part. B

Begins: 23/3/81
Ends: 25/3/81

PO -CH /GH/0057

PART B

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

CHANCELLORS APPEARANCE BEFORE THE TREASURY AND CIVIL SERVICE SELECT COMMITTEE

Disposal Directions: 25 Years

[signature]
25/7/95.

PO -CH /GH/0057
PART B

11

(without attachments)

PRINCIPAL PRIVATE SECRETARY

cc PS/Chief Secretary
PS/Financial Secretary
Mr Burns
Mr Middleton
Mr Battishill
Mr Bridgeman
Miss Brown
Mr Evans
Mr Unwin
Mr Monck
Mr Allen
Mrs Gilmore
Mr Sedgwick
Mr Bush or
Mr Blower or
PS/Customs
PS/Revenue
Mr Ridley

To be flagged

Chancellor

CU advice is that it's probably worth reading the pps by Ward & by Kay/Morris – & skimming the other pps flagged.

JW
23/3

OUTSIDERS' PAPERS TO THE TREASURY COMMITTEE

1. It may help you in organising the Chancellor's papers for the 25 March hearing to have the attached checklist of papers submitted to outsiders by the Committee.

2. You have already had copies of most of the papers sent to us by the Committee but I attach to this note copies of TR(Budget) 8, 10 and 11 which you have not had so far. The briefing for 25 March, being supplied separately, covers points raised in these papers and in those received earlier.

3. Copies of the various papers have gone to those directly concerned with briefing. If copy recipients would like a copy of any of them would they please contact Mr Blower (ext 3267) later this week. But would they please note:-

(i) photocopying is expensive: "is your copy really necessary" or could you share?

(ii) because of staff shortages in CU it will not be possible to supply spare copies today.

M T Folger

M T FOLGER
23 March 1981

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1981 BUDGET: OUTSIDERS' PAPERS TO TREASURY COMMITTEE AS AT 23 MARCH 1981

TR(BUDGET) serial	Title	Author(s)	circulation
* 1	The March 1981 Budget and Economic Prospects	Ward	Mr Unwin's 17 March minute to Mr Cassell
+ 2	The March 1981 Budget and Public Expenditure White Paper	Ormerod & Capella	
3	internal Committee paper	-	
4	An Analysis of the Budget Changes using the NIESR model	Henry	Mr Folger's 17 March minute to Mr Unwin
5	internal Committee papers	-	-
6		-	-
7	unknown (paper not yet received by Committee)	Budd	-
+ 8	Monetary Policy Aspects of the Budget	Miller	Mr Folger's 23 March minute to PPS
9	internal Committee paper	-	-
10 +	St James' Group Forecasts - Effects of Budget (simulation results only)	Hills (reporting EIU results)	Mr Folger's 23 March minute to PPS
11	The Budget and the Public Expenditure White Paper	National Council of Building Material Producers	

TR(Sub TX) serial	Title	Author(s)	circulation
* 28	The Impact of the 1981 Budget	Kay & Morris	Mr Unwin's 17 March minute to Mr Cassell
29	Some Tax Implications of the 1981 Budget and Associated Measures	Hills	

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INLAND REVENUE
MANAGEMENT DIVISION
SOMERSET HOUSE

PS/CHANCELLOR

24 March 1981

SELECT COMMITTEE - WEDNESDAY 25 MARCH

1. As you know, the Chancellor is to appear before the Treasury and Civil Service Select Committee tomorrow, and one of the subjects he is likely to be questioned about is the effect of the Budget on Inland Revenue staffing levels. Following the request made at last week's hearing, a draft memorandum was submitted to the Chancellor for approval, before being sent on to the Committee. The memorandum is self explanatory, but there are one or two points which it may be helpful to bring out.

Taxpayer numbers

2. The decision not to raise personal allowances and other thresholds has an effect on taxpayer numbers which might be illustrated by means of a table.

		000's	
	1980/81	1981/82 (Post Budget)	1981/82 (with indexation)
Taxpayers	25,560	26,090	24,840
Higher rate taxpayers included in above	760	1,000	640

Z BRIEF ON IR STAFFING

3. If there had been full indexation in the Budget, there would have been a fall in the number of taxpayers in 1981/82 compared to 1980/81 of 720,000. As there

cc Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
Sir Douglas Wass
Mr Unwin
Mr Battishill
Mr Cropper

Sir Lawrence Airey
Mr Green
Mr Boyd
Mr Taylor Thompson
Mr Gracey
Mr Houghton
Mr Flaxen
Mr McConnachie
Mr Pinder

was no increase in allowances, there will instead be an increase in the number of taxpayers compared to 1980/81 of 530,000. The same pattern is repeated for higher rate taxpayers. Indexation of allowances would have taken 120,000 taxpayers out of higher rates compared to 1980/81. Non-indexation means instead that 240,000 go into the higher rates.

4. Some members of the Committee might seek to present these figures rather differently, by pointing to the difference in effect between full indexation and no increase. Because the first would have resulted in a decrease, and the second an increase in the number of taxpayers, this is the worst picture that could be presented. On this basis, there will be 1,250,000 more people paying income tax in 1981/82 as a result of the Budget than if there had been full indexation, and 360,000 more people will be paying tax at the higher rates.

Staffing Effects

5. Compared with 1980/81 we will need to spend 375 more manyears in 1981/82 dealing with these increased numbers, rising to 550 manyears thereafter. The difference in taxpayer numbers with and without full indexation would imply a total staff cost of 840 manyears in 1981/82 and 1120 thereafter. However, there will also be a "one-off" saving of time in dealing with the generality of taxpayers in 1981/82 as a result of the Budget. This is because, as allowances are not being increased, there will be no need to carry out a general PAYE recode in 1981/82, and this will save us up to 500 staff. (All these costings are given in "manyears", which represents the work a fully trained member of staff would do in a year.)

6. On the financial side, the additional cost to the Revenue of the increased staff needed over 1980/81 levels is nil for 1981/82 (because of the offsetting savings described above) and about £m3 each year (at current prices) thereafter. The financial cost of not increasing allowances and thresholds, compared to full indexation is about £m2.0 for 1981/82 (after taking account of the offsetting savings) and about £m6.7 each year thereafter.

7. Other changes associated with the Budget also have manpower implications. The main one of these is the application of PAYE to benefits from company cars. To set up the scheme will cost 40 manyears in 1981/82, but there will be a staff saving in 1982/83 of 100 manyears and in 1983/84 of 200 manyears. However, this

proposal has not yet been announced and therefore no mention of it should be made in front of the Committee. The "net" cost to the Inland Revenue of all the Budget measures is estimated at 450 manyears in 1981/82, 520 in 1982/83 and 450 thereafter, as compared with the staff requirement for 1980/81, but for ~~1980/81~~ 1981/82 the costs will be more than offset by the savings arising from the avoidance of a Budget recoding exercise.

General

8. In spite of the Budget measures, Inland Revenue numbers have fallen and will continue to fall. They have come down by over 8500 since the Government took office, and a further 1300 savings or so will be achieved by April 1982.

AP.

A PINDER

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H. M. TREASURY

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PLEASE NOTE EMBARGO

NOT FOR PUBLICATION, BROADCAST OR USE ON CLUB TAPES BEFORE 18.30 HOURS MONDAY 23 MARCH 1981

23 March 1981

SPEECH BY THE FINANCIAL SECRETARY TO THE TREASURY

Attached is the text of the speech to be .be given this evening by the Financial Secretary to the Treasury, the Rt Hon Nigel Lawson MP, at the Institute for Fiscal Studies, London.

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48/81

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THE BUDGET STRATEGY

Text of a lecture given by the Rt Hon Nigel Lawson MP, Financial Secre to the Treasury, to the Institute for Fiscal Studies on Monday 23 Marc 1981

I was invited to speak about the Budget Strategy. I am afraid I have to confess that there is nothing new about that strategy. It is the strategy on which we embarked as soon as we assumed office a little under two years ago; and it is the strategy that was subsequently enshrined in the Medium Term Financial Strategy launched, in both quantified and qualified form, at the time of the 1980 Budget, almost exactly a year ago.

Such consistency and firmness of purpose is, I recognise, somewhat unusual and deeply shocking. It has inevitably attracted a considerable amount of criticism, some of which I shall seek to answer during the course of this talk.

But there is one respect in which the Budget undoubtedly marks a setback - a temporary setback, I believe, but one nevertheless which I have no wish to deny.

Right from the outset we have had what in this exalted company I think I can safely call a macroeconomic and a microeconomic policy objective. The macroeconomic objective is the conquest of inflation, to be achieved by the monetary and fiscal stance of which this year's Budget is a notable part. The microeconomic policy objective is the improvement of the performance of the supply aide of the economy, by the removal of unnecessary market distortions in general and the enhancement of incentives by income tax cuts in particular.

The reconciliation of these two objectives depends essentially on a progressive and adequate reduction in the real level of public expenditure. As we said quite clearly in the Manifesto on which we were elected: "The State takes too much of the nation's income; its share must be steadily reduced." Insofar as this does not occur, then, as this year's Budget has shown, we are likely to find that the fiscal balance necessary for continued success in the battle against inflation requires an increase rather than a diminution in the real burden of income tax.

As the Budget Red Book - the Financial Statement and Budget Report - put it, "Although this does not prejudice the achievement of the Government's monetary policy and financial strategy, it is clearly unsatisfactory in the context of the Government's wider economic objectives." And this year's Public Expenditure White Paper, also published on Budget day, put the matter equally clearly in its very first sentence: "The totals in 1980-81 and in 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."

Meanwhile, we have to live over the coming financial year with a burden of income tax higher than any of us would have wished. The Institute for Fiscal Studies has made its usual expert appraisal of the distributional and incentive effects of the tax changes announced in the Budget. So far as the distributional effects are concerned, I note that you - or should I say Mr Kay and Mr Morris, on your behalf - have reached the general conclusion that it is the better off who suffer most as a result of this Budget. This broadly confirms our own in-house analysis, although it may come as a surprise to some of our opponents.

So far as incentives are concerned, however, there is a rather fundamental difference between the IFS approach and ours. Broadly speaking, you treat almost all forms of taxation equally, with a

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heroic lack of discrimination. Thus, for example, you treat the employer's National Insurance Surcharge as if it were wholly a tax on the individual, just like income tax. By contrast, while not denying the relevance of the overall burden of taxation, we attach special importance so far as incentives are concerned to a man's marginal rate of income tax. That, for example, is why we chose to keep personal allowances and thresholds unchanged in money terms rathe than increase the basic rate by 3 per cent. The route the Chancellor chose increases the marginal rate of tax for that minority of the population, who, as a result of non-indexation, find themselves pushed into a higher tax bracket (or indeed pushed into tax for the first time). But the alternative would have increased the marginal rate of tax for the overwhelming majority of the population.

Perhaps I may be permitted a personal note at this point, since my name is particularly associated with the so-called Rooker-Wise provision, which we shall not be implementing this year. Indeed, the Leader of the Opposition has called for my resignation on that account.

In fact, as anyone who cares to re-read the Hansard reports of the debates on the 1977 Finance Bill can readily discover, my position has been consistent throughout. I have never believed that automatic indexation was realistic: no Chancellor's hands can be tied in this way. What matters is that, instead of the norm being no change in the allowances in money terms, the norm should be full revalorisation. Instead of no change in money terms requiring, as it used to, no Budget resolution, no clause in the Finance Bill, and no approval by Parliament, the failure to revalorise now has to be open and explicit: it requires a Budget resolution, a clause in the Finance Bill, and the express approval of Parliament. And that situation has been in no way altered by this year's decision: section 24 of the Finance Act, 19[illegible] as it now is, remains fully on the Statute Book.

I believe that this significant change, which I helped to bring about in 1977, will greatly increase the probability that the allowances - ar since 1980 the higher rate thresholds, too - maintain their real value over time, which I continue to believe to be a good thing. But it cann and does not ensure that this is so. That is impossible. But what is also now impossible, thanks to section 24, is an increase in the burden of income tax by stealth. Certainly, no-one could claim that what we have done this year has gone unnoticed: nor, of course, dic the Chancellor make any attempt to conceal either it or its consequence: He made the position absolutely clear in his Budget speech; and the underlying arithmetic was set out at the beginning of the FSBR.

But to return to the broad Budget strategy.

There is, I believe, general agreement - it is not of course universal agreement: nothing in economic policy can ever attain that status - but general agreement on three propositions.

First, that the conquest of inflation is both a good in itself and a necessary (even if not in itself a sufficient) condition of sustained economic growth.

Second, that inflation is in fact coming down.

And third, that this has been brought about by tight financial conditions. It is self-evident that this progress in the battle against inflation could not continue if government were to resort, instead, to periodic fiscal boosts in order to secure some short-lived advantage in terms of output. That being so, it is desirable not merely to refrain from such action, but in addition to let everyone know that the Government has no intention of proceeding in this way. People have a right to know where they stand (particularly after the excesses of the past), and will adjust their expectations accordingly.

That, in essence, is the meaning and purpose of the Medium Term Financial Strategy.

And why that Strategy remains firmly in place.

Nevertheless, in reviewing the pattern of events over the past year, two specific questions presented themselves in this context.

The first was whether last year's very high rate of recorded growth of broad money would fuel a resurgence of inflation in the future - and, if so, what we proposed to do about it.

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The second, rather less important, question was whether we should be trying to get off the hook of £M3.

Taking the second of these questions first, it is undoubtedly true that £M3 was not a very good guide to underlying monetary conditions last year. This was in part thanks to the removal of the corset and the unwinding of the distortions for which the corset has been responsible.

However embarrassing in the short term, this change was thoroughly desirable. And now that the distortions have been largely removed, there are clear signs of a marked deceleration in the rate of growth of £M3.

But of course we never were impaled on the hook of £M3 in the way that our critics have frequently alleged. We have all along made clear - perhaps most definitively in the Green Paper on Monetary Control we published a little over a year ago - that to assess underlying monetary conditions properly it is necessary to take account of all the various monetary indicators, broad and narrow alike; we also take into account the level of real interest rates.

But for a country with a Budget deficit the size of ours, the importance over the medium term of a broad aggregate like £M3, with its clear link with fiscal policy, cannot be gainsaid.

None of this, however, goes far to answer the more important of the two questions I posed - whether last year's very high recorded growth of broad money, which was certainly not wholly the result of the corset episode, has serious implications for future inflation.

Clearly, this is something we shall need to watch carefully; since in theory any increase in liquidity as shown by the wider measures of money might be spent to fuel inflation later.

But in practice this is unlikely to occur, not least because much of the increase in liquidity, representing as it does an attempt by the private sector to make good the ravages of inflation on their financial assets, will be firmly held. Analysis of the figures suggests that private holdings of financial assets, including in particular broad money, are now at a more normal real level, and there should be no repetition of what was a special, one-for-all,

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surge in the demand for money. Although it would be unwise to read too much into short-term movements of broad money, it is notable that, over the past three months, the rate of growth of £M3 has come back sharply to plumb in the middle of the target range: a deceleration we predicted last November, incidentally, when MLR was lowered from 16% to 14%.

So there is every reason to be quietly confident that the track we have set for £M3 from now on will produce a sufficient degree of financial tightness over the coming years; and given the determined steps we have taken to cut back the PSBR means that this should be compatible with lower interest rates than would otherwise have been the case.

Meanwhile, as I pointed out in a speech I made in Zurich a couple of months ago, the experience of the past year has also demonstrated the need to improve our funding techniques. This is not merely a matter of improving our ability to control £M3 in an inevitably uncertain world; it is also because, as I argued at Zurich, "It is the method of as well as the need for, funding which largely determines the system by which interest rates are generated at both the short end and the long end of the market".

The new indexed gilt, for the first issue of which lists open and close this week, is of the first importance in this context. There are, of course, other considerations, too. An indexed gilt reduces the risk of the Government having to pay very high debt interest in real terms as inflation comes down, while in the meantime there is a measure of immediate relief to the PSBR. But the biggest gain at the present time is to our techniques of monetary control. This arises partly because we will be selling - in addition to conventional gilts, which will of course remain on offer - a different kind of instrument which will have its own unique appeal to the institutions concerned: a greengrocer selling apples and oranges will on the whole do better than one who insists on selling nothing but apples. But the gain also arises because of the method of sale: the indexed gilt is perforce being sold by auction and will continue to be sold in this way. Among other things it will thus provide a means of influencing long term rates of interest directly rather than attempting to do this at a distance by operating on short rates.

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All in all, I have little doubt that the addition of the indexed gilt to our funding armoury will, over time, enable us to achieve our overall monetary objectives at a lower level of interest rates than would otherw be the case, to the benefit of the economy as a whole and of industry in particular.

But of course the main argument current raging over the Budget is not concerned with the innovation of the indexed gilt.

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Once again we are involved in an argument as to whether an attempt by the Government to pay for its expenditure by increasing taxes is deflationary. Unlike many arguments of this kind this is not a debate on whether to have more public expenditure or not. The debate on this Budget has been whether or not we should pay explicitly for the planned level of expenditure. It is the aim of this Government to attempt to reduce the share of public expenditure in output; but it is also an important objective to financ any expenditure in a responsible way.

This surely seems reasonable enough. But the contention of some of our critics is that any attempt to reduce the PSBR by increased taxes will produce a downward spiral of output. This argument suggest that the increased taxes levied in the Budget will so reduce demand and output that tax revenues will fall and public expenditure increase to the point where the PSBR, instead of falling, will actually rise. And if, instead of accepting this, the Government continues to pursue its lower PSBR target a further dose of fiscal contraction would have to be administered, which would be equally self-defeating - and so on (presumably) ad infinitum.

Needless to say, this view is wholly mistaken. It displays a major misunderstanding both of Government policy and of how the economy works.

The first important point is that the fiscal stance has to be assessed against the background of a fixed money supply target. This aspect of the debate is not whether to have a higher money supply target or not, although that itself may be a separate issue; this aspect of the debate is whether, given the money supply target, we should have a higher or a lower Budget deficit. It is the Government' contention that it is essentially the growth of the money supply in relation to the inflation rate that will be the prime determinant of the overall level of domestic demand and hence output in the economy, and not the fiscal stance. And we have no intention of allowing our monetary stance to be such as to lead output to spiral downwards. Over the winter of 1979/80 monetary policy was undoubtedly and necessarily tight; inflation was accelerating and was in turn well

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above the rate of monetary growth. Since last summer there has been a major transformation. Monetary growth has accelerated while the inflation rate itself has been falling. And now that the overall level of real money balances is back to a more normal level, we can expect to see some stabilisation of domestic demand emerging in the economy.

Looking ahead, we begin the next financial year with an underlying inflation rate close to 10 per cent per annum. This is roughly on line with, albeit at the top end of, the new target band of 6-10 per cent fixed for the growth of money supply over the next financial year. Furthermore over the course of the year we expect the inflation rate to fall to 8 per cent. Taking into account the upward trend in velocity, which is on average some 1-2% a year, this is quite enough to allow some real recovery of domestic demand. Irrespective of the stance of fiscal policy, and given the monetary path we have set, for as long as inflation continues to be reduced it is thus quite wrong to imagine that output can spiral downwards.

Moreover, even in fiscal terms it is important to be clear that we have deliberatly refrained from raising taxes to pay for the extent by which the PSBR is being inflated as a result of the recesssion being greater than expected. Essentially, this is not a matter of discretionary action but rather one of the operation of automatic stabilisers. In a recession it is normal for private borrowing to be reduced, thus making way for the higher level of public borrowing that tends automatically to occur on existing policies. I explained this analysis and approach in a speech to a Financial Times Conference on January 1980 and repeated it in Zurich earlier this year. So I trust I do not need to elaborate any further tonight. In terms of figures, our calculations suggested that in 1981/82 the PSBR will be some £3 billion higher than we envisaged last year as a result of the recession being greater than we then expected. Taking thi into accountwe have raised the original Medium Term Financial Strategy guideline for the appropriate level of the budget deficit from £7½ billion to £10½ billion.

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I trust that this, too, will help to reassure these who fear that we are somehow trying to chase our own tail in all this. We are not. But I do not believe that it has yet been sufficiently appreciated that, given a particular rate of monetary growth, the fiscal stance has its main impact upon the distribution of demand rather than upon the level of domestic demand. In particular, as a result of the level of interest rates, a low deficit tends to favour investment rather than consumption, whereas a high deficit favours consumption rather than investment.

If we cut public borrowing by raising taxes then with a fixed money supply it is likely that either bank lending must rise or the level of bond sales by the Government can be allowed to fall. If savings have been reduced by the increased level of taxes then we might expect some decline in bond sales but if interest rates are allowed to fall and bank lending by the private sector is allowed to rise to replace some of the fall in public sector borrowing then in turn this will have an impact upon the total level of domestic demand. Is there any reason to believe that demand will fall if we replace lower public sector borrowing by higher private sector borrowing? Is there any special merit in public sector borrowing? I must confess I cannot see it.

Alternatively suppose that the benefit of the lower fiscal deficit is reflected in considerably lower debt sales. In this case there are now more financial resources available in the private sector to lend to other parts of the private sector. If the private sector does not have to lend to the Government is it note possible that some of its available funds might go to the company sector, and boost expenditure that way? Why should it follow that, as a society, we can make ourselves better off by collectively paying the Government less tax and instead collectively lending them more money; particularly as the interest rates on Government stock will have to be raised to persuade us all to lend that money to the Government.

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The truth is that the reduction in the PSBR brought about by the Budget is unlikely to make much overall difference to the total level of demand. In the short term, there may be some very modest contractionary effect. But the more important point is that, taking full account of the Budget, we expect output to be on a rising trend during 1981/82.

To sum up, the main demand effect of this Budget as we see it, is to change the balance of demand between consumers and companies; and between consumption and investment. In the short run, but only in the short run, if we cut taxes and leave the money supply unchanged we may get a little more demand - but even that is not certain. But in the long run we will only succeed in giving more resources to consumers and pensalising private sector borrowers; this particular applies to the company sector who will find their access to funds reduced and the price of those funds increased.

In the Medium Term Financial Strategy we have set a path for fiscal policy that is consistent with monetary policy so as to have balanced development of the financial markets. We have attempted to ensure that as far as possible the growth of the total level of financial assets in the economy will be at a rate consistent with the money supply target. The fiscal framework as set out should lead to a growth of national debt that is consistent with the money supply. In turn this should avoid excess pressure upon the markets for government debt. We believe that it is unwise to unbalance this pattern by running large fiscal deficits and forcing the financial markets to take an excessive burden of debt. But at the same time we are not attempting to impose an undue burden on the taxpayer by trying to cut the fiscal deficit faster than is required to meet the monetary target at ~~a~~ reasonable rate of interest. This is a balanced policy. Both monetary policy and fiscal policy should move in step with each other. While no-one likes paying higher taxes, and this I accept, it is wholly wrong to suppose or suggest that the Budget imposes an unduly severe fiscal policy upon the economy.

However, in recent weeks we have had a resurgence of mechanical calculations concerning the effects of policy changes. The Treasury Committee of the House of Commons have argued that to get inflation down by 1 per cent requires, over a four-year period, a cumulative loss of output of 4% and the equivalent of a year's additional unemployment for 650,000 people. At the same time we have had assertions of the so called deflationary impact of the budget estimated at some 1-2 per cent of output. What we appear to have been provided with is a DIY policy trade-off kit. But it is only when we look at the implications that we really begin to see the nonsense implied in such calculations.

Take first the so-called inflation/unemployment trade-off. 'If a lasting fall in the rate of inflation of about 1 per cent per annum can be achieved at a cost of 650,000 man-years unemployment, presumably this calculation can equally well be reversed and thus provide us with a simple way of curing unemployment if only we are prepared to accept the higher inflation. Let us see what this would imply in practice. The Public Expenditure White Paper assumes an average unemployment rate of 2.5 million in 1981/82 and 2.7 million in 1982-83 and 1983-84. This level might imply a cumulative unemployment figure of about 10 million over four years. Suppose that we wished to have no more than a cumulative level of 4 million unemployed over the next four years; that is an average of 1 million. The solution, according to the Treasury Committee's ready-reckoner, is simple. All we need to reduce unemployment by 6 million over this period is 9 per cent higher inflation for ever. You may be forgiven for thinking that this is quite remarkable. But why stop at 1 million as a target? Surely we cannot be satisfied with anything less than abolishing unemployment for the next few years entirely. And what is needed for that? Again, according to this ready reckoner 15 per cent higher inflation for ever and we can have four years of zero unemployment. Who can possibly take this sort of nonsense seriously, particularly when we recall that the crucially important feature of the past quarter of a century is the

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the way on which inflation and unemployment, under successive governme[nts] have steadily and inseparably risen.

Then we have the other set of number-mongers who predict that the £4 billion tax increase in the budget will have knocked 2 per cent off output. That is with an unchanged money supply. Extrapolating this in much the same way produces the obvious answer to our low level of output. If a £15 billion PSBR would have been 2 per cent better than a £10½ billion PSBR why stop there? A £20 billion PSBR might have added yet a further 2 per cent to output. But perhaps what we really needed was a £30 billion PSBR so as to generate a further 5 per cent of output and really get our factories humming.

In the 1960's the UK had an inflation rate of about 3½ per cent; during the lifetime of the last government this had risen to an average of 15 per cent per annum. At the same time unemployment rose from a level of under ½ million in the early 1960's to an avera[ge] level of 1¼ million in the period of the last Government. Now we learn that apparently all that was preventing us from avoiding this deterioration in unemployment was a failure to let inflation rise high enough. So far from having too much inflation it now appears that our unemployment problems are because we have had too little inflation. Does it surprise you that we have got into our present difficulties of high inflation and high unemployment when we have a significant group of people who believe in such magic.

It is claimed by the proponents of these ideas that the calculations are based upon the Treasury model. It just goes to show how careful you have to be when handling a model. Certainly the keepers of these models never intended such absurd calculations to be made. The models are based upon historical information generated over a period only when there was no active monetary policy; they are based upon a period when any attempt to control inflation was temporary; and they are based upon a period when policy tended to be directed towards validating wage and price increases for fear that to refuse to do so would cause short-term pressure on demand and output.

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The conclusions of the Treasury Committee are based on the assumption that the future must be like the past, mindlessly extrapolated. The whole purpose of the present Government's economic strategy is to ensure that the future is not like the past. In the early stages of a change of policy people do require time to adjust to the changed circumstances. We are aware of this. But it would be totally wrong to assume that they will never learn; or that they will learn in some mechanical dumb animal way. To assume that is sadly to underestimate the perceptiveness and self interest of unions and companies alike, and the adaptability of the economy as a whole. The early stages of bringing down inflation are inevitably difficult; that much is well know and accepted. But blindly to extrapolate such experience over a larger time period is totally wrong.

FST Criticism of TCSC

I mentioned a few moments ago that, not only do we not accept that the Budget is in any significant sense contractionary, but that we in fact expect to see output on a rising trend over the coming financial year, 1981-82.

This expectation is reinforced by the behaviour of the indicator series published regularly by the CSO. The longer leading indicator has been rising since November 1979, the shorter leading indicator since November 1980, and the coincident indicator has ceased to fall since last November. Moreover, there is a growing amount of anecdotal evidence from industry tending to confirm this presumption.

'That's all very well', reply the gloom-mongers and assorted sceptics, 'But where is the growth going to come from?' The most obvious answer is that, just as the recession had as three important components a mass wave of destocking, a sharp increase in the savings ratio, and the world recession, so the recovery is likely to be assisted by a slowing down in the rate of destocking, as inventories approach the desired level, by a fall in the savings ratio, as inflation and inflationary expectations fall, and by some upturn in the world economy, generally expected to occur this year.

But behind this scepticism lies the usually unspoken assumption that no economic recovery is ever possible other than by a conscious act of demand management by an expansionist government. This view, which is remarkably widely and deeply held, is not merely economic nonsense - implying as it does that the economy in general and the labour market in particular is quite incapable of adjusting to changing conditions, an that market forces are not merely blunted by the imperfections of the real world: they don't operate at all. It is also, and much more obvious historical nonsense. If neo-Keynesian demand management were the necessary condition of economic growth, we would all still be living in caves and wearing woad, instead of listening to lectures at the centrally-heated Charing Cross Hotel. I am, needless to say, making no value judgement here.

Or take the 1930s, about which there is a great deal of talk, not all of it very well informed, nowadays. The depth of the great depression, in 1932, was very grim indeed for a large number of people. But the

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recovery from that depression, so far as this country is concerned (s
others fared less well), was astonishingly vigorous. And it occurred
not because of rearmament: that happened later. Nor was there any hi
of governmental demand management: that took a further decade to conq
the Treasury. It occurred in the context of a policy of
economic orthodoxy, comprising minimal State interference, sound mone
and low interest rates.

If we want to learn lessons from the past - and we should - it would
well to learn the right ones, from the real past.

Mr Chairman, the strategy of this year's Budget is the medium-term strategy we have been pursuing since we took office. It is a strategy dedicated above all to the conquest of inflation, and it has already achieved an encouraging degree of success towards that end. And it is a strategy that lays the essential foundation for the wider economic objectives, in terms of growth and employment, which we all share.

Meanwhile, the alternatives put before us all add up to the beguiling but fatal proposition that public expenditure, even in an age of inflation, doesn't have to be paid for. Too often, politicians have been tempted down this primrose path, and been rightly condemned for doing so. Here is a Government that has had the courage to resist that temptation.

Reference 23/3/81 5

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TREASURY AND CIVIL SERVICE SELECT COMMITTEE.

BACKGROUND PAPERS AND OTHER BRIEFING.

FLAG A – MR FOLGER OF 23 MARCH
COVERING PAPERS ON

FLAG B – VELOCITY

FLAG C – OECD DEFINITION OF PSBR.

FLAG D – STOCKBUILDING

FLAG E – UNEMPLOYMENT

FLAG F – 1981-82 PSBR PROJECTION.

FLAG G – MR BRIDGEMAN OF 24 MARCH

FLAG H – PAPER ON OUTTURN IN 1980-81.

FLAG J – BRIEF ON ECONOMIST ARTICLE

FLAG K – TRANSCRIPT OF 18 MARCH HEARING.

Also Revised version of IR Note on staffing implications (Z)

CODE 18-77

26

1. MR ~~UNWIN~~ 23/3/81

2. CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Sir Douglas Wass
Mr Burns
Mr Middleton
Mr Battishill
Mr Burgner
Mr Bridgeman
Miss Brown
Mr Cassell
Mr Evans
Mr Monck
Mr Allen
Mrs Gilmore
Mr Turnbull
Mr Ward
PS/Customs
PS/Revenue
Mr Ridley

ERRORS in F§5 and H§5

f is inadequate?

PAPERS FOR TREASURY COMMITTEE

1. Annex A to Mr Unwin's submission of 20 March listed eight papers in preparation for the Committee following the 18 March session with officials. He explained that we would try to get drafts to you for approval tonight so that as many as possible could go over to the Committee tomorrow (though not early enough to provide members with time to absorb them properly).

2. I now attach for your approval drafts of five of the papers:

No.	Title	Co-ordinating Division
1.	Velocity, real £M3 and Private Sector Financial Wealth	HF3
2.	OECD Definition of PSBR	GEA1
3.	Stockbuilding	EA
4.	Natural rate of unemployment	MP
5.	1981-82 PSBR projecting and forecasts	CU

Papers 1 and 2 are still subject to final titivation but we should be grateful if you could clear them as they stand and leave the lead divisions with discretion for final editing.

3. Paper 3 is a response to the Committee's request for more details of the stocks forecast, including a breakdown between manufacturing and the distributive trades, and within manufacturing into materials and fuel, work in progress and finished goods. Mindful of your decision last autumn not to increase the scope of forecasting material made available, the draft goes only part way to meeting the Committee: it gives in broad terms the scale of destocking forecast for manufacturing, and the stock/output ratio for mid 1982, but no more. As always, by providing this information we should set a precedent and would have to expect to be asked for it again in future. But it would be difficult to be any less forthcoming than we propose.

