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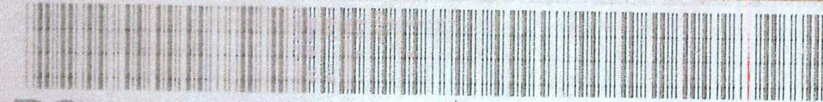

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PART D

FINANCE BILL 1987

FOR DISPOSAL ADVICE SEE INSIDE COVER

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PART D

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SECRET

FROM: JILL RUTTER
DATE: 24 April 1987

PRINCIPAL PRIVATE SECRETARY

cc:
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir Peter Middleton
Mr Cassell
Mr Scholar
Miss Sinclair
Miss C Evans
Mr Walters
Mr Haigh
Ms Goodman
Mr Dyer
Mr Romanski
Mr Cropper
Mr Tyrie
Mr Ross Goobey

Mr Johns - IR
Mr Wilmott - C & E

Mr Graham - Parliamentary Counsel
Mr Neubert MP

FINANCE BILL: CLAUSES TO BE INCLUDED IN A SHORTENED BILL

The Chief Secretary has discussed with the Chancellor which clauses the Government would seek to have included in a truncated Finance Bill, if the timetable were to be curtailed by an early election. I attach at Annex A a list of those clauses which the Chief Secretary and Chancellor think the Government should attempt to get included and at Annex B a list of the clauses which they think should be dropped.

2 In addition to the clauses identified the Chief Secretary would hope to gain assent to all clauses passed in Committee of the Whole House and in the sessions of Standing Committee that had taken place before the announcement of any possible election. I have therefore not included the Committee of the Whole House clauses in the list.

3 The Chief Secretary would be grateful for the comments from his Ministerial colleagues and officials on those lists. In particular he would be grateful if colleagues could identify any freestanding clauses which they think should be added to the list of clauses for which the Government would try to negotiate passage with the Opposition.

4 The Chief Secretary would be grateful if officials could warn him of any difficulties with the clauses identified to be passed in a truncated Bill - particularly with respect any amendments that are likely to be made and any areas in which the Government would be open to criticism for legislating before allowing proper time for consultation.

5 The assumption is that the measures dropped for the shortened Finance Bill will be resuscitated in the event of an early election in a post-election Finance Bill. The Chief Secretary would be grateful for advice in particular on whether the capital gains tax clauses which are on the "to be dropped" list could in a post-election Finance Bill still be enacted to take effect from the beginning of the financial year.

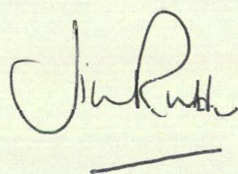
6 The Chief Secretary would be grateful for official advice on the miscellaneous and supplementary clauses (161 onwards)

7 The Chief Secretary and the Chancellor were unsure about the implications of dropping Clauses 27 and 29 - invalid care allowance and unemployment benefit and income support etc. I would be grateful for urgent advice from Mr Scholar, in consultation with ST as necessary, on whether those have to be included in a pre-election Finance Bill.

8 The Chief Secretary would also be grateful for the Financial Secretary's advice on which clauses on oil taxation (153 - 159) ought to be included in a short Finance Bill, bearing in mind the need to take account of representations and the problem with technical clauses.

SECRET

9 The Chief Secretary would be grateful for very urgent comments from Ministers and officials.



JILL RUTTER
Private Secretary

ANNEX A: CLAUSES TO BE RETAINED

Clause 1 - Unleaded petrol

Clause 2 - Vehicle excise duty

Clause 3 - Abolition of general betting duty on on-course bets.

Clause 4 - Gaming machine licence duty: rates

Clause 11 - Accounting for and payment of tax.

Clause 12-Credit for input tax

Clause 15 - Supplies to groups

Clause 17 - Valuation of supplies at less than market value

Clause 18 - Isssue of securities

Clause 24 - Personal reliefs: operative date for PAYE

Clause 25 - Relief for interest

Clause 26 - Increased personal relief for those aged eighty and over

Clause 28 - Increased relief for blind persons

Clause 30 - Registered friendly societies

Clause 31 - Relief in respect of certain income of trade unions - the Chief Secretary thinks that these two clauses together (30 + 31) should be negotiable as a package with the Opposition.

Clause 32 - Charities payroll deduction scheme

Clause 35 - Employees seconded to educational bodies

Clause 36 - Relief for costs of training etc.

Clause 37 - Time for payment of corporation tax by certain long-established companies and building societies

Clause 46 - Business expansion scheme - Films

Clause 150 - Maintenance funds for historic buildings etc

Clause 151 - Acceptance in lieu: waiver of interest

ANNEX B: MEASURES TO BE DROPPED FROM THE SHORT FINANCE BILL

Clause 5 - Gaming machine licence duty: other amendments

Clauses 6 - 10: Amendments of the Management Act

Clause 13 - Supplies abroad etc

Clause 14 - Registration

Clause 16 - Tour operators

Clause 19 - Interpretation and miscellaneous further amendments

Clause 34 - Occupational pension schemes

Clause 38 - Payments of interest etc between related companies

Clause 39 - Close companies: meaning of "associate"

Clause 40 - Apportionment of income etc of close companies

Clauses 41 - 44: Unit trusts and investment companies

Clauses 47 - 53 Provisions having an overseas element

Clauses 54 - 56 Oil industry: ACT

Clauses 57 - 60: Miscellaneous

Clauses 61 - 68 Capital Gains (but see equery)

Clauses 69 - 106: Personal Pension Schemes

Clauses 107 - 122 - Profit related pay

Clauses 123 - 137 - Taxes Management Provisions

Clauses 138 - 164 Stamp duty

Clause 148 - Interest in possession

Clause 149 - Securities

Clause 152 - Personal Pension Scheme

INLAND REVENUE
CENTRAL DIVISION
SOMERSET HOUSE

FROM: L J H BEIGHTON
24 APRIL 1987

1. CHAIRMAN

2. FINANCIAL SECRETARY

On the whole John Kay's rather simplistic views have not gained much currency - and it would be a pity to see them gaining ground in the House. He really does ignore the massive reforms achieved since 1979. The reference to the US (last paragraph) reflects a recent IFS Conference; but you may prefer to keep to the domestic scene and omit [ ]

24/4

FINANCE BILL : SECOND READING

In Wednesday's debate, Mr Forman commented that he thought the arrangements for tax advice to Ministers were not conducive to the sort of radical tax reform he would like to see. He quoted John Kay's valedictory lecture to the Institute for Fiscal Studies in support of this.

After a newspaper article based on Mr Kay's lecture last autumn Ministers said they had in mind that they would set the record straight when opportunities arose (Mr Heywood's note of 31 October 1986). As there was no opportunity to mention the point in your winding-up speech, you may wish to write to Mr Forman pointing out the Government's achievements in tax reform and setting the record straight on Mr Kay's allegations.

... I attach a draft letter.

LJHB

L J H BEIGHTON

cc Chancellor
Chief Secretary
Economic Secretary
Minister of State
Mr Scholar
Mr Cropper
Chairman
Mr Isaac
Mr Painter
Mr Beighton
Policy Directors
Mr Calder
Mr Johns
Mr Walker
PS/IR

Treasury Chambers, Parliament Street, SWIP 3AG

Nigel Forman Esq MP
House of Commons
Parliament Street
LONDON
SW1

I was very grateful for what you had to say in the Finance Bill Second Reading debate last Wednesday in support of the Budget. You will not be surprised to know that I was also very interested to hear what you had to say about radical tax reform. This is an issue in which we have a close interest: we have already made considerable headway, and we hope to be able to do more in the next Parliament.

I am afraid I did not have time in my winding-up speech to comment on what you said; but as you quoted from John Kay's valedictory address to the Institute for Fiscal Studies, I thought I ought to write to you to point out that what he said was - unfortunately - misleading in a number of important respects. Taking the passage you quoted about the economic and tax policy advice we get from the Inland Revenue, I can say from my own experience - and John Kay has none - that the Revenue's advice to Ministers on any topic covers the full range of economic social and political considerations as well as the purely administrative and compliance issues. Both the Treasury and Inland Revenue have economists - who work closely together - and who, contrary to Mr Kay's assertion, undertake and commission significant amounts of research and analysis; and the Revenue does engage in strategic planning. Moreover, officials engaged in tax policy work have a considerably wider range of experience than simply tax administration. I enclose an article from the latest edition of Fiscal Studies whch you may like to read. It sets out the facts of the case.

You mentioned the United States' approach to tax reform as a model for the UK. There is much to admire in what the US administration has achieved; but since we came into office we, too, have made very considerable headway in tax reform. Indeed, we set out on this road before the Americans. We have increased personal allowances by 22 per cent in real terms, reduced the top rate of tax on income from 98 per cent to 60 per cent, and cut the basic rate from 33 per cent to 27 per cent; we have abolished the National Insurance Surcharge, Investment Income Surcharge, Development Land Tax and Capital Transfer Tax on lifetime Giving; we have radically reformed

the taxation of businesses by cutting corporation tax from 52 per cent to 35 per cent (for small companies from 42 per cent to 27 per cent) and removing accelerated capital allowances and stock relief. In addition we are this year removing a number of unjustified tax breaks to produce a more level playing field for businesses.

There are good reasons for our not following the American approach to fiscal legislation. Our own traditions and institutions are, of course, very different; but in any event I do not believe that we would have achieved more if we had adopted the American approach: you may know that some people in the US hold the view that their reforms were over-complex, will not achieve their objectives, and could well be undone in the next few years. However that may be, our reforms have reduced complexity for many individuals and businesses, and are clearly achieving their objectives as our strengthening economic performance shows. And our incremental approach to reform shows every sign of achieving long-lasting benefits.

NORMAN LAMONT

'Fiscal Studies': Vol 18 No. 1 February 1987

Tax Policy and Management: The Role of the Inland Revenue

LEONARD BEIGHTON*

I. INTRODUCTION

There has been some public debate in recent months about the approach of the Inland Revenue both to giving advice on tax policy to government Ministers and to management of the tax system (for example, John Kay's (1986) valedictory address to the Institute for Fiscal Studies). Some of these comments appear to be based on a misunderstanding of the Inland Revenue's role. In the hope that it will help to inform the debate, I explain in this article what we are trying to do in the Inland Revenue and how we see our function.

II. THE BOARD OF INLAND REVENUE

The Board of Inland Revenue is responsible for advising the Chancellor of the Exchequer on questions involving policy on direct taxation (and the stamp duties). After the Chancellor has decided those questions and Parliament has enacted legislation giving them effect, the Board is responsible for implementing them as part of their statutory responsibility for the care and management of the direct taxes (Section 1 of the Taxes Management Act 1970 as far as income tax, corporation tax and capital gains tax are concerned).[1] They are accountable in general terms to Treasury Ministers for their stewardship, but Ministers do not get involved in the day-to-day business of running the Department. In particular, Ministers do not have access to information about people's confidential tax affairs (without their consent) or intervene in how they are to be taxed.

Board members are formally appointed by the Crown. But they are civil servants and in all other respects they are in an identical position to civil

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* Leonard Beighton is the Director of Central Division at the Inland Revenue.

[1] The Inland Revenue is also responsible for the provision of rating and valuation services, but this aspect of our duties is not covered in this article.

servants in other departments. The Chairman, Tony Battishill, is a Permanent Secretary; five of the other six members of the Board are Deputy Secretaries and the seventh is an Under Secretary. The Chairman, both Deputy Chairmen and one other Board member have had extensive experience in other departments, and the other three have spent much of their careers in a wide range of operational offices of the Department responsible for the day-to-day contact with taxpayers and the handling of their affairs.

III. REVENUE ADVICE ON TAX POLICY

One respect in which the Board of Inland Revenue is on all fours with civil servants in other departments is in relation to the advice given on tax policy. Treasury Ministers are responsible for taking decisions on what the tax law should be, subject always to parliamentary approval, and in taking their decisions it is first to the Inland Revenue that they turn for advice as far as the direct taxes are concerned. The conventions governing this advice are exactly the same as in other departments. Ministers take the decisions and are responsible for them to Parliament, and the advice they receive from their officials prior to taking the decisions is confidential. Officials are then responsible for ensuring that the decisions of Ministers and Parliament are properly implemented.

Policy advice is provided by six Policy Divisions in the Inland Revenue's Head Office which report to the two Deputy Chairmen of the Board. One division provides advice on personal taxation, another on business taxation, another on the capital taxes, and so on. Like the Board, these divisions are manned by people with a variety of experience. At a recent count some two-thirds of senior policy staff (Principal grade and above) had worked for part of their career in various operational units of the Revenue, nearly half had spent some of their career in other government departments (or quasi governmental bodies) and one-fifth had experience of employment outside the Civil Service. Moreover, Policy Division staff are in daily touch with their colleagues in the Technical and Management Divisions to ensure that Ministers have the best technical advice possible and are able to take full account of the staffing and operational implications before decisions are taken.

There is also close liaison with the Treasury's Fiscal Policy Division which is concerned with tax issues across the board in relation to the government's wider economic and financial objectives, and has a general co-ordinating role. In addition, the Treasury has a considerably larger cadre of professional economists than we do and our statisticians and economists work closely with them in order to ensure that Ministers are fully advised on the macro- and micro-economic implications of tax changes and have as accurate forecasts of future tax yields as possible. Where the interests of another department are closely involved — for example, the Department of Energy on North Sea

taxation, and the Department of Health and Social Security on the interaction between tax and benefits — those Departments as well as the Treasury are consulted. The same is true of the Bank of England on matters affecting financial institutions. This means that Ministers get detailed professional advice on the effects of different courses of action on tax yield, economic behaviour, distributional implications and so forth.

Most of the analytical work by the Department's economists and statisticians is unpublished because it is intimately bound up with the process of policy advice. Nevertheless, some is published each year in the Financial Statement and Budget Report and the Autumn Statement, both of which contain estimates of tax yields or costs resulting from legislative changes. We publish annually a volume of *Inland Revenue Statistics*; and information from the Survey of Personal Incomes is available both in tabular form and as an anonymised data tape of individual records. Occasional background papers and articles have been published such as the Revenue paper (1983) 'Cost of tax relief for pension schemes: appropriate statistical approach'. Analytical work may also be published in general government documents. For example, last year the Green Paper on the Reform of Personal Taxation contained a detailed analysis of the distributional implications of the introduction of transferable allowances, not only taken on their own but also when resulting changes in entitlement to social security benefits were taken into account. The 1982 Green Paper on Corporation Tax provided substantial background statistical information on the corporation tax system and analysed the effects of the options considered in the paper.

In addition to the research work that the Revenue carries out itself, it sponsors, with the Treasury, independent research on taxation. Apart from one-off consultancy exercises like the Business Expansion Scheme study mentioned below, we have together formed a consortium with the Economic and Social Research Council which has financed independent research. This has included a number of recent projects on personal and corporate taxation from the Institute for Fiscal Studies, personal taxation studies at the London School of Economics, and research into the compliance costs of taxation at Bath University (*Financial Times*, 28 November 1986). The Treasury has also sponsored research directly, such as Professor Brown's project at Stirling University on direct taxation and labour supply, in which we take a close interest. In this way the Department does much to support independent research. The Revenue makes increasing use of private sector consultants in this whole area, including the interaction of policy and management considerations. Close touch is also kept with economists outside the government service, so as to ensure that we are able to benefit from the latest academic thinking. In our work leading up to the 1984 business tax reforms, for example, we drew on the seminal work of King and Fullerton (1984) even though it had not been published by the time of the Budget.

1. Policy Evaluation

Policy advice to Ministers can be divided into two main groups. First, it may be concerned with the broad strategy of the tax system — for example, together with the Treasury we looked at the whole field of savings and investment, focusing in particular on tax neutrality, before work on the 1984 tax reforms was set in hand. Second, it may be concerned with consideration of more detailed issues which fall within the broad strategic approach which has been settled by Ministers.

In either event any consideration of proposals has to be evaluated against many, sometimes conflicting, criteria. It is hardly possible to prescribe an exhaustive list of all the considerations that may be relevant in considering a possible initiative in tax policy, but the 1986 Public Expenditure White Paper (HMSO, 1986a) contained a check list of the more important ones. These were:

(i) the cost or yield to the Exchequer and the distribution of gainers and losers among different categories of taxpayer;
(ii) the economic effects of the proposals and any behavioural changes they would be likely to induce;
(iii) the consistency of the proposals with the general thrust of the Government's tax policy, and its broader economic, financial and social policies;
(iv) the implications for other parts of the tax system, for the social security system, or for other proposals which Ministers may be considering;
(v) the likely effect on the perceived fairness and general acceptability of the tax system;
(vi) the effect of the proposals in increasing or reducing the complexity of the tax system;
(vii) the administrative implications, including effects on public expenditure and the use of public service manpower;
(viii) the compliance burden on employers, businesses and other taxpayers;
(ix) any views bearing on the proposals expressed in Parliament, or by representative bodies or by individual taxpayers;
(x) any relevant international obligations arising from, for example, double taxation agreements or European Community obligations.

The relative weight given to these various factors will differ according to circumstances and the nature of the proposal being considered.

Our job is to ensure that Ministers are made aware of the relevant considerations, and receive the best advice possible on the likely effects of measures they have in mind. Once changes have been made, or new measures introduced, it is also our job to see whether the intended results are being achieved and, if they are not, to consider whether some further action should be taken and if so what. Let me give an example.

The Business Expansion Scheme (BES) was designed to encourage a

greater supply of outside equity capital for risky small businesses. Officials worked up a detailed scheme under ministerial guidance, based on the Business Start-up Scheme, and the legislation was introduced in 1983. This, however, was not the end of the story. We also needed to monitor whether the new scheme was meeting its objectives. Consultants (Messrs Peat Marwick Mitchell) were employed to examine how far the BES was in fact providing additional risk capital for small businesses. Their report (Peat Marwick Mitchell, 1986) suggests that by and large the scheme was generating additional equity capital as intended, but that not all the projects were of the risky type originally envisaged. So this year's Finance Act made permanent the original temporary scheme, but it narrowed the scope of qualifying investment so as to target the relief more accurately. It was unusual for a proposal to stem from an external survey of this type, but a substantial proportion of tax changes derive from studies made within the Revenue of how far tax reliefs or rules are fulfilling the intentions behind them. No scheme is likely to be free of deadweight, but it is important with tax provisions — just as with public expenditure — to keep the accuracy of targeting under review. It is not simply a matter of tax avoidance but of ensuring that tax reliefs are cost-effective and are doing the job that Parliament intended.

2. Where Proposals for Tax Change Come From

There are many other sources of tax changes. Naturally, many stem from Ministers' own political aims, and obviously all have to be consistent with their objectives. Others come from representations by the various representative bodies and interest groups. A third source is Ministers and officials in other government departments and public committees and commissions of enquiry (such as the Keith Committee on the Enforcement Powers of the Revenue Departments). Lastly some proposals for change originate within the Revenue itself.

Given the widely differing nature and importance of the various proposals, it is not always easy to separate out the different sources of a particular proposal or to measure the weight of proposals from a particular source. All sources are significant: for example, just counting separate proposals without any weighting for their importance, in a recent year of the proposals initially considered in detail (a tithe of those put forward), about a tenth were provisions that had to be considered each year (like the rate of income tax which has to be fixed annually), about a fifth derived directly from ministerial initiatives, and another fifth from private sector representations. Three-tenths came from other government departments and committees, and the remaining fifth came from Revenue officials. But wherever the ideas originated, it is the Chancellor of the Exchequer who decides, giving such weight as he thinks fit to our advice.

3. The Cycle of Policy Work

The annual cycle in which officials draw together the various sources of advice and information, assess them against the criteria listed in (i) to (x) above, discuss them with Ministers, convert ministerial decisions into instructions for Parliamentary Counsel to draft into legislation, and assist Ministers in piloting the legislation through the House of Commons, is described in detail in Chapter 7 of the Board's Annual Report for 1983. There is not room to repeat the description here. But two aspects stand out.

First is the growing importance of direct consultation to supplement full parliamentary scrutiny of tax proposals. There are regular discussions between the leading representative bodies and senior Revenue officials; and *ad hoc* discussions are held with interested parties on specific proposals. These vary in formality from the full-scale type of consultation such as that on the recent Green Paper on the Reform of Personal Taxation (HMSO, 1986b) with a published paper, a timetable of several months for comments and a full-scale review by Ministers, to a quick discussion during the course of a Finance Bill with interested parties about a problem they have identified in legislation to be debated in the House of Commons perhaps in a couple of days time.

Second is that, as society becomes increasingly complex, so time scales lengthen. Representative bodies that want their views to influence thinking must let us have them earlier and earlier. November is nowadays none too early for the following Budget.

IV. THE REVENUE AND THE INDIVIDUAL TAXPAYER

Turning from policy to implementation, it is in relation to its dealings with individual taxpayers that the Revenue's statutory independence is most significant. As a rule, we do not, as explained above, involve Ministers in individual decisions. But we are tightly bound by the general law on what we can do. Taxpayers can appeal to an independent tribunal (the General or Special Commissioners) if they are dissatisfied with their assessments. On points of law there is a right to appeal to the Courts. If they are dissatisfied with the way their case has been handled in other respects, they can get help from their MP or Ministers. MPs can call on the Parliamentary Commissioner for Administration (the Ombudsman) to investigate a case of alleged maladministration and he will examine our papers and can interrogate officials during his investigation.

Last July the Board issued a Taxpayer's Charter[2] setting out the principles of service to taxpayers which for many years we have aimed to achieve. The

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[2] Published in Board of Inland Revenue Report for the year ended 31 December 1985, Cmnd 9831, p.3.

rights that this identified for taxpayers were the rights to help and information, to courtesy and consideration, to fairness, to privacy and confidentiality, and to expect the Revenue to have regard to taxpayers' costs in complying with the law. These are general aspirations which guide our dealings with taxpayers and, with a Department of nearly 70,000 staff and a taxpayer population approaching 30 million, it is not always easy to achieve them to our complete satisfaction in every case. But the Department is concerned to try to provide this level of service in as high a proportion of cases as we can, consistent with the resources available to us.

In fulfilling our statutory tasks of assessing and collecting tax, we have to be — and are — fully aware of the impact of the tax code on our consumers — individuals and businesses alike. We are conscious of our responsibilities towards taxpayers, both in our day-to-day dealings with them and within the broader policy context. We have played a very positive and constructive role within the Government's wider deregulation initiative in attempting to reduce the burdens which the tax system places on the taxpayer. This is a good example of the very careful balance we have to strike at all times between getting tax receipts to flow into the Exchequer and our wider responsibilities to taxpayers — a balance which also lay at the root of the recommendations of the Keith Committee.

V. DEPARTMENTAL MANAGEMENT

The Revenue is a large and decentralised organisation employing nearly 70,000 staff in over 900 offices up and down the country. There are three main networks of local offices — tax offices assessing tax, collection offices collecting the tax, and valuation offices valuing property. There are a number of operational offices not linked to the main networks including the Capital Taxes Offices (administering inheritance tax and its predecessors) and Stamp Offices (administering stamp duties) and a number of specialist offices. Finally there are a number of regional offices and our Head Office based in Somerset House in London. The total cost of running the Department in 1985/86 was a little over £1 billion.

Managing the Department is therefore a substantial responsibility in itself. The Board performs this management function within a framework laid down by Ministers. The government determines the resources — manpower and finance — available for the Department. It also lays down the principles of personnel and management policy that we have to follow (for example, open and fair recruitment is safeguarded and monitored by the Civil Service Commission) and the levels of pay we can offer.

1. Departmental Staff

By far the most important resource of the Department is the people who

work in it. Staff-related costs account for nearly 90 per cent of our total costs. We need staff with a wide range of skills in view of the diversity of the work we do. Although we employ many people with a wide range of professional training and experience, nearly two-thirds of our staff are in the two most junior clerical grades where the salary ranges run from around £3000 to a little over £7000. The Department is getting younger — most of the staff are under 35 with almost a fifth, the biggest single age group, being between 21 and 25. For a long time many of the staff in the Department have been women — the proportion is now about three-fifths and is still increasing. In response to this trend we have been doing a great deal to make patterns of work more flexible and responsive to women's needs. In the 1970s we took the lead in the Civil Service in introducing flexible working hours. More recently we have greatly expanded the opportunities for part-time working.

The skills we need are ones that are in high demand by other employers too. We have suffered a marked increase in resignations in recent years, particularly in some key grades and areas. Since 1982 there has been a fourfold increase in the number of resignations of fully trained Inspectors of Taxes, reflecting in particular the sharp increase in the remuneration of accountancy skills in the private sector. 1986 saw, however, a welcome if only small reduction in the number of resignations following the steps that we have taken to stem the flow. Resignations of professional Valuers, examiners from the Capital Taxes Offices, and of clerical and executive staff, particularly in London and the south-east, have also increased sharply. These losses put a considerable burden on our training effort — for example, it costs some £40,000 to train a fully trained Inspector of Taxes (so that he can carry out the full range of work on examining business accounts) — and the proportion of our staff in local offices who are trainees and lack experience is rising rapidly. We are therefore having to develop a strategy for improving recruitment and retention of staff and for using as productively as we can the skills of the staff we have. Over the years we have had major programmes to move clerical work to areas of the country where recruitment and retention is easier, and we are currently looking to see if we can do the same for some of our trained Inspector jobs.

2. Control of Resources

The Department's management work, like its policy work, is governed by an annual cycle — in this case the annual public expenditure and estimates cycle. This starts, as for other Departments, with the Public Expenditure Survey which sets resources for a three-year forward period, and is published in detail in the Public Expenditure White Paper around January. This sets the resources for the Department in both manpower and money terms. The overall allocation for the next financial year is converted into more detailed estimates presented to Parliament in the spring. At any time, we are working

within limits set by the government on the total cash we can spend in the financial year, limits on our running costs (i.e. all costs other than capital costs) and to targets for our manpower at the end of the financial year. The cycle is closed by the publication of an annual report[3] to Parliament recording the Board's stewardship of its resources for the preceding year. A recent study by the National Audit Office (1986) showed that the Inland Revenue and Customs and Excise were unique in publishing comprehensive retrospective reports on the whole of the Departments' activities.

Internally, as part of the Civil Service Financial Management Initiative, we have embarked on a major exercise to decentralise control of these resources and to improve accountability for their use. At the top level we have set up a Senior Management System under which each Division reports to the Board on its performance against its objectives for the previous year and on its objectives for the following year. These reports are reviewed at a series of Board meetings with Divisions in December and January which set the direction for the Department for the year ahead. The reports are published the following spring or summer.

At the same time we are setting up a line management budgeting system which allocates resources to individual line managers down to local office level, gives them greater freedom in allocating their resources within their budget, and holds them accountable for their performance against their budget. Management information systems are being improved in conjunction with this. This system at present covers 75 per cent of the Department and will be extended to the remaining 25 per cent next year. This is not just a change in accounting procedures: it requires a significant change in management style to use the new freedom effectively and to adapt to different controls from in the past. Fuller descriptions of the Senior Management System and our line management budgeting system can be found in articles by Symons (1985) and Willingham (1986).

3. Improvements in Efficiency

Over the last few years the Department has taken a number of important measures to improve efficiency. The total number of staff employed has been reduced by nearly 20 per cent since April 1979 (Figure 1). Of the 15,000 staff saved, about 5000 are due to legislative changes; the rest are due to managerial improvements in efficiency. There are a number of strands to this in addition to the changes in financial management described above.

Computerisation

One of the most important of these involves our harnessing the potential of

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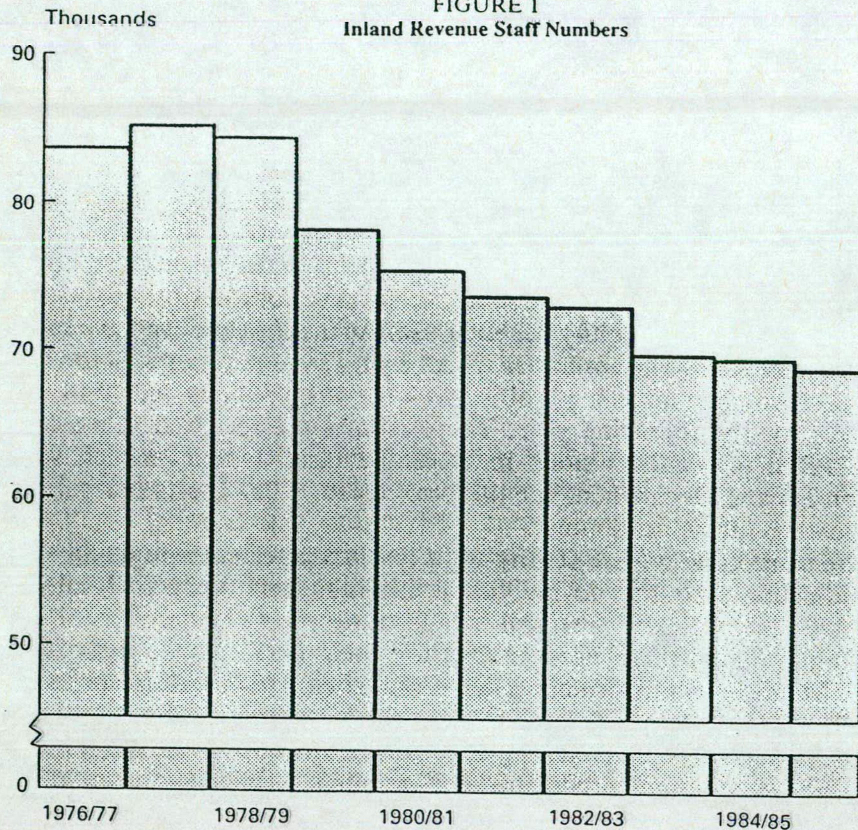
[3] Latest Annual Report is for the year ended 31 December 1985, Cmnd 9831.

FIGURE 1
Inland Revenue Staff Numbers



information technology. We started converting PAYE to computers in the 1960s, and in Scotland PAYE was centralised at a computer centre in East Kilbride as long ago as 1968. Further work was, however, suspended in 1970 when the incoming Government decided to review the future of PAYE. This led to the proposed tax credit system, which in turn was suspended by the new Government in 1974. Planning switched back to computerising PAYE, but in the meantime technology had moved on and trials proved that, rather than a batch processing system centralised at a few centres like East Kilbride, a distributed on-line system with local offices linked to the computer centres would provide a better solution and be more efficient. It would also be more convenient for staff and taxpayers alike. Plans for a system on these lines were reviewed again on the change of Government in 1979 and a revised plan was approved by Ministers in 1980. During the development phase it was decided to broaden the programme to include Schedule D assessing as well as PAYE, making this one of the larger computer applications of its kind in Europe.

The project involves twelve mainframe computers and some 25,000 visual

display units linked in. An independent team of researchers said of it: 'In short, COP [computerisation of PAYE] has displayed a thrusting, prudent management strategy which has not only ensured the development of the system on schedule, but has actively sought ways to enhance the programme to the benefit of the Inland Revenue, the taxpayer and the British computer industry' (Morris and Hough, 1986). In no small part this success has been due to the effective use of outside expertise — harnessing the skill and experience of private sector consultants with the Department's own operational and information technology expertise.

This is not our only computer system in existence or planned. During the 1970s while the future of PAYE was under review, we pushed ahead with the computerisation of the collection of tax and corporation tax assessing. We now have plans to convert these systems on to more flexible and up-to-date technology and this will improve our level of service to the public over the next few years. And we have used computer systems for many years on statistics, pay and personnel matters. A fuller account of the Department's plans for the future can be found in *The Direction of Change* which we published in April 1985.

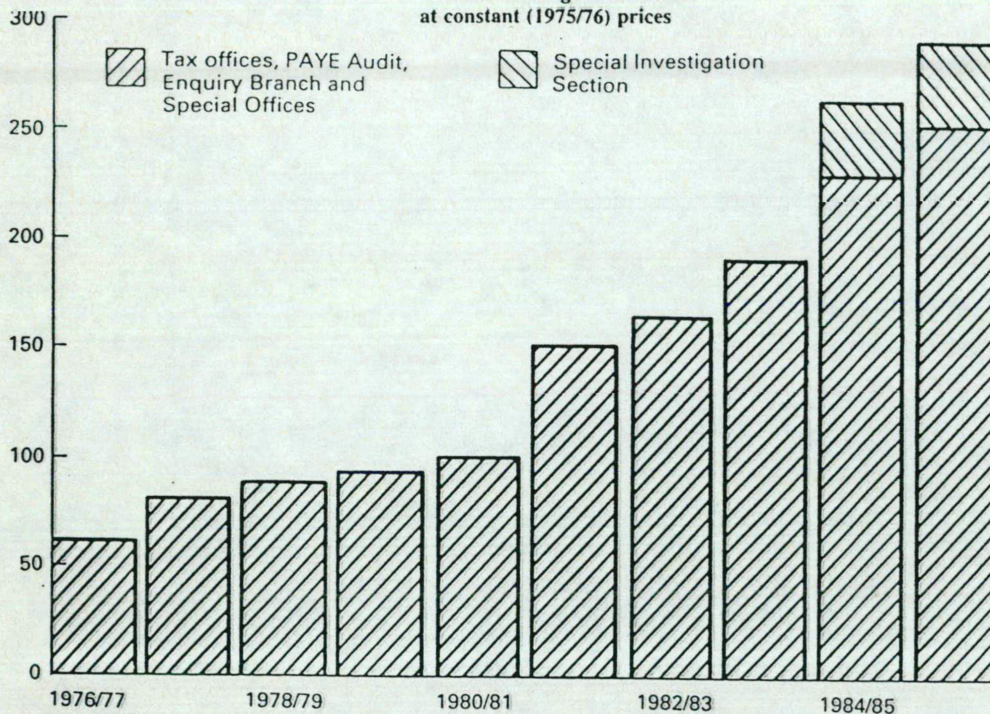
Network reorganisation

At the same time we have been slimming down our networks of local offices. The number of local offices in our networks will be reduced by over a quarter: the reorganisation of our tax office and collection network should be complete by 1988/89 (saving annual accommodation costs of £8 million at 1986/87 prices) and that of our valuation office network sometime after 1990.

Better investigation methods

A rather different type of measure to improve efficiency has been in our investigation work. Since the late 1970s we have made considerable improvements in the cost-effective deployment of our trained Inspector resources. We have monitored in greater detail adjustments made to accounts, introduced a more systematic method of allocating resources, and set targets for the number of cases to be investigated. A chain of special offices has been set up to handle some particularly complex cases and problems of avoidance and evasion. And in 1985 we reorganised our Enquiry Branch and other head office investigation sections. As a result, the yield of our investigation and audit work has increased by 25 per cent a year on average over the last decade *in real terms* and is now six times what it was in 1976 (Figure 2).

FIGURE 2
Yield of Investigation Work at constant (1975/76) prices



Notes: Figures for 1976 / 77 to 1981/82 are for years ended 31 October; for 1982/83 onwards they are for years ended 31 March. For 1983/84 and earlier years, figures for the yield from Special Investigation work are not available.

Manpower planning

The rundown in staff numbers has not been easy to manage and we have devoted considerable attention to effective manpower planning. We have worked very closely with the Institute of Manpower Studies in developing effective planning techniques. And we have met our challenging targets for reductions with minimal compulsory redundancies.

Changes in management style

This does not mean that there have been no problems. During 1985 our arrears rose to historically unprecedented levels as a result of the pressures caused by office reorganisations and preparatory work for computerisation, growth of work greater than forecast, and the high levels of resignation and resulting inexperience among clerical staff (particularly in London and the south-east).

In November 1985 a major effort to tackle the backlog was launched with the backing of Ministers and unions. There were three specific changes:

authorisation (with trade union co-operation) and funding of substantial overtime working; an increase in our manpower targets to cope with the extra work volumes; and a number of functional changes (mostly of a temporary nature) in lower-priority work.

The result has been a major turnaround, with work on hand down by more than a third, arrears over a fortnight old down by over two-thirds, outstanding repayment claims fewer than for several years, and routine cyclical work more advanced. But as important has been the less tangible change in management style arising from the clear commitment throughout the Department to better communication and more active targeting on priority jobs. This fits in with a longer-term programme to improve communications by way of attitude surveys, a regular house journal, newsletters from the Chairman, and regional seminars with local management.

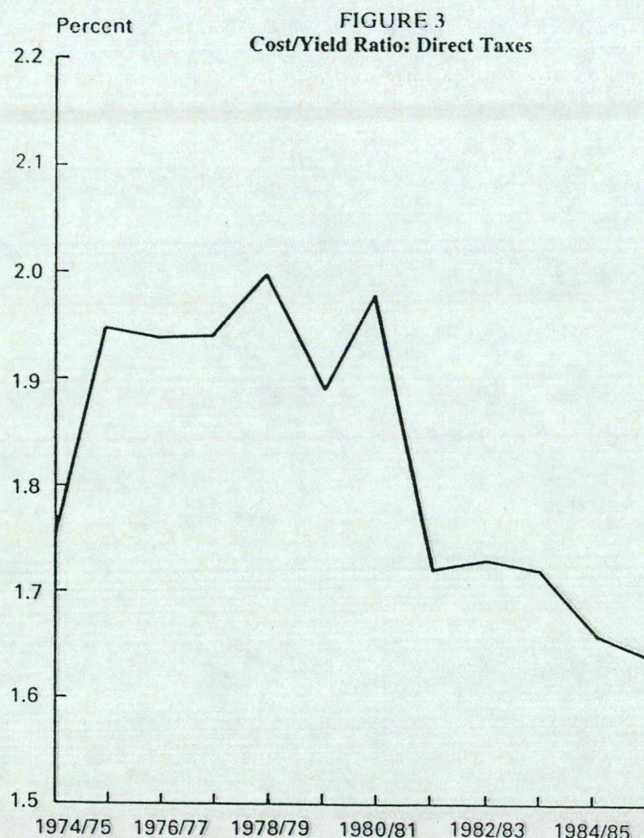
4. Measurement of Performance

Unlike a private sector business the Revenue has no simple measure of improved profit to show from its efficiency measures. Our job is *not* to maximise the revenue but to ensure that the *correct* amount of tax is assessed and collected. There are a variety of indicators which can be used. Each tells part of the story but each, if pursued as the sole measure of performance, could be misleading. The problems can be seen by considering two in a little detail.

An important indicator is the relation between the amount of tax we collect and the cost of doing so. We have been publishing cost/yield ratios in our Annual Report for many years. Last year, at 1⅔p for every pound collected, the ratio reached the lowest level since we started to calculate it on the present basis in 1974/75 (Figure 3). We publish cost/yield ratios for the individual taxes in the Board's Report and also for our main forms of investigation work. But there are real snags with this as a measure of performance: changes in tax law (for example, a change in the basic rate of tax) can affect the yield without any alteration in the real burden of work. And while the effect on cost/yield is one aspect of policy change to be taken into account, it is by no means a decisive one. In order to secure their economic and social objectives, Ministers may very reasonably decide to introduce reliefs which add to our staffing need while reducing the yield.

Another indicator, employed by John Kay in his valedictory lecture (1986, p.13) is the average number of assessments made per member of staff. But this can actually be a perverse measure of our departmental performance. As we attempt under PAYE to collect the right amount of tax from employees during the year, about four in every five Schedule E taxpayers do not need an assessment at the end of it. In recent years we have taken efficiency measures to cut down the number of assessments required to reduce the Department's workload. But Schedule E taxpayers still need their records kept up to date

FIGURE 3
Cost/Yield Ratio: Direct Taxes



during the year. So any increase in the figures of assessments would tend to reflect a failure in performance rather than the reverse.

We believe the sensible approach is to use a variety of performance indicators. A number of these have been developed and are in active use as management tools. Some of them are set out in the Revenue section of the Public Expenditure White Paper, including targets on progress of line management budgeting, milestones for reorganisations, progress in reducing arrears, proportion of accounts investigated, and number of cases handled per professional Valuer. The Board's Annual Report and Senior Management System publish a wider range of information about our performance.

VI. INTERACTION BETWEEN MANAGEMENT AND POLICY

The Revenue is sometimes asked whether it has a policy view 'of its own'. It cannot, and does not, have a policy view — above all, not one at variance

with that of the government of the day. But inevitably policy decisions put constraints on management decisions and vice versa. Administrative considerations point in the direction of a relatively simple, broad-based system with the minimum of distortions requiring the policing of difficult borderlines between forms of income or category of taxpayer. But administration is only one of the ten criteria listed above which need to be taken into account for tax policy. Some legislative changes like Mortgage Interest Relief at Source (MIRAS) have been of major assistance in keeping down the cost/yield ratio. Others inevitably pull in the opposite direction because of wider economic, social or political considerations.

Changes of government (and we had three in the 1970s) do of course alter the overall thrust of our activities. But today major changes take ever longer to plan as we seek to take advantage of the latest technological developments. So our Departmental Development Plan (Inland Revenue, 1985b, para.11) (a very brief and general outline of which was published in July) displays the intended progress of each of our major activities over the next ten years — and the interactions between them — while retaining the flexibility to adjust to any changes there may be in the political scene, in technology and in society. More generally, the objectives the Board has set out for itself have one eye firmly on the sort of conditions in which we may perhaps be working by the middle of the 1990s.

Conversely, the methods of assessing and collecting taxes and the timetable for changes (e.g. computerisation) also affect policy decisions and can put real constraints on the feasibility or extent of particular policy changes, at least in the short term. For example, transferable personal allowances would hardly have been feasible under the old manual system of PAYE and Schedule D, and their introduction will only really be practicable after the COP and CODA (computerisation of Schedule D assessing) programmes are complete and an integrated departmental data network is in place.

If transferable allowances are introduced, there will be a need to keep within strict bounds other organisational changes at the same time. There is a similar interaction between the introduction of an improved on-line computer system for the collection of tax and some of the policy changes in the compliance field which are being considered following the report of the Keith Committee (1983).

VII. CONCLUSION

A great deal is happening in the Inland Revenue and the pace of change is accelerating. A lot remains to be done. On policy it will be Ministers who determine what they want done and how. On management, too, they set the framework. Within this there are many things we have to do — to improve our measurement and targets for performance, constantly to improve our efficiency, to establish budgeting as a way of life among our line managers,

and to recruit, retain and motivate a professional workforce so that we can give a high level of service to the public. We have to develop the skills of our staff to the full, increase their job satisfaction and exploit the potential of information technology. Only in this way shall we be able to meet the demands of all those to whom we are accountable.

We therefore welcome debate, and are interested to learn how outsiders see the direction in which the Revenue should go. We try to be open to ideas, but it is important that they should be based on the facts. I hope this article and the publications I have referred to in it will help to provide the factual background for that debate.

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Rvp

FROM: A C S ALLAN
DATE: 24 April 1987

MR HUDSON

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir P Middleton
Mr Peretz
Mr Scholar
Mr Kelly
Mr Cropper
Mr Ross Goobey
Mr P Lilley MP
Mr Mace - IR

FINANCE BILL: CWH CLAUSES ON INCOME TAX AND EXCHANGE CONTROL

The Chancellor discussed with you and others yesterday evening the points to make in the debates on the clauses on income tax and exchange control.

Exchange control

2. On reflection, the Chancellor decided he should not do this clause himself: to do so would raise the profile unnecessarily. He would discuss at Prayers today which other Minister should do it.

3. There was some discussion about the main points to make in the debate.

(i) The main themes should be (a) the benefits over the past 7½ years from abolition of exchange controls; (b) a telling critique of the Hattersley proposals; and

(c) some play on the divisions in the Opposition between those who would prefer full exchange controls, those who supported Mr Hattersley, and those who favoured unrestricted devaluation.

(ii) It would be helpful to look out what was said in speeches etc at the time of abolition: this would support the point that events had developed in the way the Government had predicted at the time, in spite of the scepticism and doubts expressed then.

(iii) We should (without relying on the IFS) shoot down the canard that there is a fixed quantum of investment, and more overseas means less at home.

(iv) We should also shoot down the other canard that investment overseas is at the expense of direct exports from the UK: all the evidence shows that increasing in direct investment led to increased export opportunities.

(v) We should make something of the inevitable waste of talented manpower and effort that would be employed in getting round the Hattersley controls.

(vi) Something should be made of the historical exegesis: Britain had traditionally had a large stock of overseas investments and had benefitted very considerably from that; they had been run down very heavily to pay for the War, but had now been built up to the highest level since the War. We should take the opportunity to publicise the £110 million estimate of net overseas assets at end-1986.

(vii) Something should be made of the point that the largest overseas investors were the Japanese, and that did not seem to harm their performance.

(viii) Soon after abolition, Harold Lever had made a very good speech in the debate in the House of Lords; that was worth looking out again.

Income tax

4. The Chancellor thought the outline covered most of the main points. He would want to start on the Mais theme (ie that the purpose of macro economic policy was to keep inflation down, and that growth and employment relied on micro economic policies of which the key was taxation, and cuts in income tax in particular); he would then explain what the clause did; then go on to point out that the opposition were out of step with the rest of the world, where income tax was being cut not just in the major industrialised countries but also in countries with left of centre Governments such as New Zealand and in developing countries such as India; he would finish with a piece on the economy.

5. Other points he would need to cover were:-

(i) The "hidden agenda" claims on VAT. Mr Ross Goobey agreed to dig out some useful quotes which the Labour Party had made before the 1983 election about a secret manifesto.

(ii) Figures (in some detail) for the burden of taxation as measured by income tax and NICs and for real take home pay. He would also want to cover the point that the overall tax burden had had to increase in the early years of this Government because of the problems inherited; and he would explicitly accept that it was still too high: but this would be contrasted with the contradictory position taken by the Opposition, who argued that the tax burden was too high but then proposed to increase it.

(iii) Reworked figures for the effect of the Budget on nurses, so as to take account of the latest pay awards. Mr Mace agreed to do this.

(iv) In the section on the economy he would probably want to make something of the comparative record on public sector capital spending under the present Government and under the previous Labour Government.

(v) The Labour party's points about 'consumer boom' invited the riposte that they believe that a pound in tax cuts goes on imports whereas a pound in extra pay is spent at home. On the general line on 'consumer boom', he thought the point to stress were not so much that the growth in 1987 was expected to be less than in 1986, but rather that the balance between investment and consumption in this upswing was much better compared with the previous upswring, and that growth had been exceptionally steady.

(vi) If the Labour party did put down amendments proposing a reduced rate band, then the points to make were: (a) are they in favour of reducing tax or not?; (b) the Government is working towards a reduced rate of 25 per cent covering the whole of the basic rate band ; and (c) the whole argument about how the Labour party would have used this money is irrelevant: they would not have been in this position in the first place.

6. Mr Lilley suggested that it was important to make something of the effects on incentives, and the way the tax cuts allowed more scope for people to save and invest, and hence accumulate capital. The Chancellor asked Mr Lilley to draw up some suitable political points he should make.

7. The Chancellor felt the speech should be about 25 minutes in length. You agreed to prepare a draft on Monday.

ACSA

A C S ALLAN

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THE INDEPENDENT

Alliance faces tax cut fire

The Alliance will be accused by both Tory and Labour MPs next week of ambivalence over the 2p cut in the basic rate of income tax which forms the centre-piece of the Finance Bill. Liberal and SDP members intend to vote against the cut when the House spends two days in committee on the Bill, but are not expected to make any commitment to reverse it.

Labour wants to concentrate on tax cuts on Wednesday and on the proposals to abolish exchanges controls on the following day.

RH12.51

UNCLASSIFIED

FROM: A P HUDSON
DATE: 22 April 1987

CHANCELLOR

cc Mr Peretz
Mr Scholar
Mr C W Kelly
Mr Allan
Mr Cropper
Mr Ross Goobey
Mr Mace - IR

FINANCE BILL

At tomorrow's meeting, we can discuss the handling of next week's debate, and how best to organise our material. I attach brief notes of the main points.

2. On <u>income tax</u>, I have included a suggested outline for an opening speech. This can draw extensively on Mr Mace's note on Clause (below).

3. On <u>exchange controls</u>, Ms Goodman's minute covers a lot of material. For tomorrow it might be best to focus on Speaking Note A, at the front, which covers the key arguments.

APH

A P HUDSON

INCOME TAX

Likely form of debate

Difficult for Opposition to amend Bill, but they may put down amendment in favour of Reduced Rate Band.

- If so, Labour will open, with Chancellor to respond.
- If not, or following debate on amendment, debate on Clause stand part, with Chancellor opening and Labour responding.

Positive points to get across

2. Cut in income tax improves incentives.

3. Builds on previous reductions since 1979. Committed to more.

4. Labour Government would mean higher income tax for everybody.

Possible outline of speech

5. Clause 20 very important - not just in itself; but because goes to the heart of difference between parties.

6. Clause itself reduces basic rate by 2p. Means [over £3 a week to man on average earnings etc.] Builds on previous income tax reductions. (Examples.)

7. Real take-home pay up for all. Cf Labour record.

8. Committed to going further. Other parties committed to increase taxes.

9. Difference much more than a matter of bookkeeping: different approach to the economy and society. Government believes in improving incentives to succeed; other parties don't. Government believes low-tax free enterprise economy works better; other parties don't. Government believes in leaving people free to spend their own money; other parties don't.

Main theme

10. Government approach in van of gathering world consensus (examples); other parties out of step.

Likely Labour arguments

11. Tax burden still higher than 1979.
Needed to get borrowing down to sort out economic mess. Reduced tax burden consistently since 1981. Committed to go further.

12. Tax cuts not sustainable. Will be reversed/VAT increased after election.
Strength of economy means cuts are sustainable. Allegations on VAT merely a smokescreen to try to hide Labour plans. Check - 1983 'secret manifesto'

13. Income tax cuts wrong social choice.
Part of "hat-trick", alongside increase in priority spending.

14. Income tax cuts wrong economic choice.

- Jobs. Income tax reductions stimulate enterprise and hence create more jobs.
- Fuel consumer boom. Growth of consumers' expenditure expected to be lower in 1987 than 1986.
- Suck in imports. Effect same as wage increase. Why assume British firms unable to respond to extra demand? Forecast shows no increase in rate of growth of imports in 1987.

15. Rich have done much better than poor under this Government.
Real take-home pay up for all - unlike under Labour. This Budget restricts benefit at top levels. But no apology for necessary cuts in top rates in 1979. Yield of higher rate tax gone up, and top 5 per cent pay higher share of burden, in spite of cuts since 1979.

16. Should have reintroduced Reduced Rate Band.
Reduced Rate Band very costly, and has less impact on incentives than basic rate cut. Complicated for employers and the Revenue.

MR 6/11

Why do this now?

EXCHANGE CONTROLS

Likely form of Debate

1. The Opposition may put down an amendment which would introduce their own scheme of tax penalties on investment overseas.

   - If so, Labour will open and the Chancellor responds.
   - If not, or following that debate, Chancellor will open on Clause stand part.

Positive points to get across

2. Abolition of controls wholly beneficial to economy.

3. Controls inefficient and damaging at any time. Now unlikely to be technically viable.

4. Abolition facilitated build up of net overseas assets.

Likely Labour arguments

5. Tax penalty on overseas investment a better approach

   - Against interests of pensioners/investors.
   - Difficult to operate.
   - No shortage of funds for investment. Labour's National Investment Bank unnecessary, and previous similar bodies failed disastrously.

- list beneficial consequences of Ex con abolition
- other countries

BOARD OF INLAND REVENUE

FINANCE BILL 1987

CLAUSE 20

CLAUSE 20: CHARGE OF INCOME TAX FOR 1987-88 AND THE THRESHOLDS AND RATE BANDS

SUMMARY

1. Clause 20 imposes the new basic rate of income tax of 27 per cent for 1987-88. The higher rates of tax remain unchanged but the first (40 per cent) higher rate threshold is increased by £700 (to £17,900) in line with the statutory indexation provisions. The second (45 per cent) higher rate threshold is increased by £200 (to £20,400). The other higher rate thresholds remain at their 1986-87 levels.

DETAILS OF THE CLAUSE

2. Subsection (1) imposes income tax at the basic rate of 27 per cent, and fixes the first higher rate threshold ("the basic rate limit") and the higher rate bands, for 1987-88.

The proposed rate bands for 1987-88 are as follows:

1986-87 £	Rate %	1987-88 £
	27	0-17,900
0-17,200	29	
17,201-20,200	40	17,901-20,400
20,201-25,400	45	20,401-25,400
25,401-33,300	50	25,401-33,300
33,301-41,200	55	33,301-41,200
Over 41,200	60	Over 41,200

3. Because the bandwidths for the 50 per cent, 55 per cent and 60 per cent higher rates are not being changed from their 1986-87 values, and the 40 per cent and 45 per cent bands are slightly narrower than in 1986-87, subsection (2) disapplies the statutory indexation provisions of section 24 Finance Act 1980 in so far as they apply to these bands.

BOARD OF INLAND REVENUE

PART II SPEAKING NOTES (NOT FOR CIRCULATION)

GENERAL NOTE

4. Basic rate of tax reduced from 29 per cent to 27 per cent. Higher rates of tax remain at the levels set in the 1979 Budget.

5. The threshold for the first (40 per cent) higher rate of tax is increased by £700 in line with the statutory indexation provisions. The increase is based on the rise in the Retail Price Index between December 1985 and December 1986 which was 3.7 per cent. In practice the percentage increase in the threshold works out at 4.1 per cent because of the statutory rounding formula included in the indexation provisions. The threshold for the second (50 per cent) higher rate is increased by £200, an increase of 1 per cent over the 1986-87 value. This is less than the indexation increase which would have been £900. The other thresholds remain at their 1986-87 levels. Under indexation the threshold for the 60 per cent rate, for example, would have gone up by £1,700.

Costs

6. Against the indexed base the cost of the reduction in the basic rate is:

	£ million
1987-88	1,910*
1988-89	2,690*
Full year	2,600

* Excluding costs of £290 million in 1987-88 and £130 million in 1988-89 for the consequential reduction in the rate of Advance Corporation Tax.

The yield from the changes in the higher rate thresholds measured against the indexed base is:

	£ million
1987-88	40
1988-89	80
Full year	80

Compared with indexation the full income tax package costs £1,880 million in 1987-88 (£1,920 million cost as a result of the basic rate cut (£1,910 million) and the higher age allowance for those aged 80 and over (£10m) less £40m additional yield from the slice of taxable income above £20,400 (the new 45 per cent threshold) because the second and subsequent thresholds are not fully indexed).

Number of taxpayers

7. Number of higher rate taxpayers will be about 180,000 fewer than if allowances and thresholds had remained at 1986-87 levels.

Staff Numbers

8. The increase in the first higher rate threshold (basic rate limit) means that the Revenue staff requirement will be about 70 less in a full year compared with the position had the threshold remained at its 1986-87 level. Including the effect of the allowance increases, the staff requirement will be about 225 less in a full year compared with no change. Taking the combined effect of both the Budget measures and the forecast changes in taxpayer numbers, existing Revenue manpower will need to increase by about 185 units in a full year. This is because of the underlying growth in the number of taxpayers (and higher rate taxpayers) compared with 1986-87.

General line on income tax

[See Annex 1 for typical weekly tax reductions]

9. The Chancellor said in his Budget Speech "There is now a worldwide consensus on the economic desirability of tax reform and tax reduction, and in particular the reduction of income tax..... Lower rates of tax sharpen up incentives and stimulate enterprise, which in turn is the only route to better economic performance". [Hansard 17 March 1987 Col 827.] The personal allowances are now 22 per cent higher in real terms compared with 1978-79 and the married man's allowance is at its highest level in real terms since the war. As a result 1.4 million people have been taken out of income tax altogether. There is now a strong case for concentrating tax reductions on the basic rate since this is the starting rate of tax and the crucially important marginal rate for 94 per cent of all taxpayers.

10. The reduction in the basic rate improves incentives for 20.8 million taxpayers of working age. The new rate of 27 per cent is the lowest basic or standard rate of income tax since before the Second World War. (CAUTION: there were lower reduced rates in the 1950s which were the marginal rates for the majority of taxpayers.) This year's reduction is a further stage in implementing the Government's objective of a basic rate of 25 per cent and means that since 1979 the basic rate has been reduced by 6 percentage points from 33 per cent. As a result everyone is now paying less in both income tax and NIC than they would be if the 1978-79 tax and NIC regimes had simply been increased in line with inflation.

11. The reduction in basic rate will also cut the marginal tax rate for 90 per cent of the self-employed. Taken with the corresponding reduction in the small companies rate of Corporation Tax from 29 per cent to 27 per cent in Clause 22, this will mean a significant reduction in the tax burden on small businesses which are so important for future growth.

12. The clause makes no changes in the higher rates of tax. It is right this year to concentrate resources on reducing the basic rate of tax which helps the overwhelming majority of taxpayers. But as the Chancellor has said, we may well need to bring our top rate down further, in the next Parliament.

/BACKGROUND NOTE

BOARD OF INLAND REVENUE

BACKGROUND NOTE

The following points may be raised in debate.

Should have raised allowances, not cut basic rate?

13. The Government's objective is both to increase allowances and cut the rates of income tax over time. Before the Budget allowances were already 22 per cent higher in real terms than in 1978-79 and the greater part of that increase had been achieved during the present Parliament. But prior to the 1p cut last year, there had been no reduction in the basic rate since 1979.

14. The UK is around the average for OECD countries as regards the point in the income distribution at which a taxpayer becomes liable to income tax. But our rate of tax affecting modest incomes is high by international standards.

15. The cut in basic rate improves incentives for 94 per cent of all taxpayers of working age and for about 90 per cent of the self-employed amongst them. An increase in allowances improves incentives only for those taken out of tax. The basic rate cut is worth more than an equal-cost increase in allowances to everyone on average earnings and above and to many below average earnings. (CAUTION: the majority of taxpayers (58 per cent) would be better off with an equal-cost increase in allowances than with the 2-point cut in the basic rate. See Annex 2 for details of an equal-cost allowance increase.)

Should have reintroduced reduced rate band?

16. A reduced rate band is pointless, except in so far as it is in practice the marginal rate for significant numbers of taxpayers. But this would be very costly. For the same loss of revenue as the 2-point cut in the basic rate it would have been possible to introduce a reduced rate band of only £1,300 at 20 per cent. This would have had a smaller effect on incentives. It would have reduced marginal rates only for single people earning less than £72 per week (32 per cent of average earnings) and for married men earning less than £98 per week (43 per cent of average earnings). Only some 2.2 million

taxpayers out of the total of 22.2 million of working age would have seen a reduction in their marginal rates. By contrast the reduction in the basic rate reduces marginal rates for 20.8 million taxpayers of working age. The reduced rate brackets for national insurance contributions introduced in 1985 were a more cost-effective means of cutting marginal rates for the very lowest paid than a reduced rate income tax band. When the previous Government left office in 1979 there was a reduced rate band of 25p. It is this Government's aim that before long the basic rate will be 25p.

17. A reduced rate income tax band also imposes extra compliance costs on employers and additional administrative burdens on the Inland Revenue. For small employers doing the work without computer assistance the weekly task of calculating PAYE becomes much more complicated with a reduced rate band; and larger employers with computerised payrolls would have to make changes (which could be substantial) to their computer programs to build in the new rate structure. They would need to be given time to make the necessary adjustments. In the Inland Revenue the abolition of the previous reduced rate band in 1980 saved 1,300 staff. It would not be practicable to reimpose an additional administrative burden of that sort during 1987-88 when staff in local tax offices are still heavily engaged in changing to computerised working for PAYE.

Greatest cash reductions go to the highest paid?

18. This year's tax changes have been deliberately structured to ensure that the highest incomes get little more than under indexation. With a progressive income tax system it is inevitable that - even with bare indexation to leave the real burden of tax unchanged - the higher paid get larger cash reductions in income tax. But less than full indexation of the second and subsequent higher rate thresholds this year means that the 60 per cent rate taxpayer gets only £2.17 per week more than he would have done under statutory indexation with no basic rate cut. That is a smaller gain than for a married man earning £185 per week (80 per cent of average earnings). On the slice of income above the threshold for the 45 per cent rate (£20,400) the total tax taken in 1987-88 will be £40m more than it would have been under indexation.

