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PART A

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PART A

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PART A

1986 BUDGET FINANCIAL STATEMENT AND BUDGET REPORT AND MEDIUM TERM FINANCIAL STRATEGY

DD's 25 years 26-01-95 NAziz.

STARTS:-22-11-85
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PART B

1986 Elan
Budget

Financial
Statement
+ Budget Report
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Papers.
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FROM: MISS C E C SINCLAIR
DATE: 22 NOVEMBER 1985

CHANCELLOR OF THE EXCHEQUER

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FSBR: PRESENTATION OF TAX CHANGES

In the run up to the last FSBR you asked whether the presentation of the direct effects of changes in taxation and national insurance in Part 1 could be brought into line with the Budget scorecard by showing first and second year figures instead of first and full year figures. We thought it helpful to let you have a note in good time for you to consider possible changes for the 1986-87 FSBR.

2. This note has been prepared in conjunction with Inland Revenue, Customs and Excise, CU and ET. I fear the subject does not lend itself to pithy summary.

Challenge.

<u>The Budget Scorecard</u>

3. The purpose of the scorecard is to provide Ministers with a running check of the PSBR and direct revenue effects for the next two years of Budget proposals. In arriving at estimates of the PSBR and direct revenue effects, the base forecasts already allow for the cost (or yield) of indexation (or revalorisation), so the scorecard shows the impact of Budget proposals net of these costs or yields - ie against an <u>indexed</u> base.

The FSBR

4. The FSBR is a principle means of presenting information to MPs, the media and the public about the overall effect of the Budget and of the individual proposals. Table 1.1 provides a summary of the Budget giving the direct revenue effects (not PSBR effects), on Government receipts in the first year and on taxpayers's liabilities in the first complete year to which the change applies. The latter are referred to as "full year" effects. These summary figures have traditionally been shown both against an indexed and against an unindexed base. In contrast, the presentation of the figures for individual proposals in table 4.2 has traditionally been against an unindexed base; but in recent years, effects against the indexed base have been included in footnotes.

Greater alignment between scorecard and FSBR

5. We consider first the effects of including second year figures on the scorecard basis in table 1.1, and then how table 4.2 might be adapted.

Table 1.1: Summary of Budget Effects

6. Annex A shows table 1.1 as it appeared in the 1985 -86 FSBR.

7. If we were to include second year costs in table 1.1, a number of points would arise which you will want to consider.

8. First, you may not think it appropriate to make an explicit assumption about decisions that will not be taken until the next year's Budget - ie that taxes will be indexed or revalorised. Although direct tax indexation is based on statute, revalorisation is not.

9. Second, figures for the second year on an unindexed base will attribute some very large costs (or yields) to this Budget. Annex B shows table 1.1 with first and second year costs on both an indexed and an unindexed base. The key differences between Annex B and the table which actually appeared in the FSBR are:

i. much smaller figures for the effects on second year receipts than for the effect on liabilities in the first full year for changes which take some time to take effect (capital taxes, VAT, YTS);

ii. much larger figures, against the unindexed base only, for the main indexation/revalorisation items (income tax allowances and excise duties). The reason for this is that the Budget proposals are themselves indexed/ revalorised in calculating second year costs/yields; while no such assumption needs to be made to produce full year costs. This point is explained in more detail in the appendix.

10. One way round the problem mentioned in paragraphs 8 and 9 would be to calculate the second year effects of a given Budget change without making any assumptions about Budget decisions or indexation in the second year. This would generally produce a second year figure closer to the present full year figure. But it would no longer be possible to produce a sensible figure of second year costs against an indexed base; and it would be a complete departure from the scorecard method. Moreover, it would not sit easily with the forecasting assumptions for the second year in other parts of the FSBR, in particular the MTFS chapter. We assume that, for these reasons, such an approach should be ruled out.

11. An alternative would be to show first and second year figures against an indexed base only, with the effects of indexation/revalorisation shown at the bottom of the table. This would not get round the problem discussed in paragraph 8, but it would help with the problem in paragraph 9. However, it could be disadvantageous where we wanted to highlight figures against an unindexed base, eg if it had not been possible to index tax allowances fully, or a change in the structure of taxes were proposed designed to avoid losers in cash terms. A switch in emphasis to an indexed presentation might also appear odd at a time when inflation is low and forecast to fall further.

12. Annex C shows how table 1.1 would look on this basis. The key points are:

i. as with Annex B, there are smaller figures for changes which take some time to come completely into effect;

ii. differences between the <u>unindexed</u> and <u>indexed</u> base figures appear at the bottom of the table as the effects of indexation.

13. A further aspect of introducing second year costs is that people may be able to deduce more than you would wish about some of the underlying economic assumptions. For example, an estimate of the second year effect of a change in the basic rate could reveal assumptions about the growth in earnings two years ahead. Also, focussing attention on the second year receipts from Budget changes might lead to pressure for more detailed forecasts to be published for <u>total</u> tax receipts in the second year. This could also lead to the need for greater openness about the detailed economic assumptions for year two.

<u>Table 4.2</u>

14. Before deciding on whether second year effects should replace full year effects in table 1.1, it is worth considering what changes would be needed in table 4.2. There are two questions:

- should full year figures be retained as well?

- what base (indexed, unindexed or both) should be used?

We consider each in turn. Annex D gives the existing table 4.2.

<u>Should full year figures be retained in table 4.2</u>?

15. There would be no point in continuing to show figures for annual liabilities (full year figures) in table 4.2 if they provided little or no additional information to the first and second year receipts figures.

16. For most Customs taxes (including VED) and some Revenue taxes, there are relatively short lags in payments (up to 3 months or

so). In these cases and where in addition the size of the tax base (income, expenditure etc) is much the same in year 1 and year 2, there should be little or no difference between the change in annual liabilities calculated on the tax base for year 1 and the change in receipts for year 2.

17. However, for some Inland Revenue taxes, the difference can be considerable, because of long lags between the time when liability arises and tax falls due for payment. In these cases, estimates of liabilities provide important additional information about the effects of a change. Moreover, estimates of liabilities provide the best single indication of the continuing burden/benefit of any tax change. For this reason, it seems desirable to continue to publish figures for annual liabilities in answer to PQs and (where appropriate) as a supplement to receipts figures in the FSBR. It would mean that, overall, rather more information would be given than at present on the effects of the Budget, a minor presentational point which could be used with the TCSC.

Should table 4.2 show first and second year figures against both an indexed and an unindexed base?

18. At present the figures in table 4.2 are shown against an unindexed base. If we show first and second year figures in table 1.1 either against both bases, (Annex B) or against an indexed base only (Annex C), we would need to give the same information in table 4.2. The question is how best to do this; as well as giving information on full year liabilities. Annex E shows a three column approach showing figures against an indexed base only. The effects of indexation are given in footnotes. This approach would be obviously consistent with the version of table 1.1 in Annex C.

19. It could also be regarded as consistent with the approach to table 1.1 in Annex B, since figures against an unindexed base could be obtained from the information in the footnotes. The alternative of a 6 column version of table 4.2 is pretty unappealing, quite apart from highlighting the problem described in paragraph 9.

20. In Annex E, we have reverted to an earlier practice in no longer showing totals for the full year figures, since individual

figures may relate to different time-periods and totals would not be required for carrying forward to table 1.1. We have also taken the opportunity to "clean up" the presentation of table 4.2. In particular, the word "negligible" has been replaced by an asterisk; and we have redefined it to mean less than £5 million instead of less than £1 million, since the latter figure has been used for some years and its value has diminished considerably.

21. In concluding discussion of table 4.2, it needs to be said that neither the second year figure nor the full year provides a complete picture of the effect of a tax change in which:

- the effect of the change builds up over time (eg the introduction of a new capital allowance, the abolition of premium relief for new life assurance policies); or

- the change alters the time profile of tax payments (eg alteration of the rate of capital allowance, phasing out of APRT).

In describing proposals of this kind, it will continue to be necessary to provide supplementary data in the FSBR as we do at present, either in footnotes or in the text.

Conclusions

22. There are two mains reasons for introducing second year costs into the FSBR:

a. it would mean that Treasury Ministers were not presented with alternative sets of figures in the scorecard and the FSBR (although there are advantages in continuing to show full year liabilities as well in table 4.2);

b. it would give taxpayers and commentators a clearer idea of the impact of the Budget on tax payments in year two.

23. Against these considerations you will need to weigh the points discussed in paragraphs 8 to 13 above:

- explicit assumptions about the following year's Budget;

- effect of moving the FSBR more towards an indexed presentation;

- possible need for greater openness about some economic assumptions.

(as I think we did all our points)

24. There is an alternative way of meeting the point at (a). We could include full year figures in the scorecard. Last year such figures were included only in the last two editions of the scorecard. Their inclusion at an earlier point in the exercise would avoid Ministers needing to become familiar with a new set of figures shortly before the Budget.

25. The decision on this issue is very much a matter of Ministers' choice. It would be helpful to know:

i. whether your main interest is in lining up the figures used in the scorecard and in FSBR; or whether you see wider benefits in introducing second year costs into the FSBR.

to include full year costs in the scorecard

ii. If the first, would you feel that the solution suggested in paragraph 24 would be satisfactory?

iii. If the second, do you favour the presentation in Annex B (indexed and unindexed base) or Annex C (indexed base only), with corresponding changes in table 4.2 (Annex E).

iv. Or having considered the options for change, do you prefer the status quo?

CAROLYN SINCLAIR

The Derivation of Second Year Indexed and Unindexed Figures

In the scorecard, second year figures are presented against an indexed base, using the assumption that the Budget proposals - for example for income tax and excise duties - are themselves indexed in the second year. This is illustrated, by an example, in the table below.

Single Persons' Income Tax Allowance

	Year 0 1984-85	Year 1 1985-86	Year 2 1986-87
Unindexed base	2,005	2,005	2,005
Indexed base(1)	2,005	2,105	2,215
Budget proposal for 1985-86 (indexed in 1986-87)		2,205	2,315

(1) assuming, for illustration, indexation by 5% in 1985-86 and 1986-87.

The scorecard cost against the indexed base in year 2 reflects the difference between £2,315 and £2,215. The difference between £2,215 and £2,005 is the cumulative cost of indexation in year 2. The unindexed cost for year 2 reflects the difference between £2,315 and £2,005.

Using these methods, the various costs for the 1985 Budget income tax changes may be summarised as follows:

£ million

	Effect on receipts First year (1985-86)	Effect on receipts Second year (1986-87)	Effect on liabilities Full year (at 1985-86 levels)
Cost against indexed base	-730	-940	-910
Cost of indexation	-860	-2,110	-1,115
Cost against unindexed base	-1,590	-3,050	-2,025

Thus in this instance, the cost against the unindexed base is relatively large in the second year, because the figure of £3 billion includes two years of indexation.

ANNEX A (from 1985-86 FSBR)

Table 1.1 Budget measures: direct effects on public sector transactions([1])

£ million at current prices

	Effect in 1985–86		Effect in a full year([2])	
	Changes from an indexed base	Changes from a non-indexed base	Changes from an indexed base	Changes from a non-indexed base
Tax proposals([3])				
Income tax allowances and thresholds	−730	−1 590	−910	−2 025
Capital taxes	−20	−30	−215	−260
VED	+130	+230	+130	+230
Other Excise duties([4])	+105	+590	+110	+605
VAT	+60	+60	+190	+190
Other tax changes	−40	−40	+235	+235
Total tax proposals	−495	−780	−460	−1 025
Proposed changes in National Insurance Contributions				
Employers' NICs	−30	−30	−80	−80
Employees' NICs	−100	−100	−270	−270
Self employed etc. NICs	−30	−30	−100	−100
Total NICs proposals	−160	−160	−450	−450
Expenditure Measures([5])				
Youth Training Scheme	Nil	Nil	−150	−150
Community Programme	−75	−75	−250	−250
Total Expenditure measures	−75	−75	−400	−400
Total Direct Effects([6])	**−730**	**−1 015**	**−1 310**	**−1 875**

([1]) +/− indicates an increase/decrease in revenue, or a decrease/increase in expenditure. All figures are rounded to the nearest £5 million.

([2]) See footnote (*a*) to Table 4.2.

([3]) The figures are estimates of the direct effects of the tax proposals on public sector transactions. They are not estimates of the total effects, both direct and indirect. See footnote (*a*) to Table 4.2.

([4]) Including bus fuel grants.

([5]) The figures show the direct expenditure consequences of these measures after allowing for consequential savings in unemployment and supplementary benefits as people who would otherwise be claiming benefit join the schemes. The figures shown in the full year columns are estimates of the cost in 1987-88.

([6]) Since these are estimates of direct effects the overall total differs from the effect of these measures on the PSBR—which is shown in paragraph 1.05.

ANNEX B

Table 1.1 Budget measures: direct effects on public sector transactions

£ million at current prices

	Effect in 1985-86		Effect in 1986-87	
	Changes from an indexed base	Changes from a non-indexed base	Changes from an indexed base	Changes from a non-indexed base
Tax proposals:				
Income tax allowances	-730	-1590	- 940	-3050
Capital taxes	- 20	- 30	- 95	- 120
VED	+130	+ 230	+ 130	+ 230
Other excise duties	+105	+ 590	+ 120	+1225
VAT	+ 60	+ 60	+ 100	+ 100
Other tax changes	- 40	- 40	+ 115	+ 115
Total tax proposals	-495	- 780	- 570	-1500
Proposed changes in NICs				
Employers' NICs	- 30	- 30	- 95	- 95
Employees' NICs	-100	- 100	- 290	- 290
Self employed etc NICs	- 30	- 30	- 105	- 105
Total NICs proposals	-160	- 160	- 490	- 490
Expenditure measures				
YTS	NIL	NIL	- 70	- 70
Community programme	- 75	- 75	- 235	- 235
Total expenditure measures	- 75	- 75	- 305	- 305
Total Direct Effects	-730	-1015	-1365	-2295

ANNEX **C**

Table 1.1 Budget measures: direct effects on public sector transactions

£ million at current prices

	Effects on receipts in:	
	1985-86	1986-87
Changes from an indexed base:		
Tax proposals:		
Income tax allowances	- 730	- 940
Capital taxes	- 20	- 95
VED	+ 130	+ 130
Other excise duties	+ 105	+ 120
VAT	+ 60	+ 100
Other tax changes	- 40	+ 115
Total tax proposals	- 495	- 570
Proposed changes in NICs:		
Employers' NICs	- 30	- 95
Employees' NICs	- 100	- 290
Self employed etc NIC	- 30	- 105
Total NIC proposals	- 160	- 490
Expenditure measures:		
YTS	Nil	- 70
Community programme	- 75	- 235
Total expenditure measures	- 75	- 305
Total direct effects on top of indexation	- 730	-1365
Effects of indexation:		
Income tax allowances etc	- 860	-2110
Capital taxes	- 10	- 25
VED	+ 100	+ 100
Other excise duties	+ 485	+1105
Total effects of indexation	- 285	- 930
Total direct effects, including indexation	-1015	-2295

ANNEX D (from 1985-86 FSBR)

Table 4.2 Direct effects of changes in taxation and national insurance (a)

£ million

	Forecast for 1985–86	Forecast for a full year (a)
INLAND REVENUE		
Income tax		
Increase in single allowance of £200 and married allowance of £300	−1 370 (b)	−1 700 (b)
Increase in additional personal allowance and widow's bereavement allowance of £100	−10 (b)	−10 (b)
Increase in age allowance of £200 (single) and £300 (married) and income limit of £700	−120 (b)	−160 (b)
Increase in basic rate limit of £800 to £16,200	−50 (b)	−80 (b)
Increase in further higher rate thresholds	−40 (b)	−75 (b)
Fringe benefits—car and car fuel scales	Nil	+45 (d)
Reduction in share retention period under approved profit sharing schemes	−4 (e)	−10 (e)
Relief for self employed national insurance contributions	−25	−55
Business Expansion Scheme—inclusion of research and development and exclusion of property development	Negligible	−1
Basis of assessment of partnerships	Negligible	Negligible (f)
Change in relief on covenanted gifts to charities	Negligible	−1
Offshore life assurance	Nil	Negligible
Extension of mortgage interest relief at source	Negligible	−2 (g)
Composite rate for bank interest—minor changes	Negligible	Negligible
Income tax and corporation tax		
Building Society special arrangements	Nil	−20 (h)
Short life assets	Nil	(i) (j)
Postponement of allowances on ships	Negligible	(k)
New rules for scientific research allowance	Negligible	Negligible
Charge to tax in respect of certain deep discount bonds	Negligible	Negligible
Limited partners' losses	Negligible	(l)
Limit on gifts for business entertaining	Negligible	Negligible
Set-off of first year allowances	Nil	Nil
*New rules for date capital expenditure incurred	−15	−25
*Reduction in allowances for agricultural buildings	(i) (m)	(i) (m)
*Reduction in rate of initial allowance for hotels	(i) (m)	(i) (m)
*Changes in allowances for patent rights and know-how	(i) (m)	(i) (m)
*Reduction in rate of initial allowance for dredging	(i) (m)	(i) (m)
*Abolition of use requirement for writing down allowances	Negligible	Negligible
*Capital allowances on fixtures	Negligible	Negligible
*Relief for investment managers acting for non-residents	Negligible	Negligible
*Friendly Societies life assurance business	Nil	Nil
Income tax, corporation tax and capital gains tax		
Commodity and financial futures, and traded options	Negligible	Negligible
*Accrued income charge on securities	Negligible	+300 (n)
Income tax, capital gains tax, capital transfer tax and stamp duties		
Minor exemptions for securities issued by European Communities	Nil	Nil (o)
Corporation tax		
London Regional Transport—accumulated tax losses	Nil	Nil
Corporation tax and capital gains tax		
Indexation relief based on March 1982 values	Nil	−105 (p)
Other changes to indexation relief	Nil	−50 (q)
Transactions between connected persons	Nil	Negligible
Oil taxation		
Removal of immediate PRT exploration and appraisal relief for onshore fields	+10	+6
Restriction of immediate PRT relief for extended production tests, and other minor changes	+10	+10
Capital gains tax		
Indexation of annual exempt amount	Nil (b)	−10 (b)
Reform of retirement relief	Nil	−4
Development land tax		
Abolition	−20	−50 (r)

Table 4.2 Direct effects of changes in taxation and national insurance *(continued)* (*a*)

£ million

	Forecast for 1985–86	Forecast for a full year (*a*)
INLAND REVENUE *(continued)*		
Capital transfer tax		
Indexation of chargeable rate bands	−12 (*b*)	−35 (*b*)
Extension of exemption for amenity land	Negligible	−5
Stamp duties		
Repeal of duty on gifts	−10	−10
Repeal of duty on contract notes	−4	−4
Other changes	Negligible	Negligible
TOTAL INLAND REVENUE	−1 660	−2 050 (*s*)
CUSTOMS AND EXCISE		
Value added tax		
Withdrawal of zero-rating of advertisements in newspapers, journals and periodicals	+30	+50
Increase in registration limits	Negligible	Negligible
*Implementation of Keith recommendations	+50	+150 (*t*)
Relief for certain goods temporarily imported for process or repair	−30	Nil
Extension of bad debt relief	Nil	−25
Exemption of transactions between credit and charge card companies and participating retailers	+15	+20
Relief for certain computer equipment bought with donated funds	−5	−5
Excise duties		
Increase in rate of spirits duty	+10 (c)	+10 (c)
Increase in rate of beer duty	+115 (c)	+120 (c)
Increase in rate of duty on cider and perry	+5 (c)	+5 (c)
Increases in rates of wine and made-wine duties	+45 (c)	+45 (c)
Increases in rates of duty on light oil, etc.	+200 (c)	+200 (c)
Increase in rate of duty on heavy oil for use in road vehicles	+50 (c)	+50 (c)
Increases in rates of tobacco products duties	+170 (c)	+180 (c)
TOTAL CUSTOMS AND EXCISE	+655	+800
Vehicle excise duty		
Changes in rates of duty	+230	+230
VED on 3 wheeled cars	Nil	Nil
VED: Temporary First Licensing	Negligible	Negligible
Other		
Bus fuel grants	−5	−5
TOTAL CHANGES IN TAXATION	−780	−1 025 (*s*)
National insurance contributions		
Reduction in rates for employers	−30	−80
Reduction in rates for employees	−100	−270
Reduction in rates for self-employed and voluntary rates	−30	−100
TOTAL CHANGES TO NATIONAL INSURANCE CONTRIBUTIONS	−160	−450

* Items so marked were announced before Budget Day.

(*a*) The direct effects of tax changes are generally estimated by applying the new and old tax rates and allowances to the taxable income and expenditure expected in the economic forecast in Part 3, taking account of changes in taxpayers' behaviour arising from the tax change where these behavioural changes can be readily estimated. For the meaning of a full year see the note on page 9 of the FSBR 1981–82. The full year figure for national insurance contributions is the difference between the revenue that would have been received in respect of 1985–86 on the basis of the contribution rates and earnings limits announced in November 1984, and the revenue that would have been received in respect of 1985–86 if the new arrangements had been fully in place at the start of that year.

Table 4.2 Direct effects of changes in taxation and national insurance *(continued)*

(*b*) *Taxes subject to statutory indexation.* The table below shows the direct revenue effects of indexing the income tax main allowances and thresholds (which are shown as the first five lines in Table 4.2 above), the capital gains tax exempt amount and the capital transfer tax threshold and bands by reference to the increase in the general index of retail prices between December 1983 and December 1984 (4·6 per cent), rounded in accordance with the statutory provisions, together with the costs of the proposed changes on top of indexation:

Direct Revenue Effects — £ million

	Indexation		Proposed changes on top of indexation		Total	
	1985–86	Full Year	1985–86	Full Year	1985–86	Full Year
Income tax						
Main allowances	−770	−960	−730	−910	−1 500	−1 870
Basic rate limit	−50	−80	Nil	Nil	−50	−80
Further higher rate thresholds	−40	−75	Nil	Nil	−40	−75
Total income tax	**−860**	**−1 115**	**−730**	**−910**	**−1 590**	**−2 025**
Capital gains tax						
Exempt amount	Nil	−10	Nil	Nil	Nil	−10
Capital transfer tax						
Thresholds and bands	−12	−35	Nil	Nil	−12	−35

(*c*) The table below shows the direct revenue effects of indexing the excise duties by reference to the increase in the general index of retail prices between December 1983 and December 1984 (4·6 per cent):

Direct Revenue Effects — £ million

	Indexation		Proposed changes compared with indexation		Total	
	1985–86	Full year	1985–86	Full Year	1985–86	Full Year
Commodity						
Beer, cider and perry	+70	+75	+50	+50	+120	+125
Wine	+25	+25	+20	+20	+45	+45
Spirits	+30	+30	−20	−20	+10	+10
Tobacco	+105	+110	+65	+70	+170	+180
Petrol	+200	+200	Nil	Nil	+200	+200
Derv	+50	+50	Nil	Nil	+50	+50
VED	+100	+100	+130	+130	+230	+230
Minor duties	+10	+10	−10	−10	Nil	Nil
Bus fuel grants	−5	−5	Nil	Nil	−5	−5
Total	**+585**	**+595**	**+235**	**+240**	**+820**	**+835**

(*d*) Effect on tax liabilities in respect of 1986–87; the yield in 1986–87 will be £40 million.
(*e*) These estimates are highly uncertain.
(*f*) The proposal affects partnership changes taking place after 19 March 1985, but the basis of assessing liabilities for 1985–86 will for most cases be the same as before. Receipts will build up from about £5 million in 1986–87 to about £30 million in 1988–89.
(*g*) In addition in 1986–87 and in 1987–88 there will be £5 million and £20 million respectively of relief brought forward from the following year. These estimates are highly uncertain.
(*h*) Reduction in corporation tax. The proposal brings forward payments of composite rate income tax within the financial year. This reduces the earnings of societies (and therefore the corporation tax on those earnings). There is also a reduction in the cost of funding the PSBR.
(*i*) Affects tax liabilities from 1986–87.
(*j*) The cost will depend upon the proportion of expenditure on machinery or plant which is depooled. If the proportion were 25 per cent and the disposal value of assets sold were 10 per cent of their cost, revenue costs could rise from nil in the first two years to about £300 million by 1991–92.
(*k*) Highly uncertain and depends upon take-up by industry. The cost could be up to £40 million by 1990–91.
(*l*) Indeterminate saving, possibly about £30 million. Depends partly on the outcome of current litigation.
(*m*) These items were included as part of the 1984 Budget corporation tax measures and their effects were included in the forecast published in the 1984–85 FSBR.
(*n*) Effective from 28 February 1986. Effect on tax liabilities in respect of the year from that date.
(*o*) Essentially a codifying measure.
(*p*) Capital gains tax −£75 million; corporation tax −£30 million. The cost in 1986–87 will be £35 million (capital gains tax £25 million; corporation tax £10 million).
(*q*) Capital gains tax −£40 million; corporation tax −£10 million. The cost in 1986–87 will be £20 million (capital gains tax £15 million; corporation tax £5 million).
(*r*) Development land tax −£75 million; capital gains tax +£10 million; corporation tax +£15 million. The cost in 1986–87 will be £40 million (development land tax −£45 million; capital gains tax +£2 million; corporation tax +£3 million).
(*s*) Includes +£345 million in respect of items not taking effect until 1986. Components will not necessarily sum to total because of rounding.
(*t*) The yield in 1985–86 will come from larger assessments raised against certain persistently defaulting traders. Implementation of the Keith Committee proposals will lead to additional revenue from improved compliance amounting to £600 million by 1988–89. The full year yield will accrue from penalties, surcharges and interest, building up over time to an annual total of £150 million. There will also be a continuing reduction of Government debt interest.

(MEASURED AGAINST INDEXED BASE)

ANNEX E

£ million

...ble 4.2 Direct effects of changes in taxation and national insurance [a]

	Impact on liabilities in full year	Impact on rece... in: 1985-86	1986-
INLAND REVENUE			
Income tax			
Increase in single allowance of £200 and married allowance of £300	-845	-680	-865(
Increase in additional personal allowance and widow's bereavement allowance of £100	- 5	*	- 5(
Increase in age allowance of £200 (single) and £300 (married) and income limit of £700	- 60	- 50	- 70(
Increase in basic rate limit of £800 to £16,200	Nil	Nil	Nil(
Increase in further higher rate thresholds	Nil	Nil	Nil(
Fringe benefits—car and car fuel scales	+ 40	Nil	+ 40
Reduction in share retention period under approved profit sharing schemes	- 10	- 5	- 10(
Relief for self employed national insurance contributions	- 55	- 25	- 55
Business Expansion Scheme—inclusion of research and development and exclusion of property development	*	*	*
Basis of assessment of partnerships	+ 5	Nil	+ 5(
Change in relief on covenanted gifts to charities	*	*	*
Offshore life assurance	*	Nil	*
Extension of mortgage interest relief at source	*	*	- 5(
Composite rate for bank interest—minor changes	*	*	*
Income tax and corporation tax			
Building Society special arrangements	- 20	Nil	+ 5(h
Short life assets	(j)	Nil	Nil
Postponement of allowances on ships	(k)	*	*
New rules for scientific research allowance	*	*	*
Charge to tax in respect of certain deep discount bonds	*	*	*
Limited partners' losses	*	*	*
Limit on gifts for business entertaining	*	*	*(1
Set-off of first year allowances	Nil	Nil	*
†New rules for date capital expenditure incurred	- 25	- 15	Nil
†Reduction in allowances for agricultural buildings	(m)	(m)	- 10
†Reduction in rate of initial allowance for hotels	(m)	(m)	(m)
†Changes in allowances for patent rights and know-how	(m)	(m)	(m)
†Reduction in rate of initial allowance for dredging	(m)	(m)	(m)
†Abolition of use requirement for writing down allowances	*	*	(m)
†Capital allowances on fixtures	*	*	*
†Relief for investment managers acting for non-residents	*	*	*
†Friendly Societies life assurance business	Nil	Nil	*
			Nil
Income tax, corporation tax and capital gains tax			
Commodity and financial futures, and traded options	*	*	*
*Accrued income charge on securities	+300	Nil	+150(n
Income tax, capital gains tax, capital transfer tax and stamp duties			
Minor exemptions for securities issued by European Communities	Nil	Nil	Nil(o)
Corporation tax			
London Regional Transport—accumulated tax losses	Nil	Nil	Nil
Corporation tax and capital gains tax			
Indexation relief based on March 1982 values	-105	Nil	- 35(p)
Other changes to indexation relief	- 50	Nil	- 20(q)
Transactions between connected persons	*	Nil	*
Oil taxation			
Removal of immediate PRT exploration and appraisal relief for onshore fields	+ 5	+ 10	+ 5
Restriction of immediate PRT relief for extended production tests, and other minor changes	+ 10	+ 10	+ 10
Capital gains tax			
Indexation of annual exempt amount	Nil	Nil	Nil(b)
Reform of retirement relief	*	Nil	*
Development land tax			
Abolition	- 50	- 20	- 40(r)

Table 4.2 Direct effects of changes in taxation and national insurance (a) *(continued)*

£ million

	Impact on liabilities in full year	Impact on receipts in: 1985-86	1986-
INLAND REVENUE *(continued)*			
Capital transfer tax			
Indexation of chargeable rate bands	Nil	Nil	Nil(
Extension of exemption for amenity land	*	*	*
Stamp duties			
Repeal of duty on gifts	- 10	- 10	- 10
Repeal of duty on contract notes	- 5	- 5	- 5
Other changes	*	*	*
TOTAL INLAND REVENUE		-790	-920
CUSTOMS AND EXCISE			
Value added tax			
Withdrawal of zero-rating of advertisements in newspapers, journals and periodicals	+ 50	+ 30	+ 50
Increase in registration limits	*	*	*
†Implementation of Keith recommendations	+150	+ 50	+ 60
Relief for certain goods temporarily imported for process or repair	Nil	- 30	Nil
Extension of bad debt relief	- 25	Nil	- 25
Exemption of transactions between credit and charge card companies and participating retailers	+ 20	+ 15	+ 20
Relief for certain computer equipment bought with donated funds	- 5	- 5	- 5
Excise duties			
Increase in rate of spirits duty	- 20	- 20	- 20
Increase in rate of beer duty	+ 45	+ 45	+ 50
Increase in rate of duty on cider and perry	+ 5	+ 5	+ 5
Increases in rates of wine and made-wine duties	+ 20	+ 20	+ 20
Increases in rates of duty on light oil, etc.	Nil	Nil	Nil
Increase in rate of duty on heavy oil for use in road vehicles	Nil	Nil	Nil
Increases in rates of tobacco products duties	+ 70	+ 65	+ 75
TOTAL CUSTOMS AND EXCISE		+175	+ 230
Vehicle excise duty	+130		
Changes in rates of duty	+130	+130	+135
VED on 3 wheeled cars	*	*	*
VED: Temporary First Licensing	*	*	*
Other			
Bus fuel grants	+ 5	- 5	- 5
TOTAL CHANGES IN TAXATION		-490	- 560
National insurance contributions			
Reduction in rates for employers	- 80	- 30	- 80
Reduction in rates for employees	- 270	-100	- 270
Reduction in rates for self-employed and voluntary rates	N/A	N/A	N/A
TOTAL CHANGES TO NATIONAL INSURANCE CONTRIBUTIONS			

†Items so marked were announced before Budget Day.

(a) The direct effects of tax changes are generally estimated by applying the new and old tax rates ar expenditure expected in the economic forecast in Part 3, taking account of changes in taxpayers' where these behavioural changes can be readily estimated. For the meaning of a full year see the The full year figure for national insurance contributions is the difference between the revenue tha 1985-86 on the basis of the contribution rates and earnings limits announced in November 1984 received in respect of 1985-86 if the new arrangements had been fully in place at the start of that

* Negligible

ANNEX E (cont)

Footnote (b) Direct Revenue Effects of indexation

£ million

	Impact on annual liabilities	Impact on receipts in 1985-86	1986-87
Income tax:			
Main allowances	- 960	- 770	- 1,860
Basic rate limit	- 80	- 50	- 190
Further higher rate thresholds	- 75	- 40	- 60
Total income tax	- 1,115	- 860	- 2,110
Capital gains tax Exempt amount	- 10	Nil	- 5
Capital transfer tax Threshold and bands	- 35	- 12	- 20

Footnote (c) Direct Revenue Effects of Revaloristion

Beer, cider, perry	+ 75	+ 70	+ 170
Wine	+ 25	+ 25	+ 60
Spirits	+ 30	+ 30	+ 65
Tobacco	+ 110	+ 105	+ 245
Petrol	+ 200	+ 200	+ 450
Derv	+ 50	+ 50	+ 115
VED	+ 100	+ 100	+ 200
Minor Duties	+ 10	+ 10	+ 20
Bus Fuel Grants	- 5	- 5	- 10
Total Excise Duties	+ 595	+ 585	+ 1,315

ANNEX E (cont)

Annex E (footnotes

d) **

e) These estimates are highly uncertain

f) The proposal affects partnership changes taking place after 19 March 1985, but the basis of assessing liabilities for 1985-86 will for most cases be the same as before. Receipts will build up to about £30 million in 1988-89.

g) Represents relief brought forward from following year. There will be a further £20 million transitional cost in 1987-88. These estimates are highly uncertain.

h) The proposal brings forward payments of composite rate income tax within the financial year and initially increases receipts. However this earlier payment reduces the earnings of societies and so reduces their corporation tax liability. In the first year of operation the tax liability is estimated to be reduced by £20 million.

i) **

j) The cost will depend upon the proportion of expenditure on machinery or plant which is depooled. If the proportion were 25% and the disposal value of assets sold were 10% of their cost, revenue costs could rise from nil in the first two years to about £300 million by 1991-92.

k) Highly uncertain and depends upon take up by industry. The cost could be up to £400 million by 1990-91.

l) Indeterminate saving, possibly about £30 million. Depends partly on the outcome of current litigation.

m) These items were included as part of the 1984 Budget corporation tax measure and their effects were included in the forecast published in the 1984-85 FSBR.

n) Effective from 28 February 1986.

o) Essentially a codifying measure.

p) 1985-86: capital gains tax £75 million, corporation tax £130 million. 1986-87: capital gains tax £25 million, corporation tax £10 million.

q) 1985-86: capital gains tax £40 million, corporation tax £10 million. 1986-87: capital gains tax £15 million, corporation tax: £5 million.

r) 1985-86: development land tax £75 million, capital gains tax £10 million, corporation tax £15 million. 1986-87: development land tax £45 million, capital gains tax £2 million, corporation tax £3 million.

s) **

t) The yield in 1985-86 will come from larger assessments raised against certain persistently defaulting traders. Implementation of the Keith Committee proposals will lead to additional revenue from improved compliance amounting to £600 million by 1988-89. The full year yield will accrue from penalties, surcharges and interest, building up over time to an annual total of £150 million. There will also be a continuing reduction of Government debt interest.

Note

** denotes footnotes from original FSBR table which would no longer be required.

FROM: R A L lORD

DATE: 28 NOVEMBER 1985

cc. Chief Secretary
Sir P Middleton
Sir T Burns
Mr H Evans
Mr Odling-Smee
Mr Scholar
Mr Turnbull
Miss Peirson
Mr Cropper
Mr Davies

LORD TO CH/EX 28/11

CHANCELLOR

PUBLIC SECTOR TRANSACTIONS: CURRENT AND CAPITAL

Mr Riley's Table 3A in the briefing for your appearance before the TCSC presents a neat equivalence between capital expenditure and the borrowing requirement. But I think if you wish to restore the "line" in the FSBR there are good arguments for also considering some elements of the other formulations which he has set out.

2. In theory there is a good case for charging depreciation to current expenditure and giving capital expenditure net. It is only net capital spending which adds to the nation's assets and which will yield additional benefits in the future to service new debt.

3. But in practice we really have not much clue what level of depreciation we should be charging. Adding together the gross investment figures of past years may or may not tell us something about the present value of the public sector's assets. We can all think of assets whose value has never approached their cost.

4. Table 1.13 of the Public Expenditure White Paper was devised to emphasise the relatively high level of capital expenditure on a "common sense" definition compared with the more meagre numbers shown in the national accounts and formerly in the PEWP. Showing public

sector transactions net of depreciation will take us backward rather than forward so far as the infrastructure lobby is concerned.

5. Secondly, although the numbers work out rather neatly on the basis of table 3A' for 1985-86, I assume they will look less favourable next year with a probable move from current surplus to current deficit and a higher proportion of net fixed capital formation financed by privatisation receipts.

6. Thirdly, I think it difficult to regard taxes on capital as current receipts. Bringing them down under capital transactions upsets the symmetry of table 3A' but would be all right if capital spending were given gross. This was an important point in Barry Bracewell-Milnes' paper for the IoD which you asked me to look at some time ago. (I am sorry I have not responded on this subject until now).

7. Presenting figures gross would enable us to show a relatively high level of fixed capital formation and a healthy current surplus. Financing capital spending out of current surpluses as well as privatisation receipts and debt is clearly more prudent than relying on the two latter. The balance of advantage, in the context of increased privatisation receipts and North Sea revenues, seems to me in favour of a presentation emphasising prudence.

8. If challenged on the size of the current surplus we could concede the relevance of depreciation, but argue that the precisely appropriate level of depreciation is impossible to determine.

9. In sum, I would go for the wide definition of capital expenditure (i.e. the Table 1.13 definition including defence capital with some of the reserve allocated), no depreciation charge and taxes on capital under capital transactions. There seems to be no reason why all the

other public expenditure accounting systems - PESC, cash limits, estimates - should not go on as before. So long as it is perfectly clear that budgetary policy is not being set simply on the basis of the need to finance capital expenditure then it should not be any more difficult to make savings on capital spending as opposed to current than it was before.

RL

R A L LORD

C

The [illegible] of [illegible] and [illegible] are [illegible] the PSBR

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FROM: T BURNS

DATE: 29 November 1985

Ch/ Chris Riley's note on the Buiter article — in the folder — is interesting background, (a good summary?) Some influential academic thinking in this area RB 6/12

SIR PETER MIDDLETON

cc Mr Butler
Mr Odling-Smee
Mr Scholar
Mr Spackman
Mr Turnbull
Mr Riley
Mr M Williams
Mr R Pratt

SIR T. BURNS → SIR P. MIDDLETON 29/11

BALANCE SHEET ISSUES, THE PSBR AND THE MTFS

You asked for my views about the agenda notes on fiscal policy attached to Mr Scholar's minute of 1 November. I have restricted my comments to the longer term issues at this stage as they seem to be the main source of misunderstanding. The shorter term considerations will also be important when it comes to making a judgement about the fiscal stance for next year.

General accounting considerations

2. One of the important functions of a set of accounts is to determine the amount of funds that can be distributed whilst maintaining the value of the business intact. As I understand it, the technique of identifying a separate capital account has been successful in the private sector because it helps in making that decision. It separates the purchase of assets with a life greater than one year from other expenditure, acknowledging that the benefits are spread over the lifetime of the asset.

3. The Government has a similar problem. It has to choose between financing expenditure by taxation or borrowing. One of the important factors to be taken into account in making this

decision is to avoid imposing an unfair burden on the present or future generations. A second consideration is the desire to avoid unnecessary sharp changes in tax rates. For both reasons the principle of borrowing to finance expenditure on assets is obviously attractive because it helps to spread out tax payments so that assets are paid for as they are consumed, rather than when they are bought.

Asset sales

4. This issue has been highlighted, paradoxically, because of the substantial programme of asset disposals rather than a particularly sharp change in the level of capital expenditure. But the problem remains the same.

5. If the Government sells an asset it receives a lump sum but loses the stream of income in the future. If the lump sum is used to cut taxes the level of disposable income today will be increased but at the expense of disposable income in the future. Tax rates will have to rise, as the scope for asset sales runs out, to a level above where they would have been in the absence of the asset sales.

How big a stream in practice? There was [illegible]

6. Taxes can only be reduced now without reducing future disposable income to the extent that:

- the proceeds from the asset sale exceed the discounted value of the projected earnings stream of the asset. This may happen if the assets can be used more efficiently in the private sector than the public sector;

- the cost of borrowing by selling assets is less than the cost of selling debt. This may happen if it opens up new markets, and introduces new customers to the capital markets.

7. In practice neither effect is likely to be very big, and there may be factors operating in the opposite direction, for example the difficulty of obtaining a sale price that fully reflects the future value of the asset.

?

8. The implication is that the vast bulk of the receipts from privatisation should be viewed as financing - albeit better quality financing - and the PSBR (as we measure it) should be correspondingly reduced.

North Sea revenues

9. The revenues accruing to the Government from the sale of North Sea oil pose a similar problem. By definition North Sea oil is a non-renewable resource. If the revenues are used to cut taxes this means that all of the benefit goes to the current generation. And as the oil runs out taxes will have to rise back to the level they would have been in the absence of the oil discovery. If we want to ease the process of adjustment (on the balance of payments as well as for disposable income) and distribute the benefit to future as well as present generations there is a case for turning the proceeds into an annuity so that it generates an income for the future. This can be done by reducing taxes only to the extent of the permanent income from the oil, using the balance to reduce government debt and hence saving interest charges in the future.

Why so

10. There is no particular efficiency argument for sharing the proceeds with future generations - that is an issue of income distribution over time. But there are clear efficiency gains from avoiding large and disruptive tax changes.

Fixed assets

11. The same principle can be applied to the acquisition of capital assets by the public sector. If they will produce a return in the future there is a case for borrowing the initial cost and spreading the payments over the life of the asset.

12. The case is obvious when the return is financial, which can include the savings of rentals on buildings and equipment as well as surpluses of public corporations, local authority housing accounts etc. Then the project will be self financing. But it also applies to assets yielding non-financial returns. In that case taxes are higher for a number of years as the assets yield

[illegible] to the same extent because tax is only paid if the return benefits, reflecting the speed of the asset's depreciation, rather than being very high for one year only. (At the aggregate level this is only relevant if the level of investment is changing markedly).

Some Complications

13. This is all fairly straightforward and as a theoretical construct would probably receive widespread support. However, there are some obvious practical complications. Some commonly mentioned problems are as follows:

- the fear that if we acknowledge the legitimacy of borrowing to finance capital expenditure this will lead to higher public expenditure and a higher level of taxation generally, and it will create problems for the public expenditure control system;

- the fear that changes in borrowing for these reasons may have short run implications for demand, monetary policy and interest rates that will conflict with the overall financial strategy;

- the practical difficulties of assessing what should be included under this heading of capital transactions.

A route to higher expenditure?

14. The danger this approach provides for public expenditure control has probably been overstated. I see this analysis as directed towards the question of how to finance a given level of expenditure rather than the justification of any particular level of spending . Once the level of expenditure has been decided this approach helps in determining the extent to which is should be financed by taxation rather than borrowing. It is in this respect that I see the force of the arguments presented here, that we should take into account the balance between capital and current spending, asset sales and North Sea oil revenues.

15. I realise that there are dangers that it will damage expenditure control if wrongly applied. We will find it more difficult to argue against public capital expenditure on grounds of needing to control the PSBR. But is this a legitimate argument in the first place? Normally it should be unnecessary. The case against capital expenditure should be on grounds of the rate of return, and the taxation implications of financing depreciation, interest charges, and any higher accompanying expenditure rather than a rigid PSBR constraint. We do try to claim that worthwhile projects are not being held up to any significant extent by lack of finance.

Damage to the MTFS?

16. There has been some worry expressed that the approach would damage the logic of the MTFS. Again I think this is overstated. There are two potential short-term problems that might emerge. The first is that if the PSBR is set on the basis of longer term considerations it might conflict with short-term objectives for demand. The second is that it might conflict with the objectives for inflation, interest rates and money supply.

17. But there is a range of feasible combinations of monetary and fiscal policy that are consistent with the inflation and money GDP growth objectives of the MTFS. It is possible to increase the PSBR to finance additional expenditure or tax cuts without increasing money GDP by increasing interest rates at the same time - and vice versa. This could be seen as altering the level of interest rates regarded as acceptable under the MTFS, and will of course have implications for other aspects of the economy. For example in this case we would probably have a higher exchange rate, a smaller current account surplus on the balance of payments, and maybe in the short run a better output/inflation split within money GDP.

How do we measure capital?

18. The problem of measuring the public sector balance sheet is a more important complication:

- the measurement problem is acute for much of capital expenditure, largely because of the difficulty of measuring market prices, depreciation and real capital gains or losses;

- it is difficult to decide the magnitude of other important transitory factors. For example, it can be argued that the present level of unemployment represents the temporary problem of adjusting to the emergence of North Sea oil, the elimination of overmanning and the reduction of inflation. The logic applied above would point towards spreading the cost of this expenditure and tax foregone into the future;

i.e...

- is any significance to be attached to a particular figure for net worth? On some definitions the asset position of the public sector exceeds the level of public sector debt, on others the opposite. Should this be taken into account? What is an appropriate figure of net worth to aim for and should it be changing over time?

Implications for the PSBR

19. The problem of measurement must make us cautious in in trying to apply this approach in practice to determine the absolute size of the PSBR . I doubt if it can be done on a mechanical basis. But the logic lying behind the analysis should be a useful aspect of our discussions on fiscal policy.

20. One obvious approach is to take these factors into account on an incremental basis when looking at the change in the PSBR from one year to another, and when comparing the PSBR profile in successive editions of the MTFS. This avoids some of the measurement problems, especially those connected with not knowing the right level of measureable net worth, and with the omission from the calculation of balance sheet times that change only slowly.

21. Comparing 1986-87 with 1985-86 shows two major changes in the accumulation of the assets and liabilities discussed in this note. North Sea revenues are now expected to be £2.3 billion lower and Privatisation receipts are expected to be £2.25 billion higher. On the face of it these factors more or less offset each other. However there is another oil related factor to be taken into account. If we were building up an "oil fund" with the exceptionally high current oil revenues that fund would be accumulating interest that we would be reinvesting in the fund. Therefore changes in these notional interest receipts would also be going to reduce the PSBR. Taking these oil and asset sales related factors together points towards reducing the PSBR next year.

a grand new prin

explain

22. Another way of putting the numbers together would be to compare the outlook as it now looks with what we thought at the time of the Budget. Again only two items have changed significantly since then: asset sales and North Sea revenues. Asset sales are projected to be £2.5 billion higher than in the last MTFS and North Sea revenues some £2 billion less. This suggests that for an equivalent long run fiscal stance the PSBR in 1986-87 should be a little less than in the 1985 MTFS.

23. There are other factors that could be taken into account in assessing the long-term implications for increments to the PSBR. Two potentially measurable ones are:

- changes in the erosion of the real value of public sector debt because of changes in inflation;

- sharp changes in unfunded pension liabilities, as in 1987-88 if the proposed SERPS modifications go through.

24. But this approach cannot at this stage lead directly to a figure for the absolute size of the PSBR. In addition to measurement problems with many of the factors already mentioned (eg. North Sea oil permanent revenues, depreciation of public

capital stock), there are other long term factors that might be taken into account (eg. the costs associated with the present high level of unemployment), and the level of net worth to aim for is itself uncertain.

25. However, the balance sheet approach suggests a range of additional information that should be taken into account in assessing whether the level of the PSBR is right from the point of view of its long-term impact on asset accumulation and sustainability:

- the real interest rate path that the fiscal stance implies if the level of money GDP is to be kept on track;

- the recent and projected accumulation of overseas assets and the implications for the balance of payments;

- estimates of the sustainability of the stance and what is required in terms of both taxation and public expenditure control to bring about a smooth transition to a world with diminishing oil revenues and without asset sales.

25. This requires more work on the longer term pressures and a considerable amount of judgement. But the calculations presented in the accompanying MP note are important factors and should help in forming that judgment (the note is in response to your minute of 23 October where you asked me to prepare a worked example of how we would go about setting the PSBR). In particular it tries to show more fully how the long-term implications fit in with the short-term ones within the context of the MTFS.

Postscript

26. This note has concentrated on some important longer term considerations that need to be taken into account when setting the PSBR. It has not considered some of the equally important short-term issues about the balance of monetary and fiscal policy, for example:

- the implications for tax cuts and the supply side benefits this might bring;

- the implications for the exchange rate and interest rates and their possible influence on the balance of inflation and output;

- the balance between traded and non-traded goods, and between manufacturing and non-manufacturing;

- the short term effects on expectations and the credibility of the anti-inflationary policy;

- the political pressures that might emerge for an easing of fiscal policy if there is dissatisfaction with the level of interest rates and the exchange rate. ?

27. We hope to take both short and long term considerations into account in the Chevening paper.

T.B.

T BURNS

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SETTING FISCAL POLICY: WORKED EXAMPLE

This note illustrates the decision-making process for setting fiscal policy that is summarised in Sir Terence Burns' minute of 8th October to Sir Peter Middleton. The numbers for 1986-87 and earlier years are consistent with the October forecast. The numbers for later years are stylised but they broadly reflect the judgments about the medium term which follow from the short-term forecast. More considered numbers are being prepared for when the real decisions are taken.

Objectives

2. The starting point is to set out assumed objectives for inflation and money GDP growth. The inflation objective is taken to be a declining path from the end of the published forecast, passing through 3% in about 1988 and heading on down at about $\frac{1}{2}$ percentage point a year. To obtain an output and hence money GDP path, a view is taken about the growth of productive potential over the medium term, and of the scope for output to grow faster than productive potential consistently with declining inflation. It is therefore necessary to consider where we are in relation to the NAIRU, and also the possibility of a change in the NAIRU.

3. The objectives that emerge in this way are not the last word. It may make sense to modify them when the policy implications, as discussed below (paragraphs 7 and 24), become apparent. Iteration between objectives and policies can take place at a later stage.

4. The objectives illustrated in Table 1 are based on the October forecast to 1986-87 and the 1985 MTFS for 1987-88 and 1988-89. The inflation rates and onshore output growth rates in 1987-88 and 1988-89 are the same as in the 1985 MTFS. But, as we now expect a slower reduction in North Sea production than at Budget time, money GDP and total output grow slightly faster than in the 1985 MTFS.

Interest Rates and Monetary Aggregates

5. The first step is to compute the interest rates and money supply growth rates that are judged to be consistent with the objectives and the

PSBR path in the 1985 MTFS. If the particular mix of monetary and fiscal policies that this reveals is unattractive for any of the reasons discussed below a different PSBR path can be tried and the interest rate and monetary growth implications recalculated[1].

6. Illustrative numbers for interest rates and monetary aggregates are shown in Table 2. The calculations are extremely rough, and do not necessarily represent our final view of what monetary policy would be required to deliver the objectives in Table 1, given the PSBR path in the 1985 MTFS and other aspects of the medium-term outlook (eg US interest rates, asset sales, etc).

7. One feature of the numbers is worth noting at this stage. Although the objectives for money GDP growth in Table 1 are achieved, the split between output growth and inflation is less favourable than was intended. Output growth is down by ½-1 percentage point in the last two years, and inflation up. This is a common feature of forecasts which tend to show an unfavourable output/inflation split in later years. It presents us with a choice between assuming a better outcome and altering the objectives. The first amounts to assuming a more favourable supply performance, eg faster productivity growth or slower wage growth, than is implied by the initial projections so that lower inflation with unchanged money GDP growth becomes feasible.

The Mix of Monetary and Fiscal Policies

8. The next stage is to consider whether we like the mix of monetary and fiscal policies that is implied by the 1985 MTFS path for the PSBR and the

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(1) This illustration starts from the existing PSBR path, then looks at the monetary implications, and then reassesses the PSBR. It could have been done the other way round: start from existing monetary policy, look at the implications for the PSBR, and then reassess monetary policy. The final resting place should not in principle be very different. The point is that fiscal and monetary policy both affect the objectives and so should be set simultaneously at Budget time. The order adopted here reflects the way the forecast is carried out, with a fixed PSBR and with interest rates varied to deliver, as far as possible, the desired money GDP path and money supply growth within the existing MTFS ranges.

monetary policy that has to go with it to achieve the objectives. There are four things to look at in assessing whether a different fiscal/monetary mix would be preferable: its impact on (a) the fiscal adjustment and hence the scope for tax cuts (b) the economy in the short to medium term (c) the economy in the long term (d) expectations.

9. The impact of a different fiscal/monetary mix on the fiscal adjustment is obvious and needs no illustration here. A higher PSBR and interest rate strategy clearly provides more scope for tax cuts than a lower PSBR/interest rate one.

10. The impact of a different fiscal/monetary mix on the economy in the short to medium term is of interest at both aggregate and sectoral levels. At the aggregate level it has been argued, especially in recent years, that a move towards a looser fiscal policy and a tighter monetary policy will raise output and reduce inflation for given money GDP growth. This was the policy change proposed by Dornbusch (Charter for Jobs paper) and Blanchard (CEPR paper) among others, and it reflects their interpretation of what has been happening in the US. At the sectoral level such a change in mix will worsen the financial position of the public sector and the tradeable goods sector and improve that of the personal, non-tradeable goods and overseas sectors. This can be seen in recent years in the US where monetary policy has tightened relative to fiscal policy.

