

PERSONAL AND CONFIDENTIAL



10 DOWNING STREET

20 February 1980

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer

Dear Geoffrey,

Here is the promised paper on the Budget and Budget presentation. Norman and I will be doing further thinking on the presentation side, and perhaps we can talk about that in two or three weeks' time.

Yours sincerely
A handwritten signature in dark ink, appearing to read 'John Hoskyns', with a horizontal line underneath.

JOHN HOSKYNS

BUDGETINTRODUCTION

- 1.1 This note contains our thoughts for the 1980 Budget, setting it in the expected political context of the Employment Bill and the steel strike, and the general question of economic expectations. Not being an economist, of course many of the suggestions may not be workable, either for logistical reasons or because there would be secondary and tertiary effects of which I am unaware.
- 1.2 As you know, I felt last June that the whole situation was far too serious for us to concentrate on MISC 14. I felt we should have focussed on a major and explicit "Stabilisation Programme" and we could then have started work on the indexation problem. With hindsight - always easy - the June Budget could have been more of a shock package, and presented as such. But that was one of the inevitable problems in the heat of taking office, particularly as we had a Budget on the critical path from day one.
- 1.3 Because we've never had any of the Chequers teach-ins on Government Strategy of which there was talk just after the election - and which we are now thinking about more positively - I suspect that many of the colleagues still have no concept of the make-or-break nature of our economic strategy and the fact that there appears to be no smoother ride available.
- 1.4 We must assume that our opponents, from the Right of the PLP to the far Left of the union movement, are having some success in representing us as a divisive and class-based Government - not the ideal setting in which to introduce a very tough Budget - so we will have to work hard at the communications and possible symbolic policies. These symbolic policies and soft words are necessary as much as anything in order to soothe the nerves of those colleagues and back-benchers who don't understand how near the edge of the precipice we are, or who won't face up to it.

2. BUDGET OBJECTIVES

- 2.1 There are two distinct objectives. First, obviously the Budget arithmetic has to be right so that the balance is what you, as Chancellor, want. Second - related but different - the shape of Government spending has to be altered in such a way that it is stable, so that it doesn't simply grow in uncontrollable and increasingly distorted ways. As we know, automatic indexing makes the economy hard to control, in terms of both total public spending and the distribution of that spending.
- 2.2 We have so little time, and so much ground to cover, that I feel one has to start by saying: "If there were no political and social constraints, what would we want the main numbers to look like, for the economy to regain flying speed?" Then we have to see how we can so shape the package, in the sense of "a fair deal in an emergency", that people will accept it with a sense of unity, rather than simply blame the Government for disappointing their

expectations. Are there symbolic policies which would prove that we are not taking these tough measures because we are fighting a class war, but precisely because we are determined to get the answers right for everyone's benefit - "cruel to be kind"?

2.3 There are really three parts of the public expenditure exercise:

- The big numbers (housing, transfer payments of all kinds) which we have to change fast, before the whole system goes under.
- The expenditure follies - locust institutes or whatever they were - which take time to hunt down and scrap.
- Improving cost effectiveness - the Rayner exercise - which again is a voracious consumer of quality manpower and takes time.

I fear we are slipping into the wrong mode and, instead of going for the big numbers and being brave, we are going for the small numbers and looking mean.

2.4 You remember at our working dinner with the Prime Minister and Keith January I used the words "shock package". It was disappointing that the Indexation Group stopped looking at the lessons of Belgium, "Loi Unique", as soon as it read about the riots! No questions were asked about whether the riots were avoidable, whether there was anything to learn from the economic measures then taken, in their effect on Belgium's economic recovery. We have our riots - and deaths too - at Hadfield, Red Lion Square, Grunwick, Southall - but without any economic benefits. It's not a question of foolhardy confrontation etc, but of looking calmly at others' experience in similar situations of emergency, and asking what is to be learned.

In many ways, I feel that the more severe the "shock package", the easier, not the harder, it will be to sell. I'll come back to this point in section 4 below. The problem we have to face is that most people have given up expecting any Budget to work, any Government to solve the problems - and they don't really think the problems are their fault (which, to the extent of OPEC, of course they're not). I had hoped that we would be able to weave three things together: the steel strike, the Employment Bill, and the Budget, in order to focus public impatience on the futility of union action and then combine a tough Budget for everybody, with a toughened Employment Bill for the unions. The tough Budget would also have been our fallback position and the whole thing would have hung together. However, our opportunity to dominate that debate and link these three things together has probably passed.

