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PART G

CONFIDENTIAL

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PART G

1986 BUDGET AUTUMN STATEMENT

DD'S 25 years 2-2-95 N.Aziz.

PO -CH /NL/0055

PART G

STARTS:-2-12-86

26.1.87

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pugt

From: J ODLING-SMEE

cc as ~~before~~

2nd December 1986

MR WALTERS

Mr Odling-Smee

(dont think this is right - Para 2.05 of the printed Autumn Statement contained the Chancellor's commitment that the 87/88 PSBR "would be held to 1¾% of GDP." The TCSC Report should stick closely to the words in para 2.05

MCS 2/12

cc Chancellor
Sir Peter Middleton
Sir Terence Burns
Mr Cassell
Mr Peretz
Mr Scholar 9o/1
Mr Sedgwick
Mr Turnbull

TCSC'S DRAFT REPORT ON THE AUTUMN STATEMENT

The fourth sentence of paragraph 18 says that the Chancellor made a commitment in the Autumn Statement to a PSBR figure of $1\frac{3}{4}$% of GDP, the same as in the MTFS. The oral statement in the House did not actually refer to a figure for the PSBR, and the printed document mentioned it only as an assumption underlying the forecast. It would therefore be more accurate to stick to the precise language of the Chancellor's statement in the House, perhaps along the following lines:

No!

> "This year the Chancellor has departed from previous practice, saying in his Autumn Statement that there will be no relaxation of the fiscal stance set out in the MTFS."

Since paragraph 21 mentions the figure of $1\frac{3}{4}$% of GDP, nothing is lost from deleting it from paragraph 18.

JOS

J ODLING-SMEE

2134/009

fwp

FROM: A Turnbull
DATE: 1 December 1986

WALTERS

cc Chancellor
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Sedgwick
Mr Odling-Smee
Mr Peretz
Mr Scholar

TCSC'S DRAFT REPORT ON THE AUTUMN STATEMENT

I attach copies of the pages dealing with public expenditure with manuscript suggestions marked:

2. Points to make to the Clerk are:

(i) the second half of paragraph 34 is a sleight of hand by the Committee's advisers. For years they have urged the Treasury to pay more attention to debt interest and when we give greater prominence to GGE which includes it, they switch their emphasis back to the planning total. In addition, use of GGE effectively reintegrates into the public expenditure totals a number of the Ward adjustments, eg statutory sick pay.

(ii) The text needs to make clearer in paragraphs 35-37 that "departmental spending" for future years includes potential allocations from the reserves.

(iii) There is an arithmetical error in Terry Ward's calculations. He has used an increase in the GDP deflator in 1989-90 of 3½ per cent rather than the 3 per cent used in the PSBR and Autumn Statement. This means he has under-estimated the real increase in that year - see paragraph 36.

3. I note that there are as yet no recommendations, only observations, and rather moderate ones at that. You should establish with the Clerk that if any recommendations are to be added, we should have a sight of them.

AT

A TURNBULL

PUBLIC EXPENDITURE TRENDS (is not just about planning totals)

~~PLANNING TOTALS~~

25.In paragraph 4 we mentioned the changes which we believe have taken place in the government's policy since 1979. In the original MTFS of 1980 the government announced that:

> "A key element in this strategy is a reduction in public expenditure."[31]

In the 1986 MTFS the government said that:

> "Continued restraint in public spending plays a vital role in the Government's economic strategy. The cash planning totals set by the Government in the White Paper are designed to hold total spending broadly level in real terms"[32]

In the 1986 Autumn Statement the government said that:

> "The Government is determined ... to see to it that total public spending even without taking account of privatisation proceeds, continues to decline as a percentage of GDP"[33]

26.Both the Chancellor and officials maintain that the objective of policy has always been to reduce public expenditure as a proportion of GDP and that this objective is intact. We do not dispute this. As the Chancellor pointed out:

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31. 1980 MTFS, page 16, paragraph 5
32. 1986 MTFS, page 14, paragraph 2.25
33. Chancellor's Autumn Statement

"in the document 'The Right Approach to the Economy', which was a quasi ~~stated~~ economic manifesto published before the 1979 Manifesto proper, we thought that public expenditure was taking an excessive share of GDP and we wished to see it progressively decline. That theme has been have continuously ~~continued~~ and it is that which accurately describes ~~described~~ what has happened since 1982/83. It is that which also characterises the public expenditure plans which are published in the Autumn Statement."[34]

27. Nonetheless, while it is true that the Government's underlying objective has been to reduce the public expenditure to GDP ratio, spending policy since 1979 has been formulated in stronger terms. Before the shift to cash planning, the operational objective was to reduce public expenditure in volume terms. Since then it has been to hold expenditure constant, or broadly constant, in real terms.

28. We questioned the Chancellor and officials on this point. The Chancellor replied that:

"if you look at what has actually happened there has been a continued growth in real terms of public expenditure but the growth since 1982 was less than the growth of the economy as a whole .... we have improved our performance if you accept the overall

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34. Q84

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objective .... the presentation I used in this Autumn Statement accurately represents the reality not merely of what is planned but also what has been happening since 1982/83."[35]

29.Officials from the Treasury took the view that: "[It is] less a change of objective but more a change of the speed at which the objective is being achieved".[36]

30.We accept that the current formulation of spending policy represents the government's past achievements and its current ambitions, but it is in our view a modification of the government's previously stated policy for public expenditure over successive planning periods. We have commented before on the realism of cash plans which show overall expenditure being held flat in real terms while previous plans had invariably been exceeded.[37] The Chancellor, in effect, admitted the policy change with regard to the current plans:

> "If you look at the previous planning totals, the 'broadly constant' was a description of a gently rising trend in real terms but by a very small proportion ... and it marked a big improvement on the trend previously. That proved in the event to be over-ambitious, and, therefore, the planning totals have had to be increased slightly although the growth still is less than the growth has been in real terms in the past ..."[38].

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35. Q85
36. Q26
37. eg Sixth Report of the TCSC 1984-85 paragraphs 26-29
38. Q93

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33. The underlying increase in the planning total this year over 1984/85 is, in fact, somewhat higher than 2%. Privatisation proceeds are expected to be about £2 billion higher than in 1985/86 and expenditure in 1985/86 was affected by the one-off effects of the ending of the coal strike. Real departmental expenditure (ie the planning total before deduction of privatisation proceeds) is likely to be 3.4% higher than 1985/86[41]. During questioning the Chancellor said that:

1985-86?

> "You ... have to recall that in 1985-86 public expenditure was exceptionally low. I think really it is better to look at the two years from 1984-85 to 1986-87 together. There was a marked dip in 1985-86, as is clear if you look at the graph, which I suppose was partly due to inflation 'being higher in 1985-86 than we expected. In the same way, of course, inflation has been lower in 1986-87 than expected.' If you are on a cash planning system, which we are, then ... you tend to have fluctuations in real terms of that kind"[42]

He added that:

> "The figures in the Autumn Statement would show that even if you exclude privatisation proceeds, then as I say, each year, including 1986-87, on our latest estimates ... there is a reduction [in general government expenditure] as a percentage of GDP"[43]

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41. Table x (from Terry Ward's note)
42. Q97
43. Q98

34. We accept that on this definition public expenditure has continued to decline as a proportion of GDP. Nevertheless a substantial real increase in departmental expenditure, exceeding the growth in GDP, has occurred this year and cash expenditure is likely to exceed the largest ever Reserve by £1.3 billion. ~~[In our view the government would have far more cause for satisfaction if departments' real expenditure were showing a decline as a proportion of GDP as well as general government expenditure, especially since the upward trend in departments' real spending continues into 1987/88.]~~

Delete

~~But~~ Previously the committee favoured use of an aggregate that includes debt interest. When we do the Committee switches back

(ii) 1987/88-1989/90

35. £5 billion has been added to the sum of departmental spending[1] and the reserve ~~plans~~ for 1987/88 compared with the plans announced in the Budget, an increase of about 4% in real terms. About £1 billion of this increase is on capital expenditure, mainly in the areas of housing schools and roads. This is expected to lead to an increase of 2% in departments' real expenditure in 1987/88 over 1986/87. Within the overall increase, the plans for several departments have been increased substantially: Home Office, Education and Housing plans have been increased by more than 10%; Environment, Transport and the Lord Chancellor's Department have been increased by 7-10%. The Chancellor told the House that:

"The public expenditure increases I have announced

1 Equals the planning total less privatisation proceeds

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allow us to make realistic provision both for local authority current expenditure, over which the Government has no direct control, and for demand led programmes such as social security, while still leaving scope for increased spending on services to which the Government attaches particular priority"[44]

We regard the £1 billion increase in capital expenditure as welcome, particularly in the light of our previous criticisms of the government's approach to capital spending.[45]

36.The ~~spending plans~~ planning total (less privatisation proceeds) for 1988/89 ~~are~~ is 4.5% higher than at Budget time, with increases as high as 20% in real terms above previous plans in the case of Education. However, although these plans have been revised substantially upward, the overall outturn for departments is intended to be only slightly higher in real terms than 1987/88.[46] In 1989/90 the overall planning total less privatisation proceeds is expected to increase by ~~only~~ about ~~1%~~ 1½% over 1988/89.

37.The profile of the spending plans is thus very familiar. Departmental expenditure (including future allocations from the reserve) will increase substantially above previous plans in the near term, but spending will somehow be restrained after that (the average increase in the final two years of the planning period is planned to be ~~0.6%~~ 0.9% a year) to fall below the trend established since 1979 (of around 1.5% a year)[47]

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44. Chancellor's Autumn Statement
45. reference to previous TCSC reports
46. Tables y, z (Terry Ward's Table 1, 3
47. see Graph 1 (Terry Ward's graph)

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THE CHANCELLOR'S AUTUMN STATEMENT, 1986

INTRODUCTION

1.In preparing our comments on the 1986 Autumn Statement, we took evidence from the Chancellor of the Exchequer, and from Sir Terence Burns, the Chief Economic Adivser to the Treasury and other Treasury officials. To all of those who gave evidence we wish to express our gratitude for their assistance.

2.Our thanks are due also to those who assisted us in the capacity of specialist adviser - Mr Gavyn Davies, Mr Christopher Johnson, Mr Bill Martin, Mr David Savage and Mr Terry Ward. We received help also from the Parliamentary Unit at the University of Warwick.

3.As in previous years we have been supplied with a set of alternative forecasts in order to assess independently the Treasury's Industry Act forecasts. Teams from the Henley Centre, the London Business School, the National Institute for Economic and Social Research and Phillips and Drew submitted two sets of forecasts. The first reflects their own assumptions about major future developments, the second a set of what we assume are the latest Treasury assumptions.

4.In previous reports we have drawn attention to the fact that although the Government has been successful in achieving a number of its economic ends, the manner in which these have been achieved has differed from that originally propounded in successive versions of the Medium Term Financial Strategy (MTFS). It is important that economic policy should be flexible, and able to deal with circumstances not originally foreseen. However, there are limits to the extent to which policy can reasonably be said to exhibit continuity. We think it would be more appropriate, when policy has obviously changed, for the Chancellor to admit it. Otherwise it is more difficult for us to learn lessons from past experience or indeed to ascertain what present policy really is. In this report we draw attention to various important changes which have taken place in the government's policy since 1979.

MONETARY POLICY

POLICY AND TARGETS

5. Since it assumed office the Government's stated economic policy aim has been to bring down the rate of inflation and to create conditions for a sustainable growth of output and employment.[1] To achieve these the Government devised and implemented the Medium Term Financial Strategy (MTFS).

6. As originally enunciated, the MTFS was quite straightforward. Inflation could best be reduced by

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1. FSBR 1980-81 p 16 para 1

reducing the rate of growth of the money stock. Accordingly the Government published a series of money stock targets for the following four years and gave details on how these targets would be realised:

> "The Government believes that its monetary policy can best be formulated if it sets targets for the growth of one of the aggregates against which progress can be assessed. This gives the clearest guidance to those concerned in both financial markets and domestic industry, on which to assess the direction of Government policy and to formulate expectations."[2]

The monetary target chosen was a measure of broad money, £M3:

> "If one aggregate is to be chosen for the target there seems to be considerable agreement that £M3 best suits the present circumstances of the United Kingdom. It is also relatively easy to define in terms of the banking system."[3]

Paragraph 4 of the original MTFS was quite explicit about the manner in which policy would be achieved:

> "It is not the intention to achieve [the] reduction in monetary growth by excessive reliance on interest rates. The Government is therefore planning for a

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2. Green Paper on Monetary Control Cmnd 9858 para 8
3. ibid para 10

> substantial reduction over the medium-term in the Public Sector Borrowing Requirement (PSBR) as a percentage of Gross Domestic Product (GDP)".[4]

The Government viewed the relationship between the PSBR and the growth of the money supply as "not a simple one."[5] Nevertheless;

> "although the relationship between the PSBR and £M3 is erratic from year to year, there is no doubt that public sector borrowing has made a major contribution to the excessive growth of the money supply in recent years .... If interest rates are to be brought down to acceptable levels the PSBR must be substantially reduced as a proportion of GDP over the next few years".[6]

7. We acknowledge the fact that the Government has been very successful in achieving a reduction in the level of inflation. However in succeeding versions of the MTFS, the operation of monetary policy has become increasingly obscure. We have now reached the point where the main instrument for controlling inflation seems to be the manipulation of short term interest rates.[7] The role of £M3, both as a diagnostic indicator of monetary conditions and as an intermediate target has become increasingly unclear. Various other financial indicators, including the exchange rate, are now considered in assessing monetary

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4. MTFS 1980-81 para 4
5. ibid para 4
6. ibid para 4
7. cite

conditions although the Government has never indicated their relative importance.

8. As an intermediate target, £M3 was formally supplemented by PSL2 from 1982-84, and by MO from 1984. It was briefly suspended altogether between October 1985 and March 1986. At various times, including the present, the Government has also appeared to have an implicit exchange rate target. The intention in the original MTFS of allowing interest rates to fall as the PSBR was reduced has been eroded.

9. In our previous reports we have recommended that the House be given greater information about the operation of monetary policy.[8] The Government have preferred, however, to address outside audiences on these matters. Once again, the Autumn Statement contains little on Monetary Policy. Sir Terence Burns told us that an exposition of monetary policy:

> "is not the role of the Autumn Statement. The Autumn Statement presents forecasts of the economy, it presents the figures for public expenditure. Of course, the Chancellor has made a statement about monetary policy in the Mansion House which is also customary at this time of the year. The Autumn Statement is not the occasion for a re-statement of monetary policy."[9]

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8. HC(1985-86)313 Fourth Report from the Treasury and Civil Service Committee paras 14 and 32, HC(1985-86)57 Second Report from the Treasury and Civil Service Committee
9. Q3

The Chancellor referred us to his speech to the Lombard Association.[10] We affirm our previous position. Statements on macro-economic policy should be made in the House so that they may be subject directly to questioning from Members.

10. In his Lombard Association speech the Chancellor maintained that monetary policy had been essentially unchanged since the publication of the first version of the MTFS although there had been subsequent changes in emphasis. He said

> "It is monetary policy that lies at the heart of the MTFS",

and short term interest rates are

> "the essential instrument" of monetary policy.

The guiding principle of policy is:

> "to maintain, ... a level of short term interest rates that will deliver the monetary conditions needed to reduce inflation."

While the original version of the MTFS did not preclude the use of interest rate policy to influence monetary conditions, particularly if there were unforeseen

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10. Q114

developments in the economy, their role in determining monetary policy was not regarded as of great importance.*

The enhanced role, which the Chancellor is now giving to interest rates seems to us to constitute more than a change of emphasis.

11. During questioning the Chancellor confirmed this stance.[11] But the Lombard Association speech continued to lay stress on the role of the monetary targets in assessing the role of monetary conditions:

?

> "Movements in the aggregates outside their target ranges always establishes a presumption (Chancellor's emphasis) in favour of changing short term interest rates.

12. While the government retains £M3 amongst the indicators it takes into account, the Chancellor himself has pointed out on a number of occasions that there has been a major change in the relationship between £M3 and money GDP in recent years.[12] In the 1986 MTFS an 11-15% target range was set for £M3. As Paragraph 1.61 of the Autumn Statement points out, however, £M3 grew at a rate in excess of 18% to mid-September and it has been clear for some months that £M3 growth has been above the target range. This produced no change in the level of short term interest rates. Indeed Para 1.61 of the Autumn Statement seems to argue

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11. Q109
12. See, for example, Mansion House Speech 1985, Lombard Association Speech 1986

* MTFS 1980-81 paras 4 and 16

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might

that given the change in the velocity of circulation caused by innovation and institutional change in the money x might markets, any £M3 number ~~would~~ be consistent with low inflation. When asked if this interpretation was correct the Chancellor replied; "Yes, that is what is implied here, certainly".[13]

13. Nonetheless in his Lombard Association speech the Chancellor justified the retention of £M3 on the grounds that its demise might be interpreted as endorsing the build up of liquidity that is occurring in the economy. We expressed concern at this build up of liquidity in our report on the 1986 Budget.[14] Since that time, there has been little to suggest that the build up of liquidity, graphically described by the Governor of the Bank of England as an overhanging glacier, has declined despite the fact that real interest rates have remained high. We suggested to the Chancellor that there was a danger of the experiences of the early 1970s, when easy credit led to a boom, and subsequent collapse in the property and secondary banking sectors, being repeated. He maintained that:

> "the conditions between 1972 to 1974 and now are as different as chalk and cheese. If you look at MO, if you look at what was happening to public spending and house prices then, if you look at the PSBR as a share of GDP then if you look at what was happening to money GDP and, perhaps most strikingly, if you look at

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13. Q155
14. HC(1985-86)313 Fourth Report of the Treasury and Civil Service Committee, 1985-86 para 54

interest rates, where real interest rates then were, if anything negative whereas now they are at an historically high positive. The differences are quite dramatic."[15]

Nonetheless, the build up of liquidity is also dramatic. Moreover, the behaviour of narrow money (M1) in 1972-74 and that of the present day measure of narrow money MO are not greatly different. We reiterate our anxiety about the build up of liquidity and note that the Governor of the Bank has also recently expressed his concern.[16]

should compare MO wit MO

14. According to the Government, the narrow indicator, MO, continues to occupy an important role in the assessment of financial conditions. Sir Terence Burns pointed out that,

> "one of the reasons for the last increase in interest rates was because the growth of MO, the narrow measure of money had picked up quite sharply".[17]

15. However, we still believe that movements in the exchange rate are having a more profound influence on the government's actions. In both his statement and in subsequent broadcasts the Chancellor placed a considerable emphasis on the exchange rate. In his view sterling has now adjusted downwards sufficiently to offset the balance of payments losses from lower oil prices, "..... the necessary adjustment of the exchange rate to the oil price collapse has now taken place."[18] Accordingly, further

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15. Q130
16. Loughborough Speech
17. Q3
18. Oral Statement

depreciation in the currency would be resisted, presumably through interest rate increases, since intervention has been ruled out except to 'smooth' changes.[19]

16.Once again we questioned both the Chancellor and officials as to whether this stance was the equivalent of an exchange rate policy. Sir Terence Burns told the Committee that the role of the exchange rate in the assessment of policy remained unchanged:

> "we constantly point out that there is not an exchange rate target".[20]

The Chancellor admitted that while he did not wish to see the trade weighted index decline further, he had no intention of announcing an explicit target:

> "The reality of foreign exchange markets, (and this does not apply to monetary ~~makes it very different from~~ targets, ~~the reality of the foreign exchange market~~ would make that in my opinion an unwise course of action".[21]

and,

> "I can quite understand that good people with all the best motives would like greater certainty as to what point one would act in order to affect the exchange rate. On the other hand, that degree of certainty

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19. Q78
20. Q7
21. Q151

would also be playing into the hands of the short-term operators. In practical market management, I do not think it is sensible to be any more explicit that I have been".22

See Terry's comment

17. We acknowledge the difficulties which have arisen following the change from a policy based on straightforward concern with monetary targets to one in which the exchange rate is used to control inflation directly by influencing import prices and indirectly by not validating inflationary wage settlements.

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22. Q~~152~~ 153

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FISCAL STANCE

18. Since 1980 each MTFS has outlined a possible path for the PSBR for a number of years ahead. In successive Budget documents it has been stressed that these figures are illustrative only. Although they are conventionally used in the Autumn Statement forecasts, we have been told in the past that the PSBR for the following year would not be set until Budget time. This year the Chancellor has departed from previous practice, making a commitment in the Autumn Statement to a PSBR figure of 1 3/4% of GDP, the same as in the MTFS. He told the Committee that:

> "I have, ~~...~~ exceptionally, gone further than is usual at this time of the year so as to dispel from the start any worry there might be that the increased planning totals imply a relaxation of ~~fiscal~~ public borrowing. I have therefore explicitly reaffirmed the Government's commitment to the fiscal stance set out in the 1986 MTFS"~~.23~~ and made it clear that the PSBR next year will be held to 1 3/4 % of GDP." 23

X public

19. The announcement of the PSBR target is thus designed to maintain financial market confidence by suggesting that substantial tax cuts will not be forthcoming in the 1987 Budget:

Not quite what you've ever said, but perhaps not unhelpful.

> "As I said in the House in the questioning that followed the Autumn Statement, a pound used in

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23. Q82

expand

additional public expenditure is a pound which is not available for reductions in taxation, unless you are prepared to ~~extend~~ the borrowing requirement, and I have made it clear and explicit that that I will not do"[24]

20. However, although the PSBR target figure is the same as that in the 1986 MTFS, the underlying paths for public expenditure and, hence, taxation are substantially different from that outlined in the MTFS. As well as reducing the PSBR as a percentage of the GDP, the Government has had for several years the objective of reducing the burden of taxation as a method of improving economic incentives and improving overall economic performance. The Green Paper on expenditure into the 1990s[25] saw a return to mid-1960s levels of taxation as a desirable objective and the Chancellor has announced his intention eventually to reduce the standard rate to 25p. When asked whether the increase in spending in 1987/88 of over £4 billion implied that the aim of bringing the standard rate of income tax down to 25p would have to be deferred, the Chancellor replied:

> "Certainly I agree with that. As I said in the House in the questioning that followed the Autumn Statement, a pound in additional public expenditure is a pound which is not available for reductions in taxation, unless you are prepared to ~~extend~~ the borrowing

USED

expand

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24. Q107
25. The Next Ten Years: Public Expenditure and Taxation into the 1990s. Cmnd 9189, 1984

requirement, and I have made it clear that that that I will not do"[26]

21. The Chancellor has committed himself to a target for the PSBR of 1 3/4% of GDP in 1987/88. We asked him how unconditional this target was, given that the 1985 Autumn Statement put the average PSBR forecast error at this time of year at 3/4% of GDP, equivalent to £2½ billion. The Chancellor replied that:

> "I cannot guarantee that at the end of the year the PSBR will in fact turn out to be what I have said at the time of the Budget,"[27] but

> "the important thing which I think the Committee shoud focus on is that they have been told the PSBR will be set at 1 3/4% of GDP, that is a genuine figure, within a margin of error, will be the outcome".[28]

22. The Chancellor also said that in setting the PSBR one of the guidelines was that it:

> "can be comfortably financed in a non-inflationary way,"[29]

even if it does not turn out as expected. However, the Chancellor would not be drawn on the steps the Government would take if it appeared that the PSBR was off-track next year.

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26. Q107
27. Q111
28. Q112
29. Q111

23.On the fiscal stance itself, there appears to be little change over the 1986/87 position, which has been slightly expansionary. Estimates of both the cyclically adjusted PSBR and cyclically adjusted Public Sector Financial Deficit are unchanged from 1986/87 levels.[30] However, there may be some secondary fiscal stimulus from the shift towards increased public spending, which generally has stronger short run effects than reductions in taxes.

Terry doubts this.

24.The Government has been fortunate this year that spending overruns have not led to a higher PSBR than forecast. The reason for this is unexpectedly high non-oil tax revenues due to the phenomenon of "real fiscal drag". Unexpectedly high increases in real earning growth have led to proportionately higher increases in tax revenues due to the progressivity of the tax system.

30. See Table 1 Gavyn Davies' paper

PLANNING TOTALS

25. In paragraph 4 we mentioned the changes which we believe have taken place in the government's policy since 1979. In the original MTFS of 1980 the government announced that:

> "A key element in this strategy is a reduction in public expenditure."[31]

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32. 1986 MTFS, page 14, paragraph 2.25
33. Chancellor's Autumn Statement

"we said ...

"in the document 'The Right Approach to the Economy', which was a ~~stated~~ quasi- economic manifesto published before the 1979 Manifesto proper, that we thought that public expenditure was taking an excessive share of GDP and we wished to see it progressively decline. That theme has been ~~continued~~ there continuously and it is that which accurately describe~~d~~S what has happened since 1982/83. It is that which also characterises the public expenditure plans which are published in the Autumn Statement."[34]

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28. We questioned the Chancellor and officials on this point. The Chancellor replied that:

"if you look at what has actually happened there has been a continued growth in real terms of public expenditure but the growth since 1982 ~~was~~ has been less than the growth of the economy as a whole .... we have improved our performance if you accept the overall

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34. Q84

objective .... the presentation I used in this Autumn Statement accurately represents the reality not merely of what is planned but also what has been happening since 1982/83."[35]

29. Officials from the Treasury took the view that: "[It is] less a change of objective but more a change of the speed at which the object is being achieved".[36]

30. We accept that the current formulation of spending policy represents the government's past achievements and its current ambitions, but it is in our view a modification of the government's previously stated policy for public expenditure over successive planning periods. We have commented before on the realism of cash plans which show overall expenditure being held flat in real terms while previous plans had invariably been exceeded.[37] The Chancellor, in effect, admitted the policy change with regard to the current plans:

> "If you look at the previous planning totals, the 'broadly constant' was a description of a gently rising trend in real terms but by a very small proportion ... and it marked a big improvement on the trend previously. That proved in the event to be over-ambitious, and, therefore, the planning totals have had to be increased slightly although the growth projection
> is still ~~is~~ less than the growth has been in real terms in the past ..."[38].

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35. Q85
36. Q26
37. eg Sixth Report of the TCSC 1984-85 paragraphs 26-29
38. Q93

31. If this development means that the spending plans set out in the Autumn Statement and PEWP more accurately reflect the likely outcome then these documents are rendered more useful and in that sense the change is welcome. However, the change must be regarded as more than presentational if we take seriously the original claim of cutting public expenditure (see paragraph 25).

(i) Outcome in 1986/87

32. The estimated outturn for the planning total in 1986/87 is £140.4 billion. This is approximately £1.3 billion, or about 1%, above the cash plans set out in the 1986 Budget. In real terms, the increase in the planning total is almost 2%, because general inflation has been lower than the Treasury forecast at Budget time. The main reasons for this are a 9% overrun in local authority spending, and unexpected demand led expenditure in the social security area. Even though the main spending overruns are in areas over which the Treasury has little, if any, direct control in the short run, we note that all departments, with one exception, look likely to exceed the cash plans set out in the Budget, despite lower than expected inflation.[39] We also note that during our inquiry on the 1985 Autumn Statement we questioned the likelihood of social security expenditure being held in real terms this year after 3 years of real growth exceeding 4% a year.[40]

Almost all depts have LA spending

39. Table x (Terry Ward's Table 4)
40. Second Report of the TCSC, 1985-86 para 42

33. The underlying increase in the planning total this year over 1984/85 is, in fact, somewhat higher than 2%. Privatisation proceeds are expected to be about £2 billion higher than in 1985/86 and expenditure in 1985/86 was affected by the one-off effects of the ending of the coal strike. Real departmental expenditure (ie the planning total before deduction of privatisation proceeds) is likely to be 3.4% higher than 1985/86[41]. During questioning the Chancellor said that:

> "You ... have to recall that in 1985-86 public expenditure was exceptionally low. I think really it is better to look at the two years from 1984-85 to 1986-87 together. There was a marked dip in 1985-86, as is clear if you look at the graph, which ~~I suppose~~ was partly due to inflation being higher in 1985-86 than we expected. In the same way, of course, inflation has been lower in 1986-87 than expected. If you are on a cash planning system, which we are, then ... you tend to have fluctuations in real terms of that kind"[42]

He added that:

> "The figures in the Autumn Statement would show that even if you exclude privatisation proceeds, then as I say, each year, including 1986-87, on our latest estimates ... there is a reduction [in general government expenditure] as a percentage of GDP"[43]

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41. Table x (from Terry Ward's note)
42. Q97
43. Q98

34. We accept that on this definition public expenditure has continued to decline as a proportion of GDP. Nevertheless a substantial real increase in departmental expenditure, exceeding the growth in GDP, has occurred this year and cash expenditure is likely to exceed the largest ever Reserve by £1.3 billion. In our view the government would have far more cause for satisfaction if departments' real expenditure were showing a decline as a proportion of GDP as well as general government expenditure, especially since the upward trend in departments' real spending continues into 1987/88.

'real' expenditure as a proportion of GDP is a nonsense.

(ii) 1987/88-1989/90

35. £5 billion has been added to the departmental spending plans for 1987/88 announced in the Budget, an increase of about 4% in real terms. About £1 billion of this increase is on capital expenditure, mainly in the areas of housing schools and roads. This is expected to lead to an increase of 2% in departments' real expenditure in 1987/88 over 1986/87. Within the overall increase, the plans for several departments have been increased substantially: Home Office, Education and Housing plans have been increased by more than 10%; Environment, Transport and the Lord Chancellor's Department have been increased by 7-10%. The Chancellor told the House that:

"The public expenditure increases I have announced

> allow us to make realistic provision both for local authority current expenditure, over which the Government has no direct control, and for demand led programmes such as social security, while still leaving scope for increased spending on services to which the Government attaches particular priority"[44]

We regard the £1 billion increase in capital expenditure as welcome, particularly in the light of our previous criticisms of the government's approach to capital spending.[45]

36. The spending plans for 1988/89 are 4.5% higher than at Budget time, with increases as high as 20% in real terms above previous plans in the case of Education. However, although these plans have been revised substantially upward, the overall outturn for departments is intended to be only slightly higher in real terms than 1987/88.[46] In 1989/90 the overall planning total is expected to increase by only about 1% over 1988/89.

37. The profile of the spending plans is thus very familiar. Departmental expenditure will increase substantially above previous plans in the near term, but spending will somehow be restrained after that (the average increase in the final two years of the planning period is planned to be 0.6% a year) to fall below the trend established since 1979 (of around 1.5% a year)[47]

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44. Chancellor's Autumn Statement
45. reference to previous TCSC reports
46. Tables y, z (Terry Ward's Table 1, 3
47. see Graph 1 (Terry Ward's graph)

increase in

38. Despite the relaxation of departmental spending plans, the planning total may be put under pressure again next year. One area of concern is the likelihood of a significant adverse relative price effect against the public sector. Recent increases in teachers' and firemen's pay are not favourable precedents, despite the Chancellor's view that no conclusions should be drawn from the firemen's settlement.[48] Import prices are also likely to rise more quickly than overall domestic prices. Therefore, intended real increases in expenditure may be substantially offset by increases in input prices. Finally, the Reserve has been set some 20% lower than last year even though this year's Reserve has proved some 25% too low.

39. The Chancellor, however, considers that the Reserve will be adequate:

> "The reserves are, with the exception of last year, the highest we have ever had both in absolute terms and as a proportion of the planning total ... This year there is a much bigger increase in local authority current expenditure which we believe to be a realistic estimate and therefore we believe reserves on the scale of last year are not required.[49]

40. We welcome the forward provision for local authority spending this year in place of the unsatisfactory practice of repeating the cash figures for the first year of the

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48. Q106
49. Q105

planning period. However, it will be some time before it becomes clear whether these are realistic estimates.

PROSPECTS

41. The Chancellor views the outlook for the economy in 1987 as one of balanced growth.[50] Overall GDP growth is expected to pick up to 3% in 1987 from the pause experienced after the oil price fall. Within this, manufacturing output is expected to increase by 4% after remaining static in 1986, the growth in exports of goods and servicess is expected to increase from 1% this year to 3% in 1987, imports of goods and services are expected to grow more slowly and investment is expected to continue at relatively high levels. The composition of demand growth is expected to shift slightly away from consumption, with an assumed halt in the decline in the savings ratio. Companies' disposable incomes are expected to rise again in real terms. The RPI is forecast to increase by 3 3/4% in 1987, slightly lower than forecast at Budget time, and the GDP deflator is also expected to increase 3 3/4% in 1987. The current account forecast has been revised substantially both for 1986/~~87~~, in respect of which it is reduced from a £½ billion surplus to a nil balance, and for 1987, where it is reduced from £1½ billion surplus to £1½ billion deficit. ?? [This is mainly due to the unexpectedly slow response to the change in oil prices.] This is mainly due to the initial impact of the fall in oil price.

42. While the Treasury's forecasts are generally in line with those prepared for the Committee,[51] there are some aspects which are subject to a measure of uncertainty. Paragraph 1.50 of the Autumn Statement states that:

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50. Q82
51. See Table x

"With RPI inflation 3 percentage points lower than it was at the start of the last pay round, pay settlements are expected to be a little lower than last year: indeed, there have already been signs of a move towards lower settlements in the private sector in recent months"

Coupled with a rise in productivity, due to the expected increase in manufacturing output, this fall in pay increases could result in a decline in the rate of unit labour cost growth, though to a level still well above most of the UK's competitors. However, the expectation that wage increases will moderate contrasts with paragraph 1.48 which notes that even though price inflation has fallen there has been no decline ~~in the~~ so far in the published figures for the underlying rate of growth in average earnings.

43. We asked officials for the basis of their confidence that wage increases would moderate at a time when profits are still rising, when evidence exists of skill shortages in certain areas and when claims have been made that capacity constraints are emerging. In reply, Sir Terence Burns said:

"There are signs in the CBI settlements, as I understand it, that there has been some small reduction in the rate of settlements and our own monitoring of those figures would support that"[52]

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52. Q60

He also took the view that neither vacancy rates nor capacity utilisation were unduly high, and felt that developments in other developed economies would not be as favourable as perhaps expected.[53] These factors, he felt, could be expected to lead to some decline in domestic pay increases and convergence in unit labour cost movements between the UK and elsewhere. However, Sir Terence agreed that:

> "the growth of labour costs continues to be disturbing."[54].

While we acknowledge these favourable factors, even if they are borne out by events, the gap between unit labour cost changes in the UK and elsewhere, shown in Chart 1.9, will look little different from those of the past three years.

44. If wage increases overall do not fall as expected, other aspects of the forecast could be put under some pressure. A further deterioration in relative unit labour costs might lead to calls for a further exchange rate depreciation to maintain competitiveness. Indeed, even if events turn out as expected some pressure on the exchange rate may develop in the medium term. However, officials noted that:

> "the Chancellor has made clear [that] he is not prepared simply to follow a policy of exchange rate depreciation to validate higher levels of earnings in

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53. Q45
54. Q65

Could add (Qu 142) "The Chancellor added that "to follow this policy would be a complete surrender to inflationary pressures"".

this country relative to those in our competitor countries.[55]

45.On employment, the Autumn Statement notes the growth in total employment of around one million between March 1983 and June 1986. While employment growth in the service industries continued strongly, overall employment growth has slowed recently due to the reduction in output growth. However, the pickup in output growth expected in 1987, together with the favourable demographic outlook, points to a somewhat more favourable prospect for unemployment in the near future, provided the expected fall in pay settlements occurs.

46.The forecast for the current account of the Balance of Payments has been revised substantially downwards since the Budget. Nevertheless, manufactured exports are expected to increase sharply due to growth in world markets and "the lagged benefits of last year's gain in competitiveness."[56] The very substantial fall in the £/DM rate together with the expected benefits of the J-curve effect tend to refinforce this encouraging view.

47.As regards competitiveness, we questioned officials on the consistency of this last factor with the view expressed last year that "the experience of the last five years suggests that export volumes have not been very responsive to price and cost changes."[57]

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55. Q60
56. 1986 Autumn Statement para 1.25
57. 1985 Autumn Statement para ?

Sir Terence Burns told us that:

> "There is no inconsistency in those statements. The statement last year was a relative statement, it was suggesting how response it was compared to some other views which had been expressed. It did not say exports were totally unresponsive."[58]

We suggested that the beneficial effects of exchange rate movements depend on the extent to which they are perceived as permanent. Sir Terence replied that:

> "I would accept that the fact that there are fluctuations in the exchange rate is possibly one reason why factors in the exchange rate are not as great as they have been before".[59]

48. The Committee will continue its inquiries into the nature of the effect of exchange rate changes on exports.

49. On the imports side, the Treasury discounted the large rise in imports seen in recent months.

> "I think it is still early days to be sure to just what extent those [import] pressures will continue.[60]

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It remains to be seen whether the almost flat demand in real terms for imports forecast for 1987[61] is realised.

shows 4½% growt.

It remains to be seen whether import growth will, as forecast, be no faster in 1987 than in 1986.

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58. Q38
59. Q9
60. Q36
61. see Table 1.15 1984 Autumn Statement

Not true: Table 1.15 forecasts 4½% growth of imports in volume terms

However, the Committee accepts Sir Terence Burns's point that the Treasury, in general, do not have a record of over optimistic predictions of the Balance of Payments.[62]

62. Q36

CONFIDENTIAL

FROM: D N WALTERS
DATE: 1 DECEMBER 1986

CHANCELLOR OF THE EXCHEQUER — 1/12
SIR PETER MIDDLETON
SIR TERENCE BURNS
MR CASSELL
MR SEDGWICK
MR TURNBULL
MR ODLING-SMEE
MR PERETZ
MR SCHOLAR

cc Mr Culpin

TCSC'S DRAFT REPORT ON THE AUTUMN STATEMENT

... I attach a copy of the TCSC's draft report on the Autumn Statement. This has been sent to give us an opportunity to correct any factual inaccuracies. I would be grateful for any comments (including nil returns) by close on Tuesday (2 December) in order that I can meet the TCSC's deadline.

** 2. I should stress that the draft has been sent to us on a confidential basis and it should not be revealed that we have it.

I have not sought to correct or amend their own effusions, however tendentious; but I insist that quotations from me (or from the AS) are correct. See accordingly corrections on pp 22 passim.

D N WALTERS

Ch

(1) Great confusion about objectives, indicators & instruments of monetary policy (partly explained by pique that you don't make major statements to them / the House).

(2) Factual corrections to p8, p9, p12, [p23], p25, p26, p29.

AA

(see also note by David Peretz & Terry below)

16/17 December.

Final version (pa)

Rut

TR 278

IN CONFIDENCE

FOR THE USE OF THE COMMITTEE ONLY

F/19

TREASURY AND CIVIL SERVICE COMMITTEE

CHAIRMAN'S DRAFT REPORT

THE CHANCELLOR'S AUTUMN STATEMENT, 1986

cc Mr Kelly
Mr Gray
Miss O'Mara
Mr Pickering

This is a confidential 1st draft of the TCSC report - it may change quite a bit before publication next Wednesday - but you can use this as background for 1st order briefing. I will be circulating a short brief on the report when we have the final version on Tuesday.

CE

5.12.

IN CONFIDENCE

THE CHANCELLOR'S AUTUMN STATEMENT, 1986

INTRODUCTION

1.In preparing our comments on the 1986 Autumn Statement, we took evidence from the Chancellor of the Exchequer, and from Sir Terence Burns, the Chief Economic Adivser to the Treasury and other Treasury officials. To all of those who gave evidence we wish to express our gratitude for their assistance.

2.Our thanks are due also to those who assisted us in the capacity of specialist adviser - Mr Gavyn Davies, Mr Christopher Johnson, Mr Bill Martin, Mr David Savage and Mr Terry Ward. We received help also from the Parliamentary Unit at the University of Warwick.

3.As in previous years we have been supplied with a set of alternative forecasts in order to assess independently the Treasury's Industry Act forecasts. Teams from the Henley Centre, the London Business School, the National Institute for Economic and Social Research and Phillips and Drew submitted two sets of forecasts. The first reflects their own assumptions about major future developments, the second a set of what we assume are the latest Treasury assumptions.

4.In previous reports we have drawn attention to the fact that although the Government has been successful in achieving a number of its economic ends, the manner in which these have been achieved has differed from that originally propounded in successive versions of the Medium Term Financial Strategy (MTFS). It is important that economic policy should be flexible, and able to deal with circumstances not originally foreseen. However, there are limits to the extent to which policy can reasonably be said to exhibit continuity. We think it would be more appropriate, when policy has obviously changed, for the Chancellor to admit it. Otherwise it is more difficult for us to learn lessons from past experience or indeed to ascertain what present policy really is. In this report we draw attention to various important changes which have taken place in the government's policy since 1979.

MONETARY POLICY

POLICY AND TARGETS

5.Since it assumed office the Government's stated economic policy aim has been to bring down the rate of inflation and to create conditions for a sustainable growth of output and employment.[1] To achieve these the Government devised and implemented the Medium Term Financial Strategy (MTFS).

6.As originally enunciated, the MTFS was quite straightforward. Inflation could best be reduced by

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1. FSBR 1980-81 p 16 para 1

reducing the rate of growth of the money stock. Accordingly the Government published a series of money stock targets for the following four years and gave details on how these targets would be realised:

> "The Government believes that its monetary policy can best be formulated if it sets targets for the growth of one of the aggregates against which progress can be assessed. This gives the clearest guidance to those concerned in both financial markets and domestic industry, on which to assess the direction of Government policy and to formulate expectations."[2]

The monetary target chosen was a measure of broad money, £M3:

> "If one aggregate is to be chosen for the target there seems to be considerable agreement that £M3 best suits the present circumstances of the United Kingdom. It is also relatively easy to define in terms of the banking system."[3]

Paragraph 4 of the original MTFS was quite explicit about the manner in which policy would be achieved:

> "It is not the intention to achieve [the] reduction in monetary growth by excessive reliance on interest rates. The Government is therefore planning for a

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2. Green Paper on Monetary Control Cmnd 9858 para 8
3. ibid para 10

> substantial reduction over the medium-term in the Public Sector Borrowing Requirement (PSBR) as a percentage of Gross Domestic Product (GDP)".[4]

The Government viewed the relationship between the PSBR and the growth of the money supply as "not a simple one."[5] Nevertheless;

> "although the relationship between the PSBR and £M3 is erratic from year to year, there is no doubt that public sector borrowing has made a major contribution to the excessive growth of the money supply in recent years .... If interest rates are to be brought down to acceptable levels the PSBR must be substantially reduced as a proportion of GDP over the next few years".[6]

7. We acknowledge the fact that the Government has been very successful in achieving a reduction in the level of inflation. However in succeeding versions of the MTFS, the operation of monetary policy has become increasingly obscure. We have now reached the point where the main instrument for controlling inflation seems to be the manipulation of short term interest rates.[7] The role of £M3, both as a diagnostic indicator of monetary conditions and as an intermediate target has become increasingly unclear. Various other financial indicators, including the exchange rate, are now considered in assessing monetary

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4. MTFS 1980-81 para 4
5. ibid para 4
6. ibid para 4
7. cite

conditions although the Government has never indicated their relative importance.

8. As an intermediate target, £M3 was formally supplemented by PSL2 from 1982-84, and by MO from 1984. It was briefly suspended altogether between October 1985 and March 1986. At various times, including the present, the Government has also appeared to have an implicit exchange rate target. The intention in the original MTFS of allowing interest rates to fall as the PSBR was reduced has been eroded.

9. In our previous reports we have recommended that the House be given greater information about the operation of monetary policy.[8] The Government have preferred, however, to address outside audiences on these matters. Once again, the Autumn Statement contains little on Monetary Policy. Sir Terence Burns told us that an exposition of monetary policy:

> "is not the role of the Autumn Statement. The Autumn Statement presents a forecast~~s~~ of the economy and it presents the figures for public expenditure. Of course, the Chancellor has made a statement about monetary policy in the Mansion House speech which is also customary at this time of the year. The Autumn Statement is not the occasion for a re-statement of monetary policy."[9]

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8. HC(1985-86)313 Fourth Report from the Treasury and Civil Service Committee paras 14 and 32, HC(1985-86)57 Second Report from the Treasury and Civil Service Committee

9. Q~~3~~4

The Chancellor referred us to his speech to the Lombard Association.[10] We affirm our previous position. Statements on macro-economic policy should be made in the House so that they may be subject directly to questioning from Members.

10.In his Lombard Association speech the Chancellor maintained that monetary policy had been essentially unchanged since the publication of the first version of the MTFS although there had been subsequent changes in emphasis. He said

> "It is monetary policy that lies at the heart of the MTFS",

and short term interest rates are

> "the essential instrument" of monetary policy.

The guiding principle of policy is:

> "to maintain, ... a level of short term interest rates that will deliver the monetary conditions needed to reduce inflation."

While the original version of the MTFS did not preclude the use of interest rate policy to influence monetary conditions, particularly if there were unforeseen

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10. Q114

developments in the economy, their role in determining monetary policy was not regarded as of great importance.* The enhanced role, which the Chancellor is now giving to interest rates seems to us to constitute more than a change of emphasis.

11.During questioning the Chancellor confirmed this stance.[11] But the Lombard Association speech continued to lay stress on the role of the monetary targets in assessing ~~the role of~~ monetary conditions:

> "Movements in the aggregates outside their target ranges always establishes a presumption (Chancellor's emphasis) in favour of changing short term interest rates.

12.While the government retains £M3 amongst the indicators it takes into account, the Chancellor himself has pointed out on a number of occasions that there has been a major change in the relationship between £M3 and money GDP in recent years.[12] In the 1986 MTFS an 11-15% target range was set for £M3. As Paragraph 1.61 of the Autumn Statement points out, however, £M3 grew at a rate in excess of 18% to mid-September and it has been clear for some months that £M3 growth has been above the target range. This produced no change in the level of short term interest rates. Indeed Para 1.61 of the Autumn Statement seems to argue

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11. Q109
12. See, for example, Mansion House Speech 1985, Lombard Association Speech 1986

* MTFS 1980-81 paras 4 and 16

that given the change in the velocity of circulation caused by innovation and institutional change in the money markets, any £M3 number ~~would~~ might be consistent with low inflation. When asked if this interpretation was correct the Chancellor replied; "Yes, that is what is implied here, certainly".[13]

13.Nonetheless in his Lombard Association speech the Chancellor justified the retention of £M3 on the grounds that its demise might be interpreted as endorsing the build up of liquidity that is occurring in the economy. We expressed concern at this build up of liquidity in our report on the 1986 Budget.[14] Since that time, there has been little to suggest that the build up of liquidity, graphically described by the Governor of the Bank of England as an overhanging glacier, has declined despite the fact that real interest rates have remained high. We suggested to the Chancellor that there was a danger of the experiences of the early 1970s, when easy credit led to a boom, and subsequent collapse in the property and secondary banking sectors, being repeated. He maintained that:

> "the conditions between 1972 to 1974 and now are as different as chalk and cheese. If you look at MO; if you look at what was happening to public spending and house prices then; if you look at the PSBR as a share of GDP then; if you look at what was happening to money GDP and, perhaps most strikingly, if you look at

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13. Q155
14. HC(1985-86)313 Fourth Report of the Treasury and Civil Service Committee, 1985-86 para 54

interest rates, where real interest rates then were, if anything negative, whereas now they are ~~at an~~ historically high and positive, the differences are quite dramatic."[15]

Nonetheless, the build up of liquidity is also dramatic. Moreover, the behaviour of narrow money (M1) in 1972-74 and that of the present day measure of narrow money MO are not greatly different. We reiterate our anxiety about the build up of liquidity and note that the Governor of the Bank has also recently expressed his concern.[16]

14.According to the Government, the narrow indicator, MO, continues to occupy an important role in the assessment of financial conditions. Sir Terence Burns pointed out that,

> "one of the reasons for the last increase in interest rates was because the growth of MO, the narrow measure of money, had picked up quite sharply".[17]

15.However, we still believe that movements in the exchange rate are having a more profound influence on the government's actions. In both his statement and in subsequent broadcasts the Chancellor placed a considerable emphasis on the exchange rate. In his view sterling has now adjusted downwards sufficiently to offset the balance of payments losses from lower oil prices, "..... the necessary adjustment of the exchange rate to the oil price collapse has now taken place."[18] Accordingly, further

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15. Q130
16. Loughborough Speech
17. Q3
18. Oral Statement

depreciation in the currency would be resisted, presumably through interest rate increases, since intervention has been ruled out except to 'smooth' changes.[19]

16. Once again we questioned both the Chancellor and officials as to whether this stance was the equivalent of an exchange rate policy. Sir Terence Burns told the Committee that the role of the exchange rate in the assessment of policy remained unchanged:

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> "we constantly point out that there is no~~t~~ ~~an~~ exchange rate target".[20]

The Chancellor admitted that while he did not wish to see the trade weighted index decline further, he had no intention of announcing an explicit target:

X

> "The reality of foreign exchange markets, and this does not ~~makes it very different from~~ apply to monetary targets, ~~the reality of the foreign exchange market~~ would make that in my opinion an unwise course of action".[21]

and,

> "I can quite understand that good people with all the best motives would like greater certainty as to what point one would act in order to affect the exchange rate. On the other hand, that degree of certainty

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19. Q78
20. Q7
21. Q151

would also be playing into the hands of the short-term operators. In practical market management, I do not think it is sensible to be any more explicit that I have been".[22]

17. We acknowledge the difficulties which have arisen following the change from a policy based on straightforward concern with monetary targets to one in which the exchange rate is used to control inflation directly by influencing import prices and indirectly by not validating inflationary wage settlements.

