it being the direct causal link which is in doubt. But even if the link does exist, it is thought

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much more likely that monetary policy would have to work through higher unemployment (via the "Phillips curve") and the exchange rate than simply through the formation of revised expectations in labour or products' markets. Thus the costs in terms of unemployment of a restrictive monetary policy are thought to be very high (with estimates derived from the Treasury model being used to show an expensive short-term "trade-off"). The Report even mentions claims that there may be permanent costs without sustained benefits.

Chapter 9: Control of the Money Supply

The MFTS is criticised as over-rigid. £M3 is also considered to be a misleading indicator, although the Government's "apparent move away from £M3 as the sole monetary indicator" is welcomed. Conditional targets or some alternative, more flexible approach to monetary targets year-by-year would be preferred. Whilst it is noted that the Government has not used its stated instruments (PSBR, interest rates) more intensively this year to achieve its target, this is not in itself a criticism of Government action. There seems to be no enthusiasm for monetary base control and the Committee does not produce any new views on monetary techniques.

Chapter 10: The Development of Policy

This is mainly a plea for a formalised but eclectic approach to setting policy instruments. Econometric models would be used to give advice on how the ultimate objectives of policy could be achieved at least cost to the economy (relying very much on Jeremy Bray's familiar themes). It is acknowledged that the state of the art is not sufficiently developed for this to be used on its own to provide automatic solutions, but suggests that more resources should be devoted to "policy optimisation" work in the Treasury and Bank and by the Committee itself. Access to the Treasury model, and evidence based upon it, should also be improved subject to cost considerations.

HF3
H M Treasury
4 March 1981

CONFIDENTIAL

SELECT COMMITTEE MONETARY REPORT: MAIN POINTS

Although the Committee's Report is generally critical of the use of monetary targets, in many important respects it does endorse elements of the Government's policy. In particular, it does allow certain "supportive lines" to be referred to as follows:-

SUPPORTIVE LINES	QUOTATIONS
i) acknowledges the link between growth in the money supply and inflation;	i) "Over the long term the money supply and price level appear to have moved together." (Conclusions and 8.27)
ii) welcomes the Government's readiness to announce medium and longer term objectives which express its policy intentions;	ii) "We welcome the readiness of the Government to announce medium and longer term objectives which express its policy intentions (Conclusions and Chapter 9.48)."
iii) recognises the Government's commitment and success in achieving tight monetary conditions in 1980;	iii) "Although the monetary target for the first year of the MTFS was significantly overshot, there has been no doubt about the Government' wish to reach its monetary target and it has made considerable efforts in that direction .... monetary conditions have been tight." (Conclusions and Chapter 3.34)
iv) accepts the Government's view that external factors such as North Sea Oil and the surpluses of other oil producers, as well as the Government's monetary policy, were responsible for the high level of sterling and that some of the rise may well be transitory.	iv) "Some, but not all, of the recent rise in sterling would appear to be due to policies designed to achieve monetary restriction." (Conclusions and Chapter 7.48)

SUPPORTIVE LINES	QUOTATIONS
v) doubts that direct controls or intervention can bring about a significant, sustainable change in the exchange rate and accepts that there would anyway be consequences for the money supply;	v)"..it is possible to operate some controls or exert influences upon capital movements and thus the exchange rate in the short term. Such controls may not be as effective in holding the exchange rate in conditions of serious long term disequilibrium." (Conclusions and Chapter 7.50).
vi) recognises that departure from an intended path for the PSBR in the middle of a recession would not necessarily endanger the objective of reducing inflation – as the Chancellor said in his November statement to the House;	vi) "It may be possible to depart from the target paths for PSBR and monetary growth in the middle of a recession without endangering the objective of reducing inflation...". (Chapter 6.29).
vii) states that the tightness of monetary policy is not completely measured by a single monetary aggregate as was made clear in the Government's Green Paper on Monetary Control; — as	vii) "The tightness of monetary policy is not adequately measured by one monetary aggregate." (Chapter 3.27)
viii) acknowledges that the MTFS was a bold experiment intended to change expectations;	viii) "The MFTS was a bold experiment intended to change expectations about the future of the economy." (Conclusions and Chapter 9.47)
ix) refrains from criticising any specific policy actions taken by the Government, implicitly endorsing those made since last November;	[ix] ["Policy optimisation is a development rather than a replacement of the forecasting exercises in the Treasury and elsewhere." (Chapter 10A.3)]

However, the Report also contains several fundamental criticisms of Government policy which are bound to receive extensive coverage:

(i) the lack of evidence of a direct causal relationship from money supply to inflation (conclusions and chapter 8.27)

(ii) the potentially high costs of a tight monetary policy in terms of unemployment (conclusions and chapter 8.21)

(iii) the limitations of £M3 as an indicator of monetary conditions (conclusions and chapter 9.45)

iv) the "rigidity" of the MTFS (conclusions and chapter 9.45)

Against this, there are two notable ommissions from the Report which can usefully be commented upon:

(i) no coherent alternative anti-inflationary strategy is presented; and

(ii) no assessment is made of the likely costs of not pursuing a policy designed to bring down the rate of inflation.

4/3/81. 2

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SELECT COMMITTEE MONETARY REPORT: DEFENSIVE BRIEFING

1. Monetary growth doesn't cause inflation

Committee accepts that over the long term the money supply and price level have moved together. Their doubts are in fact about whether there is a direct or simple causal relationship. But it is clear that monetary growth is a necessary condition for continued inflation and that only if it is successfully controlled can inflation be brought down.

2. Costs of tight monetary policy too high

Costs of not having a responsible monetary policy would be higher and would be long-lasting. We are now experiencing some of the short-term costs in terms of unemployment and output of tightening monetary policy, but these would have been substantially reduced if wage settlements had been conducted responsibly.

3. Treasury model shows no simple relationship between £M3 and inflation

In the short run, many factors can affect this relationship. But in the long run there is no escaping the fact that the money supply and inflation do move together as the Committee acknowledges.

4. Treasury econometric evidence refutes money as sole cause of inflation

Treasury paper shows importance of money in long run. But in the short run - as the paper indicates - other factors can be significant.

5. Treasury model shows enormous costs of tightening monetary policy

Treasury model simulations are only one possible method of assessing consequences of policy changes, and are subject to very great uncertainties. There are well established difficulties of using models to estimate the effects of major policy changes aimed at changing people's general attitudes and expectations.

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6. Wrong to use £M3 as the sole monetary indicator

Green Paper on Monetary Control pointed out very clearly that £M3 was never intended as the sole indicator. But because of familiarity to market and close connections with fiscal policy it is the best one to use for the target aggregate itself.

7. £M3 a misleading indicator

Particular problems this year relating to ending of the corset. £M3 is also less sensitive than narrow aggregates to levels of interest rates. But the special nature of the recession last year, with a high level of personal savings and at the same time a high level of bank borrowing by companies helps to account for the rapid growth of all the broad monetary aggregates. But there is no reason why these attributes should cast doubts on its usefulness as a medium-term indicator or target.

8. MTFS too rigid

The Government needs to present its intermediate targets in an easily comprehensible and direct form. But in no sense was the MTFS for the period up to 1983/84 an overly-rigid framework for setting those targets. It was made clear last year that precise rates of growth within the period would need to be determined at the time.

9. Target should be inflation rate, not money supply

The ultimate objective of our economic strategy is to bring down the rate of inflation and sustain it at a low level. To achieve that it is necessary to control the rate of growth of the money supply. Money supply is more directly within our power to influence and specific monetary targets give a clearer guide to the private sector of the fiscal and monetary stance we shall adopt.

10. Controlling the exchange rate

Committee agree that direct controls aimed at keeping the exchange rate down are unlikely to be very effective and they have no policy to offer themselves. They also suggest that a combination of factors - North Sea Oil, the surpluses of other oil producers, monetary policy - have recently pushed up the exchange rate and point out the possible inflationary consequences of aiming to bring it down.

11. Account should be taken of exchange rate in setting monetary targets

Monetary targets must be set clearly and demonstrably with reference to the ultimate objective of reducing inflation. The exchange rate is an important route through which monetary policy will bring down the rate of inflation. But it is only one of many factors which can affect the speed with which this comes about. In setting the instruments of monetary policy over a short period it is appropriate to look at a variety of indicators - real interest rates, the exchange rate, all the monetary aggregates - but the £M3 target retains primacy especially in the medium term.

12. Germany and Switzerland successfully switch between monetary and exchange rate targets

These countries have followed responsible and successful monetary policies for years. Their inflation rate has consequently stayed low. We are not yet in this position. To bring about continued deceleration in inflation from a high level, it is useful to maintain a single, clearly expressed monetary target.

13. Government failed to foresee how severe the effects of their policies would be

The 1980 Budget forecast gave a good indication of the fall in total output that year. However, as the Committee acknowledges, the level of the exchange rate in 1980 and the severity of the recession could not have been precisely forecast by conventional techniques. In fact, the exchange rate was higher than was assumed and there were underestimates of the fall in manufacturing output and the rise in unemployment. Nevertheless, had wage settlements been lower - as they were in other countries - then the impact of the recession on industry in particular would undoubtedly have been smaller than it turned out.

14. Monetary targets haven't changed expectations

We are now seeing signs that attitudes are changing. People are beginning to understand that our policies are bringing down the rate of inflation and that they must adapt their behaviour accordingly. The more moderate wage settlements we are now seeing in the private sector are an indication of this.

15. Monetary strategy has just been "old-fashioned deflation"

No. Workers realise they have a choice between higher wages and jobs. It is up to them.

16. Dangerous to make £M3 target the determinant of the PSBR path

Treasury evidence pointed out that in the short run many factors can affect the relationship between the PSBR and £M3. But it also made clear that, in the medium term, if we are to maintain control over the money supply and achieve moderate real interest rates, we do need to bring down the size of the PSBR. To the extent that the PSBR rises as a result of the recession, it is usually possible to accommodate this increase in an unchanged monetary target, without implying an excessive level of real interest rates.

17. Monetary target should be dependent on prospects for economy (Bank of Canada)

Essential for success of counter-inflationary strategy that have targets which decelerate year by year.

18. Better to use policy optimisation techniques

As Report acknowledges, econometric models have considerable limitations, both in explaining the economy and as a basis for determining policy. Although techniques are improving, we note the reservations expressed in the 1978 "Ball" Report about devoting resources to this area.

19. Access to the Treasury Model is too costly

It is an inescapable fact that access to models of this kind is expensive. It would in principle be desirable for academics to have cheaper and easier recourse to the model, but the Treasury cannot undertake to bear the heavy costs this would involve. We note the Committee's proposals to discuss with the SSRC how the needs of the Committee and Parliament can best be served.

20. North Sea Oil revenue to be used to promote structural change

Revenue from North Sea oil is already helping to reduce the PSBR and allowing us to pursue our monetary strategy at lower interest rates. This is crucial aid to the private sector.

21. Fuller public debate needed on monetary control

Since the Green Paper was issued last March, there has been an extensive opportunity for the public to comment on the issues raised and two seminars have been held by the Treasury and the Bank. Discussions are continuing, but the changes announced to date in monetary control techniques have been evolutionary and generally welcomed and there is still opportunity for ample public debate.

HF3
H F Treasury
4 March 1981

pwp 3

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MR WIGGINS

cc PS/Financial Secretary
Mr Folger

TREASURY COMMITTEE'S REPORT

It occurred to me that it might be useful for the Chancellor and the Financial Secretary to have a few thoughts conveniently at hand in case either of them finds it necessary during the day to put any comment on the record on the Treasury Committee's Report.

2. I attach a few notes. It would be wrong to be too dismissive of the Report; but we presumably want to "put it in its place".

So far the press seem to have been quiet (no coverage, so far as I can see, in the Times, F.T., or Guardian). So perhaps it will be possible to lie low.

J B UNWIN
5 March 1981

c. Mr. T.P. Lankester, 10 Downing St

I understand that the TCSC Press Conference this morning was a v. low key affair. Tsy have so far managed to maintain a very low profile. If you have any detailed questions Jon Shields (x4632) could field them.

JW
5/3

cc Ass to Chief Whip.

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POSSIBLE SPEAKING POINTS ON TREASURY COMMITTEE'S REPORT

Not had time to study. But seems useful and compendious analysis. Gathers a lot of different views and bring them usefully together.

2. Wrong for me to offer instant conclusions. But some quick impressions on a quick skim through:-

i) report is eclectic analysis rather than coherent expression of view by Committee itself. Committee obviously had same (understandable) problem as on previous occasions. Analysis rightly sceptical in many ways. But fails to offer any coherent alternative strategy; and (perhaps glaring omission) seems not to assess costs of <u>not</u> pursuing policy to bring down inflation.

ii) some criticisms of Government policies. This understandable. We never claimed our policies perfect. But many <u>misunderstandings</u> (eg ill-founded criticism of rigidity of MTFS); and many comments <u>supportive</u> of Government policies (eg welcomes Government's readiness to announce medium and longer term objectives; recognises Government's commitment and success in achieving tight monetary conditions in 1980).

3. Again, wrong to react instantly. Committee has spent long time and effort in producing Report; therefore deserves considered study. But suspect it will prove more valuable to <u>students</u> than those who actually have to take policy decisions. Certainly nothing in it to cause Government to change fundamental policy.

placed in H of C Library 12 March 1981
(see WA col 387 reply to Sir William Clark)

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COMPARISONS OF THIS YEAR'S AND LAST YEAR'S MEDIUM-TERM PROJECTIONS OF EXPENDITURE, REVENUE AND BORROWING IN THE FINANCIAL STATEMENT AND BUDGET REPORT

Note by HM Treasury

1. Comparison of the medium-term projections of revenue and expenditure in Tables 6-8 of this year's Financial Statement and Budget Report with the corresponding projections published last year is complicated because there have been substantial changes in expenditure volumes, absolute and relative prices and real tax rates between the two sets of projections.

2. Table 1 attached shows the projections compared in cash for the three years 1979-80, 1980-81 and 1981-82, and in cost terms at 1979-80 prices for the years 1980-81 to 1983-84. As explained in paragraph 25 of the FSBR, the figures at 1978-79 prices in last year's projections can be approximately translated to the 1979-80 price base used this year by inflating them by 16½ per cent (the movement in the general price level between 1978-79 and 1979-80 assumed when last year's projections were made). As it has turned out the view of changes in general prices between 1978-79 and 1979-80 has not changed much, but it should be noted that this scaling retains the relative prices assumed last year.

3. The figures in Table 1 show that both revenue and expenditure totals are generally much higher in both cash and cost terms than those projected a year ago. However, the greater increase is in the expenditure projections. In 1980-81, general government expenditure in cash is now expected to be about £3½ billion higher than the projection made last year, and in 1981-82, about £6 billion

higher. Because the general level of prices in these two years is now expected to be lower than had been thought a year ago, the increases are even larger when expressed in cost terms (ie including the relative price effect (RPE)): £4½ billion and £7 billion in 1980-81 and 1981-82 respectively. For any category of public expenditure its relative price is the ratio of its deflator to the deflator for GDP at market prices (which serves as a measure of the general price level). Thus for any given level of public sector pay and prices a fall in the GDP deflator will increase the relative price of public expenditure and hence the RPE.

Detailed Reconciliation of Projections in 1980 and 1981 FSBR's

4. The latest estimate puts cash expenditure in 1979-80 about £1 billion higher than the estimated outturn published last year. The under-estimation was mainly on goods and services and subsidies. Much of the upward revision has fed through into the projections for later years.

5. 1980-81 In cash, general government expenditure in 1980-81 is now expected to exceed last year's forecast by about £3½ billion, despite the £½ billion reduction in contributions to the European Communities' budget negotiated in May. The main factors contributing to this increase are:

(i) The recession: the difficulties, both conceptual and practical, of making precise calculations were set out in a recent article*. It is estimated that, as a consequence of

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*"The impact of the recession on the PSBR", Economic Progress Report, February 1981.

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the recession being deeper than expected and affecting unemployment and other aspects of the labour market more than expected, expenditure in 1980-81 is some £1½ billion higher in cash terms. The main categories affected are social security benefits, spending on special employment measures and redundancy fund payments.

(ii) General government expenditure on goods and services is about £1½ billion higher than forecast, partly reflecting likely overspending in some areas - notably defence and local authorities - and less underspending elsewhere.

(iii) Debt interest payments are about £1 billion higher, partly reflecting higher interest rates, partly higher borrowing.

6. General government receipts in 1980-81 are about £½ billion lower than forecast. This shortfall partly reflects the extent and form of the recession: lower employment has reduced receipts of income tax and national insurance contributions (though, mainly because earnings rose more than forecast, receipts from these two sources are in total about £1 billion higher). Lower than expected growth in the volume of consumers' expenditure has reduced receipts of indirect taxes. In addition there has been a substantial shortfall on indirect taxes for other reasons, including a shift in demand away from taxed goods.

7. The difference between the general government borrowing requirement and the PSBR consists of public corporations' market and overseas borrowing. Last year's projections assumed net repayments

of £1.3 billion in 1980-81; the outturn is expected to be only half that. The principal reason for this is higher total borrowing by public corporations other than nationalised industries.

8. 1981-82 and Later Years. Many of the factors contributing to the higher expenditure in 1980-81 also explain why expenditure is now expected to be higher in subsequent years than was projected a year ago: activity is now assumed to be lower throughout the period (and unemployment higher for a given level of activity); under-spending is assumed to be less than allowed for a year ago, and interest payments are expected to be larger.

9. Most of these increases are reflected in the Public Expenditure White Paper (Cmnd 8175). For 1981-82 this implies an increase in general government expenditure including debt interest of the order of £3½ billion in 1980 survey prices or £4½ billion in cash. The projections in Part II of the FSBR also take account of developments since the White Paper went to press, such as higher debt interest and the Budget measures shown in Table 1 of the FSBR. There have also been changes in the adjustments between general government expenditure shown in the White Paper and that projected on national accounts definitions, with higher non-trading capital consumption and higher government lending to certain public corporations. This latter change does not affect the figures in the White Paper because the capital expenditure of the corporations - which is included in those figures - is not expected to be any higher.

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0. As noted earlier, the relative price effect is larger in the latest projections in both 1980-81 and 1981-82 than had been expected a year ago, mainly reflecting the lower general price level. The higher level of relative prices carries forward into the later years, but the divergence from last year's projections of the RPE is not expected to increase further.

11. The latest projections of government revenue in constant prices are higher in all years. The effect in 1980-81 on receipts at current prices of the recession (see paragraph 6 above) and the lower general price level was partly offset by higher than expected receipts from some other sources (notably income tax and local authority rates). Receipts at current prices are therefore lower by a smaller proportion than the general price level, so that receipts at constant prices are higher than projected a year ago. In 1981-82 and subsequent years most of the increase in receipts reflects changes in taxes and contributions announced in the Budget and the Chancellor's statement of 24 November 1980.

12. The result of all these changes is that by 1983-84 general government expenditure is about £5 billion higher in cost terms at 1979-80 prices than projected a year ago and general government revenues (after the implied fiscal adjustment) are about £4 billion higher.

HM TREASURY
12 MARCH 1981

TABLE 1: PUBLIC SECTOR BORROWING: A COMPARISON OF THE 1980 AND 1981 FSBR PROJECTIONS

	A: £bn in cash			B: £bn in cost terms at 1979-80 prices[1]			
	1979-80	1980-81	1981-82	1980-81	1981-82	1982-83	1983-84
General Government Expenditure							
(i) 1980 FSBR	87.7	104	113½	87	84½	82½	82½
(ii) 1981 FSBR	88.8	107½	119½	91½	91½	90	87½
General Government Receipts[2]							
(i) 1980 FSBR	-77.6	-94	-105½	-78½	-78½	-78	-79
(ii) 1981 FSBR	-78.4	-93½	-108	-79½	-82½	-83	-83
GGBR (i) 1980 FSBR	10.0	10	8	8½	6	5	3½
(ii) 1981 FSBR	10.4	14	11½	12	9	7	4½
PSBR							
(i) 1980 FSBR	9.1	8½	7½	7	5½	4½	3
(ii) 1981 FSBR	9.9	13½	10½	11½	8	6½	4

[1] The figures published in the 1980 FSBR have been converted to last year's view of 1979-80 prices by using the GDP deflator as estimated at Budget time 1980.

[2] After deducting implied fiscal adjustment.

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miller

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Evidence to the Treasury and Civil Service Committee of the House of Commons

Monetary Policy Aspects of the Budget

Marcus Miller
University of Warwick (16 March 1981)

This paper is divided into two sections. In the first the provisions of the Budget in modifying the Medium Term Financial Strategy and the methods of monetary control are discussed, and the principles underlying present policy discerned. In the second section the practical problems facing the monetary policy endorsed in the Budget are considered, using as a framework for discussion the topics covered in the recent report on Monetary Policy of the Treasury Committee (HC 163-I)

Section I. Adjustments to the Medium Term Financial Strategy (MTFS) made in the Budget, and analysis of the principles underlying current policy.

The Medium Term Financial Strategy

The essential logic of the MTFS is that inflation is to be controlled by controlling the growth of money supply within announced target ranges; and that such monetary objectives are to be achieved "without excessive reliance on interest rates" by a consistent path for the PSBR. The stance of fiscal policy, as measured by the PSBR, is thus to be geared to attaining monetary objectives, and not to stabilising the economy (as has typically been the case in most post-war Budgets).

/̲As the present Government has, in addition, the "structural" objective of reducing the level of taxation (as a percentage of national income) so as to stimulate the economy, this aim together with the PSBR paths following from its monetary policy, dictates a corresponding path for Government expenditure. The size of the Government's expenditure programmes is determined by its chosen method of curbing inflation and its aim of reducing the tax burden. _7

Monetary growth and the PSBR

A chart comparing the projected link between monetary growth and fiscal stance with past experience was prepared for the meeting with Treasury officials last year[1] and this is reproduced below as Figure 1. It was evident that the MTFS sought to impose a much tighter coordination of monetary and fiscal policy than had been achieved before. As can be seen from the chart, for example, while the rates of monetary growth since the first oil crisis had remained below 12% up to 1978/79, the size of the PSBR (relative to GDP) associated with this monetary growth was much greater than planned in the MTFS.

Although monetary conditions were widely agreed to be "tight" in 1980/81 (on most indicators other than £M3 itself) and although the Treasury Ministers tried to cut spending when possible, both monetary and fiscal targets have been considerably overshot this year.

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1 See HC 163-II, p.129

In his Budget speech the Chancellor explained that the overshooting of the £M3 target could be explained by three factors:

(1) The ending of the Corset

(2) The nature of the current recession (with its squeeze on on Company profits and growth of personal incomes.)

(3) The high level of acquisition of financial assets by the private sector.

Rebasing £M3

It was argued that these could be "accommodated" by rebasing the money supply so as to grow from the level now reached. As these factors were not expected to recur , however, the growth rates from this new level are to be the same as previously planned.

The consequence of this "rebasing" exercise for the possible future levels of £M3 is shown in Figure 2 below.
/‾Although the Chancellor had explained that why he would accommodate the excessive rise in £M3, the FSBR nevertheless asserts that "it is the Government's intention to consider clawing back some of the past year's rapid growth of £M3 by permitting an overshoot as and when the opportunity arises." So it is with evident reluctance that this adjustment has been made._7 Despite the fact that there are problems requiring such substantial rebasing, the Chancellor has decided to retain £M3 as the centrepiece of his monetary strategy.

Adopting the PSBR path

The PSBR to be associated with planned monetary growth over the next three years is a little more relaxed than in the original MTFS. The startling departure from the original MTFS, together with the PSBR adjustments made in this year's Budget, are shown in Figure 3 which shows how, apart from the "rebasing", the basic strategy is being preserved intact for the remaining years of its planned life.

Principles underlying current policy

The principles underlying the co-ordination of monetary and fiscal policy and the relationship between the nominal and the real PSBR can be clarified with reference to Figure 4. In this Figure we redraw the projected path for the nominal PSBR as a percentage of GDP at market prices, but we relabel the vertical axis so as to measure the rate of <u>inflation</u>. /‾We assume that the rate of inflation anticipated by the government lies within the target ranges expressed for £M3 so the monetary targets are reproduced as the limits on expected inflation. It can be seen that the FSBR forecast for inflation next year, for example, is precisely the midpoint of the growth range for £M3, namely 8%._7

The "inflation tax"

Also shown on the chart is a line (the 45° line) labelled "inflation adjustment". This line indicates (approximately), for any given rate of inflation, the inflation adjustment that should be made to the <u>nominal</u> PSBR so as to obtain the corresponding <u>real</u> PSBR. (For discussion of these concepts see HC 163.I Annex to Chapter 6 and HC 163-II p.48). The inflation adjustment is sometimes referred to as an "inflation tax" as it measures the amount by which inflation reduces the real value of Government debt held by the private sector.

1980/81 as an example

Thus in the current financial ie 80-81 year, for example, against a nominal PSBR of 6% of GDP (see the Red Book p.18) one must set an inflation adjustment greater than that. The inflation rate, measured for this purpose by the Consumers' Expenditure Deflator, is assumed to be 15% for 1980/81 (as the Bank of England provided an estimate of 14.8% for calendar 1980). For an inflation rate of 15% the line shows that the inflation tax is 7½% of GDP so that the real PSBR is in fact in surplus to the tune of 1½% GDP. $-6+7\frac{1}{2}=1\frac{1}{2}$

/The reason why the inflation tax (as a % of GDP) is about half the rate of inflation is because the nominal value of outstanding Government debt is approximately half that of one year' GDP. As x% inflation cuts the value of these assets by x%, this "inflation tax" will be ½x% of GDP. /

Zero "real" PSBR

Following these principles we see that the MTFS has the feature that the projected "inflation tax" roughly balances the projected nominal PSBR so as to give a real PSBR fairly close to zero as a percentage of GDP. The real PSBR for 1983 would, on these calculations, actually be in surplus by about 1%.

From these considerations the underlying logic of the MTFS may be more apparent: the nominal deficit means that the Government is <u>creating</u> financial assets, but inflation <u>destroys</u> the value of such financial assets. If the rates of creation and destruction are balanced, so that the real deficit is zero, there will be no change in the real value of Government debt in private hands.

Since under the MTFS the reductions in the Government's nominal deficit are by and large expected to be matched by inflation taxation, (so keeping the real PSBR close to zero), so supporters of the Government's policy can argue that the cuts in the deficit are not contractionary: they are not contractionary because the tax increases or spending cuts which reduce the nominal PSBR, are to be offset by a reduction in the inflation tax.

Inflation tax and savings

The way in which such a reduced inflation tax would affect an economic forecast is by reducing the personal savings ratio: persons will not need to save as much out of current income when inflation is low, because inflation will not be robbing them of so much of the value of their savings. Precisely such an argument is contained in the FSBR para 13, p.27 where it is argued that "the rate of personal savings ... is likely to fall, ... partly because the recent and forecast declines in inflation reduce the amount of saving necessary to maintain intact the real value of financial assets."

If inflation falls along with the money supply, and if people are only saving as much as they are so as to keep the value of their financial assets constant in real terms, then the cuts in the PSBR need not be contractionary.

Rising real balances if inflation slows sharply

So far we have made the simple assumption that the rate of inflation expected by those designing the MTFS will be the same as the monetary growth rate; but after 1981 the authorities anticipate growth of real output at a rate of 1¾% p.a. in 1982, 1983 so the growth of price inflation might need to be lower than the planned growth of money. We note in Professor Minford's forecast for example that inflation is indeed forecast to fall below the mid points for monetary growth; thus Minford[1] has inflati falling to about 4% in 1983/84. These optimistic assumptions on inflation would cimply that the arrow shown in Figure 4 would lie even more closely along the "real balanced budget" 45° line than is shown here.

MTFS principle of balancing the budget".

What the above describes is the logic which appears to underlie the close linkage between monetary growth and the nominal PSBR "designed into" the MTFS. It will be seen that the principle underlying the MTFS is that of balancing the budget taking account both of explicit taxation (direct and indirect) and also of what we have called "inflation taxation". As the

1 As reported in the Daily Telegraph 16/3/81

present government is more than most loth to resort to inflation taxation, so its plans are to phase out inflation taxation and consequently to approach a nominal PSBR of close to zero (as a percent of GDP). in the medium term.

One interesting feature of the Budget was the cautious introduction of indexed debt. If all government debt were indexed, there would be no "inflation tax", since holders would be compensated for inflation. Hence the authorities would be forced to balance the nominal PSBR. [One of the virtues of indexing debt is precisely that it reduces the numerical PSBR by those interest payments which are presently made to compensate debt holders for inflation. As the indexation provisions effect the compensation automatically, the nominal interest outgoings fall, and the size of the nominal PSBR becomes the real PSBR.]

In addition to this cautious step to make Government debt more attractive to institutional holders, there were steps made in the direction of adopting Monetary Base Control. In particular the fixing of interest rates by the setting of MLR was to be phased out, with MLR rising and falling according to market pressures. The very act of cutting MLR on Budget day itself, however, suggested that any such reform of the methods of monetary control was not imminent.

The levying of a tax on Bank profits was not to be interpreted as the introduction of a direct method of controlling the money supply: it was a once-off tax and was not levied on interest bearing deposits, which would be highly sensitive to such a tax. The request to collect figures for M_2 suggests that this might become a target for control in the future, and control of M_2 would be aided by a continuing tax on profits from non interest bearing deposits.

Thus the Budget left the target for and the methods of monetary control substantially as they were before, namely that £M3 is the target and is to be controlled by manipulation of interest rates and of the PSBR.

With the commitment to reducing interest rates the need to cut the PSBR became paramount and largely explained why the stance of fiscal policy was so contractionary.

Section II Practical problems facing the policy endorsed in the Budget

In its recent Report on Monetary Policy the Treasury Committee considered the consequences of implementing the MTFS and found a number of practical considerations which implied that it was a high risk policy. We use the framework of the Report to consider the policy endorsed by the Budget.

Inertia of inbuilt inflation

The first and most obvious problem facing current policy is what happens if the assumption made above that inflation will melt in the face of monetary targets fails to be true. In that case one will have the reduction of the nominal PSBR without any matching reduction in the inflation tax, so the economy will be subjected to a fiscal contraction, with the inflation adjustment offsetting the nominal PSBR and leading to the prospect of a significant surplus in the real PSBR. This is indeed what appears to have taken place in the current fiscal year as shown in Figure 4. Unless the optimism about the flexibility of prices shown by "New Classical" Monetarists[1] (and by the "International Monetarists") is justified, then it is likely that the policy will tend to reduce inflation by the effects of such a fiscal contraction on real output and employment with output costs considered below.

Shifts in private sector behaviour

A second problem arises from the possibility that there may be shifts in the private sector's demands for the financial assets of the public sector. It is an elementary principle of Keynesian stabilisation policy that shifts in the private sector's propensity to save in this form of public sector debt will tend to cause fluctuations in income unless they are snatched by corresponding dissaving by the public sector. In the chapter of the Report which examined this issue the Committee considered the case where there was an upward shift in the private sector's propensity to save (or acquire financial assets). To satisfy this demand at stable interest rates it was observed that the government would need to allow the PSBR to rise and also to allow the money supply to increase above its target levels. It was argued that this would not be

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1 See Report, Chapter 4

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inflationary because the financial assets were exhypothesi being saved - and this would apply to the £M3 component of such extra savings. Indeed the Chancellor accepted some such argument when he argued, in his Budget Statement, that one reason for accommodating the large rise in £M3 this year was because the private sector were aiming to rebuild their portfolios of financial assets relative to the level of income: "At the same time, there has been a high level of private investment in financial assets. That can be seen as an attempt by the private sector to rebuild its holdings of such assets, whose purchasing power had been sharply eroded by inflation. It has included an increase in holdings of interest-bearing money. But to the extent that it merely involves returning to a more normal level of financial assets it need not fuel inflation."

Stabilising the budget or the economy

Once one concedes that the portfolios of the private sector may be in disequilibrium, it is evident that the decision to continuously balance the real PSBR is a dangerous one. If the Government insists on balancing its (inflation-adjusted) budget, how can the private sector increase the ratio of financial assets relative to income? The answer will have to be "by reducing real income". The Committee specifically examined how pursuit of the Monetary targets would involve the balancing of the budget, and the switching off of the automatic stabilisers (which tend to do the opposite).[1] But the consequence would be that the level of GDP would be less stable.

Rises of current policy

The revised MTFS appears to assume that the private sector both starts in equilibrium and remains in equilibrium as regards its desired ratio of financial assets to income. If either or both of these assumptions are false, the level of real income will not be as stable as the stability of the Government's financing strategy might seem to imply.

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1 The automatic stabilisers in the form of taxes received and unemployment benefits paid out tend to put the government into deficit automatically when the economy goes into recession, and vice versa.

he failure o regain ompetitive- ess

Another aspect of the MTFS which attracted considerable attention among the witnesses was the effects of contractionary monetary policy for the level of international competitiveness. While the Chancellor has reduced the level of nominal interest rates in the Budget, it is not clear whether real interest rates have fallen since inflation forecasts have shown inflation falling too. The inflation forecasts built into the revised MTFS seem to be over-optimistic, assuming that inflation falls well below 10% in the next year to two. And the Chancellor plans to claw back the recent overshoot when the opportunity arises. Such prospects of continuing monetary tightness will probably not lead to a substantial easing of the exchange rate, but rather to a continuation of the current overvaluation of the currency.[1]

Of course if the US for example were to indulge in a monetary squeeze this will lower sterling relative to the dollar, but to look for salvation on the exchange rate from monetary contraction in the U.S. is risky too. What if the U.S. repeats the UK experience and its imports fall as fast as UK imports have recently? A severe contraction of the world's largest economy is hardly the best environment in which a trading economy like the UK is to regenerate itself, as the events of the late 1920s and the early 1930s showed.

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1 It was interesting to note that a procedure resolution was moved enabling the forthcoming Finance Bill to include legislative provisions for improving the Treasury's statutory powers of exchange control, making it more symmetrical as between the control of outflows (the usual problem) and inflows (the current problem). Details of the new provisions will appear in a Schedule to the Finance Bill.

Output costs of current policy

The Report also considered the possible costs in terms of lost output and employment of the MTFS in circumstances where inflation failed to respond in the way in which New Classical economists like Professor Minford predict. The evidence of the Treasury model was of output losses of 4 "point years" of GDP for each one per cent reduction of inflation in the medium term. How far does the Government's own forecasts bear out such calculations? What time path of GDP is one to associate with the neat £M3 and PSBR paths shown in Figure 3?

Potential GDP

It is of course conceded by the Government that GDP (includi oil production) has been falling in absolute terms since 1979, but it was argued that the bottom of the recession has now been reached. For a growing economy, with a rising labour force and advances in the techniques of production, output must however keep <u>rising</u> in order to stop unemployment from rising. Output in the UK did indeed rise by an average of 2.8% annually for the quarter century from the end of the war to the early 1970s. Since 1973 most countries in the West appear to have suffered a substantial slowdown in their actual and potential growth rates. Even if one assumes that the potential output in the UK is only growing at a half or third of the rate actually achieved in the 1950s or 1960s, when we lagged behind most of our competitors, the GDP losses incurred so far and projected for the next few years are substantial. In Figure 5 we show the path of GDP since 1979, falling by 2½% in 1980 and by 2% in 1981, but rising by 1¾% in both 1982 and 1984 as projected in the Red Book. Taking the loss of GDP from a potential path growing by 1% p.a. gives a cumulative loss since 1979 by 1983 alone equivalent to 20¾% of one year's GDP. If the underlying GDP growth is 1½% p.a., this loss rises to 25¾% of one year's GDP. And in both cases, despite the recovery starting from now, the economy lies substantially below the potential path in 1983 itself. Even if the economy reaches the point shown under the MTFS, what likelihood is there of it accelerating to reach the potential path, and what likelihood is there that this will take place without sacrificing some or all of the gains in reducing inflation made by 1983?

but could this loss have been avoided?

Permanently high unemployment

As time proceeds it appears more and more probable that the MTFS will only succeed in holding down inflation in the longer run by permanently keeping output beneath the potential growth path, i.e. by keeping the level of unemployment at a higher level. It this is so, then the case for using other instruments of economic policy - such as prices andincomes controls, must be that much stronger, but the perception that unemployment may have to rise to a permanently higher level in absence of accommodation by both unions and government may of course increase the probability that some accommodation may be found.

Monetary Control

As regards monetary control the MTFS is to remain centred on £M3 despite its vulnerability to factors which lead to the confusions over the year and the belated rebasing in the budget. The fact that £M3, a broad monetary aggregate is related both to the wealth people save as well as the flow of expenditure makes the interpretations of its behaviour inherently difficult. The easy assumption made in the budget that the problems of interpretation are only relevant to 1980/81 seems over-optimistic. It was acknowledged that the effects of interest rates on £M3 are weak in the short run, and it was in any case the intention of the Chancellor to bring interest rates down. But this throws the task of controlling £M3 onto fiscal policy, with all the risks that that entails.

The move towards Monetary Base Control and towards floating MLR do not appear to be consistent with the aim of achieving control of the money supply "at reasonable interest rates" without the willingness to adjust fiscal stance as necessary help to keep interest rates stable. One would assume that any substantial moves in the direction of reforming the monetary system, and selecting a new target such as M_2 would be matters of concern to the Treasury Committee and about which it would wish to be kept informed as the discussion proceeds.

Monetary Base Control 'a will o' wisp'

The notion that the current experiment in monetary policy simply needs a reform in the methods of monetary control in order to ensure success is, I believe, a dangerous delusion.[1] These methods might instead encourage wide fluctuations in interest rate and exchange rates in the attempt to control an (inappropriate) broad monetary target which is not particularly sensitive to the

1 I have tried to develop this argument in more detail in "Monetar Control in the UK" Cambridge Journal in Economics, March 1981

level of interest rates. Greater fluctuations in rates might help to stabilise the monetary stock, but at an unacceptable cost in terms of destabilising the real economy.

