PREM 19/172

Confidential Filing

Economic Strategy

Pay and Prices Monthly Economic Report

ECONOMIC POLICY

PART 1 : MAY 1979

PART 5 : FEB 1980

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
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PART 5 ends:-

Tsy to PM 30/6/80.

PART 6 begins:-

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TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
MISC 14 (80) 8	1.2.80
E (A)(80) 11	22.2.80
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E (EA)(80) 17	25.3.80
E (80) 33	1.4.80
E (80) 38	29.4.80
E (80) 50	4.6.80

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Signed CWayland Date 9 February 2010

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PERSONAL

T Burns
Second Permanent Secretary
Chief Economic Adviser

30 June 1980

Dear Tim,

I enclose a draft of my presentation to Cabinet on 3rd July. I am working on a further draft which will contain some revisions.

Yours

Terry

(TERRY BURNS)

c.c. Mr R Ibbs
Mr J Hoskyns

Mr T Lankester
10 Downing Street
London SW1

Outline Notes on Economic Strategy

Introduction - Summary of Strategy

FINANCIAL STRATEGY

1. PERMANENT REDUCTION OF INFLATION REQUIRES A MONETARY STRATEGY
2. EXACT TIME PATH AND LAGS UNKNOWN – PROBABLY AVERAGE LAG ABOUT 2 YEARS
3. NECESSARY TO HAVE A CONSISTENT FISCAL POLICY WHERE PSBR IS REDUCED AS PERCENTAGE OF INCOME
4. CUT IN PSBR BY CUTTING SPENDING. TAXES TOO HIGH.
5. HAVE MEDIUM TERM FINANCIAL STRATEGY

1. The Government's financial strategy is essentially a monetary strategy designed to attack the central problem of inflation. In addition to the financial strategy a number of policies are directed towards the supply side of the economy e.g. abolition of price controls, foreign exchange controls, reduction in taxation. But as inflation remains the central problem I will be concentrating upon the financial aspect of the strategy. The Government believes that in order to reduce the inflation rate permanently it is necessary to reduce monetary growth. Other policies, particularly attempts at administrative control are necessarily short lived and lead to pay/price explosions when the policy ends.

2. The exact monetary path connected with a particular inflation rate is unknown and so are the precise time lags. But experience both in the UK and the rest of the world suggests that if we can reduce monetary growth, inflation will be reduced by roughly the same amount once the time lags have worked through. Average time lag is probably about 2 years.

3. The Government believes that in order to achieve this monetary strategy without excessive interest rates it is necessary to have a consistent fiscal policy. As monetary growth is reduced it is necessary to reduce the growth of total financial assets in the economy. This implies a reduction in Government borrowing as a percentage of output. Again we do not know the precise relationship. It almost certainly varies over the business cycle.

4. A key aspect of the financial strategy is that the reduction in PSBR should be achieved by reducing the share of government spending in output. Taxes are already too high.

5. Because the strategy is for the medium term the Government has published a medium term financial framework. This contains:

- monetary target
- public spending plans
- an illustrative fiscal framework

The Background

6. This strategy is being implemented against a difficult background. Judged by conventional measures of the growth of output, inflation and unemployment the economic performance of the industrial countries has

undergone a marked deterioration in recent years. In the case of each of these measures UK performance has also deteriorated;

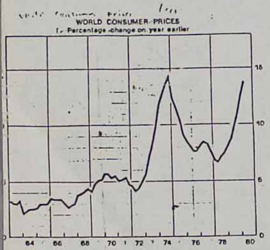
UK growth has deteriorated in line with the rest of the world; in the case of inflation the deterioration in the UK has been worse than elsewhere.

World and UK Inflation Background

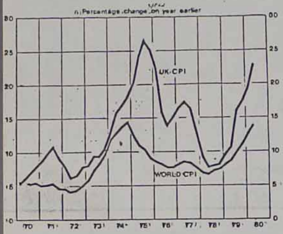
7. The underlying rate of inflation has been increasing since the early 1960's. The table shows that world inflation in the 1970's was double what it was in the 1960's. For the UK the acceleration was worse. After keeping within 1% of the world average inflation rate in the 1950's and 1960's the UK inflation rate moved significantly ahead of our major trading partners in the 1970's.

INFLATION

	1963-69	1970-78
US	3.8	6.6
JAPAN	5.0	9.6
W. GERMANY	2.5	5.0
FRANCE	3.6	8.6
ITALY	3.4	12.2
U.K.	4.3	12.0
WORLD	3.6	7.7



8. This underlying acceleration of world inflation can also be seen by comparing the rate of inflation at the same point of successive cycles. The low point of the cycle has been at higher and higher rates of inflation. The UK has the same pattern of upward drift of the underlying inflation rate.



9. If we concentrate upon the 1970's we can see that the timing of the broadsweep of inflation movements is the same in the UK as in the world as a whole. Since mid 1978 the OECD inflation rate has risen from $6\frac{1}{2}$ per cent to 14 per cent; at the same time the UK rate has risen from $7\frac{1}{2}$% to 22%. The rise in world prices is largely the effect of the further doubling of oil prices which has had a direct effect upon inflation equivalent to the increase in 1974. Although the percentage increase in oil prices has been lower than in 1974 it now has a greater weight in expenditure. In addition world demand has been growing rapidly since mid 1978 and this has contributed to inflationary pressure.

GROWTH RATES

	1963-69	1970-78
WORLD	4.5	2.9
US	4.4	2.8
JAPAN	11.3	6.1
GERMANY	4.5	3.0
U.K.	3.1	1.8

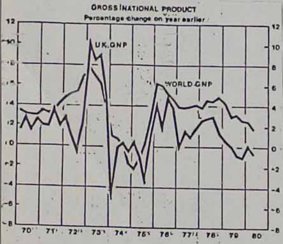
World and UK Output

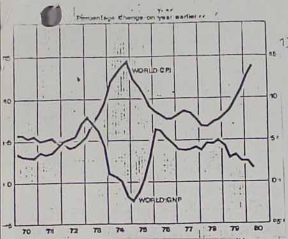
10. There is widespread agreement that the underlying growth of world output has fallen; opinions vary but it is possible to place the point of major change in the late sixties or early seventies. The average growth/ for the period 1963-69 is contrasted with the growth rate from 1970-79. Growth rates of total output have virtually halved. For individual countries the results vary in degree but the underlying pattern is similar.

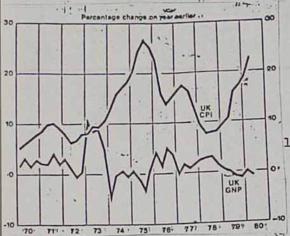
11. The UK growth rate has been systematically worse than average for a hundred years. Throughout the post war period the gap has been about 2%. There is some debate about whether the gap between UK and world growth is increasing. The most gloomy of observors argue that the extent of the poor UK performance has been disguised by North Sea oil and by a large effective currency depreciation for much of the seventies; they would also point to the growing penetration of imports of manufacturers. I take a less gloomy view and observe that the 2% a year growth gap between the UK and elsewhere has been fairly stable and that rising import penetration has been largely a reflection of growing trade pentration world wide.

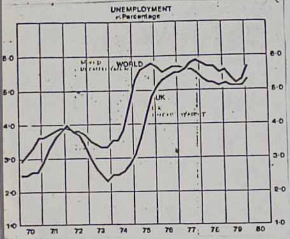
	U.K. GROWTH	OECD GROWTH	DIFFERENCE
1900-13	1.9	2.9	1.0
1921-38	1.7	2.4	0.7
1950-60	2.5	4.2	1.7
1960-70	2.7	5.2	2.5
1970-80	1.3	3.5	2.2

12. Looking in more detail at the cyclical pattern of output in the 1970's we can see the close correspondence of the UK and world output changes. Recessions in the UK tend to be strongly associated with recessions in the world as a whole. Similarly the periods of rapid growth also tend to coincide.









13. A comparison of growth and inflation points up a very sharp lesson - both for the world and the UK. Whenever the inflation rate accelerates growth slumps; and whenever it decelerates the growth rate picks up; The recent rise in inflation is now beginning to have its effect upon the growth rate this year and early next. When inflation is reduced we can expect growth both here and the rest of the world to recover although the extent of the recovery will depend upon the underlying strength of the economies.

World/UK Unemployment

14. The UK unemployment rate has been rising each cycle since 1960. Again there is close correspondence with the average of the major countries since 1967. There was a major increase in unemployment in 1970; then again in 1974/5; and we now seem to be about to surge again. I shall return to this problem again.

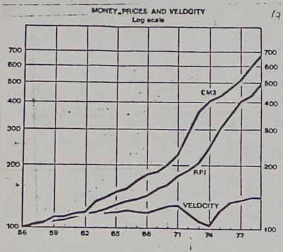
Monetary Strategy

15. I would now like to look at the monetary strategy in some more detail. Want to

(i) point up the evidence and experience of the past 10 years since the world moved to floating exchange rates;

(ii) trace out progress over the past year

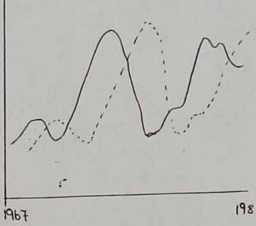
(iii) assess how we might expect the strategy to unfold in the period ahead -



16. The fundamental belief underlying the monetary strategy is that in the medium term inflation rates are determined by monetary growth. This can be illustrated in two ways.

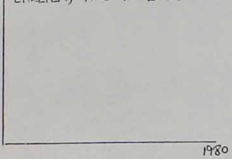
(i) the velocity of money - the ratio of national income to money supply has been broadly stable when compared to the movement of money and prices separately. There is an upward trend possibly reflecting changes in banking practice. And there have been periods when the relationship was disturbed such as 1972/3 by a change to the banking system and rapid monetary expansion world wide. But there are strong forces which bring us back to that trend. This implies that government induced changes in money tend to be reflected in changes in nominal income and in practice most of this will be due to prices changing.

MONETARY GROWTH AND INFLATION



(ii) the second approach is simply to chart over the past 10 years the growth of money supply and the inflation rate. The relationship comes out clearly after a longish lag.

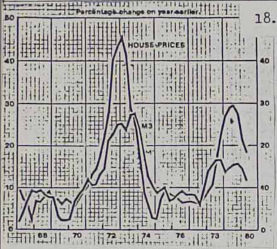
MONETARY GROWTH (2 YEARS EARLIER) AND INFLATION



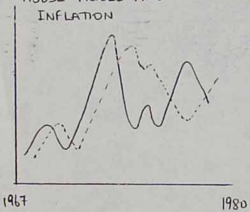
17. Of course there are other influences upon the price level; money is not the only thing that matters for inflation, particularly in the short-run.

- oil prices and world prices clearly have a major effect. Already mentioned the scale of the effect
- the rise in VAT had a short run effect
- the timing of nationalised industry prices, rates, rents and food prices.
- the timing of pay settlements

1. UNDERLYING FORCE IS MONETARY GROWTH
2. TEMPORARY FACTORS
   - OIL PRICES AND WORLD PRICES
   - RISE IN VAT
   - TIMING OF NATIONALISED INDUSTRY PRICES
   - TIMING OF PAY SETTLEMENTS



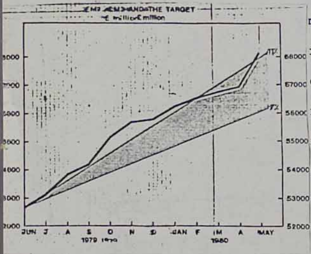
HOUSE PRICES AND INFLATION



18. The crucial feature of the money/price relationship over which we have little control is the matter of time lags. I have emphasised the way in which inflation lags behind monetary growth. Of course some prices move immediately; these are the markets that are most sensitive to monetary changes. Important examples are the foreign exchange market and the housing market. Both usually signal well in advance the likely course of inflation in general. We can see the historical correspondence between monetary growth and house prices. There is clear overshooting with house prices rising by a multiple of monetary growth during booms but the broad movement coincides. Similarly we can see how the movement of house prices clearly leads the inflation rate.

INFLATION AND HOUSE PRICES (2 YEARS EARLIER)

19. The latest bout of inflation shows up in the monetary figures from the end of 1977. Monetary growth moved from 7% per annum to 15% per annum. By 1978/79 when general inflation was still modest house prices were beginning to accelerate reaching an annual growth of 30% in mid 1979. The increase in general inflation followed just as the inflation in 1974/75 followed the monetary growth and house price explosion of 1972. This time the time lag appears to be shorter. In the mid 70's the time lag was about $2\frac{1}{2}$ years. Recently the lag between the upturn in house prices and the upturn in inflation was only 18 months. This is not surprising as the population is becoming increasingly aware of the inflationary process.



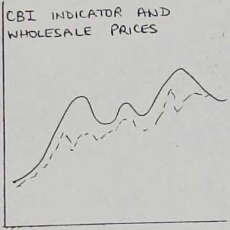
20. Now the whole sweep of inflationary pressure may be about to be reversed. There is increasing evidence that money supply is coming under tighter control and the slowdown in inflation is likely to follow. In the first part of 1979/80 there were problems of monetary control:

(i) the PSBR was biased with a large deficit in the first half of the year

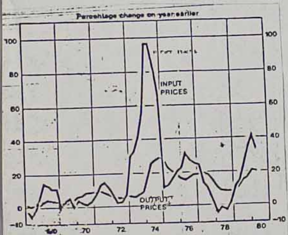
(ii) there were considerable lags in tax payments due to industrial disputes

The rise in MLR to 17% and a favourable budgetary position has brought us back towards the target.

21. Just as monetary growth is now slowing down so is the growth of house prices. After peaking at 30 per cent per annum the latest figure is below 20% on a year earlier and looking at the recent monthly movement of prices there is the prospect of sharper deceleration later this year. This all points to a slowdown of inflation in general.



22. Another important indicator is the CBI indicator of firms planning to put up prices in the following four months. The last figure is the lowest since 1973 i.e. before the first oil price increase. The high exchange rate and monetary contraction is clearly affecting profit margins. If earnings growth now slows down a sharp deceleration in inflation is possible.

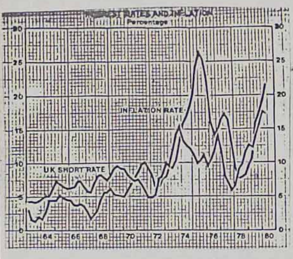


23. Another indicator of future price movements is the behaviour of wholesale input prices. These show the price increases that are paid by manufacturing industry. From early 1977 to early 1979 wholesale input prices were falling due to weak oil prices (because of the fall of the dollar) and lower commodity prices in general. As world growth picked up and oil

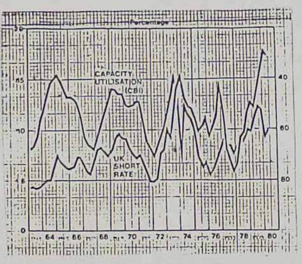
prices surged again the series move sharply upwards despite the strength of sterling. Now there is the first sign of some easing; in the months since February the world prices have been falling and even oil prices have been rising less rapidly. Soon this could be translated into lower <u>output</u> prices and then lower inflation.

<u>Interest Rates</u>

24. One matter of great concern to everyone has been the high rates of interest that we have faced over the past year. There are several important influences upon the level of interest rates:



(i) inflation in general is important as potential savers need to have compensation for the likely fall in the purchasing power of their savings. Even with interest rate at 17% savers are still getting no return, even before tax.

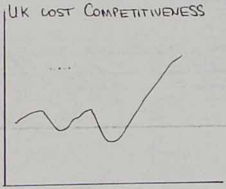


(ii) interest rates tend to be bid up in a boom when companies are stocking and pressure is reduced when destocking reduces companies need for cash. So interest rates tend to move with the economic cycle.

(iii) interest rates have to be relatively high when governments are attempting to keep monetary growth below the going inflation rate in order to dissuade potential borrowers from banks and to encourage holders of cash to purchase government securities. The extent to which interest rates have to be raised depends upon the scale of government borrowing. The higher is the PSBR the higher the level of interest rates that are needed.

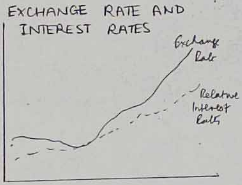
25. During 1979 and early 1980 each of these factors was pointing towards higher interest rates as domestic demand was strong, inflation rising and the monetary target tight. During much of 1979 government borrowing was very high. Now there is the possibility of some reversal of these pressures as recession emerges and inflation is reduced. The tightness of the monetary target relative to the current inflation rate will remain a pressure restraining the fall in interest rates but this year's budget was designed to help this process by producing a much tighter fiscal stance and so reducing government borrowing. After allowing for inflation and the evidence of cyclical downturn this represents a considerable tightening. Reduced sales of government debt are crucial if we are to get interest rates down and this means lower government borrowing. So far this year there have

been signs of some similar PSBR problems emerging with an overrun of expenditure but it is necessary that this should be temporary. There will also be statistical problems with the removal of the 'corset'.



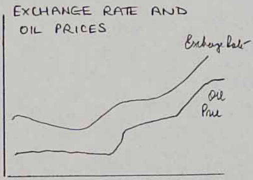
Exchange Rate

26. A further matter of concern has been the behaviour of the exchange rate. Since May 1979 the effective exchange rate has risen by [10%]. At the same time UK inflation has [10%] faster than competitors inflation and costs. The result has been a massive 25% loss on cost competitiveness. This is putting a sharper strain of adjustment on parts of the economy. It is very difficult to identify precisely the reason for the strength of sterling.



(i) the overall monetary strategy has probably contributed

(ii) interest rates have been high and therefore attracted money



(iii) the rising oil price damages UK balance of payments less than other countries and appears to have turned us into a petro-currency.

The balance between them is a matter of fine judgement but probably (iii) the most important.

27. The effect of the oil price increase upon the UK is unlike its effect on other countries. As we are self-sufficient there is no direct change in the terms of trade and home national disposable income is not damaged when the oil price changes. This contrasts with net oil importers. Of course we suffer reduced export demand but this may be offset in part by lower commodity prices.

28. While in broad terms the effect may be self-cancelling different sectors of the economy experience differing fortunes

PERSONAL SECTOR

COMPANIES

GOVERNMENT

- personal consumer : suffers high prices of energy
  : benefits from low impact prices due to exchange rate rise

- firms not trading internationally affected in same way
  : higher energy costs
  : lower import costs

- firms exposed to international competition suffer
  : higher energy costs
  : squeeze on prices and profits due to higher exchange rate

- Government gains additional oil revenue - after lag.

29. Result has been much higher exchange rate than expected. Effect has been to put considerable downward pressure on prices but has caused problems for companies. The effect of the loss of competitiveness is very uncertain but could be damaging to manufacturing if unit costs are not reduced.

Unemployment

30. In summary therefore the anti-inflationary policy is causing considerable pressure for the economy in the short run. The benefit from the strategy should emerge in the defeat of inflation. But in the process of monetary deceleration it is expected that output and employment will suffer if pay and prices do not move quickly into line with monetary growth. It is clear that the pattern of unemployment over the next few years will be determined by the time lags in the response of wages and prices to the monetary deceleration. If wages rise rapidly compared to money supply

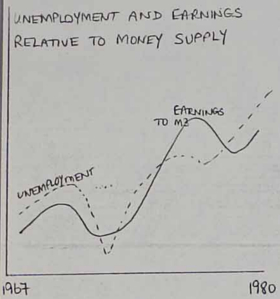
(i) real money balances are squeezed. There is not enough money to finance the higher level of costs. Then output is squeezed and hence jobs are lost.

(ii) if pay rises relative to prices company profitability suffers and jobs are squeezed further.

IF WAGES RISE FASTER THAN MONEY SUPPLY

(1) OUTPUT REDUCED AND JOBS LOST

(2) PROFITABILITY SQUEEZED AND MORE JOBS LOST



31. An examination of the past 10 years shows that the movement of unemployment is closely related to the movement of earnings relative to money. When earnings rise faster than money supply unemployment goes up.

- between the end of 1968 and end of 1971 earnings grew by 12% more than money supply as income policy breakdown collided with the post IMF monetary control. Unemployment rose by 300 thousand; that is approximately 25 thousand for each 1% excess earnings.
- between end 1973 and the beginning of 1977 earnings grew by 40% relative to money supply as post income policy earnings explosion coincided with monetary deceleration. Unemployment rose by 850 thousand. Just over 20 thousand for each 1% extra earnings.

32. The pattern has been similar in reverse. Unemployment has fallen when earnings have grown less rapidly than money supply.

- between end 1971 and end 1973 earnings grew by 25% less than money supply largely because of rapid monetary acceleration. Unemployment fell by almost 400 thousand; little less than 20 thousand for each 1 per cent.

- between early 1977 and end 1979 earnings grew by 3% less than money; partly due to accelerating money and pay restraint. Unemployment fell 150 thousand which is somewhat more than expected on basis of previous experience.

33. On average therefore one can say that over the past 10 years unemployment has risen by 20 thousand for each 1% excess earnings growth. Earnings have now been growing faster than money supply since the end of 1978. The excess to date is probably about 12%; Since September 1979 unemployment has risen by 250 thousand.

ROFILE OF WAGES SLOWDOWN
- TRADED GOODS SECTOR AFFECTED (MANUFACTURING) BY EXCHANGE RATE
THEN NON-TRADED
IMPORTANT THAT PUBLIC SECTOR ALSO MOVES IN LINE

34. On the basis of previous time lags it will be some time before the gap between earnings growth and money supply is removed. The market forces for pay deceleration are being felt in the traded goods sector; labour intensive manufacturing will continue to be most affected. Afterwards the private sector should follow the deceleration in manufacturing pay as the labour market weakens. It is important the public sector pay also moves in line. It is also important to recognise that even though wage claims may be 'explained' by previous monetary behaviour this does not <u>justify</u> such increases. The transitional problems of bringing down inflation are much smaller the faster that wages and prices are brought into line with the monetary growth rate.

Outlook and Options

35. This is the background to the Chancellor's paper on the outlook for the economy. Money supply now running close to the target; inflation and earnings have been growing at 20%; the result is recession and sharply rising unemployment. There are signs that inflation is slowing down and pay increases in manufacturing are much lower than elsewhere. Next year should see some major progress; this should then lay the base for a period of recovery but this cannot happen until pay and money are brought into line.

36. Within this framework it may be sensible to look at some alternative options for policy.

OPTION I
RELAX MONETARY POLICY
e.g. CUT INTEREST RATES
- SHORT TERM REDUCTION IN UNEMPLOYMENT
BUT
- HIGHER INFLATION BUILT IN
- UNEMPLOYMENT BENEFIT TEMPORARY

(i) Relax monetary target by having lower interest rates. One possible quick route to lower unemployment might appear to be an acceleration of monetary growth to 22% so that it is in line with the recent growth of earnings.

The problem is that

- its effects would be short lived
- it would keep the inflation rate at 20%; the benefits to unemployment would be temporary and we would simply have higher inflation. Initially such a policy might ease interest rates as

credit was relaxed but soon the higher inflation would increase interest rates.

OPTION II

RELAX FISCAL POLICY
eg CUT NIS
- HELP COMPANIES CASH FLOW AND MAYBE HELP PRICES

BUT

- HIGHER INTEREST RATES
- POSSIBLY HIGHER EXCHANGE RATE
- ENCOURAGE WAGE SETTLEMENTS

(ii) a second course of action might be to relax fiscal policy whilst attempting to keep monetary control e.g. cut NIS. Almost certainly this would involve higher interest rates and possibly a higher exchange rate. Probably a failure to hit the monetary target.

OPTION III

STATUTORY INCOMES POLICY

- REDUCE UNEMPLOYMENT, INFLATION ?

BUT

- EFFECT ONLY TEMPORARY
EXPLOSION IN 1982/83?
- POSTPONES ADJUSTMENT

(iii) a third option is to attempt to bring wages and prices into line by statutory means. In the past this has had some short term success but

- it does not last for long. Maybe two years.
- it postpones the period of adjustment of the labour market.

OPTION IV

REDUCE EXCHANGE RATE

3 POSSIBLE ROUTES
- INTERVENTION
  : WILL IT WORK
  : HOW MUCH
  : EFFECT ON MONEY SUPPLY
- EXCHANGE CONTROLS
  : HOW PERMANENT
  : WHEN WEAR OFF
  : WHAT DISRUPTION
- LOWER INTEREST RATES
  : LOWER PSBR OR
  : CREDIT CONTROLS

BUT

DAMAGES INFLATION

(iv) attempt to reduce exchange rate

Possible routes

- intervention
- exchange controls
- lower interest rates by cutting PSBR or credit controls

None of these offer much hope for a sustained improved outlook.

CONCLUSIONS

(1) MONEY SUPPLY UNDER CONTROL
(2) ORIGINS OF INFLATION
(3) SIGNS THAT INFLATION TO TURN
(4) INTEREST RATES KEPT UP BY INFLATION, etc
(5) EXCHANGE RATE KEPT UP BY OIL
(6) UNEMPLOYMENT RISING BECAUSE OF PAY FASTER THAN MONEY
(7) SLOWDOWN IN INFLATION LAY BASIS FOR GROWTH

37. Conclusions

(i) Money supply growth is now under control. After growing at 15% per annum between Autumn 1977 and Autumn monetary growth has been 9% per annum over the past 6 months.

(ii) The period of rapid monetary expansion was accompanied by another boom in house prices and followed by a general increase in inflation. This was exacerbated by oil prices, incomes policy breakdown, VAT.

(iii) There are now signs that inflation is about to turn. Indicated by

- recent figures
- house prices
- input prices
- CBI indicator

(iv) Interest rates have been kept high by

- need for monetary control
- inflation

Should see some improvement especially as PSBR brought down. Important that is sustained.

(v) Exchange rate has risen sharply because of

- high interest rates and tight money
- oil prices

Leading to strong pressures on companies but helps inflation.

(vi) Unemployment rising rapidly because of excessive pay settlements. This will continue until pay brought down to monetary growth rate. Important that pay round is successful.

(vii) Slowdown in pay and inflation within the monetary target will lay basis for growth and reduction in unemployment.

FINANCIAL STRATEGY

PERMANENT REDUCTION OF INFLATION REQUIRES
A MONETARY STRATEGY

EXACT TIME PATH AND LAGS UNKNOWN
-AVERAGE LAG ABOUT 2 YEARS BUT CAN VARY

A CONSISTANT FISCAL POLICY TO AVOID EXCESSIVE INTEREST
RATES THAT THE PSBR IS REDUCED AS PERCENTAGE OF PSBR

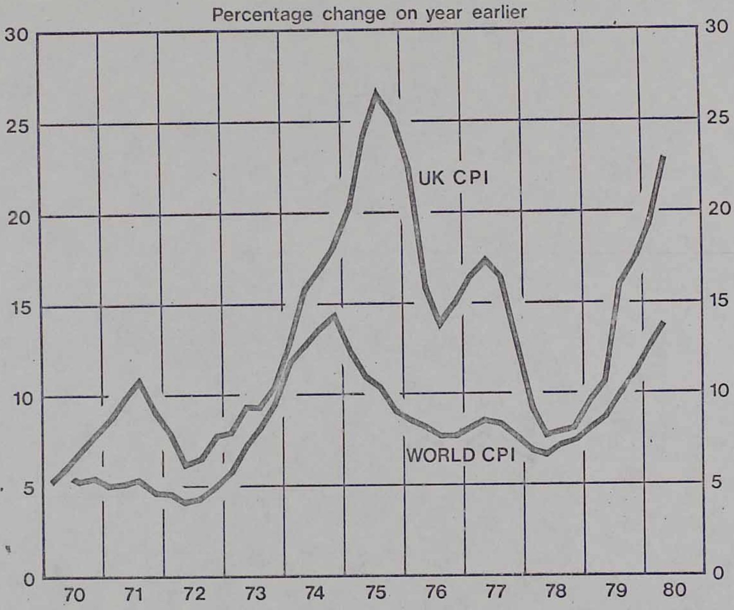
CUT PSBR BY REDUCING SPENDING, TAXES TOO HIGH

INFLATION

	1963-69	1970-78
USA	3·0	6·7
JAPAN	5·0	9·8
W GERMANY	2·5	5·2
FRANCE	3·6	9·0
ITALY	3·4	13·1
UK	4·2	12·8
WORLD	3·4	8·0

WORLD CONSUMER PRICES

Percentage change on year earlier

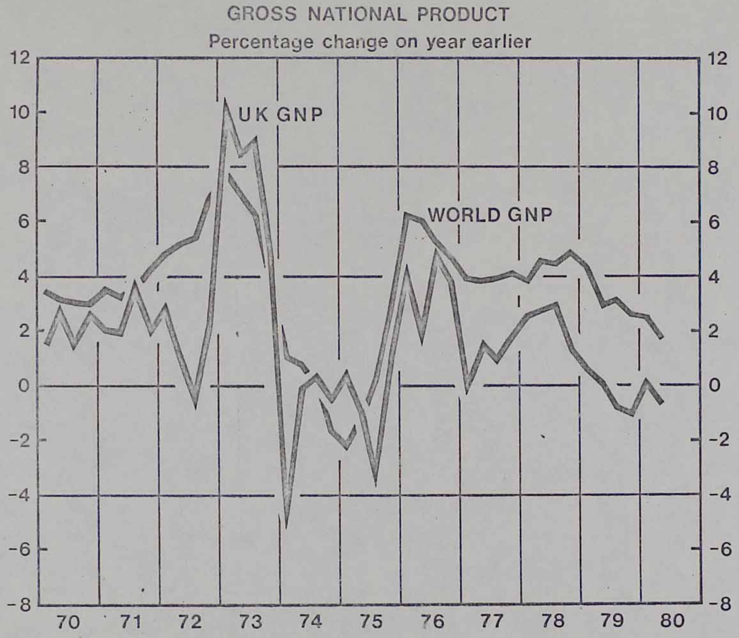

Percentage change on year earlier
30
25
20
15
10
5
0
UK CPI
WORLD CPI
70
71
72
73
74
75
76
77
78
79
80
4

GROWTH RATES

	1963-69	1970-78
WORLD	5·3	3·6
USA	5	3·3
JAPAN	~~4~~ 8	5·3
GERMANY	~~8~~ 4	2·7
UK	2·9	2·3

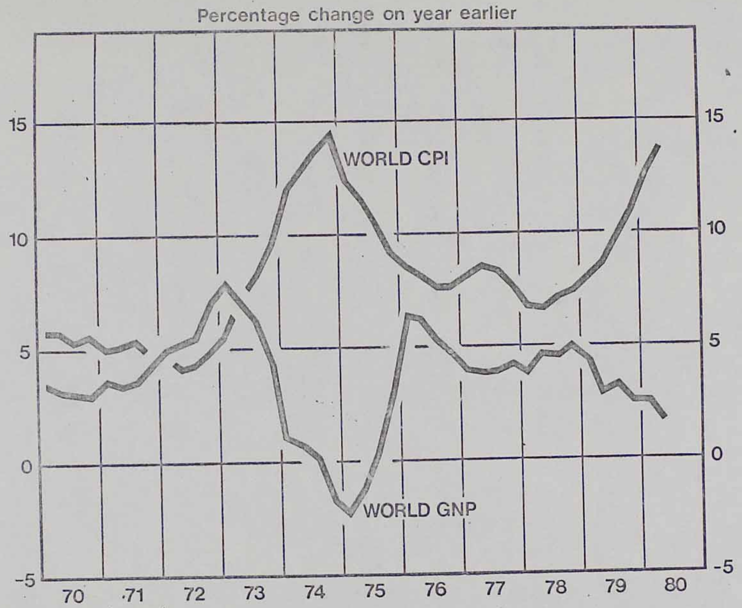
6

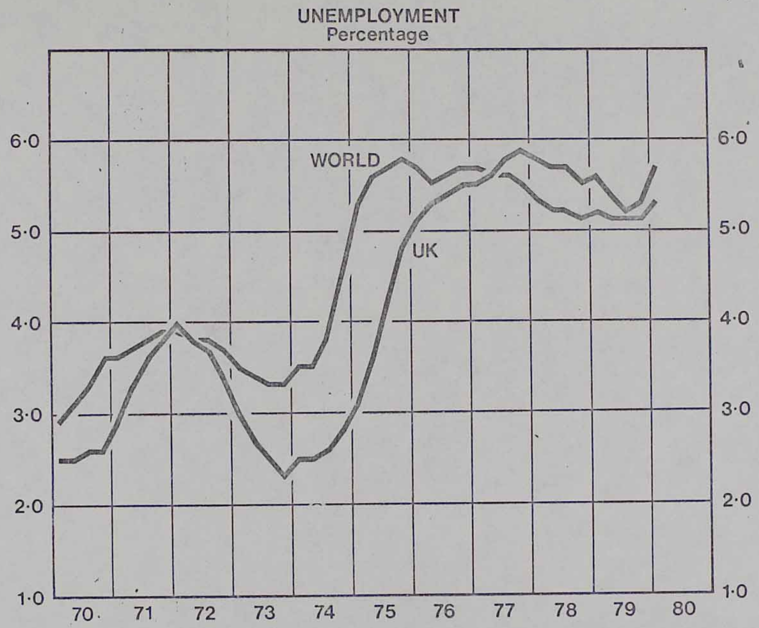
	UK GROWTH	OECD GROWTH	DIFFERENCE
1900-13	1·9	2·9	1·0
1921-38	1·7	2·4	0·7
1950-60	2·5	4·2	1·7
1960-70	2·7	5·2	2·5
1970-80	1·3	3·5	2·2

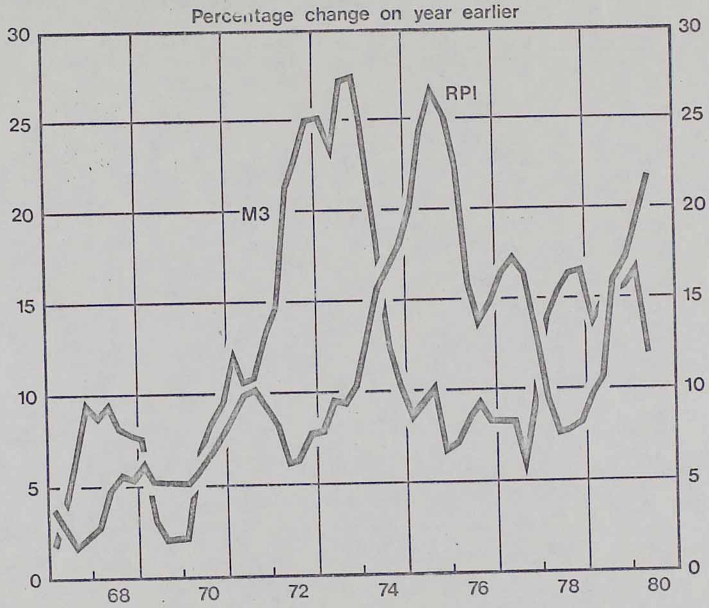


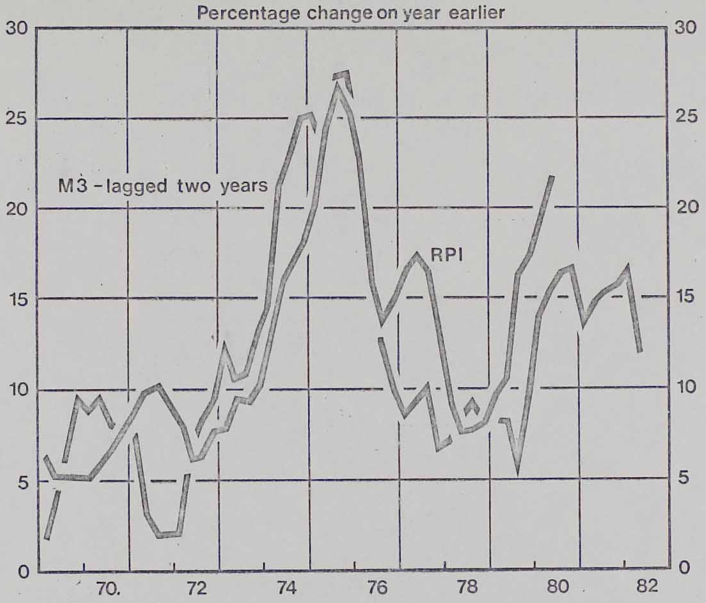
GROSS NATIONAL PRODUCT
Percentage change on year earlier
UK GNP
WORLD GNP
12
10
8
6
4
2
0
-2
-4
-6
-8
70
71
72
73
74
75
76
77
78
79
80