3. A POSSIBLE APPROACH

3.1 Indexation and de-indexation

3.1.1 Although the ad hoc group has made considerable progress with this confusing subject, it has, still not, I think, reached what MIT call "the second level of insight". The connections are somehow

still missing. Getting to grips with such a subject is inevitably an iterative process, and I felt there were one or two iterations still to go. This section attempts to telescope those final iterations.

- 3.1.2 There has been some confusion about the objectives of indexing and de-indexing. Sometimes we have been talking about living with inflation, sometimes about ending it. At other times, about a different but related objective - de-indexing simply in order to cut public spending.

De-indexing obviously is necessary in order to cut spending. De-indexing tended originally to be confused with partial indexing, which was regarded with suspicion because it was seen as a form of incomes policy. Those inhibitions have gone now, though the words "partial indexing" are not used and instead the report talks of discretion to index less than fully.

Much of the discussion about indexing (as distinct from de-indexing and its usefulness in either living with or ending inflation (confusion often existing about which objective we were talking about at any one time), always turned out to refer, by implication, to full indexing. But everyone agreed that full indexing was, by its nature, destabilising - and horrendously so under the impact of external price shocks. By contrast, the context of partial indexing - which surely must be a damping device, in the control system sense - was, as I say, ignored in the early discussions.

Having gone round in circles a bit, we eventually came to three pretty clear conclusions:

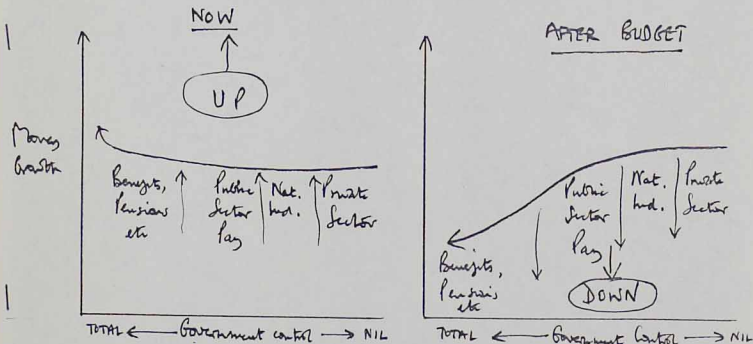
- (1) Our overall purpose is to help us to end inflation, not to live with it - though discussion still tended sometimes to proceed as if the aim was the latter rather than the former.
- (2) Fully indexed "blank cheque" commitments must be, de facto, partially indexed, by the exercise of Government discretion.
- (3) This principle of partial indexation may need to be extended, to avoid distortion and achieve fairness; and the extent to which it was partial, in percentage points, must be uniform for presentational fairness. A stable currency is, after all, effectively an indexation of everything at the same (zero) inflation rate.

- 3.1.3 How the process would work. We have a spectrum of control for indexing purposes. At one end we have those things completely under Government control like benefits and allowances and tax bands, at the other we have the private sector subject to market pressures and conceivably to exhortation. In the middle we have the public sector, where the Government can exert some influence.

Given that we cannot in the end get inflation down unless money incomes fall, if we are to avoid excessive transitional unemployment

where should the money income deceleration start? Our original policies assumed that it would have to start the hard way in the private sector, under pressure of unemployment and bankruptcies. This has always seemed to me to be the wrong way - or at least a very difficult one - because, as we have argued before, highly competitive unions, under economically illiterate union leaders, are simply forced, in general, to outdo each other's attempts to outdo anticipated inflation. That really is an unstable situation. It could never make sense for us to wait for that to turn, while the rest of the system (public sector pay under Government influence, and social security payments under Government's absolute control) remained fully indexed! So start at the other end. Everything that Government pays out must be immediately partially indexed. That is the leading edge of money income deceleration. Government must then treat as top priority making public sector pay follow suit, no doubt with a less sharp deceleration and a little later, in time. We have to get away from comparability, to something like comparability - X%. We may even have to consider a partially-indexed freeze in the public sector, but that would have to be thought through in the context of a larger package. This, coupled with trade union law reform to tilt the balance in both private and public sectors, should really be the central focus of all our efforts over the next 3 years.

That process would begin to reduce the inflationary pressures in the private sector in three interconnected ways. The first is the direct pay and benefit comparisons made by negotiators; the second is the easing of Government's blank cheque commitment to welfare beneficiaries; the third way is the more indirect consequence of the first two, through the resulting reduction in the PSBR and thus interest rates.



It will be very important that spending Ministers really understand that this process is crucial and that its aim is not the continual reduction of the real value of benefits, but the triggering of a systemic deceleration in money incomes, and thus more easily in money supply.

