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20/2077

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BUDGET SECRET

FROM: S F D POWELL
DATE: 26 February 1986

SIR TERENCE BURNS

cc Mr Evans
Miss Peirson

TAX RECEIPTS ON INDEXED 1983-84 ALLOWANCES

You asked to see some of the detail underlying the calculation of central government non North Sea taxes on indexed 1983-84 allowances etc. in the table on page 10 of Huw Evans' January forecast report, as updated for the effects of package B and other changes since the last forecast. I attach a table.

2. First, you will notice the numbers in the last row are slightly higher than the most recent ones shown to you by Huw Evans. For the latter I was using out-of-date national insurance contribution figures.

3. The critical part of the calculations is the measurement of the effects of the Budget measures, relative to an indexed base. I have used the figures published in part 1 of the relevant FSBR. For the 1984 Budget, however, where the profile of the revenue effects of the corporation tax package is uneven, I have used figures supplied to me by the Inland Revenue. I have also tried to take out of the FSBR numbers any Budget measures affecting the North Sea. I cannot be sure to have done it properly, so there is plenty of scope here for measurement error.

Stephen Powell

S F D POWELL

5+2/2/26

20/2077

CENTRAL GOVERNMENT NON-NS TAXES AND NICs

£billion

	1983-84	1984-85	1985-86	1986-87	1987-88
(1) Total non-NS central gov't taxes (strike adjusted)	97.0	103.4	112.4	123.2	133.7
(2) Accruals adjustments	- 0.5	+ 0.3	- 0.6	- 0.4	- 0.4
(3) Total non-NS tax receipts	96.5	103.7	111.8	122.7	133.3
Effects of:					
(4) 1984 Budget	-	-	+ 1.6	+ 1.0	+ 0.7
1985 Budget	-	-	+ 0.7	+ 0.9	+ 0.9
1986 Budget	-	-	-	+ 0.1	+ 0.1
(5) Adjusted receipts ((3) + (4))	96.5	103.7	114.0	124.7	135.0
(6) Non NS GDP (strike-adjusted)	289.3	311.1	339.7	370.6	394.8
(7) (5) as % of (6)	33.4	33.3	33.6	33.7	34.2

9/2972

CONFIDENTIAL

FROM: C MELLISS

DATE: 27 February 1986

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Butler
Mr Byatt
Mr Cassell
Mr Evans
Mr Odling-Smee
Mr Peretz
Mr Scholar
Mr Davies
Mr Mowl
Miss Peirson
Mr Riley
Mr Allum
Mr Grice
Mr Cropper
Mr Lord
Mr H Davies
Ms Turk

11.00 Meeting.

ECONOMIC FORECAST: $12.50 OIL PRICE VARIANT

This note presents the results of the $2.50 oil price variant promised in Mr Evans' minute to you of 25th February. It also discusses briefly recent views of outside forecasters on the effects of the change in oil prices.

Forecast Variant

2. The forecast variant assumes that oil prices fall by a further $12.50 per barrel from 1st March, and that they continue to be lower by this amount for the next four years. A fall from a level of $15 may not, we think, lead to the same policy responses in the UK or the rest of the world as a fall from $20. Hence the forecast variant presented here differs markedly from the $15 variant shown in the January forecast.

Effects on the World Economy

3. For the world economy, the policy assumptions used here have been modified

560/2/26

in two important respects from those reported in the $15 variant:-

(i) we assume no further reductions in nominal interest rates in industrialised countries; (it might have been better to have allowed for some further interest rate falls in the later part of the period);

(ii) given the severe current account deficits faced both this year and next in the base case by OPEC countries, they are assumed to respond to even lower oil prices by cutting back hard on imports of both goods and services, so as to prevent any further current account deterioration.

We make the same assumption as before about fiscal policy reactions in the industrialised countries, i.e countries with high budget deficits allow the increase in activity and fall in inflation to feed through to lower deficits.

4. The two changes in the policy assumptions both act to shift the effects on the oil-consuming world towards a larger fall in the rate of inflation at the expense of a smaller increase in activity. Clearly, a number of other combinations are possible.

5. The level of consumer prices in the major seven industrialised countries is therefore expected to be as much as 1½ per cent lower after two years, and 2 per cent lower after four years. Real GNP in the same countries is, on the other hand, projected to be only ¼ per cent higher by 1987, (see table 2). This contrasts with a rise of over 1 per cent in the $15 variant. There is a limited increase in total imports to the major seven countries and one of similar size for non-oil developing countries. Together this is sufficient to offset in broad terms the sharp reduction in OPEC imports. However after removing the extra oil trade and allowing for the UK's relatively high dependence on OPEC markets, the UK-weighted measure of world trade in manufactures could be, if anything, a little lower in 1986, 1987 and 1988 compared to the central forecast.

Effects on UK Economy

6. In contrast to the $15 forecast variant, we have assumed that the PSBR is allowed to rise because of the fall in oil revenues. We have also assumed that the average growth in M0 and £M3 is unchanged; interest rates are also little changed. North Sea production is assumed to be only slightly reduced, but exploration and investment are both cut back further.

7. The forecast variant is shown in levels terms in table 1 and as differences in table 2 attached.

8. The exchange rate falls by 2 to 2½ per cent as a result of the further weakening of prices. This is not sufficient to prevent a deterioration in the current balance, of nearly £½ bn in 1986-87 and about £¾ bn thereafter. This is more than all accounted by the net contribution of the North Sea i.e. the trade account effect plus IPD items.

9. As table 2 shows, the forecast variant suggests that there might be a small (0.1 to 0.2 per cent) gain to UK GDP. The change to the level of RPI is very small, a reduction of less than 0.1 per cent by 1987 Q4. (Wholesale prices and the GDP deflator would fall by slightly more, perhaps by between ¼ and ½ per cent by the same date.) As in the$15 variant, there is little change in inflation: although world inflation is proportionately lower, the effect in the exchange rate is proportionately bigger because of the higher PSBR. In the absence of any change to the fiscal adjustment, consumers' expenditure now rises slightly compared with the main forecast. There is also a small increase in net exports in volume terms, although it is much smaller than in the $15 dollar variant because of the change in the assessment of world trade.

10. As with the $15 variant the onshore economy gains, in terms of activity at the expense of the North Sea. However in terms of Real National Disposable Income the UK is worse off. RNDI is perhaps ¼ per cent below what it would otherwise have been.

11. The reduction in North Sea revenues in 1986-87 is put at about £¾ bn, and about £1 bn in the following years. This gives a level of North Sea revenue of £5¼ bn in 1986-87. The increase in the PSBR is only slightly less than this.

Outside Forecasters' Views

12. You have commented, Mrs Lomax minute to Mr Davies of 24th February, that the Treasury is alone in showing higher inflation as a result of the fall in oil prices. This of course depends on the policy assumption, but our general conclusion from the variants is that inflation is little changed as a result of a fall in oil prices. To our knowledge the London Business School and Oxford Economic Forecasters are the only ones to have presented a quantified oil price forecast variant similar to our own, although others have made less formal assessments.

13. In commenting on the LBS $5 variant, described in the note attached to Mr S Davies minute to you of 21st February, we said that we thought the sterling price of oil was given too high a weight in producer prices. Further examination shows the weight to be 20 per cent: the corresponding figure in the Treasury model is 5.5 per cent. This more than accounts for the differences in inflation. (We are in correspondence with LBS about the weight: the Treasury model uses input-output analysis to determine this number.)

14. Among other assessments:

(i) **Simon and Coates** (The Economic Analyst, February 1986) say that the fall from $18.5 to $13.0 per barrel would cut the RPI by about 1¼ per cent after a year on unchanged interest rates and exchange rates. Phillips and Drew have also published a ready reckoner of this type, again based on a constant exchange rate. This does not seem out of line with our own figuring, and they do acknowledge that some of the beneficial effect would probably be erroded by higher interest rates and a lower exchange rate.

(ii) **Patrick Minford** (Sunday Telegraph 23rd February.) No specific mention of effect on UK inflation, but says, in relation to a halving of oil prices from $30, that 'world inflation should be some 2 per cent lower on average over the next few years'. This is perhaps too optimistic: we would expect a step change in prices lasting for 2 years or so after which inflation might rise with the increase in activity. Professor Minford says UK inflation will be 2 per cent by end 1986, without specifying the contribution from oil or from the exchange rate.

(iii) **Oxford Economic Forecasting** (Guardian 26 February) gives a figure for the effect of lower world oil prices on UK GDP (+0.6% after 3 years for a 20 per cent lower oil price) but no figure for the effect on inflation.

15. Another way in which it is possible to gain an impression of how outside forecasters view the effect of oil prices is to look at recent forecasts in which oil prices have changed significantly. Two such are Phillips and Drew and the National Institute. Of course judgements about many variables will have changed, but for what they are worth both have revised up their inflation forecasts whilst revising down the oil price.

16. The evidence presented by outside forecasters does not lead us to revise our own assessments, although we recognise that the margins of uncertainty are considerable.

CM

C MELLISS

LOWER OIL PRICE VARIANT

TABLE 2

% change from base

Year	World Major 7 (excl. UK) GDP	Major 7 (excl. UK) Consumer Price Index	UK Real GDP	RPI	Nominal GDP	Real National Disposable Income	£ Effective exchange rate
1986-87	0.2	-0.6	0	0	-0.2	-0.2	-2.2
1987-88	0.2	-1.4	0.1	-0.1	-0.3	-0.2	-2.2
1988-89	0	-1.8	0.1	-0.1	-0.3	-0.2	-2.4
1989-90	0	-2.0	0.2	-0.3	-0.4	0	-2.6

Year	Labour cost(1) competitiveness	Earnings	Employees in employment (000s)	North Sea Revenue (£bn)	PSBR (£bn)	World Trade in manufactures (UK weighted)
1986-87	-2.2	+0.1	0	-0.8	0.7	-0.3
1987-88	-1.5	+0.1	25	-1.1	0.9	-0.3
1988-89	-1.5	0.0	15	-1.1	0.9	-0.2
1989-90	-1.8	-0.1	0	-1.1	1.0	+0.1

(1) Fall represents improvement in competitiveness.

TABLE 1: SUMMARY TABLE FEBRUARY 1986 FORECAST

		MAIN FORECAST ($15 oil price)	LOWER OIL PRICES ($12.50)
1.	World GNP (major 6) % change on year earlier		
	1986	3.4	3.5
	1987 H1	3.8	3.9
2.	Effective Exchange Rate (1975 = 100)		
	1986 Q4	72	70½
	1987 Q2	72	70½
3.	Oil prices, $ Brent spot		
	1986 Q4	15.0	12.5
	1987 Q2	15.3	12.8
4.	Nominal GDP (MP) (% change on year earlier)		
	1986-7	6.5	6.3
	1987-8	6.3	6.2
5.	GDP Volume (% change on year earlier)		
	1986	3	3
	1987 H1	2	2
6.	RPI (% change on year earlier)		
	1986 Q4	4	4
	1987 Q2	3¾	3½
7.	Current Balance (£ billion)		
	1986	4	3½
	1987 H1 Annual rate	2	1½
8.	PSBR (£ billion)		
	1986-7	6	6¾
	1987-8	7	8

RWP

3120/25

FROM: A G TYRIE
DATE: 16 JANUARY 1987

SIR PETER MIDDLETON

cc PS/Chancellor
PS/Chief Secretary
Mr Culpin
Mr Romanski

Bob Porter of the Sunday Telegraph rang me this morning to ask if he could discuss developments in Labour's spending plans since the issue of the £28 billion costing in July. I explained that I was in purdah but would seek permission to give him the information he wanted later on this afternoon.

2. May I have that permission?

M. May

pp **A G TYRIE**

Phoned through.

This seems fine ok providing conversation is solely on Labour's plans.

SECRET

(DB) 9/2/87

FROM: P N SEDGWICK
DATE: 5 FEBRUARY 1987

SIR T BURNS

Sptd PNS

cc Sir P Middleton
Mr F E R Butler
Mr Cassell
Mr Odling-Smee
Mr Scholar
Mr Turnbull
Mr Mowl
Mr Riley
Mr Ritchie

PROJECTIONS OF GOVERNMENT REVENUES IN THE 1987 FSBR

Before the Chancellor's meeting on Monday to discuss Chris Riley's paper of February 3 on the 1987 MTFS I would like to set out some of the potentially adverse consequences that could stem from the currently preferred treatment of future government revenues in the FSBR. The issues I discuss in this note primarily concern the figures for general government receipts over the medium term in part 2 of the FSBR, but to the extent that there is some massaging of the revenue figures for 1987-88 - a possibility discussed in paragraph 42 of Chris Riley's note - there could be problems elsewhere in the FSBR, notably part 1 (table 1.2) and part 6.

2. The proposed approach for the fiscal projections is

(a) for the public expenditure figures to be consistent with the published cash plans, though there is - as Andrew Turnbull has shown - some very modest scope for manipulating the national accounts adjustments and debt interest to produce more realistic GGE/GDP ratios;

and (b) the government receipts figures to be adjusted downward in order to produce fiscal adjustments over the medium term that are both realistic (given the likelihood of upward revisions to the public expenditure plans) and modest.

3. Before considering the implications of this general approach for the path of government receipts for 1987-88 onwards it is worth taking account of what will be the most recently available recorded

information that the outside world is likely to be absorbing at the time of the budget.

4. The attached table is an expanded version of table 8 in the recent PSF forecast report, though with non-oil rather than total GG receipts. The estimate for non-oil GG receipts in 1986-87 will be about £3½b. (2½ per cent) higher than estimated in the 1986 FSBR. The increase on a year earlier will be 9¼ per cent, nearly 3 percentage points higher than our estimate of Money GDP growth in 1986-87 of 6½ per cent. (This difference will be even greater if we use an estimate of Money GDP growth consistent with the CSO's 'recorded' data.) Most (£3b.) of this upward revision since the 1986 FSBR of £3½b. in GG non-oil receipts can be attributed to CT and VAT. After the completion of the papers we are preparing for the Chancellor on CT and VAT I think that we will be as well placed as can be expected - given our surprise at the buoyancy of these taxes so far during 1986-87 - to explain why they have risen so much.

5. The FSBR will have considerable detail in parts 1, 2, and 6 on our estimates of revenue in 1987-88. Subject to any downward revision of the type discussed in paragraph 2 above, which for realism cannot be too great, the cash figure for GG non-oil receipts in 1987-88 is, as the attached table shows, going to be over £8b. (no less than 5 per cent) higher than the figure published in the 1986 FSBR.

6. To the extent that there is going to be a tax package greater than the £2b. fiscal adjustment published in the 1986 FSBR the difference will be a little less than a simple comparison of the published figures will suggest. Panel B of the table shows the GG non-oil receipts figures for various published and internal forecasts for the years from 1987-88 <u>before</u> fiscal adjustment. (This is the way that the figures for effective tax rates in my main report and Colin Mowl's PSF reports have been calculated. A reader of the FSBR can calculate these figures.) Comparison of the 1986 FSBR and latest estimates on this basis gives the best indication of the scale of the upward revision to GG non-oil receipts.

7. The likely enormous upward revision to our published estimate of GG receipts in 1987-88 can - oversimplifying somewhat - be largely attributed to three factors:

(i) higher than expected effective tax rates for CT and VAT, which accounts for £2½-3b. of the revision to 1987-88 receipts from a year ago,

(ii) removal of explicit downward adjustments to the projections of taxes in the 1986 FSBR (to keep the forecast fiscal adjustment low),

and (iii) a lower level for Money GDP in 1987-88 in the 1986 FSBR than we will publish in the 1987 FSBR: the Money GDP figure in the 1986 FSBR was deliberately chosen to be lower than the previous internal forecast (Chris Riley's paper explains that such downward adjustment to Money GDP is common when constructing the MTFS projections).

I regard the total downward adjustment of revenues for publication purposes in the 1986 FSBR as the direct adjustments in (ii) plus some part of the indirect adjustments as a result of (iii). While there is no unique way of defining such downward adjustments, I do not regard (ii) on its own - about £1.3b. - as an adequate estimate of the total presentational adjustment.

8. There is a strong possibility that the more assiduous and astute outside commentators will suspect that part at least of the huge upward revision to receipts for 1987-88 since the 1986 FSBR represents removal of presentational adjustments. There is certainly no way that we will be able to argue that changes of views on the likely effective rates of CT and VAT explain the major part of the upward revision for that year: they probably account for about one-third of it.

9. It would probably be easier to explain away the changes in our published estimates for receipts in 1987-88 were it not for the likely method of treating revenues from 1988-89 onwards. On the basis of PSF's current best estimate of GG non-oil revenues pre-fiscal adjustment for the Plans Case with revenues adjusted to produce the

forecast fiscal adjustment (as discussed in Chris Riley's note) will be only 5.6 and 4.3 per cent higher than a year earlier in 1988-89 and 1989-90, compared with growth of Money GDP of 6.3 and 5.8 per cent respectively. Implementing the proposals set out in Chris Riley's paper, ie with downward adjustments to non-oil revenues (assumed here to be entirely on non-oil revenues, though in the past oil receipts have been adjusted too to some extent), would have them rising by amounts significantly less than Money GDP from 1988-89, both pre and post fiscal adjustment. The run of figures pre-fiscal adjustment would be as follows.

	Money GDP (% change)	GG non-oil receipts (% change)
1987-88	7.3	9.0
1988-89	6.3	5.6
1989-90	5.8	4.3

10. Only simple calculations with the data in the FSBR are needed to produce the figures in the attached table comparing the figures in 1986 and 1987 FSBR's, and in turn comparing these with Money GDP growth. Alert commentators could therefore easily conclude that we had massaged the figures for 1988-89 downwards in a major way.

11. The presentational problems that we have so far concentrated on in discussions on the numbers for the FSBR in large part stem from

(i) the desire to stick to the PEWP public expenditure figures even though they are consistent with lower inflation assumptions than are proposed for the FSBR - hence the tendency for shares of GGE in GDP to be below those in the PEWP,

and (ii) the desire not to show large fiscal adjustments.

In deciding on how to present the fiscal numbers in the FSBR I think that we should put more weight on the credibility of the figures for government receipts. Quite apart from the possibility that after the

1986-87 we could face major problems defending deliberately biased numbers before the TCSC, etc., we should be wary of letting outsiders get the impression from observation of our practice last year and in the next FSBR that the revenue figures are deliberately doctored to serve the particular presentational requirements of the time. There could well be occasions in the future when we will very much want to convince sceptical commentators that our revenue projections have not been deliberately biased in an upward direction.

P.N.S

P N SEDGWICK

A

NON-NORTH SEA GENERAL GOVERNMENT RECEIPTS : SUCCESSIVE FORECASTS £bn

AFTER FISCAL ADJUSTMENT		1984/5		1985/6		1986/7		1987/8		1988/9		1989/90	
		CASH	REAL	CASH	REAL	CASH	REAL	CASH	REAL	CASH	REAL	CASH	REAL
OUTTURNS		128.8 (6.2)	97.0 (1.8)	140.3 (8.9)	99.4 (2.5)	–	–	–	–	–	–	–	–
JANUARY	1986	–	–	–	–	147.9 (5.4)	102.3 (2.9)	156.9 (6.1)	103.9 (1.6)	165.9 (5.7)	104.5 (0.5)	176.7 (6.5)	106.7 (2.1)
FSBR	1986	–	–	–	–	149.8 (6.8)	102.7 (3.3)	157.7 (5.3)	104.2 (1.4)	163.1 (3.4)	104.3 (0.1)	168.3 (3.2)	104.4 (0.1)
JUNE	1986	–	–	–	–	150.1 (7.0)	103.3 (3.9)	160.2 (6.7)	106.2 (2.8)	168.6 (5.2)	106.6 (0.4)	178.2 (5.7)	108.2 (1.5)
OCTOBER	1986	–	–	–	–	150.8 (7.3)	103.9 (4.5)	161.4 (7.0)	106.9 (2.8)	171.5 (6.3)	108.3 (1.3)	183.4 (6.9)	109.4 (1.0)
JANUARY	1987	–	–	–	–	153.5 (9.4)	105.6 (6.2)	164.5 (7.2)	108.3 (2.6)	178.1 (8.3)	111.6 (3.0)	191.1 (7.3)	113.4 (1.6)
MTFS	(i)	–	–	–	–	153.5 (9.4)	105.5 (6.1)	164.3 (7.0)	108.1 (2.4)	170.9 (4.0)	107.9 (-0.2)	177.8 (4.0)	108.5 (0.6)
MTFS	(ii)					153.5 (9.4)	105.5 (6.1)	164.3 (7.0)	108.1 (2.4)	170.9 (4.0)	107.9 (-0.2)	177.8 (4.0)	108.5 (0.6)

MONEY/REAL GDP GROWTH		MONEY	REAL	MONEY	REAL	MONEY	REAL	MONEY	REAL	MONEY	REAL	MONEY	REAL
OUTTURNS		7.4	2.9	9.9	3.4								
JANUARY	1986	–	–	–	–	6.7	2.3	6.8	2.1	7.0	1.7	5.7	1.2
FSBR	1986	–	–	–	–	6.8	2.9	6.4	2.4	6.0	2.5	5.5	2.4
JUNE	1986	–	–	–	–	5.7	2.6	7.0	2.9	6.6	1.7	5.5	1.2
OCTOBER	1986	–	–	–	–	5.5	2.3	7.3	3.0	8.0	2.9	8.0	2.0
JANUARY	1987	–	–	–	–	6.6	3.3	7.3	2.8	7.8	2.5	7.8	2.4
MTFS	(i)	–	–	–	–	6.6	3.3	7.3	2.8	6.3	2.2	5.8	2.2
	(ii)	–	–	–	–	6.6	3.3	7.3	2.8	6.3	2.2	5.8	2.2

B

NON - NORTH SEA GENERAL GOVERNMENT RECEIPTS : SUCCESSIVE FORECASTS £bn

BEFORE FISCAL ADJUSTMENT	1984/5		1985/6		1986/7		1987/88		1988/89		1989/90	
	CASH	REAL	CASH	REAL	CASH	REAL	CASH	REAL	CASH	REAL	CASH	REAL
JANUARY 1986	-	-	-	-	149.8 (6.8)	103.9 (4.5)	163.0 (8.8)	108.1 (4.0)	174.9 (7.3)	110.4 (2.1)	184.9 (5.7)	111.7 (1.2)
FSBR 1986	-	-	-	-			160.0 (6.8)	105.7 (3.0)	169.4 (5.9)	108.3 (2.5)	177.6 (4.8)	110.2 (1.8)
JUNE 1986	-	-	-	-			162.3 (8.1)	107.6 (4.3)	176.4 (8.7)	111.6 (3.7)	186.2 (5.6)	113.1 (1.3)
OCTOBER 1986	-	-	-	-			163.7 (8.5)	108.4 (4.3)	179.3 (9.5)	113.2 (4.4)	194.3 (8.4)	115.9 (2.4)
JANUARY 1987	-	-	-	-			167.4 (9.0)	110.2 (4.4)	182.9 (9.3)	114.6 (4.0)	196.0 (7.2)	116.7 (1.8)
MTFS (i)	-	-	-	-			167.4 (9.1)	110.2 (4.4)	180.6 (7.9)	114.2 (3.6)	189.2 (4.8)	115.7 (1.2)
MTFS (ii)	-	-	-	-			167.2 (9.0)	110.0 (4.3)	176.5 (5.6)	111.6 (1.5)	184.0 (4.3)	112.4 (0.7

MTFS (i) : PLANS CASE IN MR RILEY'S SUBMISSION TO CHANCELLOR OF 3 FEB..

MTFS (ii) : AS MTFS (i) BUT WITH RECEIPTS ADJUSTED DOWN TO GIVE FISCAL ADJUSTMENT IN MR RILEY'S FORECAST CASE.

