Chapter 1
Post Budget policy assessment

> For the economic observer, it is a very exciting Budget indeed. At long last, decisions have been made in a coherent framework. Without pretending to be able to foresee the future, there is a strategy for those elements which governments can influence. (Mr. Samuel Brittan, *Financial Times*, 27 March 1980)

Government decisions are now being made by reference to nothing more than a broad political philosophy together with monetarist generalisations which are demonstrably false as applied to the British economy. Because the government has not attempted to foresee the future beyond the short term, it has adopted commitments to reduce growth of the money supply and to cut public expenditure* without estimating their effects. The short-term consequences, for which official forecasts have been made, are recognised by the government to be almost uniformly adverse. Longer-term benefits, reduced inflation and resumed economic growth, are merely adumbrated in general terms. Moreover the presentation of the medium-term strategy is incomplete and internally inconsistent. There is no administrative plan for implementing public expenditure and money supply targets nor any assessment of medium-term economic prospects of a kind which could help to determine whether the targets are feasible.

The analysis below and in the next chapter indicates that the government's policies will rapidly depress the economy and weaken British industry without necessarily reducing inflation. The official short-term forecast understates the prospective fall in spending and output this year. The long-term expectation of resumed economic growth held out by the government is illusory because it takes no account of the damage to foreign trade, production and employment which will be caused by monetary restriction and cuts in government borrowing. The official projections of government revenue and expenditure, which assume resumed economic growth, are therefore misleading.† The government's expectation of reduced inflation has been and will continue to be falsified, both because the government is itself raising rents, charges and nationalised industry prices and because the present high exchange rate will become impossible to sustain.

The first two sections below identify faults in the analysis presented by the government and show where policies will go wrong. The last part of the chapter summarises the case for a fully worked-out strategy using all the main instruments of economic management to achieve sustained growth of spending, production and employment and minimise inflation. The whole discussion rests on a full analysis of short- and medium-term problems of the economy given in Chapter 2.

Short-term prospects

Official forecasters are so pessimistic about exports and import penetration that they expect the balance of payments to remain in deficit to the extent of about £2½ billion this financial year, despite higher North Sea oil production and despite a 2½% fall in GDP. The main grounds for such pessimism are the slowdown in world trade and the loss of UK competitiveness due to a high sterling exchange rate (which the government intends to maintain). But at the same time, official forecasters underestimate the recession this and the tight budgetary policy will cause and therefore underestimate the budget deficit.

Their forecasts for the balance of payments and the public sector deficit imply that the private sector will reduce its financial surplus. Indeed the private sector would have to spend *more* relative to income not only by the amount of the reduction in the public sector deficit but also by the amount of the expected fall in stock-building – a total of some £5 billion at current prices. Thus the forecasts can only be correct if consumption and private fixed investment together rise by about £5 billion relative to private income.

This seems very implausible. Personal borrowing is being discouraged by high interest rates which show no sign of coming down. Companies are under severe financial pressure which is expected to worsen. Indeed, in his Budget speech the Chancellor warned banks and their customers to be cautious about the scale of their lending and borrowing 'in the difficult economic conditions foreseen for 1980/1'. Surprisingly, the official forecast shows no fall at all in real consumption. In the circumstances it seems far more likely

*According to the present official definition which allows 'expenditure' cuts to take the form of higher council rents, charges for services, and even increases in nationalised industry prices!

†But note that the estimate of public borrowing (the PSBR) even for this financial year, is stated to have a margin of error of ± 3% of GDP or £6 billion (Budget Statement, p. 27).

that both private consumption and investment will decline this year. But in that case demand and output will contract more rapidly and unemployment will rise faster than officially forecast. The tax base will be smaller, nationalised industries will make less profit or incur larger losses, and the result for public finances will be a larger borrowing requirement.

Medium-term prospects

When it comes to looking further ahead, government strategy involves only two commitments – to reduce growth of the money supply to the range of 4-8% in three years' time and to cut public expenditure (on the official definition) by 5½% over the same period. No progress will have been made on either commitment this year since the short-term money supply target of 7-11% is the same as that fixed last year and public expenditure is estimated to cost as much in real terms this year as last. No explicit plan has been given of how the commitments will be met after this year, nor of effects on the economy or even on public finances. It is suggested that inflation should fall and that economic growth should resume. But the only figuring consists of an arbitrary projection showing total public expenditure and receipts up to 1983/4 (Budget Statement, pp. 17-19) on the assumption that GDP, having fallen by 2½% between 1979 and 1980, rises at an average rate of 1% per annum thereafter.

According to the figures in this table, public borrowing (at 1978/9 prices) should fall from £8 billion last year to £2½ billion in 1983/4 and within this profile there should be £3½ billion available for tax cuts or additional spending by the latter year. This prospect of a falling PSBR with money to spare rests on three assumptions: that public expenditure will be cut by £4 billion *after* this year; that the North Sea will yield £2½ billion extra revenue; and that economic growth will be sufficient to yield an additional £2½ billion increase in government revenue at constant (inflation-adjusted) tax rates.

