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Alex
Lawson

PART D

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DD: 25 years

Begin: ~~18/9/85~~ 7/6/85

[Signature] 5/9/85

Ends: ~~29/11/85~~ 13/9/85 (CONTINUED)

1985 PUBLIC EXPENDITURE
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PROGRAMMES

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PART D

10 JUN 1985

Slip



DEPARTMENT OF HEALTH & SOCIAL SECURITY

Alexander Fleming House, Elephant & Castle, London SE1 6BY

Telephone 01-407 5522

From the Secretary of State for Social Services

F PES: P.P.

Andrew Turnbull Esq
Private Secretary
10 Downing Street

7 June 1985

A bit late!

Dear Andrew,

SOCIAL SECURITY REVIEW

I attach Q and A briefing on the social security Green Paper. Copies go to Private Secretaries to all members of the Cabinet, the Paymaster General and the Chief Whip and to Richard Hatfield (Cabinet Office).

Yours sincerely
Stephen

S H F Hickey
Private Secretary

EXCHEQUER	
-10JUN1985	
MR WATSON	
CST/ST/ST EST	
SIR P MINNEMTON	
MR BAILEY	SIR T BURNS
MS SEAMMEN	

MR SCHOLAR
MISS NOBLE MR LOR

THE STOCK EXCHANGE

(Handwritten initials)

SIR NICHOLAS GOODISON
CHAIRMAN



LONDON, EC2N 1HP
TELEPHONE: 01-588 2355
TELEX: 886557
TELEGRAMS: STOCKEX LONDON EC2

7th June, 1985

1/6

Dear Nigel

CH/EXCHEQUER	
REC.	11 JUN 1985
ACTION	MR LANKESTER
COPIES TO	EST
	SIR P MIDDLETON
	MR CASSELL
	MR HALL MR D JONES

I thought you might like to see this.
Do let me know if you would like me to expand on it.

Yours ever

Nicholas

The Rt. Hon. Nigel Lawson, M.P.,
Chancellor of the Exchequer,
H.M. Treasury,
Parliament Street,
London,
SW1P 3AG.

Following the announcement of the vote, Sir Nicholas Goodison, Chairman of The Stock Exchange issued the following statement:

"The crucial vote permitting any firm to be owned upto 100% by an outside investor has been passed by 82.67%, a very big majority. This shows the good sense and keen understanding of members of The Stock Exchange. They know that the future health of the national market in securities depends on making changes which will retain the bulk of securities business in this country within our competitive stock market.

The second vote has alas failed by a very small margin. It required 75% of those voting: it achieved 73.64%.

This means that not quite enough members supported the Council's view that in the long term proprietorship of The Stock Exchange should be shifted to firms and that members should be able to realise some value if they so wish from their present proprietorship by the sale of shares. The constitution of The Stock Exchange remains unchanged and the shares will not be transferable.

This vote is less crucial to the future competitive position of The Stock Exchange and of its member firms. Most people trying to gain support of a proposal would be very happy with 73.64%. I am however sad because the opportunity has been lost to reform the constitution and to ensure a closer identity in the future between the firms who will be largely paying for The Stock Exchange's services and the government of The Stock Exchange. We will have to seek other ways of solving this difficult problem, maybe by making changes in due course to the method in which we form policy.

We will also have to reconsider the manner in which firms who apply for membership of The Stock Exchange will be asked to pay for entry. I am not hopeful that we can find any other change to the constitution of The Stock Exchange which would be acceptable to the required majority.

Meanwhile the way is open for the Council to alter the rules to permit the necessary commercial changes in our market: and this, with the very encouraging support of the members, we will do."

5th June, 1985

CONFIDENTIAL

~~BF 20/6/85 2nd leg~~

~~BF 14/6~~

27/6
BF 26/6

5/1 PM
for info.
DB 7/6

From: D R H BOARD

Date: 8 June 1985

~~Douglas: time / to~~
class?

MR BAILEY

Note

Byatt to draft.

DB
21/6

cc Mr Anson
Mr Byatt

SOCIAL SECURITY GREEN PAPER

At a discussion earlier this week, the Chancellor and Sir Peter Middleton agreed that figures needed to be obtained from DHSS in response to the Chief Secretary's letter as soon as possible - certainly well before the summer holiday season. The Chancellor thought it might be necessary to set up a joint official group possibly linked with work on the Chancellor's own Green Paper; it might be necessary for the Chancellor to write to Mr Fowler. Sir Peter would be grateful if you could consider this.

Douglas Board

D R H BOARD

Private Secretary

From: J ODLING-SMEE

8th July 1985

SIR TERENCE BURNS

cc Chancellor of the Exchequer
Chief Secretary
Financial Secretary
Minister of State
Economic Secretary
Sir Peter Middleton
Mr Bailey
Mr Byatt
Mr Cassell
Mr Evans
Mr Sedgwick
Mr Wicks
Mr Culpin
Mr S Davies
Mr Folger
Mr Melliss
Mr Mowl
Mr Riley
Mr Grice
Mr Kelly
Mr Pratt
Mr Spencer
Mr Whittaker
Mr Cropper
Mr Lord
Mr H Davies

Ca
hova terisib
exciting conference, judging
by this account. And may be
wondering to grab the headlines
when published.

Ke
12/7

Thanks.
PSR with my margin comment
on p 2.
PSR sph v John P... ..

CONFERENCE ON GOVERNMENT BORROWING

Chris Riley and I attended this one-day conference at the National Institute on 3rd July. Apart from our paper, there were papers by David Currie, Alan Budd, Giles Keating and Geoffrey Dicks, and David Savage and Chris Johns (National Institute). I attach an approximate list of participants and, for you only, copies of these three papers. (My secretary will send copies to others on request.)

2. Although there was some overlap between the papers, there was no general connecting thread and no attempt was made to link the four sessions. The discussion on each paper was fairly self-contained.

Odling-Smee and Riley

What was the answer?

3. The discussion on our paper mostly kept to the long-term issues that I emphasised in my introductory remarks (copy attached). Andrew Britton asked whether it mattered whether the public sector debt was held internally or externally. Chris Allsop made a different sort of distinction between inside assets and liabilities (ie those of the public sector) and outside assets and liabilities (ie those of the nation). We agreed that these were not distinguished clearly in the paper, but we thought that this would not affect the conclusions. John Flemming said that he prefers his tax-smoothing model to our emphasis on the distribution of consumption over time, because he prefers the underlying Barrovian saving model. Contrary to our paper, he said that the tax-smoothing model does determine the desired level of debt as a result of the inter-temporal budget constraint. Christopher Dow expressed scepticism about whether it was worth considering the various adjustments that we discussed, since their order of magnitude may well be trivial beside the problem of not knowing where the starting point should be (ie whether there is an initial disequilibrium in the debt to income ratio that should be corrected). He was also suspicious of the claim that there was a clear relationship between deficits and interest rates. David Vines said that another way to look at what we were saying about the long term was to construct a small growth model involving investment functions for the private sector and the public sector, and consumption functions that took account of the tax rate effects, etc.

4. A few remarks were made about the short term. Maurice Peston queried our conclusion that the nominal PSBR should be held fixed in the face of an inflation shock. David Currie argued along the lines of his own paper that targetting the PSBR and the money supply was destabilising. We replied that the illustrative path for the PSBR was not a rigid target. Mike Wickens asked why we should worry about the PSBR anyway. Why not just target the final objectives and let the PSBR turn out to be whatever that implied?

Currie

5. David Currie's paper does not present any new findings, but brings together his thoughts on three broad issues: the problem of policy design under rational expectations; the design of fiscal policy when there is deficient demand (including the problem of international interactions and the need for co-ordinated expansion); and the design of fiscal policy rules in a stochastic world. There is a very helpful summary in the first three pages of his paper. I attach a note on the paper that Chris Riley prepared before the meeting. We thought that it was a useful paper - David Currie is rather good at synthesising in intelligible language recent theoretical developments - even though it contains nothing new and was obviously put together rather quickly.

6. Among the points made in the discussion were:

a. in practice governments more usually renege on policy commitments because of stochastic disturbances (eg unforeseen developments or unforeseen consequences of the original policies) than because there is a more optimal path that was predictable in advance that they can switch to now;

b. it is not easy to observe or measure governments reneging. Going back on simple policy statements (U-turns) is not necessarily a case in point because this may be consistent with following a more sophisticated rule. The key thing that one wants to measure is whether governments renege on what they are expected to do, not on what they say they will do;

c. there may be very little room to expand fiscal policy because of inflexibility in the labour market, which would be reflected in higher inflation. Jim Ball and Maurice Peston surprisingly agreed on this!

d. Andrew Britton wondered whether there was a sense in which monetary policy should be assigned mainly to dealing with the effects of different policies in different countries, and fiscal policy to more narrowly domestic objectives.

Budd, Keating and Dicks

7. Their paper was rather thin. In one section it presented new simulations of the effects on money supply of an increase in output brought about by either higher exports or higher consumption. Similar results to those in the Middleton et al 1979 paper were obtained. There was much confusion about the meaning of the results, and whether the LBS model of the real economy and the supply side determined the particular results obtained. The simple point that the effects on broad money depend on whether the asset demand functions are shifted (the consumption case) or not (the export case) was not put very clearly in the paper.

8. The second question was about the effects of an increase in the PSBR and hence in the debt-income ratio on interest rates. The discussion became animated only when it turned to the long-run consequences of a fiscal expansion. Maurice Peston and Chris Riley said that the criticism in the paper of the argument in the Treasury evidence to the TCSC in 1980 that interest rates and the share of debt in portfolios would have to rise continually was rather overstated and technically incorrect. Calculations that Stephen Davies did last year showed that it took 80-odd years for most of the adjustment in debt to be made and the debt would only asymptote to a new equilibrium. Interest rates may respond more quickly, however, under rational expectations. Chris Allsop made some intemperate remarks about how ridiculous it is to worry about rising debt income ratios and debt interest payments. Mike Wickens pointed out that the increase in interest payments in the simulations could be financed by a miniscule increase in tax rates. But it was accepted that a rise in the PSBR of 1% of GDP due to 1% higher public expenditure may have to be financed ultimately by a tax increase of higher than 1%, due to rising interest rates and debt interest payments.

Savage and Johns

9. The National Institute paper was a rather boring description of the various adjustments that they make to the financial deficit of the public sector, together with a discussion of what the numbers show for the last 20 years. I attach notes by Chris Riley and Peter Spencer that were prepared before the meeting.

10. The discussion was entirely about the measures themselves and not about the last 20 years. Most people were critical. The underlying problem

was that fiscal stance is clearly a multi-dimensional concept (the dimensions relating to different time periods in the future, the effects on different variables, the effects under different monetary policy assumptions, etc) and so there can be no "correct" uni-dimensional measure. Andrew Britton suggested that their measure would be useful for people doing econometric work who did not have a complete model, eg Layard and Nickell. But John Flemming pointed out that this would almost certainly not be legitimate: given the fixed (non-unit) weighting system adopted, and the presumption that the true weights should change over time, lagged values of the demand-weighted deficit would definitely not correspond to the lagged effects of policy. Alan Budd said that there may be a spurious correlation between cyclically adjusted deficits and the ratio of GDP to trend, a point he attributed to you.

JOL OS

J ODLING-SMEE

CONFERENCE ON GOVERNMENT BORROWING 3 JULY 1985

Chairman: A Britton

Participants

C Allsop	R Layard
A Bain	D Mayes
J Ball	G Maynard
R Biswas	J Meade
A Budd	G Midgley
V Chick	J Odling-Smee
A Chrystal	J Peckman
T Congdon	M Peston
D Currie	C Riley
G Dicks	D Savage
C Dow	I Saville
W Eltis	J Shields
J Flemming	R Thomas
B Hopkin	D Vines
C Johns	M Wickens
C Johnson	D Worswick
G Keating	

APPROACHES TO THE PSBR

INTRODUCTORY REMARKS

I shall not attempt to go through the whole paper in these introductory remarks, since I assume that you have all had an opportunity to read it. Instead I shall try to indicate three things:

- a. the scope and coverage of the paper, what isn't here as well as what is;
- b. why we came to write about these issues;
- c. what can be concluded at this stage, from the point of view of policy and also areas where further analysis is required.

Scope and Coverage

2. In some ways the paper is a general survey of the main issues that arise in considering the appropriate level of public sector borrowing. As such it can only skim the surface of many issues - we ourselves are conscious of the very brief treatment of short-term issues in Section V, only six pages on issues that are the subject of nearly all the voluminous writing on fiscal policy in the literature and the policy debate of the last few decades.

3. Moreover there are some things which we do not consider at all. The most relevant of these omissions in the context of the policy debate in the UK in recent years is a discussion of setting the PSBR when macro-economic policy is directed at reducing the rate of inflation. The discussion about structural and long-term issues in Sections II-IV assumes that inflation is given, while inflation enters the discussion of the short-term in Section V as shocks in some underlying stable world. Nowhere do we consider setting the PSBR when the aim is to change inflation from its present level.

4. But I do not want to waste time explaining what is not in the paper. Turning to what is here, the bulk of the paper is devoted to a discussion of the factors relevant to setting the PSBR in the long term, which we think of as being a world in which output growth and inflation are both given. The paper discusses the basic purpose of borrowing in such circumstances, and suggests that it can be justified in terms of either the need to ensure an optimal distribution of consumption over time, or to avoid unnecessary

and distortionary changes in tax rates. This leads on to a discussion of the implications of changes in the composition of government expenditure and revenue, since different expenditure and revenue items themselves have a different impact on the distribution of consumption over time, and therefore call for different PSBR responses in order to stabilise that distribution. Thus we argue that higher worthwhile public investment - worthwhile in the sense that, even if it does not yield any financial returns, it at least satisfies sensible cost-benefit criteria - may justify a higher PSBR in the long term. Similarly, the PSBR should be lower than otherwise during the period of maximum exploitation of North Sea oil, if it is assumed that the government wishes to ensure that future as well as contemporary generations benefit from North Sea oil revenues.

5. These long-term and structural considerations take the debate back, in a sense, to some of the classical concerns about the uses to which government taxation and borrowing is put, and hence its desirability or otherwise. In more modern times these issues have surfaced in the context of the "burden of debt" debate. Even more recently, the concern in some countries about the rapid rise in the ratio of the stock of public sector debt to GDP has also focussed attention on the need to think in long-term and stock terms as well as in short-term and flow terms.

Why we came to write about these issues

6. It may help you to appreciate the relevance of the discussion of these long-term and structural issues to the practical problem of setting the PSBR if I summarise why we came to think about them. There were three particular analytical problems that we have been aware of in the Treasury for some time.

7. I shall start with the Medium Term Financial Strategy. The declining PSBR in the MTFS is explained in terms of its impact on interest rates for a given path of money supply. In principle, a view has to be taken about what level of interest rates is desirable. This in turn raises questions about the appropriate balance between investment and consumption, or, more generally, the balance between consumption in the future and consumption in the present.

8. The story has to be changed somewhat if one believes that interest rates are set externally - because capital is perfectly mobile inter-

nationally, for example. In this case, changes in the PSBR would not alter interest rates, so what should determine them? This led us to generalise the argument about the impact of changes in the PSBR on the balance between present and future consumption from the closed economy case to the open economy: the difference is that the transmission mechanism in the open economy is through external capital flows and the accumulation or decumulation of net overseas assets, whereas in the closed economy case it is through interest rates and the accumulation or decumulation of domestic assets.

9. In thinking further about the impact of government borrowing on asset accumulation, both domestic and external, we naturally found ourselves looking more closely at other activities of government that relate to asset accumulation, such as public investment and the taxation of North Sea oil.

10. Secondly, the preparation of the Government's Green Paper on Public Expenditure and Taxation into the 1990s led us to ask what level of PSBR the government would wish to see in the long term when inflation was zero. (It was assumed for the purposes of the Green Paper that inflation would be zero by the end of the period, ie 1993-94.) The figure that is presented in the Green Paper is 1 per cent of GDP for the PSBR in 1993-94, when it is assumed that output is growing at 2 per cent a year. This is consistent with a constant ratio of public sector debt to GDP at about the current level. While a constant debt-income ratio seems a fairly sensible thing, we were conscious of the fact that debt-income ratios have changed considerably in the past, and that recent work by Buiter and others had drawn attention to the implications of changes in other assets and liabilities for the level of and changes in the stock of debt. Again this led us to look at other items in the public sector balance sheet. We now conclude (paragraph 51) "that a rule that relates the growth of debt to the nominal growth of the economy alone is a considerable over-simplification".

11. Thirdly, a number of specific changes in the public sector's balance sheet have been occurring recently. Obvious examples are sales of public sector assets, the run-down of North Sea oil and hence of the potential revenues available from that source, and the accruing unfunded state pension liabilities. It can be argued, and has been argued by some people, that changes in these and other public sector assets and liabilities should be

met by offsetting changes in public sector debt. If the argument is based on the sort of long-term considerations that we discuss in this paper, it would seem to have much in its favour.

12. The same conclusions do not always follow if questions are asked from the point of view of the short-term impact of fiscal policy on demand. The conclusions are the same with asset sales - asset sales have little impact on demand, and so there is no need to spend the proceeds in order to have an offsetting influence. But they are not the same in the case of accruing unfunded pension liabilities: assuming income-constrained saving behaviour, these neither affect the public sector accounts now, nor do they affect demand in the short term; therefore there is no need to change the PSBR on account of short-term demand management considerations. But long-term structural factors suggest a reduction in the PSBR.

13. This is a particular illustration of a more general point, that long-term and short-term factors do not always point in the same direction. Choices have to be made, and some objectives given lower priority than others. This is even more so when further complications are introduced - such as the aim of reducing inflation by means of macro-economic policies.

Some Conclusions

14. No very precise conclusions about fiscal policy emerge from the discussion in the paper of long-term aspects of borrowing. There are serious difficulties with measuring some of the relevant concepts - eg the relevant stocks of public sector capital, North Sea oil revenue, unfunded pension liabilities, etc. Moreover, it is not clear whether the initial structure of the public sector balance sheet is about right or not. Nevertheless the analysis provides an analytical framework within which it is possible to consider the implications of things such as the exploitation of North Sea oil, the abolition of SERPs and other factors.

15. Further analysis could fruitfully be undertaken in a number of areas. I shall mention only two. First, following on from what I have just said, more quantification of some of the relevant concepts would be helpful. The pioneering work by Ashworth, Hills and Morris at the Institute for Fiscal Studies could well be followed up. One aspect, for example, that we have never seen measured is the stock of educational expenditure which, although classified as current expenditure, we suggest in the paper might be

something that could be financed by borrowing. Decisions would have to be made about a number of things, such as the rate at which educational expenditure "depreciates". Presumably it could be set equal to the same rate at which the human capital that it created depreciates. This might sound fairly easy, but what about equivalent calculations for, say, health and defence expenditure?

16. Secondly, we have not given any thought in this paper to some aspects of the interaction between short- and long-term considerations. We have said that deviations of the PSBR from its long-term optimal position can be justified in the short term, we have not suggested what order of magnitude - in terms of both size and duration - of deviation might be acceptable. One of the articles we refer to, by Kotlikoff, presents some simulations in which there is a disturbing non-linearity between the degree of crowding out of private sector capital formation and the duration of a temporary increase in the public sector deficit. This suggests that one might be able to derive formal conclusions about optimal deviations of the PSBR from its long-term position.

17. There are many other areas where further analysis would be useful. At this stage we are especially interested in your reactions to some of the basic ideas that we present here, although suggestions about extensions and developments would certainly be helpful.

THE CONDUCT OF FISCAL POLICY: DAVID CURRIE

(C. J. Nisley)

The paper is in three sections.

Section 1

2. We would agree with much of the material in this section, including the doubts cast on setting policy instruments "to achieve pre-set targets for the PSBR and the money supply, suitably defined". Although the MTFS still contains such targets, the importance of the NEDO pledge to maintain the growth of money GDP is widely appreciated. (Privately, I think we would doubt the wisdom of stopping at money GDP, given the arguments in our forthcoming paper, but we obviously would not say this.)

3. We are also very sympathetic to the notion of using forward looking indicators as an aid to setting policy. (That is the idea behind the work we have been doing on interest rate rules, and support is available in Peter Westaway's paper.) However, we might ask the following question. Why is it that forward looking indicators, such as the exchange rate, appear in practice - ie on average in the past - to contain less information about future inflation and the growth of money GDP than the past values of these series? Is this because the path of these variables tends to be much smoother than the path of the exchange rate because of the inherent noise in the relevant relationships? Or is it because one would expect the relationship to be highly dependent on the policy regime in operation, and this has not been stable? Or does it mean that policy has actually been operated in a way which takes account of the information in the exchange rate efficiently, so as to produce relatively smooth out-turns for inflation and nominal income?

Section 2

4. I don't think we would have any difficulty with Currie's comments on the international co-ordination of policy. Also, we would tend to agree with him about the risks of operating a combination of loose fiscal and tight monetary policies (the problems associated with unwinding, and the potentially destabilising consequences if they are not unwound). But these are not over-riding if changes in the mix are fairly small and the government fully recognises the temporary nature of them.

5. We would have considerable doubts about Currie's analysis of the need for more expansionary policies. First, it seems clear that any move to expand demand will lead to higher inflation than would otherwise have been the case, though not necessarily in absolute terms. The desirability of raising money demand therefore depends on the relative weight put on inflation and output/employment objectives. The second difficulty, which in current circumstances is particularly acute, is to know where the NAIRU actually is. The present evolution of prices and earnings does not lead one to feel great confidence that it is much below present levels.

6. We might ask Currie why he believes there is need for a real depreciation of the exchange rate in the long run if more expansionary monetary and fiscal policies are pursued. Unless one takes the view that markets are unlikely to adjust at all, only the price level is likely to be much changed in the long run, with the real exchange rate remaining much as before. However, a move to the NAIRU does involve a real exchange rate depreciation, and more expansionary policies may bring this about more quickly.

Section 3

7. The first point on this section is that we would have to agree with Currie that rigid PSBR targets are undesirable. That is certainly the implication of our paper. (The PSBR figures in the MTFs are not, of course, targets. Neither are they independent of the state of the economy, at least in principle.)

8. Currie's comments on the compatibility of a fiscal policy which allows the automatic stabilisers to operate and unchanging monetary targets invites a number of questions. He raises the issue of possible instability if the monetary target relates to broad money. The main thing with broad money is that it is relative interest rates which would have to change over the cycle, and this would probably have rather limited effects on demand. Furthermore, the PSBR is not a good indicator of changes in wealth for an open economy with a banking system: in a cyclical context much would depend in practice on the nature of the cycle. For narrow money, of course, the link with the PSBR is much less clear, and it is the level of interest rates which is relevant. Interest rates would tend to be stabilising in this case.

THE MEASUREMENT OF FISCAL STANCE: WIESR

(C. O. Niles)

The paper is in three sections.

Budget Concepts

2. The authors do not believe that much weight should be put on the public sector current account. This is because they believe disposable income to be more important than wealth in determining private expenditure; and for this purpose the deficit is more relevant. They appear to believe that the decline in public sector savings since the early 1970s is likely to have reduced the sustainable growth rate of the economy (page 4, middle paragraph). This could indeed be so. But the moral of our paper is that financing capital formation out of taxation ^{in the early post-war period} (if the figures are to be believed) reduced present consumption unduly in relation to future consumption. A reduction in public sector saving could arise either as a result of lower capital spending or because of higher borrowing and hence higher interest rates. Are the Institute arguing for lower public sector borrowing(!) or higher public investment?

3. The Institute state a preference for the financial deficit, rather than the PSBR, when measuring fiscal stance. I think we would tend to agree with them in principle, but would note that:

- PSBR figures are available in more timely fashion, and are thus more helpful for monitoring purposes;
- the PSBR is less subject to measurement error than the financial deficit, and typically a large unidentified item is necessary to reconcile the two;
- some elements of net lending, such as industrial support, are given at preferential rates, and so are not matched one-for-one by new assets.

Derived Indicators of Fiscal Stance

4. The NIESR clearly believe that disposable incomes are more important than wealth in determining private sector expenditure. Hence their preference for the financial deficit rather than public sector saving as an indicator of fiscal stance, and also their liking for demand-weighted measures of the deficit. It also explains their scepticism about the value of inflation adjustment. We might perhaps ask them whether this means they are able to explain movements in the savings ratio in the mid-1970s and the period since 1979 without attributing a significant role to wealth effects.

5. We would agree with the Institute that applying a cyclical adjustment to the budget deficit is helpful in assessing longer term movements and abstracting from short-lived cycles in output. But they argue (page 11) that it is necessary to abstract from the influence of output on the deficit in order to identify the influence of the deficit on output. We would surely want to take issue with this latter point, along the lines of paragraph 80 of our paper: whether a change is automatic or discretionary is largely irrelevant to its effect on the economy. We would also want to stress that in producing cyclical adjustments, the aim should be to ensure that they balance out to zero over a suitable run of years. It is ~~not~~ clear from the paper that this is ^{not} so for the Institute's estimates.

Fiscal Stance, 1965-84

6. The discussion in this section is not very illuminating. It completely ignores the link between the fiscal deficit and inflation, and so any conclusions about the effects of fiscal policy on demand and activity must be taken with a pinch of salt. Even if, as the Institute argue, inflation-adjusted measures of the deficit give too much weight to short-run variations in inflation, inflation adjustment is surely essential in making longer term comparisons (eg on page 20 when comparing fiscal stance in 1968, 1977 and 1981).

7. We may have doubts about the usefulness of the inflation-adjusted deficit in assessing the stance of fiscal policy, and hence as a guide to setting policy, but this is because we attach importance to inflation

as an objective. For our purposes, when setting policy, we would want to adjust for the target rate of inflation rather than the actual rate. But this is quite compatible with the notion that the inflation-adjusted deficit as conventionally measured gives an indication of the implications of fiscal policy for demand given the actual rate of inflation - "fiscal conditions".

Conclusions

8. The paper concludes that the early 1970s and the period 1980-81 were atypical in the sense that variation in the fiscal stance was procyclical. It is argued that the deflationary move made in 1981 has not been sufficiently reversed. I think at this point, we would want to stress the importance of fiscal policy in the context of counter-inflation policy.

THE MEASUREMENT OF FISCAL STANCE

(P. D. Spear)

Comments on a conference paper by the NIESR

This is a pretty standard piece on the description and measurement of fiscal policy, based on the conventional NIESR structural deficit measure.

2. The paper begins with quite an interesting if lengthy discussion of public sector savings and net worth, but this does not lead anywhere and they conclude that the financial deficit offers a better measure of fiscal stance. The role of inflation adjustments is played down on the grounds that the effects on demand are rather smoother than implied by the usual calculations. Indeed the reader is left to make his own inflation adjustments (p6).

3. As far as I can see the only innovation is in the use of a quarterly measure. But in my view this is a step in the wrong direction, stretching the underlying assumptions too far. This series is very erratic (see for example the movements shown in 1974 and 1975 in chart 1) but NIESR do not seem to be too worried about this. They suggest (p18) that it might be due to an unreliable CSO seasonal adjustment or the cash payment rather than 'work done' basis of government expenditure. Consequently they smooth the series out using a four quarter centred moving average. However it is surely more reasonable to argue that expenditures (and revenues) affect the economy with a lag, and that the erratic quarterly path reflects a failure to take account of these lags. This would make a backward moving average more appropriate. Moreover the effect of output changes on the budget balance will also come through with a lag, and this should also be smoothed out in a backward-looking way. The NIESR output and smoothing adjustments, taken together, are clearly inappropriate as they stand and probably give a misleading impression of the short-run stance of policy.

4. NIESR argue (p15) that although structural deficit indicators are relatively crude they are "less dependent upon their assumptions" than alternative approaches based on full model

simulations. They argue that such measures are 'model free' and play down the crucial role played by the high employment output trend assumption, the demand weights and the other parameters. But the use of parameters derived from econometric models clearly makes them model dependent, and to substitute the information which these models contain about supply side trends and the various lags involved, by crude assumptions must surely make them inferior.

5. NIESR do seem to be slightly concerned about the shifts in the trend growth in productive potential which appear to have taken place since 1973. Their central estimate for the trend since 1973 is 2% rather than the 2.7% used for earlier years. Two variants of (3% and 1%) are shown in chart 2, which serve to show the sensitivity of these measures to changes in trend. They seem to accept that longer term comparisons of fiscal stance are likely to be misleading for this reason, but argue that comparisons between one cycle and the next are fairly reliable. However it is almost certainly wrong to represent the experience since 1973 in terms of a single break in productivity trends. It now appears that there was a marked fall in the growth in productivity during the mid to late 1970s, followed by a marked upturn during the 1980s. Moreover, it is important to take other supply-side changes (such as increases in the NAIRU and oil price shocks) into account in assessing such trends. Presumably the NIESR model could be used to throw some light on these issues. Failing this, the sort of mid-cycle adjustments adopted by the OECD could be used. As they stand, the NIESR measures do not provide a reliable medium term standard of comparison.

6. The paper offers a short commentary on fiscal policy since 1965. This is little more than a description of how the stance of policy responded to changes in output and does not attempt to say how policy affected output. The polemics are reserved for the conclusion. This asserts that the tightening of policy in 1980-81 reinforced a sharp downturn, arguing that this was "immoderate" and "based on a misjudgement of the underlying condition of the economy at the time". It is surely more accurate

to say that it was based upon a different view of the way the economy worked to the one adopted by NIESR, one which in the event proved more realistic. NIESR argue that the deflationary stance adopted in 1981 has yet to be fully reversed.

CONFIDENTIAL AND PERSONAL

FROM: MISS M E PEIRSON
DATE: 11 June 1985

- de.*
1. MR CASSELL
 2. CHANCELLOR OF THE EXCHEQUER

*Clerks
pl
minutes
over.
R*

cc Sir P Middleton
Sir T Burns
Mr H P Evans
Mr Battishill
Mr Lankester
Mr Devereux
Dr I Webb
Mr Wells - CSO

PSBR IN MAY

1. The first provisional outturn for the PSBR in May is £1.0 bn, £0.2 bn below last month's forecast (see table attached). This is the average of market expectations, which are between $£\frac{1}{2}$ bn and $£1\frac{1}{2}$ bn. Our estimate is subject to revision before publication on Tuesday 18 June. In the first 2 months of 1985-86 the PSBR was £2.8 bn, £0.7 bn below the Budget profile.

2. The CGBR(O) in May was provisionally £1.2 bn, £0.2 bn below last month's forecast, much as reported in Mr Devereux's note of 4 June. Higher Customs and Excise receipts (by £0.2 bn), a higher surplus on the National Insurance Fund (by £0.2 bn) and other factors were partly offset by lower Inland Revenue receipts (by £0.1 bn) and higher supply expenditure (by £0.3 bn, largely offsetting the shortfall in April).

3. The LABR in May was provisionally nil (net), compared with a forecast repayment of £0.1 bn. The PCBR was provisionally a net repayment of £0.2 bn, close to forecast.

4. The difference between the Budget profile and the PSBR outturn for April and May together is due to the CGBR(O) being £1 bn below profile, partly offset by the LABR being nearly $£\frac{1}{2}$ bn above profile. The shortfall on the CGBR(O) is largely due to higher Customs and Excise receipts (by $£\frac{1}{2}$ bn) and a higher surplus on the National Insurance Fund (by $£\frac{1}{4}$ bn).

5. The monthly note, presenting updated estimates for May and revised forecasts for June-August, will be circulated next Monday. As usual we shall send you the draft press briefing at the same time. On the following Friday (21 June) we shall send you a revised forecast for 1985-86 as a whole, as part of the report on the summer economic forecast.

Mep

MISS M E PEIRSON

CONFIDENTIAL & PERSONAL

£ billion

	May 1985			April-May 1985			April-May 1984
	Provisional outturn	Last month's forecast	Difference	Provisional outturn	Budget profile	Difference	Outturn
CGBR(O)	1.2	1.4	- 0.2	2.4	3.4	- 1.0	3.2
LABR	-	- 0.1	0.1	0.8	0.4	0.4	0.8
PCBR	- 0.2	- 0.2	- 0.1	- 0.4	- 0.3	- 0.1	- 0.4
PSBR	1.0	1.2	- 0.2	2.8	3.5	- 0.7	3.6

CONFIDENTIAL & PERSONAL



I am content for this
to be circulated, provided
it is clearly stated
that these are no
private views of Messrs
O-S & R, & wh
the views of HMV.

I have (myself) some
reservations about some
parts of it* - a final X
particular in place!

* if ~~there~~ is too much to
'close home' times. No word
matters.



Ch.

This is clearly an expansion
of earlier internal papers on
setting the PSBR. I don't detect
any significant changes in
the financial assumptions.

At some stage you will
have to read it carefully.
I don't think you need to
do so now..

But could you confirm
that you are content for this
to be considered to be
Academic Panel? (Everyone
clearly much chastened by Pay votes)

Rh.

12/16

From: J ODLING-SMEE

12th June 1985

CHANCELLOR OF THE EXCHEQUER

cc Sir Peter Middleton
Sir Terence Burns
Mr Riley

CONFERENCE PAPER ON THE PSBR

With the agreement of Sir Peter Middleton and Sir Terence Burns, Mr Riley and I are going to give a paper to a conference being held by the National Institute on 3rd July. The subject of the conference is Government Borrowing and Economic Policy, and the other speakers are David Currie (a member of the Academic Panel), Alan Budd and Giles Keating, and the National Institute themselves. The papers will probably be published in the National Institute Economic Review. I attach the programme and list of invitees showing those who had accepted at the beginning of this month.

2. I shall be sending you a draft of our paper next week. In the meantime we are planning to send the attached version out tomorrow to the Academic Panel which is due to take it at its regular meeting on 21st June. Sir Peter Middleton and Sir Terence Burns have seen earlier versions and are content with this. Perhaps you would let me know if you see any difficulty. Following the publicity after the pay and jobs paper the Chairman is well aware of the importance of not allowing comparisons to be made in public between the Panel version and the conference version. I do not believe that there will be any problems this time.

3. If you do not wish to read the whole paper at this stage, you can get quite a good idea of what it contains from paragraphs 1, 10-12 and the final paragraph.

OL 01

J ODLING-SMEE

Government Borrowing and Economic Policy

A One-day Conference at the National Institute of Economic and Social Research

Wednesday 3rd July, 1985

Provisional Programme

9.30 - 11.00 John Odling-Smee and Chris Riley
Approaches to the PSBR

Coffee

11.30 - 1.00 David Currie
The PSBR as an Intermediate Target

Lunch

2.00 - 3.30 Alan Budd and Giles Keating
Government Borrowing and Financial Markets

Tea

4.00 - 5.30 NIESR
Government Borrowing and Aggregate Demand

Conference on The Budget Balance and Economic Policy July 3rd 1985

Participants

R Alford		D MacDougall	
C Allsop	Yes	R Matthews	No
M Artis	Yes	G Maynard	Yes
A Bain	Yes	J Meade	Yes
J Ball	Yes	M Miller	Yes
C Bean	Yes	P Minford	
M Beenstock		G Pepper	Yes
D Begg		D Peel	No
V Chick	Yes	M Peston	Yes
A Chrystal	Yes	M Posner	Mayer - yes
T Congdon	Yes	H Rose	Yes
C Dow	Yes	I Saville	Yes
W. Ekins	Yes	R Sargent	No
J Flemming	Yes	D Vines	
C Goodhart	Yes	D Worswick	Yes
B Griffiths	No	J. Shields	Yes
B Hopkin Hopkin	Yes	J. Peckham	Yes
C Johnson	Yes		
R Layard	Yes		
D Lomax	Yes (provisional)		
P.M. Jackson	Yes		
(Heister)			

APPROACHES TO THE PSBR⁽¹⁾

I. INTRODUCTION

1. This paper considers a range of issues relating to the overall stance of fiscal policy. It considers issues of principle which arise in the present economic environment given the present government's approach to economic policy. It is not concerned with the present stance of policy per se, or with its relationship to the current conjuncture. The paper focuses on approaches to determining the appropriate size of the fiscal deficit, bearing in mind the interaction between this and the composition of the deficit.

2. The arguments in the paper are developed mainly in terms of the Public Sector Borrowing Requirement (PSBR), since that is the way the Government expresses its fiscal policy objectives in the Medium Term Financial Strategy (MTFS). But that is not to imply that the PSBR is considered the ideal measure of fiscal stance. It clearly is not; and indeed there may be no such thing. Rather than focus on an alternative measure, such as the Public Sector Financial Deficit or the General Government Borrowing Requirement, which would also have drawbacks, the paper follows the same approach as the Government. It describes the stance of fiscal policy in terms of the PSBR, and discusses the implications of changes in its composition and its other known characteristics for PSBR objectives.

A Brief History

3. Attitudes to public sector deficits and debt have varied considerably over the last 200 years. The classical economists - including Smith, Say and Ricardo - were almost unanimous in condemning public debt. Although it was conceded that deficit financing was permissible in times of war, they were concerned that in peacetime it would lead to irresponsible government and wasteful expenditure. Although apparently less painful than taxation, the burden of debt could become considerable because of the taxation required to service it. Taxation was considered harmful because of the burden it imposed on productive industry. In this environment, low expenditure and fiscal surpluses were the order of the day, except in war time.

(1) The views expressed in this paper are those of the authors, and not necessarily of the Treasury.

The ratio of public sector debt to nominal GDP fell fairly steadily during the nineteenth century from the level it reached at the end of the Napoleonic Wars (Chart 1).

[Chart 1: Debt-income ratios over last 200 years in UK and US.]

4. During the course of the nineteenth century, however, the potentially productive character of public expenditure came to be more widely recognised. A distinction was increasingly drawn between productive and non-productive purposes for which debt might be incurred. A case could be made for incurring debt if the expenditure it financed yielded benefits in the future to match the additional debt service⁽²⁾. In practice this argument applied mainly to capital expenditure and the finance of wars. Attitudes to expenditure became more relaxed as economic growth reduced the burden of debt and allowed a widening of the tax base.

5. But the sharp build-up of debt during the 1914-18 war led to renewed concern. The Colwyn Committee, set up in 1924 to examine the effects of the debt, argued for a gradual reduction, though it did not specify how far. One reason advanced for this conclusion was the need to sustain national credit-worthiness in case another war required further massive borrowing. Another was the risk that falling prices would increase the real burden of existing debt. The prevailing view in the inter-war period was that it was desirable at least to balance the budget, and ideally to run a surplus.

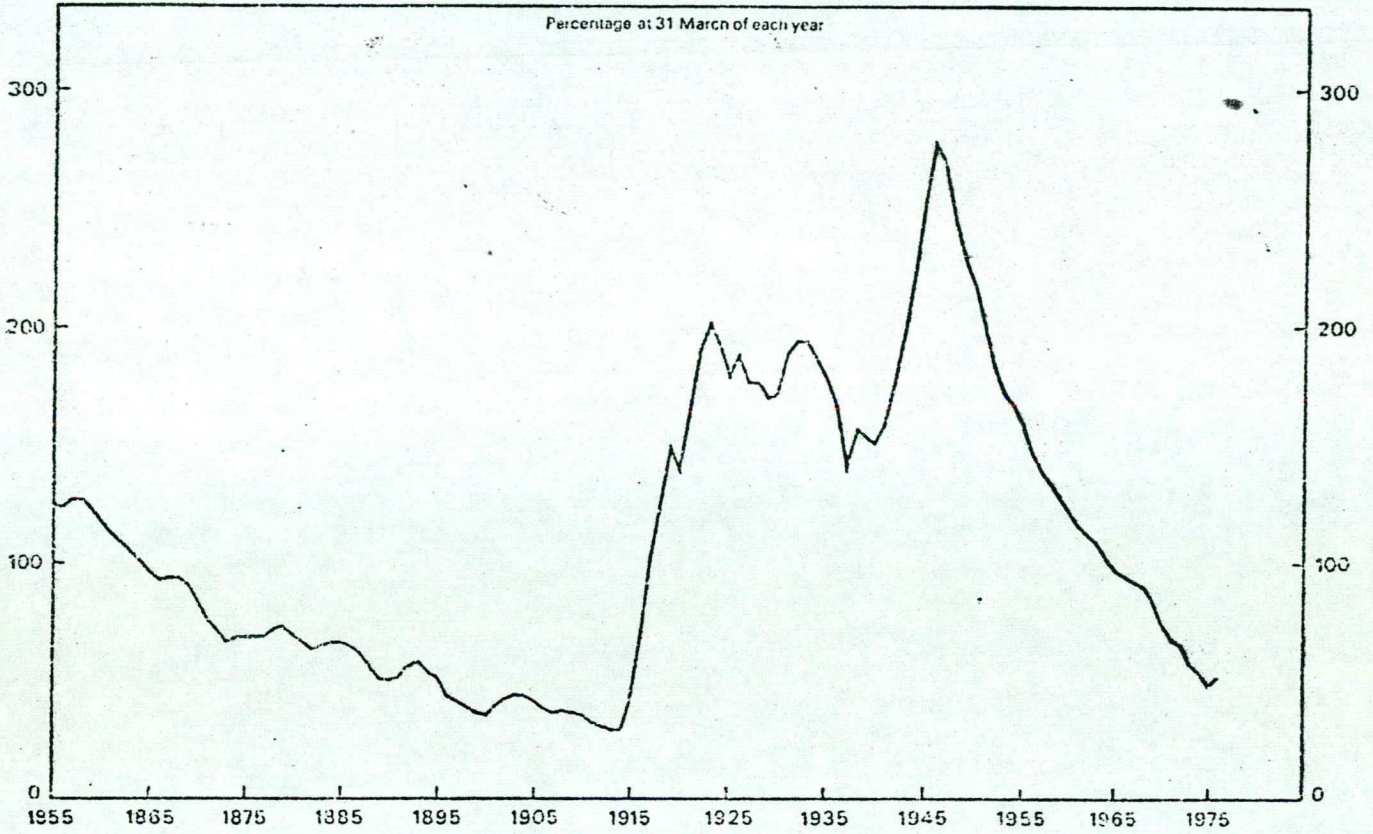
6. In the UK, and in many other industrialised countries, the Keynesian revolution in the late 1930s led to a significant change in thinking about fiscal policy. The link between deficits and aggregate demand became the main focus of analysis, and fiscal policy was seen as a means of achieving an appropriate level of real demand, and hence employment, in the short

(2) The Equivalence Theorem, which equates taxation and debt in terms of their effects on expenditure, was recognised by Ricardo as a theoretical possibility but discounted in practice.

UK

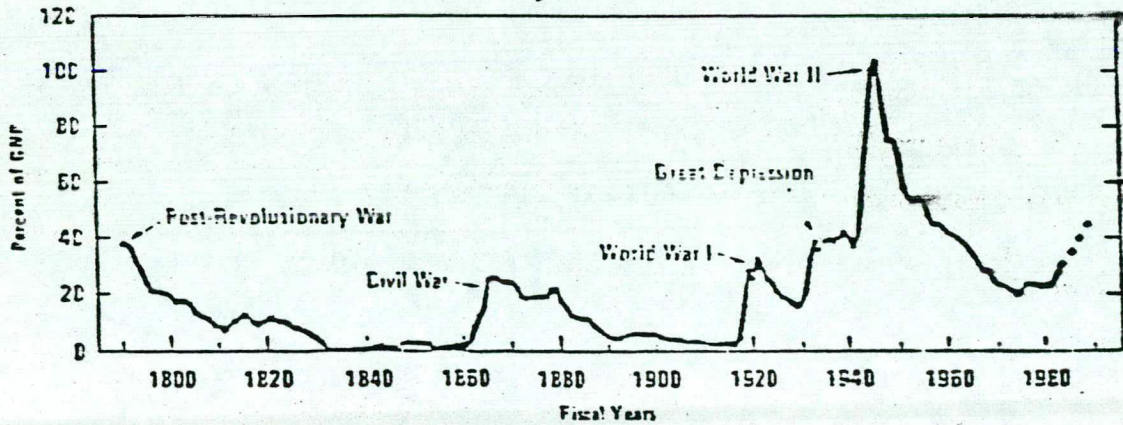
Ratio of national debt to gross national product

Percentage at 31 March of each year



US

Privately Held Federal Debt



SOURCE: Congressional Budget Office, from material cited in James R. Barth and Stephen D. Morrell, "A Primer on Budget Deficits," *Economic Review*, Federal Reserve Bank of Atlanta, August 1982, pp. 6-17.

term.⁽³⁾ This analysis was widely accepted in the 1950s and 1960s, and deficits on the budget were seen in many cases as both desirable and necessary.