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* 58,3,-12,-12,-12,-12
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* 63,3,12,12,12,12
* 64,3,136,126,120,120
* 65,3,10,10,10,10
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System> SAVE DATA NIUNROUNDED
System> REPORT USING NI5REPORT
System> DISPLAY
```

SECRET

Can't give
+ P/E – PEWP
+ Fiscal adj – as computed
+ Taxes – residual
Drawbacks – revise up PEWP without cost to £/adj: not good discipline.

FROM: C J RILEY
DATE: 6 FEBRUARY 1987

SIR T BURNS

cc Mr Odling Smee
Mr Sedgwick
Mr Mowl
Mr Ritchie
Ms Turk

PROJECTIONS OF GOVERNMENT REVENUES IN THE 1987 FSBR

I was interested to see Peter Sedgwick's minute of 5 February on this.

2. I am sure it is right to be careful not to doctor the revenue projections so much that we produce implausibly low figures. My submission to the Chancellor said as much (paragraph 44), but we cannot go into much greater detail until we are closer to finalising the numbers. The forecast is still subject to significant revision, and the Budget package has to be taken into account.

3. We should not exaggerate the difficulty of explaining our revenue projection for 1987-88, and the difference from last year's MTFS. The fact that money GDP is higher - which may itself cause presentational difficulties of a different sort - accounts for a good deal of the difference (£2½ billion), and this should not be difficult to explain. We have been quite clear about the fact that money GDP is not a target in the short term, and that the data are subject to significant revision. The downward adjustment applied to the money GDP figure for publication in the 1986 MTFS accounted for a small proportion - about ¼ - of the difference, worth only around £½ billion in revenue.

4. The main presentational difficulty for 1987-88 clearly arises in explaining the revisions to our view of effective tax rates. I was struck by how much more this was worth than the downward adjustments we made to revenues for presentational reasons. It is right that presentational adjustments should not be so great that they exceed the margins of error surrounding the forecast. One

option would be to shade down our estimate of effective tax rates in 1987-88, which would both reduce the scale of the presentational problems slightly and satisfy the Chancellor's desire for caution.

5. Turning to the later years, I don't think it would be impossibly difficult to defend a projection in which GG non-oil receipts grew slightly - but not too much - less than the growth of money GDP (strictly, non-North Sea GDP). Among the factors we could point to are:

- a declining share of interest and other receipts as interest rates stay flat or fall in nominal terms

- a decline in the share of CT receipts reflecting the impact of the 1984 reforms

- the possibility that some of the recent rise in effective tax rates is temporary, partly reflecting cyclical factors.

6. But clearly we must not produce implausibly low numbers, which cannot be explained by factors such as these, unless we are prepared to say explicitly that the projections are deliberately cautious. It is fairly easy to recognise the presentational pitfalls in producing doctored projections. But it is less easy to devise alternative approaches which satisfy the requirements which Peter mentions in his paragraph 11.

7. As I understand it, there is no question of us departing from the cash figures for the planning total given in the PEWP, and it is this which gives rise to our problems on GG expenditure and the fiscal adjustments. We could, I suppose, simply present the PEWP figures for the GGE percentages after 1987-88, without giving cash figures for the planning total, but this is not really a solution to the problem. It would be entirely straightforward to derive the implied cash figures for the planning total to the nearest £1 billion or so, which would be evidently different from the figures in Chapter 5.

8. Another alternative would be to show significantly higher fiscal adjustments than implied by our central forecasts of public expenditure. But the Chancellor was strongly opposed to doing so last year, and may well not want to go too far in this direction this year. We shall see what he says at Monday's meeting.

9. I can see no easy way around these problems. We have to trade off degrees of implausibility in the various components of the projection.

C J RILEY

ps8/8A

FROM: A C S ALLAN
DATE: 2 February 1987

CHANCELLOR

MEETING ON FORECAST

This afternoon's meeting is largely a public relations exercise, with the full cast of Ministers, advisers and forecasters. I think it would be better to let the discussion range fairly widely, and in particular better not to put too much emphasis on exactly what numbers we might publish: you have already discussed this with Peter and Terry separately.

2. I suggest the main points to go through are:

(a) World background. Reasonably favourable, but dependent on assumption of some additional fiscal stimulus in Japan and Germany. Strong recovery in world trade, largely as a result of turn-round in non-oil developing countries' imports.

(b) UK demand and output. Large discrepancies in recent statistics, probably profits and investment in particular. Prospects for 1987 good (and reasonably balanced). Interesting new definition of savings ratio (paragraph 112).

(c) Balance of payments. Import growth looks high (though Terry's point about through-year growth in 1986). Latest figures suggest slightly better outlook?

(d) Pay. Reasonably promising in private sector, but large increase is forecast for public sector: realistic? Can we get them down?

(e) Inflation/RPI. "Blip" in summer. Generally, plateau of about 4 per cent RPI and 7 per cent money GDP.

(f) Fiscal prospects. Conservative revenue forecasts (VAT, CT, stamp duty). And possibly pessimistic on public expenditure for 1988-89. $15/$18 oil.

(g) Monetary prospects. Interest rates assumed to remain constant. M0 starts above 6 per cent in 1987-88, but falls back. Odd forecast for rising long rates.

Policy implications

3. Very large fiscal adjustment implying scope for both large tax package and cut in PSBR. Prospects for balance of payments no problem, but genuine worries about inflation. Above MTFS path for money GDP. Any feasible action at this stage of cycle? Ideal would be mix of higher exchange rate and lower interest rates, but no way of guaranteeing this.

AA

A C S ALLAN

THE CENTER FOR SECURITY POLICY

Frank J. Gaffney, Jr.
Director

2 February 1989

Honorable Nigel Lawson
Chancellor of the Exchequer
c/o The Embassy of the United Kingdom of Great Britain
3100 Massachusetts Avenue, NW
Washington, D.C. 20008

Dear Mr. Chancellor:

I am pleased to forward for your immediate attention a paper just released by the Center for Security Policy. It addresses a matter of utmost importance to the future security and prosperity of the West: the true nature of and prospects for Mikhail Gorbachev's perestroika.

Given the Soviet Union's increasing efforts to obtain economic and financial assistance from G-7 nations, we believe it imperative that the purposes such assistance might serve be carefully assessed. Toward that end, the Center for Security policy has prepared the attached paper, Economic and Financial Security: Gorbachev's Perestroika and How the West Should Respond. It offers -- in a concise, readable form -- a critical appraisal of the key components of the Soviet agenda in this area and specific recommendations as to how the West should respond. The paper is also very relevant to your upcoming discussions concerning the international debt crisis and the preferential treatment which the USSR and East bloc countries often receive over Latin American debtor nations and other developing countries.

We expect this paper will be receiving considerable attention in the coming weeks and months by the United States government -- both executive and legislative branches -- as the Bush Administration's "strategic reassessment" proceeds. Accordingly, we strongly encourage you to review this White Paper with care.

Sincerely yours,

Frank J. Gaffney, Jr.

Frank J. Gaffney, Jr.
Director

Attachment: a/s

1250 24th Street, N.W., Suite 600, Washington, D.C. 20037 (202) 466-0515 FAX (202) 466-0518

sw6

FROM: S W MATTHEWS
DATE: 3 February 1987

1. MR ~~EVANS~~ HME 3/2

2. CHANCELLOR

cc: Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler o/c
Mr Byatt
Mr Lavelle
Mr Burgner
Mr Mountfield
Mr Odling-Smee
Mr Scholar
Mr Dolphin
Ms Symes

Item (1) - Macro + structural adjustment
Single paper on all issues?
Synthesis Report - was conclusions + recommendations
Views on position on agenda

VISIT BY OECD SECRETARY-GENERAL: THURSDAY 5 FEBRUARY

You have agreed to see the Secretary-General of the OECD, M. Jean-Claude Paye at 12.15pm. Sir G Littler will still be in Italy and has asked Mr Evans to attend. Sir Peter Middleton will also be meeting him at 3pm. M. Paye will be accompanied by Mr Tom Alexander, his Private Secretary, and Mr Nicholas Bayne, our Ambassador at the OECD.

2. In addition to this note you may like to see Sir G Littler's minute of 3 February to Sir P Middleton on "International discussions in early 1987" (flag A).

3. A copy of Paye's itinery is set out at flag B and his curriculum vitae (prepared by the FCO) is at flag C.

Preparation for the OECD Ministerial

4. The object of Paye's visit is to prepare for the OECD Ministerial Council on 12 - 13 May. He will subsequently be visiting other major capitals, including Washington and Tokyo in late February.

5. The OECD Ministerial is still some 3 months away and, not surprisingly, the Ambassador reports that Paye's thinking about the structure of the meeting and the papers that he will prepare for it is still tentative. The agenda will almost certainly cover

macroeconomic policy, structural adjustment issues, agriculture, trade and protectionism, and relations with developing countries. You may wish to suggest to Paye that the first day of the Ministerial, when you are proposing to attend, should focus primarily on the first two questions. This was in fact broadly the pattern adopted last year.

6. Reports by the Secretary-General in response to two Mandates from previous Ministerial meetings are due to be presented in May. That on agriculture has been around in draft for a month or two and has generated entirely predictable reactions. That on Economic Performance and Structural Adjustment has only just appeared. Both reports are bulky and Paye will have to decide how to present them to the Ministerial. Last year Paye produced a single paper covering all issues. This worked well and you may like to suggest that he does the same again, even if he also circulates papers setting out the main issues on, for instance, agriculture in a little more detail. It is useful in particular to be able to discuss micro- and macro-economic policies together without any artificial constraint being imposed by the documentation for the meeting.

MACROECONOMIC PROSPECTS AND POLICIES

7. Like our own forecasts, the latest OECD Economic Outlook, which was published just before Christmas, shows a prospect of moderate growth in the major industrialised countries of 2½ - 3 per cent, with continuing low inflation. The OECD note that, while adjustment of current account imbalances appears to have started in volume terms, the imbalances are likely to remain very large in nominal terms. They are concerned about the risk that impatience with the slow rate of progress will encourage further protectionism.

8. The Economic Outlook points to the need for a change in the relative rates of growth of domestic demand in the US, Japan and Germany. It comes down marginally in favour of an exchange rate "pause" to help the changes to date to be "digested", but notes the difficulty of bringing about such a period of stability.

9. The OECD naturally tend to be supporters of greater economic policy coordination. They have not been directly involved in the indicators exercise. Encouraged by Sir Geoffrey Littler, they have been following a slightly different approach designed to analyse the circumstances in which potentially disruptive, unsustainable situations arise and how they can be avoided in future. WP3 has work in hand on this (and members of the Secretariat visited the UK last week to discuss the chosen historical episode). Paye appears to accept that OECD's role is largely a background one of providing good quality forecasts and analyses, and a forum for discussing them without pressure to negotiate.

10. On policies, the OECD continue to call for substantial cuts in the US Federal budget deficit and for Japan to take measures to maintain a growth rate of domestic demand in excess of productive potential. OECD increasingly stress the need to increase labour market flexibility, encourage industrial adjustment, liberalise trade, cut agricultural support etc in order to improve world economic prospects in the longer term.

Line to take

- Similar view of world economic prospects.

- Sound financial policies remain the key to sustainable growth with low inflation.

- Share concern over protectionist threats in the US, encouraged by large current account imbalances and slow adjustment.

- See a case for pause in exchange rate adjustment, but vital that fiscal and monetary policies in US, Japan and Germany support reduction in imbalances.

STRUCTURAL ADJUSTMENT

11. The Secretary-General's report was commissioned by the 1985 Ministerial. The US pressed particularly strongly for it. We too hoped that the report would argue strongly in favour of microeconomic policies to promote competition and make markets work better, in order to maintain the momentum of earlier OECD work on Positive Adjustment Policies and the Costs and Benefits of Protection. The synthesis report, as currently drafted, fulfils this requirement pretty well. But it is a little short on recommendations and its concluding section on how policy reform might contribute to better economic performance in future is somewhat general. A summary of the draft report is at flag D. (At Sir T Burns' suggestion, we have also included a complete copy) [initials]

12. The report's emphasis on microeconomic policies (combined with a stable, medium-term macroeconomic framework) to improve performance is welcome in a domestic context. We will want to press for the report to be de-restricted and published. The importance attached to international competition and open markets is also welcome, and it is disappointing that the conclusions do not say more about what the OECD and its members should do in this context.

13. Paye will have heard initial reactions to the report at the meeting of the OECD Executive Committee in Special Session on 3 - 4 February, immediately before his visit to London. The most wide-ranging discussion of the report, before it is re-drafted and circulated for the Ministerial meeting, will be at an ad hoc meeting of EPC on 19 - 20 February, which Sir Peter Middleton will be attending. The Secretary-General, though, has editorial control of the report, and is not bound by the comments of EPC and other OECD committees.

Line to take

- Welcome report. In line with Government view of how to improve economic performance. Numerous domestic measures in this vein. Supports approach UK taking on agriculture and in the GATT negotiations.

- International dimension of trade and industrial policies very important. Is report able to make more specific recommendations on these aspects? What follow-up work in OECD does Paye envisage?

AGRICULTURE

14. The Ministerial meeting will be presented with a report on agriculture, which attempts to quantify and compare levels of support in different countries, using the concept of "producer subsidy equivalents". (Annex E summarises the main findings of the report). Paye will also be circulating his own short paper and we have just received a draft of this.

15. With the modalities of the GATT round now settled, the role of the OECD is inevitably a subordinate one. Its work on agriculture has nevertheless provided important technical background to the negotiations, and we are pressing for it to be updated and published as soon as possible. The Secretariat have also been looking at the broader effects of protection of agriculture and WP1 (which Mr Odling-Smee attends) will be discussing the subject in a couple of months' time.

16. You made protectionism in agriculture one of the main themes of your intervention at last year's OECD Ministerial, and of your speech at the IMF/IBRD Annual Meetings, where you succeeded in getting a discussion of agriculture on the agenda for the Development Committee meeting in early April. Paye's support for the line which you have taken is somewhat equivocal and there are some signs of this in his draft note on Agriculture for the Ministerial, which emphasises the complexity of reducing protection, the need for transitional measures etc.

Line to take

- Very useful work by OECD on making international comparisons of protection of agriculture by OECD members.

- Want to see Mandate study updated and published as soon as possible.

- Early reduction in protection must be a priority. Need to create right political climate for reform. But short term and transitional measures must be consistent with market-oriented long run solution.

INTERNATIONAL TRADE

17. As in the case of agriculture, OECD's contribution to negotiations on trade is an indirect one. But we welcome the technical contribution that it can make in such areas as the measurement of non-tariff barriers and analysis of their effects, and regimes and rules for trade in services. OECD's specialised committees remain vital fora for testing support for ideas in the trade field.

18. Discussions on tied-aid credits are continuing under the auspices of the OECD and the subject will once again be on the Ministerial agenda, but there are no issues to raise with Paye at this stage.

OECD STAFF

19. Over the next couple of years, mainly because of retirements, there will be a number of important changes in the upper echelons of the OECD Secretariat. The UK is currently well represented at this level, and we will want to ensure that this continues to be the case. Any attempt to impose national quotas would work against us. In most cases the retirements are not imminent and we will be discussing priorities, suitable candidates etc with other Departments in due course.

Line to take

- Understand that a number of retirements of senior staff are in prospect over next couple of years. Important to recognise merit. UK has very good candidates.

SM.

S W MATTHEWS

FROM: MRS A F CASE
DATE: 3 February 1987

Ch
CST wants to raise at his bilateral
AWK 4/2

CHIEF SECRETARY

Pse tell CST that I have squared PM.
N

cc Chancellor
Economic Secretary
Minister of State
Sir P Middleton
Sir G Littler o/r
Mr Lavelle o/r
Mr Mountfield o/r
Mr Edwards
Mr P Davis
Mr Bush
Mr Denison
Miss Barber
Mr Beales - UKREP

Told PS/CST
AWK 4/2

**OECD CONSENSUS NEGOTIATIONS;
COMMUNITY MANDATE ON TIED AID CREDITS**

Negotiations on improving discipline in tied aid financing have been underway for some years. The UK has consistently backed these efforts. The Community agreed a negotiating mandate at the April 1986 ECOFIN but no progress was made at the subsequent OECD Ministerial Council later that month, principally because of Japanese opposition to proposed changes in the method of calculating the concessionality of aid loans. Such changes are in our view a sine qua non of improving discipline since without such the Japanese, one of the major practitioners, would not be affected at all. Since then negotiations have continued with a view to reaching a compromise agreement before the next OECD Ministerial Council in May 1987.

2. At last month's Consensus meeting satisfactory progress was made. A relatively tough Commission proposal had majority support and was backed, ad referendum, by the US and others as well as the Community. Only the Japanese, with some support from the Swiss and Austrians rejected it. There is therefore good hope of making progress if maximum support can be rallied behind the Community proposal in the hope that the Japanese, if isolated, will give way not later than the OECD Ministerial. If this fails, the probability is that there will be no agreement for at least another year.

3. The Community proposal lies outside the Commission's 1986 negotiating mandate. It is therefore on the ECOFIN agenda for next Monday as a "take it or leave it packagee" - the basis on which Consensus participants have been asked to consider it. However it could still be defeated there, if the various elements are pulled apart. This would allow progress to be blocked by an alliance between of the Germans and Dutch (opposed in principle but out-voted in 1986) and others who want change on particular elements but would accept the package as a whole.

4. In our view we should therefore throw our weight behind the Commission initiative as quickly and positively as possible. The compromise falls short of our objectives in some respects but it is considerably more attractive than other proposals and would result in a relative improvement in our position compared with the Japanese under the present rules.

5. We had understood that this view was shared by other Whitehall departments and therefore envisaged no difficulty in agreeing the line for ECOFIN. However, as the annexed submission to the Minister for Trade makes clear, although ECGD and DTI are prepared to accept the Community proposal at the end of the day, they intend to seek changes on a number of individual elements and, in particular, to reserve the UK's position on the abolition of matrix rates for all Category 1 countries. In our view there is nothing to be gained from this course and much to be lost.

lot yet
suired

6. From a DTI/ECGD point of view the abolition of matrix (subsidised) rates for Category 1 (richer) countries is the major difficulty. UK Ministers have collectively only agreed abolition for OECD/Consensus countries. From a Treasury point of view Category 1 abolition would be welcome as a means of reducing subsidies, by removing subsidies to the Soviet Union and the Eastern Bloc. In practice, if such provision had been in place over the past 2 years little would have been saved since very little business has been done with the Bloc. However, only yesterday Mr Channon announced an inter-governmental long term credit and financing agreement with the USSR which provides

for finance at Consensus rates. It is hoped that this will lead to further contracts, especially following the Prime Minister's visit. DTI argue that the UK would be disadvantaged in obtaining these contracts if they had to be supported at high UK interest rates. On the other hand, the elimination of subsidies on a multilateral basis is an agreed UK objective. No progress in this would ever be made if all countries insisted that no part of any package should ever damage their current position. Moreover, the staging of the Commission's proposal would mean that any contracts signed with the USSR in the next 12 months would benefit from subsidised rates.

6. Given the importance which Treasury Ministers have attached to making progress on the reduction of subsidies in this area, and the risk that the DTI/ECGD tactics would jeopardise the progress which is now within our grasp, I suggest that you write to Mr Clarke, tonight, in the terms of the draft attached.

MRS A F CASE

DRAFT LETTER TO MR CLARKE

cc Foreign Secretary
Minister of Overseas Development
Secretary of State for Trade and Industry

OECD CONSENSUS NEGOTIATIONS:
COMMUNITY MANDATE ON TIED AID CREDIT

My officials have reported to me the satisfactory progress made at the last Consensus meeting on measures to improve discipline in tied aid financing. I understand that the Commission proposal tabled ad referendum had majority support and was backed by most other countries including the US. That proposal has been tabled for endorsement by the Community at next week's ECOFIN meeting.

2. Over the past few years the UK has consistently sought a multilateral reduction in export credit subsidies including the use of tied aid credits. The proposal from the Commission, whilst falling short of what would be ideal, would nevertheless contribute to our overall aim of reducing subsidy on a multilateral basis and represent a relative improvement in our position particularly viz a viz the Japanese. It seems to me therefore an acceptable step forward to which we should give our full support.

3. In the light of the views expressed in earlier discussions in Brussels and Paris I was surprised

to learn that your officials were recommending that we seek to reopen various aspects of the package and seek improvements on points of detail, at COREPER and perhaps ECOFIN.

4. This seems to me the wrong tactical approach. By seeking improvements in those aspects we find less palatable, we risk offering an opportunity to the Germans and Dutch who are opposed in principle to use the renewed debate on individual elements to block progress entirely. The whole package may then unravel. Moreover even if the Community were prepared to agree, there seems little likelihood that such a modified package would command support among Participants. If we are to seize the opportunity offered by developments in Paris to secure our overall objectives, the Community must remain united behind the proposals tabled by the Commission.

5. I hope you will feel able to reconsider the proposed instructions for COREPER and instead take the lead within the Community in supporting the package as it stands.

6. I am copying this letter to Paul Channon and Geoffrey Howe.

FROM: SIR T BURNS
DATE: 3 FEBRUARY 1987

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Mr F E R Butler
Sir G Littler
Mr Cassell
Mr Kemp
Mr Monck
Mr Odling-Smee
Mr Scholar
Mr Sedgwick
Mr Turnbull
Mr Bottrill
Mr Culpin
Mr S Davies
Mr Mowl
Mr Cropper
Mr Ross-Goobey
Mr Tyrie

Many thanks. N.

[$18 range] [poss. $15] N

JANUARY 1987 ECONOMIC FORECAST

We discussed the latest internal forecast yesterday. This note develops my opening remarks at the meeting.

2. The forecast has a number of welcome features:

- steady growth continuing at around 3 per cent per annum;

- continued impressive productivity growth, particularly in manufacturing industry;

- falling unemployment;

- buoyant tax revenues leading to a projected undershoot of the PSBR this year with a substantial fiscal adjustment next year.

3. The problems are familiar:

- uncomfortably rapid growth of earnings;

- strong import growth;

- projected slippage of public expenditure objectives;

- continued weakness of demand in some industrial and developing countries.

4. Most of these features were present in the forecast preview we examined at Chevening. It is not surprising that my own interpretation of the policy implications has not changed much.

5. We have had several years of steady growth - at a time when other countries have grown considerably less rapidly than in earlier periods. The forecast shows continued growth of domestic demand at over 3 per cent a year. After several years of growth at this rate there is clearly a risk of some upturn of inflation and a deteriorating balance of payments current account followed by a period of slower output growth. Obviously the faster the rate of growth in the upturn the more likely these pressures are to arise. However we should be less vunerable than in some previous episodes because a significant feature of this recovery has been reasonably steady output growth.

6. Some of these signs have been emerging recently:

- the underlying inflation rate seems to be picking up again although it is difficult to disentangle the rebound from last year's very low rate from a change in trend;

- and the non-oil current account deteriorated in the second half of last year. In particular non-oil imports have risen very rapidly through 1986. The level of manufactured imports in the final quarter of last year was almost 15 per cent higher than in the first quarter of the year.

7. Given the high level of UK net overseas financial assets the balance of payments is less of a worry for its own sake than as a possible indicator of emerging domestic demand pressure relative to our trading partners. Excluding the influence of commodity

prices the balance of payments tends to move in sympathy with inflationary pressures generally.

8. I would not want to overstate these pressures:

- the two measures of capacity utilisation in manufacturing industry compiled by the CBI do not show the economy under very sharp strain;

- and there are still no general severe shortages of skilled labour.

9. But the general message of the forecast points to caution in the Budget. It reinforces the suspicion that in recent years we have not seen much, if any, improvement in the underlying inflation rate despite a favourable behaviour of commodity prices. One interpretation is that the underlying rate has been about 4 to 5 per cent since 1983-4 with variation around this being primarily the result of changes in mortgage rate and oil prices. This is not very surprising given that output growth has averaged about 3 per cent a year, which is close to our estimate of the underlying rate. Typically it is very difficult to bring inflation down during the upswing of the cycle. The challenge is to prevent a deterioration particularly if commodity prices recover.

10. As usual there are a number of other difficult forecasting judgements which have implications for policy. This time I would draw attention to two: the exchange rate/interest rate profile and the prospect for tax revenues.

Exchange Rate and Interest Rates

11. The exchange rate/interest rate profile has an important influence on the forecast because of its significance for monetary conditions generally. The judgements made in the forecast imply a gently declining exchange rate from the end of this year despite the large interest rate differential with the rest of the world. This judgement is conditioned by recent experience and the expectation of a further current account deterioration.

12. I would prefer to see a stronger exchange rate for given interest rates. This would make possible some combination of a higher exchange rate and lower interest rates which in turn would help inflation for a given growth of output. In contrast if the forecast proves to be correct we could have difficulty later this year with our assessment of monetary conditions generally. There is a danger of M0 exceeding its target in the Spring just at the time that we may be facing expectations of lower interest rates in response to the prospect of a much lower PSBR. In the absence of a higher exchange rate it will be unwise to give way to any pressure for lower interest rates. A strengthening of the exchange rate would affect that judgment to some extent even though as things stand it is difficult to see much scope for lower interest rates in the rest of 1987.

13. The key to the emergence of market pressures for a higher exchange rate for given interest rates is market confidence in the sustainability of policy. In a likely election year there is an obvious political component of sustainability; but there is also an economic component. That economic component relates in particular to the prospect for inflation and the balance of payments. Higher inflation relative to other countries and a deteriorating current account are historically the factors that lead governments to seek a lower exchange rate which only perpetuates the inflation.

14. A higher exchange rate needs to be supported by an appropriate fiscal policy if recurring balance of payments difficulties are to be avoided. This would also improve confidence by avoiding the fear that UK domestic demand was growing too rapidly relative to other countries and producing supply problems for domestic producers. In turn that has clear implications for the style of Budget you will introduce although it does not pin down very accurately the exact size. Thus there is a potential virtuous circle linking the exchange rate, the Budget and confidence.

The Government Accounts

15. One of the noticeable features of the current financial year so far has been the large increase in the estimates of tax revenue, both for this year and next. Obviously this is welcome and makes for an easier set of decisions at budget time. At the same time I remain just a little cautious. Recent revisions have been huge; and I work on the principle that the larger the revisions the less certain we are of forecasts.

16. The key issue is the extent to which the higher revenues are permanent. This involves a judgement of the part of revenues that are cyclical and those that reflect longer term considerations.

17. I suspect there is a significant cyclical element to current revenue buoyancy;

- present high Corporation Tax receipts reflect the profile of profits and investment allowances. In part these will reflect the stage of the cycle at the time and in part the transformation to the new tax regime;

- the rising share of VAT revenues could reflect a drift towards a higher proportion of expenditure on VAT-able goods. In part I would expect this to reflect the rapid growth of personal disposable income we have experienced in recent years. We have more work in hand to get to the bottom of this; for the moment I conclude that there is a cyclical element to it;

- past experience suggests that a liquid, profitable company sector is less likely to hold up tax payments. Some of the revenue buoyancy may reflect a move towards greater profitability and could be threatened if financial conditions for companies became tighter;

[illegible]

- stamp duty receipts reflect the soaring stock market and the current strength of the housing market. There is clearly a cyclical element to both of these;