It should first be noted that these estimates comprise projections of unemployment benefit based on the assumption that unemployment rises to 1.8 million and then levels off. This is inconsistent with the assumption on which the table is based that GDP only rises ½% between 1979 and 1983. If we assume more realistically that unemployment would reach 2½ million on the above output assumption, this would add nearly £1 billion to public expenditure* in 1983/4.

Next, the usual details of how public expenditure will be cut are missing from the White Paper.† In terms of programmes, spending on housing, industry and employment and nationalised industries are the main candidates for large savings. As far as housing is concerned, the options are rent increases, sales of council houses or less new building. Since new building is already reduced to its lowest level for thirty years and council house sales are slow (as well as being costly to local authorities in the long term), it seems that the brunt of this 'cut' will be borne by rent increases. In the case of nationalised industries the 'cut' is to be achieved by a £3½ billion increase in internal financing of what is envisaged to be an expanding investment programme. This 'cut' can only mean huge price increases. As for spending on industry and employment, the cut implies withdrawal of regional and industrial assistance and of financing facilities for exports.

The assumption that cuts totalling £6 billion can be made in the above programmes in the context of recession after this year's 2½% or more fall in GDP seems questionable, particularly when the government is unable to present administrative breakdowns of the planning totals in the White Paper. Any 'cuts' which do take place are likely to take the form of higher public sector prices, rents and charges.

But the most fundamental point is that the output growth assumption on which the government's medium-term financial projection is based is completely arbitrary except in the trivial sense that it is roughly the same as the average growth rate which actually occurred between 1973 and 1979. It is, explicitly, not what the government expects or intends to happen. Nor does it bear any relationship to the fiscal policies which the government proposes to follow.

A prediction of output growth conditional on proposed policies would play havoc with the projections of government revenue and spending. Consider the effects on demand if, in reality, public borrowing were to fall sharply. Expenditure and output could then only be sustained in the long term by a fast-improving foreign trade performance. Simply to offset the projected £4 billion cut in public borrowing (at 1978/9 prices) would require that exports should rise by 2% per year over and above increased import penetration. To sustain growth in GDP by as little as 1% per year as well, exports would have to rise by about 6% per year in real terms over the next three years (and by even more if the private financial surplus rises because of destocking). Yet the official short-term forecast shows exports including oil *declining*, not rising, and nowhere in the entire set of documents presented by the government is there any discussion at all of how the forecast decline in exports might subsequently be reversed.

With a large cut in public spending and a steady reduction in public borrowing, the presumption must be that GDP, far from rising after this year, would continue its absolute decline. The tax base would contract, public expenditure would be forced up and instead of there being money for tax cuts, the government would have to raise taxes, charges and nationalised industry prices, round after round.

Inflation would not be reduced in these circumstances unless the government's general threat that it

*The White Paper does give a do-it-yourself kit for translating assumptions about additional numbers of unemployed into additional net expenditure but this is no valid substitute for presenting estimates which are internally consistent. Conditional forecasts of unemployment benefits are scarcely more arbitrary than conditional forecasts of other income- or output-related items in the public accounts.

†For years after 1980/1 the White Paper gives programme totals but no breakdown by subprogramme or by economic category.

will hold down growth of money spending, regardless of the consequent fall in output and employment, really does alter wage bargaining in a fundamental way. This is implausible because the threat is so generalised that the great majority of those who achieve large wage settlements will not be those who become unemployed. Moreover the criteria of comparability and perceived fairness which are the most powerful determinant of wage bargains at present would largely have to be abandoned. Whatever the merits of such a change, there are no apparent means of bringing it about. If that is so the outcome of the government's financial targets will be a highly perverse combination of recession and continued rapid inflation.

The other component of the strategy – to reduce growth of the money supply to around 6% – is also left with no operational foundation. The recent Green Paper on Monetary Control has already discredited the idea that any automatic mechanism could be devised to guarantee the achievement of monetary targets without distortion and disruption of competition.

The money supply growth targets (Budget Statement, p. 16) which move down from 7-11% this year to 4-8% in 1983 are supposed to be harmonious with the PSBR projections in the sense that provided the fiscal strategy is implemented the monetary targets can be met with a fall in interest rates. However, while the PSBR projections are at constant prices and are 'not to be interpreted as a target path. . .', presumably because they are conditional on an arbitrary assumption about GDP, the money supply targets are in money terms and strictly unconditional. Indeed the unconditional commitment to these monetary growth targets is at the heart of the government's strategy.

The main threat implicit in official pronouncements about the monetary target is that interest rates will be used to ensure that the target is not exceeded. Monetarists may argue that the publication of the target will in itself cause people to believe prices will rise less rapidly and therefore to settle for smaller wage increases. But there is no realistic theory, let alone evidence, to support this. Given the existing institutions of wage-bargaining and price-fixing, it is wholly implausible that the mere publication of reducing money supply targets up to 1983/4 will reduce inflation this year or any year thereafter. Moreover if inflation continues, very high interest rates may be needed to bring down monetary expansion. High interest rates would strengthen sterling, eroding trading performance still further.