7. But by the early 1970s, with the breakdown of the Bretton Woods system of fixed exchange rates and the first oil shock, the Keynesian orthodoxy was increasingly being challenged. The surge in inflation and sharp deterioration in economic performance of the advanced economies prompted two types of change in the perception of how fiscal policy should be operated. The surge in inflation resulted in moves to more restrictive financial policies, and a growing awareness that curing inflation required greater control over monetary growth, and through that the growth of nominal demand. This and work on the government budget constraint (eg Christ (1968)) brought into clearer focus the link between fiscal deficits and money creation and the need for fiscal and monetary policies to be in harmony.

8. At the same time, the decline in economic growth in the 1970s gave rise to greater appreciation of the structural implications of budget deficits and the implications of high taxation and government spending for incentives and the supply side. The momentum of rising debt, expenditure and taxation, acquired in the two decades when rapid economic growth seemed assured, became a source of widespread concern.

9. The issues on which most attention focussed before Keynes have thus now resumed an important place in the debate on fiscal policy. They relate essentially to the burden of debt and the structural effects of fiscal policy on the economy, focussing on the longer term rather than the short term.

(3) Though Keynesian thinking had a profound influence on approaches to analysing fiscal policy over this period, active debate continued on the structural implications of debt finance. See, for example, Lerner (1948, 1961), Buchanan (1958).

Scope and Structure of the Paper

10. The paper attempts to review the factors relevant to setting the PSBR in both the long term and the short term. It does not discuss in any detail setting the PSBR in order to achieve declining inflation. The discussion of the PSBR in the long term takes the rate of inflation as given. In the short-term, however, the implications for inflation and the need to avoid accommodating inflationary shocks are considered.

11. The paper does not discuss aspects of the stability and sustainability of fiscal policy under bond financing. This has been the subject of much analysis in recent years following the early contribution of Blinder and Solow (1973). It is an important issue which highlights the link between current bond issues and future interest payments. Even though effective control over the PSBR eliminates the risk of a loss of control over public debt, rising interest payments within a fixed PSBR crowd out other expenditures or require rising taxation, thus putting the whole fiscal programme at risk.

12. There are three sections on long-term issues and one on the short term. The first long-term section discusses reasons for borrowing, the second the implications for borrowing of changes in public sector assets and liabilities, and the third the interaction between fiscal and monetary policy in the long term. The paper ends with a summary and conclusions.

II. THE NATURE OF BORROWING AND ITS IMPLICATIONS

13. Two important aspects of borrowing to finance expenditure rather than financing it out of current income can be identified. First, borrowing changes the timing of payments, and hence the distribution of consumption over time. Secondly, borrowing can smooth out the paths of prices and tax rates in the face of lumpiness in expenditure or revenues. These two aspects are closely related, but it is helpful to consider them separately.

The Distribution of Consumption over Time

14. An essential feature of borrowing, which economists have long recognised, is that it enables expenditure to be redistributed over time. Individuals or governments are able, by increasing their borrowing, to increase their expenditure now in relation to their income; but the

subsequent burden of interest payments and debt repayment has the effect of reducing expenditure relative to income in the future. At the same time, the nature of the expenditure brought forward by borrowing may influence the path of future income: additional investment now will increase future income and consumption possibilities, whereas additional consumption now will not.

15. At the economy-wide level, the analysis is less straightforward than implied so far. Decisions to spend and borrow in themselves have macro-economic effects - for example on interest rates, exchange rates and the balance of payments - which have second round effects on investment, consumption and future incomes. Any decision to borrow by the public sector will typically affect both the path of future income and the distribution of consumption over time. The mechanisms involved will depend on the nature of the economy, and notably the degree of openness.

Closed Economies

16. For a closed economy, the main mechanism is interest rates. Higher borrowing forces up interest rates and induces the private sector to reduce both its present consumption and its investment.⁽⁴⁾⁽⁵⁾ This reduces future income, via a lower capital stock. If the additional borrowing is used to finance consumption, the net effect is both to redistribute consumption from the future to the present and to reduce future income. If the additional borrowing finances worthwhile investment this will tend to increase future income, and at the same time redistribute consumption from the present to the future⁽⁶⁾.

(4)

(5) It might be objected that very high debt/income ratios have been achieved in wartime without excessively high real interest rates. This was true in the UK, for example, in each of the World Wars this century. But at time of war, restricted consumption possibilities together with patriotic desires to contribute to the war effort combine to diminish the upward pressure of interest rates.

(6) The question of how to define worthwhile investment is discussed later. For present purposes it is any investment which yields a useful stream of "capital services" in future. "Income" here should be taken to refer to either public sector revenue, as from a power station, or useful capital services, as from a prison.

17. This suggests the possibility of an "optimal" level of public borrowing given the available opportunities for worthwhile public investment and the rate of social time preference, associated with an "optimal" level of interest rates. The literature on growth and optimal saving indicates a relationship between the optimal interest rate and the underlying growth rate of the economy - the so-called "golden rule".⁽⁶⁾ If the PSBR were set too high, leading to an interest rate above the optimal rate, there would be too little investment and too much consumption, ceteris paribus. The present generation would be enjoying an excessive amount of consumption at the expense of future generations.⁽⁷⁾

Open Economies

18. In an open economy there are additional mechanisms involved. Changes in domestic borrowing affect the current account of the balance of payments and the exchange rate, and thus both the net stock of overseas assets and their valuation. This in turn affects future flows of income from overseas, and hence future consumption. In extreme cases where real interest rates are tied down fully in the long run by world rates, this may be the only mechanism involved. The optimal level of public sector borrowing in such an economy is associated with an optimal level of net overseas assets, related as before to social time preference and the economic growth rate.

19. An increase in public sector borrowing would be associated ex ante with a greater current account deficit, or smaller surplus, and hence ultimately a lower stock of net overseas assets⁽⁸⁾. This is analogous to a

(6)The question of how to define worthwhile investment is discussed later. For present purposes it is any investment which yields a useful stream of "capital services" in future. "Income" here should be taken to refer to either public sector revenue, as from a power station, or useful capital services, as from a prison.

(7) If the excessive PSBR was financing investment which was excessive in the sense that its rate of return was below the optimal interest rate, present measured consumption may not appear excessive. But some of the investment should be regarded as consumption.

(8)This is not a new idea. It can, for example, be found in the writings of the New Cambridge school.

lower domestic capital stock in the closed economy case. Maintenance of external balance requires that the resulting reduction in net overseas income be matched in the long run by a smaller deficit/higher surplus on the trade account. In other words the economy would ultimately have to reduce its net imports and its consumption. This would be brought about by a lower real exchange rate.

20. In practice, the mechanisms relevant for a closed economy will also be relevant for open economies, because most open economies are likely to have some freedom to vary their real interest rates relative to the rest of the world. This is certainly the case in the short run, and even in the long run it is unlikely that domestic rates would be tied down entirely by world rates. Long-run divergences in real interest rates may reflect trends in real exchange rates, possibly the result of different relative trends in traded and non-traded sectors. Such divergences may persist for some while, but are probably not closely related to the overall stance of fiscal policy. More relevant in the current context is that differences in real interest rates between countries may reflect different degrees of risk associated with the countries' debt. These may reflect differences in the size of the debt, and hence the overall stance of fiscal policy, and may thus persist in the long run.

Tax Rates and Lumpiness of Public Sector Transactions

21. Some economists, notably Barro (1974), argue that it may not be necessary - and could indeed be pointless - for the government to try to manipulate the balance between present and future consumption by varying public sector borrowing and debt in the manner suggested so far. The private sector can implement the appropriate balance itself through its access to the capital markets. It is thus indifferent between taxation and debt as a means of financing public expenditure. This view is essentially the Equivalence Theorem of Ricardo.

22. If this is accepted, the appropriate levels of taxation and debt should reflect other, essentially micro-economic, considerations. These include effects on the structure of incentives and the distribution of income. But there is a strand of the literature which focusses on the costs associated with changes in the tax system, rather than on the level of tax rates. Such changes, particularly if they are not anticipated, themselves distort the choices of the private sector and

lead to a misallocation of resources.⁽⁹⁾ There is thus a premium on maintaining stable tax rates, even though the level at which they are stable may well be a matter of indifference. In a stochastic environment tax rates should, on this analysis, follow a Martingale process.⁽¹⁰⁾ Unanticipated shocks to the level of public debt are largely accommodated, with subsequent debt servicing costs financed by changes in tax rates. Anticipated fluctuations in net government revenues should be reflected in fluctuations in public debt, with tax rates set at a level needed to finance the "permanent" stream of debt servicing costs.

23. While having many theoretical attractions, the conditions required for this type of model to hold are very stringent. The Equivalence theorem requires [amongst other things] ultra rationality, perfect capital markets, intergenerational altruism and bequests. Barro's conclusions about taxes require [among other things] proportional tax rates, and no relationship between real interest rates and the level of debt. It seems highly unlikely that these assumptions are valid, or sufficiently close to being valid to justify the conclusion that governments can be entirely indifferent to the levels of taxation and debt so long as they aim to maintain stable tax rates.

24. But nevertheless the view that changes in tax rates can be distortionary and should be kept to a minimum is important. Governments may well have objectives for tax rates on micro-economic grounds, but if so there is a clear case for moving towards them in a smooth and predictable way, and not changing them in response to short term fluctuations in public sector flows. This has implications for the cyclical behaviour of the PSBR, which we discuss in section X, as well as for the long term.

III. CHANGES IN PUBLIC SECTOR ASSETS AND LIABILITIES

25. The discussion of the distribution of consumption over time suggests a link between public borrowing decisions and changes in public sector assets (and liabilities). Insofar as the "optimal" PSBR reflects the

⁽⁹⁾This analysis presupposes that taxes are not lump sum.

⁽¹⁰⁾See Barro (1981).

appropriate balance between present and future consumption, and thus between present consumption and asset accumulation, the extent to which the PSBR finances public investment or consumption is of considerable relevance. Public investment, assuming it is worthwhile, generates a stream of returns which contribute to higher consumption. Higher public investment enables any given balance between present and future consumption to be achieved with lower private investment and/or lower net overseas investment. The implication is that higher (worthwhile) public net investment in principle justifies a higher PSBR and, probably, higher interest rates.

26. The argument can be extended to assets other than public sector capital stock, and to liabilities. For example, the potential revenue from North Sea oil represents, from the point of view of the public sector, an asset that is gradually being used up. If the PSBR were not to change during the (temporary) period of exploitation of the oil, consumption would be greater during this period than without the oil, and the balance of consumption between this and later periods changed. There is therefore a case for changing the PSBR in an offsetting direction to restore the balance. In stock terms this would be equivalent to altering public sector debt in line with changes in the "stock" of future North Sea oil revenues: some of the oil revenues would be used to reduce the debt and thus spread income into the period after the oil runs out. There is a similar case for reducing public sector debt in line with the accumulation of unfunded state pension liabilities.

27. The argument about lumpiness in public sector transactions leads to very similar conclusions about changes in public sector debt. Tax changes can be avoided if lumpy changes in public sector assets and liabilities, such as a single investment project, the "temporary" rundown of revenue from North Sea oil, and "temporary" imbalances between people's pension-related National Insurance contributions and their state pensions, are met by offsetting changes in public sector debt.

28. There are two main ways in which the balance of consumption and the lumpiness arguments differ. First, the balance of consumption argument implies in principle a view about the optimal level of debt given the levels of public sector assets and other liabilities. It may be difficult in practice to determine this optimal level, but in principle it ensures a desired path of consumption over time. The lumpiness argument, on the other

hand, implies no optimal level. It merely indicates how the level of debt should change in the face of fluctuations in public sector transactions. The second difference is that the lumpiness argument is relevant to fluctuations in both current and capital expenditures. But for the balance of consumption argument the distinction between capital and current is critical. It suggests that single large consumption projects - such as wars - should be financed entirely by taxation, while the lumpiness argument suggests that they should be financed in part by borrowing. In practice these differences may be relatively unimportant. Since, as discussed below, the conventional definitions of current and capital expenditure may not be appropriate in this context⁽¹¹⁾. But the conceptual differences remain.

29. The argument that public sector debt should move in line with changes in public sector assets and liabilities is equivalent to saying that the public sector's net worth should be maintained unchanged. [Refer to Buiter and earlier writers.] Some writers, for example Buiter (), have argued that net worth in this context should be defined in a comprehensive way to include the present value of future expenditure commitments and the right to tax as well as conventional debt and investments.

30. In principle this may be right. But obtaining a suitably comprehensive measure of net worth is difficult. On the one hand it might be argued that the right to tax effectively means that the government is able to finance whatever level of expenditure it deems appropriate. In this case net worth is automatically - but tautologously - equal to zero. But alternatively one might argue that the right to tax and spend, appropriately measured, does not change over time and can therefore be ignored. Either way, these difficulties point towards the desirability of including in net worth all assets and liabilities which are not constant over time: North Sea oil revenues and immature unfunded pension schemes, for example. However, a consequence of ignoring some elements which would feature in a fully comprehensive measure of public sector net worth is that the appropriate level of net worth is no longer clearly defined. It is, however, unlikely to be zero.

(11) Single large consumption projects may not really exist: wars, for example, may be events that should properly be regarded as investments because they buy peace, freedom, national self-esteem or such like for a few more years or decades.

31. Another problem is that some relevant components of the public sector balance sheet are difficult to measure - the cases of the fixed capital stock and North Sea revenues are discussed below. Nevertheless, the concept of unchanged net worth is valuable and suggests ways in which the PSBR should be related to changes in public sector assets even if correcting^{ions} in initial stock disequilibria cannot be made with any precision.

32. The rest of this section discusses the implications for debt of trends in public sector assets and liabilities in the context of a rule which maintains public sector net worth unchanged. Public investment and North Sea revenues are used to illustrate the main issues, though other assets are also mentioned.

Public Sector Investment

33. The link between public net investment and the optimal size of the PSBR brings into sharp focus the criteria used to evaluate public sector investment projects. The arguments set out above assume implicitly that all projects considered worthwhile at the level of interest rates consistent with the "optimal" PSBR do go ahead; and that the distribution of worthwhile projects between the public and private sectors is also optimal. Inevitably the latter is a matter of judgement, and inextricably linked to views about the efficiency and appropriate size of the public sector. Evaluation of public sector projects must clearly take into account the potential effects on the private sector of government involvement in the economy. A desire to reduce the role of government in order to rejuvenate the private sector points to lower public net investment and a lower PSBR than would otherwise be the case.

34. The appropriate definition of public investment raises conceptual and practical difficulties. First, it is necessary to separate "worthwhile" investments that should properly be financed by borrowing from other investments that should be regarded more like consumption. Certain types of public investment may produce significant social returns but little or no pecuniary return. Examples are prisons and public parks.⁽¹²⁾ Such

(12) Wars may perhaps come into this category, though they may also in many cases generate pecuniary returns.

investments may have little if any effect on future incomes and consumption in a national accounting sense, but nevertheless raise them in a broader sense. The arguments above apply equally to this sort of investment, which can be considered worthwhile if future generations would be willing to pay for the benefits they yield by higher taxation. Insofar as they are considered worthwhile in this sense, it is legitimate to finance them by public borrowing, and hence future rather than current taxation. In this they are analogous to investments yielding pecuniary returns.

35. Secondly, there is the reverse problem. Some expenditure at present classified in the national accounts as current expenditure should perhaps be classified for this purpose as investment since it yields benefits in future periods. Wars have been mentioned. More generally there are expenditure on military hardware, much expenditure on education (which is in large part investment in human capital) and, perhaps to a lesser extent, health. Such expenditures can legitimately be financed by borrowing.

36. Thirdly, the appropriate definition of investment to be compared with the PSBR is net of depreciation but after allowing for both expenditure on maintenance and valuation changes resulting from inflation. Net rather than gross investment is the appropriate concept because this is what determines changes in net assets and liabilities, which in turn determine future returns. But there are severe problems with measuring depreciation and capital appreciation, yet they are crucial to the measurement of net investment.

37. As discussed above, one might in principle wish to compare the stock of debt with the stock of fixed assets and other assets and liabilities, all in relation to the desired level of net worth. The stock of fixed assets is, however, difficult to measure. The only comprehensive data are the CSO's balance sheet data. However, these are based on cumulating investment series and making fairly arbitrary assumptions about depreciation. Some public sector assets probably continue to yield benefits well after they are assumed to have depreciated to a tiny proportion of their initial value. Regularly maintained roads and public buildings are an

obvious example⁽¹³⁾. But others may have ceased to provide a useful stream of benefits long before they disappear from the measured stock. Concorde, for example, arguably should never have been recorded as an asset.

38. Thus, there are conceptual and practical difficulties with measuring public sector capital in the context of a net worth criterion for public borrowing. They are, however, probably somewhat less severe in the case of flows - net investment - than in the case of stocks - capital, assuming depreciation and capital appreciation are broadly smooth. Although it seems unlikely that the level of the capital stock can be used operationally for deciding the appropriate level of public debt in the medium term, it may be possible to take account of trends and shorter-term movements in public net investment in assessing the appropriate PSBR path.

39. It should be noted that the implications of changes in public investment for the PSBR are essentially the same whether the change results from transactions in existing assets or from expenditure on new assets. An asset sale, for example, would have to be accompanied by a one-off reduction in the PSBR if the public sector's net worth was to be maintained unchanged. It would be necessary to leave the balance between present and future consumption unchanged; with a loss of income from the asset by the public sector offset by lower debt interest payments.⁽¹⁴⁾

(13) This example illustrates the general point that maintenance expenditure should in principle be added to investment expenditure, and both should be depreciated, in measuring capital stock, for these purposes. This is not, however, the convention adopted by the statisticians.

(14) Complications arise if ~~that~~ the sale price of the asset does not equal the capitalised stream of returns available to the public sector, perhaps because the prospective returns to the asset when in private hands are expected to be greater than when it was publicly owned. The net worth calculation would have to take account of this, and the appropriate change in the PSBR would not necessarily exactly equal the value of the asset sale.

North Sea Revenue

40. As already noted, the arguments in Section II apply also to North Sea revenues. There is a case for sharing the benefits of the North Sea with future generations, and for smoothing the path of tax rates. To simplify the discussion this section assumes that the aim is to share the benefits fully with future generations. However, it could be argued that only part of the benefits should be shared, with the rest being retained by the present generation as compensation for the transitional costs associated with the rise and fall of oil production.

41. Full sharing of the benefits suggests that present taxpayers should consume only the permanent income from the North Sea - ie the level of income which the North Sea could generate indefinitely, assuming the revenue was suitably invested - and save the remainder. This would permit some reduction in general taxation; but the PSBR would be lower than otherwise when actual revenues exceed permanent revenues, as at present. In the long run the stock of debt would be lower. Future generations would benefit from reduced debt servicing costs, permitting lower taxation (and higher consumption) within an unchanged PSBR.⁽¹⁵⁾

42. Translating this approach into quantitative form poses considerable difficulties, however. Total reserves from the North Sea are not known with certainty, and neither are oil prices and the rate of depletion. Estimates have to be based on long-term projections which are by their very nature extremely hazardous. A further complication is that both total economically viable oil reserves and the rate of depletion are to some extent dependent on the government's financial policies, as well as developments in the domestic and world economies. Nevertheless, it is possible to derive figures, based on reasonably plausible estimates of production, prices and tax rates, to illustrate the kind of calculation involved. This is done in a rough and ready way below.

(15) The effect on tax rates would not be entirely fixed under this approach, assuming a growing economy. The absolute reduction in taxation would be, however, implying a reduction in tax rates which diminishes as the economy grows.

43. The starting point is the projection of North Sea revenues in the 1985 MTFS. This is extended to 1993-94 along similar lines to the projection in the 1984 Green Paper on Public Expenditure and Taxation⁽¹⁶⁾, and then beyond that on the assumption that oil output ceases in around 2020. This resulting projection, described in detail in the Annex, is subject to great uncertainties, which increase as one moves further into the future. But it is sufficient to illustrate the broad implications of the approach described earlier for the appropriate PSBR path.

44. Using a real discount rate of $2\frac{1}{2}\%$, "permanent" revenue from the North Sea currently available to the public sector is put at £2³/₄ billion at 1985-86 prices, about $3\frac{3}{4}\%$ of GDP.⁽¹⁷⁾ This indicates the cut in taxation which would in principle be justified on the assumption that the benefits are fully shared with future generations. Comparing this with the estimate of actual revenue for 1985-86 in the FSBR -£13¹/₂ billion, or about $3\frac{3}{4}\%$ of GDP - implies that the PSBR should be about 3% of GDP lower than without the revenue. As revenues decline relative to GDP in subsequent years, the PSBR reduction also declines. The figures are summarised in the table below.

(16) "The Next Ten Years: Public Expenditure and Taxation into the 1990s"
H M Treasury, March 1984 (Cmnd 9189).

(17) Varying the precise assumptions in a plausible way would, of course, alter the calculations. Changing the discount rate by 1% would change the estimate of "permanent" revenues by around £1 billion per annum, or about $1\frac{1}{4}\%$ of GDP at current levels. Higher real oil prices and a less rapid decline in production would mean significantly higher revenues in the 1990s and early years of the next century, but given the overall profile, the effect on "permanent" revenue would be relatively muted.

North Sea Revenues, Debt, and the PSBR

£bn, 1985-86 prices	1985-86	1988-89	1993-94	2020-21
Actual revenue	13 ¹ / ₂	7 ¹ / ₂	6 ¹ / ₂	0
Permanent revenue/ reduction in taxes	2 ³ / ₄	2 ³ / ₄	2 ³ / ₄	2 ³ / ₄
Reduction in debt interest payments	-	3 ₄	1 ¹ / ₄	2 ³ / ₄
Reduction in PSBR	10 ³ / ₄	5 ¹ / ₂	5	0
Reduction in stock of Public Sector debt	10 ³ / ₄	31 ¹ / ₂	58	110

 Reduction in PSBR equals actual revenue plus debt interest saving
 less permanent revenue.

45. The temporary reduction in the PSBR indicated by this methodology relates to a baseline in which there is no North Sea oil and, for example, public investment is taken as given. In practice, if such an adjustment were implemented it would lead to lower interest rates and some combination of a higher domestic capital stock and a larger stock of overseas assets. Any reduction in the PSBR should therefore be less than one-for-one to the extent that lower interest rates make more public investment projects worthwhile.

Other Public Sector Assets and Liabilities

46. There are, of course, a number of other components of net worth that are not constant over time and that might be taken into account in assessing changes in public sector debt. One obvious example is the outstanding stock of loans to the private and overseas sectors (eg local authority mortgages, lending to industry, overseas aid). In principle they are very similar to fixed assets. Although they are absolutely small, they are not constant over time.

47. Another example which is more akin to North Sea oil revenues in that it is temporary rather than permanent is the cost of high unemployment. To the extent that unemployment is above the level sustainable in the longer term, perhaps reflecting structural changes in the world economy - due to

rapid technological change, oil price shocks, the emergence of newly industrialised economies, or the need to bring down inflation - there is a case for sharing the costs with future generations and smoothing out the path of tax rates over time. This would mean running a higher PSBR now, and building up debt while the transitional process lasts.

48. Unfunded pension arrangements such as the state scheme and some public sector occupational schemes provide another example. In many countries demographic changes foreshadow a significant increase in the burden of pensions in the next century. To the extent that these are provided by the state and are unfunded, this too provides a reason for running a lower PSBR than would otherwise be the case. The present SERPS arrangements in the UK, which involve a rapid build-up in unfunded pension liabilities, are a case in point. But the changes foreshadowed in the recent Green Paper on Social Security⁽¹⁸⁾ imply a shift to funding pensions explicitly in the private sector. The case for running a lower PSBR to finance future pension commitments would, under the Green Paper proposals, be significantly diminished.

Conclusions

49. These various arguments about the PSBR in the long term can be drawn together and illustrated with figures for recent years. Public sector net investment in the national accounts sense has averaged about [¹/₂%] of GDP in [the period 1980-84]. On its own, this might be taken to suggest that the PSBR should also be about [¹/₂%] of GDP in the absence of inflation. But a case can be made for a higher PSBR on the grounds that it is appropriate to borrow to finance some "consumption" expenditure and expenditure on unemployment. But against this the PSBR should arguably be lower because of "transitory" North Sea revenues (about 3% of GDP) and accruing unfunded pension liabilities. In addition, there may be a case for changing the PSBR to bring the initial level of net worth into line with the desired level, though it is not clear in which direction this effect points.

(18) Source

50. Inflation complicates the story somewhat. It affects some but not all elements of the public sector balance sheet. In particular most elements rise with inflation, but debt does not. Thus, if there is steady-state inflation of, say, 5% and the debt to GDP ratio is 50%, it is necessary to add $2\frac{1}{2}\%$ of GDP to whatever conclusion for the PSBR emerges from the calculation that ignores inflation.

51. The net effect of all these factors on the appropriate path of the PSBR in the long term cannot be assessed except on the basis of a number of necessarily arbitrary assumptions. Nevertheless, the analysis provides an analytical framework within which to consider the implications of developments such as the exploitation of North Sea oil, the abolition of SERPS and other factors. And it makes clear, for example, that a rule that relates the growth of debt to the nominal growth of the economy alone is a considerable over-simplification.

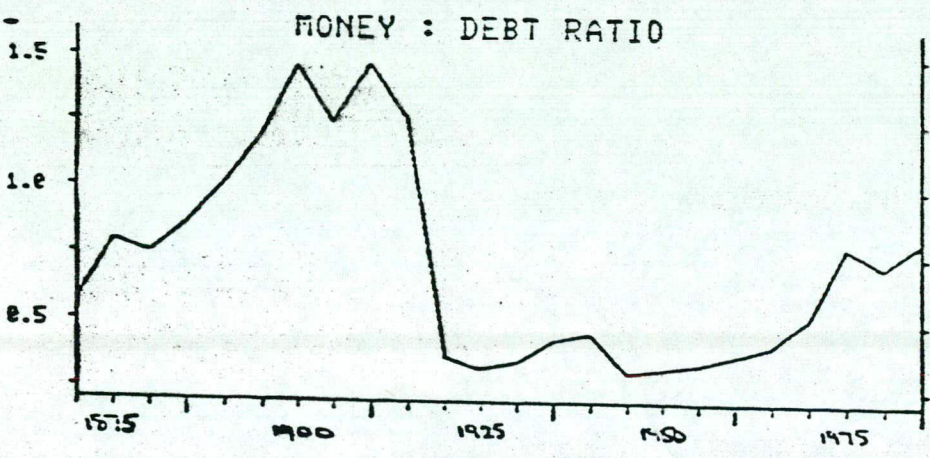
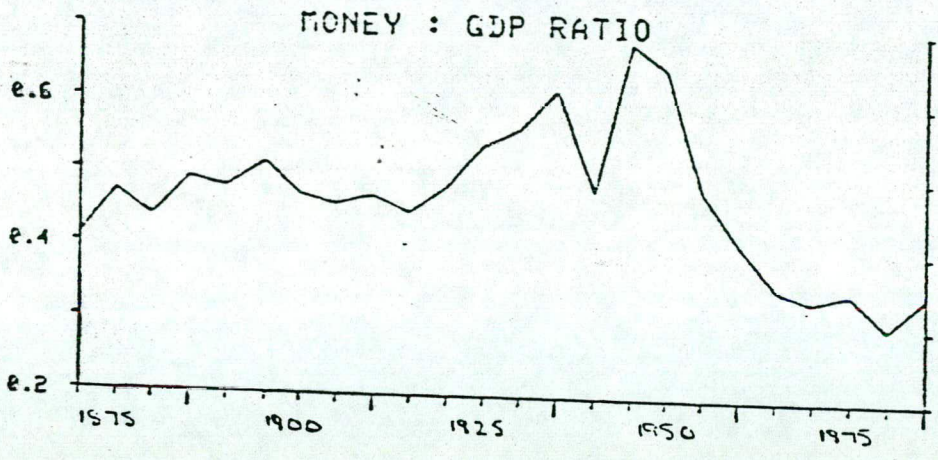
IV. THE MIX OF MONETARY AND FISCAL POLICY IN THE MEDIUM AND LONG TERM

52. The discussion so far in this paper has considered the evolution of government borrowing and debt in the light of the implications for investment and the inter-temporal distribution of consumption, and for tax rates. There has been no discussion of the way government borrowing is financed, and the monetary implications. The presumption has been that the debt issued is predominantly interest bearing, but there is a separate issue about the link between debt creation and monetary policy. Since the increased emphasis on control of monetary growth in the 1970s, the link between monetary and fiscal policy has occupied a more important place in analysis of the appropriate size of the PSBR.

53. The framework for analysing the links between monetary and fiscal policy is provided by the portfolios of the private sector. Government debt is a major component of private sector portfolios, together with overseas assets, and claims on fixed capital. For the non-bank private sector, money and bank loans are also major components. Portfolio shares can and do change significantly over time, as Chart 2 illustrates for the non-bank sector. In particular, money has not always grown at the same rate as government debt. Different relationships between the growth of money and debt imply different mixes of monetary and fiscal policy.

[Chart 2: Private Sector portfolio shares]

CHART 2



54. The choice of the monetary-fiscal policy mix in the long term therefore depends on the appropriate path of portfolio shares, especially the relative shares of debt and money. Alternatively the choice can be presented in terms of the pattern of relative interest rates which is most appropriate. High levels of the PSBR relative to the rate of monetary growth, for example, would tend to put upward pressure on long-term interest rates - particularly those on government debt - relative to short-term rates. They would also probably imply a falling share of overseas assets and a lower exchange rate in the long term.

X | 55. The simplest approach would be to assume unchanged portfolio shares. This might be justified on the grounds that, while shares may change in the medium term, trend changes in shares cannot be sustained indefinitely (except in the sense that they might asymptote to a fixed value). Simple calculations which assume fixed wealth/income ratios and fixed portfolio shares have been done for the UK by various authors.⁽¹⁹⁾ Taking a debt/income ratio of about 50% - roughly the current level - and assuming real growth of 2% per annum, indicates a PSBR of roughly 1% of GDP at zero inflation. This is the illustrative figure given in the Green Paper on Public Expenditure and Taxation.⁽²⁰⁾ It provides a simple "debtist" rule which is analogous to, and consistent with, a simple "monetarist" rule which says that 2% monetary growth is required to bring about zero inflation if the underlying rate of output growth is 2%.

56. But, in practice, portfolio trends can persist for long periods, justifying significant departures from the simple rules. For example, financial innovation in many countries has led to trend changes in the velocity of monetary aggregates. Institutional, tax and other changes can lead to progressive changes in the supply of particular forms of debt: an example is corporate debentures, which have effectively dried up in the UK and hence increased the share of government debt in private portfolios.

57. The natural approach is to set the mix of monetary and fiscal policies in the medium to long term so as to accommodate trends in portfolio preferences over time. The aim might be to maintain a structure of relative

(19) For example Congdon () and [].

(20) Paragraph 55, page 18.

yields, defined to include both nominal returns and valuation changes, that reflects only differences in the marketability and risk characteristics of different assets. Imbalances between the supply and demand for different assets that might tend to push the structure of yields away from this optimal pattern should not be allowed to persist into the long term. The result of such policies would be to maintain portfolio shares, in line with investors' preferences.

58. Departures from such policies will gradually distort portfolio shares and relative interest rates. Although the changes may take time to produce major distortions, the potential implications in the long run will be foreseen by financial market operators. Expectational influences will tend to bring forward effects which might otherwise build-up only over a long period of years. In practice, of course, much will depend on how the configuration of policies is seen in the markets, and whether it is expected to persist in the future. Perhaps only the US is in a position to impose substantial changes in portfolio shares for a sustained period without losing the confidence of the markets, because of the special role of the dollar. Overseas residents may well be prepared to accept large build-up of dollar assets for a considerable period, although the current US position is probably not ultimately sustainable.

59. The application of these general principles is not straightforward. Measurement of ex ante yields, including expected capital gains, is far from easy. And it is not straightforward to decide what pattern of relative interest rates would reflect only marketability and risk characteristics of assets. Looked at from the other side, desirable long-term trends in portfolio shares are not easy to identify directly, though past behaviour may provide some guide.

60. The analysis in earlier sections suggested a number of structural reasons why changes in the ratio of public sector debt to income may be appropriate, but did not discuss the implications for monetary policy. Although the earlier analysis indicated that lower public sector debt would be accompanied by an increase in the domestic capital stock and higher stocks of overseas assets, there is no clear message about changes in the shares of other assets. Probably the most neutral assumption is that a downward adjustment to the PSBR, leading to lower accumulation of domestic

financial assets generally, would point to lower growth of broad money. But while this conclusion may be qualitatively fairly robust, its implications in quantitative terms are difficult to assess in practice.

61. To sum up this section, there is a need to ensure that monetary and fiscal policies are in harmony in the medium to long term, irrespective of the paths of asset accumulations and debt implied by the analysis in earlier sections. This effectively means not distorting portfolio shares. Simple rules for the PSBR and monetary growth, based on existing shares and ratios to GDP and an assumed path for money GDP, typically have to be modified to allow for trends in the desired ratio of debt to GDP and medium-term trends in portfolios due to institutional and other changes.

V. MONETARY AND FISCAL POLICY IN THE SHORT TERM

62. The discussion so far has been concerned with the paths for government debt and portfolio shares in the long term. This section discusses policies that give rise to variations in debt and portfolio shares around these paths.

The Scope for Short-term Variations

63. Fluctuations in portfolio shares and deviations of government debt from a desired long-term path for just a few years are not likely to have serious destabilising effects, or to jeopardise long-term objectives. Similarly interest rates and exchange rates that are different from those compatible with portfolio balance and the desired path for debt are also tolerable for limited periods.

64. However, any purely short-term deviations have to be reversed at some stage. If the PSBR is temporarily above the path consistent with longer-term objectives, so that debt is growing more rapidly than desired, there should be an offsetting period of a lower-than-trend PSBR so as to bring the stock of debt back to the desired path. Similarly, if monetary growth is temporarily high in relation to the growth of total portfolios, this must be followed by a period of relatively slow monetary growth. Reversing these short-term deviations will eliminate any temporary deviation of interest rates and exchange rates from the desired path.

65. The need to reverse any purely short-term changes in the overall stance of policy and the fiscal/monetary mix places some bounds on the scope for policy adjustments in the short term. Governments would be unwise to make supposedly short-term changes that were difficult to reverse in the future. Three other factors strengthen the case for a cautious approach. First, the nature of any shock hitting the economy and calling for a policy adjustment cannot always be fully assessed at the time. Secondly, since fiscal and monetary policy changes in the short term have to be largely reversed in time, usually only those shocks which are themselves thought to be temporary should be met with a temporary policy adjustment. Thirdly, economic agents, especially financial markets, may doubt the ability or willingness of the government to reverse short-term policy changes, especially when those changes are large. Their behaviour may force the government to change course before the effects of the policy changes have been felt.

66. Nevertheless there is clearly some room for changes in the stance and mix of policy in the short term. Policy responses to cycles in economic activity and temporary shocks hitting the economy are obvious examples. In many cases it might be appropriate to change the overall stance of policy without altering the mix of monetary and fiscal policies. In other cases changes in the mix might be desirable. Before discussing possible policy responses to cycles and shocks, we look at the effects of changes in the stance and mix of fiscal and monetary policies.

The Effects of Changes in Monetary and Fiscal Policies

67. A change in the overall stance of monetary and fiscal policies, with both expanding or contracting to the same extent, tends to change both output and inflation in the same direction in the short term⁽²¹⁾. In most

(18) There is no unambiguous way to define a balanced change in monetary and fiscal policies. It could be defined as equal growth in debt and money, or as no change in the pattern of relative yields. The two will not necessarily be the same because of differential changes in factors other than yields that affect the demand for debt and money: wealth and income, for example.

theoretical models, except those with no supply constraints at all, most of the output gains following an expansionary change are temporary⁽²²⁾. Most of the increase in prices is, however, permanent.

68. A change in the mix of monetary and fiscal policies, for a given overall stance of policy, will not necessarily change output and inflation in the same direction in the short term. If the output-inflation trade-offs associated with fiscal and monetary policies are different, there may be a tendency for output and inflation to move in opposite directions. Thus if fiscal policy produces a smaller impact on inflation for a given change in output than monetary policy, a fiscal expansion associated with a monetary contraction may lead to both higher output and lower inflation in the short term. Most theoretical models suggest that such a policy combination will not be stable or sustainable in the long term.

69. The Treasury model shows this kind of behaviour in the short term. The output-inflation trade-off is weaker (in the sense of a smaller change in inflation for a given change in output) for fiscal policy changes than for monetary policy changes. This is mainly because fiscal policy has a smaller impact on the exchange rate than changes in interest rates, and the exchange rate has a relatively big impact on prices. A simulation illustrating this property is presented in Table 1 (Panel A). It shows a fiscal expansion (lower income tax) combined with a monetary contraction (higher short-term interest rates), so as to leave nominal GDP unchanged. The exchange rate rises, inflation falls initially and GDP rises in the short term.⁽²³⁾⁽²⁴⁾

(22) Some permanent increase in output may occur if the capital stock rises during the period of temporarily higher output. On the other hand output may end up permanently lower if the higher inflation reduces the efficiency of the economy and/or the level of investment.

(23) No importance should be attached to the precise numbers or dynamics. To keep nominal GDP unchanged from quarter to quarter it was necessary to move interest rates every quarter, thus producing an uneven path for some variables, especially the exchange rate.

(24) The use of income tax as the fiscal policy instrument produces slightly different results from those associated with other tax or expenditure changes.

70. The simulation in Table 1 (Panel A) implicitly assumes that financial markets expect the monetary contraction to be sustained. But they might doubt the sustainability of the policy mix and instead expect that the fiscal expansion will be accommodated at some stage by higher monetary growth and hence inflation. Their expectations of higher inflation may cause a downward movement in the exchange rate and, assuming that the authorities seek to maintain the path of monetary GDP an upward movement in short-term interest rates.

71. This case is illustrated in Panel B of Table 1 which compares two simulations, with and without expectations of monetary accommodation. In both simulations there is a fiscal expansion (lower income tax) and a monetary contraction (higher short-term interest rates) and the path of money GDP is kept unchanged. The one without expectations of monetary accommodation shows the same picture as Panel A. The other simulation shows that, the picture is now reversed. Output now falls while inflation increases. The fall in the exchange rate, which is larger ex ante than ex post, is the main reason for this⁽²⁵⁾.

(25) Again, no importance should be attached to the precise numbers or dynamics

Table 1

Effects of Change in the Fiscal-Monetary Policy Mix:

Different Market Reactions⁽¹⁾

(Changes from Base)

	Year 1	Year 2	Year 3
A. <u>No monetary accommodation expected⁽²⁾</u>			
Short-term interest rates (% points)	0.9	0.9	1.2
Real GDP (% of base)	0.2	0.4	0.6
Inflation ⁽³⁾ (% points)	-0.2	-0.2	-0.2
Exchange rate (% of base)	1.1	-0.1	0.7
B. <u>Monetary accommodation expected⁽²⁾</u>			
Short-term interest rates (% points)			
Real GDP (% of base)			
Inflation ⁽³⁾ (% points)			
Exchange rate (% of base)			

⁽¹⁾Policy mix changed by reducing income tax so as to increase ex post PSBR by 1 percentage point of GDP throughout, while varying short-term interest rates so as to keep money GDP unchanged.

⁽²⁾In B it is assumed that financial markets expect that the fiscal expansion will eventually be accommodated by a monetary expansion (ie that the change in mix will not be sustained, and that the overall policy stance will be altered). [Technical statement about what was imposed on simulation.] In A no adjustments to the pure Treasury model simulation were made.

⁽³⁾GDP deflator.

Responses to Cycles and Shocks

72. It is helpful to consider the implications of this sort of analysis for short-term policy responses. Deviations of the economy from the path considered appropriate in the medium term may well call for a policy response, and the nature of the deviation may affect what sort of response is appropriate. We consider essentially temporary deviations, and assume that confidence in the overall stance of policy remains unchanged.

73. For illustrative purposes, and to link back to the simulation results, we can consider deviations in money GDP from a medium-term path. An increase in money GDP above this path would call for a tightening of the stance of policy. This could entail either some increase in interest rates or a tightening of fiscal policy, or both. But given that prices and output are important in their own right, different types of money GDP change may call for different mixes of monetary and fiscal response.

74. Consider first deviations which are predominantly associated with movements in real GDP, with relatively little contribution from prices. The analysis above suggests a primarily fiscal response, as long as confidence can be maintained, since this would have a relatively large effect on output in relation to prices. This points to a PSBR change accompanied by relatively little change in real interest rates, with rising real and money GDP implying a fall in the PSBR.⁽²⁶⁾ In such circumstances there is a case for making the change in the PSBR roughly equal to the automatic effect of higher output - ie leaving some measure of the "cyclically-adjusted" PSBR relatively little changed - since this would avoid distortions due to changing tax and benefit rates.⁽²⁷⁾

(26) Such a response presumes that the change in GDP is not primarily a shift in the supply side, which would alter the desirable path of the economy in the medium term.

(27) For each 1% increase in GDP relative to trend, simulations on the Treasury model suggest that the PSBR would be reduced by $\frac{1}{4}$ - $\frac{1}{2}$ % of GDP at unchanged tax and benefit rates.

75. Next, we consider changes which take the form primarily of price movements, with relatively little movement in output. In this case a predominantly monetary response is suggested by the earlier analysis, since this would have a relatively large effect on prices in relation to output. This would point to leaving the nominal PSBR unchanged, while using interest rates to bring the economy back closer to the desired path. [This provides a good example of a situation in which the cyclically adjusted PSBR may be misleading. A rise in wage inflation, for example, leading to a fall in output would indicate a rise in the PSBR in ^{nominal} normal terms if it is to be held fixed in cyclically adjusted terms. But this would in effect mean accommodating higher inflation and higher growth in money GDP.]

Adjustments to the PSBR

76. Adjustments to the PSBR or the public sector financial deficit are sometimes made in order to produce a measure that is regarded as a better indicator of fiscal stance than the unadjusted PSBR. Three types of adjustment are common: the weighting of components of changes in the PSBR in accordance with their assumed impact on demand; the removal from changes in the PSBR of that part which is attributable to cyclical fluctuations in economic activity; the deduction from the PSBR of inflation tax on existing public sector debt.

77. These adjustments are all aimed at producing an indicator which measures the impact of fiscal policy more satisfactorily. In principle they could be helpful. But in practice there are many conceptual and measurement difficulties which generally make the resulting indicators unsatisfactory in certain respects. And their usefulness, even ignoring measurement difficulties, depends on the particular circumstances in which they are employed.

78. Take demand-weighting first. The idea here is to weight each element of the PSBR in terms of its effect on real demand, though the principle could easily be extended to cover other effects of fiscal policy - say inflation effects. Changes in different taxes and expenditure items do, of

course, have different effects on real demand.⁽²⁸⁾⁽²⁹⁾ In principle the demand weights that are used could reflect whatever accompanying monetary policy and set of financial market reactions were thought to be appropriate.⁽³⁰⁾ In practice, most demand-weighted measures assume an accommodating monetary policy without any such anticipatory behaviour by financial markets. But any assumption is essentially arbitrary, and not necessarily appropriate to the particular circumstances involved.

79. Another problem with demand-weighting is that effects on demand vary over time. Often, demand-weighted measures ignore this, taking account only of the first-round impact of changes in taxes and expenditure after allowing for saving and import leakages or focussing on effects in a single time period. By ignoring the full implications of lags and second round effects, time-series of demand-weighted deficits typically do not represent accurately the effects on demand of fiscal policy. And, of course, they completely ignore other effects of fiscal policy, such as those on inflation.

80. Cyclically-adjusted measures are designed to distinguish "discretionary" from "automatic" changes in the observed deficit. But again, these are subject to many difficulties. First, there is in general no firm basis on which to make an objective distinction between discretionary and automatic changes. The measures usually assume that the "cycle" accounts for changes in the deficit associated with output growth

(26) Savage (1982) sets out the weights used by the National Institute. They range from zero for current grants paid ahead to 90% for current expenditure on goods and services, with oil taxes (20%) and most other taxes (59%) in between.

