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J B Unwin
Under Secretary

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T P Lankester Esq
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Dear Tim,

I enclose on a personal basis copies of the two general briefs on the economic outlook and the Budget that we are giving the new Chancellor.

2. If you have any queries, please give me a ring (or Margaret O'Mara if I am not available).

Yours
Brian

J B UNWIN

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A1

OVERALL ECONOMIC OUTLOOK

Note by the Central Unit

This note summarises the economic prospect facing the UK over both the short and medium term. It does not make any policy recommendations but is intended to set the general background to the major policy decisions the Chancellor will need to take in the next few months, especially those which concern his Budget (see brief A2). Separate briefs and submissions will be available on individual subjects and policy issues.

THE SHORT-TERM PROSPECT

2. The forecasts on which the assessment below is based contain a number of policy assumptions which broadly reflect the position from which the Chancellor is starting and imply no judgement about the policies he may himself wish to adopt. On taxation they assume the indexation of the main personal allowances provided for in the recent Finance Act but no increases in the specific indirect tax rates. On public expenditure they assume the plans of the previous administration broadly as set out in the last Public Expenditure White Paper (Cmnd 7439), together with the Chief Secretary's Statement of 23 February on the operation of cash limits in 1979-80. The forecasts are necessarily uncertain and subject to significant margins of error but will provide some indication of the likely development of the economy during 1979-80. Revised and more detailed forecasts will be submitted in 2-3 weeks.

(i) Earnings and prices

3. Pay settlements in the year ending July 1979 are likely to lead to earnings increases averaging 13-14 per cent with the public and private sectors faring about equally. In the absence of major policy initiatives pay increases in the economy as a whole may well remain at about the same level in the 1979-80 pay round. This assumes that comparability agreements are extended to some further public sector groups and that as a result earnings in the public services rise by 18% which is significantly more than in the rest of the economy. This represents a bunching together in 1979-80 of a "catching up" process covering large parts of the public services. Prices will probably be rising faster this year than last. Even with no increase in indirect taxation, the RPI will probably rise by around 10-11 per cent during 1979 and by a similar rate during 1980.

(ii) Growth

4. Although the economy grew by around 3% in 1978, growth is likely to be around only 1½ per cent in both 1979 and 1980 and will probably be insufficient to prevent some rise in unemployment. The main problem is the failure of domestic industry to match growth in demand by increased production - in 1978 consumer spending rose by 5½ per cent while manufacturing output grew by less than 1 per cent. Company profits are likely to remain low, reflecting a depressed domestic economy and an uncompetitive level of labour costs, but because of a low rate of stockbuilding and a downturn in the level of investment no widespread liquidity problems are foreseen.

(iii) Balance of payments

5. The current account of the balance of payments should remain in approximate balance in 1979 though it seems likely to move into deficit in 1980, largely as a result of the loss of competitiveness. In addition the capital account is likely to be weakened by a reduction in inflows by foreign oil companies to finance North Sea oil development.

(iv) PSBR

6. On unchanged policies, the Public Sector Borrowing Requirement (PSBR) is expected to rise from just over 5 per cent of GDP (£8½ billion) in 1978-79 to some 5.3 per cent of GDP (£10 billion) in 1979-80.

(v) Domestic and External Monetary Policy

7. Continuation of the 8-12 per cent target range for the growth of £M3 has been assumed for 1979-80. Achievement of that target with existing fiscal policies would almost certainly require a rise in interest rates from the current levels. The recent upward movement of the exchange rate is likely to continue throughout most of the current quarter but then to be reversed in line with the deterioration in the balance of payments referred to above and the prospects for the money supply and inflation in the UK compared with other countries. The consequence of this would be an effective rate of around 60-62 by the end of 1979-80.

8. From this summary of the short-term prospect, it is clear that the economy faces two major and inter-related problems: a rising rate of inflation and slow growth.

