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PART A

CHEVENING 1984 PAPERS
14-15 JANUARY 1984

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PART A

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CHEVENING; 14, 15 JANUARY 1984

Papers and Agenda

Papers

1.	Policy Background to the MTFS	:	Sir Terence Burns
2.	Personal Borrowing	:	Mr Cassell
3.	The FSBR: handling the PSBR	:	Mr Battishill
4.	Tax Issues	:	Mr Cassell
5.	Assets, public expenditure, and borrowing	:	Mr Bailey and Sir Terence Burns
6.	Additional material on public expenditure	:	To follow

[Also relevant: Personal taxation: Background to Budget decisions: Mr Monger (22.12.83)
Financial Statement and Budget Report 1983-84
Autumn Statement 1983; Part 1 of the draft 1984 Public Expenditure White Paper]

Agenda

SATURDAY 14 January

1. **MACRO-ECONOMIC STRATEGY AND THE MTFS**

[references are to paper 1 except where otherwise specified]

(a) Policy background: paragraphs 1-20 review policy and performance since 1980. Is this accepted? Any points arising?

(b) MTFS period - paragraphs 21-28

(i) Is it agreed that the MTFS should continue to be based on financial years rather than changed to calendar years? [Paper 3: paragraphs 6-25]

(ii) For what period should the MTFS be rolled forward - by one year (to 1986-87), two years (to 1987-88) or three years (to 1988-89)?

The 1980 MTFS covered four years, those in 1981-83 covered only three years. The main considerations are the impact on expectations and the effects on future freedom of manoeuvre. The greater difficulty of making realistic assumptions (and their relationship to any public expenditure exercise) for later years needs to be taken into account. Also:

(iii) Are the implications likely to be acceptable when the MTFS is rolled forward next year, and in later years (paragraph 27)?

Note that the MTFS even if covering five years in 1984 could be shortened for later years, as in the last Parliament.

(c) Medium term outlook. (paragraphs 29-39). Although the split of money GDP between output and inflation cannot be pre-determined by Government, the MTFS objectives must reflect the potential performance of the economy. Over the next 4-5 years, without any major change in policies, is it reasonable to expect

(i) inflation on average to continue to fall gently from 5 per cent?

(ii) better output growth than in the 1970s but not necessarily as high as most recently?

(iii) growth in productivity and productive potential to decelerate a bit?

(iv) some labour market adjustment on productivity and wages, with some fall in unemployment?

(d) Medium term objectives. (paragraphs 40-46). The Mansion House Speech provides the starting point. It is now necessary to consider particular numbers that can be published as assumptions about medium-term developments.

(i) On inflation is it enough to aim for something less than price stability in 4-5 years time; or should there be a tougher (or easier) objective?

(ii) Are the likely implications for output and employment acceptable?

(iii) Is it reasonable to look forward to a fall in money GDP from about 8 per cent to 5-6 per cent over the period (subject to periodic review)?

(e) Money (pargraphs 47-53 and tables on pages 22 and 23). Firm decisions cannot yet be taken, but a decision of likely trends in velocity over the short and medium term can indicate the sort of monetary paths likely to be consistent with the policy objectives. In particular:

(i) Broad money. What are the considerations bearing on the 1984-85 target? Do those tend still to point towards lowering the target as in the MTFS? Or are there reasons for deferring a move down to 6-10 per cent. Is the broad shape of the path suggested in paragraph 50 satisfactory?

(ii) Narrow money. Presumably there should be a lower range than for broad money? Should the target range decline more slowly than that for broad money to reflect the expected behaviour of velocity? Does a lower growth rate argue for a narrower range or is it safer to keep a 4 per cent band? Is the broad shape of the path suggested in paragraph 53 satisfactory?

(iii) Personal borrowing. Are the conclusions of paper 2 on personal borrowing acceptable? Are any steps necessary to restrict personal borrowing - December bank lending figures were on high side?

(iv) Next steps after Chevening? Need for note on more detailed monetary issues? [Timetable assumes first draft MTFS first week of February.]

(f) PSBR (paragraphs 54-77). The discussion needs to separate the medium-term PSBR target from the speed of adjustment towards it.

(i) Medium term objective: considerations include:

- the need to reduce real interest rates
- whether the downward trend in the ratio of public sector debt to money GDP will continue and, if so, at what rate
- the low level of net capital expenditure, resulting in part from the higher level of asset sales
- the fact that North Sea revenues are near their peak
- the rise in future pension commitments

What weight should be given to these factors?

(ii) Speed of adjustment: considerations here include

- the stage of the cycle
- the lags in the response of money GDP and inflation to fiscal policy
- the pattern of North Sea oil revenues
- the pattern of asset sales

- the room for manoeuvre on fiscal policy in the next <u>two</u> years.

Note paragraphs 74-77, including the table on page 29.

(g) <u>Implications for 1984-85</u>

There are a number of issues:

(i) Firm decisions on next year's PSBR must await the forecast. But, <u>for immediate working purposes,</u> is it reasonable to assume no scope for net tax cuts next year?

(ii) The Autumn forecast suggested a small <u>negative</u> fiscal adjustment for 1984-85 with a significant <u>positive</u> adjustment in 1985-86. Is it more sensible to look at 1984-85 and 1985-86 together?

(iii) What does this mean for the likely general shape of the Budget? And for the balance between tax increases and tax reductions? And for the balance between the personal and business sectors?

2. <u>TAX ISSUES</u>

[references are to paper 4]

A <u>Income tax</u> (paragraph 5)

(a) Is the priority to increase tax thresholds? Should indexation be regarded as an overriding minimum requirement? Should we aim in the Budget arithmetic at a target increase <u>above</u> indexation? If so, what might that be?

(b) Should the increase in personal allownces also apply equally to

(a) all allowances (including the elderly)

(b) higher rate bands

or would differential increases be possible? Are there more complicated packages related to the interaction of NIC and income tax which should be looked at?

(c) What priority should be given to raising the Investment Income Surchrage threshold this year?

(d) What about child benefit? Because of the distributional implications should decisions on CB uprating be considered alongside those on personal allowances? If so, how should this be taken forward?

B **Corporation Tax and NIS** (paragraphs 7 and 10-14)

(a) Is a reduction this year in (i) the main corporation tax rate (ii) the small companies rate a high priority? (This needs to be considered alongside structural changes - below)?

(b) Is abolition (or reduction) of NIS a high priority this year?

C **Are there other direct tax candidates for relief next year?**

(a) a reduction in stamp duty on equities financed by ending the exemption of gilts from stamp duty and CGT (paragraphs 19-21)?

(b) Share options?

(c) Mortgage interest ceiling?

(d) Capital taxes?

(e) Others?

D **Specific duties** (Annex 3)

(a) Are these to be increased at least in line with inflation? Is it possible to consider doing more than indexation? Across the board, or for particular duties?

(b) What about the Community wine: beer problem. How is that to be approached?

(c) What about the future of VED?

E **VAT etc**

What is the scope for raising extra revenue from:

- extending the VAT base (paragraphs 27-32);
- ending the postponed accounting system for VAT on imports;
- imposing a licence duty on personal credit (paragraph 18);
- any other changes?

What are the main constraints?

- RPI effects: how much could we stand this year?
- effects on business; balance between services and manufacturing?
- staffing considerations?

- practicability for 1984-85?

F Tax reform

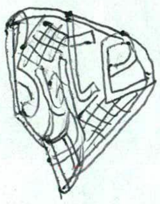
Could and should "tax reform" be adopted as a major theme for the Budget? A number of issues already under consideration: composite rate for banks; changes in building society taxation (paragraphs 16-17). Beyond these what should be the other priority areas for tax reform?

(a) Company taxation: do we proceed with the stock relief and capital allowances package (paragraphs 7 and 10-14)? If so:

(i) on the basis proposed by the Financial Secretary?

(ii) what if anything should be said about reducing CT rates in later years?

(iii) is it better to compensate companies by reducing CT rates or abolishing NIS, if the resources are not available to achieve both?



(iv) how explicit should the Government be at this stage about its longer-term intentions for company and reform?

(v) how can the problems of gainers and losers (eg much of manufacturing industry, unincorporated businesses and leasing operations) be overcome? Do they matter?

(b) pensions and life assurance (paragraphs 22-26): work is in hand on taxing lump sums and pensions funds' investment income; and various changes in the treatment of qualifying life assurance policies:

(i) How is this work going?

(ii) Are there possibilities for action this year? With what kind of revenue consequences (presumably not for 1984-85)?

(iii) On pensions, does Mr Fowler's review preclude early action?

(c) North Sea (paragraph 15): is it right to rule out any further structural changes in the North Sea regime at this stage (beyond limited action on "farmouts")

(d) VAT (paragraphs 27-32): Should the longer term aim be to extend the VAT base even further? By applying a reduced rate to some (or all) remaining zero-rated items? Are there any clear "no-go" areas?

Next Steps

(a) How should we proceed on outstanding items?

(b) Would it be now sensible to draw up a programme of meetings, with papers, for the next month?

(c) The timetable envisages a Budget speech outline by 3 February; and the first draft of the speech by 17 February. Is this confirmed?

(d) Consultations with other Ministers?

(e) Are the suggestions in paper 3 (paragraphs 26-38) for trying out a new expenditure section in the FSBR and for more extensive use of rounding acceptable?

(f) Any other issues?

SUNDAY 15 JANUARY

3. ASSETS, PUBLIC EXPENDITURE AND BORROWING

[references are to paper 5]

The central issue here is about the implications of public expenditure capital transations for appropriate levels of public sector borrowing. Issues for discussion are:

(a) Is it right to consider decisions to undertake public sector investment separately from decisions about how it is to be financed? Is the analysis in paragraphs 4 and 5 agreed?

(b) Is it agreed that micro-economic arguments in paragraph 6 point to a "target" level of public borrowing which allows for the net acquisition of assets? If so is there any dissent from the conclusions in paragraph 7?

(c) Decisions on the PSBR need also to reflect wider policy objectives for interest rates, money GDP and money supply. These will not necessarily point to the same level of PSBR in every case. How far, therefore, should the conclusions in paragraph 7 be modified by the macro economic arguments in paragraphs 12-14. In particular is it agreed that:

- the essential choice is between higher interest rates and higher taxes;

- that in financing one-off capital projects the general presumption might be in favour of some higher borrowing (and higher interest rates) rather than higher taxes;

- in the case of a change in trend in public expenditure the analysis needs also to consider the reasons for the change;

- there is a potential difference between financing transactions in existing assets and investment in new assets (since purchase of existing assets does not necessarily put pressure on interest rates);

- the closer substitutes the assets are for gilts the smaller the effect on interest rates (for any given nominal framework).

(d) Should the target for the PSBR be adjusted to take account of movement in asset sales (paragraph 19)? To what extent should any additional adjustment be made for fluctuations in other net capital expenditure (paragraph 20)?

(e) Should the public expenditure planning total be adjusted to exclude

- special sales of assets?

- other capital transactions?

or (for the reasons in paragraph 23) left as it is?

[Additional material to follow on public expenditure]

14. For given public expenditure and PSBR figures, the estimated fiscal adjustment depends on the details of the revenue projections, including rate receipts - and hence local authority relevant expenditure - and national insurance contributions. For example, the projections assume some fall in rates as a share of GDP, and this tends to reduce the fiscal adjustment*. The projections of total taxes, including the fiscal adjustment, are of course not influenced by these details.

15. If growth of GDP turned out to be lower than 2% - say 1% - with productivity growth correspondingly lower, this would imply a less favourable fiscal prospect. In this case even if the growth of public expenditure was held to ½% per annum after 1986-87, the scope for reducing the burden of taxation would be minimal. Conversely, however, if GDP grew at 3%, it would be possible to reduce the burden of tax to close to its 1978-79 level while permitting growth of 1½% per annum in public expenditure.

16. Other features of the economic prospect might be different for any given GDP paths:

- Lower unemployment would reduce the pressure for public expenditure increases, but it would mean a reduction in receipts - notably national insurance contributions. The net effect of, say, ½ million lower unemployment would probably be a small net reduction in borrowing.

- Higher growth of real earnings would tend to raise tax revenues, but would also increase the pressure for higher public expenditure, particularly insofar as the higher earnings accrued to public sector employees. The net effect of, say, 1% faster real earnings growth would probably be to reduce net borrowing by a small amount.

Implications

17. The growth rates of public expenditure in both case A and case B are well below past experience, as discussed earlier.

[Discussion of how the pressures described earlier in the paper relate to the prospects set out above.]

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*The assumed fall in local authorities' relevant expenditure as a share of GDP is offset by higher expenditure elsewhere within an unchanged planning total.

TABLE 1

ECONOMIC ASSUMPTIONS

Carry down to 1

	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89	1989-90	1990-91	1991-92	1992-93	93-94
Growth of GDP (fc)	-	2.7	3.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	
Inflation (GDP deflator, mp)	-	5.5	4.7	4.2	3.8	3.4	3.0	2.5	2.0	1.5	1.0	
GDP (1982-83 mp)	279.5	287.1	295.7	301.6	307.6	313.8	320.0	326.4	333.0	339.6	346.4	+21%
Growth of market sector productivity	-	2.6	3.0	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	
Narrow unemployment (million)	2.8	3.0	2.9	2.85	2.8	2.75	2.7	2.65	2.6	2.55	2.5	
Real exchange rate (1982-83 = 100)	1.0	0.965	0.96	0.95	0.94	0.93	0.92	0.91	0.90	0.89	0.88	
Real short term interest rates	5.0	4.0	3.5	3.0	2.5	2.0	2.0	2.0	2.0	2.0	2.0	
Nom.		9.5									3.0	
Growth of real wages:												
market sector	-	2.5	2.4	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	
public services	-	1.4	2.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	

TABLE 2

PUBLIC FINANCES : CASE A

£bn, 1982-83 prices	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89	1989-90	1990-91	1991-92	1992-93	
PE planning total	113.4	114.6 39.9	114.6	114.8	114.4	115.6	116.7	117.9	119.1	120.3	121.5 35.0	-4.9
GG Expenditure[1]	132.2	131.9 45.9	133.0	132.9	131.9	132.4	132.8	133.4	133.9	134.4	134.8 38.9	-7
GG Receipts[2]	121.9	121.4 42.3	125.1	126.3	127.1	127.8	129.5	131.0	132.2	133.6	135.1 39.0	-3.3
Fiscal Adjustment	-	- 0	-0.5	-0.2	1.0	1.2	1.8	2.5	2.9	3.6	4.3 1.3	PSBR -2.3 F/A
GGBR	10.3	10.5 8	7.9	6.4	5.7	5.8	5.1	4.9	4.6	4.4	4.1 ·3	-1.3 F/A -·7
PSBR	9.2	9.7	7.3	6.0	5.4	5.5	4.8	4.6	4.3	4.1	3.8	
% of GDP												
PE (GE definition)	44.7	44.0	42.7	41.9	40.9	40.3	41.8	39.2	38.7	38.1	37.6	
		3.8									1.2%	
Total Taxes:												
Before fiscal adj.	39.7	38.5	38.3	38.5	38.4	38.1	38.3	38.0	37.8	37.8	37.8	-·7
After fiscal adj.	39.7	38.5	38.5	38.5	38.1	37.7	37.7	37.3	37.0	36.8	36.5 -2.0	
Non-North Sea Taxes[3]	36.9	35.5	35.4	35.7	35.3	35.3	35.3	35.0	34.9	34.8	34.6	-1.0
North Sea Taxes	2.8	3.0	3.0	2.8	2.8	2.4	2.4	2.3	2.1	2.0	1.9	-1.1
Non-North Sea tax burden[3 4]	39.6	38.3	38.3	38.4	37.9	37.5	37.4	37.4	36.6	36.4	35.9	
PSBR	3.3	3.4	2.5	2.0	1.75	1.75	1.5	1.4	1.3	1.2	1.1	-2.3

1 National Accounts basis
2 Before fiscal adjustment
3 After fiscal adjustment
4 Taxes as % of GDP less North Sea

TABLE 3

PUBLIC FINANCES : CASE B

£bn, 1982-83 prices	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89	1989-90	1990-91	1991-92	1992-93	
PE planning total	113.4	114.6	114.6	114.8	114.4	115.6	115.7	11~~7~~6.1	116.5	116.4	117.3	+2.7
GG Expenditure[1]	132.2	131.9	133.0	132.9	131.9	132.4	131.4	131.6	131.3	130.6	130.7	
GG Receipts[2]	121.9	121.4	125.1	126.3	127.1	127.8	128.1	129.2	129.6	129.8	130.9	
Fiscal Adjustment	-	-	-0.5	-0.2	1.0	1.2	1.8	2.5	2.9	3.6	4.3	
GGBR	10.3	10.5	7.9	6.4	5.7	5.8	5.1	4.9	4.6	4.4	4.1	
PSBR	9.2	9.7	7.3	6.0	5.4	5.5	4.8	4.6	4.3	4.1	3.8	
% of GDP												
PE (GE definition)	44.7	44.0	42.7	41.9	40.9	40.3	39.4	38.7	37.9	37.0	36.4	
Total Taxes:												
Before fiscal adj.	39.7	38.5	38.3	38.5	38.4	38.1	37.9	37.5	37.1	36.7	36.6	
After fiscal adj.	39.7	38.5	38.5	38.5	38.1	37.7	37.3	36.8	36.3	35.7	35.3	
Non-North Sea Taxes[3]	36.9	35.5	35.4	35.7	35.3	35.3	34.9	34.5	34.2	33.7	33.4	
North Sea Taxes	2.8	3.0	3.0	2.8	2.8	2.4	2.4	2.3	2.1	2.0	1.9	
Non-North Sea tax burden[3 4]	39.6	38.3	38.3	38.4	37.9	37.5	36.9	36.4	35.8	35.2	34.7	
PSBR	3.3	3.4	2.5	2.0	1.75	1.75	1.5	1.4	1.3	1.2	1.1	

1 National Accounts basis
2 Before fiscal adjustment
3 After fiscal adjustment
4 Taxes as % of GDP less North Sea

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FROM: A. M. BAILEY
13th January, 1984.

CHANCELLOR OF THE EXCHEQUER

c.c. Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P. Middleton
Sir T. Burns
Mr. Littler
Mr. Cassell
Mr. Battishill
Mr. Kerr
Mr. Scholar
Mr. Riley
Mr. Ridley
Mr. Lord
Mr. Portillo

CHEVENING

Attached is an outline paper on longer-term public expenditure and taxation, which has been drafted* to suggest the ground that might be covered in a published discussion document.

Because of the sensitivity of some of this material it is intended to collect all the copies of this paper after the discussion at Chevening.

AMB

(A. M. BAILEY)

* with contributions from Sir T Burns, Messrs Scholar and Riley

PUBLIC EXPENDITURE AND TAXATION IN THE LONGER TERM

Note by HM Treasury

Introduction

1. This paper gives some views on the prospects for public expenditure and taxation in the years up to 1993-94, as a contribution to public discussion of longer-term fiscal prospects and policies.

2. Each year the Government reviews and carries forward its public expenditure plans, in the Public Expenditure Survey, and publishes the results in an annual White Paper. But as a decision-making process which produces control totals and, later, Estimates provision, this inevitably focusses on the relatively near future - at maximum, on current practice, three years ahead. To put these three years into a clearer perspective, as a framework for considering longer-term options, it is desirable to have a picture of the more distant future, both of the likely pressures for public spending up to a decade ahead and of the economic and fiscal prospect which will govern what public expenditure can be afforded.

Public expenditure - past trends

3. Public expenditure has been rising, in constant prices and as a share of GDP, for twenty years or more. Charts 1 and 2 below trace the course of total public spending on four definitions since 1963-64, both in constant prices and as a percentage of GDP. Public expenditure rose steadily until the mid 1970s, dipped until 1977, and then continued to rise as before.

4. Between 1973-74 and 1982-83 public spending grew at an annual rate of 1.3 per cent in cost terms. Since 1978-79 it has grown at about 1½ per cent a year in aggregate. Table 1 below sets out the course of public spending over this period by programme and in cash; Table 2 gives average annual rates of growth by programme since 1973-74 and 1978-79.

CHART 1

Public expenditure in cost terms[1]

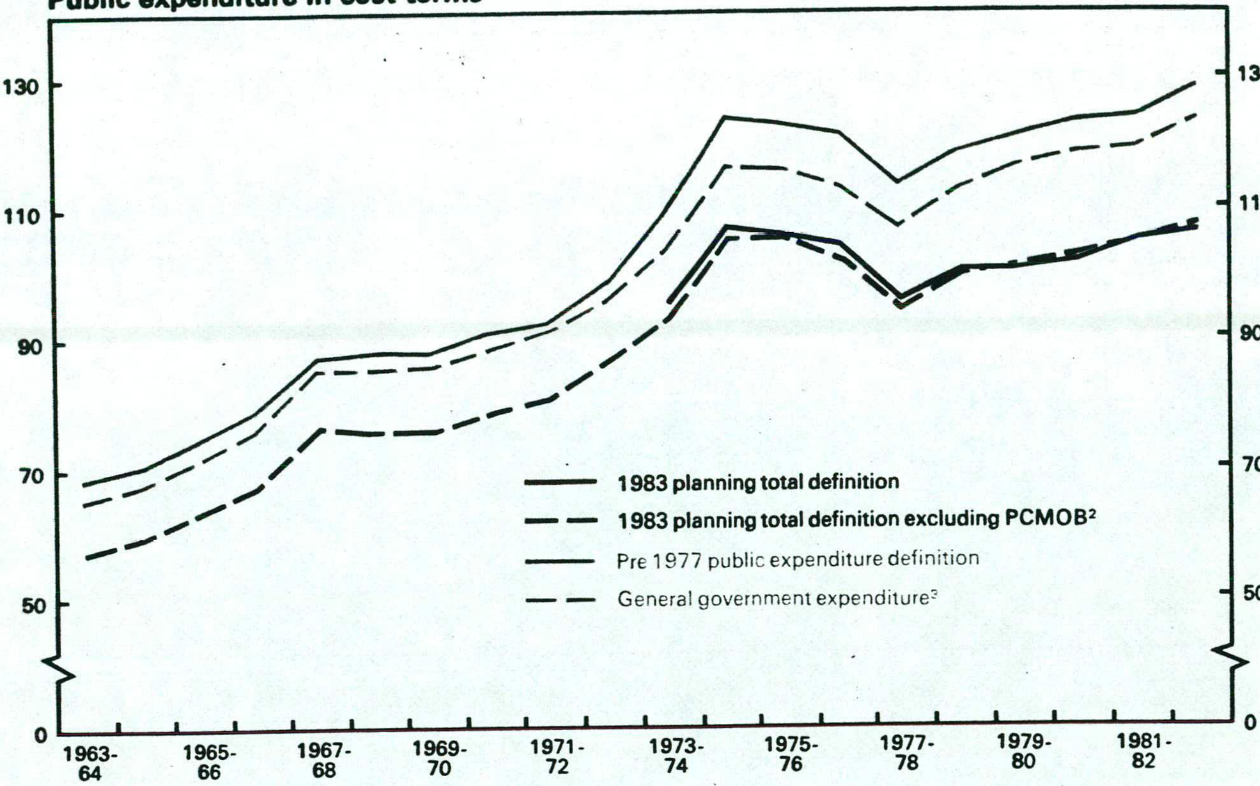
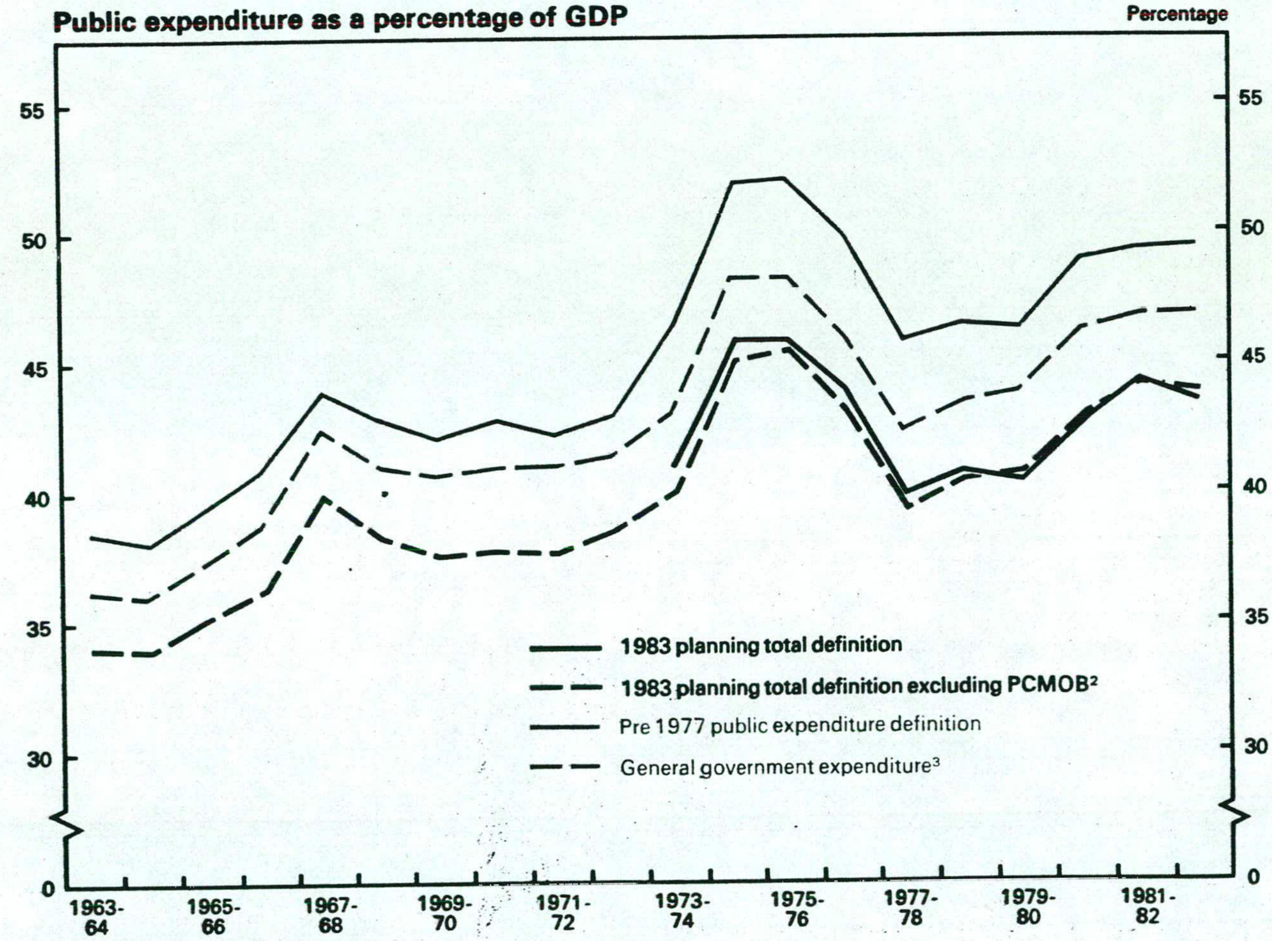


CHART 2

Public expenditure as a percentage of GDP



[1] Cash figures deflated using GDP deflator, 1981-82=100
[2] Public corporations' market and overseas borrowing
[3] National accounts source

Source: Economic Trends, November 1983

TABLE 1

TOTAL EXPENDITURE BY PROGRAMME

	1978-79	1979-80	1980-81	1981-82	1982-83
Defence	7,497	9,228	11,173	12,605	14,408
Overseas aid and other overseas services					
Overseas aid	727	798	904	978	984
Net payments to EC institutions	751	839	221	153	580
Other overseas services	367	439	496	554	600
Agriculture, fisheries, food and forestry	812	1,007	1,345	1,382	1,861
Industry, energy, trade and employment	3,991	4,007	5,149	6,771	5,716
Arts and libraries	340	404	478	524	616
Transport	2,672	3,278	4,000	4,277	4,395
Housing	3,571	4,520	4,461	3,128	2,640
Other environmental services	2,222	2,640	3,071	3,108	3,554
Law order and protective services	2,034	2,577	3,160	3,731	4,191
Education and science	7,754	8,942	10,898	11,841	12,683
Health and personal social services	7,425	8,899	11,362	12,724	13,817
Social security	16,437	19,417	23,429	28,567	32,485
Other public services	966	1,156	1,415	1,538	1,631
Common services	853	1,009	1,098	1,454	1,560
Scotland	3,713	4,547	5,359	5,830	6,243
Wales	1,489	1,769	2,112	2,218	2,384
Northern Ireland	2,132	2,446	2,899	3,215	3,500
Local authority current expenditure not allocated to programmes (England)					
Adjustment					
Special sales of assets		−999	−356	79	−488
Reserve					
General allowance for shortfall					
Planning total	65,752	76,922	92,672	104,676	113,358

% YEARLY INCREASE IN PUBLIC EXPENDITURE

TABLE 2

	between 1973-74 and 1982-83	between 1978-79 and 1982-83
Defence	2.1	4.3
Overseas and other OS	0.3	-7.8
Ag Fisheries, Food, Forestry	1.7	9.3
Industry, Energy, Trade, Empl; excl grants to NI	-5.3	1.9
Transport (excl grants to NI)	-2.5	3.4
Housing	-9.2	-17.9
OES	-2.6	0.8
Law, Order and PS	4.1	6.1
Education and Science	0.2	0.3
Arts and Libraries		2.0
Health and PSS	3.4	3.5
Social Security	5.4	5.0
OPS	1.5	1.0
Common Services	2.2	3.0
Territorials	1.4	0.6
NI ext finance	..	..
Asset Sales	..	..
Contingency Reserve etc	..	..
PLANNING TOTAL	1.3	1.5

5. The programmes which have most exerted pressure on public expenditure totals are:

i. defence: has grown from £7.5b in 1978-79 to £14.4b in 1982-83 at a real 4.3 per cent per annum on average. This is a reflection of the Government's commitment to the NATO 3 per cent target, together with the additional costs of the Falklands campaign;

ii. law and order: has grown at an average 6.1 per cent a year since 1978-79;

iii. health and personal social services: growth of about 3½ per cent a year, well in excess of the extra costs of demographic change and technological advance;

iv. social security: growth of 5 per cent a year from £16.4b in 1978-79 to £32.5b in 1982-83; partly recession-induced, but also reflecting the Government's commitment to maintain the value of the retirement pension and linked benefits, together with improvements in other areas, such as child benefit;

v. agriculture: growth of 9.3 per cent a year - mainly due to production increases and the high cost of the Common Agricultural Policy.

Public expenditure up to 1986-87

6. Since 1981-82 public expenditure has begun to fall slowly as a percentage of GDP. The 1982 Survey for the first time for many years yielded an Estimates total for the following year which was lower than the provision for that year in the preceding White Paper (Cmnd 8494). The 1983 Survey repeated this process for 1984-85, and the February 1984 White Paper shows planning totals for the three years 1984-85 to 1986-87 broadly constant in real terms. On this basis, the fall in public expenditure as a percentage of GDP may be expected to continue up to the end of the Survey period, bringing this ratio back by then broadly to its 1978-79 level. This containment of the growth in expenditure has been hard-won, and has involved the Government in hard choices. The results are set out in detail in the February 1984 White Paper.

Public expenditure - longer term prospect

7. The Government is determined to hold to the White Paper totals. To achieve this it has taken a number of difficult decisions. For example, to secure better control over high-spending local authorities which have been responsible for some of the pressure on spending totals in the past, it has introduced legislation providing powers to limit local authority rate revenues and thus restrain their spending. For central government expenditure, the system of cash limits has proved effective and is being extended wherever possible; and any unavoidable changes in non-cash-limited programmes will now have to be found from within the reserve, which has been included in the White Paper at higher levels than in the last White Paper to allow for this.

8. Beyond 1986-87, prospects for public expenditure are necessarily a good deal less certain. But already there are reasons to expect renewed pressures for increased spending:

a. Priority programmes. Within the overall total which is held broadly constant in real terms through the White Paper period, some programmes (eg defence, law and order, health, social security) show continuing real growth. In large part this reflects Government priorities, so that there is reason to expect some continuing growth in most of these programmes beyond 1986-87. Within the White Paper totals it has been found possible to accommodate this growth by real reductions in some other programmes (eg industry, agriculture, transport, education, housing and environment), but it will not be easy to secure continuing reductions in all these programmes beyond 1986-87, for a number of reasons suggested below.

b. Demography

i. Pensions.

Although between 1983 and 1993 the actual numbers above pension age increase only slightly (ie from 9.9m to 10.2m), there will be a rather larger increase in the numbers receiving state retirement pensions because of increasing eligibility rates, ie from 9.2m to 9.8m.

ii. Health.

The main demographic pressure here comes from the increasing number of older pensioners, and in particular the very elderly, who inevitably consume disproportionate amounts of health care and personal social services (over £1000 a year each, as against some £250 a year average for all ages - 1981-82 estimates, gross). Between 1983 and 1993, the numbers over 75 increase from 2.9m to 3.3m, and of this the over-85s account for 0.3m (an increase of 4.8%pa compared with 2.3%pa over the period 1973-1983).

iii. Education.

Towards the end of this decade, numbers of children of school age are expected to begin rising, reversing a small part of the decline in earlier years.

c. Technology. In a number of areas, notably defence and health, advances in technology make it possible to deliver higher output than in the past. But the new equipment is expensive, and for example in the health area, where 'demand' is virtually unlimited, the effect is to increase pressures for higher spending.

d. Capital expenditure. In some programmes, such as roads, the White Paper provision for new capital spending does not keep pace with costs. This reflects priorities within a constrained total; but in the longer term given sustained economic growth (hence more demands, eg heavier traffic) there will be pressures to spend more on maintaining and improving the stock of capital assets in the public sector.

e. Economic growth will bring demands in other areas too. Although it should allow some reduction in the need for benefit payments to the unemployed (now about 5% of the public expenditure total), there will be powerful arguments for allowing some rise in real levels of pensions and other long-term benefits (another 7% of the total) as a share in growing prosperity. To hold expenditure level in cost terms would also require that any increase in the public service pay bill (about a third of the total) is offset by a reduction in numbers employed, made possible by some combination of increased efficiency and transfers of activities to the private sector; with real incomes rising elsewhere in the economy this will not be easy to achieve. More generally, rising prosperity will encourage public demands for improved standards in the provision of services which in some cases (eg health, education, law and order) are still likely to be provided mainly in the public sector.

f. State earnings-related pensions. If the 1975 scheme remains unchanged, it will add up to 10% to the present total of public expenditure (in cost terms) by the early years of next century. This is one of the reasons for the review of pensions recently announced by the Secretary of State for Social Services.

Economic and fiscal prospects to 1992-93

9. The prospects for the economy and the fiscal prospect over the next decade are inherently uncertain. In addition to the uncertainties about the level of public expenditure discussed earlier, the fiscal prospect will be influenced by such factors as:

i. the growth of output, which will have a major impact on the amount of tax collected and on demand determined public expenditure;

ii. the level of unemployment, which will influence expenditure, particularly on social security;

iii. the rate of inflation and the level of real interest rates which, together with the profile of borrowing, will determine the levels of interest payments and receipts;

iv. real world oil prices and the real effective exchange rate, which will affect oil revenues from the North Sea;

v. the distribution of income between profits and wages, which will influence total tax revenues because of different marginal rates of tax on company and personal incomes;

vi. movements of real earnings in the public and private sectors, which will influence the movement of public expenditure relative to tax receipts.

10. The prospect for each of these variables is very uncertain. Some illustrative figures have been constructed for the period up to 1992-93. The economic background underlying the calculations takes as its starting point the forecast in the Autumn Statement for the

year ahead (ie to 1984-85) and thereafter the path set out in table 1 attached. The main features are:

- real GDP grows at 2% pa

- unemployment comes down steadily to 2½ million over the period

- inflation (GDP deflator) comes down to 3% by 1988-89 and 1% by 1992-93

- real short term interest rates come down to 2% in 1987-88, and stay there

- real oil prices rise by 14%, but despite this oil revenues fall from 3% of GDP in 1984-85 to 1.9% in 1992-93 with the fall in North Sea output

- the real exchange rate depreciates by 9% by the end of the period

- real earnings in both the market sector and in public services grow at 1% pa.

?

11. The figures are based on the assumption that the PSBR objectives for the period up to 1988-89 are achieved. Thereafter, the PSBR is assumed to come down gradually to 1% of GDP: by the end of the period money GDP is rising at 3% per annum, and the ratio of public sector debt to income is broadly stable. Within this framework, two different cases are constructed:

Case A: This assumes public expenditure cash planning totals as in the White Paper up to 1986-87 - a broadly flat path in cost terms - and 1% annual growth in cost terms thereafter. The PSBR objective is assumed to be met by varying non-North Sea taxes.

Case B: Up to the end of the period covered by the White Paper this is the same as case A. Thereafter it assumes that the burden of non-North Sea taxes - ie non-North Sea taxes as a share of non-North Sea GDP - is brought back steadily to its level in 1978-79*. Over this period the PSBR objective is assumed to be met by varying public expenditure.

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* Recent data for the burden of non-North Sea taxes, defined in this way, is as follows:

1975-76	1976-77	1977-78	1978-79	1979-80	1980-81	1981-82	1982-83	1983-84
36.5	36.4	35.4	34.7	35.7	36.9	39.6	39.5	38.4

12. The detailed figures are presented in tables 2 and 3 and summarised below:

Public Finances

Changes in share of GDP 1983-84 to 1992-93	Case A	Case B
Public expenditure	-6.4	-7.5
North Sea Taxes	-1.1	-1.1
Non-North Sea Taxes	-0.9	-2.0
PSBR	-2.3	-2.3
Non-North Sea tax burden	-2.3	-3.6

The broad picture in both cases is one in which the PSBR falls as a share of GDP, and with a falling share of North Sea taxes this requires the share of public expenditure to fall relative to the share of non-North Sea taxes. The burden of non-North Sea taxes falls more than the share of non-North Sea taxes in total GDP because of the declining contribution of North Sea output to total GDP.

13. The precise paths after 1984-85 should not be invested with too much significance in view of the stylised nature of the assumptions. But the following broad conclusions emerge:

i. If expenditure is held to White Paper levels in the early years, a positive fiscal adjustment is likely to emerge after 1984-85.

ii. If expenditure growth in cost terms is restricted to 1% after 1986-87, there is likely to be increasing scope for a positive fiscal adjustment - reaching perhaps 1½% of GDP by 1992-93 - in spite of declining oil revenues.

iii. Even if this fiscal adjustment is used entirely to reduce non-North Sea taxes, the tax burden at the end of the period is likely to remain higher than it was in 1978-79.

iv. In order to bring the non-North Sea tax burden down to its 1978-79 level, it will be necessary to have a lower profile of public expenditure after 1986-87 - growth in cost terms of perhaps ½% per annum.

14. For given public expenditure and PSBR figures, the estimated fiscal adjustment depends on the details of the revenue projections, including rate receipts - and hence local authority relevant expenditure - and national insurance contributions. For example, the projections assume some fall in rates as a share of GDP, and this tends to reduce the fiscal adjustment*. The projections of total taxes, including the fiscal adjustment, are of course not influenced by these details.

15. If growth of GDP turned out to be lower than 2% - say 1% - with productivity growth correspondingly lower, this would imply a less favourable fiscal prospect. In this case even if the growth of public expenditure was held to ½% per annum after 1986-87, the scope for reducing the burden of taxation would be minimal. Conversely, however, if GDP grew at 3%, it would be possible to reduce the burden of tax to close to its 1978-79 level while permitting growth of 1½% per annum in public expenditure.

16. Other features of the economic prospect might be different for any given GDP paths:

- Lower unemployment would reduce the pressure for public expenditure increases, but it would mean a reduction in receipts - notably national insurance contributions. The net effect of, say, ½ million lower unemployment would probably be a small net reduction in borrowing. ?

- Higher growth of real earnings would tend to raise tax revenues, but would also increase the pressure for higher public expenditure, particularly insofar as the higher earnings accrued to public sector employees. The net effect of, say, 1% faster real earnings growth would probably be to reduce net borrowing by a small amount.

Implications

17. The growth rates of public expenditure in both case A and case B are well below past experience, as discussed earlier.

[Discussion of how the pressures described earlier in the paper relate to the prospects set out above.]

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*The assumed fall in local authorities' relevant expenditure as a share of GDP is offset by higher expenditure elsewhere within an unchanged planning total.

TABLE 1

ECONOMIC ASSUMPTIONS

	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89	1989-90	1990-91	1991-92	1992-93
Growth of GDP (fc)	-	2.7	3.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Inflation (GDP deflator, mp)	-	5.5	4.7	4.2	3.8	3.4	3.0	2.5	2.0	1.5	1.0
GDP (1982-83 mp)	279.5	287.1	295.7	301.6	307.6	313.8	320.0	326.4	333.0	339.6	346.4
Growth of market sector productivity	-	2.6	3.0	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5
Narrow unemployment (million)	2.8	3.0	2.9	2.85	2.8	2.75	2.7	2.65	2.6	2.55	2.5
Real exchange rate (1982-83 = 100)	1.0	0.965	0.96	0.95	0.94	0.93	0.92	0.91	0.90	0.89	0.88
Real short term interest rates	5.0	4.0	3.5	3.0	2.5	2.0	2.0	2.0	2.0	2.0	2.0
Growth of real wages:											
market sector	-	2.5	2.4	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
public services	-	1.4	2.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0

TABLE 2

PUBLIC FINANCES : CASE A

£bn, 1982-83 prices	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89	1989-90	1990-91	1991-92	1992-93
PE planning total	113.4	114.6	114.6	114.8	114.4	115.6	116.7	117.9	119.1	120.3	121.5
GG Expenditure[1]	132.2	131.9	133.0	132.9	131.9	132.4	132.8	133.4	133.9	134.4	134.8
GG Receipts[2]	121.9	121.4	125.1	126.3	127.1	127.8	129.5	131.0	132.2	133.6	135.1
Fiscal Adjustment	-	-	-0.5	-0.2	1.0	1.2	1.8	2.5	2.9	3.6	4.3
GGBR	10.3	10.5	7.9	6.4	5.7	5.8	5.1	4.9	4.6	4.4	4.1
PSBR	9.2	9.7	7.3	6.0	5.4	5.5	4.8	4.6	4.3	4.1	3.8
% of GDP											
PE (GE definition)	44.7	44.0	42.7	41.9	40.9	40.3	41.8	39.2	38.7	38.1	37.6
Total Taxes:											
Before fiscal adj.	39.7	38.5	38.3	38.5	38.4	38.1	38.3	38.0	37.8	37.8	37.8
After fiscal adj.	39.7	38.5	38.5	38.5	38.1	37.7	37.7	37.3	37.0	36.8	36.5
Non-North Sea Taxes[3]	36.9	35.5	35.4	35.7	35.3	35.3	35.3	35.0	34.9	34.8	34.6
North Sea Taxes	2.8	3.0	3.0	2.8	2.8	2.4	2.4	2.3	2.1	2.0	1.9
Non-North Sea tax burden[3 4]	39.6	38.3	38.3	38.4	37.9	37.5	37.4	37.4	36.6	36.4	35.9
PSBR	3.3	3.4	2.5	2.0	1.75	1.75	1.5	1.4	1.3	1.2	1.1

1 National Accounts basis
2 Before fiscal adjustment
3 After fiscal adjustment
4 Taxes as % of GDP less North Sea

TABLE 3

PUBLIC FINANCES : CASE B

£bn, 1982-83 prices	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89	1989-90	1990-91	1991-92	1992-93
PE planning total	113.4	114.6	114.6	114.8	114.4	115.6	115.7	117.1	116.5	116.4	117.3
GG Expenditure[1]	132.2	131.9	133.0	132.9	131.9	132.4	131.4	131.6	131.3	130.6	130.7
GG Receipts[2]	121.9	121.4	125.1	126.3	127.1	127.8	128.1	129.2	129.6	129.8	130.9
Fiscal Adjustment	-	-	-0.5	-0.2	1.0	1.2	1.8	2.5	2.9	3.6	4.3
GGBR	10.3	10.5	7.9	6.4	5.7	5.8	5.1	4.9	4.6	4.4	4.1
PSBR	9.2	9.7	7.3	6.0	5.4	5.5	4.8	4.6	4.3	4.1	3.8
% of GDP											
PE (GE definition)	44.7	44.0	42.7	41.9	40.9	40.3	39.4	38.7	37.9	37.0	36.4
Total Taxes:											
Before fiscal adj.	39.7	38.5	38.3	38.5	38.4	38.1	37.9	37.5	37.1	36.7	36.6
After fiscal adj.	39.7	38.5	38.5	38.5	38.1	37.7	37.3	36.8	36.3	35.7	35.3
Non-North Sea Taxes[3]	36.9	35.5	35.4	35.7	35.3	35.3	34.9	34.5	34.2	33.7	33.4
North Sea Taxes	2.8	3.0	3.0	2.8	2.8	2.4	2.4	2.3	2.1	2.0	1.9
Non-North Sea tax burden[3 4]	39.6	38.3	38.3	38.4	37.9	37.5	36.9	36.4	35.8	35.2	34.7
PSBR	3.3	3.4	2.5	2.0	1.75	1.75	1.5	1.4	1.3	1.2	1.1

1 National Accounts basis
2 Before fiscal adjustment
3 After fiscal adjustment
4 Taxes as % of GDP less North Sea

PERSONAL AND
BUDGET SECRET

FROM: A M W BATTISHILL
DATE: 18 January 1984

Important
& keep

SIR T BURNS MR BAILEY MR LITTLER MR CASSELL MR ANSON MR ODLING-SMEE MR KERR	full record	cc Sir Peter Middleton
MR MONCK MR BYATT MR KEMP MR MONGER MR EVANS MR LANKESTER	Saturday only	
MR SCHOLAR	Sunday only	

CHEVENING 14-15 JANUARY

As my predecessor did last year I have prepared an informal record of the main points arising in the weekend discussions at Chevening. With Sir Peter Middleton's agreement I am circulating this, on a strictly personal basis, to those shown above. Because of the contents it has to be given a Budget Secret classification, and should be handled with caution.

2. A copy of the first day's discussion only goes also to the Chairmen of the two Revenue Departments.

AWB/

A M W BATTISHILL

PERSONAL AND
BUDGET SECRET

DISCUSSIONS AT CHEVENING

14-15 JANUARY 1984

This note records the main conclusions reached at the meeting of Treasury Ministers and officials at Chevening on 14-15 January. It does not aim to be a complete record of all that was said.

FIRST DAY

1. Macro-economic Strategy and the MTFS

The paper on the Policy Background to the MTFS by Sir Terence Burns was discussed. It was agreed that the first part of the paper confirmed that the MTFS had worked out much as expected in 1980 and 1981. Despite some difficulties in interpreting monetary signals the MTFS had succeeded in bringing down inflation and raising output. But mainly because of de-regulation broad money figures over the period had followed a somewhat different path from that originally expected. Success in bringing down the PSBR rested too much on higher taxes and not enough on lower public spending. Whilst there had been no relaxation of fiscal and monetary policy over the last year, fiscal conditions had turned out easier than expected, with the sharper fall in inflation.

On the MTFS the following conclusions were reached:

(a) the MTFS should continue to be based on financial years

- there was no virtue in converting to calendar years. Nevertheless, deciding the Budget judgement in advance of knowing the previous year's PSBR outturn was a serious difficulty. The presumption should be towards a 1985 Budget in the second half of April.

(b) On the period for the new MTFS:

(a) there were persuasive reasons for extending for a five year period ending in 1988-89; but

(b) this posed particularly difficulties for projecting public expenditure figures for the two years beyond the end of the 1984 PEWP planning period; and so

(c) drafting should proceed on the basis of a five year period, with public expenditure figures held constant in cost terms between 1986-7 and 1988-9. The MTFS could be put to Cabinet on this basis. If Ministers collectively wished to substitute some modest real growth in public spending for the last two years that too could be considered. The figures would anyway need to be consistent with whatever projections emerged on the LTPE exercise. In case of real difficulty detailed projections for only three years with the PSBR path for the last two years covered in the narrative might provide a possible fall back position.

Medium Term Outlook. The UK economy had shown itself relatively slow to change. So, with the present broad thrust of policy, existing forces for improvement would be expected to continue. Inflation would be likely to go on falling gently and output to go on rising. We could expect continued labour market adjustment, but the split between real wages and productivity adjustment was less certain.

Medium Term Objectives. The following four conclusions were reached:

(a) On inflation the ultimate aim remained price stability. It would be prudent, however, to aim by the end of the MTFS period to get about half way towards that objective. The published assumption for the final MTFS year should be a rate of not more than 3½ per cent: 3 per cent would be better.

(b) On output the objectives for inflation were likely to be consistent with a slight fall in growth by the end of the period to 2 per cent. This reflected particularly the North Sea oil profile; some inevitable slackening in the recent rapid growth in productivity; and demographic factors. But a better outturn on output or unemployment might be possible.

(c) It was reasonable, therefore, to assume money GDP growth falling to between 5 and 6 per cent over the MTFS period.

Monetary targets. On policy towards broad money:

(a) The choice was between holding to a 7-11 per cent target for another year, and then reducing by one point a year from 1985-86; or coming down to 6-10 per cent for 1984-85 and 1985-86, with a one point a year reduction thereafter.

(b) Against the background of relatively high £M3 figures, a 7-11 per cent target growth in 1984-85 might look too relaxed; especially if velocity was thought to be levelling off; but if velocity was expected to go on falling a move to 6-10 per cent might look rather tough.

(c) Further consideration would need to be given to the choice between these alternatives.

On <u>narrow</u> money:

(a) With the nominal GDP objective coming down by only about ½ per cent a year, the growth in narrow money should decelerate more slowly than that of broad money;

(b) As for the precise path the choices were between (i) accepting annual cuts of ½ per cent (which looked rather precise against 4 point ranges); (ii) changing target ranges at less frequent intervals with some flattening off towards the end of the period; or (iii) possibly starting a little higher at 5-9 per cent and coming down more steadily in one point steps (with the aim next year of coming out towards the bottom of the range).

(c) Further consideration would need to be given to the preferred course;

(d) The possibility of adopting a three point range rather than four was left open.

<u>Personal borrowing</u>. Only a brief discussion of this took place. It was recognised that continued high borrowing by the personal sector, especially if reinforced by some increase in corporate borrowing, pointed towards either somewhat higher monetary targets or a tighter fiscal stance.

<u>PSBR</u>. The following main conclusions were reached:

(a) By 1988-89 the PSBR needed to be a substantially lower proportion of GDP than at present;

(b) There were good reasons for seeking a downward step change in 1984-85. This was consistent with market reasons for redressing the likely overshoot this year; with the planned increase in asset sales next year; and with prudent action in advance of the downturn in oil revenues;

(c) With a PSBR next year of 2½ per cent of GDP it might be better to aim for a smoother path in following years, thus: 2¼ per cent in 1985-86; 2 per cent in 1986-87; $1\frac{3}{4}$ per cent in 1987-88; and $1\frac{1}{2}$ per cent in 1988-89. (But, because of asset sales, this would produce a less smooth path for PSFD.)

(d) When the forecast was ready it would be prudent to consider the fiscal prospects for the coming two years together. It would be better to avoid putting taxes up in 1984-85 only to reduce them again in 1985-86. Or vice versa.