In "selling" these measures, internally and to the public, it must be stressed that they are part of a programme to end inflation,

not to live with it. The measures themselves must by definition be "self-obsolete" over a few years. (Does that mean that they should be dismantled thereafter, or do they have a longer-term value? I don't know.)

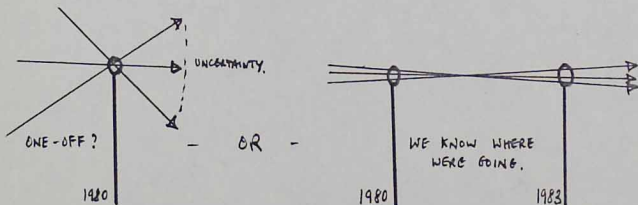
- 3.1.4 Rough justice, broad package. The package must be intelligible in space and time. The more clearly it has a time dimension with a goal and purpose, and the broader it goes, the more it will be perceived as hopeful and fair.

On the face of it, I am not sure that it is logical to only partially index rules (eg allowances and thresholds) in the same way as we partially index actual payments (eg Supplementary Benefits, public sector pay), unless we are saying that private sector pay, which is regarded by the group as automatically and fully self-indexing, should be partially indexed through the income tax system. The private sector might well remain fully-indexed, but: (a) it is subject to supply and demand; and (b) it would in any case be following benefits and public sector pay down. The group could not decide whether fiscal drag helped to cure inflation (by reducing the PSBR) or made it worse (by increasing wage pressures). But it may be that rough justice, in which everything that is going to be indexed or de-indexed is done at the same percentage of the inflation rate, is necessary because it would be too complicated to explain the reasons for doing anything different. The exception would presumably be indexed gilts.

It is a great pity that we are committed to indexing pensions in line with prices, since 5 percentage points of such big numbers would presumably make a big difference. De-indexing of public sector pensions above £1,000 a year will presumably make little difference, but it may be a useful symbolic measure.

3.2 The Time Dimension

- 3.2.1 The Budget as a whole, and the indexing measures in particular, have to alter people's expectations. They must calm people's minds as much as they stabilise the economy. A single Budget points in no direction. We need to plot some sort of framework into the future to give that sense of direction and hope.



Provided that, wherever the Budget makes long-term commitments,

they are fiscally tightening rather than promises of good things to come, there should be no difficulty. Where such pledges promise good things to come, they should only be in areas where the total numbers are small and one can therefore make the pledge with an easy mind. You remember before the election I suggested that top tax rates should come down in stages over 3 years. This would have been presented in the context of a "national emergency" Budget, extracting maximum political capital from that symbolic gesture, knowing that, because the total numbers were not large, it was one of the few promises you could safely give.*

- 3.2.2 It is in this longer timescale that the symbolic measures (eg over perks, and also over mortgage interest relief) would apply. We still seem completely confused over mortgage interest relief which has gravely distorting effects on the economy. We defend them as part of our social philosophy but at the same time tacitly reduce them by back-door de-indexing.
- 3.2.3 Valorisation of duties could be done over time so that (just as we do with phasing out of regional aid) people have time to adjust. Otherwise we'll end up with whisky being cheaper than petrol. Alcoholism is already estimated to cost the country £4bn a year (I think) according to the CPRS study.
- 3.2.4 The Rate Support Grant might be wound down in a systematic 4-year programme in the same way, so that there could not be instant uproar about arbitrary or capricious cuts. Councils would know, 3 or 4 years ahead, that RSG was coming down by X percentage points each year. It's an area where you can commit yourself, since it is a tightening rather than a loosening pledge. And they will then know where they stand, instead of having uncertainty followed by a fresh shock each year.
- 3.2.5 If there are to be major changes in capital taxes, I again suggest that they should be reduced over time, not all at once. There is so much bad news about now, and so much ammunition for our opponents to use in presenting us as stony-hearted, anti-union, anti-working class etc, that we really should be sensitive. I would advocate making any reductions gradually, and devoting great effort to explaining that, even though they are higher than in other countries (if that is the case), we are not, in today's harsh circumstances, going to bring them straight down. We should be quite explicit and say that we are phasing the reductions over time purely on symbolic grounds, grounds of fairness, because we understand how people feel. There has to be a point - and we can say so - at which we deliberately become economically illogical in order to retain contact with the great majority of people who have little capital to speak of and who will easily misjudge our actions and our motives.*
- 3.2.6 Personally, I would have liked to look again at the accessions tax idea as part of the symbolic package, because it helps to do something we have not yet done: paint the picture of the type of society we are aiming for. At present, it looks like a "rich get richer" society rather than an equal opportunity society. I

* I know that conventional political wisdom says that's not possible, "you have to do now, because you won't be able to later". But at times of discontinuity you need innovation, not convention.