- public sector pay has been growing less rapidly than private sector pay until recently. On past experience there is a cyclical element to the ratio of public to private sector pay. If the present rate proves unsustainable it would have significant implications for the pressures on public expenditure in cost terms.

18. On the other hand by no means all of the buoyant revenue can be described as cyclical:

- there seems to have been some trend in the share of VAT-able expenditure over several years;

- the CT reform package probably encouraged a change of behaviour by company Treasurers towards tax payments. Although designed to be neutral it has become increasingly likely that there has been a revenue gain from the change;

- recent changes to financial markets may have meant more active markets on a longer-term basis;

- there has been progress on restraining the growth of public expenditure in addition to the help from public sector pay.

19. This suggests approaching the revenue figures with caution. But the effective tax rate has clearly risen for the time being and with it the scope for fiscal adjustment.

Conclusions

20. I have little to add to my Chevening paper as far as policy implications are concerned. This is a valuable opportunity to make a significant reduction in the PSBR. Adjusting for privatisation proceeds there has been a tendency for the PSBR ratios in the MTFS to be revised up over time. When expenditure

was running ahead of expectations and there was little scope for tax adjustments this was understandable. Now there is room to correct for that drift and combine cautious tax reductions with a significantly lower PSBR. My own judgement of the prudent scope for tax reductions continues to be at the lower end of the range we have discussed.

T BURNS

MR 10/74

cc: PS/CST
PS/Sir P Middleton
Mr F E R Butler
Mr Anson
Miss Peirson
Miss Kelley
Mr White

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

The Rt Hon Nicholas Edwards MP
Secretary of State for Wales
Gwydyr House
Whitehall
LONDON SW1A 2ER

3 February 1987

Dear Nick

WELSH LANGUAGE LEAFLETS

Thank you for your 28 January letter.

I am writing to let you know that I will be arranging for the message about the need to take proper account of Welsh language needs in information literature to be passed on to those of my departments which have close day-to-day contact with the public.

I am pleased to note that you draw attention to the need for departments to pay heed to value for money considerations in considering whether there is a need for translation.

Yours

Nigel

NIGEL LAWSON

MR 10/75

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

Rt Hon David Howell MP
House of Commons
LONDON
SW1A 0AA

3 February 1987

Dear David

I have seen a copy of your open letter of 20 January to Mr Battishill and his reply.

As Chairman of the Board of Inland Revenue, he advises me on questions of tax policy and in doing so is in no different position from other Permanent Secretaries advising their Ministers. It is, as you know, well established that officials' advice to Ministers is tendered in confidence and it follows from this that the Chairman cannot comment publicly on policy questions of the kind set out in your letter. It is Ministers who take the decisions and it is for me to reply to the points you raise about tax reform.

As you say, many nations are getting to grips both with tax reform and with modernising their tax administrations. I wholeheartedly agree about the importance of these issues. This Government can take credit for having embarked on the process of reform earlier than most. One need look no further than the major reform of business taxation which I introduced in 1984 and which others are now emulating.

Nor have we lost sight of the need to make progress in modernising our tax administration. Again, you need look no further than the massive programme of Inland Revenue computerisation. The programme to computerise PAYE alone is among the largest of its kind in Europe: it is nearing completion, and, by common consent, has been a most successful operation, bringing benefits for taxpayers and the Revenue alike.

Let me now turn to your six questions.

1. Chapter 7 of the Green Paper on The Reform of Personal Taxation (Cmnd 9756) looked very carefully at the question of combining national insurance contributions and income tax and concluded that, taking account of the wider consequences - including distributional effects - the

benefits of a combined charge would be unlikely to justify the upheaval. But I do not have a closed mind on the subject, so if you have solutions to the specific difficulties identified in the Green Paper I should be interested to know what they are.

2. I, like you, believe that considerable benefits flow from lowering marginal tax rates - and the Government's record is a good one. Since 1979 we have brought down the top rate of income tax from 83% (98% if you include the investment income surcharge which we abolished) to 60% and the basic rate from 33% to 29%. I have made no secret of my desire to lower marginal rates still further when circumstances permit.

3. The Government has done much to promote self-employment, not least in reducing the burdens on small businesses. The number of self-employed businessmen (and women) has increased by some 50% since we took office. Last year you asked Questions in the House, and wrote to me, about the possibility that the Inland Revenue were being too strict in determining eligibility to be taxed under Schedule D. The essential question here is whether the taxpayer is in business on his own account. If he is then he ought to be taxed under Schedule D; but if he is not then he properly comes under the rules of Schedule E. It would be quite wrong - and unfair to other taxpayers - for the Revenue to turn a blind eye when people who are not genuinely self-employed claim to be taxed under Schedule D. Besides being costly in revenue, a relaxation here would do nothing to foster the true spirit of enterprise which I know you are as keen as I am to see.

4. The proposed nationally-determined business rate will complement, not contradict, the principle of national taxation of business profits. But to replace corporation tax on income or profit by a tax on business assets could, in the longer term, discourage new investment in plant and machinery, in contrast to corporation tax which makes due allowance for the depreciation of capital assets. And abolishing corporation tax for companies, but not income tax for unincorporated businesses, could create massive distortions between different businesses.

5. I believe you do less than justice to the progress we have made in reforming the capital taxes. One of the considerations when deciding to abolish development land tax was its low cost/yield ratio. The abolition of lifetime cumulation for capital transfer tax removed an obstacle to lifetime giving; and I built on this last year when I abolished the tax altogether and introduced inheritance tax in its place. Both Geoffrey Howe and I have done much to mitigate the impact of capital gains tax; even so an estimated yield of nearly £2 billion (if you include corporation tax paid on capital gains by companies) can hardly be described as

miserable. And most people have been taken out of the tax altogether, by raising the threshold. But for those who are caught, I recognise that indexation is highly complex. Would you advocate its removal?

6. Lastly savings. Were we starting with a clean slate I doubt whether we would want to create the present patchwork of tax reliefs. But we inherited a system already riddled with distortions, and which unduly favoured institutional investment in shares. And, of course, concessions like the pension tax reliefs have come to be built into people's expectations. But initiatives like the Business Expansion Scheme and Personal Equity Plans have been designed to produce a more level playing field, encourage new sources of risk capital, and promote wider share ownership - aims which I know we have in common. I know you spoke in favour of the Loi Monory approach in the recent debate on the economy. But compared with Personal Equity Plans it would suffer from a number of drawbacks: a need for restrictions to prevent premature withdrawals; scope for recycling the same money; a high initial cost (and therefore a lower annual limit on qualifying investment); and complex rules to enforce tax when money was eventually withdrawn.

Finally, I cannot allow your dismissal of the proposals in the Green Paper on the reform of personal taxation to go unchallenged. In this area it is more than usually difficult to find a consensus on the right approach to reform, but for myself I find the arguments in favour of transferable allowances, which the Green Paper clearly identified as the Government's preferred option, persuasive. If you have an alternative approach you would wish to canvass I should be very happy to consider it.

Having said all that, I am far from complacent. Much remains to be done, and much will be done - in our third term. Meanwhile I welcome debate; but I hope that it will be based on a true appreciation of our record. And, as I am sure you recognise, in public it must be with Ministers and not with their officials.

Yours

Nigel

NIGEL LAWSON

SECRET

From: J ODLING-SMEE
4th February 1987

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Sir Peter Middleton
Sir Terence Burns
Mr F E R Butler
Mr Scholar
Mr Sedgwick
Mr Culpin

PAPER FOR ECONOMIC CABINET

I attach a draft along the lines you indicated on Monday.

2. The section on fiscal prospects includes (paragraph 6) the thought that the scope for tax reductions is likely to be considerably less than the increase in public expenditure announced in the Autumn Statement, as you suggested. However, Mr Butler has pointed out that this could give an exaggerated impression of the scale of tax reductions available. This could be avoided by running together the fourth and fifth sentences of paragraph 6 so that they read:

> "The increase of £4.7 billion in the public expenditure planning total for 1987-88 that was announced in the autumn has pre-empted most of our room for manoeuvre."

3. There is nothing here at all about the lower exchange rate. Although it is a sensitive subject, it could be helpful to mention it by way of a reminder that there are still some downside risks.

4. We have dropped the current account balance from the table in Annex 1 this year, but given a figure for 1987 in the text. The unemployment figures in the table are consistent with the assumptions given to DHSS in January.

5. You were hoping to show the paper to the Prime Minister for the weekend.

Ode O-S

J ODLING-SMEE

ECONOMIC STRATEGY

The background to the Budget this year is one of steady output growth following the pause in late 1985 and early 1986. That pause reflected a slackening of growth in the world economy as a whole as it adjusted to lower commodity prices, including oil, and a substantial realignment of exchange rates. The resumption of growth in the UK has been led by vigorous export growth and supported by strong growth of demand at home.

2. Since the middle of 1981 we have experienced sustained growth that has averaged close to 3% a year. This has been one of the longest periods of steady expansion since the war, and a marked improvement on the record of the 1970s. Moreover, this growth has been achieved at the same time as inflation has been brought down from 15½% at the end of 1980 to 3¾% at the end of 1986.

3. This ~~same~~ combination of sustained growth and falling inflation is the reward for pursuing prudent fiscal and monetary policies. ~~- it does not depend on a deliberate but necessarily temporary fiscal stimulus.~~ These policies have also enabled us to cope with the coal strike and the oil price fall with minimum disruption. Confidence in the British economy is strong. It goes without saying that prudence must continue to be our watchword. ~~our strategy must continue to be based on sound policies.~~

it demonstrates clearly that expanding borrowing is

~~a continuation of~~

FISCAL PROSPECTS

below the level in the previous year's MTFS.

4. Faced with the halving of oil revenues - from £11½ billion to £6 billion - I introduced a cautious Budget a year ago, aiming to deliver for a PSBR of £7 billion in 1986-87. At the time of the Autumn Statement it seemed that we were on track to achieve this figure. However all the signs now point to an outturn well below it a somewhat lower PSBR that the Budget forecast. Despite lower oil revenues than were forecast at Budget time and a small regrettable overrun on expenditure, I am now expecting that the PSBR this year will turn out lower than the Budget figure. This is due to unexpectedly strong growth in non-oil revenues. As the economy seems to have has grown closely in line with expectations this means that the effective tax rate has been higher than we planned.

The higher revenues are not the result of faster growth in activity (which has been in line with expectations). They mean we are raising more revenue for the same level of activity, and hence

But that would now imply an increase over the likely outturn for 1986-87. That would be inappropriate at a time when demand is growing strongly, and

5. At the time of the Autumn Statement I said that the planned PSBR for 1987-88 would be held to the MTFS figure of $1\frac{3}{4}$% of GDP. [But prudence is judged in relation to what we actually achieve.] [And] I [now] judge that the PSBR next year should be no higher than the estimated outturn for this year. If anything it would be wise to set it lower.

6. This implies a PSBR for next year of less than £7 billion. On this basis there would (sh) still be some room for tax reductions in the Budget. [The scope is likely to be considerably less than the increase of £4.7 billion in the public expenditure planning total for 1987-88 that was announced in the autumn. The expenditure increases have pre-empted the greater part of the scope that might have been available for tax reductions.] TAKE IN FERB'S REDRAFT

7. It is a measure of the soundness of our policies that the public finances have been able to withstand [additions to the level of public expenditure and] the halving of North Sea oil revenues. The other side of the coin is that there has been an unintended increase in the effective tax burden. This is no part of our policy, and must reinforce our determination to cut taxes whenever we prudently can.

ECONOMIC PROSPECTS

8. During 1986 our economic performance has been influenced by the difficulties the world economy experienced in adjusting to the sharp fall in oil prices. As expected, we have seen a strong growth of demand in the industrial economies, including the UK. But the oil producers and other developing economies cut back their imports more than expected. As a result the industrialised countries experienced weak export demand in the early months of 1986. UK exports initially reflected this performance but have grown strongly since the middle of the year. By the fourth quarter of 1986 the volume of visible exports (excluding oil and erratics) was 9½ per cent higher than a year earlier. This appears to have been a stronger performance than in any other major economy. As a result manufacturing output grew rapidly in the second half of 1986, having been weak in the first half of the year.

Protectionist pressures are never far from the surface, and we must do all we can to head them off.

9. The growth of UK markets abroad should be somewhat stronger in 1987 than the low estimates of growth in 1986. There are, however, risks that the ~~outturn~~ outcome could be less favourable. Prolonged turmoil in foreign exchange markets could lead to reactions that dampen demand and output in the major economies. It is also possible that developing countries and oil producers could import ~~much~~ rather less from developed economies than we expect.

But we must be constantly on our guard against protectionist pressure which could seriously harm the outlook for world trade.

But in our

10. On the assumption, however, that demand for UK exports in 1987 grows more quickly than in 1986, and the prospect is for continued strong export growth. But because non-oil imports have been growing rapidly and the surplus on oil trade has declined by £5 billion there is likely to be a modest current account deficit of around ½ per cent of GDP in 1987, as was forecast at the time of the Autumn Statement. The surplus on oil trade has declined by £5 billion, and non-oil imports have been growing rapidly.

11. Domestic demand is expected to continue to grow rapidly in 1987 and combined with vigorous export growth should mean another year of 3 per cent growth. The composition of domestic demand growth is likely to be more balanced than last year, with slower growth of consumers' expenditure and stronger investment.

12. The steady growth performance has contributed to a welcome fall in unemployment. Since August 1986 unemployment (UK seasonally adjusted, excluding school leavers) has fallen by 107,000. With 3 per cent growth in prospect there is every chance of unemployment continuing to fall at a similar rate during 1987.

13. Since the end of the pause we have seen a further surge of productivity particularly in manufacturing industry. This builds on the good productivity performance achieved by British industry since 1981. The table below shows how British productivity growth has recovered from the low level of the 1970's. In comparison with other developed economies British productivity growth is much better than in the 1960s and the 1970s. Indeed in terms of output per head in manufacturing industry we have done better than any other member of the G7.

It needs to be seen against the background of our cumulative surplus of £21 billion since 1979.

OUTPUT PER HEAD IN THE MAJOR 7 INDUSTRIALISED COUNTRIES
(averaged annual percentage change)

	Manufacturing			Whole economy		
	1964-73	1973-79	1979-86H1	1964-73	1973-79	1979-86H1
United States	3.4	3.5	2.3	1.6	0.2	0.7
Japan	9.8	4.0	2.7	7.4	2.9	2.8
Germany	3.9	3.3	2.3	4.2	2.9	1.4
France*	5.4	3.0	2.5	4.5	2.8	1.5
Italy	5.5	2.4	2.4	5.6	1.7	1.0
Canada	4.3	2.5	3.0	2.5	0.5	0.6
UK	**3.8**	**0.7**	**3.5**	**2.7**	**1.1**	**1.8**
G7 Average	**5.0**	**3.2**	**2.5**	**3.5**	**1.5**	**1.3**

14. For 1986 as a whole the RPI inflation rate averaged 3.4 per cent - the lowest annual figure since [1967]. Since the last election most of the significant short-term swings in the monthly RPI inflation rates have reflected temporary distortions resulting from changes in the mortgage interest rate. For example, the monthly lows of 3.7 per cent in 1983 and 2.4 per cent in 1986 coincided with falling mortgage rates and the monthly high of 7.? per cent in 1985 reflected a rising mortgage rate. With no further change to mortgage rates, RPI inflation is likely to rise from 3.7 per cent in December last year to about 4½ per cent by the fourth quarter of 1987. The monthly path may continue to rise above 4½ per cent between now and the end of the year for a few more months mainly as a result of mortgage rate increases at the end of last year and the effect on the 12-month change of the temporary dip in petrol prices last summer, before turning back down again.

15. The recent and prospective performance on inflation is in historical terms a good one, and one that we can point to along with the steady growth in output and efficiency as the result of sound policies. But it remains important to maintain confidence against an uncertain international background and to keep inflation on an unambiguously downward trend in order to ensure that the long period of satisfactory growth we are experiencing continues. To maintain downward pressure on inflation will require a firm macroeconomic policy stance. Improved prospects for output and employment growth depend heavily on a further slowdown in the growth of pay.

The underlying rate of inflation (excluding the effect of mortgage interest rate changes) is likely to remain broadly stable at its present level over the next year. But

SUMMARY AND CONCLUSIONS

16. Following the growth 'pause' in late 1985 and early 1986, output growth is now again close to its average rate since 1981 of almost 3% a year. It could go a little above this in 1987. Inflation is rising from the artificially low rate recorded in the middle of last year, but should resume its gradual downward trend later this year.

17. The combination of sustained output growth and falling inflation over the medium term depends on the continuation of our sound financial policies. This means, if anything, a lower PSBR in 1987-88 than the likely outturn in 1986-87, but there should still be room for modest reductions in taxation.

18. I would welcome colleagues' views on the Budget against the background of the fiscal and economic prospects I have outlined.

ANNEX 1

	1979	1980	1981	1982	1983	1984	1985	1986	1987[1]
World GNP,[2] in major 7 economies (per cent change)	3½	1	1½	- ½	3	4½	3	2½	3
UK GDP,[2] (per cent change)	2½	-2½	-1	1½	3½	3	3½	3	3
Domestic demand,[2] (per cent change)	4	-3	-1½	2	4½	2½	3	3½	3½
Retail prices Q4 (per cent change on a year earlier)	17½	15½	12	6	5	5	5½	3½	4½ X
Interest rates (average 3-month interbank)	13½	16½	14	12½	10	10	12	11	11[3]
Unemployment (UK, per cent of working population excluding school leavers)	4½	5½	8½	10	11	11	11½	11½	10½
Sterling Index	87	96	95	90½	83	78½	78	73	(68½)[3]
~~Oil prices, $, North Sea~~	~~20½~~	~~34½~~	~~37½~~	~~33~~	~~30~~	~~29½~~	~~27½~~	~~14~~	~~18~~[4]

(1) Provisional pre-Budget figures.

(2) At constant prices.

(3) February 2.

(4) Brent price, as of February 3.

ANNEX 2: DIRECT EFFECTS OF TAX CHANGES

A. Direct Taxes: Indexation

The RPI increased in the year to December 1986 by 3.7 per cent. With indexation by this amount and statutory rounding, the figures for the main allowances and other thresholds would be:

Personal allowances	1986-87	1987-88
Single and wife's earned income allowance	2,335	2,425
Married allowance	3,655	3,795
Bands, eg:		
29% rate	0-17,200	0-17,800
60% rate	over 41,200	over 42,900

The total revenue costs of indexation of income tax (included in the forecast) are £800 million in 1987-88 and £1,080 million in 1988-89.

B. Indirect Taxes: Indexation

The effects of 3.7 per cent revalorisation of the excise duties (including VAT effects) are as follows:

VAT inclusive price change		Yield in 1987-88 £m	RPI impact £m
Beer	0.8p/pint	60	0.04
Wine	2.9p/70cl light wine	20	0.02
Spirits	20.1p/bottle	25	0.03
Tobacco	3.4p/20 king size	95	0.10
Petrol	3.7p/gallon	185	0.09
Derv	3.2p/gallon	40	neg.
VED	£3.7/car	95	0.03
Overall effect, including minor duties (included in forecast)		525	0.31

C. Ready Reckoners: Illustrative Tax Changes

	£ million 1987-88	1988-89
INCOME TAX		
Allowances and Thresholds		
1% above indexation on all statutory allowances	175	230
1% above indexation on all statutory allowances and thresholds	200	275
Rates		
Change in basic rate of 1p	1,100	1,400
CORPORATION TAX		
Change in main rate of 1 percentage point	230	400
Change in small companies' rate of 1 percentage point	20	35
VALUE ADDED TAX		
Change in VAT rate of 1 percentage point[1]	860	1,215

[1] A 1% change in the VAT rate would change the RPI by 0.5%

ANNEX 3: THE TAX BURDEN

Since the Government came to power total taxes and NICs as a proportion of GDP at market prices have risen by about 4 percentage points, though the ratio has fallen from its peak in 1981-82. The decline in 1986-87 reflects North Sea revenues (down from 3.2% to 1.3% of GDP).

Table 1

Total Taxation* as a % of GDP (market prices)

1978-79	33.8
1979-80	35.2
1980-81	36.4
1981-82	39.3
1982-83	39.1
1983-84	38.6
1984-85	39.1
1985-86	38.6
1986-87 (estimate)	38.0
1987-88 (assuming indexation)	38.0

*Including NICs and local authority rates

Add Non-north sea column?

This is not a good table — it doesn't make the point in the text. Something

this doesn't seem consistent with forecast — see below.

Personal Sector

2. Despite reductions in income tax, total personal taxes (direct and indirect, including employees' NICs and domestic rates) in 1986-87 are about [£] billion higher in real terms (ie 1986-87 prices) than they were in 1978-79. For income tax and national insurance contributions the following table shows how the proportion of gross pay they represent rose up to 1981-82, particularly for the low paid:

Table 2

Income Tax and NICs as a % of Gross Earnings*

	½ average earnings	average earnings	2 average earnings
1978-79	16.0	27.8	31.4
1981-82	20.8	29.3	32.2
1982-83	20.8	29.8	32.3
1983-84	20.1	29.6	31.7
1984-85	19.3	29.2	31.5
1985-86	18.9	29.0	31.5
1986-87 (estimate)	18.9	28.4	30.9
1987-88 (indexation)	19.4	28.7	31.1

*Adult male earnings (all occupations). Married couple, wife not working: the couple are assumed to have no children, to avoid distortion of the figures from the abolition of child tax allowances.

3. These figures reflect the rise in the standard employees' NIC rate from 6¼% to 9%. The lower rates introduced in the 1985 Finance Act do not affect the cases shown. So far as income tax is concerned, personal allowances have increased by about 22% in real terms since 1978-79, slightly faster than earnings. The basic rate has been reduced from 33p to 29p, but the 25p reduced rate band has been abolished.

4. As the table shows, indexation of allowances in the Budget would lead to a slight rise in the proportion of incomes taken in tax and NICs. This is because earnings are assumed to rise by 6½% compared with the indexation percentage of 3.7%.

5. Following the sharp rise in corporation tax receipts this year, total taxes paid by businesses (outside the North Sea) are now slightly higher as a percentage of GDP than in 1978-79. Within this total, the major change has been a fall in employers' NICs and NIS as a percentage of GDP, offset by increases in corporation tax, business rates and 'other' taxes as the following table shows:

Table 3

Taxes Paid by Businesses £bn in 1986-87 Prices

(figures in brackets are % of GDP)

	Corporation Tax[1]	Taxes on self employment incomes	Employers' NICs and NIS	Rates	Other[2]	Total
1978-79	7.4 (2.2)	2.5 (0.7)	10.3 (3.1)	4.9 (1.5)	3.8 (1.1)	28.8 (8.6)
1986-87 (estimate)	11.2 (2.9)	2.9 (0.8)	8.7 (2.3)	6.7 (1.7)	5.4 (1.4)	34.9 (9.1)

[1] Excludes North Sea, but includes ACT

[2] VED, car tax, road fuel duty, duty on rebated oils, capital taxes

c/ This is now for your approval.

CC 4/2

FROM: S P Judge

DATE: 4 February 1987

PS/CHANCELLOR OF THE EXCHEQUER

cc PS/Sir Peter Middleton
Sir Terence Burns
Sir Geoffrey Litter
Mr F E R Butler
Miss Kelley
Mr Instone
Mr Needle
Estimate Clerk

OK ✓

ESTIMATES 1987-88
CLASS XIX VOTE 11: ECONOMIC AND FINANCIAL ADMINISTRATION (HM TREASURY)

I attach Mr Needle's submission of 30 January, which the Minister of State has approved.

SJ

S P JUDGE
Private Secretary

FROM: E J NEEDLE
30 January 1987

JK 2.2.87

1. MISS J KELLEY
2. SIR PETER MIDDLETON PEM
3. MINISTER OF STATE ✓ PB 4/ii
4. CHANCELLOR OF THE EXCHEQUER

~~Copies attached for -~~
~~Sir Terence Burns~~
~~Sir Geoffrey Littler~~
~~Mr F E R Butler~~
sent forward JK 9.2

cc - Mr Instone

ESTIMATES 1987-88
CLASS XIX VOTE 11: ECONOMIC AND FINANCIAL ADMINISTRATION (HM TREASURY)

This submission seeks approval for the Treasury Estimate for 1987-88.

Coverage

2. The Estimate covers the administrative costs of the Treasury; certain advisory bodies for which the Treasury accounts; and expenditure associated with the award of honours and dignities. It also provides grants in aid to the Royal Trustees, to bodies associated with the works and history of Parliament, to the National Economic Development Council and to the Chequers Trust. Provision has been made for 1,892 staff.

PES

3. The proposed gross Estimate of £55.343 million is offset by Appropriations in Aid of £3.635 million leaving a net requirement of £51.708 million. It is within the Public Expenditure Survey provision, the running costs ceiling and the manpower plans announced in the 1987 Public Expenditure White Paper. The Estimate has been scrutinised by the responsible expenditure division (LG2) who are content.

The Estimate

4. The table at Annex A shows the progression from last year's outturn, through this year's Vote and forecast outturn to next year's Estimate. The latter is £5.723 million (12.4 per cent) higher than this year's Vote and £6.481 million (14.3 per cent) higher than the forecast outturn. £0.750 million (1.7 per cent) of the latter is matched by corresponding net reductions in other Votes where the responsibility for expenditure has been transferred between departments. These changes are referred to in the Introduction to the Estimate. Explanations for significant variations from this year's forecast outturn are given in the following paragraphs.

Treasury Administration (Subhead B1)

5. Treasury administrative costs at £37.121 million account for 67.1 per cent of the gross Estimate. This is £4.710 million (14.5 per cent) higher than this year's provision and £5.503 million (17.4 per cent) above the forecast outturn. The bulk of the increase over the forecast outturn is for Information Technology (IT) and pay and allowances.

a. **Information Technology (£3.086 million).** The capital and running costs of the joint Central Statistical Office (CSO)/Treasury computer installation are currently borne on the Cabinet Office Vote. Upwards of 70 per cent of the work is for the Treasury and, in recognition of this, operational responsibility and the associated costs will transfer to the Treasury on 1 April 1987. The computer itself will be replaced during the year and the additional provision is required mainly for this purpose and for the extension of the electronic office project.

b. **Basic pay and allowances (£1.606 million).** The increase results from a forecast increase in pay costs of 5 per cent (£0.951 million), the transfer of 25 staff from the CSO following the computer transfer referred to above (£0.347 million) and the full year effect of clerical restructuring (£0.045 million). The remainder anticipates that next year we can recruit and retain more staff than in 1986-87.

Most of the remaining £0.811 million provides for expected price increases.

Rating of Government Property Department (Subhead C1)

6. The provision is £0.104 million (12.7 per cent) above the forecast outturn. The increases arise from the anticipation that the staff vacancy position prevailing in 1986-87 will be eliminated (£0.030 million); the additional staff and other costs needed to prepare for the proposed non-domestic revaluation to take effect from 1 April 1990 (£0.026 million); and expected price increases and minor volume changes (£0.048 million).

Chessington Computer Centre (Subheads C2 and C3)

7. The overall provision is £1.150 million (18.9 per cent) above the forecast outturn. £0.624 million of this is for increased expenditure on IT equipment and running costs, notably some £0.4 million for the purchase of additional equipment to enhance the existing mainframe computer to cater for the growth in demand for Chessington's services; some £0.1 million for an increase in staff in post from the 1986-87 position to cope with the transfer of

responsibility for the National Savings Department and Forestry Commission payrolls from the Scottish Office, plus a small contingency margin to cover discretionary ADP allowances. The remainder is mainly due to expected price increases.

Other Subheads

8. The rest of the Vote provides for a decrease against the 1986-87 forecast outturn of £0.276 million. Major variances from forecast outturn are as follows:

Subhead A1: Royal Trustees: Grant in Aid (+ £0.138 million)

The increase mainly results from the revaluation of the fixed grant to the Civil List which is paid from the Consolidated Fund.

Subhead A2: Parliament Bodies: Grant in Aid (- £0.268 million)

The decrease results from the peak in expenditure this year when the UK hosted the Annual Conference of the Commonwealth Parliamentary Association.

Subhead B2: National Economic Development Council: Grant in Aid (+ £0.058 million)

This increase represents only 0.8 per cent of this year's grant following the agreement to hold NEDO's expenditure down by £0.120 million.

Former Subheads (- £0.505 million)

Former Subhead C6: Sale of Shares was a one-off item for 1986-87 which will not recur. Responsibility for former Subhead B4, Review Board for Government Contracts, was transferred to the Ministry of Defence with effect from 1 July 1986.

Appropriations in Aid (+ £0.280 million)

Appropriations in Aid in 1987-88 are expected to be lower than this year, largely because there will be no receipts from the sale of shares.

Recommendation

9. Expenditure bids have been scrutinised and agreed by the Planning Board. They are within the PES and running costs allocation. The underlying manpower figures are consistent with the totals shown in the Public Expenditure White Paper. I therefore recommend that you approve the net provision of £51.708 million.

EJNeedle

E J NEEDLE

FOG3

Class XIX, Vote 11 Economic and financial administration (HM Treasury)

DRAFT

Introduction

1. This Vote is treated as a cash limit.

2. It covers the administrative costs of the Treasury; certain advisory bodies for which the Treasury accounts; and expenditure associated with the award of honours and dignities. It also provides grants in aid to the Royal Trustees, to bodies associated with the works and history of Parliament, to the National Economic Development Council and to the Chequers Trust. Provision has been made for 1,893 staff at 1 April 1987 decreasing to 1,892 by 31 March 1988.

3. Subhead B1 is divided into sub-items to reflect the organisation of the Central Treasury. The sub-items provide for the following costs:

