H. M. TREASURY

Parliament Street, London SW1P 3AG, Press Office: 01-233-3415
Telex 262405

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SPEECH BY THE FINANCIAL SECRETARY TO THE TREASURY

Attached is the text of the speech to be be given this evening by the Financial Secretary to the Treasury, the Rt Hon Nigel Lawson MP, at the Institute for Fiscal Studies, London.

PRESS OFFICE
HM TREASURY
PARLIAMENT STREET
LONDON SW1P 3AG

01-233 3415

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THE BUDGET STRATEGY

Text of a lecture given by the Rt Hon Nigel Lawson MP, Financial Secretary to the Treasury, to the Institute for Fiscal Studies on Monday 23 March 1981

I was invited to speak about the Budget Strategy. I am afraid I have to confess that there is nothing new about that strategy. It is the strategy on which we embarked as soon as we assumed office a little under two years ago; and it is the strategy that was subsequently enshrined in the Medium Term Financial Strategy launched, in both quantified and qualified form, at the time of the 1980 Budget, almost exactly a year ago.

Such consistency and firmness of purpose is, I recognise, somewhat unusual and deeply shocking. It has inevitably attracted a considerable amount of criticism, some of which I shall seek to answer during the course of this talk.

But there is one respect in which the Budget undoubtedly marks a setback - a temporary setback, I believe, but one nevertheless which I have no wish to deny.

Right from the outset we have had what in this exalted company I think I can safely call a macroeconomic and a microeconomic policy objective. The macroeconomic objective is the conquest of inflation, to be achieved by the monetary and fiscal stance of which this year's Budget is a notable part. The microeconomic policy objective is the improvement of the performance of the supply aide of the economy, by the removal of unnecessary market distortions in general and the enhancement of incentives by income tax cuts in particular.

The reconciliation of these two objectives depends essentially on a progressive and adequate reduction in the real level of public expenditure. As we said quite clearly in the Manifesto on which we were elected: "The State takes too much of the nation's income; its share must be steadily reduced." Insofar as this does not occur, then, as this year's Budget has shown, we are likely to find that the fiscal balance necessary for continued success in the battle against inflation requires an increase rather than a diminution in the real burden of income tax.

As the Budget Red Book - the Financial Statement and Budget Report - put it, "Although this does not prejudice the achievement of the Government's monetary policy and financial strategy, it is clearly unsatisfactory in the context of the Government's wider economic objectives." And this year's Public Expenditure White Paper, also published on Budget day, put the matter equally clearly in its very first sentence: "The totals in 1980-81 and in future years are higher than previously expected and higher than the Government would wish in the light of their financial and economic objectives. The Government regard this development as one which requires the most serious attention during the 1981 annual Survey, when the plans for 1982-83 onwards will be reviewed."

Meanwhile, we have to live over the coming financial year with a burden of income tax higher than any of us would have wished. The Institute for Fiscal Studies has made its usual expert appraisal of the distributional and incentive effects of the tax changes announced in the Budget. So far as the distributional effects are concerned, I note that you - or should I say Mr Kay and Mr Morris, on your behalf - have reached the general conclusion that it is the better off who suffer most as a result of this Budget. This broadly confirms our own in-house analysis, although it may come as a surprise to some of our opponents.

So far as incentives are concerned, however, there is a rather fundamental difference between the IFS approach and ours. Broadly speaking, you treat almost all forms of taxation equally, with a heroic lack of discrimination. Thus, for example, you treat the employer's National Insurance Surcharge as if it were wholly a tax on the individual, just like income tax. By contrast, while not denying the relevance of the overall burden of taxation, we attach special importance so far as incentives are concerned to a man's marginal rate of income tax. That, for example, is why we chose to keep personal allowances and thresholds unchanged in money terms rather than increase the basic rate by 3 per cent. The route the Chancellor chose increases the marginal rate of tax for that minority of the population, who, as a result of non-indexation, find themselves pushed into a higher tax bracket (or indeed pushed into tax for the first time). But the alternative would have increased the marginal rate of tax for the overwhelming majority of the population.

