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PART A

CONFIDENTIAL

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PART A

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PART A

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Ends: 22/12/86 [signature] 5/9/95

CHANCELLOR'S 1986 PAPERS
ON CITY FINANCIAL ISSUES

CONFIDENTIAL

FINANCIAL SECRETARY TO THE TREASURY

FROM: VIVIEN LIFE
DATE: 4 February 1986

PS/CHANCELLOR

cc Sir P Middleton
Mr Monck
Mr Moore
Mr M Hall
Mr Culpin
Miss O'Mara
Miss Sinclair
Mr Grimstone
Mr Hyman
Mr McIntyre
Mr Davies

OK. I will write to Goodison myself. (X refers). or perhaps psr. —

WIDER SHARE OWNERSHIP : NUMBER OF SHAREHOLDERS

1. The Financial Secretary has read Mr Grimstone's minute of 4 February.

2. In his view the suggested line for Questions is right.

3. However, he thinks it is essential not to let the Stock Exchange get away with pressing for tax changes on the basis of figures that they know to be false. He thinks that at the very least either the Chancellor or he himself should write to Nicholas Goodison on this; not simply out or irritation but because we will certainly want to use the Valin Pollen statistics at some point - and we might as well start smoking them out now.

X

VL

VIVIEN LIFE

CONFIDENTIAL

852/6

CONFIDENTIAL

CHANCELLOR

FROM: G E GRIMSTONE
DATE: 6 February 1986

cc Financial Secretary
Sir P Middleton
Mr Monck
Mr Moore
Mr M Hall
Mr Culpin
Miss O'Mara
Miss Sinclair
Mr Hyman
Mr McIntyre
Mr Davies

Ch
Letter to issue?

OK

WIDER SHARE OWNERSHIP : NUMBER OF SHAREHOLDERS

Following my submission dated 4 February, I now attach, as requested, a draft letter for you to send to Sir Nicholas Goodison picking up the discrepancy about the number of shareholders in the UK. I think that it would be counter-productive to stir this up too much because we do not want to tip the Stock Exchange into a position where they feel it necessary to defend their lower figure. I have therefore worded the draft letter rather cautiously and you might want to make it personal to Sir Nicholas.

G.E.G.

G E GRIMSTONE

852/6

PERSONAL & CONFIDENTIAL

Pl type for Ch's sig

Draft letter from : Chancellor
to : Sir Nicholas Goodison
Chairman
The Stock Exchange

WIDER SHARE OWNERSHIP

Although I was pleased to see that your Retail Developments Advisory Committee is advancing the case for wider share ownership, I am surprised that their report claims that only 6 per cent of the adult population in the UK owns shares at present. The research which you commissioned yourselves from Valin Pollen last Autumn suggests that the ~~GB~~ figure (for Great Britain) is 16 per cent. The research recognises that this figure is higher than other sources have indicated (a major survey early in 1985 gave a figure of 10.2 per cent) but attributes this to the more detailed questioning in your latest survey.

I quite accept that establishing the true extent of direct shareholding is not at all straightforward, and estimates are bound to vary a little. However, this is of course an area of considerable interest to the Government as well as to the City, and I do not think that it helps either of us to under-estimate the progress that has been made in recent years. In order to clear up any confusion, we have now asked the Office of Population Censuses and Surveys (OPCS) to organise some further research on our behalf and we will of course keep your people in touch with the results once we have them.

I cannot of course say anything at this stage about the proposals in the Committee's report for changes in taxation affecting equity investment.

N L

~~CONFIDENTIAL~~

1988/29

RESTRICTED

Prev pps (turn over)

* I wd like to release this in my New York speech: the first release? No Shh So no. Then can then be an BPR follow-up article.

FROM: J P McINTYRE
DATE: 26 MARCH 1986

1. MR GRIMSTONE
2. FINANCIAL SECRETARY

cc Chancellor
Chief Secretary
Economic Secretary
Minister of State
Sir P Middleton
Mr Monck
Mr Moore
Mr Culpin
Miss O'Mara
Mr M Hall
Mr Hyman
Mr Crompton o/r
Mr H J Davies

If you and the Chancellor wish, a lot can be made of this. The fact that OPCS have produced the figure will give it high status and 14% will cause quite a stir.

G.P.G. 26/3

SHARE OWNERSHIP: NOP SURVEY

We now have the results of the NOP Survey on share ownership, commissioned on our behalf by the Office of Population Censuses and Surveys.

2. The survey was conducted between mid-February and mid-March among a representative sample of the adult population in Great Britain. Over 7,000 interviews were carried out. The main findings were:

(i) Shareholders of any kind: 14%

NB. Let us be quite sure this does not include so-called 'Bldg Soc shares', as we?

(ii) Employee shareholders: 3%

(iii) Holders of BT shares: 6%

(iv) About half BT shareholders hold no other shares.

3. The survey therefore broadly confirms the findings of last Autumn's research by the British Market Research Bureau for the Stock Exchange, namely that the proportion of the adult population owning shares is considerably higher than we had previously thought (and higher than the 6% figure put about by the Stock Exchange recently and frequently referred to in the press).

4. The annex to this minute sets out, for comparison, the other evidence we have collected on share ownership.

5. The NOP figure of 14% is not quite as high as the BMRB's 16% but is in the same ball-park. NOP tell us that there is a 95% confidence factor of ± 1.5% on the 14% figure, which means that the real number almost certainly lies within the range of 12.5% - 15.5%

6. NOP have also told us that the 14% figure is consistent with the findings of other surveys they have undertaken since May 1985, though if anything they feel it may be slightly on the high side.

7. We have pressed NOP on the inaccuracy of their results as far as BT shareholders are concerned. The survey points to 6% or around 2½ million. In fact, our latest information on the number of BT shareholders indicates between 1.6 and 1.7 million. NOP's response was that this difference on the BT figure was not sufficient to call seriously into question the validity of the total shareholders number.

8. In terms of absolute numbers, 14% is equivalent to 6 million or so adult shareholders in Great Britain. As the annex shows, this compares with around 3 million in 1979 according to the regular BMRB survey whose results we obtained at the end of last year. The number therefore appears to have broadly doubled. This is the claim which we have been making publicly, except that we had thought the increase was around 1½ million to 3 million. Not only is the current figure much higher; so is the 1979 base.

<u>Publicising the Figures</u>

9. You and the Chancellor may wish to consider how best to make use of these figures. They could be included in a speech or in material for an appropriate Parliamentary occasion, such as the Finance Bill debate (2nd Reading due late next on month) or Treasury Questions (next 17 April).

10. Another option would be to have the figures released initially in a more low-key way, to reduce the risk that doubt

would be cast on the independence of the research. OPCS might have been suitable from this point of view, but I gather that they do not issue publicity material about work which they have not carried out themselves but simply commissioned on Departments' behalf. The Economic Progress Report is a possibility - the next edition is due out on 23 April. Although EPR carried an article on Wider Share Ownership as recently as the November-December edition (giving a 2.8 million figure for shareholders) this probably would not rule out a short up-date.

X 11. Whichever route is chosen, we will need to clear the text of any release in draft with the NOP (a standard contract condition). When it has been decided how best to publicise the figures, we will provide draft material.

Paul McIntyre

J P McINTYRE

ANNEX A

Year to 31 March	BMRB Survey[1] Proportion of population owning shares and implied absolute numbers (millions)		Inland Revenue data[2] (millions)
1978-79	7.1%	3.0	1.7
1979-80	7.0%	2.9	1.6
1980-81	7.3%	3.1	1.6
1981-82	6.4%	2.7	1.6
1982-83	5.9%	2.5	1.5
1983-84	5.8%	2.5	1.5
Apr-Sept 1984	6.2%	2.7	)
Oct-Dec 1984[3]	7.4%	3.2	) not available
Jan-Mar 1985	10.2%	4.4	)
Aug-Sept 1985[4]	16.0%	7.0	

Notes:

(1) A survey of 24,000 representative adults across Great Britain. Absolute numbers calculated by applying percentages of shareholders to total GB adult population estimates for each year provided by OPCS. No population estimate for 1985 is yet available: 1984figure of 43.5 million is therefore used for 1985 calculation.

(2) Based on an annual analysis of around 100,000 tax returns. Indicates the number of people declaring dividend income for tax purposes.

(3) BT floated November 1984.

(4) Results of special survey carried out for Stock Exchange (sample 1,000 but more searching questions than in regular surveys).

2647/021

FROM: G E GRIMSTONE

DATE: 2 APRIL 1986

CHANCELLOR Ch Relevant to your New York speech

cc: Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Mr Monck
Mr Moore
Mr Culpin
Miss O'Mara
Mr Hall
Mr Crompton
Mr Ross-Goobey

Thanks. I agree with X.

AWK 3/4

SHARE OWNERSHIP: NOP SURVEY

I agree the attached advice from Mr McIntyre. I do not think that you need to feel worried about making a lot of the 14% shareholders's figure. The background to the figure will stand scrutiny. We can explain that at the end of last year an unpublished Stock Exchange survey of a representative sample of 1,000 adults showed that 16% owned shares. Because this figure was higher than we had realised, Ministers asked for it to be verified before it was quoted. We asked the Office of Population Censuses and Surveys for their advice on how best to do this. They are acknowledged experts in this area. They commissioned NOP Market Research to find out the correct number. Suitable questions were devised by OPCS and NOP and asked of a representative sample of over 7,000 adults. NOP tell us that there is a 95% confidence factor of $\pm$ 1.5% on the 14% figure which emerged. This, taken together with the earlier 16% figure which was produced quite separately by the British Market Research Bureau gives us as much confidence as we could hope for.

X 2. Once you have released the overall figure in whatever forum you consider appropriate, I think that it would be helpful to write up in an authoritative way the findings of the OPCS/NOP survey and publish it in the EPR. To make sure we get it absolutely right, we can ask OPCS to help with this.

3. Incidentally, if you have time, you might like to glance at the full report of the Survey which I attach. There is some interesting stuff on regional and socio-economic variations which we will draw out once the full results are made public.

G E G.

G E GRIMSTONE

1988/35

RESTRICTED

See covering note
[initials] 2/4

FROM: J P McINTYRE
DATE: 2 APRIL 1986

1. MR GRIMSTONE

2. CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Mr Monck
Mr Moore
Mr Culpin
Miss O'Mara
Mr Hall
Mr Crompton
Mr Ross-Goobey

SHARE OWNERSHIP: NOP SURVEY

X1 Mrs Lomax' minute of 27 March asked for reassurance that the 14% share ownership figure reported by the NOP survey does not include building society share accounts.

2. I have discussed this with NOP. They are confident that those interviewed will not have thought that building society share accounts should be included. They point out that the only general question about shareholding (which might conceivably have caused confusion in this way) followed questions asking about shareholdings in specific companies such as BT and in the companies people worked for. The context was therefore very much one of owning shares in companies.

3. NOP nonetheless think there is some risk that investments in unit trusts may have been included by some interviewees. This is why they feel that, if anything, the 14% figures may be a little on the high side, as I reported in my minute of 26 March. But the problem seems likely to be a small one. Other NOP work puts the number of investors in unit trusts at 2-3%, and NOP accept that some of these also own shares directly.

4. I have also spoken to the British Market Research Bureau on this point. They think it unlikely that their 16% figure for share ownership (in the survey conducted for the Stock Exchange last Autumn) was significantly affected by inadvertent inclusion of unit trusts. This is because the share ownership

questions were asked in the context of holdings in BT and employing companies and also because, later in their interviews, people were asked specifically about unit trust holdings.

5. The BMRB research picked up a rather higher figure (5%) for unit trust investors. But they also found that over two thirds of them also held shares directly. Reading across to the NOP survey, this would suggest that, at the very outside, no more than about 1-1½% of the 14% figure for shareholders could have been accounted for by investors in unit trusts without any direct shareholdings.

Speech Material

6. I attach draft paragraphs for your consideration which could serve as the basis for the relevant part of your New York speech. The reference to the NOP survey has been cleared with NOP.

Paul McIntyre

J P McINTYRE

Draft

One important result of our policies has been a revival in share ownership by individuals. When we came to office at the end of the 1970s, something like 7% of the British adult population were shareholders. The results of a major new survey have just become available and show that the figure has risen to around 14%. In other words, the number of shareholders in Britain has roughly doubled.

This is clearly a major advance. But we know from your own example, here in the United States, how much more can be achieved. I understand that a survey by the New York Stock Exchange has shown that around 40 million Americans, or 22 per cent of the adult population, were shareholders in 1983. Perhaps it has increased further since then. But our latest figures suggest that we are catching you up.

SECRET AND COMMERCIAL IN CONFIDENCE

Ian

FROM: F CASSELL
4th April 1986

PS/CHANCELLOR

cc PS/Financial Secretary
PS/Economic Secretary
Sir P Middleton (o/r)
Mr Peretz
Mr Norgrove - No 10

STANDARD CHARTERED

You will have seen Ms Life's minute of earlier today.

The Deputy Governor rang this afternoon to say that the discussions between Jeremy Morse and Lord Barber had reached no agreement. Lord Barber said that Standard would not welcome a bid from Lloyds except if Standard itself was under attack from a predator.

Standard's share price, however, has rocketed up - from 639 at last night's close (and 450 a few weeks ago) to over 800. Lloyds therefore felt itself obliged to make an announcement that it had approached Standard with an offer of 750p a share. Lloyds is also, I understand, asking for a Stock Exchange inquiry into the price movements in Standards shares.

Standard has itself put out an announcement expressing surprise at the bid. Its board is meeting on Tuesday to discuss the bid.

The Deputy Governor told me he was concerned at the speed of events today. The way Standard shares had shot up suggested that there may be another potential bidder in the background. The Bank think that a Lloyds/Standard grouping would make good sense, and strengthen British banking. The Deputy hoped that this may still come about. From his conversations today relations between Jeremy Morse and Lord Barber seemed to be good, and the Standard Board when it meets on Tuesday might take a favourable view of linking with Lloyds. But the massive increase in the share price, which leaves the present Lloyd's offer stranded, was not helpful in this context. Nor, more generally, does it reflect well in the City.

F CASSELL

N. M. Rothschild & Sons Limited
New Court
St. Swithin's Lane
London EC4P 4DU
(Registered Office)

DRAFT REPLY BY 9.5.86 PLEASE

CH/EXCHEQUER
REC. - 1 MAY 1986 1/5
ACTION MR J FARMER-IR
COPIES TO FST
MR CASSELL
MR MONGER
MISS SINCLAIR
MR CROPPER
PS/IR

From the Chairman

30th April, 1986

Dear Chancellor,

It has come to my attention that, as a result of the definition of 'relevant emoluments' adopted by the Inland Revenue, a company which operates a Finance Act 1984 share option scheme is forced to discriminate against directors who make extra provision for their retirement by way of additional voluntary contributions ("AVCs") to a pension scheme. Thus, supppose two directors are paid exactly the same salary because they are of comparable standing, one of them paying AVCs but the other not. If it was decided to grant them both share options under an approved share option scheme to the maximum permissible, then the AVCs must be deducted from the salary of the director who pays AVCs when calculating his maximum level, and he would have to be granted fewer options than the director not paying AVCs. This would seem to me most inequitable.

I regard share options as an important way to incentivise senior directors and it would appear unfortunate that because someone has decided to forgo spending now in order to save and make provision for old age he is penalised for so doing. I feel sure that this effect of excluding AVCs from the definition of 'relevant emoluments' was not intended, nor is it specifically set out in the legislation, and I would ask that you consider changing this definition. After all, should a company make the whole of the salary pensionable and the company pay all the pension contributions, these pension contributions are not treated as a deduction for the purposes of "relevant emoluments".

I shall look forward to hearing your views on the above in due course.

Yours sincerely,
Evelyn

Evelyn de Rothschild

The Rt. Hon. Nigel Lawson, MP,
H.M. Treasury,
Parliament Street,
London.
SWI

1991/11

FROM: J D CROMPTON
DATE: 6 MAY 1986

Mary Rutter

Nigel

1. MR GRIMSTONE

2. CHANCELLOR

Table 1 attached is interesting but other than showing that shareholders have substantially increased, there's not much to be made of it. We have now arranged that the General Household Survey from next year will include questions of share ownership. For the future therefore much better information will be available.

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Mr Monck
Mr Moore
Mr Peretz
Mr Culpin
Mr M Hall
Miss O'Mara
Miss Sinclair
Mr McIntyre
Mr Ross-Goobey
Miss White IR

THE DECLINE OF SHARE OWNERSHIP

Your Private Secretary's minute of 14 April passed on your request for further information about share ownership before 1979. You asked two main questions:

(i) What is the evidence for the decline of share ownership before 1979?

(ii) How many shareholders were there in the peak year?

This note summarises the information available to us in this area. It concludes that there is little evidence for a fall in shareholder numbers before 1979. The basis for the claim that the individual shareholder has been in long term decline has come from studies into the proportion of total UK equity held by the personal sector (which is a wider category than individuals). These studies do not tell us anything definite about the number of individual shareholders.

Shareholder numbers

2. We have two sets of information on numbers of individual shareholders before 1979:

(a) British Market Research Bureau estimates of the number of adult shareholders in Great Britain each year from 1973-74. While these figures may be a little erratic (the 1973-74 figure in particular looks rather strange) they are the only direct estimate of shareholder numbers for this period that we have.

