The Economic Background To The November 1995 Budget

Research Paper RP 95/114

21 November 1995

This short Paper describes the current state of the UK economy, presents some short run forecasts and reproduces a tax 'ready reckoner' to allow Members to cost some of the tax adjustments that could form part of the Budget package. Members are also reminded of an accompanying Library Paper, Economic Indicators (95/106) which provides a wider range of purely statistical data on the UK economy.

Timothy Edmonds
Economic Policy & Statistics Section

House of Commons Library

CONTENTS

		Page
I	**Introduction**	5
II	**The current state of the economy**	7
	A. General demand	7
	B. Inflation	9
	C. The labour market	11
	D. The exchange rate & trade	12
	E. Public finances	15
III	**Forecasts for the UK economy**	18
IV	**Budget Ready reckoner**	19

I Introduction

The corresponding Paper written this time last year began with an extract from the then contemporary forecast from the National Institute which featured the optimism which characterised much of the contemporary economic commentary. It noted, for example:

> "the UK economy is now enjoying an exceptionably favourable period of expansion combined with very low inflation. Output growth over the last twelve months has been significantly above trend."[1]

The UK was then experiencing something which has been much sought after but which had eluded more than one Chancellor of the Exchequer an export led, low inflation, boom. This year's assessment is less buoyant and up beat. But, it could also be described as being more normal, typical of an economy that has 'used up' some of the slack created during the recession and which has already taken advantage of big changes in the competitiveness of its exchange rate.

The current forecast from the National Institute notes that:

> "Most of the economic news since our last forecast in May points to an earlier reduction in the rate of economic growth in the UK than we had been expecting at that time. At the aggregate level, GDP growth for the first quarter of the year was revised downwards slightly to 0.7% and growth in the second quarter is estimated to have fallen to 0.6%. Recent business surveys indicate less optimism than was apparent in the earlier part of the year. Other recent figures are indicative of a lack of optimism among households: the weakness of retail sales has continued, house prices have fallen again and the decline in the level of unemployment has abated."[2]

It is fair to say that recent events have served to resolve what had been the major policy debate throughout the earlier part of the year, was the UK economy growing too fast? This debate came to be played out on the stage of the monthly meetings between the Governor of the Bank of England and the Chancellor, where the meeting was popularly described in some sections of the press as a battle of wills over the future direction of interest rates, with the Chancellor resisting calls by the Governor to raise interest rates to fight inflation.

The minutes of these meetings (published sometime after the event) describe how great these

[1]National Institute Economic Review 3/94, p3

[2]National Institute Review 3/95, p9

pressures were in the first part of the year. In both the May and June Minutes, the Governor called for an increase in interest rates of ½ per cent. In May they noted that:

> "The Governor concluded that the Bank's view on all this was quite clear. On the balance of risks he was bound to advise that interest rates be increased by ½ per cent now. If this did not happen, the authorities could be faced very quickly with a loss of credibility and a very difficult market situation."[3]

What emerges quite clearly from reading successive Minutes, is how uncertain both the Bank and the Treasury were about the state of the economy during the Spring. The problems which were reflected upon in the equivalent Paper last year concerning the lack of precise knowledge of the extent of the 'output gap', were faithfully reproduced in this year's discussions. Even the phenomenon of the National Lottery added to the sum of economic confusion.

Interest rates were not raised and, as is well known now, subsequent economic data suggests that the economy has slowed down on its own accord (see above). Doubts remain over whether or not the government will meet all of its policy targets, however, the question central to the debate of six months past has now been resolved.

[3] Monthly Monetary Meeting 5th May 1995, p7

II The Current State of the Economy

A. General Demand Conditions

Total GDP growth for the twelve months to 1995 Q3 is provisionally estimated to be 2.4%[4], just over half of the corresponding figure for last year. Most economists would accept that this slow down was inevitable and that growth of about 2.5% a year was in accordance with the economy's long term growth potential, however, it has been the accumulating evidence of a slow down in the economy which has attracted most of the economic commentary in the press and elsewhere. Furthermore, this is a lower rate of growth than that which formed the basis of the Budget judgement last year[5] and is one of the factors behind the concern for the state of the public finances.