Perhaps I may be permitted a personal note at this point, since my name is particularly associated with the so-called Rooker-Wise provision, which we shall not be implementing this year. Indeed, the Leader of the Opposition has called for my resignation on that account.

In fact, as anyone who cares to re-read the Hansard reports of the debates on the 1977 Finance Bill can readily discover, my position has been consistent throughout. I have never believed that automatic indexation was realistic: no Chancellor's hands can be tied in this way. What matters is that, instead of the norm being no change in the allowances in money terms, the norm should be full revalorisation. Instead of no change in money terms requiring, as it used to, no Budget resolution, no clause in the Finance Bill, and no approval by Parliament, the failure to revalorise now has to be open and explicit: it requires a Budget resolution, a clause in the Finance Bill, and the express approval of Parliament. And that situation has been in no way altered by this year's decision: section 24 of the Finance Act, 1980, as it now is, remains fully on the Statute Book.

I believe that this significant change, which I helped to bring about in 1977, will greatly increase the probability that the allowances - and since 1980 the higher rate thresholds, too - maintain their real value over time, which I continue to believe to be a good thing. But it cannot and does not <u>ensure</u> that this is so. That is impossible. But what is also now impossible, thanks to section 24, is an increase

in the burden of income tax by stealth. Certainly, no-one could claim that what we have done this year has gone unnoticed: nor, of course, did the Chancellor make any attempt to conceal either it or its consequences. He made the position absolutely clear in his Budget speech; and the underlying arithmetic was set out at the beginning of the FSBR.
But to return to the broad Budget strategy.
There is, I believe, general agreement - it is not of course universal agreement: nothing in economic policy can ever attain that status - but general agreement on three propositions.

First, that the conquest of inflation is both a good in itself and a necessary (even if not in itself a sufficient) condition of sustained economic growth.

Second, that inflation is in fact coming down.

And third, that this has been brought about by tight financial conditions. It is self-evident that this progress in the battle against inflation could not continue if government were to resort, instead, to periodic fiscal boosts in order to secure some short-lived advantage in terms of output. That being so, it is desirable not merely to refrain from such action, but in addition to let everyone know that the Government has no intention of proceeding in this way. People have a right to know where they stand (particularly after the excesses of the past), and will adjust their expectations accordingly.

That, in essence, is the meaning and purpose of the Medium Term Financial Strategy.

And why that Strategy remains firmly in place.

Nevertheless, in reviewing the pattern of events over the past year, two specific questions presented themselves in this context.

The first was whether last year's very high rate of recorded growth of broad money would fuel a resurgence of inflation in the future - and, if so, what we proposed to do about it.

The second, rather less important, question was whether we should be trying to get off the hook of £M3.

Taking the second of these questions first, it is undoubtedly true that £M3 was not a very good guide to underlying monetary conditions last year. This was in part thanks to the removal of the corset and the unwinding of the distortions for which the corset has been responsible.

However embarrassing in the short term, this change was thoroughly desirable. And now that the distortions have been largely removed, there are clear signs of a marked deceleration in the rate of growth of £M3.

But of course we never were impaled on the hook of £M3 in the way that our critics have frequently alleged. We have all along made clear - perhaps most definitively in the Green Paper on Monetary Control we published a little over a year ago - that to assess underlying monetary conditions properly it is necessary to take account of all the various monetary indicators, broad and narrow alike; we also take into account the level of real interest rates.

But for a country with a Budget deficit the size of ours, the importance over the medium term of a broad aggregate like £M3, with its clear link with fiscal policy, cannot be gainsaid.

None of this, however, goes far to answer the more important of the two questions I posed - whether last year's very high recorded growth of broad money, which was certainly not wholly the result of the corset episode, has serious implications for future inflation.