(b) Inland Revenue estimates of the number of tax units (husbands and wives count as one unit) reporting dividend and similar income on their tax returns for each year since 1963-64. Since many basic-rate taxpayers do not need to make tax returns, these figures do not represent an estimate of the total number of shareholders, but may give an indication of the trend. A definitional change after 1972-73 makes direct comparisons between early and more recent years rather difficult to draw.

The BMRB and Revenue statistics - updated to 1985 - are set out in Table 1.

Shareholding from 1973-1979

3. The BMRB figures suggest that the number of shareholders in the UK was on the increase between the mid- and late- 1970s, from around 2½ million in the period to 1973-74 to 1974-75 (allowing for the odd 1973-74 figure) to 3 million in 1978-79. This gentle upward trend seems to be supported by the Revenue figures for 1974-75 to 1978-79. Both sources suggest a decline in shareholding from around 1980 to 1983-84.

4. The Revenue figures for the years 1963-64 to 1972-73 seem to suggest that the number of shareholders over this period remained fairly constant - although this is necessarily a rather tentative conclusion. Little more can be said about shareholder numbers over this period.

Other evidence on the decline of personal shareholding

5. The most powerful evidence for the decline of personal shareholding over the last two decades comes from surveys of company share registers conducted in 1963 and 1969 by the Department of Applied Economics at Cambridge, and in 1975 and 1981 by the the Stock Exchange. These surveys did not provide estimates of shareholder numbers, but rather estimated the proportion of UK equities held by "persons" in these years.

In this context, "persons" includes not only individuals but also unincorporated businesses, the Corporation of Lloyds and investment clubs. It is not clear whether this wider definition affects long-term trends; certainly a similar definition used by the Central Statistical Office to measure equity flows shows considerable short-term fluctuations that do not seem to reflect changes in individual ownership patterns. The DAE/Stock Exchange figures were updated in 1978 and 1984 by Phillips and Drew; however, as personal holdings are the residual term in the model of stock market holdings their estimates are unlikely to be very reliable.

6. This information is summarised in Table 2. The main conclusion is that the proportion of the stock market held by the personal sector fell from 54% in 1963 to 28% in 1981 and - according to Phillips and Drew - to 22% in 1984. It is far from certain that the recent increase in number of shareholders has reversed or even halted this decline; moreover, given the measurement problems involved; a clearer picture is unlikely to emerge until the next Stock Exchange survey is published in 1988.

John Crompton

J D CROMPTON

Table 1

Year to 31 March	BMRB Survey[1] Proportion of population owning shares and implied absolute numbers (millions)		Inland Revenue data[1] (millions)	
1964			2.12	
1965			not available	
1966			2.27	
1967			2.24	
1968			2.23	Dividends, interest annuities etc. taxed at source
1969			2.29	
1970			2.16	
1971			2.26	
1972			2.21	
1973			2.12	
1974	5.4%	2.2	1.66	
1975	6.6%	2.7	1.55	
1976	6.9%	2.9	1.59	
1977	6.6%	2.7	1.69	Dividends from UK companies
1978	7.7%	3.2	1.60	
1979	7.1%	3.0	1.68	
1980	7.0%	2.9	1.60	
1981	7.3%	3.1	1.58	
1982	6.4%	2.7	1.56	
1983	5.9%	2.5	1.46	
1984	5.8%	2.5	1.47	
1985(March)	10.2%[3]	4.4	not yet available	
1985 (Sept)	12.1%[4]			

Notes:

(1) A Survey of 24,000 representative adults across Great Britain. Absolute numbers calculated by applying percentages of shareholders to total GB adult population estimates for each year provided by OPCS. No population estimate for 1985 is yet available: 1984 figure of 43.5 million is therefore used for 1985 calculation.

(2) Based on an annual analysis of a large representative sample of tax returns. Figures for years to 1972-73 are for all tax units (ie husbands and wives count as one) declaring dividend income or certain other categories of investment income; from 1973-74, the figures are for dividend income only.

(3) Figure for final quarter 1984-85 only (ie post-BT sale); other BMRB figures are averages over full year.

(4) Average for six months April-September 1985.

Table 2: Value of personal sector shareholdings 1963-1984

	1963	**1969**	**1975**	**1978***	**1981**	**1984***
Value of persons' holdings £bn	14.9	18.0	16.7	21	28.0	42.5
Real value of persons' holdings £bn 1984-85	100.5	93.5	42.3	37	32.7	42.5
Total market value £bn	27.7	37.8	44.5	63	99.4	193
Real total market value £bn 1984-85	186.8	206.9	112.9	112.2	115.9	193
Proportion of total market held by persons	54%	47.4%	37.5%	33%	28.2%	22%

*less reliable than other figures; see below

Source: detailed research undertaken by Department of Applied Economics at Cambridge in 1963 and 1969 and continued by Stock Exchange 1975 and 1981. 1978 and 1984 figures are estimates by Phillips and Drew, based on Stock Exchange work but less reliable.

Real prices are calculated using GDP deflators.

See paragraph 5 for definition of personal sector holdings.

201/16

CONFIDENTIAL

CHANCELLOR OF THE EXCHEQUER

FROM: N MONCK
DATE: 7 May 1986

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir P Middleton
Sir T Burns
Mr Wilson
Mr Byatt
Mr Kemp
Mr Burgner
Mr Odling-Smee

Mr Scholar
Mr Spackman
Mr Culpin
Mr Gilhooly
Mr Riley
Mr Shaw
Mr White
Mr Guy
Mr C Fletcher
Mr Ross Goobey
Mr H Davies
Mr Lewis - I/R

Thanks. 3(b) is strongly not on. It is a choice betw. (a) & (c). If we go the (a) route, we must be prepared to exclude the "shelter" area altogether. This could be done either by confining the scheme to mfg (& taking an extreme case), or [illegible] to take a political [illegible] sharp knife) or by [illegible] the PSt. ~~[illegible]~~ [illegible] a quick note on that. N.

PROFIT SHARING: PROGRESS REPORT

The purpose of this note is to give you, separately from the briefing for NEDC which will go to all Ministers, a fuller note on reactions so far and forthcoming decisions before the summer.

2. The briefing for NEDC on Monday, 12 May, assumes that your aim will be to keep open the option of issuing a consultative document before the summer without in any way committing yourself to going ahead with one. Your reference to profit sharing in the Budget Speech has in general been warmly welcomed but this is to some extent misleading; much of the support is for very broad or vaguely formulated ideas of profit sharing. For example the Institute of Directors' Survey gave respondents no real description of what you had in mind. The "unexpected" enthusiasm reported by the FT was also uninformed. Our detailed exchanges suggest, so far, that firms favour a very permissive scheme of tax relief for versions of profit sharing of their choice which are directed much more at employee identification than at the employment benefits you envisaged in the Budget Speech.

3. It is early days even in our preliminary discussions and in any case businessmen may not be at all good at predicting their own reactions, particularly in the longer term. But the signs so far are that the choice facing you in June may be between:

(a) going ahead with a consultative document setting out a scheme amended on the lines of paragraphs 10 to 12 below. This would be designed to be more workable than the initial scheme but it would not be very permissive. Take up might be modest outside the "slicker" area. It would still have an employment flavour. The benefits might be presentational and longer term;

(b) going ahead with a consultative document setting out a permissive scheme without significant employment benefits. The cost of a permissive scheme with high take-up could well reduce your ability in later Budgets to cut the basic rate of income tax. Tax relief without significant employment benefits would be harder to justify, though you could point to the potential benefits of higher productivity for output and living standards;

(c) deciding not to go ahead with a consultative document.

<u>The initial scheme</u>

4. The initial scheme contains a number of features aimed at the medium term employment objectives in the Budget Speech. In particular we suggested that tax relief would among other things be conditional on conversion of a significant proportion of earnings to profit-linked income, though we offered to allow this to be spread over two years.

5. Secondly, we proposed that new recruits between profit declarations should either be paid base pay or, when employment rose, a lower total rate resulting from dividing a fixed pool of profit-linked income between the increased number of employees. Without these provisions there would be no change between profit declarations compared with a conventional fixed wage system.

6. An economic assessment of the potential benefits of a scheme of this kind by Messrs White and Riley is at Annex A.

<u>Reactions so far</u>

7. We are now rather over half way through the "preliminary discussions". Of the individual companies, we have talked to Lloyds Bank, BT, Boots and, less

formally, to John Lewis. ICI*, Sainsburys, Toshiba and United Biscuits are still to come. Of the employers' associations, we have talked to the CBI, The Institute* of Directors, the Chamber of Commerce, the Engineering Employers Federation and the Industrial Participation Association. We have also had brief exchanges with TUC officials and Norman Willis has published a fairly explicit article (see Annex B). Of the employers' organisations, the CBI are carrying out the most extensive consultation. They will be ready with a full report on this in June. The CBI may well include the substance of these in their paper on pay for the July NEDC.

8. All of the employers' organisations have indicated with various degrees of warmth that they would like you to go ahead with a consultative document. But both they and the individual companies we have seen so far do not favour our initial scheme and would strongly prefer something much more permissive.

9. In particular several points damaging to the prospect of employment gains have emerged pretty clearly:

(a) the employers we have seen dislike qualifying rules which would ensure that the marginal cost of additional employees between profit declarations would be lower than it would be with a fixed wage system. They are anxious either about their ability to recruit if they could only pay base pay or about the administrative problems of recalculating profit-linked income if employment rises. They are also alarmed by the reaction of existing workers to a cut in PLI when employment rose (though they probably exaggerate this risk);

(b) the employers we have spoken to thought a conversion of 20 per cent of earnings in one year into PLI would not be negotiable in their main business. Nor do they think the alternative of a transition over two years (ie a 10 per cent conversion in the first year with 5 per cent tax relief) would be a big enough relaxation to alter this conclusion though there might be exceptions such as Lloyds Bank's estate agencies;

(c) some employers think that the introduction of PLI would make them hold on to some workers for a little longer than they do at present in bad times;

(d) most employers thought that there would be interactions with base

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*the Minister of State in the Chair.

pay negotiations, though the message was not clear. It would be difficult to hold day base pay changes below the going rate when profits rise and there would be compensation to a greater or lesser extent in base pay negotiations if profits fell;

(e) employers see the benefits of profit sharing as increasing identification and productivity which they often saw as resulting in higher remuneration but possibly lower levels of employment than might otherwise have been the case. None of the employers we have seen envisages expanding sales and total profits by lowering the price in the way that Weitzman thinks would be madc possible by the introduction of a share system.

This means that employment may well not benefit in the short run, for the types of reason described in Annex A. But greater stabilisation of employment in the face of variations in demand and costs may nevertheless be possible.

Possible amendments to the initial scheme

10. We think that it would probably be necessary to allow new recruits to receive the same as existing workers. In that case it would be important to encourage firms to declare profits more than once a year (although it would certainly not be a statutory requirement) and to do so as soon as possible so that PLI could fall quickly if profits per head fell rather than being stuck for a whole year. A difficulty about this is that although most large companies now announce results twice a year, these are not formally audited though the auditor looks at the figures. To allow unaudited figures to be used as a basis for calculating PLI and hence tax relief, it would be necessary to use management accounts for profit declarations quarterly and half-yearly but with an adjustment being made when audited figures for the full year are available. Any profit figures used for this purpose would have to be revealed to shareholders and potential investors at the same time as they are disclosed to workers. There would not be a problem for six-monthly figures which are already widely published. But there would be a change for those companies which, as would be desirable, moved to a quarterly declaration of profits for calculating PLI. If profit sharing spread successfully, this would bring the UK into line with the USA where quarterly results are published much more widely than here.

11. A second relaxation would be to extend the transition over three instead of two years. The numbers for the size of the conversion into PLI each year might be 7 per cent or, if you wanted a round number, 5 per cent (adding up

to 15 per cent at the end of the transition). Such an extension would greatly reduce the extent to which workers were apparently being asked to put their existing pay at risk. (In fact, because of the damping effect of the formula we have proposed, which happens to be similar in form to Boots', the risk is smaller than it appears to be. Annex C shows how total pre-tax earnings vary with various changes in profits)

12. A further variant would be to allow the parties to agree to stop the conversion after either one or two years but to retain the corresponding limited degree of tax relief.

13. Many of those we have seen argued that the tax relief should be permanent. Some of them argued that if it has to be withdrawn, it should at least be done in stages to minimise the risk of a blip in pay to compensate for the abrupt loss of tax relief. Taken with extension of the initial transition, this might mean that some degree of tax relief might last for 7 years or so.

14. The alternative basis for a consultative document would be effectively to give up the short-term potential benefits to employment and introduce a broad permissive scheme primarily aimed at the benefits of employee identification. We have always known that there would be fewer practical problems about that. The problem is justification and revenue cost.

15. Even if you had in mind a consultative document spelling out a range of schemes (as well as describing progress so far) you would need to decide in advance whether you were prepared to retreat to that extent. It may be easier to take these decisions before you have published a consultative document than afterwards.

The TUC

16. The Willis article at Annex B goes beyond normal TUC skirmishing and comes pretty close to pre-empting serious discussion with the TUC.

17. First of all he treats profit sharing explicitly under the general TUC opposition to "wage flexibility". He demonstrates once again that NEDC is a dialogue of the deaf by claiming that flexibility "will only reduce the demand which the economy needs so badly": he ignores the pledges you have given at NEDC as well as in Budget Speeches about maintaining nominal demand. Thirdly he claims that profit sharing would "increase the insecurity of working people", totally ignoring the potential trade-off between security of pay and security

of jobs.

18. His final sentence is more dismissive than would be compatible with staking-out a negotiating position. It reads:

"Co-operation is one thing, being conned is different".

19. Mr Willis is taking this line at the same time as endorsing recent remarks by Labour Party and trade union leaders in favour of some kind of pay restraint in the interests of giving priority to employment.

20. He is equally inconsistent in showing interest in the recent Swedish innovation. Under this employers pay a levy on profits and the pay bill into five regional investment funds in which trade union representatives have a controlling vote. These funds pay a 3 per cent real return into a national superannuation fund. The rationale for this in Sweden according to an article in the current NatWest Quarterly Review is:

"To redistribute in favour of the employees the profit windfall generated by the system of centralised wage bargaining".

The windfall arises because trade unions are led by their interest in employment to agree to a wage rate in the national framework settlement which enables the marginal firm to survive and to maintain employment while intra-marginal firms get away with lower wages than they might otherwise pay. So here again there is a recognition on the part of unions of the link between pay and employment.

Conclusion

21. The admittedly incomplete evidence so far suggests that you will have to decide between the three broad options in para 3 above. It may be easier to do this as part of the decision whether or not to produce a consultative document rather than after receiving reactions to a consultative document. Unless you are already clear now which way you want to go, this supports the approach to NEDC in the briefing of keeping your options open - neither committing yourself to publishing a consultative document nor sharpening the disagreement with Norman Willis, though the latter would be perfectly possible on the basis of his unhelpful article at Annex B.

J. Odm
for N M

201/37

pwp

CHANCELLOR OF THE EXCHEQUER

FROM: N MONCK
DATE: 29 May 1986

cc Chief Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr Kemp
Mr Culpin
Mr Shaw
Mr Guy

PRESS STORIES ON PROFIT SHARING

You have asked for a draft letter to Lord Young about the press stories in yesterday's Financial Times and today's Daily Telegraph (attached).

2. As the attached draft letter explains, the content of the stories points strongly to Lord Young or one of his Ministers as the source. But as usual in these cases we have no hard evidence.

3. My enquiries with DE officials have only produced negative evidence. Lord Young saw Philip Bassett last week about Deregulation but an official was present and his notes contain nothing about profit sharing. DE officials say they have said nothing to the press at their level that could lead to these stories. Yesterday their Press Office referred the Daily Telegraph correspondent to the Treasury Press Office. IDT received several enquiries from journalists who assumed that Lord Young was the source for the Bassett story. IDT said they knew nothing about the story. This line worked with all the papers except The Telegraph.

4. The background to all this is the pressure from almost everyone we have talked to - both individual companies and the CBI etc. - for phasing-in the build-up of profit related pay and the associated tax relief over several years. It would in my view be unrealistic to stick to a 20 per cent conversion in a single year except as part of a considerably wider range of permissible options. The support for this is, of course, linked to the argument for minimising the proportion of existing pay which employees are asked to put at risk. In that sense it has some resemblance to the scheme which Lord Young put to you in February. But there would be no question of presenting a phasing-in scheme of the kind sketched out in my progress report to you of 7 May as conditional on freezing basic pay, because of the strong incomes policy flavour.

5. The support for phasing-in will be reflected in the report on the views of the CBI Employment Policy Committee which I expect to get next week.

6. Both the CBI and the EEF have denied any responsibility for the FT story.

7. In view of the state of the evidence you may prefer to talk to Lord Young rather than send him the attached letter. I do not see what is really gained from putting your protest on paper. But this is obviously very much a personal choice for you and in any case we need to agree the line in the last paragraph of the draft letter with DE.

Bill Gr

pp.

N MONCK

FINANCIAL TIMES

Ministers consider new profit-sharing scheme

BY PHILIP BASSETT, LABOUR EDITOR

MINISTERS ARE considering a way to encourage profit-sharing that would differ from that suggested by Mr Nigel Lawson, the Chancellor. There are fears that his idea would not attract employees.

The alternative being considered would formally link pay rises and profitability, rather than tie a set proportion of pay to profits.