The rate of growth in the index of production has fallen consistently throughout the year. From a peak of nearly 6% in the twelve months up to the second quarter of 1994 and over 4% in the first quarter of 1995, production in the third quarter of 1995 rose by 1.2% over the previous twelve month period. The slow down has been particularly marked in manufacturing and appears to be accelerating. Comparing the third quarter of 1995 with the previous quarter manufacturing output was 0.2 per cent higher with the majority of industries recording small increases in production, but comparing August with September, output fell by 0.6 per cent with decreases occurring in most manufacturing industries. Some sectors of manufacturing have done better than others. In the durable goods industries an increase of 1.7 per cent in output of cars was not enough to offset a decrease of 2.1 per cent in the other durable goods industries. Non-durable goods industries output decreased by 0.6 per cent in the third quarter of 1995 compared to the previous quarter. The decrease was mostly due to the clothing and footwear industries which fell by 4.8 per cent.

One component of the recovery last year which has now worked itself out is the strength of overseas demand for British exports. This demand has now stabilised at a more 'normal' level (see below).

Corporate investment has been sluggish during the year, confounding forecasts of strong, post-recession growth and investment has not picked up to the sort of levels reached at this time in the economic cycle that it reached after most previous recessions. Whether this says something about the nature of the economy now, or whether the moral is simply that each

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[4]CSO Press Release (95) 124 23 Oct 1995

[5]Growth for 1995/96 estimated to be 3%, FSBR table 3A.1

recession is different is difficult to say. Output of the investment goods industries increased by 0.1 per cent in the third quarter of 1995 compared to the previous quarter, but was 0.6 per cent lower than in the same period a year ago. Although the reason for the apparent slowness of investment to pick up is not clear, lack of corporate funds is not a main candidate. Profitability of UK companies is extremely high. According to the CSO:

> "The net rate of return on capital employed by industrial and commercial companies in 1994 was 10.0%, the highest since 1988. This compares with 8.7% in 1993, and was the third successive year to show an increase."[6]

Another economic summary harked back to the mid 1980s too:

> "Aggregate company sector liquidity is currently running at levels last seen during the Lawson boom of 1987-88".[7]

Some of this liquidity has been used in merger and takeover activity, expenditure on acquisitions in the first half of 1995 was some 150% of the *whole* of 1994[8].

Statistics from the personal sector present a confusing picture. On the one hand real disposable income has grown at about the same rate as the economy as a whole, but on the other hand, retail sales remain completely flat, only 0.1% higher in volume terms between October 1994 and 1995. Two suggestions explaining this paradox start at opposite ends of the consumer cycle. The National Institute[9] point out that the fastest growing component of personal income has been:

> "dividends, much of which is held indirectly in pension funds and therefore does not constitute a cash receipt for the typical household. "

UBS Research, however, point out that:

> "Increased spending on the national lottery accounted for about (a quarter) of the rise (in consumers expenditure) in the first quarter. The lottery's introduction has also probably partly displaced spending upon other goods,"

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[6]CSO (95) 136, July 1995

[7]UBS Global Research, UK Economic Forecasts, 4th Q 1995 p 27

[8]Financial Statistics, table 6.1c

[9]National Institute Economic Review 3/95, p 15

B. Inflation

The annual average increase in prices[10] for 1994 was 2.3%, just within the Government's stated aim of keeping inflation within the bottom half of the 1%-4% range. The annual rate almost certainly looks to be higher in 1995. The Treasury's Summer economic forecast suggested that the RPI(X) will increase by 3% in the year to the fourth quarter of 1995. A recent average of forecasts made by independent forecasters is that it might be higher still. However, the Panel of Independent Forecasters, the six wise men, reported in their pre-budget paper that:

> "We all expect inflation to remain within the government's 1-4 per cent target range in the short term. All of us think that this can be achieved with interest rates either at or below their current levels and with some modest tax cuts."

Clearly the Panel view the slow down in the economy as providing the Chancellor with some justifiable room for relaxation of either his fiscal or monetary stances should he wish to do so. A less relaxed view appeared in the Bank of England's latest Inflation Report.

It drew particular attention to the following economic data:

- The money supply figures showed growth in excess of the target range for M0 and at the top of the growth range for M4;
- sterling's effective exchange rate rose by 1.1% in the three months to November, but expectations of future interest rates have declined;
- real GDP growth is below trend growth;
- underlying average earnings growth fell between May and August; and although employment increased in the summer some signs suggest that total labour demand did not actually increase.