Clearly, this is something we shall need to watch carefully; since in theory any increase in liquidity as shown by the wider measures of money might be spent to fuel inflation later.

But in practice this is unlikely to occur, not least because much of the increase in liquidity, representing as it does an attempt by the private sector to make good the ravages of inflation on their financial assets, will be firmly held. Analysis of the figures suggests that private holdings of financial assets, including in particular broad money, are now at a more normal real level, and there should be no repetition of what was a special, one-for-all, surge in the demand for money. Although it would be unwise to read too much into short-term movements of broad money, it is notable that, over the past three months, the rate of growth of £M3 has come back sharply to plumb in the middle of the target range: a deceleration we predicted last November, incidentally, when MLR was lowered from 16% to 14%.

So there is every reason to be quietly confident that the track we have set for £M3 from now on will produce a sufficient degree of financial tightness over the coming years; and given the determined steps we have taken to cut back the PSBR means that this should be compatible with lower interest rates than would otherwise have been the case.

Meanwhile, as I pointed out in a speech I made in Zurich a couple of months ago, the experience of the past year has also demonstrated the need to improve our funding techniques. This is not merely a matter of improving our ability to control £M3 in an inevitably uncertain world; it is also because, as I argued at Zurich, "It is the method of as well as the need for, funding which largely determines the system by which interest rates are generated at both the short end and the long end of the market".

The new indexed gilt, for the first issue of which lists open and close this week, is of the first importance in this context. There are, of course, other considerations, too. An indexed gilt reduces the risk of the Government having to pay very high debt interest in real terms as inflation comes down, while in the meantime there is a measure of immediate relief to the PSBR. But the biggest gain at the present time is to our techniques of monetary control. This arises partly because we will be selling - in addition to conventional gilts, which will of course remain on offer - a different kind of instrument which will have its own unique appeal to the institutions concerned: a greengrocer selling apples and oranges will on the whole do better than one who insists on selling nothing but apples. But the gain also arises because of the method of sale: the indexed gilt is perforce being sold by auction and will continue to be sold in this way. Among other things it will thus provide a means of influencing long term rates of interest directly rather than attempting to do this at a distance by operating on short rates.

All in all, I have little doubt that the addition of the indexed gilt to our funding armoury will, over time, enable us to achieve our overall monetary objectives at a lower level of interest rates than would otherwise be the case, to the benefit of the economy as a whole and of industry in particular.

But of course the main argument current raging over the Budget is not concerned with the innovation of the indexed gilt.

Once again we are involved in an argument as to whether an attempt by the Government to pay for its expenditure by increasing taxes is deflationary. Unlike many arguments of this kind this is not a debate on whether to have more public expenditure or not. The debate on this Budget has been whether or not we should pay explicitly for the planned level of expenditure. It is the aim of this Government to attempt to reduce the share of public expenditure in output; but it is also an important objective to finance any expenditure in a responsible way.

This surely seems reasonable enough. But the contention of some of our critics is that any attempt to reduce the PSBR by increased taxes will produce a downward spiral of output. This argument suggests that the increased taxes levied in the Budget will so reduce demand and output that tax revenues will fall and public expenditure increase to the point where the PSBR, instead of falling, will actually rise. And if, instead of accepting this, the Government continues to pursue its lower PSBR target a further dose of fiscal contraction would have to be administered, which would be equally self-defeating - and so on (presumably) ad infinitum.

Needless to say, this view is wholly mistaken. It displays a major misunderstanding both of Government policy and of how the economy works.