(e) So long as the forecast showed the PSBR next year coming out within the range £8-$8\frac{1}{2}$ billion, before any fiscal adjustment, the Chancellor was inclined to go for a broadly neutral Budget. To take direct action to reduce a prospective PSBR by £$\frac{1}{2}$ billion or less would look too much like fine tuning. Similarly, the markets would be likely to draw a distinction between a PSBR next year of £$8\frac{1}{2}$ billion resulting from real tax cuts in the Budget, and the same figure resulting from a strictly neutral Budget. At this early stage there were some indications that a neutral Budget might be consistent with a PSBR of something less than £$8\frac{1}{2}$ billion, though the first print out from the forecast would not be ready until 23 or 24 January.

2. Tax Issues

Balance of the Budget

Two main conclusions:

(a) Within a broadly neutral Budget there were no compelling reasons this year to suggest tilting the net balance between companies and persons one way or the other;

(b) Nevertheless, the composition of the Budget would be crucially important: in particular, it would be important to include tax changes designed to reinforce the Government's main strategic aims for the supply side, the tax base and the level of income tax thresholds.

Income tax thresholds

The forecast would assume simple indexation in line with prices. There was a case for regarding earnings indexation (plus $1\frac{1}{2}$ per cent real: Option 1) as a minimum objective - avoiding increasing income tax relative to earnings, avoiding staff increases, and so on. A case could also be made for a larger real increase in thresholds if that made it possible to abolish (either fully or in part) some other outdated allowances and reliefs. Thus, moving to Option 2, combined with ending the minor personal allowances, the foreign earnings deduction and the foreign emoluments deduction, appeared to involve only an extra net PSBR cost over Option 1 in 1984-85 of something like £70 million. Decisions on personal allowances and thresholds would need to be made in the light of the wider Budget arithmetic. For the present, the various options should remain open. It should be assumed, subject to the next paragraph, that the higher rate threshold and bands, and the IIS threshold, would increase by the same percentage as applied to the main personal allowances (though abolition of the IIS remained the eventual objective).

A "combined" package

Further urgent work was needed on the possibilities of a package combining abolition of the National Insurance UEL and the NIS with a 10 point reduction in higher rates of income tax. The initial results (Mr Monger's note of 13 January) should be refined in two ways: by reducing the income limits for the age allowance (rather than the quantum of allowance); and to explore the net effect on losers of various real increases in the main personal allowances. The emergence of a satisfactory package on these lines would override the provisional conclusions in the preceding paragraph.

Child benefit

The balance of argument seemed to point towards settling child benefit along with other social security benefits in the late spring rather than at the time of the Budget. The possibility of taxing child benefit was raised; but there was little enthusiasm for that. The Inland Revenue would provide a note.

Other income tax matters

(a) Pension Funds and Superannuation It was agreed to rule out any major action on this front until after Mr Fowler's enquiry on pensions.

(b) Life Assurance. There were attractions in withdrawing life assurance premium relief for new policies at a revenue gain of some £100 m in the first year; but the possibility of phasing out relief on existing policies should receive further consideration. Final decisions should wait until after discussion with the Secretary of State for Industry and Trade.

(c) Share Options. Improving the tax treatment was a high priority. Various options costing £25-40 million were being examined. The Financial Secretary would report back.

(d) Mortgage interest ceiling. There was no case for raising this again this year.

(e) Business Expansion Scheme. Action should be taken to close the agricultural loophole.

Company taxation

It was desirable to move on stock relief and capital allowances in the 1984 and subsequent Budgets on the lines so far suggested. (It would be important to announce from the outset what the long term aim of the phased programme would be - though it would not be possible to be specific about the precise phasing.) But further consideration needed to be given to very short life assets; to whether (eventually) 4 per cent writing down allowances for industrial buildings was adequate to meet replacement cost; and to the possibility of continuing to apply the (reduced) capital allowance regime to films after 1987. There was no substantial discussion of the Corporation Tax rate or of NIS (except in the context of a "combined" National Insurance and income tax package). Some modest reduction in the small companies rate, alongside any larger reduction in the main Corporation Tax rate, was not ruled out.

Building Societies

The preference for dealing with building societies' gilts transactions by litigation (subject to Counsel's opinion) other than legislation was confirmed. The case for considering a change in the special 40 per cent rate alongside timing of changes in the main Corporation Tax rate was also noted.

North Sea Taxation

There was no case for further major structural changes this year.

Capital taxes

CGT and CTT. There seemed no need this year to go beyond revalorisation of the thresholds. There were attractions in reducing the CTT top rate to 60 per cent at small revenue cost; this would need to be considered when the scope of the Budget was clearer.

Development Land Tax. This was not a priority for action this year.

Stamp Duties. Subject to any further ideas from the Stock Exchange about a possible transactions tax, reducing the duty on share transfers to 1 per cent was a high priority. There were also attractions in applying the same reduction to transfers of land and buildings to offset removal of VAT zero-rating from building alterations (see below). There was also a case for applying a very small rate of duty (eg 0.1 per cent) to gilts transactions.

VAT. The main conclusions here were:

(a) Some widening of the VAT base was a priority.

(b) There were attractions in a package removing zero-rating from newspapers, periodicals (but not books) etc; newspaper advertisements; and news services; building alterations, hot take-away food (possibly including some specified cold items). This offered a prospective yield of some £610 m in the first year and some £965 m in a full year. (The inclusion of books would add £60 m and £80 m.)

(c) Removing the postponed accounting system from imports offered a potential yield of up to £800 million and was very attractive. Customs & Excise would report urgently.

Credit Licence duty. Customs were urgently preparing a note. This should be extended to cover a licence duty on all credit as well as just personal credit. But there would be very considerable political objections to the proposal, particularly because of its effect on mortgage finance for house purchase.

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VED. Broad revalorisation should be assumed.

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(a) It was clearly necessary to take account of asset sales in judging the appropriate level of the PSBR for given financial conditions and our public presentation should acknowledge that (as the Chancellor had said at the December TCSC hearing). Indeed, in presenting the borrowing figures there might be a case for giving rather more prominence to the figures of asset sales and the net capital formation component of public spending.

(b) The possibility of adjusting the planning total to exclude sales of assets or other capital transactions should not be pursued. It would be wrong to treat special sales of assets differently from some other capital transactions; and impossibly difficult to define and justify more extensive adjustments.

(c) The present approach, in which broad account was taken of prospective asset sales in judging the right level of borrowing, combined with the proposed more extensive treatment of capital expenditure in the Public Expenditure White Paper, was to be preferred.

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(a) The Government could hardly avoid publishing some kind of document on long term public expenditure as a contribution towards public discussion.

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(c) The approach suggested in Mr Bailey's note, though not without its own difficulty (particularly regarding economic assumptions) looked much more promising.

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(i) It would be better to show inflation dropping to zero;

(ii) the real exchange rate should be held constant on the usual stylised basis;

(iii) it would not be prudent to show a higher growth rate than 2 per cent throughout the period - notwithstanding the difficulty of reconciling an apparently strong financial position with fairly cautious assumptions about the response of the real economy;

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(f) Case B would be the best one to put to Cabinet: they should be offered the aim by 1993-94 of at least bringing non-North Sea taxes back down to the level of 1978-79 and shown how public spending might perform in relation to this aim. There should be projections of (i) constant (cost terms) public spending after the 1984 PEWP horizons and (ii) ½ per cent (real) increases after 1988-89. (The output and unemployment paths might differ, by 1993-94, between case (i) and case (ii).

(g) Whatever the outcome, further urgent work should be put in hand on the composition of the prospective tax burden in 1993-94 and the shifts within it.

(h) The paper should be redrafted urgently in the light of discussion so that it could be circulated for the economic Cabinet on 9 February.

(i) Finally, the aim was to publish the document on Budget day alongside the FSBR as background to the Government's long term strategy.

17 January 1984

pwp

PERSONAL AND
BUDGET SECRET

FROM: A M W BATTISHILL
DATE: 18 January 1984

SIR T BURNS
MR BAILEY
MR LITTLER
MR CASSELL
MR ANSON
MR BATTISHILL
MR ODLING-SMEE
~~MR KERR~~
MISS O'MARA
MR MONCK paras 5-17
MR BYATT "
~~MR KEMP~~
MR MONGER
MR EVANS
MR LANKESTER paras 1-4.

full record

Saturday only

? MR CROPPER

~~MR SCHOLAR~~ ~~Sunday only~~

cc Sir Peter Middleton

? B 1984

SIR L AIREY (IR)
MR FRASER (C+E)

CHEVENING ~~14-15~~ 12-13 JANUARY

As my predecessor did last year I have prepared an informal record of the main points arising in the weekend discussions at Chevening. With Sir Peter Middleton's agreement I am circulating this, on a strictly personal basis, to those shown above. Because of the contents it has to be given a Budget Secret classification, and should be handled with caution.

2. A copy of the first day's discussion only goes also to the Chairmen of the two Revenue Departments.

A M W BATTISHILL

PERSONAL AND
BUDGET SECRET

DISCUSSIONS AT CHEVENING

14-15 JANUARY 1984

This note records the main conclusions reached at the meeting of Treasury Ministers and officials at Chevening on 14-15 January. It does not aim to be a complete record of all that was said.

FIRST DAY

1. Macro-economic Strategy and the MTFS

The paper on the Policy Background to the MTFS by Sir Terence Burns was discussed. It was agreed that the first part of the paper confirmed that the MTFS had worked out much as expected in 1980 and 1981. Despite some difficulties in interpreting monetary signals the MTFS had succeeded in bringing down inflation and raising output. But mainly because of de-regulation broad money figures over the period had followed a somewhat different path from that originally expected. Success in bringing down the PSBR rested too much on higher taxes and not enough on lower public spending. Whilst there had been no relaxation of fiscal and monetary policy over the last year, fiscal conditions had turned out easier than expected, with the sharper fall in inflation.

On the MTFS the following conclusions were reached:

(a) the MTFS should continue to be based on financial years

- there was no virtue in converting to calendar years. Nevertheless, deciding the Budget judgement in advance of knowing the previous year's PSBR outturn was a serious difficulty. The presumption should be towards a 1985 Budget in the second half of April.

(b) On the period for the new MTFS:

(a) there were persuasive reasons for extending for a five year period ending in 1988-89; but

(b) this posed particularly difficulties for projecting public expenditure figures for the two years beyond the end of the 1984 PEWP planning period; and so

(c) drafting should proceed on the basis of a five year period, with public expenditure figures held constant in cost terms between 1986-7 and 1988-9. The MTFS could be put to Cabinet on this basis. If Ministers collectively wished to substitute some modest real growth in public spending for the last two years that too could be considered. The figures would anyway need to be consistent with whatever projections emerged on the LTPE exercise. In case of real difficulty detailed projections for only three years with the PSBR path for the last two years covered in the narrative might provide a possible fall back position.

Medium Term Outlook. The UK economy had shown itself relatively slow to change. So, with the present broad thrust of policy, existing forces for improvement would be expected to continue. Inflation would be likely to go on falling gently and output to go on rising. We could expect continued labour market adjustment, but the split between real wages and productivity adjustment was less certain.

Medium Term Objectives. The following four conclusions were reached:

(a) On inflation the ultimate aim remained price stability. It would be prudent, however, to aim by the end of the MTFS period to get about half way towards that objective. The published assumption for the final MTFS year should be a rate of not more than 3½ per cent: 3 per cent would be better.

(b) On output the objectives for inflation were likely to be consistent with a slight fall in growth by the end of the period to 2 per cent. This reflected particularly the North Sea oil profile; some inevitable slackening in the recent rapid growth in productivity; and demographic factors. But a better outturn on output or unemployment might be possible.

(c) It was reasonable, therefore, to assume money GDP growth falling to between 5 and 6 per cent over the MTFS period.

Monetary targets. On policy towards broad money:

(a) The choice was between holding to a 7-11 per cent target for another year, and then reducing by one point a year from 1985-86; or coming down to 6-10 per cent for 1984-85 and 1985-86, with a one point a year reduction thereafter.

(b) Against the background of relatively high £M3 figures, a 7-11 per cent target growth in 1984-85 might look too relaxed; especially if velocity was thought to be levelling off; but if velocity was expected to go on falling a move to 6-10 per cent might look rather tough.

(c) Further consideration would need to be given to the choice between these alternatives.

On <u>narrow</u> money:

(a) With the nominal GDP objective coming down by only about ½ per cent a year, the growth in narrow money should decelerate more slowly than that of broad money;

(b) As for the precise path the choices were between (i) accepting annual cuts of ½ per cent (which looked rather precise against 4 point ranges); (ii) changing target ranges at less frequent intervals with some flattening off towards the end of the period; or (iii) possibly starting a little higher at 5-9 per cent and coming down more steadily in one point steps (with the aim next year of coming out towards the bottom of the range).

(c) Further consideration would need to be given to the preferred course;

(d) The possibility of adopting a three point range rather than four was left open.

<u>Personal borrowing</u>. Only a brief discussion of this took place. It was recognised that continued high borrowing by the personal sector, especially if reinforced by some increase in corporate borrowing, pointed towards either somewhat higher monetary targets or a tighter fiscal stance.

<u>PSBR</u>. The following main conclusions were reached:

(a) By 1988-89 the PSBR needed to be a substantially lower proportion of GDP than at present;

(b) There were good reasons for seeking a downward step change in 1984-85. This was consistent with market reasons for redressing the likely overshoot this year; with the planned increase in asset sales next year; and with prudent action in advance of the downturn in oil revenues;

(c) With a PSBR next year of 2½ per cent of GDP it might be better to aim for a smoother path in following years, thus: 2¼ per cent in 1985-86; 2 per cent in 1986-87; 1¾ per cent in 1987-88; and 1½ per cent in 1988-89. (But, because of asset sales, this would produce a less smooth path for PSFD.)

(d) When the forecast was ready it would be prudent to consider the fiscal prospects for the coming two years together. It would be better to avoid putting taxes up in 1984-85 only to reduce them again in 1985-86. Or vice versa.

(e) So long as the forecast showed the PSBR next year coming out within the range £8-8½ billion, before any fiscal adjustment, the Chancellor was inclined to go for a broadly neutral Budget. To take direct action to reduce a prospective PSBR by £½ billion or less would look too much like fine tuning. Similarly, the markets would be likely to draw a distinction between a PSBR next year of £8½ billion resulting from real tax cuts in the Budget, and the same figure resulting from a strictly neutral Budget. At this early stage there were some indications that a neutral Budget might be consistent with a PSBR of something less than £8½ billion, though the first print out from the forecast would not be ready until 23 or 24 January.

2. Tax Issues

Balance of the Budget

Two main conclusions:

(a) Within a broadly neutral Budget there were no compelling reasons this year to suggest tilting the net balance between companies and persons one way or the other;

(b) Nevertheless, the composition of the Budget would be crucially important: in particular, it would be important to include tax changes designed to reinforce the Government's main strategic aims for the supply side, the tax base and the level of income tax thresholds.

Income tax thresholds

The forecast would assume simple indexation in line with prices. There was a case for regarding earnings indexation (plus 1½ per cent real: Option 1) as a minimum objective - avoiding increasing income tax relative to earnings, avoiding staff increases, and so on. A case could also be made for a larger real increase in thresholds if that made it possible to abolish (either fully or in part) some other outdated allowances and reliefs. Thus, moving to Option 2, combined with ending the minor personal allowances, the foreign earnings deduction and the foreign emoluments deduction, appeared to involve only an extra net PSBR cost over Option 1 in 1984-85 of something like £70 million. Decisions on personal allowances and thresholds would need to be made in the light of the wider Budget arithmetic. For the present, the various options should remain open. It should be assumed, subject to the next paragraph, that the higher rate threshold and bands, and the IIS threshold, would increase by the same percentage as applied to the main personal allowances (though abolition of the IIS remained the eventual objective).

A "combined" package

Further urgent work was needed on the possibilities of a package combining abolition of the National Insurance UEL and the NIS with a 10 point reduction in higher rates of income tax. The initial results (Mr Monger's note of 13 January) should be refined in two ways: by reducing the income limits for the age allowance (rather than the quantum of allowance); and to explore the net effect on losers of various real increases in the main personal allowances. The emergence of a satisfactory package on these lines would override the provisional conclusions in the preceding paragraph.

Child benefit

The balance of argument seemed to point towards settling child benefit along with other social security benefits in the late spring rather than at the time of the Budget. The possibility of taxing child benefit was raised; but there was little enthusiasm for that. The Inland Revenue would provide a note.

Other income tax matters

(a) Pension Funds and Superannuation It was agreed to rule out any major action on this front until after Mr Fowler's enquiry on pensions.

(b) Life Assurance. There were attractions in withdrawing life assurance premium relief for new policies at a revenue gain of some £100 m in the first year; but the possibility of phasing out relief on existing policies should receive further consideration. Final decisions should wait until after discussion with the Secretary of State for Industry and Trade.

(c) Share Options. Improving the tax treatment was a high priority. Various options costing £25-40 million were being examined. The Financial Secretary would report back.

(d) Mortgage interest ceiling. There was no case for raising this again this year.

(e) Business Expansion Scheme. Action should be taken to close the agricultural loophole.

Company taxation

It was desirable to move on stock relief and capital allowances in the 1984 and subsequent Budgets on the lines so far suggested. (It would be important to announce from the outset what the long term aim of the phased programme would be - though it would not be possible to be specific about the precise phasing.) But further consideration needed to be given to very short life assets; to whether (eventually) 4 per cent writing down allowances for industrial buildings was adequate to meet replacement cost; and to the possibility of continuing to apply the (reduced) capital allowance regime to films after 1987. There was no substantial discussion of the Corporation Tax rate or of NIS (except in the context of a "combined" National Insurance and income tax package). Some modest reduction in the small companies rate, alongside any larger reduction in the main Corporation Tax rate, was not ruled out.

Building Societies

The preference for dealing with building societies' gilts transactions by litigation (subject to Counsel's opinion) other than legislation was confirmed. The case for considering a change in the special 40 per cent rate alongside timing of changes in the main Corporation Tax rate was also noted.

North Sea Taxation

There was no case for further major structural changes this year.

Capital taxes

CGT and CTT. There seemed no need this year to go beyond revalorisation of the thresholds. There were attractions in reducing the CTT top rate to 60 per cent at small revenue cost; this would need to be considered when the scope of the Budget was clearer.

Development Land Tax. This was not a priority for action this year.

Stamp Duties. Subject to any further ideas from the Stock Exchange about a possible transactions tax, reducing the duty on share transfers to 1 per cent was a high priority. There were also attractions in applying the same reduction to transfers of land and buildings to offset removal of VAT zero-rating from building alterations (see below). There was also a case for applying a very small rate of duty (eg 0.1 per cent) to gilts transactions.

VAT. The main conclusions here were:

(a) Some widening of the VAT base was a priority.

(b) There were attractions in a package removing zero-rating from newspapers, periodicals (but not books) etc; newspaper advertisements; and news services; building alterations, hot take-away food (possibly including some specified cold items). This offered a prospective yield of some £610 m in the first year and some £965 m in a full year. (The inclusion of books would add £60 m and £80 m.)

(c) Removing the postponed accounting system from imports offered a potential yield of up to £800 million and was very attractive. Customs & Excise would report urgently.

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17 January 1984

Chief Economic Adviser to the Treasury

Forecast, Budget Judgement, PSBR etc

Evans   Forecast 27/1

Financial Mkt 31/1

Public Finances 30/1

TB   Foreign Mkt 30/1

TB   PSBR + Monetary Ranges for MTFS 27/1

Tax Mkt 10/2

JOS   MTFS PSBR + M. ranges 10/2

HPE   PSBR forecasts 24/2

Bailey   P/E in FSBR 29/2

TB   PSBR Mkt 1/3

HPE   "

Bailey   P/E in FSBR 2/3

CST
FST
MST

Monck   PSBR 6/3

Stibbard   "   6/3

Forecast
– Finance
– FSBR   16/3

A66

CONFIDENTIAL

FROM: HUW EVANS
27 January 1984

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
PCC members
Mr Lankester
Mr Lavelle
Mr Monger
Mr Odling-Smee
Mr Scholar
Mr Watson
Mrs Lomax
Mr Mowl
Mr Riley
Mr Sedgwick
Mr Shields
Mr Ridley
Mr Lord
Mr Portillo

Sir L Airey - I/R
Mr Fraser - C/E

TREASURY ECONOMIC FORECAST

I attach a copy of the report on our (internal) January forecast, for discussion at the second Overview on 31 January. Mr Bottrill is today circulating a report on the world economy; and a report on oil will be round shortly.

2. The fiscal prospect, and the changes since the autumn forecast, are covered, in outline, on pages 2-4 of the introductory section of the attached report. More details will be available in a report on public sector finances to be circulated on Monday.

3. Over the next few weeks, we shall be re-working the public sector projections. Last year we set in train improvements designed to help with the problem of forecasting spending and borrowing in the last part of the financial year. This is likely to lead to changes in our estimate for 1983-84; and, together with other information, may lead to changes in our estimates for 1984-85.

4. More generally, the timetable provides for a draft of the forecast section in the FSBR to be circulated in the second half of February.

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H P EVANS

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CONFIDENTIAL

TREASURY ECONOMIC FORECAST

JANUARY 1984 REPORT

Contents	Page number

CONFIDENTIAL

TREASURY ECONOMIC FORECAST: JANUARY 1984 REPORT

Introduction and summary

This is the report on the internal forecast and describes our best view of the next two or three years. Separate reports are being produced on the prospects for the world economy, for public finances and for oil. More details on the UK forecast are available on request. A revised and updated forecast will be published on March 13 in the FSBR. The forecast is mainly concerned with 1984 and 1985, but has been tentatively extended into later years.

2. The Autumn Statement, including a short-term forecast, was published in mid November. Economic statistics available since then are, broadly, consistent with that forecast. In particular, the inflation rate remains low; while there has been even stronger growth in consumer demand, and an earlier than expected recovery in exports. The labour market is strengthening. But industrial output, at least on provisional estimates, is still showing only moderate recovery. The balance of payments, with revisions to earlier data, is in larger than expected surplus.

3. On the world economy we take a similar view to that of the IMF and OECD. It looks as though there may be several years of moderate growth and fairly low inflation:

Major 6*, per cent per annum

	1981-83	1983-85
GNP Growth	1	3½
Inflation	6	5

*US, Canada, Japan, Germany, France and Italy

4. But there are major worries about the world economy:

(i) the performance of most European economies continues poor with little progress likely on unemployment;

(ii) the size and duration of the US fiscal and trade deficits threaten turmoil in financial markets.

5. The fiscal prospect is set out in some detail in a separate report, essential reading for a full understanding of public finances in the forecast. For 1983-84 our estimates of the PSBR made from July onwards have moved within the narrow range of £10-11 billion. The precise figure in this forecast is £10.5 billion but that is likely to change as further information, including the new expenditure returns, becomes available over the next few weeks. This estimate assumes that EC refunds of about £½ billion will benefit the CGBR before the end of March. This is one of the main uncertainties about 1983-84, together with local authority borrowing and central government spending.

6. Our forecast of the PSBR and the fiscal adjustment are summarised in the table below:

£ billions

	1982-83	1983-84	1984-85	1985-86
PSBR	9	10½	8	8
(per cent of GDP)	(3¾)	(3½)	(2½)	(2¼)
Fiscal Adjustment	-	-	1	5

7. Subject to a margin of error of several billions either way, our latest forecast suggests that a 2½ per cent PSBR, equivalent to £8 billion, is consistent with a cut in taxes - relative to full revalorisation - of about £1 billion in 1984-85. Subject to even larger errors, our assessment of 1985-86 is that there might be scope for a further £4 billion tax cut (cumulatively £5 billion) on the assumption of a 2¼ per cent PSBR.

8. The forecast for 1984-85 is based on:

(i) full revalorisation of direct and indirect taxes by 5.3 per cent;

(ii) asset sales of £2 billion;

(iii) a full spend of the £2¾ billion reserve on public expenditure. This difficult judgment assumes:

a normal level of contingencies (£¾ billion);
overspending by local authorities of about £1 billion (highly uncertain in the present climate);
overspending on demand-led programmes (much of it social security) of £1 billion; offset by a normal, nearly £½ billion, degree of underspending on cash limited expenditure.

9. The change in the fiscal adjustment since the Autumn Statement mainly reflects increased revenue:

i) Higher North Sea oil receipts (over £½ billion) on account of higher production and higher sterling oil prices (reflecting the higher value of the dollar).

ii) Higher receipts (£1 billion) from personal income tax and national insurance contributions (partly higher employment, partly estimating changes).

iii) Higher receipts (£¼ billion) from Customs taxes because of higher consumer spending.

10. The forecast for 1985-86 is based on:

i) revalorisation of 4½ per cent;

ii) asset sales of £2 billion;

iii) no change in the contribution rates for National Insurance - even though there is a surplus forecast of £1-1½ billion (much the same, we think, as in 1984-85).

iv) A full spend of the reserve of £3¾ billion.

11. On the basis of the public expenditure plans for 1985-86, which show a 4½ per cent increase in cash terms, equivalent on this forecast to little change in cost terms, the growth in onshore revenues induced by a 2½ per cent expansion of the economy provides the basis for the sizeable fiscal adjustment, equivalent to about 1 per cent of GDP, despite the beginnings

of a fall in North Sea revenues. This position in 1985-86 has been a feature of all recent forecasts, although its size is obviously highly uncertain. It is crucially dependent on keeping public expenditure constant in real terms and on growth in the economy.

12. The assumptions of a gradual fall in the PSBR and in the growth rate of the main monetary aggregates points to a continuing slow decline in the growth of money GDP:

	1982-83	1983-84	1984-85	1985-86
PSBR, percentage of GDP	3¼	3½	2½	2¼
Growth rates				
£M3	11	11	9	8½
MO	4	7	6½	6
Money GDP	9	8½	8	6½

13. Growth of nominal income is generally more stable than that of the monetary aggregates, and consequently somewhat less difficult to forecast. The split of money GDP between quantity and price might be as follows:

	growth rates, per cent			
	1982-83	1983-84	1984-85	1985-86
Output	2½	3	3	2½
Prices	6½	5	5	4

14. The broad picture on the demand side is of export growth offsetting for 1984, but not fully for 1985 and beyond, the slowdown in the growth of domestic demand. Consistently with recent and prospective increases in profitability, the recovery continues through 1984 and into 1985:

per cent changes on a year earlier

	1982	1983	1984	1985
Domestic demand	3	4½	3½	2½
of which consumer spending	1½	3½	3½	3
Exports	1½	1	5	3
Imports	3	5	7½	4
Total output (GDP)	2	3	3	2½

15. There may be a gentle fall in unemployment in 1984. After 1985, with oil production expected to fall, the growth of the UK economy consistent with no change in unemployment may be no more than 1½ per cent per annum. For both cyclical and trend reasons, growth in the economy may slow further after 1985.

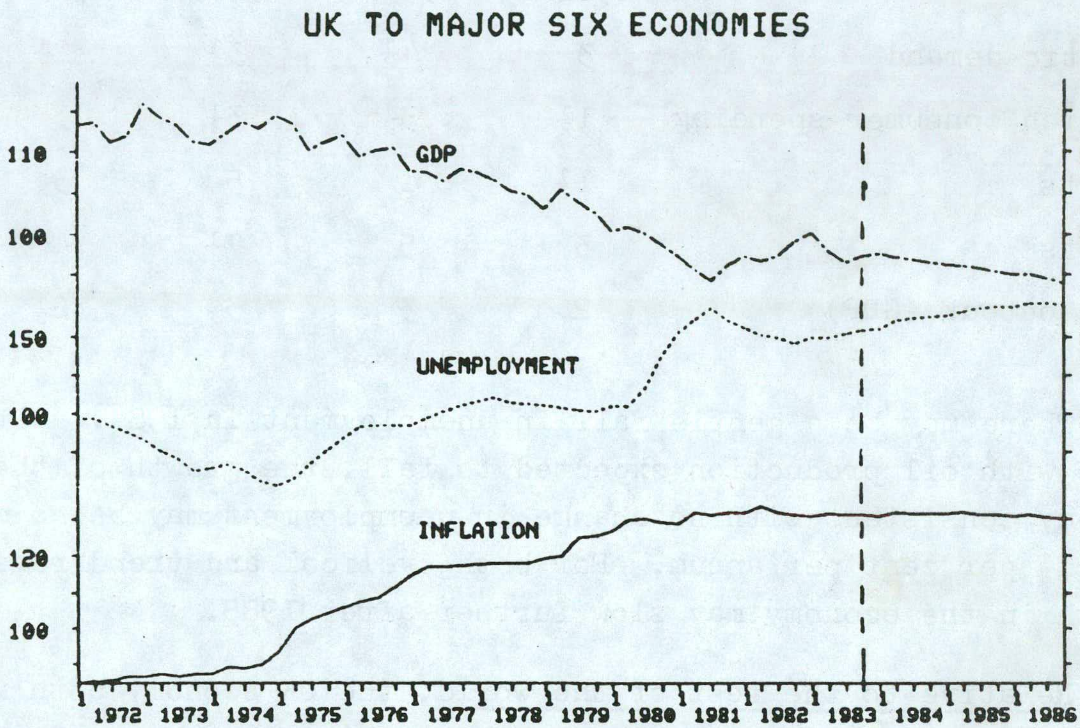
16. Relative to the rest of the world, the UK economy both went into and is recovering from recession earlier than most other countries. The comparisons over a longer time span are as follows:

per cent per annum

	1964-73	1973-79	1979-83	1983-85
major 6	5.3	2.9	1.3	3½
UK	2.9	1.3	0.2	2¾
UK less oil	2.9	0.6	-0.3	3

Thus the forecast of UK output growth shows a smaller gap than in most past periods, especially when oil is excluded.

17. The chart below shows that UK prices are no longer rising faster than the rest of the world, and that the fall in unemployment in other countries (dominated by the USA) is now, and is expected to remain, greater than in the UK.



18. Monetary growth is assumed to decline slowly, but with the growth of money incomes tending to fall slowly the forecast for activity and prices should be consistent with a fall in interest rates. The extent and timing is bound to be heavily affected by US and other rates and by the movement of the exchange rate but some time in 1984, as inflationary expectations decline, there may be scope for a further fall in interest rates.

19. The uncertainties in this forecast are best illustrated by the average errors from past forecasts:

	Forecast	Average errors* calculated from: Last 10-15 years	Last five Budget forecasts
GDP growth, 1984 on 1983	3	1	½
RPI rise to the fourth quarter of 1984	4½	2	1½
Current account of balance of payments 1984, £ billion	1½	2	2½
PSBR, 1984-85, per cent of GDP	2½	1½	1
(£ billion equivalent in brackets)		(4½)	(3)

*applicable to forecasts made at Budget time

20. There are, as always, some obvious risks attached to this forecast. One that has been highlighted by outside forecasts - wrongly so far - is on inflation. Two recent pieces of information may give cause for concern: the sharp rise [NB CONFIDENTIAL until 31 January] in the CBI balance of firms expecting prices to rise; and the indications from the CBI of an increase in wage settlements in manufacturing in recent months. The CBI balances do not have a very good track record as a forward indicator, and the CBI information on wage settlements is probably less reliable than the data from the DE's economy-wide (but unpublished and confidential) series for wage settlements which suggests little change in wage settlements in recent months. Were the recent combination of sharp rises in exports and consumer spending to continue for long then domestic inflation could be a problem. Otherwise, the main risk to the inflation forecast perhaps lies with the exchange rate.

SUMMARY TABLE AND COMPARISON OF FORECASTS

	FSBR/MTFS MARCH 1983	AUTUMN STATEMENT	JANUARY 1984
World Trade in Manufactures			
(% change on year earlier)			
1982	- 3½	- 3	- 3
1983	1	- ½	1
1984	6½	5½	4½
1985	6½	6½	5
GDP Volume			
(% change on year earlier)			
1981	- 2½	- 1½	- 1½
1982	½	2	2
1983	2	3	3
1984	2½	3	3
1985	2½		2½
Manufacturing Output			
(% change on year earlier)			
1981	- 6½	- 6½	- 6½
1982	- ½	½	0
1983	2	1½	1
1984	2½	3	2½
1985	2	1½	1½
Unemployment			
(UK sa excluding school leavers, millions, new definition)			
1982 Q1	2.7	2.7	2.7
1983 Q1	3.0	3.0	3.0
1984 Q1	2.9	2.9	2.9
1985 Q1	3.0	2.9	2.8
1986 Q1	3.0	2.8	2.8

	FSBR/MTFS MARCH 1983	AUTUMN STATEMENT	JANUARY 1984
RPI (% change on year earlier)			
1981 Q4	12	12	12
1982 Q4	6	6	6
1983 Q4	6	5	5
1984 Q4	5½	4½	4½
1985 Q4	5	4½	4
Effective Exchange Rate 1975 = 100			
1981	95	95	95
1982	91	91	91
1983	81	83	83
1984	82	84	83
1985	81	83	83
Current Balance (£ billion)			
1981	6	6½	6½
1982	4	5½	5½
1983	1½	½	2
1984	1½	0	1½
1985	- ½	1	½
Nominal GDP (mp) (% change on year earlier)			
1981	9½	9½	9½
1982	9	9½	9½
1983	7½	8½	8½
1984	8½	8	8½
1985	8	7½	7

	FSBR/MTFS MARCH 1983	AUTUMN STATEMENT	JANUARY 1984
PSBR and Fiscal Adjustment (£ billion)			
1981-82	8½	9	9
1982-83	7½	9	9
1983-84	8	10	10½
1984-85	8 (½)	8 (- ½)	8 (1)
1985-86	7 (4)	7 (4)	8 (5)
Interest Rates Short-term per cent			
1981-82	14	14	14
1982-83	11½	11½	11½
1983-84	9½	9½	9½
1984-85	8	8½	8½
1985-86	7½	8	8
Money Supply £M3 (% change on year earlier)			
1981-82 target period	13½	13½	13
1982-83 " "	9½	10	11
1983-84 " "	9	10½	11
1984-85 " "	9	10	9
1985-86 " "	8	8½	8½
Money Supply £M0 (% change on year earlier)			
1981-82 target period	N/A	N/A	2½
1982-83 " "	N/A	N/A	4
1983-84 " "	N/A	N/A	7
1984-85 " "	N/A	N/A	6½
1985-86 " "	N/A	N/A	6

The world economy

21. Our forecast for the UK is conditional on the assumption that existing policies will be maintained. For other countries we attempt an unconditional forecast: our best guess at what will actually happen. This involves judgments about policy developments abroad, and in particular about the US.

22. Like nearly all commentators, we judge that the deficits on the Federal Government budget and on the current balance of payments are not sustainable. In the case of the government deficit, the ratio of government debt to national income is continuing to rise strongly and sooner or later will be curbed, either with a lower nominal deficit or by faster growth of nominal income (mainly through inflation) or both. In the case of the current account deficit the rest of the world's dollar assets are rising at a rate that cannot be sustained indefinitely.

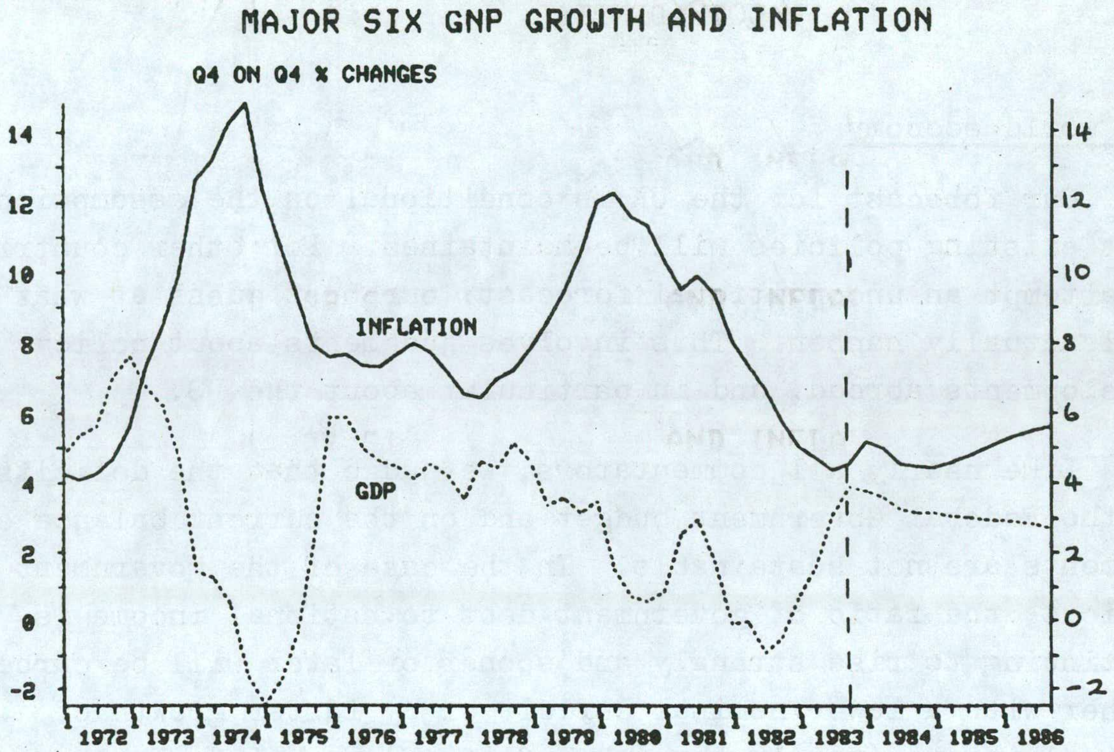
23. In our main forecast we assume that there is some fiscal tightening after the Presidential election, to affect mainly 1986 and beyond. This slows growth and helps to limit the rise in inflation stemming partly from what may be a considerable fall in the dollar though we have no way of judging the timing. In Europe efforts to reduce structural budget deficits continue, and growth picks up only slowly.

24. The forecast for output, inflation and trade is summarised in the following table and chart:

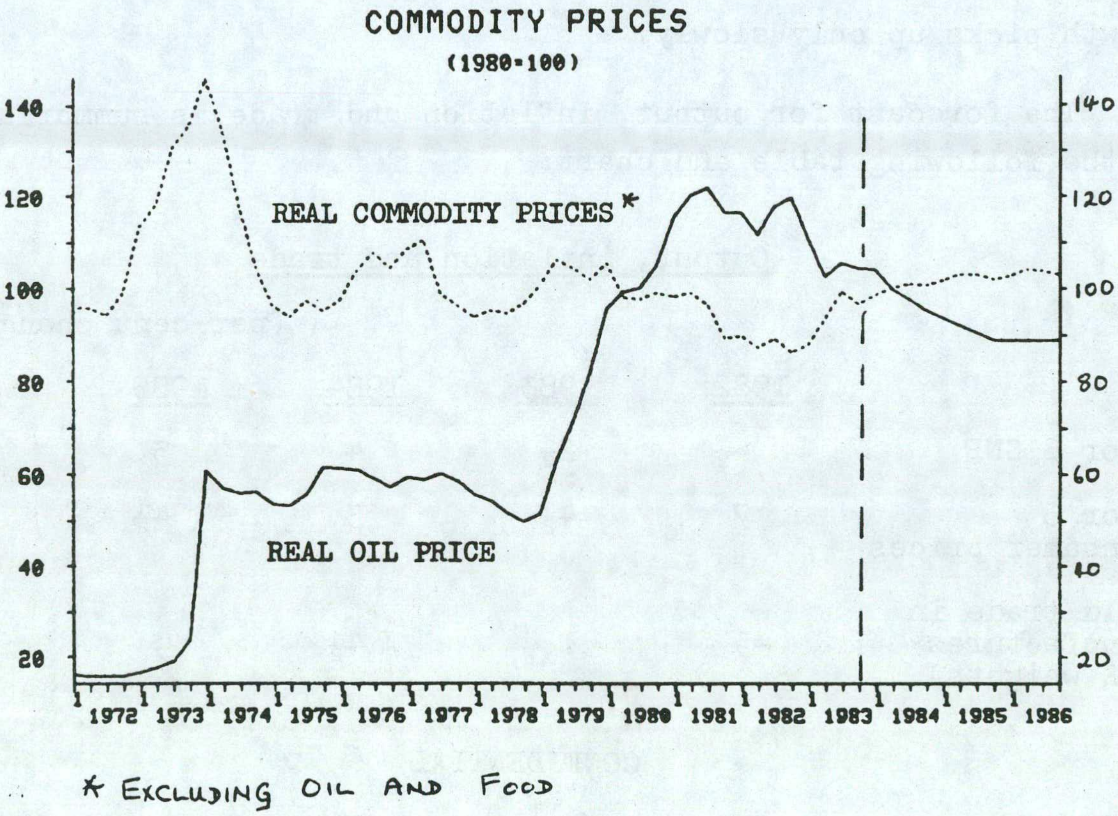
Output, inflation and trade

(per cent changes)

	1982	1983	1984	1985
Major 6 GNP	-½	2½	4	3
Major 6 consumer prices	7	4½	5	4½
World trade in manufactures (UK weights)	-3	1	4½	5



25. There may be some further rise, relative to the general rate of inflation, in prices of industrial materials as industrial production rises 4-5 per cent a year in the OECD. But the scale is modest. For oil, potential supply continues to exceed demand and the real price may continue to fall for another two years or so. Except for oil producers, many developing countries are improving their debt/income and debt servicing positions, and so contributing to the rise in world trade.



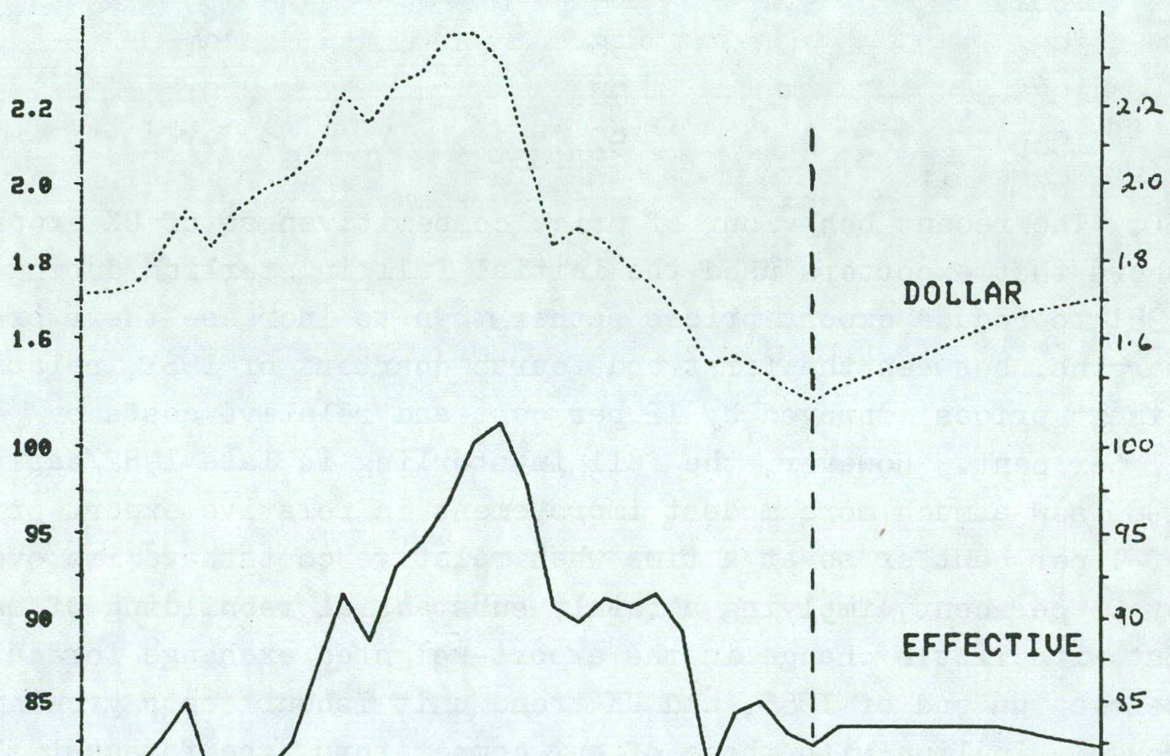
* EXCLUDING OIL AND FOOD

The exchange rate and relative costs

26. Over the past year or so sterling has been falling against the dollar and rising against most European currencies - a pattern which we expect to be reversed over the forecast period. The current level of the effective exchange rate is close to that in the first half of 1983.

27. In projecting a broadly flat effective rate at a level of around 83, we have taken account of forward rates (in the short term), of the path of oil prices (constant in depreciating dollar terms until end 1985), the continuing surplus on the current account, the further fall in UK inflation, and the likely pattern of capital flows. Oil production, expected to decline from 1985 (possibly by 20 per cent by 1988) may lead to some modest fall in the rate beyond 1985 though much of this, and perhaps all, may already be discounted in the current value of the exchange rate.

STERLING EFFECTIVE EXCHANGE RATE AND DOLLAR RATE



28. Tentatively - because we have said this before and been wrong - we see sterling rising against the dollar and falling against the deutschmark. Because of the smaller weight of the dollar, the export weighted index falls a little in the forecast (2 per cent between 1983 and 1985, compared with no change forecast for the effective rate). Thus the weighting of different exchange rates can make some difference when there are sharp movements in cross rates, and the weights used in the effective rate are not always appropriate. But the effect is not large relative to the uncertainties involved in exchange rate forecasting.

29. The table below shows our projections of relative costs and prices:

1980 = 100

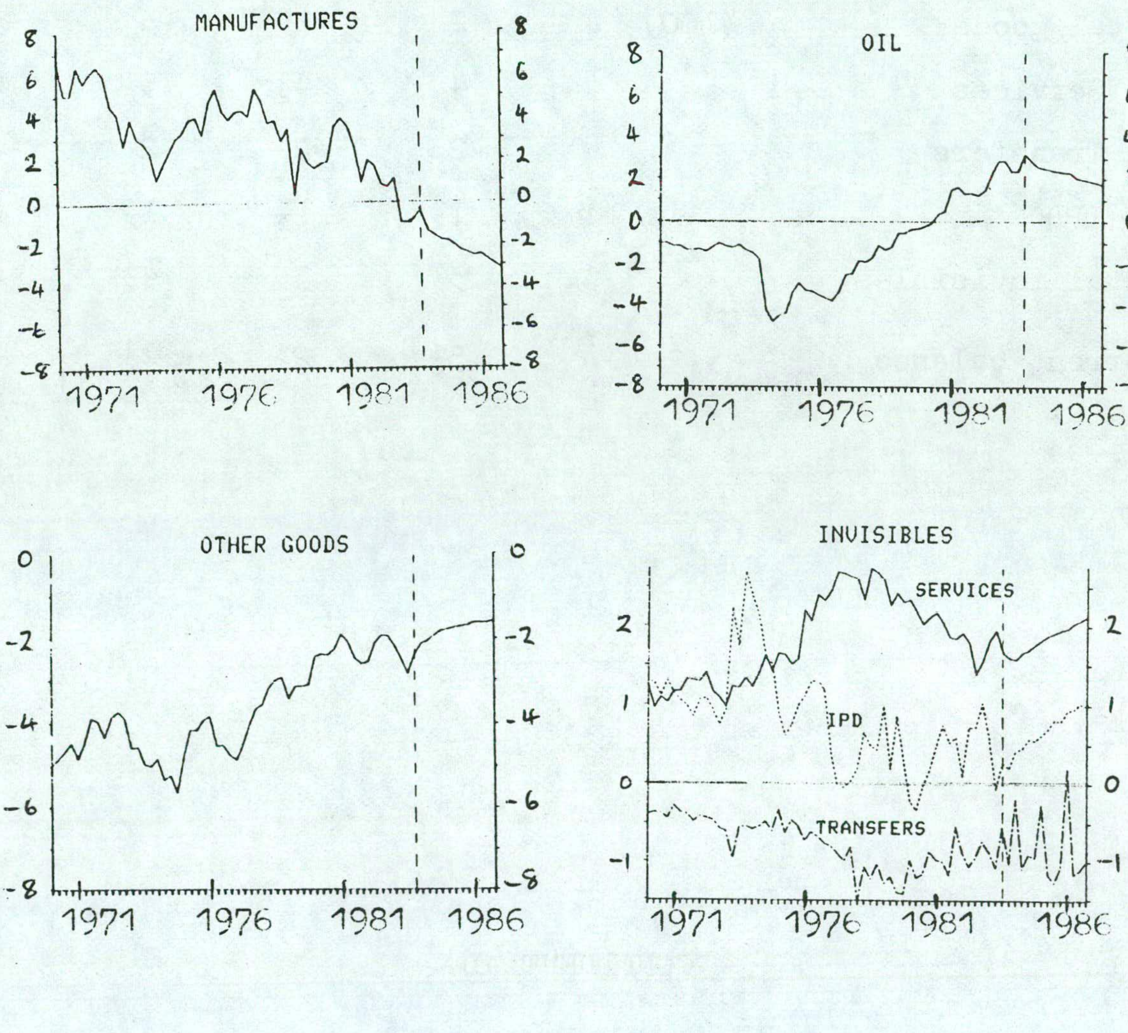
	Relative unit labour costs	Relative export prices
1970-1980 average	75	83
1981	108	98
1982	104	93
1983	96	91
1984	98	91
1985	97	91

30. The recent behaviour of price competitiveness of UK exports shows that exporters used the initial fall in sterling during 1981 to reduce export prices rather than to increase their profit margins: between the first and fourth quarters of 1981, relative export prices improved by 12 per cent and relative costs by 11 per cent. However, the fall in sterling in late 1982/early 1983 saw a much more modest improvement in relative export prices of 1 per cent or so at a time when relative costs have improved by $5\frac{1}{2}$ per cent, implying a fairly substantial rebuilding of margins. But with little change in the export-weighted exchange forecast before the end of 1985, and UK trend unit labour costs growing roughly in line with those of our competitors, the forecast shows little further change in relative export prices or relative labour costs in the next couple of years.

Trade and the balance of payments

31. The large current account surpluses of 1981 and 1982 were succeeded by a moderate surplus in 1983. We expect no major change over the next few years, although forecasting errors and data revisions tend to be large.

32. The changing composition of the current account is shown in the charts below. These show the balances on the main items as a proportion of GDP. (Note that the scale of the two lower charts is larger than the scale of the top two). Since the early 1970s the balance on manufactures has been declining, and is now negative and expected to stay negative, while other goods and services show a generally rising trend. Beyond 1985, as the oil balance declines, and - we think - the other trends continue, there could be some worsening in the overall current account.



