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For my money PIC greatly exaggerates the benefits from a big reduction in the PSBR because of higher income tax. If personal savings were to be maintained, personal consumption w^d be cut, part of the PSBR gain offset, the economy deflated & overseas investment increased (because the current account w^d be in bigger surplus). If people reduced their savings, the funds would not be available for investment in industry — so there w^d be little prospect of a big fall in interest rates (which w^d need to be maintained at a level sufficient to ensure the availability of savings for industry to borrow). JW 23/12

A few thoughts arising out of the Friday morning think meeting.

There is obvious perplexity about the M_3 over-run, but I do not detect anyone arguing confidently that M_3 has suddenly become a meaningless symbol. There is only one legitimate doubt - whether the abolition of exchange control has in some way opened up London to certain financial operation hitherto excluded, with a direct bearing on M_3. It would be useful to know whether there has been a quantum leap on this account.

Otherwise, we either look for a 20 per cent rate of inflation in eighteen months time, or we look for a precipitate drop in the rate of increase of M_3 over the next few months. My money would be on the latter. If M_3 actually contracted for a few months that would probably serve to erase the inflationary consequences of the recent 20 per cent peak rate of growth.

The rate of increase in M_3 will drop

<u>either</u> as a consequence of ever deepening depression
<u>or</u> as a consequence of reining in the PSBR.

If long and medium term interest rates remain at present levels, and unemployment moves up from two million towards three million, then nobody will dare to put up prices and the closure of British industry will go on apace. It will presumably slow down when the balance of payments begins to go sour again, sterling falls steeply overseas and trade improves. Inflation will however then start rising again.

The alternative is, via sharp reduction of the PSBR, to restore a proper balance between consumption and investment. British industry has, throughout the seventies, been starved of investment; the consequences can be clearly enough seen in loss of vitality and the inability to cope with the oil-induced exchange rate. Meanwhile most branches of the public sector have been similarly starved.

It would not be unreasonable to state the level of excess consumption in the economy at approximately £16 billion p.a. (£800 pa per family) made up of £11 billion PSBR and £5 billion North Sea revenue. The using up of an irreplaceable capital asset can hardly be classified as legitimate consumption. The closest parallel is with the sale of our investments in Argentine railways, in far more difficult circumstances, to pay for meat in the late 1940s.

To divert £16 billion straight from consumption to investment would not be a practical proposition. A five point lift in the basic and other rates of income tax, transferring about £5 billion from private consumption to the capital market, would not be out of the question.

Fortunately the very rigid contractual element in the pattern of British savings would ensure that this gesture was not wasted. In a very flexible economy, people might react to a steep rise in the basic rate of income tax by cutting back hard on their savings. In the UK, because saving is a contractual commitment, the 'leakage' through that route would not be serious. Saving would continue on a massive scale; the only difference being that it would no longer all be absorbed by gilt edged issues and straightway spent by government in maintaining current expenditure.

The ideal sequence of events from the point of view of British manufacturing industry would be:

i) increase of £5 billion in the yield of income tax
ii) equivalent reduction in PSBR
iii) lower medium and long term interest rates, plus cutback in growth of money supply

iv) more private sector investment, particularly in construction
v) hopefully, a fall in the exchange rate
vi) if so, higher exports and lower imports, hence more jobs.

It might, on the other hand, be wise to divert say half of the £5 billion extra tax yield into high return public sector investment (rail, telecommunications, motorways, for example). It should be no part of Conservative policy to promote a situation of "Private affluence, public squalor", a situation which can, in the nature of things, be neither stable nor durable. In order to ensure that this £2½ billion did go into investment in the public sector, and not simply into wages, the device of the "Oil Fund" could be employed. Money placed in the Oil Fund would be allocated to very specific "additional" public sector investment projects, and the public would be given very thorough briefing about the use being made of the precious oil reserves.

One writes of income tax as the natural source of revenue on the scale needed to make a significant dent in the PSBR. Given that welfare payments are sacroscant, there is no other practical way. Small amounts of revenue could probably be squeezed out of the system by devices such as VAT blocking on road fuels, higher tax on fringe benefits, and yet more tax on the North Sea. But these would be desperate measures.

Far better to move boldly on the income tax rate, explaining it very simply as the consequence of:

i) the catastrophic performance of the nationalised industries
ii) the added cost of unemployment, plus loss of tax revenue, in a recession
iii) maintaining social security payments at a level the community can barely afford.

It would have to be explained, which is true, that the prospect of a 25 per cent income tax by 1983/4 has been swallowed up by the aftermath of the dreadful 1970s.

Such a move would restore the initiative to the government. There would then be the prospect of tax cuts leading up to the next General Election; there would be sufficient income to carry out lesser tax reforms, such as that of capital taxation, involving a certain amount of revenue loss.

Above all, this measure would take the pressure of double figure interest rates off industry and local authorities, and make possible a revival of new investment. This would not save from extinction many firms that have been staggering on for years and have now come to the end of the road. But it would hasten the development of those new "firms" which are "waiting in the wings" to replace them.

Britain is not primarily the victim of a cyclical recession. It is the victim of industrial change on a massive scale. The situation is very like that of the 1930s when, under the surface of an apparently long drawn out depression, a number of new and powerful industries were taking shape - motors, aircraft, radio, gramophone, TV, holiday camps, tinned food, semi detached housing for the millions. One cannot yet be sure what will be the new industries of the 1980s, although it is a fair bet that they will include the construction of large numbers of apartment blocks for commercial letting, together with CEFAX communications, satellite TV and the battery car.

Be that as it may, there is little point in looking for the end of the current recession to bring a revival in shipbuilding, textiles or steel on the sites at present being closed down. Elsewhere, and in different shapes, maybe. But not where they are now, and above all, not without a great deal of new investment.

This, I submit, is the forward looking expansionary economic policy we should be embracing. Not the tense contractionary policy that is forced on us at present by the determination to maintain current living standards at whatever long run cost. Nobody is going to be forced below the bread line by a 5p rise in the basic and higher rates of income tax. Everybody would have to tighten their belts, but there would be immediate compensating advantages like lower building society mortgage rates. For the £6,000 a year family on average earnings, the extra tax cost would be about £200 a year -

and barely anything at all with a mortgage of £10,000 if interest rates fell by 3 per cent. It would amount to a setback equivalent to about one years's growth in real incomes at recent rates of progress.

P J CROPPER
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