Budget file

4

R 17/5

Problems

1. Even the modest income tax-cutting programme envisaged requires us to "give away" £2½bn in year 1 (£3.2bn subsequently in a full year).

2. The PSBR is currently put by the Treasury at £10bn and by outside commentators. Initial anxieties that this is an underestimate have been partly dispelled. But a new forecast, due on May 23rd, is bound (almost) to lead to a higher estimate.... And the new Treasury estimate would have to be published in the Red Book.

3. Furthermore, the date of the revised forecast is so late that it would make a considered amendment to the proposed budgetary package very difficult within the period up to the Budget. In particular the scope for a further round of Departmental discussions on expenditure would be almost zero. So the new forecast could well blow the Budget off course, unless the Budgetary arithmetic could be adjusted to contain a lot of room for manoeuvre.

4. The expenditure economies in 1979/80 currently being bid for need to amount to at least £2bn merely to reduce the PSBR as at present forecast to an acceptable level. In addition, a little more (say a few £100 million) is almost certainly needed to provide room for manoeuvre for the tax changes.

5. In the event, Treasury bids for 1979/80 economies below current expenditure levels are only some £1.5bn or so, of which only about half really counts, the other half being disposals of assets. While valuable in their own right, these latter do nothing to help the balance of the economy, to ease the inconsistency between a high public sector financial deficit and a tight monetary policy,

or to lower interest rates. About £1.2bn of further economies seems needed in year 1 even to meet the minimal objective of getting the PSBR down to £8bn. And more still would be needed to provide the extra "few £100m" mentioned in 4 above, to ease the tax changes in.

6. To put the same point a different way, when the present package of (hoped-for) 1979/80 economies and tax changes is put together, the projected PSBR comes down only from £10bn to a little over £9bn. If the economies cannot be obtained, or the forecast worsens, the projected budgetary arithmetic would be even worse.

7. That is not all. Responsible commentators who set the tone will look at trends in the PSD more than PSBR. The present package would almost certainly raise the PSD substantially, both in £ at current prices and as a proportion of GDP. It will, on present calculations, be mercilessly criticised. And it would almost certainly only be compatible with a 7-11% monetary target if very high interest rates were considered acceptable.

8. On a quite different front, the internal composition of the fiscal side of the package seems, on initial analysis, to threaten a position in which any tabulation by income group of the effect of the Budget on the position of families will show all except the richest appearing to do badly from the Budget changes, even when the effects of the first 1979 Finance Act are included. This is part of the case (if presentational tricks are impossible, or to be eschewed on grounds of principle) for having more expenditure savings available than currently planned. Only then can one "float off" the tax package without leaving people afraid of being worse off, or arousing dangerously higher inflationary expectations.

9. There is also lurking in the background the question of monetary policy. If the whole package is considered "incredible" in terms of its PSD impact, the problems of managing the Gilts market could become swiftly unmanageable.

10. Finally one must consider the short run RPI impact on top of the much higher underlying rate of inflation than envisaged last autumn.

SOLUTIONS

11. The position is, then, very unsatisfactory; ineed one might almost say it threatens to be impossible. What, then is to be done? The alternatives are as follows. They can be crudely classified into five groups of proposals, under the headings:

- Expenditure
- Revenue
- Targets
- Monetary policy
- Timing.

12. On the expenditure front one could look for more economies. Obvious areas to go for would be:

- more policy changes
- less recruitment
- morartoria on procurement
- action to diminish or delay awards under the Clegg references and related settlements [currently due to cost £1,250m this past financial year alone, and much more in every full year hereafter].
- tougher cash limits, not least on the LAs and the NIs
- lower debt interest (by means, probably, of new financing instruments and some debt conversion)
- the whole social security complex, which cries out for long term treatment.

13. On the revenue front one might go for

- higher charges
- an energy tax (Gas in practise) and higher coal and electricity prices, thus permitting lower NI cash limits
- bigger increases in the excises, VED etc.

14. One might also reconsider the principal targets which constrain the package. These would be:

- the tax package - could one cut income taxes less?
- the PSBR - could one tolerate a higher figure, particularly if at the same time one could get the PSD lower than in 1978/79 as a GDP percentage.

15. Raising the PSBR target could only by considered in the context of a broader presentation of budgetary and expenditure strategy which buttressed long run confidence from several angles, and enabled the markets to swallow the bitter pill of a very difficult 6-12 months by holding out the vision of a promised land by Budget 2. The chief ingredients of this broader framework would probably be

- a clear and credible (ie PM endorsed) commitment to major spending of economies in years 2-5, eg getting firmly back to the 1977/8 outturn by year 3 or 4
- a commitment to study other means of monetary control, such as the monetary base
- a major innovation in the instruments of Government borrowing such as extensive use of index linking and conversion of outstanding borrowing.

This would need to be done as part of a Budget which did not arouse inflationary expectations enough to alarm the markets.

16. Other avenues to explore might include

- the proposal to delay the tax cuts until late in the financial year
- a decision to publish the old NIF forecast in the Red Book, unless that due on May 23rd is "better" than the present one.

OTHER ISSUES

17. The information currently available about the economic prospect and the effects of the budgetary package need to be supplemented in the following respects with

(a) a full presentation of the contribution, if any to public spending economies in year 1 of the decisions made or expected on cash limits;

(b) an assessment of the internal consistency of an £8bn PSBR, a 7-11% monetary target and the pattern of interest rates they would jointly imply;

(c) an estimate of the path of the RPI over the next 6-12 months implied by current fiscal proposals and the possible increases foreseen in Nationalised Industry prices etc;

(d) a "mock-up" of the Red Book forecast, taking the present NIF as modified by the latest Treasury estimates of the macro-affects of the overall package;

(e) an analysis of the effects of the proposed package on the PSF Deficit (as well as PSBR) in £bn and as GDP shares;

(f) an early indication from the Inland Revenue as to whether these are insurmountable problems in cutting in some taxes in the middle of the financial year.

18. Finally there needs to be very careful consideration of the timing of the present short-term forecast, due at the moment on May 23rd. On the face of it, there is an overwhelming case for advancing it, suppressing it or delaying it by at least a month.