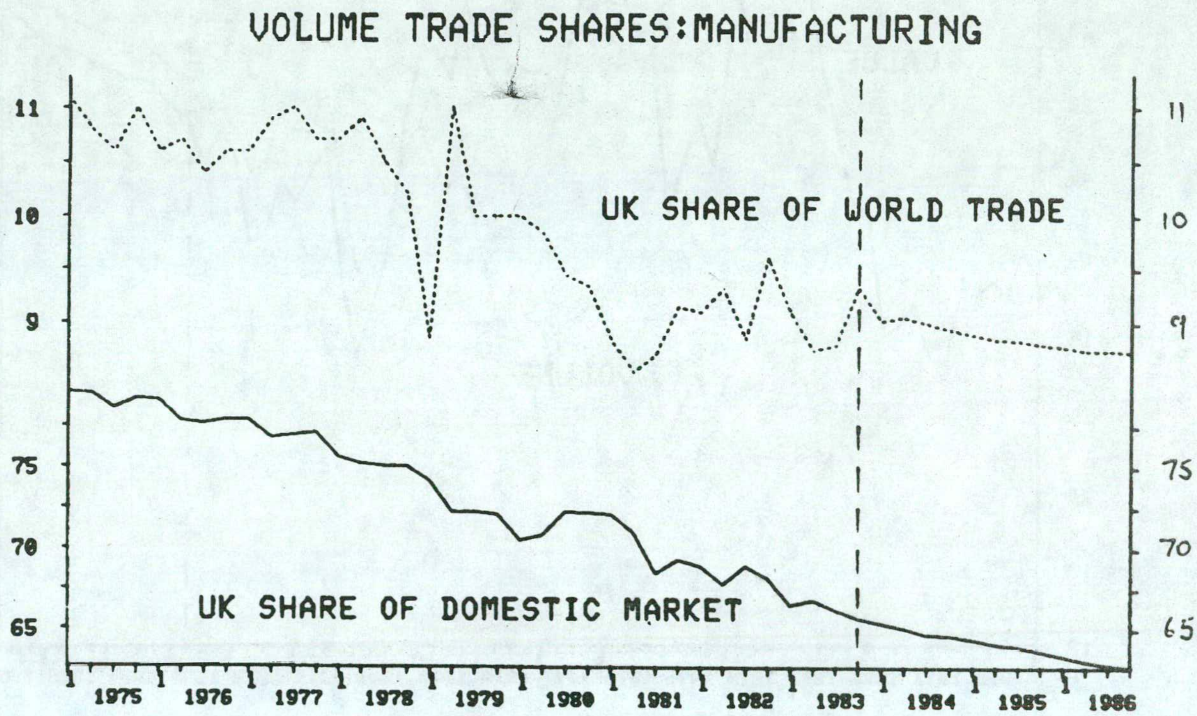
33. The charts give an impression of the longer-term trends. The table below shows our forecast of the balances by sector for the recent past and the next two years:

Surpluses and deficits, £ billion

	(per cent of total goods)	1982	1983	1984	1985
Fuel	(17)	4½	7	7	6½
Manufactures	(66)	2½	-2	-4½	-7
Other goods	(17)	-5	-6½	-5½	-5
Total goods	(100)	2	-1	-3	-5½
Services		4	4½	5½	6½
Transfers		-2	-2	-2	-2½
IPD		1½	½	1½	2
Total invisibles		3½	3	4½	6
Current balance		5½	2	1½	½

34. The prospects for oil reflect the path of production which is expected to peak in 1984 or 1985 and the continued weakness in oil prices through the forecast period (see chart on page). A separate note on the forecasts for oil production and revenues will be circulated by MP2. For goods excluding oil and manufactures, there has been a persistent decline in the deficit, reflecting increasing UK exports of food and some other non-manufactures, and a fall in the propensity to import food and basic materials.

35. The balance on manufactures turned into deficit in 1983. This tendency was inevitable, given the swing in the oil balance (unless the whole of the gains from oil had been invested abroad); a moderate decline in the oil surplus and a rising surplus on other goods and on services suggest that the balance on manufactures is likely to stay in (increasing) deficit. But these arithmetical calculations tell us nothing about the level of domestic output, nor about the level of the exchange rate, likely to be consistent with this overall picture. In volume terms, imports have been increasing their share of the UK market for manufactures for many years; and the UK has tended to lose share in overseas markets.



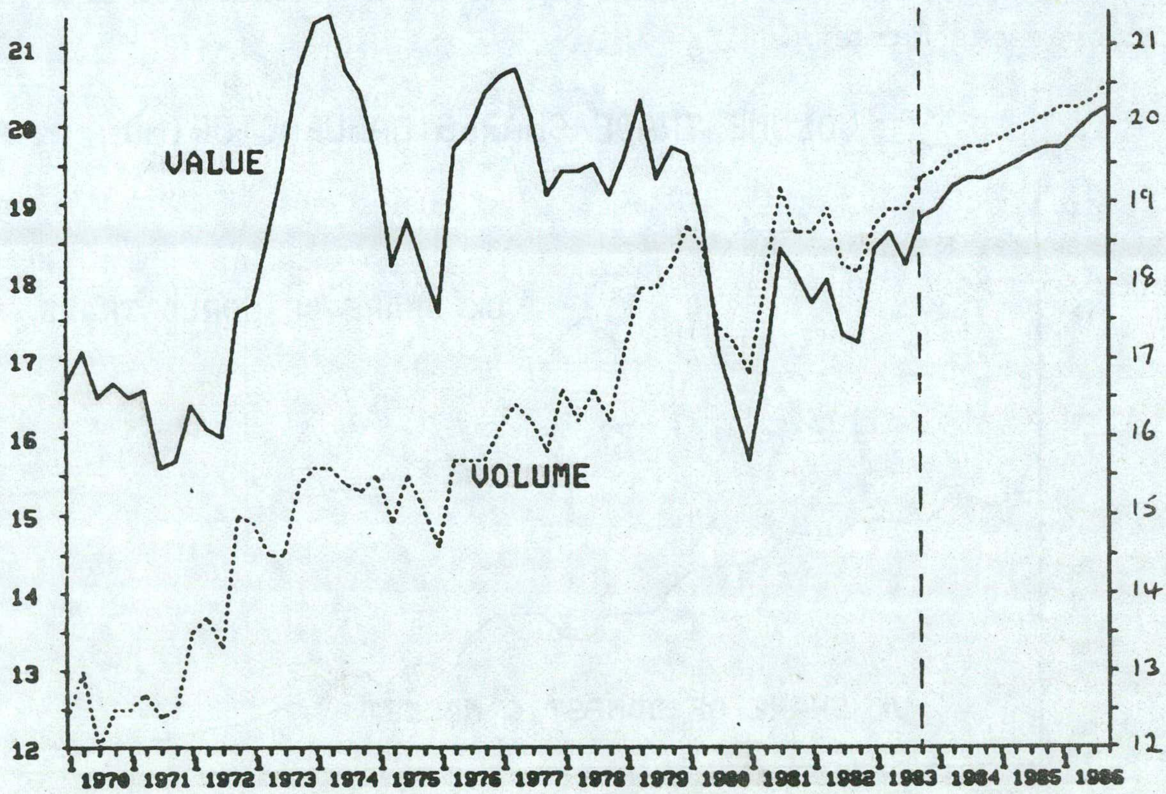
36. The decline since the early 1970s in UK volume shares in manufacturing has been mitigated by two factors:

(i) a low growth in demand for manufactures in the UK, relative to the demand for goods and services in total.

(ii) A gain in the terms of trade - also known as a loss of price and cost competitiveness.

37. The overall picture for import penetration is shown in the chart below. In volume terms there was a slower rise in import penetration economy-wide than for manufactures alone; while in value terms there have been large fluctuations but no major trend. Comparing where we are now with 1972 suggests some upward trend in the value share (continued in the forecast) **after** allowance is made for the commodity price booms of 1973-4 and 1977 and for the tendency for the pressure of demand in the UK, relative to the rest of the world, to fall between 1973 and 1983.

IMPORT PENETRATION EXCL.FUEL (% OF TFE)



38. The fluctuations in export volumes have continued into recent months: after low figures in the middle quarters of 1983, recent monthly figures have risen sharply and the fourth quarter was some 5 per cent above the annual average. But the seasonal adjustment could be at fault and we have therefore discounted, to some extent, the fourth quarter level of exports as a starting point for the forecast.

39. For 1984 and 1985 we foresee a fairly rapid rate of growth of exports of manufactures as the world recovery continues against a background of recent improvements in cost competitiveness for UK products. For imports of manufactures, some fall on the rapid growth rate seen this year seems likely in 1984, while in 1985 the slower growth in the domestic demand for manufactures should restrain import growth.

40. The outlook for trade prices is important both for the balance of payments and for domestic inflation. Overall, the terms of trade (less fuel) have hardly changed over the last three years: the fall in sterling has been offset (at least until 1983) by falls in the world terms of trade between commodities and manufactures; and by importers into the UK cutting their profit margins (which were very high in early 1981) until now it looks as though, taking manufactures and non-manufactures together, importers are charging prices in the UK which are not out of line with those charged elsewhere. (This also implies that were sterling to fall there would probably be somewhat more effect on the domestic price level than was observed in the period 1981-3).

41. Overall the terms of trade are not expected to change much, with both import and export prices rising at an annual rate of about 5 per cent, compared with a rise of 10 per cent in import prices in 1983.

42. The invisibles balance - made up of services, transfers, and net interest, profits and dividends - has, so far, shown disappointingly little improvement. The build up of UK owned foreign assets, from a net £20 billion at end-1980 to an

estimated £70 billion by end-1983, has been accompanied by little growth in net IPD. This may reflect, in part, the inadequacy of the provisional statistics for 1983. Genuine factors include the falls in world interest rates since 1981 and the emergence of the UK from recession earlier than other countries (and hence an earlier rise in UK profits and thus debits). Ignoring, to a considerable extent, the message of the 1983 IPD statistics (which imply a very low return on UK owned assets abroad), the forecast sees a substantial growth year by year. The services balance, as a percent of GDP, should rise as recovery in the rest of the world continues, but, as the chart on page 15 shows, by 1986 the balance in real terms, is still below the level in the late 1970s.

43. Overall, the current account surplus in 1983 is put at some £2 billion; the proposed change in treatment of gold will raise that by £½ billion or so; and it would not be surprising if there were upward revisions (common in earlier years) to early estimates of the surplus on invisibles, particularly IPD. There is not much change in the current account surplus for 1984 and a small decline in 1985. Very broadly, this reflects growth in the UK which is a little less than in the industrialised countries as a whole, with no major change in commodity prices. Beyond 1985 the tendency for the current account to worsen may continue as oil production falls. But that will be only one influence amongst many.

Demand and activity

44. The personal sector's spending, particularly on consumer durables and dwellings, has been rising rapidly since early 1982. By the end of 1983, the volume of total consumer spending was some 7 per cent higher than in early 1982, with durable spending up 40 per cent. Over this period the real income, after tax, of the personal sector rose by only about 3 per cent.

45. While we can explain the modest rise in non-durable spending over this period in terms of the rise in income and falls in inflation and interest rates, the boom in durables has been considerably stronger than we, or our equations, foresaw. Consumers have taken on extra debt - from banks, building societies and shops - in order to finance the fall in the savings ratio. A sharp improvement in consumer confidence since 1982 has reflected: the resumption of a rise in real incomes, particularly for those in work; lower inflation and interest rates; as well as a strengthening of asset prices. We made some allowance for this in earlier forecasts - considerably more than most outside forecasters - but the fall in the saving ratio has been quicker than we expected.

46. The forecast for consumer spending takes account of the flows in income and saving, together with analysis of the stock of wealth implied by the flows and revaluations. In the absence of major shocks, the prospects are for continued real growth in after-tax income, as the rise in earnings remains above price inflation and as employment grows slowly. (A lower growth in real wages, much of which would be offset in the medium term by higher employment, would probably affect the distribution of income between those in and those out of work, as much as the total income of the personal sector). From 1985-86 in particular, the forecast/assumption of a substantial cut in income tax - dependent on keeping public expenditure roughly constant in real terms - allows faster growth in real incomes, which is the main factor behind the rise in consumer demand over the next few years.

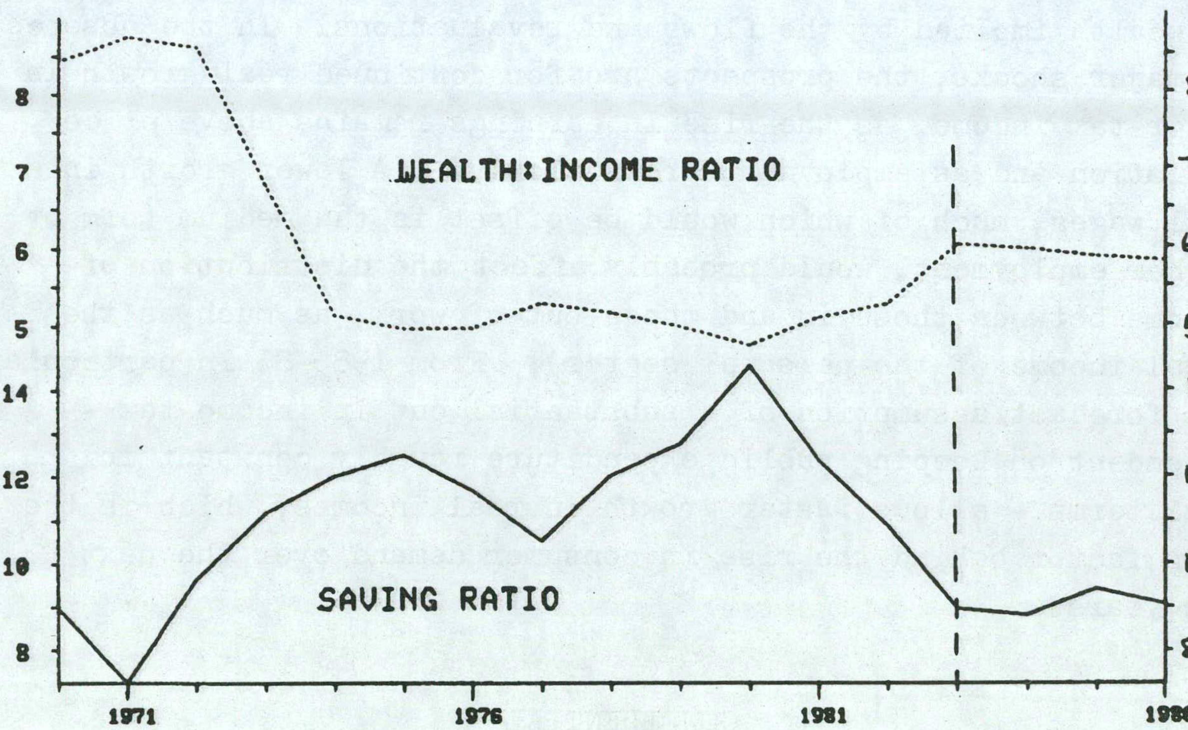
per cent changes on a year earlier

	Real Personal disposable income	Expenditure (constant prices) on: durables	non-durables	dwellings
1982	0	8	1	7
1983	1½	18	2	22
1984	3½ (½)*	9	3½	5
1985	3½ (1½)*	-1	3½	5

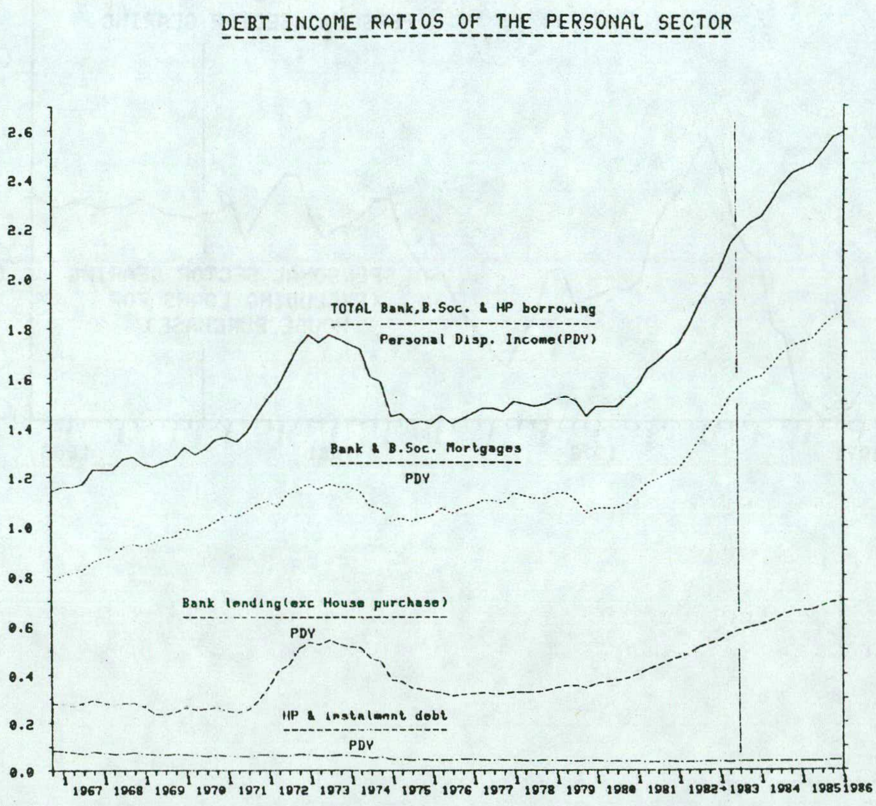
*of which fiscal adjustment.

47. Personal sector spending may grow broadly in line with incomes in 1984 and 1985, consistently with little change in the ratio of net financial wealth to income, as falls in interest rates and rises in asset prices increase personal sector wealth. A roughly constant saving ratio reflects the opposite influences of the strong rise in real incomes and the fall in inflation. Investment in dwellings has been helped by the rapid growth in housing improvement grants but investment in new housing is also strengthening.

SAVING RATIO AND WEALTH:INCOME RATIO

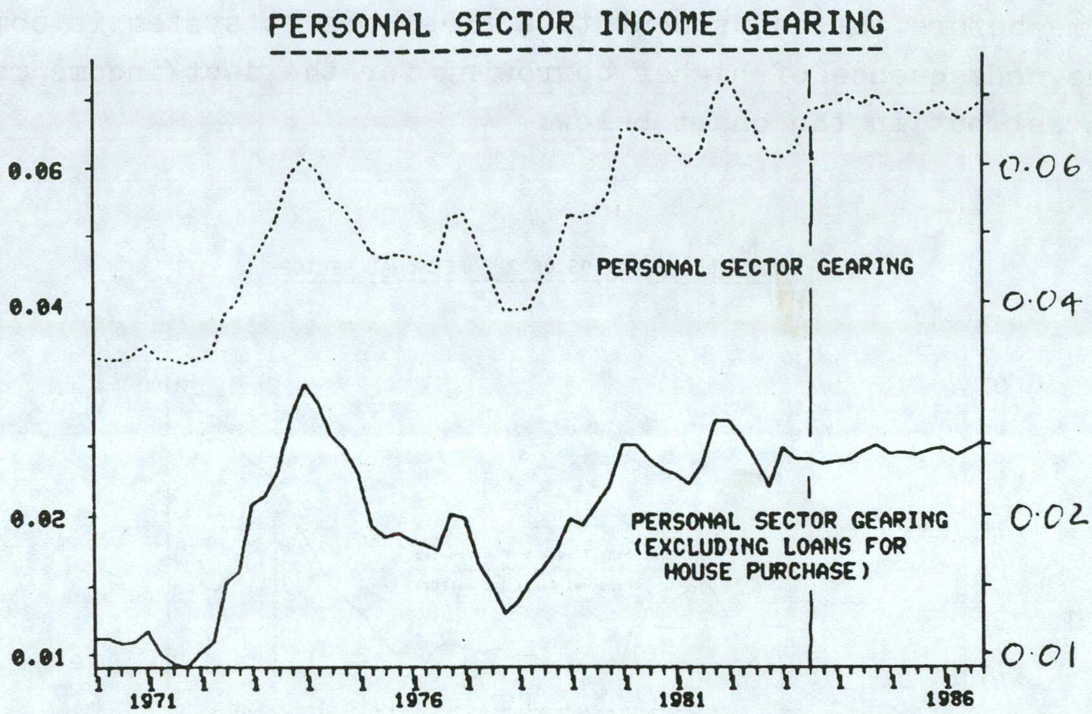


48. This forecast of consumer spending and saving is reflected in continued growth of debt, at a slower rate than in recent years, but still well above the growth of income. We have little idea how far or fast this will go: it may yet be some time before the adjustment to a freer credit system is complete. The consequence of higher borrowing for the debt/income ratios is set out in the chart below:



49. The historically high levels of the debt/income ratio suggest that the personal sector could be more vulnerable to rises in interest rates - and possibly more volatile in its spending - than in the past. But there do not seem to be any obvious limits in the short or medium term.

50. While the stock of debt continues to rise in relation to income, the fall in interest rates means that the level of interest payments, in relation to income, has not risen further since 1981, and no substantial change is envisaged:


PERSONAL SECTOR INCOME GEARING
0.06
0.04
0.02
0.01
0·06
0·04
0·02
0·01
PERSONAL SECTOR GEARING
PERSONAL SECTOR GEARING
(EXCLUDING LOANS FOR
HOUSE PURCHASE)
1971
1976
1981
1986

The company sector

51. All the evidence points to a rapid increase in company profits since the low point of early 1981, reflecting both higher domestic sales and better margins at home and overseas. In real terms, the level of profits, excluding North Sea operations, has risen by over one third, back to the level of early 1980. Companies have increased their spending since 1981, but more slowly than income, and so improved their liquidity position. Bank borrowing declined in 1983.

52. It is difficult to go beyond these very general statements because of the size of the discrepancies in the company sector statistics (the "balancing item") in the national accounts:

Industrial and commercial companies (including oil), £ billion

	Financial surplus	Other identified financial* transactions	Balancing item	Borrowing requirement
1981	2½	-4½	-2	4**
1982	2	-4½	-5	8½**
1983 (first three quarters, annual rate)	6½	-5½	-8	7

* including investment abroad

** including effects of CS strike (reduced borrowing by perhaps £2 billion in 1981 and increased it by a similar amount in 1982)

Thus companies borrowed much more in 1982 and 1983 than can be explained by identified transactions, and built up their liquid assets.

53. The CSO are investigating the reasons for these large discrepancies. While columns 1, 2 and 4 are all subject to measurement error, other financial transactions, column 2, may

well be most vulnerable: we have assumed that much of the balancing item represents unrecorded outflows of capital.

54. Our forecast shows business investment rising in 1984, and in 1985 more strongly, especially in manufacturing, than presently indicated by the DTI's intentions inquiry:

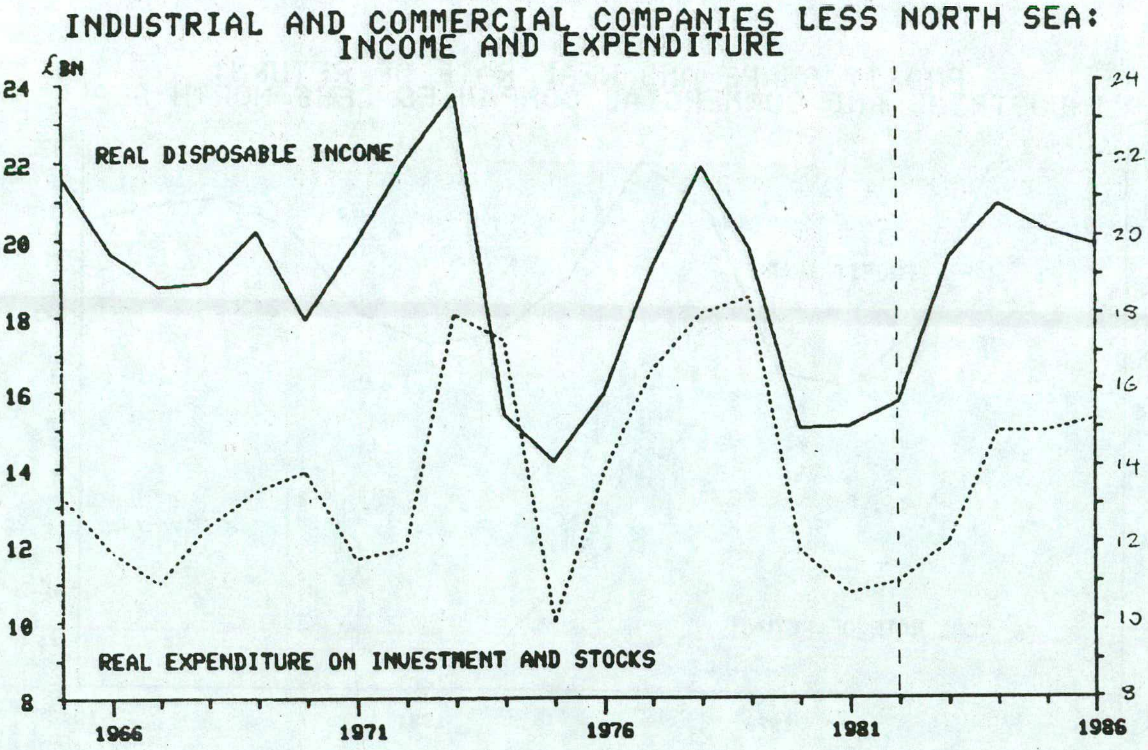
<u>Business investment</u>, constant prices

	level in 1982 £ billion	per cent changes on a year earlier			
		1982	1983	1984	1985
Manufacturing (including leased assets)	6	-5	-5	9½ [9½]	7 [0]
Other (excluding assets leased to manufacturers)	14	8½	6½	7 [7]	7 [5]

[ ] indicates DTI intentions inquiry

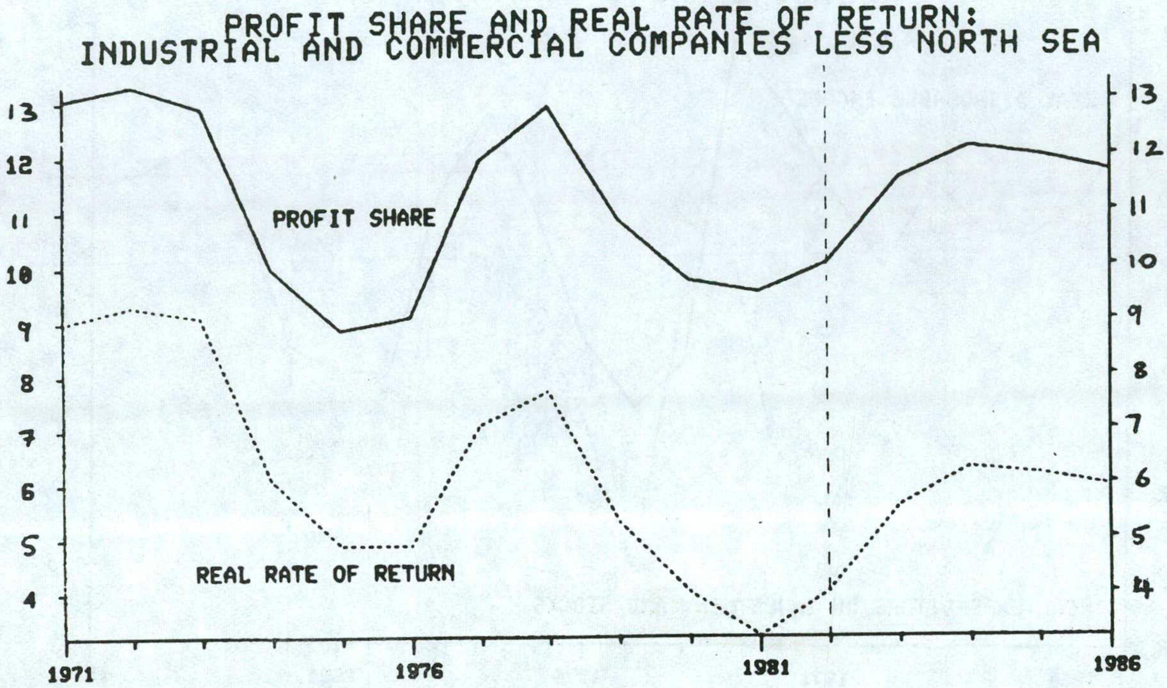
55. Stocks held by manufacturers and distributors were run down in 1982 and 1983 by a total of some £1½ billion at 1980 prices; we forecast an increase of £2 billion by the end of 1985, leaving the ratio of stocks to sales close to its level in the second half of 1983.

56. This growth in expenditure on fixed assets and stocks, together with a resumed rise in dividends and a slower growth of profits, is forecast to lead to a fall in the financial surplus - as would be expected in the second half of a cyclical upturn. It is very unclear what all this means for borrowing by companies, but some increase in bank lending to companies, from current very low rates, seems likely.

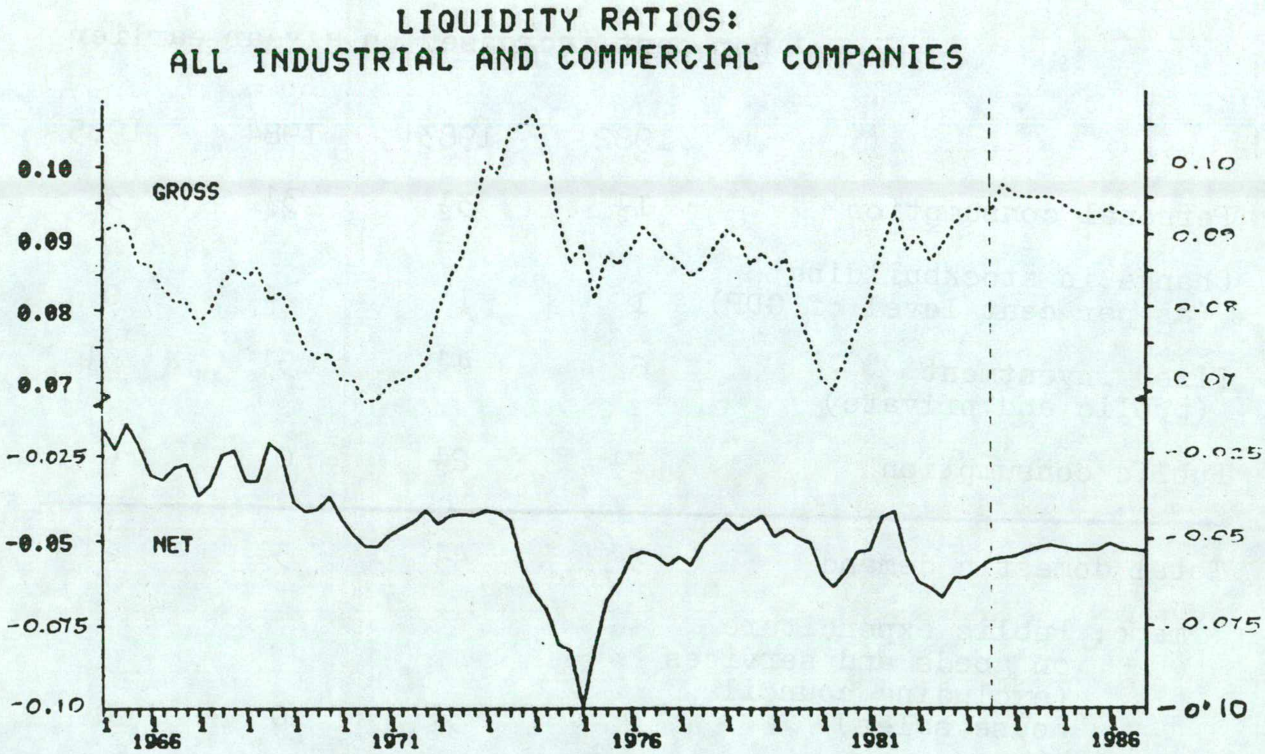


57. Company spending will be influenced by the prospects for growth, profitability and the cost of capital, as well as by their income. While some improvement in all these factors points to a continued increase in the volume of expenditure, the pace of expansion is not expected to be as fast as in most previous periods of recovery - partly because other factors in the recovery (world trade and government policy) are less expansionary than in the past. Business confidence - as indicated by recent CBI surveys and perhaps by recent trends in hours and employment - has improved sharply, though not yet much reflected in the statistics of manufacturing output.

58. While there are many difficulties of measurement, company profitability seems to be low relative to the 1970s and even more in relation to the 1960s:



Even if the (prospective) rate of profitability now and in the forecast period were substantially higher than shown in this chart, it would still be true that the incentive to hold financial assets, relative to real assets, is greater now than it was in the 1960s or 1970s, because of the current level of real interest rates. This is one factor in the current and prospective build up of financial assets by companies, which leaves their liquidity ratios relatively high. In the chart below the net liquidity ratio is defined after deducting bank borrowing. Both the equity and capital gearing forecasts suggest further falls and hence a fairly comfortable position, on average.



59. Companies' willingness/desire to maintain their (gross) liquidity ratios at relatively high levels since 1972/3 may reflect in part the much smaller spread between bank borrowing and lending rates, compared with the sixties.

60. The prospects for domestic demand at constant prices are summarised in the table below:

per cent increases on a year earlier

	1982	1983	1984	1985
Personal consumption	1½	3½	3½	3
Change in stockbuilding (as per cent level of GDP)	1	1	½	0
Fixed investment (public and private)	6	4½	5½	3½
Public consumption	1½	2½	0	0
Total domestic demand	3	4½	3½	2½
memo: Public expenditure on goods and services (excluding council house sales)	2	3	0	0

61. With the benefit of better profitability, there are reasonable prospects that as in 1982 and 1983 a good part of this demand will be met from higher production at home, even though, for manufactures, import propensities will go on rising. The growth in demand in 1983 was nearly all domestic; as this slows a little in 1984, we expect world demand for our exports to be picking up, producing another year of about 3 per cent growth in domestic output. With the consumer boom fading a little by 1985, and world recovery not very rapid, output growth may slow down.

	1982	1983	1984	1985
Domestic demand	3	4½	3½	2½
Exports of goods and services	1½	1½	5½	3
Imports of goods and services	3	5	7½	4
Domestic production - GDP	2	3	3	2½
- Manufacturing	0	1	2	1½

62. Prospects for 1986 are for a further slowdown, accentuated by the decline in oil production.

63. Thus far in the recovery, the growth of manufacturing output has been slower than for GDP as a whole, only partly we think because of measurement problems. The faster growth of manufacturing exports, in particular, in 1984 should raise the growth of manufacturing output nearer to that of total output.

64. Problems of measuring GDP, particularly in 1983, remain. Evidence since the Autumn Statement has tended to confirm the 3 per cent estimate for GDP growth between 1982 and 1983, though estimates will remain very provisional until at least August, when the Blue Book data is available, The current annual rate of growth of GDP, at the turn of the year, may well be in the range 3-4 per cent.

Employment and unemployment

65. The labour market improved in the second half of 1983. For manufacturing, where we have the most up to date information on employment and hours, recent monthly figures are shown in the following table:

Manufacturing

	Employees (average monthly change) thousands	Average weekly hours 1962 = 100
1982 Q4	-31	91.0
1983 Q1	-21	91.1
Q2	-20	90.8
Q3	-9	91.7
October	+6	92.2
November	+12	92.4

66. Employment, in total, is now rising slowly, and unemployment not changing much. (This would be consistent with some continuing rise in the labour force). Recent changes have been as follows:

Average monthly changes, seasonally adjusted

	Total Employed labour force	Unemployment excluding school leavers
1982 Q4	-34	28
1983 Q1	-6	26
Q2	+5	25*
Q3	+19	4*
Q4		-2

*After allowing for Budget changes

67. The build-up in the effects of special employment measures has continued. It is estimated that in the absence of changes in

SEMS, unemployment, on the measure used in the table, would have risen by an average of about 10 thousand a month in the second half of 1983.

68. Longer term productivity movements have been as follows:

output per head, per cent changes on a year earlier

	1964-73	1973-79	1979-81	1981-83	1983-86
Manufacturing	4	1	$-\frac{1}{4}$	6	$3\frac{1}{4}$
Non-manufacturing (excluding general government and oil)	$3\frac{1}{2}$	0	$-1\frac{1}{4}$	$2\frac{1}{4}$	$1\frac{3}{4}$

These are actual growth rates and over the period of the recovery from 1981 are higher than the underlying figures.

69. The judgment in the forecast is that in both sectors productivity growth will continue well above that in the periods 1973-79, and 1979-81 (only a part of the recorded very low growth rates can be explained by cyclical developments), but rather less, mainly for cyclical reasons, than in the 1981-83 period. Very tentatively, we forecast underlying productivity growth rates of $3-3\frac{1}{2}$ per cent a year in manufacturing and $1\frac{1}{2}$ per cent a year in the rest of the private sector.

70. The figures for output per head take no account of lower weekly hours, more holidays and a trend towards part-time work. The National Institute reckon that these factors make for a growth in output per hour some 1 per cent a year faster than in output per employee, for the economy as a whole, over the period 1960-1982. It is not clear that this gap will change over the future.

71. Higher employment may be nearly matched by growth in the labour force, which may continue at around $\frac{1}{2}$ per cent or 125 thousand a year. With a little help, at least until well

into 1984, from special employment measures, the total number of claimants - including or excluding school-leavers - may fall gently in 1984.

Potential growth rates

72. Some years ago all forecasts included an estimate of the growth rate of the economy consistent, once all the lags were worked through, with a constant level of unemployment: at its crudest, this calculation (rather grandly known as productive potential) added together the growth of labour supply and the growth of labour productivity. The limitations of this approach were emphasised by the substantial fluctuations in estimates of productivity growth, and even more by the evidence that unemployment was a very poor indicator - at least over a trend of five years or more - of the general pressure of demand.

73. Nevertheless these calculations retain some value as a way of describing the forecasts of output and unemployment:

per cent per annum

	1982-84	1984-86	1986-88
Underlying labour productivity in total (non-oil) economy	1.5	1.7	1.7
Labour force	0.6	0.5	0.3
Oil production (contribution to GDP growth)	0.3	-0.3	-0.5
Total "potential" GDP	2.4	1.9	1.5
Growth of GDP forecast	3	2	

74. Three periods are distinguished, partly because of the very different movements in oil production. Because of the cyclical recovery, actual growth in output per head is currently above the underlying trend and we are not seeing much reduction in unemployment.

75. There is some presumption that, starting from a position in 1982 of a considerable margin of spare capacity, and without - partly by assumption - any major shocks, the economy should be capable of growing at or above its potential growth rate for a time, as the forecast suggests it will in 1984 and 1985.

Inflation

76. The fall in inflation, which had begun by about mid 1980, came in two stages. The first was when the competitive pressures, both domestic and external, drastically reduced firms' ability to pass on cost increases; output was declining; and profit margins were squeezed. But once demand and output began to pick up, from the first half of 1981, and firms were able to control cost increases (mainly by reducing their labour forces, without much contribution from real wages), profit margins began to recover while the rate of inflation continued to fall.

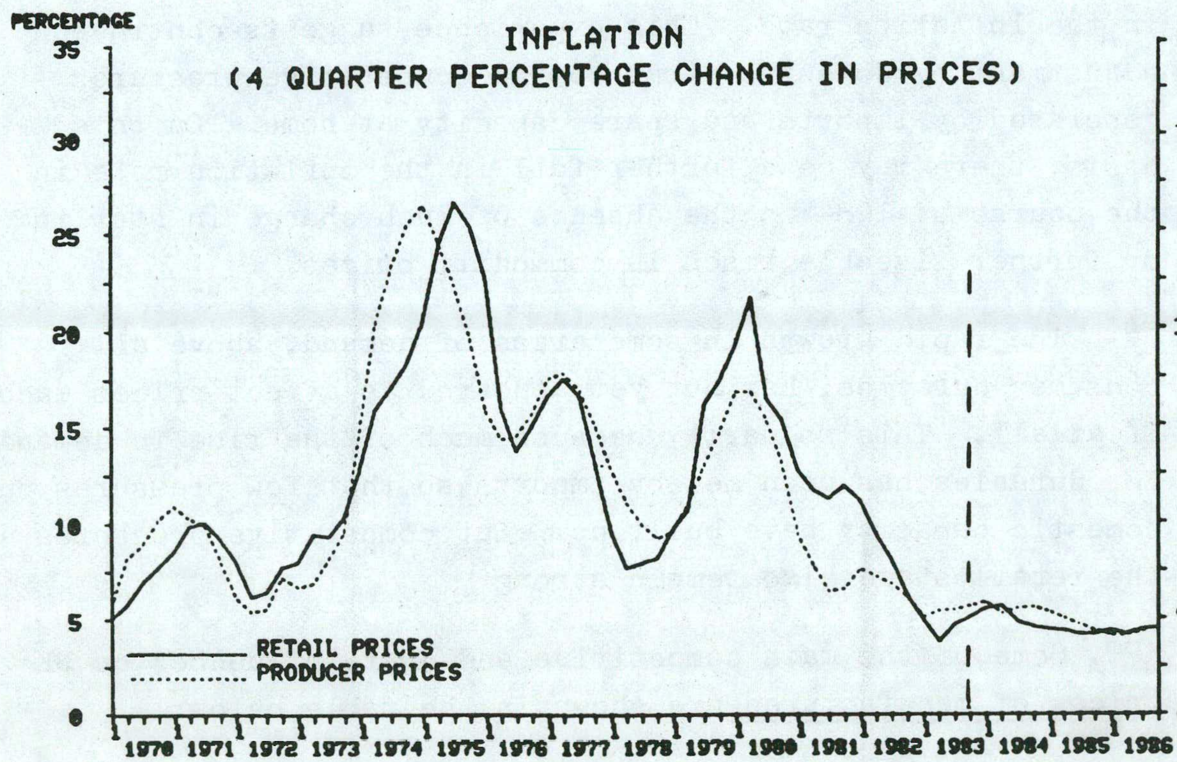
77. Through 1983, despite several factors unfavourable to inflation - the fall in the exchange rate in late 1982/early 1983, sharp rises in some commodity prices, and an expansion of domestic demand of some 4-5 per cent - there was no rise in the inflation rate. This experience suggests continued adjustment by domestic firms to the competitive pressures generated by imports and spare capacity at home. On this basis, there may be a further fall in the inflation rate in the course of 1984 in the absence of much change in sterling or further sizeable rises in commodity prices.

78. The rapid growth in some areas of demand, above all consumer durables, has not yet appeared to affect prices much if at all. This is partly because much of the rise in demand for durables has been met by imports so that few pressures on domestic capacity have built up. But competitive pressures at the retail stage also remain strong.

79. Some of the main competitive and cost influences on UK prices of manufactures are shown in the table below:

	World export prices of manufactures, in sterling	UK unit labour costs (actual)	Import costs	Percentage of firms working below a satisfactory level of capacity
	per cent changes on a year earlier			
1982	13	4	7	76
1983	11½	2½	9	70
1984	5½	4	6	63
1985	4	4	4	59

80. The forecast of private sector prices allows for the improvement in profit margins in the domestic market to continue through 1984 but to peter out in 1985. The chart below shows inflation as measured both by retail prices and by manufacturers' output prices:



81. The forecast of the RPI and its components is summarised in the table below:

	(Weights in total)	1983 Q4	1984 Q4	1985 Q4
		per cent changes on a year earlier		
Food	(22)	6	3½	3
Housing	(13)	6½	7	4
Nationalised industries	(7)	1½	3½	3
Other	(58)	5	4½	4½
Total	(100)	5	4½	4

The housing forecast allows for (i) a 7 per cent rise in the rate poundage in April 1984 and (ii) a cut in the mortgage rate of ¾ per cent before the end of 1984. (Without that forecast cut, the rise in the RPI would be 0.2 per cent higher.)

82. The May 1984 RPI figure, to be used for the November 1984 social security upratings, we continue to put at 5½ per cent.

83. Despite the recession and the steep rise in unemployment, the rise in average earnings has kept ahead of prices. It is still convenient, and consistent with the behaviour of wage bargainers, to think in terms of pay rounds starting in the autumn. On this basis, earnings and prices have moved as follows:

	Earnings (underlying, whole economy)	Retail prices	Price expectations* formed at start of pay round
	per cent changes on a year earlier		
1980 Q3	22	16½	[13]
1981 Q3	11½	11	[13]
1982 Q3	9	8	10-11
1983 Q3	7¾	4½	7
1984 Q3 (forecast)	7¼	5	6-7

*consensus forecast of Q4 RPI published in autumn of preceding year

84. To some extent, wage bargains take account of price expectations, as well as the actual movement in prices over the previous year. At any rate since 1981, inflation has fallen faster than expected: this has left wage earners with higher real wages than they (or employers) expected when the wage settlements were made - though the numbers employed have generally fallen faster than expected. Thus the inevitable adjustment of wage costs has come to a greater extent than expected from employment and less from real wages. But the higher than expected outcome on real wages in the last two pay rounds has not yet led, to any significant extent at all, to lower wage settlements. The failure to anticipate fully the extent to which inflation would fall has played a part in offsetting the willingness of both employers and employees to negotiate cuts - or a standstill - in real wages. This opportunity may not recur in the forecast period: we expect the rise in earnings to stay ahead of the rise in prices, though to a diminishing extent as (we assume) price expectations are more nearly correct and the economy slows down after 1984. In addition the sizeable fiscal adjustment - assumed to take the form of increases in income tax allowances - raises real take home pay and so reduces the pressure for wage increases.

per cent changes on a year earlier

	Earnings (underlying)	Retail prices	Real take-home pay (of which fiscal adjustment)
1983 Q3	$7\frac{3}{4}$	$4\frac{1}{2}$	$3\frac{1}{2}$
1984 Q3	$7\frac{1}{4}$	5	$2\frac{1}{2}$ ($\frac{1}{2}$)
1985 Q3	$6\frac{1}{2}$	4	5 ($2\frac{1}{2}$)

85. For the public services as a whole we assume pay settlements in the current round averaging $4\frac{1}{2}$-5 per cent, with earnings growth $5\frac{1}{2}$-6 per cent, a little less than for the economy as a whole. In the manufacturing sector, recent earnings figures (underlying growth of $9\frac{3}{4}$ per cent in the year to November) suggest, apart from higher overtime, that the faster productivity growth is being reflected, in part, in earnings. We forecast that this will continue.

ANNEX: COMPARISON OF FORECASTS

Treasury Forecasts

1. Table A compares the current Treasury forecast with the last two Budget Forecasts and the Autumn Statement published in November.

2. UK output is expected to grow a little faster in 1984 than the last forecast suggested. This largely reflects a faster growth in consumption and fixed investment. Both import and export volumes are expected to rise faster because of the more buoyant picture for domestic and world demand. The current account is expected to show a larger surplus in 1984 mainly because of improved non-fuel terms of trade and a larger surplus on trade in oil and, to a lesser extent, on invisibles. The forecast for RPI inflation is little changed.

Outside Forecasts

3. Table B compares the latest Treasury Forecast with a consensus obtained by averaging outside forecasts. Unlike previous forecasts there now seems to be broad agreement on prospects for the PSBR in 1984-85 though there is a wide spread between Liverpool (£6.4 bn) and NIESR (£10.1 bn). Despite this agreement the outlook for growth in £M3 is somewhat lower in the Treasury view than the consensus forecast.

4. On inflation in 1984 the Treasury forecast is significantly lower than the consensus, despite a faster growth in earnings than most outside forecasters foresee. In part this reflects a higher level of the exchange rate in the Treasury projections but it probably also results from faster growth in productivity, a slower rise in profit margins and perhaps lower import prices.

5. Prospects for output in 1984 are more buoyant in the Treasury forecast. Consumer demand in particular is much stronger than in the consensus projections. In part this reflects the higher growth in real personal disposable income in the Treasury projections as a result of higher earnings growth and lower inflation.