7


Percentage change on year earlier
WORLD CPI
WORLD GNP
15
10
5
0
-5
70
71
72
73
74
75
76
77
78
79
80


UNEMPLOYMENT
Percentage
WORLD
UK
6·0
5·0
4·0
3·0
2·0
1·0
70
71
72
73
74
75
76
77
78
79
80


Percentage change on year earlier
30
25
20
15
10
5
0
68
70
72
74
76
78
80
M3
RPI
60


Percentage change on year earlier
M3 - lagged two years
RPI
30
25
20
15
10
5
0
70.
72
74
76
78
80
82

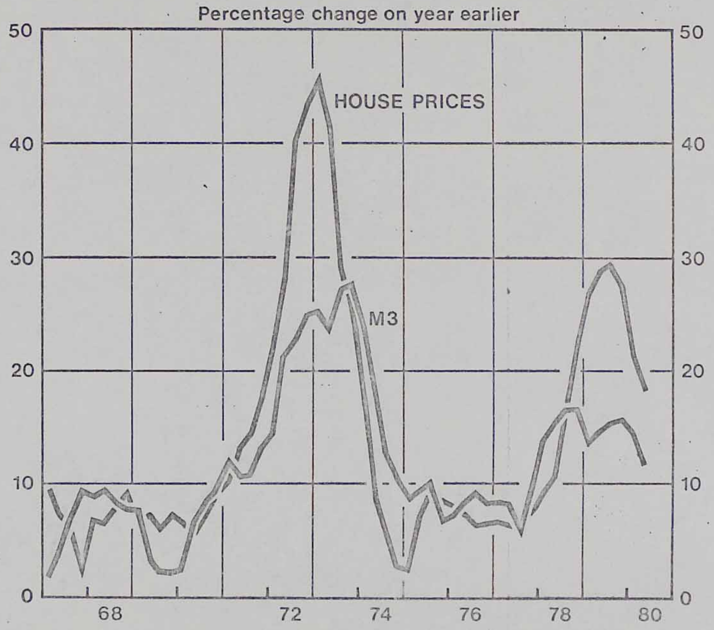
11

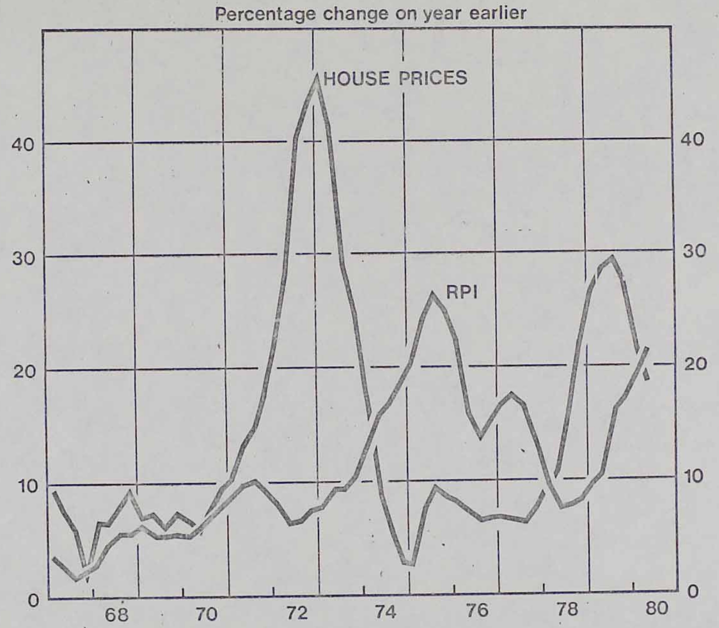
INFLATION

UNDERLYING FORCE IS MONETARY GROWTH

TEMPORARY FACTORS CAN ALSO BE IMPORTANT

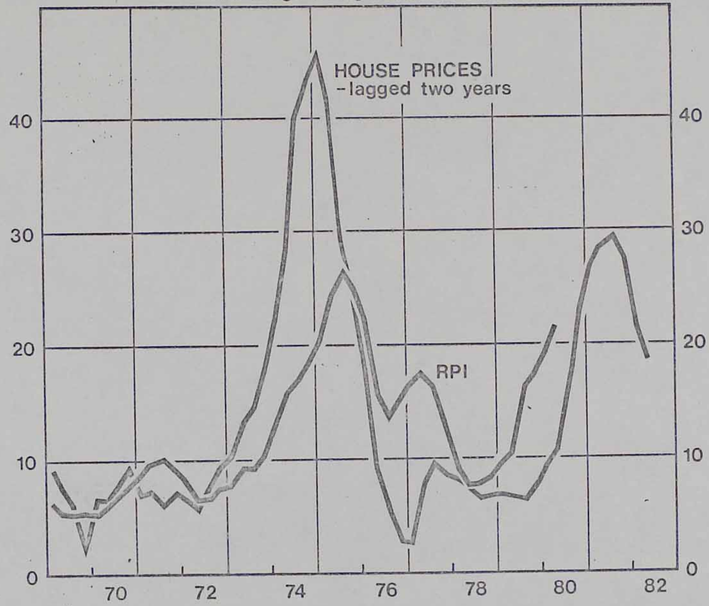
- OIL PRICES AND WORLD PRICES
- RISE IN VAT
- TIMING OF NATIONALISED INDUSTRY PRICES
- TIMING OF PAY SETTLEMENTS


Percentage change on year earlier
HOUSE PRICES
M3
50
40
30
20
10
0
68
72
74
76
78
80



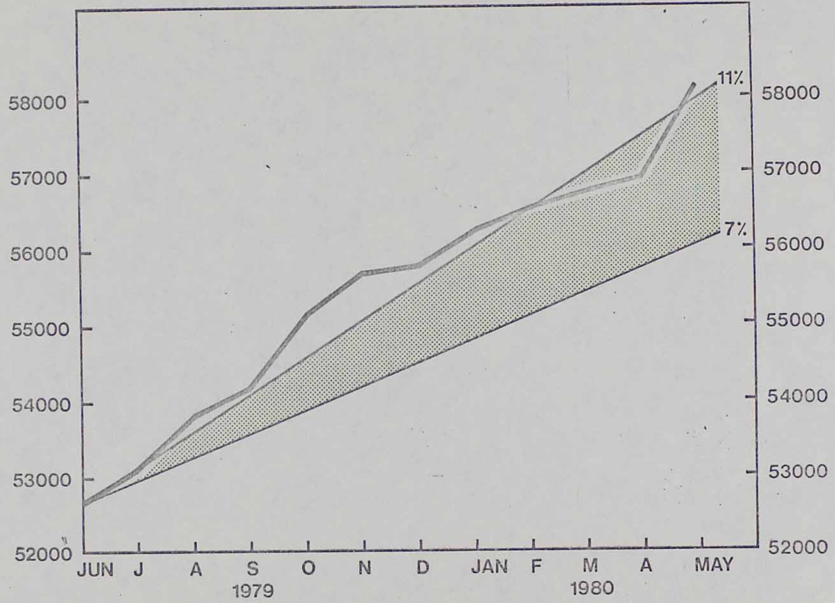
Percentage change on year earlier
HOUSE PRICES
RPI
40
30
20
10
0
68
70
72
74
76
78
80

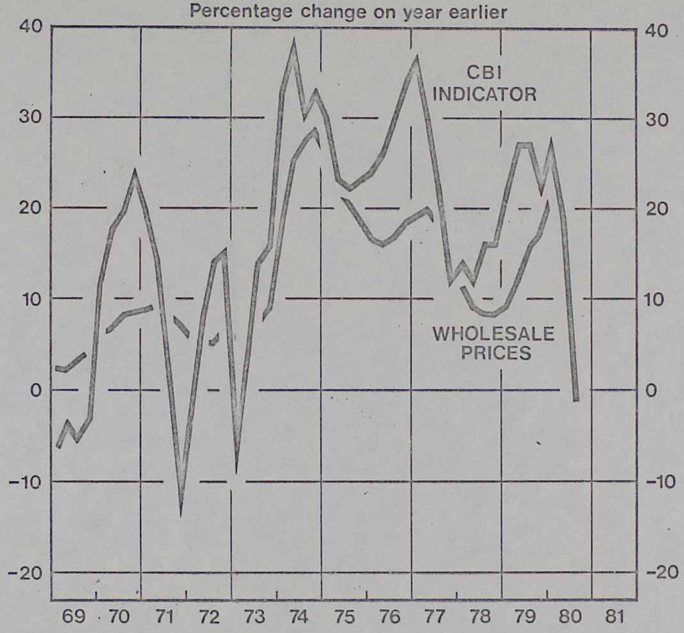
Percentage change on year earlier



16

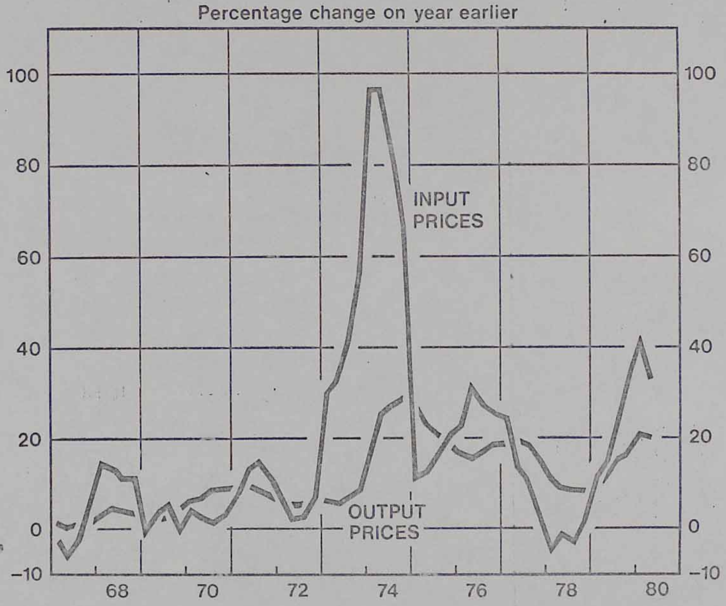
£M3 AND THE TARGET
£ million





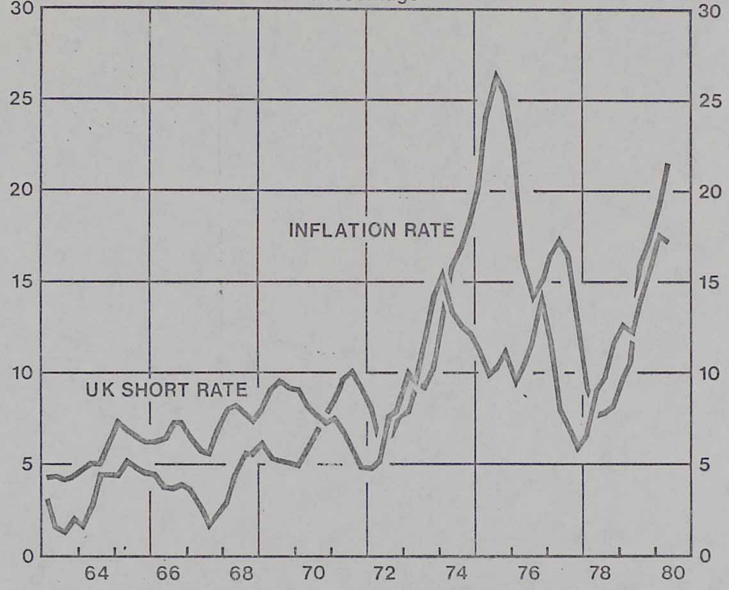
Percentage change on year earlier
CBI INDICATOR
WHOLESALE PRICES
40
30
20
10
0
-10
-20
69
70
71
72
73
74
75
76
77
78
79
80
81

17

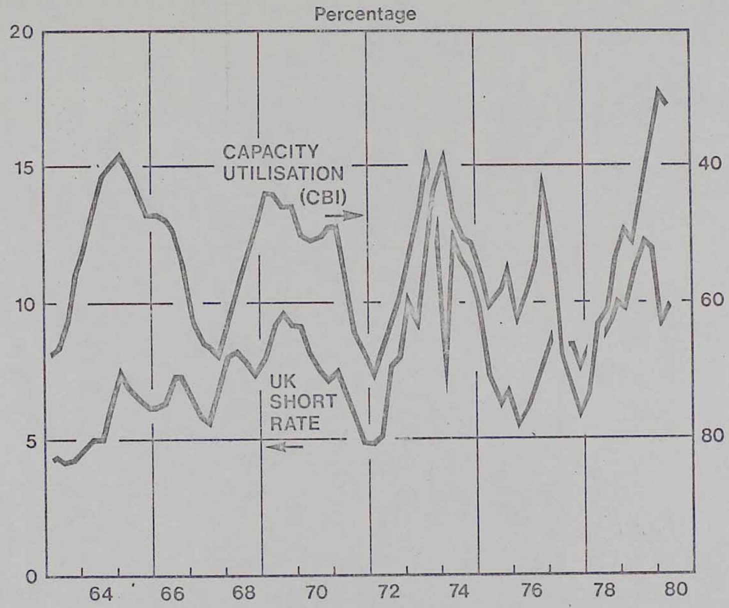

Percentage change on year earlier
100
80
60
40
20
0
−10
INPUT PRICES
OUTPUT PRICES
68
70
72
74
76
78
80

INTEREST RATES AND INFLATION

Percentage

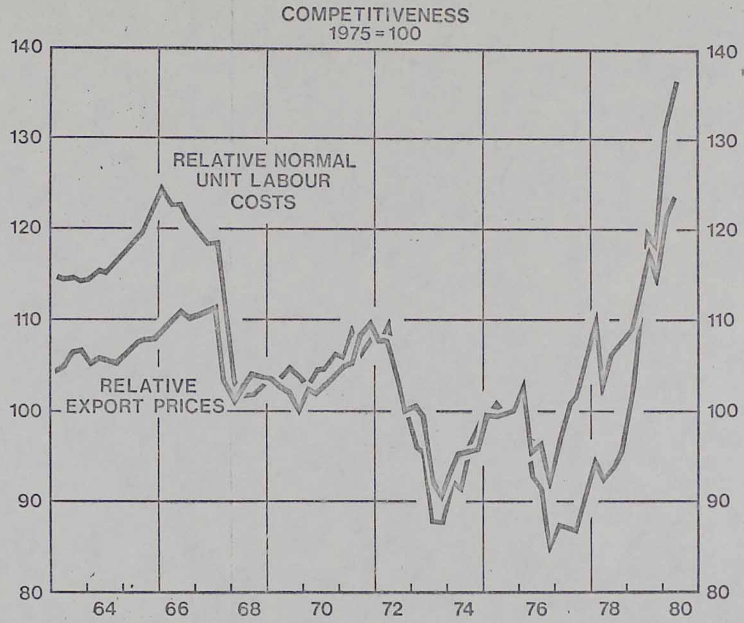


20

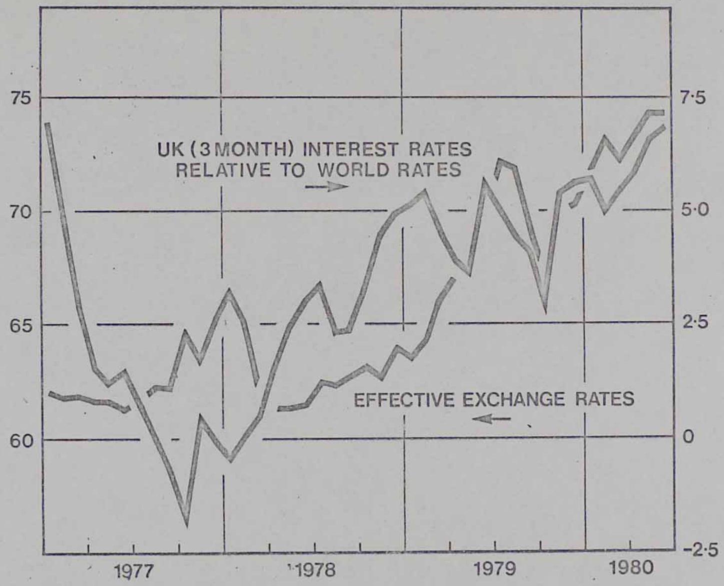


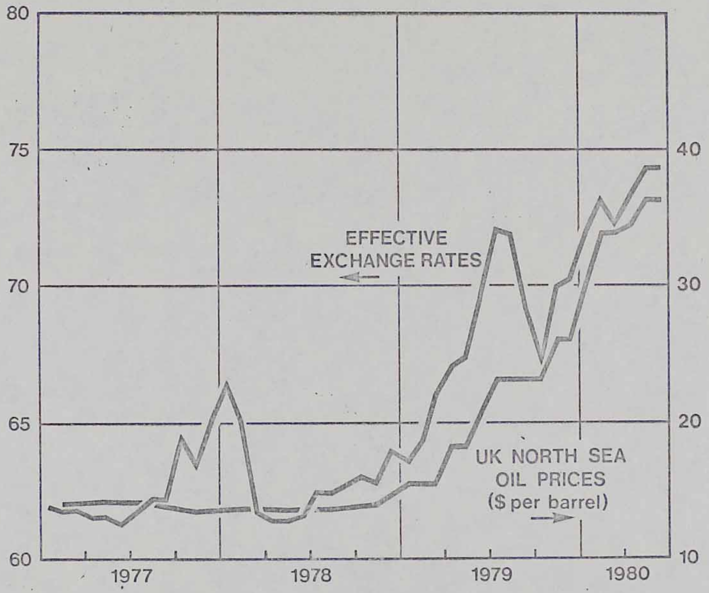
Percentage
20
15
10
5
0
40
60
80
CAPACITY
UTILISATION
(CBI)
UK
SHORT
RATE
64
66
68
70
72
74
76
78
80

21



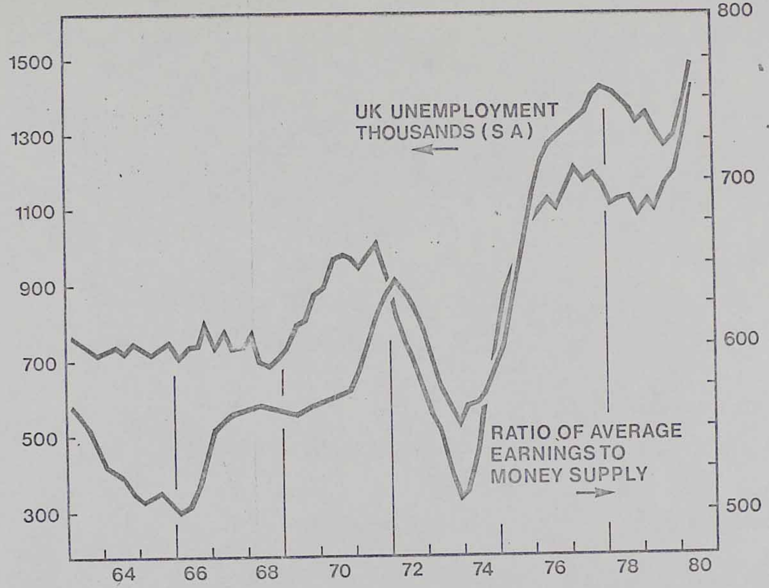
COMPETITIVENESS
1975 = 100
140
130
120
110
100
90
80
RELATIVE NORMAL
UNIT LABOUR
COSTS
RELATIVE
EXPORT PRICES
64
66
68
70
72
74
76
78
80


UK (3 MONTH) INTEREST RATES
RELATIVE TO WORLD RATES
EFFECTIVE EXCHANGE RATES
75
70
65
60
7·5
5·0
2·5
0
-2·5
1977
1978
1979
1980



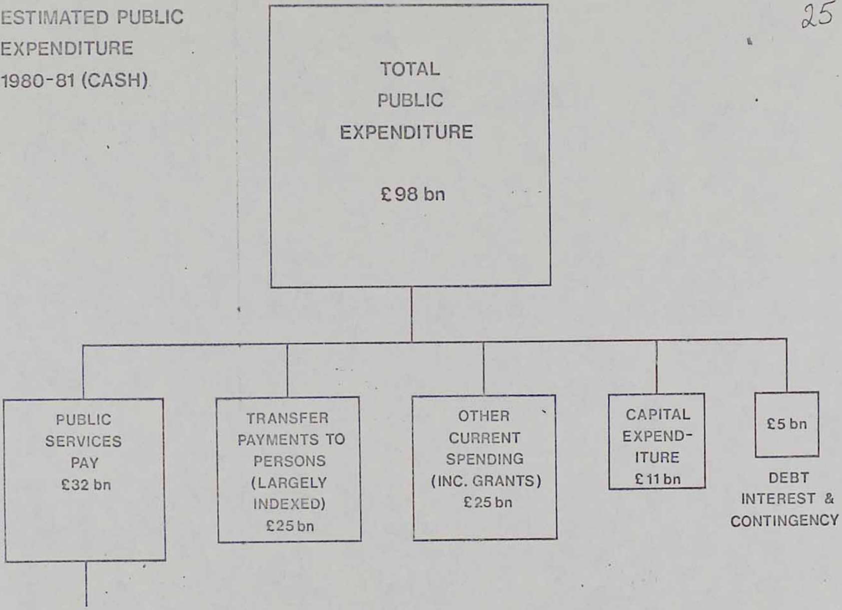
80
75
70
65
60
40
30
20
10
EFFECTIVE EXCHANGE RATES
UK NORTH SEA OIL PRICES ($ per barrel)
1977
1978
1979
1980

23


UK UNEMPLOYMENT
THOUSANDS (S A)
RATIO OF AVERAGE
EARNINGS TO
MONEY SUPPLY
1500
1300
1100
900
700
500
300
800
700
600
500
64
66
68
70
72
74
76
78
80

34

ESTIMATED PUBLIC EXPENDITURE 1980-81 (CASH)



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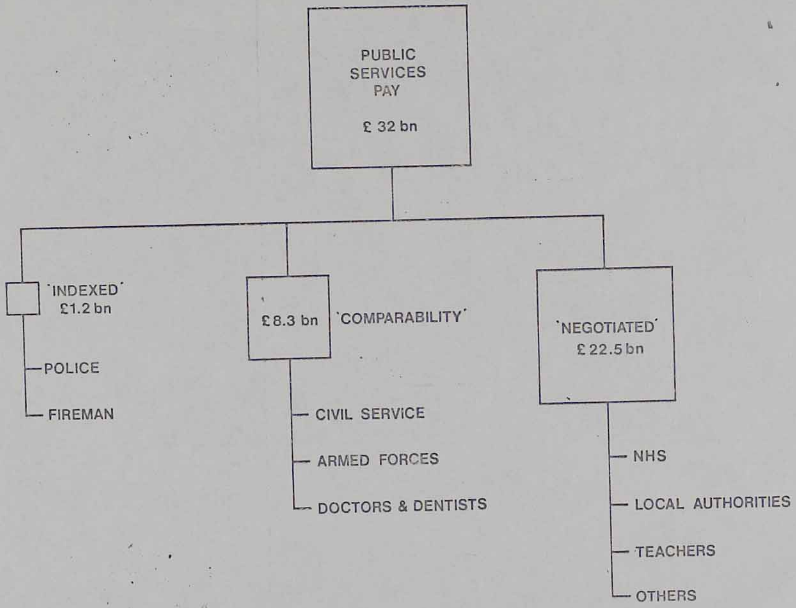


PUBLIC SERVICES PAY
£ 32 bn
'INDEXED'
£1.2 bn
POLICE
FIREMAN
£8.3 bn
'COMPARABILITY'
CIVIL SERVICE
ARMED FORCES
DOCTORS & DENTISTS
'NEGOTIATED'
£22.5 bn
NHS
LOCAL AUTHORITIES
TEACHERS
OTHERS

RANGES FOR GROWTH OF MONEY STOCK (£M3)

	78-79	79-80	80-81	81-82	82-83	83-84
% CHANGE DURING YEAR	—	—	7-11	6-10	5-9	4-8

PUBLIC SECTOR BORROWING - 1978-79 PRICES, £ BILLION

	78-79	79-80	80-81	81-82	82-83	83-84
TOTAL EXPENDITURE	74·0	$74\frac{1}{2}$	$74\frac{1}{2}$	73	71	$70\frac{1}{2}$
TOTAL RECEIPTS	-65·0	-66	$-67\frac{1}{2}$	$-67\frac{1}{2}$	$-69\frac{1}{2}$	-71
IMPLIED FISCAL ADJUSTMENT	—	—	—	—	$2\frac{1}{2}$	$3\frac{1}{2}$
GGBR	9·0	$8\frac{1}{2}$	7	$5\frac{1}{2}$	4	3
PSBR	9·3	8	6	5	$3\frac{1}{2}$	$2\frac{1}{2}$
PSBR AS % OF GDP	$5\frac{1}{2}$	$4\frac{3}{4}$	$3\frac{3}{4}$	3	$2\frac{1}{4}$	$1\frac{1}{2}$

EFFECT OF RELAXING MONETARY POLICY

E.G. FISCAL EXPANSION AND/OR LARGE CUT IN INTEREST RATES;

RAISE MONETARY GROWTH TOWARDS CURRENT GROWTH OF EARNINGS

SHORT TERM REDUCTION IN UNEMPLOYMENT (AFTER LAGS)

BUT

HIGHER INFLATION BUILT INTO ECONOMY WITH DAMAGING CONSEQUENCES

UNEMPLOYMENT BENEFIT TEMPORARY

REDUCTION IN INTEREST RATES TEMPORARY

STATUTORY INCOMES POLICY

—POSSIBLY REDUCE UNEMPLOYMENT AND INFLATION INITIALLY

<u>BUT</u>

—EFFECT ONLY TEMPORARY

EXPLOSION IN 1982/83

RELAX FISCAL POLICY BUT KEEP MONETARY TARGET

E.G. CUT IN NATIONAL INSURANCE SURCHARGE (NIS)

- MAY HELP COMPANIES CASH FLOW
  AND REDUCE COSTS

BUT

- HIGHER INTEREST RATES
- POSSIBLY HIGHER EXCHANGE RATE
- ENCOURAGE HIGHER WAGE SETTLEMENTS

REDUCE EXCHANGE RATE

3 POSSIBLE ROUTES

- INTERVENTION : WILL IT WORK?
  : HOW MUCH WILL BE NEEDED?
  : EFFECT ON MONEY SUPPLY AND INFLATION

- INFLOW CONTROLS (HAVE ALREADY ABOLISHED OUTFLOW CONTROLS)
  : CAN THEY BE MADE TO WORK
  : MEANS LOWER BOND SALES AND HIGHER INTEREST RATES OR LOWER PSBR

- LOWER INTEREST RATES
  : REQUIRES LOWER PSBR IF WANT TO KEEP MONETARY TARGET

<u>BUT</u> . DAMAGES SHORT TERM INFLATION OUTLOOK

NB No formal meeting note.

Econ Pol (Public Sector Pay) Pt 2.

Econ Pol.

PRIME MINISTER

Meeting with the Chancellor: 0900 AM: Thursday 26 June

I have warned the Treasury that you will probably want to go over with the Chancellor the reasons for the high central government expenditure and borrowing recorded for the first two months of this financial year.

The Chancellor is meeting the Governor this evening, and he may want to report on the monetary prospects.

I suggest you also discuss where you hope to get to at E Committee tomorrow morning on public sector pay. John Hoskyns has put in a very useful paper: in particular, he suggests that we ought to have a clear idea of what sort of figure we are aiming at for public sector settlements in the next round. There must be a figure implicit in the medium term financial strategy - that is, assuming we are going to get a resumption of growth in the economy by 1982. I do not know what that figure is. But one thing is certain: the higher the public sector pay out-turn, the higher will be private sector settlements and inflation, and the further off will be the recovery in output. Furthermore, in order to stay within the PSBR projections in the financial strategy, if public sector pay is too high, the volume of expenditure will probably have to be cut further. I say "probably" because more inflation in the economy would mean higher revenue; but revenues would also be held back by the lower level of activity in the economy resulting from a higher rate of inflation.

The Treasury have sent over a copy of their medium term projections, which the Chancellor mentioned to you last week. Although such projections are no better than the assumptions on which they are based, Table 1 - which shows their central projection - is worth looking at. This shows GDP continuing to fall in 1981 and only beginning to recover in 1982; manufacturing output continues to fall in 1982. Unemployment, albeit probably the most difficult variable to project, rises throughout the period to 1983 to a level of 2.1 million. A crucial assumption is that earnings, having risen by 18% in 1980 compared with 1979, will

/rise

rise by 13% in 1981. If we could achieve a lower figure than this, the output prospect would be better because of better competitiveness. It seems to me that we should do everything we can to get earnings below 13% in 1981; but we must not be unrealistic. To aim for too much risks total failure à la Callaghan in 1978.

Finally, it is not just public service settlements we must get down. We must also strive to get nationalised industry settlements down. It is the latter which are more influential in regard to private sector settlements; and we have neither the cash nor the headroom on the RPI to pay for high settlements in the nationalised industries. I realise that achieving this is easier said than done.

One last point. The Chancellor may tell you where he has got to with Mr. Whitelaw on police pay. Mr. Whitelaw has apparently argued vigorously that we must stick to the Edmund-Davies formula - i.e. increase their pay by average earnings which will mean about 22%. The Chancellor has reluctantly agreed. If we are to cut back MPs' pay and top public servants, I wonder if we could not also cut back police pay by say 2½%. If we do not, what is the point of setting an example in the first place?

R.

25 June 1980

mc

Econ Pol.

Caxton House Tothill Street London SW1H 9NA

Telephone Direct Line 01-213 6400

Switchboard 01-213 3000

Martin Hall Esq
HM Treasury
Great George Street
LONDON SW1P 3AG

24 June 1980

Dear Martin,

EARNINGS AND REDUNDANCIES

Thank you for your letter of 18 June about the Chancellor's wish for more work to be done on the relationship between earnings increases and redundancies. We have started on this, in conjunction with Treasury officials. I will let you know of worthwhile results.

I am sending a copy of this letter to Tim Lankester

Yours ever
Richard Dykes
R T B DYKES

EXTRACT FROM "THE ECONOMIST"
JUNE 21 1980

BUSINESS BRIEF

Can the government win?

Over the next year, the prospects for the world economy in general, and for Britain's in particular, look bleak. But from 1982 onwards, Britain's economy should recover. How much so will depend decisively on what happens to wages and industrial competitiveness. The St James's Group's* latest assessment of the four years ahead was carried out

THE ST JAMES'S GROUP FORECAST

at a moment when large question marks again hang over the government's ability to restrain wages.

The group's secretariat has used the treasury's own model of the British economy to test the effect of three different levels of wage settlements over the next four years (see feature). Its "central" forecast is based on the assumption that wages follow the middle road described there.

This main forecast also depends on some important assumptions about government policy:

(a) Public spending falls by less than the government envisages. It drops by 3½% between 1979-80 and 1983-84 (in real terms), while the projections issued with the budget suggest a fall of nearly 5½%. The bigger fall projected by the government looks unobtainable. It depends on targets for nationalised industry borrowing that would require massive price increases and sharp cuts in investment.

(b) As usual, it is assumed that indirect taxes and income tax allowances are raised in line with inflation. But it is also assumed in this central forecast that income tax rates are steadily reduced in line with Tory promises: by 1984-85 the basic rate is 25p. And the employers' surcharge on national insurance contributions is phased out during 1982 and 1983.

(c) The government therefore finds it impossible to reduce its public sector borrowing requirement in line with the forecasts issued with the budget (see table 2). And money supply grows above the path laid down in the government's brand-new medium-term financial plan: in fiscal 1981 sterling M_3 rises 13½% and in fiscal 1982, 15%, when the monetary plan suggests declining ranges of 6-10% and 5-9% for those two years.

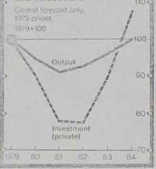
In spite of this relaxation, the recession looks pretty steep. This central forecast places its deepest point towards end-1981. By then, unemployment is approaching 2¾m, real gdp is nearly 7% lower than in late 1979, but inflation has only fallen to just under 14%. Manufacturing output is a disastrous 11½% lower, than in late 1979, and investment 23% down. Since sterling falls only slowly, industry is even less competitive than it was when Mrs Thatcher took office in 1979 (when it was already bad enough). Exporters suffer, and imports make further inroads into domestic markets. Imports of finished manufactures are expected to rise nearly 6%—over a period in which real incomes fall.

This grim portrait of the government's first two years is not so very different from the treasury's own. Both, of course, are darkened by gloom from abroad. Rising oil prices, and the deflationary policies followed by governments trying to prevent a permanent rise in inflation, are likely to dent world growth by about as much as in 1974-75. A rise in oil prices is similar to an indirect tax on consumers and producers, from which the revenues go (mainly) to Opec. In Britain, for example, the recent rise in oil prices has been equivalent to last year's 7% rise in the rate of Vat: it added 3% to prices and reduced gdp by 2-2½%. Britain, of course, is cushioned by North Sea oil: its balance of payments and terms of trade are not damaged by higher oil prices (although manufacturing industry suffers from contracting export markets and sterling's oil-boosted strength). The British government, not Opec, gains most of the higher revenue from higher prices—though only after rather a delay. Meanwhile, government finances suffer from lower gdp growth.

Pain for industry

Manufacturing output and investment

Central forecast only, 1975 prices 1979=100



1: Summary of the central forecast

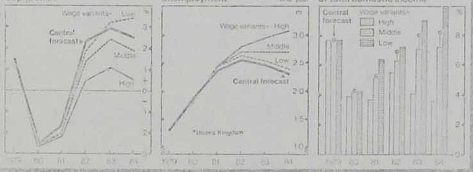
	Annual average 1974-79*	Annual average 1979-84†	1979	1980	1981	1982	1983	1984
Real gdp (annual % increase)	1.7	0.7	1.5	−2.6	−1.7	2.3	2.9	2.5
Retail price index (annual % increase)	15.5	12.3	13.4	18.4	13.8	11.6	8.9	8.7
UK unemployment (as % of labour force)	5.2	9.2	5.3	6.4	9.1	10.4	10.3	9.8
Balance of payments, current account (£ bn, current prices)	−0.9	0.0	−2.4	−1.3	−1.5	−0.8	−1.3	−0.7
Net company, non-oil profits as a percentage of total domestic income	7.5	8.1	7.7	4.2	5.3	6.9	8.0	8.2

*Average for the five year period up to and including 1979. †Average for the five year period up to and including 1984.

How much recovery?

In the three wage variants, PSBR is constrained at the level of government projections. In central forecast, wages are the same as in middle wage variant but PSBR is relaxed.