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22. Q152

IN CONFIDENCE

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FISCAL STANCE

18.Since 1980 each MTFS has outlined a possible path for the PSBR for a number of years ahead. In successive Budget documents it has been stressed that these figures are illustrative only. Although they are conventionally used in the Autumn Statement forecasts, we have been told in the past that the PSBR for the following year would not be set until Budget time. This year the Chancellor has departed from previous practice, making a commitment in the Autumn Statement ~~to a PSBR figure of~~ that the PSBR in 1987-88 would be held to 1 3/4% of GDP, the same as in the MTFS. He told the Committee that:

> "I have, exceptionally, gone further than is usual at this time of the year so as to dispel from the start any worry there might be that the increased planning totals imply a relaxation of ~~fiscal~~ public borrowing. I have therefore explicitly reaffirmed the Government's commitment to the fiscal stance set out in the 1986 MTFS, and made it clear that the PSBR next year will be held to 1¾ per cent of GDP".[23]

19.The announcement of the PSBR target is thus designed to maintain financial market confidence by suggesting that substantial tax cuts will not be forthcoming in the 1987 Budget:

> "As I said in the House in the questioning that followed the Autumn Statement, a pound used in

23. Q82

additional public expenditure is a pound which is not available for reductions in taxation, unless you are prepared to ~~extend~~ expand the borrowing requirement, and I have made it clear and explicit that that I will not do"[24]

20. However, although the PSBR target figure is the same as that in the 1986 MTFS, the underlying paths for public expenditure and, hence, taxation are substantially different from that outlined in the MTFS. As well as reducing the PSBR as a percentage of the GDP, the Government has had for several years the objective of reducing the burden of taxation as a method of improving economic incentives and improving overall economic performance. The Green Paper on expenditure into the 1990s [25] saw a return to mid-1960s levels of taxation as a desirable objective and the Chancellor has announced his intention eventually to reduce the standard rate to 25p. When asked whether the increase in spending in 1987/88 of over £4 billion implied that the aim of bringing the standard rate of income tax down to 25p would have to be deferred, the Chancellor replied:

> "Certainly I would agree with that. As I said in the House in the questioning that followed the Autumn Statement, a pound used in additional public expenditure is a pound which is not available for reductions in taxation, unless you are prepared to ~~extend~~ expand the borrowing

24. Q107
25. The Next Ten Years: Public Expenditure and Taxation into the 1990s. Cmnd 9189, 1984

requirement, and I have made it clear that that that I will not do"[26]

21. The Chancellor has committed himself to a target for the PSBR of 1 3/4% of GDP in 1987/88. We asked him how unconditional this target was, given that the 1985 Autumn Statement put the average PSBR forecast error at this time of year at 3/4% of GDP, equivalent to £2½ billion. The Chancellor replied that:

> "I cannot guarantee that at the end of the year the PSBR will in fact turn out to be what I have said at the time of the Budget,"[27] but

> "the important thing which I think the Committee should focus on is that they have been told the PSBR will be set at 1 3/4% of GDP, that is a genuine figure, which within a margin of error, will be the outcome".[28]

22. The Chancellor also said that in setting the PSBR one of the guidelines was that it:

> "can be comfortably financed in a non-inflationary way,"[29]

even if it does not turn out as expected. However, the Chancellor would not be drawn on the steps the Government would take if it appeared that the PSBR was off-track next year.

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26. Q107
27. Q111
28. Q112
29. Q111

23. On the fiscal stance itself, there appears to be little change over the 1986/87 position, which has been slightly expansionary. Estimates of both the cyclically adjusted PSBR and cyclically adjusted Public Sector Financial Deficit are unchanged from 1986/87 levels.[30] However, there may be some secondary fiscal stimulus from the shift towards increased public spending, which generally has stronger short run effects than reductions in taxes.

24. The Government has been fortunate this year that spending overruns have not led to a higher PSBR than forecast. [The reason for this is unexpectedly high non-oil tax revenues due to the phenomenon of "real fiscal drag".] Unexpectedly high increases in real earning growth have led to proportionately higher increases in tax revenues due to the progressivity of the tax system.

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(this assertion cannot be derived from AS forecast: Chapter 1.64 describes the upward revision of nearly £2 billion to the forecast of non oil receipts in 1986-87 as 'largely the result of buoyant VAT and corporation tax receipts')

30. See Table 1 Gavyn Davies' paper

PUBLIC EXPENDITURE ~~PLANNING TOTALS~~ TRENDS

25. In paragraph 4 we mentioned the changes which we believe have taken place in the government's policy since 1979. In the original MTFS of 1980 the government announced that:

> "A key element in this strategy is a reduction in public expenditure."[31]

In the 1986 MTFS the government said that:

> "Continued restraint in public spending plays a vital role in the Government's economic strategy. The cash planning totals set by the Government in the White Paper are designed to hold total spending broadly level in real terms"[32]

In the 1986 Autumn Statement the government said that:

> "The Government is determined ... to see to it that total public spending even without taking account of privatisation proceeds, continues to decline as a percentage of GDP"[33]

26. Both the Chancellor and officials maintain that the objective of policy has always been to reduce public expenditure as a proportion of GDP and that this objective is intact. We do not dispute this. As the Chancellor pointed out:

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31. 1980 MTFS, page 16, paragraph 5
32. 1986 MTFS, page 14, paragraph 2.25
33. Chancellor's Autumn Statement

we said....

"in the document 'The Right Approach to the Economy', which was a ~~stated~~ quasi- economic manifesto published before the 1979 Manifesto proper, that we thought that public expenditure was taking an excessive share of GDP and we wished to see it progressively decline. That theme has been ~~continued~~ were continuously and it is that which accurately ~~described~~ describes what has happened since 1982/83. It is that which also characterises the public expenditure plans which are published in the Autumn Statement."34

27. Nonetheless, while it is true that the Government's underlying objective has been to reduce the public expenditure to GDP ratio, spending policy since 1979 has been formulated in stronger terms. Before the shift to cash planning, the operational objective was to reduce public expenditure in volume terms. Since then it has been to hold expenditure constant, or broadly constant, in real terms.

28. We questioned the Chancellor and officials on this point. The Chancellor replied that:

"if you look at what has actually happened there has been a continued growth in real terms of public expenditure but the growth since 1982 ~~was~~ has been less than the growth of the economy as a whole .... we have improved our performance if you accept the overall

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34. Q84

IN CO[illegible]

FOR THE USE OF THE [illegible]

objective .... the presentation I used in this Autumn Statement accurately represents the reality not merely of what is planned but also what has been happening since 1982/83."[35]

29. Officials from the Treasury took the view that: "[It is] less a change of objective but more a change of the speed at which the objective is being achieved".[36]

30. We accept that the current formulation of spending policy represents the government's past achievements and its current ambitions, but it is in our view a modification of the government's previously stated policy for public expenditure over successive planning periods. We have commented before on the realism of cash plans which show overall expenditure being held flat in real terms while previous plans had invariably been exceeded.[37] The Chancellor, in effect, admitted the policy change with regard to the current plans:

> "If you look at the previous planning totals, the 'broadly constant' was a description of a gently rising trend in real terms but by a very small proportion ... and it marked a big improvement on the trend previously. That proved in the event to be over-ambitious, and, therefore, the planning totals have had to be increased slightly although the growth projected is still ~~be~~ less than the growth has been in real terms in the past ..."[38].

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35. Q85
36. Q26
37. eg Sixth Report of the TCSC 1984-85 paragraphs 26-29
38. Q93

31.If this development means that the spending plans set out in the Autumn Statement and PEWP more accurately reflect the likely outcome then these documents are rendered more useful and in that sense the change is welcome. However, the change must be regarded as more than presentational if we take seriously the original claim of cutting public expenditure (see paragraph 25).

(i) Outcome in 1986/87

32.The estimated outturn for the planning total in 1986/87 is £140.4 billion. This is approximately £1.3 billion, or about 1%, above the cash plans set out in the 1986 Budget. In real terms, the increase in the planning total is almost 2%, because general inflation has been lower than the Treasury forecast at Budget time. The main reasons for this are a 9% overrun in local authority spending, and unexpected demand led expenditure in the social security area. Even though the main spending overruns are in areas over which the Treasury has little, if any, direct control in the short run, we note that all departments, with one exception, look likely to exceed the cash plans set out in the Budget, despite lower than expected inflation.[39] We also note that during our inquiry on the 1985 Autumn Statement we questioned the likelihood of social security expenditure being held in real terms this year after 3 years of real growth exceeding 4% a year.[40]

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39. Table x (Terry Ward's Table 4)
40. Second Report of the TCSC, 1985-86 para 42

33. The underlying increase in the planning total this year over 1984/85 1985-86 is, in fact, somewhat higher than 2%. Privatisation proceeds are expected to be about £2 billion higher than in 1985/86 and expenditure in 1985/86 was affected by the one-off effects of the ending of the coal strike. Real departmental expenditure (ie the planning total before deduction of privatisation proceeds) is likely to be 3.4% higher than 1985/86[41]. During questioning the Chancellor said that:

> "You ... have to recall that in 1985-86 public expenditure was exceptionally low. I think that really it is better to look at the two years from 1984-85 to 1986-87 together. There was a marked dip in 1985-86, as is clear if you look at the graph, which ~~I suppose~~ was partly due to inflation being higher in 1985-86 than we expected. In the same way, of course, inflation has been lower in 1986-87 than expected. If you are on a cash planning system, which we are, then ... you tend to have fluctuations in real terms of that kind"[42]

He added that:

> "The figures in the Autumn Statement would show that even if you exclude privatisation proceeds, then as I say, each year, including 1986-87, on our latest estimates ... there is a reduction in public spending ~~[in general government expenditure]~~ as a percentage of GDP"[43]

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41. Table x (from Terry Ward's note)
42. Q97
43. Q98

34. We accept that general government expenditure ~~on this definition public expenditure~~ has continued to decline as a proportion of GDP. Nevertheless a substantial real increase in departmental expenditure, exceeding the growth in GDP, has occurred this year and cash expenditure is likely to exceed the largest ever Reserve by £1.3 billion. In our view the government would have far more cause for satisfaction if departments' real expenditure were showing a decline as a proportion of GDP as well as general government expenditure, especially since the upward trend in departments' real spending continues into 1987/88.

(ii) 1987/88-1989/90

35. £5 billion has been added to the sum of departmental spending and the Reserve[1] plans for 1987/88 compared with the plans announced in the Budget, an increase of about 4% in real terms. About £1 billion of this increase is on capital expenditure, mainly in the areas of housing schools and roads. This is expected to lead to an increase of 2% in departments' real expenditure in 1987/88 over 1986/87. Within the overall increase, the plans for several departments have been increased substantially: Home Office, Education and Housing plans have been increased by more than 10%; Environment, Transport and the Lord Chancellor's Department have been increased by 7-10%. The Chancellor told the House that:

"The public expenditure increases I have announced

1 Equals the planning total less privatisation proceeds

IN CONFIDENCE

FOR THE USE OF THE COMMITTEE

allow us to make realistic provision both for local authority current expenditure, over which the Government has no direct control, and for demand led programmes such as social security, while still leaving scope for increased spending on services to which the Government attaches particular priority"[44]

We regard the £1 billion increase in capital expenditure as welcome, particularly in the light of our previous criticisms of the government's approach to capital spending.[45]

36. The ~~spending plans~~ planning total (less privatisation proceeds) for 1988/89 ~~are~~ is 4.5% higher than at Budget time, with increases as high as 20% in real terms above previous plans in the case of Education. However, although these plans have been revised substantially upward, the overall outturn for departments is intended to be only slightly higher in real terms than 1987/88.[46] In 1989/90 the overall planning total less privatisation proceeds is expected to increase by ~~only~~ about ~~1%~~ 1½% over 1988/89.

37. The profile of the spending plans is thus very familiar. Departmental expenditure (including future allocations from the Reserve) will increase substantially above previous plans in the near term, but spending will somehow be restrained after that (the average increase in the final two years of the planning period is planned to be 0.~~6~~9% a year) to fall below the trend established since 1979 (of around 1.5% a year)[47]

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44. Chancellor's Autumn Statement
45. reference to previous TCSC reports
46. Tables y, z (Terry Ward's Table 1, 3
47. see Graph 1 (Terry Ward's graph)

38. Despite the relaxation of departmental spending plans, the planning total may be put under pressure again next year. One area of concern is the likelihood of a significant adverse relative price effect against the public sector. Recent increases in teachers' and firemen's pay are not favourable precedents, despite the Chancellor's view that no conclusions should be drawn from the firemen's settlement.[48] Import prices are also likely to rise more quickly than overall domestic prices. Therefore, intended real increases in expenditure may be substantially offset by increases in input prices. Finally, the Reserve has been set some 20% lower than last year even though this year's Reserve has proved some 25% too low.

39. The Chancellor, however, considers that the Reserve will be adequate:

> "The reserves are, with the exception of last year, the highest we have ever had both in absolute terms and as a proportion of the planning total ... This year there is a much bigger increase in local authority current expenditure, ~~which~~ what we believe to be a realistic estimate and therefore we believe reserves on the scale of last year are not required.[49]

40. We welcome the forward provision for local authority spending this year in place of the unsatisfactory practice of repeating the cash figures for the first year of the

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48. Q106
49. Q105

planning period. However, it will be some time before it becomes clear whether these are realistic estimates.

PROSPECTS

41. The Chancellor views the outlook for the economy in 1987 as one of balanced growth.[50] Overall GDP growth is expected to pick up to 3% in 1987 from the pause experienced after the oil price fall. Within this, manufacturing output is expected to increase by 4% after remaining static in 1986, the growth in exports of goods and servicess is expected to increase from 1% this year to 3% in 1987, imports of goods and services are expected to grow more slowly and investment is expected to continue at relatively high levels. The composition of demand growth is expected to shift slightly away from consumption, with an assumed halt in the decline in the savings ratio. Companies' disposable incomes are expected to rise again in real terms. ~~The RPI is forecast to increase by 3 3/4% in 1987, slightly lower than forecast at Budget time, and~~ The GDP deflator is also expected to increase 3 3/4% in 1987. The current account forecast has been revised substantially both for 1986, in respect of which it is reduced from a £3½ billion surplus to a nil balance, and for 1987, where it is reduced from £1½ billion surplus to £1½ billion deficit. This is due to the unexpectedly slow response to the change in oil prices.

42. While the Treasury's forecasts are generally in line with those prepared for the Committee,[51] there are some aspects which are subject to a measure of uncertainty. Paragraph 1.50 of the Autumn Statement states that:

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50. Q82
51. See Table x

The RPI is forecast to increase by 3¼ per cent in the year to the fourth quarter of 1986, slightly lower than forecast at Budget time, and by 3¾ per cent in the year to the fourth quarter of 1987;

> "With RPI inflation 3 percentage points lower than it was at the start of the last pay round, pay settlements are expected to be a little lower than last year: indeed, there have already been signs of a move towards lower settlements in the private sector in recent months"

Coupled with a rise in productivity, due to the expected increase in manufacturing output, this fall in pay increases could result in a decline in the rate of unit labour cost growth, though to a level still well above most of the UK's competitors. However, the expectation that wage increases will moderate contrasts with paragraph 1.48 which notes that even though price inflation has fallen there has been no decline so far in the published figures for the underlying ~~in the~~ rate of growth in average earnings.

43. We asked officials for the basis of their confidence that wage increases would moderate at a time when profits are still rising, when evidence exists of skill shortages in certain areas and when claims have been made that capacity constraints are emerging. In reply, Sir Terence Burns said:

> "There are signs in the CBI settlements, as I understand it, ~~that there has been~~ of some small reduction in the rate of settlements. And our own monitoring of those figures would support that"[52]

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52. Q60

He also took the view that neither vacancy rates nor capacity utilisation were unduly high, and felt that developments in other developed economies would not be as favourable as perhaps expected.[53] These factors, he felt, could be expected to lead to some decline in domestic pay increases and convergence in unit labour cost movements between the UK and elsewhere. However, Sir Terence agreed that:

> "the growth of labour costs continues to be disturbing."[54].

While we acknowledge these favourable factors, even if they are borne out by events, the gap between unit labour cost changes in the UK and elsewhere, shown in Chart 1.9, will look little different from those of the past three years.

44. If wage increases overall do not fall as expected, other aspects of the forecast could be put under some pressure. A further deterioration in relative unit labour costs might lead to calls for a further exchange rate depreciation to maintain competitiveness. Indeed, even if events turn out as expected some pressure on the exchange rate may develop in the medium term. However, officials noted that:

> "the Chancellor has made clear [that] he is not prepared simply to follow a policy of exchange rate depreciation to validate higher levels of earnings in

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53. Q45
X 54. ~~Q65~~ 60

this country relative to those in our competitor countries.[55]

45. On employment, the Autumn Statement notes the growth in total employment of around one million between March 1983 and June 1986. While employment growth in the service industries continued strongly, overall employment growth has slowed recently due to the reduction in output growth. However, the pickup in output growth expected in 1987, together with the favourable demographic outlook, points to a somewhat more favourable prospect for unemployment in the near future, provided the expected fall in pay settlements occurs.

46. The forecast for the current account of the Balance of Payments has been revised substantially downwards since the Budget. Nevertheless, manufactured exports are expected to increase sharply due to growth in world markets and "the lagged benefits of last year's gain in competitiveness."[56] The very substantial fall in the £/DM rate together with the expected benefits of the J-curve effect tend to refinforce this encouraging view.

47. As regards competitiveness, we questioned officials on the consistency of this last factor with the view expressed last year that "the experience of the last five years suggests that export volumes have not been very responsive to price and cost changes."[57]

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55. Q60
56. 1986 Autumn Statement para 1.25
57. 1985 Autumn Statement para ?

Sir Terence Burns told us that:

> "There is no inconsistency in those statements. The statement last year was a relative statement. It was suggesting how respons~~e~~ive it was compared to some other views which had been expressed. It did not say exports were totally unresponsive."[58]

We suggested that the beneficial effects of exchange rate movements depend on the extent to which they are perceived as permanent. Sir Terence replied that:

> "I would accept that the fact that there are fluctuations in the exchange rate is possibly one reason why ~~factors in the~~ the short term effects of exchange rate changes are nct as great as they have been ~~before~~ in the past".[59]

48.The Committee will continue its inquiries into the nature of the effect of exchange rate changes on exports.

49.On the imports side, the Treasury discounted the large rise in imports seen in recent months.

> "I think it is still early days to be sure to ~~just~~ what extent those [import] pressures will continue.[60]

It remains to be seen whether the ~~almost flat demand~~ in real terms for imports forecast for 1987[61] is realised.

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58. Q38
59. Q9
60. Q36
61. see Table 1.15 1984 Autumn Statement

(no : Table 1.15 forecasts 4½% growth of imports in volume terms)

However, the Committee accepts Sir Terence Burns's point that the Treasury, in general, do not have a record of over optimistic predictions of the Balance of Payments.[62]

62. Q36

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HOUSE OF COMMONS

First Report from the

TREASURY AND CIVIL SERVICE COMMITTEE

Session 1986–87

MINISTERS AND CIVIL SERVANTS

Together with the Proceedings of the Committee

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FIRST REPORT

MINISTERS AND CIVIL SERVANTS

The Treasury and Civil Service Committee has agreed to the following Report:

INTRODUCTION

1. Our Seventh Report in the last session of Parliament dealt with "Civil Servants and Ministers: Duties and Responsibilities".[1] Subsequently the Government published a reply as Cmnd 9841, on the same day that the Defence Committee published its report on "Westland plc: The Government's Decision-Making".[2] The Government's reply to this was published as Cmnd 9916.

2. We set out this sequence of events, as some of the issues we originally reported on in general terms arose specifically in the Defence Committee's examination of the Westland case. In particular the important question of "Accountability" is discussed in all four documents.

3. We are concerned with the underlying general principles involved rather than the particular circumstances of the Westland case. After they had replied to us, the Government decided to make a new statement on the general principle of Accountability, and the question of whether civil servants should answer questions put to them by select committees, when they replied to the Defence Committee's report. Clearly such a general statement ought to have been included in the Government's reply to us. We therefore respond in this report to both Government replies in so far as they are concerned with the overall relationship between Ministers and civil servants and select committees.

4. Our report on Ministers and Civil Servants dealt specifically with the issue of Accountability and concluded: "We invite and recommend that the Government and other interested parties should produce for reconsideration specific proposals on how the crucial question of Accountability should be dealt with in future."[3]

5. It is unfortunate that the Government made no response to this in their reply to us and, in reply to the Defence Committee's report, stated: "the Government proposes to make it clear to civil servants giving evidence to select committees that they should not answer questions which are or appear to be directed to the conduct of themselves or of other named individual civil servants".[4]

6. This caused grave concern, which was strongly expressed in the debate on the Adjournment which took place on 29 October 1986. However the Leader of the House in winding up the debate stated that no new instructions would be finally and formally issued to civil servants until we and the Liaison Committee had had an opportunity to consider the matter.[5]

7. Consequently, the first part of this report analyses in greater depth than before the question of Accountability, as part of our continuing dialogue with the Government on the relations between Ministers and civil servants. We hope it will also be of assistance to Members of the Liaison Committee and to the House as a whole in considering the practical implications of the Government's proposed instruction to the civil service. The second part deals with the Government's response to other important matters raised in our report on Civil Servants and Ministers.

PART I: THE ISSUE OF ACCOUNTABILITY

ACCOUNTABILITY AND SELECT COMMITTEES

8. We begin by establishing the common ground. In their reply to our Seventh Report the Government "endorsed the Committee's two basic propositions on Accountability: that Ministers and not officials are responsible and accountable for policy; and that officials' advice to Ministers is and should remain confidential". But, as we have already pointed out, "the difficulty arises not with regard to Ministerial policy or official advice but with accountability for actions by civil servants".[6]

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[1] Seventh Report, HC 92–I, 1985–86.
[2] Fourth Report, HC 519, 1985–86.
[3] Seventh Report, para 3.19.
[4] Cmnd. 9916, para 44.
[5] HC Deb (1985–86)103, c. 415–6.
[6] Seventh Report, para 3.17.

9. It is evidently necessary to spell out our earlier arguments in more detail since the Government's response in Cmnd 9916 (paras 39–44) contains a number of misconceptions.

10. First, the Government state that "Select committees exercise their formal powers to inquire into the policies and actions of departments by virtue of the accountability of Ministers to Parliament." This is too narrow a view. It is true that Ministers now normally answer to Parliament in the first instance before a select committee; but this does not mean that the powers of committees depend on or derive from the Accountability of Ministers to Parliament. **Select committees exercise their formal powers to inquire into policy and actions of departments because Parliament is sovereign and has established the select committees to monitor Government departments on its behalf, giving them the traditional powers to send for persons and papers.**

11. There are of course conventions on how these powers should be exercised. In particular, if a witness refuses to appear he may be formally summoned to do so by order of the committee. If he then fails to comply, his conduct may be reported to the House, which will take such steps as it deems necessary. In much the same way, a witness who refuses to answer a question properly put to him may be reported to the House.[1] In either case, the individual concerned can be held guilty of a contempt. The proposal by the Government in Cmnd 9916 to inhibit civil servants in the scope of the evidence they give to select committees, though it might make use of this procedure more frequent, cannot alter the underlying position.

12. At this point, we must consider the Government's reference, in Cmnd 9916, to the report of the 1977–78 Procedure Committee. In support of their views, they quote the following passage:

> "it would not . . . be appropriate for the House to seek directly or through its committees to enforce its rights to secure information from the Executive at a level below that of Ministerial head of the department concerned . . . since such a practice would tend to undermine rather than strengthen the accountability of Ministers to the House."[2]

13. However, the Procedure Commitee stated in their preceding paragraph that "the powers of committees, and the procedure for enforcing these powers, need strengthening . . . Doubts about the rights of committees to seek access to such information . . . could seriously undermine attempts to establish departmentally related committees as effective agencies of the House."[3] In particular, the "appropriateness of questioning Ministers" is to be seen as part of the recommendation (not quoted by the Government in either reply) that "in future select committees should be empowered by the House to order the attendance of Ministers." In view of the emphasis put on the Accountability of Ministers in the Government's replies, it would seem appropriate for the Government to reconsider its response to this recommendation.

The distinction between "actions" and "conduct"

14. In our original report on "Ministers and Civil Servants" we referred to Accountability for the "actions" of civil servants. The Government at the beginning of paragraph 44 of their reply to the Defence Committee's report refer both to "actions or conduct of individual civil servants": but the final sentence of Cmnd 9916 concludes that "civil servants giving evidence to select committees . . . should not answer questions . . . directed to the *conduct* of themselves or of other named civil servants."

15. It is possible to regard the "actions" and "conduct" of civil servants as synonymous. But we think it is important and helpful to define these terms separately, in order to distinguish two different concepts. We therefore define the "actions" of civil servants as those activities which are carried out on the instructions of, or are consistent with the policies of the Minister concerned, while we define "conduct" as activities which fall outside that definition and may indeed amount to "misconduct".

Civil servants' "actions"

16. As far as "actions" are concerned, select committees regularly take evidence from officials concerning their actions. In such cases, there is an implicit assumption that the relevant Minister has given his authority for the answers to be given, and that what officials have done is—unless and until the contrary is proved—on his instruction or in furtherance of his policy. We are in no doubt that it would be quite wrong and entirely unacceptable for any restrictions to be placed

[1] Erskine May, *Parliamentary Practice* (20th edition) pp 697, 747. Attendance of Ministers at a select committee, if they are Members of the House, cannot be compelled by order of the committee, but only by order of the House. (C.J. 1688–93 51 and Erskine May, *op cit.* p 741).
[2] Select Committee on Procedure, First Report, HC (1977–78) 588, para 7.20.
[3] *ibid*, paras 7.19, 7.21, 7,22.

on the giving of such evidence, and we are sure that—on reflection—the Government have no intention of doing any such thing. It is obviously highly desirable that the Government should make this clear.[1]

CIVIL SERVANTS' "CONDUCT"

17. Examination of a civil servant's "conduct" by a select committee—in the sense defined above—is likely to be necessary only in most unusual circumstances—see para 26. It nonetheless raises various points of principle which can best be analysed by reference to the famous but often misunderstood "Crichel Down case".

18. We referred to this in our Seventh Report. In fact the circumstances which led in 1954 to a ministerial resignation following the much criticised conduct of named officials are complex and what has become regarded as the Crichel Down doctrine actually seems to be based on the speech which was made at the time by the then Home Secretary, Sir David Maxwell-Fyfe.[2]

19. He distinguished four situations. In the first, "where there is an explicit order [to an official] by a Minister, the Minister must protect the civil servant who has carried out his order". Secondly, "where the civil servant acts properly in accordance with the policy laid down by the Minister, the Minister must protect and defend him". Thirdly, "where an official makes a mistake or causes some delay, but not on an important issue of policy . . . the Minister acknowledges the mistake and he accepts responsibility although he is not personally involved. He states that he will take corrective action . . . He would not, in those circumstances, expose the official to public criticism". The fourth case is "where action has been taken by a civil servant of which the Minister disapproves and has no prior knowledge, and the conduct of the official is reprehensible, then there is no obligation on the part of the Minister to endorse what he believes to be wrong, or to defend what are clearly shown to be errors of his officers. The Minister is not bound to defend action of which he did not know, or of which he disapproves."[3] The implication in this case is that the official concerned would be identified.

20. The first and second of Sir David Maxwell-Fyfe's cases are dealt with above: conduct covered by the circumstances of the third case is not relevant to our present analysis.

21. It is really the fourth case distinguished by Sir David Maxwell-Fyfe which needs to be considered as far as "conduct" of an individual official is concerned. When there is *prima facie* evidence that an identified civil servant is open to criticism or it emerges in the course of a committee's inquiry that this may be so, should the committee be prevented from establishing the facts of the matter by putting questions to individual civil servants?

22. Three arguments are adduced in paragraph 44 of Cmnd 9916 to support the conclusion that civil servants should not "answer questions which are or appear to be directed to the conduct of themselves or of other named civil servants."

23. First, "the civil servant is liable to be constrained in his answers by his instructions from or his Accountability to his Minister, or by his duty of confidentiality." He may not therefore speak freely in his own defence. Secondly, there is a risk that "the process of questioning may be affected by political considerations." And finally, a select committee inquiry conducted in public and protected by privilege "would give the civil servant concerned no safeguards and no rights, though his reputation and even his career might be at risk."

24. However, these arguments do not appear convincing in the context of officials' "conduct" as we have defined it above. For example, it is difficult to see how party political capital could be made out of a situation in which an official has acted beyond ministerial instructions or policy, except so far as the Minister has failed to prevent it. Even in that circumstance, a committee's criticism would go to the competence of the Minister, regardless of party.

25. It may be that in very exceptional circumstances it could be difficult to ensure absolute fairness, but nonetheless an investigation into the facts may be necessary to protect the public interest. We certainly share the Government's concern that the reputations of civil servants should not be put at risk unfairly. But if there is one thing which is clear from recent events, it

[1] The Public Accounts Committee is in a special position in this regard, partly because of the particular responsibilities of Accounting Officers. But the select committee on the Parliamentary Commissioner for Administration is another where there is a strong presumption that the administrative doings of officials will be a major part of their concern. Many other select committees hear evidence about the actions of officials, depending on the area of administration or policy with which they are concerned.

[2] HC Deb (1953–54)530 c. 1284 ff.

[3] We have, however, made a distinction between "actions" and "conduct"—see para 15.

is that an internal inquiry followed by a statement in the House that there is no need for any further action does not necessarily clear the reputation of the individual whose conduct has been questioned. This is evidently a matter of concern to Ministers, civil servants and Parliament alike. There is therefore a powerful case, when named officials' reputations or careers are at stake, for any future internal inquiry to be conducted on the basis that it will be published.

CONCLUSION

26. We cannot stress too strongly that it is only on very rare occasions that select committees of the House of Commons are likely to come to the conclusion that it is necessary for them, in carrying out the duty laid upon them by the House to monitor the work of Government departments and report on them, to investigate the conduct of individual civil servants. We agree with the Leader of the House that it would be inappropriate for a select committee to set itself up as a disciplinary body. Discipline must be exercised in the traditional way, through the Accountability of Ministers on the floor of the House. But this is not to say that a select committee should not, in appropriate circumstances, question individual civil servants about their conduct. We see no reason to suppose that in doing so they will not act as responsibly in the future as they have in the past. No doubt if an error were detected which was shown to be outside Ministerial instruction or policy, a committee would wish to draw it to the Minister's attention and invite him to comment on it before the committee makes a report to the House.

27. An instruction of the kind which the Government proposes to issue would be open to misinterpretation, and might inhibit civil servants from giving select committees information in the way they have always done. Moreover, in cases where a select committee has reason to suppose that the "conduct" of an individual official may be open to criticism, it is obviously in the interests of both Parliament and the Government that the facts should be established and drawn to the attention of the Minister concerned and to the House. Any instruction which, however rarely, operated so as to make this more difficult is certainly undesirable.

PART II: DUTIES AND RESPONSIBILITIES

28. We turn now to the Government's response to some of the other important proposals in our Seventh Report which have not been covered in Part I. The Government welcomed the Report "as a contribution to the public discussion of a number of important and sensitive issues." But the Report was more than a vehicle for continuing a debate. It contained specific recommendations. On the whole, given the depth of our inquiry and the weight of the evidence submitted in favour of our views by former Prime Ministers, Secretaries of State, Heads of the Civil Service and Permanent Secretaries, the Government response to the recommendations was disappointing. The case for some of our recommendations has been reinforced by recent events. We therefore believe they require further consideration by the Government.

MANAGING THE CIVIL SERVICE

(i) *Ministers*

29. As a matter of principle, and in the interests of leadership and better morale, we considered that there should be a single Minister for the Civil Service, to whom the Head of the Home Civil Service should report.[1] At present, Ministerial responsibility for the civil service is split three ways. The Government "see no grounds for changing the existing organisation at the present time." Although they acknowledge that in arriving at the best way of arranging these functions, much depends on individual policies, priorities and personalities, the Government argue that the Committee's proposal has been found wanting in the past, in that it divorced responsibility for civil service pay and manpower from the Treasury's general responsibility for the central management of expenditure.[2] Maintenance of morale is for senior management at large and the Government as a whole.

30. We readily admit that there are real problems in finding an ideal structure of ministerial responsibilities for the civil service. At the same time, whatever solution is found to the administration problem, the Government must not lose sight of the need to provide, from an identifiable position at the head of that structure, a clear lead to the civil service.

[1] Seventh Report, paras 5.38, 5.44.
[2] Cmnd 9841, paras 37, 40, 42.

(ii) *The Cabinet Secretary and Head of the Civil Service*

31. We recommended that the posts of Secretary to the Cabinet and Head of the Home Civil Service should not be combined in future, on grounds of workload and possible conflict of interest.[1]

32. We also suggested that there was need for a "leadership ethos" or single responsibility at official as well as ministerial level for restoring morale in the civil service. We agree with the Government that this is a matter for the Government as a whole, but it does not follow that there is no need for someone to give a lead.

33. As to workload, the Government does no more than assert that "provided that the incumbent delegates sensibly, his burden is manageable".[2] Our recommendation, however, was based on views of (among others) a former Prime Minister, two former Heads of the Civil Service, and two ex-Permanent Secretaries. All of them thought the combined job created an excessive workload (or might give rise to conflicts of interest.) Our view that the need for the Cabinet Secretary to travel abroad made it difficult to combine that responsibility with the post of Head of the Civil Service reinforced our recommendation.

34. Weighty evidence also supported the conclusion that combining the two posts created a risk of conflict of interest. This view was shared by another ex-Prime Minister, and a former Departmental Permanent Secretary. We do not accept the Government view that, since the Head of the Civil Service cannot take up a public position in advocating the interests of the civil service, there can be no conflict of interest. Such conflicts may very well arise, even though they are not made public.

35. We note that in their reply to the Defence Committee[3] the Government quoted our conclusion regarding the problem created by the "dual role" of one individual who combines the posts of the Head of the Civil Service and Cabinet Secretary, and the conclusion that "the Government sees no grounds for changing the existing organisation at the present time."

36. We recognise that to make a change when the present incumbent is fulfilling both functions would involve some dislocation but our view on the principle is unchanged.

AN APPEALS MECHANISM

37. We welcome the Government's acceptance of our proposal that that Head of the Civil Service should be prepared personally to consider appeals from officials who have followed procedures but whose crises of conscience remain unresolved.[4] We accept of course that this procedure should not cover disciplinary or straightforwardly personnel issues, and frivolous or vexatious appeals should be prohibited. The Government advance no reason, however, for not applying these principles, *mutatis mutandis*, to the Diplomatic Service and the Northern Ireland Civil Service. We think officials in these bodies should enjoy the same privileges in this matter as the Home Civil Service.

PRESS AND INFORMATION OFFICERS

38. Press and information officers, it seemed to us, might come under particular pressure to act in a political manner: in consequence, Ministers who required these officers to do more than present and describe their policies should (we recommended) make political appointments.[5] The Government do not accept this proposal,[6] on the grounds that it is difficult in practice to draw a sharp line between "presenting and describing" and "justifying and defending" policies. In their view, the real distinction is between the policy of the government and the party political dimensions of that policy. We are by no means convinced. It is obviously difficult to draw a clear distinction both between party political and government information policies and between factual description and persuasion and justification. In cases where there is likely to be any doubt, therefore, a press officer should be a political and not an official appointee. Otherwise, a civil servant carrying out the duties of a press officer may find himself open to accusations of partisan bias.

[1] Seventh Report, para 5.44. Our view was shared by the Defence Committee, following their inquiry into decision-making in connection with Westland plc, Fourth Report, HC519(1985–86) para 214.
[2] Cmnd 9841, para 40–41.
[3] Cmnd 9916, para 33.
[4] *Ibid.* paras 4.12-4.16: Cmnd 9841, para 19.
[5] Seventh Report, para 5.20.
[6] Cmnd 9841, para 29.

Outside appointments

39. While preserving the character of a career service, we argued for regular infusions, temporary and permanent, of highly motivated people of proven ability into the higher civil service.[1] We are glad to note that the Government's reaction does not significantly vary from our prescription.[2]

Special advisers and cabinets

40. In our original report, we proposed that the British system of discrete groupings round a senior Minister—junior ministerial colleagues and Parliamentary private secretary, private office and special advisers—should move closer to a situation in which each Minister appoints a *cabinet* to assist him in running his Department. In fact our proposal approximated more closely to an expanded private office than a *cabinet*: but to emphasise that it was more than a private office we proposed to call it a Minister's Policy Unit. We recommended that a full experiment should be conducted in more than one Department, in order to assess the effectiveness of the Policy Unit.[3]

41. This seemed to us a cautious proposal, as the Government appear to recognise. Given limitation of cost and of numbers (a point which we ourselves made) the Government response accepted that there would be no constitutional difficulty in formalising and extending the existing arrangements as we proposed. Such a Unit would be "another possible way" of arranging ministerial support; "there may not be a substantial gap between the arrangements as they have evolved within many Ministers' offices and the thrust of the views expressed by the Committee." We are not unappreciative of the spirit in which the suggestion was received, but the Government have drawn back from any degree of commitment. They prefer "not [to] rule out the possibility of further evolution of existing arrangements in the direction the Committee may have in mind".[4] In the absence of any argument against experimenting in the way we have recommended, and the relatively small divergence between existing arrangements and the first stage of our proposal, we hope the Government will go ahead with such an experiment.

1st December, 1986

[1] Seventh Report, para 5.18.
[2] Cmnd 9841, paras 26–28.
[3] Seventh Report, paras, 5.23, 5.28–32.
[4] Cmnd 9841, paras 31, 35.

PROCEEDINGS OF THE COMMITTEE RELATING TO CONSIDERATION OF THE REPORT

MONDAY 1 DECEMBER 1986

Members present:

Mr Terence L Higgins, in the Chair

Mr Anthony Beaumont-Dark
Mr John Browne
Mr Ralph Howell
Mr Austin Mitchell
Mr John Townend
Mr Richard Wainwright
Mr John Watts

Draft Report (Ministers and Civil Servants), proposed by the Chairman, brought up and read.

Ordered, That the draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 18 read and agreed to.

Paragraph 19 read, amended and agreed to.

Paragraphs 20 to 24 read and agreed to.

Paragraphs 25 and 26, read, amended and agreed to.

Paragraph 27 read and agreed to.

Paragraph 28 read, amended and agreed to.

Paragraphs 29 to 35 read and agreed to.

Paragraph 36 read, amended and agreed to.

Paragraph 37 read and agreed to.

Paragraphs 38 and 39 read, amended and agreed to.

Paragraphs 40 and 41 read and agreed to.

Ordered, That the Report, as amended, be the First Report of the Committee to the House.

Ordered, That the Chairman do make the report to the House.

Ordered, That the provisions of Standing Order No. 116 (Select committees (reports)) be applied to the Report.

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Ch

I have been checking TCSC report against our corrections. The only one of your points they have (perversely) ignored is in Para 33, where you had amended the end of the quote to read "although the growth projected is still less than" (instead of "although the growth still is less than")

AA.

CE2

CONFIDENTIAL

FROM: MISS C EVANS
DATE: 9 DECEMBER 1986

not seen

1. **MR SCHOLAR**

2. **CHANCELLOR OF THE EXCHEQUER**

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir Peter Middleton
Sir Terence Burns
Sir Geoffrey Littler
Mr F E R Butler
Mr Anson
Mr Cassell
Mr Kemp
Mr Monck
Mr Turnbull
Mr Sedgwick
Mr Odling-Smee
Mr Peretz
Mr Culpin
Miss O'Mara
Mr Gray
Mr Kelly
Mr Riley
Mr Dyer

TCSC REPORT ON THE AUTUMN STATEMENT

You have a copy of the final revise of the TCSC report which will be published at 4pm tomorrow. We have received this proof in confidence and it should not be revealed that we have it.

2. The Committee have taken on board most of the amendments we suggested to the earlier version. There are a number of new sections which make the report rather more critical than before, as follows:

para 7 which maintains that the rate of inflation has remained broadly unchanged since 1983 and has fallen in 1986 mainly because of the fall in commodity prices;

para 10 includes a recommendation that statements on macro economic policy should be made in the House (the context suggests that the Committee mean statements on monetary policy)

para 15 says that the Committee is not convinced that MO is an efficient index of true monetary conditions

para 18 notes 'the disappearance of the Treasury's former claim for the MTFS, that it would damp down inflationary expectations'

para 19 claims that 'monetary policy is uncertain because the Government wishes both to prevent interest rates from rising and the exchange rate from falling'

and quotes PM's FT interview.

CONFIDENTIAL

in <u>paras 22-24</u> the Committee say that in setting the PSBR 'the maintenance of financial market confidence has been given absolute priority' but claim that the PSBR pledge is not as binding as it appears.

<u>para 25</u> 'the Government's rationale for particular targets for the PSBR is obscure'

<u>para 26</u> 'we consider that the Government's own strategies should now concentrate on the far more relevant and useful figure of the Public Sector Financial Deficit'

<u>para 27</u> says that buoyant tax revenue could finance tax cuts with the result that fiscal policy will then have become pro-cyclical.

3. The conclusions are contained in a new para 53 which refers to 'substantial changes' in policy on public expenditure, the money supply and exchange rates and interest rates.

4. The report contains only one specific recommendation (in para 10) that statements on macro economic policy should be made to the House. There is also an implied recommendation (in para 26) that policy should concentrate on the Public Sector Financial Deficit.

5. I shall be letting Mr Culpin have a line to take on the report.

Carys Evans

MISS C EVANS

CE2

CONFIDENTIAL

Mr Walters to second return p-

PWP

FROM: MISS C EVANS
DATE: 9 DECEMBER 1986

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2. CHANCELLOR OF THE EXCHEQUER

Spare

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir Peter Middleton
Sir Terence Burns
Sir Geoffrey Littler
Mr F E R Butler
Mr Anson
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Carys Evans

MISS C EVANS

SECOND REPORT

The Treasury and Civil Service Committee has agreed to the following Report:

THE GOVERNMENT'S ECONOMIC POLICY: AUTUMN STATEMENT

INTRODUCTION

1. In preparing our comments on the 1986 Autumn Statement, we took evidence from the Chancellor of the Exchequer, and from Sir Terence Burns, the Chief Economic Adviser to the Treasury and other Treasury officials. To all of those who gave evidence we wish to express our gratitude for their assistance.

2. Our thanks are due also to those who assisted us in the capacity of specialist adviser—Mr Gavyn Davies, Mr Christopher Johnson, Mr Bill Martin, Mr David Savage and Mr Terry Ward. We received help also from the Parliamentary Unit at the University of Warwick.

3. As in previous years we have been supplied with a set of alternative forecasts in order to assess independently the Treasury's Industry Act forecasts. Teams from the Henley Centre, the London Business School, the National Institute for Economic and Social Research and Phillips and Drew submitted two sets of forecasts. The first reflects their own assumptions about major future developments, the second a set of what we assume are the latest Treasury assumptions.

4. In previous reports we have drawn attention to the fact that, although the Government has been successful in achieving a number of its economic ends, the manner in which these have been achieved has differed from that originally propounded in successive versions of the Medium Term Financial Strategy (MTFS). It is important that economic policy should be flexible, and able to deal with circumstances not originally foreseen, but we think it would be more appropriate, when policy has obviously changed, for the Chancellor to admit it. Otherwise it is more difficult for us to learn lessons from past experience or indeed to ascertain what present policy really is. In this report we draw attention to various important changes which have taken place in the Government's policy since 1979.

Monetary Policy and Targets

5. Since it assumed office the Government's stated economic policy aim has been to bring down the rate of inflation and to create conditions for a sustainable growth of output and employment.[1] To achieve these the Government devised and implemented the Medium Term Financial Strategy (MTFS).

6. As originally enunciated, the MTFS was quite straightforward. Inflation could best be reduced by reducing the rate of growth of the money stock. Accordingly the Government published a series of money stock targets for the following four years and gave details on how these targets would be realised:

> "The Government believes that its monetary policy can best be formulated if it sets targets for the growth of one of the aggregates against which progress can be assessed. This gives the clearest guidance to those concerned in both financial markets and domestic industry, on which to assess the direction of Government policy and to formulate expectations."[2]

The Monetary target chosen was a measure of broad money, £M3:

> "If one aggregate is to be chosen for the target there seems to be considerable agreement that £M3 best suits the present circumstances of the United Kingdom. It is also relatively easy to define in terms of the banking system."[3]

Paragraph 4 of the original MTFS was quite explicit about the manner in which policy would be achieved:

> "It is not the intention to achieve [the] reduction in monetary growth by excessive reliance on interest rates. The Government is therefore planning for a substantial reduction over the medium-term in the Public Sector Borrowing Requirement (PSBR) as a percentage of Gross Domestic Product (GDP)".[4]

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[1] FSBR, 1980–81, p. 16 para 1.
[2] Green Paper on Monetary Control, Cmnd 9858 para 8.
[3] ibid para 10.
[4] MTFS, 1980–81, para 4

The Government viewed the relationship between the PSBR and the growth of the money supply as "not a simple one."[1] Nevertheless:

> "although the relationship between the PSBR and £M3 is erratic from year to year, there is no doubt that public sector borrowing has made a major contribution to the excessive growth of the money supply in recent years . . . If interest rates are to be brought down to acceptable levels the PSBR must be substantially reduced as a proportion of GDP over the next few years".[2]

7. We acknowledge the fact that the Government was very successful both in achieving a reduction in the PSBR and in the level of inflation. But since its first term in office, the rate of inflation has remained broadly unchanged, and has declined in 1986 mainly because of the steep fall in oil and other commodity prices. Domestic symptoms of inflation have not been greatly affected, and wage rises in particular have shown no significant tendency to come down.

8. In successive versions of the MTFS, the operation of monetary policy has become increasingly obscure. We have now reached the point where the main instrument for controlling inflation seems to be the manipulation of short term interest rates.[3] The role of £M3, both as a diagnostic indicator of monetary conditions and as an intermediate target has become increasingly unclear. Various other financial indicators, including the exchange rate, are now considered in assessing monetary conditions although the Government has never indicated their relative importance.

9. As an intermediate target, £M3 was formally supplemented by PSL2 from 1982–84, and by MO from 1984. It was briefly suspended altogether between October 1985 and March 1986. At various times, including the present, the Government has also appeared to have an implicit exchange rate target. The intention in the original MTFS of allowing interest rates to fall as the PSBR was reduced has been eroded.

10. In our previous reports we have recommended that the House be given greater information about the operation of monetary policy.[4] The Government have preferred, however, to address outside audiences on these matters. Once again, the Autumn Statement contains little on Monetary Policy. Sir Terence Burns told us that an exposition of monetary policy:

> "is not the role of the Autumn Statement. The Autumn Statement presents a forecast of the economy and it presents the figures for public expenditure. Of course, the Chancellor has made a statement about monetary policy in the Mansion House Speech which is also customary at this time of the year. The Autumn Statement is not the occasion for a re-statement of monetary policy."[5]

The Chancellor referred us to his speech to the Lombard Association.[6] We affirm our previous position, namely that statements on macro-economic policy should be made in the House so that they may be subject directly to questioning from Members, and **we so recommend.**

11. In his Lombard Association speech, the Chancellor maintained that monetary policy had been essentially unchanged since the publication of the first version of the MTFS although there had been subsequent changes in emphasis. He said:

> "It is monetary policy that lies at the heart of the MTFS",

and short term interest rates are:

> "the essential instrument" of monetary policy.

The guiding principle of policy is:

> "to maintain . . . a level of short term interest rates that will deliver the monetary conditions needed to reduce inflation."

While the original version of the MTFS did not preclude the use of interest rate policy to influence monetary conditions, particularly if there were unforeseen developments in the economy, their role in determining monetary policy was not regarded as of great importance.[7] The enhanced role, which the Chancellor is now giving to interest rates seems to us to constitute more than a change of emphasis.

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[1] ibid para 4.
[2] ibid para 4.
[3] 1986 Autumn Statement, para 1.59.
[4] HC(1985–86)313: Fourth Report from the Treasury and Civil Service Committee, paras 14 and 32; HC(1985–86)57: Second Report from the Treasury and Civil Service Committee.
[5] Q. 4.
[6] Q. 114.
[7] MTFS, 1980–81, paras 4 and 16.

12. During questioning the Chancellor confirmed this stance.[1] But the Lombard Association speech continued to lay stress on the role of the monetary targets in assessing monetary conditions:

> "Movements in the aggregates outside their target ranges always establishes a *presumption* (Chancellor's emphasis) in favour of changing short term interest rates.