(27) Use of the financial deficit rather than the PSBR is sometimes justified in terms of demand weighting since many of the financing items that enter the PSBR but not the PSFD - asset sales for example - probably have only a small impact on real demand.

(28) If, for example, monetary policy was generally non-accommodating it would be appropriate to assume that a fiscal expansion would produce higher interest rates which would offset part of the direct impact on demand. Even if it was accommodating, financial markets might anticipate the higher inflation and raise interest rates anyway.

greater or less than some assumed trend⁽³¹⁾. But the choice of trend in the recent past, particularly within a cycle, is inevitably somewhat arbitrary, and so therefore is the cyclical adjustment. Furthermore, the extent to which interest rate changes should be considered automatic or discretionary over the cycle is another difficult issue on which arbitrary judgements have to be made.

81. A further problem is that measures of the cyclically adjusted deficit depend critically on the structure of tax and benefit rates in the economy. Economies with different fiscal structures may exhibit quite different paths for the cyclically adjusted deficit, even if the paths of the unadjusted deficit and the behaviour of the economies generally are otherwise identical. A measure that only allows for discretionary changes in the deficit may therefore have little bearing on the total effect of fiscal policy on the economy⁽³²⁾.

82. There is also no unambiguous measure of the inflation-adjusted deficit. Different variants are possible depending on whether the inflation tax is defined to depend on actual inflation or on the difference between the effective nominal interest rate paid on government debt and some assumed real interest rate; and depending on the measure of debt used in the calculation⁽³³⁾. In principle one might also wish to allow for the possibility that the impact on demand of changes in the inflation tax may be different from the impact of other changes in the PSBR. Some measures do allow for this and some do not⁽³⁴⁾.

(31) See, for example, Savage (1982), Muller and Price (1984), and IMF (1985).

(32) However, as noted earlier, stabilising tax rates may be considered desirable in its own right for reasons of efficiency. But this is essentially a micro-economic consideration, whereas cyclically adjusted deficits are normally used in a macro-economic context.

(33) See, for example, the recent discussion by Miller (1985).

(34) The inflation-adjusted demand-weighted deficit used by the National Institute attaches a weight of 20% to the inflation tax (Savage (1982)).

Use of Adjusted Measures for Setting Policy

83. Thus there are difficulties with both the definition and measurement of adjusted measures of the fiscal deficit. A more important question, however, is how far indicators that are primarily descriptive can be used in a prescriptive role. There has been a tendency for some commentators on fiscal policy to suggest implicitly that fluctuations in adjusted measures should be avoided, or that the aim should be to keep the adjusted PSBR or financial deficit close to some previously specified level. But it is not possible to formulate general rules of this type for the adjusted PSBR without regard to other considerations, such as the appropriate long-term PSBR, the desired evolution of the economy in the short term, and the nature of disturbances to the economy.

84. In general, the optimal PSBR in the long term, even with no inflation, will be non-zero, and perhaps changing slowly over time. There is thus no presumption that particular adjusted measures should remain zero or even fixed in the long term. Moreover, the discussion in this section suggests that they should also not be fixed in the short term relative to their long-term values.

85. Thus, for example, cyclically and inflation-adjusted PSBRs should not be fixed in response to cycles or other disturbances arising from the price side. A rise in inflation would tend to reduce the inflation-adjusted PSBR, and also output and hence the cyclically-adjusted PSBR. It would clearly be incorrect to respond to such a disturbance by seeking to restore either of these adjusted PSBRs to their original values, since that would involve a further expansion of nominal demand when it would be more appropriate to keep it under control.

86. On the other hand, it may be appropriate to keep the cyclically-adjusted PSBR constant in the face of temporary fluctuations in output originating from real changes. Allowing the automatic stabilisers alone to work means that tax and benefit rates are unchanged and distortions minimised, and it avoids the need to take a view - which would sometimes turn out to be wrong - about how much of the change in economic activity was essentially temporary and therefore an appropriate target of offsetting action.

87. But, in general, adjusted measures of the PSBR or the financial deficit do not provide any guidance to fiscal policy changes in the short term, although they may be useful indicators in some circumstances. In assessing short-term changes in the mix of fiscal and monetary policies, there is really no alternative to analysing all the circumstances surrounding each situation.

VI. SUMMARY

88. The main points that emerge from this paper are as follows:-

a. Economists before Keynes were mainly concerned with the structural implications of budget deficits and public debt. After Keynes, increasing attention was paid to the relationship between deficits and aggregate demand in the short term. Now long-term issues have re-emerged. The paper considers both the long term and the short term.

b. Public sector borrowing can be used to optimise the distribution of consumption over time and to avoid unnecessary changes in tax rates.

c. This would be achieved if the path for government debt were set so that the net worth of the public sector was unchanged. Debt would therefore alter in line with movements in other assets and liabilities such as the capital stock of the public sector, the "stock" of North Sea revenues and unfunded state pension liabilities.

d. There are considerable practical difficulties with such a policy because of problems with defining and measuring the appropriate concept of public sector capital stock and other assets and liabilities. Nevertheless the analytical framework is helpful.

e. Monetary and fiscal policies need to be in harmony in the medium to long term. This means that portfolio shares should not deviate too much from the long-term trends caused by financial

innovation, institutional change and changes in portfolio preferences. Simple rules for the PSBR and monetary growth, based on existing shares and ratios to GDP, typically have to be modified to allow for trends in the desired ratio of debt to GDP and in portfolio shares.

f. Short-term deviations in the PSBR and monetary growth from their long-term paths can be accepted, though they generally need to be reversed. They should not be too large because: bigger changes are more difficult to reverse than smaller ones; it may be difficult to judge whether a disturbance is going to be temporary or not; and financial markets may lose confidence in the sustainability of policy.

g. Responses to short-term fluctuations and temporary shocks depend on the source of the disturbance. Changes in the PSBR are a more appropriate response to movements in output than to movements in prices.

h. Maintaining an unchanged cyclically-adjusted PSBR in the face of fluctuations in output might sometimes be a sensible policy, particularly if the cycle originates from the real side. But there are severe difficulties of measurement.

j. Maintaining an unchanged cyclically-adjusted or inflation-adjusted PSBR is not a sensible policy if the aim is not to accommodate shocks to the inflation rate.

CONFIDENTIAL

From: SIR PETER MIDDLETON

Date: 13 June 1985

MR ODLING-SMEE

cc Sir T Burns
Mr Bailey
Mr Anson
Mr Byatt
Mr Scholar
Mr Spackman
Mr Watson
Mr Mowl
Mr Riley
Ms Seammen
Mrs Holmans
Mr Hood
Mr Pratt
Mr Ritchie
Mr Short
Mr Spencer

MACRO-ECONOMIC EFFECTS OF PENSION PROPOSALS

Thank you for your minute of 11 June and the attached paper which is very helpful. I think we can call this a draw! I still find it a bit difficult to believe that market imperfections will lead to greater savings. But unless we can be sure of this, offsetting action on the lines of paragraphs 7 and 8 of your minute looks doubly dangerous. I wonder how in practice these considerations will be brought to bear on the forecasting/policy decision process for macro management.

Peter Middleton
PP (Private Secretary)
P E MIDDLETON

COVERING CONFIDENTIAL & PERSONAL

Cl.
Comments?

Shaw? OK
prop.

FROM: MISS M E PEIRSON
DATE: 17 June 1985

Rh.
17/6.

PPS/CHANCELLOR

cc Mr Cassell

DRAFT PRESS BRIEFING ON PSBR IN MAY

I attach the draft press briefing on the PSBR in May, for tomorrow's publication. The aim is to circulate the briefing to List A recipients by 10.30 am tomorrow. Any comments which the Chancellor might have can be taken on board provided you can let Mr Clark (ext 3093) have them before 9.30 am tomorrow, and earlier if possible.

M.E.P.

MISS M E PEIRSON

COVERING CONFIDENTIAL & PERSONAL

FROM: MISS M E PEIRSON
DATE: 17 June 1985

- 1. MR CASSELL *not seen in draft*
- 2. CHANCELLOR OF THE EXCHEQUER

Ther...
M...
minutes one
R.

gone

Copy, with PPS letter, attached for:

Mr Turnbull - No 10

cc List A

List B (distributed at 2.30 pm, 18 June)

Sir P Middleton
Sir T Burns
Mr H Evans

Chief Secretary
Financial Secretary
Economic Secretary
Minister of State

Mr Peretz
Mr Mowl
Mr Stibbard
Mr M Williams
Mr Powell
Mr Cropper
Mr Wells - CSO
Mr Walton - IR
Mr Wilmott - C & E

Mr Lankester
Mr *L Watts*
Mr Devereux
Dr Webb

Mr Bailey
Mr Odling-Smee
Mr Scholar
Mr Burgner
Mr Folger

MONTHLY NOTE ON THE PSBR

1. I attach a report on the PSBR outturn for May. This outturn will be published by press notice at 2.30 pm tomorrow, 18 June.

2. In this note, as usual, outturn in the latest month (May) is compared with the forecast made a month ago. Outturns for April and May together are compared with the Budget profile. Forecasts for June-August are also included.

3. The press notice is confined to comparisons between outturn in 1985 and outturn in 1984. In addition, as last month, the press briefing will warn that the normal degree of front-end-loading of the PSBR may be expected in 1985-86.

MEP

MISS M E PEIRSON

PUBLIC SECTOR BORROWING

Summary

- The PSBR for May is provisionally estimated at £1.0 billion, about £0.2 billion lower than last month's forecast. Lower than expected borrowing on central government's own account and by public corporations was partly offset by higher net local authorities' borrowing.

- Borrowing in the first two months of 1985-86 (£2.8 billion) was £0.7 billion lower than the Budget profile (Chart 1) and £0.8 billion lower than in April-May 1984 (Chart 2).

- The PSBR is forecast at £2 billion over the next three months, to bring the total for the first five months of 1985-86 to £4¾ billion, £½ billion below the Budget profile.

Figures in this report are not seasonally adjusted and also may not sum precisely because of rounding.

Chart 1 : Comparisons with Budget profiles for 1985-86

£ billion cumulative

- = 1985-86
- - - = Latest forecasts
- = Budget profile

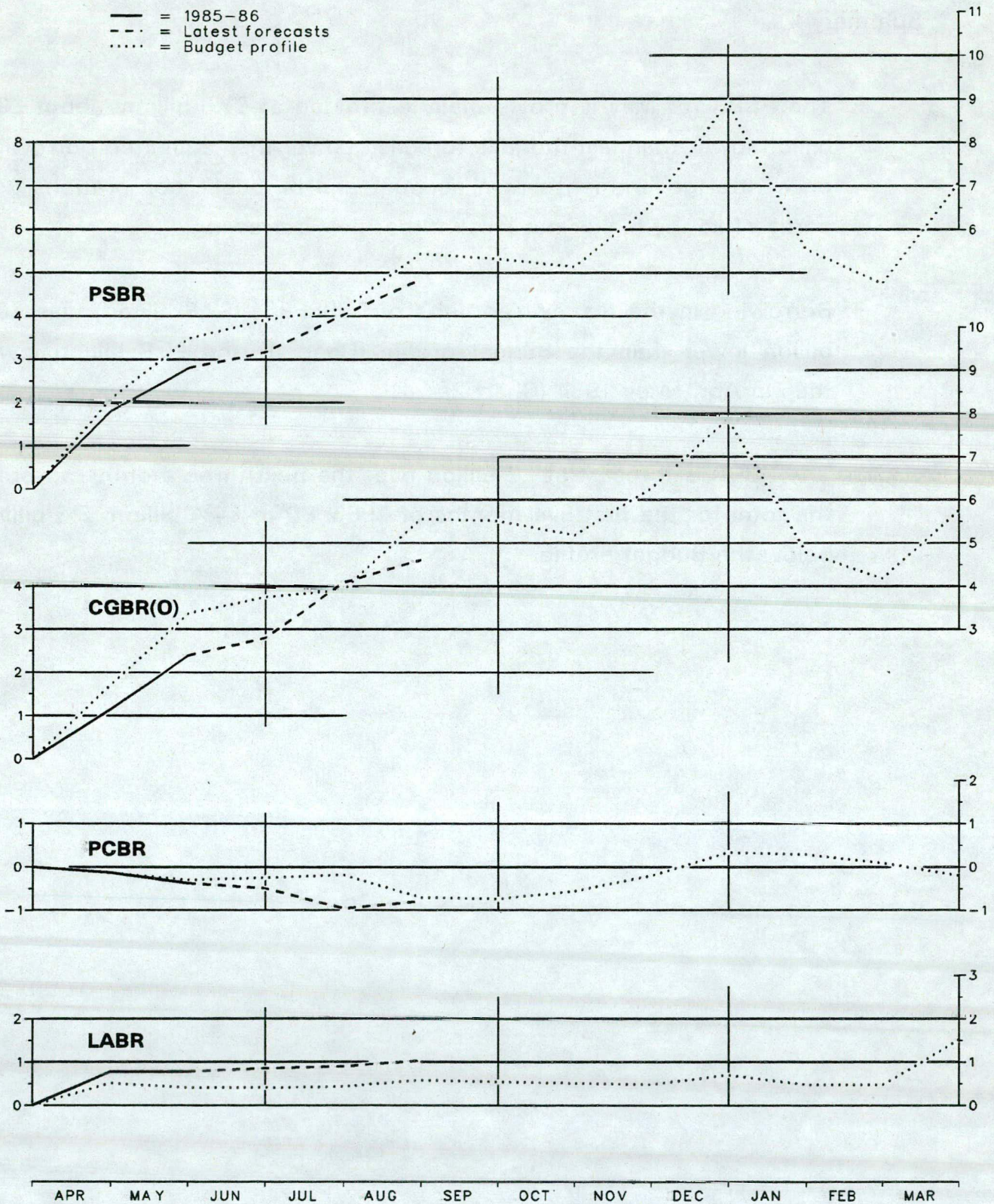
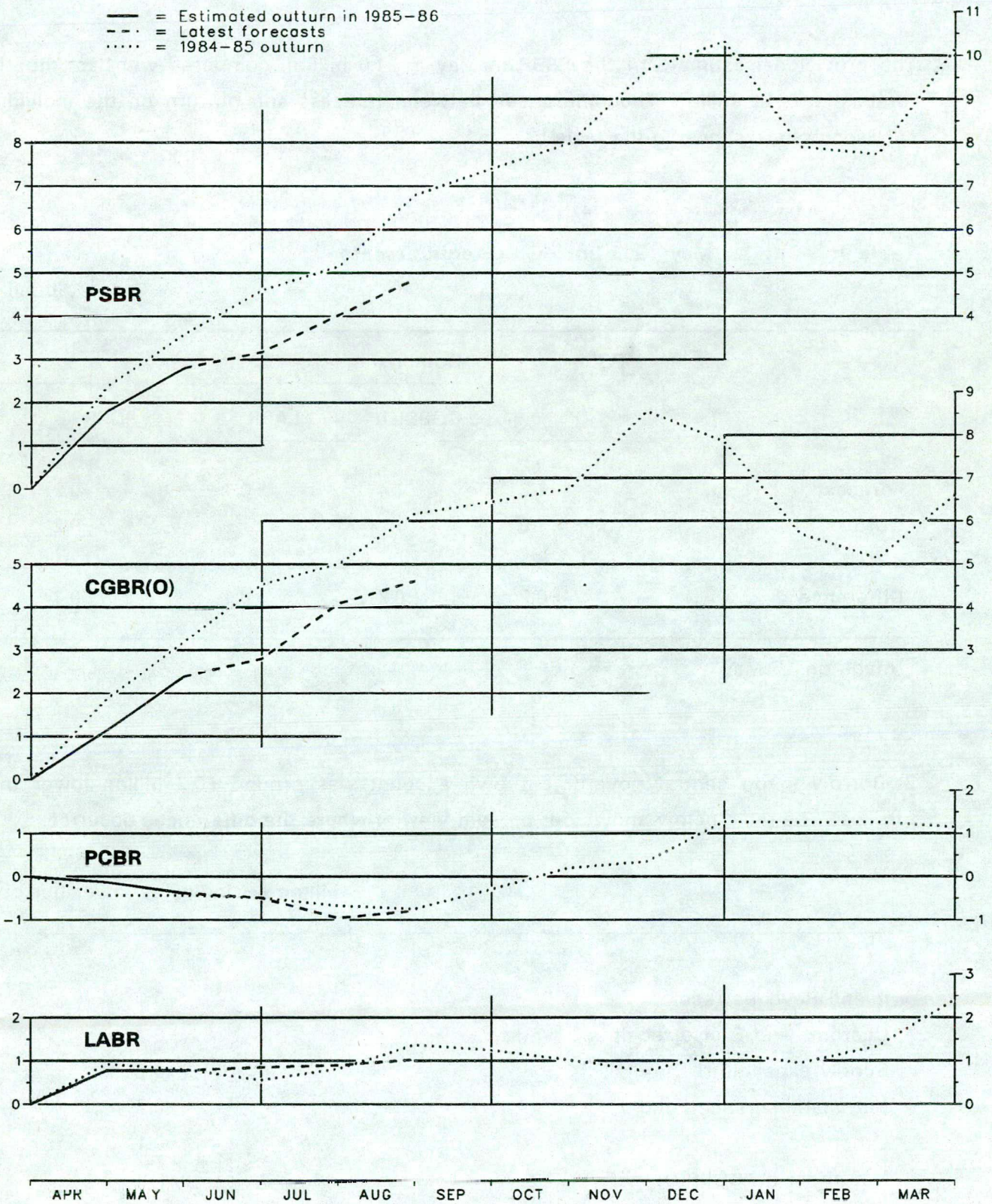


Chart 2 : Comparisons with last year's outturns

£ billion cumulative

- = Estimated outturn in 1985-86
- - - = Latest forecasts
- = 1984-85 outturn



Borrowing in May

(Comparisons in this section are with last month's forecast)

The provisional estimate of the PSBR in May is £1.0 billion, compared with last month's forecast of £1.2 billion. The differences between forecast and outturn on the individual sub-sectors are shown in the table below.

Table 1: May 1985 borrowing requirements

	£ billion			
	PSBR	Comprising		
		CGBR(O)	LABR	PCBR
Forecast*	1.2	1.4	-0.1	-0.2
Outturn	1.0	1.2	-	-0.2
Difference	-0.2	-0.2	0.1	-0.1

*made on 16 May

2. Borrowing on central government own account was around £0.2 billion lower than forecast. The table below shows our present view of where the differences occurred.

£ billion (- indicates lower borrowing)

Inland Revenue receipts	+0.1
Customs and Excise receipts	-0.2
Supply expenditure	+0.2
National Insurance Fund	-0.2
Other	-0.1
Net effect on CGBR(O)	-0.2

3. Lower Inland Revenue receipts in May offset the higher receipts in April. Customs and Excise receipts in May from VAT and tobacco duty were each £0.1 billion higher than forecast. Higher supply expenditure, due mainly to MOD procurement and health, largely offset the shortfall in April. The larger than expected surplus on the National Insurance Fund resulted from higher contributions, but this is thought to reflect a timing change.

4. The local authority account is provisionally estimated to have been in exact balance in May, compared with last month's forecast of a net debt repayment of £0.1 billion. This error is small in relation to the normal monthly variation in borrowing.

5. Public corporations made a net repayment of debt of £0.2 billion in May, close to last month's forecast. A major influence on the outturn was a repayment of over £0.1 billion by the Electricity Council following high receipts from customers in the month.

April and May

(comparisons in this and following sectors are with the Budget profile)

Table 2: Total April-May borrowing requirements

£ billion

	PSBR	Comprising		
		CGBR(O)	LABR	PCBR
Budget forecast	3.5	3.4	0.4	-0.3
Outturn	2.8	2.4	0.8	-0.4
Difference	-0.7	-1.0	0.4	-0.1

6. The cumulative PSBR for the first two months of 1985-86 was £2.8 billion. This is about £0.7 billion below the Budget profile (see Chart 1 and Table 2) and about £0.8 billion below

the same period last year (Chart 2), when the April PSBR was unusually large.

7. Cumulative borrowing in April and May on central government's own account was £1.0 billion lower than the Budget profile. The main reason is higher Customs and Excise receipts (by £0.5 billion). Some of this is expected to unwind in the next few months, but a somewhat higher level of VAT is expected to continue. Other factors which reduced borrowing in April and May were lower supply expenditure (by £0.2 billion), a larger surplus on the National Insurance Fund (by £0.2 billion), and higher interest receipts.

8. Local authorities borrowed £0.8 billion in April and May, some £0.4 billion more than in the Budget profile. Borrowing in April was particularly high, possibly because of a spillover from 1984-85.

9. Public corporations made a net repayment of debt of £0.4 billion in April and May, close to the Budget profile.

June to August

10. The PSBR in the period June to August is forecast to be £2 billion, bringing the total for the first five months of 1984-85 to £4¾ billion, £½ billion under the Budget profile.

11. Table 5 shows the latest detailed profile of borrowing on central government own account for June to August; a comparison with the Budget forecast for the first five months and the outturn in April-August 1984 is provided in Table 6.

12. The forecast for June-August is close to the Budget profile. Lower Customs and Excise receipts (by £0.2 billion offsetting some of the extra receipts in April and May), lower receipts from asset sales (by £0.3 billion due to different assumptions about timing), and a lower surplus on the National Insurance Fund (by £0.1 billion), are offset by lower supply expenditure (by £0.5 billion, partly reflecting the lower grant to the NCB), and higher Inland Revenue receipts (by £0.2 billion).

13. The monthly path of the CGBR(O) is as follows.

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- In June, the CGBR(0) is forecast to be £½ billion. The second call on BT shares will bring in £1¼ billion. Debt interest payments are low.
- In July, the CGBR(0) is forecast to be £1¼ billion. Supply expenditure will be fairly high, with a £½ billion grant to the National Coal Board (this grant, previously scheduled for August, will be used to repay NCB borrowing from central government during the coal strike and will not affect the PSBR); debt interest payments are also high. Partly offsetting these, Inland Revenue receipts will be high, including the second instalment of schedule D tax from the self-employed (£1 billion), quarterly advance corporation tax (£½ billion) and the first payment of banks' composite rate tax (£¼ billion).
- In August, the CGBR(0) is forecast to be £½ billion. VAT receipts will be high (as in February, May, and November).

14. Local authorities are expected to borrow about £¼ billion over the next three months, as in the Budget profile. In previous years, local authorities have on average been small net repayers of debt over the three months June–August. A markedly different pattern is expected this year because since 1 April 1985 large non-domestic ratepayers have had the right to pay rates by monthly instalment. However, forecasting changes in behaviour is always hazardous.

15. Public corporations are expected to show a net repayment over the next three months, as in the Budget profile, with a large repayment of £½ billion by the National Coal Board in July (on receipt of a deficit grant, see paragraph 13).

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Table 3: Latest monthly profiles
(Budget profiles in italics for comparison)

£ billion

	PSBR		Comprising					
			CGBR(O)		LABR		PCBR	
1985-86								
Apr	1.8	<i>2.1</i>	1.1	<i>1.7</i>	0.8	<i>0.5</i>	-0.1	<i>-0.1</i>
May	1.0	<i>1.4</i>	1.2	<i>1.6</i>	-	<i>-0.1</i>	-0.2	<i>-0.2</i>
Jun	0.4	<i>0.4</i>	0.4	<i>0.4</i>	0.1	<i>-</i>	-0.1	<i>0.1</i>
Jul	0.9	<i>0.3</i>	1.3	<i>0.2</i>	-	<i>-</i>	-0.5	<i>0.1</i>
Aug	0.8	<i>1.3</i>	0.5	<i>1.6</i>	0.1	<i>0.2</i>	0.2	<i>-0.5</i>
Cumulative								
Apr	1.8	<i>2.1</i>	1.1	<i>1.7</i>	0.8	<i>0.5</i>	-0.1	<i>-0.1</i>
May	2.8	<i>3.5</i>	2.4	<i>3.4</i>	0.8	<i>0.4</i>	-0.4	<i>-0.3</i>
Jun	3.2	<i>3.9</i>	2.8	<i>3.8</i>	0.9	<i>0.4</i>	-0.5	<i>-0.2</i>
Jul	4.0	<i>4.2</i>	4.1	<i>3.9</i>	0.9	<i>0.4</i>	-1.0	<i>-0.2</i>
Aug	4.9	<i>5.4</i>	4.6	<i>5.6</i>	1.0	<i>0.6</i>	-0.8	<i>-0.7</i>

Figures for April and May are outturns

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Table 4: PSBR for 1985-86 - Comparisons with 1984-85 and Budget profile

£ billion

	1984-85	1985-86	Differences from		
	Outturn	Budget profile	Latest update ⁽¹⁾	1984-85 outturn	Budget profile
	1	2	3	3-1	3-2
Apr	2.4	2.1	1.8	-0.6	-0.3
May	1.2	1.4	1.0	-0.2	-0.4
Jun	1.0	0.4	0.4	-0.7	-0.1
Q2	4.6	3.9	3.2	-1.4	-0.7
Jul	0.6	0.3	0.9	0.3	0.6
Aug	1.6	1.3	0.8	-0.8	-0.5
Sep	0.6	-0.1			
Q3	2.8	1.4			
Oct	0.6	-0.2			
Nov	1.7	1.4			
Dec	0.7	2.4			
Q4	2.9	3.6			
Jan	-2.4	-3.4			
Feb	-0.2	-0.8			
Mar	2.4	2.3			
Q1	-0.2	-1.8			
Cumulative					
Apr	2.4	2.1	1.8	-0.6	-0.3
May	3.6	3.5	2.8	-0.8	-0.7
Jun	4.6	3.9	3.2	-1.4	-0.7
Jul	5.2	4.2	4.0	-1.1	-0.1
Aug	6.8	5.4	4.9	-1.9	-0.6
Sep	7.4	5.3			
Oct	8.0	5.1			
Nov	9.7	6.5			
Dec	10.3	8.9			
Jan	7.9	5.6			
Feb	7.7	4.8			
Mar	10.2	7.1			

⁽¹⁾Figures for April and May are outturns

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**Table 5: Central government transactions – May
outturn and latest forecasts for June–August**

£ billion

	May		Latest forecasts		
	forecast	outturn ⁽¹⁾	Jun	Jul	Aug
Receipts					
<i>Consolidated Fund</i>					
Inland Revenue	3.7	3.6	3.2	5.4	3.7
Customs and Excise	2.9	3.1	2.5	2.8	3.4
Other ⁽²⁾	1.4	0.9	1.8	0.8	1.4
<i>National Loans Fund</i>					
Interest etc. receipts	0.5	0.5	0.6	0.4	0.4
Total Receipts	8.3	8.0	8.1	9.4	8.9
Expenditure					
<i>Consolidated Fund</i>					
Supply expenditure ⁽³⁾	7.6	7.8	7.3	8.5	7.8
Adjustment to Supply Services basis ⁽⁴⁾	–	–0.1	–	–	–
Other	0.3	0.3	0.4	0.4	0.4
<i>National Loans Fund</i>					
Service of the national debt	1.6	1.6	0.5	1.8	1.0
Net lending	–	0.1	–	–0.2	0.4
Total Expenditure	9.5	9.6	8.2	10.5	9.5
Other funds and accounts (+ increases borrowing) (– reduces borrowing)	0.6	–0.2	0.5	–	0.3
CGBR	1.7	1.4	0.7	1.1	0.9
On-lending	0.3	0.1	0.3	–0.2	0.4
CGBR(O)	1.4	1.2	0.4	1.3	0.5

⁽¹⁾Due to time lags in some items reaching their final accounting destination, figures of forecast and outturn may not be strictly comparable for the components identified, but there is no effect on the overall CGBR.

⁽²⁾Includes National Insurance Surcharge and receipts from sales of assets

⁽³⁾On a cheques issued basis. Supply includes an element of on-lending in the form of public dividend capital etc.

⁽⁴⁾Reflects changes in balances of departmental accounts with the Paymaster General, timing and other differences between cheques issued by departments and payments to them from the Consolidated Fund. An offset to this item is included in "Other funds and accounts".

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Table 6: Central government transactions⁽¹⁾ – comparisons for April–August

£ billion

	1984	1985	
	Outturn	Budget forecast	Latest update
Receipts			
<i>Consolidated Fund</i>			
Inland Revenue	17.4	19.4	19.6
Customs and Excise	13.5	14.7	15.0
Other ⁽²⁾	4.2	6.2	5.2
<i>National Loans Fund</i>			
Interest etc. receipts	1.9	2.3	2.6
Total Receipts	37.0	42.5	42.4
Expenditure			
<i>Consolidated Fund</i>			
Supply expenditure ⁽³⁾	36.7	40.3	39.4
Adjustment to Supply Services basis ⁽⁴⁾	–	–	0.3
Other	1.9	1.6	1.8
<i>National Loans Fund</i>			
Service of the national debt	5.3	5.8	5.8
Net lending	–	0.3	0.3
Total Expenditure	43.9	48.1	47.6
Other funds and accounts (+ increases borrowing) (– reduces borrowing)	–0.5	0.6	–0.2
CGBR	6.3	6.2	5.0
On-lending	0.2	0.6	0.4
CGBR(O)	6.2	5.6	4.6

⁽¹⁾Due to differences in treatment of some items in the accounts between the periods/forecasts shown, and time lags in some items reaching their final accounting destination, figures for the components identified may not be strictly comparable.

⁽²⁾Includes National Insurance Surcharge and receipts from sales of assets.

⁽³⁾On a cheques issued basis. Supply includes an element of on-lending in the form of public dividend capital etc.

⁽⁴⁾Reflects changes in balances of departmental accounts with the Paymaster General, timing and other differences between cheques issued by departments and payments to them from the Consolidated Fund. An offset to this item is included in "Other funds and accounts".

From: JOHN CLARK
XX June 1985

MR CULPIN - IDT

MR LANG - CSO Press Office

cc List A

Chancellor
Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr Cassell
Mr H Evans

Mr Lankester
Mr Folger
Miss Peirson
Mr Peretz
Mr Watts
Mr R Evans
Mr Ward - CSO
Mr Wright - B/E
Mr Turnbull - No. 10

List B

(distributed at 2.30pm, 18 June)

Mr Stibbard
Mr Spencer
Mr Cropper
Mr Lord
Mrs Hillier - IR
Mr D Mitchell - C and E

DRAFT BRIEFING FOR 18 JUNE PSBR PRESS NOTICE

FACTUAL

The PSBR figures for May will be published at 2.30pm on 18 June. The provisional outturns, together with figures for the first five months of 1984 and 1985, are shown in Table 1. Cumulative figures for the PSBR and its components for 1984-85 and 1983-84 are shown in Table 2 overleaf.

Table 1: Borrowing requirement outturns £ billion

	Jan-May 1984	Jan-May 1985	May 1985
Central government on own account	2.3	1.1	1.2
Local authorities	1.9	2.0	-
Public corporations	-0.7	-0.5	-0.2
PSBR	3.5	2.6	1.0
Memo: CGBR (including borrowing for on-lending to LAs and PCs)	3.6	2.2	1.4

Note: Figures may not sum precisely because of rounding.

Table 2: PUBLIC SECTOR BORROWING REQUIREMENT - Comparison with the last two years

Cumulative £ billion

	Central government on own account			Local authorities borrowing requirement			Public corporations borrowing requirement			Public sector borrowing requirement		
	1983-84	1984-85	1985-86	1983-84	1984-85	1985-86	1983-84	1984-85	1985-86	1983-84	1984-85	1985-86
	Apr	0.9	1.9	1.1	0.5	0.9	0.8	-0.2	-0.4	-0.1	1.2	2.4
May	2.4	3.2	2.4	0.3	0.8	0.8	-0.3	-0.4	-0.4	2.4	3.6	2.8
Jun	3.7	4.5		-0.1	0.6		-0.4	-0.5		3.2	4.6	
Jul	4.5	5.0		-0.0	0.8		-0.6	-0.7		3.9	5.2	
Aug	5.7	6.2		0.3	1.4		-0.4	-0.7		5.6	6.8	
Sep	6.6	6.4		0.3	1.2		-0.0	-0.3		6.9	7.4	
Oct	6.7	6.8		0.3	1.0		0.1	0.2		7.1	8.0	
Nov	8.3	8.6		-0.2	0.8		0.4	0.4		8.5	9.7	
Dec	9.1	7.8		0.1	1.2		0.6	1.3		9.8	10.3	
Jan	6.3	5.7		0.1	0.9		0.7	1.3		7.1	7.9	
Feb	6.7	5.1		0.2	1.3		0.6	1.3		7.5	7.7	
Mar	8.2	6.6		1.2	2.4		0.3	1.1		9.7	10.2	

Note: Figures may not sum precisely because of rounding.

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(DRAFT)

2. The (provisional) PSBR for May is £1.0 billion. This is in line with the average of forecasts of City analysts, which are for borrowing of between £½ billion and £1½ billion in May.

3. The May outturn brings the cumulative PSBR for the first two months of 1985-86 to £2.8 billion, £0.8 billion lower than over the same period last year, although it should be stressed that comparisons over several months are more useful because of the volatile nature of the PSBR. This is why the press notice concentrates on comparisons over the last five months.

POSITIVE

May PSBR

Borrowing in first five months of calendar 1985 £0.8 billion lower than in corresponding period of 1984.

DEFENSIVE/FACTUAL

1. Front-end loading

Background

Last year Chancellor said "almost all" of PSBR in 1984-85 was expected in first half of year; such high front-end loading was expected because of special receipts in second half of year (VAT on imports and BT). But the prolongation of the coal strike added substantially to borrowing in the second half, so in the event no more than three-quarters of the PSBR was in the first half-year. In 1985-86, BT second call receipts (June) will reduce borrowing in the first half-year, but higher corporation tax receipts (than in earlier years) will reduce borrowing in the second half-year, so on balance no reason to expect front-end-loading to be very different from past average of about two-thirds.

Line to take

Although very uncertain at this stage, no reason to suppose that proportion of borrowing

in first half-year will be very different from usual (around two-thirds). British Telecom second call receipts will benefit PSBR in first half of 1985-86, but higher corporation tax receipts (than in earlier years) will principally benefit second half.

2. Asset sales

Line to take

First instalment (approaching £0.2 billion) from sale of British Aerospace shares received in May, second instalment (£169 million gross) due in September. Second instalment of BT receipts (nearly £1.2 billion) due in June. Budget forecast for 1985-86 £2.5 billion.

3. Supply Expenditure

Background

For first two months of 1985-86, supply services (which represents issues to departments from the Consolidated Fund) were 7.3 per cent higher than in April-May 1984. The comparable increase in supply expenditure (which represents cheques issued by departments and differs from supply services because of changes in departmental balances with the Paymaster General) is slightly lower. The latter increase is not published and is based on less firm information. No Budget forecast of supply in 1985-86 was included in the FSBR. Table 5.3 showed Main Estimates provision only, which is unsuitable for comparing against outturn.

Line to take

Much too early in year to draw conclusions from the figure - cannot read much from two months' outturn. In any case, figures for supply services do not take account of changes in departmental balances. The increase in actual supply expenditure for April and May together compared with April-May 1984 is somewhat lower (although the estimate for this is less firm than for supply services).

4. May RPI

Background

May RPI shows 7 per cent rise over May 1984, compared with 4¾ per cent assumed in PEWP. This affects social security upratings in November (though for some benefits slightly different price indices are used), and so will add to supply expenditure and to National Insurance Fund expenditure.

Line to take

Effect on social security uprating (hence expenditure) will not occur until November. Any extra costs which cannot be absorbed within DHSS programme will be charged to the £5 billion expenditure reserve. Higher RPI than assumed in PEWP adds £¼ billion to social security expenditure in 1985-86.

5. EC refunds

Line to take

Whole of 1983 refund received in 1984-85. 1984 refund of 1000m ecus (about £¾ billion at present) expected in late 1985-86. 1985 arrangements are different, and will reduce UK monthly contributions, starting in 1986.

6. Inland Revenue receipts

Background

Total Inland Revenue receipts in May were £3.6 billion, 6¼ per cent higher than in May 1984. April and May together (£7.3 billion) were 9½ per cent higher than the same period last year. Budget forecast for 1985-86 was for receipts of £56.2 billion, up 11.6 per cent on 1984-85.

Line to take

Inland Revenue receipts in May were £3.6 billion, and the total for April and May was £7.3 billion. Little can be read from only two months' figures.

7. Oil Revenues

Background

Pound:Dollar exchange rate higher than 1.10-1.15 assumed in Budget for 1985 (TCSC minutes, 27 March 1985, p8)

Line to take

Whatever happens, little or no effect on oil revenues until September. Much too soon to draw conclusions - oil revenues depend on both sterling oil prices and production. Oil production forecasts very uncertain.

8. Customs and Excise revenues

Background

Customs and Excise revenues in May were £3.1 billion, 9½ per cent higher than in May 1984. April and May together (£6.4 billion) were 21 per cent higher than over the same period last year. Budget forecast for 1985-86 was for receipts of £36.3 billion, up 2¼ per cent on 1984-85 (low increase because 1984-85 receipts were boosted by change in VAT on imports).

Line to take

Receipts in April and May were both boosted by high pre-Budget clearance of tobacco and alcohol from bonded warehouses. Little can be read from two months' figures.

9. Local authorities

Background

Preliminary estimate is that local authority account was in exact balance in May, compared with small net repayment of debt in May on average over past five years. But difference small compared with normal fluctuations.

Line to take

Local authority borrowing pretty much as one would expect.

10. Public corporations

Background

Public corporations made a net repayment of debt of £0.2 billion in May (provisional), bringing total repayment for first two months of 1984-85 to £0.4 billion.

Line to take

Public corporations have shown a net repayment of debt in the first two months in each of the last 3 years. Receipts from consumers normally exceed expenditure in early part of financial year.

John Clark (ext 3093)
PSF Division, HM Treasury

Mrs Lowax

cc. Mr. Riley

FROM: J ODLING-SMEE
DATE: 21 June 1985

psf

Our written report of the
(see x)
conference is now being circulated.

CHANCELLOR OF THE EXCHEQUER

I hope that it will be possible
to arrange a meeting with the
Chancellor (4). We are as interested
in his general views about the role
of fiscal policy and the PSBR as in
his views on the ideas in our paper.

cc Sir Peter Middleton
Sir Terence Burns
Mr Cassell
Mr Evans
Mr Culpin
Mr Davies
Mr Riley
Mr Grice
Mr Kelly
Mr Spencer

if (see
advance -
p1 head)
219

8/16/9

CONFERENCE PAPER ON THE PSBR

10-9 8/7

... I attach more or less the final version of the Odling-Smee/Riley paper for the conference at the National Institute on 3 July. I would be grateful for your agreement to our sending it out on Tuesday, 25 June.

2. The Academic Panel meeting this afternoon that was to have discussed it has been cancelled because only two or three Panel members were available. We shall be having an internal meeting instead so that we can obtain additional reactions from Treasury colleagues. Should this result in our wishing to make any changes of substance I shall let you know early on Monday. Otherwise we only have to tidy up in a few places, adding the list of references and the annex on North Sea oil.

Y || 3. You had some reservations about parts of the previous draft, and they may still
X || apply to the present one. We would be interested to know what they are, and perhaps
we could have a discussion when other business is less pressing. We would report
on the reactions of the others at the conference and on the other papers
... (programme attached).

J H Pennell
J ODLING-SMEE



FROM: MISS M O'MARA

DATE: 25 June 1985

Handwritten initials, possibly 'MO' or 'MOM', in the top right corner.

MR ODLING-SMEE

- cc Sir P Middleton
- Sir T Burns
- Mr Cassell
- Mr Evans
- Mr Culpin
- Mr Davies
- Mr Riley
- Mr Grice
- Mr Kelly
- Mr Spencer

CONFERENCE PAPER ON THE PSBR

This is to confirm that, as I told you, the Chancellor is content for the paper attached to your minute of 21 June to be sent out.

MOM
MISS M O'MARA

262/005

28 JUN 1985

CONFIDENTIAL

(F) Fowler CP

S:PM

FROM: J R JAMESON
DATE: 27th June 1985

SIR PETER MIDDLETON

Note
Spoke to Vordank
KFM

cc Mr Bailey
Sir T Burns
Mr Anson
Mr Byatt
Mr Watson
Mr Monger
Mr G P Smith
Mr A C S Allan

117

Mr Bailey's views
don't take Anson's
view looking at Byatt.

THE "NEW" STRUCTURE OF THE TAX SYSTEM

One of the working groups set up following Mr Jenkin's minute of 13th June to the Prime Minister will produce exemplifications of various proposed packages, showing the effects by reference first to Local Authorities and then to households. The relevant data was being assembled at present. The aim was to start the detailed work at the beginning of July, and to agree by the end of that month the format the material which would be presented to Ministers. The Group would examine first the distributional effects of the package as originally proposed, including minor changes to remove the more unacceptable consequences, secondly the possibility of combining a residents' charge with some form of property tax, thirdly the possibility of a graduated residents' charge, and finally and to the extent that time permitted other ideas such as local sales or income taxes. Once the methodology for producing exemplifications had been established, it would be possible within reason to examine a wide range of possibilities, including for example the retention of a property tax either in whole or in part. (E(LF)(0)1st Meeting minutes).

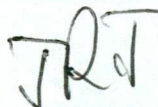
2. This work must be completed by early September, in time for Mr Jenkin to prepare his report to E(LF) at a meeting at the end of that month. Mr Allan and Mr Speedy will represent the Treasury on this group.

3. I think that Mr Byatt's proposals (26th June) fit in with this. The White Paper on local government finance is not due

CONFIDENTIAL

CONFIDENTIAL

to be published until the end of the year; and it should be possible to ensure, through Mr Byatt's group, that it is consistent with the Chancellor's Green Paper and Mr Fowler's White Paper. But I share Mr Watson's concern (27th June) that "gainers and losers" should not be excluded. They are as important to LG finance as to the other topics.



J R JAMESON

CONFIDENTIAL

29 JUN 1985

(A) Fowler Group Paper etc.
SLPM

CONFIDENTIAL

FROM: A. M. BAILEY
28th June, 1985.

MR. BYATT

c.c. Sir P. Middleton /
Sir T. Burns
Mr. Anson
Mr. Jameson
Mr. Monger
Mr. G. P. Smith
Miss Noble

TAXES AND BENEFITS

We have discussed the latest position on this. Mr. Heppell (DHSS) is consulting Mr. Fowler on whether he can provide the necessary information for your informal working-party to carry out its remit on the inter-relationships between social security post-Fowler and the tax system as in the Green Paper. We shall be told Mr. Fowler's response either at a Treasury/DHSS meeting on Tuesday, or earlier.

2. If he agrees, the way should be clear to set up your working-party (including ST and DHSS non-economists) and to report to the Chancellor; perhaps you will let Sir Peter Middleton have (through me) a draft submission for this.

3. But if Mr. Fowler does not agree, the only way of taking the work forward would appear to be for the Chancellor to write asking him to reconsider. Again it would be helpful if you would submit a draft, in consultation with ST; we agreed that this should be as precise as possible about the information from DHSS which is really necessary for the work, and not already available to us.

AMB

A. M. BAILEY

FROM: J ODLING-SMEE
DATE: 28 June 1985

cpwp

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Minister of State
Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Bailey
Mr Littler
Mr Anson
Mr Byatt
Mr Cassell
Mr Monck
Mr Evans
Mr Monger
Mr Moore
Mr Scholar
Mr Sedgwick
Mr Watson
Mr Culpin
Mr Davies
Mr Melliss
Mr Mowl
Mr Riley
Mr Grice
Mr Kelly
Mr Pratt
Mr Spencer
Mr Wicks
Mr Cropper
Mr Lord
Mr H Davies

CONFERENCE PAPER ON THE PSBR

I attach the final version of the paper by myself and Mr Riley for the conference on Government Borrowing and Economic Policy at the National Institute on 3 July. We understand that it is being sent out to conference participants today. I attach a copy of the programme for the conference. The National Institute are planning to publish the conference papers in the August issue of their Review.