From this mixed bag of news the Bank comment that:

> "In the long run, inflation is determined by monetary growth, but in the short term the state of the business cycle is also important. When output is below its long run potential path, and unemployment is above its natural rate, there is a downward pressure on inflation relative to its expected rate. A rise in inflation expectations puts upward pressure on wage settlements and prices. If it were accommodated by monetary policy, actual inflation would also rise. So along a spectrum of shorter to longer run influences on inflation, the key

[10] Based upon the RPI excluding mortgage interest payments (RPI(x))

issues for the outlook are:

- How will the components of demand evolve?

- Will earnings accelerate significantly?

- Is the rapid growth of money and credit a temporary phenomenon, reflecting changes in the relationship between desired holdings of money and nominal income, or is it a signal that nominal demand will accelerate?"[11]

Of these factors the Bank concludes that the first is likely to change little, on the second the risks are on the up-side, ie it is more likely that earnings will rise faster, than that they will remain moderated by unemployment, changing employment patterns etc. Lastly, monetary growth is likely to subside rather than continue expanding at its current rate.

This of course leaves the Bank in a slightly uncomfortable position, having called, unsuccessfully for higher interest rates earlier on in the year, it now finds that on its own evidence it was probably wrong to do so. On balance the risks:

> "are more evenly distributed around the central projection than earlier in the year. Consequently, although not the most likely outcome, there is now a somewhat greater chance that inflation will be below 2½% [the Government's target] in two years' time"[12]

This change in assessment was justified thus:

> "Earlier the main risk to the inflation outlook was that second round effects of higher import prices would push up inflation. So far there has been only limited signs of that."

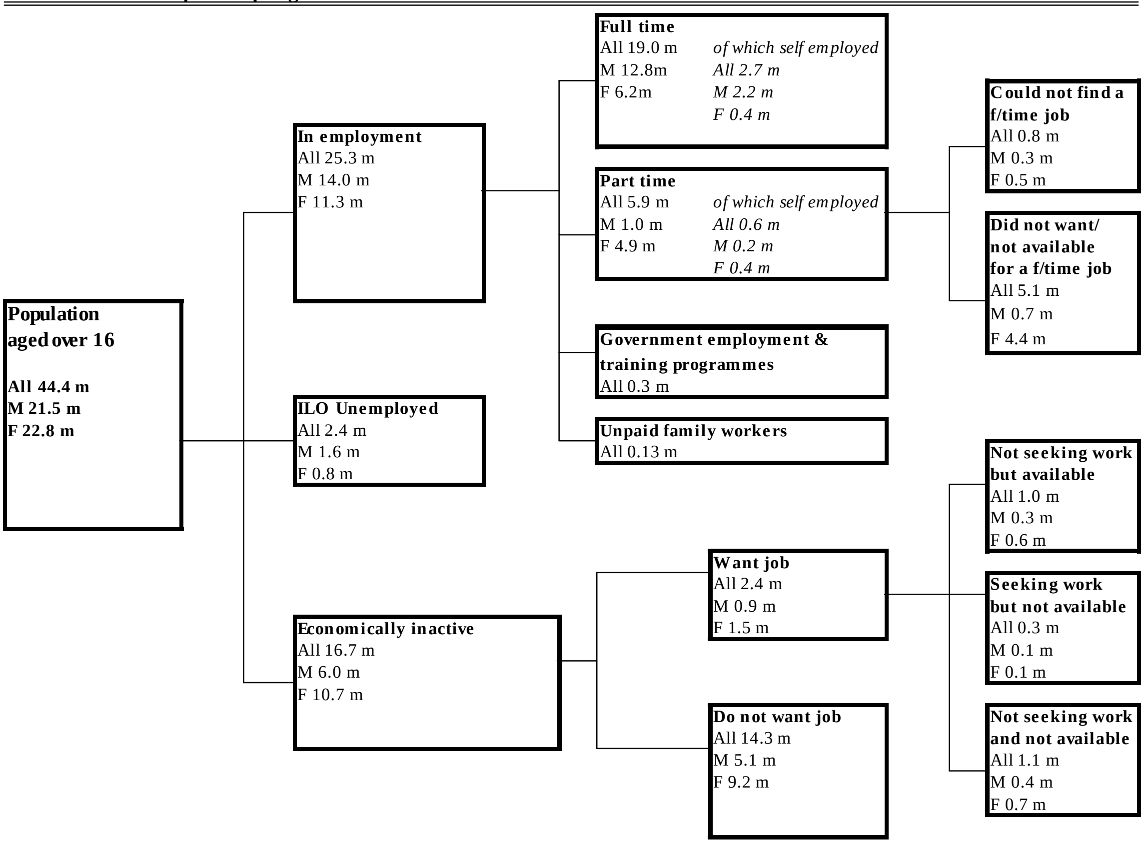
[11] op cit p 43

[12] op cit p 46

C. The Labour Market

The plan below illustrates the dispersion of the labour force in Great Britain in the Spring of 1995. Each box represents the most important destinations of key groups and, in some cases, their reason for being there.