13. Although the Government retains £M3 amongst the indicators it takes into account, the Chancellor himself has pointed out on a number of occasions that there has been a major change in the relationship between £M3 and money GDP in recent years.[2] In the 1986 MTFS an 11–15 per cent target range was set for £M3. As Paragraph 1.61 of the Autumn Statement points out, however, £M3 grew at a rate in excess of 18 per cent to mid-September and it has been clear for some months that £M3 growth has been above the target range. This produced no change in the level of short term interest rates. Indeed Para 1.61 of the Autumn Statement seems to argue that, given the change in the velocity of circulation caused by innovation and institutional change in the money markets, any £M3 number might be consistent with low inflation. When asked if this interpretation was correct the Chancellor replied: "Yes, that is what is implied here, certainly".[3]

14. Nonetheless, in his Lombard Association speech the Chancellor justified the retention of £M3 on the grounds that its demise might be interpreted as endorsing the build up of liquidity that is occurring in the economy. We expressed concern at this build up of liquidity in our report on the 1986 Budget.[4] Since that time, there has been little to suggest that the build up of liquidity, graphically described by the Governor of the Bank of England as an overhanging glacier, has declined despite the fact that real interest rates have remained high. We suggested to the Chancellor that there was a danger of the experiences of the early 1970s, when easy credit led to a boom and subsequent collapse in the property and secondary banking sectors, being repeated. He maintained that:

> "the conditions between 1972 to 1974 and now are as different as chalk and cheese. If you look at MO, if you look at what was happening to public spending and house prices then; if you look at the PSBR as a share of GDP then; if you look at what was happening to money GDP and, perhaps most strikingly, if you look at interest rates, where real interest rates then were, if anything negative, whereas now they are historically high and positive, the differences are quite dramatic."[5]

Nonetheless, the build up of liquidity is also dramatic. Moreover, the behaviour of narrow money (M1) in 1972–74 and that of the present day measure of narrow money MO are not greatly different. We reiterate our anxiety about the build up of liquidity and note that the Governor of the Bank has also recently expressed his concern.[6]

15. According to the Government, the narrow indicator, MO, continues to occupy an important role in the assessment of financial conditions. Sir Terence Burns pointed out that:

> "one of the reasons for the last increase in interest rates was because the growth of MO, the narrow measure of money, had picked up quite sharply".[7]

We have not been convinced that MO is an efficient index of true monetary conditions.

16. However, we still believe that movements in the exchange rate are having a more profound influence on the government's actions. In both his statement and in subsequent broadcasts the Chancellor placed a considerable emphasis on the exchange rate. In his view sterling has now adjusted downwards sufficiently to offset the balance of payments losses from lower oil prices, " . . . the necessary adjustment of the exchange rate to the oil price collapse has now taken place."[8] Accordingly, further depreciation in the currency would be resisted, presumably through interest rate increases, since intervention has been ruled out except to "smooth" changes.[9]

17. Once again we questioned both the Chancellor and officials as to whether this stance was the equivalent of an exchange rate policy. Sir Terence Burns told the Committee that the role of the exchange rate in the assessment of policy remained unchanged:

[1] Q. 109.
[2] See, for example, Mansion House Speech 1985, Lombard Association Speech 1986.
[3] Q. 155.
[4] HC(1985–86)313: Fourth Report of the Treasury and Civil Service Committee, 1985–86, para 54.
[5] Q. 130.
[6] Governor of the Bank of England's Mansion House Speech, 1986.
[7] Q. 3.
[8] H.C. Deb., 1986–87, Vol. 103, col. 1086.
[9] Q. 78.

"we constantly point out that there is no exchange rate target".[1]

The Chancellor admitted that, while he did not wish to see the trade weighted index decline further, he had no intention of announcing an explicit target:

"The reality of foreign exchange markets, and this does not apply to monetary targets, would make that in my opinion an unwise course of action"[2]

and:

"I can quite understand that good people with all the best motives would like greater certainty as to what point one would act in order to affect the exchange rate. On the other hand, that degree of certainty would also be playing into the hands of the short-term operators. In practical market management, I do not think it is sensible to be any more explicit than I have been".[3]

18. We acknowledge the difficulties which have arisen following the change from a policy based on straightforward concern with monetary targets to one in which the exchange rate is used to control inflation directly by influencing import prices and indirectly by not validating inflationary wage settlements. We note the disappearance of the Treasury's former claim for the MTFS, that it would damp down inflationary expectations.

19. We believe that monetary policy is uncertain because the government wishes both to prevent interest rates from rising and the exchange rate from falling. As the Prime Minister said in her interview to the Financial Times of 19 November 1986: "I do not want interest rates any higher." But, asked about the sterling D-Mark rate, she said "I think it has gone low enough". Clearly it may be impossible for both objectives to be achieved. The danger is that the Government, by not committing itself firmly to either objective, may weaken market confidence to such a point that neither is achieved.

Fiscal Stance

20. Since 1980 each MTFS has outlined a possible path for the PSBR for a number of years ahead. In successive Budget documents it has been stressed that these figures are illustrative only. Although they are conventionally used in the Autumn Statement forecasts, we have been told in the past that the PSBR for the following year would not be set until Budget time. This year the Chancellor has departed from previous practice, making a commitment in the Autumn Statement that the PSBR in 1987–88 would be held to $1\frac{3}{4}$ per cent of GDP, the same as in the MTFS. He told the Committee that:

"I have, exceptionally, gone further than is usual at this time of year so as to dispel from the start any worry there might be that the increased planning totals imply a relaxation of public borrowing. I have therefore explicitly reaffirmed the Government's commitment to the fiscal stance set out in the 1986 MTFS, and made it clear that the PSBR next year will be held to $1\frac{3}{4}$ per cent of GDP".[4]

21. The announcement of the PSBR target is thus designed to maintain financial market confidence by suggesting that substantial tax cuts will not be forthcoming in the 1987 Budget:

"As I said in the House in the questioning that followed the Autumn Statement, a pound used in additional public expenditure is a pound which is not available for reductions in taxation, unless you are prepared to expand the borrowing requirement, and I have made it clear and explicit that that I will not do"[5]

22. The increase in public spending has therefore absorbed resources which might otherwise have been available for tax cuts (or reduced borrowing, which might have led to lower interest rates). Accordingly it seems that the Government's long-stated aim of reducing the basic rate of income tax to 25p[6] will have to be deferred. Beyond that, the Chancellor made it clear that the PSBR ceiling of $1\frac{3}{4}$ per cent of GDP for 1987–88 was unconditional and would not be altered even if there were significant changes in the economic environment. Evidently the maintenance of financial market confidence has been given absolute priority and the pursuit of other objectives, which might possibly require a different PSBR, has been subordinated to this.

23. At the same time, it was acknowledged by the Chancellor that any forecast for the PSBR made at this time of year is subject to a margin of error.[7] The 1985 Autumn Statement put the

[1]Q. 7.
[2]Q. 151.
[3]Q. 152.
[4]Q. 82.
[5]Q. 107.
[6]See, for example, the Conservative Party Manifesto, 1979.
[7]Q. 111.

average error at ¾ per cent of GDP (equivalent to £2½ billion). The margin of error is only slightly less for any figure announced at Budget time. This means that any PSBR target does not have precise implications for taxation, nor is any figure precisely verifiable. The constraint on fiscal policy entailed by the Chancellor's firm commitment to a PSBR figure for next year is therefore not as binding as it might appear to be at first sight. Moreover present accounting conventions (as regards the treatment of asset sales in particular) provide additional scope for adjusting policy, should the need arise, without infringing the PSBR target.

24. As the Chancellor said:

"I cannot guarantee that at the end of the year the PSBR will in fact turn out to be what I have said at the time of the Budget,"[1] but

"the important thing which I think the Committee should focus on is that they have been told the PSBR will be set at 1¾ per cent of GDP; that is a genuine figure, which within a margin of error, will be the outcome".[2]

The Chancellor also said that in setting the PSBR one of the guidelines was that it:

"can be comfortably financed in a non-inflationary way"[3]

even if it does not turn out as expected. However, the Chancellor would not be drawn on the steps the Government would take if it appeared that the PSBR was off-track next year.

25. What *has* changed since the Budget Statement is the Treasury's assessment of the UK's balance of payments position, which is now substantially worse than previously expected. It is questionable in the light of such changed circumstances whether it is appropriate to maintain unchanged the Government's original borrowing target. But as we noted in our review of the 1986 Budget, the Government's rationale for particular targets for the PSBR is obscure. The target appears now to be chosen more by presentational need than by a considered appraisal of economic realities. In short, what the MTFS now lacks is a coherent framework for the setting of fiscal policy.

26. The original intention of focussing attention on the public sector borrowing requirement was to create a climate of rational expectations by making Government intentions absolutely clear. Since the PSBR is, for various reasons, an ambiguous measure, and since the figures are further confused by the then unanticipated scale of asset scales, currently running at a very high level and forecast to go even higher, we consider that public debate and the government's own strategies should now concentrate on the far more relevant and useful figure of the Public Sector Financial Deficit. For the year ahead our estimates are that this will run at £14½ billion and the following table shows its increase compared to the PSBR for each year since 1979.

Table 1
PSBR and Public Sector Financial Deficit since 1979

£ billion

	1979–80	1980–81	1981–82	1982–83	1983–84	1984–85	1985–86	1986–87	1987–88
PSBR	10.0	12.7	8.6	8.9	9.8	10.2	5.8	7.7	7*
PSFD	7.9	11.5	6.2	8.4	12.1	13.8	10.25	12**	14.5**

*From MTFS, 1986–87, Table 2.5
**See Table 3 Appendix 1.

27. The Government has been fortunate this year that spending overruns have not led to a higher PSBR than forecast. At paragraph 1.64, the Autumn Statement describes the upward revision of nearly £2 billion to the forecast of non-oil receipts in 1986–87, as "largely the result of buoyant VAT and corporation tax receipts." Unexpectedly high increases in earning growth have also led to proportionately higher increases in tax revenues due to the progressivity of the tax system. A similar process could occur in 1987. Sufficient buoyancy of tax revenue, fuelled by economic growth, could provide the Government with an opportunity to finance both the extra public expenditure announced in the Autumn Statement and cuts in the rate of income tax. If this occurs, fiscal policy will then have become pro-cyclical in nature, boosting through tax cuts an economy already in recovery.

[1]Q. 111.
[2]Q. 112.
[3]Q. 111.

Planning Totals

28. In paragraph 4 we mentioned the changes which we believe have taken place in the Government's policy since 1979. In the original MTFS of 1980 the Government announced that:

"A key element in this strategy is a reduction in public expenditure."[1]

In the 1986 MTFS the Government said that:

"Continued restraint in public spending plays a vital role in the Government's economic strategy. The cash planning totals set by the Government in the White Paper are designed to hold total spending broadly level in real terms"[2]

In the 1986 Autumn Statement the Government said that:

"The Government are determined . . . to see to it that total public spending even without taking account of privatisation proceeds, continues to decline as a percentage of GDP"[3]

29. Both the Chancellor and officials maintain that the objective of policy has always been to reduce public expenditure as a proportion of GDP and that this objective is intact. We do not dispute this. As the Chancellor pointed out:

"we said . . . in the document 'The Right Approach to the Economy', which was a quasi economic manifesto published before the 1979 Manifesto proper, that we thought that public expenditure was taking an excessive share of GDP and we wished to see it progressively decline. That theme has been there continuously and it is that which accurately describes what has happened since 1982/83. It is that which also characterises the public expenditure plans which are published in the Autumn Statement."[4]

30. Nonetheless, while it is true that the Government's underlying objective has been to reduce the public expenditure to GDP ratio, spending policy since 1979 has been formulated in stronger terms. Before the shift to cash planning, the operational objective was to reduce public expenditure in volume terms. Since then it has been to hold expenditure constant, or broadly constant, in real terms.

31. We questioned the Chancellor and officials on this point. The Chancellor replied that:

"if you look at what has actually happened there has been a continued growth of public expenditure in real terms but the growth since 1982 has been less than the growth of the economy as a whole . . . we have improved our performance if you accept the overall objective . . . the presentation I used in this Autumn Statement accurately represents the reality not merely of what is planned but also what has been happening since 1982/83."[5]

32. Officials from the Treasury took the view that: "[It is] less a change of objective but more a change of the speed at which the objective is being achieved".[6]

33. We accept that the current formulation of spending policy represents the government's past achievements and its current ambitions, but it is in our view a modification of the Government's previously stated policy for public expenditure over successive planning periods. We have commented before on the realism of cash plans which show overall expenditure being held flat in real terms while previous plans had invariably been exceeded.[7] The Chancellor, in effect, admitted the policy change with regard to the current plans:

"If you look at the previous planning totals, the "broadly constant" was a description of a gently rising trend in real terms but by a very small proportion . . . and it marked a big improvement on the trend previously. That proved in the even to be over-ambitious, and, therefore, the planning totals have had to be increased slightly although the growth still is less than the growth has been in real terms in the past . . ."[8]

X

34. If this development means that the spending plans set out in the Autumn Statement and PEWP more accurately reflect the likely outcome then these documents are rendered more useful and in that sense the change is welcome. However, the change must be regarded as more than presentational if we take seriously the original claim of cutting public expenditure (see paragraph 28).

[1]MTFS, 1980–81, p. 16, para 5.
[2]MTFS, 1986–87, p. 14, para 2.25.
[3]H.C. Deb., 1986–87, Vol 103, col. 1084.
[4]Q. 84.
[5]Q. 85.
[6]Q. 26.
[7]eg HC(1984–85)213: Sixth Report from the Treasury and Civil Service Committee, paras 26–29.
[8]Q. 93.

(i) *Outcome in 1986–87.*

35. The estimated outturn for the planning total in 1986–87 is £140.4 billion. This is approximately £1.3 billion, or about 1 per cent, above the cash plans set out in the 1986 Budget. In real terms, the increase in the planning total is almost 2 per cent, because general inflation has been lower than the Treasury forecast at Budget time. The main reasons for this are a 9 per cent overrun in local authority spending, and unexpected demand-led expenditure in the social security area. Even though the main spending overruns are in areas over which the Treasury has little, if any, direct control in the short run, we note that all departments, with one exception, look likely to exceed the cash plans set out in the Budget, despite lower than expected inflation.[1] We also note that during our inquiry on the 1985 Autumn Statement we questioned the likelihood of social security expenditure being held in real terms this year after 3 years of real growth exceeding 4 per cent a year.[2]

36. The underlying increase in the planning total this year over 1985–86 is, in fact, somewhat higher than 2 per cent. Privatisation proceeds are expected to be about £2 billion higher than in 1985–86 and expenditure in 1985–86 was affected by the one-off effects of the ending of the coal strike. Real departmental expenditure (ie the planning total before deduction of privatisation proceeds) after allowing for the unwinding of the coal strike is likely to be 3.6 per cent higher than 1985–86[3]. During questioning the Chancellor said that:

> "You . . . have to recall that in 1985–86 public expenditure was exceptionally low. I think that really it is better to look at the two years from 1984–85 to 1986–87 together. There was a marked dip in 1985–86, as is clear if you look at the graph, which was partly due to inflation being higher in 1985–86 than we expected. In the same way, of course, inflation has been lower in 1986–87 than expected. If you are on a cash planning system, which we are, then . . . you tend to have fluctuations in real terms of that kind"[4]

He added that:

> "The figures in the Autumn Statement would show that even if you exclude privatisation proceeds, then as I say, each year, including 1986–87, on our latest estimates . . . there is a reduction in public spending as a percentage of GDP"[5]

37. We accept that on this definition public expenditure has continued to decline as a proportion of GDP. Nevertheless a substantial real increase in departmental expenditure, exceeding the growth in GDP, has occurred this year and cash expenditure is likely to exceed the largest ever Reserve by £1.3 billion. In our view the government would have far more cause for satisfaction if departments' real expenditure were showing a decline as a proportion of GDP as well as general government expenditure, especially since the upward trend in departments' real spending continues into 1987–88. In 1987–88, any reduction in departmental spending as a proportion of GDP is likely to be small or non-existent.

(ii) *1987–88—1989–90.*

38. For 1987–88, £5 billion has been added to the sum of departmental spending and the Reserve,[6] compared with the plans announced in the Budget, an increase of about 4 per cent in real terms. About £1 billion of this increase is on capital expenditure, mainly in the areas of housing, schools and roads. This is expected to lead to an increase of 2 per cent in departments' real expenditure in 1987–88 over 1986–87. Within the overall increase, the plans for several departments have been increased substantially: Home Office, Education and Housing plans have been increased by more than 10 per cent; Environment, Transport and the Lord Chancellor's Department have been increased by 7–10 per cent. The Chancellor told the House that:

> "The public expenditure increases I have announced allow us to make realistic provision both for local authority current expenditure, over which the Government has no direct control, and for demand led programmes such as social security, while still leaving scope for increased spending on services to which the Government attaches particular priority"[7]

We regard the £1 billion increase in capital expenditure as welcome, particularly in the light of our previous criticisms of the government's approach to capital spending.[8]

[1] Table 3 Appendix 4.
[2] HC (1985–86) 57, Second Report from the Treasury and Civil Service Committee, para 42.
[3] Table 1 Appendix 2.
[4] Q. 97.
[5] Q. 98.
[6] That is, the planning total less privatisation proceeds.
[7] H.C. Deb., 1986–87, Vol 103, col 1084.
[8] See, for example, HC (1984–85) 213: Sixth Report from the Treasury and Civil Service Committee, para 41ff.

39. The planning total (less privatisation proceeds) for 1988–89 is 4.5 per cent higher than at Budget time, with increases as high as 20 per cent in real terms above previous plans in the case of Education. However, although these plans have been revised substantially upward, the overall outturn for departments is intended to be only slightly higher in real terms than 1987–88.[1] In 1989–90 the overall planning total is expected to increase by about 1½ per cent over 1988–89.

40. The profile of the spending plans is thus very familiar. Departmental expenditure (including future allocations from the Reserve) will increase substantially above previous plans in the near term, but spending will somehow be restrained after that (the average increase in the final two years of the planning period is planned to be 0.9 per cent a year) to fall below the trend established since 1979 (of around 1.5 per cent a year)[2]

41. Despite the relaxation of departmental spending plans, the planning total may be put under pressure again next year. One area of concern is the likelihood of a significant adverse relative price effect against the public sector. Recent increases in teachers' and firemen's pay are not favourable precedents, despite the Chancellor's view that no conclusions should be drawn from the firemen's settlement.[3] Import prices are also likely to rise more quickly than overall domestic prices. Therefore, intended real increases in expenditure may be substantially offset by increases in input prices. Finally, the Reserve has been set some 20 per cent lower than last year even though this year's Reserve has proved some 25 per cent too low.

42. The Chancellor, however, considers that the Reserve will be adequate:

> "The reserves are, with the exception of last year, the highest we have ever had both in absolute terms and as a proportion of the planning total . . . This year there is a much bigger increase in local authority current expenditure, what we believe to be a realistic estimate and therefore we believe reserves on the scale of last year are not required.[4]

43. We welcome the forward provision for local authority spending this year in place of the unsatisfactory practice of repeating the cash figures for the first year of the planning period. However, it will be some time before it becomes clear whether these are realistic estimates.

Prospects

44. The Chancellor views the outlook for the economy in 1987 as one of balanced growth.[4] Overall GDP growth is expected to pick up to 3 per cent in 1987 from the pause experienced after the oil price fall. Within this, manufacturing output is expected to increase by 4 per cent after remaining static in 1986, the growth in exports of goods and services is expected to increase from 1 per cent this year to 3 per cent in 1987, imports of goods and services are expected to grow more slowly, and investment is expected to continue at relatively high levels. The composition of demand growth is expected to shift slightly away from consumption, with an assumed halt in the decline in the savings ratio. Companies' disposable incomes are expected to rise again in real terms. The RPI is forecast to increase by 3¼ per cent in the year to the fourth quarter of 1986, slightly lower than forecast at Budget time, and by 3¾ per cent in the year to the fourth quarter of 1987; the GDP deflator is also expected to increase 3¾ per cent in 1987. The current account forecast has been revised substantially both for 1986, in respect of which it is reduced from a £3½ billion surplus to a nil balance, and for 1987, where it is reduced from £1½ billion surplus to £1½ billion deficit. This is due to the unexpectedly slow response to the change in oil prices.

45. While the Treasury's forecasts are generally in line with those prepared for the Committee,[5] there are some aspects which appear optimistic. Paragraph 1.50 of the Autumn Statement states that:

> "With RPI inflation 3 percentage points lower than it was at the start of the last pay round, pay settlements are expected to be a little lower than last year: indeed, there have already been signs of a move towards lower settlements in the private sector in recent months".

Coupled with a rise in productivity, due to the expected increase in manufacturing output, this fall in pay increases could result in a decline in the rate of unit labour cost growth, though to a level still well above most of the UK's competitors. However, the expectation that wage increases will moderate contrasts with paragraph 1.48 which notes that even though price

[1] Tables 1 and 3, Appendix 4.
[2] See Graph 1, Appendix 4.
[3] Q. 106.
[4] Q. 82.
[5] Tables 1 and 2, Annex.

inflation has fallen there has been no decline so far in the published figures for the underlying rate of growth in average earnings.

46. We asked officials for the basis of their confidence that wage increases would moderate at a time when profits are still rising, when evidence exists of skill shortages in certain areas and when claims have been made that capacity constraints are emerging. In reply, Sir Terence Burns said:

> "There are signs in the CBI settlements, as I understand it, of some small reduction in the rate of settlements. And our own monitoring of those figures would support that"[1]

He also took the view that neither vacancy rates nor capacity utilisation was unduly high, and felt that developments in other developed economies would not be as favourable as perhaps expected.[2] These factors, he felt, could be expected to lead to some decline in domestic pay increases and convergence in unit labour cost movements between the UK and elsewhere. However, Sir Terence agreed that:

> "the growth of labour costs continues to be disturbing."[3].

While we acknowledge these favourable factors, even if they are borne out by events the gap between unit labour cost changes in the UK and elsewhere, shown in Chart 1.9, will look little different from those of the past three years.

47. If wage increases overall do not fall as expected, other aspects of the forecast could be put under some pressure. A further deterioration in relative unit labour costs might lead to calls for a further exchange rate depreciation to maintain competitiveness. Indeed, even if events turn out as expected, some pressure on the exchange rate may develop in the medium term. However, officials noted that:

> "the Chancellor has made clear [that] he is not prepared simply to follow a policy of exchange rate depreciation to validate higher levels of earnings in this country relative to those in our competitor countries.[4]

48. On employment, the Autumn Statement notes the growth in total employment of around one million between March 1983 and June 1986. While employment growth in the service industries continued strongly, overall employment growth has slowed recently due to the reduction in output growth. However, the pickup in output growth expected in 1987, together with the favourable demographic outlook, points to a somewhat more favourable prospect for unemployment in the near future, provided the expected fall in pay settlements occurs.

49. The forecast for the current account of the Balance of Payments has been revised substantially downwards since the Budget. Nevertheless, manufactured exports are expected to increase sharply due to growth in world markets and "the lagged benefits of last year's gain in competitiveness."[5] The very substantial fall in the £/DM rate together with the expected benefits of the J-curve effect tend to reinforce this encouraging view.

50. As regards competitiveness, we questioned officials on the consistency of this last factor with the view expressed last year that "the experience of the last five years suggests that export volumes have not been very responsive to price and cost changes."[6]

Sir Terence Burns told us that:

> "There is no inconsistency in those statements. The statement last year was a relative statement. It was suggesting how responsive it was compared to some other views which had been expressed. It did not say exports were totally unresponsive."[7]

We suggested that the beneficial effects of exchange rate movements depend on the extent to which they are perceived as permanent. Sir Terence replied that:

> "I would accept that the fact that there are fluctuations in the exchange rate is possibly one reason why the short term effects of exchange rate changes are not as great as they have been in the past".[8]

51. The Committee will continue its inquiries into the nature of the effect of exchange rate changes on exports.

[1]Q. 60.
[2]Q. 45.
[3]Q. 65.
[4]Q. 60.
[5]1986 Autumn Statement para 1.25.
[6]1985 Autumn Statement para 1.20.
[7]Q. 38.
[8]Q. 9.

52. On the imports side, the Treasury discounted the large rise in imports seen in recent months.

"I think it is still early days to be sure to what extent those [import] pressures will continue."[1]

It remains to be seen whether demand in real terms for imports forecast for 1987[2] is realised. However, the Committee accepts Sir Terence Burn's point that the Treasury, in general, do not have a record of over-optimistic predictions of the Balance of Payments.[3]

53. We have over the years examined government fiscal and economic policy in the light of its own proclaimed intentions. We have chronicled the movement away from the original intention of reducing public expenditure in real terms, the monetarist emphasis on the £M3 money supply, and the desire to facilitate rational expectations. It is now clear that in respect of the key factors of public expenditure control, reduction in the money supply, and the use of interest and exchange rates there has been a substantial change in policy. In the interests of informed public debate, these should be openly explained and avowed, so that the government's present position, its merits and its problems, can be rationally discussed.

3rd *December* 1986

[1] Q. 36.
[2] See Table 1.15, 1986 Autumn Statement.
[3] Q. 36.

ANNEX

TABLE 1

Base Forecasts

Variable	Henley	LBS	NIESR	P&D	Treasury
A. Output and Expenditure at 1980 prices—% change					
(i) GDP (factor cost)					
1987 over 1986	2.8	3.0	2.4	2.7	3.5
1988 over 1987	2.1	3.2	2.1	1.9	
(ii) Consumers' Expenditure					
1987 over 1986	2.8	4.1	3.7	3.7	4.0
1988 over 1987	2.8	3.1	2.1	2.3	
(iii) General Government Current Expenditure					
1987 over 1986	2.2	1.0	2.2	1.7	1.5
1988 over 1987	1.5	0.9	1.0	1.3	
(iv) Fixed Investment					
1987 over 1986	3.5	2.4	3.1	3.2	2.25
1988 over 1987	2.4	4.1	3.2	0.8	
(v) Exports (Goods and Services)					
1987 over 1986	4.2	4.8	4.3	1.3	3.0
1988 over 1987	3.0	6.4	2.7	1.3	
(vi) Imports (Goods and Services)					
1987 over 1986	4.5	4.7	8.8	4.0	4.5
1988 over 1987	3.6	4.7	3.3	3.2	
(vii) Changes in Stockbuilding as per cent GDP					
1987 over 1986	0.5	−0.1	0.5	0.2	0
1988 over 1987	0.5	−0.1	0.3	0.5	
B. Balance of Payments, Current Account £ billion					
1987	−2.1	−2.4	−5.6	−3.4	−1.5
1988	−2.9	−1.2	−7.2	−4.5	
C. PSBR, £ billion, fiscal years					
1987–88	9.5	7.8	11.6	9.0	7.0
1988–89	11.5	7.1	12.8	12.1	
D. Retail Price Index. % change					
Q. 4 1986 to Q. 4 1987	4.7	3.5	5.8	5.2	3.75
Q. 4 1987 to Q. 4 1988	5.7	4.4	6.8	6.0	
E. Money Supply (£M3) % change Q. 1 1987 to Q. 1 1988	16.0	9.5	[1]	14.5	12.5[2]
F. Unemployment, UK, excluding school leavers, millions					
1987 Q. 4	3.0	3.1	2.94	3.1	3.05[3]
1988 Q. 4	2.9	3.1	2.89	3.0	
G. Effective Exchange Rate					
1987 Q. 4	66.2	64	66.1	65.1	67.3[4]
1988 Q. 4	64.5	62	64.1	62.5	

[1]Not forecast.
[2]Mid Point of rate.
[3]Based on the Autumn Statement Estimate ie "Great Britain excluding school leavers etc".
[4]"The forecast assumes that sterling remains close to its present level in both dollar and effective terms".

TABLE 2

Common Assumptions Forecast

	Variable	*Henley*	*LBS*	*NIESR*	*P&D*
A.	Output and Expenditure at 1980 prices—% change				
(i)	GDP (factor cost)				
	1987 over 1986	2.7	2.8	2.2	2.4
	1988 over 1987	2.0	2.4	1.9	1.6
(ii)	Consumers' Expenditure				
	1987 over 1986	3.0	4.2	3.6	3.5
	1988 over 1987	3.2	3.0	2.1	1.5
(iii)	General Government Current Expenditure				
	1987 over 1986	1.5	1.6	1.5	1.5
	1988 over 1987	1.0	0.5	1.3	1.0
(iv)	Fixed Investment				
	1987 over 1986	3.3	2.4	3.1	3.1
	1988 over 1987	2.3	2.8	2.7	1.0
(v)	Exports (Goods and Services)				
	1987 over 1986	4.0	4.3	4.3	1.5
	1988 over 1987	2.8	4.9	2.2	1.4
(vi)	Imports (Goods and Services)				
	1987 over 1986	4.8	4.8	8.6	3.9
	1988 over 1987	3.9	3.8	3.1	2.2
(vii)	Changes in Stockbuilding as per cent GDP				
	1987 over 1986	0.5	−0.1	0.5	0.2
	1988 over 1987	0.5	−0.3	0.2	0.4
B.	Balance of Payments, Current Account £ billion				
	1987	−2.5	−2.3	−5.0	−2.7
	1988	−3.5	0.2	−5.2	−2.8
C.	PSBR, £ billion, fiscal years				
	1987–88	9.0	7.1	11.2	7.0
	1988–89	10.5	8.6	12.5	7.0
D.	Retail Price Index. % change				
	Q. 4 1986 to Q. 4 1987	4.3	3.9	5.7	4.3
	Q. 4 1987 to Q. 4 1988	5.5	3.4	5.9	4.9
E.	Money Supply (£M3) % change Q. 1 1987 to Q. 1 1988	16.2	9.5	[1]	13.1
F.	Unemployment, UK, excluding school leavers, millions				
	1987 Q. 4	3.0	3.1	2.95	3.15
	1988 Q. 4	2.9	3.2	2.94	3.19
G.	Effective Exchange Rate				
	1987 Q. 4	67.3	67.3	67.3	67.3
	1988 Q. 4	67.3	67.3	67.3	67.3

[1] Not forecast.

TABLE 3

Assumptions in Common Assumptions Forecast

% Change Q. 4 1986–Q.1 1989 (unless otherwise stated)	
North Sea Output	−12.0
World Oil Price ($)	0
$/£ rate	0
Effective Exchange Rate 1975:100	67.3
World Interest Rates (% points).	0
World Export Prices	9.3
World Trade in Manufactures	10.4
UK short-term interest rates (% points)	0
Government expenditure (1980 prices)	
1987–88 over 1986–87	1.5
1988–89 over 1987–88	1.0

SOURCES FOR TREASURY ASSUMPTIONS:

North Sea Output	1986 Brown Book Appendix 14 (See paragraph 1.44 Autumn Statement).
World oil price	Autumn Statement paragraph 1.16
Exchange rates	Autumn Statement paragraph 1.22
Interest-rates	Reference in paragraph 1.59 Autumn Statement
World export prices	Inferred from forecasts of UK Output prices (Table 1.6) and terms of trade excluding oil (Table 1.2), Autumn Statement.
Trade in manufactures	Table 1.1 Government consumption Table 1.15

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TREASURY AND CIVIL SERVICE COMMITTEE

PRESS NOTICE

Autumn Statement

The Second Report of the Treasury and Civil Service Committee entitled, The Government's Economic Policy: the Autumn Statement, will be published at 4 pm on Wednesday 9 December, when a press conference will be held in Committee Room 15 at the House of Commons.

The Report will be published as HC27 with Confidential Final Revise copies available on the usual basis from room 304, St Stephen's House, Embankment, SW1 from noon on Tuesday 9 December.

D F HARRISON
Clerk

4 December 1986

cc Chancellor 12/2
Chief Secretary
FST
EST
MST
Sir P Middleton
Sir T Burns
Mr FER Butler
Mr Anson, Mr Cassell
Mr Turnbull
Mr Sedgwick
Mr Revolz
Mr Culling Smee
Mr Scholar
Miss O'Mara
Mr Culpin

Chancellor

PWP

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HOUSE OF COMMONS

Second Report from the

TREASURY AND CIVIL SERVICE COMMITTEE

Session 1986–87

THE GOVERNMENT'S ECONOMIC POLICY: AUTUMN STATEMENT

Together with the Proceedings of the Committee, Minutes of Evidence and Appendices

This Document is issued in advance on the strict understanding that no approach is made to any organisation or person about its contents before the time of publication.

NOT FOR PUBLICATION, BROADCAST OR USE ON CLUB TAPES BEFORE:—

1600 Hours GMT on 10 December 1986

The Treasury and Civil Service Committee is appointed under S.O. No 130 to examine the expenditure, administration and policy of the Treasury, Management and Personnel Office, the Board of Inland Revenue, and the Board of Customs and Excise and associated public bodies, and similar matters within the responsibilities of the Secretary of State for Northern Ireland.

The Committee consists of a maximum of eleven members, of whom the quorum is three. Unless the House otherwise orders, all Members nominated to the Committee continue to be members of the Committee for the remainder of the Parliament.

The Committee has power:

(a) to send for persons, papers and records, to sit notwithstanding any adjournment of the House, to adjourn from place to place, and to report from time to time;

(b) to appoint specialist advisers either to supply information which is not readily available or to elucidate matters of complexity within the Committee's order of reference.

The Committee has power to appoint one sub-committee and to report from time to time the minutes of evidence taken before it. The sub-committee has power to send for persons, papers and records, to sit notwithstanding any adjournment of the House, and to adjourn from place to place. It has a quorum of three.

Friday 9 December 1983

The following were nominated as members of the Treasury and Civil Service Committee:

Mr Anthony Beaumont-Dark	Mr Peter Lilley
Mr John Browne	Mr Austin Mitchell
Mr Nicholas Budgen	Mr Brian Sedgemore
Mr Mark Fisher	Mr John Townend
Mr Terence L Higgins	Mr Richard Wainwright

Mr Ralph Howell

Mr Terence L Higgins was elected Chairman on 13 December 1983.

The following changes in the membership of the Committee have been made.

Friday 27 January 1984: Mr Peter Lilley discharged; Mr Roger Freeman appointed.

Wednesday 26 February 1986: Mr Roger Freeman discharged; Mr John Watts: appointed.

Friday 28 November 1986: Mr Mark Fisher discharged.

The cost of preparing for publication the Shorthand Minutes of Evidence taken before the committee and published with this Report was £761.06

The cost of printing this Report is estimated by Her Majesty's Stationery Office at £9,072.00.

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APPENDICES TO THE MINUTES OF EVIDENCE

SECOND REPORT

The Treasury and Civil Service Committee has agreed to the following Report:

THE GOVERNMENT'S ECONOMIC POLICY: AUTUMN STATEMENT

INTRODUCTION

1. In preparing our comments on the 1986 Autumn Statement, we took evidence from the Chancellor of the Exchequer, and from Sir Terence Burns, the Chief Economic Adviser to the Treasury and other Treasury officials. To all of those who gave evidence we wish to express our gratitude for their assistance.

2. Our thanks are due also to those who assisted us in the capacity of specialist adviser—Mr Gavyn Davies, Mr Christopher Johnson, Mr Bill Martin, Mr David Savage and Mr Terry Ward. We received help also from the Parliamentary Unit at the University of Warwick.

3. As in previous years we have been supplied with a set of alternative forecasts in order to assess independently the Treasury's Industry Act forecasts. Teams from the Henley Centre, the London Business School, the National Institute for Economic and Social Research and Phillips and Drew submitted two sets of forecasts. The first reflects their own assumptions about major future developments, the second a set of what we assume are the latest Treasury assumptions.

4. In previous reports we have drawn attention to the fact that, although the Government has been successful in achieving a number of its economic ends, the manner in which these have been achieved has differed from that originally propounded in successive versions of the Medium Term Financial Strategy (MTFS). It is important that economic policy should be flexible, and able to deal with circumstances not originally foreseen, but we think it would be more appropriate, when policy has obviously changed, for the Chancellor to admit it. Otherwise it is more difficult for us to learn lessons from past experience or indeed to ascertain what present policy really is. In this report we draw attention to various important changes which have taken place in the Government's policy since 1979.

Monetary Policy and Targets

5. Since it assumed office the Government's stated economic policy aim has been to bring down the rate of inflation and to create conditions for a sustainable growth of output and employment.[1] To achieve these the Government devised and implemented the Medium Term Financial Strategy (MTFS).

6. As originally enunciated, the MTFS was quite straightforward. Inflation could best be reduced by reducing the rate of growth of the money stock. Accordingly the Government published a series of money stock targets for the following four years and gave details on how these targets would be realised:

> "The Government believes that its monetary policy can best be formulated if it sets targets for the growth of one of the aggregates against which progress can be assessed. This gives the clearest guidance to those concerned in both financial markets and domestic industry, on which to assess the direction of Government policy and to formulate expectations."[2]

The Monetary target chosen was a measure of broad money, £M3:

> "If one aggregate is to be chosen for the target there seems to be considerable agreement that £M3 best suits the present circumstances of the United Kingdom. It is also relatively easy to define in terms of the banking system."[3]

Paragraph 4 of the original MTFS was quite explicit about the manner in which policy would be achieved:

> "It is not the intention to achieve [the] reduction in monetary growth by excessive reliance on interest rates. The Government is therefore planning for a substantial reduction over the medium-term in the Public Sector Borrowing Requirement (PSBR) as a percentage of Gross Domestic Product (GDP)".[4]

[1] FSBR, 1980–81, p. 16 para 1.
[2] Green Paper on Monetary Control, Cmnd 9858 para 8.
[3] ibid para 10.
[4] MTFS, 1980–81, para 4

The Government viewed the relationship between the PSBR and the growth of the money supply as "not a simple one."[1] Nevertheless:

> "although the relationship between the PSBR and £M3 is erratic from year to year, there is no doubt that public sector borrowing has made a major contribution to the excessive growth of the money supply in recent years . . . If interest rates are to be brought down to acceptable levels the PSBR must be substantially reduced as a proportion of GDP over the next few years".[2]

7. We acknowledge the fact that the Government was very successful both in achieving a reduction in the PSBR and in the level of inflation. But since its first term in office, the rate of inflation has remained broadly unchanged, and has declined in 1986 mainly because of the steep fall in oil and other commodity prices. Domestic symptoms of inflation have not been greatly affected, and wage rises in particular have shown no significant tendency to come down.

8. In successive versions of the MTFS, the operation of monetary policy has become increasingly obscure. We have now reached the point where the main instrument for controlling inflation seems to be the manipulation of short term interest rates.[3] The role of £M3, both as a diagnostic indicator of monetary conditions and as an intermediate target has become increasingly unclear. Various other financial indicators, including the exchange rate, are now considered in assessing monetary conditions although the Government has never indicated their relative importance.

9. As an intermediate target, £M3 was formally supplemented by PSL2 from 1982–84, and by MO from 1984. It was briefly suspended altogether between October 1985 and March 1986. At various times, including the present, the Government has also appeared to have an implicit exchange rate target. The intention in the original MTFS of allowing interest rates to fall as the PSBR was reduced has been eroded.

10. In our previous reports we have recommended that the House be given greater information about the operation of monetary policy.[4] The Government have preferred, however, to address outside audiences on these matters. Once again, the Autumn Statement contains little on Monetary Policy. Sir Terence Burns told us that an exposition of monetary policy:

> "is not the role of the Autumn Statement. The Autumn Statement presents a forecast of the economy and it presents the figures for public expenditure. Of course, the Chancellor has made a statement about monetary policy in the Mansion House Speech which is also customary at this time of the year. The Autumn Statement is not the occasion for a re-statement of monetary policy."[5]

The Chancellor referred us to his speech to the Lombard Association.[6] We affirm our previous position, namely that statements on macro-economic policy should be made in the House so that they may be subject directly to questioning from Members, and **we so recommend.**

11. In his Lombard Association speech, the Chancellor maintained that monetary policy had been essentially unchanged since the publication of the first version of the MTFS although there had been subsequent changes in emphasis. He said:

> "It is monetary policy that lies at the heart of the MTFS",

and short term interest rates are:

> "the essential instrument" of monetary policy.

The guiding principle of policy is:

> "to maintain . . . a level of short term interest rates that will deliver the monetary conditions needed to reduce inflation."

While the original version of the MTFS did not preclude the use of interest rate policy to influence monetary conditions, particularly if there were unforeseen developments in the economy, their role in determining monetary policy was not regarded as of great importance.[7] The enhanced role, which the Chancellor is now giving to interest rates seems to us to constitute more than a change of emphasis.

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[1] ibid para 4.
[2] ibid para 4.
[3] 1986 Autumn Statement, para 1.59.
[4] HC(1985–86)313: Fourth Report from the Treasury and Civil Service Committee, paras 14 and 32; HC(1985–86)57: Second Report from the Treasury and Civil Service Committee.
[5] Q. 4.
[6] Q. 114.
[7] MTFS, 1980–81, paras 4 and 16.

12. During questioning the Chancellor confirmed this stance.[1] But the Lombard Association speech continued to lay stress on the role of the monetary targets in assessing monetary conditions:

> "Movements in the aggregates outside their target ranges always establishes a *presumption* (Chancellor's emphasis) in favour of changing short term interest rates.

13. Although the Government retains £M3 amongst the indicators it takes into account, the Chancellor himself has pointed out on a number of occasions that there has been a major change in the relationship between £M3 and money GDP in recent years.[2] In the 1986 MTFS an 11–15 per cent target range was set for £M3. As Paragraph 1.61 of the Autumn Statement points out, however, £M3 grew at a rate in excess of 18 per cent to mid-September and it has been clear for some months that £M3 growth has been above the target range. This produced no change in the level of short term interest rates. Indeed Para 1.61 of the Autumn Statement seems to argue that, given the change in the velocity of circulation caused by innovation and institutional change in the money markets, any £M3 number might be consistent with low inflation. When asked if this interpretation was correct the Chancellor replied: "Yes, that is what is implied here, certainly".[3]

14. Nonetheless, in his Lombard Association speech the Chancellor justified the retention of £M3 on the grounds that its demise might be interpreted as endorsing the build up of liquidity that is occurring in the economy. We expressed concern at this build up of liquidity in our report on the 1986 Budget.[4] Since that time, there has been little to suggest that the build up of liquidity, graphically described by the Governor of the Bank of England as an overhanging glacier, has declined despite the fact that real interest rates have remained high. We suggested to the Chancellor that there was a danger of the experiences of the early 1970s, when easy credit led to a boom and subsequent collapse in the property and secondary banking sectors, being repeated. He maintained that:

> "the conditions between 1972 to 1974 and now are as different as chalk and cheese. If you look at MO, if you look at what was happening to public spending and house prices then; if you look at the PSBR as a share of GDP then; if you look at what was happening to money GDP and, perhaps most strikingly, if you look at interest rates, where real interest rates then were, if anything negative, whereas now they are historically high and positive, the differences are quite dramatic."[5]

Nonetheless, the build up of liquidity is also dramatic. Moreover, the behaviour of narrow money (M1) in 1972–74 and that of the present day measure of narrow money MO are not greatly different. We reiterate our anxiety about the build up of liquidity and note that the Governor of the Bank has also recently expressed his concern.[6]

15. According to the Government, the narrow indicator, MO, continues to occupy an important role in the assessment of financial conditions. Sir Terence Burns pointed out that:

> "one of the reasons for the last increase in interest rates was because the growth of MO, the narrow measure of money, had picked up quite sharply".[7]

We have not been convinced that MO is an efficient index of true monetary conditions.

16. However, we still believe that movements in the exchange rate are having a more profound influence on the government's actions. In both his statement and in subsequent broadcasts the Chancellor placed a considerable emphasis on the exchange rate. In his view sterling has now adjusted downwards sufficiently to offset the balance of payments losses from lower oil prices, " . . . the necessary adjustment of the exchange rate to the oil price collapse has now taken place."[8] Accordingly, further depreciation in the currency would be resisted, presumably through interest rate increases, since intervention has been ruled out except to "smooth" changes.[9]

17. Once again we questioned both the Chancellor and officials as to whether this stance was the equivalent of an exchange rate policy. Sir Terence Burns told the Committee that the role of the exchange rate in the assessment of policy remained unchanged:

[1] Q. 109.
[2] See, for example, Mansion House Speech 1985, Lombard Association Speech 1986.
[3] Q. 155.
[4] HC(1985–86)313: Fourth Report of the Treasury and Civil Service Committee, 1985–86, para 54.
[5] Q. 130.
[6] Governor of the Bank of England's Mansion House Speech, 1986.
[7] Q. 3.
[8] H.C. Deb., 1986–87, Vol. 103, col. 1086.
[9] Q. 78.

"we constantly point out that there is no exchange rate target".[1]

The Chancellor admitted that, while he did not wish to see the trade weighted index decline further, he had no intention of announcing an explicit target:

"The reality of foreign exchange markets, and this does not apply to monetary targets, would make that in my opinion an unwise course of action"[2]

and:

"I can quite understand that good people with all the best motives would like greater certainty as to what point one would act in order to affect the exchange rate. On the other hand, that degree of certainty would also be playing into the hands of the short-term operators. In practical market management, I do not think it is sensible to be any more explicit than I have been".[3]

18. We acknowledge the difficulties which have arisen following the change from a policy based on straightforward concern with monetary targets to one in which the exchange rate is used to control inflation directly by influencing import prices and indirectly by not validating inflationary wage settlements. We note the disappearance of the Treasury's former claim for the MTFS, that it would damp down inflationary expectations.

19. We believe that monetary policy is uncertain because the government wishes both to prevent interest rates from rising and the exchange rate from falling. As the Prime Minister said in her interview to the Financial Times of 19 November 1986: "I do not want interest rates any higher." But, asked about the sterling D-Mark rate, she said "I think it has gone low enough". Clearly it may be impossible for both objectives to be achieved. The danger is that the Government, by not committing itself firmly to either objective, may weaken market confidence to such a point that neither is achieved.

Fiscal Stance

20. Since 1980 each MTFS has outlined a possible path for the PSBR for a number of years ahead. In successive Budget documents it has been stressed that these figures are illustrative only. Although they are conventionally used in the Autumn Statement forecasts, we have been told in the past that the PSBR for the following year would not be set until Budget time. This year the Chancellor has departed from previous practice, making a commitment in the Autumn Statement that the PSBR in 1987–88 would be held to $1\frac{3}{4}$ per cent of GDP, the same as in the MTFS. He told the Committee that:

"I have, exceptionally, gone further than is usual at this time of year so as to dispel from the start any worry there might be that the increased planning totals imply a relaxation of public borrowing. I have therefore explicitly reaffirmed the Government's commitment to the fiscal stance set out in the 1986 MTFS, and made it clear that the PSBR next year will be held to $1\frac{3}{4}$ per cent of GDP".[4]

21. The announcement of the PSBR target is thus designed to maintain financial market confidence by suggesting that substantial tax cuts will not be forthcoming in the 1987 Budget:

"As I said in the House in the questioning that followed the Autumn Statement, a pound used in additional public expenditure is a pound which is not available for reductions in taxation, unless you are prepared to expand the borrowing requirement, and I have made it clear and explicit that that I will not do"[5]

22. The increase in public spending has therefore absorbed resources which might otherwise have been available for tax cuts (or reduced borrowing, which might have led to lower interest rates). Accordingly it seems that the Government's long-stated aim of reducing the basic rate of income tax to 25p[6] will have to be deferred. Beyond that, the Chancellor made it clear that the PSBR ceiling of $1\frac{3}{4}$ per cent of GDP for 1987–88 was unconditional and would not be altered even if there were significant changes in the economic environment. Evidently the maintenance of financial market confidence has been given absolute priority and the pursuit of other objectives, which might possibly require a different PSBR, has been subordinated to this.

23. At the same time, it was acknowledged by the Chancellor that any forecast for the PSBR made at this time of year is subject to a margin of error.[7] The 1985 Autumn Statement put the

[1] Q. 7.
[2] Q. 151.
[3] Q. 152.
[4] Q. 82.
[5] Q. 107.
[6] See, for example, the Conservative Party Manifesto, 1979.
[7] Q. 111.

average error at $\frac{3}{4}$ per cent of GDP (equivalent to £2$\frac{1}{2}$ billion). The margin of error is only slightly less for any figure announced at Budget time. This means that any PSBR target does not have precise implications for taxation, nor is any figure precisely verifiable. The constraint on fiscal policy entailed by the Chancellor's firm commitment to a PSBR figure for next year is therefore not as binding as it might appear to be at first sight. Moreover present accounting conventions (as regards the treatment of asset sales in particular) provide additional scope for adjusting policy, should the need arise, without infringing the PSBR target.

24. As the Chancellor said:

> "I cannot guarantee that at the end of the year the PSBR will in fact turn out to be what I have said at the time of the Budget,"[1] but

> "the important thing which I think the Committee should focus on is that they have been told the PSBR will be set at 1$\frac{3}{4}$ per cent of GDP; that is a genuine figure, which within a margin of error, will be the outcome".[2]

The Chancellor also said that in setting the PSBR one of the guidelines was that it:

> "can be comfortably financed in a non-inflationary way"[3]

even if it does not turn out as expected. However, the Chancellor would not be drawn on the steps the Government would take if it appeared that the PSBR was off-track next year.

25. What *has* changed since the Budget Statement is the Treasury's assessment of the UK's balance of payments position, which is now substantially worse than previously expected. It is questionable in the light of such changed circumstances whether it is appropriate to maintain unchanged the Government's original borrowing target. But as we noted in our review of the 1986 Budget, the Government's rationale for particular targets for the PSBR is obscure. The target appears now to be chosen more by presentational need than by a considered appraisal of economic realities. In short, what the MTFS now lacks is a coherent framework for the setting of fiscal policy.