Mr Lawson, in his Budget speech this year, said he was planning tax incentives for profit-sharing. Last month, he put more detailed, although still sketchy, proposals for a scheme linking pay and profits to the National Economic Development Council.

By those, half a proportion of pay agreed by employer and employees would be linked to profits and might be given income tax relief.

The Treasury paper to the council suggested 20 or 10 per cent of pay might be tied to profits. Treasury officials estimated that, at 10 per cent, a worker on average earnings would pay £5 less in tax.

Opponents of such a scheme suggest it would be unpopular, in that it would jeopardise too great a proportion of earnings if profits were poor or non-existent.

There are doubts in the Cabinet as to whether the Government could implement a scheme that could cut guaranteed pay by the large proportions entailed.

An alternative is being proposed beside that of the Chancellor, before the drafting of a government consultative document on the issue, due in July.

The new suggestion is that profit-sharing be tied to pay increases, especially when (as minister hope) such rises are less than current levels. An employer would put money for pay rises in a pool, the size of which would depend on company profits.

It is argued that, with inflation low as at present, pay increases of 4 per cent or so (the level to which typical settlements might fall, ministers hope) would not be much missed if they had to be forfeited in the event of a company failing to make a profit. But pooling the rise money and linking it to profits could create rises equivalent to 7 to 8 per cent.

Proponents of the alternative claim that, over two to three years and depending on company performance, its effect would be roughly equivalent to setting aside from guaranteed pay the 20 per cent proportion that the Chancellor has suggested.

The Confederation of British Industry says today that Mr Lawson's scheme could improve workers' commitment and involvement in the success of their enterprise. It also feels that profit sharing could reduce upward pay pressures, make companies more likely to retain labour in difficult times and recruit when conditions improve.

The CBI is asking its member companies for their views on the scheme.

Profitsharing raises fears, Page 18; OECD urges worker flexibility, Back Page

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2/3

FINANCIAL TIMES

WEDNESDAY MAY 28, 1986

Profit-sharing raises fears over 'sensitive' company information

BY MANI DEB

18

EMPLOYERS are concerned that linking pay directly to profits could lead unions to seek disclosure of sensitive information, the Confederation of British Industry says in a report.

The CBI was giving the initial findings of its talks with employers on the Chancellor's proposals to link profit-sharing to pay.

A number of important details are not known but questions employers will have to consider when deciding on the merits of the initiative include:

- Would companies be willing to link pay automatically to profit? Profit levels can reflect a number of factors, such as the influence of exchange rates which have little to do with employee performance.
- Disclosure of sensitive information to unions. The TUC has already made it clear it would be seeking an increase in "industrial democracy."
- Will it be possible to negotiate over "base" pay while allowing profit-related pay to continue to be determined separately?
- Any tax relief on such schemes would create unequal treatment between those who can introduce such arrangements and those who can not either for practical reasons or they are not profit-making organisations.
- Would companies be able to calculate individual profit and loss accounts for separate operating units if they set up profit-sharing schemes below company level?

The CBI is seeking members' views on whether the potential benefits of the proposals are enough to outweigh the practical problems.

In welcoming the proposals, the CBI has already said any Treasury scheme must be flexible so proposals can accommodate differing company circumstances.

The idea of annual pay rises could be on the way out, the CBI suggests. It says: "The annual pay review, taken for granted during the recent period of high inflation, is now itself the subject of review in many companies."

Pay settlements in manufacturing industry continue to average 6.25 per cent, according to provisional figures from CBI's Pay Databank, which was also released with the report. The figure, for the first four months of this year, is the same as the final quarter of last year. The average for the whole of 1985 was 6.5 per cent.

Employment Affairs Report May/June 1986. CBI, 103, New Oxford St, London WC1A 1DU. £13.

THURSDAY MAY 29,1986

Daily Telegraph

DOUBT OVER PROFIT LINK WAGE PLAN

By Our Business Editor

DIFFERENCES are emerging among Ministers about profit-related pay proposals as employers express concern that the move could lead to unions demanding confidential information from firms.

Mr Lawson, Chancellor, is planning to produce a Green Paper soon giving details about the plan to offer tax incentives to workers who agree to link part of their pay to company profits.

But Lord Young's Employment Department is understood to be putting forward alternatives based on a "pooling" arrangement involving pay and profits.

Treasury officials were yesterday insisting that Mr Lawson retained overall responsibility for the strategy, but it is clear that other ideas are now gaining ground.

Under the Treasury formula half the profit-related income in pay packets would be free of tax, possibly increasing take-home pay by up to £5 a week. About 20 per cent. of total pay would be tied to company performance.

Earnings at risk

The Treasury ideas are being criticised in the Employment Department and some other parts of Whitehall on the grounds that they would not prove popular with employees because a sizeable proportion of earnings would be at risk if profits slumped.

Employment Department officials are suggesting an entirely different approach with employers setting aside money for pay rises and putting it in a pool before distribution. The size of the pool would be determined by company profits.

The Confederation of British Industry, while welcoming the Lawson initiative as a means of reforming pay bargaining, has reservations about some of the underlying implications.

One problem worrying employers is the amount of additional and possibly sensitive information union negotiators would demand in determining the profit element in pay rises.

THE STANDARD

Pay rises

INFLATION is down to three per cent but pay settlements are stuck at double that rate, despite exhortations from Ministers worried about our competitiveness abroad.

Chancellor Nigel Lawson has suggested linking a part of pay to profits, but that would run the risk of rejection by workers fearful of actual cuts in bad times.

Now an alternative is being mooted in Whitehall, tying profit - sharing to increases so that in lean years a rise might be forgone but the pay packet would remain stable. That is more likely to be an acceptable way forward to curbing unjustified awards.

5/1.

DRAFT LETTER FOR THE CHANCELLOR TO SEND TO LORD YOUNG

PRESS STORIES ON PROFIT SHARING

The stories in yesterday's FT and today's Telegraph are causing us considerable difficulty. Journalists on other papers are asking about them and seeking to make more of alleged disagreements within the Government. This threatens to bring our profit sharing initiative into disrepute and harm the prospect of making it a success.

2. The alternative approach which is described in the FT report sounds very like the proposal you sent me on 26 February that:

> "Employees who enter a profit sharing scheme instead of receiving an annual pay increase will not pay tax on the income received through the scheme."

There is also a reference to a pool, linked to profits, from which pay rises would be funded. I understand that this is not inconsistent with suggestions which your officials have made to mine. But although the Telegraph piece refers to your officials, the FT story appears to have a Ministerial source.

3. I hope you will agree that these press stories are damaging and untrue. There is no question of disagreement at this stage, when the results of the preliminary discussions are still not complete and officials are starting to digest them. There are, of course, no detailed proposals on the table for collective discussion and so the question of disagreement

in Cabinet can hardly arise. The suggestion that the Government would lay down, as a condition of tax relief, that there should be no increase in base pay is not only at odds with my NEDC paper. It is also damagingly close to an incomes policy of the kind peddled by the Alliance. It could almost have been lifted from their policy papers. It is completely at odds with our view that pay is a matter for which management must take responsibility. Such suggestions may pre-empt our eventual response to the widespread pressure for phasing-in profit related pay, which we shall certainly need to consider carefully.

/ trust

4. I hope you will agree to do everything possible to kill these stories of a rift and to avoid the incomes policy flavour in these stories. I suggest that your press office could point out that DE officials have been involved throughout the preliminary discussions which are now nearly complete. The next stage will be for our officials, together with those of the Revenue, to consider the points that have been made and to report to Ministers who have now begun to consider what the response should be. They should make it clear that there is no truth in the suggestion that freezing basic pay will be a condition of tax relief.

From: K F MURPHY

Date: 5 June 1986

MR GUY

Mr Copeman was right to stress the importance – whatever we should do – of promotion. We should wait for details though. N

cc PPS
PS/Chief Secretary
Mr Monck
Mr Shaw
Mr G White
Mr Gilhooly
Mr Cropper

PROFIT SHARING: MEETING WITH GEORGE COPEMAN

Sir Peter Middleton has seen a copy of your note of 3 June (below) of the meeting with Mr Copeman. He has commented that Mr Copeman's schemes would appear to have the effect of adding to unemployment if they always provide add on bonuses over existing (excessive) pay rates.

I don't think Mr Copeman would accept that unit labour costs rose faster in ~~Copeman~~ companies with his schemes than in comparable companies without schemes. N.

KFM

K F MURPHY
Private Secretary

CHANCELLOR

FROM: G E GRIMSTONE
DATE: 23 June 1986

cc Financial Secretary
Mr Monck
Mr Moore
Mr Hall
Miss Sinclair
Mr McIntyre
Mr Ross-Goobey

Thanks - I'm not keen on releasing the ~~[illegible]~~ detailed VP results ourselves, but I hope the SE's launch of this booklet gets plenty of prominence -

WIDER SHARE OWNERSHIP FIGURES

You may like to see the attached minute to me from Mr McIntyre which gives details of a booklet which the Stock Exchange are publishing later this week on "The Changing Face of Share Ownership". It puts into the public domain for the first time the research which the Stock Exchange commissioned last year and I think that it will be generally helpful to you. It features the Stock Exchange's view that "between 12% and 16% of the adult population of the UK are now shareholders - and there is evidence that their numbers are growing".

G.E.G.

G E GRIMSTONE

3398/35

UNCLASSIFIED

FROM: J P McINTYRE
DATE: 23 JUNE 1986

MR GRIMSTONE

cc Mr Monck
Mr Moore
Mr Hall
Miss Sinclair
Mr Ross-Goobey

STOCK EXCHANGE FINDINGS ON SHARE OWNERSHIP

We have received a proof copy of the Stock Exchange booklet "The changing face of share ownership" which is to be launched at a press conference by Sir Nicholas Goodison on Wednesday of this week. I attach a copy.

2. The booklet provides some welcome support for our NOP research on the number of individual shareholders, stating that "between 12 per cent and 16 per cent of the adult population of the UK are now shareholders - and there is evidence that their numbers are growing". The lower figure is drawn from the Target Group Index study covering 24,000 adults a year, conducted by the BMRB, and the higher figure is taken from the BMRB's omnibus survey with 2 samples of around 1,000. The 16 per cent figure, you will remember was produced by the study commissioned by Valin Pollen on behalf of the Stock Exchange and carried out in August and September last year.

3. The sentence on page 4 of the booklet describing the results of the poll commissioned by OPCS on our behalf from the NOP, is not very happily worded from our point of view in that it suggests that the survey was the Treasury's own work. I have given the Stock Exchange alternative wording which makes clear the involvement of both OPCS and NOP, but I am told that it is now too late to make any changes. A pity, but no serious harm done I think.

4. The rest of the booklet brings out some of the other main features of the Valin Pollen research, including:

(i) Share ownership is more widely spread among the population than previously thought;

(ii) one quarter of shareholders have less than £500 invested in shares;

(iii) around one half have shares in only one company;

(iv) shareholders have been hanging on to their shares - 80 per cent had not sold in the previous 12 months;

(v) nearly one third of shareholders had got them through an employer's scheme.

I understand that the Stock Exchange are also launching a second booklet on Wednesday, which is intended to be a simple guide to buying and selling shares. People will be able to get this booklet by cutting out a coupon from newspaper adverts which will begin on Thursday. We are being sent a copy of this booklet as well.

Paul McIntyre

J P McINTYRE

THE CHANGING FACE OF SHARE OWNERSHIP

Today, more and more people are buying shares. The Stock Exchange has been finding out who they are. This booklet presents its findings.

THE STOCK EXCHANGE

13/6

How was the research carried out?

The bulk of the information in this report is derived from a market research study of 483 shareholders in Great Britain. They were interviewed in person in their own homes, using a carefully designed questionnaire covering a wide range of aspects of shareownership.

In order to ensure that the sample was representative of shareholders in Great Britain, data on the demographic profile of shareholders and on the *types* of shares held (eg. British Telecom, employee schemes, other types of shares) was used for careful corrective weighting. This information came from two sources: the Target Group Index, a major and continuing market research study of 24,000 adults a year, conducted by the British Market Research Bureau, and two studies carried out on BMRB'S 'omnibus' survey, ACCESS, each with nationally representative samples of just over 1,000 adults.

The whole project was designed jointly by Valin Pollen and BMRB, and commissioned by Valin Pollen on behalf of The Stock Exchange. Fieldwork took place in August and September 1985. Its finding were analysed in the following months in the context of a continuing campaign to encourage a wider awareness of the role of The Stock Exchange and the extension of share ownership.

This report presents a selection of the most important findings of the research.

Some myths exposed.

When it comes to describing the "typical" private shareholder, myths are in plentiful supply.

"The private shareholder is a dying breed."

"Few individual shareholders take a really active interest in the market."

"It's really only the upper income groups who are significant."

And so on.

If this study does nothing else, it should act as a useful corrective to some of the received opinions. It shows, for example that:

Between 12% and 16% of the adult population of the UK are now shareholders – and there is evidence that their numbers are growing.

58% of shareholders are in the C1, C2 and DE socio-economic groups.

42% of current shareholders are women.

The average shareholder has a portfolio worth nearly £4,000, spread among four companies.

Nearly half of all shareholders check the value of their holdings at least once a week.

The following pages are designed to provide a new and valuable source of information on shareownership in the UK.

Who are the shareholders?

HOW MANY?

In recent months, information has come to light suggesting that rather more people in the UK own shares than used to be thought. In its own study, conducted in February of this year, The Treasury came to the conclusion that 14% of the adult population own shares. The two 'omnibus' studies carried out for The Stock Exchange suggested a slightly higher figure of 16%. The Target Group Index currently indicates a level of 12%.

The exact figures do vary, probably because of differences in the way people are asked about shareowning. We believe that a number of people who own shares do not necessarily think of their holdings as 'shares' unless questioned quite closely, as in the surveys conducted for The Stock Exchange. Quite clearly the true figure must now be at least 12% (5 million) of the UK adult population, and probably rather more.

Shareholder penetration — Table 1

	Men	Women	Total
Unweighted base	475	536	1,011
	%	%	%
Shareholders	20	12	16
Non shareholders	80	88	84

WHO?

Table 2 shows how shareholders are divided by age group, sex and social class.

As can be seen, shareholders currently have an "up market" profile, 42% of them falling into social grades A or B (Senior white-collar workers/professionals and managers). Within the adult population as a whole, only 17% fall into these social grades. However, the situation is not completely lopsided, as almost one third of shareholders are in Social Class C1 (Junior white-collar workers).

Shareholders are also more likely to be men, and are more middle aged than elderly than the population as a whole. Again, however, the bias should not be exaggerated, since women are a substantial minority among share investors.

Shareholders are rather more prevalent in the South East. Some 37% of the shareholders interviewed lived in Greater London and the South East, compared with 32% of all adults.

Profiles of shareholder groups **Table 2**

	All Shareholders	B.T. Only	Own Company	Shares in B.T.
Unweighted base	483	84	112	237
	%	%	%	%
Men	58	52	73	60
Women	42	48	27	40
AB	42	27	34	35
C1	29	31	29	29
C2	16	24	22	19
DE	13	19	16	17
15 – 24	7	11	6	6
25 – 34	13	13	17	12
35 – 44	18	15	23	17
45 – 54	19	11	28	15
55 – 64	18	20	14	21
65+	25	30	12	28

It can also be seen that those who own shares in British Telecom tend to be younger than other shareholders, and fewer are in AB social class – showing that this type of privatisation is popularising share ownership in the UK.

READING HABITS

Table 3 shows the current reading habits of shareholders. The Daily Telegraph figures prominently, and is read by just over a quarter of shareholders. On Sunday, the Sunday Times and Sunday Express figure most prominently.

NEWSPAPER READERSHIP	Table 3	
Base: All shareholders	(483)	
	Read Regularly	Read City Pages
Daily Newspapers	%	%
Daily Express	14	11
Daily Mirror	9	4
Daily Mail	17	14
The Sun	10	2
The Times	12	11
Daily Telegraph	28	27
The Guardian	6	6
Financial Times	6	10
Daily Star	2	*
Daily Record	2	*
Local Daily Paper	25	13
None of these	13	25
Don't know	–	–
Sunday Newspapers		
Sunday Express	25	14
Sunday Mirror	9	3
Sunday People	7	2
News of the World	10	3
Sunday Telegraph	17	13
Sunday Times	24	17
The Observer	13	9
The Mail on Sunday	11	7
Sunday Mail	6	2
Sunday Post	6	2
None of these	20	40
Don't know	*	1

However, a wide variety of other newspapers are read by significant proportions – The Sun and The Mirror attract about one tenth of shareholders each.

ATTITUDES TO MONEY

Overall, shareholders appear confident in their understanding and control of their financial affairs and are involved and interested in financial matters. They do not, however, regard themselves as particularly financially ambitious and are not by any means obsessed with making money.

Respondents were given a set of cards, each bearing a statement about money, and asked to sort the cards to show how strongly they agreed or disagreed with each statement. Responses were ranked on a scale of 5 points for *strong agreement* to 1 point for *strong disagreement*.

