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TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
Confidential Annex to CM(73)	
60th Conclusions (extract)	12.12.73
CP(73) 139	12.12.73
Confidential Annex to CM(73)	
61st Conclusions, Minute 6	13.12.73
CM(73) 62nd Conclusions "Economic Situation"	17.12.73

The documents listed above, which were enclosed on this file, have been removed and destroyed. Such documents are the responsibility of the Cabinet Office. When released they are available in the appropriate CAB (CABINET OFFICE) CLASSES

Signed Wayland
J R Green
Prime Minister's Office Records
Hepburn House, Marsham Street

Date 17 Dec 2002

PP

Published Papers

The following published paper(s) enclosed on this file have been removed and destroyed. Copies may be found elsewhere in the Public Record Office.

HOUSE OF COMMONS HANSARD,

17 DEC 1973, COLUMNS 952-980

"ECONOMIC SITUATION"

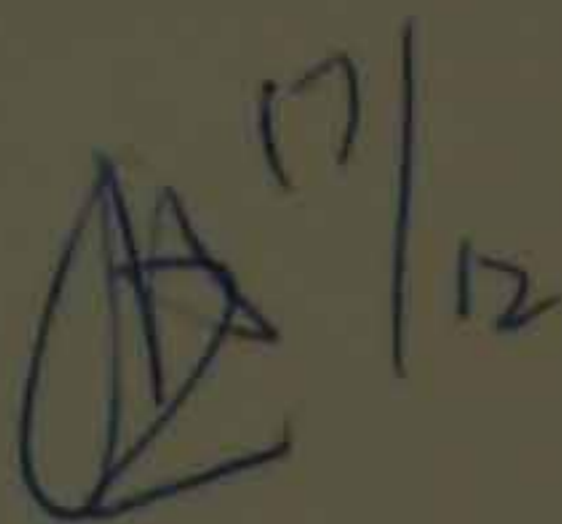
Signed

CAWayland

Date

17 Dec 2002

pp. J R Green
Prime Minister's Office Records
Hepburn House, Marsham Street

17/12


Secretary of State

The option to have a wife's income charged for tax separately from her husband's dated from the beginning of 1972-73. So the surcharge will be levied separately, where a husband and wife exercised that option.