26. The original intention of focussing attention on the public sector borrowing requirement was to create a climate of rational expectations by making Government intentions absolutely clear. Since the PSBR is, for various reasons, an ambiguous measure, and since the figures are further confused by the then unanticipated scale of asset scales, currently running at a very high level and forecast to go even higher, we consider that public debate and the government's own strategies should now concentrate on the far more relevant and useful figure of the Public Sector Financial Deficit. For the year ahead our estimates are that this will run at £14$\frac{1}{2}$ billion and the following table shows its increase compared to the PSBR for each year since 1979.

Table 1

PSBR and Public Sector Financial Deficit since 1979

£ billion

	1979–80	1980–81	1981–82	1982–83	1983 84	1984–85	1985–86	1986–87	1987–88
PSBR	10.0	12.7	8.6	8.9	9.8	10.2	5.8	7.7	7*
PSFD	7.9	11.5	6.2	8.4	12.1	13.8	10.25	12**	14.5**

*From MTFS, 1986–87, Table 2.5
**See Table 3 Appendix 1.

27. The Government has been fortunate this year that spending overruns have not led to a higher PSBR than forecast. At paragraph 1.64, the Autumn Statement describes the upward revision of nearly £2 billion to the forecast of non-oil receipts in 1986–87, as "largely the result of buoyant VAT and corporation tax receipts." Unexpectedly high increases in earning growth have also led to proportionately higher increases in tax revenues due to the progressivity of the tax system. A similar process could occur in 1987. Sufficient buoyancy of tax revenue, fuelled by economic growth, could provide the Government with an opportunity to finance both the extra public expenditure announced in the Autumn Statement and cuts in the rate of income tax. If this occurs, fiscal policy will then have become pro-cyclical in nature, boosting through tax cuts an economy already in recovery.

[1]Q. 111.
[2]Q. 112.
[3]Q. 111.

GDP
for 1979-80 to
1987-88

Planning Totals

28. In paragraph 4 we mentioned the changes which we believe have taken place in the Government's policy since 1979. In the original MTFS of 1980 the Government announced that:

> "A key element in this strategy is a reduction in public expenditure."[1]

In the 1986 MTFS the Government said that:

> "Continued restraint in public spending plays a vital role in the Government's economic strategy. The cash planning totals set by the Government in the White Paper are designed to hold total spending broadly level in real terms"[2]

In the 1986 Autumn Statement the Government said that:

> "The Government are determined . . . to see to it that total public spending even without taking account of privatisation proceeds, continues to decline as a percentage of GDP"[3]

29. Both the Chancellor and officials maintain that the objective of policy has always been to reduce public expenditure as a proportion of GDP and that this objective is intact. We do not dispute this. As the Chancellor pointed out:

> "we said . . . in the document 'The Right Approach to the Economy', which was a quasi economic manifesto published before the 1979 Manifesto proper, that we thought that public expenditure was taking an excessive share of GDP and we wished to see it progressively decline. That theme has been there continuously and it is that which accurately describes what has happened since 1982/83. It is that which also characterises the public expenditure plans which are published in the Autumn Statement."[4]

30. Nonetheless, while it is true that the Government's underlying objective has been to reduce the public expenditure to GDP ratio, spending policy since 1979 has been formulated in stronger terms. Before the shift to cash planning, the operational objective was to reduce public expenditure in volume terms. Since then it has been to hold expenditure constant, or broadly constant, in real terms.

31. We questioned the Chancellor and officials on this point. The Chancellor replied that:

> "if you look at what has actually happened there has been a continued growth of public expenditure in real terms but the growth since 1982 has been less than the growth of the economy as a whole . . . we have improved our performance if you accept the overall objective . . . the presentation I used in this Autumn Statement accurately represents the reality not merely of what is planned but also what has been happening since 1982/83."[5]

32. Officials from the Treasury took the view that: "[It is] less a change of objective but more a change of the speed at which the objective is being achieved".[6]

33. We accept that the current formulation of spending policy represents the government's past achievements and its current ambitions, but it is in our view a modification of the Government's previously stated policy for public expenditure over successive planning periods. We have commented before on the realism of cash plans which show overall expenditure being held flat in real terms while previous plans had invariably been exceeded.[7] The Chancellor, in effect, admitted the policy change with regard to the current plans:

> "If you look at the previous planning totals, the "broadly constant" was a description of a gently rising trend in real terms but by a very small proportion . . . and it marked a big improvement on the trend previously. That proved in the even to be over-ambitious, and, therefore, the planning totals have had to be increased slightly although the growth still is less than the growth has been in real terms in the past . . ."[8]

34. If this development means that the spending plans set out in the Autumn Statement and PEWP more accurately reflect the likely outcome then these documents are rendered more useful and in that sense the change is welcome. However, the change must be regarded as more than presentational if we take seriously the original claim of cutting public expenditure (see paragraph 28).

[1]MTFS, 1980–81, p. 16, para 5.
[2]MTFS, 1986–87, p. 14, para 2.25.
[3]H.C. Deb., 1986–87, Vol 103, col. 1084.
[4]Q. 84.
[5]Q. 85.
[6]Q. 26.
[7]eg HC(1984–85)213: Sixth Report from the Treasury and Civil Service Committee, paras 26–29.
[8]Q. 93.

(i) *Outcome in 1986–87.*

35. The estimated outturn for the planning total in 1986–87 is £140.4 billion. This is approximately £1.3 billion, or about 1 per cent, above the cash plans set out in the 1986 Budget. In real terms, the increase in the planning total is almost 2 per cent, because general inflation has been lower than the Treasury forecast at Budget time. The main reasons for this are a 9 per cent overrun in local authority spending, and unexpected demand-led expenditure in the social security area. Even though the main spending overruns are in areas over which the Treasury has little, if any, direct control in the short run, we note that all departments, with one exception, look likely to exceed the cash plans set out in the Budget, despite lower than expected inflation.[1] We also note that during our inquiry on the 1985 Autumn Statement we questioned the likelihood of social security expenditure being held in real terms this year after 3 years of real growth exceeding 4 per cent a year.[2]

36. The underlying increase in the planning total this year over 1985–86 is, in fact, somewhat higher than 2 per cent. Privatisation proceeds are expected to be about £2 billion higher than in 1985–86 and expenditure in 1985–86 was affected by the one-off effects of the ending of the coal strike. Real departmental expenditure (ie the planning total before deduction of privatisation proceeds) after allowing for the unwinding of the coal strike is likely to be 3.6 per cent higher than 1985–86[3]. During questioning the Chancellor said that:

> "You . . . have to recall that in 1985–86 public expenditure was exceptionally low. I think that really it is better to look at the two years from 1984–85 to 1986–87 together. There was a marked dip in 1985–86, as is clear if you look at the graph, which was partly due to inflation being higher in 1985–86 than we expected. In the same way, of course, inflation has been lower in 1986–87 than expected. If you are on a cash planning system, which we are, then . . . you tend to have fluctuations in real terms of that kind"[4]

He added that:

> "The figures in the Autumn Statement would show that even if you exclude privatisation proceeds, then as I say, each year, including 1986–87, on our latest estimates . . . there is a reduction in public spending as a percentage of GDP"[5]

37. We accept that on this definition public expenditure has continued to decline as a proportion of GDP. Nevertheless a substantial real increase in departmental expenditure, exceeding the growth in GDP, has occurred this year and cash expenditure is likely to exceed the largest ever Reserve by £1.3 billion. In our view the government would have far more cause for satisfaction if departments' real expenditure were showing a decline as a proportion of GDP as well as general government expenditure, especially since the upward trend in departments' real spending continues into 1987–88. In 1987–88, any reduction in departmental spending as a proportion of GDP is likely to be small or non-existent.

(ii) *1987–88—1989–90.*

38. For 1987–88, £5 billion has been added to the sum of departmental spending and the Reserve,[6] compared with the plans announced in the Budget, an increase of about 4 per cent in real terms. About £1 billion of this increase is on capital expenditure, mainly in the areas of housing, schools and roads. This is expected to lead to an increase of 2 per cent in departments' real expenditure in 1987–88 over 1986–87. Within the overall increase, the plans for several departments have been increased substantially: Home Office, Education and Housing plans have been increased by more than 10 per cent; Environment, Transport and the Lord Chancellor's Department have been increased by 7–10 per cent. The Chancellor told the House that:

> "The public expenditure increases I have announced allow us to make realistic provision both for local authority current expenditure, over which the Government has no direct control, and for demand led programmes such as social security, while still leaving scope for increased spending on services to which the Government attaches particular priority"[7]

We regard the £1 billion increase in capital expenditure as welcome, particularly in the light of our previous criticisms of the government's approach to capital spending.[8]

[1] Table 3 Appendix 4.
[2] HC (1985–86) 57, Second Report from the Treasury and Civil Service Committee, para 42.
[3] Table 1 Appendix 2.
[4] Q. 97.
[5] Q. 98.
[6] That is, the planning total less privatisation proceeds.
[7] H.C. Deb., 1986–87, Vol 103, col 1084.
[8] See, for example, HC (1984–85) 213: Sixth Report from the Treasury and Civil Service Committee, para 41ff.

39. The planning total (less privatisation proceeds) for 1988–89 is 4.5 per cent higher than at Budget time, with increases as high as 20 per cent in real terms above previous plans in the case of Education. However, although these plans have been revised substantially upward, the overall outturn for departments is intended to be only slightly higher in real terms than 1987–88.[1] In 1989–90 the overall planning total is expected to increase by about 1½ per cent over 1988–89.

40. The profile of the spending plans is thus very familiar. Departmental expenditure (including future allocations from the Reserve) will increase substantially above previous plans in the near term, but spending will somehow be restrained after that (the average increase in the final two years of the planning period is planned to be 0.9 per cent a year) to fall below the trend established since 1979 (of around 1.5 per cent a year)[2]

41. Despite the relaxation of departmental spending plans, the planning total may be put under pressure again next year. One area of concern is the likelihood of a significant adverse relative price effect against the public sector. Recent increases in teachers' and firemen's pay are not favourable precedents, despite the Chancellor's view that no conclusions should be drawn from the firemen's settlement.[3] Import prices are also likely to rise more quickly than overall domestic prices. Therefore, intended real increases in expenditure may be substantially offset by increases in input prices. Finally, the Reserve has been set some 20 per cent lower than last year even though this year's Reserve has proved some 25 per cent too low.

42. The Chancellor, however, considers that the Reserve will be adequate:

> "The reserves are, with the exception of last year, the highest we have ever had both in absolute terms and as a proportion of the planning total . . . This year there is a much bigger increase in local authority current expenditure, what we believe to be a realistic estimate and therefore we believe reserves on the scale of last year are not required.[4]

43. We welcome the forward provision for local authority spending this year in place of the unsatisfactory practice of repeating the cash figures for the first year of the planning period. However, it will be some time before it becomes clear whether these are realistic estimates.

Prospects

44. The Chancellor views the outlook for the economy in 1987 as one of balanced growth.[4] Overall GDP growth is expected to pick up to 3 per cent in 1987 from the pause experienced after the oil price fall. Within this, manufacturing output is expected to increase by 4 per cent after remaining static in 1986, the growth in exports of goods and services is expected to increase from 1 per cent this year to 3 per cent in 1987, imports of goods and services are expected to grow more slowly, and investment is expected to continue at relatively high levels. The composition of demand growth is expected to shift slightly away from consumption, with an assumed halt in the decline in the savings ratio. Companies' disposable incomes are expected to rise again in real terms. The RPI is forecast to increase by 3¼ per cent in the year to the fourth quarter of 1986, slightly lower than forecast at Budget time, and by 3¾ per cent in the year to the fourth quarter of 1987; the GDP deflator is also expected to increase 3¾ per cent in 1987. The current account forecast has been revised substantially both for 1986, in respect of which it is reduced from a £3½ billion surplus to a nil balance, and for 1987, where it is reduced from £1½ billion surplus to £1½ billion deficit. This is due to the unexpectedly slow response to the change in oil prices.

45. While the Treasury's forecasts are generally in line with those prepared for the Committee,[5] there are some aspects which appear optimistic. Paragraph 1.50 of the Autumn Statement states that:

> "With RPI inflation 3 percentage points lower than it was at the start of the last pay round, pay settlements are expected to be a little lower than last year: indeed, there have already been signs of a move towards lower settlements in the private sector in recent months".

Coupled with a rise in productivity, due to the expected increase in manufacturing output, this fall in pay increases could result in a decline in the rate of unit labour cost growth, though to a level still well above most of the UK's competitors. However, the expectation that wage increases will moderate contrasts with paragraph 1.48 which notes that even though price

[1]Tables 1 and 3, Appendix 4.
[2]See Graph 1, Appendix 4.
[3]Q. 106.
[4]Q. 82.
[5]Tables 1 and 2, Annex.

inflation has fallen there has been no decline so far in the published figures for the underlying rate of growth in average earnings.

46. We asked officials for the basis of their confidence that wage increases would moderate at a time when profits are still rising, when evidence exists of skill shortages in certain areas and when claims have been made that capacity constraints are emerging. In reply, Sir Terence Burns said:

> "There are signs in the CBI settlements, as I understand it, of some small reduction in the rate of settlements. And our own monitoring of those figures would support that"[1]

He also took the view that neither vacancy rates nor capacity utilisation was unduly high, and felt that developments in other developed economics would not be as favourable as perhaps expected.[2] These factors, he felt, could be expected to lead to some decline in domestic pay increases and convergence in unit labour cost movements between the UK and elsewhere. However, Sir Terence agreed that:

> "the growth of labour costs continues to be disturbing."[3].

While we acknowledge these favourable factors, even if they are borne out by events the gap between unit labour cost changes in the UK and elsewhere, shown in Chart 1.9, will look little different from those of the past three years.

47. If wage increases overall do not fall as expected, other aspects of the forecast could be put under some pressure. A further deterioration in relative unit labour costs might lead to calls for a further exchange rate depreciation to maintain competitiveness. Indeed, even if events turn out as expected, some pressure on the exchange rate may develop in the medium term. However, officials noted that:

> "the Chancellor has made clear [that] he is not prepared simply to follow a policy of exchange rate depreciation to validate higher levels of earnings in this country relative to those in our competitor countries.[4]

48. On employment, the Autumn Statement notes the growth in total employment of around one million between March 1983 and June 1986. While employment growth in the service industries continued strongly, overall employment growth has slowed recently due to the reduction in output growth. However, the pickup in output growth expected in 1987, together with the favourable demographic outlook, points to a somewhat more favourable prospect for unemployment in the near future, provided the expected fall in pay settlements occurs.

49. The forecast for the current account of the Balance of Payments has been revised substantially downwards since the Budget. Nevertheless, manufactured exports are expected to increase sharply due to growth in world markets and "the lagged benefits of last year's gain in competitiveness."[5] The very substantial fall in the £/DM rate together with the expected benefits of the J-curve effect tend to reinforce this encouraging view.

50. As regards competitiveness, we questioned officials on the consistency of this last factor with the view expressed last year that "the experience of the last five years suggests that export volumes have not been very responsive to price and cost changes."[6]

Sir Terence Burns told us that:

> "There is no inconsistency in those statements. The statement last year was a relative statement. It was suggesting how responsive it was compared to some other views which had been expressed. It did not say exports were totally unresponsive."[7]

We suggested that the beneficial effects of exchange rate movements depend on the extent to which they are perceived as permanent. Sir Terence replied that:

> "I would accept that the fact that there are fluctuations in the exchange rate is possibly one reason why the short term effects of exchange rate changes are not as great as they have been in the past".[8]

51. The Committee will continue its inquiries into the nature of the effect of exchange rate changes on exports.

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[1] Q. 60.
[2] Q. 45.
[3] Q. 65.
[4] Q. 60.
[5] 1986 Autumn Statement para 1.25.
[6] 1985 Autumn Statement para 1.20.
[7] Q. 38.
[8] Q. 9.

52. On the imports side, the Treasury discounted the large rise in imports seen in recent months.

"I think it is still early days to be sure to what extent those [import] pressures will continue."[1]

It remains to be seen whether demand in real terms for imports forecast for 1987[2] is realised. However, the Committee accepts Sir Terence Burn's point that the Treasury, in general, do not have a record of over-optimistic predictions of the Balance of Payments.[3]

53. We have over the years examined government fiscal and economic policy in the light of its own proclaimed intentions. We have chronicled the movement away from the original intention of reducing public expenditure in real terms, the monetarist emphasis on the £M3 money supply, and the desire to facilitate rational expectations. It is now clear that in respect of the key factors of public expenditure control, reduction in the money supply, and the use of interest and exchange rates there has been a substantial change in policy. In the interests of informed public debate, these should be openly explained and avowed, so that the government's present position, its merits and its problems, can be rationally discussed.

3rd *December* 1986

[1]Q. 36.
[2]See Table 1.15, 1986 Autumn Statement.
[3]Q. 36.

ANNEX

TABLE 1

Base Forecasts

Variable	Henley	LBS	NIESR	P&D	Treasury
A. Output and Expenditure at 1980 prices—% change					
(i) GDP (factor cost)					
1987 over 1986	2.8	3.0	2.4	2.7	3.5
1988 over 1987	2.1	3.2	2.1	1.9	
(ii) Consumers' Expenditure					
1987 over 1986	2.8	4.1	3.7	3.7	4.0
1988 over 1987	2.8	3.1	2.1	2.3	
(iii) General Government Current Expenditure					
1987 over 1986	2.2	1.0	2.2	1.7	1.5
1988 over 1987	1.5	0.9	1.0	1.3	
(iv) Fixed Investment					
1987 over 1986	3.5	2.4	3.1	3.2	2.25
1988 over 1987	2.4	4.1	3.2	0.8	
(v) Exports (Goods and Services)					
1987 over 1986	4.2	4.8	4.3	1.3	3.0
1988 over 1987	3.0	6.4	2.7	1.3	
(vi) Imports (Goods and Services)					
1987 over 1986	4.5	4.7	8.8	4.0	4.5
1988 over 1987	3.6	4.7	3.3	3.2	
(vii) Changes in Stockbuilding as per cent GDP					
1987 over 1986	0.5	−0.1	0.5	0.2	0
1988 over 1987	0.5	−0.1	0.3	0.5	
B. Balance of Payments, Current Account £ billion					
1987	−2.1	−2.4	−5.6	−3.4	−1.5
1988	−2.9	−1.2	−7.2	−4.5	
C. PSBR, £ billion, fiscal years					
1987–88	9.5	7.8	11.6	9.0	7.0
1988–89	11.5	7.1	12.8	12.1	
D. Retail Price Index. % change					
Q. 4 1986 to Q. 4 1987	4.7	3.5	5.8	5.2	3.75
Q. 4 1987 to Q. 4 1988	5.7	4.4	6.8	6.0	
E. Money Supply (£M3) % change					
Q. 1 1987 to Q. 1 1988	16.0	9.5	[1]	14.5	12.5[2]
F. Unemployment, UK, excluding school leavers, millions					
1987 Q. 4	3.0	3.1	2.94	3.1	3.05[3]
1988 Q. 4	2.9	3.1	2.89	3.0	
G. Effective Exchange Rate					
1987 Q. 4	66.2	64	66.1	65.1	67.3[4]
1988 Q. 4	64.5	62	64.1	62.5	

[1] Not forecast.
[2] Mid Point of rate.
[3] Based on the Autumn Statement Estimate ie "Great Britain excluding school leavers etc".
[4] "The forecast assumes that sterling remains close to its present level in both dollar and effective terms".

TABLE 2

Common Assumptions Forecast

Variable	*Henley*	*LBS*	*NIESR*	*P&D*
A. Output and Expenditure at 1980 prices—% change				
(i) GDP (factor cost)				
1987 over 1986	2.7	2.8	2.2	2.4
1988 over 1987	2.0	2.4	1.9	1.6
(ii) Consumers' Expenditure				
1987 over 1986	3.0	4.2	3.6	3.5
1988 over 1987	3.2	3.0	2.1	1.5
(iii) General Government Current Expenditure				
1987 over 1986	1.5	1.6	1.5	1.5
1988 over 1987	1.0	0.5	1.3	1.0
(iv) Fixed Investment				
1987 over 1986	3.3	2.4	3.1	3.1
1988 over 1987	2.3	2.8	2.7	1.0
(v) Exports (Goods and Services)				
1987 over 1986	4.0	4.3	4.3	1.5
1988 over 1987	2.8	4.9	2.2	1.4
(vi) Imports (Goods and Services)				
1987 over 1986	4.8	4.8	8.6	3.9
1988 over 1987	3.9	3.8	3.1	2.2
(vii) Changes in Stockbuilding as per cent GDP				
1987 over 1986	0.5	−0.1	0.5	0.2
1988 over 1987	0.5	−0.3	0.2	0.4
B. Balance of Payments, Current Account £ billion				
1987	−2.5	−2.3	−5.0	−2.7
1988	−3.5	0.2	−5.2	−2.8
C. PSBR, £ billion, fiscal years				
1987–88	9.0	7.1	11.2	7.0
1988–89	10.5	8.6	12.5	7.0
D. Retail Price Index. % change				
Q. 4 1986 to Q. 4 1987	4.3	3.9	5.7	4.3
Q. 4 1987 to Q. 4 1988	5.5	3.4	5.9	4.9
E. Money Supply (£M3) % change				
Q. 1 1987 to Q. 1 1988	16.2	9.5	[1]	13.1
F. Unemployment, UK, excluding school leavers, millions				
1987 Q. 4	3.0	3.1	2.95	3.15
1988 Q. 4	2.9	3.2	2.94	3.19
G. Effective Exchange Rate				
1987 Q. 4	67.3	67.3	67.3	67.3
1988 Q. 4	67.3	67.3	67.3	67.3

[1]Not forecast.

TABLE 3

Assumptions in Common Assumptions Forecast

% Change Q. 4 1986–Q.1 1989 (unless otherwise stated)	
North Sea Output	−12.0
World Oil Price ($)	0
$/£ rate	0
Effective Exchange Rate 1975:100	67.3
World Interest Rates (% points).	0
World Export Prices	9.3
World Trade in Manufactures	10.4
UK short-term interest rates (% points)	0
Government expenditure (1980 prices)	
1987–88 over 1986–87	1.5
1988–89 over 1987–88	1.0

SOURCES FOR TREASURY ASSUMPTIONS:

North Sea Output	1986 Brown Book Appendix 14 (See paragraph 1.44 Autumn Statement).
World oil price	Autumn Statement paragraph 1.16
Exchange rates	Autumn Statement paragraph 1.22
Interest-rates	Reference in paragraph 1.59 Autumn Statement
World export prices	Inferred from forecasts of UK Output prices (Table 1.6) and terms of trade excluding oil (Table 1.2), Autumn Statement.
Trade in manufactures	Table 1.1 Government consumption Table 1.15

PROCEEDINGS OF THE COMMITTEE RELATING TO THE REPORT

WEDNESDAY 3 DECEMBER 1986

Members present:

Mr Terence L Higgins in the Chair

Mr Browne	Mr Townend
Mr Budgen	Mr Wainwright
Mr Mitchell	Mr Watts

Draft Report (The Government's Economic Policy: Autumn Statement) proposed by the Chairman, brought up and read.

Ordered, That the Chairman's draft Report be read a second time, paragraph by paragraph.

Paragraphs 1 to 3 read and agreed to.

Paragraph 4 read, amended and agreed to.

Paragraphs 5 and 6 read and agreed to.

Paragraph 7 read, amended, divided and agreed to (now paragraphs 7 and 8).

Paragraph 8 (now paragraph 9) read and agreed to.

Paragraph 9 (now paragraph 10) read, amended and agreed to.

Paragraph 10 (now paragraph 11) read and agreed to.

Paragraphs 11 and 12 (now paragraphs 12 and 13) read, amended and agreed to.

Paragraph 13 (now paragraph 14) read and agreed to.

Paragraph 14 (now paragraph 15) read, amended and agreed to.

Paragraph 15 (now paragraph 16) read and agreed to.

A paragraph—(*Mr Mitchell*)—brought up and read, as follows:

"The importance attached to the future consequences of the expansion of M3, so weighty in the Government's original thinking on inflation now appears to have been abandoned in favour of a strategy, new for this Government but used, if not avowed, by most British governments since the war, of concentrating the fight against inflation on interest rates and the exchange rate. The Chancellor agreed that this was the strategy:

> 'Certainly the interest rates are set at the rate needed to fight inflation, that is absolutely right. The level of exchange rate, what is happening to the exchange rate is an important determinant of that . . . The whole essence of the battle against inflation can be summed up in one hyphenated word and that is "non accommodation". That is what it is all about.' (Qs. 137 and 138)

We are concerned that the consequences fall disproportionately on that sector of the economy, manufacturing, which must carry the main effort to ease the balance of payments constraint. Interest rates are higher than they would otherwise be, and higher than our competitors, in order to impose the discipline and to prevent market forces bringing the pound down. The exchange rate appreciates in real terms as costs rise, often through circumstances industry is unable to control, such as regional disparities, skill bottlenecks and the need to sustain continuity of production. The long term consequences of such a double squeeze cannot be beneficial to a sector which has already been hard hit. Moreover the strategy works if at all by making imports cheaper and by punishing manufacturing industry for costs it can do little about."

Motion made, and Question put, That the paragraph be read a second time.

The Committee divided.

Ayes, 3	Noes, 3
Mr Budgen	Mr Browne
Mr Mitchell	Mr Townend
Mr Wainwright	Mr Watts

Whereupon the Chairman declared himself with the Noes.

Paragraph 16 (now paragraph 17) read and agreed to.

Paragraph 17 read as follows:

"We acknowledge the difficulties which have arisen following the change from a policy based on straightforward concern with monetary targets to one in which the exchange rate is used to control inflation directly by influencing import prices and indirectly by not validating inflationary wage settlements."

Amendment proposed, at the end to add the words:

"However, we urge the Government to consider more seriously the long term consequences of such a strategy for the manufacturing sector of the economy"—(*Mr Mitchell*)

Question put, That the Amendment be made.

The Committee divided.

Ayes, 2	Noes, 3
Mr Mitchell	Mr Budgen
Mr Wainwright	Mr Townend
	Mr Watts

Another Amendment proposed, at the end to add the words:

"We do not consider that allowing market forces to operate freely on wage rates and hence labour costs but setting out deliberately to frustrate their consequential effects on the exchange rate is tenable for any sustained period, without further eroding the manufacturing base of the economy"—(*Mr Mitchell*)

Question put, That the Amendment be made.

The Committee divided.

Ayes, 2	Noes, 3
Mr Mitchell	Mr Budgen
Mr Wainwright	Mr Townend
	Mr Watts

Another Amendment proposed, at the end to add the words:

"The logical corollary of such a one-sided intervention must be either some form of incomes policy to help industry to restrain its own labour costs or special help and direct encouragement to industry through investment other incentives to allow it to expand, sustain confidence, and carry the double burden imposed on it through interest rates and an exchange rate both higher than they would otherwise be"—(*Mr Mitchell*)

Question put, That the Amendment be made.

The Committee divided.

Ayes, 2	Noes, 3
Mr Mitchell	Mr Budgen
Mr Wainwright	Mr Townend
	Mr Watts

An Amendment made.

Paragraph, as amended, agreed to (now paragraph 18).

Another paragraph—(*Mr Mitchell*)—brought up and read, as follows:

"The Government's counter-inflationary strategy disciplines industry in order to force it to reduce labour costs over which it has little or no control. In doing so it inflicts direct harm on a manufacturing sector which is important for jobs and national survival. It thus makes it more difficult to attract resources and investment into the emerging balance of payments problem.

Industry is not the pace setter in inflation. The rich are. The engine of inflation is now the financial and services sector, particularly in the South East. It is characterised not so much by goods inflation as by an asset inflation of house and stock exchange prices. This is politically expedient. The majority of the population, who are not employed in manufacturing, have the benefit of cheap imports and a once and for all increase in their standard of living. It is, however, economically shortsighted. Manufacturing, constrained by international competition and weakened by high interest rates and an uncompetitive exchange rate, falls further behind the financial and service sectors, compounding its longstanding losses of talent, management and skills, becoming less attractive to ability.

An effective anti-inflationary strategy requires selective control of credit to restrict speculation and asset appreciation. It should concentrate on the sheltered services, and not the internationally traded sector. This is the engine of growth in the economy. It must be rebuilt and expanded if we are to reduce unemployment and pay our way in the world as the oil contribution falls away. It can do so if expansion is encouraged and sustained by a competitive exchange rate and low interest rates neither of which are likely on present governments policies."

Motion made, and Question put, That the paragraph be read a second time.

The Committee divided.

Ayes, 1	Noes, 4
Mr Mitchell	Mr Budgen
	Mr Townend
	Mr Wainwright
	Mr Watts

Another paragraph—(*Mr Budgen*)—brought up, read the first and second time, amended and added (now paragraph 19).

Paragraph 18 (now paragraph 20) read, amended and agreed to.

Paragraph 19 (now paragraph 21) read and agreed to.

Paragraph 20 read, as follows:

"However, although the PSBR target figure is the same as that in the 1986 MTFS, the underlying paths for pubic expenditure and, hence, taxation are substantially different from that outlined in the MFTS. As well as reducing the PSBR as a percentage of the GDP, the Government has had for several years the objective of reducing the burden of taxation as a method of improving economic incentives and improving overall economic performance. The Green Paper on expenditure into the 1990s saw a return to mid-1960s levels of taxation as a desirable objective and the Chancellor has announced his intention eventually to reduce the standard rate to 25p. When asked whether the increase in spending in 1987–88 of over £4 billion implied that the aim of bringing the standard rate of income tax down to 25p, the Chancellor replied:

'Certainly I agree with that. As I said in the House in the questioning that followed the Autumn Statement, a pound in additional public expenditure is a pound which is not available for reductions in taxation, unless you are prepared to extend the borrowing requirement, and I have made it clear that that I will not do'."

Paragraph disagreed to.

Another paragraph—(*The Chairman*)—brought up, read a first and second time, amended and added (now paragraph 22).

Paragraph 21, read, amended, divided and agreed to (now paragraphs 23 and 24).

Paragraph 22 read, as follows:

"The Chancellor also said that in setting the PSBR one of the guidelines was that it:

"can be comfortably financed in a non-inflationary way'

even if it does not turn out as expected. However, the Chancellor would not be drawn on the steps the Government would take if it appeared that the PSBR was off-track next year."

Paragraph disagreed to.

Paragraph 23 read, as follows:

"On the fiscal stance itself, there appears to be little change over the 1986–87 position, which has been slightly expansionary. Estimates of both cyclically adjusted PSBR and cyclically adjusted Public Sector Financial Deficit are unchanged from 1986–87 levels. However, there may be some secondary fiscal stimulus from the shift towards increased public spending, which generally has stronger short run effects than reductions in taxes."

Paragraph disagreed to.

Another paragraph—(*Mr Mitchell*)—brought up, read the first and second time, amended and added (now paragraph 25).

Another paragraph—(*Mr Mitchell*)—brought up, read the first and second time, amended and added (now paragraph 26).

Paragraph 24 (now paragraph 27) read, amended and agreed to.

Paragraphs 25 to 32 (now paragraphs 28 to 35) read and agreed to.

Paragraphs 33 to 37 (now paragraphs 36 to 40) read, amended and agreed to.

Paragraphs 38 to 40 (now paragraphs 41 to 43) read and agreed to.

Paragraphs 41 and 42 (now paragraphs 44 and 45) read, amended and agreed to.

Paragraphs 43 to 45 (now paragraphs 46 to 48) read and agreed to.

Another paragraph—(*Mr Mitchell*)—brought up and read as follows:

> "We must underline our concern that Government projections are at their most optimistic, and therefore in greater danger of being invalidated by events, in the crucial area of the balance of payments. The most striking recent developments have been the growth of imports and the comparative weakness of exports. Strong consumer demand, sustained by wage increases above the level of inflation must sustain demand for imports while high interest rates and a consequential overvaluation in real terms will not be beneficial to exports. While the Government has recently substantially revised its estimates of invisible earnings, we note that the Treasury forecast for the balance of payments is more optimistic than that of most independent surveys. At best there is a strong probability of a tightening balance of payments constraint of the old, pre-oil type. At worst there is the possibility of a substantial balance of payments deficit with consequential effects on the exchange rate."

Motion made, and the Question put, That the paragraph be read a second time.

The Committee divided.

Ayes, 1	Noes, 4
Mr Mitchell	Mr Budgen
	Mr Townend
	Mr Wainwright
	Mr Watts

Paragraphs 46 to 48 (now paragraphs 49 to 51) read and agreed to.

Paragraphs 49 (now paragraph 52) read, amended and agreed to.

Another paragraph—(*Mr Mitchell*)—brought up, read a first and second time, amended and added (now paragraph 53).

Resolved, That the Report, as amended, be the Second Report of the Committee to the House.

Ordered, That the Chairman do make the report to the House.

Several papers were ordered to be appended to the Minutes of Evidence.

Ordered, That the Appendices to the Minutes of Evidence taken before the Committee be reported to the House—(*The Chairman*).

MINUTES OF EVIDENCE

TAKEN BEFORE THE TREASURY AND CIVIL SERVICE COMMITTEE

MONDAY 17 NOVEMBER 1986

Members present:

Mr T L Higgins, in the Chair

Mr John Browne
Mr Ralph Howell
Mr Austin Mitchell
Mr John Townend
Mr Richard Wainwright
Mr John Watts

Examination of Witnesses

SIR TERENCE BURNS, Chief Economic Adviser, MR F CASSELL, Deputy Secretary, Public Finance, MR M C SCHOLAR, Under Secretary, Fiscal Policy Group, MR A TURNBULL, Under Secretary, General Expenditure Policy Group and MR P SEDGWICK, Under Secretary, Forecasting and Analysis Group, HM Treasury, called in and examined.

Chairman

1. We are most grateful to you and your colleagues for coming along this afternoon to give evidence on the Autumn Statement and, as you know, we shall be taking evidence on Thursday from the Chancellor of the Exchequer. We are not, in fact, in our usual room—it may look the same from your point of view but there are several more rows which we hope will give rather more space. We will be asking questions on various aspects of the Autumn Statement. If you have any preliminary remarks you would like to make then we will be glad to hear them.

(Sir Terence Burns) I have no introductory comments to make.

Chairman: We can start, I think, with Mr Watts who has the first set of questions.

Mr Watts

2. Would you agree that the stance on monetary policy in the Autumn Statement amounts to an exchange rate target?

(Sir Terence Burns) No, I would not. The stance on monetary policy in the Autumn Statement is as set out in the MTFS last March and by the Chancellor in his Lombard speech in April.

3. I recall in his evidence to us in our post Budget inquiry the Chancellor was laying much greater emphasis on the matter of the exchange rate, particularly as a restraint on inflationary pressures on the economy and we have seen, in the Autumn Statement, a very substantial downgrading of the weight placed on other monetary targets.

(Sir Terence Burns) I do not agree with the last part of that statement. There is no doubt that the exchange rate does have an important part to play in the assessment of monetary conditions and the Chancellor has repeatedly made that clear. But he has also made clear that monetary targets also have an important role to play. Indeed, in the Mansion House speech he pointed out that one of the reasons for the last increase in interest rates was because the growth of MO, the narrow measure of money, had picked up quite sharply.

4. We have no explicit monetary targets in this statement at all?

(Sir Terence Burns) Indeed not. That has been the position in all previous Autumn Statements that I can recall. Indeed, we frequently have exchanges at this time of year along these lines. The Chairman often puts to me the question: "Why is there not a greater treatment of monetary policy in the Autumn Statement?" I point out that is not the role of the Autumn Statement. The Autumn Statement presents a forecast of the economy, and it presents the figures for public expenditure. Of course, the Chancellor has made a statement about monetary policy in the Mansion House speech which is also customary at this time of the year. The Autumn Statement is not the occasion for a re-statement of monetary policy.

5. If I can pursue the exchange rate point: how confident is the Treasury that the assumption made in the forecast that the effective exchange rate will remain at about its present level is a realistic one?

(Sir Terence Burns) I emphasise, of course, that this is not a forecast, it is specifically stated to be an assumption. I would not dream of attempting to forecast the exchange rate. I have watched too many people for too many years get their fingers burnt at that game. I cannot for that reason make any particularly strong statements about what is going to happen to the exchange rate. As we have seen so often in the past it can move quite sharply in either direction in ways which catch people by surprise. I think this is a realistic assumption. Also I should point out that it is an assumption which we usually make in these forecasts.

6. It is no more than an assumption and we would not necessarily expect to see any measures to damp down significant deviations either up or down?

(Sir Terence Burns) It certainly is only an assumption. I do not think the second statement that you make follows from that. As I agreed earlier, the Chancellor has frequently said the exchange rate is an important indicator that is taken into account in the assessment of monetary conditions. On that basis sharp movements of the exchange rate would

[Mr Watts *Contd*]
clearly have indications for policy. Because it is an assumption for the purposes of this forecast it does not invalidate the general statement about the role of the exchange rate in the assessment of monetary policy.

7. So there is an implicit target but not an explicit one?

(Sir Terence Burns) There is neither an implicit target nor an explicit target. That is also something which I have had cause to state in this room or, as the Chairman points out, in another room, on several occasions in the past. This game of hunt the exchange rate target is an old and familiar friend and we constantly point out that there is no exchange rate target.

8. Finally, if the pound were to fall in effective terms, how would this affect the forecasts for exports in the current account?

(Sir Terence Burns) If the exchange rate were to be lowered then in time we would expect prices to be higher; we would expect the volume of exports to be higher. And, in time, we would expect the current account to improve although, as we know, for some time there may be adverse movements because of the familiar characteristics of the J-Curve.

9. What reasons would you have to expect beneficial effects on exports in the absence of any certainty about the future course of exchange rates? I find in talking to businessmen that uncertainty about the future level of exchange rates is one of the factors that seems to deter businesses from taking advantage of what might turn out to be a short-term improvement in international competitiveness?

(Sir Terence Burns) I accept that there is inevitable uncertainty about the exchange rate. It is a characteristic of the exchange rate system that the world has. That fact inevitably means a change in exchange rates will have a smaller impact on exporters' decisions because, obviously, they must take into account the extent to which it is going to persist. However, despite that, the evidence is clear that changes in the exchange rate do have an impact upon export performance. Possibly that impact is not as great as was once thought and again this is a subject on which we have had exchanges in this Committee. I would accept that the fact that there are fluctuations in the exchange rate is possibly one reason why the short term effects of exchange rate changes are not as great now as they have been in the past. I do not think that invalidates the general proposition that it will in time—I stress in time—have an effect on export performance.

Chairman

10. Could I just pursue two points raised by Mr Watts. Are we wrong in thinking the Chancellor has recently gone on record saying that he would not wish to see the exchange rate any lower than it is at present?

(Sir Terence Burns) That is correct, he said that in an interview on BBC Television last Sunday. I cannot recall the exact words but it was a statement along those lines.

11. That would seem to imply an exchange rate target at any rate in a downward or upward direction depending which way you are looking at it?

(Sir Terence Burns) I cannot explain any more than was contained in what the Chancellor said. If you wish to explore that further you will have to wait until Thursday.

12. Perhaps we might do that. Can I pursue the other point that Mr Watts raised which is the extent to which there are monetary policy statements in the Autumn Statement. I think we regarded the public sector borrowing requirement as a monetary policy within the medium term financial strategy, but would I be right in thinking that this is the first time in an Autumn Statement that a view has been put forward about PSBR?

(Sir Terence Burns) Yes. The position of the PSBR in this Autumn Statement is not quite the same as it was last year. We have, of course, always presented a forecast on the assumption that the PSBR for the next financial year, was the same as in the previous year's MTFS. And of course there has been a very strong presumption that come the time of the Budget that, indeed, would be the PSBR for the following year. Indeed, I think if you look at the last three or four years you will find in each case the PSBR in the Budget has been set either at or just below the level that was given in the previous year's MTFS. Nevertheless it was a presumption. This year the Chancellor has gone further than that and he has said that the PSBR next year will be held to that figure. He has done that because there was some question as to whether or not people would interpret the changes to the planning total as implying the fiscal stance would be relaxed next year. In order to make quite clear that that would not be the case he felt it was necessary on this occasion to go a little bit further in terms of the statements about fiscal policy.

13. To that extent there is this year a statement about monetary policy in the Autumn Statement whereas there has not been recently?

(Sir Terence Burns) A statement about fiscal policy.

14. Yes, but a relationship between the two?

(Sir Terence Burns) There is indeed that extra dimension this year to the Autumn Statement.

15. And the medium term financial strategy has clearly been placed in the context of the PSBR as well as the monetary indicator?

(Sir Terence Burns) It has but it is specifically the fiscal side that the Chancellor was addressing here because it was specifically that side that might have been called into question as a result of the increases to the planning total.

Chairman: I think Mr Browne has a couple of quick questions relating to what Mr Watts was talking about.

[Chairman *Contd*]

Mr Browne

16. Further to the Chairman's question before last when the Chancellor said that he did not wish to see sterling go any lower, to which indicator do you think he was referring, was it sterling against the deutschmark, sterling against the US dollar, sterling against the trade-weighted index, or another?

(Sir Terence Burns) I do not think he was actually specific about it but my guess would be he had in mind the sterling index. That is the measure that most of our statements about the exchange rate refer to.

17. Thank you, that is very interesting. It implied, although he did not give a figure, that there was a sort of psychological floor possibly on the trade-weighted index basis. Do you feel there is also a psychological ceiling or lid to sterling which the Chancellor would have in mind?

(Sir Terence Burns) I do not think that follows. You have to interpret his comments about the exchange rate in the context of the kind of movement we have seen recently. On previous visits to this Committee the Chancellor has stressed that, he did not want to see excessive movement in the exchange rate, but he also wanted to keep a relatively bracing exchange rate. And above all he stressed that he did not approve of exchange rate changes to accommodate differential movements in inflation or cost pressure. However, because of the oil price reduction this year it was inevitable that there would be some reduction of the exchange rate. As he has said that correction has now taken place and he wants to emphasise that that period of exchange rate depreciation is now behind us. We are back to the same principles that were in place previously.

18. Thank you very much.

(Sir Terence Burns) And, therefore, that is the reason that lies behind the emphasis of the statement.

Mr Townend

19. Sir Terence, what is the real underlying increase in the departmental expenditure now for 1986–87 in percentage terms over 1985–86?

(Sir Terence Burns) I will pass that to Mr Turnbull.

(Mr Turnbull) In real terms?

20. I mean the real departmental expenditure excluding asset sales and excluding the change in the cost of interest?

(Mr Turnbull) The increase in the planning total from one year to the next in terms of outturn is from £133.6 billion to £140.4 billion. In 1985–86 privatisation proceeds were £2¾ billion and in 1986–87 £4¾ billion.

21. Is not the underlying increase bigger because the 1985–86 figures were bloated by the effects of the coal strike, by some one point 25 billion? If you get down to the real departmental spending is it not increasing by something like 4 per cent.

(Mr Turnbull) I am not sure in the event that the increase in the coal strike in 1985–86 was necessarily as large as that. It is very difficult to disentangle the finances of the NCB, as it then was. Towards the end of the year it enjoyed a very rapid improvement. About £1 billion was the figure we estimated at the time.

22. This Committee was given a figure of about £1¼ billion.

(Mr Turnbull) Yes.

23. If you take that into account are we not up to 4 or 5 per cent and that actually is greater than the estimated increase in the gross domestic product in the Autumn Statement is forecast to be over 3.1.

(Mr Turnbull) You started by saying you wanted to get to an underlying figure. Taking any one year to year movement, particularly when you have the difficulty of making corrections for a specific factor, is not necessarily the way to do it.

24. As far as the public are concerned they are interested in departmental expenditure. We have had this argument about asset sales before, but accepting you exclude asset sales and you allow for the distorting effect of the miners' strike in 1985–86 it would be true, would it not, that departmental spending is increasing in 1986–87 faster than the increase in GDP?

(Mr Turnbull) I would have thought there is not a lot of difference between them. In 1985–86 we had a very sharp fall in real terms followed by, in 1986–87, a rise in real terms. You are trying to describe the rise in 1986–87 in real terms as in some sense a measure of the underlying change, I am not sure it is wise to do that.

25. What I have said is correct, is it not, whether you think it is wise or not? If you make the adjustments that I suggested to you in actual fact the departmental spending is rising at a higher percentage rate in 1986–87 than GDP?

(Mr Turnbull) For 1986–87 the planning total itself is estimated to rise in real terms 2.2 per cent; and excluding privatisation proceeds by 3.5 per cent, which in that year is, as you say, higher than the real growth of GDP.

26. Particularly if you add £1¼ billion for the coal strike and the change in the interest rate. Can I proceed? Do you agree that this year's Autumn Statement indicates there has been a significant change in the Government public spending policy?

(Mr Turnbull) Some people try to describe it as that but the underlying objective, which has been an objective for a number of years, has been to reduce the share of public spending as a proportion of national income. That is an objective one finds expressed back in 1979 before the present Government came to power. You find it appearing again in the Long Term Green Paper issued in 1984. It has been there as a constant theme although there

[Mr Townend *Contd*]
have been varying statements about the speed with which that objective is going to be achieved. It is clear that one is going to make slower progress towards it if expenditure is rising at 1 to 1½ per cent in real terms than if it were constant in real terms. I would see it as less a change of objective but more a change of the speed at which that objective is being achieved.

27. You did state in the 1986 FSBR that the aim was to hold total public spending broadly level in real terms. Now that is a statement that has not been repeated this year. It does seem we have moved away from that now and, instead of trying to hold public spending in real terms, we are trying to reduce the total of public spending as a percentage of GDP, which is slightly different.

(Mr Turnbull) The objective of reducing public spending as a share of national income was also there in the FSBR.

28. To that extent there has been a change in direction or change in emphasis?

(Mr Turnbull) A change in degree, yes, within the broad framework of trying to bring the share down. The statement of bringing the share down was in the FSBR and in the previous White Paper as well. It has been around for a very long time.

29. Could you tell me what assumption has been made in producing these figures for public sector pay in the next finance year 1987–88?

(Mr Turnbull) There is not necessarily any assumption about public sector pay, except in some very special circumstances such as teachers. In the case of departmental cash limits what is agreed is the case amount and that does not involve the assumption of a particular level of pay. In the case of local authorities, provision is made and GREs are set and the outcome will vary according to the increase in pay. The degree of pressure that people are under will vary according to the increase in pay. The survey is not put together by taking an assumption about pay, as it used to be two years ago.

30. When departments are doing their budgets, they must surely in their own minds take account to some extent the sort of figures they will include. If pay increases are going to average 3 per cent this is very different from pay increases averaging 8 or 9 per cent. I know you set the departments' budgets. You said that departments have cash limits.

(Mr Turnbull) The essence is that the *departments* have that view; what they agree with the Treasury are the cash limits or the running cost limits.

31. The Government has been preaching to private industry that pay increases are too great and they should get them down to roughly the level of inflation. We would hope the Government would set an example but clearly, if pay rates go up much faster, you are going to be digging into the reserves. In the next financial year the reserves are at a lower figure than in the current year. When one considers that this Autumn Statement shows an overrun of expenditure—a considerable overrun of expenditure, when one considers pressure on wages, are you confident that the figure you have in the next financial reserve will be adequate?

(Mr Turnbull) The reserve for 1987–88 is higher in aboslute terms and as a proportion of the planning total than any previous year except the year we are now in, when there were particular circumstances of local authority decisions on how to provide for local authorities in the survey. The provision for 1986–87 was set only ½ per cent above the 1985–86 outturn and at the same cash level thereafter. Given that we now have local authority spending projected to rise at 4½ per cent next year, that implies a very different size of reserve. We have gone back to reserves that are lower than last year but still higher than previous years. Moreover, the rise steps between the reserves in each year are larger than they have been before.

32. So you are quite happy that the reserves in the statement are adequate?

(Mr Turnbull) We have obviously thought about the size of reserve required. The size of reserve that the Treasury settles upon has to reflect the nature of the decisions on programmes and the contingencies it has to cover.

33. My last question is would you agree that, if the Government had kept to its forecast and its plans as set out in the previous Autumn Statement, it would have been considerably easier for the Chancellor to achieve his aim of bringing the standard rate down to 25p in the £.

(Mr Turnbull) I think the Chancellor has acknowledged that himself in his statement about not spending the same pound twice.

Mr Wainwright

34. Sir Terence, my questions are about the balance of payments on current account. First of all, there is a very substantial difference between the 1986 forecast of total current balance in the Budget Statement this year and, the same heading of forecast, in your Autumn Statement this year, dropping from £3½ million surplus to nil. The biggest single discrepancy between those two balance figures is accounted for in manufactures. Could you give us some breakdown of the factors which have led you to revise this forecast, specially with manufactures, so substantially?

(Sir Terence Burns) I take it you are asking about the factors which lie behind the changed performance?

35. Indeed.

(Sir Terence Burns) By far the main factor was the extent to which world trade growth did not turn out as anticipated—I should emphasis world trade in manufactures. It has been a very difficult year obviously for forecasters as far as the balance of payments is concerned. We have had some very big changes in oil prices, big changes in exchange rates,

[Mr Wainwright *Contd*]
and big changes in commodity prices. Assessing the impact of those changes upon world markets, I accept, has proved difficult. Above all, what has happened during the course of 1986 is that the growth of world trade in manufactures has not been as buoyant as we expected. In particular, tracing it back, it has to do with the speed with which the non-OECD countries cut their import levels. The growth of imports in the OECD countries had been relatively buoyant through 1986, reflecting the relatively rapid growth of domestic demand. But those countries whose exports have suffered, both the oil producers and the other commodity producers, have been forced, or have felt it necessary, to cut their level of imports. This explains why, across the main industrial countries, growth in industrial production has done rather worse than the growth of output as a whole. Basically what has happened in the industrial countries is that domestic demand has risen rapidly, as expected, but exports across the board have been relatively weak. We think it reflects the extent to which the markets have been weak although it will be some time before we get all the information in.