4. The position on the remaining three papers is as follows:-

- Staff etc cost for Revenue implied by non-revalorisation of allowances:

  Revenue are I understand submitting this to you direct tonight;

- 1980-81 spending out-turn:

  GEP have not been able to complete this;

- Distributional effects of Budget:

  as foreshadowed in the attachment to Mr Unwin's minute, FP have concluded that they could not complete a paper on this (which would require a great deal of very careful and detailed work) in time for submission to the Committee tomorrow. Mr Battishill can explain further at your meeting tomorrow.

Conclusion

5. We should be grateful for your early approval of the five papers attached (subject to final editing in the case of the first two papers). We will then be able to get final versions to the Committee tomorrow afternoon.

M T Folger

M T FOLGER
23 March 1981

B

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23/3/81. 6 J

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RESTRICTED

Chancellor of the Exchequer

cc: Chief Secretary
Financial Secretary
Minister of State(C)
Minister of State(L)
Sir Douglas Wass
Mr Ryrie
Sir Anthony Rawlinson
Mr Burns
Mr Middleton
Mr Byatt
Mr Christie
Mr Unwin
Mr Bridgeman
Mr Cassell
Mr Monck
Mrs Case
Mr Wicks
Mr Norton

"ECONOMIST" 21-27 MARCH ARTICLE
"FAIR-WEATHER FORECASTS"
(page 45)

I understand that you have asked for briefing on this article, particularly with the TCSC in mind. The theme of the article - the difficulty of financing nationalised industry investment within the PSBR - is covered in some briefing provided by Mr Cassell. This note is about more specific points from the article.

2. The article comments are based on table 17 in the FSBR (copy attached). The figures quoted are drawn either from the column giving current cost operating profits (which is an innovation in this FSBR) or external finance limits (the last column on the right of the table).

3. The figures quoted appear accurate. Those for gas and electricity are adjusted to take account of the price concessions to large energy users announced in the Budget. But neither the gas nor the BNOC figure take account of the gas levy or changes to North Sea taxation (see footnote (9) to the 1981-82 table). As the article points out, the table does not make allowance for concessions to the coal industry (keeping uneconomic pits open and reducing imports). However you announced an increase in the size of the Contingency Reserve in your Budget Statement. The increased expenditures for coal given in the article are broadly correct as far as they go. But there will be repercussions affecting prices and pay and the eventual bill will be considerably higher. If the Committee press you on figures for coal you should avoid being drawn and refer them to Mr Howell as sponsor Minister.

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4. The article goes on to imply that the nationalised industries will need more finance in 1981-82 than their current EFLs allow. This is undoubtedly correct. Apart from the coal concessions several industries base their requirements for finance on economic assumptions which are likely to prove optimistic. Their revenue is likely to be below forecast. For this reason we have made provision for the industries within the Contingency Reserve of £1250m which is intended to cover all contingencies. However these dispositions should not be revealed to the Committee. If pressed you should emphasise the inevitable uncertainty of EFLs which are the residual between large flows of expenditure and revenue and are highly sensitive to trading conditions. /This is emphasised in Cmnd 8175 and was spelt out at great length in the paper sent to the Committee last November./

5. The second part of the article deals with so-called "escape routes" for the nationalised industries because of the difficulty of financing desirable investment from within the PSBR. The article mainly concentrates on British Rail. You should avoid getting drawn on the details (these should be referred to Mr Fowler). It would be best if (in addition to Mr Cassell's briefing) you were able to rest on the formula used in your winding-up speech in the Budget Debate i.e. that you are continuing to search for ways of attracting private capital to provide investment where this offers real pressure for improved performance on the management of the industry and where monetary consequences are more beneficial than alternative forms of finance.

6. The article refers to proposals to involve private capital in connection with BR plans for electrification, by way of leasing fixed assets to BR (there are a number of different ideas around, of this kind). You may however like brief comments on the 3 "problems" which the article identifies in the way of a leasing solution to funding investment over existing levels. You could draw on this if necessary:

i) Equipment suppliers are reluctant to make the investment without a Government guarantee. This could well be a stumbling block. Private sector investment with a Government guarantee is scarcely distinguishable from Government borrowing. It involves no pressures on performance.

ii) Nationalised industries have to score the capital value of leases against their EFLs. This is correct. The reason for this requirement is to discourage the industries from using leasing as a device for evading controls on borrowing and force them to consider whether leasing makes better commercial sense than outright purchase.

iii) The Government's "fear of being accused of bolstering nationalisation". This is all rather confused and has little to do with leasing as such. (Leasing <u>may</u> be a step towards privatisation if it leads to a transfer of control from the industry to the private sector; however most leasing projects are not of this kind.) BR's holding company (which is referred to) is the vehicle for holding BR assets pending their privatisation. While BR holds a majority interest in the subsidiary all its borrowing counts towards BR's EFL. Whether this holding company could be a possible vehicle for private finance for the Channel Tunnel or for electrification is no more than speculation at this stage. If it were, its structure would of course be entirely different.

TUB

T U BURGNER
23 March 1981

Enc:

FINANCING OF CAPITAL REQUIREMENTS OF THE NATIONALISED INDUSTRIES

Table 17. Financing of Capital Requirements of the Nationalised Industries

A. 1980–81 Estimated Outturn(1)

£ million

	Capital requirements(2)			Financed by(2)							
				Internal resources(3)					External finance		
	Fixed assets in the UK	Other	Total	Current cost operating profit	Interest, dividends and tax(4)	Depreciation etc.(5)	Other receipts and payments	Total	Government grants(6)	Net borrowing, issues of PDC(7) and leasing	Total(8)
National Coal Board	800	−45	755	−268	−257	433	15	−77	251	581	832
Electricity (England and Wales)	963	339	1,302	233	−568	1,234	228	1,127	5	170	175
North of Scotland Hydro-Electric Board	41	30	71	39	−61	47	4	29	16	26	42
South of Scotland Electricity Board	134	15	149	−18	−79	157	31	91	—	58	58
British Gas Corporation ...	523	141	664	436	8	444	176	1,064	—	−400	−400
British National Oil Corporation	278	−23	255	298	−14	168	8	460(9)	—	−205 (10)	−205
British Steel Corporation ...	175	53	228	−712	−179	298	−300	−893	—	1,121	1,121
Post Office	1,613	−220	1,393	807	−529	1,237	15	1,530	—	−137	−137
British Airways Board	270	6	276	−128	−76	160	16	−28	—	304	304
British Airports Authority ...	85	6	91	14	−13	68	4	73	—	18 (11)	18
British Railways Board... ...	342	−130	212	−818	−74	197	117	−578	673	117	790
British Transport Docks Board	10	1	11	7	−9	19	4	21	—	−10	−10
British Waterways Board ...	7	—	7	−24	−2	1	2	−23	26	4	30
National Freight Company Ltd.	36	−1	35	−5	−11	23	17	24	6	5	11
National Bus Company ...	64	−1	63	−55	−18	41	10	−22	66	19	85
Scottish Transport Group ...	16	−1	15	−10	−1	13	1	3	21	−9	12
British Shipbuilders	13	16	29	(12)	−5	(12)	(12)	−136	42	123	165
Total	5,370	186	5,556		−1,888			2,665	1,106	1,785 (13)	2,891

(1) No figures are included for British Aerospace. The sale to the public of shares in a successor company took place in February 1981, leaving the Government holding 48·4 per cent.
(2) The capital value of leased assets is included.
(3) The current cost breakdown of internal resources in general reflects broad adjustments to historic cost data.
(4) The total figure for interest alone is −£1,856 million.
(5) Including cost of sales adjustment, monetary working capital adjustment and other items not involving the movement of funds.
(6) Shows subsidies and capital grants received during the year.
(7) Including issues under Section 18 of the Iron and Steel Act 1975.
(8) Except in the case of BNOC, the figure shown against each industry is the estimated outturn against its external financing limit for the year.
(9) Excludes the proceeds of advance payments for oil.
(10) Includes BNOC's net payments into the National Oil Account.
(11) Includes £19 million from the redemption of local authority bonds.
(12) Current cost figures not available.
(13) Of which:

Government loans	780
Issues of PDC (including issues under Section 18 of the Iron and Steel Act 1975) ...	1,390
Overseas borrowing	−139
Market borrowing	−246
Short term borrowing and leasing	—

Table 17—(*continued*). Financing of Capital Requirements of the Nationalised Industries

B. 1981–82 Forecast(1)

£ million

	Capital requirements(2)			Financed by(2)							
				Internal resources(3)					External finance		
	Fixed assets in the UK	Other	Total	Current cost operating profit	Interest, dividends and tax(4)	Depreciation etc.(5)	Other receipts and payments	Total	Government grants(6)	Net borrowing, issues of PDC(7) and leasing	Total (8)
National Coal Board	888	−29	859	−269	−294	525	11	−27	267	619	886
Electricity (England and Wales)	1,221	6	1,227	412	−594	1,386	188	1,392	9	−174	−165
North of Scotland Hydro-Electric Board	44	35	79	47	−64	60	4	47	14	18	32
South of Scotland Electricity Board	239	−66	173	−34	−87	180	37	96	—	77	77
British Gas Corporation(9) ...	733	136	869	627	−111	489	181	1,186	—	−317	−317
British National Oil Corporation(9)	370	19	389	438	−14	288	37	749	—	−360 (10)	−360
British Steel Corporation ...	198	149	347	−399	−152	281	−113	−383	—	730	730
Post Office: Telecommunications	2,148	38	2,186	1,100	−545	1,440	11	2,006	—	180	180
Posts and Giro ...	146	−4	142	59	−7	69	5	126	—	16	16
British Airways Board	203	5	208	18	−113	193	9	107	—	101	101
British Airports Authority ...	95	2	97	25	−17	71	4	83	1	13	14
British Railways Board... ...	382	−97	285	−885	−81	233	98	−635	780	140	920 (11)
British Transport Docks Board	13	2	15	4	−7	22	1	20	—	−5	−5
British Waterways Board ...	6	—	6	−26	−3	1	2	−26	29	3	32
National Freight Company Ltd.	45	3	48	3	−7	27	18	41	2	5	7 (11)
National Bus Company ...	52	7	59	−46	−22	49	3	−16	60	15	75
Scottish Transport Group ...	16	−1	15	−12	−5	15	—	−2	22	−5	17
British Shipbuilders	30	50	80	(12)	−3	(12)	(12)	−70	43	107	150
Total	6,829	255	7,084		−2,126			4,694	1,227	1,163 (13)	2,390

(1) No figures are included for British Aerospace. The sale to the public of shares in a successor company took place in February 1981, leaving the Government holding 48·4 per cent.
(2) The capital value of leased assets is included.
(3) The current cost breakdown of internal resources in general reflects broad adjustments to historic cost data.
(4) The total figure for interest alone is −£1,933 million.
(5) Including cost of sales adjustment, monetary working capital adjustment, and other items not involving the movement of funds.
(6) Shows subsidies and capital grants received during the year.
(7) Including issues under Section 18 of the Iron and Steel Act 1975.
(8) Except in the case of BNOC, the figure shown against each industry is the external financing limit for the year.
(9) In the case of BGC and BNOC the figures exclude the impact of the proposed gas levy and of changes to North Sea taxation.
(10) Includes BNOC's net payments into the National Oil Account.
(11) Includes £53 million in the case of BR and £13 million in the case of NFC available solely to finance costs arising as a result of BR's decision to withdraw from its Collect and Deliver parcels business.
(12) Current cost figures not available.
(13) Of which:

Government loans	891
Issues of PDC (including issues under Section 18 of the Iron and Steel Act 1975) ...	927
Overseas borrowing	−544
Market borrowing	−311
Short-term borrowing and leasing	200

→ Chancellor 7

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SEPARATE ACTION COPIES

MR BATTISHILL
MR BRIDGEMAN
MR CASSELL
MR EVANS
MR MONCK
MR UNWIN

copies for information

→ Chancellor of the Exchequer
Mr Middleton
Mr Allen
Mrs Gilmore
Mr Bush or
Mr Ridley

PS/Customs
PS/IR

TREASURY COMMITTEE: TRANSCRIPT OF 18 MARCH HEARING

1. I attach the uncorrected transcript of last week's session with officials. It should be handled with discretion until a corrected version is published by the Committee.

2. Could action recipients please let Mr Bush have any suggested corrections to their evidence by the close this Wednesday 25 March.

3. There will be a formal proof version of the evidence later but, the Committee Clerks tell me, we ought to get all our points in on the transcript version on this occasion: the Committee Report and accompanying evidence will be printed and published in double quick time.

M T Folger

M T FOLGER
23 March 1981

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cc: Mr. Battishill
Mr. Bridgeman
Mr. Cassell
Mr. Evans
Mr. Monck
Mr. Unwin
Mrs. Gilmore

CHANCELLOR

OUTSIDERS' PAPERS TO THE TREASURY COMMITTEE

You asked at your meeting this afternoon for brief notes on what the various post-Budget papers said.

... 2. These are attached in tabular form. The references to the relevant briefs submitted by Mr. Unwin yesterday are also given.

M T Folger

(M.T. FOLGER)
24 March 1981

No.	Author(s) and Title	Comment	Particularly relevant briefing etc.
TR(Budget)1	Ward The March 1981 Budget and Economic Prospects	Very wide ranging but rather superficial. Assesses plausibility spending and other MTFS projections to 1983-84. Some doubtful analysis of likely 1980-81 spending outturn stresses alleged "unanticipated relative price changes". Expresses scepticism about nationalised industries turnround and realism of 1% MTFS GDP growth assumption. Questions advisability of giving primacy to monetary restraint and suggests Budget will, overall, harm industry. Reports CEPG model results suggesting Budget tax increases will cut output 1% in 1981, 2% in 1982 and raise unemployment by .3m.	C,D,E,F,H,K,L,N. Also draft paper to Committee under Mr. Bridgeman's 24 March submission.
TR(Budget)2	Ormerod & Capella The March 1981 Budget and the Public Expenditure White Paper	Compares FSBR forecasts with EIU runs on Treasury Model. Suggests prospects for output and unemployment worse than FSBR implies. Sees Budget as contractionary, wrongly views MTFS figures for PSBR as "targets" and denies any strong connection between PSBR and interest rates	G,H,J,K,L,U.

No.	Author(s) and Title	Comment	Particularly relevant briefing etc.
TR(Budget)4	Henry An analysis of the Budget changes using the NIESR model.	Content as suggested by title. Confused and amateurish. Takes very mechanistic view on calculating economic effects of Budget, which are seen as deflationary.	H,J,L.
TR(Budget)8	Miller Monetary policy aspects of Budget	Suggests MTFS intention is to provide for zero "real PSBR". Takes up TCSC (Monetary Policy Report) suggestion of heavy output loss implied by anti-inflation policies.	K,U,V. 24 March submission from Mr. Cassell. 25 March note by Mr. Bush on previous Bank evidence on PSBR
TR(Budget)10	Hills St. James' Group forecasts - Effects of Budget	Reports EIU cranking of Treasury Model. On their definition of Budget, suggests by 1984 Q1: GDP 3% down unemployment .3m up etc.	H,J,K,L.
TR(Budget)11	National Council of Building Material Producers. The Budget and the Public Expenditure White Paper	Criticises cuts in public sector capital programmes. Criticises RIG, Granny Bond extension etc. as likely to divert finance from private sector uses (new housing and construction)	D,E,G,L,V.

No.	Author(s) and Title	Comment	Particularly relev t briefing etc.
TR(Sub TX)28	Kay and Morris The impact of the 1981 Budget	Reasonably fair assessment (on its own terms) of distributional effects of Budget tax changes. Points out overall effect was to redistribute income "from both top and bottom to the middle" [of income range].	S. Also Mr. Battishill's notes submitted by Mr. Unwin 24 March
TR(Sub Tx)29	Hills Some tax implications of the 1981 Budget and associated measures	Comments on worsening of poverty trap, increase in number of taxpayers, pattern of real increases in excise duties etc.	S,T. Draft IR paper on administrative implications.

24/3/81. 39 38

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Mr Burns
Mr Middleton
Mr Monck
Mr Bridgeman
Mr Evans
Mr Unwin
Mr Burgner
Mr Battishill
Mr Folger

TREASURY COMMITTEE: DR BRAY'S QUESTION

You have received a letter from Dr Bray warning that when you go to the Committee tomorrow he will return to the question he put to us last Wednesday on "is it just a coincidence that the real PSBR implied in the Budget is about zero?"

2. This question, as his letter implies, is prompted by the paper by Marcus Miller. Professor Miller, following the sort of exercises previously done by Taylor and Threadgold, adjusts the nominal PSBR for the effects of inflation in reducing the real value of the stock of outstanding government debt. The resulting concept, termed "the real PSBR", is regarded by many as a better measure of the fiscal stance than changes in the nominal PSBR. On this view the implication that the real PSBR implied in the Budget, and indeed through the MTFS period, is close to zero could be taken as suggesting that fiscal policy is intended to be broadly neutral, neither contractionary nor expansionary. This presumably is what Dr Bray is trying to establish.

3. There are considerable difficulties with using the real PSBR as a criterion for Budget-making. It would no doubt be quite a good benchmark if we were already starting from an acceptable rate of inflation, rather than from a rate that we are still seeking to reduce. Aiming at a particular PSBR in real terms could, however, easily degenerate into endorsing a fiscal policy that would accommodate whatever the going rate of inflation happens to be. In reaching your judgement on the £10½ billion PSBR for 1981-82 you gave most weight to consistency with the monetary objectives and the general thrust of policy towards lowering inflation. You

explained in your Budget speech why you ruled out the £7½ billion implied in last year's projections, as unduly restrictive in the more depressed conditions of the economy, and justified £10½ billion as being "consistent with the monetary target that I have just announced. I also believe it to be a sum that can be financed without placing undue strains upon the capital markets".

4. I am sure this is the line to hold to, and not get drawn into technical debate with Dr Bray about the desirability, or otherwise, of a zero real PSBR. However, as it happens, the way the MTFS is set up would imply that if inflation declines in line with the monetary target then the illustrative PSBR path in the projections would be roughly zero in real terms. But I think this is better regarded as an incidental feature of the projections, not as a deliberate objective that we had in mind in producing them.

5. I attach a draft speaking note on the lines indicated above, and also, for convenience, the pages of the transcript of last Wednesday's hearing covering the exchange with Dr Bray.

F CASSELL
24 March 1981

DRAFT SPEAKING NOTE

REAL PSBR

I explained in my Budget speech how I reached my judgement that it would be right to provide for a PSBR in 1981-82 of some £10½ billion, or a little more than 4 per cent of GDP. [I ruled out the £7½ billion implied in last year's illustrative projections as unduly restrictive in the conditions of lower output and higher unemployment than had been envisaged when those projections were made. As I said, I believe the figure £10½ billion to be consistent with the monetary target announced for 1981-82, and also to be a sum that can be financed without placing undue strains upon the capital markets.]

2. It is no doubt true, as Professor Miller suggests in his paper, given the prospect foreseen for inflation, that this implies a real PSBR of close to zero. Certainly, if inflation falls more or less in line with the declining monetary target, the projections in the medium-term financial strategy would imply a real PSBR fairly close to zero. This is because fiscal policy in these projections is set to be consistent with a growth in the total financial assets of the private sector that is more or less in line with the monetary target. Hence money supply, total financial assets and the stock of government debt would all move together broadly in step through the period. And if inflation follows much the same path, the PSBR - which measures the nominal increase in the stock of public debt - would be close to zero in real terms. But that is not the same as saying

that a zero real PSBR is the objective. As the discussion of the MTFS in the Red Book makes clear, the projections of the PSBR are not to be taken as targets. Fiscal policy in any particular year will be operated so that the PSBR for that year - in nominal or real terms - will be consistent with declining monetary growth in the particular circumstances of the time. What the real PSBR will be through the MTFS period - and indeed what the economy's real growth will be - will depend to a very large extent on the pace at which inflation falls.

(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

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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.

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cc: Mr. Battishill
Mr. Bridgeman
Mr. Cassell
Mr. Evans
Mr. Monck
Mr. Unwin
Mrs. Gilmore

CHANCELLOR

OUTSIDERS' PAPERS TO THE TREASURY COMMITTEE

You asked at your meeting this afternoon for brief notes on what the various post-Budget papers said.

... 2. These are attached in tabular form. The references to the relevant briefs submitted by Mr. Unwin yesterday are also given.

M T Folger

(M.T. FOLGER)
24 March 1981

No.	Author(s) and Title	Comment	Particularly relevant briefing etc.
TR(Budget)1	Ward The March 1981 Budget and Economic Prospects	Very wide ranging but rather superficial. Assesses plausibility spending and other MTFS projections to 1983-84. Some doubtful analysis of likely 1980-81 spending outturn stresses alleged "unanticipated relative price changes". Expresses scepticism about nationalised industries turnround and realism of 1% MTFS GDP growth assumption. Questions advisability of giving primacy to monetary restraint and suggests Budget will, overall, harm industry. Reports CEPG model results suggesting Budget tax increases will cut output 1% in 1981, 2% in 1982 and raise unemployment by .3m.	C,D,E,F,H,K,L,N. Also draft paper to Committee under Mr. Bridgeman's 24 March submission.
TR(Budget)2	Ormerod & Capella The March 1981 Budget and the Public Expenditure White Paper	Compares FSBR forecasts with EIU runs on Treasury Model. Suggests prospects for output and unemployment worse than FSBR implies. Sees Budget as contractionary, wrongly views MTFS figures for PSBR as "targets" and denies any strong connection between PSBR and interest rates	G,H,J,K,L,U.

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No.	Author(s) and Title	Comment	Particularly relevant briefing etc.
TR(Budget)4	Henry An analysis of the Budget changes using the NIESR model.	Content as suggested by title. Confused and amateurish. Takes very mechaninistic view on calculating economic effects of Budget, which are seen as deflationary.	H,J,L.
TR(Budget)8	Miller Monetary policy aspects of Budget	Suggests MTFS intention is to provide for zero "real PSBR". Takes up TCSC (Monetary Policy Report) suggestion of heavy output loss implied by anti-inflation policies.	K,U,V. 24 March submission from Mr. Cassell. 25 March note by Mr. Bush on previous Bank evidence on PSBR.
TR(Budget)10	Hills St. James' Group forecasts - Effects of Budget	Reports EIU cranking of Treasury Model. On their definition of Budget, suggests by 1984 Q1: GDP 3% down unemployment .3m up etc.	H,J,K,L.
TR(Budget)11	National Council of Building Material Producers. The Budget and the Public Expenditure White Paper	Criticises cuts in public sector capital programmes. Criticises RIG, Granny Bond extension etc. as likely to divert finance from private sector uses (new housing and construction)	D,E,G,L,V.

No.	Author(s) and Title	Comment	Particularly relevant briefing etc.
TR(Sub TX)28	Kay and Morris The impact of the 1981 Budget	Reasonably fair assessment (on its own terms) of distributional effects of Budget tax changes. Points out overall effect was to redistribute income "from both top and bottom to the middle" [of income range].	S. Also Mr. Battishill's notes submitted by Mr. Unwin 24 March
TR(Sub Tx)29	Hills Some tax implications of the 1981 Budget and associated measures	Comments on worsening of poverty trap, increase in number of taxpayers, pattern of real increases in excise duties etc.	S,T. Draft IR paper on administrative implications.

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24/3/81

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TREASURY COMMITTEE INDEX TO BRIEFING

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W Ray, Morris and Hill's papers.
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CU
23 March 1981

AA. Financial effects of Civil Service dispute

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CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Sir Douglas Wass
Mr Burns
Mr Middleton
Mr Battishill
Mr Burgner
Mr Bridgeman
Mr Cassell
Mr Evans
Mr Monck
Mr Allen
Mrs Gilmore
Mr Folger
Mr Cropper

TREASURY COMMITTEE: 25 MARCH

I attach briefing for your use before the Committee on Wednesday, at 4.30pm. An index is attached immediately below.

2. I am sorry that the briefing is not as tidy in the time available as it might have been. It seeks, however, to cover the main issues that arose last week at the session with officials and other points you yourself have raised. It is, of course, a supplement to the extensive Budget briefing and other material recently provided (e.g. Mr Williams' note of today's date on tomorrow's unemployment figures). I should draw your attention to a few specific points:-

(i) brief D on various nationalised industry points is submitted for defensive purposes should the Committee raise with you the points in the Clerk's letter to me of 20 March. We can consider after Wednesday's session whether the letter merits a formal reply. You need feel under no obligation to put the points on record at the hearing itself. I have also attached to brief D a speaking note on nationalised industry financing that we had at hand last week.

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(ii) Brief G provides no more than a holding form of words on the PSBR and nationalised industry etc investment. It is intended to be consistent with other recent statements (e.g. by the Chief Secretary) but not to shut the door on change entirely. But there is such a complex of difficult issues here, that we have not yet resolved internally, that we cannot hope to settle them by Wednesday and holding remarks of this kind seem as far as you could prudently go. One of the associated problems, however, is sale and lease back, and we may be able to take this a little further in discussion with you (in the Telecommunications context) tomorrow.

(iii) We are submitting separately drafts of the various papers commissioned from us last week. It now seems almost certain that we shall not be able to produce the distributional note requested by Mr Meacher. This is perhaps no bad thing in advance of the meeting and you will be able to draw on the notes produced by FP at S below.

J B UNWIN
23 March 1981

PUBLIC SPENDING ETC

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A BRIEF

(A) BRIEF

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."

GEP Group
16 March 1981

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14

(B)

BRIEF

B
BRIEF

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.

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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.

GEP Group
16 March 1981

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CREDIBILITY OF PUBLIC EXPENDITURE PROFILE

(a) General

There are four general reasons why I think that the profile for public expenditure shown in the White Paper is credible notwithstanding that public expenditure this year has been higher than expected, and we expect it to rise slightly in the coming year.

2. The first is the point which my rt hon friend the Chief Secretary made in the House, namely that it takes time to change public expenditure programmes. They tend to have a considerable inbuilt momentum of their own. For example, securing the reductions in spending on schools to reflect the fall in the number of children would in many cases require the re-organisation of work within the schools and in some the closing of schools. All that takes time. Similarly some policy changes require legislation: for example the Earnings Related Supplement to a short-term benefits ends next January. I think that the right way to look at the events of last year is not to say that expenditure rose, instead of falling, but to say that we achieved two-thirds of the switch in spending plans which we had intended, notwithstanding the unexpected difficulties which arose.

3. The second point is that we have adjusted our plans to allow for the experience of the last year and, of its nature, that is not an experience which is likely to be repeated.

Much of it was due to the form which the recession took. The fall in GDP was much as we had expected. But there was a far sharper reduction in manufacturing output and a far more rapid reduction in employment than we had expected. There are now definite signs of the recession reaching its low point [as I have already discussed]. And the exceptional shakeout of labour last year is of its nature unlikely to be repeated. Therefore, while I am afraid there may be some further increase in unemployment, I think that the working assumptions for unemployment levels used in the White Paper are more likely to prove realistic than the last ones did. Similarly, we have been able to take account of the effects of the recession on the finances for the nationalised industries.

4. Third, while the effects of some of these changes and assumptions carried through into the later years they do not all do so. For example, the amount of redundancy payments is linked more closely to the rate at which unemployment is increasing than to the absolute level of unemployment. The same applies to the need for a temporary short time working scheme.

5. Finally, to the extent that some of the effects do carry right through the period, we took further decisions to cut expenditure programmes last autumn, which I announced in November, which should largely offset those effects.

(b) Local authorities

6. It is too soon to be certain of what the outturn for local authority current expenditure this year will be. But the signs

are that it will be significantly less than was envisaged when my rt hon friend the Secretary of State for the Environment called for revised budgets last summer. It may still, in the affected area, be about 2% over what was allowed for in the White Paper. This is disappointing: but on the other hand, as I mentioned above, there are difficulties in a sharp turnround in public expenditure. I am confident that given time, and also given the incentive to keep to expenditure plans given by the new block grants system, local authority expenditure will come back into line as provided for in the White Paper fairly quickly.

7. As my rt hon friend the Secretary of State for the Environment said on Sunday, we hope that the steps which we have taken will prove sufficient to ensure that local authorities adjust their expenditure in line with the views of central government. If they do not prove sufficient, then we will have to consider taking further powers. But we would hope that that is not necessary.

(c) Industrial support

~~yours~~

8. I ~~Ex~~Accept that the decline in the industry programme may be somewhat less than the sharp decline (from £820 million in 1981-82 to £30 million in 1983-84) ~~both~~ shown against the programme in the White Paper. That is because the programme figures ~~largely~~ can only reflect decisions already taken. If a case is made out for additional measures of support, then that will be a charge to the Contingency Reserve: that is what the Reserve is for.

9. In particular, the programme does not provide for support for British Leyland after 1982-83. The British Leyland corporate plan aims for a return to viability by then. But the Government

do not rule out the possibility that British Leyland will seek further modest and declining support after that. As I said it would be a charge on the Reserve.

10. Finally, as far as the decline in expenditure on the redundancy fund and the temporary short time working scheme is concerned, this is because the level of payments is related more to the rate of change in unemployment, than to its actual level. Therefore the take-up is assumed to fall off after 1981.

(d) Nationalised industries

[See separate brief from PE.]

GEP Group
23 March 1981

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D

NATIONALISED INDUSTRY FIGURES OUT OF DATE : SPEAKING NOTES
(See Clerk's letter of 20 March immediately below)

As the White Paper makes clear the projections are based on those submitted by the industries themselves last summer. The forecasts of demand of output on which they were based were the industries' own. They do not necessarily reflect therefore the Treasury forecast whether in November or more recently. The White Paper points out that the figures are more than usually uncertain as a result of the recession and will need to be re-examined in this year's Investment and Financing Review.

D
NAT IND FIGURES SPEAK. NOTES

/DEFENSIVE_7 The projections inevitably reflect a snapshot at a particular point in time. The industries (like all businesses) are constantly reviewing the trading outlook and adjusting their business plans accordingly. For that reason the forecasts have to be reassessed annually.

Nationalised Industry Pricing

Paragraph 3 of Part III of the White Paper identifies economic pricing, together with reductions in current losses and improvements in efficiency as the main components of the improvement in internal resources in the last White Paper (Cmnd 7841). The next paragraph goes on to explain that this improvement has had to be revised downwards in the face of the recession. Nevertheless, Cmnd 8175 also projects an improvement in nationalised industries based on continued application of the same 3 policies.

The major area where real price increases are implied is Energy. When announcing financial targets for the gas and electricity industries in January 1980 the Secretary of State said that domestic gas prices were likely to increase by some 10% in real terms in each of the three year periods to 1982-83, and electricity prices were likely to increase by about 5% over and above the increase in the industry's own costs over the period as a whole.

As explained in paragraph 50 the Telecoms figures assume a real rate of return of 6% on net assets in 1981-82, although the precise financial target for that year has yet to be set. How large a price increase that implies must depend to some extent

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on how well BT can control their costs, but one might fairly look for an increase not out of line with the movement of the RPI.

Elsewhere real price increases do not play a significant role and the improvement in performance should come from lower costs and improved efficiency. Overall there is plenty of scope for this.

British Steel Corporation

Ministers have now approved the BSC plan and set an EFL for 1981-82 at £730 million in line with the provisional figure shown here. The very great uncertainty attaching to BSC's prospects, and hence to that figure, was brought out by the Industry Secretary in his statement of 24 February; Mr MacGregor admits that his own plan is optimistic. BSC's results are heavily dependent not only on the improvement in its own performance - so far on target - but on factors such as exchange rate, the maintenance of some kind of order in the European market, and the timing of an upturn in steel ordering in the UK.

Estimate of cost of coal development

It is not possible to give a figure now for the cost of the commitments the Government has given on imports and the Board's financial constraints. This will depend on the outcome of further discussions.

PE2
23 March 1981

(see also speaking note on the "turnround" in nationalised industry financing also attached).
[illegible]

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Burgner
" Mr Bridgeman
Mr Cassell
Mr Evans
Mr Unwin
Mrs Case
Mr Wicks.

COMMITTEE OFFICE
HOUSE OF COMMONS
LONDON SWIA OAA
01-219 3285 (Direct Line)
01-219 3000 (Switchboard)

] minute of 20 March refers.