RIA

17. xii

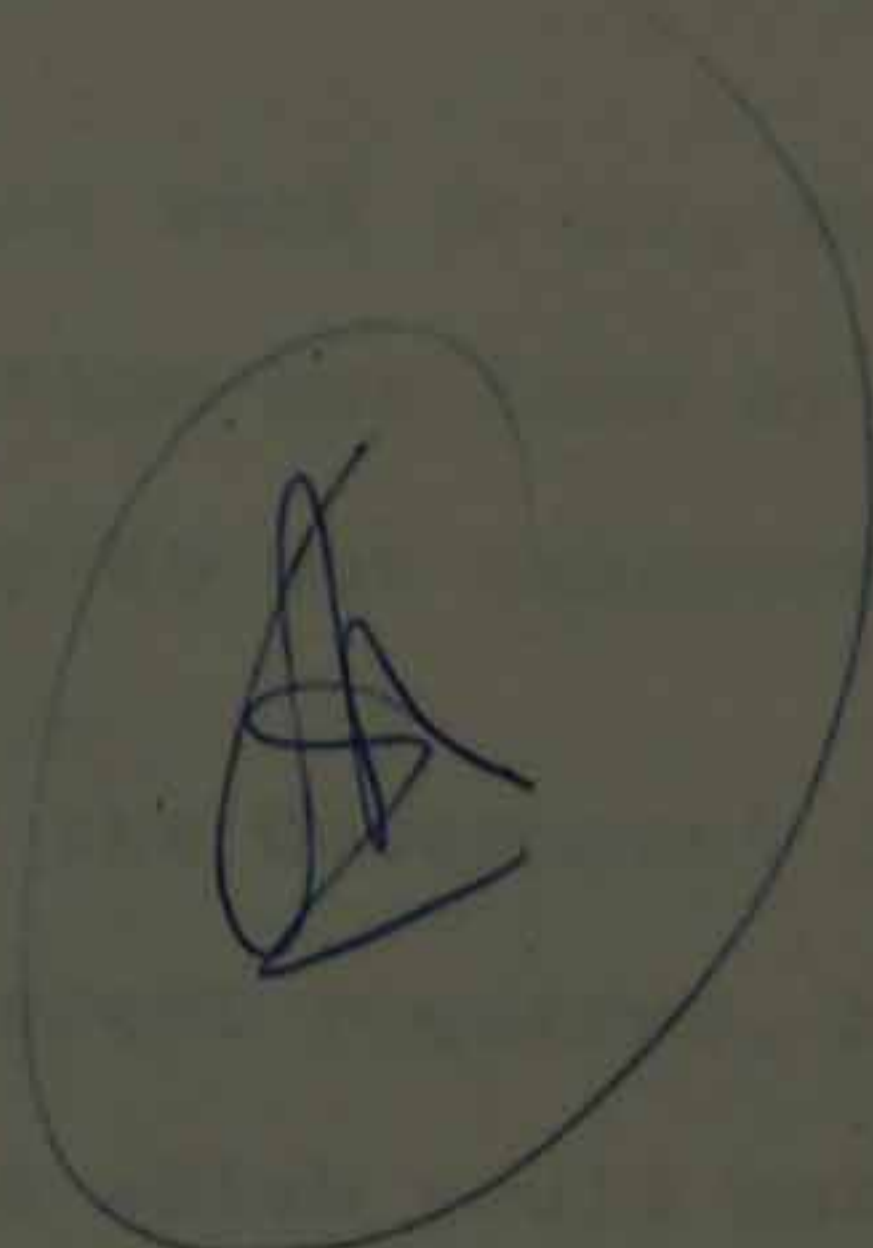
Mr. R.T. Armstrong



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CHIEF SECRETARY



- cc: PS/Paymaster General
- PS/Financial Secretary
- PS/Minister of State
- Sir Douglas Allen
- Sir Kenneth Berrill
- Sir Douglas Henley
- Mr. Mitchell
- Mr. Wass
- Mr. F. Jones
- Mr. Middleton
- Mr. Sewill

Mr. Dalton (I.R.)

DRAFT STATEMENT

I attach Parts I, II and III of the draft statement in the form in which the Chancellor revised them on Saturday. He would be grateful if you and the other recipients of this minute would consider these sections urgently, and let me have written amendments by 11.30 a.m.

Two further sections of the statement will be circulated for comments as soon as possible, and the Chancellor will wish to discuss the whole statement later in the day.

(C.W. FRANCE)
15th December 1973

Econ Pol

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*Discussed
with
9pm
16 Dec 73*

REVISED DRAFT STATEMENT OF CHANCELLOR OF THE EXCHEQUER

FOR MONDAY 17TH DECEMBER 1973

PART I

Over the past week or so, many have described the situation which we as a nation now face as by far the gravest since the end of the war. They do not exaggerate.

The duty of the Government is to take whatever action the national interest requires, however severe, but equally to avoid measures which could make an already forbidding situation even worse.

Before I come to the measures which are immediately necessary, I must describe to the House the economic outlook against which the decisions have been taken.

During the past two months, a series of deliberate acts have been taken, both abroad and at home, which are at present starving this country of energy. The first act, and the one over which this country has the least control, was the decision of the oil-producing and exporting states on [17th] October to bring about by unilateral action an entirely new price regime for oil. As I have already made clear on a number of occasions, this change alone must inevitably make all oil-importing countries worse off than they would otherwise be, though, for reasons I shall explain, this change in the price of oil, without any other developments, would not in itself have frustrated a policy of economic expansion.

/But the subsequent

But the subsequent decision of the ^{Some} [Arab ?] [Middle East] oil producers, on ~~, (in large part for political reasons,)~~ to reduce the supply of oil to the rest of the world to a level which is well below present requirements has created an entirely new situation.

Although the supply situation in 1974 is unpredictable, it is now only too probable that there will be an energy shortage in all the oil-importing countries leading to stagnant, if not falling, output accompanied by rising unemployment. In all these countries output is expected to fall faster than incomes, with consequent increases in demand pressures for goods and services. We will share those problems.

But in the case of our own country, these problems have been compounded by another factor, specific to the United Kingdom - the industrial action in the coal and electricity industries, and on the railway. This, at a critical time when we are expecting inadequate oil supplies, has cut down the availability of the primary alternative fuel, has diminished our ability to get available oil and coal to the right places for consumption, and has also made it more difficult when electricity supplies diminish to ensure that essential services are not threatened.

At this immediate point of time, by far the greatest issue facing the nation is the fact that it is this industrial action, not the future shortage of oil, which has put British industry on to a three-day week and threatened the security of employment of so many of our people.