36. Those very powerful factors being as you describe, are you not really very optimistic in your 1987 forecast of the total balance of payments outcome of a deficit of only £1½ billion, in view of the trends which you have just been elaborating?

(Sir Terence Burns) There have been some sharp movements recently. If you examine the balance of payments forecasts which have been made by the various people who engage in this business, there have been some quite sharp revisions in recent months, largely reflecting the actual outcome in the last three to four months. I think it is still early days to be sure to what extent those pressures will continue. After quite a period when imports grew relatively slowly compared to the growth of final demand, we have suddenly seen quite a sharp increase in the summer months. A lot of the forecasts of the current account have changed as a result of that. We think this is not necessarily an optimistic forecast, although I would stress and fully accept that the standard error around balance of payments forcasts is huge. The other thing I could point out in self defence is that, by and large, we have not had a record of being excessively optimistic about the balance of payments. I accept that is the way it has turned out in 1986, but if you go back and look at the record over the last five or six years, I think you will find, by and large, the errors have been in the other direction. I never like to be forced into the position of saying, "Absolutely, this forecast is the only one there could possibly be", just as I want to resist any suggestion from your side of the table that we are inevitably unduly pessimistic or optimistic on any item. I accept, with all the humility that all forecasters should express, that forecasts can turn out to be wrong.

37. While acknowledging the Treasury's successes in forecasts in past years, a lot of things have changed in this year's Autumn Statement. It occurs to us the forecasting system may be one of them.

(Sir Terence Burns) That is an incorrect assumption; there has been no change to the forecasting system. There may have been some change in some of the people engaged in the forecasting system, as I said earlier, but there has been no change in the forecasting system.

38. In trying to explain your forecast for 1987 exports, in paragraph 1.25 of the Autumn Statement you speak about world markets expecting to grow more rapidly, and then, "This, together with the lagged benefits from this year's gain in competitiveness, suggests that exports should continue to grow steadily." However, in the Autumn Statement of last year, 1985, you said, "The experience of the past five years suggests that export volumes have not been very responsive to price and cost changes."

(Sir Terence Burns) There is no inconsistency in those statements. The statement last year was a relative statement. It was suggesting how responsive it was compared to some other views which had been expressed. It did not say exports were totally unresponsive. If you recall we had an exchange about this particular subject. And indeed we had a further exchange when I came with the Chancellor, and again you expressed some dismay at my statement, if I remember—or certainly Mr Mitchell expressed those thoughts.

39. It was both of us.

(Sir Terence Burns) We have not changed our view about that. And indeed the forecasting system which has been used has exactly the same impact of changes in competitiveness on exports as last year. There has been a significant change in competitiveness over the past year and even with the relatively small impact of that change upon exports you would expect to see this shown up in our export performance. I repeat, I do not regard those statements as inconsistent. I never said at any stage there was no impact of changes of competitiveness upon exports. What I said was that we had over the course of the 1980s, revised down the size of that impact. But nevertheless it still left a significant effect, and that, essentially is what is producing this slightly faster growth of UK exports than world trade.

40. The words which were actually used were those I quoted from last year's Autumn Statement.

(Sir Terence Burns) But they are not inconsistent with what I have just said, I am sure.

41. We can pursue this on Thursday, but I would like to move to invisibles, because here again I would like to ask why you are able to produce a relatively optimistic forecast for the future of the balance of invisibles and put it for this current year, 1986, to £8½ billion whereas in the Budget it was only £5 billion? That is a very steep increase after only 8 months. I would like to put these figures to you: the official estimated surplus of invisibles for the first nine months of this present year is stated to be £5.8 billion, and that includes nearly £0.5 billion of the delayed rebate from the EEC. The Department of Trade and Industry in its customary press notice

[Mr Wainwright *Contd*]
about the balance of payments puts in the invisible balance for the final three months of this year, following the nine months I have just mentioned, an invisible balance surplus of £600 million a month. These figures together do not add up to what in the Statement is the optimistic total outcome of £8½ billion for invisibles.

(Sir Terence Burns) Could I check an earlier statement you made? Did you say our Budget forecast had the invisible surplus at £5½ billion, because according to the document I have here it is £8 billion?

42. You are quite right. I am sorry.

(Sir Terence Burns) So there really is very little difference between the forecast we make now and the forecast we made at Budget time.

43. Nevertheless, you are expecting something which the figures do not appear to validate.

(Sir Terence Burns) Let met make some general comments and then Mr Sedgwick will make some more specific comments. Monitoring what is happening to invisibles during the course of the year is always very difficult. If anything, there is a tendency for the figures eventually to be revised upwards. When information first appears there is often an under statement, particularly, on the IPD account. From memory the second quarter figure, where we have detailed information, is showing a surplus of £2 billion, so at that rate I do not think we are far away from it. The significant change between 1985 and 1986 is the movement of the IPD account. This reflects two factors: one is the reduced debits on the North Sea account, because with lower oil revenues there is less accruing to overseas oil companies; and with the high level of net overseas assets we have quite a good return on non-oil IPD.

(Mr Sedgwick) I think the fact that the figures are as high as they are in the first half of the year might make anyone suspect we might be correct in assuming there would be a much larger overall invisible surplus than last year. The figure for last year has been revised up from £5 billion, which it was at the time of the Budget this year, to £5.8 billion, so there is evidence of the tendency to revise the figures upwards. Apart from the effects this year of depreciation on our earnings from foreign assets, which Sir Terence has just referred to, there are, of course, lower payments from North Sea profits earned on the part of foreign companies which are automatically recorded as debits in the balance of payments accounts. These payments abroad are much lower with lower oil prices. There is one other effect that is worth mentioning. We think that the figures for credits on tourism have probably been affected, to some extent, in the earlier part of this year by the fears of terrorism in America in particular. But we think any such effect could have been a few hundred million pounds and should wear off over time.

44. Can I ask whether in the trade forecasting and policy forecasting you really feel you have allowed sufficiently for the fact our unit wage costs appear to be stuck at a figure of approximately growing at 5 per cent per annum overall, there is no indication they are dropping. Manufacturers, by and large, are enjoying rising profits which makes it very difficult for them to resist pay and earnings rate increases. You have only to look at the daily newspapers to see the evidence of increasing skill shortages, exporting employers competing for skilled people in the labour market and that we are getting very near to capacity as far as effective modern competitive plant use is concerned. Do you not think those factors should engender some caution that our exports will increase to the level you have indicated?

(Sir Terence Burns) I think we have been cautious on our judgment about the pattern of exports. On unit labour costs which you mentioned, the most recent figure we have is 3½ per cent up on the previous year. The figures that appeared over the winter months very much reflected the weakness of manufacturing output and as manufacturing output has picked up so has the growth of productivity. As a result the computed figures for unit labour costs in manufacturing have declined.

Chairman

45. Over what period?

(Sir Terence Burns) That is the last figure published, the figure for September; the twelve month change to September. I also suspect that some of the figures for unit labour costs in the main G5 competitors are rising faster than we had previously estimated, also reflecting their low growth of manufacturing output and continued growth of earning. I would not dispute that ours are still rising faster than the average of our main competitors. But of course we have had this quite substantial exchange rate change which has affected competitiveness. I think the other things you mentioned were mainly to do with skill shortages, capacity etc., which are rather more difficult to read. Vacancy figures have risen very sharply in recent months but they are still not at the very high level that we have sometimes seen when there were pressures upon capacity. I noticed the balance of answers to the CBI question about skilled shortages, although it has risen, is still not in the region which has previously suggested great pressures. They are two questions in the CBI survey dealing with capacity; one about the capacity level manufacturers are working at; and one asking what are the constraints upon output. The answers point in slightly different directions. I do not see a great threat from that side. Without a shadow of doubt, capacity utilisation has picked up. But I think we are some way from the pattern of events which we would customarily associate with real supply constraints upon export performance. If I can emphasise, I do not want to be dogmatic about this or any other aspect of the forecast but I think it is quite a sensible forecast under the circumstances. It does not give as much weight possibly to the last two or three months' figures as some forecasters have given but I think it would be a mistake to do that at this stage until we have some more months' information.

[Chairman *Contd*]

Chairman: A single supplementary from Mr Browne.

Mr Browne

46. Sir Terence, would you accept that just as in the field of corporate finance, also in the case of Government finance, it is not just the level of borrowing in itself that is a critical issue alone but also the use of proceeds? Therefore when you see in the United States that the standard rate of tax will be cut dramatically with effect from 1st January 1987, in an economy where there is still increasing of public expenditure this time financed by borrowing, would you feel this Government would be prepared in future to increase borrowing if the use of proceeds, the use to which this money were put, were considered good for the economy, ie to finance a massive reduction in standard rate of tax within the United Kingdom; or is the present rise in public expenditure an overwhelming set back to any prospect of a significant rate of reduction in United Kingdom income tax?

(Sir Terence Burns) I can only attempt myself to interpret policy as I see it. Clearly this Government has not set about reducing income tax on the basis of a higher borrowing requirement in the hope that the lower tax rates would generate the additional revenues which people have talked about in the United States as following from their lower taxes.

47. Do you think it would in the future?

(Sir Terence Burns) That is very much a question which you should put to the Chancellor. So far the overall fiscal stance has been a matter of considerable importance to this Government and they have been prepared to increase tax, as they did in 1981, if it was necessary, in order to maintain a credible fiscal stance. I do not see any signs of that overall approach changing.

Mr Mitchell

48. Can I just express my joy that our exchanges on the exchange rate had such a marvellous educative effect on Treasury thinking?

(Sir Terence Burns) I am sorry to disappoint you Mr Mitchell.

49. It does seem a very substantial change from last year.

(Sir Terence Burns) What is the substantial change?

50. You are making the best of a bad job. The exchange rate has gone down, therefore you have to find virtue in that process. What you said would not happen last year will happen because exports will have to increase. You need them to fill the figures in and therefore they will because of depreciation.

(Sir Terence Burns) I appreciate your desire to make debating points on this subject but I really do not think that is fair. The Chancellor made quite clear in his speech some years ago at Cambridge that in the face of sharply changing oil revenue there would have to be some real exchange rate change as part of the correction mechanism. During the course of the last few months he has accepted what we have seen in the way of exchange rate change as that behaviour in practice. I repeat we have not changed our views about the impact of exchange rate changes or of changes in cost competitiveness upon exports. Maybe we should but we have not; and in time you will see what the scale of the effect will be.

Mr Mitchell: I will not continue the rhetorical questions. In 1981 when the pound was at its height, we were told it was not really all that bad for industry after all and it was making them leaner and fitter. Last year we were told competitiveness was not all that important. This year, because there is a gap to be filled, we are told that depreciation will give certain advantage to which you will allow exports to increase to fill it. Can I move on because I do not want to turn on to———

Chairman

51. A process of mutual education.

(Sir Terence Burns) Chairman, I enjoy this experience where one is fighting for the final word but, out of deference to Mr Mitchell, I will cease to question him.

Mr Mitchell

52. To move on to something there is agreement on: Industry and the economy are being crucified on the cross of high interest rates which are higher than our competitors which means putting up the cost of living higher than it should be and yet you seem to be assuming, as I read the statement, they will continue at this daft level. Is that correct? Are you assuming interest rates will continue at this level, maybe even increase?

(Sir Terence Burns) We do not publish forecasts on interest rates, never have done, and I am not going to start now.

53. The housing element in the RPI is put at $10\frac{1}{4}$% so that assumes interest rates will be as high as now. In the Summary paragraph 1.01 says: " . . . the recent rise in mortgage interest payments will add about half a per cent to RPI inflation for the next year" which assumes they come in a bit further because they do not come in until November.

(Sir Terence Burns) One thing you must bear in mind in looking at the figure for the contribution of housing and the RPI excluding mortgage rate, is that even if there is no change in the mortgage rate the total RPI tends to grow faster than the RPI excluding mortgage rate. This is because of the way in which it is computed using a lagged growth of house prices. They have been growing at 10 per cent per annum which is rather faster than the rest of the index. You cannot look at that component and say the excess of that over general inflation is bound to imply increases in mortgage rates. The housing component would tend to grow faster anyway reflecting the way that component is computed.

54. Are you assuming that interest rates will stay at this level?

[Mr Mitchell *Contd*]

(Sir Terence Burns) I do not wish to be drawn on the subject of what we have assumed for interest rates. It has been our practice that we do not get into the business of making forecasts of interest rates. We have, it is true, of course, presented information for the RPI which contains some clues but I do not want to go beyond that.

55. If the exchange rate is assumed to stay broadly flat at about this level and we take it that interest rates are being set in forecasts to validate that assumption, in other words they are being used to support that assumption———

(Sir Terence Burns) The interest rates used are those we judge to be necessary to deliver, in broad terms, monetary conditions that are consistent with the MTFS. The exchange rate is one part of that.

56. Since there is a worsening current account position does that not imply a further rise in interest rates to offset the effect on sterling of the worsening current account?

(Sir Terence Burns) Not necessarily. We would suggest that, by and large, movements in capital account are possibly more important than the movements of the current account as far as exchange rate determination is concerned. There is already a significant differential between our interest rates and those elsewhere, as you yourself pointed out. I do not think you can conclude it must be necessary to have higher interest rates to deliver this exchange rate. That is a matter of judgment. We have a long practice of not commenting upon assumptions about interest rates. We make an assumption about the exchange rate and we publish it but I do not wish to be drawn further on that.

Mr Mitchell: Thank you. let me come to the exchange rate assumption because you said———

Chairman

57. Could I interrupt for just a moment?

(Sir Terence Burns) I do not want to be too tedious about this, Chairman.

58. I understand, of course, the traditional position but I was just going to say on the figure in Table 1.7 for housing where we are given a $10\frac{1}{4}$ per cent increase for that component of the RPI in the fourth quarter of 1987 could you let us have a breakdown of that figure between interest rates and housing prices, if necessary lagged?

(Sir Terence Burns) I am not sure that I can do that, Chairman, because you are then asking for the interest rate assumption.

59. But it is there, is it not?

(Sir Terence Burns) It is implicit in those figures, that is true. May I take your request away? I will, of course, take your request away and discuss it with the Chancellor.

Mr Mitchell

60. Could I just pursue Mr Wainwright's point about unit labour costs which are rising substantially, more rapidly than our competitors. I personally see little basis for the assumption that they will not continue to rise at this rate and at a higher level than our competitors. I think the Incomes Data Services figures indicated there has been no fall in settlements, the Government has no policy for incomes apart from prayer, and profits seem to be high and they are not going into investment in the same degree that they are being paid into wages creating a climate in which unit labour cost inflation can go on. If it does remain high at that level does it not require further depreciation of sterling to sustain an improvement in competitiveness?

(Sir Terence Burns) I would make two comments on that. There are signs in the CBI settlements, as I understand it, of some small reduction in the rate of settlements. And our own monitoring of these figures would support that. We would claim there are some signs that a low inflation rate is being translated into low settlements, but I agree by no means by enough and the growth of labour costs continues to be disturbing. On the other hand we do think we wil be seeing lower rates of increase in unit labour costs. We see a figure of $2\frac{1}{2}$ per cent for 1987 reflecting in part a lower rate of pay settlements and in part a faster growth of productivity as output grows faster in 1987. That will reduce its growth of over labour costs to a figure reasonably close to the average of the other major countries but still possibly a bit above them. However, the Chancellor has made clear, as I mentioned earlier, that he is not prepared simply to follow a policy of exchange rate depreciation to validate higher levels of earnings in this country relative to those in our competitor countries.

61. If that figure is not accurate, a depreciation would be necessary and would also be desirable to draw investment into the balance of payments and exports will that depreciation be resisted?

(Sir Terence Burns) Yes, and the gain in competitiveness we have experienced recently will be to some degree eroded. The Chancellor has debated with you on several occasions about this. He sees it that once you give in to this process by simply following high labour costs with currency depreciation you are in a vicious circle which can only get worse.

62. I will ask that of him as well but it might not have the same devastating effect that it has had on you.

(Sir Terence Burns) If you have no more effect on the Chancellor than you have had on me it will take a long while.

63. That implies depreciation will be resisted. How will it be resisted? Will it be resisted by raising interest rates or the use of reserves? Have we learned any lessons from attempts to stop the fall in the recent period?

(Sir Terence Burns) I do not think one would imagine trying to use reserves over a long period of time in order to compensate for higher rates of growth of labour costs in this country. It would have to be resisted by a general tightening of policy and ensuring that the faster rates of growth of earnings did not show up in faster inflation and exchange rate depreciation.

[Mr Mitchell *Contd*]

64. One final question. This has been regarded as a political Autumn Statement because spending money looks incredible for a Government that has been saying it has been impossible to do that, and suddenly all of this develops before an election is likely. You may have seen the cover of Private Eye this week with the Prime Minister holding out pound notes saying: "Here are some of my new policies". A good job has been done in the Autumn Statement providing figures to make this look feasible and look as though it is responsible, as though there is not going to be a Nemesis; yet that figuring looks at its most incredible to me for the balance of payments. In other words, we seem to be running a risk of a substantial balance of payments problem with consequent threat to sterling. The calculation seems shakiest there, the calculation on the increase in invisibles, the calculation on the increase in exports for manufacturing industry which has been very hard hit, which has skill shortages and faces rising interest rates, which has not invested at the level of its competitors. The forecasts on that are slowing of imports which again looks slightly incredible. Would it be true to say that the risks are greatest on the balance of payments and the figures are most likely to be invalidated in that area?

(Sir Terence Burns) I suggested earlier that balance of payments forecasts inherently have a large standard error. I do not see the risk as any greater than the normal error that surrounds forecasts of this particularly difficult magnitude.

Chairman

65. I thought you were saying earlier it was a particularly difficult year for forecasting in this area, forecasting the balance of payments.

(Sir Terence Burns) 1986, I think, has been a particularly difficult year. But there have been very difficult years in the past from which we compute the average range we would expect it to be within. I do not see the risks as being any greater than that. I think that a lot of the response that you are suggesting is not surprising in the circumstances of the times. Put it this way; I do not think the scale of current changes warrants the cover of Private Eye.

Mr Mitchell

66. You were saying there would be a big fall off in imports in 1987. Why should that occur? They will not be increasing the way they have been doing?

(Sir Terence Burns) We have not assumed there will be a great fall off. Between the second half of 1984 and the first half of 1986, there was relatively slow growth of imports considering the growth of domestic demand. We have then seen in the second half of 1986 a very big increase in level of imports. What is not clear is what lies behind that. We are assuming, year on year, that imports of goods and services in 1987 will grow by 4½ per cent compared with 5 per cent growth in 1986. That cannot be described as a great rate of change.

Mr Howell

67. Sir Terence, could I ask a few questions on public sector manpower and the implications in the Statement. What progress has been made with the Rayner reviews regarding efficiency and waste in the public sector?

(Mr Turnbull) That is probably for me to answer. These scrutinies are now called Efficiency Unit scrutinies rather than Rayner scrutinies. They are still continuing and our estimate is that since 1979 they have led to savings of £300 million a year and to the saving of around 22,000 posts.

68. Are you satisified that these savings make overall savings because, for instance, on the question of the saving of a few million pounds in staff in employment offices, many hundreds of millions have been spent because people no longer have to register and it is much easier to carry on being unemployed. Do you get the point I am making?

(Mr Turnbull) Since 1979 something like 130,000 posts have been saved in the Civil Service and there are various reasons for that. Some of those have come about because of pure efficiency savings, some through contracting out, some through privatisation, some through hiving off. But the example you have given can be looked at in one of two ways, maybe as a streamlining of procedures or cutting out of a function. It is a separate argument as to whether cutting out that function turned out in retrospect to be a good thing. But there are numerous ways in which these manpower savings in the Civil Service have been made.

69. Could I turn to the question of local government? It must be a great disappointment that local government is still spending 9 per cent more than it should be spending and the bulk of this, I think everybody accepts, is in manpower itself. Do you think, Sir Terence, the manpower watch is having any real effect?

(Mr Turnbull) Local authority manpower, having fallen for a number of years, is now rising, with an increase between 1985 and 1986 of about three-quarters of 1 per cent. That is not a large increase but it is still a small increase in contrast with the fall in the Civil Service as a whole. But, as has been explained on a number of occasions to this Committee, the Government does not control local authority manpower directly; it sets a financial regime and does not even control spending directly. It sets a regime of grant, of GREs, the taper at which the grant is removed, a series of disincentives against increasing spending, but the ultimate decision on manpower is for local authorities to make. With regard to what you refer to as manpower watch, central government obviously watch manpower but they do not control it and are not the employers for that manpower.

70. That is a terrible weakness in the whole of our system, is it not?

(Mr Turnbull) It is called local government.

71. Yes, but is there no prospect of doing anything more? The Government made attempts to

[Mr Howell *Contd*]

control local government but it has not been successful, has it?

(Mr Turnbull) The Government has set the financial regime and for the high spending councils there is also the rate capping regime. It has established the Audit Commission whose job is to identify savings. This has no statutory power to enforce its findings but must act by publicity and example. It tries to encourage councils to follow the practice of the best. That is as far as central government is able to go while local government is still a separate decision-making entity.

72. But all these schemes have failed. What prospect is there that they are going to do other than fail in the future?

(Mr Turnbull) A Green Paper was issued last January—and the process of consultation on that has, I think, just been completed and the Government is considering the replies. One of the themes of that Green Paper, which is anticipated in the Bill on Scotland, is to increase local accountability, increase transparency, so that local electors can see how it is that expenditure rises and local taxation rises. There are changes proposed in the grant regime which will help make that possible.

73. Could I just turn to one point on wages? Do you think that, since we insist on fully indexed linking benefits, the Government is actually forcing up wages? Since the benefits are index-linked and tax-free, it is necessary for wage-earners at the lower end of the scale to acquire higher wages than they otherwise would. Do you not see that, Sir Terence, as the Government itself acting against its real intention of holding wages steady?

(Sir Terence Burns) I understand the mechanism you were describing, but if wages were also no more than index linked we would be somewhat more content than we are at the moment. I would have thought the influence which is coming from that direction is diminishing relative to levels of earnings. And of course one has to take into account the more general social objectives at the same time. In that sense there are conflicting pressures at work.

74. You accept there are conflicting pressures in this area?

(Sir Terence Burns) I am not sure. Speaking personally I have never been persuaded there is a huge impact all the way up the earnings scale from these pressures, but I fully accept that there are points in the earnings distribution where it does exercise an influence.

75. Thank you. I wonder if I could ask a question on Table 1.8 on employment. I cannot quite make the arithmetic add up there, but it seems we are talking of the employment labour force rising, whereas in actual fact whole time jobs are being exchanged for part-time jobs. Do you think there is any real value in this table at all?

(Sir Terence Burns) Yes, otherwise we would not present it! The figures are collected on this basis and that is how we also make our projections. Obviously they are described as part-time; it is not as if we were dressing part-time jobs up as something else.

76. But when we are talking about manpower in the civil service we are talking about whole time equivalents, and there seems to be some inconsistency in totting up all the part-time jobs and implying they are full time.

(Sir Terence Burns) It is rather easier to work out the full-time equivalent number if you yourself are the employer rather than if you are simply monitoring what is going on in the economy at large. As far as I am aware we do not have information to make an accurate assessment of full-time equivalents.

Mr Browne

77. What evidence does the Treasury have that wage settlements are likely to moderate in the face of, first of all, high corporate profits, and, secondly, indications of serious skill shortages in the very business areas where the high profit margins are made?

(Sir Terence Burns) There are a number of factors which we think have an influence upon the rate of growth of earnings, although one cannot define that with any great precision. The main one is the previous growth of prices; in other words the inflation rate in the period before. We have seen quite a substantial slow down in the rate of inflation and we would expect that to show up in terms of a lower growth in earnings. If you look historically, you can see this happen fairly clearly. Company profitability also possibly has some effect, but we are not looking for any great change between this year and next year. I think we have to accept there is a certain inflexibility about the rate of growth of earnings. The whole concept of a going rate and pay round means one does not get the sharp changes in the rate of growth of earnings which the Chancellor would like to see, given the rate of change in inflation. As far as pressures in the labour market are concerned, I referred to this earlier and clearly the labour market is looking a bit tighter than it was. We can see this by looking at the figures for vacancies and by looking at the figures for skilled labour shortages in the CBI survey. I would not myself have said it was yet at a level which would have been sufficient to compensate for the down pressure one would be expecting to see upon earnings growth coming from the lower inflation rate.

78. Could I ask you to summarise briefly what you feel the Government have learnt in balancing intervention in the foreign exchange market with interest rates and doing what they wish to do with sterling, whether it is up, down or whatever and not asking for target levels? How do you feel the experience of past years has distilled in getting that balance?

(Sir Terence Burns) I would say that we see a short-term role for intervention, but that intervention is not something that can be used to bring

[Mr Browne *Contd*]
about sustained changes to exchange rates. Therefore intervention is essentially tactical. If one wants to have a rather longer lasting impact upon exchange rates then it is a question of interest rate policy and the pressure which is coming from monetary policy as a whole.

Mr Browne: Thank you.

Chairman: I think we should bring our proceedings to a close now but Mr Mitchell has a quick question for you.

Mr Mitchell

79. You indicated that the wage costs earlier this year were boosted by the impact on productivity of a slow down in output which takes place?
(Sir Terence Burns) Yes.

80. Could we take it then that the underlying rise in unit costs was less than the actual figure for the early part of the year?
(Sir Terence Burns) Yes.

81. In that case there is an underlying rise in unit costs in the forecast, stripping out the fact of a cyclical improvement in productivity?
(Sir Terence Burns) I do not want to be too precise about this but we can take 1986–87 together. In 1986 the growth of unit labour costs probably overstates the underlying rate. The figure for 1987 probably understates it a little. We would expect the 4 per cent growth in manufacturing output which is anticipated in the forecast for 1987 to lead to a faster rate of growth of productivity in manufacturing than we have experienced on average.

Chairman: We are very grateful to you, Sir Terence, and your colleagues for your help in setting the scene and clarifying a number of issues before we take evidence from the Chancellor on Thursday. We are most grateful to you all for coming.

THURSDAY 20 NOVEMBER 1986

Members present:

Mr Terence L Higgins, in the Chair

Mr Anthony Beaumont-Dark
Mr John Browne
Mr Nicholas Budgen
Mr Ralph Howell
Mr Austin Mitchell
Mr John Townend
Mr Richard Wainwright
Mr John Watts

Examination of Witnesses

THE RT HON NIGEL LAWSON, a Member of the House, Chancellor of the Exchequer, examined.

SIR PETER MIDDLETON, KCB, Permanent Secretary, HM Treasury, called in and examined.

SIR TERENCE BURNS, Chief Economic Adviser, and MR ANDREW TURNBULL, Under Secretary, General Expenditure Policy Group, HM Treasury, called in and further examined.

Chairman

82. Mr Chancellor, may I welcome you on behalf of the Committee to what has now become a traditional annual event, namely, your evidence on the Autumn Statement in preparation for the report which we hope to prepare for the Floor of the House of Commons. You are indeed most welcome. You will have noticed that, although the view from your present seat has not greatly changed from the previous one, there are a considerable greater number of people sitting behind you. I hope this is advantageous from your point of view, but it does, however, create a bigger problem as far as the acoustics are concerned, because obviously it is difficult for those at the back to hear. That being said, we are glad you are able to come. Perhaps I might first ask you, in very traditional form, to introduce your officials for the benefit of the shorthand writers, and also ask whether there are any preliminary remarks you care to make.

(Mr Lawson) Thank you very much indeed, Mr Chairman, for your words of welcome. As you know, I am always happy to appear before your Committee. On my right is Sir Peter Middleton, Permanent Secretary to the Treasury; on my left is Sir Terence Burns, Chief Economic Adviser; and on the far right is Andrew Turnbull, Under Secretary in charge of the General Expenditure Policy Group. You kindly invited me to say a few words and, if I may, I will say a few words about three subjects: first, the continuity of the Government's approach to public spending; secondly, public sector borrowing next year; and, thirdly, the prospects for economic growth. On public expenditure, I have announced an increase in the planning totals for 1987–88 and 1988–89 within the overall constraint of ensuring that total public expenditure continues to decline as a proportion of GDP. Even excluding privatisation proceeds, we have reduced the proportion of national income taken by public spending every year since 1982, and the plans set out in the Autumn Statement carry that process on a further three years. By the end of the current planning period, in 1989–90, the ratio of public spending to national output will be back to the level of the early seventies. Some commentators have professed to see a discontinuity in all of this. There has been, it is true, a discontinuity, but that was back in 1982–83 when general government expenditure as a proportion of GDP stopped rising, as it had been doing continuously once the immediate aftermath of the IMF crisis in 1976 was over, and went on doing until the legacy of the Labour Government had worked its way through the system. Since then this ratio has declined, just as the rate of growth of public spending in real terms has declined, even excluding privatisation proceeds, from about 3 per cent a year in the decade up to 1979 to about $2\frac{1}{4}$ per cent a year during our first Parliament, and about $1\frac{3}{4}$ per cent a year in the present Parliament so far. The increase envisaged in the Autumn Statement over the next three years is at the still lower rate of 1 per cent a year. The same continuity of policy may be seen in public sector borrowing. In successive versions of the MTFS my predecessor and I have mapped out a course for the PSBR in which it would gradually diminish as a proportion of GDP. Throughout my time as Chancellor I have stuck firmly to this. In successive budgets I have set the PSBR at or a little below the level given in the previous year's MTFS. And apart from 1984–85, when I allowed public borrowing to expand to finance the expenditure needed in resisting the coal strike, the outturn on the PSBR has been broadly in line with that envisaged at the time of the Budget. For this financial year, the figures published on Tuesday of this week confirm that the PSBR remains on track. For next year I have, exceptionally, gone further than is usual at this time of year so as to dispel from the start any worry there might be that the increased planning totals imply a relaxation on public borrowing. I have therefore explicitly reaffirmed the Government's commitment to the fiscal stance set out in the 1986 MTFS, and made it clear that the PSBR next year will be held to $1\frac{3}{4}$ per cent of GDP. Finally, Chairman, I turn briefly to the prospects for growth over the coming year. The past five years since the world recession of 1980–81 have seen a remarkable stability in the growth performance of the economy. Growth has averaged almost 3 per cent a year over the whole of this period, without very much variation from year to year. There has been a relatively brief pause earlier this year, but that has now passed, as I predicted it would, and the Industry Act forecast suggests that it is set to continue at this rate in 1987.

[Chairman *Contd*]
This expected growth is not, as some critics have asserted, the result solely of a fragile and very rapid growth of consumer spending. The forecast is for a somewhat slower rise in consumer spending next year, much faster growth of non-oil exports—something which has already begun in the second half of the current year—and continuing growth in non-oil business investment from its record level this year, broadly in line with the growth of the economy as a whole; in other words, balanced growth.

83. Mr Chancellor, thank you for introducing your officials. Perhaps I might take this opportunity of expressing our appreciation to Sir Terence Burns and his colleagues who gave evidence on Monday; it was very helpful. I turn immediately to the point you made in your opening remarks regarding the continuity of government policy. I ask you to turn your mind back to early 1980 when you were financial Secretary, a post much older than that of Chancellor of the Exchequer.

(Mr Lawson) Is it?

84. Yes, indeed. I ask you whether it was the case at that time that the Government's intention was to reduce public expenditure progressively in volume terms?

(Mr Lawson) That aspiration has never been achieved, as you see by looking at the figures, and therefore it was a long time ago that we ceased to talk in those terms. I cannot remember when that was, but it always seems sensible to me that the description should correspond with reality.

The reality is that, in addition to saying what you have referred to in 1980, we said in the 1979 Manifesto—and I think we also said it in the document "The Right Approach to the Economy", which was a quasi economic manifesto pubished before the 1979 Manifesto proper—that we thought that public expenditure was taking an excessive share of GDP and we wished to see it progressively decline. That theme has been there continuously and it is that which accurately describes what has happened since 1982/83. It is that which also characterises the public expenditure plans which are published in the Autumn Statement. As I say, this is a remarkable change from the historical trend, which has been towards a steady increase in public expenditure as a share of GDP. It was slightly curious during the Labour Government, when you had an astonishing rise of something like 12 per cent in real terms in the first two years followed by the great disaster, the bailing out by the IMF in 1976 and so on; then you had an almost equally sharp fall, as capital expenditure was cut drastically. So you had during that period an inverted 'V'. But the long-term trend has been public expenditure rising faster than the growth of the economy as a whole and that is what we have sought to reverse and that is, indeed, what we *have* reversed. The plans continue that trend.

85. But if we then look at what happened between 1980 and, say, 1984, the policy then seemed to be to keep the level of public expenditure broadly stable in cost terms, is that correct?

(Mr Lawson) As I say, if you look at what has actually happened there has been a continued growth of public expenditure in real terms, but the growth ever since 1982 has been less than the growth of the economy as a whole. So the share of GDP has been declining; and the rate of growth of public expenditure has been declining, as I say, within that period. The rate of growth of public expenditure in real terms during this Parliament has been less than the rate of growth in real terms during the last Parliament, despite the fact that in a sense it is easier to make reductions at the beginning of a period of office, simply because you make the easy changes first and it then gets progressively more difficult. Nevertheless, despite that we have improved our performance if you accept the overall objective. As I say, I think the presentation I used in this Autumn Statement accurately represents the reality not merely of what is planned but also what has been happening since 1982/83.

86. Nonetheless, in terms of the continuity of policy, the objective in 1980 was to reduce public expenditure in real terms, by 1983 it was to hold it constant in real terms and we are now in a situation where it is the growth which has to be reduced rather than the absolute level and it has to be reduced as a percentage of GDP? That is a fair assessment of the way in which the policy has developed, is it not?

(Mr Lawson) I would say it is the way in which the presentation has developed rather than the policy. I think the policy has been consistent throughout and you can see a practically straight line on the graph showing what we have done. As I say, in so far as there has been any change it has been an improvement. The rate of growth in real terms of public expenditure has slowed down. I think it is the presentation which has changed slightly. I would not want to make too much of it. If you think of the extraordinary cataclysmic changes there have been in previous governments with the policy turning round 180° and all you can find here is a minor change in presentation, I think that is quite remarkable.

Chairman: No doubt we will wish to study carefuly what you have just said. Can we turn now to the question of manpower, and you will not be surprised that I am going to call on Mr Ralph Howell!

Mr Howell

87. Chancellor, may I congratulate you on the way in which you have presented your Autumn Statement, so that you please practically all your supporters and confound almost all your opponents. I would also like to say how pleased I am that you are maintaining your course of reducing public expenditure as a percentage of GDP. There are two points which I am sure concern us all and one is the fact that local government is not properly under control, having spent 9 per cent more than was intended, and also that the manpower watch figures show that we are employing more people in local

[Mr Howell *Contd*]
government than we were a year ago and there has been a rise since 1982. What can be done to counter this?

(Mr Lawson) I have no doubt whatever that you have identified a major problem. You will know what we have done already to try and influence local government spending through the way in which the rate support grant operates and through the introduction of rate-capping in the cases of the worst overspenders. We have no control at all over local government manpower, none whatever, and the position is not satisfactory. I have before this committee previously said that in my opinion the constitutional position we have in this country between local and central government is very unsatisfactory. We have a typically British compromise which arguably gives us the worst of both worlds. We neither have the out-and-out centralisation of a unitary state carried to its logical conclusion, as they have in France, nor do we have a federal constitution as they have in Germany. So there is just a mix and a muddle and nobody knows who is responsible for what, which enables local authorities, if they are so minded—and a number are—to act in a wholly irresponsible manner. This was kept in check in the past by a kind of concordat. It was one of the conventions of the constitution that local government, even though it was not obliged statutorily to do so, nevertheless conformed to the overall economic policy of the government of the day, whatever government it happened to be. But that progressively has broken down and certainly now, with a large number of local authorities under labour control, many of them, though not all, have not the slightest intention of co-operating with the economic policy of the government of the day. As I say, that convention of co-operation has gone, so we have to think of changes. There are two ways in which this is being approached now. One is the proposals we have made for changes in the method of local government finance, which are designed to bring a much greater degree of local accountability, accountability by local authorities to their electors. Pretty well everyone will pay the community charge whereas only a relatively small number of people pay rates. We are seeing another change, too—and I do not know where it will lead at the end of the day—in the situation which has arisen over the pay of teachers. When you think that education is easily the biggest single item in local authority expenditure and that teachers' pay is a very large part of that, the fact that we have now decided to scrap the Burnham machinery altogether and make a major change in this field is an indication of another way in which this problem can be addressed. Meanwhile, we are going to have this problem over local authority spending and it is something we have to live with.

88. The other major subject is the problem of DHSS spending and the open-ended nature of the social security package. Have you any plans for limiting some of the huge amounts of money which are being paid, often to people who are not really, in many cases, in need?

(Mr Lawson) We are certainly taking various steps to try and ensure that money is not paid to people who are not entitled to it, to strengthen the administrative side of the DHSS in this respect, and also to reinforce the Availability For Work test for Unemployment Benefit and Supplementary Benefit which fell into disuse through a false economy which we took on the staff side in the early years. But there are no plans to deprive people of what they are actually entitled to.

89. But surely something must be done in the case which has recently come to light of a family costing £2,000 a week. Another example was where somebody had got in trouble in his business and had taken out a very large mortgage on his house and was costing the State £1,200 a month. Surely there must be some urgency to put a top limit on such payments so that such examples could never happen again.

Mr Mitchell: Is this the City of London or the DHSS?

Mr Howell

90. I am talking about payments which are being made.

(Mr Lawson) I am not sufficiently familiar with the case you mentioned to know the precise circumstances and whether the family concerned was entitled to that amount of money or not. If they were not, then clearly steps need to be taken to see that that does not happen. I think that it is clearly something which has to be kept under review, and we did have a major review of social security, as you know, quite recently under the Secretary of State. Various changes are to come into operation—I think most of them in April 1988—as a result of the outcome of that review.

91. Could I turn to the question of wages rising faster than you would like. Do you agree that as long as we have fully indexed benefits, tax-free, that will cause an upward pressure on lower wages, which will ricochet all the way up the scale?

(Mr Lawson) Most of benefit expenditure is not now tax-free. Child Benefit is tax-free, but most of the rest has either always been taxable, like pensions, or is on benefits which we brought into tax, like Unemployment Benefit. But certainly a case can be made for saying that the level of benefits does cause the level of unemployment to be higher than it otherwise would be. I cannot quantify how much higher, but I know that academic studies done by economists about the Thirties suggested that what happened was that you had prices and wages actually falling but benefits staying the same in cash terms—so that they were actually going up in real terms—that was a major contributory cause of the high level of unemployment. But as I say, we have no plans to make any changes other than the plans which have already been announced in the light of the Secretary of State's Review.

92. My last question is while everybody is concerned at the level of unemployment and wish to do everything possible to reduce it, are you equally

[Mr Howell *Contd*]
concerned at the labour shortages which are developing in many parts of the country? Even in my constituency, where we have above average unemployment, employers are having great difficulty in recruiting in many instances. I feel this is going to cause considerable trouble as the economy tries to expand.

(Mr Lawson) There are some shortages of particular skills, although I must say that my sympathy for employers is slightly tempered by the lack of investment they make in training. The main answer to a lack of skilled people, if the labour market is working that way, is to train people. Partly because of developments in technology you can train people far, far quicker to do these jobs than through the old methods, when you had a long apprenticeship: with modern machinery people can be taught much more quickly. I think it is a great weakness in this country that British industry and British employers spend so little money on training, and I think this is something which is being increasingly recognised. You may recall I mentioned this in my Budget Speech. It is a weakness, and the time was when profitability in industry was so low that it was understandable; businessmen could not afford to spend money on training. That is no longer the case. There has been a very welcome recovery in profitability, and I would like to see more money spent on training, which is, I think, the answer to the problem of skill shortages.

Mr Townend

93. I was intrigued listening to your reply to the Chairman when you said the changes in public expenditure policy in the White paper were presentational. Can I remind you that as recently as the Budget you did say in real terms the planning total is expected to remain broadly constant over the period to 1988–89. Most people would consider that is a significant change in policy.

(Mr Lawson) As I said in my opening remarks, we have increased the planning total. If you look at the previous planning totals, the "broadly constant" was a description of a gently rising trend in real terms but by a very small proportion—it was a very small percentage amount—and it marked a big improvement on the trend previously. That proved in the event to be over-ambitious, and therefore the planning totals have had to be increased slightly, although the growth projected is still less than the growth has been in real terms in the past, throughout the whole of the period we have been in office.

94. Can I turn to this financial year, where despite a very large reserve, we have overrun on expenditure. Would you agree that if you take account of the unwinding of the effect of the coal strike and delete asset sales, in actual fact the underlying increase in expenditure is something like £6 billion over the previous year, which is an increase of some 4.3 per cent, this is greater than the percentage increase in GDP?

(Mr Lawson) I do not. I think that the figures that you take for the effects of the coal strike are figures which we would no longer agree with. We have revised, in the light of greater knowledge, our estimate of the effect of the coal strike in 1985–86, so the growth would not be, on the coal strike adjusted basis, as great as that.

95. What would that be?

(Mr Lawson) I do not know whether Mr Turnbull has the figure in his head; I do not.

Chairman

96. Has it been published?

(Mr Lawson) No, it has not been published.

Mr Townend

97. We were given a figure last year of £1.25 billion.

(Mr Lawson) In the light of greater knowledge, we have revised that downwards. I do not know what the latest estimate is, but it is lower than that. You also have to recall that in 1985–86 public expenditure was exceptionally low. I think that really it is better to look at the two years from 1984–85 to 1986–87 together. There was a marked dip in 1985–86, as is clear if you look at the graph, which was partly due to inflation being higher in 1985–86 than we expected. In the same way, of course, inflation has been lower in 1986–87 than expected. If you are on a cash planning system, which we are, then—although I do not think this is the only reason—you tend to have fluctuations in real terms of that kind. Indeed, to some extent it is inherent in the system of cash planning.

98. Having accepted that, even if the figure for the coal strike were half the figure of £1.25 billion, the increase would still be in percentage terms higher than GDP. Perhaps I can go on to another question.

(Mr Lawson) The plain fact is that the figures are here. The figures in the Autumn Statement would show that even if you exclude privatisation proceeds, then as I say, each year, including 1986–87, on our latest estimates—of course, the year is not over yet—there is a reduction in public spending as a percentage of GDP. If you take a run of three years: 1984–85, excluding privatisation proceeds, 46.25 per cent; 1985–86, sharp fall to 44.75 per cent; 1986–87, small further fall to 44.5 per cent.

99. That is not allowing for any unwinding at all of the coal strike.

(Mr Lawson) That is what has actually happened.

Chairman

100. Perhaps we might have a note which would clarify what the figure now is for the coal strike.

(Mr Lawson) I do not know whether Mr Turnbull can help.

Chairman: I think we should move on. Let us have the figure later and we can analyse it.

Mr Townend

101. In Table 1.15 under the heading "General Government Consumption", the figures are fairly static in the first and second half of 1985 and the

[Mr Townend *Contd*]
first half of 1986, but suddenly jump sharply in the second half of 1986, and then level off again. Can you explain why that has happened?

(Mr Lawson) Let me just get the Table.

102. It is page 24 of Table 1.15, "General Government Consumption." In the first and second half of 1985 and the first half of 1986 are fairly stable. Then you get a big jump in the second half of 1986, and then it becomes stable again. Can you explain that big jump in those two half-years?

(Mr Lawson) There may be other factors, but I will ask Mr Turnbull, because it is on the public expenditure side. Perhaps I should not speculate, but public expenditure does have these patterns.

(Mr Turnbull) One possible factor here is the pattern of teachers' pay. During the year 1985–86 there was effectively no increase. If there was a settlement reached in the middle of March 1986, that could account for some part of this.*

Chairman

103. How much?

(Mr Turnbull) I could not give you a figure for that.

Mr Townend: It must be more than teachers' pay with a jump as sharp as that.

Chairman

104. What are the other factors?

(Mr Turnbull) We will have to go into the detailed figures to see what the various increases are.

(Mr Lawson) I will be happy to let you have a note on that. There is nothing to hide at all. Quite what the incidence is of various factors I do not know. Teachers' pay might possibly be one of the factors.

Mr Townend

105. Turning to the reserves. In the curent year we have overrun expenditure inspite of very large reserves, in the coming year the reserves are 20 per cent less. You have said you are confident that that figure will be adequate, but presumably it must depend on public sector pay increases keeping within or perhaps just above the rate of inflation. Is that correct?

(Mr Lawson) The reserves are what I consider to be adequate taking into account everything, including departmental running costs. All the contingencies are covered. The reserves are, with the exception of last year, the highest we have ever had both in absolute terms and as a proportion of the planning total. Last year, in the first year's plans there was a very, very tight figure given for increases in local authority spending. In the subsequent years there was no further increase at all; the same cash figure was rolled on, and it was explained that this was purely a convention. We did not expect that to happen, but we had not at that time been able to agree to what the figure should be, so we put in a big reserve. This year there is a much bigger increase in local authority current expenditure, what we believe to be a realistic estimate—and so on for the subsequent years—and therefore reserves on the scale of last year are not required. And this year's reserves are bigger than in any of the previous years, other than last year. I was interested in reading the various scribblings just before the Autumn Statement where there was a general consensus that reserves of this size—£3 billion–3½ billion—would be necessary, and I was criticised in advance for an alleged disire to bring the reserves down to £2 billion. In fact the reserves have been set at a figure which I consider adequate and which before the event the scribblers would have considered adequate as well.

106. Obviously, if public sector wages go up along the line of the recent firemen's settlement of 7 per cent the situation could be different.

(Mr Lawson) I do not think you should draw any conclusions from that.

107. It would seem to me, looking at the figures, that if you were able to stick to the planning totals which were put out in last year's Autumn Statement, at the next Budget it would be well within the realm of possibility for you to be able to achieve your aim of bringing the standard rate down to 25p. Do you agree that by increasing spending in 1987–88 by over £4 billion that aim will have to be deferred?

(Mr Lawson) Certainly I would agree with that. As I said in the House in the questioning that followed the Autumn Statement, a pound used in additional public expenditure is a pound which is not available for reductions in taxation, unless you are prepared to expand the borrowing requirement, and I have made it clear and explicit that that I will not do.

Chairman

108. Chancellor, I think we want to move on to the fiscal stance about which Mr Wainwright has some questions, but may I say we would appreciate a note about the point made on Table 1.15. We were under the impression that these were figures given in volume terms and therefore they excluded teachers' pay.

(Mr Lawson) I am not sure.

Mr Wainwright

109. It would be helpful in compiling our report if you could describe what are the main instruments of your counter-inflation policy.

(Mr Lawson) The main instrument of counter-inflation policy is, and always has been, monetary policy, and the essential instrument of monetary policy is the interest rate.

110. Moving on to the public sector borrowing requirement, your Autumn Statement very rightly stresses the immense number of uncertainties to which the British economy is unavoidably subject;

*The Treasury note confirms that, unlike real terms changes in the planning total and general government expenditure, the volume terms figures shown in the forecast would not be affected by a rise in teachers' pay.

[Mr Wainwright *Contd*]
it is out of British control. In those circumstances, how unconditional is your PSBR target of £7 billion?

(Mr Lawson) It is a firm commitment which I have given. I was not obliged to give it but I chose to do so.

111. But apart from extraneous uncertainties, it is a notoriously difficult subject because, as you rightly said in your 1985 Autumn Statement, "the average errors in PSBR forecasts at this time of year [autumn] have been $\frac{3}{4}$ per cent of GDP, equivalent to £2$\frac{1}{2}$ billion." That being so, how do you reconcile your statement that the PSBR will not be a penny piece more than £7 billion?

(Mr Lawson) I thought it was quite clear, and I am sorry that some people do not understand it. What I was talking about was the PSBR which I will be setting in the Budget in the normal way, which I do every year in the Budget and previous Chancellors have done likewise. I cannot guarantee that at the end of the year the PSBR will in fact turn out to be what I have said at the time of the Budget. But, as I said earilier, with the exception of the coal strike year, which was quite exceptional and explicitly so, where there was a sudden shock which I decided it would be right to take on the borrowing requirement, the outturn has been pretty close to what I said at the time of the Budget; sometimes a little above and sometimes a little below. Last year's outturn was below it and this year so far it seems to be on track. I did touch on this in my Lombard Association speech. Dealing with fiscal policy, I said that one of the guidelines of fiscal policy is to set the PSBR at a level which not merely can be comfortably financed in a non-inflationary way but which has a margin, so if there is a shock of the kind we had because of the coal strike you can still finance it in a non-inflationary way, which is what we did. However, I am not anticipating or expecting a coal strike in 1987–88.

112. Without anticipating a coal strike—God forbid!—you are yourself on record as saying, very rightly, that the PSBR figure, which is the residue of two enormous totals, is subject to errors which average £2$\frac{1}{2}$ billion. If there were to be an overshoot of that order, would you finance it by increasing the PSBR or raising taxes?