Figure I

ANNEX 3
MONETARY GROWTH & PSBR/GDP
PRESENT PLANS & PAST PERFORMANCE

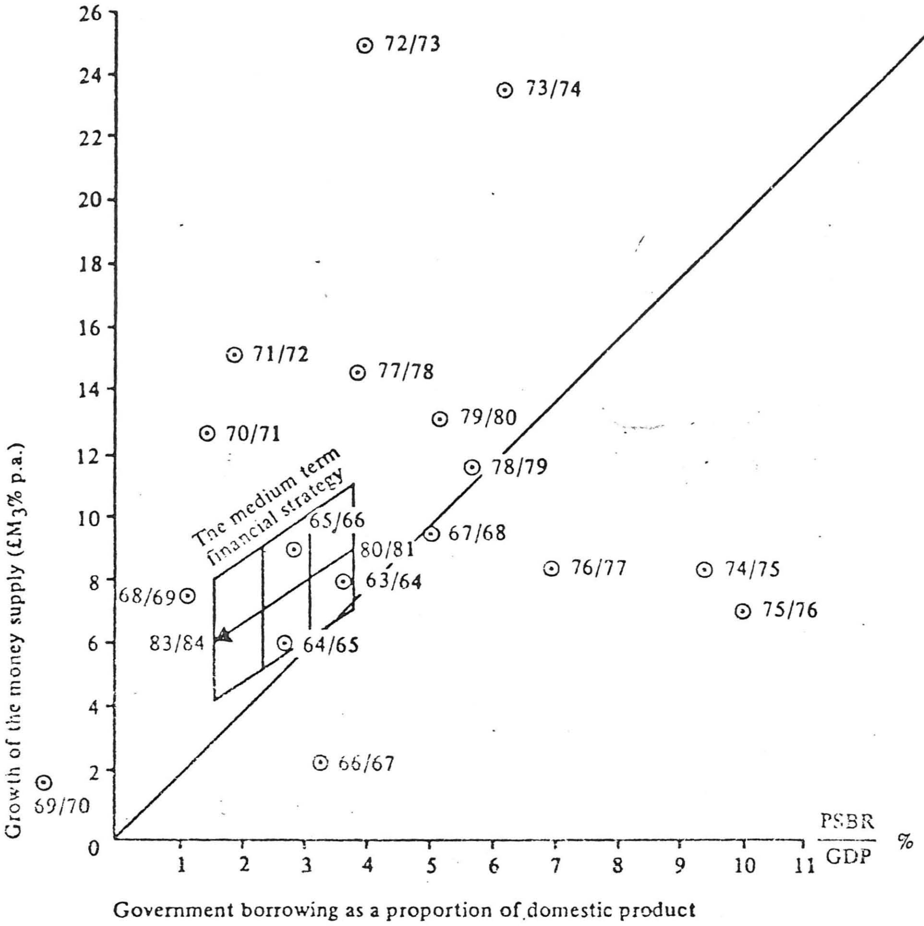
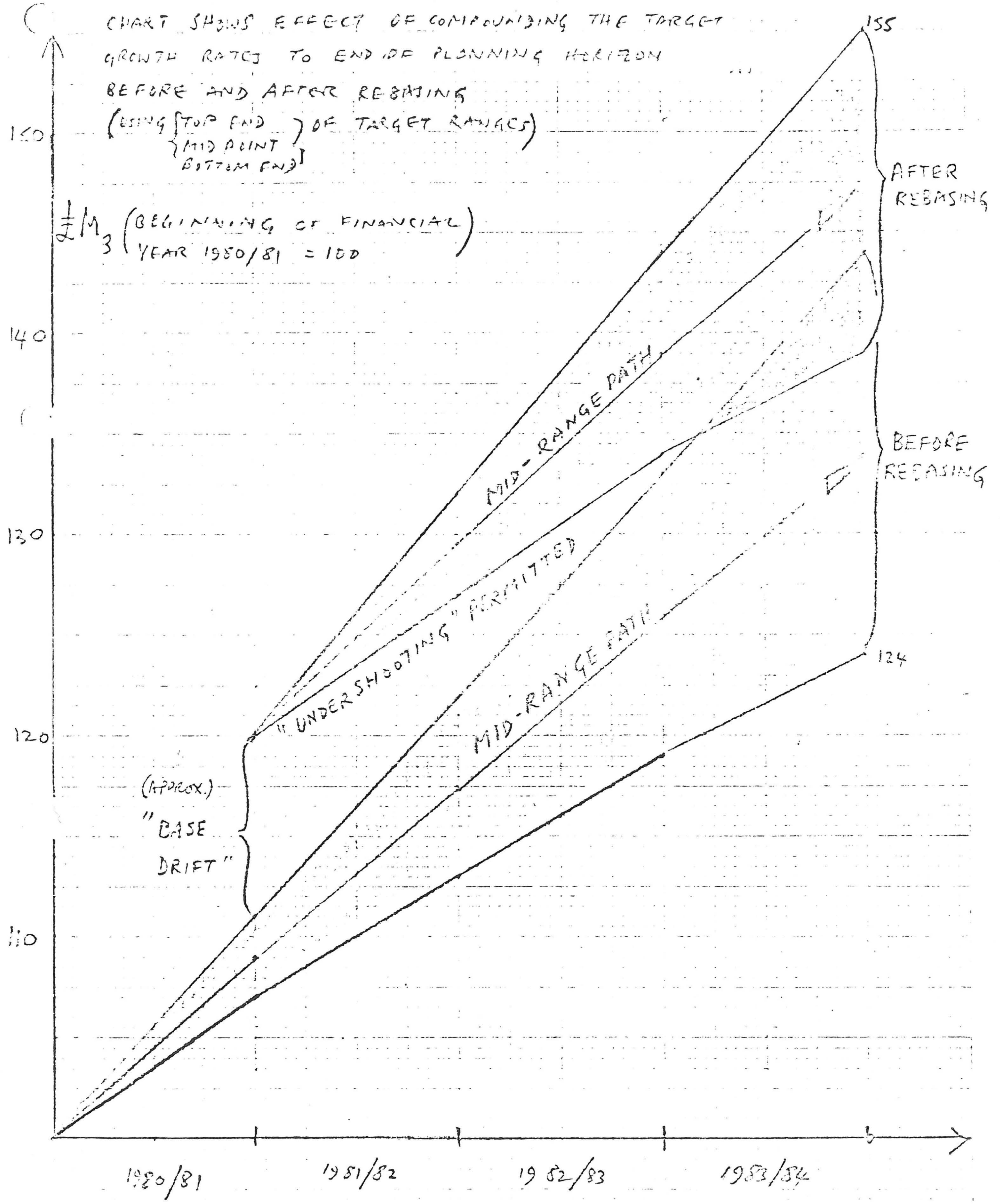


FIG 2 EFFECTS OF "REBASING" ON FUTURE TARGET LEVELS OF £M3



MTFS

TARGET GROWTH RANGES	7%–11%	6%–10%	5%–9%	4%–8%

OW THE MTFS HAS BEEN REVISED IN THE LIGHT OF 1980/81

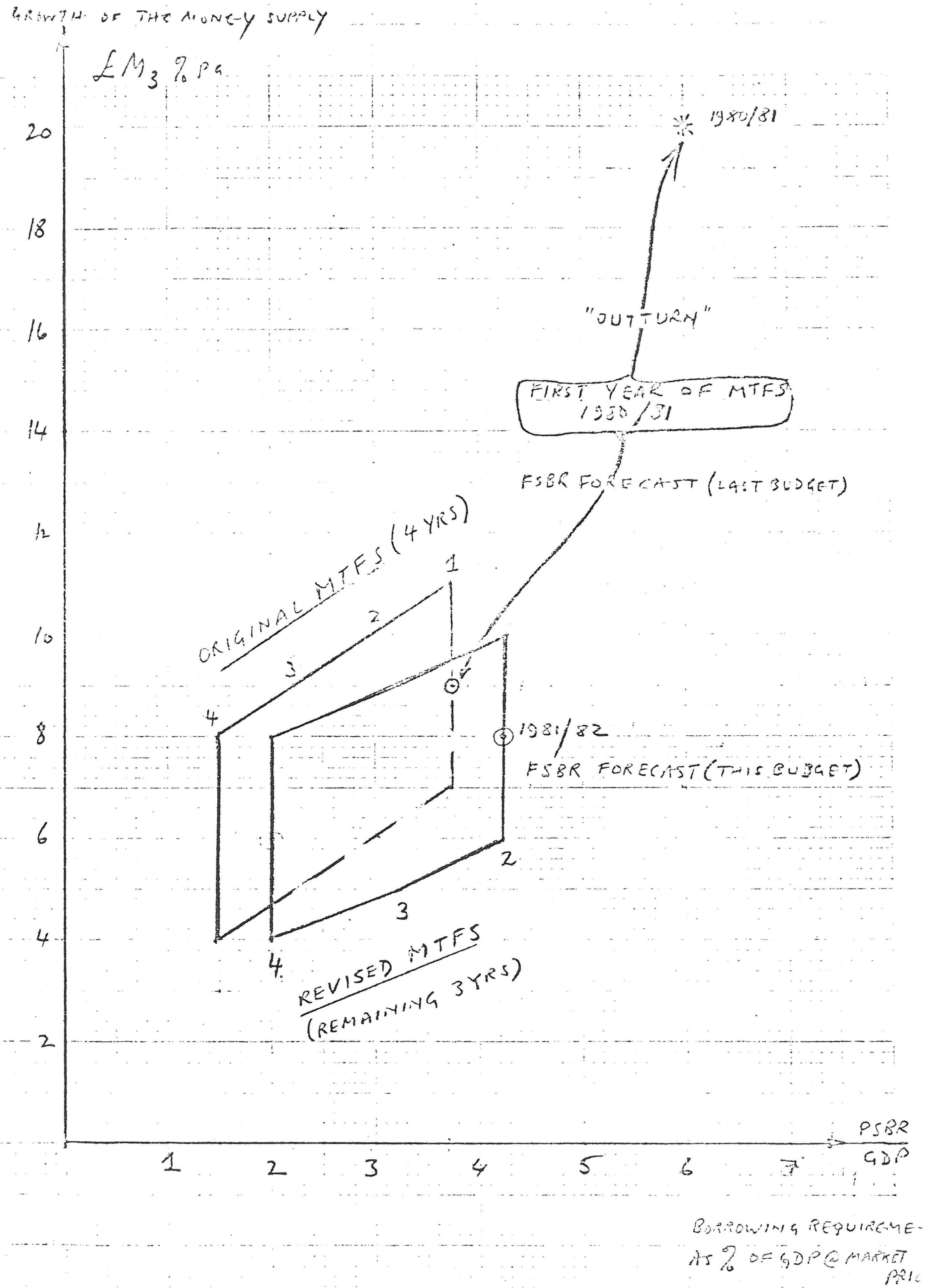
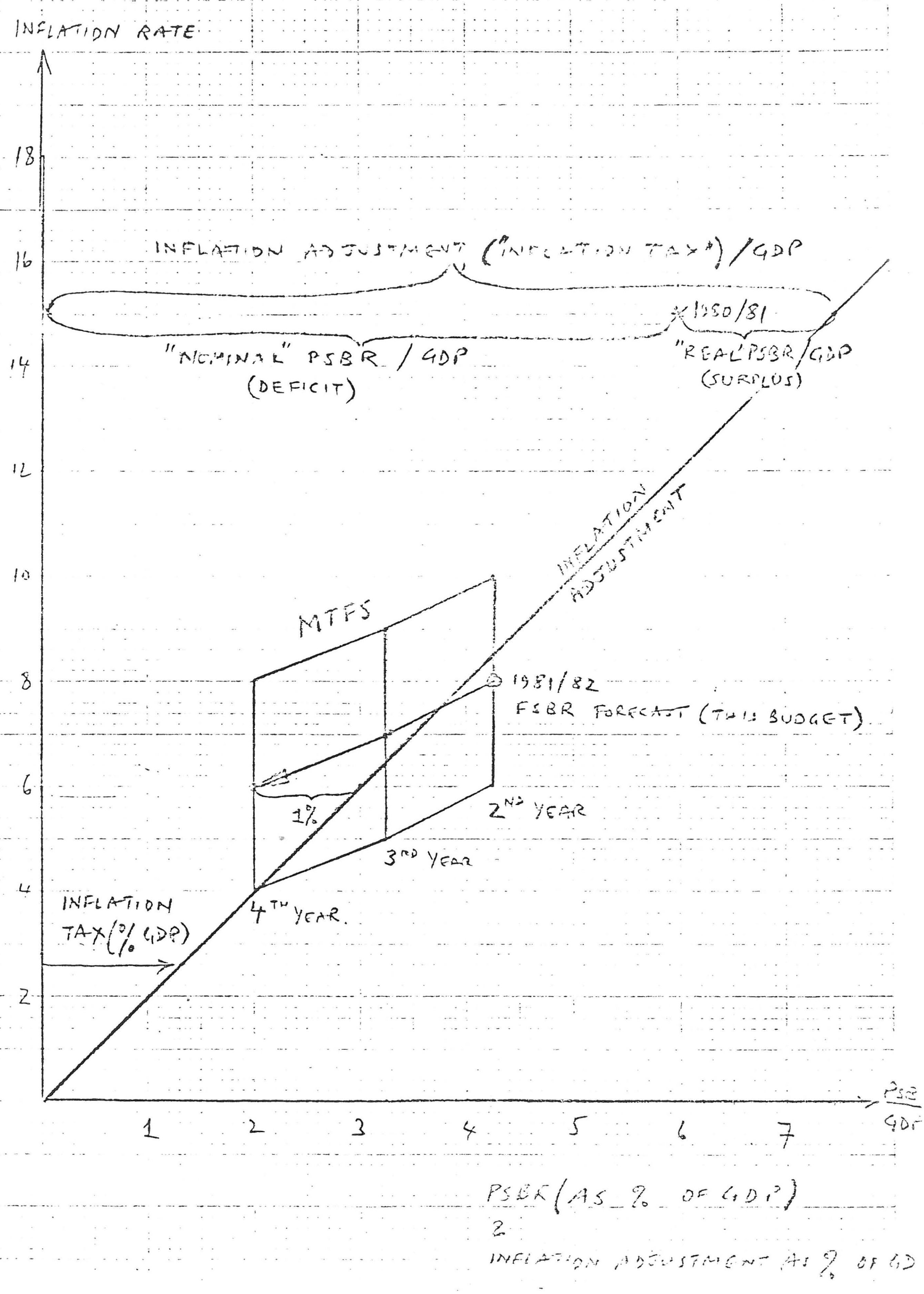


FIG 4. HOW THE MTFS PLANS TO OFFSET THE NOMINAL PSBR BY THE "INFLATION TAX"

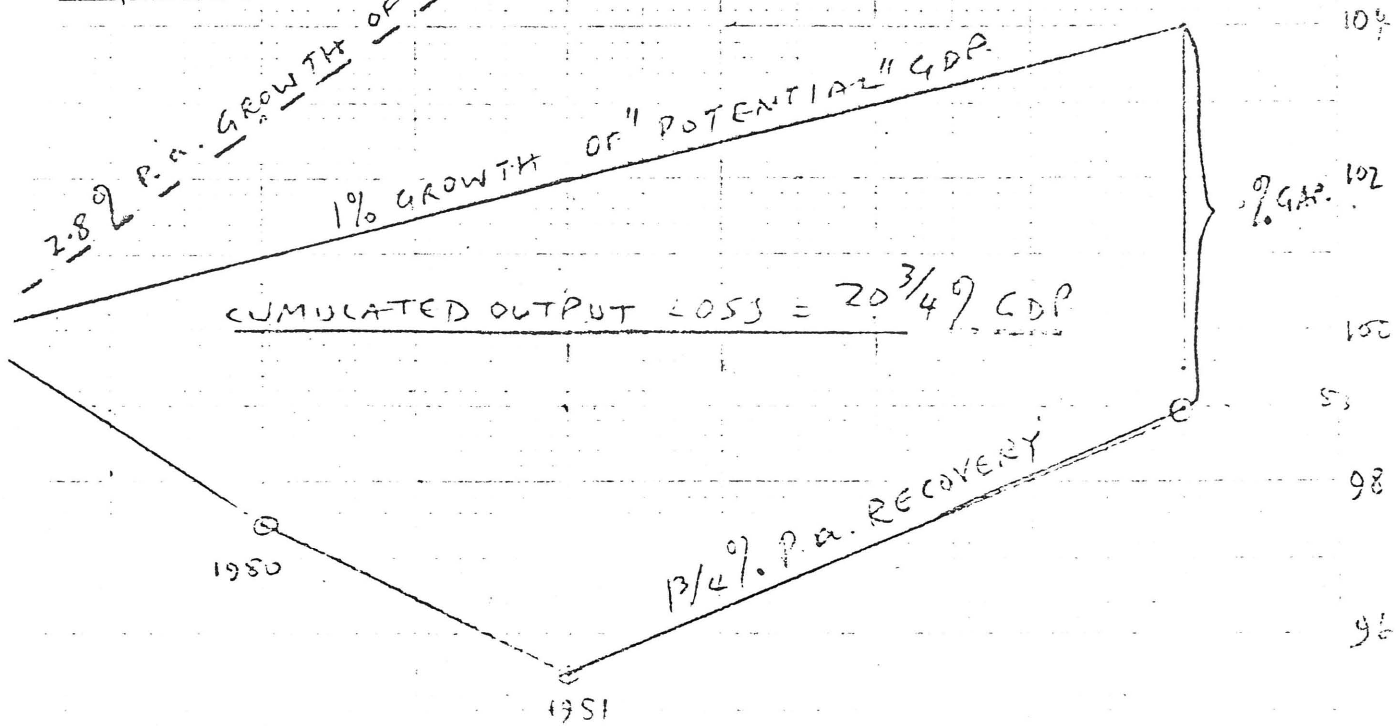


COSTS OF PRESENT ANTI-INFLATIONARY POLICY BY 1983

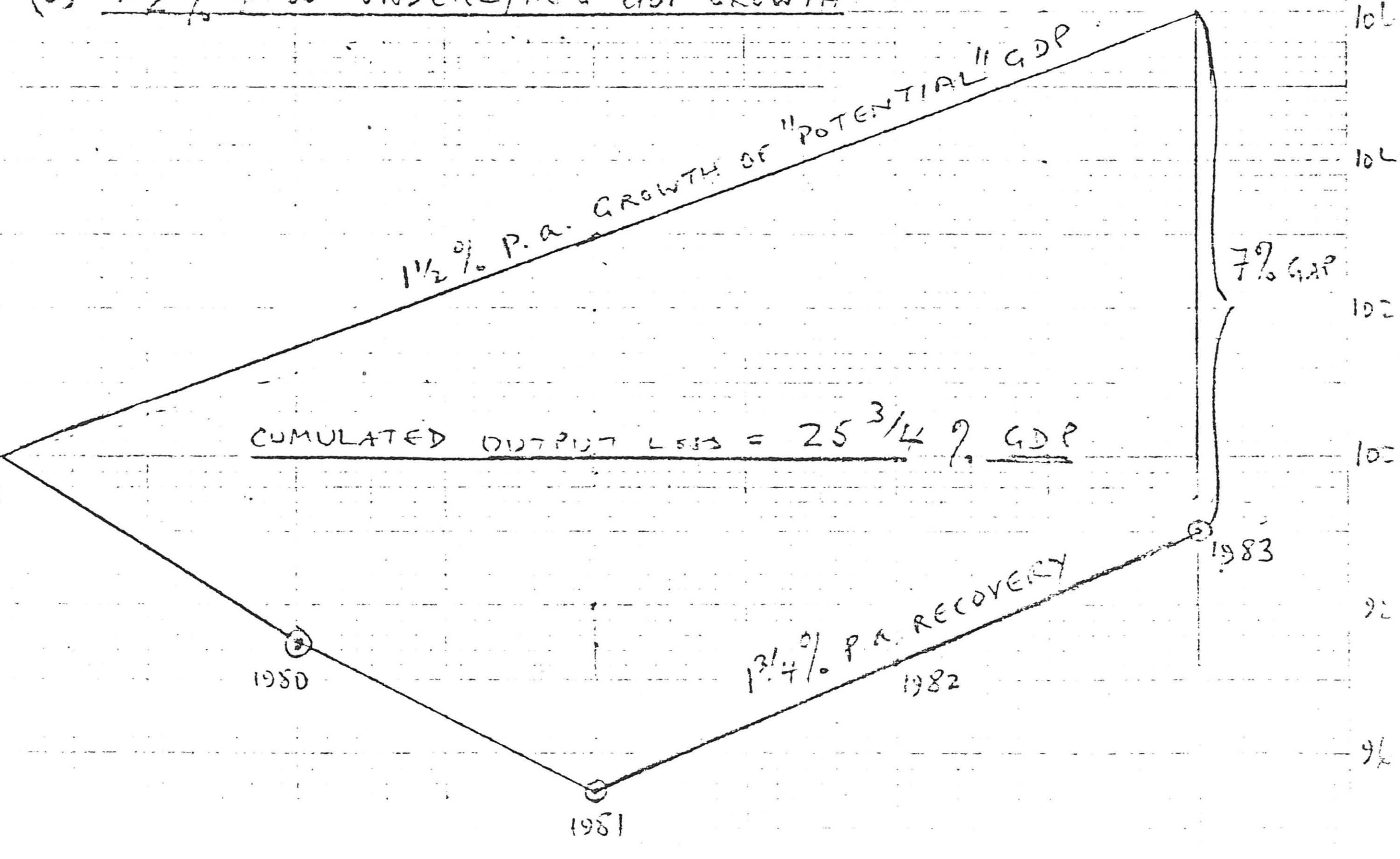
TWO DIFFERENT ASSUMPTIONS OF UNDERLYING GROWTH)

p.a UNDERLYING,
P GROWTH.

2.8% p.a. GROWTH OF 1950s & 1960s



(b) 1½ % p.a UNDERLYING GDP GROWTH



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I AGREED TO STAY WITH 25M

Govr

601 - 4444

xt 3121

- OIL COYS CHANGE PRICING VOLUNTARILY

16/3/81, 37

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
Sir Douglas Wass
Mr Burns
Sir Kenneth Couzens
Sir Anthony Rawlinson
Mr Ryrie
Mr Middleton
Mr Battishill
Mr Bridgeman
Miss Brown
Mr Burgner
Mr Cassell
Mr Evans
Mr Monck
Mr R Allen
Mrs Gilmore
Mr Folger
Mr Wren-Lewis
Mr Ridley
Mr Cropper
Mr Cardona

PS/Customs
PS/IR

TREASURY COMMITTEE: SESSION WITH OFFICIALS 4.15PM 18 MARCH

Messrs Battishill, Bridgeman, Cassell, Evans, Monck and I will be giving oral evidence to the Treasury Committee on the Budget on Wednesday afternoon. The purpose of this minute is to clear with you in advance the line we propose to take on a number of sensitive issues.

2. The ostensible purpose of our appearance is to provide factual and elucidatory comment on the Budget. Your own appearance on 25 March will be opportunity for the Committee to ask questions about the policy judgements that underlie it. However, as we know from experience, the dividing line between questions of "fact" and "policy" can be a very fine one - at least so far as some members of the Committee are concerned. And there are particular points on which the scope of officials' answers is bound to disappoint the Committee. As indicated above, therefore, this note sets out

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what seem likely to be the most sensitive areas and seeks your agreement to the line we propose to take. We may have to indicate in some cases that we cannot give fuller information and that if the Committee wish to press further, they must address their questions to you. But we shall obviously try not to be too flat-footed about it.

3. I accordingly attach as Annexes to this note speaking notes indicating the line we propose to take on seven particular areas:-

A: Unemployment assumptions and outlook.

B: Economic effects of the Budget.

C: Budget effects on Industry.

D: Heavy Fuel Oil Duty.

E: Distributional effects of the Budget and the burden of taxation.

F: Monetary targets, monetary control and interest rates.

G: MTFS: economic growth, medium term tax burden etc.

H: Public expenditure: further cuts and consulting/informing the Committee about the new system of cash planning.

4. We may also be questioned about the financial deficit of the company sector. You will recall that in a private session last summer the Committee pressed for forecasts of this (and much else) to be released to them as a matter of routine. In a subsequent "in confidence" letter to Mr du Cann you explained that you were unable to agree to that as the forecasts were so uncertain. If questioned about the immediate prospect for the company sector deficit we would propose to respond on the following lines:-

"In 1980, company sector deficit turned out less than a lot of people expected. For all companies, £4 billion in 1979, £1½ billion in first three quarters of 1980.

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Forecasts not published, partly because margins of error huge. But further destocking combined with slowdown in domestic costs and therefore somewhat better prospect for profits implies companies should not suffer large deficit in 1981."

5. I should be grateful to know whether you are content with the line we propose to take. If you have any points, they could be discussed at the meeting arranged with you tomorrow morning.

J B UNWIN
16 March 1981

A

40 A

ANNEX A

Unemployment Assumptions

1. The White Paper uses the broad working assumption that the wholly unemployed in the UK will average 2.6 million in 1981-82 (2.5 million in GB and .1m in Northern Ireland). This compares with 2.3 million in mid-February, seasonally adjusted. It implies a slower rate of increase than we saw last winter, which is consistent with the forecasts for GDP. For 1982-83 onwards the White Paper uses a working assumption of 2.8 million (2.7 million GB and .1m Northern Ireland). This is compatible with the GDP assumption used in the MTFS for the whole period 1981-82 to 1983-84, which, as the FSBR points out, is broadly in line with the current range of outside forecasts.

Will unemployment hit 3 million this year?

2. I hope not. Unemployment predictions are very uncertain and it would be misleading to be tied to any particular point figure. Actual numbers will, for example, depend on how many school leavers register in the summer. [The maximum number of school leavers registered in 1980 was just under 300,000 in July.]

[IF PRESSED

3. We would not expect the trend [if the seasonally-adjusted figures] of the main series [ie excluding school-leavers] to reach 3 million. Unemployment forecasts are subject to big errors and successive governments have not published them.]

B

4a B

ANNEX B

ECONOMIC EFFECTS OF THE BUDGET

Afraid we cannot offer any quantified assessment of the effects of the measures announced in the Budget. Artificial to look at them except in the context of policies and prospects as a whole.

2. If taken by themselves, the fiscal changes announced in the Budget can be described as restrictive. But the direct effects on demand in the short term would be likely to be substantially offset by other factors such as the fall in interest rates made possible by a lower PSBR, the lower savings ratio and a lower level of imports.

3. Budget measures must be related to wider policy stance and prospect. Tax increases are <u>partial</u> complement to additional spending over and above that assumed in MTFS a year ago (about £6 billion in cash). So looking at both sides of fiscal account tax increases in fact only meet just over half of extra 1981-82 spending. Again, unlike last year, financial year starts with underlying rate of inflation within new monetary target. Therefore mis-description to label overall fiscal and monetary stance as deflationary.

4. More meaningful to look at prospects as shown in Industry Act forecast. This shows that both total output and manufacturing output expected to pick up in second half 1981 and further in first half 1982. By first half 1982 total output could be 1% higher than year earlier. This will help limit rise in unemployment which already beginning to show some signs of easing off.

[IF PRESSED

5. The fundamental problem with estimates of the supposed effects of the Budget on output and unemployment is the potential unrealism of their starting point. The government's view, as explained by the Chancellor, was that to budget for a 1981-82 PSBR of £14 billion would have been irresponsible and unacceptable. With such a prospect the confidence of financial markets could well have been strained so much as to bring a

funding crisis. The interest rate effects suggested by a conventional economic model could thus be major underestimates.]

Have you done simulations of the Budget's effects?

6. Yes. Naturally Ministers have been advised of various simulation results. [As already explained] A good deal of judgment has always to be applied to these in assessing the economic effects of the Budget.

Can the Committee see the simulations?

7. Simulations carried out in the course of advising Ministers are not normally published. The Committee does of course have direct access to the Treasury model via the House of Commons Library.

C

CONFIDENTIAL

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ANNEX C

THE BUDGET AND INDUSTRY

CBI Estimates

(See attached CBI handout: 1 to 2% off GDP and 100,000 extra unemployed, £1 billion off non-North Sea iccs profits "next year" [1981-82 or 1982?])

1. [As already explained] It is misleading to produce precise estimates of the effects of the Budget in isolation. The alternative to action to reduce the prospective PSBR could well have been higher interest rates - not lower - and all assessments need to reflect that.

Composition of tax measures

2. Naturally the CBI and others would have liked more relief for business. But within the tight overall position there was simply not enough room to provide across-the-board help. However the great weight of the revenue-raising measures bears on persons, the North Sea and the banks rather than on the hard-pressed parts of industry and commerce. And some significant selective fiscal relief is going to industry. Ministers' judgment was plainly that it would not be feasible to hit the personal sector even harder to cover further relief for industry.

Arithmetic of help for businesses

Background figures

3. See separate note attached.

Line to take

4. Because of doubts about successfully modelling the consequences of some alternative approach which would have provided for a £14 billion PSBR, hard to be precise about the overall effects on industry. But there are undoubtedly measures of significant direct benefit:

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... first the benefits of lower interest rates - which the CBI have previously estimated [Budget Representations published 3 February] as worth £350m a year off "companies' annual interest charges on bank borrowings" for each 1% reduction. [NB £350m was always an overestimate of the net benefit which the CBI now seem to put at £250m per 1% - close to our own (confidential) estimate of £280m.] Interest rate reduction particularly valuable when more companies than usual are "tax-exhausted".

NB important to stick to these words

... second the improved stock relief scheme - minus the credit restriction - worth £180m in 1982-82, £400m in 1928-83 and £450m in a full year.

... third the energy measures - worth some £120m in 1982-82. Within this, new arrangements proposed by the electricity industry, for example, could benefit some large industrial consumers by up to 8% of their electricity costs.

... fourth the various other measures to encourage enterprise and small business. Much more significant than their revenue cost might imply. Nevertheless latter estimated at over £90m in a full year.

5. Of course businesses will pay more in excise duties following the Budget [NOT FOR USE: an estimated £700m in a full year assuming a non-indexed base, say £350m from a revalorised base] But looking at the direct effects, including those of the MLR change, there are still worthwhile measures of help for the hardest-pressed parts of business.

Indirect effects of "deflation"

6. [As already explained] it is misleading in the Government's view to label the Budget as "deflationary". The "indirect" effects of an excessive PSBR would certainly not have been in industry's long term interests. While the precise effects of the Budget itself are unknowable it is relevant that the government's forecasts show both GDP and manufacturing output turning up in the course of 1981.

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Arithmetic of help for businesses

Background note

1. The direct effects of the Budget fiscal measures [NB excluding changes in CTT and items like business start-up schemes where the relief flows to persons, though bringing benefit to business] affecting non-North Sea non-banking business are (all figures from FSBR):

	revenue cost/public expenditure (+) £m	
	1981-82	full year
stock relief	180	450
ceiling for CT small companies rate	12	21
industrial buildings allowance: increase to 75%	negl	25
CT extension of group relief	negl	25
relief for capital losses against investment companies' profits	negl	10
DLT	negl	2
VAT registration limits	5	10
total tax reliefs	197	539
petrol (say)	-320	-320
derv (say)	-270	-270
VED (say)	-100	-100
net tax relief (tax increase-)	-493	-151
gas and electricity	118	?(public spending consequences after 1981-82 undecided)
boiler conversion scheme (helps industry even though does not add to total public spending)	?	?
net direct fiscal relief (+)	-375	-151 +?

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2. Adding the (confidential) Treasury estimate of the effects of the 2% MLR change we get

	560 [700]*	560 [700]*
net direct Budget effect	175 [315]*	509 +? [649 +?]*

* figures in square brackets based (rather illegitimately) on CBI 3 February estimate of effects of interest rate changes on "interest charges on bank borrowings".

3. So, even allowing in full for the excise duty changes, the net direct effects of the Budget help non-North Sea non-banking business. But there are real dangers in attempting an overall assessment of this kind (eg interest rates may prove volatile over the year ahead) and its results should not be quoted.

Reconciliation with CBI figures

4. The above figures can be reconciled with the CBI figures (as attached) by making the following adjustments:-

	CBI figure for net extra 1981-82 "take" from companies	550
less	"excess" increase in employer NIC from April (tweaking of UEL?) which is not a Budget measure	-175
	net direct fiscal relief 1981-82	-375

(which is the total given in para 1)

5. The CBI handout assesses the net relief due to the MLR change at 500 (ie 250 per 1% point) as compared with the 700 (ie 350 per 1% point) given in their Budget representations as the effect on "interest charges on bank borrowings". The 250 per 1% point is near the Treasury estimate of 280.

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<u>Full simulation results</u>

6. Taking account of the indirect effects of the Budget on output, demand etc the MP2 assessment (Mr Burns' 9 March submission to the Chancellor) is that, working from an indexed base, the Budget as defined implies a £½ billion annual reduction in icc's disposable income less dividend payments, from 1981-82 onwards. From an unrevalorised base the effect might be a £¾ billion reduction. These model-based estimates are confidential and, for the reasons explained by Mr Burns, are potentially misleading.

CU
16 March 1981

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CBI Representations following 1981 Budget

1. The Chancellor drew attention to the imbalance between the fortunes of individuals and businesses.

2. He certainly hit individuals with failure to Rooker-Wise and with increases in specific duties twice the rate of inflation.

3. But he failed to give any net fiscal relief to business. On the contrary, the effect was to take away some £500-600 million from business generally, plus £400 million from the banks, plus £1 billion from the oil companies, making a total of nearly £2 billion. (See attached table.)
   If it were right to count the 2% cut in MLR as a Budget measure, this would be equivalent to a net relief of £500 million.

4. In the circumstances, the least we can ask for is the reinstatement of our demands for 2 points off NIS and abolition of Heavy Oil Duty. This would cost £1.3 billion in 1981/82, and increase the PSBR by £1 billion (allowing for the increase in revenue and reduction in expenditure resulting from the consequential higher activity), to £11½ billion instead of the Chancellor's estimated £10½ billion after the Budget measures.

5. This would be quite restrictive enough. The PSBR in 1980/81 is estimated by the Chancellor at £13½ billion. Allowing only for inflation, the corresponding figure in 1981/82 would be nearly £15 billion. (This allows nothing for the adverse effects of the deeper recession on government receipts and spending.)

6. We regard a cut to £10½ billion as excessive. Our preliminary estimates suggest that the Budget would reduce output by 1%-2% and increase unemployment by at least 100,000 next year; and reduce profits of individual and commercial companies (outside North Sea) by £1 billion or more.

7. We reckon that a PSBR of £11½ billion would be consistent with the Chancellor's target growth of £M3 of 6%-10% and with a continued fall in interest rates.

8. An alternative strategy to give business the same reductions in cost as the £1.3 billion tax concessions described in paragraph 4, by reducing MLR, would need a reduction of 5 percentage points. This would only be practicable if there were an effective campaign to cut current public spending substantially.

CBI
13 March 1981

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(1)

DIRECT EFFECTS OF BUDGET ON BUSINESS IN 1981/82

GIVE	£ million	
Stock relief	180	450
Small companies corporation tax rate	12	
Energy prices	118	
VAT; increase in registration limits	5	
	315	

TAKE		
DERV (100%)	270	
Petrol (35% of 910)	320	
Vehicle excise duty (45% of 225)	100	350x5
Employers' National Insurance Contribution (2)	[175]	
	865	
Less "GIVE"	315	
Net TAKE.	550	

PLUS - Oil	[1020]	
Banks	[400]	

(1) Excluding indirect effects through deflationary effects of Budget

(2) Announced in November. Excess over what necessary.

D

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ANNEX D

HEAVY FUEL OIL DUTY

/The Order Paper already contains probing questions about the relationship between the duty and gas price contracts, including questions from Mr Tim Eggar, a member of the Treasury Committee./

Line to take

/As provided by Department of Energy for general use./
There are a number of contracts for the supply of gas to the British Gas Corporation in which the gas price is linked to the price of heavy fuel oil (including duty). Heavy fuel oil has, in fact, for many years, been taken as one of the price markers in commercial arrangements for the supply of fuels generally.

The linkage in gas contracts varies considerably from contract to contract. Overall the effect of a reduction in heavy fuel oil duty would be to increase the cost of gas purchased by BGC and, with it also, our gas import bill to the point where the wider national interest would not be served by reducing the duty. We have therefore concentrated on providing assistance to industry on energy prices directly in addition to measures already recently implemented, such as restricting renewal prices for firm industrial contracts to some 70% of the related oil price; and tempering the price for new firm industrial contracts.

Details of individual contracts

Not for the Treasury to comment on gas purchase contracts. These are commercial matters which are confidential between BGC and the oil companies concerned.

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Why does not the gas price fall with reductions in the price of heavy fuel oil?

The details are for the Department of Energy.

/ If pressed. We understand that clauses in the various contracts are very varied: some have this simple relationship but others are more complex as far as fuel oil duty is concerned. Also, fuel oil duty is often only one of many elements involved./

How many contracts involved?

I believe there may be up to half a dozen.

Who negotiated the contracts. Were they approved by the Department of Energy. Were they reviewed by the Department?

A matter for the Department. /Or refer to the reply to Mr Eggar's question for 17 March if answered by then./

Were the Treasury involved?

Not to my knowledge. It would be most unusual for the Treasury to be involved when such contracts are negotiated.

What would be the extra cost of gas to BGC from reducing or abolishing the duty?

/Another of Mr Eggar's questions for 17 March./ This is a matter for the Department.

Renegotiation? What action to break the link with fuel oil duty?

/ Third of Mr Eggar's questions./

This is a sensitive commercial matter on which it would be unwise to comment. In any case, a matter for Department of Energy.

<u>But would not the Treasury support renegotiation?</u>

Depends on the costs and benefits involved. Many considerations: industrial costs; effect on gas prices; effect on imports; use of national resources.

E

ANNEX E. 53

DISTRIBUTIONAL IMPLICATIONS

Take-home pay reduced for everyone

True. But Budget must be viewed in the context of the rise in real personal incomes over the last three years when real output only marginally increased. Between 1977 and 1980 real after tax income of individuals rose by 17%.

Budget regressive

No. Including the non-indexation of income tax allowances and rate bands the largest cuts in real income fall on those with very high incomes.

/If pressed on details. Up to the top of the basic rate band, about £13,500, if married, the extra income tax, compared with indexation, is a flat amount of £99 . But above that the extra tax rises, both in cash and in proportion to net income. At £15,000 it is 2.5%; at £30,000 4.5%; at £40,000 4.8 %. This is the effect of not indexing the rate bands./

Indirect taxes

These are estimated to cut purchasing power by about 2% on average; for some people a little less, for others a little more, depending on expenditure patterns.

/If pressed on details. For most single people the cut is about 2%. For married couples the effect is rather sharper for those on below average incomes, and rather less than 2% for higher incomes. But the data on family spending is not very reliable at the top and bottom of the income scale./

Hits families

No. Families are helped by the 50p increase in Child Benefit from November which fully keeps pace with inflation. In proportionate terms this gives most help to families in low incomes.

Wouldn't it have been fairer if the Chancellor had fully indexed and paid for this by raising the basic rate?

This would have different effects at different points on the income scale. It would have benefited those on smaller incomes; but it would also have helped those on very high incomes - because of the indexation of the higher rate scale. But a large number of people on middle incomes would have been worse off.

/Only if the basic and higher rates had been increased to pay for indexation would the result have been generally more progressive./

Mr Robin Cooke's figures

As we understand it, these related to a family earning £3,500 and £15,000. Latter only just paying higher tax rate. At even higher earnings levels the decision not to index the allowance and rate bands means an even bigger proportionate cut in net income.

/If pressed offer following figures: extra tax from non-indexation.

Gross income	Income tax	% of net income
£ 3,500	£ 99	3.5
£ 7,000	£ 99	2.0
£15,000	£ 260	2.5
£20,000	£ 486	3.8
£30,000	£ 790	4.5
£40,000	£1028	4.8

Figures are for a married couple with only husband earning./

Sunday Times article/IFS figures

Mr Lipsey's figures are in line with what we would expect. No reason to doubt them; but cannot comment in detail without more information about his assumptions.

/One important point of detail. He includes the effect of higher NICs but omits the increases in pensions and child benefit. This would improve the relative position of the poorer families even more./

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Budget reverses move away from taxing income to taxing consumers expenditure

No, both income tax and expenditure taxes were increased in the Budget. But, allowing for forecasts of personal income and consumers expenditure next year, total taxes on consumers' expenditure actually expected to rise a little as a share of total taxation, not fall.

/Figures from FSBR table 19. Between 1980/81 and 1981/82:

Income tax yield increases by 14¼%
Customs and Excise taxes by 17½%
(including VAT)./

What if NICs included?

The increase in income tax and employees' contributions will be rather more than the increase in the tax on consumers' expenditure. But the difference is not large.

/Note: Figures are as follows:

		As % of GDP at factor cost.	
	I.T.	Employees NICs	Taxes on expenditure
1978/79	12.9	2.8	10.7
(est) 1980/81	13.1	3.0	12.7
(forecast) 1981/82	13.6	3.5	13.5

Budget hits incentives

For the bulk of working population marginal rates of income tax will be unchanged next year. They will be rather higher for people with very low and very high incomes. /Marginal rates will be generally higher if national insurance contributions are included; but the effect of this on incentives depends how people view NICs./

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<u>Won't everyone face higher marginal rates because of the increases in excise duties?</u>

There will be rather higher rates of tax on some kinds of expenditure (drink, tobacco, petrol etc) but the Government take the view that, for incentives, this is better than raising rates of income tax.