— B1(1) for the pay costs of Treasury Ministers and other office holders;

— B1(2) for the central area including Ministers' private offices, economic briefing, public relations, domestic management and IT strategy, and office services;

— B1(3) for divisions dealing with pay, pensions and allowances of civil and other public servants, MPs and the judiciary, and industrial relations policy in the Civil Service;

— B1(4) for divisions dealing with economic and other specialist advice;

— B1(5) for divisions dealing with general co-ordination and policy advice, fiscal and monetary policy, international finance and the management of the Consolidated and National Loan Funds;

— B1(6) for divisions dealing with the control of public expenditure, manpower and departmental running costs, and the Head of the Government Accountancy Service and his staff; and

— B1(7) for the Treasury Security Guard whose recoveries for security guard services provided to the Cabinet Office and Chequers are appropriated in aid in subhead BZ.

4. There have been the following changes from the 1986–87 Vote to reflect organisational changes within the Central Treasury:

— provision for those divisions dealing with the application of Information Technology and statistical support for economists which was included in sub-item B1(4) has been transferred to B1(2); and

— provision for the division providing economic advice on international and some domestic monetary matters which was included in sub-item B1(4) has been transferred to B1(5).

In addition, responsibility for the joint Central Statistical Office/Treasury computer facilities and associated staff and other costs has been transferred to the Treasury from Cabinet Office (Class XX, Vote 2). The costs now appear in sub-item B1(2).

5. Responsibility for the Review Board for Government Contracts was transferred to the Secretary of State for Defence with effect from 1 July 1986. Provision for ~~this office~~ the Review Board which used to fall on subhead B4, now falls on the Ministry of Defence (Defence Procurement) Vote (Class I, Vote 2). Former subhead C6, sale of government shares, is no longer required.

6. Table 1 at the end of the Vote shows the main programmes for which services on this Vote are provided without repayment from other Votes. Table 2 lists the Ministers and office holders whose salaries are provided from subhead B1, and Table 3 shows the expected use of the grant in aid to the National Economic Development Council (subhead B2).

7. The costs of the Central Computer and Telecommunications Agency and the Civil Service Catering Organisation are met from Class XIX, Votes 13 and 14 respectively.

8. The 1987–88 provision is 11.1 per cent (£5,160,000) above the 1986–87 provision of £46,548,000. Some £3.1 million of this is due to the purchase of additional and replacement computer equipment ~~[and the replacement of the joint Central Statistical Office/Treasury configuration]~~, and £0.4 million is due to enhancement of the Chessington computer to cater for the growth in demand for its services. The remaining £1.7 million is due to price changes.

9. Symbols are explained in the introduction to this booklet.

ANNEX A

Subhead		1985-86 Outturn	1986-87 Vote	1986-87 Forecast Outturn	1987-88 Estimate	Percentage Increase 1987-88 Estimate Bid Over 1986-87: Vote	Percentage Increase 1987-88 Estimate Bid Over 1986-87: Forecast Outturn
		£000	£000	£000	£000	%	%
A1:	Royal Trustees: Grant in Aid	310	470	470	608	+29.4	+29.4
A2:	Parliamentary Bodies: Grant in Aid	1,165	1,600	1,600	1,332	-16.8	-16.8
B1:	Treasury Administration	30,698	32,411	31,618	37,121	+14.5	+17.4
B2:	NEDC: Grant in Aid	6,792	7,115	7,115	7,173	+ 0.8	+ 0.8
B3:	Banking Cost of Appeals	-	4	1	4	-	+300.0
	Review Board for Government Contracts	141	282	30	-	-	-
B4:	Public Sector Pay Review Bodies	21	23	23	24	+ 4.3	+ 4.3
BZ:	Appropriations in Aid	- 981	- 1,195	- 1,040	- 1,235	+ 3.3	+18.8
C1:	Rating of Government Property Department	768	849	816	920	+ 8.4	+12.7
C2:	Chessington Computer Centre - Current	5,732	5,767	5,765	6,618	+14.8	+14.8
C3:	Chessington Computer Centre - Capital	899	333	333	630	+89.2	+89.2
C4:	Honours and Dignities	625	672	672	689	+ 2.5	+ 2.5
C5:	Chequers Trust: Grant in Aid	208	224	224	224	-	-
C6:	Sale of Shares	75	150	475	-	-	-
CZ:	Appropriations in Aid	- 1,573	- 2,720	- 2,875	- 2,400	-11.8	-16.5
VOTE TOTAL		44,880	45,985	45,227	51,708	+12.4	+14.3

ps2/47R

UNCLASSIFIED

RLJ

FROM: CATHY RYDING

DATE: 5 February 1987

MR NEEDLE

cc PS/Minister of State
PS/Sir P Middleton
Sir T Burns
Sir Geoffrey Littler
Mr F E R Butler
Miss Kelley
Mr Instone
Estimate Clerk

ESTIMATES 1987-88

CLASS XIX VOTE 11:

ECONOMIC AND FINANCIAL ADMINISTRATION (HM TREASURY)

The Chancellor has seen your minute of 30 January and Mr Judge's minute of 4 February.

2. The Chancellor approves the Treasury Estimate for 1987-88.

CR

CATHY RYDING

RT4.4

CONFIDENTIAL

cc PS/MST
Sir P Middleton
Sir G Littler
Mr Lavelle
Mr A Edwards
Mr Mortimer
Mr Crabbie
Mr Cropper

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

FOREIGN SECRETARY

OD(E)(87) 2ND MEETING

There is a serious inaccuracy in the record of our discussion in OD(E) on 3 February which I would like to correct.

Sub-paragraph c. on page 2 does not record the fact that I argued strongly in the meeting that no overall economic or financial advantage to the UK arose from the structural funds. Peter Brooke was also struck by this omission. It is clearly important that the official record of our discussion should not convey the impression that Ministers collectively accepted that there were such advantages, and that we would welcome increased receipts from the funds if only that did not cause problems for our wider objectives on the Community Budget.

I am copying this minute to other members of OD(E) and to Sir Robert Armstrong.

NL

N.L.
5 February 1987

From Major General W D Mangham CB

N4
B.

The Brewers' Society

42 PORTMAN SQUARE · LONDON W1H 0BB

TELEPHONE · 01-486 4831 (16 LINES)
FAX · 01 935 3991 · TELEX · 261946

The Rt Hon Nigel Lawson MP
The Chancellor of the Exchequer
Treasury Chambers
Parliament Street
LONDON SW1P 3AG

ADVICE BY 19.2.87 PLEASE

CH/EXCHEQUER
REC. 09 FEB 1987 4/9/2.
ACTION MR JEFFERSON-SMITH C+E
COPIES TO CST FST EST MST
MR SCHOLAR
MISS SINCLAIR
MR McKENZIE
MR CROPPER
PS/C+E

6 February 1987

Dear Chancellor,

It was kind of you to see my Chairman and myself this morning and as always we found the discussion extremely useful.

I promised to check the figures we were using in relation to increases in Excise Duty, and I hope the following will reassure you of the accuracy of our assertions.

The first sentence of our submission in October 1985 read:

> "Between May 1979 and March 1985, beer duty increased by 142%, which is over twice the increase in the RPI 70%. This is on top of the general increase in the rate of VAT from 8% to 15% in June 1979."

The figures excluding VAT were:

	RPI	Excise Duty on a 1037° beer per barrel
May 1979	215.9	21.490
March 1985	366.1	52.074
% increase	70%	142%

The present situation, giving in addition the VAT figures, is as follows:

	RPI	Excise Duty	VAT	Total
May 1979	215.9	21.490	7.245	28.735
March 1986	381.6	52.074	29.113	81.187
% increase	77%	142%	302%	183%

/.....

To go on.

NC/10.

Part B

In this case the increase in excise duty is just under twice the rate of inflation, but still well over if VAT is included.

Our usual approach has been to use a simple comparison as between the percentage increases of RPI and Duty. This was the basis of the remarks made verbally by my Chairman at the meeting today.

I do hope this has made the matter clear.

Yours sincerely,

David Maughan

Director

Tony
PPs are in with You, I put the string in last night and hasn't come out yet.
Meena 6/2

~~Thanks~~ (in with ~~PPS~~ Ch). b/f 9/2 pl T.

CH/EXCHEQUER
REC. 06 FEB 1987 6/2.
ACTION CST
COPIES TO

FCS/87/027

Meena
Thanks: RJP

CHANCELLOR OF THE EXCHEQUER

~~Thanks:~~ b/f 12/2 pl

Tony
I am afraid they still haven't come out yet.
Meena 10/2

Meena
Have pps come out again yet?
T.

Conversion of Ankara to Natural Gas:

ATP Soft Loan

1. I have seen a copy of Paul Channon's letter to you of 30 January, recommending that we should be prepared to support the AMEC bid for a negotiated contract for the Ankara natural gas conversion project.

2. As Paul Channon says, winning this contract would be a breakthrough for the UK in major project work in Turkey. To stand any chance of being awarded a negotiated contract, however, the firm will need fully competitive financial support.

3. While the economic and political outlook in Turkey remains somewhat uncertain over the next couple of years, we cannot afford to neglect the medium to long term prospects for UK exporters in this large and expanding market. As links with the European Community are strengthened, the commercial opportunities for exporters are likely to grow. Although I recognise

/that

that the Turkish economy still faces a number of problems, we should not let disappointing economic indicators for 1986 blind us to the undoubted potential of the market. If we fail to support British industry until Turkey's economic problems have disappeared, the opportunities are likely to have disappeared also: our competitors will be too well entrenched. While I appreciate there is a fine balance between risks and opportunities here, I feel sure that British interests are best served in this instance by agreeing to provide ATP support for this project in soft loan form.

(GEOFFREY HOWE)

Foreign and Commonwealth Office

5 February 1987

From: R B SAUNDERS
Date: 5 February 1987

PRINCIPAL PRIVATE SECRETARY

cc Sir G Littler
Mr Lavelle
Mr H Evans
Mr Matthews

Good point
Will make a
para 12/13

OECD 25TH ANNIVERSARY SYMPOSIUM: OCTOBER 1986

The Chancellor will recall that Sir Peter Middleton attended this symposium (full title: "Opportunities and Risks for the World Economy: The Challenge of Increasing Complexity") and took part as a panel speaker in one of the sessions. The OECD intend to publish the proceedings of this symposium and have asked Sir Peter Middleton for a contribution. I attach a copy of what he will be sending, which is based on his oral interventions during the session for which he was a panel member.

RBS

R B SAUNDERS
Private Secretary

I should like to make a number of comments about economic interdependence and draw out some implications for policy and the role of Government. In order to do this I concentrate on three of the trends which we have identified in this Symposium and which we can expect to continue over the next 25 years: the development and increasing use of information technology; the increasing predominance of financial transactions; and the increasingly multinational organisation of the production and sale of other goods and services.

2. These are all changes which are taking place largely independent of Government action. They are forces to which governments have to react rather than developments which they control. I believe, and hope, that they will produce a shift in the focus of international co-operation between governments.

3. There seems little room for doubt that we shall see a further escalation in the growth of financial transactions including transactions in money, and an increasing divergence in the growth of these transactions from the more modest growth in other trade flows. There are two good reasons.

4. First is the impact of information technology. This is one of the areas to which new technology is particularly applicable. Dealing costs have come down dramatically - on some estimates by 80% over the past decade. The world has become one large market where trading follows the sun around the globe. There is a market open somewhere 24 hours a day. Technology enables the financial trader to take advantage of tiny margins which become available round the world as an increasing variety of financial instruments become available. It is good business to do so. Moreover it is an area where computers can be programmed to carry out the operations automatically every bit as easily as they can be used in a manufacturing process.

5. Second, there seems to be every reason to expect that there will be further moves to free domestic markets from regulations

which inhibit expansion in this area and the ability to take part in the most rapidly growing part of the world economy. It is difficult to imagine a successful attempt to inhibit or confine these very fluid transactions because they can with the greatest of ease be switched elsewhere. And this ease will increase as the multinationalisation of production and marketing proceeds.

6. But it does not seem at all likely that these financial transactions will take place in a completely unregulated atmosphere. Investors need an adequate degree of protection. Moreover because of the need to maintain the fragile basis of confidence on which many depend, there is a clear demand from the practitioners for prudential regulation. And the extreme fluidity of these operations between organisations and countries means that regulation is bound to become based on internationally agreed standards. A level international playing field will be an increasingly important requirement for the game. Regulatory authorities are aware of this, but it is difficult to see how much progress can be made without the active involvement of governments.

7. The explosive development of financial transactions has also opened up opportunities of a wholly undesirable kind. I refer to the opportunities for financial fraud and similar criminal activity. Like the flows themselves this knows no national boundaries. It can only be dealt with in the context of some sort of common framework of detection, prosecution and conviction. The system will be different in different countries but it must offer a broadly similar prospect for detecting and punishing wrong doing. This is clearly going to be a problem of extreme complexity to deal with. As one of our contributors mentioned earlier, some of the restrictive practices operated by the professions make trade restrictions seem a relatively easy area to tackle. Yet co-operation between the police, lawyers and accountants is essential to keep pace with devices of increasing complexity and ingenuity. The difficulty we all have in making this effective in our own countries only serves to show what a major task this will be internationally over the next quarter of a century.

8. Taking a much broader view, the growth in international money transactions, and the emphasis which many speakers have given to confidence, must imply that a powerful discipline is at work. It is a discipline which is felt by all western governments in framing their domestic macro-economic policy. Confidence for this purpose is the confidence that governments are themselves pursuing sound financial policies. The discipline is simply that small deviations or suspected deviations from financial rectitude produce an enormous penalty in the form of huge flows of money going elsewhere. It is likely to be a good deal more severe a discipline than anything devised by governments. And it is one which governments are likely to find irresistible. Intervention may be of value if conducted tactically and on an internationally concerted basis. But a simple inspection of the size of official reserves in relation to even the daily size of money transactions shows how little power governments have to frustrate the movement of markets.

9. At the same time it is becoming more difficult to detect whether countries are adopting a disciplined approach. This is because monetary conditions - which at the end of the line is the aspect of policy of most concern to markets - are becoming increasingly difficult to define and control. The very forces which have contributed to the international environment which I have described make the assessment of domestic monetary developments more difficult. Liberalisation both internally and externally, has the unfortunate effect of distorting monetary indicators. I doubt whether any country in the world would claim that it has a set of monetary measures about which it can be at all confident.

10. So it is not surprising that countries have increasingly come to look directly for an external discipline to complement their domestic indicators. The exchange rate is bound to play an increased role at least for a time. This does not in my view lead one to believe that stabilisation of exchange rates is at all a practical goal for the next 25 years. Exchange rate adjustments are necessary to absorb strains, and to play a part

in the wider adjustment process in the international economy. I doubt whether Richard Cooper's dream of a central monetary authority is very realistic in any short timescale.

11. The increasing importance of external disciplines will mean that the forces pushing central governments into a more co-operative stance will continue. There is still much to understand about inter-relationships between economies - and much to understand about how others, especially in international financial markets, see the same relationships. This is entirely to be welcomed.

12. But there is one thing which we must not forget in our crystal ball gazing. Government is a finite resource. Governments cannot be involved in everything or do everything with equal efficiency. When one contemplates the many potential claims on government time which have been made round this table, it is certain that choices will have to be made. I believe that one choice which might be made is to devote less time to macro-economic policy at an international level and a good deal more to micro-economic and supply side issues. Though I have recognised the benefits of closer co-operation at a macro level, it is important to take a realistic view of what can be achieved. It is regrettably very tempting for politicians to try to cut a figure on the international stage in the macro area. Results seem possible in an electoral timescale. And publicity is easy to come by.

13. Yet there is little doubt that the really difficult issues concern the long term supply performance of our economies. How do we make them more productive? How should we adapt to change? How does one country's economic apparatus impact on others? Perhaps most of all, how do markets really work? Most people would subscribe to the concept of efficiently working markets. Yet there is no agreement at all about what this means, and there is definitely no agreement about the role which governments can and should play.

14. These are fundamental problems. They are fundamental to the growth of our economies within the international macro-economic

framework. And they are fundamental in the sense that any improvements require painstaking action for results which can only occur over a long timescale.

15. There are at present some encouraging signs that the balance of priorities in international co-operation is changing. The work of OECD is an example. More time is being spent on the analysis of the real factors affecting growth and less on some of the more obscure aspects of macro-economics. If this symposium has done nothing else, it has demonstrated that such a change in priorities must be right. That it is happening means that we can face the future with a little more confidence.

CONFIDENTIAL
UNTIL 11.30 A.M MONDAY 9 FEBRUARY then
UNCLASSIFIED

RWD

FROM: P DAVIS
DATE: 6 FEBRUARY 1987

1. MR S J DAVIES SJD
2. CHANCELLOR OF THE EXCHEQUER

cc : PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir Peter Middleton
Sir Terence Burns
Mr Monck
Mr Culpin
Mr Sedgwick
Mr Gilhooly
Miss O'Mara
Mr Pickford
Mr Brooks
Mr Hacche
Mr Pickering
Mr Hefford
Mr Cropper
Mr Ross Goobey
Mr Tyrie

PRODUCER PRICES FOR JANUARY

The Producer Price Indices for January will be published at 11.30 a.m. on Monday 9 February. The level of the output price index rose by 0.7 per cent between December and January, and the twelve month rate of change rose slightly from 4.2 per cent in December, to 4.3 per cent in January, the first increase in the 12 month rate since May 1986. Excluding the food, drink, and tobacco industries, the 12 month increase in the output price index to January was 4.2 per cent, rising slightly from the December figure of 3.9 per cent.

2. While there is usually a relatively large monthly increase in the output price index in January, the indication is of some pick-up in the trend in inflation. This is consistent with recent changes in the balance of firms recorded in the CBI Quarterly Industrial Trends Survey as expecting to raise prices over the next four months. After seasonal adjustment, this balance rose from 15 per cent in October to 22 per cent in January.

PPI
sn-ch-sept

CONFIDENTIAL
UNTIL 11.30 A.M MONDAY 9 FEBRUARY then
UNCLASSIFIED

PRODUCER PRICES (PERCENTAGE CHANGE OVER A YEAR EARLIER)

	Output prices		Input Prices		
	All	All excl FDT*	All	All (Seasonally Adjusted)	All excl FDT*
1985 Q3	5.6	6.5	- 0.7	- 0.7	1.2
Q4	5.1	5.9	- 5.4	- 5.5	- 5.1
1986 Q1	5.0	5.0	- 9.5	- 9.7	-11.9
Q2	4.5	4.3	- 9.4	- 9.2	-12.4
Q3	4.4	4.0	- 9.2	- 9.1	-13.1
Q4	4.2	3.9	- 4.0	- 4.5	- 5.5
October	4.3	4.0	- 5.2	- 5.2	- 7.4
November	4.2	3.8	- 3.5	- 4.1	- 4.9
December	4.2	3.9	- 3.3	- 4.3	- 4.5
January	4.3	4.2	- 2.5	- 3.3	- 3.1

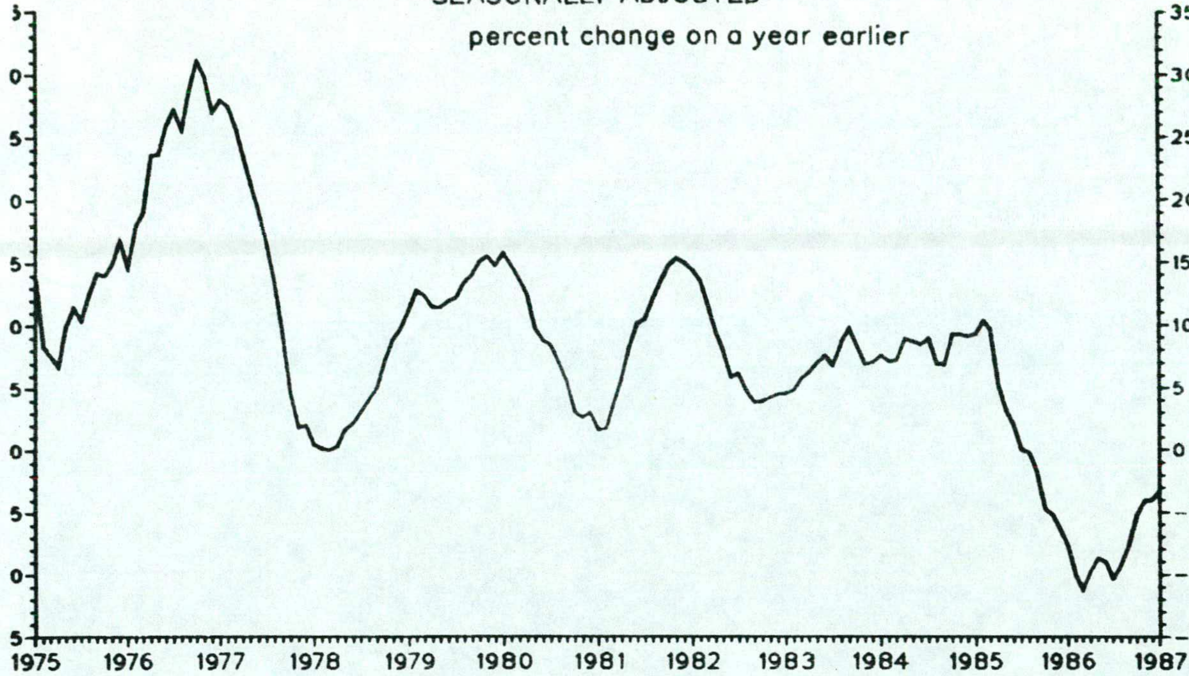
* Excluding the food, drink and tobacco industries.

3. The producer price index for materials and fuels purchased by manufacturing industry increased by 1.0 per cent between December and January and has risen by 9.8 per cent since July. About 6 percentage points of this increase is attributable to seasonal changes in electricity prices. The input price index is now 2.5 per cent below its level of a year ago. Excluding the food, drink and tobacco industries, the producer input price index increased by 1.2 per cent in January over the previous month but was 3.1 per cent below its level in January 1985.

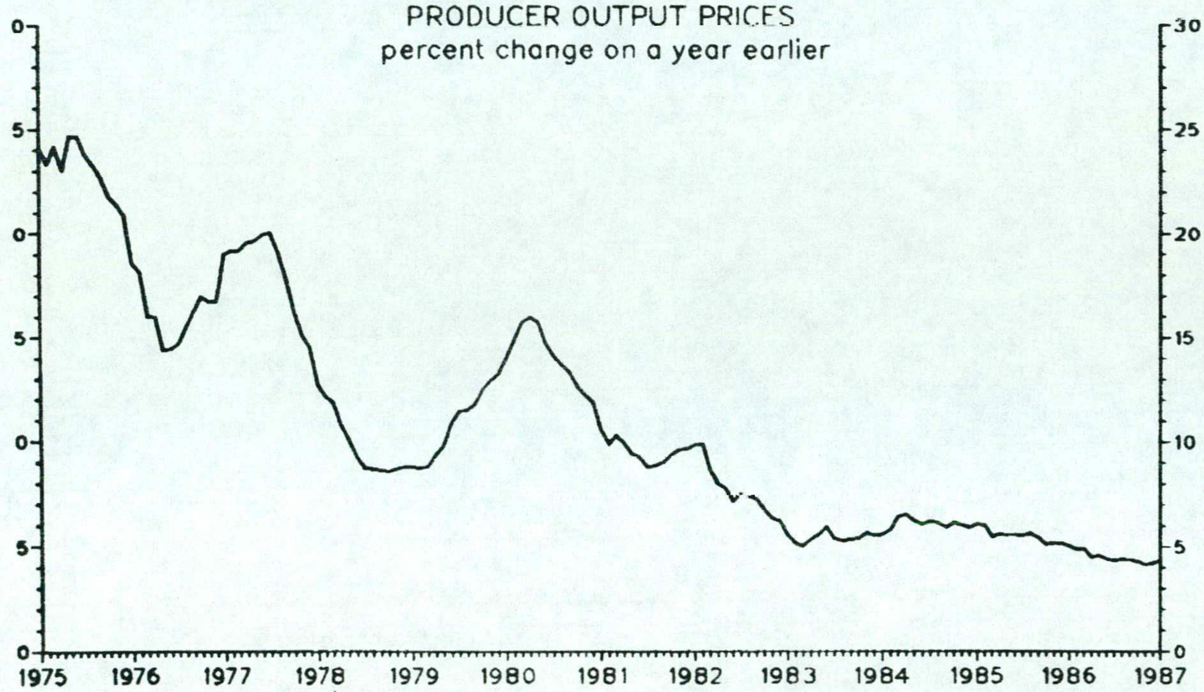
4. I attach two charts showing movements in producer input and output prices since January 1975.

PAUL DAVIS
EA1 DIVISION
X 3434

MATERIALS AND FUEL PURCHASED BY MANUFACTURING INDUSTRY
SEASONALLY ADJUSTED
percent change on a year earlier



PRODUCER OUTPUT PRICES
percent change on a year earlier



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D : 9-10-86 G : TIREE.DISMANCOM

ps8/19A

PERSONAL AND CONFIDENTIAL

cc Chief Secretary
Sir P Middleton
Mr F E R Butler
Mr Anson
Mr Scholar
Miss Peirson
Mr Instone
Miss Noble
Mr Tyrie
Mr Cropper

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

PRIME MINISTER

HOUSING POLICY

I would like to offer some comments on Nicholas Ridley's paper on housing policy before our meeting on 10 February.

I strongly support his general objectives - breaking up council estates and transferring ownership away from local authorities; increasing owner occupation; reviving the private rented sector; and reducing public sector costs.

I also support Nicholas' general approach. In examining his proposals and carrying the work further, I think we need to concentrate on the two subjects picked up in your private secretary's letter of 2 February:-

(i) how we limit and control the effects of his proposals on housing benefit;

(ii) how we get private management into the large public estates: this is not explicitly addressed in Nicholas' proposals, though I know he attaches importance to it; it is also the subject of the paper from the Policy Unit. This is where the greatest scope for saving public expenditure lies, since housing authorities have to spend so heavily on maintenance.

Other aspects which I suggest we must tackle are:-

(iii) other measures to break up public supply of housing;

(iv) further measures to revive the private rented sector: but I have to say that I am strongly opposed to doing this via tax reliefs to private landlords, which would extend the overall subsidisation of housing to a ridiculous extent;

PERSONAL AND CONFIDENTIAL

(v) the effect on job mobility of North/South differences in property values.

I amplify these points in the following paragraphs.

(i) <u>Limiting and controlling the effects on housing benefit.</u>

Nicholas proposes a new financial mechanism to put pressure on local authorities to raise rents to economic levels, thus reducing Exchequer subsidies to local authority housing accounts. This is welcome. But the effect would be, according to the figures attached to his minute, that housing benefit will almost treble from the present level of about £3½ billion for the UK.

There is also a danger that, because housing benefit recipients can be indifferent to their rents, local authorities and private landlords may go above economic rents and - in effect - simply collect the money from the government. Nicholas envisages controlling this through regional ceilings on rent qualifying for housing benefit and through pressure on local authorities' external finance.

We need to be very sure that this would work, and more generally that we have machinery to keep housing benefit under control: otherwise the consequences for the Exchequer could be catastrophic. We need also to consider whether we should continue to meet 100 per cent of the housing costs of those receiving benefit, or whether - as we shall be doing for rates and the community charge - we should set the benefit level at a lower proportion.

(ii) <u>Getting private management into the large estates</u>

The paper by the No.10 Policy Unit suggests a "Big Bang" approach. I see its attractions; but I am sceptical about its practicability. It would be a massive undertaking to be tackled all at once in the face of opposition from many housing authorities; and there is likely to be a severe social problem in persuading council tenants - a high proportion of whom, as the Policy Unit paper points out, are pensioners, single parent families or unemployed - to act responsibly as members of Trusts. There is also a real risk that the Trusts will be taken over by left wing activists, who would be even worse than local authorities.

My feeling is that a gradualist approach is the more realistic option. The paper by the Policy Unit makes a valuable suggestion in pointing out that some - I recognise not all - estates would be viable if their capital debt were removed. I would be interested in Nicholas' comments on the scope for using this means to get estates into the ownership and management of the private sector, either in the form of housing associations or some other body. The arguments are not easy: writing off debt would reduce the upward pressure on rents and hence make it harder for the rest of the private rented sector to compete. But it is well worth pursuing.

(iii) Other measures to break up public supply of housing

I think that we must look also at other ideas for breaking up the big estates. Some examples are:-

(a) greater incentives for occupiers of local authority flats to buy: for example, I understand that official valuations very often do not realistically reflect the low market value of such properties;

(b) penalties on local authorities who do not re-let property quickly enough, including the removal of such property from local authority control;

(c) reducing the categories of homeless which local authorities are under a duty to house; at present this is open to abuse.

(iv) Further measures to revive the rented sector

Nicholas' proposals would not reverse the decline in the private rented sector, only reduce it. They do not say anything about landlords' rights of recovery of their property (the security of tenure problem), and I am convinced that this remains one of the important obstacles to private letting. Deregulation of new lettings, on tenure as well as rents, would seem to be an essential first step.

(v) <u>The effect on job mobility of the gap in North/South property values</u>

Many people will not take jobs in the North, because they are afraid that they will not be able to afford to buy if they return South. This problem would be eased if they could hold on to their houses in the South and let them while they were away. This in turn would be eased if the anxieties about letting were removed; and there may also be capital gains tax complications which I would be willing to look at ways of easing.

<u>Next steps</u>

I agree with Nicholas that we should aim to legislate as soon as possible in the next Parliament. There are a large number of issues to be addressed in detail, with which the Treasury will need to be associated, and the DHSS should be brought into the work on housing benefit. I suggest we should agree at our meeting how this further work should be handled.

I am copying this minute to Nicholas Ridley.

NL.

N.L.

6.2.87

3694/26

FROM: D J WILSON
DATE: 6 February 1987

1. **MR MOWL** P.J.M. 6/2

2. **CHANCELLOR OF THE EXCHEQUER**

cc CST
Sir P Middleton
Sir T Burns
Sir G Littler
Mr F E R Butler
Mr Cassell
Mr Kemp
Mr Evans
Mr Odling-Smee
Mr Turnbull
Mr Bottrill
Mr Davies
Mr Riley
Mr Cropper
Mr Tyrie
Mr Ross Goobey

Thanks.

TREASURY FORECAST EXERCISE (FISCAL ADJUSTMENT FORECAST ERROR)

Mr Sedgwick's note to Chancellor of 28 January said that further work would be done on the errors in fiscal adjustment forecasts (para 3 refers). This note briefly sets out the methodology and results of this calculation.

2. The fiscal adjustment forecast error is calculated by comparing the PSBR outturn with forecast. But it is essential to allow for differences between the fiscal policy assumption made in the forecast and the fiscal policy announced in the Budget. In other words calculation of the error must adjust for the difference between the <u>forecast</u> fiscal adjustment and the <u>actual</u> adjustment announced in the Budget - in most recent years there has been a sizeable difference between the January forecast fiscal adjustment and the actual adjustment carried out. Straightforward comparison of the PSBR forecast and outturn would clearly include policy changes in the forecast error (incorrectly).

3. The table overleaf sets out the calculation of the error for the last five financial years and also the latest assessment for 1986-87 using the most recent forecast of the PSBR (£5.2 billion). In each case the errors are those made in January forecasts. There are several key features brought out by the table:

(i) that the average absolute error (ie. ignoring signs) on the fiscal adjustment forecast is equivalent to £2¼ billion (£2 billion if we include 1986-87) at current levels of GDP;

(ii) that, on average, the fiscal adjustment has been overestimated by an amount equivalent to £1.6 billion;

(iii) the forecasts for 1985-86 and, almost certainly, for 1986-87 underestimated the scope for fiscal adjustment whereas three of the previous four forecasts had overestimated it.

4. The report on the January Forecast (paragraph 60) estimated that the average error on fiscal adjustment forecasts made over the last ten years was equivalent to about £5 billion. This is much larger than the error over the last five years given in paragraph 3(i) above. There is no doubt that in general PSBR forecast errors have been lower in the last five than the last ten years but the difference between the two figures may also be due to different methods used to produce then.

DAVID WILSON

3694/26

= 4-3+5-6

FISCAL ADJUSTMENT FORECAST ERRORS

1	2	3	4 4-3	5	6 5-6	7	8	9
Forecast made	For financial year	PSBR forecast	PSBR outturn	Budget measures*	January Forecast of fiscal adjustment	Error in Forecast of fiscal adjustment	Error as % of nominal GDP	Error corrected for coal strike effect
January 1986	1986-87	7610	[5160] -2450	-985	-2240	[-1195]	[-0.31]	[-0.31]
January 1985	1985-86	7077	5783 -1294	-940	-1768	-466	-0.13	-0.13
January 1984	1984-85	7993	10172(7422) +2179 (-571)	-300	-1099	2978(228)	0.91	0.07
January 1983	1983-84	8029	9753 +1724	-1933	-2080	1871	0.61	0.61
January 1982	1982-83	7539	8859 +1320	-1986	0	-666	-0.24	-0.24
January 1981	1981-82	10155	8632 -1523	+3611	0	2088	0.80	0.80

Summary Statistics

	7	8	9
Average absolute error on January 1981 - January 1985 Forecasts	1614	0.54†	0.37†
Average absolute error on January 1981 - January 1986 Forecasts	[1569]	[0.50†]	[0.36†]
Bias° on January 1981 - January 1985 Forecasts	1161	0.39	0.22
Bias° on January 1981 - January 1986 Forecasts	[743]	[0.27]	[0.13]

Key:-

Column 7 = Column 4 - column 3 - column 6 + column 5

† 0.5% or GDP is approximately £2½ billion, in relation to forecast 1987-88 GDP (£413053m)

* 'Budget measures' refers to the fiscal adjustment actually made, (direct revenue impact only, any second round effects have not been allowed for).

° Bias indicates whether, on average, the forecast has been over or underestimated. In this case, the forecast fiscal adjustment has been overestimated on average by 0.39% of GDP, or by 0.22% of GDP if the effects of the coal strike are allowed for. These are equivalent in current prices to approximately £1.6 billion and £0.9 billion.

NB Figures in parentheses, columns 4 and 7, are after adjustment for the coal strike.

CONFIDENTIAL

FROM: P N SEDGWICK
DATE: 28 JANUARY 1986

CHANCELLOR

cc CST
Sir P Middleton
Sir T Burns
Sir G Littler
Mr F E R Butler
Mr Cassell
Mr Kemp
Mr Evans
Mr Odling-Smee
Ms Peirson
Mr Turnbull
Mr Bottrill
Mr Davies
Mr Mowl
Mr Riley
Mr Cropper
Mr Tyrie
Mr Ross Goobey

TREASURY FORECAST EXERCISE

You asked three questions on the main forecast report. These are

(i) what are the recorded errors on the PSBR in the last five financial years (para.50)?

(ii) what is the end-1986 estimate for the value of the UK's net overseas assets (para.76).

and (iii) why does NHS manpower rise after 1987-88?

This note deal with these in turn. Mr Mowl provided the material for (i) and (iii) and Mr Bottrill that for (ii).

(i) PSBR errors

2. The average absolute error on the January forecast of the current year PSBR is equivalent to £1½ billion for forecasts made over the last ten years and £1½ billion for forecasts over the last five years. The table below gives details of errors made in the last five years.

