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Prime Minister

This note is generally very helpful and should point up the issues for discussion (though I don't believe medium-term monetary targets are on until we are seen to be sticking to the existing targets). Would you like this circulated for next Friday's discussion?

Qa 04358

To: MR LANKESTER

From: SIR KENNETH BERRILL

The Economic Outlook

Flag A

next Friday

1. I have seen the paper attached to the Chancellor's minute of 27 November, which is shortly due to be discussed by a small group of Ministers under your chairmanship.

2. The CPRS strongly supports the line taken by the Chancellor and would like to offer some comments as a contribution to the discussion. We have therefore produced the attached note. If you felt that this was a useful way of bringing out the main issues you may feel that this should be circulated to the Ministers concerned on the small group.

3. I am sending a copy of this minute to Sir Robert Armstrong.

KB

28 November 1979

Att

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29 NOV 1979

THE ECONOMIC OUTLOOK

Note by the Central Policy Review Staff

In the paper attached to his minute of 27 November the Chancellor of the Exchequer argues that, on any realistic assessment of the economic prospect, the public expenditure plans which Cabinet have endorsed are incompatible with the Government's monetary and taxation objectives.

2. This is not altogether surprising. As the Chancellor has pointed out, the decisions on public expenditure fell far short of what he had said would be required; and recent developments have increased that requirement, not reduced it. In particular the economy is moving into sharp recession and there is unlikely to be an early recovery given the present outlook for world trade and our current performance on inflation and productivity.

3. This does not in any sense demonstrate a "failure" of the Government's strategy. Ministers recognised from the start that the first task was to break the inflationary spiral; and that this almost certainly meant that economic conditions - growth, unemployment, inflation - would be poor in the first 2-3 years, even if the Government adhered strictly to the main features of the strategy. In practice, they have been blown somewhat off course. The economy has been slow to respond to monetary controls and fiscal changes. Monetary growth has been too high; the income effects of cutting personal taxation appear to many to have been largely offset by indirect taxes and higher interest rates; "stable" public expenditure will still be a rising proportion of a falling GNP; Civil Service numbers have yet to fall. In all these respects it can be argued that the strategy has not yet been given a chance.

4. The diffulties in pursuing the strategy are immense but, as an aid to considering them, we suggest that Ministers may find it helpful to work through the following questions.

(1) Control of Inflation

5. We assume that Ministers will want to confirm (i) that controlling inflation remains their first priority, and (ii) that no contingency planning should be undertaken for a formal incomes policy. If so, the reliance placed on strict monetary discipline is that much the greater, since a reasonable deceleration of inflation almost certainly implies one or two years in which money incomes have to rise less than prices.

Monetary Targets

6. There is a compelling need to reduce inflationary expectations: otherwise the operation of monetary policy will be painful indeed and the bankruptcies and unemployment will hit the weak rather than the greedy (big firms can get credit easier than small). Among the possibilities for reinforcing the current stance on monetary policy and influencing expectations are:-

(i) Setting a target rate of growth for money supply for a period some years hence eg 7% as the centre of the range for 1983. Would this be a sharp enough contraction? Would it carry conviction?

(ii) Setting a target path for money supply in the coming years eg that the centre of the range would fall by ½% or 1% a year. This might look less like "virtue tomorrow" than (i) above, and therefore be better received.

(iii) Charting a downward course for the PSBR, either in absolute terms or as a proportion of GNP. This could add credibility to the money supply targets, and discourage undue reliance on interest rates. Against this we would argue that a second monetary target is unnecessary for confidence; undesirable in closing off sensible policy options of a counter-cyclical kind; and conceivably impossible to adhere to (the deeper the slump the more the PSBR tends to widen).

(iv) Devising a medium-term financial plan which charted not only monetary growth, but also the course of tax and public expenditure.

Fiscal Targets

7. Any substantial forward commitment on monetary growth would, of course, have implications for the Government's tax and expenditure aims, whether they were spelled out in a financial plan or not. Ministers therefore need to reach a judgement now on the broad fiscal balance for at least the next 2-3 years.

(2) Tax Objectives

8. The long-term aim is to reduce the basic rate of income tax to 25%. This is probably unattainable during the lifetime of the present Government. On present plans and assumptions the overall burden of taxation would almost certainly have to be increased over the next 2-3 years. As the scope for increases in indirect and corporate taxes is limited, personal tax rates would probably have to be raised as well - perhaps by a substantial amount.

9. Are Ministers prepared to trim their tax objectives? Is it more realistic to aim at a basic rate of say, 27 or 28% in 4 years' time? (As a rough ready reckoner 1% off the basic rate is equivalent to about £0.7 bn of public expenditure).

(3) Public Expenditure

10. With present prospects for inflation and growth it is difficult to escape the conclusion that even relatively modest tax and monetary objectives are incompatible with current public expenditure plans. If the plans are to be reopened, the following are among the general considerations Ministers will need to take into account:-

(i) For 1980-81 the scope for savings is necessarily more limited than for later years. Plans have been announced; RSG and nationalised industry cash limits have been promulgated; social security upratings have been set; a greater proportion of capital expenditure has been committed. A "crash" cuts exercise for 1980-81 would be more readily understood against the background of an economic "crisis". The potential trade-off between tax and expenditure is a less compelling justification, particularly if the main target is inflation and expenditure savings take the form of increased charges or reduced subsidies/benefits.

(ii) If there are to be further savings for the later years, is it worth publishing the decisions already taken, even on a provisional basis? Will this not mean that the Government will be criticised twice over for making "cuts"?

Priorities

11. Ministers will need to consider whether the planned expenditure growth on Defence and Law and Order should be protected. Subject to that, the following would seem to be among the main possibilities for substantial

further savings:-

- an across-the-board volume squeeze (perhaps through cash limits) with minimal exemptions. There is some scope for this in 1980-81 (central Government) and much more in subsequent years.
- a moratorium on capital expenditure (to be avoided if possible).
- a further cut in housing (capital); and increased rents in later years.
- employment services (MSC programmes).
- the social security programme (well over one-quarter of total programmes). Can we afford to go on uprating benefits by prices? Is there a case for "prices or earnings, whichever is the less"? Need there be any uprating of Child Benefit next year (not statutorily required)? Can Earnings Related Supplement be abolished?

Conclusion

12. The heart of the Government strategy is the breaking of inflation by strict adherence to monetary targets. At the same time the productivity of the economy is to be stimulated by reducing the size of the public sector, reducing the level of taxation (especially direct tax) and increasing incentives. The monetary and fiscal objectives are of a piece, in that a large public sector and a large PSBR will make the monetary targets that much more difficult to sustain.

13. At the moment the Government has yet to get on course for its strategy. The CPRS believes that there is no way of reconciling the Government's objectives with the public expenditure plans recently endorsed. It believes that the prospect would look immensely better if those plans were reduced by, say, £1 bn in 1980-81, and £2 bn in each of the following two years. Thereafter one would hope that inflation would have been reduced and the economy would have turned round but, given the uncertainties, it seems doubtfully worth while to plan that far ahead at this stage. If public expenditure savings of this order are thought unrealistic, Ministers should recognise that their underlying strategy will have little chance to prove itself over the next 2 or 3 years.