11. Our estimates suggest that there is very little improvement in the inflation/output split to be had from loosening fiscal policy by cutting income tax and tightening monetary policy (Table 3). Although there is a more favourable impact when expenditure is raised or employers' NICs reduced, the benefits last for only a year or two. These estimates do not take any account of a loss of confidence in financial markets following such a change in policy mix.

12. So far the analysis has been fairly conventional. An extra dimension is added by the analysis of the impact of a different fiscal/monetary mix on the economy in the long term. A permanent move towards a looser fiscal policy and a tighter monetary policy for given money GDP growth increases consumption in the short term at the expense of investment, both domestic and overseas, and future consumption.

13. Some of the symptoms of this are obvious in the case of the United States. The real interest rate is high, and the rate of increase of public debt is rapid as is also the decline in net overseas assets (which have even changed sign). Although domestic investment has been sheltered from the high real interest rates by generous tax allowances, this has worsened the budget deficit and thrown more of the long-term problem onto the external side.

14. An assessment of changes in public sector debt in relation to changes in other public sector assets and liabilities provides an indication of how the long-term balance is changing. Some of the relevant numbers are illustrated in Table 4. The first panel (A) shows real interest rates in the UK and the US, with the difference between the two throwing some light on the independent pressure on UK interest rates coming from the UK policy mix. Panel B shows estimates of changes in public sector assets and liabilities. The sign convention is such that positive items point to a positive PSBR and vice versa. The level of the total row is not meaningful because the table is not comprehensive and there is uncertainty about objectives for total net worth; but changes in the total provide useful indicators of long-term factors. The main changes since the 1985 MTFS are summarised in Panel C.

15. It might help to clarify the policy approach if some conclusions are drawn from Table 4, although the numbers are still provisional. The main points are:

i. fiscal policy as reflected in the PSBR path in the 1985 MTFS may be loose relative to monetary policy in terms of the long-term effects, especially in 1986-87. The evidence for this includes the high and rising real interest rates (Panel A), the decline between 1985-86 and 1986-87 in additions to net public assets (Panel B), and the change in the 1986-87 position since the 1985 MTFS (Panel C);

ii. there might be a case, stemming from declining North Sea revenues, for a flat PSBR path after 1986-87 if the PSBR in 1986-87 had been set at a level consistent with long-term objectives.

16. Finally, it is necessary to consider the impact of changes in the fiscal/monetary mix on expectations. These are likely to be influenced by the published numbers for monetary growth and the PSBR, and by perceptions of the underlying thrust and sustainability of policy. (Expectations are also affected by what is said or believed about objectives for inflation and money GDP growth, but the discussion here is restricted to expectataions resulting from different policy mixes for a given money GDP growth.)

17. Taking monetary growth first, the mix of fiscal and monetary policies that we have started with in this worked example implies considerably faster £M3 growth than in the 1985 MTFS, and slightly slower M0 growth than in the 1985 MTFS in the last two years of the period (Table 2). However, the increase in £M3 growth is mostly due to the assumption of no overfunding. The issues of expectations and presentation that it presents are therefore not directly related to the setting of fiscal policy, and are not considered further here. The slower growth of M0 in 1987-88 and 1988-89 brings it within the 1985 MTFS target ranges, instead of above them. While this barely justifies reducing the published ranges, such a move might be contemplated if it was desired to indicate that monetary policy was to be tighter.

18. The difficulty with fiscal policy is that the maintenance of the same PSBR path as in the 1985 MTFS would probably be perceived to be a loosening of policy because of the extra asset sales (not fully offset by reduced oil revenues). If expectations were not to be seriously damaged, consideration would therefore have to be given to signalling a tightening of either monetary or fiscal stance. The starting point of this example implies a tightening of monetary stance, which could be signalled by reducing the range for M0 growth. But this might not be enough.

19. Markets might be worried not only by a loosening of overall macro-economic policy, as when fiscal policy loosens without an offsetting tightening of monetary policy, but also by a change in the mix. They might expect that a move towards a looser fiscal policy and a tighter monetary policy, while being satisfactory - perhaps even beneficial - in the short term, would be unsustainable in the long term. It would lead to a squeeze on companies in the traded goods sector, a worsening balance of payments position, rising public sector debt relative to net assets, and a rise in consumption at the expense of investment. The pressure resulting from these disequilibria might be perceived to become intolerable, as in the US, and

lead to a policy change. Markets might signal their doubts about the sustainability of the strategy of looser fiscal and tighter monetary policy early on, and they could effectively prevent its being pursued. This possibility would be another factor to keep in mind when assessing the fiscal/monetary mix.

Conclusions

20. This note does not provide the material to assess the fiscal/monetary mix for real. But it may help to explain the approach being advocated if the various points made above in relation to the illustrative numbers are drawn together. The illustration began from an assumed set of objectives, which were similar to those in the 1985 MTFS, then suggested that higher interest rates would probably be required to achieve them than was thought to be the case in the 1985 MTFS, assuming the same PSBR path as before.

21. The following arguments were suggested for accepting this policy mix or for moving towards a looser fiscal/tighter monetary mix:

a. the scope for tax cuts is greater;

b. there may be some short-term improvement in the split of money GDP growth between inflation and output growth.

22. The following arguments were suggested for adjusting the policy mix so that fiscal policy was tighter and interest rates lower:

a. the financial position of the traded goods sector would be better;

b. the long-term impact of the policy mix, in the sense of its effects on asset accumulation and the balance between future and present consumption, would be neutral;

c. policy would be perceived to be more sustainable, mainly because of a. and b. and associated factors (especially the level of interest rates and the exchange rate), and financial markets would be less likely to undermine it.

23. These arguments would have to be weighed up. If the conclusion was that the policy mix should be different from the starting point, a new policy mix that was consistent with the same objectives would be identified. The same set of questions about this policy mix would be posed as in paragraphs 8-19 above, and a new set of conclusions drawn. In principle this iterative process could be pursued for some time. In practice the desired policy mix would probably become apparent relatively early.

24. Finally, the possibility of a further iteration between policies and objectives should be recalled. If <u>all</u> feasible policy mixes for a given set of objectives look unattractive for some of the reasons in paragraphs 8-19, it might make sense to reconsider the objectives. This brings us back to some of the considerations briefly mentioned at the beginning (eg paragraphs 2-3 and 7).

Table 1

Objectives

	1984-85	1985-86	1986-87	1987-88	1988-89
				Percentage change	
Inflation (GDP deflator)	4.5	5.0	4.2	3½	3
Output	2.5	4.0	2.3	2.4	2.2
(Non-North Sea)	(2.7)	(4.0)	(3.1)	(2.6)	(2.5)
Money GDP	7.3	9.1	6.9	6.1	5.4

Table 2

Interest Rates and Monetary Aggregates

	1984-85	1985-86	1986-87	1987-88	1988-89
				Percentage	
Interest rates					
Short	10.9	11.7	10.4	11	11
Long	10.9	10.4	9.9	11	11
Money supply growth					
M0	5.3	5.7	5.1	3½	3½
£M3	10.0	14.0	11.5	10.5	8
Money GDP growth	7.3	9.1	6.9	6	5½
Inflation	4.5	5.0	4.2	4½	4
Output growth	2.5	4.0	2.3	1½	1½

1985 MTFS

	1984-85	1985-86	1986-87	1987-88	1988-89
Interest rates					
Short	10.9	11.9	10.1	9.3	8.5
Long	10.9	10.8	10.2	9.3	8.5
Money supply growth					
M0	4.8	4.4	4.6	5.5	4.4
£M3	9.3	8.3	7.5	6.6	5.6
Money GDP growth	6.8	8.4	6.6	5.7	5.0

Table 3

Changes in Fiscal/Monetary Mix: Short-Term Impact

(Effects of 1 percentage point rise in PSBR/GDP ratio with unchanged money GDP; percentage changes from base)

	GDP	Inflation(1)	Short-term interest rates	Real exchange rate	Current account(2)	Public and Private consumption(2)	Domestic and Overseas investment(2)
Reduction in Income Tax							
Year 1	+0.1	-0.1	+1.5	+0.4	-0.3	+0.4	-0.3
Year 2	+0.1	-0.1	+1.0	+0.1	-0.1	+0.1	-0.1
Year 3	-0.1	+0.1	+3.5	+1.0	-0.3	+0.3	-0.5
Reduction in Employers' NICs							
Year 1	+0.7	-0.7	+0.2	-1.1	-0.4	+0.5	-0.3
Year 2	+0.6	-0.6	+1.7	+0.3	-0.2	+0.4	-0.2
Year 3	-0.1	0	+4.1	+1.8	-0.3	+0.5	-0.6
Increase in CG Investment							
Year 1	+0.6	-0.3	+3.4	+0.7	-0.6	-0.1	+0.2
Year 2	-0.3	+0.3	+3.2	+0.6	-0.1	-0.6	+0.3
Year 3	-1.1	+1.2	+5.1	+1.4	0	-0.5	0

(1) GDP deflator

(2) Changes from base as percentage of money GNP

Table 4

Changes in Fiscal/Monetary Mix: Long-term Impact

	1984-85	1985-86	1986-87	1987-88	1988-89
A. Real Interest Rates (%)(1)					
UK					
Short-term	5.4	6.7	6.2	6½	7
Long-term	5.4	5.4	5.7	6½	7
US					
Short-term	6.4	4.3	4	4	4
Long-term	8.8	7.7	7	6½	6
B. Changes in Public Sector Assets and Liabilities (£bn)(2)					
Special asset sales	-2.1	-2.5	-4.8	-4.8	-4.8
Other "Riley adjustments"(3)	-0.3	-0.6	-0.3	-0.1	0
Net public sector investment(4)	2.4	2.0	2.1	2.2	2.2
North Sea revenues(5)	-11.7	-11.8	-10.5	-9.1	-9.1
Indexed gilts adjustment	-0.4	-0.7	-0.4	-0.5	-0.5
Erosion of real value of debt	5.6	6.5	5.9	5.4	5.2
Total	-6.5	-7.1	-8.0	-6.9	-7.0
PSBR	10	8	7½	7	7½
C. Main Changes in Projections of Assets/Liabilities since 1985 MTFS(£bn)(2)					
Special asset sales	-0.1	0	-2.5	-2.5	-2.5
North Sea revenues	0	1.5	1.5	0.9	1.2
Total	-0.1	1.5	-1.0	-1.6	-1.3

(1) Nominal interest rates minus growth in GDP deflator

(2) Increase in assets or decrease in liabilities (except for PSBR): +

(3) Other essentially capital transactions

(4) Sales of land and existing buildings (eg council houses) are netted off.

(5) Net of permanent revenue, and including debt interest saving that would have been obtained had earlier net revenues been used to reduce debt.

RR3.79

FROM: MRS R LOMAX

DATE: 2 December 1985

cc Chief Secretary
Sir P Middleton
Sir T Burns
Mr H Evans
Mr Odling-Smee
Mr Scholar
Mr Turnbull
Miss Peirson
Mr Riley
Mr Cropper
Mr H Davies

RL to LORD 2/12

MR LORD

PUBLIC SECTOR TRANSACTIONS: CURRENT AND CAPITAL

The Chancellor was grateful for your minute of 28 November. He generally agrees with you, with the exception of your paragraph 6 (where you argue that it is difficult to regard taxes on capital as current receipts). He has noted that there is no essential difference between a tax on capital and local authority rates, or indeed taxes on the income from capital.

2. More generally he has observed that the old "line" was intended to be about gross capital spending and so should the new one. He would be grateful if you would prepare proposals on that basis.

RL.

RACHEL LOMAX

67

From: SIR PETER MIDDLETON

Date: 5 December 1985

Ch/ I sympathise with Pete's view that this is very laborious, but surely it is very urgent. I'd be inclined to save it for Xmas (or post Xmas) reading. Return if you feel the same.

RL
6/12

CHANCELLOR

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir T Burns
Mr Cassell
Mr Scholar
Mr Monger
Miss Sinclair
Mr G P Smith
Mr Pratt

FSBR: PRESENTATION OF TAX CHANGES

It seems to me that the answers to the questions posed by Miss Sinclair in her submission of 22 November are quite simple.

Calculating the 2nd year cost of indexation against a

(a) Indexing the cost/yield of tax changes against an unindexed base makes no sense conceptually and produces ridiculous results - see the table at the bottom of the appendix. Drop this one.

Completely underindexed

(b) The full year effect is calculated differently in Customs and Revenue. But in both cases it is a metaphysical concept which bears no relationship to any particular year. As we discovered last year it results in a table which cannot be added up. This concept can be of help in explaining the structural effects on the tax system of certain tax changes. But it really has no place in the FSBR.

Calculating the cost of tax changes

? costing

(c) The scorecard approach - indexing against an indexed base - is logical. We use it ourselves. We could convert the FSBR table to this basis with very little risk that it would be noticed. But it is a sensible thing to do in any event.

2. I therefore recommend that you go for the presentation in Annex E (without the column headed: Impact on liabilities in a full year) for table 4.2 of the FSBR with corresponding changes in table 1.1.

PEM

P E MIDDLETON

096

pso

FROM: MRS R LOMAX

DATE: 10 December 1985

SIR TERENCE BURNS

cc: PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir P Middleton
Mr Cassell
Mr Odling-Smee
Mr Peretz
Mr Scholar
Mr Sedgwick
Mr Cropper
Mr Lord
Mr H Davies

MEDIUM TERM FINANCIAL STRATEGY

The Chancellor told you yesterday that he has already decided to roll forward the MTFS for one more year (and no more) in the next FSBR.

RL

RACHEL LOMAX

What sort of spend? [illegible]

Fm mix: [illegible] to think, Choose your PSBR to get whatever the rate you think desirable.

Now, we are not [illegible], we need to lower PSBR than [illegible]. (It was discussed over the mix) [It acts on the [illegible]]

<u>Ch.</u>

There two notes cover much of the ground we went over at the last meeting. As you know Terry & Peter have been having this debate for months, & could spend another 1½ hours on capital expenditure alone without difficulty.

You may, however, think it worth spending some time on the interesting questions notes at the end of

Terry's note. For all the

theoretical debate, the last

2 points on X & Y and the

~~and I think we both~~

~~know~~. are that, in any

justification, are closest to

the knuckle.

Terry thinks you

won't get away with

large tax cuts, unless you

cut the PSBR. I'm sure he

could do you a matrix of

possible paths of PSBR &

fiscal adjustments now. (Indeed

my guess is he will work back

from one in working his

Chevening paper).

Peter warns ~~would~~ you

contention of Germany with

a significant rise in interest

rates from present levels —

hence the affair of last month's

monetary prospects note

(incidentally not tickled through

by him — whoever wrote — I never

saw it!).

I'm also fairly sure that

these sorts of issues will be

uppermost in the PM's

mind. And it would be good

to map out the

areas of agreement &

disagreement at this

sufficiently, to avoid

any unseemly displays

of disunity on Sunday

night.

RW.

6/12

Mrs Lomax   cc Sir T Burns

Permanent Secretary
H M TREASURY

You might like to show this exchange to the Chancellor before TB and I see him on Monday. It illustrates the present state of the debate - which is by no means concluded

PM
6/12.

But read Terry's note first - Peter's is a comment on his much fuller analysis.

RL. 6/12

3K

ypm

From: SIR PETER MIDDLETON
Date: 6 December 1985

SIR T BURNS

cc Mr F E R Butler
Mr Odling-Smee
Mr Scholar
Mr Spackman
Mr Turnbull
Mr Riley
Mr M Williams
Mr Pratt

SIR P MIDDLETON → SIR T. BURNS 6/12

BALANCE SHEET ISSUES: THE PSBR AND THE MTFS

Thank you for your minute of 29 November. I am grateful for the work which has been put into this by you and the other economists. The issues are now clearer and the figures in the annex to your note provide an essential sense of scale.

2. As you know from our many discussions I have great doubts about the approach, while being in agreement with some of the conclusions. The best thing at this stage would be for me to say how I see the issue rather than try to score points off your approach.

3. I start from the assumption that the object of economic policy is the highest sustainable rate of non-inflationary growth in GDP. The role of the public sector is to further this objective while carrying out its functions and to avoid disruptive tax - or indeed other - changes if that is possible.

4. A current/capital distinction for the public sector is not very helpful in this context. The reasons for private sector accounting do not apply in the public sector. First, the business is the whole of the UK, not just the public sector. Second, capital has two characteristics in the private sector: it is bulky and it is something which you spend money on today to yield a return in the future. In the public sector, the bulkiness is smoothed out so that capital is just another continuous annual stream of

spending. I think you agree with this, it is certainly implied by the bracketed paragraph at the top of page 4 of your note which says at the aggregate level the relevant concept is marked changes in the level of investment. But more fundamentally, capital expenditure is not the only stream of expenditure which is done now for future benefit - education, training, a lot of health expenditure, maintenance, chunks of defence expenditure etc are incurred in order to yield exactly such a return.

5. If one was to play the private sector game, I should say that inspection of the capital and current public expenditure flows led to the conclusion that the two had both pluses and minuses as far as contributing to the growth of future GDP was concerned. There is no sense in whch it could be said a priori that one was more likely to add to GDP than the other. The important task for the Government is to improve the quality of its expenditure and revenue across the board - in terms of its contribution to the long run of growth of GDP.

6. I am afraid that I do not agree that the dangers to expenditure control of your proposed approach are overstated. If it is right to borrow to finance the public sector's buying of capital goods because this will increase public sector income and thus help put downward pressure on taxes, where does the argument end. You might conclude that because the Government's capital programme is flat in net terms, borrowing should be low. But equally you could use the argument to show that more capital expenditure is needed to justify the present - and indeed higher - levels of borrowing.

7. The problem seems to come from looking at the public sector in its own right rather than as part of the wider economy (see paragraphs 5 and 14 of your note). The former suggests that the state take on as much income generating activity financed by borrowing as we can. The latter leads us to a considerable extent in the opposite direction because of the efficiency gains from private sector activity. If the criteria is the growth of GNP privatisation makes sense. If it is the balance sheet of the public sector it does not.

8. It would be fair to ask how capital programmes are to be determined. Here I do not think I should quarrel much with the

proposition that they should be viable when properly appraised allowing for relative prices at the relevent current long term rate of interest - provided they could not be undertaken more efficiently in the private sector and provided that the efficiency gains from lower taxes are thrown into the balance in determining the total level of public expenditure.

9. I have one final comment on this aspect of the issue. I am by no means convinced that the current/capital split in the private sector is as well based as you suggest. Three quarters of industrial costs are related to people. British industry has suffered for centuries from a lack of skill in the labour force - both management and more widely. It is at least arguable that we should have been better off if a bit more investment had been put into developing human capital, than in an excessive amount of physical capital, much of it with dreadfully low productivity. The same applies in my view to the excessive investment in the infrastructure in the Victorian era.

10. I hope that by now you do not think I am arguing against borrowing. I am not in favour of a balanced budget. Some borrowing seems to me to be quite in order. I simply would not determine the amount in relation to the rate of growth of the net public sector capital programme.

11. It is reasonable for the Government to borrow so long as it is thought that GDP will rise in the future. We need not then be too concerned about future generations who by definition will be better off as a result of what we are doing. I should be inclined to determine the amount almost exclusively by monetary considerations. The PSBR would be set so as to avoid injecting financial assets into the economy to an extent which poses a threat to counter-inflationary policy. When stable prices have been achieved, we can afford to be a bit more sophisticated about cyclical adjustments and the like. But not before.

how do you judge that?

a

12. In assessing the threat to counter-inflationary policy, we could do worse than consider the level of real and nominal interest rates needed to prevent the value of money falling (or falling very much). This is some indication of the weight which monetary

and how?

has to bear in the fiscal/monetary mix.

13. You have spelled out a number of relevant concerns at the end of your paper. A relatively high interest rate/exchange rate regime undoubtedly keeps downward pressure on costs. But when as now, we have very high real interest rates relative to the rest of the world, I should counsel great caution with the PSBR. And for two reasons: first we should ask ourselves whether we have a sustainable policy; if things went wrong could we contemplate a significant rise in nominal interest rates? And, related to this, is the economy out of balance in the sense that too great a relative pressure is now being put on the UK manufacturing and the trading sector.

Mean? (the trade-off [illegible] [illegible] [illegible])

14. This approach leads me to regard any transfers of assets between the public and private sectors in terms of their substitutability for financial or real assets. So far as most privatisation is concerned, we should not go far wrong if we regard the proceeds as funding with supply side benefits. I would not therefore completely discount asset sales, but equally I should not give them a very high score on a monetary Richter scale giving points for taking pressure off interest rates.

[illegible] [illegible]

15. I do not agree that this is a short term approach in contrast to the long term approach in your paper. At a 7% real long term interest rate, it is doubtful whether you are talking about a longer period in terms of years than I am. But the real point is that sound monetary and financial policies are every bit as much in the long term interest of future generations as are the matters to which you draw attention.

16. I hope all this is not too lacking in intellectual and economic rigour. But I think it helps to set out a rather different approach so that we can have a constructive discussion.

PEM

P E MIDDLETON

PUBLIC SECTOR FINANCIAL DEFICIT

LOMAX
S:R T
BURNS
11/12

1-24

CONFIDENTIAL

pf for next Burns bilateral

FROM: MRS R LOMAX
DATE: 11 DECEMBER 1985

SIR TERENCE BURNS

cc Sir Peter Middleton
Mr Cassell
Mr Evans
Mr Odling-Smee
Miss Peirson
Mr Powell

PUBLIC SECTOR FINANCIAL DEFICIT

The Chancellor is interested in the idea of redefining the public sector financial deficit to include the accruals adjustment, thus effectively putting it on a cash basis. He thinks this would make it more useful for expositional purposes, in part by producing a smoother series. Miss Peirson produced the attached note in very short order yesterday which the Chancellor has seen. He finds the PSFD (cash) table of considerable interest, though he is not convinced by the arguments in Miss Peirson's covering minute. He has commented that we also need to consider what we are measuring these concepts for.

2. The Chancellor would like to discuss these ideas with you at some stage, preferably before Christmas. He would therefore be grateful if you would take a look at Miss Peirson's note.

RL.

RACHEL LOMAX

Ch/
I imagine Terry has forgotten about this - as I had, until the office machine regurgitated it. Are you still interested

Yes, but I forget to mention this - post Xmas.

RL

16/1

CHANCELLOR OF THE EXCHEQUER

I find Miss Peirson's ~~[illegible]~~ minute wholly unconvincing, & the PSFD (cash) table of considerable interest. I wd like to discuss with Sir TB later wk.

CX.

See table on back.

Adding on the accruals adjustment doesn't result in an ideal series for recent years – though it is a little better than the PSFD (accrued).

Margaret has got a little excited about this but her points at 5(i) and 7(a) are worth bearing in mind. I don't see that 7(b) is a killer. And she doesn't address the question of what are we

Rg2L

concerning these things.

few.

RL.

10/12.

21/2080

CONFIDENTIAL

FROM: MISS M E PEIRSON
DATE: 10 December 1985

PEIRSON → LOMAX 10/12

MRS LOMAX

cc Sir P Middleton
Mr Cassell
Mr Evans
Mr Odling-Smee
Mr Powell

PUBLIC SECTOR FINANCIAL DEFICIT

1. You said that the Chancellor was wondering whether to adopt, in partial replacement of the PSBR, the PSFD on a cash basis, ie the PSFD plus the "accruals adjustment" in line 28 of table 6.5 of the FSBR.

2. The PSFD, whether cash or accrued, could not be measured quickly and accurately, but you said the idea was not to use it for monitoring purposes but merely as a good alternative definition of the "financial balance". Attempts to meet criticism of the PSBR by adjusting it for special asset sales have simply led commentators to adjust it for other asset sales, North Sea revenues, Old Uncle Tom Cobbleigh and all. But if a wellestablished definition like the PSFD, which already excludes special asset sales, were used, there would not be the same temptation to adjust it further.

3. You added that the Chancellor had suggested that the PSFD should be in cash because then it might show less of an erratic path in recent years: he was thinking particularly of the civil service strike effects.

4. My immediate comments are as follows. First, I attach the figures requested, showing the PSFD, both accrued and cash, as % GDP and in cash. The PSBR is given for comparison.

5. Secondly, if there is to be a move to give more prominence to the PSFD, I recommend that it should be on the usual accrued basis, for the following reasons:-

(i) That is the internationally agreed basis, and the national accounts definition. We stand more chance of its being accepted without adjustment if we do not start adjusting it ourselves.

(ii) The "underlying" path of the PSFD, ie abstracting from the effects of the civil service strike, is shown more accurately by the accrued basis than cash, for on the (estimated) accrued basis there has been an attempt to remove the effects of the strike. The success of the attempt depends on the estimates of the strike effects, which cannot be said to be perfect, but the result is better than if the deficit is translated back to cash.

6. Against those two points, it is true that keeping the PSFD on an accrued basis means losing the benefit to 1984-85 of the acceleration of VAT on imports. But such measures to affect the timing (only) of improvements in the PSBR are, I believe, fairly rare. And now that 1984-85 is well over, and was anyway distorted by the miners' strike, we can afford to lose that particular benefit.

7. Thirdly, however, I do not recommend giving more prominence to the PSFD, for the following reasons:-

(a) It would not stop the adjustments, in particular for North Sea oil. For instance, I attach table 24 of the current draft of the IMF report on the UK (which officials are studying), which starts with the general government financial deficit (described as the "financial balance") and then adjusts it for sales of council houses, special sales of assets and North Sea oil (plus inflation and certain other changes described as "cyclical").

(b) The PSFD is likely to rise after 1985-86 in relation to the PSBR, because of the effect on the latter of the substantially higher special asset sales. A rough forecast for 1986-87, assuming an unchanged PSBR, is shown in the first table attached.

MEP

MISS M E PEIRSON

CONFIDENTIAL

PSBR and PSFD

	PSBR		PSFD (accrued)		PSFD (cash)	
	£bn	% GDP	£bn	%GDP	£bn	%GDP
1971-72	1.0	1.6	0.7	1.1	0.6	1.1
72-73	2.4	3.6	2.0	3.0	2.0	3.0
73-74	4.3	5.8	3.5	4.6	4.1	5.5
74-75	8.0	8.9	6.0	6.7	6.9	7.7
75-76	10.3	9.3	8.1	7.4	8.7	7.9
76-77	8.3	6.4	7.4	5.8	7.8	6.1
77-78	5.4	3.6	6.6	4.4	7.2	4.8
78-79	9.3	5.4	8.5	4.9	9.5	5.5
79-80	10.0	4.8	8.2	3.9	10.6	5.1
1980-81	12.7	5.4	12.0	5.1	13.3	5.7
81-82	8.6	3.3	5.8	2.2	7.5	2.9
82-83	8.9	3.1	8.5	3.0	8.3	2.9
83-84	9.7	3.2	12.0	3.9	11.9	3.9
84-85	10.2	3.1	12.5	3.8	12.1	3.7
1985-86*	8.0	2.2	11.1	3.1	11.1	3.1
1986-87**	7.7	2.0	[12.3]	[3.2]	[12.8]	[3.3]

* Autumn Statement forecast.

** Rough forecast based on Autumn Statement projections and assuming PSBR at 2% of GDP.

Table 24. United Kingdom: Cyclical Effect of Fiscal Policy

(In percent of GDP)

	1978/79	1979/80	1980/81	1981/82	1982/83	1983/84	1984/85 Budget	1984/85 Actual	1985/86 Budget	1985/86 Revised 1/
Actual fiscal data 2/										
Financial balance	-4.0	-3.0	-4.0	-1.9	-2.7	-3.9	-2.6	-3.6	-2.8	-3.2
Financial balance, adjusted for sales of council houses 3/	-4.2	-3.2	-4.3	-2.4	-3.4	-4.4	-3.0	-4.1	-3.2	-3.6
Financial balance, adjusted for sales of council houses and special sales of assets 3/	-4.2	-3.7	-4.5	-2.4	-3.6	-4.8	-3.6	-4.7	-3.9	-4.3
Cyclically neutral financial balance										
Unadjusted 4/	-4.0	-3.8	-6.6	-7.9	-8.1	-7.6	-7.5	-7.4	-7.0	-6.7
Adjusted for sales of public sector assets	-4.2	-4.0	-6.8	-8.1	-8.3	-7.8	-7.8	-7.6	-7.2	-7.0
Adjusted for sales of public sector assets and oil 5/	-4.2	-3.2	-5.5	-6.0	-5.9	-5.3	-5.1	-4.3	-3.8	-4.0
Change in cyclical effect 6/ (expansionary +)										
Unadjusted	...	-0.8	-1.8	-3.5	0.7	1.7	-1.3	-0.1	-0.4	0.3
Adjusted for sales of public sector assets	...	-0.8	-1.8	-3.5	0.7	1.7	-1.3	-0.1	-0.4	0.3
Adjusted for sales of public sector assets and oil	...	—	-1.3	-2.6	0.9	1.8	-1.1	0.7	-0.3	-0.1
Memorandum items (expansionary +)										
Change in inflation adjusted financial balance 7/	...	-3.6	-0.2	2.1	2.4	2.4	-1.5	-0.3	-1.0	-0.6
Change in inflation-adjusted PSBR 7/		-3.1	-0.6	2.1	1.4	1.2	-1.2	-0.1	-1.4	-1.1

Sources: CSO, Financial Statistics; HMSO, Financial Statement and Budget Report, The Government's Expenditure Plans; and staff calculations.

1/ Based on Autumn Statement, November 1985.
2/ General government.
3/ Treats sales of assets as financing rather than negative expenditure.
4/ Revenue is cyclically neutral if its ratio to actual GDP is the same as in the base year (1978/79). Cyclically neutral expenditure (net of unemployment benefits) maintains the same ratio to potential GDP as base year, and adds actual (or projected) unemployment benefit. Potential GDP equals actual GDP in 1978/79 and grows thereafter at a rate derived by adding 2 percent to the actual increase in the GDP deflator.
5/ Treats oil and gas revenue as cyclically neutral.
6/ Cyclical effect is the difference between the cyclically neutral balance and the actual fiscal balance. Change (from previous year) in the cyclical effect indicates the net (expansionary or contractionary) impulse of fiscal policy.
7/ Adjusted for the impact of price increases on outstanding government debt.

DRAFT IMF REPORT

8/659

1258

537/194

Covering SECRET

FROM: MISS M E PEIRSON
DATE: 16 December 1985

112/43

MR LORD

cc Mr Evans
Mr Odling-Smee
Mr Scholar
Mrs Butler
Mr Turnbull
Mr Riley
Mr M L Williams
Dr Webb

FSBR TABLE 6.5: CURRENT AND CAPITAL

1. We spoke. Following the exchange of minutes between Mr Odling-Smee and myself, I attach a version of table 6.5 as we would now recommend it.

2. If you put this version of table 6.5 to the Chancellor, please could you mention that:-

(i) the 1986-87 forecast figures used are based on the autumn forecast and will be (perhaps considerably) revised in the current forecasting round;

(ii) the expenditure Reserve for 1986-87 is fully allocated to the individual economic categories, so as not to distort the current surplus and total capital expenditure: a separate submission will be put forward during January concerning the question whether, in the 1986 FSBR, the Reserve should be thus allocated (as it was in the 1984 FSBR) or not (as in the 1985 FSBR);

(iii) the financial deficit is reinstated, as in the previous published versions (but unlike the versions of table 6.5 put to the Chancellor on 25 and 26 November): I think the Chancellor would want to show it, and since international organisations and some UK commentators favour the financial deficit it is helpful to them and to us if we publish our forecast of the deficit.

3. Other points are that

(iv) taxes on capital are under current receipts, as requested; indeed, more than half of such taxes in 1984 was accounted for by capital gains tax, which according to international guidelines should be classified as current receipts (an example of such guidelines is the European System of Accounts, extracts attached): the other components in 1984 were death duties and tax on other capital transfers (both capital under ESA) and development land tax (current under ESA, but disappearing);

(v) in the published version of the table, there will be other columns showing (as usual) the sectoral breakdown (central government, local authorities, total general government, public corporations).

MEP

MISS M E PEIRSON

TABLE 6.5: PUBLIC SECTOR TRANSACTIONS

(Autumn forecast for 1986-87)

	Line	£bn
CURRENT TRANSACTIONS		
Current expenditure		
Current expenditure on goods and services(1)	1.	- 78.7
Subsidies	2.	- 7.9
Current grants to personal sector	3.	- 49.8
Current grants paid abroad	4.	- 2.3
Current grants within public sector	5.	-
Debt interest	6.	- 18.9
Total current expenditure	7.	- 157.6
Current receipts		
Taxes on income	8.	52.6
Taxes on expenditure	9.	60.9
Taxes on capital	10.	2.1
NICs, etc	11.	26.2
Gross trading surplus	12.	8.0
Rent and oil royalties etc	13.	5.3
Interest and dividends from private sector & abroad	14.	4.6
Interest and dividends within public sector	15.	-
Miscellaneous current transfers	16.	0.3
Imputed non-trading capital consumption	17.	2.4
Total current receipts	18.	162.4
Current surplus	19.	+ 4.8
CAPITAL TRANSACTIONS		
Capital expenditure		
Gross domestic fixed capital formation(2)	20.	- 13.2
Increase in stocks	21.	- 0.3
Capital grants to private sector (net)	22.	- 2.6
Capital grants within public sector	23.	-
Total capital expenditure	24.	- 16.1
FINANCIAL DEFICIT (line 19 - line 24)	25.	- 11.3
FINANCIAL TRANSACTIONS		
Net lending to private sector and abroad	26.	- 0.1
Cash exp. on company securities (net)	27.	+ 4.8
Transactions concerning pension schemes (net)	28.	+ 0.5
Accruals adjustments	29.	- 0.5
Miscellaneous financial transactions	30.	- 1.0
Borrowing requirement(3)	31.	7.7

(1) Excludes defence capital expenditure (2) Includes defence capital expenditure

(3) Lines 26 + 27 + 28 + 29 + 30 + 31 = - line 25

452. In the system of accounts net accident insurance premiums are recorded:

- among uses in the distribution of income account (C 3) of resident policy holders
- among uses in the current transactions account of the rest of the world (for non-resident policy holders) (C 7)
- among resources in the distribution of income account (C 3) of resident insurance enterprises
- among resources in the current transactions account of the rest of the world (for non-resident insurance enterprises) (C 7).

Accident insurance claims (R 52)

453. Definition: Accident insurance claims (R 52) represent the claims due under contracts in respect of accident insurance[1]; that is, the amounts which insurance enterprises are obliged to pay in settlement of injuries or damages suffered by persons or goods (including fixed capital goods), and the additional sums paid to the insured in the form of redistributed profits.

454. Accident insurance claims do not include payments which constitute social benefits (see 478 b).

455. Accident insurance claims are treated in the accounts as direct flows from insurance enterprises to the units which are the ultimate beneficiaries.

In the system of accounts, they are recorded:

- among uses in the distribution of income account (C 3) of resident insurance enterprises
- among uses in the current transactions account of the rest of the world (in the case of non-resident insurance enterprises) (C 7)
- among resources in the distribution of income account (C 3) of the beneficiary sectors
- among resources in the current transactions account of the rest of the world (in the case of non-resident beneficiaries) (C 7).

UNREQUITED CURRENT TRANSFERS NOT ELSEWHERE CLASSIFIED (N.E.C.) (R 60)

456. These transfers cover unrequited current transfers other than taxes linked to production and imports (R 20) and subsidies (R 30).

Current taxes on income and wealth (R 61)

457. Definition: Current taxes on income and wealth (R 61) cover all compulsory payments levied periodically by general government and by the rest of the world on the income and wealth of institutional units.

458. The total value of the taxes which should be recorded includes any interest charged on arrears of taxes due and any fines imposed by taxation authorities; it also includes any charges which may be imposed in connection with the recovery and assessment of taxes outstanding. Correspondingly, it is reduced by the amount of any rebates made by general government as a matter of economic policy and any refunds made as a result of over-payments.

---

[1] Life insurance claims do not appear as such in the system of accounts. They are divided between:
a) claims constituting a form of social benefits
b) other life insurance claims.
The former are included under the heading social benefits and the latter are not treated as distributive transactions. Both categories of life insurance claims affect the change in insurance technical reserves (F 90) which appear in the financial account (see 569).

459. Current taxes on income and wealth include, in particular:

a) taxes on personal income (income from employment, property, entrepreneurship, pensions, etc.), including taxes on ownership of land and buildings whenever these constitute merely a device for assessing and collecting the total income tax (see 417.3)
b) taxes on the profits of companies and of other corporate bodies
c) capital gains taxes
d) current taxes on the capital or wealth of households, corporate enterprises and non-profit institutions
e) taxes on lottery, gambling or betting winnings
f) taxes paid by households on the use of vehicles which are not used for business purposes.

460. Current taxes on income and wealth do not include:

a) inheritance taxes, death duties or taxes on gifts inter-vivos, which are deemed to be levied on the capital of the beneficiaries and are shown under the heading capital taxes (see 4109 a)
b) occasional or exceptional levies on capital or wealth which are shown under the heading capital taxes (see 4109 b)
c) licence fees for the use of radio and television sets, the proceeds of which are allocated to the broadcasting and television services. These fees are treated as purchases of market services (see 308 a).

461. In the system of accounts, current taxes on income and wealth are recorded:

- among uses in the distribution of income account (C 3) of the sectors in which the tax payers are classified
- among resources in the distribution of income account (C 3) of general government
- among uses and resources in the current transactions account of the rest of the world (C 7).

Actual social contributions (R 62)

462. Definition: Actual social contributions (R 62) include all payments made by insured persons or their employers, either directly or through a collection agency, to institutions providing social benefits in order to acquire and/or preserve the right to these benefits.

463. Actual social contributions, are divided into:

a) Employers' actual social contributions (R 621). These correspond to flow R 102 (see 410)
b) Employees' social contributions (R 622)
c) Social contributions by self-employed and non-employed persons (R 623).

This breakdown of actual social contributions is given in table 11.

Although employers may pay their contributions directly to the insurers – as well as their employees' contributions in many cases – all these contributions are first shown in the accounts as part of the compensation of resident or non-resident employees, and are then deemed to be subsequently paid by resident or non-resident households to the insurers.

464. According to the sectors or sub-sectors which receive them, actual social contributions can be divided into:

a) social contributions to social security funds
b) social contributions to other sub-sectors of general government (e.g. pension contributions made to central or local government)

4104. *Investment grants to general government* include all payments made to subsectors of general government([1]) for the purpose of financing capital formation. The most important examples are transfers from central government to local authorities for the specific purpose of financing their gross fixed capital formation. It should be emphasized that transfers of a general character intended for various or indeterminate purposes are shown under current transfers within general government, even if they are partly used to cover expenditure on capital formation.

4105. *Investment grants to private non-profit institutions* from general government and from the rest of the world are distinguished from current transfers to private non-profit institutions by using the same criterion (see 4104).

4106. *Investment grants to the rest of the world* should also be restricted to transfers with the specific objective of financing capital formation by non-resident units. They include, for example, unrequited transfers for the construction of bridges, roads, factories, hospitals or schools in developing countries, or for constructing buildings for international organisations. They may comprise instalment payments over a period of time as well as single payments. This heading also covers the supply of fixed capital goods free of charge.

4107. In the system of accounts, investment grants are recorded:

- among uses in the capital account (C 5) of general government
- among resources in the capital account (C 5) of the sectors receiving the grants
- among uses and resources in the capital account (C 5) of the rest of the world

Capital taxes (R 72)

4108. Definition: Capital taxes are compulsory payments levied by general government at irregular intervals on the capital or wealth of institutional units.

4109. Capital taxes include:

a) inheritance taxes, death duties and taxes on gifts inter-vivos, which are deemed to be levied on the capital of the beneficiaries
b) occasional and exceptional levies on capital or wealth([2]).

4110. In the system of accounts, capital taxes are recorded:

- among uses in the capital account (C 5) of the sectors in which the tax payers are classified
- among resources in the capital account (C 5) of general government
- among uses and resources in the capital account (C 5) of the rest of the world.

Other capital transfers (R 79)

4111. Definition: Other capital transfers (R 79) cover transfers other than investment grants and capital taxes which do not themselves redistribute income but redistribute saving or wealth among the different sectors or subsectors of the economy or the rest of the world.

([1]) Investment grants within general government are flows internal to the general government sector and do not appear in a consolidated account for the sector as whole.

([2]) However, capital gains taxes are shown in the accounts under the heading current taxes on income and wealth (see 459 c).

CHANCELLOR OF THE EXCHEQUER

Ch.

The main aim of this meeting is to cheer up the troops. They have put a lot of work into developing the analysis of how you should set the PSBR in the long term; they know you are sceptical; you said so publicly at the TCSC; but they haven't had a chance to argue their case with you.

I'm sure Terry & Peter wouldn't mind if you made Odling Smee & Riley do a fair amount of the talking.

They've had 2 long sessions with you – & these will be in on the Chevening discussions.

It is a pity that the CST couldn't come – we did try hard to find a time that would suit him, without success. But, given the purpose of the meeting, I thought it better to have it now, than wait till a more convenient time after Xmas.

Odling-Smee has provided an annotated agenda. There is also a further note from Terry & Pete which you have not seen.

RL 18/12

P.S.

The Economist's latest analysis is quite elegant. The slightly irritating feature of this debate is the impression it creates of pulling up the MTFS by the roots every year. To make any operational sense of latest thinking, it would help to know how it relates to the long term framework used to set the MTFS numbers after the election. That would help me decide whether it is sensible to treat the MTFS as a starting point. (Of course, in practice it is quite different now is, since expectations are heavily conditioned by the numbers we know many of).

I don't mean this is all intellectual woolliness. In fact, our early thinking about fiscal policy was heavily £M3-centred. The loss of faith in broad money has left something of an intellectual vacuum, which was becoming a problem even when I worked in this area. Since at least 1982 we (& others) have been groping to fill it. I still don't think we've got an analysis that properly integrates fiscal and monetary policy – that's at the root of a lot of Peter's instinctive dissatisfaction

ODLING-SMEE 18/12

15/2261

FROM: J ODLING-SMEE

DATE: 18 December 1985

CHANCELLOR OF THE EXCHEQUER

cc Financial Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Butler
Mr Cassell
Mr Scholar
Mr Riley
Mr Lord
Mr Davies

FISCAL POLICY IN THE LONG TERM

You are holding a meeting on this tomorrow. Although a number of papers on this subject have been prepared over the last year or two, Sir Peter Middleton and Sir Terence Burns have agreed that the only papers that need be in front of the meeting are those exchanged between them with the titles: "Balance sheet issues: The PSBR and the MTFS." There are three such minutes.

Burns to Middleton, 29 November

Middleton to Burns, 6 December

Burns to Middleton, 18 December

Copies of the first two are attached.

2. The main questions arising out of this exchange of minutes are set down in the attached pages. These might be helpful for structuring the discussion.

JOS

J ODLING-SMEE

30/2261

CONFIDENTIAL

1. Inflation and the mix of fiscal and monetary policies

- Are different mixes of fiscal and monetary policy consistent with any given objectives for money GDP growth or inflation?

- Is the link between monetary policy and inflation unique, or does it also depend on other factors (eg. the fiscal stance, world economic developments)?

2. The choice between different policy mixes

Assuming that, for given money GDP or inflation objectives, a choice exists, how much weight should be attached to the following factors:

- the size of the fiscal adjustment and hence the scope for tax cuts

- the impact of a different mix on the economy in the short to medium term (eg. effects on: output/inflation split, wage moderation, current account, relative financial positions of different sectors - personal, tradeable goods, non-tradeable goods, etc.)

- long-term pressures from different policy mixes (eg. effects on capital accumulation, both domestic and overseas, and on balance between present and future consumption; sustainability of present tax rates and expenditure levels)

- impact of different policy mixes on expectations?

3. Long-term issues

- Does the balance sheet approach (ie. comparing borrowing with increases in net assets) provide a helpful way of assessing long-term pressures (as in private sector accounts)?

- What supplementary information might be helpful (eg. level of real interest rates, accumulation of overseas assets, calculations of sustainability of present tax rates and expenditure levels)?

CONFIDENTIAL

4. Current and capital expenditure

(public?)

- Would there be more total expenditure if borrowing was more clearly related to net capital expenditure (eg. because investment appraisals are inevitably rather judgemental)?

- Do measurement problems (eg. depreciation) make any link between borrowing and capital expenditure too unreliable in practice?

CONFIDENTIAL

FROM: T BURNS

DATE: 18 December 1985

SIR PETER MIDDLETON

cc Chancellor
Financial Secretary
Mr F E R Butler
Mr Cassell
Mr Scholar
Mr Spackman
Mr Turnbull
Mr Riley
Mr M Williams
Mr Pratt
Mr Lord
Mr H Davies

BURNS → MIDDLETON 18/12

BALANCE SHEET ISSUES: THE PSBR AND THE MTFS

Thank you for your minute of 6 December commenting on mine of 29 November. I think it helps to clarify some of the disagreement.

2. I divide this note into two parts. One sets out what I think are misinterpretations on your part of my case. The second part comments on some of your own views.

Clarifying my note

3. It is clear that I still have not managed to set out some of my views unambiguously.

4. There are a number of hints in your minute (eg paragraph 15) that the approach I outlined would involve inflationary policies. This is not the case.

5. We are not suggesting that monetary and financial policies should be any less sound than they have been. Rather we are concerned with ways of choosing the best policy from within the whole class of sound policies.

6. Nor are we suggesting that there should be more capital expenditure (your paragraph 6), and certainly not that there should be excessive investment, in the sense of marginal investment projects not being "worthwhile". The emphasis in my note is with ways of financing a given amount and structure of expenditure. It is conditional on that expenditure being set in a rational way. To argue for more capital expenditure in order "to justify present - and indeed higher - levels of borrowing" would be quite irrational.

7. My minute does not imply any reluctance to privatise (your paragraph 9). Whether to sell or not should be decided on efficiency grounds. My argument was directed to the question of what to do with the proceeds. It does not in any way discourage privatisation, even where the assets are earning income.

8. Although we look at the balance sheet of the public sector, this is because of the implications that it holds for the Government's impact on the economy as a whole, and not for its impact on the public sector alone. I do not agree with your distinction between the whole of the UK and the public sector. Public sector finance is important because of the interaction between the public and private sectors.

9. It is true that there are expenditures which are classified as current expenditures but which create future returns (your paragraph 4). The fact that this is very difficult to take into account quantitatively is not an argument for not trying to deal with those issues that can be handled. The best should not be the enemy of the good.

10. You say that neither capital nor current expenditure is more likely to add to the growth of future GDP than the other (paragraph 5). While there may be individual cases that prevent there being a neat equivalence between capital expenditure and future GDP, it is surely the case that "worthwhile" capital expenditure - properly defined - contributes more to future GDP than most current expenditure (eg pensions, other transfers, etc).

11. You argue that private sector investment differs from public sector investment because it is more lumpy (paragraph 4). The implication is that, in cases where the private sector is not lumpy - eg large companies in sectors not much affected by the business cycle, the distinction between current and capital expenditure is not helpful. I do not agree with that. Moreover, public sector investment is lumpy, even when considered gross of asset sales: it has declined markedly over the last decade or so.

Your views

12. Essentially I agree with your own views about how the PSBR should be set (paragraphs 11-14). If I have understood you correctly, you are saying that the choice between alternative mixes of fiscal and monetary policy for given money GDP growth or inflation objectives should be based on what they imply about interest rates. ‖??!

13. That is essentially what we are also saying. But we try to take the analysis further by providing a framework for deciding when interest rates are "too high". In particular, we take account of the role of interest rates in influencing the balance between investment and consumption. We have tried to illustrate how this expanded framework can handle asset sales, North Sea revenues, capital expenditure, unfunded pension liabilities, etc.

14. The challenge as I see it is to integrate a longer-term intertemporal dimension with the more familiar shorter-term approach to macro-economic policy.

15. Finally I am doubtful whether the object of economic policy is the highest sustainable rate of non-inflationary growth in GDP (your paragraph 3). If it were, one would expect to see less borrowing and more financing out of taxation for any given level of expenditure. Surely the object of policy is the optimal distribution of welfare over time, which would give due weight to present requirements as well as to future ones. I see the concern with the balance sheet as an attempt to achieve that. (h?

V. Howard

p.p. T BURNS

COVERING
SECRET

LORD TO CH/EX 18/12

FROM: R A L LORD

DATE: 18 DECEMBER 1985

cc. Chief Secretary
Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr H Evans
Mr Odling-Smee
Mr Scholar
Mr Turnbull
Miss Peirson
Mr Riley
Mr Cropper
Mr H Davies

Thanks. I wd like to have a go @ a variant of the 2nd version of this: see if you can find some way to fix up a session with Lord. (CST shd be present). N.

CHANCELLOR

PUBLIC SECTOR TRANSACTIONS: CAPITAL AND CURRENT

You asked for some further work on restoring the "line" between current and capital transactions in the FSBR. Attached is a table supplied by Miss Peirson showing how Table 6.5 of the FSBR might look for 1986-87, in summary form, on the basis you indicated.

2. Also attached is an alternative presentation of the numbers in which I have set out the table more on pre-1965 lines. Personally I find it rather easier to see what is happening under the alternative, but it may take up more space. In previous years we have given a breakdown for each row between central government, local government and public corporations (see table from FSBR attached). If this is included, when available, it would be necessary to put expenditure on one page and receipts on the facing page. It may or may not be possible to run 1985-86 and 1986-87 on the same two-page spread one above the other.

So do I

3. Both versions of the table include capital taxes under current receipts. This contrasts with the National accounts treatment but is partially supported by international guidelines such as the European System of Accounts which classifies CGT as current. A halfway house would be to include CTT receipts (which ETA regards as capital) under the financing of capital expenditure and CGT under current receipts. This would reduce the current surplus by about £0.7bn. and introduce a

1. Tyrie 2. Prof 3. pmp

NOTE OF A MEETING IN HM TREASURY ON
THURSDAY 19 DECEMBER AT 12 NOON

Present
Chancellor
Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Cassell
Mr Odling-Smee
Mr Scholar
Mr Riley
Mr Cropper
Mr Lord
Mr H Davies

FISCAL POLICY

The meeting discussed Mr Odling-Smee's annotated agenda of 18 December. The exchange of minutes between Sir Peter Middleton and Sir T Burns - "Balance sheet issues: The PSBR and the MTFS" - was also relevant.

Inflation and the mix of fiscal and monetary policies

2. Mr Odling-Smee argued that, since both fiscal and monetary policy affected the economy as a whole, different mixes of the two were in principle consistent with any given objective for monetary GDP or inflation. He doubted whether it made much difference whether monetary policy was defined in terms of monetary growth or interest rates.

3. In discussion the following points were made:-

(i) The range of feasible fiscal/monetary mixes was limited. The ratio of the stock of money to the stock of public sector debt could not be varied indefinitely without setting up strains; and the financial markets were likely to anticipate this and react accordingly.

(ii) Some countries clearly had more freedom to vary their fiscal/monetary mix than others; the United States had considerable room for manoeuvre because of the special position of the dollar, but it too faced long term constraints.

(iii) The link between money and prices was likely to be affected by the fiscal stance. For given monetary growth, a looser fiscal stance would raise the velocity of narrow money. The implications for broad money velocity were ambiguous; recent experience suggested that a higher PSBR and higher interest rates might depress velocity, even in the medium term. The sensitivity of velocity to fiscal policy was one reason why it was sensible to set <u>ranges</u> for monetary growth.

4. The Chancellor argued that the scope for varying the fiscal/monetary mix was more limited the more open the economy. The UK Government had considerable freedom to vary fiscal policy; its influence over real interest rates was very much less. Sir Terence Burns thought there were external constraints on fiscal policy too; but they operated over a longer time period, chiefly through the current account and market confidence. The combination of a higher PSBR and higher interest rates would also mean rising debt interest, adding to the PSBR and creating a potentially unstable situation.

5. The Chancellor accepted that there were limits on the extent to which fiscal policy could be varied, but commented that in the past higher PSBR's had often been associated with inflationary

finance. The market implications of a change in the policy mix would not necessarily be the same. Nevertheless market expectations were clearly an important consideration.

6. In discussion, it was argued that UK real interest rates were not completely determined by outside influences. Real interest rates did vary between countries and, with the exception of Japan, our real rates were clearly relatively high. The Chancellor attributed this in large part to the UK's inflationary track record, relative to Germany and Japan, over a long period of years. More recently doubts about the monetary framework had also helped to keep interest rates high. Sir T Burns noted that the UK had not experienced a greater degree of fiscal tightening than other countries; fiscal policy had been tightened here earlier, but other countries had made more progress recently.

7. Assuming that there was some scope to choose the fiscal monetary mix, it was agreed that the implications for wage bargaining, the relative financial positions of different sectors, and for the current account were all clearly relevant. Recent analysis suggested that effects on the output/inflation split were not very significant. The composition of fiscal policy also mattered.

