



Prime Minister^②

A useful counter to Owen.
Hattersley and Heath

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Andrew Turnbull
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14 January 1985

Dear Andrew

IFS SIMULATION OF £1 BILLION EXTRA PUBLIC SPENDING

1. We had a brief word this afternoon about wrong use of these results, which were prepared by the LBS for the IFS who published them early last year in their "Green Budget". Mr Hattersley on 6 December (OR cols 535-6) and Dr Owen on 10 January (OA col 901) both reported these as extra public investment in infrastructure. In fact they refer to extra spending on public employment. This is made clear in the attached extract from the IFS document and I understand Mr Odling-Smee has confirmed it with Dr Budd subsequently.

the Health in his Sunderland Speech

2. The main thrust of our case against extra government spending as a way of using the fiscal adjustment now no longer rests on quantified model results. Nevertheless I think it would be useful if an opportunity could be found to point to the sloppy homework which Dr Owen, Mr Hattersley and perhaps others have done on this point. It is hardly surprising that spending £1 billion directly on government employment creates lots of jobs!

3. There is a second-order point about the IFS presentation of the comparison between tax cuts and higher spending. Their tax cut package would be about one-third smaller in PSBR terms than their £1 billion public spending package. But there does not seem to be much to be gained by addressing that point at this stage.

4. I attach a copy of briefing which we prepared on this subject for the last Treasury First Order Questions. This may be useful to you.

5. I am sending copies of this letter to Margaret O'Mara, Robert Culpin and John Odling-Smee.

Yours Mark

M T FOLGER

Appendix E. Macroeconomic Simulations

In Section 4 we presented simulations based on the London Business School Macroeconomic Model of the effects of various changes. This Appendix, written by LBS, describes the main assumptions and mechanisms which lead to the results.

The simulations reported in this Appendix have been carried out on a base run of the new version of the LBS model which has been recently re-estimated to take account of the rebasing of the National Accounts data to 1980 prices. The base run assumes that policy is constant, which is interpreted to mean no changes in tax rates but full indexation of allowances and specific duties. The simulations are all of fiscal changes, and are carried out on the assumption of fully accommodating monetary policy. They are therefore not necessarily compatible with the monetary guidelines or counter-inflationary objectives of the Medium Term Financial Strategy. The assumption that monetary policy is fully accommodating means that fiscal stimulus puts little or no upward pressure on interest rates, and these simulations therefore show a larger increase in demand and hence output than would occur if monetary growth were fixed. The following paragraphs briefly describe the model mechanisms which produce the effects shown in Table E1.

Income tax cut

A classic Keynesian stimulus increases disposable incomes and hence consumption and output. The increase in output has a favourable effect on unit costs and holds down prices at first, but eventually this is outweighed by faster growth of wages reflecting the increased pressure of demand. The stimulus also increases the PSBR which pushes up the money supply and leads to a fall in the exchange rate. This eases the competitive pressure on domestic producers and allows them to increase profit margins. The combined effect of higher wages and a lower exchange rate means that prices are significantly higher by the end of the period, and there is a net deterioration in competitiveness. Imports are boosted substantially both by the extra output and by the rise in domestic prices, and the combined income and price elasticities produce a large deterioration in the balance of payments. The additional output also leads to an increase in employment, but the elasticities are fairly small. The increase in output of 0.9 percent is produced by an increase of 0.6% in the labour force, with the balance coming from improved productivity.

TABLE E1. MACROECONOMIC EFFECT OF SELECTED POLICY CHANGES

		Income Tax Basic rate to 27%	Expected % Changes		Public spending + £1 billion	
			Allowances 5% more than indexation	VAT to 20%		
% difference between base run and variants (except balance of payments and unemployment)						
GDP	year 1	0.4	0.1	- 0.4	- 0.7	0.3
	year 4	0.9	0.2	- 1.8	- 0.8	0.4
Retail prices	year 1	0.1	-	1.0	2.1	0.6
	year 4	1.1	0.3	5.1	-	0.8
Earnings	year 1	0.2	-	0.2	- 0.3	0.7
	year 4	1.7	0.4	3.4	- 1.7	1.2
Balance of payments (£bn)	year 1	- 0.5	- 0.1	0.3	1.5	- 0.3
	year 4	- 3.9	- 0.9	2.5	4.0	- 1.5
Real disposable income	year 1	1.6	0.4	- 0.9	- 2.1	0.1
	year 4	2.6	0.6	- 1.7	- 1.7	0.3
Money supply	year 1	0.6	0.2	-	- 0.3	0.2
	year 4	2.3	0.6	- 3.4	- 3.0	0.6
Unemployment ('000s)	year 1	- 30	- 7	- 10	- 30	- 165
	year 4	- 130	- 30	-	100	- 185

Increase in Allowances

The simulation of changes in allowances is very similar in its effects to the cut in the basic rate. The direction is the same in every case, and the absolute magnitude substantially smaller, reflecting a smaller initial stimulus.