(Mr Lawson) That is a purely hypothetical question, and the important thing which I think the Committee should focus on is that they have been told that the PSBR will be set at 1$\frac{3}{4}$ per cent of GDP; and that is a genuine figure which, within a margin of error, will be the outcome.

Mr Budgen

113. You know that you are widely and rightly admired———

(Mr Lawson) I did not know that!

114. —for the medium-term financial strategy and for your Zurich speech as evidence of your implacable determination to eliminte inflation and to make that elimination more important than any other objectives of either economic or political policy. Therefore, we have all been very interested to read your recent statements about monetary policy. The position is at present that you find the monetary aggregates are no longer a satisfactory guide to future inflation?

(Mr Lawson) This is a very important subject and a very complex one and that is why I thought it right—and when I last met this Committee (it was just before then) I told the Committee I was going to make the speech—to set out how we operate monetary policy and why, very clearly and very lucidly. It is not perhaps ideal bedside reading but in it I have set out—more fully than in most countries—how we operate monetary policy. It is all there in my Lombard Association speech. Certainly it is true, if your take broad money, particularly the best-known broad money aggregate, £M3,—though it is true for the other broad money aggregates as well—there is not a clear relationship between their growth and the growth of money GDP, which is what the core of the policy is. Therefore, one needs to interpret it carefully. This is not new, incidentally. I think it is becoming increasingly difficult but it happened right from the beginning, from 1980, as I recall, and we have increasingly had to put weight on M0—and I introduced this as soon as I became Chancellor and it is a useful guide—and on the exchange rate. As I say, the policy and the way it is practised and implemented is set out very fully in my Lombard Association speech. Other countries, too, are experiencing similar difficulties at the moment. Germany started targeting central bank money, as they call it, a composite aggregate, in 1975 and they have hit the target every year since 1978. But this year they are well above it yet I do not think there is much fear of a great resurgence of inflation in Germany.

115. Can I use an old-style expression, "overheating", and can we look through the indicators in the economy and ask you whether they might indicate overheating. For instance, could you remind us by how much on average London house prices have increased in the last year?

(Mr Lawson) I do not have the figure offhand.

116. Can I suggest about 20 per cent. Might that not be an indication of overheating and loose credit?

(Mr Lawson) I think that if one is trying to assess whether there is what you call overheating—and by that I understand you to mean that the economy is running up against a supply constraint, that it cannot met the demand that there is in the economy—you have to look at all the evidence. I must say, looking at all the evidence all over the country, I do not believe there is overheating, nor does it really emerge out of the CBI surveys.

117. But you keep referring to "all the evidence". Let me go through a few of the pieces of evidence and you tell me which of the pieces of evidence I have left out.

(Mr Lawson) A change in relative prices, which is what you are talking about, is not evidence of overheating.

[Mr Budgen *Contd*]

118. Might not house and property prices be one piece of evidence in the mosaic?

(Mr Lawson) Yes, they might.

119. Might share prices be one piece of evidence?

(Mr Lawson) Not of overheating in a direct sense. Certainly share prices might be an indication of financial laxity.

120. Do you agree with the Governor of the Bank of England that liquidity in the company sector may be an indication of easy credit?

(Mr Lawson) No, I would not say that liquidity in the company sector is evidence of excessive credit.

121. Did not the Governor say that there were dangers from the present level of liquidity in his Loughborough speech?

(Mr Lawson) There are two issues here. There is the question of whether the growth of credit is presaging increased inflation, and those who watch it very carefully have to form a judgment about that based on all the other financial indicators and what is happening in the economy. Then there is the quite separate question of whether there are prudential risks in the extension of credit in particular cases.

122. But dangers to the banking system as opposed to dangers to future policy?

(Mr Lawson) That is right.

123. Let us go through a few of these guidelines. For instance, might not wage increases running at between 7 and 8 per cent—and I am talking about average manual workers not the more favoured sector in the City—be an indication that credit has become fairly lax?

(Mr Lawson) I do not think so. We do have a problem, as I have said on a number of occasions, of an excessive growth of unit labour costs as a result of excessive growth of wages in the economy. But this is something which is not new, and if you are going to say that is a sign of overheating, of inflationary pressure, then you have to say that that has been the case for some years now, yet what we have seen is inflation coming down to the lowest level for something like 20 years. The pay problem is much more closely connected with the level of unemployment—a point I have made on previous occasions.

124. For instance, yesterday in the House Sir Peter Hordern drew attention to the level of new hire purchase credit—I am sure your advisers have it, it is column 610—and he said, and I expect he got it right, that the level of hire purchase new credit in 1981 was £7.8 billion, by 1985 it had risen to £13.5 billion and in the first six months of this year it rose 50 per cent. He went on to say that the same sort of figures were to be seen for bank lending. I expect you were present and heard those remarks?

(Mr Lawson) Yes, I was present.

125. If those figures are true, is that not an indication that the economy is enjoying a dangerously fast consumer boom?

(Mr Lawson) First of all, as I say, over the past five years the economy overall has been growing at a pretty steady rate of around $2\frac{1}{2}$–3 per cent a year or thereabouts and there has been no great change in that. The upswing is quite remarkable, both in its steadiness and its duration, which contrasts quite markedly with previous upswings. Then if you look beyond the overall pattern of what has been happening to the economy and look within it, to see whether you think there is overheating, you point to some factors. One could point to other factors. One could point to the level of unemployment, which is still high, although I am glad to say it now appears to be coming down; one could point to the amount of overtime working, which is lower than a year ago; the fact that the most recent CBI surveys say that what is most likely to limit output is lack of demand rather than capacity constraints. If you look at the level of unskilled vacancies, which is rising all the time, it is still not historically high. The same is true of skilled vacancies. Despite the shortages, the level of skilled vacancies is not anything like as high as it was when we had overheating in the economy in the past. If you look at land prices throughout the country, there is no sign of overheating there.

126. Chancellor, that is not so.

(Mr Lawson) Yes, it is so. If you look at M0, which is a very useful indicator, it is edging up a little bit, and this is one of the reason why I decided the interest rate should go up by one per cent last month. But M0 is still within its target range. Outside London house prices are not rising at anything like the rate at which you indicated they are in Central London—I take your word for it—and, indeed, there are some signs that the rate of increase in house prices outside London may be falling off a bit. One has to make an assessment based on all of the evidence and not a part of it.

127. Just taking up two of the points you made, could you please tell us of any occasion when the CBI has complained that demand has been excessive?

(Mr Lawson) There have, certainly been such occasions in CBI surveys.

(Sir Terence Burns) Two of the CBI indicators, the Chancellor mentioned—skilled vacancies and firms constrained by capacity shortages—showed very high figures in 1972–73. What you have to do is look at these figures relative to the historical average. And if you do compare the position today relative to the historical average you will find there are not the signs of pressure.

128. It is true, of course, as far as agricultural land is concerned, but there is an indication that forces in agricultural land think that eventually the Common Agricultural Policy will come unstuck, is there not?

(Mr Lawson) Maybe Central London is a similar special factor.

129. As far as development land is concerned?

(Mr Lawson) I really do not think that a change in relative prices, as I said earlier, is a sign of overheating.

[Mr Budgen *Contd*]

130. Just a final point: on development land it is not a question of change in relative prices, development land has gone up very fast throughout the whole of the country. Is that not a particular indication of loose credit just as it was in the period 1972 to 1974?

(Mr Lawson) The conditions between 1972 to 1974 and now are as different as chalk and cheese. If you look at M0; if you look at what was happening to public spending and house prices then; if you look at the PSBR as a share of GDP then; if you look at what was happening to money GDP and, perhaps most strikingly, if you look at interest rates, where real interest rates then were, if anything, negative, whereas now they are historically high and positive, the differences are quite dramatic.

Chairman

131. I think we should move on. I did not quite hear the date of the comparison which Sir Terence Burns made?

(Sir Terence Burns) I was speaking about the same period Mr Budgen was mentioning which was 1972/73.

Mr Browne

132. I believe you are on record as saying you do not wish to see sterling fall further, can you tell us against which benchmark you are looking, is it against the US dollar, the deutschmark or the trade weighted index? Could you tell us if there is a psychological floor in your book for sterling and is there also a psychological ceiling?

(Mr Lawson) I suppose the thing I look at most is the index. You are quite right. As far as the exchange rate is concerned, the view which I have expressed to this Committee before, I think last year, is that the exchange rate should always be exercising a financial discipline on the economy: I do not believe in a weak exchange rate. We are pursuing an anti-inflationary policy and it is desirable to have an exchange rate which is reinforcing it. What we had to do earlier this year was to allow the exchange rate to fall because of the sharp collapse of the oil price. There clearly had to be a step change in the exchange rate and that duly occurred. This is something that I pointed out as far back as 1984 when I gave a talk in Cambridge entitled "What will happen when the oil runs out". There had to be an exchange rate adjustment, though I was then envisaging it happening more gradually than has in fact happened. Again, I said the same thing when I gave evidence to the Aldington Committee in the other place. This adjustment has duly happened, but it has now come to an end and the step change has occurred. So we are back to the policy of having an exchange rate which is exercising a financial discipline and that means that I do not wish to see it fall further. I do not know whether you call that psychological or not: it is operational.

133. May we now turn to the subject of the European Monetary System? Would you agree that for a currency such as sterling—whether or not it is actually perceived as a petro currency—that going into EMS is not an easy policy and would not be automatic. We would have to negotiate entry and we would effectively link ourselves with the deutschmark block in a mechanism which would reduce our options for the Government; and whilst the United Kingdom economy is much more competitive purely from a marketing mix point of view instead of purely from a price point of view it is still not competitive enough *vis-à-vis* Western Germany? Therefore, if we were to join, United Kingdom interest rates would become potentially much more volatile and subject to strong upward pressure and our counter-inflationary policy you have outlined in a question previous would be out of our determined, democratic hands and subject to the vagaries of the marketplace.

(Mr Lawson) First of all, of course, the EMS is not solely composed of Germany but also contains France, Belgium, Holland, Italy, Denmark, Luxembourg and Ireland. I think that is the lot.

134. It is effectively a deutschmark block.

(Mr Lawson) They are all members and I think one has to bear that in mind rather than thinking of it solely as Germany although certainly the deutschmark is far and away the most important currency within the ERM. That is a necessary qualification to the way in which you were expressing it. Secondly, there has to be financial discipline. You cannot run the economy successfully without financial discipline any more than you can run a company successfully without financial discipline. If you are going to keep on top of inflation there has to be financial discipline and no form of financial discipline is a soft option. One has to make a judgment as to whether this particular form of financial discipline on balance is more desirable, or more helpful, or more useful than the forms of financial discipline which one can, and does, apply outside the ERM. I notice this Committee itself reported on this matter a little while back and came to the conclusion it was not desirable to join the ERM. I notice your Chairman in his interesting speech yesterday said he had changed his mind.

Chairman: With respect, the Committee's report did not say that and what I pointed out was the relevant exchange rates have changed since.

135. Could I turn you to page 18 of the Autumn Statement, Table 1.7, to look at the figure on the fourth quarter under housing, $10\frac{1}{4}$ per cent. Could you give us some idea of your underlying assumption as to the interest rate used for that?

(Mr Lawson) No. We do not forecast interest rates.

Mr Browne: Thank you.

Mr Mitchell

136. I was interested in what you said to Mr Wainwright, that interest rates are a central weapon against inflation, which was echoed now by what you have said to Mr Browne, that the exchange rate is a financial discipline. That means there has been

[Mr Mitchell *Contd*]
a basic change in government attitudes towards the exchange rate, does it not, because in 1980 you were telling us you had no policy for the exchange rate. It was a kind of residual. Now, clearly the strategy seems to be to keep it up by high interest rates, interest rates heavier and higher than our competitors and to stop the tendency for market forces to bring it down in order to fight inflation by presumably making imports cheaper.

(Mr Lawson) I do find that this continual harking back to 1980 when—as you reminded the Committee—I was Financial Secretary to the Treasury, has a nostalgic charm which appeals to me greatly. I am happy to talk about that for some time. What happened in 1980 was interesting. There were a combination of factors: you had a totally discredited Labour Government replaced by a Conservative Government in which there was great worldwide confidence at a time when we were in the latter period of the Carter regime in the United States which had lost all international confidence completely. Coinciding with those factors you had this sudden rather belated discovery by the markets that Britain was a substantial oil producer, likely to be so for some time, at a time when that was a rather desirable thing to be. So that led to the market pushing up sterling very substantially indeed; greater—I readily concede—than we had expected at the time, certainly far more than I had expected. There was very little we could sensibly do about it without really undermining our monetary policy and financial policy very considerably. We also recognised very quickly, and indeed this was said a number of times, that the pressure from the exchange rate was one of the reasons why we could take a relatively relaxed view of the fact that sterling M3 was overshooting the target range, by quite a wide margin. We said that we would still get—as a result of the overall balance of financial discipline as such—inflation down. Indeed that proved to be the case. I have no doubt whatever that the high exchange rate at that time, looking back, was a very important instrument in getting inflation and inflationary expectations down.

137. Just that it was not avowed. Thank you for the fascinating history lesson. Is the exchange rate being kept now at a level higher than market forces would have it, by higher interest rates than our competitors, in order to fight inflation?

(Mr Lawson) Certainly interest rates are set at the rate needed to fight inflation, that is absolutely right. The level of the exchange rate, what is happening to the exchange rate is an important determinant of that; that I have made clear on a number of occasions.

138. Two questions arise from that: you mentioned the step change produced by the fall in oil prices, why should there not be a decline in interest rates by the fact our labour costs are going up faster than our competitors? Surely that too would require the pound to come down?

(Mr Lawson) If you wish simply to surrender to the potential inflationary forces in the economy, that is indeed what you would do and you would have steadily increasing inflation. The whole essence of the battle against inflation can be summed up in one hyphenated word, and that is "non-accommodation". That is what it is all about. What you are advocating, and what I resist, is a policy of accommodation.

139. I am advocating not going back to the mistakes of 1980 and 1981 when the over-valued exchange rate was ruinous for industry and destroyed our manufacturing by 28 per cent of our manufacturing capacity. What is the logic of hitting industry with high interest rates to punish it for the increase in labour costs? First of all, this hits manufacturing rather than services; secondly, manufacturing cannot control its labour costs and Government cannot either because all it does is preach sermons; thirdly it penalises investment; fourthly it puts up RPI by higher mortgage rates and fifthly it means we have to carry a double burden, high interest rates and over-valued exchange rates. What is the virtue to industry of that?

(Mr Lawson) The virtue to industry of that is that it benefits from low inflation instead of high inflation which there would be under the policies which you are advocating. It is perfectly true, and I search for common ground always with you Mr Mitchell———

140. Might be rather muddy!

(Mr Lawson) I am intrepid. It is absolutely true that if industry were to get a better grip of its costs, in particular its pay costs, then I do not think that it would be necessary, as part of the anti-inflationary strategy, to have interest rates as high as they are today.

141. It is a form of salvation through suicide: inflicting damage on the economy which we need to survive as oil falls away.

(Mr Lawson) It is a curious form of suicide when industry is growing steadily and is more profitable than it has been for decades—not years, more profitable than it has been for decades. Indeed, I notice—quite astonishingly really because I do not think they normaly do take sides in the party political battle at all—that at their recent conference, the CBI came out in unequivocal support of the Government's economic policy, which I do not think they would be doing if it was actually a policy of industrial suicide because they are not stupid. If you look at what is happening to the economy, in terms not merely of inflation but the steady growth, the steady improvement in profitability, the fact that investment is at all time record levels, then I think it is quite impossible to sustain the thesis which you are putting forward.

142. The Government too, of course, engaged us in some element of double talk on this issue. It is not only my thesis. In 1980 the Government was saying that the over-valuation of 1980 and 1981 would inflict no great harm on industry and would bring effects in the form of discipline. Now you are

[Mr Mitchell *Contd*]
saying in the projections in the Financial Statement, there are going to be benefits from the fall in the value of the pound, exports will increase next year and imports will be restrained next year. Why should not those processes, those benefits, go further by allowing the pound to come down to counteract the increases in labour costs?

(Mr Lawson) I have explained why this would be a complete surrender to inflationary pressures and it would also remove all financial discipline which is necessary if industry is going to become more competitive and the country is going to prosper in the long run. Yours is an essentially short-term approach which we have seen all too often in the past. It has produced not merely high inflation but a weakened and debilitated industry in contrast to the more vigorous and healthy industry we have today.

143. In terms of projections, particularly on balance of payments which does seem rather optimistic, are we at risk of a very tight balance of payments constraint which will produce a sterling crisis in its wake, you are surely more vulnerable? In other words, the financial statement and, indeed, the Chancellor's act is rather like a highwire act on the wire of high interest rates, I think, keeping a rickety show on the road.

(Mr Lawson) Nothing rickety about it.

144. What is in many respects a rickety show on the road is kept then by your marvellous Buster Keaton dead pan expression pretending all is well, keeping everything going until the election *après quoi* the deluge.

(Mr Lawson) There will never be a deluge if this Government is returned.

145. It does not matter which shower is in, Chancellor, there will be consequences from the fact that things have been allowed to let slide to keep the mood happy until the election.

(Mr Lawson) You seem to have done an extraordinary U-turn. A moment ago you were accusing me of having everything far too tight and crucifying industry and now you are saying that everything is being loosened up for the election. I wish you would make up your mind.

146. This somewhat rickety show is being kept going for the election, and the only way to regenerate it is to bring down interest rates and stimulate investment in manufacturing, particularly in the exporting industry and make the economy competitive again.

(Mr Lawson) I will bring down interest rates when it is prudent and safe to do so and not before then. I would have thought your own strictures about the high level of interest rates should dispose of any idea somehow that what we are engaged in is some great relaxation because we think that will be helpful in the context of the election. There has been no change in the policy stance at all, as I indicated in my opening remarks; and this is the policy stance that we will be continuing after we have won the next election, whenever that may be.

147. That is just in terms of this relaxation. Can we take it, therefore, if the PSBR overshoots (I am talking about the whole stance across 1987/88) can we take it that excess will be clawed back in principle in 1988/89, thus maintaining your commitment to the £7 billion PSBR?

(Mr Lawson) That is a purely hypothetical question, and I will have to decide what action is right in the light of the circumstances at the time as I have done each year since I have been Chancellor of the Exchequer.

Mr Watts

148. I would like to pursue your answer to Mr Wainwright about the interest rate being the essential instrument of monetary policy. In your view is the main role of the interest rate to reduce the demand for borrowing by making it more expensive, or is the major way it exercises an influence by maintaining sterling at a level which keeps up the pressure?

(Mr Lawson) The role is to keep financial conditions sufficiently stringent to ensure that inflation remains low and ultimately to eliminate inflation altogether and have stable prices. There are various indicators of financial conditions of which narrow money and the exchange rate are particularly important. The interest rate clearly does have an effect ultimately on the amount of credit in the economy, but the relationship there is far more complex, far less clear and is difficult to establish. Also, when you are thinking of broad money, the question on which one has to make a judgment is the extent to which holders of broad money are willing holders of broad money. Where there has been a shift in the propensity to hold broad money that, itself, does not pose any inflationary dangers. If, on the other hand, you judge that they are unwilling holders—and it was the Governor of the Bank of England at some stage before this Committee who had a colourful expression about an "avalanche"———a glacier—

Chairman

149. Frozen glacier.

(Mr Lawson) Then, of course, you have to take rapid action because otherwise there will be very real inflationary dangers, but I see no sign of the glacier being about to melt.

Mr Watts

150. As the monetary aggregates are no longer considered to be such a reliable indication.

(Mr Lawson) It is broad money which is a particular problem in this country. Monetary aggregates are being difficult in most countries. Not only the Germans but the Americans are exceeding their targets both for M1 and M2 and the French are exceeding theirs. It is pretty much a worldwide disease. In so far as the difficulty is linked with financial liberalisation and innovation, I think it is fair to say there is no country in the world which has gone further along the path of financial liberalisation and innovation than the United Kingdom.

[Mr Watts *Contd*]

151. In view of that, and the emphasis you were giving to the importance of the exchange rate as one of the indicators of monetary conditions, have you given consideration to setting the exchange rate target range in the same way we had a target range for £M3, both to give an indication of where you intend that exchange rate discipline to be exercised and to remove uncertainty?

(Mr Lawson) The reality of foreign exchange markets, and this does not apply to monetary targets, would make that in my opinion an unwise course of action. I think there is clearly a case for being part of an explicit regional fixed exchange rate system. Alternatively, you can have the sort of policy which we have at the present time. I do not actually think there is a viable halfway house.

152. You reasserted earlier in your oral statement you did not wish to see sterling fall further.

(Mr Lawson) That is right.

153. I believe when you made the statement the basket was 69½ and I believe it is 67½. I understand that when you say "not fall any further", you do not want to stay exactly on that spot for the whole of the year. When there is such a variation over a relatively short period of time, I think that adds to uncertainty as to precisely what is intended in the period.

(Mr Lawson) The question of uncertainty is a very difficult one. I can quite understand that good people with all the best motives would like greater certainty as to at what point one would act in order to affect the exchange rate. On the other hand, that degree of certainty would also be playing into the hands of the short-term operators. In practical market management, I do not think it is sensible to be any more explicit than I have been.

Mr Watts: Thank you.

Chairman

154. Thank you very much Chancellor, I wonder if I might take up one or two of the points which have been raised already? I think you are aware there are some colleagues who have to be elsewhere in the House which is why we are slightly like an Agatha Christie thriller where the characters keep disappearing. This is in so sense my colleagues being discourteous to you. Could I ask you a couple of points which came up in the earlier discussion. In Paragraph 61 of the Autumn Statement it says: "for the past six years, high rates of growth of broad money . . . have been consistent with appropriately tight monetary conditions and thus a substantial fall in inflation."

(Mr Lawson) Yes.

155. Are you now saying that regardless of what is happening to M3 that might be consistent with low inflation or continuing to battle against inflation?

(Mr Lawson) Yes, that is what is implied here, certainly. I do not have the figures in my head but the change in the velocity of £M3 as between, say, the 1970s and 1980s is quite remarkable. I quoted the figures for, one five year period and another five year period in my Lombard Speech, showing that the ratio between the growth of money GDP and the growth of £M3 in one period and the ratio in another was quite different. This overrunning of the £M3 targets has been pretty well a feature of the period we have been in office, except for a short period when it was kept down by very heavy overfunding. I think this Committee was among those who queried whether that was achieving anything and I think it was partly this Committee's views on that which led us to abandon overfunding as a way of life. There has been this general tendency for broad money to grow very rapidly and yet, and this is the important thing, inflation has come down and come down very markedly and that is the proof of the pudding.

(Sir Peter Middleton) It is also true of Europe as a whole, or OECD as a whole.

156. You began by speaking of continuity of policy. The views you express now are radically different to those expressed at the beginning of the Government's period of office.

(Mr Lawson) I think that it is perfectly true to say that right at the beginning we did not expect to see such a sharp change in the velocity of £M3, but it actually happened very early on and we very quickly realised that things were changing. Indeed, in my Zurich speech to which Mr Budgen referred I alluded there to the fact that £M3 was giving a false reading. Although it is perfectly true we did not expect to see this sharp change when we first took office in 1979 it is something that became apparent very quickly thereafter: you will remember the abolition of the corset and the growth which continued in £M3 after it. This is not in any sense a new development, although it has become more pronounced so far as broad money generally is concerned as financial liberalisation and financial innovation have developed much further.

(Sir Peter Middleton) One might say that inflation has come down.

Chairman: Yes, we understand that. Chancellor, we have, as you have noticed, gone back quite a bit to the situation in the earlier years of the present Government because it seemed to us perhaps there could be some lessons to be learnt as I think you indicated perhaps some of them have been learnt. Obviously we will need to consider very carefully the various points you have made before producing our report for the House. We would appreciate the couple of notes we mentioned earlier on in order to help us in reaching our conclusions. Having said that, can I express my thanks to you and your colleagues for coming this afternoon. Thank you.

Appendix 1

Memorandum by Gavyn Davies, Specialist Adviser to the Committee

THE 1986 AUTUMN STATEMENT

SUMMARY

The main points of this memorandum are as follows:

(i) The Autumn Statement involves something of a shift in strategy, with the displacement of tax cuts by extra public spending. Essentially, a £4 billion increase in general government expenditure has, on plausible estimates of Treasury arithmetic, absorbed a £3 billion increase in the underlying buoyancy of non-oil revenues, and half of the £2 billion previously set aside for tax cuts. This may theoretically leave scope for £1 billion of tax cuts in the 1987 Budget within a £7 billion PSBR target.

(ii) If the level of public spending had been held to previous targets, the Chancellor could, on these estimates, have reduced tax by £5 billion in the next Budget—enough to cut income tax to 25 pence in the £—without increasing the MTFS estimates for borrowing.

(iii) The decision to substitute public spending for tax cuts does, however, seem sensible. There is no economic case for further fuelling consumer spending (and imports) at present. Public spending can have larger benefits to employment in the short-term, with a lower import content, than the spending generated by tax cuts. However, it is possible that the *composition* of public spending proposed by the Chancellor has too large an element of public sector pay relative to help for the unemployed and capital spending.

(iv) The Chancellor has clearly stated an intention to hold next year's PSBR unchanged at £7 billion, in which case the fiscal stance would be approximately neutral. In the absence of any monetary standard (such as EMS membership), and of any direct government action to control pay settlements, a neutral fiscal stance is sensible. Anything more stimulative would not appear justified, given the outlook for inflation, unit costs and money GDP. However, it is clear that the government is operating in a second best world. If pay pressures could be mitigated by direct government action, then a more expansionary fiscal stance could be safely undertaken.

(v) The Chancellor has also hinted that sterling has now fallen far enough to offset the balance of payments losses from lower oil prices. Again, this seems right for the moment, but a further sterling depreciation will eventually be needed if pay deals do not fall.

(vi) All this is based on the assumption that the Chancellor hits his PSBR targets. On this basis, the markets would accept the package with equanimity. But the markets are currently sceptical about the Chancellor's resolve. It seems quite likely that public spending will overshoot the newly-increased targets for 1987/88, taking the PSBR to £9–10 billion. The actual fiscal stance would then be easier than the government targets imply. This would re-inforce the case for direct counter-inflation action.

(vii) Now that real public spending levels are planned to rise in the medium-term, there will be continuing conflicts between PSBR limits and tax cutting objectives. The underlying buoyancy of non-oil revenues will not continue at present rates after the unsustainable consumer boom ends. Specifically, a tax increase of some £3 billion might be needed to hit a £7 billion PSBR target in the years after 1987/88. Probably, the PSBR targets will be eased to avoid this.

12 *November* 1986

I. ECONOMIC STRATEGY

Increasingly, the Autumn Statement has been downgraded as an informative guide to economic strategy, and this year the Statement has contained little more than the bare details of the public expenditure plans for next year, along with the Treasury's economic forecast. This is a matter for regret. However, it is still possible to make some comments about the likely fiscal stance for next year, since the Chancellor has gone out of his way to reiterate the £7 billion PSBR target built into the MTFS. Furthermore, there have been some wider hints about economic strategy, which make it possible to discern the government's latest thinking, in outline at least.

First, it is useful to look at the fine print of the Treasury's statements on *financial conditions* contained in its forecast summary, since this involves an important change of wording since last year. In publishing a forecast, it is necessary to make clear the monetary conditions assumed, and last year the November documents explicitly stated that:

> "The forecast assumes that monetary policy will continue to be directed towards sustaining downward pressure on the growth of money GDP and hence on inflation, as in the MTFS, and that short-term interest rates will be set so that *the paths of the monetary aggregates* and the exchange rate are consistent with this objective." (My emphasis.)

This year, the form of words on the monetary assumption is very different:

> "The forecast assumes that short-term interest rates will be set to maintain monetary conditions that are consistent with the counter-inflationary aims of the MTFS."

Note that, in this year's formulation, there is no mention of "the paths of the monetary aggregates and the exchange rate" necessary to maintain downward pressure on inflation, nor is there any mention of money GDP. This seems to offer yet further evidence of a downgrading in monetary aggregates as a guide to medium-term policy—not even the Chancellor's favourite M0 is mentioned in this key paragraph about the government's monetary policy. This is bound to fuel speculation—which is already rife in the City—about the lack of a monetary standard at the heart of the government's policy.

Mr Lawson has clearly attempted to neutralise these suspicions by emphasising two different strands in his thinking. First, he has been much more explicit than he was last November about his intention to stick to the PSBR targets built into the MTFS in the forthcoming financial year. In particular, in broadcasts subsequent to the Statement, he has emphasised that there will be "not a penny piece of additional borrowing" on top of the £7 billion PSBR target. Last year, the assumption *was* made that the medium-term PSBR targets would be maintained, but this was presented more as a technical assumption, rather than a firm commitment. Clearly *the Chancellor has gone out of his way to emphasise that the additional public spending incorporated in his plans has displaced the tax cuts which would otherwise have been available, rather than adding to PSBR limits.*

The second strand which has received greater emphasis this year is the government's attitude towards the *exchange rate*. Again, this has been particularly notable in Mr Lawson's broadcasts since the Statement itself, in which he has suggested that he is willing to increase interest rates in order to prevent a further depreciation in the currency, and that he believes that sterling has now adjusted downwards sufficiently to offset the balance of payments losses from lower oil prices. In the Treasury forecast itself, the usual technical assumption of a stable exchange rate is made, but this year the Chancellor's oral statement specifically stated that ". . . the necessary adjustment of the exchange rate to the oil price collapse *has now taken place*". (My emphasis—note the past tense.) This suggests that the Treasury believes that the drop in the exchange rate this year has been sufficient to replace entirely the lost oil benefits to the current account and, for the time being, it seems that the Chancellor will seek to prevent a further depreciation in the currency.

The Strategy

The overall outline of the strategy now being pursued is therefore reasonably clear. Monetary targets have undergone yet another ratcheting downwards in their importance, leaving the government leaning more heavily than ever on fiscal targets and the exchange rate to exert financial discipline. This is obviously a complete reversal of the order of priorities in the original version of the MTFS, in which fiscal policy was supposed to be subordinate to monetary objectives. It also leads to the inevitable and familiar question about the EMS: if the Chancellor is relying on a stable exchange rate to exert counter-inflationary discipline, why stay out of the system which would make that discipline most effective?

Sterling

With this proviso, it seems to me that the Treasury has been sensible to accept that the necessary downward adjustment to sterling has been made for the time being. At a sterling effective rate of around 69, there has been a depreciation of 12 per cent since the 1985 average, which means that UK competitiveness (after allowing for the more rapid rate of increase in unit costs in Britain than in other countries) may have improved by around 7–8 per cent. Net oil exports are likely to deteriorate by around £4.5 billion between 1985 and 1987, with about £2 billion of the current account loss being offset by lower payments of interest, profit and dividends to foreign companies operating in the North Sea. A depreciation of 7–8 per cent in the real exchange rate would, on most standard calculations, be capable of offsetting a current account loss of £2.5 billion over a period of two or three years.[1] On this basis, the Chancellor is right to argue that the necessary downward adjustment to sterling has now been made. On the other hand, two offsetting arguments need to be considered. First, the non-oil current account has also deteriorated this year, suggesting that a somewhat larger reduction in the real exchange rate may be needed to offset the overall deterioration in the current account which seems to be taking place. Second, the UK is suffering an ongoing loss of competitiveness from the fact that its unit labour costs are rising 3–5 per cent more rapidly than those in other countries, which means that a continuing depreciation in the nominal exchange rate would be needed to maintain this year's real competitiveness improvement. In consequence, it appears likely that some further downward move in the *real* exchange rate will be needed in the years ahead to prevent a current account deficit from emerging, while the *nominal* rate may need to move down rather more rapidly in order to offset the change in relative unit labour costs. But I am talking here about the *medium-term*. The speed at which these exchange rate adjustments should be made needs to be heavily circumscribed, since the downward shift in the currency always involves a major boost to inflationary pressures in Britain. Already, the depreciation which has occurred this year seems likely to cause more upward pressure on inflation than the Treasury expects in 1987 (see below); any further depreciation now

[1] In recent Treasury simulations, a 50 per cent change in the exchange rate is reported to produce a change of around £3 billion in the current account after 3 years. (C L Melliss, "HM Treasury Macroeconomic Model, 1986", Government Economic Service Working Paper No 90.)

would run severe risks of sending the underlying inflation rate well above 5 per cent as we enter 1988. *Since this is not acceptable, it seems that the Chancellor is right to attempt to put the brakes on the downward momentum in sterling for the time being.* This will probably involve a continuation of the mixture of direct foreign exchange intervention, with judicious increases in interest rates if necessary, which the authorities have used to stabilise the currency in recent weeks. (The *threat* of such action, now made clear by Mr Lawson, may be sufficient in itself to provide extra support for the currency.) In the longer-term, however, some further downward move in sterling is almost certain to be needed, unless the government can introduce some alternative mechanism for getting a better grip on unit labour costs.

Fiscal Policy—Tax vs. Public Spending

Next, the overall *fiscal stance* and its composition. Here, much depends on whether the Chancellor succeeds in hitting his £7 billion PSBR objective for next year. If he does, then the fiscal stance will be characterised by two main features. First, compared with previous versions of the MTFS, there will be a major substitution of additional public expenditure in place of tax reductions. In my view, this is wholly to be welcomed, especially in the current climate of explosive growth in consumer credit, and a deteriorating balance of payments. It is clear that the consumer needs no further stimulus at present, and some dampening action might actually be appropriate. In these circumstances, the substitution of public spending for tax cuts can only be beneficial. Furthermore, on virtually all calculations, public spending has a lower import content, and a higher jobs content, per unit of PSBR cost than tax cuts. It therefore seems much more accurately directed at the particular problems which confront Britain than another large reduction in income tax. Such a reduction may have beneficial supply-side advantages in the long-term, and could help to dampen pay pressures, but these effects are far from certain. The substitution of public spending for tax cuts, while a very clear deviation from the government's previous objectives, is therefore to be welcomed.

The *composition* of the increase in public spending is not yet crystal clear, but seems to be rather less appropriate to the present needs of the economy. There must be a suspicion that a large proportion of the additional spending will leak into public sector pay, which has some of the same economic effects as a tax cut directed solely at the public sector, and may have adverse knock-on effects on private sector pay. It would seem that rather more direct action to help the unemployed might have been a preferable alternative. Furthermore, the new spending plans involve an increase of only around £1 billion in capital expenditure, which seems rather meagre for a category which remains in urgent need of attention, after many years of cutbacks.

The Overall Fiscal Stance

Turning to the overall fiscal stance, I mentioned in my post-Budget memorandum to the Committee that the Chancellor had missed an opportunity to set out a coherent "permanent income" framework for setting public borrowing targets as oil prices change. Instead, he then attempted to maintain the fiction that borrowing could be held at whatever number he first thought of, almost whatever happened to oil prices. (This was accomplished, of course, by allowing the PSFD (public sector financial deficit) to rise in response to lower oil revenues, disguising the PSBR consequences by increasing privatisation.) I argued, however, that (by chance?) the PSFD had actually been increased by almost exactly the right amount on permanent income grounds to compensate for the oil revenue losses. All of this still seems true, which suggests that on these long-term grounds the fiscal stance is roughly appropriate. But what about the shorter-term impact of the fiscal stance on aggregate demand? Table 1 shows my latest estimates of movements in the cyclically-adjusted PSBR and PSFD over the past few years. These figures assume that the Treasury will hit its PSBR target of £7 billion in 1987–88, which implies a PSFD of around £12 billion. On this basis, the overall stance of fiscal policy looks likely to be approximately neutral next year, after an expansionary move in the cyclically-adjusted PSFD equivalent to 1.1 per cent of GDP this year. (Within this broad neutrality, there may be some second-order benefits to aggregate demand from the substitution of public spending for income tax cuts, since the former have larger demand effects in the short-run. Also, there is the possibility that an overshoot in the PSBR—which is likely (see below)—will produce a more expansionary stance than is currently intended.) *This approximately neutral stance on existing targets appears sensible*, at least in the absence of any direct measures to reduce the level of pay settlements. The economy has just received a substantial boost from a depreciation in the exchange rate, while the activities of the deregulated financial markets are permitting an uncontrolled credit injection, which is not being much dampened by high real interest rates. In consequence, economic growth looks likely to pick-up sharply in the next 12 months, after the slow-down phase in 1985–86, which was largely caused in my view by the tightening in fiscal stance last year (much of which was unintended). Meanwhile, inflation pressures are definitely rising. Money GDP looks set to rise by 7 per cent in 1987–88, somewhat more than expected in the last Budget, while unit costs (my preferred target) will definitely accelerate in 1987. Overall, therefore, a sizeable fiscal boost would be inappropriate at present—*unless accompanied by a new counter-inflation weapon.*

TABLE 1

CHANGES IN THE FISCAL STANCE

	Changes in Fiscal Policy (% of GDP)			
	Actual PSBR[1]	*Actual PSFD*[1]	*Cyc. Adj. PSBR*[1]	*Cyc. Adj. PSFD*[1]
Change in:				
1979–80	−0.5	−0.9	−0.1	−0.5
1980–81	0.5	1.0	−3.7	−3.2
1981–82	−2.1	−2.7	−4.4	−5.0
1982–83	−0.2	0.7	−0.5	0.4
1983–84	0.1	1.0	0.6	1.5
1984–85[2]	−0.9[2]	−0.4[2]	0.0[2]	0.5[2]
1985–86	−0.7	−1.5	−0.7	−1.6
1986-87[3]	0.3	1.1	0.3	1.1
1987–88[3]	−0.1	−0.1	0.0	0.0

[1]Negative figures indicate a discretionary tightening in the fiscal stance. The cyclically-adjusted figures are the best guide to the policy stance, since they exclude the impact of variations in economic activity on government revenue and expenditure.
[2]Figures for 1984–85 (but not 1985–86) exclude the direct impact of the miners' strike on government borrowing (£2.8 billion) and real GDP (1.3 per cent).
[3]Figures for 1986–87 and 1987–88 are based on *intended* policy as outlined in the 1986 MTFS. If the 1987–88 PSBR and PSFD exceed targets, the policy stance would be more expansionary than shown here.

Summary

On economic strategy, I would therefore sum up as follows. In the absence of a monetary standard (such as EMS membership), and in the absence of any direct government action to control pay settlements (such as a tax on excessive deals, possibly with exceptions being made for profit-related pay increases), the overall strategy of substituting extra public spending for tax cuts within an unchanged PSBR target seems reasonable. Certainly, in present circumstances, it is important for the Chancellor to put the brakes on the sterling depreciation, and to avoid fuelling the consumer boom by being tempted into large tax cuts next year. *But in my view it is very clear that the government is operating in a second best world.* It seems to me that if pay pressures could be mitigated by any of the new mechanisms recently proposed, then a more expansionary fiscal stance, concentrating in particular on a much larger boost to job creation, could be safely undertaken. This would be the first best policy which the government is currently ignoring.

II. The Fiscal Arithmetic

This section looks at the details of what the Chancellor has announced about public spending and borrowing, and comments on the likelihood that the new targets can be achieved.

1986–87 and 1987–88

Table 2 gives a clear demonstration of what has happened in the Autumn Statement. Column 1 shows the latest estimates of expenditure and revenue for the current financial year (1986–87); column 2 shows the forecasts made for next year by the Treasury in the 1986 Budget; column 3 shows the Autumn Statement estimates for next year's spending, along with revenue figures *implied* by the latest Treasury economic forecasts; column 4 shows the latest Goldman Sachs forecast of the most likely actual outturn. The two columns on the right-hand side of the table show differences between the Treasury's Autumn and Budget arithmetic, and then between the Goldman Sachs forecasts and the Autumn Statement figures.

Taking 1986–87 first, the Treasury has reiterated its previous belief that the PSBR will eventually end the current year close to its £7 billion target. This is despite the fact that government expenditure is now expected to be £1.25 billion higher than shown in the Budget plans, while oil revenues are down by £1.5 billion. These short-falls are offset by a drop in public corporations' market borrowing; and by the buoyancy of non-oil revenue and national insurance contributions, which are presently estimated to be running £2 billion ahead of Budget plans. According to the Treasury, corporation tax and VAT are the main contributors to this excess. Provided that the buoyancy of VAT in particular is maintained (and there seems little reason why it should not be, given the continuing rapid growth in consumers' expenditure), then the £7 billion PSBR target should be comfortably achieved this year.

Turning to *1987–88* we can see how Treasury plans have changed by comparing columns 2 and 3. Departmental spending plans have risen by a massive £7.5 billion in the Autumn Statement, but this has been offset by higher asset sales and an allocation of the contingency reserve, leaving the planning total up by £4.6 billion. General government spending is up by slightly less (£4 billion). The revenue side of the accounts has not been published by the Treasury, but estimates of the relevant figures can be made by using the Treasury's economic forecasts to construct implied tax yields. On this basis, it seems likely that non-oil taxation will exceed the 1986 Budget plans by some £3.5 billion next year, but that £0.5 billion of this will be offset by a further drop in oil taxation. This would leave general government receipts around £3 billion higher than was expected in this year's Budget. On these figures, the Treasury arithmetic seems to imply that there is theoretically very little scope for tax cuts—perhaps of only around £1 billion—if the

PSBR target is to be maintained at £7 billion. Essentially the £4 billion of extra public spending has absorbed the £3 billion of unexpected buoyancy in non-oil tax, as well as half of the £2 billion previously set aside for tax cuts next year.

TABLE 2

THE FISCAL ARITHMETIC

(£ billion)	*1986–87 Estimate*	*1987–88 1986 Budget F'cast*	*1987–88 Autumn Statement F'cast*	*1987–88 Goldman Sachs F'cast*	*Differences in 1987–88 Autumn Statement less Budget F'cast*	*Differences in 1987–88 GS F'cast less Autumn Statement*
	(1)	*(2)*	*(3)*	*(4)*	*(3)–(2)*	*(4)–(2)*
Expenditure						
Departments	145.2	142.6	150.1	155.6	7.5	5.5
Contingency Reserve	0.0	6.1	3.5	0.0	−2.6	−3.5
Asset Sales	4.8	4.8	5.0	5.0	0.2	0.0
Planning Total	140.4	143.9	148.6	150.6	4.7	2.0
Other Adj.	24.0	25.6	25.1	25.0	−0.5	−0.1
Gen. Govt. Exp.	164.4	169.5	173.7	175.6	4.2	1.9
Revenue						
Oil Tax	4.5	4.0	3.5[1]	3.5	−0.5	0.0
Non-oil Tax	113.5	120.0	123.0[1]	122.6	3.0	−0.4
Nat. Ins.	26.5	28.0	28.5[1]	28.5	0.5	0.0
Other Adj.	12.0	12.0	12.0[1]	12.0	0.0	0.0
Gen. Govt. Receipts[2]	156.5	164.0	167.0[1]	166.6	3.0	−0.4
Tax Cuts	—	2	1[1]	1.7	−1	1
Gen. Govt. Borr. Req.	8	8	8[1]	10.7	0	3
Public Corp. Market Borr.	−1	−1	−1[1]	−1.0	0	0
PSBR	7	7	7[1]	9.7	0	3

[1]Author's calculations of figures implied by Treasury economic forecasts.
[2]Before tax cuts.
Note: Numbers are rounded in some cases.

If the Chancellor were to stick to the figures in column 3 of Table 1, then this should present the financial markets with relatively few long-term problems. The absence of large tax cuts, taken together with somewhat more honest public expenditure plans, and a PSBR target unchanged at £7 billion, does not add up to any form of disaster for gilts or sterling. But the problem is that the market believes that there may be some further slippage in public expenditure, and that there is a reasonable chance of the Chancellor being tempted to announce tax reductions on top of the expenditure increases. Column 4 shows what might happen on these assumptions. On public spending, I assume that the most likely outcome for next year is that the Autumn Statement plans, though high in themselves, are exceeded by a further £2 billion. This is justified on the following grounds. At the equivalent time last year, the Treasury allowed itself a £4.5 billion Contingency Reserve for the forthcoming year, and still appears to have missed its target by *at least* £1.25 billion. This suggests that a Reserve of around £6 billion might be "par for the course" at the present stage of the planning process, rather than the £3.5 billion actually incorporated into the Treasury's plans. Now, it can be argued that this low Reserve is a response to better prospects for control of local authority spending and social security spending this year. But a central forecast must remain sceptical about this, especially since upward pressures on public sector pay appear to be much greater this year than last, and do not yet seem to have been fully incorporated into the Autumn Statement arithmetic (though it does include a £0.5 billion allowance for the latest teachers' offer). On balance, the Treasury's plans therefore look a little tight, and the Goldman forecast (for example) shows an overrun of around £2 billion in actual spending next year. This alone would take the PSBR outturn up from the Treasury's target of £7 billion to around £9 billion. On top of this, there must be a risk of some extra tax cuts being introduced in the Budget, even if these do not appear to be fully in line with fiscal prudence. In Table 2, I show the impact of assuming that £1.5–2 billion of tax cuts are introduced instead of the £1 billion included in column 3; this takes the forecast outturn for the PSBR up to £9.7 billion. *At first sight, this might appear worrying, but it would still represent only 2.5 per cent of nominal GDP; and the government would presumably try to steer the figure back down over the medium-term.*

1988–89 and Thereafter

If the Treasury's fiscal plans for 1987–88 look tight, with the PSBR objectives quite likely to be exceeded, the medium-term plans published with the 1986 Budget for 1988–89 and thereafter look even more problematic. In the aftermath of the Autumn Statement, Mr Lawson has reiterated two of his previous promises about medium-term fiscal developments. First, he has said that the additional public spending included in his new plans will not lead to any increase in the £7 billion PSBR target over the medium-term. Second, he has repeated the long-term objective of achieving a 25p in the £ basic rate of income tax.

However, on realistic medium-term arithmetic, these two objectives no longer appear compatible: one or the other will probably have to give.

The Treasury's new medium-term spending plans are based on the assumption of average annual growth in real spending of 1.25 per cent, compared with zero in previous White Papers. Although this rate of growth remains below the assumed increase in real GDP, the Treasury will be hard-pressed on past performance to ensure that the medium-term rate of growth in public spending is consistent with the published objectives. Indeed, if the plans are exceeded by as much as they have been in the past, then the real level of spending would be likely to grow in line with the expected 2.5 per cent rate of growth in real GDP. *This demonstrates the full measure of the change of public spending strategy in the Autumn Statement*: in previous years, the Treasury has at least *intended* to allow *all* of the proceeds of economic growth to go to tax cuts, with *none* going to improvements in public services. It now seems likely that the public spending horse has well and truly bolted, and that the Treasury will find it futile to close the stable door in 1988. The real level of spending will have been ratcheted permanently upwards. Furthermore, pressures on spending are anyway likely to emerge from an overshoot in inflation relative to the 3 per cent Treasury objective. The forecasts shown in Table 3 assume that the public spending limits are slightly exceeded in real terms after 1987–88, and that the rate of inflation runs around 2 per cent per annum above the levels implied in the Treasury projection. This produces a substantial excess in public spending, even relative to the Autumn Statement arithmetic. Compared with the plans published in the 1986 Budget, the excess rises from around £6 billion next year to about £16 billion at the end of the decade. (This assumes that all of the additional inflation is passed into public spending in nominal terms, with none being squeezed out by the operation of cash limits.)

On the revenue side, higher inflation than is expected by the Treasury also boost receipts, but buoyancy in real government revenue will diminish as consumer spending slows, and as oil receipts decline. Hence, the overshoot in revenue shown in Table 3 is substantially less than the overshoot in expenditure, leading to a potentially very large excess in public borrowing towards the end of the decade. For these reasons, control of the PSBR is likely to remain very problematic after 1987–88. Specifically, on the projections summarised in Table 3, tax *increases* of around £3 billion would be needed in 1988–89 to bring the PSBR back to £7 billion. Even for a newly-elected government, that seems a tall order—so public borrowing seems set to continue exceeding the MTFS targets. There consequently seems little or no chance of the MTFS borrowing limits being compatible with a 25p basic rate of income tax, at least for several more years. (If the government left tax rates unchanged in the final two financial years of this decade, the PSBR might run at an annual rate of £9–10 billion.)

TABLE 3

FISCAL POLICY—SUMMARY TABLE

£ billion	*1986–87*	*1987–88*	*1988–89*	*1989–90*
Gen. Govt. Expenditure				
1986 Budget	163	170	175	180
Likely Outturn	164½	175½	186	196
Gen. Govt. Receipts				
1986 Budget	156	164	174	182
Likely Outturn	156½	166½	178	189
Tax Cuts[1]				
1986 Budget	—	2	4	3
Likely Outturn	—	1¾	0	0
PSBR				
1986 Budget	7	7	7	7
Likely Outturn	7¼	9¾	10	9
PSFD[2]				
1986 Budget (Implied)	12	12	12	12
Likely Outturn	12	14½	15	14

[1]New tax cuts to be announced each year. Cumulative totals can be derived by summing these figures.
[2]Assumes privatisation receipts in line with Treasury target of £5 billion a year.