19. Taken together, this year's allowance increases and basic rate cut mean that nearly all taxpayers will pay between 1 and 2 per cent less of their income in tax. The percentage reductions are largest for those at the top of the basic rate band.

Should have reduced top rate of tax?

20. All income tax rates need to come down if we are to remain competitive with those countries which are currently making substantial changes in income tax - including reductions in their top rates. But right this year to give priority to reducing the marginal rate for the largest number of taxpayers.

Narrowing of higher rate bands means increased marginal rates for some?

21. Compared with indexation, only around 5 per cent of the 1.2 million higher rate taxpayers will have increased marginal rates under the higher rate structure proposed in the Clause. It was right this year to restrict the increases in the higher rate thresholds so that resources could be concentrated on reducing the basic rate which is the marginal rate for nearly 21 million taxpayers of working age.

Gains to the rich since 1978-79

[Of the £12 billion reduction in income tax compared with an indexed regime some £3.6 billion (30 per cent) benefits the top 5 per cent of tax units with 1987-88 incomes at £27,000 and over.]

22. Everyone will pay less income tax in 1987-88 than under a 1978-79 indexed regime. A married man on average earnings would pay £10.50 per week more in income tax under an indexed 1978-79 regime. The top 5 per cent of taxpayers now pay some 28 per cent of the total income tax yield compared with 24 per cent in 1978-79.

23. It is inevitable in a progressive tax system that the better off will have gained more as a result of the reduction in the absurdly high marginal tax rates which were inherited from the previous Labour Government. But those changes were made 8 years ago. This year's Budget changes - which are what the current Finance Bill is concerned with - give only £2.17

per week more than statutory indexation to the 60 per cent rate taxpayer. In percentage terms, the 60 per cent taxpayer gets a reduction of 0.2 per cent of income, compared with 1.3 per cent for a married man on average earnings. It is difficult to see how that can be described as a handout to the rich. (See Annex 4 for details of comparison with indexed regime.)

Marginal rates including NICs up for many since 1978-79?

24. This is not the case. Compared with an indexed 1978-79 tax regime, marginal rates (income tax and NICs) are now lower for 85 per cent of taxpayers. The combined marginal rate at average earnings is now 36 per cent compared with 39.5 per cent in 1978-79. For the low paid marginal rates have risen compared with an indexed 1978-79 regime only at very low earnings levels (less than one-third average earnings for single people; less than 40 per cent of average earnings for married men). These are typically not breadwinners; fewer than 3 per cent of married men are affected. Moreover there are now 1.4 million fewer taxpayers compared with indexed 1978-79 regime.

Too little done for the elderly?

25. The age allowances have been fully protected against inflation and elderly taxpayers also benefit from the basic rate cut. The allowance increase means a minimum tax reduction of 95p per week for an elderly married couple and 61p per week for a single person. In addition a new higher age allowance has been introduced this year for those aged 80 and over (see Notes on Clause 26). This will give extra help to this group and will mean a minimum tax reduction of £1.90 for a married couple over 80 and £1.23 for a single person. About 400,000 very elderly single people and married couples benefit; up to 25,000 of them taken out of tax by the extra allowance.

26. The age allowances are at their highest level in real terms since they were introduced in 1975-76. They are around 12 per cent higher in real terms than in 1978-79, and over 20 per cent higher than the basic allowances. The allowances for those aged 80 and over are higher still.

27. Around two-thirds of elderly households will have no tax to pay in 1987-88. A single pensioner can have up to £17 per week over the basic pension before paying tax (about £1 more than in 1986-87); married couples can have up to £26 per week (£1 more than in 1986-87).

Real take-home pay?

28. Real take-home pay in 1987-88 will be higher than in 1986-87 for everyone whose earnings grow in line with the average (assuming 6.5 per cent earnings rise and 4 per cent price rise, year on year in line with the earnings assumption used by the GAD for the 1986 Autumn Report and the forecast for the RPI in the FSBR). For those on average earnings real take-home pay will be over 21 per cent higher in 1987-88 than in 1978-79. Real take-home pay of married men without children on average earnings fell by 1 per cent under last Labour Government. (Figures for other households in Annex 3.)

Those at lowest decile of income distribution have had no real gains

29. Those at lowest decile have had small but real increase in take-home pay since 1978-79. The increases are larger than the corresponding rise under the last Labour Government between 1973-74 and 1978-79 (see Annex 3).

Real take-home pay has increased much faster for higher paid?

30. Only partly compensates for squeeze under Labour Government. Since 1973-74 real take-home pay for married man without children has increased by under 14 per cent for those on five times average earnings as against over 18 per cent for those on half average earnings. (See Annex 3.)

Burden of income tax and NIC compared with 1978-79

31. Average rates of tax and NIC lower than in 1978-79 for those above about average earnings. But the proportion of income taken in tax and NIC is lower for everyone compared with indexed 1978-79 regime. A married man (without children) on half average earnings - around £113 per week - will pay 9.7 per cent of his earnings in income tax in 1987-88 compared with 12.9 per

cent if the 1978-79 regime inherited from the previous Labour Government had simply been indexed.

32. Income tax liabilities in 1987-88 will be about £12 billion lower than if 1978-79 rates and allowances indexed to 1987-88 levels were in force. This means that those earning £5,000 per year (£100 per week) or less have had their tax bills reduced on average by about 27 per cent under this Government. (See Annex 4.)

Increase in additional rate on discretionary trusts

33. For 1987-88 the additional rate on discretionary trusts will be 18 per cent compared with 16 per cent for 1986-87. This is because the rate is fixed automatically as the difference between the second higher rate (45 per cent for 1987-88) and the basic rate (27 per cent).

34. The additional rate for trusts represents a flat-rate equivalent to the progressive higher rates of income tax on individuals. The higher rates of tax are not being reduced in this year's Bill and it is therefore right that the corresponding charge on the income of discretionary trusts should remain at 45 per cent in total. Beneficiaries of a trust get full credit for both the basic and additional rate tax when income is distributed to them.

Should have reduced composite rate in line with basic rate

35. Section 26 Finance Act 1984 provides for the composite rate to be fixed on a preceding year basis. This method of calculating the rate was introduced to meet the operational requirements of banks involved in the composite rate scheme. The rate for 1987-88 was fixed by statutory instrument on 17 December 1986 at 24.75 per cent. This was based on the tax rates and tax status of investors in 1986-87 and reflects the reduction in basic rate for that year. The benefits of this year's reduction in the basic rate will feed through into the composite rate in 1988-89. In the meantime the composite rate at 24.75 per cent is still well below the basic rate at 27 per cent.

Basic rate cut means reduction in income for charities?

36. Where - as is frequently the case - an individual covenants to pay a certain sum to charity after deduction of tax at the current basic rate the repayment available to the recipient will be slightly reduced in 1987-88 as a result of the cut in the rate to 27 per cent. But this is an inevitable consequence of the reduction in the basic rate. The 1986 special incentives for charitable giving, including removal of the limit on higher rate relief for covenanted donations and tax relief for corporate and payroll giving, together with the general tax reductions being made this year, will encourage donors to give more.

/ANNEXES

BOARD OF INLAND REVENUE

ANNEX 1

CHANGES IN INCOME TAX PAYMENTS

(- Means reduced payments)

(£ per week)	Single	Married
Multiples of average earnings[1]		
0.5	- 1.85	- 1.59
0.75	- 2.98	- 2.73
1	- 4.12	- 3.87
1.5	- 6.38	- 6.14
2	- 9.34	- 9.44
5	- 9.59	-10.17
Average pensioner[2]	- 0.78	- 1.85

Relative to indexation (£ per week)	Single	Married
0.5	- 1.34	- 0.81
0.75	- 2.47	- 1.95
1	- 3.61	- 3.08
1.5	- 5.88	- 5.36
2	- 6.21	- 6.88
5	- 2.17	- 2.17
Average pensioner[2]	- 0.16	- 0.90

(1) Full time adult male (all occupations). Average earnings will be £227.30 a week in 1987-88 with 6.5 per cent earnings growth.

(2) Assumed to have gross income of £65 a week (single) and £135 a week (married).

BOARD OF INLAND REVENUE

ANNEX 2

COMPARISON OF 2-POINT CUT IN BASIC RATE AND EQUAL COST INCREASE IN ALLOWANCES

i. If money spent on basic rate reduction had been used to increase main personal allowances further, would finance additional increase in main allowances of 12 per cent to:

	£	
Married man's	4,235	(+440)
Single (and wife's (earned income)	2,715	(+290)
Age: married man's	5,225	(+550)
Age: single	3,310	(+350)
Aged income limit	11,000	(+1200)

Compared with indexation, would mean 1.2m fewer taxpayers, of which 800,000 would be of working age. Fewer than 10 per cent would be families with children.

ii. Full year cost of 2-point reduction in basic rate £2,600 million.

iii. Basic rate cut worth more than equal cost increase in allowances to:

(a) Single person earning over 55 per cent of average earnings (£125 per week)

(b) Married man earning over 85 per cent of average earnings (£195 per week).

BOARD OF INLAND REVENUE

iv. BUT NB

Majority of taxpayers would be better off with equal cost increase in allowances - see table below

COMPARISON OF 2p CUT IN BASIC RATE AND EQUAL COST INCREASE IN PERSONAL ALLOWANCES: 1987-88

(Numbers of tax units*, thousands)

Non-aged	Gain under equivalent allowance increase	Lose under equivalent allowance increase
Single	4,350 (53%)	3,900 (47%)
Married	5,850 (57%)	4,400 (43%)
Aged		
Single	900 (69%)	400 (31%)
Married	1,100 (79%)	300 (21%)
TOTAL	12,200 (58%)	9,000 (42%)

* Husband and wife counted as one.

ANNEX 3

AVERAGE RATES OF INCOME TAX AND INCOME TAX PLUS NIC: REAL TAKE-HOME PAY

Table 1 Percentage of Earnings paid in income tax

Multiples of average earnings (1)	0.5	0.75	1	1.5	2	5
Single						
1978-79	17.0	22.4	25.0	27.7	29.5	50.5
1986-87	16.8	20.9	22.9	24.9	27.3	43.2
1987-88 (actual)	15.9	19.6	21.5	23.3	26.2	43.4
1987-88 (indexed)(3)	19.4	23.9	26.2	28.5	31.8	55.0
Married with one earner and no children						
1978-79	9.5	17.3	21.3	25.2	27.2	48.8
1986-87	9.9	16.3	19.4	22.6	24.9	41.8
1987-88 (actual)	9.7	15.4	18.3	21.2	23.7	42.0
1987-88 (indexed)(3)	12.9	19.6	23.0	26.3	29.4	53.3
Married with one earner and one child(2)						
1978-79	2.6	12.7	17.8	22.9	25.4	47.9
1986-87	3.3	11.9	16.1	20.4	23.2	41.1
1987-88 (actual)	3.3	11.1	15.1	19.1	22.1	41.4
1987-88 (indexed)(3)	6.6	15.3	19.7	24.2	27.8	52.7
Married with one earner and 2 children (2)						
1978-79	4.1	8.1	14.4	20.6	23.7	47.1
1986-87	3.4	7.4	12.8	18.2	21.6	40.5
1987-88 (actual)	3.1	6.9	12.0	17.0	20.5	40.8
1987-88 (indexed)(3)	0.2	11.1	16.6	22.1	26.2	52.1

[Footnotes see over]

(1) Full time adult males (all occupations). (£227.30 a week in 1987-88 with 6.5 per cent earnings growth.)

(2) Under 11, and netting off child benefit.

(3) Liability in 1987-88 under indexed 1978-79 regime.

Proportion of earnings taken in income tax in 1987-88

Compared with 1986-87

- Lower for those between 1/2 and around 4 times average earnings. (Single person earning £47 - £64 per week, married man earning £73 - £100 per week and most 60 per cent taxpayers pay a higher proportion than in 1986-87.)

- But for families with children, at 1/2 average earnings, income tax less child benefit takes higher proportion of earnings than in 1986-87 (because child benefit lower relative to average earnings in 1987-88 than in 1986-87).

- Higher for those above 4 times average earnings (because of less than full indexation of higher rate thresholds).

Compared with 1978-79

- Lower for all those above about 1/2 average earnings.

- Higher for couples at 1/2 average earnings (because allowances and basic rate cut do not offset withdrawal of reduced rate band).

Compared with indexed 1978-79 regime in 1987-88

- Lower for everyone. Down by over 4.5 percentage points for those at average earnings.

BOARD OF INLAND REVENUE

Table 2 Percentage of earnings paid in income tax and NIC

Multiples of average earnings (1)	0.5	0.75	1	1.5	2	5
Single						
1978-79	23.6	28.9	31.5	33.3	33.7	52.2
1986-87	25.8	29.9	31.9	32.9	33.3	45.6
1987-88 (actual)	24.9	28.6	30.5	31.1	32.1	45.8
1987-88 (indexed)(3)	25.9	30.4	32.7	33.2	35.3	56.4
Married with one earner and no children						
1978-79	16.0	23.8	27.8	30.8	31.4	50.5
1986-87	18.9	25.3	28.4	30.6	30.9	44.2
1987-88 (actual)	18.7	24.4	27.3	29.0	29.6	44.4
1987-88 (indexed)(3)	19.4	26.1	29.5	31.1	33.0	54.8
Married with one earner and one child(2)						
1978-79	9.1	19.2	24.3	28.5	29.6	49.6
1986-87	12.3	20.8	25.1	28.4	29.2	43.6
1987-88 (actual)	12.3	20.2	24.1	26.9	28.0	43.7
1987-88 (indexed)(3)	13.1	21.9	26.3	29.0	31.4	54.1
Married with one earner and 2 children (2)						
1978-79	2.5	14.6	20.9	26.2	27.9	48.8
1986-87	5.6	16.4	21.8	26.2	27.6	42.9
1987-88 (actual)	5.9	15.9	21.0	24.8	26.4	43.1
1987-88 (indexed)(3)	6.7	17.6	23.1	26.8	29.8	53.5

(1) Full time adult males (all occupations). (£227.30 a week in 1987-88 with 6.5 per cent earnings growth.)

(2) Under 11, and netting off child benefit.

(3) Liability in 1987-88 under indexed 1978-79 regime.

BOARD OF INLAND REVENUE

Proportion of earnings taken in income tax and NICs in 1987-88

Compared with 1986-87

- Lower for those between 1/2 and 4 times average earnings (though higher for families with children at 1/2 average earnings for income tax and NICs less child benefit).
- Higher for those above 4 times average earnings.

Compared with 1978-79

- Lower for single people at or above three-quarters average earnings.
- Lower for couples and one child families at or above average earnings.

Compared with indexed 1978-79 regime

- Lower for everyone. Down by over 2 percentage points for those on average earnings.

REAL TAKE-HOME PAY

Table 3 Percentage increase in real take-home pay 1986-87 to 1987-88

Multiples of average earnings (1)	0.5	0.75	1	1.5	2	5
Single	3.6	4.2	4.6	5.2	4.3	2.2
Married with one earner & no children	2.7	3.5	4.0	4.8	4.4	2.1
Married with one earner & 1 child	2.4	3.3	3.8	4.6	4.2	2.1
Married with one earner & 2 children	2.1	3.0	3.6	4.5	4.1	2.1

(1) Full time adult males (all occupations). (£227.30 a week in 1987-88 with 6.5 per cent earnings growth.)

Real take-home pay 1986-87 to 1987-88

On illustrative 6.5 per cent earnings rise and 4 per cent price rise, real take-home pay will rise by over 3.5 per cent between 1986-87 and 1987-88 for those on average earnings.

Table 4 Percentage change in real take-home pay

Multiples of average earnings (1)	0.5	0.75	1	1.5	2	5
Single						
1973-74 to 1978-79	-1.0	-2.2	-2.8	-3.6	-4.1	-18.5
1978-79 to 1987-88	19.6	22.2	23.7	25.8	24.8	38.2
1973-74 to 1987-88	18.3	19.5	20.0	21.2	19.8	12.6
Married with one earner and no children						
1973-74 to 1978-79	2.4	0.4	-0.9	-2.2	-2.4	-17.0
1978-79 to 1987-88	18.0	20.8	22.5	24.9	25.1	36.8
1973-74 to 1987-88	20.8	21.3	21.5	22.1	22.2	13.7
Married with one earner and one child						
1973-74 to 1978-79	4.2	1.8	0.4	-1.4	-1.6	-16.9
1978-79 to 1987-88	17.6	20.4	22.1	24.5	24.6	36.0
1973-74 to 1987-88	22.5	22.5	22.5	22.8	22.7	13.0

BOARD OF INLAND REVENUE

Multiple of average earnings (1)	0.5	0.75	1	1.5	2	5
Married with one earner and two children						
1973-74 to 1978-79	4.2	2.0	0.6	-1.2	-1.4	-16.9
1978-79 to 1987-88	17.5	19.9	21.6	24.1	24.3	35.3
1973-74 to 1987-88	22.4	22.4	22.4	22.7	22.6	12.4

(1) Full time adult male (all occupations). (£227.30 a week in 1987-88 with 6.5 per cent earnings growth.)

BOARD OF INLAND REVENUE

Real take-home pay 1978-79 to 1987-88

On illustrative 6.5 per cent earnings rise and 4 per cent price rise for 1987-88 on 1986-87

- real take-home pay will be at least 17.5 per cent higher in 1987-88 than in 1978-79 for those above half average earnings;

- increase over 21 per cent for those between 1 and 2 times average earnings;

- real take-home pay fell for families, without children, on average earnings under last Labour Government.

But

- earnings of lower paid and manual workers have grown more slowly than average for all occupations;

- nevertheless real take-home pay for those on lowest decile still up compared with 1978-79; and increase larger than comparable increase between 1973-74 and 1978-79.

Table 5 Percentage change in real take-home pay at lowest decile

Single	
1973-74 to 1978-79	- 0.8
1978-79 to 1987-88 (1)	6.0
Married, one earner, no children	
1973-74 to 1978-79	2.3
1978-79 to 1987-88	5.6
Married, one earner, 2 children (2)	
1973-74 to 1978-79	4.1
1978-79 to 1987-88	6.5

(1) The latest available information about earnings at points on the earnings distribution is for April 1986. The 1987-88 lowest decile figures have been constructed by assuming that pay increases only in line with inflation between 1985-86 and 1987-88.

(2) Both children under 11. Includes Family Allowance, child tax allowances and child benefit to enable comparison between tax system before and after abolition of child tax allowances.

BOARD OF INLAND REVENUE

ANNEX 4

COMPARISONS WITH INDEXED 1978-79 TAX REGIME

The table below shows the reductions in income tax liabilities, at 1987-88 income levels, of the proposed 1987-88 allowances, thresholds and rates compared with the 1978-79 regime indexed to 1987-88 levels by reference to the statutory formula. The comparisons therefore allow for budgetary changes in income tax rates and allowances, but not for any changes in the definition of the income tax base. As child tax allowances were being phased out in 1978-79 they have been excluded from the comparisons.

Range of Total income in 1987-88[1]	Number of units paying tax in 1987-8	Reductions in income tax compared with 1978-79 indexed regime		
		Total	Average[2] per tax unit	% Red'n from 1978-79 indexed regime
£	(million)	£m	£	%
Under 5,000	3.2	340	80	27.0
5,000-10,000	7.6	1940	250	20.4
10,000-15,000	5.3	2530	480	20.7
15,000-20,000	2.7	1930	710	20.4
20,000-30,000	1.6	1980	1240	20.8
30,000-50,000	0.6	1430	2460	20.6
Over 50,000	0.16	1710	10710	25.7
Total	21.2	11900	540	
Over 30,000	0.7	3140	4240	21.3

Reductions due to

	£ million
Higher rates and thresholds	1,745
Investment Income Surcharge	820

(1) All information is in terms of tax units - that is, married couples are counted as one and their incomes combined.

(2) Based on numbers of tax units liable to pay tax under the indexed 1978-79 regime; this is 950,000 units more than expected under the Budget proposals (covering about 1.4m individuals if working wives are counted separately). 770,000 of these tax units have income below £5,000 and the remaining 180,000 have incomes between £5,000 - £10,000.

BOARD OF INLAND REVENUE

FINANCE BILL 1987

CLAUSE 23

CLAUSE 23

CLAUSE 23: DEDUCTION RATE FOR SUB-CONTRACTORS

SUMMARY

1. This clause reduces the deduction rate to be applied to payments to sub-contractors in the construction industry from 29 per cent to 27 per cent in line with the basic rate of income tax. The new rates will not come into effect until 2 November 1987 to allow time for new tables to be prepared and issued to contractors.

BOARD OF INLAND REVENUE

PART II SPEAKING NOTES (NOT FOR CIRCULATION)

GENERAL NOTE

2. The purpose of this clause is to reduce, from 29 per cent to 27 per cent, the rate of deduction under the special tax deduction scheme for the construction industry. Under the scheme, a contractor is obliged to make a deduction of a sum on account of income tax and Class 4 National Insurance contributions from all payments to sub-contractors who do not hold exemption certificates, and pay the amount over to the Revenue. The deductions are credited against the sub-contractor's liability when he submits his accounts and returns to the tax office at the end of the year. Any excess is set-off against any arrears of tax and the balance is repaid.

3. There is no automatic connection between the deduction rate and the basic rate of tax although the two have moved in step for the last five changes of rate and this is convenient for the industry. Moreover, a reduction in the rate of deduction is a help, at the margin, to the cash flow of sub-contractors who do not have exemption certificates.

Cost

4. Reduction in yield of £m15 in 1987/88, of £m45 in 1988/89 and £m30 a year thereafter.

DEFENSIVE NOTES

The deduction rate is still too high?

5. The reason for keeping the deduction rate more or less in line with the basic rate is to ensure that individuals who suffer the deductions make themselves known to the Revenue. A large differential would encourage an individual to accept the deductions and make no returns as his true liability would exceed the tax already paid. The cost of materials is excluded from the amount of the payment to the sub-contractor to which the deduction is applied. Thus, broadly, the deduction is applied to the labour content.

BOARD OF INLAND REVENUE

Why no reduction before November?

6. Time lag matches timetable for last four changes of rate. Necessary because the sub-contractor rate is not covered by the Provisional Collection of Taxes Act: and because of the need to send relevant instructions and ready reckoners to every contractor. Time lag not a known source of complaint in the industry.

Why 2 November change, not 6 November as in past years?

7. Last year's rate change, and others previously, were for payments made on or after 6 November. 6 November is a Friday this year. Thursday and Friday are both common paying days in the building industry. Rather than have an effective date that splits the two common payment days, we thought it was better to shift the change forward. So the lower rate will apply to payments made on or after Monday 2 November.

/BACKGROUND NOTE

BOARD OF INLAND REVENUE

BACKGROUND NOTE

8. Representations were made to the Keith Committee on the Enforcement Powers of the Revenue Departments that a deduction rate pitched at the same level as basic rate was too high; took no account of the trading expenses of the sub-contractor other than cost of materials; gave rise to cash-flow difficulties; and was an encouragement to evasion. The Committee recommended a withholding rate of half basic rate, pending more accurate evaluation of where it should appropriately be set. Representatives of the larger firms, including the Building Employers' Confederation, support keeping the deduction rate in line with basic rate. Ministers decided to reject the Keith recommendation. This rejection was made public in the 12 December 1986 consultative document "The Inland Revenue and the Taxpayer" and has aroused no comment.

Finance Bill 1987
Clause 160

CLAUSE 160: REPEAL OF EXCHANGE CONTROL ACT

Summary

1. This Clause repeals the Exchange Control Act 1947. Exchange controls were abolished in 1979, but, the Exchange Control Act 1947 was kept on the Statute Book. Until then they had been in continuous operation since the outbreak of war in 1939. The Act worked by imposing restrictions on a range of financial transactions except where permission was given. Controls were removed in 1979 by retaining the Act but giving permission under it for all transactions.

CLAUSE 160

Details of the clause

2. Subsection (2) maintains the Treasury's powers to validate after the event certain pre-1979 transactions. Up till now these powers have been exercised under Sections 18(2), 28(3) and 29(3) of the Act. Under those subsections the Treasury could issue a certificate declaring an act, which might otherwise have been prohibited under the Act, to be valid as if Treasury permission had been given beforehand. Transfers of securities, assurance policies and property under settlements are all eligible for such certificates.

3. Subsection (3) provides that Section 150(5) of the Capital Gains Tax Act 1979, which adjusts the market value of assets to take account of restrictions imposed under the Exchange Control Act 1947, shall cease to have effect except in relation to valuations prior to the final abolition of all exchange controls on 13 December 1979.

4. Subsection (4) extends the repeal to the Channel Islands and the Isle of Man. Under Section 43(2), the 1947 Act applied to the Isle of Man except as modified by an Order in Council. Section 43(3)

provided for the Act to be extended to the Channel Islands by an Order in Council. Orders were made in 1947, (SI 1947/2034 and SI 1947/2066) covering both and these have remained in force since 1979. They will lapse automatically when the Act is repealed.

Plf

FROM: A C S ALLAN
DATE: 24 April 1987

MR HUDSON

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir P Middleton
Mr Peretz
Mr Scholar
Mr Kelly
Mr Cropper
Mr Ross Goobey
Mr P Lilley MP
Mr Mace - IR

FINANCE BILL: CWH CLAUSES ON INCOME TAX AND EXCHANGE CONTROL

The Chancellor discussed with you and others yesterday evening the points to make in the debates on the clauses on income tax and exchange control.

Exchange control

2. On reflection, the Chancellor decided he should not do this clause himself: to do so would raise the profile unnecessarily. He would discuss at Prayers today which other Minister should do it.

3. There was some discussion about the main points to make in the debate.

(i) The main themes should be (a) the benefits over the past 7½ years from abolition of exchange controls; (b) a telling critique of the Hattersley proposals; and

(c) some play on the divisions in the Opposition between those who would prefer full exchange controls, those who supported Mr Hattersley, and those who favoured unrestricted devaluation.

(ii) It would be helpful to look out what was said in speeches etc at the time of abolition: this would support the point that events had developed in the way the Government had predicted at the time, in spite of the scepticism and doubts expressed then.

(iii) We should (without relying on the IFS) shoot down the canard that there is a fixed quantum of investment, and more overseas means less at home.

(iv) We should also shoot down the other canard that investment overseas is at the expense of direct exports from the UK: all the evidence shows that increasing in direct investment led to increased export opportunities.

(v) We should make something of the inevitable waste of talented manpower and effort that would be employed in getting round the Hattersley controls.

(vi) Something should be made of the historical exegesis: Britain had traditionally had a large stock of overseas investments and had benefitted very considerably from that; they had been run down very heavily to pay for the War, but had now been built up to the highest level since the War. We should take the opportunity to publicise the £110 million estimate of net overseas assets at end-1986.

(vii) Something should be made of the point that the largest overseas investors were the Japanese, and that did not seem to harm their performance.

(viii) Soon after abolition, Harold Lever had made a very good speech in the debate in the House of Lords; that was worth looking out again.

Income tax

4. The Chancellor thought the outline covered most of the main points. He would want to start on the Mais theme (ie that the purpose of macro economic policy was to keep inflation down, and that growth and employment relied on micro economic policies of which the key was taxation, and cuts in income tax in particular); he would then explain what the clause did; then go on to point out that the opposition were out of step with the rest of the world, where income tax was being cut not just in the major industrialised countries but also in countries with left of centre Governments such as New Zealand and in developing countries such as India; he would finish with a piece on the economy.

5. Other points he would need to cover were:-

(i) The "hidden agenda" claims on VAT. Mr Ross Goobey agreed to dig out some useful quotes which the Labour Party had made before the 1983 election about a secret manifesto.

(ii) Figures (in some detail) for the burden of taxation as measured by income tax and NICs and for real take home pay. He would also want to cover the point that the overall tax burden had had to increase in the early years of this Government because of the problems inherited; and he would explicitly accept that it was still too high: but this would be contrasted with the contradictory position taken by the Opposition, who argued that the tax burden was too high but then proposed to increase it.

(iii) Reworked figures for the effect of the Budget on nurses, so as to take account of the latest pay awards. Mr Mace agreed to do this.

(iv) In the section on the economy he would probably want to make something of the comparative record on public sector capital spending under the present Government and under the previous Labour Government.

(v) The Labour party's points about 'consumer boom' invited the riposte that they believe that a pound in tax cuts goes on imports whereas a pound in extra pay is spent at home. On the general line on 'consumer boom', he thought the point to stress were not so much that the growth in 1987 was expected to be less than in 1986, but rather that the balance between investment and consumption in this upswing was much better compared with the previous upswring, and that growth had been exceptionally steady.

(vi) If the Labour party did put down amendments proposing a reduced rate band, then the points to make were: (a) are they in favour of reducing tax or not?; (b) the Government is working towards a reduced rate of 25 per cent covering the whole of the basic rate band ; and (c) the whole argument about how the Labour party would have used this money is irrelevant: they would not have been in this position in the first place.

6. Mr Lilley suggested that it was important to make something of the effects on incentives, and the way the tax cuts allowed more scope for people to save and invest, and hence accumulate capital. The Chancellor asked Mr Lilley to draw up some suitable political points he should make.

7. The Chancellor felt the speech should be about 25 minutes in length. You agreed to prepare a draft on Monday.

ACSA

A C S ALLAN

3751/017

FROM: P D P BARNES
DATE: 24 April 1987

PS/CHIEF SECRETARY

cc PS/Chancellor 2
PS/Financial Secretary
PS/Minister of State
Sir P Middleton
Mr Cassell
Mr Scholar
Miss Sinclair
Mr Evans
Mr Dyer
Mr Walters
Mr Haigh
Mr Cropper
Mr Tyrie
Mr Ross Goobey

PS/IR

PS/C&E

Mr Neubert MP

Mr McClain-Chief Whips Office

FINANCE BILL: COMMITTEE OF THE WHOLE HOUSE

Further to our conversation this morning, I confirm that the Economic Secretary is happy to accept the Chief Secretary's offer to handle clause 33 and schedule 4 in the Finance Bill Committee of the whole House.

PB

P D P BARNES
Private Secretary

pup

FROM: A C S ALLAN
DATE: 24 April 1987

MR HUDSON

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir P Middleton
Mr Peretz
Mr Scholar
Mr Kelly
Mr Cropper
Mr Ross Goobey
Mr P Lilley MP
Mr Mace - IR

FINANCE BILL: CWH CLAUSES ON INCOME TAX AND EXCHANGE CONTROL

The Chancellor discussed with you and others yesterday evening the points to make in the debates on the clauses on income tax and exchange control.

Exchange control

2. On reflection, the Chancellor decided he should not do this clause himself: to do so would raise the profile unnecessarily. He would discuss at Prayers today which other Minister should do it.

3. There was some discussion about the main points to make in the debate.

(i) The main themes should be (a) the benefits over the past 7½ years from abolition of exchange controls; (b) a telling critique of the Hattersley proposals; and

(c) some play on the divisions in the Opposition between those who would prefer full exchange controls, those who supported Mr Hattersley, and those who favoured unrestricted devaluation.

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ACSA

A C S ALLAN

5012/028/AC

Ref: RCA/CE/8

FROM: D WEATHERLY

DATE: 24 April 1987

1. MR K E BRADLEY KB 24/4
2. MR A WILSON AW 24/4
3. CHIEF SECRETARY

cc Chancellor
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Mr F E R Butler
Mr Anson
Mr Judd
Mr D Moore
Mr Burgner
Mr Gilmore
Miss Peirson
Mr Hawton
Mr Mason
Mr Revolta
Mr A M White
Mr Instone
Mr M L Williams
Mr Bonney
Ms P Boys

FEES AND CHARGES : REVIEW OF DEFICIT SERVICES.

You asked for further information about the 19 priority services (ie services with a substantial deficit in 1985-86) which we identified from the latest Annual Statement to the PAC on Fees and Charges. (Mr Felstead's minute of 12 February 1987 refers).

2. I attach a table showing the cost recovery history for each of the services over the past 3 years and the cost recovery plans agreed between Departments and Expenditure Divisions. I have also commented on the likelihood of the cost recovery plans being met.

3. The table breaks down into the categories we have previously used, as follows:

Ref A7-D2: services where full cost recovery can be achieved quickly.

Ref B2-D1: services where full cost recovery may take 2 or 3 years.

Ref A15-C8: services awaiting the outcome of a review or legal judgment.

4. Action is in hand in all cases where a target cost recovery date has not yet been fixed.

5. We will monitor the services to check that the break-even forecast is on target. Where slippage occurs, we will take this up initially with the Department concerned and the appropriate Expenditure Division. The need for any further action will then be considered.

(C A Division)

19 PRIORITY REVIEW SERVICES

Reference	Department: Service	1984/85 Actual		1985/86 Actual		1986/87 Forecast		Cost Recovery Plans	Realistic Assessment
		Deficit £	% of Full Cost	Deficit £	% of Full Cost	Deficit £	% of Full Cost		
A7	Home Office: Firearms Certificates	376,000	8.52	652,000	13.49	343,000	6.92	Break-even 1987-88	Should be achievable.
A12	Home Office: Data Protection Registrar	308,000	100	1,418,866	76.99	(2,128,000) surplus	-	Break-even 1986-87	Latest fee application envisages increase to meet full costs in 1987-88.
A13	Department of Transport: Bus Registration	-	-	302,000	100	454,000	58.28	Break-even 1987-88	Break-even is dependent on demand forecast for routes being met.
A16	Department of Transport: Marine Examination Fees	199,272	13.63	152,789	11.19	282,550	19.72	Break-even 1987-88	The latest Fee increase was not implemented until Feb 1987 which did little to alleviate the 1986-87 Forecast deficit. Break-even in 1987-88 should be achievable.
A17	Department of Transport: Fishing Vessel Surveys	605,000	75.64	497,157	66.30	449,000	57.27	Break-even 1987-88	Past performance suggests this is optimistic though 35 per cent increases have been introduced from 1 Feb 1987.
A18	Department of Transport: Seamens Documentation	230,730	80.33	163,304	72.58	155,661	66.05	Break-even 1987-88	Two tier system of charging has been introduced from 1 Feb 1987. However there is no experience yet on how the new system will work.
A19	Department of Transport: Marine Survey Fees	1,431,000	30.75	189,000	5.73	280,000	8.54	Break-even 1987-88	Should be achievable.
A21	Northern Ireland Office: Firearms Certificates	129,300	19.38	169,309	23.74	76,600	9.74	Break-even 1987-88	Should be achievable.
B1	Department Health and Social Security: Youth Treatment Centres	1,194,000	31.84	768,000	19.52	406,000	9.24	Break-even 1987-88	Should be achievable.
C7	Department of Environment: Building Research Establishment Publications	200,000	40.00	192,399	37.49	100,000	18.18	Break-even 1987-88	DOE Finance Division have agreed that, in accordance with Fees and Charges guidance, notional income may be included in MTA. DOE are also reviewing other accounting arrangements to bring them into line with Treasury guidance.
D2	Foreign and Commonwealth Office: Fee-bearing Consular Services	4,272,000	69.95	4,356,000	70.66	-	-	Break-even 1987-88	The main fees have been increased by 60 per cent from 1 April 1987. This together with a re-assessment of applicable costs should result in break-even in 1987-88.
B2	Department of Environment: Building Control Fees	22,500,000	33.09	22,000,000	30.5	19,000,000	25.67	Break-even 1989-90	Slow but sure progress. Could be a year slippage.
B3	MAFF: Licences-Dumping at Sea Act and Food and Environmental Protection Act	59,931	61.11	155,041	75.72	210,932	48.96	Break-even 1989-90	Should be achievable.
D1	Foreign and Commonwealth Office: Visa Services	1,652,000	25.71	2,600,000	26.00	-	-	Break-even date not set yet.	The first priority is break-even for the "new regime" services by 1988-89 followed by full cost recovery for all visa services, probably in 1990-91.
A15	Department of Transport: Vehicle Testing MOT	540,000	14.83	494,000	12.51	445,000	10.01	Subject to legal query.	As certificate fee is part of overall MOT fee, exact recovery is unlikely. 1987 Fee increase due in July under discussion. Also affected by legal query.
C4	Department of Transport: PSV Driver Licensing	496,000	87.63	375,000	73.82	226,000	32.47	Subject to legal query.	Slow but sure progress towards full cost recovery, but at present held up by legal query.
C5	Home Office: Vehicle Removals	951,923	34.89	1,609,100	47.60	1,624,500	44.05	No forecast break-even	Future action dependent on contracting out of service in June 1987.
C6	Department of Environment: Planning Inspectors	211,000	28.67	228,571	32.26	296,900	35.77	No forecast break-even	The Commencement Order allowing increased charges, under Section 42 of the Housing and Planning Act 1986 is planned to operate from Aug/Sept 1987. The Finance Division (DOE) are liaising with the inspectorate at Bristol to help identify full costs for the MTA.
C8	Department of Energy: Government Oil Pipeline and Storage System	-	-	10,608,000	32.82	12,630,000	35.35	Break-even 1990-91	Slow but sure progress.

Henry Ansbacher Holdings PLC

One Mitre Square London EC3A 5AN Telephone 01-283 2500 (PBX) Telex London 8812459 Fax 01-626 0866

RD

24th April 1987

23 APR 1987

MR FAWCETT IR
PPS CST MST EST
MR Scholar
MR Cropper
PS/IR

The Rt. Hon. John MacGregor,
HM Treasury,
Whitehall,
London SW1.

Dear John

I know that you must be so busy with every aspect of the Finance Bill. I, therefore, apologise to disturb you with this approach which comes from our Managing Director of our Guernsey subsidiary. I think it is a well argued case and I do hope that it will either receive proper debate or be held over to a future occasion when further consideration can be given to it.

Yours ever

Charles.

Charles Longbottom
Director

Registered Number 1180361, England.

CLAUSE 47 OF THE FINANCE BILL 1987

1. The purpose of this memorandum is to suggest that this clause is unusual, if not objectionable, in a number of respects and that it should be carefully considered by legislators before being enacted and should not be rushed through Standing Committee ahead of the general election.

2. Sub-section 1 of the clause reverses the decision of the High Court in December 1986 in the case of Padmore v. Commissioners of Inland Revenue, in which it was held, reversing a decision of the Special Commissioners in March 1981, that a UK resident partner in a Jersey partnership was not, under the terms of the UK/Jersey double taxation arrangement, liable to UK income tax on his share of the profits of the partnership.

3. It is not contested that there may be good grounds for reversing the effect of this decision, though it could well be argued that arrangements similar to those applicable to Controlled Foreign Corporations would be more equitable, so that UK income tax would only arise if either the partnership were established in a tax haven (broadly speaking a jurisdiction in which the effective tax rate is less than half the UK tax rate) or the profits were distributed.

4. It is however suggested that for the provisions of double taxation arrangements (which are not confined to Jersey and are contained in most double taxation arrangements entered into with the UK) to be unilaterally overuled by a hastily enacted provision of the Finance Act rather than by re-negotiation with the countries concerned is unfortunate if not undesirable.

5. Irrespective of the provisions of sub-section 1 considerable exception is taken to the provisions of sub-section 2, which are to the effect that the amendment made by sub-section 1:-

> "shall be deemed always to have been made".

To quote Sir G Howe in the debate on the Finance Bill, 1978:-

> "Although I understand the difficulties ..... to march down the road of introducing retrospective legislation is to make a very fundamental and important change of principle ..... This is a serious path down which to march and we shall challenge the Government on it because it is dangerous to overturn this principle".

6. In the case to which Sir G Howe referred retrospection was at least limited to the preceding 2 years. Clause 47 is retrospective indefinitely. Moreover, retrospection has never before been used in legislation overriding freely negotiated double taxation arrangements. The retrospection was justified by the Chancellor by the argument:-

> "that the new legislation only restores the legal position to what it was thought to be before the case".

7. By whom? The fact is that for some 5 years the Inland Revenue have quoted the decision of the Special Commissioners in the Padmore case in March 1981 against tax payers without, because of the confidential nature of decisions taken by Special Commissioners, enabling tax payers to see the relevant judgment or understand the reasoning behind it and for the interim 5 years prior to the High Court decision tax payers have been waiting for a definitive ruling. It seems extraordinary that Parliament should now be asked to restore the Inland Revenue view of the law without regard to the views of tax payers and their advisers in situations which are in no way akin to the "Rossminster" type of tax avoidance schemes, but fundamentally affect major international professional partnerships.

J. M. B.
24.4.87

United Kingdom members of partnerships controlled abroad.

47.—(1) At the end of section 153 of the Taxes Act (partnerships controlled abroad) there shall be added the following subsections—

"(4) In any case where—

(a) a person resident in the United Kingdom (in this subsection and subsection (5) below referred to as "the resident partner") is a member of a partnership which resides or is deemed to reside outside the United Kingdom, and

(b) by virtue of any arrangements falling within section 497 of this Act (double taxation relief) any of the income or capital gains of the partnership is relieved from tax in the United Kingdom,

the arrangements referred to in paragraph (b) above shall not affect any liability to tax in respect of the resident partner's share of any income or capital gains of the partnership.

(5) If, in a case where subsection (4) above applies, the resident partner's share of the income of the partnership consists of or includes a share in a qualifying distribution, within the meaning of Part V of the Finance Act 1972, made by a company resident in the United Kingdom, then, notwithstanding anything in the arrangements, the resident partner (and not the partnership as a whole) shall be regarded as entitled to that share of the tax credit in respect of the distribution which corresponds to his share of the distribution."

1972 c. 41.

(2) Nothing in subsection (1) above affects

(a) the determination of any Commissioners or the judgment of any court made or given before 17th March 1987, or

(b) the law to be applied in proceedings on appeal to the Court of Appeal or the House of Lords where the judgment of the High Court or the Court of Session which is in issue was given before that date,

but, subject to that, the amendment made by subsection (1) above shall be deemed always to have been made.

Limitation of group relief in relation to certain dual resident companies.

48.—(1) Notwithstanding anything in the enactments relating to group relief, no loss or other amount shall be available for set off by way of group relief in accordance with section 259 of the Taxes Act if, in the material accounting period of the company which would otherwise be the surrendering company, that company is for the purposes of this section a dual resident investing company.

PWP

CONFIDENTIAL—FINAL REVISE

[to be published as House of Commons Paper 293 by Her Majesty's Stationery Office Price £7.70 net]

HOUSE OF COMMONS

Sixth Report from the

TREASURY AND CIVIL SERVICE COMMITTEE

Session 1986–87

THE 1987 BUDGET

Together with the Proceedings of the Committee, the Minutes of Evidence and Appendices

Ch
(1) Bit better on clashes between yr & Gov.
(2) Still don't understand IR/credit policy
(3) V irritating: they have not picked up all the corrections to yr evidence in the Report itself, though they have in the transcript of evidence. I am pursuing with the Clerks what can be done about this (*)
(4) Massive alternative report by Austin Mitchell.
AA

(* they have now come back to me to say many apologies, entirely their fault, will draw it to Terence Higgins' attention, but nothing they can do @ this stage)

Thanks. The mistakes on the graphs are v. serious.

This Document is issued in advance on the strict understanding that no approach is made to any organisation or person about its contents before the time of publication.

NOT FOR PUBLICATION, BROADCAST OR USE ON CLUB TAPES BEFORE:—

12.00 Hours BST on 22 APRIL 1987

The Treasury and Civil Service Committee is appointed under S.O. No 130 to examine the expenditure, administration and policy of the Treasury, Management and Personnel Office, the Board of Inland Revenue, and the Board of Customs and Excise and associated public bodies, and similar matters within the responsibilities of the Secretary of State for Northern Ireland.

The Committee consists of a maximum of eleven members, of whom the quorum is three. Unless the House otherwise orders, all Members nominated to the Committee continue to be members of the Committee for the remainder of the Parliament.

The Committee has power:

(a) to send for persons, papers and records, to sit notwithstanding any adjournment of the House, to adjourn from place to place, and to report from time to time;

(b) to appoint specialist advisers either to supply information which is not readily available or to elucidate matters of complexity within the Committee's order of reference.

The Committee has power to appoint one sub-committee and to report from time to time the minutes of evidence taken before it. The sub-committee has power to send for persons, papers and records, to sit notwithstanding any adjournment of the House, and to adjourn from place to place. It has a quorum of three.

Friday 9 December 1983

The following were nominated as members of the Treasury and Civil Service Committee:

Mr Anthony Beaumont-Dark
Mr John Browne
Mr Nicholas Budgen
Mr Mark Fisher
Mr Terence L Higgins
Mr Ralph Howell
Mr Peter Lilley
Mr Austin Mitchell
Mr Brian Sedgemore
Mr John Townend
Mr Richard Wainwright

Mr Terence L Higgins was elected Chairman on 13 December 1983.

The following changes in the membership of the Committee have been made:

Friday 27 January 1984: Mr Peter Lilley discharged; Mr Roger Freeman appointed.

Wednesday 26 February 1986: Mr Roger Freeman discharged; Mr John Watts appointed.

Friday 28 November 1986: Mr Mark Fisher discharged.

Monday 2 February 1987: Mr Tony Banks appointed.

The cost of preparing the Shorthand Minutes of Evidence taken before the committee and published with this Report was £1,329-15.

The cost of printing this Report is estimated by Her Majesty's Stationery Office at £12,828.

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HM TREASURY
Mr M C Scholar, Mr D L C Peretz, Mr J Odling-Smee, Mr P Sedgwick and Mr A Turnbull 1

Thursday 26 March 1987

BANK OF ENGLAND
The Rt Hon R Leigh-Pemberton, Mr E A J George and Mr J S Flemming 15

Monday 30 March 1987

HM TREASURY
The Rt Hon Nigel Lawson, MP, Sir Peter Middleton, KCB, and Sir Terence Burns 27

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SIXTH REPORT

The Treasury and Civil Service Committee has agreed to the following Report:

THE 1987 BUDGET

Introduction

1. Before preparing this report, we took evidence from the Chancellor of the Exchequer, Treasury officials, the Governor of the Bank of England and Bank officials. The oral evidence and a number of detailed written submissions from the Treasury, the Bank and the Board of Inland Revenue are appended to this report.

2. As in previous years, we have been supplied with a set of alternative forecasts, in order to make an independent assessment of the Treasury's Industry Act forecasts. Teams from the Henley Centre, the London Business School, the National Institute for Economic and Social Research and Phillips and Drew submitted two sets of forecasts. The first reflects their own assumptions about major future developments, the second a set of what we believe may be the latest Treasury assumptions.

3. Our advisers were Mr Gavyn Davies, Mr Christopher Johnson, Mr Bill Martin and Mr Terry Ward, to all of whom we are most grateful. The texts of the written papers which they prepared for us are set out in appendices to the Report. We also had before us two papers prepared for Members at large by the Parliamentary Unit of the University of Warwick. Those comprised an evolution of alternative fiscal measures on the econometric models of the Treasury, the London Business School, the National Institute for Economic and Social Research, and the Bank of England; and results from the Treasury model on fiscal policy and exchange rate targets.

Budget Documents

4. In our report on the 1986 Budget, we expressed the opinion that there was a substantial demand for clear, if semi-technical, presentation of Budget details which at present commercial productions meet to some extent, but which might be of interest to HMSO. Such a development would be particularly appropriate following the substantial and very welcome improvements of recent years in the form and presentation of all the Budget papers. We therefore recommended that the Treasury, together with HMSO, should look into the possibility of further promotion of the Financial Statement and Budget Report (the Red Book) and perhaps a revised Budget Supplement to the Economic Progress Report; and that the list of contents should once more appear on the front of the Budget day press releases.[1]

5. We must record our satisfaction with the Treasury's response. The contents list of press releases duly appeared. Perhaps more significantly, HMSO sent out 19,000 promotional leaflets and order forms for the Red Book as "essential reading for businesses of all kinds, students of economics and the well-informed layman." Thirdly, a version of the EPR *Budget in Brief* was put on sale at one of the main London railway stations at a very reasonable price. This was an experiment to test the market, at a modest total cost. The income from sales turned out to be greater than the expenditure:[2] we very much hope that the Treasury and HMSO will feel encouraged to repeat the experiment on a wider scale next year, whilst maintaining editorial objectivity. We look forward to hearing the outcome of HMSO's promotion of the current Red Book and (in due course) of the results of the marketing of next year's *Budget in Brief*.

Monetary Policy

6. The latest statement of the Government's monetary policy is contained in paragraphs 2.04–2.17 of the Red Book. The underlying aim of policy remains the same as that articulated in previous versions of the MTFS. Paragraph 2.04 states that, "policy is directed at maintaining monetary conditions that will bring about a gradual reduction in the growth of money GDP over the medium term." These will be achieved through the setting of "monetary and fiscal policies to achieve monetary conditions which will deliver [the Government's] objectives for money GDP".[3] Short-term interest rates remain "the essential instrument of monetary policy"[4]

[1] Fourth Report, 1985–86 (HC313) paras 7–9.
[2] HC Deb(1986–87) vol 113, c. *398*.
[3] Para 2.06.
[4] Para 2.07.

and will continue "to be maintained at levels necessary to keep monetary conditions on track."[1] Paragraph 2.09 explains that "monetary conditions are assessed in the light of movements in narrow and broad money, and the behaviour of other financial indicators, in particular the exchange rate".

7. While the Government has again stated a target range for narrow money MO for 1987–88 it has refrained from setting a target range for £M3. Paragraph 2.17 of the Red Book states that "both the Chancellor and the Governor of the Bank of England have drawn attention to the increasing difficulties in interpreting changes in broad money. With rapid and pervasive changes in financial practices there is no simple relationship between broad money growth and money GDP." The target range for MO growth in 1987–88 is 2–6 per cent, unchanged from the range indicated in last year's MTFS.

8. The Red Book is more explicit than usual about the role of the exchange rate in monetary policy. Paragraph 2.10 notes that, "at a meeting of Finance Ministers and Central Bank Governors of six major industrial nations in Paris on 22 February, it was concluded that a period of stability would be desirable. Accordingly the UK and other countries represented there agreed to cooperate closely to that end. The MTFS projections assume that there is no major change in either the sterling exchange rate index or the sterling/dollar exchange rate from year to year." While the latter assumption always accompanies each new version of the MTFS, given the Chancellor's post-Budget comments[2] there now seems to be clear justification for assuming that the Government has an implicit exchange rate target. We return to this question in paras 34–41.

9. In seeking guidance on changes in monetary conditions, the Government continues to place the main emphasis on narrow money. Paragraph 2.14 explains that, "if the underlying growth of MO threatens to move significantly outside its target range in 1987–88 there is a presumption that the Government will take action on interest rates unless *other indicators* [our emphasis] clearly suggest that monetary conditions remain satisfactory". We expressed interest in the "other indicators" used to assess monetary policy and their role relative to MO in determining possible changes in short term interest rates. Treasury officials told us that in addition to narrow money, broad money and the exchange rate

> "We look at quite a range of evidence. Movements in asset prices, house prices, the stock-exchange—can produce valuable evidence about monetary conditions. The most up-to-date information about inflation itself, which includes producer prices as well as consumer prices. Movements in the oil price which is clearly one of the important factors which affect the exchange rate, and to some extent movements in the interest rates themselves, and how our rates compare with rates abroad and interest rate differentials. I do not want to give the impression that that is a complete list."[3]

They went on to say that:

> "MO has proved quite a reliable indicator for a number of years, so we would need some persuading that it was telling us wrong things but, if the range of other evidence said it was giving us a misleading message, then we would do precisely what it says in that paragraph. [2.14]."[4]

10. In previous reports we have expressed doubts about the suitability of MO as a leading indicator since there have been occasions on which it appeared to respond to money GDP changes with a lag, rather than leading changes in nominal income. Although in oral evidence the Treasury attempted to refute this claim, referring us to published research which seemed to show that "if anything, the evidence is that money GDP follows MO",[5] we remain unconvinced, and are relieved to find that in assessing monetary conditions MO is supplemented by such a range of other indicators.

11. The recent behaviour of some of the indicators used to assess monetary conditions calls for greater clarity about the use made of them by the authorities.

(but about "distinct divergence of view" omitted)

12. In our reports both on the 1986 Budget and the Chancellor's Autumn Statement we expressed concern at the build up of liquidity, graphically described by the Governor of the Bank of England as an "overhanging glacier of liquidity." The Red Book alludes to the

[1] Para 2.07.
[2] *Financial Times*, 19 March 1987.
[3] Q. 11.
[4] ibid.
[5] Q. 3.

continuing build up of private sector liquidity but gives the impression that the Government felt no particular anxiety about this, together with any future consequences that such a build up might have on the economy. Paragraph 2.15 tells us that:

> "Private sector borrowing has been rising and is now over 10 per cent of GDP. It has clearly contributed more than public borrowing to upward pressure on real interest rates. These trends are likely to persist, so that broad money growth may continue at around its recent rate, well in excess of the growth rate of money GDP."

13. In oral evidence, however, the Chancellor seemed to argue that the growth in personal bank lending and the upward pressure on interest rates was in some sense a reflection of Government policy in other areas:

> "If you look at the figures, the growth as a share of GDP is entirely attributable to the growth of mortgage borrowing. Although there is no doubt some equity withdrawal, this borrowing is primarily for the purpose of house-purchase and home improvement. It is part of the Government's policy to encourage home ownership, including the purchase by council tenants of the homes in which they live. That therefore leads to more mortgages being taken out. Provided that we can contain the monetary consequences of that, which we are doing, and have done—then I do not regard that as a matter of concern."[1]

However house prices have continued to rise, and they are one of the Government's "other indicators".

14. When we questioned the Governor about the growth of personal credit he was less sanguine. He told us that, "we are concerned that we have a monthly increase of £2.5 billion in bank lending."[2] On prudential grounds the Bank of England has

> "seen fit to make observations before now to the retail banks above all—indeed, to all providers of credit—that they should think very carefully about the level of personal borrowing. . ."[3]

15. When asked if the point had been reached where direct volume controls should be imposed on the supply of personal credit, the Governor told us that:

> "I would not be at all averse to those if they can be effected. They are a form of direct control or physical control against which in some respects we set our face at the moment, but if they could be effected I think it would be a not inappropriate instrument."[4]

He did go on to point out, however, that given the amount of change that had occurred in financial markets he did not think that the imposition of volume controls would provide an effective solution.

16. As regards the effective means of controlling the build up of liquidity in the economy, the Red Book places the onus on short-term interest rates. When asked if, in the determination of the appropriate policy, it was important to distinguish between the various factors responsible for growth of the money supply, such as an underfunded PSBR or an autonomous increase in the demand for consumer credit, the Chancellor told us that:

> "I do not think it is very necessary to distinguish between them, since what matters is overall monetary growth and we do not have separate instruments for separate causes of monetary growth. Whatever the cause of excessive monetary growth or monetary growth one might consider to be excessive, the only real instrument one has to deal with it is the level of interest rates, particularly short term interest rates".[5]

Sir Peter Middleton concurred that:

> "with a given fiscal policy, since we abolished exchange controls and the corset came to an end, the only instrument is interest rates, there is not another one."[6]

We assume from this that the Government bases its approach on funding the PSBR completely, and uses short-term interest rates to control any increase which may take place in the growth of credit about that deemed to be consistent with its overall macro-economic objectives.

17. There seems however to be considerable uncertainty about the extent to which bank lending and the demand for credit generally respond to changes in short-term interest rates. The view was put to our predecessor Committee in 1980–81, by Professor Friedman that:

[1] Q. 187.
[2] Q. 122.
[3] Q. 123.
[4] Q. 138.
[5] Q. 184.
[6] Q. 187.

"Manipulating interest rates . . . has a highly erratic and undependable influence on the quantity of money demanded over the kind of short periods which . . . are crucial for monetary control (periods of a few months up to a year or more.)"[1]

A different view was taken by the Governor of the Bank of England in our current inquiry who put it to us that while mortgage borrowing may be more sensitive to the rate of interest,[2] ordinary private borrowing is not very responsive to such changes.[3] As the Bank has reminded us on a number of occasions, lending to the private sector—whether personal consumer credit or mortgages—has increased significantly in the past, irrespective of the rate of interest. Moreover, most of the previous discussion on the control of monetary growth by the use of short-term interest rates has taken place against a different background from that of today. Even if Professor Friedman is wrong, and even if only a proportion of borrowing is interest-rate sensitive, the Government's task in restraining overall monetary growth—stopping the overhanging glacier from expanding still further—will be doubly difficult at a time of falling interest rates.

Public Expenditure after the Budget

18. We welcome the increased emphasis given this year to a discussion of the relative advantages of increases in public expenditure, cuts in taxation, and changes in government borrowing. We now turn to consider public expenditure, the PSBR, and the forecasting of the fiscal adjustment.

19. The upward revision in the estimate of inflation from $3\frac{3}{4}$ per cent at the time of the Autumn Statement to 4 per cent in the latest Industry Act forecast will affect the real value of the public expenditure plans represented in the Autumn Statement. The £4.5 billion then added to the existing planning total has since been offset to a significant extent by a general erosion in what authorities are capable of purchasing with the cash budgets allocated to them. When adjusted to take account of the forecast rise in inflation, the planning total for 1987–88 has been reduced in real terms by around £1.4 billion at 1985–86 prices. The rate of growth in expenditure, which was to be about 2 per cent between this year and next, is now estimated to be 1.5 per cent in the case of the planning total and 1.1 per cent if debt interest is included.[4] Both figures are below the average rate experienced since 1978–79.

20. We asked Treasury officials if, given the forecast increase in inflation together with the unrevised planning totals, the spending plans announced at the time of the Autumn Statement could be met. We were told that, "the Govenment will be seeking to hold those totals."[5] It was pointed out however that the Planning Total might not now be so sensitive to changes in the rate of inflation.

"One other factor to bear in mind is that when inflation is rising one major source of risk is the fact that social security benefits are linked to inflation. The timing of the upratings now operates by taking the inflation rate in the year to September applying it from the following April. Thus for the coming year the social security benefits have an uprating that has already been settled and whatever happens to inflation in the current months will not affect the rate of expenditure during 1987–88. Thus there is a very large chunk which, in effect, is immune from current movements of inflation".[6]

Nonetheless past experience suggests that spending is likely to overshoot the Planning Total.

The PSBR

21. The expected outturn for the PSBR in 1986–87 is £4 billion, or about 1 per cent of GDP, and the Chancellor announced a similar target for 1987–88. In announcing the PSBR target for 1987–88 the Chancellor said:

"Since its inception in 1980, the MTFS has indicated a steadily declining path for the PSBR expressed as a percentage of GDP. We have now reached what I judge to be its appropriate destination—a PSBR of 1 per cent of GDP. My aim will be to keep it there over the years ahead. This will maintain a degree of fiscal prudence that, until this year, has been achieved on only two occasions since 1950."[7]

[1]Third Report, 1980–81 (HC163–I) para 6.8.
[2]Q. 151.
[3]Q. 119 and 120.
[4]See Appendix 1 (Terry Ward).
[5]Q. 99.
[6]Q. 100.
[7]HC Deb (1986–87) 112, c. 818.

22. We have for some time discussed in evidence with the Treasury the relevance of the PSBR as a measure of the Government's underlying need to borrow when privatisation proceeds are a significant source of finance. In 1987–88, the PSBR target is £4 billion, and privatisation proceeds are expected to total £5 billion. Although the Government continues to frame its fiscal policy in terms of the PSBR, we welcome the fact that it has effectively acknowledged our previous arguments. For example, Chart 2.5 of the Red Books shows the evolution of the PSBR as a percentage of GDP: it shows both PSBR and privatisation proceeds, and the sum of the two. We note that the Public Sector Financial Deficit, which measures the Government's underlying need to borrow *before* privatisation proceeds are subtracted from expenditure, is forecast to fall from 2.9 per cent to 2.3 per cent of GDP. It is not clear to us why the Government has not reduced the PSBR still further, to below 1 per cent, when the underlying need to borrow exceeds the long run target of 1 per cent. We note the Chancellor's argument[1] that holding the PSBR steady at 1 per cent is the modern equivalent of the balanced budget doctrine.