Gdp growth — Unemployment* end-year — Non-oil profits as % of total domestic income



Wasting Britain's oil years

If wages follow the path we show the picture for Mrs Thatcher, come the next election, is not an unpleasant one—on the surface. (But—see box—that is a very big "if", and probably requires a shift of policy.) Inflation drops into single figures by 1983. Income tax cuts of £3 billion by 1983 allow for a pre-election consumer boom, but the balance of payments on current account stays in modest surplus. Unemployment will by 1984 have been

*The St James's Group is a forecasting club of leading British industrial, commercial and financial companies in both the public and the private sectors, of which *The Economist* is a member. It is run by the Economic Assessment Unit of the Economist Intelligence Unit, which prepares forecasts with the aid of the treasury's own macroeconomic model of the economy, though, of course, making its own independent assumptions about the large number of exogenous variables needed to make forecasts with the model. This article was prepared by the secretariat and does not, of course, necessarily correspond exactly to the views of all members of the group. The secretariat's latest full report on the medium term will be published shortly by the EIU, price £250.

Murray and Howe see wages quite differently

over 2m for three years, so that the public outcry may have died down. Ministers might even be able to claim a slight fall resulting from the consumer boom as a positive credit for their policies. Gdp grows more rapidly in 1982-84 than the average for 1974-79. Even if they have missed their money targets, the PSBR will have nearly been halved, and income tax cut, allowing ministers to claim that they recharged the private sector.

But average output growth for 1979-84 as a whole will have been a miserable 0.7% (see table 1). Worse, manufacturing industry's output will still be lower than in 1979 and the consumer boom will have been largely serviced by imports. Table 3 shows how dependent Britain is becoming on oil to keep its trade figures from total disaster. In 1984, Britain's current account would, excluding oil, be nearly twice as deep in the red as in the nadir of 1975—even in real terms. The five years over which North Sea oil was making its greatest contribution to the economy will have been largely wasted: they will have seen a shrinking, not an expanding, of the industrial base needed to fit Britain for when the oil runs out.

2: The FSBR

	Fiscal years, % of gdp 1979	1980	1981	1982	1983	1984
Government projection*	4¾	3¾	3	2¼	1½	n.a.
St James's Group central forecast	4¾	4	4½	3¾	2¾	1¾

*1980 Financial Statement and Budget Report

3: The trade balance, the exchange rate and competitiveness

Central forecast

	£ billion, current prices: Trade balance	Contribution of North Sea oil	Effective exchange rate†	Sterling/dollar rate†	Relative wholesale prices*, 1975=100
1979	−3.3	+5.5	67.8	2.12	113.1
1980	−2.2	+9.8	70.7	2.19	125.3
1981	−2.4	+13.3	64.4	2.01	121.5
1982	−1.0	+18.6	62.3	1.94	119.8
1983	−1.4	+22.0	60.9	1.89	118.4
1984	−2.6	+24.8	60.4	1.88	119.5

†Average for the year; *defined as the index of UK wholesale prices divided by a weighted average of the indices of competitors' wholesale prices.

4: Tax pressures

Tax changes needed to meet the government's PSBR projections (+=tax increases, −=tax cuts)

	Fiscal years, £ billion (1978-79 prices) 1981-82	1982-83	1983-84
High wage variant	+2	+1½	+1½
Middle variant	+2½	+ ½	−2
Low wage variant	+2	− ½	−3

What's going to happen to wages?

On all the other assumptions built into the St James's Group's central forecast, the treasury model would—left to itself—predict that wages will rise by an average 17% in the 1980-81 pay round, and that wage inflation does not drop into single figures until 1983-84. But in this central forecast it is assumed either—improbably—that monetary policy has a stronger effect on wages earlier, or that because monetary restraint fails to prevent big wage rises, the government finds itself forced to change tack and impose some kind of wage restraint directly—rather than run up to the next election with wage inflation still so very high. The 1980-81 wage round is assumed to be about 15½%, falling to 11% a year for the three rounds from mid-1981. At the end of the forecast period, therefore, this central case actually assumes a rather higher wage round than the model would predict, as income restraint begins to wear off. But Mrs Thatcher must seek re-election before then.

However, if the government does not change course, monetary policy is unlikely to bring wages down so fast. So three variants aim to test the effect of different wage assumptions. They are also used to test the assumption that the government does actually manage to stick to its forecasts for the PSBR, which roughly follows the path shown in the government's projection (see table 2) in all three variants. In:

- The middle variant, wages behave as in the central case. However, since the PSBR falls more sharply, the recession is rather steeper (output falls over 2% in 1981 as well as 1980). Naturally, the government has much less leeway on taxes than in the central forecast, where a bigger PSBR allows tax cuts. In this variant, it actually has to increase them by a total of £3 billion (in 1978-79 prices) in 1981-82 and 1982-83; and can only give back a modest £2 billion in 1983-84. Still, this is better than in:
- The high-wage variant, where it is assumed that wages are completely unaffected by present policies. The wage round to mid-1981 averages 20%, falling only 1% a year thereafter. The recession, again, is very steep; manufacturing output falls even more sharply, because industry is even more uncompetitive: sterling does not fall by enough to compensate for the higher rise in labour costs, though it does drop by more than in the other forecasts, helping to push up prices even more. Inflation never drops near single figures. Profits are squeezed severely. And the struggle to control public borrowing is hideously difficult: taxes have to be raised by a total of £5 billion in 1981-84. Only in:
- The low-wage variant does the government's task begin to look easy. But this assumes wage increases drop to 10% in the 1980-81 pay round, and by 1% a year thereafter (ie, to 7% by 1983-84). Unsurprisingly, inflation is cut by two thirds; manufacturing output recovers well, rising nearly 4% in 1983 and over 5% in 1984; both the balance of payments and sterling are stronger (the pound never falls below $2), and the government can hand out £3½ billion in net tax cuts in 1982-83 and 1983-84. Though unemployment still tops 2.6m by 1982, it falls steadily thereafter.

This last forecast looks wildly over-optimistic. But all of them involve some wishful thinking, in that they assume—as an aid to the government's PSBR aims—that it can actually cut spending by as much it plans to (which, see main text, looks improbable). On the other hand, the St James's Group has found the government's estimates of North Sea oil revenue to be pessimistically low—as other research organisations have also argued. But far less attention has been paid to the treasury's forecast of non-oil revenues.

These, by contrast, appear too optimistic. The government assumes non-oil revenue will rise by £1 billion (again in 1978-79 prices) over the period, whereas the St James's Group forecasts show a drop of £1½ billion—before discretionary tax cuts—because of the fall in output. This £2½ billion difference is roughly equivalent to the extra oil revenue projected in these forecasts compared with the treasury's. So the two differences broadly cancel each other out.

cc Mr Hoskyns

J.F.

For folder for Chancellor mtg for Thursday.

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

20 June 1980

Dear Tim,

We spoke earlier today about the paper on medium term economic prospects which the Treasury has made available to Chief Economic Advisers in a number of Departments. I attach a copy.

Yours ever

John Wiggins

T. P. Lankester Esq

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ECONOMIC PROSPECTS IN THE MEDIUM TERM

I INTRODUCTION AND SUMMARY

This paper considers economic prospects for the period to 1983. The economic projections discussed here are consistent with the Government's Medium Term Financial Strategy (MTFS) as presented in Part II of the Financial Statement and Budget Report (FSBR) 1980-81. The work on these projections was done in March, and some aspects of them may already have changed, though the broad scenario for the medium term still stands.

2. The oulook for growth is poor. Table I shows GDP only exceeding its 1979 level in 1983 (and then by only ½%). However, by the end of the period both wage and price inflation have fallen to around 7½ per cent per annum, growth is faster and unemployment is starting to fall, albeit slowly. Table II compares this outlook with the views of the main outside forecasters.

3. A number of factors account for this poor prospect, but the major one is the level of trade competitiveness. Relative unit labour costs in 1980-83 are expected to be around 40 per cent higher than in 1978. Between 1978 and 1980 domestic labour costs increase by about 32 per cent, compared with an average figure for competitors of 10 per cent (in domestic currencies); this together with a rise in the effective exchange rate of more than 14 per cent over the same period explains the deterioration in competitiveness. In the medium term sterling is kept high by relatively high interest rates and sterling's role as a petro-currency. These factors are sufficient to outweigh the impact of a large cumulative current account deficit over the next four years.

II THE ECONOMIC BACKGROUND

In retrospect, 1979 was a reasonably good year for output, with GDP growing by 1.7 per cent, though half of this could be attributed to the growth of North Sea oil. GDP growth in 1979 was rather above the trend rate that seems to have established itself in recent years. However, there were some worrying features that cast severe doubt on the immediate future for the economy. In particular inflation rose, manufacturing output remained very sluggish, unemployment was moving upwards by the end of the year, and relative labour costs had jumped by 18 per cent. The problem of competitiveness and the UK's position in world markets amplifies what is expected to be a modest recession for the world economy into a major decline for the UK.

2. The rest of this paper deals briefly with the main features of the economic prospect.

WORLD ECONOMY

3. The real world price of oil, defined as the ratio of the world oil price to the price of exports of manufactures, rose by 201 per cent between the end of 1978 and the first quarter of 1980. (This is considerably less than the 366 per cent during 1973.) It is assumed to remain constant at this level thereafter. Industrial production in OECD economies grew by 4½ per cent in 1979 and is forecast to rise by 1 per cent in 1980, and thereafter to grow on average at 3 per cent (which compares with 2¼ per cent for 1973-79).

4. World trade in manufactures (UK weighted) grew by over 6 per cent in 1979 and, despite a slowing down in growth during 1980 and 1981, is expected to remain fairly buoyant. It is projected to grow on average by 5¼ per cent per annum after 1980, which compares reasonably well with the 5½ per cent between 1973 and 1978, although well below the trend of the '60s and early '70s.

MONEY AND BORROWING

5. The projections assume the Government's commitment to a progressive reduction in the growth of the money supply, which is held at the centre of the announced ranges. This is achieved by reducing the PSBR (as a proportion of GDP) and by varying the level of interest rates. Interest rates are shown to fall quite slowly in nominal terms, but to rise fairly

sharply in real terms. The PSBR path shown in Table III (taken from p.19 of the 1980-81 FSBR) is designed to enable nominal interest rates to fall at the same time as the monetary target is achieved.

6. Table III shows an 'implied fiscal adjustment' for the last two financial years. This represents surplus revenue, given the path for the PSBR necessary to achieve the monetary targets. This could be used to cut taxation or increase expenditure; in these projections it was assumed that the fiscal adjustment would be used to cut income tax, as this was felt to be more in keeping with the Government's aim.

7. A further complication is that even if the projection of GDP turns out to be correct the components may be different, and this would have implications for both revenue and expenditure. This possibility has been explored by calculation of two alternative cases, both of which keep GDP fixed at its level in the main projections by varying trade performance. The first case keeps the savings ratio up at its existing level, and this gives a lower yield from indirect taxes. The second has earnings growth declining more slowly (to 11 per cent in 1983) and this increases the relative price of public expenditure and worsens the position of the company sector. Both cases would lead to a fiscal adjustment of £2.0b. in 1982-83 and £1.7b in 1983-84, ie decreases of £0.5b and £1.8b respectively from the main projection. Neither of these variants represents an implausible outcome, and the reduction in the fiscal margin is independent of any impact on GDP. It is, of course, possible that the fiscal adjustment will be higher rather than lower than in the main projections.

PUBLIC EXPENDITURE

8. Exogenous public expenditure is consistent with the White Paper (Cmnd 7841), after allowance for shortfall and allocation of the contingency reserve. Endogenous public expenditure takes account of policy changes announced in the White Paper, eg to real rates of social

ty benefits, but is consistent with the economic developments as projected in this note. The main categories of endogenous public expenditure are debt interest, housing subsidies, social security payments, and public corporations' borrowing. It is assumed that National Insurance contribution rates will be varied in order to achieve a balancing of the fund.

9. The volume of total public expenditure is planned to fall by 4 per cent between 1979-80 and 1983-84.. The bulk of this occurs between 1980-81 and 1982-83, when expenditure falls by nearly 5 per cent in national accounts terms. Further details of public expenditure in cost terms is set out in Table IV, which is reproduced from the 1980-81 FSBR (Table 6, p.17).

TAXATION

10. It is assumed that in each Budget from 1981 onwards personal allowances, tax rate bands, and specific excise duties are revalorised in line with the increase in the RPI over the previous calendar year. The resultant level of revenues is shown in Table V. These are very sensitive to developments in the economy. Particularly important are the level of activity, the rate of inflation, and the components of total final expenditure. In general, revenue projections are more sensitive than expenditure projections to variations in output. Table V also shows the North Sea contribution to Government receipts.

III FORECASTING JUDGEMENTS

PRODUCTIVITY AND PRODUCTIVE POTENTIAL

The underlying growth of productivity in the private sector of the economy (and the nationalised industries) is thought to have fallen quite dramatically during the 1970's, and the extent to which this process is to be continued (or reversed) is extremely uncertain. The view taken in the MTFS projections is set out in Table VI.

TRADE AND OUTPUT

2. When constructing a forecast it is not usual to use the existing import equations unadjusted. The approach in the recent past has been to project a constant linear, rather than exponential, increase in the trend average import propensity, and to place an upper limit on the marginal import propensity. The main doubts about properties of the equations concern the size of the competitiveness elasticities, the cyclical demand-elasticities, the trend, and effects of incentives. These doubts are particularly important for a projection in which competitiveness is at such adverse levels.

3. Even if some of the above doubts are justified, it is felt that the economy should achieve average growth of 1 per cent after 1980. The projections of exports and imports (in Table I) are consistent with this view. Within the totals for exports and and imports there are still some marked adverse trends. In particular the volume of exports of manufactures grows by only 4 per cent between 1979 and 1983, in comparison with 23 per cent for imports of manufactures. Perhaps the most difficult issue in this assessment of economic prospects is to decide whether trade will behave in this way if competitiveness is as projected or whether this and other pressures will themselves generate a different level of competitiveness.

4. The implications of the projections of trade for manufacturing output are shown in Table I. This sector is likely to experience two very bad years; by 1983 output is still almost 5 per cent below its 1979 level.

[PR]ICES AND EARNINGS

5. The projected path for earnings is consistent with the existing equation for earnings from the middle of 1981, but has a lower level before then. The reduction in wage inflation combines with the effect of the exchange rate staying up to give a similar fall in price inflation. However, for those in work real take-home pay survives the recession remarkably well, and is boosted in the later years by the assumed use of the fiscal adjustment to cut direct taxation. A major worry is the outlook for the profitability of the non-oil company sector over the next two years.

6. The rate of price inflation is 18.1 per cent in 1980, but falls sharply thereafter. (There is substantial deceleration of prices during 1980 so that the figure for the year as a whole is consistent with the rate of 16½ per cent between 1979(4) and 1980(4) in the FSBR.)

TABLE I THE MTFS PROJECTION

							ANN[illegible] AVERA[illegible]	
ACTIVITY	1978	1979	1980	1981	1982	1983	1978 -1980	[illegible] -19[illegible]
GROSS DOMESTIC PRODUCT	2.8	1.7	-2.5	-0.5	1.0	2.6	-0.4	1.0
MANUFACTURING OUTPUT	0.4	0.2	-4.5	-2.2	-0.2	2.1	-2.2	-0.3
UNEMPLOYMENT* (%)	5.6	5.3	6.1	7.6	8.5	8.7	5.7	7.7
000's	1376	1304	1475	1839	2050	2104		
PRICES AND COSTS								
AVERAGE EARNINGS	13.7	15.4	18.4	12.8	8.7	7.5	16.9	9.6
RETAIL PRICES	8.3	13.4	18.1	12.3	8.6	7.9	15.7	9.6
REAL TAKE HOME PAY	6.4	2.6	-0.7	-0.0	3.4	1.8	1.9	1.7
BALANCE OF PAYMENTS								
EFFECTIVE EXCHANGE RATE	63.0	67.8	72.0	72.4	71.8	71.1	67.6	71.8
LABOUR COST COMPETITIVENESS	94.4	111.7	126.5	133.0	132.9	132.7	110.9	131.3
CURRENT BALANCE (£B)	0.9	-2.4	-2.7	-1.0	-1.3	-2.5	-1.4	-1.6
PSBR AND FINANCIAL FORECAST	1978/9	1979/80	1980/1	1981/2	1982/3	1983/4	1978/9 -1980/1	1980/1 -1983/4
(FINANCIAL YEARS)								
PSBR (£B)	9.3	9.1	8.5	7.4	6.3	4.6	9.0	6.7
PSBR AS % OF GDP (MARKET PRICES)	5.6	4.8	3.7	2.9	2.3	1.5	4.7	2.6
£M3 (% CHANGE THROUGH YEAR)	11.6	12.0	9.4	8.0	7.0	6.0	10.7	7.0
L. A. 3-MONTH INTEREST RATE	10.7	14.9	14.0	9.2	9.0	8.5	13.2	10.2
20 YEAR GILT RATE	12.9	13.3	12.7	10.6	10.1	9.5	13.0	10.7

*Unemployment excluding school leavers

TABLE I THE MTFS PROJECTION (Contd.)

	1978	1979	1980	1981	1982	1983	ANNUAL AVERAGE 1978-1980	ANNUAL AVERAGE 1980-1983
DEMAND AND OUTPUT								
CONSUMERS' EXPENDITURE	5.5	4.1	0.9	0.4	1.4	2.4	2.5	1.4
PUBLIC CONSUMPTION	1.9	1.1	-0.1	0.3	0.5	0.8	0.5	0.5
GROSS FIXED INVESTMENT	1.5	-3.0	-2.3	-4.4	1.6	4.9	-2.7	0.6
CHANGE IN STOCKS (% OF GDP)	0.9	1.4	-0.4	-0.4	-0.0	0.4	-0.7	0.3
TOTAL EXPORTS (G + S)	1.9	2.0	0.5	0.2	2.1	3.7	1.2	2.0
TOTAL IMPORTS (G + S)	3.7	11.0	2.2	0.1	3.5	4.2	6.5	2.6
GROSS DOMESTIC PRODUCT	2.8	1.7	-2.5	-0.5	1.0	2.6	-0.4	1.0
MEMORANDUM ITEMS								
WORLD TRADE IN MANUFACTURES	4.7	6.2	4.6	3.9	5.7	6.4	5.4	5.3
REAL NATIONAL DISPOSABLE INCOME	4.7	2.4	-1.7	0.5	1.4	2.4	0.3	1.4
REAL PERSONAL DISPOSABLE INCOME	6.9	5.7	-0.8	-2.7	1.4	2.2	2.4	0.3
SAVINGS RATIO	15.1	16.5	14.9	12.2	12.2	12.1	15.5	12.9

TABLE II : CURRENT UK MEDIUM TERM PROJECTIONS

		1980	1981	1982	1983	AVERAGE 1979-83
GDP	LBS (a)	-1.7	0.4	2.4	2.5	0.9
	(b)	-3.0*	0.3*	2.0*	1.5*	0.2*
	P&D (a)	-1.9	-0.1	1.5	0.6	0.0
	(b)	-2.3	0.3	-	-	-
	NIESR	-1.1	0.6	-	-	-
	CEISS	-3.4	0.1	0.1	2.7	-0.1
	CEPG	-6.7	-3.6	-1.3	0.0	-2.8
	MTFS	-2.5	-0.5	1.0	2.6	0.2
INFLATION (Consumer Expenditure Deflator)	LBS (a)	17.7	14.1	9.0	7.7	12.1
	P&D (a)	18.4	14.0	13.3	12.8	14.6
	(b)	18.7	15.4	-	-	-
	NIESR	17.2	14.9	-	-	-
	CEISS	18.6	10.9	9.4	6.5	11.4
	CEPG	19.1	12.6	10.9	9.8	13.1
	MTFS	18.0	12.5	8.5	7.6	11.7

≠LBS - London Business School ((a) February 1980, (b) March 1980)

≠P&D - Phillips & Drew ((a) February 1980, (b) March 1980)

NIESR - National Institute (May 1980)

CEISS - Cambridge Econometrics (March 1980)

CEPG - Cambridge Economic Policy Group (April 1980)

* Figures for financial rather than calendar year.

≠ For both LBS and P&D (a) represents the last full published forecast and (b) represents a forecast that is consistent with the MTFS assumptions on fiscal policy, and was presented as evidence to the Treasury Committee.

TABLE III

PUBLIC SECTOR BORROWING

1978-79 Prices (£ billion)

	1978-79	1979-80	1980-81	1981-82	1982-83	1983-84
Total expenditure	74.0	74½	74½	73	71	70½
Total receipts	-65.0	-66	-67½	-67½	-69½	-71
Implied fiscal adjustment	-	-	-	-	2½	3½
General Government Borrowing Requirement (GGBR)	9.0	8½	7	5½	4	3
PSBR[1]	9.3	8	6	5	3½	2½
(as percentage of GDP at market prices)	5½	4¾	3¾	3	2¼	1½

(1) The difference between the GGBR and the PSBR-public corporation borrowing from the private sector and overseas-is consistent with Table 14 of the 1980-81 FSBR for 1979-80 and 1980-81, and with Cmnd 7841, Table 1.1, line 9 for subsequent years.

TABLE IV

GENERAL GOVERNMENT EXPENDITURE

(£ billi[illegible])

	1978-79	1979-80	1980-81	1981-82	1982-83	1983-8[illegible]
General government expenditure at 1979 survey prices (1)	68.1	71	70	68½	67½	67½
At 1978-79 prices						
General government expenditure in cost terms (2)	64.6	66½	66	64½	63	63
Special sales of assets (3)	-	-1	-½	-	-	-
Shortfall (4)	-	-¾	-½	-¾	-¾	-¾
Interest payments (5)	7.6	8	8	7½	7½	7
National accounts adjustment (6)	1.8	1½	1½	1½	1½	1½
Total expenditure in national accounts terms (7)	74.0	74½	74½	73	71	70½

(1) Expenditure on programmes by central government and local authorities and the contingency reserve. See Cmnd 7841, Table 1.1 lines 1,2 and 5. Debt interest payments are shown separately below. Since most plans are not decided in detail yet for the years after 1980-81 broad assumptions have been made about the share of general government in the total of expenditure on programmes shown in Cmnd. 7841, Table 1.1 for 1981-82 to 1983-84. For convenience, the whole of the contingency reserve is allocated to general government in all years in this table.

(2) Line 1 revalued to 1978-79 prices in cost terms ie.including the relative price effect. For each category of public expenditure its relative prices is the ratio of its deflator to the deflator for GDP at market prices. The figure for 1978-79 is equal to the sume of the lines for central government and local authorities in Cmnd 7841, Table 5.3.

(3) Cmnd, 7841, Table 1.1, line 10, revalued to 1978-79 prices. For 1979-80 includes revenue offsets to planned expenditure and a small element attributable to public corporations.

(4) Cmnd, 7841, Table 1.1, line 12 revalued to 1978-79 prices with certain adjustments in respect of public corporations. Includes the net effect of different economic assumptions from those used in Cmnd 7841.

(5) For 1978-79 as in Financial Statistics, March 1980.

(6) Adjustment to convert line 2 to the definitions used in national accounts statistics. For 1978-79 includes residual measurement differences.

(7) For 1978-79 equal to line 4 of Financial Statistics, March 1980, Table 2.4. This base year is chosen because it is the latest complete year for which outturn figures, and full details of relative prices, are available.

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TABLE V

GENERAL GOVERNMENT RECEIPTS

	1978-79	1979-80	1980-81	1981-82	1982-83	1983-84
General Government Receipts at 1978-79 prices* (£ billion)						
Taxes on income expenditure and capital	48.3	52	52½	52	54	55½
of which NS revenues	0.7	2	3	3½	5	5
National Insurance, etc.	10.2	10	10	10½	10½	10½
Interest and other receipts	6.5	4	5	5	5	5
Total Receipts	65.0	66	67½	67½	69½	71

*Converted to 1978-79 prices by using the deflator for GDP at market prices, so that these projections are directly comparable with the expenditure projections in Table III.

TABLE VI

PRODUCTIVE POTENTIAL

	1978	1979	1980	1981	1982	1983
(1) Trend productivity growth (% pa) (adjusted for cyclical effects)						
(i) Manufacturing	1.5	1.5	1.7	1.6	1.6	1.5
(ii) Private non-manufacturing	1.0	1.0	1.2	0.7	0.7	0.9
(iii) Total (excl. N.Sea oil)	1.0	1.0	1.2	0.9	0.9	1.0
(2) Labour Force	0.4	0.2	0.3	0.5	0.7	0.8
(3) North Sea Oil contribution	0.7	0.9	0.1	0.6	0.4	0.2
(4) Productive Potential (1(iii) +2 +3)	2.1	2.1	1.6	2.0	2.0	2.0

Econ Pol

NOTE FOR THE RECORD

I have recorded separately the results of the discussion which the Prime Minister had with the Chancellor this afternoon about the British Council budget and the composite rate paid by the building societies.

Other points which came up were:

I The Chancellor said that the Treasury were circulating a note on the medium term prospect to Chief Economic Advisers in other main departments - to enable them to brief their Ministers for the July 3rd Cabinet. The Prime Minister said she had no objection but she would like to see a copy of the note herself.

II Referring to Sir Robert Armstrong's recent letter to Sir Douglas Wass about the handling of the July 3rd Cabinet, the Chancellor said that he would like to circulate a paper to colleagues. If he did not, colleagues would criticise him for not giving them a sufficient opportunity to consider the issues. The Prime Minister agreed.

III The Chancellor said that he was having second thoughts about the "Pliatzky exercise" i.e. the study being carried out on the proposal to give away shares on the British Colombia model. He had come to the view that the Government could not afford the loss of funds which it would involve and it would distract attention from other issues. The Prime Minister said that Ministers would have to consider the issue properly when the Pliatzky Report was ready.

20 June 1980

TL

PRIME MINISTER

MEETING WITH THE CHANCELLOR, 1230 PM FRIDAY 20 JUNE

This is your weekly meeting, which had to be postponed.

The Chancellor wishes to raise the following:

I Money supply and public expenditure

He has already warned you that the CGBR for the first quarter is likely to be very large. He also mentioned that Mr. Pym has put in for an increase in the defence cash limit. (This is not strictly true: Mr. Pym's minute at Flag A says that defence spending will not go up in real terms by 3% "unless there is an increase in the cash limit". But the implication is pretty clear.)

II Composite rate for the building societies

The Chancellor has minuted you at Flag B. A decision is apparently required before you go to Venice on a new composite rate. Under existing law, the rate ought to be increased from 21% to about 24% - because the average tax liability of building society investors has increased since the rate was last set four years ago. But an increase of this magnitude would almost certainly result in the building societies either putting up the mortgage rate or having to offer investors a lower interest rate. The Chancellor is proposing that the composite rate should only go up to 22½% this year, but this will require legislation which needs to be introduced on Monday. (It seems extraordinary that we have not been given more notice of this.)

III Handling of economic strategy discussion in Cabinet on 3 July

Robert Armstrong has written to Douglas Wass about this (Flag C); the Chancellor wants to discuss further.

TL.

19 June 1980

CONFIDENTIAL

19 June 1980

PRIME MINISTER

THE PAY ROUND DEBATE

I attach a paper suggesting an approach to the Pay Round Debate. It is rather long, because the problem it addresses is not trivial. It is weekend reading, with no critical deadline. We probably need to discuss by the end of this month or early July.

1. We cannot launch this Debate until we are sure where it is meant to take us. We can't determine that without a stocktake on where we have got to on the three main strands of our strategy - trade union reform, monetary policy, public expenditure and public sector pay. These things are all interlinked. We have not got far with the trade unions. Our position on public sector pay is only starting to become clear as a result of recent meetings.

2. Experience of past Governments suggests a tendency to drift into what the historians later recognise as the crucial period with little or no idea of what they are doing. We are now moving into what could be the first, and critical, six months of a make-or-break year. The thinking must be done before the uproar begins. This period could be our last chance to get public sector pay under control, and thus public expenditure, and thus the whole climate for private sector pay settlements, and thus inflation and the level of unemployment and bankruptcies.

3. The present potential confusion includes such things as getting off on the wrong foot with Boyle; dethroning comparability in such a way that we get maximum disruption in the public sector; colleagues not understanding the implications of the Medium-Term Financial Strategy; uncertainty about where to pitch cash limits in the context of that strategy; the difficulty of talking publicly about pay, without implying a norm; determining how we should treat trade union leaders over the coming months.

4. When we have discussed this, a shorter version, perhaps leaving out sections 4 and 5.7, could be used to brief colleagues. I am copying this note and the paper to Geoffrey, Keith and Angus, but to no-one else at this stage.

JOHN HOSKYNS

CONFIDENTIAL

19 June 1980

Policy Unit

THE PAY ROUND DEBATE: PROBLEMS, OBJECTIVES, RISKS, STRATEGY

1. INTRODUCTION

1.1 The Pay Round Debate is really about getting the right relationship between pay settlements in the economy as a whole and the monetary targets in the Medium-Term Financial Strategy (via cash limits in the Public Sector). The Debate will have to be renewed and sustained for each pay round throughout the four-year "Transition Phase" from today's high inflation to 1984's Stable State. This is because, throughout this Transition, the economy as a whole will be pressing for more new bank notes each year than the Government is prepared to provide. The process of Transition is utterly different from Stable State, posing different problems which require different solutions.

1.2 We must know what we're trying to do

1.2.1 We are now at the point where things can start to go very much worse or rather better, depending on how well we have thought through what we are trying to do, and on how skilfully we do it. We will inevitably face an internal and external crisis of belief as people ask, "Will the Thatcher experiment work? Is monetarism the answer?" etc. Because there is great pressure on Government to lose its nerve, there is a similar danger that we press on blindly, refusing to consider whether any parts of the strategy might be wrong. As the pressure mounts, blind faith can take over, with minimal internal discussion - and thus minimal internal understanding - for fear that such discussion will provoke disagreement.

1.2.2 We can't start one part of the exercise while we are still confused on other parts. We cannot launch the Debate itself until we are quite clear what the Debate is intended to achieve. But we can't decide what the Debate is meant to achieve until we are similarly clear about our policies in the Public Sector; in particular, the head-on collision between comparability and cash limits, and the extent to which we are prepared to allow nationalised industries - ostensibly operating at arm's length - to pass on high pay increases to their customers, where monopoly power allows.

1.2.3 At present, we are still in the process of working out a strategy which integrates these different parts of the problem. If we start making speeches etc before that strategy is developed, we will find ourselves doing what all Governments do when they either haven't understood the problem or haven't worked out the detailed programme for solving it. They resort to an appeal to the public to deliver, almost as an act of charity, altered behaviour which is not really a rational response to Government's policies or messages.

1.2.4 There has been some internal discussion about the need for increased contact with trade union leaders. Ideas have ranged from invitations to working lunches with the Prime Minister to more formal discussions on how Government and unions can work together, within the framework of Government economic policy, to speed the recovery of areas most hard-hit by redundancies (ie local enterprise agencies, enterprise zone thinking, with unions, big business, local authorities working to increase job mobility, speed the start up of new enterprises etc). We should take no action on any of these ideas until we are clear what the Pay Round Debate is meant for; otherwise we could make a first move with union leaders which turns out to be incompatible with the rest of our strategy.

1.3 The purpose of this paper

1.3.1 Although there is no question of the Government going down the familiar route of political negotiation with the TUC, the Pay Round Debate is nevertheless a kind of negotiation. The Government is negotiating with the trade union leaders for public opinion. The prize to be won is public opinion, including trade union membership opinion. As with any other negotiation (like British Leyland) we are unlikely to win it unless we go into it with clear objectives, a clear sticking point and, if possible, a strategy which positions us at a "point of indifference"; that is, a point at which we have a strong chance of winning the prize, almost regardless of the strategy our negotiating opponents adopt. That is not always possible, but we believe that in this case such a point of indifference can be found.

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1.3.2 The structure of the paper is as follows:

SECTION 2	WHAT IS THE PROBLEM?
SECTION 3	WHAT ARE OUR OBJECTIVES?
SECTION 4	WHAT ARE THE RISKS?
SECTION 5	A POSSIBLE APPROACH
SECTION 6	TIMING
SECTION 7	ACTION

2. WHAT IS THE PROBLEM?

2.1 Set the problem in the context of Government strategy

2.1.1 The Government is committed to reducing inflation to about 5% by 1984. This involves a Transition Phase of 4 years in which monetary growth decelerates (in line with the Medium-Term Financial Strategy - MTFS) to Stable State from which recovery starts.

2.1.2 The way the Transition Phase goes will affect the chances and speed of subsequent recovery. If the monetary deceleration is borne primarily by the Public Sector, the Private Sector will be set to recover. If it is not, not. If the Public Sector bears its share, there could be demonstrable signs of recovery by the 1984 election. Otherwise, recovery could be very difficult even during 1985-89. At present, the signs are that the burden is being borne by the Private Sector.

2.1.3 The Government's position is that there will be no change of policy, whatever the pressure from trade unions or employers, because this would mean the abandonment of the battle against inflation and for the recovery of the Private Sector. There will therefore be no relaxing of monetary controls; no easing of pressure on the PSBR and public spending; no statutory incomes policy or freeze; no political bargaining with the trade unions in return for "restraint".

2.2 The trade union response

2.2.1 As with previous Governments grappling with similar problems, the response of the trade unions tends to make difficult problems almost insoluble. In the Public Sector, the unions operate in many cases from a position of monopoly power, often with the ability to do great damage. The comparability system is backward-looking and compares with those who survive in Private Sector employment, not with those on the dole, and is therefore inherently de-stabilising; it keeps in check the militants who want to use all-out disruption, but is itself inconsistent with cash limits and thus with the MTFS.

2.2.2 In the Private Sector, the variety of enterprises and industries and the presence of competitive pressures increases the chance of realism on the shop floor and consequent revolt of trade union members. However, the time lags are such that this can often happen (as with British Leyland and Chrysler) when the enterprise is already past the point of no return. Free market economists, most of whom have no first hand experience of commercial management, may be right when they say that liquidation does not destroy assets. But it can destroy the enormous non-balance-sheet investment in any enterprise - investment in planning, product and market strategy, management systems, corporate ethos and esprit de corps - in short, as McKinsey's put it, "the way we do things round here". It takes 5-10 years to get a new company off the ground; 5-10 years to turn a big "sleeper" into a "thruster"; most Governments scarcely get into their stride at all in terms of managerial and political competence, in the all-too-brief 5 years allowed to them.

2.2.3 Trade union leaders will spend the summer preparing extravagant demands for the next pay round, designed - knowingly or not - to create the maximum unnecessary unemployment and lost production. Some of them will be doing so with the deliberate intention of thwarting or even bringing down the Government; others because they dare not appear less militant than their militants; and all will be caught in the dilemma we described in our Strategy Paper of 12 June 1979: ". . . trade unions trying to pre-empt each other's attempts to anticipate the future inflation rate". This dilemma traps the most moderate and sensible leaders.

2.3 "The fear of Norms"

2.3.1 One difficulty, which can reach the point of absurdity, is the fear of setting a norm. The minutes of E Committee, 9 July 1979: "In further discussion, it was generally agreed that the Government should not set a 'Pay Norm' in the next round, nor should it allow a de facto 'norm' to emerge. It would not be easy to set cash limits in a way which would avoid this, but the effort would have to be made."

2.3.2 In the past, the problem has been that if we talk about a single percentage figure which we regard as a desirable outturn; we appear to be appealing to people to settle at that figure. Since no-one is then prepared to settle for less, the question is how many people will settle for more? Provided we concentrate on explanation rather than exhortation, we can display the likely results of different outturns. Then we are not appealing to anybody to do anything, which is futile anyway. We are simply ensuring that they know what aggregate outcomes will produce what results.