Errors in January forecasts of the PSBR for the current year

	Forecast £b	Outturn £b	Error £b	Error % of GDP
1981	10.1	8.6	-1.5	-0.6
1982-83	7.9	8.9	+0.9	+0.3
1983-84	10.5	9.8	-0.7	-0.2
1984-85	10.9	10.2	-0.7	-0.2
1985-86	6.8	5.8	-0.9	-0.3
Absolute average				0.3*

* equivalent to £1¼ billion at current GDP levels.

3. On reflection I am not convinced that the estimate of the average error for the fiscal adjustment for the year ahead given in paragraph 50 of the main forecast report is soundly based. We will let you have a note quite soon with precise figures on past errors.

(ii) The UK's net overseas assets

4. There are problems with both the annual estimates of the UK's net overseas assets published in the Pink Book and with the methods used by the CSO to project them forward quarterly (though they do not publish their quarterly figures). This is therefore a particularly uncertain area for monitoring.

5. The problems with the estimates of net overseas assets relate to our understanding of the capital account and the balancing item. The Pink Book estimates of net overseas assets are based partly on inquiries by the DTI and the Bank of England on stocks of assets and partly on cumulated recorded capital flows. The coverage of the available information is not sufficient to generate reasonably firm estimates of net overseas assets. The abolition of exchange controls and the ending of certain DTI inquiries about trade credit in 1982, following the Rayner review of the Government Statistical Service, together reduced the amount of available information.

6. The latest Pink Book included an estimate of £80 billion for the UK's net external assets at end-1985. The cumulative balancing item over the period to end 1985, however, has been positive to the tune of £9 billion since 1979, or £15 billion back to 1973. If the bulk of the balancing item really represents under-recording of the current balance, this may have little or no effect on the UK's net foreign asset position which is measured independently. If the balancing item, however, typically reflects unrecorded net capital inflows then the position is less clear. It may suggest that the CSO's estimate of revaluation effects is wrong, and leave the net asset position unchanged. Alternatively where it affects the stock figures calculated from cumulative recorded capital flows, it might suggest that the CSO's estimates of the UK's net assets are overstated. We cannot exclude the possibility that the Pink Book figure of £80 billion is an overestimate.

7. Even if the £80 billion for end-1985 is correct, we have difficulties with the way the CSO projects the figure forward to derive its quarterly path. Discussions with the CSO during the forecasting round identified areas where apparently incorrect currency composition or stock market valuation effects were being used. In particular too great a weight was being attached to non-dollar currencies which overstated the increase in the sterling value of assets as a result of the pound's depreciation against the DM and Yen etc in the first three-quarters of 1986. No allowance had been made for the £6 billion positive balancing item over the period.

8. The CSO latest (unpublished) estimates suggest that net foreign assets were worth about £115 billion at the end of the third quarter. Our own estimate , allowing for the revaluation adjustment and balancing item, is £100-105 billion - although this is still a crude approximation. We estimate that further revaluation changes in the fourth quarter might yield an end-1986 figure of £105-110 billion.

9. In view of these uncertainties the forecast report did not include a figure for net foreign assets. You may recall that in last year's FSBR, the CSO's estimate of £90 billion was quoted. This had to be revised down to £80 billion when the Pink Book was published. We want to avoid the use of similarly misleading figures this year. We have

already approached the Bank of England directly about the currency composition. We are also trying to improve the measure of stock market valuation effects so that we can crosscheck the CSO's methods. When we are a little more certain about some of the troublesome issues in estimating net foreign assets we will formally approach the CSO - as on some other important issues - about their methodology.

(iii) <u>Health service manpower</u>

10. Over the last four years total employment in the health service has declined, but numbers of those giving direct patient care (60 per cent of the total) have been increasing. The forecast that total employment might, at some time in the near future, start rising is based mainly on two considerations.

(i) The drive for efficiency savings will continue, but the scope for achieving these via reductions in numbers of support staff will diminish.

(ii) The number of patients, particularly the elderly, will continue to rise, creating increased demand for doctors and nurses which is likely to be satisfied given the government's current attitude towards the health service.

11. The extent of the rise in health service manpower in the forecast is however very small, less than ¼ per cent per annum. It contributes very little therefore to the forecast increase in the central government pay bill, well under £50 million a year.

12. ST are in agreement with this general interpretation but have not been involved in detailed calculations to endorse the precise numbers in the forecast.

PNS

P N SEDGWICK

CONFIDENTIAL

PMP

FROM: **A BOTTRILL**
DATE: 6 FEBRUARY 1987

CHANCELLOR

cc Sir P Middleton
Sir G Littler
Sir T Burns
Mr Cassell
Mr Monck
Mr Byatt
Mr Lavelle
Mr Evans
Mr Odling-Smee
Mr Melliss
Mr Mowl
Mr Riley
Mr S Matthews
Mr S Davies
Mr Barrell
Mr Owen
Mr Patterson
Mr Young

$18 OIL PRICE ALTERNATIVE FORECAST

The attached note reports an alternative version of the January forecast to illustrate the effects of assuming an $18 a barrel world oil price - as promised by Mr Sedgwick at your meeting on 2 February to discuss the forecast.

2. The note describes (i) the oil price assumption, (ii) prospects for the world economy, (iii) the alternative forecast for the UK and (iv) an annex by MP comparing these results and previous oil price variants.

3. The main features of the present exercise are rather poorer prospects for output and inflation than in the January forecast but a slight improvement in the balance of payments.

A Bottrill

A BOTTRILL

The oil price assumption

Our alternative projection assumes that world oil prices - as measured by OECD average import prices - remain at $18 a barrel through both 1987 and 1988. This is in line with OPEC's aims. It contrasts with the January forecast where oil prices were projected to fall back from present levels to about $15 a barrel in the second half of this year before being held constant in real terms through 1988. The effect is to leave oil prices on average $2.35 higher than the base in 1987 and $2.17 higher in 1988. Forward prices are at present showing an average 20 cents discount for the rest of 1987 from the current West Texas spot price of $18.05 a barrel - although forward prices have not always proved good predictors. Brent prices in the $18 case show a small premium over world prices averaging $18.5 over 1987 and 1988 as a whole compared to $15.5 in the January forecast.

Table 1: Oil price assumptions

		Nominal world price* $ barrel		Real world price* 1980=100		Nominal N.Sea price $ barrel	
		January	$18 case	January	$18 case	January	$18 case
1987	1	17.0	17.5	50.5	52.0	17.0	17.5
	2	15.8	18.0	45.9	52.6	16.1	18.7
	3	14.5	18.0	41.3	51.4	15.0	18.7
	4	14.9	18.0	41.3	50.0	15.4	18.6
1988	1	15.2	18.0	41.3	48.6	15.7	18.6
	2	15.6	18.0	41.3	47.5	16.1	18.6
	3	16.0	18.0	41.3	46.2	16.6	18.6
	4	16.5	18.0	41.6	45.0	17.1	18.6

* OECD average import prices

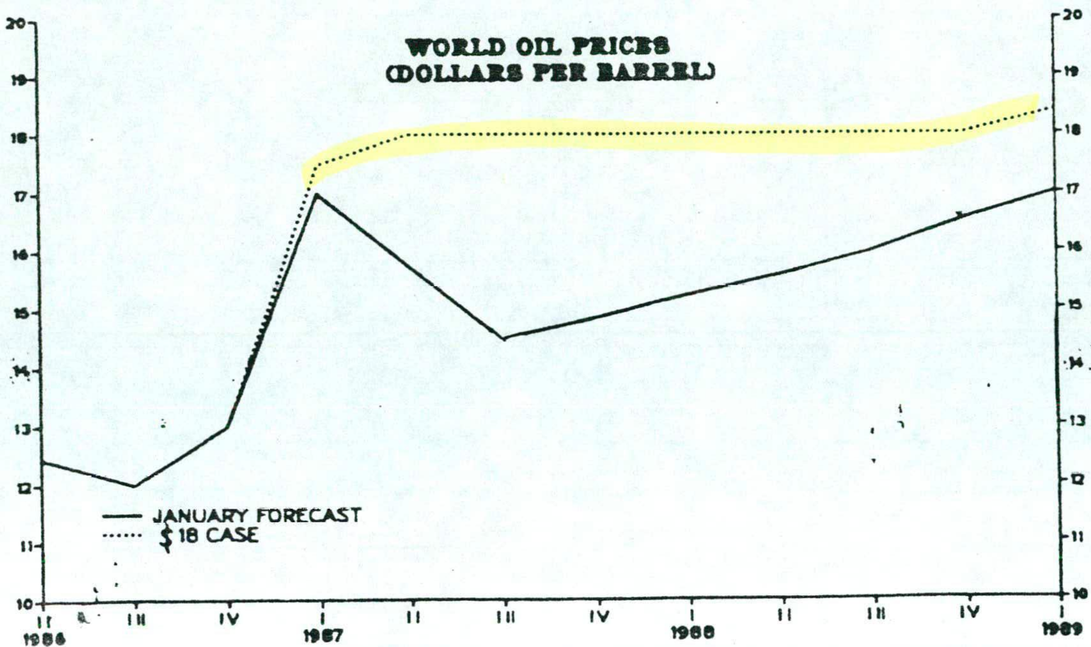

Table 2: Forward oil prices

($ barrel)

	West Texas	Brent
February 5	18.55	17.95
March	18.56	17.90
April	18.52	17.85
May	18.40	
June	18.21	
July	18.06	
August	17.98	
September	17.95	
October	17.90	
December	18.05	

Effects on world economy

2. No significant fiscal policy reaction is assumed in the major OECD economies outside the UK in response to the higher oil price. This contrasts with the tightening of policy in many countries after the 1979-80 oil price rise and reflects the current low rate of inflation. General government deficits can therefore be expected to be slightly higher as a proportion of GNP as the effect of lower activity as a result of higher oil prices outweighs the increase in revenues stemming from higher inflation. On the other hand there is bound to be some concern at the possibility of higher inflation and faster growth in the money stock. We have assumed on balance that monetary policy will be only partially accommodating. Nominal interest rates may increase a little, reversing at least some of last year's fall. The increase, however, is less than the rise in inflation and monetary growth is faster than in the January forecast.

3. The main forces acting on the world economy are similar to those reported in earlier analyses of the effects of a change in oil prices. The main levels figures are included in table 3 and differences from the January forecast in table 4.

4. The deterioration in oil-importing countries' terms of trade is accompanied by higher inflation and a slower growth of domestic demand. The annual inflation rate in the major OECD economies rises by ½ per cent to 3 per cent by the end of 1987 and to almost 4 per cent by the end of next year. The rise in prices is not fully matched by higher earnings and the consequent slowing of real income

growth combined with wealth effects produce lower consumers' expenditure and hence lower domestic demand than in the January forecast. For the major OECD economies, the impact on real GNP growth is offset partly by higher demand from oil-producing countries which reduce their imports less steeply in 1987 and 1988 than in the January forecast. Industrial countries' real GNP growth is little changed in 1987 but is ½ per cent lower in 1988 giving increases of 2 3/4 per cent in each year. The reduction in domestic demand growth is a little greater.

5. The growth in total world trade is also reduced by higher oil prices. The initial impact takes the form of reduced oil trade as non-oil producers switch to alternative energy sources. Trade in manufactured products is only reduced as domestic demand growth slows in the non-oil producing parts of the world. In particular the growth of main manufacturing countries' exports - although little changed in 1987 - might be only 3½ per cent in 1988 instead of the 4 per cent forecast in January.

Effects on UK economy

6. In the case of the UK we have assumed that the effects of higher oil prices on the PSBR, particularly through higher oil revenues, are reflected ex post half in a larger fiscal adjustment and half in a reduction of the PSBR as in the original forecast. We have assumed that with stronger external current balance and sterling exchange rate domestic interest rates do not follow the rise in foreign interest rates. The overall result is a small rise in nominal GDP as higher inflation is offset only partly by lower output growth.

7. The alternative forecast is included in levels in table 3 and differences for January in table 4.

8. Higher oil prices lead to a small improvement in the UK's current account in contrast to other industrial countries whose payments balances deteriorate. The effect on the exchange rate, however, is difficult to judge. If the higher oil price was expected to persist, then the value of North Sea oil reserves and export earnings would rise and the exchange rate might appreciate

significantly. Our present assumption that the oil price is only temporarily higher leads to a muted exchange rate response with sterling temporarily higher than in the January forecast then returning towards its previous level. The decision not to follow the rise in world interest rates contributes to this.

?

9. The rise in the net oil trade surplus by £0.5 billion, however, is more than enough to offset a deterioration in non-oil trade as a result of the higher exchange rate and slower world growth. It also offsets the increase in IPD payments abroad by North Sea companies and the reduction in the sterling value of other IPD credits as a result of the pound's appreciation. The current balance, therefore, shows a small improvement of £0.2 billion in 1987 and £0.1 billion in 1988. This still leaves the projected deficit at close to £3 billion in each year.

10. The $18 oil case suggests that real GDP growth might be slightly lower than in the January forecast - still close to 3 per cent in 1987 but slightly below 2½ per cent in 1988. The fall in real GDP reflects:-

- lower non-oil net exports because of lower world trade, and worse competitiveness

- a small fall in non North Sea investment and stockbuilding caused by lower non-oil output and a reduction in profits

- lower consumers' expenditure, mainly because the larger fiscal adjustment is not enough to offset the effect of higher prices on real personal disposable incomes.

11. The effect of higher oil prices on domestic inflation is only partly mitigated by the appreciation of sterling. Retail prices, therefore, are ½ per cent higher by the second quarter of 1988, pushing the year-on-year increase in the RPI to 5 per cent. This is a rather greater effect than reported in January 1986. This reflects partly the result of further research on the relationship between oil prices and petrol prices but more importantly it takes account of our experience during the past year of the impact of oil prices on other

energy prices, particularly those of nationalised industries, for example the agreement between the CEGB and NCB in May 1986.

12. The financial position of non North Sea companies deteriorates in 1987 compared to the January forecast. However by 1988 companies have sufficiently adjusted their expenditure that their financial position is little affected. There is a slight fall in the personal sector saving ratio as prices move ahead of earnings despite a small increase in the fiscal adjustment.

13. Compared to the January forecast, the Brent oil price is assumed to be \$2.50 a barrel higher to average \$18.4 in 1987 and to be \$2.20 higher in 1988 to average \$18.60. This compares with the present price of \$17.7. The higher dollar price more than offsets the effects of a stronger \$/£ rate so that North Sea revenues increase by £0.9 billion in 1987-88 and £0.8 billion in 1988-89. This increases the levels to £5.4 billion and £4.6 billion respectively, the fall between the two years reflecting the underlying fall in North Sea output and continued sterling appreciation against the dollar. Output is assumed over the period covered by this note not to rise in response to the temporary increase in prices.

14. The assumption that the increase in North Sea revenue is divided broadly equally between an increased fiscal adjustment and a lower PSBR raises the overall fiscal adjustment from £2.9 billion to £3.3 billion in 1987-88 and from \$4.8 billion to £5.0 billion in 1988-89.

This is also
ie £3.3 billion fiscal adjustment
and a £3.7 billion PSBR.

Table 3: Summary table

		January forecast	$18 oil price
1.	World oil prices		
	1987	15.5	17.9
	1988	15.8	18.0
2.	World GNP (major 6) % change		
	1987	2.8	2.8
	1988	3.0	2.7
3.	World consumer prices (major 6) % change		
	1987	2.2	2.4
	1988	3.1	3.9
4.	Main manufacturing countries' exports of manufactures (UK wts) % change		
	1987	3.6	3.5
	1988	4.1	3.4
5.	PSBR £ billion		
	1987-88	4.3	3.9
	1988-89	2.2	2.0
6.	Cumulative fiscal adjustment £ billion		
	1987-88	2.9	3.2
	1988-89	4.8	5.0
7.	Nominal GDP % change		
	1987-88	7.3	7.6
	1988-89	7.8	7.7
8.	Effective exchange rate (1975=100)		
	1987	68.7	69.8
	1988	67.3	68.0
9.	Real GDP % change		
	1987	3.1	2.9
	1988	2.5	2.3
10.	Retail prices % change		
	1987 Q4	4.4	4.8
	1988 Q2	4.6	5.1
11.	Current balance £ billion		
	1987	-3.1	-2.9
	1988	-3.3	-3.2
12.	North Sea Revenue £ billion		
	1987-88	4.5	5.4
	1988-89	3.8	4.6

CONFIDENTIAL

Cases [illegible] reflect a fall from 30 to 15?

Table 4: $18 oil case per cent differences from January forecast (per cent from base levels)

Year	Oil prices* $ barrel	Major 6 GNP	Major 6 CPI	Manufacturing countries' exports of manufactures	Real GDP	RPI	Nominal GDP
1987	$2.35	0	0.2	-0.1 ???	-0.2	0.2	0.2
1988	$2.17	-0.3	1.0	-0.8	-0.4	0.5	0.2

Year	£ exchange rate index	Labour cost competit-iveness	Current balance (£ bn)	Earnings	Employment (000s)	North Sea revenues† (£ bn)	Fiscal adjustment† (£ bn)	PSBR (£ bn)†
1987	1.7	1.9	0.2	0	-6	0.9	0.4	-0.4
1988	1.2	0.6	0.1	-0.1	-38	0.8	0.2	-0.3

* OECD average import prices   † FY 1987-88 and FY 1988-89

CONFIDENTIAL

ANNEX

DIFFERENCES FROM PREVIOUS FORECAST VARIANTS

1. In broad terms the forecast variant presented here is qualitatively similar, taking account of the different scale and direction of the change in oil prices, to those presented in January and February last year. However there are important quantitative differences. For example, the effects on GDP and inflation are now stronger and that on the current balance rather weaker than a year ago. These differences can be attributed to differences in policy assumptions, changes that have been made to the Treasury model, and revisions in the light of experience to our views about the way that the world and UK economies respond to changes in world oil prices. Also it is likely that there are important asymmetries when comparing oil price rises and falls and we have attempted to allow for these in preparing the forecast variants.

v. doubtful - for GDP

?

2. The effects on GDP are significantly stronger, after adjusting for scale, than those reported early last year. For example, in the forecast variant reported on 27th February 1986 GDP showed little change in the first year and a change of 0.1 per cent in the second, compared to the falls of 0.2 and 0.4 per cent shown here. The effect on the RPI is also larger, so that whereas this forecast variant shows a rise of 0.2 and 0.5 per cent the corresponding figures last year were 0 and 0.1 per cent. There are a number of reasons why the GDP and inflation responses are stronger than formerly:

how

- the adverse effects on world trade and activity are greater, mainly because major OECD countries have not responded by cutting interest rates to the extent thought likely last January. It has therefore been assumed that a rise in oil prices would result in higher world interest rates, consistent with the higher weight that now seems to be given to achieving reductions in inflation.

- a small rise in oil prices from a level of $15 is assumed not to be accompanied by a rise in North Sea production and investment whereas a sustained fall in oil prices was assumed to lead to reductions in production and investment and offset the rise in non-oil GDP.

- the assumption that the fiscal adjustment rises by only half the increase in oil revenues gives rise to a smaller offset to the reduction in real personal disposable than if it had changed to the full extent as assumed in the variant last year.

- the fall in real earnings before tax is now thought to be greater than before because:

  - we now attach more weight to the likelihood that the reduction in profits (in the first year) will restrain upward pressure on nominal earnings

  - we have strengthened the domestic price effects of a change in oil prices as a result of reconsidering the response of nationalized industries prices and petrol prices to a change in oil prices.

3. The effects on the current balance, adjusting for the scale of the change in oil prices, are now much less than we reported a year ago, despite the change in the size and composition of the output response. Last year the effects in the first and second year were for a deterioration of £0.4 bn and £0.9 bn respectively as a result of the fall in oil prices. The corresponding figures in the January 1987 variant are for improvements of £0.2 bn and £0.1 bn. Of course, an implication of this is that we now think that last year's fall in the oil price may have had smaller adverse effects on the current balance than we first thought. The main reasons for the changed view are:-

(i) a worse outcome on world trade which affects exports;

(ii) we have changed our view in a number of ways about the response of the IPD account such that there is now a small deterioration in the non-oil IPD account when oil prices rise;

4. Despite all the changes that have taken place the view about the effects on the PSBR and North Sea revenues remain broadly unchanged.

366/42

APPOINTMENTS IN CONFIDENCE

Alex - does C need to see?

CHIEF SECRETARY

FROM : R G LAVELLE

6 February 1987

How long ago did Mr Stephens leave ECGD? R.

cc Chancellor
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir G Littler
Mr Anson
Mr Kemp
Mr Mountfield
Mrs Case

CHIEF EXECUTIVE - ECGD

My minute of 12 December recommended you to agree to the appointment of Mr Malcolm Stephens (currently with Barclays but ex-ECGD) as a successor for Mr Gill, the present Chief Executive.

2. You will recall the background. Ministerial consideration of the ECGD Management Review led to the conclusion that the present departmental structure should be retained with Mr Gill as Chief Executive but with three of five Under Secretary posts being filled from the private sector. Mr Gill then offered to retire early in order to make room for a private sector Chief Executive on the understanding that four of the Under Secretary posts should remain filled by civil servants. The post was advertised. Mr Stephens was front runner, with a considerable gap between him and other outside candidates.

3. The expectation at that stage was that Mr Stephens would be prepared to settle for something close to the Deputy Secretary salary on offer. In practice, there have been very lengthy negotiations about salary etc in which Mr Stephens sought Second Permanent Secretary status and salary and a ten year contract. This has now been resolved on the basis of offering a seven year contract at £55,000 a year on a personal basis. The last point should ensure that paying Mr Stephens more does not inflate expectations/grading of the whole of ECGD's top management structure.

4. Very recently, Mr Gill (the present Chief Executive) has expressed concern that Mr Stephens may want to set aside the work of the Management Review and substitute something of his own. He intends to brief Mr Channon in discussing the assignment to emphasise the need to implement the Review, as agreed Ministerial policy, and to take it forward quickly. We have told Mr Gill that we support this. Among Ministers' objectives in seeking a private sector input into ECGD's top management was to ensure active implementation of a more commercial approach. A start has been made on this but, as you are aware, much remains to be done and many of ECGD's present management practices and systems still need fundamental reform. Whilst Mr Stephens will no doubt want to develop a style of his own, our expectation has been that Mr Stephens as Chief Executive would not hold up the changes in train, since his acquaintance with the private sector would lead him to expect such systems as a matter of course.

5. Unless we have any further adverse indications of Mr Stephens' intentions, I do not think you need get involved in this. This note simply brings you up to date on the state of play. But in any contacts you may have with Mr Channon, it would be desirable to emphasise that Stephens' job is to put the Review proposals into force as soon as possible, not to dig them up and start all over again.

R

R G LAVELLE

Meena Pse thank

FROM: H J BUSH
DATE: 9 February 1987

CHANCELLOR

cc Chief Secretary
Economic Secretary
Sir P Middleton
Sir G Littler
Mr F E R Butler
Mr Lavelle
Mr Mountfield
Mr Peretz
Mrs Case
Mr C W Kelly

C/ This is one of the two ECGD guaranteed vehicles that have been under negotiation for some time.

CE 9/2

NBR:

ECGD : GEFCO BOND ISSUE

You will be interested to know that the $150m GEFCO bond issue was launched early today in the Tokyo market where it was anticipated there might be significant Japanese demand. In the event, the Japanese initially proved rather cautious. But, once the London market opened, the issue was fully - and quickly - subscribed. The issue was very tightly priced but there was a good demand for the paper attracted by the quality of the HMG name. We understand that the bonds have been trading well during the day and have indeed strengthened against US Treasuries.

2. If anything, the terms on the bond were somewhat finer than had been anticipated. However, the subsequent translation into floating rate funds through a swap (necessary to match the vehicle's receipts from Yugoslav and the Philippines) suffered slightly from the adverse movement in the swap markets over the last few months. Nevertheless, the all in cost of funds achieved was a competitive 38 basis points below LIBOR.

Henry Bush

H J BUSH

CH/EX

10 FEB 1987

RP

NL/10
B

Westminster Management Consultants

65 Swinburne Road,
Putney,
London SW15 5EQ
Telephone:
01-392 1254
0273-554181 (Brighton Office)

Ch
EST wants to raise this
AWK
10/2

I Stewart Esq
Economic Secretary to the Treasury
H M Treasury
Parliament Street
London SW1

9th February 1987

Told PS/EST
AWK

Dear Mr Stewart,

THE 1987 BUDGET: ANALYSIS AND IMPLICATIONS
A Seminar at Westminster Central Hall on March 18th 1987

No, he spoke to me and I told him to write in.
Guy

Further to my telephone conversation with your Parliamentary Private Secretary today, I am writing to ask whether you might be interested in participating in the above event which our company has organised.

The format of the seminar is planned as follows. If it were convenient for you, we would suggest that you open the afternoon's proceedings with an address of no more than thirty minutes' duration between 2.00pm and 2.30pm. The address would be general in nature, explaining the broad thrust of the Budget proposals and setting the context for the detailed examination of the minutiae that would follow. This examination would be carried out in five speeches. To date, each of the following accountancy firms have agreed to participate: Messrs Coopers & Lybrand, Peat Marwick Mitchell, Deloitte Haskins & Sells, and Ernst & Whinney. The anticipated audience, which would number no less than five hundred, would consist of representatives from industry and the City. The event will, of course, be the subject of a considerable publicity drive.

I would stress that we would be prepared to design the conference around your timetable so that, for instance, you could speak at the end rather than the beginning of the day. As you will note, the venue is particularly convenient for the Treasury.

I do hope that you will feel that this event would prove an effective forum in which to transmit the main messages of the Budget to the leaders of the business community.

For your information, I enclose some literature on our most recent conference.

I look forward to your reply at your earliest convenience.

Yours sincerley,

John Walker

John Walker
Director

Enc.

SECRET

CH/EXCHEQUER

REC. 09 FEB 1987 9/2

ACTION CST

COPIES TO Sir P Middleton
Sir T Burns
FER Butler
Mr Sedgwick
Mr Odling-Smee
Mr Culpin

pup

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

9 February 1987

Dear Alex,

PAPER FOR ECONOMIC FORECAST

The Prime Minister has seen the draft of the Chancellor's paper for Cabinet on Thursday attached to your letter to me of 6 February.

The Prime Minister's only comment was to suggest that the final sentence of paragraph 5 ("There is no reason to risk anything here") is insufficiently strong. Subject to an amendment to meet this point, she is content that the paper should be circulated to Cabinet colleagues today.

Yours,

David.

(David Norgrove)

Alex Allan, Esq.,
HM Treasury

SECRET

3693/2

CONFIDENTIAL AND PERSONAL

FROM: COLIN MOWL
DATE: 10 February 1987

1. **MR CASSELL**
2. **CHANCELLOR OF THE EXCHEQUER**

cc Sir P Middleton
Sir T Burns
Mr Peretz
Mr Sedgwick
Mr Scholar
Mr Ritchie
Mr Devereux
Dr Clark

No reversal of recent trends in January! And a downward revision of the estimate for April/December. The news that with only 2 months to go we've borrowed only £½ billion will fuel a lot of speculation.

In the light of this, I wd like an urgent revision of the outlook for 1987-88 (& thereafter). There must be a strong presumption that the current Budget package wd produce a lower PSBR than that @ present projected, & I may come to show this. NL.

PSBR IN JANUARY

1. The first provisional outturn for the PSBR in January is a net repayment of £3.7 billion. Last month's forecast was for a repayment of £3.4 billion (see table 1 attached). The average of the market forecasts currently available is a repayment of £2¾ billion, with a range of £1¾-£3½ billion. This outturn is subject to revision before publication at 11.30am on Tuesday 17 February.

2. The undershoot on last month's forecast is accounted for by local authorities and public corporations. The central government own-account surplus of £3.5 billion was as forecast last month. The surplus was slightly smaller than reported in Mr Evans's minute of 3 February because the reduction in central government bank deposits was slightly bigger than assumed.

3. In the first ten months of 1986-87 the PSBR was provisionally £0.4 billion, £3.8 billion lower than the Budget profile. Borrowing by all three sectors is below profile. Table 2 attached summarises the position.

!

4. The monthly note, presenting updated estimates for January and revised forecasts for February and March, will be circulated next Monday, 16 February.

Colin Mowl

COLIN MOWL

CONFIDENTIAL & PERSONAL

TABLE 1

£ billion

	January 1987			April-January 1987			April-January 1986
	Provisional outturn	January forecast	Difference	Provisional outturn	Budget forecast	Difference	Outturn
CGBR(O)	- 3.5	- 3.5	-	2.1	4.0	- 1.9	2.8
LABR	- 0.1	-	- 0.1	- 0.7	0.4	- 1.1	0.5
PCBR	- 0.2	0.1	- 0.2	- 1.0	- 0.2	- 0.8	- 0.1
PSBR	- 3.7	- 3.4	- 0.3	0.4	4.2	- 3.8	3.1

TABLE 2

PSBR APRIL-JANUARY* - £ billion

(receipts -, outlays +)

	Budget Profile	Outturn	Difference between outturn and Budget £b	Profile %**
CG Receipts				
Non-oil taxes	-80.3	-82.4	-2.2	-3
Oil taxes and royalties	-4.4	-3.4	+1.0	+22
NIC's	-18.0	-18.5	-0.5	-3
Privatisation proceeds	-2.9	-3.3	-0.4	-13
Other receipts	0	+0.1	+0.1	-
CG Outlays				
Supply and other expenditure	101.9	101.7	-0.2	0
Debt interest (net expenditure)	7.7	7.9	+0.3	+3
CGBR(O)	4.0	2.1	-1.9	-
LABR	0.4	-0.7	-1.1	-
PCBR	-0.2	-1.0	-0.8	-
PSBR	4.2	0.4	-3.8	-

* figures may add due to rounding
** a dash indicates that percentage changes are not meaningful

COVERING SECRET

pms

FROM: MISS M O'MARA
DATE: 10 February 1987

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Odling-Smee
Mr Scholar
Mr Sedgwick
Mr Pickering
GJ/03

BRIEFING FOR CABINET: 12 FEBRUARY

I attach the following briefs for Thursday's Cabinet produced by EA, FP and IF, as well as EB:

- A Economic prospects
- B Fiscal prospects
- C Oil
- D Employment and unemployment
- E Tax options
- F Transferable allowances
- G International comparisons

Mr Odling-Smee will be submitting separately speaking notes to introduce your paper and MG1 will be putting up their usual brief on interest and exchange rates tomorrow.

MOM

MISS M O'MARA

A. ECONOMIC PROSPECTS

Factual

(a) Outturn for 1986

(i) Fifth year of **GDP growth** - exact growth figure still uncertain but likely to be in the 2½-3 per cent range. Activity seems to have accelerated during the course of 1986; CSO's latest assessment is that the current trend for GDP growth is in the 2-4 per cent range.

(ii) **RPI inflation** in December at 3.7 per cent (3.5 per cent excluding mortgage interest payments); compared with 5.7 per cent in December 1985 (5.1 per cent excluding mortgage interest payments).

(iii) **Current account** in broad balance for 1986 as a whole against a Budget forecast of £3½ billion surplus. Much of the forecast error accounted for by unexpectedly low world trade growth: markets for UK manufactured exports may have grown by 2 per cent or less in 1986, compared with a Budget forecast of 5 per cent. Exports rose strongly in the second half of 1986: in Q4 exports of goods excluding oil and erratics up 9½ per cent on a year earlier in real terms (same as growth of imports excluding oil and erratics).

(iv) 1986 FSBR's claim that "the prospects for unemployment are better than they have been for some years" borne out by fall of 107,000 in **unemployment** in the five months to December.

(b) Outlook for 1987

(i) December DTI investment intentions survey projected 6 per cent real growth in **business investment** in 1987.

(ii) Rising trend in private housing starts (7½ per cent up in 1986) points to continued strong growth in **housing investment** in 1987.

cm
pns-ecobrf

(iii) Latest CBI quarterly survey (for January) shows general improvement since the previous survey (for October) in position of manufacturing industry, with marked rises in export and domestic order book and in expected growth in output.

(iv) Meanwhile no signs of any emerging supply constraints: proportion of firms quoting skilled labour or capacity as a factor limiting output remains at low levels (9 per cent and 15 per cent respectively).

(v) **Consumers' expenditure** should remain quite buoyant but is not likely to repeat the 5 per cent rise seen in 1986: last year real earnings growth was boosted by the fall in price inflation which is now being reflected with a lag in pay settlements and earnings.

(vi) World markets for UK manufactured exports should grow more strongly in 1987 than 1986 as non oil LDC imports start to recover. (Latest forecast is for 4 per cent growth in 1987 as against under 2 per cent in 1986.)