As far as the industrial situation is concerned, I must repeat what I have said before. In the general interest, it is inconceivable that any Government could agree to a dispute being settled by an offer outside the limits approved by Parliament.

Because this is the case, and because many millions of people are now beginning to suffer not just inconvenience and worry, but hardship and indeed danger, I cannot believe that the sound common sense of the British people will not prevail.

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In the UK just over half our energy is, at present, provided by imported oil, a rather lower proportion than most other industrial countries. It follows that, but for the immediate industrial disruption, we are better placed than most of our overseas competitors such as Japan or Germany. Furthermore, in the years to come our situation will be fundamentally improved by the increasing output of alternatives to imported oil - more nuclear power, more coal, more North Sea gas and, above all, by North Sea oil. But this cannot affect 1974, and it is the economic policy for the British economy in 1974, with our 50% dependence on imported oil, which we have to consider.

With all the uncertainties of the Middle East situation, it is impossible to predict, for the 12 months ahead, either the price (of) the UK will have to pay for imported oil or the amount which will be made available to us. But it is already inevitable that the price will be very much higher than in the first nine months of this year and that the supplies will be less than we need. The unanswerable questions are "how much higher" and "How much less than we need".

The extra cost of oil to our balance of payments is a severe blow. Our balance of payments was in considerable deficit before this oil situation developed, although there was then reason to believe that, as the effective depreciation of sterling worked through into the balance of payments,

/the deficit

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the deficit would begin to improve next year. A deficit was expected and has been financed in large degree by deliberately-planned foreign borrowing. But international borrowing will now take on an entirely new dimension for the world as a whole. From some of the ^{tasks} I have had, there is emerging, I believe, a general consensus that the industrial nations, as a group, must expect, to some extent, to borrow back the money to pay for this increase rather than to join in a self-defeating deflationary or protectionist race to counteract the effect of the rise in the price of oil on the current balance of each individual country. But in our case, given our substantial deficit without the oil problem some corrective action now needs to be undertaken to keep the prospective total deficit within acceptable limits.

But the problems created by the rise in the price of oil coming on top of the rise in world prices of other commodities - severe as they are - are overshadowed by the uncertainties about the volume of oil which we will receive.

It has to be remembered that the levels of supply to which the Arab producers refer are those of the first 9 months of 1973. But on our original forecast of the growth of the economy, our oil needs in late 1974 would have been some [5%] greater than this reference level.

/We must

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We must now accept that output in 1974 is likely to be significantly below the levels for which we were hoping, although no worthwhile estimate of GDP can be made until it ^{is} possible to forecast energy supplies. The present troubles affecting coal, transport and electricity are bound to reduce output in the early weeks of the year. As for oil, the best estimates are that a 10% shortfall is the most that can be coped with without loss of output. If, in 1974, oil deliveries were more than 5% below those in the reference period in 1973, this would amount to a shortfall of more than 10% compared with our needs. If over the year as a whole, the oil cut were to turn out to be 15% there would be a fall in GDP rather than the 3½% growth which we had in prospect.

In this situation two points must be stressed. First, we do not know, and we cannot at this stage know, what energy supplies will be available throughout 1974. More than in any other period, therefore, it is essential to be prepared to act again as circumstances change or clarify. The second important point to stress is that oil shortage on the scale which seems possible could mean that, while the shortage lasts, we might have to accept the living standards of a year ago rather than the improvements which we could have expected in the year ahead. To recognise that is to do no more than to face up to the realities of the situation.

/Some cut

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Some cut back in personal consumption will result automatically through short-time working and temporary unemployment. But the fall in output will be greater than the fall in expenditure, because those who are unemployed will spend their social security benefits, and many consumers will reduce their rate of earnings. If nothing is done there will be pressure of excess demand which will draw down stocks and hold back exports.

In this situation it is necessary in my judgment, for the Government to take steps now to reduce demand by £1200 million in the coming year. This is the best estimate that can be made at this time, but the uncertainties are unprecedented and I will not hesitate to take further action at any time if developments should require it.

/PART II - LAND

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PART II - LAND

Before I come to the measures necessary to achieve this, there is one particular matter which can conveniently be dealt with at this stage - transactions in land and buildings.

I have in the past explained why I do not think that a straight increase in the rate of Capital Gains Tax on land transactions is the answer. Unlike income tax, Capital Gains Tax is charged at a flat rate, and I do not believe that it is the wish of anyone, who reflects on this problem, to increase that rate in the case of comparatively small transactions of the ordinary kind. The sort of large windfall profits which I have previously described in this House as "offensive", fall into a different category.

