APPENDIX 1

Memorandum by Tim Congdon, Economist, L Messel & Co

SUMMARY

1. The economic outlook has deteriorated seriously in the twelve months between the publication of Cmnd 7049 and Cmnd 7439. The main reason is that the budget deficit is £2 billion higher than expected a year ago. To keep within the Government's monetary targets and maintain the fight against inflation, that has required an increase in interest rates to check loan demand from the private sector and has contributed to a weaker balance-of-payments performance than expected.

2. Cmnd 7439 forecasts a 1978–79 public sector borrowing requirement of £7·3 billion, while the general government borrowing requirement is £8·0 billion (both figures in 1977–78 prices). The implied repayment of debt by the public corporations of about £750 million (in current prices) is much higher than expected in the April 1978 Budget estimates. But the White Paper gives little evidence on how or why this has occurred. If anything, the public corporations external financing needs seem to have increased relative to April 1978 expectations. One problem here is in determining the status of the £700 million shortfall provision for nationalised industries' investment expected in April 1978 and its relationship to the £2,000 million shortfall allowance for "total public expenditure" which the White Paper posits. The Treasury should clarify the convention it is using.

3. The £7·2 billion 1979–80 PSBR forecast is based on two dubious assumptions —that earnings growth in the current and the subsequent pay rounds will be 7 per cent; and that the relative price effect (a measure of how public sector costs are rising compared to private) will have a favourable effect of £0·4 billion. Faster earnings growth would not necessarily increase the PSBR because revenues, as well as expenditure, would be higher. But the relative price effect assumption, particularly its wage cost components, seems too optimistic.

4. Many of the problems in the presentation and interpretation of the White Paper would be overcome if there was more widespread use of estimates in current price terms. This would also be consistent with the amalgamation of cash limits and the Estimates.

The latest Expenditure White Paper (Cmnd 7439) is clearer in presentation than its predecessor, but gives no more encouragement about the financial outlook. There has, in fact, been a marked deterioration in Britain's economic prospects over the last twelve months and some figures in the White Paper go part of the way to providing an explanation The estimates in Cmnd 7439 of the prospective public sector borrowing requirement in the present financial year, in 1979–80 and 1980-81 are at the root of the trouble. In section 1 of this memorandum, their economic significance will be discussed. In section 2, some doubts will be cast on the plausibility of the PSBR estimates. In section 3, recommendations for improvements in presentation in future years will be made.

1. *The economic significance of large budget deficits*

In Table 8 of Cmnd 7049, estimates were given of the general government borrowing requirement in 1977–78, 1978–79 and 1979–80; in terms of 1976–77 prices, they were £5·5 billion, £5·4 billion and £4·3 billion respectively. In Table 7 of Cmnd 7439 similar estimates are given for the same years and 1980–81; in terms of 1977–78 prices, they are £4·9 billion, £8·0 billion, £7·8 billion and £6·9 billion. Roughly speaking, therefore, the GGBR is over £2 billion higher in 1978–79 and 1979–80 than envisaged a year ago.

The Government has declared its commitment on several occasions over the last twelve months to achieve a much slower rate of money supply growth than in

1977–78 (over 15 per cent), despite the enlargement of the budget deficit. There has been an inevitable conflict between fiscal and monetary policy, which has been resolved by a sharp rise in interest rates and "corset" restrictions on the growth of bank liabilities to check credit demands from the private sector. Moreover, as the balance-of-payments position has been less good than hoped, the scope for repaying Britain's large overseas debts has been reduced.