The first important point is that the fiscal stance has to be assessed against the background of a fixed money supply target. This aspect of the debate is not whether to have a higher money supply target or not, although that itself may be a separate issue; this aspect of the debate is whether, given the money supply target, we should have a higher or a lower Budget deficit. It is the Government's contention that it is essentially the growth of the money supply in relation to the inflation rate that will be the prime determinant of the overall level of domestic demand and hence output in the economy, and not the fiscal stance. And we have no intention of allowing our monetary stance to be such as to lead output to spiral downwards. Over the winter of 1979/80 monetary policy was undoubtedly and necessarily tight; inflation was accelerating and was in turn well above the rate of monetary growth. Since last summer there has been a major transformation. Monetary growth has accelerated while the inflation rate itself has been falling. And, now that the overall level of real money balances is back to a more normal level, we can expect to see some stabilisation of domestic demand emerging in the economy.

Looking ahead, we begin the next financial year with an underlying inflation rate close to 10 per cent per annum. This is roughly on line with, albeit at the top end of, the new target band of 6-10 per cent fixed for the growth of money supply over the next financial year. Furthermore over the course of the year we expect the inflation rate to fall to 8 per cent. Taking into account the upward trend in velocity, which is on average some 1-2% a year, this is quite enough to allow some real recovery of domestic demand. Irrespective of the stance of fiscal policy, and given the monetary path we have set, for as long as inflation continues to be reduced it is thus quite wrong to imagine that output can spiral downwards.

Moreover, even in fiscal terms it is important to be clear that we have deliberatly refrained from raising taxes to pay for the extent by which the PSBR is being inflated as a result of the recesssion being greater than expected. Essentially, this is not a matter of discretionary action but rather one of the operation of automatic stabilisers. In a recession it is normal for private borrowing to be reduced, thus making way for the higher level of public borrowing that tends automatically to occur on existing policies. I explained this analysis and approach in a speech to a Financial Times Conference on January 1980 and repeated it in Zurich earlier this year. So I trust I do not need to elaborate any further tonight. In terms of figures, our calculations suggested that in 1981/82 the PSBR will be some £3 billion higher than we envisaged last year as a result of the recession being greater than we then expected. Taking this into account we have raised the original Medium Term Financial Strategy guideline for the appropriate level of the budget deficit from £7½ billion to £10½ billion.

I trust that this, too, will help to reassure these who fear that we are somehow trying to chase our own tail in all this. We are not. But I do not believe that it has yet been sufficiently appreciated that, given a particular rate of monetary growth, the fiscal stance has its main impact upon the distribution of demand rather than upon the level of domestic demand. In particular, as a result of the level of interest rates, a low deficit tends to favour investment rather than consumption, whereas a high deficit favours consumption rather than investment.

If we cut public borrowing by raising taxes then with a fixed money supply it is likely that either bank lending must rise or the level of bond sales by the Government can be allowed to fall. If savings have been reduced by the increased level of taxes then we might expect some decline in bond sales but if interest rates are allowed to fall and bank lending by the private sector is allowed to rise to replace some of the fall in public sector borrowing then in turn this will have an impact upon the total level of domestic demand. Is there any reason to believe that demand will fall if we replace lower public sector borrowing by higher private sector borrowing? Is there any special merit in public sector borrowing? I must confess I cannot see it.

Alternatively suppose that the benefit of the lower fiscal deficit is reflected in considerably lower debt sales. In this case there are now more financial resources available in the private sector to lend to other parts of the private sector. If the private sector does not have to lend to the Government is it note possible that some of its available funds might go to the company sector, and boost expenditure that way? Why should it follow that, as a society, we can make ourselves better off by collectively paying the Government less tax and instead collectively lending them more money; particularly as the interest rates on Government stock will have to be raised to persuade us all to lend that money to the Government.

The truth is that the reduction in the PSBR brought about by the Budget is unlikely to make much overall difference to the total level of demand. In the short term, there may be some very modest contractionary effect. But the more important point is that, taking full account of the Budget, we expect output to be on a rising trend during 1981/82.

To sum up, the main demand effect of this Budget as we see it, is to change the balance of demand between consumers and companies; and between consumption and investment. In the short run, but only in the short run, if we cut taxes and leave the money supply unchanged we may get a little more demand - but even that is not certain. But in the long run we will only succeed in giving more resources to consumers and pensalising private sector borrowers; this particularly applies to the company sector who will find their access to funds reduced and the price of those funds increased.