Attitudes to saving	Table 4
Base: All Shareholders (483)	Mean Score*
I like to feel in control of my finances	4.5
I always know roughly how much money I have at any time	4.30
I always pay my bills on time	4.10
I consider myself to be financially comfortable	3.68
You have to take risks to make money	3.46
I try to keep up-to-date on which savings and investments offer the best opportunities so that I can switch my money to them	3.29
I consider myself to be financially ambitious	2.84
I spend a lot of time thinking about money and what I would do with it if I had more	2.84
Many of the goals in my life are tied to moeny	2.63
I'm not very interested in savings and investment	2.48
I leave all my finances to my wife/husband to look after	2.24

*Mean Score: 5 = Strong Agreement, 1 = Strong Disagreement

Number of companies in which shares are held	Table 7
Base: All Shareholders (483)	%
1	51
2	11
3	9
4 – 5	10
6 – 7	4
8 – 10	4
11 – 15	4
16 – 20	1
21 – 30	1
31 – 50	*
Over 60	1
Don't know/not stated	4
Average number of companies in which shares are held	4.1

How active are shareholders?

Around half the shareholders interviewed had shares in only one company, and a fifth hold investment in 2 or 3 firms. The average (mean) number of companies in which shares are held is 4.1.

CHECKING VALUES

Shareholders tend to check on the value of their holdings quite frequently. Table 8 shows how often people found out about the value of their shares – either by checking themselves, or being told by someone else.

Frequency of checking value of shares	Table 8
Base: All shareholders (483)	%
At least 3 times a week	29
Once or twice a week	18
Once or twice a month	12
Every three months or so	10
Every six months	12
Once a year	6
Hardly ever	7
Never	5

BUYING AND SELLING

Many shareholders appear to be passive when it comes to buying and selling shares, but there is markedly more buying activity than selling. This finding is consistent with general evidence of increasing investment in stocks and shares by private individuals.

As Table 9 shows, just over half the shareholders interviewed had made a *purchase* in the preceeding 12 months, but only a fifth had made a *sale*. The figure also shows the number of transactions (*either* buying or selling) made in the past year.

All their answers were aggregated and are shown, averaged out, in Table 4. A score higher than 3 shows net agreement with the proposition, and score less than 3 indicates net disagreement.

These net average scores, whilst representing the overall positions do not show the considerable variety of people's answers. For example, although there is a net agreement that 'You have to take risks to make money' 9% of shareholders 'disagree strongly,' and a further 15% 'tend to disagree'.

Amount invest in shares	Table 5
Base: All shareholders (483)	%
Less than £500	23
£501 – £1,000	13
£1,001 – £2,000	7
£2,001 – £3,000	5
£3,001 – £4,000	–
£4,001 – £5,000	2
£5,001 – £7,000	4
£7,001 – £10,000	3
£10,001 – £15,000	2
More than £15,000	9
Refused to answer	11
Don't know	22
Average	£3,975

How much is invested?

As might be expected, the number and value of shares owned varies considerably. Almost a quarter of those interviewed had less than £500 invested in shares. Around half the sample had up to £3,000 invested.

On the basis of the respondents' answers, we estimate that the average (mean) value of shareholdings at just under £4,000. Many people refused to state or didn't know the value of their holdings, and they are not included in our calculation of average holdings. The average rises with social class, from £1,300 among DE's to £6,000 amongst ABs, and with age, from £600 among 15-19 year olds to £6,800 amongst over 65s.

The average amount amongst those with *only* BT shares is around £1,200, compared with £4,000 in the rest of the sample.

How were shares acquired?

The clear majority of shareholders bought their shares themselves. However, it is interesting to note that 30% obtained shares through a scheme run by their employer.

The proportion of *C2DEs* among those who obtained shares through an employer's scheme is markedly higher than among shareholders generally. This lends weight to the view that such schemes make a positive contribution of broadending shareownership.

How shares are obtained **Table 6**

Base: All shareholders (483)	%
Bought them myself	66
Obtained them through a scheme run by my employer	30
Inherited them	19
I was given them	9
Other answers	1

Some respondents obtained shares in more than one way, so this table adds up to more than 100%.

As is to be expected, we found that buying and selling activity is rather higher among those with larger and more valuable share portfolios.

Buying and selling shares in past year — **Table 9**

	No. of Times		
	Bought	**Sold**	**Transactions**
Base: All Shareholders (483)			
No. of occasions	%	%	%
None	47	81	45
1	29	9	29
2 – 3	15	4	12
4 – 10	6	4	9
11 or more	1	1	4
Don't know	2	1	2
Average no. of times	1.3	0.7	2.0

Other investments

Base: All Shareholders (483) Table 10

	% holding	Mean amount
Current account at a bank	84	£925
Building society account	81	£4,946
Premium bonds	60	£473
Bank deposit/ savings account	49	£1,994
Unit trusts	22	£6,372
"Other" National Savings Certificates	22	£2,879
Government Securities (Gilts)	19	£6,920
Index-linked National Savings Certificates	13	£3,139
Investment/ ordinary account with TSB	10	
Investment/ ordinary account with NSB	10	
Government SAYE scheme	8	
National Girobank	7	
British Savings Bonds	3	
Local Authority securities	1	

Where else do shareholders invest?

For nearly all those interviewed, shares form only part of a wider portfolio of investments. Table 10 shows what percentage of shareholders have other types of investments – and where enough were interviewed to make figures indicative, the average amount put into those other forms.

Some people are naturally reluctant to divulge details of the *size* of their investments, and we have excluded those who refused to say, or didn't know, from the calculation of the amounts held.

Taking into account penetration levels, it is apparent that it is *Building Societies* which have the largest proportion of shareholders investments.

On a rough calculation, the average savings and investments of shareholders are £13,200 *in total* with some 30% in shares, 30% in building societies, 11% in Unit Trusts and 10% in Gilts.

On this basis, there appears to be considerable potential for *existing* shareholders to increase the amount of their investment in shares compared to other savings vehicles.

How do shareholders feel about shares?

It is apparent that most shareholders find shares an interesting and often enjoyable way of investing money. At the same time, they are conscious that more risk is involved than is the case with, for instance, a building society account. Nevertheless, the perception of risk doesn't seem too powerful a deterrent, and most shareholders would like it to be easier to buy shares.

Shareholders were asked to what extent they agreed or disagreed with a series of comments about shares and the stock market. Their answers were attributed point scores on the following scale:

Agree strongly	**5**
Tend to agree	**4**
Neither agree or disagree	**3**
Tend to disagree	**2**
Disagree strongly	**1**

A selection of their answers are shown in Table 11. This shows the net score for comments, as well as the proportion of those interviewed who agreed or disagreed in each case.

Attitudes to shares			Table 11
Base: All Shareholders (483)			
	Mean Score*	Agreeing %	Disagreeing %
Buying shares is a risky business	3.93	77	10
I think stocks and shares are an interesting way of saving or investing	3.88	73	13
Shares are a good way of making money work for you	3.81	72	10
I think it should be made easier to buy shares	3.67	60	16
Stocks and shares are an enjoyable way of investing money	3.50	56	20
I'm only interested in big share sales like British Telecom	2.51	32	58
I don't really know how to go about buying shares	2.39	31	63

*Mean score: 5 = Strong Agreement, 1 = Strong Disagreement

PERFORMANCE

Most respondents appear well satisfied with the way their shares have performed.

They were asked "Broadly speaking, how would you describe the overall performance of your shares?" They answered as follows:

Very good	33%
Fairly good	48%
Neither good nor bad	14%
Fairly bad	3%
Very bad	1%
Not stated	1%

Only a small proportion of shareholders have had a bad experience with their investment, and a large majority would appear to be well pleased.

What about non-shareholders?

Naturally, The Stock Exchange has also been keen to understand the views of the majority of the population which does not own stocks and shares.

Non-shareholders interviewed in the omnibus study were asked if they agreed or disagreed with a series of statements which had also been put to respondents in the shareholder study. Again, a point score was attributed to their answers (see Section 9). The following table highlights some of the more interesting comparisons.

Attitudes of shareholders and non-shareholders **Table 12**

	Shareholders	Non-shareholders
Base: Unweighted	149	862
	%	%
I think stocks and shares are an interesting way of saving or investing	3.47	2.85
If I had some spare money to invest I would consider stocks and shares	3.62	2.66
I follow the Stock Market closely	2.53	1.34

As can be seen, non-shareholders generally feel more remote from the stock market, and tend to believe that they haven't enough money to buy shares.

In order to better understand the attitudes of non-shareholders, Valin Pollen commissioned a series of *qualitative* research studies from The Research Busines – studies which concentrate on discussing with non-shareholders their attitudes in a free and open-ended way. This extensive work led The Stock Exchange to conclude that it would be possible to reduce much of the apparent alienation of non-shareholders if they can be given sound information about stocks and shares, and if the whole process of buying shares could be demystified.

The Stock Exchange's advertising campaign makes a start on this process. We hope it will lead to more people having a chance to become involved in what appears to be a satisfying means of investing.

71.3 24/6

cc Sir P Middleton
Sir T Burns
Mr Culpin
Mr H Davies

Chancellor

You may like to read Mr Shaw's note, if not the full lecture, after looking at the revised draft of the consultation document, especially Mr Shaw's para 5 c, d, and (e)

NM 30/6

Thanks.

MR MONCK

FROM: P A SHAW

DATE: 30 June 1986

cc Mr Burgner
Mr White
Mr Riley
Mr Gilhooly
Mr Guy
Mr Issacs (IR)
Mr Lewis (IR)
Mr Farmer (IR)

Mr Culpin

PROFESSOR WEITZMAN: THE CASE FOR PROFIT SHARING

The Treasury has received a copy of Professor Weitzman's public lecture text to be given in London on Monday 7 July. The text arrived without being covered by a letter. The text may well have been sent by Professor Weitzman but there is no evidence to confirm that conclusion.

2. The speech is a careful presentation of the merits of profit sharing. He avoids excessive claims for employment benefits. Three quarters of the lecture is devoted to addressing criticisms of his approach to profit sharing. We will build into Q and A briefing many of the same answers put forward by Professor Weitzman.

3. Professor Weitzman puts claims for higher employment levels modestly. He says:

"The point is not that widespread conversion to profit sharing would instantly result in full employment by itself, thereafter rendering macro-economic policy unnecessary. That kind of polarised way of posing the issue is a red herring. To help create a tight labour market and improve employment-inflation trade off so that macro economic policy can be used more effectively, it suffices that during downswings a few less workers than under a wage system are laid off and during upswings a few more workers than under a wage system are hired."

4. And in conclusions he says:

"The profit sharing variant of a capitalist firm is a viable, healthy organism that has passed the market test for survival with flying colours. If European-style economies were to encourage this species to take hold by granting significant tax concessions to profit-sharing income, it is difficult to see how any great harm could be done and easy to see how a lot of good might come of it."

5. The following are the main strands in the lecture which are not consistent with the Government's approach:

a. Professor Weitzman sometimes shows his Keynesian origins. For example he says:

"What then is causing the unemployment? There is only one answer. But, like a coin, the answer has two sides. Side 1 is that unemployment is caused by insufficient aggregate demand (relative to money wages). Side 2 is that unemployment is caused by too high money wages (relative to aggregate demand). Sometimes it is useful to stress one side of the coin; but sometimes the other. But it is always the same coin."

b. Although prefering profit sharing to a tax-based incomes policy he does not totally rule out the latter approach. He says:

"There are many possibilities here - including tax-based income policies, multi-tierred pay systems, employee ownership or control, profit sharing and several others. I am in favour of maintaining a positive, constructive attitude towards all measure that might improve the employment-inflation trade off. But in my opinion profit sharing is the most solidly based of the alternatives and, I believe, holds by far the most promise."

Later on he describes profit sharing as an already existing variant of capitalism and incomes policies as an artificially engineered creation. But he does not dam tax-based incomes policies as hard as we would like.

c. He advocates strong tax incentives to encourage profit sharing with tax relief:

"only being granted in situations where the union and employer explicitly agree to forswear any restrictiving hiring practices"

Professor Weitzman is fairly insistent about the need for a requirement that there by no collusive restrictions on new hiring.

d. He advocates the case for control on base pay.

"I believe that the introduction of a significant tax break for the profit-sharing component of a worker's income.....would go a long way towards improving the employment-inflation trade off in a fundamental way. But I am not so fanatical abeliever in the power of the market or of my own theories, that I would not take the extra precaution of writing into the tax legislation the additional condition that in order for the tax advantages of profit sharing income to be obtained, workers must agree to a base wage no higher than that of some arbitrary previous date, say July 7 1986 for example. Perhaps this extra stipulation is not needed, especially once the programme is kept going. But why take chances? It could always be removed later.

e. He is surprisingly unenthusiastic about share schemes. He refers to a "spate of tax gimmicks" encouraging employees to pay workers stock in lieu of wages. He argues:

"Whatever the possible political and social merits or drawbacks of a world of worker capitalists, it is difficult to find a hard economic rationale in favour of worker capitalism as opposed to ordinary capitalism. When workers are paid so many pounds worth of stock in lieu of wages, why does that encourage the company to hire the unemployed or to keep down prices?.....Perhaps the fact that workers "own" a part of the company helps to moderate wage demands or motivates harder work, although the empirical evidence is mixed at best."

6. It is likely when the consultative document comes out that some commentators will draw a distinction on these points between the approach of Professor Weitzman and that of the Government. Our lines of reply are fairly clear: on,

a. Welcome Professor Weitzman's emphasis on profit sharing irrespective of whether he is described as Keynesian or a monetarist,

b. endorse Professor Weitzman's criticisms of a tax based incomes policy when compared to profit sharing;

c. it would be a matter for employers to decide whether they wanted agreement on specific points from employees before applying for approval to a profit sharing scheme;

d. it will be for employers to decide in a responsible way about base pay: not persuaded that conditions about not increasing in base pay would be workable;

e. share schemes have been valuable but profit related pay would provide a new and valuable additional dimension.

7. You thought that you might attach this minute to your submission to the Chancellor this evening. Perhaps copy recipients could let us know if they think that my summary is off beam.

PAS

P A SHAW

The Case for Profit-Sharing

I come from a state in the U.S. -- Massachusetts -- where the unemployment rate has averaged 4% over the last couple of years, and from a metropolitan area -- Boston -- where the unemployment rate has been even lower. Furthermore, this is a region of the country which not such a very long time past bore roughly the same relation to the rest of the United States as northern England does to southern England today. Fifteen years ago Massachusetts was a place with one of the worst unemployment rates in the U.S., with empty textile or shoe factories and run-down blighted areas all over the landscape. How the economic turnaround occurred is a story that must be saved for another time. The point I wish to make here is this. Massachusetts today bears witness to the fact that there is no reason in principle that unemployment rates of 4% or less are unattainable.

When I buy computer equipment, or go out to eat in a restaurant, or carry on any other economic transaction, I am not aware that the service is slower or the product inferior than in other places or other times with much higher unemployment. The system seems to be working well even though unemployment is 4%. The only thing in short supply is labor. Some companies actually offer to bus in workers from outlying regions or inner city locations. Employees in many firms get a bonus if they can deliver up an acceptable new co-worker.

Why can't this regional story be repeated on a national level? Why can't the U.S. as a whole have such a tight labor market? And, more to the point here, why can't Great Britain get down to such low unemployment levels, to the levels you took for granted two decades ago?

Because of the two-headed monster -- stagflation. Illusions of being able to fine tune aside, we know how to get unemployment down and output up by the usual expansionary monetary and fiscal measures. We also know how to break inflation by policy-induced recessions. What we do <u>not</u> know -- and this is the central economic dilemma of our time -- is how <u>simultaneously</u> to reconcile reasonably full employment with reasonable price stability. Expansionary policies dissipate themselves, to an excessive degree, in too-large wage and price increases rather than expanded employment and output.

Why this has occurred in general, more so in European economies than in America or Japan, and with particular vengeance in Britain, is a subject of some dispute. Here I can only deal somewhat casually with the two main contending explanations.

One school of thought blames the adverse economic situation on a high "natural rate of unemployment". A standard explanation at one time relied on "demographic factors", but they have mostly been going the other way lately. A different story emphasizes the "revenge of the welfare state". A theory now popular contends that long-term unemployment is largely inertial or hysteresis-like -- once unemployment continues long enough, no matter how it started, it almost gets built into the system, perhaps because the long term unemployed outsiders do not or cannot act effectively as a disciplining force in wage setting, perhaps because of the rise of an "unemployment culture", perhaps due to other factors. Anyway, for whatever reasons, the "non-accelerating-inflation-rate-of-unemployment" or NAIRU has apparently deteriorated. That this has actually occurred is undeniable, both from common-sense observations and from the formal statistical approaches which, in effect, practically make the NAIRU a weighted average of past unemployment rates. In practice the high NAIRU explanation almost amounts to a tautology. It almost amounts to saying that the unemployment rate is high because the unemployment rate is high. I think the more honest practitioners of this approach admit they are close to a tautology in terms of actual explanatory power.

Another approach is the au courant explanation that European-style unemployment is of the classical rather than Keynesian variety, caused by "too high" <u>real</u> wages. A problem with this line of argument is that real wages no more "cause" employment levels than the other way around. Both are simultaneously determined within the economic system. Given money wages and aggregate demand, companies <u>choose</u> employment levels and prices. Hence, the aggregate <u>real</u> wage (money wage divided by the price level) is no less determined by the decisions of firms than is employment. The germ of truth this approach is trying to capture, I think, by artificially compressing an inherently dynamic story into a static framework, is that the too-high real wage <u>aspirations</u> of workers, coupled with too-great insider power in wage setting and a too-compliant tendency of employers to give in, ultimately causes a form of unemployment that cannot be reduced by ordinary macroeconomic policies. But I am not sure the workers ever actually <u>attain</u> the higher real wages they aspire to attain because the effect of higher money wages is mostly to push up the prices of goods workers buy. Somewhat ironically, real wages would probably end up higher in the kind of full employment boom-economy that is attainable in practice only when there is greater money wage restraint.