Higher VAT

The effects of changing VAT are notoriously hard to estimate. A great deal depends on the reaction of wages, and it is not clear that the events of 1979, when a large part of the VAT increase was passed on into prices and wages, would be repeated if another VAT increase

were to occur. To illustrate these uncertainties we have shown two sets of results. The first set, in the left hand column, are taken from the version of the LBS model that was being used for forecasting just before the re-estimation on a 1980 price basis. In this simulation the VAT increase is passed on in prices and subsequently affects wages. There is nevertheless a fall in real incomes and output declines. This improves the balance of payments, but the improvement is fairly modest, given the size of the fall in output, because of decline in competitiveness. This comes from two sources: the rise in wages is pushing up domestic costs; and the fall in the PSBR and consequent fall in the exchange rate pushes up the exchange rate. The effect on employment of a decline in output is offset by the fall in *real* wages, and there is no net change in unemployment.

A rather different scenario is shown in the second set of results (in the right hand column), taken from the latest version of the LBS model. The key difference is that wages are assumed to be driven by employers' ability to pay rather than by employees' demands, so the VAT increase is not passed on into wages. As a consequence wages tend to fall rather than rise (compared with the base level) and the improvement in cost competitiveness limits the fall in output and improves the balance of payments. But despite a fall in real wages, unemployment rises in response to the increase in output. The rise in taxes also reduces the PSBR and reduces monetary growth in this simulation, and the consequent effects on the exchange rate and prices offset the original upward impulse from higher taxes.

Taken together these simulations show that under almost any circumstances a VAT increase will reduce real disposable incomes, reduce output and improve the balance of payments. But the long term effect of the VAT increase on prices and employment depends crucially on the reaction of wages, and this is extremely uncertain.

Higher Public Spending

In this simulation an extra £1bn was spent on an increase in public employment. Since the output of public employees is measured in the national accounts by their income this leads to a direct increase in measured GDP, (though it may be questioned whether this accurately reflects the true value added.)

The increase in output has a much larger effect on employment than any other method of stimulating the economy, but as a consequence the effect on prices is also relatively large, as the downward pressure of demand pushes up prices, and the productivity offer is small. The balance of payments is thus affected adversely even though the import content of the extra public spending is relatively small.

Appendix F. The Privatisation of British Telecom

The budgetary position in 1984-5 depends to a considerable extent on the amount raised from the sale of shares in British Telecom. Figures in the range £4bn - £5bn have been widely quoted as the likely proceeds from the sale of a half interest in the privatised concern.

The assets of British Telecom had a historic cost value in 1983 of £8bn net of a stated liability of £1.25bn to the Post Office and British Telecom pension funds. The corresponding current cost figure is £15.3bn. Long term liabilities to lenders other than the UK government were just under £500m (mainly foreign currency lending covered by government exchange guarantees). If the whole of BT's debt to the UK government were transformed into equity, the value of the resulting company would therefore be around £7.5bn (in historic cost terms) and £15bn (in current cost terms).

These figures probably mean little. British Telecom does not have a register of assets owned of the type universally maintained by private companies, and its annual accounts are regularly qualified on this account. More fundamentally, the type of assets with which existing telephone equipment would be replaced today are so completely different that historic cost records, however adjusted, can provide very little indication of the current replacement cost of assets.

The earnings of British Telecom may therefore provide a better guide to its value. In 1981-2 and 1982-3 these were approximately £1.5bn, before tax, interest or supplementary depreciation. BT is unlikely ever to pay Corporation Tax, at this level of profitability, except ACT on its dividends. On a full 52% tax charge, its profits would be £750 million. Applying a price-earnings ratio of 10 (something in between the figures for Cable and Wireless and the old style AT and T, for the two most comparable stocks) would suggest a value of £7.5bn. This is evidently a low figure — a more realistic tax charge would imply a much higher value, a conservative policy would indicate a higher earnings multiple.

However this takes no account of any prospect of increased efficiency in British Telecom, which is suggested as an argument for privatisation. A 5% reduction in operating costs would increase profits by about £250 million per annum. Nor does it take account of the opportunity for a privately owned BT, which is unlikely to be subject to a significant competition in the major part of its business, to raise prices. Suppose a 25% increase in tariffs across the board led

LBS results suggest extra public spending on infrastructure produces more jobs than tax cuts?

[Mr Hattersley wrongly said (OR cols 535-6 6 December) that LBS simulations, conducted in conjunction with IFS in early 1984, referred to extra £1 billion spent on public "infrastructure". In fact they referred to extra spending on government employment. Results suggested that after 4 years, £1bn addition to PSBR used for this purpose would mean 185,000 new jobs, compared with 30,000 flowing from raising personal allowances at PSBR cost of perhaps £0.6 billion. Note that simulations did not assume fixed monetary framework - IFS describe them as "not necessarily compatible with the monetary guidelines or counter - inflationary objectives of the MTFs".]

RHG should do his research more carefully. LBS figures with which he misled the House are estimated results of spending more on government employment, not infrastructure. Any government can give a short run boost to jobs if it simply takes on huge numbers of extra civil servants. But this soon chokes wealth - creating sectors of the economy and makes problems worse. LBS results show prices higher, and balance of payments worse, if PSBR raised to cover extra government spending.

LBS figures assume higher spending would be covered by a £1 billion increase in the PSBR, Within the MTFs framework net number of jobs arising from extra £1 billion spent on government employment would be much less than 185,000.

[IF PRESSED] IFS presentation of LBS results misleading as their tax cut package would be about one third smaller in PSBR terms than their £1 billion public spending package.

14 JAN 1985