Summary

On the fiscal arithmetic, I would conclude the following. It is probable that the unpublished Treasury arithmetic allows scope for around £1 billion of tax reductions next year within a £7 billion PSBR target. However, the public spending targets look a little tight, and an overrun of £2 billion looks fairly likely. Assuming £1 billion of tax cuts, this would put the PSBR next year up to £9 billion. If the Chancellor were tempted (misguidedly) to squeeze larger tax cuts into a pre-election Budget, the PSBR outturn could easily rise to £10 billion, implying a PSFD of £15 billion. The financial markets would show concern if risks were taken with fiscal prudence in order to maximise tax cuts next year, not only because of the public borrowing consequences, but also for the more general economic reasons mentioned in Section I. After 1987–88, a large overshoot in public spending relative to 1986 Budget plans now seems almost inevitable. This is likely to exceed the buoyancy in non-oil revenues, making a £7 billion PSBR target incompatible with tax reductions. On present forecasts, such a PSBR target might require £3 billion of tax *increases* in 1988–89; alternatively, with no increase in taxation, the PSBR would rise to £10 billion.

III. The Treasury's Economic Forecast

In general, the Treasury's economic forecast, which shows real GDP growth accelerating, inflation steady on an underlying basis, and only a relatively mild deterioration in the balance of payments, looks slightly optimistic, but not outlandishly so. The main problem concerns next year's inflation profile. The Treasury's relatively optimistic forecast of 3.75 per cent inflation at the end of 1987 is based on several optimistic assumptions, including a stable exchange rate, a small reduction in pay settlements in the current round, a sharp acceleration in productivity growth, and constant profit margins. Most outside forecasters are not so optimistic about the exchange rate, or about unit labour costs, as the Treasury, and the consensus view is that inflation will be about 1 per cent higher than the official forecast at the end of next year. Furthermore, there is a severe danger that the rate will still be rising at that time.

Because of this higher inflation, there may be a little less buoyancy in real GDP next year than the Treasury forecast suggests. It expects 3 per cent real GDP growth, much of which is explained by a 4 per cent increase in real consumption. With inflation running higher than the Treasury indicates, this consumption prediction looks a little optimistic, and domestic demand may run slightly below the Treasury estimate. More important, the official prediction of a rise of only 4.5 per cent in the imports of goods and services next year looks very low, given recent trends in import penetration. More rapid growth in import volume would not only depress GDP, but lead to a current account deficit rather larger than the £1.5 billion shown in the Treasury projection. It is not clear why the Treasury is more optimistic about imports, and the balance of payments, than most outside forecasters. It has been suggested that the Treasury forecasters have applied a large judgmental adjustment to the original projections produced by their econometric model in the field of imports, and it would be interesting to discover whether this is in fact true.

Finally, the Treasury appears to have assumed that there will be no reduction in short-term interest rates over the forecast period. The increase of over 10 per cent in the housing component of the RPI in the 12 months ended 1987Q4 suggests that mortgage rates are expected to remain at or above present levels, and this is confirmed by the fact that the Treasury states that the recent rise in mortgage rates will add about 0.5 per cent to price inflation "for the next year". *This suggests that officials see no scope for the present very high level of interest rates to ease over the next 12 months.*

12 *November* 1986

Appendix 2

Memorandum by Bill Martin, Specialist Adviser to the Committee

THE 1986 AUTUMN STATEMENT

The Autumn Statement forecast is based on one key proposition. Fiscal policy, relaxed in the last Budget, is to remain lax, but interest rates are to remain high. The aim is to stabilise sterling while generating a pre-election boomlet. The short term risks are obvious. Another sterling crisis and a further hike in interest rates. But the longer term risks are of greater concern. The sustainability of policy is now in doubt, adding to uncertainty—something the Medium Term Financial Strategy was supposed to avoid. Meanwhile, the imbalance between booming consumption and weak investment growth is damaging the economy's productive potential. Despite the attempt to cheer us up, the Autumn Statement is a depressing read.

PUBLIC SPENDING

The planning total has been raised by £4¾ billion in 1987–88, following a £1¼ billion upward revision to the estimated outturn for this financial year. £5½ billion has been added to the old 1988–89 plans. The planned cash increase is worth nearly 6 per cent in 1987, falling to less than 4 per cent in 1988. A further 4½ per cent rise is pencilled in for 1989. The increments to the old plans are fairly fiddle-free. £¼ billion each year has been added to planned privatisation receipts—now £5 billion per annum from 1987—and a similar amount has been added to projected receipts from council house sales. Both items are treated best as financing items rather than as negative public expenditure.

If met, the new plans would have the effect of restoring expenditure back to its previous inexorable growth trend in "real terms", that is, cash spend excluding the effects of economy-wide inflation. On the Chancellor's inflation forecast, spending on the planning total measure will rise by 2 per cent this year and next, substantial upward revisions on the previous plans (Table 1 and first graph).

TABLE 1

PUBLIC SPENDING PLANNING TOTALS#

FY	*Est outturn 1979–85*	*% growth pa, real terms** plans 1986*	*1987*	*1988*
(a) Unadjusted	1.1	2.2(0.5)	2.1(−0.3)	0.2(−0.2)
(b)(a) ex asset sales*/coal strike	1.3	4.3(2.5)	1.8(−0.5)	0.0(−0.4)

*Privatisation proceeds and council house sales.
#1986 White Paper/Budget plans in parentheses.
**Cash spend relative to official projected increase in economy-wide inflation as measured by the GDP deflator: currently 3 per cent in 1986–87 and 3¾ per cent in 1987–88. The Budget projection of 3½ per cent inflation is taken for 1988–89.

The underlying increase this year is a great deal more. Spending in 1985–86 was bloated by the once-off costs of the coal strike—worth about £1¼ billion—while asset sales will be some £2 billion higher in 1986 than last year. Together these factors add 2 per cent to underlying growth in expenditure, giving over 4 per cent in all. This surge probably reflects the reaction of budget managers to their unhappy experience in 1985 when real spending was squeezed out by the operation of cash limits and an unexpected pick up in inflation (the Treasury forecast 5 per cent, the outcome was 6 per cent).

At first sight then, the new spending targets appear to accommodate the normal kind of upward pressure on real spending with a further allowance for catch up this year. Such apparently generous targets should be hittable. But doubts arise on several counts:

* The reserve for 1987 (£3½ billion) is below this year's allowance (£4½ billion) which has proved inadequate.
* Although real spending is set to rise by an average 1¼ per cent per annum, as the Chancellor said, the profile is heavily front-loaded. For 1988, planned real growth is only ¼ per cent, well below trend.
* Prices for public sector goods and services are likely to be rising faster than inflation economy-wide (as measured by the GDP deflator).
* The Treasury's forecast that economy-wide inflation will stay below 4 per cent may well prove too optimistic.

On our estimates, the *relative* price of public provision will be rising at around double its trend rate of increase (of ¾ per cent per annum) over the next two years (second graph). Public sector pay, around a third of total spending, will probably rise by 7½–8 per cent per annum allowing for the cost of the likely teachers' settlement. Relative prices will get a further boost from the prospective increase in import prices which are excluded as a matter of definition from the GDP deflator. Meanwhile, inflation economy-wide looks set to bounce along in a $4\frac{1}{2}$-$5\frac{1}{2}$ per cent band, thanks to the strong underlying trend in unit wage costs. *The result is that the average price of all public provision may well be advancing at 6 per cent or more over the next two years.*

By excluding these price rises from cash plans, we derive the implications for the "volume" of public expenditure. The implications do not make joyful reading. *For 1987, we find a fall of $\frac{1}{4}$ per cent in public spending volume, followed by a remarkable 3 per cent decline in 1988, if the plans are met.* Is that credible? We have argued that spending this year is inflated to an extent, reflecting a catching up process after the unaccustomed belt tightening of 1985. For this reason, we give the Chancellor the benefit of doubt on 1987 plans. We withdraw support in 1988, however, Usual pressures for volume increases indicate the likelihood of a massive spending overrun, perhaps up to £6 billion, that year in the absence of a sharp shift in policy. This is our first worry.

BUDGET ARITHMETIC

The burgeoning bill for public spending is being paid for out of buoyant non-oil tax receipts. As a result, the Treasury's conventional budget arithmetic probably shows that the Chancellor could still deliver tax cuts and stick to his £7 billion PSBR figure next year and thereafter. Apparently, he can spend extra billions but claim to be fiscally prudent. It's all done with mirrors, of course. Budget arithmetic is a wholly inadequate way of assessing the prudence or otherwise of the "Government's overall fiscal stance". This is our second worry.

We start with the usual sums

Table 2 shows our guesstimates of the Treasury's internal forecasts for non-oil taxes (including national insurance) on income, expenditure and capital. This component of tax take can be related to projections of non-oil money GDP built up from the few clues scattered through the Autumn and Budget Statements.

TABLE 2

GUESSTIMATED TREASURY REVENUE FORECAST—£ BILLION UNLESS STATED

FY	1985	1986	1987	1988
Money GDP	360.5	380	406.5	431
Oil value added	17	8	7	7
Non-oil money GDP	343.5	372	399.5	424
Non-oil tax take	127.5	140	151	161
(% of non-oil GDP)	(37)	(37.5)	(38)	(38)
Oil revenue	11.5	4.5	4	4
Other receipts	12.5	12	12	13
General Govt receipts	151.5	156.5	167	178

Figures rounded to nearest £$\frac{1}{2}$ billion.

This year the Treasury has discovered an extra £2 billion of non-oil revenue compared with the Budget forecast, despite a probably modest downward revision of estimated non-oil money GDP. Revenue forecasts for 1986 have been boosted by the upward revisions to tax take in 1985. That raised the base level for future projections. But revenues are also rising faster than incomes, thanks in part to the progressive nature of the tax system. On this basis, the Treasury have probably increased its Budget forecasts for non-oil tax take by £3 billion in 1987 and by £4 billion in 1988. We reckon these revisions carry straight through to overall government receipts with oil prices steady at $15 a barrel.

Table 3 gives our reconstruction of the Treasury's familiar PSBR table. On these tentative numbers the net effect of extra spending and extra tax take is to reduce the scope for tax cuts in 1987 from £2 billion, projected in the Budget, to £1 billion. Such parsimony pays off in 1988, however, assuming public spending stays on target. Here we see a bountiful £$4\frac{1}{2}$ billion "fiscal adjustment"—higher even than in the Budget projections.

TABLE 3

GUESSTIMATED TREASURY PSBR FORECAST £ BILLION, UNLESS STATED

FY	1987 Before	1987 Now	1988 Before	1988 Now
General Government:				
expenditure	170	173.5	175	179.5
receipts	164	167	174	178
Fiscal adjust previous	—		2	1
annual	2	1	4	4.5
GG borrowing	8	7.5	7	7
Public corps borrowing	−1	−0.5	—	—
PSBR	7	7	7	7
(as % money GDP)	(1.75)	(1.75)	(1.5)	(1.5)
Money GDP	407	406.5	431	431

Figures rounded to nearest £½ billion. "Before" = 1986 Budget projections.

PROSPECTS AND POLICY

Our concern is that this kind of figuring will be used as justification for tax cuts. In truth there is no such justification. The Chancellor's borrowing plans were laid down before he or the Treasury realised the full enormity of Britain's looming balance of payments problem. The Treasury has had to scale down its March Budget forecast from a £3½ billion surplus on current account to a nil balance in 1986. Next year, where it once anticipated surplus (£1½ billion at an annual rate in 1987H1), it now sees deficit (£1½ billion). Plans for borrowing set on the basis of the Budget computer prints cannot be right in the Autumn Statement printouts. The right plans must be based on a realistic assessment of Britain's economic problems.

The economy is now beset by a number of the difficulties which we predicted in our evidence to the Committee in March. The key concerns are:

* Evidence of emerging supply constraints. Spare capacity in manufacturing industry is low, despite poor growth. In the labour market, the ratio of vacancies to unemployment is rising strongly, earnings increases show little sign of moderation and skill shortages abound.
* Investment expenditure has been weak relative to consumption and is forecast by the Treasury to remain so.
* The non-oil trade deficit is widening sharply at a time of dwindling oil surpluses.
* The trend rise in unit wage costs appears to be stuck at around 5 per cent per annum. Coupled with the turnaround in import prices and high profits growth, it implies an escalation in inflation from now on.

The Treasury forecast plays down these unhappy developments. Although it sees a larger non-oil deficit—£14 billion in 1987 as compared with £10½ billion in 1985—the overall current account deficit is contained by a remarkable increase in the projected invisibles surplus.

The officially estimated surplus on invisibles in the first nine months of this year is £5.8 billion and includes the once-off benefit of the delayed rebate on UK contributions to the European Community's Budget worth nearly £½ billion. The official projection on invisibles is now £600 million a month indicating a figure for the full year of under £8 billion. The Treasury forecasts £8½ billion this year rising to £9 billion in 1987. This looks particularly optimistic on the basis of current estimates.

We have similar reservations about the export forecast. It is not unreasonable that non-oil export volumes should grow a little faster than world trade—though the Treasury has on previous occasions played down the importance of competitiveness changes. What is questionable is whether manufacturers have capacity of the right quantity and quality to take advantage of sterling's decline to the extent the Treasury now appears to assume. Overall, we expect a current account deficit in excess of £3 billion next year, getting bigger.

The Treasury is similarly over-optimistic on inflation. Wage settlements are assumed to fall despite the pull of strong profits growth and tighter labour markets. It forecasts also a very sharp fall in unit labour costs in manufacturing industry. However, much of that fall is attributable to the cyclical pick up in output and, as a result, should not be a significant influence on manufacturers' pricing behaviour. We would expect to see a rising profit margin in relation to unit wage costs, not a fall in prices. Buoyant margins are being encouraged in any event by sterling weakness and robust demand. We expect inflation over 4½ per cent by end 1987.

TOUGH BUDGET REQUIRED

In these circumstances, the Chancellor's policy settings implicit in the Autumn Statement are plainly wrong. Resources have to be redirected into improving the balance of payments and boosting investment but without re-igniting inflation. *The first requirement is a reduction in real interest rates and a further fall* *in sterling*. (Sterling has probably fallen by enough to compensate for the oil price drop but not for other factors which are undermining the current account.) However, at a time of near-full capacity, falling sterling has to be accompanied by a cut back in domestic expenditure. Falling sterling combined with surging domestic demand is simply a recipe for inflation. *The second requirement, therefore, is a tough fiscal stance*.

Table 4 gives the Committee some idea of how tough. It shows two model simulations producing, over three years, roughly equal improvements on the current account. The scale of that improvement—a cumulative £4 billion—is probably not out of line with UK needs over the next few years. Indeed, it may understate them. In (A) sterling falls 10 per cent each year—cumulating to over a 30 per cent against the baseline level. That does the trick, but only at the cost of accelerating inflation—4½ points up by year 3.

TABLE 4

HOW TO RIGHT THE CURRENT ACCOUNT

	Yr 1	*Yr 2*	*Yr 3*
(A) Large depreciation			
Current account (£bn)	Nil	1	3.25
GDP growth (% pts)	0.5	1	0.75
Inflation (% pts)	1	2.5	4.5
(B) Depreciation & tough Budget			
Current account £bn	0.5	0.5	3
GDP growth (% pts)	0.25	Nil	Nil
Inflation (% pts)	Nil	0.5	Nil

(A) Steady depreciation of 10 per cent a year.
(B) Depreciation of 3 per cent in years 1 and 2 only, plus tax increases.

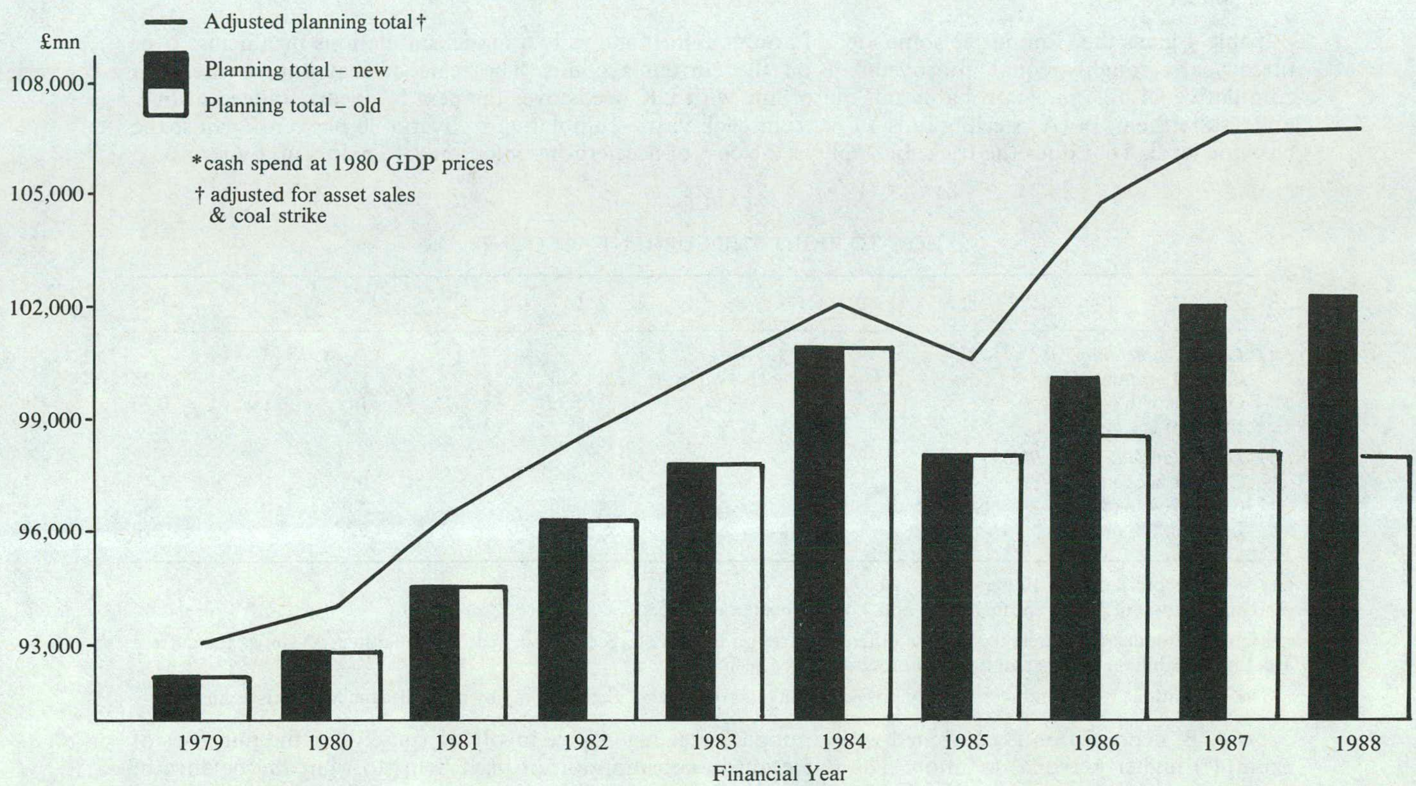
Figures, rounded to nearest 0.25, show differences from a baseline forecast, eg in year 2, simulation (A) shows the current account is £1 billion better than it would otherwise have been.

The simulations were conducted on Phillips & Drews macro-model of the economy by my colleague Mr Chris Johns.

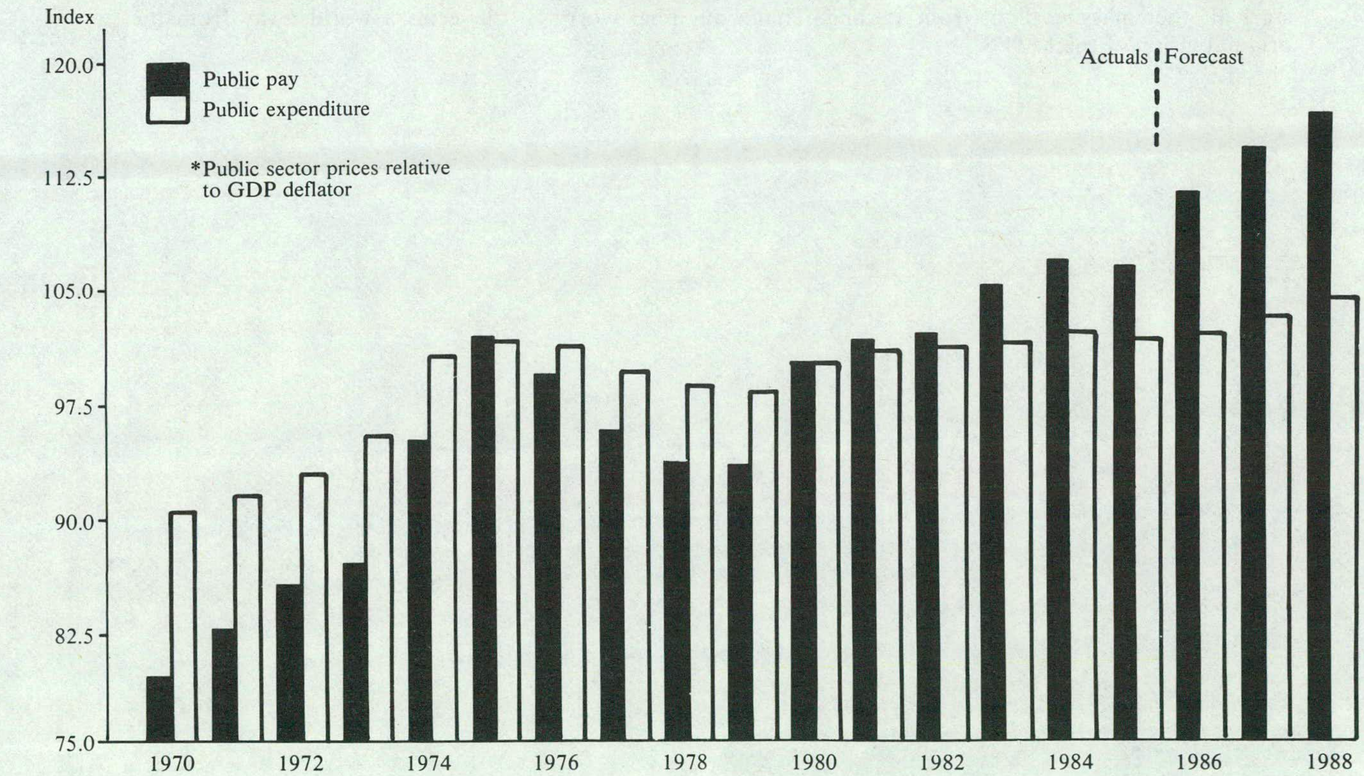
So in B, depreciation is combined with a tough budgetary stance involving (purely for the purposes of example) higher personal taxation. The reduction in consumption of itself helps to right the balance of payments, so the required cumulative fall in sterling is only 6 per cent over 2 years. Inflation barely moves. And despite the tax increases, output is not depressed—because of the rise in net exports. The bad news for the chancellor is that simulation (B) involves a cumulative rise in the standard rate of income tax of 7p in the pound!

Political pressures could, conceivably, deflect the present Chancellor from adopting this route. *But tough budgets will come sooner or later in our view*. It would be far better that they came as a result of a cool appraisal of the true needs of the economy. Regrettably it is far more likely that the belt tightening will start another massive flight from sterling. That's our final worry. It all seems a world away from the original vision of the MTFS.

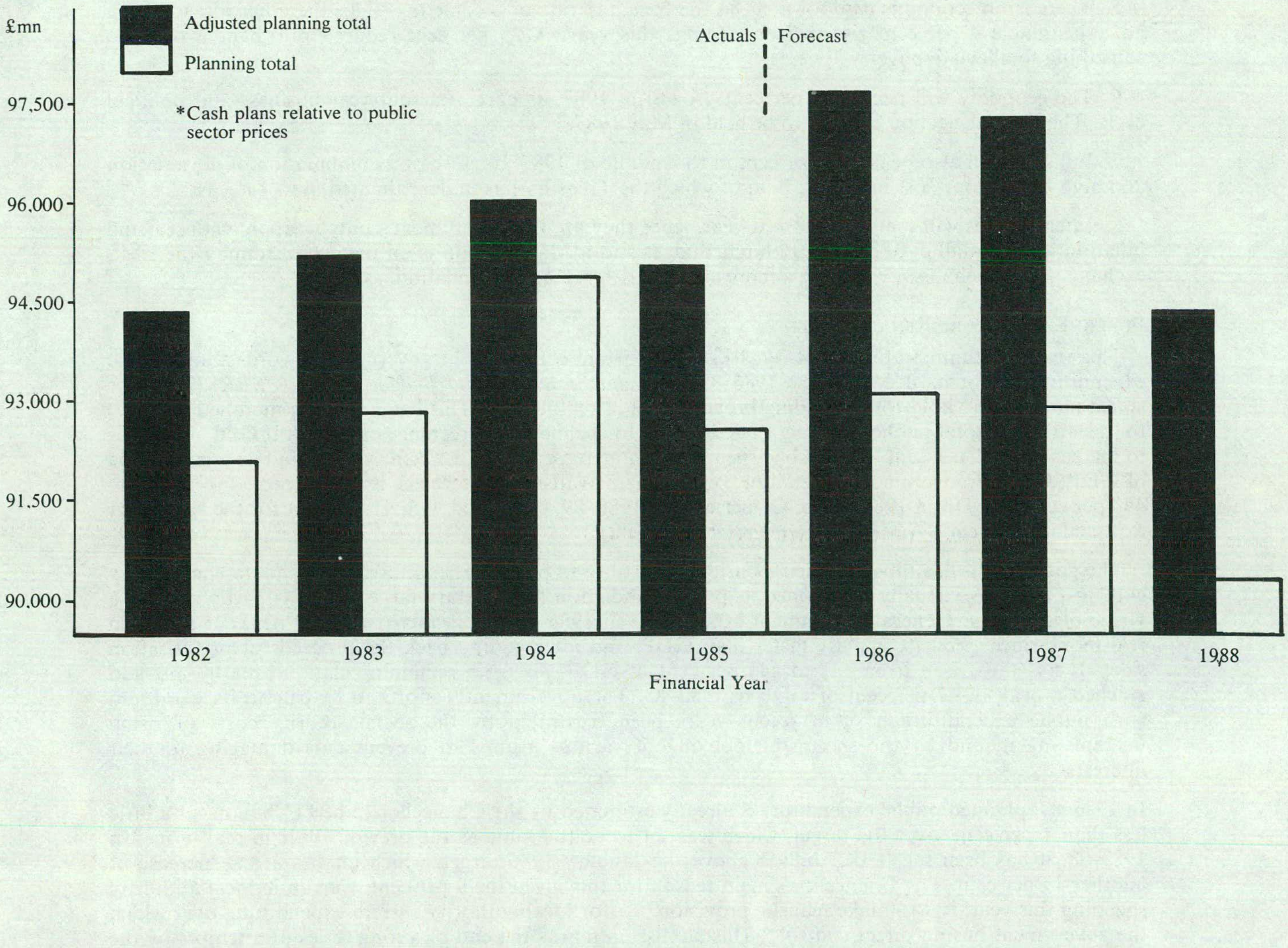
Real public spending back on trend*



Relative prices rising (Index, 1980 = 100)*



Public Spending Volumes (1980 prices)*



Appendix 3

Memorandum by Christopher Johnson, Specialist Adviser, to the Committee

AN ASSESSMENT OF THE AUTUMN STATEMENT
November 1986.

SUMMARY

1. The government has abandoned its aim of keeping public expenditure stable in real terms, and is planning only to prevent it from rising as fast as gdp.

2. The change is a recognition of the reality that the government has generally failed to prevent public expenditure rising in real terms, and that there is a strong popular demand for more spending on education, health and housing.

3. The increases in public expenditure in 1987–88 will do no more than offset the rise in tax revenue, and will change the fiscal stance only from contractionary to neutral.

4. The Chancellor may be able to give away about £1 billion in tax cuts in the March 1987 Budget, but would have been able to make £4½ billion tax cuts, and reduce income tax to 25 per cent, had he achieved his public expenditure target for 1987–88.

5. There is no economic case for a cut in the basic tax rate of income tax, since there has already been an unjustifiable 4 per cent rise in real earnings this year. A 25 per cent reduced rate band would do something to alleviate poverty.

6. The economy will peak at 3 per cent growth in 1987, as part of a four-year business and political cycle. The general election is likely to be held in May 1987.

7. Inflation will also peak at 5 per cent in the middle of 1987, because of a combination of devaluation and high unit labour cost increases, both of which the Treasury has underestimated in its forecast.

8. Interest rates will remain high next year, since they are the government's only weapon against rising inflation, but a small cut between a March Budget and a May election is on the cards. Joining the EMS exchange rate mechanism would be a more effective defence against inflation.

PUBLIC EXPENDITURE REHABILITATED

This year's Autumn Statement (*AS*) marks an important change in the government's words about public expenditure, if not its deeds. In the 1986–87 *Financial Statement and Budget Report* (*FSBR*) (2.25) the stated aim was to "hold total spending broadly level in real terms". This has now been modified (*AS*, 17) to "see to it that total public spending . . . continues to decline as a percentage of GDP". If GDP continues to increase at 2–3 per cent, then public spending can increase at 1–2 per cent, yet still fall as a percentage of GDP. General government expenditure, excluding privatisation proceeds, is now expected to fall from 44½ per cent of GDP in 1986–87 to 42¾ per cent in 1988–89, compared with 41 per cent for the same year expected in last year's Autumn Statement (*AS*, Table 2.1).

The government has thus modified its original hostility to public expenditure, and its preference for tax cuts, just as it has virtually abandoned its pristine addiction to monetary targets. This is partly making a virtue of necessity. General government expenditure in 1986–87 has in fact risen by 2 per cent a year in real terms since 1978–79, slightly faster than GDP, and after adding back the proceeds of privatisation sales. It has thus risen from 43¼ to 44½ per cent of GDP, far from remaining static in real terms, and reached a peak of 47 per cent of GDP in 1982–83. The government's efforts to be true to its word and curb public expenditure have in recent years been frustrated by the social security costs of rising unemployment, and by the successful lobbying of various groups to prevent cuts damaging to their interests.

In 1986–87, planned public expenditure is already estimated by the Chancellor to be £1¼ billion, or a little less than 1 per cent, over the target, which was set to be the same as the previous year in real terms. In 1987–88, it has been set at £4.7 billion above the January 1986 target, which implies a real increase of another 1¾ per cent. The Chancellor's main reason for this given the 9 per cent overrun in local authority spending this year, is: "to make realistic provision . . . for local authority current expenditure, over which the government has no direct control." This admission marks the end of a long series of attempts by the central government to find different ways to cut back local authority spending, which made it as unpopular with its own backbenchers from the Shires as with the Labour urban councils. It may be wondered whether even the more modest target of having public expenditure rise less rapidly than GDP can be attained.

EDUCATION PRIORITIES

The new approach to public expenditure sharply upgrades the priority given to education, doubtless because the inadequacies of this sector are seen as being the root of Britain's economic backwardness. About half the extra money will go to increase teachers' salaries, and the other half to various other improvements. Education will get 11.2 per cent of total programme expenditure in 1987–88, compared with 9.9 per cent this year, while defence will fall from 12.8 to 12.2 per cent. The important battle has switched from the Falklands to the craft, design and technology workshops of the comprehensive schools.

In 1987–88 education will get an extra £2.2 billion (15.3 per cent) above what was previously planned. Social security will get £1.7 billion (3.8 per cent), because unemployment is higher than forecast. Unemployment in Great Britain, excluding school leavers, is now 3.1 million, the official assumption of its average in the current year. The government assumes that it will fall to 3.05 million in 1987–88, then stay there for the next two years. (*AS*, 3.02). The other increases in planned public expenditure are thus not expected to yield more than a token cut of 50,000 in unemployment, which will continue to be a heavy financial burden, particularly as more people move from short-term to the higher long-term benefit rates. This is partly because some of the extra expenditure, such as the rise in teachers' salaries, will be swallowed up by the relative price effect rather than adding to volume by means of additional numbers employed.

Other increases have been announced for health, of £700 million (3.4 per cent), and for housing, of £360 million (12.7 per cent). The government appears to have recognised that increases in these services cannot all be provided by the private sector, even though it may play a greater or lesser role. As incomes rise, so does the demand for education, health, housing and other social services. While State industries are being privatised, with savings to the public purse and perhaps gains in efficiency, the government has been unable or unwilling to privatise the health and education services in the same way, in spite of occasional radical temptations. If the provision of these services is to be increased and improved, an increase in public expenditure cannot be avoided. A doctrinaire hostility to all forms of public expenditure has had to give way to a more pragmatic concern to finance those that can be justified on their merits in such a way as to avoid excesses of inflation, public debt, or taxation.

The Fiscal Stance

In view of such important changes in public expenditure, the Chancellor met some scepticism when he claimed that there would be no relaxation of his fiscal stance. As measured by the public sector borrowing requirement (PSBR), there has been a slight relaxation from a PSBR of £5.8 billion, or 1.6 per cent of GDP, in 1985–86 to one of a forecast £7 billion, or 1.8 per cent of GDP, in 1986–87. However, in 1987–88, the stance will be unchanged, with a PSBR of £7 billion fractionally augmented by raising privatisation sales from a projected £4.75 billion to £5 billion. The fiscal stance, after adding back these sales, which are accounted for as negative public expenditure, will be a deficit of £12 billion, or 2.9 per cent of GDP in 1987–88, still modest by comparison with most countries.

The reason why the fiscal stance has remained so neutral is that tax revenue is rising faster than public expenditure, which thus has to be increased if the fiscal stance is not to tighten. It is remarkable that general government receipts – mainly tax revenue – are rising by 3½ per cent in 1986–87, in line with inflation, after a drop of £7 billion in North Sea tax to £4½ billion. North Sea tax was £1 billion lower than estimated at the time of the Budget, but non-North Sea tax, mainly VAT and corporation tax, looks like exceeding the Budget estimate by £2 billion, because consumer spending and profits are higher than forecast.

The buoyancy of non-North Sea tax revenue is due to the phenomenon known as "real fiscal drag". An example of how this works in the case of income tax is given in Table 1; it also operates in a more complex manner for corporation tax. "Fiscal drag" means the tendency for tax to rise faster than income; the income elasticity of the tax is greater than one. The multiple by which the tax rises faster than the income can be found simply by dividing the marginal by the average rate of tax. The example has been simplified to give a fiscal drag of 1 as long as the increase in income is no more than inflation; this is what is involved in indexing a tax system. But as soon as there is a real increase in income, tax rises twice as fast as income—a fiscal drag of 2—because the marginal rate of 38 per cent is twice the average rate of 19 per cent.

Thus the high marginal rate of income tax and national insurance which the Chancellor is committed to reducing is in fact a great advantage to him in keeping down the PSBR. Far from discouraging effort at the margin, it may act as a disincentive to unwarranted real wage increases. There is just as much to be said for raising the marginal rate of tax as a form of tax-based incomes policy as there is to be said for lowering it from 29 to 25 per cent to give work incentives. If the Chancellor wishes to help the lower paid, he could do so by either raising tax thresholds by more than inflation, or by introducing a 25 per cent reduced rate band, which would be a cheap way of achieving his goal for at least some taxpayers.

The size of the fiscal adjustment, or tax give-away, that the Chancellor may have in his March Budget is shown in Table 2. Compared with his 1986 Budget calculations (*FSBR* 1986–87, Table 2.5), general government expenditure may turn out £3½ billion higher in 1987–88, and general government receipts £2½ billion higher. This reduces the fiscal adjustment from £2 billion to £1 billion. This would be enough to cut income tax by 1p in the pound, raise the income tax thresholds by 5 per cent more than inflation, or bring in a 25 per cent reduced rate band. A more effective use of the money would be to cut employers' national insurance contributions, thus reducing labour costs, and giving an incentive to hire more labour.

If the Chancellor had not exceeded his general government expenditure target by £3½ billion then, given the £2½ billion extra tax revenue and the £2 billion planned fiscal adjustment, he would have been able to reduce taxes in the 1987 Budget by £4½ billion, or by 4 pence in the pound, to 25 pence. Partly by lack of control and partly by deliberate intent, £3½ billion that might have been put into tax cuts has been diverted into general government expenditure—a measure of the magnitude of the policy switch that has taken place. As the Chancellor well put it: "Clearly a pound cannot be used twice. A pound which is used in higher public expenditure is not available for reductions in taxation." (*Hansard*, 6 November 1986, Column 1090).

THE POLITICAL CYCLE

The Autumn Statement has been taken as an indication that a general election is in the offing. A possible date would be 7 May, 1987, so that the local and general elections could be combined. This would be only four years after the 1983 general election, instead of the statutory five, but that too was held after only four years. There are striking parallels. The pound was weakened by political speculation in early 1983, and Mrs Thatcher increased public expenditure with the famous words to local authorities: "Spend, spend spend." However, the Autumn Statement's measures could be justified on the grounds that unemployment is too high, and extra public spending is a more efficient way of reducing it than tax cuts. The test of whether these are no more than short-term political opportunism will come after the election, when we shall see whether the spending increases are cut back again. If the economy does show signs of over-heating, it would be better to increase taxation than to cut expenditure; if public expenditure overruns even its new targets, it would be better to increase borrowing, at least up to a point, than to downgrade the new priorities once more.

A four-year business cycle is forecast to coincide with a four-year political cycle, see Table 3. Economic growth has been disappointing in the UK this year, because there was not enough growth in the rest of the world to provide the expected demand for British exports. Real GDP will have increased by only 2½ per cent (2 per cent adjusted for the coal strike) instead of the 3 per cent forecast by the Treasury at the time of the Budget, and manufacturing output not at all. Although consumer demand at 5 per cent real has risen even more strongly than forecast, exports have risen by only 1 rather than 5 per cent; it is this rather than the rise in imports, of 5 rather than the forecast 6 per cent, which is the worry. Partly as a result, fixed investment has risen by only 2 rather than the forecast 5 per cent.

In 1987, the Treasury is probably right in forecasting growth rising to 3 per cent, with a continuing consumer boom, and a revival in exports, with non-oil exports rising by 5½ per cent to offset the expected fall in oil export volume as North Sea output falls and domestic consumption increases. However, the rise in exports may turn out to owe more to continuing devaluation than to any rise in world trade, since growth in the industrial countries as a whole may be no faster than in the UK. The Treasury forecasts that "sterling remains close to its present level in both dollar and effective terms", in other words about $1.41 and 68.5. It is unlikely that the dollar will hold its value against the other currencies in the effective rate basket, as implied by the Treasury. It is more likely that it will remain unchanged against the dollar, but fall 6½ per cent on the effective rate to 64 on average. The current account, given the J-curve, is also likely to have a deficit of £2 billion rather than the £1½ billion forecast by the Treasury.

INFLATION DOUBTS

The main doubts about the Treasury forecast relate to inflation. The forecast for the fourth quarter of 1986 has been shaded from 3½ per cent to 3¼ per cent. It would have been better to leave the original figure. As the Treasury point out, the recent mortgage rate rise will add ½ per cent to the October inflation figure, and this in itself is likley to push the fourth quarter average up to 3½ per cent. The Treasury forecast of 3¾ per cent for the fourth quarter of 1987 is a more serious underestimate. The Treasury's view that inflation may rise to a peak in the middle of next year and then fall is acceptable, but the peak is likely to be as high as 5 per cent, falling to 4½ by the fourth quarter, see Table 4.

The Treasury shows (*AS*, Table 6) how lucky manufacturing industry has been in 1986 to have an 11½ per cent fall in its cost of materials and fuel in 1986. So far did this offset the egregious 6 per cent rise in unit labour costs that total costs rose only ½ per cent. Even so output prices were raised by 4 per cent, leading to a substantial increase in non-oil profits. In 1987, the Treasury expects the cost of materials and fuel to rise by 2 per cent, but this could be 9 per cent if the pound falls rather than remaining stable. The Treasury forecasts a drop from 6 to 2½ per cent in unit labour costs, and a rise in total costs and output prices of 3½ per cent, but this could be up to 2 per cent higher if devaluation raises import costs. This is close to the Treasury's forecasts of a 3¾ per cent rise in 1987–88 of the GDP deflator, the index of home costs based on pay and profit increases per unit of output.

Such a low figure seems unlikely. As the Treasury points out (*AS*, 1.48) "in spite of the fall in price inflation there has been no decline so far in published figures for the underlying rate of growth in average earnings. The underlying growth of real pre-tax earnings is likely to be above 4 per cent in 1986". It goes on to say (*AS*, 1.50) that there have been signs of a move toward lower settlements in the private sector, though clearly this is less true of the public sector. The Treasury expects earnings to fall in the present pay round, even though overtime working is increasing in such a way that earnings could remain the same even though basic pay settlements might fall. Productivity growth should pick up from this year, the Treasury says, and unit labour costs for the non-oil private sector rise by 4 per cent.

The Effect of Oil on Inflation

The fall in oil prices has, for a time at least, cut retail prices, but has not had the expected effect on earnings and thus on the GDP deflator of the non-North Sea economy, see Table 5. The Treasury points out (*As*, 1.52) that the fall in North Sea profits (and prices) has reduced the GDP deflator for the 1986–87 to 3 per cent. However, this means that the GDP deflator for the rest of the UK economy is running at 6 per cent. (See the Treasury's note in response to my memorandum on this point in the Committee's report on the 1986 Budget.) In 1987–88 the North Sea sector will make hardly any difference to the GDP deflator. The sterling oil price may rise 10 per cent, with an offsetting fall in output, and the North Sea will account for only 2 per cent of GDP. The deflator for the non-North Sea economy will have to fall from about 6 to about $3\frac{3}{4}$ per cent if the Treasury is to be right in its forecast of a $3\frac{3}{4}$ per cent deflator for the whole economy.

If the Treasury are underestimating retail price inflation for 1987, the reason will be that they are not expecting a further effective rate devaluation of $6\frac{1}{2}$ per cent, which would in itself be enough to add about 1 per cent to retail price inflation. This in itself would not affect the GDP deflator, which does not include import prices. However, if average earnings continued to rise by $7\frac{1}{2}$ per cent, and productivity went up by $2\frac{1}{2}$ per cent—a bit more than this year—then unit labour costs would rise by 5 per cent, and the GDP deflator by a similar amount, the exact figure depending on the change in profits, which have a far smaller weight than pay in the GDP deflator.

The inflationary pressure of high real pay increases is still the main restraint on even faster fiscal expansion than the Chancellor's moderate package, and the chief threat to its survival after the election is over. Although there are so many unemployed, there are skill shortages, especially in the South-East, which are driving up pay rates, and the relatively high rate of utilisation of the capital stock may make firms more inclined to raise prices than output when demand is brisk. The slide into the red of the balance of payments is an associated constraint, because it is worsened by lack of competitiveness on pay and prices, which tends to channel a rising proportion of extra demand into imports.

The Treasury's forecast at the time of the March 1986 Budget that economic growth would be $2\frac{1}{2}$ per cent in 1988–89 and 1989–90 (*FSBR* 1986–87, Table 2.2) is unlikely to have changed. Thus the 3 per cent growth forecast for 1986–87 in the Autumn Statement is likely to be followed by a decline, as policy is tightened after the election to deal with inflation and the balance of payments deficit.

The Role of Interest Rates

The Chancellor's only remedy (*AS*, 1.59) is the cryptic statement that "short term interest rates will be set to maintain monetary conditions that are consistent with the counter-inflationary aims of the MTFS (medium term financial strategy)". The Treasury forecasts (*AS*, Table 7) that the housing component of the retail price index will rise by $10\frac{1}{4}$ per cent between the fourth quarters of 1986 and 1987. This amounts to a forecast that mortgage rates will still be at least as high as the present $12\frac{1}{4}$ per cent. It is consistent with a fall in interest rates between a March Budget and a May election, and a subsequent rise back to present levels or higher. As in the USA, monetary stringency may turn out to be the antidote against any excess of fiscal expansion. Joining the exchange rate mechanism of the European Monetary System would be a better policy. The time may at last be ripe for this next summer, whoever wins a May 1987 general election.

Some of the most recent research by the Treasury suggests that, far from keeping wage inflation down, high interest rates may raise it by raising the exchange rate, thus reducing import costs, boosting profits, and allowing firms to pay higher wages. In *A Model of Wage Bargaining* (Treasury Working Paper No. 44) Penelope A. Rowlatt concludes: "Earnings are expected to have an inverse relationship with the price of materials and fuel (firms will make a greater effort to hold down labour costs if their profits are being squeezed by rapid rises in other costs.)" The policy conclusion would appear to be to let interest rates and the exchange rate fall, thus raising import costs, squeezing profits, and making firms reduce their wage increases. The net result might be higher retail prices, but a lower GDP deflator, more moderate real pay rises, better competitiveness, and more employment.

TABLE 1

REAL FISCAL DRAG AND INDEXATION

	Original position	5% increase for inflation	5% real increase
1. Pre-tax income	10,000	10,500	10,500
2. Tax allowance (indexed 5%)	5,000	5,250	5,000
3. Taxable income (1–2)	5,000	5,250	5,500
4. Tax at 38% (29% + 9% NIC)	1,900	1,995	2,090
5. Marginal rate of tax =tax increase/income increase		19% (95/500)	38% (190/500)
6. Average tax rate (4/1)	19%	19%	19.9%
7. Increase in tax	—	5%	10%
8. Fiscal drag =marginal/average tax rate in original position (5/6)	—	1	2

TABLE 2

PUBLIC SECTOR BORROWING AND THE FISCAL ADJUSTMENT

(Figures in brackets are from Financial Statement and Budget Report 1986–87)

	£ billion cash 1985–86	1986–87	1987–88
General government expenditure	158½ (158)	164½ (163)	173½ (170)
General government receipts	151½ (150)	156½ (156)	166½ (164)
Fiscal adjustment from previous years		—	—
Annual fiscal adjustment		—	1 (2)
GGBR	7 (8)	8 (7)	8 (8)
Public corporations' market and overseas borrowing	−1 (−1)	−1 (0)	−1 (−1)
PSBR	6 (7)	7 (7)	7 (7)
Money GDP at market prices	360 (358)	380 (382)	407 (407)
PSBR as per cent of GDP	1½ (2)	1¾ (1¾)	1¾ (1¾)

Source: 1985–86 and 1986–87, Autumn Statement 1986, 1987–88, Lloyds Bank estimates of unpublished Treasury forecasts.

TABLE 3

COMPARISON OF ECONOMIC FORECASTS

	1986			1987		
Aggregate Demand (% change over previous year)	*HM Treasury Budget (FSBR)*	*Autumn Statement*	*Lloyds Bank*	*HM Treasury Budget (FSBR) (first half year only)*	*Autumn Statement*	*Lloyds Bank*
Real GDP	3.1	2.3	2.0	2.4	3.0	3.0
Consumers' expenditure	3.9	4.8	4.4	3.9	4.0	3.8
General government consumption	0.8	1.8	1.2	0.8	1.5	2.0
Fixed investment	5.0	2.2	2.0	0.4	2.3	3.0
Stockbuilding (contribution to GDP growth)	0.0	0.0	0.1	0.2	0.3	0.0
Exports of goods and services	4.9	1.1	0.6	3.1	3.2	4.0
Imports of goods and services	5.8	5.0	4.7	4.9	4.6	5.0
Balance of payments and inflation						
Current account (£bn)	3.5	0.0	−0.5	1.5	−1.5	−2.0
Retail price inflation (fourth quarter)%	3.5	3.25	3.5	3.5	3.75	4.6
Exchange rate (average)	74.5	73.5	73.5	74.5	68.5	64.0
Major 7 countries growth	3.5	2.5	2.6	4.0	3.0	3.0
World trade	5.5	4.5	4.2	5.5	4.0	3.7

TABLE 4

RETAIL PRICE INFLATION
FORECAST MONTHLY PROFILE THROUGH 1987

	Underlying month % change	Seasonal foods factor	Special factors[1]	Actual monthly % change	12-month % increase Monthly	Quarterly
1986						
Jan–Sept average	0.25	0.02	−0.01	0.26	3.4	
Oct	0.25	0.04		0.29	3.1	
Nov	0.25	0.01	0.55[2]	0.81	3.6	3.5
Dec	0.25	0.04		0.29	3.8	
1987						
Jan	0.25	0.10		0.35	3.9	
Feb	0.25	0.03		0.28	3.8	3.9
Mar	0.28	0.08		0.36	4.1	
Apr	0.28	0.09	1.00[3]	1.37	4.5	
May	0.30	0.04		0.34	4.6	4.6
Jun	0.30	−0.02	−0.40[4]	−0.12	4.6	
Jul	0.33	−0.23		0.10	5.0	
Aug	0.33	−0.04		0.29	5.0	4.9
Sept	0.35	−0.07		0.28	4.7	
Oct	0.35	0.04		0.39	4.8	
Nov	0.38	0.01		0.39	4.4	4.6
Dec	0.38	0.04		0.42	4.5	
Year average	0.32	0.00	0.05	0.37	4.5	4.5

[1]Special factors include mortgage interest rates, petrol prices, indirect taxes, rates and rent.
[2]Assumes general 1.25 per cent mortgage rate rise.
[3]Assumes Budget tax increases adds 0.5 per cent and rate and rent rises a further 0.5 per cent.
[4]Assumes 1 per cent mortgage rate cut.
Source: Lloyds Bank

TABLE 5

GDP AND DEFLATORS

North Sea and rest of the economy
The Treasury's implicit assumptions

	1985–86	*1986–87*	*1987–88*
North Sea gdp	£18bn	£9bn	£9bn
Changes: volume		−0.0%	−10.0%
deflator		−50.0%	+11.0%
total		−50.0%	0.0%
Rest of economy gdp	£342bn	£371bn	£398bn
Changes: volume		+2.4%	+3.4%
deflator		+6.0%	+3.7%
total	+8.5%	+8.5%	+7.2%
Whole economy gdp	£360bn	£380bn	£407bn
Changes: volume		+2.5%	+3.1%
deflator		+3.0%	+3.8%
total		+5.6%	+7.1%

Source: Autumn Statement, Lloyds Bank estimates

Appendix 4

Memorandum by Terry Ward, Specialist Adviser to the Committee

NOTES ON THE 1986 AUTUMN STATEMENT

1. The plans announced by the Chancellor in his Autumn Statement entail an increase in total public expenditure in real terms for the first time since the Government came to power seven years ago. But since, in contrast to what was intended, real expenditure has in fact risen every year over this period (except for 1985–86 which is a special case in being affected by the natural reduction in spending after the miners' strike), it is arguable that this year's plans reflect not so much a policy reversal on the part of the Government towards a new expansionary attitude to public spending as a more realistic acknowledgment of what in practice is feasible.