Long term issues

8. Mr Odling-Smee said that recent work had focussed on longer term issues. No one claimed that the balance sheet approach provided clear cut answers; but he thought it was a useful way of summing up some important arguments.

9. Sir T Burns added that the balance sheet approach was not inconsistent with the original MTFS framework. The 1980 MTFS had started from monetary targets; the associated fiscal path was intended to allow targets to be achieved without putting "excessive

pressure" on interest rates. The balance sheet approach was an attempt to provide a framework for deciding when interest rates were too high. The relevant criteria included long term considerations as well as the more familiar short term ones. The sustainability of the fiscal stance was an important long term issue, given the likely profile of asset sales and North Sea oil production, and radical changes in SERPS.

10. Summing up, the Chancellor said he accepted these arguments up to a point. But the Government's strategy was for the medium term rather than the long term. If it was successful over this horizon, the effect on expectations and the performance of the economy would broaden the range of available choices.

RL.

RACHEL LOMAX
20 December 1985

Distribution

Those present
PS/CST
PS/FST
PS/EST
PS/MST
Mr Peretz
Mr Sedgwick

new line in the bottom right section of the table. I do not see any presentational advantage in this, but I make the point in case you feel that it might make the new style table more acceptable to those who take an interest in these things.

4. Miss Peirson makes the following points

(i) the 1986-87 forecast figures used are based on the autumn forecast and will be (perhaps considerably) revised in the current forecasting round;

(ii) the expenditure Reserve for 1986-87 is fully allocated to the individual economic categories, so as not to distort the current surplus and total capital expenditure; a separate submission will be put forward during January concerning the question whether, in the 1986 FSBR, the Reserve should be thus allocated (as it was in the 1984 FSBR) or not (as in the 1985 FSBR);

(iii) the financial deficit is reinstated, as in the previous published versions (but unlike the versions of table 6.5 put to you on 25 and 26 November): since international organisations and some UK commentators favour the financial deficit it is helpful to them and to us if we publish our forecast of the deficit.

RL

R A L LORD

PUBLIC SECTOR TRANSACTIONS 1986-87 : SUMMARY

TABLE 6.5: PUBLIC SECTOR TRANSACTIONS

	Line	£bn
		(Autumn forecast for 1986-87)
CURRENT TRANSACTIONS		
Current expenditure		
Current expenditure on goods and services[1]	1.	- 73.1
Subsidies	2.	- 7.9
Current grants to personal sector	3.	- 49.8
Current grants paid abroad	4.	- 2.3
Current grants within public sector	5.	-
Debt interest	6.	- 18.9
Total current expenditure	7.	- 152.0
Current receipts		
Taxes on income	8.	52.6
Taxes on expenditure	9.	60.9
Taxes on capital	10.	2.1
NICs, etc	11.	26.2
Gross trading surplus	12.	8.0
Rent and oil royalties etc	13.	5.3
Interest and dividends from private sector & abroad	14.	4.6
Interest and dividends within public sector	15.	-
Miscellaneous current transfers	16.	0.3
Imputed non-trading capital consumption	17.	2.4
Total current receipts	18.	162.4
Current surplus	19.	+ 10.4
CAPITAL TRANSACTIONS		
Capital expenditure		
Gross domestic fixed capital formation[2]	20.	- 18.8
Increase in stocks	21.	- 0.3
Capital grants to private sector (net)	22.	- 2.6
Capital grants within public sector	23.	-
Total capital expenditure	24.	- 21.7
FINANCIAL DEFICIT (line 19 - line 24)	25.	- 11.3
FINANCIAL TRANSACTIONS		
Net lending to private sector and abroad	26.	- 0.1
Cash exp. on company securities (net)	27.	+ 4.8
Transactions concerning pension schemes (net)	28.	+ 0.5
Accruals adjustments	29.	- 0.5
Miscellaneous financial transactions	30.	- 1.0
Borrowing requirement[3]	31.	7.7

20.3

6L?

(1) Excludes defence capital expenditure (2) Includes defence capital expenditure

(3) Lines 26 + 27 + 28 + 29 + 30 + 31 = - line 25

SECRET

TABLE 6.5: PUBLIC SECTOR TRANSACTIONS
(Autumn forecast for 1986-87)

Make it a new table 6.6

	£bn.
Current expenditure	
Current expenditure on goods and services	73.1
Subsidies	7.9
Current grants to personal sector	49.8
Current grants paid abroad	2.3
~~Current grants within public sector~~	~~-~~
Debt interest	18.9
Total current expenditure	152.0
Capital expenditure	
Gross domestic fixed capital formation	18.8
Increase in stocks	0.3
Capital grants to private sector (net)	2.6
~~Capital grants within public sector~~	~~-~~
Total capital expenditure	21.7

	£bn.
Current receipts	
Taxes on income	52.6
Taxes on expenditure	60.9
Taxes on capital	2.1
NICs etc	26.2
Gross trading surplus	8.0
Rent and oil royalties etc	5.3
Interest and dividends from private sector and abroad	4.6
~~Interest and dividends within public sector~~	~~-~~
Miscellaneous current transfers	0.3
Imputed non-trading capital consumption	2.4
Total current receipts	162.4
Current surplus	**10.4**
Capital expenditure financed by	
Current surplus	10.4
Privatisation receipts and other cash expenditure on company securities (net)	4.8
Pension scheme transactions (net)	0.5
Net lending to private sector and abroad	-0.1
Accruals adjustments	-0.5
Miscellaneous financial transactions	-1.0
Borrowing requirement	7.7
	21.7

?

20.3

Eh?

!

Scrap [illegible] them!

What are these

Memo item: financial deficit* 11.3

* Total capital expenditure less current surplus

PUBLIC SECTOR TRANSACTIONS 1986-87

FSBR TABLE

Table 6.5 Public sector transactions(1) by sub-sector and economic category

£ billion

1984–85 Latest estimate

	Line(2)	General government: Central govern-ment	General government: Local author-ities	General government: Total(3)	Public corpora-tions	Public sector
Current and capital receipts						
Taxes on income(4)	*1*	48·1	—	48·1	−0·1	48·0
Taxes on expenditure(4)	*2*	39·8	12·8	52·6	—	52·6
Taxes on capital(4)	*3*	1·8	—	1·8	—	1·8
National insurance, etc. contributions	*4*	22·7	—	22·7	—	22·7
Gross trading surplus	*5*	−0·4	0·3	−0·1	6·5	6·4
Rent and oil royalties etc.	*6*	2·7	2·8	5·6	0·6	6·1
Interest and dividends from private sector and abroad	*7*	2·1	0·6	2·7	1·0	3·7
Interest and dividends within public sector	*8*	4·8	−2·3	2·5	−2·5	—
Imputed charge for non-trading capital consumption	*9*	0·9	1·4	2·3	—	2·3
Capital transfers from private sector	*10*	—	—	—	0·2	0·2
Total	*11*	**122·6**	**15·7**	**138·3**	**5·6**	**143·9**
Current and capital expenditure						
Current expenditure on goods and services(5)	*12*	−44·1	−27·3	−71·4	—	−71·4
Subsidies	*13*	−5·7	−1·3	−7·0	—	−7·0
Current grants to personal sector	*14*	−39·8	−3·7	−43·5	—	−43·5
Current grants paid abroad	*15*	−2·4	—	−2·4	—	−2·4
Current grants within public sector	*16*	−20·2	20·2	—	—	—
Debt interest	*17*	−14·8	−1·7	−16·5	−0·5	−17·0
Gross domestic fixed capital formation	*18*	−2·8	−3·1	−6·0	−6·9	−12·9
Increase in stocks	*19*	−0·2	—	−0·2	0·1	—
Capital grants to private sector	*20*	−2·3	−1·1	−3·5	—	−3·5
Capital grants within public sector	*21*	−0·8	0·2	−0·5	0·5	—
Unallocated Reserve	*22*	—	—	—	—	—
Total	*23*	**−133·1**	**−17·9**	**−151·0**	**−6·8**	**−157·8**
Financial surplus/deficit(6)	*24*	**−10·6**	**−2·1**	**−12·7**	**−1·2**	**−13·9**
Financial transactions						
Net lending to private sector and abroad	*25*	−0·2	0·1	−0·1	—	−0·1
Cash expenditure on company securities (net)	*26*	2·0	—	2·0	0·3	2·3
Transactions concerning certain public sector pension schemes	*27*	0·5	—	0·5	—	0·5
Accruals adjustments	*28*	1·1	—	1·1	—	1·1
Miscellaneous financial transactions	*29*	0·4	−0·4	−0·1	−0·4	−0·5
Borrowing requirement(7)	*30*	**6·8**	**2 4**	**9·2**	**1·3**	**10·5**

(1) Sign convention: receipts positive, payments negative.

(2) Relationship between lines: Current balance = sum of lines (1), (2), (4) to (9), (12) to (21) and part of (22)
(24) = (11) + (23) = − {(25) to (30)}.

Outturn data

6.17 Outturns for the PSBR, and for the detailed central government transactions as in Tables 6.6 to 6.9, are compiled monthly and published by press notice 12 working days after the end of the month and then in more detail in Tables 2.5 and 3.12 to 3.16 of the following issue of *Financial Statistics*. Outturns for the details of the PSBR on national accounts definitions, as in Tables 6.2 to 6.5, are compiled quarterly and published in Sections 2 to 5 of *Financial Statistics* three months after the end of the quarter. The first national accounts outturns for 1984–85 will appear in the June issue of *Financial Statistics*, including Supplementary Table 13 which is based on Table 6.5 above.

	Line(2)	1985–86 Forecast: General government: Central government	Local authorities	Total(3)	Public corporations	Public sector (£ billion)
Current and capital receipts						
Taxes on income(4)	*1*	53·2	—	53·2	−0·3	52·9
Taxes on expenditure(4)	*2*	42·2	13·6	55·8	—	55·8
Taxes on capital(4)	*3*	1·9	—	1·9	—	1·9
National insurance, etc. contributions	*4*	24·6	—	24·6	—	24·6
Gross trading surplus	*5*	−0·4	0·4	−0·1	7·6	7·6
Rent and oil royalties etc.	*6*	2·6	3·0	5·6	0·6	6·2
Interest and dividends from private sector and abroad	*7*	3·0	0·7	3·7	1·0	4·7
Interest and dividends within public sector	*8*	5·3	−2·6	2·7	−2·7	—
Imputed charge for non-trading capital consumption	*9*	0·9	1·6	2·5	—	2·5
Capital transfers from private sector	*10*	—	—	—	0·2	0·2
Total	*11*	**133·2**	**16·7**	**150·0**	**6·5**	**156·5**
Current and capital expenditure						
Current expenditure on goods and services(5)	*12*	−46·3	−27·6	−73·9	—	−73·9
Subsidies	*13*	−4·7	−0·8	−5·5	—	−5·5
Current grants to personal sector	*14*	−42·1	−3·9	−46·0	—	−46·0
Current grants paid abroad	*15*	−2·4	—	−2·4	—	−2·4
Current grants within public sector	*16*	−20·4	20·4	—	—	—
Debt interest	*17*	−16·4	−1·6	−18·0	−0·5	−18·5
Gross domestic fixed capital formation	*18*	−3·1	−2·6	−5·7	−6·1	−11·8
Increase in stocks	*19*	−0·1	—	−0·1	−0·3	−0·4
Capital grants to private sector	*20*	−2·2	−0·6	−2·8	—	−2·8
Capital grants within public sector	*21*	−0·9	0·4	−0·5	0·5	—
Unallocated Reserve(8)	*22*	*−3·6*	*−1·3*	*−4·9*	*−0·1*	−5·0
Total	*23*	*−142·2*	*−17·6*	*−159·9*	*−6·4*	**−166·3**
Financial surplus/deficit(6)	*24*	*−9·0*	*−0·9*	*−9·9*	*0·1*	**−9·8**
Financial transactions						
Net lending to private sector and abroad	*25*	−0·1	0·1	−0·1	—	−0·1
Cash expenditure on company securities (net)	*26*	2·5	—	2·5	0·1	2·6
Transactions concerning certain public sector pension schemes (net)	*27*	0·2	—	0·2	—	0·2
Accruals adjustments	*28*	0·2	—	0·2	—	0·3
Miscellaneous financial transactions	*29*	0·5	−0·7	−0·2	0·1	−0·1
Borrowing requirement(7)	*30*	*5·8*	*1·5*	*7·3*	*−0·2*	**7·1**

(3) General government expenditure in Tables 2.2, 2.4, 5.2 and 5.4 = (23) + (25) + (26) + public corporations' borrowing from central government (Table 6.4). General government receipts in Tables 2.3 and 2.4 = (11) + (27) + (28) + (29).

(4) Lines (1) + (2) + (3), first column = first line of Table 6.2 = central government taxation in national accounts terms. It includes, besides Consolidated Fund taxation receipts (see footnote (7) to Table 6.8), the gas levy, accruals adjustments and VAT paid by but refunded to local authorities and government departments, as well as some other small items. The first line of Table 2.3 also includes oil royalties and local authorities' rates.

(5) Including non-trading capital consumption.

(6) The balance of receipts and expenditure, financed by net borrowing/lending shown in lines (25) to (30).

(7) Borrowing by central government on own account and total borrowing by local authorities and public corporations. Borrowing by local authorities and public corporations from central government is shown in Tables 6.3 and 6.4.

(8) Expenditure estimates for 1985–86 in lines (12) to (21) are based on the programme plans in Cmnd. 9428, plus the Budget measures. The £5 billion Reserve in line (22) has been notionally allocated to the central government, local authorities and public corporations sectors, pro rata to the programme plans for those sectors. This notional allocation carries no implications for the degree to which the Reserve will actually be spent in those sectors. The allocation and the resulting totals, both in this and in earlier tables, are therefore shown in italics.

FROM: MRS R LOMAX

DATE: 3 January 1986

SIR PETER MIDDLETON

cc: PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir T Burns
Mr Cassell
Mr Monger
Mr Scholar
Miss Sinclair
Mr G P Smith
Mr Pratt

PS/IR
PS/C&E

FSBR: PRESENTATION OF TAX CHANGES

The Chancellor has seen Miss Sinclair's minute of 22 November. In your note of 6 December, you recommended that we should go for the presentation in Annex E (without the column headed "Impact on liabilities in a full year") for table 4.2 of the FSBR, with corresponding changes to table 1.1. The Chancellor broadly agrees with this conclusion.

He has commented that for score card purposes we will, as usual, need to see both first and second year revenue effects, calculated against an indexed base. In the few cases where these are wildly different from the full year cost, this should be recorded in the supplementary notes.

RL.

RACHEL LOMAX

093

RL
TO
LORD
3/1

Fix meeting

FROM: MRS R LOMAX

DATE: 3 January 1986

MR LORD

cc: Chief Secretary
Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr H Evans
Mr Odling-Smee
Mr Scholar
Mr Turnbull
Miss Peirson
Mr Riley
Mr Cropper
Mr H Davies

PUBLIC SECTOR TRANSACTIONS: CAPITAL AND CURRENT

The Chancellor was grateful for your minute of 18 December. He is attracted to your alternative presentation (or a variant on it). He will be holding a brief meeting to discuss shortly.

RL

RACHEL LOMAX

2385/039

Pps

ECONOMIC SECRETARY TO THE TREASURY

Ch

This would be my interpretation too – but we'd put the full year figures in footnotes, when they were interesting (as well as possibly in the Budget speech)

The new presentation would remove the obligation to present full year figures in all cases (with the implication that they can be totalled)

R 14/1

PPS

FROM M J NEILSON
DATE 7 January 1986

cc Sir P Middleton
PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State
Sir T Burns
Mr Cassell
Mr Monger
Mr Scholar
Miss Sinclair
Mr G P Smith
Mr Pratt
PS/IR
PS/C&E

FSBR: PRESENTATION OF TAX CHANGES

The Economic Secretary has seen your minute of 3 January; Sir Peter Middleton's minute of 5 December did not reach this office.

2. The Economic Secretary has asked whether the second paragraph of your minute means that full year figures will not be published anywhere. He considers that there is a case for publishing full year figures in those situations where they form the basis of the case presented to Parliament. One example of this is the accrued income scheme which was justified in terms of the full year impact of £300 million.

M J NEILSON

RR7.56

pwp

FROM: MRS R LOMAX
DATE: 15 January 1986

cc Sir P Middleton
PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State
Sir T Burns
Mr Cassell
Mr Monger
Mr Scholar
Miss Sinclair
Mr G P Smith
Mr Pratt
PS/IR
PS/C&E

PS/ECONOMIC SECRETARY

FSBR: PRESENTATION OF TAX CHANGES

The Chancellor has seen your minute of 7 January asking whether full year figures will be dropped altogether in the proposed new presentation. The Chancellor's view was that full year figures should appear in footnotes where they were particularly interesting, as well as possibly in the Budget speech. The point of the new presentation is to remove the <u>obligation</u> to present full year figures in <u>all</u> cases, with the implication that they can be totalled.

RL

RACHEL LOMAX

CONFIDENTIAL

1. ~~Raclet~~
~~(checked by Margaret Peirson)~~

2. ~~B/f with further note (or 22/1)~~

~~b/f 11/2~~

~~12/2~~

20/2

4/2

NOTE OF A MEETING HELD IN HM TREASURY ON WEDNESDAY 15 JANUARY 1986

Those present: Chancellor of the Exchequer
Chief Secretary
Sir T Burns
Mr F E R Butler
Mr Odling Smee
Mr Turnbull
Mr Scholar
Miss Peirson
Mr Lord

PUBLIC SECTOR TRANSACTIONS: CAPITAL AND CURRENT

The meeting discussed Mr Lord's minute of 18 December and the draft table attached to that note. It was agreed that Mr Lord's proposed table should be presented as a summary table - perhaps in Part 1 of the FSBR - in addition to the existing table 6.5. It was not a replacement for the present table 6.5. The two questions for discussion were therefore:

a. Did the balance of advantage lie in publishing something on these lines?

b. How could the table be simplified?

Publish a summary table?

3. Mr Butler was concerned that the table did not convey any particular message - and that people would try to read one into it. Mr Turnbull said it might lead to pressure for historical data on these lines, which would show the current surplus on a declining

trend. Sir T Burns said it was important not to claim too much for the new table. On the other hand, the following points were made:

a. There was considerable interest, in Parliament and elsewhere, in this information.

b. Whatever the trend, the table would show the present position to be better than many imagined.

c. To do nothing would suggest either that there was something to hide, or that the Government was indifferent to the distinction between current and capital.

d. What was now table 1.14 in the Public Expenditure White Paper (formerly table 1.13) had been a worthwhile improvement - and this new table, on the same basis, would bring the FSBR into line.

e. The table did not contain any information which the TCSC and others could not obtain now.

f. The information concerning the current surplus etc had only been dropped from table 6.5 for the past two years to avoid complexity.

4. Summing up this discussion, the Chancellor said that the balance of advantage clearly lay in publishing a summary table, in addition to the existing table 6.5. The meeting then turned to ways in which the draft table could be simplified.

Simplification

5. The following changes were agreed to the table attached to Mr Lord's note:

a. <u>Current expenditure</u>. Delete "current grants within public sector". Amalgamate the 3 remaining lines for subsidies and grants.

b. <u>Current receipts</u>. Amalgamate the first three lines as "taxes". Delete "etc" after "NICs", and add a footnote to explain what was included here. Amalgamate everything else as "other".

c. <u>Capital expenditure</u>. Delete "capital grants within public sector". Gross up "gross domestic fixed capital formation" with respect to council house and other asset sales, to bring it into line with table 1.14 of the PEWP. Those asset sales should be added to "Capital expenditure financed by".

d. <u>"Capital expenditure financed by"</u> The second line should be labelled simply "privatisation receipts" with a footnote to explain the remainder. The next four items should be amalgamated as "other". (It was arguable that "net lending" should be transferred to "Capital expenditure"; but it was very small and, if it were transferred, the derivation of the financial deficit would no longer be clear.)

6. It was agreed that the table should not be accompanied by a text to explain its purpose or significance.

7. Miss Peirson was asked to provide a revised table in the light of discussion.

A W KUCZYS

Copied to: Those present
Sir P Middleton

Mr H Evans
Mr Riley
Mr Cropper
Mr H Davies

13/024

CPS

FROM: MRS R LOMAX

DATE: 16 January 1986

MR H P EVANS

cc Sir P Middleton
Sir T Burns
Mr Butler
Mr Scholar
Mr Turnbull

WINTER FORECAST: POLICY ASSUMPTIONS

The Chancellor was grateful for your minute of 10 January. He has no comments on your proposed assumptions.

RL.

RACHEL LOMAX

CONFIDENTIAL

FROM: H P EVANS
DATE: 10 January 1986

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr Butler
Sir G Littler
Mr Cassell
Mr Kemp
Mr Monck
Mr Monger
Mr Odling-Smee
Mr Peretz
Mr Scholar
Mr Turnbull
Mr Davies
Mr Mowl
Miss Peirson
Mr Cropper
Mr Lord
Mr H Davies

WINTER FORECAST: POLICY ASSUMPTIONS

I attach a note on the policy assumptions we propose for the winter forecast now under way. The assumptions, which have been agreed in PCC, are broadly the same as in earlier forecasts.

2. Circulation of the forecast reports is scheduled for January 31: a note on preliminary indications of the forecast is being circulated separately today.

HPE

H P EVANS

hpe64b

POLICY ASSUMPTIONS

CONFIDENTIAL

POLICY ASSUMPTIONS FOR THE WINTER FORECAST

Note by EA and PSF

The winter forecast is an internal exercise: an Industry Act Forecast will be published in the FSBR. In general, the approach is to base the forecast on the macro policies set out in the 1985 MTFS.

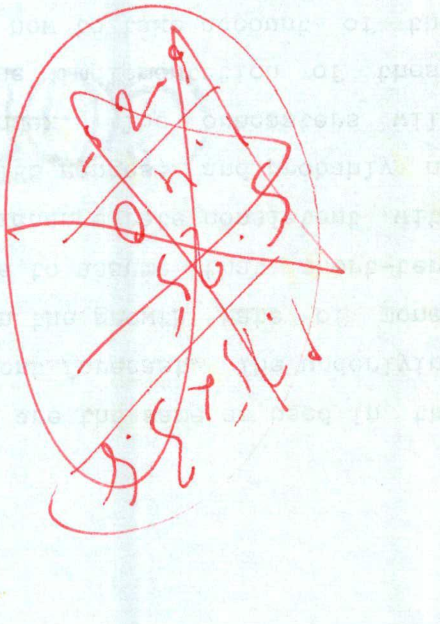
Monetary policy

2. The assumptions proposed for monetary policy are the same as used in the internal autumn forecast and in the Autumn Statement forecast. The underlying gim is assumed to be to exert downward pressure on the growth rate of money GDP, broadly as assumed in the MTFS. We propose to assume that short-term interest rates are set so as to keep M0 and the exchange rate consistent with this. This will involve keeping M0 within its MTFS ranges; and probably no major changes from year to year in the sterling index. The forecasters will consult Sir Terence Burns and Mr Cassell over the implementation of these assumptions in the new forecast and in particular how to take account of the growth of broad money.

3. The PSBR will be assumed to be broadly fully funded over each financial year as a whole, including 1985-86, with no significant under or over funding. £M3 and other measures of broad money will be forecast on this basis. We propose to assume no change in the national savings target of £3 billion in future years (though if the target were raised to, for example, £3½ billion for 1986-87, the forecast would be little affected).

Fiscal policy

4. For 1986-87 the MTFS assumption for the PSBR was 2 per cent of GDP, or £7½ billion; for 1987-88 and 1988-89 it was 1¾ per cent (£7-7½ billion). Decisions on the appropriate path for the PSBR, taking into account a range of factors (such as the higher asset sales and lower oil revenues than assumed in the MTFS), will be taken at Budget time. At this stage it is

assumed that the PSBR ratios in the MTFS will be maintained for all years covered by the forecast; and that asset sales will be as in the public expenditure plans.

5. On these assumptions, the forecast will re-assess the scope for fiscal adjustments in 1986-87 onwards. By convention this is measured after revalorisation and is assumed to take the form of income tax cuts.

Public Expenditure

6. The starting point for the public expenditure forecast for 1986-87 onwards is the 1986 PEWP. To these programme plans (excluding the Reserves) will be added estimating and other changes.

7. The estimating changes will include overspends or underspends on all programmes, resulting from any estimates of higher take-up of demand-led programmes and any other pressures. The forecast will allow for realistic levels of local authority spending, in contrast to the flat cash provision in the plans. The forecast will also allow for the effects of different economic assumptions from those underlying the 1986 PEWP plans.

8. In particular, the forecast of public expenditure will take account of the outlook for inflation, unemployment, interest rates etc emerging from the main forecast - to the extent that these are different from the economic assumptions used in constructing the 1986 PEWP plans. Overall, **public service earnings** will be assumed to rise from now on at about the same rate as in the private sector, except for an addition to the teachers' salary bill of £1¼ billion spread over four years.

9. Other assumptions include:

(a) Local government current expenditure and finance. The present system (with rates and no targets) is assumed to continue until 1990. In recent years, grant as a percentage of total relevant expenditure (outturn, not provision) has fallen sharply, from 57 per cent in England in 1980-81 to around 46½ per cent in 1985-86 .The decisions about grant in 1986-87, together with a preliminary forecast of expenditure, suggest a further small reduction in the grant percentage to under 46 per cent. For 1987-88 and beyond, it is proposed to assume no further change in grant as a percentage of forecast total relevant expenditure: that will probably imply moderate increases in the real level of grant, and annual rises in local authority rates rather above the general rate of inflation.

(b) Local government capital. New regime for controls on gross expenditure begins in 1988-89.

(c) Nationalised industries. Energy prices are mostly expected to fall in real terms in 1987-88 and 1988-89 (following increases in 1986-87) as a result of the fall in oil prices. Water prices are assumed to rise in real terms. No other real price increases after 1986-87 are assumed. We assume that efforts to stay within EFLs will be made, taking the form of modest cuts in investment, and efficiency savings. Even so, the resulting external financing requirements of the industries seem likely to exceed the 1986 PEWP plans. British Airways is assumed to be sold in 1986Q2 and British Gas in 1986Q3.

10. The overall forecast of public expenditure will show whether the Reserves in the 1986 PEWP are expected to be sufficient to cover the likely total of claims. The autumn forecast pointed to the likelihood of claims exceeding the Reserve in both 1987-88 and 1988-89.

Revenues

11. It is proposed to assume that pension policy will be as in the Social Security White Paper, with minimal short-term effect. No changes in National Insurance contribution rates are assumed in April 1987.

Variant

12. We propose to include in the report a variant on oil prices, with policy assumptions the same as in the Powell/Horton working paper: non-accommodating monetary policy and unchanged tax rates (and so a different PSBR).

at some stage, you'll presumably want to see a variant or this variant where some of the PSBR effect is absorbed by higher petrol & derv. This is a reasonable starting point.

hpe4ob

NOTE OF A MEETING IN HM TREASURY
ON FRIDAY 7 FEBRUARY 1986 AT 4PM

Present:

Chancellor
Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Evans
Mr Odling-Smee
Mr Peretz
Mr Scholar
Mr Riley
Mr Cropper
Mr Lord
Mr H Davies

MEDIUM TERM FINANCIAL STRATEGY

Papers

Policy implications of January forecast: Sir T Burns, 6 February.

Issues for the 1986 MTFS: Sir T Burns, 6 February

Issues for the 1986 MTFS: Mr Odling-Smee, 7 February.

A range for money GDP: Mr Odling-Smee, 7 February.

Policy implications of the forecast

2. Sir Terence Burns said that the approach to the Budget was greatly complicated by considerable uncertainty about the likely course of oil prices, and about the effects of the major change that had already taken place. The appropriate response should be flexible enough to cope with a wide variety of circumstances, in the run-up to the Budget and thereafter. There were risks in both directions: in different circumstances, the

Budget could prove too tight or too loose. It would be wrong to take decisions on the basis of a single "best guess".

3. In recent years much effort had been devoted to analysing the possible implications of a sharp fall in oil prices; but the result should still be treated with caution. A large fall in the oil price was outside the experience on which conventional economic relationships were based. The effects of lower oil prices were not necessarily the obverse of the two previous sharp rises.

4. On balance, there were clear gains to industrial countries as a whole from lower oil prices. In the short term the UK's position would be relatively unaffected though there would be significant differences between and within various sectors of the economy. The longer term effects should be beneficial; with lower oil prices the adjustment to falling oil production would be smoother and easier to cope with.

5. Against this background, it was right to approach the Budget with caution, to be prepared for a wide variety of possible outcomes, and to create as much room for manoeuvre after the Budget as possible.

6. The Chancellor said he had reached very similar conclusions. The outlook was highly uncertain. While the sharp fall in oil prices had reduced the scope for tax cuts, it was not necessarily bad for the economy. The political mood was also right for a cautious Budget. It would be important to consider how the policy stance might subsequently be adjusted, if the assumptions on which the Budget was based proved wrong. He would prefer to be faced with a need to relax policy - either by cutting tax or reducing interest rates - rather than to tighten up.

7. Deliberate caution might be reflected in the assumptions chosen for oil prices or the PSBR - or a mixture of the two. In practice it would be very difficult to base the Budget figuring on an oil price which was significantly different from the prevailing price (spot or forward). A higher figure could easily look ridiculous; though it might be possible to go, say, $2 below the current price.

8. With oil prices around their current level ($17-18) he would be inclined to go for a PSBR of £7 billion (or perhaps a fraction under, for presentational reasons). It would be sensible to consider the scope for tax cuts within this figure on the assumption that oil prices might fall further - say to $15. At this stage, he would rule out tax increases; a very much lower oil price - $10-12 - would probably mean taking the strain on the PSBR. This did not seem very likely. At some stage oil prices could well rebound, and clearly the further the oil price fell, the smaller the risk of further falls.

9. In discussion, it was suggested that the correct response was to construct two parallel Budget packages consistent with a £7 billion PSBR, on different assumptions about oil prices. The existing package would still be feasible, with an oil price of around $20; but it would also be right to look at a much smaller package - of around a £¼ to £½ billion. In practice, especially with the OPEC meeting on Budget Day itself, circumstances were likely to point to the smaller package. But were the oil price to recover during the course of the Finance Bill, it might be possible to introduce additional measures from the existing Budget package.

10. The Chief Secretary stressed the difficulty of announcing further tax cuts once the public expenditure round was under way. The Chancellor agreed that it would be desirable to make any changes during the course of the Finance Bill.

11. It was agreed that:-

(i) the working assumption for the PSBR in 1986/87 should be £7 million - 1¾ per cent of GDP.

(ii) an alternative Budget package, of around £¼ billion, should be considered at the Overview meeting on Monday.

A range for money GDP

12. The Chancellor said that he wanted to give money GDP a higher profile in the 1986 MTFS. But he was convinced that having a target range for money GDP was not the way to do it. It might still be useful to publish some of the information about variability, and the extent of data and forecasting errors.

Economic assumptions for the MTFS

13. After a brief discussion, the assumptions proposed in paragraphs 2 to 7 of Mr Odling-Smee's paper were approved.

14. The Chancellor said he would be reluctant to publish the sort of profile for the annual fiscal adjustment shown in the table in paragraph 17 of Mr Odling-Smee's note; but he noted that the size of the fiscal adjustment would depend on the oil price assumption, and no decisions could be taken yet.

15. It was provisionally agreed that the MTFS should assume a PSBR of 1¾ per cent of GDP in 1987/88, 1988/89 and 1½ per cent of GDP in 1989/90.

16. The Chancellor asked for a further note on the relationship between oil revenues and the PSBR; the TCSC would certainly ask how far oil revenues could be treated in the same way as other revenues, and what adjustments had been made to the PSBR to allow for the change in oil revenues. This would be important in presenting the PSBR profile in the MTFS, and in explaining

any subsequent adjustments, in the light of unexpected changes in oil prices.

Drafting the MTFS

17. The Chancellor said the underlying aim should be to reaffirm the importance of the MTFS. Money GDP was at the heart of the policy, though it could not be an operational target. He doubted whether it would be possible to describe the operation of monetary policy in any great detail in the MTFS itself; it would require a longer exposition and he was therefore considering making a major speech on the subject shortly after the Budget. He was quite attracted to moving the section on recent financial developments to Part III of the FSBR.

18. On the description of fiscal policy, the Chancellor doubted whether he would want to expand on his comment in last year's Budget Speech that there is nothing sacrosanct about the precise mix of fiscal and monetary policy; but he invited Mr Odling-Smee to prepare a draft for consideration. There should probably be some discussion of the implications for the appropriate PSBR path of North Sea oil revenues and asset sales, as in the past; but this need not be very elaborate. Discussion of the appropriate responses to unexpected developments might be better handled in the Budget Speech; he was not inclined to cover this ground in the MTFS.

19. It was agreed to use last year's format for the fiscal projections.

RL.

RACHEL LOMAX
11 February 1986

Distribution

Those present
Mr Sedgwick (or)
Mr Walsh

NOTE OF A MEETING IN HM TREASURY
ON FRIDAY 7 FEBRUARY 1986 AT 4PM

Present:
Chancellor
Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Evans
Mr Odling-Smee
Mr Peretz
Mr Scholar
Mr Riley
Mr Cropper
Mr Lord
Mr H Davies

MEDIUM TERM FINANCIAL STRATEGY

Papers

Policy implications of January forecast: Sir T Burns, 6 February.

Issues for the 1986 MTFS: Sir T Burns, 6 February

Issues for the 1986 MTFS: Mr Odling-Smee, 7 February.

A range for money GDP: Mr Odling-Smee, 7 February.

Policy implications of the forecast

2. Sir Terence Burns said that the approach to the Budget was greatly complicated by considerable uncertainty about the likely course of oil prices, and about the effects of the major change that had already taken place. The appropriate response should be flexible enough to cope with a wide variety of circumstances, in the run-up to the Budget and thereafter. There were risks in both directions: in different circumstances, the

Budget could prove too tight or too loose. It would be wrong to take decisions on the basis of a single "best guess".

3. In recent years much effort had been devoted to analysing the possible implications of a sharp fall in oil prices; but the result should still be treated with caution. A large fall in the oil price was outside the experience on which conventional economic relationships were based. The effects of lower oil prices were not necessarily the obverse of the two previous sharp rises.

4. On balance, there were clear gains to industrial countries as a whole from lower oil prices. In the short term the UK's position would be relatively unaffected though there would be significant differences between and within various sectors of the economy. The longer term effects should be beneficial; with lower oil prices the adjustment to falling oil production would be smoother and easier to cope with.

5. Against this background, it was right to approach the Budget with caution, to be prepared for a wide variety of possible outcomes, and to create as much room for manoeuvre after the Budget as possible.

6. The Chancellor said he had reached very similar conclusions. The outlook was highly uncertain. While the sharp fall in oil prices had reduced the scope for tax cuts, it was not necessarily bad for the economy. The political mood was also right for a cautious Budget. It would be important to consider how the policy stance might subsequently be adjusted, if the assumptions on which the Budget was based proved wrong. He would prefer to be faced with a need to relax policy - either by cutting tax or reducing interest rates - rather than to tighten up.

7. Deliberate caution might be reflected in the assumptions chosen for oil prices or the PSBR - or a mixture of the two. In practice it would be very difficult to base the Budget figuring on an oil price which was significantly different from the prevailing price (spot or forward). A higher figure could easily look ridiculous; though it might be possible to go, say, $2 below the current price.

8. With oil prices around their current level ($17-18) he would be inclined to go for a PSBR of £7 billion (or perhaps a fraction under, for presentational reasons). It would be sensible to consider the scope for tax cuts within this figure on the assumption that oil prices might fall further - say to $15. At this stage, he would rule out tax increases; a very much lower oil price - $10-12 - would probably mean taking the strain on the PSBR. This did not seem very likely. At some stage oil prices could well rebound, and clearly the further the oil price fell, the smaller the risk of further falls.

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RL.

RACHEL LOMAX
11 February 1986

Distribution

Those present
Mr Sedgwick (or)
Mr Walsh

EMPLOYMENT AND ENTERPRISE MEASURES: PRESENTATION IN FSBR

F.E.R.B. To CH/EX 13/2

EEM

FV

COPY NO 1 OF 25

FROM: F. E. R. BUTLER
13th February, 1986.

CHANCELLOR OF THE EXCHEQUER

c.c. Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P. Middleton
Sir T. Burns
Sir G. Littler
Mr. Cassell
Mr. Monck
Mr. A. Wilson
Mr. Scholar
Mr. Evans
Mr. Monger
Mr. Odling-Smee
Mr. Pratt
Mr. Cropper
Mr. Lord
Mr. H. Davies
Sir L. Airey, IR
Mr. Isaac, IR
Mr. Battishill, IR
Sir Angus Fraser, C & E
Mr. Knox, C & E

EMPLOYMENT AND ENTERPRISE MEASURES: PRESENTATION IN THE FSBR

I agree with the conclusions of the Central Unit note on the presentation of employment and enterprise measures.

2. Whether the employment and enterprise measures should be charged to the Reserve or added to public expenditure totals depends to some extent on their size. We will not be in a position to reach a final judgement on this until the Chief Secretary and you have concluded your discussions with Lord Young.

3. Provided that the measures are of moderate size and you are content with the way they can be presented in the Budget, there is a strong case for charging them to the Reserve, both on the general grounds I argued on Monday and because it looks odd to say that we cannot find room for measures costing £75 million or so out of a reserve of £4½ billion. It is

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precisely to accommodate small initiatives of this kind that we have a Reserve in the plans.

4. A similar argument applies to 1987-88. But there is a further argument in that case. At present the forecasts suggest that spending will exceed the plans by £2 billion in that year. It will be our objective in the 1986 Survey to stop that happening, either by restricting the excess spending or by persuading the Cabinet to make offsetting reductions. But since there is a risk that we might have to raise the 1987-88 planning total in the autumn, it would be better not to do so in the Budget as well.

F.E.R.B.

F. E. R. BUTLER

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Employment and enterprise measures: presentation in the FSBR

NOTE BY CENTRAL UNIT

Note by the Central Unit

X 1. Lord Young is proposing a package of employment and enterprise measures whose net public expenditure cost, excluding the proposals for extending the Community Programme, is £75 million in 1986-87 and £140 million in 1987-88. Officials are discussing scaled-down versions of all these measures (excluding, again, the Community Programme) whose net public expenditure cost would amount to £30-60 million in 1986-87 and around £90 million in 1988-89. The details are summarised in the notes to the scorecard and set out in full in Mr Monck's minute to the Chief Secretary of 10 February. — in separate folder.

SCOPE WITHIN THE RESERVE

2. The discussions have proceeded on the assumption that any such measures that are agreed will be financed from the public expenditure Reserve.

3. GEP's view of the public expenditure outturn coincides with the January forecast: both consider that the prospects for 1986-87 and 1987-88 are extremely tight. In 1986-87, the projected claims are expected to absorb fully the Reserve of £4½ billion. In 1987-88 the present signs are that, in the absence of offsetting policy measures, the planning total would be overspent by around £2 billion.

4. In constructing the forecast it was assumed that, in addition to estimating changes, £¾ billion would be added each year to departmental programmes through discretionary allocations and that any additional new employment measures would be found within this sum. The forecasters were working on the assumption that any such new measures might be £150 million (net public expenditure) in 1986-87. This assumption does not represent a policy view about the size of package that can be afforded, or that £150 million has been budgeted for and that anything up to this figure can be accommodated without worsening the picture shown by the forecast. The £150 million should be seen in effect as a charge on this separate (notional) component of the Reserve; the more that is spent in this area the less can be accommodated on other measures or demands that arise during the year.

It true X ?

5. Given this prospect could a package of £75 million in 1986-87 and £140 million in 1987-88 be accommodated within the planning total? In relation to the size of the planning total or even of the size of the Reserve, and the accuracy with which either can be forecast

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or controlled the figures are not large. It would be odd to say publicly in March, even before the start of the financial year, that a Reserve of £4½ billion which we have hitherto argued is fully realistic, is so much under pressure that even another £75 million cannot be accommodated and that the planning total should be raised.

6. We cannot, therefore, argue in relation to 1986-87 that the introduction of such a package clearly takes us past the point where the Reserve cannot cope. For 1987-88 the addition of such a package is unlikely to make the difference between hitting the target and missing it; if the forecast is right the effect is more likely to be that of adding further to an overshoot.

Presentation in the FSBR

7. This paper argues that, whether or not employment and enterprise measures are to be financed from the Reserve they can be given as much or as little prominence as is desired in the FSBR; in particular, they can be shown in the summary table in Part 1 of the FSBR whether or not they are financed from the Reserve and scored against the fiscal adjustment.

8. The presentation of expenditure measures in the summary table in Part 1 of the FSBR has varied substantially since 1980 (details are at Annex A). An analysis of the precedents shows:

(i) The summary table traditionally gives the direct revenue and/or public expenditure effect of individual measures or groups of measures, on the lines of Table 2 of the Scorecard. The overall PSBR/fiscal adjustment effect (ie the total shown in Table 1 of the Scorecard) is given in the text, but is not given in the FSBR summary table or broken down by individual measures.

(ii) Where there have been expenditure measures they have usually been included in the summary table (eg in 1980, 1981, 1982 - when the planning total was reduced - and 1985) but were not in 1983 (which was the only year in which all expenditure measures were charged to the Reserve and the planning total left unchanged).

(iii) Where expenditure measures have been included in the summary table, they have sometimes been shown in a separate part of the table from the tax measures (1980 and 1981); and sometimes shown in a more obviously combined table (1982 and 1985).

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(iv) Where expenditure measures have been shown in the summary table their effects have usually not been added to those of tax measures. The exception is 1985, when overall totals were given.

(v) Where expenditure measures have been charged to the Reserve, they have not previously been shown separately in the summary table.

TABLE 1
BUDGET 'A' BASIS

Charging employment measures to the Reserve

9. On this basis, the table might appear thus:

TABLE 1 on a Budget 'A' basis

	1986-87	1987-88
Tax Proposals		
(Changes from an indexed base)		
Income tax reductions	1875	2480
Capital tax reductions	45	150
Excise duties increase	700	780
Other tax changes	+5	+75
Total tax reductions from an indexed base	1215	1775
Effects of Indexation		
Income tax - revenue loss	1135	2405
Capital tax - revenue loss	20	65
Excise duties - revenue gain	800	1295
Total tax reductions	1570	2950
Expenditure Measures+		
Enterprise allowance	20	90
New Workers Scheme	25	50
Long term unemployed	110	90
Loan Guarantee scheme and other measures	Neg	15
Total expenditure increases	155	245
Offsetting reduction in social security benefits*	80	105
Net call on the Reserve	75	140

+assumes Lord Young's proposals for each measure.

*the benefit savings underlying the net public expenditure figures have not yet been agreed with DHSS.

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TABLE 1 on a Budget 'B' basis

	1986-87	1987-88
Tax Proposals (Changes from an indexed base)		
~~Income tax reductions~~	~~0~~	~~0~~
Capital tax reductions	45	150
~~Excise duties increase~~	~~0~~	~~0~~
Other tax changes	+5	+115
Total tax reductions from an indexed base	40	35
Effects of Indexation		
Income tax - revenue loss	1135	2405
Capital tax - revenue loss	20	65
Excise duties - revenue gain	800	1295
Total tax reductions	395	1210
Expenditure Measures		
Enterprise allowance	20	90
New Workers Scheme	25	50
Long term unemployed	110	90
Loan Guarantee scheme and other measures	Neg	15
Total expenditure increases	155	245
Offsetting reduction in social security benefits	80	105
Net call on the Reserve	75	140

Don't like this: separate components

Do we have to have this here? ('Don't like' CR)

TABLE 1 BUDGET 'B' BASIS

On this presentation it would perhaps be best not to add the employment measures to the tax measures, as the former would not by definition result in a change to total planned expenditure, while the latter would amount to a change from forecast receipts.

10. The format of the above tables is slightly different from that in previous years, in that the effects of indexation are shown at the bottom of the table, rather than in two additional columns - which are, in any case, irrelevant to the expenditure measures. This is a simplification of the table which we were, in any case, going to suggest.

Is much unhelpful

Expenditure Measures added to the Planning Total

11. If expenditure on employment measures is added to the planning total it is assumed in this paper that the planning total will be increased by the net not the gross public expenditure cost of the employment measures.

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12. On this basis, the summary table in Part 1 of the FSBR might look like this:

TABLE 2 on a Budget 'A' basis

Effects of the Budget on receipts and expenditure

	1986-87	1987-88
Tax Proposals (Changes from an Indexed Base)		
Income tax reduction	1875	2480
Capital taxes reduction	45	160
Excise duties increase	700	780
Other tax changes	+5	+75
Total tax reductions	1215	1775
Expenditure Increases		
Enterprise allowance	20	90
New Workers Scheme	25	50
Long term unemployed	110	90
Other measures	Neg	15
Gross expenditure increase	155	245
Offsetting reduction in social security benefits	80	105
Net increase in Planning Total	75	140
Total Budget tax reductions and expenditure increases from an indexed base	1290	1915
Effects of Indexation on Taxation Receipts		
Income tax - revenue loss	1135	2405
Capital taxes - revenue loss	20	65
Excise Duties - revenue gain	800	1295
Total Budget tax reductions and expenditure increases	1645	3090

TABLE 2 BUDGET 'A' BASIS

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TABLE 2 on a Budget 'B' basis

	1986-87	1987-88
Tax Proposals (Changes from an Indexed Base)		
Income tax reduction	0	0
Capital taxes reduction	45	150
Excise duties increase	0	0
Other tax changes	+5	+115
Total tax reductions	40	35
Expenditure Increases		
Enterprise allowance	20	90
New Workers Scheme	25	50
Long term unemployed	110	90
Other measures	Neg	15
Gross expenditure increase	155	245
Offsetting reduction in social security benefits	80	105
Net increase in Planning Total	75	140
Total Budget tax reductions and expenditure increases from an indexed base	115	175
Effects of Indexation on Taxation Receipts		
Income tax - revenue loss	1135	2405
Capital taxes - revenue loss	20	65
Excise Duties - revenue gain	800	1295
Total Budget tax reductions and expenditure increases	470	1350

TABLE 2 BUDGET 'B' BASIS

13. In all these tables the employment measures are itemised gross to maximise their impact. The social security offset is also shown, so that the net effect on the Planning Total can be given. In Table 2 this can then be added to the revenue effects of the tax changes to show the total direct effects of the Budget ("Total Budget tax reductions and expenditure increases"). But if preferred, the expenditure measures could simply be itemised net. This would reduce the number of sub totals on the table, without much if any loss in presentation since employment measures are well known to produce benefit savings.

14. It would not be possible to show the employment measures gross without giving the social security offset unless the Planning Total were also increased by the gross cost of the measures.

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Summary

15. Although there are no precise precedents for showing in the summary table in Part 1 of the FSBR expenditure measures which have been charged to the Reserve, the variation in the table for other reasons in the past years suggests that this need not be a bar from doing so on this occasion. But since in this case it would be awkward to add tax reductions to expenditure non-increases the total direct effects of the Budget (ie the sum of tax and expenditure measures) should perhaps not be summed in the table - but there are plenty of precedents for that. Indeed, not adding everything up is arguably more consistent with the desire to steer the emphasis in Budget presentation away from "the effects of the Budget" and to focus attention on the consequences of financial policy as a whole.

16. On the other hand, if it were decided to add employment measures to the Planning Total, a presentation in the summary table in line with last year's precedent would be appropriate.

17. On either basis, the tables could be adapted to show the individual employment measures net or gross.

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ANNEX A

1. In **1985** expenditure measures were added to the planning total and were scored in Table 1.1. The total direct effects of expenditure measures, NIC changes and tax proposals were added together to give an overall total.

2. In **1984** there were no expenditure measures.

3. In **1983** expenditure measures were met from the Reserve and were not listed in Table 1.1. In that year Table 1.1 covered only taxes (and NIS).

4. In **1982** there was a mixture of expenditure measures. Some were not costed but were charged to the Contingency Reserve which was itself raised by £150 million. £200 million was added to programmes. The resulting increase in the planning total of £350 million was more than offset by other reductions in expenditure of £600 million. Both the increase to programmes and the increase in the Contingency Reserve was shown in Table 1. But the offsetting savings were not. Moreover, there was no attempt to add together the revenue effects of tax proposals and the expenditure effects of the expenditure measures.

5. In **1981** the additions to programmes and to the Contingency Reserve were shown in Table 1, but, as in 1982, not added to the revenue effects of tax changes.

6. The **1980** treatment was exactly as in 1981 - ie changes to programmes and changes to the Contingency Reserve were shown in Table 1 but not added to the changes to taxes.

7. There was no Budget summary in **1979**.

ANNEX A

1. The Budget Proposals

Definition of the Budget

1.01 The main proposals in the Budget are summarised in Table 1.1 below and described in detail in Parts 4 and 5. The Budget is defined to include tax changes and changes to national insurance contributions announced in the Budget Speech, together with certain other tax changes which have been announced since last year's Budget. It also includes the expenditure consequences of new measures announced in the Budget Speech for the plans set out in the Public Expenditure White Paper (Cmnd. 9428).

Table 1.1 Budget measures: direct effects on public sector transactions([1])

£ million at current prices

	Effect in 1985–86		Effect in a full year([2])	
	Changes from an indexed base	Changes from a non-indexed base	Changes from an indexed base	Changes from a non-indexed base
Tax proposals([3])				
Income tax allowances and thresholds	−730	−1 590	−910	−2 025
Capital taxes	−20	−30	−215	−260
VED	+130	+230	+130	+230
Other Excise duties([4])	+105	+590	+110	+605
VAT	+60	+60	+190	+190
Other tax changes	−40	−40	+235	+235
Total tax proposals	−495	−780	−460	−1 025
Proposed changes in National Insurance Contributions				
Employers' NICs	−30	−30	−80	−80
Employees' NICs	−100	−100	−270	−270
Self employed etc. NICs	−30	−30	−100	−100
Total NICs proposals	−160	−160	−450	−450
Expenditure Measures([5])				
Youth Training Scheme	Nil	Nil	−150	−150
Community Programme	−75	−75	−250	−250
Total Expenditure measures	−75	−75	−400	−400
Total Direct Effects([6])	**−730**	**−1 015**	**−1 310**	**−1 875**

([1]) +/− indicates an increase/decrease in revenue, or a decrease/increase in expenditure. All figures are rounded to the nearest £5 million.

([2]) See footnote (*a*) to Table 4.2.

([3]) The figures are estimates of the direct effects of the tax proposals on public sector transactions. They are not estimates of the total effects, both direct and indirect. See footnote (*a*) to Table 4.2.

([4]) Including bus fuel grants.

([5]) The figures show the direct expenditure consequences of these measures after allowing for consequential savings in unemployment and supplementary benefits as people who would otherwise be claiming benefit join the schemes. The figures shown in the full year columns are estimates of the cost in 1987–88.

([6]) Since these are estimates of direct effects the overall total differs from the effect of these measures on the PSBR—which is shown in paragraph 1.05.

Taxation

1.02 The net effect of the tax proposals in the Budget is shown on two alternative bases. The first, conventionally used in the preparation of economic forecasts, allows for the full indexation of 1984–85 excise duty rates and main income tax allowances and thresholds in line with inflation in the year to December 1984. On this basis, the tax proposals in the Budget are expected to cost £495 million in 1985–86. The second basis, which corresponds with the actual changes in tax rates and allowances to be included in the Finance Bill, measures the effects of those changes as compared with existing rates and allowances. On this basis, the increase in income tax allowances and thresholds is estimated to cost £1,590 million and the increase in excise duties to yield an additional £820 million in 1985–86.

National insurance contributions

1.03 The cost of the changes to national insurance contributions is expected to be £160 million in 1985–86. Details are given in Part 4.

Expenditure measures

1.04 Table 1.1 lists the net costs of the public expenditure measures in the Budget. These will be added to the public expenditure planning totals. Details of these and other changes to the planning totals are given in Part 5.

PSBR

1.05 The PSBR for 1985–86 has been set at £7 billion, or 2 per cent of GDP at market prices. The Budget measures are expected to contribute about £¾ billion to this figure over and above the cost of simply indexing tax rates and allowances. This allows for indirect as well as direct effects on public sector transactions.