These problems were predictable, being the direct result of the £2 billion increase in the budget deficit from the level originally planned in Cmnd 7049. The increase was caused by the income tax cuts in the 11 April 1978 Budget. The Government can nevertheless be excused its mistake by the advice it received from the great majority of economists at the time. A book, *Demand Management*, published last year and containing a series of papers given to a conference arranged by the National Institute of Economic and Social Research, concluded with an observation by Mr Michael Posner that, "All authors seemed to agree that a measure of fiscal relaxation was appropriate 'now'—December 1977—and this at least provided an element of common ground." None of the authors referred to publicly changed their minds in the next three months.(1)

If the Government wants to reduce the rate of inflation by monetary restraint, to allow greater financial room for industrial expansion and to begin the repayment of Britain's overseas debts, the budget deficit must be lowered. In a paper to the Expenditure Committee on last year's White Paper, a medium-term financial plan was proposed aimed at achieving these objectives; the PSBR was to be reduced progressively from an expected £6·7 billion in 1977–78 to £3·8 billion in 1980–81, while money supply growth was to come down from an expected 10½ per cent in 1977–78 to 4 per cent. in 1980–81.(2) Although the figures given were for purposes of illustration, the argument for a plan remains valid and has been given an obvious relevance by events. The budget deficit has been increased—and inflation is about to accelerate, the private sector is being deterred from borrowing by high interest rates and no significant progress has been made in paying back Britain's debts (except by running down the reserves).

In the paper proposing a medium-term financial plan, it was remarked that the publication of joint revenue and expenditure projections in Cmnd 7049 was "not a minor presentational reform, but may foreshadow a great improvement in the co-ordination of fiscal and monetary decision in this country"(3) As a speculation on how policy might be conducted in 1978, that was sadly wrong. However, it is true that fiscal policy is now constrained by the need to keep the PSBR compatible with the money supply targets and, indeed, that monetary objectives, not "demand management", have become the overriding consideration in Budget decisions. In Cmnd 7439, the Government has gone a stage further down this road by providing PSBR, as well as GGBR, estimates.

However, this is only a token change and in other respects the White Paper is disappointingly short on statements about the framework of monetary policy within which its expenditure decisions will take effect. There is a warning that in Case C, the 11 per cent earnings growth case that the Treasury put forward as one of three alternative economic forecasts to 1982, "Monetary growth is assumed to be less than accommodating to the growth of nominal GDP" (paragraph 33, p 9). But that is all. Case C projects 2 per cent growth in GDP between 1977 and 1982, compared to 3 per cent for Case A (where earnings growth is 7 per cent in the present wage round and 5 per cent thereafter). It is most unlikely that low rates of money supply growth have any long-run effect on employment levels and, as the Treasury's alternative forecasts seem to rely on the notion that monetary restraint will cause higher unemployment over an extended period, they are to be criticised. Incidentally, the sentence in paragraph 26, p 7, that, "In the short-term actual and potential output growth can differ markedly, but as the time horizon lengthens productive potential becomes an increasingly dominant influence on the growth of output" cannot be easily reconciled with the numbers in Table 6, p 9, where actual growth is 1 per cent lower in Case C than Case A over a five year period.

Before moving on to an analysis of the PSBR estimates in the White Paper, a comment should be made about the very bad productivity performance it assumes.

There has been no change in view on this subject between Cmnd 7049 and Cmnd 7439. Cmnd 7049 said that, "even allowing for the faster growth of labour supply and the contribution made by the rising output of North Sea oil, . . . it would be imprudent to count on a faster growth of productive potential than 3 per cent a year." (paragraph 52, p 12); Cmnd 7439 says that, "even with North Sea oil and a faster growth of the labour supply, productive potential is unlikely to grow much above its pre-1973 trend of 3 per cent" (paragraph 29, p 8). But Cmnd 7439 does, on Table 5, p 8, give more precise calculations to support the statements showing that the growth of output per head dropped from 2½ per cent between 1964 and 1974 to ¾ per cent between 1974 and 1977 and is expected to be between only 1½ and 2¼ per cent over the five years to 1982. The much slower growth rate is partly responsible for the intractable problem of the Government's finances, because higher output would benefit tax revenues and reduce the budget deficit.(4) The White Paper does not investigate the causes of the deterioration in productivity trends, crucial though this must be to the evolution of economic policy in the next few years.(5)

2. *The reliability of the PSBR estimates in Cmnd 7439*

The PSBR levels forecast in Cmnd 7439 are too high. Even so there are some reasons for believing that they are underestimates. Clues about the more questionable figures are contained in the White Paper, although once again the document plays a game of statistical hide-and-seek to obscure the true situation. Four points may be emphasised.