COMPARISON OF TREASURY FORECASTS

TABLE A

	1982 FSBR/MTFS	1983 FSBR/MTFS	AUTUMN STATEMENT 1983	JANUARY 1984
Money Supply £M3*				
(% Change on year earlier)				
1982 Q1	14.5 (15.5)	13.8	13.8	14
1983 Q1	11.1 (11.6)	9.7	10.2	11.1
1984 Q1	8.9 (9.2)	9.0	9.9	9.8
1985 Q1	7.0 (7.3)	8.8	9.2	8.2
1986 Q1			8.0	8.3
PSBR				
£billion (% of money GDP)				
1981-82	10.6 (4.2)	8.7 (3.4)	8.8 (3.4)	8.8 (3.4)
1982-83	9.5 (3.4)	7.5 (2.7)	9.2 (3.3)	9.2 (3.3)
1983-84	8.4 (2.8)	8.2 (2.8)	10.2 (3.4)	10.5 (3.5)
1984-85	6.7 (2.0)	8.0 (2.5)	8.1 (2.5)	8.0 (2.4)
1985-86			7.0 (2.0)	7.8 (2.0)
Fiscal Adjustments (£ billion)**				
1981-82	-	-	-	-
1982-83	-	-	-	-
1983-84	- 0.3	-	-	-
1984-85	- 2.1	- ½	+ 0.5	- 1.1
1985-86			- 3.8	- 4.9
Nominal GDP (mp)				
(% Change on year earlier)				
1981	10.1	9.6	9.7	9.7
1982	10.6	8.8	9.3	9.4
1983	9.2	7.5	8.4	8.4
1984	9.9	8.6	8.0	8.6
1985			7.6	7.0
RPI				
(% Change on year earlier)				
1981 Q4	11.9	11.9	11.9	11.9
1982 Q4	9.0	6.2	6.2	6.2
1983 Q4	7.1	5.8	5.2	5.0
1984 Q4	6.0	5.4	4.2	4.5
1985 Q4			4.6	4.1

* The 1981 FSBR/MTFS was based on the old monetary sector

** A negative sign signifies a reduction in taxation

	1982 FSBR/MTFS	1983 FSBR/MTFS	AUTUMN STATEMENT 1983	JANUARY 1984
Labour Cost Competitiveness				
(Ratio of UK to competitors costs 1975 = 100) ***				
1981 Q4	139.3	131.4	102.4	102.4
1982 Q4	136.2	132.2	98.5	102.1
1983 Q4	130.3	121.0	91.0	97.4
1984 Q4	129.8	121.0	90.5	98.3
1985 Q4			92.1	96.7
Current Balance (£ billion)				
1981	8.3	6.0	6.6	6.5
1982	4.2	4.0	5.4	5.4
1983	2.9	1.5	0.6	2.0
1984	3.3	1.5	0.1	1.7
1985			1.1	0.6
Manufacturing Output				
(% Change on year earlier)				
1981	- 6.4	- 6.4	- 6.6	- 6.4
1982	3.2	- 0.6	0.4	0.1
1983	2.2	1.8	1.3	1.1
1984	1.9	2.4	2.8	2.3
1985			1.4	1.7
GDP Volume (fc)				
(% Change on year earlier)				
1981	- 2.0	- 2.5	- 1.6	- 1.6
1982	1.4	0.7	1.8	2.0
1983	2.4	2.0	2.8	2.9
1984	2.8	2.7	2.9	3.2
1985			2.8	2.5

***FOR COLS 3 AND 4 1980=100

	1982 FSBR/MTFS	1983 FSBR/MTFS	AUTUMN STATEMENT 1983	JANUARY 1984
Interest Rates %				
Short Term				
1981-82	14.2	14.2	14.2	14.2
1982-83	13.5	11.3	11.5	11.5
1983-84	11.9	9.6	9.6	9.7
1984-85	10.2	7.5	8.3	8.7
1985-86			8.1	7.8
World Trade in Manufactures				
UK Weighted				
% Change on year earlier				
1981	4.1	3.3	3.3	3.3
1982	4.0	- 3.3	- 3.1	- 2.8
1983	4.6	1.0	- 0.7	1.0
1984	5.5	6.6	5.3	4.7
1985			6.3	5.1
UK Exports of Goods and Services				
(% Change on year earlier)				
1981	- 1.5	- 2.3	- 2.0	- 2.0
1982	3.3	0.7	1.4	1.4
1983	3.7	0.9	0.6	1.4
1984	4.4	5.0	4.0	5.5
1985			3.9	3.1
Average Earnings				
(private cyclically adjusted - % change on year earlier)				
1981 Q3	13.6	10.2	9.6	10.2
1982 Q3	9.0	10.0	10.3	10.0
1983 Q3	8.3	6.9	8.2	7.7
1984 Q3	7.4	6.9	7.2	7.5
1985 Q3			6.4	6.5
Effective Exchange Rates				
1975=100				
1981	94.9	94.9	94.9	94.9
1982	88.5	90.6	90.6	90.6
1983	84.6	80.5	83.4	83.3
1984	81.9	81.8	83.6	83.2
1985			83.0	83.5

	1982 FSBR/MTFS	1983 FSBR/MTFS	ATUTMN STATEMENT 1983	JANUARY 1984
Unemployment				
(UK sa excl school leavers - millions, new definition)				
1981 Q4	2.6	2.6	2.6	2.6
1982 Q4	2.8	2.9	2.9	2.9
1983 Q4	2.8	3.0	2.9	2.9
1984 Q4	2.8	3.1	2.9	2.9
1985 Q4			2.8	2.9
I & C Companies' Financial Surplus/ Deficit, £ billion				
1981	1.4	2.0	2.7	2.7
1982	0.2	1.1	2.3	2.5
1983	- 1.8	0.7	4.8	7.3
1984	- 0.9	2.3	4.6	4.3
1985			5.0	1.2

TABLE B	Treasury January 1984	Consensus Forecast	Range of outside forecasts
£M3 % change on year earlier			
1983-84	9.8	10.1	10.0 (NIESR, P&D) - 10.6 (LBS, Henley)
1984-85	8.9	10.2	9.1 (S&C) - 11.2 (Henley)
1985-86	8.2	11.4	10.7 (LBS) - 11.8 (Henley)
£M1 % Change on year earlier			
1983-84	11.8	12.3	10.5 (P&D) - 15.3 (LBS)
1984-85	11.2	10.1	8.0 (P&D) - 12.4 (LBS)
1985-86	10.2	8.8	8.5 (LBS) - 9.0 (NIESR)
Interest rates (short-term) Treasury bill rate %			
1983-84	9.3	8.8	No range. (LBS, P&D)
1984-85	8.1	8.7	7.9 (LBS) - 9.5 (P&D)
1985-86	7.2	7.9	no range. (LBS)
PSBR £bn			
1983-84	10.5	9.5	8.9 (NIESR) - 10.0 (Henley)
1984-85	8.0	8.4	6.4 (Liverpool) - 10.1 (NIESR)
1985-86	7.8	7.7	4.7 (Liverpool) - 10.2 (NIESR)
Exchange rate 1975 = 100			
1983 Q4	83.1	83.6	83.0 (P&D, S&C) - 84.7 (NIESR)
1984 Q4	83.5	80.4	78.8 (NIESR) - 82.5 (P&D)
1985 Q4	83.5	77.7	73.5 (NIESR) - 80.0 (P&D, S&C)
Current Account £bn			
1983	2.0	1.1	0.6 (LBS, S&C, Liverpool) - 1.8 (Cambridge)
1984	1.7	0.8	- 0.4 (CBI) - 2.2 (Cambridge)
1985	0.6	1.1	- 0.6 (Henley, PSD) - 5.6 (Liverpool)
Average earnings % change on year earlier			
1983	8.1	7.7	6.0 (Cambridge) - 8.6 (Henley)
1984	7.2	6.6	5.6 (Cambridge) - 7.2 (P&D)
1985	6.6	6.4	4.6 (Cambridge) - 7.5 (Henley)
RPI (CPI) % change on year earlier			
1983 Q4	5.0	5.1 (5.3)	RPI: 5.0 (P&D) - 5.2 (NIESR)
1984 Q4	4.5	6.1 (5.6)	RPI: 5.6 (P&D) - 6.8 (NIESR)
1985 Q4	4.1	6.1 (6.5)	RPI: 5.0 (S&C) - 7.2 (Henley)
RPDI % change on year earlier			
1983	1.5	0.7	0.0 (LBS) - 1.6 (Henley)
1984	3.5	1.2	0.5 (NIESR) - 2.1 (Henley)
1985	3.8	0.9	- 0.8 (NIESR) - 1.7 (LBS)

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	Treasury January 1984	Consensus Forecast	Range of outside forecasts
Import Volume goods and services %			
1983	5.2	4.7	4.4 (S&C) - 4.9 (Henley, Cambridge)
1984	7.6	4.0	3.3 (S&C) - 4.9 (CBI)
1985	4.1	2.7	2.6 (NIESR, P&D) - 2.9 (S&C, Henley)
Export Volume goods and services			
1983	1.4	0.5	0.1 (S&C) - 1.0 (OECD)
1984	5.5	3.8	2.5 (CBI) - 4.5 (OECD)
1985	3.1	3.9	2.7 (P&D) - 5.0 (NIESR)
GDP* Output Volume, % change on year earlier			
1983	(2.9)	2.0	1.8 (LBS) - 2.2 (NIESR, S&C)
1984	(3.2)	2.1	1.8 (S&C) - 2.4 (LBS)
1985	(2.5)	1.6	1.0 (NIESR) - 2.4 (LBS)
Unemployment million, Q4 (UK adults, sa)			
1983	2.94	2.97	2.9 (NIESR) - 3.13 (LBS)
1984	2.87	3.01	2.9 (CBI) - 3.12 (LBS)
1985	2.89	3.10	2.88 (LBS) - 3.3 (NIESR)

'Consensus' includes: National Institute (November 1983)
London Business School (October 1983 - Economic Outlook) and (December 1983 - Financial Outlook)
Phillips & Drew (January 1984)
Cambridge Econometrics (January 1984)
CBI (November 1983)
Simon & Coates (January 1984)
Henley Centre (January 1984)
Liverpool (December 1983)

though results are not reported for some variables by some forecasters.

*Treasury figures are for the average measure of GDP, outside forecasts for the output measure.

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A66

FROM: COLIN MOWL
DATE: 31 January 1984

1. MR CASSELL
2. ECONOMIC SECRETARY

cc Sir Terence Burns
Mr Lankester
Mr Evans
Mr Odling Smee
Mrs Lomax
Mr Pirie
Mr Sedgwick
Mr Shields
Mr Riley
Mr Peretz
Mr Bennett
Mr Vernon
Mr Hood
Mr O'Donnell
Mr Hibberd
Mr Fisher
Mr Ridley

FINANCIAL FORECAST

I attach a note which describes in more detail the financial aspects of the economic forecast submitted by Mr Evans on 27 January (Treasury Economic Forecast). I hope you will find it useful background for monetary policy discussions. The material in the note is organised as follows:

Colin Mowl

COLIN MOWL

17/120

14/2

FINANCIAL FORECASTS - JANUARY 1984

Introduction

This report discusses in more detail the financial aspects of the economic forecast circulated by Mr Evans on 27 January (Treasury Economic Forecast: January 1984 Report). The financial forecast has, as usual, been prepared jointly with the Bank of England.

2. The rest of the forecast, particularly the variables which are important influences on financial developments, is summarised and, compared with the Autumn Statement, in the table overleaf. The outlook for GDP and inflation has changed very little since the autumn. GDP is forecast to grow by 3% in 1984-85, the same rate as this year, and to rise only slightly less in 1985-86. Inflation is projected to fall a little from its current rate and to be in the 4-4½% range in each of the next three years. The growth of money GDP is therefore expected to decline slightly.

3. The PSBR is by assumption reduced from £10½ billion in 1983-84 to £8 billion in 1984-85 and 1985-86. This, together with a deteriorating balance of payments current account, implies a fall in the private sector financial surplus. However the current account forecast for 1983-84 has been revised up since the autumn partly due to revisions to back data, and so the deterioration in the current account is now smaller. Most of the fall in the private sector financial surplus lies in the company sector. The personal sector surplus, boosted by the assumed fiscal adjustment, holds up in 1984-85 and rises somewhat in 1985-86. The falling private sector surplus leads to slower growth in private net financial wealth, although capital gains on gilts due to falling interest rates moderate the deceleration.

Policy Assumptions

4. The PSBR is assumed to be kept to 2½% of GDP in 1984-85, 2¼% in 1985-86 and 2% in 1986-87 by a fiscal adjustment on personal income tax. The assumptions about public sector finances are described in detail in the "Forecast Report on Public Finances"(submitted by Mr Shields on 30 January). Monetary policy is assumed to operate as described in the last MTFS, that is, giving weight to other indicators

THE REST OF THE FORECAST: SUMMARY TABLE

Inflation (TFE deflator, % change on a year earlier)	Autumn Statement 1983 *	January 1984
1983 Q1	6.5	6.7
1984 Q1	5.7	5.2
1985 Q1	4.5	4.3
1986 Q1	4.9	4.1
1987 Q1	4.8	4.6
Output (GDP, % change on previous year)		
1982-83	2.1	2.3
1983-84	2.7	3.0
1984-85	3.0	3.1
1985-86	2.5	2.3
1986-87	1.1	1.5
PSBR (£ billion)		
1982-83	9.2	9.2
1983-84	10.2	10.5
1984-85	8.1	8.0
1985-86	7.0	7.8
1986-87	5.6	7.4
Current Account (£ billion)		
1982-83	5.4	5.3
1983-84	0.0	2.1
1984-85	0.5	1.4
1985-86	0.6	0.8
1986-87	0.0	-0.6
ICCs Financial Surplus (£ billion)		
1982-83	3.7	4.1
1983-84	5.0	7.8
1984-85	5.2	3.2
1985-86	4.3	0.9
1986-87	2.7	0.7
Persons' Financial Surplus (£ billion)		
1982-83	8.5	8.8
1983-84	6.4	7.0
1984-85	4.4	7.1
1985-86	4.8	9.5
1986-87	4.3	8.3

Real TFE % change on previous year	Autumn Statement 1983 *	January 1984
1982-83	3.0	2.9
1983-84	2.6	3.4
1984-85	3.6	3.8
1985-86	2.7	2.6
1986-87	1.8	2.0
Nominal GDP (market prices, % change on previous year)		
1982-83	9.0	9.2
1983-84	8.3	8.3
1984-85	7.8	8.1
1985-86	7.5	6.7
1986-87	6.8	6.0
Personal Disposable Income (% change on previous year)		
1982-83	7.2	7.5
1983-84	7.5	7.7
1984-85	6.5	7.8
1985-86	8.6	8.0
1986-87	7.0	6.3
Private Sector Net Financial Wealth (% change on a year earlier)		
1983 Q1	28.1	28.4
1984 Q1	12.1	11.0
1985 Q1	10.4	10.3
1986 Q1	6.2	7.1
1987 Q1	4.8	5.1
Private Sector Gross Financial Wealth Denominated in £ (% change on a year earlier)		
1983 Q1	13.2	13.2
1984 Q1	12.3	13.0
1985 Q1	10.5	11.2
1986 Q1	7.6	8.8
1987 Q1	6.8	7.5

* In general most of the detail given here was not published. Moreover the figures for 1985-86 and 1986-87 in the internal forecast consistent with the Autumn Statement were not given as much scrutiny as usual due to complications arising from the rebasing of the national income accounts.

of monetary conditions such as the exchange rate and interest rates, as well as the monetary aggregates. For the purposes of this forecast it was agreed that we should assume that the growth rates of MO and £M3 would remain within the following ranges:

	1984-85	1985-86	1986-87
MO	4-8	3-7	2-6
£M3	7-11	6-10	5-9

The Exchange Rate

5. The effective rate for sterling traded in the range 83-86 between end-June 1983 and November, but has since weakened, partly on fears of a lower oil price, and is currently around 82. It is now well below its pre-election peak of 88 but has not come under any heavy selling pressure and the general fall has been associated with a decline in UK interest rates relative to the world and particularly the US. Indeed much of the fall since mid June can be attributed to the rise in the dollar against all currencies which is mainly related to expectations of a continued high Federal deficit and consequent interest rate fears. Against the mark, sterling has actually appreciated since mid June.

6. Over the forecast period no major change is expected for the nominal effective rate. In the short term we assume a slight appreciation as fears about the oil price recede and the dollar weakens. This is broadly consistent with current forward rates which imply no change. Because UK inflation prospects relative to the world are good, the path of the nominal rate implies a decline in the real exchange rate. We believe that this is consistent with no major imbalance in the UK current and structural capital account positions. There may therefore be scope for UK interest rates to fall below world rates, without exerting significant downward pressure on sterling especially since the dollar is forecast to decline. Factors thought to influence the market's view of future rates, such as UK real money supply relative to the world and the dollar oil price, are broadly flat in the projection and are not expected to generate large destabilising outflows. However the forecast decline in North Sea production could exert some downward pressure towards the end of the forecast period although this may already be largely discounted in current rates.

7. Though a forecast nominal rate of 83.5 by 1984 Q4 is higher than the consensus of outside economic forecasts it is within the range of such forecasts and compares with projections by 'specialist currency forecasters' of 84 by Phillips and Drew, 85 by Lloyds Bank and 81 by LBS Exchange Rate Outlook.

8. The projections of sterling cross rates is shown below. These are always subject to great uncertainty particularly when, as in the forecast, we expect sharp cross currency movements. They show that within the broad pattern of a flat sterling rate in effective terms, sterling is expected to appreciate against the dollar and French franc but depreciate against the yen and mark.

Sterling Exchange Rates

	Nominal Effective Exchange Rate	£/Dollar Rate	£/DM Rate	£/FF Rate	£/Yen Rate	Real Effective Exchange Rate (1980/81=100)
1982/83	88	1.67	4.08	11.4	417.5	89
1983/84	84	1.49	3.93	12.0	355.9	86
1984/85	84	1.51	3.85	12.3	335.4	85
1985/86	83	1.62	3.64	12.2	315.7	84
1986/87	82	1.70	3.44	12.0	296.5	82

Interest Rates

9. Eurodollar rates have remained fairly stable since the Autumn. Despite the pressure on sterling UK rates have not changed much either. They are currently in the region of 9%. There could be a base rate cut in June, possibly of a half per cent, preceded by a gentle decline in market (3 month) rates which should fall below 9% before mid-summer. With monetary growth largely within the target ranges and little change in the exchange rate a further ½ point cut in base rates could occur by or soon after the beginning of next year. Whilst wholesale rates should continue to decline, competition for personal deposits may provoke the banks to set their 7 day retail rates more aggressively. Building Society rates, the chief competitor, should be reduced in the summer after the base rate cut, and again in the New Year at which point the mortgage rate would be at 10% where it stood at the beginning of 1983.

Long term interest rates are expected to decline gradually, and 20 year rates might fall below the psychological 10% level (below which they have not been since 1973) in 1984, possibly before the budget. 10 year rates may remain above this level for longer reflecting the recent concentration of funding in shorter gilts.

	Eurodollar Interest Rate	World Basket Short Rate	UK 3-month Interbank Interest Rate	UK 20-year Long Term Interest Rate	Inflation (Final Expenditure Prices)
1983-84	9.8	9.3	9.7	10.5	5.4
1984-85	10.1	8.6	8.7	9.3	4.8
1985-86	10.8	8.3	7.8	8.7	4.0
1986-87	10.4	8.2	7.3	8.2	4.4

Sectoral Flow of Funds

10. The current forecast has many features in common with the Autumn Statement. The pattern of financial surpluses and deficits is shown below. However, because of problems of errors and omissions in the historic data, considerable caution is required in interpretation: this point is discussed more fully in paragraph 13 below.

Sectoral Financial Surplus and Deficits and the PSBR (£bn)

	Persons	**ICCs**	**Financial Cos**	Total Private	Overseas+	Public Sector	PSBR
1982-83	8.8	4.1	0.8	13.7	-4.9	- 9.0	9.5
1983-84	7.0	7.8	0.4	15.2	-5.3	-11.2	10.4
1984-85	7.0	3.2	0.3	10.5	-2.1	- 8.4	8.0
1985-86	9.5	0.9	-0.4	10.0	-1.4	- 8.6	7.8
1986-87	8.2	0.7	-0.7	8.2	-0.8	- 8.2	7.4

\+ The overseas financial surplus is the negative of the current account surplus

11. The substantial moderation in the scale of the current account surplus is expected to lead a sharp reduction in net non bank private sector (NBPS) capital outflows, which will tend to moderate the effects of the current account on domestic wealth. As compared with net outflows of £8.6 billion in 1982-83, we are expecting net outflows of £4.2 billion in 1983-84 and £3.9 billion the following year. Net direct investment outflows persisted in 1982-83 but they were much reduced from the

previous year and in 1983-84 the prospect is for a modest inflow. The net inflow is expected to persist over the forecast period due to good prospects for UK profitability but may decline as world growth strengthens. Although gross outward portfolio investment is expected to decline from recent high levels, it should remain substantial as financial institutions continue to build up their desired holdings of overseas stock. The overseas capital account forecast is summarised in the table below.

EXTERNAL FLOWS (£bn)

	Current Account	Net Direct Investment	Outward Portfolio Investment	Private Inward Portfolio*	Sterling Balances	Other Items**
1982-83	5.2	-0.7	-6.2	-3.3	2.1	3.1
1983-84	2.1	1.0	-6.6	-1.4	2.9	1.9
1984-85	1.4	1.1	-6.0	-1.0	3.0	1.5
1985-86	0.8	0.5	-5.4	-0.5	3.3	1.4
1986-87	-0.6	0.2	-5.2	0.0	4.1	1.6

* Including the balancing item

** Oil investment, trade credits, company borrowing, deposits overseas, banks FC liabilities, intervention

12. Life Assurance and Pension Funds are not expected to acquire overseas securities on the same scale in 1983-84 as last year. The effects on total purchases of securities will be partly offset by the healthy outlook for capital issues by ICCs and the large sales of public sector assets. Nevertheless, their total purchases of securities are expected to be less in 1983-84 than in the previous year. However, even with higher purchases of gilts and rather lower unidentified payments, OFIs as a whole are expected to maintain their substantial holdings of bank deposits. In later years, as there is some gradual increase in OFIs investment in property and a higher level of public sector asset sales, the build up of deposits is expected to be more subdued if still rapid.

13. The financial position of Industrial and Commercial Companies (ICCs) is enigmatic. Recently they have been running very substantial surpluses as recorded in the national income accounts. However, a large part of this surplus has not been recorded in the individual components of the

financial accounts: the discrepancy has been made up by the unidentified transactions or balancing item. The scale of this problem makes interpretation and forecasting of ICCs' net borrowing requirement very hazardous. But in 1984-85 and the following years as their surplus declines, we expect ICCs net borrowing requirement to increase. This year, however, their very substantial surplus coupled with the healthy capital issues and borrowing from overseas, should allow ICCs to continue to increase their holdings of financial assets in relation to nominal expenditure. Next year the rise in public sector asset sales is expected to crowd out some new capital issues. In the light of this we are projecting capital issues by ICCs of £2.4 billion as compared with £2.6 billion this year. This represents a good performance by the standards of recent years.

14. Having fallen at the beginning of the year, sterling bank borrowing by ICCs recovered strongly in the last two quarters of 1983. We anticipate that this recovery will be maintained in later years in line with the increased net borrowing requirement. This, along with continued borrowing from overseas - ie inward investment - is expected to allow ICCs to continue to increase their holdings of financial assets. However, as the cycle develops, we expect that in relation to nominal expenditure, their holdings will decline.

15. The <u>personal sector</u> is expected to remain in a comfortable position: the small reduction in its recorded financial surplus as compared with 1982-83 and its increased contributions to Life Assurance and Pension Funds is more than offset by their share of the "unidentified receipts" from ICCs and the small increase in their borrowing from banks and building societies. Both banks and building societies have continued to expand their loans for house purchase rapidly, and all the indicators point to this being continued. For banks this is a very secure and reasonably profitable line of business, and so we expect they will be willing to continue to advance a little over £3½ billion a year. Building Societies have also been willing to increase their lending, which they have financed by bidding for deposits. It seems probable that the demand for mortgages will continue apace: the change in the maximum size mortgage which may be set against income tax has left many people with a mortgage of less than optimum size, and it will be several years before people have fully adjusted to the new rules. We also expect that bank lending for consumption and to

unincorporated business will grow strongly. These are amongst the highest earning assets in banks' portfolios, and so it seems probable that they will be happy to expand this line of business. There is a worry that after several years of very rapid growth of its borrowing the personal sector will become overextended. However, with the outlook for gently declining interest rates, we expect that the personal sector's interest payments will account for a broadly constant share of their disposable income.

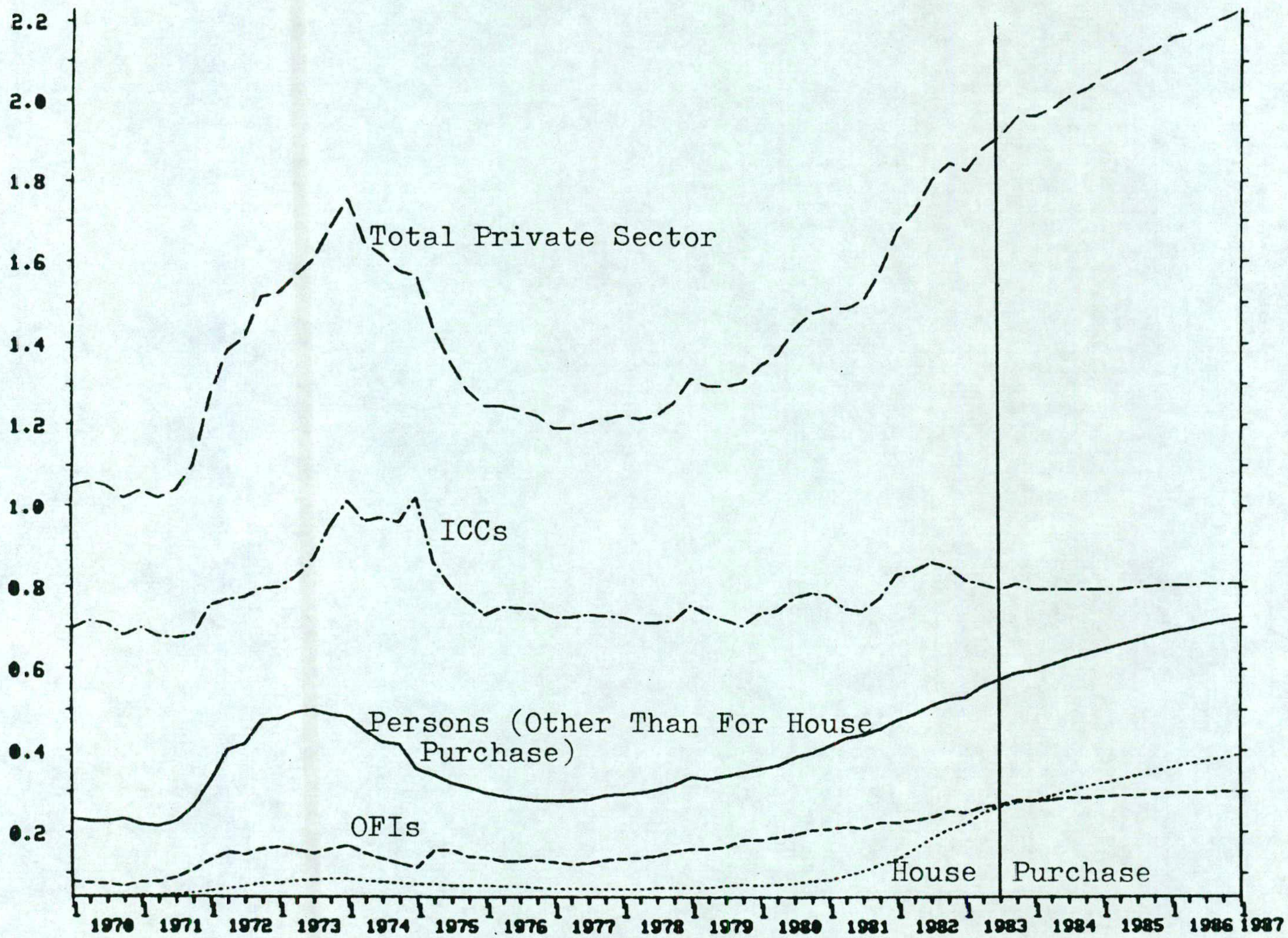
16. The conventional flow of funds arithmetic suggests that the factors mentioned above should allow persons to absorb about £3 billion of National Savings investments as well as increasing their holdings of bank deposits a little faster than the overall growth of £M3.

17. The forecast for bank lending in sterling to the private sector is shown below and the chart on the following page:

Sterling bank lending, £ billion, (% change in brackets)

	Persons				
	Consumption + Unincorporated Business	House Purchase	ICCs	OFIs	Total Private Sector
1981-82	4.7(28)	2.7(80)	5.9(18)	1.7(20)	15.0(25)
1982-83	4.7(22)	4.9(80)	2.5(7)	2.2(21)	14.3([illegible])
1983-84	5.9(22)	4.2(38)	2.4(6)	2.6(21)	15.1(17)
1984-85	5.5(17)	3.6(24)	3.4(8)	1.8(12)	14.2(14)
1985-86	5.2(14)	3.6(19)	3.8(8)	1.6(10)	14.2(12)
1986-87	5.2(12)	3.6(16)	3.8(8)	1.5(8)	14.1(11)

CHART 1 Bank Lending In Sterling To The Private Sector Relative To Private Sector GDP - Total And By Sector



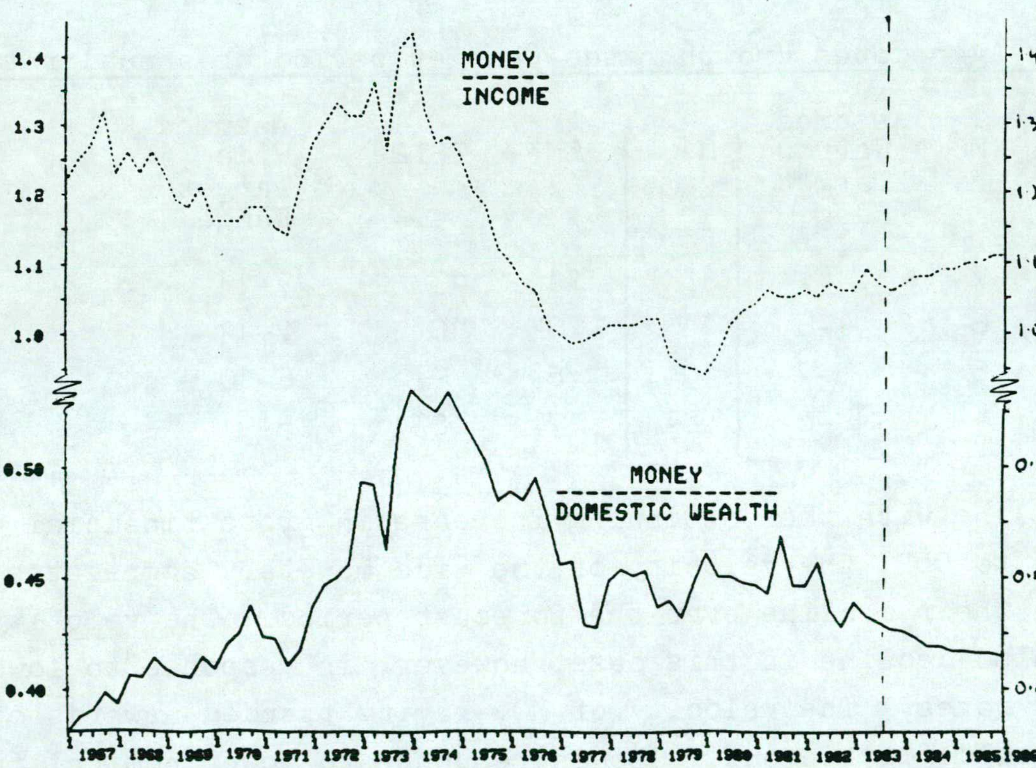
* including Issue Department holdings of commercial bills

9

Monetary Aggregates

18. The growth of £M3 picked up sharply at the beginning of the financial year, but since then the July measures to control the PSBR have combined with exceptionally buoyant gilt sales to bring £M3 growth down. As a result we expect £M3 to finish the current target period only slightly above the recommended range. In later years, this deceleration should continue and put £M3 within the target ranges. PSL2 growth, affected by continuing high inflows into building societies, is likely to grow rather faster than £M3 and breach the range this year by a significant margin. Although continuing to grow faster than £M3 in 1984-85 and beyond, PSL2 growth should nonetheless fall within the target ranges in these years. The deceleration of the wide monetary aggregates in general follows the slow down in the growth of the private sector's total financial wealth.

CHART 2 STERLING M3 IN RELATION TO INCOME & WEALTH



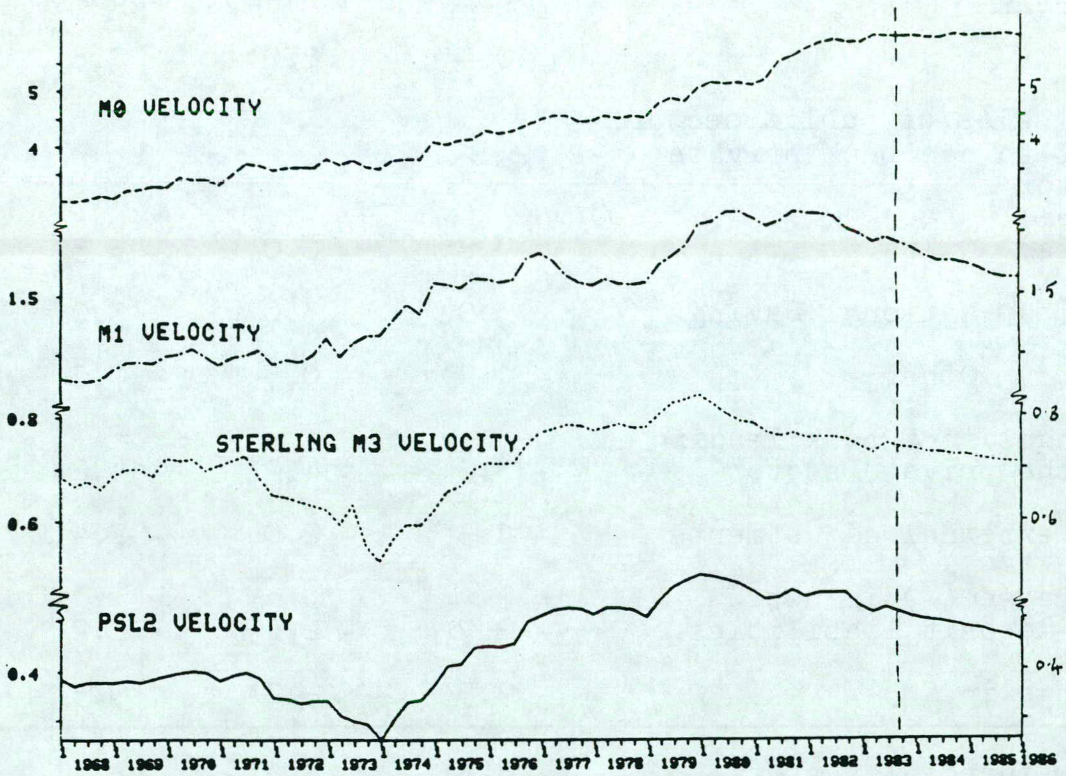
19. Turning to the narrow aggregates, the growth of MO is expected to continue to grow relatively slowly, as a result of the increasing use of cash saving devices such as credit cards and bank accounts. Offsetting this, however, is the effect of falling interest rates, which makes cash cheaper to hold. Reflecting this we expect MO growth to peak at around 7% at the end of this target period, after which growth is expected to subside, remaining within the range assumed for narrow aggregates throughout. M1, by contrast, is expected to grow rapidly, being the most interest sensitive of all the aggregates. It should certainly exceed the narrow range and may even exceed the range set for the wide aggregates too. The newest aggregate, M2, is one about which we know very little owing to the absence of a sufficiently long back run of data. It has so far behaved in a similar way to MO, growing at only a slightly faster rate. However, this aggregate contains a substantial portion of building society deposits which, although falling as a share of total deposits in the last two years, is now likely to stabilise or even rise. This, in association with continued high building society net receipts, may push up the growth of M2 relative to MO quite significantly, although this prediction is more than usually uncertain.

Monetary Aggregates growth rates (target period or annual rate)

	MO	Assumed Narrow Target Range	M1	£M3	PSL2	Assumed Wide Target Range
1983-84	7	-	13	11	13	7-11
1984-85	6½	4-8	11	9	10	7-11
1985-86	6	3-7	10	8½	9½	6-10
1986-87	4½	2-6	8½	7½	8½	5-9

20. In line with the continuing increase in gross financial wealth relative to GDP, the velocity of the wide monetary aggregates should maintain their decline, over the forecast period. The velocity of M1 should also decline in this case, however, in response to lower nominal interest rates. The velocity of MO, having trended upwards over the past, should flatten out, also in response to lower nominal interest rates. The velocity of the main aggregates is shown in the chart below.

CHART 3 MONETARY AGGREGRATE VELOCITIES



Public Sector Debt Sales

21. Gilt sales (net of redemptions) are expected to total £11.7 billion in 1983/4, £9.8 billion going to the non bank private sector. Because the PSBR is lower, there will be less pressure to fund in 1984-85 and long rates could therefore come down a bit more. The forecast allows for net gilt sales to the non-bank private sector of £6 billion in 1984-85. Both this year and next the share of gilts in private sector financial wealth is expected to rise but this is entirely due to revaluations of existing holdings resulting from falling long term interest rates. A national savings target of £3 billion has been assumed for 1984/5, similar to the £3 billion we expect to come in this year. The target for next year should be sustainable given the flat projection for personal saving relative to this year. The table below summarises the forecast of the sales of debt to the non-bank private sector and other counterparts to the change in £M3.

£M3 and the counterparts

£billion	1983-84	1984-85	1985-86	1986-87
PSBR	10.4	8.0*	7.8*	7.4*
Net sales of public sector debt to non bank private sector				
(a) Gilts	9.8	6.0	5.3	4.8
(b) National Savings	3.0	3.0	3.0	2.6
(c) Other	- 1.9	- 0.5	- 0.3	- 0.5
Changes in £ bank lending to the private sector	13.9	14.2	14.2	14.1
Net external adjustments	- 1.3	- 2.0	- 2.4	- 3.2
Increase (-) in net non-deposit liabilities	- 2.7	- 2.4	- 2.2	- 2.0
Change in £M3	9.5	9.2*	9.5*	9.3*
(a) financial year (%)	9.8	8.8*	8.4*	7.6*
(b) target period (%)	11.0	8.8*	8.4*	7.6*

* New definition of the PSBR and £M3

27. Overfunding is expected to be small over the next few years, but market assistance, though modest, will probably still be required.

£ billion

	1983-84	1984-85	1985-86	1986-87
Overfunding	0.5	0.5	0.1	-0.5
Market Assistance	1.0	1.3	1.1	0.4

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FROM: G W MONGER
22 Dedember 1983

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Mr Middleton
Sir T Burns 11/9/12
Mr Byatt
Mr Cassell
Mr Battishill
Mr Watson
Mr Allen
Mr Griffiths
Mr G P Smith
Mr Martin

PS/Inland Revenue

CHANCELLOR OF THE EXCHEQUER

PERSONAL TAXATION

I attach a paper on the background on personal taxation which may be useful for forthcoming Budget discussions. It has been agreed with the Inland Revenue and is a companion piece to their submissions on the approach to the 1984 Budget.

G W MONGER

569/12

PERSONAL TAXATION: BACKGROUND TO BUDGET DECISIONS

Introduction

This paper sets out the background to Budget decisions on personal taxation. In view of the Manifesto commitment to further improvements in personal allowances and lower rates of income tax, it looks at developments in the personal tax burden over a long period, also providing information on developments since 1978-79 and the position that will apply in 1984-85 on the conventional assumption of indexation of income tax allowances and thresholds by 5 per cent and the forecast of an increase in prices of 4½ per cent and earnings of 6½ per cent between 1983-84 and 1984-85. Given the fiscal prospect indicated by the Autumn forecast, it also sets out the effects of providing the fiscal adjustment by restricting the increase in allowances and thresholds. Again in view of the Manifesto commitment, the paper also examines the particular incentives problems of the poverty and unemployment traps and alternative approaches to reducing the traps. Against this background, a companion paper by Inland Revenue examines specific options for the Budget decisions on personal tax.

Total taxation

2. Although there have been periods when the ratio has been reduced, over the past three decades total taxation (including national insurance contributions and local authority rates) as a proportion of GDP has markedly increased. Since the Government came to power the increase has been some 4.5 percentage points. The figures are set out in Table 1 and the ratio is now higher than at any time in the last 30 years. In this and subsequent tables the position which will apply in 1984-85 on the forecast assumptions is also shown:-

Table 1	Total taxation as a percentage of GDP at market prices
1960[1]	28.5
1965	30.8
1970	37.5
1975-76	36.3
1978-79	34.1
1981-82	39.7
1982-83	39.6
1983-84 (forecast)	38.7
1984-85 (forecast, assuming no fiscal adjustment necessary	38.8
1984-85 (allowing for fiscal adjustment)[2]	39.0

[1] Financial year figures on an equivalent basis are not available for years prior to 1972-73.

[2] The assumption here is of an increase in allowances and thresholds of only 2 per cent (ie prices indexation -3 per cent), which is Option 4 in the Inland Revenue paper.

3. Within these totals, the long-term trend has been for more marked increases in income tax and NICs than in most other taxes. Almost half of the 10 percentage point increase in the total tax ratio is accounted for by these two, even though they only account for a third of total taxes. Under the present Government this trend has been checked to the extent that, especially since 1981-82, the burden of income tax has fallen somewhat and is now lower than it was in the 1970s, though not in the 1960s. National insurance contributions have however increased over the whole period, with quite substantial rises since 1978-79. Indirect taxes paid by persons, such as VAT, have also risen sharply since 1978-79 and are now higher than in the 1960s and 1970s. The following table shows how the main taxes paid by persons, including employees' national insurance contributions and indirect taxes (comprising VAT, excise duties, VED, car tax and an estimated figure for domestic rates), have moved in relation to GDP:-

TABLE 2

Taxes paid by persons as percentage of GDP at market prices

	Income tax	NICs	Indirect taxes	Total
1960	7.9	1.7	11.2	20.8
1965	9.2	2.2	11.8	23.2
1970	11.7	2.3	12.4	26.4
1975-76	13.9	2.6	11.1	27.6
1978-79	11.1	2.4	10.7	24.2
1981-82	11.2	2.9	13.0	27.1
1982-83	11.0	3.2	13.1	27.3
1983-84 (forecast)	10.4	3.4	13.0	26.8
1984-85 (forecast)	10.5*	3.4	13.0	26.9

*Note: The slight rise in income tax as a proportion of GDP despite the assumed 5 per cent increase in allowances reflects the 6½ per cent forecast increase in earnings.

Income tax allowances and thresholds

4. Allowances have been statutorily indexed by reference to retail price movements over the previous calendar year since the latter part of the 1970s. Table 3 shows how the single and married allowances have moved in relation to prices over the longer period.

Table 3

Indices of thresholds (1961-62 = 100) at constant prices.

	Single Allowance	Married Allowance
1961-62	100	100
1965-66	121	115
1970-71	142	124
1975-76	121	105
1978-79	124	118
1981-82	115	110
1982-83	122	117
1983-84 (forecast)	133	128
1984-85 (full indexation	134	129
1984-85 (allowing for fiscal adjustment	130	125

5. The allowances have thus increased in real terms both over the longer period and since 1978-79. In comparison with earnings, however, they have fallen over the whole period, although under the present Government they have broadly kept pace, with a significant rise since 1981-82. Table 4 illustrates these developments.

Table 4

Personal allowances as a percentage of average earnings (for full-time males all occupations)

	Single Allowance	Married Allowance
1961-62	22.8	37.2
1965-66	25.3	39.1
1970-71	25.6	36.7
1975-76	19.5	27.6
1978-79	20.1	31.3
1981-82	17.8	27.7
1982-83	18.8	29.4
1983-84 (forecast)	20.0	31.4
1984-85 (full indexation)	19.8	30.9
1984-85 (allowing for fiscal adjustment)	19.2	30.1

Average rates of tax

6. Looking at the period since 1961-62 the basic rate of income tax is broadly unchanged, reduced rates have been abolished and the higher rates have been reduced. Tax allowances have been increased by 25-30 per cent in real terms (ie in relation to prices) but have fallen by around 15 per cent in relation to average earnings, while employees' national insurance contributions as a proportion of gross earnings have increased from 4½ per cent at average earnings to 9 per cent this year and next at all earnings levels between the lower and upper limits. The effect of the income tax changes alone and the combined effect of both income tax and NIC changes are shown in the following tables. The NIC tables are for those not contracted out of SERPS.

Table 5

Income tax as a percentage of gross earnings

Multiples of average earnings	SINGLE ½	1	1½	2	MARRIED ½	1	1½	2
1961-62	7.5	17.2	21.5	23.7	2.6	12.8	18.6	21.5
1965-66	9.7	20.0	24.1	26.1	3.3	15.6	21.1	23.9
1970-71	15.6	23.8	26.6	28.0	8.5	20.3	24.2	26.2
1975-76	21.3	28.2	30.5	33.9	15.7	25.3	28.6	31.9
1978-79	17.3	25.2	27.8	29.7	9.9	21.5	25.3	27.4
1981-82	19.3	24.7	26.4	29.4	13.3	21.7	24.4	27.2
1982-83	18.7	24.4	26.3	28.7	12.4	21.2	24.2	26.6
1983-84 (forecast)	18.0	24.0	26.0	27.8	11.2	20.6	23.7	25.5
1984-85 (indexation)	18.1	24.1	26.0	27.9	11.4	20.7	23.8	25.7
1984-85 (with fiscal adjustment)	18.5	24.2	26.2	28.3	11.9	21.0	24.0	26.1

MARRIED + 2 CHILDREN (Income tax net of family allowance or CB as a percentage of earnings)

Multiples of average earnings	½	1	1½	2
1961-62	-4.7	3.4	11.7	16.3
1965-66	-3.7	5.9	14.6	19.0
1970-71	-4.8	13.6	19.8	22.8
1975-76	+4.1	19.6	24.7	28.5
1978-79	-3.6	14.7	20.8	23.9
1981-82	-	15.0	20.0	23.8
1982-83	-1.3	14.4	19.7	23.2
1983-84 (forecast)	-3.0	13.5	19.0	22.0
1984-85 (indexation)	-3.1	13.4	19.0	22.1
1984-85 (with fiscal adjustment)	-2.6	13.7	19.1	22.5

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TABLE 6

Income tax and NIC as a percentage of gross earnings

Multiples of average earnings	SINGLE ½	1	1½	2	MARRIED ½	1	1½	2
1961-62	13.6	21.7	24.5	25.9	8.6	17.3	21.6	23.7
1965-66	16.7	25.0	27.4	28.6	10.4	20.6	24.4	26.3
1970-71	23.3	29.3	30.2	30.7	16.2	25.7	27.8	28.9
1975-76	26.8	33.7	34.3	36.8	21.2	30.8	32.4	34.8
1978-79	23.8	31.7	33.3	33.8	16.4	28.0	30.8	31.6
1981-82	27.1	32.4	33.4	34.6	21.1	29.4	31.4	32.4
1982-83	27.5	33.1	34.1	34.6	21.1	29.9	32.0	32.4
1983-84 (forecast)	27.0	33.0	34.2	34.0	20.2	29.6	32.0	31.7
1984-85 (indexation)	27.1	33.1	34.3	34.1	20.4	29.7	32.0	31.9
1984-85 (with fiscal adjustment)	27.4	33.2	34.4	34.5	20.9	30.0	32.2	32.3

MARRIED + 2 CHILDREN (Income tax and NICs net of family allowance or CB as % of gross earnings)

Multiples of average earnings	½	1	1½	2
1961-62	1.4	7.9	14.7	18.6
1965-66	3.3	10.8	17.9	21.5
1970-71	2.8	19.0	23.4	25.5
1975-76	9.6	25.1	28.5	31.4
1978-79	2.9	21.2	26.3	28.0
1981-82	7.8	22.8	27.0	29.1
1982-83	7.5	23.1	27.6	29.1
1983-84 (forecast)	6.0	22.5	27.2	28.1
1984-85 (indexation)	5.9	22.4	27.2	28.2
1984-85 (with fiscal adjustment)	6.4	22.7	27.4	28.7

7. For all the groups covered by the tables the burden of income tax has thus increased over the period as a whole, with very substantial increases for some of the lowest paid. Looking at the period of the present Government, the burden has been reduced for all but the lowest paid, reflecting the lower basic and higher rates and, for those with children, the real increase in child benefit. For the lowest paid, these are offset by the abolition of the lower rate band. When NICs are included, the increase in the burden of tax is more marked, with all groups at these income levels facing a higher burden in 1983-84 than in 1978-79 and with substantial increases over the longer period. Since 1978-79 only those above twice average earnings have had a reduction in their tax burden. Again, the low-paid have fared worst.

Real net earnings

8. Because on average gross earnings have increased faster than prices, a higher proportion of income taken in tax does not necessarily mean that people are worse off. Table 7 provides figures for changes in real net earnings for periods since 1973-74.

Tables overleaf/

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TABLE 7

Increases in real net earnings

	SINGLE					MARRIED				
Multiples of average earnings	½	1	1½	2	5	½	1	1½	2	5
1973-74 to 1978-79	-1.1	-2.9	-3.6	-4.1	-18.7	+2.4	-0.8	-2.2	-2.5	-17.1
1978-79 to 1983-84	+3.0	+5.4	+5.9	+7.2	+24.4	+2.6	+5.0	+5.7	+7.2	+23.1
1973-74 to 1983-84	+1.9	+2.3	+2.1	+2.8	+ 1.1	+5.1	+4.2	+3.4	+4.6	+ 2.0
1983-84 to 1984-85 (indexation)	+1.7	+1.8	+1.8	+1.7	+ 1.7	+1.6	+1.7	+1.8	+1.7	+ 1.6
1983-84 to 1984-85 (with fiscal adjustment)	+1.2	+1.5	+1.7	+1.1	+0.6	+0.9	+1.3	+1.5	+1.0	+ 0.6

MARRIED + 2 CHILDREN

Multiples of average earnings	½	1	1½	2	5
1973-74 to 1978-79	+4.3	+0.5	-1.1	-1.5	-17.1
1978-79 to 1983-84	+4.1	+5.7	+6.1	+7.3	+22.0
1973-74 to 1983-84	+8.5	+6.2	+4.9	+5.7	+ 1.1
1983-84 to 1984-85 (indexation)	+2.0	+1.9	+1.9	+1.8	+1.7
1983-84 to 1984-85 (with fiscal adjustment)	+1.4	+1.6	+1.7	+1.2	+0.7

While some groups suffered a fall in real net earnings between 1973-74 and 1978-79, all have gained since 1978-79. Over the ten years as a whole all groups are better off, but (as a result of changes before 1978-79) those with children have done better than those without and the married have done better than the single. As between low and high income groups, there is no very marked pattern over the whole period since 1973-74, but the high income groups have done better since 1978-79.

Marginal rates and incentives

9. As well as the tax burden, marginal rates of tax have increased for the majority of households over the period since 1961-62, mainly because of the abolition of the extensive reduced rate structure that existed then. Taxpayers on half average earnings in 1961-62 had an effective marginal tax and a NIC rate of 17 per cent if they had no children, and if they had children they were not in tax at all. In 1983-84 all these taxpayers had a marginal rate of 39 per cent (income tax 30 per cent, NIC 9 per cent). This is, in fact, a slight improvement on 1978-79, when the marginal rate of tax and NIC was 39.5 per cent (income tax 33 per cent, NIC 6.5 per cent), <u>except</u> where there were children, when the marginal tax and NIC rate was 31.5 per cent because of the combination of child tax allowances and the reduced rate band. The abolition of the latter has thus increased marginal rates for some of the low paid, who in addition suffer from particular incentives problems becuase of the interaction of the tax and social security systems.

The poverty trap

10. The poverty trap is the term usually applied to the very high marginal rates faced by some low-paid workers who are both paying income tax and NIC and receiving means-tested benefits (such as family income supplement - FIS - and housing benefit). If earnings rise, tax and NIC increase and means-tested benefits become smaller. The result is an implicit tax rate which can exceed 100 per cent.

11. It is difficult to estimate the number of people affected by the poverty trap because not everyone entitled to means-tested benefits claims them. Estimates of the number claiming FIS and paying income tax and NIC in recent years are shown in the following table. The marginal rate of people in this position in 1983-4 is at least 89 per cent.

Table 8

Recipients of FIS paying income tax and NIC

	FIS recipients	of whom: paying tax and NIC	per cent
1973-4	75,000	15,000	20
1978-9	70,000	50,000	72
1981-2	143,000	119,000	83
1982-3	190,000	160,000	84
1983-4 (forecast)	205,000	161,000	79
1984-5 (forecast)	205,000	161,000	79

12. The trend has thus been a deterioration in the trap, both since 1978-9 and over a longer period. The range of income over which income tax and FIS overlap has increased: for a man with two children it ran from 35 per cent of average earnings to 53 per cent in November 1978 and runs from 31 per cent to 55 per cent in November 1983. As a consequence there are now more people in the trap, while the maximum marginal rate that is theoretically possible has risen to 109 per cent. The number of households in the trap in 1984-85 is expected to be very similar to the number in 1983-84 on the assumption of indexation; an increase in allowances of less than indexation would slightly increase the number in the trap.

13. Some households not entitled to FIS also have high marginal rates: the combination of income tax, NIC and housing benefit can currently produce a marginal rate of up to 72 per cent. Because of the recently announced changes to housing benefit, marginal rates will rise in April 1984 for some of these households: some 130,000

will see their marginal rate rise from 67 per cent to 79 per cent. But the changes will reduce marginal rates for others - again, about 150,000 - because they will lose entitlement to housing benefit altogether.

Unemployment trap

14. The unemployment trap is the situation where the gap between in-work income and out-of-work income is very narrow or even non-existent. Since the problem is one of relativities, the components of the trap are two-fold: earned income net of tax and national insurance contributions plus in-work benefits less travel to work costs on the one hand and benefits paid to the unemployed on the other. The latter may be either unemployment benefit (UB) or supplementary benefit (SB) or a combination. Those out of work for more than a year are wholly dependent on SB and increasingly the short-term unemployed receive some SB top up to their UB. In these cases it is the SB level which determines total out-of-work income and small changes to UB (or child benefit) have no effect.

15. Table 9 shows the movement in the ratio of out-of-work income to in-work income between successive Novembers (following the annual benefit uprating) for a single non-householder over 21 years and for a married man with two children.

Table overleaf/

Table 9

Ratio (%) of income out-of-work to income in-work

Single non-householders

Multiples of average earnings	Short-term ½	Short-term 2/3	Short-term 1	Long-term ½	Long-term 2/3	Long-term 1
November 1978	91.3	75.8	59.1	41.4	32.1	22.2
1981	72.9	58.7	43.9	41.7	31.9	21.6
1982	49.7	37.9	25.7	44.3	33.8	22.9
1983	51.0	39.0	26.5	42.8	32.7	22.3
1984 (forecast)	50.4	38.6	26.2	42.4	32.4	22.1

Married man + 2 children

	Short-term ½	Short-term 2/3	Short-term 1	Long-term ½	Long-term 2/3	Long-term 1
November 1978	131.3	102.2	82.9	86.7	78.9	58.1
1981	110.6	100.4	76.7	90.0	82.5	61.8
1982	93.9	88.2	67.4	91.1	85.6	65.4
1983	94.2	88.3	65.8	90.2	84.6	63.0
1984 (forecast)	92.1	92.1	65.2	88.3	88.3	62.5

16. These figures show that for the short-term unemployed the trap has improved over the life of this Government. This is largely because of the aboliton of earnings-related supplement to UB. The figures also reflect the taxation of out-of-work benefits, which means that those short-term unemployed who previously received tax rebates when out-of-work now receive much smaller ones (and not until they return to work or reach the end of the tax year).