9. The projected rise in the rate of inflation this year is largely due to high growth of earnings in the 1977-78 and 1978-79 pay rounds. Control over the rate of inflation is a precondition for sustained economic expansion and higher growth. Higher rates of inflation tend also to be unstable. They create uncertainty and reduce the willingness of companies to invest, particularly as they are inevitably accompanied by high nominal interest rates. The value of personal savings is eroded and this makes consumers less willing to spend. The effects of domestically generated inflation also tend to be reinforced from the external side. The balance of trade and output will be adversely affected insofar as there is a loss of competitiveness through the exchange rate failing to respond on the lines described above.

THE MEDIUM-TERM PROSPECT

10. Attempts to predict the course of the economy further into the future are even less certain and also subject to large margins of error. Recent trends in the international environment and in the UK's performance give no grounds for expecting a rise in the sustainable rate of growth in the early 1980s or an autonomous decline in the rate of inflation. Only a substantial improvement on the supply side of the economy is likely to warrant expectation of a significantly better outcome.

(i) Productivity and Growth

11. The underlying growth of productivity has declined in recent years and on present prospects there is no reason to expect any early improvement. The fall in productivity has more or less offset the contribution that the rise in North Sea oil output and the faster growth of the labour supply have made to the economy's productive potential. In time, faster growth of output could lead to a recovery in the growth of productivity but until inflation is contained and competitiveness improved there is little prospect of achieving a sustained increase in growth. Lying behind these trends is a long history of industrial inertia, inefficiency and lack of innovation, and on present prospects it may well be difficult for the economy to sustain growth much above a rate of 1-2 per cent over the next few years. Since about half of this would represent an increase in North Sea oil output, the prospects for the rest of the economy, particularly manfacturing, are extremely worrying. Such slow growth may well lead to a continued rise in unemployment but it is difficult to predict the increase with any accuracy.

(ii) Competitiveness and trade performance

12. The adverse trends in Britain's trading performance in manufactures have also been a major factor depressing the economy's growth. Exports of manufactures have risen at less than the growth rate of world trade (though there has been some improvement

in performance in recent years) and imports of finished manufactures have risen much faster than the growth of the domestic economy. UK labour costs have risen at a much faster pace than our main competitors' and this has been compounded recently by the appreciation in the effective sterling exchange rate, reflecting in part the direct and indirect effects of North Sea oil and of domestic monetary policy. As a result large parts of British industry have become uncompetitive - over the past two years, UK labour cost competitiveness has probably worsened by about 10 per cent. The benefit that North Sea oil has brought to the balance of payments has been largely offset by a deterioration in non-oil items. Though the current account has been close to balance in the past two years, and may not be far from balance in the years ahead, this has to be seen against the background of a generally depressed economy and a major contribution from North Sea oil.

(iii) The PSBR and Monetary Prospects

13. An important implication of the poor growth prospect is that, on present public expenditure plans (which assume a 2% annual growth path, which is higher than the prospect for the growth of the economy as a whole) and unchanged tax rates, the PSBR would increase both in absolute amount and as a percentage of GDP. In consequence, even to contain the growth of the money supply, substantially higher nominal interest rates could well be required. A reduction in the PSBR would reduce the growth prospect even further, at any rate for the first year or two.

WORLD ENVIRONMENT

14. The problems of high inflation and low growth are common to the majority of industrialised countries, although the UK suffers more than most. They are likely to be intensified in the short-term as a result of the loss of a substantial proportion of Iranian oil exports. Over the medium-term too there is little sign of a return to the trend rates of growth in world trade experienced in the 1960's and early 1970's and on average, GNP in the industrialised countries will probably rise by only 3 per cent a year, compared with an average growth of 5-5½ per cent in the decade to 1973. We cannot therefore rely on the expansion of other economies to extricate us from our own difficulties. In a number of international fora - IMF, OECD, EEC and the seven power summits - a lot of effort has gone into the negotiation of international programmes of concerted action. These are helpful as an assurance against a major world recession; but they should not be expected to improve more than marginally the outlook for the UK, as described in this brief.