<u>Income tax burden greater than when Government came to power</u>

Not true as a general statement. A family with average earnings can expect to pay a smaller proportion of his earnings in income tax next year than in 1978/79.

/But at lower income levels, the burden of income tax will be higher than when the Government came to power. The break-even point for a married man is at 90% of real average earning's in 1978/79./

<u>Tax burden will rise. By what proportion of GDP?</u>

Too soon for precise figures. Depends on output, income and expenditure next year. /But could represent extra 2 or 3 points of GDP./

F

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CONFIDENTIAL

16/3/81

ANNEX F

MONETARY POLICY

Interest Rates: Criteria and Prospects

We shall do our best - by stressing continuity between the Green Paper of March 1980, the MLR cut in November 1980 and the Budget Speech and by making a virtue of flexibility and judgement as opposed to rigid and automatic rules - to prevent the sensitive points from becoming apparent. But if pressed hard, we may not succeed in this. The points which may emerge are these:

a. As the many monetary indicators and factors affecting their significance mentioned in the Budget Speech as relevant to interest rates point in different directions, we cannot say in advance which will be given most weight or how interest rates will be set. An allied point is that although the Government intends and expects to achieve the £M3 target, the commitment to do so is not absolute;

b. although the Government hopes that a future reduction in interest rates will be compatible with the new monetary target, it may not turn out to be so and nothing can be said that rules out the possibility of an increase in interest rates.

2. The attached passages indicate the proposed line including, in square brackets, possible fall-back supplementaries.

Clawback of 1980-81 Over-run

3. We have no clear policy on the circumstances in which clawback would be attempted.

Monetary Control

4. The potentially sensitive points are the slow progress since November and the absence of any decisions on our destination and on whether MBC in any of its forms is a serious candidate. We shall of course make a virtue of the evolutionary approach. We propose also to suggest that the obvious next step would be some widening of the band within which short term interest rates would be allowed to move.

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CONFIDENTIAL

PROPOSED LINE ON MONETARY QUESTIONS

Criteria for Interest Rates

"The Chancellor said that decisions about short term interest rates would continue to take account of the whole range of monetary indicators and other factors that affect the significance of the numbers, especially the progress of inflation, [the effect on real rates of interest, the external pressure exerted by the level of the exchange rate]. Within this range of indicators the past and prospective movement of £M3 in relation to the target will generally be the primary factor. But we shall be monitoring the others. [They will be particularly important if £M3 seems to be diverging from the target and also from the other indicators. If there is such a divergence, the first question we shall need to consider is the reason for it and the relevance to it of a possible change in interest rates. It is not possible to say in advance of a particular situation what judgement the authorities will make. This is not a field where mechanistic rules, whether simple or complicated, make sense]."

Prospects for Interest Rates

"MLR has come down by 5 points from 17% to 12% since the summer and short rates are now lower than equivalent rates in Germany and the USA. Ministers want interest rates to come down further if possible. The Budget measures and the funding innovations increase the chances of that but interest rates must depend on the Government's overall assessment of monetary conditions".

Clawback

"It is impossible to foresee the exact circumstances in which clawback would be desirable [enough for interest rates to be set higher than would otherwise be needed]. But the situation would probably be one where continued reduction of inflation seemed jeopardised either by monetary developments or by other factors [such as a fall in the exchange rate]."

CONFIDENTIAL

Monetary Control

"Some of the changes outlined in November have already been made, for example in the Bank's market operations in bills. This gives the market a greater influence over the structure of interest rates for maturities over one month. Other changes desirable in themselves include the end of the Reserve Asset Ratio as a minimum requirement which will come about as soon as the Bank's current round of discussions on monetary control are complete. This will help to avoid round-tripping.

The changes would be compatible with monetary base control. But no decision has been taken on whether to move in the direction [or on which form of MBC seems most promising]. No decision is likely to be taken until the arrangements described in November have been in operation long enough for them to be assessed. It is right to proceed in this way because changes in control can go badly wrong as "Competition and Credit Control" demonstrated clearly. One possible development after the next stage would be a widening of the band within which interest rates could vary. [The size of the band now envisaged has not been decided/stated.]"

G

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ANNEX G

MEDIUM-TERM ISSUES

Growth Assumption

The assumption in this year's FSBR is for growth of ½ per cent per annum between 1980 and 1983. This is a working assumption made for calculating the projections of government revenue, expenditure and borrowing. Though not itself a forecast it falls within the range of recent outside forecasts. The lower growth for the medium-term than assumed in last year's FSBR reflects the deterioration in prospects for the period immediately ahead: GDP in 1981 is now expected to fall by about 2 per cent, compared with the ½ per cent fall expected a year ago. Average growth between 1981 and 1983 is therefore by implication 1¾ per cent a year. [This means that the latest projections assume a rather sharper cyclical movement in output than was assumed last year.]

Sources of Growth in the Medium-Term

Before answering the specific question on the sources of growth in the medium-term it is worth emphasising three points. First the FSBR does not include a forecast of growth beyond the short-term. There is a working assumption on growth in order to calculate the medium-term projections of government revenue, expenditure, and borrowing, but no attempt to predict the precise timing or extent of movements in GDP after the first half of 1982, still less the precise composition in terms of categories of expenditure, output, or income of such movements. Second there has in the past been a tendency by forecasters to underestimate the cyclical fluctuations in output. Third though it is customary to talk about growth prospects in terms of the main categories of final expenditure, it is essential to look at the constraints on supply as well, and in particular to examine the factors that are likely to influence companies' output decisions.

The forecast movements in the main categories of expenditure over the period to mid-1982 are shown in Table 11 of the FSBR. We would expect the recovery in output to reflect the end both of destocking and of the cyclical downturn in investment; some fall in the savings ratio as consumers respond to lower inflation; the effect of lower interest rates and an improvement in corporate profitability; and an eventual improvement in trade prospects as world trade recovers and the economy becomes more fully adjusted to the high value of sterling and the recent loss of competitiveness.

A large run-down in stocks was the major factor contributing to the fall in output last year, and we foresee continued destocking during the current year, though at a declining rate. But by 1982 we would expect the adjustment to be more or less complete. Even if there is little addition to stocks in 1982, the fact that they are no longer being run-down will mean that the major contractionary force in the economy will have ceased to operate. Similarly, one might expect the cycle in fixed investment to have run its course, though the depth of the current recession suggests that the recovery in fixed investment may be somewhat later than the recovery in stockbuilding.

As one gets beyond 1981 there should also be some more positive influences at work. World trade should be rising more quickly than this year. With lower inflation consumers will find that the real value of their financial wealth is less rapidly eroded, so that one might expect some reduction in the savings ratio. Companies will find that the pressure on their profit margins is eased as the prices of inputs rise less rapidly, and this could be an important influence on output of many firms. One possible interpretation of the recent fall in output is that firms whose profit margins have been squeezed - in all sectors of the economy, not just the trading sector that has been affected by the loss of competitiveness - have been forced to reduce their output. As margins recover output should rise again. The recovery in output should also be helped by a reduction in nominal interest rates. The expansionary effect of lower interest rates is difficult to quantify precisely; but it could be considerably stronger than is represented in most macroeconomic models including the Treasury's.

Q. What is the personal tax burden implied in the revenue and expenditure projections for 1983-84?

A. The direct tax burden on persons will of course rise substantially in 1981-82. Thereafter its course will depend on several factors, in particular the growth of the economy and the level of public expenditure. The projections published in Table 8 of the FSBR suggest that on present expenditure plans and growth in the economy averaging the assumed $\frac{1}{2}$ per cent a year over the period 1980-83 there should be some room for tax cuts in 1983-84. [If pressed: If these wholly took the form of reductions in the basic rate of income tax, this would be equivalent to about $3\frac{1}{2}$p off.] As the FSBR says, in broad terms the fiscal adjustment implied for the later years would do no more than offset the rise in the personal tax burden in 1981-82.

Q. Is the implied tax burden on persons higher in 1983-84 than when the Government came to office?

A. In terms of income tax the burden should be lower. In terms of total taxes - direct and indirect - and contributions paid by persons it would on present expenditure plans be higher.

[Note: The personal tax burden is defined here as income tax as a percentage of personal income. On this definition, the implied reduction in 1983-84 just about offsets the real increases in 1980-81 and 1981-82 and gets the ratio below its level in 1978-79. If National Insurance contributions were included the implied tax burden in 1983-84 would be about the same as in 1978-79. If VAT, specific duties and local rates were also included, the tax burden would be much higher than when the Government came to office. We would not propose to give figures for this - but it would be difficult to refuse to answer qualitatively if asked.]

We shall also be preparing short technical briefs on assumptions used in constructing the projections of National Insurance flows, the Relative Price Effect, and the North Sea revenues.

H

ANNEX H.

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H. Public Expenditure

1. Further cuts

What further cuts has the Government in mind?

Line to take

The Government has not decided yet whether there should be cuts, or what they should be.

Decisions are a matter for the annual review.

However the White Paper gives figures for the planning totals which are higher than Government had originally hoped. The MTFS shows that these are difficult to reconcile with objectives for taxation. Hence need to look again carefully at possibility of further reduction.

NB. Decline to give any examples.

Key Quotes

White Paper (Cmnd 8175)

> "The totals in 1980-81 and future years are higher than previously expected and higher than the Government would wish in the light of their financial and economic objectives. The Government regard this development as one which requires the most serious attention during the 1981 annual survey, when the plans for 1982-83 onwards will be reviewed."

Budget Speech

> "Our decisions for the future are designed to ensure that the volume of spending falls after 1981-82. The public expenditure White Paper shows a planned fall of 4 per cent. by 1983-84. Whether we can spend even on that scale must depend on how far we can afford to do so. During the annual review later this year we shall be looking hard at the possibility of further reductions in those plans." (10 March, Col 767.)

Chief Secretary

"None the less it is disappointing that the recessionary effects and other increases have meant that even in 1983-84 we shall not have secured all the reduction in spending that we had hoped for last year, so we shall be having a very careful look in the coming annual survey to consider whether more can be done to offset the increases that have occurred and make more progress towards our original targets over the next three years." (11 March, Col 927.)

FST (Weekend World)

"Spending departments will be asked for suggestions, at least in first instance."

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H2. Cash Planning System

Possible Questions:

What form will it take?
Will the Select Committee be consulted about it?

Line to take

(i) The changed system

The Government has taken decision in principle to switch to cash, particularly as the basis for decisions on the focal year - 1982-83 in the coming survey.

The exact way in which this will be applied is now being developed as part of the usual preparatory work on the 1981 survey. Chief Secretary may have more to say in debate on PEWP.

The advantages to be gained were those set out by Chancellor:

(a) change whole framework of decisions to bring in availability of finance;

(b) remove implicit presumption of carrying forward volume plans intact;

(c) increase cost consciousness, accountability and flexibility in management of programmes.

It will not make major cuts any easier. But it will provide a more relevant framework for decisions.

This is not a shift from Plowden concepts of looking at totality of expenditure, relating it to the economy and economic objectives, and taking account of implication of decisions for more than the year ahead.

Concept of volume only planning now inappropriate given inflation, and emphasis on finance in economic management. Cash limits were first recognition of need to change. This change will carry that through.

(ii) Consultation with the Committee

The form of the system within Government is a matter for Government: it is essentially a question of the way in which material is assembled for decision by Ministers. (It is not for the Committees.)

We will be consulting others in the public sector; - local authorities and nationalised industries: eg the implication for work in the Expenditure Groups of the Consultative Council.

The form of the Public Expenditure White Papers has tended to reflect the survey process. Ministers will certainly want the White Paper to reflect the new system and emphasis on cash. They will probably want to tell the Committee what changes in the White Paper they have in mind, somewhat nearer the time.

17/3/81.

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MR CASSELL

cc Mr Burns
Mr Middleton
Mr Battishill
Mr Bridgeman
Miss Brown
Mr Evans
Mr Monck
Mr Sedgwick
Mr Folger
Mr Ridley

also for information

Principal Private Secretary
PS/Chief Secretary
PS/Financial Secretary

PAPERS TO THE TREASURY COMMITTEE

I attach copies of two papers (received last evening) submitted by Terry Ward and by the EIU to the Treasury Committee.

2. At a quick glance through they seem to me to be on predictable lines and not to raise many issues which we have not expected to be raised. I do not recognise, however, some of the figures in the Terry Ward note and we shall need to look further at these.

3. Particular points that struck me were:-

Terry Ward:

- capital/current breakdown (what is the answer to his debating point in paragraph 9?);
- nationalised industries turn-around (paragraphs 10 and 11);
- questioning of assumption about £M3 velocity (paragraph 16);
- scepticism on assumption of upturn in 1981 (paragraph 21).

EIU:

- credibility of expenditure plans and in particular nationalised industries' figures (paragraph 2);
- reference to Treasury "internal forecasts" for medium term and criticism of projections as being optimistic (paragraphs 7 and 8);

- prediction of 3 million unemployed on narrow definition by end 1982 (paragraph 9);

- questioning of denial that excessive £M3 growth in 1980 will lead to higher future inflation (paragraph 12);

- criticism of MTFS PSBR "targets" and PSBR/interest rate relationship (paragraphs 16-18).

4. I am trying to contact Mr Hubback to find out whether there are more papers to come.

J B UNWIN
17 March 1981

PS. I also attach two papers just received (TR(Sub TX)29 and TR (Sub TX)) on the tax implications of the Budget. I have not yet had time to read but at a quick glance they seem more suitable for discussion in the Sub Committee with the Revenue Departments present.

TR(Sub TX)29

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It would be most helpful if
[illegible] could complete the figures
for wine in Table 2. (PQ
answers refer to written correspondence
on the subject.)
Members will probably ask for
answers to the questions raised
in paras 5 & 6.
John Hills

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TREASURY AND CIVIL SERVICE COMMITTEE

Some Tax Implications of the 1981 Budget and Associated Measures

A. The Overall Impact

1. I attach a paper (TR(Sub TX)28) prepared by the Institute for Fiscal Studies describing the overall effect for basic rate income tax payers of the decision not to index tax thresholds, the increases in indirect taxation and the increase in National Insurance Contributions. Their analysis shows a sharp increase in the proportions of marginal income paid in direct and indirect taxes by different households (comparing the situations after the 1980 and 1981 Budgets) and a sharp fall in the value of the "tax credits" implicit in the tax system. In other words the changes both reduce the value of additional earnings ("incentives") and reduce the progressivity of the tax system.

2. As Kay and Morris also point out the decision not to index the thresholds for higher rates of tax will have hit those on the highest incomes disproportionately. The effect of the Budget is therefore worst for those at the top and bottom of the income distribution.

B. The Poverty Trap

3. The decision not to index personal allowances will, when the social security system is uprated in November, widen the "poverty trap" (the earnings range over which families can face effective marginal tax rates of near or above 100%). The 1% increase in the rate of National Insurance contributions now taking effect will deepen the poverty trap.

4. It is not possible to give a precise picture of what the poverty trap will look like in November until the DoE announces the uprating of the rent and rate rebate system. However, if one

assumes that it will be uprated by 9% in line with the Supplementary Benefit scale rates[1] it is possible to give an estimate. A couple with two children in receipt of Family Income Supplement and rent and rate rebates would face effective marginal tax rates of 104.25% over the weekly earnings range £42 - £72.48 and of 99.25% from £72.48 - £82. This would mean that they would be better off by £1.23/week earning £42 rather than £82. (The picture is worsened if they lose free school meals when earnings exceed their FIS "prescribed limit" of £82.) The equivalent figures for the worst part of the poverty trap in previous years are shown in Table 1.

Table 1 The Poverty Trap 1978-81 November 1981 prices[1]

	Earnings range where subject to income tax and FIS clawback	Gain in net disposable resources[2] over that earnings range
November 1978	£43.84 - £74.50	+ £0.66
November 1979	£44.17 - £76.84	+ £0.40
November 1980	£45.22 - £81.40	- £0.75
November 1981	£42.00 - £82.00	- £1.23[3]

1 Deflating by RPI, assuming 10% increase November 1980-November 1981

2 Earnings + FIS + Child Benefit - Tax - National Insurance - Rebated rent and rates.

3 Assuming rebate system is uprated by 9%.

(Table is calculated for a married couple with two children, a single source of earned income and assuming that they pay average England and Wales rent and rates and claim rebates. November 1981 rent is taken to be £11.59 and rates as £4.65.)

C. The Number of Income Tax Payers

5. The Budget Statement did not contain an estimate of the additional number of income tax payers resulting from the combination of unchanged tax thresholds and rising money earnings.

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1 So that the "needs allowance" for a couple with two children becomes £77.28/week and the "earnings disregard" £10.46/week.

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When personal allowances were increased by about 18% in 1979/80 the Chancellor described this as keeping 1.3 million people out of income tax. The failure to uprate by about 15% might therefore bring an extra million or so people into taxation. The Government must have an estimate of the number of income tax payers in 1981/82 in order to have estimated income tax revenue. To establish the effect of non-indexation one needs to know what the number <u>would have been</u> if indexation had been carried out. (With falling inflation this would have been somewhat below the 1980/81 figures, provisionally given as 21.3 million single people and married couples and 4.8 million taxpaying wives in Table 1.2 of Inland Revenue Statistics 1980.)

6. It would also be interesting to know what the effect on the Inland Revenue's manpower requirements of what may be a 4-5% increase in the number of income taxpayers.

D. <u>Indirect Taxes</u>

7. Table 2 shows the change in the value of indirect taxes (VAT and specific duties) on cigarettes, alcohol and petrol since 1966. It can be seen that the increased duties announced in the Budget more than compensated for estimated inflation between April 1980 - April 1981 for all items but with greatest effect on cigarettes, beer and petrol. Over the period 1966-81 only the indirect taxes on beer and petrol have kept pace with inflation whilst the real value of the indirect taxes on spirits has almost halved.

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Table 2. Post Budget Indirect Taxes 1966-81 at April 1981 prices[1]

	Cigarettes[2]	Whisky[3]	Beer[4]	Petrol[5]	Wine[6]
1966	76.2	8.95	20.5	85.7	
1969	75.5	9.22	19.7	96.4	
1972	61.4	7.51	16.0	78.4	
1975	64.7	6.24	16.7	82.5	
1978	57.7	5.16	14.8	63.6	
1979	57.4	4.96	16.5	66.9	
1980[7]	57.4	4.72	16.3	69.5	
1981	67.0	4.92	19.2	83.0	

1 Excise Duty + VAT. Deflated by RPI assuming 10.4% increase April 1980-April 1981.

2 Pence per 20 king size.

3 £ per popular brand standard bottl

4 Pence per pint.(o.s.g. 1037)

5 Pence per gallon of 4 star petrol.

6

7 June figures except for cigarettes which is August.

Sources: Reports of Customs & Excise; Kay and King 'The British Tax System'; Institute of Petroleum; DE Gazette.

8. The opprobrium which successive Chancellors have suffered from increasing these taxes by less than inflation is explained by the nature of the specific duties, mostly being set in cash amounts for particular quantities of dutiable goods. It would be interesting to know what the objection, apart from the numerical size of the tax rates, to moving to an ad valorem basis[1] would be: part of the tax on cigarettes is on this basis, so there would not appear to be a fundamental objection to this principle. If all indirect taxes were ad valorem Budget Statements would only contain announcements of changes in real indirect taxes. Also the taxes would gradually increase over the year rather than in sudden jumps.

no prices of factor inputs to dutiable goods move very differently from ~~rest~~ inflation - generally

1 For instance the duty on petrol is now about 62.8p/gallon and VAT is charged at 15% on the price including duty. With a retail price of £1.55/gallon including VAT this gives a total indirect tax of 83p/gallon. The same effect would be achieved with a single ad valorem tax at a rate of 115.3%.

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Table 2. P[illegible]get Indirect Taxes 1966-81 at Apr[illegible] prices[1]

	Cig[illegible]tes[2]	Whisky[3]	Beer[4]	Petrol[5]	W[illegible]
1966	[illegible]	8.95	20.5	85.7	
1969	[illegible].5	9.22	19.7	96.4	
1972	61.4	7.51	16.0	78.4	
1975	[illegible]	6.24	16.7	82.5	
1978	57.[illegible]	5.16	14.8	63.6	
1979	57.4	4.96	16.5	66.9	
1980[7]	57.4	4.72	16.3	69.5	
1981	67.0	4.92	19.2	83.0	

1 Excise Du[illegible]T. Deflated by RPI assuming 10.4% [illegible]ase April 1980-[illegible] 1981.

2 Pence per [illegible]g size. [illegible]3 £ per popular brand [illegible]ard bottle.

4 Pence per [illegible](o.s.g. 1037)5 Pence per gallon of [illegible] petrol.

6 [illegible] 7 June figures except [illegible]igarettes which is August.

Sources: Repo[illegible]f Customs & Excise; Kay and King '[illegible]ritish Tax [illegible]em'; Institute of Petroleum; DE Ga[illegible]

8. The opp[illegible]m which successive Chancellors ha[illegible]ered from increa[illegible]ese taxes by less than inflation [illegible]ined by the natur[illegible]the specific duties, mostly being [illegible]ash amounts for [illegible]ular quantities of dutiable goods. [illegible]ould be interesti[illegible]now what the objection, apart fr[illegible] numerical si[illegible] the tax rates, to moving to an *ad* [illegible]m basis[1] would [illegible]rt of the tax on cigarettes is on [illegible]asis, so there wou[illegible] appear to be a fundamental object[illegible] this principle. [illegible] indirect taxes were *ad valorem* B[illegible] Statements [illegible]ly contain announcements of chan[illegible] real indirect ta[illegible]lso the taxes would gradually inc[illegible]over the year ra[illegible]an in sudden jumps.

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1 For insta[illegible] duty on petrol is now about 62.8[illegible]n and VAT is char[illegible] 15% on the price including duty[illegible] a retail pric[illegible] £1.55/gallon including VAT this g[illegible] total indirect ta[illegible]83p/gallon. The same effect would[illegible] achieved wi[illegible]single *ad valorem* tax at a rate of [illegible]%.

E. Granny Bonds

9. The extension of "granny bond" eligibility to those aged over 50 means that prospective purchasers are more likely to be taxpayers, especially that they will face tax rates above the basic rate. (Pensioners not only have lower incomes but also receive age allowance.) On normal bonds tax is paid on nominal interest receipts; not tax is paid on the equivalent gain in nominal redemption value of granny bonds. Issue of granny bonds therefore leads to a "tax expenditure" equivalent to the tax which would have been paid on this increase. It would be interesting to know what the cost will be: if nominal interest rates and inflation were both 10% and basic rate taxpayers bought up £1 billion worth of granny bonds the yearly tax expenditure would be £30 million. The tax expenditure will be higher the greater the proportion of higher rate income tax payers taking up the issue.

F. Stock Relief

10. In November 1980 the Inland Revenue issued a Consultative Document on Stock Relief for Corporation Tax. At the time it appeared that the document was only "consultative" to the extent that some minor technicalities had not been decided. I circulated a note on the proposals (TR(Sub TX)22) and press comment on them (TR(Sub TX)26). One of the most criticised aspects of the proposals was the idea of a "credit restriction" on relief available to heavily geared companies. In the Budget Statement the Chancellor responded to comment on the original proposals by announcing that the credit restriction would not be introduced. (Although he did say that it would be "reviewed in the context of other possible changes in the promised corporation tax Green Paper".) In the event therefore the paper on stock relief did lead to meaningful consultation.

16th March 1981 John Hills

The Impact of the 1981 Budget

This paper uses a simple framework for analysing the tax system as a whole to see the overall impact of the 1981 budget. The basis of the procedure is to examine the relationship between incomes and tax paid for all taxes, so that we describe the whole tax system in a single schedule analagous to the income tax schedule, with a basic rate of tax and a 'tax credit' equivalent in value to the basic allowance. It is the overall tax schedule which, we believe, determines both the distributional and incentive effects of the tax system. The method is described in more detail in the article by Kay and Morris in the Nov* 1979 issue of Fiscal Studies. We have extended the analysis to cover the period since 1978-79.

The principal conclusions we reach are as follows:
(i) prior to the last budget, the real burden of taxation on all basic rate taxpayers was slightly higher than in 1978-79, and the distribution was very slightly less progressive.

(ii) the present budget greatly increased these trends. For a single-earner couple, the marginal rate of tax - the proportion of additional earnings absorbed in tax of all kinds - is now about 57%. This is around 2½% higher than before the budget or in 1978-79. It is the size of this figure which determines the disincentive effect of taxation. Slightly less than half of this effect is due to national insurance contributions - petrol tax - direct or indirect - is responsible for much of the remainder.

Thus disagree

(iii) the distribution of tax bills is now significantly less progressive than before the budget, or in 1978-79. This is mainly because of the effects of income tax and tobacco duties; the failure to index personal allowances hits low earners disproportionately as does the rise in taxes on tobacco (since tobacco consumption is virtually unrelated to earnings).

& the highest earners.

(iv) as a qualification to (iii), it should be noted that our analysis relates only to basic rate taxpayers. The failure to index thresholds also had a disproportionate effect on higher rate taxpayers. Thus the overall distributional effect of the budget was to redistribute from both top and bottom to the middle.

The table below illustrates the analysis for a single earner couple. The appendix shows what has happened to other household types and over the whole period since 1978-79.

16th March 1981

J.A. Kay and
C.N. Morris

* A copy of part of the article is attached.

Table 1

The Effect of the 1981 Budget : Single earner couples

	Before the Budget		After the Budget	
	Tax Credit (£)	Marginal rate (%)	Tax Credit (£)	Marginal rate (%)
Income Tax	615	24.2	615	24.2
NI	-	5.9	-	6.8
DIRECT	615	30.9	615	31.0
VAT	83	5.6	83	5.5
Petrol	38	1.1	55	1.6
Drink	3	1.5	4	2.0
Tobacco	-162	-	-215	-
Housing	-62	1.1	-62	1.1
Licences	15	0.4	18	0.5
Intermediate	-42	2.6	-53	3.2
INDIRECT	-126	-12.3	-170	13.9
Employer NI	-	12.0	-	12.0
TOTAL	489	54.4	445	56.9

APPENDIX : THE CHANGING UK TAX SYSTEM

FIGURE 1 CHANGES IN OVERALL MARGINAL RATES 1978-81

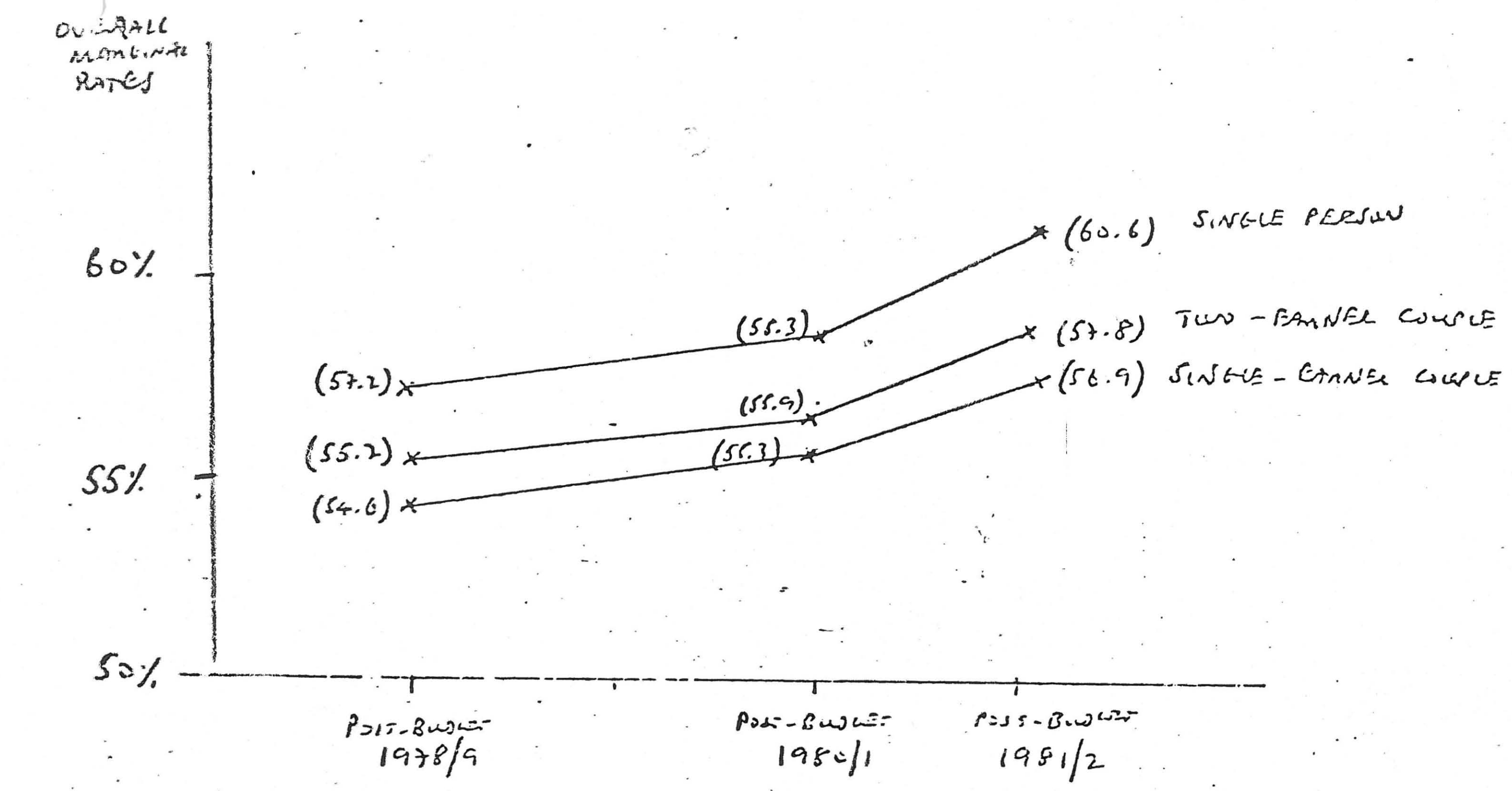
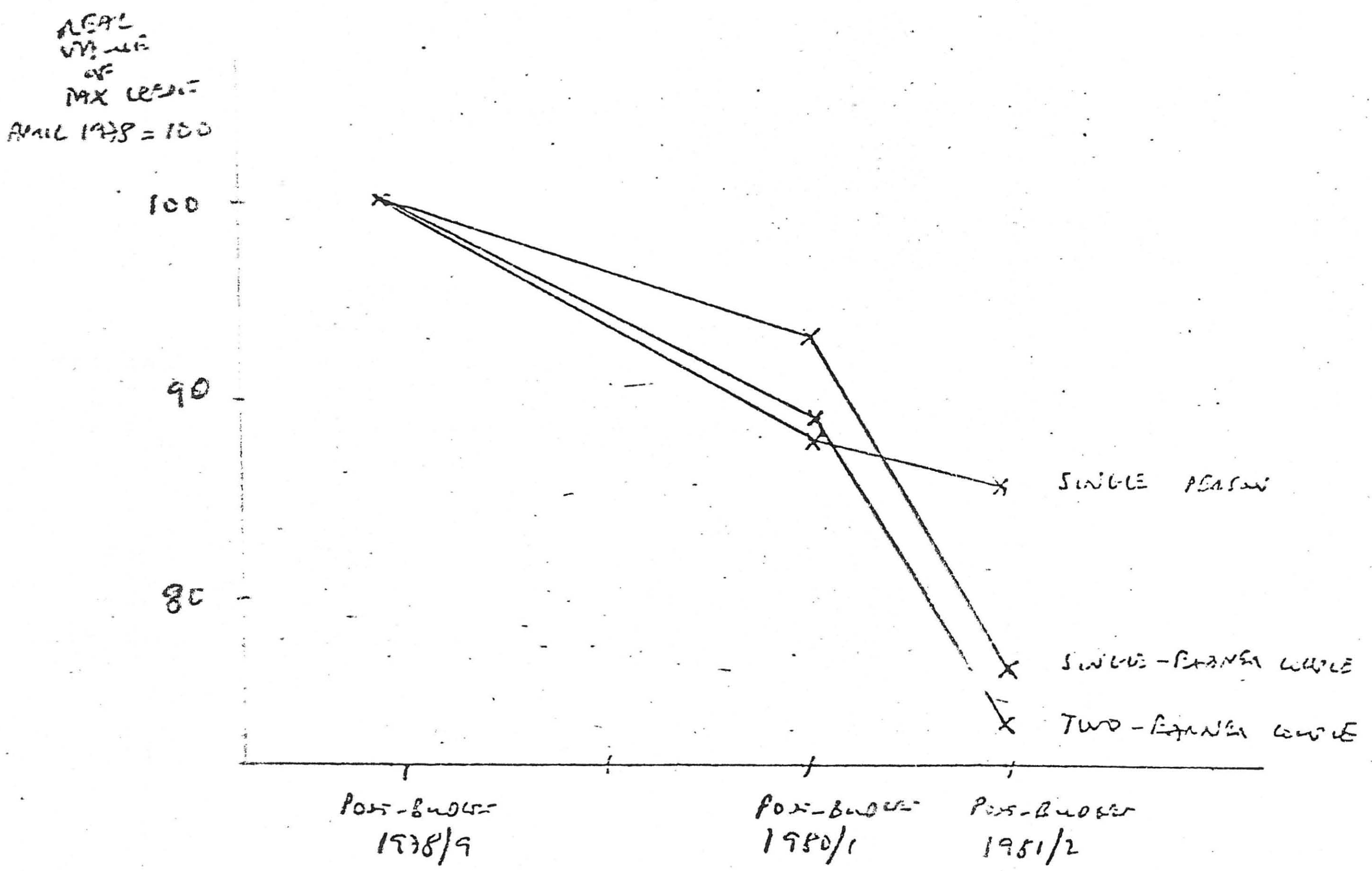


FIGURE 2 CHANGES IN REAL VALUE OF TAX CREDITS



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THE CHANGING UK TAX SYSTEM 1978-81

Single person

Contracted-in to SERPS. Below NI Ceiling. Basic Rate Taxpayers.

	1978/9 POST-BUDGET		1980/81 POST-BUDGET		1981/2 PRE-BUDGET		1981/2 POST-BUDGET	
	TAX CREDIT (£)	MARGINAL RATE (%)	TAX CREDIT (£)	MARGINAL RATE (%)	TAX CREDIT (£)	MARGINAL RATE (%)	TAX CREDIT (£)	MARGINAL RATE (%)
Income Tax	347	27.3	355	24.1	349	24.2	349	24.1
Employees NIC's	-	5.8	-	5.9	-	5.9	-	6.8
DIRECT	347	33.1	355	30.0	349	30.1	349	30.9
VAT	39	3.3	84	6.0	99	6.0	99	5.9
Petrol	27	1.4	40	1.5	42	1.4	60	1.9
Drink	49	3.1	64	2.8	66	2.5	89	3.4
Tobacco	-16	0.9	-17	0.8	-16	0.7	-21	1.0
Housing	-46	1.3	-65	1.5	-76	1.6	-76	1.6
Licenses	17	0.5	19	0.7	19	0.6	23	0.7
Intermediate	-27	2.9	-29	2.9	-27	2.6	-34	3.2
INDIRECT	43	13.4	96	16.3	107	15.4	140	17.7
Employer's NIC's	-	10.7	-	12.0	-	12.0	-	12.0
TOTAL	390	57.2	451	58.3	456	57.5	489	60.6
Real Value March 1981 prices	570		504				489	

THE CHANGING UK TAX SYSTEM 1978-81

Single-earner Couple

Contracted-in to SERPS. Below NI Ceiling. Basic Rate Taxpayers.

	1978/9 POST-BUDGET		1980/81 POST-BUDGET		1981/2 PRE-BUDGET		1981/2 POST-BUDGET	
	TAX CREDIT (£)	MARGINAL RATE (%)	TAX CREDIT (£)	MARGINAL RATE (%)	TAX CREDIT (£)	MARGINAL RATE (%)	TAX CREDIT (£)	MARGINAL RATE (%)
Income Tax	550	27.8	618	24.2	615	24.2	615	24.2
Employees NIC's	-	5.8	-	5.9	-	5.9	-	6.8
DIRECT	550	33.6	618	30.1	615	30.1	615	31.0
VAT	34	3.1	66	5.6	83	56	83	5.5
Petrol	24	1.1	36	1.3	38	1.1	55	1.6
Drink	2	1.8	-1	1.8	3	1.5	4	2.0
Tobacco	-147	-	-164	-	-162	-	-215	-
Housing	-38	0.9	-53	1.1	-62	1.1	-62	1.1
Licenses	11	0.5	15	0.6	15	0.4	18	0.5
Intermediate	-41	2.9	-33	2.9	-42	2.6	-53	3.2
INDIRECT	-155	10.3	-143	13.2	-126	12.3	-170	13.9
Employer's NIC's	-	10.7	-	12.0	-	12.0	-	12.0
TOTAL	395	54.6	475	55.3	489	54.4	445	56.9
	577		532					

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THE CHANGING UK TAX SYSTEM 1978-81

Two-earner couple

Both Contracted-in to SERPS. Below NI Ceiling. Basic Rate Taxpayers.

	1978/9 POST-BUDGET		1980/81 POST-BUDGET		1981/2 PRE-BUDGET		1981/2 POST-BUDGET	
	TAX CREDIT (£)	MARGINAL RATE (%)	TAX CREDIT (£)	MARGINAL RATE (%)	TAX CREDIT (£)	MARGINAL RATE (%)	TAX CREDIT (£)	MARGINAL RATE (%)
Income Tax	892	27.5	966	23.8	957	23.9	957	23.9
Employees NIC's	-	5.8	-	5.9	-	5.9	-	6.8
DIRECT	892	33.3	966	29.7	957	29.8	957	30.7
VAT	18	3.4	45	6.2	66	6.2	66	6.1
Petrol	-	1.0	4	1.1	7	1.0	9	1.4
Drink	-17	1.9	-13	1.8	-9	1.6	-12	2.1
Tobacco	-90	0.4	-97	0.3	-97	0.3	-128	0.4
Housing	-37	1.1	-49	1.3	-56	1.4	-56	1.4
Licenses	-23	0.5	2	0.5	3	0.5	4	0.5
Intermediate	-61	2.9	-66	2.9	-60	2.6	-76	3.2
INDIRECT	-210	11.2	-174	14.2	-146	13.6	-193	15.1
Employer's NIC's	-	10.7	-	12.0	-	12.0	-	12.0
TOTAL	682	55.2	792	55.9	811	55.4	764	57.8
	997		887					

From *Fiscal Studies*, November 1979

Direct and Indirect Taxes; Some Effects of the 1979 Budget

J A Kay and C N Morris

There were two principal elements to the June 1979 budget. One was the very substantial reductions which were made in the higher rates of income tax. The second was the major shift from direct to indirect taxation involved in raising the standard rate of VAT from 8 percent to 15 percent while reducing the basic rate of income tax and raising the tax threshold. This paper deals with the second of these elements. We are therefore concerned only with the way in which the budget redistributed income and altered incentives and disincentives among those with incomes below the level at which higher rates of tax apply—now around £12,000 per year. This does of course cover the overwhelming majority of taxpayers.