17. On the other hand, the trap has worsened for the long-term unemployed because SB (including housing costs) has increased faster than net earnings in work.

18. There should be a slight improvement in the trap in November 1984 relative to November 1983, as after-tax earnings are forecast to rise faster than out-of-work benefits. The exception is the group affected by the housing benefit changes: these lower in-work income without affecting out-of-work income. This explains the marked worsening of the trap shown in Table 9 for married men at 2/3 average earnings. An increase in allowances less than indexation in 1984-85 would mean a further deterioration in the trap for some of this group.

Ways of alleviating the traps

19. Increases in income tax allowances, reductions in tax or NIC rates and increases in child benefit are all good for one or both traps. But some do more for one aspect of the traps and some for another. The choice between them thus depends on the importance attached to imrpoving one aspect rather than another.

20. If the objective is to reduce marginal rates for all those in the poverty trap - without creating losers or increasing the numbers trapped - the options are a lower basic rate, a lower NIC rate or a reduced rate band. But none of these would have a significant impact without a huge cost: £1 billion spent on lowering the basic rate or the NIC rate would only lower the maximum marginal rate from 109 per cent to 108 per cent and even a reduced rate band, if it was wide enough to extend up to the FIS run-out point, would only get the marginal rate down to 107 per cent.

21. Action on the poverty trap is therefore probably best concentrated on making significant reductions in marginal rates for sub-groups of those affected, by removing them altogether from tax or entitlement to a means-tested benefit. The choice here is between real increases in tax allowances and real increases in child benefit. The latter permits a reduction in FIS prescribed amounts, thus floating people off FIS, without making anyone worse off. For a given cost the child benefit route frees more people. For example, a 5 per cent real increase in allowances, costing nearly £1 billion, would take 6,000 out of the trap.[1] The same money spent on child benefit, assuming that all the real increase was clawed back from FIS recipients by reducing the FIS prescribed amounts,

(1) Although in all it would take some 400,000 people out of tax.

would take out 40,000. The reason is that the child benefit route takes out people from the top end of the trap, where the distribution is much denser than at the bottom.

22. As for the unemployment trap, the effects differ for the short- and long-term unemployed and for those with and without children. For the short-term unemployed raising tax allowances has little beneficial effect. Those unemployed only part of the tax year are likely to remain taxpayers and thus gain as much from higher allowances as people who do not experience unemployment. So the cost of a spell of unemployment, or of a marginal week's addition to an existing spell, is not altered. This is estimated to apply to about 3 million of the 5 million people expected to experience unemployment in 1983-4.

23. Either reducing the basic rate or raising child benefit would have some beneficial effect on the short-term unemployed[(1)], but the effects would not be great within feasible cost constraints. Table 10 below shows how £1 billion spent on each of the three policy changes would affect the ratios shown in Table 9.

Table overleaf/

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(1) It would be necessary to raise child benefit in real terms while holding SB child additions constant in real terms, In other words, the unemployed would not get the benefit of the real child benefit increase.

Table 10

Effects of raising allowances, cutting the basic rate and raising child benefit on short-term replacement ratios.

	Single non-householder		
Multiples of average earnings	½	2/3	1
November 1983	51.0	39.0	26.5
November 1984:			
Bare indexation	50.4	38.6	26.2
Indexation + 5% on allowances	50.8	39.0	26.6
Indexation and 1p off basic rate	49.8	38.0	25.8
Indexation and £1.75 on CB	50.4	38.6	26.2

	Married man + 2 children		
Multiples of average earnings	½	2/3	1
November 1983:	94.2	88.3	65.8
November 1984:			
Bare indexation	92.1	92.1	65.2
Indexation + 5%	92.2	92.2	65.4
Indexation and 1p off basic rate	91.6	91.2	64.4
Indexation and £1.75 on CB	89.8	89.4	63.2

24. None of the changes shown above have a major impact (for example, none are enough to reverse the effect of the housing benefit changes for those affected). Child benefit has the biggest effects, but only 15 per cent of the unemployed have children (although they are the group with the highest replacement ratios and it is arguable that the ratios of those in work are just as important).

25. For the long-term unemployed higher allowances would increase the incentive to take a job, like the other two measures. Their relative cost-effectiveness is shown in the following table:

Table 11

Effect of raising allowances, cutting the basic rate and raising child benefit on long-term replacement ratios.

	Single Non-householder		
Multiples of average earnings	½	2/3	1
November 1983	42.8	32.7	22.3
November 1984:			
Bare indexation	42.4	32.4	22.1
Indexation + 5%	42.0	32.2	22.0
Indexation and 1p off basic rate	42.0	32.1	21.8
Indexation and £1.75 on CB	42.4	32.4	22.1

	Married man + 2 children		
Multiples of average earnings	½	2/3	1
November 1983	90.2	84.6	63.0
November 1984:			
Bare indexation	88.3	88.3	62.5
Indexation + 5%	87.4	87.4	62.0
Indexation and 1p off basic rate	87.9	87.6	61.8
Indexation and £1.75 on CB	86.9	85.7	60.6

26. The limited effectiveness of tax and child benefit changes suggests that a greater impact on the trap might be achieved by changes to the social security system.

Summary

27. The position indicated by the paper can be summarised as follows:-

(i) Over the longer period there has been a marked increase in income tax as a proportion of GDP, though there has been an improvement here under the present Government and especially since 1981-82. This improvement is, however, more than offset by the increase in NICs;

(ii) allowances have increased in real terms both over the longer period and since 1978-79. The latter will remain the case even if allowances are only increased by 2 per cent in 1984-85;

(iii) over the longer period allowances have fallen in relation to earnings. Since 1978-79 they have broadly kept pace, but an increase in allowances of less than 6½ per cent in 1984-85 would mean a further deterioration;

(iv) over the longer period the burden of income tax has increased; since 1978-79 it has been reduced for all but the lowest paid. The position of the latter would further deteriorate if allowances were only increased by 2 per cent;

(v) when NICs are taken into account, the burden has increased for all but the highest paid over both the 1978-79 to 1983-84 and the longer period. Again, an increase in allowances of only 2 per cent would mean a further deterioration.

(vi) increases in earnings faster than prices have meant that real after tax earnings have improved for all groups since 1978-79 and over the longer period;

(vii) over the longer period marginal rates for the great majority of taxpayers have increased. Since 1978-79 there has been a very slight improvement for most taxpayers, but a deterioration for some of the lower paid;

(viii) the poverty trap has deteriorated, both since 1978-79 and over the longer period. The picture on the unemployment trap is better for the short-term unemployed, but the trap has worsened for the long-term unemployed.

(ix) the recently announced housing benefit changes deepen the poverty trap for some people, but take others out of it. These changes also worsen the unemployment trap;

(x) without very considerable cost, very little can be achieved on the traps through changes in taxes or universal benefits. For 1984-85 an increase in allowances below indexation would mean a further slight deterioration in the poverty trap and worsen the unemployment trap for some people.

FP1/DEU4
DECEMBER 1983

FROM: J ODLING-SMEE

DATE: 23 December 1983

Chancellor

MR MIDDLETON

cc Sir T Burns
Mr Bailey
Mr Byatt
Mr Scholar
Mr Riley
Mr Spackman

FINANCING PUBLIC EXPENDITURE : OUTLINE OF A PAPER FOR CHEVENING

Sir Terence Burns asked me to send you the attached outline.

JO-S

J ODLING-SMEE

This is what was once the asset sales paper. It will be produced jointly by Mr Bailey and Sir T. Burns, and would be for the second day at Chevening. Some of the practical implications need to be brought out more clearly.

We shall also have ready a note on the PSBR dealing with - among other things - the possibility of moving to a calendar year accounting basis and alternative PSBR presentations if we stick to the financial year

JM 23/12.

JJ 23/12

FINANCING DIFFERENT TYPES OF

PUBLIC EXPENDITURE

Outline of a Discussion Paper

This paper is concerned with financing different types of public expenditure, particularly where the expenditure is lumpy and there is a continuing flow of benefits to be derived from that expenditure. In general this involves capital expenditure of one kind or another, and it includes the acquisition of assets previously owned by the private sector. Although the bulk of the analysis is in terms of asset acquisition it can be carried over to asset sales.

2. The analysis is in terms of a world of zero inflation. Therefore it provides the framework for deriving the appropriate borrowing profile in a world of stable prices. Allowing for inflation would mean taking into account the impact of the inflation tax and the effect of inflation on the real value of debt outstanding. These can be grafted on to the analysis.

3. The important operational questions are

- how to treat capital transactions in relation to the appropriate levels of borrowing;
- the extent to which asset sales and capital expenditure are conceptually equivalent, although of opposite sign;
- how to assess their movement in relation to the public expenditure planning and control procedures.

4. The paper will attempt to define the characteristics of three different kinds of expenditure and asset transactions.

(a) Income-earning capital expenditure. Examples: building a power station, developing an oil field, nationalising a profitable industry. The transaction involves:

(i) a once-and-for-all capital expenditure
(ii) an income stream from the asset
(iii) interest payments on the outstanding debt

If the project is profitable we would expect the flow of income (ii) <u>net</u> of depreciation to exceed the interest charges on the original expenditure. Cumulatively there is no need for any taxation; if the project is profitable there will be a dividend to distribute in the form of lower taxes.

(b) Expenditure that yields a future 'income' stream for the private sector. Examples: roads, education, defence hardware. This transaction involves:

(i) a once-and-for-all capital expenditure
(ii) an "income" that takes the form of future benefits to the private sector that are usually partly or wholly non-pecuniary
(iii) interest payments on the outstanding debt

If the project is profitable we would expect the flow of benefits, net of depreciation, to exceed the interest charges on the original expenditure. It will be necessary to raise taxes to provide an income to the gpvernment which when added to any higher tax receipts stemming from the higher private income, is equal to the interest charges. If the investment project is profitable this should leave the private sector with higher post-tax income or benefits than would have been the case without the investment and higher taxation. However at constant level of higher tax rates there is likely to be a borrowing requirement in the initial period and a surplus in later periods as the borrowing is repaid.

(c) Expenditure that yields no future benefits. Examples are money transfer payments and wasteful capital expenditure: this needs to be financed from taxation and there is no problem of an imbalance of expenditure and tax revenue through time.

5. The question is the extent to which it is legitimate to borrow in cases (a) and (b) above. (Borrowing to finance wasteful capital expenditure is not legitimate because it would impose an unjustified burden on future taxpayers - as measured by the excess of debt interest payments (iii) over income (ii). Hence the classification under case (c).) The argument for borrowing is that it is disruptive and inefficient to raise taxes and lower them in line with the variations in expenditure and income when they are so uneven. Financial markets will be willing to lend if they can be assured that the income will emerge to finance the loan, either from higher trading receipts or from taxation. As we have described, this should be possible if the project yields either income or benefits to the private sector for which it is generally acceptable that they should pay taxes.

6. One objection to such borrowing is that it will crowd out private sector investment. But if the rate of return on the public sector project is higher than on private sector projects this should not matter. But there needs to be good reason why the public sector rather than the private sector should be carrying out the project, otherwise the presumption must be that it would be more effectively done by the private sector.

7. This points to the case for public borrowing to finance asset accumulation and a debt repayment to offset asset sales. But for this purpose asset and capital transactions must be seen on a net basis, ie after allowance for depreciation (and implicitly the repayment of principal). This implies

(a) that with a one-shot expenditure there will be borrowing in the first year and repayment in subsequent years;

(b) that a steady level of capital expenditure for many years in practice means little in the way of borrowing as aggregate depreciation will tend towards the level of gross expenditure;

(c) when capital expenditure is growing over time, new expenditure will exceed depreciation (net capital expenditure is positive) and continuous aggregate borrowing is legitimate.

Although the main focus of interest here is capital expenditure, the distinction between expenditure that justifies borrowing and other expenditure does not correspond to the capital/current split. Some current expenditure (eg education) yields future benefits, and some wasteful capital expenditure does not.

8. Asset sales fall into this framework in reverse. Relative to the position when the assets are owned by the public sector the borrowing requirement in the initial year of sale should be reduced. In subsequent years it can be increased to some extent as there is no longer any need to repay debt in line with the depreciation of the asset once it is transferred to the private sector. The cumulative amount of the increased PSBR in these later years will approximate to the sale price of the asset. Effectively the receipts from the sale are spread over what would have been the lifetime of the asset.

9. Efficiency aspects of asset sales: in many cases assets will be more efficient when operated by the private sector. Since the purchase price will (ignoring capital market imperfections) tend to reflect expected profitability in the private sector, the Government will gain financially from the sale. Savings on debt interest payments ((iii) in para 4) will exceed income forgone (ii). Since the PSBR should change (be lower in the year of the sale, higher afterwards) this means that taxes can be lower (or other expenditure higher) in the years following the sale than if there had been no difference in efficiency between the public and private sectors.

10. Some complications that affect the measurement of the stream of income obtained from an asset, although not the general principles:

(a) some income from assets (eg land) comes in the form of capital gains rather than interest or dividends;

(b) council house rents net of maintenance expenditure are only tenuously related to the cost of borrowing and the price at which the houses are sold.

11. Discussion of the similarities and differences between new capital expenditure and purchases and sales of existing assets. Similarities stem from fact that both existing and new assets provide a future income stream, and so initial PSBR can be higher when expenditure incurred or asset purchased and lower afterwards during repayment period. Differences associated with financial consequences: new expenditure adds to demand and puts upward pressure on interest rates for given monetary growth or debt-income ratio; an asset purchase does not (or does only to a much lesser extent).

12. Some operational implications:

- there is a case for taking account of shifts in the net asset position of the public sector in decisions about borrowing and expenditure.

- this applies to both asset sales (purchases) and investment: but the different financial implications of the two also have to be taken into account.

- measures of the net asset position of the public sector are needed: in principle these should include all expenditures that yield future benefits, even those that are "current" (eg education).

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13. Questions for discussion:

- arguments for and against the special recognition of net capital expenditure in PSBR decisions

- arguments for and against any special treatment in public expenditure planning and control

- similarities and differences between capital expenditure and asset sales

- practical implications.

FROM: A M W BATTISHILL
DATE: 9 January 1984

1. **SIR PETER MIDDLETON**
2. **CHANCELLOR OF THE EXCHEQUER**

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Mr Littler
Mr Bailey
Sir T Burns
Mr Cassell
Mr Monck
Mrs Lomax
Mr Cropper
Mr Lord

Sir L Airey - IR
Mr A Fraser - C&E

CHEVENING

Attached below is an annotated agenda for the weekend discussions.

[signature]

A M W BATTISHILL

[illegible]
Sir TB [illegible]

33

FROM: F CASSELL

11 January 1984

CHANCELLOR

cc - Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr Littler
Mr Bailey
Mr Battishill
Mr Kerr
Mr Ridley
Mr Lord
Mr Portillo

Sir Lawrence Airey, IR
Mr A M Fraser, C&E

CHEVENING: TAX ISSUES

I attach a paper on tax issues. This has been drafted by FP in consultation with the Revenue departments. It reports the state of play in various areas, the revenue costings of the main options under consideration, and suggests some particular points for discussion.

Some updating may be required in the light of meetings later this week.

F CASSELL

TAX ISSUES

Ministers have made clear the priority they attach to raising the personal tax thresholds by the maximum amount resources permit. They have also been examining a number of areas of the tax system where there seems to be scope for major structural change. The work has taken particular account of the balance between taxes on labour and on capital; the balance between different forms of saving; the need to broaden the tax base; and the staff savings that could arise.

2. Much of the work originates from wide-ranging reviews in several areas and, in particular, the major study by Inland Revenue/Treasury officials of the taxation of savings and investment completed last summer. This study identified a number of severe distortions in the tax system. In the savings field, these include the preferential tax treatment of life assurance and pension funds, and tax reliefs for owner-occupation. On the company sector/investment side, the study raised questions about whether the corporation tax (CT) system could be made more neutral as between retentions and distributions, and between debt and equity financing. It also pointed out that the present capital allowances system creates a distortion both between different forms of business expenditure and between different types of investment.

3. A number of the areas covered by this study were selected by Ministers as worthy of further consideration. Decisions on certain changes to the tax regime for banks and building societies have already taken place. And further work has been done on company taxation, changing the tax arrangements for pensions and life assurance, the tax treatment of gilts and equities and extending the VAT base.

4. Against this background, this note discusses the issues which arise for the 1984 Budget, including the scope for raising the thresholds, and shows what effect the wider structural changes under consideration could have on tax revenues in 1984-85 and subsequent years.

1984 Budget

5. In looking at the 1984 Budget we have taken as the starting point a nil fiscal adjustment. The main issues for decision appear to be :

- the scope for increasing the income tax personal allowances/thresholds over and above the inflation adjustment (5 per cent) assumed in the forecast;

- the strength of the case for a reduction in the corporation tax rate, and/or NIS, affecting CT payable in 1984-85, as a "payment on account" of the offset if the abolition of stock relief and a reduction of capital allowances is announced in the Budget; and

- how the additional revenue required to achieve a nil fiscal adjustment should be raised, in particular:

  - the scope of any extension of the VAT base;

  - the amount which could be looked for from a licence duty on institutions providing personal credit;

  - additional indirect tax increases which could be required over and above price indexation.

Work is also underway on proposals for reducing stamp duty on equities, and the scope for financing this by offsetting savings elsewhere.

6. The costs over and above indexation of a range of options for increasing the income tax thresholds are given in Annex 1. An earlier Inland Revenue submission ('Approach to the 1984 Budget: options for personal tax changes') shows that earnings indexation (prices + 1½ per cent) is the minimum required if Ministers are not positively to lose ground in relation to various key objectives, ie if income tax is not to rise as a proportion of income, if the number of people subject to income tax is not to increase and if we are to avoid a large increase in the staff requirement in this area. The interaction between changes on tax allowances and child benefit also needs to be considered.

7. There is a case for action on the corporation tax rates to apply to CT payable in 1984-85. A reduction of say two percentage points in the rates would undoubtedly help in softening the impact of a Budget announcement to abolish stock relief and reduce capital allowances, even though the latter would not come into effect until 1985-86. But the cost - £220 million in revenue terms in 1984-85 - would be high in the context of a nil fiscal adjustment and would significantly reduce the scope for increasing the personal allowances. An alternative (if lower CT rates rather than the abolition of NIS is the objective - see para 11 below) would be to announce the CT rate applying to CT payable in 1985-86 at the same time as fixing it at 52 per cent for the previous year.

8. At the present stage of Ministers' consideration of Finance Bill starters, there is likely to be a small positive yield - perhaps £75 million in revenue terms - in 1984-85 (mainly as a result of the proposed change to the date for repayment of ACT to oil companies which reverses itself in 1985-86).

9. We now turn to the main areas of tax reform that are under consideration.

Company taxation

10. As the first stage in a medium-term programme of reforming the company tax regime, the Financial Secretary has proposed the following package of changes to be announced in the 1984 Budget:

a. the abolition of stock relief;

b. the reduction of first year capital allowances on plant and machinery from 100 per cent to 75 per cent;

c. the reduction in initial allowances for industrial buildings from 75 per cent to 50 per cent.

11. This could make way for a reduction of 8 percentage points in the CT rate for financial year 1984 (affecting tax paid by companies in 1985-86), which would not normally be set until the 1985 Budget. Account also needs to be taken, however, of the Government's

objective to abolish NIS over the course of this Parliament. How the two would fit together is for discussion.

12. Over a period of years we might move to an economically more rational capital allowance system where first year and initial allowances for machinery and plant and industrial buildings are abolished, leaving writing down allowances of 25 per cent a year for the former and 4 per cent a year for the latter. Action might also be taken (and possibly foreshadowed in the 1984 Budget) to restrict capital allowances for certain items (structures, decor items, equipment and apparatus installed in buildings, etc) which enjoy treatment as machinery and plant that was largely unintended, and to tidy up the system generally.

13. Such a programme of reform has considerable economic attractions. It would substantially reduce the distortions between investment and other forms of business expenditure such as labour costs, and also the choice between different types of investment. A lower CT rate would reduce the bias against equity finance. And stock relief was introduced at a period when inflation and corporate liquidity were at very different levels from today. Politically however there would be difficulties. There would be a substantial number of losers, including capital intensive companies (eg parts of manufacturing), holders of large stocks, unincorporated businesses and small companies. Overall, the effect on North Sea companies seems likely to be more or less neutral, but the effect of the reductions in capital allowances could be adverse to some new investment. Further work on this will be needed to establish whether any offsetting changes in the North Sea fiscal regime would be required. Reducing capital allowances for plant and machinery to as low as 25 per cent would have very serious effects on the leasing industry and its customers, particularly tax-exhausted companies.

14. An important question for discussion is whether, should action be taken this year along the lines indicated in paragraph 10 above, the whole medium-term strategy should be unveiled. There would be intense pressure from industry (and, because of leasing, the banking sector) for the Government to indicate its future intentions. And there is a strong case for allowing industry to make its long term

term investment decisions on the basis of some certainty about the tax regime. Against that, there are obvious difficulties in entering into expensive forward commitments; and the more that is revealed at an early stage, the greater will be the scope for industry to mount effective opposition to frustrate any subsequent steps.

North Sea taxation

15. There are no proposals at this stage to introduce further major structural changes in the North Sea fiscal regime. But Ministers are considering action to limit potentially substantial losses or deferments of CT as a result of farmouts.

Banks and Building Societies

16. There are important differences between the tax treatment of the building societies and the banks that have led to accusations of discrimination. The following decisions have been taken which should reduce these distortions and make competition fairer:

a. A composite rate for taxing interest paid by banks, like that applied to the building societies, is to be introduced. A major additional attraction of this change is that it wold save up to 1,000 Revenue staff. It will also avoid most of the big increase in staff that would be needed if the banks were to start paying interest on current accounts. We intend to legislate in the 1984 Finance Bill, for implementation in 1985-86, subject to discussion with the BBA who are being consulted on a confidential basis.

b. The special 40 per cent rate of corporation tax applying to building societies and other mutuals is something of an anomaly, dating from the change to the "imputation" system of corporation tax in 1973. The Chancellor has agreed that this difference of treatment should be abolished, though it has not yet been agreed whether this should take effect in the 1984-85 tax year or later.

c. Building societies' profits on gilts are now, unlike those of the banks, taxed as capital gains, whereas in fact in a number of cases the proceeds arguably form part of the societies' trade and should therefore be subject to corporation tax. Counsel's advice is being sought so as to determine whether this difference of treatment could be resolved through litigation rather than by legislation.

17. The effect of the change at (a) on tax revenue is uncertain but likely to be small. (b) and (c) would increase revenue by about £100 million in a full year. The effect on the mortgage rate would be minimal (0.2 per cent at the most).

18. An Official Working Group recently carried out a study of <u>bank taxation</u>. It concluded that there is not at present a strong case for taxing bank profits but that there is a stronger one for taxing customers of the banks and other financial institutions. The Chancellor has asked for further work to be done on one of the options considered in the report - a licence fee for all institutions providing credit for persons. A fee set at ½ per cent of the volume of outstanding credit might raise some £400 million a year (assuming no clawback of revenue through income tax, etc) if mortgage lending were included, which would be desirable in economic terms, and £75 million if it was excluded. We are considering whether the tax could be made effective from 1984-85.

<u>Tax treatment of gilts and equities</u>

19. Officials have recently submitted a report to the Chancellor on the possibility of financing a reduction in stamp duty on equities by ending the exemption of gilts from stamp duty and CGT. A 1 percentage point reduction in the rate of stamp duty on equities might cost about £175 million in 1984-85, plus a consequential loss of duty through the creation of companies to hold at least the larger commercial buildings. This further loss of revenue might build up over a period to perhaps £50 million.

20. The major problem of raising revenue from ending the tax exemptions for gilts is that, given the terms of their issue, existing stocks would have to continue enjoying the exemption. If new stocks alone were subject to tax, revenue would build up very slowly. Moreover, ending the tax exemption for new gilts would drive up yields, and the increased debt interest costs might well offset any extra

tax revenue. Ending CGT exemption for new gilts is unlikely to raise significant amounts of revenue because of indexation provisions, the fact that losses will be allowable, and the current tax exemption for major classes of investor.

21. If Ministers favour reducing stamp duty on equities to 1 per cent, leaving the rate of duty unchanged elsewhere, despite the political difficulties, it is for consideration whether the first year cost of about £175 million (ignoring the "knock on" effects) could be financed by other tax changes in the area of financial institutions. There are attractions in reducing the rate of stamp duty by 1 per cent on all assets, but this would be considerably more expensive - about £460 million for the first year.

Pensions and life assurance

22. In the case of pensions, work is being done in two areas:

- taxing the lump sum paid with pensions, and

- taxing the pension funds' investment income.

Large amounts of money are involved. In theory, the eventual yield from taxing lump sums could be some £650 million a year at present levels; and the potential yield from taxing the investment income of the pension funds is up to £2¼ billion a year, although this figure does not allow for any changes in the funds' (or pensioners') behaviour. Neither figure allows for any offset from, for example, greater difficulty in increasing contributions from public sector employees. However, the potential yield from both these reforms will increase progressively in future years, as the pension schemes themselves move towards maturity.

23. Economically, a change in this direction makes good sense. The present system in effect subsidises pensions, to the extent that it gives full relief for pensions contributions, but does not bring into tax the full amount of pension payments. The value of the lump sum is in the region of one quarter of the total value of the pension, and the subsidy is thus substantial. Taxing the investment income of the funds could contribute significantly towards the objectives of reducing both the perceived fiscal attractions of such investment -

thus achieving a better allocation of resources - and the dominance of pension funds in the equity market. Either change would be compatible with a move towards portable pensions.

24. There would be severe difficulties, however. Taxing the lump sum would have a direct and visible effect on most pensioners. Taxing the funds' investment income would be instantly opposed by the funds. A lengthy transitional period would probably be necessary. There is also a strong view that the changes would have to be placed in the context of a much wider new approach to provisions for retirement generally. And there is the difficulty of making substantive changes in the pension field while the Fowler Review is underway.

25. Various changes in the tax treatment of qualifying <u>life assurance policies</u> - including, for new policies, the immediate abolition, or phasing out, of life assurance premium relief (LAPR) and perhaps the taxation of the proceeds from policies (net of total premia paid) - are being considered. If current policies are to be affected, transitional arrangements would be necessary.

26. These changes would go some way towards removing the distortions created by the present tax treatment of life assurance. The length of the transitional period would determine how quickly the full benefit to the Exchequer would be realised, but it could be around £100 million in the first year, if relief on new policies was stopped overnight. The main long-term effect would be the saving from the withdrawal of LAPR from existing policies, the cost of which is currently running about £700 million a year or more. This could eventually be reduced to nil by phasing out the relief on existing policies over a period of, say, ten years.

<u>VAT and Excise duties</u>

27. Customs and Excise have submitted papers on possible packages for extending the VAT base. Annex 2 shows the additional revenue that could be expected from applying VAT to the main zero-rated items either at the current standard rate of 15 per cent or at a reduced rate of 5 per cent.

28. The main package currently under consideration would apply VAT at the standard rate to books, newspapers and news services, building alterations and take-away food. This would produce £760 million additional revenue in 1984-85 and £1050 million in a full year.

29. The 0.5 per cent impact effect on the RPI of this package would add £65 million in 1984-85 and £175 million in a full year to the cost of indexing all social security benefits. The effects on tax allowances and thresholds would not feed through until 1985-86 when account would be taken of the December 1984 RPI figures. The cost of additional indexation as a result of the VAT package would be about £100 million in a full year.

30. A possible addition to the package would be taxation of non-domestic construction. If effective anti-avoidance measures could be worked out, this would bring in additional revenue of up to £275 million in a full year. Customs and Excise are considering urgently with the Inland Revenue whether it is possible to devise suitable measures which would make the tax stick on the exempt (mainly financial) sector. Further consideration would need to be given to how the public expenditure costs of imposing VAT on non-domestic constructions might be reduced.

31. A further possibility, which is not however an option for 1984, would be to introduce a reduced rate of VAT. Applying a 5 per cent rate to the remaining zero rated items would yield additional revenue of about £2 billion a full year. The impact effect on the RPI would be about 1.3 per cent. If desired the RPI effect could be moderated either by staging the introduction of the new rate or by shifting some items which are currently standard-rated to the reduced rate.

32. If action is to be taken on the VAT base in the 1984 Budget detailed preparatory work needs to be set in hand very soon.

33. A background note on the excise duty with tables showing the effects of revalorisation is attached at Annex 3.

Costings

34. The direct revenue effects of the main changes outlined above are set out in Annex 1. (Figures for pensions and life assurance are not given both because discussion with Ministers is still at an early stage and because the costings for the early years are heavily dependent on the transitional provisions that are announced). The table can be used as a set of "building blocks" to construct various tax packages, given the overall fiscal adjustment in each year. The memorandum items at the bottom of the table are a series of ready-reckoners on NIS, corporate tax, income tax and VAT which can be used for this purpose. (Annex 3 provides further ready-reckoners on indirect taxes). The effects on the PSBR will depend on how the economy is affected by the tax change. Assuming no accompanying change in monetary policy, the PSBR effects might be a little lower than the direct revenue effects, depending on the tax change considered. Further work will need to be done on PSBR effects once the shape of the Budget decisions becomes clearer.

Points for discussion/decision

35. The following questions might be used as a basis for discussion:

i. With the priority given to increasing tax thresholds, what are Ministers' preliminary views on the trade-off between highly desirable increases over indexation in 1984-85 and the tax-raising measures necessary to finance them?

ii. Could and should "tax reform" be adopted as a major theme for the 1984 Budget?

iii. Beyond the decisions (eg on financial sector) already taken, what should be the priorities for tax reform?

iv. In order to create a politically viable company tax package, should the Government announce a reduction in the CT rates for financial year 1983? What if anything should be said about raising CT rates and/or NIS in later years; and how explicit should it be about its longer-term intentions for company tax reform?

v. How can the problems of gainers and losers (eg manufacturing industry, unincorporated businesses and leasing operations) be overcome?

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Annex 1: Revenue effects of proposed major structural tax changes

[£million]	1984-85	1985-86	1986-87	1987-88
Company tax				
a. Abolition of stock relief	Nil	+350	+650	+750
b. Reduction in first year allowances for plant and machinery to 75%	Nil	+500	+750	+750
c. Reduction in first year allowances for industrial buildings to 50%	Nil	+ 30	+ 50	+ 60
Total of (a) to (c)[1]	Nil	+930	+1550	+1660
Banks and Building Societies				
a. Composite rate for banks	Nil	Small	Small	Small
b. Abolition of special 40% CT rate for Building Societies) c. Taxing Building Societies' profits on gilts)	Nil[2]	+100	+100	+100
d. Licence duty on personal credit (including mortgages)	+400	+400	+400	+400
Total of (a) to (d)	+400	+500	+500	+500
VAT - extension of base *	+670	+1050	+1050	+1050

Memorandum items*	1984-85	1985-86	Full Year	
NIS abolition (in 1985)	Nil	-750	850	
Reducing CT rate and small companies' CT rate by 1%	-110	-180	-190	
Increase in personal allowances and thresholds over indexation: + 1½% (3)	-260	-330	-330	For [illegible]
+ 3%	-500	-640	-640	3 offsets [illegible]
+ 6%	-950	-1200	-1200	
Increase in IIS threshold to £10,000	Neg	-50	-85	
Reducing Stamp Duty on equities to 1%	-175	-175	-175	

* Figures at 1984-85 prices

1) The aggregate effect is greater than the sum of the parts, because of the interaction between the abolition of stock relief and the reduction of allowances.

2) If existing CT payment dates for Building Societies continue, the revenue yield in 1984-85 would be £80 million. The nil figure shown assumes a change to the normal 9-months rule for companies.

3) Earnings indexation.

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ABOLITION OF VAT ZERO RATINGS: 1984/85 FULL YEAR REVENUE AND RPI IMPACT EFFECT

		5% £m	(RPI effect) %	15% £m	(RPI effect) %
Group 1	Food	1225	0.9	3650	2.2
Group 3 Group 4	Books and newspapers Talking books for the blind	125	0.1	✓ 375	0.3
Group 5 Group 6	Newspaper advertisements News services	10	nil	25	nil
Group 7	Fuel and power	450	0.3	1350	1.0
Group 8	Construction (new construction and alterations)	410*	nil	1225*	nil
Group 10	Transport (internal passenger)**	160	0.1	475	0.2
Group 17	Young persons' clothing and footwear	85	0.1	250	0.2
Group 2 Group 9 Group 11 Group 12 Group 13 Group 14 Group 15 Group 16	Sewerage services and water International services Caravans and houseboats Gold Banknotes Drugs (excluding prescription charges Imports, exports Charities	nil/small/indeterminate			
		2465		7350	

60/85

Books + Newsp.	400	290
B. Alterations	450	250
Hot Takeaway	200	130
	~~1050~~ 965	670
	f.y.	first year

* (i) Assuming that it is possible to make tax stick on exempt traders. If they are able to avoid all tax the estimate falls to £950 million at (15%) or £325 m (at 5%)

(ii) Estimate is for net additional revenue and excludes extra tax paid by Central Government of the order of £275m (at 15%) or £90m (at 5%)

**This estimate is for all internal passenger transport.

Annex 3

INDIRECT TAXES

This note is for background only. A full submission on excise tax options will come forward later in the month.

Alcoholic drinks duties

2. Table 1 below gives, for reference purposes only, the price, revenue and RPI effects of 5 per cent revalorisation of each of the drinks duties. The position on these duties is complicated this year by the need to take account of the judgement by the European Court of Justice, that the UK's current tax rates favour beer at the expense of wine, contrary to Article 95 of the Treaty of Rome. The implications of this decision are being considered separately in consultation with the Law Officers. It is therefore not possible to consider changes in the beer duty or in the wine duty in isolation - their relative levels must also be taken into account. As a general guide, however, an increase of 1p on beer might have to be accompanied by a reduction of the order of 23-24p on light wine to conform with the Court's judgement. A 2p increase in beer could imply a reduction in the wine duty of the order of 20p on wine.

Other indirect taxes

3. On the assumption that changes in the drinks duties to take account of the European Court's decision can be made in such a way as not to require any recoupment of revenue from other excise duties, table 2 shows the broad effects of revalorisation of the other duties. The figures differ from those included in the Autumn Statement because the price changes have been rounded to produce more realistic increases.

4. The table also illustrates the effects of changes in the rates of VAT and car tax.

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TABLE 1: 5% REVALORISATION OF THE DUTIES ON ALCOHOLIC DRINKS

	Full year revenue effect(1)	Change in price of typical item(2)	Percentage change in price of typical item	RPI impact effect(3)	Approx effect of duty change on consumption
	(£m)	(p)	(%)	(%)	(%)
Beer (pint at 1037° OG)	80	0.9	1.4	0.06	- 0.3
Light wine (75cl bottle)	16	4.9	1.7	0.02	- 1.5
Fortified wine (75cl bottle of sherry)	6	6.3	1.7	0.01	- 1.5
Sparkling wine (75clbottle)	1	5.9	0.6	-	- 1.5
Spirits (75cl bottle at 40%	25	26.2	3.5	0.04	- 2.9
Cider (pint)	1½	0.3	0.5	-	- 0.1
Made-wine 75cl bottle British sherry)	2	5.8	2.9	-	- 1.5
	131½			0.13	

Notes (1) At 1984-85 levels of prices and consumption
(2) Including associated VAT
(3) The RPI impact effect had been calculated to the nearest 0.01%. Published estimates of RPI effects are normally to the nearest 0.1%.

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Table 2

(£m 1984-85 prices and income levels)

	Price change	% change in duty	Full year[1] Revenue (£m)	RPI impact[3] effect (%)
Tobacco (20 king size)	4p	6.09	135	0.15
Petrol (gallon)	4½p	5.4	225	0.10
Derv (gallon)	3½p	4.9	45	-
VED (car + light van)	£5	5.9	90	0.05
VED (HGVs)	£7.50 £147.00	5.0	19	-

	First year yield/cost (£m)	Full year yield/cost (£m)	RPI impact effect (%)
VAT rate + 1%	550	740	0.5
Car tax rate + 5%	250	340	0.2 [2]

(1) Assuming implementation on 1 April, the first-year revenues would be the same as the full-year for petrol, derv and VED; and approximately eleven-twelfths of the full year revenue for tobacco.

(2) This is the change in the RPI that would occur after about 3 months: there is no impact effect since new cars do not feature in the RPI.

(3) Footnote on RPI as previous table.

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FROM: A. M. BAILEY

11th January, 198~~3~~.4

CHANCELLOR OF THE EXCHEQUER

c.c. Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T. Burns
Mr. Littler
Mr. Cassell
Mr. Battishill
Mr. Kerr
Mr. Ridley
Mr. Lord
Mr. Portillo

Sir Lawrence Airey, IR
Mr. A. M. Fraser, C & E

CHEVENING: ASSETS, PUBLIC EXPENDITURE AND BORROWING

Sir T. Burns and others have contributed to the attached paper, which considers in turn

- classes of capital transactions, assets and benefits
- criteria for investment
- microeconomic arguments for financing by borrowing as against taxation
- macroeconomic arguments on the same issue
- implications for the PSBR
- implications for public expenditure control.

It concludes with a list of questions for discussion.

AMB

(A. M. BAILEY)

ASSETS, PUBLIC EXPENDITURE AND BORROWING

This paper considers the implications of "capital" transactions, now included in public expenditure, for the appropriate levels of public-sector borrowing. It assumes a world of price stability, and thereby avoids some of the complications of inflation without altering the main conclusions.

2. "Capital" transactions are defined widely, to include anything which generates a continuing flow of benefits, such as new capital formation, the acquisition of an existing asset or current expenditure (eg on R and D, education) that has some characteristics of "investment".

Three types of "assets" and their associated benefits can be distinguished:

i. Assets which earn a stream of income - eg power stations, telecoms.

ii. Assets which generate a stream of benefits, which do not accrue as public-sector income (except via tax) but which increase private sector income and taxable capacity - eg roads, education.

iii. Assets which yield a stream of benefits which are unlikely to add to taxable capacity - eg prisons, defence hardware.

3. It is simplest to consider first the decision to make a new capital investment. There are two questions:

a. Should it go ahead?

b. How should its financing be treated?

There are both microeconomic and macroeconomic aspects of the second question.

The decision to invest

4. For income-earning assets (i), the decision whether or not to go ahead is in principle straightforward. If the project is profitable the flow of income net of depreciation should exceed the interest charges on the original capital expenditure. (In practice the return from a project may be uncertain, and has to exceed the required rate of return, which is

not necessarily equal to the market interest rate in the short term. These complications do not alter the basic conclusion, and are ignored here.) Cumulatively there is no need for any taxation; if the project is profitable there will be a dividend to distribute in the form of lower taxes.

5. Non-income-earning assets may add to the private sector's taxable capacity as benefits accrue (ii) or they may not (iii). But in either case the question for decision is whether the stream of benefits is worth more than the costs of the extra taxation required to finance them. For economic benefits (eg roads) it may be relatively easy to measure the benefits and compare them with the interest cost of financing. But for other benefits (eg defence) the "value" of the continuing benefits is unquantifiable and has to be weighed against the extra tax burden by the same kind of political judgment as for current spending.

Financing "capital" expenditure: microeconomic aspects

6. If a capital project qualifies as worthwhile under these tests, the question arises whether it should be financed initially by taxation, or by borrowing on which the interest and repayment charges then have to be met from trading receipts or taxation later. The microeconomic case for borrowing is that future generations will benefit from this expenditure and so should share its costs. Financial markets recognise this and are willing to lend when they are assured that a stream of benefits will emerge commensurate with the financing costs, whether the loan is financed from higher trading receipts or from taxation. Also for a large one-off item of expenditure, it is disruptive and inefficient to raise and lower taxes to match the uneven cash flow.

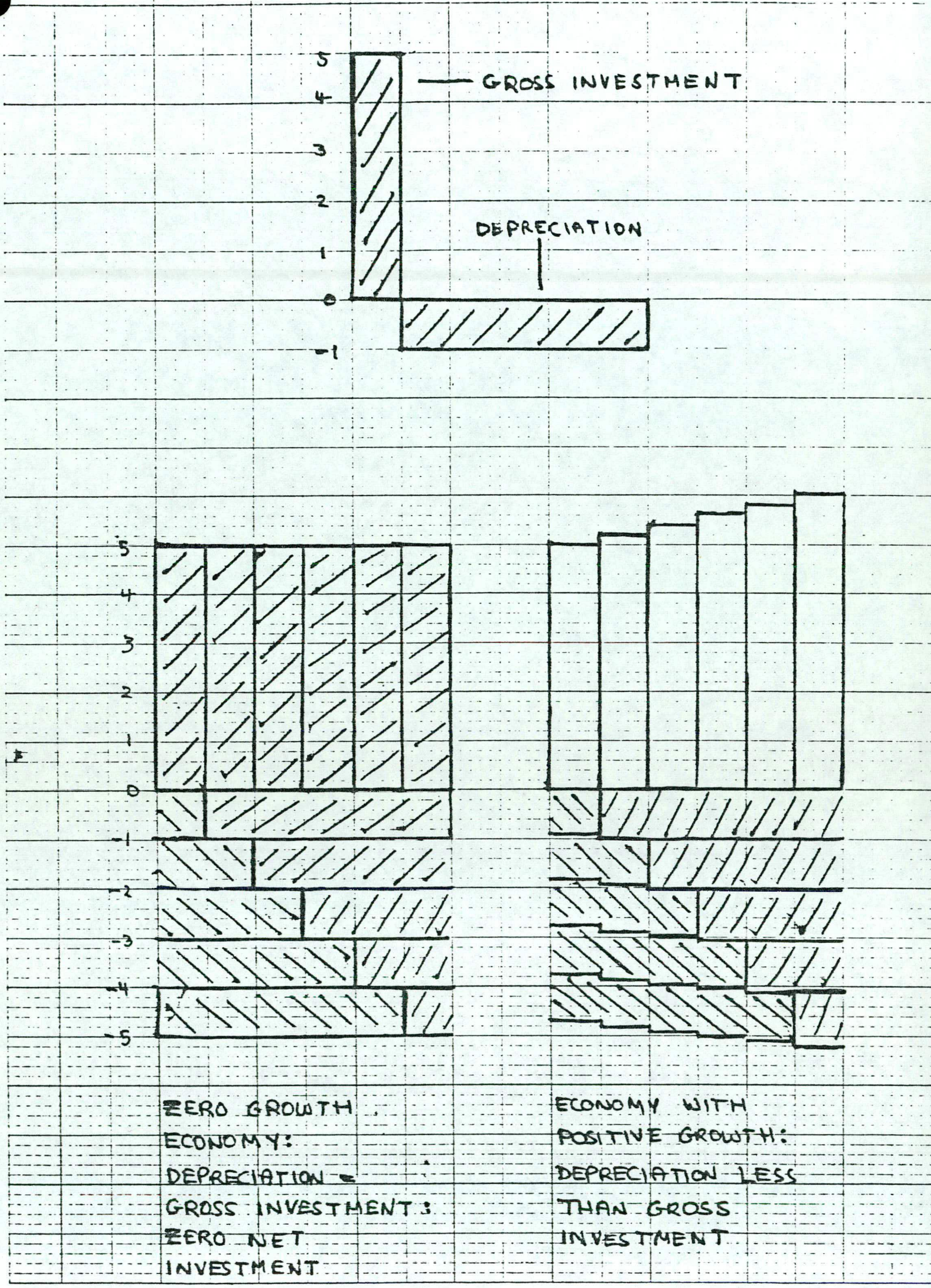
7. This argument points to the case for a target level of public borrowing which allows for the net acquisition of assets. The reason why capital transactions should be on a net basis (ie after allowance for depreciation) is so that proper account is taken of repayments of loans to finance earlier expenditure as well as of new loans to finance new expenditure. The net borrowing implications of gross and net expenditure can therefore be summarised:

a. a one-shot expenditure can be financed by borrowing in the first year and repayment in subsequent years: Chart 1 (top panel) illustrates the impact on borrowing, assuming that the asset lasts 5 years;

b. a steady level of capital expenditure for many years would point to little or no borrowing in practice as aggregate depreciation will tend towards the level of

CHART 1

ILLUSTRATIVE EXPENDITURE AND DEPRECIATION FLOWS



gross expenditure: this is shown in Chart 1 (bottom left), where aggregate depreciation (plotted below the line) exactly balances new investment above the line;

c. when capital expenditure is growing over time, new expenditure will exceed depreciation (net capital expenditure will be positive) and continuous aggregate borrowing is legitimate: Chart 1 (bottom right) shows a larger volume of new investment above the line than the aggregate depreciation below the line.

8. The argument applies equally to new capital investment by the public sector and to purchases of existing assets from the private sector. Provided that the assets yield benefits, both transactions justify borrowing to finance them. Conversely the sale of an asset should be accompanied by an equivalent reduction in borrowing. In later years borrowing can be somewhat higher than it would have been because of the reduced need to repay debt. Effectively the receipts from the sale are spread over what would have been the lifetime of the asset. If the asset is operated more efficiently in the private sector, the Government will tend to gain financially from the sale because the sale price will reflect expected profitability in the private sector.

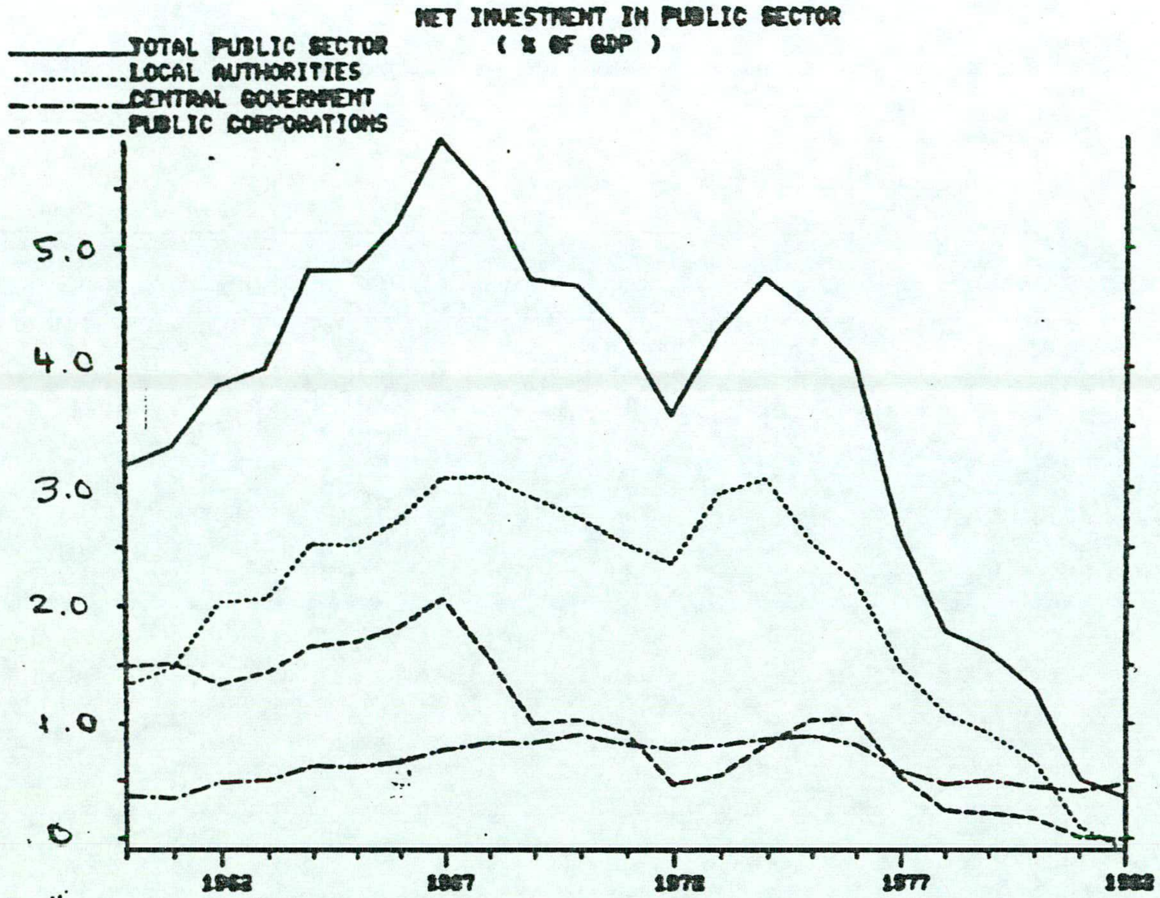
9. It is not easy to quantify the implications of these microeconomic arguments for the appropriate amount of public sector borrowing. The measurement of depreciation, and indeed of "capital" spending, is inevitably rather arbitrary (see paragraph 23 below). A partial picture is provided by the figures for net investment on a national accounts basis estimated by the CSO. These show that public sector net investment in both new and existing assets exceeded 5% of GDP in the mid-1960s, and has since fallen steadily, apart from a small fluctuation in the mid-1970s, to almost zero now (Chart 2). The bulk of this fall is attributable to local authorities, although there were also falls in both central government and public corporations. All of the fall up to 1974 was accounted for by the decline in net investment in new assets, but both new assets and net purchases of existing assets have contributed to the fall since then.

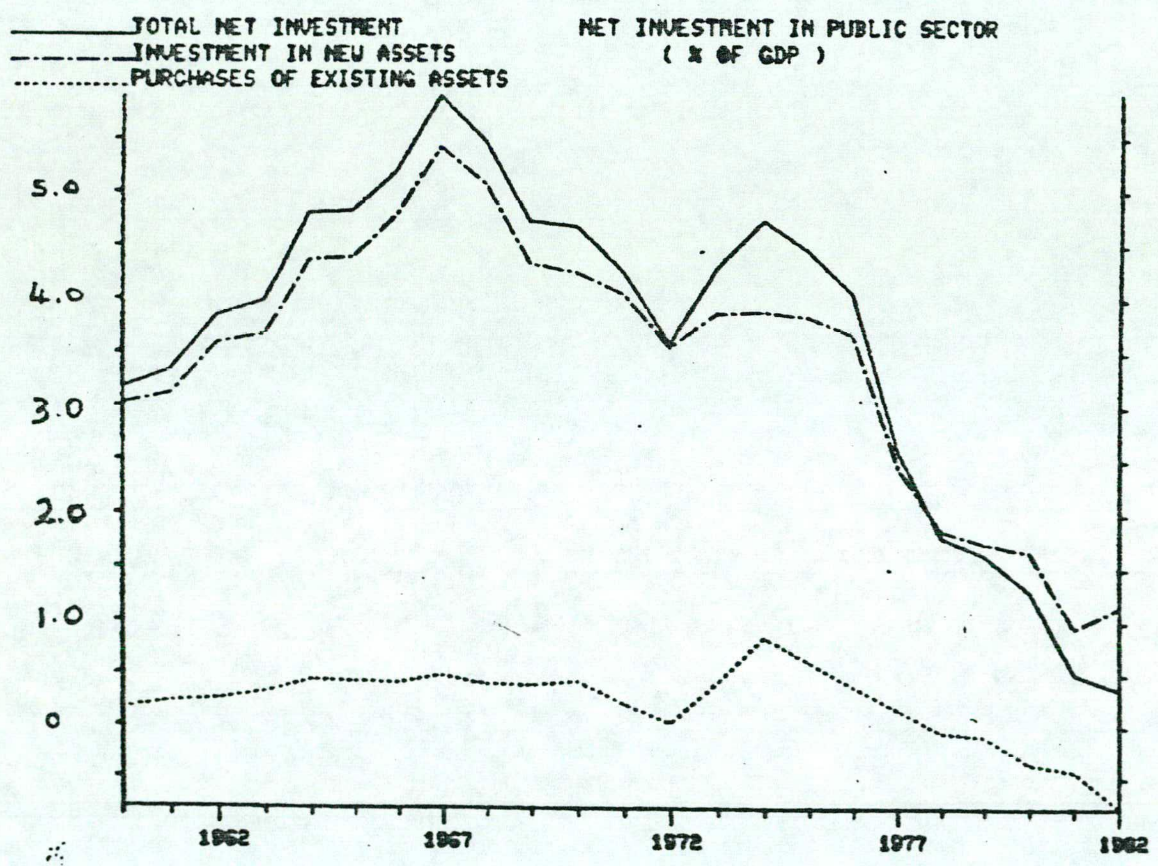
10. The absolute level of the net investment figures in Chart 2 does not necessarily point to the level that the PSBR should be, mainly because other types of "capital" transaction relevant to the PSBR are not included. If there has been fairly continuous growth in this other expenditure, as there probably has been, the level of borrowing could be higher than that shown in the chart. However, the downward trend in the net investment ratio is striking and could well indicate a downward trend in total net "capital" expenditure. The implication is that the target for the PSBR ratio should have

CHART 2

PUBLIC SECTOR NET INVESTMENT

(Percent of GDP)





been falling over the last 15 years, quite apart from any fall that may have been required to correct for an initially excessive PSBR. However, this ignores the possibility that some of the projects in the years of high public sector investment were unprofitable and should not have been financed by borrowing at all.