What, then, is causing the unemployment? There is only one answer. But, like a coin, the answer has two sides. Side one is that unemployment is caused by insufficient aggregate demand (relative to money wages). Side two is that unemployment is caused by too-high money wages (relative to aggregate demand). Sometimes it is useful to stress one side of the coin; sometimes the other. But it is always the same coin.

In either case, the key to non-inflationary full employment is an economic expansion that holds down the marginal cost to the firm of acquiring more labor. Pure macroeconomic policy alone -- the purposeful manipulation of financial aggregates -- is no longer sufficient to guarantee full employment without inflation because labor costs begin to rise well before the economy starts to strain at full capacity.

At this point the honest Keynesian puts in the awkward if obligatory footnote about the need for some form of incomes policy. But this phrase is usually added rather mechanically, as an afterthought, with little enthusiasm or follow up. I think it may be time to reverse the emphasis. In countries like Britain and France (or, for that matter, Argentina and Israel) today the main operational issue is how to introduce greater wage restraint and "flexibility" into the labor market, especially as it starts to become tight. Compared with this issue the nuances of how best to reflate the economy are relatively straightforward. Although the dilemma being described is currently seen most starkly in some European economies, the same basic issues are involved almost everywhere. Things have reached a point where a surprising number of macroeconomists of Keynesian or classical persuasion have essentially abandoned the hope that traditional macroeconomic policies can do a great deal to promote prosperity. I would argue, as a general proposition, that implementable structural changes in the labor market should be a relatively more pressing concern than the demand management policies currently occupying the attention of most macroeconomists.

There should be more focus on the labor market itself, on measures to build in automatic flexibility and to reform out structural rigidities --

not so much to replace traditional macroeconomic policies as to enable them better to deliver non-inflationary full employment. Such measures must be applied uniformly throughout society, not just loaded on blue-collar workers. What is required is bold institutional change in incentive structures to make it in employers' strong self-interest automatically to maintain high levels of output and to keep prices low. There are many possibilities here -- including tax-based incomes policies, multi-tiered pay systems, employee ownership or control, profit sharing, and several others. I am in favor of maintaining a positive, constructive attitude toward all measures that might improve the employment-inflation tradeoff. But in my opinion profit sharing is the most solidly based of the alternatives and, I believe, holds by far the most promise.

Profit sharing is not an exotic innovation, untried and unknown. The largest private employer in the world, General Motors, currently shares profits with its employees under an agreement with one of the largest unions in the world, the United Automobile Workers. That agreement was explicitly hammered out at the Ford and G.M. bargaining tables in the fall 1984 negotiations in order to insure that more previously laid off automobile workers could be put back on the payroll and that fewer automobile workers would lose their jobs in the future if there were an economic downturn in the U.S. automobile industry. The record shows that both sides -- union and management -- understood quite clearly the tradeoff between increased profit sharing and increased jobs. (Incidentally, lady luck smiled on this endeavor because profits have been higher than expected and each worker is several thousand dollars richer than if a strict wage settlement had been negotiated.)

About 15% of American firms, including some of the most advanced, practice some form of profit sharing. U.S. profit sharing firms include, in addition to General Motors and Ford, such big name companies as Texas Instruments, Hewlett Packard, Sears Roebuck, Proctor and Gamble, Eastman Kodak, Xerox, Levi Strauss, Polaroid, BankAmerica, Chase Manhatten, Johnson's Wax, Kellogg, Standard Oil of California, Prentice Hall, Digital Equipment, and many, many others. Almost the entire Japanese economy, it can be argued, is in essence a profit-sharing system. Fully one fourth of an average Japanese worker's pay is in the form of a twice yearly bonus with strong profit-sharing overtones. Virtually any Japanese firm you have ever heard of is essentially a profit-sharing company. Korea and Taiwan operate with similar nation-wide profit-sharing systems, although the bonus is a somewhat lower fraction of total pay, closer to 15% on average. In Europe there is much less profit sharing than in the U.S., and a fortiori less than in Japan.

I will turn presently to the important issue of whether or not, or to what extent, such examples can be used to "prove" that profit sharing leads to better economic performance and particularly to higher and more stable employment levels. As you might guess, this issue is difficult to resolve decisively without the ability to perform controlled experiments, although I think it is possible to build a reasonable case on circumstantial evidence that profit sharing has lots of good effects, microeconomic and macroeconomic. For my purposes now, I want to state two strong, essentially indisputable propositions that follow from the record.

The record shows that the profit-sharing firm is an indigenous species in Japan, Korea, Taiwan, and, to a lesser proportion, in the United States. Furthermore, at the very minimum, these economies do not appear to be suffering because of profit sharing, nor do the profit-sharing firms or their workers seem to be doing poorly -- if anything it is the other way around. I do not think such observations are trivial or irrelevant. To see why, contrast profit sharing with some other proposals to improve labor market performance. For example, labor cooperatives or labor-capital partnerships (whether of the "equalitarian" or "discriminating" varieties), or various incomes policies (whether wage-price controls or tax-based incomes policies) in my opinion represent more radical and far-fetched mutations of a market economy that are basically just not out there making it on their own. With respect to improving the performance of European-style economies via profit sharing, the issue is, through moral persuasion and financial incentives, to move towards an already existing variant of capitalism -- not towards some artificially engineered creation. I think that is an important, if not decisive, distinction.

The case for widespread profit sharing is like the case for free trade. It is not true that free trade benefits every individual. It is not even true, in a realistic world of increasing returns to scale and imperfect competition, that free trade must benefit the community as a whole. Yet, when all is said and done, when the possible costs and benefits of alternative trade policies have been calculated, weighted by the relevant probabilities, and added up, most economists agree that free trade is the best policy. The argument for profit sharing is of this same form. It is possible to dream up unlikely counterexamples and to interpret the existing evidence perversely. But the bulk of economic theory, empirical evidence, and common sense argue that widespread profit sharing will help to improve macroeconomic performance. The bottom line is that it is easy to envision situations where profit sharing helps economic performance while it is difficult to imagine scenarios where profit sharing damages an economy, which is as much as can be claimed for any economic idea.

It is no mystery why profit sharing makes the employer view things fundamentally differently. In a profit-sharing system the young school graduate looking for work comes with an implicit message to the employer saying: "Hire me. I am reasonable. Your only absolute commitment is to pay me the base wage. That is my marginal cost to you. The profit-sharing bonus is like a variable cost, depending to some extent on how well the company is doing. So you have a built-in cushion or shock absorber if something should go wrong." By contrast, the young British school leaver looking for work in a wage system now comes to a potential employer with the implicit message: "Think very carefully before you hire me. I am expensive and inflexible. You will have to pay me a fixed wage independent of whether your company is doing well or poorly, and you will not easily be able to lay me off if your business goes badly." Is it difficult to deduce in which situation companies might be expected to more eagerly recruit new hires and in which situation new hiring commitments are likely to be avoided when at all possible? The essence of the case for profit sharing is the basic idea that on the margin the profit sharing firm is more willing than the wage firm to hire new workers during good times and to lay off fewer workers during bad times.

So far I have outlined, in general form, the basic argument why, for a given level of aggregate demand and worker remuneration, profit sharing tends to result in higher levels of employment and output with lower prices. The essential message is that widespread profit sharing, operating within a sympathetic social and political climate (which, for Britain, unquestionably means some basic changes in attitudes), can serve as the operational centerpiece of a broadly based program that, in conjunction with traditional macroeconomic policies, has a good chance of significantly reducing unemployment without increasing inflation. This message survives critical scrutiny. Furthermore, any realistic economic recovery program for Britain is going to have to confront the same basic issues and problems that the profit sharing approach does, and I doubt there is a program that can do it as well or command the broad support it can.

I will not dwell further on this basic line of argument, in part because some of you are already familiar with it and in part because I want to move on to other matters. The technical aspects of modeling a profit-sharing economy have been treated in the academic literature. The formal mathematical models seem to bear out the contention that a profit-sharing economy tends to deliver superior macroeconomic performance compared to a wage economy. I would like now to deal with some of the major objections that have been raised against profit sharing. The most effective format, I believe, is to answer the important questions the way they are typically posed by astute critics.

<u>Question: A system that shares profits is analogous to the notorious sharecropping system in agriculture. As was pointed out by many of the classical economists, such a system reduces the incentives to invest because the capitalist must share some part of increased profits with the workers. Wouldn't profit sharing cause underinvestment, too little capital, and too low labor productivity?</u>

Answer: The classical economists were wrong about this point, or at least incomplete. The issue is now well understood in the modern sharecropping literature. The critics had in mind a situation where pay parameters were more or less permanently frozen. In that case profit sharing would, indeed, cause underinvestment for the well-publicized reason that any incremental profits would have to be shared with labor. But over the longer time horizon relevant to decisions about durable capital investments, where either base wages or profit-sharing coefficients (or both) respond to the invisible hand of the market and the visible hand of collective bargaining, both wage and profit-sharing systems stimulate equal efforts toward output-increasing improvements -- to the point where the marginal value of capital equals the interest rate. Even if this theoretical isomorphism between investment in wage and profit-sharing systems did not exist, the cost of capital is only one side of the picture, and probably the less important side. The more dominant consideration is the demand side. If profit sharing results in a macroeconomic environment where output is being stabilized at or near the full-employment, full-capacity level, while a wage economy results in erratic, fluctuation-prone output and capacity utilization levels, there is bound to be more investment in a profit-sharing economy. And, as if these two arguments were not enough, interest rates, investment tax credits, and the like could be used to influence investment decisions in any system. The really important distinction concerns the average level of unemployed resources.

<u>Question: A key part of the mechanism causing a profit-sharing firm to want to expand employment is that the marginal value of labor under such a system exceeds the marginal cost of labor. But this occurs because, in effect, the additional hired worker dilutes the profits per worker which the previously hired workers receive. Wouldn't this cause resentment by the already existing labor force against newly hired workers and, in extreme cases, lead to restrictions against new hires?</u>

Answer: First of all, it is important to keep things in perspective by realizing that even a worst-case scenario where profit sharing "merely" dampens economic downturns by encouraging employers to lay off fewer workers during recessions still represents an economic benefit of potentially enormous magnitude. If profit sharing did nothing more than reduce downside risks to an economy, it would still be tremendously important. And when it comes to internal labor relations, let us not forget that the wage system is hardly a bed of roses. Younger, untenured workers are pitted against older high-seniority workers in the jobs vs. wages decision. Featherbedding is widespread. Workers resist the introduction of new labor-saving technology and, more generally, take relatively little interest in the fortunes of the firm because they do not have any direct stake in its profitability. Worker alienation is widespread in an environment where the employer is essentially indifferent on the margin to whether the worker stays or goes.

Any system where a substantial number of the major firms are operating with the marginal cost of labor lower than the marginal value of labor will have an inherent predilection toward providing more employment and expanding output. This tendency may take a long time to be fully realized, it may be frustrated by aggressive unions (where they exist) or voluntarily slowed by the employers themselves. But if the incremental, hardly-noticed decision at the margin has more of a bias than before to lean toward letting go of fewer workers during bad times and taking on more of them during good times, then gradually, perhaps imperceptibly, the system will ratchet itself toward an ever-tighter labor market. The point is not that widespread conversion to profit sharing would instantly result in full employment by itself, thereafter rendering macroeconomic policy unnecessary. That kind of polarized way of posing the issue is a red herring. To help create a tight labor market and improve the employment-inflation tradeoff so that macroeconomic policy can be used more effectively, it suffices that during downswings a few less workers than under a wage system are laid off and during upswings a few more workers than under a wage system are hired. Why is the employers' incentive to maintain or even slowly increase employment in a system of widespread profit sharing likely to prevail over the insider workers' possible incentive to resist new hires?

First of all, in the situation where an entire economy of profit-sharing firms is geared up and functioning smoothly at full employment, there is a significant excess demand for labor as a whole and there are no long-term jobless people to be picked up easily. In that case, the image of hordes of labor out there about to be so rapidly brought on board profit-sharing firms that they will cause significantly noticable depreciation of per capita profitability, in the short period between labor contract negotiations, is ridiculous. New workers cannot be gotten except from other firms reluctant to part with them. The tenuous aftermath of hiring a few more workers in one profit-sharing firm will scarcely be noticed, disguised as it must be behind a myriad of more important economic changes that much more directly influence short term profitability per worker. In a profit-sharing system, effort spent to enhance productivity and profits has a much higher payoff for the already-employed workers of a profit-sharing firm than effort spent on restricting new hires.

The more relevant issue than what happens when there already is full employment concerns getting there from a situation of less than full employment. For this purpose I advocate strong tax incentives making it in workers' strong self-interest to want to take some significant fraction of their pay in the form of profit sharing with no restrictions on new hires.

I would also hold out the hope of a simultaneous gradual macroeconomic expansion as a quid pro quo for the widespread adoption of profit sharing with no hiring constraints. I have calculated that even under very extreme assumptions a substantial tax reduction for profit-sharing income would break even and pay for itself as a tax reform if it reduced the unemployment rate by just a couple of percentage points. That may sound a bit too much like "supply side economics", but the fact is that unemployment is expensive, as well as immoral, so that virtually any measure which significantly reduced unemployment would yield enormous savings to society. Those who argue that Britain has never had it so good for the 87 percent with work are at best uttering a half-truth. The other half of the truth is that everyone could gain significantly, including the 87% with jobs, if the far-too-high unemployment rate could be reduced. This is because the 13% without work pay essentially no taxes, yet they must be fed, they must be clothed, they must be housed, they must be kept warm in the winter, their children must go to school, and they must receive health benefits. These are paid for by real transfers of income from the 87% of those who are working to support the 13% who are not.

The tax benefits for sharing profits should only be granted in situations where the union and employer explicitly agree to forswear any restrictive hiring practices. No trade union is compelled to petition for the special tax status of a share plan. But if it chooses to participate, a union cannot enjoy the considerable tax benefits without reaffirming an already existing legal commitment to open its ranks to as many qualified members and apprentices as the company wishes to hire under the agreed-upon share contract. The normal expectation is that profit-sharing firms will wish to expand employment somewhat when there are unemployed workers available to be hired. If a trade union or an employer finds repugnant the idea of hiring unemployed workers, they shouldn't sign up for the plan. "No collusive restrictions on new hiring" is a logical requirement for the government to insist upon, since the basic reason the differential tax treatment is being granted in the first place is to encourage increased employment. I do not think such a plan can be fairly characterized as anti-labor. Instead, it works within the existing framework, asking only that trade unions play their fair role in helping to get unemployed workers on board the company and producing output so these much-too-high unemployment rates can be reduced to almost everyone's advantage.

It is best to be under no illusions about the political realities involved in making an economy-wide transition to a system based on profit sharing principles. Any change hurts some people, and they will shout loudest to preserve the status quo even though, as with free trade, a share system is highly beneficial to the population as a whole. When all is said and done, no matter how well designed are the incentives, such change will require genuine consensus, a general agreement cutting across left-right political lines, that the broad social gains of full employment without inflation are worth more than the narrow private losses which inevitably will be incurred here and there. If you in Britain want to reduce unemployment, an obvious prerequisite is that you are going to have to create a climate where it is socially acceptable, even advantageous, to hire unemployed workers. This issue is going to have to be faced honestly by any employment promoting scheme, not just profit sharing.

I believe that pure self interest based on strong tax incentives in favor of profit-sharing income will go a long way toward convincing unions and others to look favorably upon a system which holds out the promise that aggregate output will be produced, and consumed, at the full-employment level even if it erodes some part of the monopoly rent above competitive pay which they currently enjoy. If the tax incentives are strong enough, a unionized firm will not only be enticed to join the share economy, but in a sense will be driven to enroll. It will be compelled because, if many other firms adopt share plans and if the pecuniary advantages in the form of tax savings are significant enough (larger than the union premium), a union will be unable to compete for members without following course. And the potential tax benefits could be made extremely attractive without doing fiscal harm to the federal budget since the increases in government revenues and decreases in outlays obtained from even moderate expansion of employment are so enormous. No trade union would be compelled to petition for the special tax status of a share plan. But, to repeat the point yet one more time, when it chooses to participate a union cannot enjoy the tax benefits without forswearing restrictive hiring practices.

In summary, then, it must be admitted that widespread profit sharing will probably alter the nature of industrial relations. There is no question but that workers sharing profits with management represents a different way from the wage system of doing business in the labor market. It could even be argued that share bargaining is likely to prove healthy and invigorating for labor unions -- calling for new expertise and an expanded role in working with firms to increase profitability. The relevant theory shows that if the firm retains control of the employment decision, other things being equal a profit-sharing system results in greater output, higher employment, and lower prices. The trick is to make the transition to profit-sharing while preserving the employer's traditional right to decide, ultimately, the employment level, at the same time allowing workers to bargain over base wages and profit-sharing coefficients. I do not think this trick is that all difficult to accomplish because, in contrast to other reform proposals, it builds on some already existing natural tendencies. Throughout the world, profit sharing is not an exotic innovation or an externally-imposed artifice, but an already existing reality for many tens of millions of workers. Since widespread conversion to profit sharing will undoubtedly require government incentives anyway, the issue then reduces to reinforcing with such incentives, or at least not undermining, management's traditional right to hire and fire as they see fit.