The criticism is valid, notwithstanding that, as I explained in my Budget Statement last March, profits from speculation in land are already fully taxed as income, so that for individuals the rate can be as high as 75% or in some cases even 90%; and that, in the case of company profits which are distributed, the combination of corporation tax and income tax can together amount to nearly 93% of the underlying profits.

Where land is held as an investment, however, gains on disposal are taxed as capital gains at a rate of 30%. But, as I said in the Budget, it has to be recognised that any increase of taxation on land disposals could lead either to people withholding from the market land which would otherwise have been made available, or to an increase in land prices, or both.

/What has

What has to be weighed, therefore, is the risk that higher taxation would have this effect against the widely-held public view that the taxation of certain land profits is seriously inadequate.

I have come to the conclusion that this is a risk which must be accepted, and I have accordingly decided that new measures are called for.

For the reasons I have given, I am sure that it would be wrong to raise the general 30% rate of Capital Gains Tax. This is a long term tax and, when this rate was fixed in 1965, the then Government justified the fact that it was lower than the rates of income tax by acknowledging that there was no allowance for the effect of inflation. That is still the case today. What is required is something which recognises the particular nature of certain land profits.

What differentiates land from other assets liable to Capital Gains Tax is the fact that with land an owner can quite fortuitously make huge windfall gains simply as a result of decisions made by planning authorities acting on behalf of the community as a whole. It is the huge gains due to this development value - or even to potential development value - which people find offensive. It is this element in the gain on a disposal - the development gain - which should be liable to taxation at a rate higher than 30%.

/This was

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This was of course the concept that underlay the Betterment Levy established by the previous Government's Land Commission Act. But the Act suffered from a number of fundamental defects which were no doubt the main reason why its repeal was unmourned. The truth is that the Betterment Levy was a bad tax and that was why it failed.

It was not graduated according to a taxpayer's ability to pay.

It was charged on individuals when there was no disposal, so that those individuals often had to realise other savings to pay it.

It sometimes imposed a burden on the ordinary owner-occupier and on others who were in no way involved in land development or land speculation.

/And

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And, perhaps most important of all, the Levy fell upon a huge number of totally insignificant transactions which involved a mammoth bureaucracy and a vast interference with thousands of perfectly inoffensive small transactions in land, far removed from the kind of large windfall gains which have been the principal source of disquiet in recent years.

I am sure that there is no wish to return to that kind of impost. Whatever is done must avoid each of those objections to the Betterment Levy.

The House will remember that during the debates on the Land Commission Bill, my rt. hon. Friends argued that the particular problem of development gains, as distinct from normal land transactions, could be dealt with by an extension of the Capital Gains Tax. This is the concept we have been working on with a view to legislation in the next Finance Bill. The change will now be made forthwith.

To avoid the mistakes of the Betterment Levy, the new charge must have three principal features.

First, it must be charged at rates which take account of the vendor's ability to pay.

Second, it should normally be paid only when there is a disposal.

/And third,

And third, the great mass of small land transactions and, of course, all sales by owner occupiers must be excluded. These are not the cases which have given rise to public disquiet.

Legislation will accordingly be included in the 1974 Finance Bill to tax development gains much more severely. The new tax rates will apply to disposals of land or buildings in the UK after today.

Tax at the new rates will be charged on the gain in development value during the vendor's period of ownership. But only gains above a number of closely-defined limits will be subject to the new charge.

Subject to these limits - which I will outline in a moment - gains in development value made by individuals who are liable to income tax will be taxed as income at normal income tax rates up to 75%. Development gains made by companies will be taxed as income at the full corporation tax rate but companies will not be able to set payments of advance corporation tax against the corporation tax payable on these gains. Individuals will be able to claim to spread the gain backwards over 4 income tax years or such lesser period during which the land or buildings have been in their ownership.

As with the existing charge to Capital Gains Tax, the principal private residence or a house occupied by a dependent relative will be exempt.

/The limits

The limits will be as follows.

First, there will be excluded from the new charge all disposals of land and buildings by an individual in any year where the total proceeds do not exceed £10,000. For companies, in order to avoid the dangers of fragmented sales by companies in the same ownership, the threshold will be £1,000.

Second, there will be excluded disposals where the total gain - that is, existing use gain as well as development gain - is less than 20% of the cost. That simple test will enable the Revenue to disregard at a glance many disposals where the development gain must be quite small.