TREASURY AND CIVIL SERVICE COMMITTEE

MJ Folger
23.3.81

20th March 1981

TCSC
20/3

Dear Brian,

As you know Members did not ask questions about the prospects for nationalised industries on Wednesday but it might well save time when the Chancellor appears on the 25th March if the Treasury could answer some or all of the following questions:

The Public Expenditure White Paper (Cmnd 8175) - paragraph 4 of Part 3 - says that the nationalised industry projections are based on the 1980 Investment and Financing Review. This review is - I believe-some six months old and the external financing limits were announced in November. Does this mean that the projections are based on last November's forecast about future output, especially manufacturing output, which were more optimistic than are the latest Treasury forecasts published with the Budget?

Paragraph 3 of Part 3 of the White Paper (page 166) forecasts 'a steady rise in the level of internal resources throughout the period as a result of the phased application of economic pricing policies particularly in the gas and electricity industries ..." This implies increases in the real prices especially in the light of the considerably higher planned capital expenditure of the nationalised industries. The discussion on the British Gas Corporation confirms that real gas prices are projected to rise by 10 per cent per annum. What are the implied increases for the other major industries, in particular for British Telecommunications, and Electricity?

Is there any further information about the prospects for the British Steel Corporation that you can now give the Committee: the existing estimates are said to be only provisional (paragraph 37 of Part 3)?

Can any estimate be made of the costs of the recent agreement to delay closure of uneconomic coal mines and reduce coal imports?

Yours sincerely
D F Hubback

J.B. Unwin Esq.,
H M Treasury

D.F. Hubback
Clerk to the Committee

(SPEAKING NOTE)

63 N 23

NIs not like Depts.

TURNROUND IN NATIONALISED INDUSTRY FINANCING

Speaking Note

1. The Government has never sought to disguise the uncertainties to which the figures for nationalised industry finance are subject It would be unrealistic to suppose that the affairs of trading bodies could be predicted with anything like the certainty of many Government spending programmes. Small variations in the industries' turnover can result in very significant changes in the financing figures. For example, the increase in nationalised industries' external financing limits this year of about 40% represents only 2 % of their aggregate turnover.

NAT INDS TURN ROUND SPEAK. NOTES

2. The figures in last year's White Paper have inevitably, had to be reviewed and adjusted in the light of events. As the Treasury paper submitted to the Committee in /November/ explained, the forecasts in Cmnd 7841 were the industries' own, based on estimates submitted in the first half of 1979. These estimates did not take full account of the unusually sharp change in economic prospects between the time of their preparation and the publication of the White Paper. This was particularly true of 1981-82 onwards since the figures for 1980-81 were updated when the EFLs were set in the autumn of 1979. Recognition of this uncertainty over the economic outlook led the Government, as explained in Cmnd 7841, to increase the size of the Contingency Reserve. In the event all the increases in nationalised industries' financing requirements in 1980-81 have been contained within the Reserve and have not added to public expenditure.

3. The figures in this year's White Paper are not subject to the same uncertainty since the economic outlook has not changed

so sharply since the industries' forecasts were prepared. But they remain uncertain. They reflect a snapshot at a particular point in time, but over a period of four years ahead the plans and results of business organisations will inevitably change as trading conditions change. The steel industry is a case in point. The figures in the last White Paper took account neither of the intensity of the recession nor of the effect of the steel strike. The present White Paper includes a more realistic assessment of future demand as well as higher figures to take account of the short term costs of rapid restructuring.

4. The Government's policy is that over the period of the White Paper the industries' needs for external finance should be reduced through economic pricing, reductions in the level of current losses and improvements in efficiency. To achieve this some of the industries must implement far reaching changes. These planned changes - and their beneficial effects - are reflected in the forecasts. It would not be right for the Government to soften the pressures on the industries to bring about improvements in their performance by providing unnecessary finance or to protect them from the need to revise their financing plans in the face of changes in economic circumstances.

NB. Cmnd 7841 projects reduction of c £2¼ bn at 1980 Survey prices between 1980-81 & 1983-84.

Cmnd 7841 References:

Table 3.1 Borrowing Figures
Table 3.2 Capital Requirements
Table 3.5 Breakdown of industry financing figures for 1981-82.

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CAPITAL AND CURRENT EXPENDITURE

SPEAKING NOTE

(E)

I do not think that it is very useful to look at comparisons of the capital and current content of expenditure programmes in total, or in isolation from the Government's priorities for its expenditure programmes.

2. Our overriding priority is to get the total for public expenditure onto a downward path. Within that, there are four main programmes for which we are pledged in one way or another to provide for an increase. Two of these, Defence and Social Security, by definition include no capital expenditure. The other two, Health and Law and Order, include a relatively small proportion of capital expenditure, about 5% in each case. But these proportions are increasing.

3. Most of the reductions to offset the increases in those four programmes are coming from another four, industry, housing, education and science, and finance for the nationalised industries. The largest single reduction is coming from housing, which of course includes a high proportion of capital expenditure. There are two reasons why we think a reduction in public sector investment in housing is appropriate. The first is that we have now largely caught up with the arrears in housing which faced this country after the last war. So there is less need for housing construction as a whole. The second is that we think it right that the bulk of new housing should now be in the private sector. I would hope that the fall in interest rates, which has been faciliated by this Budget, will lead to a revival in the private sector housing market, and so private sector construction.

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4. In the case of eduction, we again face a very different situation from that which has existed until recently. The school population is now falling, not rising. So the need for new schools to cater for a growing school population has passed. It is only natural in that situation that capital expenditure should decline very rapidly.

5. Finally, while we are looking for a reduction in the claims of the nationalised industries on the public sector borrowing requirement, which is essentially their contribution to public expenditure, we do not envisage that that will be at the cost of fixed investment. Indeed, fixed investment in the nationalised industries is shown in the White Paper to be increasing from the low level of recent years. The change from the public expenditure figure will come about because more of that investment will be financed by nationalised industries from their own resources.

Procurement

6. It has been suggested that we have been cutting capital expenditure, and allowing the amounts spent on administration to increase. That is a false dichotomy. We have in fact been cutting the costs of administration. The size of the Civil Service has fallen by 5% since we came to office. Local authorities are now beginning to cut back on their administrative staff. The Secretary of State for Social Services has taken action to cut back on administration in the Health Service. Indeed, the total public services wage and salary bill is only staying fairly constant in so-called volume terms because we are providing for increased staff at the sharp end - doctors, nurses and so on. Current expenditure on procurement of goods and services from the private sector,

which of course includes much of the Defence programme, is virtually level. The switch in the economic categories of expenditure is essentially a switch between capital expenditure and transfer payments, notably social security payments.

Background note

The figures on which the speaking note is based are as follows :

	1975-76	1976-77	1977-78	1978-79	1979-80	1980-81	1981-82
Current expenditure on goods and services excl wages and salaries							
Central government	11,148	10,969	10,890	11,058	11,289	11,860	11,962
Local authorities	3,340	3,133	2,966	3,104	3,229	2,844	2,694
Total*	14,488	14,102	13,856	14,162	14,518	14,705	14,656
Gross domestic fixed capital formation							
Central government	2,163	1,990	1,594	1,573	1,533	1,564	1,653
Local authorities	6,677	6,093	4,919	4,201	3,830	2,889	2,093
Other public corporations	1,566	1,500	1,303	1,190	1,061	938	891
Total*	10,406	9,583	7,816	6,964	6,425	5,392	4,637
Grand total	24,894	23,685	21,672	21,126	20,943	20,097	19,293

BACK-GROUND NOTE

*Shown in the White Paper, Cmnd 8175, table 1.8

2. The plans for the years after 1981-82 are provisional, and the decisions necessary to permit an economic analysis of expenditure for those years have not yet been taken. But the indications are that the plans imply no great change from the 1981-82 position shown in the above table.

3. The reasons why the bulk of defence expenditure is classified as current spending (including spending on items, like ships and aircraft, which on other programmes would be capital equipment) is that defence goods are, in the context in which they are used, consumables which do not add to productive capacity.

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F

Economic Analysis of Public Expenditure Figures
(Cmnd 8175 : Table 1.12)

The Chancellor will recall that last April he was pressed by the Committee on the fact that no economic analysis of public expenditure was given for 1981-82 and later years. The main reason for this was that there was no analysis of the housing programme for later years between subsidies, capital expenditure etc. (Copy of exchanges attached.)

2. Mr T Ward, one of the special advisers, has pointed out in his paper to the Committee that Table 1.12 of the new White Paper (Cmnd 8175) shows the differences from the previous White Paper by economic category for 1981-82. He remarks "Precisely how this is possible is not explained".

3. If the Chancellor is pressed as to whether figures which he has said were not available were available (and whether comparable figures for 1982-83 are now available) he should say:

> "Figures for 1981-82 did not exist a year ago (and similar figures for 1982-83 do not exist now), because decisions about the split of housing programmes had not been taken at that time for the later years.
>
> However, when we came to prepare the White Paper, it was considered than an economic analysis of the £2.3 billion change in the planning total for 1981-82 would be useful.
>
> For the majority of programmes such an analysis was available.
>
> There were however a few cases, notably housing, where firm decisions had not been taken last year about the split by sub-programme for 1981-82.
>
> This meant that firm figures for the economic analysis had not existed at the time of the last White Paper.
>
> In the case of housing therefore the figures used in completing table 1.12 represent the policy change announced in November

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(-69) and the change in the programme due to "estimating changes" (+77) notably the effects of changed interest rate assumptions on the figures for subsidies.

So in that case, it is essentially an analysis which identified changes, rather than differences between two complete sets of figures.

Next year, we would no doubt include a footnote explaining the somewhat hybrid construction of the table.

4. The Chancellor could point out that it was not a case of the Government withholding information a year ago, it was a case, perhaps, of trying to be too helpful now!

GEP Group
23 March 1981

NATIONALISED INDUSTRY INVESTMENT: SPEAKING NOTE

Frequently urged that public sector investment, particularly by nationalised industries (NIs), be increased, because in short-run would give additional business to private industry and in longer run add to productive potential.

Those who urge this not always clear whether such investment should increase totals of public sector spending and borrowing or be accommodated within existing totals by cutting back other spending.

Distinction important. Whatever medium-term benefits, in short-term £ of additional public investment has much same effect as £ of public expenditure on current goods and services. If additional investment allowed to add to PSBR would tend to raise interest rates, and discourage other expenditure, including private investment. Except in short-term, net effect on private industry may not be beneficial. Effect on future growth of productive potential uncertain.

These unhelpful side-effects could be avoided if new investment in place of some other spending already planned. Raises question of what other spending should be cut, and whether if such reductions can be achieved should be used to reduce total spending, rather than change balance of different programmes within it. Issues for next annual review.

G1. NAT. IND. INVEST. SPEAK NOTES

Beware of jumping to conclusions, particularly where NIs concerned. Some decline in NI investment in recent years, but on nothing like scale that much recent comment suggests. Public expenditure white paper (Table 3.2) shows NI investment higher in coming three years than in past two.

Rate of return of much NI investment has been appallingly low; over-investment in some (eg steel capacity). If projects in prospect offering good rates of return, hope they can be accommodated within present totals of investment programmes. Criteria applied to public investment designed to favour projects offering high return. Real trouble is that such projects much rarer than sometimes suggests, and some NIs not good at containing their current costs (and so have to cut investment).

PAY v. CAPITAL

As indicated in Budget wind-up, ready to consider alternative methods of financing NIs. Two advantages if right form could be devised. Might introduce market discipline for management. Might also tap new sources of finance and avoid adverse effects on interest rates. Open mind, but experience, so far at least, is that methods of financing which meet these criteria exist more in imagination than in real world.

AND FOR RESOURCE ALLOCATION

BUT NONE FUNDS IN MKT PLACE ALREADY ~~[illegible]~~ BEING MOBILISED for PSBR

FOR ALL N.Is:

EVERY 1% off COSTS = £300M.

73 33

CROWDING OUT

Most of us dislike the term, but as generally used it refers to the extent to which an increase in public expenditure displaces private expenditure.

2. In a fully employed economy it is obvious that increased public expenditure, however financed, must displace private expenditure. This is known as "real resource crowding out". There is no dispute about it. It is obviously not relevant in today's conditions.

3. The issue today is whether an increase in public expenditure financed by borrowing will crowd out private expenditure. There are various ways in which this could come about - through the effect on interest rates, exchange rate, prices or expectations.

4. The interest rate route is the one most frequently discussed. Much turns here on monetary regime assumed. With a fixed money supply, the increased public borrowing would have to be financed by additional debt sales, so raising interest rates (and possibly also exchange rate). Sensitivity of private spending to changes in interest rates difficult to estimate. Most research suggests it is fairly inelastic in the short-run. But obviously much depends upon the starting level of interest rates and the general financial position of the private sector. On balance, initial demand-boosting effects of additional Government expenditure on goods and services likely to outweigh the demand-reducing effects arising from the higher interest (and exchange?) rates. In other

G2 CROWD OUT SPEAK NOTES

words, in the short-run unlikely that additional public expenditure would crowd out, <u>one-for-one</u>, private expenditure. But interest rate effects are probably stronger in the medium-term and the question is more open as one moves further ahead. [There would also be longer run consequences following from the change in the pattern of expenditure, with more of it determined by the government and less in the market sector.]

5. If the additional borrowing were financed not by debt sales but by a faster growth of money supply, interest rates would presumably not rise as much initially (and with inflationary expectations rising, real interest rates might fall). However, the higher monetary growth would be expected to lead to higher inflation, and this could reduce private expenditure, both by creating uncertainty and by raising the personal saving ratio (as persons try to maintain the real value of their wealth).

6. Crowding out is thus a complex issue that in the end can only be resolved empirically. It would seem unwise to take any dogmatic line about the extent to which additional public expenditure would lead to crowding out <u>in the short-term</u>. Even with unchanged money supply, the displacement of private expenditure would probably be considerably less than one-for-one .

7. These same arguments, of course, suggest an even more agnostic line on the extent to which a fall in interest rates resulting from a reduction in public expenditure and borrowing would "crowd in" additional private expenditure. The usual analogy of "pushing on a string" probably has some force in the short-term.

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H
UNEMP. BRIEF & SPEAK NOTES

Brief H

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 .1 million 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 .1 million 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._7

/_IF PRESSED

3. We would not expect the trend /_of the seasonally-adjusted figures_7 of the main series /_i.e. excluding school-leavers_7 to reach 3 million. Unemployment forecasts are subject to big errors and successive governments have not published them._7

Sunday Times article: "3.7 million jobless"

4. A copy is attached. It is not clear how the figure was derived. Line to take: forecasts uncertain, of course Treasury looks at likely economic developments on different assumptions, outturn just as likely to be better than expected. Question and answer brief attached.

Unemployment figures published on 24 March

5. Brief by EB attached.

EA Group
24 March 1981

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UNEMPLOYMENT

<u>Is the Treasury forecasting 3.7 million unemployed by the end of 1983?</u>

The Treasury does not publish forecasts of unemployment. The figures used as illustrative assumptions in the Public Expenditure White Paper (page 125 of Cmnd 8175) are much lower than this. The growth assumption in the Medium Term Financial Strategy - ½% a year from 1980, implying appreciably faster growth after this year - likewise implies a much lower figure for unemployment.

<u>What are the unemployment assumptions in the Public Expenditure White Paper?</u>

Wholly unemployed, excluding school-leavers, GB

	Million
1981-82	2.5
1982-83	2.7
1983-84	2.7

These are illustrative assumptions and not forecasts.

<u>But isn't unemployment likely to go higher than this?</u>

As inflation continues to come down, and provided we stick to the medium-term strategy, the prospects for creating jobs will improve. Post-war history shows that increases in unemployment have been associated with increases in inflation.

<u>Won't unemployment hit 3 million this year?</u>

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.

<u>Why doesn't the Government publish forecasts of unemployment?</u>

Partly because of the uncertainties, successive Governments in the UK have not published such forecasts. What matters is sticking to policies designed to create sustainable growth and employment. This means improving competitiveness throughout the economy.

<u>If the Sunday Times report is wrong, why doesn't the Government deny it?</u>

All sorts of speculative reports appear in the press from time to time. The Government is under no obligation to confirm or deny every such report.

But doesn't the Treasury model produce very pessimistic forecasts of unemployment?

As can be seen from the array of forecasts published by many different institutions, a wide variety of views is available: a considerable measure of scepticism is in order.

Hasn't the Treasury constructed forecasts on more pessimistic assumptions about growth?

As always, a wide variety of projections have been considered, but we have no intention of adding to the substantial amount of material already made available.

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obless could hit .7m-Treasury

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S.T. ARTICLE

alker urges new industrial plan

by Michael Jones, Political Correspondent

CLUSIVE

DING cabinet dissident esterday for a new govern- ndustrial strategy, as ll sources disclosed a easury forecast for un- ent next year. This sec- re suggests that, on the sumptions, there may be) out of work by the end

r Walker, agricultural and the only prominent of the cabinet not yet to have endorsed Sir Howe's Budget, urged rnment now to adopt a positive industrial inter-

ent Conservatives who his views said last night alker's call gave Mrs what may be her last o preserve cabinet unity ect the Tories from the of electoral disaster.

us reports of a possible the position of the prime herself are already begin- rculate in both Whitehall minster. They have been ed by Tory fears, shared Thorneycroft, the party , of the possibility of al social democratic suc- the next election.

authoritative Whitehall aid last night that the yment forecast, the ever to come out of the , indicates that the three- barrier may be broken by the first quarter of next year.

Tory MPs have been assured, however, that the recession is beginning to bottom out and that higher output will help to limit rises in unemployment. But a 3,700,000 projection has not been anticipated and Sir Geoffrey Howe is likely to face questions about the basis for his Budget confidence when he appears this week before the Commons select committee on the Treasury.

The shock figure will add to the political speculation surrounding Walker's speech yesterday, which will be followed today by another speech to the dissident Tory Reform Group conference in Oxford.

Walker's friends were at pains to stress last night that his purpose was not to provoke a cabinet crisis. His aim was rather to suggest a formula for rallying the cabinet around a strategy which was consistent with the expenditure of billions of pounds to preserve essential industries, and which was at the same time aimed at restoring both industrial and Tory Party fortunes.

But prolonged controversy seems the likely result. Walker offered the chancellor no support for his Budget yesterday. Last night fresh demands for a purge of the cabinet "wets" were being made.

George Gardiner, right-wing Tory MP for Reigate, told a constituency meeting that "a determined effort is being made by a minority of Tories at Westminster to undermine Margaret Thatcher and secure her replacement as party leader—if possible before the next election." He went on: "When so-called Tory voices urge a radical change of course, or that we should tear up major election pledges, their real hope is that Margaret Thatcher will be discredited, then disowned."

Under Tory Party rules, Mrs Thatcher could face a leadership challenge this autumn. I understand that this has been privately mooted at Westminster but ruled out at this stage.

Walker said yesterday that the government had three years left to convince the country that it was "succeeding to create the most competitive and successful economy . . The next few years of the British economy can only be about the creation of a British commercial presence that is able to compete with its rivals and has advantages comparable with theirs."

Defending the state aid already given and the fresh funds earmarked for basic industries, he said that non-intervention would have meant the loss of Britain's shipbuilding, coal, aircraft engine, car, steel and fishing industries.

SUNDAY TIMES
22 MARCH 1981

~~SECRET until 11.30 am on 24 March 1981~~ declassified 13.30 hrs M T Hodge 24.3.81

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CHANCELLOR

cc Chief Secretary
Financial Secretary
Sir Douglas Wass
Mr Ryrie
Mr Burns
Mr Evans
Mr Unwin
Mr Allen

BRIEF MARCH FIGURES

MARCH UNEMPLOYMENT FIGURES

1. March unemployment and vacancies figures will be released tomorrow, Tuesday, 24 March at 11.30 am.

2. The total number of UK unemployed was 2,485,000 an increase of 21,000 compared with February. The percentage rate increased to 10.3 per cent.

3. UK seasonally adjusted unemployment excluding school leavers was 2,381,000, an increase of 77,000 since February. The percentage rate increased to 9.9 per cent.

4. Seasonally adjusted vacancies fell by 1,000 to 97,000.

Comment

5. There are now a number of signs that conditions are easing somewhat. The situation will however remain one of rising unemployment, albeit at a less rapid rate. Nonetheless it is encouraging that the very rapid rate of increase in unemployment in the latter part of 1980 appears to be over.

(a) Recent months unemployment figures show that the rate of increase eased around the turn of the year.

	Monthly increases 000s seasonally adjusted excluding school leavers
3 months to November	111
December (5 week month)	107
January	92
February	76
March	77

79

(b) December and January's fall in manufacturing employment, 66,000 and 47,000 respectively, was less than the 77,000 per month average experienced in the second half of 1980.

(c) The flow off the register has been rising gradually since the middle of last year; from 263,000 in July to 280,000 in January and February (3 monthly averages). The flow onto the register, which has been rising since mid 1979 appears to have peaked in December (368,000 -3 monthly average), with January and February showing declines to 359,000 (3 monthly average)

(d) Although vacancies (seasonally adjusted) fell in February and March the large declines of last year are over. Vacancies rose in December and January.

(e) The decline in overtime appears to have bottomed out - against this short-time rose during January.

6. The Department of Employment will be releasing figures that imply a sharp rise in the register effect of special employment measures in February. This could be interpreted by some commentators as casting doubt on the improvement in recent unemployment figures. The Department of Employment's view, which they will be putting across in press briefing, is that taking account of the nature of the register effect estimates, and taking a perspective extending over earlier months, the special employment measures do not affect the interpretation of recent unemployment statistics to any marked extent.

<u>Line to take</u>

7. Ministers will no doubt wish in public, to stress the uncertainty of predicting and assessing future level of unemployment; to recognise that the indications that the rate of increase has moderated is encouraging; to continue to reiterate the link between excessive pay settlements and lost jobs; and to stress the desirability of building on the recent evidence of moderating pay settlements.

CHKWilliams.

C H K WILLIAMS
EB

23 March 1981

80 40 J

THE RECESSION: THE TIMING OF RECOVERY IN OUTPUT

At the March 18 session with the Treasury Committee, it was put to officials that the latest forecast implied a different, and later, path for recovery in the economy than the previous (November) forecast and the statements made to the Committee by Mr Burns on 1 December.

2. There is no need to be defensive about this. Obviously the precise timing of recovery is uncertain, and will remain so even after the first CSO figures are published, but the forecast and its interpretation has changed very little since the autumn.

J BRIEF

2. The half yearly paths of output (GDP) in the two forecasts are as follows:-

GDP, 1975 = 100

1980	1980 I	1980 II	1981 I	1981 II	1982 I
November Industry Act Forecast	108.5	104.8	105.0	105.2	-
March 1981 FSBR	109.1	105.8	104.9	105.6	106.1

4. In evidence in 1 December, Mr Burns confirmed that he expected the bottom of the trough in terms of output to be reached "sometime between /‾1 December_7 and /‾the spring of 1981_7". An extract from the record is attached.

5. We still expect the bottom of the trough to be reached and for a gentle recovery to begin sometime in the first half of 1981.

6. There is, it should be added, a real risk that recovery will not take place in the first half of this year or even at all this year: such an outcome would be well within the margin of error. There is some danger that overemphasis on the probability of recovery could backfire on the Government.

Line to take

1. Prediction and measurement are not at all exact; nobody knows precisely when the recovery will begin.

2. The evidence from business surveys (industry now appreciably less pessimistic than in the autumn); most outside forecasts; the CSO's leading and coincident indicators - all these point to recovery beginning sometime in the first half of this year.

/3. The

3. The Government's own forecast, which in general is not very different from outside forecasts, shows an end to destocking and the holding up of consumers' expenditure (partly because of a fall in the savings ratio induced by lower inflation) as the main factors in the recovery.

4. A separate note is being sent to the Committee on stockbuilding. Further questions could be met by reference to the past behaviour of stocks - falls in which do not usually last long - and by some surprise that the Committee should appear to put the onus of proof on to forecasts which assume an end to destocking.

5. In response to a suggestion by the Committee that, margins of error being what they are, the forecast could imply no recovery in output this year, the point may be made that there is an equal chance of the recovery being faster than expected; and, if pressed, that were destocking to go on longer, or be deeper, than expected, then the subsequent recovery could well be sharper.

Sources of recovery

1. End to destocking (even a deceleration in destocking helps).
2. Lower inflation should lead to a reduction in savings ratio / increase in proportion of income consumed (i.e. people need to save less to maintain real wealth).
3. Cyclical recoveries in world trade, and in investment in 1982 (latter reflecting lower interest rates / higher company profitability / gradual adjustment of the economy to higher exchange rate).

EA Group
23 March 1981

Timing of recovery

The Committee may suggest there is some difference between the view of Mr Burns (the trough occurring sometime around the spring of 1981) and the statement by Mr Evans ("some general recovery perhaps in the second half of this year").

Line to take:

(1) The forecast of GDP shows a fall in the first half of 1981, a rise in the second half.

(2) This is consistent with the trough in output occurring in the first half of 1981 - possible, as the CSO coincident indicators suggest, that it has already occurred.

(3) Thus the start of some recovery in output can be expected in the first half of 1981, continuing into the second half and into 1982.

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EXTRACT

2ND REPORT FROM TCSC SESSION 1980-81

MINUTES OF EVIDENCE TAKEN BEFORE THE

TREASURY AND CIVIL SERVICE COMMITTEE

TCSC 2ND REPORT

Mr Sheldon

46. We were told that the bottom of the trough in output was not likely to come much before the end of next year, that is, the winter of 1981–82. Do you wish to revise it?

(Mr Burns) I indicated that we expected output to stop falling sometime over the course of this winter and that the level of output in the first half of next year would be broadly the same as it was in the second half of this year. I did not wish to be precise about when it would take place, but we are looking at a fall this winter.

47. The bottom of the trough in terms of output you would anticipate to be in broad terms round about the spring of 1981?

(Mr Burns) Sometime between now and then, yes.

48. That is a change from the view which was put to this Committee some few months ago.

(Mr Burns) I cannot remember the precise details of that.

49. Q96.

(Mr Burns) I would say it is consistent with what we have been saying in the sense that I mentioned earlier, that we have seen a much sharper decline in stocks earlier than was anticipated. And I would expect that the consequence of that compression in de-stocking, and the tremendous speed of the de-stocking which has gone on over the last few months, would be to bring forward the point at which there would be some recovery.

EXTRACT FROM TCSC EVIDENCE OF 18 MARCH HEARING 84 44

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.

TCSC EVIDENCE 18 MARCH

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

85 45

MEDIUM-TERM ISSUES : GROWTH, TAX BURDEN ETC

(K)

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

K BRIEF

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 substantiall 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 ½ 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 3½p 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.

K TAX SPEAK. NOTES

[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.

MP Group
16 March 1981

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ECONOMIC EFFECTS OF THE BUDGET : SPEAKING NOTES

Afraid 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 <u>tax increases in fact only meet just over half of extra 1981-82 spending.</u> Again, unlike last year, financial year starts with an underlying rate of inflation comparable to 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.

L SPEAK NOTES

5. Outside forecasters generally expect a similar pattern of output: ie a recovery by 1982. [USE WITH DISCRETION: Some commentators (FT 18 March) have suggested that, on average, outside forecasts are not markedly more pessimistic on output following the Budget than they were beforehand.]

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[IF PRESSED

6. The fundamental problem with estimates of the supposed effects of the Budget on output and unemployment is the potential unrealism of their starting point. As explained

mainly the minor forecasts
(Phillips & Drew) & the majors
produce more pessimistic post Budget assessments.

Gn

in the Budget Speech, 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 under-estimates.]

<u>Are there Treasury model simulations of the Budget's effects?</u>

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

<u>Can the Committee see the simulations?</u>

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

CU
23 March 1981

18 March 81

UK NEWS

Recession forecasts are more pessimistic

BY PETER RIDDELL, ECONOMICS CORRESPONDENT

THE RECESSION should bottom out this year but the recovery in 1982 is likely to be modest and unemployment will probably continue to rise, according to a survey of economic forecasts published since the Budget.

The accompanying table shows eight forecasts published in the last week. The list is not intended to be comprehensive though it covers neo-Keynesian bodies such as the Economist Intelligence Unit and monetarist bodies such as the Liverpool Group headed by Professor Patrick Minford. The former are more pessimistic.

These projections are compared with a sample of 17 forecasts published on Monday, February 9.

The two samples are not strictly comparable, but it is clear that the forecasters have become slightly more pessimistic about the outlook this year. They generally believe that the turning point will come in the summer or early autumn rather than now.

In early February the average projected decline in total output for 1981 was 1.6 per cent. The latest estimate is a drop of 1.73 per cent. Some forecasters, including the Treasury and stockbrokers Phillips and Drew have, however, revised their forecasts downwards by about ½ a percentage point.

The volume of consumer spending is expected to fall 0.6 per cent compared with a previous projection of a fall of 0.3 per cent.

These revisions are small and reflect not only the impact of the tax increases in the Budget but also the general deterioration in the economic outlook in the last couple of months. Forecasters such as the London Business School and the National Institute were already becoming more pessimistic before the Budget.

COMPARISON OF FORECASTS

Percentage change year-on-year in constant 1975 prices unless stated		Average forecast in early Feb.	Treasury*	Phillips and Drew	Economic Models	Hoare Govett	Wood Mackenzie	Liverpool Group†	Staniland Hall	Economist Intelligence Unit
Gross Domestic Product	1981	−1.6	−2.0	−3.5	−1.9	+0.8	−2.5	−0.2	−2.0	−2.5
	1982	+1.7	+1.1	+1.5	+2.0	+2.1	+3.2	+2.9	+2.2	−0.8
Consumer Spending	1981	−0.3	−0.8	−1.2	−2.0	+1.1	−0.2	+0.1	−1	−0.9
	1982	+1.9	+1.1	+2.0	+0.7	+1.8	+1.5	+1.1	+2	+0.5
Exports	1981	−3.0	−5.3	−2.4	−3.8	−3.1	−3.5	—	—	−6.2
	1982	+2.4	−1.6	+2.9	+1.9	+4.5	+3.4	—	—	−1.7
Imports	1981	−0.8	−2.5	+2.3	−6.8	−2.7	−2.4	—	—	−2.6
	1982	+4.9	+8.0	+5.4	+2.7	+7.1	+10.1	—	—	+3.6
Retail Price Inflation 12 month rate of increase	1981, 4th	10.2	10.0	10.5	11.7	8.9	9.9	9.5	10.0	12.0
	1982, 2nd	—	8.0	9.4	—	—	9.3	—	—	—
	1982, 4th	9.2	—	10.5	9.5	8.7	—	5.4	9.0	10.0
Unemployment (UK adults, 4th qtr., m)	1981	2.6	—	2.9	2.6	2.75	—	2.5	2.8	2.6
	1982	2.75	—	3.1	2.7	—	—	2.6	3.0	2.9
Current Account (£bn)	1981	+1.4	+3.0	+3.0	+3.8	+4.9	+2.0	+2.0	—	+3.2
	1982	−0.6	0	−0.7	+3.2	+1.9	+0.3	+1.5	—	+1.3

* 1982 forecasts for Treasury and Wood Mackenzie are for first half compared with first half of 1981.
† Liverpool Group forecasts for inflation and unemployment are average not fourth quarter levels.

Collapse of United Industrial 'was caused by bad management'

BY ANDREW FISHER

90

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THE COLLAPSE of toiletry wholesaler United Industrial Company in 1976 was brought about by bad management, a costly French venture and an unexplained lack of gross profit for 17½ months, a Department of Trade report concluded.

Once the previous management left in 1974, having been found diverting some of UIC's profits, the quality of management and control "unhappily fell far short of even acceptable

said: "The overall picture of the continuing business is one of increasing failure, with falling turnover and falling profits, accelerating into serious losses."

It added that there was no doubt that Eridor Trading, effectively managed by Mr. Eli Harris, "had been siphoning off some of the group's profits and that those directors connected with Eridor [redacted]led to declare their [redacted] to the remaining dir[redacted]UIC."

ful competition with UIC, which was based in Leeds.

"They left behind no regular or patterned structure of management," the report said. Mr. Dennis Hillman-Eady, who lived in Monaco and owned 15 per cent of UIC, became its chairman early in 1974. He and his family later bought more shares.

It was his idea to go into France, a decision that cost UIC a total of £303,000 for no return. "Whether it was a bril-

had most interest in Monaco, the inspectors said, made the management tasks more difficult. "In effect, he attempted to manage the group by telephone."