FSBR 1984

1. The Budget Proposals

The Budget

1.01 The main proposals in the Budget are summarised in Table 1.1 below and described in detail in Part 4.

Summary table

Table 1.1 Budget measures: Direct Effects(1)(2) on Public Sector Transactions(3)

£ million at current prices

	Effect in 1984–85		Effect in a full year	
	Change from indexed base	Change from non-indexed base	Change from indexed base	Change from non-indexed base
Income tax allowances and thresholds	−940	−1 820	−1 470	−2 610
Corporation tax rates, stock relief and capital allowances	−280	−280	−250	−250
Other income tax and other direct taxes	+190	+175	+450	+395
Stamp duties	−450	−450	−460	−460
National insurance surcharge(4)	−335	−335	−865	−865
Value added tax	+375	+375	+650	+650
Excise duties	+200	+835	+215	+860
VAT: withdrawal of postponed accounting for imports	+1 200	+1 200	0	0
Total	−40	−300	−1 730	−2 280

(1) The figures in the Table and those presented in Part 4 are estimates of the direct effects of the measures on public sector transactions; they are not estimates of the net effects of all the changes in public sector transactions, both direct and indirect.

(2) The direct effects of tax changes are generally estimated by applying the new and old tax rates and allowances to the taxable income and expenditure in the economic forecast in Part 3, in certain cases including estimates of the immediate effects of the change on taxpayers' behaviour. For instance the estimates of the Customs and Excise taxes allow for the changes in taxation resulting both from substitution by consumers between goods and from the change in real incomes.

(3) +/− indicates an increase/decrease in revenue.

(4) Figures exclude public sector payments of £120 million in 1984–85 and £485 million in a full year. Public expenditure will be reduced accordingly. See Table 5.1.

Tax proposals

1.02 The net effect of the tax proposals in the Budget is shown on two alternative bases. The first, conventionally used in the preparation of economic forecasts, allows for the full indexation of 1983–84 excise duty rates and main income tax allowances and thresholds in line with inflation in the year to December 1983. On this basis the tax proposals in the Budget are broadly revenue neutral in 1984–85. The second basis, which corresponds with the actual changes in tax rates and allowances to be included in the Finance Bill, measures the effects of those changes as compared with existing rates and allowances. On this basis the increase in income tax allowances and thresholds is estimated to cost £1,820 million and the increase in excise duties to yield an additional £835 million in 1984–85. The full year figures shown in Tables 1.1 and 4.2 are calculated on the conventional basis, referred to in Part 4. In 1985–86 the net revenue cost of the Budget measures from an indexed base is estimated at over £1·8 billion.

The effect on the PSBR

1.03 Allowing for indirect, as well as direct, effects on public sector transactions, the Budget measures are expected to leave the PSBR in 1984–85 broadly as it would have been on conventional assumptions about the indexation of tax rates and allowances. The level of the PSBR is expected to be £7¼ billion, or 2¼ per cent of GDP (at market prices).

FSBR 1983

1. The Budget Proposals

The Budget

1.01 The main proposals in the Budget are summarised in Table 1.1 below and described in detail in Part 4. These figures and those presented in Part 4 are estimates of the direct effects of the measures on public sector transactions; they are not estimates of the net effects of all the changes in public sector transactions, both direct and indirect, brought about by the tax and expenditure decisions. The Budget is defined to include the tax changes announced in the Budget Speech, and policy changes to the expenditure plans set out in the Public Expenditure White Paper (Cmnd. 8789).

Summary table

Table 1.1 Budget measures: Direct Effects(¹) on Public Sector Transactions(²)

£ million at current prices

	Effect in 1983–84		Effect in a full year	
	Change from indexed base	Change from non-indexed base	Change from indexed base	Change from non-indexed base
Income tax allowances and thresholds	−1 170	−2 000	−1 490	−2 545
Other income tax and other direct taxes	−295	−310	−365	−410
National Insurance Surcharge(³)	−215	−215	−390	−390
Excise duties	10	595	10	605
Other indirect taxes	—	−5	—	−5
Total	**−1 670**	**−1 935**	**−2 235**	**−2 745**

(¹) The direct effects of tax changes are the differences between the yields estimated by applying the new and the old tax rates and allowances to the taxable income and expenditure projected in the post-Budget forecast. A further adjustment is made to the estimates of the Customs and Excise taxes to allow for the changes in taxation resulting both from substitution by consumers between goods and the change in real incomes.

(²) +/− indicates an increase/decrease in revenue.

(³) Figures exclude public sector payments of £80 million in 1983–84 and £215 million in a full year. Public expenditure will be reduced accordingly.

Tax proposals

1.02 The net effect of the tax proposals in the Budget is shown on two alternative bases. The first, conventionally used in the preparation of economic forecasts, allows for the full indexation of 1982–83 excise duty rates and main income tax allowances and thresholds in line with inflation in the year to December 1982. On this basis the net effect of the tax proposals in the Budget is to reduce revenue by £1,670 million in 1983–84 and by £2,235 million in a full year. The cost in 1983–84 of the increase in the main income tax allowances and thresholds over and above full revalorisation is estimated to be £1,170 million. The second basis, which corresponds with the actual changes in tax rates and allowances to be included in the Finance Bill, measures the effects of those changes as compared with existing rates and allowances. On this basis the increase in income tax allowances and thresholds is estimated to cost £2,000 million and the increase in excise duties to yield an additional £595 million in 1983–84.

Public expenditure measures

1.03 Public expenditure measures announced in the Budget total £238 million in 1983–84. They are listed in Part 4 and in Table 5.7. Their cost will be met entirely from the Contingency Reserve. They will not therefore lead to any increase in the public expenditure planning total for 1983–84 announced in the

White Paper. There will however be a reduction in planned public expenditure as a result of the further cut in the National Insurance Surcharge announced in the Budget, which will be recovered from central government and nationalised industries. In Table 1.1, the reduction in public expenditure is offset against the gross cost of the change in the Surcharge.

The effect on the PSBR

1.04 Taking the tax and expenditure changes together, and allowing for indirect, as well as direct, effects on public sector transactions, the Budget measures are expected to add about £1·6 billion to the PSBR, compared with what it would have been on conventional assumptions about the indexation of tax rates and allowances. The level of the PSBR in 1983–84 is expected to be around £8 billion, or 2¾ per cent of GDP (at market prices).

The Autumn measures

1.05 Other changes affecting 1983–84 are set out in the Autumn Statement, published in November. They include the 1 percentage point reduction in the National Insurance Surcharge from 2½ per cent to 1½ per cent; changes to public expenditure plans which kept the planning total for 1983–84 within the figure given in the 1982 White Paper as modified by the 1982 Budget (£120.7 billion); and limited increases in employees' and employers' National Insurance Contributions. The reduction in the National Insurance Surcharge and the effect of holding the increase in National Insurance Contributions below the amount needed to balance the Fund were estimated to cost nearly £1 billion in 1983–84.

FSBR 1982

PART 1

THE BUDGET PROPOSALS

1.1. The main tax and expenditure proposals in the Budget are summarised in Table 1 below and described in detail in the remainder of Part 1. These figures and those presented in Table 2 are estimates of the direct effects of the Budget on public sector transactions; they are not estimates of the net effects of all the changes in public sector transactions, both direct and indirect, brought about by the Budget. The Budget is defined to include the tax changes announced in the Budget Speech, and policy changes to the expenditure plans set out in the White Paper. (Cmnd. 8494.)

1.2. The net effect of the tax proposals in the Budget is shown on two alternative assumptions about the tax rates and allowances that constitute unchanged policy. One approach, conventionally used in the preparation of economic forecasts, is to allow for the full indexation of 1981–82 excise duty rates and main income tax allowances and thresholds in line with inflation to the year to December 1981. On this basis the net effect of the tax proposals in the Budget is to reduce revenue by £1,555 million in 1982–83 and by £2,520 million in a full year. The cost in 1982–83 of the increases in the main income tax allowances and thresholds over and above full revalorisation is estimated to be £200 million, and that of less than full indexation of excise duties to be £60 million.

1.3. The alternative presentation, which corresponds with the actual changes in tax rates and allowances to be included in the Finance Bill, measures the effect of those changes as compared with existing rates and allowances. On this basis the increase in income tax allowances and thresholds is estimated to cost £1,840 million and the increase in excise duties to yield an additional £1,150 million in 1982–83.

TABLE 1. DIRECT EFFECTS(1) ON PUBLIC SECTOR TRANSACTIONS(4)

£ million at current prices

	Effect in 1982–83		Effect in full year	
	Change from indexed base	Change from non-indexed base	Change from indexed base	Change from non-indexed base
1. *Tax Proposals*				
Income tax allowances and thresholds	−200	−1,840	−260	−2,445
Other income tax and other direct taxes	−210	−210	−920	−920
National Insurance Surcharge(2)	−1,000	−1,000	−1,195	−1,195
Excise duties	−60	1,150	−55	1,165
Other indirect taxes	−85	−85	−90	−90
Total	−1,555	−1,985	−2,520	−3,485
2. *Expenditure Measures*				
Programmes	200	200		
Contingency Reserve	150	150		
Total(3)	350	350		

(1) The value of expenditure decisions is taken to measure their direct effect. The direct effects of tax changes are the differences between the yields estimated by applying the new and the old tax rates and allowances to the taxable income and expenditure projected in the post-Budget forecast. A further adjustment is made to the estimates of the Customs and Excise taxes to allow for the changes in taxation resulting both from substitution by consumers between goods and the change in real incomes.

(2) The full year effect is for a one point reduction in the rate. Estimates include public sector payments of £360 million in 1982–83 and £430 million in a full year. Public expenditure will be reduced accordingly. See Part 4, paragraph 4.14.

(3) Effect on planning total offset by savings of some £600 million in 1982–83 resulting from expenditure consequences of tax proposals and estimating changes. See Table 19.

(4) +/− indicates an increase decrease in revenue or expenditure.

1.4. Expenditure decisions in the Budget include direct increases in public expenditure of some £350 million in 1982–83. These measures are described in the following section. They are more than offset by reductions in other expenditure. In addition, the cost of the freeze in industrial gas prices is estimated to be about £60 million in 1982–83[1].

1.5. Taking the tax and expenditure changes together, and allowing for indirect, as well as direct, effects on public sector transactions, the Budget measures are expected to add about £1·3 billion to the PSBR, compared with what it would have been on conventional assumptions about the indexation of tax rates and allowances. The level of the PSBR in 1982–83 is expected to be around £9½ billion, or 3½ per cent of GDP (at market prices).

[1] As a result of consequential changes in the gas levy, this is reflected in a reduction in gas levy receipts and a reduction in the British Gas Corporation's external financing limit for 1982–83. See Table 2 (other direct taxes) and Table 21 of Part 4.

EXPENDITURE MEASURES

Housing improvement

An additional £100 million will be made available to local authorities in 1982–83 for the improvement and insulation of private houses. Rates of intermediate and repairs grant will be increased for one year only.

Industrial innovation

New measures to promote research and innovation in industry will involve additional expenditure of £20 million in 1982–83, £35 million in 1983–84 and £45 million in 1984–85. No provision is made for this in Table 1: it will be met from the contingency reserve.

Energy

The external financing limits of the electricity supply industry for 1982–83 announced on 2 December 1981 will be raised by some £100 million, to accommodate special arrangements to benefit certain large industrial users of electricity, in addition to the arrangements on electricity prices announced in the 1981 Budget Statement.

The external financing limit of the National Coal Board for 1982–83 will be increased to accommodate the renewal of the measures first announced in June 1981 to avoid further increases in foundry coke prices until the winter. No provision is made for this in Table 1: the expenditure will be met from the contingency reserve.

Social security

The Budget includes the extension of the restoration of the 2 per cent shortfall to unemployment benefit, supplementary allowances, and certain other benefits. These additions to expenditure are not provided for in Table 1. They will be met from the contingency reserve.

Employment

No provision for any new measure is made in Table 1. As expenditure arises it will be met from the contingency reserve.

Contingency reserve

The contingency reserve for 1982–83 is increased from £2,250 million (as in Cmnd. 8494) to £2,400 million to accommodate these Budget measures.

FSBR 1981.

PART I

THE BUDGET PROPOSALS

THE BUDGET AND THE ECONOMIC CONTEXT

The Budget represents a further step towards the achievement of the Government's medium-term objectives of bringing down inflation and creating the conditions for sustainable growth of output and employment. In order to permit its monetary objectives to be met at tolerable interest rates, the Government's aim is to contain public sector borrowing to a real level well below that of 1980–81. Within this overriding requirement, the Budget is designed to give some more direct relief to particularly hard-pressed sectors of industry and to provide more opportunities for enterprise, particularly for new and small businesses.

2. The main tax and expenditure proposals are summarised in Table 1 below and described in detail in the remainder of Part I. These figures and all those presented in this part are estimates of the direct effects of the Budget on public sector transactions; they are not estimates of the net effects of all the changes in public sector transactions, both direct and indirect, brought about by the Budget(1). The Budget is defined to include the tax changes announced in the Budget speech, together with the supplementary petroleum duty, changes in petroleum revenue tax reliefs and the new stock relief scheme foreshadowed in November for which legislation will be included in the Finance Bill. It also includes policy changes in expenditure plans compared with the White Paper on the Government's Expenditure Plans 1981–82 to 1983–84 (Cmnd. 8175) which is published today. The tax decisions in the Budget are measured from the tax rates which ruled in 1980–81.

3. The net effect of the tax proposals in the Budget will be to raise an extra £3,610 million revenue in 1981–82 and £2,650 million in a full year. In 1981–82, the increase in excise duties is estimated to yield £2,420 million, supplementary petroleum duty and changes in petroleum revenue tax relief £1,020 million and the once-for-all 2½ per cent special tax on banking deposits £400 million. The scheme for stock relief together with changes in capital taxation and measures to encourage enterprise, etc., are estimated to cost some £200 million in 1981–82.

TABLE 1. DIRECT EFFECTS ON PUBLIC SECTOR TRANSACTIONS(2)

£ million at current prices

Tax Proposals	Effect in 1981–82	*Effect in a full year*	Expenditure Measures	Effect in 1981–82
Income tax	−5	+40	Programmes	+120
Other direct taxes	+1,220	+190	Contingency reserve	+200
Excise duties	+2,420	+2,445		
Other indirect taxes	−25	−25		
Total tax proposals	+3,610	+2,650	Total expenditure measures	+320

The total net direct effect of the Budget is to reduce the public sector borrowing requirement in 1981–82 by £3,290 million, the increase in revenue less the increase in expenditure. The PSBR is forecast to be £10½ million in 1981–82 (4¼ per cent of GDP).

(1) The value of expenditure decisions is taken to measure their direct effect. The direct effects of tax changes are the differences between the yields estimated by applying the new and the old tax rates and allowances to the taxable income and expenditure projected in the post-Budget forecast. A further adjustment is made to the estimates of the Customs and Excise taxes to allow for the changes in taxation resulting from both substitution by consumers between goods and the change in real incomes. Estimates of both direct and indirect effects together would also allow for second round changes in tax receipts and some items of expenditure, especially unemployment benefits. These changes occur because of induced movements in some or all of incomes, prices, interest rates, the exchange rate and unemployment and hence taxable income and expenditure. Further details of the definition of the effects of tax changes are provided in the methodological note to Table 2 (on page 9).

(2) +/− indicates an increase/decrease in revenue or expenditure.

4. It is also possible to measure the change in revenue from taxation in relation to a base in which the 1980–81 excise duty rates and main income tax allowances and thresholds are fully indexed to allow for inflation in the year to December 1980. On this basis the Budget is estimated to increase revenue by over £4,310 million in 1981–82, of which £1,900 million is accounted for by the decision not to revalorise the income tax allowances and thresholds this year and £1,220 million by the increase in excise duties over and above revalorisation.

5. Expenditure decisions included in the Budget are expected to produce a direct increase in public expenditure of £320 million at 1981–82 prices. These are described in the following section. They comprise the effect of the decision to increase the contingency reserve for 1981–82 as a precaution and increases in certain external financing limits.

6. Taking tax and expenditure proposals together the direct effect of the Budget on the public sector borrowing requirement (PSBR) is expected to be a reduction of £3,290 million. The resulting PSBR in 1981–82 is forecast to be £10½ billion or 4¼ per cent of market price GDP compared with 6 per cent in 1980–81.

7. The public sector financial deficit (PSFD) is expected to decline from 5¼ per cent of GDP in 1980–81 to 2½ per cent of GDP in 1981–82. The detailed forecast is shown in Tables 14 and 15 of Part IV.

8. The increase in excise duties is estimated to have an immediate impact on the retail prices index of 2 per cent. Otherwise the Budget will not alter the RPI in the short term. Over time, given control of the money supply, its indirect effects on the RPI will tend to offset the short run effect.

EXPENDITURE MEASURES

Nationalised industries' external financing limits

The external financing limits of the electricity supply and gas industries announced on 24 November 1980 will be raised by £118 million to accommodate action proposed by the industries to meet concern about industrial energy prices compared with those in Europe.

Boiler conversion scheme

2. Expenditure likely under this scheme in 1981–82 cannot be estimated reliably at this stage and no specific provision for it is made in Table 1. As expenditure arises it will be met from the contingency reserve with no addition to the planned total for public expenditure.

The contingency reserve

3. There are changes in both the operation and the size of the contingency reserve provided in the public expenditure planning total. The change in its use as a control is that in 1981–82 decisions to increase cash limits, whether in respect of pay and prices or volume, will be charged to the reserve. (Previously, only decisions which increased the volume of public expenditure during the year were charged.) To reflect this broadening of control and also recent developments, including those in the coal industry, it has been decided to set the contingency reserve in 1981–82 at £2,500 million, cash, compared with the £2,000 million shown in Cmnd. 8175. This increase in the reserve will imply extra spending of no more than £200 million; the broadening of control should exert downward pressure on the level of expenditure.

FSBR 1980

PART I

THE BUDGET PROPOSALS

THE BUDGET AND THE ECONOMIC CONTEXT

The Budget is a further stage in the Government's medium-term policy of reducing inflation and improving the supply side of the economy. The central feature of the anti-inflation policy is the gradual reduction of monetary growth. To achieve this reduction without intolerably high interest rates public sector borrowing will be reduced over the medium term. The Budget is intended to achieve a real level of public sector borrowing in 1980–81 significantly lower than in 1979–80.

2. The medium-term plans for monetary growth are discussed in Part II. The Budget proposals are summarised in Table 1 below and described in detail in the remainder of Part I. These figures and all those presented in this Part are estimates of the direct effects of the Budget on public sector transactions; they are not estimates of the net effects of all the changes in public sector transactions, both direct and indirect, brought about by the Budget.(1) The Budget is defined to include all the expenditure decisions since the November White Paper(2) and the tax changes announced in the Budget Speech. The changes in the Budget are measured from the expenditure plans for 1980–81 in that White Paper and the tax rates and allowances which ruled in 1979–80.

3. The tax proposals in the Budget are broadly neutral in their revenue effects. The main proposals are for a reduction in income tax worth just under £1·2 billion in 1980–81, and an increase in specific duties yielding a little over £1·2 billion. Taking into account a number of other tax changes including those relating to petroleum revenue tax (Table 2), there is expected to be a net increase in revenue of £¼ billion in 1980–81. The corresponding figures for a full year represent a small reduction in revenue.

4. It is also possible to measure the change in revenue from taxation in relation to a base in which the 1979–80 specific duty rates and main income tax allowances and thresholds are fully indexed to allow for inflation. On this basis the Budget is estimated to increase revenue by over £1 billion in a full year.

TABLE 1. DIRECT EFFECTS ON PUBLIC SECTOR TRANSACTIONS(3)

£ millions

Tax Proposals	1980–81 Current prices	*Full Year 1980–81 prices*	Expenditure Measures	1980–81 Current prices	*1980–81 1979 Survey prices*(4)
Income tax	−1,190	(−1685)	Programmes	−900	(−670)
Other direct taxes	+245	(+90)	Contingency reserve	+325	+(250)
Specific duties	+1,245	(+1,275)			
Other indirect taxes	−65	(−60)			
Total tax proposals	+235	−(380)	Total expenditure measures...	−575	(−420)

The total net direct effect of the Budget is to reduce the borrowing requirement in 1980–81 by £810 million, the sum of the increase in revenue and the reduction in expenditure. The PSBR is forecast to be £8,536 million in 1980–81.

(1) The value of expenditure decisions is taken to measure their direct effect. The direct effects of tax changes are the differences between the yields estimated by applying the new and the old tax rates and allowances to the taxable income and expenditure projected in the post-Budget forecast. A further adjustment is made to the estimates of the Customs and Excise taxes to allow for the changes in taxation resulting from both substitution by consumers between goods and the change in real incomes. Estimates of both direct and indirect effects together would also allow for second round changes in tax receipts and some items of expenditure, especially unemployment benefits. These changes occur because of induced movements in some or all of incomes, prices, interest rates, the exchange rate and unemployment and hence taxable income and expenditure. Further details of the definition of the effects of tax changes are provided in the methodological note to Table 2 (on page 11).

(2) The Government's Expenditure Plans 1980–81, Cmnd 7746

(3) +/− indicates an increase/decrease in revenue or expenditure.

(4) See also Table 3.

5. The expenditure decisions included in the Budget measures are for a direct reduction in public expenditure programmes of about £900 million at 1980–81 prices. The Government have increased the contingency reserve for 1980–81 by £325 million, at 1980–81 prices, as a precaution. The Government will aim to keep as much as possible of the reserve unspent. Table 3 also shows for convenience the other revisions to expenditure programmes since the November White Paper. The full White Paper on the Government's Expenditure Plans 1980–81 to 1983–84 (Cmnd. 7841) is published today.

6. Taking tax and expenditure proposals together, the direct effect of the Budget on the public sector borrowing requirement (PSBR) is expected to be a reduction of £810 million. The resulting PSBR in 1980–81 is forecast to be £8½ billion, or 3¾ per cent of market price GDP, compared with 4¾ per cent in 1979–80. The public sector financial deficit (PSFD) is expected to decline from 3½ per cent of GDP in 1979–80 to 3 per cent in 1980–81. The detailed forecast is shown in Tables 14 and 15 in Part IV.

7. In the short-term the reduction in public expenditure is likely to reduce economic activity slightly. This is probably also true of the net effect of reducing direct and raising indirect taxes. But these measures are a necessary step in the medium-term strategy of reducing the burden of public sector borrowing and improving incentives. They will therefore be beneficial to sustainable economic growth.

8. The average increase in specific duties does not go beyond what is necessary to prevent the erosion in their real value by inflation over the past year. It is estimated to have an immediate impact on the retail prices index (RPI) of 1·1 per cent. Otherwise the Budget will not alter the RPI in the short term, except for the effects of increases in prescription charges and council rents in the autumn which will add about 0·2 per cent. Over time, given control of the money supply, its indirect effects on the RPI will tend to offset the short run effect. The Budget is estimated to reduce the tax and price index (TPI) slightly, with the increase in the RPI being more than offset by the effects of the income tax reduction.

CONFIDENTIAL

Inland Revenue

Policy Division
Somerset House

FROM D Y PITTS
DATE 17 FEBRUARY 1986

DYP 17/2.

1. MR BATTISHILL

2. CHANCELLOR OF THE EXCHEQUER

OIL PRICES

1. I attach the views you requested of Mr Elliss, Controller of the Oil Taxation Office, on an FT article of 5 February on oil prices.

2. He gives these from great experience and keeps in touch informally with what is happening, but is the first to point out that the Revenue have no independent sources of information about current prices. Because we assess past periods, we are one step behind the game. (The OTO are now examining returns of sales to 30 June 1985). Our forecast of tax take is therefore based on estimates of production and prices provided by the Treasury after consulting Department of Energy.

cc	Chief Secretary	Chairman
	Financial Secretary	Mr Battishill
	Economic Secretary	Mr Pollard
	Minister of State	Mr Pitts
	Sir Peter Middleton	Mr Painter
	Sir T Burns	Mr Calder
	Sir G Littler	Mr Elliss
	Mr Cassell	Mr Johnson
	Mr Monck	Miss Hill
	Mr H Evans	Mr Stewart
	Mr Moore	PS/IR
	Mr Robson o/r	
	Mr Hacche	
	Mr Patterson	
	Mr Cropper	
	Mr Davis	
	Mr Lord	

3. When we do assess, we use the prices producers got for arm's length sales and these and any other relevant actual prices for applying market value to sales not at arm's length. These are not necessarily the same as the publicly quoted prices. For example, the latter are not necessarily either comprehensive or accurate statements of actual deals done - especially for the two-thirds of the market which is not Brent oil - and on the other hand do include many sales by persons who are not producers (traders, speculators).

4. There seem to be two questions. First, have producers been getting more than the low prices publicly quoted, eg $20 rather than $16 as FT suggests? We have no independent source of information from which to check this. But if there is now a refiners' market (Mr Robson's minute of 12 February), we would not expect refiners generally to pay more for security of supply - whether in netback deals or otherwise - than they could pay by waiting to buy on the open market. There may be some temporary and timing imbalances in an uncertain market, but they would not add up to much.

5. Secondly, are the quoted prices in Brent for the months so far a sufficiently accurate guide to those which will form the basis of assessments to tax in due course? As I have said, they are not necessarily the same, but past experience has shown that the Treasury's estimates of oil prices derived from quoted sources have been sufficiently close to the average prices eventually used in tax assessments for these months. There must be greater uncertainty now, but we have no information on which to check whether an adjustment is due in an especially volatile market.

6. The Treasury's forecast in any case also covers future months to the end of 1986. In present conditions, we would expect that the margin of error for uncertainty in this forecast of prices for the rest of this year would greatly outweigh any difference between quoted prices and assessed prices for the first quarter.

DP

D Y PITTS

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Controller

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Telephone 01-438 6908

Mr P Wynn-Owen
PS/Chancellor

Your reference

My reference

Date 13 February 1986

OIL PRICES

1. In your note dated 10 February to Ms Leahy you minuted that the Chancellor would like to have my views - I assume on the pricing issues raised by FT leading article of 5 February. I should explain that because our pricing work is done retrospectively - for example we shall not receive companies' PRT returns for the second half of 1985 until the beginning of next month - information we hold about current market activities is effectively limited to that culled from oil journals and comments made by oil companies during our discussions with them. However, I am pleased to offer the following comments. I am sorry about the delay.

2. As regards the numbers in the article itself, I would say that the Brent crude spot price quoted, $16 per barrel, is about right for delivery in March or April, but the comparators are over-stated or, if correct, relate to an earlier time and for a proper comparison in a falling market need to be discounted. The suggested volume of "netback" deals by Saudi Arabia for crude for European refineries, 2.5m bpd is surely exaggerated. PIW of 10 February quotes a figure of 1.7m bpd for all western destinations, including USA. As regards the "secret" netback deals in Brent crude, yielding $20 pb, I suggest that if such deals have been struck they can only

relate to an earlier period; it would not make sense for a refiner to pay \$3 pb more than he need pay on the spot market. (I comment more on the net back deal below.) The "buying prices posted by US major companies" with which Brent spot price is also compared, are the prices which US refiners post for US domestic crudes delivered to their refineries. I understand that the actual deals are done at different prices. As regards the prices quoted, \$24 - \$25 pb, Platts Oilgram of 7 February, quotes the price for West Texas Intermediate crude, the nearest equivalent to Brent, at \$23 before deduction, \$19.5 after. The spot price of this crude is quoted as \$17; in comparing WTI with Brent, one usually allows for a freight differential of about \$1 pb. There can be no doubt that the spot price of Brent has fallen substantially in recent weeks, but Brent is not alone. According to PIW, the price of WTI has fallen from \$25.50 a month ago to \$16.5 bp and Dubai Fateh, another crude which is sold spot, from \$24.85 to \$14.50 pb. The prices quoted for a month ago were probably for delivery about now, with payment due now.

3. It is a recognised feature of the Brent Blend forward crude market that many more deals are done in the crude than there are cargoes moved - nearly 10 times as many last year according to a recent report. This has led to the development of so-called "paper" barrels; the \$16 pb quoted by the FT would fall in that category. The multiplicity of deals means that any particular price reported in the press has a small chance of relating to an actual sale by a producer of the crude, eventually to be reflected on its PRT return, although if the price is accurate, it will be indicative of the prices at which arms length sales of crude from the North Sea on a single cargo basis are likely to have been made at that time. Further, although there is more

Brent blend crude sold than any other crude from the UKCS, it does account for only one quarter to one third of total UKCS production. Forties Blend is the next biggest, then Ninian There are no significant forward markets in these crudes and hence prices for arms length deals are quoted much less widely and the prices, although tracking Brent, show less volatility.

4. Although the FT article talks of "secret" netback deals in Brent crude having been done, it is doubtful whether very many have in fact been concluded. On this subject, PIW of 10 February says "Few, if any, have been concluded so far", although US refiners are seeking to sign them. To our knowledge none of the UKCS producers sold its production on this basis up to the middle of 1985, the latest period for which we have details of disposals, although we have learned of one deal, involving a trader and a major refiner, as purchaser, in 1984. Netback deals are not an entirely new phenonmenon although in the past they have only featured - occasionally - in term contracts for the sale of Middle East or Caribbean crudes, and then sometimes in a slightly different form as "processing arrangements". Their popularity recently has grown out of an attempt by OPEC producers to disguise sales made, in reality, at a discount from official selling prices. They are complicated transactions and, I think are only likely to take hold in the spot market if there is a continuing substantial surplus and producers are anxious to secure outlets at the expense of a higher price. There are several seemingly negotiable elements in a netback contract: the assumed yield of products; the source of reference of spot product prices and the dates those prices are to be used; the refining fee; the notional freight element (spot crude sales are usually made f.o.b. while a netback deal is likely to assume delivery to the refinery), and the date of payment (the credit period). In practice most of these elements could become standardised leaving none or, say, only the refining fee to be negotiated. The price resulting from a netback deal is still a "spot" price, but instead of the price

being known at the time the deal is struck, it is only ascertainable when the spot prices of the relevant products for the relevant period are known. There is invariably a relationship in the market between the spot price of products and the spot price of crude. In a netback contract, both the seller and the buyer take some risk that the spot product price may move adversely in the period between the date of the deal and relevant pricing period, although if the refining fee etc is correctly pitched, the refiner is broadly protected against loss. Some of this risk would be capable of being hedged in the product futures market.

5. In computing the 6 monthly PRT liabilities of the North Sea producers, we take account of the proceeds of sales of production at arms length and the aggregate monthly market values of production sold or transferred to affiliates or refined by the producing company itself (the assessment also includes an opening and closing stock adjustment at market values). Today we expect to find most of the arms length sales to have been on a spot, single cargo, basis, contracted for within usually a few weeks of the delivery date; some sales will have been made under term contracts at prices related to spot prices at say the time of delivery. In a period of market instability the various sale prices are likely to show a wide variation, but the PRT assessment for arms length sales is on the actual proceeds realised. If any sales were made to third parties on a product netback basis, then the proceeds of these sales would be included also.

6. For non-arms length sales and appropriations, where market values are taxed, we seek to determine and negotiate with the companies the price which the crude in question would have fetched had it been sold under an arms length contract at the relevant time in the month. This valuation exercise has been particularly difficult since the middle of 1984 (when BNOC was finally unable

to sustain sales at the "BNOC term" price and was obliged to sell at spot prices) as the market has been unsettled and there has not been the same degree of price transparency. Our sources of data on prices actually realised in arms length transactions are the PRT returns made by each of the producer companies which, of course, include independents with no down-stream interests, and further information which we get from the companies about other transactions in North Sea crudes which they or their affiliates, including refiners, have entered into. Because of the constraints imposed by the valuation legislation, and also with a view to eliminating the long forward speculative transactions in Brent crude, in our current valuation exercises, for spot deals we are only having regard to contracts made within about a month before the delivery date of the crude. Under this approach the FT price of $16 pb if it was for delivery in say April, would not be taken into account in our assessment of market values.

R M Elliss

Controller

L.2.55 punf

Copy PS/CST
PS/FST
PS/EST
PS/MST

FROM: MRS R LOMAX
DATE: 19 February 1986

Mr Cropper
Mr Lord
Mr H Davies

MR SCHOLAR

cc Sir P Middleton
Sir T Burns
Mr Cassell
Mr Monger
Mr Culpin
Miss Sinclair
Miss O'Mara
Mr Pratt
PS/IR
PS/C&E

1986 FSBR AND BUDGET EPR

The Chancellor has been reflecting on the format of the FSBR and has noted the absence of any readable account of the detailed Budget measures. He suggests the following two-pronged approach:-

(i) the existing Part 4 (the Budget tax and National Insurance proposals in detail) should be recast in plain English, and should aim to provide a coherent exposition of what the various tax measures are and how they fit together. This may require some general explanation of the Government's approach to tax policy, without going as far as the Budget Speech. He thinks that Chapter 5 on public expenditure strikes about the right balance between philosophy and fact; and we should aim to use approximately the same tone of voice in drafting the tax chapter. He would like to retain Table 4.2 (direct effect of changes in taxation and national insurance) in its present place, and broadly the same form. But the technical matter now contained in Part 4 - assuming the Revenue feel it is still necessary - could be relegated to an annex.

(ii) The Budget EPR - which currently provides the only comprehensive account of the Budget in popular form - should be made available at the same time as the FSBR. It may be possible to produce a special edition of the EPR at the security printers; but, if not, we should consider issuing an advance copy using internal word processor and reproduction facilities.

2. The Chancellor would be grateful if you would pursue both these ideas. (In practice, he imagines that most of the work on (i) will fall to FP, in consultation with the revenue departments, and on (ii) to Mr Culpin and Miss O'Mara.) He would like to see an early draft of the new look Part 4 by the end of next week; this will give him an opportunity to comment on the general approach, even though some of the tax measures will not yet have been finally decided. He would also be grateful for early advice on the feasibility of producing a Budget EPR on Budget Day itself.

RL.

RACHEL LOMAX

Note of 'x' 1

1/2077

SECRET

~~Tony~~

Check this against your record of the meeting - there's any difference but don't pursue it this year.

R

FROM: MISS M E PEIRSON
DATE: 18 February 1986

MR SCHOLAR

cc Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Evans
Mr Odling-Smee
Mr Turnbull
Mrs R Butler
Mr Riley
Dr Webb
Mr Kuczys
Mr Cropper
Mr Lord

PUBLIC SECTOR TRANSACTIONS: CAPITAL AND CURRENT

x1 1. I attach the proposed summary version of table 6.5, on the lines agreed at the Chancellor's meeting on 15 January, and taking in comments on my draft of 23 January. - not copied to us

2. The figures are based on the latest forecast, with the Reserve in 1986-87 fully allocated.

3. One of the aims expressed at the Chancellor's meeting was that the definition of capital in this table should be brought into line with that of the PEWP table 1.14, which shows gross capital including defence. Unfortunately, although this has been done as far as possible, there remain some largely ineradicable differences, principally because the PEWP table excludes:

(a) capital spending by nationalised industries which have been, or are about to be, privatised,

(b) changes in the level of stocks,

(c) certain national accounts adjustments, and

(d) in 1986-87, any allocation from the Reserve.

Table B attached shows the differences.

4. I have avoided footnotes. As Mr Odling-Smee suggested, the explanation of the main differences from table 6.5 can be put in the text of chapter 6, and the rest can be left to briefing. This has meant reinstating a qualification to the NICs stub, as you suggested, but I hope it looks reasonably user-friendly.

5. The financial deficit is not shown: I argued for it, but if we are retaining table 6.5 it is unnecessary here.

6. Finally, note that the table highlights public sector gross debt interest, not a definition we now employ.

MEP

MISS M E PEIRSON

THE PUBLIC SECTOR'S FINANCES: CAPITAL AND CURRENT

£billion

	1985-6 latest estimate	1986-7 forecast		1985-6 latest estimate	1986-7 forecast
Current expenditure			**Current receipts**		
Current expenditure on goods and services	68.8	74.1	Taxes and royalties	113.5	118.7
Current grants and subsidies	56.7	60.0	National insurance and other contributions	24.3	26.2
Debt interest	18.1	18.8	Trading surpluses, rent, interest & other	17.9	18.1
Total current expenditure	143.5	152.8	Total current receipts	155.8	163.0
			Current surplus	**12.2**	**10.2**
Capital expenditure			**Capital expenditure financed by**		
Gross domestic fixed capital formation	20.2	19.7	Current surplus	12.2	10.2
Increase in stocks	0.6	0.4	Central privatisation proceeds	2.6	4.8
Capital grants (net)	2.7	2.7	Council house and other net sales	2.0	1.8
			Other financial transactions (net)	0.5	-1.0
			Borrowing requirement	**6.2**	**7.0**
Total capital expenditure	23.4	22.7		23.4	22.7

SECRET

Table B

Differences between new FSBR table and PEWP table 1.14

	1985-86 latest estimate	1986-87 forecast
		£billion
Capital spending in PEWP table 1.14	21.6	21.4
plus capital of privatised industries	+ 1.0	+ 0.5
stocks	+ 0.6	+ 0.4
national accounts adjustments	+ 0.2	+ 0.2
allocation from Reserve	-	+ 0.3
other differences	-	- 0.1
Capital spending in new FSBR table	23.4	22.7

SECRET P-P

Earlier pps

FROM: M C SCHOLAR
DATE: 19 February 1986

MISS PEIRSON

cc: Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr H P Evans
Mr Odling-Smee
Mr Turnbull
Mrs R Butler
Mr Riley
Dr Webb
Mr Kuczys
Mr Pratt
Mr Cropper
Mr Lord

PUBLIC SECTOR TRANSACTIONS: CAPITAL AND CURRENT

Many thanks to you and Dr Webb for the summary version of Table 6.5. This is now very clear. I congratulate you on managing without footnotes: this helps a lot with the presentation in the FSBR.

2. The next step is for us to include this in the draft of part 6 of the FSBR which we put to the Chancellor (and the printer) next week.

MCS

M C SCHOLAR

Rachel

There are no significant differences from what was agreed at the meeting. Margaret's covering note explains why it is not possible to bring the definition of capital fully into line with PEWP Table 1.14 (and her Table B sets out the differences).

Michael Scholar is satisfied that this does meet the remit from the January meeting, but urges that Ch shd not see it yet. It wd be better for him to see it next week, in context, in the 1st draft FSBR.

AWK

SECRET

1986 FSBR: TABLE 6.5 ALLOCATING THE RESERVE

PEIRSON → CH/EX 20/2

b/f with advice from CST (24/2 - rebase)

14/2073

CONFIDENTIAL

FROM: MISS M E PEIRSON
DATE: 20 February 1986

CHANCELLOR

cc Chief Secretary
Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Anson
Mr Cassell
Mr Kemp
Mr Evans
Mr Jameson
Mr Odling-Smee
Mr Scholar
Mr Turnbull
Mrs R Butler
Mr Culpin
Mr Gilhooly
Mr Gray
Mr Grimstone
Mr Pirie
Mr M Williams
Mr A Allan
Mr Stock
Dr Webb
Mrs Ryding
Mr Lord

Ch/ Whatever alone in the Treasury the CST's views do not appear to have been sought. You'll want to consult them before deciding.

RL 20/2

1986 FSBR: TABLE 6.5: ALLOCATING THE RESERVE

1. Last year it was decided not to allocate the expenditure Reserve for the year ahead in table 6.5 of the FSBR, except notionally between sectors. This submission seeks your agreement to allocating it fully according to the Budget forecast, in this year's FSBR, as was done in 1984. (In 1983 the treatment was more mixed - see below. Copies of the 1983, 1984 and 1985 tables are attached, at A, B and C.) The submission has been agreed with Sir Peter Middleton, Sir Terence Burns and Mr F E R Butler, and with GEP, LG, PE and Pay Groups.

Background

2. You have already decided to keep table 6.5, as well as a more summary version (on the lines Mr Lord suggested). It shows the detail of economic categories and sectors which helps to give substance to our published forecast of the PSBR for the year ahead. That published forecast is in fact based on a fully detailed forecast of all categories of receipts and expenditure, including a forecast of the allocation of the Reserve.

3. The problem of allocating the Reserve in table 6.5 is the fear that outsiders will compare the results with the PEWP plans and deduce what overspending the Government expects on various sensitive categories, such as pay, local authority relevant current expenditure, and local authority capital.

4. Because of that fear, up to and including the 1983 FSBR, in the table equivalent to 6.5, the Reserve was notionally allocated entirely to central government. In 1982 that caused

trouble: because of the low (plans) figure for local authorities' expenditure, local authority rates had to be massaged down to produce a sensible borrowing figure. The press noticed the difference between the Budget forecast of rates and the rate increases actually known by then, which were much higher.

5. Accordingly, in 1983, although the old-style Contingency Reserve remained notionally allocated (see A attached), some allowance for general overspend was allocated to local authorities (allocated fully to economic categories). However, that caused trouble too. It resulted in the gross allowance for shortfall (on central government) in the FSBR table being higher than the net allowance for shortfall (on the whole public sector) in the PEWP. The TCSC asked for a reconciliation of the FSBR table with the PEWP, but rather than reveal the forecast overspend on LAs the Government replied (D attached) saying there was "no easy or direct reconciliation". There was no come-back from the TCSC.

6. In 1984, the plunge was taken and the new-style Reserve (which includes all allowances for overspend and underspend) was fully allocated (B attached). There was no public reaction whatever, and no deductions, uncomfortable or otherwise, were made about the Government's forecast of overspends.

7. In 1985, however, because of the extra £2 billion which was to be added to the Reserve in the Budget, the old fears revived and the Reserve was "notionally" allocated to the three sectors, pro rata to the PEWP's programme plans (C attached). But the press seized on the £1.3 billion thus allocated to local authorities, treated it as a genuine forecast of overspend, and embarrassed the Government.

Case for Full Allocation of the Reserve

8. There are strong arguments in favour of full allocation across sectors and economic categories:-

(i) The Budget judgement is based on the assumption that the whole of the Reserve will actually be spent.

(ii) The forecasts of the economy and of the public sector accounts are based on the same assumption that the whole of the Reserve will be spent.

(iii) Informed commentators are well aware that both the Budget judgement and the forecasts are based on this assumption.

(iv) Allocating the Reserve in full makes for a more realistic and defensible forecast of the PSBR and public sector accounts.

(v) Finally, the allocation of the Reserve provides a better base for monitoring during the year. (The 1985 "Budget forecast" of supply expenditure, based on the notional allocation , was too high.) Both in public and internally, it is impracticable to monitor against more than one base.

Scope in 1986 for Deducing Overspends

9. Outside commentators, including the special advisers to the TCSC, have shown no sign of attempting to work out for themselves what overspends might be hidden in table 6.5 (either in 1983 or in 1984). However, Annex E examines what they might manage to deduce if they did try this year, assuming the Reserve were fully allocated as in 1984. Annex E includes in particular a comparison with PEWP table 1.14 (on gross capital spending).

10. Broadly, the conclusions are that the comparison would be particularly difficult this year, and that little could be deduced except:

- there is a large allocation from the Reserve to local authority current expenditure on goods and services (but the Government has already indicated that some overspend on provision is expected);

- not very much has been allocated to capital spending (but an outsider would probably exaggerate the amount involved).

In particular, there would be no inferences about extra provision for central government pay which could not be easily rebutted.

11. Thus, nothing embarrassing to the Government could be deduced even if the (heroic) attempt were made.

12. If it were made, the general line to take would be that the Budget judgement did indeed allow for a full allocation of the Reserve. Some system of allocation has to be made for the purpose of building up the forecast, including that of revenues. If the Government were actually asked for a reconciliation, a refusal could be given as in 1983. The additional point could be made that to reveal the precise allocation of the Reserve would be inimical to public expenditure control.

Possible Modification of Non-Allocation

13. An alternative to full allocation would be to have no allocation at all. That is, there would be no notional allocation to the three sectors. Instead, the Reserve would be shown as a single item in the public sector column, in a separate line outside the expenditure block but above the

financial deficit line* (see version at M attached). No sectoral totals of receipts, expenditure or borrowing would be shown, either here or elsewhere in the FSBR.

14. Then the true Budget forecast of the sectoral totals of receipts, expenditure and borrowing could be used as a monitoring base, though not published.

15. This treatment could be defended by reference to the trouble caused last year by the notional attribution to the local authorities. But it would mean showing a number of gaps in table 6.5 and elsewhere, and a similar solution was rejected for that reason last year. X

New Summary table

16. Without full allocation in table 6.5 there would be problems for the proposed new summary table, which separates current and capital expenditure and shows the current surplus. If the Reserve were notionally allocated to current expenditure, both the current surplus and capital expenditure would be distorted downwards.

Views of DOE

17. Since DOE are the Department who have been most troubled by the results of the notional allocations, and indeed protested to the Treasury both in 1983 and 1985, their views have been sought. Their strong preference at official level is for full allocation rather than notional allocation: see letter of 23 December 1985, at N attached.

Views within Treasury

18. Other Groups are content with the recommendation of full allocation.

19. In particular, GEP have been concerned at the implications for expenditure control of showing projected outturns which differ from what are public expenditure control totals. But they regard the way this would be done in table 6.5 of the FSBR as acceptable, where the context is much wider and the definitions adopted are not relevant for control.

---

* The Reserve should be outside the expenditure block because part of it is usually expected to be required to meet a shortfall in receipts (eg nationalised industry receipts other than grant), not an excess of expenditure. It should be above the financial deficit line so that the deficit shown is reasonable, as well as the PSBR. (In 1983 the TCSC published a criticism of the fact that the contingency reserve and shortfall allowance had been put below the deficit line.) In principle some of the Reserve could be used to meet a shortfall in privatisation proceeds, which are in line 27 outside the financial deficit, but we do not usually forecast such a shortfall.

20. There is a minority view within GEP in favour of non-allocation, because of the note sent recently to the TCSC arguing that the specific components of the Reserve cannot be identified, which might appear to conflict with an allocated Reserve in the FSBR a few weeks later. However, the rest of GEP argue that the conflict can be resolved: Y

- The FSBR table will be confined to 1986-87, whereas the TCSC were focussing principally on the implications for the Reserve in the following two years of the decision to carry forward only the cash value of local authority current spending.

- The allocation has no implications for policy and public expenditure control. It is done to maintain consistency with the forecast's assumption that the Reserve is fully spent. It does not imply that the Reserve contains implicit provision for specific services or that it is planned to allocate the Reserve on the basis of the assumptions. In contrast the White Paper sets out the Government's expenditure plans. It would be inconsistent with its role as a control document to indicate what use may be made of the Reserve.

21. LG are also content, and PE. In an ideal world, Pay would prefer notional allocation or none at all, but recognise the strength of the counter-arguments.

Conclusion

22. We recommend that, in table 6.5 in the 1986 FSBR, the Reserve in 1986-87 be fully allocated across sectors and economic categories, as it was for 1984-85 in the 1984 FSBR. (The summary version, showing the current surplus, would be treated similarly. But tables such as 5.4 which show expenditure broken down by department would not have the Reserve allocated, since that would at once reveal the forecast overspends on sensitive items.) The table would then look roughly as in H attached.

23. Failing full allocation, we recommend that the Reserve be not allocated at all, so that Table 6.5 would look as in M attached.

MEP

MISS M E PEIRSON

A

1983 FSBR

A 1983 FSBR

£ million

		1983–84 Forecast				
		General Government			Public corporations	Public sector
		Central government	Local authorities	Total		
Current receipts						
Taxes on income	1	42 892	—	42 892	−246	42 646
Taxes on expenditure	2	37 020	13 030	50 050	—	50 050
National insurance, etc. contributions	3	21 241	—	21 241	—	21 241
Gross trading surplus	4	−160	288	128	9 624	9 752
Rent and oil royalties etc.	5	1 674	3 106	4 780	506	5 286
Interest and dividends from private sector and abroad	6	1 761	518	2 279	852	3 131
Non-trading capital consumption	7	846	1 396	2 242	—	2 242
Total	8	**105 274**	**18 338**	**123 612**	**10 736**	**134 348**
Current expenditure						
Final consumption	9	−40 368	−25 648	−66 016	—	−66 016
Subsidies	10	−4 259	−1 232	−5 491	—	−5 491
Debt interest to private sector and abroad	11	−11 881	−2 218	−14 099	−669	−14 768
Current grants to personal sector	12	−36 724	−3 103	−39 827	—	−39 827
Current grants paid abroad	13	−2 013	—	−2 013	—	−2 013
Total	14	**−95 245**	**−32 201**	**−127 446**	**−669**	**−128 115**
Current transfers within public sector						
Current grants	15	−19 362	19 362	—	—	—
Interest and dividends	16	4 527	−1 752	2 775	−2 775	—
Balance: current surplus/deficit	17	**−4 806**	**3 747**	**−1 059**	**7 292**	**6 233**
Capital receipts						
Current surplus	18	−4 806	3 747	−1 059	7 292	6 233
Taxes on capital	19	1 550	—	1 550	—	1 550
Capital transfers from private sector	20	—	—	—	153	153
Total	21	**−3 256**	**3 747**	**491**	**7 445**	**7 936**
Capital expenditure						
Gross domestic fixed capital formation	22	−2 551	−2 404	−4 955	−8 096	−13 051
Increase in stocks	23	−298	—	−298	−661	−959
Capital grants to private sector	24	−2 020	−740	−2 760	−63	−2 823
Total	25	**−4 869**	**−3 144**	**−8 013**	**−8 820**	**−16 833**
Capital transfers within public sector	26	**−866**	**346**	**−520**	**520**	—
Financial surplus/deficit (balance of current and capital accounts)	27	−8 991	949	−8 042	−855	−8 897
Financial transactions—(net)						
Transactions concerning certain public sector pension schemes	28	160	—	160	—	160
Accruals adjustments	29	−57	78	21	27	48
Miscellaneous financial transactions	30	715	−419	296	117	413
Lending to private sector	31	−221	−408	−629	−239	−868
Lending, etc. abroad	32	−3	—	−3	−101	−104
Cash expenditure on company securities	33	−150	—	−150	−43	−193
Total	34	**444**	**−749**	**−305**	**−239**	**−544**
Lending within public sector	35	−4 186	1 991	−2 195	2 195	—
Unallocated items:						
Special sales of assets	36	750	—	750	—	750
Contingency reserve (1)	37	−1 097	—	−1 097	—	−1 097
General allowance for shortfall (2)	38	1 600	—	1 600	—	1 600
Contribution to Public sector borrowing requirement	39	**11 480**	**−2 191**	**9 289**	**−1 101**	**8 188**
Sectoral borrowing requirement		8 547(3)	−200	8 347(3)	1 094	

(1) See table 5.7 for allocation of Contingency Reserve.

(2) Differs from table 5.10 because of holdback on local authorities' grants.

(3) Excludes unallocated items. See paragraphs 5.21 and 5.22.

1984 FSBR

B

£ billion

	Line([2])	1984–85 Forecast: General government: Central govern-ment	Local authori-ties	Total	Public corpora-tions	Public sector
Current and capital receipts						
Taxes on income	1	48·0	—	48·0	−0·2	47·8
Taxes on expenditure	2	39·6	12·9	52·5	—	52·5
National insurance, etc. contributions	3	23·0	—	23·0	—	23·0
Gross trading surplus	4	−0·3	0·2	−0·1	9·4	9·3
Rent and oil royalties etc.	5	2·1	3·0	5·1	0·6	5·6
Interest and dividends from private sector and abroad	6	1·8	0·6	2·4	0·8	3·2
Interest and dividends within public sector	7	4·8	−2·3	2·4	−2·4	—
Imputed charge for non-trading capital consumption	8	1·0	1·6	2·6	—	2·6
Taxes on capital	9	1·7	—	1·7	—	1·7
Capital transfers from private sector	10	—	—	—	0·2	0·2
Total	11	**121·8**	**16·0**	**137·8**	**8·3**	**146·1**
Current and capital expenditure						
Current expenditure on goods and services([3])	12	−43·5	−26·8	−70·3	—	−70·3
Subsidies	13	−4·9	−1·3	−6·3	—	−6·3
Current grants to personal sector	14	−39·6	−3·6	−43·3		−43·3
Current grants paid abroad	15	−1·9	—	−1·9	—	−1·9
Current grants within public sector	16	−19·5	19·5	—	—	—
Debt interest to private sector and abroad	17	−13·8	−1·4	−15·2	−0·8	−16·0
Gross domestic fixed capital formation	18	−2·8	−2·7	−5·4	−7·6	−13·1
Increase in stocks	19	−0·2	—	−0·2	−0·4	−0·6
Capital grants to private sector	20	−2·3	−0·7	−3·0	−0·1	−3·1
Capital grants within public sector	21	−0·8	0·3	−0·5	0·5	—
Total	22	**−129·4**	**−16·8**	**−146·2**	**−8·4**	**−154·6**
Financial surplus/deficit([4])	23	**−7·6**	**−0·8**	**−8·4**	—	**−8·5**
Financing components (net)						
Lending to private sector and abroad	24	−0·3	−0·1	−0·4	−0·2	−0·6
Lending within public sector	25	−5·8	4·4	−1·4	1·4	—
Cash expenditure on company securities	26	1·9	—	1·9	—	1·9
Transactions concerning certain public sector pension schemes	27	−0·1	—	−0·1	—	−0·1
Accruals adjustments	28	0·9	−0·1	0·8	−0·1	0·6
Miscellaneous financial transactions	29	−0·1	−0·2	−0·3	−0·2	−0·5
Contribution to public sector borrowing requirement	30	11·1	−3·1	7·9	−0·7	7·2
Sectoral borrowing requirements([5])	31	**5·3**	**1·3**	**6·6**	**0·6**	**7·2**

([3]) Including non-trading capital consumption.