DL JS

J ODLING SMEE

Government Borrowing and Economic Policy

A One-day Conference at the National Institute of Economic and Social Research

Wednesday 3rd July, 1985

Provisional Programme

- 9.30 - 11.00 John Odling-Smee and Chris Riley
Approaches to the PSBR
- Coffee
- 11.30 - 1.00 David Currie
The PSBR as an Intermediate Target
- Lunch
- 2.00 - 3.30 Alan Budd and Giles Keating
Government Borrowing and Financial Markets
- Tea
- 4.00 - 5.30 NIESR
Government Borrowing and Aggregate Demand

Conference on The Budget Balance and Economic Policy July 3rd 1985

Participants

R Alford

C Allsop Yes

M Artis Yes

A Bain Yes

J Ball Yes

C Bean Yes

M Beenstock

D Begg

V Chick Yes

A Chrystal Yes

T Congdon Yes

C Dow Yes

W Ems Yes

J Flemming Yes

C Goodhart Yes

B Griffiths No

B ~~Hopkin~~ Hopkin Yes

C Johnson Yes

R Layard Yes

D Lomax Yes (provision)

D MacDougall

R Matthews No

G Maynard Yes

J Meade Yes

M Miller Yes

P Minford

G Pepper Yes

D Peel No

M Peston Yes

M Posner ~~Yes~~ - Yes

H Rose Yes

I Saville Yes

R Sargent No

D Vines

D Worswick Yes

J. Shields Yes

J. Peckham Yes

P.M. Jackson - Yes
(Heider)

APPROACHES TO THE PSBR

by

John Odling-Smee and Chris Riley

HM TREASURY

June 1985

APPROACHES TO THE PSBR

	<u>Page Number</u>
I INTRODUCTION	1
A Brief History	1
Scope and Structure of the Paper	3
II THE NATURE OF GOVERNMENT BORROWING AND ITS IMPLICATIONS	4
The Distribution of Consumption over Time	4
Tax Rates and Lumpiness of Public Sector Transactions	7
III CHANGES IN PUBLIC SECTOR ASSETS AND LIABILITIES	8
Public Sector Investment	10
North Sea Revenue	12
Other Public Sector Assets and Liabilities	14
Conclusions	15
IV THE MIX OF MONETARY AND FISCAL POLICY IN THE MEDIUM AND LONG TERM	16
V MONETARY AND FISCAL POLICY IN THE SHORT TERM	19
The Scope for Short-term Variations	19
The Effects of Changes in Monetary and Fiscal Policies	20
Responses to Cycles and Shocks	21
Adjustments to the PSBR	22
Use of Adjusted Measures for Setting Policy	24
VI SUMMARY	25
ANNEX	
NOTES	
REFERENCES	

APPROACHES TO THE PSBR

John Odling-Smee and Chris Riley⁽¹⁾

I. INTRODUCTION

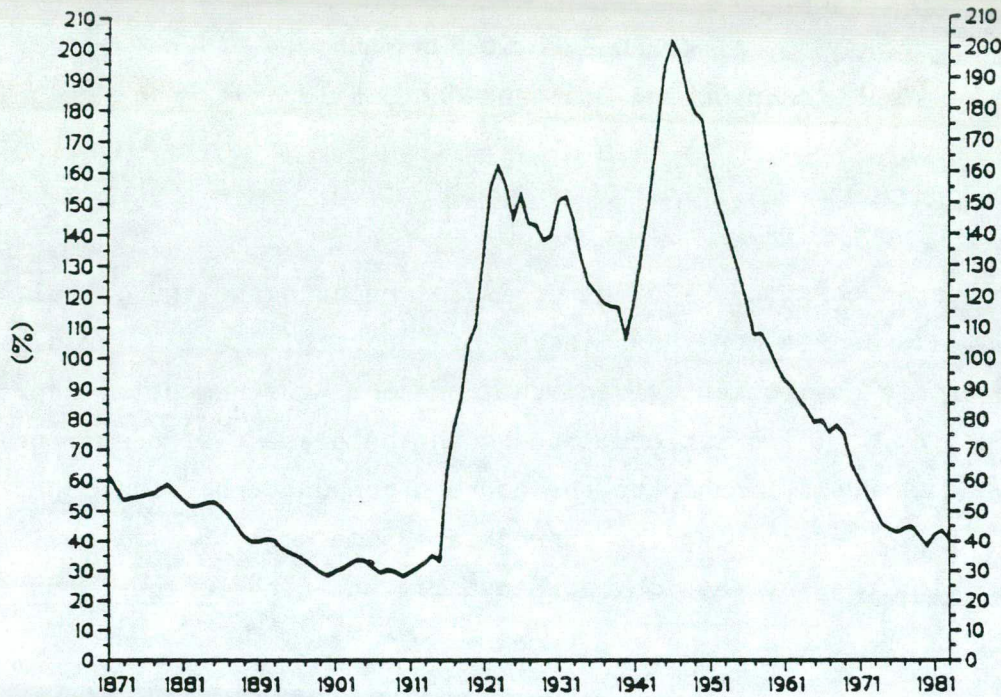
1. This paper considers a range of issues relating to the overall stance of fiscal policy. It considers issues of principle which arise in the present economic environment given the present government's approach to economic policy. It is not concerned with the present stance of policy per se, or with its relationship to the current conjuncture. The paper focuses on approaches to determining the appropriate size of the fiscal deficit, bearing in mind the interaction between this and the composition of the deficit.

2. The arguments in the paper are developed mainly in terms of the Public Sector Borrowing Requirement (PSBR), which is the way the Government expresses its fiscal policy objectives in the Medium Term Financial Strategy (MTFS). But that is not to imply that the PSBR is considered the ideal measure of fiscal stance. It clearly is not; and indeed there may be no such thing. Rather than focus on an alternative measure, such as the Public Sector Financial Deficit or the General Government Borrowing Requirement, which also have drawbacks, the main arguments are expressed in terms of the PSBR, but the implications of changes in its composition and its other known characteristics are also discussed.

A Brief History

3. Attitudes to public sector deficits and debt have varied considerably over the last 200 years. The classical economists - including Smith, Say and Ricardo - were almost unanimous in condemning public debt. Although it was conceded that deficit financing was permissible in times of war, they were concerned that in peacetime it would lead to irresponsible government and wasteful expenditure. Although apparently less painful than taxation, the burden of debt could become considerable because of the taxation required to service it. Taxation was considered harmful because of the burden it imposed on productive industry. In this environment, low expenditure and fiscal surpluses were the order of the day, except in war time. The ratio of national debt to nominal GDP fell fairly steadily during the nineteenth century from the level it reached at the end of the Napoleonic Wars (Chart 1).

CHART 1 RATIO OF NATIONAL DEBT TO GNP



Ratio of total central government liabilities to GDP at current market prices. Source: Bank of England.

4. During the course of the nineteenth century, however, the potentially productive character of public expenditure came to be more widely recognised. A distinction was increasingly drawn between productive and non-productive purposes for which debt might be incurred. A case could be made for incurring debt if the expenditure it financed yielded benefits in the future to match the additional debt service⁽²⁾. In practice this argument applied mainly to capital expenditure and the finance of wars. Attitudes to expenditure became more relaxed as economic growth reduced the burden of debt and allowed a widening of the tax base.

5. But the sharp build-up of debt during the 1914-18 war led to renewed concern. The Colwyn Committee, set up in 1924 to examine the effects of the debt, argued for a gradual reduction, though it did not specify how far. One reason advanced for this conclusion was the need to sustain national credit-worthiness in case another war required further massive borrowing. Another was the risk that falling prices would increase the real burden of existing debt. The prevailing view in the inter-war period was that it was desirable at least to balance the budget, and ideally to run a surplus.

6. In the UK, and in many other industrialised countries, the Keynesian revolution in the late 1930s led to a significant change in thinking about fiscal policy. The link between deficits and aggregate demand became the main focus of analysis, and fiscal policy was seen as a means of achieving an appropriate level of real demand, and hence employment, in the short term.⁽³⁾ This analysis was widely accepted in the 1950s and 1960s, and deficits on the budget were seen in many cases as both desirable and necessary.

7. But by the early 1970s, with the breakdown of the Bretton Woods system of fixed exchange rates and the first oil shock, the Keynesian orthodoxy was increasingly being challenged. The surge in inflation and sharp deterioration in economic performance of the advanced economies prompted two types of change in the perception of how fiscal policy should be operated. The surge in inflation resulted in moves to more restrictive financial policies, and a growing awareness that curing inflation required greater control over monetary growth, and through that the growth of nominal demand. This and work on the government budget constraint (eg Christ (1968)) brought into clearer focus the link between fiscal deficits and money creation and the need for fiscal and monetary policies to be in harmony.

8. At the same time, the decline in economic growth in the 1970s gave rise to greater appreciation of the structural implications of budget deficits and the implications of high taxation and government spending for incentives and the supply side. The momentum of rising debt, expenditure and taxation, acquired in the two decades when rapid economic growth seemed assured, became a source of widespread concern.

9. The issues on which most attention focussed before Keynes have thus now resumed an important place in the debate on fiscal policy. They relate essentially to the burden of debt and the structural effects of fiscal policy on the economy, focussing on the longer term rather than the short term.

Scope and Structure of the Paper

10. The paper attempts to review the factors relevant to setting the PSBR in both the long term and the short term. It does not discuss setting the PSBR in order to achieve declining inflation. Thus it covers most but

not all of the issues that need to be taken into account in setting PSBR within the framework of the Medium-Term Financial Strategy. The discussion of the PSBR in the long term takes the rate of inflation as given and abstracts from short term fluctuations in output. In the short term, however, inflation and money incomes are not necessarily assumed to be given. One of the questions of interest is the impact of short-term variations in the PSBR; another is the appropriate fiscal policy response to an inflationary shock.

11. The paper does not discuss aspects of the stability and sustainability of fiscal policy under bond financing. This has been the subject of much analysis in recent years following the early contribution of Blinder and Solow (1973). It is an important issue which highlights the link between current bond issues and future interest payments. Even though effective control over the PSBR eliminates the risk of a loss of control over public debt, rising interest payments within a fixed PSBR crowd out other expenditures or require rising taxation, thus putting the whole fiscal programme at risk.

12. There are three sections on long-term issues and one on the short term. The first long-term section discusses reasons for borrowing, the second the implications for borrowing of changes in public sector assets and liabilities, and the third the interaction between fiscal and monetary policy in the long term. The paper ends with a summary.

II. THE NATURE OF GOVERNMENT BORROWING AND ITS IMPLICATIONS

13. Two important aspects of government borrowing can be identified. First, since it changes the timing of payments, financing expenditure by borrowing rather than out of current income permits changes in the distribution of consumption over time. Secondly, borrowing can smooth out the path of tax rates in the face of lumpiness in expenditure or fluctuations in the tax base. These two aspects are closely related, but it is helpful to consider them separately.

The Distribution of Consumption over Time

14. An essential feature of borrowing, which economists have long recognised, is that it enables expenditure to be redistributed over time.

Individuals or governments are able, by increasing their borrowing, to increase their expenditure now in relation to their income; but the subsequent burden of interest payments and debt repayment has the effect of reducing expenditure relative to income in the future. At the same time, the nature of the expenditure brought forward by borrowing may influence the path of future income: additional investment now will increase future income and consumption possibilities, whereas additional consumption now will not.

15. Some economists, notably Barro (1974), argue that it may not be possible for the government to alter the balance between present and future consumption by varying public sector borrowing and debt. The private sector can implement the appropriate balance itself through its access to the capital markets. Any attempt by the government to alter this by borrowing more or less will simply cause the private sector to behave in an offsetting manner. This view is essentially the Equivalence Theorem of Ricardo. It implies that the appropriate levels of taxation and debt should reflect other, essentially micro-economic, considerations. These include effects on the structure of incentives and the distribution of income.

16. While having many theoretical attractions, the conditions required for this type of model to hold are very stringent. The Equivalence Theorem requires ultra rationality, perfect capital markets, intergenerational altruism and bequests. It seems highly unlikely that these assumptions are valid. We prefer to assume that, while there might be a minority of households who behave in this way, most households base their saving behaviour on a life-cycle approach subject to liquidity constraints due to imperfect capital markets⁽⁴⁾. This assumption would imply a relationship between the level of government borrowing and the distribution of consumption over time.

17. The mechanisms by which changes in borrowing affect the distribution of consumption are complex. Decisions to spend and borrow in themselves have macro-economic effects - for example on interest rates, exchange rates and the balance of payments - which have second round effects on investment, consumption and future incomes. Borrowing by the public sector will typically affect the path of future income as well as the distribution of consumption over time. The mechanisms involved will depend on the nature of the economy, and notably the degree of openness.

Closed Economies

18. For a closed economy, the main mechanism is interest rates. Higher borrowing forces up interest rates and induces the private sector to reduce both its present consumption and its investment.⁽⁵⁾⁽⁶⁾ This reduces future income, via a lower capital stock. If the additional borrowing is used to finance consumption, the net effect is both to redistribute consumption from the future to the present and to reduce future income. If the additional borrowing finances worthwhile investment this will tend to increase future income, and at the same time redistribute consumption from the present to the future⁽⁷⁾⁽⁸⁾

19. This suggests the possibility of an "optimal" level of public borrowing, given social time preference and the available opportunities for worthwhile public investment, which is associated with an "optimal" level of interest rates. The literature on growth and optimal saving indicates a relationship between the optimal interest rate and the underlying growth rate of the economy - the so-called "golden rule". If the PSBR were raised above the optimal level, leading to an interest rate above the optimal rate, there would be too little investment and, initially, too much consumption, ceteris paribus. The present generation would be enjoying an excessive amount of consumption at the expense of future generations.⁽⁹⁾

Open Economies

20. In an open economy there are additional mechanisms involved. Changes in domestic borrowing affect the current account of the balance of payments and the exchange rate, and thus both the net stock of overseas assets and their valuation. This in turn affects future flows of income from overseas, and hence future consumption. In extreme cases where real interest rates are tied down fully in the long run by world rates, this may be the only mechanism involved. The optimal level of public sector borrowing in such an economy is associated with an optimal level of net overseas assets, related as before to social time preference and the economic growth rate.

21. An increase in public sector borrowing would be associated ex ante with a greater current account deficit, or smaller surplus, and hence ultimately a lower stock of net overseas assets⁽¹⁰⁾. This is analogous to a lower domestic capital stock in the closed economy case. Maintenance of

external balance requires that the resulting reduction in net overseas income be matched in the long run by a smaller deficit/higher surplus on the trade account. In other words the economy would ultimately have to reduce its net imports and its consumption. This would be brought about by a lower real exchange rate⁽¹¹⁾.

22. In practice, the mechanisms relevant for a closed economy will also be relevant for open economies, because most open economies are likely to have some freedom to vary their real interest rates relative to the rest of the world. This is certainly the case in the short run, and even in the long run it is unlikely that domestic rates would be tied down entirely by world rates. Long-run divergences in real interest rates may reflect trends in real exchange rates, possibly the result of different relative productivity trends in traded and non-traded sectors. Such divergences may persist for some while, but are probably not closely related to the overall stance of fiscal policy. More relevant in the current context is that differences in real interest rates between countries may reflect different degrees of risk associated with the countries' debt. These may reflect differences in the size of the debt, and hence the overall stance of fiscal policy, and may thus persist in the long run.

Tax Rates and Lumpiness of Public Sector Transactions

23. There is a strand of the literature on borrowing which focusses on the welfare costs associated with changes in tax rates.⁽¹²⁾ Such changes, particularly if they are not anticipated, distort the choices of the private sector and lead to a misallocation of resources.⁽¹³⁾ There is thus a premium on maintaining stable tax and benefit rates, irrespective of the levels of expenditure to be financed. In a stochastic environment tax rates should, on this analysis, follow a Martingale process.⁽¹⁴⁾ Unanticipated shocks to the level of public debt are largely accommodated, with subsequent debt servicing costs financed by changes in tax rates. Anticipated fluctuations in net government revenues should be reflected in fluctuations in public debt, with tax rates set at a level needed to finance the "permanent" stream of debt servicing costs⁽¹⁵⁾.

24. Although some of the assumptions that are required for Barro's conclusions to hold are not wholly plausible⁽¹⁶⁾, the view that distortions can be reduced by keeping changes in tax and benefit rates to a minimum is important. Governments may well have objectives for tax rates on micro-

economic grounds, but if so there is a clear case for moving towards them in a smooth and predictable way, and not changing them in response to short-term fluctuations in public sector flows. This has implications for the cyclical behaviour of the PSBR, which we discuss in section V, as well as for the long term.

III. CHANGES IN PUBLIC SECTOR ASSETS AND LIABILITIES

25. The discussion of the distribution of consumption over time suggests a link between public borrowing decisions and changes in public sector assets (and liabilities). Insofar as the "optimal" PSBR reflects the appropriate balance between present and future consumption, the extent to which the PSBR finances public investment or consumption is of considerable relevance. Public investment, assuming it is worthwhile, generates a stream of returns which contribute to higher consumption. Higher public investment enables any given balance between present and future consumption to be achieved with lower private investment and/or lower net overseas investment. The implication is that higher (worthwhile) public net investment in principle justifies a higher PSBR and, probably, higher interest rates⁽¹⁷⁾.

26. The argument can be extended to assets other than the public sector capital stock, and to liabilities. For example, the potential revenue from North Sea oil represents, from the point of view of the public sector, an asset that is gradually being used up. If the PSBR were held unchanged, expenditure would be greater during the (temporary) period when the oil is being exploited than when it is exhausted. If this expenditure were to take the form of consumption, the balance of consumption between the period of exploitation and later periods would be changed. There is therefore a case, given unchanged public investment opportunities, for changing the PSBR in an offsetting direction to restore the balance of consumption. In stock terms this would be equivalent to altering public sector debt in line with changes in the present value of future North Sea oil revenues: some of the oil revenues would be used to reduce the debt and thus spread income into the period after the oil runs out. There is a similar case for reducing public sector debt in line with the accumulation of unfunded state pension liabilities.

27. The argument about lumpiness in public sector transactions leads to conclusions about changes in public sector debt which are rather similar.

Tax changes can be avoided if lumpy changes in public sector assets and liabilities, such as a single investment project, the "temporary" rundown of revenue from North Sea oil, and "temporary" imbalances between people's pension-related National Insurance contributions and their state pensions, are met by offsetting changes in public sector debt.

28. There are two main ways in which the balance of consumption and the lumpiness arguments differ. First, the balance of consumption argument implies in principle a view about the optimal level of debt given the levels of public sector assets and other liabilities. It may be difficult in practice to determine this optimal level, but in principle it ensures a desired path of consumption over time. The lumpiness argument, on the other hand, implies no optimal level. It merely indicates how the level of debt should change in the face of fluctuations in public sector transactions. The second difference is that the lumpiness argument is relevant to fluctuations in both current and capital expenditures. But, for the balance of consumption argument, the distinction between capital and current is critical. It suggests that single large consumption projects should be financed entirely by taxation, while the lumpiness argument suggests that they should be financed in part by borrowing. In practice these differences may be relatively unimportant since, as discussed below, the conventional definitions of current and capital expenditure may not be appropriate in this context⁽¹⁸⁾. But the conceptual differences remain.

29. The argument that public sector debt should move in line with changes in public sector assets and liabilities is equivalent to saying that the public sector's net worth should be maintained unchanged. Some writers, for example Buiters (1983), have argued that net worth in this context should be defined in a comprehensive way to include the present value of future expenditure commitments and the right to tax as well as conventional debt and investments.

30. In principle this may be right. But obtaining a suitably comprehensive measure of net worth is difficult. On the one hand it might be argued that the right to tax effectively means that the government is able to finance whatever level of expenditure it deems appropriate. In this case comprehensive net worth is automatically - but tautologously - equal to zero. But alternatively one might argue that the right to tax and spend, appropriately measured, does not change over time and can therefore be ignored. Either way, these difficulties point towards the desirability of

including in net worth at least those assets and liabilities which are constant over time: North Sea oil revenues and immature unfunded pension schemes, for example. However, a consequence of ignoring some elements which would feature in a fully comprehensive measure of public sector net worth is that the appropriate level of net worth is no longer clearly defined. It is, however, unlikely to be zero.

31. Another problem is that some relevant components of the public sector balance sheet are difficult to measure - the cases of the fixed capital stock and North Sea revenues are discussed below.⁽¹⁹⁾ A recent heroic attempt to measure some of the main balance sheet items was made by Ashworth, Hills and Morris (1984). Despite their efforts, the measurement problem is clearly severe. Nevertheless the concept of unchanged net worth is valuable and suggests ways in which the PSBR should be related to changes in public sector assets even if corrections in initial stock disequilibria cannot be made with any precision.

32. The rest of this section discusses the implications for debt of trends in public sector assets and liabilities in the context of an approach which relates debt to other items in the balance sheet. Public investment and North Sea revenues are used to illustrate the main issues, though other assets are also mentioned.⁽²⁰⁾

Public Sector Investment

33. The link between public net investment and the optimal size of the PSBR brings into sharp focus the criteria used to evaluate public sector investment projects. The arguments set out above assume implicitly that all projects considered worthwhile at the level of interest rates consistent with the "optimal" PSBR do go ahead; and that the distribution of worthwhile projects between the public and private sectors is also optimal. We do not consider here how to decide on this distribution. To some extent it is a matter of judgement, and inextricably linked to views about the efficiency and appropriate size of the public sector. Evaluation of public sector projects must clearly take into account the potential effects on the private sector of government involvement in the economy. A desire to reduce the role of government in order to rejuvenate the private sector would point to lower public net investment and a lower PSBR than would otherwise be the case.

34. The appropriate definition of public investment raises conceptual and practical difficulties. First, it is necessary to separate "worthwhile" investments that should properly be financed by borrowing from other investments that should be regarded more like consumption. Certain types of public investment may produce significant social returns but little or no pecuniary return. Examples are prisons and public parks.⁽²¹⁾ Such investments may have little if any effect on future incomes and consumption in a national accounting sense, but nevertheless raise them in a broader sense. The arguments above apply equally to this sort of investment, which can be considered worthwhile if future generations would be willing to pay for the benefits they yield by higher taxation. Insofar as they are considered worthwhile in this sense, it is legitimate to finance them by public borrowing, and hence future rather than current taxation. In this they are analogous to investments yielding pecuniary returns.

35. Secondly, there is the reverse problem. Some expenditure at present classified in the national accounts as current expenditure should perhaps be classified for this purpose as investment since it yields benefits in future periods. Wars have been mentioned. More generally there are expenditure on military hardware, much expenditure on education (which is in large part investment in human capital) and, perhaps to a lesser extent, health. Such expenditures can legitimately be financed by borrowing.

36. Thirdly, the appropriate definition of investment to be compared with the PSBR is net of depreciation but after allowing for both expenditure on maintenance and valuation changes resulting from inflation. Net rather than gross investment is the appropriate concept because this is what determines changes in net assets and liabilities, which in turn determine future returns. However, there are severe problems with measuring depreciation and capital appreciation, yet they are crucial to the measurement of net investment.

37. As discussed above, one might in principle wish to compare the stock of debt with the stock of fixed assets and other assets and liabilities, all in relation to the desired level of net worth. The stock of fixed assets is, however, difficult to measure. The only comprehensive data are the CSO's balance sheet data. But these are derived by cumulating investment series and making fairly arbitrary assumptions about depreciation. Some public sector assets probably continue to yield benefits well after

they are assumed to have depreciated to a tiny proportion of their initial value. Regularly maintained roads and public buildings are an obvious example⁽²²⁾. But others may have ceased to provide a useful stream of benefits long before they disappear from the measured stock. Concorde, for example, arguably should never have been recorded as an asset.

38. Thus, there are conceptual and practical difficulties with measuring public sector capital in the context of a net worth criterion for public borrowing. They are, however, probably somewhat less severe in the case of flows (net investment) than in the case of stocks (capital), assuming that depreciation and capital appreciation are fairly smooth. Although it seems unlikely that the level of the capital stock can be used operationally for deciding the appropriate level of public debt in the medium term, it may be possible to take account of trends and shorter-term movements in public net investment in assessing the appropriate PSBR path.

39. It should be noted that the implications of changes in public investment for the PSBR are essentially the same whether the change results from transactions in existing assets or from expenditure on new assets. An asset sale, for example, would have to be accompanied by a one-off reduction in the PSBR if the public sector's net worth was to be maintained unchanged. This would be necessary to leave the balance between present and future consumption unchanged; with a loss of income from the asset by the public sector offset by lower debt interest payments.⁽²³⁾

North Sea Revenue

40. As already noted, the arguments in Section II apply also to North Sea revenues. There is a case for sharing the benefits of the North Sea with future generations, and for smoothing the path of tax rates. To simplify the discussion, this section assumes that the aim is to share the benefits fully with future generations. It could be argued that only part of the benefits should be shared, with the rest being retained by the present generation as compensation for the transitional costs associated with the rise and fall of oil production, but the discussion ignores this complication.

41. Full sharing of the benefits suggests that present taxpayers should consume only the permanent income from the North Sea - ie the level of income which the North Sea could generate indefinitely, assuming the revenue

was suitably invested - and save the remainder. This would permit some reduction in general taxation or an increase in expenditure; but the PSBR would be lower than otherwise when actual revenues exceeded permanent revenues, as at present. In the long run the stock of debt would be lower. Future generations would benefit from reduced debt servicing costs, permitting lower taxation and higher consumption within an unchanged PSBR.(24)

42. Translating this approach into quantitative form poses considerable difficulties, however. Total reserves from the North Sea are not known with certainty, and neither are future oil prices and the rate of depletion. Estimates have to be based on long-term projections which are by their very nature extremely hazardous. A further complication is that both the total of economically viable oil reserves and the rate of depletion are to some extent dependent on the government's financial policies, as well as developments in the domestic and world economies. Nevertheless, it is possible to derive figures, based on reasonably plausible estimates of production, prices and tax rates, to illustrate the kind of calculation involved. This is done in a rough and ready way below.

43. The starting point is the projection of North Sea revenues in the 1985 MTFS. This is extended to 1993-94 along similar lines to the projection in the 1984 Green Paper on Public Expenditure and Taxation(25), and then beyond that on the assumption that oil output ceases in around 2020. This resulting projection, described in more detail in the Annex, is subject to great uncertainties, which increase as one moves further into the future. But it is sufficient to illustrate the broad implications of the approach described earlier for the appropriate PSBR path.

44. Using a real discount rate of $2\frac{1}{2}\%$, "permanent" revenue from the North Sea currently available to the public sector is put at $\pounds 2\frac{3}{4}$ billion at 1985-86 prices, about $3\frac{1}{4}\%$ of GDP.(26) This indicates the cut in taxation which would in principle be justified on the assumption that the benefits were fully shared with future generations. Comparing this with the estimate of actual revenue for 1985-86 in the FSBR ($\pounds 13\frac{1}{2}$ billion, or about $3\frac{3}{4}\%$ of GDP) implies that the PSBR should be about 3% of GDP lower than without the revenue. As revenues decline relative to GDP in subsequent years, the PSBR reduction also declines. The figures are summarised in the table below.

North Sea Revenues, Debt, and the PSBR

£bn, 1985-86 prices	1985-86	1988-89	1993-94	2020-21
Actual revenue	13 ¹ / ₂	7 ¹ / ₂	6 ¹ / ₂	0
Permanent revenue/ reduction in taxes	2 ³ / ₄	2 ³ / ₄	2 ³ / ₄	2 ³ / ₄
Reduction in debt interest payments	-	3 ₄	1 ¹ / ₄	2 ³ / ₄
Reduction in PSBR	10 ³ / ₄	5 ¹ / ₂	5	0
Reduction in stock of public sector debt	10 ³ / ₄	31 ¹ / ₂	58	108

Reduction in PSBR <u>equals</u> actual revenue <u>plus</u> debt interest saving <u>less</u> permanent revenue.				

45. The temporary reduction in the PSBR indicated by this methodology relates to a baseline in which there is no North Sea oil and other things are unchanged: for example, public investment is taken as given. In practice, if such an adjustment were implemented it would lead to lower interest rates and some combination of a higher domestic capital stock and a larger stock of overseas assets. Any reduction in the PSBR should therefore be less than one-for-one to the extent that lower interest rates make more public investment projects worthwhile.

Other Public Sector Assets and Liabilities

46. There are, of course, a number of other components of net worth that are not constant over time and that might be taken into account in assessing changes in public sector debt. One obvious example is the outstanding stock of loans to the private and overseas sectors (eg local authority mortgages, lending to industry, overseas aid). In principle they are very similar to fixed assets. Although they are absolutely small, they are not constant over time.

47. Another example, one which is more akin to North Sea oil revenues in that it is temporary rather than permanent, is the cost of high unemploy-

ment. To the extent that unemployment is above the level sustainable in the longer term, perhaps reflecting structural changes in the world economy - due to rapid technological change, oil price shocks, the emergence of newly industrialised economies, or the need to bring down inflation, there is a case for sharing the costs with future generations and smoothing out the path of tax rates over time. This would mean running a higher PSBR now, and building up debt while the transitional process lasts.

48. Unfunded pension arrangements such as the state scheme and some public sector occupational schemes provide another example. In many countries demographic changes foreshadow a significant increase in the burden of pensions in the next century. To the extent that these are provided by the state and are unfunded, this too provides a reason for running a lower PSBR than would otherwise be the case. The present SERPS arrangements in the UK, which involve a rapid build-up in unfunded pension liabilities, are a case in point. But the changes foreshadowed in the recent Green Paper on Social Security⁽²⁷⁾ imply a shift to funding pensions explicitly in the private sector. The case for running a lower PSBR to finance future pension commitments would, under the Green Paper proposals, be significantly diminished.

Conclusions

49. These various arguments about the PSBR in the long term can be drawn together. Public sector net investment in the national accounts sense averaged about $3\frac{1}{4}\%$ of GDP in the period 1980-83. On its own, this might be taken to suggest that the PSBR should also be about $3\frac{1}{4}\%$ of GDP in the absence of inflation. But a case can be made for a higher PSBR on the grounds that it is appropriate to borrow to finance some "consumption" expenditure and expenditure on unemployment. But against this the PSBR should arguably be lower because of "transitory" North Sea revenues (about 3% of GDP) and accruing unfunded pension liabilities. In addition, there may be a case for changing the PSBR to bring the initial level of net worth into line with the desired level, though it is not clear in which direction this effect points.⁽²⁸⁾

50. Inflation complicates the story somewhat. It affects some but not all elements of the public sector balance sheet. In particular most elements rise with inflation, but debt does not. Thus, if there were steady inflation of, say, 5% and the debt to GDP ratio is 50%, it would be

necessary to add $2\frac{1}{2}\%$ of GDP to whatever figure for the PSBR emerges from the calculation that ignores inflation.

51. The net effect of all these factors on the appropriate path of the PSBR in the long term cannot be assessed except on the basis of a number of necessarily arbitrary assumptions. Nevertheless, the analysis provides an analytical framework within which to consider the implications of developments such as the exploitation of North Sea oil, the abolition of SERPS and other factors. And it makes clear, for example, that a rule that relates the growth of debt to the nominal growth of the economy alone is a considerable over-simplification.

IV. THE MIX OF MONETARY AND FISCAL POLICY IN THE MEDIUM AND LONG TERM

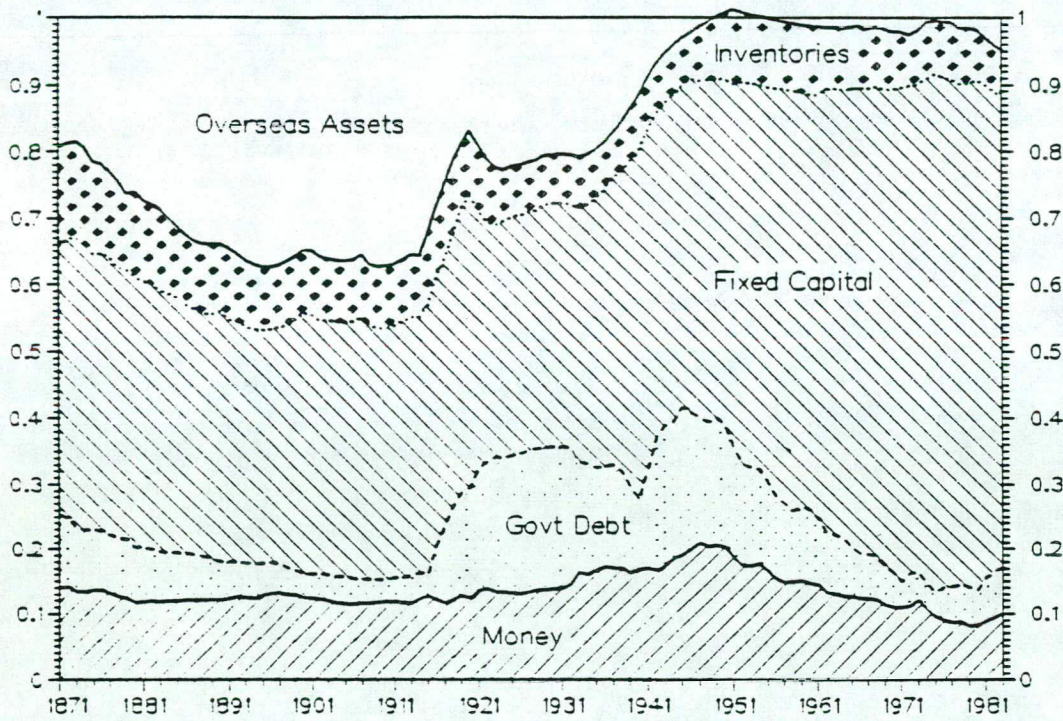
52. The discussion so far in this paper has considered the evolution of government borrowing and debt in the light of the implications for the inter-temporal distribution of consumption, and for tax rates. There has been no discussion of the way government borrowing is financed, and the monetary implications. The presumption has been that the debt issued is predominantly interest bearing, but there is a separate issue about the link between debt creation and monetary policy. Since the increased emphasis on control of monetary growth in the 1970s, the link between monetary and fiscal policy has occupied a more important place in analysis of the appropriate size of the PSBR.

53. The framework for analysing the links between monetary and fiscal policy is provided by the portfolios of the private sector. Government debt is a major component of private sector portfolios, together with overseas assets, and claims on fixed capital. For the non-bank private sector, money and bank loans are also major components. Portfolio shares can and do change significantly over time, as Chart 2 illustrates for the non-bank sector. In particular, money has not always grown at the same rate as government debt. Different relationships between the growth of money and debt imply different mixes of monetary and fiscal policy.

54. The choice of the monetary-fiscal policy mix in the long term therefore depends on the appropriate path of portfolio shares, especially the relative shares of debt and money. Alternatively the choice can be presented in terms of the pattern of relative interest rates which is most

CHART 2: NON-BANK PRIVATE SECTOR PORTFOLIO SHARES

A: PHYSICAL AND FINANCIAL ASSETS



B: FINANCIAL ASSETS

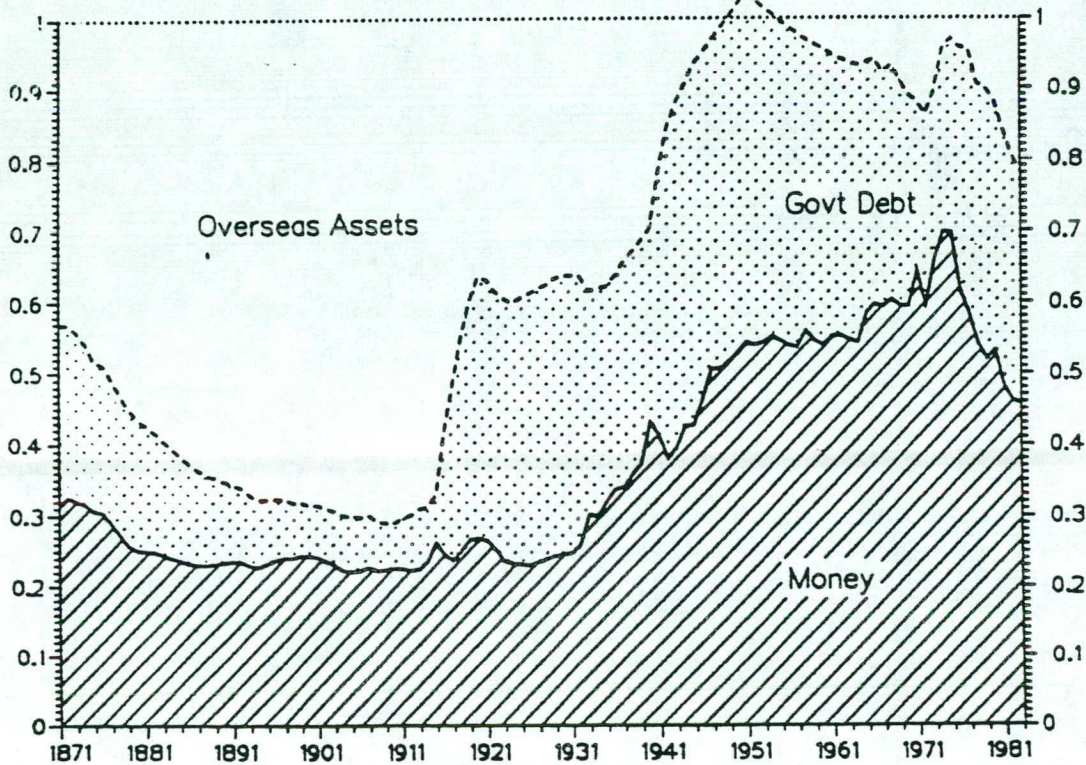


Chart 2: Sources and Definitions

1. Money: M3 (i) 1871-1969 Capie and Webber (1985), Table 1(9).
(ii) 1969-1983 Financial Statistics, Table 11.2

2. Government Debt: central government liabilities less official, overseas and bank holdings, at nominal values:
 - (i) 1871-1962 "The 'National Debt' and Public Sector Debt" Economic Progress Report, July 1982. Bank holdings obtained from "The British Economy: Key Statistics", Table M.
 - (ii) 1963-1983 Annual Abstract of Statistics, Table 18.3. Bank holdings from Financial Statistics, Table 6.2.

3. Fixed Capital: total net capital stock, less central government, at current replacement cost.
 - (i) 1871-1960 Feinstein (forthcoming)
 - (ii) 1961-1983 CSO Blue Book, Table 11.7

4. Inventories: book value of stocks and work in progress
 - (i) 1871-1919 Feinstein (forthcoming)
 - (ii) 1920-1938 Feinstein (1965)
 - (iii) 1945-1983 CSO Blue Book, Table 12.4

5. Overseas Assets: net stock at market values
 - (i) 1871-1964 Matthews et al (1982), Table 5.2 (interpolated)
 - (ii) 1965-1983 CSO Pink Book, Table 1.1

Note: The pre-1945 data are not generally very firmly based and only illustrate broad orders of magnitude.

appropriate. High levels of the PSBR relative to the rate of monetary growth, for example, would tend to put upward pressure on long-term interest rates - particularly those on government debt - relative to short-term rates. They would also probably imply a falling share of overseas assets and a lower exchange rate in the long term.

55. The simplest approach would be to assume unchanged portfolio shares. This might be justified on the grounds that, while shares may change in the medium term, trend changes in shares cannot be sustained indefinitely (except in the sense that they might asymptote to a fixed value). Simple calculations which assume fixed wealth/income ratios and fixed portfolio shares have been done for the UK by various authors.⁽²⁹⁾ Taking a debt/income ratio of about 50% - roughly the current level - and assuming real growth of 2% per annum, indicates a PSBR of roughly 1% of GDP at zero inflation. This is the illustrative figure given in the Green Paper on Public Expenditure and Taxation.⁽³⁰⁾ It provides a simple "debtist" rule which is analogous to, and consistent with, a simple "monetarist" rule which says that 2% monetary growth is required to bring about zero inflation if the underlying rate of output growth is 2%.

56. But, in practice, portfolio trends can persist for long periods, justifying significant departures from the simple rules. For example, financial innovation in many countries has led to trend changes in the velocity of monetary aggregates. Institutional, tax and other changes can lead to progressive changes in the supply of particular forms of debt: an example is corporate debentures, which have effectively dried up in the UK and hence increased the share of government debt in private portfolios. Profit rates can differ between countries for extended periods because of different opportunities for expansion, and this can give rise to sustained changes in the share of overseas assets.

57. The natural approach is to set the mix of monetary and fiscal policies in the medium to long term so as to accommodate trends in portfolio preferences over time. The aim might be to maintain a structure of relative yields, defined to include both nominal returns and valuation changes⁽³¹⁾, that reflects only differences in the marketability and risk characteristics of different assets. Imbalances between the supply and demand for different assets that might tend to push the structure of yields away from this optimal pattern should not be allowed to persist into the long term. The

result of such policies would be to maintain portfolio shares in line with investors' preferences.

58. Departures from such policies will gradually distort portfolio shares and relative interest rates. Although the changes may take time to produce major distortions, the potential implications in the long run will be foreseen by financial market operators. Expectational influences will tend to bring forward effects which might otherwise build up only over a long period of years. In practice, of course, much will depend on how the configuration of policies is seen in the markets, and whether it is expected to persist in the future. Perhaps only the US is in a position to impose substantial changes in portfolio shares for a sustained period without losing the confidence of the markets, because of the special role of the dollar. Overseas residents may well be prepared to accept a large build-up of dollar assets for a considerable period, although the current US position is probably not ultimately sustainable.

59. The application of these general principles is not straightforward. Measurement of ex ante yields, including expected capital gains, is far from easy. And it is not straightforward to decide what pattern of relative interest rates would reflect only marketability and risk characteristics of assets. Looked at from the other side, desirable long-term trends in portfolio shares are not easy to identify directly, though past behaviour may provide some guide.

60. The analysis in earlier sections suggested a number of structural reasons why changes in the ratio of public sector debt to income may be appropriate, but did not discuss the implications for monetary policy. Although the earlier analysis indicated that lower public sector debt would be accompanied by an increase in the domestic capital stock and higher stocks of overseas assets, there is no clear message about changes in the shares of other assets. Probably the most neutral assumption is that, given the growth of nominal incomes, downward adjustment to the PSBR, leading to lower accumulation of domestic financial assets generally, would point to lower growth of interest-bearing forms of money. But while this may be sensible in qualitative terms, its implications in quantitative terms are difficult to assess in practice. And for non-interest-bearing money the conclusion is likely to be reversed because of the effect of lower nominal interest rates.

61. To sum up this section, there is a need to ensure that monetary and fiscal policies are in harmony in the medium to long term, irrespective of the paths of asset accumulations and debt implied by the analysis in earlier sections. This effectively means not distorting portfolio shares. Simple rules for the PSBR and monetary growth, based on existing shares and ratios to GDP and an assumed path for money GDP, typically have to be modified to allow for trends in the desired ratio of debt to GDP and medium-term trends in portfolios due to institutional and other changes.

V. MONETARY AND FISCAL POLICY IN THE SHORT TERM

62. The discussion so far has been concerned with the paths for government debt and portfolio shares in the long term. This section discusses policies that give rise to variations in debt and portfolio shares around these paths.

The Scope for Short-term Variations

63. Fluctuations in portfolio shares and deviations of government debt from a desired long-term path for just a few years are not likely to have serious destabilising effects, or to jeopardise long-term objectives. Similarly interest rates and exchange rates that are different from those compatible with portfolio balance and the desired path for debt are also tolerable for limited periods.

64. However, any purely short-term deviations have to be reversed at some stage. If the PSBR is temporarily above the path consistent with longer-term objectives, so that debt is growing more rapidly than desired, there should be an offsetting period of a lower-than-trend PSBR so as to bring the stock of debt back to the desired path. Similarly, if monetary growth is temporarily high in relation to the growth of total portfolios, this should be followed by a period of relatively slow monetary growth. Reversing these short-term movements will eliminate any temporary deviation of interest rates and exchange rates from the desired path.

65. The need to reverse any purely short-term changes in the overall stance of policy and the fiscal/monetary mix places some bounds on the scope for policy adjustments in the short term. Governments would be unwise

to make supposedly short-term changes that were difficult to reverse in the future. Three other factors strengthen the case for a cautious approach. First, the nature of any shock hitting the economy and calling for a policy adjustment cannot always be fully assessed at the time. Secondly, since fiscal and monetary policy changes in the short term have to be largely reversed in time, usually only those shocks which are themselves thought to be temporary should be met with a temporary policy adjustment⁽³²⁾⁽³³⁾. Thirdly, economic agents, especially financial markets, may doubt the ability or willingness of the government to reverse short-term policy changes, especially when those changes are large. Their behaviour may force the government to change course before the effects of the policy changes have been felt.