Third, there will be excluded disposals where the disposal proceeds do not exceed the current use value plus 10%. That will take out most cases where there is merely a slight prospect of future development.

/These limits

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These limits are essential to exclude the great mass of small disposals, or disposals with a little development value, which would otherwise clog up the machinery of valuation and collection.

No significant revenue is at stake with these limits. And they will enable the new charge to be operated by the Inland Revenue with relatively few additional staff.

And as I have said, a principal private residence, or a house occupied by a dependent relative, will be exempted from the new charge, just as they are exempted from the Capital Gains Tax.

There will be provisions to extend the charge to disposals of shares in close land-owning companies and to interests in certain trusts, which means that it will be of no advantage to an individual to hold his land interests through a private company.

I turn next to another, and even more difficult, area in this general context of the taxation of land and buildings - the case where a property investment company has unrealised gains accrued over many years on which, because there are no disposals, any capital gains tax is postponed indefinitely. This was, of course, inherent in the Capital Gains Tax as introduced by the then Government in 1965. An example will illustrate the point. A development company acquires land

/ at its current

at its current use value. It subsequently gets planning permission, builds, and lets the building without any premium. Under the law as it stands, the letting in these circumstances is not a disposal for the purposes of Capital Gains Tax.

This general problem also we have been considering, and I have come to the conclusion that it is wrong to allow liability to be postponed in these circumstances because, as a matter of common sense, to let the premises is in fact one way of disposing of them.

The 1974 Finance Bill will therefore provide that where material development of land or buildings in the United Kingdom, other than residential development, has been carried out by an owner and the property is subsequently let for the first time, this first letting will be treated as a disposal for all purposes of the Capital Gains Tax including where appropriate the charge on the development gain. The charge will apply to all such first time lettings after today.

Here again, it is necessary to have a limit below which this new occasion of charge will not operate. It would be wrong for the Revenue to be concerned with the great mass of small commercial lettings that may be made of new buildings up and down the country - for instance, where a shop with a store at the back is built and the store is let to a tenant. Only, therefore, where the proceeds of lettings

/ are equivalent to

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are equivalent to a rack rent of £2,500 or more a year will a disposal be treated as having taken place for Capital Gains Tax.

Finally, on this part of my statement, I should make it clear that any capital gains from the disposal of land which are not subject to the new charge or to the new rule about first lettings - for instance gains below the thresholds and so on - will all remain subject to the normal tax charge on capital gains.

Because of the importance of these changes which I have inevitably had to explain [them] at some length, the Inland Revenue is publishing a fuller statement setting out more of the details which will be contained in the legislation.

It is obviously very difficult to estimate the yield of proposals of this sort, but the best estimate that can be made is that their total yield will amount to some £80 million in a full year.

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PART IIICONSUMER CREDIT, COMPETITION AND CREDIT CONTROL,
INDIRECT TAXATION, ENERGY PRICES

I return now to the action which is necessary to reduce home demand in order to leave sufficient of our reduced resources available for export and for productive investment in the private sector.

First, consumer credit. Despite the inherent disadvantages in normal circumstances, I am sure that it is right, in the present exceptional situation, to reduce demand arising from personal consumption by reimposing controls on hire-purchase, credit sale, and hiring agreements. My rt. hon. Friend, the Secretary of State for Trade and Industry has accordingly made the necessary Order. These controls will cover a wide range of consumer items and will take effect from midnight tonight. The details of the terms and coverage are being announced separately by the Department for Trade and Industry.

The banks and finance houses are being asked not to lend to persons or to offer check trading facilities on terms more favourable than those permitted under the Hire Purchase controls. At my request steps are also being taken to ensure that the provision of credit through credit cards is similarly restrained.

With my agreement, the Governor is also taking steps to strengthen the techniques for controlling the growth of money

/ and credit.

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and credit. The clearing banks have been asked to make certain changes in their practices designed both to limit arbitrage transactions and to secure a better control over the growth of their lending. The Governor is also requesting all banks and deposit-taking finance houses to adhere to a new technique under which non-interest-bearing special deposits would be placed with the Bank of England if their interest-bearing liabilities grow at more than a specified rate.

With the introduction of this new device, and in view of the pressures on banks' liquidity which may arise in the period ahead, the call for the second 1 per cent of special deposits announced on 13th November is no longer required. The intention of these monetary control changes is not to impose an additional squeeze outside the field of consumer credit: it is to ensure that we have effective control over money and credit during the difficult period which lies ahead. [Interest Rates?]