23. We are in any case unclear why a PSBR of 1 per cent of GDP is regarded as an "appropriate destination". Officials from the Treasury suggested a number of reasons for maintaining a positive PSBR, principally the contribution which a declining PSBR could make to the Government's money GDP objective:

> "There is clearly a demand for public sector debt and, as long as the economy is growing, there will be some interest in holding debt. That is one argument. Another is that it would be quite consistent with the growth of money GDP that the Government is seeking. In the very long term of course that is a growth which is equal to the rate of growth of productive potential, and the Government sees no difficulty about selling an extra amount of debt which would match the accumulation of assets to some extent. I do not mean exactly match but taking place in a world where there is also some accumulation of assets this would be a stable and sustainable situation.[2]

and

> "The objective of every fiscal policy since the first MTFS in 1980 has been to keep public sector borrowing at a level, and if necessary on a declining trend, which will support monetary policy. The role of monetary policy has been to create monetary conditions which will bring about the desired growth of money GDP and in the early days put heavy downward pressure on inflation. We are now saying that the illustrative path of the PSBR over the medium term of 1 per cent of GDP is fully consistent with those broad objectives".[3]

24. The Chancellor gave primacy to the desirability of preventing the ratio of debt to real GDP from rising:

> "It has been clear to me throughout my time as Chancellor that 1 per cent of GDP would be an appropriate destination. This was implicit, for example, in the Green Paper "The Next Ten Years: Public Expenditure and Taxation into the 1990s", which I published simultaneously with my first Budget in 1984. If you turn to paragraph 55 of that Green Paper, you will see it stated that, "In the period to 1988–89, the PSBR is assumed to follow the illustrative path set out in the MTFS. Thereafter it is assumed to fall further as a share of GDP from $1\frac{3}{4}$ per cent in 1988–89 to 1 per cent in 1993–94". The reasoning behind the 1 per cent equilibrium level implicit in the Green Paper was made rather more explicit in my Lombard Association speech last April; let me quote from that: "There is, of course, no scientific formula for determining the 'right' size of the PSBR . . . But, . . . over the medium and longer term, it is clearly important that the amount of public debt, and the burden this imposes, should not rise as a proportion of GDP". Over the medium and longer term the Government's objective is zero inflation. It follows that money GDP will then grow at the real rate of growth of the economy, perhaps an underlying $2\frac{1}{2}$ per cent a year, to be on the safe side. Against that background 1 per cent PSBR will ensure that public debt does not rise as a share of GDP. This is the modern equivalent of the balanced budget doctrine. By contrast, to allow the debt GDP ratio to remain constant on anything other than a zero inflation basis is simply a recipe for accelerating inflation."[4]

25. With a PSBR at 1 per cent of GDP, the public debt ratio may be stable; but the Chancellor has not offered any arguments in favour of this or any other ratio. He has simply stated that he does not want it to increase. The Chancellor acknowledged that this target has been achieved

[1] Q. 172.
[2] Q. 69.
[3] Q. 73.
[4] Q. 172.

more quickly than anticipated due to two factors, the unexpectedly strong revenue outturn and the contribution of asset sales. However, no reasons have been given why the current debt: GDP ratio is preferable to that which would have obtained if the economy had evolved in line with the 1984 Green Paper, which did not envisage the fall to 1 per cent until 1993–94.

26. Officials from the Treasury admitted a connection between the accumulation of new public assets and the level of borrowing. The Chancellor rejected a more formal analysis of public finances in terms of a government or national balance sheet which considered both public sector assets and liabilities and incorporated the notion of the net worth of the government sector:

> "I do not think it is possible in practical terms to know what the net worth of the public sector is, whereas you do know what public sector debt is.[1]"

27. We note that the framework for determining the PSBR in the long term is designed to avoid a situation where public debt grows as a proportion of GDP. The Chancellor, quite rightly, wishes to avoid a situation in which public debt grows uncontrollably. But beyond that he has given no compelling reason for one level of debt rather than another. Indeed, if the Government believe that past borrowing was excessive, it might even be argued that a case existed for reducing overall public debt by the creation of fiscal surpluses. We urge the Treasury to address this issue more fully in future versions of the MTFS.

FORECASTING

28. When announcing the planning total increases in the Autumn Statement, the Chancellor implied strongly that the scope for tax cuts was substantially reduced. Indeed, a target for the PSBR of $1\frac{3}{4}$ per cent of GDP without any tax cuts then seemed to be the best the Chancellor was hoping for. He told us that:

> "As I said in the House in the questioning that followed the Autumn Statement, a pound used in additional public expenditure is a pound which is not available for reductions in taxation, unless you are prepared to expand the borrowing requirement, and I have made it clear and explicit that I will not do[2]

29. The difference between the situation anticipated in October and that which occurred is due almost entirely to the fact that Government revenue was substantially higher than expected. Non-oil receipts (including interest and dividends) were about £4 billion higher in 1986 than those projected in last year's Budget. £$1\frac{3}{4}$ billion of this is due to higher than expected corporation tax receipts. We asked Treasury officials the reasons for this large forecasting error. There were two reasons:

> "One is that I think we underestimated profits in the previous year, particularly for financial companies. That was one reason. The other is that following a period when there have been substantial growth of profit over a number of years, and large profit growth in each year, it is very difficult to estimate the extent to which previously tax exhausted companies begin to pay tax. I think that the latter is probably one of the most important reasons—or the main reason—why this time last year we underestimated onshore (which is what we are talking about here) Corporation Tax receipts in 1986–87[3].

30. So far as concerns the movement of companies into tax-paying positions officials said that:

> "a good deal of this information becomes available on an aggregate basis, which is what one needs here for making forecasts of total Corporation Tax receipts somewhat in arrears".[4]

31. The Inland Revenue have supplied the committee with an account of their forecasting procedures. On the crucial question of companies moving into tax paying positions they said that:

> "Although the amount of loss has to be agreed ultimately with each company and recorded in the tax office files, the process can be protracted particularly in the case of the larger, more complex group transfers and overseas tax. In consequence it would be some years before the agreed figure would actually appear in a central record and its use as a forecasting base would therefore be very limited. We believe that a more reliable estimate of the loss overhang can be estimated, from tax offices each year in respect of the sample of companies used in the forecasting model. Here, however, as has been explained, an estimate of total

[1] Q. 213.
[2] Second Report, 1986–87 (HC27) para 21.
[3] Q. 105.
[4] Q. 108.

losses for the current year requires a projection over at least two years and is therefore subject to a wide margin of error."[1]

The Inland Revenue appear to rely excessively on taxable profits already three years old. Their forecasting should embrace information on profits in more recent years, despite the narrower range of samples available. There should also be more intensive scrutiny of the estimated £25 billion to £30 billion of outstanding agreed tax losses, to examine the possibility of estimating more closely the likely application of such losses, which could reduce the yield of Corporation Tax year by year.

32. The increase in Corporation Tax receipts, which is becoming increasingly important, is expected to continue in 1987–88. Another £1½ billion of the higher general government receipts in 1986–87 is attributed to a miscellaneous category including a statistical balancing item.

33. We note that the significant and unexpected reductions in taxation and the PSBR target announced for 1987–88 have been made possible only because the original forecasts proved inaccurate. The fiscal environment has changed in only a few months. We note the forecasting difficulties experienced by the Inland Revenue: nevertheless, we urge the Treasury to endeavour to improve its forecasting performance in this area so that such surprises, even pleasant ones, are less likely in future.

THE LOUVRE ACCORD

34. The agreement reached in Paris between the group of six major industrial nations on exchange rate intervention represents a significant advance on the Plaza Agreement of September 1985. The Governor told us that:

> "The understanding which emerged from the Louvre Accord was that the exchange rate parities that prevailed at that time were considered satisfactory, and that if there were divergences in that, the central banks of the countries present would concert any action to correct the divergences . . . If I might say this, Mr Chairman, the experience of both the Louvre Accord and the Plaza too eighteen months before that, in September 1985, shows that there is actually a very effective role for the central banks where we can really be sure that the central banks, the five or six or seven, are operating together, and operating in circumstances in which the overall market situation is receptive to that concerted intervention."[2]

35. The Governor's statement suggests very strongly to us that target ranges for the G6 currencies have been established, if only informally or implicitly. However, both the Chancellor and the Governor would not admit that any target bands existed. The Chancellor told us that:

> "I am saying that we did go into the question of currency fluctuations very thoroughly. We did go into the nuts and bolts, but we also agreed we would not reveal those to the market"[3]

> "I am not saying whether they [target bands] exist or not. What I am saying is, we do not publish the nuts and bolts of the Paris Accord."[4]

36. The Governor said that specific ranges were not even discussed:

> ". . . quite honestly, very little is said between us central bankers, actually, about figures, numbers and money. We have an understanding"[5]

37. We cannot see how the G6 can conclude that existing parities are "about right" without also having in mind bands around these parities which they regard as acceptable. Our scepticism is reinforced by reports that the Japanese Prime Minister has admitted that a target rate of Y150 to the dollar was discussed and agreed by all parties in Paris.[6] Secondly, if central banks do not discuss "figures and numbers" it is difficult to see how they could agree on concerted action when these "acceptable parities" are breached.

38. The Chancellor's reason for not making public the "nuts and bolts" of the G6 meeting, including whether or not target ranges exist was:

> "The advantage of that is so as not to make it easy for the operators on the foreign exchange market to speculate or deal successfully against the policy of the countries represented at the Louvre"[7]

[1] Appendix 6, para 9 (Board of Inland Revenue).
[2] Q. 143.
[3] Q. 257.
[4] Q. 256.
[5] Q. 145.
[6] *Daily Telegraph* 31 March 1987 p 19.
[7] Q. 259.

The Governor agreed, stating:

"I think we are more effective in our concerted intervention if we can leave the market guessing about at what moment we come in and out."[1]

In the wake of the Louvre meeting we find this argument less convincing than previously. Having agreed and announced publicly that existing parities are satisfactory, the authorities in the G6 countries have effectively told the markets that they will resist substantial movements away from the parities. All that remains is for the markets to test the bounds of the central banks' tolerance. It is unlikely to take long for them to do so.

39. The Governor admitted that in operational terms, the Accord and membership of the ERM (Exchange Rate Mechanism) of the EMS are similar:

"Those who are members of the Exchange Rate Mechanism at the moment would readily recognise that membership carries with it the problem that it is not possible to continue at the same time a totally independent domestic monetary policy and the whole issue here is the value that one puts relatively on the ability to continue to run an independent domestic monetary policy as against the benefits of being in a recognised exchange rate bracket. You say would it not be better to be in because we are, to some extent, operating as though we are in. Actually, if we are operating as though we are in—and I would readily concede that perhaps since the Louvre Accord we are operating as though we are in something because we are cooperating within that Accord, and may I emphasise it is an accord, it is not a formal agreement—we do still at the present moment retain the right to operate an independent monetary policy. I think it is known that the Bank of England has said before that in principle probably we would favour full membership provided our entry would be consistent with the anti-inflationary objectives of the MTFS. We still have the problem of being an oil-producing country as against the other members and I do not think I can say much more to you than that those are the issues. It remains, I think, primarily—not primarily, of course, but absolutely a matter for the Government, not for the Bank of England, and I think you will have to wait and see what happens."[2]

40. The two are not, however, completely equivalent. The claimed advantages which might occur from joining the ERM—improved business confidence, a lower risk premium in UK interest rates, and a guarantee of assistance in difficulties from fellow members—do not seem to flow from the Accord. On the other hand, the presumption which now exists that the Bank of England will defend existing parities involves a loss of that flexibility and tactical advantage over the markets which the Chancellor commended.

41. A consequence of not disclosing the "nuts and bolts" of the Accord is that the G6 countries' likely response to changed circumstances is not clear. However, the Chancellor indicated that each country is expected to maintain policies consistent with the current pattern of exchange rates:

"If domestic action is needed, then there is the presumption that that would be taken by the country that needs to take the action. If, however, it does not appear that that is the case and, therefore, that intervention would be appropriate in the currency markets, that intervention would be concerted."[3]

Better

The Governor suggested that a major change in the underlying economic environment might be accommodated by changes in exchange rate parities:

"I do not think that this was specifically talked about there, but I would feel confident enough to take upon myself this sort of interpretation of the view there, which is that if there was some major structural change in the world economic situation which affected one of the partners there specifically, it would be understood that they would either be released to a degree from their commitment or there would be a different reaction from them. The movement of the oil price would be I suppose, the most typical of all the sorts of things that would come under that heading."[4]

BALANCE OF PAYMENTS

42. The forecast for the current account of the Balance of Payments has been revised substantially downwards since the Autumn Statement in part reflecting revisions to estimates of

[1] Q. 145.
[2] Q. 159.
[3] Q. 219.
[4] Q. 144.

the invisibles balance in 1986. The Balance of Payments deficit for 1987 is now forecast at £2.5 billion as compared with the Autumn Statement figure of £1.5 billion. More significantly, for longer term economic prospects, the deficit in trade in manufactures is forecast to increase from £5.5 billion in 1986 to £8 billion in 1987.

43. This assessment may be too pessimistic. In the first place, the economy achieved a real improvement in competitiveness in 1986. Moreover, para 3.22 of the Red Book points out that "most of the gain in competitiveness seems likely to be maintained over the year ahead." The January and February 1987 Balance of Payments figures suggest that the 'J-curve effect' is beginning to show. Secondly, the forecast assumes an oil price of US$15 a barrel, which is likely to be low. The price of oil has firmed, and since the UK is an important exporter of oil, there should be a favourable consequence for the Balance of Payments. We are therefore less concerned about the Balance of Payments than a number of other commentators.

6 *April* 1987

ANNEX

TABLE 1

BASE FORECASTS

	Variable	Henley	LBS	NIESR	P&D	Treasury
A.	Output and Expenditure at 1980 prices—% change					
(i)	GDP (factor cost)					
	1987 over 1986	3.1	2.9	2.8	2.9	3.0
	1988 over 1987	2.5	2.7	2.4	2.0	
(ii)	Consumers' Expenditure					
	1987 over 1986	3.8	3.9	4.3	3.9	4.0
	1988 over 1987	2.5	3.2	3.7	2.3	
(iii)	General Government Current Expenditure					
	1987 over 1986	2.6	0.8	2.2	1.9	1.0
	1988 over 1987	1.3	1.0	1.0	1.5	
(iv)	Fixed Investment					
	1987 over 1986	2.5	4.5	2.8	3.4	4.0
	1988 over 1987	4.0	4.2	4.6	2.9	
(v)	Exports (Goods and Services)					
	1987 over 1986	4.0	4.3	3.3	3.8	4.0
	1988 over 1987	2.5	3.4	1.3	1.2	
(vi)	Imports (Goods and Services)					
	1987 over 1986	5.4	4.7	8.0	6.4	6.0
	1988 over 1987	3.1	3.6	4.2	3.4	
(vii)	Changes in Stockbuilding as per cent GDP					
	1987 over 1986	0.6	0.14	0.9	0.1	0.5
	1988 over 1987	0.7	0.07	0.0	0.4	
B.	Balance of Payments, Current Account £ billion					
	1987	−2.8	−1.9	−2.6	−2.8	−2.5
	1988	−2.1	−0.7	−4.0	−3.3	
C.	PSBR, £ billion, fiscal years					
	1987–88	5.3	4.3	8.6	5.5	4.0
	1988–89	7.5	4.7	6.3	7.2	
D.	Retail Price Index, % change					
	Q. 4 1986 to Q. 4 1987	4.1	3.2	4.7	4.4	4.0
	Q. 4 1987 to Q. 4 1988	5.4	3.5	5.9	5.5	
E.	Money Supply (£M3) % change					
	Q. 1 1987 to Q. 1 1988	16.0	14.5	[1]	15.4	[1]
F.	Unemployment, UK, excluding school leavers, millions					
	1987 Q. 4	2.9	3.1	2.9	3.0	3.05[2]
	1988 Q. 4	2.9	3.1	2.9	2.9	
G.	Effective Exchange Rate					
	1987 Q. 4	68.0	70.0	67.2	68.2	72.5[3]
	1988 Q. 4	66.7	70.0	65.1	63.9	

[1]Not forecast.

[2]Based on the Autumn Statement Estimate ie "Great Britain excluding school leavers etc".

[3]"The MTFS projection assume that there is no major change in either the sterling exchange rate index or the sterling/dollar exchange rate from year to year."

TABLE 2

COMMON ASSUMPTIONS FORECAST

	Variable	*Henley*	*LBS*	*NIESR*	*P&D*
A.	Output and Expenditure at 1980 prices—% change				
(i)	GDP (factor cost)				
	1987 over 1986	2.4	2.5	2.3	2.6
	1988 over 1987	2.6	1.8	2.2	1.5
(ii)	Consumers' Expenditure				
	1987 over 1986	3.8	3.7	4.2	4.0
	1988 over 1987	2.8	2.4	3.6	2.6
(iii)	General Government Current Expenditure				
	1987 over 1986	1.0	1.1	1.3	1.0
	1988 over 1987	1.0	0.7	1.0	1.0
(iv)	Fixed investment				
	1987 over 1986	2.3	4.3	2.4	3.2
	1988 over 1987	3.8	2.9	4.8	1.5
(v)	Exports (Goods and Services)				
	1987 over 1986	3.2	3.5	4.1	3.0
	1988 over 1987	1.5	1.4	0.6	−2.3
(vi)	Imports (Goods and Services)				
	1987 over 1986	5.7	4.2	8.9	5.8
	1988 over 1987	3.6	2.3	4.2	0.8
(vii)	Changes in Stockbuilding as per cent GDP				
	1987 over 1986	0.6	−0.05	0.8	−0.3
	1988 over 1987	0.7	−0.1	0.1	0.2
B.	Balance of Payments, Current Account £ billion				
	1987	—3.2	—0.6	−4.1	−3.4
	1988	−3.5	1.44	−4.1	−4.5
C.	PSBR, £ billion, fiscal years				
	1987–88	4.5	6.2	8.8	6.0
	1988–89	6.5	8.2	7.5	8.5
D.	Retail Price Index. % change				
	Q. 4 1986 to Q. 4 1987	3.9	3.1	3.7	4.0
	Q. 4 1987 to Q. 4 1988	4.4	2.9	4.9	3.9
E.	Money Supply (£M3) % change				
	Q. 1 1987 to Q. 1 1988	15.0	14.7	[1]	14.1
F.	Unemployment, UK, excluding school leavers, millions				
	1987 Q. 4	2.9	3.1	2.96	3.1
	1988 Q. 4	2.9	3.2	2.9	3.2
G.	Effective Exchange Rate				
	1987 Q. 4	72.5	72.5	72.5	72.5
	1988 Q. 4	72.5	72.5	72.5	72.5

[1]Not forecast.

TABLE 3

ASSUMPTIONS IN COMMON ASSUMPTIONS FORECAST

% *Change Q. 4 1986—Q. 1 1989* *(unless otherwise stated)*	
North Sea Output	—12.0
World Oil Price ($)	0
$/£ rate	0
Effective Exchange Rate	72.5
1975:100	
World Interest Rates (% points)	0
World Export Prices	8.16
World Trade in Manufacturers	7.6
UK short-term interest rates (% points)	0
Government expenditure (1980 prices)	
1987–88 over 1986–87	1.0
1988–89 over 1987–88	1.0

Sources: North Sea Output: HC Debates (1986–87) Vol 112. No. 68 col. 44.
Other Assumptions: The Red Book.

PROCEEDINGS OF THE COMMITTEE RELATING TO CONSIDERATION OF THE REPORT

MONDAY 6 APRIL 1987

Members present:

Mr Terence L Higgins, in the Chair

Mr Banks	Mr Austin Mitchell
Mr Beaumont-Dark	Mr Sedgemore
Mr Browne	Mr Townend
Mr Budgen	Mr Wainwright
Mr Ralph Howell	Mr Watts

Draft Report, proposed by the Chairman, brought up and read.

Draft Report, proposed by Mr Mitchell, brought up and read, as follows:

THE 1987 BUDGET

INTRODUCTION

1. The British economy in 1987 presents an historic opportunity to combine a long overdue reform of the tax-benefit system with the change in fiscal, monetary and exchange rate policies necessary to put the unemployed back to work. By opting instead for the electoral window-dressing of misdirected tax cuts and a doctrinaire reduction in the Public Sector Borrowing Requirement the Chancellor has thrown the opportunity away. As a result the current welcome improvement in economic performance will peter out. Instead of boosting the economy onto that path of high and sustained growth which is essential if the damage done from 1979 to 1982 is to be made good and Britain's manufacturing base rebuilt he has opted for the ostrich position.

2. The economy has in fact been stimulated by two developments which government proclaimed to be undesirable and dangerous: an expansion of public spending and a fall in the exchange rate. The behaviour of the economy was less favourable than the Chancellor had anticipated in his 1986 budget but the situation was transformed by a wholly unanticipated fall of some 10 per cent in the exchange rate below the levels then forecast. The volume of our exports rose 6 per cent and this, coupled with a consumer boom sustained by a lower than expected savings ratio, a 4½ per cent increase in real disposable incomes and a massive expansion of consumer borrowing led to a substantial increase in revenue particularly from Corporation Tax and VAT.

3. Taken with a possible increase in the Public Sector Financial Deficit, currently very low by both historic and international standards, this bonus could have allowed the Chancellor to achieve several essential objectives, an opportunity open to few of his predecessors since the war. An increase in public spending would have increased employment substantially and allowed the deficiencies which have emerged in housing the public infrastructure, local authority and nationalised industry investment, and such services as health and education to be made good after several years of skimping and cuts. Spending on improved benefits would have channelled money directly to a section which needs it badly and spends it quickly, thus removing unfairnesses and stimulating demand at the same time. Tax cuts, though less beneficial to employment could have been devoted to reductions in National Insurance Contributions thus bringing down labour costs and allowing a regional incentive to employment outside the South East. The whole tax structure could have been reformed and made fairer.

4. Instead of seizing his opportunity the Chancellor has opted for a holding strategy which guarantees that the economic improvement will peter out. Investment is down, particularly in manufacturing industry where there has been a net disinvestment. Instead of being sustained, the benefits from the fall in the exchange rate are being endangered by a reversion to the old short-sighted strategy of keeping the rate as high as possible by interest rates which remain far too high. Competitiveness has already deteriorated substantially compared to the best levels attained last year: and the Chancellor has now unwisely agreed to maintain sterling in undisclosed bands, an EMS strategy without actual membership of the Exchange Rate Mechanism. He has also announced that he would like to keep sterling "about where it is now" which, at an index of 72–3 is far too high to sustain competitiveness.

5. The government was ready to take the credit for the benefits arising from a fall in the exchange rate which it neither anticipated nor wanted and, indeed, worked hard to stop. It has not, however, seen the benefits available by sustaining it. Nor has it been prepared to change policies in the substantial way required if the unemployed are to be put back to work and the economy put into full gear to face the world. These require a change of government and a new approach dedicated to expansion, reconstruction and social justice. The opportunity to effect that change will shortly present itself to the British electorate. We have therefore used the present Chancellor's last budget as the occasion for a more sustained look at the causes of our present economic discontents. An economy running at half-cock betrays its responsibilities to the British people, so we have considered the keys to the major expansion which is required if Britain is to survive the gradual removal of the oil prop which has been so grievously misused by this government. Without it monetarist economic policies would have produced an even greater disaster than they already have. It cannot last forever. We must prepare for a future when it is no longer there.

THE NATURE OF THE PROBLEM

6. No solution to Britain's problems can be of practical use unless it recognises that the loss of four million jobs is entirely due to a deficiency of spending on UK goods and services by home and overseas buyers. Mass unemployment is always caused by a deficiency in spending. Mr James Callaghan was mistaken when he told the Labour Party Conference in 1976 that we could no longer spend our way out of a recession. There is no other way out. A deficiency can only be remedied by an increase.

good ammunition

7. This deficiency springs from two causes. The general one, common to Britain and many other advanced countries, particularly those in the EEC, is credit and fiscal policies deliberately kept far tighter than they should be because of the obsessive fear of inflation. Central banks destroy jobs when they bring about a shrinkage in the flow of money in their regulation of credit. The deficiency in spending in the countries whose exchange rates are determined by the European Monetary System has led to the loss of up to ten million jobs through the "non-accommodating" monetary policies pursued by their central banks. Similarly the Chancellor, in his 1981 Zurich speech, recognised that "in a recession it would be wholly appropriate . . . for monetary growth and the PSBR to be allowed to rise above the medium term trend line".[1] This suggests discretionary action to boost the budget deficit by an amount equal to the natural increase brought about by the reduction. Unless mass unemployment is to be regarded as a permanent norm.

8. The position of the UK is worse than that of any of the other countries whose economies are being under-run because of credit and fiscal policies which are too tight. Here the shortage of domestic purchasing power has been heightened by a grossly overvalued exchange rate. This has been a feature of British policy since the war. The overvaluation reached insane height from 1979–1981, though without producing that determined action to get the exchange rate down which has characterised American reaction to a similar threat to their currency. An overvalued exchange rate reduces the demand from overseas for UK products and ensures that a higher proportion of the reduced demand for consumption and investment within the UK is met by imports. In a normal situation the balance of payments deficit resulting from this surge of imports would have brought down the exchange rate. This self correcting mechanism has been frustrated in Britain by high interest rates, increased each time there was a threat to the pound, and, more important, by oil, enabling us to balance our payments without depressing the exchange rate and thus to buy still more goods and services from abroad to destroy jobs at home.

9. The current fall in the value of the dollar, and the rise in the Deutschmark and the Yen which are necessary if Germany and Japan are to trade fairly with the rest of the world, both combine to present Britain with an historic opportunity to recover the ground lost to our competitors in home and export markets. Seizing this opportunity requires a total change in policy, to one dedicated to making the pound competitive and keeping it so, to bringing down interest rates to the kind of "cheap money" levels which characterised pre and post-war recovery, and to a deliberate expansion of the economy to eliminate the deficiency in spending. All this must be on a sustained basis. We recall the relaxation of monetary and exchange rate policy in 1982–83 to prepare the way for the 1983 election. This was characterised by the same vigorous expressions of confidence about the health of the economy which are being made today and followed, once the election was safely over, by rising unemployment and a further contraction of our industrial base.

North Sea Oil

10. The problem of North Sea oil and gas needs to be considered separately because it has important implications for fiscal policy. The problem arises because income from employment in the extraction of mineral oil and gas accounts for only a small fraction of the value of the end product, amounting to £560 million in 1985 out of a total contribution to GDP of £18,896 million.[2] Our reserves of oil and gas are in effect a capital asset created by the bounty of nature. Unless we take steps to neutralise the adverse effect on the exchange rate the revenue from North Sea oil will necessarily be used directly or indirectly to pay for the unemployment which it has itself created. What the government has taken from the North Sea with one hand will continue to be paid out in unemployment benefit with the other.

11. That problem would not arise if the economy was operating at full capacity because the revenue from North Sea oil could then be used to sustain a higher rate of growth than would otherwise be possible. However unless, and until we are confronted with such a welcome choice government should have ensured that the whole of the windfall profit on the extraction of oil and gas was invested overseas, either by the Government directly, as in many other oil-producing countries, or indirectly through an accommodating change in fiscal, monetary and exchange rate policy.

12. The oil and gas rightly belonged to the British people. The windfall profit from its exploitation should have been used for the benefit of all. The money, if it had been invested overseas on their behalf, could have been used in the next century to finance a large part of the increase in pensions which will then fall due without imposing so great a burden on the working population as the government have claimed. What is now a poisoned chalice would have become a bowl of nectar for the enjoyment of succeeding generations.

13. Investing the oil revenues overseas would have increased the borrowing requirement because it would no longer be available to pay unemployment benefit. Yet because the unemployment which it has

[1] Treasury Press Release 14 January 1981 p. 19.

[2] CSO United Kingdom National Accounts 1986, Tables 2.2 and 2.3.

financed is in effect the other side of the same deflationary coin it would be literally counter-productive to fund any part of the short-fall by an increase in borrowing and/or taxation. Thus the deficiency in purchasing power which the windfall profit represents must be made good by monetisation of the debt if the problem is to be satisfactorily resolved.

UNEMPLOYMENT

14. There can be no understanding of the problems facing the nation without the realisation that the whole of the increase in unemployment since the UK joined the EEC can be accounted for by the loss of jobs in manufacturing. This loss of jobs in manufacturing can likewise be accounted for by the decline in the UK share of home and export markets. This is evident from the trade figures.

15. These show that the relative volume of exports to imports of finished manufactures fell by no less than half—from 204 to 100—between 1970 and 1980 and by a further one-third to 67 between 1980 and 1986. This unprecedented deterioration in the UK balance of trade is very largely due to the increase over the whole period of 397 per cent in the volume of imports, particularly imports from other EEC countries, whose share of the total rose by over half from 35 to 55 per cent. The corresponding increase in UK exports was only 61 per cent, of which the EEC share rose from 30 to only 41 per cent.

16. The value of manufactured exports in 1970 was 49 per cent higher than the value of imports. In 1986 it was 13 per cent lower. This decline represents a loss of output of £41 billion, of which £19 billion is accounted for by the loss of exports and £22 billion by the increase in imports. Much is being made of the deficit of £4 billion with Japan. This is a side-show compared to the deficit of £11 billion with other EEC countries and the loss of trade with third countries which has resulted from our entanglement with the trade-destroying policies of the EEC.

THE EXCHANGE RATE

17. We recognise that there is little prospect of the UK regaining more than a small part of the ground which has been lost in export markets since 1973 even if the EMS countries and Japan respond to American pressure by pursuing expansionist policies. The correction of the enormous imbalance of trade which exists between the USA and the rest of the world will ensure that competition from Germany and Japan in the principal export markets is replaced by that of the US. UK exports to the US, which in the case of finished manufactures now accounts for 18 per cent of the total, will be particularly hit as a result of the appreciation of 40 per cent in the value of sterling against the dollar over the past two years.

18. This need not mean that the government is powerless to remedy the situation created by the wasted years of the monetarist experiment. The growth of imports has destroyed many more jobs than the loss of exports. We are convinced that if it were not for the Treaty of Rome steps could be taken consistently with the UK's obligations under the GATT to roll back the tidal wave of imports which has destroyed at least 2 million jobs. Even on the most optimistic assumption about the growth of world trade the volume of imports will have to be reduced by more than a third to enable unemployment to be reduced to an acceptable level.

19. We believe that such a reduction is well within the bounds of possibility. The UK was faced with exactly the same problem in the 1930s, but nevertheless succeeded in combining a very high rate of internal economic growth with external equilibrium. In 1931 imports of manufactures were equal to 36.8 per cent of manufacturing output. By 1936 the figure was down to 19.7 per cent[1] despite an unprecedented increase of 58 per cent in manufacturing output to 38 per cent above the 1929 peak.[2]

20. The economic and political problems which confronted the government in the 1930s were no less forbidding than they are today. The essential difference was the open-mindedness of officials at the Treasury who did not hesitate in giving advice to put the national interest before those of the Bank of England and its protegees in the City.[3] Sterling was allowed to fall by a massive 35 per cent against the currencies which remained on the gold standard and today's equivalent of £45 billion was advanced to an Exchange Equalisation Account to keep it there. Tariffs were imposed on imports right across the board, rising to as much as 50 per cent on what were described as abnormal importations. Restrictions were placed on overseas investment and trade agreements were signed with countries whose industries complemented rather than competed with our own. The UK became the most instead of the least successful industrial country. Employment increases by 2.6 million in five years, equivalent to 4 million in today's terms. Half the new jobs were in manufacturing. Unemployment fell by half to 1.3 million. The cannon-fodder of WW2 were untouched by it and long-term unemployment at its peak was only two-fifths of the present figure. Employment itself rose to 1.8 million above the 1929 peak.[4]

Monetary Policy

21. The protection afforded to British industry by this combination of devaluation and tariff protection was a necessary though not a sufficient condition for recovery. Protection enabled British goods to be substituted for foreign goods, but much more than that was required to halve unemployment at a time when the labour force was expanding much faster than it is today. The answer lay in monetary policy.

[1] Bank of England Panel Paper No 23, p 37, Table C.
[2] OEEC Historical Indices of Industrial Production, 1901–60.
[3] See Susan Howson, British Monetary Policy 1919–1939.
[4] Times Review of Industry June 1962, London & Cambridge Bulletin No 42, cols 39 & 40.

22. Mr P N Sedgwick of HM Treasury has shown in a paper submitted to the Bank of England Panel of Academic Consultants[1] that the real money supply rose in the first half of 1933 by no less than 18.2 per cent to 43 per cent above the 1926 level. There is every reason to suppose from examination of the evidence that this was largely responsible for the consumer boom which made the recovery possible. The rate on 3 month's Bank Bills fell from an average of 5.30 per cent in 1929 to 0.71 per cent in 1933 and 0.57 per cent in 1935. That figure is now 10 per cent. The yield on Consols fell over the same period from 4.60 per cent to 2.89 per cent. The current figure is 9.25 per cent.

23. We do not share the Chancellor's view that the difference of over 6 percentage points between the rates quoted in London and Frankfurt on three months bills is not a matter of great concern. We accept as a statistical fact his contention that the difference is not all that much greater than the difference in the rate of inflation. However any underlying assumption that the real rate of return on borrowed money must be the same in London as in other financial centres, would be simplistic. It is not credible that it should be as high as 4 per cent in any country which is suffering from mass unemployment.

24. The appropriate rate of interest must be that which balances savings and investment in conditions of full employment at a high and sustainable rate of growth. We do not know by how much the real rate of interest will have to fall in the UK to achieve this, but the evidence shows that from 1934 to 1953 the real rate of return on bank bills was less than half the rate of inflation and in our view it is no coincidence that these years were by far the most successful in our economic history.

25. The problem which the government faces is largely of their own making. The increase of 12–13 per cent in the real money supply in the twelve months to the end of February should have been enough to bring interest rates down to the German level. This has not happened because the lack of selective controls over credit combined with the removal of exchange control has transformed the banking system into a gigantic casino in which the nation's assets have become speculative counters to be sold to the highest bidder regardless of the welfare of the British people. No solution will be found for our economic problems while this situation lasts.

26. The rate of interest is as high as it is because the government wants it that way. Time and time again the Bank of England have intervened in the money markets. Always to stop interest rates from falling in response to market forces, never to push them lower. We do not regard this as dictated by events. High interest rates have enabled the banking system to earn enormous profits at the expense of the real economy. In view of their record it was not to be expected that the banker's bank would pursue a policy which would have the opposite effect.

Inflation

27. Inflation has been described as a situation in which too much money chases too few goods. There is nothing in that simple proposition to suggest that the problem can best be solved by reducing the supply of money rather than by increasing the supply of goods. Common sense suggests that in conditions of less than full employment the optimum solution would be an increase in the supply of goods. The satisfaction which the government has expressed about the recent improvement in relative unit labour costs as a result of the increase in output reinforces our view that the deflationary policies pursued by successive governments over the past thirty years had the opposite effect to that intended. The reduction in our rate of growth raised our unit costs faster than those of our competitors.

28. What made the situation far worse after the demise of the Bretton Woods system was the realisation that the exchange rate could be used to reduce the cost of living by making imports cheaper, reinforced by the assurances given by Prof. (now Sir) Terry Burns and other international monetarists at the London Business School that the adverse effect on British industry would be transient because of the level of UK costs and prices would soon fall to that of other countries through the operation of what they described as the "Law of One Price".

29. No better assessment of the consequences of this self-deception has been made since Ricardo pointed out in 1819 that "if we sell our goods at a high money price and buy foreign goods at a low money price . . . it may well be doubted whether this advantage will not be purchased at many times its value, for to obtain it we must be content with the diminished production of home commodities; with a high price of labour and a low rate of profit."[2] The loss of nearly 3 million jobs and a quarter of our manufacturing base is a painful tribute to his perceptiveness.

The Exchange Rate

30. Our understanding of what the Chancellor told us is that the government is not concerned about the damage which this policy has inflicted on the real economy. His declared objective of keeping the pound at its present level is proof, if proof were needed, that he does not want to reduce the numbers of unemployed, provided the total can be got below the figure of 3 million which the Government believe is an electoral liability. The Chancellor has hardly disguised his view—shared by most other financial journalists—that unemployment is simply the result of the "long overdue shedding of surplus manpower in overmanned companies and industries, and by the closure of plants that never had an economic future"[3].

[1] Bank of England Panel Paper No 23, p 41, Table D.
[2] D Ricardo, "Notes on Malthus" in Principles of Political Economy, ed J H Hollander and T E Gregory (Baltimore, 1928).
[3] Treasury Press Release 14 January 1981.

Yet error is not atoned by repetition. The truth is that he and his peers have never understood that the scope for international trade is created, not by the difference in overall costs of production in the various countries, but by the variance of production costs around the overall national average.

31. International trade takes place between countries like Germany and India because the huge differences between the two in wages and productivity are reflected in the exchange rate, allowing each country to concentrate on the production of goods and services it can produce best without running into balance of payments difficulties. This is so even in the case where everything produced in one country is produced less efficiently than in any other. Ministers only condemn themselves when they condemn British industry for a lack of competitiveness because real wages are too high or productivity is too low. What they are really saying is that the exchange rate is above the equilibrium level at which we can balance our trade with the world at full employment and a high and sustainable rate of growth. Any other exchange rate is a distortion.

32. Any form of government intervention, whether fiscal or monetary, which prevents the exchange rate falling to a competitive level imposes two distinct costs. The *first* of these is the misallocation of resources as trade and investment take place at prices damaging to output and employment in the UK—export prices are higher than they should be and import prices lower; the real cost of overseas investment is less and the real cost of inwards investment is higher; too much business is given to overseas residents and too little to domestic residents; output and employment are lower than would otherwise be the case and foreign investment carries too great a weight in domestic portfolios. The *second* and no less significant cost arises as a result of the inevitable tightening of fiscal and monetary policy to support the chosen parity, resulting in higher interest rates and a decline in the rate of economic growth.

33. We were therefore dismayed to learn from the Chancellor that he had agreed at the recent meeting of the Group of Five in Paris to include sterling in the new arrangements for exchange rate stabilisation despite the huge imbalance of trade with the EEC and, to a much lesser extent, Japan. The rate of exchange, like the rate of interest, is essentially a market-clearing mechanism and should be treated as such. The equilibrium rate for sterling is the rate which enables the UK to balance its overseas accounts in conditions of full employment at a high and sustainable rate of growth. Although opinions may differ on what constitutes full employment, it makes no sense in a world in which economic parameters are constantly changing for the UK to agree to *any* arrangement for exchange rate stabilisation now or at any time in the future.

Competitiveness

34. The reality which the finance ministers and central bankers at the Paris meeting have chosen to ignore is that both sterling and the dollar are still grossly overvalued by reference to past performance and present need. The real value of the dollar at the beginning of this month was 20 per cent higher than in 1979. In the absence of trade restrictions it can only be a matter of time before it falls by a good deal more than that in response to the deficit in the balance of payments. The real value of sterling has risen even more. The Deutschmark is the currency which matters most in the case of the UK. Our real exchange rate has already risen by 7 per cent this year. It is now 25 per cent above the level which prevailed in 1973–74 and late 1976, though even then sterling was overvalued by reference to past performance and any objective economic test of what was required in the best interests of the real economy.

35. The terms of trade tell a similar story. Though the government have never admitted it, there is now general agreement that the rise in the value of sterling in 1980 was a disaster. Export prices rose much faster than import prices. As a result the terms of trade for finished manufactures rose to 25 per cent above the 1973–74 level. The trade-weighted average exchange rate for sterling has since fallen by 25 per cent, but because most of the reduction has been offset by the higher rate of inflation in the UK, the beneficial effect on output and employment, though welcome, has been relatively small. This is underlined by the February trade figures, which show that since 1980 import prices for finished manufactures had gone up less than 3 per cent relative to export prices, still 22 per cent higher than in 1973–74 and over 40 per cent higher than in 1981. Small wonder that imports now account for one-third of the UK market and that the UK share of exports by the main manufacturing countries has fallen from 25 to less than 8 per cent, behind that of Italy as well as Germany, Japan, the US and France.

36. It is not clear to us why the Chancellor wishes to sustain output and employment in Germany and Japan at the expense of output and employment in the UK. The fall in the nominal exchange rate to DM2.72 in February would have made British industry much more competitive at home and overseas. What is happening now raises the suspicion that, as in 1983, the ground is being prepared to take back after the election what has had to be conceded over the past twelve months to avoid defeat at the polls.

Economic Growth

37. The Chancellor claimed in his Budget Statement that during the 1960s, and again in the 1970s, growth in manufacturing productivity in the UK was the lowest of all the seven major industrial countries in the world, but that during the 1980s the annual rate of growth of output per head had been the highest. We agree with him that this would be remarkable if it were the whole story, but, like so many of the claims made by Treasury spokesmen in recent years, it is not.

38. What is missing from this comparison is any figure which tells us whether manufacturing output per head has actually improved as a result of the monetarist experiment. Figures published in Economic

Trends show that in the decade ending in 1973 manufacturing output per head rose no less than 50.4 per cent, an annual average of 4.2 per cent. In the 13 years ending in 1986 the figure was only 33.2 per cent, an annual average of only 2.2 per cent.[1]

39. This assumes that the published figures mean what the Chancellor says they mean. They almost certainly do not. The loss of jobs in labour-intensive industries such as textiles and miscellaneous manufactures—where 36 and 41 out of every 100 jobs have been lost since June 1979—must have raised the published figure of output per head in manufacturing generally regardless of anything that has actually happened on the factory floor.[2] The tens of thousands of cases in which production has been concentrated in a reduced number of plants because of the loss of business at home and overseas to foreign competitors must have had an even more dramatic effect on the figures. The number of redundancies and closures has slowed down since 1980 and the rate of increase in manufacturing output per head has also slowed down from 6.6 per cent in 1982 to only 1.9 per cent in 1986.

40. What matters in anything but the shortest of short runs is total output. Figures supplied by HM Treasury in a written answer confirm that output per head of the working population has increased by only 3.3 per cent in the whole of the past seven years and by only 4.3 per cent over the whole period since 1973.[3] We conclude from this that the present government have done better than the last government, but that, so far as manufacturing is concerned, the rate of economic progress since 1979 has been little more than one-tenth of what it was before the monetarist experiment began.

41. The Chancellor may nevertheless be right in claiming that during the 1980s the annual rate of growth of output per head in UK manufacturing has been the highest of all the seven major industrial countries. His choice of dates certainly makes for a favourable comparison because the UK figure of manufacturing output per head *fell* by a record 4 per cent in 1980 despite the increase of 5 per cent in the volume of world trade. We agree that this was a remarkable achievement. There have only been 3 other years in the past 35 in which productivity in UK manufacturing industry has actually fallen. The first was in 1961, when it fell by 0.8 per cent. The other two were in 1974 and 1975, when it fell by, respectively, 1.5 and 2.6 per cent. We would not wish to defend the excessive monetary squeeze which crippled industry in 1974–75, but in fairness it should be pointed out that in 1975 the decline was just as great in Japan, Germany and France and it is not unreasonable to suppose that at least part of the blame for what happened in the UK can be put on the decline of 4 per cent in the volume of world trade in manufactures, the first decline since WW2.

42. A year ago the UK ranked third out of the seven largest countries in an IMF comparison of output per man-hour based on 1980 and fourth in a comparison based on 1979. However a comparison based on *normalised* output per man-hour puts us behind every other country, including ten others, in one case and last but one in the other, as shown in the following table:

	Output per Head Increase on		*Normalised Increase on*	
	1979	*1980*	*1979*	*1980*
UK	127.2	128.5	113.2	111.2
France	131.8	129.7	129.2	124.8
Italy	133.4	126.1	124.7	121.5
Germany	122.7	122.1	124.3	120.9
USA	121.3	121.3	118.3	115.9
Canada	120.3	119.7	112.9	111.7
Japan	139.6	129.7	148.5	142.6

43. The Economic Secretary criticised the normalised figures on the grounds that they are constructed in a "backward looking way", but for the reasons given in paragraph 38 above we do not share his view that the Treasury estimate of the underlying trend is closer to the truth than the series constructed by the IMF: both may well be too flattering. This is not to imply that the Chancellor made a mistake. The latest figures may indeed show that manufacturing output per head has increased by more in the UK since 1980 than in any of the other six countries, but for the reasons we have given the comparison is not one to which we would attach any economic significance so far as the health of the UK economy is concerned.

44. We attach far more significance to what is happening in the real world. This tells us that in 1986 manufacturing output in the UK was 9 per cent *less* than it was in 1973 and that in *every* year since 1980 manufacturing industry in the UK reduced its stock of fixed capital by not replacing its plant and machinery.

45. We know of no other country which could even begin to match these remarkable figures. Our industrial performance has lagged behind that of other countries for well over a century, but we know of no comparable period in which manufacturing output did not *increase* at least twice as fast as it has fallen since the monetarist fashion became accepted orthodoxy. The contrast with the 1930s could not be more complete. In 1937 manufacturing output was 59 per cent higher than in 1924 and 38 per cent higher than

[1] Economic Trends, Annual Supplement 1987, p 108.
[2] Dept of Employment, Written Reply, Official Report, 26 March 1987.
[3] Written reply, Treasury 2 March 1987, Official Report, Vol. 111.

in 1929, the previous peak.[1] We also know of no other peacetime year in which manufacturing industry was running down its capital. In the five years ending in 1985 total disinvestment amounted to £6.6 billion and such figures as are available suggest that 1986 will add to the total.

46. This is evidently not a matter which has caused the government concern. Mr Norman Tebbit made this clear in evidence to the Trade and Industry Committee on the growth in the imbalance of trade in manufactured goods between the UK and the existing and prospective members of the EEC[2]. Our impression is that the Chancellor is of the same mind. Neither appears to have thought out the implications. As the Department of Trade pointed out in an article on export performance in *Trade and Industry* dated September 1, 1978, high rates of productivity growth have been associated with high rates of output, export growth and employment in manufacturing. They did not conclude that there was a causal relationship. In our view there is and the destruction of a large part of our manufacturing base since 1979 will reduce out economic performance for many years to come. We also believe that it has robbed the British people of the ability to defend these islands against conventional attack.

PRESENT PROSPECTS AND PRESENT NEEDS

47. The restatement of the government's fiscal, monetary and exchange rate policies set out in the Financial Statement and Budget Report for 1987–88 offers no hope to the millions of unemployed and their children on social security who go hungry to school each morning knowing that as soon as their education is completed they too will be denied the basic human right to provide a fair day's work for a fair day's pay. Any room for doubt there may have been on that score has since been removed by the decision to hand over the management of the British economy to the Bundesbank by effectively tying sterling to the Deutschmark through the exchange rate mechanism of the European Monetary System.

48. One man's income is another man's expenditure. It follows from this that there can be no increase in the number of jobs in the absence of an increase in public and/or private spending. We accept that an increase in public spending on goods and services financed by an increase in borrowing and/or higher taxation will have a less than commensurate effect on employment if it leads to higher interest rates and/or a reduction in private spending. We also agree that in the absence of a change in monetary policy an increase in private spending at the expense of saving is unlikely to be very helpful because of the adverse effect on interest rates and the exchange rate.

49. This does *not* mean that little or nothing can be done to reduce the level of unemployment to an acceptable level. What was possible in the 1930s is possible in the 1980s. Mass unemployment has not been visited upon the UK by Divine Justice. It was the work of the Bank of England and what was done can be undone. The four million jobs lost since 1973 were deliberately destroyed by the monetarist ratchet of tight money, high interest rates and a high exchange rate. They can only be recreated by reversing the process by which they were destroyed. What is required is a relaxation of monetary policy to bring down both interest rates and the exchange rate to a competitive level.

50. The government know this and act on it when it suits their political purpose. When the Government wanted to increase manufacturing output in the run-up to the last election the Bank of England obliged them by pumping £8 billion into the economy by buying commercial bills, a debt instrument which does not show up in the money supply. This time round the abandonment of monetary targets has made such tactics unnecessary and in 1986 the commercial banks duly obliged by printing no less than £24 billion of new money, an average of £413 for every man, woman and child in the UK. The contrast both times round with the policies pursued by the Bank before the 1979 election could not be more marked. Deflation and a rising exchange rate were then the order of the day.

51. The course of events over the past year has demonstrated beyond doubt that if it wished the government could reduce unemployment to the 1–2 per cent which were the norm until the late sixties, but it is abundantly clear that, provided the figure can be got below the magic figure of three million, the government do not wish to reduce unemployment substantially and to be fair it must be said that they have never pretended otherwise. Their answer to the problem has always been to dismiss it by proclaiming that unemployment is the fault of both the Unions and the unemployed themselves for resisting changes in working practices, for not working hard enough and/or for not accepting a cut in their living standards. Unemployment as such is barely mentioned in this year's Financial Statement and Budget Report and then only to dimisss it with the statement that "a sustained major reduction in unemployment will continue to depend on moderation in pay settlements."[3]

52. This is economical of the economic truth. The New Earnings Survey for 1986 shows that since 1979 the gross weekly earnings of the median full-time adult male manual worker had risen in real terms by less than 3 per cent and that the corresponding figures at the upper and lower deciles were 8 per cent and *minus* 3 per cent. The gross weekly earnings of their analogues among non-manual workers had risen by 17 per cent and by 26 and 6 per cent respectively. This is proof, if proof is needed, that those who make the goods which have to compete with those of other countries at home and abroad have been impoverished by the monetarist ratchet of tight money, high interest and a high exchange rate for the benefit of the dealers in money and the speculators in assets who have done more than anyone else to push up the general level of costs and prices.

[1] OEEC Historical Indices of Industrial Production 1901–60.
[2] Second Report, Session 1983–84, HC461.
[3] Financial Statement, para 3.56.

53. We pointed out in paragraph 31 above that Ministers only condemn their own ignorance of fundamental economic laws when they blame our lack of competitiveness on the level of wages and/or the level of productivity. The level of employment is determined by the level of the exchange rate and it is an inescapable fact that the whole of the benefit from the much-acclaimed increase in labour productivity in UK manufacturing industry since mid-1984 has been wiped out by the increase in the value of sterling over the past couple of months as a result of intervention by the Bank of England to stop interest rates from falling. It is a sad reflection on the politicisation of both the Treasury and the Government Economic Service that the Financial Statement should be used as a vehicle for political propaganda devoid of economic truth.

54. The government's strategy is evidently to combine an increase in consumer spending power with a fall in the exchange rate to ensure that a rather higher proportion of the increase in demand goes to British suppliers without putting up import prices faster than the rate of inflation. This reduces the pressure on industrial profits and has a sufficient impact on employment outside the industrial sector to enable them to claim that all is for the best in the best of all possible worlds.

55. What is required to bring down unemployment to an acceptable level is an increase in the real money supply by far more than the additional £45 billion which needs to be spent on UK-produced goods and services to provide jobs for 3 million out of the total of 4 million who are unable to find remunerative work. This would bring down both interest rates and the exchange rate to ensure that the UK takes advantage of the appreciation of the Deutschmark and the Yen to recover the jobs which have been lost to our foreign competitors at home and overseas.

56. The Government's current policy of allowing sterling to appreciate against the dollar to enable sterling to become a *de facto* member of the Exchange Rate Mechanism of the European Monetary System under pressure from the EEC and the Bank of England has thrown away this opportunity. It may indeed lead to another reduction in output and employment in British industry as a result of increased US competition in both home and exports markets and, of course, in the US itself.

57. The figures underline the danger we face. The US trade deficit amounted to $148 billion in 1986. This was very largely due to the reduction since 1980 of nearly 20 per cent in the volume of US exports of manufactures and the increase of over 100 per cent in the volume of imports. Imports of manufactures are now 70 per cent higher than exports. This enormous loss of trade has to be made good at no matter what cost, if the US is to pay its way in the world. The relative price of US exports of manufactures is still 20 per cent higher than in 1979 and it is clear from recent trade figures that the dollar will have to fall by more than this to enable the US to balance its accounts.

58. We must face up to the implications. The US share in the value of UK exports of finished manufactures has increased by 70 per cent from 10.4 per cent in 1979 to 17.7 per cent in 1986. The EEC share over the same period remained at 41.5 per cent. The US share of the value of UK imports of finished manufactures, which had been as high as 28 per cent in 1970, declined from 16.0 to 14.3 per cent. The EEC share, which had been 35 per cent in 1970, also fell by a percentage point to 55 per cent. No less than *two-thirds* of the total increase in UK exports of finished manufactures since 1979 have gone to the US. The statistical comparison is not quite so dramatic if semi-manufactures are included, but the arithmetic suggests that the UK has contributed about £3.5 billion to the US deficit and that this amount of trade will be at risk if the dollar falls to a competitive level. Much more will be at risk in third markets and perhaps in our own, particularly if the EEC persists in using public funds to compete unfairly with the US in world markets.

59. The predatory trade policies of Germany and to a lesser extent Japan robbed the UK of two-thirds of its exports of manufactures and were undoubtedly responsible for the collapse of the Bretton Woods system. We are therefore at a loss to understand why the government has now decided to help bail the Germans out by an apparent agreement to tie sterling to the Deutschmark within the framework of the EMS. The deterioration of £15 billion since 1970 at current prices in our trade balance with the EEC has already cost us a million jobs. This latest move will undoubtedly cost us a great many more.

60. The present slump in output and employment is not only by far the longest and deepest we have ever experienced; it is also unique in that it shows no sign of coming to an end of its own volition. Under the gold standard the seeds of recovery were sown by an increase in credit, leading to a reduction in the rate of interest and an increase in bank lending, as well as by a fall in the real exchange rate, encouraging exports and discouraging imports. The problem today is that most of the huge amount of money *created* by the commercial banks is being used to fuel the increase in share and house prices regardless of the level of interest rates. Very little of it is going directly or indirectly into the production of goods and services in the UK. As a result money GDP in 1986 rose by only 6 per cent even though the money supply rose by a massive 19 per cent.

61. What is needed to remedy this state of affairs is a public commitment to cheap money through the re-introduction of Bank Rate backed by differential reserve requirements which would discourage the *uproductive* use of money by making the commercial banks and other lending institutions hold non-interest-bearing deposits at the Bank of England in proportion to their advances for other than approved purposes. This would help bring down interest rates for those making productive use of money.

THE MEDIUM TERM EMPLOYMENT STRATEGY.

62. The *objective* must be to raise output of goods and services to the level required to maintain full employment at a high and sustainable rate of growth without raising the rate of inflation and without reducing the living standards of those in work.

63. The *strategy* must be to reverse the monetarist ratchet of tight money, high interest rates and a high exchange rate in a way which maximises spending on UK-produced goods and services rather than on foreign holidays, imports, and investment in fixed assets and stocks and shares. This means increasing the money supply by the amount required (i) to finance the provision of at least 3 million extra jobs and (ii) to accommodate the reduction in the velocity of monetary circulation required to bring down interest rates and the exchange rate to a level which is consistent with full employment at a high and sustainable rate of economic growth.

64. The first step must be to increase the rate of growth to 5–6 per cent a year for at least three years by increasing home and overseas demand for UK-produced goods and services by a cumulative £22 billion a year in real terms, requiring:

(i) an increase in the money supply of whatever amount is required to (a) increase the level of public and private spending by the required amount and (b) reduce the level of short-term interest rates from the current 9.5 per cent to 4 per cent.

(ii) the transfer of responsibility for printing money from the private to the public sector by (a) imposing selective controls over the creation of bank etc credit and (b) increasing the public sector financial deficit by whatever amount is required to increase the money supply to the required level.

(iii) a reduction in the value of sterling to a competitive level implying an immediate fall in the pound to, at most, $1.30, DM2.35 and Yen 185.

65. The second task must be to reform the whole of the tax-benefit system to:

(i) distribute the increase in real wealth made possible by the increase in output in ways which reduce the impact of the fall in the exchange rate on costs and prices.

(ii) transfer more of the burden of taxation from persons to business.

(iii) to reduce the incentives to saving and to transfer more of the burden of taxation from earned to investment income by raising income tax and reducing national insurance charges *pari-passu*.

(iv) to reform the system of personal taxation to get rid of the poverty and employment traps without giving an uncovenanted benefit to those with high incomes.

(v) to raise child benefit very substantially, financed in part by making the whole subject to tax.

? (vi) to oblige married couples to make a joint return of income if the wife does not opt for separate assessment.

(vii) to reduce speculation in assets

A BUDGET FOR GROWTH

66. We *urge* the Chancellor to withdraw his proposals for taxation in 1987–88 to enable new proposals to be put forward on the following lines to give effect to the proposed Medium Term Employment Strategy.

(a) Business Taxation

67. In 1985 Companies paid only 9.0 per cent of their income in mainstream corporation tax and 5.7 per cent in advance corporation tax. The nominal rate of mainstream corporation tax has since been reduced to 35 per cent compared to about 50 per cent in most other industrial countries. The rate of advanced corporation tax has also been reduced in line with the standard rate of income tax to only 27 per cent. It is in effect a withholding tax on dividends which counts as a tax credit to the payee. The very low rate of tax on companies is not being used to invest in British industry and we *recommend* that the rate of both mainstream and advance corporation tax is raised to 52 per cent.

68. We make two further *recommendations* for the benefit of productive industry:

(i) The employer's national insurance contribution to be reduced by 5 percentage points for each employee engaged in manufacturing outside the South East.

(ii) The Treasury to provide an automatic guarantee and interest-rate subsidy to cover a specified proportion of all medium-term loans by banks and other approved institutions for investment in manufacturing industry by new enterprises or by existing enterprises which have already made full use of their capital and depreciation allowances.

69. We also *recommend* that the whole cost of fringe benefits be disallowed as a cost in addition to being charged as income to the recipient.

70. We put the revenue cost and yield as follows:

Increase in MCT Mainstream CT	+£7.30 billion
Increase in ACT (one off)	+£4.35 billion
Reduction in NICs	−£3.15 billion
Loan scheme	−£0.15 billion
Fringe benefits	+£1.00 billion

making a net gain to the revenue of some £5.0 billion in a full year.

(b) Personal Taxation

71. National insurance is the government's main instrument for transferring resources from the poor to the rich. It is not a system of insurance because most of the huge increase in expenditure on welfare payments since 1973 are the direct result of government policy and would never have been incurred if successive governments had not set out to reduce output and employment for reasons of public policy. The rate of contribution should therefore be reduced to reflect this. The method of assessment is also largely responsible for creating the poverty and employment traps. We therefore *recommend* a reduction in the employee's contribution rate from 9 to 3 per cent, the introduction of personal allowances on the same basis as income tax, and the abolition of the upper earnings limit.

72. The present structure of income tax is also highly regressive and is now so riddled with exception for those on hither incomes that the yield from an increase of 1p in the standard rate is now only 76 per cent of the figure for national insurance although income tax covers earned as well as unearned income. We also believe that the opportunity should be taken to change the system of allowances to facilitate the separate assessment of men and women for income tax purposes. We therefore *recommend:*

(i) an increase in the personal allowances to £2,500 and £5,000 for, respectively, single persons and married couples, an increase in the age allowances to £3,000 and £5,000, and the abolition of the wife's earnings election and the married women's earnings allowance.

(ii) a reduced-rate band of £1,000 for single persons and £2,000 for married couples at 15 per cent, followed by a standard rate-band of 25 per cent of £7,250 for single persons and £9,500 for married couples followed by four higher-rate bands of £5,000 in 5 per cent steps for single persons and three higher rate bands of £7,000. £7,500 and £7,500 in 5 per cent steps for married couples.

(iii) the introduction of a claw-back (on the lines of the present age allowance) of £2,500 of the single allowance and £3,000 of the married allowance, at the rate of £4 for every £10 of income starting at £4,500 for single persons under 65, £5,000 for those over 65, and £9,000 for all married couples.

(iv) child allowance to be increased to £20 for the first child and £15 for subsequent children, the whole to be taxed.