66. Nevertheless there is clearly some room for changes in the stance and mix of policy in the short term. Policy responses to cycles in economic activity and temporary shocks hitting the economy are obvious examples. In many cases it might be appropriate to change the overall stance of policy without altering the mix of monetary and fiscal policies. In other cases changes in the mix might be desirable. Before discussing possible policy responses to cycles and shocks, we look at the effects of changes in the stance and mix of fiscal and monetary policies.

The Effects of Changes in Monetary and Fiscal Policies

67. A change in the overall stance of monetary and fiscal policies, with both expanding or contracting to the same extent, tends to change both output and inflation in the same direction in the short term⁽³⁴⁾. In most theoretical models, except those with no supply constraints at all, most of the output gains following an expansionary change are temporary⁽³⁵⁾. Most of the increase in prices is, however, permanent.

68. A change in the mix of monetary and fiscal policies, for a given overall stance of policy, will not necessarily change output and inflation in the same direction in the short term. If the output-inflation trade-offs associated with fiscal and monetary policies are different, there may be a tendency for output and inflation to move in opposite directions. Thus if fiscal policy produces a smaller impact on inflation for a given change in output than monetary policy, a fiscal expansion associated with an increase in interest rates may lead to both higher output and lower inflation in the short term.

69. This sort of result may reflect a number of factors. A combination of fiscal expansion and higher interest rates is likely to raise the exchange rate if confidence in the overall stance of policy is sustained, and this tends to reduce prices for a given level of output. The fiscal expansion may have much the same effect itself if, for example, it takes the form of a tax reduction which reduces the pressure for high wage settlements. But some factors may work in the opposite direction. Higher interest rates may themselves tend to raise prices for given levels of output. This could occur directly, such as the effect of a higher mortgage rate on the RPI, or indirectly via a higher cost of capital.

70. The balance of these factors is essentially an empirical matter. In many models the exchange rate effect dominates, and this has generally been true of the Treasury model. But other models, particularly those relating to the US economy, give greater weight to the positive relationship between interest rates and prices. For present purposes we proceed on the basis that a combination of a higher PSBR and higher interest rates is likely to mean a more favourable split between output and prices in the short run. But in the longer term this may not be so.

Responses to Cycles and Shocks

71. It is helpful to consider the implications of this sort of analysis for short-term policy responses. Deviations of the economy from the path considered appropriate in the medium term may well call for a policy response, and the nature of the deviation may affect what sort of response is appropriate. We consider essentially temporary deviations, and assume that confidence in the overall stance of policy remains unchanged.

72. For illustrative purposes we can consider deviations in money GDP from a medium-term path. An increase in money GDP above this path would call for a tightening of the stance of policy. This could entail either some increase in interest rates or a tightening of fiscal policy, or both. But given that prices and output are important in their own right, different types of money GDP change may call for different mixes of monetary and fiscal response.

73. Consider first deviations which are predominantly associated with movements in real GDP, with relatively little contribution from prices. The

discussion above suggests a primarily fiscal response, as long as confidence can be maintained, since this would have a relatively large effect on output in relation to prices. This points to a PSBR change accompanied by relatively little change in real interest rates; if real and money GDP were rising a fall in the PSBR would be indicated.⁽³⁶⁾ There may be a case for making the change in the PSBR roughly equal to the effects of the automatic stabilisers, leaving the "cyclically-adjusted" PSBR relatively little changed, since this would avoid distortions due to changing tax and benefit rates.⁽³⁷⁾

74. In the case of changes which take the form primarily of price movements, with relatively little movement in output, a predominantly monetary response is suggested by the earlier discussion insofar as this would have a relatively large effect on prices in relation to output. This would point to leaving the nominal PSBR unchanged, while using interest rates to bring the economy back closer to the desired path.

Adjustments to the PSBR

75. Adjustments to the PSBR or the public sector financial deficit are sometimes made in order to produce a measure that is regarded as a better indicator of fiscal stance than the unadjusted PSBR. Three types of adjustment are common: the weighting of components of changes in the PSBR in accordance with their assumed impact on demand; the removal from changes in the PSBR of that part which is attributable to cyclical fluctuations in economic activity; the deduction from the PSBR of inflation tax on existing public sector debt.

76. These adjustments are all aimed at producing an indicator which measures the impact of fiscal policy more satisfactorily. In principle they could be helpful. But in practice there are many conceptual and measurement difficulties which generally make the resulting indicators unsatisfactory in certain respects. And their usefulness, even ignoring measurement difficulties, depends on the particular circumstances in which they are employed.

77. Take demand-weighting first. The idea here is to weight each element of the PSBR in terms of its effect on real demand, though the principle could easily be extended to cover other effects of fiscal policy - say inflation effects. Changes in different taxes and expenditure items do, of

course, have different effects on real demand.⁽³⁸⁾⁽³⁹⁾ In principle the demand weights that are used could reflect whatever accompanying monetary policy and set of financial market reactions were thought to be appropriate.⁽⁴⁰⁾ In practice, most demand-weighted measures assume an accommodating monetary policy without any such anticipatory behaviour by financial markets. But any assumption is essentially arbitrary, and not necessarily appropriate to the particular circumstances involved.

78. Another problem with demand-weighting is that effects on demand vary over time. Often, demand-weighted measures ignore this, taking account only of the first-round impact of changes in taxes and expenditure after allowing for saving and import leakages or focussing on effects in a single time period. By ignoring the full implications of lags and second round effects, time-series of demand-weighted deficits typically do not represent accurately the effects on demand of fiscal policy.

79. Cyclically-adjusted measures are designed to distinguish "discretionary" from "automatic" changes in the observed deficit. But again, these are subject to many difficulties. First, there is in general no firm basis on which to make an objective distinction between discretionary and automatic changes. The measures usually assume that the "cycle" accounts for changes in the deficit associated with output growth greater or less than some assumed trend⁽⁴¹⁾. But the choice of trend in the recent past, particularly within a cycle, is inevitably somewhat arbitrary, and so therefore is the cyclical adjustment. Furthermore, the extent to which interest rate changes should be considered automatic or discretionary over the cycle is another difficult issue on which arbitrary judgements have to be made.

80. A further problem is that measures of the cyclically adjusted deficit depend critically on the structure of tax and benefit rates in the economy. Economies with different fiscal structures may exhibit quite different paths for the cyclically adjusted deficit, even if the paths of the unadjusted deficit and the behaviour of the economies generally are otherwise identical. A measure that only allows for discretionary changes in the deficit may therefore have little bearing on the total effect of fiscal policy on the economy⁽⁴²⁾.

81. There is also no unambiguous measure of the inflation-adjusted deficit. Different variants are possible depending on whether the inflation

tax is defined to depend on actual inflation or on the difference between the effective nominal interest rate paid on government debt and some assumed real interest rate, and depending on the measure of debt used in the calculation⁽⁴³⁾. In principle one might also wish to allow for the possibility that the impact on demand of changes in the inflation tax may be different from the impact of other changes in the PSBR. Some measures do allow for this and some do not⁽⁴⁴⁾.

Use of Adjusted Measures for Setting Policy

82. Thus there are difficulties with both the definition and measurement of adjusted measures of the fiscal deficit. A more important question, however, is how far indicators that are primarily descriptive can be used in a prescriptive role. There has been a tendency for some commentators on fiscal policy to suggest implicitly that fluctuations in adjusted measures should be avoided, or that the aim should be to keep the adjusted PSBR or financial deficit close to some specified level. But it is not possible to formulate general rules of this type for the adjusted PSBR without regard to other considerations, such as the appropriate long-term PSBR, the desired evolution of the economy in the short term, and the nature of disturbances to the economy.

83. In general, the optimal PSBR in the long term, even with no inflation, will be non-zero, and perhaps changing slowly over time. There is thus no presumption that particular adjusted measures should remain zero or even fixed in the long term. Moreover, the discussion in this section suggests that they should also not be fixed in the short term relative to their long-term values.

84. Thus, for example, cyclically and inflation-adjusted PSBRs should not be fixed in response to cycles or other disturbances arising from the price side. A rise in inflation would tend to reduce the inflation-adjusted PSBR, and under plausible assumptions would also reduce output and hence the cyclically-adjusted PSBR. It would clearly be incorrect to respond to such a disturbance by seeking to restore either of these adjusted PSBRs to their original values, since that would involve a further expansion of nominal demand when it would be more appropriate to keep it under control. A more sensible response would be to keep the actual PSBR unchanged, as discussed earlier.

85. On the other hand, it may be appropriate to keep the cyclically-adjusted PSBR constant in the face of temporary fluctuations in output originating from real changes. Allowing the automatic stabilisers alone to work means that tax and benefit rates are unchanged and distortions minimised, and it avoids the need to take a view - which would sometimes turn out to be wrong - about how much of the change in economic activity was essentially temporary and therefore an appropriate target of offsetting action.

86. But, in general, adjusted measures of the PSBR or the financial deficit do not provide much guidance to fiscal policy changes in the short term, although they may be useful indicators in some circumstances. In assessing short-term changes in the mix of fiscal and monetary policies, there is really no alternative to analysing all the circumstances surrounding each situation.

VI. SUMMARY

87. The main points that emerge from this paper are as follows:-

a. Economists before Keynes were mainly concerned with the structural implications of budget deficits and public debt. After Keynes, increasing attention was paid to the relationship between deficits and aggregate demand in the short term. Now long-term issues have re-emerged. The paper considers both the long term and the short term.

b. Public sector borrowing can be used to achieve a desirable distribution of consumption over time and to avoid unnecessary changes in tax rates. In principle these two criteria might have different implications for setting the PSBR in some circumstances, but in practice these differences are probably of limited importance.

c. In the medium to long term, the path for government debt should generally be set so that the net worth of the public sector, appropriately defined, is unchanged. Debt will therefore alter in line with movements in other assets and liabilities such

as the capital stock of the public sector, the present value of North Sea revenues and unfunded state pension liabilities.

d. There are considerable practical difficulties with such a policy because of problems with defining and measuring the appropriate concept of public sector capital stock and other assets and liabilities. Nevertheless the analytical framework is helpful.

e. Monetary and fiscal policies need to be in harmony in the medium to long term. This means that portfolio shares should not deviate too much from the long-term trends caused by financial innovation, institutional change and changes in portfolio preferences. Simple rules for the PSBR and monetary growth, based on existing shares and ratios to GDP, typically have to be modified to allow for trends in the desired ratio of debt to GDP and in portfolio shares.

f. Temporary deviations in the PSBR and monetary growth from their long-term paths can be accepted, though they generally need to be reversed. They should not be too large because: bigger changes are more difficult to reverse than smaller ones; it may be difficult to judge whether a disturbance is going to be temporary or not; and financial markets may lose confidence in the sustainability of policy.

g. Responses to short-term fluctuations and temporary shocks depend on the source of the disturbance. Maintaining an unchanged cyclically-adjusted PSBR in the face of fluctuations in output might sometimes be a sensible policy, particularly if the output change is large relative to associated price changes. But there are severe difficulties of measurement. Maintaining an unchanged cyclically-adjusted or inflation-adjusted PSBR is not a sensible policy in the face of shocks which primarily affect inflation.

1. The starting point for the calculations described in paragraphs 42-44 of the paper is a long term revenue projection. This is set out in table A1 below, and is derived as follows:

- (i) Up to 1988-89 the figures are taken from the 1985 MTF5 projections.
- (ii) Between 1988-89 and 1993-94, the path is based on the projection in Annex 4 of the 1984 Green Paper on Public Expenditure and Taxation, amended as necessary to link with the earlier years.
- (iii) The figures after 1993-94 are purely illustrative, though broadly plausible.

Table A1: North Sea Revenues (£billion; 1985-86 prices)

1985-86	13.5	1997-98	4.5	2010-11	1.3
1986-87	11.0	1998-99	4.0	2011-12	1.1
1987-88	8.5	1999-2000	3.5	2012-13	1.0
1988-89	7.5	2000-01	3.2	2013-14	0.9
1989-90	7.3	2001-02	3.0	2014-15	0.8
1990-91	7.1	2002-03	2.7	2015-16	0.7
1991-92	6.9	2003-04	2.5	2016-17	0.6
1992-93	6.6	2004-05	2.3	2017-18	0.5
1993-94	6.4	2005-06	2.1	2018-19	0.4
1994-95	5.9	2006-07	1.8	2019-20	0.3
1995-96	5.5	2007-08	1.6	2020-21	0.2
1996-97	5.1	2008-09	1.5	2021-22	0.1
		2009-10	1.4		

2. Future revenues are then discounted to yield the real net present value. This can then be converted into a stream of permanent revenue, expressed at constant 1985-86 prices, defined as that constant stream of income which could be obtained in perpetuity were all future revenues to

be invested in a fund yielding the assumed discount rate.⁽¹⁾ A real discount rate of 2½% per annum is used in the main calculation cited in the text, but in order to test the sensitivity of this assumption the calculations have been repeated using 3½%.

3. The figures obtained using this methodology are summarised in table A2.

Table A2: Permanent North Sea Revenues (£billion; 1985-86 prices)

<u>Discount Rate</u>	<u>Net Present Value of North Sea Revenues in 1985-86</u>	<u>Permanent North Sea Revenue</u>
2½%	108	2.7
3½%	100	3.5

4. The calculations in the text use the figures for permanent revenue to derive adjustments to the PSBR, on the assumption that the aim is to reduce taxes or increase expenditure permanently to the extent of the permanent revenue. The discount rate is assumed to be unaffected. The figures are based on the following relationships:

$$ADJ = PR - AR + rD$$

$$\Delta D = ADJ$$

$$PR = r \left[\sum_{i=0}^{35} AR_{+i} (1+r)^{-i} \right]$$

where ADJ = adjustment to the PSBR

D = change to the stock of public sector debt

AR = actual revenue

PR = permanent revenue

r = discount rate

(1) Only revenues from 1985-86 onwards are taken into account in defining permanent revenue. Earlier revenues and the way they are spent are deemed for this purpose to be water under the bridge.

NOTES

- (1) The views expressed in this paper are those of the authors, and not necessarily of the Treasury.
- (2) The Equivalence Theorem, which equates taxation and debt in terms of their effects on expenditure, was recognised by Ricardo as a theoretical possibility but discounted in practice.
- (3) Though Keynesian thinking had a profound influence on approaches to analysing fiscal policy over this period, active debate continued on the structural implications of debt finance. See, for example, Lerner (1948), Buchanan (1958) and Ferguson (1964).
- (4) The importance of the assumptions about private saving behaviour for the analysis of the impact of deficits and debt on the economy has been recognised for some time. See, for example, Modigliani (1961) for an early application of the life-cycle model, and Cavaco-Silva (1977) for further refinements.
- (5) There has been much debate about the effect of fiscal deficits on interest rates, particularly in the US (see, for example, US Treasury (1984) for a survey). Our interpretation of the literature is that, as long as allowance is made for the influence of the cycle on both interest rates and deficits, there is clear evidence of a positive relationship. There are, of course, strong theoretical reasons for such a relationship.
- (6) It might be objected that very high debt/income ratios have been achieved in wartime without excessively high real interest rates. This was true in the UK, for example, in each of the World Wars this century. But at time of war, restricted consumption possibilities together with patriotic desires to contribute to the war effort combine to diminish the upward pressure on interest rates. The disinvestment abroad that occurred in both World Wars also worked in the same direction.
- (7) The question of how to define worthwhile investment is discussed later. For present purposes it is any investment which yields a useful stream of "capital services" in future. "Income" here should be taken to refer to either public sector revenue, as from a power station, or useful capital services, as from a prison.
- (8) See Diamond (1965) for the first detailed discussion of these issues in an overlapping generations model.
- (9) If the excessive PSBR was financing investment which was excessive in the sense that its rate of return was below the optimal interest rate, present measured consumption may not appear excessive. But some of the investment should be regarded as consumption.

- (10) This is not a new idea. It can, for example, be found in the writings of the New Cambridge school.
- (11) Persson (1983) discusses these issues in detail in the context of Diamond's overlapping generations model extended to an open economy.
- (12) See, for example, Barro (1979, 1981).
- (13) This analysis presupposes that taxes are not lump sum.
- (14) See Barro (1981).
- (15) Barro also argues for stable tax rates on the grounds that tax collection costs may increase more than proportionally with the level of tax rates. Total collection costs over a period of years during which a given amount of aggregate revenue is collected will therefore be minimised if tax rates are constant.
- (16) For example, it is assumed that there is no relationship between real interest rates and the level of debt.
- (17) It is, of course, an old idea that borrowing to finance capital expenditure is acceptable and that current expenditure should be financed from taxation. It lay behind the willingness of public bodies in the nineteenth century to issue bonds to finance capital projects and the willingness of the private sector to take them up. But according to Buchanan (1958) the classical economists were slow to articulate a coherent theory along these lines. Smith took the first steps away from the mercantilist position but was hampered in that he did not trust governments not to use borrowing powers to finance consumption. "Ricardo confused the whole argument by his highly abstract model which appeared to contain elements of the earlier mercantilist views. And the third major figure [J.S. Mill] ... was hopelessly confused" (p.105). Buchanan argues that a "classical" theory was clearly emerging by the end of the nineteenth century, with Leroy-Beaulieu (1906) its clearest exponent.
- (18) Single large consumption projects may not really exist. Wars, for example, may be viewed as such, but alternatively they may be events that should properly be regarded as investments because they buy peace, freedom, national self-esteem or such like for a few more years or decades. Other examples pose similar difficulties.
- (19) A general measurement problem that is not discussed below is posed by the possibility that the impact of different components of the public sector balance sheet on the distribution of consumption over time may not be proportional to their values in the balance sheet. For example, high-yielding and low-yielding capital assets may be valued at the same replacement costs whereas their effects on the distribution of consumption would

more properly be captured by a measure that reflected discounted future returns. Less obviously, the impact of debt on the distribution of consumption, operating through interest rates and external capital flows, may not be equivalent, pound for pound, to that of the public capital stock and other assets. If this were the case, the criterion for net worth should allow the level of net worth to change according to its composition. This possibility is ignored in what follows, but it provides a further reason for avoiding over-precise rules for the PSBR based on net worth.

(20) Kotlikoff (1984) adopts a still broader approach in which all policy measures which affect the distribution of consumption over time, including, for example, inflationary money creation and changes in the tax structure (eg investment incentives which raise investment relative to consumption) as well as public investment, are taken into account. He focusses on the "economic deficit", defined as the redistribution of resources across generations, rather than on the actual deficit.

(21) Wars may perhaps come into this category, though they may also in many cases generate pecuniary returns.

(22) This example illustrates the general point that maintenance expenditure should in principle be added to investment expenditure, and both should be depreciated in measuring capital stock for these purposes. This is not, however, the convention adopted by the statisticians.

(23) Complications arise if the sale price of the asset does not equal the capitalised stream of returns available to the public sector, perhaps because the prospective returns to the asset when in private hands are expected to be greater than when it was publicly owned. The net worth calculation would have to take account of this, and the appropriate change in the PSBR would not necessarily exactly equal the value of the asset sale.

(24) The effect on tax rates would not be entirely fixed under this approach, assuming a growing economy. The absolute reduction in taxation would be, however, implying a reduction in tax rates which diminished as the economy grew.

(25) The Next Ten Years: Public Expenditure and Taxation into the 1990s
H M Treasury, March 1984 (Cmnd 9189).

(26) Varying the precise assumptions in a plausible way would, of course, alter the calculations. Changing the discount rate by 1% would change the estimate of "permanent" revenues by around £1 billion per annum, or about 1.4% of GDP at current levels. Higher real oil prices and a less rapid decline in production would mean significantly higher revenues in the 1990s and early years of the next century, but given the overall profile, the effect on "permanent" revenue would be relatively muted.

(27) Reform of Social Security DHSS, June 1985 (Cmnd Nos.9517-9519).

(28) Uncertainty about the optimal level of net worth stems from at least three sources: first, the exclusion from conventional balance sheets of some items, such as the right to tax, that might appear in a comprehensive balance sheet (paragraph 30); second, the possibility that the impact on the distribution of consumption over time of different items may not be proportional to their values in the balance sheet (note 19); third, changes over time in the optimal level of net worth, conventionally measured, because of borrowing to finance current expenditure that should properly be regarded as investment although it does not give rise to an asset in the balance sheet.

(29) For example Congdon (1976), Budd and Dicks (1983), and Budd, Dicks and Keating (1985).

(30) Paragraph 55, page 18.

(31) This may prove difficult in practice since realised capital gains in general differ from expectations. Only in steady states would this not be a problem.

(32) Permanent changes, such as the oil price rise of 1974 for example, have to be accepted and the economy has to adjust to them. This may involve shifts in policy, as described earlier, if the changes are not foreseen. There may, however, sometimes be a case for temporarily changing policy in the face of a permanent shock, to ease the transition to the new situation.

(33) Moreover, some models suggest that the duration of any temporary changes in government borrowing should be limited. The simulations carried out by Kotlikoff (1984) show that the degree of crowding out of private sector capital formation as a result of a temporary deficit rises more than proportionately with an increase in the duration of the deficit.

(34) There is no unambiguous way to define a balanced change in monetary and fiscal policies in the short term. It could be defined as equal changes in the growth in debt and money, or as no change in the pattern of relative yields. The two will not necessarily be the same because of differential effects of changes in factors other than yields that affect the demand for debt and money: wealth and income, for example.

(35) Some permanent increase in output may occur if the capital stock rises during the period of temporarily higher output. On the other hand output may end up permanently lower if the higher inflation reduces the efficiency of the economy and/or the level of investment.

(36) Such a response presumes that the change in GDP is not primarily a shift in the supply side, which would alter the desirable path of the economy in the medium term.

(37) For each 1% increase in GDP relative to trend, simulations on the Treasury model suggest that the PSBR would be reduced by $\frac{1}{4}$ - $\frac{1}{2}$ % of GDP at unchanged tax and benefit rates.

(38) Savage (1982) sets out the weights used by the National Institute. They range from zero for current grants paid abroad to 90% for current expenditure on goods and services, with oil taxes (20%) and most other taxes (59%) in between.

(39) Use of the financial deficit rather than the PSBR is sometimes justified in terms of demand weighting since many of the financing items that enter the PSBR but not the PSFD - asset sales for example - probably have only a small impact on real demand.

(40) If, for example, monetary policy was generally non-accommodating it would be appropriate to assume that a fiscal expansion would produce higher interest rates which would offset part of the direct impact on demand. Even if it was accommodating, financial markets might anticipate the higher inflation and raise interest rates anyway.

(41) See, for example, Savage (1982), Muller and Price (1984), and IMF (1985).

(42) However, as noted earlier, stabilising tax rates may be considered desirable in its own right for reasons of efficiency. But this is essentially a micro-economic consideration, whereas cyclically adjusted deficits are normally used in a macro-economic context.

(43) See, for example, the recent discussion by Miller (1985).

(44) The inflation-adjusted demand-weighted deficit used by the National Institute attaches a weight of 20% to the inflation tax (Savage (1982)).

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CONFIDENTIAL

FROM: R J DEVEREUX
DATE: 2 July 1985

1. MR CASSELL
2. CHANCELLOR OF THE EXCHEQUER

cc Sir P Middleton
Sir T Burns
Mr H P Evans
Mr Battishill
Mr Lankester
Miss Peirson o/r
Mr Watts
Dr I Webb

CGBR IN JUNE

The preliminary estimate of the CGBR in June is £0.7 billion, bringing the cumulative total since 1 April 1985 to £3.0 billion. Within this the CGBR(0) is estimated to have been £0.4 billion in June and £2.8 billion since 1 April 1985. These figures are not yet firm and may change with later information before publication on 16 July in the monthly press notice on the PSBR.

2. The CGBR(0) outturn for June is as forecast last month.

3. The cumulative CGBR(0) since 1 April 1985 is £1.0 billion lower than forecast in the Budget profile. The main factors are lower supply expenditure (by £0.5 billion) and high Customs and Excise receipts (by £0.3 billion). The June forecast of the CGBR(0) for 1985-86 was £0.3 billion lower than the Budget forecast. Lower supply expenditure and higher Customs and Excise receipts (both beginning to show already) are expected to be offset by lower Petroleum Revenue Tax receipts in the second half of the year.

4. Further analysis of the outturn in June, together with forecasts for the next three months, will be given in the next Ministerial note on the PSBR in two weeks' time.

R J Devereux
R J DEVEREUX

CONFIDENTIAL

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CENTRAL GOVERNMENT TRANSACTIONS (2)

£ billion

	Inland Revenue	Customs & Excise	Other own account	CGBR(O)	Net	Lending	CGBR
					IAs	PCs	
1st April 1985 - 30 June 1985							
Outturn (1)	+ 10.5	+ 8.8	- 22.1	- 2.8	- 0.5	+ 0.3	- 3.0
Budget profile	+ 10.4	+ 8.5	- 22.7	- 3.8	- 0.5	- 0.3	- 4.5
Difference	+ 0.1	+ 0.3	+ 0.6	+ 1.0	-	+ 0.5	- 1.6
1st April 1984 - 30 June 1984	+ 9.6	+ 7.7	- 21.8	- 4.5	- 0.5	+ 0.1	- 4.9
Calendar June 1985							
Outturn (1)	+ 3.2	+ 2.4	- 6.0	- 0.4	- 0.3	+ 0.1	- 0.7
Last month's forecast	+ 3.2	+ 2.5	- 6.1	- 0.4	- 0.3	-	- 0.7
Difference	+ 0.1	- 0.1	-	-	-	-	-

(1) Preliminary estimate, subject to revision

(2) + indicates a receipt, net receipt, or difference which reduces the CGBR

- indicates a payment, net payment, or difference which increases the CGBR

CONFIDENTIAL



FROM: MRS M HENSON
DATE: 8 JULY 1985

MR DEVEREUX

CGBR IN JUNE

The Chancellor has seen and noted your minute of 2 July.

Meena Henson
MEENA HENSON

CONFIDENTIAL AND PERSONAL

June was bound to be a good month, given the BT call. In the event it turned out better than we expected, but much of the improvement is

FROM: MISS M E PEIRSON

DATE: 9 July 1985

1. MR CASSELL

2. CHANCELLOR OF THE EXCHEQUER

cc Sir P Middleton

Sir T Burns

Mr H P Evans

Mr Peretz

Mr Wicks

Mr Devereux

Dr I Webb

Mr Wells - CSO

in the LABR - which moves erratically.

C.
Interesting, esp' X.

Ruo 9/7

9/7
Handwritten signature

PSBR IN JUNE

1. The first provisional outturn for the PSBR in June is -£0.1 bn, £0.4 bn below last month's forecast (see table attached). This is close to the bottom of market expectations, which are between a net repayment of £¼ bn and net borrowing of £1 billion. Our estimate is subject to revision before publication on Tuesday 16 July. In the first 3 months of 1985-86 the PSBR was £2.7 bn, £1.2 bn below the Budget profile.

2. The CGBR(O) in June was provisionally £0.3 bn, £0.1 bn below last month's forecast and slightly below the outturn reported in Mr Devereux's minute of 2 July.

3. The LABR in June was provisionally a net repayment of £0.4 bn, compared with forecast borrowing of £0.1 bn. The PCBR was provisionally close to zero, compared with a forecast net repayment of £0.1 bn.

4. The cumulative difference of £1.2 billion between the Budget profile and the PSBR outturn for April to June is due to the shortfall on the CGBR(O). As Mr Devereux explained, the June forecast of the CGBR(O) for 1985-86 as a whole was only £0.3 bn below the Budget forecast, because the lower supply expenditure and higher Customs receipts affecting the April-June outturns are expected to be largely offset by lower PRT later in the year. The June forecast of the PSBR for 1985-86 was even closer to the Budget forecast.

5. The monthly note, presenting updated estimates for June and revised forecasts for July-September, will be circulated next Monday. As usual we shall send you the draft press briefing at the same time.

MEP

MISS M E PEIRSON

CONFIDENTIAL & PERSONAL

£ billion

	June 1985			April-June 1985			April- June 1984
	Provisional outturn	Last month's forecast	Difference	Provisional outturn	Budget profile	Difference	Outturn
CGBR(O)	0.3	0.4	- 0.1	2.7	3.8	- 1.1	4.5
LABR	- 0.4	0.1	- 0.4	0.4	0.4	-	0.6
PCBR	-	- 0.1	0.1	- 0.4	- 0.2	- 0.1	- 0.5
PSBR	- 0.1	0.4	- 0.4	2.7	3.9	- 1.2	4.6

CONFIDENTIAL & PERSONAL

COVERING CONFIDENTIAL & PERSONAL

FROM: MISS M E PEIRSON
DATE: 15 July 1985

→ PPS/CHANCELLOR

cc Mr Cassell

DRAFT PRESS BRIEFING ON PSBR IN JUNE

I attach the draft press briefing on the PSBR in June, for tomorrow's publication. The aim is to circulate the briefing to List A recipients by 10.30 am tomorrow. Any comments which the Chancellor might have can be taken on board provided you can let Mr Clark (ext 3093) have them before 9.30 am tomorrow, and earlier if possible.

Ch/
Any comments?
(see also the
monthly note on
PSBR)

Clark
15/7



MISS M E PEIRSON

COVERING CONFIDENTIAL & PERSONAL

From: JOHN CLARK
XX July 1985

MR CULPIN - IDT

MR LANG - CSO Press Office

cc List A

Chancellor
Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr Cassell
Mr H Evans

Mr Peretz
Miss Peirson
Mr Watts
Mr Pickering
Mr R Evans
Mr Ward - CSO
Mr Wright - B/E
Mr Turnbull - No. 10

List B

(distributed at 2.30pm, 16 July)

Mr Stibbard
Mr Spencer
Mr Cropper
Mr H Davies
Mr Lord
Mrs Hillier - IR
Mr B Sexton - C and E

DRAFT BRIEFING FOR 16 JULY PSBR PRESS NOTICE

FACTUAL

The PSBR figures for June will be published at 2.30pm on 16 July. The provisional outturns, together with figures for the first three months of 1984-85 and 1985-86, are shown in Table 1. Cumulative figures for the PSBR and its components for 1984-85 and 1983-84 are shown in Table 2 overleaf.

Table 1: Borrowing requirement outturns

£ billion

	Apr-Jun 1984	Apr-Jun 1985	June 1985
Central government on own account	4.5	2.7	0.3
Local authorities	0.6	0.4	-0.4
Public corporations	-0.5	-0.3	-
PSBR	4.6	2.7	-0.1
Memo: CGBR (including borrowing for on-lending to LAs and PCs)	4.9	2.9	0.6

Note: Figures may not sum precisely because of rounding.

Table 2: PUBLIC SECTOR BORROWING REQUIREMENT – Comparison with the last two years

Cumulative £ billion

	Central government on own account			Local authorities borrowing requirement			Public corporations borrowing requirement			Public sector borrowing requirement		
	1983-84	1984-85	1985-86	1983-84	1984-85	1985-86	1983-84	1984-85	1985-86	1983-84	1984-85	1985-86
	Apr	0.9	1.9	1.1	0.5	0.9	0.8	-0.2	-0.4	-0.1	1.2	2.4
May	2.4	3.2	2.4	0.3	0.8	0.8	-0.3	-0.4	-0.3	2.4	3.6	2.8
Jun	3.7	4.5	2.7	-0.1	0.6	0.4	-0.4	-0.5	-0.3	3.2	4.6	2.7
Jul	4.5	5.0		-0.0	0.8		-0.6	-0.7		3.9	5.2	
Aug	5.7	6.2		0.3	1.4		-0.4	-0.7		5.6	6.8	
Sep	6.6	6.4		0.3	1.2		-0.0	-0.3		6.9	7.4	
Oct	6.7	6.8		0.3	1.0		0.1	0.2		7.1	8.0	
Nov	8.3	8.6		-0.2	0.8		0.4	0.4		8.5	9.7	
Dec	9.1	7.9		0.1	1.2		0.6	1.3		9.8	10.3	
Jan	6.3	5.7		0.1	0.9		0.7	1.3		7.1	7.9	
Feb	6.7	5.2		0.2	1.3		0.6	1.3		7.5	7.8	
Mar	8.2	6.7		1.2	2.4		0.3	1.1		9.7	10.2	

Note: Figures may not sum precisely because of rounding.

2. The (provisional) PSBR for June is a net repayment of £0.1 billion. This is at the lower end of the forecasts of City analysts, which lie between a net repayment of £¼ billion and borrowing of £1 billion. BT receipts of nearly £1.1 billion in the month account for low figure.

3. The June outturn brings the cumulative PSBR for the first quarter of 1985-86 to £2.7 billion, £1.9 billion lower than over the same period last year.

POSITIVE

Borrowing in first quarter of 1985-86 £1.9 billion lower than in first quarter of 1984-85. BT receipts of nearly £1.1 billion account for some but not all of reduction.

DEFENSIVE/FACTUAL

1. Front-end loading

Background

Last year Chancellor said "almost all" of PSBR in 1984-85 was expected in first half of year; such high front-end loading was expected because of special receipts in second half of year (VAT on imports and BT). But the prolongation of the coal strike added substantially to borrowing in the second half, so in the event no more than three-quarters of the PSBR was in the first half-year. In 1985-86, BT second call receipts (June) has reduced borrowing in the first half-year, but higher corporation tax receipts (than in earlier years) will reduce borrowing in the second half-year.

Line to take

British Telecom second call receipts have already benefitted PSBR in first half of 1985-86, but higher corporation tax receipts (than in earlier years) will principally benefit second half.

2. Asset sales

Line to take

Bulk of receipts (nearly £1.1 billion) from second instalment of BT shares received in June, remaining £0.1 billion being received in July. (June receipts shown in "other funds and accounts", column 12 of Table 2 of press notice). Budget forecast for 1985-86 £2.5 billion.

3. Supply Expenditure

Background

For first three months of 1985-86, supply services (which represents issues to departments from the Consolidated Fund) were 6.6 per cent higher than in April-June 1984. The comparable increase in supply expenditure (which represents cheques issued by departments and differs from supply services because of changes in departmental balances with the Paymaster General) is similar. The latter increase is not published and is based on less firm information. No Budget forecast of supply in 1985-86 was included in the FSBR. Table 5.3 showed Main Estimates provision only, which is unsuitable for comparing against outturn.

Line to take

Supply services in first quarter of 1985-86 6.6 per cent up on 1984-85. Much too early in year to draw conclusions from the figure - cannot read much from three months' outturn.

4. Social security upratings

Background

May RPI showed 7 per cent rise over May 1984, compared with 4¾ per cent assumed in PEWP. This affects social security upratings in November (though for some benefits slightly different price indices are used), and so will add to supply expenditure and to National Insurance Fund expenditure.

Line to take

Social security uprating (hence expenditure) will not occur until November. Higher RPI than

assumed in PEWP adds £170 million to social security expenditure in 1985-86. Any extra costs which cannot be absorbed within DHSS programme will be charged to the £5 billion expenditure reserve.

5. EC refunds

Line to take

Whole of 1983 refund received in 1984-85. 1984 refund of 1000m ecus (about £570 million at present) expected in late 1985-86. 1985 arrangements are different, and will reduce UK monthly contributions, starting in 1986.

6. Inland Revenue receipts

Background

Total Inland Revenue receipts in June were £3.2 billion. Total for the first quarter 1985-86 was £10.5 billion, 9¼ per cent higher than a year ago. Budget forecast for 1985-86 was for receipts of £56.2 billion, up 11½ per cent on 1984-85, but this includes sharp increase in corporation tax receipts in fourth quarter of 1985-86.

Line to take

Inland Revenue receipts in June were £3.2 billion and the total for first quarter £10.5 billion. July sees the first payment of the new composite tax rate on bank deposits, which satisfies the basic rate income tax liability of the individual depositors. Rate of increase year-on-year forecast in Budget includes corporation tax, most of which received in fourth quarter of financial year.

7. Oil Revenues

Background

Pound:Dollar exchange rate now higher than 1.10-1.15 assumed in Budget for 1985 (TCSC minutes, 27 March 1985, p8)

Line to take

Whatever happens, little effect on oil revenues until September. Much too soon to draw conclusions - oil revenues depend on both sterling oil prices and production. Oil production forecasts very uncertain.

8. Customs and Excise revenues

Background

Customs and Excise revenues in June were £2.4 billion. Total for first quarter 1985-86 (£8.8 billion) was 14¼ per cent higher than over the same period last year. Budget forecast for 1985-86 was for receipts of £36.3 billion, up 2¼ per cent on 1984-85 (low increase because 1984-85 receipts were boosted by change in VAT on imports).

Line to take

Receipts in first quarter £8.8 billion. Little can be read from three months' figures.

9. Local authorities

Background

Preliminary estimate is that local authorities made a net repayment of debt of £0.4 billion in June bringing total net borrowing to £0.4 billion in first quarter 1985-86.

Line to take

The June repayment is in line with experience of recent years, owing to seasonally high rate income.

10. Public corporations

Background

Public corporations' account was (provisionally) broadly in balance in June, giving net repayment of debt of £0.3 billion for first quarter of 1985-86.

Line to take

Public corporations have shown a net repayment of debt in the first quarter in each of the last 3 years. Receipts from consumers normally exceed expenditure in early part of financial year.

John Clark (ext 3093)
PSF Division, HM Treasury

COVERING CONFIDENTIAL & PERSONAL

FROM: MISS M E PEIRSON
DATE: 15 July 1985

1. MR CASSELL
- 2. CHANCELLOR OF THE EXCHEQUER

Copy with PPS letter, attached, for:

Mr Turnbull - No 10

cc List AList B (distributed at 2.30 pm, 16 July)

Sir P Middleton
Sir T Burns
Mr H Evans
Mr Peretz
Mr Wicks
Mr L Watts
Mr Devereux
Dr Webb

Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Mr Bailey
Mr Moore
Mr Odling-Smee
Mr Scholar
Mr Mowl

Mr Stibbard
Mr M Williams
Mr Pickering
Mr Powell
Mr Cropper
Mr H Davies
Mr Lord
Mr Wells - CSO
Mr Walton - IR
Mr Wilmott - C & E

*Ch/Draft press briefing
below this - for
comments/approval
by 9.30am DWK
15/7*

MONTHLY NOTE ON THE PSBR

1. I attach a report on the PSBR outturn for June. This outturn will be published by press notice at 2.30 pm tomorrow, 16 July.
2. In this note, as usual, outturn in the latest month (June) is compared with the forecast made a month ago. Outturns for April to June are compared with the Budget profile. Forecasts for July-September are also included.
3. The press notice is confined to comparisons between outturn in the first quarter of 1985-86 and outturn in the same period last year.

M E Peirson
MISS M E PEIRSON

COVERING CONFIDENTIAL & PERSONAL

PUBLIC SECTOR BORROWING

Summary

- The PSBR for June is provisionally estimated as a net repayment of debt of £0.1 billion, compared with last month's forecast of borrowing of £0.4 billion. This better than expected outturn was almost entirely due to local authority borrowing - possibly reflecting a lower takeup than we had assumed of the option for large non-domestic ratepayers to pay monthly.
- Borrowing in the first quarter of 1985-86 (£2.7 billion) was £1.2 billion lower than the Budget profile (Chart 1) and £1.9 billion lower than in the first quarter of 1984-85 (Chart 2).
- The PSBR is, however, forecast at £2¼ billion over the next three months, some £¾ billion higher than in the Budget profile. This partly reflects lower oil revenues and asset sales (the latter due to timing). The forecast for the first half of 1985-86 as a whole is therefore £5 billion, only slightly below the Budget profile.

Figures in this report are not seasonally adjusted and also may not sum precisely because of rounding.

Chart 1 : Comparisons with Budget profiles for 1985-86

£ billion cumulative

- = Estimated outturn in 1985-86
- - - = Latest forecasts
- = Budget profile

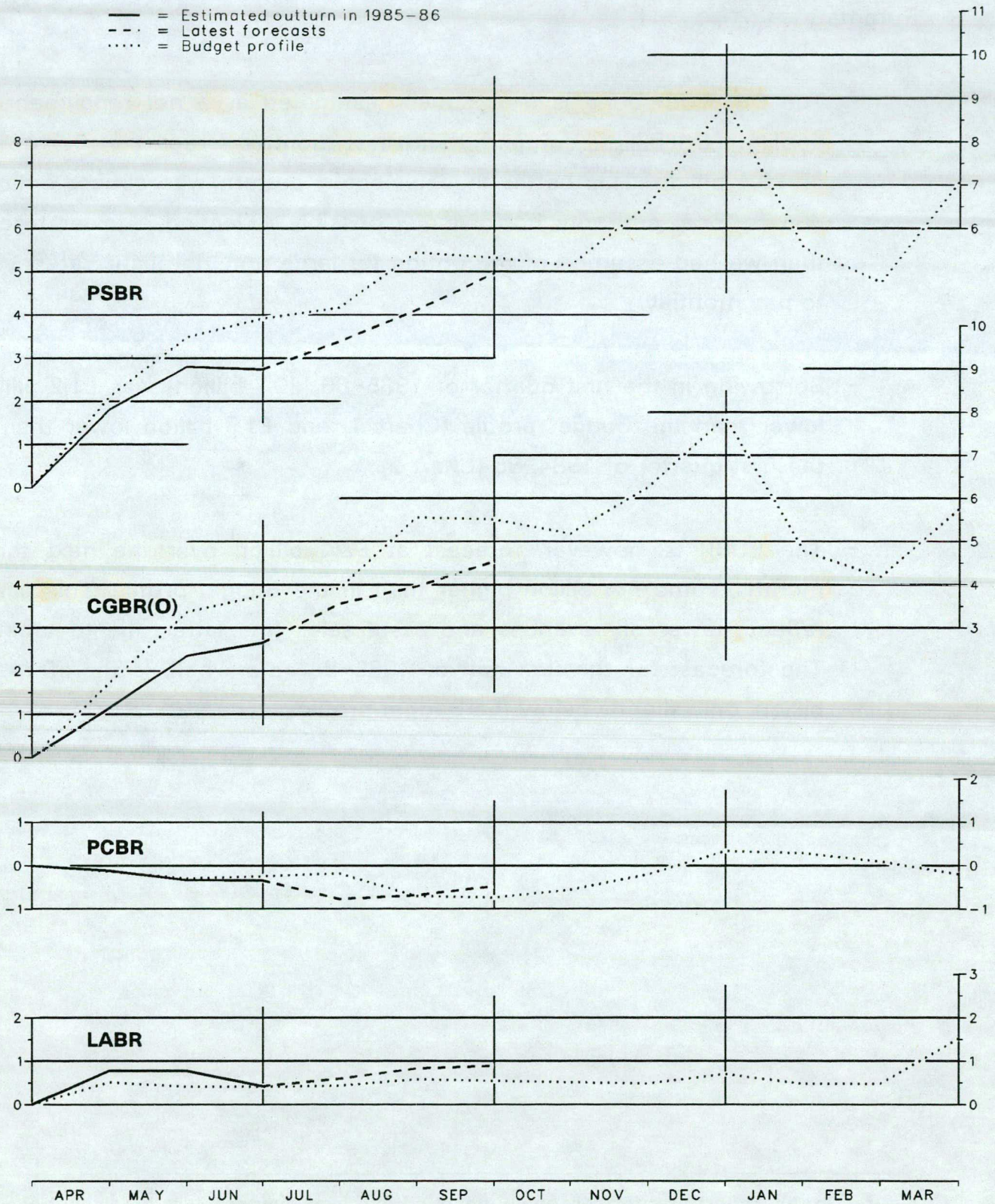
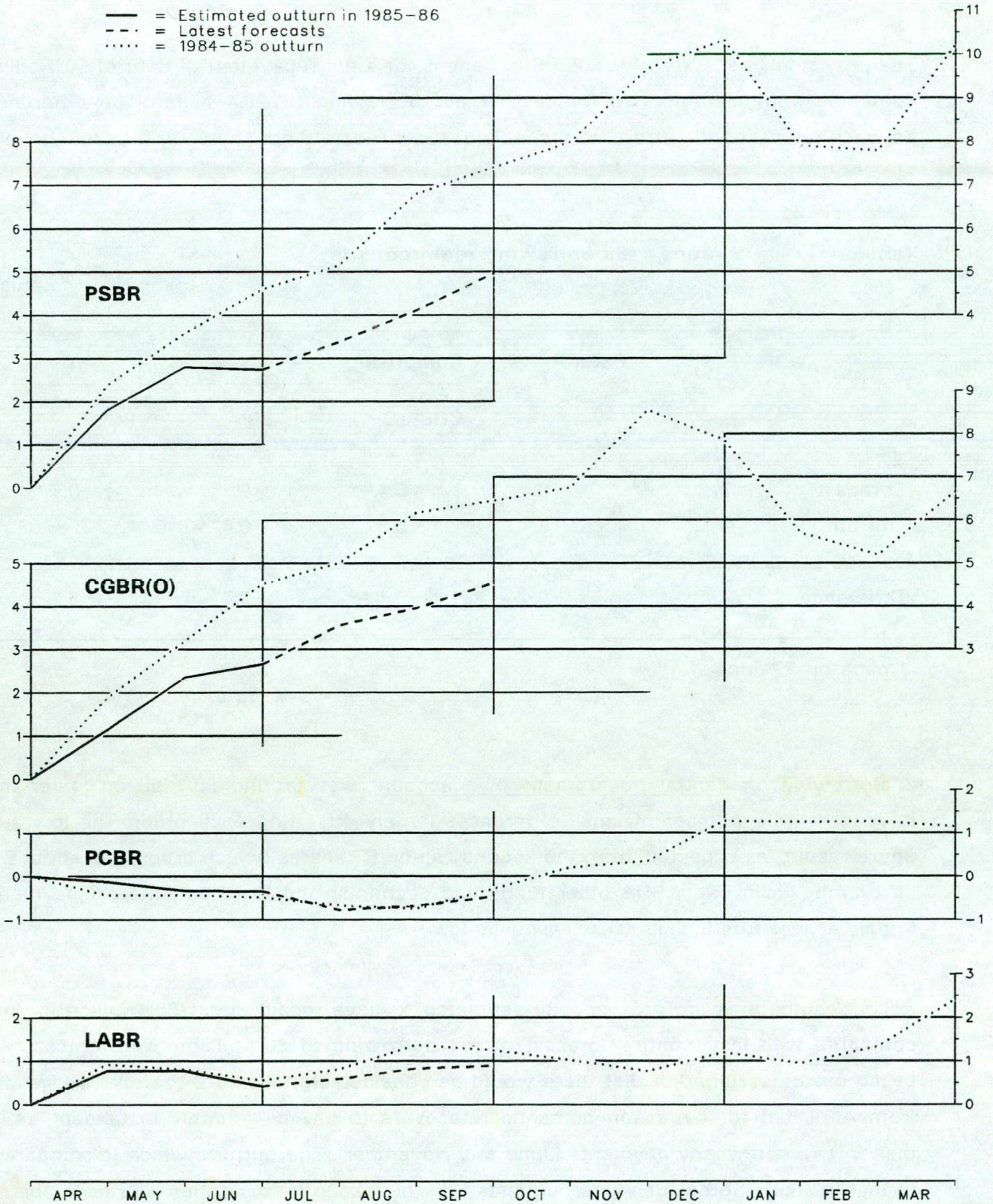


Chart 2 : Comparisons with last year's outturns

£ billion cumulative

- = Estimated outturn in 1985-86
- - - = Latest forecasts
- = 1984-85 outturn



Borrowing in June

(Comparisons in this section are with last month's forecast)

The provisional estimate of the PSBR in June is for a net repayment of debt of £0.1 billion, compared with last month's forecast of net borrowing of £0.4 billion. The differences between forecast and outturn on the individual sub-sectors are shown in the table below.