Despite the appointment of a deputy, "Mr. Hillman-Eady, a forceful personality, retained the power and appears to have used it not always to the best advantage of the group."

One way in which UIC tried to build up turnover was by

in France, apparently supported by the rest of the board, was mainly executed by Mr. Hillman-Eady "who lacked the necessary expertise and knowledge of foreign law and commercial practice to which he pretended."

He also, said the inspectors, "enjoyed extensive expenses and commissions for which in the event he gave no value." But they said they were satisfied that he expected the venture to succeed.

spectors said.

Though profitable up to the early 1970s, UIC lost some £76,000 after extraordinary items in the year to June 30, 1975. In the following 17½ months losses were estimated by the inspectors at nearly £500,000.

After June 1975, UIC failed to earn a gross profit margin, they added. Since there was no evidence that products had been sold for no more than they cost, the absence of a margin must be

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ASSUMPTION ABOUT GREEN POUND IN FORECAST

Facts

1. Treasury officials were asked last week what assumption was made in the short term forecast about the level of the green pound. They responded on the lines that, because this was a delicate matter currently under negotiation, they were unable to give an answer. But they agreed to consider whether any more information could be given.

CONFIDENTIAL: NOT FOR USE

2. The forecast did assume a green pound revaluation sufficient to hold the sterling increase in EC farm prices this year to 5%.

3. As a result of the realignment effects of the Italian lira devaluation the UK positive MCA will, at present exchange rates, be reduced from 14.1% to some 12%.

Comment

4. Given the present state of the CAP price-fixing negotiations it would be damaging and highly embarrassing to reveal the forecast assumption.

Line to Take

5. Level of green pound an issue currently under negotiation as part of the CAP price-fixing. EC Commission have proposed cut in UK positive MCAs of 5 points, equivalent to green pound revaluation of just over 6%. Given present state of the complex price-fixing negotiations hope that Committee will understand that it would not be appropriate to give the green pound forecast assumption.

IA 1
23 March 1981

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CONFIDENTIAL

THE BUDGET AND INDUSTRY

N

I 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?])

<u>Line to take</u>

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.

2. Naturally 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 <u>is</u> 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.

II ARITHMETIC OF HELP FOR BUSINESSES

<u>Background figures</u>

3. See separate note attached

<u>Line to take</u>

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:

... <u>first</u> the benefits of lower interest rates - which the CBI have previously estimated [Budget Representations published 3 February] as worth <u>£350m</u> a year off "companies' annual interest charges on bank borrowings" <u>for each 1%</u> reduction.

N CBI BRIEF AND SPEAK NOTES

[E]SSENTIAL [T]O USE THESE WORDS EXACTLY

[NB £350m was always an over-estimate 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".

... second the improved stock relief scheme - minus the credit restriction - worth £180m in 1981-82, £400m in 1982-83 and £450m in a full year.

... third the energy measures - worth some £120m in 1981-82. 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.

III INDIRECT EFFECTS OF "DEFLATION"

Line to take

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.

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 afte[r] 1981-82 undecided)
boiler conversion scheme (helps industry even though does not add to total public spending)	?	?
net direct fiscal relief (+)	-375	-151 +?

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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Full simulation results

7. 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 cc'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
23 March 1981

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

CBI REPS POST-BUDGET

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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.

99 59 (P)

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HEAVY FUEL OIL DUTY

[There have already been probing questions in the House about the relationship between the duty and gas price contracts, including questions from Mr Tim Eggar, a member of the Treasury Committee. Copies of questions already answered are attached.]

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.

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

A matter for my right hon Friend, the Secretary of State for Energy.

[If pressed. I 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?

A matter for my right hon Friend.

[If pressed. I believe there may be up to half a dozen which could be affected.]

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

[One of Mr Eggar's questions]

A matter for my right hon Friend. As his answer (on 17 March) indicate details of individual gas supply contracts are commercially confidential. Contracts for the sale of gas to the BGC were negotiated between them (or their predecessors) and the producers; the contracts were not reviewed or approved by the Department of Energ

Is the Norwegian Frigg contract involved the main contract

[As suggested by Sue Cameron in the Financial Times on 19 March, copy attached.]

Cannot comment. [That is for my right hon Friend.]

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

[Another of Mr Eggar's questions.]

Cannot comment. As my right hon Friend's answer (on 17 March) indicated this concerns the contents of confidential commercial contracts and is essentially a matter for the BGC.

Cost to the Exchequer of abolishing/reducing by 50%/reducing to the European average/the heavy fuel oil

VERY

Over a number of years, the cost would be substantial. There would also be an increase in our gas import bill.

[Confidential. The Chancellor will presumably not be drawn on figures. But the interdepartmental report found that Frigg eventually more than doubles the other direct costs of abolishing the duty; and adds over 40% to the cost of halving the duty.]

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

[The third of Mr Eggar's questions.]

This is a sensitive commercial matter on which it would be unwise to comment. As my right hon Friend's answer (on 17 March) made clear any decision to renegotiate gas supply contracts is a matter for the various contracting parties.

But would not the Treasury support renegotiation?

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

FP Group
23 March 1981

ORAL/PRIORITY WRITTEN/ORDINARY WRITTEN/FOR ANSWER. TUESDAY. 17. MARCH.
FILE TO BE RETURNED NOT LATER THAN. 4pm. MONDAY. 16. MARCH.
ACTION OFFICER. W. MacIntyre... Gas. COPIES TO.............
QUESTION PUBLISHED ON 13/3/81/ PAGE NO....... P.Qs
ORDER NO...... QUESTION NO...... MP's PARTY CON.

File ref. DEPARTMENT OF ENERGY PQ NO.

GAS PQ 40/191

86 W Mr Tim Eggar (Enfield North): To ask the Secretary of State for Energy, which gas supply contracts link the price of gas to the British Gas Corporation to the level of fuel oil duty; which body was responsible for negotiating these contracts; and whether the contracts were specifically reviewed and approved by his Department.

Details of individual gas supply contracts are commercially confidential. Contracts for sale of gas to the British Gas Corporation were negotiated between them (or their predecessors) and the producers. My Department have not reviewed and approved contracts.

Official approval	Ministerial approval	Oral/Written
EWS 16/3/	Mr David Howell..........	given on..
	Mr Hamish Gray..........	OR col....
	Mr Norm...	

File ref. | DEPARTMENT OF ENERGY | PQ NO.

GAS PQ 40/193 | WEDNESDAY 18 MARCH 1981 | 486

86 W Mr Michael Grylls (North West Surrey): To ask the Secretary of State for Energy if, following the Chancellor's Budget statement on 10th March 1981, he will give further details on the reasons why a reduction in a heavy fuel oil tax from £8 a ton to the average in the rest of the European Economic Community of £2 a ton, would put up the cost of gas purchased by the British Gas Corporation; what the other consequences referred to in his statement would have been; and what the cost would be if he reduced heavy fuel oil tax to the average in the rest of the European Economic Community. [Transferred]

MR. NORMAN LAMONT

The effect of a reduction in heavy fuel oil duty on the cort of gas purchased by the British Gas Corporation results from provisions in confidential contracts between BGC and its suppliers. The magnitude of this effect is a matter for the Corporation. The size of direct effects on the Exchequer resulting from a reduction in HFO duty is a matter for the Chancellor.

ORAL/PRIORITY WRITTEN/~~ORDINARY WRITTEN~~/FOR ANSWER. Tuesday. 17. March......
FILE TO BE RETURNED NOT LATER THAN 4pm... Monday.. 16.. March........
ACTION OFFICER.................. Gas.......... COPIES TO.................
QUESTION PUBLISHED ON 13./.3./.81./ PAGE NO.......
ORDER NO...... QUESTION NO...... MP's PARTY Con..

File ref. DEPARTMENT OF ENERGY PQ NO.

GAS PQ 40/190

85 W Mr Tim Eggar (Enfield North): To ask the Secretary of State for Energy, what actions he intends to break the link between the price of gas supply contracts and the level of heavy fuel oil duty.

Any decision to renegotiate gas supply contracts ~~would be~~ is a matter for the parties to the contracts.

Official approval	Ministerial approval	Oral/Written
..16/3/..	...vid Howell........	given on..........
	Hamish Gray..........	OR cols..........
	Mr Norman Lamont.........	
	Mr	

HOUSE OF COMMONS PARLIAMENTARY QUESTION 105 65

ORAL/PRIORITY WRITTEN/~~ORDINARY WRITTEN~~/FOR ANSWER. Tuesday 17 March 1981

FILE TO BE RETURNED NOT LATER THAN 4pm Monday 16 March

ACTION OFFICER Dr Evies Gas COPIES TO

QUESTION PUBLISHED ON 13/3/81 PAGE NO

ORDER NO QUESTION NO MP's PARTY CON.

File ref. GAS 40/192

DEPARTMENT OF ENERGY

PQ NO.

SofS for Energy.

82 Mr Tim Eggar (Enfield North): To ask ~~Mr Chancellor of the Exchequer~~, what would have been the increase in the cost of gas to the British Gas Corporation if he had reduced the level of fuel oil duty by: (a) 25 per cent, (b) 50 per cent, (c) 75 per cent, and (d) 100 per cent.

714

This concerns the contents of confidential commercial contracts, and is essentially a matter for the British Gas Corporation.

Official approval SWS 16/3/

Ministerial approval
Mr David Howell
Mr Hamish Gray
Mr Norman Lamont
Mr John Moore

Oral/Written given on
OR cols

66

Q

Q (IND). ENERGY PRICES. BRIEF & SPEAKING NOTES

INDUSTRIAL ENERGY PRICES

Background

There have been suggestions since last summer that UK prices to industry might be out of line with those in Europe. A good deal of study by various interested parties followed and was discussed at NEDC in January. A Task Force was set up to narrow differences of opinion on the facts. Their report, discussed at NEDC on 4 March, showed that prices to the vast majority of industrial consumers remained in line with Europe, but a limited but important number of large users of electricity and gas were paying more for supplies.

Government action announced in Budget

The Budget Speech announced relaxation totalling £118 million on the external financing limits of British Gas Corporation (£73m) and the electricity supply industry (£45m). This is to accommodate new measures proposed by the industries in response to concern expressed at NEDC. (Details of measures are annexed). The measures are in addition to the flexibility the industries have already shown during the course of the debate on pricing, such as the Gas Corporation's holding back on its traditional link with gas oil prices for firm (ie non-interruptible) gas supplies. The Speech also announced that the Government was committing £50 million over the next two years for grants to industry towards the cost of converting industrial oil fired boilers to coal.

Effect on public expenditure

The £118m EFL changes will add to the 1981-82 public expenditure totals. The adjusted EFL's appear in Table 17B of the FSBR. Expenditure in 1981-82 for the boiler conversion scheme cannot be estimated reliably at this stage; it will be met from the contingency reserve, without increasing the planning total. (The effect on later years' expenditure will be considered in the 1981 nationalised industries investment and financing review).

LINE TO TAKE

Measures do not close the pricing gap with Europe?

The Task Force report showed that some of the major causes of disparity for large users were different cost structures in other countries, and exchange

/.......

rate movements. We made it clear at NEDC that the Government remained committed to economic pricing of energy and that it would not be appropriate to base prices in the UK on cost structures in other countries or to take account of fluctuations in exchange rates. (If pressed; the measures will certainly help, but they are not intended to bridge the largest gaps in prices identified in the NEDC Report. It is inevitable that price differences will remain - for example, in relation to electricity prices based on France's lower cost hydro-electric resources and considerable nuclear programme).

Too little help for industry?

The limits on movement in energy pricing are to some extent set by the economics of supply. For example, there would be statutory constraints on supplying electricity below cost - as well as the arguments of commercial good sense and economic pricing. The Government has always made it clear that it is not in the business of generalised energy price subsidies. But this is a matter on which questions should be addressed to D/Energy. The measures announced, together with those already being taken, will provide substantial help to UK industry.

Is the package the Government's final response to the NEDC Task Force Report?

The Secretary of State for Energy indicated to NEDC on 4 March that the Government would respond within a fortnight. This we did in the Budget. I know of no reason to expect further action based on the Report.

Does the help on electricity and gas go to energy-intensive companies or to all large consumers indiscriminately?

The prices charged by energy supply industries are generally more closely linked to the characteristics of the demands upon them, rather than to whether these demands are a high proportion of individual consumers' costs. But energy intensity and high loads quite often go together, as in chemical process use. The details of the action proposed by the industries are matters for the Secretary of State for Energy and for the Corporations themselves. /Mr Shepherd has shown interest in the distinction between high loads and energy intensiveness.7

ANX TO Q

Gas

- Renewal prices for all gas purchased on contract by industrial customers will be held at their present levels until December 1, 1981.

- The existing provision for price escalation of 1p/therm per quarter in firm gas contracts (ie gas supplied on a continuous basis) will not be applied in the period to December 1, 1981.

Electricity

- The electricity supply industry in England and Wales will offer a new arrangement to customers who can take advantage of load management terms. This will mean that larger industrial consumers who can adjust their demand at short notice can cut their electricity costs.

- Additional flexibility will be introduced by area boards into their special agreements with industrial customers with the aim of reducing as far as possible the impact of rising electricity costs.

- In Scotland, the Scottish Electricity Boards will review their pricing arrangements to ensure that the overall price for electricity charged to large industrial consumers on special agreements is no less favourable than the price charged under the new arrangements to consumers with similar load characteristics in England and Wales. No increase is required in the Scottish Boards' external financing limits.

PE I

23 March 1981

(INDUSTRIAL POLICY)

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SPEAKING NOTES ON "CONSTRUCTIVE INTERVENTION"

1. The Government possesses and makes use of a number of powers to intervene constructively in support of private industry.

2. Through our ownership and control of BL and Rolls Royce we fund directly the application of high technology by those companies.

3. The BL Metro, introduced to time and to cost /£300 million/, has since its launch last autumn established itself as one of the four best selling models in the UK market. Early reports on its European launch suggest that it will be a success in that important but difficult market. The funding of BL Corporate Plan by the Government at a cost of £1 billion over the next two years will see BL well on the way to completing a new family of cars spearheaded by the Metro The plan is vital to the return of BL to profitability and the whole of the UK motor components industry should benefit from this and the Government's funding of the Plan.

R CONST INTERVENTION SPEAK NOTES

4. In the case of Rolls Royce we are providing for example launching aid for new versions of the RB-211 which are already achieving some success in the teeth of fierce competition from their American rivals.

5. We also continue to provide selective assistance to industry both regional and national. This can prove particularly important for internationally mobile projects. For example, Mitel, the Canadian telecommunications company, recently announced plans to build its European headquarters in Gwent, helped by a Regional Development Grant and regional selective assistance. The Government also provides assistance towards industry's research and development costs and further benefit should flow to industry from the £50 million package, centred on increased support for R&D and product development, that I announced last November.

6. The NEB continues to play an active role in stimulating high technology. We have authorised the completion of its investment plans for INMOS, and have backed its proposal for CELLTECH - a joint venture with the private sector in the new and challenging field of biotechnology.

7. In the case of ICL, because of our major user interests, we have acted decisively to mobilise private lending to meet a temporary crisis. Although our action is limited to the provision of a guarantee for up to two years on lending of up to £200 million, it can scarely be characterised as the act of a Government blindly indifferent to the problems of private industry.

8. /All these steps have been taken within existing powers. Where we recognise the existance of gaps in the market we may take action to remedy them. The financing of small firms is a case in point and the steps I announced in the Budget should encourage the establishment and development of small businesses and the opportunities they can provide./

IA DIVISION
23 March 1981

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TAX

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

The pattern is more complicated than that. The Budget will have varying effects according to people's circumstances. But, 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

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proportionate terms this gives most help to families on 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 /Budget debates second day./

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./

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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Won't everyone face higher marginal rates because of the increases in excise duties,

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 preferable to raising rates of income tax again.

Income tax burden greater than when Government came to power

Not true as a general statement. Next year a man on average earnings will pay roughly the same proportion of his income in income tax as he did when the Government took office. But real incomes have risen over that period.

/Figures: Income tax as % of income at average earnings

	Single	Married
1978/79	25.2	21.6
1981/82	24.7	21.8

Note: But at lower income levels, the burden of income tax will be higher than when the Government came to power./

Tax burden will rise. By what proportion of GDP.

Total taxation as a percentage of GDP at market prices is forecast at about 40 per cent in 1981-82. This compares with 35 per cent in 1978-79, 36½ per cent in 1979-80 and an estimated outturn of 38 per cent in 1980-81.

/Proposed reply to Mrs Renee Short's Priority Written Question of 17 March/

FP Group
23 March 1981

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MAINTAINING THE REAL VALUE OF THE EXCISE DUTIES

1. The paper TR(sub TX)29 discusses (para 7) the movements in real values of the tax burden (duty plus VAT) on excise duty goods since 1966. Para 8 of the paper suggests that there could be advantages in moving the excise duties to an ad valorem basis.

2. In questioning officials on 18 March Mr Michael English MP drew attention to the decline in the real value of cigarettes and whisky over the period 1966-1981 and indicated that he might return to the matter on the occasion of the Chancellor's appearance. Before the session with officials it had been suggested that the Committee might wish to discuss the arguments relating to ad valorisation. This brief concentrates therefore mainly on these aspects in which the Committee has already indicated an interest.

A. REAL VALUE

3. Para 7 of TR (sub TX)29 includes a table of real values for the tax burden on the main excise duty goods. Officials were asked informally if they could complete the figures for wine. Our completed version of the table (otherwise unamended, but see para 4 below) is as follows:-

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	68.5
1969	75.5	9.22	19.7	96.4	102.7
1972	61.4	7.51	16.0	78.4	83.6
1975	64.7	6.24	16.7	82.5	114.1
1978	57.7	5.16	14.8	63.6	97.3
1979[7]	57.4	4.96	16.5	66.9	96.0
1980[7]	57.4	4.72	16.3	69.5	95.5
1981	67.0	4.92	19.2	83.0	99.4

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 bottle.
4. Pence per pint (o.s.g. 1037)
5. Pence per gallon of 4 star petrol.
6. Pence per 75 cl bottle of table wine.
7. June figures except for cigarettes which is August.

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

T EXCISE DUTIES SPEAK NOTES

Coincident indicators

Volume of retail sales
Index of mfg. production
CBI survey – capacity utilisation
– Δ in stocks of materials
GDP measures (Y, E & O)

Lagging indicators

Unemployment
Vacancies
Investment in mfg. plant & machinery
Eng. industries' orders in hand
Level of mfg stocks.

Longer leading indicators

3 months prime bank bills

NAFA by ICCs

Total housing starts

FT 500 share index

CBI survey – Δ in optimism

Shorter leading indicators

Credit extended by FHA, retailers etc

New car registrations

CBI survey – Δ in new orders

– expected Δ in stocks of materials

Gross trading profits of companies net of stock apprec.

Statistical evidence for upturn

(i) Tentative signs from retail sales that bottoming out at end 80 (as recorded by coincident indicators).

(ii) This a little earlier than suggested by longer & shorter leading indicators

(iii) But no guide to strength of recovery

(iv) Marked improvement in housing starts

	Private	Public	thousands
Dec 80	6.6	2.8	
Jan 81	10.3	3.1	

(Public housing starts probably still on a downward trend — but private sector average in 2nd half of 1980 about 8 thousand, & falling)

[The figures could, however, be a freak, & we shd not make too much of them.]

Chmn of Housebuilders Fed. thought these figures gave promise of a reasonably good year.

4. For his own use the Chancellor will wish to note that the table is unsatisfactory in the following respects:

(a) The RPI assumption for 1981 excludes the effect of the Budget. The unpublished Treasury forecast for April based on the NIF suggests a year-on-year rate of inflation of close to 13% <u>including</u> the effects of the Budget.

(b) Officials have found difficulties in reconciling the Committee's figures with their own estimates. Many of the discrepancies are minor and may represent small differences in the methods of estimation. The Committee's series for whisky seems more reliable than most of the others.

(c) The series for cigarettes is especially difficult to reconcile. The Committee's advisers have used king-size cigarettes as the typical commodity, although these were rare in 1966 and 1969. In practice, many of the figures seem to be reasonably close to official figures for standard tipped cigarettes, which were the usual measure in the earlier years. From 1978 the tax burden on both kinds of cigarettes has been substantially the same.

(d) The figures for 1966 appear to include the effects of the July Regulator operation and are not merely post-Budget as stated.

(e) Footnote 7 is presumably intended to relate to 1979 and not to 1980. In 1979 there was, of course a June Budget followed in August by a revenue-neutral adjustment between the specific and ad valorem elements in the duty on cigarettes.

5. If questioned about the fall in the real value of tax burdens, the Chancellor may wish to draw on the following material:-

(a) <u>Base Year</u>. Whether there has been a decline in real value depends on the choice of base year, which is inevitably a somewhat arbitrary exercise. For example, 1972 would still show a fall in real value for whisky, but not cigarettes. If, on the other hand, one were to take 1978 representing the last Labour Budget as the base-line for the present administration, it would be apparent that the real value of the tax burden on cigarettes, beer and petrol has been more than maintained, and that there have been varying degrees of success in restoring some of the erosion of previous years. The table annexed to this brief provides details of the changes made by the present Chancellor in each of his three Budgets.

(b) Cigarettes. All Chancellors have to make a careful judgment between revenue considerations and other factors which may point in more than one direction - such as health policy and prices policies. Otherwise, not for present Chancellor to discuss decisions of his predecessors.

The table reproduced in paragraph 3 above suggests that the effect of the increase to 15% VAT in 1979 and the revalorisation of 1980 was broadly to maintain the real value of the tax burden. This year revenue considerations dictated a substantial addition to the duty raising an extra £500 million from all tobacco in 1981-82 and £510 million in a full year*. On the basis of the calculations of the Committee's advisers the real tax burden on cigarettes is about 16% higher than after the last Labour Budget in 1978. (See Annex for details of all Budget changes). /IF PRESSED ONLY: The estimates for 1981-82 allow for a volume fall in consumption compared with 1980-81 of about 9%. The size of the figure follows from the high proportion (now 75%) of tax in price but the effect is not, of course, inconsistent with the thrust of Government health policy. Employment in the tobacco industry has in any case been falling (present level: just under 40,000) as a result of the secular trend against smoking./

(c) Whisky. Again a careful judgment is required. Particular care has to be taken in raising the level of the duty on

(* Total revenue forecast from tobacco in 1981-82: £3,220 million) spirits because of the very high price elasticity of demand /‾IF PRESSED: A price elasticity of - 1.3 was used for Budget estimates._7 and the high weight of tax in price (close to 80% for whisky at typical post-Budget off-licence prices). The combination of these factors makes it difficult to do more than broadly maintain the real value of the duty in any particular year; otherwise, one would risk invoking the law of diminishing returns and there would be an effect on the RPI disproportionate to any additional revenue secured. Account has also to be taken of the effects of the Scotch Whisky industry which is one of our most important export earners.

Overall, the real value is about 4% - 5% less than in 1978. The action the Chancellor took in his Budgets of 1980 and 1981 came as close to revalorising the duty in line with inflation in the previous calendar year as considerations of taxable capacity and revenue potential allowed (see annex for details). There was a modest fall in real value in 1979, but a duty increase in addition to the increase in VAT to 15% would have been unrealistic.

The following table shows the spirits component of the relevant entry in FSBR Table 19 (Taxation and Miscellaneous Receipts):-

£ million

	/‾1979-80	1980-81		
	Outturn7	Budget forecast	Estimated outturn	1981-82 forecast
Spirits, beer, wine cider and perry		2,825	2,600	3,200
Spirits only	/‾ 1,152_7	1,270	1,160	1,275

Implicit fall in volume compared with last year: about 4%.

B. AD VALORISATION

6. This is a complex issue but, if questioned, the Chancellor may wish to draw on the following points:-

(a) Obvious prima facie attractions in ad valorem duties which, as the paper suggests, would allow them to move up in line with factor costs, with the Government intervening only to make real changes.

(b) The present specific basis is very economical. No accident that, apart from cigarettes and experimental mixed Danish system for spirits, EC countries generally operate specific duties. Commission's proposals for harmonisation of structures of duties on drinks and oil based on specific duty concept.

(c) Considerable practical difficulties in ad-valorisation:

(i) If ad valorem duties charged like present specific duties at point of production, could be major problems of valuation and encouragement to vertical integration with profit margins being taken after duty point had been passed.

(ii) If charged at retail stage, almost insuperable problems of control with very high rates of duty (for example: excluding VAT, about 300% for whisky, 225% for cigarettes, 90% for petrol and 40% for typical beer) payable by about 125,000 retail outlets in drinks trade, 30,000 garages etc. Collection of 15% VAT often difficult enough already. Civil Service manpower policies etc.

(iii) Present mixed specific/ad valorem system for cigarettes works only because linked to tight system of maximum retail prices operated by the small number of producers. By no means a universal feature for excise duty goods. Revalorisation of specific element still necessary.

H.M. Customs
23 March 1981

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	Price effect of Budget change	Specific duty increase %	New typical price	Tax component in price: Duty	Total	%
1. Cigarettes (20 king size)						
Pre-Budget 1979	-	-	(57p)	35.1p	39.3p	68.9
Post-Budget 1979	+ 6p	(VAT increase)	63p	36.8p	45.0p	71.4
Post-Budget 1980	+ 5p	+ 14%	73p	42.2p	51.7p	70.9
Post-Budget 1981	+ 14p	+ 34½%	91p	55.2p	67.1p	73.7
2. Whisky (typical bottle, off-licence)						
Pre-Budget 1979	-	-	(£4.55)	£3.16	£3.50	76.9
Post-Budget 1979	+ 30p	(VAT increase)	£4.85	£3.16	£3.79	78.1
Post-Budget 1980	+ 50p	+ 13½%	£5.50	£3.56	£4.28	77.8
Post-Budget 1981	+ 60p	+ 14½%	£6.30	£4.08	£4.90	77.8
3. Beer (typical pint, 1037°, public bar price)						
Pre-Budget 1979	-	-	(36p)	7.5p	10.2p	28.3
Post-Budget 1979	+ 2½p	(VAT increase)	39p	7.5p	12.6p	32.3
Post-Budget 1980	+ 2p	+ 22½%	44p	9.1p	14.9p	33.8
Post-Budget 1981	+ 4p	+ 38%	51p	12.6p	19.3p	37.8
4. Petrol (gallon, 4-star)						
Pre-Budget 1979	-	-	(£0.95)	30p	40.6p	42.7
Post-Budget 1979	+ 10p	+ 22½%	£1.05	36.8p	50.5p	48.1
Post-Budget 1980	+ 10p	+ 23½%	£1.32	45.5p	62.7p	47.4
Post-Budget 1980	+ 20p	+ 38%	£1.52	62.8p	82.6p	54.3
5. Light wine (75 cl bottle of table wine, off-licence)						
Pre-Budget 1979	-		(£1.80)	53.6p	66.9p	37.2
Post-Budget 1979	+ 10p	(VAT increase)	£1.90	53.6p	78.4p	41.3
Post-Budget 1980	+ 8p	+ 14%	£2.00	61.1p	87.2p	43.6
Post-Budget 1981	+ 12p	+ 17%	£2.15	71.4p	99.4p	46.2

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TREASURY AND CIVIL SERVICE COMMITTEE

BRIEFING FOR CHANCELLOR'S APPEARANCE: MONETARY QUESTIONS

Criteria for interest rates

As indicated in the Budget Speech, decisions about short term interest rates will continue to take account of the whole range of monetary indicators and other factors that affect the significance of the numbers, especially progress in reducing 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 sterling M3 in relation to the target would generally be the primary factor, though we shall be monitoring the others. If monetary growth were exceeding the target range, the first question we should need to consider would be the reason for it and the relevance of it to 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. The Government naturally 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 not possible to specify exactly the circumstances in which clawback would be desirable. The situation will probably be one where the continued reduction of inflation seemed jeopardised either by monetary developments or by other factors such as a fall in the exchange rate.

U MONETARY BRIEF

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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 1 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 a move to monetary base control, but no decision has been taken on whether to move in that direction, or on which form of MBC seems most promising. No decision is likely to be taken until the arrangements described last 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.

HF3

23 March 1981

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(V)

TREASURY AND CIVIL SERVICE SELECT COMMITTEE

BRIEFING FOR THE CHANCELLOR'S APPEARANCE 25 MARCH 1981

Indexed Gilts

Reactions to the indexed gilt have been mixed. Some commentators have welcomed it, others have expressed reservations. A summary of these different reactions is in the attached note. There are a number of angles from which criticism can come and defensive notes are provided below. It is important however to get across the rationale for introducting IGs.

Positive

cf. criticism for not doing so

(i) The issue of an indexed gilt demonstrates the Government's confidence in bringing inflation down. For a Government committed to bringing down inflation, IGs promise to be a cheaper form of funding than long dated fixed interest stocks at current yields. A Government not wholeheartedly committed to reducing inflation would not wish to issue them.

(ii) Two major advantages for monetary policy. First, by eliminating uncertainty in the market about future real yields, indexed borrowing should benefit both lenders and borrowers. Secondly, there are important advantages for monetary control. Addition of a new instrument, which will be sold by action, offers more flexibility enabling Government to match preferences of investors more closely. This should enable funding programme to be sustained.

* (iii) In due course, as the stock of IGs grow, it will be possible for pension funds and insurance companies to offer pension benefits in the private sector with an element of index linking.

Defensive

(i) A further regrettable step to an indexed society?
Aware of the problems which extensive indexation can create, but important to distinguish between indexation e.g. of wages

V
Index-Gilts Brief

It should at the same time be made clear if necessary that the issue is not a response to the Scott Report on which the Government have not yet taken decisions!

and benefits where a level of real income is guaranteed and which often provides the springboard for additional claims, and a long term financial contract. With the IG, the real return is determined by the market and only a lender holding the asset to maturity is guaranteed any particular return, which may or may not be positive.

(ii) A regrettable response to Scott

An indexed gilt has been under discussion for many months - questions were put by Committee to Governor in July last year. Initiative should be seen in context of move to improve funding and monetary control, though ultimately there will be benefits in pensions area.

(iii) Could be disastrously expensive compared with conventional gilts.

Its cost in real terms will be the same in 15 years as now. Historically conventional gilts have proved cheap only because inflation has been greater than expected. Doubtful whether Governments can continue to benefit at expense of investors. Certainly not right for Government to plan for such an uncovenanted benefit.

(iv) Effects on company sector - competition with equities

Appreciate these concerns. Certainly possible that IGs could compete well with equities, depressing their price. But a number of benefits to offset against this. First, not our intention to use IGs to allow us to increase borrowing and total gilts sales/therefore effect should be to allow interest rates on conventional gilt to decline, a fall from which companies can also benefit. Their average cost of capital may not as a result be increased. Secondly, to the extent that IGs improve monetary control, there should be a beneficial impact on inflationary expectations and the Government's monetary targets should be achieved at lower interest rates.

(v) Why the restriction on eligibility?

As the Governor made clear in his evidence in June (copy attached) we were concerned that a novel asset like this could attract unwanted capital inflows. By restricting IGs to UK pensions business, the area where they are most suited, it should be possible to eliminate these inflows.

(vi) Why a 2 per cent real yield when Granny Bonds have no coupon?

The real yield is not necessarily 2 per cent - that depends on price IGs sell for. Now that we have added a bonus, there is in effect a small positive real yield on index linked certificates.

(v) What is the logic of limiting eligibility of index linked certificates

We have accepted that there is a role for index linking of small savings up to a specified holdings limit. No particular merit in the 50 year old age limit but it could have caused a disruptive surge into National Savings if the limit had been removed altogether. Whether we move further will depend on how successful we are in meeting our £3 billion objective.

HF3
23 March 1981

ANNEX A

COMMENT ON INDEXED GILTS

Reactions to the IG issue have been somewhat slow to develop. Most initial commentaries were descriptive, though Wednesday's Daily Telegraph quoted Mr Henry James of the National Association of Pension Funds as saying that the introduction of IGs was "most welcome" though he warned against expectations of index-linking of private sector pensions in the near future. A number of commentators interpreted it as a move in response to Scott, and were surprised at the speed with which the Government had reacted.