Labour Market 'Snapshot' Spring 1995



Source: Labour Force Survey Spring 1995, Employment Gazette October 1995

The LFS is a quarterly survey which covers approximately 60,000 households in the UK, comprising about 150,000 people. The survey poses a series of questions about respondents' personal circumstances and labour market activity. The results are then grossed up and weighted so as to be representative of the country as a whole. The ILO (International Labour Organisation) measurement of unemployment is different from that commonly used in the UK where the claimant count is recorded. The ILO measurement of unemployment covers people without a job who are available to start work within the next two weeks and had either looked for work in the four weeks prior to the interview or were waiting to start a job that they had already obtained. The economically inactive are people who are neither in employment nor unemployed on the ILO definition, many might, for example, be looking after children or other family members. All data is unadjusted for seasonal variations.

The table is interesting since it gives an overview of what people are doing in the workforce. Some stereotypes are reinforced by the figures. Male full time employment remains the most popular category, female employment is split nearly equally between full and part time employment, but, contrary to some expectations, most people who work part time do so from choice rather than from necessity. Of 5.9 million part timers only 800,000 did so because of the perceived absence of a full time job.

The most encouraging feature of the labour market over the last year has been the continuing fall in the number of people counted as being unemployed. The number of unemployed claimants at the time of the last budget was, seasonally adjusted, 2,470,300 (8.8% of the workforce). The latest figures, for October 1995, show the number of unemployed as being 2,265,500 (8.1% of the workforce). This represents a decline of about 25,000 per month over the last year's worth of figures, a decline which virtually ground to a halt in May, June and July, but which seems to have regained some of its former momentum despite the tiny increase seen this month.

In this section of last year's Paper some attention was paid to the 'disappearing workforce', wherein it was noted that falls in the number of unemployed happened simultaneously with falls in the number of people employed and some reasons were put forward that might explain this, for example the reclassification of people as being long term sick or disabled instead of unemployed. There is less of a conundrum this year: while unemployment has fallen by 329,700 between June 1994 and June 1995, employment has risen by 251,000. It is normal to expect the number of people to be taken off of the unemployment register to be less than the number of new jobs being created, since new employment opportunities encourage some individuals, currently categorised as being 'inactive, to rejoin the workforce.

D. The Exchange Rate & Trade

The graph on the following page tracks sterling's movements against both the US dollar and the deutschmark in 1994 and 1995 to date. Generally speaking it continues to be the case that when sterling strengthens against the dollar it weakens against European currencies. The net effect of this is has been to maintain a broadly stable trade weighted index. Thus the economy this year has not been the recipient of a substantial, export-led demand boost from overseas markets. The conditions which generated such activity last year, a falling exchange rate in 1993 and recovery from economic recession on the continent have declined as a potent force for UK growth this year.

The balance of payments statistics are notoriously prone to revision and fluctuate wildly between periods. Recent quarterly figures illustrate this. In the third quarter of 1994 there was a small surplus on the current account of £446 million. By the second quarter of 1995 this had turned into a deficit of £2.4 billion, the highest deficit recorded since the fourth quarter 1993.