(vii) Better world trade prospect, and UK exporters' large gain in competitiveness (more than 15 per cent fall in UK's unit labour costs relative to competitors since the second half of 1985) mean that the recent strong growth of **manufactured exports** should continue in 1987.

(viii) Overall prospects are for **balanced growth** in 1987: prospects for exports and investment in 1987 seem to have improved since the Autumn Statement.

(ix) **Current account deficit** in 1987 is forecast: probably of the order of ½ per cent of GDP (£2[-3] billion).

(x) **RPI** forecast to rise by about 4[- 4½] per cent over the year to 1987 Q4; most of the rise since the 1986 trough in inflation accounted for by the path of mortgage rates.

(xi) Fall in **pay settlements** has occurred in recent months (settlements monitored by CBI averaged 4.7 per cent in Q4 1986, compared with 5.6 in Q3 and 6.3 in 1985Q4).

(xii) Forecast suggests **unemployment** should continue to fall at similar rate to that experienced in recent months: revised assumptions for public expenditure issued to Departments are for 2.8 million adults unemployed in GB in 1987-88 on average (cf December 1986 figure of 2.99 million).

(xiii) Current average of **outside forecasts** is for:

1987 GDP growth	of 2.7 per cent
1987 Current account deficit	of £3.0 billion
1987 Q4 RPI	of 4.9 per cent

Positive

(i) Forecast shows completion of sixth successive year of GDP growth - since the upswing started in 1981 growth has averaged almost 3 per cent compared with average 2 per cent a year in the 1970s - and fourth successive year of employment growth.

(ii) Productivity in manufacturing up $4^{3}/_{4}$ per cent over the year to November 1986.

(iii) Manufactured exports picking up strongly - rose by 5 per cent in 1986Q4 on previous quarter compared with 3½ per cent rise in manufactured imports.

Defensive

(i) **Consumer boom?** Forecast is for balanced growth: indeed, already over the year to Q4 86 exports rose roughly twice as fast as consumer spending.

(ii) **Rise in consumers' expenditure just sucking in imports, reflects imbalanced growth.** In fact, composition of recent real growth in imports is weighted towards capital goods - which rose almost 15 per cent and between first and second halves of 1986.

(iii) **Current account deficit - Treasury too optimistic?** On average outside forecasters show a £3 billion deficit in 1987 - a temporary deficit of this size would not be a cause for concern, given the period of time which UK trade patterns inevitably need to adjust to lower oil prices. But already trade performance better than the pessimists predicted: current account in 1986 virtually in balance compared with, for example, National Institute's mid November forecast of a £1$^3/_4$ billion deficit for 1986.

(iv) **Inflation rising again?** RPI inflation expected to rise during the first part of 1987, mainly reflecting pattern of mortgage rate and petrol prices changes in 1986; but resumption of downward path in inflation expected in the second half of 1987.

(v) **Prospects for exchange rate?** Sterling index has been broadly stable since the autumn. Continuation of this stability during 1987 seems a central assumption, though as always wide range of possible outcomes.

FISCAL PROSPECTS

B. **Factual**

(a) Historical Statistics on PSBR

	PSBR			PSBR excluding privatisation proceeds		PSFD	
	Cash (£bn)	Real terms (1985-86 prices) (£bn)	Ratio to GDP (per cent)	Cash (£bn)	Ratio to GDP (per cent)	Cash (£bn)	Ratio to GDP (per cent)
1970-71	0.8	4.0	1½	0.8	1½	-0.2	-½
1971-72	1.0	4.5	1¾	1.0	1¾	0.7	1¼
1975-76	10.3	27.6	9¼	10.3	9¼	8.1	7¼
Average 1974-75 to 1978-79	8.2	20.6	6¾	8.3	6¾	7.3	5¾
1979-80	10.0	16.1	4¾	10.4	5	8.2	4
1985-86(1)	5.8	5.8	1½	8.5	2¼	8.4	2¼
Average 1979-80 to 1985-86	9.4	11.7	3½	10.5	3¾	9.8	3½

(1) If adjusted for coal strike, PSBR and PSFD ratio to GDP roughly 0.3 per cent lower in 1985-86.

(b) PSBR in 1986-87 - Forecasts

	£ billion except where stated		
	1986 FSBR	1986 AS	January 1987 Internal*
(+) General Government Expenditure	163.4	164.5	165.1
(-) General Government Receipts	155.9	156.3	158.3
(+) Public Corporations Market & Overseas Borrowing	-0.4	-1.1	-1.5
PSBR	7.1	7.1	5.2
PSBR excluding privatisation proceeds	11.9	11.8	9.7
PSBR as % of money GDP	1.8%	1.8%	1.3%

[* January forecast has not been circulated outside the Treasury, except to No.10]

(c) Non-Oil Revenues in 1986-87 - Forecasts

	1986 FSBR	1986 AS	£ billion January 1987 Internal*
Total Non-North Sea Taxes	111.5	113.1	114.8*
of which:-			
Income Tax	38.7	38.3	38.6*
Corporation Tax	9.4	10.3	11.2*
VAT Receipts	20.7	21.4	21.8*
Stamp Duty	1.4	1.7	1.8*
NIC s	26.2	26.3	26.4*
Other Receipts	12.1	12.2	12.2*
Total General Government Non-North Sea Receipts	149.8	151.6	153.4*

[* indicates figure derived from January forecast, not circulated outside Treasury]

Non-oil revenues now forecast £3½ billion* higher than at FSBR time. (AS forecast showed £2 billion upward revision.) Corporation tax, VAT, stamp duty together account for more or less all of upward revision to forecast. Other non-oil revenues (eg. income tax, NIC s) no higher than earlier forecasts.

(d) 1986-87 PSBR Outturn to date (monthly figures)

PSBR in nine months to December was £4.4 billion - well below expectations based on £7 billion PSBR for year as whole. (1985-86: outturn to December, £7.6 billion; outturn for year as whole, £5.8 billion).

Table below compares outturn to December with Budget profile. [NB Budget profiles are not circulated outside Treasury, except No.10.]

PSBR APRIL-DECEMBER - £ billion
(receipts -, outlays +)

	Budget Profile	**Outturn**	**Difference between outturn and Budget Profile**
CG Receipts			
Non-oil taxes	-67.3	-69.5	-2.2
Oil taxes and royalties	-3.5	-2.5	+1.0
NIC's	-15.9	-16.3	-0.5
Privatisation proceeds	-2.9	-3.3	-0.4
Other receipts	-	-0.5	-0.5
CG Outlays			
Supply and other expenditure	90.7	91.6	+0.9
Debt interest (net expenditure)	6.0	6.1	+0.1
CGBR(O)	7.1	5.5	-1.6
LABR	0.5	-0.4	-0.8
PCBR	-0.1	-0.8	-0.6
PSBR	7.4	4.4	-2.9
(excluding privatisation proceeds	(10.3)	(7.6)	(-2.6)

[NOTE: JANUARY PSBR FIGURES AVAILABLE TUESDAY, 10 FEBRUARY, PUBLISHED TUESDAY, 17 FEBRUARY]

(e) 1986-87 Tax Receipts to December

	£ billion	**% change on year earlier**
Total Inland Revenue and Customs	69.8	+7
(excluding oil in brackets)	(67.4)	(+16)
Of which:- Corporation Tax	6.2	+25
VAT	14.7	+15
Stamp Duty	1.2	+55

(f) 1986 MTFS Path for PSBR

	1986-87	1987-88	1988-89	1989-90
£bn	7	7	7	7
% of GDP	1¾	1¾	1½	1½

Positive

(i) Continuing progress on reducing public sector borrowing. PSBR in 1985-86 lower as percentage of GDP than in any year since 1970-71. Now quite likely that PSBR for 1986-87 will turn out as low - perhaps lower.

[NB. For the PSBR in 1986-87 to turn out lower than 1985-86 as a percentage of GDP will require an outturn of £6.0 billion or below.]

(ii) PSBR looks likely to undershoot £7 billion forecast for 1986-87 - despite shortfall of over £1 billion on North Sea revenues.

Defensive

(i) Likely undershoot on PSBR in 1986-87 largely explained by buoyant non-oil tax revenues. But considerable uncertainty about prospects for revenues in 1987-88. Main sources of buoyancy in tax revenues in 1986-87, Corporation Tax and VAT. In both cases, don't fully understand why tax receipts so buoyant - rise in receipts not fully explained by increase in tax base (company profits, consumers' expenditure). May not be able to count on similar buoyancy of revenues next year.

not part of Govt policy to increase effective tax rate

(ii) Continuing restraint on public expenditure necessary to maintain progress on reducing public sector borrowing. Buoyant non-oil tax revenues meant able to accommodate £1.3 billion in-year upward revision to planning total for 1986-87, without damaging PSBR prospects. Cannot count on this happening again. Plans already provide for 2% real terms increase in planning total for 1987-88.

OIL

Factual

(i) Prices

(a) Brent Spot prices

		\$/bl	£/bl
1983		29.30	19.33
1984		28.77	21.29
1985	Q1	27.51	21.42
	Q2	26.95	21.43
	Q3	27.36	19.98
	Q4	28.32	19.76
1986	Q1	17.72	12.31
	Q2	12.78	8.46
	Q3	12.43	8.38
	Q4	14.81	10.35
1987	January	18.44	12.23
	9 February	17.85	11.75
High	15 January 1987	18.88	
Low	14 June 1986	8.55	

(b) Prospects for prices: Futures/forward prices in $ per barrel on 8 February 1987 (opening)

	February	March	April	December
West Texas Intermediate Futures	Not App	18.49	18.45	18.00
Brent Forward	18.10	17.90	17.80	Not App

Autumn Statement and Internal January forecast assumption - North Sea price averages \$15 per barrel in 1986 and 1987.

(ii) **Output**

(a) Production in 1986: DEn provisionally estimate 1986 crude oil and NGL production of 126.9 million tonnes - a slight decline on the 1985 figure. Further fall expected in 1987.

(iii) **Investment:** North Sea investment likely to have been around 4 per cent of total UK capital expenditure in 1986. Investment fell in 1986 and a further fall seems likely in 1987.

(iv) **Balance of payments**

(a) Visible oil trade balance £ billion

1980	1981	1982	1983	1984	1985	1986 IAF	1987 IAF
0.3	3.1	4.6	7.0	6.9	8.2	4.0 (4.2)†	3½ (3.8)†

† latest forecast

- Effects on current account of smaller trade surplus reduced by lower North Sea payments to foreign companies.

(vi) **North Sea Revenues**

Autumn Statement forecast of revenues 1986-87 - £4½ billion. January internal forecast £4.9 billion compared with 1985-86 receipts of £11½ billion. January Forecast for future years *: 1987-88, £4½ billion; 1988-89, £4 billion; 1989-90, £4½ billion.

Ready Reckoner:	Effect on North Sea Tax take 1987-88 receipts	(£ million) Full year
$1 per barrel increase in oil price	+ 360	+ 420
£1 per barrel increase in oil price	+ 560	+ 640
1 million tonne per annum increase in oil production	+ 45	+ 50

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* Not published

Positive

(i) Use made of North Sea Revenue

- Reduced PSBR/GDP ratio frees resources for private investment.
- Increase in net overseas assets to $80 billion at end-1985, earning almost £5 billion per year.
- Official overseas debt reduced by 14 per cent since 1979.

Defensive

(i) Effect of lower prices on North Sea production: Production in 1986 and 1987 little affected by oil price fall. Oil prices would have had to fall further and remain low before production from existing fields became unprofitable.

(ii) Impact of lower oil price on North Sea exploration and development: Exploration and development depend on price expectations looking far ahead. At current price levels, likely that some North Sea activity has been postponed, as reflected in forecast of North Sea investment. But short term investment costs have fallen and in the long term many analysts expect real oil prices to rise in 1990s.

(iii) Effect on North Sea supply industries: Inevitable that some industries will contract as result of halving oil price. Not right for Government to subsidise activities that have become unprofitable pre-tax.

(iv) Effect of oil price fall on employment: North Sea sector accounts for small proportion of UK employment. Oil price fall since end-1985 should stimulate employment in non-North Sea industries.

(v) <u>Effect of lower oil prices on balance of payments</u>: Oil trade surplus will be reduced but partly offset by reduced invisible earnings by foreign owned companies operating in North Sea. Lower exchange rate will encourage exports and import substitution and offset decline in value of net oil exports.

PERSONAL AND CONFIDENTIAL
until 11.30 am
on Thursday 12 February

D. EMPLOYMENT AND UNEMPLOYMENT

Factual

(i) GB employed labour force rose:

- by 1,088,000 between June 1983 and September 1986 (services +1,420,000, manufacturing -227,000);
- by 216,000 over year to September 1986 - compared with 341,000 in year to September 1985, and 406,000 in year to September 1984;
- and by 80,000 between June and September 1986.

(ii) Governments compared

Changes in employment ('000s)

	Employees in employment (females, part-time)	Self employed	Total employed labour force*
March 1974-March 1979	+328 (+384)	-101	+192
March 1979-September 1986	-1,443 (+202)	+853	-582
June 1983-September 1986	+552 (+246)	+536	+1,088

* Includes employment in armed forces

(iii) Manufacturing employment:

Average monthly change ('000s)

March 1974 to March1979	March 1979 to June 1983	March 1979 to December 1986 (latest available)	June 1983 to December 1986 (latest available)
-10,000	-33,000	-22,000	-7,000

(iv) Growth in labour force: labour force rose by 192,000 between 1984 and 1985, following rise of 512,000 between 1983 and 1984.

(v) Unemployment

- Adult seasonally adjusted total little changed in January, a small rise of 300 following five consecutive monthly falls. Level 3,119,000, 11.3 per cent of working population.
- Over past six months seasonally adjusted total has fallen on average by 17,000 a month. Over last three months fallen by 16,000 a month.
- Effect of employment measures on count estimated to have risen by about 5,000 a month on average over last year.

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on Thursday 12 February

- Headline total rose by 68,000 in December to 3,297,000, 11.9 per cent of working population.

- Long term unemployment fell 7,000 between July and October (latest data available), to 1.34 million, period in which numbers would normally increase because of seasonal influences.

- Youth unemployment rate fallen from around 20 per cent in 1983 to 18 per cent in October 1986 (latest data available).

- Recent falls in unemployment spread across all regions except Scotland.

(vi) Stock of unfilled vacancies: little changed in January at 210,000 following fall in prevous month. Rose steadily between January and November 1986.

(vii) Unemployment changes:

Seasonally adjusted adult unemployment ('000s)

	Total	**monthly changes**
February 1974- May 1979	+639	+10
May 1979- January 1987	+1967	+22
June 1983- December 1987	+233	+5
January 1986 January 1987	-34	3

(viii) Unemployment duration: 25 per cent leave register within 1 month, 50 per cent within three months, over 60 per cent within six months, and 80 per cent within year.

(ix) Comparisons of employment growth in Europe:

(a) Since 1979 Q1
GB employment fallen over ½ million compared with rise of ½ million for EC 10 and fall of ¼ million for EC 12.

(b) Since 1983 Q2
GB employment up over 1 million, compared with ½ million for EC 10, and ¼ million for EC 12.

(x) Comparison of unemployment changes: Major 7

In 3 months to December, fall in unemployment rate -0.2 percentage points in UK, -0.6 percentage points in Canada, -0.1 percentage points in Japan, US and Germany, no change in France (figures for Italy not available).

(x) Youth unemployment: In 1985 youth unemployment rate 19 per cent for UK, 22 per cent for EC10, 24 per cent for EC12.

WPU

PERSONAL AND CONFIDENTIAL
until 11.30 am
on Thursday 12 February

Positive

(i) Adult unemployment (seasonally adjusted) fell by 104,000 in six months to January - largest 6 month fall for thirteen years.

(ii) Unemployment trend downward. Average fall 17,000 in last six months. Seasonally adjusted total lower than year ago. [CONFIDENTIAL TO CABINET: Even without Restart and other measures previous upward trend would, at least, have been halted and possibly marginally reversed.]

(iii) Long term unemployment fallen in last three months.

(iv) Youth unemployment rate below EC average and falling. (Fallen 60,000 in last year, 100,000 in last three years.)

(v) Vacancies in last three months at highest level for seven years, 30 per cent up on year earlier.

(vi) Employment increase in Q3 fourteenth consecutive quarterly increase - longest period of continuous employment growth for almost 30 years.

(vii) Over one million more jobs created since June 1983; more than whole of rest of Community in same period.

(viii) Self employment risen in every year since 1979. Total increase of 850,000 up almost a half.

(ix) Surest route to more jobs is slower wage growth. 1 per cent lower real wages could lead to 110,000 to 220,000 new jobs over time.

Defensive

(i) January figures mark end of downward unemployment trend Too much should not be read into one month's figures. Unemployment fallen 100,000 in last six months.

(ii) Increase in employment slowing. Increase in 1986Q3 of 80,000 largest quarterly rise for 18 months.

(iii) US employment record: Flexible labour markets, not loose fiscal policy, reason for better US record on jobs. Between 1974 and 1985 US employment rose 23 per cent while in UK fell 3 per cent. Over same period US real wages fell 4 per cent; rose 13 per cent in UK.

(iv) Employment growth mainly in service sector. General shift of industrial pattern away from traditional 'smoke stack' manufacturing industries. Employment growth simply reflects this.

Contact point: G Hacche (EB) 270 5207

10 FEBRUARY 1987

WPU

CE32 CONFIDENTIAL

E **TAX OPTIONS**

FACTUAL

1. Basic personal allowances increased by 22 per cent in real terms since 1979.

2. Basic rate cut 4 percentage points to 29 per cent.

3. Lower rate band of 25 per cent on first £750 taxable income abolished.

4. Since 1979 "not contracted out" NIC rate up from 6.5 per cent to 9 per cent for those earning £100-295 per week.

5. Reduced NIC rates for low paid introduced in 1984 Budget. For 1987-88 employee rates will be:

Below £39	-	0%
£39-£64.99	-	5%
£65-£99.99	-	7%
£100-£295	-	9%

6. One point off basic rate would cost £1,100 million in 1986-87, and £1,400 million in a full year.

7. Each percentage point increase in allowances above indexation would cost £175 million in 1987-88, and £230 million in 1988-89.

8. Income tax and NICs as a percentage of earnings of married men at average earnings still higher (28.4 per cent) than in 19878-79 (27.8 per cent).

9. For those on average earnings, cut of 2p in basic rate does more to reduce percentage of earnings taken in tax and NICs than equal cost increase in allowances.

10. Of those taken out of tax by threshold increase only about 20 per cent are married men of working age; the remainder are pensioners, juveniles and other single people, and working wives.

CONFIDENTIAL

Traps

11. Increasing allowances better for traps pre-and post-Fowler. But differential between allowances and basic rate cuts less post-Fowler. Effect on traps pre- and post-Fowler on entitlement basis:

	Number with marginal tax rate over 70%	Number with replacement ratio over 80%
Present social security		
2p cut basic rate	0	-50,000
Equivalent increase allowances	-20,000	-90,000
After social security reform		
2p cut basic rate	-20,000	-60,000
Equivalent increase allowances	-30,000	-90,000

Reduced rate band

12. Reduced rate band indexed from 1978-79 would cover first £1,600 of taxable income.

13. Reduced rate band of £1,300 at 20 per cent would cost the same as 2p off basic rate.

14. Reduced rate band can only reduce marginal rates for significant numbers of taxpayers if it is reasonably wide eg £3-5,000. This would be expensive.

CONFIDENTIAL

International comparisons of starting tax rate and level of threshold

15. Starting tax rate and combined tax/social security rate on employment income and thresholds in £ (converted using purchasing power parities). Rates/thresholds for 1986 except France (1985) and UK (1986-87). Rates give total of national and local income taxes at typical rates.

(i) **Single person:**

	Tax rate %	Tax and Social Security rate %	Tax Threshold %	Threshold as % of APW earnings %
Denmark	43	49	1,575	18
France	26	37	4,160	59
West Germany	22	36	1,720	21
Italy	12	19	2,780	35
Japan	15	24	2,505	31
Netherlands	15	33	2,200	27
US	11	18	1,875	17
UK 1986-87	29	34	2,335	26

(ii) **Married without children**

	Tax rate %	Tax and Social Security rate %	Tax Threshold %	Threshold as % of APW earnings %
Denmark	43	49	3,000	30
France	7	19	4,620	66
West Germany	22	36	2,020	38
Italy	22	29	3,745	49
Japan	15	24	3,425	43
Netherlands	15	33	4,040	49
US	11	18	3,070	29
UK 1986-87	29	36	3,655	40

APW = Average Production Worker

POSITIVE

1. Cut in basic rate reduces marginal rate for all 20 million working taxpayers. Improves incentives for more people than allowance increase.

2. By international standards, starting rate of tax in UK is high. But on thresholds, our position compares favourably with a number of countries, including West Germany and US.

3. Have already done a great deal for low paid - threshold increases of 22 per cent in real terms and reduced NICs on low earnings.

4. Basic rate cut of more value than equal cost allowance increase to single person or working wife earning above about £125 - eg the nurse. Worth more to any married man on about £195 or above (average earnings £227 (1987) a week).

5. Political impact of basic rate cut. 29p half way to 25p objective. Need to keep up momentum.

6. Basic rate cut would reduce marginal tax rates for majority of unincorporated businesses. Would also target tax reductions on those unincorporated businesses which lost most from the withdrawal of stock relief and reform of capital allowances.

DEFENSIVE

1. Allowances increase does more for those on lower incomes than basic rate cut. Need to balance this against importance of improving incentives widely by cutting marginal rates. Those in middle of income distribution benefit more from basic rate cut than equal cost increase in allowances.

2. Politically unhelpful to favour higher paid. Top 5 per cent now paying bigger share of income tax than 1979 (27 per cent of total 1986-87, 24 per cent 1978-79). International trend to cut top rate taxes eg US, France, Australia, New Zealand, Canada, Sweden, Japan, Italy. Need to avoid brain drain.

3. Lower borrowing and interest rates better than tax cutting strategy. Cutting taxes does not necessarily lead to lower revenue. Since 1979 have cut effective rates of capital gains tax, capital transfer tax and stamp duty - in all cases have seen revenue rise by over 20 per cent in real terms.

BRIEF F

TRANSFERABLE ALLOWANCES

Factual

(i) **Green Paper**

"The Reform of Personal Taxation" (Cmnd 9756), published Budget Day 1986, outlined possible system of independent taxation with transferable allowances. Followed by period of public consultation which ended 30 September 1986.

Majority of all those expressing preference supported introduction of transferable allowances.

No announcement yet made about outcome of consultations or future action.

(ii) **Proposal**

Incomes of husband and wife would be taxed separately.

Married man's allowance would be phased out; each partner would have same allowance equal to that of single person.

Married person could transfer any unused part of allowance to his/her partner.

(iii) **Proposals would**

give married women greater privacy and independence in tax matters;

remove discrimination against marriage;

make increases in tax thresholds more cost effective in helping low earners;

help unemployment and poverty traps

(iv) **Timing**

Transferable allowances could not come into effect before early 1990s (when Inland Revenue computerisation projects completed.)

(v) **Opposition proposals on taxation of husband and wife**

(a) **Labour Party**

Proposals set out in "Social Security and Taxation", published 18 September.

Amount to mandatory separate taxation with higher benefits:

- independent taxation of men and women;
- abolition of married man's allowance;
- higher child benefit for first child so no couple with child would lose;
- improved disability allowances and benefits for carers;
- new cash benefit to compensate older childless couples.

(NB No indication of effect on pensioners).

(b) **SDP/Liberals**

Detailed SDP proposals set out in "Merging Tax and Benefits", published August 1986

- independent taxation of husband and wife;
- abolition of married man's allowance;
- complicated arrangements to protect pensioners;
- no specific compensation for others but suggest many couples, especially low earners, would be compensated through other proposals eg basic benefit, higher child benefit.

"The Time Has Come", published jointly by SDP and Liberals, 26 January, proposes.

- abolition of married man's allowance with protection for pensioners;
- basic benefit;
- higher child benefit.

(NB Provides no figures.)

Positive

(i) Outcome of consultations - majority of those expressing preference supported introduction of transferable allowances.

(ii) All major parties agree taxation of husband and wife needs to be reformed. Only Government has come forward with fully thought out option for reform.

Defensive

(i) Why not have single allowance for husband and wife, with cash benefits to compensate for loss of married man's allowance (variant might be child tax allowances)?

Such an approach would

- reduce tax threshold for married men
- be inflexible in recognising variety of personal circumstances which lead women to stay at home (not just child-rearing)
- tax many more heavily only to give money back in increased benefits
- ignore marriage (though not children)

(ii) Where do we go next on Green Paper? Aim to enter pre-electoral period with commitment to provide independence and privacy in tax matters for married women after the election. Little pressure so far to make position explicit.

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BRIEF G: INTERNATIONAL COMPARISONS

1. GDP/GNP growth

- Growth in UK expected to be above major seven average and EEC average in 1985, 1986 and 1987.

	percentage change from year earlier		
	1985	1986 (estimate)	1987 (forecast)
United Kingdom	3.4	3.0	3.1
United States	2.7	2.5	2.7
Japan	4.7	2.4	3.1
Germany	2.5	2.5	2.9
France	1.4	2.4	2.5
Italy	2.3	2.7	3.2
Canada	4.0	3.5	2.9
Major seven	3.0	2.6	2.8
EEC	2.5	2.5	2.8

Note: WEP forecasts for 1987 except EEC (source OECD)

European league table

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2. Inflation

- UK inflation now highest in G5 and higher than EEC average, but lower than Italian or Canadian inflation.

- UK inflation expected to be highest in G7 in 1987.

			percentage change from year earlier	
	1985	1986	December 1986	1987 (forecast)
United Kingdom	6.1	3.4	3.7	4.7
United States	3.5	2.0	1.1	3.5
Japan	2.1	0.4	-0.3	-0.6
Germany	2.2	-0.3	-1.1	0.1
France	5.8	2.5	2.1	2.7
Italy	9.2	6.4	4.8	4.3
Canada	4.0	4.1	4.2	2.8
Major seven	3.8	2.0	1.3	2.5
EEC	6.4	3.4	2.9	2.8

Note: WEP forecasts for 1987 except EEC (OECD forecast)

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3. Current account

- UK deficit forecast for 1987 small compared to imbalances of other countries (especially US, Japan, Germany) even when expressed as percentage of GDP.

$ billion (% of GDP)

	1985	1986 (estimate)	1987 (forecast)
United Kingdom	5(1)	0 (-)	-5(-1) ½%
United States	-118(-3)	-141(-3½)	-157(-3½)
Japan	49(3½)	87(4½)	89(4)
Germany	14(2)	37(4)	36(3)
France	1(-)	4(½)	3(½)
Italy	-4(-1)	8(1½)	10(1½)
Canada	0(-)	-7(-2)	-5(-1½)
Major seven	-53(-½)	-10(-)	-29(-½)

Note: WEP forecasts

4. Unit labour costs in manufacturing

- Growth of unit labour costs in UK still faster than in most other G7 countries, but gap has narrowed recently.

percentage change from year earlier

	1984	1985	latest
United Kingdom	3.8	6.0	3.5 (Sept)
United States	-1.8	1.8	-0.1 (Sept)
Japan	-5.3	1.9	1.1 (Sept)
Germany	-0.9	0.0	3.7 (Sept)
France	3.5	2.1	-0.4 (Q2)
Italy	2.8	4.5	-0.8 (Q2)
Canada	1.9	2.2	4.2 (May)

Notes: Figures for France and Italy from IMF, others from OECD. Not adjusted for output relative to trend.

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5. Productivity growth

- Since 1979 productivity growth in manufacturing faster in UK than in any other G7 countries.

- Since 1979 whole economy productivity growth in UK second only to Japan among G7.

percentage change at an annual rate

	Manufacturing productivity 1979-86	Whole economy productivity 1979-86
United Kingdom	3.3	1.8
United States	2.4	0.8
Japan	2.6	2.9
Germany	2.2	1.6
France	2.1	1.6
Italy	2.8	1.8
Canada	3.0	1.4
Major seven	2.5	1.4

Note: Includes estimates for 1986.

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6. Interest rates

- Short rates in UK second highest (after Italy) among G7 countries.

- Long rates in UK highest in G7 countries.

per cent

	One year ago (3.2.86)		Now (2.2.87)	
	3-month money-market rate	10-year bond yield	3-month money-market rate	10-year bond yield
UK	13.1	11.3	11.0	10.2
US	7.7	9.0	6.0	7.2
Japan	6.1	5.8	4.0	4.9
Germany	4.6	6.6	4.1	6.2
France	8.9	10.0	8.6	8.9
Italy	15.9	13.5	11.9	9.9
Canada	11.2	11.1	7.5	8.5

7. General government financial deficit

- UK deficit lower, as a percentage of GDP, than G7 average.

	1985	1986
United Kingdom	2.6	3.1
United States	3.4	3.4
Japan	1.4	1.5
Germany	1.1	1.0
France	2.6	2.9
Italy	14.0	12.5
Canada	6.6	5.4
Major seven	3.4	3.4

Covering SECRET

From: J ODLING-SMEE
10th February 1987

1. SIR PETER MIDDLETON PM 10/2.
2. CHANCELLOR OF THE EXCHEQUER

cc Sir Terence Burns
Mr Sedgwick

SPEAKING NOTE FOR CABINET

I attach a draft speaking note, which reflects discussion on an earlier draft with Sir Terence Burns.

2. There is probably more material here than you will wish to use. If you indicate which parts you are most interested in, I can streamline it tomorrow.

J O-S

J ODLING-SMEE

SPEAKING NOTES FOR CABINET ON 12 FEBRUARY

Review of 1986

Overview: Output and inflation turning out fairly close to Budget forecast, despite fears in spring and summer that activity was weak. Tax revenues rather higher [Fiscal prospects much better than expected. Balance of payments worse.] Relate this to AS and say "Tax revenues rather higher than expected. Balance of payments in line."

2. **Details:**

	FSBR forecast	AS	Latest forecast	
GDP growth 1986 (%)	3	2½	3	)
				) Annex 1
RPI Q4 1986 (%)	3½	3¼	3½	)
PSBR 1986-87 (£bn)	7	7	under 7	
Current account 1986 (£bn)	3½	0	about zero	

3. **Oil price:**

- major cause for concern a year ago, [because we could not be sure where it would go and what its effects would be]

- we were confident that it would in time help the world economy and hence the UK, but timing uncertain

- [outturn was slightly lower oil price than assumed ($14 for average 1986 instead of assumed $16½; it fell from $15 on Budget day to a low of $9 in July).]

- drop in oil revenues from £11½ bn to £4½ bn

4. **World economy:**

- world domestic demand grew as expected, though GNP grew more slowly (latest GNP forecast for major 7: 2½%; FSBR: 3½%)

- exports to non-OECD oil producers and other primary producers fell sharply in first part of 1986

- manufacturing output down particularly badly in G7, and with it productivity growth in several countries

- inflation came down faster than expected (absolute falls in consumer prices in Germany and Japan)

- oil-importing industrial countries took a greater than expected part of benefits of fall in oil price in lower inflation rather than higher output in first year

- this will change, helped by major fall in interest rates in spring 1986.

5. **Exchange rate and interest rates:**

- sterling market affected by uncertainties in oil market

- we managed to calm markets in January 1986, when oil price falling rapidly, by moving rapidly to raise interest rates (by 2 points)

- exchange rate actually fell less up to summer than we had expected, given oil price fall

- this, together with lower world interest rates, provided opportunity for reduction in UK interest rates (base rate down to 10% in May from 12½% at Budget time)

- fall in mortgage rates coupled with decline in petrol prices contributed to temporarily low RPI (2.4% in July)

- pressure emerged before summer holidays for further cuts in interest rates because of perceived slowdown in economy

- we resisted and subsequent events justified this, especially:

  a. fall in exchange rate from 76 in June to 68 in October

  b. later figures which showed that pick-up in demand (first consumption, then exports) had started in second quarter

- against background of firming of world interest rates, continued uncertainty in foreign exchange market and rising M0 growth, judged it right to raise interest rates (base rate + 1%, to 11%) in October

- since October markets have been relatively calm, despite uncertainty in oil market, sharp movements in other currencies ($ and EMS pressures) and election fears. No doubt helped by confidence in our macro-economic policies.

6. **Output and productivity:**

- sluggish growth in first half of 1986

- suggestions before summer holidays (eg from CBI) that action should be taken (eg reduction in interest rates) to encourage demand

- we argued that we were seeing the expected "pause" following oil price fall, as oil producers cut imports sharply

- subsequently borne out by events: pronounced recovery in second half of year

- now appears likely that 3% growth achieved in 1986

- productivity performance has also improved, especially in manufacturing (up $4\frac{3}{4}$% over year to November 1986; $3\frac{1}{2}$% since 1979: best G7 performance - table in Cabinet paper)

7. **Balance of payments current account:**

- main difference between Budget forecast and latest figures is net trade in manufactures (FSBR: deficit of £3 billion; latest figures: deficit of £6 billion)

- manufactures hardest hit by slowdown in demand for UK exports earlier in the year

- net oil surplus also lower than expected (by £1 billion) because of lower price than assumed

- exports of manufactures grew more rapidly in second half of year (in Q4 volume of exports of goods excluding oil and erratics up 9½% on a year earlier)

- imports also growing rapidly (also 9½% to Q4 for imports excluding oil and erratics). But latest figures show improving position on manufacturing trade (exports rose 5% in 1986 Q4 on previous quarter, and imports 3½%).

8. **Revenues and PSBR:**

- despite lower oil price (hence North Sea revenues lower by £1½ billion than expected), total revenues now likely to be higher than forecast in Budget

