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For your Saturday meeting. Done after
complete consultation with K S & G M. It intro
long because it was done in
too much of a hurry.

WITH COMPLIMENTS

AR 30/6.

SOME MAIN ECONOMIC ISSUES

This note sets out as briefly as possible the stage reached in working out our position on a number of central issues, and points up a number of important matters for discussion.

PUBLIC SPENDING, TAXATION AND GOVERNMENT BORROWING

2. At the global level we have in effect to plan the best combination of economies in spending, reductions in the public sector deficit and tax reductions, gross and net (i.e. after allowing for "switching" from direct to indirect taxation). To reach our preferred outcome is rather like solving a set of simultaneous equations with three unknowns by what mathematicians call the method of "successive approximations". One starts by specifying intuitively sensible figures in each of the three areas, confronts each with the other two, adjusts one's initial judgements and then reworks everything again before a second attempt at juxtaposing and harmonising. This iterative process has to be undertaken afresh each year, since the ground moves quickly under one's feet, particularly as regards public spending. So far this year we have completed, roughly, the first confrontation and are preparing to embark on the second. We will certainly need a third before the election if it can be managed.

3. All the arithmetic involves prodigious uncertainties, while demanding the clearest thinking. We cannot yet be confident on either front, and hence most of the figures which follow are the broadest possible orders of magnitude, with the possible exception of the tax computations. Some of the policy judgements are more complex still - for examples over the proper course to seek for the Government's financial deficit (PSD) over the years, or what RPI increase is tolerable in the early days of office. Finally we must note that many secondary effects can only be allowed for in the crudest ways and have not yet been considered at all this year. For instance, how much must we make added provision for the needy

to offset some of the hardship involved in higher VAT, excise duties and council rents? In some cases these secondary issues could well turn out to be quite primary in due course, either in economic or political terms.

ECONOMIES IN PUBLIC SPENDING

4. The renewed search for economies conducted bilaterally by Messrs. Howe and Lawson with all major spending colleagues has just ended, and the very crude position is as follows (a full report will be available shortly). We sought a package of economies - net of our major commitments to increased spending in such areas as Defence and Law and Order - which would keep public spending at the outturn level experienced in 1977/78, the latest year for which tolerably firm figures are available. That dictated a year-by-year path for net economies as follows:

	£ billions 1978/79 prices			
	1978-79	1979-80	1980-81	1981-82
Sought	2.9	3.5	4.1	4.3
Obtained		2.1	3.7	4.9

The apparent shortfalls between target and proposals agreed - large in 1979-80, smaller in 1980-81 - are striking, but not necessarily disastrous. For they can only be judged in conjunction with the (as yet incomplete) assessment of their implications for taxation and the PSD. In that light we might well judge that the economies sought in the earlier years were unnecessarily large. However it is clear that we are faced with a dual problem over the first year or so. It is almost impossible to establish (at least at present) what public spending will be in the financial year 1978-79; and it is even more awkward to have to assess what economies could meaningfully be made in the last 6 months up to April 1979 in relation to that hypothetical and unknown figures.. Hence the empty space in the table under 1978-79. The global shortrun judgement is of course still more unclear until we know the longer term implications of Healey's proposed 1½ per cent

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increase in the NI surcharge. All one can say is that it is possible that we could squeeze out a few hundred millions of extra economies in spending in 1978-79, and that the surcharge would give us more room for manoeuvre later in a number of complex ways.

GOVERNMENT BORROWING

5. The dominating issue in deciding on a course for the PSD is its consequences for the money supply, which in turn have to be appraised against the course for inflation should be. This is discussed later. At present suffice it to say that two paths have been selected, one involving getting the PSD down to about 2½ per cent of GDP in the last year (1981-82) the other to 1½ per cent. It cannot be sufficiently emphasised that a small or even zero rate of monetary expansion is compatible in principle and practice with a PSD or PSBR of considerable size. Everything hinges on how far that PSD or PSBR is "covered" by private and external sector lending. A zero deficit could well imply quite a sharp rate of monetary contraction in today or tomorrow's circumstances. Both are very tough targets by historical standards. Even the 2½ per cent (dubbed "easy") PSD is very low by our experience in the 1960s and 1950s. The 1½ per cent target ("hard") is therefore still more draconian. Even the easy target could well imply money supply growth as low as the 3 - 5 per cent zone, and inflation running at 1 - 2 per cent per annum in the early 1980s. The technical issues underlying the computation and prophesy of the proper PSD path are so complex as to be almost insurmountable in opposition, but one can be fairly confident that both figures are on the cautious side. The target figures we have worked with are as follows:

Desired PSD	1978-79	1979-80	1980-81	1981-1
<u>Easy:</u> as % of GDP	5.1	3.3	2.8	2.5
in £bn constant prices	6.5	4.3	3.8	3.4
<u>Hard:</u> as % of GDP	5.1	3.3	2.4	1.5
in £bn	6.5	4.3	3.3	2.1

GOVERNMENT REVENUE

6. The next issue is the likely path of Government revenue. This depends on three matters - the real growth of the economy, the buoyancy of the tax yield and the special contribution to be anticipated from North Sea oil.

a) GDP

We have taken two views. The "main" case assumes that the economy averages 2.8 per cent per annum real growth over the period 1977-81, of which 0.7 per cent per annum is attributable to oil and therefore 2.1 per cent per annum to the "normal" economy. The "worse" case allows for the same contribution from oil, but concedes only a 1.6 per cent per annum average growth rate for the normal economy. Of course, we aim for much better than that: but all experience shows the folly of assuming the maintenance of high growth in ones planning.

b) Buoyancy of revenue

We judge, after careful technical enquiries, that revenue will grow in line with GDP in both real and nominal terms, excluding the taxes and royalty fees on North Sea oil, assuming all direct and indirect taxes and excises are fully indexed from the current year onwards. This latter assumption is important, since some of our tax proposals naturally reflect a degree of indexation, and we have not yet fully worked out how much. At present we are therefore likely to be slightly over-estimating the cost of our tax reforms.

c) North Sea oil

The revenue accruing to HMG cannot be forecast accurately. Since it is projected to be running at £3bn. a year or so by the 1980s, the allowance made for it is of great importance.

To indicate the maximum range of uncertainty implied, the scope for tax reductions analysed below covers both extremes - i.e. assuming the official estimates of oil revenue are correct, and assuming at the other extreme that there is no oil revenue whatever. The realistic estimates are in fact near the upper end of the range.

HOW MUCH DO OUR SPENDING PLANS ALLOW US TO GIVE AWAY?

7. On the basis of all the work and assumptions so far described the money available for net tax reductions works out as follows (in fbn current 1978-79 prices, which are also the basis of the tax computations which are set out later in this paper):

	1979-80	1980-81	1981-82
<u>Main Case</u> - 2.8 % p.a. GDP			
Easy PSD	1.7 - 3.9	4.5 - 7.3	6.1 - 9.6
Hard PSD	1.7 - 3.9	3.9 - 6.6	4.4 - 7.9
<u>Worse Case</u> - 2.3 % p.a. GDP			
Easy PSD	1.0 - 3.1	2.0 - 5.6	4.5 - 8.0
Hard PSD	1.0 - 3.1	2.3 - 5.0	2.8 - 7.3

THE TAX PACKAGE

8. At a recent meeting considerable progress was made by the Treasury team, Lord Cockfield and Patrick Jenkin in identifying options for the first tax package. The main conclusions of that meeting are set out in some detail in Appendix 1. There are a number of points which emerge when one juxtaposes these "first-round" conclusions and the figures for net tax reductions in the previous paragraph.

a) The net tax reduction required to finance the proposed package is some £1½ - 2 bn and that allowing for a measure of indexation which is really costless given the approach we have adopted in paragraph 6 (b). That could be accommodated even on the gloomiest prognosis unless North Sea

revenue is considerably less than projected (less than £1 bn as against the £1½ bn or so anticipated for 1978/9, to spell the figures out).

b) More generous, or at least equally generous "giveaways" could be anticipated in both the subsequent years.

c) But the package does appear to involve a daunting, sudden jump in prices, since it might add some £5 bn to prices of (mainly) consumption, which could in turn put up the overall price level by some 4 per cent, and the RPI by somewhat more. However this apparent problem could turn out to pose fewer difficulties than these crude figures suggest. The scale of the necessary "switch" may be barely negotiable, making timing the crucial question.