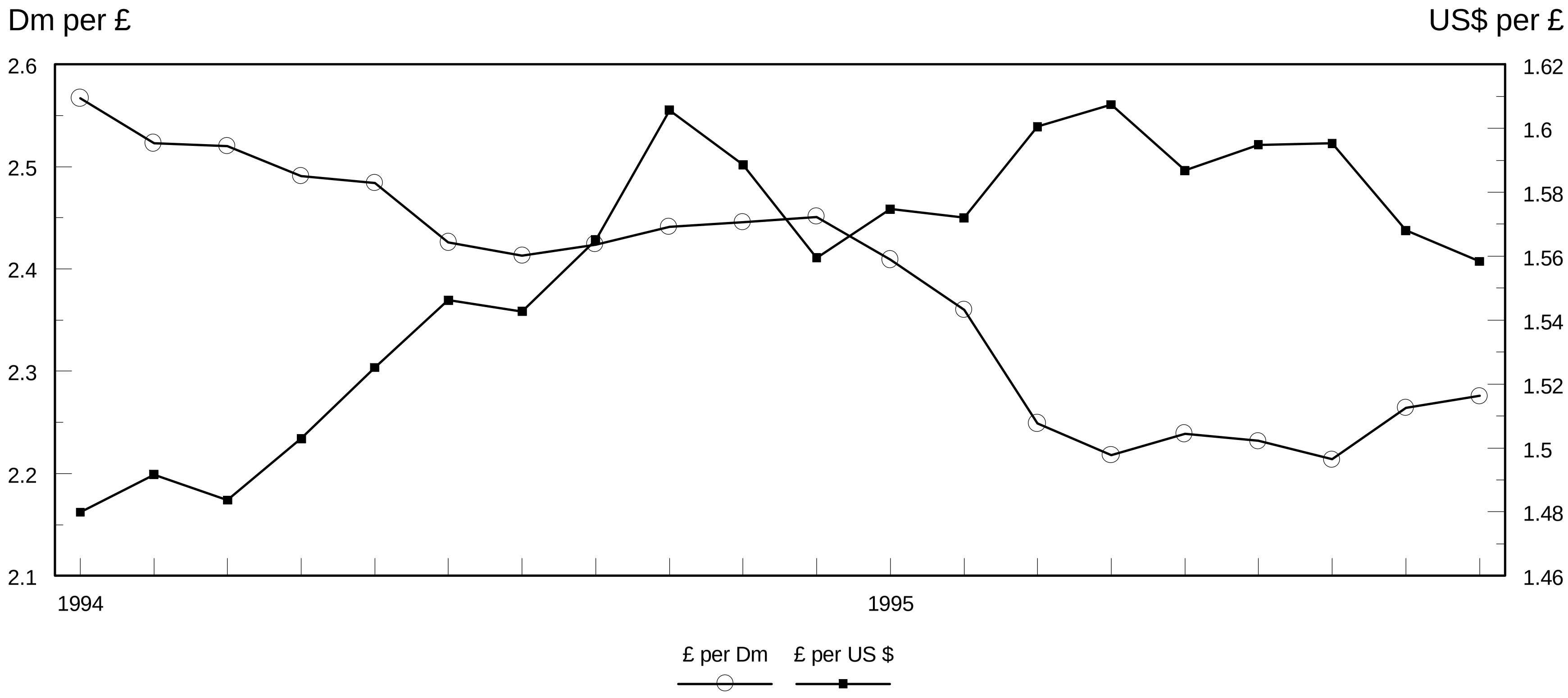
A large part of the worsening of the current account has come about due to a decline in net investment income from abroad rather than from a poor performance in the traded goods sector. The Panel of Independent Forecasters has mixed views on why the current account has worsened. Some members pointed to the weak export performance and attributed it to capacity constraints and a failure of British manufacturers to invest sufficiently, whereas others pointed out that UK manufacturers have used the declining exchange rate to raise their sterling price of exports. This has had the effect of raising UK profits but has effectively limited growth in market shares.

Estimates for the current account in 1995 vary. The Treasury in its Summer assessment forecast a deficit of £2 billion in 1995 and £1 billion in 1996. The Panel's verdict was less optimistic with a range of deficits of between £8.9 and £2.9 billion for 1995 and a £9.4 billion deficit and a £1.5 billion surplus in 1996.

Sterling Exchange Rate

US Dollar & Deutschmark exchange rate

Jan 1994 - September 1995



Monthly average rates

E. Public Finances

For both economic and political reasons it has been the state of the public finances which has garnered the greatest volume of comment in the lead up to the budget. It is easy to understand why. The government is committed to reducing the PSBR as a percentage of GDP over the course of the economic cycle. A general election is no more than eighteen months away and it would be politically helpful to the government to 'find' some room for reductions in taxation and/or growth of expenditure in key areas. As the economy slows down the PSBR increases. According to the IFS[13] every one percentage point fall in the rate of growth means a deterioration of £4 billion in the government's finances, worth perhaps 2p on the basic rate of tax.

