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MR NORRGROVE - No 10

David,

The Chancellor thought
the PM might like to see Sam
Britten's piece on thresholds in
yesterday's FT (second page below).

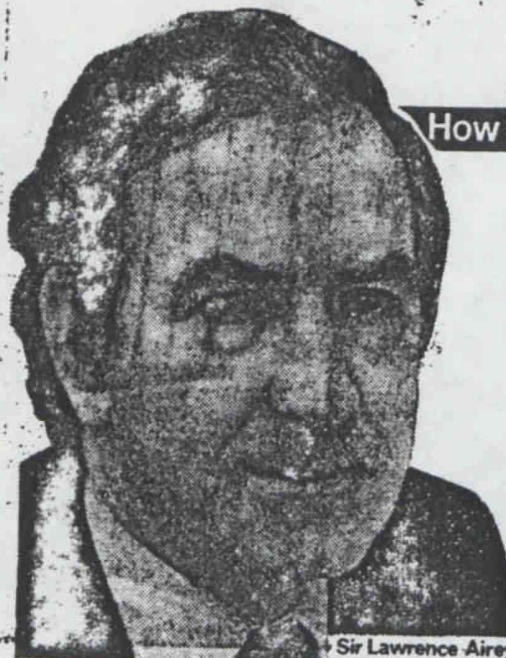
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ECONOMIC VIEWPOINT

Time to forget yesterday's slogans

By Samuel Brittan

N/S



Sir Lawrence Airey

How Social Security Reform affects the poverty trap

Married man and his non-working wife, with two children of primary school age, living in rented accommodation for which they pay rent of £20 p.w. and rates of £6 p.w.

	£ per week					
Wage	70.00	85.00	100.00	115.00	130.00	145.00
Less: Tax	1.07	5.57	10.07	14.57	19.07	23.57
Nat. Insurance	4.90	5.95	9.00	10.35	11.70	13.05
Plus: Family Credit	29.23	22.61	17.40	10.99	4.59	—
Child Benefit	14.00	14.00	14.00	14.00	14.00	14.00
Hosng. Benefit	6.01	4.32	2.98	1.33	—	—
Net income after White Paper	113.27	114.41	115.31	116.40	117.82	122.38
Net income, current system	117.42	116.90	114.19	114.44	117.26	122.38

Source: Andrew Dilnot and G. K. Stark; Fiscal Studies, feb 1986

It used to be said: "Every dark cloud has a silver lining." But this useful adage has been reversed by professionally gloomy financial commentators, who predicted the end of the world when the price of oil shot up in 1973-74 and 1979-80 and are again predicting the end of the world now that Opec is collapsing.

My own view is that the two earlier oil price explosions did set off the prolonged bout of "stagflation" from which many countries have been suffering, although they were not its fundamental cause. Similarly the collapse of the Opec cartel is the best world economic news we have had for many years.

Interestingly enough, the two most optimistic—but also realistic—appraisals come from two different sides of the political spectrum: from the Simon and Coates *Economics Analyst*, whose staff is headed by a former Callaghan economic adviser, Gavin Davies; and from the *Forhall Review* edited by Lawrence Kudlow, adviser to the former Republican US Budget Director, David Stockman.

Both emphasise supply side effects. With much lower energy prices, both profits and the value of workers' output should increase, thereby moving real wages nearer to market-clearing levels. UK non-oil trading profits, which have already shot up rapidly since

1981, are expected by Simon and Coates to rise by a further 16 per cent in 1986 and another 10 per cent in 1987, partly reflecting lower oil prices and partly the recent depreciation of sterling.

There are also immediate worldwide benefits on the conjunctural front with less inflation and more output for any given growth of nominal demand. Mr Kudlow has now raised his 1986 real growth forecast for the US to 5 or 6 per cent and shaded his inflation forecast down to 5 per cent.

The more cautious London Business School expects that OECD economic recovery "now three years old" will be prolonged into 1986 and reach a growth peak in 1987 on account of lower oil prices (as well as the fall in the dollar and the trend to lower nominal interest rates already in the pipeline).