<u>Question: What is the proper role of trade unions in a profit-sharing system? If labor is treated like more of a residual claimant, wouldn't workers demand more of a say in how the firm is run?</u>

Answer: First of all, labor as a whole is no more of a residual claimant under profit-sharing than under a wage system. In both cases, total labor income is variable. In a wage system, the employment level changes to absorb shocks, while in a share system it is more the nominal level of pay that adjusts. In one case the outsiders and fringe workers absorb all of the change, in the other it is spread among the insider workers.

The right of labor to organize and bargain collectively is not a natural right like life, liberty, and the pursuit of happiness. It is a special monopoly privilege granted by the state to increase the general welfare. A framework of laws and traditions has grown up over the years, which demarcates, to a tolerably usable approximation, what is the proper or traditional scope of collective bargaining agreements as opposed to the proper or traditional domain of management's right to unilaterally control certain other decisions. Under U.S. law, for example, unions simply do not have the right to bargain explicitly about the employment level. In technical parlance, employment is not a mandatory subject to bargaining. If management does not want to bargain about employment levels, the unions have no legal recourse. Mandatory subjects to bargaining include payment formulas, grievance procedures, rules about layoffs and recalls, safety and working conditions, and so forth. Generally speaking, the union has a say about pay formulas and working conditions, but no say about how the business is otherwise conducted, including the employment decision.

I would propose that this traditional demarcation of labor-management roles be preserved under a profit-sharing system, as it already is in most unionized profit-sharing firms of the U.S. or Japan. Typically it has been found that profit-sharing workers naturally take a greater interest in the profitability of the firm than do wage workers. But that does not necessarily mean that it is efficient for workers to serve on boards of directors or to be formally involved in decisions about new product lines, marketing strategies, and so forth. On the other hand maybe it's not such a bad idea for workers to get involved under certain circumstances. I do not think that hard and fast rules must be applied here. There are lots of cases where increased worker participation with the aim of raising company profits can be a good thing for both the workers and the company. The only absolute commandment is: "thou shalt not restrict thy unemployed brothers and sisters from taking a job". In other words, co-determination is not a code word for collusive restriction of new hires.

One natural and legitimate concern of a profit-sharing union will be the proper definition and verification of profits to be used in the pay formula. This should be spelled out in some detail in the pay agreement, and the union will want some means of verifiability. There is, for example, the issue of what measure of profitability is desired, and whether it should be based on company-wide figures or on the operations of a more narrowly defined profit center. In any case the profits should be accountable. A new and potentially constructive role for labor unions is thus created by a profit sharing pay system. Under a wage contract any fool can determine whether he is being paid the specified amount. But under profit-sharing agreements, the average worker may need or want an advocate to make sure the contract is properly written, correctly specified, and fairly enforced.

<u>Question: Under a wage system the firm bears all the risk, while under a profit-sharing system the worker bears some risk. Doesn't profit sharing</u>

therefore represent a socially inefficient form of risk bearing, since the stockholder can naturally diversify risks more easily than the worker?

Answer: As this point is usually further developed, there is a good reason why capital should bear more risk than labor. Capital can be diversified in any portfolio, whereas labor tends to have but one job at a time. Therefore, the argument goes, it is better if the variable component of business income would accrue largely to capital, while the worker is paid a fixed wage. Right? Wrong!

This argument, so widely parroted and seemingly so plausible, is in fact deeply fallacious. A fallacy of composition is involved. What is a correct statement for the individual high-seniority worker who already has job tenure is patently false for the aggregate of all would-be workers. The problem of unemployment is in fact the largest income risk that labor as a whole, as opposed to the median tenured worker, faces, and it is concentrated entirely on the marginal or outsider worker. If more variable pay for the individual helps to preserve full employment for the group, while fixed pay for the individual tends to contribute to unemployment, it is not the least bit clear why overall welfare is improved by having the median worker paid a fixed wage. Actually, the correct presumption runs the other way around.

What is true for the individual tenured worker is not true for labor as a whole. When a more complete analysis is performed, which considers the situation not as seen by a tenured, high-seniority worker who already has job security, but by a neutral observer representing the entire population, it becomes abundantly clear that the welfare advantages of a profit-sharing system (which tends to deliver full employment) are enormously greater than a wage system (which permits unemployment). The basic reason is not difficult to understand. A wage system allows huge first-order losses of output and welfare to open up when a significant slice of the national income pie evaporates with unemployment. A profit-sharing system stabilizes aggregate output at the full employment level, creating the biggest possible national income pie, while permitting only small second-order losses to arise because some crumbs have been randomly redistributed from a worker in one firm to a worker in another. It is extremely difficult to cook up an empirical real-world scenario, with reasonable numbers and specifications, where a profit-sharing system with a moderate amount of profit sharing (say

20% of a worker's total pay) does not deliver significantly greater social welfare than a wage system.

As if this argument alone were not enough, it would be a mistake to extrapolate the demand variability now observed in the firms of a wage economy to a share economy. Such cyclical industries as machine tools, metals, building materials, construction, and the like would not fluctuate nearly so much, since the share economy is operating at or near full capacity. Every firm of a profit-sharing system would presumably exhibit significantly greater demand stability than we are now accustomed to because a budding recession cannot feed upon itself in a fully employed economy.

Any economy is full of uncertainty. There are no absolute guarantees, and if the uncertainty does not come out in one place, it will show up in another. I am saying that it is much better, much healthier, if everyone shares just a little bit of that uncertainty right at the beginning rather than letting it all fall on an unfortunate minority of unemployed workers who are drafted to serve as unpaid soldiers in the war against inflation. It is much better if people will agree that only 80% of their pay is going to be tied directly to the funny looking pieces of paper currency -- which are themselves an illusion, although a very useful illusion -- and 20% will be tied to company profits per employee. Then the economy can be much more easily controlled to have full employment <u>and</u> stable prices. Society will be producing, and hence consuming, at its full potential. If people will face up to the uncertainty right at the beginning, and if everyone accepts some small part of it, than society as a whole will end up with higher income and less uncertainty overall.

The crucial thing to decide is whether or not profit sharing would significantly reduce unemployment. The traditional "insurance" argument in favor of a wage system is fallacious, being based on a partial equilibrium view which does not take into account the radically different macroeconomic consequences of the two systems for overall employment and aggregate output.

<u>Question: Does widespread profit sharing replace traditional macroeconomic policy?</u>

Answer: Probably not. Probably the more realistic way to think of profit sharing is as a way of making macroeconomic policies work more effectively in the sense of improving the underlying employment-inflation tradeoff. With some tendency to automatically hold the economy at or near full employment, profit-sharing perhaps imparts somewhat more of a monetarist or classical flavor to economic policy, as opposed to a wage economy with its more closely associated Keynesian overtones.

But it must be said that we really don't know for sure. The most optimistic imaginable scenario would be that a significant dose of profit sharing in an economy with strong free-market forces would almost make redundant the need for macroeconomic policy to stabilize the employment level, liberating it to perform other important functions. The most pessimistic scenario I can think of would improve macroeconomic performance only marginally, making a perhaps somewhat better, but not qualitatively different employment picture. The truth is probably somewhere in between. It is very difficult for me to imagine any realistic circumstances under which profit sharing could actually worsen the employment-inflation tradeoff.

<u>Question: What guarantee is there that a profit sharing system will work the way you say it should? How can we be sure that tax breaks for profit sharing income will not just dissipate themselves in increased pay for insider workers rather than new hiring of unemployed outsiders?</u>

Answer: In a free market wage economy, the basic mechanism keeping wages from exploding toward infinity is the natural resistance of the employer to paying more than he wants to, backed, ultimately, by some of the checks and balances of competition throughout the system. British labor does not now have the power to unilaterally dictate whatever wage level they wish, irrespective of labor market conditions and product market conditions. I do not see why labor's bargaining power should suddenly increase under a profit sharing system. The relevant theory shows that at the same labor payment level a profit sharing system will have less unemployment than a wage system. The basic determinant of employment, aside from aggregate demand, is the base wage, not the profit share. In order to believe that increased profit sharing would have no effect on employment one has to be prepared to believe that its introduction would be accompanied by an exactly offsetting increase in labor's bargaining power to secure just as high a base wage as under a wage system and, additionally, some share of profits to boot.

I believe that the introduction of a significant tax break for the profit-sharing component of a worker's income, under the conditions of free hiring of new workers I have previously described, would go a long way toward improving the employment-inflation tradeoff in a fundamental way. But I am not so fanatical a believer in the power of the market, or of my own theories, that I would not take the extra precaution of writing into the tax legislation the additional condition that in order for the tax advantages of profit sharing income to be obtained, workers must agree to a base wage no higher than that of some arbitrary previous date, say July 7, 1986 for example. Perhaps this extra stipulation is not needed, especially once the program gets going. But why take chances? It could always be removed later.

Question: In your scenario profit sharing increases employment by making it in the self interest of the firm to want to hire more workers during good times and lay off fewer workers during bad times. Couldn't the same end be accomplished more directly by giving firms an employment subsidy of some sort?

Answer: An employment subsidy amounts to a reduction in the payroll tax, on the margin. There is little doubt that such a measure would expand output and employment in the short run, just as would other Keynesian stimulative policies. An employment subsidy has the additional advantage of operating more directly on employment and output while putting less upward pressure on prices. But after the employment subsidy has been set in place, and the economy has adjusted to a new equilibrium, it will be just as vulnerable as before to contractionary shocks. An employment subsidy does not eliminate the fundamental problem that a sticky wage economy responds to insufficient aggregate demand or too-high wages by restricting output and employment.

Of course another employment subsidy could be added on to deal with the second contractionary shock, and so forth. But over time this would cumulatively increase the budget deficit, and inflation. An employment subsidy might be very worthwhile as a short term expansionary measure, essentially in the Keynesian tradition. But it does not eliminate the fundamental flaw of a wage economy.

Question: Your arguments about profit sharing having more favorable employment properties seem mostly to be based on short-run disequilibrium

<u>considerations, when pay parameters are quasi-fixed. But our unemployment problem in Britain is not so much a bad short run disequilibrium, but rather a too-high non-accelerating-inflation-rate-of-unemployment, or NAIRU. Would widespread profit sharing lower the NAIRU?</u>

Answer: Yes, it presumably would. Furthermore, the short-run and long-run unemployment problems are probably related.

In order to talk meaningfully about the effects of profit sharing on the NAIRU, one has first to have some idea about what is causing such a high NAIRU in the first place. There are several theories. Some are more persuasive than others, and they are not mutually exclusive.

A leading theory contends that long term unemployment is largely inertial or hysteresis-like. Whatever initial disequilibrium caused the increased unemployment in the first place, once unemployment continues long enough it almost gets built into the system, perhaps because the long term unemployed outsiders cannot or do not act effectively as a disciplining force in wage setting, perhaps because working skills atrophy without work, perhaps because the plight of the long-term unemployed gets forgotten by the electorate, perhaps for other reasons. In this view the rate of change of unemployment typically has a more powerful effect on wage settlements than the absolute level of unemployment.

If this kind of inertial effect lies behind the too-high NAIRU, then presumably widespread profit sharing would lower or eliminate it. The long term unemployment would have difficulty developing in the first place out of an initial contractionary shock because profit sharing firms are reluctant to let go of workers. Taking as given this kind of NAIRU, leaving aside how it got started in the past, the natural expansionary bias of a profit sharing system would act as a built-in counterforce to "gobble up" the unemployed. The "gobbling up" process could of course be speeded by traditional expansionary macroeconomic policies which, under profit sharing, pose less danger of causing prices to accelerate because the employment-inflation tradeoff has been improved. So any way you look at it, profit sharing should definitely help to diminish long term inertial unemployment.

Another theory of why the NAIRU is so high is that labor has too much bargaining power. Whether a switch from a wage system to profit sharing would lower this kind of NAIRU depends on what it is that labor and management bargain over. If they bargain over pay parameters, but management controls the employment decision, a switch to profit sharing would lower the NAIRU. If labor and management bargain over both pay parameters and employment levels, the NAIRU would be the same under either system. In between bargaining would yield in-between results, with the NAIRU then being somewhat lower under profit sharing than under a wage system.

A third class of theories, based on the so called "efficiency wage hypothesis", holds that long term unemployment is caused by companies themselves choosing to pay above market-clearing wages because otherwise workers would shirk too much on the job. Within this kind of model, which has limited, if any, relevance for understanding the rise of European unemployment, the "natural rate" would be the same under a wage or profit sharing system.

To the extent that too-high unemployment in European-style economies is aided by overly generous unemployment and welfare benefits, which creates some voluntary unemployment, presumably the labor payment mechanism per se makes little or no difference. So "the revenge of the welfare state" kind of unemployment would not be affected by a switch to profit sharing.

Finally, there is the long-standing identification of the "natural rate" with semi-permanent frictional or structural unemployment, due to continuously occuring microeconomic changes. This kind of unemployment, it is usually said, cannot be reduced by pure macroeconomic policies except temporarily and at the cost of increasing inflation. As with inertial unemployment, however, the wage system is heavily implicated in frictional or structural concepts of the NAIRU. After all, both wage and profit-sharing systems respond to shifts in relative demands by sending a signal that eventually transfers workers out of a losing firm or sector and over to a winner. With a wage system the signal to a worker that his firm is a loser in the game of capitalist roulette, and it is time to look for a new job with a winning firm, is the boot -- the worker is laid off and must suffer through an unemployment spell of some duration while searching for the new job. Under a profit-sharing system, the firm does not voluntarily let go of a worker because of weak demand. Instead it is the worker who chooses to leave because pay is too low relative to what is readily available elsewhere at successful firms eager to include new workers into their current profit-sharing payment plans.

Summing up, in none of the standard scenarios does a profit-sharing system cause a higher NAIRU than a wage system, and in most of the more reasonable descriptions a profit-sharing system generates a lower NAIRU than a wage system. In addition, of course, the profit sharing system has better disequilibrium properties when pay parameters are sticky in the neighborhood of the NAIRU unemployment rate.

From all of these theoretical exercises considered together it seems difficult not to draw the conclusion that a profit-sharing economy is more likely to have lower unemployment than a wage economy.

Question: If profit sharing represents such a great idea for operating a market economy, why don't we see more examples of it arising spontaneously?

Answer: First of all, there are some significant examples of profit sharing. In Japan, Korea, and Taiwan, it can be argued, steps have been taken in this direction. The performance of these economies hardly supports the view that widespread profit sharing is likely to prove harmful to economic health. In the U.S. economy, about 15% of firms have what they call profit-sharing plans. Although the issue has not been carefully studied in a rigorous way, it is clear that many of these profit-sharing firms are among the most progressive, advanced companies in the economy. As just one informal indication, in a well-known book called The 100 Best Companies to Work for in America, over half of the cited companies have profit sharing plans of some kind.

The reason profit sharing is not more widespread despite its benefits involves an externality or market failure of enormous magnitude. In choosing a particular contract form, the firm and its workers only calculate the effects on themselves. They take no account whatsoever of the possible effects on the rest of the economy. When a firm and its workers select a labor contract with a strong profit sharing component they are contributing to an atmosphere of full employment and brisk aggregate demand without inflation because the firm is then more willing to hire new "outsider" workers and to expand output by riding down its demand curve, lowering its price. But these macroeconomic advantages to the outsiders do not properly accrue to those insiders who make the decision. Like clean air, the benefits are spread throughout the community. The wage firm and its workers do not have the proper incentives to cease polluting the macroeconomic environment by converting to a share contract. The essence of the public-good aspect of the problem is that, in choosing between contract forms, the firm and its workers do not take into account the employment effects on the labor market as a whole and the consequent spending implications for aggregate demand. The macroeconomic externality of a tight labor market is helped by a share contract and hurt by a wage contract, but the difference is uncompensated. In such situations there can be no presumption that the economy is optimally organized and society-wide reform may be needed to nudge firms and workers towards increased profit sharing.

Question: You talk mostly about the favorable macroeconomic effects of profit sharing. Why don't you put equal stress on the good microeconomic properties, the effects on motivation and productivity, which is an aspect that many people identify with profit sharing?

Answer: The microeconomic aspect is also important. The two biggest economic tasks of our time are to resolve the unemployment-inflation dilemma and to increase productivity growth. It is just possible that a well-designed profit-sharing economy has a big advantage in both of these important areas.

The few formal studies that have been done tend to show that greater profit sharing in firms is positively related to increased productivity. One of the problems in interpreting this result is that it is not clear whether the profit sharing is causing the higher productivity or whether some hidden third factor, call it superior management, tends to cause the more progressive firms to have both profit sharing and high productivity.

Most economists would say that there are no grounds for subsidizing profit sharing on its possible productivity-enhancing merits because these are strictly internal to the firm. Firms do not need to be subsidized to take other productivity-enhancing measures, so why should they be especially subsidized for profit sharing? I mostly agree with this interpretation, but I am not entirely sure because in practice a labor payment mechanism may have large demonstration effects.

As for the employment stabilizing effects of profit sharing on the level of the individual firm, these have only just begun to be studied in a formal way. My distinct impression from talking with representatives from a fair number of profit sharing firms is that the built-in profit sharing shock absorber protects jobs during bad times and that both labor and management understand this feature quite well, to the point of regarding it as self-evident.