Under the legislative provisions governing VAT, and by means of the more traditional regulator which covers the revenue duties, the taxation of goods and services can be raised without the need for a Finance Bill. The effectiveness of action on indirect taxation is well established, by its frequent use in the past.

/Its disadvantage is,

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Its disadvantage is, of course, that any increase in the taxation of goods and services makes a direct contribution to raising prices, but this is a disadvantage which, depending on the circumstances, previous Governments have accepted. The conclusion which I have reached, is that the necessary restraint on domestic demand should be achieved in other ways and therefore, there will be no increase in indirect taxation at this time.

There is one area of prices which I should particularly mention. At a time of the most acute energy shortage and in our present financial difficulties, it is that we are subsidising coal and electricity prices at a mounting rate. Unless action is taken on coal prices, the financial support required for coal, which exceeds £150 million this financial year, could easily be doubled next year. The subsidy for electricity is running at about £75 million a year, but this does not take account of the cost of the present emergency. Consultations with the industries on the price of coal and electricity will therefore be carried out as a matter of urgency. Arrangements will be made to safeguard the neediest households.

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PART IV - DIRECT TAXATION

I come now to the taxation of income, where there will be one change.

There is here a dilemma which has to be squarely faced. Any increase in the basic rate of income tax is bound to hit millions of ordinary people who, through absolutely no fault of their own, but entirely as a consequence of the deliberate actions of others, abroad and at home, will soon find themselves with thinner pay packets as a result of the three-day working week. So, with one exception, I do not intend at this time to increase the direct taxation of incomes.

Rehearsal

Those on higher incomes will in general obviously be better able to cope with the situation we face. I have decided that in respect of the last year of surtax, 1972/73, there will therefore be a 10% surcharge on total surtax bills. This surcharge will be payable half on 1st July 1974 and half on 1st January 1975.

The surcharge will not apply to anyone over 65 on 5th April 1974. The yield will be £35 million.

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PART V - PUBLIC EXPENDITURE

With the fall in output resulting from the shortage of energy, there will be some automatic fall in private demand as incomes fall due to short time working and temporary unemployment. But without a deliberate act of government, there would be no such fall in demand by the public sector. It would be quite wrong for the public sector to continue unabated its demands for goods and services and its consumption of energy, leaving the private sector to bear the whole of the brunt of the energy shortage.

Despite the small rise in public expenditure which was planned for each of the next three years, I am sure that it is right that the main weight of the action I am taking should lie, not on persons or private sector industry, but on public expenditure.

To do this will release resources for personal consumption, for exports and for private industrial investment.

It is important to be clear about the purpose of reducing public expenditure in a situation of energy shortage. Shortage of energy and constraint on economic growth is bound to lead to a rise in unemployment. That cannot be

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avoided. It is inherent in the situation. But the direction of the cuts in public expenditure must be such as to avoid, as far as is humanly possible, a reduction in employment in the public sector being added to the inevitable unemployment created by the energy shortage in the private sector. It is energy that action in the public sector has to release, not men. There would be no point, in the wholly unique situation we face, in saving public expenditure by deliberately reducing the numbers of public servants. The particular reductions in public expenditure must therefore be directed, not just as elsewhere, to cutting the demand for energy in the form of heating of buildings, use of cars and lorries, and so on, but also, and of far greater significance, to cutting the indirect demand for energy by reducing public construction programmes and public purchases of supplies of all kinds.

The Government has therefore decided that public expenditure on building and construction, on plant and equipment, and on supplies of all kinds will be reduced, and, subject only to a very few exceptions, the reductions will apply in respect of all programmes which use resources in this way.

There will be no reduction in investment in the energy industries themselves, or in public sector house building.

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The Ministers concerned are accordingly making arrangements for a reduction of one-fifth in the total of their capital and equipment programmes, and of one tenth in the total of their procurement of supplies and other current expenditure on goods and services excluding staff costs. Somewhat lower reductions will apply only where essential supplies, for example for the health service, would otherwise be jeopardised.

In implementing this decision, the Ministers concerned will determine the priorities within their own programmes. For instance, the Ministers concerned will also make every effort to avoid adding to unemployment in cases where work could otherwise proceed because supplies of materials are adequate. Cases of special difficulty will be considered with the Treasury, but the renegotiation of contracts in certain cases cannot be excluded if we are to make sure that work which is of a lower priority does not pre-empt resources needed elsewhere, for instance to maintain exports or important household needs.