([4]) The balance of current and capital accounts, financed by net borrowing/lending. The financing components are shown in lines 24 to 30.

([5]) Line 30 adjusted for lending within public sector.

1985 FSBR

C

C
1985
FSBR

£ billion

	Line(2)	1985-86 Forecast: General government: Central govern-ment	Local authori-ties	Total(3)	Public corpora-tions	Public sector
Current and capital receipts						
Taxes on income(4)	1	53·2	—	53·2	−0·3	52·9
Taxes on expenditure(4)	2	42·2	13·6	55·8	—	55·8
Taxes on capital(4)	3	1·9	—	1·9	—	1·9
National insurance, etc. contributions	4	24·6	—	24·6	—	24·6
Gross trading surplus	5	−0·4	0·4	−0·1	7·6	7·6
Rent and oil royalties etc.	6	2·6	3·0	5·6	0·6	6·2
Interest and dividends from private sector and abroad	7	3·0	0·7	3·7	1·0	4·7
Interest and dividends within public sector	8	5·3	−2·6	2·7	−2·7	—
Imputed charge for non-trading capital consumption	9	0·9	1·6	2·5	—	2·5
Capital transfers from private sector	10	—	—	—	0·2	0·2
Total	11	**133·2**	**16·7**	**150·0**	**6·5**	**156·5**
Current and capital expenditure						
Current expenditure on goods and services(5)	12	−46·3	−27·6	−73·9	—	−73·9
Subsidies	13	−4·7	−0·8	−5·5	—	−5·5
Current grants to personal sector	14	−42·1	−3·9	−46·0	—	−46·0
Current grants paid abroad	15	−2·4	—	−2·4	—	−2·4
Current grants within public sector	16	−20·4	20·4	—	—	—
Debt interest	17	−16·4	−1·6	−18·0	−0·5	−18·5
Gross domestic fixed capital formation	18	−3·1	−2·6	−5·7	−6·1	−11·8
Increase in stocks	19	−0·1	—	−0·1	−0·3	−0·4
Capital grants to private sector	20	−2·2	−0·6	−2·8	—	−2·8
Capital grants within public sector	21	−0·9	0·4	−0·5	0·5	—
Unallocated Reserve(8)	22	*−3·6*	*−1·3*	*−4·9*	*−0·1*	−5·0
Total	23	*−142·2*	*−17·6*	*−159·9*	*−6·4*	**−166·3**
Financial surplus/deficit(6)	24	*−9·0*	*−0·9*	*−9·9*	*0·1*	**−9·8**
Financial transactions						
Net lending to private sector and abroad	25	−0·1	0·1	−0·1	—	−0·1
Cash expenditure on company securities (net)	26	2·5	—	2·5	0·1	2·6
Transactions concerning certain public sector pension schemes (net)	27	0·2	—	0·2	—	0·2
Accruals adjustments	28	0·2	—	0·2	—	0·3
Miscellaneous financial transactions	29	0·5	−0·7	−0·2	0·1	−0·1
Borrowing requirement(7)	30	*5·8*	*1·5*	*7·3*	*−0·2*	*7·1*

(3) General government expenditure in Tables 2.2, 2.4, 5.2 and 5.4 = (23) + (25) + (26) + public corporations' borrowing from central government (Table 6.4). General government receipts in Tables 2.3 and 2.4 = (11) + (27) + (28) + (29).

(4) Lines (1) + (2) + (3), first column = first line of Table 6.2 = central government taxation in national accounts terms. It includes, besides Consolidated Fund taxation receipts (see footnote (7) to Table 6.8), the gas levy, accruals adjustments and VAT paid by but refunded to local authorities and government departments, as well as some other small items. The first line of Table 2.3 also includes oil royalties and local authorities' rates.

(5) Including non-trading capital consumption.

(6) The balance of receipts and expenditure, financed by net borrowing/lending shown in lines (25) to (30).

(7) Borrowing by central government on own account and total borrowing by local authorities and public corporations. Borrowing by local authorities and public corporations from central government is shown in Tables 6.3 and 6.4.

(8) Expenditure estimates for 1985–86 in lines (12) to (21) are based on the programme plans in Cmnd. 9428, plus the Budget measures. The £5 billion Reserve in line (22) has been notionally allocated to the central government, local authorities and public corporations sectors, pro rata to the programme plans for those sectors. This notional allocation carries no implications for the degree to which the Reserve will actually be spent in those sectors. The allocation and the resulting totals, both in this and in earlier tables, are therefore shown in italics.

D

Letter to TCSC, 1983

APPENDIX 5

Note by HM Treasury

LETTER TO THE CLERK TO THE COMMITTEE

In advance of our appearance this afternoon I am replying to your letter of 17 March addressed to Peter Mountfield.

First, you asked for a reconciliation in Table 5.8 in the Financial Statement and Budget Report (FSBR) and Table 1.8 in the recent Public Expenditure White Paper (Cmnd 8789). There is no direct or easy reconciliation. Table 5.8 is compiled using CSO national accounts definitions; expenditure items are defined differently for the purposes of public expenditure and not all are included in Cmnd 8789 planning totals. The purpose of Table 5.8 is to show the contributions the various sectors make to the Public Sector Borrowing Requirement (PSBR). A simpler and more immediate reconciliation between the PSBR and the figures in Table 1.8 of Cmnd 8789 can be found in Table 5.5 of the FSBR, where the totals from Table 1.8 are shown. The PSBR as shown in Table 5.5 are of course the same as those shown in Table 5.8—£7.5 billion in the former put more precisely at £7,512 million in the latter for 1982–83; and £8.2 billion and £8,188 million respectively in 1983–84.

Second, you asked for a reconciliation between Tables 5.8 and 2.3 in the FSBR. This is achieved as follows. Table 2.3 line 6 equals Table 5.8, row 11, third column. Table 2.3 line 7 equals the sum of the following lines in Table 5.8 third column; lines 14, 25, 26, 31, 32, 33, 35, 36, 37 and 38.

Third, you asked for a reconciliation between line 4 in Table 2.3 (and footnote 4) with the figures given in Table 5.6. For 1983–84 line 4 of Table 2.3 (differences due to policy etc) reflects revisions to the Public Expenditure Planning Totals since Cmnd 8789 (shown in Table 5.6) plus an assumption about the general Government share of the £1.2 billion general allowance for shortfall included within the revised planning total (after taking account of Budget measures affecting the Contingency Reserve, and revised economic assumptions). Line 3 of Table 2.3 makes no allowance for shortfall as a result of the planning total adjustment (line 2). For the later years, line 4 of Table 2.3 reflects the (necessarily highly uncertain) forecasting judgment, on the Medium Term Financial Strategy assumptions, that the provisional reserve of £3 billion per year will not be fully used.

Fourth, you asked about updated information on the financing requirement of the nationalised industries. I confirm that the latest available detailed coordinated information on individual nationalised industries corresponding to the format used in previous FSBRs is set out in Table 3.4(b) and 3.5 of Cmnd 8789. Certain changes will flow from the Budget (ie adjustments to take account of the new NIS rate proposed) and a table of updated EFLs will be published in due course.

Next, you asked about the numbers of people taken out of tax in 1983–84 as a result of the Budget proposals. Under the Chancellor's proposals ¾ million fewer people will pay income tax in 1983–84 than if the personal allowances had increased by only 5.4 per cent in line with the statutory requirement. 1¼ million fewer people will pay income tax than if the allowances had remained at 1982–83 levels.

Finally, you asked how many of those taken out of tax are family heads with dependent children. Figures for numbers of tax payers include, in addition to their husbands, those wives whose earnings are above the maximum wife's earned income relief. A more appropriate definition when considering this question is that of the tax unit, where husband and wife are counted as one. It is estimated that under the Chancellor's proposals 850,000 fewer tax units will pay income tax in 1983–84 than if the personal allowances had remained at their 1982–83 levels; and that about 500,000 fewer tax units will pay income tax than if the allowances had merely been indexed by 5.4 per cent. Of these 500,000 tax units, it is estimated that about 80,000 are family heads with dependent children; and about 10,000 of these family heads are single parents.

E P Kemp
23 *March* 1983

D
LETTER
TO TCSC
1983

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ANNEX E

Scope in 1986 for Deducing Overspends

1. This annex examines how much an outsider might be able to deduce about the allocation of the Reserve in 1986-87, by comparing FSBR table 6.5 (assuming full allocation in that table, as in 1984) with the PEWP. The comparison with table 2.10 of the PEWP, covering all spending, is examined first; then the comparison with PEWP table 1.14 on capital; and lastly the comparison of year-on-year growth rates.

Comparison of both current and capital spending

2. As it happens, the task of comparison is made considerably more difficult this year because the main corresponding PEWP table, showing the programme plans broken down by sector and economic category, has been changed. The new version (table 2.10, attached at F) is significantly different from table 6.5, even for central and local government. For instance, expenditure on goods and services (other than pay) is not split between capital and current.

ANNEX E

3. It would nonetheless be possible for a very determined and knowledgeable person, using table 2.10 and certain other tables in the PEWP (eg the one on gross public sector capital), to make a fairly good guess at a break-down of the PEWP plans approximately comparable with table 6.5. At G attached is a table comparing the figures for 1986-87 he would get from the PEWP with the table 6.5 figures. (The latter are based on the January forecast*. The resulting table 6.5 is at H attached. The detailed figuring will change before the table is published, but it gives a fairly good idea of what the figures will look like, especially for expenditure.)

4. The best figures the outsider could get from the PEWP are shown in column 1 of table G (though he would be more likely to make some serious errors); those from table 6.5 are in column 2; the differences are in column 3, and are analysed in columns 4-6. The outsider would not know the remaining errors he was making in deriving the PEWP figures (column 4); neither would he know the distribution of the national accounts adjustments (column 5); and therefore he could not deduce the allocation of the Reserve (column 6).

5. He could make a stab at column 5, using published information about past national accounts adjustments (which are the adjustments needed to get from the planning total in the PEWP to general government expenditure on a national accounts basis in the FSBR). But it is no easy matter to allocate even these past adjustments to economic categories.

6. If he did so, he might manage to derive something

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* The expenditure figures being slightly adjusted to use up the whole of the Reserve, and the whole of the fiscal adjustment being taken on personal income tax.

 E continued

approaching the sum of columns 4 (errors) and 6 (Reserve allocation), and deduce that:

(i) there was very little, if anything, allocated from the Reserve to central government cegs (current expenditure on goods and services), ie pay plus procurement;

(ii) there was a large allocation from the Reserve (possibly around £2 billion) to local government cegs;

(iii) there was a modest allocation (perhaps £½ billion) to central government gdfcf and nothing to local authority gdfcf (see also below on the comparison with the PEWP table on capital);

(iv) there was a modest net allocation (perhaps £¼ billion) to total public corporations' borrowing (CG lending to PCs plus PCMOB): but he could not deduce the position on grant to PCs and so he could deduce nothing about forecast overspend on external finance.

7. The only potentially embarrassing item in the above list is (ii). But the Government has already indicated that some overspend on provision is expected, and it is unlikely that the outsider would get close to the true figure.

Comparison of capital spending

8. The outsider might well take a special interest in the comparison with PEWP table 1.14 on capital spending (attached at K). That table explicitly states that no allowance is made for allocations to capital spending from the Reserve. Attached at L is a comparison of the best figures the outsider might get from the PEWP and FSBR tables. (There is no breakdown of general government between central and local in the PEWP table.)

9. Table L shows that the outsider would be likely to deduce correctly that a modest allocation had been made to general government capital spending on goods and services. However, he might wrongly think that a sizeable allocation had been made to public corporations' capital spending: even if he realised that there was some difference for industries about to be privatised, he could not know how much to allow. Such a mistake would tend to help the Government's case.

Comparison of year-on-year growth rates

10. An easier approach which the outsider might adopt is to look at the growth rates between 1985-86 and 1986-87. With full allocation of the Reserve, the growth rates for some of the categories in table 6.5 of the FSBR (shown in column 7 of table G) would be higher than the growth rates for the nearest equivalent PEWP categories. The main deductions the outsider might make, and the possible answers, are as follows:-

E continued

(i) Central government cegs rises in the FSBR by 6.7%, on the face of it implying either a large increase in procurement or some provision for pay increases above 5%. But the sum of the first three lines of table 2.10 of the PEWP - representing Departmental net running costs plus other central government pay - also rises by 6.8%, so no extra allowance is necessarily implied by the FSBR figures.

(ii) Local authority cegs rises by 7%, whereas provision for relevant current expenditure in the PEWP rises by only 1%, implying a considerable allocation of the Reserve to the latter category. But relevant current is rather different from cegs and, as said above, some likely increase above PEWP has already been acknowledged.

(iii) Central government current grants to persons rise by over 6%, whereas social security in the PEWP rises by only some 4%. But there is other expenditure in the former category (eg special employment measures, and redundancy and maternity payments).

1986 PEWP TABLE 2.10 F

Table 2.10 Planning total by spending authority and economic category

£ million

	1980–81 outturn	1981–82 outturn	1982–83 outturn	1983–84 outturn	1984–85 outturn	1985–86 estimated outturn	1986–87 plans	1987–88 plans	1988–89 plans
Central government									
Departmental running costs	7,959	8,995	9,799	11,293	11,986	12,588	13,321	13,750	14,100
Running costs receipts	−1,498	−1,821	−1,899	−2,805	−3,065	−3,260	−3,382	−3,520	−3,600
Other public sector pay	10,383	11,651	12,506	13,343	14,064	15,071	16,127	16,820	17,490
Transfers to the personal sector	26,935	32,179	36,437	38,211	40,811	43,994	45,558	46,900	48,500
Purchases of goods and services	14,310	16,424	18,769	19,478	22,150	23,778	24,381	25,020	25,500
Transfers to the corporate sector	8,270	8,580	6,502	6,106	7,906	6,678	5,766	4,610	4,480
Payments overseas	805	1,061	1,784	2,326	2,665	2,551	2,548	3,120	3,040
of which:–									
Finance for public corporations (including nationalised industries) included above	3,748	4,118	2,619	2,860	4,508	2,797	1,684	840	770
Total central government (excluding finance for public corporations)	63,416	72,949	81,279	85,093	92,010	98,602	102,636	105,900	108,800
Local authorities									
Other public sector pay	15,041	16,745	18,082	18,909	20,527	20,620	20,135	20,140	20,150
Transfers to the personal sector	1,481	1,894	2,543	4,789	4,865	4,817	4,802	4,800	4,900
Purchases of goods and services	7,297	6,495	7,075	8,460	8,529	9,035	9,599	9,790	9,890
Transfers to the corporate sector	1,309	1,553	1,547	1,128	1,018	958	710	720	760
of which:–									
Finance for public corporations (including nationalised industries) included above	118	122	142	149	152	161	48	50	50
Total local authorities (excluding finance for public corporations)	25,010	26,563	29,105	33,138	34,787	35,269	35,198	35,400	35,600
Nationalised industries' external finance									
Grants and subsidies	1,192	1,448	1,872	1,899	2,715	2,651	1,909	1,430	1,300
Net lending	2,779	1,365	1,774	661	−545	965	213	−250	−110
Market and overseas borrowing	−751	741	−1,504	−275	1,658	−1,423	−1,193	−1110	−1220
Total nationalised industries' external finance	3,220	3,553	2,143	2,285	3,827	2,193	929	70	−30
List I and II public corporations' external finance(1)									
Grants and subsidies	203	285	314	336	347	346	362	380	400
Net lending	139	79	45	52	151	95	112	100	110
Market and overseas borrowing	−16	−7	−62	−5	−4	18	13		
Total List I and II public corporations' external finance	326	356	297	383	494	459	487	480	510
List III public corporations(1)(2)									
Subsidies	320	331	322	341	339	305	316	330	340
Goods and services	437	330	301	280	290	171	120	150	180
Grants	29	29	34	45	58	66	73	40	30
Net lending and other capital transactions	287	337	356	−120	−77	−92	−44	−20	−40
Total List III public corporations	1,072	1,027	1,014	546	610	451	466	500	520
Planning total by economic category									
Departmental running costs	7,959	8,995	9,799	11,293	11,986	12,588	13,321	13,750	14,100
Running costs receipts	−1,498	−1,821	−1,899	−2,805	−3,065	−3,260	−3,382	−3,520	−3,600
Other public sector pay	25,423	28,396	30,588	32,252	34,591	35,690	36,262	36,970	37,640
Transfers to the personal sector	28,305	34,091	39,073	42,672	45,432	48,619	50,249	51,600	53,300
Purchases of goods and services	22,044	23,248	26,145	28,218	30,969	32,984	34,101	34,960	35,570
Transfers to the corporate sector	10,006	10,480	8,347	7,488	9,150	7,803	6,616	5,460	5,370
Payments overseas	805	1,061	1,784	2,326	2,665	2,551	2,548	3,120	3,040
Reserve							4,500	6,250	8,000
General privatisation proceeds	−405	−494	−488	−1,142	−2,091	−2,622	−4,750	−4,750	−4,750
Adjustments(3)						−150	−400		
Planning total	92,639	103,955	113,349	120,303	129,638	134,203	139,066	143,900	148,700

(1) *Details of individual public corporations included in Lists I, II and III are shown in Table 6.1.*
(2) *Figures include the capital expenditure of these corporations and government subsidies to them.*
(3) *See footnote(*) to Table 2.1.*

F
1986
PEWP

7/2073

Differences between PEWP and FSBR table 6.5

TABLE G

1986-87 £billion	1986 PEWP	FSBR table 6.5	Difference	of which: Errors in deriv'n of PEWP figs*	National accounts adjustments	Allocation of Reserve	FSBR growth between 1985-86 and 1986-87
Central Government	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Current exp.on goods & services	47.2	49.4	2.2	- 0.3	2.3	0.3	6.7%
GDFCF	2.9	3.3	0.4	0.3	0.1	-	3.1%
Stockbuilding	0.4	0.2	- 0.2	-	- 0.2	-	
Current grants abroad	2.6	2.7	0.3	-	0.2	0.2	3.8%
Net lending to priv. sec & abroad		0.2			-		
Subsidies	52.1	5.8	2.2	-	0.2	1.1	1.8%
Current grants to persons		45.8			0.8		6.3%
Capital grants		2.7			0.1		
Net lending to PCs	0.3	0.2	- 0.1	-	0.5	- 0.6	
Total CG	105.5	110.3	4.8	-	3.9	0.9	
Local Authorities							
Curr. exp. on goods & services	26.1	30.4	4.3	0.3	2.2	1.8	7.0%
GDFCF	3.7	3.6	- 0.1	- 0.3	-	0.3	3.9%
Current grants to persons	5.5	4.5	0.6	-	-	0.6	9.8%
Capital grants		0.7			-		
Subsidies		1.2			-		
Net lending		- 0.3			-		
Total LA	35.2	40.1	4.9	-	2.2	2.7	
Privatisation proceeds	- 4.8	- 4.9	- 0.1	-	- 0.1	-	
General Government expenditure (excl debt interest)	136.0	145.5	9.5	-	6.0	3.6	
less Nat. accs. adjs.	-	- 6.0	- 6.0	-	- 6.0	-	
plus PCMOB	- 1.6	- 0.7	0.9	-	-	0.9	
Other PC adjs.	0.2	0.2	-	-	-	-	
Reserve	4.5	-	- 4.5	-	-	- 4.5	
Planning Total	139.1	139.1	-	-	-	-	

* Due to insufficient detail in PEWP concerning capital expendit

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G

G DIFFERENCE BETWEEN PEWP AND FSBR

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1986 FSBR TABLE 6.5 : Allocated Reserve

£ billion

		1986-87 Forecast				
		General government			Public corpora-tions	Public sector
	Line[2]	Central govern-ment	Local authori-ties	Total[3]		
Current and capital receipts						
Taxes on income[4]	*1*	51.9	–	51.9	-0.2	51.7
Taxes on expenditure[4]	*2*	46.8	15.4	62.2	–	62.2
Taxes on capital [4]	*3*	2.8	–	2.8	–	2.8
National Insurance,etc. contributions	*4*	26.2	–	26.2	–	26.2
Gross trading surplus	*5*	-0.6	0.3	-0.3	7.6	7.3
Rent and oil royalties etc.	*6*	1.5	2.9	4.4	0.6	4.9
Interest and dividends from private sector and abroad	*7*	3.0	0.6	3.6	0.9	4.6
Interest and dividends within public sector	*8*	5.8	-3.1	2.7	-2.7	–
Miscellaneous current transfers	*9*	0.3	–	0.3	–	0.3
Imputed charge for non-trading capital consumption	*10*	1.0	1.5	2.4	–	2.4
Capital transfers from private sector	*11*	–	–	–	0.2	0.2
Total	***12***	**138.6**	**17.6**	**156.3**	**6.4**	**162.6**
Current and capital expenditure						
Current expenditure on goods and services[5]	*13*	-49.4	-30.4	-79.7	–	-79.7
Subsidies	*14*	-5.8	-1.2	-7.0	–	-7.0
Current grants to personal sector	*15*	-45.8	-4.5	-50.3	–	-50.3
Current grants paid abroad	*16*	-2.7	–	-2.7		-2.7
Current grants within public sector	*17*	-21.6	21.6	–	–	–
Debt interest	*18*	-17.0	-1.2	-18.3	-0.5	-18.8
Gross domestic fixed capital formation	*19*	-3.3	-3.6	-6.9	-5.4	-12.2
Increase in stocks	*20*	-0.2	–	-0.2	-0.2	-0.4
Capital grants to private sector	*21*	-2.3	-0.7	-3.0	–	-3.0
Capital grants within public sector	*22*	-1.1	0.7	-0.4	0.4	–
		–	–	–	–	–
Total	**23**	**-149.2**	**-19.3**	**-168.5**	**-5.6**	**-174.1**
Financial surplus/deficit[6]	**24**	**-10.6**	**-1.7**	**-12.3**	**0.8**	**-11.5**
Financial transactions						
Net lending to private sector and abroad	25	-0.2	0.3	0.1	-0.1	-0.1
Cash expenditure on company securities (net)	26	4.9	–	4.9	–	4.9
Transactions concerning certain public sector pension schemes	27	0.6	–	0.6	–	0.6
Accruals adjustments	28	-0.8	0.1	-0.7	0.1	-0.7
Miscellaneous financial transactions	29	-0.4	-0.2	-0.6	-0.2	-0.9
Borrowing requirement[7]	*30*	**6.5**	**1.6**	**8.1**	**-0.5**	**7.6**

(1) Sign convention : receipts positive, payments negative.

(2) Relationship between lines : Current balance = sum of lines (1),(2),(4) to (10),(13) to (18)
(24) = (12) + (23) = - { (25) to (30) }

(3) General government expenditure in Tables 2.2, 2.4, 5.1 and 5.5 = -{ (23) + (25) + (26) } + net lending to public corporations (Table 6.4)
General government receipts in Tables 2.3 and 2.4 = (12) + (27) + (28) + (29)

(4) Lines (1)+(2)+(3) = first line of Table 6.2 = central government taxation in national accounts terms. It includes, besides certain Consolidated Fund receipts (see footnote (7) to Table 6.8), accruals adjustments and VAT paid by but refunded to local authorities and government departments as well as some other small items. The first line of Table 2.3 also includes oil royalties and local authorities' rates.

(5) Including non-trading capital consumption.

(6) The balance of receipts and expenditure, financed by net borrowing/lending shown in lines (25) to (30).

(5) Including special sales of assets.

(8) Borrowing by central government on own account and total borrowing by local authorities and public corporations. Borrowing by local authorities and public corporations from central government is shown in Tables 6.3 and 6.4.

H
1986
FSBR

K

1986 PEWP

Table 1.14 Public sector capital spending[1]

£billion

	1983-84 outturn	1984-85 outturn	1985-86 estimated outturn	1986-87 plans	1987-88 plans	1988-89 plans
Goods and services						
General government						
Expenditure on dwellings	2.5	2.6	2.2	2.4	2.5	2.4
New construction other than dwellings	4.5	5.0	5.0	4.6	4.7	4.8
Purchases (net) of vehicles, plant and machinery	1.2	1.1	1.3	1.2	1.1	1.1
Defence expenditure						
Construction	0.5	0.6	0.8	6.0	6.1	6.2
Equipment	4.2	4.8	5.2			
Total general government goods and services	12.9	14.1	14.4	14.2	14.4	14.6
Real terms (base year 1984-85)	*13.5*	*14.1*	*13.7*	*12.9*	*12.7*	*12.5*
Public corporations including nationalised industries[2]						
New construction other than dwellings	1.7	1.5	1.8	1.9	1.9	1.9
Purchases of vehicles, plant and machinery	2.6	2.6	2.6	2.7	2.2	2.2
Total goods and services	17.3	18.2	18.8	18.7	18.6	18.7
Capital grants to the private sector	3.4	3.2	2.8	2.7	2.4	2.4
Total goods and services plus capital grants to the private sector	20.7	21.3	21.6	21.4	20.9	21.1
Real terms (base year 1984-85)	*21.6*	*21.3*	*20.6*	*19.5*	*18.4*	*18.0*

The figures for 1986-87, 1987-88 and 1988-89 make no allowance for allocations to capital spending from the Reserve.

[1] *See footnotes to Table 2.17 in Part 2.*

[2] *Excluding industries that have been, or are about to be, privatised. A provisional allowance is included for investment by the National Coal Board in the plan years.*

K
1986
PEWP

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TABLE L

Differences on capital between PEWP and FSBR

1986-87 £billion	PEWP table 1.14	FSBR table 6.5	Difference	of which: Errors in deriv'n	National accounts adjustments	Allocation of Reserve
Total general government goods and services	14.2	14.3°	0.1	- 0.1	0.1	0.2
Public corporations' goods and services	4.6	5.4	0.8	0.8*	0.1	- 0.1
Capital grants to private sector	2.7	2.9	0.2	-	0.1	0.2
Total goods and services plus capital grants to private sector	21.4	22.6	1.2	0.7	0.2	0.3

* Most of this is because the PEWP table excludes the capital expenditure of industries which have been, or are about to be, privatised.

° This figure is derived by adding defence capital to, and subtracting asset sales from, the table 6.5 figure in order to get to PEWP definitions.

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L DIFFERENCES ON CAPITAL BETWEEN PEWP AND FSBR

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1986 FSBR TABLE 6.5 : Unallocated Reserve

£ billion

	Line[2]	1986-87 Forecast: General government: Central government	Local authorities	Total[3]	Public corporations	Public sector
Current and capital receipts						
Taxes on income[4]	1	51.9	-	51.9	-0.2	51.7
Taxes on expenditure[4]	2	46.8	15.4	62.2	-	62.2
Taxes on capital [4]	3	2.8	-	2.8	-	2.8
National insurance,etc. contributions	4	26.2	-	26.2	-	26.2
Gross trading surplus	5	-0.6	0.3	-0.3	7.7	7.4
Rent and oil royalties etc.	6	1.5	2.9	4.4	0.6	4.9
Interest and dividends from private sector and abroad	7	3.0	0.6	3.6	0.9	4.6
Interest and dividends within public sector	8	5.8	-3.1	2.7	-2.7	-
Miscellaneous current transfers	9	0.3	-	0.3	-	0.3
Imputed charge for non-trading capital consumption	10	1.0	1.5	2.4	-	2.4
Capital transfers from private sector	11	-	-	-	0.2	0.2
Total	12					162.7
Current and capital expenditure						
Current expenditure on goods and services[5]	13	-49.1	-28.5	-77.7	-	-77.7
Subsidies	14	-5.8	-0.9	-6.7	-	-6.7
Current grants to personal sector	15	-44.9	-4.2	-49.1	-	-49.1
Current grants paid abroad	16	-2.5	-	-2.5	-	-2.5
Current grants within public sector	17	-21.1	21.1	-	-	-
Debt interest	18	-17.0	-1.2	-18.3	-0.4	-18.7
Gross domestic fixed capital formation	19	-3.3	-3.4	-6.7	-5.5	-12.1
Increase in stocks	20	-0.2	-	-0.2	-	-0.2
Capital grants to private sector	21	-2.2	-0.6	-2.8	-	-2.8
Capital grants within public sector	22	-1.1	0.7	-0.4	0.4	-
Total	23					-169.7
Unallocated Reserve	24					-4.5
Financial surplus/deficit[6]	25					-11.5
Financial transactions						
Net lending to private sector and abroad	26	-0.2	0.3	0.1	-0.1	-0.1
Cash expenditure on company securities (net)	27	4.9	-	4.9	-	4.9
Transactions concerning certain public sector pension schemes	28	0.6	-	0.6	-	0.6
Accruals adjustments	29	-0.8	0.1	-0.7	0.1	-0.7
Miscellaneous financial transactions	30	-0.4	-0.2	-0.6	-0.2	-0.9
Borrowing requirement[7]	31					7.6

(1) Sign convention : receipts positive, payments negative.

(2) Relationship between lines : Current balance = sum of lines (1),(2),(4) to (~~9~~ 10),(~~12~~ 13) to (~~21~~ 18) and part of (~~22~~ 24)
(~~24~~ 25) = (~~11~~ 12) + (~~23~~ 24) = - { (~~25~~ 26) to (~~30~~ 31) }

(3) General government expenditure in Tables 2.2, 2.4, 5.1 and 5.5 = -{ (~~23~~ 24) + (~~25~~ 26) + (~~26~~ 27) } + net lending to public corporations (Table 6.4)
General government receipts in Tables 2.3 and 2.4 = (~~11~~ 12) + (~~27~~ 28) + (~~28~~ 29) + (~~29~~ 30)

(4) Lines (1)+(2)+(3) = first line of Table 6.2 = central government taxation in national accounts terms. It includes, besides certain Consolidated Fund receipts (see footnote (7) to Table 6.8), accruals adjustments and VAT paid by but refunded to local authorities and government departments as well as some other small items. The first line of Table 2.3 also includes oil royalties and local authorities' rates.

(5) Including non-trading capital consumption.

(6) The balance of receipts and expenditure, financed by net borrowing/lending shown in lines (25) to (30).

(5) Including special sales of assets.

(8) Borrowing by central government on own account and total borrowing by local authorities and public corporations. Borrowing by local authorities and public corporations from central government is shown in Tables 6.3 and 6.4.

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1986
FSBR
UNALLOCATED RESERVE

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Department of the Environment
2 Marsham Street London SW1P 3EB
Telephone 01-212 3434

Direct line 01-212-5041

[Extract]

Ms M Pierson
H M Treasury
Parliament Street
LONDON
SW1P 3AG

23 December 1985

Dear Margaret

LOCAL AUTHORITY FORECASTS IN THE FSBR

At your forecasting meeting earlier this month you asked for DOE's view on the treatment of the Reserve in relation to local authority forecasts published in the 1986 Financial Statement and Budget Report (FSBR).

Various solutions to this problem have been adopted in recent years but it seems to us that for next year there are only two real options:

(i) base the expenditure figures in FSBR on realistic forecasts, as in 1984; or

(ii) base the expenditure figures on PES provision and show a notional allocation of the Reserve to sectors, as in 1985.

I have consulted widely within DOE and our strong view is that (i) is the better option. This was the solution which Mr Heiser proposed in his letter to Mr Bailey of 21 March following the difficulties which option (ii) caused us all this year. We do recognise that this approach entails some risk of forecast overspends being exposed in public. But against that:

(a) the 1984 figures, which also showed an overspend, passed without comment. This may be because of the difficulty in disentangling the familiar aggregates from National Accounts definitions;

(b) even if the overspends are exposed, they will at least be realistic forecasts which we can defend publicly; our forecasts of current expenditure will have been based largely on rate increase announcements which will be in the public domain; and

(c) we will in any case have to make public forecasts shortly after FSBR on the basis of our revenue and capital budget returns.

J E KIDGELL
FINANCE, LOCAL AUTHORITY STATISTICS

N
LOCAL AUTHORITY FORECASTS IN THE FSBR

PMP.

Mrs Lomax

c.c. Mr Evans

Mr Mowl

RECONCILIATION OF FSBR AND LATEST REVENUE PROJECTIONS

The North Sea oil prices for calendar 1986 (on which 1986-87 revenues mainly depend; C.T. in 1986-87 depends mainly on prices in 1985) are given below

	FSBR	\$15 case
£ oil price	20·5	11·7
\$ price	26·1	16·6 (\$15 from Q2 \$21½ in Q1)
\$/£ rate	1·27	1·47

The fall in the sterling oil price is 43%, smaller than in the Chancellor's figuring. (the FSBR price is rather lower and the '\$15 case' price rather higher than in the Chancellor's calculations). A fall of 43% in the sterling oil price would reduce revenues by £6.7bn. (using the ready reckoner that a 1% lower price would reduce revenues by £140 m in 1986-87).

North Sea production is currently 7 per cent (9 m tonnes) higher than in the FSBR forecast. This according to ready reckoners would raise revenues by about £1 bn.

Hence, would expect overall change in revenues of about £5 bn based on ready reckoners. Inland Revenue model which deals with all this in a more sophisticated way produces a change of -£5·2 bn* split as follows:

Price -£6·3 bn.

Production/other +£1·1

Glyn Hacche

* from £11·3 bn to £6·1 bn. (£6·1 bn. is from latest forecast run which uses new $ figure)

Gwyn Hacche

34A/~~2nd~~ 3rd

CHANCELLOR OF THE EXCHEQUER

HONI SOIT QUI MAL Y PENSE

PR

Pls let me have a reconciliation of the apparent loss of nearly £5 bn of oil revenues in 1986/87, on the $15 a bbl assumption, from £11½ bn projection for 1986-87 in the 1985 MTFS to £6½ bn now forecast.

So far as I can recall, the 1985 forecast was based on $28 a bbl and a £/$ exchange rate of at most $1.20. We are now forecasting $15 a bbl with an exchange rate of at least $1.40.

over

This implies a fall in the £ oil price from £23.3 a bbl to £10.7 a bbl – a fall of 54%. Yet oil revenues fall by only 43%. Whilst output is expected to be slightly higher, this increase cannot be enough to square the circle.

All these figs are for money, so may not be quite right. But I don't believe they are all that far out; so please let me have a full reconciliation before the occasion.

N

2236/009

FROM: MISS M O'MARA

DATE: 21 February 1986

MR CULPIN

cc: Mr Scholar
Mrs Lomax (personal)
Mr Pickering
A/41

1986 FSBR AND BUDGET EPR

I have seen Mrs Lomax's minute of 19 February containing the Chancellor's proposal that the Budget EPR might be made available at the same time as the FSBR, with the thought that you and I would be in the lead on this.

2. This minute is simply to register that in practice we would have to look to IDT to take on the bulk of this work, as I mentioned to you at a recent Central Unit meeting. On past performance, EB will be stretched to the limit producing the Budget brief, especially under the BLO rules, and on top of that, we have First Order questions the previous week, with all the extra work that entails for us! If the Chancellor does decide to dispense with the Budget snapshot this year, I imagine that will free resources in IDT. EB will, of course, be happy to offer suggestions on material IDT write but I am afraid there is no way in which we could be responsible for producing successive drafts.

MOM

MISS M O'MARA

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FROM: GWYN HACCHE

DATE: 26 February 1986

PPS/CHANCELLOR

cc Sir P Middleton
Sir T Burns
Mr Cassell
Mr Scholar
Mr Evans
Mr Odling-Smee
Mr Mowl
Mr Robson
Mr Elliss - IR
Mr Pitts - IR
Mr Stewart - IR

OIL PRICE ESTIMATES

1. Mr Pitts, in his minute to the Chancellor of February 17, noted that the prices on which their forecast of tax take is based are provided by Treasury after consulting D. Energy, and that Treasury estimates of oil prices derived from quoted sources have been 'sufficiently close to the average prices eventually used in tax assessments for these months'. This note gives more information on the price estimates given to Inland Revenue and confirms that in recent years our procedures for deriving the price estimates seem to have been fairly reliable.

Gwyn Hacche

GWYN HACCHE

OIL PRICE ESTIMATES SENT TO INLAND REVENUE

Inland Revenue currently only have PRT assessment information for periods up to June 1985. We have sent them a price for 1985 Q3 based on oil company returns to D.Energy (this yields a price of £19/bl or $26.2/bl). The prices we have given them for 1985 Q4 and 1986 Q1 are based on Brent spot prices for delivery in the next month as follows:

$/bl	Average Brent Spot price*
Sept	27.7
Oct	28.5
Nov	29.7
Q4	28.6
Dec	26.6
Jan	22.1
Feb	15.9
Q1	21.5

* The variation in price in any one month is about $2 except in January when it reached $8½.

Thereafter a judgement has been made on the world oil price and the appropriate relativity between North Sea and world crudes.

3. This procedure, which is typical of what we do, raises two main questions:

(i) how accurate a measure of the average price used in North Sea tax assessments is the D.Energy data for the North Sea price?

(ii) how accurate a measure of the North Sea price is the data for the Brent spot price?

4. In principle the D. Energy oil price data should be the same as the average price used in North Sea tax assessments. Both

returns - to the Inland Revenue and to D.Energy - ask for oil prices to be quoted on the same basis. For oil sold at arms length the returns ask for the actual price realised; for other deals the D.Energy return stipulates that the price entered should be the tax reference price used for PRT assessments. However Inland Revenue may ask for the tax reference price put forward by the company to be amended, so that the final tax valuations could use slightly different prices than those in the company returns sent to D.Energy. D.Energy ask companies to note these revisions in subsequent returns, so that both series should in due course be the same over the past though revisions have not yet been received for 1985.

5. Comparing the D.Energy and Inland Revenue price series suggests that differences between the two are likely to be small. The average difference between D.Energy returns and arms length tax prices was about one per cent in the two years to 1985H1 and there is no a priori reason to suggest that average prices for non arms length disposals should be significantly different from average arms length prices.

6. The data used for Brent spot prices is the average of daily closing Brent spot prices, as quoted in the Financial Times, for delivery in the following month. In the estimates sent to Inland Revenue we therefore lag the spot prices by one month. To convert the spot prices into sterling we use the $/£ exchange rate which is contemporaneous with the delivery date although the actual rate used by the revenue will be the rate at the time of payment (usually 30 days after delivery)*. The differences between this series and the returns collected by D.Energy reflect, amongst other things the fact that the spot prices relate only to Brent rather than all North Sea crudes; that no allowance is made for oil not traded spot, spot deals for delivery in more than one month's time and spot deals at prices not recorded in the press; and that the monthly average spot price reflects only closing prices and is not weighted by the number of deals done at different spot prices. Nevertheless this series appears to track the D.Energy

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* Using the contemporaneous $/£ rate seems to result in smaller errors than are obtained with the $/£ rate at delivery.

data reasonably well. In the past four years the average difference between the series based on Brent spot prices and the D.Energy data has been ½ per cent or 10 pence a barrel (10p a barrel for a year is equivalent to £60m in revenues). The average absolute error has been 1½ per cent or 30 pence a barrel (30 pence a barrel for a quarter is equivalent to £50m in tax revenue). It seems possible however that the errors may become larger with greater oil price volatility.

7. In the past the procedures described above have provided reasonably reliable estimates of tax valuations. Errors have however tended to be greater in periods of greater price volatility. This indicates that our estimates of tax valuations for early 1986 when oil prices fell sharply may be subject to a significantly larger margin of error than normal. This should not however affect our estimate of revenues in 1985-86 of £11½ billion, as revenues in 1985-86 depend mainly on prices in calendar 1985. As regards the 1986-87 revenues forecast, as Mr Pitts pointed out the margin of error for uncertainty in the forecast of prices for the rest of this year would greatly outweigh any difference between quoted prices and assessed prices for the first quarter.

Amended in the light of today's discussion. No need to discuss on Mon.

SH- 3.51

THE ECONOMY: RECENT DEVELOPMENTS AND PROSPECTS TO MID-1987

Summary

Demand and Activity

3.01 1985 saw further big increases in both exports and business investment. For the forecast period substantial growth is likely not only in most areas of domestic spending but also in exports. Total domestic production and manufacturing output are both expected to record further growth in the range 2-3 per cent.

Labour Market

3.02 Employment has continued to rise, with an estimated extra 219 thousand jobs in the year to September 1985. In spite of this there has been some further rise in unemployment over the last year. However, with labour force growth now likely to fall, prospects for unemployment are better than for some years.

Inflation

3.03 After rising in the early months of 1985, inflation has been on a downward path since June and in January 1986 the RPI increase was 5½ per cent. The inflation rate is expected to be at or below 4 per cent for most of the forecast period.

Assumptions

3.04 The UK forecast is based on the assumption that fiscal and monetary policies are set within the framework of the MTFS.

North Sea oil prices are assumed to average \$15 in 1986-87. Neither the sterling index nor the sterling dollar exchange rate are assumed to change much.

World Economy

3.05 Output in the world economy has now been rising since early 1983, and inflation has been coming down since 1980. The recent large fall in oil prices will be of particular help to oil importing countries both in the developed and developing world. Assisted by further moves to lower interest rates, a period of low inflation and good growth in output and trade is in prospect. Many of the problems arising from payments imbalances and debt repayments will remain. But the benefits to trade, output and inflation from the fall in oil prices should prove substantial.

Trade and the current account

3.06 Exports have grown strongly over the last two years: in 1985 manufactured exports grew twice as much as world trade. The current account of the balance of payments is expected to remain in sizeable surplus despite the big fall in oil prices. Offsets include higher export earnings on other goods - with most overseas markets benefit ing from the fall in oil prices - lower profits earned by foreign oil companies in the North Sea, and higher earnings from the UK's stock of overseas assets.

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WORLD ECONOMY

Recent developments

3.07 After a spurt in 1983 and the first half of 1984, US economic growth has slowed down sharply. By the final quarter of 1985 real GNP was $2\frac{1}{2}$ per cent higher than a year earlier. The performance of the US economy has strongly influenced the pattern of economic growth in other major industrialised countries. In Japan and Germany, in particular, output grew significantly faster than domestic demand in both 1984 and 1985, thanks to the substantial external contribution to demand, stemming in large part from the US. More recently the recovery in Europe has strengthened and growth has become less dependent on exports to the United States. In Japan growth has shown some signs of slackening, although remaining high by European standards.

3.08 Domestic demand is now growing at similar rates in the United States and other major industrialised countries. But the effect of much faster growth between 1982 and 1984 in the US, together with the effects of the rise - still only partially reversed - in the dollar, are seen in the pattern of current account balances: a large deficit in the US and large surpluses in Germany and Japan. There have, though, been a number of helpful steps toward reducing these imbalances over the past year. Slower growth in the US has not only reduced the increase in US imports, but also contributed to lower interest rates and a fall in the dollar. The latter was helped by the Plaza Agreement of 22 September between the Finance Ministers of the Group of Five. Nevertheless, a period in which US domestic demand growth is significantly slower than that in Europe and Japan is likely to prove necessary if current account surpluses and deficits are to be reduced.

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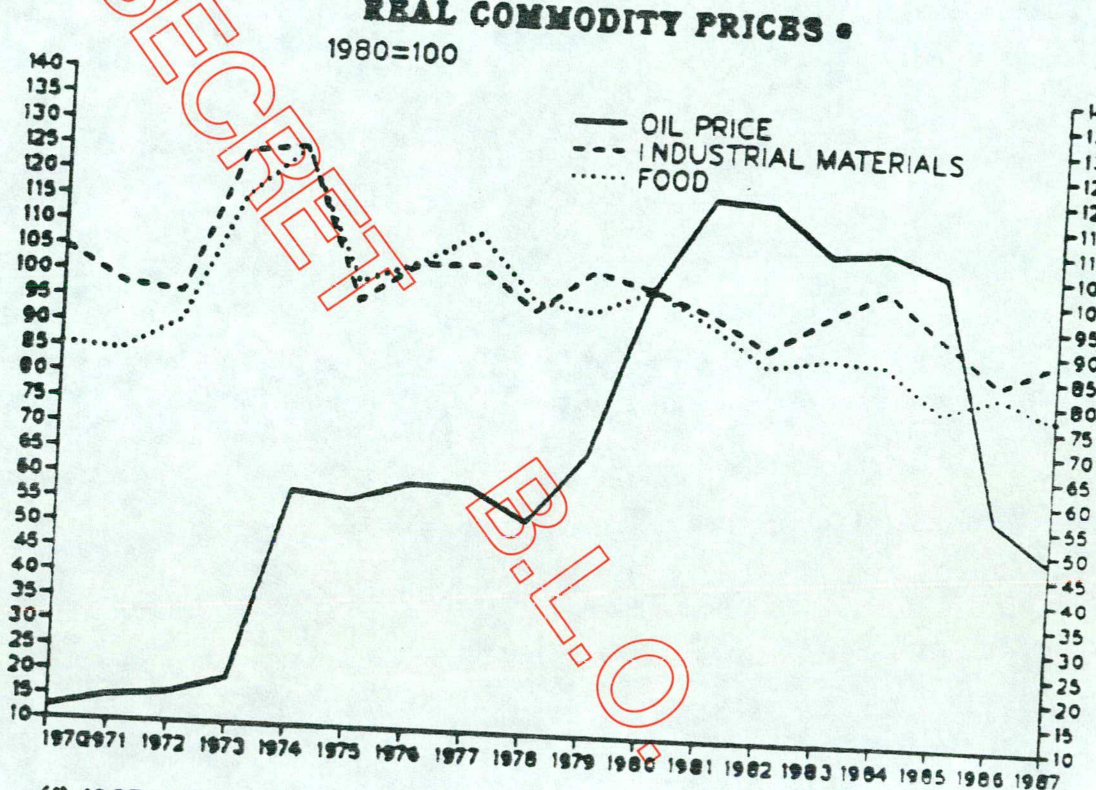
3.09 The rate of inflation fell further in 1985: consumer prices in the major industrialised countries increased on average by about 4 per cent, compared with over 4½ per cent in 1984. This partly reflects the weakness of primary product prices, (see chart 3.1).

CHART 3.1 (1987 to be removed and industrial materials and food to be combined).



(1) 1987 1ST HALF-YEAR
* IN RELATION TO PRICES OF MANUFACTURES

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3.10 Since December 1985, oil prices have fallen sharply. The background to these oil price developments is set out in chart 3.2. Before the first oil price shock the non-communist world demand for oil was around 48 million barrels per day, and about 30 mbd of this was produced by OPEC members. Despite the 1973-74 increase in oil prices OPEC managed to maintain roughly this level of production throughout the 1970's. After falling in 1974 and 1975 total demand for oil rose again during the rest of the decade, while non-OPEC supply grew by roughly the same amount in absolute terms.

CHART 3.2 Oil supply (to be revised)

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3.11 Experience since the second sharp increase in oil prices in 1979 has been very different. Demand for oil has fallen and non-OPEC supplies have continued to rise sharply. OPEC's pricing policy made it effectively the residual source of supply and demand for OPEC oil nearly halved: from about 30 mbd in 1979 to less than 17½ mbd on average in 1985. A large share of the production cuts fell on Saudi Arabia.

3.12 Towards the end of 1985 Saudi Arabia indicated that it was no longer prepared to maintain its own production at very low levels in order to maintain the existing level of prices. The resulting increase in supply, combined with no sign that other producers were prepared to make offsetting cuts in their production, has produced a sharp fall in prices.

Prospects

3.13 Total demand and supply for oil may well respond only slowly to the large fall in price, and so excess capacity is likely to be present for some time. This forecast assumes that prices will settle at around $15 per barrel - rather below, in real terms, the level between 1974 and 1979.

3.14 The prices of most other primary products are also unlikely to strengthen significantly over the next year or so, since with some exceptions (for example a temporary shortfall in the coffee crop), supplies are abundant and stocks relatively high. The industrial countries can therefore expect further improvements in their terms of trade, raising real incomes and enabling inflation to fall further (see table 3.1).

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Table 3.1: World economy

	percentage change on a year earlier			
	1984	**1985**	**1986**	**1987 first half**
Major Seven countries*:				
Real GNP	4½	2½	3½	4
Consumer prices	4½	4	2½	1½
World trade, at constant prices				
Total imports	10	3	6	5½
Trade in manufactures (UK weighted)	8½	4	5	5

* USA, Japan, Germany, France, UK, Canada and Italy.

3.15 The growth of real GNP in the **United States** should pick up in 1986, benefiting from lower oil prices and from the effect of the lower dollar on trade. Consumers' expenditure, while growing more slowly than in recent years, should be helped by the lagged effects of lower interest rates, lower oil prices, and rises in asset prices.

3.16 Growth in **Japan** may be a little weaker in 1986 as the expansion of domestic demand may not be sufficient to compensate for a slowdown in the growth of exports. In most **European countries** the economic recovery should strengthen in 1986, with the rate of growth increasing, particularly in Germany.

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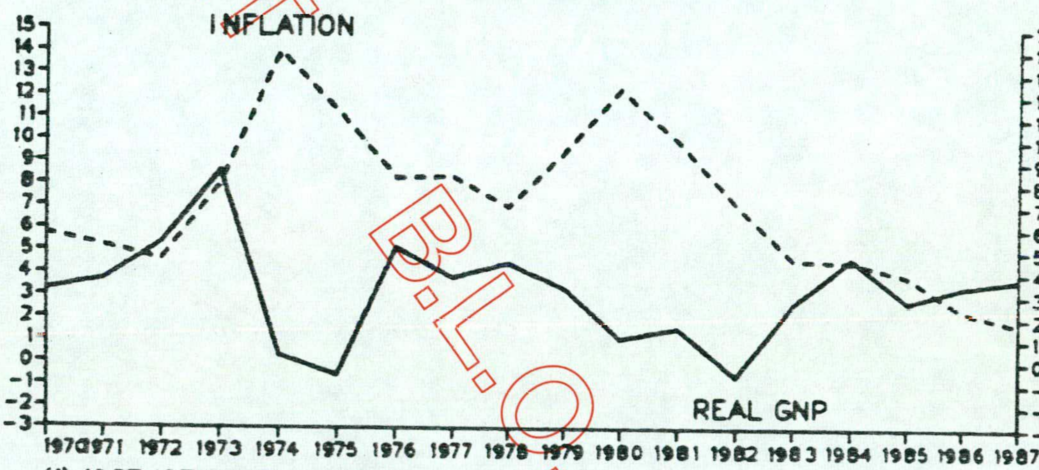
3.17 Overall the major industrialised countries may grow by about 3½-4 per cent over the next year. Together with lower inflation and interest rates in the major countries and the reduced cost of their oil imports, this should provide a better prospect for the non-oil developing countries, despite weak commodity prices. Oil producing countries, on the other hand, particularly those already heavily indebted, face severe difficulties and will have to cut their imports further.

CHART 3.3 (1987 to be deleted)

MAJOR 7 ECONOMIES REAL GNP AND INFLATION

ANNUAL % CHANGE



(1) 1987 1ST HALF-YEAR ON 1986 1ST HALF YEAR

Table 3.2: World import volumes, annual growth rates

	USA	Japan	Europe*	OPEC	Developing countries	Other	Total
Weights in 1984	19	8	31	7	14	22	100
1984	24	11	6	- 10	8	10	10
1985	3	1	5	- 8	1	6	3
1986	9	8	7	- 16	7	5	6

* Germany, France, UK, Italy, Netherlands and Belgium

3.18 This picture of world activity is reflected in the pattern of world trade growth. Import growth is likely to be strongest in oil-importing countries and in those whose exchange rates have appreciated most over the past year. This points to rapid growth of imports into Europe, Japan and many developing countries, but to large falls in oil producers' imports. Overall import growth in 1986 should be well above that of 1985.