The planned movement in public finances as predicted in successive Summer forecasts is shown in the table below:

Public finances (i)

Central government expenditure — **£ billions**

	Summer Economic Forecast	
	1994	1995
1993/94	**278.9**	
1994/95	291.6	**287.1**
1995/96	309.9	301.9
1996/97		310.9

Public finances (ii)

Central government receipts — **£ billions**

	Summer Economic Forecast	
	1994	1995
1993/94	**232.3**	
1994/95	254.3	**249.4**
1995/96	280.7	276.4
1996/97		293.4

Public finances (iii)

PSBR — **£ billions**

	Summer Economic Forecast	
	1994	1995
1993/94	**46.0**	
1994/95	36.1	**35.3**
1995/96	27.9	23.6
1996/97		16.1

Source: Summer Economic Forecasts, table 2.1

[13]Quoted in the Economist 30 September 1995, p 27

These tables present a picture of public finance seemingly under control, slight shortfalls in planned revenue being more than met by under spending by government departments. The latest available figures, however, suggest that the outturn will be less in agreement with the forecast. In the 1995/96 financial year, the PSBR up to September has reached £20.4 billion against a forecast of £23.6 billion for the entire year. For the sake of comparison, the 1994/95 PSBR total at the same point in the year was £20.1 billion (subsequently to rise to £35.9 billion). Clearly the balance of risk lies on the side of a serious overshoot of the target. Other factors too appear to be working against further substantial cuts in the PSBR. To begin with, the substantial increase in taxation over the last two years as a result of phased in tax changes will now start to work their way out of the economy and the growth in receipts is expected to slow. Indeed the Treasury have found it hard to explain why current receipts have not been higher still given the level of economic activity: spending on the national lottery (not-Vatable) is cited as a possible culprit in this respect. On the other side of the equation the current forecasts are based upon the assumption that the government's targeted measure of expenditure[14] is forecast to grow in real terms by only ¾% and zero per cent in 1995/96 and 1996/97. This is a much harder base from which to look for cuts than if expenditure was already growing strongly in real terms.

Much of the pre budget press comment has assumed that the Chancellor will make tax cuts of anything between £3 billion and £6 billion[15]. Various commentators have looked at the budget arithmetic, none seem to have any particularly unique insights, but vary more in their expectation of how far the Chancellor will go or will be forced to go.

One candidate for 'finding money' is the contingency reserve. This sum, is designed to cover unexpected, future expenditures, civil emergencies, wars etc. The reserve is normally fixed for the three years to come on an increasing basis, on the grounds that the unexpected is more quantifiable next year than it is three years hence. This annual reduction in the reserve in the past has been used to cover departmental overruns, however, if the Chancellor could say that the reserve can be prudently reduced, above and beyond what it is normally reduced by, suddenly that amount of money becomes available for a public spending 'cut'. When this procedure has been used before, it was justified on the grounds that inflation had been lower than forecast (an identical justification was given for some of the other reductions in departmental budgets). Clearly this line of argument cannot be sustained this time, and instead, the Chancellor may need to rely upon a more 'structural' justification, emphasising

[14]Defined in the 1995 Summer Economic Forecast as being "the government's objective for public spending is now expressed in terms of GGE(X)-general government expenditure excluding privatisation proceeds and lottery financed spending, and net of interest and dividend receipts"

[15]This is a convenient assumption since without it there would be no story, however, the possibility that big tax cuts will not feature has to be considered. Norman Lamont in his 1992 pre-election Budget made fairly modest tax changes, 'giving away' less than £1.5 billion with expensive items such as the introduction of a lower rate band of 20%, partly offset by a range of increases in indirect taxation.

previous Departmental successes in not overspending. Roger Bootle writing in the HSBC Greenwell Budget Paper comments that:

> "It is even possible that the Chancellor could be much more radical, by abolishing the Reserve altogether, on the grounds that public spending is now under control. This would be a real gamble, but the money thus raised could fund a spectacular 3p cut in the basic rate of tax next year with the promise of a further 2p off next year."

An alternative way to ease the stringency upon spending targets would be to revise the targets. Currently the government's aim is to restore budget balance by the end of the decade. It would be possible to argue that a more realistic aim would be to concentrate on meeting the Maastricht 3% criteria. This would automatically enable future projections of expenditure and receipts to be cast in a more generous light.