6 For UK, conventional wisdom = Filled wisdom

believe that all our thinking about how to hold the whole social and economic system together and give it a new sense of direction, cohesion and hope, is still pigmy-thinking when set beside the UK problem. The inefficiency costs of faulty allocation etc must be balanced against the social and political costs, at a time of great stress. Perhaps we really won't wake up to it until after we've lost the next election. We have the choice of being radical or politically obsolete. However, this is probably a minority view!

4. COMMUNICATIONS

- 4.1 I believe there is a sort of "perception threshold". Below that threshold, life appears normal and this Budget is just another Budget presented with a lot of double talk and unlikely to make the faintest difference to anything. Above that threshold, it can become more drastic and yet be welcomed for it. Once it is above the threshold, and therefore looks bold (in the sense of being tough, not in the sense of being a high-risk give-away, which of course it can't be) and fair, and provided it is likely to be seen by the media (who will pass the message on) as likely to work - then one can make it bolder still! This is why I felt it was a pity we didn't look more carefully at the Loi Unique, because we don't live in normal times. Britain behaves as if it does, which is why it fails.
- 4.2 Whatever the shape of the Budget, it must be presented in a way which communicates a sense of strategy and direction to the electorate and there must be no double talk, no presentation of Rooker-Wise as tax reductions, or de-indexation as if it was "no change". The money illusion has gone. There is no chance that people (certainly at the electoral margin, and probably anywhere else for that matter) will be fooled. The messages accompanying the Budget will have to be carefully designed to make Labour and the unions' reaction look irresponsible and out of date.
- 4.3 Norman and I have done some thinking about how the broadcast might put the Budget over. Here are just a few thoughts, in no special order:
- (1) Make it fresh, interesting, different. Perhaps some "what if" questions - even a computer display. If wages do this, if OPEC does that, what are the outcomes?
 - (2) You could outline the boundaries within which you have to operate. "If we could persuade everyone to take no increases, and we completely stopped indexing all benefits, the numbers would look like this - inflation could come down very fast. But in a free society we have to accept that it won't be so simple. At the other extreme, the Government could make itself very popular by cutting this and raising that and you'd all think it was a wonderful Budget - but look at what would happen to prices, look at what would happen to unemployment, look what would happen to interest rates etc."
 - (3) Talk deliberately in a timeframe which takes you beyond the next general election.

- (4) You could be quite explicit about public sector pay, explaining how the de-indexing is designed not to make the whole burden fall on one group - that we cannot have - but to trigger the process of a decline in money pay increases. If you make it clear that we have to lean on public sector pay, with the reasons, for the benefit of stable prices for all, they can't really complain later. It is almost advanced consultation. "If you really don't want that, then don't say I didn't warn you. Now's the time to start looking for jobs elsewhere. If you can't get them, perhaps you'll realise there are advantages in being in the public sector."

- 4.4 The aim should be to talk about a range of outcomes, to remind people that we live in a small economy in a dangerous world, that oil and union behaviour could upset all our calculations (no reason why you shouldn't refer to the Green Paper, the fact that everyone knows that the eccentric British trade union law makes our Budget and economic management a more difficult problem than it is in other countries). Show people that it is a probabilistic exercise, not a book-keeping procedure. Don't worry about talking over the heads of the audience, give them something that really makes them think. The papers will tease out the message for those who don't immediately understand it. The end result should be a heightened awareness of the fact that we'd better behave sensibly together in a small island economy which is going slowly down the tubes, and should make Healey's response sound like a lot of obsolete guff.
- 4.5 Though there will obviously be secret information problems, Norman and I would be very happy to work with Tony Jay and perhaps Terry Burns (with his extensive economic model experience) to see if we couldn't put together some really interesting visual and educational modules.
- 4.6 Finally, nothing to do with communications, one further thought. The more of a shock package it is, the more you should think seriously about having a special impost upon the upper tax rates. This will horrify you even more than my original suggestion about phasing the top tax reductions. But a little bit of symbolic policy could buy you a lot of room for getting the anti-inflationary arithmetic right faster, and we haven't much time. At the moment, all our "economic realism" is linked to two things: first, incomprehension by the public, so that there is fear of the unknown, of an uncertain and frightening future; second, divisiveness which must at the margin make more and more people wonder whether we are the dreadful party the Left tries to paint us. If we can take that same realism and couple it with concrete evidence of fair-mindedness, and also, by exploring the future in terms of "what if" questions and different outcomes, so that it is a nasty future which is known rather than a much more frightening unknown, then our realism could lead to hope instead of fear.