(v) taxation of the full value of fringe benefits.

73. We put the revenue cost and yield as follows:

Abolition of wife's earnings allowance	+£3.50 billion
Reduced-rate band	−£5.50 billion
Fringe benefits	+£1.00 billion
Other changes in income tax	+£8.30 billion
Reduction in insurance contributions	−£11.25 billion
Increase in child benefit	−£4.10 billion

resulting in a net cost to the revenue of an estimated £7.05 billion.

(c) Other Measures

74. Relief for mortgage interest and pension fund is now very largely a means of tax avoidance on investment income.

75. We *recommend* phasing out the relief for mortgage interest as the rate of interest falls so that nobody has to pay more in cash terms after tax at the standard rate than he has to pay at the present time. We also *recommend* (i) offsetting mortgage interest against investment income for the purposes of relief (ii) confining relief to the standard rate of tax (iii) reducing the amount of which relief is given to £24,000 when the new scales are introduced to maintain the rate of subsidy at the present level and (iv) abolishing stamp duty on the sale of dwellings.

76. We also *recommend* withdrawal of tax privileges from all pension funds which are not fully invested in index-linked gilt-edged securities providing portable pensions and an index-linked annuity at retirement.

77. We belive that speculation in assets needs to be discouraged. We therefore *recommend* the imposition of a duty of 1 per cent on the share capital in the case of agreed acquisitions and of 3 per cent in the case of contested acquisitions. We also *recommend* imposing stamp duty on the sale of securities and not on their purchase, the amount depending on the length of time the securities have been held.

78. The fall in the price of food was an important factor in the recovery of the 1930s because a much higher proportion of household budgets was spent on food and the fall in price released a lot of purchasing power for spending on other goods. The fall also helped to relieve poverty among the unemployed. The Common Agricultural Policy has had the opposite effect. Agricultural protection ultimately benefits only the landlord and it is no coincidence that (i) rents have risen to £50 per acre (ii) the price of agricultural land has risen from £9 to £1,500 an acre since 1938 and (iii) half the food produced in England is produced by very wealthy farmers cropping over 500 acres. The cost of protection in the late 1960s was of the order of £1.2 billion. It is now of the order of £6 billion, of which £4 billion falls on the consumer and £2 billion on the taxpayer, through the UK and EEC Budgets. We *recommend* the replacement of the common agricultural policy by a 10 per cent tariff, automatic dumping duties on imports from all sources, a system of guarantees limited to small farmers, and provision for rural development.

79. Membership of the European Economic Community has brought the UK no economic benefits and enormous economic losses. We therefore *recommend* a reduction in the UK contribution to the EEC Budget to a proportionate share of the cost of running the institutions.

80. We put the revenue cost and yield of these measures as follows:

Changes in entitlement to MIRAS	+£2.0 billion
Abolition of stamp duty on dwellings	−£0.8 billion
Reduction in agricultural protection	+£2.0 billion
Reduction in EEC Contribution, net	+£1.0 billion
Reduction in pension relief	+£1.0 billion

81. The phasing out of the MIRAS scheme when interest rates fell to less than 7 per cent would save a further £3 billion. The extension of the EEC tariff to imports from the EEC combined with a smaller reduction in the exchange rate would raise another £2 billion. These monies would then be used to reduce personal taxation and/or increase benefits.

82. Our proposals for changes in taxation, taken together, will produce a revenue gain of £2 billion immediately, £5 billion in the longer term. There will also be a considerable saving in means-tested benefits, particularly for children. These savings can be used to increase pensions and other social security benefits. The increase in output and employment as a result of the Medium Term Employment Strategy will also produce large savings in social security and other benefits paid to the unemployed and currently running at £7 billion a year as well as a considerable increase in the yield on direct and indirect taxes.

CONCLUSION

83. In devoting the unexpected increase in revenue arising from devaluation and the consumer boom to tax cuts which are unnecessary and borrowing cuts which have not brought down interest rates the Chancellor has thrown away an historic opportunity. He has also implicitly accepted that unemployment will remain high because nothing has been done to boost the economy beyond its present inadequate and unsustainable rate of growth.

84. This government has therefore thrown away the easy years when oil provided extra tax revenues and a balance of payments surplus. Instead of using the oil benefits to expand to invest and to sustain the economy through its traditional balance of payments problems in a way never possible before the eighties, government has used them to finance imports of manufactured goods to destroy jobs in this country and spent the tax benefits on supporting the unemployed thus created.

85. This waste makes the need for expansion all the more urgent, its necessary scale all the more massive. We have proposed to generate it by methods which will affront vested interests particularly in the City. However those interests have been of little benefit to the real economy of jobs and making and exporting things and services and the orthodoxies they have urged on governments have been so damaging that there is now no alternative to radical change and a massive and sustained boost to growth. This is now the only way to bring down Britain's shameful and wasteful level of unemployment and equip our economy to face the world and generate the standard of living our people have a right to expect of it. Our proposals will return the economy to full employment and to an upward spiral of self generating growth. We commend them to the present Chancellor's successor.

Motion made and Question proposed, That the Chairman's draft Report be read a second time. paragraph by paragraph.

Amendment proposed, to leave out the words "Chairman's draft Report" and insert the words "draft Report proposed by Mr Mitchell"—*(Mr Mitchell.)*

Question put, That the Amendment be made.

The Committee divided.

Ayes, 3	Noes, 6
Mr Banks	Mr Beaumont-Dark
Mr Mitchell	Mr Browne
Mr Sedgemore	Mr Budgen
	Mr Townend
	Mr Wainwright
	Mr Watts

Main Question put and agreed to.

Paragraph 1 read, amended and agreed to.

Paragraphs 2 to 4 read and agreed to.

Paragraph 5 read, amended and agreed to.

Paragraphs 6 and 7 read and agreed to.

Paragraphs 8 to 10 read, amended and agreed to.

Paragraph 11 read as follows:

"Nonetheless we feel we must continue to exhibit concern about the recent behaviour of some of the indicators used to assess monetary conditions. Our concern is heightened by the fact that there seems to be a distinct divergence of views about their behaviour on the part of the authorities."

Paragraph disagreed to.

A paragraph—*(Mr Mitchell)*—brought up and read as follows:

"Nevertheless we can hardly be satisfied with the government's present stance on monetary indicators. If interest rates are to be used to keep monetary conditions "on track", it would seem essential to be able to assess their impact. Yet M0 appears to lag rather than lead. Cash transactions are a diminishing proportion in an age of rapid credit expansion by £M3 has been abandoned after the government has been frequently unable to meet its proclaimed £M3 targets. The new range of indicators proferred in para 9 seems very wide. The correlations between each of them, and between all or any and money supply proper are largely unknown. There seems to be a difference of emphasis about their behaviour on the part of the authorities. The central importance accorded to money supply figures in the government's initial strategy has been abandoned. Yet it is difficult to see that it has been replaced by anything by a watching brief which can give rise to no rational expectations on anyone's part."

Motion made and Question put, That the paragraph be read a second time.

The Committee divided.

Ayes, 5	Noes, 5
Mr Banks	Mr Beaumont-Dark
Mr Budgen	Mr Browne
Mr Mitchell	Mr Howell
Mr Sedgemore	Mr Townend
Mr Wainwright	Mr Watts

Whereupon the Chairman declared himself with the Noes.

Another paragraph—*(Mr Wainwright)*—brought up, read the first and second time and inserted (now Paragraph 11).

Paragraph 12, read, amended and agreed to.

Paragraph 13 read as follows:

"In oral evidence, however, the Chancellor seemed to argue that the growth in personal bank lending and the upward pressure on interest rates was in some sense a reflection of Government policy in other areas:

> ". . . if you look at the growth of private borrowing, it is entirely attributable—entirely as a share of GDP—to the great growth of mortgages primarily, although there is no doubt some equity withdrawal for the purpose of house-purchase and home improvement. Of course, it is part of the Government's policy to encourage home ownership including the purchase by council tenants of the homes in which they live. Therefore, that leads to mortgages being granted. Therefore, provided that we can contain the monetary consequences of that, which we are doing, and have done—then I do not regard that as a matter of concern."

Amendment proposed, in line 9, at the end to add the words, "We appear to be involved in a circular process, whereby more credit pushes up house prices, and higher house prices justify more credit and encourage demands for higher salaries. We have doubts about the economic value of the resulting asset inflation, which widens regional disparities and ties up more and more capital in house prices"—*(Mr Mitchell)*.

Question put, That the Amendment be made,

The Committee divided.

Ayes, 5	Noes, 5
Mr Banks	Mr Beaumont-Dark
Mr Budgen	Mr Browne
Mr Mitchell	Mr Howell
Mr Sedgemore	Mr Townend
Mr Wainwright	Mr Watts

Whereupon the Chairman declared himself with the Noes.

Paragraph agreed to.

Paragraph 14 read and agreed to.

Paragraphs 15 and 16 read, amended and agreed to.

Paragraph 17 read as follows:

"There seems however to be considerable uncertainty about the extent to which bank lending and the demand for credit generally respond to changes in short-term interest rates. The view was put to our predecessor Committee in 1980–81, by Professor Friedman that:

"Manipulating interest rates . . . has a highly erratic and undependable influence on the quantity of money demanded over the kind of short periods which . . . are crucial for monetary control (period of a few months up to a year or more.)"

A different view was taken by the Governor of the Bank of England in our current inquiry who put it to us that while mortgage borrowing may be more sensitive to the rate of interest, ordinary private borrowing is not very responsive to such changes. As the Bank has reminded us on a number of occasions, lending to the private sector—whether personal consumer credit or mortgages—has increased significantly in the past, irrespective of the rate of interest. Moreover, most of the previous discussion on the control of monetary growth by the use of short-term interest rates has taken place against a different background from that of today. Even if Professor Friedman is wrong, and even if only a proportion of borrowing is interest-rate sensitive, the Government's task in restraining overall monetary growth—stopping the overhanging glacier from expanding still further—will be doubly difficult at a time of falling interest rates."

Amendment proposed, in line 15 at the end to add the words, "Thus there is now a strong case for the government to look at the possibilities of controlling and channelling credit"—*(Mr Mitchell)*.

Question put, That the Amendment be made.

The Committee divided.

Ayes, 3	Noes, 4
Mr Banks	Mr Budgen
Mr Mitchell	Mr Townend
Mr Sedgemore	Mr Wainwright
	Mr Watts

Paragraph agreed to.

Paragraph 18 read and agreed to.

Paragraph 19 read, amended and agreed to.

Paragraphs 20 and 21 read and agreed to.

Paragraph 22 read, amended and agreed to.

Paragraphs 23 and 24 read and agreed to.

Paragraph 25 read as follows:

"With a PSBR at 1 per cent of GDP, the public debt ratio may be stable, but the Chancellor has not offered any arguments in favour of this or any other ratio. He has simply stated that he does not want it to continue increasing. The Chancellor acknowledged that this target has been achieved more quickly than anticipated due to two factors, the unexpectedly strong revenue outturn and the contribution of asset sales. However, no reasons have been given why the current debt: GDP ratio is preferable to that which would have obtained if the economy had evolved in line with the 1984 Green Paper, which did not envisage the fall to 1 per cent until 1993—94."

An amendment made.

Another amendment proposed, in line 7 at the end to add the words:

"Moreover we note that the PSBR with all its faults, is still low by historic levels at a time when resources of labour and capacity are unemployed. The public sector financial deficit, a more useful measure is also lower than for most of our competitors."—*(Mr Mitchell)*.

Question put, That the Amendment be made.

The Committee divided.

Ayes, 3	Noes, 4
Mr Banks	Mr Budgen
Mr Sedgemore	Mr Howell
Mr Wainwright	Mr Townend
	Mr Watts

Paragraph, as amended agreed to.

Paragraph 26 read and agreed to.

Paragraph 27 read, amended and agreed to.

Paragraph 28 to 30 read and agreed to

Paragraph 31 read as follows:

"The Inland Revenue explained their forecasting methods for Corporation Tax."

Paragraph disagreed to.

Another paragraph—(*The Chairman*)—brought up, read the first and second time, amended and inserted (now Paragraph 31).

Paragraph 32 and 33 read, amended and agreed to.

Paragraph 34 read and agreed to.

Paragraph 35 read, amended and agreed to.

Paragraphs 36 and 37 read and agreed to.

Paragraphs 38 and 39 read, amended and agreed to.

Paragraph 40 read as follows:

"The two are not, however, completely equivalent. The advantages which might occur from joining the ERM—improved business confidence, a lower risk premium in UK interest rates, and a guarantee of assistance in difficulties from fellow members—do not seem to flow from the Accord. On the other hand, the presumption which now exists that the Bank of England will defend existing parities involves a loss of that flexibility and tactical advantage over the markets which the Chancellor commended. In some respects the Government appears to have the worst of both worlds."

An amendment made.

Another amendment proposed, in line 5, to leave out from "commended" to the end of the paragraph.—(*Mr Townend*).

Question put, That the Amendment be made.

The Committee divided.

Ayes, 5	Noes, 4
Mr Browne	Mr Banks
Mr Budgen	Mr Mitchell
Mr Howell	Mr Sedgemore
Mr Townend	Mr Wainwright
Mr Watts	

Paragraph, as amended, agreed to.

Paragraph 41 read, as follows:

"The action that would be taken under the Accord if the underlying fundamentals in any of the G6 diverged from their present states is also unclear. The Governor told us that a major structural change in one of the economies could release it from its obligations under the Accord. The Chancellor, on the other hand, took the view that:

> "If domestic action is needed, then there is the presumption that that would be taken by the country that needs to take the action"

Finally, we note that the basis of the Accord, the view that existing parities are about right, is contradicted by the Chancellor's statement in his Budget speech that

> "There are still serious imbalances afflicting the three major economies—the United States on the one hand, and Japan and Germany on the other—which if not handled properly, could lead to a simultaneous downturn in all three"

It will be surprising, therefore, if some of the G6 currencies do not come under renewed pressure."

Paragraph disagreed to.

Another paragraph—(*The Chairman*)—brought up, read the first and second time, amended and inserted, (now Paragraph 41).

Paragraphs 42 and 43 read, amended and agreed to.

Another paragraph—(*Mr Mitchell*)—brought up, and read the first time, as follows:

"CONCLUSION

The Chancellor has found himself in the fortunate position of having some £6–7 billion of extra tax revenue and a healthier economy than anticipated at the time of the last budget.

This is thanks in large part to the depreciation of sterling which has stimulated exports and profits, adding extra corporation tax to the increased VAT from a consumer boom sustained by earnings increases and the rapid growth of consumer credit. The Chancellor has chosen to allocate these extra resources to tax cuts and PSBR reductions. That is a political decision, which some Members of the Committee support, others disagree with. It is however relevant for us to ask whether the present expansion will be sustained or is in danger of petering out. We are concerned that having benefited from the fall in sterling the

Chancellor is still apparently prepared to see it go up again and to attempt to sustain its rate against a Deutschmark against which Britain is still overvalued in real terms. Meanwhile interest rates remain high in historic terms or against our competitors. All these are inhibitions on the sustained and substantial expansion which is essential if there is to be any marked reduction in unemployment."

Motion made and Question put, That the Paragraph be read a second time.

The Committee divided.

Ayes, 3	Noes, 6
Mr Banks	Mr Browne
Mr Mitchell	Mr Budgen
Mr Sedgemore	Mr Howell
	Mr Townend
	Mr Wainwright
	Mr Watts

Motion made and Question put, That the report be the Sixth Report of the Committee to the House.

The Committee divided.

Ayes, 6	Noes, 3
Mr Browne	Mr Banks
Mr Budgen	Mr Mitchell
Mr Howell	Mr Sedgemore
Mr Townend	
Mr Wainwright	
Mr Watts	

Ordered, That the Chairman do make the report to the House.

Several papers were ordered to be appended to the Minutes of Evidence.

Ordered, That the Appendices to the Minutes of Evidence taken before the Committee be reported to the House.—(*The Chairman*).

Ordered, That the provisions of Standing Order No 116 (Select committees (reports)) be applied to the Report.

MINUTES OF EVIDENCE

TAKEN BEFORE THE TREASURY AND CIVIL SERVICE COMMITTEE

WEDNESDAY 25 MARCH 1987

Members Present:

Mr Terence L Higgins, in the Chair

Mr Tony Banks	Mr Brian Sedgemore
Mr Anthony Beaumont-Dark	Mr John Townend
Mr John Browne	Mr Richard Wainwright
Mr Nicholas Budgen	Mr John Watts

Examination of Witnesses

MR M C SCHOLAR, Under Secretary, Fiscal Policy Group, HM Treasury, MR D PERETZ, Under Secretary, Monetary Group, HM Treasury, MR P SEDGWICK, Under Secretary, Forecast and Analysis, MR J ODLING-SMEE, Under Secretary, Medium Term and Policy Analysis, HM Treasury, and MR A TURNBULL, Under Secretary, General Expenditure Policy, HM Treasury, called in and examined.

Chairman

1. Mr Scholar, you and your colleagues are most welcome this afternoon to the beginning of our annual festivities, and we are grateful to you and your colleagues for coming along. I should perhaps mention, since this is a public session, that we shall be taking evidence from the Governor of the Bank of England in public tomorrow at 4.45 and from the Chancellor of the Exchequer on Monday at the unusual time of 2.15. You will appreciate that the pressure of time this year is very considerable because we always seek to produce a report for the benefit of the House ahead of the second reading of the Finance Bill and between now and then the recess intervenes. The result is we have very little time both to take evidence and to draft a report ahead of the recess, and will need to have it available immediately afterwards. This does mean we are up against time, and that is the explanation for the somewhat unusual timing of the evidence which we shall be taking. Thank you all very much for coming. Perhaps I might invite you in the traditional way to introduce your colleagues, and then we might go straight to questioning. I presume there is no initial statement you wish to make, given that the House has been debating the matter for some days.

(Mr Scholar) Thank you, Mr Chairman. On my left is Mr Peretz of the Monetary Group of the Treasury. On his left is Mr Sedgwick of the Forecast and Analysis Group. On my immediate right is Mr Odling-Smee of the Medium Term and Policy Analysis Group, and on his right is Mr Turnbull of the General Expenditure Policy Group.

Chairman: Thank you very much. We would like to start clarifying some points as far as monetary policy and the exchange rate is concerned.

Mr Sedgemore

2. I wonder if you could help us with the rising fog of monetary indicators—M0, M1, PSL1, PSL2, DCE, and no doubt several others. Let us start with M0. This Committee has in the past argued that it is of little consequence in assessing the state of monetary conditions, that it is of limited importance as a measure of transactions demand because of the increasing growth of cheques and credit cards, and we have asserted, as I believe other people have, that it lags behind rather than anticipates growth in money GDP. So why do the Treasury continue to use it as a monetary indicator. Should we not be looking at an alternative?

(Mr Peretz) I think a lot of the arguments are set out in the Budget documents, and have been set out at rather greater length in various statements, including the Chancellor's Lombard Association Lecture last year, which was perhaps the longest and most extended explanation of monetary policy. Taking M0, I think we accept that in some ways it is not an ideal narrow aggregate, and some of the reasons are set out in the Red Book as to why other possible narrow aggregates are not very useful, such as non-interest-bearing money which you might think would be useful. But what has been true in practice is that M0 has proved a fairly reliable indicator of monetary conditions and reliable guide to policy over quite some period of time.

Chairman

3. Before or after the event?

(Mr Peretz) Before the event, I think I would say, Mr Chairman. As to the question of whether it is lagging or not, I would refer you to the article we produced in the May/June Treasury EPR last year, which presented a piece of work which looked at whether the relationship between M0 and money GDP was more stable if you looked at it lagged by a period. On the whole it seemed that if you took the relationship between M0 one year and money GDP the next, that shows a slightly more stable relationship than between M0 and money GDP in the same year. So I think if anything the evidence is that money GDP follows M0. I should add to that that M0 does have a useful practical advantage in that it is an indicator which is actually available very quickly after the event, whereas the figures we get or the indications we get of money GDP follow some months after it has actually happened. For M0 we have a reading of some kind almost every week. It is quite quickly available after the end of

[Chairman *Contd*]
each month, so that even if you thought that it was a coincident indicator rather than one which was leading, it would still be a very useful one.

Sedgemore

4. For what years? You say these figures—I have not read this article, I must confess—show that money GDP follows M0. What period does that study cover?

(Mr Peretz) This was the EPR article published in May/June last year. It goes back to 1975, and covers the period 1975–85.

5. And there is a constant relationship, is there?

(Mr Peretz) No, there is not a constant relationship. I do not think anybody would want to pretend that there are exact relationships which follow precisely. But it is true that M0 has shown a more stable relationship than any of the other monetary aggregates, narrow ones or broad ones, and therefore I think as a practical matter it has a track record which we need to look at. We are not the only country to look at narrow aggregates; the Swiss target their version of M0; and the principal German target, which is Central Bank money, in fact consists as to 50 per cent or so of notes and coin. So we are not all that extraordinary in international terms either.

6. If we could look at the cheques and credit card side of this, does their increasing use matter, either in terms of monetary conditions or in terms of wider economic policy? Would it matter if plastic cards became 110 per cent of income?

(Mr Peretz) It clearly is true that things like that, which you might call technical innovation, affect the velocity of M0. But our experience has been that they affect it in a fairly steady way rather than in jumps in particular years, so it has been a regular and fairly steady effect, which appears in the velocity trend. There is a chart, 2.2, in the Red Book, which shows the M0 velocity trend over a number of years, and shows just how stable it has been. It is not a straight line, but it is not a bad version of a straight line.

7. So you are happy that as far as monetary indications are concerned, the growth of plastic cards does not matter, because it is not big enough to change velocity of circulation?

(Mr Peretz) One of the reasons why we look at a range of indicators rather than just one is that it is clear that almost any single indicator can be subject to distortions from time to time. As I say, up to now that has not happened for M0. But I think one can be confident that as long as one was looking at a range of evidence, if it did happen, you would spot that it was doing something slightly peculiar from the other evidence.

8. Are there any other economic implications of the growth of personal debt and plastic cards? I repeat what I said just now: would it matter if personal debt largely from the use of plastic cards became 110 per cent of income?

(Mr Peretz) Personal borrowing is one of the factors that goes to affect the growth of the broader aggregates of money, and the broader aggregates of liquidity, and certainly I think again the Budget documents make it clear that we continue to pay attention to those. But they have proved very difficult to interpret in recent years because the rapid growth of personal borrowing combined with a build-up of personal assets of roughly the same rate and magnitude, and these, to the extent they are liquid assets, appear to be liquid assets which are willingly held: and insofar as that is true, it is not a matter of particular concern . . .

9. How do you pay attention to them—in relation to which broader money indicator?

(Mr Peretz) We look at a range of broader aggregates. Last year we had a target for sterling M3, and for many years before that, but that is not the only broader aggregate. I think there is a paragraph in the Red Book which says that the broader aggregates which include building society liabilities as well as bank liabilities, may be slightly less erratic than those which contain just bank liabilities. That is not particularly surprising since to some degree banks and building societies are now operating in very much the same market, competing with each other.

10. Are we still taking any notice of £M3? I thought the Chancellor said we were.

(Mr Peretz) I think the Chancellor said very clearly he still was.

11. It says here in the Red Book at 2.14, "If the underlying growth of M0 threatens to move significantly outside its target range in 1987–88 there is a presumption that the Government will take action on interest rates unless other indicators clearly suggest that monetary conditions remain satisfactory." What are these "other indicators" and how would they have to behave to prevent an increase in interest rates?

(Mr Peretz) There is a range of indicators we look at, apart from various measures of broad money and narrow money and the exchange rate, which are in a sense the three most important indicators, as highlighted in the Red Book. We look at quite a range of evidence. Movements in asset prices—house prices, the stock exchange—can produce valuable evidence about monetary conditions. The most up-to-date information about inflation itself, which includes producer prices as well as consumer prices. Movements in the oil price which is clearly one of the important factors which affects the exchange rate, and to some extent movements in the interest rates themselves, and how our rates compare with rates abroad and interest rate differentials. I do not want to give the impression that that is a complete list. But perhaps I have said enough to give some indication of the range of things that are taken into account. As to paragraph 2.14 I think this paragraph really does mean precisely what it says, very much the answer I gave earlier on to Mr Sedgemore. M0 has proved quite a reliable indicator for a number

[Sedgemore *Contd*]
of years, so we would need some persuading that it was telling us wrong things but, if the range of other evidence said it was giving us a misleading message, then we would do presisely what it says in that paragraph.

12. I am simply puzzled as to what you said because you have got to deal with cause and effect and you have got to deal with time lags. M0 goes outside its range and then you look at these other indicators which appear to be stable. I take it you are saying something like that it is not changing very much so there is no need to start changing policy on interest rates, but if the purpose of M0 is actually to give you a trigger that something is going wrong, then what is the point of this statement? If it goes outside the range, do you then suddenly say "We are going to ignore the trigger"?

(Mr Peretz) I think what it would create is precisely what it says in the paragraph, a presumption that something is going wrong unless the other evidence were pointing clearly in the other direction.

13. The other evidence could only give a static analysis; it cannot give a dynamic analysis. You could not tell whether the evidence was going to point in no direction at all until it happened, until the time had passed.

(Mr Peretz) Well, these things do not happen instantaneously, I think that is one point. Indeed, it would be quite wrong to react to every single week's or month's reading of a particular aggregate because there are obviously random fluctuations and variations in some of these things.

14. Are you really telling us it is an intuitive process; you have lots of indicators, and somebody sits down and does not take any notice of M0, £M3 or broad money but "intuits" some kind of balance between them? Is it in fact some kind of curious art none of us understands?

(Mr Peretz) No, but I am saying at the end of the day it is a matter of judgment. There are a number of—really three principal—things the Government takes into account in making decisions, in assessing monetary conditions, and then taking decisions on interest rates: the movement in M0 as judged against its target range, the behaviour of the exchange rate, and the behaviour of broad money, which has proved difficult to interpret in recent years but is still something which very much has to be taken into account. Then there is a range of other evidence I tried to give you an indication of we would also look at. It would be foolish to ignore any information we think is useful.

Mr Townend

15. Short term interest rates are still rather higher than most of our industrial competitors'. In view of the state of the market and the strength of sterling in recent weeks, why has the Government been so reluctant to allow a significant drop?

(Mr Peretz) There have been two half-percent cuts in the base rates in the last two weeks. I have tried to explain the way the Government makes decisions about interest rates. It has been much more fully set out, for example, in the Lombard Association speech and elsewhere. They aim to keep interest rates at a level, on average, that keeps monetary conditions tight enough to maintain downward pressure on inflation. There are sometimes also, I should say, tactical market issues———

Chairman

16. The acoustics in this room are very bad. It is extremely difficult for the people behind you to hear. Could you please speak up?

(Mr Peretz) Sometimes also tactical decisions to be made about how best to achieve the level of interest rates—the level which the Government have judged right. But the level of interest rates today—I do not think I can say more than this—reflects the Government's current judgment both of monetary conditions and market pressures. Beyond that I would say the Government's stated intention has been to operate policy in a cautious manner, and not to take any risks with inflation.

Mr Townend

17. Is one of the reasons given in paragraph 2.15, which says, "Private sector borrowing has been rising and is now over 10 percent of GDP . . . It has clearly contributed more than public borrowing to upward pressure on real interest rates." Is it really the level of private sector borrowing which is keeping interest rates higher?

(Mr Peretz) That is certainly one of the factors that has affected the level of interest rates.

Chairman

18. What estimates have you of relevant elasticity as far as that is concerned as to the relationship between short term interest rates and private borrowing?

(Mr Peretz) I do not think it is really a question of necessarily setting interest rates at a level that restrains borrowing to a particular rate of growth. It is more a question of taking account of the rate of growth of borrowing in so far as it affects the rate of growth of broader aggregates.

19. We are talking about *private* borrowing.

(Mr Peretz) Private borrowing affects the rate of growth of broad money because one of the counterparts———

20. We understand that. What estimate have you made of elasticity? You were saying just now the rate of interest is supposed to affect the level of private borrowing; you must have some idea what the relationship is.

(Mr Peretz) I think all I was saying was the rate of interest—the level of interest rates—is higher than it would otherwise be were the rate of private borrowing less.

Mr Townend

21. Is the Government worried at the present pressure put on by private borrowing?

[Mr Townend *Contd*]

(Mr Peretz) The Government's judgment is that with the current level of interest rates, and the current level of growth of broader aggregates, the combination is roughly right.

Chairman

22. That is not the question. Would you answer the question?

(Mr Peretz) Your question is?

Mr Townend

23. Is the Government worried about present pressure on increased liquidity in the private sector and private borrowing?

(Mr Peretz) The answer is that that is one of the things which goes into the setting of interest rates.

Chairman

24. We understand that. That is not the question.

(Mr Peretz) I am not———

Mr Budgen

25. Is it the desire of the Government that this level of private borrowing should be reduced?

(Mr Peretz) I think one could say, if it were lower, then the level of interest rates might be lower and that would be consistent with the same downward pressure on inflation.

26. Is the answer to my question—listening to the various ways in which people have formulated it—yes or no?

(Mr Peretz) Your question is? I mean, the Government———maybe this is a question you should ask the Chancellor rather than me.

27. We will.

(Mr Peretz) The Government's position on the level of private borrowing is that it is market processes which determine the level of private borrowing, and that the instrument of Government policy is the level of interest rates.

28. You are saying then the Government does not have a view about the amount of private borrowing that is now taking place?

(Mr Odling-Smee) Perhaps I could say, following up what Mr Peretz has just said, that the Government is concerned that the private financial markets should operate in a relatively unfettered way and that borrowing should be whatever is determined by the process as they go on within that. The Government would be concerned if that led to monetary conditions which were not consistent with objectives for money GDP over the medium term. Mr Peretz has been explaining that there is no reason to believe that monetary conditions at the moment are inconsistent with those objectives, despite what might appear to be rather alarming levels of borrowing to some people.

Mr Townend

29. What, if anything, can be done to correct the increase in private credit? Is it purely putting up interest rates, or do you have other ammunition in the locker?

(Mr Peretz) The instruments of Government policy are interest rates and, over a slightly longer time horizon, fiscal policy. I am not sure what other instrument you are suggesting there might be.

30. I am asking you.

(Mr Peretz) It is certainly true that governments in the past have tried to control credit by volume controls of one kind or another and governments overseas have tried that too. I think as financial markets have become more sophisticated that has become extremely difficult and something which has proved not to work very well.

31. Not an option that is being considered by the present Government?

(Mr Peretz) No.

Mr Beaumont-Dark: Well, I must tell you that I have never heard such twaddle!

Mr Sedgemore: He is in his academic mood today!

Mr Beaumont-Dark

32. One of my great joys is that I am not an academic. I have to live in the real world, and that is not the same thing. One of the reasons why I thought the Budget was good—and it *was* good; I thought it was the best Budget since 1979—was that I understood that the reason why the Chancellor quite rightly resisted the normal temptation of any full-blooded politician to spend other people's money was such a strategy would do one essential thing, which was that if you had three and a half billion that you kept in the bank instead of enjoying it upon wine, women and song, it meant that you would be able to get interest rates down. Then we have these old women in Threadneedle Street, who you then tell me, and us, reflect the Government's views. How can that be true? We will ask the Chancellor on Monday, but surely the great aims of the Chancellor's policy should be two things: to reduce the cost of money, which is at usurious levels in this country against all our competitors, and that the pound should not keep on going up. Would you not agree that one of the great tragedies we have had was that when the pound went to two dollars and more it acted like a scythe throughout manufacturing industry? Are you telling me that interest rates, with this little grovelling half per cent here and half per cent there, like some miser who does not want to give people their own money, is really what you are advising the Chancellor? I do not blame him. What advice is he getting? Are you really, along with those gnomes in the Bank of England, telling the Chancellor he should not reduce interest rates? Yes or no? What are you telling him?

(Mr Peretz) I am not sure I am allowed to tell you.

Mr Beaumont-Dark: I may not want to hear it!

Chairman: Order. It is, I think, a well-established convention that the advice of officials to the Chancellor is something they do not reveal.

[Mr Beaumont-Dark *Contd*]

Mr Beaumont-Dark: If it is bad, it ought to be private! What is your view on it? Are you actually telling us—because you have got to be here to do something—that you think interest rates at the moment are right or not? Do not tell us what advice you are giving him; what advice are you giving the British public, who pay us? Do you say that interest rates are too high, too low, or right? Which are they?

Chairman: I think that is really a question one ought to pursue with the Chancellor.

33. No, otherwise why are they here? What advice are you giving me, as a humble back-bencher, with a small "h"? I am fed up with this.

(Mr Peretz) I will make two comments. One is that, as I have already said, short-term interest rates have come down 1 per cent, or if you look at market rates, they have come down slightly more. Second, long-term interest rates have come down from a 20-year yield for gilts of around 10 per cent in January or February to rather under 9 per cent now. One should not forget about long-term rates as one of the costs to industry in borrowing.

(Mr Odling-Smee) Perhaps I could add a couple of comments as well, Mr Chairman. I think that what one can say in reply to Mr Beaumont-Dark's question about the effects of the Budget on interest rates is that over a period of time, and not necessarily for the first ten days or whatever, the fact that the Chancellor has not spent all of the money, to use Mr Beaumont-Dark's language, will bring about somewhat lower interest rates than would otherwise have occurred. So I think that he is right to welcome the Budget on that account. That is all I wanted to say.

34. Can I just say this? You said, and I agree, that we people who do not live in the clever world take things on rather a more simplistic basis, but you said the private financial market should operate freely. It obviously is not, and I will tell you why it is not: because it stands out, even for people like me to see. Here you have got the pound at $1.62. You may say I bleat about manufacturing industry, but when oil is gone you will depend upon my people and my kind to manufacture it, because it will not be coming out of the ground; it will have to go over the ground. Why is it that you think that the pound should keep on going up? Why should the pound be $1.62 when in a manufacturing sense there is no justification for it? If we took 1 per cent or 1½ per cent off interest rates and the pound came down to $1.50, would there be blood flowing in the river? No; there would be prosperity flowing through industry. That is what matters. Why do you clever boys think it is much better to have a higher pound than higher industrial activity? Why? Tell me why. Tell my people, tell Birmingham people, manufacturing people, why.

(Mr Peretz) One point is that the Chancellor has said repeatedly recently that he is very happy with the level of the pound at its current level.

35. Is he?

(Mr Peretz) And that he would, by implication be unhappy were it to go up or down very significantly. Another comment is that it is a good deal lower now than it was a year and a half ago. In effective terms it has come down from somewhere in the 80s a year and a half ago to 72 today.

Chairman: I think this again is a matter which we would wish to pursue with the Chancellor or the Governor.

Mr Banks

36. I am sorry that I was late, Chairman. I came in at the point that Brian Sedgemore was asking whether the amount of private personal borrowing and plastic cards was actually important, and I thought it was being said that the Government was not too worried about that; it did not make any difference. Subsequently, however, one heard that it was the level of private borrowing that was causing the upward pressure on interest rates, but then interest rates were being kept at levels to protect against inflation. The question is this really: since overseas experiences have been mentioned why then do we appear to have the worst of all possible worlds, which is to be amongst the highest short-term interest rates and the highest rate of inflation in Europe.

(Mr Peretz) There could be some relationship between interest rates and inflation.

Chairman: We understand that.

37. I entirely understand that point, but if the Government is saying that it does not want interest rates to come down in order to protect against inflation, why have we still got the highest level of inflation and the highest level of short-term interest rates? Some must be doing it a bit better than us, must they not?

(Mr Odling-Smee) There has been a recent change in our position vis a vis Europe—perhaps one should put it the other way round: in some of the European countries vis a vis our position—in that the fall in the oil price helped to reduce inflation in most other European countries quite sharply last year, and it did not have the same effect on us because of our special position as a net oil exporter. So that in itself produced an inflation differential that was relatively adverse to us. In response to that—partly in response to that, but there are other things such as growth of private credit and further factors—it has been necessary to have somewhat higher interest rates here. So to some extent these two factors you observe—higher inflation at the moment and higher interest rates—are both the result of the developments over the last year or two in the world economy, especially falling oil prices.

38. So if private borrowing is causing interest rates to stay high, and if the Government were to do something about the level of private borrowing, one could assume then that interest rates would go down.

[Mr Banks *Contd*]

(Mr Odling-Smee) I am not sure what it is the Government could do other than keep interest rates higher.

Mr Browne

38A. Chairman, does the Treasury find it disturbing that there appears to be a continuing upward trend in the private sector of liquidity and of borrowing, despite the fact that interest rates, as we have heard, remain at very high levels in real terms? Could you say what you feel should be done to curb this demand for credit in those circumstances?

(Mr Peretz) We keep being asked more or less the same question, Mr Chairman. I find it very difficult to give a different answer than the one we have given so far.

39. I am not trying to ask you what advice you are giving the Chancellor, as has been asked before, because I quite understand this is not the forum for that advice to be aired in public, but I am trying to ask what your views are on the alternative options and therefore what you see—just as an individual member of the Treasury—can be done to curb the demand for credit in present circumstances.

(Mr Peretz) Interest rates are the most obvious and main instrument of the policy and that is, indeed, one of the reasons why interest rates are so high. Perhaps a slight diversion if I may, Mr Browne, you said real interest rates are high. It is never very easy to know what real interest rates actually are. You compare interest rates with current inflation but really you ought to be comparing nominal interest rates with people's expectations of future inflation. There was an article in the Bank of England Quarterly some time last year—I do not recollect the precise date—which compared our real interest rates with other countries on various different bases. On some bases our rates are not necessarily higher than other countries. It depends on the basis of comparison. One of the reasons why our real interest rates might be higher than other countries, is that clearly it takes a great many years for governments, for countries, to establish an international track record, if you like, of aiming for low inflation—countries like Germany, which has had twenty years or more, ever since the war, of track record of that kind. People in the market———

Chairman

40. Mr Peretz, can I ask you please to listen to the questions and to seek to answer the questions rather than going off in a different direction. The question was, apart from interest rates, what are the alternative ways you might consider could be used to restrict the growth of private credit?

(Mr Peretz) Mr Chairman, I mentioned one before—direct controls of one kind or another. I said experience—not just in this country, in other countries—is that such controls were increasingly unworkable even if you thought they were desirable. I do not address the question whether they are desirable or not. Apart from that, in the longer run fiscal policy has a role to play.

41. On consumer credit?

(Mr Peretz) On the level of interest rates.

42. Yes, but the question was on consumer credit.

(Mr Odling-Smee) Fiscal policy could restrict the demand for credit by slowing down the growth of money incomes.

Chairman: Thank you very much. Mr Browne?

Mr Browne

43. Thank you very much for that answer. By the way, I am very interested in what you said about real interest rates. It is just the normal terminology. What I am saying—and I think most people would agree—is that, despite your answer, that is the normal view. I would agree more with your definition myself, but does that mean that the outlook for inflation is going to be higher?

(Mr Peretz) I think what it means is———

44. People expecting higher inflation?

(Mr Peretz) What one would hope it would mean is, as it becomes clear that inflation is on a downward track, then interest rates will come down and the longer this track is—that, I think, is the Government strategy—the longer the medium term strategy is held in place, the longer it is made clear that inflation is on a downward track, then the more likely it is that nominal interest rates can be got down and kept down and held down in a sustainable way.

45. I was very interested in your answer to Mr Sedgemore's question about the relatively stable relationship between the growth of M0 and money GDP. Does this therefore mean that broad money, however you define it, does or does not continue to have a role in the formulation and operation of monetary policy?

(Mr Peretz) No, I think it is fairly clearly set out in the documents. It does continue to have a role, it is just that the Chancellor decided its behaviour had been so—"erratic" is the wrong word—so difficult to interpret over the last few years that it would actually be less helpful rather than more to have a target range for it. So we will continue to take it into account, if you like in the same sort of way the Government takes account of the exchange rate, but without any precise guideline for it.

46. Finally, the Chancellor said he would like sterling to remain roughly at its present level, say at 72, as you just told us. Does this indicate that he and the Government are changing their views and thinking of negotiating entry to the European Monetary System?

(Mr Peretz) The Chancellor is on record very recently on the European Monetary System as saying there is a balance of advantages and disadvantages, which is kept under review, but the time is not right to join yet. I think the one thing which has changed—maybe this might help you—is the recent Paris Agreement between the major six countries which has created slightly different conditions

[Mr Browne *Contd*]
for the operation of policy. First of all, the fact the agreement took place reflected the fact that the pattern of international exchange rates now is much closer to what one might think would be justified by fundamental economic circumstances than has been true for some time. Certainly that is what the communique from the Paris Agreement concluded. So that the conditions that are there are much better than they have been for many years to achieve stability of exchange rates. The other element of the Agreement was the commitment of the six Finance Ministers present to operate policy in order to try and achieve a period of stability. I think that does put the operation of our own policy in a slightly different context than it has been up to now—if only that it means in our own policy decisions we are in a position to give slightly greater weight to achieving exchange rate stability because the chances of achieving that are rather better than they have been. Every exchange rate has two parties to it. It is much harder to control your exchange rate if you are trying to do it by yourself, but with an international agreement like that it is slightly easier.

Mr Watts

47. At the time of our inquiry into the Autumn Statement the Sterling Index was a little over 67 and the Chancellor told us he was happy with it, but at that level, and did not wish it to move significantly either up or down. In his interview with the Financial Times on 19 March he said again that he would like to see sterling remain at its present level. I think, Mr Peretz, you referred to that in reply to an earlier question about 72. Does the Chancellor's recent statement imply a target range, although not an acknowledged one, of 72 to 73, or what are we to understand by his recent comment?

(Mr Peretz) I am trying to remind myself of his words. I thought my recollection was he said he would not particularly like to see it go any lower than 67, or whatever the rate was at the time, rather than saying he thought that was about right. When he came back from the Paris meeting he indicated he had already said he did not want to see it go any lower than it had been, and as a result of the Paris Agreement he would not want to see it go substantially higher than it was then, which was around 69 or thereabouts. More recently, after the Budget, he indicated that he was very happy with it around its current level. I do not think it would be helpful for me to go beyond that. Suggestions of target ranges are really slightly wide of the mark—narrow or wide. I must rest on what the Chancellor has said, which is that he is quite happy with it around its current level, as indeed very much follows from the terms of the G6 Communique. All the finance ministers felt a period of stability of exchange rates, in current circumstances, around their current levels would be right and they would work to that end.

48. But does not the agreement at Paris to try to achieve a greater stability give rather more support to the notion of having a declared target range and are not the risks of doing that somewhat diminished when all of the major industrial countries have pledged themselves to try to achieve that stability?

(Mr Peretz) Mr Chairman, I am in some difficulty because almost anything any official says on this subject—or the Chancellor for that matter—is liable to misinterpretation in some form or other. I think the Chancellor has made it absolutely clear that he does not think it makes sense for this country to have an explicit exchange rate target outside the formal arrangement of the exchange rate mechanism of the EMS. We are not members of that at the moment. If we were to join, it would be a different matter. He has also made it clear that in line with the G6 agreement, he is content with the current level of sterling and is hoping for a period of exchange rate stability. I cannot go beyond that, because almost anything I said would be interpreted as meaning something slightly different.

49. It does seem to be a variable sort of stability, which has moved from an index of 67 in October/November to 72 or 73 now. That is quite a large percentage variation, but I acknowledge that this is perhaps a matter to be pursued with the Chancellor rather than with you. There have been some rumours that foreign money is likely to flood into London because of our continuing relatively high interest rates, and indeed, the strength of sterling. If that were to occur, and sterling strengthened above whatever is the Chancellor's unacknowledged ceiling for sterling, what action would we expect to see? Would it be on interest rates?

(Mr Peretz) Well, I think it is really, in a sense, all set out in the medium-term financial strategy. The exchange rate is certainly one of the factors taken into account in interest rate decisions. If the exchange rate were to move and nothing else were to move, that would be a reason for judging that the monetary condition had tightened. One would need to look at all the circumstances, but it might be a reason for reducing interest rates. The other weapon on the exchange rate is intervention, which is available to central banks.

50. But if interest rates were reduced in order to assist the rise in the parity of sterling, is there not a risk that a fall in interest rates might loosen credit conditions? We have already spent a fair amount of time discussing the growth of private sector borrowing; is there not a dilemma there?

(Mr Peretz) Yes, there certainly is a potential dilemma there. All I would say is what I said before, that I think that the prospects of cutting through that dilemma are rather better than they have been for a long time, because the international environment is one where one has a much better environment for pursuing a period of exchange rate stability than there has been for some time. But Governments in the past have been faced with the dilemma in very acute form, and it could indeed happen again. It is not true at the moment, I should say. I think the exchange rate and certainly the M0 monetary evidence is all pointing the same way, which is that current conditions are satisfactory.

[Mr Watts *Contd*]

51. One final point: within the forecast, wherever exchange rates have a significant impact on the forecast, what is the assumption of the index which has been used in preparing the forecast?

(Mr Sedgwick) That is set out as clearly as we ever set it out in paragraph 306 of the Red Book. It says "that the exchange rate will remain close to its current level," and "current" was in the week or so before the Budget.

52. And that was?

(Mr Sedgwick) It averaged somewhere in the region of 70-ish round about then.

53. So a little lower than it is now?

(Mr Peretz) I do not think you should read too much precision into the precise rate. Small differences may not have that much effect on the forecast itself. It is a very small variation.

Mr Wainwright

54. I have some questions about the record of various forms of growth that were mentioned in the Chancellor's speech. For instance, in one passage he said that by contrast during the 1980s Britain's growth rate has been the highest of all the major European economies, but is it not a fact that if one takes the 1980s—that is, starting the comparison at the beginning of the 1980s—it is simply not so; we are not at the top of the European economies.

(Mr Scholar) I think that it is indeed the case that we are at the top of the league table of *major* European countries, which is, I think, the qualification which the Chancellor made when this assertion was being made, but I think Mr Sedgwick may want to say something more about that.

55. I hope he will also pay attention to Italy, which is certainly recorded by the OECD as ahead of us.

(Mr Sedgwick) Let me just clarify the basis of the numbers or the rankings that the Chancellor was talking about. They were talking about growth in the 1980s compared with the 1960s and 1970s. Growth in the 1960s was taken as growth between 1960 and 1970, and in the 1970s was between 1970 and 1980, and in the 1980s was between 1980 and 1986. On that basis it is clear for the major European economies that growth in the UK has been higher than for the others. It is, however, perfectly true that if you wish to define the 1980s as from 1979 until 1986, the ranking is somewhat different then. The UK has an average growth rate which is the same as that of Germany, rather above that of France and a little below that of Italy, but I think as long as one defines over what period these comparisons are made, it is clear what the position is, and I think the general point is that in recent years the growth in the UK economy has compared more favourably with the other major economies.

56. But the OECD tables which we have, the heading is precisely 1980 to 1986, not 1979 to 1986.

(Mr Sedgwick) I do not recognise these numbers. I think there have been another set of comparisons around, which have been used, which are from 1979 to 1985. These show the average growth in the UK about the same as most of the other major European economies, rather above that of the Netherlands, and a bit below that of Italy. I do not actually have in front of me the OECD figures you refer to.

57. We had better have a note about that. It will be important that we have it before we see the Chancellor, because we must get our tables right. I have them here.

(Mr Scholar) I think it would be helpful if perhaps after this hearing you could let us have a copy of the evidence which you are looking at.

Mr Watts: Yes, sure.

Chairman: We might reverse the usual procedure and we will let you have a note!

58. Growth measured as output per head, again another passage of the Budget speech: the Chancellor said that during the 1980s our annual rate of growth of output per head has been the highest of all the seven major industrial countries. Well, now, that again does not tally with our figures from the OECD and I just wonder———

(Mr Sedgwick) I think the Chancellor said that was true of the output per head of people in manufacturing industry, did he not?

59. What he said was during the 1980s the annual rate of growth of output per head "has been the highest of all the seven major industrial countries".

(Mr Sedgwick) I thought that was a remark about manufacturing industry.

(Mr Scholar) I thought it followed upon a sentence about manufacturing, but that is purely from memory.

60. You are saying this is intended to be manufacturing?

(Mr Scholar) I am looking at the text of the speech now. In the Budget Statement the Chancellor said that "During the 1960s and again in the 1970s growth in manufacturing productivity in the United Kingdom was the lowest of all the seven major industrial countries in the world". He then went on to say, "During the 1980s our annual rate of growth of output per head in manufacturing has been the highest of all the seven". I think it is quite clear.

61. Did he say in his second sentence "output per head in manufacturing"?

(Mr Scholar) Yes, indeed.

Mr Wainwright: Thank you. That clarifies that.

Chairman

62. Might I pick up one or two random points? They are very random, really filling in gaps in some of our thinking. I would be right in thinking, would I not, that the medium term financial strategy up to now has been for a steadily declining path for PSBR?

(Mr Odling-Smee) That is right.

[Chairman *Contd*]

63. The proposal now is that it should remain at a constant percentage of the GNP?

(Mr Scholar) That is right.

64. What is the reason for the change of policy?

(Mr Odling-Smee) The change, going from a declining path to a flat path is not a distinct change of policy, because clearly one could not every year into the future of the next fifty years always look for a declining path or else one would end up with a very large negative PSBR. At some stage this had to come to an end and the———

Mr Budgen

65. It is not a change of policy then?

(Mr Odling-Smee) Quite so. There is no change of policy in the MTFS. Did I say there was a change of policy?

Chairman

66. I think you accepted what I said, which was a change of policy.

(Mr Odling-Smee) No, I am sorry. Perhaps I could explain what I intended to say, that there has been a change in the direction of these trends. You were drawing attention to a purely arithmetic statement. I was going on to explain it was not a change of policy because at some stage the declining trend would have to end. We have now reached that stage and have been able to reach that stage because of the unexpected buoyancy in revenues which has enabled the Chancellor to go down to a figure of 1 per cent of GDP, which is lower than has ever been suggested at the end of any of the rows of MTFS figures in the past. That is the figure which he judges is the appropriate figure for the medium and long term.

67. But, in fact, that 1 per cent figure, as you understand it, is not one which this Committee would accept since we have taken a different view from the Chancellor regarding the way in which assets sales proceeds should be treated. If you look at it as we are inclined to do, namely, as a means of funding PSBR, the figure would be approximately still 2 per cent.

(Mr Odling-Smee) Yes.

68. Why should one not go on downward then to 1 per cent in those terms?

(Mr Odling-Smee) I think the Chancellor would expect in the long term to go down to 1 per cent in those terms. He recognises that there are not enough assets to go on selling forever and at some stage that process has to come to an end—not in this Parliament or the next, perhaps two or three Parliaments beyond that—and, as we approach that stage, then through holding the PSBR itself to 1 per cent of the GDP, the adjusted PSBR you favour would fall towards 1 per cent of GDP and then to 1 per cent in the long term asymptomatically.

69. I knew asymptomatically was going to appear at some stage of this discussion. Why should the PSBR remain positive?

(Mr Odling-Smee) There is clearly a demand for public sector debt and, as long as the economy is growing, there will be some interest in holding debt. That is one argument. Another is that it would be quite consistent with the growth of money GDP that the Government is seeking. In the very long term of course that is a growth which is equal to the rate of growth of productive potential, and the Government sees no difficulty about selling an extra amount of debt which would match the accumulation of assets to some extent. I do not mean exactly match but taking place in a world where there is also some accumulation of assets this would be a stable and sustainable situation.

Chairman: I wonder if I might just continue on the ragbag of points I have before turning to Mr Budgen who may well wish to come back to this particular one.

Mr Budgen

70. Could I just clear this one up because I am a sincere admirer of Mr Olding-Smee's verbal dexterity but I do not understand how he is able to say there has been no change of policy. In the original medium term financial strategy the public sector borrowing requirement was seen to be continuously declining, was it not?

(Mr Odling-Smee) Yes.

71. It is true, is it not, that that originally took no account of sales of assets?

(Mr Odling-Smee) That is true.

72. Are you now saying that you concede that we are going to come from a downward path on to a flat path? You blandly say there is no change of policy. How on earth can you say that.

(Mr Odling-Smee) Well, I have just explained that, although there is a change of arithmetic, that is not a change of policy. The original MTFS to which you referred did not go so far as 1987–88 so we do not know what it would have said about it.

73. Come now, Mr Odling-Smee. We all enjoy this entertainment but the figures show the changes in policy. It is like saying, for the sake of argument, there has been a 4 pence cut in, shall we say, the standard rate of tax, but it does not convey any change of policy whatever. Just because you say it with such confidence and dexterity, it does not follow that it is true, does it?

(Mr Odling-Smee) No, I agree with that. There are other reasons why it is true. It is true that the numbers have changed and it is true that within the medium term financial strategy as a whole it is necessary from time to time to change the numbers, but we do that in a way which is consistent with the broad objectives of the medium term financial strategy. The objective of every fiscal policy since the first MTFS in 1980 has been to keep public sector borrowing at a level, and if necessary on a declining trend, which will support monetary policy. The role of monetary policy has been to create monetary conditions which will bring about the

[Mr Budgen *Contd*]
desired growth of money GDP and in the early days put heavy downward pressure on inflation. We are now saying that the illustrative path of the PSBR over the medium term of 1 per cent of GDP is fully consistent with those broad objectives. I agree the numbers are different, but the role of fiscal policy remains the same.

(Mr Scholar) Could I add one point? The Committee has in the past made the point that the PSBR was of less interest than the public sector financial deficit, or the PSBR with the proceeds of privatisation added back into that. If we imagine a profile in which the proceeds of privatisation stretch on some years at the sort of figures which are put into the Red Book—about £5 billion a year—it is worth noting that on that measure the proportion of GDP taken by that aggregate will very gradually decline as the £5 billion reduces in real terms.

Chairman

74. I think all of this is helpful when we come to pursue matters with the Governor and the Chancellor. Can I come back to my diverse point which I will seek to deal with as quickly as possible. There is a proposal in the Budget that the rate of Capital Gains Tax charged on, for example, insurance companies shall be at the Corporation Tax rate thereby increasing the burden on such companies and raising quite a lot of revenue. Could you tell us the reason for that change?

(Mr Scholar) I think it was that the life assurance companies were treated in this proposal no differently from the rest of the corporate sector, and the aim was simplifying and streamlining move, to apply the main Corporation Tax rate or the small companies rate as the rate at which gains were charged, and the proposal made no discrimination in that regard as between life assurance companies and any other company.

75. But given that this change will adversely affect those who hold insurance policies, was any consideration given to that—just as a "streamlining" exercise?

(Mr Scholar) I think it was recongised that this measure would have differential effects on different sectors and on different companies; some companies would be gainers and some would be losers—some sectors would be gainers and some would be losers. I would add to that that the effect on life assurance companies was considered.

76. But purely for a "streamlining" reason, you say? One's constituents may be rather worried about this kind of "streamlining".

(Mr Scholar) I think that the Chancellor, when he looked again at Corporation Tax in this Budget, saw himself bringing forward a number of measures to complement the 1984 reform of Corporation Tax, of which this was one. The other measures are the change of Corporation Tax payment dates—the "pay and file" proposal and so on. This was, if you like, the second lap of the reform which he had begun in 1984.

77. The other very quick question I have is this: does the Treasury inflation forecast assume a mortgage rate cut?

(Mr Peretz) It is not the practice to reveal interest rate forecasts which form part of the forecast. This is a longstanding tradition, Mr Chairman, and I do not think we can break it.

(Mr Sedgwick) Which the Chancellor restated when he appeared here after the Autumn Statement.

(Mr Peretz) There is an obvious market reason for it.

78. Could you tell me what the effect on the RPI would be of fully indexing alcohol and tobacco duties?

(Mr Scholar) 0.3 per cent—that is the figure for the revalorisation of all the duties—not just tobacco and alcohol.

Mr Budgen

79. Mr Odling-Smee, what you were saying was, was it not, that even if the PSBR flattens out the disciplines remain the same?

(Mr Odling-Smee) Yes.

80. And that does not involve you in any exposition of political policy, does it?

(Mr Odling-Smee) No. I agree with that presentation.

81. Let us now turn to inflation: the rate of inflation was 4 per cent, is that right?

(Mr Scholar) When?

82. Last year. It was anticipated to be 4 per cent and has turned out to be a little lower.

(Mr Scholar) It averaged something below that in 1986.

83. About a quarter of a per cent below that?

(Mr Scholar) That is right.

84. It was anticipated now to go up to 5 per cent, is that right?

(Mr Scholar) In the Budget? No.

85. But with corrections? The consequence of the non-indexation of duties, and the anticipation of some fall in interest rates—you are, I think, entitled to say, are you not, that you had anticipated some fall in interest rates but you are not entitled to say how much, is that right?

(Mr Scholar) I think we would decline to make any comment about our expectations on interest rates. That I think is the normal practice which the Committee has in the past accepted.

86. You are not even allowed to say that, now that the market situation has gone, when the calculations were made at the time of the Budget, you anticipated some but an unspecified amount of interest rate fall?

(Mr Scholar) I think it would be a departure from our practice.

[Mr Budgen *Contd*]

87. You are not allowed to say that?

(Mr Scholar) No.

88. I see. Well, are you able to say by how much the RPI is reduced for each 1 per cent fall in the mortgage rate? You are allowed to say that, are you not?

(Mr Scholar) If we can remember the number! I think it is 0.3 per cent.

(Mr Sedgwick) If you bear with me a second I will tell you the exact number. As you may know, there have been some revisions to the weighting system in the RPI which took effect from the announcement of the last monthly figures, and the effect on the level of the RPI of a 1 per cent reduction in the mortgage rate is now 0.36 per cent rather than 0.44 per cent which it was under the previous weights.

89. I see. So the consequence of not indexing the Excise Duties, and if the Committee were without any evidence from you to assume that the Chancellor had anticipated a 1 per cent fall in the mortgage interest rate, would be, (or would this be wrong) that there is an underlying rate of inflation of about 5 per cent which has been reduced down to about 4 per cent by the action of the Chancellor acting upon the RPI?

(Mr Sedgwick) Well, I am not going to get involved in saying what has been assumed on interest rates———

90. No. *We* are making that assumption. We are not trapping you into anything.

(Mr Sedgwick) What I *can* say is what is in the forecast, and indeed what the Chancellor has said, which is that there is some expectation of some rise from the current level of RPI inflation to about 4.5 per cent in the middle of this year, with it coming down to 4 per cent, which is the figure given in the Red Book, by the fourth quarter of this year, and for the RPI inflation rate to be at that level in the second quarter of 1988. Those forecasts take account of the Budget measures.

91. That means that the underlying rate is about 5 per cent and you are knocking off something in excess of half a per cent for the reductions in mortgage interest rates and for non-indexation of duties, does it not?

(Mr Sedgwick) The point about indexation of duties is correct; that is a temporary once-and-for-all effect on the RPI that would stay in for 12 months. I am not going to say anything more about the mortgage rate.

(Mr Scholar) I think it would be fair, if one takes changes in the mortgage rate out of the future, also to take them out of the base. We would resist the suggestion that the underlying rate of inflation is 5 per cent. I would prefer to say, on the assumptions the Committee has made, that that is the peak rate rather than the underlying rate.

92. The underlying rate has gone up, has it not?

(Mr Scholar) I really cannot answer that question.

93. The unrigged rate has gone up, has it not?

(Mr Odling-Smee) The actual inflation rate has obviously gone up. The concept of underlying rate needs to be defined. It is not something which has a natural definition.

94. Of course. Is it true that that is also occurring at a time when commodity prices are continuing to be at a very low level?

(Mr Sedgwick) Certainly there have been very large falls in commodity prices, but in recent months there have been some signs that some have begun to rise again.

95. You mean there is no change of policy but they are flattening out?

(Mr Sedgwick) There is not a policy on commodity prices as such. These, whether we like it or not, are determined in world markets. If we measure them in SDRs there was quite a large fall over the last year or so; and the assumption underlying the forecast here is that world commodity prices will rise a little from the historically low levels, which in real terms they reached at the end of last year.