These decisions on public expenditure will entail a reduction in the total of the current expenditure which was accepted by the local authorities in England and Wales in the recent rate support grant discussions, and a reduction in the amount of grant previously envisaged for 1974/75. Corresponding arrangements will be made in Scotland.

/ The usual detailed

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The usual detailed annual White Paper on Public Expenditure which was due to be published this week, was prepared before the developments which have caused this statement. Although ^{it does not take account of my present} ~~it is therefore now out of date in~~ ^{state} ~~many respects~~, it will still be published as a baseline for the reductions which I have announced.

The reductions in 1974/75 will total some £1,200 million. A table will be circulated in Hansard setting out the reductions in the various programmes and the effect on the totals of public expenditure which had previously been planned for next year. Copies will be available in the Vote Office.

This is by far the largest reduction in public expenditure for the coming year which has ever been made, both in absolute and in relative terms. It is bound to mean curtailing and deferring many desirable projects, to which we had been looking forward, but I think that the British public will prefer this way to the alternatives which I have rejected at this time.

The result will be that, whereas public expenditure on goods and services had been expected to rise by 3.0 per cent next year, it will now fall by about 3½ per cent and whereas total public expenditure was expected to rise by

/ under 2 per cent

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under 2 per cent next year, it will now fall by over 2 per cent.

Since immediate action will be necessary to fulfil these decisions, there will in consequence be a reduction also in this year's public expenditure.

PART VI - POSSIBLE END

I do not think that any of my predecessors would dispute that, in the face of the many uncertainties ahead of us over the coming year, an economic judgement at this time is - to put it mildly - more difficult than usual. This is why it is important to say quite openly that, while I believe that the judgement I have made is the right one, I shall not flinch from taking, at any time, any further action which may be required in the national interest.

Within five to seven years about two thirds of our oil requirements will be met from the North Sea, and beyond that we ^{shall} [may well] be self-sufficient. This alone will give Britain an immense industrial advantage. It will transform our balance of payments.

But over the next year or so, it must be said that the British people face a [severe] test, and that over this period they will not achieve the prosperity they expected. No Government, no Party, could honestly pretend otherwise.

I hope the House will permit me one personal word. I have taken the action which I believe to be right. I have tried to be fair. I hope the nation will respond.

PRIME MINISTER

The Chancellor had a word with me this evening about the preparation of the measures. He made four points:-

1. He wondered whether it was really right that you should make the Statement in the House tomorrow. You will have to absorb an enormous amount of detail and there would be a danger of your being cut out.
2. He wondered whether you were planning that Ministers should meet over the weekend to complete the package: I said that this would no doubt be decided in the light of progress made at Cabinet tomorrow morning.
3. He emphasised that he was very keen to announce the economic measures himself.
4. He said that it would help him if it could be firmly announced in your Statement tomorrow that he would be making a Statement on Monday: this would enable the printing to be set in hand and would concentrate everybody's mind wonderfully.

He said that he would be considering further the suggestions made at the meeting this evening.

F. E. R. BUTLER

TOP SECRET

PRIME MINISTER

COPY NO. 1 OF 4 COPIES

At a meeting with Sir William Armstrong, Sir John Hunt and Sir Douglas Allen this morning, I learned a little more about the Treasury's contingency plans for a January package. You may like to have this note of the plans, so that you can think about some of the timing implications.

2. The hope is that it will be possible to get past the publication of the November trade figures on 13 December without further measures. If it was thought that further measures were necessary, the Treasury would propose the re-introduction of hire purchase and certain measures in the field of credit control.

3. The credit control measures they have in mind are the change in interest rate arrangements described to you by the Governor, to discourage the "merry-go-round" and take the "bubble" out of the money supply figures, and the introduction of a penal special desposit scheme, in which the Bank of England would call for special deposits against increases in bank deposits (or bank advances) above a certain level. This would be virtually a ceiling control. Even if these credit control measures are not required to be published on 13 December because of the trade figures, the Treasury may well propose that they should be put into effect before the end of the month, as a permanent change in credit control arrangements.

4. The economic forecasts which are at present being completed suggest a deficit of £3,000 million on the balance of payments next year. This forecast is obviously highly

uncertain. It assumes an oil price of \$5.20 a barrel, which some regard as optimistic; and it assumes no loss of production as a result of oil shortage. On the other hand it may not allow sufficiently for improvements in the terms of trade resulting from the sort of fall in commodity prices which might occur if there was a substantial slowing down in the growth of world trade as a result of deflationary policies in a number of developed countries. The Treasury are not proposing that we should take measures to try to offset the increase in the deficit resulting from the rise in oil prices; but they think that that increase obliges us to take measures to deal with the deficit which was to be expected in any case for other reasons.