(i) Reconciliation of the PSBR and GGBR estimates.

In 1978–79 and 1979–80 the GGBR is forecast to exceed the PSBR by £0·7 billion and £0·6 billion. As no PSBR estimates were made in Cmnd 7049, it cannot be known if this represents a change of plan from January 1978. However, it is definitely a change of plan compared to April 1978 forecasts in the *Financial Statement and Budget Report*. According to the *FSBR* the GGBR in 1978–79 was to exceed the PSBR by only £100 million. The change could occur in two ways—from an increase in central government lending (from the National Loans Fund) to the public corporations, as compared to Budget estimates, or from an improvement in the public corporations' finances. Can evidence for either of these developments be assembled?

The short answer is "no". The Treasury's January Press release on "Central government transactions" shows that in the first nine months of 1978–79 the public corporations borrowed £97 million from the National Loans Fund, compared to a Budget expectation that they would borrow £21 million in the whole year. It is possible that they will borrow much more in the next three months, but no confirmation has been provided. In other words, the public corporations appear to be receiving as much NLF lending as expected in April 1978—and no more.

Information on the condition of public corporations' finances is given in Table 3.4 of Cmnd 7439 which is described as "an updating of the financing table" in the *FSBR*. In the *FSBR* the total external finance needed by the public corporations in 1978–79 was put at £1,877 million; in Table 3.4 of Cmnd 7439 it is put at £2,155 million; the implication is a deterioration of £278 million since Budget forecasts, not an improvement.

How, then, can the public corporations be repaying almost £750 million (in current prices) more debt, outside the public sector, than expected at Budget time? The answer may lie in the £700 million "deduction for shortfall" item which appears in Table 13 of the *FSBR*, but not in Table 3.4 in the White Paper (ie the Treasury is still expecting such shortfall in 1978–79, but is not including it in Table 3.4). When asked about the problem, the Treasury was unable to clarify the conventions relating to the treatment of this shortfall item. In particular, we do not know if the £700 million shortfall here is part of the £1,037 million shortfall in 1978–79 total public expenditure which, in Table 2 on p 4, the Treasury claims to have already identified.(6)

The significance of this discussion is that the £700 million gap between the GGBR and PSBR foreseen in Cmnd 7439 is, on the basis of the evidence given, not credible. The point should be answered properly by the Treasury as the gilt-edged market has been alarmed by a succession of high CGBR figures in recent months. The Government's publication of a satisfactory PSBR estimate despite them is open to interpretation as skulduggery to still the market's fears.

(ii) The deduction of £2,000 million " shortfall " from total public expenditure as a blanket provision for underspending.

The Treasury was, rather understandably, criticised for its practice in Cmnd 7049 of publishing " planned " totals, presumably controlling programmes, which differed from expected public expenditure " outturns ". In Cmnd 7439 it has overcome the difficulty by making a £2,000 million " general allowance for shortfall " in 1978–79 and in every succeeding year. This shortfall is deducted from " total public expenditure ", a category which, apart from the debt interest it includes, is used for planning purposes. The White Paper remarks that the allowance can only be " tentative ".

The imprecision of such an allowance is its chief drawback. The White Paper says that £2,000 million shortfall is expected in 1978–79, of which £1,037 million has been found and £963 million remains to be discovered. If it is not discovered the PSBR rises by almost £1 billion. Of course, shortfall may be higher than expected. We just do not know—and, on the face of it, neither does the Treasury.

Incidentally, that £1,037 million of shortfall has been deducted from " total public expenditure " in 1978–79, but none in 1979–80, causes an apparent increase in the growth of expenditure compared to Cmnd 7049. In Cmnd 7049, total public expenditure was expected to rise by 2·1 per cent between 1978–79 and 1979–80; in Cmnd 7439, the corresponding figure is 4·5 per cent. Although this is a statistical artefact caused by the shortfall conventions, it may arouse some comment.

(iii) The " relative price effect " and the 7 per cent earnings assumption.