96. The rate of inflation in Germany is now − 1 per cent. How has it been possible to achieve that in Germany and what are the different conditions that make it impossible here?

(Mr Sedgwick) In the very recent past one thing that has been happening in Germany, which—apart from Japan—is not happening elsewhere, is a very large real appreciation in the exchange rate. That must be exerting quite a powerful and profound effect on the consumer price inflation which, unless there is going to be some further large appreciation—which we assume is not the case—is a temporary effect. So if you want to think in terms of underlying inflation rates, I do not think you should take the negative rates of Germany as illustrative of sustainable price inflation.

(Mr Peretz) There is effectively a once-for-all, presumably, fall in oil price which for a country like the United Kingdom has been somewhat offset by the fall in exchange rate. For countries like Germany and Japan both the exchange rate and oil price have been pushing in the same direction, reducing inflation.

Mr Browne

97. Mr Chairman, may I quickly focus your attention on Chart 2.5 on page 12 and just point out that this chart traces the path of public sector borrowing requirement in black, together with privatisation proceeds. I wonder if you could tell us whether this total is taken just as one total, in other words, two combined, or as PSBR? Is that a combined thing, that focus of attention, which I notice has been flat for the last three years?

(Mr Odling-Smee) I do not think it is really the case that either is, as it were, the focus of attention—the single focus of attention. I think we have always said to the Committee that there is no single indicator of fiscal policy. The Government presents policy in terms of the PSBR which is the

[Mr Browne *Contd*]
black bit, and that is the way in which it is presented in Table 2.5. For example, all the numbers in the tables are presented on that basis. But we thought it would be helpful also to show in Chart 2.5 the black bit plus the white bit, which is the PSBR adjusted for privatisation proceeds.

Mr Townend

98. We established in reply to Mr Budgen's questions that inflation is going to rise this year. Last year you were aiming for it going to tail off again towards the end of the year. If there is going to be a rise, in view of that rise in inflation how confident are you that the spending totals can be kept at the level under the Autumn Statement?

(Mr Turnbull) For 1987–88 the Government plans which were set in cash terms have now been translated into the detailed control totals, that is, the cash limits in Estimates, running cost limits for government departments, external financing limits for nationalised industries. The presumption is that these will not be raised to accommodate higher inflation. If you take the experience of 1986–87 there was only one major adjustment of a cash limit to take account of higher pay, which was in the case of the National Health Service, and the presumption is that the cash limits will also be observed in 1987–88.

99. That might be the presumption. My question was also, in view of the fact that Contingency Reserve is low, how confident are you that those spending totals can be kept to, having regard to 1988?

(Mr Turnbull) The Contingency Reserve as a proportion of the planning total for 1987–88 is higher than in any year except for the year that has finished, so it is a question of judgment as to whether it is a low Contingency Reserve. All I can say is the Government will be seeking to hold those totals. One other factor———

100. You said that. My question was, are you confident they will be able to?

(Mr Turnbull) I do not know that it is my place to speculate on that or offer you my odds? One other factor to bear in mind is that when inflation is rising one major source of risk is the fact that social security benefits are linked to inflation. The timing of the upratings now operates by taking the inflation rate in the year to September and applying it from the following April. Thus for the coming year the social security benefits have an uprating that has already been settled and whatever happens to inflation in the current months will not affect the rate of expenditure during 1987–88. Thus there is a very large chunk which, in effect, is immune from current movements in inflation. That is quite an important factor to take into account.

101. There might still be considerable pressure on wages?

(Mr Turnbull) There will be pressure, there always is, but the Treasury will naturally resist that and only agree to changes in cash limits very much as an exception, as it did in 1986–87.

Mr Wainwright

102. My questions are about various forecasts. This time last year you were predicting that fixed capital formation would rise by 5 per cent. In this year's Red Book it is acknowledged that there is an increase of 1.5 per cent. What are the main factors that have led to that?

(Mr Sedgwick) I am not sure there is a ready explanation of the relatively low rate of growth of investment that at the moment appears to have taken place in 1986. The rise in total investment of half a percent is certainly lower than we had been expecting. It is not out of the question that in subsequent years (as has been the practice often in the past) the Central Statistical Office will revise the number upwards, but for the moment I think we have to take the numbers as they are. We do expect a rise in total investment in 1987, as you see in the Red Book, of 4 per cent. Perhaps I should mention the main items which underpin that view; which come from survey evidence. Both the CBI and the DTI have carried out surveys of the private manufacturing and non-manufacturing sectors (the latter being distribution, widely defined), and these do seem to suggest that significant rises will take place during the current year.

103. But did you not use similar surveys this time last year in establishing your forecast of 5 per cent.

(Mr Sedgwick) I think that is a fair point about those components of total investment which are covered by surveys which are manufacturing and private non manufacturing—mainly distribution. It does seem to me that at the moment the climate of opinion in industry is very favourable, though such generalisations are primarily about manufacturing. There is a good deal of optimism around (and the CBI surveys show that) regarding orders, particularly for exports. I would have thought in such circumstances, and given there has been a perceptible upturn in activity since the middle of 1986, that some increase in investment in 1987 over the previous year is likely. But I take the point that there have been errors in the past, and it is not out of the question that we could be wrong about this year in either direction.

104. Well, then, the surplus on invisibles, as recently as the Autumn Statement, was being estimated for 1986 by you at £8.5 billion, which we did actually express some scepticism about at the time, but the outturn figure now is £1.5 billion less. Are there any factors that can account for that?

(Mr Sedgwick) I think you have to bear in mind that when we made the forecast that was in the Autumn Statement there was a recorded surplus by the CSO at that point of £4 billion for the first half of the year, which has been subsequently revised down. The latest set of revisions revised down 1985 to some extent and, partly as a result of getting firmer information on 1985, they revised down those items of invisibles that are purely projections for

[Mr Wainwright *Contd*]
1986 as well. So we start off with the past having changed and I think the changes in the forecast are largely as a result of that.

105. Turning to the tax yield forecasts, Corporation Tax has shown an outturn rather more than 20 per cent higher than was estimated in last year's Budget. What are the factors there?

(Mr Sedgwick) Two principally. One is that I think we underestimated profits in the previous year, particularly for financial companies. That was one reason. The other is that following a period when there have been substantial growth of profit over a number of years, and large profit growth in each year, it is very difficult to estimate the extent to which previously tax exhausted companies begin to pay tax. I think that the latter is probably one of the important reasons—or the main reason—why this time last year we underestimated onshore (which is what we are talking about here) Corporation Tax receipts in financial year 1986–87.

106. I can readily believe that and that leads me to ask why you do not request the Inland Revenue to give you some sort of estimate? To my great surprise at the moment they do not ask their districts to return the amounts of agreed losses for Corporation Tax. Nobody really knows. The answer from your Minister the other day was that the total of these losses has stood at some £25 billion—30 billion in recent years, and this amount is now reducing by some several billions of pounds a year. If you do not have any better information than that, why do you not ask the Inland Revenue?

(Mr Sedgwick) I think, Mr Wainwright, this is a question that the Inland Revenue itself will have to deal with. There are forecasts in the Red Book for receipts of taxes, the principal work on which is done in the Revenue Department by Inland Revenue/Customs and Excise themselves, and I think if you have any detailed questions about how they assemble their information, say, on accumlated tax losses it is a question they would have to answer.

107. I cannot specify that you should not answer, but I am not asking for any detail of any sort. I am simply saying that these losses are agreed and are on file in the district offices, so why, as the Department responsible for the Inland Revenue, do you not require that these figures be coughed up? They are there and there is no doubt about them being there.

(Mr Sedgwick) I am not in a position to say whether the Inland Revenue are using all the information they have. I am sure that is the case, but I think it would be for them to reassure you on that point, rather than me.

108. But it does not sound as though they would be reassuring me, does it? They would be practically confessing that they have got all this information available, because agreed losses are on the files, but they are not brought out?

(Mr Sedgwick) I believe that a good deal of this information becomes available on an aggregate basis, which is what one needs for making forecasts of total Corporation Tax receipts, somewhat in arrears, but I am not myself in a position to tell you exactly how much or what the precise arrangement within the Inland Revenue for collecting the figures are.

109. But the Treasury is responsible for the Inland Revenue.

(Mr Scholar) That is not quite accurate, Mr Wainwright. We are not responsible for the Inland Revenue, they are responsible for themselves—although they are one of the Chancellor's departments, it is true. But what Mr Sedgwick said is quite right: a lot of this information comes considerably in arrear and the question as to whether in administrative terms it is worthwhile or possible for them to collect this information in a timely way for the production of forecasts is one we should perhaps pursue.

Chairman

110. It is, of course, the case that the Chancellor is responsible for the Revenue Departments, not you?

(Mr Scholar) Indeed.

111. But, given the importance of the unexpected surge in revenue which obviously had an impact on the Budget, I think, using you as a kind of postman, if we could get a note from the Revenue on precisely how they do forecast that would be illuminating.

(Mr Scholar) I am sure we could arrange for that.

Mr Wainwright: My last question is about forecasting in the Autumn Statement of the PSBR. We always approach this in a thoroughly charitable and generous and liberal spirit because we know how excruciatingly difficult it is, but in an interview—a very revealing interview—the Chancellor gave, which was published in the Financial Times just after the Budget, he described the Autumn Statement official PSBR forecast as "totally ridiculous and up the pole". Has there been any change since he reached that verdict in the method of trying to forecast this very difficult number?

Chairman

112.That sounds more like Mr Beaumont-Dark!

(Mr Sedgwick) I think you should ask the Chancellor for his views. I was not at that interview. I do think it is worth just pausing a second to see what the circumstances were at the time of the Autumn Statement when the forecast for the PSBR was made. We had figures for borrowing in the current financial year up to and including September, cumulative figures not terribly different from the year before. At the time of the Autumn Statement on 6 November the first of the two large corporation tax gathering months—which are October and January—had finished. But the information subsequently published in October was not available then. The other thing which I think is worth noting is that a good deal of the shortfall, if you compare the cumulative level of borrowing to a particular

[Chairman *Contd*]
month with the same measure in the previous financial years, is that there has been rather low local authority and public corporation borrowing. That is something which has become more obvious, to put it mildly, in the latter months of the current financial year than in the earlier months. Finally, it is worth bearing in mind that the financial year is not over yet and there is a fairly wide error margin round forecasts of the PSBR made even at this time of year. The average for the past has been about 1 billion, and obviously in individual years the error has been larger.

Mr Banks

113. Chairman, I just want to come back to a couple of points, one on the question of inflation. We were told earlier that the real interest rates somehow were influenced by inflation expectation and yet inflation rates have been more or less around about 5 per cent for some years now. How long does it actually take for expectation to start influencing interest rates then?

(Mr Peretz) Experience is that it is rather a long process. As I said earlier, a country like Germany has a long track record; we now have a track record of declining inflation over seven or eight years.

114. You have no idea how much longer we have to wait then?

(Mr Peretz) I would not care to hazard a figure in numbers of years, no.

115. And the second point is this: on our side it is generally perceived that the manufacturing industry is in an awful mess. We may be wrong perhaps—according to the Chancellor of the Exchequer we certainly are. It is just that this particular statement he made—and this was mentioned by Mr Wainwright in his earlier question—says "During the 1980s our annual rate of growth of output per head has been the highest of all the seven major industrial countries." As I understand it, manufacturing investment and manufacturing output is significantly down on 1979. I just wanted to know why we are wrong on this side, as it were, to believe that manufacturing industry is in a mess. I do not quite understand what factors have influenced us into having the highest rate of growth of output per head of all the seven major industrial countries? Is it just fewer workers and fewer factories, or is it something more substantial?

(Mr Sedgwick) I think it is helpful just to try and stick to numbers that can be measured, as far as I can help on this. It is certainly true what the Chancellor said about the rate of growth of output per head in manufacturing in the 1980s being higher than in the other major industrial economies, and in fact we published an Economic Progress Report article on productivity quite recently which has a table which shows that. You are absolutely right that for the growth of output per head to have been relatively high—given that manufacturing output has not yet reattained the last peak which was in 1979, and that was lower than the previous peak in the early '70s—there has been a considerable shedding of labour in manufacturing industry. That is absolutely true.

116. So that would be the major factor then for the high growth rate? It is not people working with a greater level of per capita investment? It is just fewer people working?

(Mr Sedgwick) There has been over the last few years—in fact since about 1981 though I am not sure of the exact period—a situation where manufacturing output has grown more or less in line with GDP, which itself has risen at just under 3 per cent. That was not the experience over the previous 15 to 20 years, when manufacturing output in the UK tended to grow rather more slowly than total GDP.

Chairman: Thank you very much. I am never quite sure whether I should be pleased or worried when, whenever the figures improve people say "This is the best result since 1973"! At all events we are very grateful to you for a most interesting session preparatory to our meeting the Governor tomorrow at 4.15 and the Chancellor on Monday at 2.15. We are very grateful to you for filling in some of the gaps before we meet them. Thank you for coming.

THURSDAY 26 MARCH 1987

Members present:

Mr Terence L Higgins, in the Chair

Mr Brian Sedgemore
Mr John Townend
Mr Richard Wainwright
Mr John Watts

Examination of Witnesses

THE RT HON R LEIGH-PEMBERTON, Governor, Bank of England; MR E A J GEORGE, Director Responsible for Home Finance, Bank of England; and MR J S FLEMMING, Economic Advisor to the Governor, Bank of England, called in and examined.

Chairman

117. Mr Governor of the Bank of England, we are most grateful to you and to Mr Flemming and Mr George for attending the Committee this afternoon as part of our usual annual festivity following the Budget, in which you have always been extremely helpful in giving us evidence on which to base our report. The report will, as you know, have to be produced at very short notice this year because of the way in which the recess comes soon after our evidence-taking sessions, but we nonetheless hope to produce it ahead of the second reading of the Finance Bill, which we presume will take place soon after the Easter recess. You have from time to time been kind enough to offer some remarks at the beginning of our proceedings, and then there are various points which we would like to pursue with you by way of questions. You are indeed most welcome, as are Mr Flemming and Mr George. Thank you very much indeed for coming.

(Mr Leigh-Pemberton) Thank you, Mr Chairman. I know you do not like prolonged opening statements, but if I assure you it is very brief, may I say a few words by way of introduction to at least establish our stance in this matter, and then I can await your questions thereafter.

It seemed to us that the circumstances in which the Budget was brought were exceptionally favourable: sustained growth of the economy had increased tax revenues to an extent which gave the Chancellor an unusually wide choice between tax cuts and reduction of the Public Sector Borrowing Requirement, and his decision to reduce the PSBR by £3 billion below the illustrative level of last year's statement was very much in accordance with the Bank's thinking. The economic assessment of our February Quarterly Bulletin noted that a low PSBR, by easing the burden of restraint falling to monetary policy, could help towards the strengthening of the economy's supply potential.

Since then we have reacted cautiously to the pressures for lower interest rates that have been seen in the markets both before and after the Budget. Two important indicators, MO and the exchange rate, no longer suggested, as they have done until recently, that monetary conditions were at risk of becoming too easy. Among other indicators, the rate of growth of £M3 and of bank credit continue to argue a need for monetary restraint, and perhaps I could stress now that the abandoning of a formal target for £M3 does not imply that the growth of broad money can or should be ignored. It reflects simply the uncertainties of the relationship with money GDP, which I described in a lecture at Loughborough last October.

Decisions on interest rate management have accordingly required a balancing of different factors. One is the need to maintain the degree of domestic restraint necessary at a time of continuing demand growth in the economy and increasing buoyancy of expectations. Another is the desirability of avoiding sharp upward movements in the exchange rate, such as could disturb the confidence of industry in assessing their output capacity for the future. Recent market conditions have created opportunities to strike a balance between these factors by engaging more actively than has been customary in operations in the foreign exchange market, and the exchange reserve losses of last Autumn have by those means been more than recovered. That is perhaps all I would like to say by way of opening, Mr Chairman. I hope that was commendably brief, but it sets the scene.

118. Thank you very much indeed. I think it does indeed set the scene. I noticed another memorable phrase. We were always impressed by your use of the expression "overhanging glacier of liquidity", which has been constantly in our minds, and perhaps I might say a word about that in a moment. We noticed a new one this afternoon: "buoyancy of expectations". I am not sure if that is as specific as the other one.

(Mr Leigh-Pemberton) Yes.

119. Could we turn to the overhanging glacier of liquidity to start with? We were surprised yesterday to find that the views of the Treasury on the response which a change in interest rates might generate as far as consumer credit was concerned were remarkably opaque. We found this curious, since it did not seem to us to be a matter of policy which would be for ministers, but rather a view as to what the elasticities might be with regard to interest rates and credit creation. Might I ask you first of all if you think that the effect of interest rates on domestic credit and the extent to which those holding real balances use them for consumption has changed significantly over the last two or three years?

(Mr Leigh-Pemberton) No, I do not think it has changed since I talked about the glacier a year ago. Clearly, the level of interest rates is the instrument, or the means, by which the attractiveness of liquidity stands or falls and therefore the extent to which it

[Chairman *Contd*]

is held. I do not think we feel unduly anxious within the Bank of England that a move in interest rates of itself is dangerous in terms of the increase of the availability of credit. It has to be seen in the context of the overall situation. It is perfectly true that credit in this country is growing at quite a fast rate, and no movement of interest rates should ever be undertaken without due consideration of that level, but I am not quite sure, Mr Chairman, what you mean by the response of the Treasury yesterday being rather opaque. I think I would wish to argue that a fall in the interest rates must be carefully considered in the overall context but in terms of levels of personal credit, I am not absolutely sure that one interest rate or another has a great effect on the amount which ordinary people feel inspired to borrow or not for their personal purposes. Is that the point?

120. You think they are not very responsive to a change in interest rates?

(Mr Leigh-Pemberton) I did not think that ordinary private borrowing by persons is all that responsive, no.

121. Has the Bank done any recent study on this?

(Mr Leigh-Pemberton) I do not think we have done any very recent studies on how ordinary individuals respond to this, no. My own feeling is that individuals tend to respond in terms—and I am talking about individuals, persons, now—of "Can I afford the repayments on this particular form of credit? I wish to buy a car; what are the monthly repayment terms?"—and if they feel they can pay those terms, they will probably buy the car. Clearly there comes a moment when the repayment terms are that much more expensive as a result of the level of interest rates, and they change their minds, but ordinary individual borrowing is only somewhat responsive to the level of interest rates, I feel.

122. Related to that, we have had a substantial reduction in the rate of inflation, and presumably that produces a real balance effect as far as the individual is concerned. To that extent he is likely to perhaps spend more in terms of market demand. Does that worry you at all?

(Mr Leigh-Pemberton) Well, yes, I think it is worrying. The level of private credit is clearly important. We see bank lending increasing every month by, let us say, on average £2.5 billion. We do our best to distinguish within that figure how much of this is in the personal sector and how much of it is in the corporate sector. Within the personal sector clearly housing represents rather a high proportion, but nevertheless, the sort of personal borrowing we are talking about comes into this. I do not think ordinary people think very quickly in terms of what is the real interest rate. I think they still think in terms of what it is actually costing them in nominal terms. It may well be that the real interest rate element has in fact risen, but as a discipline on personal consumption, I fear that it is not a very sharp instrument.

Mr Wainwright

123. I would like to pursue the very point on which you have already given part of an answer, Governor, because we all know that a great deal of very valuable anecdotal evidence from the banking sector is distilled into your direction. I wonder how far you are given the impression by retail bankers that a lot of this borrowing reflects quite high inflationary expectations, based, for instance, on the remarkable rate of inflation of house prices in some parts of the country, and whether in fact a lot of borrowers are feeling, as they have done in the past, that they had better buy today rather than pay a considerably higher price for the same durable in later years?

(Mr Leigh-Pemberton) In answering that question, may I say that I am answering rather as an act of personal subjective judgment rather than based on any statistics. I am not sure that there are any statistics available that can really direct themselves to this. I do not think now that people are so motivated as they were once upon a time by feeling that if they do not buy now they will miss the market, because in steep inflationary times prices are likely to rise. There is an element of this, I think, probably in the housing market. I think it is not entirely anxiety about missing the market, but I think it is connected to the fact that under our present system, where there is not much rented property, all young people feel that the first thing, or one of the first things, they have to do is buy a house. The result of that, of course, is that there is pressure on house prices. The relationship between house price rises and income rises, I think, has improved slightly recently overall, but equally I think our research shows—it may well be public knowledge—that the differentation between house prices in the South-east and the rest of the country has sharpened so that this pressure is greater on people in the South-east, but I think we ought, if we are talking both on the inclination to buy, whether it is houses or consumer goods, to remember that at a time of rising personal incomes people tend also to assume rising personal debt; the sense of prosperity which they have causes them to feel that here is something they have been wanting to have for a long time; their income is going up; prospects are that it will continue to go up; they can undertake a certain level of debt quite safely, and they do so, and to that extent there is a degree of increase in personal credit at a time of an increase in personal income. Insofar as one may not like that, as having some form of inflationary pressure, one cannot answer it in any way except through the interest rate instrument. If I may just say one further thing, Chairman, there is an element here that concerns us too, which is the prudential side of this. The thing has moved to a degree where we have seen fit to make observations before now to the retail banks above all—indeed, to all providers of credit—that they should think very carefully about the level of personal borrowing, and above all of certain individuals and whether they can work out really what the overall level of an individual's debt is, with plastic cards, credit cards, all the instruments at

[Mr Wainwright *Contd*]
their disposal, and I think that that is a new-ish feature and an increasing one, and one on which we like to both keep our eye and also exercise some advice, cautionary advice.

124. You have just spoken of advice to the retail bankers, and I am sure they attach great weight to your advice, and perhaps to your warnings, but what about the other sources of credit? There are a lot of anecdotes about the almost reckless way in which big stores are giving credit, with the minimum of inquiry into the credit-worthiness of the buyer, and these people have not the same means of warning them, have they, or applying any gentle pressure to them?

(Mr Leigh-Pemberton) I do not think I have any chance of exercising pressure on them except admonitory pressure through my public utterance in speeches. Incidentally I have done this not only in respect of the retail banks but I even made a public speech to the International Association of Building Societies, so that our anxiety, our concern about this, is on record. As far as big retail organisations are concerned who give credit, I think the answer to the latter is that they have probably worked out very closely that the profit that they can take on giving credit is commensurate with the profit they earn on the sale of goods and that their level of losses at the present moment is nothing like commensurate with those profits, therefore that the whole operation of granting credit through their private systems remains a source of profit to them and also of increased turnover. We have not reached the stage where I regard this as dangerous but it is an aspect of the earlier point which I made, which is that with the increasing number of means of personal credit the grantors of that credit have somehow or other got to be alert about the level of debt of an individual across all the opportunities open to him or her. At the present moment we do not actually have machinery where that can be done. If we had, I can hear some comments about intrusions on privacy and about personal rights.

125. Do you have a view about the influence of this growing weight of personal debt on wage settlements? There are a lot of warnings about the level of pay settlements still in this country, in spite of some rumours that the level may be coming down a little. Now that such a very high proportion of the average pay packet is mortgaged in personal debt, is there not a danger that higher pay rises are becoming institutionalised, that there is really an irresistable dynamic in them now because of the heavy extent to which the pay packet is already pre-empted?

(Mr Leigh-Pemberton) I must admit I have not heard of that being an element in pay negotiation. I made the point, I think, earlier, that the prospects for receipt of higher net income tend to encourage people to incur greater personal debt but I have not heard that the level of personal debt already incurred is an element in wage bargaining.

126. Could I turn to the statistical side of this? In so far as all this scenario we have been discussing is eventually reflected in the indicators of broad money, this Committee finds great difficulty in understanding what happens when the target is discarded, as with £M3, but nevertheless all the authorities still pay respectful attention to this particular indicator. We find it impossible so far to understand just what sort of attention they pay and what are the danger marks on the dial which would cause some reaction.

(Mr Leigh-Pemberton) I hope I can be helpful on this, more helpful than simply referring you to the lecture I delivered at Loughborough University last October. I think I could do better than that this afternoon, Mr Wainwright, by saying that £M3 ceased to be a formal target because as a formal target it did not look as though it was being useful. We have to acknowledge quite honestly throughout its history we very seldom ever hit it and once we had to suspend it. Therefore, to make it a formal target and yet never virtually treat it as such was perhaps being unrealistic, but it did not follow that because it ceased to be a formal target we would not have some range set for the year in our minds which would be an appropriate range for broad money growth in the context of the MTFS, say, for the coming year. It still remains something that we very definitely look at. I mentioned already earlier that we are concerned that we have a monthly increase of £2.5 billion in bank lending; that is very much a £M3 element, and I do assure you that in studying the monetary situation properly that is one of the things we look at as much as anything else. If we do not target it formally, it is related to this problem that within the aggregate one has a perverse force at work—this is where the "glacier" comes in. If people are confident about the value of financial assets, about the return that a real interest rate conveys to the depositor, well, this aggregate can actually grow in circumstances that are in fact healthy. It is a reflection of savings. So that to that extent it requires a degree of interpretation which makes it unsuitable to be a formal target, but nevertheless it is a very important indicator in our opinion—one of the very important indicators, and I emphasise *very important*—still of the overall monetary situation.

127. May I put the question this way? When you are applying, as seems to be the case at the moment, a prudent step by step approach to bringing interest rates down a little bit at a time, do you, to put it fairly crudely, bring down interest rates by half a point and then start looking to see if there has been any response in £M3 before you are inclined to proceed or advise the next step of reduction?

(Mr Leigh-Pemberton) May I thank you for the phrase, first of all, about a step by step approach to the reduction of interest rates. Then I must go on to say to you I do not think I can answer your question in the affirmative. No, I do not think in looking for the next step we necessarily say to ourselves can we see a response from £M3 as a result of that move, because in general you probably cannot. Actually a fall in interest rates might mean that bank deposits are less attractive; they would

[Mr Wainwright *Contd*]
fall as a result of that and your £M3 would fall. That would, in one sense, be very acceptable but it would not actually be quite the context in which I think you are talking about our reaction to the movements in £M3. No, I think quite honestly broad money is very much at the back of our minds and underlying the overall interpretation of the monetary situation at any given moment. Its movements throughout the year would be very encouraging if we saw a general downward trend, but I think we tend to look at the overall volume of it. If it continues to grow in this sort of way, we have to tell ourselves there is potentially a growth in the monetary situation there which you ignore at your peril.

128. Do you in fact draw that conclusion or are you inclined to say, no, this is simply one of the results of the rapid pace of change in monetary instruments and the whole financial set-up and so on?

(Mr Leigh-Pemberton) If we saw £M3 growth coming down consistently over a period of time, say over a month or two, I think we would draw encouragement from that—all other things being equal, the monetary situation was improving—and it would suggest that we could probably allow policy stance to relax somewhat. But from month to month, or week to week, as we get in the figures—we only get them monthly in this respect—it is very hard to have an immediate response. I think two or three months' trend would definitely be an important indicator for us in respect of broad money.

129. My last question is, do you see any possibility of official action through government differentiating between the sort of retail borrowing against which you were warned and admonishing retail bank managers and personal spending and, on the other hand, the new business with what appeals to a bank manager as a good prospect but which is inhibited in setting up or in developing quickly enough because of high interest rates? Do you put any faith in any means of government subsidising the cost of borrowing money for relatively small businesses which have not had the opportunity of building up resources of their own?

(Mr Leigh-Pemberton) I wish we could. I do not think it is possible to operate a differential interest rate system through the banks. The categorisation of the borrower is very difficult. It has been thought about in the past. It clearly opens up all sorts of opportunities for abuse. I think the only way, if one wanted to do this as an act of government policy, would be that there would have to be a totally separate fund of some nature which, say, the Government operated in its own right towards commendable or accredited small businesses who came within the category. May I just illustrate the difficulty by saying it is not easy to pick up, out of the millions of bank accounts that there are at the moment, to what extent an individual account under a personal name is a personal business or is an individual's borrowing to buy a new boat.

130. I was assuming corporate status, even though they were small.

(Mr Leigh-Pemberton) That might be all right, but there are a lot of unincorporated businesses. If you said "This is only going to be for incorporated businesses", there would be an outcry from the unincorporated businesses.

Chairman

131. And a lot of new corporate businesses!

(Mr Leigh-Pemberton) Yes indeed.

Mr Townend

132. Can I continue on the subject of interest rates? Many of us welcome the Budget because we think the Chancellor has been cautious. We thought that by reducing significantly the PSBR he would be able to reduce interest rates which would create incentive to industry and would be a big help to agriculture which, as you know, has some problems. I think there has been some disappointment, having regard to the strength of the markets and the strength of sterling, that since the Budget interest rates have only come down by $\frac{1}{2}$ per cent. I listened very carefully to what you said today and I listened to officials yesterday, and I still do not really know why the Bank has been so reluctant to sanction any further or higher reduction in interest rates following the Budget.

(Mr Leigh-Pemberton) May I just go back to what I described as the underlying situation where we have on the whole continuous growth in broad money above such ranges as we set ourselves in the past year—is it 19 per cent—as against a range of 11–15 per cent. Within that there is this big component of increased bank lending. We have considerable buoyancy in the economy, we have a rise in house prices, we have a certain number of underlying features which any central bank would wish to regard as flashing a red light. On the other side, it is perfectly true we have certain features which are much more encouraging; MO behaving better, just at the moment, a strong exchange rate. Quite honestly, it has been an act of judgment to decide what falls in interest rates have been appropriate in this context. I do not mind saying to you we took the view that it would be better that there should not have been a fall in interest rates actually before the Budget. We felt it would be much better for the markets to see what the new fiscal situation was. We were incidentally a little anxious about the trade figures coming out just before the Budget which included this adjustment for the figures for invisibles and, therefore, that of all figures might not have been very well accepted, and we feel above all it is necessary not to make haste too fast in this respect. It is much better, in other words, that interest rates falls should take place gradually in steps—the very words Mr Wainwright used—in a way that is sustained. If we were to be too precipitate about this we could so easily bring about the most unfortunate sequence of events which would defeat the achievements up to now. Too large a fall in interest rates could result in profit-taking in the foreign exchange market, and a fall in the pound which would result in profit-taking in the gilt-edged market. It could result in profit-taking operating through the money

[Mr Townend *Contd*]
markets and it would actually create the opposite sentiment to that which we have at the moment, which is one of overall confidence. We have taken the best act of judgment we can over this. May I say to you that I understand the pleas for lower interest rates and I think they are fully justified in the sense that people want lower interest rates. They help industry; they assist in the progress of the economy. But we must have always at the back of our minds an anxiety about our present inflation rate and the risk that the continuous slant of policy would be interrupted or broken by too precipitate a fall in interest rates. I would much rather see this thing coming gradually over a well-timed period rather that too soon. It has been our judgment that those two falls of half a point, one admittedly before the Budget and one after, have been appropriate up to now.

133. Do you feel there is a danger of the rate of inflation going up? Is that why you are reluctant to reduce interest rates further now with a reduction in the value of the pound, even though the pound is now some 5 or 6 points higher in the trade weighted index than it was in the autumn, when the Chancellor told us he thought it was about the broadly correct level? Does this indicate that there is a little worry that the inflation rate might go up?

(Mr Leigh-Pemberton) No. I think we have to be realistic about the inflation rate. Our forecast is that—let us call it 4 per cent at the moment on the RPI measurement, 3.9 or whatever it is—it is likely possibly to rise by about half a point in the middle of the year and we hope it will go down again. I say we hope; we anticipate it will go down to about 4 at the end of the year. This is measuring it through the RPI. If you care to try to measure it through other means, such as the GDP deflator, you will probably find we have an underlying inflation rate of somewhere around 4 per cent. If you look across the league table now of developed industrialised countries, you will find that is one of the highest inflation rates at the moment, so we do still have in this country—I will not say a problem with inflation but at least the presence of inflation or a potential problem with it. It is for that reason that I must insist that we are entitled to remain very careful and very cautious about the whole of our monetary policy. The basis of that policy for eight years has been consistent downward pressure on inflation and surely experience in the past has shown every now and again maybe that we have moved a little too fast, the reaction has been much more painful and it has taken a long time to restore the original position.

134. Presumably you have now, because of the latest agreements with our other industrial partners, if not an exchange rate target a level which one considers satisfactory? Do we take it there has been a slight change of view over the last four or five months and you are looking for a rather higher level for sterling than you were in the autumn?

(Mr Leigh-Pemberton) I think the level of sterling we are looking at at any given moment is much affected, quite honestly, by the oil price. We have a picture in our minds of what is the appropriate level of sterling in terms of whether it is inflationary or not in relation to the oil price and if we look back over the eighteen months or more since the major fall in the oil price and relate the oil price to sterling now, we see we are probably a little bit weaker than we were last August. The $18 barrel, for instance, suggest we ought to have an effective exchange rate of something like 74 if the exchange rate that prevailed last August is the right starting-point. It is not quite that. It is slightly less at 72 or wherever it is. So I do not think it is possible to argue that the exchange rate at the moment is too strong. The next thing you say is that you have been a party to this major understanding between the Group of six countries a month ago now, whatever it is. It has been described as Plaza II. I think the official name, at least in the terms of the French, is the Louvre Accord, but at any rate let me call it the Louvre Accord. This is a very firm understanding that the exchange rate parities that applied at the time within the six countries present there were considered to be satisfactory. When you go into that agreement, I do not think it is letting out secrets to say the Chancellor and I had some anxiety if we succeeded at that meeting in establishing some sort of level for the parities of the main currencies, especially the dollar. Indeed, we thought the markets might then feel that they should look around to see what other currency they should test and the pound might well come under pressure. The interesting thing is that we were wrong over that. It did not come under pressure in that sense. It actually strengthened very agreeably, thanks possibly to the view that the markets may have taken, as the phrase is now, of the new standing of "UK Limited", so we have an exchange rate that is, in the present context, very satisfactory. But the exchange rate is a very fickle thing and surely, looking back over at least my own experience as Governor of the Bank of England, it can play some very unpleasant tricks on you and you have to be extremely careful about taking steps that cause it to weaken.

Chairman

135. Governor, I wonder if I could just ask you to clear up three outstanding points from the discussion so far. You were speaking just now of the Bank's forecasts for inflation. Do they assume a fall in mortgage rates following the Budget?

(Mr Flemming) Yes, that is right, they take them into account.

136. The second point is that in the Chancellor's Budget Speech at column 817 he says: "The essential instrument of monetary policy must remain short-term interest rates. These will continue to be set in the light of monetary conditions," but the earlier discussions seem to suggest that the monetary conditions were not really very sensitive to interest rates. Is the right?

(Mr Leigh-Pemberton) No, I would not wish to be taken perhaps as saying that the monetary conditions are not sensitive to interest rates. I think I

[Chairman *Contd*]
was arguing above all that the personal borrower is not very sensitive to interest rates in terms of his or her predilections, but I would not want to be taken as saying that interest rates have ceased in some way to be an effective instrument, no. They are our main instrument and remain so but the effect of interest rate movements on the overall markets is still significant.

137. But not at the consumer end, so to speak?
(Mr Leigh-Pemberton) I think in terms of the personal consumer that much sharper movements are necessary before they are felt.

138. If that is so, this brings me to my third point. Do you feel that, since that side of things is not unimportant, there would be a case for some other instruments, for example making more stringent repayment conditions on credit cards or some other control of that sort?
(Mr Leigh-Pemberton) I would not be at all averse to those if they can be effected. They are a form of direct control or physical control against which in some respects we set our face at the moment, but if they could be effected I think it would be a not inappropriate instrument. But they must surely, Mr Chairman, fall foul of the same problem as I tried to enunciate about a differential interest rate to Mr Wainwright, and it is defining the categories, making them and policing them.

Chairman: Thank you very much. We would like to widen it to a more international aspect.

Mr Watts

139. Governor, perhaps I can start by exploring a little further the relationship between the oil price and the exchange rate to which you have referred. Is the aim to achieve a stability in the sterling value of oil? Is that how the relationship is considered important?
(Mr Leigh-Pemberton) No, the relationship which we work to is this. We start towards the end of 1985 when the oil price fell so much. Sterling actually held up remarkably well for nearly a year and then we suffered quite a sharp fall down to, say, 69 on the effective rate. To what extent can the authorities acquiesce in such a fall in the exchange rate? After all, a weaker exchange rate has inflationary effects. The Chancellor said then—and we would fully support that view—that the fall in the exchange rate was acceptable in the context of the fall in the oil price because a fall in the price of oil has tremendously helpful effects on inflationary pressure. The prices of many goods come down, the costs of manufactured goods, the price of heating and lighting their houses for ordinary individuals and so on, so that a fall in the exchange rate is perfectly acceptable in the context of that fall in inflationary pressure flowing from weaker oil prices. We have tried to have an equation since then about what, given the satisfactory sterling parity at that time and such-and-such a price of oil, is a reasonable sterling parity in terms of neutral inflationary consequences against such-and-such an oil price. Earlier this year when the oil price strengthened we very much hoped that the pound would strengthen relatively and equally, if the oil price falls it is acceptable that the sterling price should fall, too, so that is the relationship really—neutrality in inflationary effects of the movements in the exchange rate created by the offsetting effect of lower oil prices and, therefore, lower costs.

140. But that does come back to the sterling cost of oil, does it not, in the way in which the price of oil affects it?
(Mr Leigh-Pemberton) Yes, I think that is fair.

Chairman

141. Does it not make the export industries the plaything of the oil prices?
(Mr Leigh-Pemberton) It certainly has an effect on competiveness, yes, this is true.
(Mr George) Could I add to that that I think one has to recognise this is one of the indicators we look at alongside a lot of other indicators. It is no more significant than anything else. There obviously is a worry about taking account of the oil adjusted exchange rate in this way, and we do not for the moment attempt to do that in a very short-run sense. What we are really looking at is a very major adjustment in the oil price during the course of last year which was structural and was likely to persist. In that sense the exchange rate had to decline, oitherwise you were going to have an extremely distorted ecomomy as between the domestic and the external sectors. We were going to run into a very severe balance of payments problem on that basis. So you had to have that adjustment. You could have that adjustment without the normal inflationary implications of a fall in the exchange rate because of the offsetting impact of the oil price. But I would not like you to think we look every day and decide the oil price has gone up by 15 cents and, therefore, the exchange rate should go up. One is talking about the thing in terms of trying to take account of structural changes in oil price or changes that are likely to persist for some time. Of course, the future of the oil price is extremely difficult to predict but we knew last year that we had a big fall from 30 to less than 10 at one point. We think this year that we have had something which means that it is not going to be in single numbers but is going to be in the $15–20 range. In that broad way, one does take account of everything, and I think it is actually necessary that one should do that, otherwise in a sustainable sense the competitiveness of industry will in some sense be also distorted for quite long periods of time.

Mr Watts

142. I think it is a very interesting area. I wonder how strong the influence of the oil price is on the underlying rate of inflation. I am surprised that you took the view that it is such a strong influence.
(Mr Leigh-Pemberton) Well, we do take the view it is a strong influence. I am not sure that I can put any figures on this. I am not sure whether Mr

[Mr Watts *Contd*]

Flemming can help about the component it represents in any calculation of inflation.

(Mr Fleming) I cannot quantify it, I am afraid, but obviously there is a significant part of consumers' expenditure which is related directly to heating oil and motor vehicle oil and indirectly through the amount of oil input into a lot of manufactured products. Coming back to your earlier question, I should perhaps take this opportunity to say that while it is true that for the purposes of the calculations Mr George is describing one has to look at the sterling price of oil, it certainly is not true that the upshot is an attempt to stabilise the sterling price of oil as such. What we are talking about is trying to allow the improvement in competitiveness which is sustained, with there being no deterioration in inflation prospects. In that process there is a fall in the sterling price of oil which off-sets the wider profit margins which are a counterpart of the improvement of competitiveness for other sectors of the economy.

143. If I could broaden the discussion a little, Mr Townend referred to the G6 agreement and the intention to achieve greater stability. What action will the Bank be taking in concert with other central banks in order to maintain the stability?

(Mr Leigh-Pemberton) The understanding which emerged from the Louvre Accord was that the exchange rate parities that prevailed at that time were considered satisfactory, and that if there were divergences in that, the central banks of the countries present would concert any action to correct the divergences. In other words, we were going to have concerted intervention, and the interesting thing is that very largely that has not been necessary. I think the markets have assumed from that announcement that perhaps we have caught the situation about right. The parity is about right, and there was very little point in them seeking to test those levels. There was a modest attempt to test the dollar on the down side two or three days ago, which resulted in some intervention both in Tokyo and New York, and within reason that was effective, but this is the understanding. If I might just say this, Mr Chairman, the experience of both the Louvre Accord and the Plaza too eighteen months before that, in September 1985, shows that there is actually a very effective role for the central banks where we can be really sure that the central banks, the five or six or seven, are operating together, and operating in circumstances in which the overall market situation is receptive to that concerted intervention. I think our effectiveness actually is greater than many of us anticipated in the pre-Plaza days.

Mr Wainwright

144. Just to follow up what you have just said, Governor, which was very informative, can we take it that the Louvre Accord and the spirit of it is also an agreement to take account of the price of oil in the various currencies that are affected?

(Mr Leigh-Pemberton) I do not think that this was specifically talked about there, but I would feel confident enough to take upon myself this sort of interpretation of the view there, which is that if there was some major structural change in the world economic situation which affected one of the partners there specifically, it would be understood that they would either be released to a degree from their commitment or there would be a different reaction from them. The movement of the oil price would be, I suppose, the most typical of all of the sorts of things that would come under that heading.

145. Do you think it would have been helpful if explicit target ranges for the currencies had been set at the G6 meeting and published?

(Mr Leigh-Pemberton) I do not think so, no. I think we are more effective in our concerted intervention if we can leave the markets guessing about when we will come in and come out, and if I may say this about the councils of those sort of meetings, quite honestly, very little is said between us central bankers, actually, about figures, numbers and money. We have an understanding.

146. So you think rather than having published objectives to try to influence expectations, it is rather more effective for the markets to be uncertain and to fear getting their fingers burned if they put a particular currency under pressure?

(Mr Leigh-Pemberton) Yes.

147. Some commentators have argued recently that the strength of the economy and the high level of interest rates and the appreciation of sterling makes London very attractive to foreign capital, and that we might anticipate some substantial influx. Would you agree with that prognosis?

(Mr Leigh-Pemberton) I think it is certainly true that we have been able to sense in the last month or more, perhaps since the Louvre Accord, an assessment of UK Limited by international investors that is much more positive than we have had for some time, and I think there has been an in-flow of investment. Quite honestly, we are not able to measure this or indentify it very specifically. One sees comments to the effect that a large amount of, say, Japanese investment money is coming into the country. I think it is true that some is, but I do not think that we really know what the volumes are or necessarily what the sources are, but I think it is a fair conclusion that there is a certain amount. Yes, I regard this as healthy.

148. So if there was such a substantial in-flow, what consequences do you think that would have both for the exchange rate and interest rates?

(Mr Leigh-Pemberton) I think there would come a moment presumably, if the in-flow became too great, and we saw sterling prices of the gilt-edged market rising in a way that we would regard as unjustified, or frothy, or whatever phrase you care to use, there could be an appropriate policy reaction to that, and I think one could take it in reasonable confidence perhaps that we had become over-attractive, but it is a very difficult thing to judge, because if you reverse one market trend, it is pretty hard to know just how fast it goes and how far.

[Mr Wainwright *Contd*]

149. But if the reaction was on interest rates, is there not a danger that that would bring about too much laxity in the domestic credit market?

(Mr Leigh-Pemberton) Well, it could. It might. This is an illustration, I think, of what is the permanent—I will not say "dilemma" of the authorities, but the permanent requirement in front of us to make acts of judgment just on those sort of points. If I might say *in vacuo* a fall in interest rates is acceptable where the other components of the monetary situation are strong enough and healthy enough. It would imply a strong exchange rate, vigorous markets in the City, helpful indicators from M0, even from £M3 too, but you understand as well as I do, I think, what the components are in this situation.

150. If, as you were suggesting earlier, credit for the private person is not particularly responsive to changes in interest rates, unless they are more substantial, is there not a case for giving rather greater emphasis to the benefits to the corporate sector of having a reduced burden of debt service, and perhaps stimulating rather more capital investment? Is that not a—I hesitate to use the word in talking to a banker—risk that might be worth taking?

(Mr Leigh-Pemberton) I think this turns on the extent to which investment is considered to be inhibited at the moment by the level of interest rates. Actually the level of investment at the present moment in the country seems to be encouraging. Recent CBI surveys clearly are pointing in the right direction. I rather think last year companies invested something like £30 billion in the course of the year and £7 billion were raised in new equity issues in the City. The level of investment remains perfectly healthy I think, but I would agree with you that a fall in interest rates would either be more encouraging to investment or, of course, would reduce costs—which is an important part in this—but I am sorry to say I am not confident that we can effectively distinguish in some way between personal credit for consumption and credit borrowing by corporations for investment.

151. I was really developing from your own feeling, which is much the same as mine, that as demand for credit from the personal consumer, the private individual, is not very responsive to changes in interest rates, in a sense we should perhaps accept that there is not much we can do about their demands for credit unless we are prepared to move to some sort of volume control and therefore we should concentrate rather more on the impact of the interest rates in the corporate sector. Although you have said investment in the last year was fairly buoyant, it was very much flatter than the Chancellor predicted in this Budget last year. I think this year's Budget Report says there was only ½ per cent growth in capital formation as against 4 per cent predicted. We are now back on a 4 per cent forecast for 1987. Although there has been a lot more buoyant talk recently and evidence in the CBI surveys, whether we will see that coming in through 1987 when we did not see it in 1986 I think is still slightly doubtful.

(Mr Leigh-Pemberton) May I just go back to the matter of personal credit and its lack of response to interest rates? I think I ought to emphasise that in this I am really speaking only of personal credit for personal consumption. I think personal credit in terms of housing buying, house mortgage rates, is more sensitive to it. Of course, the capital and exchange markets are infinitely more sensitive to interest rates movements in terms of buying and selling investments, so that the lack of sensitivity to which I referred earlier is confined to a fairly small amount of the overall total credit. It is the personal consumption of the personal sector.

152. But as far as house purchase is concerned, is it so much a response to the interest rate or is it rather more just the ability to fund the debt, which in my view is probably the constraint on all personal borrowing? It is a question of whether you can meet the monthly payments, whether it is on your credit card, hire purchase on a car, or buying a house. I am not sure that in house purchase it is really the interest rate that people look at. They do not say "I'm not prepared to borrow at 14 per cent to buy a house"; they say "I cannot afford to pay the mortgage that is 14 per cent."

(Mr Leigh-Pemberton) They are sensitive to this in that it is so much larger an element of their personal disposable income in any given month. That is what affects the private individual now.

Mr Sedgemore

153. Governor, some of us believe it is precisely because the Chancellor is giving away a lot of money in his Budget, doing a lot to help people in the City of London, that there is all the more need for financial probity in the City, and some of us have some doubts about the political will of the Bank of England to act, particularly when you do not appear to be doing anything about disclosures made in the Budget Debate that the Chairman of the Take-over Panel apparently tried to stop an investigation into fraud and subsequently has spoken negligently and dishonestly in his own defence. My questions to you are these. First of all, would you support in the Finance Bill measures designed to help minority shareholders stamp out fraud in their own companies? Secondly, would you as Governor of the Bank of England be prepared to look into the position of Sir Jasper Hollom, the Chairman of the Take-over Panel, to see whether he is the right person to be there?

(Mr Leigh-Pemberton) As far as minority shareholders are concerned, I think if a case for amendment of the Companies Act was really made out we would be ready to support this. I do not wish to dodge the responsibility here but the Companies Act is the responsibility of the DTI and I am not really able to say much more to you than that. I am not convinced actually that the state of the law at the present moment is such that minority shareholders are under-protected. On the position of Sir Jasper Hollom, I do not really want to say anything

[Mr Sedgemore *Contd*]
about this particular case. I have not studied it in any great detail myself. I have read the reports, I have read Sir Jasper's response to this, and I must tell you that in the absence of much more convincing evidence I accept Sir Jasper's explanation.

154. Sir Jasper said that he did not feel he had to report to either the Fraud Squad or the DTI allegations that there had been a breach of section 42 of the Companies Act 1981 because counsel advised him there had been no breach. I have here the actual unpublished transcript in the court case of Mr Justice Knox where he actually declares quite firmly that he finds a *prima facie* breach of section 42 of the Act. Sir Jasper has equal acces to this—probably more access to this than I do, so how can you accept it? That is what worries me. You come here as the top person—I am not, I am only a Member of Parliament—and you accept what he says, but we have this evidence. How can you do that? That is not the way to look into these ———

Chairman: I have great trouble in relating this to the Budget.

Mr Sedgemore: Since the Governor seems prepared to answer the question very generally, I am asking him to explain why he is prepared to accept Sir Jasper's explanation when it flies in the face of what a judge has said.

Chairman: Our task is to investigate the surroundings of the Budget. I have some difficulty in seeing the relevance of this point.

Mr Sedgemore: The Governor—without being unkind to the Governor because he is a guest here—tried to let Sir Jasper off the hook; I am trying to put him back on the hook, where he belongs.

Chairman: That may be so, I do not see its relevance to our inquiry into the Budget—I really do not.

Mr Sedgemore: I will not pursue the question. Perhaps I could ask you to have a look at the papers which I am sending to Mr Paul Channon, Secretary of State for the Department of Trade. Then I think, being a fair man, you will weigh the evidence, as I do as a barrister, and come down on my side because I am right, you are wrong.

Chairman: One must not think it necessarily follows that barristers always prove to be right. That report is really a matter for the Trade and Industry Committee, not this Committee.

Mr Sedgemore: Could I ask a few questions about competitiveness which is———

Chairman: What this is all about.

Mr Sedgemore: To be fair, I did warn Mr Higgins I was going to ask the questions.

Chairman

155. I said so long as it relates to the Budget.

(Mr Leigh-Pemberton) I am in your hands over than, Mr Chairman.

Mr Sedgemore

156. Can you really be satisfied about the position on competitiveness when the Chancellor himself is forecasting a balance of payments deficit of £2.5 billion for this year? I believe there is a margin of error of anything up to £2.5 billion on that, so the deficit could be between nought and £5 billion. On manufacturing trade the forecast deficit is a rise from 5.5 billion in 1986 to 8 billion in 1987. Does that not give you cause for concern?

(Mr Leigh-Pemberton) It does give some cause for concern in the sense that it is disappointing that we have had this change, but may I try to put this in a degree of perspective. The deficit that is forecast to the current account for the coming year of £2.5 billion represents one half per cent of the GDP. That is not an unrespectable figure, quite honestly, and it is not one that causes us anxiety in terms in financing it or anything of that nature. Your question started, I think, on the issue of competitiveness. You made one comment about manufacturing capacity. May I say something about that. I know it is rather easy to feel some concern about the performance of the manufacturing element in our economy. I take the view that this country should earn it living where it can and if we are as successful as we are in invisibles and service industries, let us be grateful for that and the fact that we have oil. It follows, too, that we must do our best to improve our overall manufacturing performance and I think we are doing this, but it is but one element in the overall economic performance of the country and I believe on the whole that it is improving. This leads to industry's competitiveness and I think perhaps you are suggesting to me we ought to take steps to protect industry's competitiveness by adjustments in the exchange rate—devaluing in order to make industry more competitive. In a sense you do that by devaluing your currency but I think you buy a rather short-term advantage, if experience in the past is anything to go by, and you run the risk of re-opening inflationary pressures. Consequently, there is a balance to be struck between competitiveness and inflation and this leads us back to all we have said earlier about this balance between the fall in the exchange rate and fall in the oil price and the equanimity or not one has in the way those two are related in terms of the level of the exchange rate and its inflationary effect.

157. We all understand there are service industries and there is no point in denigrating them; in fact, it is rather foolish to denigrate them, but presumably almost 100 per cent of manufacturing industry is tradeable. One hundred per cent of service industries is not tradeable and neither you nor the Chancellor appear to take that into account. Is there not some long-term difficulty about this? This is not something that happened last year, that suddenly manufacturing trade has started to go wrong.

[Mr Sedgemore *Contd*]
It appears to be something more long-term. Should you not be more concerned about manufacturing industry because the decline in the growth of the trade deficit is not a new phenomenon and it may be a long-term phenomenon?

(Mr Leigh-Pemberton) I take the point about the tradeability, although a fair proportion of our service industries are very tradeable, as you will realise from the contribution that invisibles make to our balances at the moment. But if you are saying to me in so many words the financial authorities ought to be playing their part in improving the competitiveness and the growth in manufacturing industry by a devaluation, I have to say I regard that as a shortsighted and misguided response to the situation. I think I said earlier that past experience shows this tends not to work and the correct response surely must be an improvement in competitiveness in those other respects which are under our control—in productivity, in prudent investments, in the control of costs—all those elements which will restore British manufacturing industry increasingly as that side of things improves. I do not think that this improvement can, in fact, take place overnight. It is a change that has to take place gradually. It is beginning, in my belief. I think the figures and the indicators show this is taking place and I take some comfort from the quality of some of the imports coming into the country at the moment. There is disappointment that the balance on manufactured goods is now adverse for the first time in our history. I think some of those imports are intermediate goods, capital goods, and they are in the imports of raw materials, all of which suggests that they are on their way to being converted, and will improve the industrial, and finally the manufacturing balance when the process is complete. So I think the answer to this is that the competitiveness, in so far as the exchange rate has any contribution to make, has been achieved because we have had a fall in the exchange rate, which I have been at some pains to point out is not in itself inflationary in the circumstances. But it has been a fall which has improved the competitiveness of our industry as against, say, German industry and, to a lesser extent but even so, the United States.

158. When would you expect the improved competitiveness to have an impact on the balance of payments?

(Mr Leigh-Pemberton) It is anticipated that it will somewhat this year and I trust this will continue through the next year. I do not think I can point to a time or a moment when there is a level of volume which changes this.

159. Could I ask you one last question about the exchange rate mechanism. The Chancellor appears to be in favour of our joining the exchange rate mechanism; the Prime Minister appears to be against. You might like to give us your own personal view, though that is not my question. What slightly puzzles me is that the Chancellor says sterling is at just about the right level now and we appear to be embarking on a kind of informal policy as though we were in the exchange rate mechanism but doing it informally. If we are doing that, would it not make more sense to do it formally and then if we wanted to borrow money the whole thing would be easier rather than trying to run the exchange rate mechanism as it were informally?

(Mr Leigh-Pemberton) I would agree with you it is certainly an arguable position. Those who are members of the Exchange Rate Mechanism at the moment would readily recognise that membership carries with it the problem that it is not possible to continue at the same time a totally independent domestic monetary policy and the whole issue here is the value that one puts relatively on the ability to continue to run an independent domestic monetary policy as against the benefits of being in a recognised exchange rate bracket. You say would it not be better to be in because we are, to some extent, operating as though we are in. Actually, if we are operating as though we are in—and I would readily concede that perhaps since the Louvre Accord we are operating as though we are in something because we are cooperating within that Accord, and may I emphasise it is an accord, it is not a formal agreement—we do still at the present moment retain the right to operate an independent monetary policy. I think it is known that the Bank of England has said before that in principle probably we would favour full membership provided our entry would be consistent with the anti-inflationary objectives of the MTFS. We still have the problem of being an oil-producing country as against the other members and I do not think I can say much more to you than that those are the issues. It remains, I think, primarily—not primarily, of course, but absolutely a matter for the Government, not for the Bank of England, and I think you will have to wait and see what happens.

Chairman

160. May I pick up two domestic points before Mr Townend finally would like you to look a little into the future. The first one is our old friend over-funding, which we understood to have been abandoned as a policy, but it seems possible that there may, in fact, be more than full funding of the PSBR in 1986–87. Is this so and, if so, is it simply that you cannot arrange matters that accurately or is it simply an accident or whatever?

(Mr Leigh-Pemberton) Yes. I think the answer is, Mr Chairman, I assure you that the policy is that we should have a full fund and there should not be an over-funding, but in organising our funding policy, we are in fact shooting at a target that tends to vary in size up until within the last day, and the difficulty is that it continues to vary in size until after the last day, in the sense that the figure is not known until the year in which we are operating is over, so we have to make the best estimate we can, and I am sure that we are going to come out somewhere within the target. I am not quite sure whether I am capable of saying what the divergence might be. My colleagues look a little reluctant . . .

161. We understand the practical difficulties, give or take £10 billion or £5 billion.

[Chairman *Contd*]

(Mr Leigh-Pemberton) You may be assured of the genuine commitment to a proper, full fund, Mr Chairman.

(Mr George) We certainly cannot say at the moment what the margin of error this year might be, because we just do not know what the PSBR out-turn will be, but as a general proposition, I would say it was pretty accurate if we got within half a billion either side.

162. That seems pretty accurate. Can I just clear one other point? The original medium term financial strategy involved a steady reduction in the PSBR. We are now told, leaving on one side all the usual controversy about asset sales and so on, that the objective is to keep it constant at one per cent of GNP, which seems to us to be a change of policy. Are you clear why it has now to be kept constant rather than on a declining trend?

(Mr Leigh-Pemberton) I think the answer that I must give to that is that when you get down to one, you have not got very much further to go. The declining trend, as I interpret it, in the original strategy was clearly related to the importance of getting down government borrowing, and the consequent problems of funding it and so on, but when you got it down to 1 per cent, it seems to me a matter of art really for a government of the day to make up its own mind whether you are going to have a balanced Budget. You might even have a Budget surplus, but I do think in terms of the validity of monetary policy, if I may say so, it is neither here nor there, whether it is one or nought.

Mr Townend

163. Governor, can I ask you three quick questions about prospects internationally, you probably know this Committee has been very interested in and done quite a lot of work on the LDC debt. How do you see the LDC debt crisis developing in the wake of the partial default by Brazil?

(Mr Leigh-Pemberton) May I say that I do not like the word "crisis" in this context.

164. Problem then.

(Mr Leigh-Pemberton) I think "problem" is a better word, if I may say so. I think the problem is not getting easier. I would acknowledge that. Equally, I would not like at this stage for us to be hustled away from what has been the approach ever since 1982 of the case by case policy towards each individual country. It is very easy to say that all these countries are the same; they are either improving or deteriorating together. They are not, so one's comments must be qualified by bearing that in mind. It is true, I think, that even so, these countries are probably no nearer credit-worthiness now than they were in 1982, and I think that is worrying. What has been of great assistance in this respect in the period since then is the much-improved position in the creditor banks in terms of their capital base and their provisions, so that they are much better-placed to deal with whatever may emerge over this, or with whatever policy changes may become necessary than they were in 1982, so there is a flexibility around now which was not then.

165. The second question which I would like to have your comments on is how you see the problem of increased protectionism affecting the industrial world?

(Mr Leigh-Pemberton) I do not know that I have any special knowledge or assessment of this. I, like everybody else involved in these things, feel anxious about it. I understand in the United States that this tends to be a continuous threat, and the administration seem to me to be manfully battling against it, but it is something that overhangs all international financial discussion in a way that is worrying. I just hope that we can keep it at bay, but I suppose the situation is slightly worse than it was a few years ago, but I do not think I can really help you much more than by saying that.

166. Did you feel one of the principal causes is the reluctance of Japan to open up her markets despite pressure from the rest of the industrialised world?

(Mr Leigh-Pemberton) That has got something to do with it. The difficulty for Japan, I think, is that quite apart from the technical problems that they have about the Budget now and the proposals that they are making to try and improve consumption, Japanese people are not actually great consumers, and how one can correct that I do not know. That may seem an odd statement to make to you, but it is my own feeling that this has a lot to do with it.

167. That does not account for the difficulty that other countries have in entering the Japanese market. The Japanese, for example, enjoy consuming Scotch whisky, but they have a tax regime which discriminates very heavily against imported spirits.

(Mr Leigh-Pemberton) That is true.

168. The same applies with financial services. They discriminate very heavily against those, do they not?

(Mr Leigh-Pemberton) We are making progress in the financial services industry—admittedly slowly, but we are making some progress there, but I am not particularly expert in the whole matter of trade protection as operated by the Japanese.