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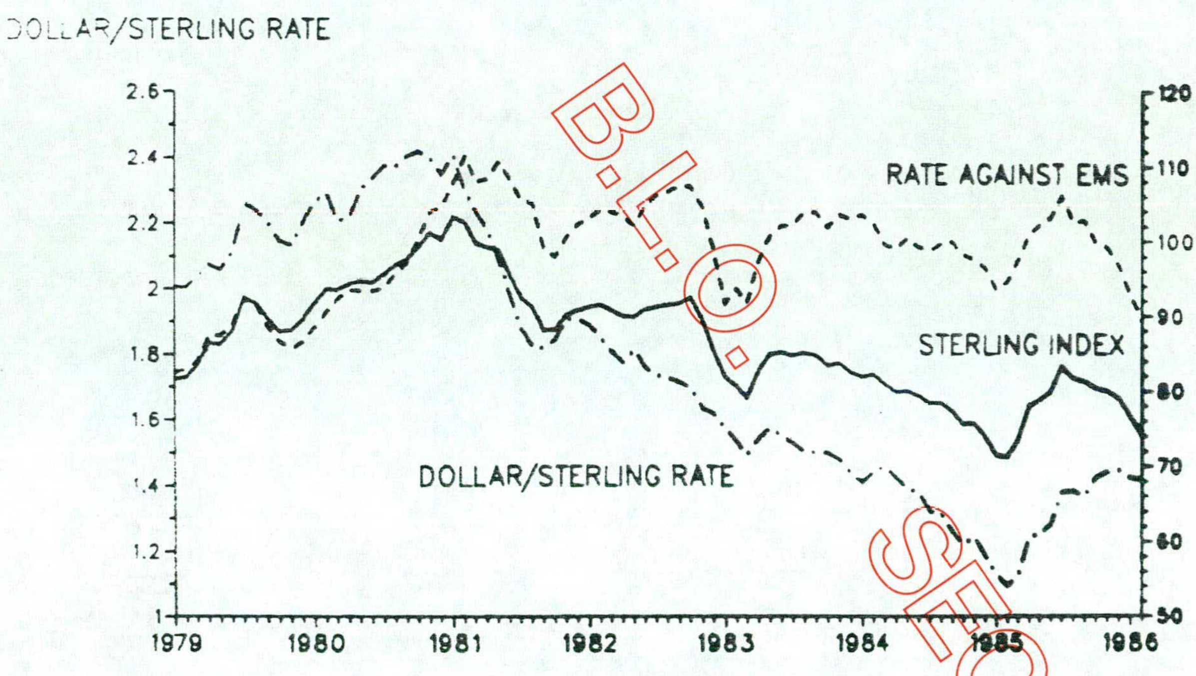
FINANCIAL CONDITIONS

Exchange Rates

3.19. The dollar has declined substantially (by over 20 per cent against a basket of other currencies) since its peak in early 1985. In 1985 as a whole the sterling index was little different from 1984. There were however some sizeable swings during the course of the year. The index rose from a lowpoint of 70½ in January to a high of 84½ in July, before declining to 78 in December. The index has fallen a little further this year as a result of the fall in oil prices. Over the past year sterling has risen by about 30 per cent against the dollar, but fallen against most other currencies.

Chart 3.5: Exchange rates for sterling



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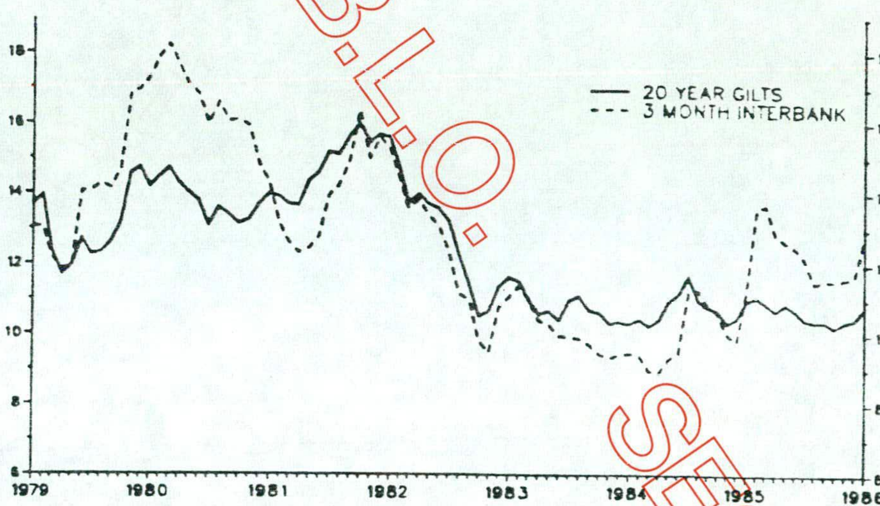
3.20 The forecast assumes that sterling will not change much from its present level either in dollar, or effective terms.

Interest Rates

3.21 Short-term interest rates fell during much of 1985 from the peak levels reached in February and March. They rose again in January this year as sterling weakened but in 1986 so far they have been a little below levels a year earlier. However in 1985-86 short rates, at 12 per cent, have on average been a point or so above the levels of 1984-85 and several points above levels in the US, and most other industrialised countries. Long rates have been much more stable. Yields on 20 year gilts have been within the 10-11 per cent range for almost all of the last three years, but in recent weeks have been at the bottom of this range. Real yields on index-linked gilts have also been relatively stable.

Chart 3.4: Interest rates in the UK



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Narrow Money

3.22 MO was near the centre of its target range in the early months of 1985-86, but growth slowed during the course of the year, in response to the increase in interest rates last winter. In recent months MO growth has generally been just above the bottom of its target range. The annual increase in MO velocity has been stable for many years now, and is expected to remain so.

3.23 Growth in the non-interest bearing component of M1, 3 per cent over the last year, has also slowed. This has been in response to higher interest rates and the increased availability of high interest cheque accounts which are in M1, contributing to an acceleration in M1 in total.

Broad Money

3.24 The rate of growth of £M3 has risen during the course of 1985-86 and has been well above both the target range set in the 1985 MTFS and the growth of money GDP. With the funding objective now set at the level needed to cover the PSBR, £M3 growth (at 14-15 per cent on a year earlier in recent months) has reflected a continued strong expansion of bank credit. Other broad aggregates have grown at much the same rate.

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3.25 The rapid expansion of broad money and credit reflects to a large extent the pace of financial innovation and liberalisation. In addition, since over two-thirds of £M3 bears interest and is now an attractive means of holding financial wealth, the high level of real interest rates may have contributed to higher bank deposits. The higher levels of financial wealth and debt in relation to incomes probably reflect a permanent shift in the private sector's portfolio which is not likely to be reversed through higher spending. They are therefore expected to be consistent with the slower growth of nominal incomes and the fall in inflation in this forecast.

TRADE AND THE BALANCE OF PAYMENTS

Relative costs and prices

3.26 The last two to three years as a whole have exhibited relatively little change in most measures of cost and price competitiveness, although there have been large short-term swings associated with movements in the nominal exchange rate. As table 3.3 shows, the effects of a lower nominal exchange rate have been broadly offset by unit labour cost increases at home above those in the UK's main overseas competitors, despite a good UK productivity performance. Assuming an unchanged exchange rate, the UK's cost and price competitiveness may be little different from the average of the last three years.

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Table 3.3: The nominal exchange rate and relative costs and prices in manufacturing.*

	Sterling Index (1975=100)	Relative actual unit labour costs	Relative export prices (1980=100)	Import Price Competitiveness
1983	83½	85	89	94½
1984	78½	83½	87½	92
1985 Estimate	78	87½	89½	91½

* Ratio of UK to overseas costs/prices

Trade prices and the terms of trade

3.27 Prices of most categories of imports fell during the course of 1985. The exchange rate appreciated during the course of the year, inflation in the developed world was low and commodity prices were weak. By the final quarter of 1985 import prices of all goods and services were 5 per cent lower than a year earlier. For 1985 as a whole, the terms of trade were 1 per cent above those in 1984 because of the weakness of commodity prices. But some decline in the terms of trade is likely in 1986 because the price of oil has fallen relative to other goods and services. As oil has a greater share in UK exports than in imports, a fall in its price reduces export prices relative to import prices. The forecast deterioration in the terms of trade means that the UK will have to export more in volume terms to purchase a given volume of imports, if the current account is not to worsen.

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Table 3.4: Trade in goods - balance of payments basis

per cent changes on a year earlier

All goods

	Export Volume	Import Volume	Terms of Trade*
1983	2	8	½ (½)
1984	8½	11	- 2 (-1)
1985	5½	3	1½ (3½)
1986(Forecast)	5½	6½	- 2½ (1)

* The terms of trade are the ratio of UK export to import prices (average values); the figures in brackets exclude oil and are on an OTS basis.

Trade volumes (goods other than oil)

3.28 As shown in chart 3.7 UK exporters of manufactures improved their share of world trade in volume terms in 1984 and may also have done so in 1985. The value share has however declined slightly as UK export prices have fallen relative to those of our competitors. The forecast of exports of manufactures (excluding erratics) in volume terms is for further growth of 5 per cent in 1986. This is the same as to the rise in world trade, but less than in 1985.

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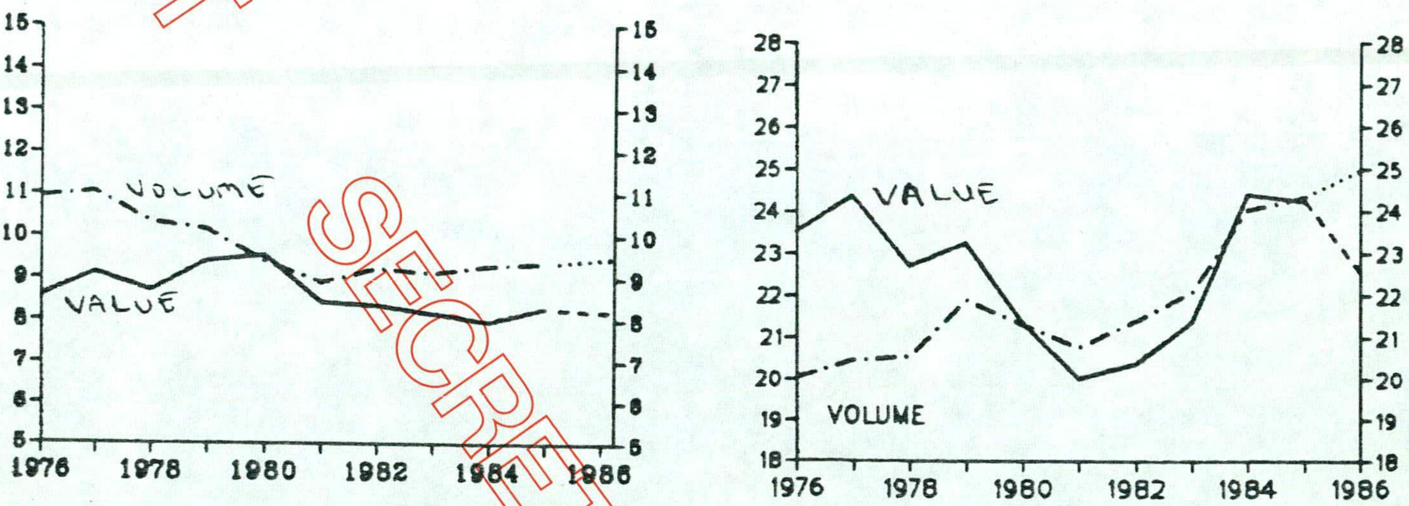
Chart 3.7: Export shares and import penetration

Share of UK exports in main manufacturing countries exports of manufactures

Share of imports in total domestic expenditure (excluding oil)



3.29 Between 1982 and 1985 the growth in domestic demand for manufactures (5½ per cent at an annual rate) has been shared by importers and domestic producers, with importers continuing to increase their share. Domestic demand for manufactures is expected to grow in 1986, because of further growth in investment and consumer durables in particular. Growth in imports of manufactures in 1986 is forecast to be around 7 per cent, twice as fast as domestic demand growth, a relationship similar to that between 1982 and 1985.

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Trade in oil

3.30 The prospect is for a substantial fall in the balance of trade in oil in 1986 as a result of lower oil prices, partly offset in the current account as a whole by reduced invisible earnings of foreign owned companies operating in the North Sea. Little change in oil production in 1986 is expected and domestic demand for oil will be below the 1985 level which was boosted by the coal strike.

Invisibles

3.31 The balance of trade in **services** has more than doubled since 1982. 1985 was an exceptionally good year, with large gains in earnings from financial services, tourism and travel. With imports of services, particularly tourism, likely to grow faster, the balance on services may show only a modest gain in 1986.

3.32 The profile of the **transfers** balance is affected by the timing of official transactions with the European Community. As the bulk of the UK's rebate on its 1984 contribution was delayed into 1986 the transfers balance was unusually low in 1985, by about £½ billion. A correspondingly high figure is projected for 1986.

3.33 The surplus on **interest, profits and dividends** (IPD) fell slightly in 1985. A rise in the non-oil IPD balance was more than offset by a deterioration on oil OPD which largely reflected a once-for-all write off of losses on BP's Sohio subsidiary. Lower oil prices in 1986 will reduce the profits of foreign oil companies operating in the North Sea more than they reduce the profits of UK oil companies' overseas operations. There should be a rise in the non-oil IPD balance as a result of a further increase in the UK's net overseas assets.

Current Account

Table 3.5: Current account of the balance of payments, £billion

	Oil	Other Goods**	Invisibles	Total: Actual and forecast	Total: After allowing for special factors*
1983	7	- 8 (-2½)	4	3	3
1984	7	- 11 (-4)	5	1	4
1985	8	- 10 (-3)	6	4	5½
1986 (Forecast)	5½	- 10 (-3½)	8½	4	3½

* The timing of EC rebates and the effect of the coal strike.

** The balance on manufactures is in brackets.

3.34 Table 3.5 summarises the current account and its main components. Allowing for the effects of the coal strike the current account was in sizeable surplus in each of the last three years and a substantial surplus is again forecast for 1986. On an underlying basis, the surplus in 1986 is expected to be lower than in 1985, as a result of the big fall in oil prices. The contribution of North Sea oil to the current account - ie the balance of trade in oil less foreign companies' North Sea profits - is forecast to fall from a strike-adjusted £6½ billion in 1985 to £3½ billion in 1986. Chart 3.8 shows the components of the account over a longer period, relative to GDP.

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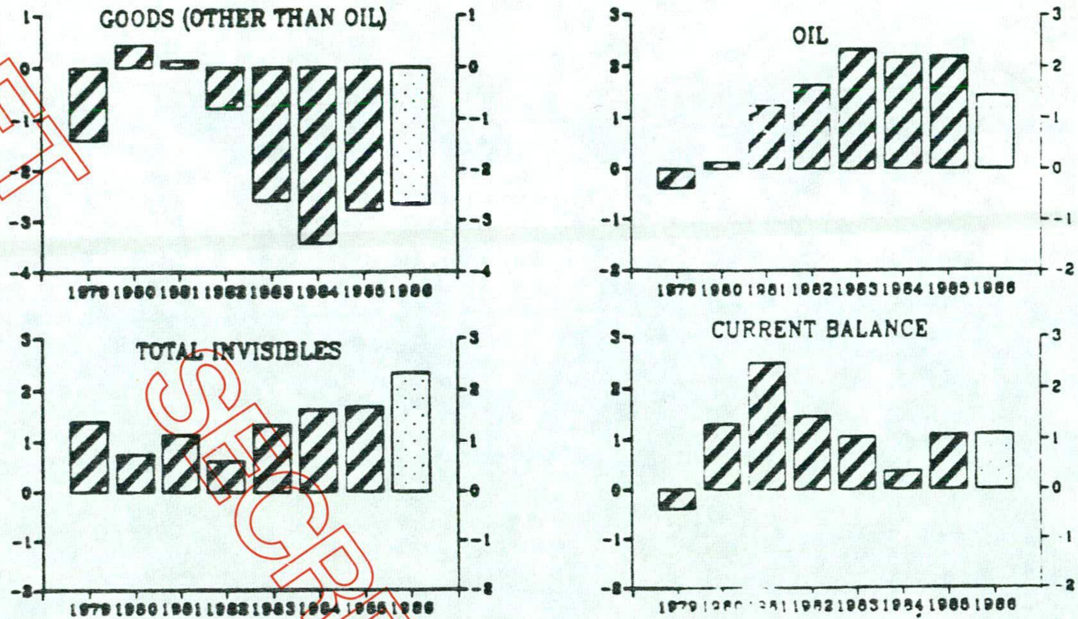
Chart 3.8: Trade balances as a percentage share of GDP



Overseas Assets

3.35 The UK's stock of net overseas assets is estimated to have been 24 per cent of GDP (£85 billion) at the end of 1985, compared with 6 per cent of GDP in 1979.

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INFLATION

Inflation and Costs in 1985

3.36. In the year to 1985Q4 the RPI increased by 5½ per cent, a little more than forecast in last year's FSBR. In the middle of the year retail price inflation touched 7 per cent reflecting in particular increases in mortgage interest rates in February and April 1985 and the weakness of sterling in late 1984 and early 1985. Between May and January retail prices rose by only 1.1 per cent in total, helped by a fall in mortgage rates; by lower petrol prices, and a general easing of cost pressures.

3.37. Import prices declined during 1985 and in the final quarter were about 5 per cent lower than in 1984Q4; the prices of imported fuels fell 14 per cent over the same period. Prices of the manufacturing sector's imported inputs fell rapidly from their peak in February and by the end of the year were 6 per cent below their December 1984 level. The rate of increase in manufacturing output prices started to slow down in the second half of 1985.

3.38. The underlying growth of average earnings (that is, abstracting from the effects of strikes, delayed settlements and other temporary factors) continued at about 7½ per cent in 1985 - little changed from 1984. With output per head growing at about 2 per cent (after allowing for the effects of the coal strike) the growth in unit wage costs was about 5½ per cent in 1985. Unit labour costs rose by about 1 per cent less mainly because of the abolition of NIS in October 1984.

In the manufacturing sector, average earnings increased by 8½-9 per cent and unit labour costs by 4 per cent. This was much faster than in most other major industrial countries. Pre-tax real earnings of employees increased by an average of almost 2½ per cent a year between 1982 and 1985.

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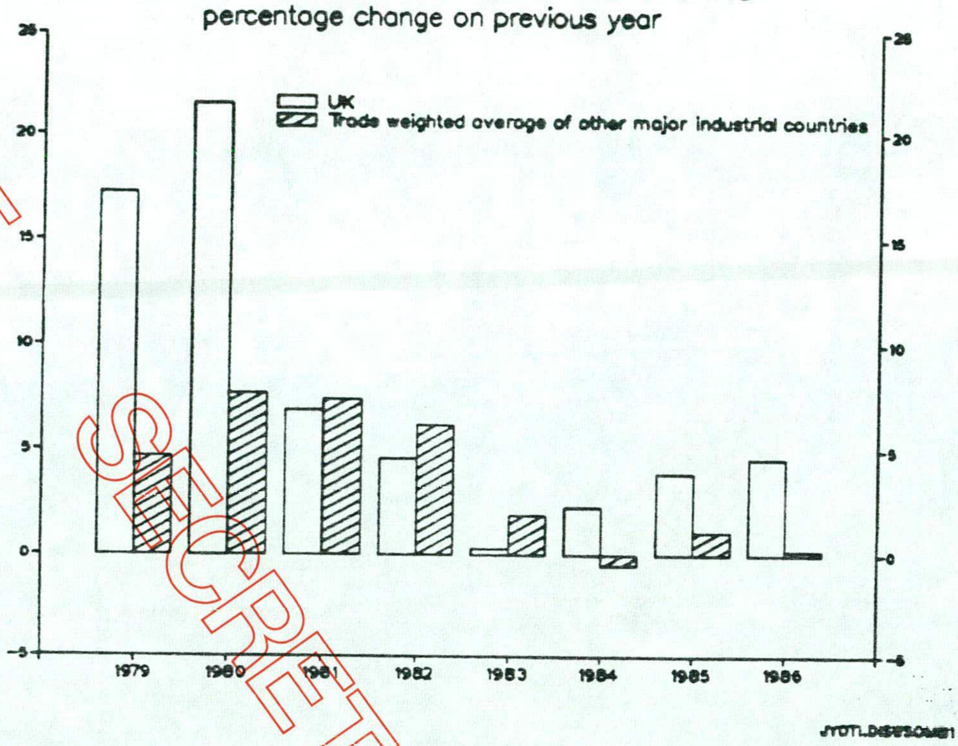
CHART 3·9

UNIT LABOUR COSTS IN MANUFACTURING
percentage change on previous year



Prospects

3.39. So far the current pay round is showing little sign of any significant change in the level of pay settlements or in the underlying rate of growth of average earnings in the private sector. Unit labour costs for the economy as a whole may rise by 5 per cent in 1986, and unit labour costs in manufacturing may rise slightly less than this. World commodity prices are likely to remain weak in 1986. With oil prices in sterling terms almost halving between 1985 and 1986, the overall cost of manufacturers' material and fuel inputs should fall quite sharply between the two years. The prospects are for very modest growth in manufacturers' total costs and a widening of profit margins for a time.

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Table 3.6: Costs in manufacturing (percentage changes on a year earlier)

	Unit Labour Costs in Manufacturing	Materials and fuels purchased by manufacturing industry(1)	Estimated Total Costs	Output Prices(1)
1983	½	8	2½	5½
1984	2½	8½	4½	5½
1985	4	4	4	6½
1986 (forecast)	4½	-11	½	4½

(1) Excluding food, drink and tobacco

3.40. The fall in import prices since the spring of 1985 has contributed to the recent low monthly growth in retail prices, and will continue to contribute to low increases in prices over the coming months. The annual rate of inflation will fall quite sharply in the months after January 1986. In the last quarter of the year RPI inflation may be about 4 per cent, with little change likely in the first half of 1987. The fall in oil prices is expected to work its way fully through to petrol prices in the course of 1986. The forecast increase in the housing component of the RPI (which covers mortgage payments, rents, rates, and other housing costs) mainly reflects the prospects for local authority rates in 1986-87.

Table 3.7: **Retail prices index**

Per cent changes on a year earlier

	Weights in 1985	1984 Q4	1985 Q4	1986 Q4 (Forecast)	1987 Q2 (Forecast)
Food	19	3½	3	3	3½
Nationalised Industries (including water)	9	4	5½	4½	3
Housing	15	10½	9½	9½	3½
Other	57	4	5½	3	4
Total	100	5	5½	4	3¾

3.41. Other price indices sometimes move differently from the RPI because of differences in coverage. In particular they vary in the degree to which they are affected by movements in import prices; and the housing component of the RPI includes a direct effect from interest rate changes which is absent from other price indices.

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3.42. The GDP deflator measures the price of domestic value added - principally unit labour costs and profits per unit of output - and excludes imports altogether. The GDP deflator covers all sectors of the economy, including oil output in the North Sea, and so is highly sensitive to the fall in world oil prices. This contributes to a marked slowdown in the growth of GDP deflator over the ~~next~~ coming year. The deflator for GDP at market prices is estimated to have increased by 5½ per cent in 1985-86, about one per cent faster than in 1984-85. In 1986-87, inflation on this measure is expected to fall back to about [3¾] per cent. With no further benefit from lower oil prices assumed after 1986, the GDP deflator is not expected to show any further decline in 1987-88.

DEMAND AND ACTIVITY

3.43. Latest estimates suggest that GDP rose by about 3½ per cent in 1985, or 2½ per cent after making allowance for the effect of the recovery from the coal strike. Over the year to the first quarter of 1985, GDP is estimated to have risen by almost 4 per cent in strike adjusted terms: this was the period which saw the most rapid growth in the world economy. Since then the path of GDP has been flatter. The rise in GDP between the first and third quarters of the year was more than accounted for by recovery from the coal strike, but growth seems to have picked up again in the fourth quarter: the preliminary estimate of the output measure of GDP showed growth at annual rate of 2½ per cent between the third and fourth quarters of the year. The flattening out of strike adjusted GDP during the middle of 1985 reflected in part the high level of business investment and North Sea output in the first quarter of the year. Output in most sectors of the economy, including manufacturing, continued on an upward trend throughout 1985.

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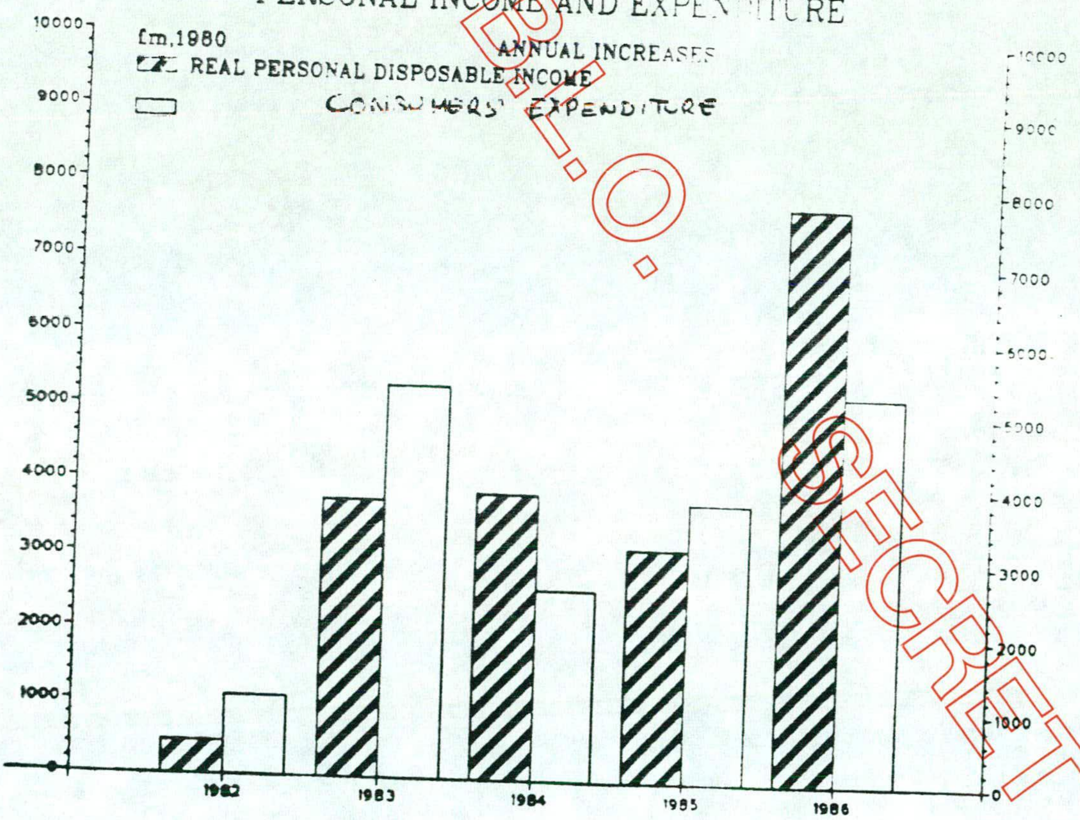
Personal Sector Expenditure

3.44. Between 1980 and 1983 the inflation rate fell by about three quarters and the personal saving ratio fell by almost a quarter. In 1984, with the uncertainties caused by the long coal strike, consumers were more cautious and saving rose. During 1985 spending has picked up again, particularly on durables which were some 7 to 8 per cent higher in the second half of 1985 than in the second half of 1984.

3.45. The combination of lower price inflation and little change in earnings growth, together with higher dividend income reflecting the buoyant profitability of the company sector, is expected to lead to substantial growth of real personal disposable income of about 4 per cent in 1986. There may be some increase in the saving ratio, as consumers adjust to higher levels of income; but most of the rise in incomes is likely to be reflected in higher spending, with continuing strength in purchases of durables. Chart 3.10 shows recent and forecast changes in personal income and consumer spending.

CHART 3.10 PERSONAL INCOME AND EXPENDITURE



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3.46 Investment in dwellings by the personal sector fell between 1984 and 1985, but a resumption in growth is expected for 1986. Investment in housing improvements, which fell in the second half of 1984, started to recover during 1985, and is expected to show further growth in 1986 as personal incomes rise. In spite of the increases in mortgage interest rates early in 1985, house prices remained firm; private housing starts which had fallen during 1984 were rising throughout 1985, and the total for the year was well above the number of completions. This trend in starts should show up in investment in new houses during 1986.

3.47 The demand for housing (as reflected in house prices) and spending on consumer durables have both been resilient in the last year or so, in spite of the high level of real interest rates. The personal sector has been responding to the financial liberalisation of recent years and the greater availability of credit as well as to the changes in interest rates. Borrowing from banks and building societies by the personal sector increased by about 18 per cent in 1985, and by 20 per cent a year on average between 1980 and 1985. This borrowing has not only helped to finance current consumption and spending on tangible assets, but has also been accompanied by substantial acquisition of financial assets: in fact the growth in the personal sectors' financial assets has recently more than matched the growth in liabilities, partly because of capital gains on holdings of equities and gilts.

COMPANY INCOME AND EXPENDITURE

3.48. Company profitability has continued the recovery that began in 1981. The net real rate of return for all industrial and commercial companies (ICCs) for 1985 is estimated to have been the highest since 1960. For non-North Sea ICCs, profitability in 1985 was higher than any time since 1973.

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3.49. The recent sharp fall in oil prices will mean a substantial reduction in North Sea profits in 1986, and the overall return earned by ICCs may fall. However, non-North Sea ICCs will be prime beneficiaries of the fall in oil prices, as they have been of the weakness of other commodity prices during 1985; their profitability is expected to increase further in 1986 (see Chart 3.11).

CHART 3.11

NET REAL RATE OF RETURN
INDUSTRIAL AND COMMERCIAL COMPANIES

NOTES: ADJUSTED FOR ESTIMATED EFFECTS OF PRIVATISATION

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Fixed Investment

3.50. Total business investment, including North Sea investment and investment by public corporations, grew by about 4 per cent in 1985. Within this total manufacturing investment increased by 5 per cent, after taking into account the increase in assets leased by manufacturing companies. This was a somewhat smaller increase than Intentions surveys had earlier suggested was likely. The pattern of investment during 1985 was greatly influenced by the reduction in capital allowances which became effective at the end of the first quarter of the year. Leasing business was particularly buoyant in the first quarter and fell back heavily thereafter.

3.51. 1986 is likely to see a similar quarterly pattern in business investment. The level of business investment in 1986 as a whole will be affected by the transition to the reformed system of company taxation announced in the 1984 Budget: this gave firms an incentive to bring investment forward that would otherwise have taken place during 1986. The fundamental prospects for business investment remain very favourable. Profitability has been rising strongly: one indication of the past and prospective recovery in profits is the buoyancy of the stock market. In addition, there is evidence from CBI surveys that an expansion of capacity will be needed in a number of industries. //P. The DTI survey published last December indicates an increase in manufacturing and service industries investment of about 1 per cent, within which total manufacturing investment is expected to fall by about 2 per cent. By contrast the CBI interpret their most recent survey as implying a 5 per cent rise in manufacturing investment in the first three quarters of 1986 compared with the corresponding period of 1985. With the additional boost to profits of most companies from lower oil prices, we expect a rise in business investment in 1986 of 4 per cent, rather more than suggested by the DTI survey.

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3.52. Table 3.8 provides details of the forecast for total investment and its major components. Overall in 1986, fixed investment is expected to show a further year of good growth. North Sea investment is expected to recover this year to a similar level to that in 1984, mainly reflecting increases in expenditures on oil fields already under development and on gas fields due for development.

Table 3.8: **Gross Fixed Domestic Capital Formation**
(at constant prices)

	1984 £ billion at 1980 prices	Per cent change on previous year 1984	Forecasts 1985	Forecasts 1986
Business(1)	29.0	10	4	4
Private dwellings(4)	9.5	4	- 1	5
General government	6.9	5	- 4	1
Total fixed investment	45.4	8	1	4½

(1) Including investment by public corporations
(2) Figures for manufacturing include assets leased from finance lessors, figures for other industries exclude these assets.
(3) Figures are for industry class 13 (1980 SIC)
(4) Includes purchases less sales of land and existing buildings by persons, companies and public corporations, other than purchases of council houses.

Stockbuilding

3.53. Survey evidence suggests that despite the low expenditure on stock building in 1985, most companies still regard their current stock levels as more than adequate in relation to output and sales. The fall in stock ratios in recent years may reflect in part cautious behaviour by companies after the last recession. Another factor has been the high cost of holding stocks as a result of the high level of real interest rates and the abolition of stock relief in the 1984 Budget. Stock ratios and the estimated real cost of holding stocks are illustrated in Chart 3.12.

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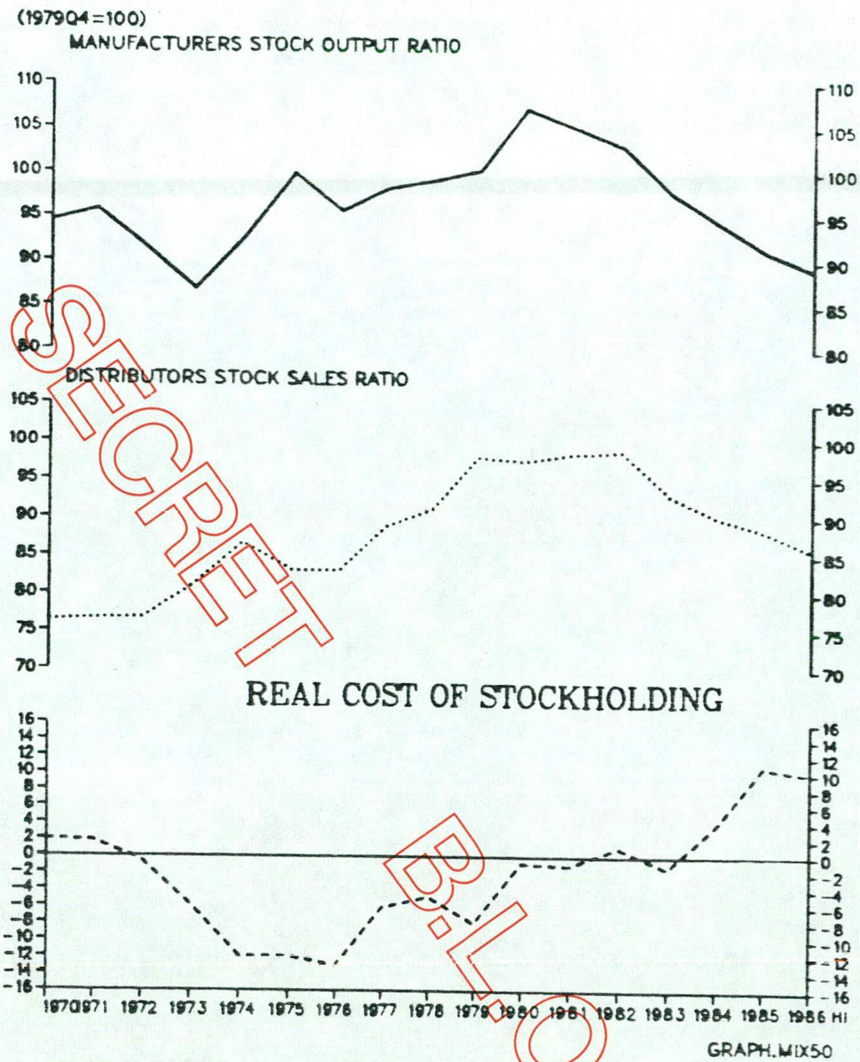
CHART 3.12 AGGREGATE STOCK RATIOS



Prospects for Demand and Activity

3.54. Strong growth in exports has made an important contribution to GDP growth over the last two years. In 1985 the increase in manufactured exports was twice the estimated increase in world trade in manufactures, while UK imports of manufactures grew less in relation to the growth in demand than has normally been the case in recent years.

3.55. The fall in oil prices has improved the prospects for world trade, and the adjustment of the exchange rate to lower oil prices has made British manufactures more competitive. As in most other industrial higher domestic demand (stimulated by lower inflation) is expected to make an important contribution to growth in 1986, but exports should also show substantial growth. The slowdown forecast for export growth in the first half of 1987 reflects the path of North Sea oil output and hence oil exports.

Table 3.9: Domestic Demand and Trade at constant prices

per cent changes on a year earlier

	1985	1986	1987 First half
Domestic demand	2	$3\frac{1}{2}$	$2\frac{1}{2}$
Exports of goods and services	$6\frac{1}{2}$	5	3
Imports of goods and services	$3\frac{1}{2}$	6	$4\frac{1}{2}$

3.56. Total domestic production is expected to increase by 3 per cent in 1986, following $3\frac{1}{2}$ per cent growth in 1985. After allowance for the coal strike, growth is close to $2\frac{1}{2}$ per cent in both years as shown in table 3.10. The average level of oil production in 1986 is likely to be close to its level in 1985 and 1984, but the fall forecast for oil output between the first half of 1986 and the first half of 1987 may cut total GDP growth by over $\frac{1}{2}$ per cent. Output growth in the non-oil economy in 1986 and the first half of 1987 is expected to be comparable to that seen in 1985. Manufacturing output has grown slightly faster than GDP since 1983. The composition of demand growth in the forecast suggests that growth in manufacturing output may continue at around the underlying rate of growth of GDP.

Table 3.10: **GDP and Manufacturing Output**

	Per cent changes on year earlier		
	1985	**1986**	**1987 First half**
GDP (average measure)	3½	3	2
GDP, adjusted for coal strike (*)	2½	2½	2
GDP, adjusted for coal strike and excluding oil output	2½	2½	2½
Manufacturing output	3	2½	2

PRODUCTIVITY AND THE LABOUR MARKET

3.57. Total employment in Great Britain is estimated to have grown by about 220,000 over the year ending September 1985, giving a total increase since March 1983 of over 700,000.

3.58. The published figures show an increase of 12,000 in the number of employees in employment during the first nine months of 1985: a further rise in the number of employees in the service industries was largely offset by falls in the production and construction industries. Self employment is assumed to have risen by about 31,000 a quarter since the middle of 1984, the same as the estimated quarterly increase over the previous three years. This compares with an increase of about 68,000 a quarter recorded between the middle of 1983 and the middle of 1984. The estimates of growth in employment over the recent past shown in Table 3.11 are subject to revision whem the Census of Employment for 1984 and the Labour Force Survey for 1985 become available.

Table 3.11: Employment (GB, seasonally adjusted)

	Employees in Employment			Self employed	HM Forces	Employed labour force
	Male	Female full-time	Female part-time			
September 1983 to September 1984	- 84	+ 19	+ 174	+ 237	+ 3	+ 349
September 1984 to September 1985	- 105	+ 20	+ 181	+ 125	- 2	+ 219

3.59. Following upward revisions to the estimates of manufacturing output, output per head in manufacturing now appears to have risen by about 3¾ per cent in 1985, close to the annual average of 3½ per cent for the period 1979-85. This marks a major improvement on the productivity performance recorded between 1973 and 1979: the trend growth in productivity in manufacturing now appears to be close to the rate achieved during the sixties (see table 3.12.) Non-manufacturing productivity has also been rising faster of late than in the 1973 to 1979 period. Growth in output per man hour has been rising at about 2 per cent per annum since 1979. However, the rise in part-time employment is currently bringing down growth in output per head in non-manufacturing, to about 1 per cent a year.

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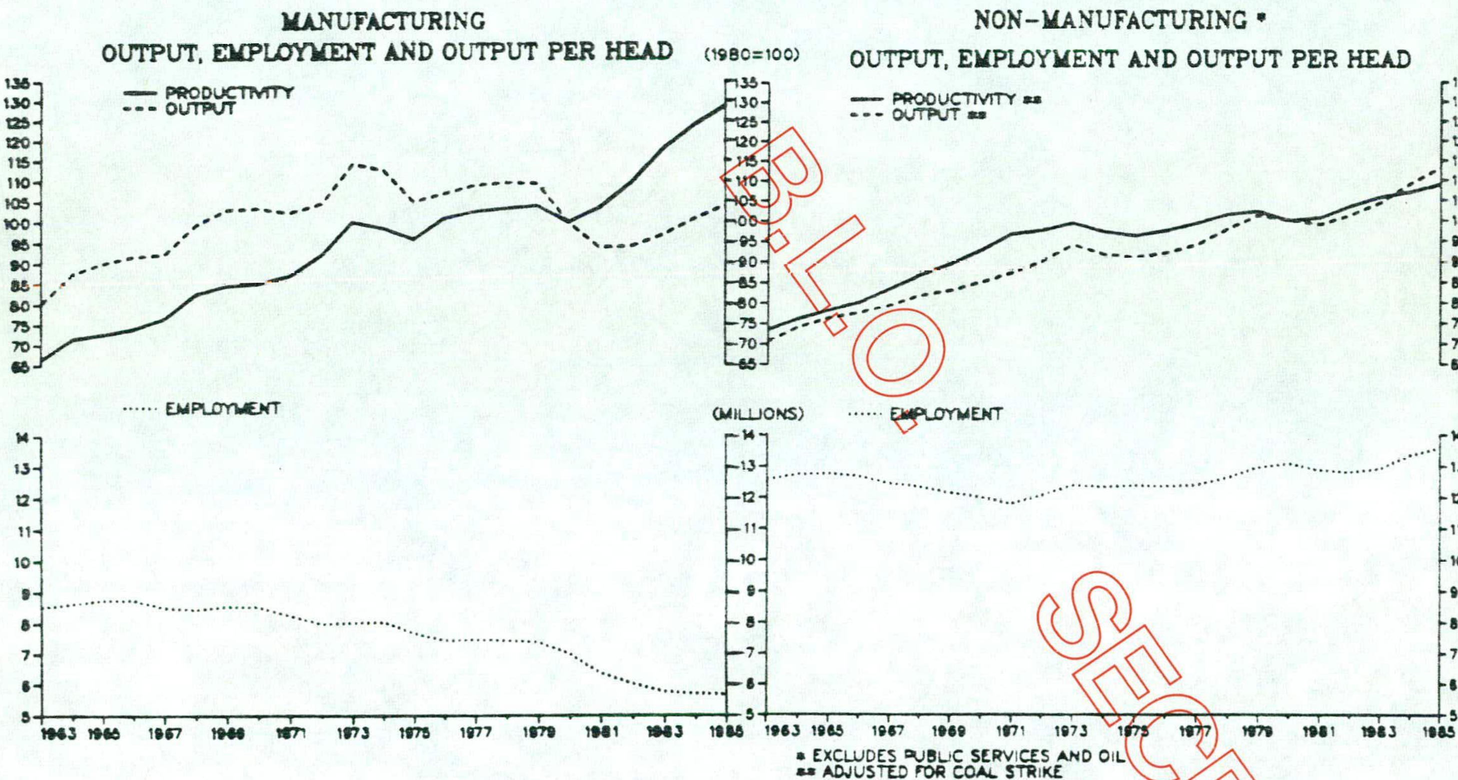
Table 3.12: Output per head of the employed labour force

	Employed Labour Force in 1984 (millions)	Percentage change in output per head (annual averages)		
		1964-73	1973-79	1979-85
Manufacturing	5½	3¾	¾	3½
Non-manufacturing*	13½	3	½	1

* Excludes public services and oil, and includes nationalised industries except steel.

CHART 3.13



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Unemployment

3.60. With output and employment continuing to grow quite strongly, and growth in the labour force starting to slow down, the prospects for unemployment are better than they have been for some years.

FORECAST AND OUTTURN

3.61. The table below compares the main elements of the forecast published in the 1985 FSBR with outturn or latest estimate:

Table 3.13: Forecast and Outturn

	Forecast	Outturn	Average error from past forecasts
RPI: per cent increase between the fourth quarters of 1984 and 1985	5	5½.	2

	Forecast	Latest estimate/ forecast	Average errors from past forecasts
Total output: per cent change between 1984 and 1985	3½	3½	1
Current account of the balance of payments in 1985, £ billion	3	4	2½
PSBR, financial year 1985-1986 £ billion	7	6¼	4½
Money GDP, per cent change between 1984-85 and 1985-86.	8½	9	2

3.62. Inflation in the fourth quarter of 1985 turned out a little higher than forecast a year ago. The forecasts made at the time of the last Budget for output growth and the current balance in 1985, and for the PSBR in 1985-86, are all very close to the latest estimates for these variables. In each case such error as there appears to have been is considerably smaller than the average error from past forecasts.

Table 3.14: The Prospects: Summary

	Forecast	Average errors from past forecasts*
A. Output and expenditure at constant 1980 prices; per cent changes between 1985 and 1986.		
Domestic demand	3½	[ ]
of which:		
Consumers' expenditure	3½	[1]
General Government consumption	1	[1½]
Fixed investment	4½	[2]
Change in stockbuilding (as per cent of level of GDP)	0	[¾]
Exports of goods and services	5	[2½]
Imports of goods and services	6	[2½]
Gross domestic product: total	3	[1]
manufacturing	2½	[3¼]
B. Inflation		
Retail prices index, per cent change on a year earlier		
1985Q4 to 1986Q4	4	[2]
1986Q2 to 1987Q2	3¾	[3½]
Deflator for GDP at market prices, per cent change on previous year		
Financial year 1985-86	5½	[ ]
Financial year 1986-87	3½	[ ]

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C. Balance of payments on current account

£billion:

1986	4	[2½]
1987 first half (at an annual rate)	2	[4]

D. Money GDP at market prices, per cent change

Financial year 1985-86	9	[ ]
Financial year 1986-87	6½	[ ]

E. PSBR

£billion (in brackets, per cent of GDP at market prices):

Financial year 1985-86	6¼ (1¾)	[1 (¼)]
Financial year 1986-87	7 (1¾)	[4½(1½)]

---

* The errors relate to the average differences (on either side of the central figure) between forecast and outturn. The method of calculating these errors has been explained in earlier publications and government forecasts (see Economic Progress Report June 1981). The calculations for the constant price variables [and the GDP deflator] are derived from forecasts made during the period between June 1965 and October 1983. For the current balance and the retail prices index, forecasts made between June 1970 and October 1983 are used. For the PSBR, Budget forecasts since 1967 are used. The errors are after adjustment for the effects of major changes in fiscal policy where excluded from the forecasts.

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RISKS AND UNCERTAINTIES

3.63. No forecast is complete without an indication of error margins. Table 3.14 sets out the average errors from past forecasts, alongside the forecasts themselves. These average errors provide an indication of possible errors in the current forecast. Those items which represent the relatively small balance between large flows in either direction are particularly subject to error. For example, the flows on either side of the PSBR approach £200 billion; and for the current account of the balance of payments exceed £150 billion.

3.64. While the size of errors will change over time as the economy fluctuates, and as forecasting techniques change, in many cases the averages have not shifted very much since 1976. For the RPI, however, average errors are derived from a period of high and fluctuating inflation, averaging 12 per cent, and overstate likely errors at current rates of inflation. The average error in the last three Budget forecasts looking ahead to the end of the year was ½ per cent.

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Table 1.15: Constant price forecasts of expenditure, imports and gross domestic product*

£ billion at 1980 prices, seasonally adjusted

	Consumers' expenditure	General government consumption	Total fixed investment	Exports of goods and services	Change in stocks	Total final expenditure	Less Imports of goods and services	Less Adjustment to factor cost	Plus Statistical adjustment	Gross domestic product at factor cost	GDP index 1980 = 100
1981	136.5	48.9	37.7	62.0	-2.5	282.7	55.9	30.2	-0.3	196.3	98.5
1982	137.6	49.4	40.1	62.8	-1.1	288.7	58.7	30.6	0.7	200.1	100.4
1983	142.9	50.2	41.9	64.4	0.7	300.1	62.1	31.6	0.2	206.7	103.7
1984	145.5	50.9	45.4	69.0	-0.1	310.6	67.9	32.9	1.9	211.7	106.2
1985	149.3	51.2	45.9	73.4	0.5	320.3	70.3	33.0	1.9	218.8	109.8
1986	154.9	51.6	48.1	77.0	0.8	332.5	74.6	34.4	1.9	225.4	113.1
1984 H1	72.5	25.2	22.5	33.8	-0.4	153.7	33.0	16.3	0.5	105.0	105.3
H2	72.9	25.7	22.8	35.2	0.2	156.8	34.9	16.5	1.3	106.7	107.1
1985 H1	73.9	25.6	23.2	37.0	0.1	159.8	35.4	16.2	0.8	109.0	109.4
H2	75.4	25.6	22.7	36.4	0.4	160.5	34.9	16.8	1.1	109.9	110.3
1986 H1	76.8	25.8	24.2	38.2	0.2	165.2	36.9	17.1	0.9	112.1	112.5
H2	78.1	25.8	23.9	38.8	0.6	167.2	37.6	17.3	1.0	113.3	113.7
1987 H1	79.3	25.9	24.2	39.4	0.5	169.4	38.4	17.5	0.8	114.3	114.7
% changes											
1983 to 1984	2	1¼	8	7	-	3¼	9¼	4	-	-	2¼
1984 to 1985	2¼	¼	1	6¼	-	3	3¼	¼	-	-	3¼
1985 to 1986	3½	1	4½	5	-	4	6	4	-	-	3
1986H1-1987H1	3	½	0	3	-	2¼	4	2½	-	-	2

* GDP figures in the table are based on "compromise" estimates of gross domestic product, reflecting for the past average movements in constant price expenditure, output and income estimates of GDP. Percentage changes are calculated from unrounded levels and then rounded to half per cent. Totals in £ billion may not add due to rounding. Figures for 1986 H1 and beyond are forecasts. Figures for periods up to the end of 1985 are based mainly on the national accounts published earlier this year (covering periods up to 1985 Q3) and incorporate some revised and later data and forecasts. A full set of national accounts, to end 1985, will be published by CSO on 21 March.

BUDGET SECRET
BUDGET LIST ONLY

NOT TO BE COPIED

SECRET

From: M L Williams
Date: 26 February 1986

1. MR F E R BUTLER

Copies attached for:
Chancellor
Sir P Middleton

2. CHIEF SECRETARY

cc Mr Anson
Mr Monck
Mr Turnbull
HEGs
Mr Scholar
Mrs Butler
Mr Gray
Miss Peirson
Mr Lord

1985-86 RESERVE

You asked for advice on the scope for measures that would have the effect of bringing expenditure forward into the current year, offsetting slippage to 1986-87 of teachers' back pay for 1985-86. This note discusses four aspects of the problem:

1) the latest prospects for 1985-86;

2) in the light of these, what should we be trying to do;

3) the scope for doing it; and

4) the implications for the 1986-87 planning total.

1985-86 Outturn

2. My note of 21 February reported a prospective underspend on the Reserve of £0.5 billion of which teachers' pay accounted for £0.4 billion. The information that we have received since then suggests a slightly higher underspend, increasing it from £0.5 billion to ~~about~~ nearly £0.6 billion, ie a planning total outturn of £133.6 billion.

3. There have been a number of partially offsetting movements from the position reported in last week's note on the Reserve and the planning total. The F10 returns that we are currently receiving from departments suggest a higher outturn on supply

of about £130 million - with higher than previously expected spending by MOD, IBAP and some minor departments, offset by lower spending on social security. We are now assuming expenditure of £60 million on the tin settlement in 1985-86, compared with the £50 million embodied in last week's reports. However, as I foreshadowed in my note, latest returns suggest that the **LA capital** overspend will be some £150 million less than previously expected; and PE now expect nationalised industries' aggregate **external financing requirement** to be some £60 million less (mainly reflecting further productivity improvements by NCB). The net increment on Supply, LA capital and EFLs is an increased underspend of nearly £0.1 billion.

4. The figures may change further in the next few days. We are still awaiting a few F10 returns, notably on housing benefits. The outturn to be shown in the FSBR does not have to be settled yet, and we will offer advice on the basis of the latest position nearer the time. It is worth noting, however, that in some respects these latest figures will slightly ease the position for 1986-87. Higher spending by MOD (£30 million) will reduce their roll forward under the end-year flexibility scheme; and about £50 million of IBAP's extra spend could be reflected in a lower requirement next year (see Mr Bonney's separate submission today).

The Objective

5. You asked us to consider whether there was a case for trying to mop up part of this underspend and, if so, what might be done.

6. The slippage of teachers' back pay will be a well understood reason for underspend in 1985-86. Although the precise sums involved are unclear, commentators could readily calculate the order of magnitude involved. In these circumstances, there is a case for limiting any offsetting action to the underspend that might have arisen anyway (ie £0.2bn), rather than the whole sum (£0.6bn). An underspend of less than £0.4 billion would leave us vulnerable to the charge that we would have overshot

the planning total if not for the fortuitous delay in ratifying the teachers' settlement. We could no doubt argue that the Reserve is all about swings and roundabouts and that, although teachers' pay went for us, other things went against. But the size and visability of the pay settlement might make this difficult to sustain.

7. A further consideration is the robustness of the present estimate of the outturn. We can be fairly confident about some elements of the total. But others are more uncertain; for example the prospective LA capital overspend is still subject to an error of, say, ±£150 million. More generally, end-year surge means that forecasting expenditure in March is particularly problematical, and our forecast now makes no allowance for general contingencies. The error can be both ways; indeed for 1983-84 and 1984-85 the (latest) final outturn has been slightly (£0.1 billion) below the relevant FSBR estimate; but for 1982-83 it is £0.3 billion higher.

8. The Government has a reasonable record in meeting the planning total, underspending in 2 of the last 4 years; but it overspent in 1983-84 and 1984-85 and to do so again would add to the doubts about the credibility of the future year plans. To the extent that we have any leverage we should therefore aim for some underspend, to avoid the risk of outturn being taken above plans as later information is incorporated.

9. I understand that Mr Butler and Mr Turnbull have already spoken to you along these lines, and you acknowledged that these arguments suggested some caution in seeking to mop up emerging underspend. Any action should be confined at most to the residual underspend, which would leave us with a good prospect of an underspend of £0.4 billion which, arguably, is expected by commentators. Even if some of our estimates were later exceeded, we would still be left with an outturn sufficiently below plans (ie at least the £0.4 billion), to leave us free to take credit - if we need to - for the slippage as one of the pressures on the Reserve in 1986-87. We could not be accused of playing the £0.4 billion twice.