Table 1: June 1985 borrowing requirements

£ billion

	PSBR	Comprising		
		CGBR(O)	LABR	PCBR
Forecast*	0.4	0.4	0.1	-0.1
Outturn	-0.1	0.3	-0.4	-
Difference	-0.4	-0.1	-0.4	0.1

*made on 17 June

2. **Borrowing on central government own account** was around £0.1 billion lower than forecast, with a number of small differences largely offsetting each other. The low June figure results, as expected, from the second call on BT shares (which brought in about £1.1 billion, shown in Table 5 in other funds and accounts) and low debt interest payments. Supply expenditure in June was seasonally low.

3. **Local authorities** are provisionally estimated to have repaid about £0.4 billion in June, compared with last month's forecast of net borrowing of £0.1 billion. The forecast was based on the assumption that there would be considerable takeup of the option (available from April 1st) for large non-domestic ratepayers to pay by monthly instalment, rather than in two half-yearly payments (June and November). The outturn, which is comparable to that in June of previous years, suggests that the takeup of this option was negligible.

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4. Public corporations' net borrowing in June was close to zero, compared with a forecast repayment of £0.1 billion. First indications suggest that there were small disparities spread across a number of industries.

April to June

(comparisons in this and following sections are with the Budget profile)

Table 2: Total April-June borrowing requirements

£ billion

	PSBR	Comprising		
		CGBR(O)	LABR	PCBR
Budget forecast	3.9	3.8	0.4	-0.2
Outturn	2.7	2.7	0.4	-0.3
Difference	-1.2	-1.1	-	-0.1

5. The cumulative PSBR for the first three months of 1985-86 was £2.7 billion. This is about £1.2 billion below the Budget profile (see Chart 1 and Table 2) and about £1.9 billion below the same period last year (Chart 2), when the April PSBR was unusually large.

6. Cumulative borrowing in April-June on central government's own account was £1.1 billion lower than the Budget profile. This was mainly due to higher Customs and Excise receipts (by £0.3 billion) and lower supply expenditure (by £0.4 billion) and a slightly larger surplus on the National Insurance Fund (by £0.1 billion). These factors are, however, expected to be largely offset later in the year by lower receipts from Petroleum Revenue Tax.

7. Local authorities borrowed £0.4 billion in April-June, very close to the Budget profile, with higher than expected borrowing in April (and to a lesser extent in May) being offset

by lower borrowing in June.

8 Public corporations made a net repayment of debt of £0.4 billion in April–June, repaying about £0.1 billion more than in the Budget profile.

July to September

9. The PSBR in the period July to September is forecast to be £2¼ billion, £¾ billion higher than in the Budget profile. The CGBR(O), LABR and the PCBR are each about £¼ billion higher, as explained below.

10. Table 5 shows the latest detailed profile of borrowing on central government own account for July to September; a comparison with the Budget forecast for the first six months and with the outturn in April–September 1984 is provided in Table 6.

11. The forecast for July–September is slightly less than £¼ billion higher than the Budget profile. Lower Inland Revenue receipts (by £0.3 billion: mainly PRT) and lower receipts from asset sales (by £0.2 billion, due to different assumptions about timing) are partly offset by a slightly larger surplus on the National Insurance Fund (by £0.1 billion) and other changes.

12. The monthly path of the CGBR(O) is as follows.

- In July, the CGBR(O) is forecast to be about £1 billion. Supply expenditure will be fairly high, with a £0.4 billion grant to the National Coal Board (which will be offset by a reduction in the PCBR – see paragraph 15); the BT receipts are expected to be transferred out of departmental balances in “other funds and accounts” into the Consolidated Fund “other receipts”, and a further £100 million received; debt interest payments are also high. Partly offsetting these, Inland Revenue receipts will be high, including the second instalment of schedule D tax from the self-employed (£1 billion), quarterly advance corporation tax (£½ billion) and the first payment of banks’ composite rate tax (£¼ billion).
- In August, the CGBR(O) is forecast to be £½ billion. VAT receipts will be high (as in February, May, and November).

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- In September, the CGBR(O) is again forecast to be £½ billion. Inland Revenue receipts will be fairly high due to large receipts of PRT (£1¼ billion). Supply expenditure includes £¼ billion grant to the National Coal Board and £¼ billion student awards.

14. Local authorities are expected to borrow about £½ billion over the next three months, similar to their behaviour over the last two years but over £¼ billion higher than in the Budget profile. This revised forecast is in line with the experience of earlier years, on the assumption (contrary to the Budget profile) that the effect of giving more large non-domestic ratepayers the option of payment of rates by instalment has been very small (see paragraph 3). The revision for July-September is thus due to timing, and is expected to be partly offset in November (the rest of the offset having occurred in June).

15. Public corporations are expected to show a small net repayment over the next three months, with a net repayment of £½ billion in July (including £¼ billion by the National Coal Board, on receipt of a deficit grant previously scheduled for August), partly offset by net borrowing in August and September. The forecast repayment over the three months is £¼ billion smaller than in the Budget profile because of higher borrowing by the National Coal Board, partly resulting from a reduction (by £150 million) in the deficit grant.

April-September

16. Cumulatively, the forecast PSBR for the first half of 1985-86 is £5 billion, close to (£¼ billion below) the Budget profile despite the low outturn in the first quarter.

17. The reasons are:

- the £1.1 billion shortfall in the CGBR(O) in the first quarter is expected to be reduced by almost £¼ billion in the second quarter, for the reasons given in paragraph 11;
- the LABR, having been (cumulatively) close to the Budget profile in the first quarter, is expected to be over £¼ billion higher in the second quarter, though

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with some offset to that in the third quarter (see paragraph 14);

- the PCBR, which was a little below the Budget profile in the first quarter, is expected to be above it in the second.

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Table 3: Latest monthly profiles
(Budget profiles in italics for comparison)

£ billion

	PSBR		Comprising					
			CGBR(O)		LABR		PCBR	
1985-86								
Apr	1.8	<i>2.1</i>	1.1	<i>1.7</i>	0.8	<i>0.5</i>	-0.1	<i>-0.1</i>
May	1.0	<i>1.4</i>	1.2	<i>1.6</i>	-	<i>-0.1</i>	-0.2	<i>-0.2</i>
Jun	-0.1	<i>0.4</i>	0.3	<i>0.4</i>	-0.4	<i>-</i>	-	<i>0.1</i>
Jul	0.6	<i>0.3</i>	0.9	<i>0.2</i>	0.2	<i>-</i>	-0.4	<i>0.1</i>
Aug	0.7	<i>1.3</i>	0.4	<i>1.6</i>	0.2	<i>0.2</i>	0.1	<i>-0.5</i>
Sep	0.8	<i>-0.1</i>	0.6	<i>-</i>	0.1	<i>-</i>	0.2	<i>-</i>
Cumulative								
Apr	1.8	<i>2.1</i>	1.1	<i>1.7</i>	0.8	<i>0.5</i>	-0.1	<i>-0.1</i>
May	2.8	<i>3.5</i>	2.4	<i>3.4</i>	0.8	<i>0.4</i>	-0.3	<i>-0.3</i>
Jun	2.7	<i>3.9</i>	2.7	<i>3.8</i>	0.4	<i>0.4</i>	-0.3	<i>-0.2</i>
Jul	3.4	<i>4.2</i>	3.6	<i>3.9</i>	0.6	<i>0.4</i>	-0.8	<i>-0.2</i>
Aug	4.1	<i>5.4</i>	4.0	<i>5.6</i>	0.8	<i>0.6</i>	-0.7	<i>-0.7</i>
Sep	5.0	<i>5.3</i>	4.5	<i>5.5</i>	0.9	<i>0.5</i>	-0.5	<i>-0.7</i>

Figures for April to June are outturns

Table 4: PSBR for 1985-86 - comparisons with 1984-85 and Budget profile

£ billion

	1984-85	1985-86		Differences from	
	Outturn	Budget profile	Latest update ⁽¹⁾	1984-85 outturn	Budget profile
	1	2	3	3-1	3-2
Apr	2.4	2.1	1.8	-0.6	-0.3
May	1.2	1.4	1.0	-0.2	-0.4
Jun	1.0	0.4	-0.1	-1.1	-0.5
Q2	4.6	3.9	2.7	-1.9	-1.2
Jul	0.6	0.3	0.6	0.1	0.4
Aug	1.6	1.3	0.7	-0.9	-0.6
Sep	0.6	-0.1	0.8	0.2	1.0
Q3	2.8	1.4	2.2	-0.6	0.8
Oct	0.6	-0.2			
Nov	1.7	1.4			
Dec	0.7	2.4			
Q4	2.9	3.6			
Jan	-2.4	-3.4			
Feb	-0.1	-0.8			
Mar	2.4	2.3			
Q1	-0.1	-1.8			
Cumulative					
Apr	2.4	2.1	1.8	-0.6	-0.3
May	3.6	3.5	2.8	-0.8	-0.7
Jun	4.6	3.9	2.7	-1.9	-1.2
Jul	5.2	4.2	3.4	-1.8	-0.8
Aug	6.8	5.4	4.1	-2.7	-1.3
Sep	7.4	5.3	5.0	-2.4	-0.4
Oct	8.0	5.1			
Nov	9.7	6.5			
Dec	10.3	8.9			
Jan	7.9	5.6			
Feb	7.8	4.8			
Mar	10.2	7.1			

⁽¹⁾Figures for April to June are outturns

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**Table 5: Central government transactions – June
outturn and latest forecasts for July–September**

£ billion

	June		Latest forecasts		
	forecast	outturn ⁽¹⁾	Jul	Aug	Sep
Receipts					
<i>Consolidated Fund</i>					
Inland Revenue	3.2	3.2	5.3	3.7	4.7
Customs and Excise	2.5	2.4	2.8	3.4	2.7
Other ⁽²⁾	1.8	0.8	2.0	1.3	0.9
<i>National Loans Fund</i>					
Interest etc. receipts	0.6	0.6	0.4	0.4	0.9
Total Receipts	8.1	7.0	10.5	8.8	9.1
Expenditure					
<i>Consolidated Fund</i>					
Supply expenditure ⁽³⁾	7.3	7.4	8.2	7.8	8.4
Adjustment to Supply Services basis ⁽⁴⁾	–	0.3	–	–	–
Other	0.4	0.3	0.4	0.4	0.3
<i>National Loans Fund</i>					
Service of the national debt	0.5	0.5	1.8	1.0	1.2
Net lending	–	0.3	–0.2	0.2	0.2
Total Expenditure	8.2	8.8	10.2	9.4	10.1
Other funds and accounts (+ increases borrowing) (– reduces borrowing)	0.5	–1.2	1.0	0.1	0.1
CGBR	0.7	0.6	0.7	0.6	1.1
On-lending	0.3	0.3	–0.2	0.2	0.5
CGBR(O)	0.4	0.3	0.9	0.4	0.6

⁽¹⁾Due to time lags in some items reaching their final accounting destination, figures of forecast and outturn may not be strictly comparable for the components identified, but there is no effect on the overall CGBR.
⁽²⁾Includes receipts from sales of assets
⁽³⁾On a cheques issued basis. Supply includes an element of on-lending in the form of public dividend capital etc.
⁽⁴⁾Reflects changes in balances of departmental accounts with the Paymaster General, timing and other differences between cheques issued by departments and payments to them from the Consolidated Fund. An offset to this item is included in "Other funds and accounts".

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Table 6: Central government transactions⁽¹⁾ – comparisons for April–September

£ billion

	1984	1985	
	Outturn	Budget forecast	Latest update
Receipts			
<i>Consolidated Fund</i>			
Inland Revenue	21.5	24.4	24.2
Customs and Excise	15.9	17.4	17.7
Other ⁽²⁾	5.0	7.0	6.3
<i>National Loans Fund</i>			
Interest etc. receipts	2.7	3.2	3.5
Total Receipts	45.0	51.9	51.6
Expenditure			
<i>Consolidated Fund</i>			
Supply expenditure ⁽³⁾	43.6	48.1	47.6
Adjustment to Supply Services basis ⁽⁴⁾	–	–	0.5
Other	2.5	2.1	2.1
<i>National Loans Fund</i>			
Service of the national debt	6.2	6.9	7.0
Net lending	0.4	0.5	0.6
Total Expenditure	52.7	57.6	57.8
Other funds and accounts (+ increases borrowing) (– reduces borrowing)	–0.5	0.7	–1.0
CGBR	7.2	6.4	5.3
On-lending	0.8	0.8	0.7
CGBR(O)	6.4	5.5	4.5

⁽¹⁾Due to differences in treatment of some items in the accounts between the periods/forecasts shown, and time lags in some items reaching their final accounting destination, figures for the components identified may not be strictly comparable.

⁽²⁾Includes receipts from sales of assets.

⁽³⁾On a cheques issued basis. Supply includes an element of on-lending in the form of public dividend capital etc.

⁽⁴⁾Reflects changes in balances of departmental accounts with the Paymaster General, timing and other differences between cheques issued by departments and payments to them from the Consolidated Fund. An offset to this item is included in "Other funds and accounts".



Inland Revenue

Policy Division
Somerset House

18 July 1985

1. MR CASSELL
2. CHANCELLOR OF THE EXCHEQUER

SMOOTHING THE PSBR : CORPORATION TAX PAYMENT DATES

1. With rising company profitability corporation tax is now becoming an increasingly important component of tax revenue. Compared with a yield of £4.8 in 1982/83, the yield in the current year is estimated at £10.1. The fact that 75 per cent of corporation tax receipts comes in the second half of the tax year (Chart A) is therefore an increasingly important factor in the uneven pattern of total revenue receipts. Despite the efforts made in recent years to smooth the PSBR this pattern is largely unchanged. The increasing importance of corporation tax is a major reason for this and therefore it is a natural candidate for any further attempt at smoothing.

2. This paper considers what could be done. Unfortunately there is not at present much scope for changes which would have a really significant effect except at considerable cost.

Advance Corporation Tax

3. There are two components in the yield of corporation tax. First advance corporation tax, which at an estimated £3.6 (net) in the current year accounts for rather over one-third of the total. It is payable quarterly 14 days after the end of the quarter in which any dividend is paid. As a result there are four payment peaks in April, July, October and January, with the biggest in January. 65 per cent of the yield falls in the second half of the tax year and 40 per cent in the last three months. However, this is basically a function of companies' distribution policy and there is not a great deal we can do about it.

4. We have, however, considered whether it would be worth requiring payment monthly instead of quarterly. This would smooth the month by month profile of receipts but clearly would not substantially affect the pattern as between the first and second halves of the year.

5. We estimate, however, that, because of the additional number of returns, the additional staff required annually would be around 25 to 35. In addition monthly accounting would require substantial changes to the existing computer programmes and systems specifications in the Accounts Offices. These are already under substantial strain and the work could not be done in the next 3 to 4 years without diverting scarce programming resources from the major developments now being carried on to pave the way for staff savings and transferable allowances. These planned developments are set out in the Departmental Development Plan which Sir Lawrence Airey sent to the Chancellor on 14 June.

Mainstream Corporation Tax

6. Rather more than 60 per cent of the corporation tax yield, however, is provided by mainstream corporation tax (MCT). Here there are two payment regimes. First, trading companies set up after 1965 and investment companies, whenever set up, pay tax 9 months after the end of their accounting period. Since the majority of companies have either a calendar or a financial accounting year the majority of the tax is payable on either 1 October or 1 January.

7. Companies set up before 1965, however, pay tax on their trading profits generally on 1 January between 9 and (nearly) 21 months following their year end. A company whose year end falls between 31 March and 5 April - both dates inclusive - will have the shortest gap. By contrast a company whose year end is 6 April will pay tax on its profits for that year on the next but one 1 January - this is the longest gap.

8. The reason for this treatment stems from the introduction of corporation tax in 1965. Before then companies paid income tax just like unincorporated businesses (except that all their tax was due on 1 January and not half on 1 July as in the case of individuals). Companies retained their payment arrangements on the transition for two reasons - first, and principally, so that they did not have to pay more than one lot of tax in a 12 month period - a simple matter of cash flow - and second, because they would be paying tax on substantially more profits than they had earned - which accentuated their cash flow disadvantage.

9. One of the problems which arises from the previous year basis of assessment to income tax is the mismatch between profits earned and profits assessed to tax: in the opening years of a business the profits of one year are charged more than once and in the closing years one year's profits drop out of assessment. If, therefore, there had been no transitional arrangements, companies would have paid more than one lot of tax on their opening year's profits without being able to benefit from the dropping out of one year's profits on cessation. Special transitional provisions were made at the time for companies which ceased to trade shortly after the change to corporation tax but these no longer apply. The different payment date rules, however, remain for continuing companies. A company set up today does not pay tax until nine months after the end of the first accounting period: this is a tax holiday which the pre-1965 companies have never had. Chart C illustrates how the different rules work.

Possible ways of smoothing the yield

10. Chart A shows the estimated pattern of receipts of net mainstream corporation tax in 1985-86. The greater part will be paid in the second half of the year, with sharp peaks in October and January.

11. Not much can be done at present to smooth the payment of tax by post-1965 companies. It would certainly be possible to introduce payment by instalments so that part of the tax due was payable later than it is today - thereby pushing some MCT forward into the first half of the following tax year. We assume, however, that this would be a course which Ministers would not be prepared to consider, particularly since there would be a substantial drop in the yield in the year of change. It would not, however, at present be possible to introduce payment by instalments with some instalments payable before the present due date given the present batch processing computer systems in the accounts offices. This is certainly something which could be done when planned changes to the computerised collection system are implemented but these lie a few years ahead yet. On present plans this might be possible in 1990.

12. What would, however, be possible to do now, would be to bring forward the date of payment for those pre-1965 companies with gaps of more than 9 months; these account for about one-third of total MCT, ie just over £b2. Here there are two possibilities -

1. to bring forward their date of payment by 3 months (subject to no company having less than 9 months to pay after their year end); or
2. to abolish the special arrangements altogether. This would presumably have to be done in stages - if it were not, some companies at the extreme would have to pay tax on 2 years' profits within a week. While there is more than one way in which the abolition could be staged, the most obvious way would be to advance payment by 3 months a year until all companies paid 9 months after the end of their year. In the extreme case a company would then find itself paying tax on 5 years' profits over 4 years.

13. Chart B shows the profile for the cumulative net CT receipts during 1985/86 on the present system, and what it might look like under Courses 1 and 2. The estimated receipts in each quarter of 1985-86 are as follows:

<u>Quarter</u>	<u>£b</u>		
	<u>Present system</u>	<u>Course 1</u>	<u>Course 2</u>
April-June	0.9	0.9	1.0
July-Sept	1.4	1.4	1.6
Oct-Dec	2.5	4.5	4.3
Jan-March	5.3	3.3	3.2
Year 1985-86	10.1	10.1	10.1

14. The majority of pre-1965 companies have a calendar accounting year and a 12 month gap. Accordingly, the effect of Course 1 would be to shift about £b2 of the tax now due on 1 January to the immediately preceding 1 October. This would still provide a substantial peaking problem and would do nothing to increase revenue in the first 6 months of the year. It would, however, smooth the total tax receipts over the year to some extent. Course 2 (once all companies were on a 9 month gap) would also have the effect of bringing about £b¼ tax now due in the second half of the year into the first half. However, the amounts involved are comparatively small so that the additional smoothing effect would not be very significant. As with Course 1, there would be big payment peaks in October and January. These figures do not take account of any changes that might be made to building society payment dates (see paragraphs 20 and 21 below).

Problems for the companies

15. The problem for the companies involved would be the obverse of the gain to the Exchequer. Companies would find themselves paying tax on the profits of 2 years in the space of 9 months. This would happen once under Course 1

and up to 4 times running in the case of Course 2. This squeeze on their cash flow would be a point of contention on its own, and might also lead them to point to the mismatch between profits earned and profits assessed arising from the transition to corporation tax. This point can perhaps be illustrated by an example.

16. A company which began trading on 1 May 1960 and which makes up its accounts annually to 30 April will have been in existence by 30 April 1985 for 300 months. It will, however, have been assessed to income tax on the profits of 71 months and corporation tax on the profits of 252 months, a total of 323 months. In other words by the end of last April it will have been liable to tax for the profits of 23 more months than it had actually been in existence. However, the corporation tax for the year to 30 April 1985 will not, under present arrangements, be due for 20 months, ie until 1 January 1987, so that by the time the tax is due to be paid the mismatch will have fallen to 3 months. Under Course 1 the tax would become payable on 1 October 1986 so that the mismatch at the time of paying would be 6 months: under Course 2, by the time the transition had worked through the tax would be payable on 1 February so that the mismatch would have risen to 14 months. Chart C illustrates this point.

Compensation

17. The companies involved would undoubtedly react to the adverse impact on their cash flow. They might also claim that they were being penalised both absolutely, because of the mismatch problem, and relatively, by comparison with post-1965 companies. One way of meeting them would be to offer a discount on their liability. A case for such a discount could be made out in respect of advancing the tax for each subsequent year: we assume that it would be confined to the year of change in which the cash flow problem would arise. The discount might take the form

of a once-for-all amount representing the after tax interest cost of advancing the first year's payment of mainstream corporation tax. Assuming a post-tax rate of interest of 8 per cent* the cost of the compensation in 1986/87 would be of the order of £50. If Course 1 were adopted this would be the total cost, but under Course 2 there would be further compensation in the remaining years of the transition. However, because the amounts involved are very much smaller the total additional cost over those years would not be more than around £10.

18. The cost of this compensation would of course be offset by a reduction in the Government's borrowing costs; and if, as surmised, compensation were not offered after the year of change the Exchequer would benefit to the extent that companies lost.

Possible counter action by companies

19. It might be possible for companies to defeat the change by finding other ways of deferring their tax payments. This is because the special payment arrangements apply "so long as the company continues to be within the charge to corporation tax in respect of that pre-1965 trade". Accordingly, it may be possible for a company carrying on a post-1965 trade to acquire a pre-1965 company carrying on another trade and merge the post-1965 trade into the newly acquired one. The tax on the profits of the post-1965 trade would thus be payable according to the pre-1965 timetable.

20. It is already possible for this trick to be worked and we are aware of instances where it has been done. Such instances have not been frequent, however, partly because it may not always be easy to achieve without some

*3 month sterling CD rate less 35% CT (at the time of preparing this note)

commercial disadvantages and partly because the possibility may not be widely known. The question is, therefore, whether making a change in payment dates would alert companies to the possibilities or incite them to take advantage of opportunities to delay tax payments which had not previously seemed worthwhile. The best assessment which we can make of the scope for this sort of counter action is that under Course 2, under which all scope for manipulation of this nature would be removed within 4 years, there might be insufficient incentive for companies to take advantage of the loophole and no anti-avoidance provision might be necessary. Under Course 1, however, under which there would be a continuing advantage in delaying payment of tax by this route, there would be some large companies which would attempt to do so and an anti-avoidance provision would be a necessary safeguard. It would probably have to take the form of a main benefit test.

Building societies

21. Building societies are a special case. Some societies have been set up since 1965 and they have the same payment arrangements as post-1965 companies; the changes being discussed here would not therefore apply to them. Of the pre-1965 societies some have the same payment arrangements as pre-1965 companies; any change in those arrangements would therefore apply to them automatically. However for reasons dating back to the reorganisation of their tax treatment in the 1940s, the majority of societies pay corporation tax on 1 January in the tax year in which their accounting year ends. For example, of the largest societies the Halifax has a 31 January year end so it pays tax a month before the end of its year; the Abbey National and Nationwide (like the majority of societies) have a calendar year accounting period and pay tax the day following their year-end; and the Woolwich and Leeds have 30 September year ends and hence have a 3-month payment gap.

22. The Building Societies Association are already pressing for these societies to be given a 9-month payment gap. There is a good case for this given all the other measures, both tax and non-tax, to bring them into line with financial institutions generally. So far we have been resisting this largely on the grounds of the PSBR cost estimated at £b½ in the year of change: about £m450 of this would move from January to October or November, and about £m50 from January to July. However if CT payment dates generally were being altered, the Association's case would be more difficult to resist. Certainly under Course 2, under which all other mainstream corporation tax would eventually be paid 9 months after the end of the year, the case for standardisation would seem unanswerable. Under Course 1 Ministers would simply have to assert - if they did not wish to concede - that there was no clear parallel; it would not however be an easy argument to maintain.

Staffing costs

23. We cannot readily identify all the companies - estimated to be around 100,000 - where tax is due more than 9 months after the end of the year. It would, therefore, be necessary to mount a special exercise to identify them. There would also be additional work in calculating the compensation. In total we estimate that Course 1 would require on setting up 35-40 units of manpower. Under Course 2, which would require the payment dates to be progressively altered in some cases, the initial cost would be slightly higher, in the region to 40-45 units. In both cases there would be rather more estimated assessments than there are today which would entail a continuing cost of the order of 10-15 units a year.

Timing of the change

24. It is now too late to make any change in respect of corporation tax due on 1 January 1986. We suggest that the changes might take effect for accounting periods ending on or after 31 December 1985. This means that for companies with calendar year accounting periods the change would take effect in respect of tax now due on 1 January 1987, which would become payable instead on 1 October 1986. Under Course 2 companies with the longest payment gaps would then be required to pay tax again at intervals of nine months on 1 July 1987, 1 April 1988 and at the beginning of 1989.

25. If, as suggested above, the change were to have effect for companies with year ends on or after 31 December 1985, we should need a decision not later than the autumn to enable preparatory work to be undertaken in Head Office. We should need an announcement in early March at the latest (ie probably before the Budget) to enable local offices to carry out the work. However, in any event, in order to avoid any charge of retrospective legislation it would be desirable to announce the change on 31 December (although it could only then be done by way of Press Notice and not by an arranged Question). The necessary legislation would then be included in next year's Finance Bill. The warning would enable company treasurers to plan for the earlier date of payment, but it would also of course allow time for opposition to be mounted in pre-Budget representations. It might for example be used to bolster the arguments which are bound to be put for not completing the final phase of the business tax reforms.

Presentation of the change

26. There is no tax logic behind Course 1. It would have to be justified therefore solely on the funding arguments. Course 2 would also introduce the standardisation argument, but given the 1965 transitional arrangements it would have to be handled with care.

Conclusion

27. A change in the arrangements for payment of mainstream corporation tax by pre-1965 trading companies would go some way towards smoothing the PSBR and thus help the management of the Government's funding programme. It would also assist the forecasters by providing during the winter a rather firmer basis on which to estimate the PSBR outturn. Moreover with the corporate sector at present fairly liquid, this would be a good time to make a change.

28. However the companies concerned would complain, possibly strongly, that they were being picked out for earlier payment solely because of the accident of history. Generally speaking (assuming broadly constant profits over the life of these companies) their different payments pattern does not provide them with any advantage over post-1965 companies (they still pay tax every 12 months), but simply recognises the impact of the transition from income tax to corporation tax. This problem of seeming to pick on pre-1965 companies would be eased or avoided if any action on smoothing were delayed for a few years: by the early 1990s it should be possible, if Ministers so wished at the time, to consider a wider range of possible changes in payment date (eg including an instalments system) which would apply to all companies equally and for which the case for compensation might be less strong.

29. If a change is to be made/ ^{now,} Course 2 (standardisation of payment gaps at 9 months) provides only a little additional smoothing compared with Course 1 (one 3 months change). So the choice between them turns largely on other considerations. The advantage of Course 2 is that, after the transitional period, the same payment rules would apply to all companies: the possibility for delaying the due payment date would be removed and we judge that it would therefore be unnecessary to include any anti-avoidance provisions. On the other hand there would be four transitional years,

not just one, in which some companies would have two tax bills within a 12 month period. Moreover it might be easier for companies to claim that Course 2 was inequitable because it would introduce the mismatch between profits earned and profits assessed which the 1965 transitional rules attempted to avoid. This would be the more significant in a year in which the recommendations of the Keith Committee were being implemented in respect of the Inland Revenue's enforcement powers and in which further consideration may be being given to the current year basis for Schedule D (Mr Corlett's minute of 18 June on Keith Committee: traders' accounts). Finally the pressure to delay payment by building societies, while difficult to counter under Course 1, would be irresistible under Course 2: the transitional cost to the PSBR of £b½ in the year of change could be the decisive consideration.

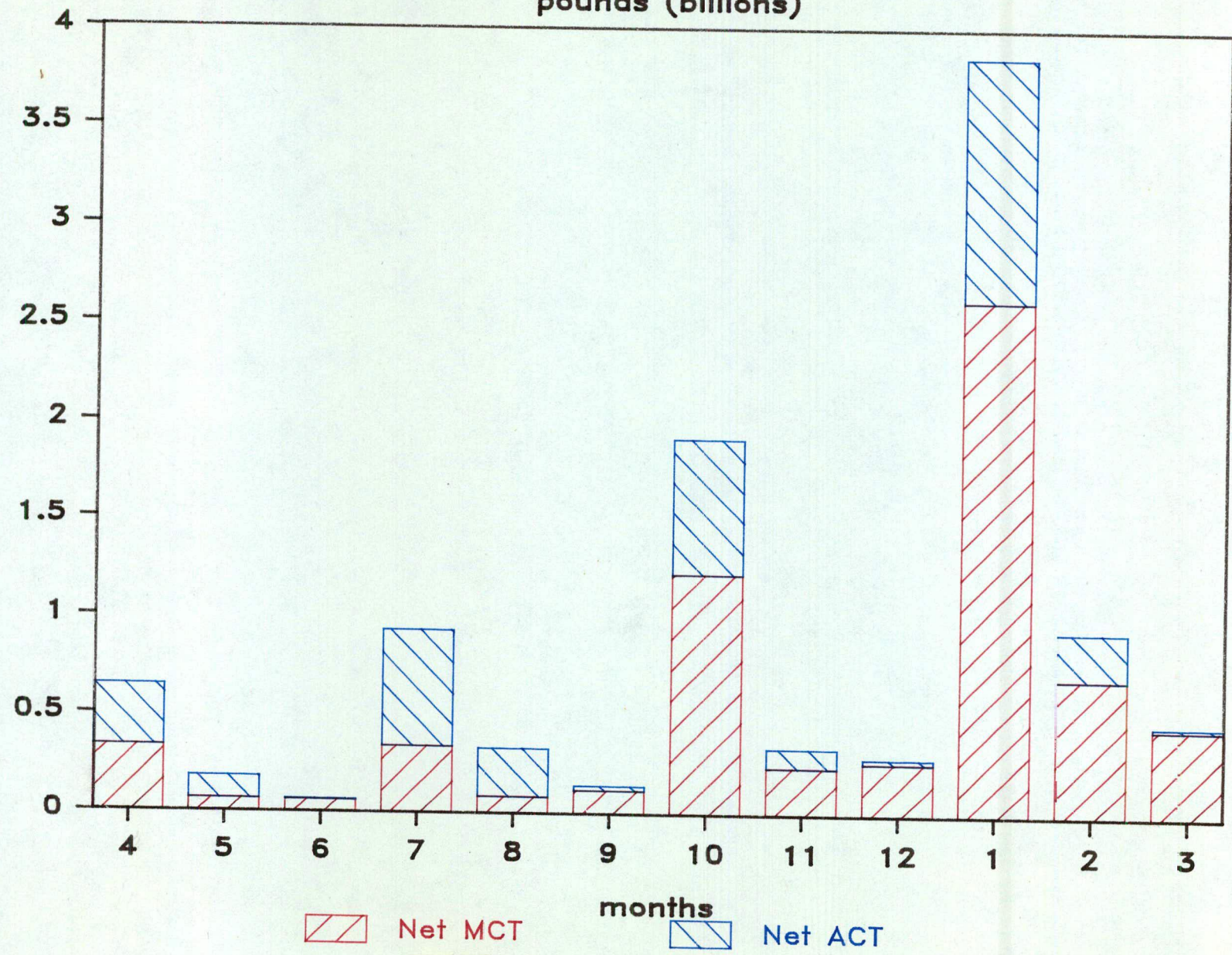
30. On balance, therefore, despite the apparent attraction of standardisation in Course 2, and the need for anti-avoidance legislation in Course 1, if this change is to be made we recommend that there should only be one jump of three months.

L J H

L J H BEIGHTON

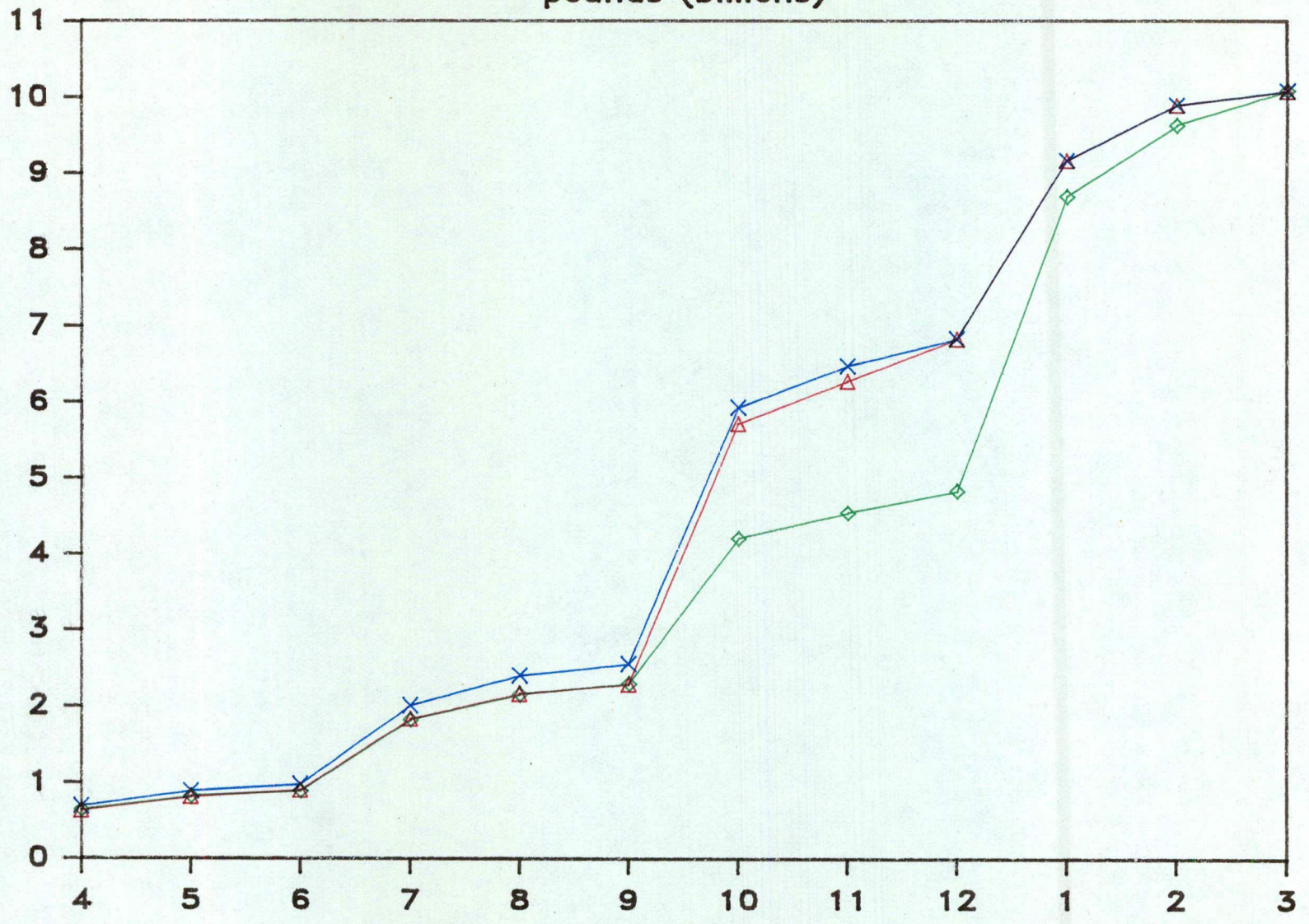
NET CT RECEIPTS 1985/6

pounds (billions)



CUMULATIVE NET CT RECEIPTS 1985/6

pounds (billions)

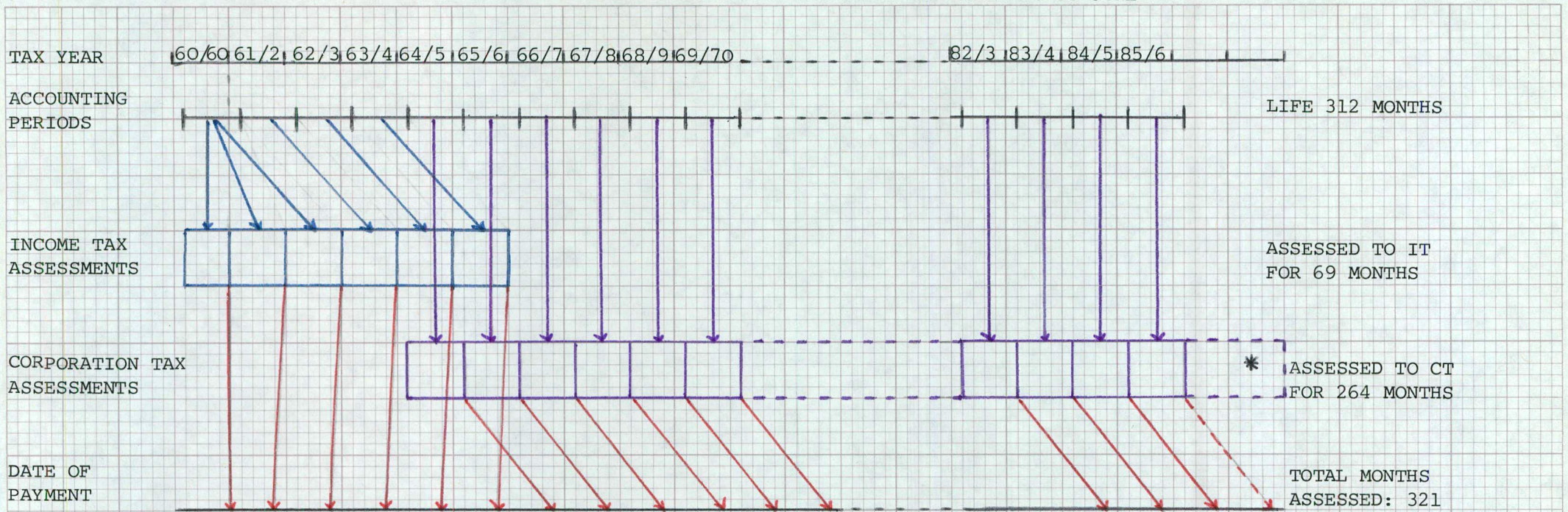


◇ Present path △ 3 Month Shift × 9 Month Gap

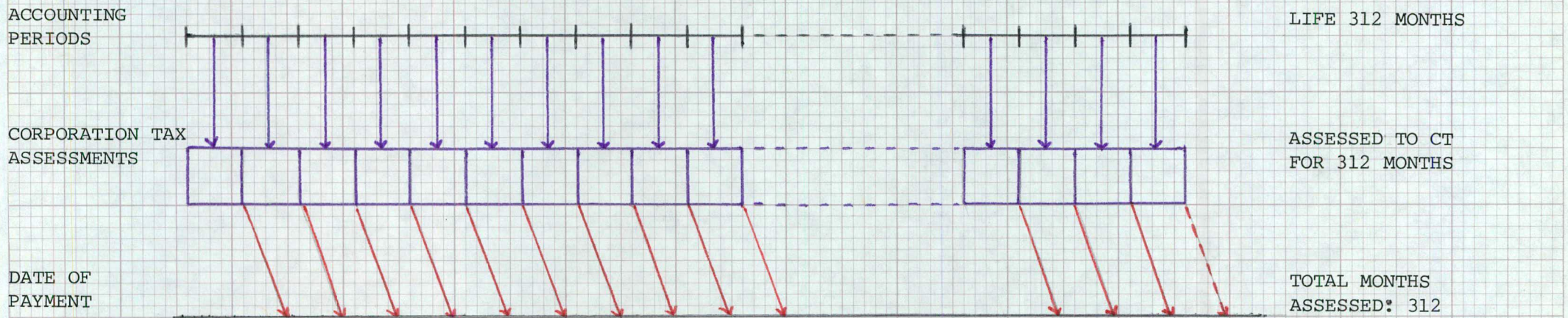


CHART C: COMPARISON OF PERIODS ASSESSED TO TAX/TIME OF PAYMENT BETWEEN PRE AND POST 1965 TRADING COMPANIES

A: PRE-1965 TRADING COMPANY. COMMENCES TRADING 1 JULY 1960. ACCOUNTS MADE UP ANNUALLY TO 30 JUNE



B: POSITION OF COMPANY OF EQUIVALENT LIFE IF CT REGIME HAD APPLIED THROUGHOUT



* extra period of tax assessments if overlap removed.