In Parliament, there were only a few references in the Budget debate. Mr du Cann said he "disliked the idea" without giving any indication of his reasoning. Mr John Browne was more forthright. He said his "most serious criticism of the Budget" related to the issue of IGs. They would "build in" inflation into the economy and reduce the will to respond to inflationary shocks in a stabilising manner. Their introduction would, furthermore, kill the corporate debt market. Mr Hordern thought the cost of IGs would be too high, and they would prevent companies issuing debentures.

There was more press coverage at the end of the week and over the weekend. Sam Brittan referred to the "long-overdue introduction" of indexed gilts, which showed that Mr Lawson had at last beaten the Bank. The Economist was in favour, but thought they should be generally available. In an editorial on Saturday (attached) the Financial Times described the decision as being of greater long-term importance than any of the fiscal measures. A further article - also attached - attempted to dispel certain misconceptions about IGs. The Investors Chronicle was critical, however, and thought IGs would represent extremely costly funding for HMG and amount to "A considerable Government subsidy to the private pension sector". An editorial described the issue as a "Trojan Horse" which the City had welcomed with misplaced enthusiasm. The potential for disruption of existing markets was enormous.

ANX TO V

Future Governments would be able to "assume control of the country's largest investment flows without legislation by offering the pension funds indexed bonds on terms they could not refuse".

We also know, from Mr Cardona's and Mr Ridley's minute of 11 March, that Gordon Pepper has made a number of criticisms though in the event he did not include them in the post Budget Bulletin. He argues that there will be large-scale switching out of equities, causing a reduction in share prices. Companies will not be able to issue indexed debt and will be forced even further into the banks, which will lead to further funding and even worse crowding out. Also, actuaries may begin to use 2 per cent or less for their real return assumptions, putting pressure on companies to top up their pension funds. The choice of a 15 year maturity was also wrong. The longer the date of a stock, the more volatile its price will be.

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23 March 1981

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FINANCIAL TIMES
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Saturday March 14 1981

Index-linking consequences

AMID THE political furore developing over the Budget, it may seem odd to suggest that a mere "technical" reform in the gilt-edged market is of greater importance than the Chancellor's controversial fiscal judgment or his restatement of the monetary targets or the regressive impact of his tax changes. But for the unemployed and for the directors of hard-pressed manufacturing companies, as well as for long-term investors of all kinds, the Government's acceptance of index-linked borrowing could mark a watershed more important than the fiscal U-turn that many of them persist in expecting, despite the Prime Minister's emphatic denials.

Foreign inflows

The immediate significance of the index-linked gilt lies in the fact that it could prepare the way for the removal of one of the most important obstacles to a substantial and rapid decline in interest rates: the need to sell long gilts to a market which will not buy them unless it anticipates that interest rates are set to fall still further.

The issue of indexed gilts, particularly if ways can be found of extending their availability to investors other than pension funds without attracting foreign inflows, should greatly ease the task of funding the Public Sector Borrowing Requirement without needing at times to manipulate short-term interest rates upwards. It could also, in time, reduce substantially the large sums of public money which are spent on debt servicing and merely have to be borrowed back from investors.

If the first issue of index-linked stock is as successful as initial reactions to the prospectus indicate that it may be, there is a good chance that further issues would be able to mop up excess liquidity in the economy quite rapidly and bring the money supply figures well within the Government's new targets. This should enable short-term interest rates to fall again without appearing to undermine the Government's medium-term financial plan: and it is on low interest rates that the whole case for expecting the Government's strategy to pull British industry out of the recession depends.

Of course, the very help which an index-linked stock can give to a government seeking to reduce interest rates while controlling monetary growth has traditionally been one of the strongest arguments against such stocks being issued. Without the need to answer to the gilt-edged market so directly for its actions there could, in theory, be less pressure on the Government to contain its borrowing. If the prospect of higher inflation makes the purchase of government bonds more attractive, rather than less attractive, it would seem that fiscal extravagance could be reconciled with monetary stringency. Fortunately the Government's other actions in last week's Budget suggest that, for the time being at least, this is not a danger. Thus from the point of view of market confidence, this will be a good time to launch the new index-linked instrument.

Whether future governments can be relied on to use index-linked borrowing prudently is a question which the markets are now anxiously pondering. The answer must surely be that political pressure, rather than market pressure, should be the primary anti-inflationary force operating in a democratic society. Many investors may not find this very reassuring; there are certainly those who consider that the acceptance of index-linking paves the way for hyper-inflation.

Greatest danger

They should remember two facts, however. One is that it was the public and not the financial markets which gave Mrs. Thatcher her large majority in the last General Election. Her victory was based substantially, though not entirely, on the promise of putting the fight against inflation above all other economic priorities. Even in the depth of the present recession, it is remarkable what a powerful resonance that commitment continues to have in the public mind. The idea that inflation is the greatest long-term danger to a nation's economic well being is now one of the points on which the consensus in Britain is strongest.

The second, and even more fundamental, point is that a government which is determined to be irresponsible in its financial policies cannot ultimately be prevented from doing damage by the financial markets. It was only when the need to curb monetary growth became widely accepted by politicians of both major parties that the famous "Duke of York" effect gave the gilt-edged market its power. A government that was hellbent on raising public spending or cutting taxes without regard for the inflationary consequences could do so with index-linked bonds or without them, simply by abandoning money supply targets altogether.

In sum, the issue of index-linked bonds has wide ranging and in some ways disturbing consequences. But at least it will give governments the chance to be honest with investors and to ensure that future taxpayers, who will have to pay the interest bills contracted today, see success in combating inflation as a blessing and not a curse.

FINANCIAL TIMES, WEDNESDAY 18 MARCH

The purpose of indexed gilts

BY ANTHONY HARRIS

THE ISSUE of indexed Government bonds next week may or may not achieve an opportunity to cut the cost of servicing the national debt in a big way. But it has already given a splendid jolt to thinking in the City, and presents some entertaining nonsense in our correspondence columns.

Before things get quite out of hand, I would like to propose some ground rules for the debate which will no doubt be still going on this time next year about whether indexed bonds are a Good Thing or a Bad Thing.

I do not want to suggest the answer to the question. In spite of the widespread impressions to the contrary, I am not particularly enthusiastic about indexed borrowing—especially redeemable indexed borrowing. I am just against over-reliance on conventional fixed money interest borrowing. But it is not necessary to know the answers in order to suggest what are the right and what are the wrong questions.

Burdens

For example, it is not an objection to indexed borrowing to suggest it represents some form of "spend now and pay later." All long-term borrowing is an effort to spend now and pay later—even the long-term borrowing indulged in by Mr. Gladstone. It is nonsense to suppose that indexed bonds represent dreadful burdens for our children. The point about an indexed bond is that it cannot under any circumstances represent a dreadful burden for our children, or an insignificant one for that matter.

It will be just as expensive in real terms to repay 15 years from now as it would be to repay tomorrow—and just as cheap. That is the point of indexation.

It is not very helpful, either, to consider taking up another reader who offers to bet that the cash outlay on the new indexed bond will be greater, from start to finish, than that on a 15½ per cent conventional gilt of the same maturity. For one thing, there is a large institution for making such bets known as the stock market. For another, it would be very odd if the cash outlay on the indexed gilt were not liable to be a great deal larger than on the conventional one. After all, the investor does not get the cash for several years, during which most of its value has been eroded by inflation.

To cut a long story short, the nature of an indexed gilt is very simple, in spite of all the obfuscation. It is just like the sort of gilt-edged investments that used to keep widows and orphans in the days of Queen Victoria when nobody had even heard about inflaton for several decades.

It has a low cost in real terms. Its cost in money terms can only be forecast by those who think that they can forecast the rate of inflation for several years ahead; and people who are as clever as that are unlikely to be interested in anything as simple minded as an indexed gilt.

You might think that this description means that indexed gilts are a good thing. This does not follow. If you regard a low cost of debt service as a good thing—which suggests that you think as a taxpayer and not as an investor—you may still question whether indexed gilts are a help. After all, Government borrowing has not involved any real cost for the past ten years or so, so why pay even one or two per cent?

Investment

However, the real question is not whether it is a good thing to cheat investors or to pay an honest if modest return, but what you borrow for. This is the issue that seems to be forgotten by everyone taking part in the debate. If the Government uses the money it raises at 2 per cent real to invest in something like a power station which will earn 3 or 4 per cent in real terms, our children will not face a burden. They will enjoy a handsome profit. If, on the other hand, the Government is borrowing the money to pay unemployment benefit or to pay the interest on unindexed debt, then whatever it borrows and on whatever terms will be a dead weight.

Since conventional borrowing mainly gets repaid in the early years in real terms, I would share the moral objections to index borrowing if it is used to finance current expenditure. But if the Chancellor has an instrument to justify some overdue real investment, then three cheers.

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the current target rate of expansion of the money supply in the short term. It is a past situation which we are dealing with, and which has been wrongly recorded. But it is a different thing to say whether or not it should be accommodated within the target for the whole year. That is plainly a subject we shall have to look at when we see the scale of reintermediation and how it happens.

483. Would you just like to comment briefly on the "Sam Brittan" point as it is sometimes known? Is the Government not trying to finance its public sector borrowing requirement primarily by perhaps unnecessarily high interest rates rather than assuming its policies succeed and index-linking its gilt-edged requirements?

(Mr *Richardson*) That, of course, is a very interesting and attractive argument. The argument, in the way it is put by him and Professor Friedman, is that if the Government had confidence in its policies and saw inflation coming down it would very quickly proceed to index-linked securities on the ground that this would reduce the cost. There are probably quite a lot of things that you could say about that. First of all, it is an enormous question to move to index-linking on a general scale. It involves an act which is hard just to limit to one particular thing. It is really taking a view that you cannot rely on the value of money, that you are prepared to index it in this way. When you look at the general question and put it in a wider context you have to try to imagine to yourselves what the consequences would be. Some anxiety has been expressed in relation to the level of the exchange rate. One of the first questions you would have to look at is, if these securities were generally available, how attractive they would be to persons outside this country as well as the persons inside. There has been a long period in which OPEC have longed to find index-linked assets into which they can put their money. If we were immediately to move to this we would be the only major country in the world which was issuing generally these kinds of securities. The question you want to ask yourself is how attractive they would prove to those people, what the inflow would be and what that inflow would do to the exchange rate?

Mr *Baker*

484. That would be assuming that all gilt-edged sales would be index-linked, would it not?

(Mr *Richardson*) Not necessarily.

485. If you made them all index-linked then there might be an enormous inflow of money into the country. I accept that argument and that would push up the exchange rate even higher. But in fact you could have a mixture could you not, of some index-linked and some not index-linked?

(Mr *Richardson*) Yes, you could. Then, of course, you would have very interesting questions about what it would do to the prices of securities that were not index-linked. That would be a consideration in trying to determine whether you are in fact getting a cost benefit from it or not.

486. So the report in the Financial Times by Miss Elinor Goodman and Mr Peter Riddell this morning, that you are examining this as a possible alternative with the Treasury has something in it?

(Mr *Richardson*) It is quite plain that a matter of that importance would not be the subject of intense examination.

487. Before we leave the ways of financing the Government debt, are you giving any thought to a much wider use of sales within the country, to British residents, of index-linked debt, ie an extension of what are known as the Granny-bonds or an extension of the SAYE which is very modest at the moment and where people in employment can only pay £20 a month into the SAYE scheme. What do you think of the idea that if that level was increased substantially or if the Granny-bonds level was increased substantially, that a much higher proportion of the Government debt could be financed from that way. You would have to sell fewer gilts—even index-linked or not—as a consequence of that policy.

(Mr *Richardson*) It is quite true that the Government's borrowing requirement is financed in part, and in great part, by sales of conventional gilt-edged stock, substantially to long-term savings institutions—life insurance companies and pension funds. The amounts actually taken from National Savings or from certificates of tax deposit are relatively small. It is perfectly possible,

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if you wanted to go to index-linked securities, to think of an extension of some kind of indexed security which would be available to persons in this country on some kind of defined but limited basis. You then have to consider both the cost of doing that -- what actual cost they would involve —and you would immediately have to consider what the effect of putting the Government into that bit of the private sector personal liquidity would do to the people who are now taking their deposits out of that sector and in particular the building societies.

488. Have you made any estimate of what you think is the proportion of the PSBR that could be funded in a more imaginative use of those sorts of schemes? Or is that not a fair question to ask you?

(Mr *Richardson*) The use of the word "imaginative" jumps quite a number of fences in one go because it immediately throws a glow of approbation on the whole idea without examination of the points that I have been making about it.

Mr *English*

489. Let us assume that you did index-link the lot. You are far too experienced an individual to really believe that thereby you would automatically have an enormous influx of money because presumably you believe in the price mechanism? Presumably one would reduce the interest rate. One might even get below the 19th century 2½ Consols rate. At some point the inflows would cease when your interest rate was extremely low on your index-linked capital, or be negative as the Swiss did on one occasion. At some point you could stop the inflow on a market basis, could you not?

(Mr *Richardson*) If there were an enormous demand for it of course it would tend to depress the rate of interest and the rate of interest would go from whatever it started as to a lesser figure. That of course is one of the problems of doing small amounts as opposed to more. You might get no very good impression of what the demand really was. But I have the feeling perhaps that you might have to take an awful lot of inflows before you arrived at that point.

490. But that is not quite what you said. You said that you could not introduce it because there would be a vast flow—I suppose we really mean America, Germany, Japan and the Middle East—from the other financial centres or the oil countries. Is that right?

(Mr *Richardson*) If I may say so, what I was trying to give was an impression of the factors that you have to take into consideration if you were thinking of moving in this direction. The risk is that you would attract a lot of the OPEC surpluses into this kind of asset. If you did so it would put an upward pressure on the exchange rate although I do not deny that if in fact the pressure to get the bonds was very heavy it would tend to reduce the rate of return on them. Whether it would go to a negative figure or not I do not know.

491. But is not the simple way to do that to put out a stock at a ludicrously low rate of interest and see what happens—half a per cent say and see what happens. It may not get taken up but you will have proved that that rate is too low at any rate.

(Mr *Richardson*) That involves all sorts of questions about the volume of the stock that you put out and how valid the experiment would be.

(Mr *McMahon*) Could I just say something on that and particularly on "could you not try a little bit and see what happens".

492. I did not say a little bit, Mr Baker did.

(Mr *McMahon*) But I just wanted to make one point that occurred also earlier on about exchange rate movements, whether one is talking about doing things to push it down or whether it might not go up all that very much if you did something else. The experience that we have taken from recent years is the extraordinary unexpectedness and unpredictability of what can happen to exchange rates. If one thinks about the movement of the yen for instance, which looked for a while unbelievably rock-like solid and fell despite all their efforts and immense intervention from 170 to 250, one gets a bit of humility about being able to devise schemes ahead of time which will have a predicted effect, either large or small or up or down. If I could just make a second point about the indexation. The effects on the markets, either domestic or external, of doing it, are also very unpredictable. It is very easy to see the point that Sam Brittan

Principal Private Secretary

c. Mr Folger

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W
Kay, Morris & Hills Brief & Speak Notes

MR UNWIN

cc: Mr Cassell
Mr Evans
Mr Wicks
Mr Todd
Mr Corlett
Mr Griffiths

SELECT COMMITTEE

It occurs to me that the Chancellor might like to have my additional notes on the Kay and Morris and Hills papers - TR (Sub TX)28 and 29.

2. These are attached. They are very brief.

AB

A M W BATTISHILL
23 March 1981

Perhaps you would add these pps to the Chancellor's Folder. Since we shall almost certainly not be able to let the Committee have before tomorrow the paper Mr Meacher asked for, the Chancellor will need to be fairly well prepared on this area. But I do not see why he should allow himself to be drawn into any detailed discussion of the Kay/Morris paper.

1074/23

[signature] 24/3/81

Treasury Committee

Comments on TR(SubTX)28 and 29

1. Do you agree that the marginal rates of tax have increased?

Yes; that must be the case.

2. Do you agree with the figures produced by our advisers?

Cannot pass judgement on the detailed figures of Mr Kay and Mr Morris. We do not know on what precise assumptions they are based. But the pattern of their results does not seem implausible. We do have reservations about the weight which can be put on calculations which add together marginal rates of direct and indirect tax - and on some of the details in their tables.

3. Why?

Because they do not allow for the element of choice which individuals have if the taxes on particular types of expenditure are increased.

4. Any comments on the figures?

Important qualification that they apply only to basic rate taxpayers. Higher ratepayers excluded - as Kay and Morris recognise.

Wholly static analysis. Does not allow for changes in income between this year and next.

Includes the increase in employees' national insurance contributions - not part of the Budget. But does not deal with families who gain 10½% increase in child benefit.

Treats employers NIC (and, we presume National Insurance Surcharge) as a tax falling wholly on personal incomes. We would think the distributional effects of NIS are not as straightforward as that.

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MR BATTISHILL

cc: Mr Corlett
Mr Kalen
Mr Hood
Mrs Boardman
Mr R J Smith

FPCS Float
DEU Float

BRIEF BY MR TODD ON I.F.S.

TREASURY SELECT COMMITTEE

I have had a very quick look at the IFS paper on the Impact of the 1981 Budget. As in the case of last year, the papers provides very little information and it is impossible to analyse their calculations in any detail. Having said this, there are several points which stand out rather clearly and which you may find to be of help as an aide memoire.

(i) Messrs Kay and Morris use a straightforward static analysis, combining both income tax and the indirect taxes in order to produce combined marginal rates pre and post Budget.

(ii) They choose to include the announced NICs as part of the Budget.

(iii) For the married couple (husband only working) the marginal rate of total taxation rises from 54.4 to 56.9 per cent. One half of this increase is accounted for by the announced change in the NIC. The greater part of the remainder is accounted for by the petrol duty increase.

/2 ...

(iv) The IFS calculation treats the employers NICs including the NIS as a tax which is borne wholly by wage earners. That is to say, they assume that if the NIS did not exist wages would be higher by 3½ per cent (there is full backward shifting); we would assume that the NIS is passed forward into prices.

(v) Very little comment is made about incentive effects and in their calculation the IFS seem to prefer judgments which are based upon the marginal rate only. Income effects are ignored and hence they would tend to regard the tax measures as being somewhat regressive and having a disincentive also. I would stress however that very little is made of this point.

(vi) The IFS analysis is expressed entirely in static terms and no account is taken of inflation through the year.

(vii) Whilst individual family types are identified, comparisons are not drawn across the income distribution. They limit themselvesto the statement that their analysis applies to basic rate taxpayers only. As you know, in our internal work we look at several different income levels within the basic rate band.

2 Might I suggest that if this subject arises our general line should be that the paper contains insufficient information for us to offer a detailed assessment and commentary. Having said this, taking the calculations as they stand we would think that the figures are broadly correct and that the general conclusions

concerning the profile of distributional effects is about right. That is to say, those at the lowest and highest incomes fair worst in proportionate terms.

DOUGLAS TODD
DEU2
17 March 1981

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CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Mr Burns
Mr Middleton
Mr Monck
Mr Bridgeman
Mr Evans
Mr Unwin
Mr Burgner
Mr Battishill
Mr Folger

TREASURY COMMITTEE: DR BRAY'S QUESTION

X
DR BRAY'S QUESTION BRIEF & SPEAK. NOTE

You have received a letter from Dr Bray warning that when you go to the Committee tomorrow he will return to the question he put to us last Wednesday on "is it just a coincidence that the real PSBR implied in the Budget is about zero?"

2. This question, as his letter implies, is prompted by the paper by Marcus Miller. Professor Miller, following the sort of exercises previously done by Taylor and Threadgold, adjusts the nominal PSBR for the effects of inflation in reducing the real value of the stock of outstanding government debt. The resulting concept, termed "the real PSBR", is regarded by many as a better measure of the fiscal stance than changes in the nominal PSBR. On this view the implication that the real PSBR implied in the Budget, and indeed through the MTFS period, is close to zero could be taken as suggesting that fiscal policy is intended to be broadly neutral, neither contractionary nor expansionary. This presumably is what Dr Bray is trying to establish.

3. There are considerable difficulties with using the real PSBR as a criterion for Budget-making. It would no doubt be quite a good benchmark if we were already starting from an acceptable rate of inflation, rather than from a rate that we are still seeking to reduce. Aiming at a particular PSBR in real terms could, however, easily degenerate into endorsing a fiscal policy that would accommodate whatever the going rate of inflation happens to be. In reaching your judgement on the £10½ billion PSBR for 1981-82 you gave most weight to consistency with the monetary objectives and the general thrust of policy towards lowering inflation. You

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explained in your Budget speech why you ruled out the £7½ billion implied in last year's projections, as unduly restrictive in the more depressed conditions of the economy, and justified £10½ billion as being "consistent with the monetary target that I have just announced. I also believe it to be a sum that can be financed without placing undue strains upon the capital markets".

4. I am sure this is the line to hold to, and not get drawn into technical debate with Dr Bray about the desirability, or otherwise, of a zero real PSBR. However, as it happens, the way the MTFS is set up would imply that if inflation declines in line with the monetary target then the illustrative PSBR path in the projections would be roughly zero in real terms. But I think this is better regarded as an incidental feature of the projections, not as a deliberate objective that we had in mind in producing them.

5. I attach a draft speaking note on the lines indicated above, and also, for convenience, the pages of the transcript of last Wednesday's hearing covering the exchange with Dr Bray.

F CASSELL
24 March 1981

DRAFT SPEAKING NOTE

REAL PSBR

I explained in my Budget speech how I reached my judgement that it would be right to provide for a PSBR in 1981-82 of some £10½ billion, or a little more than 4 per cent of GDP. [I ruled out the £7½ billion implied in last year's illustrative projections as unduly restrictive in the conditions of lower output and higher unemployment than had been envisaged when those projections were made. As I said, I believe the figure £10½ billion to be consistent with the monetary target announced for 1981-82, and also to be a sum that can be financed without placing undue strains upon the capital markets.]

2. It is ~~no doubt~~ Apparently true, as Professor Miller suggests in his paper, given the prospect foreseen for inflation, that this implies a real PSBR of close to zero. Certainly, if inflation falls more or less in line with the declining monetary target, the projections in the medium-term financial strategy would imply a real PSBR fairly close to zero. This is because fiscal policy in these projections is set to be consistent with a growth in the total financial assets of the private sector that is more or less in line with the monetary target. Hence money supply, total financial assets and the stock of government debt would all move together broadly in step through the period. And if inflation follows much the same path, the PSBR - which measures the nominal increase in the stock of public debt - would be close to zero in real terms. But that is not the same as saying

that a zero real PSBR is the objective. As the discussion of the MTFS in the Red Book makes clear, the projections of the PSBR are not to be taken as targets. Fiscal policy in any particular year will be operated so that the PSBR for that year - in nominal or real terms - will be consistent with declining monetary growth in the particular circumstances of the time. What the real PSBR will be through the MTFS period - and indeed what the economy's real growth will be - will depend to a very large extent on the pace at which inflation falls.

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(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.

Mr Unwin
c. Mr Cassell

SL 23/3

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DR. JEREMY BRAY M.P.
HOUSE OF COMMONS
LONDON SW1A OAA

01- 219 4057 (direct line)
01- 219 3000 (switchboard)

23rd March, 1981.

Dear Geoffrey,

I am not sure that Treasury officials and your advisers had seen the enclosed paper by Marcus Miller before they appeared at the Select Committee last Wednesday, 18 March. When I asked them (Q.96), "It is just a coincidence, is it, that the real PSBR with the expected inflation rate works out at about zero?", Mr. Cassel's first reply, "It was not derived that way" does not necessarily mean that it was not derived in an equivalent way - e.g. balancing the Budget after taking into account a notional "inflation tax" or many other possible expressions of the same idea.

DR BRAY 23/3.

May I give notice that I will ask you about this if I have the opportunity when you come on Wednesday?

Yours sincerely

Jeremy Bray

Rt. Hon. Sir Geoffrey Howe, M.P.,
Chancellor of the Exchequer,
Treasury Chambers,
Parliament Street,
S.W.1.

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1. MR PIRIE
2. MR MONCK
3. CHANCELLOR

cc attached for:
Financial Secretary
Sir Douglas Wass
Mr Burns
Mr Ryrie
Mr Middleton
Mr Battishill
Mr Unwin
Mrs Gilmore
Mr Cropper
Mr Lewis IR

SPECIAL TAX ON BANKING DEPOSITS

I attach, as requested in Mr Wiggins' 20 March note and commented on in (1) Mr Locke's note of the same date, a technical note on the arguments banks are using that their ability to lend to industry will be reduced by a multiplier of some 20 times the yield of the tax and a general note responding to the various criticisms which have been made of the (2) Government's proposals for use by the Paymaster General. This second, general, note is also recommended to the Chancellor as background briefing for his appearance before the Treasury Select Committee. I (3) further attach a third note with relevant tables summarizing the results of the four big clearers for 1980 which have all now been published.

Y
TAX ON BANKS BRIEF & SPEAK. NOTES

A R Boote

A R BOOTE
24 March 1981

(2) — at Flag A — is particularly relevant for the TCSC appearance tomorrow — see especially para. 2.

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24/3

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EFFECT ON CLEARING BANKS ABILITY TO LEND TO INDUSTRY OF SPECIAL TAX ON BANKING DEPOSITS

Table 1 attached shows the ratio of the clearing bank groups free capital to advances since 1977. Comparison of the 1978 and subsequent figures with the earlier figures is difficult because before 1978 full provision was made for deferred tax : this explains the rise in the ratio of free capital to advances in 1978 compared to 1977. The figures for 1978, 1979 and those available for 1980 are broadly in line with the ratio implied by the clearers press comments on the tax namely that the ratio of the banks free capital to advances is in the range 1 : 15.- 20. The table does, however, emphasise the divergence in the ratios between the various clearers reflecting their own differring policies and perhaps accounting practices. For example, Midland have a much high ratio of free capital to advances than the other clearers and even within the same banking group there are notable variations from year to year in the ratio - for example the rise in Barclays from 1978 to 1979.

2. Table 2 attached shows free capital as a percentage of deposits for the clearing bank groups. This free capital ratio to the banks liabilities we would consider of more prudential relevance than the ratio of the banks free capital to their advances. Again the figures for 1978 and 1979 show considerable differences within the clearing bank groups. It is also interesting to note that for the two groups which have published their accounts for 1980, the free capital ratio has remained the same for National Westminster and has risen significantly for Lloyds.

3. Table 3 is an attempt to show the effects on the ratio of free capital to advances and free capital as a percentage of deposits of the special tax. The table assumes the broad figures of liability to the tax widely quoted in the press. For the two banks that have published their accounts for 1980 the effect on free capital as a percentage of deposits is to lower their free capital ratio by three tenths of a percent in each case. For Lloyds the resulting percentage is still higher than the percentage in 1979 while for National Westminster the resulting figure of 3.6% is lower than any percentage for any of the banks since 1977 though certainly above the comparative percentage in earlier years. (Again comparison here is difficult). As far as the ratio of free capital to advances is concerned the picture is if anything more favourable. The effects of the special tax is to reduce the ratio for Lloyds to their

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1979 ratio while for National Westminster the resulting ratio is the same as Barclays for 1978.

4. The detailed figures for the individual clearing bank groups of the ratio of free capital to lending would therefore seem to support the view that there is no mechanistic relationship between a banks free capital and its advances. The ratio of free capital to advances has varied considerably both between the clearing banks groups and over time in the same group. The effect of the special tax on the two ratios it is possible to calculate for 1980 do not lead to results widely inconsistent with those for previous years.

5. There are various wider considerations which also throw doubt on the banks argument that their ability to lend to industry will be reduced by some multiplier of the yield of the tax. Firstly the clearers have already catered for difficulties now foreseen in their advances through large provisions for bad debts made before the figures for free capital are struck on which the ratios above have been calculated. In aggregate the clearers charged around £400 million against their 1980 profits for bad and doubtful debts. At least some therefore of the lending which the banks claim their ability to do has been reduced is already catered for outside the ratio to which they are referring. Secondly the amount of the clearers free capital is by no means immutable at least in the medium term. It is quite possible for the clearers to increase their free capital for example by a rights issue if they think it is inadequate. This is of course a matter for the clearers own decision : it is not true, however, to suggest that they have no alternative to reducing their lending even if they consider their capital base inadequate. Thirdly, as Mr Locke suggests in his 20 March note, what evidence we have on international comparisons suggest that the clearers ratio of capital to assets is fairly good by international standards. Attached at table 4 is an extract from the Banker of June 1980 based on 1979 figures : all the UK clearers are within the top ten banks in the world in terms of capital/ assets ratio.

6. For these reasons, we consider that the banks argument that the special tax reduces their <u>ability</u> to lend to industry by a multiplier of around 20 times the yield of the tax is unconvincing. Whether, of course, the tax reduces the banks <u>willingness</u> to lend to industry is another question which depends on the banks attitudes.

TABLE 1 RATIO OF FREE CAPITAL TO ADVANCES FOR CLEARING BANK GROUPS

	1977	1978	1979	1980
Lloyds	1 : 17.4	1 : 17.0	1 : 17.8	1 : 16.5
Nat West	1 : 20.6	1 : 16.6	1 : 17.6	1 : 17.9
Barclays	1 : 22.2	1 : 19.5	1 : 17.3	Na
Midland	1 : 16.0	1 : 12.4	1 : 13.3	Na
In aggregate	1 : 19.3	1 : 16.4	1 : 16.5	Na

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TABLE 2 FREE CAPITAL AS A PERCENTAGE OF DEPOSITS FOR CLEARING BANK GROUPS

	1977	1978	1979	1980
Lloyds	4.1	4.4	4.4	5.0
Nat Wset	3.3	4.2	3.9	3.9
Barclays	3.5	4.1	4.5	Na
Midland	4.2	5.5	5.1	Na
In aggregate	3.7	4.5	4.4	Na

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TABLE 3

EFFECT OF SPECIAL TAX ON FREE CAPITAL IN RELATION TO DEPOSITS AND ADVANCES

[Assuming a tax liability of

	£m
Lloyds	60
Nat West	100
Barclays	90
Midland	70
	320]

ON 1980 RESULTS	FREE CAPITAL	FREE CAPITAL AS % DEPOSITS	RATIO FREE CAPITAL TO ADVANCES
Lloyds (60)	843	4.7%	1 : 17.7
Nat.West (100)	1147	3.6%	1 : 19.5
ON 1979 RESULTS FOR CLEARERS IN AGGREGATE	3531.9	4.1%	1 : 18.0

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TABLE 4

Extract from
The Banker
June 1980

THE TOP FIFTY*
Re-ranked by capital/assets ratio†

	Bank	%
1	Compagnie Financière de Paris et des Pays-Bas	8·66
2	Lloyds Bank	6·96
3	Banco do Brasil	6·64
4	Crédit Suisse	6·58
5	National Westminster Bank	6·48
6	Union Bank of Switzerland	6·38
7	Midland Bank	6·04
8	Barclays Group	5·79
9	Crédit Agricole	5·74
10	Swiss Bank Corporation	5·68
11	J. P. Morgan	4·48
12	Sumitomo Bank	4·20
13	Fuji Bank	4·15
14	Amsterdam-Rotterdam Bank	4·12
15	Centrale Rabobank	4·09
16	Mitsubishi Bank	4·02
17	Continental Illinois Corp	3·93
18	Dai-Ichi Kangyo Bank	3·78
19	Sanwa Bank	3·77
20	Tokai Bank	3·64
21	Bank of Tokyo	3·57
22	Citicorp	3·50
23	Manufacturers Hanover Bank	3·39
24	BankAmerica	3·33
25	Canadian Imperial Bank of Commerce	3·29
26	Chase Manhattan Corp	3·27
27	Deutsche Bank	3·23
28	Banca Nazionale del Lavoro	3·19
29	Westdeutsche Landesbank	3·17
30	Chemical New York Corp	3·15
31	Daiwa Bank	2·95
32	Algemene Bank Nederland	2·86
33	Dresdner Bank	2·82
34	Banca Commerciale Italiana	2·71
35	Royal Bank of Canada	2·65
36	Bayerische Landesbank	2·60
37	Industrial Bank of Japan	2·55
38	Commerzbank	2·47
39	Bayerische Vereinsbank	2·41
40	Mitsui Bank	2·31
41	Bayerische Hypotheken- und Wechsel Bank	2·18
42	Long-Term Credit Bank of Japan	2·14
43	Taiyo Kobe Bank	2·12
44	DG Bank	2·03
45	Société Générale de Banque	1·76
46	Société Générale	1·65
47	Banque Nationale de Paris	1·40
48	Banco di Roma	1·28
49	Crédit Lyonnais	1·22
50	Norinchukin Bank	0·40

* By assets less contra accounts.
† Ratio of capital and reserves to assets less contra accounts.