The outturn on public sector finances is critically dependent on how costs are rising relative to the private sector. A footnote to Table 5.13 indicates that the relative price effect is expected to have a favourable impact on the 1979–80 PSBR of £0·4 billion (in 1977–78 prices), twice as high as in 1978–79. In the last three years, the public sector has lost ground to the private sector on pay. Political comment, newspaper headlines and the like suggest the process is unlikely to continue and, indeed, it may go into reverse. In this context, it is difficult to understand why the White Paper considers that the relative price effect may be more advantageous in 1979–80 than in 1978–79. A chart on p 235 shows the contributors to the relative price effect. Curiously, the relative price effects for land and new dwellings are assumed to be strongly adverse in 1979–80, implying that, if the overall effect is favourable, this is because of the behaviour of pay and " other procurement " costs. Is this plausible?

The other fundamental assumption behind all the numbers in the White Paper is that earnings will grow by 7 per cent in the current pay round and thereafter. It is not correct, contrary to a widely-held view, that more rapid earnings growth will raise the PSBR. Higher money incomes would boost tax revenues and, although increased public sector wages would in themselves damage the Government's finances, cuts in programmes may offset higher costs. As observed in the " Explanatory and Technical Notes ", " The Government have said that if the rate of inflation were to turn out substantially higher or lower than had been allowed for they would take stock of the position, in the light of all the circumstances of the time " (p. 242). Recent White Papers witness the power of Treasury Ministers to curb expenditure by unannounced tightening of administrative control. In both 1976–77 and 1977–78 expenditure was cut £2½ billion by these means and even in 1978–79 the item " Other changes: various " in Table 5.9 is minus £1,453 million.

The uncertainties caused by the present conflict over public sector pay are enormous—and the White Paper does not disguise them. But they make the estimates in the White Paper rather hypothetical.

(iv) Debt interest.

Table 5.13 shows "interest payments" rising from £6·7 billion to £6·9 billion (in 1977–78 prices) between 1977–78 and 1978–79—or by 3·0 per cent. This is understood to be consistent with the *FSBR* forecast in current price terms of a rise from £6,606 million to £7,541 million—or of 14·2 per cent. But, according to the January press release on "Central government transactions", the cost of servicing the National Debt rose from £3,573 million in the first nine months of 1977–78 to £4,524 million in the first nine months of 1978–79—or by 26·6 per cent. In other words, the official estimate for interest payments in 1978–79 looks too low.

3. *Recommendations for better presentation in future White Papers*

The defect of the traditional method of presenting the Expenditure White Paper is the absence of a common yardstick for all the tables, charts and statistics it contains. Since the White Paper is about how much money is spent and, to a lesser extent, about how much money is received, the obvious yardstick is cash—or, to be more long-winded, "current price terms". But in only one place, Table 11 on p 16, are figures given in such terms.

As the PSBR is of interest only in current price terms, it also should be treated in this way. The links between the table with the PSBR estimate and the tables with expenditure and revenue projections should also be made explicit and clear. Cmnd 7439 is a great improvement on Cmnd 7049 in outlining the relationships between different parts of the White Paper, with tne "Explanatory and Technical Notes" in Part 6 being particularly valuable. But the presentation could be made still more simple and straightforward if expenditure totals were in current price terms.

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NOTES

(1) M Posner (ed) *Demand Management* London: Heinemann, 1978, p 235. Some of the observers most critical of the conflict between fiscal and monetary policy in 1978 were recommending a relaxation of demand restraint in late 1977. For example, the October 1977 London Business School *Economic Outlook* argued in favour of £8,000 million domestic credit expansion in 1978–79 to be accomplished by an increase in the PSBR. Its authors have subsequently protested that the PSBR in 1978–79 is too high.

For one criticism of the April 1978 tax cuts before they were made, see T Congdon "Will Mr Healey get the balance right?", *The Times*, 7th April 1978.