It is scarcely credible that the specific problems of oil-producing developing countries, or US banks which have lent to the energy sector, cannot be kept at bay by some stretching out of interest payments and lender of last resort operations. The US has always looked after Mexico and will continue to do so.

Fears (if that is the right expression) that oil prices will fall to the level of marginal extraction costs are misguided and alarmist.

It is irrational to extract oil beyond the point where its value in the ground is likely to

rise faster than the rate of interest. Taking these factors into account the "competitive" oil price is estimated by Jeremy

Hale (also a Simon and Coates analyst) to be between \$11 and \$16 per barrel, with a bias towards the lower figure.

There are thus the supply side and conjunctural gains. But to offset them, the UK as a net oil exporter, whose exports amount to over 2 per cent of GNP, stands to lose. It will also need a terms-of-trade reduction to sell more non-oil products overseas. It is a reflection of the craziness of the British labour market that these aspects, which ought to be adverse, may actually be beneficial to output and employment.

Because of the oil price fall, some of the real depreciation of sterling, expected to occur very gradually as North Sea production tails off, has been compressed into the last few weeks, giving UK manufacturing exports and import substitutes a boost. Moreover, because of the oil price crash, the normal inflationary effects of a lower exchange rate have been held in abeyance.

The UK is not yet out of the wood on interest rates and sterling. Should the fall in sterling get out of phase with the fall in oil prices, base rates will have to rise, however hot under the collar industrialists and politicians get. So will they if next month's banking figures suggest that bank credit and

property prices are once more on the rampage.

The point about not looking at one month's figures in isolation applies just as much when they are good (as in the case of the January monetary and reserve numbers) as when they are bad.

The same applies to the unemployment figures. The December and January rise may be a statistical blip (after the earlier falls in underlying unemployment), the beginning of a new severe adverse movement, or simply indicate that over the past six to 12 months

unemployment has been rising by about 6,000 a month. If I were the Chancellor I should feel much more handicapped by having to finalise my Budget after only one more month's unemployment figures than after only one more month's money supply statistics.

Even if base rates do not rise further than their present 12½ per cent, they already represent at that level a real (but pre-tax) interest rate of 8½ per cent, if one takes seriously inflation forecasts of 4 per cent or less. British real short-term rates are about 6 per cent above German real interest rates and make sense only if it is thought that sterling will continue to depreciate in real terms against the mark at that rate.

The Chancellor might be tempted to raise his PSBR target both on the grounds of "a little Reaganomics"—that is off-setting monetary stringency, with fiscal ease—and on grounds of smoothing out the effects of

fluctuating oil revenues.

The last stated objective for the 1986-87 PSBR was £7.1bn, published in last year's version of the Financial Strategy. The estimated outturn for 1985-86 is £8bn.

Nevertheless a PSBR objective of £7bn to £8bn will already represent a dose of Reaganism. This is because it embodies an estimated £4.1bn of asset sales, compared with £1.1bn of such sales in 1983-84, and £2.1bn in the current financial year.

These asset sales are not wicked even when made to Americans, and we can forget the aristocratic collectivism of the "family silver." Nevertheless, they represent ways of financing the Budget deficit and not reducing it; and if you want to measure the fiscal stance on Budget Pay forget the PSBR and look instead at the PSFD (Public Sector Financial Deficit).

The heavens will not neces-

sarily fall in if the Chancellor borrows an extra £1bn. The market reaction will depend far more on international financial forces, the vagaries of UK bank lending and the Government's general political standing than on fiscal arithmetic. Moreover, tax concessions which encourage structural change — above all more jobs and lower pay settlements — will be better received than generalised largesse.

It would be foolish, however, to throw away the potential gains in lower inflation — and even more lower inflationary

expectations, with the possibilities the latter hold of a virtuous circle of lower prices and higher output — by raising petrol duties or other indirect taxes simply to make room for income-tax cuts.