2.3.3 However, Ministers are still going to be asked what they think would be a desirable outturn. This raises further worries. If we mention an outturn figure, are we in effect revealing a cash limit? Do we dare reveal cash limits, for fear that they look inconsistent with the monetary targets in the MTFS? And even if they don't, is the announcement of a cash limit tantamount to announcing a norm for the Public Sector? Whether it is or it isn't, what are we, the Government, intending to do to ensure that the Public Sector, which is ostensibly under Government's control, delivers the level of pay increase which, it becomes increasingly clear, the Government would really like to see? How can Government do anything of the kind, if it is in the hands of comparability and other outside bodies? Remember that this is all peculiar to the problem of Transition, the problem of rapid deceleration in the rate of increase. It has nothing to do with the pros and cons of having outside bodies advising on pay levels in the Public Sector, when there is a stable currency. It was presumably these kinds of questions which not unnaturally provoked resistance to the idea of published monetary targets - the reluctance to say publicly that you are going to do something which may turn out to be painful - or even impossible. But once those targets are published, everything else must follow consistently and coherently from them.

2.4 The "crisis of belief"

2.4.1 All these aspects of the situation - the uncomfortable implications of published monetary targets, the possibility that Public Sector unions will force the burden of deceleration onto the Private Sector, whose unions will in turn respond by destroying that Sector - all these produce great uncertainty and anxiety, a crisis of belief which has to be resolved both internally and then externally. Can the Government win through, no matter what happens, provided it has the necessary determination? Could the resulting economic damage be such that the "winning through" turns out to be losing after all? Could the unions make the consequences of Government policy so damaging that the Government is forced to change course? Is the Government sticking to its course because it knows what it's doing - or because it doesn't know what it's doing?

2.4.2 These questions have to be answered internally, before Ministers can work as an effective team in winning the Debate. They then have to be answered, and convincingly, externally because building up public confidence that the Government has thought its strategy through is itself a key component in winning with that strategy.

3. WHAT ARE OUR OBJECTIVES?

3.1 This is what we MUST achieve

3.1.1 It is not possible to predict how the pay round will go, and thus how much unemployment and delay to our anti-inflation policy there will be. The essential objective of the Debate, therefore, is to establish in the minds of the public, whatever happens, the criteria by which they judge the actions of Government, employers and trade union leaders. In particular, trade union members and the public must see that the Government is sticking to the programme it always said it would carry out, in order to reduce inflation; and that it is the trade unions who bear the main responsibility for excessive unemployment.

3.1.2 Establishing these criteria is vital. It is no good our setting the economy on the right path doing all these tough and unpopular things - getting energy prices onto a sensible basis, cutting public spending, winding down the money supply - if we get no thanks for the eventual success and all the blame for the accompanying discomfort.

3.2 This is what we WANT to achieve

3.2.1 It would be better still if, when the union leaders and militants issue their call to arms after the summer conferences, trade union members ignore the call, shout them down, demand ballots, and insist on the right to work.

3.2.2 The process by which trade union leaders settle for less than the going rate of inflation must, in the end, be the revolt of their own members when faced with job losses. That is why we have to escalate the debate, not damp it down, so that the revolt happens before it is too late.

3.3 The best result of all

3.3.1 The best result would be to win the public debate so convincingly that trade union leaders themselves were sufficiently nervous (in the case of the militant leaders) or sufficiently brave (in the case of the moderates) to advocate claims at below the going rate for inflation; ie to impose informal, responsible restraint.

3.4 Constraints

3.4.1 The most important constraint is that we should conduct the debate in such a way that we create empathy with trade union members. We must demolish the arguments of trade union leaders without appearing to insult union members by suggesting that they have stupid leaders. We have to criticise the actions of trade unions, but without creating a sense of grievance.

4. WHAT ARE THE RISKS?

4.1 Which risks do we have to take, which risks can we reduce?

4.1.1 The Pay Debate is so important because:

(a) we are not proposing to take the route of incomes policy or freeze;

(b) there will be increasing speculation about whether we will nevertheless be forced to do so.

Unequivocal rejection of that route is a precondition for achieving our objectives, but it is not sufficient on its own.

4.1.2 The incomes policy route tends to be supported by those who, at heart, do not really believe it is possible to reduce trade union power. They therefore take the view that incomes policy, however paralysing to the economy, is the only option and has to be a permanent feature. Since the Government is committed to trade union reform and already embarked on it, with the explicit purpose of freeing-up the labour market and thus the whole economy, any shift in our position on the one, might suggest a weakening of our position on the other. The two therefore have to go together. The more convinced trade union leaders, their members and public opinion become that we are committed to the "no incomes policy" route, the quicker attitudes and behaviour will change, and thus vindicate that choice of route. There is, however, one proviso. Our motives must be understood and supported. If we are seen to be determined to cure inflation for the country's good, then we are less open to criticism that we are obstinately pursuing policies "regardless of cost". But if anything we do suggests that we are simply trying to assert Government's authority for its own sake, or to teach the trade unions a lesson once and for all etc, public support could disappear.

4.1.3 Notwithstanding all this, determination and strong nerves are not enough. We need some <u>risk analysis</u> before we start, to see how and where we can take out some insurance. To what extent can the powerful unions win pay awards which do <u>not</u> put their own members out of work, but <u>do</u> bankrupt other firms and put <u>other</u> workers on the dole? Is it possible that powerful unions could persuade their members to cause so much damage (whether to themselves or to others) that the Government would, after a prolonged struggle, be forced to change course? Is the Government prepared to stick to its policies quite literally regardless of the consequences? To what extent is the route we are taking a gamble which, depending on whether we have judged it right, we may completely win or utterly lose? Or is it simply a matter of proper procedure, in which the Government is the inevitable winner, provided it does not lose its nerve? What does "winning" mean? At what cost in unemployment and bankruptcies does a victory for "will" begin to look like economic or political defeat? These are not the questions of the faint-hearted. They are the questions that the boldest military commander or businessman has to ask himself at the outset of any campaign. Already the sounds of protest can be heard from the constituencies. The time to do the risk analysis is now, before the uproar begins.

4.1.4 Once we have answered these questions, we can see whether it is necessary or possible to take out any insurance - that is, to develop a new strategy. And we can also then judge whether such a new position could be worked out without that itself prejudicing our chances.

4.1.5 We believe that the Government is not bound to succeed. It has a good chance of success, provided it commits itself publicly to the "high road" and conducts the debate with skill. But it will be a gamble. The reason for this is simple. Before monetary deceleration is to work properly, trade union power has to be reduced and brought into line with its equivalent in other countries. It is, after all, only the existence of the trade unions, with their present powers and attitudes, that makes the whole financial strategy so hard to pursue. The un-unionised part of the private sector has not the same power to perpetuate inflation or create massive unemployment, because the labour market there works, however imperfectly. The bargaining balance has not been changed sufficiently, as yet, for that to happen in the unionised part of the economy, and especially in the Public Sector. In addition to this, we know that we have scarcely started in the Public Sector, where quite apart from the real reduction in public spending, set out in the White Paper, there is an additional, and quite different (and still perhaps not fully understood) need to de-index. Some £19bn out of the public expenditure total of £74bn relates to social security. That £19bn is therefore politically difficult to de-index. The total bill to the Government for its full indexation during 1981-82 will presumably be about £2.8bn (assuming a forward-looking inflation rate of 15%). Of this, only £300m can be taken off by way of de-indexation and other measures. So the need to de-index public sector pay is that much more pressing. Recent discussions at E have shown how difficult that will be.

4.1.6 We can summarise the position, therefore, as follows. There are three main legs to our strategy: monetary deceleration, reducing trade union bargaining power, getting control of public sector pay. At present we are being too tough on Private Sector employers, because we have not yet made enough progress in the other areas. The strategy is thus extremely fragile, resting on <u>monetary deceleration alone</u>; with the main burden of that deceleration falling on the <u>Private Sector</u>; within that sector primarily on <u>employers</u>; amongst Private Sector employers primarily (due to the MLR and exchange rate) on <u>fast-growing</u> (ie cash-hungry) and <u>exporting</u> companies - those on which everything will depend from 1984 onwards.

4.1.7 If we can't move faster on the unions and Public Sector pay, we may be forced to move slower on monetary deceleration. But that would jeopardise the Medium-Term Financial Strategy and everything that flows from it, through to the next election. The question, therefore, is whether we can develop a different position to which we can move if the present strategy is not sustainable; and whether that position could provide a <u>springboard</u> from which we could actually "change gear" and move faster on all three legs of the strategy. We believe that this may be possible.

4.2 We need to prepare a "NEW-WIN" position

4.2.1 We are not saying that it is impossible to take the "high road" - that is, sticking resolutely to our present course and taking no notice of pressure from unions, employers, the City, constituencies, other institutions - and succeeding. The more committed we are to that course, the more quickly all those parties will concentrate on solving the problem amongst themselves rather than pressing us to make the problem go away. But we do suggest that we have not yet created the other conditions - trade union law and public expenditure - for ensuring success. The risks are therefore considerable.

4.2.2 We recommend that work is put in hand to develop a NEW-WIN position (section 5.7 below suggests what this position might comprise). The purpose of the NEW-WIN position would be to allow us to move much faster than we have yet considered to be politically possible, in bringing about the very conditions which we needed for success in the first place. In short:

> The problem itself must be deliberately turned into a new and better political opportunity to cure the causes of the problem.

Such a package, properly prepared, would put the Government in a "position of indifference". Either the trade unions begin to accommodate their demands to the MTFS, in which case the whole tangle of problems begins to unravel; or they do not, and we deliberately use the resulting "crisis" to make faster, not slower, progress.

5. CONDUCT OF THE DEBATE

5.1 We have to conduct the debate in such a way that, if it is not directly successful in altering trade union behaviour, it prepares public opinion for more drastic measures as part of the NEW-WIN plan. The Debate itself is an exercise in selling; a mixture of education, persuasion, empathy - and the "fear of something worse". It is not an exercise in exhortation, a matter of pleading with the trade unions or the public to behave in ways which do not appear to them to be rational.

5.2 The approach

5.2.1 The British instinct - to avoid unpleasantness at all costs - is completely wrong in this situation. We cannot get fundamental change by such subtle means that nobody is aware that it has happened! The rule, therefore, is, "When in doubt, escalate the Debate". It is not, "When in doubt, run for cover". Escalation means getting control of the Debate, taking the initiative, injecting new information into the discussion, being positive, resourceful, optimistc.

5.2.2 In particular, escalation means that we should not meet vilification by union leaders with our customary gentlemanly silence. The more trade union leaders escalate their side of the Debate - accusing Government of attacking working people, deliberately destroying British industry and the union movement etc - and the further they go in tabling absurd wage demands, the greater the <u>opportunity</u> for us to escalate the Debate in response. But our escalation should be of a different type. Theirs, as we are already seeing, consists of increasingly hysterical assertion, accusation, even smear; we have to respond to that in a completely different language, the language of intellectual clarity and honesty. It is for the public, helped by the media, to decide which "language" is more reliable and more relevant to the country's problems. But if we fail to respond to vilification, all that will happen is that the mud will stick, the Government will appear unable to defend itself, and the public will eventually begin to wonder whether there is something in what the union leaders say.

5.2.3 We must encourage the maximum dissension within the union movement: between moderate and militant union leaders and officials; between Public Sector and Private Sector unions.

5.2.4 Attitudes will not change unless we explain and educate. We cannot do that unless we are able to tell the truth, the whole truth and nothing but the truth. Anything less, and it's the old political claptrap, with no-one listening. We are asking people to behave differently. We therefore have to answer the question: "Why should I?", and avoid the response, "We've heard it all before".

5.2.5 For example, if we are to explain our monetary policies, then we should be ready to admit that we were largely responsible for the inflation of 1974 and 1975, which followed our monetary expansion in 1972 and 1973. Similarly, we should be able to use Healey's monetary contraction following 1976 in the same way. We can show how moderate pay demands helped that process but also how, because those demands were imposed in a rigid and egalitarian way, its eventual breakdown was inevitable. There is nothing to be ashamed of among adults (ie the public) in admitting error and conceding some points to your opponents.

5.2.6 If the reader believes that it would be "politically embarrassing" to be so candid, he is making the age-old mistake of preparing to conduct the debate within the conventions of Westminster. Those conventions recognise that the whole truth can never be told; that each side knows that the other side is talking "newspeak"; that there is no serious hope or intention of changing attitudes anywhere in the House. The Westminster debating conventions have little to do with solving problems in the real world. This is why political sermonising - so often shaped within those conventions - appears so fatuous to the public audience. The surest way to make opponents and the public listen is to admit that we have made mistakes too (there is no shame in referring to the monetary expansion of 1972 and 1973 - we were not "all monetarists" then) and to show that we understand their point of view and in particular the dilemma in which moderate and responsible trade unionists and trade union leaders find themselves.

5.2.7 This straight-talking approach is essential if we are to establish clearly in the minds of trade union members and officials that Government success in this Debate is not equivalent to trade union defeat. Government success is simply a victory for common sense and understanding on all sides.

5.3 The basic propositions

5.3.1 There are four propositions which we have to put across in speeches, and in our responses to events and to trade union leaders' statements:

(1) We have to define quite clearly what we mean by a U-turn; and then make it plain that there is no question of our making such a U-turn. The belief that Government will eventually lose its nerve dies hard. We understand from someone in BSC,

for example, that it was not until 25 February, 8 weeks after the steel strike started, that the ISTC and the media finally realised that the Government meant what it said and was not going to intervene; that the negotiations were indeed between BSC and the unions.

(2) We have to explain how only Government can, in the end, bring inflation down; why reduced public spending is essential if the cost of bringing inflation down is not to fall entirely on employers and workers in the Private Sector.

(3) We have to explain that Government cannot create real jobs. Trade unions and employers can, between them, create real jobs or destroy real jobs. We have to describe the process by which excessive wage demands and management concessions, and the side effects of major strikes (eg engineers, road haulage, steel) have to be paid for, in the steady toll of small and even quite large and once-successful companies.

(4) We have to tie all these strands together to show that there is no option but for Government to concentrate all its will and all its skill on bringing inflation down, while employers and unions concentrate on the survival of business, the creation of jobs and the increased productivity from which rising living standards can eventually flow.

5.3.2 Just to read such a list is enough to send most people to sleep. It has all been said so often, and so boringly, already. This is why we have to escalate the debate, disarm our audience with some plain speaking, and be ready to let a few sparks fly, if trade union leaders want to mix it. And it means considerable effort to develop messages which are not just the old cliches and platitudes.

5.4 Relate our messages to events

5.4.1 As we learned during the steel strike, speeches made in a vacuum have little effect. People learn from events, from TV pictures, and from political comment and interpretation of those events. We therefore need, at both constituency and national level, to relate bankruptcies and lay-offs as they happen to high past wage awards, to the failure to compete against foreign goods.

5:4.2 Revelations about the internal struggles within the union movement, sharp practice with the block vote, and other unsavoury aspects of trade union realpolitik, will sometimes give us opportunities to demolish the trade union myths - in particuar, that trade unions speak for their members on all topics, are the repository of the "caring" virtues, and are responsible for all increases in living standards. But as a rule, the facts will carry more weight if left to speak for themselves.

5.4.3 All this raises a general question on which we need to be clear in our minds. Should we, or should we not, seek to weaken the prestige and authority of trade union leaders?

(1) The accepted view is that, since they are themselves involved in a struggle for authority with their own militants, we should be trying to build up their authority, not weaken it further. This must be right where trade union leaders' public pronouncements make economic sense; where they are not explicitly political or anti-democratic; where they recognise Government's authority and mandate; where they do not indulge in general vilification of Government.

(2) However, where trade union leaders break these basic rules, we should not hesitate to demolish their position and their authority, though it should be done with scrupulous honesty and moderate language. If people tell lies or talk rubbish in public, from positions of authority, <u>they must be taken apart immediately</u>. Once that is done a few times, they will usually stop. The principle is very simple. We have to <u>reinforce</u> responsible public behaviour by trade union leaders and <u>discourage</u> irresponsible public behaviour.

(3) If trade union leaders strike preposterous public attitudes and say absurd things, it will be for one of two reasons: either they are themselves trying to thwart what a democratically-elected Government is trying to do; or they have so completely failed to assert their own positions, establish their own authority within their unions, that they are acting as the mouthpiece of militants. <u>Such union leaders cannot deliver anything, however hard we try to build them up</u>. What did they deliver, in the end, for all the support they received from the last Labour Government?

(4) Nor should we be fooled by the fact that many publicly hostile trade union leaders talk reasonably to us in private. If they attack us in public, they must be firmly dealt with in public.

(5) All the evidence is that, in any case, most union members have a very low opinion of their union leaders, whom they see as remote figures, out of touch with the real world, living in Whitehall, hobnobbing with Ministers and senior civil servants. The wedge we are trying to drive is not between such leaders and their militant executives and officials, but between the <u>shop floor members on one hand</u> and <u>the whole union apparatus</u>, including militant shop stewards (where it is unhealthy), on the other. Recent opinion research by the Party shows that rather more than half of trade union members do <u>not</u> believe that their union leaders are doing a good job.

5.5 <u>There will be no new outcomes if we do not introduce new information</u>

5.5.1 The basic need to introduce "new data" if attitudes and thus behaviour are to change has been stressed in earlier papers. Part of this "new data" is the use of the language of adult debate, described in Section 5.2.6.

5.5.2 Another area where new information could be introduced is for Ministers - particularly the Chancellor and the Treasury team - to pose "what if" questions and give the approximate answers that computer model(s) give, so that people can see that we do live in a world of cause and effect, however complex and circuitous. Thus the Chancellor could dramatically show what would happen if we adopted the TUC policies of increased public spending and accommodated the money supply to high wage settlements. Similarly, he could show the likely outturns in terms of employment, if settlements were <u>below</u> the going rate of inflation. The accompanying comment would be: "What actually happens is up to you. Our main job is to make sure you know what your union negotiators are doing". Where possible, the unanimity of most existing models on these issues should be stressed.

5.5.3 The area where new data is most badly needed, however, is on the cost and pay-off from going on strike. In the Public Sector, employers should display, as soon as a dispute threatens, a complete pay-off table so that people at different levels of earnings, and for different eventual settlements, can see how long they would have to work to make up for the pay lost during different lengths of strike. In all forms of debate and conflict, the more information flows, the greater the chances of satisfactory outcomes. Even where the strikers could eventually "win", they can often only do so by paying an unacceptable cost per striker, with the corresponding cost to the employer being borne by the struck-against population as a whole. This, like the automatic tracking of work force opinion which we recommended in our paper "Steel Strike: Lessons Learned" should be a matter of routine in nationalised industries.

5.5.4 We could take this idea of displaying new information further. For example, the nationalised industries could be preparing, now, with help from the relevant Departments, packages of information for the next pay round. These packages could show the extent to which the claim related to output per man, the unemployment implications in the industry, the price implications for the public, the relative position of that group of workers in the pay league table, the percentage differentials over which different groups or unions might be squabbling, the recent history of price increases and market demand for the industry, the amount of subsidy per worker and from each family in the country. Nationalised industry management is extraordinarly unimaginative and slow on the uptake in this area. For example, the idea of displaying to the public the subsidy per steel worker and per UK family did not come from BSC, but from the Government. The total cost of the strike to the average steel worker did not emerge until it was much too late to affect attitudes. The aim must be to get all this cost/benefit information out into the open, and lay it before the work force involved, the media and the public, well before the emotional demagoguery of the pay dispute itself begins. It may be that this elementary business of "conflict anticipation" by Public Sector employers is already being done, but we doubt it.

5.6 Who should speak?

5.6.1 The key speakers should be the Prime Minister and the Chancellor. The Government commitment to the MTFS has to be restated regularly, but it must be done in such a way that media coverage does not talk about "calls for pay restraint", "pleas for moderation in pay bargaining", since that has entirely the wrong effect. It simply gives the uninformed reader the impression that the Government should be in control of pay bargaining but has somehow lost control, and is therefore pleading with the union members to make acts of sacrifice, to do without what is rightly theirs.

5.6.2 The key speaker for explaining to the "Thinkers" and opinion-formers what the whole Pay Round Debate is about is almost certainly the Chancellor; perhaps also the Chief Secretary. Comments on the levels of claims, excessive settlements and consequent bankruptcies could be handled through planted Supplementaries at Question Time.

5.6.3 Speeches backing up the Prime Minister and Chancellor could come from the Secretaries of State for Employment and Industry. We believe - though colleagues may still have inhibitions about it - that (as suggested in 5.4.3 above) every time a major trade union figure says something politically extreme, anti-democratic or economically absurd, we should be ready to use that statement to reinforce our own case. This would require two or three speakers ready to react very fast. These speakers might be the Paymaster, and the Secretaries of State for Environment and Trade. Material could be developed by the No. 10 Press Office and the Policy Unit, under the Paymaster General's direction.

5.6.4 We should think carefully before trying to involve the CBI. They could well simply confuse the message we are trying to put over. The debate is between the Government of the day and the trade union leaders in their ex officio Shadow Cabinet roles - ie as Opposition politicians try to thwart Government policy, not as real trade unionists. Since part of our message would also be directed towards employers, it could further confuse things to try and enlist their aid. They will in any case be increasingly critical of Government as the going gets rougher. Indeed, we could end up with a three-cornered debate: the Government holding to its monetary policies; the trade unions mobilising all their strength to force Government to abandon those policies; and the CBI urging the Government to do so.

5.7 The "NEW-WIN" package

5.7.1 The purpose of the package, as already stated, would be to transform a crisis into an opportunity: to use the crisis to make politically possible what has hitherto appeared not to be so. The design of the package itself would obviously be a major task requiring several "iterations" before the various bits and pieces could be made to fit together properly. The list below simply suggests some of the components from which the package might be assembled. They are not mutually exclusive, and many of them overlap:

(1) A short-to-medium-term Public Sector pay policy (probably based on partial indexation).

(2) The introduction of synchro-pay, either by agreement or by law, possibly phased in through a short statutory freeze.

(3) Deeper and wider de-indexing of the social security portion of public spending. The extent, in percentage point terms, could be symbolically less than the amount of de-indexing already done and the similar extent of de-indexing in (1) above. But even 3% of £11bn (ie £19bn less £9bn for pensions) would be £330m and every little helps.

(4) A temporary surcharge on the top levels of income tax, as a purely symbolic gesture. This would probably be essential if we are deliberately presenting the package as a crisis package.

(5) Indexed pensions phased out except where no-strike agreements exist or can be negotiated in a given time scale.

(6) End Government's commitment to lay-off pay to workers affected by Public Sector go-slows and works-to-rule, where other work cannot be found. The present arrangements make Public Sector disruption virtually cost-free to the unions and thus hard to beat.

(7) Ending of all supplementary benefits to strikers' families, the offer of Government loans to trade unions (Policy Unit proposed this originally, but it was never seriously discussed. Subsequent work and the complete lack of public rumpus about the £12 deeming suggests we were right. This would add much force to the publication of "strike pay-off tables" suggested in 5.5.3 above.)

(8) Exposure of union funds.

(9) Extend financial assistance to <u>employers</u> for strike ballots, where trade unions do not make use of it. This is important in the light of (7) above.

(10) Moves to take more direct control of spendthrift local authorities (as recently outlined by the Secretary of State for the Environment), or at least the announcement of such moves, might well fit into this package. It is another case of deliberately using "crisis" to do things which might otherwise be difficult.

(11) Consider, and perhaps publicly brandish, the possibility of a referendum in connection with trade union aspects of the package. The possibility of such a move would be a powerful deterrent to trade union militancy. Similarly, the Green Paper could be a vehicle for some of these proposals. The Green Paper, in any case, should be a deterrent in the background throughout the Pay Round.

5.7.2 Knee-jerk rejection of such ideas, especially items (1), (2), (4), is no substitute for careful analysis. We should remember that such a package would only be used if it became clear that we had misjudged our chances of successfully "toughing it out". If that happened, and we had no contingency plan of this kind prepared, then this Government would be almost certainly finished for all practical purposes - that is, for the purpose of making any real impact on Britain's problems. So we are talking about taking out insurance against an eventuality which - even if it is remote, and the Policy Unit certainly do <u>not</u> think that - would be very serious indeed. The besetting weakness of Westminster and Whitehall seems to be the reluctance to think ahead and prepare for eventualities before they happen. The instinct always is to wait until the avalanche of events engulfs Government and then - disorientated and punch-drunk - to call hand-wringing meetings to decide what to do.* We must not drift into that mode as we go into the run-up for what is likely to be the make-or-break year for this Government.

5.7.3 There will be genuinely sensible trade union leaders and businessmen who will throw up their hands with horror at such a package, when it

* It is usually called "keeping our options open".

is unveiled. But we have to remember that these sensible people - the very people whose thinking has helped to bring the country to its present pass - have almost without exception much shorter time horizons than the UK problem demands. They also start from the unconscious, but characteristically British, assumption that turbulence and unpleasantness must be avoided at almost any cost, including even the cost of failing to solve a problem which will bring much greater turbulence and unpleasantness in its wake. Such people are completely out of their depth in the present situation and will always advocate fudging through from year to year.

5.7.4 An important political advantage of such a package is that, far from being seen as any sort of a U-turn, it will be seen as the Government, fully prepared for crisis, coming on stronger than ever, in its determination to set Britain on the right road. We judge that tough measures, provided they affect unpopular groups like trade unions, are strongly supported; that there is almost a subconscious need to have all the nonsense and feeble-mindedness of the last thirty years purged out of the system, <u>given the leadership to do so</u>. The conventional wisdom is that people don't want to be offered a hair shirt. We are not so sure, at this particular juncture. Opinion research now in hand should help to give us a better fix on this.

5.7.5 Finally, if such a package allowed us to move more boldly on Public Sector pay and thus public expenditure, and trade union power, we could then find that we are able to move more quickly, also, on monetary policy, thus tending towards the lower end of the target range of the MTFS. And then, of course, the whole problem would start to unwind itself rather faster.

5.8 <u>Tone of voice</u>

5.8.1 Getting the tone of voice right is a standard item in any check list on political communications. But it is particularly important in this debate. We have to spell out the consequences of irresponsible trade union behaviour in a way which, without appearing irresponsible, suggests that we are <u>almost indifferent</u> to the way things go, provided we have discharged our three main duties, as a Government: <u>first</u>, to explain to the public as fully, clearly and honestly as possible the position and the consequences of different courses of action; <u>second</u>, to maintain unrelenting pressure on public spending; and <u>third</u>, to achieve our monetary targets. The actual drafting of speeches and the way in which Ministers talk on television has therefore to convey this very calm, almost fatalistic, posture.

6. TIMING

6.1 Briefing colleagues

6.1.1 The all-day Cabinet of 16 July would have provided a badly-needed opportunity to ensure that colleagues really understood the Medium-Term Financial Strategy, and the way public expenditure, Public Sector pay, monetary policy, trade union reform and the Employment Green Paper, all fit into that central framework. We suspect that some colleagues regard the MTFS as simply a piece of arcane Treasury arithmetic which need not concern them as practical politicians. Colleagues should not be allowed to oppose or disagree with a strategy which they do not understand. But we cannot ask them to support a strategy they don't understand, either. Ask any of the other businessmen involved, outside No.10 - Derek Rayner, Robin Ibbs, David Young - and I think you will find that they are amazed by the way colleagues proceed in trying to come to grips with the crucial and complex central problems. No big company could survive five years on such a basis.

6.1.2 From the meetings and papers so far on Public Sector pay, it is clear that discussions without such preliminary education are a waste of time. The first step is to understand; the second step is to think; the third step is to discuss the results of that thinking; the fourth step is to reassemble the best bits and pieces which emerge from that discussion, into workable policies. It is all very obvious: and much easier said than done. We suggest that the first step of understanding cannot come just from reading papers - themselves often written by people who themselves do not yet fully understand. A "teach-in", in which those who do understand teach those who don't - on their feet, with diagrams, and enough time - is the only way.

6.2 Trade union conferences

6.2.1 We have agreed that directing messages to union conferences would appear as futile exhortation. Much better to take the more absurd wage claims and demonstrate their consequences for prices, taxes, unemployment.

6.3 Speeches and PPBs

6.3.1 The PPB on 18 June, featuring Reg Prentice, was designed to show, by linking "caring" to the "cost of caring" that the Government does care and the trade unions appear not to. The Chancellor is making a Thinkers' speech on "The Role of the Unions" in the context of inflation and unemployment on 9 July, and has agreed to do a PPB on 16 July. Work on both these is in hand. There are further PPBs on 3 September and 1 October (all these are television), and there are also Radio 4 PPBs on the same dates. We have not yet looked at suitable speech occasions for the Prime Minister.

7. ACTION

7.1 If colleagues feel that this is all rather an elaborate approach to political communications, they should reflect on why past efforts by politicians to affect behaviour by words - whether union members to moderate wage claims, or businessmen to invest for the future - have been so ludicrously ineffective. Such debates in the past have been launched without a clear understanding of the processes which constitute the problem; no agreed set of policies for their solution; resulting in messages which are little more than pleas for help. If we can't do better this time round, we're in trouble.

7.2 We need a meeting of the recipients of this minute to answer the following questions:

(1) Do we agree with this definition of the problem and the objectives we are trying to achieve?

(2) How do we ensure that colleagues really understand what we are doing and why?

(3) Should a NEW-WIN package be prepared? Would public knowledge of such a NEW-WIN package (whether by leak or deliberately) strengthen or weaken Government's position?

(4) When is the most likely time that, if things do go wrong, the NEW-WIN package would need to be implemented? Ie: How long have we got?

(5) We believe that the Policy Unit should lead on the preparation of the package, reporting jointly to the Prime Minister and the Chancellor. Who else should be involved in the detailed work? When should it start?

7.3 In conclusion, we would stress that the NEW-WIN package, like a deterrent weapon, greatly strengthens our hand in pursuing the Debate itself. We can go to the limit in telling the employers that it is up to them to solve their problems with their work forces and unions, and not to complain to us. We can similarly take a stronger line in the Public Sector - though that requires more careful thought. But the real point is this: the more credible the package is (whether we display it or keep it under wraps) the stronger our debating and negotiating performance will be; <u>and the less likely it is that we will have to use the package at all</u>. The analogy with nuclear deterrence is very close.

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

Richard Dykes Esq
Private Secretary
Department of Employment

R 12/6

Dear Richard,

18th June

EARNINGS AND REDUNDANCY

You sent me a copy of your letter of 4 June to Tim Lankester in response to his request (30 May) for information on the relationship between recent redundancies in individual companies and excessive pay settlements.

Although the Chancellor appreciates the problems you mention, his view remains that there is work which could usefully be done in this area. What he thinks we are looking for is not necessarily specific illustrations of a causal link between redundancies and excessive pay settlements, but a general picture of the relationship between earnings increases and redundancies, which might influence the tone of ministers' public statements. The emergence of any explicit causal links would be a useful and interesting bonus, but not one which the Chancellor would necessarily expect. So far as the confidentiality problem is concerned, I do not see that it would emerge in the kind of exercise suggested above. It would of course be relevant if we were thinking of specific illustrations. But even there, a good deal of information on particular pay settlements is published, either in the press or specialist publications, and this may be adequate for our purposes.

There are a couple of further points which the Chancellor thinks might usefully be looked at. First, it would be worth analysing the data on cases where redundancies are declared following strikes. Second, the pay settlements of companies which complain to ministers about the high level of the exchange rate may provide some guidance on the effectiveness of our monetary policies operating through the exchange rate, and could again affect the tone of ministerial statements.

The Chancellor thinks it would therefore be useful if work could go ahead on these lines, and hopes your Secretary of State will agree that his officials take the lead; the Treasury is, of course, ready to help in any way it can.

I am copying this letter to Tim Lankester.

Yrs ever,

MAH

M.A. HALL

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RECORD OF A MEETING AT 11, DOWNING STREET AT 5.00 P.M. ON TUESDAY, 17 JUNE 1980

Present:

Chancellor of the Exchequer
Minister of State (L)
Sir Douglas Wass
Mr Ryrie
Mr Burns
Mr Unwin
Mr Davies
Mr P Rayner
Mr D Smith - DEm
Mr Whitmore)
Mr Lankester)
Mr Hoskyns) No.10
Mr Ingham)
Mr Strauss)

The Chancellor said he had called the meeting to discuss the draft paper by Treasury Officials attached to Mr Hall's letter of 16 June to Mr Lankester. The arguments in the paper might form the basis for the Government's planned Education Campaign. He invited Mr Ingham to open the discussion.

2. Mr Ingham said that the Government as yet had no policy on pay except a very broad one; and the use of specific figures presented obvious dangers, but at the same time it was very hard to carry conviction without figures. In any case, the assumptions on pay built into the cash limits for 1981-82 would give a very clear pointer to the kind of figures the Government had in mind for settlements. It would certainly be useful if it could be demonstrated that rising pay settlements led to rising unemployment. He noted that arguments relating to the need for reductions in real earnings were already being used by the Government. He was being pressed in the lobby about the assumptions which would lie behind cash limits, and - for reason he had already given - he doubted

/whether explicit figures

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whether explicit figures in the pay context could be avoided when cash limits were published.

3. At a general discussion for it, the following main points were made:-

a. Cash limits would have to be fixed, and the later this was done the easier it was to settle on an assumption for pay which would be achievable; but if the limits were to be effective in changing expectations they would need to be set early in the pay round. Thus the matter would need careful thought at an early stage. The assumptions underlying last year's cash limits had been fudged, in that a composite figure had been given for pay and price increases. This would be harder this year. The Government would be asked how it arrived at the particular cash limits it chose. The eagerness with which the figure of 10%, mentioned en passant by the Secretary of State for Trade had been seized on, showed that it would be very difficult to sustain an argument for moderate pay settlements without naming figures. Last year, the fixing of cash limits had been largely left to Treasury Ministers. This had advantages for the Treasury, but this year it was desirable that colleagues should endorse the new cash limits and the assumptions which lay behind them. Discussion in E Committee, although not yet complete was moving in a helpful direction.

b. The time lag between the present and the fixing of the cash limits could be turned to good purpose. It was important to avoid concentrating attention on a single figure which all pay bargainers would seek to "beat", and instead to use a variety of arguments, often tending towards different figures, but all to low ones. Use of the arguments for keeping settlements within the monetary target range, and of not allowing increases in UK unit labour costs to exceed those in

/competitor countries

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competitor countries led away from establishing a norm and towards very low figures. It had to be borne in mind that publicity would have to be simple to be effective, and this in turn suggested a fairly narrow range. It might be a good idea to publish a graph, illustrating the various parameters which applied to pay settlements.

c. The link between high wage settlements and unemployment was a cogent one, and should be fully brought out. There were good qualitative arguments linking both loss of competitiveness and high interest rates due to excessive monetary growth to the loss of jobs. It should be made quite clear where responsibility for high pay settlements lay. The paper should bring out the consequence of our continuing national habit of pressing to maintain and ever improve real living standards regardless of the position of the economy and at almost whatever cost.

d. A series of noisy union conferences was due shortly, starting with the miners who would register a claim of 35%. It would therefore be necessary to act soon to get the message across to the widest possible audience. But there would be no advantage in directing specific ministerial messages to particular conferences - these were likely to be counter-productive.

e. The monetary arguments must be pressed home. The Government must make it quite clear that the monetary target could not be shifted to accomodate high levels of wage settlements, because of its effect through the markets on inflationary expectations and on inflation in the future. The Bank of England should be encouraged to deploy this argument publicly.