(2) Memorandum by T Congdon, Appendix 5, pp 81-87, in *2nd Report from the Expenditure Committee: 1977–78 session* London: HMSO 1978. Ironically, money supply growth in the first eight months of 1978–79 was at an annual rate of 7½ per cent, almost identical to the 8 per cent suggested in the plan. But if 4 per cent money supply growth is to be attained by 1980–81, *and there is to be scope for a significant increase in the availability of finance for an expansion of private sector activity*, a major reversal of budgetary policy is needed. That could be done either by cutting expenditure or by raising taxes. I am in favour of expenditure cuts of the required scale (over £5 billion), but this would raise questions of social philosophy. Since direct taxes are arguably too high, the alternative is a big increase in indirect taxes. My recommendation would be increases of at least £3 billion in each of the next two financial years. It is not to be expected that the Government will adopt this policy in 1979, but sooner or later something of the sort will have to be done.

(3) 2nd Report from the Expenditure Committee, ibid p 87.

(4) Some striking estimates of the possible reduction in the "constant employment budget deficit" were made by T S Ward in the 1977 *Cambridge Economic Policy Review*, on the assumption that the economy grew at 3¾ per cent a year. It is, however, difficult to reconcile his statement that, "At the tax rates set in the April 1978 Budget, the budget deficit would tend to decline by 1½–2 per cent of GNP each

year if real domestic output rose at the annual rate of 3–3½ per cent required to maintain a constant rate of unemployment," with the projections in Cmnd 7439 (See T S Ward and R R Neild *The Measurement and Reform of Budgetary Policy* London: Heinemann 1978, p 37.)

(5) This is not to say that the White Paper hides facts relevant to explaining Britain's dreadful productivity performance in recent years. A section on "Employment and training", pp 61-67, is particularly revealing. Expenditure on the functioning of the labour market has risen from £269 million in 1973–74 to £974 million in 1978–79 and is due to rise to £1,243 million in 1979–80 (in 1978 survey prices) (see Table 2.4, pp 50-51). Most of this money is spent by the Manpower Services Commission, which is said "to provide a modern, efficient and flexible service capable of responding quickly to the changing requirements of labour markets" (p 63). Similar phrases, examples of bureaucratic pap not far from Orwellian Newspeak, litter the pages. They are accompanied by a profusion of brisk-sounding acronyms (TOPS, STEP, YOP, SFES, JRS, etc), which, on examination, seem to refer to more or less identical schemes. However, the true situation does emerge. Paragraph 52 on p 61 indicates that the take-up of training places is low, with a shortfall in one case of 68 per cent, and it is easy to work out, from a table on p 63, that, whereas the ratio of registrations to placings by the Government employment service in 1973-74 was 2·44, it was 3·61 in 1977-78. In fact, the five-fold increase in expenditure on the "functioning of the labour market" since 1973 seems to have done nothing to lower unemployment and much to reduce productivity (mainly by deliberate subsidies to unprofitable jobs).

In 1959, when labour market expenditure was limited to labour exchanges, unemployment was under 2 per cent of the work-force, while wage rates hardly changed and productivity rose by over 5 per cent. In 1979, with the help of "jobcentres", TOPS, YOP, etc, unemployment will be almost 6 per cent, wages will probably rise by over 12 per cent and productivity will stagnate. It is not an impressive tribute to twenty years of increased government involvement in the workings of the labour market or to the resulting "modern, efficient and flexible service".

(6) Paragraph 9 on p 2 refers to "reductions in the estimated financing requirements of the nationalised industries". This is consistent with their repaying more debt, but not with a comparison of Table 13 in the *FSBR* and Table 3.4 in Cmnd 7439.

The Treasury has indicated to me that two elements of the public corporations' £700 million negative contribution to the PSBR can be identified in Cmnd 7439: minus £100 million overseas and market borrowing by the nationalised industries (Table 2.5) and minus £96 million short-term borrowing by the nationalised industries (Table 3.4, footnote). The other components are overseas and market borrowing by public corporations other than nationalised industries and public corporations' (net) purchases of other public sector debt. But that leaves unsolved the problem created by comparing Table 13 in the *FSBR* with Table 3.4 in Cmnd 7439.

I am grateful to the Treasury for the advice given on this point. However, attention should also be drawn—and the Treasury did not do this—to the fact that "net overseas and market borrowing of the nationalised industries" is £240 million higher in Cmnd 7439 than expected in Cmnd 7049 (Table 5.9, p 227). One is left with the strong impression that numbers do not add up.