In sum, far from providing a coherent framework within which economic strategy can be assessed, the government has proposed money supply targets and projections of the PSBR incoherently related to one another and completely unrelated to any of the objectives of economic policy. There has been no attempt to work out the relationships between the fiscal and monetary decisions made by the government and the flows of spending, costs, prices and foreign trade which will govern their impact, not only on the private sector, but also on the *ex post* financial position of the government itself. Because the government has no explicit view of how the policies should work, it will not itself recognise what has gone wrong when the policies come to grief.

The government's attitude to strategy

The most disconcerting aspect of the government's view is the admission that the policies may have bad results for some time to come. In the government's terms this is a 'break-through of realism'. Other policies, it contends, although superficially attractive and possibly less damaging in the short term, cannot work in the long run. In his Budget speech, the Chancellor quoted Mr Callaghan's statement in 1976 that 'we can no longer spend our way out of recession' to deny that there could be any permanent gain from fiscal reflation. He asserted that 'the authorities are no longer in a position to engineer a major reduction in the exchange rate' and that 'even if we could do this, it would create more inflation'. He saw the need to reduce the power of organised labour, but at the same time the government rejects any form of incomes policy to modify pay settlements. The Trade Secretary rejects import restrictions on the grounds that overseas retaliation would leave Britain in a still worse position (BBC Newsweek, 28 March). The government is against aid to industry; companies must learn to restrain costs and improve their competitiveness by themselves.

There is some element of truth in the government's critique of the policies it rejects, all (except import restriction) having been tried by previous governments (including the Heath government, of which Mrs Thatcher, Sir Geoffrey Howe and Sir Keith Joseph were members). Reflation can indeed cause balance-of-payments problems, devaluation is inflationary, incomes policies distort the pay structure and break down, import controls do present a problem of retaliation, and aid to industry can serve simply to fund decline.

But the critique is one-sided. It is also demonstrably true that fiscal reflation has stimulated higher production, devaluation has improved export performance, incomes policies have produced major if temporary reductions in inflation, import restriction does permit a higher level of economic activity in countries with inadequate export earnings, and government aid to industry has kept producers in business, many of them making a large contribution to exports or import substitution.

In any case the enumeration of good and bad effects of each policy instrument, taken in isolation, is an insufficient basis for judging what should be done. The fact that particular measures have gone wrong one by one in the past does not indicate what might be achieved if they were put together within an overall medium-term strategy founded on a realistic assessment of their combined impact.

The present government denies that such a strategy is possible. In its view hopes of economic growth must rest on a fundamental change in attitudes whereby companies will make themselves internationally competitive and workers will decide to

accept whatever wages their employers can then afford. But the government says it cannot make these things happen. Its contribution to economic reconstruction is confined to tax exemptions for small businesses, 'enterprise zones' in a few inner-city areas, and reduced welfare benefits for those who go on strike or become unemployed. It makes no claim that these measures will have much effect on overall growth.

The government's abdication from management of the economy presents acute problems for the private sector. Public expenditure cuts are aggravating the decline of output and productivity; the high exchange rate is destroying the competitiveness of industry; the abandonment of incomes policy has resulted in a rapid acceleration of inflation; the refusal to restrict imports has permitted a sustained rise in import penetration; and the withdrawal of government aid to industry is precipitating more factory closures.

What should be done

In present conditions of acute inflation and recession, it is now imperative that, however great the difficulties, the government should accept responsibility for the short- and medium-term development of the economy by undertaking active policies to prevent further rapid and chaotic decline.

In the latter part of the next chapter we outline proposals for the simultaneous deployment of all the main instruments of policy – fiscal expansion, devaluation, incomes policy, import restriction and aid to industry – in a properly articulated manner, in order to restore economic growth. Provided the policies are co-ordinated, they would diminish inflation by increasing production and augmenting government revenue. They would permit a fast recovery of industry and rising investment as well as a reversal of public expenditure cuts, a lower tax burden and higher real wages.

The greatest economic obstacle to these proposals is the risk of overseas retaliation against import restrictions which form an essential part of the plan. This risk is itself fundamentally a political one. We show in Chapter 2 that legally, under the GATT, Britain has an arguable case. Nor will import restrictions, correctly used, involve exporting unemployment or cause significant economic damage to other countries.

In any case retaliation, if it occurs, is very unlikely to prevent a substantial net benefit to Britain. There is no particular reason why developing countries (most of which have extensive import restrictions of their own and sell very few manufactures to Britain) should retaliate at all against general (as opposed to existing discriminatory) restrictions imposed by Britain. Thus even if European and North American countries did retaliate in a big way, UK exports to those countries would have to be cut by *nearly 50%* before the strategy proposed in the next chapter yielded no net benefit at all, compared with present policies. If retaliation were to reduce total exports of goods and services by 5% (as our projections assume) the net benefit would be enormous.

The correct approach therefore is not to suppose that the dangers of retaliation are so great that nothing should be done, but rather to minimise the risk through a foreign policy which recognises Britain's special economic difficulties and strives by persuasion and negotiation to establish our right to take the appropriate action.