- main increases in: CT (~~mainly~~ partly reflecting higher profits), VAT (<u>not</u> mainly higher consumers' expenditure, but speed up in payments and changes in composition), and Stamp Duty (higher turnover of houses, stocks and shares)

- PSBR likely to turn out lower than £7 billion in FSBR.

9. **Conclusion on 1986:**

- weathered storm of lower oil price remarkably well

- output growth in line with trend since 1981, inflation reduced, and unemployment began to fall

- shows importance of sound policies, which provide room for manoeuvre in face of major uncertainties (eg oil price, financial markets) while demonstrating commitment to reduce inflation.

<u>Prospects for 1987</u>

10. **Overview:** Entering seventh successive year of output growth near 3%, fifth successive year of employment growth; unemployment continuing to fall; inflation likely to continue to rise until summer, then fall gradually [**NOT FOR USE:** peak of over 5% for RPI, and 4½% excluding m.i.p]; continued buoyancy of non-North Sea revenues; small balance of payments deficit (½% of GDP - about £2 billion).

11. **Risks:**

- oil price now about $18 (1986 average $14) following OPEC agreement in December. But may not stick. Prudent to plan on basis of something lower

- world economy: domestic demand in [Germany and] Japan not growing as rapidly as one would like to restore equilibrium in balance of payments (WEP current account forecasts: US $-3\frac{1}{2}\%$, Japan $+3\frac{3}{4}\%$, Germany +3%). Could lead to further exchange rate instability or more protection

- sterling: always exposed to repercussions from oil market and other currency movements. Also worries in markets about inflation prospects. Additional problem is election

- interest rates: could be pressure in both directions. Upward pressure if monetary growth accelerates or exchange rate weakens. Downward pressure if inflationary pressures ease and Budget increases confidence.

- inflation: although present rise temporary, and inflation likely to be falling in second half of 1987, need to ensure that inflation continues on downward path over medium term

- pay: although pay settlements down 1%, less than fall in inflation. Slow adjustment of pay makes it more difficult to keep both inflation and unemployment on declining path.

Policies and Budget

12. **General:** Despite risks, economy doing well. Overriding need is to maintain current prudent policies and avoid risks. Monetary and fiscal policies to keep downward pressure on money GDP growth and inflation over medium term. MTFS will reflect this.

13. **MTFS:**

- to be rolled forward one year

- [conventional assumption about planning total in year after PEWP period. No significance for PE Survey]

- declining monetary growth over medium term with supporting low PSBR.

14. **PSBR in 1987-88:** Although last year's MTFS indicated a PSBR in 1987-88 of £7 billion, would not be right to have higher level than in 1986-87 because:

- economy likely to grow at least as strongly in 1987-88 as in 1986-87

- interest rate/exchange rate combination unfavourable, and lower PSBR will help to raise confidence and improve it

- cannot take risks with inflation, hence need to be prudent and reassure markets

- possibility of lower oil price.

15. **Taxation:**

- even with lower PSBR, could still be some room for tax cuts

- tax burden very high: without tax cuts in Budget, non-North Sea tax burden in 1987-88 (38.3%) only just below peak level in 1981-82 (38.8%) (Annex 3, Table 1)

- despite reductions since 1982-83, income tax and NICs still take higher proportion of gross incomes for those on average earnings and below than in 1978-79 (Annex 3, Table 2)

- tax on companies also higher relative to GDP than in 1978-79 (Annex 3, Table 3), but this mainly reflects increase in profits.

Conclusion

16. Economic prospects good, but need to keep an eye on potential risks, especially inflation. Improved confidence in markets will help this through better exchange rate/interest rate mix. Prudent fiscal and monetary policies essential to minimise inflation risk and improve confidence.

Covering SECRET

pmg

From: J ODLING-SMEE
11th February 1987

PRINCIPAL PRIVATE SECRETARY

SPEAKING NOTE FOR CABINET

I mentioned that some words in my draft of 10th February were not quite correct. I attach an amended version of the relevant page.

pp J ODLING-SMEE

- main increases in: CT (~~mainly~~ partly reflecting higher profits), VAT (<u>not</u> mainly higher consumers' expenditure, but speed up in payments and changes in composition), and Stamp Duty (higher turnover of houses, stocks and shares)

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g.63

SECRET AND PERSONAL

Pup

AGENDA MISS NOBLE 11/2

This is a useful basis for discussion. I hope that we will also cover the items in Annex A, because some of those are potentially significant too.
FERB 11.2.

FROM: MISS G M NOBLE
DATE: 11 February 1987

1. MR F E R BUTLER
2. PS/CHANCELLOR

cc Chief Secretary
Sir P Middleton
Miss Peirson
Mr Gibson

Please keep these for time being

SOCIAL SECURITY MEDIUM TERM OPTIONS

I attached an annotated agenda for tomorrow's meeting, based on Miss Rutter's notes of 22 and 28 January, of the discussions we had with the Chief Secretary on my paper of 16 December. In the discussions, the Chief Secretary felt that the various issues raised by my paper divided into:

- Those with immediate implications for the Manifesto
- Major options which involve difficult political considerations.
- More modest proposals which should be worked up for the next survey.

2. The agenda covers the first two. For reference, annex A gives a list of the items in the third group on which work is already in hand, or will be started shortly.

G M Noble

MISS G M NOBLE

WS US for SM

SOCIAL SECURITY: MEDIUM TERM OPTION: AGENDA

1. **The pledge**: this severely restricts the scope for savings on the retirement pension and linked long term benefits which account for almost 60 per cent of benefit expenditure. In practice it restricts action on the uprating more generally for reasons explained in the paper. It is difficult to see how the pledge to protect the basic retirement pension could be abandoned. But can any new commitments be more restricted and leave more options open. For example, can the reference to "linked long term benefits" be dropped? Is the pledge consistent with biennial upratings? Would a move to biennial upratings have to follow a similar move on pay to be politically acceptable, or could it precede it.

2. **Earnings rules**: can the Manifesto commitment to abolish the pensioners earnings rule be dropped? The absence of an earnings rule for widows can make the present provision ludicrously generous. Could one be introduced?

3. **Retirement Age**: how would the possibility of raising the retirement age for women interact with other policy proposals emerging for the Manifesto?

4. **Christmas bonus**: abolishing this would save over £100 million. The Government takes great credit for continuing to pay it and for making it a statutory entitlement. Can the manifesto avoid any reference to it? If abolition is not considered possible, can the scope be restricted to exclude recipients of attendance allowance, invalid care allowance etc.

5. **Benefits for the unemployed**: Mr Fowler is already committed to an extension of the voluntary unemployment deduction to 26 weeks from April 1988 and tightening the contribution conditions for unemployment benefit (the latter requiring legislation immediately after the election.) More radical options would include withdrawing supplementary benefit from able bodied 16 and 17 year olds and capping the amounts of benefit paid. How much can or should be foreshadowed in the Manifesto?

6. **Child benefit**: The 1985 Star Chamber agreed that there should be no uprating of child benefit in April 1988 and the PESC provision has been set accordingly (though the fact is disguised in the PEWP). Family credit, (more generous than FIS) will be introduced at the same time allowing this to be presented as better targeting. It is obviously important that the Manifesto is consistent with that and says nothing that would constrain the continued erosion of child benefit by upratings below inflation. Is the option of an actual cash reduction worth contemplating for the long term? (All other radical options were considered and rejected following the Fowler review of benefits for children and young persons.)

7. **Offsetting occupational pensions against state benefit**: there are three major options, (ii) offsetting against retirement pension, (ii) offsetting against invalidity benefit, and (iii) extending the present offset against unemployment benefit (currently restricted to over 60s). The main arguments put against these options are that they conflict with the contributory principle and weaken incentives to make private provision for retirement and ill health. Those arguments are stronger on the (i) than on (ii), and fairly weak on (iii). Any move on these would be highly controversial; should the second and third nevertheless be pursued?

8. **New benefit rates**: these offer the last chance for a major shift in the level of means tested support. Is it worth reopening the issue of making major savings in the transition to the new structure? (Note, this is only a realistic option if the election is before late October 1987 when the rates will need to be announced.)

9. **Housing benefit**: The major constraint here is the potential conflict with the emerging policy on rents. Decisions will need to be taken very soon about the structure and level of housing benefit subsidy for 1988-89 in the light of that. But a subsidy system designed to allow rents to rise will be a weak one, and more open to abuse, and we need to be clear about priorities and sure the pay off on housing policy is worth the price.

Annex A: Other issues on which work was commissioned

- Possible ways of tightening up the award of national insurance credits or home responsibilities protection, to limit access to contributory benefits.

- The effectiveness of availability for work testing, particularly in dealing with married women claiming unemployment benefit after periods of maternity pay. How far are claimants simply being moved off the count and on to other DHSS benefits?

- What more could be done on industrial injuries benefit?

- Possible options for the review of benefits for the disabled.

- A look at the penalties for fraud, the number of claimants involved, etc and any further tightening up of benefits for the unemployed.

- Work on the effect on social security spending of increases in tax thresholds or reductions in tax rates after April 1988 when entitlement will be based on net income. This issue has already come up in the exercise DHSS are just starting to recost the review implementation prior to this years survey discussions, so we should be able to work with DHSS on it, as well as doing our own internal analysis.

FROM: M C SCHOLAR
DATE: 12 February 1986

CHANCELLOR

cc: Sir P Middleton
Sir T Burns

BRIEFING FOR CABINET: 13 FEBRUARY

Following your discussion this afternoon with Sir T Burns, he and I have redrafted the speaking note which I submitted to you yesterday evening.

2. This is attached.

MCS

M C SCHOLAR

SPEAKING NOTE FOR CABINET ON 13 FEBRUARY

1. As the paper I have circulated makes clear, we have seen a dramatic fall in oil prices: and that inevitably has a profound impact on the public finances. At end-November, when oil was trading at $29 a barrel, a fall to $20 would have seemed fanciful. Yesterday the price for oil delivered in April was [$16], and there are not many around who would put money on an oil price as high as $20 through 1986-87.

2. Recently there has been considerable comment about the effect on the UK economy "when the oil runs out". The prospect was of declining oil revenues stretched
25 yrs out over several generations, well into the next century. We now face the likelihood of oil revenues halving between this financial year and the next.

3. Almost certain that we shall face uncertainty all the way up to the Budget and beyond about new level at which oil prices may settle. OPEC arranged their next ~~conference~~ meeting to coincide with the Budget. It appears to be a Saudi objective to maximise uncertainty at the moment. But one thing perfectly clear: prospective oil revenues - which fall £½ billion, all else equal, for every $1 fall in oil price - well below £11½ billion assumed in Red Book last year.

4. For the last MTFS we looked forward to a fiscal adjustment of £3½ billion for next year. If oil prices settle at $15 our revenues will have been reduced by £5 billion or so compared to the MTFS assumption of £11½ billion. It is only because non-North Sea revenues have been buoyant that I am able to offer the prospect of no increase in taxes this Budget.

$16

5. It is, of course, a considerable disappointment to lose the scope for tax cuts. This time last year we thought that, within a framework of prudent and sound financial policies, there might be scope for significant tax reductions in 1986-87. That prospect has now - temporarily, I hope - receded.

6. Against the background of so much uncertainty we must proceed very cautiously. We cannot be sure that there will be no further slide in the oil price. We must put ourselves in a position so as to be invulnerable - or an invulnerable as it is possible to be - to such a turn of events. This means that it would be prudent to leave a margin of safety.

7. Another factor I must take into account is the projected high level of proceeds from privatisation. Some critics - for example the Treasury Committee - have argued that the privatisation proceeds should not count

as negative public expenditure; instead they would prefer to describe them as a financing item. They argue that the £7½ billion PSBR set out in last year's MTFS for 1986-87 is in reality equivalent to borrowing more than £12 billion.

8. I do not accept that approach. But nevertheless it is true that privatisation puts an additional demand on financial markets even though it is in the form of equities rather than gilts. The institutions buying the companies we are privatising are the same as those to whom we sell gilts in order to finance the PSBR. In the circumstances it is only prudent to rein back to some extent the demands we make upon the financial markets from the sale of gilt edged securities.

9. These factors together mean that we should choose a PSBR no higher than the £7½ billion in last year's Red Book: and my preference would be for one somewhat below that figure. That, in turn, means that there will be little, if any, scope for a net reduction in taxation, after providing for indexation - and that judgement, in turn, depends on our being successful in holding to the public expenditure totals this year and next.

10. These last few weeks have seen a fair amount of volatility in financial markets. We have weathered

this pretty well - thanks to the perception that the underlying economy is strong, and that our policies are right.

11. For the moment markets seem to be suspending judgement. Whether we can succeed in holding interest rates at present levels will in part depend on the Budget.

12. In my view there are two reasons for our high level of interest rates. Credit demand in the UK continues to be very strong; and there has been a widespread view that sterling was likely to fall because of the rapid growth in UK labour costs and the projected decline in oil output. We now have an opportunity to create the conditions which will give us a better chance of getting interest rates down. Oil prices have fallen sharply. If we can demonstrate that we are able to maintain a prudent fiscal stance under these circumstances, market fears of the consequences of declining oil output should abate.

13. Of course it is not only ~~open~~ up to us. Industry has its part to play in restraining the growth of unit labour costs. It is important for them to realise that they have the power to make a substantial contribution towards lower interest rates.

The Economy

14. Although the assessment of the impact of lower oil prices is, naturally at this time of year, dominated by public finance considerations, the effect on the economy will be profound and pervasive.

15. In the face of the first two oil shocks the industrialised countries adjusted slowly to their loss of income: profits were squeezed and there was damage to investment and growth - and, above all, to employment. It will not be clear for some time to what extent third oil shock will be the obverse of the first two. But we may confidently expect, for industrialised countries as a whole, a considerable terms of trade gain, higher national disposable incomes and - provided it is not all taken out in wages - improved profitability and investment.

16. For our economy, the effect immediately more neutral with a loss of net oil exports and deterioration in the terms of trade. But overall growth should be broadly unaffected; we are looking for non-oil GDP to grow by 2½ per cent in both 1986 and 1987. And there should be a further decline in inflation. Most importantly, with the prospect of more lively demand abroad, and with the inflationary consequences of exchange rate depreciation offset by falling oil prices and world

Table says 3½?

inflation, manufacturing industry stands to benefit considerably from these changes. We should, in short, see much more rapid progress than anyone expected with the adjustment which so much worried the House of Lords "after the oil runs out".

17. And, as paper makes clear, we start from a much improved base. For example:-

- it is quite remarkable both how consistently productivity has grown, and how consistantly we have underestimated this. Instead of being at the bottom of the league table we are now second only to Japan, with productivity growth four times as fast as in the '70s;

- exports, too, rose more strongly than we expected in 1984 and 1985: for manufactures some way ahead of the growth in world trade;

- with a further rise in profits in 1985 capital spending by businesses continues to grow faster than output.

18. Our problem continues to be that this very buoyant economy is still not delivering falling unemployment. But there has been a marked improvement in the trend - taking account of the disappointing December

and January figures - since spring last year. With the 1985 Budget expansion of the Community programme still less than half completed, with little, if any, of the effects of the NIC restructuring yet felt, with labour force growth slowing down, prospects for further improvement look good. If industry will control its pay costs and get itself into a position to take full advantage of the more lively demand in prospect abroad, we should see a marked increase in its activity and a further marked improvement in the prospects for employment.

[illegible] on stream (6th April 86)

19. The task for us, however, is to maintain a framework of policy which makes it easier not harder for industry to get this right. Most immediately we have to consider a Budget which will cope with the damage to our public finances which has been the first effect of the oil price fall.

CONFIDENTIAL

FROM: P N SEDGWICK
DATE: 12 FEBRUARY 1987

MR ALLAN

Many thanks: I await summaries with interest.

cc Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Cassell
Mr Hawtin
Mr Odling-Smee
Mr Peretz
Mr Scholar
Mr Turnbull
Mr Mowl
Mr Riley

THE PROSPECT FOR PUBLIC SECTOR FINANCES

Your minute to Colin Mowl of yesterday recorded the Chancellor's request for an urgent revision of the outlook for public sector finances in 1987-88 and thereafter.

2. We are already in the process of revising the January forecast. In response to your note we have significantly accelerated the timetable. It might help if I set out the main elements of this timetable.

(a) **1986-87:** The monthly note on the PSBR will, on the new timetable we will be using from this month onwards, reach the Chancellor by close tomorrow, a day earlier than has so far been the rule. This will include a revised figure for the PSBR in 1986-87, and separate projections for February and March.

(b) **The prospect for 1987-88:** The latest monthly figures for borrowing suggest that we need to concentrate on the LABR and the PCBR. It is not obvious, for instance, that lower than expected borrowing by LA's in 1986-87, with a possible large increase in their balances, necessarily means that borrowing in 1987-88 and later years will be lower. To the extent that balances are greater than needed the opposite could be the case. That said, we clearly need to have a critical and detailed look at the forecast for LA's and PC's behaviour. We should be able to complete this towards the end of next week, somewhat earlier than originally planned. By that time we

because ↓ balances = ↑ LABR

will have the latest updated estimates of government revenues in future years from Inland Revenue and Customs. We should therefore be able to send the Chancellor a report on the prospect for public finances on Friday, February 20.

(c) **The later years in the MTFS**: The note that the Chancellor will receive next week should indicate, possibly in qualitative terms, how far any revisions to prospects in 1987-88 might carry forward to the later years. MP will let you have a submission on the figures for public finances in the later years of the MTFS. This will deal with the handling not only of any change in our view on the prospect for public finances since the January forecast, but also with the difficult issues of presentation that we discussed at the Chancellor's meeting on Monday of this week.

P.N.S

P N SEDGWICK

ps8/32A

PERSONAL AND CONFIDENTIAL

cc Mr Gropper

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

12 February 1987

Lord President of the Council
Privy Council Office
68 Whitehall
LONDON SW1

Dear Willie

You no doubt saw the glee with which the media seized on the Tory Reform Group Budget recommendations on Monday. I enclose one or two typical cuttings.

I wonder whether you think that, so long as its patrons continue to include a number of Cabinet Ministers, there is a case for asking the TRG to omit the list of patrons from its notepaper, where at present it displays them prominently as a deliberate means of attracting attention. The TRG can put forward whatever policies they like - I would not dream of suggesting strong-arm tactics. But it is another matter for them to put out policies that are clearly at variance with the Government line, in such a way that the press is invited to imply that they have the support of half the Cabinet.

Perhaps we might have a word about this, which causes me some concern.

Yours

Nigel

NIGEL LAWSON

STANDARD

Tory wets: Don't cut taxes

by Charles Reiss

1

CHANCELLOR Nigel Lawson is under attack from fellow Tories over the tax cuts he is expected to make in his Budget next month.

The Tory Reform Group, which includes several Cabinet Ministers, says he should make no cuts in income tax at all, rather than the reduction of up to 3p which has been forcast.

And they warn that a pre-Election spending spree which the public would expect to be followed by post-election stringency, would solve noth-

LORD WHITELAW . . . *influential*

ing—and could well lose votes.

"There are some gift horses that voters have—rightly—learned to look in the mouth."

The TRG is the most influential of the groupings on the "wet" wing of the party.

Its list of Cabinet patrons includes the Tory deputy leader Lord Whitelaw, Mr Douglas Hurd, the Home Secretary, Mr Kenneth Baker, the Education Secretary, Energy Secretary Peter Walker and Employment Minister Kenneth Clarke.

Most Tory MPs and Ministers are confident that Mr Lawson's giveway cash—up to £4 billion—will allow him to cut income tax and still have some to spare to do the other things the group wants, such as more spending on housing, the inner cities and jobs.

But the TRG's warning will not ple^se the Chancellor nor Mrs Thatcher, anxious for the Party to present a united front in the run-up to the Election.

The group's detailed proposals, titled "A Tory Budget for One Nation," says that income tax cuts would only be frittered away in spending on foreign goods to create "new jobs for our competitors."

That is much the same line taken by Labour's Shadow Chancellor Mr Roy Hattersley.

Daily Mail

'Don't cut taxes' plea by Tory wets

9

By Political Correspondent

INCOME TAX should not be cut in the pre-election budget, the Tory Reform Group warns the Chancellor, Mr Nigel Lawson, today.

The group, which heads the wet wing of the party, has Energy Secretary Peter Walker as its president, and includes Cabinet Ministers Lord Whitelaw, Kenneth Baker, Douglas Hurd and Kenneth Clarke among its patrons.

In a letter to Mr Lawson, it suggests that spare revenue available to the Chancellor thanks to Britain's spending boom should be concentrated on new homes, urban renewal and infrastructure 'in order to further reduce unemployment.'

The Chancellor is thought to be planning to reduce income tax by at least 2p in the pound on the standard rate in his budget on March 17.

He has Mrs Thatcher's support for the move, which is seen as the best way of boosting the economy and providin~ extra incentive to workers.

It also claimed that tax cuts will help swing voters behind the Tories and give Mrs Thatcher a third term.

But the TRG's strategy is more in line with Labour's economic proposals.

4374/12

CONFIDENTIAL

10
PT-B

FINANCIAL SECRETARY TO THE TREASURY

FROM: J J HEYWOOD
DATE: 20 February 1987

PS/CHANCELLOR

OK. But I wd like to have the IR Statement of Practice re Loan Stocks @ ex. Is this known as? –

cc PS/Chief Secretary
PS/Economic Secretary
PS/Minister of State
Mr Cassell
Mr Monck
Mrs Lomax
Mr Scholar
Mr Cropper
Mr Ross Goobey
Mr Graham OPC
Mr Cayley IR
Mr Prescott IR
PS/IR

SECTION 79: PROSPECTIVE REVIEW AND BVCA ISSUE

Mr Cayley's minute of 4 February reported that Section 79 should not present any problems for the BVCA if they go down the limited partnership route as currently envisaged. In the light of this, the Chancellor asked (your minute of 5 February) whether the Financial Secretary was satisfeid that this represented a solution to the Section 79 problem.

2. We have, of course, always recognised that the "Section 79 problem" consists ~~in~~ of two different strands:

(i) The immediate threat posed by Section 79 to the BVCA's limited partnership route;

(ii) The more general feeling (shared by many representative bodies and individual entrepreneurs) that Section 79 is too complicated and yet too blunt an anti-avoidance provision.

3. The Financial Secretary decided that if the BVCA could be persuaded that Section 79 did not stand in the way of the limited partnership route then he would be content to defer a review of the whole section (to look at the problem at (ii) above)

until after the Budget. Mr Prescott's note of 5 February sought the Financial Secretary's agreement on how a proposed review of Section 79 might be taken forward. The Financial Secretary has endorsed the suggested approach.

4. This leaves the original question - are the BVCA persuaded that Section 79 is not a threat to the limited partnership route? The Revenue have been working hard to provide the BVCA with the categorical assurances they appear to be seeking. Moreover, as Mr Cayley reported, the Revenue having consulted their lawyers now believe that there should be no significant tax obstacles confronting the BVCA.

5. However, the Financial Secretary asked me to establish whether the BVCA had the same perception as the Revenue. I have now managed to get a verbal answer from Tony Lorenz, who said that the BVCA are not entirely convinced that Section 79 will not bite, although things looked "very promising". I understand that a letter will shortly be issuing from the BVCA confirming that they will require further clarifications on Section 79.

6. The Financial Secretary is quite clear that, in principle, there is no reason why the limited partnership route should be hindered by Section 79. Thus, he sees no case for departing from the proposed timetable for the general review which Mr Prescott's note envisaged. The Financial Secretary will, of course, endeavour to convince the BVCA that under existing law, Section 79 is not likely to be a problem for the type of onshore vehicle they have in mind.

J.H.

JEREMY HEYWOOD
Private Secretary

4374/60

10.B

FINANCIAL SECRETARY TO THE TREASURY

FROM: J J HEYWOOD
DATE: 25 February 1987

PS/CHANCELLOR

Thanks. This seems sensible

cc PS/Chief Secretary
PS/Economic Secretary
PS/Minister of State
Mr Cassell
Mr Monck
Mrs Lomax
Mr Scholar
Mr Cropper
Mr Ross Goobey
Mr Cayley IR
PS/IR

BVCA - LIMITED PARTNERSHIPS

The Financial Secretary has Mr Cayley's note of 24 February and Mr Tony Lorenz's letter of 20 February.

2. The Revenue have been working with the BVCA on a model for a limited partnership arrangement tailor-made to their needs. This is rather different from a formal Statement of Practice, and many of the details of the model will have nothing to do with tax.

3. The Financial Secretary agrees with Mr Cayley that it would not really be appropriate for a model of this kind to be published as a formal Revenue Statement of Practice. However, the Financial Secretary would be quite happy for the BVCA to circulate to their members a set of guidelines, cleared by the Revenue. The Financial Secretary also thinks it might be possible to issue a Revenue Press Notice when these guidelines are finalised, which would draw attention to their existence. The Financial Secretary thinks that this might usefully coincide with the Budget Debate.

4. Since many of the details of these guidelines will not involve taxation matters, the Financial Secretary thinks that the BVCA will need to take the lead in preparing them, although the Revenue will continue to give assistance where appropriate. This does mean, however, that we are in the BVCA's hands on timing.

5. The Financial Secretary has asked me to emphasise to the BVCA that he would like this all sorted out as soon as possible.

J.H.

JEREMY HEYWOOD
Private Secretary

RC6.96

CONFIDENTIAL

cc CST
MST
Sir P Middleton
Mr F E R Butler
Mr Anson
Mr Luce
Mr Chivers
Mr Kemp
Mr Gilhooly
Mr S Willis
Mr Cropper

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

PRIME MINISTER

CIVIL SERVICE PAY 1987

... I attach a note by the Treasury, prepared after discussion with interested Departments, on the current state of play on Civil Service pay negotiations. It seeks to pull together all of the various initiatives which are currently alive, and makes proposals for the next steps.

I am content with these proposals, and if you and our other colleagues agree I will ask my officials to proceed accordingly, consulting Departments as appropriate and reporting to us as and when necessary.

As you will see from the note, the situation is a lively one. On the one hand ideas of a potentially radical and far-reaching nature are being developed - for instance in the context of geography, merit and indeed the whole pay structure. There are opportunities here for putting into practice the ideas which I advanced at NEDC last November and about which Kenneth Clarke spoke yesterday. On the other hand we need continually to keep an eye on the costs involved, given our policy of containing Civil Service running costs; and the schemes themselves need to be examined most carefully because of their possible ramifications.

The sort of developments now under discussion can have two sorts of costs.

- First, while in the long-run they will make it easier to hold down the pay bill by relieving the critical pressure points, in the short-run there will be initial costs - for example, extra money for London Weighting or for assimilation to the new pay spine.

- Secondly, insofar as the proposals involve or lead to greater delegation to Departments, this can have a cost if Departmental managers are not required to operate the new freedom responsibly, or if the devolved budgets against which they work are insufficiently robust.

It is of very great importance that we understand the need to move only when the money can be accommodated within the pay settlement of the year, and we have got suitable practices and systems in place.

So far as 1987-88 goes the note records our decision of December that we should aim for a settlement whose overall cost is not much more than the rate of inflation. I propose that we maintain that position.

I am copying this to the other members of MISC 66, and to the Secretaries of State for the Home Department, the Environment and Education and Science, and also to Sir Robert Armstrong.

NL.

N.L.

12 February 1987

CIVIL SERVICE PAY 1987

Note by the Treasury

At the meeting on 4 December 1986 MISC 66 agreed that the aim for 1987 should be a settlement whose overall cost is not much more than the rate of inflation. Additionally emphasis was put on the need to make a start on geographical pay, with particular reference to London and the South East of England. More generally, and dating further back, MISC 66 has emphasised the need to develop the Civil Service pay system more flexibly so as better to respond to market and other needs and to get better value for money. This note, prepared after discussion in MISC 67, makes proposals for the way forward now.

Prospects for 1987 seen currently

2. The current prospects for a peaceful and worthwhile settlement at a relatively low cost are difficult to assess. Informal contacts with some unions suggest that whatever their public aspirations, which (as the unions themselves recognise) are generally wholly unrealistic, and notwithstanding the rather higher rates of settlement seen elsewhere and the fairly moderate settlements in the Civil Service in previous years, something around the RPI, plus something in return for managerial and other flexibilities, is about the best they expect without a bruising argument. But the public rhetoric is fierce, and the recent overturning by the militants in the IRSF Conference of their Executive, leading to a possible IRSF, CPSA, Society and CSU consortium, is ominous. So is the mood of staff in a number of areas.