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RESPONSE TO CRITICISMS OF SPECIAL TAX ON BANKING DEPOSITS

There have been various criticisms of the proposed special tax on banking deposits: the suggested response to these criticisms is as follows.

1. Criticism: The special tax is dangerous in principle because of its element of retrospection - "to penalise banks ..... on a basis that was not known at the time the business was legitimately done is quite simply wrong."

Response: Retrospection can come as no surprise in view of the high interest rates in 1980. Ministers made it clear it the 1980 Finance Bill debate that they were continuing to look at the possibility of a special tax; the tax is in any case payable in the 1981/82 financial year.

2. Criticism: The reduction of the banks' capital as a result of the tax will reduce their ability to lend. Sir Jeremy Morse - Chairman of the Committee of London Clearing Bankers - has been widely reported as stating that every pound removed from the banks capital base removes between £15 and £20 from the banks ability to lend.

Response: There is no mechanistic relationship between the size of a bank's capital base and its ability to lend - indeed this relationship has varied considerably over the past few years. The special tax will reduce the banks' free capital ratios below what they otherwise would have been but their ratios are currently quite high and should continue to be fully adequate. The banks are already catering for difficulties now foreseen through large provisions for bad debts made before profits are struck. The level of bank support for industry is a matter of their commercial judgement and it would often not be in the banks' best commercial interest to withdraw such support.

3. Criticism: The special tax sets a dangerous precedent by taxing success, making profit a dirty word and will only be used to back losers, e.g nationalised industries.

Response: Bank profits on domestic business are not a result of their extra exertions so much as the high level of interest rates. Non-interest-bearing deposits are a reasonable measure of the banks' endowment profits resulting from high interest rates. The proceeds of the tax are not going to back losers but to help hard pressed sectors of industry. ~~such as by lower interest rates.~~

4. Criticism: Recent high banking profits reflect the banks profit cycle and are not excessive.

Response: Most banks have had two very good years. Their recent experience contrasts sharply with that of manufacturing industry. The recent Economist survey on international banking confirmed that the return on assets of the four largest clearers was way ahead of all their major international rivals.

5. Criticism: The profits on the clearers' domestic business fell in 1980 and the tax is therefore effectively a tax on the clearers' good overseas results.

Response: It is true that the clearers' domestic profits for 1980 were down on their results for 1979. However, in part this is because of the generous pay increases they agreed in 1980 - for the year as a whole staff costs on average rose by around 30% compared to 1979. The special tax is justified by the exceptional profitability of banks in the recent past and not just in 1980.

6. Criticism: The tax will wipe out virtually all of the clearers' after-tax current cost accounting profits for 1980 which are in any case well down on the figures for 1979.

Response: The post-tax profits of the four largest clearers on a current cost accounting basis were over £400 million for 1980 which compares with their estimated liability to the tax of around £300 million. On a current cost accounting basis as well as a historical cost accounting basis, banks have also done relatively well over the past few years. In any case it is arguable that the current cost accounting profits understate the taxable capacity of the banks just as historical cost accounts are argued to overstate their taxable capacity.

7. Criticism: The Government should have accepted the clearers' offer to refinance £1 billion of export credit lending or should have made it clear why this offer was unacceptable and that the alternative was a special tax.

Response: The banks' offer to take back responsibility for £1 billion of export credit lending would have meant little real contribution from the banks. The Government tried to find an alternative to the special tax, but the clearing banks would not agree to sharing the subsidy costs of export credit and other fixed rate lending. Indeed they said that they would rather be taxed. The Government made it quite clear to the clearers why their offer to accept responsibility for £1 billion of lending was unacceptable and that a likely alternative was a special tax.

8. The effect of the tax on individual banks such as the National Girobank, the Co-operative Bank, Yorkshire Bank and the Trustee Savings Bank is particularly harsh.

Response: I am afraid that I cannot comment on the tax affairs of any individual institution.

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RESULTS OF BIG FOUR CLEARING BANK GROUPS

The four big clearers have now all published their results for 1980.

2. I attach at Table 1 the historical cost profits for 1980 of the four clearers and at Table 2 their current cost profits. Total pre-tax historical cost profits for 1980, at around £1450 are about £100m down on their 1979 results - a fall of about 7%. Current cost pre-tax profits fell by about £180m - 18% - to just over £800m. Table 3 shows the post-tax position for 1980. On a historical cost basis post-tax profits were over £1000m; on a CCA basis just over £400m.

3. Table 4 shows the charge against profits for bad and doubtful debts. In 1980 the total charge for specific provisions was around £330m, for general provisions about £75m (in aggregate £405m); the respective figures for 1979 were around £63m and £60m (aggregate £124m).

AR Boote

A R BOOTE
23 March 1981

Table 1

£M

Historical Cost Basis Pre-Tax Profits of Clearers for 1980

	1979 (1)	1980 (2)	Change 1980 on 1979 (3)	Percentage change (4)
Lloyds	276.6	289.9	+ 13.3	+ 5%
National Westminster	441	410	- 31	- 7%
Barclays	529.4	523.5	- 5.9	- 1%
Midland	315.5	231.8	- 83.7	-26½%
In aggregate	1562.5	1455.2	-107.3	- 7%

Table 2: £M

<u>Current Cost Pre-Tax Profits for 1980</u>

(including CCA Adjustments for Associates)

	1979	1980	Change 1980 on 1979	Percentage change
	(1)	(2)	(3)	(4)
Lloyds	169.6	164.5	- 5.1	- 3%
National Westminster	285	243	-42	-15%
Barclays	355.8	309.6	-46.2	-13%
Midland	183	94	-89	-49%
In aggregate	993.4	811.1	-182.3	-18.3%

Table 3 £M

1980 Profit after taxation

	Historical Cost Basis	Current Cost Basis
Lloyds	202.1	76.7
National Westminster	318	151
Barclays	371.4	157.5
Midland	169.7	32
	1061.2	417.2

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Table 4 £M

<u>Charge against profits for bad and doubtful debts</u>

	1979			1980		
	Specific	General	Total	Specific	General	Total
Lloyds	1.9	9.3	11.2	52.6	15.2	67.8
National Westminster	26	14	40	95	25	120
Barclays	25.5	35	60.5	102.9	31.6	134.5
Midland	9.9	2.2	12.1	79.2	3.5	82.7
In aggregate	63.3	60.5	123.8	329.7	75.3	405

SPEAKING NOTE ON THE FINANCIAL EFFECTS OF THE CIVIL SERVICE DISPUTE

The disruption to the normal flow of government revenue, caused by the Civil Service dispute, will inevitably mean that the central government borrowing requirement for 1980-81 will be higher than the estimate of £12,760 million which we published in the Financial Statement and Budget Report. Even now, however, it is hard to say what the difference will be. As I said in the House of Commons on Monday, it is clear that a substantial proportion of the revenue due this month has been received. However, the due date for the regular monthly payments of PAYE and national insurance contributions was last Thursday (the 19th). That money is still coming in and we really cannot tell yet what proportion will be received.

Revenue which is delayed beyond the end of March will of course, be received in the next financial year, so what we are talking about is really just temporary funding, rather than a net addition to the borrowing requirement taking the two years together.

AA Civil Service Dispute Brief & Speak Note

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CIVIL SERVICE DISPUTE: FINANCIAL EFFECTS

BACKGROUND NOTE

1. In all revenue collecting departments lodgments were delayed on Monday 9 March, because of the one-day strike by all unions.

2. In Customs and Excise, selective action began on Tuesday (the 10th) when data processors, who among other things sort and encode cheques for the payment of VAT, remained on strike. Alternative arrangements for the payment of VAT by large traders were put into operation but a large number of smaller payments are held up. VAT receipts are comparatively low in March and the impact of the strike on exchequer receipts is being mitigated by our inability to make repayments of VAT to traders entitled to them.

3. In Inland Revenue, normal working was resumed on Tuesday and in general things were back to normal by the end of the day. The staff of the Accounts Offices at Cumbernauld and Shipley were called out, indefinitely, from the afternoon of Friday 13 March, affecting the PAYE and National Insurance take. There was little impact on receipts until 19 March, when the PAYE and National Insurance deducted by employers in February was due to be paid. Something like £2.5 billion of receipts were due to be processed by the two centres between 18-31 March. The impact of the strike is being mitigated by receipts from large employers who have been asked to pay directly into the Inland Revenue account at the Bank of England and by the alternative arrangements at Bush House. But it is too early to say just how effective these are being.

4. The Times this morning suggests that Whitehall is deliberately withholding information on the effect of the strike. This is not true. We simply do not know yet. At a very rough estimate, the cumulative central government borrowing requirement for the year so far is perhaps £750 million larger than it would have been if the strikes had not occured. However some of the loss may be recouped later this week - the alternative arrangements take

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rather longer than the normal procedures - and the position is still not clear enough to make any estimate public.

HM Treasury
24 March 1981

LINE TO TAKE ON THE FINANCIAL EFFECT OF THE STRIKE

As the Chancellor said to the House yesterday, it is too soon to make a reliable judgment of the financial impact of the Civil Service dispute. A substantial proportion of the revenue due has been received.

/If pressed: We should know later this week when we have a better estimate of the total amount of PAYE received/.

SUPPLEMENTARIES

HAS THERE BEEN A SIGNIFICANT EFFECT YET?

VAT receipts are comparatively low in March and the impact of the strike is reduced by the inability to make repayments of VAT to traders entitled to them. Most of the PAYE receipts due in March were not payable until last Thursday (the 19th).

CAN PRECISE FIGURES OF THE EFFECT BE GIVEN?

It is still too early to give definite figures. /‾If pressed we should know more later this week when we will have a better estimate of the total amount of PAYE received7.

FINANCIAL PENALTIES FOR CIVIL SERVANTS ON STRIKE:

People in the Civil Service are not paid for days that they are on strike. /‾People who refuse to do their normal work can also be suspended without pay7.

SUGGESTION IN THE "TIMES" THAT INFORMATION IS BEING WITHHELD?

Information is not being withheld. The due date for the regular monthly payments of PAYE and national insurance was last Thursday (the 19th). This money is still coming in and it is too early to say what proportion will be received.

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cc. Financial Sec
Mr Bridgeman
Mr Cassell
Mr Folger

Chancellor

Treasury Committee

Mr Hubback phoned this evening with a list of questions the Committee will have before them tomorrow.

I have set them out on the attached sheets with a very quick commentary alongside them. Most are as expected & covered by the material you have. But if you have time you may find it helpful to go quickly through the list & my comments.

Apologies for manuscript – I hope it is legible.

[signature]

24/3/81

QUESTION	COMMENT
BUDGET GENERALLY	
Effects on output, manufacturing sector, unemployment, investment etc?	See briefs H & L. Stress virtuous effects of lower interest rates & inflation. (Perhaps refer to encouraging signs in latest housing starts figures).
Effects on work incentives?	Use line in FST's speech – no increase in basic tax rate. (NIC (E) increase necessary for reasons explained last Nov).
Effects on Exchange rate?	Don't be drawn. Can't predict.
Why £10½bn PSBR? Effects on interest rates of higher PSBR?	Refer to Budget speech. Consistent with monetary & other objectives. Also takes reasonable account of recession. Higher PSBR cause higher interest rates – but can't quantify.
Size of 1981-82 PSBR if tax allowances revalorised & Nov 1980 measures excluded? ?	See Treasury note. Artificial to isolate particular changes. Must look at overall fiscal/monetary stance.
End of recession? Sources of recovery? Stockbuilding?	See brief J & paragraph to be included on stockbuilding in letter.
How can consumption be major source of growth if only increased by 0.2% for each 1% reduction in model (number given by Mr Evans last week)?	Refuse to discuss such detail. Evans dealt with it last week. Consumption in any case only part of sources of recovery.
Will inflation increase again when recovery comes?	No reason to expect this. Signs of real change in attitudes (more pay = fewer jobs etc).
PUBLIC EXPENDITURE	
Future levels of support for industry & employment?	See section (c) of Brief C. Important point is that PEWP figures can only reflect decisions already taken. Also special situation of B.L.
Nationalised Industries – various questions likely on plausibility of	

Figures.	See briefs at D.
Is a public sector pay rise of only 6% plausible next year?	Refer to para 9 on page 5 of PEWP. Bridgeman dealt with last week. This is provision, not norm.
Capital/current balance?	See brief E.

MEDIUM TERM STRATEGY.

Why is a low PSBR necessary to get interest rates down, given 1980 experience?	Special circumstances last year (as explained in FSBR etc). But now must ensure that £M3 comes down.
Do you agree with FST's speech on non deflationary nature of Budget – especially his point on real money supply?	Refer also to need to look at overall fiscal stance. Tax increases only partial offset to higher spending (up £6bn in cash on plans of year ago).
Have you (in light of 1980 experience) abandoned £M3-inflation link?	No. special circs last year as explained
Why not have PSBR target range?	No PSBR "target". Figures in MTFS illustrative. Will decide precise figure in light of circs.
What is Treasury's medium-term forecast?	Cannot reveal. Nor did predecessors.
In what circs will you allow £M3 to exceed target range? How much of 1980 £M3 excess will you claw-back.	Wait & see.
Have you decided to set up MBC?	As Monck said last week, no decisions taken. "Darwinian" approach.

EXCHANGE RATE

Is reduction necessary to restore competitiveness?	Refer to other factors – notably unit labour costs (responsible for well over half loss of competitiveness over past 2 years).

At what £ rate will you apply proposed new inflow controls?	As Unwin explained last week, this is purely technical change. No change of policy. EC requirement. [If pressed – only envisage use in situation of major external financial crisis].
TAXATION	
Why not increase basic rate rather than leave allowances unchanged?	See Brief S. If questioned on distributional effects, refer to Treasury paper to come.
INDEXED GILTS.	
Is this fundamental change in funding policy?	No. Evolutionary. See Brief V.

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Vol. 416
No. 29

Wednesday
4 February 1981

PARLIAMENTARY DEBATES
(HANSARD)

HOUSE OF LORDS

OFFICIAL REPORT

Industry: The Public Sector

2.46 p.m.

Lord Beswick rose to call attention to the constant ministerial criticism of the public sector of the British economy; to the sale of profitable publicly-owned assets; and to the need for a more constructive and positive policy which recognises the value of a properly-balanced and integrated mixed economy; and to move for Papers.

Industry: The Public Sector

Debate resumed.

4.18 p.m.

Lord Harris of High Cross: My Lords, I would have waited just a little longer, but I am glad to begin by thanking the noble Lord, Lord Beswick, for the opportunity to join in this wide-ranging debate. If I may say so, without appearing to patronise, I thought that his speech was quite delightful and that it was, in parts, very plausible and that it tended in other parts towards excessive complacency.

I must at the outset apologise to noble Lords that a meeting of the Political Economy Club, of which I am the honorary secretary, will prevent me from staying until the end of the debate. But I shall read the full *Hansard* with special interest because in one respect at any rate I stand midway between the Opposition and the Government Benches on this matter.

I must confess that I do not make any complaint about ministerial criticisms of the so-called "public sector". But I do complain that Ministers have not acted sufficiently on their criticism in curbing the heavy cost of what I would rather call the present governmental conglomerate.

Government, in all its aspects, now spends one-half of the national income and it employs almost one-third of the total labour force. In raising its revenue it is inevitable that it should throw some burdens on to private industry. Taxes, after all, inflate costs; they discourage effort, they discourage investment and they can discourage employment. Yet much of this hard won tax revenue is then spent on shielding the nationalised industries from the very market disciplines to which private industry is fully subjected. A series of Written Answers last October from the noble Lord, Lord Cockfield, revealed the fact that the current and capital subsidies to the nationalised industries—excluding the NEB—amounted since 1960 to £26,000 million at 1978–79 prices.

Steel, which is dealt with quite separately for accounting purposes, has, in addition, already run away with £6,000 million since nationalisation in 1967. I do not believe that it is fanciful to regard this process as a perverse transfusion of finance from struggling, productive industry to a pampered and often less efficient sector under Government control and regulation. If we were to add the cost of nationalised health, nationalised education, nationalised housing and assorted local government services, the full burden on the private sector would be truly crushing.

I sometimes detect some scepticism in this House about economists and their conflicting theories. I think that is a healthy instinct, and it seems to me it would be particularly correct on the issue before us today. I want to say that throughout my lifetime much of the most damaging Government intervention of which I complain has been based upon a false deduction drawn from an abstract economic theory. This theory taught to every first-year economist, starts from a concept which is called "perfect competition". Perfect competition assumes that consumers and producers have complete knowledge of all relevant facts. It assumes that there is free mobility of all the factors of production, and it assumes an unmixed range of products that are homogeneous and compete only in price.

Not surprisingly, economists who come into the real world find that markets do not operate in full accord with this textbook model. But they then make the naive deduction—a misplaced deduction—that if private enterprise works "imperfectly", public intervention would necessarily work better. It has taken long decades of empirical experience to discover that Government failure is often so much worse than so-called market failures.

This word "public"—of which the noble Lord, Lord Beswick, made such effective use—is often a semantic pretence. I once recall seeing a notice board which gave the game away; it read simply "Public property—keep out". The plain truth is that the ordinary public have less access to the control of the National Coal Board or the BNOC than they have to ownership of Shell or ICI. The critical difference which makes public industries different from private industries is that the nationalised industries cannot go bankrupt, because the public can be made to pay their debts.

As the noble Earl the Minister said, where nationalised industries are monopolies they can sometimes collude with powerful trade unions to batten on the public as both taxpayers and customers. There are many examples which we could take, but the case of the National Coal Board is instructive. The oil cartel obligingly raised the price of the main alternative fuel ten-fold in the decade of the 1970s. Yet the National Coal Board, having raised its price six-fold in a decade, is to this day still a charge upon the Exchequer, and its coal is still more expensive than coal we could import from the United States or from Australia.

It is well known, especially to those who have been involved in nationalised industries, that they have often become the playthings of political expediency. There are many examples in many industries going back over the last 20 or more years. But my favourite example was revealed by one of the former colleagues of the noble Lord, Lord Beswick, a Labour Member of Parliament who is now going straight. Sir Richard Marsh has told how, when he was Minister of Transport in the late 1960s, he found that there was a railway line 90 miles long which lost £380,000 a year and carried six regular passengers. He set his heart on what may seem to be a rather modest ambition for an able Minister in a radical reforming Government: he set himself the objective of closing that uneconomic line. He has told how he mounted a strong case and brought it, with some confidence, before the Cabinet, where he reports it was turned down after very little discussion when the Welsh Secretary declared that that railway line happened to run through six marginal constituencies.

We must make these allowances when we talk of how the public sector will be run. There was once in Cambridge a Professor of Economics who understood the real world rather better than some of the present incumbents. His name was Alfred Marshall. When students used to urge on him that this and that problem should be solved by Government intervention, Marshall always used to ask the same question—you will find it in the " Memorials " of Alfred Marshall: " Do you mean Government all-wise, all-just, all-powerful or Government as it now is? "

The trouble with our mixed economy is that the frontier between the market and the political domain is drawn on no stable principle. Every extension of Government soon creates a pretext for further encroachments. I think that the noble Lord, Lord Beswick, said " Heaven help us if we leave everything to the market economy ". Of course the noble Lord is setting up an Aunt Sally. We need Government—we need effective Government—to fulfil quite specific tasks, well understood in the literature on the subject. We need Government to provide defence, to provide law and order, to guarantee minimum standards, to assist those poor or handicapped who cannot maintain themselves in a market system. We need Government—dare I say it?—to provide a stable monetary system.

But in Britain and elsewhere the mixed economy has degenerated into a muddled, mixed-up economy. It muddles the jobs which Governments have to perform with jobs which the market could do better. It muddles help for the needy with indiscriminate provision of welfare and other services for all, irrespective of need. It muddles compassion and good intentions with ill-chosen methods and perverse results.

I conclude with a simple question. When Governments of both parties have so often failed to live up to their hopes and promises, should not the noble Lord, Lord Beswick, and others set a more modest objective for politicians in the future? Let us suppose that we aimed at getting central and local government out of all activities which private enterprise could do better. We would then free politicians and their hard-pressed bureaucracies to concentrate on the limited range of tasks which Governments must discharge and which, in our experience, they have often discharged very badly indeed.

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Y AND CIVIL SERVICE SELECT COMMITTEE

<u>Velocity, Real £M3 and Private Sector Financial Wealth</u>

Note by the Treasury

At the meeting with Treasury officials on 18 March, the Committee requested additional information on the velocity of £M3, real £M3 and private sector financial wealth in relation totheir historical trends.

2. The FSBR, in discussing financial developments in 1980-81 pointed out that the real financial wealth of the private sector had been depressed in 1979 by the effects of high inflation and high interest rates and that the rapid growth during 1980-81 had restored it to a more normal level. Chart A plots real gross financial wealth (using the RPI as the deflator) and its trend over the past 17 years. The series for financial wealth used in this chart was constructed by Treasury officials using conceptually similar methods to those adopted by the CSO for sector balance sheets (see, for example, Economic Trends November 1980). The chart illustrates that the first quarter of 1980 was some way below trend and that the starting point for the coming financial year represents a more normal position.

3. As earlier Treasury evidence to the Committee has made clear, gross financial wealth appears to be an important determinant of the growth of £M3. It is therefore not surprising to find that the profile of real £M3, plotted in chart B, is quite similar to that of real financial wealth, although, of course, the slopes of the trend lines differ, and in particular that recent developments may be interpreted as a movement back towards the trend. (The trend which is shown in the chart has been estimated over the period 1963Q1 to 1980Q4, excluding data for 1972Q1 to 1974Q4. This exclusion reflects the fact that major institutional changes during that period may have seriously distorted the £M3 series, and is

consistent with the practice adopted in earlier submissions to the Committee.)

4. Chart C shows the path of £M3 velocity (the ratio of nominal GNP to £M3) over the period, and tells a broadly similar story. The trend shown has been estimated on the same basis as the trend of real £M3, excluding the 1972-1974 data. The recent reduction in velocity brings it from its position in early 1980 when it was noticeably above trend to its level at the start of 1981, much closer to the trend.

H.M. Treasury
24 March 1981

NOTES TO THE CHARTS

Chart A: Real Gross Financial Wealth

The nominal gross financial wealth series is unpublished data, prepared by Treasury officials. The chart shows this series deflated by the RPI (Jan 1974 = 100) expressed in logs. The trend shown is estimated on these log-levels for all quarterly data points from 1963 Q1 to 1980 Q4.

Chart B: Real £M3

The chart shows quarterly seasonally adjusted £M3 levels, deflated by the RPI (Jan 1974 - 100) expressed in logs. The trend is estimated on log-levels of the real £M3 series over the period 1963 Q1 to 1980 Q4 on all data points except 1972 Q1 to 1974 Q4.

Chart C: Velocity of £M3

The chart shows GNP-based quarterly £M3 velocity (the ratio of GNP at current prices seasonally adjusted expressed at an annual rate to the centred quarterly average of monetary stock seasonally adjusted) expressed in logs. The trend is estimated on the logs of velocity series over the period 1963 Q1 to 1980 Q4 on all data points except 1972 Q1 to 1974 Q4.

DRAFT

Chart A. Real Financial Wealth

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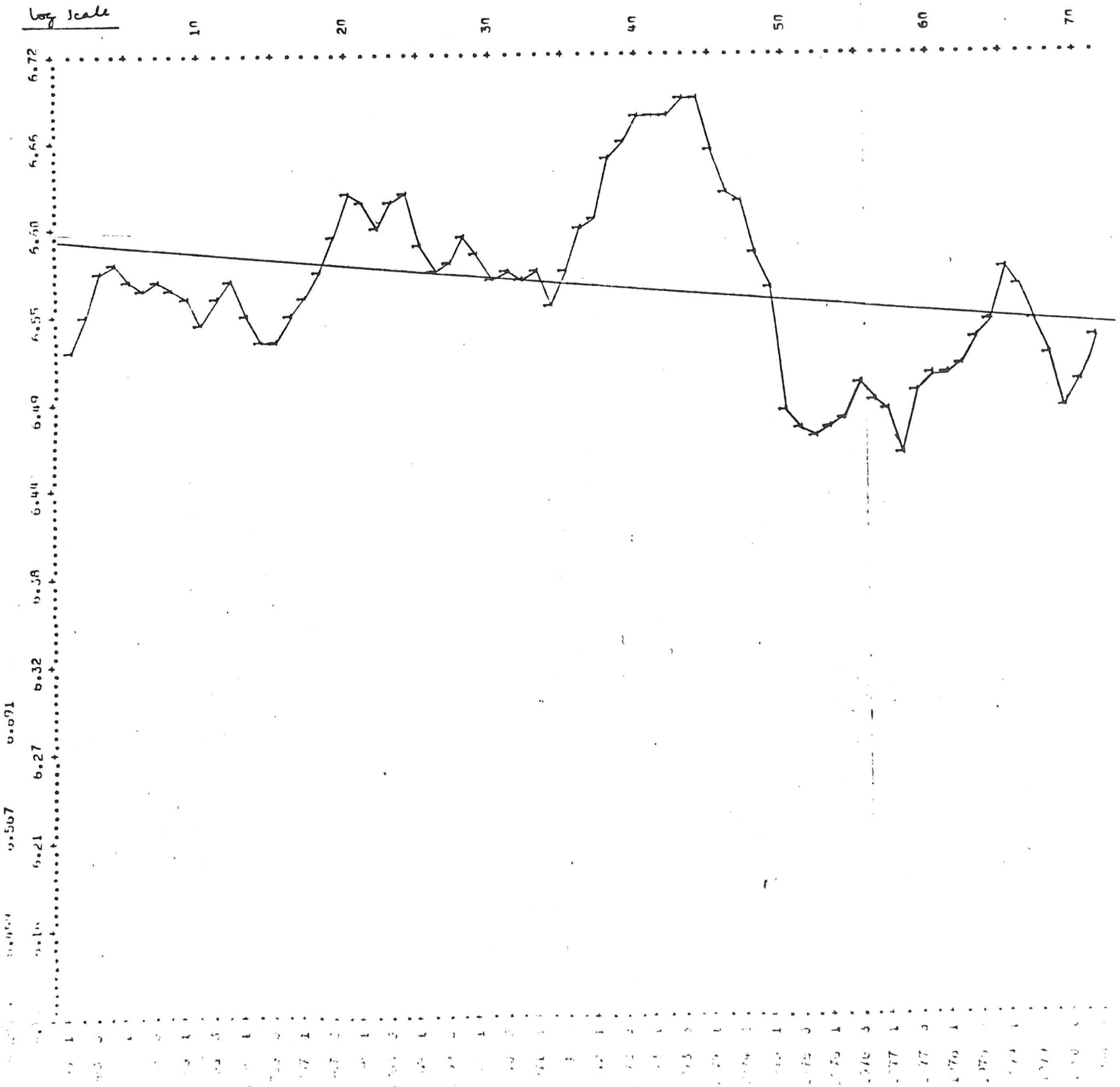

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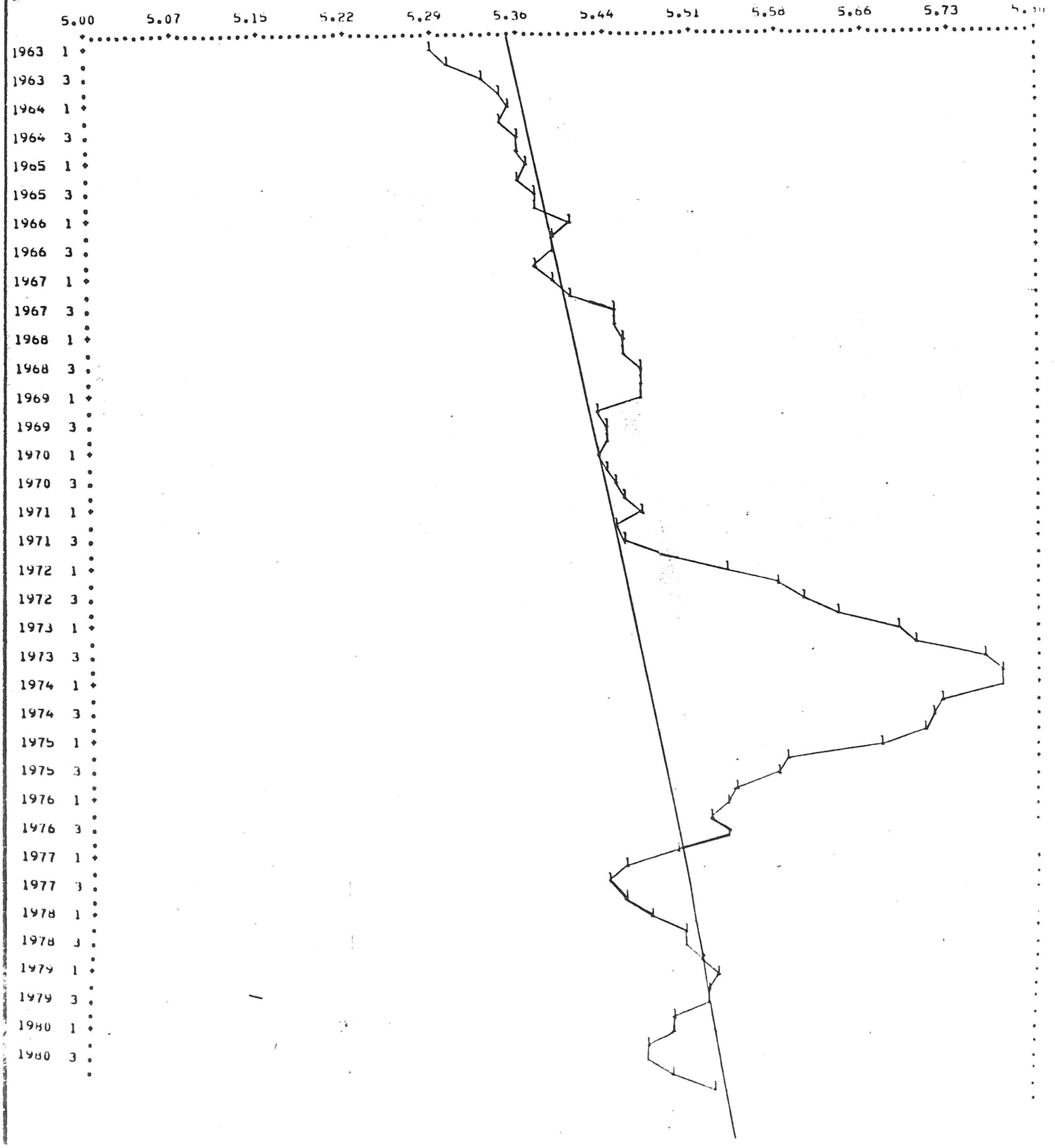
VARIABLE	MINIMUM	MEAN	MAXIMUM	INTERVAL 7.300-03
1 9 LREM3	5.295	5.490	5.776	



log scale

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Chart C. £M3 VELOCITY. (GNP-based)

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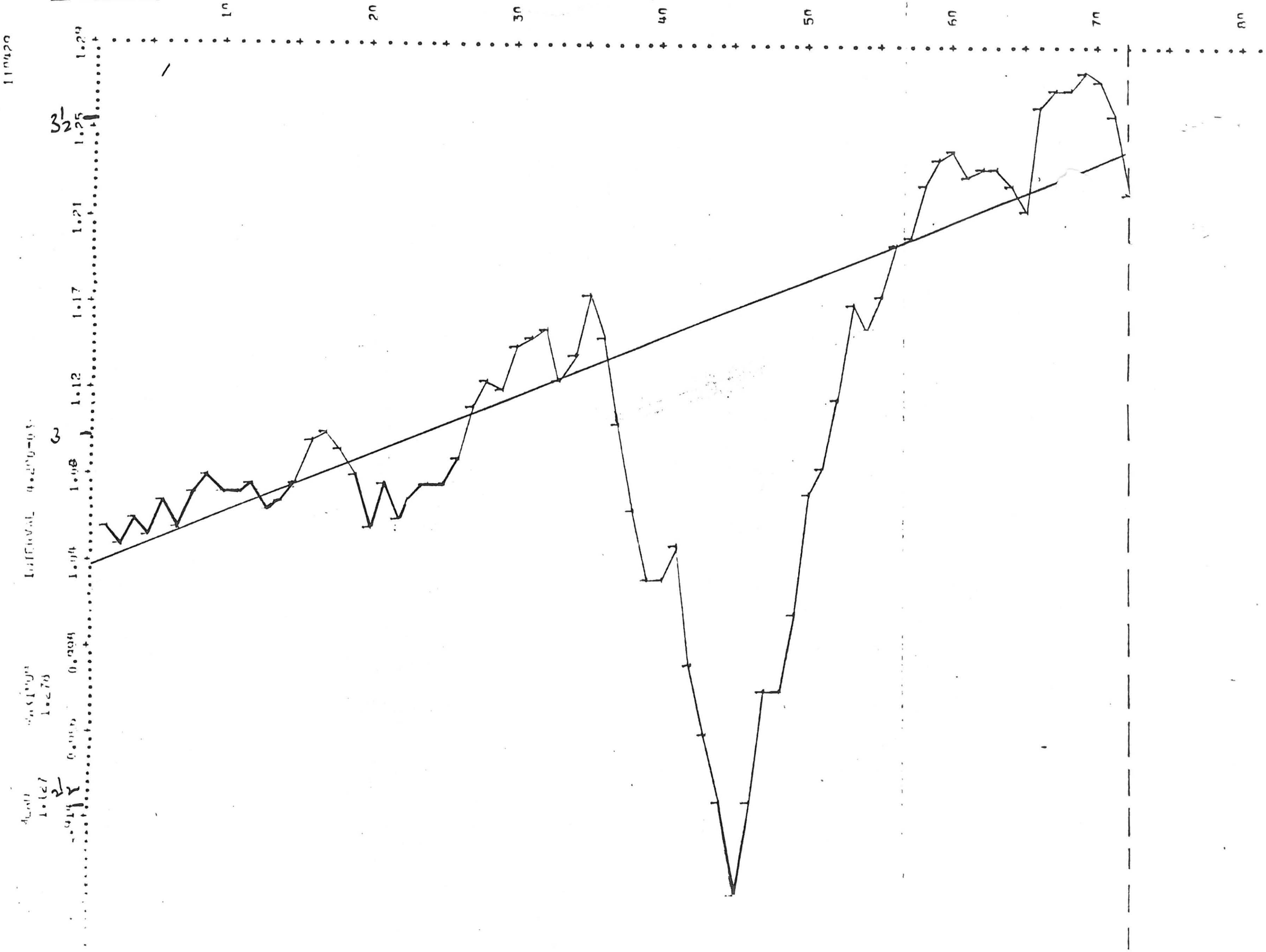
Log scale.