/The paper should

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f. The paper should bring out the trade-off between levels of pay and the quality of public services; this argument should help to dispel the image that cash limits were simply Treasury shibboleths. Mr Jenkin had deployed the points well in his recent Cheltenham Speech. Officials had tried to establish figures which showed a direct link between numbers of unemployed and percentage rises in wages. This had proved very difficult; but some progress was now being made.

g. The argument that an increase in the real price of oil led to a corresponding real reduction in the standard of living applied to substantial importers of oil; but not to a country such as the UK which was self-sufficient in oil. In principle the UK Government would somehow recycle to tax payers the increase in its revenues due to the real increase in the oil price, either through limiting the extent of public expenditure cuts or by abstaining from raising additional taxes in other ways. Mr Burns would reflect further on this.

h. The arguments should not be represented in so sophisticated a way that the basic wages/prices link, which was widely understood, was obscured. The Government should make maximum play of the fact that the RPI will be falling. More generally, in pressing the need for lower pay settlements emphasis should be put on the positive point of beating inflation rather than on the unattractive (but inescapable) requirement to reduce real living standards.

CONCLUSION

The paper would be revised to take account of the discussion. E Committee should complete its discussion of public sector pay policy in advance of Cabinet on 26 June. It was desirable that the Committee should take this paper in revised form as soon as possible thereafter. The paper should distinguish more sharply

/than the existing

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than the existing draft between operational decisions - eg when and how to fix cash limits - and the identification and refining of arguments to be deployed in the Educational Campaign. The relevant material would need to be ready to be deployed at Cabinet on 3 July.

R.I.T
for
M A HALL
19 June 1980

Distribution

Those present
Chief Secretary
Financial Secretary
Sir Anthony Rawlinson
Mr Middleton
Mr Dixon
Mrs Heaton
Mr Ridley
Mr Cropper
Mr Cardona

Econ Pol

SIR ROBERT ARMSTRONG

I have shown the Prime Minister your Minute A02355 of 16 June 1980, and she is content for the Cabinet meeting of 3 July to be arranged in the way you suggest in paragraph 5.

C. A. WHITMORE

17 June 1980

1.

Prime Minister.

Content with the arrangements proposed at X? Yes

Ref. A02355

MR. WHITMORE

The Chancellor of the Exchequer may raise with the Prime Minister shortly the question how to "stage manage" the economic discussion on 3rd July.

2. I attach a copy of a letter which I have sent to Sir Douglas Wass on this subject. He tells me that these proposals commend themselves to the Chancellor of the Exchequer.

3. One problem is that, because of the size and shape of the Cabinet Room, it is very difficult for someone to make a presentation to Ministers in such a way that he can readily be seen and heard by all Ministers. It is particularly difficult if the presenter wants to use visual aids. I understand that the Chancellor of the Exchequer takes the view that Mr. Burns and Mr. Ibbs should make their presentations not from the table but standing up and away from it.

4. If that is accepted, I think that we may have to think in terms of having the economic discussion either in the State Dining Room, with Ministers sitting round a table, the Prime Minister with her back to the window and the presenter standing on the opposite side of the room, under Lord Nelson; or in the Pillared Room, with Ministers sitting round in a semi-circle of chairs with the presenter at the centre of the circle.

5. In either case it would be disadvantageous to start the meeting in the Cabinet Room, go upstairs for the economic discussion, and return to the Cabinet Room for the last item on the agenda, following the economic discussion. So I think that the balance of advantage is probably in favour of holding the whole of the Cabinet meeting on 3rd July upstairs in the State Dining Room. The

X Cabinet would then proceed in the usual way; and, when the regular items were concluded, Mr. Burns and Mr. Ibbs would be invited in to make their presentations; they would leave at the end of the economic discussion, so that the Cabinet could complete its business.

RTA

(Robert Armstrong)

16th June, 1980

CONFIDENTIAL

Econ Pol

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

16th June, 1980

T. Lankester, Esq.,
Private Secretary,
10, Downing Street

Dear Tim,

INFLUENCING NATIONAL PAY BEHAVIOUR

.... I enclose a copy of a Treasury paper for discussion at tomorrow's meeting at 5.00 p.m. at No.11.

I am copying this letter to Bernard Ingham and John Hoskyns, and to Douglas Smith in the Department of Employment.

Yours ever,

M.A. HALL

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Econ Pol

INFLUENCING NATIONAL PAY BEHAVIOUR

1. People's expectations about pay settlements are influenced by a number of considerations, including past and future expected rates of inflation and what other groups have settled for. Although there has been some variety in the level of settlements over the last year, following the removal of all restraints, there has still been a tendency for some kind of going rate to emerge, or at least a range within which people expect to settle. The range of expectations for settlements at the moment is around 18%, with total earnings some 3% above this. There has been a tendency for the range to edge upwards in the last few months, while the RPI has been rising.

2. The danger is that we will move into the Autumn with expectations still hovering at around this level. So the climate may be one in which settlements of say 13% or 14% are regarded as low and 16% or 17% will be considered satisfactory. What is needed is to create a climate in which the figures to which people's minds naturally move are lower than this.

3. It is of course important to avoid anything which looks like the Government setting a norm. But one can distinguish between a government-announced norm and a range of expectations which can grow up. In countries which have been more successful in dealing with inflation, such as Germany, there is no norm; but there is a range of influences on employer and employee behaviour which help keep expectations within a range which is compatible with moderate or falling inflation. It is not easy to exercise a downward influence on expectations. But by drawing on economically defensible figures which point to substantially lower increases in earnings it may be possible to bring home to people the step change in expectations which is necessary. This note considers the various arguments which might be used to induce a climate of expectations in which pay settlements over the coming year will be of an altogether smaller order of magnitude than last year's.

4. The two factors which provide the clearest guide to the general level of pay settlements which can be accommodated without causing additional inflation and higher unemployment are the target growth range for the money supply and the effect of relative labour costs on

international competitiveness. Other factors may also be used to influence thinking but they are less basic. And there are pitfalls to be avoided in the use of every argument.

Monetary Targets

5. A strong case can be made that if wage increases in general exceed the growth of the money supply significantly this will lead to increased unemployment. It can be shown that during the 1970s unemployment rose when the growth of earnings exceeded the growth of M3, with only a short lag, and fell when they grew more slowly than M3. The two graphs attached show (i) the relationship between unemployment and the ratio of average earnings to the money supply and (ii) the percentage change in unemployment compared with a year earlier and the percentage change in the ratio of average earnings to money supply compared with a year earlier.

6. It is not possible to determine at all precisely the rate of increase in average earnings over the coming year above which unemployment would rise more than it otherwise will. The rapid growth of earnings in the past means that there is already a considerable rise in unemployment in the pipeline. But on recent evidence and given the monetary target the threshold must be in the region of 9% or 10%.

7. What use it would be best to make of this is of course another question. There is a strong case for arguing that everyone, other Ministers in the Government, industrial and trade union leaders and the public at large should be made fully aware of this underlying fact. But the fact is that the money targets are themselves a subject of controversy and arouse strong emotions in some quarters. There is a risk that the logic of this approach will be turned on its head by those who are opposed to the Government's policies who will argue that it is the Government which is creating unemployment through tight monetary policies. The Government can of course reply that the targets are essential if inflation is to be reduced. But it will be necessary to consider carefully how this argument in paragraph 5 above should be used and by whom.

Competitiveness

8. An approach based on our competitive situation points to very similar figures. If we lose competitiveness further by allowing our labour costs to continue to grow faster than in other countries, more jobs will be lost. Over the last year we have suffered a serious loss of competitiveness, with our earnings rising at about double the rate in other OECD countries on average (20% as against 10%) and the exchange rate appreciating by about 8% at the same time. This loss of competitiveness must already entail a substantial rise in unemployment. Assuming that the exchange rate does not move significantly, any further rise in our relative unit labour costs must mean more unemployment in the sector of the economy which is involved in international trade.

9. Once again one cannot be very precise. The OECD forecasts that earnings in the OECD area this year will rise by about 10%, and one might reasonably assume that the rate of increase will be similar in the first half of 1981. Making allowance for improvements in productivity, unit labour costs in our main competitor countries, on average, are likely to be rising over the coming year by something substantially less than 10%, perhaps as little as 7%. In other words, if we are to do no more than avoid a further loss of competitiveness through labour costs over the coming year (a modest aim), wage settlements ought probably to be in single figures. There is a strong case for saying that if settlements in industries involved in international trade in general exceed about 10% there will probably be a further loss of jobs.

10. This argument is open to the objection that competitiveness can be influenced by the exchange rate; and if during the year the exchange rate fell significantly the argument might be weakened. It may also be argued that the high exchange rate is in part a consequence of the Government's monetary policy, so that it is the Government, in fact, which is creating unemployment. But there are strong and widely accepted arguments against depreciation of the exchange rate as a means of improving competitiveness and it should therefore be possible to carry some conviction by arguing that an increase in labour costs in the industries involved in international trade beyond a figure of

roughly 10% implies a further loss of jobs. But once again it will be necessary to consider how such an argument should be presented and by whom.

Retail Price Index

11. The RPI obviously has a powerful influence on wage expectations - indeed perhaps the most powerful single influence. Arguments related to the RPI, if they are to be successful in reducing pay expectations must rely on convincing people

a. that they should accept wage settlements below the RPI ie accept a cut in real earnings- and

b. that the RPI will be falling over the coming year (for reasons other than pay restraint). The forecast is that the movement of the RPI through the 1980/81 pay round may be about 13.5%.

12. These two arguments taken together could be used to mount a case for figures not greatly different from those suggested by the arguments based on the money supply and competitiveness. The public understands well that high wages result in high inflation. One would argue that if inflation is to fall further without a substantial further rise in unemployment, wage settlements must keep below the forecast rise in the RPI. One could reinforce this by pointing to the behaviour of other countries. In the OECD as a whole average earnings have increased by less than retail prices over the last year, although this picture is dominated by experience in the United States, where consumer prices have been increasing by about 6% more than earnings. But in a number of other countries also - Netherlands, Sweden and Australia for example - earnings are rising more slowly than prices. In Germany, France and Japan earnings are just keeping pace with inflation; nevertheless because of high productivity growth this implies an increase in unit labour costs in these countries well below the rate of inflation.

13. The difficulty about relying too much on this argument is simply that it invites people to think in terms of the RPI and this probably tends to make them think in terms of matching it. There is also the

difficulty of persuading people that the RPI will fall as much as the Government expects - there may be some scepticism about this, especially since we have just come through a year in which the RPI was rising and a number of groups who settled early in the round believe they have lost out in consequence. The TPI is not likely to offer much additional ammunition since it is forecast to run at annual rates above the RPI over the next pay round.

Cash Limits

14. The Government's own decisions about pay in the public services will have an important impact on the general atmosphere. Obviously it will be essential to consider any proposals for putting about figures which one might hope would influence the private sector against this background. The question of the precise level at which cash limits for pay should be set is a difficult one which will require careful consideration. It is too early now to come to conclusions about this and indeed the question when the limits should be set and published is still undecided. However, the Government can expect to exert some influence on the general climate merely by going for lower figures for the public services than last year, illustrating its determination to get inflation down. But how much lower? The Chancellor has already indicated that the cash limit of 13% in the Rate Support Grant must be the starting point for deciding the provision for 1981/82, by which time inflation should be falling. Will it be realistic to envisage going as low as the range of figures suggested by arguments based on the money supply and competitiveness? Conversely if those arguments, suggesting figures in the region of 10%, were used by the Government would this make it difficult for the Government to set cash limits for pay in the public sector any higher, eg at 12%?

Conclusion

15. All this suggests that the following questions should be considered urgently

a. Should the Government embark on an effort to influence thinking and pay behaviour using not only general arguments but arguments which suggest a range of figures significantly lower than present expectations?

b. If so, should the arguments based on the money supply and competitiveness be used so as to suggest that settlements exceeding something like 10% will add to unemployment?

c. What use should be made of arguments relating to the RPI and reductions in real earnings?

d. What implications does this carry for the fixing of cash limits and what line should Government spokesmen be taking on this question now?

16. There are also questions about who should put forward any arguments on this subject and when. It could be argued that some of the ideas discussed above - for example the argument based on the money supply - should be presented by others such as the Governor of the Bank of England or the CBI rather than Ministers.

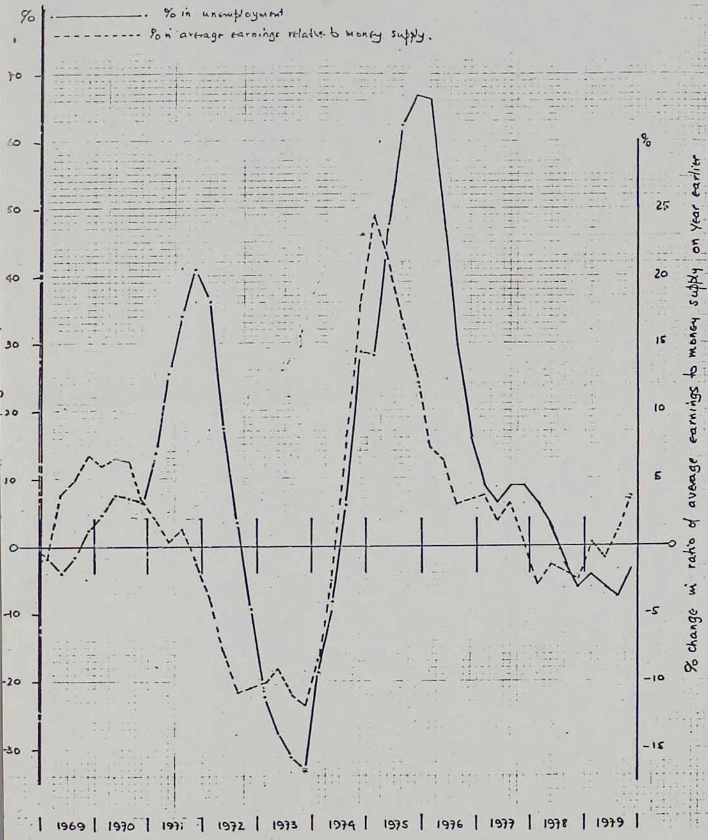
by reference to monetary growth. The high level of settlements in the last pay round has exacerbated the problem for this year, both because of the precedents they have set and because the starting point for the next round will be above the level assumed when the monetary targets were set. The savings and settlement figures can only therefore have a value as a reference point, being a figure which is substantially more than can be afforded this year.

CONCLUSION

15. The increases in earnings which would be consistent with the planned growth in the money supply and at least maintaining our competitiveness would be in single figures. The prospects of actually achieving this in the next pay round are slim, but nonetheless the importance of these criteria for determining the appropriate level of pay settlement means that they should be given prominence in the hope of exercising a moderating influence on settlement levels. It must be made clear that the consequence of failing to meet our monetary targets and maintaining competitiveness will be either a substantial reduction in real income with a minimal increase in employment or the maintenance (or a small fall in) real incomes with a considerable increase in unemployment. We need radically to change the climate of wage bargaining and this cannot be done without indicating that the problem is a serious one which will necessitate some hardship.

conflict v. 10% real [illegible]

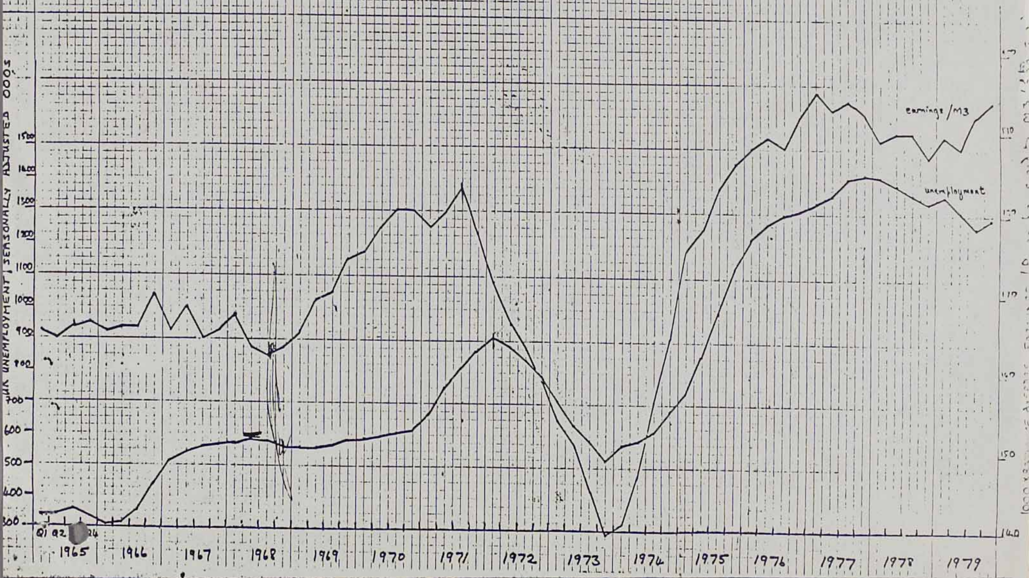
16. If the Chancellor agrees that this message is one which should be put across, a number of questions arise on presentation, but these can probably best be considered in the context of further work on the education/publicity campaign. Our present concern is to estblish whether he considers that the message of the importance of the figures for growth of the money supply and competitiveness in the pay bargaining context should be developed.



% in unemployment
% in average earnings relative to money supply.
%
70
60
50
40
30
20
10
0
-10
-20
-30
%
25
20
15
10
5
0
-5
-10
-15
% change in ratio of average earnings to money supply on year earlier
1969
1970
1971
1972
1973
1974
1975
1976
1977
1978
1979

GRAPH 1

GDP ← $\frac{M}{P}$



CABINET OFFICE

With the compliments of
Sir Robert Armstrong KCB, CVO
Secretary of the Cabinet

C.A. Whitmore, Esq.

70 Whitehall, London SW1A 2AS
Telephone: 01-233 8319

CONFIDENTIAL C

CABINET OFFICE

70 Whitehall London SW1A 2AS Telephone 01-233 8319

From the Secretary of the Cabinet Sir Robert Armstrong KCB CVO

16th June, 1980

Ref. A02354

My dear Douglas,

Arrangements for Handling the Cabinet Discussion on 3rd July

We had a word about these arrangements earlier today.

As I told you, the proposal is to start Cabinet early - probably at 9.30 am - and hope to conclude the three regular items in half an hour. The Cabinet would then move to a discussion of the medium term economic outlook, as a basis for its subsequent review, on 10th July, of public expenditure. There will be one other substantive item on the agenda after the economic discussion.

I know that the Prime Minister will wish so to structure the papers and the discussion that the Cabinet does not need to have to revert to the economic discussion the following week. You told me that the Chancellor of the Exchequer did not wish to circulate his own paper on the economy in advance of the meeting on 3rd July. I think that this suggests that we should structure the discussion in the following way:-

(a) It is intended that Terry Burns should open the discussion with a presentation. No doubt he will want to circulate in advance various tables and charts as visual aids for this presentation. I suggest that these should be circulated neutrally, under a note by the Secretary of the Cabinet.

(b) Terry Burns's presentation might be followed by a presentation by Robin Ibbs.

(c) The Chancellor of the Exchequer should not circulate, either before or after this meeting, his own note on the medium term outlook and its implications for subsequent discussions on public expenditure. He should, however, intervene in the discussion, probably towards the end of it, with a "set piece" which would seek to do two things:

/(i)

Sir Douglas Wass, GCB

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(i) To establish a consensus that the Government should continue on its existing strategy for managing the economy.

(ii) To state the implications of the economic outlook and strategy for the public expenditure decisions which the Cabinet will be asked to consider the following week.

We should aim at reporting this "set piece" fully in the Cabinet minutes, in order to make it unnecessary for the Chancellor of the Exchequer to circulate a memorandum and thus risk reopening the economic discussion on 10th July.

I should be grateful if you would let me know whether Terry Burns is likely to wish to use visual aids - projections or a blackboard - during his presentation. The shape of the Cabinet Room makes this difficult, and if he wanted to use visual aids of that kind - as opposed to tables and charts circulated in advance - we should have to consider how best to arrange matters so that everybody could see and hear properly.

Yours ever
Robert Armstrong

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Mr Lyhnn [handwritten] Econ PS1. c Mr Yaxtaste [handwritten]

See my earlier note [handwritten]

pw [handwritten] 13 NG 13-6 [handwritten]

MR MOWER

cc Principal Private Secretary
Mr Ryrie
Mr Middleton
Mr Unwin
Mr Davies
Mr Gaffin No. 10

REQUEST FROM PANORAMA

The Chief Secretary has seen your note of 12 June about the "Panorama" request for an interview for their programme on the economy to be shown on Monday 23 June.

2. He is in principle ready to do this, but considers it most important that he should not find himself in a false position in his interview, following the cancellation of the 16 July Cabinet. He would not want to do the interview unless the news of the cancellation had already been released.

3. He would therefore be grateful if you would report further when the question of release of information on the cancellation (and of the alternative arrangements made) has been resolved. In the meantime no acceptance should be given to the BBC.

AP [signature]

A C PIRIE
13 June 1980

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13 June 1980

PRIME MINISTER

ECONOMIC STRATEGY

In my covering note to Douglas Hague's paper, I said that I thought that both Budgets had been too little and too late. You wrote a question mark in the margin and this is a response to that question mark.

When I talk of Budget, I mean both Budget and Expenditure White Paper. It is in the latter area that we are obviously off course.

We have recognised the total confusion surrounding nationalised industry policy, and that is now being addressed. On public expenditure generally - which really means public sector pay - we haven't started. (My original suspicion that the need to de-index the whole of public sector pay, simply as part of the medium-term strategy, was not generally understood, is increasingly borne out by the papers received, by a recent conversation I had with someone in the Treasury, and by enquiries that Douglas has been making there, at my request.)

As I say, I believe that we are a long way off course; that nothing else matters until and unless we get this right. I enclose a copy of a letter I wrote to Geoffrey following a conversation I had with him, as our input to his Budget thinking. I have marked in yellow the most relevant passages.

If the Medium-Term Financial Strategy is to be achieved without colossal damage to the private sector, it has to be accompanied by the appropriate de-indexing of public sector pay <u>and</u> real cuts in manpower. But the de-indexing is the most important, the most urgent and the part that can be done <u>fast</u>. The third leg of the strategy is the rapid reduction in trade union power, and freeing-up of the labour market, so that the monetary medicine can work.

So we now have one leg of the stool, but the other two missing. And that leg of the stool - the monetary deceleration itself - bears down on the <u>private sector first and foremost</u>; on the <u>employers</u>, much more than the work force; and, through interest rates and high exchange rate, on the very employers we need for the future - fast-growing, cash-hungry, exporting.

I believe that the likely problems arising out of the pay round will in fact present an opportunity for getting some of these things right, faster, while there is still time. I mentioned this in the context of relationships with trade union leaders and we are preparing a paper to explain what we mean.

JOHN HOSKYNS

Mr Ingham

c Mr Lankester

CST content to do programme. But uncomfortable if Panorama do not know 16 July cabinet cancelled. Hence how/when to let it be known needs settling. Mr Lankester engage we talk with PM at Monday's media briefing

RC
13-6

CHIEF SECRETARY

c c Principal Private Secretary
Mr Ryrie
Mr Middleton
Mr Unwin
Mr Davies
Mr Gaffin
No 10

REQUEST FROM PANORAMA

BBC TV "Panorama" is planning a programme on the economy for Monday 23 June - ahead of the July 16 Cabinet. They have invited you to conclude the programme with a filmed interview of about 7 to 8 minutes, (edited down from perhaps 15 minutes).

The programme in total will be about 30 minutes long. It will include interviews with industrialists in the West Midlands and also film of Ministers (including the Prime Minister) speaking publicly on the Government's economic policies.

The presenter, Michael Cockerell, will be able to give you a full description of the preceding part of the programme. And he will let us have an outline of the questions that he will put to you. They would focus in particular on the difficulties facing industry with high interest rates and high exchange rates and the prospect for pay settlements in the next round.

As to mechanics, the BBC would very much like to film the interview in your room some time next week. If you agreed, we could try to find a slot when they could set up their equipment while you were out of the office.

Given Panorama's intention to run a programme of this kind, it is of some importance to conclude it with an advocacy of the Government's policy.

B L Mower

B L MOWER
12 June 1980

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Econ Pol

B/F 2-7-80

10 DOWNING STREET

Copied to:
Econ Pol: Pub Expen and Cash Limits.

From the Principal Private Secretary

SIR ROBERT ARMSTRONG

CABINET MEETING ON ECONOMIC STRATEGY

The Prime Minister discussed your minute A02289 of 9 June 1980 with the Chancellor of the Exchequer and you immediately after the meeting of E this morning.

It was agreed that Cabinet should have a general economic discussion at its meeting on 3 July and that the PES papers should be taken on 10 July. The Prime Minister was anxious that there should be another substantive item for discussion on the agenda for the meeting on 3 July. If we proceeded in this way, there would be no need for the special meeting of the Cabinet on Wednesday 16 July, though nothing need be said for the time being about cancelling this meeting.

You said that you would now discuss the preparations for the meetings on 3 and 10 July with Sir Douglas Wass.

I am sending a copy of this minute to Mr. Wiggins (Treasury).

CAW.

11 June 1980

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2

cc: Chief Secretary
Financial Secretary
Sir Douglas Wass
Mr. Ryrie
Mr. Middleton
Mr. P. Davies
Mr. P. Dixon
Mr. Unwin
Mr. Cropper

Mr. T. Lankester (No.10)

MR. BURNS

Prime Minister
Dept. of Employment won't do this work.
So the Treasury are going to do it.
TL 10/6

EARNINGS AND REDUNDANCY

The Chancellor has seen your minute of 5 June, and agrees that work should be set in hand on recent redundancies in individual companies and excessive pay settlements in the year or two preceding; and on pay settlements in companies that complain about the high level of the exchange rate.

2. In this context, you will wish to take account of the attached note by Sir Michael Edwardes, listing pay settlements in BL's suppliers. BL are now telling their suppliers that they will have to take account of the latter's pay settlements in deciding whether or not to agree price increases in components.

M.A. HALL
10 June 1980

PAY SETTLEMENTS - MAJOR SUPPLIERS

AUSTIN MORRIS AND LEYLAND VEHICLES

NOTES: 1) All supply Austin Morris

2) Those marked with asterisk also supply Leyland Vehicles

Lucas Electrical (not yet settled)	17.4%
Automotive Products	16.5%*
Hardy Spicer	17.5%*
Lucas Girling	17.4%*
Smiths Industries - Instrumentation	17.4%*
- Heaters	13.5%
Triplex Safety Glass	16.6%*
Garringtons	12.0%
RHP Bearings	15.0%*
Hepworth and Grandage	15.0%
Dunlop (Wheel Division)	17.87%*
Cam Gears	16.84%*
Wilmot Breaden Bumpers	15.9%
Firth Furnishings	15.0%
Rists Limited	16.0%
Bromsgrove Castings	8.8%
Lay's Malleable Castings Co.	14.0%
Qualcast (Derby) Limited	19.0%
Wilmot Breaden Mechanisms	17.0%
ICI Limited	16/19%
Rubery Owen (Darlaston)	17.0%*
Pianoforte Supplies	16.0%
GKN Sankey	14.6%*
Gloucester Foundry	15.0%
Borg Warner Transmissions Division	18.0%
Vowles Foundries	10.0%
Concentric Pumps	20.0%
Dartmouth Auto Castings	15.0%
Kangol Magnet	19.2%

Kay Metzeler	18.0%
Britax (Wingard)	15.0%
Ripaults	6.0% on 1.10.79 18.0% on 1.5.80
Smethwick Drop Forging	17.3%
Jonas Woodhead	15.0%*
Jersey Kapwood	16.0%
BSA Sintered Components	20.0%
J. Burns (Glynwed Plastics)	17.5%
Britax (Vega)	19.0%
A.C. Delco	15.4%
Autocast (Bourne)	14.0%
Marley Foam	20.0%
Blackheath Stamping	15.0%
Holset Engineering	18.5%*
Low and Fletcher (Willenhall)	21.0%
Condura Fabrics	17.5%
Coopers Filters	7.5%*
Schlegal (U.K.)	26.5%
Miles Redfern	17.0%
RMI Limited	20.0%
Vandervell Products	16.0%
Glacier Metal	16.0%*
Ward and Goldstone	18.0%
Magnatex	17.0%
Sterling Metals	14.0%*
Glynwed Screws and Fastenings	12.5%
Carrington Co. Limited	16.0%*
Silent Channels	16.0%
Speciflex	15.0%
John Stokes and Sons Limited	15.0%
Smith Clayton Forge	11.0%
Rockwell Thompson	14.9%*
Bonnella Switches	18.5%
Scottish Stamping and Engineering Co.	15.2%*
Radio Mobile Limited	12.5%
George Taylor and Sons	15.0%

Duport Foundries	18.75%
Wolverhampton Die Castings	18.4%
Yarwood Ingram	17.5%
Metallifacture Limited	17.0%
Metal Castings (Worcester)	16.0%
Ball Plastics	12.5%
GKN Automotive Fasteners	17.0%*
Aluminium Bronze Co.	16.0%
Barratt Engineering	20.0%
Bloxswitch Lock and Stamping Co.	16.9%
Omers Faulkners	15.2%
T.I. Cox Limited	14.9%
Bescot Drop Forgings	15.0%
Bridgetown Industries Limited	16.0%
Perkins Engines	12.5%*
British Steel	11.0%* (plus 4.5% guaranteed bonus)

<u>Public Utilities</u>

Water	21.4%
Gas	19.5%
Electricity	19.0%

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1.

Prime Minister.

The most sensible course seems to me to be to have the general discussion on 26th June, followed by the PES discussion on 3rd July. This would not rule out a later general discussion after the recess, if you wanted one then as well. But before you take a decision, I suggest you have a word with the Chancellor. The first opportunity will be after E on Wednesday morning. Agree?

[illegible] 9 vi

Yes MT

Ref. A02289

MR. WHITMORE

Cabinet Meeting on Economic Strategy

You asked me to look again at the date of the meeting, at present arranged for Wednesday, 16th July, to discuss the Government's economic strategy.

2. We need to look at this in relation to the arrangements for discussing the 1980 Public Expenditure Survey (PES). The Cabinet will start to consider the 1980 PES in July, and will resume discussion after the Summer Recess. The first meeting is provisionally planned for 3rd July, and there will probably be a second later in the month. As at present envisaged, the meeting on 3rd July will take papers by the Chancellor of the Exchequer on the general economic background, his proposals for the approach to the 1980 Survey, and the main issues. There is a danger that, if the discussion on general economic strategy is known to be coming on 16th July, Ministers will not wish really to begin to tackle the public expenditure problems on 3rd July. On the other hand, the Treasury do not wish to lose momentum on the PES exercise by postponing the first discussion from 3rd July.

Or that the discussion on 3 July will preempt much of that on 16 July.

3. With these points in mind the main options seem to be as follows.

4. First, we could stick to 16th July. The arguments in favour of this are that that date has had some publicity, and any change could be misconstrued by the Press; and that it may be difficult to find another full day convenient to all Ministers.

5. Secondly, the meeting could be scrapped altogether. I think that this would be a pity. A general review of strategy on the lines envisaged would be helpful in preparing the way for policy decisions later in the year.

6. Thirdly, it might be possible to combine the economic strategy discussion with the first public expenditure discussion on 3rd July. This might be done by spending the morning on the general discussion and then turning later in the day, after your Question Time, to the PES papers. Another possibility would be for the PES discussion to be taken on another day shortly afterwards. This would relate the discussion of public expenditure clearly to a preceding discussion of general

Not a starter. On present plans you are likely to be making a statement that day (on a highly sensitive defence matter); and you are then due to fly to Edinburgh for the visit to Holyrood Palace.

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economic strategy. It could be presented as a natural and necessary opening to the PES discussions rather than as a "crisis Cabinet". It would mean that there was less time available for the general discussion than we have been envisaging; and it would lead to an extremely burdensome day.

7. Fourthly the general discussion could be brought forward to 26th June and serve as an introduction to the PES discussion on 3rd July. The PES material will not be available by 26th June; but perhaps this does not really matter. Indeed it might be a good thing if public expenditure considerations were not too much uppermost in Ministers' minds when they discussed general economic strategy.

8. Fifthly it would be possible to defer the discussion until immediately before the Recess - late July or early August. But this does not really seem to make sense: the time for such a discussion is either at the beginning of the first round of PES discussions in early July, or after the Recess, when the second round is about to begin.

9. Sixthly, the general discussion could be deferred until after the Recess. This would give Ministers a useful opportunity for a general stocktaking before the Party Conference. It might also be a useful precursor to the PES discussions which will be resumed after the Recess.

10. The main choices are thus to go ahead with the 16th July meeting as planned; to hold it as part of the regular Cabinet meeting on 26th June; to hold it on 3rd July or thereabouts, so to combine it closely with the opening of the PES discussions; or to defer it until after the Recess.

11. Subject to your decision on the timing, the next step will be to prepare an agenda for the meeting. I suggest that it might start with a presentation by Mr. Burns of the economic strategy. If you agree you might ask the Chancellor to consider this and to let you have more detailed proposals. I think that Mr. Ibbs should also be asked to prepare a contribution.

RTA

ROBERT ARMSTRONG

9th June, 1980

6 June 1980

PRIME MINISTER

Pl copy to
Econ Pol
Public Expenditure

DOUGLAS HAGUE'S PAPER

I attach a copy of Douglas' paper and you are seeing him on 17 June at 5pm.

The paper is worth a read. I think Douglas has had an important insight. At first glance it may appear to be a rather long-term subject, but it has important political significance in the context of our drive to reduce public spending. It shows that this drive is imperative not as a matter of political belief alone, but as a matter of economic logic.

As you know, we have been looking at the problem of "economic stabilisation" since the election and have been increasingly concerned with the importance of de-indexing. I mentioned the relative price effect in my summary of the Long Campaign paper which we discussed in January. It now appears that it is an even more powerful destabiliser than we had realised.

? I remain personally convinced that both Budgets have been much too little and much too late and that we shall eventually have to consider a "shock package", as I was urging in January.

Since writing the paper, Douglas has done a computer regression analysis on historical figures for several national economies and the results bear out his thesis.

He would like to publish the paper as an article in the Times, once he has done a little more checking and has got second opitions from one or two other people. I think we should encourage that.

JH

JOHN HOSKYNS

Agreed - but -
(1) the same problem must arise in other countries
(2) the paper ignores the possibility that with increasing prosperity people will do more for themselves & rely less on the state. MT.

1 June 1980 JH

THE CENTRAL PROBLEM OF PUBLIC EXPENDITURE

A basic characteristic of public expenditure is that productivity rises more slowly in the public than in the private sector. The "output" of a civil servant, or of a teacher with a given size of class, increases little, if at all, over time. There are obviously parts of the public sector where productivity does increase, but there are many where it does not. Wynne Godley and Christopher Taylor estimate that, over the period 1955-71, the price of public sector current output rose about 2% faster than prices in general.(1) This is what economists call the relative price effect. The implication is that public sector productivity rose by some 2% per annum less than in the private sector.

I here develop a simple model to indicate the likely consequences of a relative price effect of this size. The conclusion is that unless public attitudes to Government spending can be radically altered, the present problems over public expenditure will merely be the forerunners of a growing crisis.