15. Most outside forecasters share the above gloomy assessment of the problems in the medium-term. There is little consensus, however, about the effects on the economy of major policy changes. The main issue for macro-economic policy, in the immediate future, is how far to press anti-inflationary policies, such as strict fiscal and monetary policies, with their probable damaging effects on profits, output and employment in the short-term at least. The major problems in the economy may be helped by successful macro-economic policies to some extent - for example, lower inflation and reduced expectations of future inflation would encourage investment. But these major problems seem to stem from deep-seated attitudes and rigidities in both management and the work-force and require fundamental improvements on the supply side of the economy.

ANNEX

General Government Account and public sector borrowing reqiurement

(Positive sign = receipt)

£ million

General Government receipts	1978-79	1979-80
Taxes on income	22555	27511
Taxes on expenditure	18713	21160
National Insurance contributions	10080	11430
Local authority rates	5996	7076
Gross trading surpluses	219	230
Rent dividends and interest	6421	7144
Total current receipts	63984	74551
General Government Expenditure		
Final consumption	-33505	-38667
Current grants	-20345	-24387
Subsidies	-3714	-4211
Debt interest	-7655	-8720
Total current expenditure	-65219	-75985
Current surplus	-1235	-1434
Investment and stockbuilding	-4630	-5411
Capital grants	-1861	-1973
Taxes on capital	938	1015
Net acquisition of financial assets	-6788	-7803
Net lending to public corporations	-1513	-2899
Other net lending	-396	-47
Other adjustments	-9	-366
General Government borrowing requirement	-8706	-11021
Public corporations' borrowing other than from general government (Positive sign = repayment)	+248	+912
Public Sector Borrowing requirement	-8458	-10109

Note: Showing figures to the nearest £1 million does not imply accuracy of this order. Error margins for PSBR forecasts are normally considered to be in the region of £2000 - 3000 million.

A2

BUDGET

Note by the Central Unit

This note assumes that the Chancellor will wish to introduce an early substantive Budget (a separate submission will recommend 12 June as the appropriate and earliest feasible date) and its purpose is to draw attention to the main policy issues on which urgent decisions will be required. It is to be read in the context of Brief A1 which summarises the overall economic outlook; and more detailed briefs on the specific tax and other policy issues referred to will be available to the Chancellor separately as he requires them.

Money Supply and PSBR

2. As we understand it, the Prime Minister and the Chancellor will regard a progressive reduction in the rate of growth of the money supply as the main priority in the task of mastering inflation. The Budget, and the fiscal policies contained in it, will therefore be structured to give effect to this intention.

3. In the Budget the Chancellor will be expected to announce the monetary guidelines for the 12 months to mid-April 1980 and he will therefore need to consider the desired growth of the money supply over this period. At present the growth of the money supply is expressed as a target range for the growth of £M3, which has been rolled forward for a 12 month period at six monthly intervals. The current 8-12 per cent range applies to the year ending mid-October 1979.

4. In setting a new target a judgement will have to be made on two closely related questions: the main influences on £M3, and the effect on the economy of different target ranges for the growth of the money supply. The main policy decisions that affect the growth of £M3 include - the size and structure of the PSBR; external policy, in particular the possibility of any substantial intervention to influence the exchange rate; the acceptability of the prospective level and pattern of interest rates; and direct controls on the banking system (eg, through the use of the SSD scheme).

5. On existing policies (which include the indexation of the main personal allowances as in the April Finance Act at a full year revenue cost of about £1 billion and the implementation of the petroleum revenue tax increases estimated last August as worth about £140 million in 1979-80) the PSBR in the current year is forecast at around 5.3 per cent of GDP (about £10 billion). Attached at Annex is a table showing the main revenue and expenditure com-

pon[illegible]s. On any view of its composition, some reduction will be required to keep the money supply within the existing 8-12 per cent range during 1979-80 and to allow some further reduction in interest rates, let alone achieve growth within a lower target range should the Chancellor decide on this for this year.