Rachel,

A reply should be
with us by the end
of this week.

Siobhan
24/7

Good.

(pwp)

3/15 26/7

Just for us to check
that the paper
actually arrives.

✓ Siobhan.



bf 24/7

FROM: MRS R LOMAX
DATE: 18 July 1985

Sussex

*pl. can what
we can expect*

*a reply
(Mills by)*

MR ODLING-SMEE

cc Sir P Middleton
Sir T Burns
Mr Riley
Mr Grice
Mr H Davies

*near what
to very*

(later)

R

CONFERENCE ON GOVERNMENT BORROWING

The Chancellor has seen your minute of 8 July to Sir T Burns. In paragraph 3 he wonders what the answer to Andrew Britton's question was (does it matter whether public sector debt is held internally or externally?) In the same paragraph, he would also welcome some elucidation of John Flemming's learned intervention.

RL

RACHEL LOMAX



P.S. This is
unfused 6mm
felt
which is
programmed
again.

C.

The point you raised (Rachel of 8 May) is dismissed by Frank in para's 2 and 4.

The rest concerns the case for changing CT. Frank's note make it all sound pretty unappetizing, whereas the paper by Leonard Brighton below reads a bit more positively I think.

Note timetable point in Frank's para 19. If you are interested by this, you may well want a meeting (though I'm not sure that it needs to be before the Recess).

I am more grateful
for the very thorough study.
I wd like to see FSI & have
a look @ this, & let
me have the 19/7 virus. We
can then have a meeting
in Sept. Given
I think you do need a
meeting - but not until September

on which we wd like to
take no. deliver & no
pushed
time. etc.

CONFIDENTIAL

FROM: F CASSELL
19 July 1985

CHANCELLOR

cc Financial Secretary	Mr Cherry
Sir P Middleton	Mr Corlett
Sir T Burns	Mr Lawrance
Mr Evans	Mr Matheson
Mr Monger	Mr Painter
Mr Peretz	Mr Pitts
Mr Wicks	Mr Fitzpatrick
Miss Peirson	Mr Whitear
Miss Sinclair	Mr Prescott
Mr Lord	Mr Carr
Inland Revenue:	Private Secretary
Mr Battishill	
Mr Beighton	

SMOOTHING THE PSBR

You raised with me after the Budget the question of taking some further action to smooth the PSBR within financial years. As I explained in my note of 24 April, this unevenness is largely attributable to the skewness of Corporation Tax receipts (which, with the end of NIS and the recovery in profits, now account for a larger share of Government revenues). We have explored again with Inland Revenue the scope for smoothing CT receipts during the year. This is our report.

PRT

2. First, however, I should answer your query (Mrs Lomax's note of 8 May) about whether some further change in PRT timing might be made to offset the skewness of corporate tax.

3. We think not. The pattern of PRT payments was laboriously negotiated with the oil companies not long ago, in an attempt to smooth the PRT pattern itself. To negotiate a new pattern, heavily weighted towards the first half of the year, would be difficult; and since the amounts of PRT are forecast to decline quite rapidly the effort would not seem worthwhile. Annex 1 attached on PRT expands on the latter point.

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Other factors

4. We have also considered whether there are other regular receipts or payments that contribute significantly to the skewness of the PSBR profile. However, there seems nothing worth further attempts to smooth at this stage, following the considerable efforts in the past. In particular:-

i. Departmental spending is now fairly smooth during the year, apart from the inevitable peak in March;

ii. Schedule D tax was uneven, but this will diminish considerably (at least as between the two halves of the financial year) with the introduction of composite rate for bank interest and comparable changes in payments of composite rate tax by building societies from annual to quarterly (see Annex 2 attached);

iii. The EC rebate will cease to be lumpy under the new arrangements;

iv. The National Insurance Fund is regularly in deficit in the December quarter and in surplus in the March quarter, because of early payment of benefits before Christmas and late collection of contributions after Christmas, but there is probably nothing to be done about that (the swing is £½ billion);

v. The LABR is regularly high in the June and March quarters, when rate income is low and expenditure high (at least in March), but that can hardly be remedied;

vi. The PCBR is regularly high in the December quarter, mainly because of high borrowing by Electricity and Gas as the winter begins but before they collect payment: this should diminish following Gas privatisation.

If we want a smoother PSBR, therefore, it is CT we will have to address.

Case for changing CT

5. The case for looking at CT is best demonstrated by the first chart of the PSBR on the next page. The solid line shows the latest forecast quarterly profile of the PSBR, and the dotted line what the profile would look like if CT (both MCT and ACT) were fully smoothed during the year. The contrast is expected to become more marked, as CT is forecast to grow from £6 billion in 1983-84 to £10 billion in 1985-86 and around £13½ billion in 1988-89.

6. Fully smoothing the CT flow is not a practical possibility; the second chart shows the effect of a more limited scheme (described below) that might be feasible next year. Such a change would have significant effects in reducing the PSBR in the first three quarters of the financial year. Though this would not greatly change the imbalance between the two halves of the financial year this would nevertheless have considerable advantages:-

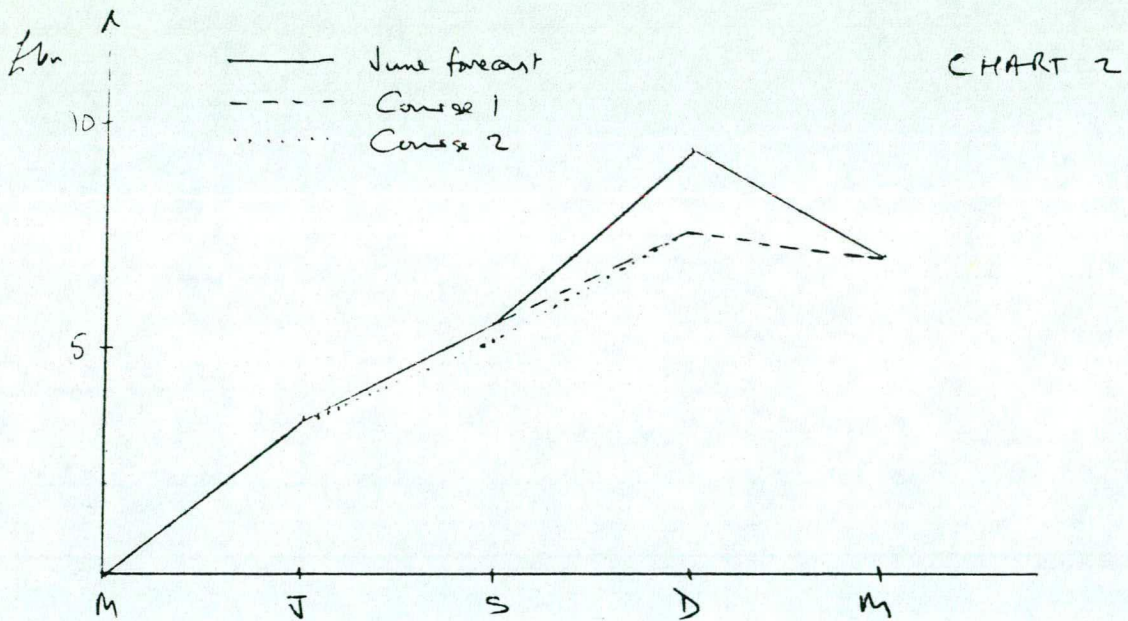
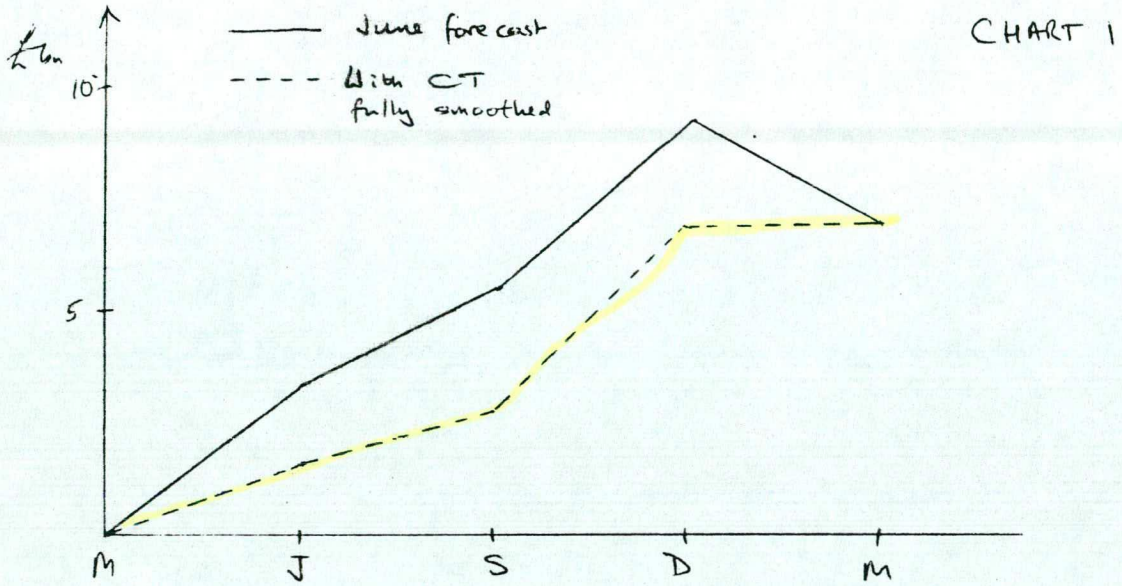
i. The shifting forward of revenues would result in a permanent interest saving.

ii. The PSBR would not by the end of December invariably stand above the figure for the full year given in the Budget. That should ease presentation.

iii. The earlier receipts of CT should help the forecasting of the year's total in the pre-Budget period.

7. There is an offset to i., from the probable £½ billion cost to the PSBR in the first year of change, resulting from the building societies' problem (see below). However, it is not perhaps a direct offset because we may have to concede the point soon anyway, whether or not we make any change to CT for companies.

PSBR, 1985-86
Cumulative, £bn



Timing of change

8. This question has of course been examined many times before, notably 4½ years ago. The case for a change was well recognised, but because of the companies' then tight liquidity it was felt to be the wrong time to change. Companies' liquidity and profits, however, are now high. One argument for further delay is that the Keith proposals are to be implemented next year. There could be a risk of souring the reception if both changes went ahead at or around the same time.

Practicalities of changing CT

9. We and Inland Revenue have looked carefully at the practical possibilities of smoothing the payments of CT. The attached paper by Inland Revenue goes into the matter in some depth.

10. It considers first the possibility of smoothing ACT. I would certainly recommend that the eventual aim should be to move from quarterly to monthly payments. I accept however that this minor improvement is not worth the diversion of scarce resources at this stage. Therefore we should wait until the computer work already planned to achieve staff savings and transferable allowances has been completed.

11. Inland Revenue next consider MCT. Again, the firm aim should be to achieve payment by (advance) instalments. This however will have to wait until about 1990, when the computer facilities will be available (following the complete overhaul of the Revenue's computer system for its Accounts Offices). Meanwhile, I think we ought to consider the limited degree of smoothing possible before then by the methods Revenue suggest.

12. Two possible alterations to the payment dates for pre-1965 companies are examined, as described in the Revenue paper. These companies at present pay their CT on 1 January between 9 and 21 months after the end of their accounting year, whereas post-1965 companies pay their CT 9 months after their accounting

if they are ✓

year whenever that may be (usually 1 October or 1 January). The first possible alteration (course 1) would bring forward the payment dates of the pre-1965 companies by 3 months (subject to a minimum period of 9 months); the second (course 2) would follow that up with successive annual 3-month advances until all pre-1965 companies (like post-1965 companies) were paying after 9 months.

13. The effect these would have in smoothing the PSBR is demonstrated in the second chart above. Not much effect in the first half of the year (only a little from course 2 and none from course 1), but considerable smoothing between the last two quarters. The latter is important, for all the three reasons given in paragraph 6 above.

14. There are obvious objections to such alterations from the companies' point of view, so that it might be difficult to secure the legislation (particularly given the Keith changes). Also, there would be staff costs to the Revenue, put at around 35-45 manpower units initially, followed by around 10-15 units continuing.

Choice between courses 1 and 2

15. As Revenue say, there is little extra smoothing to be gained from course 2 - which continues to bring CT payments forward until every company has a lag of 9 months - and anyway payment by instalments should eventually produce a better solution. So the choice between courses 1 and 2 has to be made on other grounds.

16. Course 2 has the advantage of eliminating a loophole that has worried Revenue for some time. Moreover, although it might seem that course 1 would enable us to maintain the distinction between building societies and companies, HF advice is that we could not continue to do so. The societies are being brought more into line with banks and companies. We might anyway therefore soon lose the £½ billion to the PSBR mentioned in

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the Revenue paper (though probably not all at once if we were making no changes); and 1986-87, with the expected big receipts from Gas, might be a good year to sustain this once-for-all loss.

17. On the other hand, course 2 is more disadvantageous to the companies, and therefore more difficult to achieve. We could, as the Revenue paper suggests, offer compensation (under either course); but that might not be enough to see the legislation through.

18. These arguments between the two courses are finely balanced. The Revenue paper comes down in favour of course 1.

Announcement and legislation

19. Revenue suggest legislation in the next Finance Bill. They recommend an earlier announcement, however, despite the time that will give for opposition to be built up: that will enable them to make the necessary preparation, and to catch companies with accounting years ending on 31 December 1985 while avoiding the charge of retrospective legislation. Their suggestion, which I support, is an announcement around 31 December.

Conclusion

20. There is no doubt that the full solution of the skewed CT profile must wait until the computers are in place. We should then be able to secure monthly payments of ACT, and advance instalments of MCT. But that will not be until the early 1990s. In the meantime, with the higher weight of CT in government revenues, the unevenness of the PSBR within financial years is likely to get worse.

21. The scheme outlined in the Revenue paper below would achieve a useful smoothing of MCT. This would be helpful both to the operation of monetary policy and should also improve our forecasting and monitoring of the PSBR.

CONFIDENTIAL

22. However, such a change would doubtless be opposed by the companies affected, who would see themselves disadvantaged in what they would regard as a discriminatory way. The question, therefore, is whether the benefits of the smoother PSBR are worth the outcry that would be caused by disturbing the present CT arrangements.

23. This is not easy to judge. From my own viewpoint in the Treasury I think the change is worth making. The Revenue, understandably, put more weight on the fuss it may cause.

24. If you are prepared to go ahead, the change could be announced around the end of 1985 for legislation in the 1986 Finance Bill to take effect in respect of tax due on 1 January 1987. We would recommend adopting course 1, accepting the need to compensate companies on the lines suggested by Revenue, at a cost of £50 million in the first year and accepting the consequent change in building society payments, and the £½ billion cost to the PSBR in 1986-87.

25. We are very ready to discuss this if you wish.



F CASSELL

PRT

1. The following table compares the amounts of CT and PRT forecast for the current year and 3 years ahead:-

		June forecast			£bn		
		1985-86			1988-89		
		Total	Apr-Sept	Oct-Mar	Total	Apr-Sep*	Oct-Mar*
CT		10.1	2.4	7.7	13.5	3.3	10.2
PRT		6.9	3.9	3.0	4.7	2.2	2.5
Total		17.0	6.3	10.7	18.2	5.5	12.7

2. In 1985-86, were it possible, shifting two-thirds of PRT from the second into the first half of the year would even out completely the uneven distribution of total CT and PRT receipts. But by 1988-89, shifting even the whole of PRT to the first half of the year would not be enough to offset the uneven CT pattern. In later years the amounts of PRT would be even smaller.

3. It is worth noting, as regards PRT, that the September and March peaks, which still remain, should diminish as oil production falls. Even in the current year the latest forecast of PRT is less peaked than the Budget forecast, because of changes since then to the forecast path of the oil price and the exchange rate during 1985.

[* The half-yearly split for 1988-89 was calculated on the assumption that the individual patterns of payments of net ACT and of net MCT by public corporations, North Sea companies and others respectively, follow those in 1985-86.]

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ANNEX 2

Schedule D

The following table compares the actual and forecast profiles for Schedule D for 1984-85 and 1986-87, ie before and after the change in banks' and building societies' payments from annual to quarterly.

	June forecast		£bn
	1984-85		1986-87
Apr-Jun	0.4	} 30%	0.8
Jul-Sep	1.3		2.6
Oct-Dec	0.6	} 70%	0.8
Jan-Mar	3.3		3.3
Total	5.6		7.5

psp

FROM: MRS R LOMAX

DATE: 22 July 1985

cc Financial Secretary
Sir P Middleton
Sir T Burns
Mr Evans
Mr Monger
Mr Peretz
Mr Wicks
Miss Peirson
Miss Sinclair
Mr Cassell
Mr Lord
PS/IR
Mr Battishill - IR
Mr Beighton - IR
Mr Cherry - IR
Mr Corlett - IR
Mr Lawrence - IR
Mr Matheson - IR
Mr Painter - IR
Mr Fitts - IR
Mr Fitzpatrick
Mr Whitear
Mr Prescott - IR
Mr Carr - IR

PS/FINANCIAL SECRETARY

SMOOTHING THE PSBR

The Chancellor was most grateful to Mr Cassell for the very thorough study reported in his minute of 19 July. As a next step, he would like the Financial Secretary to have a look at this and let him have his views. He would then hope to have a meeting in September. Given the prospective implementation of the Keith recommendations on Inland Revenue, the Chancellor's own inclination would be to take no action at the present time. This view is reinforced to some extent by the recent agreement to aim for a lower level of funding.

Rh.

RACHEL LOMAX



Ch.

There's nothing very
morning here, but you
promised a meeting before the
holiday, so we might as well
get it over of the way.

I suppose the main question
is whether we're other interested
in something to P&P, and
why. I think probably yes, a
balance; the market are still
capable of getting upset by head
and leading. They're not to be
able sceptical of our explanations.
And the market will get worse. But

it's our the world's biggest
problem.

Two practical suggestions
are summarised in paras 12 →
in France & elsewhere, then more
detail in para 10 of m of the IR
paper at the Annex.

You were inclined to
do nothing on kinetic grounds.
But there is still an open
question - You could take a
preliminary view, ^{crossing} ~~controversial~~
~~whether we are doing it~~ go ahead on
that.

I don't see a 5th & 6th command
option 2.

RH 12/9

CONFIDENTIAL



1. Darryl In hand
 See any write below -
 We'll need a meeting in Sept
 Cost as stated + FSTI

PRINCIPAL PRIVATE SECRETARY

 FROM: VIVIEN LIFE
 DATE: 23 July 1985

2 of 219

cc Sir P Middleton *
 Sir T Burns *
 Mr Evans *
 Mr Monger *
 Mr Peretz *
 Mr Wicks * Mr Scanlan *
 Miss Peirson *
 Miss Sinclair *
 Mr Cassell *
 Mr Lord
 PS/IR
 Mr Battishill - IR *
 Mr Beighton - IR *
 Mr Cherry - IR
 Mr Corlett - IR
 Mr Lawrence - IR
 Mr Matheson - IR
 Mr Painter - IR
 Mr Fitts - IR
 Mr Fitzpatrick
 Mr Whitear
 Mr Prescott - IR
 Mr Carr - IR

bf 12/9
 (for meeting
 on 13/9)

(+ anyone
 may want
 to bring)

SMOOTHING THE PSBR

Your minute of 22 July mentioned that the Chancellor would like the Financial Secretary to look at Mr Cassell's and Mr Beighton's work on smoothing the PSBR. His comments are as follows:

"We did of course look at the pre-1965 company corporation tax payment pattern nearly two years ago. Although we were attracted to the logic of change, we found that the impact on companies was sufficiently difficult as to discourage action.

I can see the advantages to the PSBR in para 6 of Mr Cassell's minute; but even without the problems of Keith implementation I have major doubts about the arguments for change:

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(i) para 6(3) argues that early receipts of CT would help with forecasting. But I wonder how difficult it is to forecast during the pre-budget period the level of CT receipts under the present arrangements, in comparison with the other variables.

(ii) I would find it helpful to be given some indication of the character and size of the 100,000 companies who would be involved. In particular how many of the top 100 companies would be included. This would give a clearer indication of the amount of fuss the change would cause.

(iii) The problem of compensation is surely more complex than the sum involved. Whatever the year chosen as the year of transition, companies involved are likely to claim that this year was abnormal and so the level of compensation inappropriate to the true disadvantage they have suffered.

(iv) The corporate sector will only just have completed the corporation tax rates/allowances changes in April 1986. It would therefore be useful to let them settle down and learn to live with 35% for a while. Keith is already a sufficient additional complication.

However confusing, the present system does not disadvantage the Exchequer in terms of total receipts, only in terms of cashflow; while it may be an historical anomaly it does work. Whenever changed it would produce a major storm among the corporate sector (who would find little comfort in our explanation) in return for only a modest benefit to the Government. "

Vivien Life

VIVIEN LIFE

1. P. M. P.
2. P. M. P.

PK

*I will like to
know more
on the discussion
balance with Rom?*



FROM: ECONOMIC SECRETARY
DATE: 26 JULY 1985

CHANCELLOR

*Ch.
Para 8 covers the needs
of future confidence.*

- cc: Sir P Middleton
- Sir T Burns
- Mr Cassell
- Mr Peretz
- Mr Sedgwick
- Mr Wood
- Mr George - B/E
- Mr Willetts - No 10

*Because you and the bank you
and the PBT will be out of the office
in the latter half of August, do you
have it open some general thoughts
now? I suggest you also discuss with
Peretz at your next balance*

FUNDING TARGET

*Ken.
26/7*

At the funding meeting I chaired on Tuesday, we discussed how to put into practice the principles of funding policy agreed at the Prime Minister's meeting on 16 July. I attach a detailed record of the discussion.

2. We discussed four main issues:-

- (i) the definition of overfunding we should work to;
- (ii) how month by month targets for gilts sales should now be calculated;
- (iii) more immediately, what target should be set for the next two months; and
- (iv) what kind of new stocks should we issue.


3. My recommendations, which the Bank accept, are as follows.

4. First, the policy of cutting back funding to no more than needed to cover the PSBR should be directed towards the wide definition of funding, taking account of funding from external

direct sales to UK non-banks. This probably means avoiding short-dated conventional issues. There may also from time to time be scope to buy in shorter dated stocks which are more likely to be held by banks or overseas. This would ease the pressure of maturities over the next five years and help smooth the hump in the yield curve. This would provide scope, if there were demand at acceptable yields, for larger sales of new medium and longer-dated stock. This is something we will have to deal with ad hoc, but I have told the Bank that they can expect only limited freedom to issue next-century stocks, and for the moment none at all for conventionals longer than 2004.

a sop
to the
Bank.

why?



PP IAN STEWART

From: J ODLING-SMEE
26th July 1985

CHANCELLOR OF THE EXCHEQUER

cc Sir Peter Middleton
Sir Terence Burns
Mr Riley
Mr Grice
Mr H Davies

CONFERENCE ON GOVERNMENT BORROWING

*As requested - about
discussion of the paper
published by NIER two
days ago:*

Ruo 22/8

You asked a couple of questions about the discussion of our paper at the National Institute conference.

2. First, you asked what the answer was to the question raised by Andrew Britton, namely whether it matters that the public sector debt is held internally rather than externally. Our answer is that **in an open economy in which domestic public sector debt is a close substitute for overseas debt, it does not matter.** The net external asset position of the economy as a whole would be the same, for a given size of total public sector debt, whether that debt was held by residents or non-residents. If it were held largely by non-residents, the private sector would hold a larger amount of net overseas assets than if the public debt were held mostly by residents. But the total net overseas asset position of the economy, and hence the balance between present and future consumption, would be the same in the two cases.

but to 1

3. The situation could be **different** if capital were **not very mobile** internationally. In this case changes in the ownership of public sector debt would not necessarily give rise to offsetting changes in the net overseas assets of the private sector. But there would be larger effects on interest rates, and hence offsetting effects on the domestic capital stock. Nevertheless the balance between present and future consumption could be affected by whether the public sector debt was held internally or externally. We have not worked out fully the consequences of this case.

4. Secondly, you asked for some elucidation of John Flemming's remarks about his preference for a tax-smoothing model over our analysis which was based on the distribution of consumption over time. The approach that he

*Para 2
conclusion
to conclusion
sales above
C. UK
As requested - about
discussion of the paper
published by NIER two
days ago:
Ruo 22/8*

of
(pre)
Ricardian
equivalence
however -
(in which I
remember
meeting
you as FST,
(think))

prefers is one in which it is assumed that the private sector regards the issuing of government bonds as being equivalent to an increase in taxation, because they recognise that taxes will eventually have to be increased in order to service the bonds. In this case, changes in the PSBR do not have any impact on interest rates, net overseas assets, or the distribution of consumption over time. Principles for setting the PSBR cannot therefore be derived from considerations of the optimal distribution of consumption over time. A different reason for preferring one level of the PSBR to another has to be found. In John Flemming's approach, which is closely related to the work of Barro, it is argued that the PSBR should be such as to minimise fluctuations in taxes, because changes in tax rates are distortionary. This implies that lumpy expenditures and revenues should be financed by changes in borrowing rather than by changes in taxation.

5. In the draft of our paper that we presented to the conference, we had misunderstood one of the implications of the tax-smoothing model. In particular, we thought that it did not lead to a specific level of the PSBR, only to the conclusion that the PSBR should change in line with lumpy expenditures and revenues. Following his intervention at the conference, we now realise that versions of the model do give a precise rule for the PSBR, and we have amended the paper that will be published in the National Institute Economic Review accordingly.

6. However, we think that Barro's approach is highly unrealistic. The conditions required for this type of model to hold are very stringent. As we say in the paper, it requires ultra-rationality (ie that decisions made by economic agents now take account of the implications for all future periods to infinity), perfect capital markets, and intergenerational altruism (ie the present generation that is making decisions now attaches as much weight to the welfare of all future generations as to its own). It seems highly unlikely that these assumptions are valid. We therefore persist in believing that borrowing by the government is not equivalent to taxation, and hence that it does alter the distribution of consumption over time.

DL 01

J ODLING-SMEE

1/655

FROM: R J DEVEREUX
DATE: 2 August 1985

1. MR CASSELL ✓
2. CHANCELLOR OF THE EXCHEQUER ✓

cc Sir P Middleton
Sir T Burns
Mr H P Evans
Mr Wicks
Mr Peretz
Miss Peirson o/r
Mr Watts
Dr I Webb

C. Some pretty accurate forecasting going on in this area.

Pro 2/3

CGBR IN JULY

The preliminary estimate of the CGBR in July is £0.6 billion, bringing the cumulative total since 1 April 1985 to £3.5 billion. Within this, the CGBR(0) is estimated to have been £0.8 billion in July and £3.5 billion since 1 April 1985. These figures are not yet firm and may change with later information before publication on 16 August in the monthly press notice on the PSBR.

2. The CGBR(0) outturn for July is £0.1 billion lower than forecast last month, due mainly to higher Inland Revenue receipts.

3. The cumulative CGBR(0) since 1 April 1985 is £0.4 billion lower than forecast in the Budget profile. The main factors are lower supply expenditure and higher taxation receipts.

4. Further analysis of the outturn in July, together with forecasts for the next three months, will be given in the next Ministerial note on the PSBR in two weeks' time.



R J DEVEREUX

CONFIDENTIAL

CENTRAL GOVERNMENT TRANSACTIONS (2)

£ billion

	Inland Revenue	Customs & Excise	Other own account	CGBR(0)	Net Lending		CGBR
					IAs	PCs	
1st April 1985 - 31 July 1985							
Outturn (1)	+ 15.9	+ 11.6	- 31.1	- 3.5	- 0.6	+ 0.7	+ 3.5
Budget profile	+ 15.8	+ 11.3	- 31.0	- 3.9	- 0.7	- 0.5	- 5.1
Difference	+ 0.2	+ 0.3	- 0.1	+ 0.4	-	+ 1.2	+ 1.6
1st April 1984 - 31 July 1984	+ 14.1	+ 10.4	- 29.5	- 5.0	- 0.5	+ 0.2	- 5.4
Calendar July 1985							
Outturn (1)	+ 5.4	+ 2.8	- 9.0	- 0.8	- 0.2	+ 0.4	- 0.6
Last month's forecast	+ 5.3	+ 2.8	- 9.0	- 0.9	- 0.1	+ 0.4	- 0.7
Difference	+ 0.1	-	-	+ 0.1	-	-	+ 0.1

(1) Preliminary estimate, subject to revision

(2) + indicates a receipt, net receipt, or difference which reduces the CGBR

- indicates a payment, net payment, or difference which increases the CGBR

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1. Please thank
2. AWP

FROM: MISS M E PEIRSON
DATE: 16 August 1985

J.E.

- 1. MR CASSELL
- 2. CHANCELLOR OF THE EXCHEQUER

✓

Copy with Private Secretary letter, attached, for:

Mr Flesher - No 10

cc List A

List B (distributed at 2.30 pm, 16 August)

Sir P Middleton
 Sir T Burns
 Mr H Evans
 Mr Peretz
 Mr L Watts
 Mr Pickering
 Mr Devereux
 Dr Webb

Chief Secretary
 Financial Secretary
 Economic Secretary
 Minister of State
 Mr Bailey
 Mr Moore
 Mr Odling-Smee
 Mr Scholar
 Mr Mowl

Mr Stibbard
 Mr M Williams
 Mr Powell
 Mr Cropper
 Mr H Davies
 Mr Lord
 Mr Wells - CSO
 Mr Walton - IR
 Mr Wilmott - C & E

MONTHLY NOTE ON THE PSBR

1. I attach a report on the PSBR outturn for July. This outturn will be published by press notice at 2.30 pm today, 16 August.
2. In this note, as usual, outturn in the latest month (July) is compared with the forecast made a month ago. Outturns for April to July are compared with the Budget profile. Forecasts for August-October are also included.
3. The press notice is confined to comparisons between outturn in the first 4 months of 1985-86 and outturn in the same period last year.

MEP

MISS M E PEIRSON

PUBLIC SECTOR BORROWING

Summary

- The PSBR for July is provisionally estimated at £0.6 billion, very close to last month's forecast. Borrowing on central government's own account was as forecast. Larger than expected net repayments by public corporations were offset by higher local authorities' borrowing.
- Borrowing in the first four months of 1985-86 (£3.2 billion) was £0.9 billion lower than the Budget profile (Chart 1) and £1.9 billion lower than in the first four months of 1984-85 (Chart 2).
- The PSBR is, however, forecast at £1¾ billion over the next three months, some £¾ billion higher than in the Budget profile. The forecast for the first seven months of 1985-86 as a whole is therefore £5 billion, close to the Budget profile, with higher local authority borrowing offset by lower borrowing on central government's own account.

Figures in this report are not seasonally adjusted and also may not sum precisely because of rounding.

Chart 1 : Comparisons with Budget profiles for 1985-86

£ billion cumulative

- = Estimated outturn in 1985-86
- - - = Latest forecasts
- = Budget profile

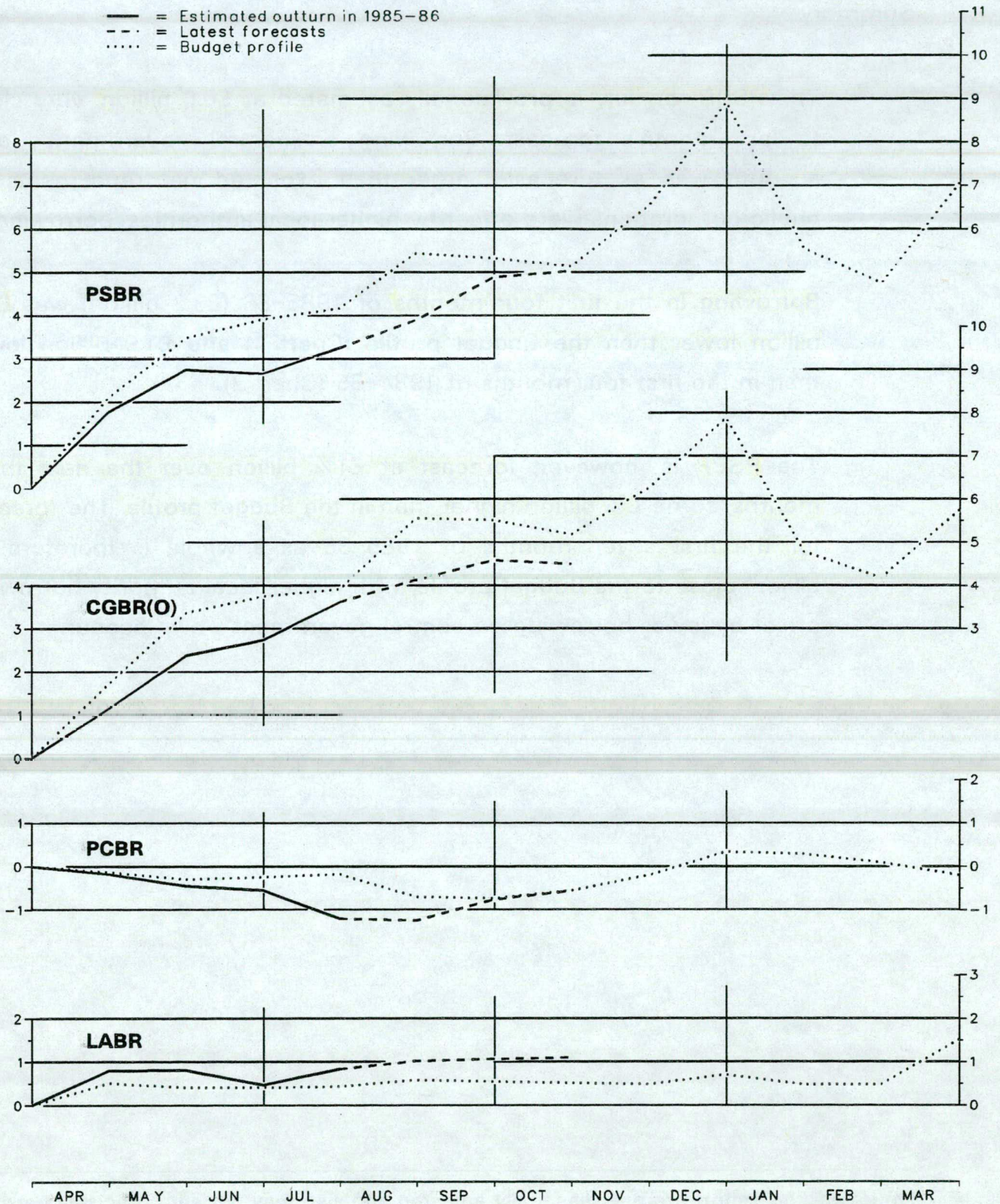
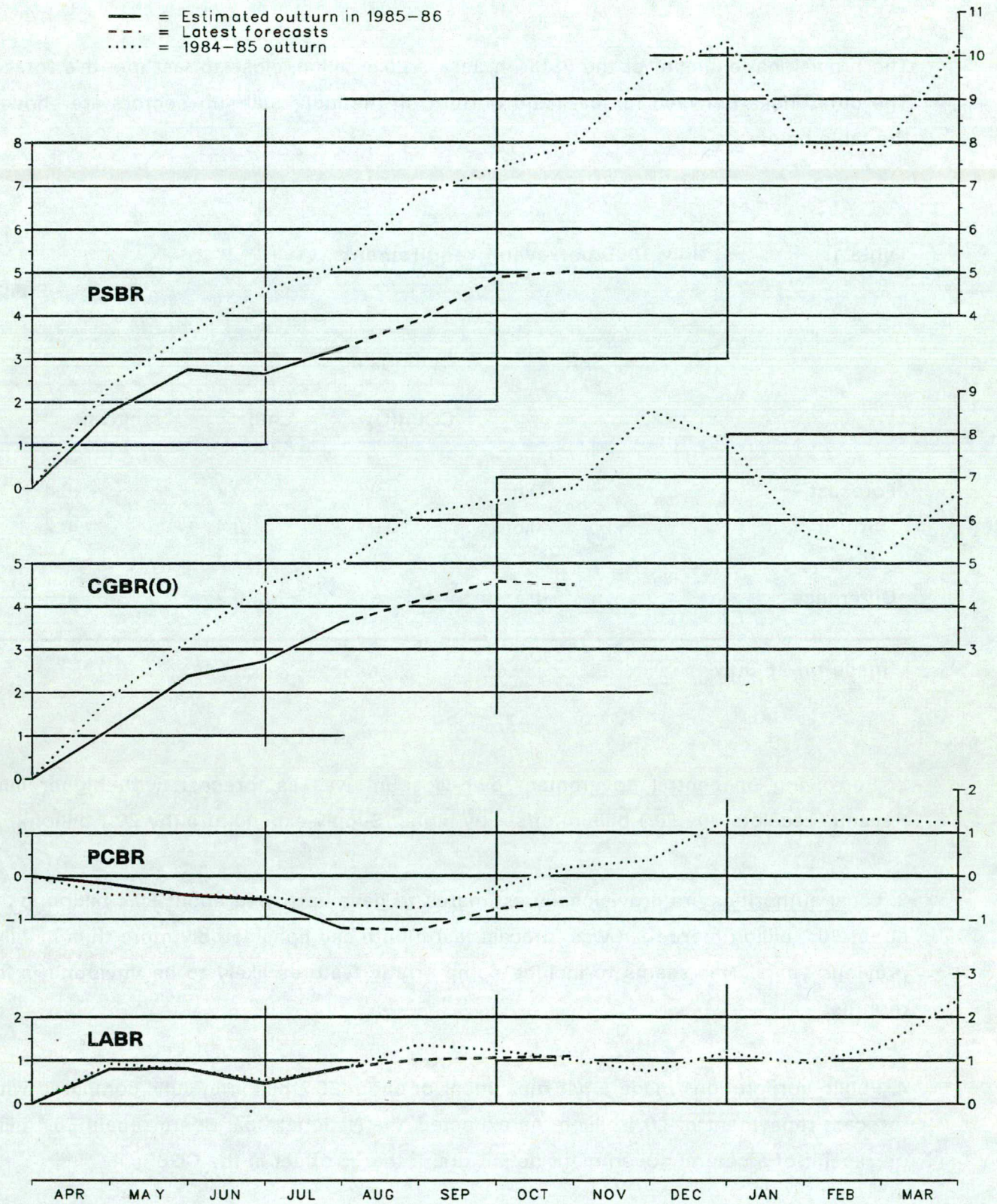


Chart 2 : Comparisons with last year's outturns

£ billion cumulative

- = Estimated outturn in 1985-86
- - - = Latest forecasts
- = 1984-85 outturn



Borrowing in July

(Comparisons in this section are with last month's forecast)

The provisional estimate of the PSBR in July is £0.6 billion, close to last month's forecast. The differences between forecast and outturn on the individual sub-sectors are shown in the table below.

Table 1: July 1985 borrowing requirements

£ billion

	PSBR	Comprising		
		CGBR(O)	LABR	PCBR
Forecast*	0.6	0.9	0.2	-0.4
Outturn	0.6	0.9	0.4	-0.7
Difference	-0.1	-	0.2	-0.2

*made on 15 July

2. Borrowing on central government own account was as forecast, with higher Inland Revenue receipts (by £0.1 billion) offset by higher Supply expenditure (by £0.1 billion).

3. Local authorities are provisionally estimated to have borrowed about £0.4 billion in July, about £0.2 billion more than was forecast last month and considerably more than in July in previous years. This seems to include some erratic features likely to be unwound in later months.

4. Public corporations made a net repayment of about £0.7 billion in July, compared with a forecast repayment of £0.4 billion. As expected, the National Coal Board repaid £0.4 billion on receipt of a central government deficit grant: that is offset in the CGBR(O).

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April to July

(comparisons in this and following sections are with the Budget profile)

Table 2: Total April-July borrowing requirements

£ billion

	PSBR	Comprising		
		CGBR(O)	LABR	PCBR
Budget forecast	4.2	3.9	0.4	-0.2
Outturn	3.2	3.6	0.8	-1.2
Difference	-0.9	-0.3	0.4	-1.0

5. The cumulative PSBR for the first four months of 1985-86 was £3.2 billion. This is about £0.9 billion below the Budget profile (see Chart 1 and Table 2) and about £1.9 billion below the same period last year (Chart 2), when the April PSBR was unusually large.

6. Cumulative borrowing in April-July on central government's own account was £0.3 billion lower than the Budget profile. This was due mainly to higher Customs and Excise receipts (by £0.3 billion), higher Inland Revenue receipts (by £0.2 billion), higher interest receipts (by £0.1 billion), and a higher surplus on the National Insurance Fund (by £0.1 billion), partly offset by lower receipts from asset sales (by £0.5 billion, due to different assumptions about timing). The difference from the Budget profile is expected to be largely offset later in the year by lower receipts from Petroleum Revenue Tax. Supply expenditure in April-July was close to the Budget profile, only because a deficit grant of £0.4 billion to the National Coal Board was paid in July instead of August as expected at Budget time; otherwise supply was lower than expected.

7. Local authorities borrowed £0.8 billion in April-July, £0.4 billion more than in the Budget profile. £0.1 billion of the excess can be attributed to temporary borrowing by authorities who were late in setting a rate (this should be repaid by the end of the year); possibly another £0.1 billion of the excess in April may be attributable to overspill from 1984-85;

and part of the excess in July seems due to erratic features likely to be unwound later in the year.

8. Public corporations made a net repayment of debt of £1.2 billion in April–July, repaying about £1.0 billion more than in the Budget profile. More than half the difference is known to be due to timing, with the earlier than expected receipt of a grant to the National Coal Board (£0.4 billion) and deferment of a PDC payment to British Steel (£0.1 billion).

August to October

9. The PSBR in the period August–October is forecast to be £1¾ billion, £¾ billion higher than in the Budget profile but £1 billion lower than over the same period last year. The increase on the Budget profile is more than accounted for by higher borrowing by public corporations, mainly due to timing.

10. Table 5 shows the latest detailed profile of borrowing on central government own account for August–October; a comparison with the Budget forecast for the first seven months and with the outturn in April–October 1984 is provided in Table 6.

11. The forecast of the CGBR(O) for August–October is £½ billion lower than the Budget profile. The main differences are lower supply expenditure (by £½ billion, excluding an increase in EC advance contributions which is offset elsewhere in the account), most of which is due to different assumptions about the timing of grants to the NCB (and is offset in the PCBR); higher Customs and Excise receipts (by £¼ billion); higher receipts from asset sales (by £¼ billion, again due to different timing assumptions); and a slightly larger surplus on the National Insurance Fund; partly offset by lower Inland Revenue receipts (by £¾ billion, mainly PRT).

12. The forecast monthly path of the CGBR(O) is as follows.

- In August, the CGBR(O) is forecast to be £½ billion. VAT receipts will be high (as in February, May, and November). The first call on Britoil shares will raise £¼ billion. Supply expenditure is fairly low but includes £¼ billion grant to the National Coal Board.

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- In September, the CGBR(O) is again forecast to be £½ billion. Inland Revenue receipts will be fairly high due to large receipts of PRT (£1¾ billion: not as high as in the Budget profile). Supply expenditure includes £¼ billion grant to the National Coal Board, £¼ billion student awards and £¼ billion teachers' superannuation. The second call on British Aerospace shares will raise £¼ billion.

- In October, the CGBR(O) is forecast to be a small surplus. Inland Revenue receipts will be high due to receipts of North Sea Corporation Tax (£½ billion) and Advance Corporation Tax (£¾ billion). Supply expenditure is fairly high because of high cash-limited expenditure, particularly defence.

13. Local authorities are expected to borrow about £¼ billion over the next three months, a little above the Budget profile. The revised forecast reflects a pattern of borrowing closer to that in earlier years, on the assumption that the effect of giving non-domestic ratepayers the option of payment of rates by instalment has been smaller than assumed in the Budget profile (see last month's note). This revision is due to timing and is expected to be offset in November.