Assumptions

I assume that each year productivity in the private sector rises 2% more quickly than output in the public sector, in which I include the nationalised industries. This is reasonable in the light of the Godley and Taylor findings. Since they conclude that we have been experiencing this differential productivity performance for at least 25 years, I consider the effects of a relative productivity difference of this size over periods of 20, 30 and 50 years.

I assume that, initially, national output is 100. Out of this, 25 is from the public sector and 75 from the private. There is full "comparability" in public sector pay. Everyone is paid the full rate made possible by private sector productivity, but I assume no rise at all in productivity in the public sector.

There are at all times just 100 units of labour. Output per unit of labour is therefore initially one unit per annum, with 25% of the labour force in the public sector and 75% in the private. The only

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(1) See "Measuring the effect of public expenditure", in Public Expenditure edited by Michael Posner, Cambridge, 1977, p.126.

tax is a flat-rate one on all output (expenditure). The rate is initially 25%, that required to pay the 25% of the working population who are in the public sector.

Results

With this model, after 20 years, national output rises from 100 to 136 units per annum. If there has been no movement of labour to or from the public sector, its output will still be 25. Private sector output will have risen by 2% per annum from 75 to 111. Since everyone gets the full pay increase made possible by the rise in private sector productivity, unit pay rises from 1.00 to 1.48. Total pay is 148, of which the public sector takes 37 (25 x 1.48). The tax rate remains 25%. That rate on the pay of 148 yields the necessary 37 units.

There is, however, an important change. Instead of representing 25% of output as they did 20 years earlier, the 25 units of public sector activity now account for only 18%. This is what keeps the tax rate at 25%, even though the relative price effect has raised public sector costs per unit of "output" to 1.48 times private sector costs.

Many of them will do things themselves

The electorate may accept this situation, but it may not. Now that the rest of the economy has become more prosperous, people may argue that the public services must match this improvement. It is, I suspect, precisely this kind of feeling which lies behind Galbraith's famous crack about private affluence and public squalor. And discussion in terms of the national income accounts tends to dodge the issue altogether by assuming that the output of a public sector employee is worth exactly what he is paid - a conveniently circular argument.

What happens if the public does not accept the situation? Suppose the electorate insists that the output of the public sector must rise in line with that in the private sector? The public sector will then always account for 25% of national output and in the model, after 20 years, national output will be only 132 and not 136. This is because, to produce 25% of national output, there would be 33 units of labour in the public sector, producing 33 units of output - 25% of 132. This leaves 67 units of labour in the private sector. With their output of 1.48 units each, total private sector output is 99.

The reason why national output is four units less than on the earlier assumptions is that eight units of labour have moved from the private to the public sector. Since they there produce only one unit each as against the 1.48 in the private sector, output falls by a net 0.48 units for each unit of labour that moves.

This may seem bad enough, but the relative price effect also takes its toll: output has fallen by 3%, but the tax rate has risen to 33% instead of 25%.

After a further decade, the situation is worse still. If we assume that after 30 years only 25 of the 100 units of labour are in the public sector, national output will be 161, 25 from the public sector and 136 from the private. Pay is now 1.81 and the tax rate still 25%, but the public sector now accounts for only 15% of output.

If the Government feels obliged to maintain public sector output at 25% of the total, national output will be reduced to 150, a fall of 7%. There are now 38 units of labour in the public sector, producing 38 units of output. The 62 units in the private sector have an output of 1.81 each, giving them 112 out of the national total output of 150. The reason output has fallen by 7% is again lower productivity in the public sector. The tax rate is 38%.

If the process continued over a full 50 years, and if public sector output was held at 25% of total output, 47% of the labour force would then be in the public sector. The tax rate, at 47%, would be almost twice that of 50 years earlier. Output would be 189, 17% lower than if public sector output had been held at 25 units, when it would have represented only 11% of total output. And, for the record, after 100 years, the tax rate would be 70%. As much as 70% of the labour force would be in the public sector and, if this were a real-world economy, it would be in ruins.

This model shows just how serious the problem of public expenditure really is. Behind all the politics, there is an inexorable economic process at work. We have to recognise it and learn how to halt it. Or it will overwhelm us. Fifty years may seem a long time to wait for such a process to have serious effects, but the Welfare State was born around 1945. We are already into the fourth decade of a process like that outlined in the model.

Qualifications

Hague's Law, then, is this. Even if we hold the proportion of output coming from the public sector constant, if private sector productivity rises faster than public, then pay "comparability" means that tax rates will rise exponentially. They will ultimately become unacceptable. We have designed an arrangement for destroying the economy.

Obviously there are qualifications to such a simple model, but in Britain today they may actually make the situation worse, not better. It is true that the proportion of the working population in the public sector is only a little below 25%, but in 1964 it was only 15%. Moreover, the model ignores transfer payments. These are an important element in taxation, since they represented about 24% of current Government expenditure in 1978. The model takes no account of the fact that, as tax rates rise, evasion increases and taxes have to rise even further.

The model also ignores the fact that many of the services like health care and education that, with increasing affluence, people demand on an increasing scale, are provided largely by the public sector. A market economy would deal with the consequences by rationing the services through price and/or by forcing radical changes in the way they are provided. Since we provide these services "free", we have turned the problem into a fiscal one, and so a national one.

This discussion has also ignored inflation, but that is an advantage. One of the biggest obstacles to rational public debate on public spending is that money is no longer a reliable measuring rod. Even those who try to avoid being confused by arguments in terms of "funny money" usually fail.

Closer inspection of the model does, however, show that, on our assumptions, the relative price effect itself generates inflation. Initially, 100 units of output cost 100. After 20 years on our "worse case", 132 units cost 148. Unit cost has risen by 12% over 20 years. The reason is that public sector pay is linked to productivity in the private sector, and not to average productivity over the economy, including the public sector. There is, I suspect, a similar inflationary mechanism at work in the real world. In the model, the important point is that this inflationary element accelerates. In years 1 to 20, inflation averages only 0.6% p.a. In years 91 to 100, it averages 3%, and is rising.

It may be argued that this model is based on what happened in the 1950s and 1960s. Slower growth of productivity in the 1970s has held back the process I have described. This may be true. Yet, even if productivity in manufacturing does not pick up soon, we seem to be on the verge of changes which will bring big increases in productivity in services, like banking, through mechanisation. In any case, we cannot base our policies on the assumption that our central policy - the improvement of performance and productivity in the private sector - will fail.

Consequences

There are only two possible courses of action and we must pursue them both. We must increase public sector productivity even in fields like administration and education where productivity is not so much a dirty word as an unknown one.

Because success in this is at best problematical, we must at the same time start a public debate on the issues raised here. We must convince all but the hard core of the Left, and even them if possible, that if we are to have tolerable rates of tax and acceptable rates of growth, we have to make radical changes. We shall have to abandon many public sector activities where productivity cannot be increased; charge for them; or turn them over to the private sector. And even where productivity can be increased, this may not happen unless we move those activities, too, into the private sector. We may also need to find ways to alter the tax and social security systems to protect the poor and disadvantaged. But the first priority is to set off a public discussion.

Conclusion

This model shows the remarkable power of a basic economic process. This is not a matter of politics, but of the mathematics of compound growth. The process in practice is less smooth than in the model, but it is equally powerful. As Tim Congdon recently pointed out in The Times, pay policies operate in the UK by enabling us to "con" the public sector. For a year or two, we force public sector pay to fall behind what full comparability with the private sector would give. Then, as in 1974-5 and 1979-80, the inevitable pay explosion occurs, led by the public sector.

6 June 1980

The lesson is that we must take a totally new look at the problem of public spending. De-indexing the public sector, though a useful holding operation, cannot halt an inexorable process like this. The process has to be stopped in its tracks. De-indexing can give us only time, and perhaps not much even of that.*

We must, quite simply, begin to <u>dismantle the public sector</u> as we know it. We must raise productivity where we can, and abandon activities entirely where we cannot. Otherwise, continuing inflation and rising taxation will destroy us. The White Paper on Government Expenditure is absolutely right: public expenditure lies at the very heart of our present economic difficulties.

Increasing the Welfare State in its present, bureaucratic, form, we have, with the best of intentions, but appalling lack of foresight, built the ultimate Doomsday Machine.

DOUGLAS HAGUE

* I think Douglas is confused on this point. De-indexing is necessary for transition from high to low inflation. It is a completely different issue from that of cutting P.E. in real terms. It will only do that if the de-indexation is more savage than the monetary targets call for.

cc Mr Wolfson
Mr Hoskyns

TL (DR)

MR. MIDDLETON

c.c. PS/Chancellor
Chief Secretary
Financial Secretary
Sir D. Wass
Mr. Ryrie
Mr. P. Davies
Mr. P. Dixon
Mr. Unwin
Mr. Cropper
Mr. T. Lankester, No.10

EARNINGS AND REDUNDANCY

You will have seen Tim Lankester's request to Department of Employment for information on recent redundancies in individual companies and excessive pay settlements in the year or two preceding. They have refused this request on the grounds of relevance, confidentiality and the claim that the information cannot be used with any confidence.

2. I feel that we should support some work in this area. Even if it is not for direct quote it would be useful to know the level of pay settlements in those firms where redundancies are taking place. It would enable us to make the connection between pay and unemployment with slightly more confidence. It is not necessary to justify any causal connection in particular cases but if, for example, we find that pay settlements in the relevant companies have been well below average this might affect the tone of Ministerial speeches.

3. It would also be useful to examine the pay settlements in those companies that complain to the Prime Minister or Chancellor about the high level of the exchange rate. This might also affect the tone of statements on the subject.

(TERRY BURNS)
5th June, 1980.

cc Mr Wolfson
Mr Hoskyns

Econ Pol 2

Prime Minister
Facts.

TL 5/6

Caxton House Tothill Street London SW1H 9NA

Telephone Direct Line 01-213 6400

Switchboard 01-213 3000

Tim Lankester Esq
10 Downing Street
LONDON SW1

4 June 1980

Dear Tim,

In your letter of 30 May you said that the Prime Minister would like to know whether any clear connection can be shown between recent redundancies in individual companies and excessive pay settlements.

The Department has information on redundancies based on those cases where employers have a statutory obligation, under Part IV of the Employment Protection Act, to notify the Secretary of State of redundancies occurring in particular circumstances. Redundancies typically arise from a combination of factors, and a wide variety of reasons are quoted by employers eg lack of demand, general inflation, insolvency, loss of orders, declining market, business transferred elsewhere, and so on. We also have a good deal of information about pay settlements in the private sector, obtained on a voluntary and confidential basis.

We have looked very hard at all of this information, but I am afraid that it just does not provide the sort of factual detail about the trading and financial position of particular firms that would justify asserting - or even conjecturing - a casual (causal) connection between the redundancies and particular pay settlements. For example, we have no means of estimating the effects of a pay settlement upon a particular firm's unit labour costs. We might be able to find examples of redundancies flowing from pay settlements involving productivity and de-manning, but this is clearly not what is wanted.

causal?

There would also be problems of confidentiality in quoting such information in the way you describe. It is, of course, a well-established principle that information compulsory obtained under statute should be used only for the intended statutory purposes; and firms supplying us with pay information on a goodwill basis would soon stop doing so if they were spotlighted in this way. Press reports are an unreliable substitute.

In short, we do not see how the information we have can be used with any confidence in the way suggested. A possible alternative might be to look at changes in the levels of labour costs and redundancies in various industries. This would take time, but we could put the work in hand if you think it would be helpful.

I am copying this letter to Martin Hall (Treasury).

Yours ever

Richard Dykes

R T B DYKES
Private Secretary

4 JUN 1980

LK

Econ Pol.

Caxton House Tothill Street London SW1H 9NA

Telephone Direct Line 01-213 6400

Switchboard 01-213 3000

T Lankester Esq
Private Secretary
10 Downing Street
LONDON SW1

cc Mr Wolfson

2 June 1980

Dear Tim,

In your letter of 30 May you asked if the information on the possible connection between redundancies and excessive pay settlements could be available for the Prime Minister's meeting on Tuesday. It will not be possible to meet that time-scale because the information is not readily available in a suitable form. However we will provide a note as soon as we can this week.

A copy of this goes to Martin Hall (Treasury).

Yours ever
Richard Dykes

RICHARD DYKES
Principal Private Secretary

BK.

File

Noc: David Wolfson
John Hoskyns
Bernard Ingham

10 DOWNING STREET

From the Private Secretary

30 May 1980

BF 16.6.80

The Prime Minister would like to know whether any clear connection can be shown between recent redundancies in individual companies and excessive pay settlements in the year or two preceding. I understand that you have data both on major redundancies and pay settlements at the companies concerned, and I would be grateful if you could provide a list so that we can see whether there is this relationship. If there are a number of good examples where the relationship holds, the Prime Minister believes that it might be desirable for Ministers to quote them so as to bring home the importance of realistic pay bargaining in the year ahead.

I don't know how much work is involved in preparing this material; but it would be helpful, if possible, if we could have it in time for the Prime Minister's meeting with your Secretary of State and the Chancellor of the Exchequer on Tuesday.

I am sending a copy of this letter to Martin Hall (HM Treasury).

T. P. LANKESTER

Richard Dykes, Esq.,
Department of Employment

PM already informed. MAP 21/

Foreign and Commonwealth Office

London SW1A 2AH

Econ Pol

20 May 1980

Dear David,

Thank you for your letter (PS(80)10) of 19 May. Since agreeing the date of 16 July as provisionally put forward, we have learned that the FCO are Top for Questions on that day. However, since the convenience of other colleagues is obviously paramount, the Lord Privy Seal would propose, subject to the Prime Minister's concurrence, to absent himself from the meeting for the duration of Question Time only.

I am sending a copy of this letter to Tim Lankester (No 10).

Yours ever,

S J Gomersall

S J Gomersall
Private Secretary to the
Lord Privy Seal

D J Wright Esq
Private Secretary to the
Secretary to the Cabinet
Cabinet Office
Whitehall
London SW1

CONFIDENTIAL

CONFIDENTIAL

Cabinet Office,
Whitehall,
London, SW1.

19th May, 1980

PS(80) 10

Dear Private Secretary,

Cabinet Meeting on Economic Strategy

You will already have been contacted by Committee Section in the Cabinet Office about plans for a special meeting of the Cabinet to discuss Economic Strategy on Wednesday, 16th July.

This is to confirm that the Prime Minister has agreed that this meeting should take place on that date. The meeting will be held at No. 10 and will begin at 10.30 am. After a break for lunch, the meeting will continue into the afternoon, probably finishing at about 4.00 pm. I should therefore be grateful if you could ensure that this date is now firmly included in your Minister's diary.

Yours sincerely,

(Signed) D.J. WRIGHT

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10 DOWNING STREET

P.a.

From the Principal Private Secretary

SIR ROBERT ARMSTRONG

CABINET MEETING ON ECONOMIC STRATEGY

The Prime Minister has seen your minute A02076 of 2 May 1980.

She agrees that this Cabinet meeting should be held on 16 July starting at 10.30 am.

She is also content for Mr. Ibbs and Mr. Burns to take part in the meeting, and she proposes to discuss your suggestion that Sir Douglas Wass might attend with the Chancellor of the Exchequer when she next sees him.

C. A. WHITMORE

Noted by CS.
please return to
Mr Whitmore.
CS. 9/5

9 May 1980

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1.

Prime Minister.

Agree Wednesday 16th July for this special meeting of the Cabinet?

I strongly support X/ below. I am sure Sir Douglas Wass would make a valuable contribution at a meeting of this kind. Content?

CONFIDENTIAL

Ref. A02076

MR. WHITMORE

Cabinet Meeting on Economic Strategy

As requested in your minute of 18th April, we have been trying to find a date for a meeting of the full Cabinet to discuss Economic Strategy. The best date from among those which you suggested to us seems to be Wednesday, 16th July. This is likely to create problems only for the Lord Privy Seal and the Chief Secretary, Treasury. They would both be available in the morning but would probably have to leave early in the afternoon: the Lord Privy Seal for Questions and the Chief Secretary to attend the Report Stage of the Finance Bill. The other dates present much greater difficulties for attendance by a number of Ministers.

2. I should be grateful, therefore, if you could confirm that the Prime Minister is content that the meeting should go ahead on 16th July. I understand that she is due to visit Conservative Central Office at 8.45 am but that this visit is likely to be over in time for this Cabinet meeting to start at 10.30 am. After a break for lunch, the meeting could continue into the afternoon until, perhaps, 4.00 pm. I will be minuting you further in due course about how the meeting might be organised.

Yes

3. In your minute of 18th April you suggested that Mr. Ibbs and Mr. Burns should both be present. They have been informed of the date and are both available. In addition, I think that the Prime Minister might wish to consider authorising the Chancellor of the Exchequer to bring the Permanent Secretary to the Treasury, Sir Douglas Wass, with him to the meeting if he would like to do so.

X

RA

(Robert Armstrong)

No - MT.

2nd May, 1980

- 2 MAY 1980

CONFIDENTIAL

Econ Pol file & Po

blind copy –
Messrs. Hoskyns
Wolfson

cc Sir R. Armstrong

10 DOWNING STREET

From the Private Secretary

MR. IBBS
CPRS

cc. ~~[illegible]~~

GOVERNMENT OBJECTIVES AND STRATEGIES

You and Sir Robert Armstrong called on the Prime Minister this evening to discuss your minute of 25 April. This is to record the main points arising from the discussion.

The Prime Minister said she was content with the four primary objectives listed in the annex to your minute.

Under the strategies heading, she suggested that you should add to 1(a) - "relating pay to performance and to demand and supply". She also suggested that you should consider including the need to dethrone the RPI as the basis for pay negotiations and the need to examine whether the RPI is a true measure of inflation. Under 1(b), the Prime Minister asked that the word "assisting" should be taken out of the item relating to small firms, since she did not feel financial assistance to individual firms was an appropriate strategy. Under this sub-heading, she also suggested that you should include the need to educate trade unions in the economic "facts of life".

These minor points apart, the Prime Minister said she was content with the list of strategies.

The Prime Minister agreed that the CPRS should consider individual proposals against the objectives and strategies listed (subject to the points she had made on them); she also agreed that the list would provide some useful markers against which to measure progress from time to time.

/Turning to the

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Turning to the list of policy issues in paragraph 4(c) of the minute, the Prime Minister said that she agreed that these were indeed areas where further work was needed. She agreed that the CPRS should concentrate for the moment particularly on public sector pay and policy on nationalised industries.

J. P. LANKESTER

30 April 1980

CONFIDENTIAL

Qa 05007

To: PRIME MINISTER

From: J R IBBS

Government Objectives and Strategies

1. In order to see how the CPRS can be most helpful, and how to plan its work accordingly, I have been trying to define as clearly as possible what the Government is aiming to achieve, i.e. the 'objectives', and the main lines of policy that are being pursued to reach these objectives, i.e. the 'strategies'. In both instances I have tried to concentrate on the central points of the programme - obviously there may be a multitude of other policies which back up the principal lines of attack.

2. I have arrived at four main objectives and several strategies in support of each, some of which are relevant to more than one objective. These objectives and strategies are listed on the attached sheets.

3. The main sources I have tapped are your own description to me last November of your objectives, the Manifesto, and discussion within the CPRS. I have also consulted Sir Robert Armstrong and I hope that he can be present during further discussion.

4. My purpose in drawing up the list is to provide a basis which will -

(a) enable the CPRS in preparing collective briefs to have a firm framework against which to assess and comment upon particular proposals. I want to be able to identify and draw attention to the implications which any proposal has across the broad raft of strategies. The desirability of doing this has been apparent to me from the items with which I have already come into contact at E Committee such as energy subsidies for horticulture and fishing, INMOS, and the electricity industry EFL;

(b) provide some markers against which progress on specific strategies can be monitored and so make it possible to suggest in some instances where some additional complementary policy or modification may be necessary;

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(c) enable any gaps where the range of strategies aimed at a primary objective appears to be insufficient in the light of events, and thus make it possible to suggest some further ideas. Examples of areas which have emerged from the discussion so far as being unclear or lacking momentum are:

Policy on pay, particularly public sector
Policy on Nationalised Industries
Policy on unemployment
Attitude to and pressure on local authorities
Selection of where funds should be spent
Full economic pricing of goods and services
Benefits to be derived from North Sea oil
Policy on encouraging technological advance

5. I should be grateful for an opportunity to check with you whether you would regard the objectives and strategies on the attached list as correct and sufficient for this immediate purpose, and whether the broad approach I am proposing to take is appropriate. I understand that arrangements have been made for me to see you at 5.30 p.m. on Wednesday, 30 April, and perhaps we could discuss the list then.

6. I am sending a copy of this minute and attachment to Sir Robert Armstrong.

25 April 1980

Att

Government Objectives and Strategies

The Government has four primary objectives:

(1) to create a vigorous and healthy free market economy;

(2) to create a society in which individuals are free and encouraged to make economic and other decisions for themselves while those most in need are protected;

(3) to improve defence and law and order;

(4) to obtain re-election for a further period of Office because about ten years would be needed to achieve these objectives.

Objective (1) is co-ordinated collectively by Ministers and responsibility for Objectives (2) and (3) is largely devolved to relevant individual Ministers.

Strategies

Several strands of the Government's strategies assist the achievement of more than one of the four main objectives. The main strategies in support of each objective are as follows:

(1) To create a vigorous and healthy free market economy.

Strategies: (a) reduce inflation, in the medium term rather than necessarily immediately, by

- reducing the rate of growth of money supply
- trade union reform and more even balance of power in industrial relations
- reducing the level of PSBR in relation to GDP.

(b) improve industrial performance by

- reducing central and local government bureaucratic controls
- stimulating competition by returning public corporations to the private sector and reducing monopolies
- improving incentives
- encouraging and assisting small and innovative firms
- ensuring that industries with a future that provide tradeable goods and services survive

(c) reduce the size of (central and local) Government and eliminate waste.

(2) To create a society in which individuals are free and encouraged to make economic and other decisions for themselves while those most in need are protected.

Strategies:
- (a) greater emphasis on indirect rather than direct taxation
- (b) reduce dependency on social security and ensure benefits to to those most in need
- (c) reform the law on picketing and trade union ballots
- (d) reduce the influence of bureaucracy
- (e) remove distortions in the pricing of goods and services to allow freedom of choice
- (f) changes to housing policy - own your own home, etc.
- (g) improve standard of education.

(3) To improve defence and law and order.

Strategies:
- (a) commitment to an annual 3 per cent rise in real expenditure on defence
- (b) raise the pay and staffing levels of the armed and police forces
- (c) maintain the United Kingdom's nuclear deterrent capability - e.g. Polaris replacement
- (d) preparedness to stand up and be counted when challenged
- (e) sharpen penalties for anti-social behaviour - short sharp shock.

(4) To obtain re-election for a further period of Office in order to attain the objectives within ten years.

Strategies:
- (a) get the most unpalatable of measures out of the way as early as possible in the first part of this period of Office
- (b) maintain commitment to objectives and face painful decisions
- (c) increase public understanding of the true economic and other facts, and so gain acceptance and support for the less pleasant aspects of (a) and (b).

25 April 1980

Original returned to J. Hoskyns

25 April 1980

PRIME MINISTER

CPRS TERMS OF REFERENCE

At our discussion on Strategy work on Sunday, 23 March, we agreed that one of the urgent items on the list was the establishment of clear terms of reference for CPRS.

Since then I have had a number of discussions with Robin Ibbs who, not surprisingly, was already thinking on similar lines. You are seeing him on Wednesday, 30 April on this topic.

From my discussions with Robin, he appears to take very much the same view that we do: that there is a need for the clearest possible understanding of the Government's objectives and that the strategies for reaching those objectives are still only under development, with a lot of work still required, and those strategies will continue evolving through the life of the Government. He has commented to me on the need for a more "directed" CPRS, with the work related to strategy. He has received the impression that, in the past, CPRS members have tended to be allowed to do whatever happens to interest them.

From the above, it is clear that his general view of strategy and of the CPRS' role fits ours very well. At our meeting on 23 March, I suggested that another key area for study was the nationalised industries, and that this could itself be one of the priority tasks for the CPRS once the latter's terms of reference were agreed. Robin and I have discussed this and he had already concluded that work was urgently needed on the whole question of EFL's.

We are now putting together the paper you asked for on the lessons learned in the steel dispute. One of the recommendations in that paper will be that a study be put in hand on Government's relationships with the nationalised industries, the meaning of intervention and non-intervention; and the EFL study fits naturally into this. We will be suggesting that CPRS might lead that study, and Robin knows that we will be saying so.

It seems to me that Robin is setting off in very much the right direction.

JH

JOHN HOSKYNS

CABINET OFFICE

With the compliments of
Sir Robert Armstrong KCB, CVO
Secretary of the Cabinet

C.A. Whitmore, Esq.

70 Whitehall, London SW1A 2AS
Telephone: 01-233 8319

PERSONAL

Econ Pol

CABINET OFFICE

70 Whitehall, London SW1A 2AS Telephone 01-233 8319

From the Secretary of the Cabinet Sir Robert Armstrong KCB, CVO

25th April, 1980

Ref. A02036

You may have seen that my Private Secretary has written round to the Private Secretaries of Cabinet Ministers about a "Chequers day" on economic strategy, with the suggestion that Terry Burns and Robin Ibbs would be invited to be present.

I fear that there may have been some confusion about this between here and No. 10. I was under the impression that the Prime Minister had discussed this idea, including the participation of Terry Burns, with the Chancellor of the Exchequer, who had said that he agreed. It now seems that, though the idea has certainly been discussed by the Prime Minister and the Chancellor, it is not clear how far they agreed upon participation by other people than Cabinet Ministers. If I had known that, I should of course have wanted to have a word with you before our letter went out; indeed, perhaps I should have done that anyway.

I have little doubt that, if the Chancellor were to take the view that you should come as well as - or even instead of - Terry, the Prime Minister would be perfectly content.

ROBERT ARMSTRONG

Sir Douglas Wass, GCB

Told John Wiggins of the existence of this letter.

CA. [initials]
29 IV.

cc A Duguid 2

CONFIDENTIAL

Prime Minister

Forecast outturn for earnings for the current pay-round: pretty worrying.

TL.
24/4

Caxton House Tothill Street London SW1H 9NA

Telephone Direct Line 01-213 6400
Switchboard 01-213 3000

Rt Hon Sir Keith Joseph Bt MP
Secretary of State for Industry
Department of Industry
Ashdown House
123 Victoria Street
LONDON SW1

24 April 1980

Agreed but doubt its accuracy

Dear Keith

MONTHLY PAY BRIEF

Since no early meeting of E(EA) has been arranged, I am sending copies of the April Pay Brief to colleagues for information.

This gives the customary review of current pay negotiations and statistical information about settlements. I would draw your attention in particular to paragraph 3 which attempts a forecast of the outturn of the current pay round.

The forecast is for an underlying increase in average earnings of about 22% to 24%. This reflects first the level of current round pay settlements, which cannot be expected to fall in the remaining months of the round. Although there are signs at the margin that monetary pressure is beginning to bite on negotiations, it has yet to be reflected in the general level of settlements. Secondly the increase in earnings will reflect the pressures of pay drift which are likely to increase average earnings about 3% more than new settlements would suggest. Thirdly, in the public sector, there is the effect of increases flowing through into this round from the previous one, because of comparability awards, staging or delayed settlements. These will probably contribute another 2% to the overall increase in earnings.

I am copying this to the Prime Minister and to members of E(EA).

Yours
Jim

PAY BRIEF FOR MINISTERS : POSITION IN MID-APRIL

1. Since the last pay brief in mid-March 27 major groups (10 in the public sector) covering about 1.1m employees have had settlements for the pay year 1979/80. This brings the total for the year to 158 (39 in the public sector) covering about 5.8m employees - about half of all employees in the major groups monitored. At this point last year there had been 115 settlements covering about 4.9m employees.

2. The weighted average level of settlements for the major groups which have settled since mid-March is about 17% (18% in the public trading sector, 16½% in the public services sector and 17% in the private sector). The weighted average level of current pay year settlements cumulatively since 1 August 1979 is about 16½% (17½% in the public trading sector, 14% in the public services sector and 18½% in the private sector).

3. A prediction of the overall rise in earnings over the 12 months of pay bargaining to July 1980 can now be attempted. In the private sector there is no evidence to suggest that the current pattern of settlements will change much over the remaining months to July. In addition there will be 'drift' of about 3%, reflecting the known tendency for earnings to exceed estimates of settlements. Similar assumptions apply to the public corporations. In the public services, the present average level of settlements will probably be pushed up by increases recommended by review bodies and by the influence of the civil service settlement. In addition earnings in the public services will increase because of 'drift' (about 2½%), Clegg awards (about 5½%) and other increases occasioned by settlements in the previous pay round (about 4½%). Overall the index of earnings is likely to show an underlying increase of about 22-24%.

see attached note
MS

Claims and Negotiations

4. In the public sector British Rail clerical and conciliation grades (150,000) are being recommended to accept a staged offer worth about 19% in the first year with a reduction in hours from 40 to 39 from November 1981. The proposal provides for changes in working practices. Negotiations will now start on the Comparability Commission's report recommending increases averaging 18.2% for Teachers (621,300). Negotiations on the 1980 pay claim based on the average earnings index will take place at the same time. Scottish teachers have rejected an offer of 13%. BBC Staff (28,000) are seeking pay parity with ITV companies, which is estimated by the unions as an increase of 30%, and are disappointed with the recent offer, reported to be 15% plus 5% for grade restructuring. Negotiations are continuing on the claim for increases of at least 30% for NHS Nurses and Midwives (484,00). The Union of Post

Office Workers is recommending its members in the Post Office postal grades (152,900) to accept in a ballot an offer of 15% with staffing changes. Negotiations begin now for London Transport employees (47,000). If the LT budget permits offers of only 12% industrial action on rail and buses may follow quickly. Following their in-house comparability study agreement has been reached by Local Authority non-manuals (E & W) (529,000) on increases averaging 13% from 1 January 1980 on top of the 9.1% paid from 1 July 1979.

5. In the private sector an improved offer of 19% with a reduction in working hours from June 1982 is being considered by Construction Industry employees (775,000). NGA have rejected an offer estimated at 17.5% with reduction in hours from 40 to 37½ by July 1982 made by British Printing Industries Federation (167,000) and have taken selective industrial action which, in response to suspension of members, may now be stepped up to shut down provincial newspapers and affect certain national newspapers. SOGAT and NATSOPA are recommending the same offer and balloting members. Claims worth 25-30% have been made by union and staff associations on behalf of London Clearing Banks staff (151,000) and the banks have responded by offering 19% which has been rejected by the banking union. Negotiations continue in Cotton, Manmade and Allied Fibres Industry (60,000) where an offer to Spinning and Weaving Operatives of 7% plus 4% for productivity has been rejected. An offer of 17.5% plus one day extra holiday is being accepted on behalf of London Brick Company employees (6,300). ICI Ltd will respond by mid-May to a substantial claim by its process workers (51,000)

Prices

6. The year on year rate of increase in retail prices was 19.8% in March compared with 19.1% in February. The year on year rate of increase in the tax and price index was 17.6% in March compared with 16.9% in February.

Earnings

7. The year on year rate of increase in average earnings for the whole economy was 18.6% in February compared with 20.1% in January. In the older series which mainly reflects manufacturing industry the year on year figure was 18.9% in February compared with 20.6% in January.

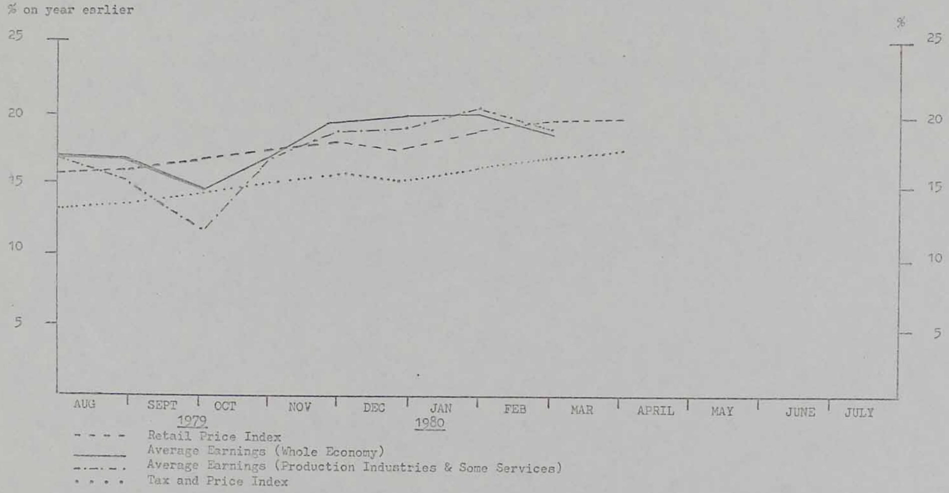
Real Disposable Income

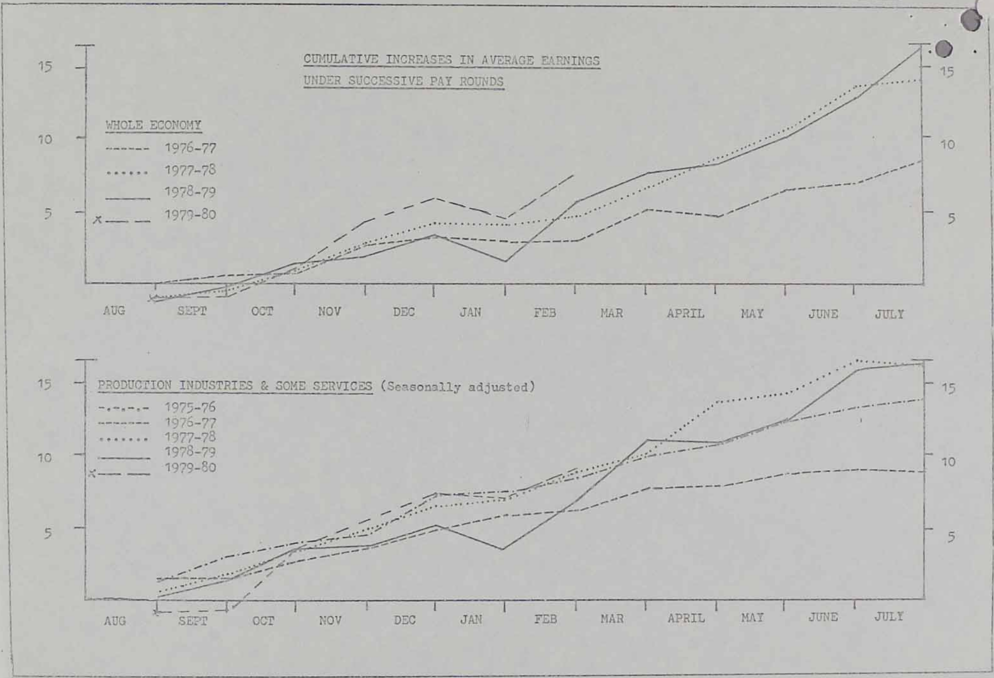
8. The real disposable income of the typical family (described in the mid-July Pay Brief) rose by around 1.9% in the year to February.