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C

ND CIVIL SERVICE COMMITTEE

BORROWING REQUIREMENT ON THE OECD DEFINITION

Note by H M Treasury

The Committee has asked for a note on what the borrowing requirement for 1980-81 and 1981-82 would be on the OECD definition.

2. The OECD uses, for the purpose of international comparisons, the concept of the general government financial balance. In terms of the United Kingdom financial statistics this consists of:

(i) the general government (ie central government and local authorities) financial deficit; <u>plus</u>

(ii) any liabilities of public corporations to general government that are written-off.

3. The main differences between the PSBR and the general government financial deficit are the exclusion from the latter of the public corporation sector and of general government financial transactions, including loans to other sectors of the economy and transactions in securities.

4. Estimates of the general government financial deficit for 1980-81 and 1981-82 are given in Table 15 of the Financial Statement and Budget Report (HC 197) (Line 28 of the general government column). However the figures of £8.8 billion and £3.8 billion for 1980-81 and 1981-82 respectively are not comparable, since some of the unallocated items (lines 36 and 37) of £1.4 billion within the PSBR forecast for 1981-82 will in the event be within the general government financial deficit.

5. Forecasts are not normally made of the amount of liabilities to general government which will be written-off in a year. Such writes-off are solely balance-sheet transactions which are not included in the FSBR. (They are reported in the Supplementary Statements to the Consolidated Fund and National Loans Fund Accounts.) The amount written-off in 1981-82 could be affected by the power to restructure the capital of the British Steel Corporation contained in the Iron and Steel (No.2) Bill now before the House.

HM TREASURY
<u>24 March 1981</u>

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3 D

NATURAL RATE EMPLOYMENT

Note by H.M. Treasury.

The level of unemployment at which inflation would remain stable in the Treasury model can be inferred from the equations determining prices and earnings. The coefficients in the earnings equation are not based on estimated relationships. In using the model for forecasts or policy simulations a considerable amount of judg~~e~~mental adjustment is applied to this sector. However, if the current equations are used without adjustment and if import prices grow in line with domestic prices, the level of unemployment at which inflation would remain stable in the model is about 5 per cent.

H.M. Treasury
24 March 1981

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E

STOCKBUILDING

NOTE BY HM TREASURY

The path of stockbuilding in the manufacturing and distributive sectors of the economy in recent years is set out in table 1. This shows that the fall in stocks in 1980 took place in all sectors and, within manufacturing, in all three components of stocks.

2. Table 2 shows the stock/output ratios for manufacturing. By the end of 1980, this ratio was at a high level by comparison with the average of 101 for the period 1975 to 1979. Because sales have fallen much less than output, reflecting the major contribution of destocking to the fall in output, the stock/sales ratio for manufacturing has risen much less. Reliable figures for this series are not, however, available.

3. Table 11 in the FSBR shows that further destocking of £2 billion is forecast in 1981. Some four-fifths of this is expected to be in manufacturing. The combination of this forecast of destocking with the forecast for manufacturing output given on page 27 of the FSBR results in a forecast of the stock output ratio, in manufacturing, of about 101 in mid 1982, very close to the average level over the period 1975-79.

H.M Treasury
24 March 1981.

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TABLE 1

VALUE OF PHYSICAL INCREASE IN STOCKS

1975 prices seasonally adjusted

£ million

PERIOD		TOTAL	MANUFACTURING				WHOLESALING	RETAILING
			Total	Materials and fuel	Work in progress	Finished goods		
Level of stocks at end of 1979		29,203	20,111	7,208	7,184	5,719	4,849	4,243
1972		-89	-288	-88	49	-248	173	26
1973		2,235	1,170	829	379	-37	432	633
1974		1,427	1,251	470	265	516	361	-185
1975		-1,456	-1,101	-922	-212	33	-249	-106
1976		722	363	27	265	71	131	228
1977		1,064	580	129	215	237	412	72
1978		648	335	-18	244	109	-15	328
1979		765	166	-105	-67	338	178	421
1980		-2,050	-1,388	-692	-471	-224	-439	-224
1977	Q1	474	252	122	116	14	103	119
	Q2	493	224	7	30	186	237	32
	Q3	-80	11	2	-27	36	-40	-51
	Q4	177	92	-3	95	-	113	-28
1978	Q1	147	74	-1	13	62	34	39
	Q2	177	85	-34	44	75	-49	141
	Q3	156	69	-8	36	41	21	66
	Q4	168	108	26	152	-70	-22	82
1979	Q1	46	-115	-94	-76	55	75	87
	Q2	367	153	97	77	-22	152	63
	Q3	226	204	- 6	82	128	-73	95
	Q4	125	-76	-103	-149	177	25	176
1980	Q1	-667	-471	-228	-181	-62	-116	-80
	Q2	-176	60	-32	-30	123	-80	-157
	Q3	-383	-279	-188	-45	-46	-112	8
	Q4	-824	-698	-244	-215	-239	-131	5

stimates are shown to the nearest £ million but should not be regarded as accurate to this degree.

TABLE 2

STOCK : OUTPUT RATIOS 1975 PRICES

STOCKS LEVEL END 1974 = 100

Seasonally adjusted	Total	Materials and fuels	Work in progress	Finished goods
1970	95	91	98	96
1971	96	91	98	101
1972	91	86	96	95
1973	89	88	92	87
1974	96	97	97	92
1975	102	97	104	107
1976	98	91	102	104
1977	100	92	105	107
1978	101	91	106	110
1979	102	91	108	113
1980	110	94	115	129
1979 1	103	91	109	113
2	99	89	105	108
3	104	92	110	114
4	103	90	108	117
1980 1	105	91	110	121
2	108	93	112	127
3	111	94	116	132
4	114	98	121	136

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(5)

F

1981-82 PSBR PROJECTIONS AND FORECASTS

Note by HM Treasury

The 1980-81 FSBR gave illustrative fiscal projections consistent with the medium term financial strategy. These were based on the public spending plans set out in Cmnd 7841 and a conventional assumption of tax rates and allowances fixed in real terms. The projections for 1981-82 implied a PSBR of some 3 per cent of GDP. As the FSBR explained, the PSBR figures given were not targets. Fiscal policy for any particular year would be framed consistently with declining monetary growth in the circumstances of the time.

2. As the Chancellor explained in his Budget speech on 10 March 1981 (OR col 763) the projected 1981-82 PSBR of 3 per cent of GDP translated into an absolute figure of about £7½ billion at forecast 1981-82 outturn prices.

Pre-Budget PSBR

3. The Chancellor went on to explain that, taking account of the increase in National Insurance contributions announced in November 1980, and the expenditure plans in Cmnd 8175, the PSBR for 1981-82 would have been £14 billion before allowing for any Budget changes in nominal tax rates and allowances. (On the alternative assumption of maintenance of tax rates and allowances in real terms, the corresponding pre-Budget PSBR would have been about £15 billion.)

Reasons for changes in the fiscal outlook

4. As was explained in the Treasury note placed in the House of Commons Library on 12 March 1981 (see WA col 387 reply to a question from Sir William Clark MP) much of the increase in the prospective PSBR between the projection in the 1980-81 FSBR and the position foreseen in advance of the 1981 Budget was due to increased public expenditure. General government expenditure for 1981-82 is projected following the Budget at some £119½ billion cash, compared with the equivalent of £113½ billion cash envisaged a year earlier.

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5. The net increase of £6 billion reflects a variety of "estimating" and "policy" changes which have occured in the course of the past year. Of the latter, those announced in the Chancellor's statement last November included reductions amounting to some £1.4 billion cash and the negotiated reduction in the EC Budget contribution (worth about £.8 billion cash). The expenditure measures in the 1981 Budget added some £.3 billion cash to the plans in Cmnd 8175.

National Insurance Contributions

6. The increase in the rate of employees' National Insurance contributions announced in November 1980 and now the subject of the Social Security (Contributions) Act 1981, is estimated to make a contribution of about £1 billion to revenue in 1981-82.

HM Treasury
24 March 1981

180 120 G

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Sir Douglas Wass
Mr Burns
Mr Middleton
Mr Battishill
Mr Burgner
Miss Brown
Mr Cassell
Mr Evans
Mr Monck
Mr Allen
Mrs Gilmore
Mr Turnbull
Mr Ward
PEX
Mr Folger
PS/Customs
PS/Revenue
Mr Ridley

PAPERS FOR TREASURY COMMITTEE

I now attach a sixth paper for the Treasury Committee - that on the public expenditure outturn in 1980-81 agreed between GEP and GEA. If you agree it, it could go across with the others tonight or separately tomorrow morning.

2. It may strike the Committee as being uninformative - particularly on the analysis between volume and costs. The hard truth is that we only have partial information, particularly from local authorities, for a year that has not yet ended!

3. I also attach a slightly revised version of the note on the borrowing requirement on the OECD definitions. (Now ~~attached~~ incorporated in Mr Folger's minute of 23 March).

J.M.B.

J M BRIDGEMAN
24 March 1981

25/3/81.

Real PSBR / Monetary Report Reply 121

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Real PSBR/ Monetary Report Reply. Speaking Notes

CHANCELLOR

cc Chief Secretary
Financial Secretary
Mr Middleton
Mr Burns
Mr Bridgeman
Mr Cassell
Mr Monck
Mr Unwin
Mr Folger

TREASURY SELECT COMMITTEE: 25 MARCH

A. "Real PSBR"

1. I attach the quotes from Mr Goodhart's evidence to the Select Committee mentioned by Mr Unwin at your meeting yesterday. Apart from the answer to question 200 of 7 July 1980 that to question 197 - stressing the need in practical terms for the PSBR to be compatible with monetary targets - is also useful.

B. Formal requirement for reply to monetary Report

2. On the question of a formal reply to the Select Committee's Monetary Report the position is as set out in Mr Unwin's minute of 20 March, ie the Government are under no obligation to reply in any particular form (though most Committees' reports have been answered in the form of a published reply or in a Ministerial letter). Where, as in this case, there are no specific recommendations it is possible to avoid a written reply altogether, as we did in the case of last year's Report on 'The Budget and the Government's Expenditure Plans'.

3. The burden of that earlier report was dealt with in a speech by the Chancellor in the House on 7 May. On this occasion the Committee could be referred to Ministerial speeches since the Budget and could be told that their comments on the Government's economic strategy would be taken into account in forthcoming speeches.

4. The Clerk to the Committee has already indicated his view that no written reply will be necessary.

5. It would, of course, be courteous to inform the Committee that the

Government does not intend to furnish a formal reply to their Monetary Report. If the occasion to do so does not arise this afternoon we will need to consider sending a letter across.

Harry Bush

H J BUSH

25 March 1981

(Mr *Goodhart*) Are you suggesting that the level of interest rates is not high enough?

194. No, I am suggesting that the rate of inflation is much higher than it was in the nineteenth century.

(Mr *Goodhart*) That is a suggestion that the level of real interest rates, the real cost of interest rates, is not all that high at the moment. It seems high to manufacturing companies because they have no profits to put it against and because they are under cash flow pressure. But it is not necessarily that high to large areas of the British economy.

Chairman: I will not tell you what my constituents think of interest rates, particularly in the farming community.

Mr *Eggar*

195. I have one question on the whole question of the money supply. Is the greatest criticism of monetary policy not that in fact we have had some control over the amount of monetary growth since 1976 and yet we still have a rate of inflation over 20 per cent?

(Mr *Walker*) One of the observations I want to make is, yes, it is indeed the case that we have had a monetary policy of something like the present form since 1976. Of course a lot of other things have also happened since 1976. It is important to bear in mind the significance of external factors. For example the real oil price fell by 15 per cent in 1978, a year when inflation, if you do it in terms of the twelve-month RPI, fell to 8 per cent or possibly a little bit below at one point. We had by contrast in 1979 an increase in the nominal oil price of over 100 per cent. So the world economy backcloth against which monetary policies are being pursued has been a dramatically changing one. I talked about oil prices as the biggest single factor. There were of course other factors like the behaviour of other commodity prices which fell sharply in the period leading to the inflation trough in 1978 and of course, for a spell at any rate, very significantly thereafter.

196. I would just make the comment that I would have thought that a monetarist would not believe that the price of oil, for instance, should affect the rate of inflation if the monetary policy is working correctly. I will now go on to the PSBR. One of the most remarkable things about the evidence we have received from various different quarters has been the way in which, with the exception of Professor Minford, all the commentators have denied that strict control of the PSBR is a necessary prerequisite for effective monetary control. Does the Bank really believe that that link is essential?

(Mr *Goodhart*) Analytically one understands clearly what Professor Friedman and the monetarists are saying—analytically.

197. And Professor Kaldor.

(Mr *Goodhart*) And Professor Kaldor and indeed I would have thought most economists of most professions have argued that you can have a quite wide range of differing borrowing requirements and achieve a particular monetary target by changing the mix of the fiscal policy on the one hand and interest rates on the other. While that may be the case analytically, in practice I do not think there is a single central banker who I have heard or read any statements from over the course of the last decade who has not emphasised that in practical terms unless the borrowing requirement of the Government is maintained consistently with the monetary targets the pressures on that monetary policy will be such that the monetary policy will either have to act quite unacceptably harshly on the private sector or all will go bust. So for practical purposes there is a need for consistency whatever the case may be in pure theory and in pure analysis.

198. There may be a need for consistency but surely we are talking about relative peaks and troughs of PSBR. Would you not for instance agree that in times of recession PSBR should be allowed to rise?

(Mr *Goodhart*) That is not inconsistent with the achievement of monetary targets. Allowing a PSBR to rise steadily in a trend rate, if you like the underlying rate of growth in the PSBR, allowing that to rise whilst at the same time you are trying to bring monetary growth down, would, I would suggest, be inconsistent. It is the underlying trend rates that you have to bring about consistency in.

199. But in order to achieve consistency do you ignore the level of economic activity in the country?

(Mr *Goodhart*) No. The medium-term financial plan—as I recall, I do not have a copy with me—makes it quite clear that the PSBR will vary and can be allowed to vary as the economy varies cyclically.

200. What about the concept of the real PSBR? Is this a concept which you think has any advantages rather than going for nominal PSBR?

(Mr *Goodhart*) If you are going to adjust the real PSBR you have to remember that you have to adjust the other sectors also in real terms and the counterpart of the change in the real PSBR is equally a change in the real position of the private sector. So if you are going to look at the real PSBR and say it was that much lower, equally you would have to look at the personal sector and say that adjusted in inflation terms the savings ratio of the personal sector did not actually rise. However you care to look at the statistics the underlying position of the economy remains unchanged.

201. In other words, to be logical you have got to change all your different figures and all the aggregates you are looking at in real terms?

(Mr *Goodhart*) There is a reasonable case, not only for having inflation adjusted accounts for the company sector, indeed not only a reasonable case but an overwhelming case, there is a considerable case for looking at inflation adjusted accounts throughout the whole of the national income statistics. The CSO might think of that.

202. On page 10 in your evidence, in the answer to question 9, you say quite clearly "The trend size of the PSBR should be modified to take account of changes in the proportion of the national capital stock within the public sector". If you accept that do you not think that the same logic means that the PSBR should be modified to take account of the changes of the investment programmes of the nationalised industries, ie those industries that are already within the public sector? In other words should not planned increases in the investment programmes of existing nationalised industries, be reflected in an increased PSBR and should that not be clearly stated by the Government?

(Mr *Goodhart*) Again that is not a question for the Bank really. You are going to be talking to the Treasury and I recognise that it is a valid question at the moment but I am not sure that it is one for us.

203. But, with respect, you have just told me about the necessary trend and consistency of the PSBR and one of the things that goes to make up the PSBR is quite clearly the nationalised industries and their borrowing power.

(Mr *Flemming*) But what is stated is that the trend size of the PSBR should reflect the proportion of the capital stock in the public sector. It does not say that you should redefine the PSBR every time there is an agreement with a nationalised industry to change its investment plans.

204. Do you not think there would be some advantages to that?

(Mr *Flemming*) The expenditure by that nationalised industry would have to be financed and would be a part of the borrowing requirement of the public sector.

Dr *Bray*

205. Is the difference between the nationalised industry investing and a private industry investing, of any relevance?

(Mr *Flemming*). That is a question about the relevance of the PSBR as opposed to other demands for finance. But if the question is how large is the public sector borrowing requirement and we have a definition of the PSBR it includes the financing requirements of industries in the public sector and does not include those that are in the private sector.

Mr *Eggar*

206. So you see no advantage in changing that definition?

(Mr *Flemming*) In terms of definition I would see no advantage in changing it. If there were a PSBR target, which there is not, the question would be different. Obviously such a target would be the sum of the planned expenditures that were to be financed by borrowing and would be revised

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1. MR WICKS NCW 24-3

2 MR FOLGER

cc Mr Bridgeman
Mr Cassell
Mr Unwin
Mr Battishill
Mr Evans
Mrs Gilmore
Mr Wiggins
Mr Thornton

TREASURY COMMITTEE TODAY: FURTHER BRIEFING

I attach further briefing on energy prices, following yesterday's press conference by the CEGB. This seems to have been handled badly. The industry did not clear their line in advance with the Department, although we understand that a Departmental press officer was present at the briefing.

2. I attach defensive briefing for the Chancellor this afternoon. Any more detailed or technical questions should of course be referred to Mr Howell.

Jane Henderson

MS J E HENDERSON
25 March 1981

SUPPLEMENTARY BRIEFING FOR TREASURY COMMITTEE APPEARANCE: ELECTRICITY PRICING PACKAGE

Background

In the Budget you announced an addition of £45m to the electricity industry's EFL for 1981-82 to enable them to offer certain pricing concessions to large intensive users of electricity. These involve:

- New load management terms so that larger consumers who can adjust demand at short notice can cut their costs.

- Additional flexibility in pricing be Area Boards for customers with special agreements.

Mr Howell's press notice said that together these measures could y ield benefits of up to 8 per cent for some customers.

2. Today's Financial Times and Guardian report on yesterday's press conference by the CEGB at which they gave further details of the load management measures, which will give benefits of up to 4 per cent to some consumers (press extracts attached). The CEGB are reported to have said:

i) That industrial consumers will be entitled to price reductions under the new load management category only if they can reduce their power consumption at short notice - possibly as little as 15 minutes.

ii) The new load management category would not be a permanent feature of the tariff structure; it was made possible because of excess capacity and because load reductions saved the Board from having to operate expensive gas turbine plant which is to be phased out by 1983.

iii) The CEGB "is resigned to missing its financial target for the three years to 1983" (note: Mr Howell wrote to colleagues on 13 March saying that he had no plans to revise the financial target for the electricity

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Elec Prices

industry at present, but that he was expecting the industry to make proposals).

3. The CIA and BISPA are reported to have said that (i) and (ii) made the new scheme "trivial" and of benefit to only a handful of their members.

Line to Take - Defensive

4. All these matters are for the Department of Energy, but if pressed you can draw on the following:

(i) Are the Concessions only Temporary? We shall of course be discussing with the industry the implications of maintaining the measures announced in the Budget for the later years in the Investment and Financing Review. The Department of Energy will continue to monitor closely comparative energy prices to industry.

(ii) Only a Handful of Consumers will Benefit: the new load management category announced by the CEGB will help those consumers who can vary their loads at short notice. Steel and chemical companies may well be among those who benefit. Discussions are now underway between the Area Boards and those customers who may be able to benefit when the new bulk supply tariff is introduced on 1 April. In addition to the load management measures, the Electricity Council will be announcing details of the additional flexibility to be offered by Area Boards to customers on special agreements. These should enable some customers to reduce their costs by a further 4 per cent.

(iii) The Industry says that it will miss its Financial Target: the financial target announced by the Secretary of State for Energy just over a year ago with the agreement of the industry is designed to run for 3 years. It has been in operation for just under 12 months. I understand that no proposals have been received from the industry regarding their ability to meet the target. If the industry expects difficulty in meeting its target, they will no doubt pass this information to the Department of Energy so that discussions can be held.

Elec-tricity Prices Spain North

Reference GUARDIAN 25 MAR F

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CEGB reveals its 'trivial' energy cutting scheme

By James Erlichman,

The Central Electricity Generating Board yesterday announced details of its new "load management scheme" which it claims could cut the electricity bills of heavy industrial users by up to 4 per cent.

Big industrial consumers will be entitled to reductions if they agree to cut the power used in their plants drastically at just 15 minutes notice.

The scheme, announced under the CEGB's 1981-82 bulk supply tariff comes after months of protest about high energy costs from the chemical, steel, and paper industries and follows the Chancellor's £168 million energy aid package announced in the Budget.

The Budget package effectively gave the electricity industry £45 million to spend in finding "greater flexibility" toward large industrial consumers. The Government later indicated that this could mean electricity price cuts of up to 8 per cent for some industrial users.

But private industry attacked these concessions as derisory after citing a report from the National Economic Development Council which showed that industrial electricity prices were between 10 and 35 per cent lower on the Continent.

Industrialists were even more scathing last night when they saw the first practical evidence of how the Budget energy package would be applied.

The Chemical Industries Association attacked the CEGB load management scheme as "trivial" and the British Independent Steel Producers Association described it as "a mere illusion."

The CEGB loses money every time surges in demand force it to switch on inefficient power generating plant. It says savings can be made, which will be passed on to customers by the area boards, if companies agree to reduce power in their plants drastically at 15 minutes notice.

Such a load management scheme with less stringent conditions is already in operation. But the new scheme, industrialists claimed last night, was largely unworkable because the cost in lost production in meeting the electricity cuts on such short notice would outweigh the 4 per cent saving on the tariff.

The Chemical Industries Association said that only around 10 per cent of its members would even qualify for the scheme and "only a handful of these would find it worthwhile."

Even the CEGB conceded yesterday that the scheme was a "temporary palliative" designed to help British Industry toward recovery.

But both the CIA and BISPA warned last night that the measure would do "next to nothing to offset the threat of closure which many of their loss making members now face."

The Electricity Council, which has already announced 15 per cent increases for industrial users, is expected to announce its own separate schemes for "greater flexibility" within a fortnight.

Reference...188

"EXTRACT FROM THE
FINANCIAL TIMES"
DATED: 25-3-81

FT 25-3-81

Power discounts will be temporary

BY MARTIN DICKSON, ENERGY CORRESPONDENT

TARIFF concessions announced in the Budget for large industrial electricity users will be a temporary measure. They are unlikely to last more than two to three years.

This emerged yesterday when the Central Electrity Generating Board announced its bulk supply tariff for 1981-82—the wholesale price at which it sells power to Area Electricity Boards.

As indicated in the Budget, the CEGB's load management system for large industrial consumers is being extended.

Under the existing system customers can get electricity price discounts if they agree to reduce their load at times of peak national demand. Under the new C category load management system they will get bigger discounts if they agree to much shorter notice of the need for power reduction—possibly as little as 15 minutes.

The CEGB said category C supplies should not be regarded as a permanent feature of the tariff structure.

It was possible because of temporary excess plant capacity and because it saved the board operating expensive gas turbine plant used to meet sudden demand surges. But excess plant was being phased out and by 1983 cheap hydro-electric power from the Dinorwic station being built in Wales should be doing much of the gas turbines' job.

It is not clear how many industrialists will be able to use the new tariff, as many need more than 15 minutes' notice of a power reduction. Some steel and chemicals companies have said they can comply.

The CEGB estimates the tariff could reduce the maximum demand on its system by 5 to 10 per cent.

The move is likely to cut the fuel bills of companies involved by only about 4 per cent. A second concession announced in the Budget—greater pricing flexibility by Area Boards to large customers—could mean a total reduction of about 8 per cent for a few large users.

The Government has extended the industry's external financing limit by £45m to allow it to give these concessions.

Yesterday's bulk supply tariff increases make up much of the retail price rises already announced by area boards. Domestic consumers will pay about 11.5 per cent more from April 1, while industrial users face increases of 15 to 16 per cent in the next 12 months.

The supply industry expects the increases to stick until April 1982 provided the price of coal, its major fuel, does not go up by more than the November rate of inflation. This in turn depends largely on the level of the next miners' pay settlement.

Because of the recession and the need for concessions to industry the CEGB is resigned to missing the financial target the Government set it for the three years to 1983—an annual average return of 1.8 per cent on net assets valued at current cost.

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ELECTRICITY PRICES AND THE BUDGET (Note by Dept of Energy)

The package for large industrial electricity consumers announced by the Chancellor was:-

(i) The electricity supply industry in England and Wales would offer a new arrangement to customers who can take advantage of load management terms. This will mean that larger industrial consumers who can adjust their demand at short notice can cut their electricity costs;

(ii) additional flexibility will be introduced by area boards into their special agreements with industrial customers with the aim of reducing as far as possible the impact of rising electricity costs.

These measures can yield benefits of up to 8 per cent on costs to some larger industrial consumers. They will affect the industry's ability to meet its financial target and the Government has adjusted its 1981-82 EFL of -£210 million by £45 million. Today's press reports relate to (i) only: (ii) will offer further savings of up to 4 per cent.

These moves were in addition to the active role which area boards had already been taking in ensuring that their industrial customers obtained maximum benefit from the flexibility available in existing tariffs.

The Government recognised that this package could not eliminate the differences in electricity prices to large users which reflect fundamental differences in electricity cost structures internationally. For example, France has substantial hydro electric capacity and nuclear capacity which is not available to the UK whose electricity generation is currently based largely on expensive coal. The only complete solution to the UK problem is to modernise the coal industry and press ahead with the nuclear power programme announced by the Secretary of State for Energy in July last year.

190 123

MR. Middleton

1. MR BATTISHILL ✓ [initials] 25/3
2. MR FOLGER

cc: Mr Bridgeman
Mr Cassell
Mr Unwin
Mrs Gilmore
Mr Wiggins
Mr Marshall (I.R.)

PETER RIDDELL AND THE TREASURY COMMITTEE:
THE TAX BASE

The Chancellor will be familiar with the issues involved in Peter Riddell's questions about the tax base from his discussion with us earlier this week of the report of the Working Group on Tax and Savings.

2. I suggest that there is a distinction to be drawn between mortgage interest relief and the rest. On the former, there is a clear statement from the Prime Minister as long ago as July 1979 (copy attached) that there was no intention of reducing it or phasing it out.* This was effectively repeated by the Financial Secretary on 23 January this year when he announced the study into mortgage interest relief at source (MIRAS). On the other reliefs, the Chancellor has concluded that reductions would be politically difficult, if not impossible, even though, especially in the case of life assurance premium relief, there may be a strong case of principle for making them. No public statement has been made about this, however, and it could be embarrassing in view of the commitment to widening the tax base.

Christopher Kelly
C W KELLY
25 March 1981

* The Chancellor has asked us to do some more work in this area; but the form of words below talks about not "phasing out mortgage interest relief"

[initials] 25/3

TAX [illegible]

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If the Chancellor is questioned on this point, I suggest that he might answer along the following lines:-

"I have no intention of phasing out mortgage interest relief. As for the other reliefs, there is of course a dilemma. On the one hand, I would like to widen the tax base, so as to reduce the rate of tax, and eliminate potential distortions in the savings markets. On the other, I am conscious that successive Governments have thought it right that certain forms of saving thought to be socially desirable, like good pensions, should be encouraged as they are in other countries. There is also the difficulty with many of these reliefs of the expectations built up legitimately over the past and extending far into the future. I have, of course, already reduced the rate at which relief is given to life assurance premiums from 17½ to 15% with effect from this April in line with the reduction in the basic rate of tax. I have no plan at present to make any further changes in this area, but I will continue to keep the possibilities under review.

"It is not the Govt's intention to restrict the amount of [mortgage interest] relief to which taxpayers are entitled." (FST 23.1.81)

See FST, PM [illegible]

OR H of C 27/7/79 col 516

192125

MORTGAGE INTEREST (TAX ALLOWANCES)

Mr. Cryer asked the Prime Minister what consideration she is giving to reducing tax allowances on mortgages for owner-occupiers; and whether it is present Government policy, or is being considered for future implementation.

The Prime Minister: None and no.

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EXTRACT FROM FINANCIAL SECRETARY'S SPEECH, 23.1.81 [OR vol 997 no 32 cols. 596-7

I should like to take this opportunity to make an announcement about the admimistrative arrangements for giving effect to mortgage interest relief. The present arrangements for dealing with tax relief on mortgage interest go back more than 50 years. When interest rates were more stable, and when there were fewer taxpayers and house buyers, they worked well.

However, in recent years, the arrangements have become increasingly costly to administer. When interest rates change, PAYE taxpayers can frequently over-pay or under-pay tax. My right hon. and learned Friend the Chancellor of the Exchequer is therefore asking the Inland Revenue to study, together with the major lending bodies, how the arrangements for giving relief might be altered so as to make them more efficient.

In 1973, as the House will recall, a deduction of tax arrangement was considered as part of the tax credit scheme. At the time, there were difficulties with that proposal. However, much has happened since 1973. After an interval of eight years, it is sensible to go over the ground again.

We have been encouraged by the success of the scheme for giving life assurance relief at source by means of deduction from the premiums. We have a broadly similar mechanism in mind for mortgage interest, but it will be for the joint study to work out the details of any new arrangements.