169. That leads me on to my final question. One of the problems from our point of view seems to be the great reluctance of both Japan and Germany to expand their economies at this time. Now, with the American problem of deficits, America can no longer be a power-house of world trade, how do you see that problem being dealt with?

(Mr Leigh-Pemberton) That is one of the great issues that always comes up at the G5, G6, G7 meeting. It will be an issue at the interim meeting in a month's time. I think all these three great countries—United States, Germany and Japan—understand well enough what the position is. I think

[Mr Townend *Contd*]
they understand well enough what are the correct policies in the context and the Chancellor put it, I think, very well at the Louvre discussions when he said, "I do not think we need any changes in policy; what we want is implementation of the policies which we understand to be the right ones towards reducing these imbalances." The slowness in implementation is related to the domestic situation in the countries in question. In Germany it is related to the speed with which they can or cannot introduce further tax reform, and I gather that is a legal problem. I have some sympathy with my opposite number in Germany, under pressure to reduce interest rates and relax in that sort of way. Interest rates in Germany are already very low, and they for the first time almost in their history have been overshooting their money targets, so that he has got an understandable reluctance about relaxation in that field. Japan we have already talked about already, but there again it is largely a political problem I think in respect of the Budget that has just been introduced and the delay in Mr Myazawa being able to introduce some measures which I think he would like to do because of the inheritance he had from the previous government. This is not easy. It is a topic of discussion at all our meetings. People understand what is needed; pressure is expressed, goodwill is expressed as well. We have to just hope to make progress, I think.

170. You sound very pessimistic, Governor. Some of us think too much goodwill is expressed with no action, and the only thing that may make the Japanese actually act is if we and the rest of the industrialised world start retaliating against their exports here. We have very little to lose because they have such a massive surplus. Do you think that will concentrate their minds?

(Mr Leigh-Pemberton) Yes. I am not convinced about the validity of that approach. The Japanese in the City of London actually represent a source of employment, they bring business into the City which we would not have otherwise. Now, how is that going to be affected by certain forms of retaliatory moves? I think these things are very difficult. I am not convinced about the effectiveness of a much sharper policy response along the lines you have suggested.

Chairman

171. I think probably, Mr Governor, at that stage we are going a little wide again though, as you know, we are about to produce, and have indeed reported to the House, a report on the wider international aspects of the question. We now have to take evidence from the Chancellor on Monday. I should mention perhaps that we hope to see him at 2.15 on Monday, a very unusual time, because of the pressure of getting the report completed before the recess. But we are extremely grateful to you, Mr Flemming and Mr George for coming this afternoon. We have had a most interesting session. We greatly appreciate it.

(Mr Leigh-Pemberton) Thank you, Chairman, for receiving us so kindly.

MONDAY 30 MARCH 1987

Members present:

Mr T L Higgins, in the Chair

Mr Tony Banks
Mr Anthony Beaumont-Dark
Mr John Browne
Mr Nicholas Budgen
Mr Ralph Howell
Mr Austin Mitchell
Mr Brian Sedgemore
Mr Richard Wainwright
Mr John Watts

Examination of Witnesses

THE RT HON NIGEL LAWSON, a Member of the House, Chancellor of the Exchequer, examined. SIR PETER MIDDLETON, KCB, Permanent Secretary and SIR TERENCE BURNS, Chief Economic Adviser, HM Treasury, called in and examined.

Chairman

172. Mr Chancellor of the Exchequer, the Committee has seen as one of its functions in monitoring the work of the Treasury the improvement in actual documentation of our economic affairs. I believe we have over the years made some improvement in this by way of a team effort between the Treasury and this Committee. We are particularly glad to place on record the fact that three of our recommendations last year—namely, that the list of press statements on the Budget Day (which is now a major feature of the documentation) should have an index provided; secondly, that a revised Budget Supplement to the Economic Progress Report should be marketed; thirdly, that the Red Book itself should be more enthusiastically promoted—have all been accepted by the Government. We are very glad that that is so and would like to express our appreciation to the officials for the improvements which have been made. We are very glad indeed that you are able to be with us this afternoon. As you know, the timing of the parliamentary recess has put us under very considerable pressure of time because normally we have a little while between the Budget and taking evidence on it and preparing our report before the recess. The way it has worked out this year we have to do so ahead of the recess, which is earlier, and still get a report out in time for the Second Reading of the Finance Bill. We certainly hope to do that. It has, as I said, meant the time available is rather shorter than otherwise would be the case which is one of the reasons why we are meeting earlier than usual this afternoon. Nonetheless, we are very grateful to you for coming and look forward to the answers to our questions. You are indeed welcome, as indeed are Sir Peter Middleton and Sir Terence Burns, who have been helpful to the Committee on many previous occasions. Do you have any initial statement which you would care to make? Then we can proceed straight away to questions.

(Mr Lawson) Thank you very much, Mr Chairman. Let me make a statement by way of introduction which I hope will be helpful to the Committee. Before I do so, let me thank you for your kind remarks about the improvements in the documentation. It is no coincidence that we have made those improvements. We have consciously sought to follow in the ways you outlined the recommendations which this Committee has made.

The Committee is always particularly interested in what it sees as new stages in the evolution of the Medium Term Financial strategy, so it might be helpful if I focus my opening remarks on that.

First the fiscal component: as the Committee will have observed, in place of the declining path for the PSBR as a percentage of GDP, which has been the pattern in all previous versions of the MTFS from its inception in 1980, we now have a constant 1 per cent.

There is, I submit, nothing remarkable about that except that we have achieved it so soon. Clearly, the declining path cannot go on indefinitely: it has to level out at some point. It has been clear to me throughout my time as Chancellor that 1 per cent of GDP would be an appropriate destination. This was implicit, for example, in the Green Paper "The Next Ten Years: Public Expenditure and Taxation into the 1990s", which I published simultaneously with my first Budget in 1984. If you turn to paragraph 55 of that Green Paper, you will see it stated that, "In the period to 1988 89, the PSBR is assumed to follow the illustrative path set out in the MFTS. Thereafter it is assumed to fall further as a share of GDP from $1\frac{3}{4}$ per cent in 1988–89 to 1 per cent in 1993–94." The reasoning behind the 1 per cent equilibrium level implicit in the Green Paper was made rather more explicit in my Lombard Association speech last April; let me quote from that: "There is, of course, no scientific formula for determining the 'right' size of the PSBR . . . But . . . over the medium and longer term, it is clearly important that the amount of public debt, and the burden this imposes, should not rise as a proportion of GDP".

Over the medium and longer term the Government's objective is zero inflation. It follows that money GDP will by then grow at the real rate of growth of the economy, perhaps an underlying $2\frac{1}{2}$ per cent a year, to be on the safe side. Against that background a 1 per cent PSBR will ensure that public debt does not rise as a share of GDP. This is the modern equivalent of the balanced budget doctrine. By contrast, to allow the debt GDP ratio to remain constant on anything other than a zero inflation basis is simply a recipe for accelerating inflation.

It will be said, quite correctly, that we have been able to reach the 1 per cent of GDP destination

[Chairman *Contd*]

ahead of time only by virtue of privatisation proceeds of a little over 1 per cent of GDP. But that is as it should be. And over the long term privatisation proceeds will be a gradually declining share of GDP until eventually they approach zero. The aim will be to keep the PSBR at 1 per cent of GDP throughout the process.

Second, the monetary aspect: here the main evolution has been the agreement reached in Paris last month to seek a period of exchange rate stability. This is, I believe, as much in the interests of the UK—given the present constellation of exchange rates, which the earlier Plaza agreement was designed to achieve—as it is in the interests of the wider international community. When I appeared before this Committee last autumn I explained that there had been a necessary exchange rate adjustment in the face of the sharp collapse of the oil price. I also explained that the necessary adjustment was complete and that I did not wish to see the exchange rate fall any further. I stressed that I continued to wish to see an exchange rate which exercised a financial discipline and was essentially non-accommodating in the face of inflationary pressures. Also implicit in my remarks was the view that I did not wish to see a substantial rise in the exchange rate from that level, as it would clearly not make sense to reverse the exchange rate fall that had been the proper response to lower oil prices.

Since then we have had the Paris Accord. All of us who were present agreed that a period of exchange rate stability was both practicable and desirable. Following the original Plaza Agreement there had been a very large fall in the dollar; the yen and deutschmark are both up by about 60 per cent against the dollar. That adjustment had been necessary to correct the earlier dollar overshoot and to create circumstances that would lead to a correction of the growing current account imbalances. It was always recognised that it would take time—the so-called J-curve—before this correction came through, but that is no reason for seeking an overshoot in the opposite direction. It is clear that both Germany and Japan are having difficulty in adjusting rapidly to their very large exchange rate appreciations and making their economies more domestically orientated, just as it is taking time for the United States to make its own economy more export orientated.

So far as the United Kingdom is concerned, a period of exchange rate stability around the parities then prevailing had—and continues to have—obvious attractions. In the wake of the Paris Accord I therefore made explicit the view that had been implicit in my pre-Paris remarks. Policy has accordingly been conducted in this light. As I have made clear on a number of occasions however—and not least to this Committee when I last appeared before it—in practical market management terms it is not sensible to be more precise than this or to reveal any operational details. No doubt some light will be shed by the passage of time but for the present that is all I wish to say on this aspect—except perhaps to emphasise two fairly obvious points. First, right from the start the exchange rate has played a key role in the conduct of monetary policy. Second, the objective of monetary policy remains, as it always has done, the battle against inflation. The present stance of policy is fully consistent with this.

Lastly, Mr Chairman, let me say this: what I have been describing so far are the latest stages in a consistent policy that has been pursued ever since we first took office in 1979. The real change is the change that occurred in the real economy as a result of the implementation of that consistent policy. To take just two examples, both of which I mentioned in the Budget Speech, but which bear repeating. In the 1960s and again in the 1970s Britain's rate of economic growth was the lowest of all the major European countries. In the 1980s our rate of growth has been the highest of all the major European countries. Again, both in the 1960s and the 1970s growth of output per head in manufacturing in the United Kingdom was the lowest of all the seven major industrialised countries in the world. During the 1980s, it has been the highest in the so-called G7. In both cases we have gone from laggard to leader—not so much a change as a transformation.

In case there is any doubt about when the 1980s started, as every schoolboy knows the 1980s started in 1980 just as the 1970s started in 1970 and the 1960s started in 1960.

The plain fact is that British industry is in better shape than it has been at any time since the War. This came out very clearly as it happens from a very thorough five-page survey published in yesterday's *Sunday Times*. But perhaps more important still is that that is the clear message from the CBI's latest industrial trends survey, published last week. I pay tribute to industry for what it has achieved: the Government's job has simply been to create the right environment, which this month's Budget will reinforce.

Chairman: Chancellor, some of the points you have made do of course in effect answer questions which we asked officials and the Governor earlier, and we will obviously need to consider those points very carefully. I think now we should move on to the questions we have for you.

Mr Watts

173. Chancellor, you have been justifiably pleased with the economy's growth performance in the '80s and indeed you have just made reference to that in your opening remarks. If I can cast myself in the role of Oliver Twist, do you regard a range of 2½–3 per cent real growth per annum as the maximum which the United Kingdom economy can sustain?

(Mr Lawson) I do not know; we shall have to see. But the fact of the matter is it has been the fastest rate of growth of all the major countries of the European Community. It is a rate of growth which we have never sustained for a prolonged period in the past. If you look back you will see no period of six successive years in which we have ever, since the War, had growth of 2½ per cent or more. Assuming that we do get 2½ or more in 1987 (and we are forecasting 3 per cent) then we will for the

[Mr Watts *Contd*]
first time since the War have had six successive years of $2\frac{1}{2}$ per cent or more growth each year. And so, while I do not rule out the possibility of the supply side of the economy becoming more effective so that a higher rate of growth is possible, I reckon that we should not act Oliver Twist on this occasion.

174. Are there any further structural changes in the economy which you think would improve the growth potential further?

(Mr Lawson) We are pursuing a whole battery of policies ranging from trade union law reform to competition policy to the privatisation programme, and many others. I do not believe we have yet seen the full response to the changes we have already introduced: because of time lags the economy takes a long time to adjust.

175. You have mentioned the tax changes—I think particularly the Corporate Tax changes which appear to have helped to release some of the growth potential of the economy.

(Mr Lawson) I did not, but I should have done!

176. Well, I think you were implying it. What other factors do you think there are in the economy today which inhibit growth, and, as somebody who knows Slough quite well, to what extent would you think that skill shortages are now an inhibiting factor?

(Mr Lawson) I certainly would not wish to blame Slough. But I do not think there is a particular problem with skill shortages at the present time. I think, however, that most of our supply side problems are to be found in the area of the labour market generally. In a number of ways, the labour market does not operate nearly as well as it should do. The Government has taken some major initiatives, with the trade union law reforms which we have introduced, the changes in economic policy that we have introduced, and the dropping of the "beer and sandwiches in Number Ten" approach. It is now primarily up to management to ensure that the labour market works better. Within that context I would like to see British industry invest more in training than it does at the present time.

177. Finally, it does seem that unemployment problems are concentrated particularly amongst the unskilled. You have just mentioned the importance of training but do you think that, with the economy growing at around 3 per cent, it will generate jobs to pick up this army of unskilled unemployed, or must we look to training measures to do that?

(Mr Lawson) I think training measures are important, and I would like to see industry doing more in this field than it does at the present time. There have been various studies done, particularly one I recall under the auspices of NEDO, which showed that whereas the British Government devoted proportionately roughly the same resources to training as other comparable governments, the private sector of British industry did not invest as much in training as the private sector in most of our major competitor countries. That I think is something which is a weakness in the British economy. But of course the proof of the pudding is in the eating and I am glad to say unemployment is coming down and has been for the past 7 months. Although we do not make any forecasts, we suggest in the FSBR that we expect it to continue coming down for the remainder of this year.

Mr Sedgemore

178. Chancellor, in Table 3.7 headed "Real Output" you have got GDP projected to grow by 3 per cent in 1987 and $2\frac{1}{2}$ per cent in 1988, and in Table 3.1 fourth quarter of 1985 to fourth quarter of 1986, you have got output per head of the employed labour force growing in manufacturing industry at $4\frac{3}{4}$ and in the non North Sea economy at $2\frac{3}{4}$. Do not these figures, in line with other indicators, suggest that unemployment is likely to stay around 3 million for the next 2 years? First of all, do you agree with that, and secondly, do you consider that to be an indicator of success?

(Mr Lawson) No, I do not agree with it. I will ask Sir Terence Burns to explain the reconciliation of these various different tables.

(Sir Terence Burns) You are comparing here non North Sea productivity with total GDP in the other table. If you were to take non North Sea GDP of course you would have to add something like $\frac{1}{2}$ per cent to those figures.

179. And in terms of unemployment what difference does that make?

(Sir Terence Burns) Against this background of growth of non North Sea productivity there is plenty of scope there for employment to rise.

Mr Howell

180. Chancellor, I am sure you are well aware that many employers are having difficulty in recruiting labour and unfilled vacancies continue to rise. I wonder to what extent you think that is a limiting factor on greater growth?

(Mr Lawson) If you look at the CBI surveys, one of the questions firms are asked is what factors are likely to limit their output. Only a very small proportion cite a shortage of skilled labour. So that although skill shortages are undoubtedly a constraint in individual instances, they do not appear to be a major factor for the economy as a whole. It is certainly true, however, that one does come across cases all the time—I do in my constituency and you obviously do as well—where despite the fact that the unemployment register shows a large number of people registered as looking for work, when advertisements go in the papers to fill a particular vacancy, very often people do not turn up; or, if they do turn up, they do not actually turn up for the job when it is given them. But I think the various programmes which have been introduced under the aegis of the Secretary of State for Employment, particularly the Restart programme, may be helping in that direction.

181. Our American competitors, who do not have nearly as generous social security payments as we

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do, are concentrating on a workfare system in order to encourage people back to work, yet our opponents are insisting that we should give people the right to remain unemployed. Could you say a word or two about that argument, because it is becoming very topical?

(Mr Lawson) Let me say, first of all, I am well aware of the way you have been drawing attention to this very important field for many years, long before most other people were aware of the nature of the problem. It is clearly the case that there is a relationship between the level of social security benefits and the level of unemployment. On the other hand, one has also to judge what level of benefit is appropriate in a civilised society. So a balance has to be struck. As for the question of whether full benefits should continue to be available when there is clearly a job there for the individual which he chooses not to take, or a training place which he chooses not to take, I think that is something we will have to look at.

182. Following on from that, although I agree with you and everybody who has called this a prudent Budget, do you not agree there is something rather imprudent in spending money on creating YTS places, then allowing those people for whom they are provided to turn them down and carry on drawing benefit?

(Mr Lawson) I do not think that is anything to do with prudence, but the last part of your question raises an interesting point. I do believe that in a free society people should be able to turn down an offer of a training place which is made to them by the State, and that there should not be direction of labour or anything like that. The interesting question is, what then, if they have exercised their freedom to turn it down, is the obligation on the state to pay them by way of benefit? That is a difficult question and it is one which becomes a live issue only when we reach the point when we really can guarantee to everybody that there is a training place for them.

Chairman

183. I think we would like now to turn to monetary policy. In the course of doing so may I ask one initial question? Clearly control of the money supply is very important. Could you analyse for us the various components of monetary growth and the weapons which you have available for controlling them?

(Mr Lawson) I am not quite sure what you mean by the "components of monetary growth". We look at both narrow money and broad money. Narrow money is normally found more useful. That is growing pretty well at the centre of its target range.

184. Perhaps I might make my question a little clearer. For example, one might find the money supply grows because of last year's PSBR which was not funded. On the other hand, there may be expansion of bank lending for other reasons. So that there are various ways in which the money supply may grow. What I am saying is would you care to distinguish between them and tell us what means you have available of controlling money supply?

(Mr Lawson) I do not think it is very necessary to distinguish between them, since what matters is overall monetary growth and we do not have separate instruments for separate causes of monetary growth. Whatever the cause of monetary growth which one might consider to be excessive, the only instrument one has to deal with it is the level of interest rates, particularly short term interest rates.

185. Presumably it is somewhat different if one has a high PSBR which is not being funded as against a situation where, for example, there is great growth in consumer credit for one reason or other. They are not the same, are they?

(Mr Lawson) The economy can evolve in various different ways. One might have a view as to the relative shares that could be taken by the private sector or public sector. But whatever view one takes on that the question remains, is the level of monetary growth acceptable or not? If it is unacceptable, if you think it is too high in terms of your anti-inflationary objectives, then your remedy is to put up interest rates.

186. So are you saying the only means you have of controlling it is the level of short term interest rates?

(Mr Lawson) I suppose that you could, of course, deliberately set out to plunge the economy into sharp recession and that would probably have an effect on monetary growth. But that would be rather like burning the house down in order to get roast pork. Therefore, in practical terms the only way in which you control monetary growth is through the level of short term interest rates.

187. We had some difficulty when we discussed the matter with officials in seeing whether they had any idea of the relationship between the rate of monetary growth and a change in short term interest rates.

(Mr Lawson) There is clearly a relationship. I think what you may be concerned about here is the rate at which private sector borrowing has been growing. There is a sort of myth it is all plastic, but it is not all plastic. If you look at the figures, the growth as a share of GDP is entirely attributable to the growth of mortgage borrowing. Although there is no doubt some equity withdrawal, this borrowing is primarily for the purpose of house-purchase and house improvement. It is part of the Government's policy to encourage home ownership, including the purchase by council tenants of the homes in which they live. That therefore leads to more mortgages being taken out. Provided that we can contain the monetary consequences of that—which we are doing, and have done—then I do not regard that as a matter of concern. If we were concerned about the monetary consequences, the appropriate action would be to raise interest rates. That has both a direct and an indirect effect. Experience shows when the mortgage rate goes up the desire to acquire

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mortgages goes down; that is a direct relationship. But also, of course, a rise in interest rates affects the rest of the economy. So our objectives for the overall rate of monetary growth can be achieved.

(Sir Peter Middleton) If you are talking about money which if M3 is bank deposits or if M0 is the monetary base, notes and coins and bankers' balances: given fiscal policy, since we abolished exchange controls and the corset came to an end the only instrument is interest rates; there is not another one.

188. Again the overhanging glacier of liquidity, which the Governor of the Bank of England has referred to, and expansion in consumer credit which we have already commented on.

(Mr Lawson) Which? Mortgages?

189. Amongst other things.

(Mr Lawson) Overwhelmingly. I think it is important that people grasp this. Credit card use has been growing quite rapidly. But not only are they a small proportion of the total amount of consumer credit, most transactions are not credit anyway. People tend to use credit cards rather like a charge card; in other words, they use them to buy goods because that is convenient but they repay the money before they get into the credit period. Is that not what Mr Banks does?

Mr Banks

190. I do not, no.

(Mr Lawson) Mr Banks does not. In many ways, Mr Banks is different from the average United Kingdom citizen, and that is yet another. If you look at figures, you will see that of the total amount of personal sector credit outstanding, credit cards and charge cards account for under 5 per cent. And, if you look at the growth of private borrowing as a proportion of GDP, (there is a chart I had put in the FSBR specially so that this Committee could see what has been happening, the "frog" chart) that growth is entirely attributable to the growth of mortgages.

Chairman: For one moment I thought this mysterious relationship between the rate of interest and the growth of the money supply might be solved by our taking a quick sample from Mr Banks, but apparently that is not so!

Mr Wainwright

191. Chancellor, in your Budget Red Book this year you began the chapter on the MTFS by saying—not by any means for the first time—that the MTFS is intended to bring inflation down further over a period of years. In the same chapter, Table 2.3, you set out as usual your output and inflation assumptions and in that table the assumption of the annual rate of increase of inflation rises above 3 per cent per annum during each of the next three years, and comes back to a 3 per cent per annum for 1990–91, which is exactly the same figure as the one you have assumed for the year which is now ending. When do you guess it may be practicable to assume a declining rate of inflation?

(Mr Lawson) The underlying trend is declining. You would not expect it, would you, to come down in a straight line, Mr Wainwright? There are bound to be fluctuations. I think if you compare what has happened in the 1980s with what happened in previous decades, particularly the '60s and the '70s, the difference is this: that although there are fluctuations, over the earlier period each peak was higher than the previous peak; each trough was higher than the previous trough. You have now seen a period in which, although again there have been fluctuations, each peak tends to be lower than the previous peak; each trough is seen to be lower than the previous trough. The slight blip upwards from 1986–87 is occurring not only in the UK but in a number of other countries, for obvious reasons.

192. Yes. It was not as you may have noticed so much the "blip upwards" that I was asking about: it was the fact that even when we get to some sort of assumed trough in 1990–91, the annual rate of inflation is still rising by a 3 per cent rate, as you assume it is today.

(Mr Lawson) Those are not forecasts anyway. We will have to see.

193. No—I described them as assumptions.

(Mr Lawson) That is right. We will have to see how we do. That is not meant to be a trough in 1990–91—the projections just end there. I would hope the trend will go down further.

(Sir Terence Burns) The 1986–87 figure of course is unusually low because of the influence of the oil price reduction. If you were to look at the years that precede it you can see that is rather exceptional.

194. But nevertheless, are these figures not really an acknowledgment—and a just and proper acknowledgment—that far and away the greatest determining factor of the UK rate of inflation is the world rate of inflation?

(Mr Lawson) No, I would not say that. You can clearly have low inflation in a high inflation world. The Swiss have demonstrated that over many years. But it is equally clearly easier to get inflation down when all the major countries of the world are pursuing anti-inflationary policies. That is one of the reasons why I welcomed the international consensus on economic policy which there is at present.

195. But in contradistinction to world trends of inflation, could it be that the intractability of the annual rate, which you still leave at 3 per cent in 1991, is partly due to governments' fiscal policies? For instance, how far is the very rapid inflation in house prices way, way above 3 per cent (most people think it is still in double digits) due to official policies on mortgage relief, tax relief for mortgage interest, and the possibility of removing domestic rates and so on?

(Mr Lawson) I have no idea what the particular causes are of the rise in house prices. But, in any economy, you will never get everything going up at the same rate. You will always have changes in relative prices: some things going up faster than

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others. I suspect, although I do not know, that you would find that house prices rise faster than the general rate of inflation in many other countries. What we tend to see anyway over a long period in this country is a relationship between house prices and the rate of growth of earnings, rather than the rate of growth of RPI.

Chairman

196. It is Mark Twain's remark, is it not, "Buy land. They are not making it any more"?

(Mr Lawson) That is quite right.

Mr Wainwright

197. Turning to weapons for dealing with all this, does it not sometimes concern you that interest rates are now going to bear an enormous weight of policy—for instance, on industry? Especially new companies and small companies that have not been able to build up a cash mountain are very disturbed at the current high rates of interest from the point of view of improving their investment which seems to have been very low this present year, and are urging sharp drops in interest rates. On the other hand, you have just indicated that you rely on interest rates now as virtually your sole weapon so far as prices are concerned and bank lending for private purposes. Then again, there is also the sterling factor, where interest rates are believed to be potent. Do you not find sometimes you are faced with intractable contradictions?

(Mr Lawson) No, there is no intractable contradiction. There is no contradiction at all. Indeed the way we run monetary policy in this country is much the same as it is in other major countries—particularly the US and Germany. I would commend to you Mr Volcker's testimony to the Senate Banking Committee last month, on how American monetary policy is run. You will find it is very similar. As for interest rates and investment, investment has been going ahead well. There was a bit of a dip in 1986. In many ways I think it is surprising how slight it was. You will recall that when I introduced the Corporation Tax reforms in 1984, a great deal of investment was brought forward from 1985 to 1984 and from 1986 to 1985. Investment went up very sharply, and everybody predicted then that there would therefore be a dip in 1986 because of the investment being brought forward. When you have superimposed on that the sharp pause in world economic activity following the oil price collapse in the early months of 1986, it is really quite remarkable that the investment held up as well as it did. Now, of course, the forecast is for quite a smartish rate of growth this year. As for interest rates, I think it is important not to exaggerate the position. It is very difficult to say what real interest rates are. But if you take three month money market rates adjusted for the current rate of inflation, you will find that among the G5 countries, our real interest rate is only very very slightly above the others. Our real interest rate comes out at $5\frac{3}{4}$ per cent—the same as Japan, France and the United States at 5 per cent and Germany the lowest at $4\frac{1}{2}$ per cent. So that our real interest rates are, at most, $\frac{3}{4}$ per cent above the average for the G5. Now that *is* above, I grant you, but I think the difference is frequently grossly exaggerated.

198. *A propos* the United States, it is really not part of the scope of our report to investigate alleged similarities between the economic policies of the United States and this country.

(Mr Lawson) No, but there is one point, Mr Wainwright, and I think it is this: I think comparative studies in this and, indeed, most other fields are illuminating not because you are trying to study what is happening in those countries but because you are trying to see whether there is anything peculiar about the policy we pursue in this country or the developments in this country. That is why I think it is illuminating.

199. One final question: when you were eventually deciding on the fairly substantial reduction of the PSBR for the coming year, were you anxious, amongst other things, in order to accommodate the fairly rapid rise in private sector borrowing, not to allow public sector borrowing to get in its way?

(Mr Lawson) No, I do not think that was the primary reason. As I say, you can always counter whatever may be the adverse monetary effects of excessive private sector credit by the appropriate level of interest rates, or the mix between interest rates and the exchange rate. It was more that, all things considered, the economy was going very well and I felt that a prudent Budget of this kind, in which the amount by which I reduced the PSBR as compared with the MTFS yardstick was greater than the amount by which I reduced taxation, was the correct judgment in those circumstances, taking everything into account.

(Sir Peter Middleton) Could I add a little point? I think there is still a bit of confusion here. The object is not to control bank lending. Bank lending has been growing more rapidly than the growth of GDP for at least the last ten years. The object is to use interest rates to bring about monetary conditions consistent with the MTFS growth of money GDP and with bringing inflation down.

Mr Beaumont-Dark

200. If it does not sound too much like Harold Wilson, I think it is one of the best Budgets we have had since 1979.

(Mr Lawson) Thank you.

201. One of the reasons why I thought it was an excellent budget was because you resisted the terrible temptation of all politicians to spend other people's money, particularly if it was there. I thought the reason you did that was so that interest rates (I am one of those who you might say exaggerate the importance of this; perhaps that is because I come from industry) could then come down more than this half a point, with this miserly Bank of England attitude at the present time. Was that your idea—so that interest rates could come down?

(Mr Lawson) Mr Beaumont-Dark, first of all thank you very much for your kind remark about

[Mr Beaumont-Dark *Contd*]
the Budget, which I greatly appreciate. Secondly, you say you come from industry; I always thought you were a stockbroker. As for interest rates, interest rates have come down 1 per cent, half of it in anticipation of the Budget, the other half following the Budget. Certainly I felt it very desirable to reinforce the climate of confidence in the way in which the Government was managing the public finances and managing the economy generally. That climate of international confidence will obviously be beneficial to industry in this country, and I welcome the fact that industry itself in the shape of the CBI approved of the Budget.

202. It is kind of you to take an interest in my career, but I am a director of three industrial companies that employ 27,000 people. Two of them are very big, and can raise money on the stock market—which, as you say, is my other hat—and one can do that very easily. But you do neatly bring me to a point which the Bank of England made when I asked them a similar question to that which I have asked you: they gave the Marie Antoinette answer, "Let them eat cake". Companies can now raise money on the market—the big ones can. The two big companies I am a director of can raise it easily, but the small companies, which really are the seed corn of growth, have to borrow theirs upon the money market and from banks. When you say that our interest rates are not really so high, only three-quarters of a percent higher than Germany, if you take the three to five year market and the ten year market—and our interst rates are very considerably higher than our competitors—do you not think that is so? I thought the Budget was to help the long term rates come down.

(Mr Lawson) In so far as there is a relationship between the PSBR and interest rates— and the PSBR is only one of many factors that influence interest rates—a lower PSBR is clearly helpful rather than the reverse. So I certainly agree with you on that. As for five and ten year money, on the whole very few small businesses finance themselves that way. And, of course, long rates have come down quite a bit in this country over the past few weeks and months. That is something I greatly welcome.

203. Long term interest rates are still about three times the rate of inflation.

(Mr Lawson) I think it is the difference rather than the multiple which is important. You want to look at what is the real rate. In fact, the yield curve now goes down at the long end; long rates are lower—slightly lower— than short rates now; so companies can finance themselves long, if they are able to do so, more cheaply. But I do entirely agree with the importance you attach to the small businesses; and I am well aware that many of the options that are open to bigger businesses are not open to small businesses. That is why there were a large number of measures in the Budget deliberately designed to help the small business sector. Of these I think the most important is the move to cash accounting for VAT; but there were a number of other measures including, of course, the reduction in small companies' corporation tax rate from 29 per cent to 27 per cent.

204. You say that industry is in a better state now than at any time since the war. Its recovery rate may be better than at any time since the war, but many industrial companies that we depend upon to export are recovering from the pound going up to \$2.20 to \$2.40, because (as many of us said at the time) when the pound went over \$2 and soared up, it cut a tremendous swathe through manufacturing industry. There may be long term good in it but there was a lot of short term pain. Would you agree it would be very damaging if the pound were allowed to march on again so that interest rates had to be used to curb the pound from going so high that once again industrial companies bore that heat of the day?

(Mr Lawson) I do not believe that we will see, left to its own devices, a repetition of the petro-powered pound of 1980. But in any event I have made it absolutely clear that I believe that sterling is around the right level now. I think this is a helpful constellation of parities for industry. It is, therefore, an objective of policy to try and keep it at around that level. We are assisted in that by the fact that there was the international agreement to which I alluded in my opening remarks.

Mr Sedgemore

205. Chancellor, the Barclaycard spokesman says you are wrong. Over the weekend he said on average people actually borrow for four months. My question is this———

(Mr Lawson) No, that is not———

206. That is what he says.

(Mr Lawson) The statement I made is correct. It is something I have looked into very carefully.

207. Maybe he does not know his own business.

(Mr Lawson) If the Committee wishes a short note on credit cards we can let you have one.[1]

208. Thank you. Perhaps we can continue on credit cards, then: in the last two years, the base rates have fallen from 14 per cent to 10 per cent—that is a drop of 30 per cent. Access and Barclaycard have, throughout that period, continued to charge 26.8 per cent. Marks and Spencers, who will not have Access and Barclaycard, charge 29.8 per cent and Burtons charge 34.5 per cent. Is is not time that (a) the Access cartel of Nat West, Lloyds, Midlands and the Royal Bank of Scotland was broken up, and (b) that these firms behave more responsibily and follow your lead in bringing interest rates down?

(Mr Lawson) As I say, the contribution of credit cards to the totality of private sector borrowing is very small. The way most people respond to these high rates of interest is by making sure they pay the bills before they get into the credit period. There are a number of people who do not do that; those people, it would appear, behave in a way which is not terribly interest rate sensitive, and that may be

[1]Appendix 7.

[Mr Sedgemore *Contd*]

a source of profits to the credit card companies. But of course nobody forces people to finance their purchases that way. But the vast bulk of private sector borrowing—and the entire reason for the increase in private sector borrowing as a proportion of GDP—is, as I mentioned earlier, mortgages. And on mortgages, the building societies do not charge rates anything remotely approaching the rates you quoted. Nor the banks.

209. Barclaycard actually say that people borrow for four months and they are paying therefore an average APR of 19 per cent—that is what they said this weekend. You did not actually answer the question. In supporting the usurers against the customers, are you mindful of the fact that in Dante's Inferno the usurers were taken into Circle 7 and made to stand on hot sands beneath burning rains alongside the Sodomites?

(Mr Lawson) Well, I think that is a matter which, as Dante suggested, is best left to spiritual authority rather than to the Government of the day!

Chairman

210. It sounds inflammatory rather than inflationary! Mr Chancellor, we had a variety of questions about the PSBR and fiscal policies, some of which have actually been answered in your earlier statement, but I wonder if I might pursue just two of them. The first is that you were saying that there had not been a change in policy as far as the objective of the PSBR is concerned, though those who thought the previous policy was to have it steadily declining and now find it is to be maintained at a constant level might feel that was a change. But at all events we are clear what the situation is. Similarly I think there has been a dispute over a long time between yourself and this Committee with regard to how one should treat asset sales and we have consistently taken the view that one should treat that as a means of financing the PSBR rather than as negative public expenditure. I think the time has probably come for a truce as far as that is concerned. If that is so, may I nonetheless ask you whether you think your 1 per cent target for PSBR is really the appropriate one, because if one were indeed to treat the proceeds of the asset sales as a means of financing the PSBR, that figure would still be at something approaching 2 per cent—not precisely of course because the exact monetary impact is not the same in the case of asset sales as against issuing gilt-edged stock. Nonetheless it would seem, if that is so, that you still have scope for going down from the 1 per cent to a lower figure for the reasons I have just mentioned.

(Mr Lawson) As was implicit in my opening remarks, using the yardstick of Chart 2.5, if you look at the froth on the bottle of Guiness, if I may put it that way, rather than just the stout itself———

211. Well, there is as much froth as there is actual Guinness—rather more!

(Mr Lawson) Yes, it is altogether an interesting chart. It clearly follows that the amount of froth will diminish. Privatisation proceeds are now at a flat £5 billion a year, which will be a steadily declining proportion of GDP; and eventually proceeds will be less than £5 billion because we will gradually complete our privatisation programme. There is a long way to go, but we will gradually complete it. So we will be coming down eventually to a PSBR 1 per cent of GDP shown by the black stout with no froth on top of it at all, and then we shall have met—you and I.

212. Yes, but the froth at the moment is going up rather than coming down.

(Mr Lawson) No. It is at its peak level. It will be falling very slightly as a percentage of GDP, because the Public Expenditure White Paper and the Autumn Statement before it showed a steady £5 billion, and I do not wish to depart from that.

213. The only other point I think we would like to pursue is the statement in your opening remarks that the objective is to keep Government debt constant in real terms. That of course is only one side of the balance sheet. If one takes both sides of either the Government or the national balance sheet, is it your feeling that the net worth of the Government sector should remain the same over time?

(Mr Lawson) I do not think it is possible in practical terms to know what the net worth of the public sector is, whereas you do know what public sector debt is. What I suggested and what was implicit in the Green Paper in 1984 which I made more explicit in my Lombard speech last year, was that on a zero inflation basis, one wants to get to a position where public debt as a proportion of GDP is not rising. You are likely to get into all sorts of difficulties if public sector debt is rising as a proportion of GDP; it puts a burden on future generations, which I do not think one should put.

214. No, but it is very strange to look at only one side of the balance sheet, and there are improved figures which you have been creating recently which would help on the other side. Is not your objective to reduce the overall size of the public sector?

(Mr Lawson) Yes, indeed, and that is what the privatisation programme has been doing.

215. So why do you want the balance sheet to remain constant?

(Mr Lawson) No, it is not a question of the balance sheet remaining constant. The fact that there are these privatisation proceeds is reducing the Government's need to borrow—in the way you presented it. So I think it is a sensible long term objective to aim for a PSBR of 1 per cent of GDP. Although the doctrine of the balanced budget did far more good than harm during the period of its operation, nevertheless I think a more appropriate formulation now is to ensure that public debt does not rise as a proportion of GDP on a zero inflation basis.

Chairman: I think we would now like to turn to some of the international aspects of the Budget.

Mr Browne

216. Could I ask a supplementary on that? Chancellor. Obviously our oil revenues vary with the

[Mr Browne *Contd*]
price of oil, but do you not find it surprising that considering the relatively small proportion of our revenues that come from oil and gas our currency is viewed so much in the international markets as a petrocurrency?

(Mr Lawson) Yes. I think it used to be very surprising that sterling was viewed in that light, but I think that is less true now. We were able to weather, in a way that very few major oil producers were able to, the dramatic collapse in the oil price with so little damage to the public finances or to the economy, and that I think has led to a reassessment worldwide of the strength of the British economy and of the relative importance of oil within our economy.

217. With this reassessment and the fact that our Public Sector Borrowing Requirement, I think, is at very prudent levels and therefore one could argue it is reflected in the strength of sterling, what other things are preventing interest rates from coming down? This is slightly repetitive but I would like to get more focus on what is preventing a further fall in interest rates at the short term end of the market.

(Mr Lawson) As I have said, if you look at our real interest rates, in so far as one can measure them, they are not far out of line with other countries. They are higher than the other G5 countries by a very small amount and probably about average for Europe. There are a number of countries that have real interest rates higher than ours—the Netherlands does, Italy does, and a number of others. We are roughly in the middle. We have to have the level of interest rates which is necessary to keep monetary conditions on track, and that is affected by a number of different factors. I think one of the factors—I do not pretend it is the only one—that would make a difference is that after the general election we will see greater overseas confidence because there is obviously a residual nagging fear among people worldwide that there might just be a change of government, which would be disastrous for the British economy. So that is bound to be a factor, there is no point in trying to deny it.

218. My other question is on exchange rates. After the Accord, which I think all members of the Committee would agree was a desirable conclusion, really the other agreement is the European Monetary System but in this area the exchange rates are broadly published, there is a band. Why do you still feel it is so undesirable to have a broad band published of exchange target rates for sterling?

(Mr Lawson) I think it is a matter of either being in the Exchange Rate Mechanism of the EMS or not. If you are in, then the whole thing is extremely formalised and it is all published. If you are not, then it does not make practical sense to publish the "bands" within which you are operating. It would just help those who are seeking to make money at the expense of the policy. It is for precisely the same reason that the other countries who are party to what I call Plaza II, the agreement in Paris last month, do not publish bands either. In fact, we all agreed it was much more sensible not to.

219. In Plaza II what happens if a given exchange rate starts to diverge from the stability region? Is it then up to the sovereign divergent country to take corrective domestic policy action or will all members of the Accord take concerted action?

(Mr Lawson) If domestic action is needed, then there is the presumption that that would be taken by the country that needs to take the action. If, however, it does not appear that that is the case and, therefore, that intervention would be appropriate in the currency markets, that intervention would be concerted.

Mr Budgen

220. Chancellor, it seems to me, as I listen to a good deal of what you say and read what has been printed by the Treasury, that you are remarkably quiet and almost lacking in your usual vigour and self-confidence when you talk about you triumph over corporation tax. I recollect that in the days when you were a humble backbencher and a silent whip you were very eloquent in private about the advantages of fiscal neutrality. Then along came your much-heralded elevation and you introduced important changes in corporation tax. I recollect there was much abuse directed towards you from great vested interests and the stockbrokers who speak on behalf of the industry said this would decimate manufacturing industry, and our many friends in the banking industry said that the reduction in their profits from leasing would lead to a scandalous attack upon their balance sheets. Now on this issue it seems you were entirely right and they were mostly wrong. Is there a general principle that you would now once again be able to underline for the Committee?

(Mr Lawson) First of all, Mr Budgen, may I thank you very much indeed for that tribute. I am naturally quiet—the word you used I think—so it is particularly gratifying to hear the case put so eloquently by you. It is certainly interesting that the United States, when they came to do their tax reform not only followed what we had done so far as the corporate part of it was concerned but, as they will admit if you talk to them, consciously did so because they felt it was right. I believe it has proved so in our case. What I think follows is that there must be a presumption in favour of fiscal neutrality and that you need a very good reason to depart from it in particular instances. But there may well be good reasons for departing from it either on a temporary or on a permanent basis in particular instances. But I think it is quite wrong to see the corporation tax reforms simply in terms of a move to to fiscal neutrality. There was a far more precise analysis which led to that conclusion that what was wrong in this country so far as industrial investment was concerned was not that the totality of investment was necessarily inadequate but that the quality was poor, the return on investment was poor, because very often the investment decisions were being taken for the wrong reasons.

221. Chancellor, all you are saying is part of the support for the general arguments for fiscal

[Mr Budgen *Contd*]
neutrality. You are explaining now to the Committee that there are two main consequences of fiscal inequality. The first is that the general level of taxation is higher than it would otherwise be; the second that investment is inevitably distorted by taxation towards those areas which are tax breaks. There is nothing that you can describe as being completely limited to the corporation tax sector in your arguments, is there?

(Mr Lawson) I think that you do have to do two things when you are considering a possible tax reform. You have first of all to analyse the particular economic consequences of the existing lack of neutrality —the tax breaks or whatever you like to call them. And you have then to consider what would be the consquences in that particular case of removing them. That will inevitably vary from case to case.

222. In this particular instance, contrary to what the banks and manufacturing industry say, the advantages have been very substantial, have they not?

(Mr Lawson) I believe they have been, yes.

223. They have, first of all, stopped the tax incentive to use, at the margin, more machines and less men, and secondly a lower level of general taxation has been a factor in increasing the overall amount of tax-take that you have got from Corporation Tax?

(Mr Lawson) Yes. It has been a combination of the greatly increased profitability of industry, which I welcome, and of the change in the tax system. I think that the greatly increased profitability of industry is the greater factor, but nevertheless it is the interaction of the two which has produced the particular result. Incidentally, I would not disguise the fact that there have been particular sectors of the economy that have been hit and have suffered as a result of this change: that is inevitable in any tax reform. But I have no doubt whatever that the economy as a whole and the national interest have been greatly advanced by this change.

224. For instance, would not your modesty allow you to present figures showing what the consequences for personal taxation of a policy of fiscal neutrality might be? It would be purely educational, would it not? It would allow the nation to understand the advantages and disadvantages of the relatively higher taxation which they have to grin and bear, and also the advantages and disadvantages of the tax breaks which every citizen at present enjoys in just the same way as manufacturing industry and the banks much enjoyed investment allowances in the past.

(Mr Lawson) I do not see my primary role as that of an educator. I leave that to others.

Mr Beaumont-Dark

225. May I ask two things? Thinking of taxation and some of the changes you make, there are one or two people who have made comments about them so I wonder whether you could comment too. As you are aware, joint stock banks are heavily involved in overseas lending and they are being asked by Mr Baker and others to roll forward that lending so their overseas debt situation, which this Committee has been working on, means they are very heavily committed. But the Revenue take a rather odd view that the tax relief was merely a subsidy to bank lending paid by the taxpayer. The banks say (I think with some justification) that this proposal to abolish tax on overseas earnings could make it much more difficult for them in recycling the debt that is so essential, frankly, to the financial stability of the rest of the world. Has the Revenue thought of that, or does it just not like losing tax that it thinks is its due, even though everyone else could lose a lot more?

(Mr Lawson) Whether the Revenue has thought of that or not, I can assure you Treasury Ministers have; the decision to include this particular provision was a decision which was taken by me and my ministerial colleagues. The existing system gave the banks an unwarranted subsidy in my opinion; I think it is right that there should be a change which they can well afford to bear. It is right on merit otherwise it would not have been included. But it is a complicated issue which no doubt we shall discuss very fully when we get to Committee stage on this clause. As for the question of the banks and their foreign lending generally, I want to make it absolutely clear that I have not at any time interfered; I have not at any time urged the commercial banks to lend to particular Latin American countries or to re-schedule debts in a particular way. I have always made it absolutely clear that that is a decision which they must take on commercial grounds, and they fully accept that.

226. Chancellor, I accept that point and what you say—that you have not urged it—but surely you would agree, would you not, that bearing in mind the talks you have been involved in all over the world, including Japan and America, that British banks are heavily committed to this, and if they do now withdraw, of course they could afford to write debt off but if their proper tax concession is now withdrawn and they decide not to re-cycle some of that debt, do you not think we would not be playing our part in trying to save some of the Third World countries going bust and up the wall?

(Mr Lawson) I think this year's Finance Bill will have only a minor impact, if any, on their decisions in this area.

Mr Wainwright

227. I have two questions relating to the Inland Revenue: first of all, Corporation Tax yield, at any rate as estimated up to Budget Day, was some 15 per cent higher than you had allowed for in your 1986 Budget. How far do you think that overshoot—and I suppose it might have almost equally turned out to be an undershoot—was due to the fact that there is a huge overhang variously estimated in your Department of between £25 and 30 billion Corporation Tax losses which were fully agreed before you changed the law, and which are available entirely to wipe out liabilities? Now the

[Mr Wainwright *Contd*]
Inland Revenue (so the Treasury assures me) does not collect and aggregate these agreed losses. although they are all on the files of the tax districts, so that there is no precise knowledge of the full extent of them—nor is there any knowledge of how much is being used up year by year, how much the glacier is being melted away year by year. Does this not put the estimates for Corporation Tax yield into an impossible position?

(Mr Lawson) Let me respond to that in three ways. First of all, in forecasting tax revenues, I always believe in adopting a cautious approach. Secondly, this is a particularly complex and difficult field because the accumulated tax losses are distributed unevenly. The growth in company profits is also uneven, and therefore the way in which the two mesh together and lead to a particular yield of Corporation Tax depends on the relationship between the pattern of improved profitability on the one hand and the pattern of accumulated losses on the other. The third answer I would give is this: a question very much on these lines was one which you very properly put at the hearing with Treasury officials; we undertook to let you have a note from the Inland Revenue on this, and that we shall do.

228. On an entirely different tax question. Of the proposed change you made in the Budget on the rate of Capital Gains Tax and its effect on the insurance industry, the impression is, rightly or wrongly, that you have not yet said very much in explanation—let alone in defence—of this change which as you know has caused certain cries of pain from some quarters.

(Mr Lawson) I suppose you could call it, borrowing a phrase from Mr Budgen, fiscal neutrality. I think that it is reasonable that all companies' capital gains should be taxed in the same way, and I believe that the change in the rate is sensible. After all it is not capital gains tax for the most part which companies are liable to, it is corporation tax adjusted by a factor to make it apply at a different rate. That was felt to be necessary at a time when the corporation tax rate was 52 per cent. But once the corporation tax rate came down to 35 per cent it seemed to me no longer to make any sense at all to have a distinction between the corporation tax rate and the rate on other income flowing into the company. For small companies again this is a change; the small companies' rate of corporation tax was 42 per cent when we came to office and with that now down to 27 per cent they would have been charged more on their income from gains than on their income from other activities. Of course there is still the difference that there is indexation on gains. There was also a longstanding complaint about the effective double taxation of companies' gains because gains could not be offset against ACT. Although that could have been put right without the change to the rates, it was very much easier to put it right by charging all gains at corporation tax rates and allowing them to be offsetable against ACT. So I believe this is a better system and one, as I say, closer to fiscal neutrality than the earlier one.

Chairman

229. Roughly what do we think the additional revenue will be?

(Mr Lawson) It is in the Red Book. Let me refresh my memory. You mean from the insurance companies or in total?

230. Insurance Companies.

(Mr Lawson) I think, speaking from memory, that the actual yield from gains on policy holders' funds, which is where I think the dispute arises rather than on shareholders' funds, is £20 million, which is a tiny fraction of the total amount of tax they pay.

231. Will it have a retrospective effect on existing policy holders?

(Mr Lawson) No, not what I would understand as retrospective.

Mr Mitchell

232. Chancellor, why do all the figures you have given us on things like investment and growth and job creation proving how successful the Government has been—with you the greatest Chancellor since Sir Geoffrey Howe—miss out the years 1979–81?

(Mr Lawson) They do not fully do that. But I just felt that there were so many different starting dates you can have . . .

233. What would the growth rate be?

(Mr Lawson) There were so many different starting dates you can have: for international comparisons—which is what I was doing—you cannot even do the measurement from cyclical peak to cyclical peak, because the cyclical peak is in different years in different countries. It seemed to me the simple commonsense solution was to take the decades. So I took the decades, the 1960s, the 1970s and the 1980s. The difference is so striking, I think, that nobody can really cavil at it.

234. What would the economic growth rate be if you averaged out from 1979 per annum?

(Mr Lawson) The United Kingdom growth rate from 1979 to 1986 would be lower than it would be from 1980, obviously.

235. Say 1.4 per cent?

(Mr Lawson) Something of that order.

236. Very low?

(Mr Lawson) Going up every year, because each year that goes on with a higher growth rate brings up the average.

237. I uncharitably wondered if it was not because so much damage was inflicted on British industry, a 28 per cent loss of manufacturing capacity and 1.8 million loss of manufacturing jobs, in those years.

(Mr Lawson) No.

238. To really have any respectable performance at all you need to get growth now well above the

[Mr Mitchell *Contd*]
half-cock rate of growth you have got, to repair the damage and bring down unemployment.

(Mr Lawson) It is not a half-cock rate of growth. What is forecast is 3 per cent for this year. I recall an extremely well argued article you recently wrote, Mr Mitchell, in the Guardian saying that it was very stupid of the Labour Party to be crying "stinking fish" about the economy because it was totally implausible, because everybody knew the economy was doing very well. I think the line you took in the article in the Guardian was really one that did you more credit than the line you are taking—for purposes which I cannot imagine—this afternoon.

239. I am glad to know you are getting better informed, but the point is, Chancellor, you have recorded this high level of unemployment with the need to repair that damage and we do need a substantial and rapid rate of growth. There is an article by William Keegan in this Sunday's Observer———

(Mr Lawson) I would not bother to read that!

240. It is a very interesting and important article. "To return to anything like a civilised and just rate of unemployment an economy needs several years of above average growth." Saying you had returned to the rate you previously considered inadequate is not enough. That is correct, is it not?

(Mr Lawson) What is correct is that unemployment is coming down at the rate of something like 20,000 a month, which I would hope you would welcome, Mr Mitchell.

241. Is this niggardly rate of growth, by the standards achieved in the past by West Germany and Japan and which we now have the potential of going over given unused resources and the fact that we have oil, the best the British economy can do or the best it can manage with your economic policies?

(Mr Lawson) There is no point in going on about the niggardly rate of growth. You know as well as I do that the rate of growth is historically high for this country; we are growing steadily at 2½ to 3 per cent. This is not just a recovery from a recession—that period ended long since. Output exceeded the 1979 level during the course of 1983 and since then it has been going on steadily up and up and up. Of course, we did have to clear up the mess that we inherited in 1979 and that took a little bit of time; it was a painful process and was not assisted by the fact that we then had the second oil shock with the world tipping into recession. But that is all past. I do not think any purpose is served by harking back to the events of 1979–80. I am happy to discuss them, but I do not think it leads to any policy prescriptions for today.

242. Chancellor, it dodges the question rather than answering it. Is this the best rate of growth the economy can manage or is it the best it can manage under your policies?

(Mr Lawson) The steady rate of growth of 2½ to 3 per cent which we have been having has been in fact closer to 3 than 2½ per cent. Indeed, as Sir Terence Burns reminded Mr Sedgemore earlier on this afternoon, what we are forecasting within the 3 per cent growth of the economy as a whole is something like 3½ per cent for the non-oil economy, which is where the vast bulk of the jobs are. That, I think, is a satisfactory rate of growth. If we can on a sustained basis do better by improving the supply side of the economy, which is what our policies are designed to achieve, then well and good.

243. So there is no hope of bringing unemployment down substantially, given the fact that in the recovery from the last great depression in the 1930s the rate of growth was 4 per cent for a sustained period to bring unemployment down, which it did in the 1930s. With this rate of growth there is no chance of bringing unemployment down?

(Mr Lawson) But unemployment is coming down.

244. Substantially?

(Mr Lawson) Over the past 7 months at a rate of a little over 20,000 a month. That is not bad. It is still too high, I grant you, but it is coming down.

245. One of the arguments I put in that article in *The Guardian* which I am glad you have read was that a substantial proportion, say, of the growth, of the increased profits, of the improvement in exports that have taken place is due to improved competitiveness. Now, it was wise of you, therefore, taking over as Chancellor, to adopt Labour's policy of 1983 which was a 30 per cent devaluation which you have given us, but since it is responsible for so much of the improvements that have taken place, can I ask why you resisted for so long? Why, each time the pound came down, you put up interest rates, and why you are still resisting it coming down to its natural level by high interest rates?

(Mr Lawson) I tell you why we have resisted it for so long—because it was plum wrong. That is why we have continued to resist that prescription. Peter Shore I think it was, maybe under your tutelage, in 1982 called for two things: a 30 per cent devaluation———

246. Which we now have.

(Mr Lawson) ———of the pound, and a substantial increase in public borrowing—in other words, a fiscal boost. What we have had is a 20 per cent devaluation of the pound of which over half was associated with the oil price collapse. He knew nothing about that coming any more than I did, and if he had done that 30 per cent when he said he wanted to, then he would have undoubtedly felt he had to do still more following the oil price collapse in 1986. So he would have been talking about something like at least a 40 per cent devaluation, whereas what we have had is a 20 per cent. And so far from the public borrowing increasing as a share of GDP, in the way he wanted it to, we have reduced public borrowing. It would have been disastrous had we followed his prescription in either respect. That is why we have not done so.

247. The fact is the pound has come down; there are substantial benefits flowing from the new competitiveness, and you resisted it all the way down

[Mr Mitchell *Contd*]
and you still are. Are we going to get investment? You forecast in the last Red Book that investment will go up by 5 per cent. That has not occurred. Are we going to get the growth in investment? Are we going to get the economy growing more substantially than it is, unless you get interest rates down and the pound down still further?

(Mr Lawson) We have very good forecasters in the Treasury. They are certainly fallible, but they are better than any outside forecasters, and that is why *The Guardian* has just given them the "Golden Guru" award! 1986 was a peculiarly difficult year to forecast because of the dislocating effect on the world economy of the collapse in the oil price. But there is no reason whatever to believe that the Treasury's excellent track record in forecasting will not apply to our forecasts for 1987. Time, however, will tell. We will have this meeting, no doubt, in a year's time and Mr Mitchell will be able to go over this again!

248. How much of the failure to get that investment increase was in manufacturing?

(Mr Lawson) You mean how much of the forecasting error was in manufacturing?

249. Yes.

(Mr Lawson) I do not know.

(Sir Terence Burns) Manufacturing had its share of the error, the same as the other components of business investment.

250. One final question on forecasting, since you raise the effectiveness of the forecasters: you said in the *Financial Times* that the Treasury forecast for the Public Sector Borrowing Requirement for 1986-87 was "up the pole". Could I ask Sir Terence Burns whether you were right in saying that, and if you were right in saying that, have you had to change any of their forecasts this year to improve them in the same way—a kind of "fiddling while Terry Burns"—or are any of the forecasts this year "up the pole"?

(Mr Lawson) You are referring to my comment on the internal October forecast of the PSBR? I think the question is directed at you. Sir Terence, but you do not have to answer it if you do not want to. I am the person on the stand!

(Sir Terence Burns) Looking back at the forecasts we made last year I do not think that the errors are any greater than we have made on some previous occasions. As you know, as the year went on, new information emerged. Our estimate for the outturn for the PSBR for 1986-87 is now a good deal less than we thought last September/October.

(Mr Lawson) There is a seasonal pattern.

251. Is it possible that any of this year's forecasts are "up the pole" in the same way?

(Mr Lawson) I do have a certain advantage. I have been a Treasury Minister for over six years, and I have detected a seasonal pattern in the forecasters' forecasts: so I am able to aim off.

(Sir Peter Middleton) He aims off for us, and we for him. And together we get a very good forecast?

Mr Banks

252. Chancellor, firstly let me say how grateful I am to you for your advice to me on how best to use my credit cards! Secondly, could I ask for some more advice on the question of balance of payments in respect of invisible earnings, because I am a little bit confused in this area? During 1986 there was a revision upwards in the monthly calculated invisible earnings and then when the final outturn figure for 1986 was given it showed a revision downwards by £1.5 billion, I believe. Are you satisfied with the ways in which invisible earnings are calculated, and to what extent do you feel in the documents before us that one can rely on Treasury estimates for 1987?

(Mr Lawson) These figures for the invisible earnings and indeed the revisions do not emanate from the Treasury at all. We are merely consumers of these figures. The figures are produced by the Central Statistical Office. It is of course one of the areas that is intrinsically difficult to get right, and it is not surprising that there tend to be adjustments after the event for some time. Having said that, I think that what happened this year was unfortunate and I would hope that the Central Statistical Office can avoid it in the future. As for our overall position as a nation, even making full allowance for the uncertainties there are in the figures of invisibles, we have now overtaken the United States and we know have the biggest invisible surplus of any country in the world; and that is something that is set to continue.

253. In 1979, one of the first things that your Government did of course was to abolish exchange controls, and I suppose stemming from that one can claim that a great deal of earnings have been achieved in terms of money that has gone abroad and been invested. Do you have any way of estimating the impact on domestic investment of the outflow of capital from this country at all, and if so, are you able to say what differences that might have made on economic growth?

(Mr Lawson) I cannot give you a figure, but insofar as there has been an impact on domestic investment, I would expect it to be favourable. I am talking here about direct investment overseas, not portfolio investment which I would say is neutral as regards investment in this country. Where there is direct British investment overseas, British companies overseas are more likely at the margin to purchase their requirements from Britain than are, say, German owned companies or Japanese owned companies, and to the extent that that happens then obviously it has a favourable impact on investment in this country. There have been some studies done on this which I think lead to this conclusion.

254. Well, taking that point, it is also true that I think in 1983 we had the first balance of payments deficit on manufactured goods, and that deficit has increased alarmingly, so I believe some commentators have said, since 1983. First of all, in various statements I have heard you make, you do not seem particularly concerned. You do not think there is any long term damage likely to the economy because

[Mr Banks *Contd*]
of this substantial and growing balance of payments deficit on manufactured goods? Secondly, do you see that ever being turned round again or in what period of time do you see us perhaps moving back into surplus, because one was always brought up to believe that as a manufacturing nation on what we produce in terms of manufactured goods depends our worth.

(Mr Lawson) The economy has developed considerably. What I would certainly expect to see over a sustained period is that the current account as a whole would be in balance. That does not mean to say one particular component has to be in balance. I have already pointed to our invisible surplus which would suggest that you would expect visibles to be in deficit if the overall current account is in balance. One of the reasons also why I am not as concerned as you appear to be is because what I look to is the performance of British industry and in particular manufacturing industry in export markets and our manufacturing exports are doing extremely well. British industry is doing very well in world markets. That is a real test of how competitive and effective we are. You can see this if you look at the proportion of our manufacturing output which we export. When we first took office we exported something like a quarter of our manufactured output; we now export getting on for a third. If you look at the latest trade figures—I do not want to place too much importance on one month's figures—they continue a pattern we have seen for some time in which Britain's exports have been rising faster than the exports of pretty well all our major competitors.