The Scope for Action

10. Scope for action at this time of the year is clearly going to be limited. Departments could not gear up their programmes to spend significant additional sums if we are not to undermine the normal requirements of control, propriety and value for money. Both GEP and divisions are also conscious of the difficulty of approaching some departments, particularly in the light of the battles that you have been having with them in the course of the year. There is always a danger that the Treasury's credibility with departments will be damaged by exercises of this kind (and we are still suffering from our pleas to departments and local authorities at the end of 1982-83 to use up unspent provision). Your warning in October about the pressure on the Reserve has helped change the climate about claims on the Reserve. An outcome which showed expenditure (other than for teachers' pay) just below plan would validate the stand you took then. To start blowing hot now would confuse the message.

11. In exploring the scope for bringing forward expenditure we have therefore looked for schemes that meet fairly strict criteria:

i) matching savings that are guaranteed and deliverable should accrue in ~~the~~ 1986-87 - the main purposes of the exercise. There should be no risk of higher public expenditure taking the two years together (ie "relieving potential pressure" in 1986-87 will not be sufficient unless the relevant control total can be reduced);

ii) 1985-86 control totals should not be breached. There is now no opportunity to increase voted cash limits (because we are past the last date for Supplementaries), and nothing should be done that risked a cash limit breach. Other control totals, however, could in principle be increased if necesary (eg EFLs);

iii) the expenditure involved should be justified on its merits (and changing the timing should not itself carry a cost);

iv) we must avoid any comeback from the PAC by appearing to encourage schemes that involve manipulating bills or paying in advance of need;

v) in the interests of longer term expenditure control and resource allocation, we should avoid cutting across initiatives to improve budgeting or management. Thus we should rule out, say, denying departments the benefit of the end-year flexibility roll forward to 1986-87.

12. Our trawl of expenditure divisions for schemes has not suggested many candidates. Many of the possibilities offended more than one of the criteria above. One area where there might be thought to be some scope is MOD, where the sums are substantial and there are in place arrangements with contractors that allow some degree of fine tuning. But, as the attached minute from DM indicates (some copies only), there are a number of reasons for not taking action here. PSA also seemed a promising possibility; there may be scope for bringing forward purchases of freeholds or delaying prospective disposals. But such action by PSA could well breach their 1985-86 cash limit; and there could also be problems in ensuring matching savings next year.

Ch
Wd you be happy with this?
[illegible]

13. We have identified only 2 possibilities of any substance:

1) although the sale by British Shipbuilders of VSEL is now going ahead as planned, it is possible that the receipts may not fall in 1985-86; or at least there may be some scope for ensuring that the receipts are delayed to 1986-87. The benefit to the Reserve next year would be £60-£80 million although the cost in 1985-86 would

would be lower, £30-50 million; an increase in BS's EFL for 1985-86 would be required;

2) the Housing Corporation could be asked to bring forward expenditure, with a corresponding increase in their (non-voted) cash limit. The difficulty here is presentational, given the arguments with Mr Baker on the other parts of housing programme; there is also a risk that the Treasury's initiative would become public. Since only £10 million or so would be involved, we would not recommend action.

14. GEP's conclusion is that only in respect of the VSEL sale should we seek to influence the timing of expenditure/receipts; we should do nothing to jeopardise the deal or add to the parties' costs, but should rather not try to ensure it is concluded in 1985-86. However, we propose again to alert divisions to be on the look out, when proposals come to their attention, for sensibly bringing forward expenditure or delaying receipts where it can be done within the criteria above and without giving the wrong signals to departments.

The 1986-87 Planning Total

15. The slippage of teachers' back pay of course adds corespondingly to pressures on the 1986-87 planning total. I have noted previously that we might wish in future years want to remove the impact of the slippage from a run of planning total outturns with a "teachers' dispute adjustment". One possibility would be to anticipate this practice by announcing an increase in the planning total of £0.4 billion in the Budget (in the first instance by adding that sum to the Reserve). The change would be presented as a natural corollary of underspending to this extent in 1985-86 (particularly since the Government would be criticised if such underspending did not materialise). The advantages of making the change are:

1) it would effectively reinstate the assumptions on which the planning total and Reserve, as published in the PEWP, were based;

2) the Reserve would be correspondingly more manageable (and, on PSF's latest forecasts, adequate).

16. But there are important disadvantages:

1) critics might not understand why the planning total was being increased (and for the second successive budget);

2) the Reserve would normally be expected to cope with such slippage. An increase to the planning total would amount to an admission that the Reserve was likely to be under pressure;

3) to the extent that pressure on the Reserve is relevant factor in considering discretionary claims in year, an increase could mean a slightly higher than otherwise planning total outturn; against this, the presentational costs of exceeding an enhanced planning total would be much greater than an overshoot (within £0.4 billion) of the total in plans;

4) the enhancement would complicate the presentation of the Government's expenditure objectives, unless the "teachers' dispute adjustment" was made at the same time. In particular, without the adjustment, the planning total will show a real terms rise between 1986-87 and 1985-86 of 0.3% more than otherwise. In effect we would be committed to the awkwardness of using the adjustment before we knew that we had to.

17. There are arguments both ways, but on balance GEP is in favour of leaving the planning total next year at £139.1 billion as in plans.

Conclusion

18. This note has suggested that any action to mop up the likely 1985-86 underspend should be confined at most to that element that cannot be attributed to slippage of teachers' pay. However, it has argued that there is little scope for even limited action if we are not to undermine the normal requirements of control, propriety and value for money; and not to damage the Treasury's credibility with departments. You may nevertheless wish to endorse my suggestion in paragraph 14 above that divisions continue to be on the lookout for sensible opportunities to bring forward expenditure.

X 19. GEP are also of the view (paragraph 17 above) that the 1986-87 planning total should not be increased to reflect the slippage of teachers' pay.

M L WILLIAMS

31/16

SECRET

Mr. Peter L Williams c. R. Turnbull.
I agree.
PW 25/2

FROM: F MARTIN
DATE: 25 February 1986

MR KITCATT

cc Ms Seammen o/r
Mr Hansford
Mr Lopez

1985-86 RESERVE

Mr Turnbull's minute of 21 February asks groups to consider whether there are any possibilities to bring expenditure forward to 1985-86 from 1986-87.

2. My view is that given the criteria in paragraph 4 of Mr Turnbull's minute, we must report a nil return for the defence programme. In the F10 return (submitted on 18 February) MOD have forecast an underspend of £125 million on the cash limit block. (MOD will revise this forecast if necessary by the final deadline of 6 March by which date they will have preliminary figures for February spend and final bill profiles from their major contractors; there is no point in pressing MOD for a revision in the interim.) The forecast is somewhat lower than recent earlier forecasts, which, given the EYF arrangements, is some comfort to GEP. But given that MOD profiled expenditure for March is some £2 billion (with profiled expenditure in February some £1.4 billion), a forecast underspend of £125 million is a fairly narrow margin within which to operate in the closing months of the year.

3. Clearly there are possibilities for MOD to bring forward expenditure to a degree that would reduce or eliminate this underspend, either by accelerating purchases in areas such as fuel or by manipulating their end-year cash control arrangements with the major contractors. But taking the criteria in Mr Turnbull's minute in turn:-

(i) given their report on the 1983-84 manipulation of end-year billing, I am sure that such action by

MOD in 1985-6 to avoid general public expenditure problems in 1986-87 would "offend" the PAC;

(ii) we would be totally unable to ascertain, still less guarantee, whether any additional expenditure in 1985-86 was "justified on merits". Given the present turmoil in oil/foreign exchange markets who could say, for example, that increased fuel purchases in March 1985 were likely to be better value than waiting for a few months. Similarly, bill manipulation is highly unlikely to involve improved value for money; indeed, the PAC's view is that it "must" involve less;

(iii) given the narrowness of the margin provided by the forecast underspend, we certainly could not avoid a risk that MOD's block cash limit would be breached. The 1984-85 experience indicated that MOD at the centre does not have sufficient control to attempt to "fine-tune" expenditure in this way. On that occasion late instructions from the centre to certain vote managers to increase spend produced a much higher level of increased spend than planned, because of additional/unsanctioned decisions by these and other vote managers, which partly stemmed from the change in signals coming from the centre. The multiplicity of spending decision makers in MOD (the "invisible stokers" as MOD graphically put it) means that there is always a risk of an unanticipated surge in end-year expenditure. That risk is greatly increased if the stokers get any encouragement;

(v) encouraging MOD either to use their end-year cash control arrangements, or otherwise to bring forward expenditure, would certainly cut across "initiatives to improve budgeting or management". That would be particularly the case as regards Mr Levene's efforts to improve the position on contract progress payments; indeed, such a step would hand him an Ace in terms of his criticism of the adverse effects of the "over emphasis" on the delivery of cash.

4. The more general point is that MOD's present position - to reach the end of a year in which they have net expenditure in excess of £18 billion with a small forecast underspend which nevertheless provides a respectable cushion against unforeseen last-minute events - is one which in management terms we must support. It is a position which has taken years (and considerable struggle, not least by MOD at the centre) to establish, and which contrasts markedly with that in the late 1970s and early 1980s, when MOD veered between substantial underspend and overspend and almost continually threatened in-year claims on the Reserve. To ask them in effect to abandon this approach would be to devalue cash limit discipline generally and the commonsense of their present cash management approach specifically. My conclusion therefore is that we must not ask them to take any such action.

F. Martin

F MARTIN

Reserve

SECRET

FROM: F. E. R. BUTLER
27th February, 1986.

CHIEF SECRETARY

I agree very strongly with X (Mr Wms, para 19), & I further lean ~~—~~ towards Y (Mr Butler's 2(iii)): Mr Wms' 16(2) applies with equal force to this. M

c.c. Chancellor
Sir P. Middleton
Mr. Anson
Mr. Monck
Mr. Turnbull
HEGs
Mr. Scholar
Mr. M. L. Williams
Mrs. Butler
Mr. Gray
Miss Peirson
Mr. Lord

1985-86 RESERVE

I attach a submission from GEP on the merits of, and scope for, moving expenditure from 1986-87 to 1985-86.

2. I agree with the conclusions of GEP's note. I would add the following points:-

i. As we agreed when we spoke the other day, we do not want the underspending to be less than the amount held over for backpay to teachers because that would imply that we would have overspent without it. It might be different if we could say openly that we had deliberately brought expenditure forward to offset the slippage in teachers' pay. I do not think that we could say that and, if we did, it would be treated with scepticism.

ii. Unfortunately it now looks as if the underspending may be more than the teachers' backpay, although the figures are still within the margin of error. For the reasons given in GEP's note, the scope for doing anything about that is limited. If you agree and are prepared to increase British Shipbuilders' EFL for 1985-86, we will seek to delay the receipts from

VSEL until 1986-87. I would also be prepared to speak to the Permanent Secretaries of Departments with large capital budgets and say that, while we are not encouraging them artificially to bring forward expenditure and certainly want them to observe cash limits etc., we would not want their carry-forward of capital allocations under the end-year flexibility scheme this year to be larger than is now envisaged.

iii. There is a real issue whether we should formally increase the planning total for 1986-87 by the amount carried over for teachers' pay. I am persuaded by GEP's arguments that we should not make such a formal increase. But we should say clearly at the outset that it is not allowed for in the 1986-87 planning total and that it belongs to 1985-86, even though it will fall to be paid in 1986-87.

Y

F.E.R.B.

F. E. R. BUTLER

CONFIDENTIAL

B

FSBR PART 3: DRAFT

THE ECONOMY: RECENT DEVELOPMENTS AND PROSPECTS TO MID-1987

Summary

World Economy

3.01. Output in the world economy has now been rising since early 1983, and inflation has been coming down since 1980. The recent large fall in oil prices will be of particular help to oil importing countries both in the developed and developing world. ~~Helped~~ Assisted by further moves to lower interest rates, a period of low inflation and good growth in output and trade is in prospect. Many of the problems arising from payments imbalances and debt repayments will remain. But the benefits to trade, output and inflation from the fall in oil prices should prove substantial.

~~Policies and~~ assumptions

3.02. The UK forecast is based on the assumption that fiscal and monetary policies are set within the framework of the MTFS. [The large fall in oil prices that took place between November and February is assumed to persist.] North Sea oil prices are assumed to average $15 in 1986-87. [On average in 1985 the sterling index was 78, much the same as in 1984. This year it has fallen to a level of 74 in February. It is assumed not to change much from that level over the forecast period.]

a band

Neither the ~~The~~ sterling index is assumed ~~not~~ to change much.

~~Financial conditions~~ and inflation

how no $/$ XR

3.03. ~~Monetary conditions were tightened in January 1985, and for most of the year short-term interest rates were higher than in 1984.~~ After rising in the early months of 1985, inflation has been on a downward path since June and in January 1986 the RPI increase was 5½ per cent. [With a further fall in world inflation and lower oil prices more than offsetting the fall in the exchange rate,] The inflation rate is expected to be about 4 per cent for most of the forecast period.

Demand and Activity

[illegible]?

3.04. 1985 saw substantial growth in both exports and business investment. By the second half of the year, consumers' expenditure was rising at an annual rate of some 3 per cent. For the forecast period substantial growth is likely in most areas of private domestic income and spending. Total domestic production and manufacturing output are both expected to record further growth in the range 2-3 per cent.

Unemployment

3.05. Despite disappointing figures since November, the prospects for unemployment are better than for some years. Growth in employment is expected to continue; labour force growth may be slowing down; ? and the impact of measures taken in the 1985 and 1986 budgets will be increasing.

Balance of payments

3.06. The current account of the balance of payments is expected to remain in sizeable surplus despite the big fall in oil prices. Offsets include higher export earnings on other goods - with most overseas markets benefiting from the fall in oil prices - lower profits earned by foreign oil companies in the North Sea, and higher earnings from the UK's stock of overseas assets.

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WORLD ECONOMY

Recent developments

3.07 After a spurt in 1983 and the first half of 1984, US economic growth has slowed down sharply. By the final quarter of 1985 real GNP was 2½ per cent higher than a year earlier. The performance of the US economy has strongly influenced the pattern of economic growth in other major industrialised countries. In Japan and Germany, in particular, output grew significantly faster than domestic demand in both 1984 and 1985, thanks to the substantial external contribution to demand, stemming in large part from the US. More recently the recovery in Europe has strengthened and growth has become less dependent on exports to the United States. In Japan growth has shown some signs of slackening, although remaining high by European standards.

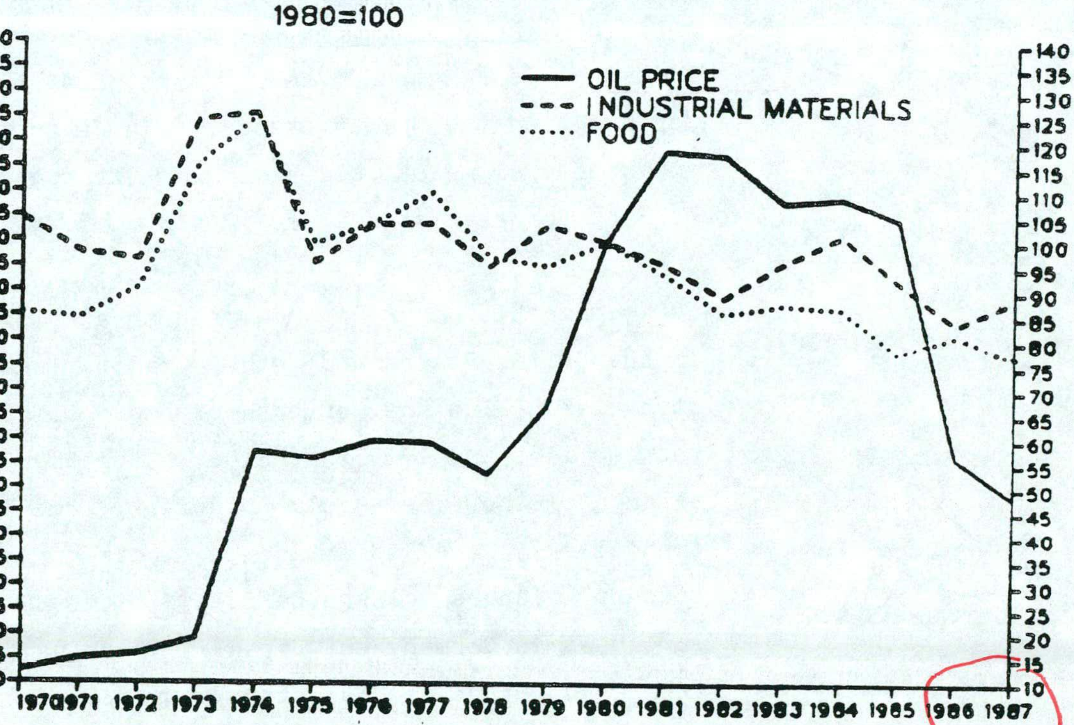
3.08 Domestic demand is now growing at similar rates in the United States and other major industrialised countries. But the effect of much faster growth between 1982 and 1984 in the US, together with the effects of the rise - still only partially reversed - in the dollar, are seen in the pattern of current account balances: a large deficit~~s~~ in the US and large surpluses in Germany and Japan. There have, though, been a number of helpful steps toward reducing these imbalances over the past year. Slower growth in the US has not only reduced the increase in US imports, but also contributed to lower interest rates and a fall in the dollar. The latter was helped by the Plaza Agreement of 22 September between the Finance Ministers of the Group of Five. Nevertheless, a period in which US domestic demand growth is significantly slower than that in Europe and Japan is likely to prove necessary if current account surpluses and deficits are to be reduced.

3.09 The rate of inflation fell further in 1985: consumer prices in the major industrialised countries increased on average by about 4 per cent, compared with over 4½ per cent in 1984. This partly reflects the weakness of primary product prices, (see chart 3.1).

CHART 3.1

REAL COMMODITY PRICES *

1980=100



(1) 1987 1ST HALF-YEAR

* IN RELATION TO PRICES OF MANUFACTURES

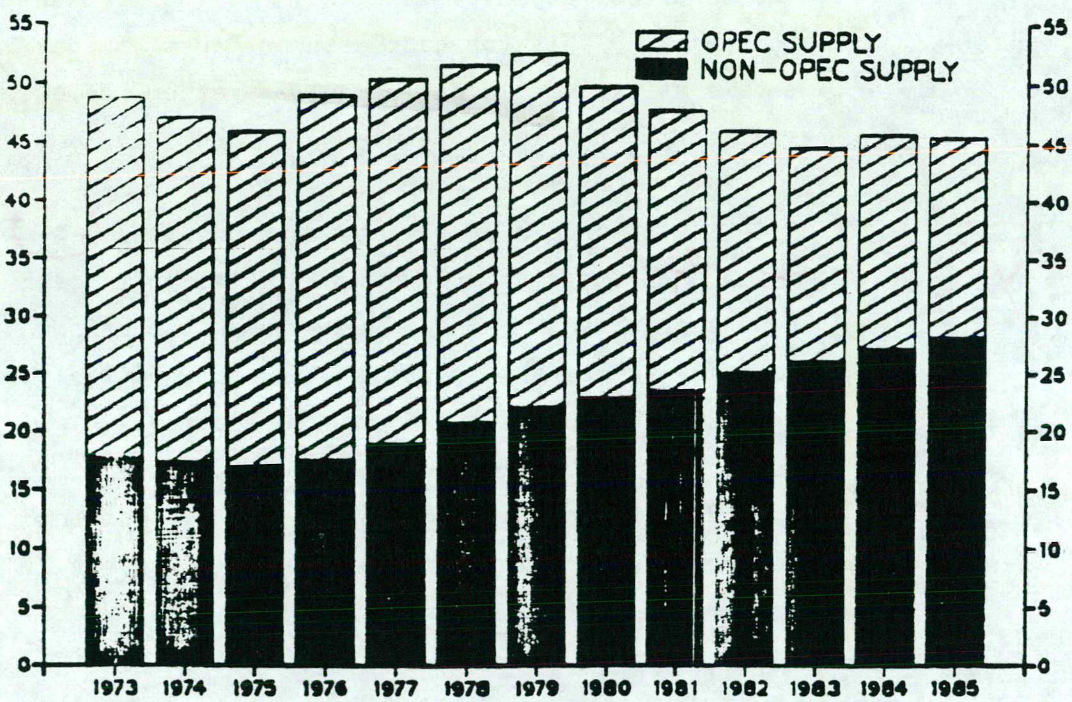
(update?)

3.10 Since December 1985, oil prices have fallen sharply. The background to these oil price developments is set out in chart 3.2. Before the first oil price shock the non-communist world demand for oil was around 48 million barrels per day, and about 30 mbd of this was produced by OPEC members. Despite the 1973-74 increase in oil prices OPEC managed to maintain roughly this level of production throughout the 1970's. After falling in 1974 and 1975 total demand for oil rose again during the rest of the decade, while non-OPEC supply grew by roughly the same amount in absolute terms.

CHART 3.2

OIL SUPPLY AND DEMAND(1)

MILLION BARRELS A DAY



1. THE HEIGHT OF EACH COLUMN REPRESENTS NON-COMMUNIST WORLD DEMAND

3.11 Experience since the second sharp increase in oil prices in 1979 has been very different. Demand for oil has fallen and non-OPEC supplies have continued to rise sharply. OPEC's pricing policy made it effectively the residual source of supply and demand for OPEC oil nearly halved: from about 30 mbd in 1979 to less than 17½ mbd on average in 1985. A large share of the production cuts fell on Saudi Arabia.

3.12 Towards the end of 1985 Saudi Arabia indicated that it was no longer prepared to maintain its own production at very low levels in order to maintain the existing level of prices. The resulting increase in supply, combined with no sign that other producers were prepared to make offsetting cuts in their production, has produced a sharp fall in prices.

Prospects

3.13 Total demand and supply for oil may well respond only slowly ~~even~~ to the large fall in price, and so excess capacity is likely to be present for some time. This forecast assumes that prices will settle at around $15 per barrel - rather below, in real terms, the level between 1974 and 1979.

3.14 The prices of most primary products other ~~than oil~~ are also unlikely to strengthen significantly over the next year or so, since with some exceptions (for example a temporary shortfall in the coffee crop), supplies are abundant and stocks relatively high. The industrial countries can therefore expect further improvements in their terms of trade, raising real incomes and enabling inflation to fall further without squeezing profit margins or reducing real wages (see table 3.1).

Table 3.1: World economy

	percentage change on a year earlier			
	1984	1985	1986	1987 first half
Major Seven countries*:				
Real GNP	4½	2½	3½	4
Consumer prices	4½	4	2½	1½
World trade, at constant prices				
Total imports	10	3	6	5½
Trade in manufactures (UK weighted)	8½	4	5	5

* USA, Canada, Japan, France, Germany, Italy and the UK

3.15 The growth of real GNP in the **United States** should remain steady through 1986, as the effects of the dollar's depreciation work through to increase the growth of exports and reduce that of imports. Consumers' expenditure, whilst growing more slowly than in recent years, should be helped by the lagged effects of lower interest rates and rises in asset prices.

3.16 Growth in **Japan** may be weaker than usual in 1986 as the expansion of domestic demand may not be sufficient to compensate for a slowdown in the growth of exports. Thereafter the Japanese economy should strengthen as the effects of the fall in oil prices and the appreciation of the yen work through to raise real personal incomes and wealth, and hence expenditure. In most **European countries** the economic recovery should strengthen in 1986, with the rate of growth increasing, particularly in Germany.

??

3.17 Overall the major industrialised countries may grow by about 3½-4 per cent over the next year. Together with lower inflation and interest rates in the major countries and the reduced cost of their oil imports, this should provide a better prospect for the non-oil developing countries, despite weak commodity prices. Oil producing countries, on the other hand, particularly those already heavily indebted, face severe difficulties and will have to cut their imports further.

CHART 3.3

MAJOR 7 ECONOMIES REAL GNP AND INFLATION

% CHANGE HALF-YEAR ON SAME HALF-YEAR OF PREVIOUS YEAR

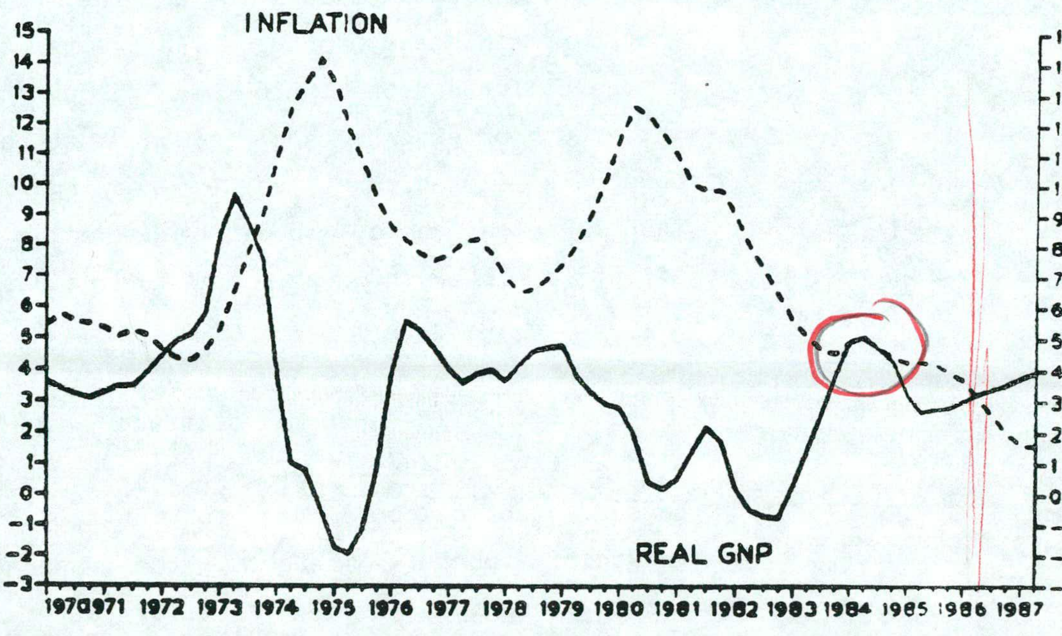


Table 3.2 : World import volumes, annual growth rates

	USA	Japan	Europe*	OPEC	Developing countries	Other	Total
Weights in 1984	19	8	31	7	14	22	100
1984	24	11	6	- 10	8	10	10
1985	3	1	5	- 8	1	6	3
1986	9	8	7	- 16	7	5	6
1987 first half	6	10	8	- 25	7	5	5½

* Germany, France, UK, Italy, Netherlands and Belgium

---

trade growth doubles

3.18 This picture of world activity is reflected in the pattern of world trade growth. Import growth is likely to be strongest in oil-importing countries and in those whose exchange rates have appreciated most over the past year. This points to rapid growth of imports into Europe, Japan and many developing countries, but to large falls in oil producers' imports.

FINANCIAL CONDITIONS

Interest Rates

transferred from Part II (ChTFS)

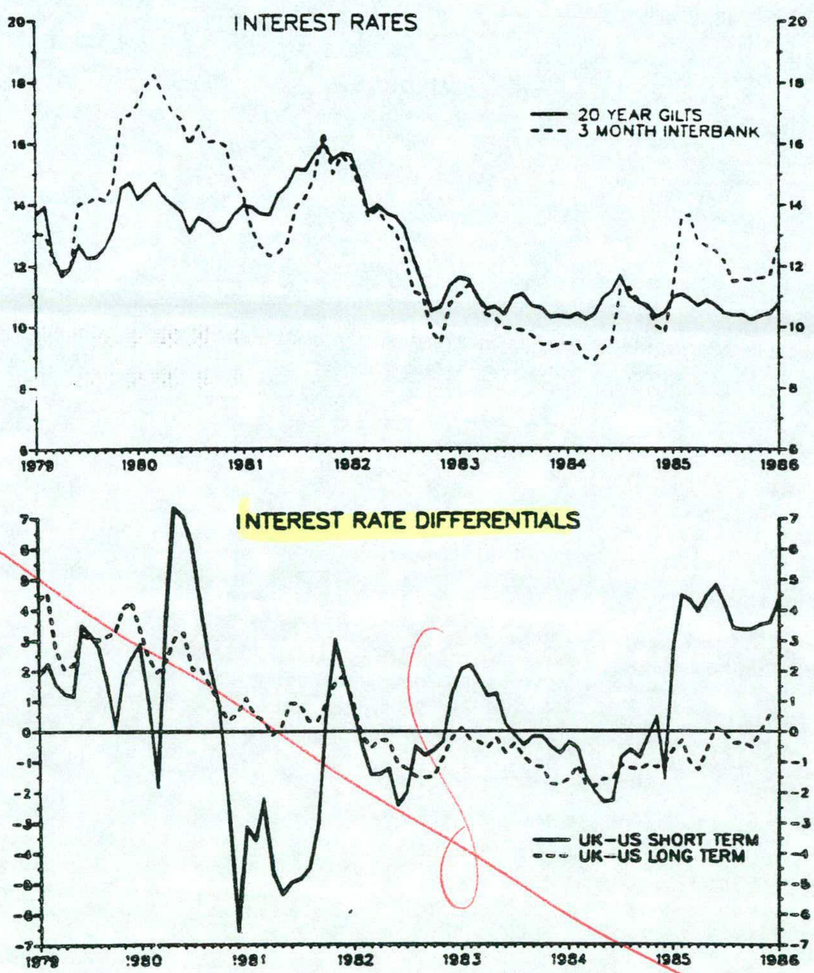
3.19 Short-term interest rates fell during much of 1985 from the peak levels reached in February and March. They rose again in January this year as sterling weakened but in 1986 so far they have been a little below levels a year earlier. However ~~on average~~ in 1985-86 short rates, at 12 per cent, have on avge been a point or so above the levels of 1984-85 and several points above levels in the US, and most other industrialised countries. Long rates have been much more stable, with 20 year gilts yields within the 10-11 per cent range for almost all of the last three years. Real yields on index-linked gilts have also been relatively stable, although they have edged up over the past year.

update?

Chart 3.4: Interest rates in the UK ~~and US~~

[Charts can be side-by-side in FSBR]

update?



do you want to underline this point (this illustrates difference between ST + LT differentials)

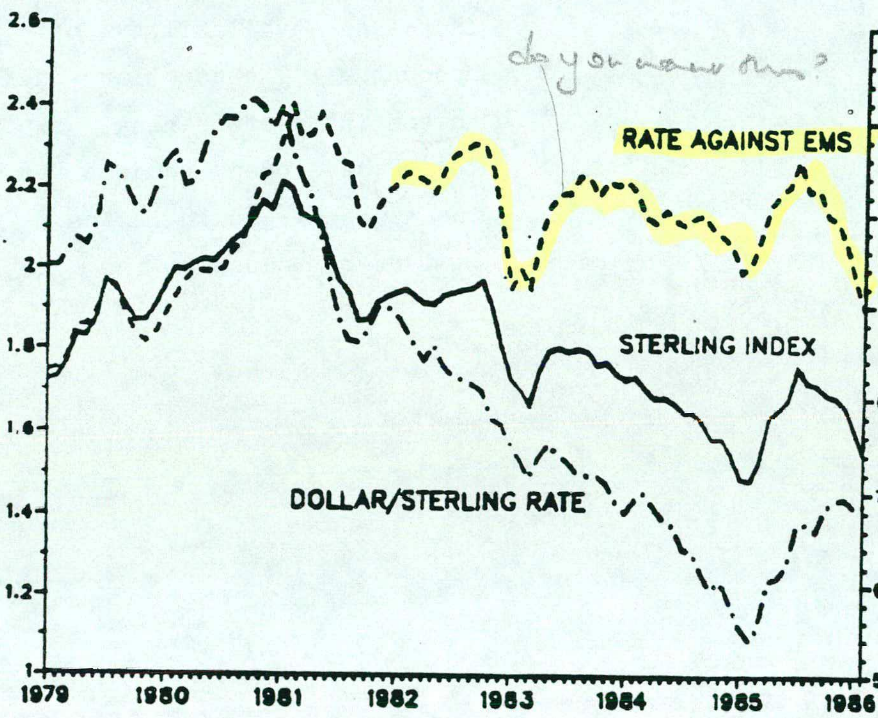
NO

Exchange Rates

3.20 In 1985 as a whole the sterling index was little different from 1984. There were however some sizeable swings during the course of the year. The index rose from a lowpoint of 70½ in January to a high of 84½ in July, when UK interest rates fell, before declining to 78 in December. The index has fallen a little further this year as a result of the fall in oil prices. The dollar has declined substantially (by over 20 per cent against a basket of other currencies) since its peak in early 1985. Over the past year sterling has risen strongly against the dollar, but fallen against most other currencies.

update

Chart 3.5: Exchange rates for sterling



do you want this?

Which scale is what?

Shallower graph

update

3.21 The forecast assumes that sterling will not change much from its ~~average level in February, when the effective rate was 74 and the £/$ rate was [1.40].~~ This implies that in 1986 as a whole the sterling index will be 5-6 per cent below its average level in 1985 (while the sterling price of North Sea oil is assumed to be some 45 per cent lower on average in 1986 than in 1985).

Publish level, either in $ or effective terms.

So?

Narrow Money

3.22 MO was near the centre of its target range in the early months of 1985-86, but growth slowed during the course of the year, ~~mainly as a delayed~~ In response to the increase in interest rates last winter. In recent months MO growth has generally been just above the bottom of its target range. Indicators of changes in the extent to which cash is used for transactions suggest that MO velocity will continue to rise at much the same trend rate as in recent years. Interest rates are likely to remain a major influence on short-term movements in velocity.

The annual inc. in MO velocity has been stable for many years now, & is expected to remain so.

Increasing velocity trend has been stable & predictable, & likely to remain so — (if anything)

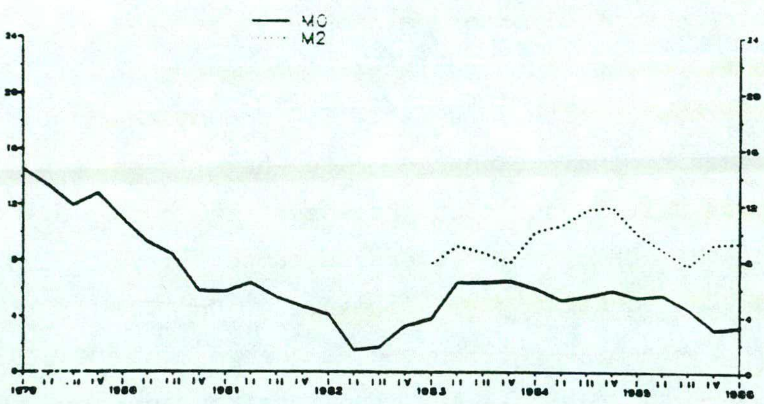
3.23 Growth in the non-interest bearing component of M1, 3 per cent over the last year, has also slowed in response to higher interest rates and the increased availability of high interest cheque accounts. The corollary has been an acceleration in the interest-bearing component of M1. Figures for M2 have been subject to substantial revisions, but now show growth in the 7-9 per cent range for most of 1985-86, close to the growth in money GDP.

Narrow?

Chart 3.6: The monetary aggregates

(averages of three banking months - per cent changes on year earlier)

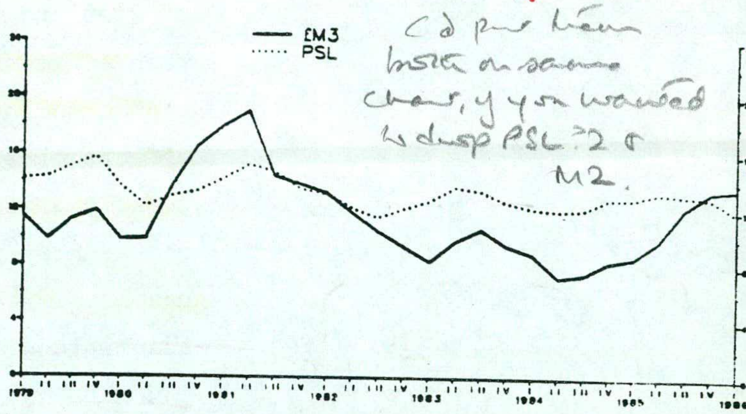
Narrow money



Broad money

yes

Cd put them both on same chart, if you wanted to drop PSL2 or M2.



Broad Money

3.24 The rate of growth of £M3 has risen during the course of 1985-86 and has been well above both the target range set in the 1985 MTFS and the growth of money GDP. With the funding objective now set at the level needed to cover the PSBR, £M3 growth (at 14-15 per cent on a year earlier in recent months) has reflected a continued strong expansion of bank credit. Other broad aggregates have grown at ~~a steadier~~ rate: for example, PSL2, plus all building society term shares, has expanded at annual rates of 12-14 per cent since the end of 1981.

much the same rate

3.25 The rapid expansion of broad money and credit reflects to a large extent the pace of financial innovation and liberalisation. In addition, since over two-thirds of £M3 bears interest and is now an attractive means of holding financial wealth, the high level of real interest rates may have contributed to higher bank deposits. The higher levels of financial wealth and debt in relation to incomes probably reflect a permanent shift in the private sector's portfolio. They are therefore expected to be consistent with the slower growth of nominal incomes and the fall in inflation in this forecast.

(likely to continue?)

or continue

CONFIDENTIAL

TRADE AND THE BALANCE OF PAYMENTS

Relative costs and prices

3.26 The last two to three years as a whole have exhibited relatively little change in most measures of cost and price competitiveness, although there have been large short-term swings associated with movements in the nominal exchange rate. As table 3.3 shows, the effects of a lower nominal exchange rate have been broadly offset by unit labour cost increases at home above those in the UK's main overseas competitors, despite a good UK productivity performance. ~~On the assumption that the recent fall in the exchange rate is not reversed~~, the UK's cost and price competitiveness may be little different from the average of the last three years.

or put another way...

Assume an unchanged

Table 3.3: The nominal exchange rate and relative costs and prices in manufacturing.*

	Sterling Index (1975=100)	Relative actual unit labour costs	Relative export prices (1980=100)	Import Price Competitiveness
1983	83½	85	89	94½
1984	78½	83½	87½	92
1985 Estimate	78	87½	89½	91
~~[1986 Assumption/ Forecast~~	~~73~~	~~86~~	~~87~~	~~91]~~

* Ratio of UK to overseas costs/prices

Trade prices and the terms of trade

3.27 Prices of most categories of imports fell during the course of 1985 as a result of an appreciation of the exchange rate and low inflation in the developed world, and weak, and in some cases falling, commodity prices. By the final quarter of 1985 import prices of all goods and services were 5 per cent lower than a year earlier. For 1985 as a whole, the terms of trade were 1 per cent above those in 1984 because of the weakness of commodity prices. But some decline in the terms of trade is likely in 1986 because the price of oil has fallen relative to other goods and services. As oil has a greater share in UK exports than in imports, a fall in its price reduces export prices relative to import prices.

Table 3.4: Trade in goods - balance of payments basis

per cent changes on a year earlier

All goods

	Export Volume	Import Volume	Terms of Trade
1983	2	8	$-\frac{1}{2}$ (-1)
1984	8	11	$-1\frac{1}{2}$ ($-1\frac{1}{2}$)
1985	6	4	1 ($2\frac{1}{2}$)
1986 forecast	$5\frac{1}{2}$	$6\frac{1}{2}$	-1 (2)

( ) terms of trade excluding oil - OTS basis

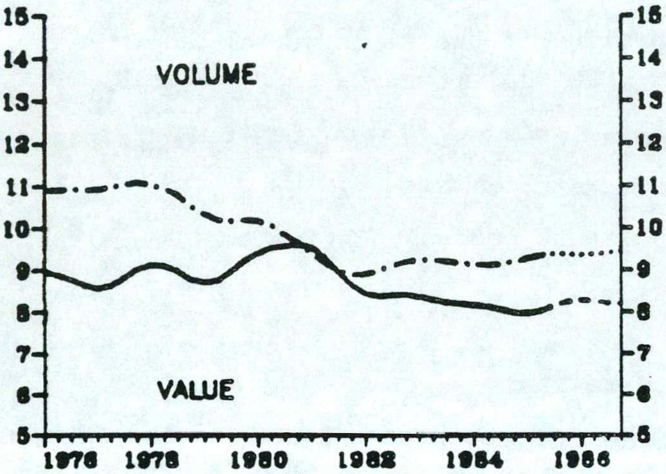
Trade volumes (goods other than oil)

3.28 As shown in chart 3.7 UK exporters of manufactures improved their share of world trade in volume terms in 1984 and may also have done so in 1985. The value share has however declined slightly as UK export prices have fallen relative to those of our competitors. The forecast of exports of manufactures (excluding erratics) in volume terms is for further growth of 5 per cent in 1986. This is the same as the rise in world trade, but less than in 1985 ~~because it is assumed that only a part of the recent good performance will be repeated.~~

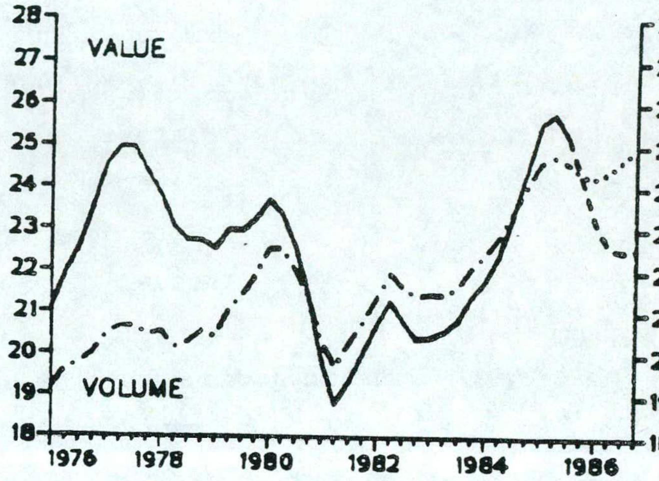
?

Chart 3.7: Export shares and import penetration

Share of UK exports in main manufacturing countries exports of manufactures



Share of imports in total domestic expenditure (excluding oil)



3.29 Between 1982 and 1985 the growth in demand for manufactures ($5\frac{1}{2}$ per cent at an annual rate) has been shared by importers and domestic producers, with importers continuing to increase their share. Domestic demand for manufactures is expected to grow in 1986, because of further growth in investment and consumer durables in particular. Growth in imports of manufactures in 1986 is forecast to be around 7 per cent, twice as fast as domestic demand growth, a relationship similar to that between 1982 and 1985.

Trade in oil

3.30 The prospect is for a substantial fall in the balance of trade in oil in 1986 as a result of lower oil prices, partly offset in the current account as a whole by reduced earnings of foreign owned companies in the North Sea. Little change in oil production is expected and domestic demand for oil will be below the 1985 level which was boosted by the coal strike.

Invisibles

3.31 The balance of trade in **services** has more than doubled since 1982. 1985 was an exceptionally good year, with large gains in earnings from financial services, tourism and travel. With imports of services, particularly tourism, likely to grow faster, the balance on services may show only a modest gain in 1986.

3.32 The profile of the **transfers** balance is affected by the timing of official transactions with the European Community. As the bulk of the UK's rebate on its 1984 contribution was delayed into 1986 the transfers balance was unusually low in 1985, by about £½ billion. A correspondingly high figure is projected for 1986.

3.33 The surplus on **interest, profits and dividends** (IPD) fell slightly in 1985. A rise in the non-oil IPD balance was more than offset by a deterioration on oil OPD which largely reflected a once-for-all write off of losses on BP's Sohio subsidiary. Lower oil prices in 1986 will reduce the profits of foreign oil companies operating in the North Sea more than they reduce the profits of UK oil companies' overseas operations. There should be a rise in the non-oil IPD balance as a result of a further increase in the UK's net overseas assets.

Current Account

Table 3.5: Current account of the balance of payments, £billion

	Oil	Other Goods**	Invisibles	Total: Actual and forecast	Total: After allowing special factors*
1983	7	- 8 (-2½)	4	3	3
1984	7	- 11 (-4)	5	1	4
1985	8	- 10 (-3)	6	4	5½
1986	5½	- 10 (-3½)	8½	4	3½

ISUC 80 estimate

do you want this (perhaps half forecast were planned?)

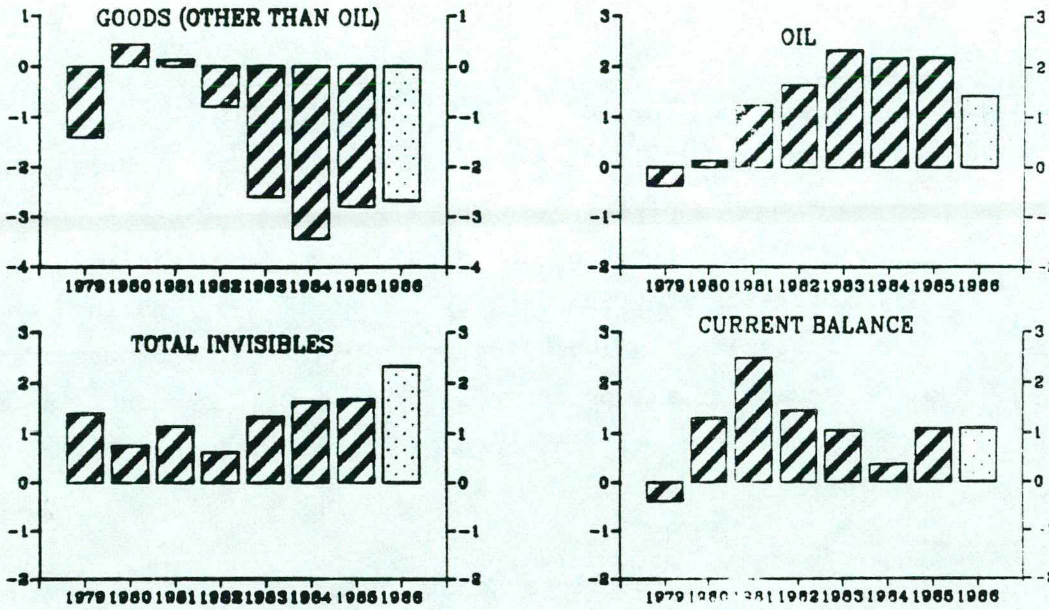
* EC rebates and the effect of the coal strike.

** The balance on manufactures is in brackets.

1983,

3.34 Table 3.5 summarises the current account and its main components. Allowing for the effects of the coal strike the current account was in sizeable surplus in 1984 and 1985 and a substantial surplus is again forecast for 1986. On an underlying basis, the surplus in 1986 is expected to be lower than in 1985, as a result of the big fall in oil prices. The contribution of North Sea oil to the current account - ie the balance of trade in oil less foreign companies' North Sea profits - is forecast to fall from a strike-adjusted £6½ billion in 1985 to £3½ billion in 1986. Chart 3.8 shows the components of the account over a longer period, relative to GDP.

Chart 3.8: **Trade balances as a percentage share of GDP**



8

Overseas Assets

3.35 The UK's stock of net overseas assets rose from 6 per cent to 24 per cent of ~~money~~ GDP between 1979 and 1984. It is estimated to have risen further in 1985, to 24 per cent of ~~money~~ GDP, or £85 billion. About two-thirds of the increase in 1985 was due to changes in asset prices and one-third to net purchases of assets.

INFLATION

Inflation and Costs in 1985

3.36. In the year to 1985Q4 the RPI increased by $5\frac{1}{2}$ per cent, a little more than forecast in last year's FSBR. In the middle of the year retail price inflation touched 7 per cent reflecting in particular increases in mortgage interest rates in February and April 1985 and the weakness of sterling in late 1984 and early 1985. Between May and January retail prices rose by only 1.1 per cent in total, helped by a fall in mortgage rates and by lower petrol prices.

3.37. Import prices declined during 1985 and in the final quarter were about 5 per cent lower than in 1984Q4; the prices of imported fuels fell 14 per cent over the same period. Prices of the manufacturing sector's imported inputs fell rapidly from their peak in February and by the end of the year were 6 per cent below their December 1984 level. The rate of increase in manufacturing output prices started to slow down in the second half of 1985.

3.38. The underlying growth of average earnings (that is, abstracting from the effects of strikes, delayed settlements and other temporary factors) continued at about $7\frac{1}{2}$ per cent in 1985 - little changed from 1984. With output per head growing at about 2 per cent (after allowing for the effects of the coal strike) the growth in unit wage costs was about $5\frac{1}{2}$ per cent in 1985. Unit labour costs rose by about 1 per cent less mainly because of the abolition of NIS in October 1984. ~~and probably some abatement of employers' pension contributions.~~ ? In the manufacturing sector, average earnings increased by $8\frac{1}{2}$-9 per cent and unit labour costs by 4 per cent. This was much faster than in most other major industrial countries. Pre-tax real earnings of employees have increased by an average of almost $2\frac{1}{2}$ per cent a year between 1982 and 1985.

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Prospects

3.39. So far the current pay round is showing little sign of any significant change in the level of pay settlements or in the underlying rate of growth of average earnings in the private sector. Unit labour costs for the economy as a whole may rise by 5 per cent in 1986, and unit labour costs in manufacturing may rise slightly less than this. World commodity prices are likely to remain weak in 1986. With a 40 per cent decline ~~fall~~ forecast for oil prices in sterling terms between 1985 and 1986, ~~and despite a lower exchange rate,~~ the overall cost of manufacturers' material and fuel inputs should fall quite sharply between the two years. The prospects are for very modest growth in manufacturers' total costs and a widening of profit margins ~~for a time.~~

check

Table 3.6: **Costs in manufacturing (percentage changes on a year earlier)**

not given before

	Unit Labour Costs in Manufacturing	Materials and fuels purchased by manufacturing industry(1)	Estimated Total Costs	Output Prices(1)
1983	½	8	2½	5½
1984	2½	8½	4½	5½
1985	4	4	4	6½
1986	4½	-11	½	4½
~~1987 First half~~	~~4½~~	~~- 2~~	~~2~~	~~2½~~

(1) Excluding food, drink and tobacco

3.40. The fall in import prices since the spring of 1985 has contributed to the recent low monthly growth in retail prices, and will continue to contribute to low increases in prices over the coming months. The annual rate of inflation will fall quite sharply over the next two months. ~~in the months after January 1986.~~ In the last quarter of the year RPI inflation may be about 4 per cent, with little change likely in the first half of 1987. The fall in oil prices is expected to work its way fully through to petrol prices in the course of 1986 and to gas [and electricity] prices charged to the domestic consumer in the the first half of 1987. One third of the housing component of the RPI is accounted for by local authority rates: [early information on 1986-87 suggests a rise of about 15 per cent.]

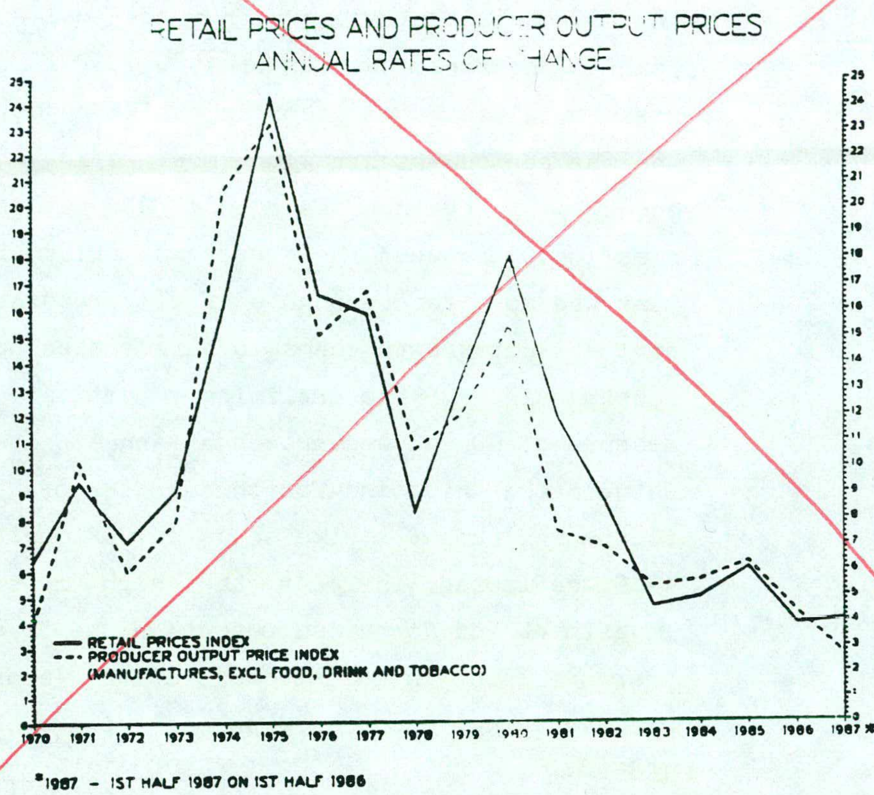
Table 3.7: **Retail prices index**

	Per cent changes on a year earlier				
				Forecast	
	Weights in 1985	**1984 Q4**	**1985 Q4**	**1986 Q4**	**1987 Q2**
Food	19	3½	3	3	3½
Nationalised Industries (including water)	9	4	5½	4½	3
Housing	15	10½	9½	9½	3½
Other*	57	4(~~4~~)	5½(~~5½~~)	3(~~4~~)	4(~~4~~)
Total	100	5	5½	4	3¾

~~* Figures in brackets exclude the effects of changes in petrol prices.~~

3.41. Other price indices sometimes move differently from the RPI because of differences in coverage. In particular they vary in the degree to which they are affected by movements in import prices; and the housing component of the RPI includes a direct effect from interest rate changes which is absent from other price indices. [~~Chart 3.9 shows past and forecast growth in retail prices and in manufacturing output prices.~~]

CHART 3.9



3.42. The GDP deflator measures the price of domestic value added - principally unit labour costs and profits per unit of output - and excludes imports altogether. The GDP deflator covers all sectors of the economy, including oil output in the North Sea, and so is highly sensitive to the fall in world oil prices. This contributes to a marked slowdown in the growth of GDP deflator over the ~~next~~ coming year. The deflator for GDP at market prices is estimated to have increased by 5½ per cent in 1985-86, about one per cent faster than in 1984-85. In 1986-87, inflation on this measure is expected to fall back to about 3½ per cent. With no further benefit from lower oil prices assumed after 1986, the GDP deflator is liable to rise a little more in 1987-88.