I

We begin by presenting a simple framework for examining the distributional effects of tax changes. The need for such a framework is evident from the fact that the consequences of the June budget are still a matter of controversy. We then apply this framework to the analysis of these consequences. We concentrate on examining distributional effects; but we should note that distributional effects and disincentive effects of taxation are simply two sides of the same coin. If under tax system A everyone pays the same amount of tax as they do under tax system B, then the incentives and disincentives which exist under the two tax systems must be exactly the same. Incentives and disincentives can only be altered if some courses of action are made less attractive and others more attractive, and this necessarily implies redistribution of the tax burden. In other words, a distributionally 'neutral' tax change will have no incentive or disincentive effects.

In order to simplify our treatment of the tax system we can treat the tax payment made by any individual as made up of two components—an amount paid on the

John Kay is Research Director and Nick Morris Senior Research Officer at the Institute for Fiscal Studies. Both are engaged on the IFS project on distributional implications of fiscal policy, which is supported by the Gatsby Foundation. A fuller explanation of the methods adopted in deriving the results presented in this paper is contained in IFS Working Paper No. 4.

whole of his income at a single marginal rate, offset by a 'tax credit' equal [illegible]e value to him of the allowances to which he is entitled, and any lower rate ba[illegible]n which he pays tax. To illustrate this approach we consider first a much simplified version of the tax system, with only two taxes, income tax and VAT, and examine the case of a married man who is a basic rate taxpayer. Suppose the basic rate of tax on him is 33 percent. Although this is his marginal rate, he pays no tax on the first £1,675 of income and a reduced rate of 25 percent on the next £750. The first of these allowances is worth £552.75 (33 percent x £1675) to him and the second is worth a further £60 ((33 percent – 25 percent) x £750). Thus the two allowances together are worth £612.75 and the system treats him as if he paid tax at 33 percent on *all* income but received a tax credit of £612.75 p.a. Under the 'tax credit' scheme proposed in the early 1970's, this is how the tax payable would have been presented and calculated. We are not necessarily suggesting here that such a reform should be adopted—it simply provides a convenient method of expressing the effects of the income tax system.

In the discussion that follows we shall be using this linearisation of the tax system to provide an insight into the effects of tax changes. To begin with we treat the taxpaying population as if it consists of a single type of unit, paying tax at the basic rate. Later we shall relax this and consider not only different types of tax unit, but also those whose incomes place them in the reduced rate band, and those with incomes above the NI contribution ceiling.

If we increase the marginal rate of tax, then it is possible also to increase the tax credit while maintaining the tax yield. Such a change increases the progressivity of the tax system. This is because everyone gains the same amount from the increase in the tax credit, while the losses from the rise in the basic rate increase in proportion to income. Consequently, low income groups gain and high earners lose. The converse of this is that the rise in the marginal rate increases disincentives to work and effort. If we lower the marginal rate and the tax credit, then the opposite effects occur—progressivity falls and disincentives decline. The normal mechanism for altering the value of the tax credit is to change the threshold, but changes in the tax rate also imply changes in the amount of the credit: the higher is the marginal rate of tax an individual pays the more valuable is a tax allowance to him.

Now introduce VAT. Suppose first there is a single rate of VAT of 5 percent, and assume that our taxpayer does not save. If there were no income tax, this would be equivalent to a marginal tax rate on income of 4.7 percent (5 percent/5 percent + 100 percent), because VAT is levied on the tax-exclusive price. But VAT can only be paid on expenditure out of income which has already borne tax. Another way of putting it is to say that of the two ways of disposing of one's income—paying it in tax or spending it—only the latter is subject to VAT. So the effective marginal rate of tax arising from VAT is only 67 percent of 4.7 percent, because only 67 percent of marginal income is available for expenditure. This gives 3.2 percent as the effective marginal rate.

To complete the picture, notice that 4.7 percent of the tax credit will be devoted, not to buying goods, but to paying VAT on them. This is equivalent to a tax on everyone who receives the tax credit of £28 (4.7 percent x £612.75). This sum is equivalent to a *negative* tax credit of that amount. A negative tax credit necessarily implies that a tax is regressive—that high income earners pay less of their income in VAT than do those with low incomes. And this is true in the model we are describing: someone whose income was entirely derived from the income tax credit would pay 4.7 percent of it in VAT while someone whose income was so high that the tax credit was an insignificant part of it would pay only 3.2 percent of income in VAT.

This is true even though VAT is a strictly proportional tax. The reason for the paradox is simply that it is not possible to pay in VAT what one has already paid in income tax, and since the rich pay relatively more income tax they have a lower expenditure per £ of income and so must pay relatively less VAT. In the light of this, it is reasonable to conclude that the sense in which a proportional VAT is regressive is a rather trivial one; although commentators regularly make statements about tax progressivity on precisely this basis. The point which emerges is that it is really only sensible to talk about distributional effects in relation to the tax system *as a whole,* and although we will examine how individual taxes contribute to that overall effect we will devote little space to discussing the progressivity of individual taxes.

The total effect of the two taxes can be seen as follows:

Tax	Tax credit	Marginal rate
	£	%
Income tax	613	33
VAT	- 28	3.3
Total	585	36.3

Recall that, other things being equal, the higher the tax credit and the higher the marginal rate, the more progressive the system. Suppose VAT is increased—say doubled. Then the 'tax credit' from VAT doubles to - £56 and so does the marginal rate, to 6.6 percent. Suppose the revenue is used to cut income tax. If the basic rate were reduced by 3.3 percent the marginal rate in total remains unchanged. But a cut in the basic rate reduces the value of the tax credit more or less proportionately. This reduction means that much less than the whole of the additional VAT revenue has been expended. The balance can be used to reduce the basic rate further. If it is, then both tax credit and marginal rate would have fallen and progressivity would have decreased. Or the credit could be increased to its initial value. This would be done by increasing the tax threshold. If this happened, the change would be distributionally neutral: everyone, whatever their income, would pay the same amount of tax as before. Finally, the whole of the additional VAT revenue might be used to increase the tax credit, by raising thresholds. In that case, both tax credit and marginal rate would have increased and the system would have become more progressive.

It follows from this simple description that any general statement about the implications for regressivity or incentives of the effects of a shift from direct to indirect taxation is wrong. Quite apart from matters concerned with the structure of indirect taxation—which we discuss in the next section—the issue hinges on the nature of the direct tax reductions which occur. If they principally take the form of increases in the tax threshold, then the shift increases progressivity and disincentives to work. If they principally take the form of reductions in the basic rate, the shift reduces progressivity and disincentives. There is a 'balanced package', somewhere in between, of threshold increase and rate reduction, which is more or less neutral in its effect.

The June 1979 budget involved changes of both kinds. In subsequent sections we show that these changes were close to being such a 'balanced package'; that they were more or less neutral. It is therefore unlikely that they could have significantly affected either the progressivity of the tax system or incentives or disincentives to effort.

Ormerod & Capella

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The March 1981 Budget and Public Expenditure White Paper

EVIDENCE TO THE TREASURY AND CIVIL SERVICE COMMITTEE OF THE HOUSE OF COMMONS

Paul Ormerod and Paul Capella, The Economist Intelligence Unit.

1. This paper is divided into three main sections. The first summarises briefly the main assumptions in our post-Budget update of our January 1981 forecast. The second discusses the similarities and the differences between this update and the Treasury forecast presented in the FSBR 1981-82. Our forecasts are obtained using the EIU's version of the Treasury model. We consider the likely future prospects for output, the PSBR, inflation, unemployment, and the prospects for any sustained recovery in output beyond the period covered by the FSBR forecast. The third section raises more general policy questions. We examine the likelihood of the Government's target for sterling M3 being met in 1981/82, and consider the appropriateness of selecting this variable as a policy target. We then discuss revenues from the North Sea, and the scope for reflationary fiscal policy. The relationship between interest rates and the PSBR is considered next, and whether the expansionary effects of lower interest rates are offset by the deflationary impacts of higher taxes or lower public expenditure. Finally, we discuss the desirability of using the PSBR as a policy target.

2. The main assumptions in our post-Budget update are as follows. The fiscal changes in the Budget are obviously included. We adopt a very similar profile on the total volume of public expenditure to the Public Expenditure White Paper (Cmnd. 8175) for the financial years 1981/82 and 1982/83. For 1983/84 we largely discount the sharp falls implied in Cmnd. 8175, so that general government expenditure on goods and services falls by only 1.2 per cent in real terms. There must, however, be genuine doubt as to whether the Government will succeed in reducing public expenditure in volume terms in future years. To the extent that public expenditure exceeds the White Paper targets, the prospects for output growth are accordingly improved. The noticeable feature of the table on page 2 of Cmnd.8175 is that the cuts planned for 1980/81 in Cmnd. 7841 have not materialised. Further, reductions in public expenditure have been postponed from 1981/82 into 1982/83 and 1983/84 This does induce a certain amount of scepticism as to whether the cuts will in fact be carried out to their (over)

full extent. This is reinforced by an examination of individual spending programmes. For example, Table 2.4 of Cmnd.8175 indicates substantial financial support for British Leyland in 1981/82, with an implicit sharp reduction in this support in both 1982/83 and 1983/84. It is reasonable to doubt that British Leyland's finances will improve to this extent in the short-term. Similarly, Table 3.1 of Cmnd. 8175 shows a very sharp reduction in Government lending to nationalised industries after 1981/82; again, it is reasonable to query the validity of this assumption. Severe limits on nationalised industries' external financing were a feature of Cmnd. 7841. These were heavily criticised at the time as being unrealistic, yet only piecemeal attempts have been made in Cmnd.8175 to accommodate these criticisms. To the extent that the targets are met, there will continue to be substantial inflationary pressure from the pricing policies of the public sector.

3. We assume that the exchange rate remains unchanged over the forecast period, at a rate against the dollar of 2.30, and at a rate of 77.5 on the old Smithsonian index. This assumption is very similar to the FSBR assumption (para. 2, page 26). Although this is an assumption, it is nevertheless consistent with our forecasts for movements in the balance of payments on current and capital accounts. On earnings, we have fixed the earnings of the non-trading public sector at the level of our January forecast, so that the rate of change is some 10 per cent in the 1980/81 pay round and 7½ per cent in 1981/82. Earnings in the rest of the economy are allowed to respond to the changes in the price level caused by the Budget, and increase by 11 and 11½ per cent in the 1980/81 and 1981/82 pay rounds respectively.

4. Comparing our post-Budget update with the FSBR forecast, we are in broad agreement with the Treasury's prediction for the growth in GDP between 1980 and 1981, with the forecasts for the PSBR in 1981/82, and the current balance of payments in 1981. On GDP growth, we would in fact be inclined to be somewhat

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more pessimistic, particularly on manufacturing output where we envisage a fall of around 8 per cent compared to the 6 per cent in the FSBR.

5. We do, however, differ to a certain extent on the prospects for recovery in GDP growth. Two preliminary remarks should be inserted here. First, the precise quarter in which GDP stops falling and begins to rise is naturally of great concern to policy makers. But the science of economic modelling and forecasting is not yet so developed that we can attach great confidence to predictions of the exact quarter in which output stops falling; we can offer guidelines. Second, we feel that there is a danger that any halt to the fall in output will be misinterpreted as signalling a 'recovery'. This would be a misuse of the word. The mere fact that GDP and/or manufacturing output stops falling and rises by a purely nominal amount does not amount to a recovery. We choose to reserve the word recovery to describe a sustained increase in output of at least 2 per cent a year.

6. With these necessary qualifications, our forecast does suggest that output has not yet stopped falling. The trough of the recession does not appear to have occurred in the first quarter of this year, and is likely to be postponed until the autumn or winter of 1981/82. This does, however, depend critically upon the forecast path for stockbuilding. The Treasury predict - £1700 million for stockbuilding (at 1975 prices) in the first half of 1981 and only (sic) - £400 million in the second half. This is the factor which produces the technical turn-round in the path of GDP growth. Even minimal re-apportioning of these figures, such as - £1500 million and - £600 million respectively, would postpone the halt in the decline of GDP to the second half of this year.

We note incidentally, that even with the de-stocking figures in the FSBR, the stock-output ratio in manufacturing would still be at a historically high figure at the end of 1981. Given that the recovery in industrial demand is likely to be weak at best, that increased consumer demand has been forestalled by the Budget's measures and that the interest charges attached to holding stocks will still be historically high at the end of 1981, it is difficult to be confident of any turnaround at all.

7. The more important question relates to the prospect for sustained recovery once de-stocking has ended. It is unfortunate that the detailed FSBR forecast only goes to the first half of 1982. As is well-known, the Treasury produce internal forecasts further into the future, and it would be helpful if they were released. In para. 15, page 17 of the FSBR, we are, however, given an indication of prospects for 1982 and 1983. It is stated, "it has been assumed that GDP growth over the three years 1980-83 averages $\frac{1}{2}$ per cent a year ..... if the economy develops in the coming year as now forecast, the assumption made for the three years would imply growth averaging about $1\frac{3}{4}$ per cent in the last two years of the period". This statement raises the obvious question as to whether these figures are simply an assumption, or whether they reflect the genuine view of the Treasury about output growth to 1983. A further point to be added is that the tax increases do seem to run contrary to the Government's previously expressed views that taxation should be reduced to restore incentives and hence increase economic growth.

8. On the Treasury's assumption, real GDP in 1983 would still be some 2 per cent below the level of 1979. A figure for manufacturing output is not given, but this GDP path must imply an even more substantial difference between the 1979 and 1983 levels of manufacturing output. On the basis of present policies, however, we regard even these projections as being somewhat optimistic. Unless the pound were to fall sharply, given the trade competitiveness position of the UK there is little prospect of our net trading volume contributing to output growth over the next three years. Private sector investment is unlikely to grow rapidly in view of the poor prospects for future demand. Public expenditure is planned to be cut back in 1982/83, and even more in 1983/84. As was noted in the EIU evidence to the Committee on the November 1980 measures, a potential source of expansion is the possibility of an increase in consumers' expenditure brought about by a fall in the savings ratio as the rate of inflation is reduced. We did, however, query the strength of this effect as contained in the Treasury's economic model, and doubted that the effect had sufficient strength to pull the British economy out of recession. We continue to hold these doubts. In summary, the prospects for sustained recovery

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in any one of the components of real expenditure GDP are slight, and a projected growth rate of $1\frac{3}{4}$ per cent for GDP in 1982 and 1983 does look optimistic.

9. Given our reservations about Treasury projections for the future output growth, we obviously regard the unemployment forecast of 2.7 million in 1982 and 1983 contained in Cmnd. 8517 as optimistic. There is potentially great confusion in comparing forecasts of unemployment, due to the proliferation of definitions which are used. Thus, the White Paper forecast of 2.5 million for 1981 may seem low, but it is on the narrow definition i.e. for Great Britain excluding school-leavers and temporarily stopped. We regard this as a reasonable forecast, although we envisage the figure of 3 million being reached even on this definition by the end of 1982.

10. On inflation, we predict the annual increase in the Retail Price Index between the fourth quarters of 1980 and 1981 to be 12 per cent, and between the second quarters of 1981 and 1982 to be 10 per cent. These compare with 10 and 8 per cent respectively in the FSBR. The main difference must undoubtedly be the level of earnings growth in the two forecasts. If we assumed total earnings growth of between 7 and 8 per cent in the 1980/81 pay round, and a continuation of this figure for the rest of 1981, we would obtain an inflation prediction close to that of the FSBR. We think, however, that such figures are unrealistically low as a forecast of earnings movements over the whole economy.

11. More generally on inflation, a certain schizophrenia runs through the FSBR regarding whether inflation is a monetary phenomenon or whether it is determined by a mark-up on costs. Para. 7 page 26 suggests quite clearly a cost plus explanation of inflation: "Retail prices will benefit from these favourable trends in costs but increases in rents and rates, further moves by some of the nationalised industries towards economic pricing, and the increase in specific duties announced in the Budget will contribute to an increase in retail prices". We note that it is government policy which is the direct cause of the latter two factors, as it is, to a certain extent of rate and rent increases, particularly the latter. In an attempt to reduce the PSBR to reduce monetary growth to reduce inflation, government policy is responsible for increasing the price level.

12. Part II of the FSBR devotes several paragraphs to explaining why the explosion of sterling M3 during 1980 'should not have the implications for future inflation which generally follow an increase in money supply' (para. 10, page 10). This short statement encapsulates the foolishness of imagining that inflation can be controlled purely by controlling a single monetary aggregate. The government deemed it essential to control the money supply to control inflation and that sterling M3 was the measure to control. When this measure ran out of control, it was suddenly discovered that there were distortions in the figures, and that M3 could grow by 20 per cent a year without leading to 20 per cent inflation after a suitable time lag. We do not deny that monetary factors can have an influence on inflation, but is is surely time to abandon the pretence that in the present British context inflation can only be controlled by controlling sterling M3.

13. On the question of future control of sterling M3, the FSBR assumes that during 1982 its growth will be at the centre of the 6 - 10 per cent target range. Again the question is raised as to how far this is an assumption and how far it is a general forecast. Our initial calculations suggest that the government might have some difficulty in meeting this target, although we would not wish to press this point too strongly. We do press the point, however, that sterling M3 is a variable over which it is extremely difficult for the authorities to maintain precise control. The three major factors which affect monetary growth are sales of gilts to the non-bank private sector, capital inflows from overseas, and bank lending to the private sector. One lesson of 1980 must surely be that this latter variable is not subject to government control, except for short-term distortions caused by direct intervention. A substantial reduction in bank lending in 1981 must be one of the assumptions made in the FSBR in order to arrive at a monetary growth rate of 8 per cent. The level of lending in 1980 was exceptionally high, and the financial pressures on companies have been somewhat eased recently, but there is still scope for a significant degree of bank lending in 1981. The relationship between capital inflows and domestic monetary growth is complicated, although higher levels of inflows will tend to be associated with higher levels of monetary growth. The points here

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are first that such inflows are difficult to control precisely and, second, that an error of only £$\frac{3}{4}$ billion on the forecast for total external foreign currency finance would lead to an error on sterling M3 growth of 1 per cent. On the demand for gilts by the non-bank private sector, a crucial factor is expectations about future interest rates, as well as the current interest rate itself. If interest rates were to rise in the future, holders of gilts incur a capital loss, and a gain if interest rates fall. As the last two years have shown, expectations of falling interest rates can be an extremely powerful factor in determining the sales of gilts. If the gilts market begins to doubt that there is scope for further substantial falls in interest rates during 1981/82, the authorities may not be able to sell sufficient gilts to meet the monetary target. And the increase in inflation caused by the Budget must be a factor inhibiting the authorities from making substantial reductions, for otherwise real rates of interest would become negative, and the overall monetary stance considerably relaxed.

14. We now turn to consider the flow of revenues from the North Sea, and the associated question of the scope for fiscal reflation in the years beyond 1981/82. The Treasury press release of 10 March 1981('Government Revenues from North Sea Oil and Gas') notes that Government forecasts of North Sea revenue, at least in 1982-4 are lower than most other forecasting bodies because a lower increase in the real world oil price is assumed, its production forecasts are low, and its forecast capital expenditure in the North Sea are high. The first two of these factors are the most important. On oil production, we share the pessimism of the Treasury. Indeed, we tend to be towards the lower end of the range of outcomes indicated by the Treasury. In 1981, we forecast production of 83 million tonnes compared with a Treasury range of 80-95 million, 91 million in 1982 compared with 85-110 million and 99 million in 1983 compared with 90-115 million. Without specifying the figure, the FSBR indicates that the Treasury assumptions on the real price of oil 'assume some modest increase in the world oil price in real terms after 1981' (para. 21 page 18). Comparison of forecasts is complicated by the existence of a gap since 1979 between Saudi crude and the relevant OPEC average price, and the assumptions which are made about the existence of this gap in the future. On the basis of the OPEC average, however, we expect a real oil price increase of 2-3 per cent in 1981, and an annual increase of aroun 5 per cent from 1982 onwards, reflecting increasing cut-backs by both OPEC and

many non-OPEC producers in order to conserve supplies. Although these figures themselves could be described as modest, we infer from the FSBR statement that they are somewhat above the Treasury assumptions. Thus, on the one hand we probably have lower North Sea oil production forecasts than the Treasury, and on the other we probably have somewhat larger increases in the real price of oil. Lacking precise figures in the FSBR we cannot be exact, but on balance we imagine that the increase in revenues from the North Sea in our forecast must be similar to those of the Treasury. The increase implied in our forecast is £2½ billion in 1982/83, followed by a further £3 billion in 1983/84.

15. Our forecasts of revenue from the North Sea are, like the Treasury's, pessimistic when compared with those of most other forecasting bodies. As a consequence, we agree with the scope for fiscal reflation in the years beyond 1981/82 implied in the FSBR on the assumption that policy is constrained by the Government's desire to meet its targets for PSBR as a percentage of GDP. Para 27, page 19 of the FSBR argues that the MTFS targets could be met, and still allow for a fiscal adjustment which would ' offset the rise in the personal tax burden in the coming year'. In other words, tax cuts worth a maximum of £2½ billions. Our forecast confirms this view.

16. We do, however, dissent from the view that the MTFS targets for the PSBR as a proportion of GDP should be adhered to. One justification for the targets, repeated in the FSBR, is that reducing the PSBR will enable interest rates to be reduced, which will in turn stimulate the real output and employment. There are two points to make here. First, there is not necessarily a strong connection between interest rates and the PSBR. And any relationship which exists certainly cannot be deduced from simple reduced-form econometric relationships of the type which were until recently used to claim a relationship between the PSBR and monetary growth. Structural relationships require structural models to explain them. In any case, it is clear that factors such as world interest rates, domestic inflation, the demand for loans from the private sector, are all potential candidates in any explanation of the level of interest rates, in addition to the level of Government borrowing.

17. Our second point here is that if it is thought necessary to cut the PSBR in order to reduce interest rates, cutting the PSBR will almost certainly lead to contractionary effects upon domestic output and employment which outweigh the expansionary effects of reductions in interest rates. The qualifying phrase 'almost certainly' is required because differing components of Government expenditure and revenues have widely different demand effects. For example, a windfall tax on bank profits is likely to have a much weaker direct effect upon the level of demand, than is the equivalent amount raised by increasing the effective tax rate on the low paid, whose marginal propensity to spend is close to 100 per cent. For an average resource content of expenditure and revenue, however, the effects of cuts in public expenditure or increases in taxation will outweigh the effects of any reasonable reductions in interest rates which are associated with them. The models of the Treasury, the Bank of England, the London Business School, the National Institute and the Cambridge Economic Policy Group all provide evidence to support this statement, although the precise quantitative effects obviously vary between models.

18. Finally, we once again draw attention to the argument against strict adherence to a particular target figure for the PSBR. Briefly, the absolute size of the PSBR fails to distinguish the effects of the budget on the economy from the influence of the economy on the budget. It would be simply perverse if the Chancellor demanded further cuts in public expenditure during 1981/82 because the PSBR was running above the target figure due to the 1981 recession being worse than expected. At the very least, the Government should move towards a target band for the PSBR, to avoid the need for a rapid succession of policy measures designed expressly to contain the PSBR below a single target figure.

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The March 1981 Budget and Economic Prospects

by

Terry Ward

1. In his Budget Statement and by his actions, the Chancellor has reaffirmed his faith in the medium-term financial strategy and the philosophy underlying it. The Government's overriding priority is still to bring down inflation; a progressive reduction in monetary growth is still regarded as the only way of achieving this and cuts in the PSBR remain the means of reducing monetary growth. Such a strategy is still put forward as helping to create the conditions for sustained recovery in the long-term. The immediate consequences for output, employment and the industrial base are largely ignored, despite the experience of the past year.

2. The concern here is, first, to identify the causes of the overshoot in the PSBR in 1980-81 and to look at what happened to public expenditure in relation to forecasts. The revised plans for Government spending up to 1983-84 and the contents of the revised medium-term financial strategy are then examined in the light of this and in the light of the changes made in the Budget. Finally there is an assessment of economic prospects in the short and medium-term.

The PSBR and Public Expenditure in 1980-81

3. The Government's ~~interest~~ latest estimate of the PSBR for the present financial year is £13½ billion, compared with a forecast of £8½ billion last March and are of £11½ billion in November. The overshoot is, therefore, now expected to be £5 billion, or £5½ billion if allowance is made for the refund of EEC contributions not included in the March 1980 Budget forecast. Since tax receipts were only £½ billion lower than forecasts, the bulk of the

or £1 bn ?

overshoot is accounted for by higher than expected public expenditure. Current expenditure on goods and services, debt interest payments, subsidies, and Government support for nationalised industries and current grants (other than those to the EEC) were all around £1 billion higher than estimated in the last Budget. The main reasons for this appear to be higher than expected wage settlements in the public sector, high interest rates (which have also been a major cause of the increase in subsidies), low profits earned by public enterprises, despite steep price increases, and high unemployment. It is clear that the recession has been directly responsible for much of the overspending by depressing the sales of nationalised industries and hence their internally generated revenue and by increasing the numbers out of work. It also seems to have led to contracts being completed more rapidly than usual because there has been little private sector work around. Goverment policy of maintaining high interest rates, together with the larger amount of debt to be serviced as a result of the increased PSBR, accounts for a large part of the remaining overshoot.

4. As can be seen from Table 1, the volume of expenditure in 1980-81 is estimated to have been only around £1½ billion at 1980 Survey prices, or less than 2 per cent, higher than planned in the March 1980 White Paper, if debt interest is ignored. The inclusion of debt-interest (net of trading income and interest receipts) pushes this up to over £2 billion at 1980 Survey prices, or over 2½ per cent of forecast expenditure. However, in cost terms (i.e. including the effect of the cost of public sector purchases rising faster than prices in the economy as a whole), the excess of total expenditure over what was forecast last March is substantially greater, at almost £4 billion at 1979-80 prices (£4½ billion at current prices) or nearly 5 per cent.

Table 1 Public Expenditure in 1980-81: Estimated Outturn compared with previous plans, in volume and cost terms

£ million at 1980 Survey prices or 1979-80 prices incl. RPE

	Planning total		Net debt interest		Total expenditure	
	Volume	Cost	Volume	Cost	Volume	Cost
Cmnd. 7439, January 1979	82334	80682	2800	2800	85134	83482
Changes, January 1979 to March 1980	-4514	-3805	+700	+700	-3814	-3105
Cmnd. 7841, March 1980	77820	76877	3500	3500	81320	80377
Changes, March 1980 to March 1981	+1425	+3073	+790	+790	+2215	+3863
Cmnd. 8175, March 1981	79245	79950	4290	4290	83535	84240
Total change, January 1979 to March 1981	-3089	-732	+1490	+1490	-1599	+758

Note: See Appendix Table A.1 for detail.

As the Chancellor emphasized in his Budget Statement, it is the cost of public spending which is the most appropriate magnitude to consider if the concern is with its financing implications. Judged in these terms, total expenditure in 1980-81 now seems to have been higher, by £750 million at 1979-80 outturn prices, than was intended by the last Labour Government, as is shown in Table 1, despite the volume of spending being lower (to which the Chancellor drew attention in his speech).

5. Table 2 shows the changes to expenditure by programme in 1980-81 since the last White Paper, in both volume and cost terms. The largest increases in the volume of spending have been in the 'Industry' programme, largely as a result of the measures to help soften the impact of high unemployment, in nationalised industry borrowing and in debt interest. The table indicates, however, the substantial difference between changes to the volume and changes to the cost of expenditure, which reflects the significant unanticipated relative price changes which have occurred during the year. In the 'Health' programme, for example, the unforeseen rise in relative costs added £800 million at 1979-80 prices to planned expenditure, or 7½ per cent, while for some baffling reason, relative price increases added 25 per cent to the cost of the 'Agriculture' programme. In the former case, as in the case of Education, higher than expected pay settlements in the public sector relative to those in the private sector seem largely responsible. Interestingly enough, 'social security' does not appear to have made a significant contribution to the overspend - indeed the cost was somewhat lower than forecast last March. Higher unemployment benefits, therefore, seem to have been offset by lower expenditure on other payments. Apart from the 'Overseas

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Table 2. Changes in Public Expenditure by Programme since March 1980 in Volume and cost terms

	Cmnd. 7841, March 1980 to Cmnd. 8175, March 1981	
	£million, at 1980 survey prices	£million, at 1979-80 outturn price including RPE
~~Reference~~ Defence	+ 130	+ 16
Overseas aid (includes EC refunds)	- 644	-584
Agriculture	+ 144	+415
Industry	+ 599	+482
Transport	- 53	+ 36
Housing	+ 181	+578
Other environ. services	- 53	+ 12
Law and order	- 18	+ 3
Education	-	+236
Health	- 87	+711
Social Security	+ 44	-246
Other public services	- 28	- 9
Common services	+ 6	+ 61
Northern Ireland	- 12	+ 73
Nationalised industries' borrowing	+ 815	+932
? Contingency reserve	- 967	-915
Shortfall	+1120	+1165
Special sales of assets	+ 175	+175
Planning total	+1425	+3073
Net debt interest	+ 790	+790
Total expenditure	+2215	+3863

Notes: See Appendix A.1 for details

aid' programme, which includes the refund of EEC contributions, 'Social security' is the only programme showing a significantly lower level of spending in cost terms than was expected in the last White Paper.

Public Expenditure by Economic Category:

6. Table 3 indicates that the higher volume of spending (as distinct from the cost) in 1980-81 is wholly accounted for by transfer payments and support for nationalised industries. Current expenditure on goods and services was more or less the same in volume terms as had been planned, while Government investment was substantially lower, at 8 per cent less than the figure in the March 1980 White Paper. These figures, however, should be interpreted in relation to the allowance for shortfall incorporated in the last White Paper and which has usually fallen to a large extent on goods and services expenditure and on investment in particular. In 1980-81, shortfall does not seem to have emerged on its usual scale, which may be a consequence in part of the recession and a more rapid completion of work and in part of the substantial cut back in expenditure programmes planned by the present Government. As so often in the past, however, investment seems to have borne the brunt of a squeeze on public spending, which on this occasion appears to have been partly due to costs rising much faster than allowed for in cash limits.

7. As shown in Table 3, while total expenditure in 1980-81 was at about the same level in real terms as five years earlier, the volume of Government investment was down by 50 per cent, which represents a reduction of 33 per cent in relation to what the last Labour Government were planning to spend. Moreover present plans are for a further reduction of 15 per cent in 1981-82.

Capital v Current

Table 3 Public Expenditure by Economic Category, 1975-76 to 1981-82

At 1980 Survey prices;

	1979-80	1980-81	1981-82
	Index numbers 1975-76 = 100		
Current expenditure on goods and services:			
Cmnd. 7439	104.2	106.2	107.4
Cmnd. 7841	102.7	102.8	103.4
Cmnd. 8175	102.5	102.8	103.0
Capital formation, general government:			
Cmnd. 7439	78.1	78.3	77.7
Cmnd. 7841	63.1	57.1	47.3
Cmnd. 8175	61.5	52.6	45.0
Total goods and services, general government:			
Cmnd. 7439	98.7	100.2	101.1
Cmnd. 7841	94.3	93.1	91.5
Cmnd. 8175	93.8	92.1	90.7
Grants and subsidies:			
Cmnd. 7439	111.3	113.6	115.1
Cmnd. 7841	109.2	109.9	107.5
Cmnd. 9175	107.7	111.4	111.2
Borrowing by public enterprises:			
Cmnd. 7439	55.6	46.0	40.6
Cmnd. 7841	74.3	41.6	*
Cmnd. 8175	73.9	72.8	38.8
Planning total:			
Cmnd. 7439	97.1	99.3	101.2
Cmnd. 7841	94.5	93.9	92.8
Cmnd. 8175	93.8	95.6	95.9
Total public expenditure, including debt interest:			
Cmnd. 7439	98.3	100.7	102.5
Cmnd. 7841	96.5	96.1	95.0
Cmnd. 8175	96.5	98.8	99.4
Total public expenditure in cost terms (i.e. including RPE);			
Cmnd. 7439	96.7	98.8	100.6
Cmnd. 7841	94.5	94.7	93.7
Cmnd. 8175	95.6	99.6	99.3

Note: See Appendix Table A.2 for details.

* Negative amount

8. Overall Table 3 shows that the planning total for public expenditure increased by 2 per cent in volume terms between 1979-80 and 1980-81 and by slightly more if debt interest is included. In cost terms, however, the increase was 4 per cent. So far as 1981-82 is concerned, the present forecast is for a rise of just under 1 per cent in the volume of total expenditure including debt interest, but for a slight fall in cost terms owing to a significant projected fall in relative costs. This compares with a reduction of 1 per cent planned last year in both volume and cost terms.

9. It should be noted that, despite the Treasury's evidence before the Committee this time last year that no breakdown had been made of the division of expenditure between economic categories for the years after 1980-81, this year's White Paper contains details of the changes by economy category for 1981-82 made since last year's White Paper. Precisely how this is possible is not explained. The breakdown indicates that the additional expenditure now planned for next year is wholly accounted for by increases in transfer payments and nationalised industry borrowing. This is partly recouped by cuts in expenditure on goods and services and on investment spending in particular.

10. Nevertheless despite the additional sum set aside for nationalised industry borrowing, the forecast for 1981-82 still shows a considerable reduction as compared with spending during the present year. A pronounced feature of last year's expenditure plans was the substantial turnaround projected for the financial position of nationalised industries. Indeed this was equivalent in size to the whole of the reduction in public expenditure planned to take place between 1979-80 and 1980-81. In the event, it has not materialised at all, and borrowing has been as high this year as last, despite large increases in prices relative to the

general rate of inflation. Given that the fall in output in 1981-82 is forecast even by the Government to be almost as large as in 1980-81, there has to be a very serious question as to whether the planned reduction in borrowing is feasible, particularly as nationalised industry fixed investment is forecast to increase by 15 per cent next year (as against a fall of 4 per cent in 1980-81). The Financial Statement shows a considerable rise in the gross trading surplus of public corporations for 1981-82 of 37 per cent, which is around 25 per cent in real terms, and compares with a fall of almost 20 per cent in nominal terms last year. In view of the financial difficulties besetting many of the industries, much of this growth in profits must presumably be assumed to arise from further price rises.

Public Expenditure upto 1983-84

11. Table 4 shows the longer term plans for expenditure and compares these with the plans published last year. Overall total expenditure is now forecast to fall by 3½ per cent between 1980-81 and 1983-84 which is slightly less than projected last year, though excluding debt interest the planned decline is somewhat greater. In general, the pattern of planned changes has not been greatly changed, except, with the higher and more realistic level of unemployment now assumed, social security payments are forecast to increase significantly over the next three years. Such payments, together with spending on 'Defence', 'Law and order' and 'Common services', are the only part of Government expenditure projected to increase. As last year, the main savings are to be made in nationalised industry borrowing, 'Housing' and the 'Industry' programme, these each accounting for half or more of the total reduction planned and

Table 4 Planned Changes to Programmes, 1980-81 to 1983-84

1980 Survey prices

	% Change 1980-81 to 1983-84	Changes as % of 1980-81 total	% Change 1980-81 to 1983-84	Change as % of 1980-81 total
Defence	+6.2	0.72	+9.6	0.82
Overseas aid and other services	-10.1	-0.15	-9.3	-0.15
EEC contributions	+2.6	0.01	+49.4	0.62
Agriculture	-20.0	-0.28	-10.5	-0.13
Industry	-36.9	-1.72	-40.3	-1.64
Transport	-5.5	-0.18	-6.2	-0.22
Housing	-47.6	-2.43	-43.6	-2.18
Other environmental services	-6.7	-0.24	-5.7	-0.22
Law and order	+5.9	0.20	+6.6	0.23
Education	-8.1	-0.86	-6.4	-0.70
Health	+4.6	0.49	+2.8	0.31
Social Security	+8.2	1.95	+1.4	0.33
Other public services	-2.2	-0.03	-3.0	-0.04
Common services	+11.2	0.15	+9.1	0.12
Scotland	-6.8	-0.36	-6.1	-0.33
Wales	-7.9	-0.16	-7.9	-0.17
Northern Ireland	-2.5	-0.07	-3.3	-0.10
Nationalised industry borrowing	*	-2.69	+	-2.46
Planning total	-4.1	-3.88	-3.5	-3.34
Net debt interest	+7.2	0.37	-14.3	-0.61
Total expenditure	-3.5	-3.51	-4.0	-3.96

Note: The figures shown in the 2nd and 4th columns for the individual programmes sum to the percentage change in total expenditure. They therefore, indicate the relative contributions of each to to total reduction in forcast expenditure.

* -£2250 million at 1980 Survey prices.

\+ -£2004 million at 1980 Survey prices

yielding a combined saving of around £5½ billion at 1980 Survey prices compared with a total saving of £3 billion. Again there are serious questions about whether these areas are capable of providing the savings required and the implications of actually achieving such savings. In each case, the reduction now planned is greater than envisaged last year, despite the failure to achieve a reduction of the intended scale in 1980-81. Moreover economic prospects over the medium-term are now decidedly worse than they seemed to be last year. The plans, therefore, appear to be even less plausible, particularly as regards nationalised industries, whose financial position is projected to improve by £2½ billion at 1980 Survey prices, and 'Industry', where the reduction is assumed to come largely from the virtual elimination of £800 million of industrial support (to BL for example) and a substantial cut in spending on redundancy payments and the Temporary Short-Time Working Compensation Scheme. It may well prove heroic to assume that there will progressively be less need for such expenditure.

The Government's Reaction to Recent Events:

12. In response to the over-spending in 1980-81 and the addition to plans in later years, the Government has announced substantial increases in taxation, amounting to £4310 million in 1981-82 in relation to the revenue which would have been yielded if tax rates and allowances had remained unchanged in real terms. The explicit intention is to reduce the PSBR back towards the level projected in last year's medium-term financial strategy. Without such tax increases, the Government argues that either money supply growth would have exceeded the target range, so jeopardizing the fight against inflation, or interest rates would have needed to increase. This view, however, is very much open to question. It is clear from the evidence collected in the course of the Committee's enquiry into monetary policy, that there is no simple relationship between the PSBR,

the money supply and interest rates. Each is very much influenced by what is happening to economic activity as well as by inflation. In 1980, for example, the substantial increase in £M3 appears to be largely attributable to an increase in private, rather than public, sector borrowing, itself partly caused by the deflationary effects of government policy and the high exchange rate. Companies experiencing a collapse in profits as output fell had little option but to have recourse to borrowing to remain in business, irrespective of the interest costs of borrowing. What would have been the effect if public expenditure had not been allowed to increase and the PSBR had been held down? This is by no means certain, but it is probable that the fall in output would have been more prounouced and possible that private sector borrowing would have been even greater.

13. Nor is it clear that Government borrowing had to be reduced in the Budget in order for interest rates to be brought down. Interest rates were progressively reduced during 1980-81, despite the substantial rise in the PSBR. It is even less clear that £10½ billion represents the appropriate level of the PSBR in 1981-82 in order to achieve monetary and interest rate targets, or that monetary growth above 10 per cent would have had disastrous inflationary repercussions. If, as the Government now apparently believes, the massive growth in the money supply over the past year will not significantly boost future inflation, why should a rate somewhat above 10 per cent cause concern? Would a higher rate of monetary growth, which may or may not have resulted from a higher PSBR (the experience of 1975 when the PSBR exceeded 10 per cent of GDP and M3 grew by less than 7 per cent should be recalled), have boosted domestic costs, the continuing slowdown in which, according to the Financial Statement

(p. 26) is likely to reduce inflation in 1982? Would not the continuing depressed level of economic activity, which was forecast even before the tax increases announced in the Budget, have continued to slowdown domestic cost increases, just as it has done in the past year? Is it justifiable to frame a Budget purely in terms of its assumed effect on one variable, the rate of monetary growth, rather than in terms of its effect on the economy as a whole?