Financing "capital" expenditure: macroeconomic aspects

11. There are macroeconomic as well as microeconomic arguments that should be taken into account in choosing the PSBR target. These are fairly familiar and relate to the desired path for interest rates, given objectives for money GDP and money supply. The two approaches will not necessarily lead to the same objective for the PSBR.

12. This can be seen first from the case of a profitable new public investment project that suddenly appears, such as the exploitation of a newly-discovered natural resource, the construction of the Channel tunnel, or the purchase of some new medical technology. The microeconomic argument suggests that borrowing should rise to the full extent of the initial expenditure. But this could put upward pressure on interest rates, which may conflict with macroeconomic objectives. The alternative would therefore be to finance at least part of the project by raising taxation, so that borrowing did not rise to the full extent of the expenditure.

13. The choice between higher interest rates and higher taxes raises similar questions to those that arise in discussions of the balance between fiscal and monetary policy. What is the impact of the alternative methods of financing on the balance of the economy (eg between consumption and investment, persons and companies)? What are the administrative and political difficulties associated with tax rather than interest rate adjustments?

14. Fluctuations in interest rates in response to fluctuations in borrowing to finance capital expenditure may well be preferable to fluctuations in taxation because they are less disruptive and they bear hardest on private capital and other interest-sensitive expenditure. The broad balance between investment and consumption would be altered less by allowing interest rates rather than taxation to fluctuate. If the conclusion is that the extra capital expenditure should be financed by borrowing so that interest rates rather than taxation take all the strain, the macroeconomic objective for the PSBR is identical to the microeconomic one. But if some of the strain is to be borne by taxation, the two will be different: the PSBR should be lower for macroeconomic reasons than the total of net capital expenditure, which is the level it would take according to the microeconomic argument.

15. Similar reasoning applies to the macroeconomic implications of changes in the trend of public sector capital expenditure as to one-off projects. But an analysis of the reasons for a change in trend is required. If, for example, the decline in net new investment by the public sector over the last 15 years reflected a reduction in profitable investment opportunities in the economy as a whole, it may not have been appropriate that borrowing should have fallen to the same extent in order to reduce interest rates and stimulate private sector investment. But if it reflected a wish to reduce public sector investment for other reasons, but not to alter the overall level of investment in the economy, an equivalent reduction in borrowing would have been warranted. Both reasons probably apply. Certainly some of the investment 15 years ago was of doubtful benefit and a reduction was desirable even without lower interest rates; but in addition a fall in interest rates to encourage more private investment has been an objective of fiscal policy in recent years.

16. The macroeconomic implications of financing "capital" expenditure point to a potential difference between transactions in existing assets and investment in new assets. Whereas new investment by either the public or the private sector puts upward pressure on interest rates on the assumption that the authorities wish to keep money GDP or money supply unchanged, the same is not necessarily true of purchases of existing private sector assets by the public sector. The closer the assets are regarded as substitutes for gilts, the smaller the impact of an asset purchase on interest rates, for given broad money supply and money GDP. Thus purchases of, say, BP shares and, to a lesser extent, the nationalisation of a private company which is paid for by selling gilts might have little effect on the level of interest rates.

Implications for setting the PSBR

17. In principle the argument of this paper is that there would be a presumption on micro-economic grounds that the target PSBR should move in line with movements in net capital expenditure. (The two should not necessarily be equal in absolute terms because there are other major transactions - not discussed in this paper - that may call for positive or negative public borrowing. The two most important are: North Sea oil revenues, which could be used in part to repay debt during the years when they are high; and the accumulation of pensions liabilities under PAYG schemes, which also points to some repayment of debt in order to keep the growth of total public sector liabilities under control.) An examination of the interest rate implications of allowing the PSBR to fluctuate to the full extent of fluctuations in net capital expenditure might then lead to a modification of the desired PSBR path.

18. It is important to separate asset sales and purchases from other expenditure. The former have only a limited impact on interest rates, and so the PSBR target should usually reflect all of the movements in them: when asset sales rise, as is expected next year, there must be a presumption that the target PSBR should fall to the same extent. Although the same is not necessarily true of other "capital" expenditure because of its interest rate implications, nevertheless it is likely that it would be desirable for at least part of the movement in it to be reflected in the PSBR and hence in interest rates. How much would depend on the macroeconomic circumstances at the time.

19. However, there are practical problems that make it difficult to set the PSBR in this way. The difficulty of measuring depreciation and the arbitrariness of deciding where to draw the line between "capital" expenditure and other expenditure are discussed later (paragraph 23). In addition there is considerable uncertainty attached to estimates of the impact of changes in expenditure on interest rates, for given money GDP and money supply. These difficulties apply primarily to transactions other than sales and purchases of existing assets. Since the latter also present fewer difficulties in principle, there is much to be said for making an explicit allowance for them in setting the PSBR.

20. Nothing so formal can be attempted at this stage for other "capital" expenditure. Nevertheless some attention should be paid to expected movements in net capital expenditure, measured on national accounts definitions, since this is the component that is likely to fluctuate most from year to year and to show the sharpest changes in trend (as shown in Chart 2). Further work on the measurement and definitional points might in time enable the adoption of a more formal approach.

Implications for public expenditure planning and control

21. If the conclusion that the PSBR should bear some relation to net capital expenditure is accepted, there are two possible courses from the point of view of public expenditure and control:

a. to leave planning and control totals as they are, but make allowances for any major shifts in the aggregate of relevant capital transactions when judging the appropriate level of public borrowing from year to year;

b. to take capital transactions of the relevant ~~bids~~ kind (depending on the macroeconomic assessment, as above) out of the public expenditure totals for planning and control purposes, and show them separately in relation to public-sector borrowing.

22. In theory there are good arguments in favour of course b. A systematic "below the line" treatment would bring out the effect of lumpy capital transactions on the borrowing requirement, and distinguish them from the ordinary run of public spending.

23. But in practice there are powerful objections to this radical course:

i. Public expenditure and its components (cash limits, EFLs) are cash concepts, showing how much cash is required to finance it by way of taxation or borrowing. Depreciation or "capital consumption" is not, and is determined by accountants (for the nationalised industries) or statisticians (for the public services) on more or less arbitrary assuptions about asset lives and replacement costs. Depreciation is even harder to measure for the "assets" created by current expenditure (eg education).

ii. Even for income-earning capital investment in the nationalised industries, there is a case for maintaining a single control total embracing both current and capital spending. It has been a standard and effective gambit, in nationalised industry pay negotiations (eg railways) to say that more money on pay means less on investment (hence future job security). Though the argument could be mounted even with separate control totals (more pay means lower rates of return means lower investment), it is more sophisticated and less likely to be effective.

iii. For non-income-earning assets, decisions are bound to involve evaluation of benefits against tax "costs" (paragraph 5 above). This is now secured by setting programme totals (roads, defence, education) covering both capital and current spending. If capital transactions were controlled separately, in terms of the tax "costs" of servicing the capital over the whole life of the asset, it is difficult to believe that these tax costs decades ahead would be taken seriously. The alternative of charging the tax cost in full when the asset is acquired, and requiring departments to compare this with the "net present value" of future benefits, is likely to be far more effective.

iv. At the far end of the spectrum there is no clear line between "capital" expenditure in the widest sense, bringing some continuing economic benefits (eg education), and almost all "social" spending (eg health, law and order) which also arguably yields some continuing benefits.

v. Even for asset sales, which might be thought of as a distinct category, there is a range of cases from "special sales of assets" through council house sales and other sales and purchases of existing assets (eg land). "Special sales of assets" could be moved out of the public expenditure planning total and below the line (where debt interest is now). But council house sales are an integral part of local authority capital spending, already segregated from local authority current. And other asset sales crop up in various programmes, subject to varying "incentive" conditions on receipts etc.

24. Hence the conclusion is reluctantly against making any change in the planning total to reflect the differing nature of capital transactions. The only practical possibility is to put special sales of assets below the line, on the grounds that these are individually larger and less predictable than other forms of capital transaction where there is a clearer trend. But other transactions such as council house sales are also lumpy and unpredictable, so there is not much logic in any difference of treatment. And there is a powerful argument against changing the definition of public expenditure yet again without very good reason.

Questions for discussion

25. The following questions are posed by this paper:

i. Is it right to consider decisions to invest separately, as in paragraphs 4 and 5?

ii. Is it agreed that the micro-economic arguments point to the conclusions in paragraph 7?

iii. How far should these conclusions be modified by the macro-economic arguments (paragraphs 12-14)?

iv Should the target for the PSBR be adjusted to take account of movement in asset sales (paragraph 19)? To what extent should any additional adjustment be made for fluctuations in other net capital expenditure (paragraph 20)?

v. Should the public expenditure planning total be adjusted to exclude

- special sales of assets?

- other capital transactions ?

FROM: F CASSELL

11 January 1984

CHANCELLOR

cc - Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr Littler
Mr Bailey
Mr Battishill
Mr Kerr
Mr Ridley
Mr Lord
Mr Portillo

Sir Lawrence Airey, IR
Mr A M Fraser, C&E

CHEVENING: PERSONAL BORROWING

I attach a paper on the recent growth of personal borrowing and its implications.

F CASSELL

PERSONAL BORROWING

This note looks at the recent behaviour of personal borrowing and the extent to which it has changed since the mid-1960s. It then considers the resulting issues of analysis and policy - which bear on such questions as the appropriate targets for broad money and the role of over-funding.

2. With the removal of the corset in mid-1980 (and the preceding abolition of exchange controls) the banks were not only freed from a direct constraint on total lending, but also had much greater freedom over its composition. As a result total bank lending rose very rapidly, and within this total there was a high growth of lending to persons, particularly for house purchase. Partly reacting to the competition from the banks, but also responding to the authorities' acquiescence in the banks' incursion into mortgage lending, the building societies dramatically stepped up their lending, and increased the range of financial services offered to depositors and borrowers. Between mid-1980 and mid-1983 the stock of lending by banks and building societies to the personal sector rose by £47 billion, or 82 per cent.

3. The high growth in lending has not been accompanied by a commensurate growth in broad money, whether measured by £M3 or any of the PSLs. Overfunding, accompanied by money market assistance, together with rising non-resident balances and non-deposit liabilities have produced a marked difference between the growth of money and the growth of credit to the private sector. One strand of monetarist analysis stresses that the importance of high monetary growth derives from the potential for the private sector to spend currency and highly liquid deposits. On this view it does not matter how fast credit grows provided monetary growth is under control. Prima facie the experience of the past three years accords with this view. Prices and nominal GDP have decelerated. Indeed there is some difficulty explaining the extent of their deceleration against the background of relatively rapid growth of broad money; these difficulties apply a fortiori to potential explanations of economic behaviour that attribute a significant role to credit.

4. There are, however, misgivings that the recent growth of personal credit could have unwanted implications for spending and prices in the future. This paper examines the arguments that give rise to these misgivings. This first part of it summarises the recent development of personal borrowing and the debt/income ratio. The second part seeks to explain these developments and assesses whether they are likely to continue. The third part assesses the extent to which the additional borrowing has increased expenditure. The final part sets out some possible conclusions.

I. THE BEHAVIOUR OF PERSONAL SECTOR BORROWING

(i) Gross debt/income ratios

5. Most discussion of personal sector debt concentrates on a few prominent constituents of it - HP, bank lending and building society lending. Panel 1 of Chart I shows how these have moved in relation to personal disposable income since the mid-1960s, and how they are forecast to move over the next few years[1]. It shows that most of these debt/income ratios are now above their previous peaks, of the early 1970s, and are forecast to rise still further.

6. This familiar story is, however, misleading. Liberalisation and the more competitive spirit it has unleashed have enabled banks and building societies to win back business from other lenders (such as local authorities, insurance companies, solicitors etc) and to displace trade credit. The lower panel of Chart I shows the effect on the debt/income ratio of adding various categories of borrowing, the top line showing the total financial liabilities of the personal sector.[2] The striking feature is the extent to which the rise in the debt/income ratio over the whole period since 1966 is lower the wider the coverage of debt. Whereas on the narrower measure - HP, bank, and mortgage lending - the debt/income ratio was above its previous peak by early 1982 this has only recently been the case with total financial liabilities.

7. The debt/income ratio in Britain is of course still far below that in the United States. There are major institutional differences between the two countries - for one thing all consumer debt interest is tax deductible in the US, whether for housing or other purposes. While there is no reason why British consumers and lending institutions will eventually converge on American debt/income ratios, these ratios provide a benchmark against which developments here can be assessed. Chart II shows one common measure of the US household debt/income ratio since 1950, and also shows equivalent measures of the household[3]

---

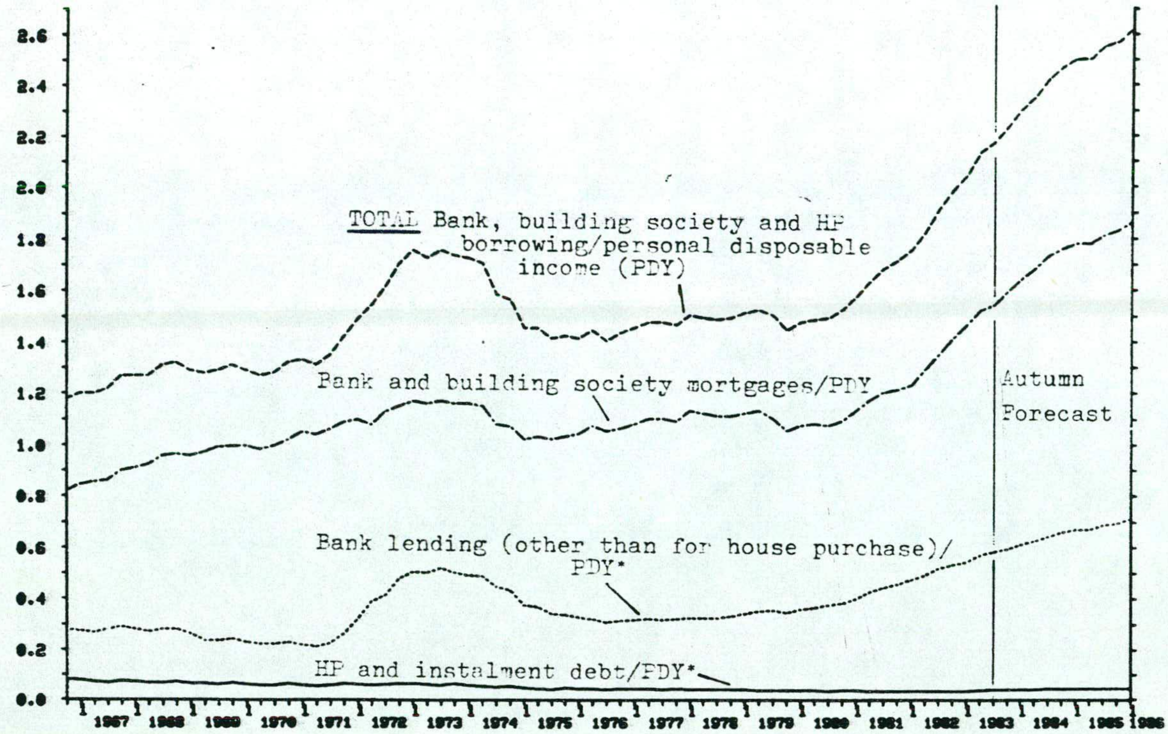
[1] The changeover from the banking to the monetary sector in 1981(4) produced a discontinuity in the series for HP debt and bank lending because the majority of finance houses were thereafter in the monetary sector and their lending became a constituent of total bank lending to the personal sector. Chart I adjusts the series for both of these to take account of this discontinuity, so that before 1981(4) the series for both are comparable with their present definitions.

[2] Annex 1 describes in detail the various components of total personal sector liabilities and gives the absolute (£b.) amount and share (%) of total liabilities for end 1978 and the beginning of 1983.

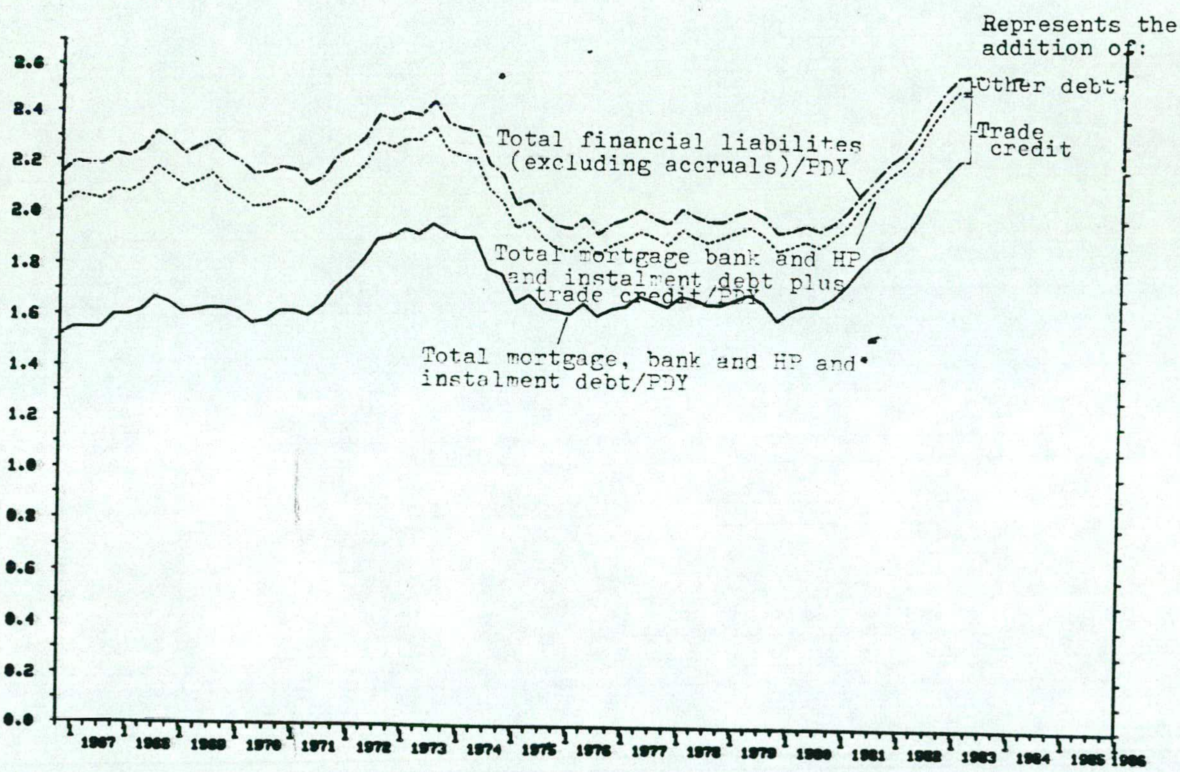
[3] The household sector excludes unincorporated businesses (which are in the personal sectors). (It is only possible to to make this adjustment in the UK for the time period shown in Chart II and for this particular definition of the debt/income ratio.)

CHART I: DEBT INCOME RATIOS OF THE PERSONAL SECTOR

PANEL 1



PANEL 2

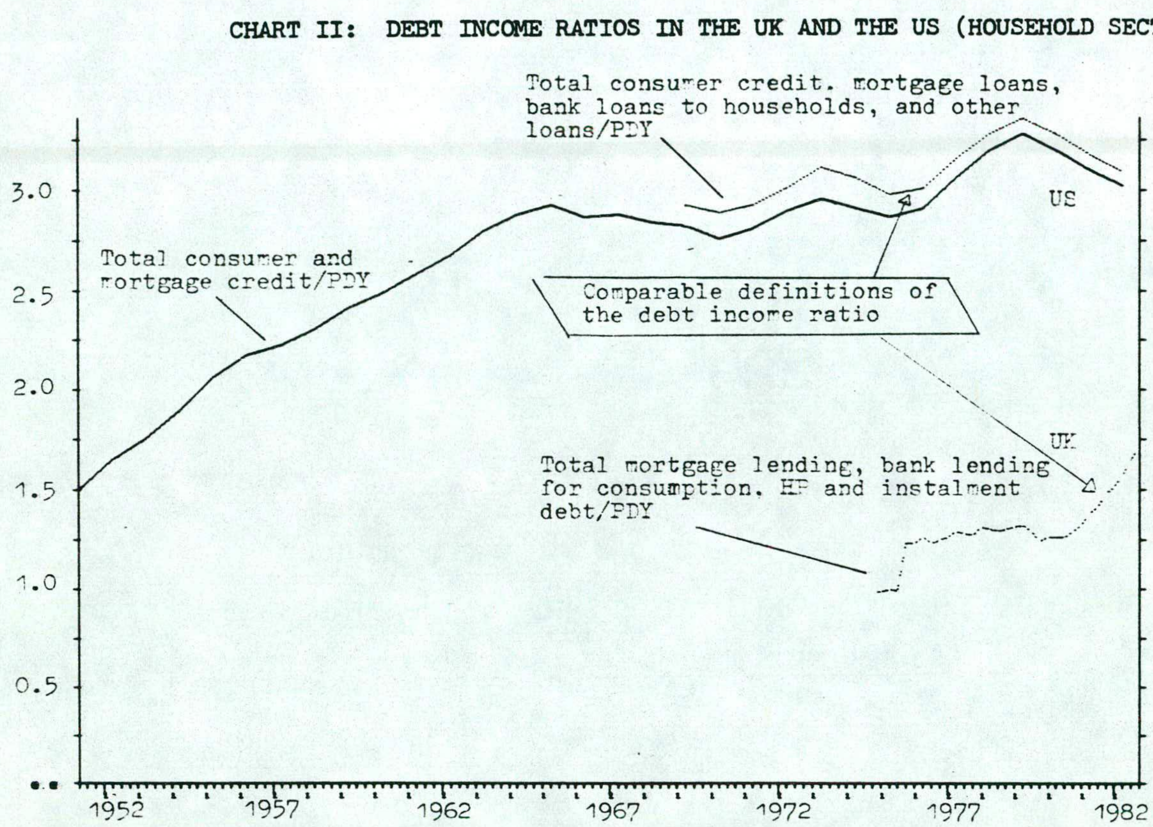


Note: Both Panels show the ratio of the stock of debt outstanding at end-quarter to the quarterly flow of personal disposable income.

*These series are rescaled before 1981Q4 to allow for the break in series, caused by the switch from the banking to the monetary sector.

debt/income ratio for the US - since 1969 - and the UK - since 1974. The US ratio has been significantly higher, but the gap has narrowed in the last few years.

CHART II: DEBT INCOME RATIOS IN THE UK AND THE US (HOUSEHOLD SECTOR)



(ii) Net indebtedness

8. The adjustment of personal sector finances since 1979 has involved substantial increases not just in borrowing from banks and building societies but also in deposits with these institutions and in national savings instruments. Chart III shows gross and net debt/income ratios for the personal sector. There is inevitably some arbitrariness both about the measure of gross credit used here - which covers only HP, banks, and building societies (because only data on these is readily available) - and about the liquid financial assets deducted from it - deposits with banks, building societies and national savings. Nevertheless this information on net credit gives a useful insight into recent developments. The net debt/income ratio of the personal sector rose sharply between 1971 and 1973, but since then there has been a fairly steady rise. In the context of this historical experience there is nothing odd about the accumulation of net liquid financial assets in the last few years, or the continuation of that accumulation expected by the forecasters.

CHART III : PERSONAL SECTOR DEBT/INCOME RATIOS

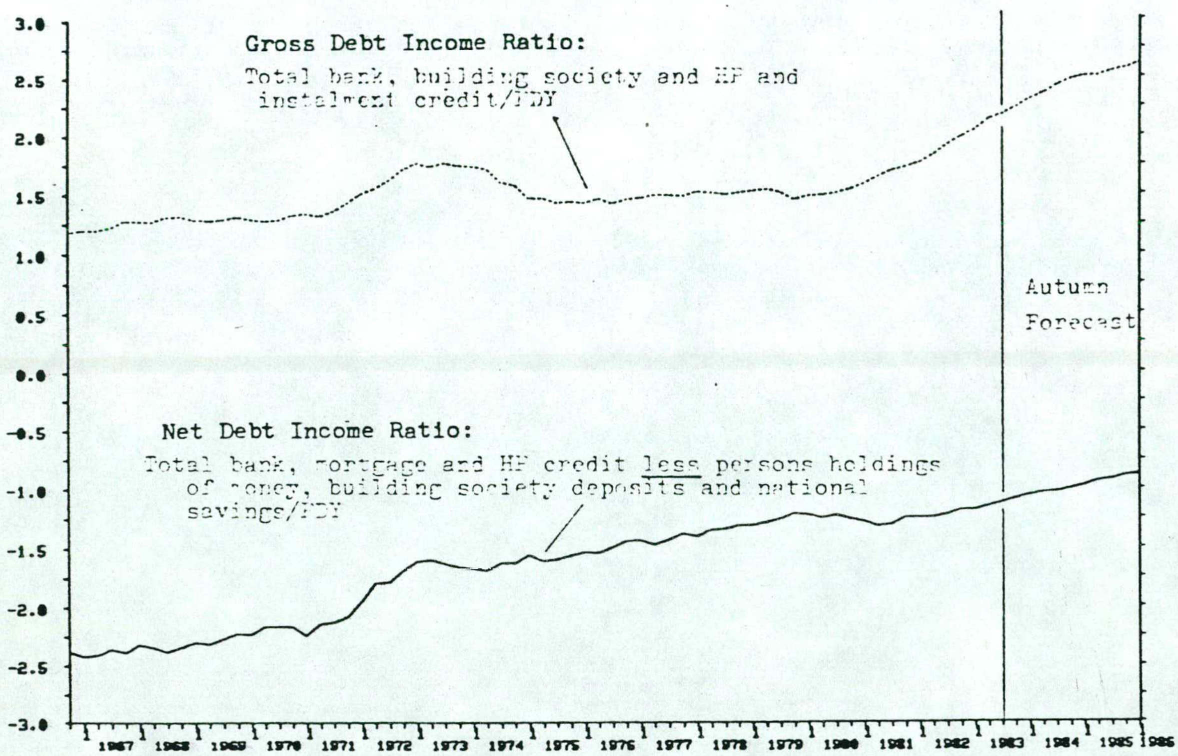
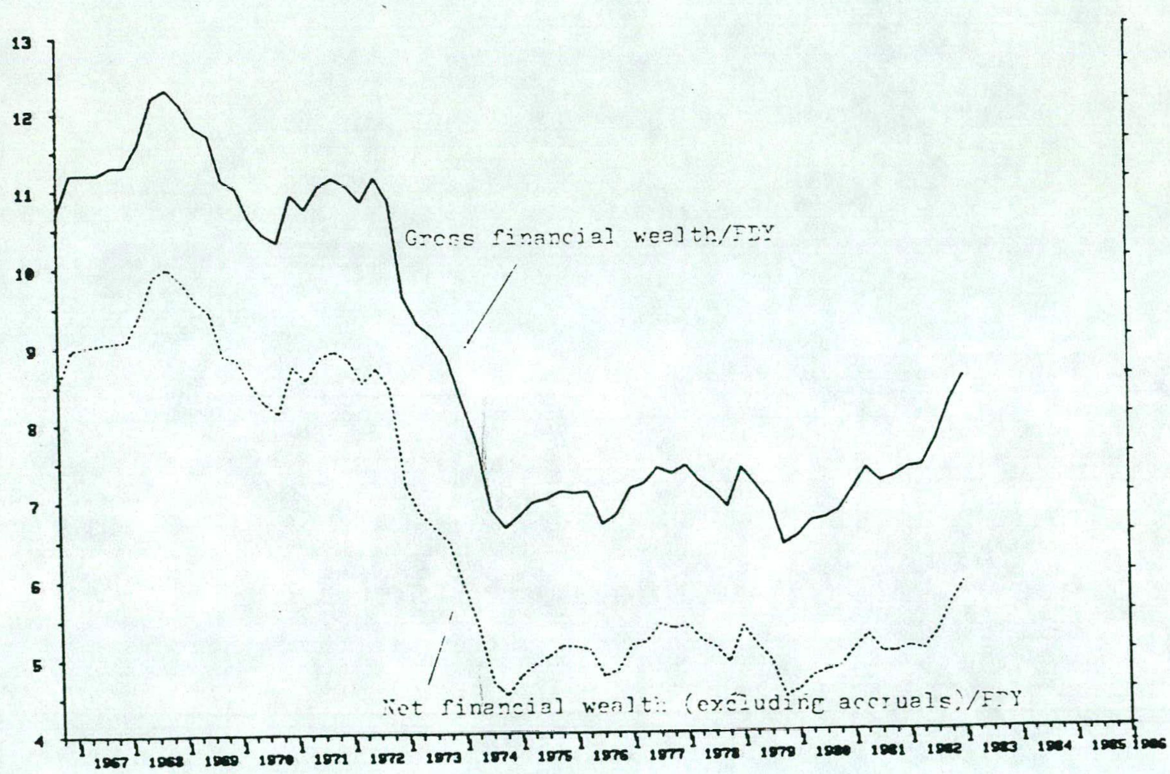


CHART IV PERSONAL SECTOR FINANCIAL WEALTH/INCOME RATIOS



9. The substantial rise in personal borrowing has been partly matched by accumulation of interest-bearing liquid assets (much of it in forms of National Savings and building society deposits that lie outside PSL2). Chart IV shows the ratios of the familiar measures of total gross and net financial wealth to disposable income. These are both dominated by the sharp falls that occurred in the early 1970s (mainly as a result of falls in the market value of gilts and equities). In the very recent past the gross ratio has risen more than the net ratio and the gap between them is higher than it has been before.

10. Since we do not measure separately personal sector payments and receipts of interest it is difficult to form clear ideas about the behaviour of net and gross income gearing. It looks as if the ratio of gross interest payments to income has tended to rise since the mid-1960s, but also to display sharp cycles around this rising trend as nominal interest rates have fluctuated. Of course a fall in interest rates, and therefore in income gearing, does not in itself mean that borrowing has been prudent. The latest forecast suggests that gross interest payments will be a lower share of income than in 1980 or 1981, though considerably higher than the average for the 1970s.

II. EXPLANATIONS FOR THE RECENT GROWTH OF BORROWING

11. The recent surge in personal borrowing needs to be seen in a longer time perspective. One would expect the debt/income ratio to rise in a society in which owner-occupation is increasing and, with higher incomes, more and more people are looking good credit risks for bankers. In fact, however, it fell sharply in the mid-1970s and did not begin rising again until the end of the decade. It seems plausible to attribute much of the recent rise to an unwinding of the developments - high inflation, squeezed real incomes, financial controls - that depressed the ratio in the 1970s. To some extent, at least, persons have been trying to get back to the desired debt/income ratios that were denied them in the long period of financial regulations. Helped by council house sales. They have also been adding rapidly to their stock of real wealth.

(i) The reaction of the banks to de-control

12. It seems likely that in this freer environment not only have persons wanted to borrow more from banks, but the banks themselves have wished to have a higher share of their lending going to persons. Lending to companies and, still more, sovereign lending abroad have become riskier in recent years.

13. Though comparison of profit margins on various categories of lending may suggest that lending for house purchase is not very attractive to the banks currently, such lending is

virtually risk-free. Moreover, for any personal lending the banks are likely to have a detailed and accurate picture of the individual's finances if his or her account is with them and can therefore readily judge the security of the loan. In HP or trade credit the lender often has little knowledge of the borrower.

(ii) Substitution of cheap for expensive credit

14. One obvious explanation for the fast growth of personal borrowing from banks and building societies is that the liberalisation of financial markets has led to the operation of something analogous to Gresham's law. Relatively cheap, market-determined, credit is now the marginal source of credit and has displaced other forms. It is unlikely that this process is yet complete. Chart V shows how much cheaper bank and building society credit is than other forms of credit (HP; credit cards).

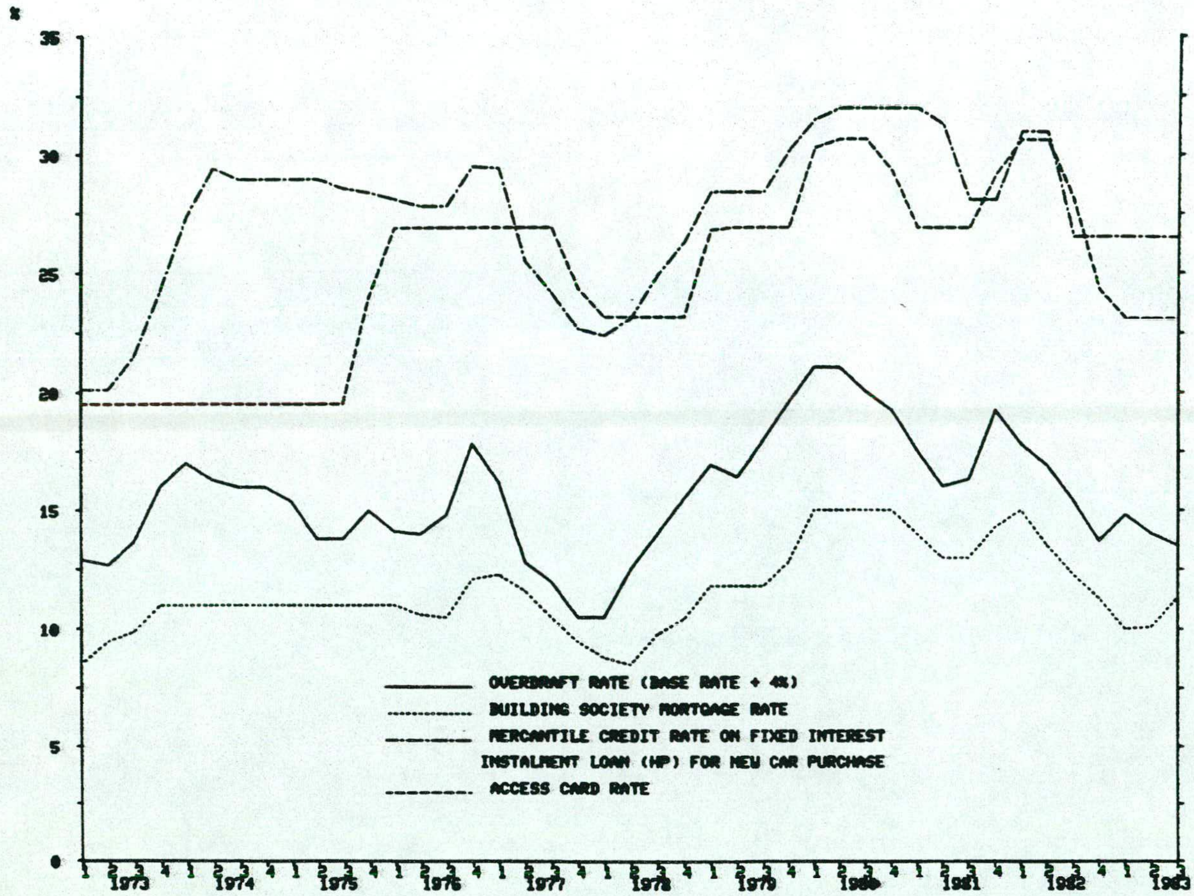
(iii) Reduced Cost of Holding Financial Assets

15. As noted in Part I, while gross debt/income ratios have risen sharply in recent years there does not appear to have been a similar rise in the net debt/income ratio, which has risen at much the same rate as in the past.

16. The reasons for this simultaneous rise in financial assets and liabilities are not clear. Because the cost of credit normally exceeds the return on financial assets it is often assumed that it is not rational for an individual to increase both simultaneously. Much of the recent increase in lending to persons may have gone to people who previously made little use of high-cost consumer credit, while it has been other parts of the personal sector that have been accumulating financial assets.

17. However, it seems likely that many people have simultaneously increased their stocks of both credit and financial assets. One effect of the removal of the curb on bank lending and the associated end of mortgage queues at building societies has been to reduce to only a few percentage points the difference between the rate of interest at the margin on personal borrowing and the net return on financial assets - because it is no longer HP or Access that is the marginal source of finance. This interest rate differential can be viewed as the "cost" of holding precautionary financial balances. If persons could readily borrow at market rates - in the way that large companies can - there would be no obvious reasons why they should want to hold large precautionary balances. Most, however, cannot do so, and without a cushion of liquid assets they might be forced to dispose of other assets if they were faced with an unexpected payment. It is quite possible, therefore, that many people have taken advantage of the substantial reduction in the marginal cost of credit to them to increase their liquid assets.

CHART V: INTEREST RATES* FOR PERSONAL BORROWING



*These are average interest rates over the quarter expressed as an annual percentage rate of increase (APR).

18. One obvious instance in which the cost borrowing is low in relation to the rates available on financial assets is lending for house purchase, because this attracts tax relief on the interest on mortgages up to £30,000[1]. There is still a substantial stock of unused mortgage tax relief. It would be rational for individuals to have as much as possible of their borrowing in the form of mortgages (up to the point at which they exhaust the tax relief), and probably to increase their total borrowing as well. It may thus be some time before the personal sector as a whole fully adjusts to the opportunities open to it now that there are no significant queues at building societies or restrictions on bank lending. There are important constraints - such as the cost of moving house - on the full exploitation of potential opportunities in the short run. But over time the availability of mortgage interest relief on the present scale within a very liberal financial system could lead to major distortions both of resource allocation and of the financial structure.

III. BORROWING AND EXPENDITURE

(i) Increased lending for house purchase

19. The increased supply of mortgage credit has undoubtedly been a major factor in the recovery in house-building. However, the growth of mortgage debt has far out-stripped the growth of the privately-owned housing stock. A significant part of the additional mortgage debt has been used for other purposes.

20. One possible, and much discussed, way in which the increase in gross borrowing has probably helped to bolster consumption is through equity withdrawal from mortgage lending. The table below shows estimates of this. It is clear that equity withdrawal is currently much greater than in the mortgage boom of the early 1970s.

EQUITY WITHDRAWAL
(£ billions)

1971	0.6	1978	1.5
1972	1.1	1979	1.8
1973	0.7	1980	1.5
1974	0.5	1981	3.4
1975	1.1	1982	6.1
1976	1.0	1983	[6.0]
1977	1.2		

---

[1] Before 1969 and between 1972 and 1974 interest on personal sector bank borrowing was similarly tax-deductible.

21. The greater the extent of equity withdrawal for a given amount of mortgage lending the less likely is that lending to generate house price booms such as occurred at the beginning and end of the 1970s. Lending for house purchase may contribute to the build up of personal sector financial assets or to higher consumption, particularly of durables, or to some combination of the two. There are no specific indicators of the extent to which equity withdrawal is increasing consumers' expenditure, and maybe inflation. The effect of equity withdrawal on consumers' expenditure is one of numerous factors that will influence judgement on monetary and fiscal policy, even though it is not directly observable.

(ii) Lower Saving

22. The recent rise in borrowing has been associated with a steep fall in the personal saving ratio. After being flat for two years, consumers' expenditure in total rose by 5¼ per cent in the five quarters to the third quarter of 1983. Spending on durable goods, which is more directly dependent on borrowing than other forms of consumption, rose by 25½ per cent over the same period. The saving ratio peaked at 15½ per cent in the third quarter of 1980 and has since fallen to 8½ per cent in the third quarter of 1983. (See Chart VI).

23. It is not easy to determine whether the rapid increase in borrowing was in part at least a cause of the increase in consumption or whether it merely represented a means of financing it. There have been few satisfactory empirical estimates of the influence of the availability of credit on consumers' expenditure. The main explanatory variables in empirical work have been real personal disposable income, and financial infuences such as liquidity, financial wealth, real and nominal interest rates, inflationary expectations and perhaps some proxy for uncertainty such as movements in unemployment.

24. The relationships embodied in the Treasury model suggest that increased real personal disposable income and the reduction in inflation explain much of the recent increase in consumption. However, there remains a significant element both of the earlier rise and the more recent fall in the saving ratio for which there is no adequate explanation. Chart VII shows that at the beginning of the recession, when the saving ratio rose sharply, the path of consumers' expenditure was lower than predicted. Over the past eighteen months, however, this increase has been much more than predicted (though, given the previous over-prediction, the current level of consumer spending is much as predicted). It is difficult to believe that the more ready availability of credit has not been an important factor in this.

CHART VI PERSONAL SAVING RATIO (per cent)

Annual data 1970-79
Quarterly data 1980(1)-86(4)

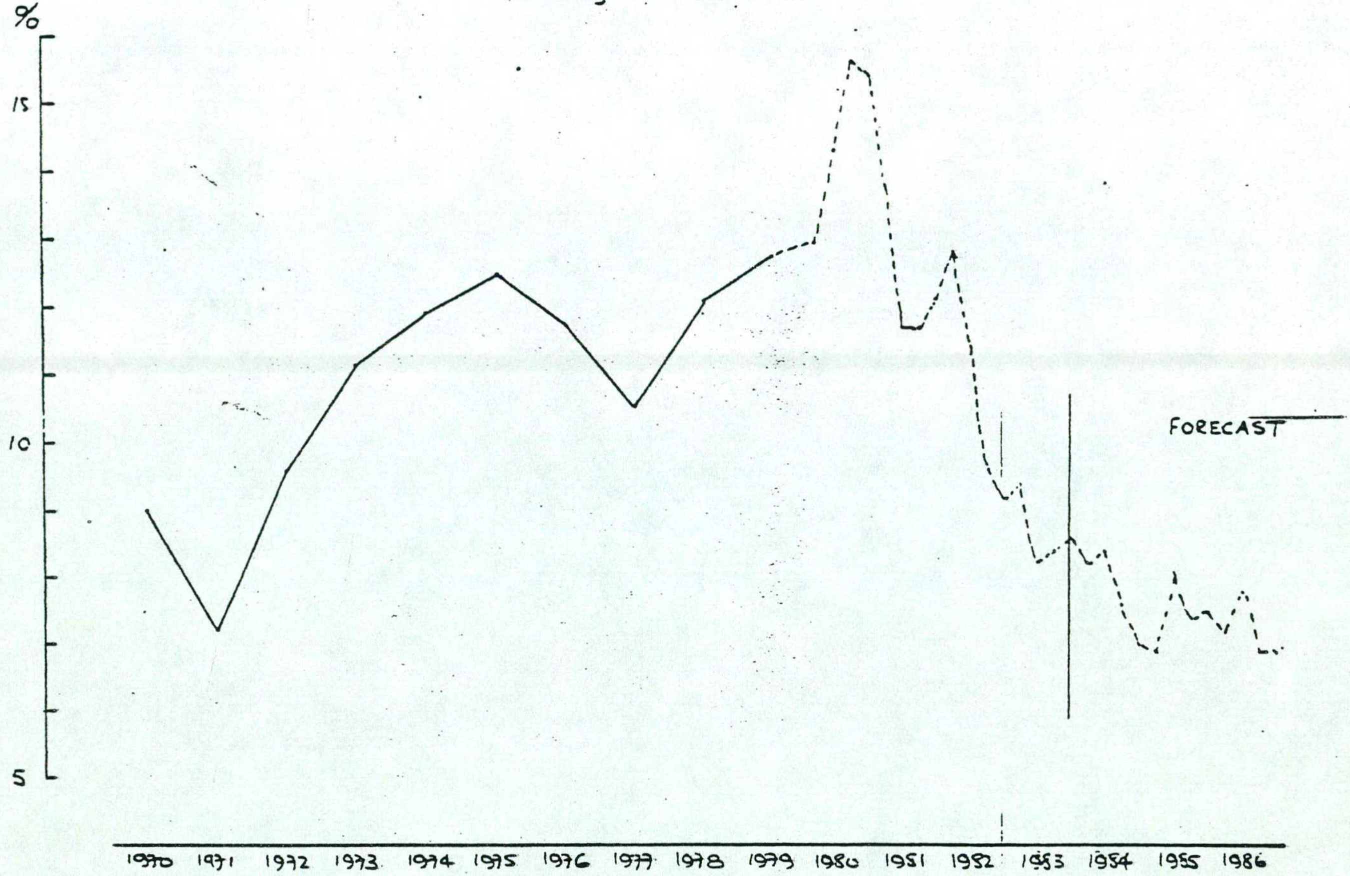
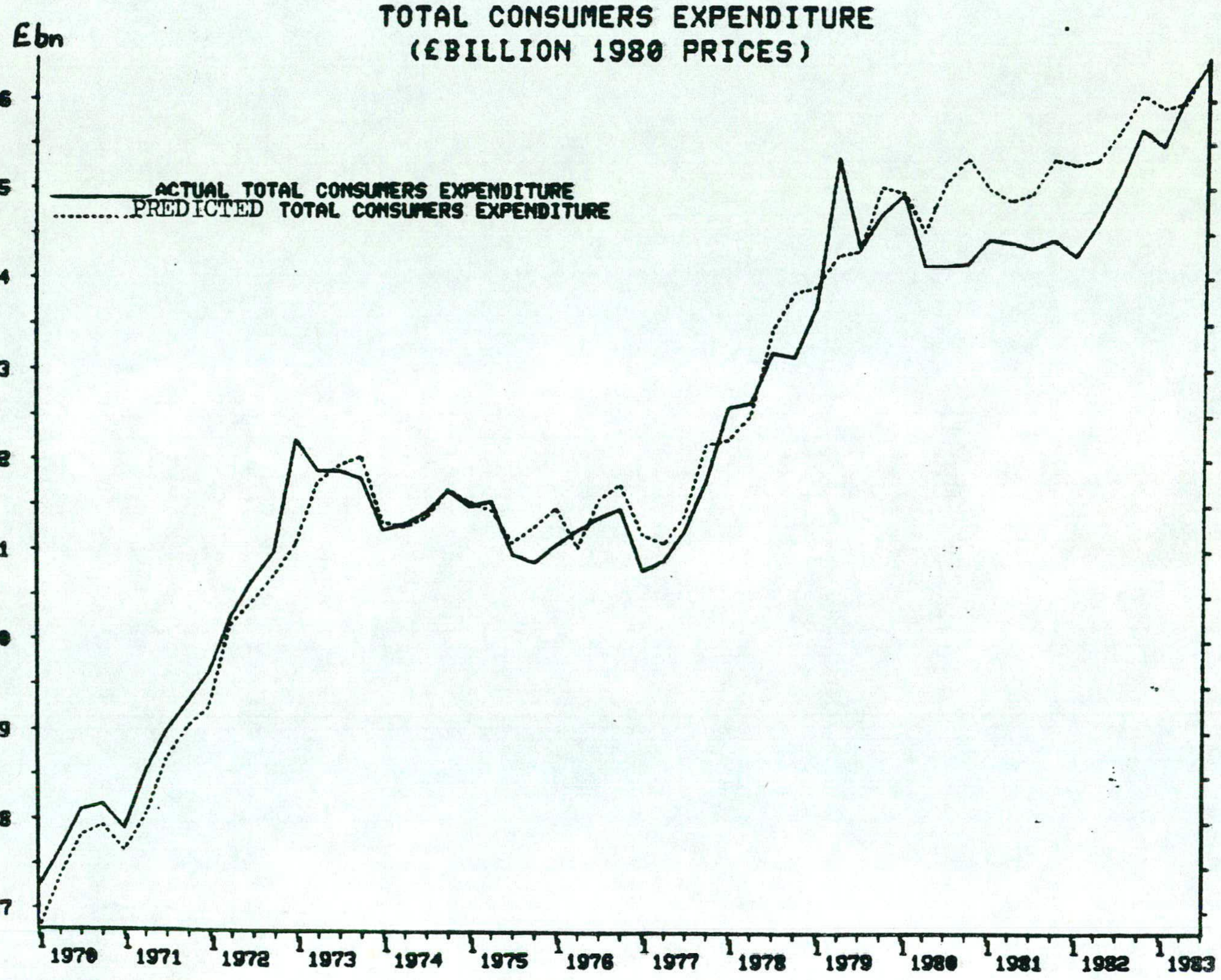


CHART VII

TOTAL CONSUMERS EXPENDITURE
(£BILLION 1980 PRICES)



25. Consumers are now taking up credit that was previously unavailable, or very expensive. This means that expenditure that might in the past have been postponed until sufficient savings had been accumulated is now going ahead. It may be some time yet before persons reach their desired debt/income ratios and levels of income gearing and the adjustment is complete. So there could be for some time to come higher levels of borrowing accompanying higher levels of consumption than would have been the case before liberalisation.

IV. CONCLUSIONS

26. Explanations of the recent behaviour of personal borrowing are too tentative to permit firm conclusions for future policy. However, some implications can be drawn from this assessment:-

(i) The ready availability of credit over the past two years has almost certainly played some part in the strong growth of consumer spending. The fact that expenditure on durables has increased so much faster than would have been expected from past relationships with movements in income, certainly points in that direction. However, it is easy to exaggerate the independent part that credit has played. Most of the decline in the personal saving ratio can be plausibly explained by changes in real income, real wealth and interest rates.

(ii) The recent trends in borrowing could go on for some time. The evidence reviewed in this paper does not support the view of some outside forecasters that the debt/income ratio is now so high that persons will be unwilling to let it rise further, and in consequence consumption will decelerate sharply. But while it is not difficult to find plausible reasons why the debt/income ratio has risen, and could continue to rise, it is much harder to assess how <u>stable</u> the present ratio might be. This is a major uncertainty in the forecast, and for policy. So it is not easy to judge whether the present level of borrowing gives cause for concern. The pace of consumer spending foreseen in the autumn economic forecast (on the assumption that borrowing continues on its upward trend) looks compatible with the Government's objectives for the economy. But there is a wide margin of error, both ways, around that forecast.

(iii) The strength of personal demand for credit could give rise to serious monetary problems if there were a marked resurgence in company demand for credit. The growth of bank credit would then create problems for monetary control, which would compel us to over-fund the PSBR or to accept a faster growth of broad money.