255. You said, Chancellor, that we were exporting a quarter of our manufacturing output and it is now a third. Could that be, of course, because our manufacturing output is that much smaller than it was in 1979 so that again is not a great success story? What I find difficult to understand is why it is that we have this capacity to suck in imports of manufactured goods in the very areas where you would have thought the British economy was able to provide those goods themselves—motor vehicles, for example, electrical goods. There is not a declining world market for these, there is an increasing world market. We do not seem able to produce the goods people in this country want to buy.

(Mr Lawson) Well, we do. What you are talking about are, relatively speaking, marginal differences; but I would not say they are totally without significance. On your first point on the statistics, the change in the ratio which I mentioned is overwhelmingly due to the increase in manufacturing exports. There has been a very, very small decline in the total manufacturing output, but it is overwhelmingly the big increase in manufacturing exports which accounts for the change in the ratio. As for why we appear to have to import manufactured goods from overseas, I suppose that this is partly because we have a particularly efficient retailing sector in this country which does scour the world to provide the British customer with the best value for money, the latest fashions, whatever it happens to be. In some other countries their retail sector is not as highly developed but I believe British industry is capable of rising to the challenge and that is again one of the reasons why I was so encouraged to see the very bullish survey of trends in manufacturing industry which the CBI put out last Tuesday.

Chairman

256. Chancellor, obviously we wish to study carefully the various answers you have given to us. Could I just pick up one point you made on the currency bands in relation to the various international monetary agreements. I think you said the other countries did not publish the bands. Our impression was previously that, although the Japanese had claimed there were such bands, the other countries had not actually admitted they existed?

(Mr Lawson) I am not saying whether they exist or not. What I am saying is, we do not publish the nuts and bolts of the Paris accord. That is slightly different.

257. Well, I understand it is slightly different, but are you saying no such bands exist or not?

(Mr Lawson) I am saying that we did go into the question of currency fluctuations very thoroughly. We did go into the nuts and bolts, but we also agreed we would not reveal those to the market and I think that was sensible, and I am sure you will understand why.

258. I may not have made my question very clear. I understand you do not propose to reveal the limits within which the band may exist. What I was not quite clear from your answer was whether such bands exist even though the limits are not announced.

(Mr Lawson) I think it did follow from my answer that I did not wish to reveal the precise nature of the agreement.

259. What is the advantage of that?

(Mr Lawson) The advantange of that is so as not to make it easy for the operators on the foreign exchange market to speculate or deal successfully against the policy of the countries represented at the Louvre.

260. How would the existence of bands enable them to do that if they did not know the figures?

(Mr Lawson) It is the first step towards finding out the figures, is it not?

Chairman: We shall wait and see whether that is so. Mr Chancellor, thank you very much indeed, and you, Sir Terence and Sir Peter, for coming along this afternoon. As I say, we hope to have produced our report in time for the Second Reading of the Finance Bill, and we are most grateful to you for your evidence.

APPENDIX 1

Memorandum by Mr Terry Ward Specialist Adviser to the Committee

NOTES ON THE 1987 BUDGET

1. The effect of the Budget measures on the economy has to be considered in conjunction with the public expenditure plans for 1987–88 announced in the Autumn Statement in November last year. Then the Government added £4.5 billion to the cash plans formulated the previous year. Now the Government has cut taxes by almost £3 billion (£2.6 billion relative to an indexed base). A total of £7.5 billion has therefore seemingly been injected into the economy. This, however, is in relation to the Government doing nothing at all on either the public expenditure or the tax front, which is a somewhat artificial basis for concluding anything about the stance of fiscal policy. More relevantly the PSBR for 1987–88 has been reduced by £3 billion in relation to the previously announced target. But most significantly of all perhaps, the PSBR adjusted for asset sales is planned to remain at more or less the same level now estimated for 1986–87 (there is still considerable uncertainty about the outcome). So in relation to the fiscal stance this year, the Budget involves little change one way or the other.

2. Nevertheless the scale of the adjustments to taxation and borrowing which have been made do indicate how much projections of expenditure and receipts have been revised since last year. In total over the year as a whole, the Chancellor has had some £10.5 billion more to allocate to spending increases, tax reductions or cuts in the PSBR than was estimated this time last year. This is illustrated in Table 1 which shows the projections for 1987–88 made in the March 1986 Budget documents and compares these with the figures which the Chancellor had before him when he made his Budget judgment—ie the estimates before the Budget changes. Thus although £4.5 had already been added to public expenditure in November, the Chancellor still had £6 billion to give away in tax cuts or further expenditure increases in March (as shown by the fiscal adjustment) without exceeding his PSBR target.

3. The reasons for the upward revision in the figures are not altogether clear. Much of it seems to have occurred, probably at least £3–4 billion, since the Autumn Statement and finalisation of the expenditure plans in November. Most of it is the result of tax revenue being far more buoyant than forecast, at £7.5 billion more than the 1986 Budget projection, but few details are available as to why this should have increased so much. A large part seems to be due to a big rise in Corporation Tax because of higher than expected profits. A significant part, however, appears to be attributable to a higher than projected level of GDP and therefore to a larger tax base than previously thought likely. The upward revision since November seems to result to a large extent from an increased projection of inflation, which is now forecast to be almost 1 per cent higher in 1987–88 than the figure in the Autumn Statement. This in itself has probably added at least £1 billion to tax yield next year.

TABLE 1

ESTIMATES OF GOVERNMENT EXPENDITURE AND RECEIPTS FOR 1987–88

£ million

	March 1986 Budget	*March 1987 pre-Budget changes*	*Difference*
Planning Total	144.5	149.0	4.5
Other Expenditure	26.0	25.0	−1.0
Total Expenditure	170.5	174.0	3.5
Total Receipts	164.5	172.0	7.5
Fiscal Adjustment	2.0	6.0	4.0
GGBR	8.0	8.0	—
PC Market Borrowing	−1.0	−1.0	—
PSBR	7.0	7.0	—

Public Expenditure after the Budget

4. The upward revision in the forecast of inflation, however, has also affected the real value of the public expenditure plans presented in the Autumn Statement. The £4.5 billion that was then added to the existing planning total has been offset to a significant extent by a general erosion in what authorities are capable of purchasing with the cash budgets allocated to them. This is indicated in Table 2 which shows the revisions to real expenditure since the plans were first presented. Thus the planning total, before the deduction of asset sales, has been reduced in real terms by around £1.5 billion, at 1985–86 prices, in 1987–88 as a result of increased inflation. The rate of growth in expenditure, which was to be about 2 per cent between this year and next, is now forecast to be 1.5 per cent in the case of the planning total and 1.1 per cent if debt interest is included. Both figures are below the average rate experienced since 1978–79.

TABLE 2

REVISIONS TO REAL EXPENDITURE IN THE BUDGET

	1986–87	*1987–88*	*1988–89*	*1989–90*
	(£ billion at 1985–86 Prices)			
White Paper Planning Total	136.5	139.3	139.7	142.1
Budget Planning Total	135.9	137.9	137.6	139.2
Difference	−0.6	−1.4	−2.1	−2.4
Wh. Paper Adj. Planning Total	143.3	146.0	146.1	148.4
Budget Adj. Planning Total	142.4	144.5	143.9	145.3
Difference	−0.9	−1.5	−2.2	−3.0
White Paper Total Expenditure	160.3	162.9	162.4	165.1
Budget Total Expenditure	159.4	161.2	160.0	161.7
Difference	−1.0	−1.6	−2.4	−3.4
	(Annual per cent changes)			
White Paper Planning Total	2.2	2.1	0.3	1.7
Budget Planning Total	1.7	1.5	−0.2	1.2
Wh. Paper Adj. Planning Total	3.6	1.9	0.1	1.5
Budget Adj. Planning Total	2.9	1.5	−0.4	1.0
White Paper Total Expenditure	2.8	1.6	−0.3	1.6
Budget Total Expenditure	2.1	1.1	−0.8	1.1

Note: Adjusted Planning Total is expenditure before deducting receipts from asset sales, including sales less purchases of land and buildings.

5. For the later years of the planning period, the effective reduction in expenditure caused by the higher inflation projected is even greater. In 1988–89, over £2 billion at 1985–86 prices has been cut from real spending, which is equivalent to almost 40 per cent of what was added in November. The effect is that the adjusted planning total is now projected to decline by 0.4 per cent between 1987–88 and 1988–89. In 1989–90, the reduction to the adjusted planning total in real terms is £3 billion. Figure 1 shows the extent to which these developments have pushed planned spending below the real levels which would have been expected on the basis of the trend rate of expenditure growth (1.8 per cent a year) which has obtained since 1978–79.

6. The increase in inflation and its effect on real expenditure plans give rise to two questions in particular. The first is why the increase should have occurred at all. The Budget documents say very little about the reasons for the upward revision in the Treasury forcast. The second is why the additional revenue which higher inflation will cause has not been used to make good the erosion in the Government's expenditure plans, but has instead been allocated to funding tax cuts. In effect, the Chancellor has altered the decision made in the Autumn and reduced the addition to spending then intended. It is unclear in what respects circumstances have changed in the interim to warrant a smaller increase, especially when revenue is turning out to be far more buoyant than expected when the plans were prepared.

Economic prospects

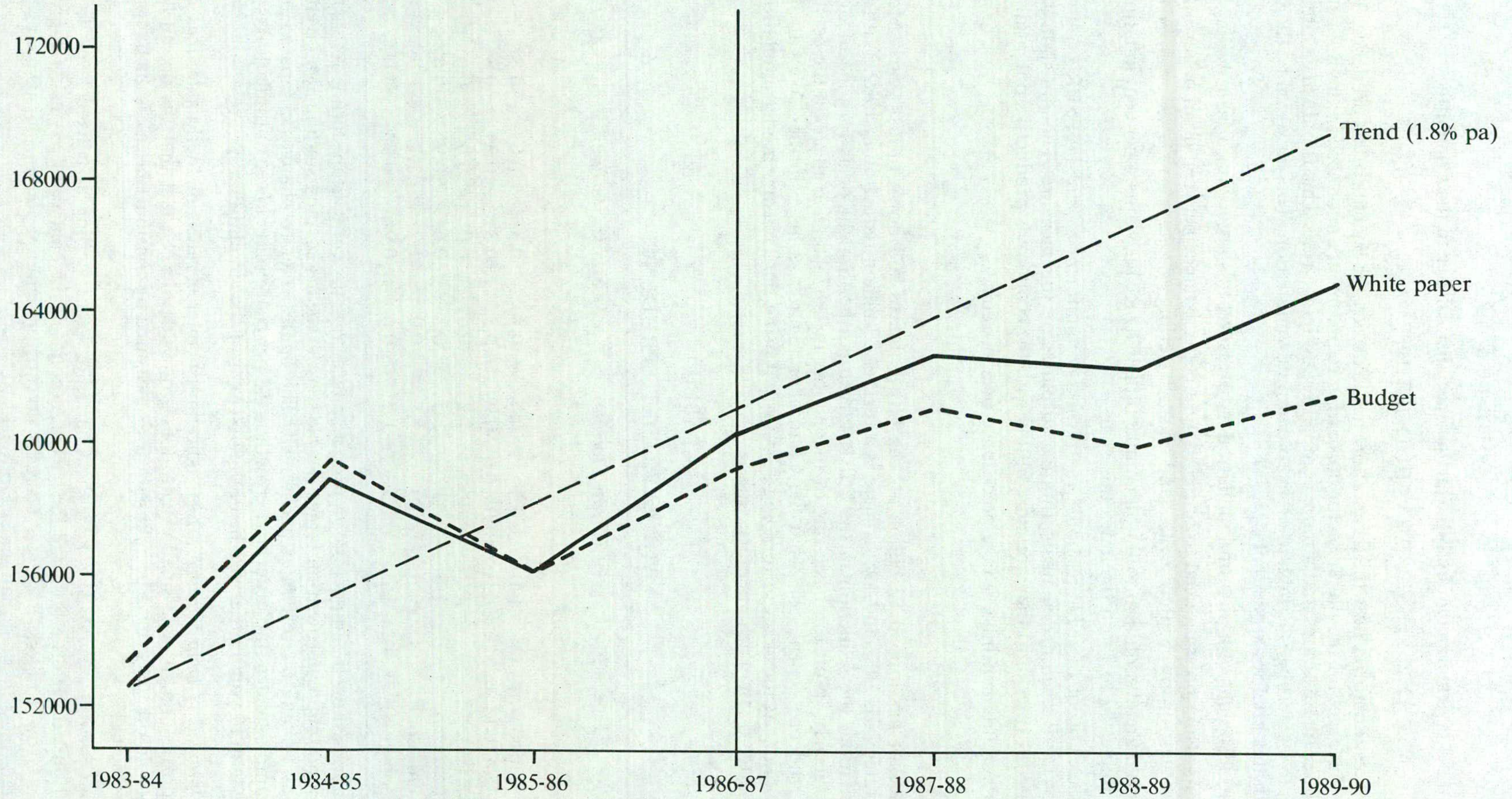
7. Despite the Chancellor's praise for the performance of the British economy in recent years and his optimism about future prospects, one aspect of the Budget forecasts ought to be a cause for concern. The balance of payments in 1987 is projected to deteriorate further, with the deficit forecast to rise to £2.5 billion. Most significantly for longer term economic prospects, the deficit in trade in manufactures is forecast to increase from £5.5 billion in 1986 to £8 billion in 1987. Yet this comes after a year when sterling depreciated substantially and cost competitiveness improved markedly—by 16 per cent between the fourth quarters of 1985 and 1986. This improvement ought presumably to be having its maximum beneficial effect on UK trade performance during the course of 1987, especially since according to the Treasury "most of the gain in competitiveness seems likely to be maintained over the year ahead." (*Financial Statement*, paragraph 3.22.) The forecast, however, is for exports to lag behind the increase in imports, despite the relatively modest growth of GDP.

8. This raises two questions. First, if the balance of payments deteriorates in such apparently favourable circumstances, how will it be possible to sustain the present rate of growth in the longer term? Secondly, if, on the other hand, 1987 is not the year when the effect of the recent large gain in cost competitiveness comes through, when does the Treasury expect it to occur on its calculations?

Cambridge
21 *March* 1987

Figure 1

Total Government Expenditure



Note: Expenditure measured before deducting receipts from asset sales and inclusive of debt interest.

Appendix 2

Memorandum by Bill Martin, Specialist Adviser to the Committee

BUDGET 1987

The main question now is how the Chancellor should deploy the benefits of his prudence. The welcome reduction in the target for the public sector borrowing requirement announced in the Budget could pave the way to lower interest rates and a more competitive exchange rate. This is industry's preference. The alternative is to let sterling ride high in order to damp down inflation. This may well be the Chancellor's preference. In this brief we argue that:

*There are clear signs of a pick-up in inflationary pressure; this argues for a firm sterling strategy.

*But there is also a pressing need to bring about a better balance between fiscal policy and monetary policy; this argues for lower interest rates and cheaper sterling.

*We can see no ready solution to this dilemma. If the Chancellor wants 4 per cent inflation next year, he needs sterling at 72 to 75 on the index this year.

*The next version of the MTFS should re-affirm a commitment to cut the PSBR progressively as a proportion of GDP, even if this means running surpluses on this measure. The aim should be to bring down real interest rates until they are more in line with the economy's productive potential.

*PSBR cuts should continue to take precedence over tax cuts.

The Options

The Chancellor has lopped £3 billion off the PSBR figures laid down in last year's Medium Term Financial Strategy for 1987 and 1988. There is a further £2 billion reduction in 1989. With little stretch of the imagination, the reduction in the PSBR target can be thought of as forgone income tax cuts, equivalent to nearly 3p off the basic rate of income tax in 1987–88. The effect on the economy of this unexpected prudence depends on what the Chancellor regards as his priorities. We can illustrate the options by looking at the effect of forgoing a 3p tax cut using the Treasury model simulations provided to the Committee by the Parliamentary Unit.

TABLE 1

THE PAY-OFF TO PRUDENCE

Option:	*(1) Cheap Sterling*			*(2) Stable Sterling*			*(3) Firm Sterling*		
Year	*1*	*2*	*3*	*1*	*2*	*3*	*1*	*2*	*3*
Growth (% points)	0.0	0.3	0.0	−0.3	0.3	0.0	−0.3	−0.3	0.0
Inflation (% points)	0.0	0.0	0.0	−0.3	−0.3	−0.3	−0.3	−0.6	−0.9
Sterling index (%)	−1.2	−1.8	−1.2	0.0	0.0	0.0	0.6	1.8	2.7
Competitiveness (%)	1.5	2.1	1.5	0.3	0.6	0.9	−0.6	−1.2	−1.2
Current account £bn	0.6	0.9	1.5	0.9	1.2	1.2	0.9	1.5	1.8
Base rates (% points)	−1.2	−1.5	−1.2	−0.6	−0.9	−0.9	0.0	0.0	0.0

The simulations show the impact of forgoing a 3p basic rate tax cut. Cheap sterling refers to a strategy of keeping money supply growth on target. Stable sterling means keeping sterling at a given level. Firm sterling means keeping interest rates unchanged. The figures refer to changes compared to a forecast base. For example, under stable sterling, growth is 0.3 per cent points lower but inflation is 0.3 per cent points better than it would otherwise be in the first year of the simulation.

Under Option 1, "Cheap Sterling"; the Chancellor lets interest rates fall. Sterling declines, competitiveness improves and so, to a small extent, does growth despite the fact that the tax burden is higher than it would otherwise have been. Inflation, as measured by consumer prices, is unchanged according to these results.

Under Option 2, "stable sterling", the Chancellor keeps sterling at a fixed level. In contrast to Option 1, inflation falls a little and the current account of the balance of payments improves initially by more. Growth falters, however. To resist upward pressure on sterling, interest rates have to fall but the fall is less marked than under Option 1.

Under Option 3, "firm sterling", the Chancellor holds out against any cut in interest rates and takes the benefit of his fiscal prudence in the form of currency appreciation. This option delivers the greatest inflation gains and the greatest growth losses.

These results, taken with an appropriate pinch of salt, highlight the Chancellor's dilemma. The greater his concern about inflation, the more he will incline towards firm sterling. But in doing so, he forgoes the benefits of improved competitiveness and lower real interest rates available under a cheap sterling strategy.

Inflation worries

The Chancellor's evident worries about inflation are well-founded. Even the Treasury forecast admits to an inflation outlook which is significantly worse than projected in last year's Budget or in the Autumn Statement. For example, the 1986 Budget forecast retail price inflation of only 3½ per cent in 1987 Q2. In this year's Budget speech, the Chancellor speaks of inflation "perhaps exceeding 4½ per cent by the summer" despite his decision to leave specific duties unchanged (thereby cutting 0.3 per cent off inflation at a stroke).

The Treasury's forecasts of money GDP growth and the split between real growth and inflation in 1987 have also taken a turn for the worse (Table 2). And perhaps most interesting of all the Treasury has radically altered its view of profit margins in manufacturing industry. In the Autumn Statement, the increase in unit costs and of product prices (excluding food, drink and tobacco) were each forecast at 3½ per cent in 1987. In the latest forecast, however, unit costs are forecast to rise by only 2 per cent while output prices rise by 4 per cent. The projected boost to margins occurs in spite of a 7–8 per cent upward revision, between the two forecasts, in the assumed level of sterling. Strong profits growth and higher inflation could be taken as classic indications of economic overheating.

TABLE 2

MONEY GDP SPLIT—TREASURY FORECASTS

	% Growth in 1987–88	
	Before	*Now*
Real Growth	2½	3
Inflation	3¾	4½
Money GDP	6½	7½

Before (Nov) = 1986 (1987) Budget estimate.
Subject to rounding error.

On one interpretation, the pick up in inflation this year is the inevitable consequence of the one-off fall in oil prices last year. The fall in the oil price depressed the price *level* but not, except temporarily, the rate of inflation. This interpretation of events is too fatalistic to our mind. The fall in the oil price provided an opportunity, which was missed, to get inflation on to a permanently lower path. Instead the decision was taken last year to relax policies. The reason involves a little history. In 1985, following a long period of policy easing in the Government's second term of office, sterling collapsed and inflation took off (Table 3). Policies were duly tightened—1985 became the year of firm sterling and firm Budget strategy. As a result, inflation was heading lower well before the oil price fell.

TABLE 3

MONEY GDP GROWTH AND INFLATION per cent

FY	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*	*1986*	*1987f*
Money GDP	14	10	9	8	9*	8½*	6	7½
Inflation	18½	10	7	4½	4½	6½	3	4½

f: Treasury Forecast *Adjusted for coal strike

With the Chancellor feeling more relaxed about inflation in 1986, he decided to loosen his grip. Adjusted for the cycle, the public sector financial deficit may have risen by 1 per cent of GDP in 1986. Sterling fell through the summer and autumn and interest rates were nudged down until last year's currency crisis forced them back up again (Table 4). The overall aim of this easing was to generate more growth and so falling unemployment in the run up to the election, even though it meant taking risks with inflation. This is what we said in our submission on the 1986 Budget. And we warned: "The Treasury expectation of 3½ per cent or so inflation must surely owe a great deal to an assumed reduction in pay inflation—possibly to 5–5½ per cent in the course of 1987. Low inflation may encourage wage moderation. But there are very powerful upward pressures on pay now in the system: robust company profits, a weaker exchange rate, a growing economy, a tightening labour market, ample supplies of bank credit. While we welcome the Chancellor's intention to encourage profit-sharing schemes as a means of promoting greater pay flexibility, we fear it will be too little, too late. 1987 may well be the year when the economy begins to overheat". It is therefore only mildly comforting that the Chancellor rejected the advice he received from some quarters to relax his grip even more last year.

TABLE 4

POLICY INDICATORS

FY	*1982*	*1983*	*1984*	*1985*	*1986*	*1987f*
Short term interest rates						
nominal	11½	9½	11	12	10½	10
real@	6	3½	5½	7½	6½	6
Sterling Index	88	83½	76	79	71½	72
Competitiveness#	90	86½	82½	89½	80½	80½
Adjusted PSBR/GDP ratio*	4	4	4½	3	2½	2½
Change in cyclically adjusted PSFD (%GDP)†	+½	+1	+1	−1½	+1	0

@nominal rate less next year's inflation rate of producer prices.
#unit labour cost competitiveness index; a lower figure indicates improved competitiveness.
*adjusted for asset sales including council house sales.
†cycle adjustment based on Phillips and Drew's economic model and assumes 2 per cent trend GDP growth f: our estimate of 1987 FSBR projections where appropriate. Figures are heavily rounded.

The Treasury's new forecast of 4 per cent retail price inflation by 1988 Q2 also rests on the assumption of a lower growth in earnings. This we question for precisely the same reasons as last year. Although settlements have slipped a little, they are now more likely to rise than fall. Inflation is picking up, not slowing down; job vacancies are approaching a cyclical peak (though, interestingly, skill shortages are not so evident) and company profits remain buoyant even on the Treasury's forecast. In manufacturing, we would be surprised to see earnings growth significantly different from the current 7¾ per cent.

Of course, pay increases could be offset by sharp productivity rises keeping down unit labour costs. Thanks to the cyclical pick up in output, manufacturing productivity is now rising strongly at well above its underlying trend. It is, however, the underlying trend growth–adjusted for the cycle—which is relevant for inflation. Cyclically boosted productivity growth, which is being misrepresented in the media as a productivity miracle, feeds higher profits, not lower inflation.

The FSBR states (paragraph 3.55): "Underlying growth in manufacturing productivity now seems to be back to the rate experienced in the late 1960s". The accompanying table shows that manufacturing productivity growth between 1979 and 1986 averaged 3½ per cent pa in contrast with 3¾ pa between 1964 and 1973. This comparison is highly misleading, however. Our estimates of cycle-adjusted productivity indicate a large once-off step improvement in producicitivity in 1980–81. Thereafter, trend productivity growth averages some 3 per cent pa. The number can be raised to the "1960s" level only if the step-improvement is included in the figuring. Overall, and bearing in mind the worse productivity trend in the non-manufacturing sector, underlying unit wage costs economy-wide still appear to be running at around 5 per cent pa.

What the Chancellor will have to rely on to deliver his 4 per cent inflation forecast next year is tight policies—and probably tighter than those assumed in the FSBR. Judged by its forecast of the housing element of the RPI, the Treasury is assuming base raes of around 10 per cent in fiscal 1987—implying yields of something like 6 per cent in real terms. (Real interest rates are difficult to measure but, for simplicity, our preference is to deduct next year's inflation rate from this year's nominal interest rate). Real yields of this magnitude are probably necessary to justify the Treasury's assumption that sterling remains stable at around 72 on the index. The fiscal stance remains broadly neutral staying flat on a cycle-adjusted basis (Table 4).

In terms of the Chancellor's options outlined at the beginning, we conclude that 4 per cent inflation might prove deliverable if he now adopts a stable sterling strategy at 72 on the index. More assuredly he will get 4 per cent next year if he allows sterling to appreciate towards the 75 region—and holds it there. The danger of both options is that they will impair the economy's longer term growth prospects by damaging productive potential.

The case for cheap sterling

On productive potential grounds, we conclude that there is a pressing need to bring about lower real interest rates and a more competitive exchange rate. Since 1980, real short term interest rates (on our forward looking measure) have averaged a pretty steady 5–6 per cent: well above any comparable period since the 1960s. And despite an improvement since 1981, manufacturers have not regained the level of price and cost competitiveness which existed through most of the 1970s. Indeed on the measure of competitiveness based on labour costs shown in the graph, the average level enjoyed over the last 3 years was rather worse than that seen in the unhappy years running up to the 1967 devaluation. (Note that an upward movement in the competitiveness index denotes a deterioration).

The consequences have been two-fold. First, it appears that without the benefit of large oil surpluses, Britain has entered a period of sustained weakness on the current account of the balance of payments.

TABLE 5

CURRENT ACCOUNT £ BILLION

1979	1980	1981	1982	1983	1984	1985	1986	1987f	1988f
−½	3	6	4	3	1½(4)	3(4½)	−1(−1½)	−2½	−2

f: Treasury Forecast. 1988 is first half at an annual rate. Figures in brackets are after adjustment for the coal strike and the timing of EC rebates.

After adjustments for distortions to the figures, the current account balance fell from a surplus of £4½ billion in 1985 to a prospective deficit of £2–2½ billion a year on Treasury forecasts for this year and next (Table 5).

These deficits come despite earnings on Britain's overseas assets, now put at £110 billion at the end of last year. Britain's invisible surplus generally does not appear to be saving the day despite hopes to the contrary. In our submission on last year's Autumn Statement, we commented: "The official projection on invisibles is now £600 million a month indicating a figure for the full year (1986) of under £8 billion. The Treasury forecasts £8½ billion this year rising to £9 billion in 1987. This looks pretty optimistic on the basis of current estimates."

TABLE 6

TREASURY CURRENT ACCOUNT FORECASTS £ BILLION

	Non-oil Visible			*Oil Account*			*Invisibles*		
	B86	*A86*	*B87*	*B86*	*A86*	*B87*	*B86*	*A86*	*B87*
1985	−10	−10½	−10½	8	8	8	5	5½	5
1986	−9½	−12½	−12½	5	4	4	8	8½	7
1987	–	−14	−15	—	3½	4	—	9	8½

B86(87): Budget 1986 (1987) estimates.
A86: Autumn Statement 1986 estimates.

Mr Lawson clearly took exception to these remarks. In his robust defence of the Autumn Statement, he is reported as saying in Hansard: "And the latest estimate that the surplus on invisibles was some £750 million a month in the third quarter of this year, with a still larger surplus likely in the fourth quarter, puts into perspective the advice confidently given to the Select Committee by one of its specialist advisers that the earlier projection of £600 million a month was 'particularly optimistic' "

It was, of course, the Treasury's forecast rather than the official £600 million a month estimate that this specialist adviser was challenging. As it turns out, the latest official guess is that invisibles are indeed running at £600 million a month. The Treasury has had to revise its 1986 number from £8½ billion to £7 billion (Table 6). It has, however, conceded only a £½ billion downward revision to the Autumn Statement projection of invisibles for 1987.

At the same time, the Treasury has raised by £1 billion its forecast deficit on the non-oil visible balance this year. Behind this revision lies a 1½ per cent point increase in the projected growth in import volume (to 8 per cent non-oil, excluding erratics) and a smaller ½ per cent point increase in the projected growth in the volume of exports (to 6 per cent). The non-oil terms of trade are now shown to improve by ½ per cent rather than to deteriorate by ½ per cent.

This worsening in the relationship between export and import volumes, non-oil, is explained by a downward revision to the Treasury's forecast of world trade growth and by the higher assumed level of sterling. The slightly encouraging trade figures for January and February suggest that the Treasury may have been overcautious on its visibles forecast so balancing the risks taken with the invisibles number. It would be churlish to quibble with the Treasury's overall current account forecast for this year and next especially in the light of an average forecast error for the year ahead of £3 billion! The persistence of the deficits is a worrying feature of the forecast.

The other worrying feature is the weakness of investment. In last year's Budget, the Treasury forecast a rise in business investment of 5 per cent in 1986. The provisional outturn was a fall of 3 per cent. North Sea investment fell because of the collapse in oil prices. But non-oil investment was also weak. In manufacturing and services, it fell 2 per cent. It is not known what proportion of this decline is due to the Chancellor's 1984 reform of the corporation tax system. The final stages of the transition to lower capital allowances and a lower corporate tax rate were achieved last year. It is possible that some investment was brought forward to benefit from the comparatively favourable tax treatment available in 1985. This forestalling would have depressed artificially the 1986 investment figure.

It is all too likely, however, that the same reforms which scooped the Chancellor lots of company tax revenue, which went to finance cuts in personal tax, have also knocked industrial investment for a six. On our calculations, the effect of the new corporate tax system as compared with the old is to add the equivalent of 1½–2 percentage points to the hurdle rate of return which investment projects have to earn

to be worth undertaking. This is a stiff increase and on some estimates of the relevant elasticities would easily account for the slump in investment last year.

For 1987, as for 1986, the Treasury is basing its investment forecast heavily on the DTI investment intentions survey. Last year, the survey pointed to a 1 per cent rise in manufacturing and service investment; this year, it suggests a 6 per cent rise. Such optimism could be easily overturned if the Chancellor does revert to a firm sterling strategy, thereby confounding expectations which were prevalent at the time of the December survey.

A further year of low investment would be unwelcome. The growth in the economy's capital stock has probably fallen since 1979 to around 2 per cent pa, significantly below the previous trend (Table 7). In manufacturing, the slowdown is more marked even though official statistics probably under-record the scrapping of equipment in the 1980–81 recession. A crude adjustment for under–recording suggests a fall not a rise in manufacturers' capital stock over the period.

TABLE 7

GROWTH OF CAPITAL STOCK* per cent pa

	1951–73	*1973–79*	*1979–86*
Whole economy	3.3	2.9	2.1
Manufacturing	3.5	2.5	1.0 (−3.3)

*gross capital stock at 1980 prices. The figure in brackets shows the effect of adjusting the manufacturing capital stock figure so that it is in keeping with the evidence of capacity utilisation given in CBI surveys. Official statistics on capital stock are not particularly reliable.

The concern is that the economy is suffering from a deficiency of physical investment. If so, it will take many years to put right. The impact of investment on the capital stock in any one year is pretty trivial. Even if manufacturing investment had risen by 100 per cent last year, the capital stock would have been only 4 per cent higher. The Treasury hopes that higher profits will do the trick eventually. In the context of its forecast of wider manufacturing profit margins, it argues: "In the longer run the higher level of profitability should lead to more investment, greater capacity, higher productivity, and hence lower inflationary pressure".

This exceptionally important argument receives not a trace of supporting evidence in the Red Book. If the Treasury now believes that cash flow determines investment it is hardly consistent with its traditional belief in the efficiency of capital markets. In any case, the evidence suggests that profits and investment have parted company in recent years. As the second graph shows, profits in manufacturing have risen sharply against their previous downward trend while investment has fallen sharply against its previous upward trend.

This disparity between profits and investment is precisely what one would expect in an economy where the real level of interest rates is held persistently well above the economy's growth rate. In these circumstances, businesses aim to squeeze higher profits out of a falling, or more slowly growing, capital stock. To an extent, this could lead to a welcome improvement in the efficiency of investment decisions. But the clear danger is that growth itself will be stunted in the longer term by the cutting out of innovative investment programmes. The Treasury's virtuous circle linking extra investment with lower inflationary pressure would become a vicious spiral.

Tax objectives

In summary, we find that the Chancellor has exercised welcome caution in cutting his PSBR target; that there is however evidence of upward inflationary pressure; that this pressure stems from a pro- cyclical easing of policy; that there is nevertheless a good case for lower interest rates and lower sterling; that, in the long run, this combination might improve the economy's supply performance and reduce inflationary pressure but that, in the short run and in current circumstances, it will undoubtedly increase it.

The conclusion we reach is that the reduction in the PSBR, welcome and large though it is, has not gone far enough. Some commentators have argued that the PSBR is now at its long run desired level: at 1 per cent of GDP it happens to be consistent with a stable public debt to GDP ratio if inflation is nil and growth is 2 per cent pa. We find "stable debtist" rules particularly unhelpful. Apart from problems of measurement it is well-nigh impossible to calculate the magic number for the desired debt ratio. We would want to argue that with real interest rates at 6 per cent and economic growth on the Treasury's medium term projections at only 2½ per cent the current debt to GDP ratio is far too high. This, however, is not a fruitful line of discussion. More revealing is the simple point that if the Chancellor wants to raise the level of investment by cutting real interest rates, he must at the same time tighten his budgetary stance in order to keep money GDP growth on target.

Can the Chancellor reduce the PSBR target further and stick to his commitment to reduce income tax rates? The answer is: no one really knows. In past Treasury forecasts, the average error in the PSBR projection for just the year ahead has been a cool £5 billion—in excess of the current target. Matters have

not improved this year. As we argued in our submission on the 1986 Autumn Statement, the risk of a substantial overshoot on public expenditure in 1988 has not fallen despite the apparent generosity of the latest plans.

In addition, the Treasury forecast of non-oil tax receipts can be little more than a shot in the dark. The forecast starts from a poorly understood and poorly estimated base figure for 1986. On the Treasury's estimates, non-oil receipts including interest and dividends were some £4 billion higher in 1986 than projected in last year's Budget. But nearly £1½ billion of this underestimate is attributed to a miscellaneous tax category ("other" in Table 1.2 of the Red Book) which includes a balancing item for statistical error! (Table 8).

Another £1¾ billion of the underestimate is put down to non-oil corporation taxes. One reason for this surge could simply be late payment of corporation tax which would normally have been paid in 1985. Another reason is that the Chancellor's 1984 reforms have had the effect of widening the tax base. Previously tax exhausted companies lost their allowances and were drawn into the tax net. This could help to explain why the rise in non-oil corporation tax payments in 1986 of over 40 per cent greatly exceeded the relevant growth in company profits. (Fiscal 1986 tax payments largely reflect profits made in calendar 1985). The big unknown is whether this gain from a wider tax base has now run its course.

TABLE 8

SOURCES OF EXTRA TAX IN 1986 £ BILLION

Non-oil taxes	+3.1	Oil taxes	−1.3
of which:		Interest etc	−0.6
non-oil corp. tax	+1.8	Trading surp. etc	+0.3
VAT	+0.8	Other	+1.3
Stamp duty	+0.4	Total	+2.8

All this leaves the Treasury tax forecasters in an unenviable position. The Chancellor is reported to have described the official PSBR forecast at the time of the Autumn Statement as "completely ridiculous" and his forecasters as "up the pole". If true, it is conceivable that blushing officials have felt bound to add a face-saving safety margin for Lawson's Luck to their latest forecasts. What they have assumed in effect is that the source of windfall tax gain in 1986—whatever it was—bestows a similar bounty on the Chancellor in 1987. With the Budget tax cuts stripped out, the Treasury's numbers for 1987 indicate around a 9½ per cent rise in non-oil tax take including national insurance. This exceeds the growth in non-oil money GDP (growing by 7½ per cent in 1987) by a margin similar to that estimated for 1986.

In later years, however, non-oil taxes are probably rising no faster than non-oil GDP on the Treasury's computer. This is quite a conservative assumption. The tax system, being slightly progressive when considered as a whole, will usually produce a rise in tax revenues somewhat in excess of the rise in incomes and expenditure. Consequently for any given structure of tax rates, the share of tax in income will tend to rise. Table 9 illustrates the point by showing what the non-oil tax burden would have been given the tax rates prevailing in 1981.

TABLE 9

NON-OIL TAX BURDEN

Non-oil taxes as per cent of non-oil GDP

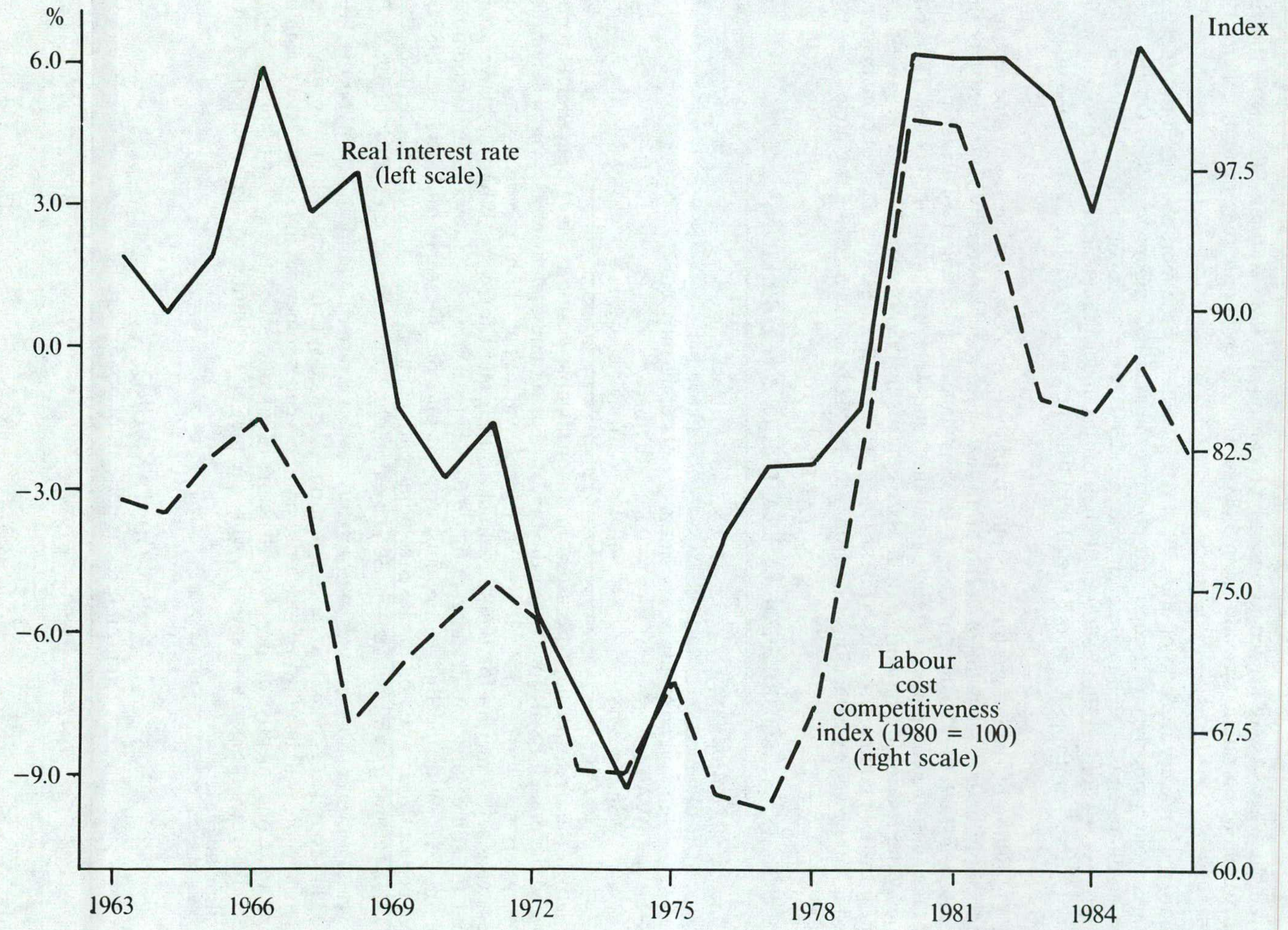
FY	*1982*	*1983*	*1984*	*1985*	*1986*	*1987f*	*1988f*	*1989f*
Unadjusted	38.4	37.9	37.8	37.2	37.7	37.8	37.8	37.7
Adjusted	38.8	39.2	39.4	39.2	39.9	40.6	40.5	40.3

f: our estimate of Budget Forecast.
The adjusted figures show our estimates of the non-oil tax burden given a constant 1981–82 tax structure.

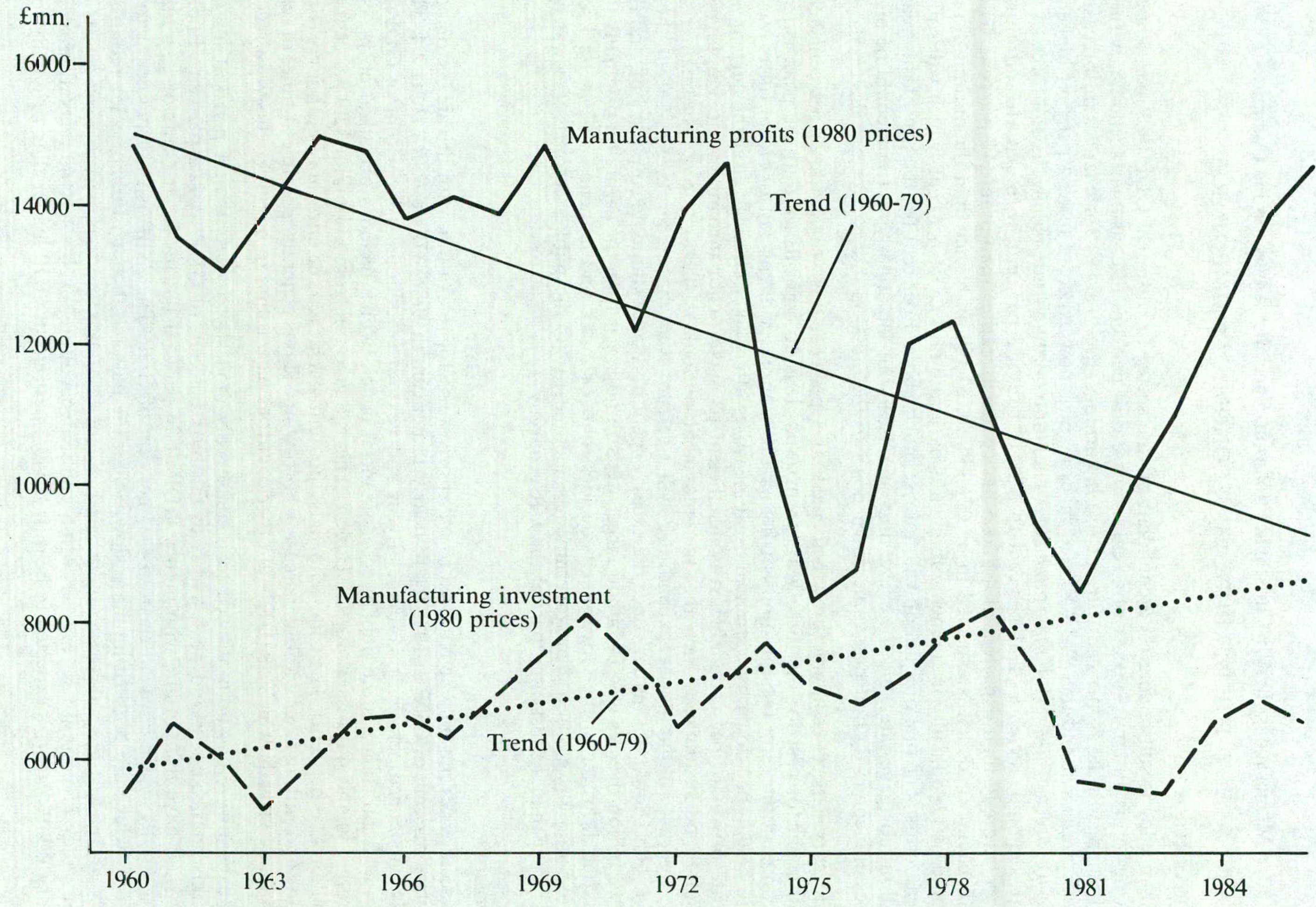
For 1988 and 1989, then, the forecast may be trying to err on the side of caution to disguise the size of the fiscal adjustment. In 1987, however, the forecast assumes a repeat performance of 1986. If that proves incorrect, revenues in 1987 will undershoot. The 1988 forecast will then appear reasonable rather than cautious. If public expenditure does explode at that time, the Chancellor will be in difficulty with his sums.

The conclusion is that the Chancellor should soft peddle on his commitment to cut tax rates. If his luck holds, tax cuts will be affordable. Economic strategy needs firmer foundations however. The long-term objective of policy should be to reduce the PSBR as a proportion of GDP—even if this means running surpluses on this measure—until real interest rates fall more in line with the economy's productive potential. PSBR cuts, not tax cuts—that's the message for the next version of the MTFS.

Real Interest Rates & Competitiveness



Manufacturing Profits and Investment



APPENDIX 3

Memorandum by Mr Christopher Johnson, Specialist Adviser to the Committee

THE 1987 BUDGET—ECONOMIC COMMENTARY

ECONOMIC OUTLOOK

The Chancellor is still relying on a confident private sector to raise real GDP by 3 per cent this year, and sticking to his autumn forecast of a real increase of 4 per cent in consumer spending, with probably not much change in the 7½ per cent current rise in earnings. (See Table 1 for changes in forecast between the *Autumn Statement* and the *FSBR*.) Fixed investment is now expected to be 4 per cent higher (only 2½ per cent was forecast in the *Autumn Statement*). The unfavourable trade balance is still forecast to reduce a domestic demand increase of 3½ per cent to a GDP rise of 3 per cent, with exports and imports both rising more strongly than expected, at 4 and 6 per cent real, rather than 3 and 4½ per cent. The current balance of payments deficit is expected to be £2½ billion, £1 billion higher than the autumn forecast, but there should be no difficulty in financing it, even if base rate falls to 9½ per cent, which will still be 5 per cent in real terms. The rate of inflation will not rise much above 4 per cent for the rest of this year, thanks to the fall in mortgage rates and the excise duty standstill, but the underlying trend could be higher than this if rises in incomes do not soon come down closer to the inflation rate.

The Treasury expects economic growth to peak at 3 per cent this year, with 2½ per cent achieved in 1986, and again forecast for the three years from 1988. It is no coincidence that the peak is forecast to occur in an election year. The question is whether the economy will run out of steam of its own accord, or have to be damped down by restrictive fiscal measures after the election. Even if the current 3 per cent growth rate proves to be sustainable, it is insufficient to make major inroads into unemployment. If it proves not to be sustainable, then the unemployment outlook is bleak indeed. The main risk to the Treasury forecast is that public expenditure will overrun even the higher targets set in the *Autumn Statement*. This should not matter, since the excess expenditure may stimulate employment, and the PSBR could be £3 billion over its new £4 billion target, yet still no larger than the £7 billion originally projected. It will matter, however, if the Government decides that it should, and launches a new attack on public expenditure after the election. The government sometimes treats the public sector as if it was an enemy country, rather than a substantial part of the UK economy.

FISCAL POLICY

Public sector restraint may be required to offset private sector relaxation, with private sector borrowing rising from 9 per cent of GDP in 1985–86 to nearly 11 per cent in 1986–87, see *FSBR* chart 2.4. The PSBR is roughly unchanged between this financial year and next, at £4 billion, or 1 per cent of GDP. A better indication of fiscal stance is the public sector financial deficit, which includes privatization proceeds and excludes other financial transactions, see Table 2. This is due to fall from £11 billion (2.9 per cent of GDP) to £9.4 billion (2.3 per cent). The Chancellor has apparently achieved the miracle of both increasing public expenditure and cutting taxes without increasing borrowing. This is generally possible at times of reasonably rapid economic growth, which the UK and other countries have found to be rather elusive in recent years.

Public expenditure has been allowed to increase only modestly, by less than 1 per cent in real terms between this financial year and next, and is to fall by 1 per cent of GDP to 42.2 per cent. Public sector receipts would have risen in line with money GDP at 7½ per cent but for the tax cuts of £2.6 billion (0.6 per cent of GDP), which have cut them to 41.3 per cent of GDP. The PSBR is the 1 per cent gap between two amounts which are both rising more slowly than the national income. Public sector receipts for this financial year and last have also risen by over 1 per cent of GDP more than was forecast a year ago, due to the buoyancy of non-oil tax revenue, while public expenditure, even after the relaxation of policy in the January White Paper, is expected to be only 0.3–0.4 per cent of GDP higher than originally forecast.

MONETARY POLICY

This has for some time taken a back seat, with fiscal policy in the driving seat. The target for M0 (notes, coin etc) is still 2–6 per cent, but means little. The target for sterling M3 has been abolished, which is equivalent to letting the banking system get on with the process of credit creation while the public sector clamps down. The exchange rate is left to the mercy of the market—which is a buyer of the pound for the time being—with no hint of EMS membership, but a promise to repeal the dormant exchange control legislation, presumably so as to prevent a future Labour government from using it. This will help to avoid a sudden rush for the exit by holders of sterling during an election campaign in the event of doubts about the re-election of the present government.

The *FSBR* (2.10) says that "the MTFS projections assume that there is no major change in either the sterling exchange rate index or the sterling/dollar exchange rate from year to year". It seems to rely on the Louvre agreement on exchange rates in February bringing about stability in both the pound/dollar and, by implication, the dollar/DM rate for rather longer than most independent forecasters would expect. If, as seems more likely, sterling and the dollar resume their falling trend against the DM this year, and sterling weakens even against the dollar next year, the Treasury's "assumption" will be called into question. However, it is only an assumption, and not the expression of a policy intention, and in any case a fall of

up to 5 per cent on the sterling index, from 72.3 to 68.6, could be regarded as not being "major". The rising balance of payments deficit may well be held by the government of the day to require some further fall in sterling after the middle of this year. If it was right, as Mr Lawson has said, for the pound to fall in response to the drop in the price of North Sea oil—and to recover slightly as the price firms up—is it not equally right for the pound to fall in response to the inevitable decline in the output of North Sea oil, and the net export surplus, over the next decade?

The Chancellor is faced with an unfamiliar problem in monetary policy. If the pound threatens to rise to the point of making British industry uncompetitive—say to over $1.70 or DM3—then the classic response will be to cut interest rates until the differential between UK and US rates no longer contains a sufficient risk premium to make the higher return on sterling attractive. However, falling money market rates may be accompanied—if to a lesser extent on account of rising inflation prospects—by falling gilt-edged yields, and a rise in both gilt-edged and equity prices. This could attract further "hot money" into London, at least until financial markets feel that the bottom of the UK interest rate cycle has been reached, and the pound might continue to rise. Meanwhile, interest rates could fall lower than the Chancellor feels that they are required to be in order to restrain the growth of private sector credit.

Such a dilemma could and should be resolved by the UK joining the EMS exchange rate mechanism. This would at least prevent destabilizing movements in the pound, up or down, which are so unsettling for exporters. Interest rates might still be rather volatile, having to fall inside as outside the EMS, in order to prevent the pound rising too far. At least their average level would be likely to be lower inside than outside the EMS.

TAXATION

The 2p cut in income tax at a cost of £2.2 billion gives the maximum benefit to those on middle incomes. There is no increase of the main personal allowances above indexation for inflation, which would have given more help to lower income earners. Most of the higher rate bands have been left unindexed. Far from promising cuts in higher tax rates, the Chancellor has given top people a slap on the wrist to mark his displeasure at recent high salary increases.

The green paper on *Profit Related Pay* is to be implemented, with 50 per cent income tax relief for up to 20 per cent or £3,000 of annual pay—which could mean the equivalent of up to an extra 4p off the basic rate. Employers may however find the qualifying conditions for these schemes too onerous to be worth it. In particular, the need to audit the profits of separate operating units has been objected to. A number of companies already have some kind of performance related remuneration structure—most existing types will not qualify for tax relief—and would not wish to disturb it in favour of a new and possibly incompatible concept.

The reduction of the basic rate to 25p remains the Chancellor's goal, but it is still not clear what economic purpose it will serve. There is little support, even in the study commissioned by the Treasury, for the supply-side theory that income tax cuts have a major effect on work incentives. Such effects occur only if there is an increase in the demand for labour, according to the study, *Taxation and Family Labour Supply in Great Britain*, by C V Brown and others (Department of Economics, University of Stirling), which is summarised in the March 1987 issue of *Lloyds Bank Economic Bulletin*.

The reduction of income tax has also been shown by the Treasury model to be the least efficient way of reducing unemployment. According to the Warwick University Parliamentary Unit, the net PSBR cost per job created, averaged over three years, is £46,900 for a cut in the income tax rate, compared with £8,500 for an increase in current public expenditure. The figures are 50 per cent higher for each person no longer unemployed, because only two-thirds of the extra jobs are reckoned to be filled by those on unemployment benefit, and thus officially counted as unemployed. (Other models give broadly the same result.) However, this is not a valid criticism of the Chancellor's income tax cuts if, as may be suspected, their main object was not to reduce unemployment but to gain re-election.

The non-indexation of the excise duties at a cost of £540 million does little except take 0.3 per cent off the Retail Price Index. It comes oddly from a government which believes in taxing expenditure rather than income. Any idea of discouraging smoking and drinking to save costs to the hard pressed National Health Service has been forgotten. There are a number of minor changes to ease the tax burden on small businesses, and a £300 million increase in VAT by a change in partially exempt status, which will hit the financial sector.

The banks will also be affected by the restriction on the use of tax credits on interest received from foreign borrowers. This will reduce the effective spread which they receive on "tax-sparing" loans to developing countries, and make such lending less attractive to the banks. It is ironical that the Treasury should thus withdraw some of the tax incentive which it now gives the banks to continue lending to developing countries, just at a moment when governments are under pressure to take on more of the burden of Third World finance from the private sector.

Economics Department,
Lloyds Bank
23rd *March* 1987

TABLE 1

CHANGES IN THE TREASURY FORECAST FOR 1987

Percentages

	Autumn Statement 1986	*FSBR 1987–88*	*Difference*
Domestic demand	3½	3½	
Consumers' expenditure	4	4	—
General government consumption	1½	1	−½
Fixed investment	2½	4	+1½
Change in stocks (% of GDP)	½	½	—
Exports of goods and services	3	4	+1
Imports of goods and services	4½	6	+1½
Gross domestic product	3	3	—
Retail prices to Q.4	3¾	4	+¼
GDP deflator 1987/88	3¾	4½	+¾
Money GDP at market prices 1987/88	7	7½	+½
Balance of payments c/a £bn	−1½	−2½	−1

TABLE 2

THE FISCAL STANCE

Percentages of GDP

	FSBR 1986			*FSBR 1987*		
	1986/87	*1987/88*	*Change between years*	*1986/87*	*1987/88* *(Change over previous FSBR)*	*Change between years*
1. General government expenditure	42.9	41.8	−1.1	43.2 (+0.3)	42.2 (+0.4)	−1.0
2. Taxation and national insurance	37.7	37.3	−0.4	38.2 (+0.5)	38.0 (+0.7)	−0.2
3. Other receipts inc. public corporation repayments	3.3	2.8	−0.5	3.9 (+0.6)	3.3 (+0.5)	−0.6
4. Public sector receipts	41.0	40.1	−0.9	42.1 (+1.1)	41.3 (+1.2)	−1.1
5. Public sector borrowing requirement	1.9	1.7	−0.2	1.1 (−0.8)	0.9 (−0.8)	−0.2
6. Financial transactions	2.3	n.a.		1.9 (−0.4)	1.4	−0.5
7. Public sector financial deficit	3.2	n.a.		2.9 (0.3)	2.3	−0.7

TABLE 3

REAL GDP PER PERSON EMPLOYED
1970–1986

Annual % change	
UK	2.0
USA	0.7
Japan	3.7
Canada	1.1
Switzerland	1 4
Germany	2.6
France	2.7
Italy	2.2
Belgium	2.5
Denmark	1.3
Ireland	3.1
Netherland	2.0
OECD	2.0
EEC	2.5

APPENDIX 4

Memorandum by Mr Gavyn Davies, Specialist Adviser to the Committee

THE GOVERNMENT'S ECONOMIC STRATEGY AFTER THE 1987 BUDGET

SUMMARY

This paper argues the following:

1. The behaviour of the real economy last year was generally less favourable than expected at the time of the 1986 Budget. Real GDP growth was a little lower than expected, and would have fallen much further short of expectations without a surge in private borrowing. Investment and exports performed much less well than expected. This pattern of demand resulted in a £4½ billion deterioration in the balance of payments, as compared to the Treasury forecast.

2. The situation was transformed by the 10 per cent devaluation in sterling last autumn. Without this event—which was specifically *not* part of the 1986 Budget strategy—the economy could have faltered on a major balance of payments crisis. Furthermore, the fiscal position was transformed by an increase in the tax-paying propensity of the non-oil economy which was also totally unexpected.

3. Neither of these key ingredients can be said to have been part of the 1986 Budget strategy. But neither were they attributable entirely to luck. In particular, the exchange rate response represented a sensible and flexible reaction to a fundamental worsening in balance of payments prospects. Such pragmatism has been a frequent and welcome feature of the Lawson Chancellorship.

4. The response of the company sector to improved competitiveness has been quicker and larger than past experience had suggested was likely. This should produce real GDP growth in line with the Treasury's forecast of 3 per cent this year, and the pattern of demand components will be healthier than last year. But there is a problem on inflation prospects. Trend unit labour costs are still rising much too fast (5 per cent pa) despite the fact that the government is temporarily turning a blind eye to this. The situation is much worse in the whole economy than it is in the manufacturing sector, which is benefiting from cyclical productivity gains. No medium-term drop in inflation is included in the Budget documents, and the rise in the rate of increase in the GDP deflator this year is out of line with behaviour in other economies. (Unit labour costs are rising twice as fast in the UK economy as in the average for the major seven.)

5. Possibly in response to this, the authorities seem recently to have shifted their stance in favour of a firmer exchange rate than desired last autumn. But therein lies a tension in the government's strategy. If a robust exchange rate is to be used to disinflate the economy over the medium-term, and to insert greater discipline into pay bargaining, it is hard to see how balance of payments problems are to be avoided *at present (or higher) rates of economic growth*. The same instrument (sterling) cannot be used to cure two different ills (inflation and the balance of payments) simultaneously.

6. The missing element in the strategy is any mechanism (apart from the long-term encouragement for profit-related pay) for controlling nominal pay. If this is considered impossible or undesirable, then there is not much alternative to the government's cautious approach to fiscal policy in the coming year. (The fiscal stance will be broadly neutral on most measures.) But under these conditions, unemployment is unlikely to fall *significantly*, at least before labour force growth levels off late in the decade.

7. Even within this second-best world, the decision to use all the scope for fiscal adjustment on income tax cuts looks inappropriate. The economic arguments in favour of extra spending on public investment or special jobs schemes, rather than income tax cuts, are now well known. Although the government argues that public spending was increased last autumn, and that the Budget income tax cuts form part of a balanced overall approach to macro-policy, the extent of any genuine increase in the public provision of real services is very limited. Most of the rise will probably be absorbed by the relative price effect.