d) The offsets required (but not yet computed) on the social security front, rent rebates, etc, could well consume some of this gross reduction - perhaps as much as £1 bn or so.

e) The particular package suggested concentrates rather heavily on raising allowances. While this will give a sizeable lump sum to all taxpayers, thus reducing or even eliminating the need for offsetting help to all but the most needy, it would undeniably be worth considering whether the need for better incentives does not point to doing more at the outset on the standard rate. With the package suggested standard rate cuts would have to be spread over a number of years. —

f) The pensioner credit option mentioned in the Appendix (but not included in the suggested package) becomes much cheaper to implement with a lower standard rate and a smaller increase in allowances than proposed; but it could not be in force before 1980-81.

g) The proposals for taxing unemployment and other benefits mentioned at the end of the annex are going to be difficult to get into operation quickly.

h) We have yet to examine the important case for giving a substantial proportion of the revenue currently raised (and, a

fortiori, likely to be raised in the future) by the National Insurance surcharge back to industry. The total bill for the original 2 per cent and proposed further $\frac{1}{2}$ per cent surcharge will be about £2.6 bn in 1978-79, about two thirds of the £4 bn or so which corporation tax is likely to yield and, probably, well in excess of the value of the stock appreciation relief. And industry looks like being in extremely serious financial deficit in 1979.

HAW FAR CAN WE MAKE DECISIONS ON TAX, SPENDING AND THE PSD?

9. Implicit in everything that has been said so far is the conclusion that it is not yet quite the right time to make firm decisions on all these matters. A lot more work needs to be done in all areas. However, subject to every possible caution and caveat, it does begin to look as if the tax and spending programmes could fit tolerably well together.

INFLATION AND THE MONEY SUPPLY

10. We have so far not thought it sensible to consider in detail the desirable and possible path for inflation over the lifetime of a Parliament. It may indeed never be possible to more than talk orders of magnitude. So the following observations are tentative, though informed by a fair amount of unsystematic but valuable discussions both in ERG and outside over the years.

11. There are several principles we might wish to follow:

a) The trend of inflation must fall perceptibly between one year and the next;

b) We should be well placed if inflation could be largely "squeezed out of the system" by the end of a 4/5 year period of Government.

c) If we attempt to force the pace of price de-escalation, the economic and political consequences will be unacceptable.

d) If we set out an inflation goal for the end of our period of office, we might stand to gain greatly. (But there are, of course, risks in so doing).

12. Principles (a) to (c) all point in the same direction. One doubts whether an accumulating de-escalation of 1 per cent off inflation in successive years will be perceptible. That would only bring it down from 10 - 11 per cent per annum in early 1979 to 6 - 7 per cent by 1983, and the likely date of the next election. Experience internationally suggests that to de-escalate at more than about 2 per cent per annum is very difficult, except when one is starting from an exceptionally high base and in most unusual circumstances, such as those encountered in 1975 to 1977. A 2 per cent de-escalation would take one from 10 - 11 per cent per annum in 1979 to 2 - 3 per cent by 1983, which would be a fairly staggering achievement. To enunciate it credibly could well have a massive effect on confidence over a year or two.

13. The implications for money supply targets are on the face of it simple, but worth touching on briefly. They will have in the main to reflect the desired inflation rate a couple of years later and, on top of that, the hoped for real growth in the economy. In the "main" GDP growth case the excess would work out at about 3 per cent. The acceptable and implied growth in total national earnings in one year (not per capita) would be roughly the same as that of the sum of real production in the same year and prices a year later, taking one year with another, except in as much as one might want to provide for higher real profits, in which case the growth figure should be shaved down a little. Since we would envisage a growth in employment the per capita growth in earnings might be of the order of $\frac{1}{4}$ per cent per annum less, and wage rates another 3 per cent or so lower still because of drift and such factors. Putting all these thoughts together would suggest the following:

Permissible target increases, per cent year on year

	1979	1980	1981	1982
Desired inflation path	9	7	5	3
f M ₃	8	6	4	2
National earnings, total	8	8	6	4
Nominal earnings per capita	7½	7½	5½	3½
Wage rates per capita	4½	4½	2½	½

It cannot be too strongly emphasised that these figures are untested, illustrative and speculative in the extreme.