14. The weight of evidence, some of which was compiled during the Committee's monetary inquiry, is against the Chancellor's assertions on all of these issues. There are other points of controversy in the Budget statement. In particular, it is hard to believe that boosting demand would not affect output at present, in view of the CBI findings that around 95 per cent of companies in January considered a lack of orders and sales to be the principal constraint on output (see CBI, The Will to Win). In this context, it is difficult to see the rationale for the Government's concern about the over spending on the defence programme which occurred in 1980-81 as a result of contractors making faster than expected progress on completing work because of the depressed level of economic activity. Why impose a moratorium on contracts, as the Government did between August and November, when there is excess capacity among suppliers?

15. It is also by no means clear that the Budget measures will 'help redress the balance of the economy in favour of business and industry' which, according to the Chancellor, they were designed to do. The higher taxes imposed on the personal sector will inevitably depress demand for the output of industry, thereby reducing profits even further and swamping any beneficial effect of the specific measures introduced in the Budget to help industry.

Saving?

The Medium-Term Financial Strategy

16. The events of the past year seem to have done little to shake the Government's faith in the medium-term financial strategy. £M3 remains the target variable, in spite of the recent and apparently unresolved difficulties in controlling its growth, on the grounds that 'over the medium-term its velocity of circulation has been *broadly stable* and ... (it) can be more readily related to the growth of nominal income (than other measures)'. (Financial Statement, p. 16, my italics). This statement is extraordinary in the light of the behaviour of the velocity of £M3 over the past decade. For example, velocity at present is some 50 per cent above its level at the beginning of 1974, and although it has tended to rise steadily over the past few years - after rapid growth in 1974 and 1975 - there is no knowing whether it will continue to grow over the next three years or whether its very recent decline in the second half of 1980 presages a reduction to lower levels.

17. The excess growth of £M3 in 1980 is not to clawed back in the immediate future, though consideration is to be given to this possibility 'as and when the opportunity arises'. The target ranges are, therefore, the same as announced last year. The PSBR projected to be consistent with these targets has been revised upwards, though by decreasing amounts for each year. It therefore shows a significantly bigger fall in relation to GDP, from 6 per cent in 1980-81 to 2 per cent in 1983-84, than in last year's version of the strategy, when the fall was from $3\frac{3}{4}$ per cent to $1\frac{1}{2}$ per cent. This is despite the underlying output growth assumption being revised downwards from an average of 1 per cent a year between 1980 and 1983 to $\frac{1}{2}$ per cent a year - a figure which seems equally as arbitrary and equally as likely to be proved optimistic on present

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Government policy, as suggested below.

18. The lower growth assumption serves to depress projections of public sector revenue, but this is more than offset by the higher tax rates announced in the Budget. Nevertheless, with the higher levels of public expenditure now planned, the possible 'fiscal adjustment' - which essentially means the scope for tax cuts - in future years, is much reduced and, indeed, is not sufficient to restore pre-Budget tax rates by 1983-84. This can be seen in Table 5, which sets out the projections in a way which enables a comparison with the previous version of the medium-term strategy to be made. General government expenditure is shown to be £4½ billion higher at 1979-80 prices than previously intended in 1981-82 and £5½ billion higher in 1982-83. In 1983-84, the difference is reduced to £3½ billion, partly as a result of an assumed fall in relative prices in that year. Relative prices are also forecast to fall in 1981-82 by 1 per cent, largely as a result of pay restraint which is assumed to hold down the rise in public sector pay by 2½ per cent below the general rate of inflation (i.e. 7½ per cent as against 10 per cent). With public sector costs projected to rise at the same rate as general inflation in 1982-83, the relative price effect is, therefore, assumed to contribute a reduction of 2 per cent to the cost of total public spending over the next three years. If achieved, it would almost certainly imply a significant fall in the real wages of government employees over this period. This may prove an assumption which is difficult to fulfill. On the other hand, failure to fulfill it could add significantly to expenditure by 1983-84. If relative prices were, for example, to increase at their historic rate of 0.8 per cent a year from 1981-82 onwards - i.e. assuming that the relative effect is indeed negative in that year -

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Table 5 Expenditure and Revenue projections in the Medium-Term Financial Strategy

£billion at 1979-80 prices

	1979-80	1980-81	1981-82	1982-83	1983-84
General government expenditure:					
last year's plans	88.8	88¾	87 [illegible]	84½	84
this year's plans	88.8	91½	91½	90	87½
Government revenue:					
last year's MFTS	78.4	80¼	80¼	82½	84½
before Budget changes*	78.4	79½	79½	81	82
General Govt. borrowing requirement:					
before Budget changes	10.4	12	12	9	5½
present target	10.4	12	9	7	4½
Fiscal adjustment:					
this year	-	-	-3	-2	-1
last year	-	-	-	+3	+4

*Revenue projections on the basis of the revised forecast of output growth and slightly lower North Sea oil revenue

it would add over £1½ billion to the cost of expenditure in 1983-84.

19. Whereas the expenditure forecasts have been revised upwards since last year, the revenue projections have been reduced as a result of a deterioration in growth prospects. This produces a gap of £12 billion between the two in 1981-82, which has had to be cut by increased taxes of £3 billion in the Budget to achieve the Government's revised target borrowing of £9 billion at 1979-80 prices. This can be regarded as a negative fiscal adjustment as shown in Table 5. In 1982-83 and 1983-84, the pre-budget gap is £9 billion and £5½ billion, requiring a negative fiscal adjustment of £2 billion and £1 billion respectively to achieve the desired level of borrowing. In 1983-84, therefore, taxes on these projections still need to be higher than before the present Budget. This contrasts with the scope for significant tax cuts envisaged last year.

20. Given this prospect, even under the relatively favourable assumptions underlying the projections, it is perhaps not surprising that the Financial Statement foreshadows a further public expenditure cutting exercise during the coming year. Yet in view of the difficulty so far experienced in securing a reduction in total expenditure it remains questionable whether much can be achieved during a time of economic recession when there is almost continuous upward pressure on spending.

Economic Prospects

21. The possibility of getting taxes down even from their present high level depends, under the Government's strategy, on economic recovery occurring despite continuous fiscal and monetary restriction. The effect of the budget measures is to depress output even further, to postpone any recovery and add to the mounting numbers unemployed. The Government

is now forecasting a fall in GDP of 2 per cent in 1981, as against the fall of $1\frac{1}{2}$ per cent forecast in November, and a decline in manufacturing output of 6 per cent as against one of 4 per cent projected four months ago. The upturn which was then confidently expected to get under way at the beginning of 1981 is not now expected to occur until much later in the year, largely because there is now thought to be more scope for additional destocking. The upturn however, seems to depend in the Government's forecast on a marked, but temporary, rise in fixed investment in the second half of 1981, which is somewhat difficult to understand given the depth of the recession and the depressed state of profits. It is also in stark contrast to the results of the CBI's recent survey of business intentions, which showed a prospective fall in manufacturing investment of 15 per cent in 1981. It is noteworthy that this upturn on the Treasury forecast is accompanied by a rapid growth of imports which quickly eliminates the large balance of payments surplus on current account, given a continuing fall in exports (despite the growth of North Sea oil production). This raises the question of how the balance of payment problems encountered with a recovery of output would be resolved, and how far the downward pressure on the exchange rate which would almost certainly arise under such circumstances would jeopardize the control over inflation.

22. In 1981, the large surplus on current account resulting from the depressed state of demand is likely to be a factor keeping the exchange rate high, and hence a factor weakening net export performance.

23. Although the Treasury short-term forecast is depressing enough, post-Budget projections on the CEPG model show an even greater fall in GDP in 1981, of almost ~~4~~ $3\frac{1}{2}$ per cent, with unemployment close to 3 million

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by the end of the year and with a substantial decline in both investment and exports. The tax increases announced in the Budget have significantly worsened the short-term outlook, reducing output by around 1 per cent in 1981 and 2 per cent in 1982, so increasing unemployment by some 300 thousand. In our view, there is little chance of an upturn this year or even next - indeed output on present policy is projected to continue declining for some years, albeit very slowly. Accordingly the Government will continue to face acute problems in keeping down borrowing. ~~Though~~ Although the PSBR may well turn out to be within the target of ~~there may be little likelihood of the PSBR exceeding~~ £10½ billion this year, the need for further tax increases or public expenditure cuts to keep down borrowing is likely to arise next year and at periodic intervals thereafter. While, ~~with~~ as the Chancellor said, it may be true that, '~~as we look forward~~ we can reasonably expect lower inflation' on these policies, it is hard to believe that we can also expect 'lower unemployment and a reversal of the upward trend in the burden of taxation', ~~indeed the damage inflicted~~ or indeed a strengthening, rather than the erosion, of the industrial base. ~~[illegible]~~

Department of Applied Economics

Cambridge

13 March 1981

Addendum: Proposed Changes in the Planning of Public Expenditure

1. In his Budget Statement, the Chancellor announced his intention of moving from a system of planning public expenditure in volume terms, to one of planning expenditure in cash terms. The planning exercise for 1982-83 will apparently be undertaken in these terms. The present procedure of expressing expenditure at constant survey prices has important defects. In particular it does not allow for changes in the relative cost of public sector purchases and payments, which have financing implications in the same way as volume changes. But planning in cash terms involves equally important problems. Some forecast has to be made of future inflation some time before the beginning of the financial year in question. Until such a forecast is made, there is no way of knowing how much finance is likely to be available for public expenditure programmes, since the available finance varies as prices change.

2. This forecast will inevitably be subject to quite a wide margin of error. There will be pressure on the Government to understate future inflation, if only because of the influence any announcement might have on the future course of prices. If inflation turns out to be more than is forecast and incorporated in the plans, then the problem still arises of keeping spending within cash limits. Forward planning does not resolve this problem since Departments have little basis for judging how tight their budgets will turn out to be. This problem seems to have been particularly acute over the past year and appears to have been met more than in the past by the simple expedient of adjusting cash limits.

3. If the volume of expenditure is successfully depressed to accommodate higher prices, the effect will be deflationary, since more will be taken out of the economy by way of increased tax revenue at unchanged tax rates

(revenue increasing more or less in line with inflation under the present UK tax system). Although a more restrictive fiscal policy might be thought desirable under these circumstances, it is by no means clear that the degree of restriction automatically imposed under this procedure is precisely of the right order.

4. Alternatively, though less likely, inflation may turn out to be less than forecast and incorporated in expenditure plans. In this case, Departments will find themselves with excess cash to spend, public expenditure will tend to rise and ~~the~~ fiscal policy will become more expansionary. Again it is by no means certain that this is the most desirable response to this turn of events.

5. A more efficient solution to the problem is to plan and control expenditure in cost terms, as proposed by the Armstrong Committee Report on Budgetary Reforms. Under this procedure, an assumption would be made about the general rate of future inflation and the cost of public expenditure programmes estimated in relation to that assumption. Plans would then be expressed at some set of constant prices, but inclusive of the relative price effect. If the general rate of inflation turned out to be higher than assumed, an adjustment could be made to the cash available for expenditure to keep it in line with the tax revenue coming into the Exchequer. If no adjustment were made for relative price changes, this would be sufficient to keep the effective cost of public expenditure unchanged and ought not to increase financing problems. A more detailed account is given in the Armstrong Committee Report (Chapter 3). It is perhaps an issue which the Treasury Committee might usefully consider.

Appendix Table A.1 Public Expenditure in 1980-81: White Paper Forecast Compared with latest Estimates, at 1979-80 Outturn Prices, incl. RPE

	Cmnd. 7439 (Jan. 1979)	Cmnd. 7841 (March '80)	Cmnd. 8175 (March '81)	Change: Jan. 1979 to March '80	Change: March 1980 to March 1981	Change: Jan. 1979 to March '81
Defence	9507	9443	9459	- 64	+ 16	- 48
Overseas aid	2368	2227	1643	-141	-584	-725
Agriculture	1065	921	1336	-144	+415	+271
Industry	3926	3462	3944	-464	+482	+ 18
Transport	3638	3223	3359	-315	- 53	-279
Housing	6794	4978	5556	-1816	+578	-1238
Other environ. services	3956	3719	3731	-237	+ 12	-225
Law and order	2956	2996	2999	+ 40	+ 3	+ 43
Education	11069	10737	10973	-332	+236	- 96
Health	10823	10714	11425	-109	+711	+602
Social Security	19803	19376	19130	-427	-246	-673
Other public services	1167	1189	1180	+ 22	- 9	- 13
Common services	1262	1166	1227	- 96	+ 61	- 35
Northern Ireland	2483	2425	2498	- 58	+ 73	- 15
Nationalised industries' borrowing	700	758	1690	+ 58	+932	+990
Contingency reserve	1735	1108	193	-627	-915	-1542
Shortfall	-2570	-1165	-	+1405	+1165	+2570
Special sales of assets	-	-500	-325	-500	+175	-325
Planning total	80682	76877	79950*	-3805	+3073*	-732
Net debt interest	2800	3500	4300	+700	+790	+1490
Total expenditure	83482	80374	84250	-3105	+3863	+758

*The sum of the programmes is £80018 m., but this is represented as £79950m. in Cmnd. 8175. The change between March 1980 and March 1981 is £3141 m. if the changes to individual programmes are summed.

Notes: The table is constructed by revaluing the figures at outturn prices, including the relative price effect, given in Cmnds. 7439 and 7841 by the change in the GDP (market price) deflator over the relevant period. As far as possible the figures have been adjusted to a common classification basis, using all the information available.

Appendix Table A.2. Public Expenditure by Economic Category

£ million at 1980 Survey prices

	1975-76	1976-77	1977-78	1978-79	1979-80	1980-81	1981-82
Current goods & services:							
Cmnd.8175	38641	38497	38298	38973	39609	39707	39796
Cmnd.7841				(38973)	39669	39726	39957
Cmnd.7439				(39123)	40280	41021	41511
Capital goods & services:							
Cmnd.8175	10431	9595	7892	7029	6414	5484	4694
Cmnd.7841				(7029)	6585	5951	4935
Cmnd.7439				(7792)	8148	8169	8100
Nationalised industries investment:							
Cmnd.8175	5403	5176	4654	4664	4715	4538	5200
Cmnd.7841	(5403)	(5176)	(4668)	(4704)	4658	4819	5171
Cmnd.7439	(5403)	(5152)	(4651)	(4533)	4596	4763	4992
Total goods and services (General Govt.)							
Cmnd.8175	49072	48092	46190	46002	46023	45191	44490
Cmnd.7841				(46002)	46254	45677	44892
Cmnd.7439				(46915)	48428	49190	49611
Grants and subsidies							
Cmnd.8175	28311	28859	28658	30348	30502	31542	31481
Cmnd.7841				(30348)	30903	31116	30424
Cmnd.7439				(30756)	31523	32154	32574
Nationalised industries' borrowing							
Cmnd.8175	2669	2439	1013	1987	1973	1942	1035
Cmnd.7841				(1987)	1984	1109	-45
Cmnd.7439				(2097)	1485	1228	1084
Net lending & special sales of assets							
Cmnd.8175	2830	1512	-387	213	-723	379	1311
Cmnd.7841				(213)	-598	-120	1054
Cmnd.7439				(505)	534	537	634

Appendix Table A.2. Public Expenditure by Economic Category (cont.)

	1975-76	1976-77	1977-78	1978-79	1979-80	1980-81	1981-82
Contingency reserve:							
Cmnd.8175	-	-	-	-	-	193	1650
Cmnd.7841	-	-	-	-	93	1160	1400
Cmnd.7439	-	-	-	51	1000	1725	2450
Shortfall:							
Cmnd.8175	-	-	-	-	-	-	500
Cmnd.7841	-	-	-	-	-280	-1120	-840
Cmnd.7439	-	-	-	-1197	-2500	-2500	-2500
Planning total:							
Cmnd.8175	82883	80902	75475	78551	77776	79245	79663
Cmnd.7841				(78551)	78356	77820	76880
Cmnd.7439				79127	80470	82334	83853
Net debt interest:							
Cmnd.8175	1694	2185	2476	2853	3834	4290	4600
Cmnd.7841				(2853)	3300	3500	3500
Cmnd.7439				2565	2680	2800	2800
Total public expenditure:							
Cmnd.8175	84577	83087	77951	81404	81610	83535	84063
Cmnd.7841				(81404)	81656	81320	80380
Cmnd.7439			(77951)	81692	83150	85134	86653
Total public expenditure at cost (i.e. incld. RPE)							
Cmnd.8175	84577	83701	77078	80220	80894	84252	83944 ~~84056~~
Cmnd.7841				(80220)	79905	80133	79207

Notes: The basic source is Cmnd.8175, Table 1.8. The figures for previous years are constructed by using the information on changes between White Papers given in Cmnd.8175, Table 1.12 and Cmnd.7841, Table 5.9. The figures for 1981-82 in respect of Cmnd.7439 are calculated by assuming that the percentage changes between 1980-81 and 1981-82 are the same when measured at 1980 Survey prices as when measured at 1978 Survey prices.

Notes to Table Appendix Table A.2. (cont.)

For the years 1975-76 to 1978-79, the value of child tax allowances (allowing for clawback), as given in Cmnd.7841, p.111 has been added to the figures for 'Grants and subsidies' to make them comparable with the figures for later years.

The contingency reserve and nationalised industries' borrowing for 1981-82 in respect of Cmnd.8175 include the additional amounts announced by the Chancellor in the Budget Statement, which are ~~This is~~ estimated at £150 million and £88 million at 1980 Survey prices, respectively.

The figures for total public expenditure at cost are calculated from the details on relative prices given in the three White Papers.

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MR UNWIN

cc Mr Burns
Mr Middleton
Mr Battishill
Mr Bridgeman
Miss Brown
Mr Cassell
Mr Evans
Mr Monck
Mr Sedgwick
Mr Ridley

For information

Principal Private Secretary COPY
PS/Chief Secretary
PS/Financial Secretary

TREASURY COMMITTEE AND THE BUDGET: PAPER TR(Budget)4 by HENRY

I attach this note by Henry sent across to us by the Clerks to the Committee earlier this afternoon.

M T Folger

M T FOLGER
17 March 1981

An Analysis of the Budget Changes using the National Institute of Economic and Social Research (NIESR) Model.

March 1981

S.G.B.Henry

(1) Introduction

This short paper provides a forecast of the effects of the Chancellor's measures on the macroeconomy over the period ending 1982 fourth quarter. The forecasts are generated using the National Institute model, and since the later discussion will consider the net effects on the economy of the Budget changes, the forecast issued by the National Institute is first briefly described. Succeeding discussion will then be concerned to show how that forecast has been altered in the light of the Budget changes.

Initially the assumptions underlying the NIESR forecast should be clarified, as they will figure heavily in the subsequent discussion. The forecast was made on the assumption of unchanged policies. This is not an unambiguous concept. In the case of the February forecast, the most relevant parts of this assumption for the later discussion, were

(i) The effective exchange rate was forecast to reach 111.6 by 1982 04. It was assumed that the increases were evenly distributed over the forecast period. [The dollar rate was assumed to move from 2.4 to 2.607 over the same period.]

(ii) That MLR be reduced by one percentage point in the Budget and by a further one percentage point in 1982.

(iii) Indexation of direct tax allowances and bands, and specific duties by the rate of consumer price inflation over the previous year.

The forecast is summarised in table 1 below.

(A full account is given in the National Institute Economic Review, February 1981.)

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TABLE 1.

Estimates and forecasts of the gross domestic product

The forecast figures are not intended to be more precise than the general statements in the text

£ million, 1975 prices, seasonally adjusted

	GDP[a]		Consumers' expenditure	Public authorities' current spending	Gross fixed investment	Exports of goods and services	Stock-building	Residual[b]	Total final expenditure[a]	Imports of goods and services	Adjustment to factor cost
	Index, 1975=100	At factor cost									
1979..	110.7	103,964	71,270	24,334	20,506	32,896	1,610	991	151,607	35,250	12,393
1980..	107.7	101,146	71,621	24,666	19,987	33,250	−2,070	154	147,608	34,137	12,325
1981..	*106.3*	*99,870*	*72,332*	*24,430*	*18,219*	*32,694*	*−2,000*	*− 174*	*145,501*	*33,377*	*12,255*
1982..	*106.5*	*100,047*	*73,481*	*24,000*	*17,492*	*33,504*	*− 600*	*− 175*	*147,702*	*35,221*	*12,434*
1979 I	108.7	25,527	17,456	6,024	4,998	7,412	659	352	36,901	8,275	3,098
II	112.5	26,420	18,375	6,089	5,052	8,663	296	133	38,608	8,990	3,198
III	110.5	25,950	17,543	6,121	5,182	8,411	324	295	37,876	8,970	2,956
IV	111.0	26,067	17,896	6,100	5,274	8,410	331	211	38,222	9,014	3,141
1980 I	110.1	25,856	18,338	6,131	5,169	8,611	− 288	260	38,221	8,982	3,383
II	108.3	25,433	17,704	6,182	5,058	8,317	− 126	− 12	37,123	8,829	2,861
III	106.2	24,940	17,689	6,193	4,923	8,138	− 656	− 51	36,286	8,325	3,021
IV Estimate ..	106.1	24,917	17,890	6,160	4,837	8,134	−1,000	− 43	35,978	8,001	3,060
1981 I Forecast ..	*106.3*	*24,957*	*17,988*	*6,160*	*4,722*	*8,136*	*− 700*	*− 44*	*36,263*	*8,254*	*3,051*
II	*106.4*	*24,997*	*18,038*	*6,150*	*4,595*	*8,137*	*− 500*	*− 44*	*36,376*	*8,318*	*3,061*
III	*106.4*	*24,986*	*18,112*	*6,080*	*4,493*	*8,195*	*− 400*	*− 44*	*36,436*	*8,381*	*3,068*
IV	*106.2*	*24,930*	*18,194*	*6,040*	*4,410*	*8,226*	*− 400*	*− 43*	*36,427*	*8,422*	*3,074*
1982 I	*106.2*	*24,944*	*18,304*	*6,000*	*4,382*	*8,276*	*− 300*	*− 44*	*36,618*	*8,583*	*3,091*
II	*106.5*	*25,017*	*18,353*	*6,020*	*4,352*	*8,360*	*− 200*	*− 44*	*36,840*	*8,720*	*3,103*
III	*106.6*	*25,043*	*18,393*	*6,000*	*4,364*	*8,415*	*− 100*	*− 44*	*37,028*	*8,870*	*3,114*
IV	*106.6*	*25,043*	*18,432*	*5,980*	*4,394*	*8,453*	*—*	*− 44*	*37,215*	*9,046*	*3,126*
Percentage changes											
1980/79	−2.7	−2.7	0.5	1.4	−2.5	1.1			−2.6	−3.2	−0.5
1981/80	*−1.3*	*−1.3*	*1.0*	*−1.0*	*−8.8*	*−1.7*			*−1.4*	*−2.2*	*−0.6*
1982/81	*0.2*	*0.2*	*1.6*	*−1.8*	*−4.0*	*2.5*			*1.5*	*5.5*	*1.5*
1980 IV/79 IV ..	−4.4	−4.4	—	1.0	−8.3	−3.3			−5.9	−11.2	−2.6
1981 IV/80 IV ..	*0.1*	*0.1*	*1.7*	*−1.9*	*−8.8*	*1.1*			*1.2*	*5.3*	*0.5*
1982 IV/81 IV ..	*0.4*	*0.5*	*1.3*	*−1.0*	*−0.3*	*2.8*			*2.2*	*7.4*	*1.7*

Source: *Economic Trends*, NIESR estimates.

(a) Output measure.
(b) The discrepancy between output and expenditure estimates of GDP.

Apart from this summary information on the forecast development of GDP and its components, other forecast items, which will figure in later comment, are

TABLE 2.

	CPI (Change, 4th quarter on 4th quarter)	Current balance (£ billion)	Unemploy ment* (GB, 4th quarter)
1981	9.6	5.1	2.67
1982	8.2	3.2	2.99

* excluding school leavers

I do not intend to discuss the basis of this forecast here, but the points made above about assumptions underlying it should be stressed, particularly (iii) the indexation assumption.

(2) The Effects of the Budget Changes

This part of the paper will outline the effects on the February forecast contained in Tables 1 and 2, when allowance is made for the Budget changes. In each exercise the assumptions used in the February forecast will be retained. The sequence followed will be to describe the probable effects of the non-indexation of the tax allowances and bands, then the effects of the over indexation of indirect taxes. Finally a complete forecast incorporating all the Budget changes will be reported, and this will be compared with the forecast provided in the Financial Statement and Budget Report (FSBR 1981-82).

A common ingredient in these exercises will be that the exchange rate forecast (i) above, will be retained. The section will conclude with an analysis of the effects of changing this forecast. I should emphasise two things about this forecast before proceeding: that it is a smoothed forecast and that it is different from the Treasury's assumption of a flat effective rate. On the first point the forecast is for an increase in the effective rate over the two year period. This in turn was due to factors favourable to sterling, including the continuing rise in the real price of oil and a favourable current balance. However, because of the difficulty of deriving reliable quarterly forecasts of the exchange rate, the increase over the two year period was assumed to take place fairly smoothly. This remark is not to minimise the considerable research effort which has gone into attempts by the NIESR, amongst others, to derive an equation for the exchange rate, capable of explaining short run movements. The current state of play of this research among UK modellers is summarised in Cuthbertson, Henry, Mayes and Savage (1980), which, briefly, showed that models based on relative price movements ('purchasing power parity') or relative money supplies ('international monetarist') were not able to account for the recent upsurge in sterling. In the face of these problems, not surprisingly, forecasters rely on ad hoc additional factors including variables related to North Sea oil (eg the LBS uses the change in £ holdings of OPEC countries, and reserves of North Sea oil in the ground, see LBS Listing February 1981). On the second point the Treasury has assumed a constant exchange rate, which may be viewed as a cautious 'working assumption'. Such an assumption will have important implications for inflation and output, and the final part of this section analyses the effect of a lower exchange rate, on the results of the forecast described under the higher rising exchange rate.

(a) <u>Simulation 1. Non indexing of Personal Tax Allowances and Tax bands</u>

TABLE 3.

	Unemployment (millions, 4th quarter)	CPI (4th quarter on 4th quarter)		GDP at factor cost (output)	
1981	2.67	1981/80	9.7	1981/80	-1.4
1982	3.05	1982/81	8.6	1982/81	0.0

The purpose of this exercise is that of illustrating the consequences of the non-indexing of direct taxes when this is considered alone. In this forecast output falls by nearly an additional ½ a percent compared with its pre Budget forecast level the end of 1982. Changes in unemployment, additional to those forecast earlier, build up slowly. The important thing to stress about these unemployment figures is that only a fraction of the long run change in unemployment arising from this change in GDP will appear by the end of 1982. As will be true of the other forecasts given here, the cumulative effect of the change on unemployment will be delayed due both to the lagged build up of the change in GDP, and the further lag in the response of unemployment to these changes in output. According to the NIESR model the full effect will take a further 1-1½ years to work out, and will then be at least twice the value of approximately 50,000 reached at the end of 1982.

Finally the CPI is increased by this tax change and is estimated to reach 231 by the 4th quarter of 1982 compared with 230 (index 1975=100), an increase of approximately 0.4 per cent. As with the previous figures for unemployment, here again it is important to emphasise what this forecast means. This quoted change is the additional increase in the CPI brought about by the increase in direct tax take. This increase however takes place against a background of falling rates of inflation, which in turn is due to exchange rate movements and a slower rate of increase in wage settlements. Thus the forecast is for a small increase in prices inflation, due to the onset of an increased tax take, as an attempt is made to recoup the real net losses in earnings which the non indexation of direct taxes implies.

(b) The non-Indexation of Direct Tax & over indexation of Indirect Taxes combined

We now combine the effects of both the change in direct taxes, and the changes in specific and ad-valorem duties announced in the Budget, i.e. on the indirect tax side there are the additional changes to those already allowed for in our unchanged policy assumption (p. 1 above). The effects on output, unemployment and inflation for the period ending in the 4th quarter of 1982 are shown in table 4.

TABLE 4.

	Unemployment (millions, 4th quarter)	CPI (4th quarter on 4th quarter)		GDP (output) at factor cost	
1981	2.681	1981/80	11.5	1981/80	-1.5
1982	3.10	1982/81	9.5	1982/81	-0.3

In this run, output falls by 1.5% in 1981/80 1982/81 compared with our pre-Budget forecast of a fall of 1.3%. In 1982/81 there is a further fall of 0.3% compared with our previous forecast of a small rise of 0.2%. Unemployment now falls by a further 54,000 by the end of the period, though again it must be emphasised, this is only part of the adjustment, and the full effects on the level of unemployment will be twice as large as this at a minimum.

The effect on the CPI is to push the annual rate of inflation (measured as 4th quarter on 4th quarter) to 11% for 81/80 and 9.5% 82/81. This compares with the Treasury's forecast of an immediate 2% addition to the RPI. Ours produces a little over 1% on the CPI, but this is due to the fact that we had already indexed excise duties in our February forecast. Also, according to our forecast, the Treasury view that this effect on price inflation quickly evaporates is not borne out. This result is partly due to our view that wage bargainers will attempt to recoup tax losses, in higher nominal wage increases, an effect which, it is interesting to note, is also present in the Treasury model.

(c) The tax changes, MLR and stock relief and changes in supplementary taxes.

The full post Budget forecast incorporating all the announced changes is shown below, using a table similar to that used in FSBR (except that it uses quarterly not half yearly values). The forecast is compared to that in the FSBR, which is reproduced as Table 5 below.

TABLE 5.

Gr[illegible] domestic product (output estimate) at factor cost, £ million, 1975 prices, seasonally adjusted

	OUTPUT INDEX 1975=100	GDP FACTOR COST	CONSUMER EXPEND	PUBLIC AUTHS. EXPEND	GROSS FIXED INVEST.	EXPORTS OF GOODS + SERVS	STOCK BUILD -ING	RESID.	TOTAL FINAL DEMAND	IMPORTS OF GOODS + SERVS	ADJ. TO FACTOR COST
I..	106.3	24957	17988	6160	4722	8136	-700	-44	36263	8254	3051
II..	106.2	24945	17960	6150	4587	8137	-499	-44	36292	8295	3051
III..	106.1	24915	18025	6086	4471	8194	-417	-43	36289	8331	3057
IV..	105.7	24829	18051	6046	4392	8224	-423	-43	36250	8355	3056
I..	105.7	24824	18148	6000	4365	8273	-324	-43	36418	8524	3072
II..	106.0	24835	18137	6020	4337	8355	-225	-43	35631	8563	3081
III..	106.0	24898	18208	6006	4347	8408	-123	-43	36797	8813	3039
IV..	106.0	24883	18233	5980	4373	8444	-24	-43	35963	8981	3099
I..	106.4	24982	18292	5980	4402	8476	76	-44	37182	9368	311[illegible]

[illegible]NTAGE CHANGES

78	2.1	2.1	4.7	2.0	-1.4	2.7			4.2	11.0	4.0
79	-2.7	-2.7	.5	1.4	-2.5	1.1			-2.6	-3.2	-.5
80	-1.5	-1.5	.5	-1.6	-9.1	-1.7			-1.7	-2.6	-.9
81	-.1	-.1	1.1	-1.9	-4.1	2.4			1.2	5.2	1.[illegible]
V/78IV	1.7	1.7	3.6	1.1	3.5	4.3			4.5	13.6	4.4
V/79IV	-4.4	-4.4	-.6	1.0	-9.3	-3.3			-5.9	-11.2	-2.[illegible]
V/80IV	-.4	-.4	1.0	-1.9	-9.2	1.1			.8	4.5	-.1
V/81IV	.2	.2	1.0	-1.5	-.4	2.7			2.0	7.4	1.4

% Δ in CPI (4th quarter on 4th quarter)		Current Balance (£billion)		Unemployment (GB. 4th quarter)
1981/80	11	1981	5.3	2.68
1982/81	9.5	1982	3.8	3.10

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TABLE 6.

FSBR (1981-82) forecast

Constant Price Forecasts of Expenditure, Imports and Gross Domestic Product[(1)]

£ million at 1975 prices, seasonally adjusted

	Consumers' expenditure	General Government expenditure on goods and services			Other fixed investment	Exports of goods and services	Change in stocks	Total final expenditure	*Less* imports of goods and services	*Less* adjustment to factor cost	*Plus* Statistical Adjustment	Gross domestic product at factor cost	GDP index 1975 =100
		Final consumption	Fixed investment	Total									
... ...	71,300	24,300	3,400	27,700	17,150	32,900	1,600	150,650	35,250	12,400	300	103,300	110·1
... ...	71,700	24,750	2,850	27,600	17,200	33,200	−2,200	147,500	34,200	12,450	0	100,850	107·4
... ...	71,100	24,950	2,150	27,100	17,000	31,450	−2,100	144,550	33,350	12,400	0	98,800	105·3
t half ...	35,850	12,100	1,650	13,750	8,400	16,050	1,000	75,050	17,250	6,300	150	51,650	110·0
ond half...	35,450	12,200	1,750	13,950	8,750	16,850	600	75,600	18,000	6,100	150	51,650	110·1
t half ...	36,050	12,300	1,500	13,800	8,750	16,900	−400	75,100	17,800	6,250	150	51,200	109·1
ond half...	35,650	12,450	1,350	13,800	8,450	16,300	−1,800	72,400	16,400	6,200	−150	49,650	105·8
t half ...	35,750	12,500	1,100	13,600	8,350	15,800	−1,700	71,800	16,300	6,250	0	49,250	104·9
ond half...	35,350	12,450	1,050	13,500	8,650	15,650	−400	72,750	17,050	6,150	0	49,550	105·6
t half ...	36,150	12,400	1,000	13,400	8,400	15,550	150	73,650	17,600	6,250	0	49,800	106·1
centage changes on earlier													
... ...	½	1½	−16	−½	½	1		−2	−3	0		−2½	
... ...	−1	1	−23	−1½	−1½	−5½		−2	−2½	0		−2	
st half ...	1	−1	−7½	−1½	½	−1½		2½	8	½		1	

P figures in the table are based on "compromise" estimates of gross domestic product.
igures in £ million are rounded to £50 million. Percentage changes are calculated from unrounded levels and then rounded to 0·5 per cent. The GDP index in the final column is ed from unrounded numbers.

% Δin RPI (4th quarter on 4th quarter)	
1981/80	10
1982/81	8

Current Account of Balance of Payments £ bn.		
1981	1st half	2
	2nd half	1
1982	1st half	0

There are several differences to highlight here. First is the difference in price forecast, already noted under (b). The difference here is that the Treasury forecast sees the increase in the price index produced by the Budget changes dropping away significantly more quickly than the National Institute. It appears that their view must assume that either there is no attempt by wage earners to recoup lost net income through higher nominal wage increases, or that additional increases in unemployment produced by the Budget

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or other direct demand effects operate sufficiently strongly to offset this. The role of the money supply in framing this Treasury price forecast (see FSBR p. 5) is unclear, although the evidence against there being predictable effects from this source onto price inflation over a one to two year horizon is overwhelming.

The effect on output in the National Institute forecast is to postpone any sign of an end to the downturn until the beginning of 1983. The Treasury see the upturn occuring at the beginning of 1982. Comparison is slightly complicated however by the use of different measures of GDP.

On unemployment, the National Institute model forecasts a steady additional increase due to the Budget measures only a part of which is incurred by the end of 1982. The full increase is of the order of 150,000 - 200,000 (GB seasonally adjusted) although precise quantifications is difficult, given the possibility of further "shake out" in employment as expectations about real demand become increasingly more pessimistic.

On the other items of the Summary tables 5 and 6, the expectation for the Current Balance in 1981 is very different between the two, largely reflecting the very strong effect on exports of declining competitiveness in the Treasury forecast. The National Institute model is more optimistic on this point, although it should be emphasised that there is some uncertainty about the size and timing of competitiveness effects on exports.

The net effect on stockbuilding of the change in interest rates and stock relie and the indirect effects working via output and expected future output is forecast to be a small increase in destocking. The changes are very small compared to those typically experienced in stockbuilding and the underlying profile is similar to the pre Budget forecast. Investment is also not forecast to increase following the Budget changes, the indirect effect of output changes slightly more than offsetting the marginal easing of credit conditions.

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For the target variables, the PSBR and £M3, the forecast is that the combined effects of all the Budget changes will be to bring the PSBR down to around £9 billion for 1982/81. This is rather more optimistic than the Treasury's view, though it should be noted that our pre Budget forecast was lower than the Treasury's appeared to be. The net effects on £M3 will be to produce an increase of 3% in the total money stock by the end of 1982, with consequent difficulty in keeping within the targeted range.

To conclude this analysis of the effects of the Budget on the major sectors of the economy, a further 'variant' forecast was made, which allowed the exchange rate (IMF effective rate) to fall by 5 per cent from the value taken in the previous forecasts. The purpose of this exercise was to quantify the effects on domestic inflation and output. A summary of the results are shown in Table 7.

TABLE 7.

Lower Exchange Rate Variant (5 per cent lower exchange rate over 81/82)

	Unemployment/millions 4th quarter	CPI 4th quarter on 4th quarter		GDP factor cost (output)	
1981	2.644	1981/80	12.2	1981	-0.9
1982	2.964	1982/81	10.6	1982	-0.2

The effect of this is effectively to reverse the increases in unemployment and decreases in output growth attributable to the budget changes. The changes are produced only with a significant increase in price inflation however.

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Reference

Modelling and forecasting the capital account of the balance of payments: a critique of the 'reduced form' approach, K. Cuthbertson, S.G.B. Henry, D.G. Mayes and D. Savage, National Institute Discussion Paper No. 37.

(Budget) 10

10

15/18

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cc B Unwin
F Cassell
~~N Monck~~

Mr Evans

We spoke. Wd you please circulate in due course.

8/
18/3

COMMITTEE OFFICE
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TREASURY AND CIVIL SERVICE COMMITTEE

St James's Group Forecasts - Effects of Budget

The EIU have supplied the attached tables showing the effect of the Budget measures (not including those announced in November or the 2% fall in MLR which they had already allowed for) on their medium-term forecast. Some principal effects (comparing their forecast incorporating the Budget measures with their previous forecast) are:

a) A 3% lower level of GDP by 1984 I;

b) 300,000 more unemployed and 400,000 fewer in employment by 1984I;

c) An improvement by 1983/84 of £3.3 billion on the current balance;

d) A reduction in the PSBR of £7 billion in 1983/84;

e) A 3% increase in the RPI by 1984 I corresponding to a 1% pa faster growth in the RPI;

f) A reduction of 6.5% in the stock of £M3 by 1984 I;

g) A reduction in gross company profits of £2.8 billion by 1983/84.

(Interest rates are kept as in the base so the effect of the lower PSBR is to reduce the growth of £M3. The assumption that the exchange rate remains unchanged seems optimistic from the point of view of production given the improvement in the current balance.)

John Hills
18 March 1981

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18/3

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17 March, 1981.

Mr. D. F. Hubback,
Clerk to the Treasury and Civil Service
Committee,
House of Commons,
London, SW1A 0AA.

Dear Mr. Hubback,

The members of the Committee may find these Difference Tables useful. They should be used in conjunction with the attached note to the St. James's Group, i.e. they show a difference between our January forecast and an undate incorporating the changes described in the note.

Yours sincerely,

Paul

Paul Ormerod,
Manager, Economic
Assessment Services.

encl.