In the Medium Term Financial Strategy we have set a path for fiscal policy that is consistent with monetary policy so as to have balanced development of the financial markets. We have attempted to ensure that as far as possible the growth of the total level of financial assets in the economy will be at a rate consistent with the money supply target. The fiscal framework as set out should lead to a growth of national debt that is consistent with the money supply. In turn this should avoid excess pressure upon the markets for government debt. We believe that it is unwise to unbalance this pattern by running large fiscal deficits and forcing the financial markets to take an excessive burden of debt. But at the same time we are not attempting to impose an undue burden on the taxpayer by trying to cut the fiscal deficit faster than is required to meet the monetary target at a reasonable rate of interest. This is a balanced policy. Both monetary policy and fiscal policy should move in step with each other. While no-one likes paying higher taxes, and this I accept, it is wholly wrong to suppose or suggest that the Budget imposes an unduly severe fiscal policy upon the economy.

However, in recent weeks we have had a resurgence of mechanical calculations concerning the effects of policy changes. The Treasury Committee of the House of Commons have argued that to get inflation down by 1 per cent requires, over a four-year period, a cumulative loss of output of 4% and the equivalent of a year's additional unemployment for 650,000 people. At the same time we have had assertions of the so called deflationary impact of the budget, estimated at some 1-2 per cent of output. What we appear to have been provided with is a DIY policy trade-off kit. But it is only when we look at the implications that we really begin to see the nonsense implied in such calculations.

Take first the so-called inflation/unemployment trade-off. If a lasting fall in the rate of inflation of about 1 per cent per annum can be achieved at a cost of 650,000 man-years unemployment, presumably this calculation can equally well be reversed and thus provide us with a simple way of curing unemployment if only we are prepared to accept the higher inflation. Let us see what this would imply in practice. The Public Expenditure White Paper assumes an average unemployment rate of 2.5 million in 1981/82 and 2.7 million in 1982-83 and 1983-84. This level might imply a cumulative unemployment figure of about 10 million over four years. Suppose that we wished to have no more than a cumulative level of 4 million unemployed over the next four years; that is an average of 1 million. The solution, according to the Treasury Committee's ready-reckoner, is simple. All we need to reduce unemployment by 6 million over this period is 9 per cent higher inflation for ever. You may be forgiven for thinking that this is quite remarkable. But why stop at 1 million as a target? Surely we cannot be satisfied with anything less than abolishing unemployment for the next few years entirely. And what is needed for that? Again, according to this ready reckoner 15 per cent higher inflation for ever and we can have four years of zero unemployment. Who can possibly take this sort of nonsense seriously, particularly when we recall that the crucially important feature of the past quarter of a century is the

the way on which inflation and unemployment, under successive governments have steadily and inseparably risen.

Then we have the other set of number-mongers who predict that the £4 billion tax increase in the budget will have knocked 2 per cent off output. That is with an unchanged money supply. Extrapolating this in much the same way produces the obvious answer to our low level of output. If a £15 billion PSBR would have been 2 per cent better than a £10½ billion PSBR why stop there? A £20 billion PSBR might have added yet a further 2 per cent to output. But perhaps what we really needed was a £30 billion PSBR so as to generate a further 5 per cent of output and really get our factories humming.

In the 1960's the UK had an inflation rate of about 3½ per cent; during the lifetime of the last government this had risen to an average of 15 per cent per annum. At the same time unemployment rose from a level of under ½ million in the early 1960's to an average level of 1¼ million in the period of the last Government. Now we learn that apparently all that was preventing us from avoiding this deterioration in unemployment was a failure to let inflation rise high enough. So far from having too much inflation it now appears that our unemployment problems are because we have had too little inflation. Does it surprise you that we have got into our present difficulties of high inflation and high unemployment when we have a significant group of people who believe in such magic.