April 1980 Department of Employment

21

AVERAGE EARNINGS AND RETAIL PRICES




CUMULATIVE INCREASES IN AVERAGE EARNINGS
UNDER SUCCESSIVE PAY ROUNDS
WHOLE ECONOMY
1976-77
1977-78
1978-79
1979-80
15
10
5
AUG
SEPT
OCT
NOV
DEC
JAN
FEB
MAR
APRIL
MAY
JUNE
JULY
PRODUCTION INDUSTRIES & SOME SERVICES (Seasonally adjusted)
1975-76
1976-77
1977-78
1978-79
1979-80

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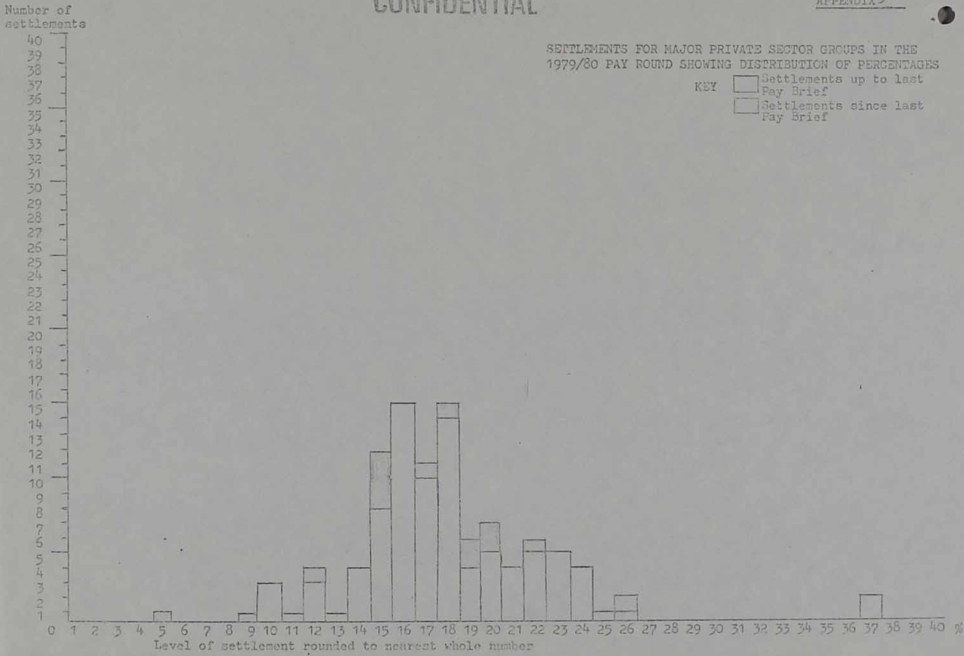
APPENDIX 5

SETTLEMENTS FOR MAJOR PRIVATE SECTOR GROUPS IN THE 1979/80 PAY ROUND SHOWING DISTRIBUTION OF PERCENTAGES



010

CONFIDENTIAL

Caxton House Tothill Street London SW1H 9NA

Telephone Direct Line 01-213 6400

Switchboard 01-213 3000

Nick Sanders Esq
Private Secretary
Prime Minister's Office
10 Downing Street
LONDON SW1

24 April 1980

Dear Nick

AVERAGE EARNINGS

You asked for some extra briefing on the effect of the comparability payments on average earnings.

... The DE's monthly pay brief, a copy of which is enclosed, shows that payments to public service workers hanging over from the last round of pay bargaining will contribute (along with wage drift) to an increase in average earnings during this round beyond the increase occasioned by current settlements. (See para 3 of the pay brief). Two elements of 'hangover' are identified in the report. Recommendations from the Comparability Commission are expected to add about 5½% to earnings in the public services; or about 1.1% to earnings averaged across the whole economy. Most of this addition comes from recommendations already made by the Commission. Fairly generous assumptions about the cost of outstanding reports have been made and included in this estimate; but they will not be a substantial addition. Some of the Commission's recommendations are for staged implementation and will fall in the next round, notably that half of the award for teachers which is for payment in September.

The other main elements of 'hangover' are the staged payments for civil servants, and the in-house comparability study for local authority non-manual staff. Together these are estimated to add about 4½% to public service earnings in the 12 months up to July, or about 0.9% to earnings averaged across the whole economy.

In total therefore 'hangover' in the public services is likely to add about 2% to the earnings outturn for this round.

Yours sincerely

John Anderson.

J ANDERSON
Private Secretary

CONFIDENTIAL

Copy 1
1) CAB/W.AMLS. Econ Pol
2) CF.

Cabinet Office,
Whitehall,
London, SW1.

24th April, 1980

PS(80) 7

Dear Private Secretary,

The Prime Minister has decided that she would like to have a discussion on economic strategy at Chequers in early July. This would be a meeting of the full Cabinet with Mr. Terry Burns and Mr. Robin Ibbs taking part. The discussion would be planned to last all morning and could run into the afternoon if necessary.

No. 10 have suggested that this meeting might take place on one of the following dates:

Saturday, 5th July

Sunday, 6th July

Sunday, 13th July

Wednesday, 16th July

I should be grateful if you could let me know by the end of April which of these dates your Minister could manage.

Yours sincerely,

(Signed) D.J. WRIGHT

CONFIDENTIAL

Original filed
Defence UK Defence Policy

NOTE FOR THE FILE

I spoke to David Wright and offered him:

14 May in London or 17 or 18 May at Chequers for OD and OD plus Defence

5 or 6 July or 13 July for all day Cabinet at Chequers

CP.

23 April 1980

CONFIDENTIAL

10 DOWNING STREET

Top Copy: filed
DEFENCE: UK Defence Policy.

From the Principal Private Secretary

SIR ROBERT ARMSTRONG

I showed the Prime Minister your minute A01836 of 31 March 1980 over the Easter holiday, and you and I had a brief word earlier this week about her reaction to your proposals. As we agreed then, I have now discussed the matter further with the Prime Minister and can let you know what she has decided.

She is firmly of the view that Foreign Policy and Defence must be discussed together. She has therefore agreed that we should aim to have a meeting of OD in two parts. The first part, which will be attended only by members of OD, will be devoted, on the basis of the paper which the FCO are preparing, to a discussion of Foreign Policy. The second half of the meeting, which should be attended, as you proposed in your minute, by Sir Keith Joseph, Mr. Atkins and the Chiefs of Staff as well as by members of the Committee, will be a session on Defence. Given its structure, this meeting might best be held at Chequers, with the Foreign Policy discussion taking place before lunch and the discussion on Defence in the afternoon. But if that proves impossible, we might instead have the meeting here in 10 Downing Street, making a start at, say, 9.15, breaking at the end of the Foreign Policy session for coffee at 11.00 and then moving on to the Defence half of the meeting from 11.15 to 13.15. This would be heavy going, but I think is on balance preferable to breaking up a London meeting into pre-prandial and post prandial sessions.

The Prime Minister wants the meeting to take place in mid May. We will try to identify one or two possible dates early next week: this is not going to be easy.

/The Prime Minister

CONFIDENTIAL

The Prime Minister agrees with your suggestion that there should be a discussion on economic strategy at Chequers in early July. This would be a meeting of the full Cabinet, with Mr. Burns and Mr. Ibbs taking part. The discussion would be planned to last all morning and could run on into the afternoon, though this should probably not be necessary. Again, we will pick a couple of possible dates.

I should like to have a word with you about how we might best let Ministers know about both of these meetings.

C. A. WHITMORE

18 April 1980

Prime Minister.

This seems to me a sensible way of proceeding consistent with the arrangements suggested in paragraph 7?

Top copy: filed DEFENCE UK Defence Pol Pt 4

(1) Defence & Foreign Policy must be discussed together. (given only OD) members and [illegible] mid-May.

(2) Econ strategy later. – Will you have time to prepare – say early July?

MW

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Ref. A01836

MR. WHITMORE

Discussion on Future United Kingdom Defence Policy

After the OD meeting on 20th March we had a brief word with the Prime Minister on the question of a further discussion of defence matters before the Secretary of State for Defence brings his proposals back to OD in June. The purpose of this minute is to make some suggestions.

2. I think that the further discussions should be confined to members of OD plus the Secretaries of State for Industry and Northern Ireland. It should take place long enough before the Secretary of State for Defence frames his final proposals for him to take into account points made in the discussion, but not so long before that the memory of it will have faded before OD considers his recommendations. This points to a date in early or mid May.

3. On form and duration I suggest that the occasion might start with a presentation, perhaps by the Chiefs of Staff and senior officials with visual aids, followed by discussion.

4. On substance I believe that what would be most helpful in the presentation is a description, in plain language, on how the Ministry of Defence plans to spend the defence budget over the next few years, the assumptions on which those plans are based, the scope for making alternative plans and the penalties which are likely to be incurred by making changes. Clearly we shall need to discuss the details of such a presentation with the Ministry of Defence, but something along these lines would allow members of OD to form a better view of the practical policy options between which the Secretary of State for Defence has now to choose, and hence lead to a more deeply considered discussion of his proposals when they come to OD in June.

5. Perhaps we could talk about the relationship of this to other possible "Chequers days" or half-days. When we discussed this with the Prime Minister we were thinking about combining the defence discussion, to last for about $1\frac{1}{2}$ hours, with a discussion of economic strategy, to last for about 2 hours,

and packing all that into one morning, to be followed by a late buffet lunch, after which Ministers would go their ways. There is also the question whether we need a similar discussion on foreign policy after Afghanistan, on which the Foreign Secretary is preparing a paper.

6. My own views are:

(1) Though we ought not to make up our minds about the discussion of foreign policy until we have seen the Foreign Secretary's paper, I incline to the view that it probably does not need a "Chequers day": it could well be done at a regular meeting of OD for which we had a clear run of $1\frac{1}{2}$ to 2 hours and no other business. That ought ideally to come before the defence discussion.

(2) If we try to pack defence and economic strategy into a single morning, we may end up rushing both and doing neither justice.

(3) The best time for the discussion of economic strategy may now be in the second half of June or even early July, when the Budget has been digested, and we have the next round of short-term forecasts. There would be something to be said for having this after rather than before the Summit meetings in June.

7. So my inclination is to favour separating the defence and economic strategy discussions; and to think in terms of a programme as follows:

(1) An OD meeting in London in late April or very early May on foreign policy.

(2) A defence discussion at Chequers on a Friday in the first half of May, to last for 2 to $2\frac{1}{2}$ hours (so starting at 10.00 am or 10.30 am), confined to members of OD, plus the Secretaries of State for Industry and Northern Ireland and the Chiefs of Staff.

(3) An economic strategy discussion at Chequers towards the end of June or early in July, to start at 10.00 am and last all morning, and continue after lunch if Ministers want to; to include certainly all members of E and perhaps all members of the Cabinet; with participation by the Government's Chief Economic Adviser (Terry Burns) and by the CPRS.

8. Perhaps we could discuss.

RTA

(Robert Armstrong)

31st March, 1980

Published Papers

The following published paper(s) enclosed on this file have been removed and destroyed. Copies may be found elsewhere in The National Archives.

House of Commons Hansard, 28 February 1980, columns 1580-1704
"Economic and Industrial policies"

Signed CAWayland Date 9 February 2010

PREM Records Team

cc: Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
Sir Douglas Wass
Mr Burns
Sir K. Couzens
Sir A. Rawlinson
Mr Ryrie

Mr Littler
Mr Middleton
Mr Bridgeman
Mr Cassell
Mr Lavelle
Mr Shepherd
Mr Bottrell
Mr Davies
Mr Folger
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F(SCT)

Treasury Chambers, Parliament Street, SWIP 3AG
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13 February 1980

Dear Edward

PA.
"economic strategy"
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When you wrote to me on 12th December last you enclosed a number of questions to which you indicated that the Treasury and Civil Service Committee would value a written response as background to the enquiries they are planning to undertake in the course of this year.

I thought that the most helpful response I could make would be to set out in this letter the main objectives of the Government's economic strategy and to relate this so far as possible to the particular points raised in the questions with your letter.

The Government's economic strategy

The main objectives of the Government's economic strategy are to reduce inflation and to create conditions in which sustainable economic growth can be achieved. This requires firm monetary and fiscal policies and we have not hesitated to take action on both fiscal policy and interest rates to curb the excessive increase in monetary growth that we inherited. At the time of the Budget last June, when the rate of monetary growth was above the previous Government's target, a target growth rate of 7-11 per cent was set for sterling M3 for the period mid-June 1979 to mid-April 1980, and Minimum Lending Rate was raised to 14 per cent. It was also estimated that the PSBR for the current financial year would be some £8¼ billion (4½ per cent of GDP).

As the Committee will be aware, however, in the period to October 1979 the underlying rate of monetary growth continued significantly above the target rate as a result of higher than expected public borrowing (due in large part to delayed Post Office and VAT payments following industrial action) and persistently high bank lending. The Government, therefore, acted to bring the PSBR back into line with the Budget estimates by advancing Petroleum Revenue Tax payments; Minimum Lending Rate was raised to

/17 per cent;

The Rt. Hon. Edward Du Cann, MP.

17 per cent; and the 7-11 per cent target annual growth rate for the money supply was extended to cover the 16 months to mid-October 1980.

A firm limit on monetary growth also requires a consistent fiscal stance if interest rates are not to rise, and this means tight control of public expenditure if the tax burden is not to increase. In the Budget I announced public spending plans for 1979-80 stabilised at the 1978-79 levels, and the White Paper published in November 1979 (Cmnd 7746) held plans for 1980-81 at the 1979-80 level. Since then, however, we have looked again at the 1980-81 plans to see where further savings are sensible and practicable, and these will be set out in due course, together with the plans for the later years, in the second White Paper. The scope is limited as the start of the financial year approaches but any further savings will mean that less needs to be found by taxes if borrowing is not to be increased.

The ways in which control of the money supply affects the growth of money national income and ultimately prices are complex. Lower monetary growth may be expected to result in a lower growth of money incomes and nominal expenditure, because of its effects on the exchange rate and asset prices and the fiscal changes required to achieve lower monetary growth. Lower growth of money incomes will ultimately lead to lower inflation; and the speed at which this occurs depends crucially on expectations in both domestic and external markets, and in particular on the effects on domestic pay negotiations. As I have made clear on many occasions, the more moderate are pay settlements, the faster will the adjustment of prices and the smaller any transitional effects upon profits, output, investment and employment.

The Exchange Rate and the balance of payments

The Government, through the Bank of England, intervene in the exchange markets to prevent excessive fluctuations in the exchange rate but they do not attempt to establish any particular value for sterling. The exchange rate for sterling is thus primarily set by market forces; and the market's perception of the appropriate rate is of course, likely to vary from time to time as particular factors assume grater or less importance in the market's judgement.

Recently, sterling has been generally firm, as the market has laid particular stress on the UK's favourable position as an oil producer at a time of rising oil prices. The market has also taken a favourable view of the Government's commitment to firm fiscal and monetary policies. The abolition of exchange control has resulted in an outflow from the private sector the direct effect of which is to reduce the money supply; but because of the factors

/referred to

referred to above these flows have been more than offset by inflows from the rest of the world.

The balance of payments on current account was in substantial deficit in 1979 but this deficit was more than offset by capital inflows; and the reserves rose. The poor trend in our trade performance in recent years, which reflects the UK's inadequate industrial performance, is a matter for concern. The way to improve this, however, is not by a depreciation of the exchange rate - since any gains to competitiveness will in time be eroded - but by higher productivity and lower cost increases.

The Government believe, therefore, that overriding priority must be given to reducing inflation, which impairs economic efficiency and discourages investment, and to strengthening the supply side of the economy.

The UK's net contribution to the EEC Budget is expected to rise to about £1.2 billion at outturn prices in 1980, making the UK the largest net contributor. This represents a massive transfer of real income to richer member countries; and adds substantially to public expenditure and the PSBR. It also has an adverse effect on the balance of payments and is contributing to the erosion of the traditional surplus on invisible account. These are the reasons why the Government are determined to achieve a very substantial reduction in the size of the transfer.

<u>The supply side of the economy</u>

Starting with my Budget last June, the Government have taken a number of steps to improve the supply side of the economy both through changes in taxation and through measures to restore the flexible working of the market economy.

So far as taxes are concerned, our primary concern is that both the structure and level should not discourage enterprise and should permit hard work and initiative to be rewarded. My Budget last June accordingly included a substantial switch in taxation away from taxes on incomes to taxes on spending. I believe that the reduction in marginal rates of income tax should be particularly helpful in improving incentives by allowing people to keep a higher proportion of extra earnings; and the increases in personal allowances helped the lower paid. The Government's longer-term aim is to reduce the basic income tax rate to no more than 25 per cent.

The Government are also concerned that in the economy at large market forces should be encouraged to work as

/freely and

freely and flexibly as possible. This is why we have abolished price, dividend and exchange controls, none of which served any useful purpose, but all of which hindered the efficient functioning of the economy.

The abolition of price controls leaves companies free to make pricing decisions in the light of market conditions. Dividend controls were widely acknowledged to be a source of distortion in the capital markets and a disincentive to progressive firms, especially smaller ones, as well as an administrative burden to both public and private sectors. And the abolition of exchange control now leaves capital markets free to direct funds to those investments - whether at home or abroad - which are expected to yield the highest returns. At the same time, the Government's Competition Bill will strengthen the power of the Director General of Fair Trading and of the Monopolies and Mergers Commission to deal with practices which restrict competition.

The Government have also eschewed all the apparatus of formal incomes policies which have failed in the past and led to distortions in the labour market. As my colleagues and I have frequently stated, the Government do not intend to intervene in individual wage negotiations except where they are inevitably involved as direct employers. They are concerned, however, that negotiators should understand and accept as quickly as possible that their own best interests are served by modest pay settlements, and that a de-escalation of pay settlements is crucial if Britain is to be transformed once more into a successful trading nation.

The Government intend to restore a broad balance of power in the framework for collective bargaining. Reforms to be effected by the Employment Bill, such as those removing specific abuses in picketing and the closed shop, have been designed to that end. Other measures in the Bill remove aspects of employment protection which have in practice turned out to discourage employment rather than improve its conditions.

<u>Economic developments since 1976</u>

The enclosure to your letter also sought information on economic policy measures and the development of the main economic indicators over the past three years. This is already largely available from published sources. Major policy measures are, for example, listed in Economic Trends monthly calendar of events. More details have also been provided both by this Government and their predecessor in successive White Papers on public expenditure and in the

/Annual Financial

Annual Financial Statement and Budget Report. And figures for GDP, unemployment and the balance of payments are published regularly in Government statistical publications. However, the Committee may find it helpful to have a summary of major policy measures and economic developments, and these are attached at Annexes A-E.

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The effectiveness of monetary policy as a means of reducing inflation

Monetary policy is essentially a medium-term policy. The practice of publishing targets for the monetary aggregates is of relatively recent origin in this country, dating from 1976. The UK's experience, therefore, is limited so that past experience may not be a good guide to developments in the new situation. The Government's commitment to a firm monetary policy has contributed significantly to the strength of sterling; and a high exchange rate has a direct beneficial effect on inflation through the reduction in the cost of imports.

For the future, I believe that the Government's determination to maintain a strict monetary policy will have an important influence on inflationary expectations, whose importance I have already stressed above. And I am confident that a progressive reduction in the rate of monetary growth over a period of years, supported by consistent public expenditure and taxation policies, will both result in a marked reduction in the rate of inflation and will prove the only way of achieving a permanent reduction.

The forecasts

Finally, the enclosures with your letter asked about the Government's forecasts for the future. A copy of the Government's Industry Act forecast published last November is attached and the Committee may find it convenient to have this to hand. A further forecast will, of course, be published with the Budget on 26 March.

.....

Yours ever

Geoffrey

GEOFFREY HOWE

I. MONETARY TARGETS

Monetary targets were first set for the year 1976-77. For that year and 1977-78 the Government's objectives were defined in terms of a limit (agreed with the IMF) on DCE, although ranges for £M3 growth were defined consistent with that limit. For subsequent periods a target range has been set for £M3 growth. The targets, and monetary growth over the target periods, have been as follows:-

Date	Period	Target	Outturn
15 Dec 1976	12 months to mid April 1977	1) DCE (limit): £9.0bn 2) £M3 (consistent range): 9-13%	1) DCE: £4.6bn 2) £M3: 7.4%
29 Mar 1977	12 months to mid April 1978	1) DCE (limit): £7.7bn 2) £M3 (consistent range) 9-13%	1) DCE: £4.2bn 2) £M3: 15.7%
11 April 1978	12 months to mid April 1979	£M3: 8-12%	£M3: 10.7%
19 Nov 1978	12 months to mid October 1979	£M3: 8-12%	£M3: 13.4%
12 June 1979	10 months to mid April 1980 subsequently extended to	£M3: 7-11% (annual rate)	£M3: 11.5% (annual rat after 6mont
15 Nov 1979	16 months to mid October 1980	£M3: 7-11% (annual rate)	

Note: All figures seasonally adjusted: growth rates calculated as seasonally adjusted increase on seasonally adjusted stock.

II. INTEREST RATES

Details of interest rate movement are available in section 13 of Financial Statistics, in particular table 13.11 for Minimum Lending Rate, table 13.10 for short term rates and table 13.7 for redemption yields on British Government securitie of different maturities. Average interest rates for the past three years are summarised in the attached table overleaf.

		Minimum Lending Rate	3-Month Inter-bank rate	20-year Government stocks
1977	1	12.31	11.81	13.89
	2	8.39	8.05	13.00
	3	7.24	6.94	12.57
	4	5.85	5.74	11.15
1978	1	6.53	6.63	11.52
	2	8.57	9.04	12.68
	3	10.00	9.67	12.63
	4	11.39	11.59	13.14
1979	1	13.02	12.67	13.35
	2	12.48	12.22	12.13
	3	14.00	14.08	12.38
	4	15.45	15.69	14.10

III. SUPPLEMENTARY SPECIAL DEPOSITS SCHEME

The SSD scheme (or "corset") was first introduced in December 1973, and has been activated on two other occasions since then. It is currently in force, although the Chancellor said in his statement of 15 November 1979 that he did not envisage it having a permanent role to play in monetary control. Details of the operation of the scheme since it was first introduced are given in the table overleaf.

SSD SCHEME: HISTORY

Date Announced	Base Period	First Penalty Period	Period of Adjustment 1/	Guideline 2/	Suspension Announced	IBELs Growth to First Penalty Period	IBELs Growth Whole Period 3/
1. 17 December 1973 (extension 30 April 1974 and [illegible] November 1974)	average mid Oct to mid Dec 1973	average mid April to mid June 1974	5 months	8% for first 6 months, then 1½% a month	28 February 1975	2.2%	7.0%
2. 18 November 1976 (extension 12 May 1977)	average mid Aug to mid Oct 1976	average mid Feb to mid April 1977	4 months	3% for first 6 months, then ½% a month	11 August 1977	-2.5%	-1.0%
3. 8 June 1978 (extensions 17 August 1978, 3 April 1979, 12 June 1979 15 November 1979)	average mid Nov 1977 to mid April 1978	average mid Aug to mid Oct 1978	3 months	4% for first 7½ months, then 1% a month		1.6%	20.6% (to most recent period, average mid Oct – mid Dec 1979)

Notes
1. The period of adjustment is the time between the announcement and the middle of the first penalty period.
2. The first part of the guideline shows allowed growth from the average of the base period to the average of the first penalty period.
3. Growth over whole period is measured from base period to the average of the last (or most recent) three months for which the scheme was in operation.

ANNEX B

PSBR 1976-1977 to 1979-80*

£ billion

	Date	1976-77	1977-78	1978-79	1979-80
1. Chancellor's Statement & letter of Intent to IMF	15.12.76	11.2	8.7	8.6	
2. Budget forecast: FSBR 1977-78	29.3.77	(8.8p)	8.5		
3. October package	26.10.77		7.5	7.0	
4. Letter of intent to IMF	14.12.77			8.6	
5. Budget forecast: FSBR 1978-79	11.4.78		(5.7p)	8.5	
6. Industry Act Forecast	Nov1978			8.0	8.5
7. Budget Forecast: FSBR 1979-80	12.6.79			(9.2p)	8.3
8. Industry Act Forecast	Nov1979				8.3
9. Outturn (Financial statistics Dec.1979)		8.5	5.6	9.3	

= Provisional or estimated outturns

* This table should be read in conjunction with the fiscal measures contained in annexes C and D.

PUBLIC EXPENDITURE AND CASH LIMIT EVENTS BETWEEN 1 JANUARY 1977 and 31 DECEMBER 1979

January 1977	Publication of Cmnd 6721 Volume I: "The Governments Expenditure Plans".
February 1977	Publication of Cmnd 6721 Volume II: "The Governments Expenditure plans".
29 March 1977	Publication of Cmnd 6767: "Cash Limits 1977/78"
August 1977	Publication of Cmnd 6902: "Cash Limits 1976/77 Provisional Outturn".
26 October 1977	Chancellor's Statement on increase in Public Expenditure of £1bn in 1978/79 (at 1977 survey prices) (OR Cols 1438-9).
January 1978	Publication of Cmnd 7049 Volumes I and II: "The Government's Expenditure Plans 1978/79 to 1981/82".
11 April 1978	Budget Statement involving an increase in expenditure on programmes of approximately £550m (at 1978 survey prices) met by a reduction in the contingency reserve.
April 1978	Publication of Cmnd 7161: "Cash Limits 1978/79".
July 1978	Publication of Cmnd 7295: "Cash Limits 1977/78 Provisional Outturn".
January 1979	Publication of Cmnd 7439: "The Governments Expenditure Plans 1979/80 to 1982/83".
23 February 1979	Statement by Chief Secretary on cash limit policy for 1979/80 (OR WA 334-5).
April 1979	Publication of Cmnd 7515: "Cash Limits 1978/80".
22 May 1979	Chancellors Statement on cash limits policy (OR cols 903-5).
22 May 1979	Minister of State CSD's statement on the government's policy on adjusting the 1979/80 cash limits to meet civil service pay increases and the recruitment ban (OR WA 77).
12 June 1979	Budget measures including £1.75 billion in specific cuts in public expenditure in 1979/80, the expected cash limit squeeze of about £1 billion and the programme of asset disposal (figures at 1979 survey prices).

October 1979	Publication of Cmnd 7681: "Cash Limits 1978/79 Provisional Outturn".
November 1979	Publication of Cmnd 7746: "The Government's Expenditure Plans 1980/81".

MAIN TAX MEASURES: DECEMBER 1976 TO DECEMBER 1979

Budget of 29 March 1977

2. Chancellor proposed reductions in direct taxation of £1.8 billion for 1977-78 (mainly on the income tax allowances with the personal allowances to be raised between 9 and 13 per cent, and the basic rate, which was to be cut by 2 pence). Increases in indirect taxation of £0.8 billion proposed (mainly on the specific duties).

3. During debate, the Finance Bill was amended, the principal changes being:-

(a) income allowances further increased by about 5 per cent;

(b) the proposed increase in the duty on road fuel was not approved; and

(c) the proposed reduction of 2p in the basic rate of income tax was limited to 1p.

Mini-Budget of 26 October 1977

4. Income tax personal allowances raised by about 12 per cent at a cost in the financial year 1977-78 of £0.8 billion. Measures introduced to help small firms.

Budget of 11 April 1978

5. Chancellor proposed £2 billion cut in personal taxation mainly by introducing a lower rate band of 25 per cent on the first £750 of taxable income and raising thresholds, the personal allowances being increased by about 5 per cent. Further measures introduced to help small firms.

6. In debate, the basic rate of income tax was reduced by 1p and the threshold for the higher rates was raised by a further

£1000. The National Insurance Surcharge was increased from 2 to 3½ per cent from 2 October 1978.

PRT measures of 2 August 1978

7. Changes proposed in the Petroleum Revenue Tax, including increasing the rate from 45 to 60 per cent from 1 January 1979. Legislation in 1979 Finance Bill.

Budget of 3 April 1979

8. Caretaker Budget because of impending General Election.

Budget of 12 June 1979

9. Direct tax reductions of £3.5 billion in 1979-80 mainly through increases of 18 per cent in income tax personal allowances and a 3p cut in basic rate. Highest rate of tax on earned income reduced from 83 to 60 per cent. Indirect tax increases of £2.5 billion mainly through unification of the 8 and 12½ per cent VAT rates at 15 per cent. PRT measures, which had been announced in August 1978, to be implemented.

PRT measures of 15 November 1979

10. Changes proposed to speed the flow of PRT revenue by requiring payment on account, effectively advancing the due date for collection by 2 months.

1. Rate of Growth of GDP

		Year on Year % increase, Average estimate
	1976	3.1
	1977	1.9
	1978	2.7
1st 3 qtrs 1979 on same period 1978	(1979)	2.0

2. Balance of payments current account £m

1976	- 1152
1977	- 202
1978	+ 714
1979 (provisional)	- 2418

3. Unemployment

		UK, seasonally adjusted, excluding school-leavers	
		000's	%
1976	Mar	1243.6	5.2
	Jun	1278.6	5.4
	Sep	1297.7	5.4
	Dec	1317.5	5.5
1977	Mar	1336.3	5.5
	Jun	1376.5	5.7
	Sep	1417.5	5.9
	Dec	1421.0	5.9
1978	Mar	1411.4	5.8
	Jun	1378.1	5.7
	Sep	1360.2	5.6
	Dec	1319.6	5.5
1979	Mar	1361.5	5.6
	Jun	1278.7	5.3
	Sep	1263.9	5.2
	Dec	1294.6	5.3

Sources

1,2 Economic Trends and Press Notice

3. D E Gazette

Economic prospects for 1980

The Industry Act (1975) requires the Government to publish economic forecasts twice yearly. This supplement reviews economic developments so far this year and looks at the prospects up to the end of 1980.

Summary

In difficult world conditions and with a recent history of rising inflation, the UK economy is likely to experience some decline in economic activity in 1980. The priority in economic policy is to counteract inflation by adherence to a declining path of monetary growth combined with the necessary fiscal restraint. This long-term policy should begin to bear fruit in 1980, with the annual increase in the retail price index (RPI) declining from about 17 per cent in the fourth quarter of 1979 to some 14 per cent in the fourth quarter of 1980. During the period of adjustment to a lower rate of inflation some adverse effects on international competitiveness, profitability and personal real incomes are almost inevitable. Any quantitative assessment of the economic prospect is subject in present circumstances to very large uncertainties. The figures put forward should not be interpreted as indicating anything more precise than that the rate of inflation next year — though declining — is likely to remain in double figures and that there will probably be some fall in real gross domestic product (GDP).

Recent developments

The higher rate of inflation over the past twelve months has reflected both high pay settlements and rises in oil and other commodity prices. Prices of materials and fuel used by manufacturing industry rose by some 20 per cent in the year to October, indicating the significant non-wage element in rising costs, even though this was greatly mitigated by the strength of sterling, for which the effective rate appreciated by nearly 10 per cent in the same period. The domestic rate of inflation, as measured either by retail prices or the wholesale price of (non-food) manufactures stood at about 17 per cent over the twelve-month period. The tax and price index, which takes account of direct as well as indirect taxation, had risen by a little under 15 per cent. Taken in conjunction with pay increases of some 15 per cent to 16 per cent on an underlying basis the real value of earnings was still increasing, though by less than in 1978 or the early months of 1979 when the trend of commodity prices had been much more favourable. An appreciating exchange rate and a relatively high rate of domestic inflation has led to a sharp loss of international competitiveness in terms of both prices and costs.

The money supply has increased by over 13 per cent over the last 12 months. And, as the Chancellor of the Exchequer explained to the House of Commons on 15 November, it was still outside the Government's 7 per cent to 11 per cent target range by mid-October. This reflected a high public sector borrowing requirement (PSBR) in the first part of the financial year and continued high bank lending. It was expected that measures taken in the Budget which increased the PSBR, such as the reductions in personal taxation, would come through faster than those which reduced it, such as higher value added tax (VAT) and sales of public sector assets. But in the event, public borrowing, especially by the local authorities and public corporations, has been higher than expected — largely as a result of industrial action which has delayed the payment of telephone bills and VAT. The rapid increase in bank lending to some extent reflects an unexpectedly buoyant rate of stockbuilding. On 15 November the Bank of England's minimum lending rate was increased from 14 per cent to 17 per cent and measures were taken to bring the forecast PSBR back to the Budget estimate of £8.3 billion. The monetary target was rolled forward for a further six months; the target range for the growth of sterling M3 is now 7 per cent to 11 per cent at an annual rate from mid-June 1979 to mid-October 1980. At the same time the supplementary special deposits scheme was extended for six months.

The weak recovery from the 1974/75 recession was checked in the autumn of 1978 and followed by a fall in activity in the early months of 1979, largely because production was disrupted by bad weather and industrial disputes. There was a marked rebound in output in the second quarter, followed by a fall in the third quarter partly as a result of the engineering industry dispute, and the trend of activity over the past 12 months has probably been fairly flat. The manufacturing sector has followed a broadly similar pattern to total GDP. Despite the lack of output growth, employment in industry has declined only marginally. Unemployment was on a downward trend until the summer of 1979, though this appears to have been checked in recent months.

Personal consumption has added to demand but there appears to have been little change in public sector demand or in private sector investment. An increasing share of consumption has been met by imports rather than by domestic production.

The growth of personal consumption reflected brisk growth in real personal disposable incomes in the period up to mid-1979. The precise timing of both income and consumption movements are complicated by the short-term effects of Budget changes. Taking the first nine months of 1979 the level of personal consumption rose by some 4½ per cent compared with a year earlier; this was probably a little below the growth in real incomes over the same period. The fall in consumption in the third quarter of 1979 partly reflected the effect of the Budget which had brought forward expenditure into the second quarter. In view of the trend in prices and real incomes the strong upward movement in consumption has probably now ceased.

Private sector investment in distributive and service industries showed a strong upward trend until mid-year, but manufacturing investment appeared to have passed a cyclical peak and private sector housing investment has declined sharply since the end of last year. Stockbuilding has remained at a fairly high level so far this year albeit with erratic quarterly fluctuations. Public sector expenditure on goods and services has remained roughly constant.

The quarterly path of overseas trade has been greatly obscured and damaged by industrial disputes. It may be best to compare the first ten months of 1979 with the equivalent period of 1978. In this period export volumes (excluding fuel) rose only marginally (three-quarters per cent) while import volumes (excluding fuel) rose by 14 per cent, with a substantially larger growth in imports of manufactures. These movements reflected strong consumer demand and worsening competitiveness and, probably, the permanent loss of some exports as a result of industrial disputes. Despite favourable terms of trade (reflecting the strong exchange rate) and continuing improvement in the balance of trade in oil, the visible balance deteriorated and over the first ten months of 1979 was in deficit by some £3 billion; of this £1½ billion was in the first quarter. The invisible surplus, on provisional figures, has also deteriorated. This reflects an estimated worsening of the services balance as well as rising North Sea oil profits accruing to foreign-owned companies and some further increase in UK net contributions to the EEC. Over the first ten months of 1979 the current account is provisionally estimated to have been in deficit by some £2½ billion. It remains highly uncertain to what extent this deficit reflects temporary disturbances.

Prospects for 1980

Policy assumptions

The forecast takes account of the measures announced on 15 November and assumes that monetary growth is held within the new target range. The public expenditure forecasts for 1980-81 are based on the recent White Paper *The Government Expenditure Plans 1980-81* (Cmnd 7746). For the purpose of this forecast tax receipts are projected on the conventional assumption that allowances, thresholds and specific tax rates are uprated in line with the RPI growth during the previous calendar year.