14. It should be noted that there are quite a variety of views about the pattern of future de-escalation of prices and money supply which would be optimal. For example a number of monetarists (on occasions including such luminaries as Friedman, Brittan and Laidler) have suggested that the cost of de-escalation would be so great that it would be better to learn to live with inflation once it has got back to a reasonably stable and tolerable level. They would, if still adhering to that view, probably advise a massive move to indexation after a short while and a lull in the war on inflation. The London Business School too, have recently argued that international inflation rates should be an important factor in deciding how far and quickly one should de-escalate. Some weight should be given to their arguments even if they are not wholly acceptable. Their tentative conclusion is that we should tolerate 8 per cent per annum or so for the next few years.

15. Finally it should be stressed that no serious monetarist would deny that there is an optimal rate of de-escalation. Too quick a monetary contraction is, in its way, as dangerous as a too modest one.

16. It is clearly interesting to consider how much of this kind of thinking might profitably be spelt out soon (numerical examples and all) and how far it would be vital that someone should do so once we were in Government.

WAGE FIGURES AND COUNTER-INFLATIONARY POLICY

17. This discussion brings one to the question of how to treat the issue of wages. A useful starting position is from "The Right Approach to the Economy" (page 16):

"What else must be done by Government to ensure that pay-bargainers and others understand and accept the imperatives on which economic stability must necessarily be built? There are obvious dangers involved in enunciating a general 'target' or 'norm' for pay bargaining. A target 'maximum' always threatens to become a 'minimum' to which everyone feels he is entitled; even a target 'range' for general pay limits is likely to drive bargainers to look for settlements at the top of the range. Yet in framing its monetary and other policies the Government must come to some conclusions about the likely scope for pay increases if excess public expenditure or large-scale unemployment is to be avoided; and this estimate cannot be concealed from the representatives of employers and unions whom it is consulting."

18. The practical conclusions as to what we should want to do are:

a) We should steer clear of a Government proclaimed norm which at one and the same time makes bargaining inflexible, provides a target for unions to attack and an excuse for confrontation and tends to jack up wage settlements which should be at the lower end of the scale. But also

b) It is desirable that bargainers - both employers and employees - should have a realistic idea of the kind of range in which the generality of settlements should fall if earnings, prices and money supply are to be consistent with one another. Markets need information if they are to function properly, and the labour market is no exception.

The responsible and realistic pattern of wage bargaining we seek will not emerge easily if the Government takes positive steps to prevent people from thinking about or discussing what responsible behaviour involves.

19. Then there are questions about what we say. These often boil down to tone of voice. Do we at this point want to dramatise the differences of view between ourselves and the Government? In particular, should we lay great stress on abolishing the system of sanctions and Government contracts, on not having a wage norm, and not having the Government talking about pay to anyone other than its own employees? Do we make a positive virtue of attacking Incomes Policies?

20. Whatever the objective truths of the issues underlying these questions, certain purely political facts are relevant. Most people favour an atmosphere of income restraint, and so do many employers (at least for the generality of businesses if not themselves). Because of recent experience we could well unsettle many people who would otherwise vote for us if we do not show some awareness of and sympathy for the idea that it is a duty of Governments to play some part, if only indirect, in ensuring moderation in wage settlements. Such considerations must surely be important in this pre-election atmosphere.

THE ECONOMIC OUTLOOK

21. A selection of background material about the economic outlook is attached in Appendix 2. The "Comparison of Forecasts" undertaken by Phillips and Drew each month gives a useful indication of the scale and speed with which the prospects for the future are altering. By and large the older the forecast, the more optimistic it is. Periods of substantial revisions of projections such as we are now witnessing are normal when the economy is full of unresolved tensions and contradictions. As they are recognised by the experts or resolved by events, the picture the forecasters paint naturally darkens dramatically. It will probably get darker yet, as emerges fairly graphically from the short summary of Phillips and Drew's latest monthly forecast, which should make depressing reading. The recent Times piece by David Blake reflects quite similar anxieties. Finally it is worth glancing again at Sam Brittan's recent Lombard piece

"Why the country is booming", even if he is stretching the meaning of the word monstrously in applying it to present circumstances, and over-optimistic about the growth of output and state of confidence.

