

Participants:

United Kingdom: Sir Geoffrey Howe, Chancellor of the Exchequer
Ambassador Henderson
Gordon Richardson, Governor of the Bank of England
Sir Kenneth Couzens, Second Permanent Secretary, UK Treasury
Terry Burns, Chief Economic Advisor, UK Treasury
Harry Walsh, Economic Counselor, UK Embassy

United States: Donald T. Regan
R. T. McNamar
Paul Volcker
Beryl W. Sprinkel
Marc E. Leland

Time and Place: September 28, 1981, at 10:30 a.m., in the Secretary's Conference Room

Subjects: U.S. economic policy, IMF/IBRD issues, U.S. controls on natural gas, unitary taxation, G-5, UK tax policy, UK business cycle.

Distribution: Messrs. Chappoton, Leddy, Erb, Dawson, Korp, Maresca, J. Newman (London)

Summary. On macro policy, Chancellor Howe's main message was for the U.S. to raise taxes and cut expenditures. Secretary Regan indicated targets for further expenditure cuts and possibilities for increased tax revenues. CHANCELLOR HOWE cautioned against too stringent conditionality on IMF loans, but fully agreed with the U.S. view on the need to increase the role of the private sector in LDC development. SECRETARY REGAN said the U.S. government's aim of accelerating deregulation of natural gas was complicated by prior political commitments. SECRETARY REGAN explained that unitary taxation (as applied in California) was politically very controversial, but a federal solution was under consideration. The British stressed the need for greater secrecy on G-5 discussions. SECRETARY REGAN asked about the economic wisdom of UK tax increases and CHANCELLOR HOWE replied these were dictated by the overriding objective of reducing the deficit. UNDER SECRETARY SPRINKEL expressed an interest in the UK economic outlook. The British confirmed that the recession appeared to have bottomed out but emphasized the importance of continued wage restraint as a positive factor in a UK recovery.

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CHANCELLOR HOWE began by stating that he wanted to reiterate privately what he had expressed publicly. The UK government firmly backed our making the defeat of inflation our top priority. He mentioned the need to use all policies in fighting inflation and emphasized the importance of the link between fiscal and monetary policy. He had argued the case against inflation at the Commonwealth Conference of finance ministers and had pointed out the implications for aid flows that the required anti-inflation fiscal actions by the developed countries entailed. He also wanted to convey to us his concern that the right balance be struck between stringency and ease on IMF conditionality.

SECRETARY REGAN replied that we had been making cautionary noises on conditionality because the LDCs had received a lot of funds lately, and when the banks are liquid they tend to lower their standards in order to increase lending. We wanted to draw attention to this problem and strengthen the hand of de Larosiere. SECRETARY REGAN said we recognized that some nations cannot meet tough conditions, but, too many soft loans would lead to defaults.

CHANCELLOR HOWE expressed general agreement on these points.

SECRETARY REGAN said he did not find that the World Bank lacked funds and he mentioned linking the World Bank's operations to those of the private sector. He said he planned to discuss with IBRD President Clausen how far IBRD/private sector linkage could go. By private sector he meant to include state-owned companies, like BP.

MR. SPRINKEL added that our emphasis on the role of the private sector should be viewed in a positive context. Historically, the sources of growth in the LDCs have been located in the private sector. CHANCELLOR HOWE agreed and added that the LDCs that have gotten rich in the latest 20 years have all encouraged private sector development. SECRETARY REGAN mentioned that OPEC development had been promoted by private firms.

MR. LELAND noted that there had been very little talk against the private sector among the LDCs. CHANCELLOR HOWE referred to the ritual sentence here and there, but agreed that the LDCs recognized that they must make their countries fit for private enterprise to live in. He cited policy changes in Uganda aimed at attracting back Asian Africans. SECRETARY REGAN remarked on the absence of controversy in the Interim Committee meeting. CHANCELLOR HOWE observed that this was his third year at these meetings and he noticed the atmosphere was changing. CHAIRMAN VOLCKER wondered why; he said it surprised him that there were not greater protests from the LDCs. MR. COUZENS thought it was because the LDCs' expectations were being scaled down. MR. LELAND said the LDCs must realize that the OECD countries were the only game in town.

CHANCELLOR HOWE mentioned President Reagan's speech of Thursday (September 24) and its apparently skeptical reception by the market. He said it was action not words that would be needed to convince the market. He mentioned the difficulties caused by exchange rate volatility.

SECRETARY REGAN reassured Howe on U.S. foreign exchange market intervention policy. He said that in a critical market situation, the U.S. authorities would be present. There may be different interpretations on what constitutes a market crisis, but we are sensible, not dogmatic, and would not permit events to imperil the system.