5. The sort of package of measures which they envisage for January would be:

- (i) a programme of reductions in public expenditure in 1974-75 totalling something over £500 million;
- (ii) a reduction in the deficit subsidies to the public energy industries (further reducing public expenditure and forcing price rises for coal, electricity and gas);
- (iii) the announcement of an increase in income tax with effect from 6 April;

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- 3 -

(iv) disallowance of tax relief for interest on borrowed money;

(v) tax measures on land and property transactions (probably a capital gains tax on betterment).

6. The Treasury do not see much joy in import controls. They believe that our E.E.C. obligations would make it extremely difficult to impose import quotas or temporary import charges. A quota scheme would in any case be likely to save only £350 million on the balance of payments in a full year, and less in the first year because of anticipation. An import deposit scheme would be less objectionable to the E.E.C.; but the monetary effects of such a scheme are likely already to be secured by other means, so that there is less of a case for this sort of scheme (which, on previous experience, does not have a major impact on imports).

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7. The Treasury believe that this combination of credit control and fiscal measures would take some of the burden off interest rates, although it does not follow that interest rates would come down immediately, unless international interest rates started to fall: the effect might be to prevent a rise which would otherwise occur.
8. The Inland Revenue and the Treasury believe that the only practicable basis for disallowing tax relief on interest payments is that adopted by Mr. Jenkins in 1969, and would propose accordingly.
9. These measures would not necessarily be the end of the story. But the Treasury think that they are likely to be needed in any case, whatever happens, to deal with the deficit which can already be foreseen, irrespective of the additional deficit arising as a result of higher oil prices.
10. The Treasury have worked out, on a contingency basis, a programme for reductions in public expenditure. This contingency programme is very much the mixture as before, with contributions from a variety of individual departmental programmes, including defence, assistance to industry, roads, health, education, and miscellaneous local government services. This may now be the only way of getting the results; but Sir John Hunt and I think that the make-up of the total will need careful thought. Sir Douglas Allen does not think that it would be possible to get by without reductions in public expenditure.
11. The future of counter-inflation would have to be rethought. It is arguable that there should be some tightening of Stage III - a withdrawal of thresholds, or even a reversion to total freeze.

The thought that this might be coming might make it easier to settle the miners' and other disputes; but it might have the effect of increasing the determination of those concerned to break the policy.

12. The December trade figures are due to be published on Monday 14 January. The Treasury think that it would be necessary to be in a position to make an announcement from then on. At present, the House of Commons is not due to resume until 21 January. It might be necessary to contemplate bringing the House back a week earlier; or surviving for a week after the trade figures without an announcement, and taking the strain on the rate.

13. This sort of programme has considerable timing implications.

14. The first implication arises from the need to change the psychology of public opinion and prepare it for the sort of prospect which we face. At some time between now and the announcement of a change of this kind, it would be necessary to change gear, from the sort of provisional "business as usual" line which we have been following so far, to more overt recognition that we face a very serious situation, which means (as you have said) at least reducing the growth of the standard of living and perhaps even a decline in living standards. It is arguable that confidence is no longer served by continuing as at present: if the situation is clearly serious and calls for action, confidence is damaged, not improved, by a continuing appearance of Governmental blindness (or refusal to see) and inaction.

15. The question then is how to signal a change of movement and when to do so. We have to look at this in relation to the present industrial disputes. The sort of change of mood

envisaged might serve as a catalyst for the miners' dispute. The next meeting of the NUM Executive is on 13 December. It seems unlikely that one could effect the change of mood before then; but the Executive can no doubt be recalled at any time, if Mr. Gormley and Mr. Daly so decide.

16. One way of signalling the change of mood might be for you to attend, and speak very seriously at, the special meeting of NEDC which it is proposed to have before Christmas. Another possibility might be to call special meetings with the CBI and the TUC. You might need to make a Ministerial broadcast. But this would all need very careful thought and preparation, given that it will not be practicable to announce a full package of measures until January.

17. This whole prospect puts a large query over your visit to China. If it is accepted that there will have to be the sort of package of measures envisaged some time in mid-January, I do not see how you can be out of the country from 1 to 17 January. If you decide to cancel or postpone the visit to China, the sooner the Chinese are told the better. The announcement of the cancellation or postponement of the visit could itself be an ingredient in the process of changing the mood in preparation for a package.

RAA

6 December 1973

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