Question: Might not two-tier wage contracts help the unemployment problem? Are they not perhaps a better route to full employment than profit sharing?

Answer: While most pay systems are based, at least in theory, on the egalitarian principle of "equal pay for equal work", recently in the U.S. there have sprung up examples of inequalitarian two-tiered wage systems that explicitly pay new hires at a lower rate than previously hired workers were at first paid. Thus, a newly hired worker this year might be paid significantly lower than last year's new hire and be tracked onto a significantly lower pay ladder. Sometimes it is intended that such discrimination be "temporary" -- e.g., for five years, or until the company regains greater profitability, or whatever -- while in other instances the intended duration of the two different pay profiles is vague.

As a theoretical matter, could the two-tiered wage system we now see occasionally springing up in the U.S. serve as a kind of model approach to eliminating or greatly reducing unemployment on the macroeconomic level? Undoubtedly a more widespread use of two-tiered systems might somewhat reduce unemployment. (It would certainly be difficult to argue otherwise -- how could it possibly increase unemployment?)

One count against such approaches is their explicitly inequalitarian nature, which, with or without labor unions, could be viewed as unfair, repugnant, or inherently conflictual. As opposed to this view one must ask, as always, whether the alternative of greater unemployment is less unfair, less repugnant, or less inherently conflictual. Still, I think there is an very fundamental difficulty with inequalitarian pay scales and with blatant violations of "equal pay for equal work", at the same level of experience and job tenure, that are not so easy to wave away. I am not sure that creating a second-class citizenry within the same work organization will not lead to strong internal tensions, as it typically does in a wide variety of other contexts. Most two-tiered pay systems do not last long in practice. A job-creating two-tiered wage system in the U.S. public sector had to be abandoned because of the antagonisms it created. The concept that all hired workers should be treated symmetrically by their employer, even if there is not a flat age-earnings profile, is, to my mind, a very deeply rooted culture myth.

Suppose it were conceded, as I think it must be, that two-tiered wage systems are likely to reduce unemployment. It might legitimately still be wondered how far this effect is likely to go. The mainstream explanation of cyclical unemployment involves wage stickiness as a central ingredient. Why would not the second-tier wage also become sticky, even if not so sticky as the first-tier wage? The answer must depend greatly upon what one believes is behind the original first-tier wage stickiness. Whatever the ultimate explanation, it is difficult to envision circumstances that would make the second tier of wages singularly free of stickiness. So that while I am prepared to believe that more widespread adoption of two-tiered wage systems might help somewhat to reduce unemployment, it is difficult for me to think of this as a breakthrough solution concept because the disequilibrium response of the two-tier wage firm will still be to lay off workers during an unexpected downturn.

The two-tiered wage idea merits attention, and we should not hesitate to turn to it if other, in my opinion better, constructs are not put in place. A major problem is that whatever forces are causing first-tier wage stickiness are likely, although perhaps in somewhat attenuated strength, to cause second-tier wage stickiness. Of course one could go to three-tier wage systems, and so on, but the endeavor seems remarkably like trying to sneak through the back door a wage flexibility that simply will not pass through the front door. Far more desirable than the inequalitarian principle of unequal pay for equal work in the same workplace, I believe, would be a system that automatically preserves full employment even when sluggish pay parameters are frozen at the "wrong" levels.

<u>Question: What is the relation between profit sharing and various forms of "employee ownership", like ESOPs, worker cooperatives, labor-capital partnerships, and so forth?</u>

Answer: "Employee ownership" is a term encompassing a broad spectrum of proposals for labor market reform. On the one hand, for some the term connotes a quite radical reorganization of work relations -- really some form of socialism or anarcho-syndicalism following loosely in the utopian tradition of, say, Robert Owen. Others see employee ownership as a variation on the prevailing capitalist theme, where workers own more of their company's stock, and thereby exert more control over its decisions. As might be expected, the kinds of suggestions for improving capitalism being considered here are often heavily tainted with ideological overtones. Indeed, ideology, rather than strictly economic considerations, usually determines a typical proponent's attitude. At the one extreme, worker management represents to some a kind of idealized democratic socialism. At the other pole, those who strongly advocate employee stock ownership plans are frequently attached to some vision of peoples' capitalism. In between are often-fuzzy images of workers' councils helping to create a more humane and more productive world. In this kind of potentially charged environment, I should perhaps make my own position clear. I am primarily interested in whether or not a proposed reorganization increases employment without accelerating inflation. The bottom-line key operational question is whether or not, after a particular form of "employee ownership" is put into place, forces are set in motion that tend to increase, or at least to facilitate, the hiring of currently unemployed workers.

A common, typically implicit, article of faith among those advocating increased employee ownership is that by eliminating the sharp distinction between "us" who work for the company and "them" who own or direct the company, economic performance will be bettered. After all, if the workers own or control the firm, the distinction between wages and profits largely vanishes, or at least becomes blurred. Isn't it then reasonable to suppose that macroeconomic policies aimed at full employment in such an environment would be more effective because the push on wages, which bedevils current efforts to reconcile low unemployment with low inflation, would be greatly diminished? It is hard to have a problem of wage explosion, after all, when, at least in the extreme case, there are no wages.

A major problem with this line of reasoning is that it is not supported by the relevant theory. Actually, the standard model of a labor cooperative whose members share an "earned surplus" dividend (instead of a wage) has rather perverse employment properties. Turning traditional firms into worker cooperatives whose members control the employment decision is unlikely to result in new hires. There is little basis for believing that labor cooperatives will aggressively attempt to integrate unemployed workers into their system. The absorption of unemployed outsiders would come about presumably through the creation of new cooperatives, which is, in my opinion, likely to prove at least as unreliable a stimulus to new hires as wage cuts in the more conventional setting.

James Meade has proposed an imaginative variant of a labor-managed cooperative based on the "inequalitarian principle" that new hires are offered a different (presumably lower) number of shares than old hands. The proposal is somewhat of a hybrid between two-tiered (or multi-tiered) wage systems and worker cooperatives. The major problem I have with all multi-tiered payment systems (whether based on inequalitarian wages or inequalitarian dividends) is in wondering why the nth tier of an n-tiered system should be assumed to be a perfectly flexible subject of rational discourse when the heart of the macroeconomic problem, or so it seems to me, is the disequilibrium created when pay parameters (of whatever sort) are inflexible in the face of changed conditions. Virtually any system assuming perfect flexibility of pay parameters for the marginal worker will yield full employment. But is this a reasonable assumption? Perhaps it is. Perhaps society can be turned in this direction. But I think that a more promising line is not to abandon the egalitarian principle, and not to abandon the idea that the capitalist, when all is said and done, determines the employment level, but rather to motivate that same capitalist to hire more workers, expand output, and charge lower prices.

I must say I regard it as ironic that some critics have latched onto Professor Meade's proposal as a kind of shield from behind which they feel emboldened to sally forth and deplore profit sharing as being flawed "in practice". For the facts are, as I have not been shy to emphasize, that over 80 million workers throughout the world are employed by profit-sharing enterprises, including many of the biggest and most advanced state-of-the-art companies in the United States and Japan. Worker cooperatives, by comparison, are a small, transient species that do not have an impressive record of dealing with high tech, to put it generously. Professor Meade's discriminating labor-capital partnership, in particular, is nonexistent. I do think the practical-minded critics might look a little more closely at practice.

What about the more openly capitalistic variants of "employee ownership" -- like employee stock ownership plans, or ESOPs? Proponents of this approach typically adhere to the following philosophy. Capitalism, they believe, is basically a very fine system. But it is marred by a too-concentrated ownership of the means of production in too few hands. Corrective measures should be taken to spread capital around, so that the community becomes closer to a nation of capitalist-workers or worker-capitalists. Especially desirable would be a situation where the worker-capitalists essentially own the company they work for. Hence the motivation for a spate of tax gimmicks encouraging employees to pay workers stock in lieu of wages.

Whatever the possible political and social merits or drawbacks of a world of worker capitalists, it is difficult to find a hard economic rationale in favor of worker capitalism as opposed to ordinary capitalism. When workers are paid so many pounds' worth of stock in lieu of wages, why does that encourage the company to hire the unemployed or to keep down prices? It is true that certain well designed stock payment plans are actually more like profit sharing and do encourage additional employment on the margin. But the typical ESOP is not like this, although perhaps it could be made more like this, for example by automatically assigning the value of individual stock distributions in proportion to profits per worker. I would say the tax benefits should be granted only in these kinds of cases. In any event such considerations are not usually what the typical ESOP supporter has in mind. Perhaps the fact that workers "own" a part of the company helps to moderate wage demands or motivates harder work, although the empirical evidence is mixed at best.

The idea that part of a worker's pay is linked to the well being of the company seems like a good idea. What is typically lacking in such discussions when they are used vaguely to support ESOPs is any kind of hard economic theory that clearly identifies motives and behaviors under employee stock ownership that would result in improved macroeconomic performance. Perhaps such a connection can be made, but it is presently elusive, at least for me. In this sense there is a strong contrast with profit sharing, where a relatively much more tight economic theory can be used to argue that there might be favorable employment consequences.

Actually, my general instinct is that worker ownership, or even worker control, is basically not a good idea under most circumstances. It is hard to believe that the modern corporation (especially in an internationally competitive environment) can be effectively run by a committee of workers.

The relative scarcity of worker cooperatives, their inability to grow, their weak record in high-tech areas -- all seem to me to be indirect evidence of this thesis. While there are bound to be specific exceptions, I fear that a worker managed firm would generally have difficulty making the hard choices that need to be made quickly in a fast-moving environment where specific circumstances of time and place are important. Managers representing workers would also, I believe, have some difficulty keeping up the torrid pace of technological innovation upon which all economic growth and welfare is ultimately based. I think it is ultimately in the workers' own self interest (just as it is ultimately in the consumers' self interest) not to sit on committees that democratically vote for what is to be produced and how it is to be produced, but rather to be presented with so many viable alternative job opportunities in a tight labor market that the capitalist overseers simply have no choice but to provide high pay and good working conditions.

Question: Is Japan an example of a share economy? What lessons can be learned from the Japanese experience?

Answer: Japan has an unusual labor payment system, where about one fourth of an average worker's total compensation comes in the form of a twice-yearly bonus supplement added onto base wages. It has by now been pretty firmly established that the Japanese bonus system can be viewed as a form of profit sharing, even though only about 15% of Japanese firms explicitly link the bonus to profitability via a prescribed formula. What I mean by saying that Japanese bonuses can be viewed as a form of profit sharing is simply the statistical statement that the ratio of bonus payments to base wages varies positively with business condition indicators, including profitability per employee.

Japan has enjoyed the lowest average unemployment rate among the major industrialized capitalist economies over the last quarter century or so. This comparatively outstanding employment record survives corrections for discouraged workers, relatively flexible hours, definitional differences, and so forth. Does the existence of a profit-sharing component of pay help in any way to account for the comparatively low, stable unemployment rate in Japan?

This is an easy question to ask but a very hard one to answer. The whole Japanese system seems to be employment promoting, so it is not possible to isolate cleanly the pure role of the bonus system. I think it is a fair statement to say that it would be more difficult for Japanese firms to maintain the full employment commitment without the automatic cushion that the bonus system provides. The Japanese experience is suggestive or supportive of the proposition that a profit sharing system can be used to help promote full employment. But we cannot go much beyond such vague statements, at least at this stage.

....

Enough, finally, of my questions and answers. You may have questions of your own. Here is the bottom line. The profit-sharing variant of a capitalist firm is a viable, healthy organism that has passed the market test for survival with flying colors. If European-style economies were to encourage this species to take hold by granting significant tax concessions to profit-sharing income, it is difficult to see how any great harm could be done and easy to see how a lot of good might come of it.

MS.19

FROM: MRS R LOMAX

DATE: 2 July 1986

MR SEDGWICK

cc PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Peretz

Rachel
Note coming later today

GREENWELL'S BULLETIN

The Chancellor has seen Gordon Pepper's speech to the 1986 annual conference of the US Financial Analysts Federation in Chicago (The health of the US financial fabric from an international perspective). His eye was particularly caught by the passage at the top of page 3:

> "The net cost of borrowing to finance expenditure on goods and services is the real rate of interest which is at a record historical height. The net cost of borrowing to acquire financial assets, however, is at a record low....banking spreads have fallen dramatically......It is not surprising that the credit explosion has gone into financial assets and has not stimulated the world economy".

The Chancellor would be grateful for your comments on this explanation of why financial innovation has led to a sharp rise in both credit and broad money.

RACHEL LOMAX

FROM: P N SEDGWICK
DATE: 10 JULY 1986

CHANCELLOR ✓

Many thanks. V. interesting. Also for the X (although it goes further than this) how is the Bank's general detailed work getting on? What's the latest state of play? N.

cc Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Peretz
Mr Mowl
Mr S Davies
Mr Walsh
Mr Hannah
Ms Rowlatt
Mr Heath
Mr Walton

GREENWELL's BULLETIN : THE COST OF BORROWING FOR INVESTMENT IN FINANCIAL ASSETS

Mrs Lomax's minute to me of July 2 asked for my comments on Gordon Pepper's explanation of why financial innovation has led to a sharp rise in both credit and broad money. The relevant passage from Gordon Pepper's lecture is

> "The net cost of borrowing to finance expenditure on goods and services is the real rate of interest which is at a record historical height. The net cost of borrowing to acquire financial assets, however, is at a record low...banking spreads have fallen dramatically..... It is not surprising that the credit explosion has gone into financial assets and has not stimulated the world economy".

2. There are three separate propositions in the Pepper Lecture, namely that

(i) both broad money and bank credit have risen while real interest rates have been high and interest rate spreads have fallen:

(ii) there has been a good deal of (bank) borrowing for stock market speculation;

and (iii) the cost of investment in physical assets is higher than for investment in financial assets.

I shall deal with these in turn.

(i) <u>The effect of banking spreads on broad money and credit</u>

3. Gordon Pepper emphasises (in the final two paragraphs of page 2 of his lecture) the role of real interest rates as a cause of high growth of broad money (and rather oddly of M1) and emphasises falling spreads as the reason why high real interest rates have not choked off demand for credit. I cannot easily construct a coherent argument from his lecture as he delivered it, but it would be possible to develop one to provide an interpretation of the high growth of broad money and credit that has some elements in common with our own explanation. We have consistently argued that removal of the corset has enabled banks to increase the size of their balance sheets, with obvious implications for the supply of both broad money and bank credit. We have also emphasised shifts in effective demand for money and credit.

4. We have explained the simultaneous build up of holdings of <u>personal sector</u> credit and deposits with banks and building societies by the narrowing of the differential between the interest rate on financial assets and <u>the most readily available</u> forms of credit following the abolition of the corset. The big difference since the abolition of the corset has been the absence of any supply constraints on low cost credit for persons. The narrowing of the effective interest rate differential between personal sector deposits and credit is in some way analagous to Pepper's argument about (wholesale) spreads. For persons the cost of holding precautionary finance is very low. Indeed for most of the period since 1977 it has even been possible - if individuals have had access to mortgage finance - to make a small turn (see Chart I) without incurring a capital risk by borrowing (nominally) for house purchase or improvement and placing the proceeds in building society premium accounts, providing the mortgage loan attracts interest relief. Of course any benefit would have been

mitigated by the significant transactions costs incurred when taking out a mortgage and perhaps by uncertainties over the future movements in interest rates. Nevertheless in the absence of supply constraints on credit individuals have been more able (gradually) to build up their stocks of liquid assets and credit at a low cost towards desired levels in recent years - a process that could still have a long way to go.

5. If a fall in wholesale banking spreads has occurred there could have been a similar process for ICC's and OFI's who may have had greater inducements simultaneously to build up gross stocks of credit and financial assets. There is little readily available information of the right type on any narrowing of banking spreads in recent years. Over a longer period, going back to the late 1960s/early 1970s, the increase in the range of interest earning assets was probably important in narrowing the spread between the average rate earned on assets and the average rate paid on borrowing. Table 1 shows what information I have been able to gather together, mainly for recent years. None of it is quite what is needed to validate Pepper's assertion about falling spreads. There are figures on domestic spreads in the US, France, Germany and Japan and on spreads on international (dollar) loans. To the extent that Germany, France, and Japan have, until recently, avoided liberalisation and had highly controlled monetary systems the figures for these economies are not helpful in the present context. The general picture is nevertheless of spreads increasing to a peak in the 1981-83 period and declining since then. Of course, these are not necessarily spreads for lending with a constant perceived risk. It is significant, however, that spreads decreased on international loans even with lower-quality borrowers.

6. Table 2 reproduces some material, derived by the Bank from the accounts of the UK clearers*. This material shows average spreads and includes for instance the (fluctuating) effects of

*This particular table - from an internal Bank paper on spreads - is now in the public domain as the Governor attached it to a letter from him to Austin Mitchell.

endowment profits on non-interest bearing accounts. In the light of this unsatisfactory evidence my own view is that Pepper is probably correct in saying that there probably has been some narrowing of spreads on loans of given risk in recent years, but that we together with the Bank should make strenuous efforts to get better data to establish whether this proposition is true.