The actual tax burden would be no lower with a switch from direct taxation. Such a course would be to repeat in a minor key, and on the inflationary downswing, the error of the Thatcher government's first Budget in 1979, which mistakenly raised indirect taxes to finance an unappreciated reduction in the basic rate.

TAX THRESHOLDS ARE OUT OF DATE

THE CAMPAIGN being launched by some Tory "wets" for an increase in tax thresholds rather than a basic rate reduction shows a characteristic failure to catch up with changes taking place in the real world, namely the consequences of the Government's Social Security reforms, which are planned for 1988.

As a result, tax changes will make virtually no difference to families of modest means over a very wide range of incomes.

The table above shows that the old poverty trap, under which increases in pay led literally to lower income, has gone. But there is a "new poverty trap" over a wider range of gross income from about £70 to £145 a week for a typical family, in which take-home income rises very little with earnings.

Such high marginal rates are an unavoidable outcome of the desire to concentrate help on those in most need,

combined with the desire to limit net outlays.

The essence of the new system is that entitlement to benefit depends on net income after tax. This means that a reduction in income tax, which had no effect under the old system, will under the new regime reduce entitlement, both to family credit and housing benefit. The result is that families in the poverty trap region will gain very little from a reduction in income tax, however brought about. A family in receipt of both Family Credit and Housing Benefit, which was taken out of income tax completely by an increase in thresholds, would see its implicit marginal "tax" rate fall only from 96 to 94 per cent.

Whereas an increase in allowances previously gave more proportional benefit to poor tax payers than to other basic rate payers, the position is now reversed. Tory "wets" please note.

But not only "wets." Precisely the same objection applies to the reintroduction of a lower rate tax band, said to be favoured by the Prime Minister. She might note that this was a TUC idea, imposed over the not quite dead body of the Treasury during the last Labour Government in return for hoped-for wage restraint which of course never materialised. It was rightly abolished by Sir Geoffrey Howe in 1979.

To reintroduce it now would be ersatz compassion, with the bulk of the gain going to those well above any conceivable lower tax bands. The one effective way of helping poor families will be via the benefit system.

There is, however, a technical case for a modest reduction in the basic rate. It is that a freezing of the married person's allowance is required in the transition to individual independent allowances,

whether transferable (as the Chancellor favours) or not. Both would be an improvement over the present system which discriminates in favour of families with two breadwinners. A slightly lower basic rate would be financed from the freezing of the married allowance; and this would itself reduce the cost of moving to transferable allowances. These are matters on which Inland Revenue chairman Sir Lawrence Airey is presumably working.

If critics of Government economic policy on the back benches and in the Cabinet were more on the ball, they would concentrate neither on thresholds nor on jingoistic anti-Americanism in industrial policy, but on the Department of Employment's unmerited cold-shouldering of special measures suggested by the Commons Employment Committee for the long-term jobless.

Contrary to some reports,

the suggestions would not cost £3.3bn this year but that sum phased over three years. The suggestions are basically for more community service projects and for a subsidy to employers for each net hiring of long-term unemployed (I am sceptical of singling out building for special attention). The aim would be a job guarantee for all the long-term unemployed, involving some 750,000 extra jobs.

The Committee pulls too many punches and mistakenly urges that community services should pay the union "rate for the job" (no doubt to bring in the Labour Members). Its report makes the same mistake as many of the Chancellor's statements in being too short, without the supporting argument, calculations and tables, which may theoretically already have been published elsewhere but which the reader is most unlikely to have by his side.

The basic argument is that for paying people a modest wage, a little above the dole to "do something," rather than the dole for doing nothing. That is why the net Exchequer cost per job of special measures has been estimated at £4,000 to £5,000 a year compared with £25,000 to £50,000 for capital spending or conventional tax cuts.

The clue to faster real growth and more market related jobs remains, however, more market-related — and usually lower — growth of both nominal and real wages. The Treasury has been saying this in various different languages since 1944; and the problem is now more with the employers than the unions.

The task of the Budget is to send them a decisive signal that low pay settlements and more jobs are now preferred to the opposite and more comfortable combination. Compared with this need, the basic rate of tax and the thresholds pale into insignificance.