It is claimed by the proponents of these ideas that the calculations are based upon the Treasury model. It just goes to show how careful you have to be when handling a model. Certainly the keepers of these models never intended such absurd calculations to be made. The models are based upon historical information generated over a period only when there was no active monetary policy; they are based upon a period when any attempt to control inflation was temporary; and they are based upon a period when policy tended to be directed towards validating wage and price increases for fear that to refuse to do so would cause short-term pressure on demand and output.

The conclusions of the Treasury Committee are based on the assumption that the future must be like the past, mindlessly extrapolated. The whole purpose of the present Government's economic strategy is to ensure that the future is <u>not</u> like the past. In the early stages of a change of policy people do require time to adjust to the changed circumstances. We are aware of this. But it would be totally wrong to assume that they will never learn; or that they will learn in some mechanical dumb animal way. To assume that is sadly to underestimate the perceptiveness and self interest of unions and companies alike, and the adaptability of the economy as a whole. The early stages of bringing down inflation are inevitably difficult; that much is well know and accepted. But blindly to extrapolate such experience over a larger time period is totally wrong.

I mentioned a few moments ago that, not only do we not accept that the Budget is in any significant sense contractionary, but that we in fact expect to see output on a rising trend over the coming financial year, 1981-82.

This expectation is reinforced by the behaviour of the indicator series published regularly by the CSO. The longer leading indicator has been rising since November 1979, the shorter leading indicator since November 1980, and the coincident indicator has ceased to fall since last November. Moreover, there is a growing amount of anecdotal evidence from industry tending to confirm this presumption.

'That's all very well', reply the gloom-mongers and assorted sceptics, 'But where is the growth going to come from?' The most obvious answer is that, just as the recession had as three important components a massive wave of destocking, a sharp increase in the savings ratio, and the world recession, so the recovery is likely to be assisted by a slowing down in the rate of destocking, as inventories approach the desired level, by a fall in the savings ratio, as inflation and inflationary expectations fall, and by some upturn in the world economy, generally expected to occur this year.

But behind this scepticism lies the usually unspoken assumption that no economic recovery is ever possible other than by a conscious act of demand management by an expansionist government. This view, which is remarkably widely and deeply held, is not merely economic nonsense - implying as it does that the economy in general and the labour market in particular is quite incapable of adjusting to changing conditions, and that market forces are not merely blunted by the imperfections of the real world: they don't operate at all. It is also, and much more obviously, historical nonsense. If neo-Keynesian demand management were the necessary condition of economic growth, we would all still be living in caves and wearing woad, instead of listening to lectures at the centrally-heated Charing Cross Hotel. I am, needless to say, making no value judgement here.

Or take the 1930s, about which there is a great deal of talk, not all of it very well informed, nowadays. The depth of the great depression, in 1932, was very grim indeed for a large number of people. But the recovery from that depression, so far as this country is concerned (some others fared less well), was astonishingly vigorous. And it occurred not because of rearmament: that happened later. Nor was there any hint of governmental demand management: that took a further decade to conquer the Treasury. It occurred in the context of a policy of economic orthodoxy, comprising minimal State interference, sound money, and low interest rates.

If we want to learn lessons from the past - and we should - it would be well to learn the right ones, from the real past.

Mr Chairman, the strategy of this year's Budget is the medium-term strategy we have been pursuing since we took office. It is a strategy dedicated above all to the conquest of inflation, and it has already achieved an encouraging degree of success towards that end. And it is a strategy that lays the essential foundation for the wider economic objectives, in terms of growth and employment, which we all share.

Meanwhile, the alternatives put before us all add up to the beguiling but fatal proposition that public expenditure, even in an age of inflation, doesn't have to be paid for. Too often, politicians have been tempted down this primrose path, and been rightly condemned for doing so. Here is a Government that has had the courage to resist that temptation.