A highly detailed account of what the Chancellor is meant to have decided appeared in the Daily Telegraph[16]. It stressed the likelihood of big cuts in the government's capital spending programme. The level of capital expenditure by general government (local and central) is estimated to be £15.2 billion in 1995/96 and then rise slightly thereafter. Of this total the largest individual items are roads (about £3.5 billion) and housing (£3.2 billion): clear candidates for reductions.

A detailed list of likely spending cuts in addition to figures for housing and roads included:

- a 5% cut in Departmental running costs
- freeze on public sector pay
- reduction in capital spending to be met by extended use of private finance initiative alternatives
- £1 billion reduction in social security payments through measures to combat fraud and tougher rules on housing benefit.

The article speculates on the use to which these savings, which the Telegraph estimate as being £6.5 billion, might be put. Their estimate is for a mix of policies focusing on the personal sector with a cut in the basic rate of tax of 1p and above inflation increases in the value of tax allowances for individuals, married couples and for the lower rate threshold.

[16] November 10th 1995

III Forecasts For The UK Economy

Ever since the start of the policy of more openness and transparency in economic policy making instituted by the then Chancellor, Mr Lamont, the Treasury has published a synopsis of the forecasts made by over thirty outside organisations. The latest forecasts are shown below:

Independent Forecasts for 1995

	Averages		November Range	
	November	October	Lowest	Highest
GDP growth (per cent)	2.7	2.8	2.4	3.0
Inflation rate (q4 per cent)				
RPI	3.5	3.5	3.3	4.0
RPI exc mortgage payments	3.2	3.1	2.6	3.7
Unemployment (q4 million)	2.27	2.28	2.20	2.48
BOP current account (£bn)	-5.2	-4.3	-9.0	7.5
PSBR (1995-96 £ bn)	28.6	27.7	25.0	33.3

Independent Forecasts for 1996

	Averages		November Range	
	November	October	Lowest	Highest
GDP growth (per cent)	2.7	2.8	1.4	3.3
Inflation rate (q4 per cent)				
RPI	3.1	3.2	1.4	4.3
RPI exc mortgage payments	3.0	3.1	1.8	4.1
Unemployment (q4 million)	2.12	2.14	1.81	2.55
BOP current account (£bn)	-4.5	-3.7	-13.0	10.8
PSBR (1995-96 £ bn)	22.6	21.7	15.0	30.0

Source: Forecasts For The UK Economy, November 1995 ed

IV Budget Ready Reckoner

The following table provides extracts from a fuller listing of the revenue effect of tax changes as published by the Treasury in its Tax Ready Reckoner, published in July 1995 as updated by written answer 8 November 1995 c904-8.

Direct effect of illustrative changes in direct taxation	£ million cost/yield	
	1996/97	1997/98
Change lower rate by 1p	850	720
Change basic rate by 1p	1,600	2,000
Change higher rate by 1p	240	560
Change personal allowance by £100	430	640
Change all personal allowances by 1%	180	260
Change all personal allowances by 10%	1,750	2,550
Increase lower rate band by 10 per cent	240	350

Direct effects of illustrative changes in indirect taxation

	Price change	% change in duty	£ million cost/yield		
			1995/96	1996/97	1997/98
Beer & cider (pint)	1p	3.5	15	105	110
Wine (75 cl bottle)	5p	4.0	5	30	35
Spirits (70 cl bottle)	25p	3.7	5	25	25
Tobacco (20 king size)	5p	2.8	40	180	190
Petrol (litre)	1p	2.6	75	310	340
Derv (litre)	1p	2.7	40	150	170
VED (public)	£5.00	3.7	50	150	150
Air passenger duty	50p/£1	10.0	10	35	35

Estimated costs of principal tax expenditures and structural reliefs 1995/96	**£ million**
Income tax relief for:	
Occupational pension schemes*	7,500
Contributions to personal pensions*	2,000
Mortgage interest	3,800
Profit related pay*	800
Exemption of:	
First £30,000 of payments on termination of employment*	1,500
Income of charities	725
Value added tax zero rating[a]	
Food	7,550
Construction of new dwellings	1,800
Books, newspapers & magazines	1,200
Children's clothing	750
Lower rate on domestic fuel & power	1,500

Note (a) As compared to full rate 17.5% VAT

Expenditures or reliefs marked* are particularly tentative and subject to a wide margin of error.

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