

SECRET

Prime Minister

12 October 1982

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To be aware of Alan's

ALAN WALTERS

PRIME MINISTER

GOVERNMENT POLICY ON UNEMPLOYMENT - CHANCELLOR'S REACTIONS (see the Chancellor's

OF 11 OCTOBER 1982

minute, at flag A)

MLS 12/10.

at flag

Most of the points which the Chancellor raises I have already covered in my memorandum of 14 September and later in the joint memorandum with Ferdinand Mount of 27 September. The Chancellor has not seen these memoranda and is understandably being defensive about claims arising from what he believes is my approval of the proposals in the Minford/Smith Report. (I was, of course, summarising not approving.)

There are, however, some errors in the Chancellor's memorandum and perhaps you might find occasion to bring them to his attention.

First, what is described as a "benefit cap" is not "effectively the wage stop under another name". It is administratively, economically and numerically quite different. The wage stop required the officials to estimate what wages would have been had the man got a job. The benefits cap, or perhaps more appropriately called ceiling, depends upon the pay level in the last job. It is the method practised by almost all European countries, with the exception of Belgium. All these countries manage to administer it effectively. Furthermore, unlike the wage stop, the benefits ceiling is not indexed. (The Chancellor describes the ideas as pretty familiar: they are indeed familiar, but not in the United Kingdom.)

So it bites harder as each year unemployed goes by.

MLS

The second error is that the Chancellor believes that the Minford/Smith results hinge on "Laffer effects". Laffer effects arise when marginal tax rates are so high that, as one reduces them, the total revenue received increases. I know the Liverpool model fairly well and I have yet to find any ubiquitous Laffer effects of that nature in the model - although there were some when the marginal tax rates were at 86% and 98%. But the advent of many marginal benefit/tax rates of near or over 100% (as shown in both the Minford and Parker studies) should make one hesitate before cavalierly dismissing Laffer effects. At 100% or so, Lafferism is simply common sense.

/The Liverpool

SECRET

The Liverpool model is, of course, different from the Treasury model. Minford has adapted his model to deal with the various problems of the benefits, tax, wages nexus. Whether Minford or the Treasury, or anyone else is "best" for dealing with such problems cannot be adduced on present evidence.

The Chancellor is, therefore, perfectly right to stress the great uncertainties of the calculated effects of Minford-type proposals - whether they come from Minford's, the Treasury or any other model. As I emphasised in my memorandum of 14 September, there is enormous uncertainty about the numerical results. And one should certainly not trust them for any crucial calculations. The important point, however, is that the policy proposals go in the right direction, particularly the lifting of the thresholds.

In fact although we agree with the Chancellor that we cannot yet say how much will be available within the MTFS next year (and Minford's calculation was, as it must be, dependent upon hypothetical assumptions), nevertheless we believe it is important in the Budget process that lifting the thresholds should be the first priority rather than the last.

Characteristically, the budgetary process begins with particular tax changes, such as NIS in response to the CBI, or excise duty in response to the whisky industry, then goes on to see what is left over for raising the thresholds. The thresholds are the residual legatee. Consequently, in real terms they have steadily fallen over the years, as was pointed out in Hermione Parker's study.

It is not so much, as the Chancellor claims, that there are "rival claims on the table". The point is the rivals are always served first and the thresholds get the left-overs. The order should be changed in 1983.

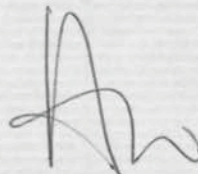
The benefits ceiling is more contentious and may be best left until after the election. However, at 90% rather than Minford's 70%, we can see a good case for associating this measure with the rise in thresholds (and boosts in child benefit) as a "package". There must be a widespread feeling that one should not get almost as much or more when one is not working. But political judgements must here

/loom much

loom much larger than economic calculation. And this must also be true of the "Workfare" proposals (which again are not familiar in the UK).

I would suggest that if you agree to the "dialogue" suggested by the Chancellor in paragraph 7, there ought to be a tight time limit. The business is urgent.

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