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APPENDIX I
THE FIRST TAX PACKAGE

1. The fiscal programme is seen as having two main features: reduction of the total tax burden and a switch from direct to indirect taxation within that total.

2. The expenditure studies suggest a margin available for tax reduction, after assuming wholesale indexation of the existing tax structure and meeting all existing public sector commitments, and on the best and worst cases set out in the main text, of:

	Best (Main Case GDP, easy PSD)	Worst (Worst GDP, hard PSD)
Year I		Unforseeable
Year II	1.7 - 3.9	1.0 - 3.1
Year III	4.5 - 7.3	2.3 - 5.0
Year IV	6.1 - 9.6	2.8 - 7.3

These figures are expressed in terms of 1978/79 survey prices.

3. Given an October 1978 election, Year II is to be identified with the financial year 1978-79, although there might have to be a six month slippage.

4. The major switch from direct to indirect taxation should be taken early on in the new Parliament. The enterprise package needs to be given the fullest possible time space to take effect. Once VAT is raised it cannot be touched again within the first Parliament. Therefore the changes in the first Budget have to be radical and largely self-financing.

5. The First Budget Package is worked out on the assumption that the increase in VAT is to be balanced by large increases in personal allowances and that the basic rate of tax is to be reduced in both the first and subsequent years as resources become available.

6. Based on AC's computations (made in terms of 1978-79 taxes and prices) the First Budget Package might be:

Increased Personal Allowances		£4.4 billion
Cuts in higher rates		£0.8 billion
Cuts in basic rate		£1.1 billion
Cuts in other taxes (IIS)		£0.3 billion
		<u>£6.6 billion</u>
Increases in VAT		£3.5 billion
Increases in Excises	£1 to	£1.5 billion
	£4.5 to	<u>£5.0 billion</u>
Gap = required net tax reductions	£1.5 to	<u>£2.0 billion</u>

7. This package embodies a cut in the basic rate from 33p to 30p in the first year, with the reduced rate band left in situ. Had the alternative approach been made, concentrating a substantial cut in the basic rate in Year I, an initial further cut of 5p from 30p to 25p would have cost approximately £1.9 billion.

8. The tabulated programme set out above involves:
- i) a fifty per cent increase in the two main personal allowances, costing £3,850 billion and a further £550 billion for an increase in the earning wife's allowance (which might be omitted in certain circumstances).
 - ii) substitution of a new scale of higher rate taxes, starting with 35% at £10,000 and rising by 5% steps to 60% at £30,000.
 - iii) an initial basic rate cut from 33% to 30% with leeway for further gradual reduction in subsequent years.
 - iv) an increase in excise duties reaching up to 25 per cent, with a particularly important decision on hydrocarbon oils.
 - v) a fifteen per cent unified rate of VAT.
 - vi) as a first stage compromise, increases to £10,000 in the starting point for Investment Income Surcharge, Capital Gains Tax, and for the definition of "higher paid" for purposes of taxation of benefits.
 - vii) minor tax allowances left in place but not indexed.
 - viii) Child Benefit indexed and the residual child tax allowances abolished in conjunction with the reduction of higher rates.

9. The great bulk of the 4½ per cent national insurance surcharge must be left in place, although some small initial relief would encourage industry.

10. Offsetting benefit increases will be necessary when VAT and the excise duties are increased, in order to compensate those who do not benefit fully from direct tax reductions. The prices link must be maintained; the earnings link reconsidered.

11. The adoption of pensioner credits is not assumed in these computations. The door might be kept open, although of course the cost of a switch to credits is substantially increased by a major lift in the personal allowances. General tax credits are not envisaged at least until the Inland Revenue has effected its computerisation.

12. A standard personal allowance for all taxpayers is envisaged, leading to removal of the present wife's earned income anomaly; AC has a scheme for this shift.

13. Taxation of unemployment benefit is to be made a DHSS responsibility at an early stage. The first four weeks of sickness benefit, and taxation thereof, is to be made the employer's responsibility; except in the case of the small

Appendix 2 omitted for copyright reasons

(Phillips & Drew *Economic Forecasts*
Summary, dated 28 June 1978, embargoed till
3 July 1978)