Inflation

Prices in the UK are rising at or a little above 1 per cent per month. In the current quarter, the retail price index is likely to be a little over 17 per cent higher than a year earlier (consistent with the Budget forecast), an increase which includes the once-and-for-all effects of the rise in VAT. The effective exchange rate is assumed to remain close to its present level in 1980, so that future import prices follow movements in world prices: although the expected recession in industrial countries may limit any rise in commodity prices, some of the effects of higher import prices that have occurred so far this year will still be feeding through into domestic prices in the early part of next year. The growth of domestic costs depends, essentially, on the climate of pay negotiations. This forecast allows for a progressive reduction in the level of settlements over the coming year in response to the Government's fiscal and monetary policies. It leads to a forecast reduction in the rate of retail price inflation (over a 12-month period) to 14 per cent in the fourth quarter of 1980. With the share of profits already exceptionally low and adversely affected by the continued rise in labour costs and by the fall in economic activity, a significant fall in the rate of inflation implies a slower growth of costs.

Demand, trade and activity

Taking account of the weakness of activity, a small fall in real personal incomes is likely in 1980, despite the prospect of large pay increases in the public services, largely based on the reports of the Clegg Commission. However, consumer confidence

Table 1: Economic Prospects to end-1980

	percentage changes 1978 to 1979	1979 to 1980
A. Output and expenditure at constant 1975 prices		
Gross domestic product (at factor cost)	1	−2
Consumers' expenditure	4	½
General Government expenditure on goods and services	½	0
Public corporations' fixed investment	−4½	−4½
Private sector investment	−2	−1
Exports of goods and services	1½	0
Stockbuilding (as per cent of GDP)	¼	−2
Imports of goods and services	11½	−2½

B. Balance of payments on current account	1979	1980
	£ billion	
	−2½	−2

C. Retail price index	*percentage changes* 4th quarter 1978 to 4th quarter 1979	4th quarter 1979 to 4th quarter 1980
	17½	14

†This margin applies to General Government consumption.

Table 2. Forecasts of expenditure, imports and gross dome

£million at 1975 prices, seasonally adjusted

	Consumers' expenditure	General Government expenditure on goods and services: Final consumption	Fixed investment	Total	Other fixed investment
1977	63,350	23,250	3,950	27,200	16,200
1978	66,700	23,650	3,350	27,000	17,150
1979	69,300	23,900	3,200	27,100	16,650
1980	69,650	24,150	3,000	27,150	16,400
1978 First half	32,950	11,750	1,750	13,500	8,650
Second half	33,750	11,900	1,600	13,500	8,500
1979 First half	34,900	11,850	1,650	13,500	8,200
Second half	34,400	12,050	1,550	13,600	8,450
1980 First half	34,900	12,100	1,500	13,600	8,300
Second half	34,750	12,050	1,500	13,550	8,100
Percentage changes					
1977 to 1978	5½	1½	−15	−1	6
1978 to 1979	4	1	−4	½	−3
1979 to 1980	½	1	−7	0	1½

Margins of error in 1[illegible] per[illegible]
1½
1½
1½†
6½
4
3½
¾
2½
£ billion 2
per cent
4

*The errors relate to the average differences (on either side of the central figure) between forecast and outturn. The method of calculating these errors has been explained in earlier publications on government forecasts, notably in November 1978 (see *Economic Progress Report Supplement* or *Economic Trends* No. 301, November 1978). The errors are after adjustment for the effects of major changes, where excluded from the forecasts, in fiscal policy and hire purchase terms controls. Quarterly forecasts are grouped so as to be comparable with the changes between calendar years as shown. For a forecast made in quarter 0 the errors (both for the constant price magnitudes and for the current account) relate to the forecast changes between the 'base year' (quarters −1 to −4) and the forecast period (quarters 1 to 4). The strict comparison with the present calendar year forecast would, of course, involve a base year comprising quarters 0 to −3. For the retail price index the margin relates to the percentage change between quarter 0 and quarter 4.

Although roughly appropriate in respect of time horizon and period covered these figures are likely to understate the true margins of error for the general reasons indicated in the concluding paragraphs of the text.

roduct

services	Stock-building	Total final expenditure	*less* Imports of goods and services	*less* Adjustment to factor cost	Statistical adjustment	Gross domestic product at factor cost	
							GDP index 1975 = 100
0	1,250	139,700	30,400	10,850	−200	98,250	105.1
0	1,100	144,300	31,600	11,850	0	100,850	107.9
0	1,450	147,350	35,300	12,300	2,200	101,950	109.1
0	−450	145,600	34,400	12,250	1,100	100,050	107.0
0	600	71,600	15,700	5,900	−50	49,950	106.9
0	500	72,700	15,900	5,950	50	50,900	108.9
0	800	73,350	17,600	6,200	1,400	50,950	108.9
0	650	74,000	17,700	6,100	800	51,000	109.2
0	−50	73,300	17,300	6,150	550	50,400	107.8
0	−400	72,300	17,100	6,100	550	49,650	106.2
		3½	4	9½		2½	
		2	11½	3½		1	
		−1	−2½	0		−2	

should be helped by the projected decline in the rate of price inflation, and the savings ratio is likely to fall. On balance, little change in personal consumption is forecast for next year.

Industrial and commercial companies are likely to meet difficult trading conditions next year, reflecting weak world demand and unfavourable UK competitiveness. The adverse effects on output and profitability, combined with tight monetary conditions, may lead to a downturn in private investment and stockbuilding, both of which appear, in any case, to be close to cyclical peaks. The forecast of private sector investment is strongly influenced by the latest surveys of firms' investment intentions undertaken by the Department of Industry and the Confederation of British Industry (CBI). Private manufacturing investment is expected to show little change this year and then fall by about 7 per cent next year, rather less than in some previous downturns. Little change is forecast for other private investment in 1980. Stockbuilding was unexpectedly high in the first half of 1979. A turning point is forecast around the end of this year as companies react to the falling away in demand and to financial pressure. The forecast is for destocking on a significant scale during 1980, implying a large turnround (some 2 per cent of GDP) between 1979 and 1980.

The forecast is for little change in the volume of General Government expenditure on goods and services in 1980. This is consistent with the White Paper on public expenditure in 1980-81 (Cmnd 7746).

Many governments overseas are tightening policies in order to contain the inflationary impact of higher oil prices, with the result that inflation may be better contained than after the 1973-74 oil price rises. In common with most international economic organisations, we expect a slowdown in world economic activity next year. The US is expected to enter a period of recession and growth in the other industrial countries is expected to slow down, but without coming to a halt altogether. Economic growth in the main industrial countries is forecast to drop from 4 per cent in 1978, to under 3 per cent in 1979 and to around 1 per cent in 1980. The growth in the volume of world trade is expected to be very slow but the growth of UK markets should be less affected and the imports of smaller OECD countries and OPEC — relatively more important to the UK — are expected to grow faster than trade in general. UK-weighted trade in manufactures, estimated to have risen 5 per cent to 6 per cent in 1979, may rise a further 4 per cent in 1980. The implication of the forecast for UK inflation combined with the assumption of a constant effective exchange rate, is that the UK's cost and price competitiveness does not change greatly from its recent level.

After a period of stability, the share of UK exports of manufactures in world trade appears to have fallen in 1979, with the disruptions caused by industrial disputes in the UK, and probably some effects of worsening competitiveness, adding to the longer-term tendency of the UK to lose share in world markets. In 1980, world trade growth is liable to be weaker and the lagged effects of changes in competitiveness more strongly unfavourable, so that there may be little change in the volume of manufacturing exports.

For both import and export volumes this forecast gives some weight to the views of outside forecasters but it is still less optimistic than most on short-term trends in trade volumes. The import propensity has moved upwards in recent years, and fluctuates cyclically though erratically from year to year. With the fall in demand forecast for 1980, the volume of imports should decline. There is particular uncertainty about the forecast for imports of manufactures.

With exports forecast to change little next year and with the prospect of a substantial fall in domestic demand — notably for stocks — the prospect is inevitably for some fall in economic activity. However, largely for cyclical reasons, there may be no further growth next year in the share of demand met from overseas. The forecast, subject of course to a large margin of error, is for a fall in GDP of the order of 2 per cent — of the same order as occurred in 1974. The implication of this forecast is that there is likely to be some rise in unemployment.

The current account

The ns of trade improved between 1977 and 1979 by about 7 per .. With little change assumed in the exchange rate and with commodity prices rising only slowly, some further improvement in the terms of trade may take place in 1980. On ibles, the outturn so far this year is, on very provisional figures liable to substantial revision, a good deal less favourable than in 1978, partly as a result of higher government payments, notably to the EEC, higher profits earned by foreign companies operating in the North Sea, and higher interest rates in the UK. While there should be an improving trend in the balance of services, higher North Sea profits will continue to reduce the net balance on interest, profits and dividends. There could be some further deterioration in the total balance on invisibles next year.

In total, the current account of the balance of payments seems likely to be in substantial deficit this year, perhaps by some £2½ billion. The figure has been affected to a considerable but incalculable extent by the effects of major industrial disputes such as those in the road haulage and engineering industries. Continuing poor performance by the motor industry has also been an important factor. Unless there are disputes on a comparable scale next year, the fall in demand for imports will probably be sufficient to bring about some improvement in the current account, though a significant deficit — possibly of the order of £2 billion — is still forecast.

Public sector borrowing

In the first six months of the current financial year the PSBR is provisionally estimated at £6½ billion. This is high in relation to the Budget forecast of £8¼ billion for the year as a whole and reflects, in particular, higher than expected borrowing by local authorities and public corporations; the latter is mainly due to the Post Office. There are, however, strong reasons for expecting a big reduction in the PSBR in the second half of the year: receipts from the higher rate of VAT and from the planned £1 billion of asset sales will be almost entirely in the second half of the year and the loss arising from the delays to telephone bills should be partially recovered, though the forecast assumes that £400 million is still outstanding at the end of the financial year. With great uncertainty still remaining, the estimated outcome was in the region of £9 billion before the acceleration of payments of petroleum revenue tax (PRT) announced on 15 November, which will reduce the PSBR by about £700 million in 1979-80, and by smaller amounts in later years.

Most of the factors which, even now, make it hazardous to forecast the 1979-80 PSBR create comparable uncertainty about the figures for 1980-81, and many other factors make the margins of error for that year even greater. The prospect for 1980-81 is affected both by the large 'Clegg' increases in public service pay and by the poor outlook for economic activity. There are, however, favourable factors too, such as a full year's receipts of VAT at the higher rate, the build-up of revenue from North Sea taxation and the recovery of the remaining backlog of Post Office receipts. On the assumptions adopted for this forecast the prospect — subject of course to a very high margin of e — is for little change from the 1979-80 level in the PSBR as a percentage of GDP. In the absence of a fall in economic activity the prospect — given the same policy assumptions — would, of course, be more favourable. If, for example, stronger private sector activity led to no change in real GDP next year rather than the forecast 2 per cent fall, the PSBR would be likely to fall by at least half per cent of GDP. With rising GDP the PSBR would be reduced still further. It should also be noted that any projection of the PSBR at this stage reflects not only very high margins of error (past experience would suggest an *average* margin of error in either direction of some 2 per cent of market price GDP) but also involves necessarily arbitrary or conventional assumptions about future policy decisions. The objective for the PSBR in 1980-81 will be determined at the time of the Budget in the light of developments in the economy and, above all, of the requirements for meeting the Government's monetary target.

Margins of error

At present any assessment involves unusually large uncertainties. In particular, there is no reliable way of using past experience to assess the pace at which inflation responds to the present emphasis of monetary and fiscal policy. This applies particularly to the effects of policy on expectations, both insofar as they influence pay settlements directly and insofar as they influence financial markets and hence, in turn, the exchange rate, domestic prices and pay settlements. Similarly, because of the loss of trading competitiveness, which has occurred and is assumed not to be corrected, the forecast is particularly sensitive to fallible estimates of cost and price elasticities. Given the strong cyclical downturn the response of investment and stockbuilding to movements in output, profitability and financial conditions is both important and more than usually difficult to predict.

In the circumstances it is not sufficient to use margins of error based on the record of past forecasts and the assessment of uncertainty has to be fairly subjective. Nevertheless, the final column of Table 1 shows the average errors obtained from past forecasts with a time horizon comparable to the present forecast for 1980. In addition to the arguments for believing that margins of error are bigger in present circumstances it should be emphasised that these are *average* errors which, by definition, have frequently been exceeded.

Given these qualifications the forecast should not be interpreted as suggesting much more than that retail price inflation is likely to slow down but to remain in double figures next year and that there will probably be some fall in real GDP.

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Economic Policy 4

PRIME MINISTER

"Contracting Out" is generating plenty of paper and little action. NAP 12/2.

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

11 February, 1980

Dear Willie

Contracting Out Public Sector Functions

The Ministerial Steering Group on Government Strategy (MISC 14) has recently been considering the scope for contracting out public sector functions to the private sector. We asked the CPRS to co-ordinate work on central government functions (including the NHS) and the enclosed report* is the result. (Work on local authorities and nationalised industries is in hand separately.)

I am writing to you and others now because I and my colleagues on MISC 14 felt that Ministers in charge of Departments would wish to take note of the results of the study so far, and to satisfy themselves that opportunities for more contracting out are not being overlooked. The initial survey suggests, as was to be expected, that the scope for contracting out differs widely between Departments. But there can be few, if any, Departments where there is no scope, bearing in mind functions common to a number of Departments as well as those specific to a particular Department.

We felt that colleagues would also wish to consider critically, so far as their own Departments are concerned, the categorisation of functions (as summarised in the table on page 7 of the report). These categorisations are based on assessments made by departmental officials, but we felt that there might well be scope for moving some functions from Category B, or even from Category C, to Category A. Generally, further consideration in the light of the wider interdepartmental experience as set out in the report may lead to some re-assessment of the possibilities.

The Rt.Hon. William Whitelaw, M.P.

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* The annexes to the report are not enclosed. But they are either already available in Departments or can be obtained from CPRS, if required.

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We feel that it is important to maintain impetus in the area, and that it would be helpful if MISC 14 could be given an opportunity to review progress before the summer break. I would, therefore, be grateful if colleagues could ask their officials to make a short progress report to the CPRS by Friday, 11th July, so that the CPRS can circulate a report to MISC 14 by the end of that month. These progress reports should set out progress made, or in prospect, towards more contracting out of departmental functions (including not only those assigned to Category A in the CPRS report, but also those assigned to Categories B or C, or other functions not covered in the report, where it is found that progress can, in fact, be made).

In the case of those general functions which concern all or most Departments, where the Civil Service Department has an overall interest (these are the functions listed in the table on page 7 which are not assigned to a specific Department), I think it would be best if CSD were initially responsible for co-ordinating a composite progress report from Departments on a similar timetable.

I am sending a copy of this letter and its enclosure to the Prime Minister, to other Cabinet colleagues, and to Paul Channon and Norman Fowler. I am also sending a copy to Sir Robert Armstrong.

GEOFFREY HOWE

Contracting out public sector functions (excluding functions of local authorities and nationalised industries)

Report by CPRS

General

1. The attached report fulfils the remit from the Ministerial Steering Group on Government Strategy (MISC 14) which asked the CPRS to co-ordinate a review of the scope for contracting out public sector functions (other than functions of local authorities and nationalised industries on which work is separately in hand).

2. The general objectives of Ministers in promoting this exercise, as we understand them, are to boost the private sector by ensuring that functions which it can carry out as, or more, efficiently are not retained within the public sector; and, by exposing the public sector to stronger competition from the private sector, to secure greater austerity in the use of public resources and manpower.

3. The CPRS has not itself been able to carry out a detailed investigation of the opportunities for contracting out, and its costs, in different areas. We have necessarily relied on departmental assessments, and we believe that only departments are in a position to conduct a proper review of their own functions. We recognise the possibility that some departments may have been more thorough than others in reviewing their functions for the purpose of this study. We think it important that impetus should be maintained, and that this exercise should be regarded as a beginning rather than an end.

Main Conclusions

4. On the basis of short notes provided by departments, we grouped functions into one of three categories:

A - Scope for further contracting out

B - Existing balance about right

C - No scope for contracting out

We found 18 functions in Category A, 14 in Category B and 10 in Category C. (The functions concerned differ widely in importance as measured by expenditure or numbers employed.)

5. In a number of areas there is already substantial contracting out e.g. contract cleaning, design work, building maintenance, and vehicle maintenance. These are areas which are common to a number of departments and in general are also those where there seems to be the largest scope for more contracting out. It is not for example obvious why in similar areas the proportion of work contracted out varies widely between different departments (or e.g. between different health authorities).

6. We consider that the most important criterion in considering the pros and cons of contracting out is cost. A decision to contract out where this is established as the more expensive course would in our view require to be justified by reference to the major importance of some other factor (e.g. the need for flexibility or spreading the risks of union monopoly). But comparative costs do need to be established as accurately as is practicable, and to be kept under regular review.

7. The review covers a number of NHS functions where there seems to be considerable scope for further contracting out, and where large sums are involved. Most of the relevant areas are already under review under the direction of Health Department Ministers. We think it entirely right that in this, as in other areas, departmental Ministers should take the lead in reviewing possibilities within their own responsibility. Since however a number of the functions are ones which are common to other departments, it will be important to ensure that the Health Departments take full note of other departments' experience and vice versa. We think that this should be achieved provided that they are fully associated with the proposed progress report.

Recommendations

8. We make the following recommendations:

(a) Ministers in MISC 14 should be invited to endorse, or to amend or query, the classifications of functions into categories as shown in Annex A.

(b) Departments with functions in Category A (as reported in Annex A or as revised by Ministers) should be asked to report on progress towards more contracting out in the functions concerned in, say, nine months time viz. early autumn 1980. (The CPRS could, if required, co-ordinate a progress report.)

(c) Departments should at the same time be asked to report whether, in the light of more detailed costings or changes in comparative costs, any scope for further contracting out of functions in Categories B or C, or of other functions not specified in this review, has been found.

(d) A comprehensive review of R & D possibilities would have been a major task for departments within the time limits of this study and other relevant work is in hand (e.g. the quango review and the review of the scientific civil service). But given that there was a very limited response to our invitation to departments to indicate areas where they thought it would be possible to contract out more R & D, Ministers might wish to consider asking departments to give R & D special attention in responding to (c) above.

(e) Departmental Ministers should be asked to take note of the results of the study so far, to satisfy themselves that opportunities for more contracting out are not being overlooked and to take a personal interest in continuing work within their own departments and in the proposed progress report.

(f) Departments should undertake, in consultation when appropriate with Treasury or CSD, cost comparisons of public and private provision on as full and accurate a basis as is practicable, and should keep these under regular review.

(g) The Treasury should complete as soon as possible its consideration of how to deal with the problem that the incidence of VAT may under present arrangements distort departmental cost comparisons of public and private provision (see paragraph 7 of report below).

CONTRACTING-OUT PUBLIC SECTOR FUNCTIONS (EXCLUDING FUNCTIONS OF LOCAL AUTHORITIES AND NATIONALISED INDUSTRIES).

General

The Ministerial Steering Group on Government Strategy decided in the early autumn to commission work by officials on the scope for the transfer of public sector functions to outside contractors (MISC 14(79)2nd Meeting, Item i.f). It was agreed that work on local authority functions should be co-ordinated by the DOE, and that work on other public sector functions (excluding the nationalised industries, work on which was separately in hand) should be co-ordinated by the CPRS, (reporting for this purpose to the Secretary of State for the Environment). This report fulfils this remit.

How the remit has been tackled.

2. We started by inviting departments to draw up their own lists of functions, within their responsibility, which seemed to be potential candidates for contracting-out to some extent. The responses, general criteria and possible gaps and omissions were then discussed interdepartmentally. Departments were then asked to prepare notes on each of the possible candidates in a common form, setting out:

(a) Definition of the function;

(b) Number of staff involved and the approximate cost;

(c) Pros and cons of contracting out;

(d) Conclusions and recommendations.

These notes provided the basis for the analysis and suggestions made in this report. The report has been discussed in draft with the departments concerned, and is generally agreed by them.

General criteria

3. We concentrated, as our remit suggested, on 'contracting-out'. We took this to cover the scope for contracting-out to the private sector functions for the provision of which the public sector is responsible, and should remain responsible, but which need not necessarily be provided by the public sector direct. This differs from an exercise which seeks to identify public sector functions which could be dropped altogether. We have sought to avoid duplicating other exercises

in hand, notably the civil service manpower cuts review (to which references are made below as appropriate) or Sir Leo Pliatzky's review of quangos.

4. An important preliminary issue was whether we, or departments, should only consider contracting-out as a possibility where it saved money. We concluded that, although cost would normally be the principal yardstick by which proposals should be judged, it might not always be regarded as over-riding. Other factors which could be relevant in particular circumstances included:

(a) quality of service or supply;

(b) reliability, including the case for spreading the risks of industrial action and reducing existing trade union monopolies;

(c) advantages of cross-fertilisation between public and private sectors of expertise, techniques etc;

(d) flexibility in adding, or reducing, capacity quickly.

However, our view that cost, properly analysed, must be the prime criterion was strongly reinforced by the Cabinet's decision (after we had started our study) to endorse the recommendation of the Lord President of the Council, that in the context of the Civil Service cuts, staff savings from putting work out should only be made where there is a reasonable expectation that this will cost less (CC(79)15th Conclusions).

5. We did not in the context of this general review seek to obtain detailed information of the comparative costs of public and private provision in particular areas. Such comparisons are often difficult (particularly in areas where contracting out is not already well established), and it may not be easy to decide on the basis to be used. Nevertheless when departments choose between public and private provision we recommend that, in consultation when appropriate with the Treasury or CSD, they should attempt to analyse the comparative costs as accurately as possible. In particular, where it is proposed to choose the option which a proper comparative analysis suggests is the more expensive, departments need to be able to offer considered justification (eg that one or more of the factors listed at (a) to (d) of para 4 above is of major importance).

6. It should also be noted that comparative costs are particularly sensitive to pay relativities which in the short term at least can vary quite widely. This suggests that comparisons of costs of public and private provision should be redone at regular intervals in order to ensure that the initial relationship has not altered.

VAT

7. We found some evidence in the course of our study that cost comparisons between 'in-house' and 'out-house' work can, under existing arrangements, be distorted by the incidence of VAT. This is because a department will generally have to pay VAT when it contracts out, but not when it has the task carried out by its own staff. The fact that VAT payments and receipts cancel out from the point of view of the Exchequer overall is not something which departments can necessarily be expected to take into account under present arrangements. We have discussed this issue with the Treasury. It does not appear to have given rise to problems in the past. But it is only recently that departments have been urged to review the scope for more contracting out. And, whatever the problem was before, it will have been aggravated by the recent substantial increase in VAT. The Treasury is now considering what guidance could be given to departments to meet the problem.

Main findings of the review

8. Annex A summarises the areas reviewed, giving the approximate current cost and numbers (where available) of the functions, split between direct public sector costs/staff, and, where contracting-out already exists, the approximate costs/staff involved. Some short notes on each area are added. This Annex is based on the fuller departmental notes on each area (referred to at paragraph 2 above). These are available as Annex B.*

9. The subject areas in Annex A have been classified into one of three broad categories on the basis of the information given in the departmental returns:

Category A covers functions where departments report scope (with or without change of policy) for more contracting-out;

Category B covers functions where there is some contracting-out at present (in some cases on a substantial scale), but departments see no scope for increasing it;

Category C covers functions where departments see no scope for any contracting-out.

10. On a crude count (ignoring the relative size/cost of the functions involved) we found 18 in Category A, 14 in Category B and 10 in Category C. In bare summary (see Annex A for a fuller summary) the topics under each category are as follows:

* not attached, but available if required.

CATEGORY A "Scope for further contracting-out"	CATEGORY B "Present balance about right"	CATEGORY C "No scope for contracting-out"
Contract cleaning	Management consultants	Catering (CISCO)
Catering (NHS)	Agency staff	London car service (PSA)
Architectural and building design work (PSA, NHS)	Computing services/staff	Interdepartmental despatch service (PSA)
Building maintenance (PSA, NHS, DOE)	Training	Car service (MOD)
	Security staff	
Regional car service (PSA)	Reprographic services	Vehicles (including ambulances) (NHS)
Road haulage (PSA)	Architectural design work (HO)	Function vehicles
Vehicles providing services	Architectural R & D (DES DHSS, DOE)	Vehicle maintenance (MOD)
Vehicle maintenance (PSA)	Building Research Establishment (DOE)	Cartographic services: defence lands (MOD)
Departmental vehicle maintenance	Vehicle maintenance (NHS)	Legal services (Treasury Solicitor)
Cartographic services (DOE, DTp, WO, PSA)	Valuation work (IR)	Laundry services (NHS)
Design/supervision of major road schemes (DTp)	Building maintenance: prisons and staff quarters (HO)	
Heavy goods vehicle testing (DTp)		
Outside Health contractors (NHS)		
Blood (NHS)		

11. It will be seen that in the main our review concentrates on central government functions, but we have also covered a number of NHS functions - some of which both involve very large sums of expenditure (eg domestic services, including cleaning £280m, catering £270m, building maintenance £220m and laundry services £50m), and seem to offer considerable scope for further contracting out.

12. We have the following comments on specific items (the numbering is as at Annex A):

Contract cleaning (item 1). The previous moratorium on further switches from direct cleaning has been lifted, and departments now have full discretion and seem keen to contract out more work; eg as part of its contribution to the Civil Service cuts, the MOD will be making economies by changing to contract cleaning where possible. Two-thirds of cleaning is already contracted out. But, since contract cleaning is generally cheaper, we suggest that departments who do not yet contract out in whole or part might be asked in nine months time (ie when other progress reports are required - see para 8(b) of the cover note) to explain the reason for their present policy and whether they see it altering over the next two or three years. Cleaning in the NHS is under review, but contracting out is at present the exception (35 out of some 2,600 hospitals). There seems major scope here for more contracting out (though opportunities may be limited by shortage of interested private sector firms).

Management consultants (item 2). Costs per consultant-day are higher for outside consultants. There is thus a tendency to rely more, rather than less, on departmental units. Only about one-eighth by value - much less in terms of man days - is contracted out. This is however an area where the important question is the quality of the results (difficult as it may be to measure this) rather than simple cost comparisons. There is a need to ensure that 'in-house' management services teams do not become inward looking. There may also be a case for using outsiders more often as part of an 'in house' team, as well as for some full contracting-out. We note that little use is made at present of outside consultants in the NHS.

Agency staff (item 3). Use of agency staff is acceptable as a means of meeting short-term needs or emergencies. But it is more expensive. We think there is no good reason for trying to increase it.

Computing services (item 4). Further contracting out is constrained by value for money considerations (on average outside consultants cost about twice as much as 'equivalent' civil servants) and also by the sensitivity of industrial relations in this area. Consultants are at present engaged to undertake special tasks, determined mainly by departmental needs and the ability to identify discrete areas of work suitable to be taken up. To this extent they provide useful flexibility, and experience. We note that NHS computer services are to be reviewed, and it will be important that the pros and cons of contracting-out are fully considered.

Training (item 5). The main scope appears to be for professional and technical training (over a third contracted-out at present), including training within the NHS.

Catering (item 7). A recent review of CISCO (Civil Service Catering Organisation) suggests that there would be substantial additional cost if this function were contracted out. The fact that only a small minority of canteens (mainly small ones) which are still run by independent departmental committees use contractors rather than direct labour points in the same direction. We understand that the Minister of State, CSD, believes that the arguments in favour of a continuing major role for CISCO are sound. As part of its contribution to the Civil Service cuts, the MOD is hoping to make economies by changing to contract catering in some non-CISCO operations. Catering in the NHS, which costs £250m, is under review. The Home Office in its residential training establishments has no experience of contracting out to provide a cost comparison with direct labour, but, if the CISCO arguments are sound, there seems no reason to urge a detailed review.

Architectural design work (item 9). This is an area where there is already substantial contracting out, and scope for more. There are marked variations between the proportion of new work contracted out as between the PSA (about 25 per cent), Regional Health Authorities (a range from 25 per cent to 60 per cent), and the Home Office (90 per cent). Although more contracting out would, according to PSA, cost more, there are some compensating arguments, in particular that it would provide greater flexibility if capital commitments have to be cut back quickly. The PSA is studying the possibility of putting more work out to private contractors as a follow up to the Civil Service cuts exercise. The position in the NHS is under review; the DHSS current general guidance is that the 'in house' commitment should not be more than 50 per cent.

Architectural R & D work (item 10) The amounts involved are much smaller than for item 9. A reasonable level of departmental capacity is required for policy reasons and there seems little or no scope for additional contracting out.

Other R & D (item 11) We have not tried to carry out a comprehensive review of research establishments, but asked departments to consider significant possibilities in their own sphere for contracting out 'in-house' R & D. The only response to this was the DOE note on the Building Research Establishment where there are arguments against more contracting out than at present (about one eighth). (The question of a wider review of R & D is dealt with in paragraph 8(d) of the cover note)

Building maintenance (item 12) There is major scope here for more contracting out. It seems to be generally no more expensive, and as satisfactory in quality. The major opportunities are in the PSA where three quarters of the work is already contracted out but where, as part of the Civil Service cuts exercise, the direct labour force of about 18,000 is to be reduced substantially over the next five years and more work transferred to the private sector; and in the NHS, where only one third is contracted out, and there is a similarly sized direct labour force. There are limited opportunities in the Home Office so far as prisons are concerned. There is some scope in DOE in the maintenance of ancient monuments.

Transport services and maintenance (items 13 & 14) There are opportunities for more contracting out both in the provision of vehicles (PSA road haulage and regional car pools) and in maintenance (departmental vehicles, PSA vehicle fleet and possibly NHS vehicles including ambulances). Contracting out for maintenance is likely to be cheaper. In Scotland most vehicle maintenance is already contracted out.

Cartographic services (item 15) Replies from DOE and Department of Transport, and PSA suggested that the scope for further contracting out should be examined but that the cost would be greater. The issue should also be considered in the context of the follow-up work on the report of the Serpell Committee which recommended that Government departments should consider giving more mapping work to the Ordnance Survey Department because of its capacity to handle such work and the scope for economies of scale.

Specialist staff-lawyers, accountants, economists, statisticians, scientists etc (items 16 & 17). CSD's assessment (and the Treasury Solicitor's so far as lawyers are concerned) suggests that there is little scope for contracting out work at present done 'in house'. But if the possibilities were to be explored in detail, it would be necessary to approach the user departments to ask for a detailed assessment in relation to the various specialist groups and also the heads of the respective groups. Neither CSD nor we, have undertaken this. It would be a major exercise so far as the main professional groups are concerned, and we rather doubt whether it would prove to be worthwhile.

13. There are a few other areas which we have reviewed, and on which we have the following comments:

(a) The professional and executive register. This was mentioned as a possible candidate by Ministers in discussion in MISC 14. PER is run by the MSC, and provides a service to people seeking work at professional and executive level and to employers seeking recruits at this level. It employs about 800 staff, at a gross cost of about £7 million a year, but fees from employers amount to about £4 million which covers the cost of recruitment activity. In respect of its fee-earning activities PER is providing a service which may compete with services provided by private employment agencies. The only method of avoiding this competition would be to drop the fee-earning services, but since this would not be "contracting-out" we concluded that this question fell outside our remit. The Department of Employment has drawn our attention to two further points. First, it would not be possible to shed those services which are provided either by PER or by the general unemployment services for the registered unemployed and which are required by the registration condition for the receipt of unemployment benefit. In addition, the MSC have recently completed a fundamental review of PER which is shortly to be submitted to the Secretary of State for Employment. The report recommends that PER should continue broadly on its present basis, but the Secretary of State's views are not yet known.

(b) Redundancy Fund. As a result of a discussion at the Ministerial Sub-Committee on Economic Affairs (E(EA)(79)20th Meeting) the group was asked to consider the possibility of contracting-out the redundancy fund, eg so that the same service would be provided by the private insurance market. DE have concluded however that the cost of redundnacy is too much within the control of employers to be regarded as an "insurable risk". A sizeable and flexible organisation is necessary. Moreover the present system includes a network of centres throughout the country to advise on the many and complicated aspects of the law. Employers collectively do not have an existing organisation capable of meeting these needs and collecting compulsory contributions from employers. Even if there were a private sector fund the need to safeguard the right of an employee on an employer's insolvency would still require a public sector fund albeit on a reduced scale - unless the £10m annual cost of insolvency provisions were met as a direct cost to the Exchequer. DE recommend therefore that the Redundancy Fund remain within the public sector, but recognize the need to avoid the accumulation of excessive surplus beyond that justified by the normal management of the Fund.

(c) British Approvals Service for Electrical Equipment in Flammable Atmospheres BASEEFA is part of the Health and Safety Executive, and its basic function is to consider applications from manufacturers of electrical apparatus for use in potentially explosive atmospheres, and to issue certificates that the apparatus has been designed, constructed, and tested in accordance with recognised standards which are specified in the certificates. Its workload has increased over the years, as has the range of standards with which BASEEFA is concerned. Recruitment and training of extra staff to deal with this has not kept pace, with the result that a substantial backlog of work has built up. This problem has greatly concerned DE, DI, NEDO, one or two sector working parties, and HSC/HSE for sometime past. The Parliamentary Under Secretary for State for Employment who has specific responsibility for health and safety matters, has authorised the setting up of a small committee of two or three senior industrialists to co-operate with HSE in order to advise and make recommendations on how improvements might be achieved. The task could take three to six months and would cover management techniques and suggestions for further contracting out certain BASEEFA activities.

(d) Agricultural development and advisory service (ADAS) ADAS employs some 5,400 staff, at a gross annual cost of about £60 million, with off-setting receipts (sales and charges) of £3 million. ADAS has recently been reviewed by an official group whose report was published early in 1979. The main issue here is not, in our view, one of'contracting out', but whether ADAS should undertake research and development and the provision of advice (as opposed to its regulatory and inspectorial work) on the present scale. The recent review generally endorsed ADAS's activities and we did not consider that it lay within our remit to pursue this further.

(e) HMSO. There are two aspects which we have discussed with the Controller of HMSO- printing and publishing . On printing, about two-thirds is already contracted out, and proposals for any change in the present balance would need to be assessed in the context of the proposed switch to a trading fund basis for HMSO as from next April, and would also need to take account of implications for industrial relations. In view of the background, we have not explored this area in depth, but we understand that CSD ministers would be happy to join a MISC 14 discussion, if that seemed appropriate. So far as government publishing is concerned, HMSO consider that there is no real scope for contracting out since the nature of the publishing undertaken by HMSO and departments is essentially dissimilar to that undertaken by commercial publishers. Nevertheless the scope for commercial firms to undertake some publishing for departments is currently under consideration by an inter-departmental group.

(f) OPCS and other survey work. Information supplied by the Survey Control Unit (CSO) shows that over 60 per cent of all social survey work (whether carried out by OPCS or other departments) is contracted out. The position for regular surveys where about one-third of the work is contracted out differs from the position for ad hoc surveys where over 85 per cent of the work is contracted out. OPCS itself, which is responsible for major continuous surveys (including the Family Expenditure Survey and the General Household Survey) contracts out about one fifth of its work, but other departments contract out nearly 90 per cent of the work. The present balance seems justifiable.

(g) We have noted that the MOD have a number of reviews in progress under the direction of MOD Ministers. These include studies of MOD Research and Development Establishments, supply management, the Royal Dockyards, and quality assurance. We have not sought to duplicate this work in progress .

14. Further information on the items referred to in paragraph 13 is contained in Annex C.*

15. Our study did not cover in detail functions of the regional departments (SO, WO, and NIO). They have however been kept in touch with the exercise, and some of the notes in Annex B* have been prepared in consultation with them. The findings of this study should be generally relevant to these departments, and they should be associated with the progress reports proposed in nine months time.

* not attached, but available if required.

CPRS

20 December 1979

PART ~~3~~ 4 ends:-

Employment to TL 30.1.80

PART ~~4~~ 5 begins:-

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