14. Public corporations are expected to borrow nearly £¾ billion over the next three months, giving net borrowing £1 billion higher than in the Budget profile. More than half the difference is due to timing, offsetting the higher repayments in April-July (see paragraph 8). In addition, the National Coal Board's borrowing is expected to be further increased (partly because of the increased EFL), and British Gas' borrowing is expected to be £¼ billion higher.

April-October

15. Cumulatively, the forecast PSBR for the first seven months of 1985-86 is £5 billion, close to the Budget profile despite the low outturn in the first four months.

16. The reasons are:

- the £1 billion shortfall on the PCBR is expected to unwind completely, with higher borrowing by the National Coal Board, British Steel and British Gas now

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expected in the next three months (partly as a direct result of lower borrowing in April-July - paragraph 14);

- the LABR is expected to be some £½ billion higher than in the Budget profile by the end of October, partly owing to the overspill thought to have occurred in April and partly because of various factors likely to be largely offset in the remainder of the year (paragraphs 7 and 13);

- partly offsetting these factors, the CGBR(O) shortfall is expected to increase from the £0.3 billion in April-July to £¾ billion by October, mainly because of lower supply expenditure (nearly £½ billion) and a higher National Insurance Fund surplus (£¼ billion), with higher Customs receipts offsetting lower Inland Revenue receipts (paragraph 11).

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Table 3: Latest monthly profiles
(Budget profiles in italics for comparison)

f billion

	PSBR		Comprising					
			CGBR(O)		LABR		PCBR	
1985-86								
Apr	1.8	<i>2.1</i>	1.1	<i>1.7</i>	0.8	<i>0.5</i>	-0.2	<i>-0.1</i>
May	1.0	<i>1.4</i>	1.2	<i>1.6</i>	-	<i>-0.1</i>	-0.3	<i>-0.2</i>
Jun	-0.1	<i>0.4</i>	0.4	<i>0.4</i>	-0.3	-	-0.1	<i>0.1</i>
Jul	0.6	<i>0.3</i>	0.9	<i>0.2</i>	0.4	-	-0.7	<i>0.1</i>
Aug	0.7	<i>1.3</i>	0.5	<i>1.6</i>	0.2	<i>0.2</i>	-	<i>-0.5</i>
Sep	1.0	<i>-0.1</i>	0.5	-	-	-	0.5	-
Oct	0.1	<i>-0.2</i>	-0.1	<i>-0.3</i>	-	-	0.2	<i>0.2</i>
Cumulative								
Apr	1.8	<i>2.1</i>	1.1	<i>1.7</i>	0.8	<i>0.5</i>	-0.2	<i>-0.1</i>
May	2.7	<i>3.5</i>	2.4	<i>3.4</i>	0.8	<i>0.4</i>	-0.4	<i>-0.3</i>
Jun	2.7	<i>3.9</i>	2.7	<i>3.8</i>	0.5	<i>0.4</i>	-0.5	<i>-0.2</i>
Jul	3.2	<i>4.2</i>	3.6	<i>3.9</i>	0.8	<i>0.4</i>	-1.2	<i>-0.2</i>
Aug	3.9	<i>5.4</i>	4.1	<i>5.6</i>	1.0	<i>0.6</i>	-1.2	<i>-0.7</i>
Sep	4.9	<i>5.3</i>	4.6	<i>5.5</i>	1.1	<i>0.5</i>	-0.8	<i>-0.7</i>
Oct	5.0	<i>5.1</i>	4.5	<i>5.2</i>	1.1	<i>0.5</i>	-0.6	<i>-0.6</i>

Figures for April to July are outturns

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Table 4: PSBR for 1985-86 - comparisons with 1984-85 and Budget profile

£ billion

	1984-85	1985-86	Differences from		
	Outturn	Budget profile	Latest update ⁽¹⁾	1984-85 outturn	Budget profile
	1	2	3	3-1	3-2
Apr	2.4	2.1	1.8	-0.6	-0.3
May	1.2	1.4	1.0	-0.2	-0.4
Jun	1.0	0.4	-0.1	-1.1	-0.5
Q2	4.6	3.9	2.7	-1.9	-1.3
Jul	0.6	0.3	0.6	-	0.3
Aug	1.6	1.3	0.7	-1.0	-0.6
Sep	0.6	-0.1	1.0	0.4	1.1
Q3	2.8	1.4	2.2	-0.6	0.8
Oct	0.6	-0.2	0.1	-0.4	0.3
Nov	1.7	1.4			
Dec	0.7	2.4			
Q4	2.9	3.6			
Jan	-2.4	-3.4			
Feb	-0.1	-0.8			
Mar	2.4	2.3			
Q1	-0.1	-1.8			
Cumulative					
Apr	2.4	2.1	1.8	-0.6	-0.3
May	3.6	3.5	2.7	-0.8	-0.7
Jun	4.6	3.9	2.7	-1.9	-1.3
Jul	5.2	4.2	3.2	-1.9	-0.9
Aug	6.8	5.4	3.9	-2.9	-1.5
Sep	7.4	5.3	4.9	-2.5	-0.4
Oct	8.0	5.1	5.0	-3.0	-0.1
Nov	9.7	6.5			
Dec	10.3	8.9			
Jan	7.9	5.6			
Feb	7.8	4.8			
Mar	10.3	7.1			

⁽¹⁾Figures for April to July are outturns

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**Table 5: Central government transactions – July
outturn and latest forecasts for August–October**

£ billion

	July		Latest forecasts		
	forecast	outturn ⁽¹⁾	Aug	Sep	Oct
Receipts					
<i>Consolidated Fund</i>					
Inland Revenue	5.3	5.4	3.7	4.5	5.2
Customs and Excise	2.8	2.8	3.4	2.7	3.1
Other ⁽²⁾	2.0	2.0	1.3	0.9	1.0
<i>National Loans Fund</i>					
Interest etc. receipts	0.4	0.4	0.5	0.9	0.6
Total Receipts	10.5	10.5	8.8	8.9	9.7
Expenditure					
<i>Consolidated Fund</i>					
Supply expenditure ⁽³⁾	8.2	8.2	7.8	8.1	8.3
Adjustment to Supply Services basis ⁽⁴⁾	–	–0.2	–	–	–
Other	0.5	0.4	0.5	0.3	0.3
<i>National Loans Fund</i>					
Service of the national debt	1.8	1.8	1.0	1.2	0.9
Net lending	–0.2	–0.1	1.2	0.2	0.2
Total Expenditure	10.2	10.2	10.5	9.8	9.8
Other funds and accounts (+ increases borrowing) (– reduces borrowing)	1.0	0.9	0.1	–0.1	0.1
CGBR	0.7	0.6	1.7	0.7	0.1
On-lending	–0.2	–0.3	1.2	0.3	0.2
CGBR(O)	0.9	0.9	0.5	0.5	–0.1

⁽¹⁾Due to time lags in some items reaching their final accounting destination, figures of forecast and outturn may not be strictly comparable for the components identified, but there is no effect on the overall CGBR.

⁽²⁾Includes receipts from sales of assets

⁽³⁾On a cheques issued basis. Supply includes an element of on-lending in the form of public dividend capital etc.

⁽⁴⁾Reflects changes in balances of departmental accounts with the Paymaster General, timing and other differences between cheques issued by departments and payments to them from the Consolidated Fund. An offset to this item is included in "Other funds and accounts".

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Table 6: Central government transactions⁽¹⁾ – comparisons for April–October

£ billion

	1984	1985	
	Outturn	Budget forecast	Latest update
Receipts			
<i>Consolidated Fund</i>			
Inland Revenue	26.0	29.9	29.3
Customs and Excise	18.9	20.3	20.8
Other ⁽²⁾	7.0	8.1	7.2
<i>National Loans Fund</i>			
Interest etc. receipts	3.1	3.7	4.0
Total Receipts	55.0	61.9	61.2
Expenditure			
<i>Consolidated Fund</i>			
Supply expenditure ⁽³⁾	51.6	56.3	55.8
Adjustment to Supply Services basis ⁽⁴⁾	-0.3	-	0.3
Other	3.0	2.4	2.4
<i>National Loans Fund</i>			
Service of the national debt	7.1	7.9	8.0
Net lending	0.8	0.8	2.0
Total Expenditure	62.3	67.4	68.4
Other funds and accounts (+ increases borrowing) (- reduces borrowing)	0.8	0.8	-1.1
CGBR	8.0	6.3	6.1
On-lending	1.2	1.1	1.6
CGBR(O)	6.8	5.2	4.5

⁽¹⁾Due to differences in treatment of some items in the accounts between the periods/forecasts shown, and time lags in some items reaching their final accounting destination, figures for the components identified may not be strictly comparable.

⁽²⁾Includes receipts from sales of assets.

⁽³⁾On a cheques issued basis. Supply includes an element of on-lending in the form of public dividend capital etc.

⁽⁴⁾Reflects changes in balances of departmental accounts with the Paymaster General, timing and other differences between cheques issued by departments and payments to them from the Consolidated Fund. An offset to this item is included in "Other funds and accounts".

From: JOHN CLARK
16 August 1985

MR CULPIN - IDT

MR LANG - CSO Press Office

cc List A

>Chancellor
Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr Cassell
Mr H Evans

Mr Peretz
Miss Peirson
Mr Watts
Mr Pickering
Mr R Evans
Mr Ward - CSO
Mr Wright - B/E
Mr Turnbull - No. 10

List B

(distributed at 2.30pm, 16 August)

Mr Stibbard
Mr Spencer
Mr Cropper
Mr H Davies
Mr Lord
Mrs Hillier - IR
Mr B Sexton - C and E

BRIEFING FOR 16 AUGUST PSBR PRESS NOTICE

FACTUAL

The PSBR figures for July will be published at 2.30pm on 16 August. The provisional outturns, together with figures for the first four months of 1984-85 and 1985-86, are shown in Table 1. Cumulative figures for the PSBR and its components for 1984-85 and 1983-84 are shown in Table 2 overleaf.

Table 1: **Borrowing requirement outturns** £ billion

	Apr-Jul 1984	Apr-Jul 1985	July 1985
Central government on own account	5.0	3.6	0.9
Local authorities	0.8	0.8	0.4
Public corporations	-0.7	-1.2	-0.7
PSBR	5.2	3.2	0.6
Memo: CGBR (including borrowing for on-lending to LAs and PCs)	5.4	3.5	0.6

Note: Figures may not sum precisely because of rounding.

Table 2: PUBLIC SECTOR BORROWING REQUIREMENT - Comparison with the last two years

Cumulative £ billion

	Central government on own account			Local authorities borrowing requirement			Public corporations borrowing requirement			Public sector borrowing requirement		
	1983-84	1984-85	1985-86	1983-84	1984-85	1985-86	1983-84	1984-85	1985-86	1983-84	1984-85	1985-86
Apr	0.9	1.9	1.1	0.5	0.9	0.8	-0.2	-0.4	-0.2	1.2	2.4	1.8
May	2.4	3.2	2.4	0.3	0.8	0.8	-0.3	-0.4	-0.4	2.4	3.6	2.7
Jun	3.7	4.5	2.7	-0.1	0.6	0.5	-0.4	-0.5	-0.5	3.2	4.6	2.7
Jul	4.5	5.0	3.6	-0.0	0.8	0.8	-0.6	-0.7	-1.2	3.9	5.2	3.2
Aug	5.8	6.2		0.3	1.4		-0.4	-0.7		5.6	6.8	
Sep	6.6	6.4		0.3	1.2		-0.0	-0.3		6.9	7.4	
Oct	6.7	6.8		0.3	1.0		0.1	0.2		7.1	8.0	
Nov	8.3	8.5		-0.2	0.8		0.5	0.4		8.5	9.7	
Dec	9.1	7.8		0.1	1.2		0.6	1.3		9.8	10.3	
Jan	6.3	5.7		0.0	0.9		0.7	1.3		7.1	7.9	
Feb	6.7	5.2		0.1	1.3		0.6	1.3		7.5	7.8	
Mar	8.2	6.7		1.2	2.4		0.3	1.2		9.7	10.3	

Note: Figures may not sum precisely because of rounding.

2. The (provisional) PSBR for July is £0.6 billion. This is in line with the forecasts of City analysts, which lie between just under £½ billion and £1 billion.

3. The July outturn brings the cumulative PSBR for the first four months of 1985-86 to £3.2 billion, £1.9 billion lower than over the same period last year.

POSITIVE

Borrowing in first four months of 1985-86 was £3.2 billion - £1.9 billion lower than in first four months of 1984-85. BT receipts of nearly £1.2 billion account for some but not all of reduction.

DEFENSIVE/FACTUAL

1. Front-end loading

Background

Last year Chancellor said "almost all" of PSBR in 1984-85 was expected in first half of year; such high front-end loading was expected because of special receipts in second half of year (VAT on imports and BT). But the prolongation of the coal strike added substantially to borrowing in the second half, so in the event no more than three-quarters of the PSBR was in the first half-year. In 1985-86, BT second call receipts has reduced borrowing in the first half-year, but higher corporation tax receipts (than in earlier years) will reduce borrowing in the second half-year.

Line to take

British Telecom second call receipts have already benefitted PSBR in first half of 1985-86, but higher corporation tax receipts (than in earlier years) will principally benefit second half.

2. Asset sales

Background

Budget forecast for total receipts from special sales of assets in 1985-86 £2.5 billion.

Line to take

Outstanding receipts (about £0.1 billion) from second instalment of BT shares received in July, bringing total net receipts from sale to £1.2 billion. About £225 million (net) from first instalment on Britoil due in August.

3. Supply Expenditure

Background

For first four months of 1985-86, supply services (which represents issues to departments from the Consolidated Fund) were about 6 per cent higher than in April-July 1984. The comparable increase in supply expenditure (which represents cheques issued by departments and differs from supply services because of changes in departmental balances with the Paymaster General) is 8 per cent. The latter increase is not published and is based on less firm information. No Budget forecast of supply in 1985-86 was included in the FSBR. Table 5.3 showed Main Estimates provision only, which is unsuitable for comparing against outturn.

Line to take

Supply services in April-July about 6 per cent up on April-July 1984-85. Still too early in year to draw conclusions from the figure.

4. EC refunds

Line to take

Whole of 1983 refund received in 1984-85. 1984 refund of 1000m ecus (about £570 million at present) expected in late 1985-86. 1985 arrangements are different, and will reduce UK monthly contributions, starting in 1986.

5. Inland Revenue receipts

Background

Total Inland Revenue receipts in July were £5.4 billion. Total for April-July 1985-86 was £15.9 billion, 12¾ per cent higher than over the same period last year. Budget forecast for 1985-86 was for receipts of £56.2 billion, up 11½ per cent on 1984-85.

Line to take

Inland Revenue receipts in July were £5.4 billion and the total for April-July £15.9 billion. July receipts included the second instalment of schedule D tax on the self-employed and the first payment of the new composite rate tax on bank deposits. ACT receipts are seasonally high in the month.

6. Oil Revenues

Background

Pound:Dollar exchange rate now higher than 1.10-1.15 assumed in Budget for 1985 (TCSC minutes, 27 March 1985, p8). Revenues in first half of year (particularly September) largely determined by what happened up to June 1985, but revenues in second half determined largely by prices and production in July-December 1985.

Line to take

Little effect from recent fall in sterling oil prices on oil revenues until September. Much too soon to draw conclusions for year as a whole - oil revenues depend on both sterling oil prices and production. Oil production forecasts very uncertain.

7. Customs and Excise revenues

Background

Customs and Excise revenues in July were £2.8 billion. Total for April-July 1985-86 (£11.6 billion) was 11¾ per cent higher than over the same period last year. Budget forecast for 1985-86 was for receipts of £36.3 billion, up 2¼ per cent on 1984-85 (low increase because 1984-85 receipts were boosted by change in VAT on imports).

Line to take

Receipts in first four months £11.6 billion. Increase over corresponding period last year greater than Budget forecast of increase for year as a whole, because receipts in second half of 1984-85 boosted by change in VAT on imports.

8. Local authorities

Background

Preliminary estimate is that local authorities borrowed £0.4 billion in July, bringing total net borrowing to £0.8 billion in April-July 1985-86, same as over corresponding period last year. Budget forecast for 1985-86 as a whole was not given (purely notional breakdown of PSBR of £7.1 billion given in part 6, including £1.5 billion for LABR). Outturn for 1984-85 was £2.4 billion.

Line to take

Pattern of local authority borrowing is erratic. Too soon to say whether borrowing in year as a whole will be as high as in 1984-85.

9. Public corporations

Background

Public corporations (provisionally) made a net repayment of debt of £0.7 billion in July, giving net repayment of debt of £1.2 billion for first four months of 1985-86. (This cumulative figure includes a revised estimate - from £0.3 billion to £0.5 billion - of the repayment made in the June quarter, resulting from the banks' quarterly returns.)

Line to take

Public corporations have shown a net repayment of debt in period April-July in each of the last 3 years. Over this period receipts from consumers normally exceed expenditure. Last month's unusually large repayment was boosted by National Coal Board repayment of nearly £0.4 billion on receipt of deficit grant from central government (which has no overall effect on the PSBR).

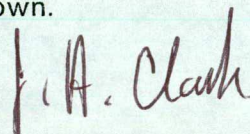
10. Large fall in OCGFA in July
(col. 12 of table 2 of press notice)

Background

This is a detail of government accounting. A major item within OCGFA is changes in the balances on departmental accounts with the Paymaster General. Departmental balances are affected by, among other things, timing differences between Supply Issues from the Consolidated Fund and actual departmental expenditure, and timing differences between Departmental receipts and their payment into the Consolidated Fund. Large fluctuations in OCGFA are not uncommon - for example October 1984 and March 1985. There are usually offsetting fluctuations in other columns. In June 1985 there was a sharp rise in OCGFA as the receipts from the BT sale went into departmental balances; in July there was a corresponding fall on OCGFA as those receipts were paid over from departmental balances to the Consolidated Fund (the fall was therefore offset in col. 4 of table 2 of press notice).

Line to take

The large fall in OCGFA in July is due mainly to the payment into the Consolidated Fund of the receipts from second call on BT shares - these receipts caused a large increase in OCGFA in June. The fall in July is offset by a rise in col. 4 of table 2 of the press notice, where the payment into the Consolidated Fund is shown.



John Clark (ext 3093)
PSF Division, HM Treasury

9/57

psr

FROM: ROBERT CULPIN
DATE: 27 AUGUST 1985

MR ODLING-SMEE

Ch.
Reported in his
morning's press

cc Chancellor *C*
Sir T Burns
Mr H Evans
Miss O'Mara
Miss Peirson
Mr Monaghan

Re.

29/8.

*[- & I think good
will come of it]*

APPROACHES TO THE PSBR

You should see the attached circular.



ROBERT CULPIN

ENC

ss walton

ECONOMIC BRIEFING

No 90
UK SECTION

Treasury approaches to the PSBR

By Bill Martin of the Phillips & Drew Economics Unit

1. A new paper by top-ranking Treasury economists provides a rare guide to developments in official thinking on fiscal policy in the UK. On our interpretation, the paper implies a reduced role for broad money supply, £M3, as a constraint on targets for the public sector borrowing requirement. It also argues against simple rules for the PSBR based on the assumption of a fixed level of national debt relative to GDP.
2. Instead, the economists argue that, in the medium to long run, government debt should move so as to maintain the 'net worth' of the public sector. If adopted, the new rule has radical implications for the PSBR.
3. Maintaining net worth means that higher (worthwhile) public investment spending can justify a higher PSBR. Public net investment is now $\frac{3}{4}\%$ of GDP but the infrastructure lobby will doubtless demand more.
4. To prevent excessive consumption, the paper argues that the PSBR should be reduced while North Sea revenues are at their height. Symmetry of treatment implies that the PSBR target should be relaxed in order to maintain consumption in the face of falling North Sea revenues. In principle, this 'North Sea adjustment' could warrant a higher PSBR target from now on.
5. Against this, the PSBR should be reduced in order to lighten the eventual burden of state pension arrangements. But this argument will have less force if the state earnings-related pension scheme is phased-out.
6. We calculate very tentatively that the new Treasury rule could be used to justify a PSBR target well over £9bn in 1986/87, compared with the £7½bn pencilled into the MTFS. In practice, the Treasury is likely to sanction a more moderate increase, and then only if inflation is well under control. Even so, the rules of the PSBR game are now set to change.

Respectable rumour has it that the Treasury is, once again, rethinking UK monetary policy; and, in particular, the usefulness of the targeted broad money aggregate, £M3. Until recently, £M3 acted in varying degrees as a guide to both interest rate policy and to fiscal policy. But the continuing difficulties of controlling or even explaining the growth of this wayward aggregate have undermined its suitability for either task. The exchange rate has, in practice, taken over as the prime determinant of short-term interest rate policy. What remains unclear is how fiscal policy and public sector borrowing requirement (PSBR) objectives are now to be set.

Shedding light on this issue comes a timely paper by two top-ranking Treasury economists.* The paper considers a range of factors which they believe have to be taken into account when gauging the appropriate stance of fiscal policy. The imprimatur of official economists does not, of course, guarantee the translation of the paper's arguments into policy. Nor do the authors cover all the vital issues; in particular, they do not analyse how the PSBR should be set to achieve declining inflation. Nevertheless, as a rare guide to developments in official thinking on PSBR objectives, the paper deserves the closest attention of financial markets.

MONETARY-FISCAL POLICY MIX

The authors consider short-and long-term factors affecting fiscal policy stance. The discussion of the longer term is especially revealing, as much for its approach as for its detail.

The distinguishing characteristic of Treasury analysis of fiscal policy, but a few years ago, was the emphasis laid on the close medium-term connection with monetary policy. Indeed, in the heyday of monetarism, it appeared that fiscal policy became wholly subordinate to the need to control broad money supply. But, by the 1985 Budget, the Chancellor was pointing out: 'There is nothing sacrosanct about the precise mix of monetary and fiscal policies required to meet the objectives of the Medium-Term Financial Strategy.' The present paper takes this argument a step further. **It underlines the considerable problems of designing practical rules for fiscal policy based on monetary considerations.**

The Treasury, of course, still endorses the theory which underpins the link between monetary and fiscal policy. The theory runs as follows. The share of public sector debt and money in private sector financial portfolios depends on the pattern of relative interest rates. So a combination of lax fiscal policy and tight monetary policy would require higher long-term interest rates to encourage investors to raise the weight of public sector debt in their portfolios.

This could be interpreted as a distortion of the pattern of yields which results naturally from such considerations as the marketability and risk characteristics of different financial assets. These distortions, if left uncorrected, could eventually become unbearable. To avoid distortions, a harmonious medium-term mix of monetary and fiscal

policies is therefore required. The mix would accommodate desirable trends in portfolio shares caused, for example, by financial innovation and changes in preferences. Different trends in money and public sector debt would imply different mixes of monetary and fiscal policy.

In practice, the Treasury argues, it is far from easy to identify the 'optimal pattern' of interest rates or, conversely, 'desirable long-term trends in portfolio shares'. **The authors are sceptical of the value of simple 'debtist' rules which assume fixed portfolio shares and a fixed ratio of national debt to GDP. For example, a rule maintaining the debt-income ratio at 50% — roughly the current level — would imply a PSBR around 4% of GDP (£15bn in 1986/87) with 8% nominal GDP growth. Calculations of this sort are unlikely to cut much ice in Treasury circles.**

More generally, we think the effect of the Treasury paper will be further to weaken the link, as perceived in Whitehall, between £M3 and PSBR objectives. If it is not easy to identify the desirable growth rate of money relative to public sector debt, it is similarly not easy to determine the desirable medium-term mix of monetary and fiscal policy. **This leaves the setting of fiscal policy in something of a vacuum.**

To fill it, the Treasury paper proposes, as a key long-term consideration, the impact of the PSBR on the mix of consumption and investment in the economy at large. Excessive public borrowing to finance consumption now could crowd out UK investment — either at home or overseas — via increased interest rates and an over-valued currency. Real interest rates, for example, could be forced far too high in relation to the economy's growth rate. A depleted capital stock would eventually impair the economy's productive potential, limiting the amount of consumption which future generations can enjoy. **A too-high PSBR results in too-high interest rates; too little investment and too much consumption today relative to consumption tomorrow.**

This approach to the PSBR has far-reaching implications.

INVESTMENT & NET WORTH

The paper argues: '**... higher (worthwhile) public net investment in principle justifies a higher PSBR and, probably, higher interest rates.**' The rationale is that borrowing to finance worthwhile public investment makes it possible to achieve any given balance between consumption now and in the future with less private sector investment.

The point can be expressed in terms of the **net worth** of the public sector — the stock of public sector physical and financial assets less its liabilities. When worthwhile public investment is financed by borrowing, the increase in public sector debt liabilities is matched by the addition to the public sector's capital stock. Net worth is maintained. The extra assets should generate benefits for 'future generations' (ourselves, in later life, as well as our children) which offset the burden of extra debt interest payments. The balance between present and future consumption is preserved. This result helps to underpin the authors' golden rule: **the PSBR should be set in the medium to long-term 'so that the net worth of the public sector, appropriately defined, is unchanged.'** The same rule also helps to avoid sharp,

*'Approaches to the PSBR' by John Odling-Smee and Chris Riley, HM Treasury. Published in August 1985 issue of the National Institute Economic Review.

unsettling changes in taxation otherwise required to finance, for example, large single investment projects.

The Treasury paper recognises the difficulties of developing the concept of net worth, however. There are problems of coverage and valuation of assets and liabilities. For example, as regards the public sector capital stock, some investment may be classified incorrectly as current expenditure (education and health spending help maintain the nation's human capital) while some spending may be classified incorrectly as investment. 'Concorde, for example, arguably should never have been recorded as an asset', says the paper. Despite the measurement problems, in our view at least as daunting as those met in the context of setting the appropriate monetary-fiscal policy mix, the authors say their new framework of thinking 'is helpful'. Such modesty should not be allowed to disguise the significant shift of emphasis that the new framework represents.

The first consequence will be to hasten the day when PSBR discussion and presentation differentiates much more clearly between current and capital account transactions. This will help re-affirm the old idea that borrowing to finance capital expenditure is acceptable and that current expenditure should be financed from taxation.

The second consequence will be to set a baseline for the PSBR target roughly equal to levels of public sector investment, net of depreciation. The authors suggest gingerly that 'it may be possible to take account of trends and shorter-term movements in public net investment in assessing the appropriate PSBR path'. Table 1 shows that public sector net investment averaged around 1½% of GDP in the late 1970s but fell to ¾% of GDP in the last five years. Noting the 1980-83 average figure, the authors opine: 'On its own, this might be taken to suggest that the PSBR should be about ¾% of GDP in the absence of inflation.' The infrastructure lobby might well conclude that the desirable figure is considerably higher.

Table 1: Public sector net investment

% GDP							
1977	1978	1979	1980	1981	1982	1983	1984*
1.7	1.3	1.6	1.3	0.4	0.3	0.8	0.8

*P&D estimate.

The third consequence is that public sector asset sales, if correctly valued, would not be used to finance tax cuts. An asset sale, the authors note: 'would have to be accompanied by a one-off reduction in the PSBR if the public sector's net worth was to be maintained unchanged. This would be necessary to leave the balance between present and future consumption unchanged; with a loss of income from the asset by the public sector offset by lower debt interest payments.'

NORTH SEA REVENUES

The logic of preserving the balance of present and future consumption has important implications for the use of North Sea oil and gas revenues. The Government, like the

proverbial pools-winner, should not 'spend, spend, spend' but save and invest a substantial proportion of the windfall. This would build up income for the future, allowing the maintenance of a steady level of consumption. The benefits of the windfall are thus spread equally between present and future generations, avoiding the headache and hangover associated with a profligate spending binge.

The paper provides an illustrative calculation of the tax cut sustainable into the long run assuming a full sharing of North Sea revenues with future generations. The Treasury puts the present value of revenues at £108bn, at 1985/86 prices, assuming a real rate of discount of 2½%. The sustainable tax cut of £2¾bn is equivalent to the annuity arising from an £108bn investment with a 2½% rate of return.

Table 2: North Sea revenue and PSBR

	£bn, 1985/86 prices			Long run
	1985/86	1986/87	1987/88	
Actual revenue§	13½	11	8½	0
Debt interest saving	—	¼	½	2¾
Sustainable tax cut	2¾	2¾	2¾	2¾
PSBR reduction*	10¾	8½	6¼	0
Debt reduction	10¾	19¼	25½	108

*PSBR reduction equals actual revenue plus debt interest saving less sustainable tax cut. Worth, as per cent GDP, in 1985/86-1987/88: 3%, 2½%, 1¾%. §Treasury projections.

With actual revenues in 1985/86 at £13½bn on Treasury numbers, a sustainable tax cut of £2¾bn implies that £10¾bn of the revenues — around 3% of GDP — should be 'saved'. **Prudent investment of the North Sea windfall therefore requires that much the greater part of current revenues should be reflected in a lower borrowing target.**

Table 2, based on the Treasury's method, brings out a further point. **As the oil revenues decline, so does the required reduction in the PSBR target. This follows if the PSBR is reduced to prevent consumption rising to the full extent of the revenues when these are at their height. Symmetry of treatment implies that consumption should not be squeezed as a result of falling North Sea revenues. This means an increase in the PSBR target over time.** (Interestingly enough, the same conclusion follows if allowance is made for the relatively small demand effects of North Sea taxation — see 'A demand-adjusted PSBR profile' by Paul Neild, *Economic Briefing* No 67.) Table 2 also shows that, in the long run, savings on debt interest payments rise sufficiently to finance the £2¾bn tax cut indefinitely.

LONG-RUN PSBR TARGET

The Treasury paper fights shy of justifying the present MTFS targets for the PSBR on the basis of its new approach. It is likely, in fact, that considerations of public sector net worth have so far entered only tangentially into official, deliberations. So, as a means of second-guessing the Treasury, it would be somewhat premature to press the new logic into fully active service. Table 3 nevertheless attempts to anticipate the possible drift in Treasury thinking.

Table 3: PSBR targets

% GDP	1985/86	1986/87	1987/88
1985 MTFS	2	2	1¾
Net investment	+¾	+¾	+1
Inflation effect	+2½	+2	+1½
North Sea effect	-3	-2	-1½
Other	+1¾(?)	+1¾min	+1¾min
Total	2	2.5min	2¾min

min = minimum target.

The first row shows current MTFS targets — likely to be slightly exceeded this year. The remaining rows show how a PSBR picture could be built up from the Treasury's new approach. The target for public sector net investment is left at the level suggested by the Treasury economists — ¾% of GDP — in 1986/87 but raised in 1987/88 in anticipation of partially successful pressure by the infrastructure lobby.

The inflation effect arises because the public sector's net worth is boosted by the erosion, due to inflation, of its debt liabilities. Steady inflation of 5% with the ratio of debt to GDP at 50% means it is necessary to add 2½% of GDP to the PSBR target which emerges from calculations which ignore inflation. The problem with this adjustment is that, in the wrong hands, it can be a recipe for accommodating ever-higher inflation rates. Our rough allowance errs on the side of caution by taking the inflation path assumed in the MTFS and builds in a slight fall in the debt-income ratio from current levels.

The adjustment for North Sea revenues is based on the Treasury figures for 1985/86. For subsequent years, we assume the Treasury re-assesses the adjustment on the basis of less sanguine assumptions for sterling oil prices. The figures shown are based on our own projections of revenue and the associated 'sustainable tax cut'.

The 'other' category represents the combined effect of changes in all other assets and liabilities relevant to the calculation of net worth. The Treasury economists argue quite reasonably that in the calculation of public sector net worth one should include at least those assets and liabilities which are not constant over time. This leaves out some elements which would feature in a comprehensive public sector balance sheet. But measurement problems render the comprehensive approach impracticable.

Even so, the candidates for inclusion in 'other' are quite numerous. Apart from small items like changes in the stock

of lending to industry or overseas aid, the Treasury paper focusses on two. The cost of unemployment — to the extent that this was above its long-run level — could be shared with future generations. This means running a higher PSBR now. Conversely, the future cost of unfunded state pension arrangements provides a case for running a lower PSBR now, to reduce the burden on future generations.

The balance of these other factors is unknown. Table 3 assumes simply that, by good chance and some judgement, the Treasury's 1985/86 PSBR target is consistent with calculations of public sector net worth. At least this assumption has the advantage of starting the PSBR calculations off from where the Treasury finds itself! The 'other' category can then be derived residually in 1985/86. It shows a net addition to the PSBR target.

In future years, it is arguable that, on the Treasury's logic, this addition should increase. The point follows from the proposals, in the Green Paper on Social Security, to run down the state earnings-related pension scheme and replace it with compulsory private saving. The Treasury paper notes: 'The case for running a lower PSBR to finance future pension commitments would, under the Green Paper proposals, be significantly diminished.'

The final row in Table 3 shows the overall result. On our tentative calculations, the Treasury's new fiscal rule — keeping the net worth of the public sector constant — raises the PSBR target in 1986/87 to at least 2½% of GDP, ½ point above the MTFS plans for 1985/86 and 1986/87. The main reason is that lower oil revenues betoken a smaller reduction in the PSBR target, an effect which is only partially offset by a lower positive inflation adjustment. The new target, were it adopted, implies a PSBR of well over £9bn in 1986/87, compared with the £7½bn now pencilled into the MTFS. A further departure from MTFS plans can be projected in 1987/88.

In practice, the Treasury is likely to be more cautious than our bold calculations imply. The authors' discussion of short-term factors affecting fiscal policy makes this clear. The Budget judgement will remain alive to the dangers of unsettling financial confidence and of accommodating inflation. Consequently, we do not expect to see a £10bn PSBR target in 1986/87, though some moderate upward adjustment from £7½bn seems probable. These are early days, however. The new Treasury approach to the PSBR changes the rules of the game. If nothing else, the setting of fiscal policy now promises even more thrills and spills, and undoubtedly missed goals.

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CONFIDENTIAL

FROM: R CARPENTER
 DATE: 3 September 1985

- MEP*
1. MISS PEIRSON
 2. CHANCELLOR OF THE EXCHEQUER

cc Sir P Middleton
 Sir T Burns
 Mr Cassell o/r
 Mr H P Evans
 Mr Peretz
 Mr Scholar
 Mr Watts o/r
 Mr Devereux o/r
 Dr I Webb

CGBR IN AUGUST

The preliminary estimate of the CGBR in August is £2.4 billion, bringing the cumulative total since 1 April 1985 to £5.9 billion. Within this, the CGBR(O) is estimated to have been £0.9 billion in August and £4.5 billion since 1 April 1985. These figures are not yet firm and may change with later information before publication on 17 September in the monthly press notice on the PSBR.

2. The CGBR(O) outturn for August is £0.3 billion higher than forecast last month, due mainly to lower Inland Revenue receipts. The reason for this shortfall is being investigated. As expected, the first call on Britoil shares realised £0.2 billion in the month.

3. The cumulative CGBR(O) since 1 April 1985 is £1.1 billion lower than forecast in the Budget profile. The main factor is lower supply expenditure (by around £0.9 billion, partly owing to differences of timing). The £1.1 billion difference is expected to be reduced in coming months, however, partly because of lower oil revenues.

4. Net on-lending to Local Authorities in August was close to forecast, at £1.1 billion. The high figure resulted from LAs' reaction to attractive interest rates on PWLB fixed rate loans; it carries no necessary implication for the LABR. Net on-lending to Public Corporations, at £0.5 billion, was £0.4 billion higher than forecast, mainly reflecting higher than expected borrowing by the Electricity Council.

5. Further analysis of the outturn in August, together with forecasts for the next three months, will be given in the next Ministerial note on the PSBR in two weeks' time.

R Carpenter
 R CARPENTER

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CENTRAL GOVERNMENT TRANSACTIONS (2)

£ billion

	Inland Revenue	Customs & Excise	Other own account	CGBR(0)	Net	Lending	CGBR
					IAs	PCs	
1st April 1985 - 31 August 1985							
Outturn (1)	+ 19.2	+ 15.1	- 38.7	- 4.5	- 1.6	+ 0.2	- 5.9
Budget profile	+ 19.4	+ 14.7	- 39.6	- 5.6	- 0.7	+ 0.1	- 6.2
Difference	- 0.2	+ 0.4	+ 0.9	+ 1.1	- 0.9	+ 0.2	+ 0.3
1st April 1984 - 31 August 1984	+ 17.4	+ 13.5	- 37.0	- 6.2	- 0.5	+ 0.3	- 6.3
Calendar August 1985							
Outturn (1)	+ 3.2	+ 3.4	- 7.5	- 0.9	- 1.1	- 0.5	- 2.4
Last month's forecast	+ 3.7	+ 3.4	- 7.6	- 0.5	- 1.1	- 0.1	- 1.7
Difference	- 0.5	-	+ 0.1	- 0.3	+ 0.1	- 0.4	- 0.6

(1) Preliminary estimate, subject to revision

(2) + indicates a receipt, net receipt, or difference which reduces the CGBR

- indicates a payment, net payment, or difference which increases the CGBR

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CONFIDENTIAL AND PERSONAL

FROM: MISS M E PEIRSON
DATE: 10 September 1985

CHANCELLOR

Clear

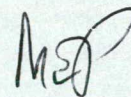
M. Peirson

our

Mark

cc Sir P Middleton
Sir T Burns
Mr Cassell o/r
Mr H P Evans
Mr Peretz
Mr Scholar
Mr Devereux o/r
Dr I Webb o/r
Mr Wells - CSOPSBR IN AUGUST

1. The first provisional outturn for the PSBR in August is £1.1 billion. This is £0.4 billion higher than last month's forecast (see table attached), but well below market expectations, which range between £1½ billion and £2¼ billion (average £1¾ billion). Our estimate is subject to revision before publication on Tuesday 17 September.
2. In the first 5 months of 1985-86 the PSBR was £4.3 billion, £1.1 billion below the Budget profile.
3. As reported in Mr Carpenter's note of 3 September, the CGBR(0) in August was provisionally £0.9 billion. This is £0.3 billion higher than forecast last month, owing to lower Inland Revenue receipts. The LABR was provisionally £0.1 billion, a little lower than forecast; and the PCBR was also provisionally £0.1 billion, compared with a forecast small net repayment.
4. Over the period April-August the PSBR was provisionally £1.1 billion below the Budget profile. However, this shortfall is not expected to be sustained in coming months; in particular, PRT receipts at the beginning of September were £¾ billion lower than in the Budget profile.
5. The monthly note, presenting updated estimates for August and revised forecasts for September-November, will be circulated next Monday.



MISS M E PEIRSON

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£ billion

	August 1985			April-August 1985			April-August 1984
	Provisional outturn	Last month's forecast	Difference	Provisional outturn	Budget profile	Difference	Outturn
CGBR(O)	0.9	0.5	0.3	4.5	5.6	- 1.1	6.2
LABR	0.1	0.2	- 0.1	0.9	0.6	0.3	1.4
PCBR	0.1	-	0.2	- 1.1	- 0.7	- 0.4	- 0.7
PSBR	1.1	0.7	0.4	4.3	5.4	- 1.1	6.8

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PSP

**RECORD OF A MEETING HELD AT 10.30AM
ON FRIDAY 13 SEPTEMBER IN HM TREASURY**

Those Present:

Chancellor of the Exchequer
 Financial Secretary
 Sir P Middleton
 Mr Cassell
 Mr Peretz
 Mr Scholar
 Miss Peirson
 Miss Sinclair
 Mr Cropper

Mr Battishill)
 Mr Beighton) Inland Revenue

SMOOTHING THE PSBR

The meeting considered Mr Beighton's minute of 18 July to the Chancellor, Mr Cassell's minute of 19 July and Miss Life's minute of 23 July.

2. The Chancellor said he would be grateful for a note explaining the risk of having to concede to the Building Societies current complaint which could cause £½ billion of revenue to slip from one year to the next.

3. The Chancellor said he was in total agreement with the conclusions of Mr Beighton's minute. If the PSBR were to be smoothed, then option 1 was clearly best. But if it was decided to press ahead with a substantial number of Keith Revenue proposals in the 1986 Budget, then it would not be wise to do this too. If the Keith package was postponed, however, perhaps something could be done.

4. The Financial Secretary said that there were several significant disadvantages in any change. It would require anti-avoidance legislation, have a cost of around

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£50 million, contain very little tax logic, and upset most of the major companies. Computerisation meant it could be done in several years' time at little or no cost.

5. Mr Cassell said the arguments in favour might not be so strong, but the increasingly uneven path of the PSBR since 1979 was a problem. A smoother profile was desirable if at all possible for the day-to-day management of money markets and improvements in forecasting. Successive Chancellors had considered smoothing the CT profile only to conclude that the difficulties were too great.

6. Mr Battishill identified several further difficulties: the prize would be less than hoped for, since the change would merely bring receipts forward into the third quarter of the calendar year and not the second; public presentation would be very tricky, since the Government had already announced many CT changes and Keith, without ever mentioning such ideas; the proposal lacked any strong tax logic and pre-1963 companies would doubtless have to be paid compensation. In short, he recommended against acting now.

7. Sir Peter Middleton agreed that there were strong arguments for not moving at the present time. But the system of tax receipts currently in operation made day-to-day monetary and financial management very difficult. Computers might help, but, as with any other tax changes, people would need reasonable notice.

8. The Chancellor said he recognised that previous Chancellors had studied this issue and rejected it. Conditions were now, if anything, much worse. Company liquidity might be better, but there had been massive upheaval in CT arrangements and the public were aware of the Keith proposals. On balance, therefore, he was against pursuing this proposal for the present.

9. The Chancellor noted CTDs currently gave companies the opportunity to pay early and receive a discount. He wondered if there was any way in which the system could be improved. Mr Peretz pointed out that improved terms on CTDs could create round-tripping. CTDs helped smooth the funding profile a little, but not much. The Chancellor suggested that it might be possible to abolish the existing CTDs and invent a new certificate of payment for tax, which would be voluntary and on fine terms. Counting as revenue, rather than funding, it would then reduce, rather than finance,



the PSBR. It would not help forecasting, due to its voluntary nature, but it would help with smoothing. He asked HF to consider this idea in its review of CTDs, liaising closely with the Revenue, and to produce a note on the whole issue.

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P WYNN OWEN

13 September 1985

Distribution:

Those present
PS/EST
Mr Evans

CHANCELLOR

FROM: P J CROPPER
DATE: 13 September 1985RATING REFORMcc Mr Lord
Mr Davies

RY

Pratt
D. Jones

I hope it is not too unhelpful to report the gist of various conversations following the E(LF) briefing meeting.

2. Although complete abandonment of the idea of regular revaluations (along German lines) is far from being the worst outcome, it looks very unattractive in administrative terms. The valuation department of the Inland Revenue has a statutory duty of care and maintenance, and will feel bound to start exerting its powers again once the situation becomes clear. That means a revival of such problems as we had a few weeks ago in the case of gentrified Islington. And one doubts very much whether big, and widening, anomalies in rating values will come to be fully capitalised in market prices.

3. The issue we are facing is not unlike that which will face us over Keith and the Inland Revenue. Are we going to sacrifice the ideal of "Good Government" in mid-Parliament, and once more defer action until some time after 1988?

4. I don't want to be accused of political naiveté; only to point out that we must expect both officials and professional people to be pretty disappointed with us if we not only fail to find a palatable ^{alternative to} ~~solution~~ on rates (that will hardly surprise many of them) but actually end up by failing to administer the existing system properly, ie. allow relative valuations to become more and more unreal.

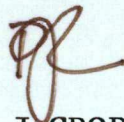
5. What this experience does do is to underline the value of a rating system which does not need periodical big

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revaluations (ie. one in which most values could be automatically indexed from one year to the next, incrementally). One might almost elevate this to being the first criterion of a good local revenue system. From that point of view the modified property tax would earn high marks.

6. This all relates principally to domestic property. In the case of industrial and commercial property I should have thought the disappointment would be just as great. After all, for every Croydon industrialist who will be spared an increase in rates, there will be one in Halesowen who will be deprived of a cut in rates. Perhaps we should regard it all as a way of hastening the demise of dead beat industry in declining regions, and of giving extra help to "winners"!

6. I recognise that the pains of transition from rates to a modified property tax would be nearly as bad as the pain involved in a straight rating revaluation. The main difference is, with MPT the change would take place behind the smokescreen of a change of system. I think this would probably make the change worthwhile.



P J CROPPER