EIU Simulation results

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ST. JAMES'S GROUP POST-BUDGET UPDATE

1. The enclosed summary and difference tables have been carried out on our January 1981 medium-term base. The run incorporates those features of the Budget and Public Expenditure White Paper which were NOT included in that forecast. The tables do NOT incorporate data revisions since our previous forecast, and are not a substitute for our complete quarterly update which will appear in about three weeks' time. The tables represent purely a simulation of the effects of the Budget and White Paper on the January 1981 base.

2. The January base run anticipated:

- the 2 per cent cut in MLR
- a proportion of the increase in indirect taxation
- the treatment of North Sea taxation
- the failure to completely index social security benefits this year.

3. Measures changed as a result of the Budget are:

- indexation of personal tax allowances in 1981/82 removed
- additional increases in indirect taxes over and above indexation
- windfall profits tax on banks
- increased target for National Savings
- lowering of fuel prices to large-scale consumers by nationalised industries
- some additional stock relief above that described in the November 1980 measure

4. Measures changed as a result of the Public Expenditure White Paper are:

- a different profile for government expenditure.

This is along the lines announced by the Chancellor, although we have partially discounted the sharp falls planned between 1980/81 and 1983/84 as a whole.

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General Government Expenditure on goods and services, percentage increase in real terms

Financial year	January 1981 base	March 1981 update
1981/82	-0.9	+0.2
1982/83	-0.1	-1.6
1983/84	+0.7	-1.2

5. We have allowed private sector earnings (including the trading public sector) to respond to changes in the price level. Non-trading public sector earnings are unchanged from the base run.

6. We have assumed that the exchange rate remains at the level of the base run. Lower interest rates were already incorporated into our forecast. Higher inflation would of itself tend to lower the rate, but against that the current balance is stronger and monetary growth somewhat lower than in the base run.

7. From the second quarter of 1982, the tax cuts assumed in the January base are retained and the usual indexation of direct tax allowances and specific duties operates.

Paul Ormerod

Paul Capella

11 March, 1981.

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TABLE 1A

SUMMARY TABLE - YEARLY PERCENTAGE CHANGES (EXCEPT WHERE OTHERWISE STATED)

	1980	1981	1982	1983	ANN.AVE. CHANGE 1980-83
ACTIVITY					
GROSS DOMESTIC PRODUCT	-2.17	-2.06	-.78	-.37	-1.07
MANUFACTURING OUTPUT	-9.01	-8.73	-.84	-.62	-3.47
UNEMPLOYMENT %	6.74	10.12	12.04	13.41	1.67
PRICES AND COSTS					
AVERAGE EARNINGS	21.08	13.98	11.05	8.14	11.03
RETAIL PRICES	17.99	12.64	10.44	8.67	10.57
REAL TAKE HOME PAY	1.99	.65	1.38	1.15	1.06
BALANCE OF PAYMENTS					
EFFECTIVE EXCHANGE RATE (SMITHSONIAN = 100)	75.00	77.50	77.50	77.50	.63
	10.62	3.33	0.00	0.00	1.10
RELATIVE WAGE COSTS	137.30	142.13	147.04	147.16	2.47
	23.00	3.52	3.45	.08	2.34
CURRENT BALANCE (£M)	2576	3195	1320	810	-442
CURRENT BAL (£M) AS % OF GDP	1.36	1.51	.56	.32	-.26
BAL OF TRDE EXCL OIL 75 PRCS	-2072	-2589	-4677	-6059	-997
PSBR AND FINANCIAL FORECAST					
PUB. SECT. BORR. REQT. (£M)	11664	11150	7700	4511	-1638
PSBR (£M) AS % OF GDP	5.05	5.27	3.29	1.77	-1.02
MONEY SUPPLY, M3	16.52	15.26	12.90	9.94	12.68
L.A. 3-MONTH INTEREST RATE	15.03	11.93	9.68	8.55	-1.82
LONG DATED GOVT. STOCK	13.71	12.75	10.25	9.25	-1.11

TABLE 1B

SUMMARY TABLE - YEARLY PERCENTAGE CHANGES (EXCEPT WHERE OTHERWISE STATED)

	1980	1981	1982	1983	ANN. AVE. CHANGE 1980-83
DEMAND AND OUTPUT					
CONSUMERS EXPENDITURE	-.02	-.06	.52	-.15	-.17
PUBLIC CONSUMPTION	.64	1.27	-1.11	-1.55	-.47
GROSS FIXED INVESTMENT	-1.23	-5.13	.02	2.89	-.53
CHANGE IN STOCKS (% OF GDP)	-1.44	-1.18	-.44	-.07	.46
CHANGE IN FORGN BAL % OF GDP	1.64	-.60	-1.55	-.68	-.77
GROSS DOMESTIC PRODUCT	-2.17	-2.06	-.78	-.37	-1.07
PRODUCTIVITY AND EMPLOYMENT					
PRODUCTIVITY EXCL OIL	1.20	1.78	1.82	1.02	1.81
LABOUR SUPPLY-MANUFACTURING	.80	.79	.68	.22	.57
LABOUR SUPPLY-OTHER PRIVATE	1.12	1.13	.94	.30	.79
LABOUR SUPPLY-PUBLIC	-.76	-.04	-.72	.81	-.26
LABOUR SUPPLY-TOTAL	.73	.72	.61	.36	.56
N.S. OIL GDP CONTRIBUTION	.09	.26	.32	.32	.30
PRODUCTIVITY POTENTIAL	2.02	2.76	2.75	2.51	2.67
TOTAL EMPLOYMENT	-2.16	-4.03	-2.65	-1.55	-2.75
MEMORANDUM ITEMS					
WORLD TRADE IN MANUFACTURES	7.54	.89	3.60	4.31	2.92
£/DOLLAR EXCHANGE RATE	2.33	2.30	2.30	2.30	-.01
REAL TAKE HOME PAY	1.99	.65	1.38	1.15	1.06
REAL DISP. INCOME	1.26	-2.51	-1.30	-1.24	-1.69
SAVINGS RATIO	14.75	13.34	11.75	10.79	-1.32
TAXES AS PROPORTION OF TDI	34.47	36.07	36.96	36.09	.81
NON-OIL PROFITS %OF TDI	10.50	10.42	10.13	10.31	-.09
NORTH SEA PROFITS % OF TDI	3.03	4.57	5.42	6.24	.80

BUDGET SIMULATION LESS MINI

CURRENT RUN LESS BASE RUN

AT 1975 BASE RUN PRICES, SEASONALLY ADJUSTED
FORECAST COLUMNS 1 TO 9 IN £ MILLION

	1 CONS EXPDT	2 PUBLIC AUTH CONS	3 FIXED INV	4 EXPORTS GOODS + SERVICE	5 INV STOCKS	6 COMP. ADJ.	7 TOTAL FINAL EXPDT	8 IMPORTS GOODS + SERVICE	9 FACTOR COST ADJ	10 G.D.P. AT F-C	11 G.D.P. P-C OF BASE RUN	12 UNEMPLOYMENT C00/S	13 UNEMPLOYMENT P-C	14 EMPLOYEES IN EMPLOYMENT
1981 QTR 2	-185.	108.	-105.	-2.	-2.	0.	-106.	-51.	-11.	-44.	-.18	3.8	.02	-5.0
QTR 3	-245.	108.	-109.	-5.	-21.	0.	-192.	-84.	-20.	-89.	-.36	12.1	.05	-16.0
QTR 4	-286.	107.	-110.	-12.	-37.	0.	-250.	-100.	-26.	-132.	-.53	24.4	.11	-32.3
1982 QTR 1	-318.	107.	-112.	-23.	-45.	0.	-311.	-115.	-31.	-165.	-.66	38.0	.17	-51.3
QTR 2	-413.	74.	-119.	-35.	-41.	0.	-535.	-163.	-58.	-314.	-1.26	63.9	.28	-84.4
QTR 3	-456.	73.	-139.	-50.	-73.	0.	-644.	-206.	-66.	-373.	-1.50	93.0	.41	-122.8
QTR 4	-498.	72.	-154.	-64.	-85.	0.	-729.	-232.	-73.	-424.	-1.70	124.2	.54	-163.8
1983 QTR 1	-555.	72.	-160.	-78.	-86.	0.	-816.	-262.	-83.	-471.	-1.88	154.3	.67	-203.5
QTR 2	-661.	-79.	-181.	-91.	-79.	0.	-1091.	-321.	-116.	-653.	-2.60	193.3	.85	-254.6
QTR 3	-713.	-79.	-199.	-104.	-119.	0.	-1214.	-372.	-125.	-717.	-2.85	233.1	1.02	-306.8
QTR 4	-760.	-79.	-214.	-116.	-127.	0.	-1296.	-399.	-133.	-764.	-3.03	273.0	1.19	-359.0
1984 QTR 1	-819.	-79.	-226.	-120.	-120.	0.	-1373.	-427.	-142.	-804.	-3.16	307.3	1.35	-404.1

BUDGET SIMULATION LESS MINI

DIFF TABLE(21) BALANCE OF PAYMENTS

AT CURRENT PRICES,SEASONALLY ADJUSTED
UNDERLYING AND FORECAST (MILLION £)

	1 EXPORT GOODS	2 IMPORT GOODS	3 VISIB BAL	4 EXPORT SERV	5 IMPORT SERV	6 BAL SERV	7 BAL TRANSF	8 BAL IPD	9 INVIS BAL	10 CURRENT BALANCE	11 CURRENT BALANCE DOLLARS(1)	12 CONTRIBNS OIL (2)
1982	-25	-1095	1070	26	-187	213	45	141	399	1469	3380	-20
1983	-155	-2224	2069	-13	-360	355	93	377	825	2894	6660	-33
1981/82	0	-460	468	34	-111	145	25	23	193	661	1524	-8
1982/83	-43	-1342	1299	18	-225	243	56	190	489	1788	4112	-24
1983/84	-212	-2540	2328	-23	-423	400	107	453	960	3288	7569	-34
1981 QTR 2	1	-62	63	9	-17	26	5	-2	29	92	212	-1
QTR 3	1	-103	104	9	-30	39	6	-1	44	148	341	-2
QTR 4	0	-137	137	9	-31	40	7	9	56	193	443	-2
1982 QTR 1	-2	-166	164	7	-33	40	7	17	64	228	525	-3
QTR 2	-4	-247	243	0	-42	50	10	27	87	330	759	-4
QTR 3	-7	-318	311	7	-52	59	13	42	114	425	977	-6
QTR 4	-12	-364	352	4	-60	64	15	55	134	486	1117	-7
1983 QTR 1	-20	-413	393	-1	-71	70	18	66	154	547	1257	-7
QTR 2	-31	-521	490	-1	-85	84	21	79	184	674	1552	-8
QTR 3	-44	-618	574	-4	-100	96	25	106	227	801	1844	-9
QTR 4	-60	-672	612	-7	-112	105	29	126	260	872	2006	-9
1984 QTR 1	-77	-729	652	-11	-126	115	32	142	289	941	2166	-8

(1) N.B.COLUMN 11 IN U.S.DOLLAR MILLIONS

(2) VALUE OF N.S. OIL PRODUCTION LESS IPD DEBITS

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BUDGET SIMULATION LESS MINI

CURRENT RUN LESS BASE RUN

AT CURRENT PRICES, SEASONALLY ADJUSTED
FORECAST £ MILLION

	1 INCOME FROM EMPLMT	2 INCOME SELF EMPLMT	3 GROSS COMP PROFITS	4 PUBLIC CORP.ETC SURPLUS	5 RENT	6 TOTAL DOM INCOME	7 STOCK APPREC	8 RESID ERROR	9 PUBLIC NET ACQ	10 PERSONS NET ACQ	11 COMPANY FIN.	12 NET ACQ IND.+ COMM.	13 BORROW REQUIRE -MENT	14 G.C.P. NET
1982	1433	-74	-1256	-315	-94	-306	598	-3	4023	-1613	-29	-1057	-3879	-1734
1983	1081	-370	-2545	-365	-171	-2370	346	-7	6441	-2857	-14	-812	-6762	-2022
1981/82	451	-3	-164	-281	-37	-34	227	-2	2418	-1619	-359	75	-2388	-346
1982/83	1515	-126	-1513	-313	-111	-548	595	-2	4556	-1903	34	-1043	-4330	-1988
1983/84	784	-453	-2859	-309	-196	-3113	268	-8	7117	-3189	3	-779	-6955	-3074
1981 QTR 2	-12	2	97	-76	0	11	5	0	534	-546	-103	170	-401	93
QTR 3	33	-3	-20	-60	-7	-57	31	0	555	-405	-97	58	-601	-45
QTR 4	134	-2	-85	-68	-11	-34	71	0	587	-323	-83	-24	-623	-142
1982 QTR 1	296	0	-156	-77	-17	46	120	-2	739	-345	-74	-128	-763	-252
QTR 2	362	-14	-337	-91	-21	-101	161	0	1005	-352	26	-386	-952	-465
QTR 3	395	-24	-301	-77	-26	-113	160	-1	1119	-432	17	-316	-1054	-515
QTR 4	380	-36	-382	-70	-30	-138	149	0	1158	-484	1	-225	-1110	-502
1983 QTR 1	378	-52	-413	-75	-34	-196	117	0	1272	-635	-10	-115	-1214	-506
QTR 2	320	-89	-683	-104	-39	-595	99	-2	1554	-660	-9	-344	-1614	-762
QTR 3	236	-108	-730	-92	-46	-740	74	-3	1729	-744	0	-217	-1682	-790
QTR 4	147	-121	-719	-94	-52	-839	56	-1	1783	-818	6	-134	-1752	-764
1984 QTR 1	81	-135	-727	-99	-59	-939	39	-1	1949	-967	6	-82	-1907	-758

PERCENTAGE CHANGES FROM BASE RUN

	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
		- - P R I C E S - -			RL DSP	WAGE	IMPORT	E X C H A N G E RATES			£M3	MONEY	REL.	REL.	MANUF
	EARNINGS	RETAIL	CONSUMER	WHOLE-S	PIRS INC	COSTS	PRICES	EFF.	DOL/£	EXPECTED		GDP	WAGE COSTS	PRICES	OUTPUT
1981 QTR 2	-.02	1.10	1.25	.01	-2.27	-.00	.27	0.00	0.00	0.00	-.19	.60	-.00	.01	-.25
QTR 3	.16	1.25	1.28	.08	-2.24	.25	.43	0.00	0.00	0.00	-.89	.42	.25	.04	-.57
QTR 4	.51	1.36	1.41	.23	-2.25	.73	.47	0.00	0.00	0.00	-1.46	.38	.73	.11	-.83
1982 QTR 1	1.02	1.55	1.59	.47	-2.43	1.41	.51	0.00	0.00	0.00	-2.06	.43	1.41	.24	-1.03
QTR 2	1.33	1.94	2.02	.00	-2.92	1.88	.71	0.00	0.00	0.00	-2.46	.14	1.88	.39	-1.06
QTR 3	1.59	2.20	2.24	1.13	-3.33	2.27	.88	0.00	0.00	0.00	-2.95	.11	2.27	.55	-2.31
QTR 4	1.74	2.39	2.43	1.41	-3.65	2.49	.99	0.00	0.00	0.00	-3.46	.11	2.49	.68	-2.66
1983 QTR 1	1.91	2.53	2.57	1.63	-4.20	2.75	1.11	0.00	0.00	0.00	-3.99	.06	2.75	.79	-2.95
QTR 2	2.01	2.83	2.09	1.82	-4.78	2.95	1.34	0.00	0.00	0.00	-4.60	-.48	2.95	.88	-3.97
QTR 3	2.06	2.93	2.99	1.96	-5.21	3.06	1.51	0.00	0.00	0.00	-5.23	-.64	3.06	.95	-4.47
QTR 4	2.10	2.99	3.07	2.07	-5.54	3.15	1.59	0.00	0.00	0.00	-5.87	-.75	3.15	1.00	-4.79
1984 QTR 1	2.16	3.03	3.12	2.15	-6.03	3.26	1.67	0.00	0.00	0.00	-6.56	-.85	3.26	1.04	-5.00

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HOUSE OF COMMONS

MINUTES OF EVIDENCE

TAKEN BEFORE THE

TREASURY AND CIVIL SERVICE COMMITTEE

WEDNESDAY 18 MARCH 1981

MR. J.B. UNWIN, MR. F. CASSELL, MR. J.M BRIDGEMAN, MR. H.P. EVANS, MR. A.M.W. BATTISHILL, MR. N.J. MONCK

Evidence heard in Public. Questions 1 - 178

MEMBERS' CORRESTIONS

Any Member of the Committee who wishes to correct the Questions addressed by him to a Witness is asked to send the correction to the Committee Clerk as soon as possible.

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WEDNESDAY 18 MARCH 1981

Members present:

Mr. Anthony Beaumont-Dark
Dr. Jeremy Bray
Mr. Edward Du Cann, in the Chair
Mr. Timothy Eggar
Mr. Michael English
Mr. Terence Higgins
Mr. Michael Meacher
Mr. Richard Shepherd
Mr. Richard Wainwright
Mr. Ken Woolmer

MR. J.B. UNWIN, Under Secretary, Head of Central Unit,
MR. F. CASSELL, Under Secretary, Chief Economic Adviser's Sector,
MR. J.M. BRIDGEMAN, Under Secretary, General Expenditure Policy Group,
MR. A.M.W. BATTISHILL, Under Secretary, Domestic Economy Sector,
MR. H.P. EVANS, Under Secretary, Economic Assessment Division, and
MR. N.J. MONCK, Under Secretary, Home Finance Division, H.M. Treasury,
called in and examined.

Chairman

1. Mr. Unwin, may I welcome you and your colleagues on behalf of the Select Committee.

(Mr. Unwin) Thank you. May I just say that I am sorry we are such a phalanx but I thought that it was such a wide coverage it would be helpful to have as many here as we could who could cover the various areas the Committee are likely to be interested in. Could I also say, if I may take my cue from what you yourself have said on previous occasions, we will certainly try to deal with all the questions put to us by the Committee but I shall not hesitate to take your previous advice and let you know when we need notice or wish to consider further any points put to us.

2. Mr. Unwin, I certainly reiterate the point that I made when we met previously. If there are matters you would prefer to send

us a paper on over the course of the next several days, ratherthan giving us what purports to be a considered answer of the Government, please feel free to do so. You know, and I am sure your colleagues know, that we are very grateful for the opportunity to have your advice and we would rather hav e your considered advice than put you in diffibulty in any way. I understand that Mr. Battishill will be prepared to answer any revenue or customs questions that occur of a general sort. That is so, is it not?

(Mr. Battishill) Yes, within limits. If I find that the detail is rather more than I can deal with I will ask you to refer to the Customs people.

3. That is well understood. Mr. Unwin, our programme is as follows. We are making a short inquiry into the budget, the White Paper, and the financial statement. We are hoping to see the Governor of the Bank of England - hopefully first - and subsequently the Chancellor over the course of the next few days and we hope to write a report for Parliament before the debate here on the White Paper. That really follows exactly the procedure that we adopted last year. What we would like to do this afternoon is to divide our questioning into sections. We will take firstly the forecasts for the economy; secondly, we will come to the medium term financial strategy and, thirdly, public expenditure; fourthly, taxation, and then there will be some subsidiary matters, no doubt, that will arise - index-linked gilts is one that has occurred to us immediately. It may well be that some of these sections will overlap to some extent. Do feel free to pass the questions round your group in any way or order that suits you, although I dare say we shall address most of them to you. The Committee has asked me to put the first point to you on their behalf. You will remember that a year ago after the budget we expressed doubts about the

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assumptions underlying the medium term financial strategies expressed in the White Paper and the financial statement. We were not doubting the medium term financial strategy: we had a good deal to say in praise of the idea of a medium term strategy. We are now looking at a fresh set of documents in which, as last year, there are a number of assumptions. Bearing in mind the doubts that we expressed last year, a number of which, alas, have proved to be only too well justified, do you think that we can regard the assumptions in the documents published this year as being more meaningful than those of last year?

(Mr. Unwin) Can I make two general points, Chairman ? Then, if I may, I will pass it on to Mr. Cassell to explore this in more detail. First of all, we have revised downwards the assumptions particularly the growth assumption, as you said, that underlies the strategy in the FSBR. We have revised it down to an average of ½ per cent., as compared with the average of 1 per cent. last year, to take account to a large extent of the prospects we now foresee for 1981/82 and, as set out in detail in the Industry Act, forecast in the FSBR. We have also taken account in constructing the MTFS of the revised public expenditure plans which are set out in the White Paper and , of course, of the revision tothe forecasts of revenue received taking account of the changes we have referred to in North Sea oil. As we point out, despite the new North Sea tax our expectation is that the North Sea oil revenues will be lower than we had previously expected and we have also taken account of the consequences of the other tax changes in the 1981/82 budget. However, the second point which I want to come to is that, as we make clear I hope in the FSBR, these are only illustrative assumptions for the purposes of constructing the projections for those years. So I am not quite sure how meaningful the term "meaningful" is in this respect, but they are the best assumptions for the purpose of constructing these projections that we can make. I wonder if I can ask Mr. Cassell if he would like to add to that?

(Mr. Cassell) I do not thinkthere is very much I would want to add to it. You have mentioned the main ones and most of these things are very uncertain, as we well know. The North Sea projections themselves rest ona number of assumptions that are open to questions but we have done the best we can. We hope that, where we know that we were vulnerable, we have got more realistic assumptions this time but you are dealing with some very uncertain concepts here.

Chairman: The Committee will no doubt want to go through a number of these matters individually.

Mr. Higgins

4. May I ask some fairly general questions to start with? In the Chancellor's budget statement on the 10th March at column 760 in the Official Report he said, "Our problem in recent years has not been a lack of final demand"; yet if one looks at the figure in the Red Book one finds that the GDP index, taking 1975 as 100, declined from 110 in the first half of 1979 to 104.9 as an expected figure inthe first half of 1981. That would seem to indicate a fairly sharp fall in the level of demand. Is that so, or is there some other way in which the statement on the one hand, and the Red Book on the other, can be reconciled?

(Mr Cassell) It is a fairly sharp fall in the level of output, certainly, though one has to be careful whether one is talking in terms of levels or changes, but that there is a fall in output is not open to dispute. The question is what lies behind it, and I think what the Chancellor had in mind there is that it is more weaknesses on the supply side of the economy than on the demand side. In other words, it is these problems such as competitiveness and low productivity and, if you like, high wage costs over a period of years

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that resulted in this very poor performance rather than a lack of demand. If you look at total final demand in money terms over the last three years, it has risen by something like 50 per cent. The problem is that so little of that has come out in terms of output.

5. Yes, that is in money terms, but do you think if the real level of demand had been higher the GDP increase would have been higher?

(Mr Cassell) Of course, but this is the question. Governments have some sort of influence over demand in money terms. They have very little influence, in the view of many of us, over the way in which those money injections are translated into real demand and, therefore, into real output.

6. So, it is not your view that there would have been any benefit in having a higher level of demand in terms of real output?

(Mr Cassell) If you could have got the higher level of demand as a result of improved competitiveness or a lower rate of inflation or improved productivity or something like that, there would certainly have been a benefit.

7. I think it is a point to which we would wish to return. Could I on a second point in relation to the facts of the case ask you, first of all, what the projected figure was this time last year when we took evidence, you remember, on the medium-term financial strategy figures for the public sector borrowing requirement for 1980? So, a year ago when we took evidence what was the expected figure on unchanged policy for the PSBR?

(Mr Cassell) In which year?

8. This year when we were looking at it a year ago?

(Mr Cassell) It was £8½ billion. You mean the forecast for 1980/81 financial year?

9. That is right.

(Mr Cassell) £8½ billion.

10. Again on the assumption of unchanged policies, what would that figure have been by now?

(Mr Cassell) I find this concept of unchanged policies a little difficult here. Do you mean if there had been no change in tax rates or public expenditure?

Dr Bray: If there had been no November measures and no budget measures and an increase in tax rate.

Mr Higgins

11. If one had re-valorised the tax rate and there had been no November measures?

(Mr Unwin) I think you are talking about the PSBR in 1981/82, not 1980/81.

12. Yes, we had last year a .4 figure. What I am seeking to establish is what the outturn would have been with what I described as unchanged policies, that is to say, if the tax had been valorised but we had not actually had the November measures?

(Mr Unwin) I do not understand. What we have is an estimated outturn for 1980/81 which the Chancellor gave in the Budget statement of £13½ billion for the current year, 1980/81. What the Chancellor did say in the Budget statement was that if he had taken no further action the PSBR next year, 1981/82, would be around £14 billion. I wonder if that is the point you are trying to press?

13. Yes, but that takes into account the November measures, does it not?

(Mr Unwin) Yes, it does indeed. What it takes into account is all the measures announced in the Budget, all the measures announced and foreshadowed last November, some of which were announced in detail and others of which, such as the North Sea tax, were translated into specific proposals in the Budget.

14. What I am seeking to establish is what would the figure have been compared with the forecast if, if you like, no corrective action had been taken?

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(Mr Cassell) We are talking of 1981/82 now?

15. That is right.

(Mr Cassell) Then the figure I should have given just now was £7½ billion for that year, not £8½ billion, which was for 1980/81.

16. What would it have been if no corrective action had been taken?

(Mr Unwin) If I recall, we gave no forecast in November or earlier for the PSBR next year but statements were made ——

Mr English

17. That was not the question. It was not whether you gave a forecast but what it is?

(Mr Unwin) I am sorry, I cannot give a forecast. What the Chancellor said last November in the published forecast was that he hoped that the PSBR in 1981/82 would be a little lower as a percentage of GDP than the PSBR he was then indicating as likely for the current year and he attached a figure of around £11½ billion to that. What he then said in the Budget statement was that if he had taken no further action now the PSBR for next year, 1981/82, would be about £14 billion as a very rough order of magnitude. Let us suppose the Chancellor in this Budge had re-valorised and only re-valorised both the personal tax threshholds and allowances and only re-valorised, not doubled, the excise duties, the outcome, other things being equal, would have been round about £15 billion, the reason for that being that you would lose about £1.2 billion in excise duties. Since you count the £1.2 billion as beneath the line, as it were, you have already done that and you would add about £1.9 billion, as I think the FSBR pointed out, for the full re-valorisation of the income tax threshholds and allowances, so very broadly, 15 instead of 14 for next year.

18. I think we are now on the same lines.

(Mr Unwin) I thought that was the point you were after.

19. But that figure of £15 billion is allowing for the November

measures, is it not?

(Mr Unwin) It takes into account the November measures on both sides of the account, the expenditure measures, the policy changes that were announced then, and also the national insurance contribution changes.

20. If we take them out as well it presumably rises above the £15 billion figure?

(Mr Unwin) It depends precisely what you take out. If you take out the 1 per cent increase in the national insurance employees' contribution in revenue terms you would lose about £1 billion next year, leaving aside the other components of the total national insurance contributions increase. If you take out the expenditure measures, I think you have to define precisely which expendituresmeasures you are talking about, whether it is simply the various policy changes which the Chancellor announced last November or whether you also take into account the total change in the expenditure plans in the White Paper for the Budget, the recent White Paper, as compared with the White Paper of a year ago. So, the definition determines the precise number you end up with.

21. I think we are now at one but it is difficult to be precise about the figures in oral discussion. I wonder if we could have a note showing exactly what the PSBR would have been compared with the original forecast if, as I put it earlier, no corrective action had been taken either in November or in the Budget, so that we can get some idea of the extent to which the PSBR was actually higher than originally planned, hoped, expected - put it how you will. I think that would be helpful.

(Mr Unwin) May I just say, Chairman, perhaps we might consider that. I am not sure that we could, as it were, reconstruct the PSBR forecast. I think there are a number of problems there. What we could do and what I think would help would be to set out the effect of discrete measures in terms of the amount of revenue expenditure that the additional subtraction of those measures would, other things being equal, have added to the equation.

22. Thank you very much. Perhaps we could have that in time for our discussion with the Chancellor?

(Mr Unwin) We will do our best.

23. The other point I wanted to press you on was the question of the up-turn in the economy. Ministers from time to time do talk about up-turns in the economy but it has been rather difficult to establish precisely the mechanism by which this up-turn is likely to come about. In our report on monetary policy we referred to the statement by the Financial Secretary of the Treasury nearly 18 months ago, in which he related that up-turn to the rate of decline in the cost of living, in relation to the rate of decline in the nominal money supply, and said what was important was the increase in the real money supply. In other words, there is a cross-over at some point between those two declining trends and at the point where they cross over, instead of having a fall in the real money supply you have an increase in the real money supply.

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Is the view of the official Treasury that that is the main mechanism by which such an upturn is likely to come about and, if so, at what level of inflation would one expect the cross-over to take place?

(Mr. Evans) I would not want to imply that there is a rigid mechanical relationship which always holds good between the growth of the real money supply and the growth of output, but nevertheless the kind of considerations which lead to that statement are behind the forecast that we have included in the Red Book. Perhaps I might say something about why we think that the downturn of the economy that took place last year will be replaced by some increase in output over the course of the next 12 months or so. First of all, in terms of the forecast itself we have been witnessing over the past 12 months a very big fall in the level of stocks, and we expect by the end of the first half of 1981 a fall of the order of 4 billion or so in the level of stocks in the British economy. Now, for reasons which I could go into if you wish, it does not seem sensible to suppose that that kind of fall will go on.

Dr. Bray

24. Why not? The stock output ratio historically is still at a very high level.

(Mr. Evans) As a result of this forecast of stocks and output the stock output ratio by the first half of next year will be at a much more normal level in relation to 1979 or, indeed, the average of 1975-79. I am not sure that the stock output ratio itself is the most relevant concept. What

the past year or so in manufacturing is a much s

than in sales in the ratio of stocks to sales and

of 1981, is already coming down. I think, there

sense to think in terms of a levelling out of st

kind of path of total stock building and of outp

25. Can you break down the stock movements in terms of manufacturing industry and distribution?

(Mr. Evans) The bulk of de-stocking in 1981 in the first half is the manufacturing industry, in this forecast. There was a lot in 1980 of de-stocking in distributive trades as well, but that may well be less this year, although we shall have to wait and see.

26. But even with that reduction in manufacturing stocks, is it not the fact that the manufacturing stock output ratio will still be at a very high level?

(Mr. Evans) No, not by the first half of next year. It will be close to its average over the 1975-79 period.

Mr. Higgins

27. I am anxious to be as quick as possible because I know my colleagues want to ask their questins. Isthe de-stocking, then, the only mechanism by which you see an up-turn occurring?

(Mr. Evans) If you look at table 11 in the Red Book it is certainly the main mechanism in the short run as it often is in recovery/in economic cycles in the short run, but it is helped also by some small increase in the biggest single item of demandwhich is consumer expenditure.

28. But that upturn is due to some increase in demand, is that right, due to the stock effects which you mentioned?

(Mr. Evans) It is due to the decision by firms that they have reached a level of stocks at which they do not wish to de-stock any further.

29. As a result of which demand increases?

(Mr. Evans) As a result of which output increases, yes.

30. Demand increases, does it not, but Mr. Cassell was telling ...lier that there would not have been any significant increase ...had been an increase in demand.

(Mr. Cassell) No. I did say you needed the increase in demand for the right reasons and, presumably, some of these reasons are holding in this period that is foreseen.

31. So you do actually see an increase in demand in the last period covered by the Red Bock but almost entirely, as I understand it, for de-stocking reasons or re-stocking reasons.

(Mr. Evans) No, it is not re-stocking. It is simply the end of therunning down of stocks. We see almost no re-stocking at all over this period. We merely see the fall in stocks coming to an end. I think this is a very important point which it is easy to misunderstand.

32. We understand what you are saying. You are saying that the rate of fall in stocks is decreasing and that in turn has a traditional acceleratory effect as far as the economy is concerned. Could I ask one final question? Do you see then some increase in the real money supply in the first half of 1982?

(Mr. Evans) We can look at the increase in the money supply in the forecast which is at the centre of the range; in other words, 8 per cent.. That is in line with the increase in prices to the second quarter of 1982 which is also 8 per cent.

33. So you are saying, in effect, that that cross-over point which we were referring to just now does happen in 1982. Is that right?

(Mr. Evans) Yes.

(Mr. Cassell) On the cross-over I think you have to take into account the velocities as well. There is a secular up-trend in velocity so that, even though the money supply was growing at the same rate as the rate of price increase, you would still have some room there for real growth which is to the extent that velocity has this trend increase.

Mr. Higgins: Yes, but we have got a very clear answer on the last point which was really what I was after.

Mr. Eggar

34. Last November the Chief Economic Adviser came to us and he said that he saw the upturn coming in the spring of this year for exactly the same reasons that you are now giving for the economic upturn coming towards the end of this year. Who was wrong and why?

(Mr. Evans) I think if you look at the two forecasts that were published, both in November and last week, they are really very similar indeed. What Mr. Burns said then was that he did not know precisely when the upturn was coming, which is what all economic forecasts say. What we are saying now is that the low point of output has been reached in the first half of 1981. Perhaps I may refer you to some economic indicators that were published today - the CSOs cyclical indicators, their leading indicators and coincident indicators. The longer leading index has been turning up for over a year now. The shorter leading indicator turned up several months ago, and the coincident indicator for the last couple of months has now flattened out. So it does seem to me, Mr. Chairman, that all these indications are consistent with the view that output around now has stopped falling, some time around now which I would not want to put into one particular month, and that some general recovery perhaps in the second half of this year should take place.

Mr. Eggar: Could I refer you to question 1053 and the answer that Professor Burns gave to Mr. Sheldon. You might want to consider the answer you have just given me in the light of the answer that Professor Burns gave Mr. Sheldon in November, and perhaps let us have an explanation of the different nuances you put on the figures before we see the Chancellor. Thank you.

Mr. Wainwright

35. Could Mr. Evans tell us rather more as to why, in the

Red Book table 11 on page 29, why it is forecast that the pace of de-stocking will slow down so markedly in the second half of this present year and actually come to an end at the end of 1981, and that re-stocking at any rate to some extent will start in 1982? It is not actually very fully supported in the narrative which is less firm than the figures.

(Mr Evans) I think that is quite understandable. One cannot pretend that the figures are accurate to the nearest 100 or 50 million. What I would say perhaps, no more than repeating what I said earlier, is that this forecast implies that the stock output ratio for the first half of 1982 would be back to the normal level. It implies that the stock sales ratio, which in many ways probably is the more relevant indicator, will have fallen to below its 1979 level and, therefore, there does not seem any strong reason why stocks should go on falling further. The typical behaviour of stocks in cycles is for a short and sharp fall followed often by a more pronounced recovery than this is.

36. But with present interest rates and the greatly reducing rate of inflation of manufacturers' stocks and industrial stocks generally, would you not agree that the real cost of stockholding is still very high? Are you expecting this suddenly greatly to reduce by the end of 1981 in order to lead to this effect in Table 11?

(Mr Evans) Whatever may be happening to the real interest rate the nominal interest rate has already come down substantially since last year and it may well be that it is the nominal rate that is just as relevant for this purpose. But if one also looks at the general prospects for the economy, not just as published by the Treasury but by other institutions, and the general expectation of some kind of recovery, then it does make sense for manufacturers and others to think in terms of stopping their de-stocking in the course of this year, simply because they will have no reason to go on reducing them much further.

37. If you accept that most businessmen are not guided simply by the nominal rates of interest they are paying in order to keep their stocks but by the real cost of keeping stocks and if you further agree that the rate of inflation of industry stocks is now relatively low - I think that the stocks index for industry is only inflating at the rate of about 4 per cent per annum - why should industry suddenly wish to end its de-stocking policy?

(Mr Evans) Because I do not think that the level of interest rate, real or nominal, has been the main factor behind what has been happening to stocks over the last 12 months or so.

38. Would it surprise you to know that the "Economist" intelligence unit, which has done a run-through of the Treasury model since the Budget, foresees de-stocking carrying on throughout 1982 and into 1983?

(Mr Evans) There are a lot of different forecasts for 1981/82. They are, as far as I can see, remarkably uniform about the prospects, particularly for output this year and next, and most of these forecasts both on stocks and output are fairly similar to the one we have before us now.

Dr Bray

39. Just to try and clear up this question about stocks, could Mr Evans supply us with the breakdown of the stock figures, not only between manufacturing and distribution but between materials, work in progress and finished goods, because it does seem from the latest economic trends as if there are about £1½ billion excess manufactured goods to come out of the system? Stocks of finished goods are still rising in the latest figures and there is about a 25 per cent excess over the 1975 to 79 average. Where is that going?

(Mr Evans) I do not think it is fair to take one kind of stock, such as finished goods, where there has been a trend over the

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past five years or more of a rise in stock output ratio. You would have to look at the stocks in total and if you do that you get a rather different picture.

40. The whole character of the rise has been that the manufacturer has control over his purchases and over his work in progress but not over his finished goods. Those have soared and the stock output ratio has soared. Do you forecast those separately and could you let us have a breakdown?

(Mr Evans) We are, as I said earlier, allowing for a further large reduction in manufacturers' stocks in the first half of 1981.

Dr Bray: If you could let us have the breakdown then we could try to figure it out.

Chairman

41. I think the trend of the questioning is clear. Mr Unwin, if it is possible for you and your colleagues to give it a bit more thought at leisure I think the Committee would be grateful for any further information you could give us because it is of the greatest significance in estimating the possibility of an up-turn. We will leave it at that for now.

(Mr Unwin) May we consider that. As you know, and have discussed in this Committee and with the Chancellor before, the figures we are publishing are the ones Ministers decided to publish, but we will certainly take this request away and consider it.

42. We understand that, too. There is no endeavour to ask trick questions. It is a matter of seeking after truth and endeavouring to check the calculations to see what we all make of them, so that we can make a proper assessment and inform Parliament accordingly.

(Mr Unwin) Of course, we will consider it in that spirit.

Mr English: That must be right because quite clearly if there is supposed to be a fall in manufacturers' stock, either there must be an increase in demand or a reduction in output to achieve it.

Mr Woolmer

43. Could I turn to the exchange rate. First of all, one estimate that has changed significantly is the forecast for the prospects for exports, which is now projected to fall by 5½ per cent, whereas I think as recently as November the figure was 3 per cent or thereabouts, which is a significant change. Why is it that since November there has been almost a doubling of the fall expected in the growth rate and a negative growth of exports?

(Mr Evans) Perhaps this is an opportunity to draw attention to the forecast errors which are given in Table 10 of our annex on export goods and services as 2½ per cent for 1981. On your question, there are two main reasons why exports are forecast to do less well than in November. The first is that the level of world trade in 1981 is now rather lower than it was before. The second is that it reflects our assessment of the most recent trends in export volumes.

44. Could I make an observation and ask a further question on the difference. The error does, of course, mean that exports should fall by 1981, so clearly there is - and I do not think you would disagree - a significant change in the estimated export performance. In the Red Book there is quite an emphasis now upon the evidence that the volume of UK exports is affected by changes in competitiveness and allied expenditure over several years. Given the very sharp fall in competitiveness, even with the recent relative improvements in that, does that mean we can expect that adverse effect to be felt for some considerable time ahead?

(Mr Evans) The forecast for exports, as you can see in Table 11, is for a further decline in the first half of 1982, so the short answer is, yes, it does go on for some time.

45. Could I turn to the question of exchange rate. Was the reduction in the pound in the few weeks prior to the Budget, when there was a strong expectation of a fall in interest rate, about what you had expected?