SECRETARY REGAN raised Howe's letter to him concerning U.S. controls on natural gas and the alleged advantage these gave to U.S. petrochemical producers over their UK competitors. He said that the cabinet had been recommending immediate deregulation, but there were political commitments that made this difficult. His written response to the letter was on it way. Any such initiative would elicit bills for a windfall profits tax, which Treasury would favor but the President is against. He cited a Treasury staff study on the subsidy element in the controls, which (MR. LELAND continued) showed that the U.S. natural gas price differential was a relatively small factor in U.S. competitiveness, compared with exchange rates, say. CHANCELLOR HOWE explained that the UK had free gas prices and a profits tax. He hoped that the United States would soon join the UK on this. The British had found the U.S. price differential to be an important problem for UK firms, in particular for some located in Northern Ireland.

CHANCELLOR HOWE asked if there might be a third expenditure cutting round, as the President indicated on Thursday night. SECRETARY REGAN said yes, but not this year. A further \$7-10 billion in cuts was being targeted for FY 1983 and an additional \$12-15 billion in FY 1984. Further cuts in entitlement programs were planned, but would be politically difficult to achieve. SECRETARY REGAN mentioned the sentiment in the House, where tax bills have to start, to re-establish taxes on the upper income groups and oil companies. The Republicans are in the minority in the House, but the Administration would fight the real battle in the Senate. SECRETARY REGAN indentified a withholding tax on interest and dividends as a source of possibly \$8-10 billion of additional revenue. MR. LELAND mentioned, however, that President Reagan, when he was Governor of California, had opposed a withholding tax.

SECRETARY REGAN raised the topic of UK taxation. He said that he was constantly reminded that the Thatcher government had cut individual income tax rates, but had raised indirect taxes. Had this been a mistake? CHANCELLOR HOWE replied that he would

not have done that differently. He said their policy had been to switch taxes, do away with the absurdly high top tax rates, reduce the enormous dependence on direct taxation, but not cut taxes. He recognized the negative effects of raising indirect taxes on prices and monetary growth. MR. BURNS added that the indirect tax increases had coincided with the end of the incomes policy, and people tried (successfully) to get back in wages what they lost in price increases. MR. COUZENS said that the thrust of U.S. criticism was that the UK policy was contrary to supply-side theory; but, he argued that the Thatcher government had always given overriding priority to reducing the deficit. CHANCELLOR HOWE acknowledged that taxes have a supply-side effect, but explained that he had to raise taxes to keep the deficit under control.

CHANCELLOR HOWE observed that UK income taxes were indexed, so that the UK tax cut had been a real one. Of the U.S. tax cuts, on the other hand, only 3 percent was real because of bracket creep. MR. SPRINKEL said this was especially the case in the first year (FY 1982). SECRETARY REGAN agreed and said that \$650 billion of additional revenue would be generated by fiscal drag between 1980 and 1985, when taxes would be indexed.

SECRETARY REGAN added that we would be closing some tax loopholes. Energy tax credits, for example, no longer made sense, since market mechanisms now provided the needed incentive for conservation.

CHANCELLOR HOWE raised the issue of unitary taxation, as applied by the State of California, and expressed concern that this method of taxation could spread to the LDCs. SECRETARY REGAN said that unitary taxation was politically very controversial but that a solution at the federal level was under consideration. MR. LELAND raised the possible implications of unitary taxation for a French government-owned bank in California. Would the State of California draw a line around the world-wide operations of the French government? If so, the practice of unitary taxation might be terminated by the California Supreme Court.

CHANCELLOR HOWE raised the G-5 meetings and the problem of secrecy. He said the G-5 was continually misunderstood and misinterpreted by the newspapers. He suggested that we stop trying to deny the existence of G-5 meetings but to reign back on reports of G-5 discussions, including the listing of items discussed. GOVERNOR RICHARDSON stated that the purpose of the G-5 meetings would be destroyed by press reports on what went on in them. SECRETARY REGAN and UNDER SECRETARY SPRINKEL agreed with this view.

MR. SPRINKEL asked about whether the UK recession had bottomed out. CHANCELLOR HOWE said that the numbers had stopped going down; according to the Bank of England the decline had stabilized. MR. BURNS said there had been a few positive signs indicating recovery. Firms' profit margins were not under as much pressure. Productivity increases were running as high as wage increases. The interest rate increases during the past six weeks were particularly unfortunate, however. GOVERNOR RICHARDSON said a key factor in the recovery would be pay settlements. Pay increases were cut by half in the latest year. He could not be certain, but substantial reductions were possible again this year. The private sector had a large financial deficit in 1980, and adjustment had been made in stocks, employment, and investment, in that order. Financial pressures on the private sector will remain strong this year. CHANCELLOR HOWE stated that concerning wages the most difficult area was in the public sector, e.g. coal miners.

Michael O'Connor
Michael O'Connor

Approve

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C. V. Korp
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