6. The PSBR is thus one of several factors to be taken into account in assessing how to achieve a desired growth of £M3, but it has assumed a special importance in view of its direct effect on market expectations. The previous Chancellor was committed to keep it to around £8.5 billion in the current year. However, its composition is in many respects as important as its size both in terms of its direct monetary effects (eg, the extent to which there are offsetting changes in bank lending) and in its effect on market confidence. For example, increases in the PSBR resulting from income tax reductions are likely to be more acceptable to the market than increases resulting from public expenditure changes.

Fiscal Options

7. To give the Chancellor a preliminary view of the implications of the main options he is likely to want to consider, a rough guide to the effect of some different possible tax changes is provided in paragraphs 10 and 11 below. More details are given in the separate tax briefs. It will also be possible to provide "ready reckoner" estimates of the effects of these and other tax changes on output, prices, the PSBR and other economic variables. (In relation to these it will be important to bear in mind that the PSBR effects of individual changes are not strictly additive; and that they do not bear a constant relation to the full year revenue effects, some being more PSBR 'rich' than others.) However, a full analysis, taking account of all the interactions, will require a more complete forecast. This will enable us to provide the Chancellor with some indication of the change in interest rates that could be necessary to keep the money supply within the desired range given the other elements of policy referred to above. We shall also be able to give an indication of the likely effects on the economy, including the short-term effects on demand and employment, of PSBRs of different size and composition, in combination with different interest rates, within the monetary limits on which the Chancellor decides.

8. In addition to the achievement of his monetary objectives, the Chancellor will also want to make an immediate start on the manifesto commitment to reduce direct taxation. In order to pay for this, both public expenditure cuts and increases in indirect taxation will be necessary.

(i) Public Expenditure

9. Decisions on public expenditure, including cash limits policy and this year's social security uprating, will need to be discussed with the Ministers concerned and will therefore

have to be pursued very quickly if they are to be announced in the Budget. The Government will in any case want to hold a major review of the medium-term public expenditure plans, but for the Budget it will be necessary to concentrate on those things which will have an immediate impact in the current year. This limits the field, but a significant contribution from public expenditure cuts is desirable, both to avoid putting undue weight on increases in indirect taxation, and as a first step towards the desired shift in the share of the public sector in national resources. The possible candidates for early cuts, including possible sales of assets, are described in brief.

(ii) Indirect Taxes

10. In considering indirect tax increases the Chancellor will wish to take account of the effects on the RPI. As a very broad rule of thumb, each £1 billion in additional full-year revenue raised from indirect taxes will add about 1% to the RPI. For example, raising the standard rate of VAT to 12½% to bring it into line with the higher rate would add about 2.1% to the RPI while bringing in about £2,250 million in a full year. (Because of the late date of the Budget, however, and the time lag in collection of VAT receipts the revenue in 1979-80 would be only about £1,200 million.) Increases in the specific excise duties would be likely to add rather more to the RPI than an increase in VAT yielding the same revenue, depending on the composition of the package.

(iii) Direct Taxation

11. The scope for making a start on the manifesto commitment to reduce income tax at all levels will depend on the size of the income tax package which the Chancellor judges would be compatible with his other objectives, including the possible increases in the indirect taxes referred to above and the resultant level and composition of the PSBR. The best means of dealing with the poverty trap through the income tax system is to raise tax thresholds. Each £10 added to the single allowance and £20 added to the married allowance cost together rather over £100 million in a full year. At the top of the scale, to cut the top rate of tax on earnings to, say, 60 per cent and to restore the value of the bands to their level at April 1973 would cost about £1 billion in a full year. If in addition the Chancellor wished to make any substantial reduction for those on middle incomes this could be done only by a reduction in the basic rate: the revenue cost of this in a full year would be about £½ billion for each penny taken off.