(Mr Unwin) I do not think there was any expectation in that sense. It is extremely difficult, as one knows from previous experience, to make any guess as to how this or that measure will affect the level of the pound in the situation of the recent Budget. There had been a great deal of discounting in advance of the prospect of a particular interest rate reduction, so I think it would be a very brave man who made any firm expectation of the pound moving in either direction. There are so many other influences on the exchange rate, as your recent report itself acknowledged.

46. So, does the Treasury have any view as to what it thinks the effect of the Budget is likely to be when the market has had time to consider it and settle down? Do you think it is likely to result in the pound veering up and down?

(Mr Unwin) I do not think any of us would care to speculate on that at all.

47. If the exchange rate were to vary significantly from the current level and significantly downwards, presumably you would have some working assumptions on the various effects that would have? What effect would you expect that to have on, firstly, production and employment, and, secondly, upon prices and wages?

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(Mr. Unwin) I think, Mr. Woolmer, it depends on why it happens. If it happens for external reasons one situation will arise. If it happens for domestic reasons, because inflation is higher than had been expected or whatever, it will have a different set of consequences. Again, I do not think we can give you a simple answer to that.

48. Do you think that there is any serious prospect at all of unemployment falling below even a million in the next five years, with the exchange rate where it is? Do you think that getting unemployment down significantly is possible with the exchange rate in real terms at its current level?

(Mr. Unwin) Yes. I think all I can refer you to is the working assumptions that we have published in the White Paper in the social security chapter on unemployment for the purpose of constructing the social security figures. The assumptions there are for GB average in 1981/82 of 2½ million. That is excluding school leavers.

49. I was not asking that. I was asking that as Treasury officials, knowing the economy as you know it, with your models as you have them and with your judgment as you have it, do you think that the exchange rate being at the level it is is compatible with any hope of getting unemployment down very significantly, down towards a million or even below two million, with the exchange rate at its present level? You must have some view about the exchange rate and unemployment.

(Mr. Cassell) It also depends upon what is happening to other elements in competitiveness; in particular, wage costs and so forth - productivity. I will be honest with you on your other question: I think I told the predecessor of this Committee about three years ago that I did not expect unemployment to fall below a million/and I think that was greeted with the general view over the medium term that it was on the pessimistic side. Almost everything that has happened since then I think would, as it were, reinforce that view. I think there is a very good chance that you can arrest the present rise and turn it down but it is wildly optimistic, I think, to believe that you are going to see a return to anything like a million within the next few years.

50. So is it a fair summary of your view, then, that the exchange rate is not sufficiently important a factor in determining prospects for reducing unemployment/and that there is still no need to have a positive view about exchange rates?

(Mr. Cassell) You are putting it all in terms of the exchange rate, Mr. Woolmer. I would rather put it in terms of competitiveness. I think competitiveness is very important indeed, but, as has been explained several times, if you look at the deterioration in competitiveness it is much more to be found in this whole succession of wage rounds, with wages going up in manufacturing by 14, 15 and 16 per cent. and productivity perhaps at best/by 2 per cent., than what has happened to the exchange rate. I think that, again, the solution to the high unemployment has got to be found on that, if you like, supply side of the economy.

51. Do the proposed amendments to the Exchange Control Act signal any change in attitude on the feasibility of inflow controls?

(Mr. Unwin) The answer is 'Not at all'. What they represent is the tidying up of exchange controls, the 1947 Act, in order to make it a bit less Draconian and a bit more symmetrical as between inflows and outflows. The Chancellor indicated, I think, last May when he made a statement about the review of the Exchange Control Act, following the removal of exchange controls in the autumn of 1979, that what they do is to tidy up the existing legislation and to put us in the position that is required by, I think, a European Council Directive. Reaching into the recesses of my memory I think it is number 156 of 1972 which requires Member States to have available the instruments for effective regulation of international capital flows, but let me stress again that it is not a presage of any change of policy on inflow controls.

52. But that has been there since 1972. Nothing has happened in nine years. You say that the reason is because after nine years it has been decided to do this.

(Mr. Unwin) Yes. The chain is that the Government decided to remove exchange controls in the autumn of 1979. This occasioned the review of the existing legislation. We could not remove the legislation entirely which might have been expected, when outward exchange controls were being taken away. What we said was that we reviewed the exchange control legislation; we could not remove it because of the standing requirements which the existing law enabled us to meet but in not a very satisfactoryway. What we are now doing is simply taking advantage of the Finance Bill, as opposed to introducing separate legislation, to tidy up these particular provisions.

Mr. English

53. When you talk about the "exchange rate", as if it were singular, what assumption have you made for the future about the relation of the ordinary exchange rate to the Green Pound? At the height of the rise in the pound sterling ordinary there was effectively an 18.8 per cent. tax on food additional to the Common Agricultural Policy. That effectively, since food is 25 per cent. of the average household budget, means an increase of nearly five per cent. in British labour costs. Are you making a similar assumption for the future or a lower one?

(Mr. Evans) We have always been a bit reticent about the Green Pound assumption in the forecasts, simply because of the negotiations that will be going on in Brussels. Perhaps we can consider whether anything more could be said on that.

Mr. Beaumont-Dark

54. On the exchange rate, Mr. Unwin said nothing that was not the truth, that the Treasury finds it most difficult - and if they find it difficult you can imagine how bloody impossible business men find it - to judge anything to do with the pound. Of course you are right, that competitiveness in the sense of improving productivity in a factory is one of the best ways to improve one's prosperity, but would you not concede that on top of all the other normal problems - if there is such a thing in manufacturing business - they have had to cope not with a gently rising pound: they have had to cope with what a manufacturer looks upon as the evil of North Sea oil because he has seen none of the benefits because the Government has continuously shoved up the cost of his oil anyway. He has seen none of the benefit. All he has seen is that he has had to do something that even you cannot think of - what is the pound going to be in six months', 12 months' time? What has happened is that the pound has been 20 per cent. or 30 per cent. more, so however much of a genius a business man is and however wonderful his workers are would you not agree that it is that very problem that has almost made it impossibe for business men really to grasp productivity? When you are up to your knees in the swamp it is difficult to remind yourself that you are there to drain it. They have got real problems. They have not got time to think of the actual long term sophisitcation of the argument. Can we honestly now believe that the Government has grasped this point, because it is an important point to business men. In the budget

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strategy you must have some idea in mind because I hope that these amendments to the exchange control might mean that. Is the Government really going to tackle it or are they willing to take a gamble by putting interest rates down more which as we saw in the short term affected the pound favourably - and 'favourably' means it fell. Are you alert to industry's problems as well as to the sophistication of financial manipulation?

(Mr Unwin) If I may say so, I do not think there is any under-estimate of the problems that you have described. At the same time, there is a realisation of the other side of that particular coin, the benefits that a high exchange rate, albeit unpredictable, has brought in terms of the cost of imported raw materials and so on, and I think there is evidence that the pressure that the pound has exerted on certain industries, again with all the difficulties of planning and so on, has had benefits in terms of the way it has manifested itself in the reduction of other costs within firms and companies.

55. But if you came to Birmingham amongst manufacturers and you told them of all the wonderful benefits of the high exchange rate, I would think you would need more of a police escort than Ian Paisley, because it is no good telling a businessman that in the end it is for his benefit. I think if he walks away from it very clearly he finds it somewhat difficult to believe. I must tell you for a manufacturer, someone involved in business, if there is to be any risk at all the risk surely has to be taken on doing something not to depress the exchange rate down to absurdity but not to protect it to such an extent by saying it will all come right in the end, because there may not be an end in the sense of a good end.

(Mr Unwin) I am not sure what alternative you are implying, Mr Beaumont-Dark.

56. I will tell you what alternative I am implying. Surely at

the very least we could do two things. We cut the interest rate by 2 per cent. Now American interest rates are dropping, so the exchange rate is now creeping to 2.27 again, having been down to 2.18. Surely we should use interest rates much more flexibly to make sure that we are not always high?

(Mr Unwin) I do not think there is any difference of view on that in the sense that the Government has said that the reason it is taking the kind of measures it took in the Budget is in order to be able to get interest rates down, and the $2\frac{1}{2}$ per cent reduction of MLR was a start in the Budget.

Mr Beaumont-Dark: There is a greater risk to industry buying than there is, in my view, of the Government not being able to raise its expenditure because they might have to cut it anyway, which would help us all anyway.

Mr Meacher

57. Can I turn to the question of prospects for growth in 1982/83. In paragraph 15 of the Red Book the figure is given for the second and third years of a growth rate of $1\frac{3}{4}$ per cent following a fall in the first year of 3 per cent. Is that a forecast or an assumption?

(Mr Cassell) It is an assumption. The assumption is $\frac{1}{2}$ per cent over the three-year period 1980-83, and if you take the first part of that period, that is, the short-term forecast in here, then arithmetically you are left with an average of about $1\frac{3}{4}$ per cent for the rest of the period.

58. So it is an arithmetical assumption based on the forecast or assumption of $\frac{1}{2}$ per cent average over the three-year period?

(Mr Cassell) Yes.

59. So the crucial factors are the basis for this assumption of $\frac{1}{2}$ per cent average over the three-year period. Can I ask what are the grounds for believing that the up-turn, if and when it comes, will be sustained and significant?

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(Mr Cassell) I might say just one thing in preface to that, that almost invariably in the past forecasts of expenditure have understated the amplitude of the cycle. One does not like looking ahead and seeing big up-turns or big down-turns, so there is a natural tendency to project forward in a kind of flat way from where you are at the moment, but if you have the turn in the economy we were talking about just now with the cessation of the run-down of stocks, which at least takes out the major contractionary element we have seen in the past year, you can then, I think, in the following two or three years look forward to some growth in consumption, mainly, I would think, as a result of the savings ratio falling by that time. As I think we have implied, the rate of inflation should have fallen a bit further from its present level. There are various real wealth effects that should flow from that. Interest rates themselves may also be improved and I think, putting those two together, you should be able to see some recovery in consumption. You should also be able to see a rather better rate of growth than you are seeing in the early part of the period for the industrialised world as a whole. 1981, as Mr Evans was implying, looks like being a relatively slow year for the world. Presumably then in the later years you will get back to something of the order of, say, the 5 to 5½ per cent rate of growth of world trade that we have seen through the latter part of the 1970s.

60. So the factors in the expansion which you would emphasise, apart from this question of the reduced rate of de-stocking, about which the Committee has already expressed some doubts as to whether a £1.3 billion reduction in the second half of this year is likely, are a rise in consumer expenditure and an improvement in world trade? Before turning to those, can I ask what emphasis, if any, you would give to private investment or public expenditure as factors in the expansion?

(Mr Cassell) We have taken public expenditure as projected in the medium-term projections here, which again are broadly consistent with the White Paper plans, so that is a declining path through the period. On investment, one would hope that by the time you get beyond 1981, well into 1982 and 1983, you would see some recovery there and again the fall in inflation, the fall in nominal interest rates that might permit, should help in that respect, as also should some recovery in profit margins.

61. Can I turn to what you have said on consumer expenditure. The forecast in the Red Book is for a very marked up-turn in the first half of 1982 by 4½ per cent - £800 million. You mentioned as relevant to this the change in the savings ratio, which is certainly very high at the moment, and the fall in interest rates. Do you think that adequately explains or justifies such a marked assumption, in view of the fact that real earnings will probably be falling and unemployment rising?

(Mr Cassell) You are talking specifically about the early part of the period now?

62. Yes?

(Mr Evans) I would not again want to put too much emphasis on the half-yearly movement. As between the first half of 1981 and the first half of 1982 there is an increase in consumer expenditure of 1 per cent, and as between the second half of 1981 and the second half of 1982, 2¼ per cent. There is a tendency, as one can see in these figures and from the retail sales index recently announced, for the first quarter's figure to be particularly high in anticipation of the Budget, even on a seasonally-adjusted basis, so that helps to explain why the first half of each of these years is a bit high, but the general tendency is for savings to come down, and come down quite perceptibly, in the case of some decline of real personal income, and that is the main reason for the small increase in consumer expenditure over the next year.

63. How far is this predicating a fall in the rate of inflation?

(Mr Evans) It certainly takes account of the rate of inflation. I could not tell you what the forecast would be if the rate of inflation were to be very different, but the fall in the rate of inflation does have the effect of reducing the amount of savings that people need to put aside in order to maintain the real value of their financial wealth, so that is one factor.

64. But it is not the major factor behind this, as I still think, quite marked assumption?

(Mr Cassell) It must be quite an important factor.

Mr Meacher: That is what I am asking.

Dr Bray

65. It is the savings ratio movements?

(Mr Evans) Certainly, yes, but, of course, those are not due exclusively to the change in the inflation rate.

66. But mainly?

(Mr Evans) Not even mainly.

Mr Eggar

67. Could I ask a technical question. This is obviously very important, so what effect would you say a 1 per cent fall in inflation would have on consumption levels?

(Mr. Evans) If you abstract from the change in real incomes that that brings about, if you change the inflation rate by one per cent. but keep real incomes constant, then according to the equation now on the Treasury model that has an effect of about 0.2 per cent. on consumer expenditure.

68. Do you believe that to be valid?

(Mr. Evans) I believe that is a reasonable estimate, yes.

Mr. Meacher: I know it is difficult to get projections of unemployment from the Treasury, but I would like to ask what you regard the natural rate of unemployment now to be and do you regard it as rising?

Chairman

69. Mr. Unwin, the Committee absolutely understands the problem about this. The Chancellor made the point quite clear when he came to see us previously. I know it is felt that if a specific forecast is announced at a question and answer session of this sort it can perhaps be misunderstood and sensationalised and so on. However, bearing that in mind, you will remember, if I may amplify something I said at the very beginning when the Committee asked me to ask a question of you on its behalf, that we were looking at a steady rate forecast to be 1.8 million throughout the whole period of the medium term financial strategy. One of the sadnesses to us is to see that that estimate, forecast, whatever you like, was very different from what the reality has been. I think it is very relevant to our examination of these papers that we should get some idea from you - not necessarily immediately - of how you see the figures in the future, because they do make a very great deal of difference to a number of matters which obviously we are bound to consider. I can see the problem you might have with

Mr. Meacher's question: on the other hand, it is very relevant from our point of view.

(Mr. Unwin) If I may say so, I saw it reported that abuse was hurled at a Treasury official walking through the pickets the other day and cries of "semanticist" were heard. I do not want to be guilty of being a semanticist but you referred to the previous forecast. Perhaps, again, I can be very tedious and make it clear that those again were the kinds of assumptions which we have discussed many times and we should be very glad to disuuss those assumptions. We will take very careful note of what you say, but I thought Mr. Meacher was on to a slightly different pointin asking us what we regarded as the natural rate of unemployment which is quite separate from the assumptions we have set out in the White Paper. I do not know whether you want to take that further.

Mr. Meacher

70. I am very interested, of course, in what the Chairman was suggesting. I think I for one would certainly be very interested to see further material on this but what I was asking was of course about an assumption in the model and not about an assumption of the real world in the next year or two.

(Mr. Cassell) I did not really want to answer that. It is a difficult concept quite apart from a difficult thing. I would answer the second part - is it rising - by saying 'No'. I do not know whether it is rising at the moment but it certainly has risen quite a lot over the past 15 years. By the 'natural rate' I take it you mean the rate of unemployment in the model that would hold inflation at whatever the current rate is, and that has risen a lot over the past ten or twelve years. Where precisely it is at the moment I do not know.

71. Could you hazard a range within which you expect it to be at the present time?

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(Mr. Cassell) You see, the trouble is, Mr. Meacher, that most of these equations in the model that bear on this are not estimated equations. They are, if you like, equations that we have imposed coefficients on to some extent. One would have much more confidence in giving you a figure for where we think the natural rate of unemployment is if this whole area in the model was based on estimated equations, but it is not.

72. Even so, given the fact that you do actually have such a figure, can you tell us what it is?

(Mr. Cassell) Off the top of my head, I could not. One would have to do some work because the model is not an unchanging thing and one thing you do learn about it is not to make instant reactions as to what is in the model at any particular moment of time, because by the time you get back to the office and look at it again you will find that it has changed.

Mr. Meacher: If it has changed when you get back this afternoon could we possibly have a note on that?

Chairman: Why do you and your colleagues not consider this exchange, Mr. Unwin, and see what further information you can give us?

Mr. Eggar

73. Mr. Chairman, perhaps I could just simply ask a factual question not directly on the MTFS. Presumably this model which we all distrust so much has been used to predict the effect of the budget on such matters as output and employment. Have you got any figures that you can let us have?

(Mr. Unwin) I do not think we could give you any quantified assessments in the way you seek them, Mr. Eggar. I think I would just make two points on that. One is that there have been a lot of estimates of the economic effects of the various measures announced on the 10th March. I think the re-assessment of those - as, for example, in the figures I saw published in the Financial Times this morning - suggest that most forecasters and commentators have revised downwards their initial assessment of the effects of the budget. I think the average of the figures that I saw in the Financial Times today, if my memory serves me correctly, is that they have revised downwards their estimate of the fall in GDP next year from something like 1.72 to 1.6 per cent. That is a very small difference but, that said, I do not think that we could give you any equivalent of that and I think that in looking at the budget, in looking at the measures that were announced on the 10th March, I think it really is only meaningful to look at that in the context of the Government's fiscal stance as a whole. What happened in the budget was that the Chancellor announced ——

74. Forgive me for interrupting but I did not expect to get very far with that question and now that you have given me the answer to the question that I felt I had to ask, perhaps we can move on to something else. Perhaps we can go back to the MTFS. Would it be fair to say that there had been a change in the emphasis of the MTFS away from the importance of £M3 and on to the importance of the PSBR?

(Mr. Cassell) No, I think not.

75. I find that slightly surprising, because we have a definite figure for PSBR and yet if we look at £M3 we find, first of all, that we have not had a target for the past four months; next that we are told in paragraph 9 that £M3 is accordingly being retained as the main target, and then it goes on " ... though as in the past year, the significance of short-run movements for interest rate policy will be interpreted in the light of other financial developments as well." What are the other target variables

that are going to be taken account of and what are the other financial developments? Are we in danger of enabling the Government to justify whatever the actual £M3 outturn turns out to be?

(Mr. Cassell) I think it says there that £M3 in the past year has not been a very good indicator of monetary conditions and I think that in interpreting movement in £M3 in the future as, indeed, in the past year we would have to have a look at a much wider range of financial indicators in judging how stringent policy was. We do not particularly want to be tied to a single number, a single target, but at least there when we are talking about money supply it does talk in the language of targetry, at least, for the coming year and over the medium term as a whole. When we talk about PSBR, we specifically say numbers. They are not targets. The language is the same as last year.

76. But then here again you seem to be getting a variation in the £M3 figures again. Paragraph 11 says: "The precise target ranges for the following years will be decided nearer the time." Are those to be announced at six-monthly intervals so that we know on a rolling programme what the targets are? How do we judge whether the £M3 figures have actually been hit or any of the many variables, because we are not quite sure what you are really aiming at?

(Mr Cassell) You have a target range for the year ahead, the year that is just beginning now, and I suppose, interpreting this at the time of the next Budget or thereabouts, there will be a target for 1982/83 and so forth. The intervening years in the MTFS last year were not targets. They were set down again as illustrative figures of a gradual de-escalation of the rate of monetary growth of round about 6 per cent in 1983/84, but we deliberately tried not to tie our hands there on the intervening years.

77. I see that and I support the importance of having different variables, different aggregates, to aim at. That is important, but what worries me is, suppose we get a £M3 growth of 8 per cent next year - purely hypothetical - and yet £M1 is much higher, the monetary base is much higher, PSBR1 and PSBR2 are all higher; does the Government then claim success in getting £M3 of 8 per cent or claim failure because they have not got the other variables?

(Mr Cassell) I think we first have to get our 8 per cent before we decide, but the logic of the way this is presented is that you would need to look, as I say, at the whole spectrum of the monetary indicators and, indeed, exchange rate and real interest rates have been mentioned before, and you have to judge then what the 8 per cent means in the context of those.

78. I think we want to come back to that later but can we get on to the PSBR. Why was the £10.5 billion PSBR chosen? Why was that the figure?

(Mr Unwin) I do not think I can say very much more than the Chancellor said in his Budget statement. He said that his judgment that he had to provide for £10½ billion PSBR was because this was the figure he believed to be consistent with the objective of monetary growth, inflation, interest rates and so on. Perhaps I could add two things. One is to stress what Mr Cassell has said, that this is in no sense a target. We are not setting up a target for 1981/82 or, indeed, for the medium term. Secondly, although I would not want to suggest that there is a mechanical process here, we reckon that the effect of the recession - the recession as we foresee it and and as it is embodied in the short-term forecast - will be to add something like £3 billion to the PSBR in 1981/82 - the worsening of the recession. The illustrative PSBR we set out in the medium-term strategy a year ago was a PSBR of 3 per cent of GDP, which is very broadly £7½ billion at 1981/82 prices. So, £7½ plus £3 is round about £10½. Again, I do not want to suggest it is a

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mechanical calculation. That is the way it was done but I want to give that to illustrate that the PSBR that the measures provide for is a PSBR which takes account broadly of the recession as we foresee it for the next year.

79. Would a higher PSBR, let us say £12½ billion, have been incompatible with falling interest rates?

(Mr Unwin) I think it is very difficult to discuss that. I think one can get into a logical "salami" process, as it were, and it would be very easy to demonstrate that 11 is not far from 10½ or that 11½ is not far from 11 and the difference between these could be represented by this or that. All I can say is that one has to choose a particular figure to provide for and that 10½ is the figure the Chancellor decided to provide for in the Budget.

80. Looking at the projected PSBR in 1982/83 and 1983/84, I notice that the fall is 2¼ per cent. The 1981/82 MTFS fall is from 2¼ per cent to 1½ per cent and that was last year. That was the figure from 1982/1983 to 1983/1984. Now we are talking about a fall to 2½ per cent. Why the difference? Why can it suddenly change very much more sharply?

(Mr Cassell) You have quite a marked increase in the tax base between those two years as a result of the Budget there, which does have a big effect in a year, and in addition when there are fewer, as it were, implied tax cuts in the later years.

81. So it is a recognition of the fact that there is less room for reduction in taxation the further we get away in 1983/84?

(Mr Cassell) Yes, within that period. In the first instance taxes have risen, which was not assumed last year, and there is much less scope for getting them down again in the remaining part of the period than was implied on last year's projections.

Mr Meacher

82. Could I ask Mr Evans to illustrate the point he made in answer to a question from Mr Eggar which seems to me quite significant. He said on this question of the relationship between inflation and consumption that a 1 per cent change in inflation might be expected to affect consumption by about 0.2 per cent?

(Mr Evans) Yes.

83. In that case, a 5 per cent reduction in inflation would affect consumption by 1 per cent, which is about £360 million in a half-year. If that is true, it does seem to me that the fall in the rate of inflation can have a relatively minor effect over the general recovery. Is that not so?

(Mr Evans) These things do not operate immediately. We are talking about a fall in the rate of inflation which has been going on for some time and is expected to go on. The annual rate of inflation was at 22 per cent some time last year. In terms of the retail price index this is now running at about 13 per cent and is forecast to come down to 8 per cent, so there is this 5 per cent reduction in the rate of inflation from the current levels, which gives at least 1 per cent on consumer expenditure, which is the increased fall for the next year. So, in terms of the forecast of consumption over the next year that is an important element but not the only one.

84. With respect, it is not an increase over the next year. This £360 million is the 1 per cent figure but the increase over the next year in the Red Book is £800 million and the point I am making is, therefore, that it is not a major factor in the up-turn.

(Mr Evans) No, with respect, the increase over the next year from the first half of 1981 to the first half of 1982 is £400 million.

85. £400 million for the full year, £800 million for the half-year?

(Mr Evans) As I tried to explain, I think it is better to concentrate on the movement between the first half of 1981 and the first half of 1982.

Dr Bray

86. Can I clear up two points in the replies to Mr Eggar. On paragraph 9, the "other financial developments" taken into account in the interest rate policy did include the exchange rate. It specifically mentioned that.

(Mr Cassell) In judging the stance of the severity of monetary policy over the past year, as is said, one looks at a whole range of indicators, the exchange rate being one of them, and I would guess in judging how stringent monetary policy is at any time in relation to whatever the £M3 figure is, that would be one among many financial indicators you would look at.

(Mr. Unwin) May I just add that paragraph 8 of the Red Book actually refers at the end to the exchange rate amongst other indicators.

87. In paragraph 7 where it is said that the past year has seen real financial wealth restored to a more normal level, how do you define "normal level"?

(Mr. Cassell) I think normality here is defined in relation to some average in the past.

88. And the fact that your evidence page 77 volume 3 of our report on monetary policy shows the velocity of money increasing by 1 per cent. per annum, does that take into account that secular increase, that change in real financial wealth?

(Mr. Cassell) This is about real financial wealth, here.

89. Do you mean wealth in relation to income, or what?

(Mr. Cassell) Wealth in relation to income, yes. There are two questions here. Thereis the relationship between total financial wealth and holdings of money within that wealth, and the other relationship - which is the one that is really being talked about here - is the relationship between total financial wealth and income. Now, that relationship - and, I suspect, also the other one - was very badly depressed during 1979 by the combined effects of high interest rates and high inflation, and it does seem to have rebounded quite a lot in 1980.

90. If those arguments applied retrospectively to 1980/81, why can they not be expected to apply to 1981/82?

(Mr. Cassell) Because you are starting from a more balanced position at the beginning of 1981/82.

91. But you do not know what the position is, because you have not been able to define it.

(Mr. Cassell) Looking at a wealth income series over a whole run of years and getting some sort of trend line into it, it does look as though you are much closer to that line - indeed, you may almost be on it.

92. Could you show us some of those nice trend lines in relation to recent years? The one you have shown us on page 77 of our report was pretty mountainous.

(Mr. Cassell) Page 77 of your report?

93. It was the velocity of money.

(Mr. Cassell) First of all, this particular sentence that you are picking on is relating to something that is wider than money. It is relating to the total financial portfolio of the private sector.

94. I appreciate that, but it would be interesting to see it, even so, for the wider one as well as for the narrower one.

(Mr. Monck) I think our feeling is that the starting point, both on wealth and on the real money supply and on velocity, are all - the starting points for 1981/82 - are all at a more normal rate, closer to the trend line than they were at the beginning of the last financial year.

95. What it would be nice to get is some measure of the accuracy of what you mean by 'normal'. It seems to me that the error margin there is likely to be 4 or 5 per cent. in relation to the one per cent. adjustments in target that you are talking about. Can you give us some estimate of the standard error of your estimate of what the normal levels of wealth are?

(Mr. Unwin) I wonder if we may consider this?

Chairman: By all means.

Dr. Bray

96. Can we move on then to the rationale for choosing £10½ billion for the PSBR? It is just a coincidence, is it, that

the real PSBR with the expected inflation rate works out at about zero ?

(Mr. Cassell) It was not derived in that way.

97. It is just a coincidence.

(Mr. Cassell) Then it is just a coincidence. The same forces that were influencing us in choosing £10½ billion also have that other effect.

98. Can you give us any other rationale for choosing £10½ billion?

(Mr. Cassell) As Mr. Unwin said, in the end it is a matter of judgment within a range, obviously. However, taking into account the sort of general medium term path of reducing the Public Sector Borrowing Requirement as a percentage of GDP, and then looking at that trend in the light of the particular conjunctural circumstances of any years, then if you more or less offset the worsening of the recession from what we have been expecting a year ago, again you come to a figure of something like £10½ billion.

99. It is again a coincidence, is it, that your figures for the percentage of GDP ratios of PSBR end up in 1983/84 this year at about the same level as they did last year, and that in order to get there a credible rate of reduction of PSBR you do land up more or less at £10½ billion.

(Mr. Cassell) No, that is not coincidence. In fact, we have consciously raised the PSBR ratio from 1½ per cent. to 2 per cent. in 1983/84 and what that determines then is the size of fiscal adjustments you build into these projections.

100. The Government would be jolly pleased if it got within 1½ per cent. of its original target.

(Mr. Cassell) That would be well within the margin of error.

101. The aim is to end up with the "told-you-so" kind of

position that you built into your original intention.

(Mr. Cassell) Yes, but it is also important how you get there.

102. The average error quoted for the PSBR is £3½ billion which means that the expected range would be £6 billion to £15 billion of PSBR.

(Mr. Evans) Yes. This error, as paragraphs 18 and 19 explain, is no more than average error for the past forecasts. That is the average absolute error; that is the status of it.

103. So it is as likely to be outside that range as it is to be inside that range.

(Mr. Evans) Yes, you could put it that way.

104. You just hope it is below rather than above.

(Mr. Unwin) We have no reason to believe that it will be.

105. In paragraph 13 of the MTFS, where you mention the reasons for the change in the illustrative tables, you mention change in the North Sea tax revenues. What exchange rate assumption did you use for North Sea tax revenue?

(Mr. Cassell) In the early part of the period it obviously is the one that is in the short term forecast which is broadly where it was when the forecast was done. Beyond that I do not think I really want to disclose the exchange rate assumption we assumed.

106. In the past year it was possible to bring down the interest rates at a time when the PSBR was rising very rapidly. Why is it considered that a large reduction of the PSBR is necessary now to reduce interest rates further?

(Mr. Cassell) It may have been possible to bring them down but there was also a very large overshoot on the money supply.

107. But with the large overshoot it was still possible to finance the borrowing requirement and bring down interest rates. What makes you think that it would not be possible to do so at a higher PSBR?

(Mr. Cassell) Because we would not want the repetition of such a rapid growth of money supply.

108. And you therefore say that the argument which you use, saying that the increases in the money supply last year that occurred were not likely to be inflation, would not apply again.

(Mr. Cassell) One would have to know the circumstances, again, but I think the type of arguments that we were talking about just now of an imbalance between the personal sector's desire for an actual holding of financial assets would be much less marked, so we believe, starting from now, than they were over the past year.

109. I do not want to anticipate the replies from the Treasury to the monetary policy report, but would you accept that the counterpart of countercyclical fiscal policy is the toleration of variations in £M3 from target paths?

(Mr. Cassell) No, I am rather puzzled by that, actually. I would expect the cyclical fluctuations in money supply in any case to be a good deal more damped than those in the PSBR if only because usually there are other components of the money supply that operate in the opposite direction to the PSBR; in other words, when the PSBR opens out because of a recessed economy you very often have other components of money supply moving in the opposite direction; perhaps less private sector demand for credit; per... private sector appetite for government debt. In an... I would expect the fluctuations to be a good deal mo... case of money supply.

wh... on the

110. In money terms more damped?

(Mr Cassell) Yes, in money or real terms, but in money terms, yes.

111. In money terms I suppose you could say that the excess growth of money supply last year was about £6 billion - 20 per cent rather than 10 per cent?

(Mr Monck) We are down to 17 on the non-adjusted basis now, so it would be less than the 17. Taking away from that six on six it is more like four, and it might continue slowing down, which has been happening in recent months.

112. And the excess of the borrowing is 5½, so it is roughly the same order of magnitude?

(Mr Monck) I think the Chancellor did make the point in his Budget speech that the offsetting movements which Mr Cassell has mentioned did not happen last year because of the special circumstances.

113. I asked last year whether anybody had done any stockastic simulations of the money supply target and was told no. Have they done any this time?

(Mr Cassell) No.

114. So you do not really know what the odds are of transgressing these high targets?

(Mr Cassell) I doubt whether we would if we had done those simulations.

115. That seems to be the same reply as last year, similar results. To return to the exchange rate assumptions, can you say at the time you made the assumptions about North Sea oil revenues was the pound at 2.20 or 2.40? It seems likely it was at 2.20?

(Mr Evans) As far as the effective rate is concerned, the policy assumptions here said it remained unchanged, about the level ...ere it was in the fourth quarter of last year, which was around 100 effective rate, or just over that.

Dr Bray: May I say the reply just now about the failure of the Treasury to do simulations would have been more impressive if the record of the measurement of the economy during the past year had been a little bit better.

Mr English

116. Before this figure of £10½ billion becomes sacrosanct, would you agree that the PSBR itself is somewhat artificial. I think the predecessor of Sir Anthony Rawlinson, your Second Permanent Secretary, Sir Leo Pliatzky, had a very considerable share in giving it its present definition and he now, of course, says we should adopt the OECD definition, which is not the same. Has that been considered, and whether it has been considered or not, could you give us the figure of what the PSBR would be under the OECD definition, which mainly affects the nationalised industries borrowing requirements, I think; I am not suggesting you give me them now.

(Mr Cassell) I do not know what the OECD definition is.

117. I think that is the answer to my first question. It has not been considered?

(Mr Cassell) It may be amongst all the various definitions of borrowing requirements given in the Red Book, the general Government borrowing requirements. We can find what is required but would have to consider it.

118. Could you send us a note on what the figure would be under the OECD definition, which mainly, I think, affects the nationalised industries, whether they are in or out of the PSBR and so forth? The other point is the question of rebaseing, which has already been touched on by Mr Eggar and Dr Bray. Could I ask you if you would all think as if you were monetarists. Are we to assume that in 1982/83 there will be some increase in inflation, say two years after the overflow of M3?

(Mr Unwin) Again, I can only refer you to what the Chancellor said in the Budget speech and what he has said on occasions in the FSBR.

We would not expect the special circumstances of last year of themselves to lead to a renewed bout of inflation.

119. Since you have referred to the Chancellor's speech, there have been fairly full reports on the discussions which led up to the Budget. Is it, in fact, the case that the Bank of England preferred rebaseing the target and there were at least junior Treasury Ministers who did not wish to do it but wished to catch up on the overflow, as it were?

(Mr Unwin) With respect, I am sure that is a rhetorical question and you do not expect me to answer it.

(Mr Monck) On the question of rebaseing, the Chancellor did say that although there were these special reasons which explained what happened in 1980/81 and which led him to expect there would not be inflationary results, it was also important not to disregard the excess and that the possibility of recovering some of the excess would be looked at if that was thought to be desirable.

120. That is one point. He also mentioned another, talking about monetary based control. I think it has now been agreed, has it not, that what actually happened was that the banks were lending to pay the interest on money they had already lent, roughly speaking. This was the suggestion, at least in the Lloyds Bank Review and the London Business School publication, but broadly speaking, you can put it another way. The Treasury and the Bank seem to have lost control over bank lending to the private sector. It is argued by some that one should have a different system of monetary based control and so forth. I am not going into the details now. I am sure everybody is familiar with it. The Chancellor seemed to indicate his preparedness to move in that direction, so one took it that he was saying, "I am not going to try and catch up on the past but I am trying to introduce some system of control for the future." Is that what was being said?

(Mr Monck) No decision has been taken on whether to move in

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the direction of monetary based control. All that has been said is that the changes which are being made in monetary control - and I think you have had a piece from the Bank on that, which you will no doubt be talking to them about - as well as being desirable in itself, be consistent with a move to monetary based control, but no decisions have been taken on whether to move in that direction.

121. Given the overflow of M3, why were the consultations mentioned in the Bank of England's November Quarterly delayed? The Bank of England in November said they were going to go straight into consultations about the effects of monetary based control and then when they came here they said they had not done so. Why were they, therefore, delayed? Was that by decision of the Treasury or by decision of the Bank?

(Mr Monck) No, the consultations took place when they were ready to hold them. I do not think it was ever said that the consultations that were mentioned in November, both by the Chancellor and by the Bank in their background note, were to be about monetary based control. They were to be about specific subjects which were mentioned by the Chancellor in his statement of 24th November.

Mr Higgins

122. Could I refer for the moment to the question I asked earlier on the medium-term financial strategy and the PSBR because I have an idea we are a little at cross-purposes on the actual years involved and also on whether the figures were being expressed at 1979/80 prices or outturn prices. The point I am really concerned about is this, that together with our advisers, we have the impression that if one l[illegible] at the figures for the 1981/82 PSBR, then the figure in the Medium-Term Financial Strategy had, as the PSBR figure,

(Mr Cassell) £7½ billion, yes.

Mr Higgins: I am not going to ask for the answ[illegible] one then took the situation forward, as I expressed it on unchanged policies, that is to say with re-valorisation but without the November measures or the Budget measures, the figures provided by our advisers suggest that the 1981/82 figure for the PSBR at 1981/82 outturn prices would be £17.8 billion, not £7.6. Therefore, if one is to bring the PSBR back to the figure of £10.5 billion mentioned by the Chancellor in his Budget statement, the difference would be between £17.8 and £10.3 billion, a very massive reduction in the PSBR as a result of the November and the Budget measures. To save time, because I think we are anxious to have this point clear before we see the Chancellor, perhaps we might let you have our advisers' figures and then you would simply confirm them or, alternatively, suggest there is some misunderstanding on our part?

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Chairman

123. Mr. Unwin, Dr. Paul Neild has produced a rather striking illustration. I do not know if you have seen a copy of that.

(Mr. Unwin) I took delivery. I have not actually looked at it yet, Chairman. May we take note of this. I said earlier that we would look at this.

Mr. Higgins

124. I think it would be easier to have your comments on his figures.

(Mr. Unwin) There seems to me to be some misunderstanding.

Chairman: If you would very kindly come back to us that would be fine, but obviously this is a point that we shall want to pursue with the Chancellor. Let us go on to public expenditure.

Mr. Wainwright

125. May I take the Committee to part III of the PSBR, page 21? In paragraph 2 the second sentence reads, "About half of the £5 billion overrun of the PSBR resulted from the recession being worse than expected, particularly in its impact on unemployment and short-time working." The paragraph does not go on to say anything about the other half. Where does the other half come from?

(Mr. Evans) Your question is about what the rest of the over-run on the PSBR was about.

126. Yes.

(Mr. Evans) There were, of course, areas in public expenditure where spending was higher than anticipated for reasons which were not connected with the recession.

127. Volume or price?

(Mr. Evans) Both. One of these areas was local authorities where the relation is not complete by any means. There does seem to have been higher spending than was expected. Another area was defence spending where you are aware of the problem. A third area was the debt interest payments which were the best part of £1 billion higher in 1980/81 than anticipated at the time of the last budget.

128. I am sorry, I did not catch that item, the £1 billion.

(Mr. Evans) The debt interest payments for the whole public sector. That was in itself partly a reflection of the higher borrowing itself, obviously, if it has implications for the debt interest, but also because interest rates were higher than expected at the time of the last budget. These were the three major items I would pick out on the expenditure side, but there was also less revenue collected - again, for reasons not concerned with the recession - particularly on indirect taxes. Some of the shortfall on indirect taxes can be attributed to the volume of consumer expenditure being less than expected or the change in the volume being less than expected; in other words, to do with the recession. Some of it was wrongly estimating the tax base for the/indirect taxes and therefore getting the forecast of indirect tax receipts too high. The outturn was lower than whathad been forecast.

129. But sticking to public expenditure, would you say that the working of the relative price effect had a considerable impact on this overshoot?

(Mr. Evans) It had some effect; I think not very considerable.

(Mr. Bridgeman) Part of the change in the relative price effect due to catching up pay awards and Clegg had been anticipated and in fact the figures for expenditure were right. If anything the relative price effect was greater than expected, because the GDP deflator moved by less than expected. So relativity was due, not to wrong forecasting with prices in the public sector, but slightly better performance than expected in the rest of the economy.

130. But in the case, for instance, of the health sector would you say that the overshoot there was largely the result of the relative price effect?

(Mr. Bridgeman) I do not think there was an overshoot in the health sector. On what basis are you suggesting that there was?

131. I am advised that there was in relative costs £800 million added at the 1979/80 prices to the planned expenditure for the health programme. What I am getting at is that throughout there appears as far as one can marshall these figures to have been a very much higher cost overshoot than volume overshoot. Perhaps we can have a note, for instance, to break this down so that we know to what extent it was volume and to what extent it was the working of the relative price effect and so on. This, I think, would be helpful.