I should make it clear that the purpose of that study is to explore the possibilities. No decision will be reached until it has been completed. I also emphasise that the study will be concerned only with the mechanism for giving tax relief. It is not the Government's intention to restrict the amount of relief to which taxpayers are entitled. Clearly, any new arrangements could only give basic rate relief at source. It follows, therefore, that relief for higher rate tax would be given separately.

The study will of course need to take account of the option mortgage scheme, but again I want to make it clear that the Government do not have in mind an extension of that scheme. An Inland Revenue press release on the proposed new administrative arrangements for mortgage interest relief is being issued today.

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- PAY MODERN FSBR Part III, §15, 18, 22 (p23-24)

- ESPEC. PUB. SECTOR Budget speech – public sector pay bill rose twice as fast as private sector

through overall shape of Budget – SECTORAL BALCE: THOR CASE NOT

– INT. RATES: " " "

A main Budget priority in determining fiscal stance (given anti-inflation reqts.) – EX. RATE can't be controlled consistently with monetary discipline

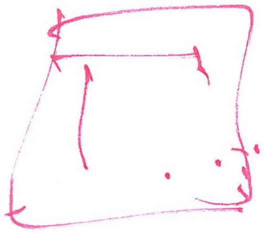
– CURRENT | CAPITAL: see G1

– REMEDY for ~~TURN ROUND~~ UPTURN see J

– INFLN DOWN IS OBJECT

– INFLN IS COMING DOWN

– ∴ MONET. CONDNS R TIGHT



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MR FOLGER

c Mr Battishill
Mr Bridgeman
Mr Cassell
Mr Unwin
Mrs Gilmore
Mr Wiggins
Mr J Hibberd
Mr Thornton

TREASURY COMMITTEE TODAY: FURTHER BRIEFING

I attach some notes on unemployment covering the points in the Lombard column.

GR Izatt

H P EVANS
25 March 1981

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FINANCIAL TIMES: LOMBARD 25 MARCH: BRIEFING NOTES ON UNEMPLOYMENT

The unemployment statistics count those who register. There are other people, out of work but seeking it, who do not register (just as there are those who register but are not available for work). Measuring the unregistered unemployed is extremely difficult and detailed questions can reasonably be referred to the Secretary of State for Employment.

There are indications that in this cycle, the increase in the numbers registered as unemployed has probably been <u>less</u> than the fall in employment; whereas in the 1974-76 period, the rise in unemployment exceeded the fall in employment.

<u>Discouraged workers</u>

The implication of the rise in unemployment in the course of 1980 being less than the fall in employment is that there has been a rise in unregistered unemployment or a fall in the number of workers actively seeking work or both. There is evidence of older males (55 and over) retiring from the labour force to a greater extent than had been foreseen; and evidence of married women not seeking jobs as actively as before.

Such workers or some of them may be discouraged from seeking work by limited employment opportunities. This is probably especially true of married females and we might expect their participation rates to recover when the economy picks up. This is an area where there is little hard evidence for the most recent past.

<u>Unemployment over 2 million</u>

Unemployment has been on a rising trend over the past twenty years. The Government has increased support for such selective employment measures as the Youth Opportunities Programme.

Copies to:

Principal Private Sec.
PS/Chief Secretary
PS/Financial Secretary
Sir D Wass
Mr Burns
Mr Middleton
Mr Bridgeman
Miss Brown
Mr Cassell
Mr Monck
Mr Evans
Mr R I G Allen
Mrs Gilmore
Mr Turnbull
Mr Folger

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H M Treasury

Parliament Street London SW1P 3AG

Switchboard 01-233 3000
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J B Unwin
Under Secretary

D F Hubback Esq CB
Treasury and Civil Service Committee
3rd Floor
St Stephen's House
St Stephen's Parade
Victoria Embankment
LONDON SW1

25 March 1981

Dear David,

EXPLANATORY NOTES

1. Following the Committee's session with officials on 18 March we discussed the various requests for elucidation of particular points which arose. We agreed to try to meet requests for information on a number of points. I am sorry that, despite best efforts, I have not been able to get material over to you earlier.

2. I now attach four notes:

1. velocity, real money supply and private sector financial wealth,

2. OECD definition of public borrowing,

3. 1981-82 PSBR projections and forecasts,

4. public spending in 1980-81.

3. The Inland Revenue are letting you have separately a note on Inland Revenue manpower and the Budget.

4. I fear that it has simply not proved possible to get to you today a note on the distributional points raised by Mr Meacher. We are still working on this and will let the Committee have it as soon as possible.

5. The Committee also raised points on the relationship between inflation and unemployment on the Treasury model and on destocking.

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6. On the former, the level of unemployment at which inflation would remain stable in the Treasury model can be inferred from the equations determining prices and earnings. The coefficients in the earnings equation are not based on estimated relationships. In using the model for forecasts or policy simulations a considerable amount of judgmental adjustment is applied to this sector. However, if the current equations are used without adjustment and if it is assumed that import prices grow in line with domestic prices, the model would suggest that the level of unemployment at which inflation might be expected to remain stable is about 5 per cent.

7. On destocking, table 11 in the FSBR shows that further destocking of £2 billion is forecast in 1981. I can now tell you that some four-fifths of this is expected to be in manufacturing. The combination of this forecast of destocking with the forecast for manufacturing output given on page 27 of the FSBR results in a forecast of the stock output ratio, in manufacturing, of about 101 in mid 1982 (end 1974 = 100) very close to the average level over the period 1975-79.

Yours sincerely

Simon Unwin

J B UNWIN

TREASURY AND CIVIL SERVICE COMMITTEE

BORROWING REQUIREMENT ON THE OECD DEFINITION

Note by H M Treasury

The Committee has asked for a note on what the borrowing requirement for 1980-81 and 1981-82 would be on the OECD definition.

2. The OECD uses, for the purpose of international comparisons, the concept of the general government financial balance. In terms of the United Kingdom financial statistics this consists of:

(i) the general government (ie central government and local authorities) financial deficit; plus

(ii) any liabilities of public corporations to general government that are written-off.

3. The main differences between the PSBR and the general government financial deficit are the exclusion from the latter of the public corporation sector and of general government financial transactions, including loans to other sectors of the economy and transactions in securities.

4. Estimates of the general government financial deficit for 1980-81 and 1981-82 are given in Table 15 of the Financial Statement and Budget Report (HC 197) (Line 28 of the general government column). However the figures of £8.8 billion and £3.8 billion for 1980-81 and 1981-82 respectively are not comparable, since some of the unallocated items (lines 36 and 37) of £1.4 billion within the PSBR forecast for 1981-82 will in the event be within the general government financial deficit.

5. Forecasts are not normally made of the amount of liabilities to general government which will be written-off in a year. Such writes-off are solely balance-sheet transactions which are not included in the FSBR. (They are reported in the Supplementary Statements to the Consolidated Fund and National Loans Fund Accounts.) The amounts written-off in both years could be affected by the power to restructure the capital of the British Steel Corporation contained in the Iron and Steel (No.2) Bill now before the House.

HM TREASURY
25 March 1981

TREASURY AND CIVIL SERVICE SELECT COMMITTEE

Velocity, Real £M3 and Private Sector Financial Wealth

Note by the Treasury

At the meeting with Treasury officials on 18 March, the Committee requested additional information on the velocity of £M3, real £M3 and private sector financial wealth in relation to their historical trends.

2. The FSBR, in discussing financial developments in 1980-81, pointed out that the real financial wealth of the private sector had been depressed in 1979 by the effect of high inflation and high interest rates and that the rapid growth during 1980-81 had restored it to a more normal level. Chart A plots real gross financial wealth (using the RPI as the deflator) and its trend over the past 17 years. The series for financial wealth used in this chart was constructed by Treasury officials using conceptually similar methods to those adopted by the CSO for sector balance sheets (see, for example, Economic Trends November 1980). This data must be regarded as provisional and is liable to change as more information becomes available, particularly for recent years. Nevertheless, the chart illustrates that the first quarter of 1980 was some way below trend that that by 1980 Q3 a more normal position had been reached.

3. As earlier Treasury evidence to the Committee has made clear, gross financial wealth appears to be an important determinant of the growth of £M3. It is therefore not surprising to find that the profile of real £M3, plotted in Chart B, is quite similar to that of real financial wealth, although, of course, the slopes of the trend lines differ, and in particular that recent developments may be interpreted as a movement back towards the trend. (The trend which is shown in the chart has been estimated over the period 1963 Q1 to 1980 Q4, excluding data for 1972 Q1 to 1974 Q4. This exclusion reflects the fact that major institutional changes during that period may have seriously distorted the £M3 series,

and is consistent with the practice adopted in earlier submissions to the Committee.)

4. Chart C shows the path of £M3 velocity (the ratio of nominal GDP to £M3) over the period, and tells a broadly similar story. The trend shown has been estimated on the same basis as the trend of real £M3, excluding the 1972-1974 data. The recent reduction in velocity brings it from its position in early 1980 when it was noticeably above trend to its level at the start of 1981, much closer to the trend.

HM Treasury
25 March 1981

NOTES TO THE CHARTS

Chart A: Real Gross Financial Wealth

The nominal gross financial wealth series is unpublished data, prepared by Treasury officials. The chart shows this series deflated by the RPI (Jan 1974 = 100), on log scale. The trend shown is estimated on these log levels for all quarterly data points from 1963 Q1 to 1980 Q3.

Chart B: Real £M3

The chart shows quarterly seasonally adjusted £M3 levels, deflated by the RPI (Jan 1974 = 100), on log scale. The trend is estimated on log levels of the real £M3 series over the period 1963 Q1 to 1980 Q4 on all data points except 1972 Q1 to 1974 Q4.

Chart C: Velocity of £M3

The chart shows GNP-based quarterly £M3 velocity (the ratio of GNP at current prices seasonally adjusted expressed at an annual rate to the centred quarterly average of monetary stock seasonally adjusted) on log scale. The trend is estimated on the logs of velocity series over the period 1963 Q1 to 1980 Q4 on all data points except 1972 Q1 to 1974 Q4.

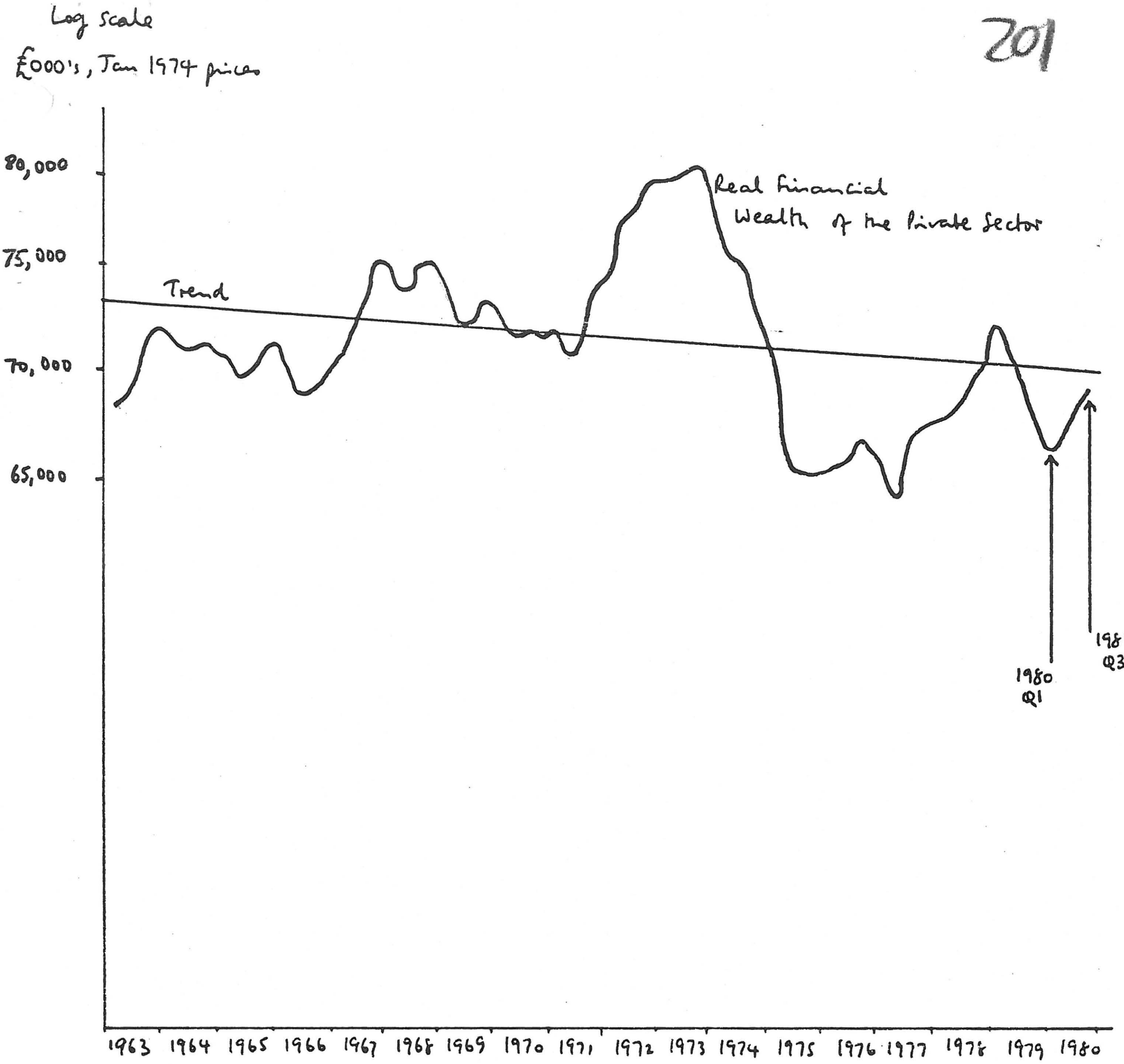

CHART A: Real Financial Wealth
Trend (estimated on 1963 Q1 to 1980 Q3)

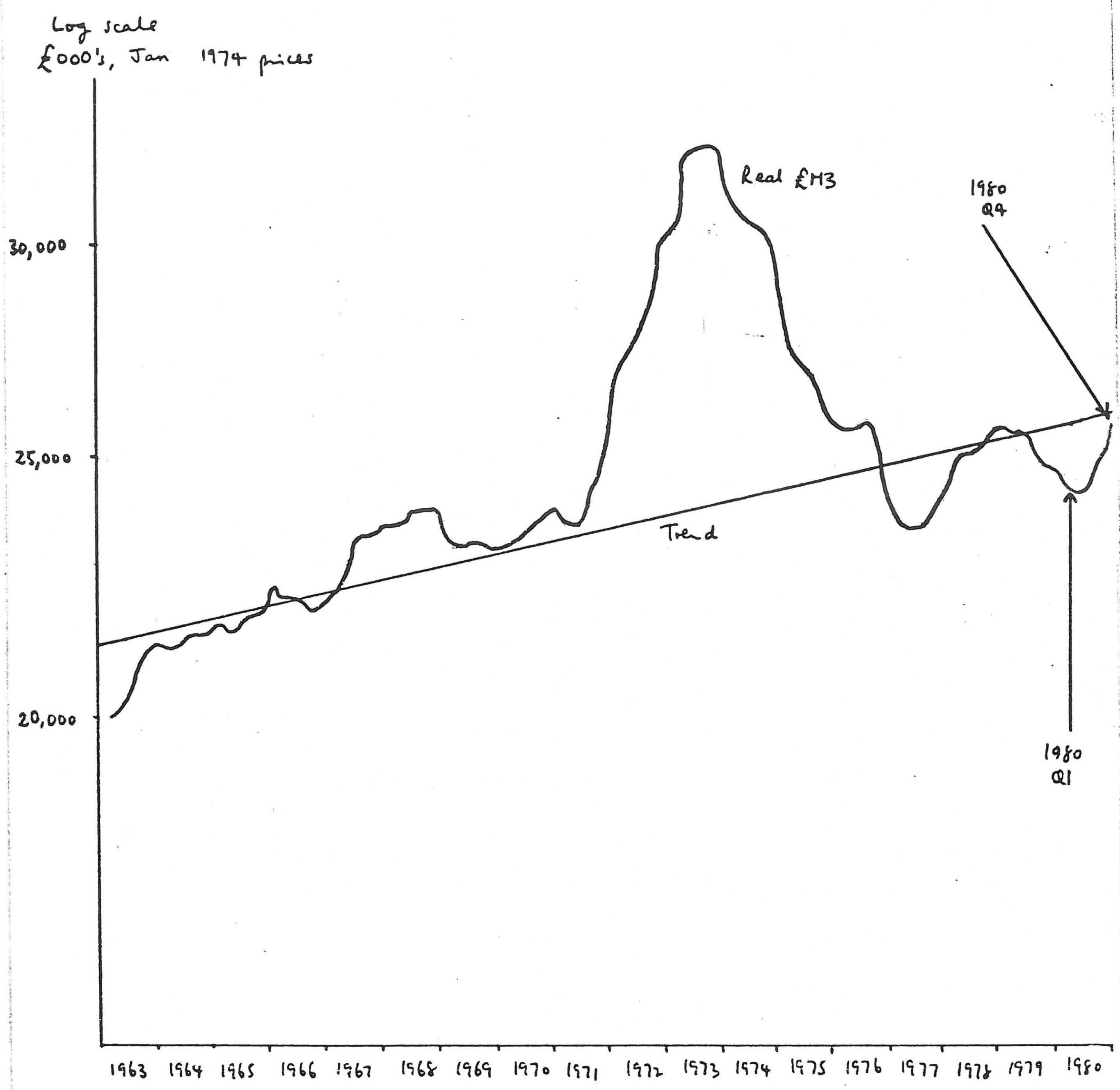

CHART B: Real £M3
Trend (estimated on 1963 Q1 to 1980 Q4, except 1972 Q1 to 1974 Q4)

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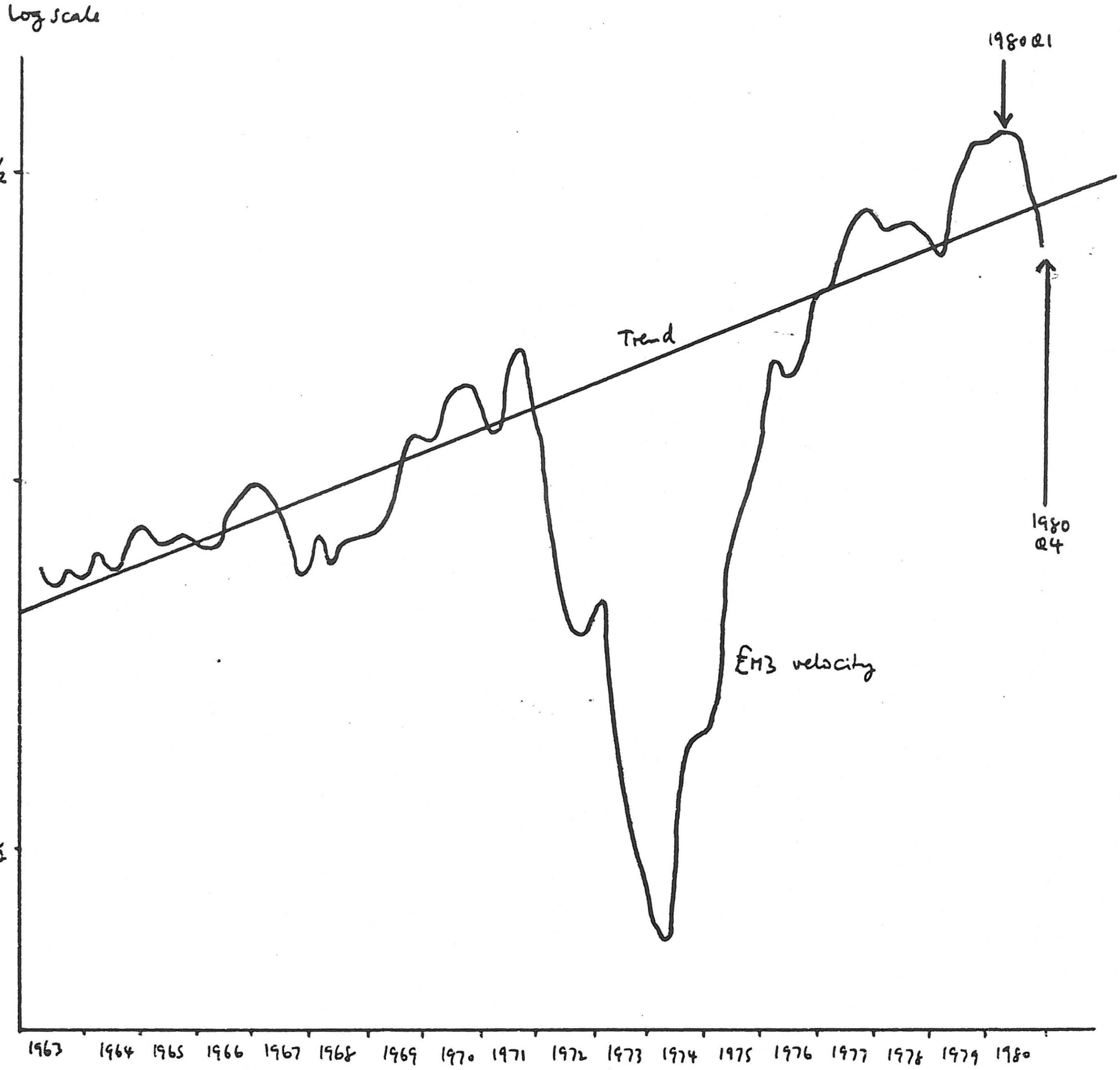

<u>CHART C</u>: <u>£M3 Velocity (GNP-based)</u>
<u>Trend</u> (estimated on 1963 Q1 to 1980 Q4, except 1972 Q1 to 1974 Q4)

TREASURY AND CIVIL SERVICE COMMITTEE

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PUBLIC EXPENDITURE IN 1980-81

Note by H.M. Treasury

The Committee asked for a note comparing the expected outturn for 1980-81 with the figures published at the time of the 1980 Budget, analysing the changes in cash so far as possible in terms of volume and cost.

2. It is important to emphasise that at this stage full information is not available for 1980-81. The quality of such partial information as is available varies. The point is well illustrated by comparing the equivalent estimates of the outturn for 1979-80 available at this time last year with the best figures now available:

Estimates of outturn of public expenditure planning total 1979-80
£ billion

	Cash	Volume (1980 Survey prices)
March 1980 estimate of outturn	76.3	78.4
March 1981 estimate of outturn	77.1	77.8
Revision	+0.8	-0.6

Cash

3. Better figures are generally available for cash than for volume. Central government expenditure is monitored and controlled in terms of cash. Information about local authority accounts is first reported in cash.

4. Table 15 of the Financial Statement and Budget Report 1981-82 (HC 197) shows the public sector transaction by economic category and the resultant estimates of the PSBR. Table 16 shows the figures adjusted to the definitions used in the Public Expenditure White Papers, and compares the expected outturn for 1980-81 with the forecastsin the 1980 FSBR.

5. The change in estimates of expenditure in 1980-81 analysed by spending authorities is as follows:

	March 1980 Budget forecast	March 1981 Estimated Outturn	Change
		£ billion	
Central Government	66.7	68.2	+1.5
Local Authority	24.2	25.0	+0.8
Certain Public Corporations (1)	1.2	1.3	+0.1
Nationalised Industries net overseas and market borrowing (2)	-0.5	-0.4	+0.1
Special Sales of Assets	-0.6	-0.4	+0.2
Contingencies (net of allowance for shortfall) (3)	0.6	-	-0.6
Planning total (after shortfall)	91.6	93.7	+2.1

Note: (1) "Certain Public Corporations" are listed in Cmnd 8175, Part 5.

(2) Government lending to Nationalised Industries is included under central government expenditure.

(3) This was not allocated to spending authorities in the March 1980 forecast, but is in the estimated outturn.

6. The main elements in the addition to central government expenditure of £1.5 billion were:

		£ million
Increases in:		
Lending to Nationalised Industries		770
Social Security payments (of which about half related to unemployment)		700
Payments from redundancy fund		250
Defence expenditure		470
Special employment measures		380
Agricultural support		150
		2,720
Less	EC Budget refund negotiated May 1980	550
	Other EC transactions	550
		1,620
Other changes (net)		-70
		1,550

The main reasons for these increases have been the direct and indirect effects the greater than expected impact of the recession. The increases in the cash controlled programmes* (primarily the increases in Nationalised Industry EFLs) were charged to the Contingency Reserve which, as noted above, was not allocated to spending authorities in the March 1980 forecasts. The latter increases did not therefore add to the public expenditure totals. 205

7. The estimated increase in local authority expenditure of £0.8 billion is based on limited information about local authority accounts, mainly about borrowing and revenue. There is at this stage still considerable uncertainty about both the total and its components. The main factors contributing to the change appear to be:

	£ million
Increases in:	
Current expenditure on goods and services	500
Subsidies - mainly the effect of higher interest rates on housing subsidies	200
Lending - probably associated with council home sales	80

B. Volume

8. We have much less information about the change in volume, particularly for local authority expenditure. Moreover, the volume changes shown between the 1980 and 1981 Public Expenditure White Papers and cash changes between the 1980 and 1981 FSBRs do not correspond to the extent that:

(a) the volume figures in the 1980 White Paper and the cash figures in the 1980 FSBR were based on different economic assumptions, eg for price changes, reflecting the fact that the figures for the former had to be settled some weeks before the post-Budget forecast incorporated in the latter was completed;

(b) the volume figures for 1980-81 in the 1981 White Paper were built up by programme from fairly early estimates provided by departments. The cash figures for 1980-81 in the 1981 FSBR tend to be more up to date and also, in the case of local authorities, reflect presumptions about the level of spending that cannot be allocated at this stage to programmes. (The cash figure for total expenditure in 1980-81 in the White Paper was derived from preliminary estimates prepared for the FSBR, and not by applying price factors to the volume figures in the White Paper.)

* Except for the Defence overspend of £260 million.

9. That said, the White Paper shows an increase over the previous White Paper of £1.4 billion in volume at 1980 survey prices: this is equivalent to £1.7 billion cash using an average re-valuation factor. The difference between that and the estimated increase of £2.1 billion in the cash spend is partly due to the net effect of the differences referred to in the previous paragraph. Some of the other reasons for significant differences, which partly net out, are:

(i) the new White Paper volume figures do not allow for pay and price changes after the 1980 survey price base (broadly autumn 1979). The increase in the cash spend reflects any price changes different from those expected a year ago, either in areas which are not controlled by cash limits, or where a cash limit has been increased. The main example of the latter is the Armed Forces Pay award (£ 50 million);

(ii) the new White Paper volume changes probably do not yet allow enough for the cash limit squeeze in 1980-81. This does not affect the cash figure. On the other hand, the White Paper contains a lower volume of spending by local authorities than is provided for in the FSBR;

(iii) the change in the volume of social security benefits between the White Papers reflects not only more benefits paid but also the effect on the real value of benefits during the year of inflation proving higher than assumed in last year's White Paper. This latter volume effect is not reflected in the cash figures in the FSBR.

Prices and costs

10. Prices in the public services in the last year generally appear to have risen a little more than expected in the FSBR a year ago, although this of course varies between different categories of expenditure. The cash figures in the last FSBR anticipated almost all increases in earnings, including the Clegg and comparability awards.

11. The increase in public sector costs relative to the rise in costs in the economy generally (the relative price effect) now appears to have been somewhat greater (a little under 1%) than expected in the FSBR primarily because the GDP deflator (used as the measure of prices generally) rose less than expected in the

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Budget arithmetic a year ago. (An analysis of the changes in the medium-term projections of revenue and expenditure was placed in the Library of the House on 12th March 1981.)

HM TREASURY
25 March 1981

1981-82 PSBR PROJECTIONS AND FORECASTS

Note by HM Treasury

The 1980-81 FSBR gave illustrative fiscal projections consistent with the medium term financial strategy. These were based on the public spending plans set out in Cmnd 7841 and a conventional assumption of tax rates and allowances fixed in real terms. The projections for 1981-82 implied a PSBR of some 3 per cent of GDP. As the FSBR explained, the PSBR figures given were not targets. Fiscal policy for any particular year would be framed consistently with declining monetary growth in the circumstances of the time.

2. As the Chancellor explained in his Budget speech on 10 March 1981 (OR col 763) the projected 1981-82 PSBR of 3 per cent of GDP translated into an absolute figure of about £7½ billion at forecast 1981-82 outturn prices.

Pre-Budget PSBR

3. The Chancellor went on to explain that, taking account of the increase in National Insurance contributions announced in November 1980, and the expenditure plans in Cmnd 8175, the PSBR for 1981-82 would have been £14 billion before allowing for any Budget changes in nominal tax rates and allowances. (On the alternative assumption of maintenance of tax rates and allowances in real terms, the corresponding pre-Budget PSBR would have been about £15 billion.)

Reasons for changes in the fiscal outlook

4. As was explained in the Treasury note placed in the House of Commons Library on 12 March 1981 (see WA col 387 reply to a question from Sir William Clark MP) much of the increase in the prospective PSBR between the projection in the 1980-81 FSBR and the position foreseen in advance of the 1981 Budget was due to increased public expenditure. General government expenditure for 1981-82 is projected following the Budget at some £119½ billion cash, compared with the equivalent of £113½ billion cash envisaged a year earlier.

5. The net increase of £6 billion reflects a variety of "estimating" and "policy" changes which have occurred in the course of the past year. Of the latter, those announced in the Chancellor's statement last November included increases amounting to about £1.5 billion, reductions of some £1.4 billion and the negotiated change in the EC Budget contribution worth about £.8 billion. The expenditure measures in the 1981 Budget added some £.3 billion to the plans in Cmnd 8175. As explained in the Treasury note of 12 March, the underlying reasons for the overall increase in expected 1981-82 cash expenditure, compared with the projection of a year ago, are forecasts of lower output, higher unemployment and debt interest and reduced underspending.

National Insurance Contributions

6. The increase in the rate of employees' National Insurance contributions announced in November 1980 and now the subject of the Social Security (Contributions) Act 1981, is estimated to make a contribution of about £1 billion to revenue in 1981-82.

HM Treasury

25 March 1981

CORRIGENDUM

P 129
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THE BOARD ROOM
INLAND REVENUE
SOMERSET HOUSE

25 March 1981

PRIVATE SECRETARY TO THE CHANCELLOR

SELECT COMMITTEE - WEDNESDAY, 25 MARCH

Mr Pinder's note of 24 March.

In the penultimate line of paragraph 7 on page 3, delete "1980/81" and insert "1981/82".

SJM

S J McManus

cc Chief Secretary
Financial Secretary
Minister of State (Commons)
Minister of State (Lords)
Sir Douglas Wass
Mr Unwin
Mr Battishill
Mr Cropper

Sir Lawrence Airey
Mr Green
Mr Boyd
Mr Taylor Thompson
Mr Gracey
Mr Houghton
Mr Flaxen
Mr McConnachie
Mr Pinder
PS/IR
Mr Blythe

pwp

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SEPARATE ACTION COPIES

MR BATTISHILL, FP
MR EVANS, EA
MR THORNTON, PE1

cc Mr Bridgeman
Mr Cassell
Mr Unwin
Mrs Gilmore
Mr Wiggins - 12/2nd

TREASURY COMMITTEE TODAY: FURTHER BRIEFING

1. A quick glance at this morning's FT (including the usual Lombard list of questions for the Committee to put to the Chancellor) suggests the following points, not covered in existing briefing, on each of which it would be helpful to have a paragraph of defensive speaking notes for the Chancellor.

(i) power discounts will be temporary (p8)
This point (if true) is not covered in the brief, now lettered Q, supplied by PE1 on 23 March. Mr Shepherd is quite likely to raise the matter with the Chancellor who will need some reply. Could PE please provide it.

(ii) tax base
Could FP please provide a paragraph on this point raised in the Lombard column.

(iii) unemployment
Could EA please provide something on the Lombard points about registration rates etc

2. Could I please have this material by noon today. It should be neatly typed and separate from any covering note. Copies should go to copy recipients of this note.

Harry Bush

M T FOLGER
25 March 1981