(iv) These risks will need to be carefully assessed in setting the monetary targets for 1984-85. The fact that persons have been borrowing heavily from banks and at the same time building up their financial assets raises the question whether it would be acceptable to accommodate the demand for credit by setting a somewhat higher range for the growth of broad money than the 6-10 per cent previously envisaged - on the argument that the additional money balances would be willingly held (ie idle balances). How far this would be acceptable would depend partly upon what was happening to narrow money. However, there are considerable risks in allowing the economy to become highly liquid. This may have no immediate effect on inflation, but it creates conditions in which spending and inflation could accelerate rapidly if some factor (eg a fall in real interest rates) led the private sector to want to spend more or, more generally, if expectations turned.

(v) If, to guard against these risks, it was desired to restrain the growth of personal borrowing, the instruments to hand are not extensive. The most effective one would be to remove or reduce tax relief on mortgage interest. If that is ruled out, it might be possible to move a little in that direction by defining more tightly the rules for eligibility (which in practice would mean confining the relief to loans for house purchase, not improvements) or, more radically, by some form of quantitative restriction on the relief on second purchases (perhaps related to a proportion of the purchase price of the house). Such restrictions would create unfairnesses and anomalies. However, if we are genuinely worried about the growth of personal borrowing they need to be considered. A consumer credit tax - covering mortgages as well as other credit - could have some <u>marginally</u> helpful effect in restraining credit. Beyond that, if we are seriously concerned about the risk of excessive consumer spending developing in the coming year, we need to look again at the possibility of devising a regulator for personal taxes that is available for use within the fiscal year.

(iv) Another aspect to be considered is the implication of the strong growth in personal borrowing for the proposals afoot for liberalising the lending activities of building societies. The societies would like to be free to make personal loans for purposes other than house purchase (they envisage only a limited amount, though in aggregate the sum could be large). A widening of their powers would be consistent with the Government's general stance on market forces and competition. However, the analysis in this note suggests that we should be very cautious in moving in this direction (at least while we have so little influence over the total volume of their lending) even though this may be seen as an arbitrary form of quantitative restriction.

ANNEX

PERSONAL SECTOR FINANCIAL LIABILITIES

The following table shows the published personal sector financial liabilities.

	£bn		% of total liabilities	
	1978Q4	1983Q2	1978Q4	1983Q2
HP and other instalment debt	3.0	2.9	4.9	2.2
(Adjusted* to allow comparison with 1983Q1)	(2.2)		(3.6)	
Bank lending other than for house purchase	8.8	27.9	14.5	21.1
(Adjusted* to allow comparison with 1983Q1)	(9.6)		(15.9)	
Bank lending for house purchase This includes trustee savings bank mortgages	1.8	12.5	3.0	9.4
Building Society lending for house purchase	31.7	62.8	52.4	47.4
Insurance company and pension fund lending for house purchase	1.7	2.2	2.8	1.7
Local Authority and other public sector lending for house purchase	3.4	5.9	5.6	4.5
Trade Credit This is primarily trade credit of unincorporated businesses but also includes unpaid household gas and electricity bills, and trade credit of non-profit making bodies. No precise breakdown is available.	7.7	14.3	12.8	10.8
Other financial liabilities The largest component is other domestic long term loans (£3bn in 1983Q2 of which about half should be consolidated). This is a catch-all category which includes among other items long term debt of stockbrokers and jobbers long term debt of charities, mortgages not included elsewhere, and several items of long term debt within the personal sector, which are not netted out of the published figures. Other financial liabilities also includes accruals of taxes, rates and interest (£0.7bn in 1983Q2) and domestic liabilities not covered elsewhere (£0.3bn in 1983Q2).	2.3	4.0	3.8	3.0
Total financial liabilities of the personal sector	60.4	132.5	100	100

*From 1981Q4 onwards the introduction of the monetary sector in the statistics reallocates a substantial part of HP and other instalment debt to banking lending. This adjustment rescales the earlier figures to allow comparison across the break in series.

FROM: F CASSELL
11 January 1984

CHANCELLOR

cc - Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr Littler
Mr Bailey
Mr Battishill
Mr Kerr
Mr Ridley
Mr Lord
Mr Portillo

Sir Lawrence Airey, IR
Mr A M Fraser, C&E

CHEVENING: TAX ISSUES

I attach a paper on tax issues. This has been drafted by FP in consultation with the Revenue departments. It reports the state of play in various areas, the revenue costings of the main options under consideration, and suggests some particular points for discussion.

Some updating may be required in the light of meetings later this week.

F CASSELL

TAX ISSUES

Ministers have made clear the priority they attach to raising the personal tax thresholds by the maximum amount resources permit. They have also been examining a number of areas of the tax system where there seems to be scope for major structural change. The work has taken particular account of the balance between taxes on labour and on capital; the balance between different forms of saving; the need to broaden the tax base; and the staff savings that could arise.

2. Much of the work originates from wide-ranging reviews in several areas and, in particular, the major study by Inland Revenue/Treasury officials of the taxation of savings and investment completed last summer. This study identified a number of severe distortions in the tax system. In the savings field, these include the preferential tax treatment of life assurance and pension funds, and tax reliefs for owner-occupation. On the company sector/investment side, the study raised questions about whether the corporation tax (CT) system could be made more neutral as between retentions and distributions, and between debt and equity financing. It also pointed out that the present capital allowances system creates a distortion both between different forms of business expenditure and between different types of investment.

3. A number of the areas covered by this study were selected by Ministers as worthy of further consideration. Decisions on certain changes to the tax regime for banks and building societies have already taken place. And further work has been done on company taxation, changing the tax arrangements for pensions and life assurance, the tax treatment of gilts and equities and extending the VAT base.

4. Against this background, this note discusses the issues which arise for the 1984 Budget, including the scope for raising the thresholds, and shows what effect the wider structural changes under consideration could have on tax revenues in 1984-85 and subsequent years.

1984 Budget

5. In looking at the 1984 Budget we have taken as the starting point a nil fiscal adjustment. The main issues for decision appear to be :

- the scope for increasing the income tax personal allowances/ thresholds over and above the inflation adjustment (5 per cent) assumed in the forecast;

- the strength of the case for a reduction in the corporation tax rate, and/or NIS, affecting CT payable in 1984-85, as a "payment on account" of the offset if the abolition of stock relief and a reduction of capital allowances is announced in the Budget; and

- how the additional revenue required to achieve a nil fiscal adjustment should be raised, in particular:

  - the scope of any extension of the VAT base;

  - the amount which could be looked for from a licence duty on institutions providing personal credit;

  - additional indirect tax increases which could be required over and above price indexation.

Work is also underway on proposals for reducing stamp duty on equities, and the scope for financing this by offsetting savings elsewhere.

6. The costs over and above indexation of a range of options for increasing the income tax thresholds are given in Annex 1. An earlier Inland Revenue submission ('Approach to the 1984 Budget: options for personal tax changes') shows that earnings indexation (prices + 1½ per cent) is the minimum required if Ministers are not positively to lose ground in relation to various key objectives, ie if income tax is not to rise as a proportion of income, if the number of people subject to income tax is not to increase and if we are to avoid a large increase in the staff requirement in this area. The interaction between changes on tax allowances and child benefit also needs to be considered.

7. There is a case for action on the corporation tax rates to apply to C^T payable in 1984-85. A reduction of say two percentage points in the rates would undoubtedly help in softening the impact of a Budget announcement to abolish stock relief and reduce capital allowances, even though the latter would not come into effect until 1985-86. But the cost - £220 million in revenue terms in 1984-85 - would be high in the context of a nil fiscal adjustment and would significantly reduce the scope for increasing the personal allowances. An alternative (if lower CT rates rather than the abolition of NIS is the objective - see para 11 below) would be to announce the CT rate applying to CT payable in 1985-86 at the same time as fixing it at 52 per cent for the previous year.

8. At the present stage of Ministers' consideration of Finance Bill starters, there is likely to be a small positive yield - perhaps £75 million in revenue terms - in 1984-85 (mainly as a result of the proposed change to the date for repayment of ACT to oil companies which reverses itself in 1985-86).

9. We now turn to the main areas of tax reform that are under consideration.

Company taxation

10. As the first stage in a medium-term programme of reforming the company tax regime, the Financial Secretary has proposed the following package of changes to be announced in the 1984 Budget:

a. the abolition of stock relief;

b. the reduction of first year capital allowances on plant and machinery from 100 per cent to 75 per cent;

c. the reduction in initial allowances for industrial buildings from 75 per cent to 50 per cent.

11. This could make way for a reduction of 8 percentage points in the CT rate for financial year 1984 (affecting tax paid by companies in 1985-86), which would not normally be set until the 1985 Budget.

Account also needs to be taken, however, of the Government's objective to abolish NIS over the course of this Parliament. How the two would fit together is for discussion.

12. Over a period of years we might move to an economically more rational capital allowance system where first year and initial allowances for machinery and plant and industrial buildings are abolished, leaving writing down allowances of 25 per cent a year for the former and 4 per cent a year for the latter. Action might also be taken (and possibly foreshadowed in the 1984 Budget) to restrict capital allowances for certain items (structures, decor items, equipment and apparatus installed in buildings, etc) which enjoy treatment as machinery and plant that was largely unintended, and to tidy up the system generally.

13. Such a programme of reform has considerable economic attractions. It would substantially reduce the distortions between investment and other forms of business expenditure such as labour costs, and also the choice between different types of investment. A lower CT rate would reduce the bias against equity finance. And stock relief was introduced at a period when inflation and corporate liquidity were at very different levels from today. Politically however there would be difficulties. There would be a substantial number of losers, including capital intensive companies (eg parts of manufacturing), holders of large stocks, unincorporated businesses and small companies. Overall, the effect on North Sea companies seems likely to be more or less neutral, but the effect of the reductions in capital allowances could be adverse to some new investment. Further work on this will be needed to establish whether any offsetting changes in the North Sea fiscal regime would be required. Reducing capital allowances for plant and machinery to as low as 25 per cent would have very serious effects on the leasing industry and its customers, particularly tax-exhausted companies.

14. An important question for discussion is whether, should action be taken this year along the lines indicated in paragraph 10 above, the whole medium-term strategy should be unveiled. There would be intense pressure from industry (and, because of leasing, the banking sector) for the Government to indicate its future intentions. And there is a strong case for allowing industry to make its long term

term investment decisions on the basis of some certainty about the tax regime. Against that, there are obvious difficulties in entering into expensive forward commitments; and the more that is revealed at an early stage, the greater will be the scope for industry to mount effective opposition to frustrate any subsequent steps.

North Sea taxation

15. There are no proposals at this stage to introduce further major structural changes in the North Sea fiscal regime. But Ministers are considering action to limit potentially substantial losses or deferments of CT as a result of farmouts.

Banks and Building Societies

16. There are important differences between the tax treatment of the building societies and the banks that have led to accusations of discrimination. The following decisions have been taken which should reduce these distortions and make competition fairer:

a. A composite rate for taxing interest paid by banks, like that applied to the building societies,is to be introduced. A major additional attraction of this change is that it wold save up to 1,000 Revenue staff. It will also avoid most of the big increase in staff that would be needed if the banks were to start paying interest on current accounts. We intend to legislate in the 1984 Finance Bill, for implementation in 1985-86, subject to discussion with the BBA who are being consulted on a confidential basis.

b. The special 40 per cent rate of corporation tax applying to building societies and other mutuals is something of an anomaly, dating from the change to the "imputation" system of corporation tax in 1973. The Chancellor has agreed that this difference of treatment should be abolished, though it has not yet been agreed whether this should take effect in the 1984-85 tax year or later.

c. Building societies' profits on gilts are now, unlike those of the banks, taxed as capital gains, whereas in fact in a number of cases the proceeds arguably form part of the societies' trade and should therefore be subject to corporation tax. Counsel's advice is being sought so as to determine whether this difference of treatment could be resolved through litigation rather than by legislation.

17. The effect of the change at (a) on tax revenue is uncertain but likely to be small. (b) and (c) would increase revenue by about £100 million in a full year. The effect on the mortgage rate would be minimal (0.2 per cent at the most).

18. An Official Working Group recently carried out a study of bank taxation. It concluded that there is not at present a strong case for taxing bank profits but that there is a stronger one for taxing customers of the banks and other financial institutions. The Chancellor has asked for further work to be done on one of the options considered in the report - a licence fee for all institutions providing credit for persons. A fee set at ½ per cent of the volume of outstanding credit might raise some £400 million a year (assuming no clawback of revenue through income tax, etc) if mortgage lending were included, which would be desirable in economic terms, and £75 million if it was excluded. We are considering whether the tax could be made effective from 1984-85.

Tax treatment of gilts and equities

19. Officials have recently submitted a report to the Chancellor on the possibility of financing a reduction in stamp duty on equities by ending the exemption of gilts from stamp duty and CGT. A 1 percentage point reduction in the rate of stamp duty on equities might cost about £175 million in 1984-85, plus a consequential loss of duty through the creation of companies to hold at least the larger commercial buildings. This further loss of revenue might build up over a period to perhaps £50 million.

20. The major problem of raising revenue from ending the tax exemptions for gilts is that, given the terms of their issue, existing stocks would have to continue enjoying the exemption. If new stocks alone were subject to tax, revenue would build up very slowly. Moreover, ending the tax exemption for new gilts would drive up yields, and the increased debt interest costs might well offset any extra

tax revenue. Ending CGT exemption for new gilts is unlikely to raise significant amounts of revenue because of indexation provisions, the fact that losses will be allowable, and the current tax exemption for major classes of investor.

21. If Ministers favour reducing stamp duty on equities to 1 per cent, leaving the rate of duty unchanged elsewhere, despite the political difficulties, it is for consideration whether the first year cost of about £175 million (ignoring the "knock on" effects) could be financed by other tax changes in the area of financial institutions. There are attractions in reducing the rate of stamp duty by 1 per cent on all assets, but this would be considerably more expensive - about £460 million for the first year.

Pensions and life assurance

22. In the case of pensions, work is being done in two areas:

- taxing the lump sum paid with pensions, and

- taxing the pension funds' investment income.

Large amounts of money are involved. In theory, the eventual yield from taxing lump sums could be some £650 million a year at present levels; and the potential yield from taxing the investment income of the pension funds is up to £2¼ billion a year, although this figure does not allow for any changes in the funds' (or pensioners') behaviour. Neither figure allows for any offset from, for example, greater difficulty in increasing contributions from public sector employees. However, the potential yield from both these reforms will increase progressively in future years, as the pension schemes themselves move towards maturity.

23. Economically, a change in this direction makes good sense. The present system in effect subsidises pensions, to the extent that it gives full relief for pensions contributions, but does not bring into tax the full amount of pension payments. The value of the lump sum is in the region of one quarter of the total value of the pension, and the subsidy is thus substantial. Taxing the investment income of the funds could contribute significantly towards the objectives of reducing both the perceived fiscal attractions of such investment -

thus achieving a better allocation of resources - and the dominance of pension funds in the equity market. Either change would be compatible with a move towards portable pensions.

24. There would be severe difficulties, however. Taxing the lump sum would have a direct and visible effect on most pensioners. Taxing the funds' investment income would be instantly opposed by the funds. A lengthy transitional period would probably be necessary. There is also a strong view that the changes would have to be placed in the context of a much wider new approach to provisions for retirement generally. And there is the difficulty of making substantive changes in the pension field while the Fowler Review is underway.

25. Various changes in the tax treatment of qualifying life assurance policies - including, for new policies, the immediate abolition, or phasing out, of life assurance premium relief (LAPR) and perhaps the taxation of the proceeds from policies (net of total premia paid) - are being considered. If current policies are to be affected, transitional arrangements would be necessary.

26. These changes would go some way towards removing the distortions created by the present tax treatment of life assurance. The length of the transitional period would determine how quickly the full benefit to the Exchequer would be realised, but it could be around £100 million in the first year, if relief on new policies was stopped overnight. The main long-term effect would be the saving from the withdrawal of LAPR from existing policies, the cost of which is currently running about £700 million a year or more. This could eventually be reduced to nil by phasing out the relief on existing policies over a period of, say, ten years.

VAT and Excise duties

27. Customs and Excise have submitted papers on possible packages for extending the VAT base. Annex 2 shows the additional revenue that could be expected from applying VAT to the main zero-rated items either at the current standard rate of 15 per cent or at a reduced rate of 5 per cent.

28. The main package currently under consideration would apply VAT at the standard rate to books, newspapers and news services, building alterations and take-away food. This would produce £760 million additional revenue in 1984-85 and £1050 million in a full year.

29. The 0.5 per cent impact effect on the RPI of this package would add £65 million in 1984-85 and £175 million in a full year to the cost of indexing all social security benefits. The effects on tax allowances and thresholds would not feed through until 1985-86 when account would be taken of the December 1984 RPI figures. The cost of additional indexation as a result of the VAT package would be about £100 million in a full year.

30. A possible addition to the package would be taxation of non-domestic construction. If effective anti-avoidance measures could be worked out, this would bring in additional revenue of up to £275 million in a full year. Customs and Excise are considering urgently with the Inland Revenue whether it is possible to devise suitable measures which would make the tax stick on the exempt (mainly financial) sector. Further consideration would need to be given to how the public expenditure costs of imposing VAT on non-domestic constructions might be reduced.

31. A further possibility, which is not however an option for 1984, would be to introduce a reduced rate of VAT. Applying a 5 per cent rate to the remaining zero rated items would yield additional revenue of about £2 billion a full year. The impact effect on the RPI would be about 1.3 per cent. If desired the RPI effect could be moderated either by staging the introduction of the new rate or by shifting some items which are currently standard-rated to the reduced rate.

32. If action is to be taken on the VAT base in the 1984 Budget detailed preparatory work needs to be set in hand very soon.

33. A background note on the excise duty with tables showing the effects of revalorisation is attached at Annex 3.

Costings

34. The direct revenue effects of the main changes outlined above are set out in Annex 1. (Figures for pensions and life assurance are not given both because discussion with Ministers is still at an early stage and because the costings for the early years are heavily dependent on the transitional provisions that are announced). The table can be used as a set of "building blocks" to construct various tax packages, given the overall fiscal adjustment in each year. The memorandum items at the bottom of the table are a series of ready-reckoners on NIS, corporate tax, income tax and VAT which can be used for this purpose. (Annex 3 provides further ready-reckoners on indirect taxes). The effects on the PSBR will depend on how the economy is affected by the tax change. Assuming no accompanying change in monetary policy, the PSBR effects might be a little lower than the direct revenue effects, depending on the tax change considered. Further work will need to be done on PSBR effects once the shape of the Budget decisions becomes clearer.

Points for discussion/decision

35. The following questions might be used as a basis for discussion:

i. With the priority given to increasing tax thresholds, what are Ministers' preliminary views on the trade-off between highly desirable increases over indexation in 1984-85 and the tax-raising measures necessary to finance them?

ii. Could and should "tax reform" be adopted as a major theme for the 1984 Budget?

iii. Beyond the decisions (eg on financial sector) already taken, what should be the priorities for tax reform?

iv. In order to create a politically viable company tax package, should the Government announce a reduction in the CT rates for financial year 1983? What if anything should be said about raising CT rates and/or NIS in later years; and how explicit should it be about its longer-term intentions for company tax reform?

v. How can the problems of gainers and losers (eg manufacturing industry, unincorporated businesses and leasing operations) be overcome?

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Annex 1: Revenue effects of proposed major structural tax changes

[£million]	1984-85	1985-86	1986-87	1987-88
Company tax				
a. Abolition of stock relief	Nil	+350	+650	+750
b. Reduction in first year allowances for plant and machinery to 75%	Nil	+500	+750	+750
c. Reduction in first year allowances for industrial buildings to 50%	Nil	+ 30	+ 50	+ 60
Total of (a) to (c)[1]	Nil	+930	+1550	+1660
Banks and Building Societies				
a. Composite rate for banks	Nil	Small	Small	Small
b. Abolition of special 40% CT rate for Building Societies) c. Taxing Building Societies' profits on gilts)	Nil[2]	+100	+100	+100
d. Licence duty on personal credit (including mortgages)	+400	+400	+400	+400
Total of (a) to (d)	+400	+500	+500	+500
VAT - extension of base *	+670	+1050	+1050	+1050

Memorandum items*	1984-85	1985-86	Full Year
NIS abolition (in 1985)	Nil	-750	850
Reducing CT rate and small companies' CT rate by 1%	-110	-180	-190
Increase in personal allowances and thresholds over indexation: + 1½% (3)	-260	-330	-330
+ 3%	-500	-640	-640
+ 6%	-950	-1200	-1200
Increase in IIS threshold to £10,000	Neg	-50	-85
Reducing Stamp Duty on equities to 1%	-175	-175	-175

* Figures at 1984-85 prices

1) The aggregate effect is greater than the sum of the parts, because of the interaction between the abolition of stock relief and the reduction of allowances.

2) If existing CT payment dates for Building Societies continue, the revenue yield in 1984-85 would be £80 million. The nil figure shown assumes a change to the normal 9-months rule for companies.

3) Earnings indexation.

ABOLITION OF VAT ZERO RATINGS:
1984/85 FULL YEAR REVENUE AND RPI IMPACT EFFECT

		5% £m	(RPI effect) %	15% £m	(RPI effect) %
Group 1	Food	1225	0.9	3650	2.2
Group 3 Group 4	Books and newspapers Talking books for the blind	125	0.1	375	0.3
Group 5 Group 6	Newspaper advertisements News services	10	nil	25	nil
Group 7	Fuel and power	450	0.3	1350	1.0
Group 8	Construction (new construction and alterations)	410*	nil	1225*	nil
Group 10	Transport (internal passenger)**	160	0.1	475	0.2
Group 17	Young persons' clothing and footwear	85	0.1	250	0.2
Group 2 Group 9 Group 11 Group 12 Group 13 Group 14 Group 15 Group 16	Sewerage services and water International services Caravans and houseboats Gold Banknotes Drugs (excluding prescription charges Imports, exports Charities	nil/small/indeterminate			
		2465		7350	

* (i) Assuming that it is possible to make tax stick on exempt traders. If they are able to avoid all tax the estimate falls to £950 million at (15%) or £325 m (at 5%)

(ii) Estimate is for net additional revenue and excludes extra tax paid by Central Government of the order of £275m (at 15%) or £90m (at 5%)

**This estimate is for <u>all</u> internal passenger transport.

Annex 3

INDIRECT TAXES

This note is for background only. A full submission on excise tax options will come forward later in the month.

Alcoholic drinks duties

2. Table 1 below gives, for reference purposes only, the price, revenue and RPI effects of 5 per cent revalorisation of each of the drinks duties. The position on these duties is complicated this year by the need to take account of the judgement by the European Court of Justice, that the UK's current tax rates favour beer at the expense of wine, contrary to Article 95 of the Treaty of Rome. The implications of this decision are being considered separately in consultation with the Law Officers. It is therefore not possible to consider changes in the beer duty or in the wine duty in isolation - their relative levels must also be taken into account. As a general guide, however, an increase of 1p on beer might have to be accompanied by a reduction of the order of 23-24p on light wine to conform with the Court's judgement. A 2p increase in beer could imply a reduction in the wine duty of the order of 20p on wine.

Other indirect taxes

3. On the assumption that changes in the drinks duties to take account of the European Court's decision can be made in such a way as not to require any recoupment of revenue from other excise duties, table 2 shows the broad effects of revalorisation of the other duties. The figures differ from those included in the Autumn Statement because the price changes have been rounded to produce more realistic increases.

4. The table also illustrates the effects of changes in the rates of VAT and car tax.

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TABLE 1: 5% REVALORISATION OF THE DUTIES ON ALCOHOLIC DRINKS

	Full year revenue effect(1)	Change in price of typical item(2)	Percentage change in price of typical item	RPI impact effect(3)	Approx effect of duty change on consumption
	(£m)	(p)	(%)	(%)	(%)
Beer (pint at 1037° OG)	80	0.9	1.4	0.06	- 0.3
Light wine (75cl bottle)	16	4.9	1.7	0.02	- 1.5
Fortified wine (75cl bottle of sherry)	6	6.3	1.7	0.01	- 1.5
Sparkling wine (75clbottle)	1	5.9	0.6	-	- 1.5
Spirits (75cl bottle at 40%	25	26.2	3.5	0.04	- 2.9
Cider (pint)	1½	0.3	0.5	-	- 0.1
Made-wine 75cl bottle [illegible]itish sherry)	2	5.8	2.9	-	- 1.5
	131½			0.13	

Notes (1) At 1984-85 levels of prices and consumption

(2) Including associated VAT

(3) The RPI impact effect had been calculated to the nearest 0.01%. Published estimates of RPI effects are normally to the nearest 0.1%.

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Table 2

(£m 1984-85 prices and income levels)

	Price change	% change in duty	Full year[1] Revenue (£m)	RPI impact[3] effect (%)
Tobacco (20 king size)	4p	6.09	135	0.15
Petrol (gallon)	4½p	5.4	225	0.10
Derv (gallon)	3½p	4.9	45	-
VED (car + light van)	£5	5.9	90	0.05
VED (HGVs)	£7.50 £147.00	5.0	19	-

	First year yield/cost (£m)	Full year yield/cost (£m)	RPI impact effect (%)
VAT rate + 1%	550	740	0.5
Car tax rate + 5%	250	340	0.2 [2]

(1) Assuming implementation on 1 April, the first-year revenues would be the same as the full-year for petrol, derv and VED; and approximately eleven-twelfths of the full year revenue for tobacco.

(2) This is the change in the RPI that would occur after about 3 months: there is no impact effect since new cars do not feature in the RPI.

(3) Footnote on RPI as previous table.

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FROM: A. M. BAILEY

11th January, 1983.

CHANCELLOR OF THE EXCHEQUER

c.c. Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T. Burns
Mr. Littler
Mr. Cassell
Mr. Battishill
Mr. Kerr
Mr. Ridley
Mr. Lord
Mr. Portillo

Sir Lawrence Airey, IR
Mr. A. M. Fraser, C & E

CHEVENING: ASSETS, PUBLIC EXPENDITURE AND BORROWING

Sir T. Burns and others have contributed to the attached paper, which considers in turn

- classes of capital transactions, assets and benefits
- criteria for investment
- microeconomic arguments for financing by borrowing as against taxation
- macroeconomic arguments on the same issue
- implications for the PSBR
- implications for public expenditure control.

It concludes with a list of questions for discussion.

AMB

(A. M. BAILEY)

Asset sales, pub exp + borrowing

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1

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FSBR Handling
PSBR - Battishill

FROM: A M W BATTISHILL
DATE: 11 January 1984

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr Bailey
Mr Littler
Mr Cassell
Mr Ridley
Mr Lord
Mr Portillo
Sir Lawrence Airey - IR
Mr A Fraser - C & E

CHEVENING

I attach a paper entitled "The FSBR: Handling the PSBR", which considers inter alia the idea of converting the PSBR path in the MTFS from a financial year to a calendar year basis.

2. An annotated agenda will follow later in the week.

A M W BATTISHILL

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THE FSBR: HANDLING THE PSBR

Note by the Central Unit

This note considers possible ways of dealing with the PSBR figures in the FSBR when the Budget takes place before the PSBR outturn is known.

2. The problem is essentially one of reconciling the need for decisions in February or early March on the fiscal stance for the coming year with the absence until mid-April of firm indications of the PSBR outturn for the year just ending, and an average forecasting error over that short period of some £1 billion or more in recent years. There are two aspects to this. First it is important to have the firmest possible baseline against which to decide the policy stance on the PSBR for the coming year. Second, it can be embarrassing if the outturn for the current year subsequently proves to be substantially different from the Budget estimate, particularly if (as was the case last year) the main cause of the difference is expected to continue to influence subsequent years.

3. In looking at possible new arrangements, we have tried to consider how far they would help to meet these two difficulties, without introducing new problems which do not exist at present. Where necessary, the note also looks briefly at any wider implications of change.

OPTIONS

4. We have looked at the following possibilities:

(a) dropping revised forecast PSBR figures for the current year in favour of firm outturn figures for the first 10 or 11 months only;

(b) converting to calendar year figures for the PSBR:

(c) reducing the information about the PSBR given in the FSBR.

The note concludes with a brief discussion of the prospects of holding the Budget after the PSBR outturn is known in years after 1984.

5. The first of these possibilities - giving an outturn for 10 or 11 months -was looked at in the summer but rejected then by the Chancellor (Mr Norgrove's minute of 9 September and Mr Kerr's of 13 September). We have re-examined the idea but confirm that it should continue to be dismissed. It would be indefensible to publish a forecast for the coming year but not one for a year which was already 10 or 11 twelfths over.

CALENDAR YEAR BASIS

6. The Chancellor asked for this to be examined. In its simplest form, it involves converting the PSBR path in the MTFS from a financial year to a calendar year basis. But given the interlocking fiscal and monetary framework, it would also make sense to move the monetary target periods onto a broadly consistent basis. We look at this further in paragraph 22 below.

7. In looking at the operational possibilities of this kind of approach we have made a number of assumptions. First, the intention is not to change the financial year to the calendar year as such. Nor is it to change the

public expenditure planning year; or the basis period for the annual taxes so that they run from 1 (or 6) January instead of 6 April. Changes of this kind (which have been examined before) would be far more sweeping, and could not be contemplated at all quickly. Indeed, moving the expenditure year and the financial year to the calendar year would defeat the purpose of the exercise if it also meant bringing the Budget forward to November: uncertainty over the PSBR outturn would simply then be moved back four months. The proposition examined here is a more limited one applying to the PSBR path in the MTFS and to the monetary targets, though it is still quite a significant change.

8. It would probably have to work something like this. The MTFS would be re-drawn on a calendar year basis from 1984 onwards. This would mean translating the present financial year forecasts of general Government expenditure, general Government receipts and public sector borrowing into forecasts for calendar years. The fiscal adjustment would also have to be put onto the same basis. Performance against forecast would be judged on the calendar year rather than the financial year figures. Public expenditure <u>planning</u> and <u>control</u> would continue to apply to the financial year, as would decisions on most taxes. But in setting fiscal and monetary policy in the Budget, the main focus would be on the effects over the calendar year already started. And the principal information base would be the calendar year ended on the preceding 31 December.

<u>Operating it in practice</u>

9. There are perhaps three main aspects to this:

(a) the effect on forecasting accuracy;

(b) the effect on the need and scope for in-year action;

(c) less important than the other two, the relationship between the first and second years of the MTFS.

The discussion below assumes that the change from a financial year to a calendar year basis would be made in the 1984 Budget.

(a) <u>**Effect on forecasting accuracy**</u>

10. The annex below sets out past PSBR figures by financial year and by calendar year. The calendar year figures have been more variable than the financial year figures. This greater variability is however partly accounted for by the effects of the Civil Service dispute and figures adjusted for this show a smoother profile.

11. It is not possible to say whether forecasting accuracy would be improved by moving to forecasts of calendar years, whilst maintaining the present financial year for control and accounting purposes. Examination of the past forecasting record is unlikely to provide strong evidence one way or the other, since until recently the quarterly profile has not been given a great deal of attention by ourselves or by Departments. The main emphasis has been on a forecast for the financial year as a whole. Moreover the timing of expenditure within the year could be affected if we moved over to calendar years for forecasting purposes. So the comparison of past calendar year forecasts with outturns would not be a very good guide to the future if we did decide to move over to calendar years as the main focus for the level of borrowing.

12. A priori arguments also lead to no clear conclusions. On the one hand it would help to know the PSBR outturn for 1983 (but only for borrowing itself and not for all the income and expenditure components) in making a

forecast for 1984, as opposed to having to forecast 1984-85 before the 1983-84 outturn is known. At the time of the March 1984 Budget we would also have some figures for the first two months of the next calendar year. On the other hand, the figures for the 1983 outturn would be difficult to interpret because:

- the control mechanisms for expenditure relate to financial years not calendar years;
- we would not know all the components of income and expenditure used in forecasting;
- Christmas and the beginning of the new calendar year would introduce a new source of uncertainty into the end year revenue and expenditure figures (as the latest December CGBR figures suggest).

13. In any event moving to a calendar year focus does not remove the problem of March uncertainty altogether. The kind of end-year surge in expenditure and borrowing last year - representing lower shortfall, not just a timing difference - would still be a problem and indeed, arguably more so, because it would throw out the Budget forecast for the calendar year already under way. The task of forecasting the end year figure should be a little easier to handle with the improvements being made to end-year monitoring, but we do not yet know how effective the new arrangements will prove to be. But to the extent that there is real improvement it will help with the present situation, as well as any new calendar year arrangement.

14. We conclude there is little reason to suggest that a switch to calendar year borrowing figures would lead to a significant improvement in forecasting accuracy. This applies both to expenditure and to revenue

forecasts. There would be some awkward transitional problems in switching the focus of attention from financial years to calendar years, especially if, as seems likely, we should be pressed to publish borrowing figures for both. And some of the snags could well persist (see below).

(b) **The effect on the need and scope for in-year action**

15. Even if a switch to calendar years were to improve forecasting accuracy, it would not be enough in itself to eliminate any possibility of error in forecasts of the PSBR - and sometimes the error could be substantial. But, more important, the effects of the PSBR going wrong could be more pronounced and the problem of corrective action made more difficult.

16. With the Budget in March and the MTFS based on financial years, problems arise first in relation to any significant departure from the forecast for the year just ending. A major difference between forecast and outturn is a source of embarrassment and inevitably tends to undermine confidence in the forecast for the year ahead - and in the Budget judgement. But, as in the spring this year and last, the forecast still retains some credibility. The Budget judgement stood and the Finance Bill was not changed despite the error in the estimate of the outturn for the previous year. The autumn measures in 1982 and last year's July measures were both based on an assessment provided by new forecasts prepared under the usual timetable.

17. With the MTFS - and fiscal policy and the PSBR - related principally to the calendar year, it seems likely that attention (and any potential concern) would focus more, rather than less, sharply on the outturn for the

March quarter of the year. For this would no longer be part of the story of last year: it would be the first instalment of the current year. So any significant departure from forecast in that quarter would have an immediate implication for the overall forecast for the current calendar year and might well increase expectation of early corrective action. The precise effects are difficult to judge; but there must at least be a presumption that the shorter timescale for action would mean that the March outturn would come to hold a greater significance for confidence in the Budget judgement.

18. At the same time, the scope for effective corrective action in the Budget would be reduced. This is because Budget changes could affect tax rates only for the remaining 9 months of the calendar year MTFS period, instead of the 12 months of the financial year, as at present. (The problem would be rather greater because the biggest tax-gathering quarter is the last one of the tax year, and this would of course fall outside the calendar year MTFS period). Such a result is bound to follow if the period applying to the financial path in the MTFS is changed, while that applying to the principal means of achieving that path - variations in tax or public expenditure - remains unchanged. Though, as noted at the outset (paragraph 7 above) without that separation the problem is simply shifted backwards in time.

19. In practice there is a risk either that bigger changes in tax rates or public spending would be needed to correct for divergences from forecast within the calendar year, or that a greater burden of adjustment for current financial conditions would have to fall on monetary policy.

20. This potential difficulty with calendar year PSBRs might be reduced if the Government declined to publish in the FSBR any estimate for the PSBR outturn in the financial year then ending. In that case the Treasury's estimate for the first quarter PSBR could not be calculated. The Industry Act forecast, Part V of the FSBR and probably also the revenue effects of tax changes and the like would in that case similarly all need to be put on a calendar year basis. But the result would not sit easily for example with a PEWP published a few weeks earlier on a financial year basis, and it would be difficult to refuse a request from the Treasury Committee for an estimate of the financial year outturn. Indeed, so long as the Government accounts were on a financial year basis, it is difficult to see how financial year figures could easily be dropped at all.

21. Finally, in this context, a switch to calendar years might tend to increase the importance of the autumn forecast and announcements. With the Budget not taking place until some way into the new MTFS calendar year the autumn PSBR forecast would acquire even greater significance and there could be more pressure to offset a prospective negative fiscal adjustment through changes in NIC. There could also be a temptation to try to validate a particular PSBR figure for the year in progress by adjusting the timing of payments and receipts between December and January.

(c) **The relationship between the first and second years of the MTFS**

22. Under the present system the figures are firm only for the first year of the MTFS; other figures are "indicative". But with a PSBR on calendar years the figure for the second year would not be set until the Budget 2½ months or so after the year had begun. This would not seem to be a

serious problem and could probably be overcome by giving the second year an intermediate status somewhat firmer than the purely indicative figures for later years. Indeed there might be an advantage in this, in that it would represent a further step away from annuality towards a greater emphasis on the medium term.

Implications for the monetary targets

23. It would not make much sense to switch to calendar years for the PSBR without also making a corresponding change to the periods for the monetary targets. Indeed not to do so would seriously weaken the coherence of the MTFS and obscure the connections between monetary and fiscal policy. So we conclude that the monetary target periods would have to be changed, too. The target period would need to run as now for 14 months in order to avoid a gap in the targets between the end of the calendar year and the following Budget. For the coming year, therefore, the target period would run from January 1984 to March 1985.

24. Although there is no necessary connection between this change and switching the monetary statistics from banking to calendar months, it would be tidy if the two changes could be made together. This is unlikely to be possible for the 1984 Budget. But we ought to be in a position to announce our intention to make the switch as from the 1985-86 target period.

Conclusion

25. To construct the MTFS on calendar year PSBR figures appears to provide a firmer base for the Budget and reduce the risk of embarassment when the financial year outturn is substantially different from the Budget

forecast made only a matter of days or weeks before. But we believe these gains would be largely illusory. For unexpected movements in the March PSBR outturn would impact directly on the current calendar year Budget forecast. Arguably the perceived need for corrective action would be greater than now, whilst the scope for it would be reduced (from 12 months to 9). This is a major obstacle to a calendar year solution which, in other respects, is at best no more attractive than present arrangements.

REDUCING PSBR DETAIL IN THE FSBR

26. This is a third option. It assumes that we stick to financial year figures for the PSBR; but try to reduce the potential impact of unexpected differences in outturn.

27. In September (Mr Kerr's minute of 13 September to Mr Norgrove) the Chancellor agreed that the aim should be to minimise the extent to which the estimated outturn is broken down in the FSBR. The Chancellor also said that the FSBR should include a point estimate, but that the Budget speech might try to avoid highlighting the precise figure either by hedging it about a bit or by instead giving a range. The following paragraphs (which need to be read alongside the 1983 FSBR) discuss in more detail how these points might be met on the assumption that financial year PSBR figures are retained.

28. Figures for the outturn year and for the future in the MTFS and IAF are already rounded to the nearest £½ billion. There does not seem to be scope for further rounding or for omitting information from these sections.

29. Part 5, covering details of Public Sector Transactions, has been considerably simplified in the past year or two but may still offer further scope for shortening and rounding.

30. Figures in the text of Part 5 are rounded to the nearest £½ billion, expressed as a fraction. It would be difficult to go beyond that, to round to the nearest £1 billion unless the MTFS figures were rounded to the same degree. But this could be awkward since the change from year to year may sometimes be only £½ billion or less in cash terms.

31. Tables 5.1 to 5.4 are summaries based on table 5.8, and, in turn, provide more detailed analysis of the figures in the MTFS and IAF.

32. Table 5.1 at least probably has to be retained. One option would be to round to the nearest £½ billion rather than, as at present, to the nearest £0.1 billion. But this would look odd for the smaller numbers in the table. It might help instead to emphasise the uncertainties by including a line at the bottom of the table which would explicitly repeat the margin of error on the PSBR, for both estimated outturn and forecast. A footnote would draw attention to the recent EPR article on the track record of PSBR forecasts. There may also be scope, though probably not for the 1984 Budget, to set out the margins of error on the components.

33. Tables 5.2 to 5.4 would be easier to drop than table 5.1, but to do so would not help to reduce embarrassment if the PSBR turned out differently from forecast; and it would attract criticism. Alternatively, the components of these tables could perhaps be taken into an expanded

table 5.1, showing for central government, local authorities and public corporations the totals of expenditure and revenue, but without all the detail. Again, there seems little to commend this: the totals for expenditure and revenue have little meaning without a statement of how they are derived. And we conclude that there is quite a good case for keeping these three tables as they are.

34. Table 5.5 was introduced in 1982 and has been generally welcomed. The TCSC and Procedure Committee were specially pleased with it. Its emphasis is on where the money comes from and where it goes, in a way designed to show relative magnitudes. There seems to be no harm in leaving this too as it is.

35. Any role it has in adding to the PSBR problem could however be reduced by incorporating it in a new section in the FSBR devoted to public expenditure. This could take account of any new decisions on public expenditure in the Budget; and update, as necessary, the White Paper figures. The section might also take in paragraphs 4.19 to 4.24, 5.15 to 5.18, 5.21, 5.22 and tables 5.6, 5.7 and 5.10 (which could well be rounded to the nearest £0.1 billion). The present Part 5 (probably to become Part 6) would then be left to express expenditure and income only in terms of national accounts and central funds and accounts.

36. The ability to provide detailed further analysis of any Budget expenditure decisions depends on how early such decisions are taken. But there may in any case be enough material scattered around the FSBR to provide the basis for a separate expenditure section. The first draft of the

FSBR could include a section on these lines if the Chancellor wishes. If it does not work in practice it would be easy enough to go back later to the 1983 format.

37. Next there are tables 5.8 to 5.12. These are very detailed, and of interest only to the most expert. One possibility would be to drop all or some of them from the FSBR, though in that case it would probably be necessary to provide them on request. On the other hand, this would be likely to arouse suspicion and lead to even more concentration on the detailed figures than if they were published as usual. Another possibility would be to round the figures in general to the nearest £0.1 billion, subject to a review of whether any of the more detailed figures are needed for reporting purposes during the year. Rounding in this way would be helpful. It would markedly change the appearance of the tables and reduce the detail.

38. Finally, the Budget speech could emphasise the uncertainties even more strongly than usual, stating the margins of error. This would probably be better than stating a range, which could complicate the presentation of the decisions on the PSBR path.

FUTURE YEARS

39. The obstacle to a Budget in April this year is the date of Easter, April 22. To wait for the 1983-84 PSBR outturn means deferring the Budget until 17th April; but it is not then possible to complete the Budget debates before the Easter recess. For the next few years Easter falls as follows:

1985 April 7

1986 March 30

1987 April 19

1988 April 3

1989 March 26

In 1985 the first estimate of the PSBR outturn should be available by Friday 12 April, and might perhaps be brought forward a day or two although the figures would be less firm. Budget Day might then be on Tuesday 16 April assuming the Easter recess ends before then as seems likely. Or it might be on 23 April to give more time to take the PSBR outturn into account. The Budget could be a few days earlier than that in 1986, 1988 and 1989, though an April Budget is probably not possible in 1987 for the same reasons that prevent it this year.

40. A later Budget is not, of course, wholly advantageous. The main advantage is that the PSBR outturn would be known before final Budget decisions are taken. The main disadvantages would be the loss of time for the Parliamentary stages of the Finance Bill (though there would be longer to draft the Bill) and the loss of revenue from the excise duties. (5 per cent revalorisation of these this year brings in a little over £10 million per week.) An immediate post-Easter Budget also has implications for work over the Easter period.

41. Nevertheless, in principle, it looks as though the Chancellor need not be constrained to an early Budget, if he prefers a later date, for 4 of the next 5 years. For next year the options can be considered in more detail when the timetable to the 1985 Budget is drawn up.

11 January 1984

PSBR Figures

	£ billion		% GDP			£ billion		% GDP	
1978-79	9.2		5½		1978	8.3		5	
1979-80	9.9		4¾		1979	12.6		6½	
1980-81	13.2	(12.6)	5¾	(5½)	1980	12.2		5¼	
1981-82	8.8	(8.2)	3½	(3¼)	1981	10.8	(7.8)	4¼	(3)
1982-83	9.2	(9.7)	3¼	(3½)	1982	5.5	(7.7)	2	(2¾)
1983-84*	10		3¼		1983+	12		4	

Figures in brackets are adjusted for the direct revenue effects of the Civil Service dispute

*Autumn Statement figures

+Q4 forecast, Q1-3 actual

CONFIDENTIAL

~~A 53~~

FROM: T BURNS
DATE: 11 JANUARY 1984

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Mr Bailey
Mr Littler
Mr Cassell
Mr Ridley
Mr Battishill
Mr Kerr
Mr Lord
Mr Portillo
Sir Lawrence Airey - IR
Mr A Fraser - C&E

CHEVENING

I attach a paper on the Policy Background to the MTFS.

TB

T BURNS

THE POLICY BACKGROUND TO THE MTFS

THE FIRST FOUR YEARS

1. The Medium Term Financial Strategy has now been in place for four years. It was introduced in 1980 at a time of high and increasing inflation, following large increases in world oil and other commodity prices and the breakdown of the previous administration's incomes policy. It set out targets for monetary growth and an illustrative path for the PSBR, with the aim of bringing inflation down progressively. Essentially the strategy has been successful, though the outturn has differed in a number of details from expectations at the time.

Economic Performance*

2. Recent behaviour of money GDP, output, and inflation is set out in the table below:

% growth	1973-79 average	1979-80	1980-81	1981-82	1982-83	1983-84[E]
Money GDP	16.8	19.9	13.7	9.7	9.2	8
Output	1.7	2.6	-4.1	-0.1	2.3	3
Inflation						
- GDP deflator	14.8	16.8	18.6	10.0	6.7	5
- RPI	15.0	15.8	16.3	11.5	7.1	4½

E = latest estimate

After growing by nearly 20% in 1979-80, money GDP decelerated to 9-10% by 1981-82 and has since remained broadly stable. The deceleration was rather sharper than assumed in the 1980 MTFS, which did not envisage nominal GDP growth under 10% until 1982-83, and then only for one year.

3. Inflation has also come down more sharply than anticipated in 1980, and has consistently been lower than forecast. The precise figures depend on the measure of prices used; but using the GDP deflator, inflation fell from nearly 19% in 1980-81 to 10% in the next year and an estimated 5% this year.

* Detailed comparison of present estimates of output and inflation with figures in successive versions of the MTFS is given in an Annex.

4. The pattern of output has been broadly as anticipated in 1980, with falls in the first two years followed by increases in the next two. But the amplitude of the swings has been slightly greater than anticipated. The 4% fall in 1980-81 was greater than forecast, though from a higher level in 1979-80, and the recovery slightly faster, particularly in 1982-83. In the first year of the MTFS, both output and inflation turned out lower than expected; but in subsequent years lower money GDP growth has gone with a more favourable split between output and prices.

5. There have been marked fluctuations in income shares over the last four years. The share of non-oil company profits, which started 1980 just below 10% - well below the levels ruling in the 1960s and early 1970s - fell sharply to reach about 6½% in the first half of 1981. Since then, however, there has been a recovery back to the level of early 1980. Meanwhile the share of wages and salaries has fallen by 3 points since 1980 to around 56%. This pattern was not anticipated in 1980: a fall in the wage share was foreseen; but the extent of the fall in profits, reflecting in part the unexpectedly high interest rates and real exchange rate, and the subsequent recovery was not.

6. The incidence of policy, with particularly strong pressures on the company sector in the first two years, led to a sharp shake-out of labour. Productivity in manufacturing - though not elsewhere in the economy - has risen much more than expected; and this has evidently proved an easier way for manufacturing firms to relieve the pressure on them than cutting real wages. As a result employment has fallen, and unemployment risen, much more sharply than envisaged when the strategy was set out in 1980, even though the level of output is much as was envisaged.

The overall stance of policy

7. The four year programme in the 1980 MTFS showed declining growth in £M3 and an accompanying profile for the PSBR which was intended, given the other economic assumptions being made at the time, to give an acceptable path for real interest rates. In the event, both monetary growth and the PSBR have declined substantially since 1980 although the precise targets have been revised

in subsequent versions of the MTFS and the scope of the monetary target has been widened to include PSL2 and M1 as well as £M3.

Monetary Growth

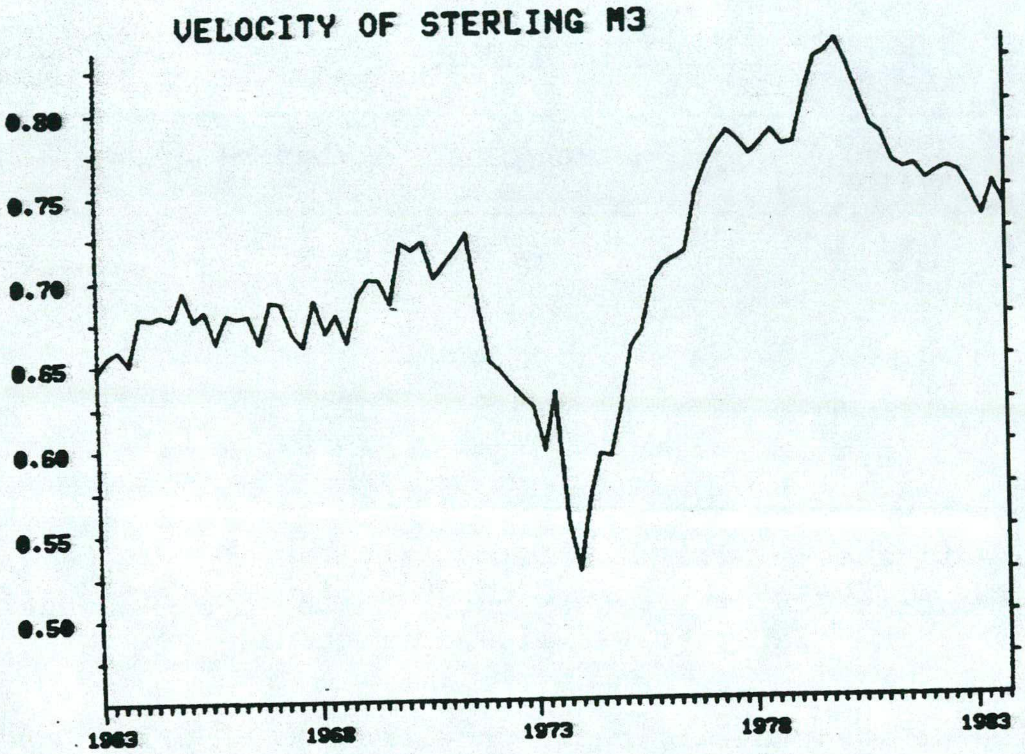
% changes*	1973-79 average	1979-80	1980-81	1981-82	1982-83	1983-84[E]
Money GDP	16.8	19.9	13.7	9.7	9.2	8
MO	12.8	7.6	8.3	2.5	5.3	7
M1	13.3	3.3	12.4	3.9	14.9	13
£M3	12.1	11.5	21.2	12.0	11.5	11
PSL2	12.3	11.5	15.3	10.8	11.4	13

E = latest estimate for target period

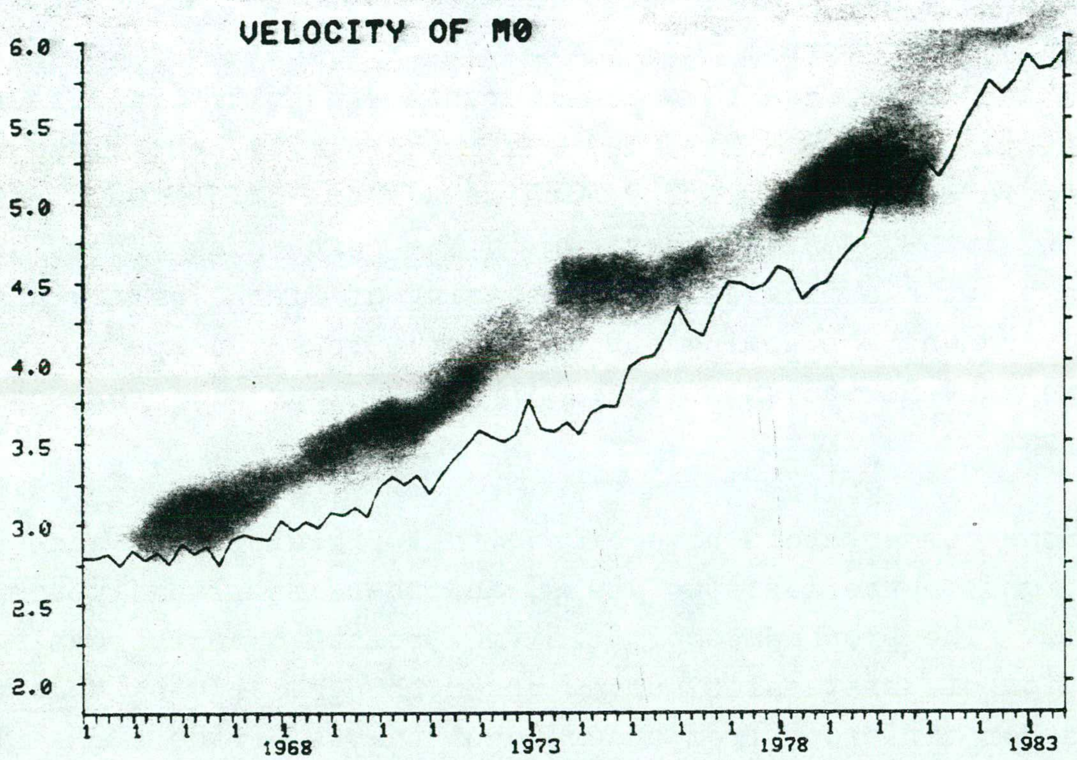
* Apart from money GDP, the growth rates quoted are % changes through the financial year (ie mid-April to mid-April).