(Mr. Cassell) We did in fact provide a note last week in response to a PQ on the comparison between the MTFS projections for all of these years in cost terms. That is in the library. We can send you a copy.

132. I will pick that up. I did not know the question had been answered. I will have a look at that.

(Mr. Bridgeman) Could I say that we have been shown some of Mr. Ward's work for the Committee and I must say that we are at present puzzled by the arithmetic which he has done on our arithmetic. We cannot see how he has got some of these figures.

Chairman

133. I think the figure that Mr. Wainwright is quoting in fact comes from Mr. Ward's paper, does it not?

(Mr. Bridgeman) Yes. I recognised it from the paper. I was merely saying that when we were trying to see how

Mr. Ward had got from the figures we had published in the White Paper to his figures we had not been able to do that particular translation process.

134. It is the sort of matter, I think, that can be dealt with at leisure.

(Mr. Bridgeman) It could.

Mr. Wainwright

135. Perhaps we could have a note as to your finding on this.

(Mr. Bridgeman) I think we would like some guidance from Mr. Ward as to how he got his arithmetic, but we can pursue this later.

136. Returning to the sentence that says that about half the £5 billion overrun resulted from the recession, particularly its impact on unemployment, Mr. Cassell will recall that when we were going over this ground last year on the 2nd April our former colleague Mr. Baker asked specifically about it and the whole thing was referred to several times during that examination. Mr. Baker asked, "If you have an increase in unemployment of about 700,000 what effect would that have on the PSBR". Mr. Cassell's answer was, "None in the way we have done these predictions because we have assumed the flow into the national insurance fund is balanced so that if you have an increase in unemployment and therefore further increases in social security payments they are balanced by an increase in the national insurance contributions." It is now being said that a great part of this overshoot was due particularly to unemployment.

(Mr. Cassell) Speaking from memory on this, we were talking there about medium term projection of the PSBR, were we not, in which case, as is said again in this paper, the conventional assumption is that you keep the flows in the fund in balance.

(Mr. Evans) Yes, whereas in the short term the flows are already determined by the policy decision on the contribution of rates and benefits that have been made.

137. But on that basis you will always be lagging behind, will you not, as long as unemployment is high? It does not eliminate it.

(Mr. Cassell) As long as it is higher than you expect it to be when you set the contribution, yes.

138. Yes. I ask that because I must say the advice we have had from simulations and so on suggest that the assumption - I know it is only an assumption - in the White Paper is very, very optimistic indeed. Are we once again heading for an overshoot on the PSBR due to the impact of unemployment?

(Mr. Cassell) The unemployment assumption in the White Paper is optimistic? I thought on the whole there was a feeling that it was probably more realistic than it had been for many years.

Mr. Wainwright: That may also be true.

Mr. Eggar

139. That is not what you told us last year.

(Mr. Evans) If you look at the table published in the Financial Times today of unemployment forecasts for 1981 they really do not suggest that the particular assumption chosen in the White Paper for 1981/82 is particularly unrealistic.

(Mr. Unwin) It may be that what you are referring to is the difference between the working assumption in the White Paper for unemployment in 1981/82 and the assumption that the Government Actuary said that he had been asked to choose when his report was published towards the end of last year, on the basis of which the national insurance contribution rates were set for 1981/82. It is true that there is a difference - though not I recall a terribly large one - between the assumption he published and the one which is now in the White Paper.

Mr Wainwright

140. But it still seems to me that, although at the end of the medium term the figures of unemployment may have no effect on the PSBR, we are heading for another overshoot on that ground this year?

(Mr Bridgeman) Can I get this into proportion because there is a false premise that the major effect of the recession on the PSBR comes from unemployment benefit. If one looks at the Financial Statement and Budget Reports and compares the expenditure figures in them and what caused the difference in the planning total between £91.6 billion and the £2¼ billion or so higher figure we have now, only about £400 million of the £2¼ billion change in public expenditure planning total definition is the additional unemployment benefit. The other items which come within the definitions related to the recession include things like addition payments from the redundancy fund of £250 million and additional costs of special employment measures, just under £400 million, unemployment benefit is but one of a range of components within the recession-related element of the public expenditure growth.

Mr Woolmer

141. On the increase in the PSBR, it would be extremely helpful, if it is possible, to have the reason for the shortfall in revenue and increased expenditure in both volume and price and some explanation as to why those variations occurred. I think what the information does help to get in proportion is the relative significance of different items rather than a general impression. Would that be possible?

(Mr Evans) It is there in some detail in Part 4 of the Financial Statement and Budget Reports, which sets outs the figures in detail in Table 12 and again later on, where we set out all the Budget forecasts of last year compared with the estimated outturn.

Mr English

142. I just want to clear up the technical side of a little puzzle about indirect tax. That surely, contrary to all the political discussions

last week, as I understand it, is about back indirect taxation and in that I include VAT. Indirect taxes in 1981 after the Budget are now just about a little less than they were in 1966 and quite a lot less than they were in 1969. Beer is about back to where it was, or slightly less than in 1966. Those are quite comprehensible. What I am a little puzzled about is that whisky is down to about half of what it was in 1966 and cigarettes - I happen to have a large factory making them in my constituency, so perhaps I should not press this point too much - are distinctly less than they were in 1966. You remember the votes in the House of Commons and if you think of the health argument and the other arguments one wonders why this particular mix was chosen. Supposing one wanted to raise the total amount. Was there some technical reason for taking whisky and cigarettes differentially?

(Mr Battishill) No technical reason. The difficulty with all the kinds of comparisons you have just made is that the results would depend critically upon which year you choose to make your comparisons with.

143. I did not choose the worse. I have chosen 1969.

(Mr Battishill) Simply, if you had chosen different years you might have got a differential set of results. On the question of whisky in particular, the fact that the duty level now is lower than it was in real terms 10 or 15 years ago almost certainly reflects the high rate of duty and, therefore, the high money figure which a Chancellor has to announce as an increase in the duty if he simply maintains the real value of that duty during times of rising inflation. I think the political constraints being what they are on Chancellors of the Exchequer in balancing these factors in a Budget statement, it is perhaps not surprising that with the whisky duty being a fairly large proportion of duty in specific terms, over the last years it has dropped behind a little bit.

144. A lot since 1938. I shall ask the Chancellor naturally on the

political aspects of this but what I am really trying to ascertain is that cigarettes and spirits were not affected by the Common Market negotiations in this respect?

(Mr Battishill) No.

Mr Meacher

145. What is the number of taxpayers who would have been taken out of tax if the tax allowances and bands had been fully indexed?

(Mr Battishill) The number who would have been taken out of tax would be about 700,000.

146. I appreciate this is not a question that could be answered now but could we have a note on the income distribution effects of the Budget on the assumption that the Rooker-Wise amendment applies, i.e., tax gains and losses are calculated net of full indexing of the allowances and bands, and am I right in thinking that on that assumption, which I agree is arguable but I think it is probably the fairest assumption in looking at the income distribution effects of changes made in the Budget either of direct or indirect taxes and national insurance contributions, the effect of the run of the last three Budgets is that if we take three levels of income, say twice average earnings and five times average earnings, the only people who are better off as a result of the series of three Budgets over the last two years are those with incomes over about £20,000. I appreciate that is a very precise question and I am not expecting an immediate answer but could we have the material to validate whether that is true or not.

(Mr Battishill) Could I ask one question of you? Better off in terms simply of the average tax burden which they bear at the moment compared with 1978/79 or better off allowing for real increases in incomes, the real line of tax rates, because they will get different results?

147. No, I do not mean in terms of tax burden. I mean in terms of gains or losses as a result of tax changes at particular points in time,

which, of course, would have to be brought into a system of constant prices because I agree they are all at different times?

(Mr Battishill) Yes. One would need to isolate the real income changes over the same period.

Mr English

148. The other interesting thing on statistics - and again I am not asking this now - is that presumably this lack of change has cost the Inland Revenue something?

(Mr Battishill) Since there will be more taxpayers there will be more work to do, yes.

149. About 5 per cent?

(Mr Battishill) 5 per cent of what?

150. About 5 per cent increase in staff, for example, a 5 per cent increase in taxpayers, is that right?

(Mr Battishill) It is 700,000 very approximately extra taxpayers in 1981/82 over 1980/81 if there had been a 5 per cent increase in allowances. That was a very specific answer to a very specific question which Mr Meacher asked.

151. I am not asking Mr Meacher's question. When you send us a note could you tell us what the effect is on the revenue as well?

(Mr Battishill) I would certainly ask. I would not like you to feel there will be 700,000 more taxpayers in 1981/82 as a result of this Budget because that was not quite the question Mr Meacher asked.

152. And I am not asking Mr Meacher's question. I am saying there must be a public expenditure effect, if you like, an increase in public expenditure, on the Inland Revenue as a result.

(Mr Unwin) What you are really asking is, does this Budget entail an additional administrative cost for which provision will have to be made.

Mr Eggar: And if so, how much?

Mr English

153. That is it. That is my question.

(Mr Battishill) We will try to answer that.

Mr Beaumont-Dark

154. Could I ask you briefly about index-linking and all that. We have "Granny" bonds. Now they have become "Mummy and Daddy" bonds and I assume very soon tney will become "Nappie" bonds because they keep on lowering it which means more people can index-link themselves. Then we have the super idea of index-linked gilts, because "this innovation reflects the confidence we have in our strategy for bringing inflation down." I have not in the short term confidence in the strategy for bringing inflation down, but Governments come and go and policies come and go and in the end almost any Government is not so much constrained by inflation but by winning elections.

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I would foresee that inflation at some period is going to go up in years to come - say to 10, 12, 15 or 20 per cent. again. It may be because of world wide reasons. Is there not a fundamental daftness in the Government committing themselves to something that the rest of the population cannot possibly afford to pay? The reason why most of us are against index-linked pensions - not, of course, you lot, we are all terribly keen on you having it - but for the rest of them the reason why we are against it is because somebody has to pay the tallyman, as they say up north, and the person who pays the tallyman is the rest of the people outside. Is there not a danger that if this index-linking seems to be a jolly wheeze at the moment and the Government gets £3 billion or £4 billion on it they will extend it and, once again, guess who will lose out: industry, because industry cannot raise long term money at the moment because of the Government overfeeding upon the market. Why, now, at this stage, do we have to be over-generous? Successive governments have defrauded investors and they have not really minded. Why now are we suddenly becoming so virtuous as to give 2 per cent. which is a real interest rate where long term investors have been used to being defrauded for the last 50 years. Why now?

(Mr. Unwin) There are two points on this. One is that one of the main purposes of the Granny Bond, so called, is to get the burden off the back of the
Chancellor made that clear in the bud
Secondly, as for your remarks about in
one of the classical arguments against
I can say is that the Government's pol
policy, is to get inflation down and in the
considerable success.

155. That is a short term answer,

that
It is a
is, as the
eligible instit

(Mr. Unwin) I think the Government's policy is a long term policy for getting inflation down. Governments come and go, that I realise, but the policy is a long term policy for getting inflation down and keeping it down.

156. You do not answer the point as to why you feel you have to give two per cent. positive interest rates when investors have been quite used, for at least 30 years, to being cheerfully robbed of about 2 or 3 per cent..

(Mr. Cassell) Do we know there is a positive two per cent. rise in interest rates?

157. I thought it was decided in the financial press for you.

(Mr. Monck) That would depend upon the price at which it sells. The main thing is what people bid for it.

158. Can industry do the same? Can industry afford to do the same? Can they afford to issue a debenture or a bond and index link it? Can those who pay the bills afford to do what the Government is doing? The Government should always ask themselves that.

(Mr. Cassell) I do not know, but there is the counter argument on this that in issuing all of these very high coupon stocks for 20 years ahead with high nominal coupons this is the thing that has crowded industry out of the debenture market, and has saddled the taxpayer with a burden that in real terms we will not know the size of.

(Mr. Monck) If the inflation programme is successful the real burden could be very considerable indeed. That was what was meant by the reference to the Government assuming that the thing would be a success on inflation. Even if you do not believe in ... there is still a case for ... widening the range of choice. ... relatively modest thing in scale at the moment. The effect ... Chancellor said, to widen the range of choice for the ...utions.

Mr. Beaumont-Dark: If you did not spend so much money you would not need gimmicks.

Chairman: I think we must begin to bring this to a conclusion.

Mr English

159. It was said a moment ago that it depends on the price index. Presumably the idea of restricting one of these measures to institutions alone was in order to cut down the demand and keep the price down and, therefore, reduce the advantage to the Exchequer?

(Mr Monck) It was not intended to cut down the price.

160. But it has that effect. If you limit the demand side of the market you must keep prices down?

(Mr Monck) I think the financial press seem to think there will be quite a substantial demand for this.

161. But less than it would have been in a general unlimited market?

(Mr Monck) Yes, but there is a supply restriction as well which will have an effect on the price. The other thing mentioned by the Chancellor was that there are not many of these things around and it would distort the market if a whole lot of people from outside came in to buy.

162. What is puzzling everybody is why the Exchequer deliberately wanted to reduce the advantage to itself?

(Mr Monck) I very much doubt it will have that effect.

Mr Shepherd

163. Could you tell us to what extent this energy price package actually reduces the cost disadvantage under which British industry is working in comparison with its Continental competitors? Was it designed to take up the difference or what?

(Mr Unwin) I think there are two points to be made. One is that the proposals in the Budget were certainly not intended to bridge these gaps identified in the report which went to the NEDC. I think we have to accept that some price differences are inevitable, for example, because of the natural advantages in particular countries such as the French hydro-electric resources and their nuclear programme. The proposals are also not intended to take into account the fluctuations in the exchange rate. I think the NEDC report identified differences in the exchange rate as being one of the principal reasons for the differences in cost. Quite clearly one could not keep altering prices to keep up with movements in the exchange rate, but the changes that were announced, which amount to something like £120 million on the EFLs of the gas and electricity industries next year, the precise way in which they will work I simply cannot tell you. This would be a matter for negotiation with the gas and electricity boards and area boards and so on. So far as electricity is concerned, I understand that the sum of the flexibility arrangements that are likely to be introduced could have the effect of reducing electricity costs to large-scale industrial users by 8 per cent.

164. By "large-scale industrial users" do you mean in total quantity large consumers or do you mean those who have a high proportion of their costs made up of energy costs?

(Mr Unwin) I think the latter, but I must confess I am not an expert on this, nor are any of my colleagues here.

165. It is unclear from the Chancellor's statement.

(Mr Unwin) It is partly unclear because precise arrangements have not yet been decided. This would be a matter for negotiation by the gas and electricity authorities with their consumers.

166. But on coking coal, which has one of the largest differentials in the energy package that came up from the NEDC report, in what way do the Government's proposals assist the competitiveness of industry using this? By all means give us a paper on that but I would be very interested to know.

(Mr Unwin) I simply do not know.

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167. I ask it because it arises out of the Chancellor's Budget. Manufacturing industry, certainly in my part of the country, sees that the Government's financial strategy seems to bear down on them almost wholly. One expects to hear special pleadings. Would you say this Budget actually aids the international competitiveness of British manufacturing industry?

(Mr Unwin) If one looks at the Budget as a whole I think one has to look at various ways in which it positively helps industry and ways in which it seeks to avoid placing a burden on industry.m In the latter category is the fact that so far as possible the Budget sought to place the burden of raising additional revenue on other than the hard-pressed areas of business, hence the tax on the banks, the tax on the North Sea, the personal tax or the failure to re-valorise income tax allowances and threshholds, and also last November the decision on employees' contributions.

168. That is an aid by omission rather than commission, is it not?

(Mr. Unwin) Yes. I said one has to look at two aspects of this but I make that point first. Secondly, there is the direct help in the budget. We have talked about the expenditure increases - £120 million on energy. There is also the proposal for £50 million over the next two or three years for conversion to coal but in addition there are the tax measures in the budget. There is the stock relief scheme which will be worth about £180 million next year and £450 in a full year. There is the range of enterprise and small business measures which is worth nearly £100 million in the full year and, then, of course, the two per cent. reduction in MLR. Adding all those up, then, there is a fairly sizeable package.

169. In what way does it aid the international competitiveness of British industry? Manufacturers argue that so much of government activity over the last year has actually diminished the competitiveness that the leading areas of inflation in their costs have been Government or Government sector directed or local authority directed. The exchange rate obviously comes into this. Looking at the central charge against it, in what way have we mitigated that or helped them to become more competitive in terms of international competitiveness? I just wondered, from the point of view of this budget. You are saying that you did not impose further costs on them that might have otherwise been justified, but I am not sure that the measures that you are saying actually amounted to very much in assisting the international competitiveness of industry.

(Mr. Unwin) I should have thought the energy measures were of direct assistance.

Mr. Shepherd: You are not actually quantifying that in terms of reducing the differential between the prices charged to French or German industrial manufacturers. Without doing that and demonstrating that you have reduced or diminished it you have reduced the burden but not taken it away.

Mr. English: Economically if you reduce the energy prices with a limited amount of interest you are not actually doing anything, are you, because the subsidy is borne by someone else?

Dr. Bray

170. There is a further catastrophic reduction in the capital expenditure of public authorities budgeted for 1981/82. Has further thought been given to separating out capital expenditure effects in the PSBR from current expenditure effects? If not, why not?

(Mr. Evans) On local authorities some of the reduction ---

171. No, I am talking about all public authorities. This is table 1.8, page 22.

(Mr. Bridgeman) There is a further reduction in capital programmes, yes, and that has been increased by the changes in expenditure decisions over the last year. I think, though, it is wrong to approach the question of the make up of public expenditure by looking at its economic classification. That is not the way decisions are taken about it. The decisions are taken in relation to the programmes and what is sensible in relation to the programmes rather than saying 'We want to have 20 per cent. on capital, 30 per cent. on transfer payments' and building it up by economic categories. That is not the political reality or the way in which any government has planned its expenditure in the last 20 years or, I think, at any time in our history. The level of capital expenditure is the product of the decisions on particular programmes. That we have had a downward trend is a reflection of the fact that a number of programmes - and one can think of them - transport and the roads, where the motorway programme is largely complete; housing, where the chronic shortage of houses of the 1950s are now a thing of the past and the Government is looking for an upturn in the private sector rather than the public sector; the school building programme where we are now facing a fall in school population and not a rise in school population, and so on. One could go through the expenditure programme and see logical reasons why capital expenditure is going down by a significant number. There are a few exceptions: courts and prisons is one, regional airports is another, where the shift is in the opposite direction, and capital expenditure of the nationalised industries.

172. It is perfectly clear there are a number of industries and areas where a capital programme is highly desirable - British Telecommunications, for example. What thought has been given to accommodating that urgent need for new investment in terms of the restraints on public borrowing?

(Mr Bridgeman) This is a matter which has been the subject of some discussion in the House in the last week, including the Chief Secretary's speech and also your speech, Mr Chairman, and also comments from the press. As the Chancellor said in his winding-up speech in the Budget debate, we are certainly interested in diversifying the forms in which the public sector seeks its finance and, indeed, the restricted indexed gilts which we were talking about five or ten minutes ago is an example of that. Therefore, the Government is certainly open-minded, in fact welcoming the possibilities of alternative ways of financing the nationalised industries. But the hard fact still remains, as the Chief Secretary pointed out, that additional expenditure on investment is, like additional expenditure on current expenditure or on other things in the short term, partly, as the Financial Times leader said this morning, the long-term economic effects of additional expenditure on investment and additional expenditure on social services, the possible demands may be very different, but in the short term when we were paying for additional school teachers or paying additional contractors for puttir up electric power over British Railways, it makes very little difference to the demand on the economy and, as the Chief Secretary said, if we increase the total of public expenditure, however it is financed, in order to accommodate these things, there will be further crowding out of private industry. That is why the Government has to impose some limit on the borrowing of the nationalised industries, irrespective of the source of financing.

Mr Wainwright: How on earth do you explain that?

Mr Shepherd

173. Do you mean to say that you think it is the Treasury's view that public spending currently is crowding out private spending?

(Mr Bridgeman) In respect of the financial markets, yes, which is why the Chancellor has hitched his PSBR deliberately in order to be able to bring interest rates down, and has said so.

Dr Bray: Can you show us any simulation which proves that in the short term?

Mr Eggar

174. Are you now really saying the reason for getting PSBR down to £10.5 billion was that it was the only way you could reduce interest rates?

(Mr Bridgeman) No, I am not saying it is the only way you could reduce interest rates. What I was saying is that one of the reasons for bringing down PSBR, both in the short-term and the medium-term financial strategy, is to achieve the monetary objectives of the Government at lower rates of interest and so ease the burden on the private sector.

Chairman

175. I think it is quite obvious, Mr Unwin, at least in the last minute that we could go on discussing these matters with you over a very

long period of time. Before I wind up the session could you tell me what is the Treasury's forecast of earnings over the next year or 18 months?

(Mr Evans) We have not given a precise figure, Mr Chairman. Indeed, we normally do not in the forecasts. We have referred to a declining trend in wage settlements and the Chancellor in his Budget speech referred to the fact that most settlements in manufacturing since November have been down to single figures and we expect that to continue.

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176. So you anticipate that settlements during the course of the current year will be lower at any rate than last year?

(Mr. Evans) Certainly much lower than last year, yes.

Chairman: Much lower, I see.

Mr. English

177. Much lower in the public sector?

(Mr. Evans) No, throughout the economy.

Chairman

178. Mr. Unwin, we shall look forward very much to having the additional material that you have kindly undertaken to give us. I do realise that we have actually asked for a quite a number of things and, at the risk of being tiresome, I think it would be helpful to have as much of that information as it is possible to let us have before we see the Chancellor during the course of next week.

(Mr. Unwin) May we take stock? We will certainly try and meet all those requests but if there are problems perhaps I could raise them with Mr. Hubbard and then we will discover which are the priority items.

Chairman: I was going to go on to suggest exactly that. The reason I am saying that I realise we have asked for a great deal is that I think the Committee does appreciate that there may be problems. I would like to say that this Committee greatly appreciates, as we always have, the frankness and helpfulness of yourself and your colleagues. I think that we have raised a number of subjects this afternoon that we should well like to explore further with you, not least this matter of capital investment. However, we will leave that for another time. You will be working on these subjects no doubt and I dare say we will have the opportunity to talk further and we shall look forward to it. Thank you for coming.

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pwp 16a 12

cc Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
Sir D Wass
Mr Burns
Sir K Couzens
Sir A Rawlinson
Mr Ryrie
Mr Middleton
Mr Battishill
Mr Bridgeman
Miss Brown
Mr Burgner
Mr Cassell
Mr Evans
Mr Monck
Mr R Allen
Mrs Gilmore
Mr Folger
Mr Wren Lewis
Mr Ridley
Mr Cropper
Mr Cardona

PS/IR
PS/Customs & Excise

MR UNWIN

TREASURY AND CIVIL SERVICE: APPEARANCE OF THE GOVERNOR AND THE CHANCELLOR

The Chancellor spoke by telephone with the Governor last night and he agreed to stay with 25 March. This means that the Governor will probably appear before the Committee after the Chancellor on 30 March.

PSJ

P S JENKINS
18 March 1981

165 PE (Budget) 11.

Pl circulate & ask SEP to arrange any further briefing necessary for the Chancellor for next Wednesday

13

THE BUDGET AND THE PUBLIC EXPENDITURE WHITE PAPER

Submission by the National Council of Building Material Producers (BMP) to the House of Commons' Treasury and Civil Service Select Committee.

20/3

Public Expenditure on Construction

The Public Expenditure White Paper once again includes a table (Table 4.5) showing estimated capital expenditure by the public sector on construction work. Although no analysis of expenditure on construction is given for the years 1982-83 and 1983-84 BMP feels that there is sufficient information on capital expenditure planned for these two years in many programmes that it is possible to estimate the construction content of most non-housing programmes.

The Government feels unable to provide a breakdown of housing expenditure in these two years between capital and current and, in the absence of a clear policy statement on the balance between current and capital spending that the Government hopes to achieve, BMP does not feel able to forecast capital expenditure on housing work in 1982-83 or 1983-84. The Secretary of State for the Environment, on at least one occasion has indicated that he wishes to give greater priority within housing to capital expenditure, something which BMP welcomes. However the size of the reductions in total net housing expenditure in 1982-83 and 1983-84 is such that, even if there is a significant fall in spending on housing sudsidies (through lower debt charges and higher rents), no recovery in capital spending seems likely.

The White Paper shows that Public Expenditure on non-housing construction, excluding the nationalised industries, has declined sharply as a proportion of both total public expenditure and of GDP. BMP's projections indicate that,on present policies, this trend is likely to continue until 1983-84.

The very low level of investment and reduced maintenance expenditure are leading to a deterioration in the quality of the nation's infrastructure, the road network and the sewers. The provision in the public sector buildings both for changing needs and replacement of out-dated facilities has also fallen to a very low level.

The Nationalised Industries

The trend in construction spending and investment generally by the nationalised industries appears to be more healthy, but the levels of investment shown in 1980-81 and subsequent years are lower than shown in the White Paper published a year ago. Accurate comparisons between the figures for expenditure on fixed assets shown in table 3.2 of the White Paper and the equivalent table last year are hampered by the lack of detailed information about the factors that should be used for each industry to convert 1979 survey prices to 1980 survey prices.

It appears, though, that the average conversion factor for nationalised industries' capital expenditure is 1.17. Using this conversion factor indicates that the volume of capital expenditure in both 1980-81 and 1981-82 is now expected to be 7% lower than the indicated in the last White Paper. Projected Capital Expenditure in 1982-83 and 1983-84 also appears to be less than the last White Paper indicated, though the reduction in these cases is slightly smaller.

The White Paper does not explain the reasons for these reductions. Part of the cause may be slippage of schemes, and the relative price effect may have played a part, but the deterioration of trading positions of nationalised industries because of the recession has forced them to cut capital spending in order to keep within their External Financing Limits. BMP is most concerned that profitable productive investment is being lost and urges that consideration be given to changing the treatment of capital investment by nationalised industries in the public accounts so that it does not suffer in this way.

Innovations in the Finance of the Public Debt

The Government is making some revolutionary changes in the financing of its debt by the introduction of the indexed gilt-edged stock and the oil bond. The extension of the "granny" bond scheme is also a major development. BMP believes that all of these measures will assist the funding of public sector debt at the expense of construction investment by the private sector. "Granny" bonds and oil bonds will compete directly with the building societies' and the effect of the new measures must be to restrict the ability of the societies to finance growth in home ownership and the building of new homes. Pension and life assurance funds regard property as one of the investments that can offer the best protection against inflation although, because it is not risk free, it rarely forms more than a quarter of a fund's total investment. The indexed gilt issue is equivalent to nearly 10% of the annual investment, of all types, by pension and life funds. It will attract funds that would otherwise go into ordinary government securities but it is likely also to divert funds from equity investment and, because it promises risk free protection against inflation, especially property investment. BMP would not find these new funding developments so hard to accept if the money diverted from financing construction work in the private sector was to be used to pay for increased expenditure on construction in the public sector. Clearly it is not; public sector construction and investment will continue to decline whilst current expenditure is hardly curbed at all.

CAPITAL EXPENDITURE ON CONSTRUCTION WORK £m 1980 Survey Prices

	OFFICIAL FIGURES					BMP. ESTIMATES	
	1977-78	1978-79	1979-80	1980-81	1981-82	1982-83	1983-84
ENGLAND							
New dwellings and improvements	2443	2116	2017	1520)			
Grants and loans to housing associations and improvment grants	829	765	733	686)	1829		
Other environmental services	1017	1085	916	901	841	815	740
Roads and transport.	766	727	759	699	681	670	670
Education	379	323	319	280	244	215	205
Health and personal social services	382	376	370	406	442	440	440
SCOTLAND	890	850	847	739	750		
WALES	365	340	347	320	296		
Other non;housing work (1) ...	616	566	651	659	596		
Non-Housing (G.B.)(Excluding (2) Nationalised Industries)	(3987)	(3847)	(3819)	(3690)	(3529)	(3450)	(3350)
Housing (G.B) (2)	(3700)	(3300)	(3140)	(2520)	(2150)		
Northern Ireland	267	247	231	215	184		
(A) TOTAL (UK) Excluding Nationalised Industries	7954	7394	7190	6425	5863		
Nationalised Industries							
Electricity	204	218	201	200	232	250	240
Gas	185	190	207	236	259	240	240
Railways	169	235	146	133	141	160	160
Coal	125	193	221	259	269	280	290
Other	283	265	222	251	313	320	300
(B) Total Nationalised Industries	966	1101	997	1079	1214	1250	1230
Total Non-Housing (G.B.) ...	4953	4948	4816	4769	4743	4700	4580
(A)+(B) TOTAL Capital Expenditure on Construction Work (UK)	8920	8495	8187	7504	7077		
Road Maintenance in England (current expenditure)	643	697	672	649	635		

(1) Includes defence new construction expenditure

(2) Using BMP estimates of Housing expenditure in Scotland and Wales

Fair-weather forecasts

How can the nationalised industries wriggle off the PSBR hook?

Britain's nationalised industry bosses must live on hope if they are to meet government expectations. According to the red book, they plan to spend £7.1 billion on fixed assets in 1981-82. Only £2.4 billion of that will come from government grants and loans, the rest (they hope) from their own efforts.

Year-on-year comparisons of nationalised industry profits are suspect, because of the way some of them play musical chairs with accounting policies. But at least the treasury has put this year's figures in current cost (inflation-adjusted) terms, and neatly circumvented some of the more reticent boards by publishing profit forecasts for the first time.

The Electricity Council's profits, which were more than halved between 1979-80 and 1980-81, are budgeted to jump by over 75% to £412m in 1981-82. And from being a net borrower this financial year to the tune of £175m—its external financing limit—the council will repay a net £165m in 1981-82. Or so the book says.

Gas industry current cost operating profits are up from £436m to £627m in 1981-82; the Post Office leaps from £807m to £1,159m; British National Oil Corporation from £298m to £438m; even British Steel's losses are scheduled to drop £313m to £400m (after appropriate creative accounting?). So is everything in the garden rosy?

No. Of the big state industries, the railways show a growing loss—though only 8% bigger than last year, with projected losses of £885m. The National Coal Board's losses are (says the book) stagnant next year at £270m. But that is already out of date. Treasury, energy and coal board officials are still working on the financial implications of the deal fixed just before the budget to avert a national miners' strike. That is an expensive game to play.

So far the coal board has plans to spend £100m-200m reducing imports and cancelling its accelerated pit closure programme in 1981-82. Between £10m and £15m a year will be spent on improved redundancy payments. And, although this does not directly affect NCB finances, another £50m will be spent over the next two years on industrial conversions from oil to coal.

Little short of a miracle could hold most of the nationalised industries to the financial straight and narrow next year. The contingency reserve for all public spending has been increased to £2.5 billion. The nationalised industries could hardly grab more than £1 billion—which would still be a significant improvement on this year's overshoot—without creating another of the prime minister's detested "unforeseen crises". So they are working on escape routes, like getting money outside the treasury's sacrosanct public sector borrowing requirement (PSBR). Difficult.

Whitehall is inching towards a decision to give British Rail the shiny new £775m electric railway it has set its heart on. The go-ahead could well be signalled sometime during the coming two or three weeks. Once, that is, a fiendish new arrangement has been worked out to get private backers to pay for the bulk of the electrification scheme while, at the same time, making them carry enough of the financial risk so that the sum can be happily taken off the PSBR.

There is no lack of private interest in investing in BR's new electrification scheme. The joint study released a month ago by BR and the department of transport gives the 20-year project a juicy 11% real rate of return. Talks are at an advanced stage with merchant bankers Morgan Grenfell, as well as equipment suppliers GEC and BICC. If it cannot have the cash itself to wire up a further 3,200 miles of its routes, BR would gladly lease the overhead wires from a private consortium.

There are three problems with this. While the heavy electrical equipment suppliers (a conservative lot) can lay their hands on the cash, they do not like carrying much of a risk. They would prefer to have the investment guaranteed by the government. Which, of course, would promptly put it back on PSBR.

The second problem is of the treasury's own making. It concerns the way public corporations have to treat lease-back schemes in their annual accounts. Sealink, BR's own ferry company, is leasing four of its latest vessels from commercial banks which, between them, put up £64m to pay for their construction. Sealink is still arguing the toss with the government about whether the ships are, in fact, company assets. The treasury is insisting that Sealink capitalise them. So they have to be squeezed under BR's own external financing ceiling.

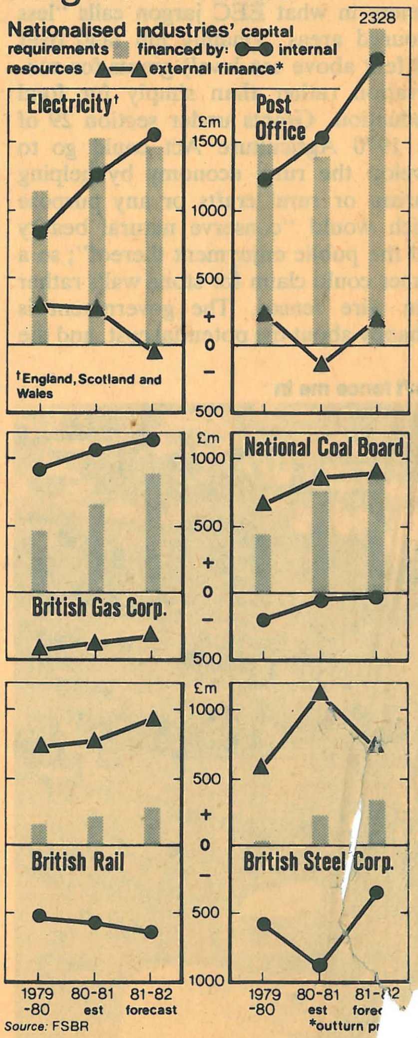
Then there is the government's own fear of being accused of bolstering nationalisation. Ironically, it is here that the most likely solution seems to be emerging.

One dodge BR has bandied around for getting its hands on private capital without upsetting either the treasury or the government is by using some sort of holding company. Last November, it set up a wholly-owned subsidiary called British Rail Investments to carry out all its privatisation ventures in shipping, hotels and property. BR's portfolio of assets ready for privatising is now worth over £220m. The same holding company now looks a promising vehicle for getting private cash into the proposed Channel tunnel project, as well as the electrification scheme.

The transport secretary, Mr Norman Fowler, has clearly been won round to BR's view about electrification. But he has yet to take the case to the cabinet. His colleagues will have to be persuaded that such a big chunk of new investment (even if it is not actually taxpayers' money) will be accompanied by new financial and non-financial disciplines. No way, for instance, will BR be allowed to have anything more than a minority interest in the joint holding company that builds and leases the electrification scheme.

British Telecom made an attempt to wriggle out of PSBR—and failed. It wanted to issue a £360m bond, tied to revenues. Still part of PSBR, said the treasury, so the telephone men are back at the drawing board.

Fingers crossed



9.11

Countryside bill

Revolt in the lords

The government is once again in trouble in the house of lords. This time it is over the Wildlife and Countryside Bill, which deals with such contentious subjects as the protection of birds and plants and public rights of way in the country.

The government miscalculated the attention their lordships would devote to the bill. The bill has so far taken up 82 hours—as much time as any of Mrs Thatcher's more important bills. The committee stage for which the government business managers had allocated only three days lasted eight days, with 10 votes in which the government suffered two defeats. During a further three days on the report stage there were 15 divisions with five government defeats.

The most significant defeat, by 48 votes to 46, was on an amendment by Lord Sandford, a former environment minister in the Heath government. This now allows the ministry of agriculture to give farmers in what EEC jargon calls "less favoured areas" (mainly hill land over 800 feet above sea level) grants for conservation rather than simply for food production. Grants under section 29 of the 1970 Agriculture Act could go to develop the rural economy by helping tourism or rural crafts or any purpose which would "conserve natural beauty and the public enjoyment thereof"; so a farmer could claim for stone walls rather than wire fences. The government is unhappy about the potential cost, and the department is anyway loth to get involved in aiding non-agricultural projects. Another defeat stops the environment secretary delegating decisions on closing footpaths to local councils.

Don't fence me in

At the end of last week the government was so grumpy about its treatment in the lords that it was threatening to drop the whole bill. Ministers will probably try to get the amendment on grants reversed in the commons.

But there is rumbling discontent among Tory backbenchers representing rural seats (the row over the petrol tax was merely the final straw), so they may oppose the government. Up to now agricultural grants have often damaged the rural landscape.

It is only a few years since the agriculture ministry actually grant-aided the removal of hedges. Even today farmers can often get grants for ditch elimination which may mean destroying hedges. An argument which may have increasing political appeal is that grants for conservation could help reduce rural unemployment and depopulation.

Social benefits

Simpler

Around two thirds of those eligible for Britain's basic social security payment, supplementary benefit, live in council housing. In 1979-80, the government paid £575m to cover their rent and rates. Meanwhile their council landlords were compensating low-income tenants with rent rebates totalling £222m and paying rebates on the rates paid by 3.1m households in both public and private sectors.

The way out of the overlap is obvious. The last chairman of the now defunct supplementary benefits commission, Professor David Donnison, hammered away at it for years under Labour and Tory governments. Now at last a unified housing benefit may be introduced.

The environment department this week proposed amalgamating all means-tested subsidies to tenants under local councils. So a long-term unemployed man would get money for food and clothing from the supplementary benefits office, but none for rent. Instead his local authority would stop charging him rent if he were its tenant or, if he were a private tenant, pay him a rent allowance.

So far so good. But the poverty lobby calculates that the switch may make thousands of tenants worse off. The government replies that the reform would take 130,000 off supplementary benefit altogether.

Stronger objections to the plan will be made where it is weakest, on staffing. A unified housing benefit admin[illegible]d by councils could save 2,000 or more civil servants. But town halls are bound to say they will require hundreds of extra staff; their employees' union, Nalgo, will certainly demand this, and councils have in the past all too frequently given way. If the government reckons they will, it may feel obliged to abandon a long-overdue improvement in the benefits system.

Trident

Fat missiles or thin?

One of the decisions still to be made about Britain's Trident missile programme is basic: how big should the submarines be? Mr Keith Speed, the navy minister, left for Washington on Thursday to try to get some advice on this, and other matters. That he is going instead of Mr Nott, the defence minister, reflects Mr Nott's recent decision to assign the management of nuclear programmes to his service ministers. Mr Speed gets Trident and Mr Geoffrey Pattie, the air force minister, cruise missiles.

The size of the Trident submarines depends on what missile-launching tubes are to be used. Britain needs to decide by the summer if its building programme is to go ahead as planned. It could use tubes designed for the Trident-1 (C-4) missile or the longer and fatter ones for the Trident-2 (D-5). The smaller missiles can fit in the larger tubes, using spacers, but not the other way round.

The problem is that the Americans, who will supply Britain's missiles, have not yet decided what they are going to do. The C-4s are already in service, and will have been for nearly 15 years when Britain gets its first Trident submarine on patrol. The Americans' original plan was to phase out C-4 in favour of D-5, which would have better accuracy and longer range.

However, the D-5 might not be built. Last year the Americans discovered they could put the same accuracy into the C-4 that the D-5 would have had. Reasoning that the extra range alone might not be worth the money ($8 billion or so), they cut the D-5 development programme.

The raw inclination of the Reagan defence team would have been to go ahead with D-5. But the *Ohio* class submarines that would carry them are in trouble: behind schedule and over cost.

To add to Trident's uncertainty Mr Caspar Weinberger, the American defence secretary, is worried about delays in the MX land-based missile programme