8. Although expenditure increases may have been ruled out on semi-political grounds, the decision to opt for income tax cuts rather than reductions in *employers' national insurance contributions* seems unwise. The latter alternative would have directly reduced labour costs (the key problem area at present) and would have alleviated the balance of payments/inflation conundrum mentioned earlier. Furthermore, it is possible to structure NIC reductions such that they impact on a regional basis, offering an employment subsidy where it is most needed. *At present, these advantages over income tax cuts seem decisive.*

9. On the medium-term financial strategy, two points are clear. The first is that there has been yet another shift towards *exchange rate targeting*. This increases the importance of the choice between EMS membership and the informal target zone system in place since the G6 meeting in Paris. On balance, and despite the beneficial "announcement effects" associated with EMS membership, the current more flexible system seems preferable (see pp 11–12). Finally, the implications of the latest version of the MTFS for the *public sector's net worth* are less damaging than before. For the first time, *privatisation proceeds* are being used mainly to retire public debt, rather than to finance government spending or tax reductions (see pp 18–19).

31 *March* 1987

The Recent Behaviour of the UK Economy

It is now widely agreed that the British economy is likely to enjoy a period of output growth in 1987 which is considerably above that being achieved by the EEC as a whole. Since this is an unusual state of affairs, it is useful to start by reflecting on the circumstances which have brought it about. In particular, it is interesting to examine the suggestions that the recent excellent behaviour of the economy has owed rather more to good luck than to good economic management.

The 1986 Out-turn

In the Treasury forecast published at the time of the 1986 Budget, growth in real GDP of about 3 per cent was predicted for 1986. We now know that the outturn figure, based on the initial estimate for the 1986 calendar year, was around 2½ per cent. So the Treasury was only marginally too optimistic overall. However, the *composition* of growth was very different from that expected by the Treasury. For example, gross fixed investment was predicted to increase by 5 per cent in 1986, but the actual outturn was only 0.6 per cent; and exports of goods and services were predicted to rise by 5 per cent, compared to an outturn figure of 3 per cent. Shortfalls in these categories of demand were somewhat compensated by consumers' expenditure, which increased by 4.7 per cent, as against the 4 per cent prediction in the 1986 Budget.

The real economy was therefore slightly less buoyant than expected by the Treasury, and was much less dependent on investment and export growth, than officials believed likely. All of the excess consumption growth seems to have been due to a lower savings ratio than the Treasury expected—real disposable income increased by about 4½ per cent, compared with the 5 per cent forecast at the time of the last Budget. Instead of rising slightly, as the Treasury believed likely, the savings ratio declined by some 0.4 per cent in calendar 1986, and this explained the faster than expected increase in consumers' expenditure, despite lower real disposable income growth. The key reason for the fall in savings appears to have been the continuing rapid increase in consumer borrowing, which allowed the personal sector to extend its purchases of durable goods by 11 per cent in 1986. This factor prevented a serious shortfall from developing in real GDP, compared to the official projection.

As noted, by far the most disturbing difference between forecast and outturn last year concerned fixed investment, especially by the business sector. This fell in real terms by 3 per cent during 1986, compared to a Treasury forecast of 5 per cent growth. But the underperformance in exports was also serious, and it partially explained the current account deficit of £1 billion which actually emerged, compared with a 1986 Budget forecast of a £3½ billion *surplus*. Overall, therefore, the pattern of growth last year was much less healthy than the Treasury expected, leading to the emergence of a *potentially* serious balance of payments problem, and a greater reliance than anticipated on the extension of private borrowing to support the economy.

The 1986 Debate on Policy

What light does this shed on the debate about economic policy which occurred at Budget time last year? At that stage, many outside forecasters (including myself) were more concerned than the Treasury about the slow-down in real activity which appeared to be taking place, and virtually all the outside forecasts at the time of the last Budget were much more pessimistic than the Treasury about the outlook for both investment and exports. In my 1986 Budget Memorandum to the Treasury Committee, I argued that economic performance was being dominated by the complex lagged response to lower oil prices, and that in these circumstances the Chancellor might have increased the public sector financial deficit (PSFD) by rather more than the £3 billion he announced in the Budget. (This increase was, of course, disguised by £3 billion of extra asset sales, which left the PSBR target unchanged; the argument in favour of a higher PSFD was based on the drop in the permanent oil tax income to be expected on the oil prices then prevailing.) I also criticised the government for downgrading its monetary targets without replacing them by an effective inflation back-stop, such as a unit cost target; and argued that real interest rates would need to remain very high because the markets would demand a risk premium for investing in UK assets under these circumstances. Finally, I said that output growth would remain reasonably healthy, at around 2–3 per cent pa in 1986 and 1987, despite an unhelpful policy background. The reason for this was the combination of lower oil prices boosting consumers' expenditure, and lower sterling working through to increase exports and investment, albeit with quite long lags.

In the event, the behaviour of the economy last year was basically supportive of those who had been cautious on prospects for output growth (and especially its investment and export components)—until an unexpected event took place last autumn. This event was the sharp slide in the sterling index in response to a clear deterioration in the UK's balance of payments prospects. Last spring, virtually none of the major forecasters expected a balance of payments deficit to emerge in 1986. As it became clear in August and September that such a deficit was quite likely, sterling adjusted downwards by some 10 per cent. As a result of this change in sterling, which took the exchange rate to levels which were temporarily about 10 per cent below those expected in the 1986 official Budget forecast, the near-term prospects for the economy were transformed. The volume of manufactured exports responded particularly quickly, rising by some 6 per cent between 1986 Q.3 and Q.4, despite the fact that UK exports markets grew by only around 1 per cent over the same period.

By the time of the Autumn Statement, the Chancellor was able to assert that the downward adjustment which had then taken place in sterling (to an effective exchange rate of around 67–68) was sufficient to eliminate over the medium-term the balance of payments losses from lower oil prices. He therefore expressed a desire to prevent the exchange rate from falling any further. He was also able to publish an economic forecast for 1987 which was reliant on export growth (3 per cent) and fixed investment ($2\frac{1}{2}$ per cent) to produce 3 per cent growth in real GDP. (Consumers' expenditure was expected to grow more slowly than in 1986, but still to expand by 4 per cent.) Most forecasters by this time agreed with the Treasury view that 3 per cent real GDP growth was possible in 1987, but argued that the balance of payments deficit would be worse than the £$1\frac{1}{2}$ billion then projected by officials, and that price inflation would tend to be somewhat higher. But the main point to note is that it was the drop in the exchange rate between the Budget and the Autumn Statement—which was specifically *not* expected at the time of the Budget—which prevented a much larger balance of payments problem from emerging, and which enabled the Treasury to hold out prospects of 3 per cent real GDP growth in 1987, despite an unpromising world trade picture.

The Autumn Statement

It is impossible to end this review of the recent past without discussing the other main element in the Autumn Statement, ie the large increase in public expenditure then announced. I was supportive of this decision at the time, arguing in my Memorandum to the Treasury Committee that the substitution of extra public spending for tax cuts seemed sensible. Although the Chancellor seems to have got the idea that specialist advisers to the Treasury Committee were uniformly critical of his strategy, my Memorandum in fact argued that:

> "The decision to substitute public spending for extra tax cuts within a fixed borrowing target seems sensible. There is no economic case for further fuelling consumer spending (and imports) at present. Public spending can have larger benefits to employment in the short-term, with a lower import content, than the spending generated by tax cuts. However, it is possible that the *composition* of spending proposed by the Chancellor has too large an element of public sector pay relative to help for the unemployed and capital spending. The Chancellor intends the fiscal stance next year to be approximately neutral. Anything more stimulative would not appear justified, given the outlook for inflation, unit costs and money GDP."

A Serious Error on the 1986–87 PSBR

All of this seems to be entirely valid, but my Memorandum then went on to make a serious error, arguing that the PSBR targets for 1987–88 (then £7 billion) could come under strain as further buoyancy in public spending in a pre-election period occurred. This made no allowance for the sudden surge in non-oil revenues which took place at the tail-end of the 1986–87 financial year, and which was not expected by any of the major forecasters. As the Chancellor has himself pointed out in a post-Budget on-the-record press briefing (see, for example, the "Financial Times" on 19 March), the Treasury forecasters themselves believed as recently as last Autumn that an *overshoot* relative to the 1986–87 PSBR target of £7 billion would probably occur. We now know that a sudden surge of non-oil revenue made this view much too pessimistic. The three main sources of additional tax buoyancy are well recognised: around £1.8 billion came from non-oil corporation tax; around £0.8 billion from VAT; and about £0.5 billion from stamp duties. The dominant factor was therefore extra corporation tax, which stemmed mainly from an increase in the effective rate of tax on the company sector as investment allowances became less generous, and as the number of tax-exhausted companies diminished. On VAT, the main source of buoyancy appears to have been the *composition* of consumer spending, which shifted towards taxed goods, rather than its absolute *level*.

Summary

In summary, the following main points emerge from this review of the last 12 months. First, the Treasury was somewhat too optimistic about the rate of GDP growth in 1986, and was much too optimistic about investment and exports. The economy was saved from a much more serious shortfall in output by a drop in the savings ratio linked to high consumer borrowing. But the main factor which transformed prospects for 1987 was the drop in the exchange rate, which was entirely unexpected by the Treasury at the time of the 1986 Budget. Without this, the strategy could have faltered on the rock of a major balance of payments crisis. This drop in the exchange rate, and the government's willingness to acquiesce in rapid rates of growth of private borrowing, were much more important to the outlook for the economy than the small changes in the fiscal stance which were taking place (see below). The fiscal position itself was transformed by a sudden surge in non-oil tax revenues which was totally unexpected by either the Treasury or any other important outside forecaster. It was the combination of a competitive currency with unexpected non-oil revenue buoyancy which left the Chancellor, and the economy, in today's relatively happy position. *Neither of these key ingredients can be said to have been part of the 1986 Budget strategy.* But nor were they attributable entirely to luck. In particular, the exchange rate strategy represented a sensible and flexible reaction to a fundamental change in balance of payments prospects. Such pragmatism has of course been a frequent and welcome feature of the Lawson Chancellorship.

THE PRESENT STRATEGY

Leaning Towards a Firmer Currency?

The government's strategy still seems to be based on maintaining an exchange rate which is sufficiently competitive to offset the medium-term impact on the economy of declining oil production and prices. In the Budget documents, the Treasury assumes that the exchange rate will show "no major change from year to year" and, since the Budget, the Chancellor has said that he would like to see sterling staying "round about where it is now". This presumably means a rate of around 72–73 on the sterling index—a level which the Governor of the Bank of England has also suggested is satisfactory. If this interpretation is correct, then the Treasury would appear to be steering the exchange rate, insofar as it can, towards the top end of the unpublished range (of about 67–73) which many people assumed had been set after the G6 Meeting in Paris on 22 February. The cautious approach to interest rate reductions which has been in evidence throughout the last few weeks also supports this view. *But the resulting exchange rate of around 72–73 is considerably higher than that on which the Autumn Statement was based only three months ago.*

It seems probable that the Chancellor has decided to lean in the direction of a somewhat firmer currency because he believes that the domestic economy is, if anything, more robust than was assumed last November, and that inflation risks are commensurately greater. (These inflation risks may be partly connected to the rise in oil prices over the last six months. Certainly, the Bank of England seems to believe that the appropriate target for sterling should be related to significant oil price changes, for both balance of payments and inflation reasons.) Although the official retail price forecast for the end of this year shows very little change compared with the Autumn Statement prediction, there has been an increase of around 0.5 per cent pa in the entire medium-term inflation path since the 1986 Budget. This has occurred despite the fact that the Treasury seems to be assuming that average earnings increases will decline this year—rather against the evidence now emerging from the manufacturing and services sector. Given the fact that there seems to be very little allowance made for mortgage rate reductions in the Treasury's inflation forecast, it is quite possible that the *1987* path for retail price inflation will be at or below the Budget forecast. But lower interest rates are not likely to have any beneficial impact on trend *medium-term* inflation. This will be set by the trend rate of increase in unit labour costs across the whole economy.

Unit Labour Costs Still Too High

Here the Budget documentation appears to be particularly lop-sided. It emphasises the recent improvement in unit labour cost increases in the manufacturing sector, without mentioning that cyclical factors are at least partly responsible for this, and without comparing manufacturing with the rest of the economy. It is true that, in manufacturing, unit labour costs during 1987 may rise by only 1½–2 per cent, at least in the first half of the year, and that this is roughly in line with the average for the major industrial countries. However, as Sir Terence Burns pointed out in evidence to the Select Committee last autumn, this improvement in manufacturing labour costs (from an increase of 5 per cent last year) owes much to the *cyclical* gains in productivity which are following the sudden boom in manufacturing output. These cyclical gains in productivity are most unlikely to be maintained. On a trend basis, manufacturing productivity is probably rising by (at best) 3.5 per cent pa, which means that trend unit labour costs in the manufacturing sector are rising at around 4 per cent pa. (This assumes that there will be no decline in average earnings increases from their recent 7½–8 per cent rate.) Furthermore, the manufacturing sector represents only around one-quarter of the whole economy, and outside this sector the situation is considerably less promising. *Trend* productivity growth for the whole economy is no higher than 2 per cent pa, while average earnings increases remain at 7½ per cent pa. Hence, trend unit labour costs are probably still rising at more than 5 per cent pa, which is roughly double the rate estimated by the OECD for the major seven economies as a whole.

Tension in the Government Strategy

It seems difficult to reconcile these trend unit labour cost increases for the whole economy with the downward path for inflation which the Treasury expects over the medium-term. This is perhaps why the Chancellor's recent statements have been consistent with a somewhat higher exchange rate (at 72–73, roughly 7 per cent higher) than the levels on which the Autumn Statement was based. But therein lies a potential tension in the government's strategy. If a robust exchange rate is to be used to disinflate the economy over the medium-term, and to insert greater discipline into pay bargaining, it is hard to see how continuing balance of payments problems are to be avoided at present rates of economic growth. Although it is very difficult to be precise about this, recent Treasury simulations (see for example C L Melliss, "HM Treasury Macroeconomic Model Manual 1986", Government Economic Service Working Paper No. 90) suggest that *a permanent change of around 7 per cent in the exchange rate may produce a deterioration of some £4–5 billion in the current account balance after three years.* If the Chancellor was right to argue that the Autumn Statement levels for the sterling index were consistent with current account equilibrium in the medium-term, then recent levels of 72–73 should—other things being equal—be consistent with a sizeable current account deficit.

Recent Trade Statistics

It is possible to argue that the encouraging balance of payments statistics for January and February have altered the situation in a more optimistic direction than is implied by these remarks. Certainly, the last five months taken together seem to indicate that export volume has responded far more impressively

to the drop in the real exchange rate than past experience would have indicated. (The level of exports since last October has been running 3–4 per cent above the level implied by our equation, which relates export deliveries to UK export markets and price competitiveness.) But two points should be remembered here. The first is that competitiveness has already deteriorated by some 6 per cent since the average for the fourth quarter of last year, and by some 8 per cent compared with the best levels attained in November. This could soon start to damage export prospects. The second point is that the economy is still operating at a level of unemployment which cannot be taken as satisfactory. Any boost to overall activity which led to a significant fall in unemployment would probably cause a serious balance of payments problem at present exchange rates, despite the recent encouraging monthly trade statistics.

What this means is that a decision to disinflate the economy via a firm nominal exchange rate will lead to a rising real exchange rate and this would not be consistent with medium-term balance of payments equilibrium at anything resembling full employment. All this simply points once again to the central importance of *controlling nominal pay increases*. Until the end of last year, government statements frequently re-emphasised the importance of this, but there was no sign of any development of direct measures to reduce pay pressures at any given level of unemployment, apart from the potentially-important (but long-term) introduction of incentives to introduce *profit-related pay schemes*.

More recently, there have been virtually no durable signs of any improvement in pay deals, but the government seems to have become more optimistic about the situation. Just why this is the case is a mystery. Unless nominal pay increases can be brought down while unemployment falls, exchange rate policy may consistently face the awkward choice between allowing inflation to rise on the one hand, and allowing the balance of payments to deteriorate on the other. This would be particularly acute if the UK's exports markets are further depressed by sluggish growth in European economies. Under such conditions, it is hard to see how a gradual return to higher levels of employment in the UK (after 1987) could be consistent with declining inflation and balance of payments equilibrium. EMS entry may provide an "announcement effect" which reduces pay deals and therefore alleviates this choice, but it is unlikely to disappear altogether on present policy.

EMS Versus Unpublished Zones for Currencies

The Precise Form of Target

Since government strategy is becoming ever-more dependent on exchange rate targeting, the precise form of the target used is an important question. At present, the authorities appear to have set an unpublished target band for the effective sterling exchange rate, though they are not willing to acknowledge this explicitly. The reason for this seems to be that they believe foreign exchange market intervention will be more successful if the markets are kept in the dark about the authorities' intervention limits. Such an arrangement would appear to have three main advantages. First, it allows for a certain amount of flexibility in setting the target range, and changing it without a major political loss of face. Second, the range can be applied to the effective exchange rate, rather than to a subset of it such as sterling's value against EMS currencies. Third, the absence of a formal set of intervention limits permits short-term deviations from the range without blowing the entire system apart.

However, the informality of the present system has one major disadvantage—it fails to take advantage of the favourable "announcement effects" of a formal arrangement. These effects may be important both in inserting extra discipline into pay bargaining, and in reassuring the company sector that they can draw up investment plans secure in the knowledge that recent competitiveness gains will not be entirely eroded. Entry into the EMS would score on both these grounds, and would also provide the UK with access to short-term borrowing facilities, and a guarantee of help from other central banks, if sterling came under pressure in any direction. So EMS entry would involve less flexibility than the present system, but it is possible to argue that this loss of flexibility would be rewarded with lower pay settlements, higher investment and—possibly—a lower average risk premium on UK interest rates. Despite these advantages, the case in favour of EMS entry over the present informal arrangement still does not seem to be watertight. If the UK had been inside the EMS over the past 18 months, it would almost certainly have been much more difficult to achieve the competitiveness gains which, it was argued earlier, have been responsible for the excellent performance of the real economy in recent months. As has occurred in the case of the French franc, it seems likely that EMS membership would have resulted in the pound sterling being dragged upwards against the dollar by a surging Deutschemark, and this would have had depressing consequences for the real economy very similar to those now being observed in France and Germany. The ability to avoid such consequences by targeting the effective exchange rate outside the EMS seems to retain an extra degree of freedom for UK policy makers which is, on occasions, extremely valuable.

Fiscal Policy

Few Changes to the Fiscal Dials

Compared to these strategic questions of how to manage sterling, the setting of fiscal policy is currently much less problematic. In fact, after all the sound and fury of the Budget has died down, it will be seen that the Chancellor has made relatively little change to the setting of his fiscal policy dials. The main features of the fiscal plans are summarised in Table 1. Assuming the government hits its targets, general

government expenditure will decline by around 0.6 per cent of GDP this year (compared with 1986–87), while general government revenue will fall by 0.5 per cent of GDP. Hence, the general government borrowing requirement and the PSBR will remain unchanged at 1.0 per cent of GDP. Allowing for privatisation receipts and other financial transactions, the public sector financial deficit will drop from 2.9 per cent of GDP to 2.3 per cent—roughly the same as the level attained in 1985–86.

Changes Since the 1986 Budget

Table 2 shows how these plans have emerged, emphasising changes since the 1986 Budget. The first two columns show the *levels* of government expenditure, revenue and borrowing, as planned in the 1986 and 1987 Budgets respectively. The third column shows changes in the *planned 1987–88 levels* between the two Budgets. Columns four and five show *changes* between 1986–87 and 1987–88, as planned in the 1986 and 1987 Budgets. Perhaps the easiest way to focus on what has happened is to concentrate on column three, which shows how plans for 1987–88 have altered over the last year. Essentially, the planning total for public expenditure has been increased by £5 billion, of which £1 billion has been offset by a drop in interest payments and other adjustments. Hence, general government expenditure is up by £4 billion. However, this is more than offset by a £6 billion increase in the underlying buoyancy of non-oil taxes, and an increase of £1 billion in other receipts. Revenue is therefore up by £7 billion, compared with an increase of £4 billion in government expenditure, which means that the PSBR has dropped by about £3 billion. (A fiscal adjustment of £2 billion was already built-in to the 1986 Budget arithmetic, and Table 2 allows for this. The tax cuts of £2½ billion which were actually introduced in the 1987 Budget were insignificantly different from those planned last year.)

Essentially, therefore, the fiscal arithmetic was transformed by the unexpected buoyancy in government revenue, which added about £7 billion to receipts. Although it is tempting to see this as a response to unexpected buoyancy in economic activity, it seems that this is not in fact the main cause of the change in receipts. The predicted level of nominal GDP in 1987–88 is only around 1 per cent higher than that expected by the Treasury a year ago, and on standard tax elasticities this may account for no more than £1½–2 billion of the extra revenue. The rest seems to have come from an increase in the tax-paying propensity of the economy. Looking at this from an economic point of view, rather than on a tax-by-tax basis, three main sources can be identified:

(i) The increase in public expenditure announced in the Autumn Statement has itself increased real public sector incomes, and predicted tax revenue has gone up accordingly (because of real fiscal drag). On Institute for Fiscal Studies' estimates, the total boost to nominal government revenue which has followed from the £4 billion rise in general government spending may be as much as £2½ billion, about one-third of the total revenue increase since the 1986 Budget. (But not all of this should count towards an explanation of the increase in the tax/GDP ratio, since higher public spending has probably also boosted nominal GDP itself.)

(ii) As oil prices fell last year, profits were switched from North Sea companies to the onshore company sector. Essentially, the industrial and service sectors did not pass on the full benefits of lower energy costs to the consumer, so non-oil company profits rose; and, as this happened, tax payments rose more than proportionately because of weak investment and the gradual elimination of tax-exhausted companies. It is hard to gauge exactly how much extra revenue this switch has generated from the onshore sector, but it could be as much as £2 billion.

(iii) Although a large part of the reduction in energy costs last year was retained by the company sector, some was passed on to the consumer, and the fall in energy spending resulted in a rise in the share of consumers' expenditure going on durable goods and other items subject to VAT. This, and the general effects of a lower exchange rate on economic activity, probably explains the remaining part (£2½ billion) of the £7 billion extra revenue.

Hence, the complicated effects of lower oil prices on the British economy, and the decision to increase public expenditure in the Autumn Statement, have in themselves increased the tax-paying propensity of the onshore economy, enabling the Chancellor to announce both tax reductions and borrowing reductions in the 1987 Budget. One clear lesson from this experience is that the status of the overall public finances was, in fact, much less threatened by higher public spending and lower oil prices than the financial markets assumed for many years.

THE POLICY STANCE

Neutral Fiscal Stance

These fiscal events have, on our calculations, left the fiscal thrust insignificantly different from neutral in the forthcoming year. As usual, we are hampered in reaching this judgment by the fact that there is no single reliable indicator available for changes in the fiscal stance. In Table 3, we show changes in the actual PSBR and PSFD planned for 1987–88, along with our estimates of these changes adjusted for variations in the level of economic activity. The best simple measure of the fiscal thrust is probably the cyclically-adjusted PSFD, since this is not distorted by privatisation receipts, and since it makes allowance for the effects of variations in economic activity on the fiscal deficit. After the major tightening in the fiscal stance up to 1981–82, there has, on this measure, been some easing in policy ever since (with the single exception

of 1985–86). Mr Lawson was at pains to argue in the Budget speech that the economic recovery since 1981 has been unconnected with any fiscal easing. But on standard measures of the fiscal stance, Mr Lawson's argument is plainly wrong—the cyclically-adjusted fiscal stance did contribute to the recovery after 1982–83. Admittedly the exchange rate has been the major factor boosting the economy lately—but no one ever argued that fiscal policy was the *only* weapon in the government's arsenal which mattered, or that it must always be the most important. For 1987–88, the cyclically-adjusted PSFD will be approximately neutral, since the predicted drop of 0.6 per cent in the actual PSFD is almost entirely due to the impact of above-trend growth in the economy, boosting government receipts and cutting government payments.

A more complicated method of assessing short-term changes in the fiscal stance is to consider the demand impact of each of the main tax and expenditure components separately. In Table 4 (prepared by my colleague Jeremy Hale), we make allowance for the fact that not all components of the government accounts have the same demand weight. For example, a cut in income tax exactly financed by lower public investment may have contractionary short-term effects on demand, because tax cuts leak into savings and imports to a greater degree than does public investment. On a demand-weighted basis, fiscal policy is calculated to be very mildly contractionary in the coming year (by about 0.3 per cent of GDP for the demand-weighted PSFD), but such a small deviation from zero is not significant.

Overall, it seems that fiscal policy will be broadly neutral with respect to aggregate demand this year. It is rather hard on this basis to suggest that the favourable outlook for the economy this year is much affected in either direction by the fiscal stance. However, it is possible to argue—as the London Business School has done—that the Chancellor could have opted for a more expansionary fiscal policy by maintaining his PSBR target unchanged at £7 billion. Compared to this hypothetical baseline, the fiscal stance *has* tightened somewhat, and has contributed to the less alarming outlook for the balance of payments which now seems to be in prospect. Another £3 billion of tax cuts, which would have been possible within a £7 billion PSBR target, could have added £1½ billion to the prospective balance of payments deficit in the coming year. This is one important reason why the Chancellor's decision to cut the PSBR target was necessary.

Turning to the monetary side, policy is now almost impossible to assess in any simple way. Real interest rates remain extremely high (see Table 5), but this will probably be insufficient to prevent real £M3 growth continuing at double digit rates. Real M0 growth (assuming the top-end of the 2–6 per cent target range is hit) will be somewhat higher than the average for recent years. The most sensible conclusion appears to be that monetary policy will continue to *accommodate* economic growth, which will be primarily generated from other sources.

The Medium-Term

No Trend Drop in Inflation

Finally, there are one or two points worth making about the latest version of the medium-term financial strategy (MTFS). The first is that the Treasury re-asserts that the central objective of the MTFS is "to bring inflation down further over a period of years, and ultimately to achieve price stability". Yet the medium-term assumptions on the inflation rate, as measured by the GDP deflator (see Table 2.3 of the Budget Red Book), shows inflation in 1990–91 stuck at 3 per cent, unchanged from the 1986–87 figure. It is hard to see how this is compatible with the stated objective of achieving a trend reduction in the inflation rate. Indeed, the inflation rate between 1986–87 and 1987–88 is shown to rise from 3 per cent to 4½ per cent, again based on GDP deflators. The Chancellor has stated that this is in line with what is occurring in other countries. *It is not*. Although in some other countries inflation, as measured by consumer prices, may rise very slightly this year in response to a bounce-back in energy costs, *the rate of change in GDP deflators in most developed countries is still on a declining trend*. For example, latest OECD forecasts show that GDP deflators in the major seven economies will rise by an average of 2.5 per cent this year, compared with 3.3 per cent last year. The UK is out of line with most other OECD countries in expecting an increase in the rate of change in its GDP deflator this year. (This is important, since the GDP deflator measures the domestically-generated element of price inflation, and may be a much better guide to long-term inflation trends than consumer prices.) This deteriorating tendency in UK inflation relative to the rest of the world is generated mainly by the rate of increase in domestic unit labour costs, *and it is the major justification for the fiscal caution which the Chancellor pursued in the 1987 Budget*. Whether the objective of demand policy is to stabilise the path of nominal GDP, or of unit costs (as I would prefer), it is difficult to make out a case for additional stimulation at present—at least in the absence of direct measures to control pay settlements.

Medium-Term PSBR Targets

On the medium-term setting of targets for the fiscal deficit, the Chancellor has said that he would like to see the PSBR held at around 1 per cent of GDP indefinitely. Hopefully, this represents a *trend* figure, rather than an absolute commitment which would be held regardless of the state of economic activity and inflation. From past experience, I take it to be the case that some short-term fiscal flexibility will be permitted if necessary, though the MTFS this year is less explicit on this point than it has been in the past. (For example, last year the Red Book stated that the MTFS "provides as firm a guarantee against inadequate money demand as it does against excessive money demand". This statement is omitted this

year.) As regards the appropriateness of a long-term target for the PSBR equivalent of 1 per cent of GDP, the Chancellor has hinted that this stems from a desire to stabilise the public sector net/GDP ratio. This would, indeed, occur if trend real growth in GDP were about 2–2½ per cent, *and if inflation were reduced to zero*. But on the Treasury's 3–4½ per cent inflation assumption over the next four years, the public sector debt/GDP ratio is likely to decline. Against this, privatisation proceeds will be maintained at somewhat more than 1 per cent of GDP. What this combination means is that, for the first time, privatisation proceeds are now being used mainly to retire public debt, rather than to finance government spending or tax reductions. The implications of the present strategy from the point of view of the public sector balance sheet are therefore less damaging than in recent years. The erosion of the public sector's real assets which occurs via privatisation will be offset by a drop in public liabilities as debt is retired. (Both concepts are measured here relative to national income.) Hence, although he may not fully realise it, the Chancellor has now taken account of those who argue that privatisation receipts should be used to retire debt, rather than to finance current transactions. In the very long-term, the Chancellor has suggested that the PSBR should be held to around 1 per cent of GDP even when privatisation receipts disappear, presumably sometime during the 1990s. This would be consistent with stability in the public sector debt/GDP ratio if inflation can be reduced to zero in the very long-term; otherwise the ratio would actually decline.

Conclusion

In view of the recent behaviour of the economy, it is very difficult to make out a strong case for the fiscal stance in 1987–88 to be significantly different from the broad neutrality which Mr Lawson has introduced. The drop in the exchange rate makes this unnecessary from the point of view of sustaining economic growth, and the continuing high rates of increase in unit costs in the UK also point to caution. But growth of around 3 per cent pa in real GDP, even if maintained, is unlikely to lead to a rapid reduction in unemployment, at least until labour force growth levels off around the end of the decade. If unemployment is to be brought down more rapidly in the meantime, then faster economic growth will be necessary—and it is hard to see how this will be compatible with both balance of payments equilibrium and a declining inflation rate. The government is currently using one instrument (the exchange rate) to control two targets (inflation and the balance of payments) and this must inevitably lead to tensions. The missing element in the strategy is any mechanism for controlling nominal pay increases. If this is considered impossible or undesirable, then it is hard to see much alternative to the government's cautious approach to fiscal policy in the coming year.

Income Tax Cuts and Other Measures

Even within this second-best world, however, it is possible to question the wisdom of the government's decision to use the available scope for tax cuts to reduce *income tax*. The arguments in favour of higher public spending rather than income tax reductions are now well known, and need not be repeated here. The government's preference for income tax over additional spending on public investment or special job measures appears to be based on three considerations. First, they point out that public spending *was* increased in the Autumn Statement, and that the cuts in income tax in the Budget form part of a balanced overall approach to macro-economic policy. Second, they seem to believe that lower income tax may reduce the pressure for pre-tax increases in average earnings over the medium-term. Third, there is still a residual belief in long-term supply-side benefits, despite the lack of evidence that these are important for basic rate tax payers (as opposed, perhaps, to higher rate payers).

These arguments can be countered. For example, the public expenditure increases announced last Autumn were mainly absorbed by the relative price effect (ie increases in public sector pay), with the real level of service provision left relatively untouched, and with public investment plans still showing a sizeable decrease after 1986–87 in real terms. The extent of any genuine increase in the public provision of real services is therefore very limited. But even if expenditure increases are ruled out for semi-political reasons, the decision to concentrate tax cuts almost entirely in the income tax area looks unwise. The alternative of reducing *employers' national insurance contributions* would have directly reduced labour costs (the key problem area at present), and would have alleviated the balance of payments/inflation conundrum mentioned in this paper. Although macro-economic model simulations need to be read with some caution, the incorporation of a link between employment and real labour costs in most of the macro-models over recent years has increased the relative attraction of cuts in employers' national insurance contributions over income tax. Under an exchange rate targeting regime, recent Treasury model simulations (see "Fiscal Policy and Exchange Rate Targets", Parliamentary Unit Briefing Paper, March 1987), show that national insurance contributions are 50 per cent more cost-effective in reducing unemployment than income tax cuts and they have more favourable consequences for inflation, the current account and the PSBR profile in the medium-term. Furthermore, it is possible to structure national insurance contribution reductions such that they impact on a regional basis, offering an employment subsidy where it is most needed. At present, these advantages seem decisive.

TABLE 1

MAIN FEATURES OF THE FISCAL PLANS

(% of GDP)

	1985–86	*1986–87*	*1987–88*
General Government Expenditure	44.1	42.9	42.3
General Government Revenue	42.2	41.6	41.1
General Government Borrowing Requirement	1.9	1.3	1.2
PSBR	1.6	1.0	1.0
Public Sector Financial Deficit	2.1	2.9	2.3

TABLE 2

CHANGES TO THE FISCAL PLANS SINCE 1986 BUDGET

(£bn)

	Levels in 1987–88			*Changes from 1986–87—1987–88*	
	1986 Budget Plan	*1987 Budget Plan*	*Change*	*1986 Budget Plan*	*1987 Budget Plan*
General Government Expenditure					
(Asset Sales)	(5)	(5)	(0)	(0)	(0)
Planning Total	144	149	5	5	9
Interest/Other	26	25	−1	2	1
Total	170	174	4	7	10
General Government Revenue					
Oil Receipts	4	4	0	−2	−1
Non-Oil Taxation	118	124	6	6	10
National Insurance	28	28	0	2	1
Other	12	13	1	0	0
Total	162	169	7	6	10
GGBR	8	5	−3	1	0
Public Corporations Market Borrowing	−1	−1	0	−1	0
PSBR	7	4	−3	0	0

Note: Figures are rounded. The government revenue figures in the 1986 Budget plans are adjusted to allow for the £2 billion 1987–88 fiscal adjustment which was expected at that stage.

TABLE 3

CHANGES IN THE CYCLICALLY ADJUSTED FISCAL STANCE

Changes in Fiscal Policy (% of GDP)

	Actual PSBR[1]	*Actual PSFD*[1]	*Cyc. Adj. PSBR*[1]	*Cyc. Adj. PSFD*[1]
Change in:				
1979–80	−0.5	−0.9	−0.1	−0.5
1980–81	0.5	1.0	−3.7	−3.2
1981–82	−2.1	−2.7	−4.4	−5.0
1982–83	−0.2	0.7	−0.5	0.4
1983–84	0.1	1.0	0.6	1.5
1984–85[2]	−0.9[2]	−0.4[2]	0.0[2]	0.5[2]
1985–86	−0.7	−1.5	−0.7	−1.6
1986–87	−0.6	0.6	−0.8	0.4
1987–88	0.0	−0.6	0.6	0.0

[1]Negative figures indicate a discretionary tightening in fiscal stance.

[2]Figures for 1984–85 (but not 1985–86) exclude the direct impact of the miners' strike on government borrowing (£2.8 billion) and real GDP (1.3 per cent).

TABLE 4

CHANGES IN THE DEMAND-WEIGHTED/CYCLICALLY-ADJUSTED BUDGET DEFICIT[1]

(% of GDP)

	1986–87	*1987–88*
PSBR		
Published Definition	−0.6	0.0
Cyclically-Adjusted	−0.8	0.6
Demand-Weighted	−0.6	−0.2
PSFD		
Published Definition	0.6	−0.6
Cyclically-Adjusted	0.4	0.0
Demand-Weighted	−0.3	−0.3

[1]Negative figures indicate a more contractionary fiscal stance.

TABLE 5

MEASURING THE MONETARY STANCE

		Real Monetary Growth (%)		*Real Interest Rates (%)*	
	Real M0[1]	*Real £M3*[1]	*Real PSL2*[1]	*Real Base Rate*[2]	*Real 20-Year Gilt Yield*[2]
1979–80	−8.1	−7.1	−6.6	−2.1	−4.4
1980–81	−7.0	7.1	1.3	−0.7	0.6
1981–82	−9.7	2.4	0.7	1.8	2.1
1982–83	−1.1	4.5	4.5	5.5	5.8
1983–84	0.7	5.0	7.1	3.3	4.9
1984–85	−0.2	4.5	9.8	7.5	5.0
1985–86	−1.3	12.0	8.6	6.4	4.7
1986–87	1.2	15.1	8.9	7.5	5.4
1987–88	2.0	—	—	6.0[3]	5.2[3]

[1]Percentage change in money stock through the fiscal year deflated by price inflation.
[2]Nominal interest rate at start of financial year less inflation rate at financial year-end.
[3]Based on *present* rates.

APPENDIX 5

Supplementary Note by the Bank of England

THE OIL PRICE, THE EXCHANGE RATE AND INFLATION

1. The Committee asked what change in the level of sterling the Bank believes would be required to offset a 10 per cent movement in the oil price. Movements in the oil price and the exchange rate affect many facets of the economy. In the Bank's oral evidence to the Committee attention was focussed on the implications for inflation and these are considered further in this note. The Bank's rule of thumb is that starting from the third quarter of 1985, before the major fall in oil prices, and when Brent crude was priced at just under $27 or about £19.50 per barrel, a £1 per barrel movement in the sterling oil price and a one point movement in the exchange rate index (in the same direction) would leave the retail price index unchanged over a two to three-year horizon. Around current levels this implies that a 10 per cent movement in the oil price would be offset by a $1\frac{1}{2}$ per cent movement in the exchange rate index.

2. The rule of thumb is based on simulations performed on the Bank's model of the UK economy.[1] Separate simulations investigate the effect of (i) a step change in the oil price, and (ii) a step change in the exchange rate. A movement in the oil price affects the retail price index both directly, through the price of oil products bought by consumers, and through a number of indirect channels, through its impact on the price of competing fuels, through industry's costs, and through world prices and the price of UK imports. A movement in the exchange rate also affects the retail price index both directly, through its impact on the price of imported goods bought by consumers, and also indirectly through the cost of inputs to UK production, and profit margins on sales in this country.

3. The rule needs to be used with care:

— It is based on some simplifying assumptions; wages and interest rates are assumed not to react; tax rates and other instruments of fiscal policy are assumed to remain unchanged in the face of the postulated movements in the price of oil and the exchange rate.

— It is not a forecast. The rule simply attempts to isolate and weigh against each other the impact of oil prices and the exchange rate. The many other factors that will affect retail prices are ignored.

— It is based on simulations around the prices and exchange rates ruling in the third quarter of 1985. Rules based on different starting points might be expected to vary.

— Movements in the oil price and the exchange rate take time to affect prices in general. The rule is based on the position after two or three years, when most, but not all, of the effects will have been seen.

4. It should be noted that the rule is couched in terms of movements in the *sterling* oil price and movements in the exchange rate *index*, since these can most straightforwardly be related to prices in this country. The impact of changes in the *dollar* oil price will depend on movements in sterling's exchange rate against the dollar, which can at times differ considerably from its movement in terms of the index.

5. Given the rule, and any sterling oil price, it is possible to calculate the level of the effective rate index that would have left the retail price index unchanged compared with the base period, the third quarter of 1985. These calculations were referred to in the Bank's oral evidence. In the spring and early summer of 1986 the modest fall in the exchange rate and steep fall in the oil price would have had a beneficial effect on retail prices. By August the net effect would have been zero, but as the exchange rate fell and the oil price rose in the latter part of the year the comparison became unfavourable. By November the actual exchange rate was about four points lower than the rate that would have left the RPI unchanged. As the exchange rate recovered this year the comparison became less unfavourable, but at the time the Bank gave oral evidence the exchange rate was still between one and two points lower than that which would have left the RPI unchanged.

6. Two notes in the Bank's Quarterly Bulletin for March 1986 and September 1986 also consider the impact of oil price and exchange rate movements on the general level of prices, as well as on activity, the current account and the PSBR.

Bank of England
1 *April* 1987

[1]They are similar to simulations made on HM Treasury's model and described in "The Economic Effects of Lower Oil Prices" G Horton and S Powell, GES Working Paper No 76.

APPENDIX 6

Note by the Inland Revenue

FORECASTING AND MONITORING OF CORPORATION TAX RECEIPTS

This note provides additional information about the forecasting of corporation tax raised in Questions 105–111 of the Committee's oral hearing on 25 March.

1. The forecast of corporation tax receipts in the coming year, published in the Financial Statement and Budget Report, comprises four main elements—Advance Corporation Tax (ACT), public sector corporation tax, North Sea mainstream corporation tax and on-shore mainstream corporation tax. Each of these elements is forecast separately. The large underforecast in 1986–87 receipts has occurred mainly in the last of the four and this note describes the methods used for the forecast of that component, and the monitoring procedures subsequently followed throughout the forecast year.

2. The main determinants of the corporation tax liability of a company are its trading profits from its UK activities and other forms of income and chargeable gains and the various offsets against that income—capital allowances, tax losses from earlier years and group relief ie transfers of losses within company groups. These items of income offsets, plus one or two other less important items, lead to the taxable income of the company from which the corporation tax liability is derived. Further offsets against this liability—Double Taxation Relief (DTR), Income Tax deducted at source, and ACT paid in the relevant year or brought forward from earlier years—give the liability to mainstream corporation tax.

3. In the 1970s forecasting of tax receipts was done at an aggregate level only, but this approach was found to be inadequate as the proportion of tax exhausted companies grew. For some years now the Department has had a corporation tax forecasting model which simulates the tax assessment procedure on a stratified sample of about 15,000 companies (2 per cent of all companies by number but about half of trading profits). The data collected from tax offices on tax determinants of yield are collected each year (a copy of the enquiry form is attached). Because of the delay in receiving company accounts and agreeing tax assessments, no data are available for the most recent periods. This means that the forecast is always based on figures projected over a period of at least two years. For example, when the 1986–87 forecast was being produced in March 1986, for the 1986–87 Financial Statement and Budget Report, virtually no tax assessment data were available in respect of individual companies for 1985—the profits of which largely determine 1986–87 receipts—and little for 1984. The base year for projections in the model was therefore 1983.

4. Although up to date data are not available for individual companies, the national accounts provide aggregate estimates of trading profits and other income for recent periods and these are used in the model. Growth rates are applied to the income figures for each individual company in the base year (1983, in the case of the 1986 Budget forecast). These growth rates are made to vary from company to company according to a statistical distribution in such a way that overall growth is consistent with the aggregate national accounts figures. The receipts of mainstream corporation tax in 1986–87 depended very largely on profits arising during 1985. When the 1986–87 forecast was first produced aggregate estimates of profits were available up to and including the third quarter of 1985 and a forecast of the final quarter was made. These estimates were, as usual, all highly provisional and may be subject to substantial revision in later years.

5. Apart from the revisions to the aggregate income figures a further element of uncertainty arises in projecting the individual growth rates within the forecasting model. These include the ranges of plausible growth, possible differences in growth patterns between large and small companies, the cross-over from profit to loss and vice-versa, and the relationship between current growth in income and past tax losses (ie the run-down of tax exhaustion). The projection procedure is a complex one and the uncertainty increases at each separate projection of a year's data.

6. Apart from company income, the only other tax determinant for which some external historical evidence for the most recent years is available at the time of the Budget forecast is investment. National accounts estimates of capital expenditure by the corporate sector are used to help to derive figures for capital allowances.

7. Information on each of the remaining tax determinants listed in paragraph 2 above comes solely from the tax assessment procedure. Thus for items such as the use of past tax losses, group relief, use of surplus ACT, etc, the 1986–87 forecast was based upon figures which had been projected from actual company data for 1983 and earlier without the benefit of external supporting evidence. This period from 1983 has been one of rapid growth in profits when the impact upon tax liabilities of such items as use of past losses and surplus ACT is particularly difficult to assess.

8. As the Chancellor pointed out in giving oral evidence to the Committee, the relationship between accumulated tax losses and growth in company profits is crucial in forecasting tax receipts, as well as the changes in accumulated tax losses and the impact upon tax exhausted companies. When estimates depend upon individual company data which are at least two years old and complex interactions between different factors they are inevitably subject to a substantial degree of uncertainty.

9. In Questions 106 and 107, Mr Wainwright referred to figures of agreed losses and the fact that the Inland Revenue do not record these figures centrally for use in forecasting. Although the amount of loss has to be agreed ultimately with each company and recorded in the tax office files, the process can be protracted particularly in the case of the larger, more complex groups which are affected by such matters as group transfers and overseas tax. In consequence it would be some years before the agreed figure would actually appear on a central record and its use as a forecasting base would therefore be very limited. We believe that a more reliable estimate of the loss overhang can be obtained by collecting figures, whether agreed or estimated, from tax offices each year in respect of the sample of companies used in the forecasting model. Here however, as has been explained, an estimate of total losses for the current year requires a projection over at least two years and is therefore subject to a wide margin of error. This was the basis of the estimate of £25–30 billion to which Mr Wainwright referred in Q.106.

FORECASTING AND MONITORING RECEIPTS DURING THE YEAR

10. The forecast for the year is monitored and updated at regular intervals during the year; and as the year progresses other forms of data become available from corporation tax assessments. The assessments are mostly issued centrally and the tax charge recorded. Details of these charges are supplied regularly each week to the forecasters throughout the year for monitoring purposes, but in practice the tax charge is a poor indicator of the final yield.

11. This is because in about two-thirds of cases the assessment has to be estimated by the Inspector, usually in the absence of the company's accounts. Inevitably the estimate will often be incorrect and the tax charge will be adjusted when the company appeals (so that a payment on account can be made) and again, if necessary, when the final liability is eventually agreed. But as the adjustments will not be made until near the date of payment, the tax charge is of little help in forecasting. The margin of error on the final outturn figure of corporation tax remains very high until December/January when a significant proportion of payments are made. The Chancellor's proposals to legislate in the coming Finance Bill on the Keith proposals for streamlining the assessments and collection of company tax liabilities ("Pay and File") will eliminate the need for estimated assessments to be made by the Inspector.

Inland Revenue
3 *April* 1987

Name of Company ....

Description of Trade 1

Section	Item		Code	Day	Mth	Year	Code
				Day	Mth	Year	
A	1 Accounting period beginning		01			19	01
	2 Accounting period ended		02			19	02
	3 Are the figures agreed with the Company or Agent? Answer "YES" or "NO"		03				03
B	4 Gross Case I & II profit or loss before any adjustment for Balancing Charges, Stock Relief, Capital Allowances and Losses brought forward	Profit	04				04
		Loss	05				05
C	6 Balancing Charges treated as a trading receipt in computing Case I income or loss		06				06
	7 Capital Allowances taken into account in computing Case I income or loss		07				07
	8 Stock Relief taken into account in computing Case I income or loss	Allowed	08				08
		Recovered	09				09
D	10 Sch. D Case I & II after adjustment for items C6, 7 & 8 above (if a loss write "O" here and the amount of the loss at item E18 below)		10				10
	11 Less losses or charges treated as losses brought forward and set against profits..		11				11
Summary of CZ11/12 (or CT3) details	12 Total of all OTHER assessable income and gains (excluding item D10)...		12				12
	13 Trading losses (including losses from later A.P.'s) set against profits (excluding item D11)		13				13
	14 Total of other deductions relieved against profits (excluding items C6, 7 & 8 and D11, 15 & 16)		14				14
	15 Charges paid and relieved against profits		15				15
	16 Group relief received		16				16
	17 Profits chargeable to Corporation Tax		17				17
E	18 Net Case 1 loss after adjustments for items C6, 7 & 8 above		18				18
	19 Management Expenses not relieved against profits (financial companies only)		19				19
	20 Total charges paid (whether or not relieved against profits)		20				20
Losses and charges	21 Losses, including charges, surrendered as Group relief		21				21
	22 Losses relieved against profits of previous A.P.'s		22				22
	23 Accumulated unrelieved losses, including charges, carried forward to later A.P.'s		23				23
F	24 A.C.T. set against tax chargeable		24				24
	25 Double Taxation relief...		25				25
	26 Income Tax set off		26				26
	27 Corporation Tax payable		27				27
G	28 A.C.T. carried back to previous A.P....		28				28

Appendix 7

Supplementary Note by HM Treasury

CREDIT CARDS AND PRIVATE SECTOR BORROWING

This note provides some further information about the use of credit cards in the context of private sector borrowing generally.

2. Table 1 shows private sector borrowing broken down into mortgage borrowing and other forms. It shows that in recent years mortgages have been growing at a rate which, expressed as a proportion of GDP, entirely explains the rise in total private sector borrowing. Thus, for example, since 1976–77 mortgages have risen from 2.9 per cent of GDP to an estimated 6.6 per cent in 1986–87. Other forms of private sector borrowing were equivalent to 4.2 per cent of GDP in 1976–77 and 4.1 per cent in 1986–87.

3. Table 2 shows the growth of the main individual components of personal sector debt in recent years. Outstanding borrowing on monetary sector credit cards (Access and Visa) amounted to 2.3 per cent of total personal debt outstanding in the third quarter of 1986, the latest period for which data is available. In addition, a part of the borrowing from consumer credit companies and other companies (mainly retailers) will be through credit and charge cards, although the exact proportion is not available. The total borrowed on all forms of credit cards is likely to be well under 5 per cent.

4. Table 3 shows year by year figures for the net increase in bank credit card debt outstanding (after allowing for repayments), as a proportion of gross credit advanced by this means during each year. This proportion is generally less than 10 per cent.

2 *April* 1987

TABLE 1
PRIVATE SECTOR BORROWING

	Private Sector Borrowing		*of which: Mortgage*		*Other*	
	£ billion	*(% of GDP)*	*£ billion*	*(% of GDP)*	*£ billion*	*(% of GDP)*
1976–77	9.2	(7.1)	3.8	(2.9)	5.4	(4.2)
1977–78	9.9	(6.6)	4.7	(3.1)	5.2	(3.5)
1978–79	11.8	(6.8)	5.6	(3.2)	6.2	(3.6)
1979–80	16.2	(7.8)	6.6	(3.2)	9.6	(4.6)
1980–81	17.3	(7.3)	7.8	(3.3)	9.5	(4.0)
1981–82	25.4	(9.8)	10.2	(3.9)	15.2	(5.9)
1982–83	24.4	(8.6)	15.1	(5.3)	9.3	(3.3)
1983–84	25.6	(8.4)	14.3	(4.7)	11.3	(3.7)
1984–85	28.4	(8.7)	17.1	(5.2)	11.3	(3.5)
1985–86	33.1	(9.2)	19.6	(5.4)	13.5	(3.8)
1986–87*	40.9	(10.7)	25.4	(6.6)	15.5	(4.1)

Notes
*Treasury estimates consistent with Chart 2.4 in the FSBR.

Private Sector Borrowing is defined as identified borrowing by persons and by industrial and commercial companies, from financial companies, and the public and overseas sectors.

Sources
Financial Statistics, March 1987, and Economic Trends, Annual Supplement 1987.

TABLE 2
COMPOSITION OF PERSONAL SECTOR DEBT

end year:	1982 £bn	(%)	1983 £bn	(%)	1984 £bn	(%)	1985 £bn	(%)	1986 £bn	Q3 (%)
TOTAL STOCK:	104.9	(100)	125.1	(100)	146.9	(100)	173.4	(100)	198.2	(100)
of which										
1. Mortgages	76.3	(72.8)	91.4	(73.1)	108.4	(73.8)	127.4	(73.5)	146.2	(73.8)
2. Consumer Credit:	16.0	(15.3)	18.9	(15.1)	22.0	(15.0)	25.9	(14.9)	29.4	(14.8)
—overdrafts & personal bank loans	10.6	(10.1)	12.2	(9.8)	14.2	(9.7)	16.3	(9.4)	18.7	(9.4)
—monetary sector credit cards	2.0	(1.9)	2.6	(2.1)	3.2	(2.2)	4.0	(2.3)	4.6	(2.3)
—consumer credit companies	1.3	(1.3)	1.8	(1.4)	2.2	(1.5)	2.8	(1.6)	3.4	(1.7)
—other*	2.1	(2.0)	2.3	(1.8)	2.4	(1.6)	2.7	(1.6)	2.7	(1.4)
3. Other Borrowing	12.5	(11.9)	14.8	(11.8)	16.5	(11.2)	20.2	(11.6)	22.6	(11.4)

*retailers and insurance companies.
Source: Financial Statistics, March 1987, Table 9.3.

TABLE 3
NET INCREASE IN CREDIT CARD DEBT OUTSTANDING AS A PERCENTAGE OF GROSS CREDIT ADVANCED

	Net Increase in Credit Card Debt Outstanding £ million	*Gross Credit Advanced on Bank Credit Cards £ million*	*(Col 1) (Col 2) %*
1980	252	2,883	8.7
1981	385	3,726	10.3
1982	450	4,898	9.2
1983	571	6,396	8.9
1984	607	8,043	7.5
1985	853	10,500	8.1

Sources: Col 1—Financial Statistics, March 1987, and Abstract of Banking Statistics, May 1986, published by the Statistical Unit of the Committee of London Clearing Bankers.
Col 2—Abstract of Banking Statistics.

Printed for Her Majesty's Stationery Office by
Brown Knight & Truscott Ltd, London and Tonbridge
Demand No. 0702293 PS6350323 C8 4/87 4146 22641

Inland Revenue

Policy Division
Somerset House

FROM: MISS R A DYALL

DATE: 27 APRIL 1987

1. MR MACE

I hope you will be able to agree to this very small amendment which would remove any doubt about the effect of Clause 26 on widow's bereavement allowance.

2. FINANCIAL SECRETARY

BAM 27/4

CLAUSE 26: INCREASED PERSONAL RELIEF FOR THOSE AGED 80 AND OVER

1. I am afraid we have identified a need for a minor clarifying amendment to Clause 26. I am sorry that this was not picked up when the clause was being drafted. The point is that the clause does not at present make clear that it has no effect on existing provisions for the additional personal allowance and widow's bereavement allowance. The possibility that there might be a doubt about this only came to our attention recently.

2. Section 14(2) of the Income and Corporation Taxes Act (ICTA) 1970 provides for the additional personal allowance (APA) for single parents to be set at an amount equal to the difference between the basic married and single person's allowances. The subsection states explicitly that it is the difference between these two allowances which determines the level of APA not the difference between the married and single age allowance. The widow's bereavement allowance (WBA) is defined as being the same amount as the APA.

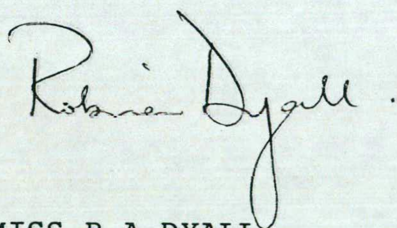
---

cc Chancellor
Chief Secretary
Minister of State
Economic Secretary
Mr Cassell
Mr Scholar
Miss Sinclair
Mr P Graham (Parliamentary Counsel)

Mr Isaac
Mr Lewis
Mr Beighton
Mr Mace
Mr O'Brien
Mr R H Allen
Mr Fraser
Mr Walker
Miss Dyall
PS/IR

3. We think Clause 26 needs to refer to Section 14(2) and make it clear that just as the APA cannot be the difference between the married and single levels of age allowance, nor can it be the difference between the married and single levels of the new allowance for those aged 80 and over. This would also settle the point for WBA. Without this amendment we are advised there is a risk a newly bereaved widow aged over 80 could claim a widow's bereavement allowance equal to the difference between the age allowances for those aged 80 and over (£1,775) rather than the proper amount (£1,370).

4. The amendment would probably involve the addition of only a few words to Clause 26, and should not be controversial. Would you be content for an appropriate amendment to be drafted and tabled for Committee stage?



MISS R A DYALL

Ch

You asked for a meeting, before Cttee Stage, to review the state of play on the 4 points in ARG's counter-briefs (Lloyd's; CGT on Life Co's; Pensions; and banks' foreign interest). This is the only time at which all Mins + Ads are available. But the aim is to keep it to ½hr if possible, as others have meetings at 10.00am — and you have other things to get on with.

AWK

27/4

Inland Revenue

Policy Division
Somerset House

FROM: I R SPENCE

DATE: 27 APRIL 1987

1. MR McGIVERN 27/4.

2. CHANCELLOR

SPENCE TO CH/EX 27/4

LLOYD'S RIC - STATE OF PLAY

You will be discussing the handling of this issue, and others, at your 9.30 am meeting on Tuesday 28 April. This summary of the state of play may be helpful.

I. Discussions with Lloyd's

Lloyd's paraded their full team for the first time on Thursday 23 April. It was led by Peter Miller (with Alan Lord also present).

---

cc Economic Secretary
Financial Secretary
Chief Secretary
Sir Peter Middleton
Mr Cassell
Mrs Lomax
Mr Scholar
Mr Haigh
Mr Culpin
Miss Sinclair
Mr Cropper
Mr Ross Goobey
Mr Jenkins (OPC)
Mr Muir (DTI)
Mr M Hewitt (Bank of England)

Mr Battishill
Mr Isaac
Mr Painter
Mr Rogers
Mr Pollard
Mr Beighton
Mr McGivern
Mr Spence
Mr Skinner
Mr Newstead
Mr Bolton
Mr Templeman
Mr Walker
Ms McFarlane
PS/IR

The Lloyd's position at the meeting was:

a. They accepted the Revenue needed an adequate locus for examining RIC, and that legislation was necessary to provide it. But they maintained that the provisions basis in the Clause was wrong in principle. Any analogy with insurance companies provisions was a false one. Lloyd's RIC is an arms' length insurance contract, not a provision; Lloyd's syndicates last for only one year; there are substantial variations in syndicate membership. They would develop their arguments in the paper they had promised earlier. They raised no new points and had no firm counter-proposals at this stage.

b. <u>The practical effects of the provisions basis</u>. They agreed it would be productive to examine the effects of the provisions basis on Lloyd's, and see to what extent their concerns could be met in practice (with or without amendments of the legislation). We had presented a paper on this. Discussion of our paper did not get very far - but so far as it went the Lloyd's professionals in the team did not find much to complain about.

Lloyd's asked for a further meeting on 30 April. This would continue discussion of the practical effects of the provisions basis. Lloyd's would produce a detailed critique of the principle of the provisions basis - but probably not till the following week.

<u>Timetable for the Consultative Programme</u>. Lloyd's are showing no real sense of urgency. They had pressed for an exchange of papers for a meeting before Easter. Their paper did not appear - and now seems unlikely to do so till early May. And meetings at the rate of one a week seemed enough for Peter Miller. It may be that Lloyd's have decided to go slow on the discussion process (perhaps with the thought that the Clause is more likely to drop from a truncated Finance Bill if they can argue that the discussions of detail will be incomplete, and alternatives unexplored, at the time that the decisions are announced on what should be dropped).

If so, press still sooner [illegible]

II. Lloyd's Lobbying

Peter Miller went out of his way at our meeting to assert that Lloyd's Council and Lloyd's officials had no part in the lobbying process (which was entirely the work of agents and members). Mr Cropper has reported on Peter Miller's own activities (his 9 April minute). And we know that Lloyd's tax manager (one of the Lloyd's team) has also been lobbying MPs (because Mr Ralph Howell has written to the Chancellor in response to "an approach" by him). We did not comment.

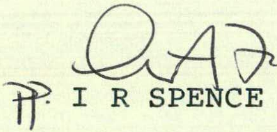
III. Does the Clause need Revision in the light of Lloyd's Criticisms?

It is too early at this stage to go firm on a judgment. We should have a clearer view when we have had our second meeting with Lloyd's later this week. However, as matters stand, our view is:

a. Lloyd's will find it difficult to deny that the Revenue needs a better locus than it has at present for examining/adjusting RIC - and Lloyd's centrally <u>have</u> conceded this;

b. No-one has as yet suggested a practicable alternative to the provisions basis put forward in the Clause. The Lloyd's counter-proposition so far seems to be that the tax criteria should not lead to challenge of Lloyd's prudential judgment - which would mean that the legislation would have little or no practical effect (this would be the result of the propositions advanced by Michael Wade in his letters which Mr Cropper has copied to the Chancellor);

c. The analogy with insurance companies - the basis of the Clause - is not a perfect one. Clearly there are differences between Lloyd's and insurance companies, because the syndicate membership can and does change to a limited extent from year to year. But this does not of itself mean that the provisions basis will not produce a reasonable result.



pp. I R SPENCE