8. In spite of unexpectedly rapid deceleration of prices and money GDP, the growth of broad money has exceeded our forecasts throughout the period. £M3 growth was well above the target ranges in 1980-81 and 1981-82, though subsequently it has been just within the higher ranges set in the 1982 MTFS. Throughout the period, broad money growth has exceeded the growth of money GDP, in contrast to the experience of the 1970's on which monetary ranges in the 1980 MTFS were largely based.

9. There have been a number of reasons for this. Financial deregulation, and particularly the ending of the corset in 1980, has led to greater intermediation by the banking system and an increase in the provision of credit to the private sector. The private sector increased its net saving substantially in 1980-81 to compensate for the effects of increased inflation on the real value of its wealth, and kept much of the increase in liquid form. High real interest rates since then may have encouraged a higher wealth/income ratio. Rapid broad money growth relative to money GDP has coexisted with tight financial conditions and better than expected progress on inflation.



10. Narrow money has behaved rather differently. The growth of M0 has been consistently some way below the growth of money GDP, as suggested by previous trends, and fell progressively from 1979-80 to 1981-82 under the influence of financial innovation and high nominal interest rates. Since then, nominal interest rates have come down and the growth of M0 has picked up somewhat, though remaining below money GDP growth. The path of M2 has been similar. The behaviour of M1 has been significantly more bumpy, reflecting its greater interest sensitivity. But taken together, the narrow aggregates have given a better indication of the tightness of policy than the broad aggregates.



11. The real money supply fell sharply in 1979-80 on all definitions as the inflation rate increased. For narrow money the fall continued almost unabated for another two years before turning up in the last two years. Real broad money has risen continuously since 1980-81.

Real Monetary Growth

% changes	1973-79 average	1979-80	1980-81	1981-82	1982-83	1983-84[E]
MO	0.4	- 11.6	- 3.3	- 6.3	1.3	1.6
M1	0.8	- 5.2	0.3	- 5.0	10.5	6.4
£M3	- 0.3	- 8.4	10.8	2.4	7.2	4.0
PSL1	- 0.1	- 8.4	2.9	1.3	7.1	2.9

E = Estimate

12. In terms of the PSBR, attempts to tighten fiscal policy in the first two years of the last parliament were not successful. The PSBR in 1980-81 turned out significantly higher than the figure in the 1980 MTFS, due to a considerable extent to the effects of recession. But 1981-82 marked a step change by comparison with the previous two years. The PSBR as a share of GDP was reduced from 5¼% in 1979-81 to under 3½% in the next three years. This contrasts with a progressive tightening of fiscal policy which the government was aiming for, and reflects an unexpectedly low PSBR in 1981-82 and an unexpectedly high figure in prospect for this year.

13. Some commentators have argued that fiscal policy has become less tight in the last two years, and there is probably some truth in this. The proponents of this view point to an increasing contribution of asset sales, among other things, arguing that these are rather different from other constituents of the PSBR. The table below gives figures for the PSBR adjusted for asset sales, and for the public sector and general government financial deficits (PSFD and GGFD).

The Stance of Fiscal Policy

£ billion (share of GDP)	Average 1979-81	1981-82	1982-83	1983-84[E]
PSBR	11.6 (5.2)	8.8 (3.4)	9.2 (3.3)	10.0 (3.3)
PSBR plus asset sales	12.4 (5.6)	9.4 (3.6)	10.7 (3.8)	12.3 (4.1)
PSFD	9.8 (4.4)	6.1 (2.4)	8.8 (3.1)	10.0 (3.3)
GGFD	7.4 (3.3)	4.8 (1.9)	7.2 (2.6)	9.5 (3.1)

E = latest estimate

14. The broad picture from these various indicators is that fiscal policy was probably tighter in 1981-82 than in the last two years; and there has been little change in the last year. But they confirm that fiscal policy is now tighter than in 1979-81, though probably less so than the reported PSBR figures suggest.

The figures for the GGFD show a smaller fall since 1979-81 and a stronger rise in the last two years than the other indicators. But despite the attention they have recently received, figures for the GGFD are not appropriate as a measure of fiscal stance. By omitting movements in the borrowing requirement for Nationalised Industries they exclude a significant change in fiscal policy as Nationalised Industry prices were raised to economic levels following a period of subsidisation.

15. Fiscal conditions have undoubtedly become easier in the last two years. This partly reflects a higher nominal fiscal deficit, but mainly the effect of lower inflation. Various indicators of the real fiscal balance are shown below. They all show a significant turnround since 1981-82, which has contributed to the recovery in output.

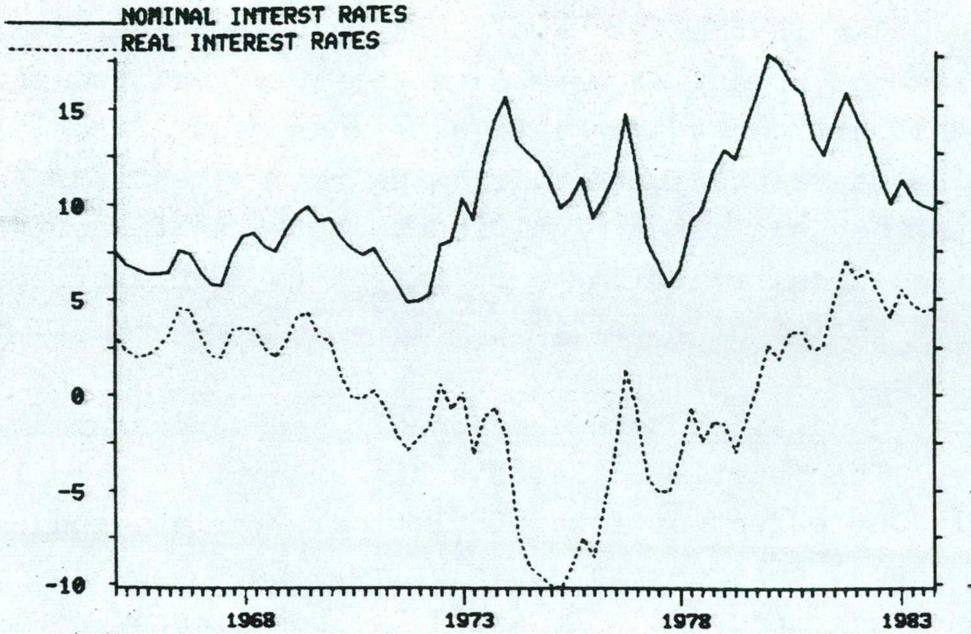
Fiscal conditions

% of GDP	Average 1979-81	1981-82	1982-83	1983-84E
Real PSBR	- 0.4	- 0.5	+ 1.1	+ 1.6
Real PSBR plus asset sales	-	- 0.3	+ 1.6	+ 2.3
Real PSFD	- 1.1	- 1.5	+ 1.0	+ 1.5
Contribution of inflation	- 5.6	- 3.9	- 2.2	- 1.8

E = latest estimate

16. After being raised to 17% in late 1979, and remaining high in 1980, nominal interest rates have been brought down significantly as inflation has fallen, with a temporary interruption in late 1981 reflecting weakness in the exchange market. However real interest rates remain high in both the UK and in other countries. They are as high, or higher, now in the UK as they were in 1980, and on this basis monetary conditions clearly remain tight.

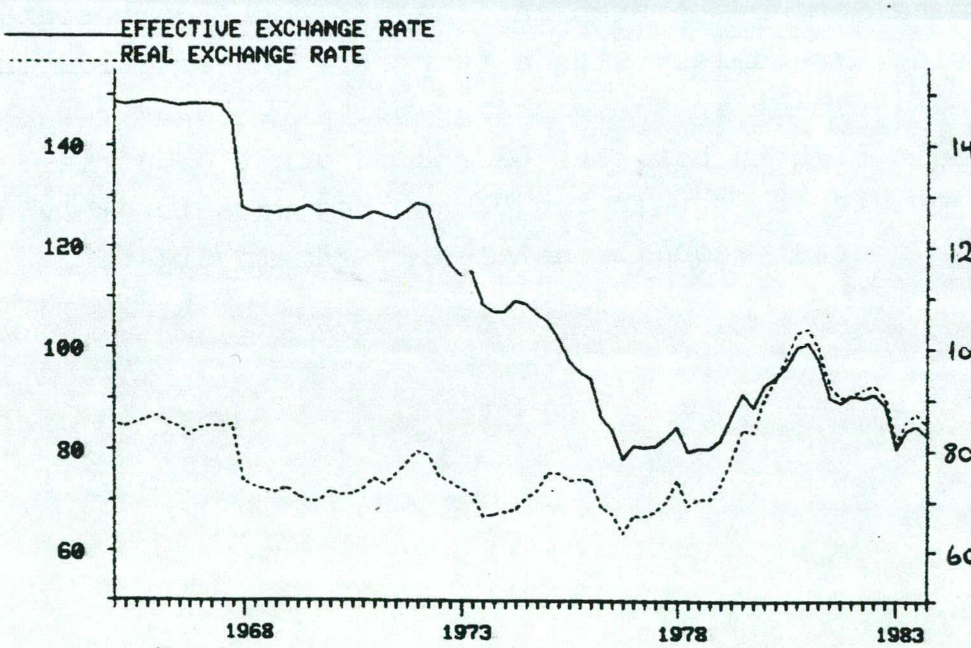
REAL AND NOMINAL
3 MONTH INTEREST RATES



REAL=NOMINAL MINUS AVERAGE OF FORWARD AND BACKWARD LOOKING INFLATION

17. The real exchange rate is now some way below its peak in the early months of 1981. Mainly this is due to a lower nominal exchange rate. The factors which drove it up from 1979 - including high nominal interest rates and high oil prices - have been at least partially reversed, but it remains well above the average level of the late 1970s. Pressure on the traded goods sector of the economy remains, though less so than in the first year or so of the MTFS.

REAL AND NOMINAL EFFECTIVE
EXCHANGE RATE



Public Expenditure and Taxation

18. An aim of policy at the outset of the MTFS in 1980 was progressively to reduce public expenditure as a share of GDP. In the event this has not been achieved. The share of General Government expenditure has tended to increase, and only this year does it seem likely that there will have been some fall. It has grown faster than forecast over the first two years of each MTFS projection published so far, but the out-turn has been particularly different from the forecast made in the first MTFS in 1980.

Government Expenditure and Receipts*

% of GDP	1979-80	1980-81	1981-82	1982-83	1983-84E
General Government Expenditure**					
1980 MTFS	44.9	45.6	44.5	42.9	41.5
Out-turn	43.5	46.1	46.5	47.3	45.7
General Government Receipts***					
1980 MTFS	39.6	41.3	41.4	42.0	41.5
Out-turn	38.4	40.2	43.1	43.6	42.1

* National Accounts basis

** Including gross interest payments

*** Including gross interest receipts, before fiscal adjustment

E = latest estimate

19. Three major factors have contributed to this. First, social security expenditure has grown more rapidly than expected, partly because of the failure to predict the extent of the rise in unemployment. Second, debt interest payments have been much higher than anticipated, both because of higher interest rates, especially in 1980-82, and also higher borrowing in some years. And local authorities have also consistently spent more than expected. But even this performance on expenditure has been difficult in the face of progressively higher bids from spending departments.

20. In the face of this out-turn for expenditure, taxes were raised sharply in 1981 budget. In spite of net tax reductions in the 1983 budget, general government receipts as a % of GDP are still expected to be higher in 1983-84 than in 1980-81 - and much higher than the figures in the 1980 MTFS, particularly if allowance is made for the fiscal adjustment of around 2% of GDP which was expected at the time. However, to a large extent this reflects higher receipts from the North Sea, which are expected in 1983-84 to be nearly four times the 1979-80 level.

THE PERIOD TO BE COVERED BY THE MTFS

21. The first MTFS in 1980 covered four financial years (1980-81 to 1983-84). The next three covered only three financial years. If the practice of rolling forward by one year only were continued, the 1984 MTFS would cover 1984-85 to 1986-87. However it is worth considering whether to extend this period to four or even five years.

22. The main argument for extending it is that it is appropriate at the beginning of a new Parliament for the Government to indicate its intentions over the whole life of the Parliament. The final year of a five-year period would be 1988-89, the Budget for which could in principle take place under the present Government if it ran its full five years.

23. The MTFS sets out the Government's broad objectives and plans for policy over the medium term. This acts as a constraint on policy in future and thereby contributes to the consistency and stability of policy over time. It also signals to the private sector what the policy framework will be, and hence encourages more efficient decisions. The longer the period of the MTFS the greater are the benefits of this kind that result.

24. There are some potential problems with a 5 year MTFS. Previous MTFSs have set out the assumptions about inflation and money GDP growth rates over the medium term which formed the basis for the financial framework. It would be difficult not to continue to do this. If a five-year period were adopted the assumptions about the end of the period would be interpreted as evidence of the Government's views about longer-term growth and inflation possibilities. It would be necessary to follow a careful line between appearing to be too optimistic and appearing over-pessimistic, while all the time emphasising the uncertainties. Similar difficulties arise with the output growth and inflation assumptions underlying any long-term public expenditure exercise, with which the MTFS would, of course, have to be consistent. The problems of this sort would be less if the MTFS covered a shorter period.

25. Another argument against extending the MTFS is that the figures for the later years carry little credibility because of the likelihood of unexpected developments. The MTFS may not therefore have a significant impact on expectations or behaviour. One aspect of the unreliability of figures for later years is that the Public Expenditure Survey only goes up to 1986-87.

26. The unreliability aspect should not, however, be given too much weight. In the case of public expenditure, the broad intention of holding the total constant in cost terms has already been mentioned in public. Any Green Paper or other document on long-term expenditure would provide the basis on which to prepare projections up to 1988-89. More generally, the later years of the MTFS will not be regarded as unconditioned projections of what fiscal and monetary policies will be - come what may. The discussion of the MTFS in the FSBR has always made clear that policies may have to change if domestic and world developments differ from those foreseen. The purpose of the numbers in the MTFS is to fill out the description in the text of the Government's broad strategy, on one particular set of assumptions about future developments. We have seen in recent years that revisions to monetary targets and PSBR paths have not affected credibility adversely when we have explained the reasons for them.

27. If the MTFS this year was to cover five years, the question arises whether the period should be rolled forward by one year in 1985 and subsequent years or whether one or two years might be dropped off the end. There is a precedent for dropping a year: the 1981 MTFS covered the three years to 1983-84 following a four-year period, also to 1983-84, in the 1980 MTFS. The argument for shortening the period would be that there was no need to go beyond the end of the Parliament. But there is a contrary argument, namly that it is helpful to show how the policy framework will evolve over the medium term, even if that goes into the next Parliament. Even with a shorter period this argument becomes relevant as the Parliament advances through its term. Whatever course might be chosen in 1985 and subsequent years, no problems are likely to be presented that should be taken into account in deciding on the period for the 1984 MTFS.

28.On balance, I favour extending the MTFS to cover five years (1984-85 to 1988-89) even if it is thought that the MTFS in subsequent years should cover only four years. I do not judge the disadvantages of presenting figures for later years that are admittedly subject to considerable revision to be serious beside the advantage of being able to chart a consistent strategy over the whole lifetime of this Parliament.

MEDIUM-TERM OUTLOOK

29. Policy for the medium term has to be set against a background of likely developments in the absence of significant policy changes. This section discusses the outlook in general terms, the next section discusses objectives, and then the remaining sections discuss the financial framework consistent with the achievement of these obectives.

30. Taking <u>inflation</u> first, the central question is whether it will continue to fall over the medium term. Those who argue that it will do so place considerable weight on the depressive effects of the relatively low <u>level</u> of economic activity and low inflationary expectations. Unemployment is expected to remain above the natural rate for some years, and capacity utilisation to be considerably short of full capacity. A further, perhaps substantial, reduction in earnings growth may occur. The low capacity utilisation may limit the extent to which companies are able to raise profit margins, and it may stimulate them to make further improvements in productivity.

31. On the other hand, others place more emphasis on the effects of <u>changes</u> in the level of economic activity. They draw attention to the pressure that rising activity tends to place on costs and prices: commodity prices and wages would tend to rise more rapidly, the exchange rate might come under pressure, and companies would take the opportunity of the growing demand to restore some of the reduction in their profit margins that they have suffered in recent years.

32. Another way of posing the question about whether inflation will come down further is to ask whether the labour market will continue to adjust. Labour market adjustment can be thought of as a situation in which real wages grow significantly less rapidly than productivity. In this situation, profit margins will increase, as they have been doing over the last couple of years, without necessarily preventing a continued downward movement in inflation.

33. The argument that the low <u>level</u> of activity will contribute to a further downward movement in inflation relies to a considerable extent on the expectation that there will be continued adjustment in the labour market. This could be reflected either in lower growth in real wages without much change in productivity growth, or in a continuation of the relatively rapid productivity growth of the last 2-3 years without much slowdown in real wage growth (or a combination of the two). Those who emphasise the inflationary impact of the <u>rise</u> in level of activity tend not to expect much adjustment in the labour market.

34. The extent of labour market adjustment is also critically important to an assessment of likely developments in output and unemployment. So also is the type of adjustment, namely whether it takes the form of slower growth in real wages or faster growth in productivity. Both types improve profitability and hence contribute to faster output growth. Real wage adjustment is likely to lead to a faster fall in unemployment than productivity adjustment. Indeed the latter may well involve some temporary rise in unemployment if the productivity gains were especially sharp. However, productivity adjustment would produce more rapid output growth than real wage adjustment, because it represents a larger rise in the rate of growth of productive potential. The real incomes of those in work would also grow faster.

35. Thus an assessment of the extent and nature of future labour market adjustment is central to the view that one takes of medium and longer-term developments. The evidence from the past provides some pointers:

- there has been considerable adjustment during the last two or three years, especially in manufacturing: profitability has risen sharply, albeit from a low level;

- this has occurred almost entirely on the productivity side: on average we have not seen markedly slower growth in real wages than had been achieved in the past;

- in general, companies have reacted to the financial pressure on them by improving productivity rather than by striking tougher bargains over real wages, by contrast with what has been occurring in the US; and on the union side there has apparently been a willingness to see jobs lost as long as the real wages of those in work were maintained.

36. Looking to the future, this sort of pattern may well continue. The low levels of productivity in the UK, especially in manufacturing, compared with those in other European countries, show that there is still plenty of scope for productivity adjustment, even without any new investment. Furthermore, the historical relationship between

productivity growth and investment suggests that only a small rise in the share of investment in GDP over the next few years would be necessary to sustain faster productivity growth of, say, an extra 1 percentage point a year, assuming that the new investment is at least as productive as it was in peace-time periods up to the late 1960s.

37. Thus some labour market adjustment on the productivity side can probably be expected. There may also be some on the wage side. It is difficult to see the present higher unemployment and changes in labour market institutions not leading to some increase in flexibility , including a greater responsiveness of real wages. But the effect may not be dramatic and it may be most significant in non-manufacturing. The emphasis in manufacturing is more likely to be on high than on low wages and productivity.

38. There may therefore be some tendency for productivity growth to fall over the course of the next five years, with diminishing scope for further catching up on our competitors and with the growth of some relatively low productivity employment. In considering the growth of productive potential it is also necessary to take North Sea oil and labour supply into account. Production in the North Sea may begin to decline later in the MTFS period, tending to pull down the growth of output per head in the economy as a whole. There may also be some decline in the growth of labour supply. Since all three components of potentive potential may tend to decelerate, it is likely that potential growth at the end of the period will be considerably less than it is now, at perhaps about 1½% a year.

39. Some tentative conclusions can be drawn about the medium-term outlook, assuming a broadly unchanged stance of policy. Some relatively slight decline in inflation from the present 5% may occur. There should also be some fall in unemployment, again possibly not very large. Output growth should remain better than in the 1970s but not necessarily as high as in the most recent period.

MEDIUM-TERM OBJECTIVES

40. The medium-term objective of fiscal and monetary policy, as set out in the Mansion House Speech, is to continue to reduce inflation gradually with the ultimate aim of price stability. Of course the policies that may be required to achieve price stability and the associated movements in output and employment are inherently uncertain as they depend on the performance of the economy and how much adjustment takes place in the labour market. Generally speaking, the more adjustment there is, the more favourable are output and unemployment developments for a given inflation objective. The assessment that follows is based on the assumption that a moderate amount of adjustment will occur.

41. The difficulty with a determined move to achieve price stability within five years on this assumption of performance, is that there would have to be a major deceleration of money GDP growth fairly early in the period. The pattern of the 1980-83 disinflation suggests that with such a sharp deceleration output growth would be initially affected more than inflation, although after a time the split of money GDP growth would become more favourable: output growth would rise again and inflation would fall. Unemployment would be adversely affected in the early years unless rapid adjustment occurred in the labour market. To achieve the objective of

price stability within this period would mean a sharp reduction in the PSBR as a percentage of GDP and in monetary growth. Even with a tight fiscal stance there would probably be a rise in interest rates and they would stay higher for a time; nominal interest rates would also be temporarily higher. It is difficult to see any room for tax cuts, unless significant reductions in expenditure could be achieved, or the disinflationary pressures in the economy turned out to be greater than seems likely.

42. The Mansion House Speech explained that a slightly less rapid movement towards price stability might be a preferable strategy. Inflation would still be kept on a downward path, but price stability would not be reached within five years. This would be consistent with bringing the growth of money GDP down significantly to, say, 5-6% a year over the period from the present rate of about 8%. The eventual movement of inflation and output growth will depend on the overall performance of the economy, and especially on labour market adjustment. If the sort of developments discussed earlier occur, and there is continued adjustment on both the productivity and real wages sides, inflation might be of the order of 3-4% after five years, and output growth average around 2½% a year over the period. There would be a reasonable expectation of some fall in unemployment assuming that productive potential was growing at about 1½% a year at the end of the period.

43. If the economy performed less well than this with little labour market adjustment and a poor supply response, inflation might not come down so far and output growth would tend to be lower for a given growth of money GDP. There would be little prospect of a fall in unemployment. On the other hand a better performance associate mainly with better labour market adjustment and improved supply conditions might see further progress being made towards price stability and output growth being somewhat better. Unemployment then might be expected to fall decisively. The objective of "supply side" policies is to improve the chance of rapid adjustment occurring.

44. If it became evident that the economy was performing better or worse than assumed then in future years it might be desirable to alter the objective for money GDP. For example, if there were a marked absence of adjustment and inflation showed little sign of falling there would be a case for aiming for greater deceleration

and tightening policy. However it would also be possible to argue that slow adjustment implied that there were substantial costs in bringing down inflation that much further. We therefore need to reconsider from time to time the judgment about the appropriate path for money GDP. For the moment our analysis points to assuming some moderate adjustment and gearing fiscal and monetary policy towards a growth of money GDP of 5½% by the end of the period.

ASSUMPTIONS FOR THE MTFS

45. Although there is considerable uncertainty about the way that the economy will develop we have to state the assumptions for output and inflation that underlie the projections for revenue and borrowing in the MTFS. It is necessary to consider the kind of figures that we might publish if it were decided to pursue the thrust of policy as outlined in the previous paragraphs. The table shows average and final year inflation and output growth associated with the reduction in money GDP to 5½% in the final year, assuming moderate adjustment.

Assumptions for the MTFS
(per cent a year)

	Output growth	Inflation	Money GDP growth
Period average	2½	4	6½
Final year	2	3½	5½

46. The assumption of moderate adjustment and average money GDP growth of 6½% a year is probably the appropriate basis to carry out the financial arithmetic. It does not show the pessimistic picture frequently observed in outside forecasts in which little adjustment takes place. But it also avoids the risk of raising doubts about the plausibility of the numbers. As we have seen recently, it is much easier to present policy when the outcome for inflation and output turns out to be better than assumed rather than the reverse.

MONETARY POLICY

47. Monetary policy will continue to be directed to the achievement of targets for monetary growth. For present purposes we assume the targets are set consistent with an objective for money GDP growth falling to 5-6% by 1988-89. Unlike previous years, however, it is the intention to have separate ranges for broad and narrow money. For broad money, the focus of attention might continue to be £M3 (and PSL2). For narrow money the aim is to focus maybe on MO (and M2).

48. Setting targets for broad money involves a number of difficult judgments. Growth of broad money has exceeded growth of money GDP since 1979-80, and the question is to what extent this downward trend in velocity will continue. Some of the factors reducing velocity in recent years may well be less important in the next five years, and some may even be reversed:

- the effects of financial deregulation should eventually slow down or stop, though how long the process of adjustment will take is not easy to predict.

- some reduction in real interest rates may partially reverse the increase in financial wealth relative to income which has been observed since 1979.

49. Whether it is reasonable to expect a reversion to the upward trend in velocity observed in the 1970s is debateable. It would mark a significant change from recent behaviour. A more cautious approach would be to work on the assumption that the velocity trend flattens off over the period. On this basis it would probably be reasonable to aim for a 1 point annual reduction in target range for broad money over the period of the MTFS from the present range of 7-11%. However this may mean £M3 in the upper half of the ranges and PSL2 near the top end. One possibility is to raise the range to 7-11% in 1984-85, particularly if the range is also to apply to PSL2, and then reduce it steadily in subsequent years. However, this would pose difficult problems of presentation, and may adversely affect confidence in financial markets. An alternaitve which would

partly get around these problems would be to stay with 6-10% for 1984-85 and hold the range at that level in 1985-86 also, before reverting to a downward path. The balance of argument depends on the weight to be given to PSL2.

50. One possible set of assumptions which, of course, will have to be considered in the light of the forecast and the views of the Bank, is illustrated below.

Broad Money Targets

	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89
Money GDP	8	7½	7	6½	6	5½
£M3	11	9	8	7	6	5
PSL2	13	10	9	8	7	6
Target range	7-11	6-10	6-10	5-9	4-8	3-7

51. For narrow money the ranges will have to be lower than for broad money. They will have to be based primarily on the behaviour of MO since we have insufficient data for M2. It is reassuring, therefore, that MO and M2 growth rates have been broadly similar since M2 data has been collected. The velocity trend for MO has been upwards at an average about 4% pa in the last 20 years. The acceleration of velocity after 1979 probably owed something to high nominal interest rates - the disinflationary policy bringing down MO growth ahead of money GDP. There are signs of a deceleration in velocity in the last year as interest rates have come down. The likely effects on velocity of interest rate changes and changes in payments habits are the two main factors to be taken into account when setting the targets.

52. The pace of change in payments habits in the next five years is very difficult to predict. But our research suggests that the effect on MO velocity has in the past been relatively smooth. We have no reason to expect that the pace of change will differ significantly from the experience of recent years. Some reduction in nominal interest rates is likely to add to MO growth over the next five years by comparison with previous trends if inflation is brought down further and real interest rates fall to some extent. If interest rates fall

by 4% over the period of the MTFS this might add around 7% to the level of MO relative to income. Since the timing is difficult to predict it makes sense to assume it is spread fairly evenly over the period.

53. This points to a slightly less rapid decline in the rate of growth of narrow money in the next 5 years than for broad money. Given the objective for money income it suggests a path perhaps as below:

Narrow Money Targets

	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89
Money GDP	8	7½	7	6½	6	5½
MO	7	6	5	4	3½	3
Target Range	-	4-8	3-7	2-6	2-6	1-5

FISCAL POLICY

54. Fiscal policy, as noted earlier, appears to have been less restrictive in 1983-84 than intended at budget time. This is part of the reason why broad money growth is near the top of the range in spite of heavy funding. It has led to high real interest rates, which may partly explain the strength of the real exchange rate. It is very difficult to judge what is the appropriate real exchange rate in the medium term. The present level is significantly above the range experienced in the latter part of the 1970s. However, it is not so far above the level of much of the 1960s and the forecasters see no strong pressures pointing to a sharp decline. Even so if anything the balance of interpretation is that a lower real exchange rate and lower real interest rates would provide a better balance for the UK economy in the present phase of adjustment.

55. The present pattern - high real interest rates, real exchange rate, PSBR and broad money growth - points to fiscal policy being relatively lax in relation to monetary policy in 1983-84. Some correction is probably desirable in 1984-85. The approach adopted here is to examine the appropriate longer term size of the PSBR as a percentage of money GDP, and then to discuss the appropriate speed

of adjustment to the chosen level.

(i) The Medium Term

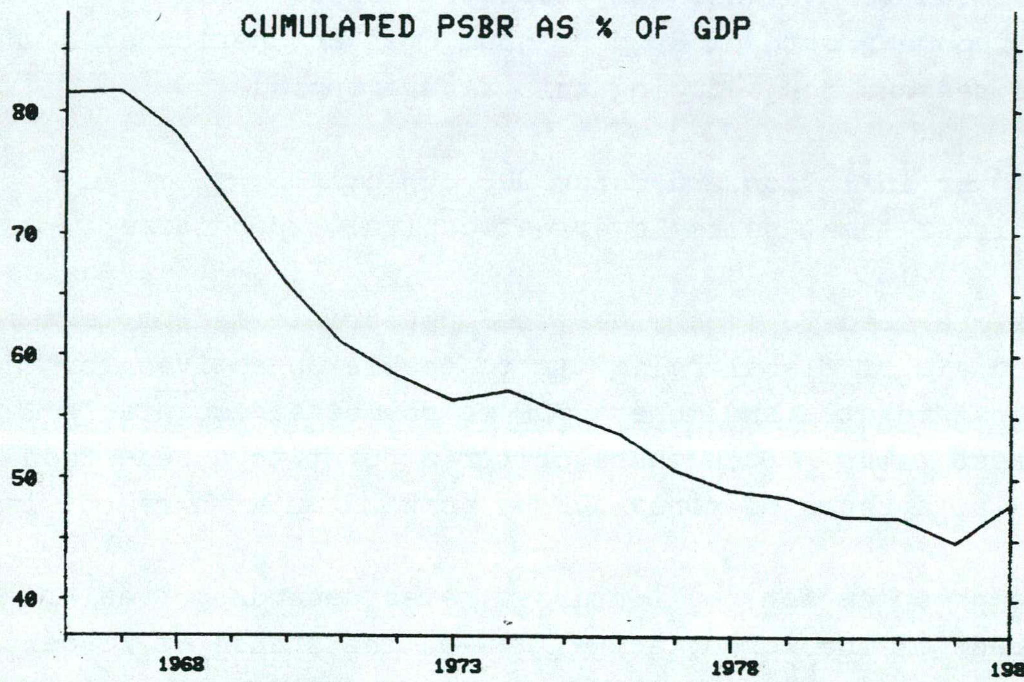
56. The 1983 MTFS assumed a PSBR ratio coming down to 2% per annum in the medium term. This was thought to be broadly consistent with nominal income growth of 8% per annum over the period as a whole. Possible reasons for reducing this figure include:

- lower inflation and money GDP objectives
- higher asset sales/lower net capital expenditure

We therefore need to reconsider the appropriate medium term ratio. The broad aim of fiscal policy is to enable objectives for the monetary aggregates and money GDP to be met at acceptable levels of interest rates. Both these criteria point to a reduction in the PSBR as a share of money GDP by comparison with recent levels.

57. The prospect for real interest rates depends on real rates in the rest of the world, as well as on the stance of fiscal and monetary policy in the UK. The impact of world rates over the next few years is uncertain, with the prospect of rising US rates, but perhaps declining rates elsewhere as the dollar comes under pressure. However adherence to the monetary targets set out above is likely to involve continuing high real interest rates unless the stance of fiscal policy is tightened significantly by comparison with 1983-84.

58. There is considerable uncertainty in choosing the path for the PSBR consistent with monetary objectives. Deriving the appropriate PSBR from a detailed analysis of the monetary counterparts and the demand for money has proved to be difficult, given the behaviour of bank lending. It is therefore also helpful to look at the behaviour of public sector debt - or the cumulated PSBR - relative to money GDP, as in the chart below.



59. The chart shows a downward trend in the ratio of debt to income until the early 1970s, but then a clear flattening off which has become more pronounced in the last two years or so. This has occurred in spite of a high rate of investment in overseas assets in recent years - the counterpart of large surpluses on current account - following the abolition of exchange controls which has led to some substitution in portfolios of foreign assets for public sector debt. One explanation of recent behaviour may be the high level of real interest rates, which appears to have been necessary to induce investors to maintain their holdings of public sector debt relative to income at recent levels. This

implies that if we are to achieve reductions in real interest rates over the medium term it may be necessary to set fiscal policy so as to bring the debt/income ratio back to its trend.

59.[a] What the trend is likely to be over the medium term is difficult to assess. The argument advanced above suggests that it may still have to be downwards. However, we also need to take into account the flattening off since the early 1970s, which may continue even with lower real interest rates. With the current account now expected to be broadly in balance, and hence little net UK investment in overseas assets, demand for public sector assets may account for a higher proportion of the private sector's net saving. Some commentators have argued that there may be no downward trend by the end of the MTFS period.

60. Against the background of 5-6% growth of money GDP by the end of the period, maintenance of an unchanged debt/income ratio would require a PSBR of roughly 2½% of GDP. If the downward trend were to continue at, say, 2% per annum - close to the average of the last 10 years - a ratio of 1½% would be appropriate. This would imply a greater degree of caution, consistent with the previous versions of the MTFS.

61. This approach merely serves to provide a benchmark against which other factors can be examined. In addition to real interest rates and the cyclical position, it is necessary also to take into account the pattern of capital expenditure, North Sea oil revenues, and other structural factors which affect the appropriate scale of public sector borrowing.

62. A parallel paper on public sector capital expenditure concludes that changes in such spending should be taken into account in assessing changes in the PSBR. Net capital spending has declined from around 5% of GDP in the mid-1960s to nearly zero now; and the figures which underlie the Public Expenditure White Paper, which has asset sales increasing from present levels and a decline in gross investment (excluding defence capital), imply a further fall to minus 1% in 1986-87.* Even allowing for the possibility that some of the capital expenditure in the earlier period was not profitable, and that some current expenditure (eg education) ought

* Part of the fall in the later years is accounted for by the assumed privatisation of BT and BA.

to be treated on a par with capital spending for this purpose, this points to lower public sector borrowing than the 2% of GDP observed in the 1960s.

Public Sector Capital Expenditure

£ billion
(%) of GDP)

	1978-9	1979-80	1980-1	1981-2	1982-3	1983-4	1984-5	1985-6***	1986-7
Gross*	9.9 (5.8)	10.5 (5.1)	12.2 (5.2)	12.1 (4.7)	11.9 (4.2)	12.4 (4.1)	11.0 (3.4)	9.3 (2.7)	9.4 (2.5)
of which:									
asset sales**	-0.4 (-0.2)	-1.5 (-0.7)	-1.1 (-0.5)	-1.3 (-0.5)	-2.5 (-0.9)	-2.7 (-0.9)	-4.2 (-1.2)	-3.7 (-1.0)	-3.6 (-1.0)
Net**	3.1 (1.8)	2.5 (1.2)	2.7 (1.2)	1.7 (0.7)	0.6 (0.2)	0.1 (-)	-2.1 (-0.7)	-2.7 (-0.8)	-3.2 (-0.9)

* Domestic capital formation less special sales of assets
** Gross council house sales plus special sales of assets
*** excluding investment by BT and BA from 1985-86

x based on estimates of capital consumption, after 1982-83

63. The pattern of oil production also points in this direction. We are now close to peak production, and as a consequence, revenues from the North Sea currently exceed the stream of additional tax which is sustainable in the longer term. It can be argued that this should be reflected in reduced public sector borrowing, with saving of debt interest used to compensate for lower revenue as the oil runs out.

North Sea Oil Revenues

	1978-89	79-80	80-81	81-82	82-83	83-84	84-85	85-86	86-87	87-88	88-89
£billion	0.6	2.4	3.9	6.5	7.8	9.0	9.9	9.7	10.1	9.2	9.7
% of GDP	0.3	1.2	1.7	2.5	2.8	3.0	3.0	2.8	2.8	2.4	2.4

64. A further consideration is the pattern of demographic change and pension provision. Higher pension commitments falling due in the next century, associated with rising numbers in retirement relative to those in work and the coming to maturity of the state scheme, point to higher net savings now than is implicit in a pay-as-you-go system. This is a potentially very important consideration for the longer term which will have to be examined further in the context of the Secretary of State for Social Services' inquiry into provision for retirement. But it is a further argument for lower public sector borrowing in current circumstances.

65. These structural factors suggest a PSBR at the bottom end of the range indicated by the debt/income calculations. The aim to reduce inflation by means of balanced fiscal monetary policies points to the same conclusion. It therefore seems appropriate to plan on the basis of a PSBR equivalent to 1½% of GDP by the end of the period. As the period is extended in future versions of the MTFS, it may be appropriate to aim for lower figures at the end as the economy moves towards price stability.

(ii) <u>The Short term</u>

66. We start from a position in 1983-4 in which the PSBR looks like being 3½% of GDP. The key issue is how quickly it is reasonable to get down to the medium term objective of 1½% of GDP.

67. It is quite acceptable to allow for the PSBR to deviate from its medium term 'norm' in response to cyclical factors. That was an important reason why we felt able to allow a rise in the PSBR ratio in the 1981 Budget, How much it should be allowed to vary over the cycle depends partly on the relative efficacy of fiscal policy and interest rates in stabilising the economy. There is no presumption that the stabilisers inherent in the fiscal system should be automatically allowed to operate fully. The combination of PSBR and interest rates appropriate at any stage in the cycle is a matter of choice for the Government.

68. Arguably it makes sense for the Government to bring the PSBR back to its appropriate medium term norm as the economy approaches a cyclically neutral position. However, a gradual move towards lower inflation probably means fiscal policy adjusting ahead of

output and inflation. This suggests it would be appropriate to bring the PSBR down to its appropriate medium term level even while unemployment remains some way above its longer term level.

69. A further consideration is that before the end of the MTFS, the contribution of oil revenues to the PSBR will start to decline as production falls. By comparison with the peak over the next two years, oil revenues may well fall by about ½% of GDP, and for any given PSBR this means higher receipts from other sources. The process of adjustment to a lower PSBR is thus likely to be harder in the later years than the PSBR numbers themselves indicate. This suggests making as much progress as possible in the early years, before the oil revenues start to fall away significantly in 1987-88.

70. A further factor to be taken into account is the profile to asset sales. Relatively high figures in the early years for example would increase the case for a relatively quick reduction in the PSBR. This conclusion is reinforced by the fact that there has been a significant rise in asset sales in the last four years, which has not been fully reflected in a lower PSBR.

71. Against these arguments for bringing down the PSBR quickly in the early years of the MTFS period must be set the fact that the room for manoeuvre on fiscal policy looks to be most limited in the next year or two. On current forecasts it may be necessary to raise taxes slightly next year in order to get back onto the path set in the 1983 MTFS, which envisaged a PSBR of 2½% of GDP in 1984-85. And yet room for manoeuvre during a period of structural tax reform would be very welcome. This argues against attempting to reduce the PSBR too quickly from its present level.

72. As regards 1984-85, there is a clear need to get back onto a downward path after the prospective overshoot this year. With asset sales rising by £1bn next year, we need to cut the PSBR by close to this amount even to stand still. In order to redress the imbalance between monetary and fiscal policy in 1983-84, and enable real interest rates to come down, there is a clear case for a larger reduction.

73. The precise number must await the outcome of the Winter Forecast. On the basis of the Autumn Forecast and the profile for the PSBR, there will probably be little scope for any net tax cuts in the 1984 Budget. To achieve a PSBR of £8 bn some increase may be necessary. I would want to see the forecast details before making a final judgment. There would be a clear case for £8½ bn rather than £8 bn if tax increases prove to be necessary to achieve the lower figure while significant tax reductions appear to be in prospect for the next year. It would be difficult to explain and justify a proposal for tax increases in 1984 to be followed immediately by tax cuts. At the same time we must be aware that this picture - a relatively difficult fiscal position in the next year or so giving way to an easier position later on - has been a feature of most recent forecasts, and in view of recent experience in forecasting public expenditure we should retain a healthy scepticism.

74. Even so, after 1984-85 the room for manoeuvre is likely to be somewhat greater; and there is then a strong case for making fairly rapid progress towards achieving the medium term objective. The medium term path I envisage, and the corresponding paths for the PSFD and GGFD, might look as follows:*

£billion (% of GDP)	1983-84	1985-86	1985-86	1986-87	1987-88	1988-89
PSBR	10 (3¼)	8½ (2½)	7 (2)	6½ (1¾)	6½ (1¾)	6 (1½)
PSFD	10 (3¼)	8¾ (2½)	7½ (2¼)	7 (2)	6½ (1¾)	6 (1½)
GGFD	9½ (3¼)	7¾ (2¼)	6½ (1¾)	6½ (1¾)	6 (1½)	5½ (1¼)

75. This implies sticking to the PSBR figures as a share of GDP in the 1983 MTFS for the first two years, with a gradual decline after that.

* Annex B shows a ready-reckoner for PSBR figures and ratios

76. The PSFD and PSBR move in a broadly similar manner. In the early years, the PSFD is slightly higher, with extra proceeds from special sales of assets being only partially offset by net lending to the private and overseas sectors. In the last two years, the PSFD may decline faster than the PSBR if the asset sales programme slows down. The GGFD, which excludes government loans to Nationalised Industries, is likely to be a little below the PSBR and the PSFD throughout the period.

77. If we succeed in holding public expenditure constant in real terms this should leave room for tax cuts in the years after 1984-5, even in the last two years when oil revenues are falling away. Estimates of the fiscal adjustment must be very speculative at this stage, and extremely uncertain in any event. Again we need to finalise the precise numbers when the new forecast is available, but the qualitative conclusion at this stage points to making significant progress towards a lower PSBR in the early years.

<u>Questions for Discussion</u>

78. There are four broad questions, relating the the period of the MTFS, the medium-term objectives, the monetary targets and the PSBR path.

79. The issue for decision on the <u>period</u> is whether to roll the MTFS forward by one, two or three years. The main considerations are:

- the impact on expectations
- the effects on future freedom of manoeuvre.

80. The Mansion House Speech provides the starting point for deciding <u>medium-term</u> objectives. It is now necessary to choose particular numbers that can be published as assumptions about medium-term developments.

81. It is not possible at this stage to make firm decisions about monetary <u>targets</u>, especially for the next year or two. Nevertheless a discussion of likely trends in velocity over the short- and medium-term can indicate the sort of monetary paths that are likely

to be consistent with policy objectives.

82. The discussion on the PSBR path should separate the medium-term PSBR target from the speed of the adjustment towards it. Relevant to the medium-term question are:

- the need to reduce real interest rates
- whether the downward trend in the ratio of public sector debt to money GDP will continue and, if so, at what rate
- the low level of net capital expenditure, resulting in part from the high level of asset sales
- the fact that North Sea revenues are near their peak
- the rise in future pension commitments

The issues that should be taken into account in deciding the speed at which the PSBR is to be moved down include:

- the stage of the cycle
- the lags in the response of money GDP and inflation to fiscal policy
- the pattern of North Sea oil revenues
- the pattern of asset sales
- the room for manoeuvre on fiscal policy in 1984-85 and 1985-86.

ANNEX A

COMPARISON OF MTFS FIGURES WITH OUTTURN

GDP/deflator (market prices)

% changes	1979-80	1980-81	1981-82	1982-83	1983-84
1980 MTFS		19.5	12.1	8.2	7.5
1981 MTFS			10.8	8.0	7.2
1982 MTFS(1)				7.8	6.9
1983 MTFS(1)					5.4
Latest estimate	16.8	18.6	10.0	6.7	5.2

(1) Annual projections of the GDP deflator were given in 1982 and 1983 MTFS, but nothing in earlier years.

RPI(2)

% changes	1980 Q4	1981 Q4	1982 Q4	1983 Q4
1980 MTFS	16.5	10.2	8.7	7.5
1981 MTFS		10.2	7.5	7.4
1982 MTFS			9.0	7.1
1983 MTFS				5.8
Latest estimate	15.3	11.9	6.2	5.1

(2) Not published in MTFS; 18 month ahead forecasts given in short term prospects.

Money GDP (Market prices)

% changes	1979-80	1980-81	1981-82	1982-83	1983-84
1980 MTFS		17.1	12.0	9.6	10.7
1981 MTFS			10.5	9.6	9.7
1982 MTFS(3)				9.7	9.7
1983 MTFS(3)					7.9
Latest estimate	19.9	13.7	9.7	9.2	8.3

(3) Annual money GDP projections were given in 1982 and 1983 MTFS, but not in earlier years.

Real GDP(4)(factor cost)

% changes	1979-80	1980-81	1981-82	1982-83	1983-84
1980 MTFS		-2.2	-0.2	+1.4	+2.8
1981 MTFS			- 0.4	+1.3	+2.3
1982 MTFS				+1.7	+2.6
1983 MTFS					+ 2.4
Latest estimate	+2.6	-4.1	-0.1	+2.3	+2.8

(4) Projections for real GDP at factor cost have been given in all published MTFS. However the annual path has not been made explicit and an average figure has always been given.

£M3(5)

% changes	1979-80	1980-81	1981-82	1982-83	1983-84
1980 MTFS		9.4	8.0	7.0	6.0
1981 MTFS			8.0	7.0	6.0
1982 MTFS				11.6	9.2
1983 MTFS					9.0
Latest estimate	11.5	21.2	12.0	11.5	10.0

(5) Illustrative ranges for £M3 were published in all MTFS. The figures for the outturn are on a mid-April to mid-April basis, MTFS figures are Q1 on Q1.

M1(6)

% changes	1979-80	1980-81	1981-82	1982-83	1983-84
1980 MTFS		16.8	17.5	0.8	9.0
1981 MTFS			14.1	14.8	14.5
1982 MTFS				10.8	13.4
1983 MTFS					11.8
Latest estimate	3.3	12.4	3.9	14.9	12

(6) Illustrative ranges for narrow measures of money were published in the 1982 and 1983 MTFS. These were the same as for broad money though the text made clear that higher numbers were possible as inflation and interest rates came down.

General Government Expenditure[7]
(including interest payments)

% of GDP	1979-80	1980-81	1981-82	1982-83	1983-84
1980 MTFS	44.9	45.6	44.5	42.9	41.5
1981 MTFS			47.7	46.1	43.9
1982 MTFS				47.0	45.0
1983 MTFS					46.4
Latest estimate	43.5	46.1	46.5	47.3	45.7

General Government Receipts[7]
(including interest receipts, before fiscal adjustment)

% of GDP	1979-80	1980-81	1981-82	1982-83	1983-84
1980 MTFS	39.6	41.3	41.4	42.0	41.5
1981 MTFS			43.1	43.2	42.7
1982 MTFS				43.4	42.3
1983 MTFS					43.3
Latest estimate	38.4	40.2	43.1	43.6	42.1

(7) Annual figures. General government expenditure and receipts and money GDP were both published in 1982 and 1983 MTFS. In 1980 and 1981 MTFS levels of government expenditure and receipts were given in cost terms. In addition figures for public expenditure as a proprtion of GDP in first and last years of the MTFS were given in 1980, 1981, 1982 MTFS.

PSBR as a proportion of GDP(8)

	1979-80	1980-81	1981-82	1982-83	1983-84
1980 MTFS	$4\frac{3}{4}$	$3\frac{3}{4}$	3	$2\frac{1}{4}$	$1\frac{1}{2}$
1981 MTFS			$4\frac{1}{4}$	$3\frac{1}{4}$	2
1982 MTFS				$3\frac{1}{2}$	$2\frac{3}{4}$
1983 MTFS					$2\frac{3}{4}$
Latest estimate	4.8	5.6	3.4	3.3	3.4

(8) Projections of the PSBR ratios have been given in all MTFS.

ANNEX B

EQUIVALENT PSBR FIGURES AND RATIOS

£ billion

% of GDP	1984-85	1985-86	1986-87	1987-88	1988-89
1	3.3	3.5	3.7	3.9	4.1
1¼	4.1	4.3	4.6	4.8	5.1
1½	4.9	5.2	5.5	5.8	6.1
1¾	5.6	6.1	6.4	6.7	7.2
2	6.5	6.9	7.3	7.7	8.2
2¼	7.3	7.8	8.3	8.7	9.2
2½	8.1	8.7	9.2	9.6	10.2
2¾	9.0	9.5	10.1	10.6	11.2
3	9.8	10.4	11.0	11.6	12.3

A53

FROM: A M W BATTISHILL
DATE: 12 January 1984

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr Littler
Mr Cassell
Mr Kerr
Mr Ridley
Mr Lord
Mr Portillo

Sir Lawrence Airey, IR
Mr A M Fraser, C & E

AGENDA

CHEVENING

I attach a suggested annotated agenda for the weekend discussions at Chevening covering the papers already circulated.

A M W BATTISHILL

290
I

Thanks. We have spoken — GP re LTPU. N.

(PMP)

CHANCELLOR OF THE EXCHEQUER

Chevening.

I have talked to PER about RIS. He agrees that the O-S-paper is no good, and has transferred it to Bailey / Scholar, to rewrite in terms of relevance to future policy.

2. PER now sees the Chevening agenda as comprising

Sat { a. Burns on M.T.F.S. et al
b. Cassell on Taxes (Conspectus)

Sat/Sun [c. Burns/Lomax on FSBR presentation of monetary targets]

Sun. { d. Scholar/O'ling Sum (revised)
e. Calendar year PSBR (Battishill.)

That squeezes out Littler on International Debt — but that's probably no great loss. The paper will be circulated anyway

3. PER's plan is to get hold of all the pps by this Friday, look at them over the week-end, and put them — revised if necessary — to Ministers on Tuesday (10 Jan). But he agrees to let me have a set this Friday (and I shall accidentally copy to you.) JOL.

✓✓

CHANCELLOR OF THE EXCHEQUER

This is now seen as a possible subject for the Chevening Sunday morning.

As a subject, it is certainly more interesting than appears from this paper!

*

Thanks. This certainly won't do as a Chevening paper in its present form. Better speak — also re LTPE.

M.