3. Within that outline the position of the separate unions is as shown in **Annex A** attached. It looks as though it might be possible to get the IPCS home very quickly now at RPI plus a move to a new pay system

(see below), plus something additional for some, especially Scientists, as discussed in **Annex B**. We are hopeful that the smaller CSU would come home again for something around RPI plus relatively inexpensive concessions in such matters as footwear and uniform for messengers (points to which the CSU attach a great deal of importance). The key to an overall peaceful settlement is however as ever the volatile CPSA, where we are still hopeful for something modest in percentage terms (albeit expressed as a flat rate of pounds per week), helped by the benefits of the big CO/DP restructuring of last year which is still working its way through. Other unions are of lesser importance, although one or two could still give trouble (eg the IRSF in respect of tax assessment and collection). Much depends on whether "the consortium" can be made to stand up and make itself effective.

Developments in the pay structure

4. Currently the Civil Service pay structure is highly stylized, with standard scales and pay rates for standard grades within which large groups of people are brigaded with little or no discrimination according to particular skill, merit or geography. We are agreed about the importance of breaking into this: the Paymaster General stressed it in relation to the economy at large in his speech last week. So far as the Civil Service is concerned various starts have been made over the past two or three years - eg the performance bonus scheme of 1984 and the introduction of special pay additions in 1985. But these are expedients, and are not permanent solutions to a long-term need for a more flexibly tuned structure. We have accordingly developed the possibility of a new structure, built around the common pay spine with spans and scales capable of being more closely attuned to personal needs, on the lines set out at **Annex C** attached. Initially it is expected that this would apply to IPCS grades only, as part of the immediate deal we hope it may be possible to enter into with them and referred to in paragraph 3 above. But conceptually, and subject to cost, managerial and industrial relations constraints and the development of the system as necessary, it could apply more widely within the Civil Service.

5. There are some particular areas in which the Civil Service pay system must develop which would be assisted by the gradual introduction of a system of this nature. Thus :-

a. **Skills and marketability.** At present the Civil Service pay system brigades together in very broad bands the skills whose market value and scarcity vary very greatly. The proposed system would enable these to be more finely differentiated so as to offer better starting pay and better ultimate prospects to the skills in short supply and less good pay and prospects to those which are plentiful. At the moment we meet these needs very imperfectly through the "special pay addition" system.

b. **Merit.** At present apart from the experimental performance bonus scheme and the discretionary pay for Grades 2 and 3 now out to consultation there is no way in which a better person is distinguished from a less good person in the Civil Service pay system. The new system would make it possible to distinguish the merit of people who are still on their scales - that is, who have not reached their "normally attainable maximum" - by withholding increments or "hopping" increments where appropriate; and would also make it possible to give the exceptionally good performer discretionary range points above their normally attainable maximum. Such a system would in concept look very like what is now proposed for Grades 2 and 3, on which we are effectively building. The note at **Annex D** discusses thinking on the present performance bonus scheme, which although useful in paving the way to a discretionary approach does not seem to be the best long-term approach; nevertheless we should retain it for 1987-88 and thus complete the planned experiment.

c. **Devolution to Departments.** The proposed system would make devolution to Departments easier, subject to the development of appropriate controls and constraints and appropriate robust local budgeting so as to avoid "drift" and degradation of the system. Departments or units of Departments would be allowed, subject to appropriate controls, to move their people to different parts of the pay spine - upwards or downwards - as the local market or local managerial needs might demand. This in turn - as a longer shot - could facilitate increased "departmentalisation", below a certain level; so that the functions in individual Departments can be better tailored vertically to the operational and managerial needs of that Department without the current constraints, as they often are, of the horizontal Civil Service pay and grading etc structure.

d. **A long-term system.** The new system involves accepting the essentials of the long-term pay arrangements (LTPA) based broadly on Megaw, which MISC 66 in November 1985 agreed should be offered to the Civil Service unions. So far only one union - the IPCS - want to take it up, and it is an integral part of joining the new system that they should do so. There is however a danger in giving LTPA to one but not all of the unions, of giving those who have not signed up on the accompanying disciplines an uncovenanted benefit, but we believe that can be surmounted. The important points are (i) that the constraints bite on the overall pay bill and does not preclude pay flexibility as between groups or individuals within the total, and (ii) that the Government retains an override in case of need. This is something that will need to be watched at each stage.

8. We would not want to press this system on unwilling unions. But if we enter into such an agreement with the IPCS it would be impossible to keep it dark. It is proposed, therefore, if and when we enter into such an agreement, to make the possible new arrangements public and, as it were, on offer to the other unions, though without commitment and without prejudice.

Geography

7. The note at **Annex E** discusses our present thinking. In short, the idea is that there should be more for London and the South East, and selectively more in other localities, paid for by a lower overall settlement - all aimed at gradually, and over time, distinguishing between different areas in the country. As MISC 66 recognised this is going to be a slow process. The new pay system would help here, in that for

similar skills it would be possible to use different parts of the spine for different parts of the country. But for "pure" geography it would probably still be necessary to retain the London Weighting system, and special pay additions (probably renamed "local pay additions") for the finer tuning. We are also looking at improved removal and transfer conditions more directly related to house price differentials. In the longer run all this should save money. But in the short run there could be additional cost - for 1987-88 up to say ½ per cent on the whole pay bill.

Cost

8. Our present instructions are to look for a settlement in 1987-88 with an overall cost not much more than RPI. This should be capable of accommodation in Departmental running cost limits set. It is too early to say whether we can achieve this, account being taken of the likely levels at which we might settle with individual unions and of what we might want to do on geography. There is also the effect of the very recent British Telecom settlement. For the time being however we are not looking for any new instructions.

Timing

9. There is a lot to be said for pressing home fast this year. To start with, this is desirable in itself - staff should not have to wait for their increases. Second, the RPI is moving against us over the negotiating period, albeit gently and temporarily. Third, developments elsewhere in the pay scene, especially the likely Review Body recommendations, may also be unhelpful. Finally, in various ways the unions are off balance at the moment and should not be given time to recover. All this points to seizing what initiatives we can, and pressing fast. At the same time, in looking for a strategy which seeks to settle early and cheaply with one or two unions (eg the IPCS and the CSU) it will be important not to give more to late settlers; this is one of the chief fears which potential early settlers have.

The way forward

10. In the light of this we propose that :-

a. We should seek a quick deal with the IPCS at RPI plus staged additions, particularly for Scientists and Professional and Technology people, in return for agreement to the new pay arrangements (paragraph 3 and Annex B).

b. Separate efforts should be made to bring in separate unions at RPI plus a touch (paragraph 3) with a view to early settlement (paragraph 6), though noting that it will be important not to settle any higher with later people (paragraph 9).

c. The possible new arrangements should be made public without commitment and without pressure (paragraph 8 and Annex C).

d. The performance bonus scheme should continue until the end of the present experiment and thereafter replaced with something akin to the scheme at Grades 2 and 3 now under discussion and/or something based on the new system discussed at Annex C (Annex D).

e. Geographical pay should be developed on the lines set out in paragraph 5 and Annex E.

11. MISC 66 are invited to agree to this way forward. Further reports will be made as necessary.

H M Treasury
February 1987

Annex A

THE POSITION OF THE UNIONS

This note summarises the likely claims as now seen.

CPSA (total number involved: 210,000)

£20 pw, with any further increases necessary to bring in a minimum wage at £115 pw, plus, the abolition of scales and a reduction in the working week of 2 hours (1 hour in London) and an increase in leave for all to 6 weeks a year. In total the claim is worth well over 20 per cent even without the hours and leave.

SCPS (111,000)

£15 pw or 15 per cent but keen to co-ordinate approach with other unions and in particular with the CPSA. Claim as it stands worth about 16 per cent.

IPCS (70,000)

Near settlement - see Annex B.

IRSF (40,000)

Instructed by conference to frame a joint claim with CPSA and SCPS, with big percentage figure (eg up to 24 per cent) mentioned.

CSU (27,000)

No current indication of a formal claim, but likely to be torn between an early settlement at a figure slightly above RPI and joining any developing consortium.

FDA/AIT (10,000)

For an unspecified but substantial increase with particular measures aimed at lawyers, accountants and fully trained tax inspectors.

POA/SPOA (22,000)

Fully occupied with the 'Fresh Start' negotiations, but likely to pick up "Wynn Parry" formula consequentials in due course.

Annex B

CIVIL SERVICE PAY 1987 - POSSIBLE DEAL WITH THE IPCS

The possible deal with the IPCS would apply only to grades where they have sole national negotiating rights, and thus would exclude (amongst others) Grade 7 and above, save as regards paragraph 3 below. The deal is not yet firm at the time of writing and even if it can be brought home the details may change, but as it stands now the essentials are :

a. Core increase from 1 April 1987 at RPI as of February 1987 - probably around 4 per cent.

b. Signing up on the new pay apparatus (see **Annex C**) with assimilation to the new scale points as from 1 September 1987.

c. Moving the settlement date to 1 August or later from next year, with an RPI increase in April 1988.

d. Acceptance of the long-term pay determination arrangements proposed in November 1985.

2. In addition

a. For Professional and Technology (P&T) grades, bringing forward to September 1987 and August 1988, increases contracted for in November 1985 but then agreed to be staged over the period up to 1 January 1989.

b. For Science grades two increases over and above the cost of assimilation, as from September 1987 and August 1988.

c. For most other IPCS national grades, as for Science grades but with the August 1988 increase only.

3. As a separate deal bringing forward of the assimilation to unified Grade 7 to October 1987 for PPTOs and in two steps to April 1988 for PSOs.

4. The total cost of all these improvements, leaving aside the basic RPI linked increase would be around £12/£13 million in 1987-88 taken net of some substantial savings on overtime etc costs and of the abating of special pay additions now in payment. Of this figure, roughly half represents a bringing forward of increases already contracted for.

5. From 1988 onwards the IPCS settlement date will be postponed to 1 August or later. In the transition to the new settlement date the IPCS grades below Grade 7 would again receive an RPI increase on 1 April 1988, measured as of February 1988. The August 1988 pay award will be determined in the light of OME evidence on the inter-quartile range of pay settlements over the 12 months to May 1988, (the "movements survey") taking account both of the RPI increase already received and of any net benefit which IPCS grades have received as a result of selective movements on to higher pay scales within the spans whether following OME evidence on the state of the market elsewhere (the "levels survey") or otherwise. 1988-89 costs, leaving aside the basic RPI linked increase, are around £17 million over 1987-88, again taken net. This figure largely represents a bringing forward of increases already contracted for.

6. Relatively few Departments are involved with any substantial numbers of IPCS grades. There is undoubtedly a degree of "dead weight" in these proposals, as there must be in any pay settlement affecting large numbers of people across the board. But this is justified against the points:

(a) that among the P&T and Scientists there are substantial areas where there are certainly recruitment and retention problems (and the date of September 1987 has been chosen to catch the 1987 graduate recruitment season) and that if these increases had not been given there would undoubtedly have been special pay additions given or other pay adjustments made instead;

(b) that there is benefit in getting the IPCS voluntarily to sign up to the new pay arrangements which will give potentiality for greater discrimination and flexibility for the future; including the potential breaking of the present pay link between Civil Service Scientists and Scientists in fringe bodies like the Research Councils; and

(c) otherwise the IPCS would not have agreed to a "core" increase as low as RPI.

7. It is important to balance this deal against the alternative. If there were no agreement the IPCS would submit claims for immediately implementing the P&T awards staged to 1 January 1988 and 1 January 1989 and for substantial increases for scientists. It would not be easy to find grounds for refusing arbitration, and at arbitration both claims would have a considerable chance of success: pay increases for some scientists and P&Ts are certainly justified on recruitment and retention grounds. While it is impossible to be certain, our judgment is that it is unlikely that the IPCS would receive less than we are offering now.

8. It would be a part of the deal with the IPCS that the costs, in cash and percentage terms, over and above the RPI element would be kept confidential. Such costs are in any case not easily calculated by outside people, although rough estimates will undoubtedly be made by the other unions in due course. The aim would be to make the "core" increases at RPI the headline figures.

A NEW PAY STRUCTURE

This note outlines the new system of pay which we hope to pilot with IPCS grades below Grade 7 in the coming year. We can assess its wider applicability in the light of that experience.

Aim

2. The aim of the scheme is to increase the flexibility of civil service pay to respond to differences of skills, merit or geography. It is generally recognised that the present ad hoc measures of flexibility - special pay additions and performance bonuses - are inadequate as the basis of a permanent pay system.

Why the IPCS?

3. The advantages of starting with the IPCS grades below Grade 7 are:

i. The IPCS are willing to try it;

ii. The numbers involved are manageable: although the IPCS has 70,000 members in total, most of the effort will be concentrated initially on about 40,000 staff;

iii. The majority of them work in only four Departments - MOD, PSA, DTI and MAFF. Those Departments are willing to try the scheme, because

iv. it offers a means of solving their pressing management problems in relation to the recruitment and retention of scientific and technical staff.

How will it work?

4. The foundation of the new system is a single row of pay points - the common pay spine. The spine we plan to use is shown in the table attached.

5. A "pay span" would be a section of the spine defined to encompass all the pay points available to be used at a particular grading level. There would be one span for each grading level (one for SEO equivalents, one for HEO equivalents etc).

6. Within each span there would be a variety of pay scales with different scale maxima. At present all scientists at a particular grade are on one scale and all engineers on another. Under the new system it will be possible to discriminate among each sort of specialists and put members of each group on higher or lower pay scales (within the boundaries set by the common span) to reflect the rates of pay which their skills properly command.

7. Staff will normally progress up the pay scale by annual increments to the scale maximum as they do at present, but there will be much more emphasis on the withholding or withdrawing of increments in cases of unsatisfactory performance and the award of double increments for outstanding performance ("hopping and stopping"). The scale maxima and minima for different groups will be adjusted by the Treasury from year to year to match the market for the skills in question.

Range Pay

8. Above the maximum of each of the pay scales there will be at least three range points which may be used, as with the scheme which is being introduced for grades 2 and 3, to reward exceptional performance. In principle, all the pay points between the scale maximum and the top of the pay span will be available for this purpose. But to maintain standards and ensure financial control there will be strict, centrally determined criteria governing the use of these range points. Range points, like normal increments, may be withdrawn under certain conditions.

Setting up the new system

9. The first step is the mechanical one of assimilating the pay of the staff concerned onto the new common pay spine. The staff will simply be assigned to the nearest pay point above their current salary as from 1 September 1987. (Special arrangements will be needed in certain cases to respect legal entitlements).

Selective migration

10. It will then be possible for Departments, by agreement with the Treasury, to transfer particular groups of staff from lower to higher scales within the same span to meet their recruitment, retention or other management needs. For large groups spread across a number of Departments this might follow a centrally conducted survey of the market. For smaller groups Departments could propose a change which would be judged against tight criteria in respect of the reason for the change, the overall cost, the increases for individual members of staff, and the possible knock-on effects elsewhere.

11. Downward migration will also be possible: it will be possible to reduce the scale maxima for particular groups, though not (for legal reasons) for people already within the group.

Devolution and financial control

12. The cost of upward migration will need to be controlled by the Treasury and budgeted for as part of the planned paybill for the year in question. If (and only if) sufficiently robust local bugeting could be developed it might be possible in due course to delegate responsibility for the control of some of these movements to Departments, and then downwards within Departments.

Career management and grading arrangements

13. Scientists will continue to be managed as scientists, and engineers as engineers, despite the fact that differentiation

is being introduced in their rates of pay. Existing grading standards will be maintained in relation to the staff in each pay span.

Pay determination in future years

14. It is proposed that a long term pay agreement on Megaw lines should be concluded with the IPCS. This would comprise centrally conducted movements and levels surveys, constraints upwards and downwards on total paybill increases during the year, arbitration by agreement, and Government override. In whatever way the planned increase in the paybill is determined decisions will need to be taken about how much, if any, of it should be use to revalorise the spine; how much to adjust the positions of certain scales within the spans; and how much should be budgeted for net upward migration from lower to higher scales. This is in line with what Ministers decided in MISC 66 in November 1985 and does not impair pay flexibility: the constraint is upon the overall paybill increase and explicitly allows individuals to get more or less within the total.

Spine		Incremental Increase	Incremental Increase
Point	Salary	£	%
1	3,146		
2	3,366	220	7.0
3	3,602	236	7.0
4	3,854	252	7.0
5	4,124	270	7.0
6	4,413	289	7.0
7	4,722	309	7.0
8	5,053	331	7.0
9	5,407	354	7.0
10	5,785	378	7.0
11	6,190	405	7.0
12	6,623	433	7.0
13	7,073	450	6.8
14	7,523	450	6.4
15	7,973	450	6.0
16	8,423	450	5.6
17	8,873	450	5.3
18	9,323	450	5.1
19	9,773	450	4.8
20	10,223	450	4.6
21	10,673	450	4.4
22	11,123	450	4.2
23	11,573	450	4.0
24	12,036	463	4.0
25	12,517	481	4.0
26	13,018	501	4.0
27	13,538	520	4.0
28	14,080	542	4.0
29	14,643	563	4.0
30	15,229	586	4.0
31	15,838	609	4.0
32	16,472	634	4.0
33	17,131	659	4.0
34	17,819	688	4.0
35	18,529	710	4.0
36	19,270	741	4.0
37	20,041	771	4.0

Annex D

PERFORMANCE BONUS EXPERIMENT

The performance bonus scheme is a three-year experiment which is due to end in March 1988. Decisions will be needed in due course about what arrangements for performance pay should be put in its place for Grades 4 to 7.

2. Although it has been very useful in starting the cultural change to a greater link between pay and performance and helpful in concentrating the minds of line and central managers on important issues, it is clear that we shall not wish to continue performance bonuses after March 1988 in their present form. The report by Hay-MSL on the first year of the experiment, which has been circulated to departments, has demonstrated that the concept is flawed. Some of the failings revealed by their report can be attributed to failings of management rather than of the scheme itself; for instance the lack of communication to staff of the reasons for the award or non-award of bonuses. But some of the failings are inherent in the scheme; for instance the difficulty in defining criteria and the degree to which mechanical constraints have undermined the basic rationale, which is to encourage good performance. More generally, there must be some doubt whether bonuses are the most effective means of encouraging high performance at these levels.

3. There are three options:

i. to end the experiment after the second round, one year early in March 1987;

ii. to continue the experiment, with any appropriate changes to extract maximum value from it, for its full three years until March 1988;

iii. to end the experiment in March 1987 and replace it immediately with a discretionary ("range") pay scheme for Grades 4 to 7 on the same lines as the scheme now under discussion for Grades 2 and 3.

4. Ending the scheme one year early (option (i)) would have the merit of saving £4 million next year (making this sum available for other running cost purposes), which could be justified in view of the doubt about the degree to which the experiment is giving value for money. But there are strong arguments against this. First, we understand that each member of staff now covered by the experiment has a contractual right to be considered for a performance award, or something very much on those lines, for the full planned duration of the scheme. More generally, terminating the experiment, without putting anything in its place, would be misinterpreted as an indication that performance pay does not work in the Civil Service and as such would make it more difficult to develop a policy in this important area. It would look very odd to be promoting performance related pay for Grades 2 to 3 and at the same time withdrawing it down the line. Ideally we should be going for option (iii) - end the experimental bonus scheme, replacing it with a better scheme. This could be done so as not to cost much more than the present performance bonus scheme and in a way which would fulfil any legal obligations.

5. However, there are real difficulties which lead us to conclude that this would not be feasible. First, a discretionary ("range") pay scheme of the kind being introduced for Grades 2 and 3 will impose a considerable extra burden on departmental personnel units and line managers. To introduce it for Grades 2 and 3 in this financial year is feasible where only 600 staff are covered, but there are more than 20,000 staff in Grades 4-7 and it would be impossible to deal with such a large group in the time, particularly when there are so many other developments in the pay and personnel management areas. Secondly, there is a strong feeling that we should get the scheme for Grades 2 and 3 underway satisfactorily and learn any early lessons before we go down to the much larger numbers involved at Grades 4-7. Thirdly, there is the point of presentation in that it might be seen by some as a victory for the Trade Union Side in abandoning early the experiment which they have opposed with such vigour. Finally, there is the very awkward link between

the pay of MPs and Grade 6. Under the Resolution of the House the pay of MPs will in the future be linked to the maximum of the salary scale for Grade 6. Initial advice suggests that as the Resolution is presently drafted there would be a risk that if we were to introduce discretionary increments for Grade 6 the link would have to be to the highest of those: the pay of MPs would thus be several thousand pounds higher.

Conclusion

6. We conclude therefore that the performance bonus experiment should be continued in 1987-88, subject to any modification which may be agreed as useful in order to get the best out of it. But, at the time of the announcement of the final scheme for Grades 2 and 3 in March, there should be a statement of intent to introduce similar arrangements for discretionary pay for Grades 4-7 when the experimental performance bonus scheme comes to its end in March 1988.

CONFIDENTIAL

Annex E

NON-INDUSTRIAL CIVIL SERVICE PAY: A GEOGRAPHICAL APPROACH

1. Questions about the possibility of introducing more variation in pay have been considered by a Treasury-chaired Working Party. Despite some differences in emphasis, the Working Party has reached broad agreement on the nature of the problem and has identified a way forward in the short-term. However, much work remains to be done on the detailed mechanisms and controls.

2. The Working Party has confined itself to the managerial aspects of the issue taking as its touchstone recruitment and retention (and what can be afforded) and has confined its work to the Civil Service rather than the broader economic issues. The evidence shows that there is a geographical imbalance in the ease with which the civil service can recruit and retain staff of adequate calibre. Most vacancies can be filled, but in some places only with staff who are of a barely acceptable calibre, and after considerable time and effort. The same places tend to have relatively high resignation rates. There is no doubt that very high rates of turnover, and inexperienced and low-calibre staff, lead to costs and inefficiency. On the other hand, there are areas where there are few resignations and embarrassingly large numbers of well-qualified applicants for the vacancies which do arise.

3. The problem areas are mainly in London and parts of the South East, but there are localised pockets elsewhere. Some towns in the South East, such as Reading, face difficulties as severe as in the worst parts of London; but other parts of South East have fewer problems than in pockets elsewhere in the country. Even within an area, there are variations between departments and, indeed, between particular offices. However, the problem in London and parts of the South East is a consistent theme. In part, this may be related to high house prices and also to relatively low unemployment and high earnings in comparable employment.

4. The reasons for the problems are a complex mix. Pay rates are not the whole story. Thus:

(i) There is a need to improve the financial package when civil servants move. (Work on this linking transfer terms more directly to house price is well in train.)

(ii) There may be scope for improving recruitment procedures.

(iii) Particularly high resignation rates in individual offices can sometimes be met by taking specific remedial action unrelated to pay.

But the working group is agreed that the recruitment and retention issues establish the case for paying relatively more to civil servants in the problem areas (which are often highly localised) within the overall financial contraints of running costs and what is available to be spent on pay.

5. In the short term, the Working Party consider that the evidence points to two moves on the pay front. First, more needs to be spent in London and parts of the South East. Apart from the existing London pay zones, the area needing extra seems to be an amoeba around London, including places like Reading and Guildford, but not the whole region. Second, the localised problems elsewhere need to be tackled. The machine proposed is two legged. First, in London and the South East, London Weighting would be retained on the present basis in the three existing zones. Staff in the grades causing most difficulty, generally non-mobile grades, would selectively qualify for the payment of a London Pay Supplement. That Supplement would also be available, again selectively, to staff in the same grades in the fourth amoeba area which would be created around the present Outer London Zone. Second, in other parts of the country, use would be made of the SPA concept with staff in the difficult grades being eligible for a Local Pay Addition (LPA).

6. In the South East, the new area would be defined centrally, covering the worst problem towns; departments would be able to pay up to a certain

sum to those of their employees in difficult grades in this area, and the three other London zones. Similarly, departments would be able to pay LPAs in other areas of difficulties subject to centrally established criteria. In both cases, of course, the cost would have to come from existing running cost limits. What these costs would be would depend on the detail of the scheme and the use departments made of it. If for example, £400 per annum was paid to all clerical and secretarial staff in these areas the cost would be over £20 million per year - more than 1½% of the pay bill. We would however expect there to be a much more selective approach with departments using their discretion to pay less than the maximum amount and to confine the payment to those locations in London and South East which were causing the greatest difficulties.

7. These changes could be made in the 1987 pay round though not necessarily from 1 April. The maximum amount available for the South East, and for LPAs, will however depend on the level of the general settlement; although even a relatively small sum per head in the South East could help with the most acute problem areas.

8. Moves on these two fronts have a great advantage from the industrial relations point of view. The Unions are aware that we are looking at the concept of geographical variations in pay rates and while formally opposed to the principle are resigned to its coming and of course they, and their members, accept London Weighting, and are coming to terms with the idea of SPAs. Approaching geographical pay by building on existing features of the machinery should help in gaining acceptance.

9. These proposals involve paying more in some areas than in others within the overall increase in the pay bill. In theory, it might be possible to pay less in other areas but any attempt to reduce salaries in real terms would be illegal and certainly cause industrial action. The way forward is therefore to aim for as low an overall settlement as possible in the years ahead which would leave room for selective increases in the problem areas; over time this would progressively correct the balance.

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Papers for RP

CHIEF SECRETARY TO THE TREASURY

FROM: **M C FELSTEAD**
DATE: **5 March 1987**

PS/CHANCELLOR

cc:
PS/Financial Secretary
Miss Sinclair
Mr Walters

NATIONAL FEDERATION OF SELF EMPLOYED AND SMALL BUSINESSES

The Chief Secretary has seen the exchange of correspondence between the Chancellor and the Federation. He has offered to see this organisation next year if necessary.

M C Felstead

M C FELSTEAD
Assistant Private Secretary