2. Even so it is questionable whether the Government has gone far enough in this direction, especially as regards the plans for the years after 1987–88, which show very little growth. Indeed the average rate of departmental expenditure growth now planned for the next three years is actually less than that experienced since 1979, despite the plans being widely received as signifying a new expansionary phase in public spending.

3. Nevertheless it is not clear what has changed since March when the last set of expenditure plans were confirmed and when the emphasis of policy was to keep government spending broadly constant in real terms over the short and medium term. While Government spokesmen have tended to present the planned increase in spending as being justified by the buoyant, healthy state of the economy, in practice economic growth is now expected to be lower this year than forecast at Budget time and, though the forecast of growth for next year has been revised upwards, the projected level of national income is no higher. Moreover the longer term outlook, in the light of the significant deterioration in the balance of payments during 1986 and the failure of the world economy to respond to the fall in oil prices, seems to have worsened rather than improved.

4. At the same time, the level of prices is now expected to be lower over the Survey period than in March, which ought to mean that the cash plans then decided would finance the purchase of more real inputs than initially intended. But more rather than less cash has been provided.

5. Given this lessening of inflation, the large over-spend now estimated for the present financial year, 1986–87, perhaps raises even more questions than the upward revision in plans for next year and the years after. But hardly any mention of this is made in the Autumn Statement, let along any explanation provided of why such a substantial over-run has occurred.

6. This lack of explanation for what has happened is symptomatic of the unsatisfactory nature of the Autumn Statement as a statement of Government policy. If past Government statements are to be believed, these expenditure plans, like their predecessors, were presumably determined by how much revenue is expected to be available in the years ahead. But since as last year no projections are given of what this is likely to be, the principal basis for assessing Government policy with regard to overall spending is denied to both Parliament and the public generally.

The Planning Total

7. Table 1 shows revisions to the planning total for public expenditure since the March Budget and the new growth path which is now planned. All the figures in the table are before the deduction of receipts from the sale of assets which represent a distorting influence on the official figures. Accordingly they show what is happening, and what is planned to happen, to the total of departmental spending.

8. As can be seen, expenditure in 1985–86 seems to have turned out lower than estimated at the beginning of the year, by around £0.5 billion, and total departmental expenditure fell in real terms for the first time since the Government took office.

9. In the present financial year, however, total spending is turning out to be significantly higher than planned in March. In cash terms, the over-run is at present estimated at £1.3 billion. But since the estimate of inflation has been revised downwards the figure in real terms is around £1 billion higher than this, at £2.2 billion at 1984–85 prices—an increase of almost 2 per cent over what was planned. On the other hand it should be noted that since part of this reduction in inflation is the result of lower prices for North Sea output it does not necessarily reflect a similar fall in the rate of increase in the costs of public sector purchases. Indeed there may well have been a rise in such costs since the Budget and accordingly a larger relative price effect than was then anticipated. This seems likely to be more so in respect of expenditure in 1986–87, given the rate at which public sector pay rises appear to have been running. But since there is no information whatsoever about relative costs in the Autumn Statement, it is hard to judge how important this factor is and therefore to assess the implications for the volume of inputs of the current set of cash plans.

10. The over-run on departmental expenditure, however, is offset to some extent by debt turning out to be around £0.5 billion lower than forecast at Budget time. Table 2 shows that if this is taken into

account the upward revision in total spending is reduced to under £1 billion in cash terms and to just over 1 per cent in real terms.

11. The effect of this overspend is to push up the rate of real growth in departmental expenditure between 1985–86 and 1986–87 from just over 1 per cent, as was estimated at Budget time, to 3.4 per cent. Total expenditure including gross debt interest payments is now expected to rise by 2.7 per cent in real terms in the present financial year. Both figures are rather more than the latest Treasury estimate of the likely growth of real output in 1986, which implies that the Government's stated aim of reducing total expenditure as a proportion of GDP will not be achieved this year, on this definition of total spending at least.

12. On the General Government definition on which the Government has chosen to focus attention, however, some reduction in this ratio may be registered. But this definition is not altogether satisfactory in that it includes the depressing effect of asset sales (which showed a large rise in 1986–87), excludes the market and overseas borrowing of nationalised industries and includes certain notional sums.

13. So far as the coming financial year is concerned, some £5 billion has been added to the plans prepared at the beginning of the year. In real terms, this amounts to an upward revision of just over 4 per cent and it means that, instead of falling slightly between 1986–87 and 1987–88, real departmental expenditure is now forcast to grow by 2 per cent.

14. For the two years after 1987–88, however, the plans imply little growth in real spending—almost none at all in 1988–89 and just 1 per cent in 1989–90. This means that, over these two years, the average growth rate of departmental expenditure now planned (0.6 per cent) is significantly less than the trend growth of around 1.5 per cent a year experienced over the past seven years of the present Government's period in office. This is illustrated in the graph which, but for the effects of the miners' strike, shows a remarkably stable growth of departmental spending since 1978–79.

15. Accordingly, even though the spending plans have been revised upwards substantially since March and for that reason may be a more realistic representation of the likley final outturn, they still entail restraining growth to a greater extent than the Government has managed to achieve in the past. From the detail of the plans, it seems that part of this restraint is to be achieved by providing a smaller Reserve than last year. Thus for 1987–88 a Reserve of £3.5 billion has been included as opposed to one of £4.4 billion for the 1986–87 this time last year—a reduction of £0.9 billion. For 1988–89, the Reserve is £5.5 billion, £0.75 billion less than the equivalent amount in last year's plans, and for 1989–90, it is £7.5 billion, £0.5 billion less. It is clearly important to investigate the reason for this change, though it may be that the Treasury believes that the more realistic nature of this year's figures will give rise to less need for supplements.

EXPENDITURE BY PROGRAMME

16. Table 3 shows the revisions to expenditure by programme since the March Budget, all the figures being expressed in real terms. It indicates that in 1985–86, spending turned out to be significantly less than estimated at the end of last year for Defence and Social Security and significantly more for Housing and Contributions to the European Community. No explanation is given for these differences.

17. In 1986–87, expenditure in a number of areas now seems to be substantially higher than forecast at the beginning of the year. In the case of Environment, the increase is over 13 per cent in real terms and in the case of Education, over 12 per cent, presumably reflecting the inadequate provision incorporated for local authorities in the initial plans. Perhaps significantly no programme appears to be showing any reduction in spending in relation to the initial plans, despite the fall in inflation since they were prepared.

18. The upward revisions to expenditure are even greater for 1987–88 and 1988–89, five programmes showing additions of around 10 per cent or more—Education (20 per cent higher in 1988—89), the Home Office, Environment, the Chancellor's Department (13 per cent up in 1988–89) and, for 1987–88, Housing. Only Contributions to the EEC have been revised downwards, and then mainly because of an apparent acceleration in payment. Apart from the programmes included in Table 3, there are also large additions to the financial limits of nationalised industries of £0.7 billion in 1987–88 and £0.4 billion in 1988–89, perhaps largely as a reflection of the fall in oil prices and the implications of this for the coal industry. But no details of the changes are given and no account of the thinking behind them.

19. Table 4 shows the effects on expenditure growth of these revisions and relates the real changes which are now planned to average growth rates over the past seven years. The significant growth taking place in many programmes in the present financial year is evident. On the latest estimates, expenditure on Education will rise by 7 per cent in real terms between last year and this, presumably in large measure because of teachers' pay increases, while spending on Health, Social Security, Transport and the Home Office will go up by between 4 and 5 per cent. How much of each of these increases is the result of high relative cost rises is not revealed, nor is it clear that the information is any longer readily available.

20. In most cases, the rates of increase in spending taking place this year are higher than those recorded over the past seven years—Defence being the notable exception. But the changes planned for 1987–88 and the two years following that are for the most part lower—in the case of Health, Social Security and

Employment substantially so. Indeed for the latter two programmes little if any real growth is planned after this year, in contrast to the rises which are now taking place. It is notable that for 1988–89 and 1989–90, hardly any programmes are planned to grow in real terms, which is very much in line with previous plans published by the present Government and which may well imply that substantial calls on the Reserve are anticipated.

21. A further feature to emerge from Table 4 is the somewhat erratic pattern of change planned for a number of programmes. For Environment, for example, spending is planned to fall considerably between this year and next, by almost 9 per cent in real terms, and then to decline less sharply in the subsequent two years, while spending on Housing is planned to increase slightly in 1987–88 but to be cut back markedly the year after, by 10 per cent. Why this should be remains obscure. It hardly seems conducive to stability and rational planning.

ECONOMIC PROSPECTS

22. The forecast set out in the Autumn Statement is for a higher rate of growth in real output next year than this year or than was projected at Budget time. Though at first sight this seems encouraging, there are a number of features of the forecast which give cause for concern about the longer term prospects for high and stable growth.

23. In particular, the balance of payments has deteriorated rapidly during 1986 and though this is largely the result of the sharp fall in oil prices it is also the consequence of a significant worsening of the balance on manufacturing trade. On the Treasury's forecast, the deficit on this account will be some £4.5 billion more in 1987 than in 1985, at £7.5 billion. While this is partly attributable to the slow growth of UK overseas markets following the collapse in the oil price—which might cause a re-assessment of the benefits to the UK of low oil prices alleged by the Chancellor at the time of the Budget—it is also an indication of the continuing weakness of British industry in world markets, which raises considerable doubts about the sustainability of growth at present rates.

24. A particularly disturbing feature of the recent past is that despite a substantial growth of company income (see Chart 8, p 16 of the document on Economic Prospects published with the Autumn Statement), manufacturers have not responded by increasing investment by anywhere near as much. Consequently it is by no means clear what the benefits to the economy of this marked shift to profits have been.

25. There is as yet little sign that producers are taking advantage of the large fall in the exchange rate vis a vis European producers that has occurred over the past year. To a significant extent it is already in the process of being dissipated by the relatively high rate of inflation in the UK, which if it persists, will entail a need for continuing exchange rate depreciation to maintain recent gains in cost competitiveness. The dilemma the Chancellor faces is that the exchange rate has become the Government's main weapon against inflation, but so far it has failed to have any discernible depressing effect on cost increases and to continue to use it for this purpose is likely to make it even more difficult to sustain growth.

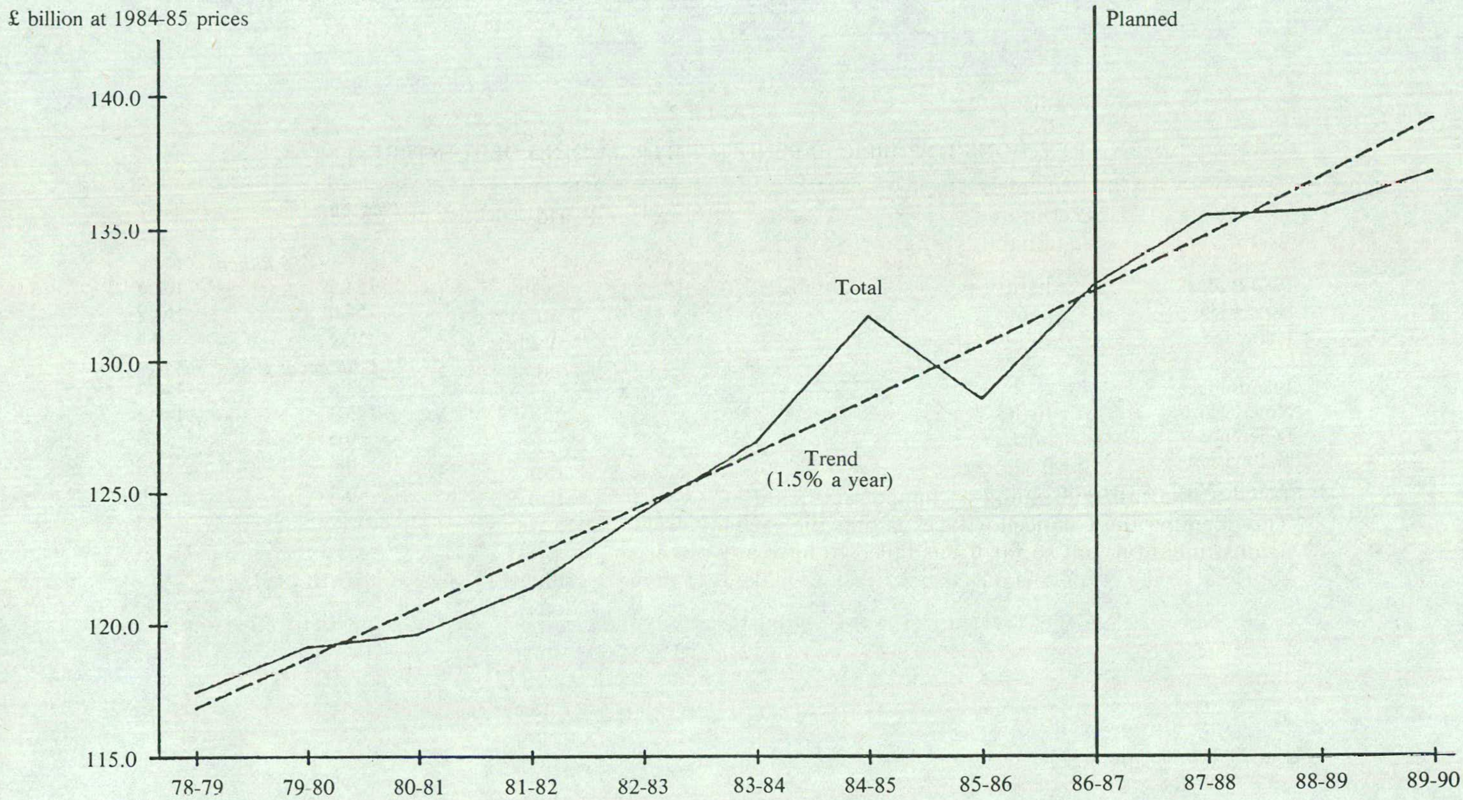
26. Nevertheless the Treasury is more optimistic about the prospects for inflation than most outside forecasters, for reasons which are not altogether clear. "Growth in average earnings is expected to fall somewhat in the present pay round" (para 50 of the document on Economic Prospects), but why is not really explained. Moreover the marked rise in profit margins which has been evident for the past two years in particular (see Table 6 of the same document) is expected to come to an end in 1987 and to restrain the rise in output prices accordingly. Again why this should happen is not explained.

27. In sharp contrast to the statements issued in the early years of the present Government's terms in office, relatively little mention is made of monetary policy—except, of course, that, whatever the growth in £M3 might imply, it will continue to be consistent with continuing low inflation. According to the Government, "for the past six years, high rates of growth of broad money . . . have been consistent with appropriately tight monetary conditions and thus a substantial fall in inflation" (op. cit. para 61). There is, however, some difficulty in judging the significance of this statement, given that the fall in inflation has been universal in developed countries and is largely attributable to sharp falls in the prices of primary products. Indeed since the rate of inflation has recently been higher in the UK than in most comparable countries, it might equally well be argued that this implies that monetary conditions have in fact been laxer here than elsewhere.

Cambridge

12 *November* 1986

Growth of Public Expenditure Planning Total, 1978-79 to 1989-90



Note: Total is measured before deducting asset sales

TABLE 1

PUBLIC EXPENDITURE PLANNING TOTAL, 1985–86 TO 1989–90

	1985–86	*1986–87*	*1987–88*	*1988–89*	*1989–90*
			£ Billion		
Total, 1986 Budget	136.8	143.8	148.6	153.4	na
New Total, Nov. 1986	136.3	145.1	153.6	159.2	166.5
Difference	−0.5	1.3	5.0	5.8	na
			£ Billion at 1984–85 Prices		
Total, 1986 Budget	129.1	130.8	130.3	129.9	na
Annual % Change	−2.0	1.3	−0.4	−0.3	na
New Total	128.6	132.9	135.6	135.8	137.2
Annual % Change	−2.4	3.4	2.0	0.1	1.1
Change since Budget	−0.5	2.2	5.3	5.8	na
% Revisions in Plans	−0.4	1.7	4.1	4.5	na

Note: The Planning Total is measured before the deducation of asset sales and therefore relates to departmental spending.

TABLE 2

REVISIONS TO PUBLIC EXPENDITURE INCLUDING DEBT INTEREST

	1985–86	*1986–87*
	£ Billion	
1986 Budget	154.5	162.0
Nov. 1986	154.0	162.9
Difference	−0.5	0.8
	£ Billion at 1984–85 Prices	
1986 Budget	145.8	147.3
Nov. 1986	145.3	149.2
Difference	−0.5	1.8
% Revision	−0.3	1.2
Year–to Year % Growth	−0.3	1.6

TABLE 3

REVISIONS TO PUBLIC EXPENDITURE PLANS IN REAL TERMS, 1985–86 TO 1988–9

	1985–6	*1986–7*	*1987–8*	*1988–9*
	% Difference from Budget Plans			
Defence	−1.4	1.2	0.6	0.7
Home Office	3.2	6.7	11.3	13.5
Education	0.1	12.3	16.2	20.8
Health	−0.3	2.1	4.3	4.5
Social Security	—1.6	2.2	2.2	1.9
Environment	−0.7	13.3	9.9	10.1
Housing	4.3	4.4	14.0	5.6
Employment	0.4	1.7	1.2	1.2
Transport	−0.3	3.5	7.0	6.4
Chancellor's Dept.	0.0	3.7	9.6	12.9
EEC Contributions	3.8	68.9	−23.8	−53.3
Other*	−0.9	3.2	6.7	7.2
Planning Total	−0.4	1.7	4.1	4.5

Note: The difference between the Autumn Statement figures expressed at 1984–85 prices as now estimated and the White Paper figures, adjusted for Budget changes, at 1984–85 prices as then estimated.

*Northern Ireland, Scotland, Wales and other departments.

TABLE 4

PUBLIC EXPENDITURE GROWTH BY MAIN PROGRAMME, 1978–79 TO 1989–90

	1978–9 to 1985–6	*1985–6 to 1986–7*	*1986–7 to 1987–8*	*1987–8 to 1988–9*	*1988–9 to 1989–90*
	Average	*% Growth per Year*			
Defence	4.3	0.5	−2.6	−2.4	−0.9
Home Office*	5.3	4.2	1.8	−0.1	−0.1
Education	−0.2	6.9	0.3	1.0	−0.6
Health	2.4	4.8	2.5	0.4	0.9
Social Security	3.8	4.6	−0.4	−0.4	0.5
Employment	7.5	15.4	−1.7	1.2	−1.1
Transport	−1.4	4.5	0.7	−4.5	−2.2
Environment	−1.1	1.1	−8.8	−2.4	−2.4
Housing†	−7.1	−4.2	1.3	−10.0	−1.8
Planning Total	1.3	3.4	2.0	0.1	1.1

Note: The Planning Total is before the deduction of asset sales. Social Security is adjusted for the effect of the change from child tax allowances to child benefits in 1979–80 and for changes in the accounting of housing and sickness benefits from 1982–83.

*Including Lord Chancellor's Department.

†Before deducting net receipts from housing sales, as estimated in the White Paper.

Appendix 5

Memorandum by the Parliamentary Unit, University of Warwick*

The 1986 Autumn Statement

1. INTRODUCTORY REMARKS

1.1 The Chancellor's Autumn statement confirms that there have ben a number of important changes in the official view of the economy in the last year and, indeed, since the last Budget. As regards 1986, GDP growth is now expected to be slightly lower than was anticipated in Autumn 1985 as is the rate of inflation. However, both the rate of growth in consumption and that of imports will be higher than earlier expected while exports and investment will both grow significantly less than was anticipated at the time of the Budget. The major consequence of this is that the budget forecast of a £3 billion current account surplus has now been adjusted down to a figure of approximately zero (see Table 1 for the details).

1.2 As one would expect, there is by this time of year a good deal of unanimity as between the official and the independent forecasters about the economic outturn for calendar 1986. This contrasts with the position immediately after the Budget in which the Treasury sharply increased its forecasts of both fixed investment and exports thereby taking them substantially above those of the independent forecasters as well as above those in its own 1985 Autumn Statement. The outturn so far this year however provides scant justification for these adjustments of the forecast. As regards 1987, the Autumn Statement is slightly more optimistic about the prospects for GDP growth than the independent forecasts compiled by the Treasury in October, but somewhat less confident on investment and exports, as shown in Table 1.

1.3 As in the previous year, the Autumn Statement contains neither projections for Government revenues for the years beyond 1986–87 nor information about the magnitude of the fiscal adjustment anticipated for the coming years. While the reasons for the Chancellor's reticence in this area are clear enough, the continuation of the practice does make it extremely difficult to interpret the Industry Act forecast. In particular, Treasury forecasts for the years after 1986 need to be assessed without any knowledge of the fiscal stimulus built into them. In view of this, it could be argued that the spirit of the Industry Act would be better observed if forecasts at the time of theAutumn Statement were required to be carried out on the basis of *unchanged* tax rates and allowances except insofar as the changes were already public knowledge.

1.4 Our reading of the Autumn Statement suggests several other major issues:

(a) The Chancellor has referred (para. 44) to the time it will take for the benefits of recent exchange rate depreciation to feed through in higher non-oil exports and lower imports. However, the Treasury model, in common with most other models of the UK economy, incorporates very low long run exchange rate elasticities. This raises questions about the nature of present exchange rate management, as well as about the Treasury's relative optimism on the balance of payments.

(b) The Chancellor has stressed that his announced increases in expenditure will be implemented without undermining the prudence of the Government's medium term financial strategy as published at the time of the last Budget. This presumably means that the scope for further tax cuts will be conditioned by the buoyancy of revenues between now and the next Budget. This surely means that fiscal policy is being operated in procyclical fashion, since better than expected growth will give rise to tax cuts and so yet more stimulus, while a worse than expected performance will produce the opposite and contractionary fiscal adjustment.

(c) The Chancellor has placed great store by the forecast reduction in the ratio of planned expenditure to GDP. In this connection, we note that a repetition of the 1986–87 forecasting errors in relation to public expenditure, GDP growth and the rate of inflation would cause that ratio to rise not fall. In view of this, and the inclusion of asset sales as negative expenditure, it is difficult to understand why the markets should be expected to take this ratio seriously as a signal of the Government's financial self-restraint.

1.5 An increase in public expenditure is more effective in getting unemployment down than a tax cut at the same cost to the PSBR. In this context it is therefore disappointing that the chancellor cannot be more positive about the prospects of a fall in unemployment in the near future. It may be that the use of high interest rates to maintain confidence in sterling (instead of entering the ERM, for example) is limiting the effects of fiscal expansion. It may be, on the other hand, that the PSBR target enforces changes in tax policy which in part offset the effects of government expenditure. (The "balanced budget" effects of government expenditure increases are examined in section 4, using the Treasury model for this purpose.)

2. THE AUTUMN STATEMENT FORECAST

2.1 Table 1 sets out the evolution of Industry Act and independent forecasts for 1986 compared to those made at various times in the past year. It can be seen that *consumers' expenditure* is expected to grow by 1 percent more than was forecast at the time of the last Autumn Statement, and that all the

*The parliamentary Unit has been set up at the University of Warwick. The Unit uses the models as they are deposited with the ESRC Macroeconomic Modelling Bureau. Neither the Bureau nor the teams supplying the models can be held responsible for the opinions and conclusions expressed in this paper.

forecasting groups now anticipate that it will again grow by significantly more than GDP in 1987. While, the 1986 outturn for *inflation*, by contrast, is likely to be below the figure in last years Autumn Statement, there is considerable disagreement about the likely situation in 1987. In particular, the LBS forecast anticipates a virtually unchanged inflation rate while the NIESR expects it to be more than two percentage points higher than in 1986. The outcome for the *trade balance* is shown to be significantly worse than was anticipated last Autumn with export growth below and import growth above expectations. The consensus forecast is for a further excess of import over export growth rates in 1987 but the LBS dissents from this with a forecast that has the two rates of growth virtually equal.

TABLE 1

FORECAST COMPARISONS

% Change in	*Forecasts for 1986* (1) *Last Year's Aut. St.*	(2) *Post Budget*	(3) *This Year's Aut. St.*	(4) *Most Recent Forecast for 1987*
GDP				
HMT	3.0	3.0	2.5	3.0
LBS	2.4	2.0	2.1	3.0
NIESR	1.9	1.9	1.8	1.8
Indep. Avg*			2.3	2.6
Retail Prices (4th Qtr)				
HMT	3.8	3.5	3.3	3.8
LBS	4.0	3.3	3.6	3.3
NEISR (CPI)	3.0	4.2	3.3	5.5
Indep. Avg*			2.9	4.5
Consumers' Expenditure				
HMT	4.0	4.0	5.0	4.0
LBS	3.8	3.1	4.7	4.1
NIESR	2.9	3.1	3.8	3.5
Indep. Avg*			3.9	3.6
Fixed Investment				
HMT	3.5	5.0	2.0	2.5
LBS	1.4	2.0	0.6	2.4
NIESR	0.2	0.1	1.1	1.8
Indep Avg*			2.3	3.4
Exports of Goods and Services				
HMT	2.0	5.0	1.0	3.0
LBS	3.7	2.2	0.7	4.8
NIESR	3.3	0.7	0.9	3.2
Indep. Avg*			1.9	3.2
Imports of Goods and Services				
HMT	4.0	6.0	5.0	4.5
LBS	4.8	4.1	4.0	4.7
NIESR	4.3	2.3	3.9	6.3
Indep. Avg*			4.3	5.0
Current Account (£ bn)				
HMT	4.0	3.5	0.0	−1.5
LBS	2.6	0.4	−0.4	−2.4
NIESR	2.3	0.1	−0.7	−5.8
Indep. Avg*			0.8	−2.3

(1) Parliamentary Unit Note on 1985 Autumn Statement.
(2) HMT: 1986 FSBR, LBS. June Economic Outlook, NIESR: May Economic Review.
(3) and (4) HMT: 1986 Autumn Statement, LBS: October Outlook, NIESR: August Review.

*Independent Average from "Forecasts for the UK Economy: A Comparison of Independent Forecasts", compiled by HM Treasury, No 1, October 1986.

2.2 Both GDP growth and inflation appear to have been overestimated by 0.5 per cent compared to the Autumn Statement of last year. Although this is well within the margin of error attached to the Treasury's forecast (Table 14, Autumn Statement), a repetition of these forecasting "errors", and of this year's overspending of the planning total by £1.3 billion, means that total public could *increase* as a percentage of GDP in the next financial year.

2.3 "The forecast assumes that sterling remains close to its present level in both dollar and effective terms" (Autumn Statement, para. 22). the same assumption was made in the 1986 FSBR, but could be more apropriate this time around. After the Budget, indeed, the effective exchange rate fell by more than

10 per cent, mainly by virtue of a depreciation against the EMS currencies (other than the Irish pound) before the Chancellor felt it necessary to increase interest rates in October. (Such an adjustment happens to correspond with the impact of a $11 oil price fall on the effective rate according to simulations on the Treasury model, see the Parliamentary Unit Memorandum on the 1986 Budget.)

2.4 The drop in the exchange rate has not prevented a deficit appearing on the current account. NIESR forecast a £5.8 billion deficit for next year, easily the most pessimistic assessment since they also expect only 1.8 per cent growth in GDP. The LBS forecast a small deficit for this year, followed by one of £2.4 billion in 1987, as compared to the Treasury's £1.5 billion deficit. At first sight, the revisions of the forecast in this respect confirm the low response to changes in competitiveness, as reflected in the values of the export elastiticities which characterise most macroeconomic models of the UK economy. On the other hand, in a previous note to the Treasury Committee we found it difficult to accept *long run* elasticities as low as those which can be derived from the models. Possibly a distinction should be made between changes of the exchange rate perceived as permanent, and fluctuations which are more likely to be reversed. If up to now most shocks under the floating exchange rate regime have been seen as temporary, then the effect of what looks like a more durable depreciation will be more pronounced.

2.5 Table 2 provides some international background for the performance of the UK economy over the past five years. Among the EEC countries the UK achieved the highest growth over the period 1980–85, and fares reasonably well on inflation. Such rankings are inevitably rather dependent on which year is chosen as a base. In particular, the choice of 1979, instead of 1980, as a base year would show a much *lower* growth performance for the UK. The drop in investment did not come to its end until 1981, so investment growth over the past four years has been very much higher than the figure for 1980–85. On the other hand in no other EEC country has the volume of imports of goods grown than exports since 1980. In this respect the UK economy is more like that of the US than like that of Japan.

TABLE 2

INTERNATIONAL COMPARISION OF INFLATION, EXPENDITURE, IMPORTS AND GROSS DOMESTIC PRODUCT IN 1985 (1980 = 100)

	EUR 12	*Germany*	*France*	*Italy*	*UK*	*USA*	*Japan*
Consumer Prices	149.1	121.0	158.0	190.3	141.5	130.5	114.4
Consumption By Households	104.8	102.4	109.0	104.6	109.1	117.4	114.8
Gross Fixed Capital Formation	97.7	93.4	98.1	99.4	110.2	129.4	115.0
Exports of Goods and Services	123.7	128.6	118.1	125.4	115.2	92.7	154.3
Imports of Goods and Services	113.0	107.6	115.5	115.9	121.1	137.3	112.2
GDP	106.1	105.9	105.8	104.1	108.7	113.1	121.5

Source: Eurostatistics 9/1986

3. Filling In The Gaps

3.1 The Atutmn Statement, which announces additional public expenditure of over £4 billion for 1987–88, has been widely interpreted as heralding a loosening of the fiscal constraints implied by the MTFS prior to a General Election, yet somewhat paradoxially in his speech the Chancellor stressed that:

> "The Government's fiscal stance has been clearly set out in the medium-term financial strategy published at the time of this year's budget. There will be no relaxation of that stance."

The difficulty in checking the plausibility (or even logical consistency) of the Chancellor's claim to be able to increase public expenditure for the coming financial year and also adhere to the original PSBR target announced in the Budget is considerably hampered by the absence of any revenue projections for the coming financial year. We therefore begin by constructing a tentative financial projection using "guesstimates" of likely revenues for 1987–88 in Table 3.

3.2 Column (2) of table 3 constructs a possible scenario for 1987–88 based on the expenditure projections in the Autumn Statement and revenue projections from the 1986 FSBR (adjusted where appropriate in the light of more recent evidence); this is then compared with the financial projections for 1987–88 as originally forecast in the 1986 FSBR shown in column (1). The expenditure projections for 1987–88 in the Autumn Statement, even after allowing for a substantial reduction in the reserve and a modest increase in asset sales (which count as negative expenditure) amount to an upwards revision in General Government expenditure of over £4 billion above the expenditure planned at the time of the Budget. Part of this expenditure overrun can be expected to be covered by buoyancy in non-oil tax revenues which for the current financial year are set to exceed the Budget forecast by £2 billion. Although for the current year a short-fall on North Sea tax revenues of about £1 billion is expected, this was largely because the oil price has been below the Budget assumption of $15 a barrel. Assuming the oil price averages $15 per barrel in 1987–88 and that the buoyancy expected in this year's non-oil tax revenues carries over into next year, then £2 billion of the additional £4 billion expenditure will be covered by higher revenues. If there is to be no relaxation in the PSBR target this would imply the complete cancellation of the £2 billion fiscal adjustment earmarked for income tax cuts in the next Budget.

3.3 The tentative nature of this arithmetic needs to be stressed. For example on the expenditure side the reserve for the coming financial year is about 2.4 per cent of the planning total, this is significantly less than the reserve in last year's Autumn Statement for the then coming financial year (ie 1986–87) of about 3.2. per cent of the planning total, and gives less scope for dealing with unexpected overruns in expenditure. On the other hand the problem of forecasting tax revenues is underlined by the fact that non-North Sea taxes are now expected to increase by 3.5 per cent more than the increase in money GDP in the current year. Hwever, there is no particular reason for expecting departures from the projections previously outlined to work in the direction of generating sufficient net revenues to allow substantial tax cuts while maintaining a PSBR target for 1987–88 of £7 billion.

TABLE 3

PROJECTIONS FOR FINANCIAL YEAR 1987–88 (£ BILLION, CURRENT PRICES)

		1 *As per 1986 FSBR*	2 *As per 1986 Autumn Statement*	(3) =(2)−(1) *Revision*
EXPENDITURE				
1	Total Expdt all depts	133.1	140.1	7
2	Reserve	6.1	3.5	−2.6
3	Asset Sales	4.7	5.0	0.3
4=1+2+3	PLANNING TOTAL	143.9	148.6	4.7
5	Interest pay's and other adjustments	25.6	25.1	−0.5
6=4+5	GEN GOVT EXPDT	169.5	173.7	+4.2
*RECEIPTS**				
	Taxes on Income, expdt and capital			
7	: North Sea	4	4	
8	: Non-North Sea	120	122	+2
9=8+7	: TOTAL	124	126	
10	NI and Other Contribs	28	28	
11	Interest and other receipts	12	12	
12=9+10+11	TOTAL RECEIPTS	164	166	+2
*BORROWING**				
13	Fiscal adjustment	2	0	−2
14=6+13−12	GEN GOVT BORROWING	8	8	
15	Pub Corps borrowing	−1	−1	
16=14+15	PSBR	7	7	

NOTE (*)
There are no projections of receipts or borrowing in the Autumn Statement, the figures in column (2) for borrowing and expenditure are "guessestimates" (see text for explanation).

SOURCE: 1986 Autumn Statement, 1986 Budget report and Parliamentary Unit calculations.

3.4 Many commentators are unlikely to accept the conclusion that having raised the prospect of a basic rate of income tax of 25p the Chancellor will fail to deliver any cut in taxation in the next Budget, particularly with a General Election looming. In the past the Chancellor has been able to accommodate higher public expenditure within an unchanged PSBR target by increasing asset sales. With asset sales already raised to £5 billion per annum for the next financial year, the scope for using this accounting anomaly (whereby asset sales are classified as negative expenditure rather than as a means of funding the borrowing requirement) would seem to be restricted.

3.5 There would of course be more room for cuts in the rate of income tax within an unchanged PSBR target if the forecast for the real economy were sufficiently optimistic on growth to generate more buoyant tax revenues (and also lower expenditure on unemployment-related benefits). The US experience under the Gramm-Rudman amendment may provide a salutory warning in this context. The amendment requires declining deficit targets that will result in a balanced budget in 1991. However, there is a suspicion that the necessity of projecting a balanced budget by 1991 has led to a tendency for the Budget forecast for the real economy to err on the side of optimism. The latest US Budget report setting out a target profile for the decline in the budget deficit, forecasts 4 per cent growth in 1986 and 1987 and beyond that "assumes" GNP growth at annual rate of 4 per cent in 1988 progressively slowing to 3.5 per cent in 1991. If this is compared with US historical experience then the official projections imply a rate of growth which has not been *sustained* (taking GDP growth over the economic cycle, measured from "peak" to "peak") since the early 1960's. It is sincerely to be hoped that the UK government's commitment to a PSBR target will not lead to a similar distortion of official forecasting practice.

4. Financing the Increase in Government Expenditure.

4.1 The recent speech of the Governor of the Bank of England at Loughborough has made clear that monetary targeting, is no longer a centrepiece of the Government's economic policy. This raises the issue of what will guide the setting of interest rates in the near future. The 1986 FSBR formulated a money GDP framework, consistent with a further reduction in inflation and continued growth in real output at a substainable rate, in which of the exchange rate require special monitoring.

4.2 Table 4 shows the effects on the Treasury model of a public spending increase by £4.8 billion in current prices, half of which is spent on central government procurement and the other half on current expenditure by local authorities. (This specification reflects the fact that the extra expenditure planned since the Budget does not directly lead to higher public sector employment.) Under "money finance", ie nominal interest rates are fixed and no fiscal adjustment is applied, the effective exchange rate is reduced by more than 1 per cent a year due to the increase in public expenditure. The reduction in unemployment reaches its peak after three years at nearly 140 thousand below the the base run level.

4.3 The PSBR target of £7 billion for 1987–88 implies that the increase in public spending has reduced the scope for fiscal adjustment in the form of income tax cuts, however. The implications of PSBR targeting are given under "tax finance" in Table 4. The corresponding column shows that the depressing effect of the public expenditure increase on the exchange rate is less than half of that under "money finance", but the effects on unemployment are correspondingly reduced.

4.4 In column 3 one sees that strict adherence to money supply targets as well as the PSBR targets requires a rise in interest rates and the real exchange rate to accompany any fiscal expansion.

4.5 In summary, what these simulations show is that relaxing the monetary targeting component of the MTFS does allow expenditure to create more jobs than heretofore: but the remaining commitment to PSBR targets (insofar as it constrains the Government to match extra spending by reduced tax cuts) substantially limits the effects of current expenditure increases on growth and employment.

TABLE 4

EFFECTS OF A £4.8 BILLION (1987 PRICES) INCREASE IN CURRENT EXPENDITURE ON THE TREASURY MODEL UNDER ALTERNATIVE FINANCING RULES
(Percentage difference from base unless otherwise stated)

	Year	(1) *Money Finance*	(2) *Tax Finance*	(3) *Strict MTFS*
GDP	1	0.9	0.6	0.6
	2	0.9	0.4	0.3
	3	0.9	0.3	0.0
	4	0.8	0.0	−0.3
Unemployment (000's)	1	−58	−36	−36
	2	−124	−61	−59
	3	−137	−41	−24
	4	−114	8	42
Employment (000's)	1	86	54	54
	2	184	91	87
	3	202	61	36
	4	168	−12	−62
Consumer Prices	1	0.5	0.4	0.4
	2	1.5	1.0	0.9
	3	2.8	1.8	1.6
	4	4.1	2.6	2.0
Average Earnings	1	0.4	0.4	0.4
	2	1.5	1.4	1.4
	3	3.2	2.6	2.5
	4	4.9	3.7	3.1
Effective Exchange rate	1	−1.1	−0.4	−0.4
	2	−2.6	−1.1	−0.6
	3	−3.6	−1.7	−0.5
	4	−4.6	−2.0	−0.7
PSBR (£bn)	1	2.9	0.1	0.1
	2	2.5	0.1	0.1
	3	2.7	0.2	0.2
	4	3.1	0.2	0.1
Current AC (£bn)	1	−2.6	−1.4	−1.4
	2	−3.1	−1.6	−1.4
	3	−3.0	−1.3	−0.9
	4	−3.0	−0.8	−0.4
Money stock (weighted av. of measures)	1	0.9	0.0	–
	2	1.9	0.4	–
	3	2.8	0.8	–
	4	3.7	1.0	–
Treasury bill rate (% points)	1	–	–	0.0
	2	–	–	0.3
	3	–	–	0.5
	4	–	–	0.3
Fiscal adjustment (£bn)	1	–	3.1	3.0
	2	–	3.1	3.1
	3	–	3.7	3.9
	4	–	4.5	5.3

(1) Money finance: Increase in expenditure assuming constant nominal interest rates.
(2) Tax finance: A fiscal adjustment in the form of an increase in income taxes is used to hold the PSBR at base run levels as a percentage of GDP.
(3) Strict MTFS: As for tax finance but nominal interest rates are increased to fix a weighted average of monetary aggregates to base values.
SOURCE: simulations conducted by the Parliamentary Unit.

Appendix 6

Memorandum from British Aggregate Construction Materials Industries

1986 Autumn Statement

The plans for increasing investment in 1987/88 are both necessary and welcome.

Consistent investment growth throughout the planning period is needed to tackle deficiencies in our built infrastructure.

The increasing planning totals could enable this investment growth to take place.

1. In evidence to the Treasury and Civil Service Committee following earlier public expenditure white papers BACMI has criticised the government for its poor investment record and we have, therefore, no hesitation in welcoming the plans for increasing investment in a number of sectors of the infrastructure outlined in the Autumn Statement.

2. Since the condition of the public sector built infrastructure was examined by NEDO* in 1985 evidence has continued to mount up of the scale of deterioration. The government's decision to increase spending on roads, housing, and urban regeneration is clearly a response to this evidence. While welcoming the planned improvements in 1987/88, however, we must continue to question the government's longer term commitment to reversing the general deterioration of the public estate.

3. The government's decision to allow real expansion of the planning total over the next three years, although at a lesser rate than GDP growth, is a departure from the previous policy of maintaining a fixed real level of expenditure. General government expenditure between 1987/88 and 1989/90 will now total over £16 billion more than was planned in the 1986 financial statement and could allow significant investment improvements throughout the period and within the MTFS framework.

4. If, for example, the share of capital expenditure on construction work within general government expenditure was raised by 1 per cent from the current 6.2 per cent for each of the next three years, the additional cost of £5.4 billion would be comfortably accommodated within the new £16 billion. It is, of course, very difficult to quantify the exact level of additional spending necessary to improve the condition of the public estate, but on the basis of the available evidence this additional 1 per cent share for construction investment is a minimum requirement. The lengthening of the funding cycle for capital budgets from the existing one year to three years would also lead to greater efficiency in the planning and execution of capital schemes than is possible at the moment with uncertain yearly allocations.

5. The Autumn Statement is, however, deficient in giving no indication of the government's medium or longer term thinking on capital and infrastructure investment, though it does confirm the declining share of public investment in recent years and the opportunity to reverse this trend, as follows:

	£ Billion cash							
	79/80	81/82	83/84	85/86	86/87	87/88	88/89	89/90
General government expenditure (1)	90	120.6	141.4	161.3	169.3	178.7	184.6	192.8
Capital expenditure on construction† (2)	7.7	8.6	10.9	10.7	10.4	11.0		
Capital expenditure share	8.6%	7.1%	7.7%	6.6%	6.2%	6.2%		

(†excluding British Gas but including significant repair and maintenance expenditure)

6. The Autumn Statement does not detail spending plans for local road investment and maintenance beyond 1987/8, rendering the government's longer term plans unclear in this sector, but the three year plans for housing and urban regeneration do not indicate any plans for long term improvements in funding.

Housing	1986/87	1987/88	1988/89	1989/90
Gross capital expenditure:				
£m cash	3,436	3,661	3,462	3,507
% change on previous years		+6.5	−5.4	+1.3
Urban regeneration†				
£m cash	495	531	543	552
% change on previous year		+7.3	+2.2	+1.6

(†including the urban programme, derelict land clearance, urban development corporations)

(1) 1986 Autumn Statement Table 2.2

(2) 1986 Public Expenditure White Paper 2.18

*NEDO: "Investment in the public sector built infrastructure"

7. In both sectors expenditure is planned to increase in real terms next year but to decline in real terms in the following two years in spite of the mounting problems which will have to be overcome at some time. In addition to planning more consistent longer term investment budgets, government should ensure that the allocated funds are spent on the designated services. Capital investment in local authority roads for example, has undershot plans by some £96 million over the last five years. Local authorities are also having great difficulty in increasing road maintenance spending to the extent planned for this year and next by central government due to their overall financial difficulties. With much infrastructure investment being channelled through local authorities, it is imperative that funding levels from central government and the financing mechanisms within which the authorities operate are such that plans result in the appropriate levels of expenditure.

8. It is not realistic to expect the deficiencies in our stock of public capital to be rectified during the period of office of one government. However, the government having decided on a new higher public expenditure benchmark, the Autumn Statement should indicate a willingness to allocate a prudently increasing share of public funding to investment and renovation as part of a medium term financial strategy, which should also encompass a medium term physical strategy.

20 November 1986

Appendix 7

Supplementary note by H M Treasury

At the hearings with both officials and the Chancellor of the Exchequer, Mr Townend argued that the underlying increase in real terms in public expenditure in 1986–87 after correcting for privatisation proceeds and for the effect of the coal strike was greater than the growth of GDP in real terms. The Committee asked for a note on this point.

2. In real terms the change in the planning total was as follows:

Per cent

	1985–86	*1986–87*
Planning total, including privatisation proceeds	−2.9	2.2
Planning total, excluding privatisation proceeds	−2.5	3.5

The corresponding figures for general government expenditure which includes debt interest are:

GGE excluding privatisation proceeds	−0.3	0.8
GGE excluding privatisation proceeds	0.0	2.0

3. At the time of the hearings in November 1985, the Treasury estimated that the impact of the coal strike on the planning total would be £2½ billion in 1984–85 and £1¼ billion in 1985–86. The Treasury now estimate that the figure for 1985–86 would be £¾ billion, principally reflecting the sharp improvement in the finances of British Coal.

4. In his evidence the Chancellor of the Exchequer pointed out that, under a system of cash planning and control, there can be fluctuations in the year to year real terms increases if the GDP deflator moves differently from what was expected at the time the plans were made. For example, the GDP deflator in 1985–86 increased by 6 per cent, against the 5 per cent projected at the time of the 1985 Budget. This change in inflation would have made very little difference to the level of cash spending in that year, the change being reflected in a bigger than expected fall in real terms. Similarly, the GDP deflator for 1986–87 is now expected to rise by 3 per cent against 3¾ per cent in the 1986 Budget, while for large parts of the public sector cash spending in this year will be unaffected.

5. To establish the underlying trend it is necessary to look at the developments over a number of years. Between the years 1983–84 and 1986–87, neither of which was affected by the coal strike and a period during which unanticipated movements in the GDP deflator even out, GGE excluding privatisation proceeds—which is the aggregate giving the best guide to underlying movements—increased by 1¾ per cent a year. Over this period, GDP increased by 2¾ per cent a year in real terms.

GENERAL GOVERNMENT CONSUMPTION

Note by H M Treasury

Table 1.15 of the Autumn Statement gives a forecast of general government consumption in volume terms at constant 1980 prices. This forecast is fully consistent with the path of public expenditure set out in Chapter 2 of the Autumn Statement.

2. General government consumption is current expenditure on goods and services, accounting for about 50 per cent of total general government expenditure. It excludes such items as capital expenditure and transfer payments (eg social security benefits).

3. There are well-known difficulties about converting cash plans into volume figures. It is not easy to find appropriate price indices for every category of general government consumption, and the provisional data in particular is subject to revision. There are additional complications over linking together the CSO's early published estimates for the first half of the calendar year, and the forecast of spending over the financial year as a whole. It is therefore not advisable to put too much weight on the precise half-yearly profiles.

4. In these circumstances the forecast claims to be no more than a guide to broad movements from one year to another. The year-on year changes in table 1.15 show fairly steady growth.

5. Since the figures in table 1.15 are *volume* forecasts, they are not affected by changes in teachers' pay.

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CE21

FROM: MISS C EVANS
DATE: 13 JANUARY 1987

I think we should write as proposed here. MCS 22/1

1. MR SCHOLAR
2. CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir Peter Middleton
Sir Terence Burns
Mr F E R Butler
Mr Cassell
Mr Anson
Mr Kemp
Mr Sedgwick
Mr Turnbull
Mr Culpin
Miss O'Mara

TCSC REPORT ON THE AUTUMN STATEMENT: GOVERNMENT RESPONSE

For the record I propose to write to the Clerk to the TCSC confirming that the Government's response to the report was made in your speech in the debate on the Autumn Statement on 17 December and that we will not be publishing a further response. (The Committee's report contained only one specific recommendation: 'that statements on macro-economic policy should be made in the House so that they may be subject directly to questioning from Members'.) Are you content with the attached draft please?

Carys Evans

MISS C EVANS

Ch
An alternative below
AA

I think orig. draft (with one word changed) will do.

CE21

DRAFT LETTER FROM MISS C EVANS TO

W R McKay Esq
Clerk to the Treasury & Civil Service Select Committee
House of Commons
LONDON SW1

TCSC REPORT ON THE AUTUMN STATEMENT 1986

its points ... made in

The Chancellor of the Exchequer has asked me to confirm that the Government's response to the Committee's report on the 1986 Autumn Statement was ~~made~~ contained in his speech in the debate on the Autumn Statement on 17 December and that the Treasury will not therefore be publishing a further response to the report.

MISS C EVANS

I am writing to confirm that the Treasury will not be publishing a written response to the Committee's report on the 1986 Autumn Statement. The Chancellor of the Exchequer commented extensively on the report in his speech in the debate on the Autumn Statement on 17 December.

UNCLASSIFIED

pup

FROM: A C S ALLAN

DATE: 26 January 1987

MISS C EVANS

cc: PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Cassell
Mr Anson
Mr Kemp
Mr Scholar
Mr Sedgwick
Mr Turnbull
Mr Culpin
Miss O'Mara

TCSC REPORT ON THE AUTUMN STATEMENT: GOVERNMENT RESPONSE

The Chancellor was grateful for your minute of 13 January. He is content for you to write to the Clerk to the Committee as you proposed (but would suggest "contained in his speech" instead of "made in his speech").

ACSA

A C S ALLAN