DEMAND AND ACTIVITY

3.43. Latest estimates suggest that GDP rose by about 3½ per cent in 1985, or 2½ per cent after making allowance for the effect of the recovery from the coal strike. Over the year to the first quarter of 1985, GDP is estimated to have risen by almost 4 per cent in strike adjusted terms: this was the period which saw the most rapid growth in the world economy. Since then the path of GDP has been flatter. The rise in GDP between the first and third quarters of the year was more than accounted for by recovery from the coal strike, but growth seems to have picked up again in the fourth quarter: the preliminary estimate of the output measure of GDP showed growth at annual rate of 2½ per cent between the third and fourth quarters of the year. The flattening out of strike adjusted GDP during the middle of 1985 reflected in part the high level of business investment and North Sea output in the first quarter of the year. Output in most sectors of the economy, including manufacturing, continued on an upward trend throughout 1985.

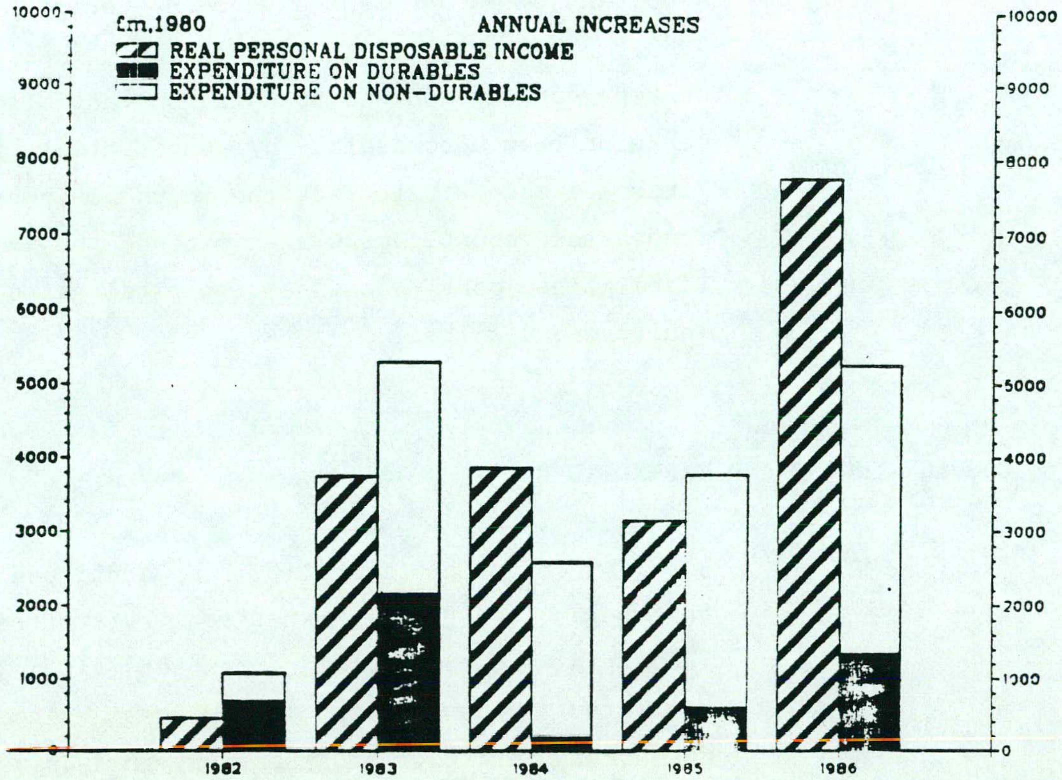
Personal Sector Expenditure

3.44. Between 1980 and 1983 the inflation rate fell by about three quarters and the personal saving ratio fell by almost a quarter. In 1984, with the uncertainties caused by the long coal strike, consumers were more cautious and saving rose. During 1985 spending has picked up again, particularly on durables which were some 7 to 8 per cent higher in the second half of 1985 than in the second half of 1984.

3.45. The combination of little change in earnings growth and lower price inflation, together with higher dividend income reflecting the buoyant profitability of the company sector, is expected to lead to substantial growth of real personal disposable income of about 4 per cent in 1986. There may be some increase in the saving ratio, as consumers adjust to higher levels of income; but most of the rise in incomes ~~should~~ be reflected in higher spending, with continuing strength in purchases of durables. Chart 3.10 shows recent and forecast changes in personal income and consumer spending.

CHART 3.10

PERSONAL INCOME AND EXPENDITURE



how given before

How robust for 1986?

3.46 Investment in dwellings by the personal sector fell between 1984 and 1985, but a resumption in growth is expected for 1986. Investment in housing improvements, which fell in the second half of 1984, ~~following the extension of VAT and the change in the availability of grants~~, started to recover during 1985, and is expected to show further growth in 1986 as personal incomes rise. In spite of the increases in mortgage interest rates early in 1985, house prices remained firm; private housing starts which had fallen during 1984 were rising throughout 1985, and the total for the year was well above the number of completions. This trend in starts should show up in investment in new houses during 1986.

§

3.47 The demand for housing (as reflected in house prices) and spending on consumer durables have both been resilient in the last year or so, in spite of the high level of real interest rates. The personal sector has been responding to the financial liberalisation of recent years and the greater availability of credit as well as to the changes in interest rates. individuals' Persons' borrowing from banks and building societies increased by about 18 per cent in 1985, and by 20 per cent a year on average between 1980 and 1985. This borrowing has not only helped to finance current consumption and spending on tangible assets, but has also been accompanied by substantial acquisition of financial assets: in fact the growth in individual holdings of persons' financial assets has recently more than matched the growth in their liabilities, partly because of capital gains on holdings of equities and gilts.

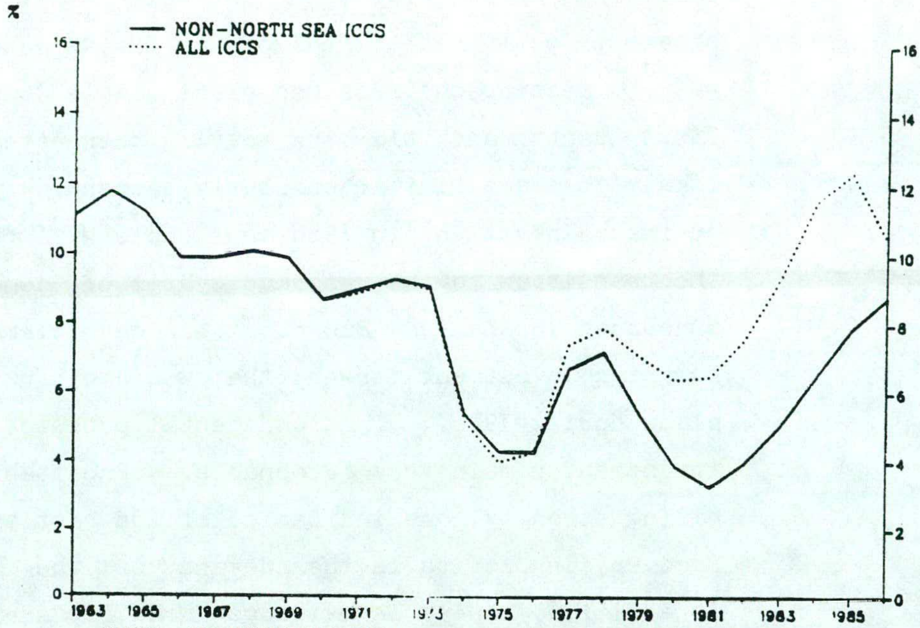
COMPANY INCOME AND EXPENDITURE

3.48. Company profitability has continued the recovery that began in 1981. The net real rate of return for all industrial and commercial companies (ICCs) for 1985 is estimated to have been the highest since 1960. For non-North Sea ICCs, profitability in 1985 was higher than any time since 1973.

3.49. The recent sharp fall in oil prices will mean a substantial reduction in North Sea profits in 1986, and the overall return earned by ICCs may fall. However, non-North Sea ICCs will be prime beneficiaries of the fall in oil prices, as they have been of the weakness of other commodity prices during 1985; their profitability is expected to increase further in 1986 (see Chart 3.11).

CHART 3.11

NET REAL RATE OF RETURN
INDUSTRIAL AND COMMERCIAL COMPANIES



and so were.

NOTES: ADJUSTED FOR ESTIMATED EFFECTS OF PRIVATISATION

Fixed Investment 3.50. Total business investment, including North Sea investment and investment by public corporations, grew by about 4 per cent in 1985. Within this total manufacturing investment increased by 5 per cent, after taking into account the increase in assets leased by manufacturing companies from finance lessors. This was a somewhat smaller increase than Intentions surveys had earlier suggested was likely. Looking ahead to 1986, the latest DTI survey indicates an increase in manufacturing and service industries investment of about 1 per cent, within which total manufacturing investment is expected to fall by about 2 per cent. By contrast the CBI interpret their most recent survey as implying a 5 per cent rise in manufacturing investment in the first three quarters of 1986 compared with the corresponding period of 1985.

What do BS think?

3.51. The ~~path~~ pattern of investment during 1985 was greatly influenced by the reduction in capital allowances which became effective at the end of the first quarter of the year. Leasing business was particularly buoyant in the first quarter and fell back heavily thereafter. 1986 is likely to see a similar quarterly pattern. The level of business investment in 1986 as a whole will be affected by the transition to the reformed system of company taxation announced in the 1984 Budget: this gave firms an incentive to bring investment forward that would otherwise have taken place during 1986. The fundamental prospects for business investment remain very favourable. Profitability has been rising strongly: one indication of the past and prospective recovery in profits is the buoyancy of the stock market. In addition, there is evidence from CBI surveys that an expansion of capacity will be needed in a number of industries. With the additional boost to profits of most companies from lower oil prices, this forecast allows for a rise in business investment in 1986 of 4 per cent, rather more than suggested by the latest DTI survey.

3.52. Table 3.8 provides details of the forecast for total investment and its major components. Overall in 1986, fixed investment is expected to show a further year of good growth. North Sea investment is expected to recover this year to a similar level to that in 1984, mainly reflecting increases in expenditures on oil fields already under development and on gas fields due for development.

Considered before, but not included

Table 3.8: **Gross Fixed Domestic Capital Formation (at constant prices)**

Gross what? (? what year)

	1984 £ billion at 1980 prices	1984	Per cent change on previous year — Forecasts 1985	1986
Business(1)	29.0	10	4	4
of which:				
Manufacturing(2)	6.4	15	5	0
Oil and gas(3)	2.9	14	-14	18
Other	19.6	8	6	5
Private dwellings(4)	9.5	4	- 1	5
General government	6.9	5	- 4	1
Total fixed investment	45.4	8	1	4½

TRSC

Could be dropped

(1) Including investment by public corporations

(2) Figures for manufacturing include assets leased from finance lessors, figures for other industries exclude these assets.

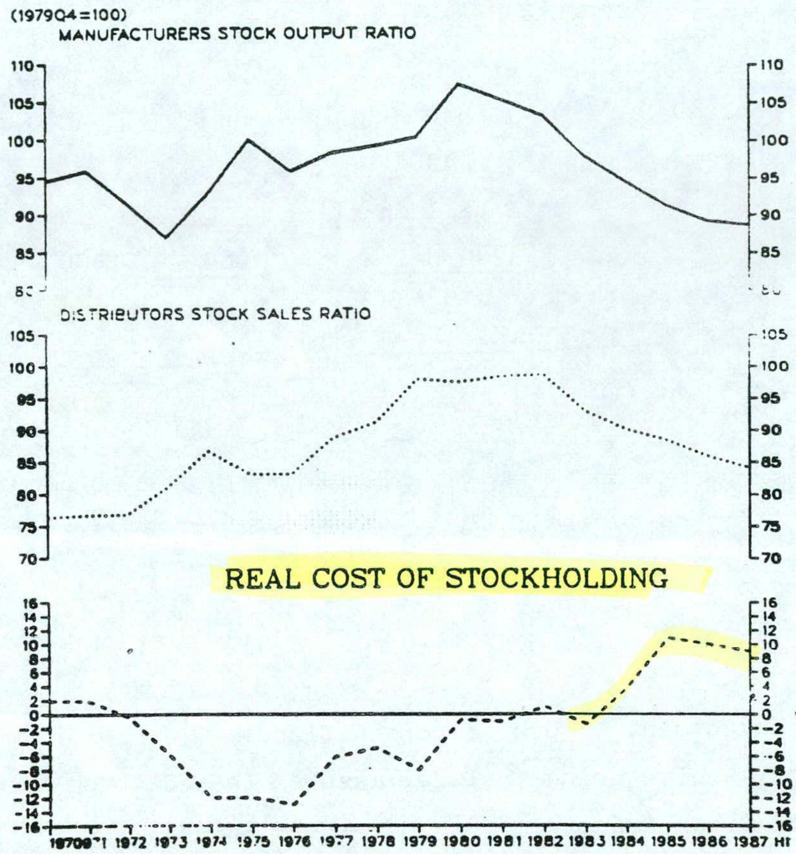
(3) Figures are for industry class 13 (1980 SIC)

(4) Includes purchases less sales of land and existing buildings by persons, companies and public corporations, other than purchases of council houses.

Stockbuilding

3.53. Survey evidence suggests that despite the low expenditure on stock building in 1985, most companies still regard their current stock levels as more than adequate in relation to output and sales. The fall in stock ratios in recent years may reflect in part cautious behaviour by companies after the last recession. Another factor has been the high cost of holding stocks as a result of the high level of real interest rates and the abolition of stock relief in the 1984 Budget. Stock ratios and the estimated real cost of holding stocks are illustrated in Chart 3.12.

CHART 3.12 AGGREGATE STOCK RATIOS



Prospects for Demand and Activity

3.54. Strong growth in exports has made an important contribution to GDP growth over the last two years. In 1985 the increase in manufactured exports was twice the estimated increase in world trade in manufactures, while UK imports of manufactures grew less in relation to the growth in demand than has normally been the case in recent years.

X

3.55. The fall in oil prices has improved the prospects for world trade, and the adjustment of the ~~sterling~~ exchange rate index to lower oil prices has made British manufactures more competitive. Nevertheless, as in most other industrial countries, growth in 1986 is expected to come more from higher domestic demand (stimulated by lower inflation) than from external trade. The slowdown forecast for export growth in the first half of 1987 reflects the path of North Sea oil output and hence oil exports.

??

Table 3.9: **Domestic Demand and Trade at constant prices**

per cent changes on a year earlier

	1985	1986	1987 First half
Domestic demand	2	3½	2½
Exports of goods and services	6½	5	3
Imports of goods and services	3½	6	4½

3.56. Total domestic production is expected to increase by 3 per cent in 1986, following 3½ per cent growth in 1985. After allowance for the coal strike, growth is close to 2½ per cent in both years as shown in table 3.10. The average level of oil production in 1986 is likely to be close to its level in 1985 and 1984, but the fall forecast for oil output between the first half of 1986 and the first half of 1987 may cut total GDP growth by over ½ per cent. Output growth in the non-oil economy in 1986 and the first half of 1987 is expected to be comparable to that seen in 1985. Manufacturing output has grown slightly faster than GDP since 1983. The composition of demand growth in the forecast suggests that growth in manufacturing output may continue at around the underlying rate of growth of GDP.

Table 3.10: **GDP and Manufacturing Output**

Per cent changes on year earlier

	1985	1986	1987 First half
GDP (average measure)	3½	3	2
GDP, adjusted for coal strike (*)	2½	2½	2
GDP, adjusted for coal strike and excluding oil output	2½	2½	2½
Manufacturing output	3	2½	2

PRODUCTIVITY AND THE LABOUR MARKET

3.57. Total employment in Great Britain is estimated to have grown by about 220,000 over the year ending September 1985, giving a total increase since March 1983 of over 700,000.

3.58. The published figures show an increase of 12,000 in the number of employees in employment during the first nine months of 1985: a further rise in the number of employees in the service industries was largely offset by falls in the production and construction industries. Self employment is assumed to have risen by about 31,000 a quarter since the middle of 1984, the same as the estimated quarterly increase over the previous three years. This compares with an increase of about 68,000 a quarter recorded between the middle of 1983 and the middle of 1984. The estimates of growth in employment over the recent past shown in Table 3.11 are subject to revision whem the Census of Employment for 1984 and the Labour Force Survey for 1985 become available.

Table 3.11: Employment (GB, seasonally adjusted)

	Employees in Employment			Self employed	HM Forces	Employed labour force
	Male	Female full-time	Female part-time			
September 1983 to September 1984	- 84	+ 19	+ 174	+ 237	+ 3	+ 349
September 1984 to September 1985	- 105	+ 20	+ 181	+ 125	- 2	+ 219

Action

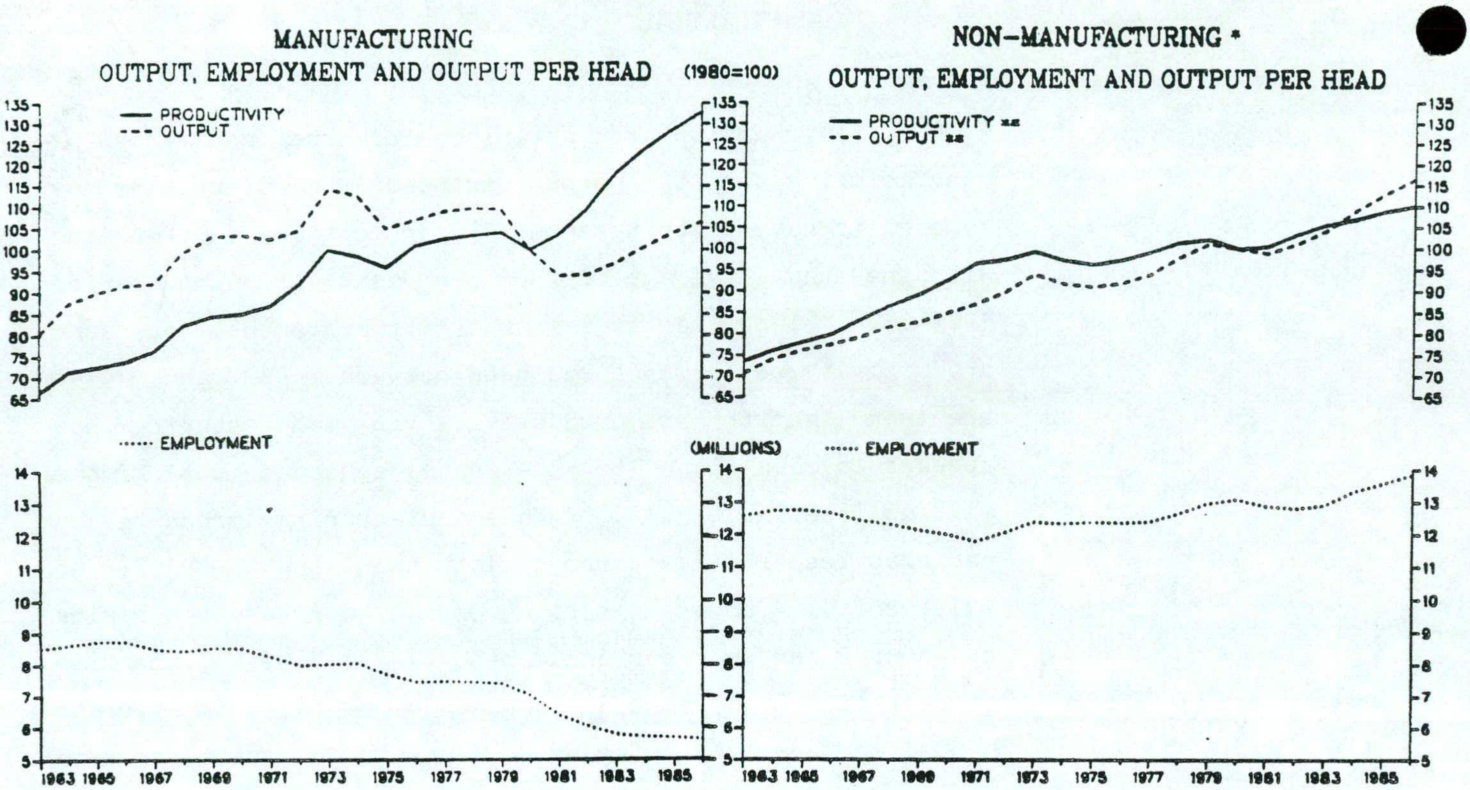
3.59. Following upward revisions to the estimates of manufacturing output, output per head in manufacturing now appears to have risen by about 3½ per cent in 1985, in line with the annual average of 3½ per cent for the period 1979-85. This marks a major improvement on the productivity performance recorded between 1973 and 1979: the trend growth in productivity in manufacturing now appears to be close to the rate achieved during the sixties (see table 3.12.) Non-manufacturing productivity has also been rising faster of late than in the 1973 to 1979 period. Growth in output per man hour has been rising at about 2 per cent per annum since 1979. However, the rise in part-time employment, ~~and hence the fall in average hours,~~ is currently bringing down growth in output per head in non-manufacturing~~,~~ to about 1 per cent a year.

man-hour ??

Table 3.12: **<u>Output per head of the employed labour force</u>**

	Employed Labour Force in 1984 (millions)	Percentage change in output per head (annual averages)		
		1964-73	1973-79	1979-85
Manufacturing	5½	3¾	¾	3½
Non-manufacturing*	13½	3	½	1

* Excludes public services and oil, and includes nationalised industries except steel.



* EXCLUDES PUBLIC SERVICES AND OIL
** ADJUSTED FOR COAL STRIKE

CHART 3.13

3.60. The "working population" (ie the sum of the employed labour force and unemployed labour force and unemployed claimants) is estimated to have fallen between the second and third quarters of 1985, after two years in which it had risen by some 850,000. The rise in working population had been associated with a pick up in female participation rates and a rise in part-time jobs. Although the rise in part-time jobs is showing little signs of coming to an end it may be that these jobs are now being filled to a greater extent by women previously claiming benefit rather than by non-claimants.

Unemployment

3.61. The trend in unemployment changed for the better during 1985, and seasonally adjusted adult unemployment fell by about 10,000 between April and November. In spite of the more disappointing figures since November, the prospects for unemployment remain better than they have been for some years. Growth in the labour force is probably now starting to slow down, much of the effect of measures taken in the 1985 Budget is still to be felt, and the measures announced in the 1986 Budget [are expected to create x additional jobs over the next year.]

FORECAST AND OUTTURN

3.62. The table below compares the main elements of the forecast published in the 1985 FSBR with outturn or latest estimate:

Table 3.13: Forecast and Outturn

	Forecast	**Outturn**	**Average error from past forecasts**
RPI: per cent increase between the fourth quarters of 1984 and 1985	5	5½.	2

	Forecast	**Latest estimate/ forecast**	**Average errors from past forecasts**
Total output: per cent change between 1984 and 1985	3½	3½	1
Current account of the balance of payments in 1985, £ billion	3	4	2½
PSBR, financial year 1985-1986 £ billion	7	6¼	4½
Money GDP, per cent change between 1984-85 and 1985-86.	8½	9	2

Discuss

3.63. Inflation in the fourth quarter of 1985 turned out a little higher than forecast a year ago. The forecasts made at the time of the last Budget for output growth and the current balance in 1985, and for the PSBR in 1985-86, are all very close to the latest estimates for these variables. In each case such error as there appears to have been is considerably smaller than the average error from past forecasts.

Table 3.14: The Prospects: Summary

	Forecast	Average errors from past forecasts*
A. Output and expenditure at constant 1980 prices; per cent changes between 1985 and 1986.		
Domestic demand	3½	[ ]
of which:		
Consumers' expenditure	3½	[1]
General Government consumption	½	[1½]
Fixed investment	4½	[2]
Change in stockbuilding (as per cent of level of GDP)	0	[¾]
Exports of goods and services	5	[2½]
Imports of goods and services	6	[2½]
Gross domestic product: total	3	[1]
manufacturing	2½	[3¼]
B. Inflation		
Retail prices index, per cent change on a year earlier		
1985Q4 to 1986Q4	4	[2]
1986Q2 to 1987Q2	3¾	[3½]
Deflator for GDP at market prices, per cent change on previous year		
Financial year 1985-86	5½	[ ]
Financial year 1986-87	3½	[ ]

W?

C. Balance of payments on current account
£billion:

1986	4	[2½]
1987 first half (at an annual rate)	2	[4]

D. Money GDP at market prices, per cent change

Financial year 1985-86	9	[ ]
Financial year 1986-87	6½	[ ]

E. PSBR
£billion (in brackets, per cent of GDP at market prices):

DISCUSS

Financial year 1985-86	6¼ (1¾)	[1 (¼)]
Financial year 1986-87	7 (1¾)	[4½(1½)]

---

* The errors relate to the average differences (on either side of the central figure) between forecast and outturn. The method of calculating these errors has been explained in earlier publications and government forecasts (see Economic Progress Report June 1981). The calculations for the constant price variables [and the GDP deflator] are derived from forecasts made during the period between June 1965 and October 1983. For the current balance and the retail prices index, forecasts made between June 1970 and October 1983 are used. For the PSBR, Budget forecasts since 1967 are used. The errors are after adjustment for the effects of major changes in fiscal policy where excluded from the forecasts.

RISKS AND UNCERTAINTIES

3.64. No forecast is complete without an indication of error margins. Table 3.14 sets out the average errors from past forecasts, alongside the forecasts themselves. These average errors provide an indication of possible errors in the current forecast. Those items which represent the relatively small balance between large flows in either direction are particularly subject to error. For example, the flows on either side of the PSBR approach £200 billion; and for the current account of the balance of payments exceed £150 billion.

3.65. While the size of errors will change over time as the economy fluctuates, and as forecasting techniques change, in many cases the averages have not shifted very much since 1976. For the RPI, however, average errors are derived from a period of high and fluctuating inflation, averaging 12 per cent, and overstate likely errors at current rates of inflation. The average error in the last three Budget forecasts looking ahead to the end of the year was ½ per cent.

Table 3.15: Constant price forecasts of expenditure, imports and gross domestic product*

£ billion at 1980 prices, seasonally adjusted

	Consumers' expenditure	General government consumption	Total fixed investment	Exports of goods and services	Change in stocks	Total final expenditure	*Less* Imports of goods and services	*Less* Adjustment to factor cost	*Plus* Statistical adjustment	Gross domestic product at factor cost	GDP index 1980 = 100
1981	136.5	48.9	37.7	62.0	-2.5	282.7	55.9	30.2	-0.3	196.3	98.5
1982	137.6	49.4	40.1	62.8	-1.1	288.7	58.7	30.6	0.7	200.1	100.4
1983	142.9	50.2	41.9	64.4	0.7	300.1	62.1	31.6	0.2	206.7	103.7
1984	145.5	50.9	45.4	69.0	-0.1	310.6	67.9	32.9	1.9	211.7	106.2
1985	149.3	51.0	46.0	73.4	0.5	320.2	70.3	33.0	1.9	218.8	109.8
1986	154.7	51.4	48.0	77.0	0.8	331.8	74.5	34.3	2.0	225.0	112.9
1984 H1	72.5	25.2	22.5	33.8	-0.4	153.7	33.0	16.3	0.5	105.0	105.3
H2	72.9	25.7	22.8	35.2	0.2	156.8	34.9	16.5	1.3	106.7	107.1
1985 H1	73.9	25.6	23.2	37.0	0.1	159.8	35.4	16.2	0.8	109.0	109.4
H2	75.4	25.4	22.8	36.4	0.4	160.4	34.9	16.8	1.2	109.9	110.3
1986 H1	76.6	25.6	24.2	38.2	0.2	164.8	36.9	17.0	0.9	111.9	112.3
H2	78.0	25.7	23.8	38.8	0.6	166.9	37.7	17.2	1.1	113.1	113.5
1987H1	79.4	25.7	24.5	39.4	0.5	169.5	38.6	17.5	1.0	114.4	114.8
% changes											
1983 to 1984	2	1½	8	7	-	3½	9½	4	-	-	2½
1984 to 1985	2½	½	1½	6½	-	3	3½	½	-	-	3½
1985 to 1986	3½	½	4½	5	-	3½	6	3½	-	-	3
1986H1-1987H1	3½	0	1	3	-	3	4½	3	-	-	2

* GDP figures in the table are based on "compromise" estimates of gross domestic product, reflecting for the past average movements in constant price expenditure, output and income estimates of GDP. Percentage changes are calculated from unrounded levels and then rounded to half per cent. Totals in £ billion may not add due to rounding. Figures for 1986 H1 and beyond are forecasts. Figures for periods up to the end of 1985 are based mainly on the national accounts published earlier this year (covering periods up to 1985 Q3) and incorporate some revised and later data and forecasts. A full set of national accounts, to end 1985, will be published by CSO on 21 March.

BR/24

CONFIDENTIAL

FROM: MRS R LOMAX
DATE: 28 FEBRUARY 1986

MR EVANS

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Butler
Mr Cassell
Mr Odling-Smee
Mr Scholar
Mr Turnbull
Mr Davies
Mr Mellis
Mr Mowl
Miss Peirson
Mr Riley
Mr Cropper
Mr Lord
Mr H Davies

1986 FSBR PART 3: ECONOMIC FORECAST

This minute records the main decisions reached at the Chancellor's meeting this morning and his additional drafting comments on Part 3 of the FSBR.

Summary

X 2. The main points ~~are~~ were:

- This section should be re-ordered, along the lines of last year's draft.

- The forecast should assume an average North Sea Oil price in 1986/87 of $15 a barrel; this should be quoted explicitly in the text.

- There should be no explicit exchange rate assumptions. The final sentence of 3.02 should be replaced by the following: "Neither the sterling index nor the dollar sterling exchange rate is assumed to change much."

- The side heading for the existing 3.02 should be "assumptions".

- The first sentence of para 3.03 should be deleted, as should ~~be~~ the first half of the final sentence in this paragraph.

- Paragraph 3.04 should be redrafted to make it clear that fixed investment and exports are expected to grow, if anything, rather faster than personal consumption.

- Paragraph 3.05 should be sidelined "labour market" and redrafted along the lines of the equivalent paragraph in last year's FSBR (deleting the reference to disappointing unemployment figures since November). The reference to special employment measures in the 1985 and 1986 Budget should also go.

- Paragraph 3.06 should be sidelined "trade and the current account".

<u>World economy</u>

3. The main points were:

- Chart 3.1: industrial materials and food should be shown in a single line. The 1987 observation should be dropped.

- Chart 3.2: the basis of this chart needs better explanation.

- Paragaph 3.16: the second sentence should be deleted, on policy grounds.

- Chart 3.3: figures for 1987 should be dropped.

- Paragraph 3.18: this should be redrafted to highlight the doubling of world trade growth expected in 1986 (possibly including some explanation of the very low figure in 1985).

Financial conditions

4. The main points were:

- The following ordering was agreed: exchange rate, interest rates, money. The exchange rate section should start with x a ~~no~~ reference to the dollar.

- Chart 3.4: the bottom panel of this chart - on interest rate differentials - was dropped. The top panel should be updated to show the recent fall in long term rates.

- Paragraph 3.21: this should be redrafted as follows: "The forecast assumes that sterling will not change much from its present level, either in dollar or effective terms".

- Paragraph 3.22: in the first sentence, delete "mainly as a delayed". Replace final sentence by "The annual increase in MO velocity has been stable for many years now, and is expected to remain so".

- Paragraph 3.23: delete the final sentence.

- Chart 3.6: this should be dropped.

- Paragraph 3.24: replace the final sentence by: "Other broad aggregates have grown at much the same rate".

- Paragraph 3.25: the final two sentences should be redrafted.

Trade and the balance of payments

5. The main points were:

- Paragraph 3.26: redraft final sentence as follows: "Assuming an unchanged exchange rate, the UK's cost and price competitiveness...".

- Table 3.3: drop the figures for 1986.

- Paragraph 3.27: end the first sentence after "the course of 1985". Replace remainder of this sentence by "appropriately neutral factual statements".

- Paragraph 3.28: in the final sentence delete: "because it is assumed ....".

- Paragraph 3.34: the second sentence should also refer to 1983.

Inflation

6. The main points were:

- Table 3.6: delete 1987 ~~in~~ first half (the same applies to other tables in Part 3 of the FSBR).

- Paragraph 3.40: the reference to electricity prices should certainly be dropped; and the reference to gas prices should be cleared with GEP. Replace the final sentence by a qualitative statement clear ~~the large part~~ much of the rise in the housing component of the RPI is due to the expected rise in local authority rates.

- Table 3.7: delete the figures in brackets.

- Chart 3.9 should be dropped.

- Paragraph 3.42: the Chancellor said he would prefer to show a growth in the GDP deflator in 1986/87 of 3¾%, rather than 3½%. He doubted whether he would want to publish figures for "on shore" GDP deflators. (This is for further discussion)

- Chart 3.10: the split between durable and non-durable consumption should be dropped.

- Paragraph 3.46: the second sentence should be redrafted to remove the reference to the extension of VAT and the change

X

in the availability of grants.

- Paragraphs 3.50 and 3.51 should be shortened, and redrafted to give more prominence to the Treasury's expectations.

- Table 3.8: this table should be dropped.

- Paragraph 3.55: the penultimate sentence should be redrafted to make it clear that growth in 1986 is expected to come both from higher domestic demand and from exports.

- Paragraph 3.60: this should be dropped.

- Paragraph 3.61: the final sentence should be deleted.

Outstanding issues

PSBR

7. The Chancellor has indicated that he will want to discuss (at Monday's meeting) what should be published about the ~~FSBR~~ PSBR in 1985/86 and 1986/87.

RACHEL LOMAX

MEETING FOLDER
(FSBR; 28/2)

CONFIDENTIAL

PSP.

From: SIR PETER MIDDLETON
Date: 26 February 1986

MR H EVANS

cc PPS
PS/Chief Secretary
Sir T Burns
Mr F E R Butler
Mr Cassell
Mr Odling-Smee
Mr Peretz
Mr Scholar
Mr Cropper
Mr Lord
Mr H Davies

PART 3

I have three general comments on the draft of Part 3 of the FSBR submitted under your note of 25 February.

2. First, it would be better to put the section on money (Sections 3.22-3.24) before the section on the exchange rate and follow that by the section on interest rates. This fits better with the way in which we normally think about these things and is the best way in which to accommodate the piece on money which in previous years has been in the MTFS section.

3. Second, it is very important to have a good reason for our assumptions on oil and the exchange rate. On oil, what is said in the text seems fine, but we shall need a more detailed justification for Select Committees and the like. On the exchange rate, the text once again is fine. But I wonder whether, if we indicate an exchange rate of about 74 in the text, we should not actually use this for the forecast rather than 73. In any event, table 3.3 cannot appear in its present form. Either the number has to be 74 or - preferably - we drop the square bracketed line completely.

4. Third, and not strictly a matter for Part 3, we must make sure that either here or more appropriately in Part 2 we have a good explanation of what is happening to the GDP deflator and money GDP following the fall in the oil price. This needs to cover both the higher path for money GDP compared to last year's MTFS and any variation between years resulting from oil.

P E MIDDLETON

BR/24

pwp

CONFIDENTIAL

FROM: MRS R LOMAX
DATE: 28 FEBRUARY 1986

MR EVANS

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Butler
Mr Cassell
Mr Odling-Smee
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RL.

RACHEL LOMAX

1. Rachel
2. RWP

SECRET

FROM: A W KUCZYS
28 February 1986

CHIEF SECRETARY

cc Sir P Middleton
Mr F E R Butler
Mr Anson
Mr Monk
Mr Turnbull
Mr Scholar
Mr M L Williams
Mrs Butler
Mr Gray
Miss Peirson
Mr Lord

1985-86 RESERVE

The Chancellor has seen Mr Williams' minute of 26 February, and Mr Butler's of 27 February. He agrees very strongly with the point in Mr Williams' paragraph 19 - that the 1986-87 planning total should not be increased to reflect the slippage of teachers' pay. He even has worries about Mr Butler's final point - that we should say clearly at the outset that it is not allowed for in the 1986-87 planning total and that it belongs to 1985-86, even though it will fall to be paid in 1986-87. He thinks Mr Williams' paragraph 16(ii) applies with equal force to this.

AWK

A W KUCZYS

SECRET

[illegible] (also applies to [illegible])

Financial Statement and Budget Report

Chapter 1: The Budget

1.01 The objective of the Government's economic policy is to defeat inflation, and to create the conditions for the steady growth of output and employment. The Financial Statement and Budget Report supplements the Chancellor's Budget Statement by describing in more detail the Medium Term Financial Strategy and the specific measures in the Budget. It also sets out the Government's revenue, expenditure and borrowing policies and its financial and economic forecasts for the year ahead.

The Government's Strategy

Medium Term Financial Strategy

1.02. The Government's economic policy consists of two main elements - the Medium Term Financial Strategy (MTFS) designed to bring down inflation, and a supply side policy, whose aim is to improve the efficiency of the economy.

1.03 To achieve the objectives of the MTFS, which is set out in detail in Chapter 2, it is vital to maintain monetary conditions consistent with a declining growth of money GDP and inflation. Short-term interest rates will be held at the levels needed to achieve this. ~~Declining growth will be supported by lower~~ Public sector borrowing, will be kept low.

1.04 The Government also intends that the burden of taxation and the role of the State in the economy should be reduced. The MTFS accordingly provides for a further decline in taxation and public expenditure as a proportion of GDP.

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Supply Side

1.05 The MTFS is complemented by the Government's supply side policies. Their intention is to improve incentives, remove unnecessary controls, and to liberate the operation of markets. Free markets encourage enterprise and initiative; improve the efficiency and adaptability of the economy; and enhance the prospects for output and employment growth. This Budget includes a number of measures - both tax and public expenditure changes - to strengthen these policies.

Expenditure, Revenue and Borrowing

1.6 To support both the MTFS and its supply side measures, the Government's intention is to reduce over the medium term the proportion of national income that is pre-empted by the State. The path of expenditure, revenue and borrowing over the next four years is set out in Chapter 2.

The Year Ahead

The Forecast

1.07 The big fall in oil prices should sustain growth and reduce inflation in the world economy. For the UK, the forecast is for a further decline in inflation, to 4 per cent by the end of 1986, combined with output growth of 3 per cent. Investment and exports are expected to grow rather more rapidly than this, and a surplus of £4 billion on the current account of the balance of payments is forecast for 1986. Chapter 3 describes the prospects in detail, including the impact of changing oil prices on the world and domestic economy.

who says?

The Fiscal Prospects

1.08 The PSBR in 1986-87 has been set at [ ] or $1\frac{3}{4}$ per cent of GDP. This leaves room for a fiscal adjustment of [ ].

Taxation and National Insurance Contributions

1.09 Given the limited scope for overall tax reductions, the Government has concentrated its tax proposals on measures designed to improve the climate for enterprise and employment; to encourage savings, investment and wider share ownership; and to provide further incentives for charitable giving. Income tax thresholds and allowances are raised in line with inflation. The increases in petrol, derv and tobacco duties are offset by the costs of leaving unchanged car and lorry VED rates and alcohol duties respectively.

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1.10 In addition, the Government have reduced by 1 per cent national insurance contributions for all employees earning less than £140 per week.

1.11 The changes to tax and national insurance contributions will cost [185m] in 1986-87 and [340m] in 1987-88. They are set out summarily in Table 1.1 and in detail in Chapter 4.

(indexed & non-indexed basis)

Public Expenditure

1.12 Table 1.1 also includes ~~higher spending on enterprise and employment.~~ The new pilot schemes for the long term unemployed (in depth interviews and the Jobstart scheme) will be extended nationwide. The rate of entry into the Enterprise Allowance Scheme will also be increased. A new scheme - the New Workers Scheme - will be introduced, providing for payments to employers of 17-20 year olds where the wages are below specified limits. The Community Programme will be expanded by [ ] places. These and other changes, which are described in full in Chapter 5, will have a net public expenditure cost (after taking account of social security benefit and other savings) of £110m in 1986-87 and £205m in 1987-88. The measures will be charged to the Reserve.

a number of new PE measures, designed to help the unemployed.

The Budget Proposals
Summary

1.13 The impact of the Budget changes is shown in Table 1.1.

Table 1.1

DISCUSS

Budget Measures: Summary of Direct Effects

£ million at current prices

	1986-87 Changes from an indexed base	1986-87 Changes from an non-indexed base	1987-88 Changes from an indexed base	1987-88 Changes from a non-indexed base
				(yield(+)/cost(-))
Tax Proposals:				
Income tax allowances & thresholds	Nil	-1135	Nil	-2405
Excise duties - petrol/derv	+135	+465	+145	+725
- VED	-135	+5	-140	+90
- tobacco	+175	+315	+180	+435
- alcohol	-175	Nil	-190	+110
- gas oil	+25	+30	+25	+35
- other minor oil duties	-25	-20	-25	-15
Stamp duty - cut in rate	-70	-70	-110	-110
- extension of base	+70	+70	+120	+120
Capital Transfer Tax	-35	-55	-55	-120
Charities - package of reliefs	Neg	Neg	-50	-50
- anti-abuse measures	Neg	Neg	+20	+20
Pension Fund Surpluses	+20	+20	+120	+120
Other tax changes	-20	-20	+20	+20
National Insurance contributions	-150	-150	-400	-400
Total tax and national insurance contributions	-185	-545	-340	-1425
Expenditure Measures:				(cost(+)/saving(-))
Enterprise Allowance	+20	+20	+90	+90
Loan Guarantee Scheme	Nil	Nil	+10	+10
New Workers Scheme	+25	+25	+50	+50
Counselling Initiative	+85	+85	+45	+45
Jobstart	+25	+25	+50	+50
Community Programme	+45	+45	+90	+90
Fraud abuse	Neg	Neg	+5	+5
Northern Ireland	+5	+5	+10	+10
Total expenditure increases	+205	+205	+350	+350
Offsetting reductions in social security benefits	-95	-95	-145	-145
Net call on the Reserve	+110	+110	+205	+205

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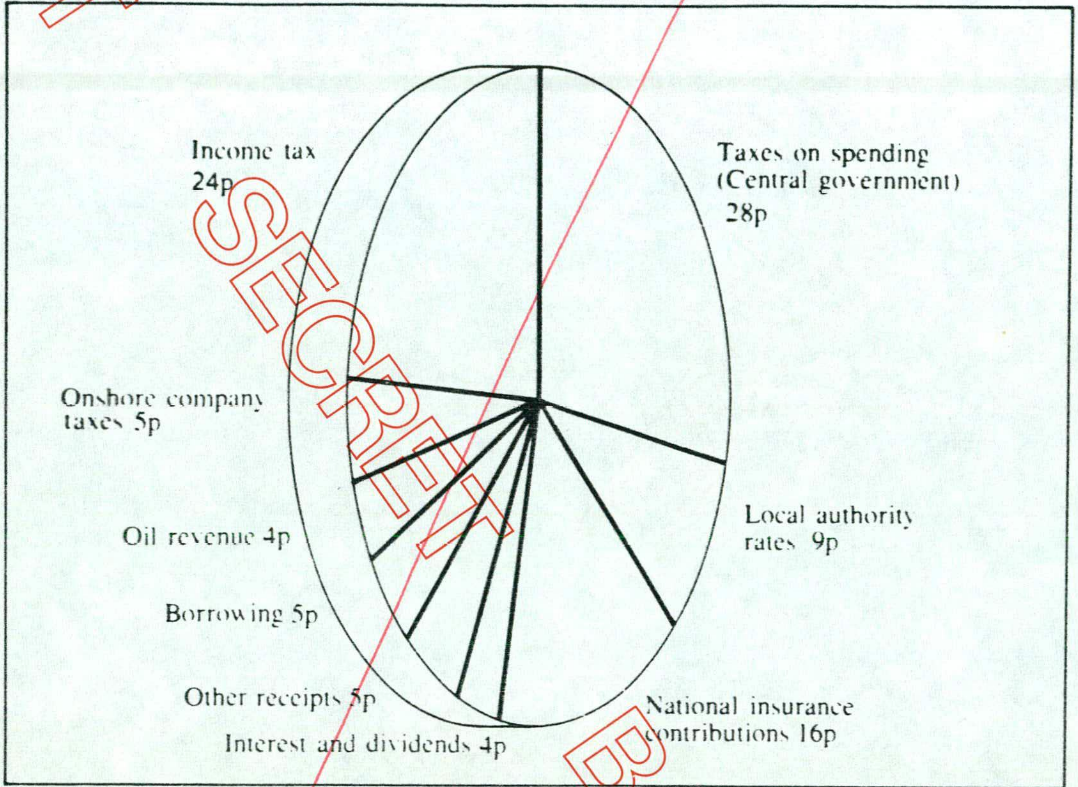
1.14 The Budget provides in 1986-87 for expenditure plans of [ ]; forecast receipts of [ ] and a forecast PSBR of [ ]. Chart 1.1 below shows the source of receipts and the direction of expenditure. These are described in more detail in Chapter 6.

not digested enough for PSBR!!

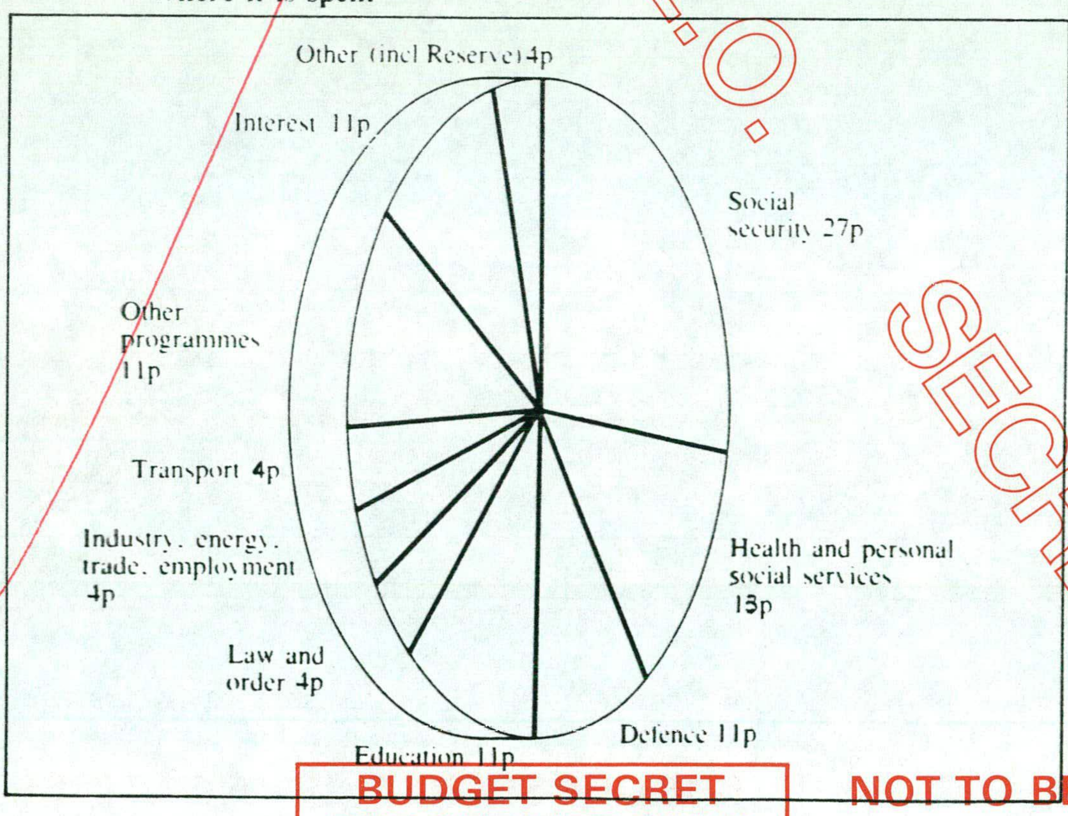
THE BUDGET POUND, 1986-87

Chart 1.1 Where it comes from



GPR
~~shift~~

Where it is spent



FSBR1(A) TRADITIONAL PART I

Appendic C

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Financial Statement and Budget Report

Chapter 1: The Budget Proposals

Definition of the Budget

1. The main proposals in the Budget are summarised in Table 1.1 below and described in detail in Chapters 4 and 5. The Budget is defined to include tax, National Insurance and expenditure changes announced in the Budget Statement, together with certain other changes set out in this Financial Statement and Budget Report.

Table 1.1

Budget Measures: Summary of Direct Effects

£ million at current prices

	1986-87 Changes from an indexed base	1986-87 Changes from an non-indexed base	1987-88 Changes from an indexed base	1987-88 Changes from a non-indexed base (yield(+)/cost(-))
Tax Proposals:				
Income tax allowances & thresholds	Nil	-1135	Nil	-2405
Excise duties - petrol/derv	+135	+465	+145	+725
- VED	-135	+5	-140	+90
- tobacco	+175	+315	+180	+435
- alcohol	-175	Nil	-190	+110
- gas oil *	+25	+30	+25	+35
- other minor oil duties *	-25	-20	-25	-15
Stamp duty - cut in rate	-70	-70	-110	-110
- extension of base } *	+70	+70	+120	+120
Capital Transfer Tax	-35	-55	-55	-120
Charities - package of reliefs	Neg	Neg	-50	-50
- anti-abuse measures *	Neg	Neg	+20	+20
Pension Fund Surpluses	+20	+20	+120	+120
Other tax changes	-20	-20	+20	+20
National Insurance contributions	-150	-150	-400	-400
Total tax and national insurance contributions	-185	-545	-340	-1425
Expenditure Measures:				(cost(+)/saving(-))
Enterprise Allowance	+20	+20	+90	+90
Loan Guarantee Scheme	Nil	Nil	+10	+10
New Workers Scheme	+25	+25	+50	+50
Counselling Initiative	+85	+85	+45	+45
Jobstart	+25	+25	+50	+50
Community Programme	+45	+45	+90	+90
Fraud abuse	Neg	Neg	+5	+5
Northern Ireland	+5	+5	+10	+10
Total expenditure increases	+205	+205	+350	+350
Offsetting reductions in social security benefits	-95	-95	-145	-145
Net call on the Reserve	+110	+110	+205	+205

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Taxation

2. The net effect of the tax proposals in the Budget is shown on the basis conventionally used in the preparation of economic forecasts which allows for the full indexation of 1985-86 excise duty rates and main income tax allowances and thresholds in line with inflation in the year to December 1985. On this basis the tax proposals in the Budget are expected to cost [35m] in 1986-87 and to yield [60] in 1987-88. Measuring the effects of the Budget proposals from existing levels of rates and allowances gives an expected cost of [395] in 1986-87 and [1025] in 1987-88. The measures are described in detail in Chapter 4.

National Insurance Contributions

3. The cost of the reductions in national insurance contributions is expected to be [£150 million] in 1986-87 and [£400m] in 1987-88. Details are given in Chapter 4.

Expenditure Measures

4. Table 1.1 shows the costs of the public expenditure measures in the Budget. These will not add to the public expenditure Planning Total as the costs will be met from the Reserve. Details of the measures are given in Chapter 5.

PSBR

5. The PSBR for 1986-87 has been set at [ ], or 1¾% of GDP. The Budget measures are expected to contribute about [ ] to this figure over and above the cost of simply indexing tax rates and allowances. This allows for indirect as well as direct effects on public sector transactions.

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