Yes, (about time)

7. If a narrowing of spreads has occurred it has probably been less the result of liberalisation and rather more the result of financial innovation (use of swaps allowing an increasing proportion of credit to be raised at minimum cost for example)) and technical change (the electronic linking of financial markets throughout the world that has contributed to fiercer competition worldwide). It is possible that in the less liberal environment before 1980 some less favoured sectors (ie not manufacturers or exporters) were unable to raise all the money they would have liked (or that banks would have liked to lend them) when the old lending guidance was more effective (it is still theoretically in force), and that as a result competition in money markets was less fierce and spreads higher. In spite of this my guess is that increased competition in money markets principally reflects factors largely outside the direct control of the authorities.

8. We do not have reliable estimates of the effect on desired holding of liquid assets and credit of, say, a large fall in spreads of, say, half a percentage point. I find it difficult to believe that even a large fall in banking spreads can have had a particularly big an effect on desired stocks. Any fall in spreads that has occurred may not have been as important as some other factors. In particular in the UK corporate treasurers are probably still being influenced by memories of the severe corporate liquidity crisis in 1974-75. At a comparatively modest cost (even before any decline in spreads in recent years) they have been able to keep large stocks of precautionary funds rolling over for use when necessary in a crisis. It may also be the case that, as argued above, for sectors other than manufacturing the

old lending guidance might have prevented companies borrowing as much as they would have liked for precautionary purposes in the late 1970's, and that these sectors have built up their stocks of debt somewhat since then.

(ii) Borrowing for stock market speculation

9. Gordon Pepper's article suggests that a good deal of borrowing is for stock market speculation. This is a completely different explanation to that on spreads in the previous section which assumes a build up of stocks of debt and precautionary liquid assets at a cost that is both small and often known. The cost of or return on credit financed stock market speculation is not known and may be difficult to predict.

10. More readily available credit for a variety of reasons may in the last few years have tempted some persons and ICC's together with a few OFI's to indulge in credit financed speculation on large capital gains in equities. Such speculation has not been as risky as in past periods of stock market strength, though it is very doubtful to what extent market operators perceived this until quite recently. The adoption of sound macro policies in the major economies has led to a major, and by no means wholly unexpected, improvement in profitability and the market value of companies. Furthermore with inflation low there is less risk now of the sharp switches in policy and falls in activity that characterised the 1960's and 1970's. On the other hand borrowing for such purposes could be risky if it continued. The real value of the stock market is now back to the average level of the pre-1973 period. It is less certain now than a year or so ago that it will rise further and stay there.

11. Unfortunately we do not know the scale of any borrowing for stock market speculation so far or whether the rate of such borrowing has begun to decline. Any propositions on this are pure conjecture. A few scraps of information are nevertheless interesting, though they could represent merely the tip of the iceberg. Facilities were made available by banks for employees of Thames Television, who would have rights to priority applications,

to finance their acquisitions of shares by bank overdraft. But they were required to sell the shares "shortly" after the offer to repay the loan - which was only a short term facility. There has been a suggestion that County Bank would do this for the BGC sale and that TSB will allow overdrafts to enable its depositors to invest in TSB shares.*

(iii) <u>The relative costs of investing in physical and financial assets</u>

12. Gordon Pepper argues in effect that record real interest rates are discouraging spending. It is true that the real cost of financing fixed investment or stock building by bank borrowing or issuing debt remains at an exceptionally high level. We have ourselves (eg in Chart 3.12 in this year's FSBR) drawn attention to the relation between the high cost of holding stock and the falling stock output ratios of recent years.

13. It is less obvious that fixed investment has become less attractive relative to holding financial assets. <u>The rate of return</u> on the existing capital stock has risen sharply in recent years. To the extent that the return on marginal investment has also risen this should have offset the disincentive effect of high real interest rates on fixed investment as it is this differential that determines the net return to investment not the real interest rate. The rise in the stock market lends support to this apparently reflecting an increased attraction of claims on real assets, in spite of the high real returns on bonds, building society deposits etc.

14. Whatever one's view on Pepper's arguments about the costs of investing in physical and financial assets, there are certain types of physical assets for which the effective real interest rate is low or even negative at the moment (though not necessarily for the whole life of any loan). The most obvious current examples are house purchase for persons and housing (though not agricultural) land for companies. These have inflation rates well above the post-tax nominal interest rate.

* The final paragraph in the attached article from to-day's Times suggests that bank credit backed share speculation could be more widespread and persistent than these examples suggest.

Conclusion

15. Gordon Pepper's lecture raises a number of very interesting issues that have one feature in common, namely that it is extremely difficult to establish them by interpretation of reliable data. My main reactions to his very compressed argument are as follows. While there could be a speculative bubble building up in financial assets - rather than physical assets (as in 1972/73) - in the UK and other countries, that will sooner or later burst with numerous unfortunate consequences, I am not convinced that this is the case yet. Perhaps of greater importance, monitoring broad money and credit will be of little use in deciding whether financial speculation has gone too far.

P.N.S

P N SEDGWICK

THE TIMES FRIDAY JULY 11

Solicitor fined for BT shares fraud involving £70,800

A solicitor made 263 applications for British Telecom shares using fictitious names when only one a person was permitted, magistrates at Bow Street, London, were told yesterday.

If Brian Taub, aged 51, of Neville Drive, East Finchley, north London, had been successful in all his applications and sold them the next day he would have made a profit of £70,800, the court was told.

Taub, a solicitor, whose offices are in Chancery Lane, denied five summonses of attempting to obtain British Telecom shares in the first trial over alleged frauds in the flotation of November 1984.

He was found guilty and fined £1,000 on each of five summons, with £1,000 costs.

Mr Michael Wright, for the prosecution, said that Taub had admitted to investigating officers that he habitually made applications for shares using false names.

He said that he thought the worst that could happen would be that his applications would be rejected and he was not acting dishonestly.

But on the morning of the flotation he took some applications to the bank, saw that a scrutineer was present, turned and left.

"He tried to contact his wife and two sons and stop them. If he was not fully aware of what he was doing he would not have decided to behave in that way," Mr Wright said.

When the press carried the report about criminal charges Taub asked the bank to return his applications.

In fact, no profit was made because his payments were refunded, Mr Richard du Cann, for Taub, said.

Mr Wright said that 93 of the applications got through the screening and they could have made a £26,200 profit. The 170 applications that were detected could have made a £44,600 profit.

In an interview with the police Taub said: "I believe I was following an accepted practice. I would not do anything by involving myself or my family in any dishonesty."

Taub has been a solicitor for 27 years.

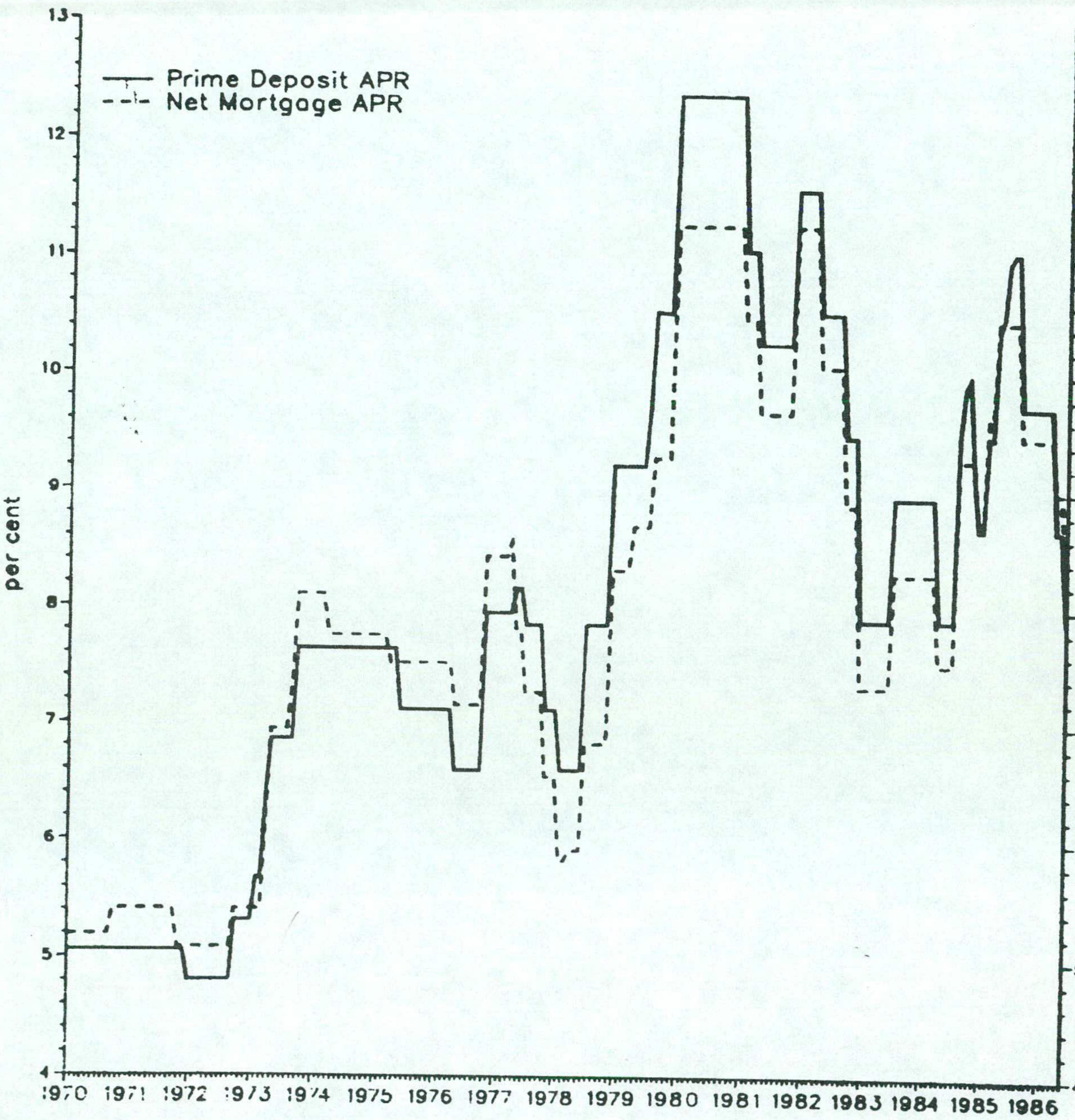
He is involved in conveyancing and commercial work. His job does not involve him in the Stock Exchange, but as an individual he has been buying new share issues for the past 12 years.

"To buy new issues avoids expenses. They are not bought with a view to sell straight away," he told the court.

Taub had a facility worth £575,000 at National Westminster Bank for buying new share issues.

X

BUILDING SOCIETY NET BORROWING AND LENDING RATES



P.HF3G8

tbla

TABLE 1A : SPREADS ON INTERNATIONAL BANK LOANS

basic points

	1979	1980	1981	1982	1983	1984	1985	1986*
OECD area	62	59	58	56	65	55	41	39
Eastern Europe	70	88	62	103	118	88	55	26
OPEC	105	77	79	94	85	76	72	44
Other LDCs	85	91	104	114	170	144	99	71
General average	79	74	80	77	115	93	60	41
Memorandum item:								
Excluding "managed" loans								
-- Other LDCs			104	114	76	69	66	71
-- General average			80	77	73	63	49	41

NB. Weighted average of spreads applied to loans of $30 million and over, with a maturity of more than three years completed or signed during the period. Tax-sparing loans as well as facilities classified under "other international bank credits" are excluded.

Source : OECD Financial Market Trends.

* January-May

tbla

TABLE 1B : SPREADS BETWEEN DOMESTIC LENDING AND DEPOSIT RATES, per cent

	JAPAN	US	FRANCE	GERMANY
1978	3.6	0.9	9.8	4.3
1979	3.0	1.5	12.5	3.5
1980	2.8	2.2	13.2	4.1
1981	3.3	3.0	12.2	5.0
1872	3.5	2.5	11.6	6.0
1983	3.3	1.7	10.6	5.5
1984	3.2	1.7	11.2	5.0
1985	3.0	1.9	11.1*	5.1
1986 Q1	n/a	1.8	n/a	5.3

Source : IMF International Financial Statistics

*1985 Q2 only

Japan : **Lending rate** : "Data relate to the average contracted interest rate on loans and discounts both for short term and long term loans by all banks".

Deposit rate : "Data relate to the Bank of Japan's guidance rates for three-month time deposits".

US : **Lending rate** : Prime rate

Deposit rate : offered rate on certificates of deposit in the secondary market.

France : **Lending rate** : "Data refer to the basic lending rate of the main banks".

Deposit rate : "Data refer to the average rate on time and savings deposits and on short term cash notes".

Germany : **Lending rate** : "Data refer to the rate on unsecured overdrafts of less than 1 million marks".

Deposit rate : "Data refer to the rate on three-month deposits under 1 million marks".

tb2

TABLE 2 : UK CLEARING BANKS NET INTEREST SPREADS (%)

	1981	1982	1983	1984	1985
Domestic					
Barclays	3.9	3.5	3.6	3.7	..
Lloyds	..	3.7	3.5	3.7	..
Midlands	2.5	3.3	3.8	3.8	3.5
Nat West	2.3	2.5	2.9	2.8	2.4
International					
Barclay	1.0	1.5	1.9	1.7	..
Lloyds	..	1.4	1.6	1.6	..
Midland	1.6	1.6	1.6	1.6	1.6
Nat West	0.5	0.8	1.0	1.0	1.1
Group					
Barclays	2.0	2.2	2.5	2.5	2.5
Lloyds	..	1.9	2.3	2.2	..
Midlands	1.8	2.1	2.3	2.1	2.3
Nat West	1.2	1.4	1.8	1.7	1.7
Memo Items					
LCB annual average base rate	13.3	11.9	9.8	9.7	12.3

Source : Bank of England, based on Clearing Banks' SEC, Annual Reports and press reports.

Inland Revenue

Policy Division
Somerset House

Thanks
Nigel

FROM: D M GREEN

DATE: 11 July 1986

PRIVATE SECRETARY TO THE CHANCELLOR OF THE EXCHEQUER

TAKE-UP OF MEASURES TO PROMOTE WIDER EMPLOYEE SHARE OWNERSHIP

1. My minute of 14 April reported on the take-up of approved employee share schemes up to 31 March 1986. The attached Annex shows the position at 30 June 1986.

2. Of the 364 1984 schemes shown in table 4 as 'under consideration' at the end of June, only 37 were still awaiting their preliminary examination by the Revenue. Of the 206 1984 applications over 12 months old and listed as 'deferred or dropped', correspondence between the Revenue and the applicants is still in fact continuing on nearly 130.

pp D M GREEN

---

c PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Mr Monger
Mr Scholar
Miss Sinclair
Mr Culpin
Mr Cropper
Mr Lord
Mr McIntyre

Mr Lewis
Mr Lawrance
Mr Beighton
Mr German
Mr Farmer
Ms Tyrrell
Mr Peel
Mrs Eaton
Mr Hunt
Mr Moore
Mr Keenay
Miss Green
PS/IR

ANNEX A

1. FA 1978 ALL-EMPLOYEE PROFIT SHARING SCHEMES : CUMULATIVE TOTALS

Date		Schemes submitted	Schemes deferred or dropped*	Schemes under consideration	Formally approved
Mar	1979	96			3
Sept		161			43
Mar	1980	228			117
Sept		277			161
Mar	1981	327			210
Sept		374			247
Mar	1982	400			278
Sept		443			310
Mar	1983	476	89	43	344
Sept		505	100	38	367
Mar	1984	552	107	53	392
Sept		591	109	49	433
Mar	1985	635	116	57	462
Sept		688	127	66	495
Mar	1986	733	135	66	532
April	1986	739	137	62	540
May		743	133	62	548
June		750	135	53	562

2. FA 1980 ALL-EMPLOYEE SAYE-RELATED SHARE OPTION SCHEMES : CUMULATIVE TOTALS

1,103

Date		Schemes submitted	Schemes deferred or dropped*	Schemes under consideration	Formally approved
Sept	1980	10			-
Mar	1981	82			22
Sept		142			89
Mar	1982	195			137
Sept		231			184
Mar	1983	267	12	40	215
Sept		308	17	36	255
Mar	1984	362	20	54	288
Sept		439	22	75	342
Mar	1985	516	27	86	403
Sept		573	43	61	469
Mar	1986	622	50	58	514
April	1986	629	53	53	532
May		640	51	58	531
June		653	51	61	541

* This column includes all cases submitted more than 12 months earlier not yet approved.

3. FA 1978 AND 1980 ALL-EMPLOYEE SCHEMES : YEARLY TOTALS

Year to	Schemes submitted	Schemes approved
June 1979	131	29
June 1980	122	117
June 1981	225	130
June 1982	157	187
June 1983	143	128
June 1984	197	125
June 1985	227	207
June 1986	201	180
	1,403	1,103

4. FA 1984 DISCRETIONARY SHARE OPTION SCHEMES : CUMULATIVE TOTALS

Date		Schemes submitted	Deferred or dropped*	Under consideration	Formally approved
Sept	1984	262	-	-	-
Mar	1985	1,125	7	916	202
Sept		1,649	58	701	890
Mar	1986	2,041	170	418	1,453
April	1986	2,122	187	407	1,528
May		2,179	194	390	1,595
June		2,246	206	364	1,676

* This column includes all cases submitted more than 12 months earlier not yet approved.

1770/007

FROM: P N SEDGWICK

DATE: 11 July 1986

Nigel

CHANCELLOR (2)

cc Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Peretz
Mr Mowl
Mr S Davies
Mr Walsh
Mr Hannah
Ms Rowlatt
Mr Heath
Mr Walton

Thanks. [!?]

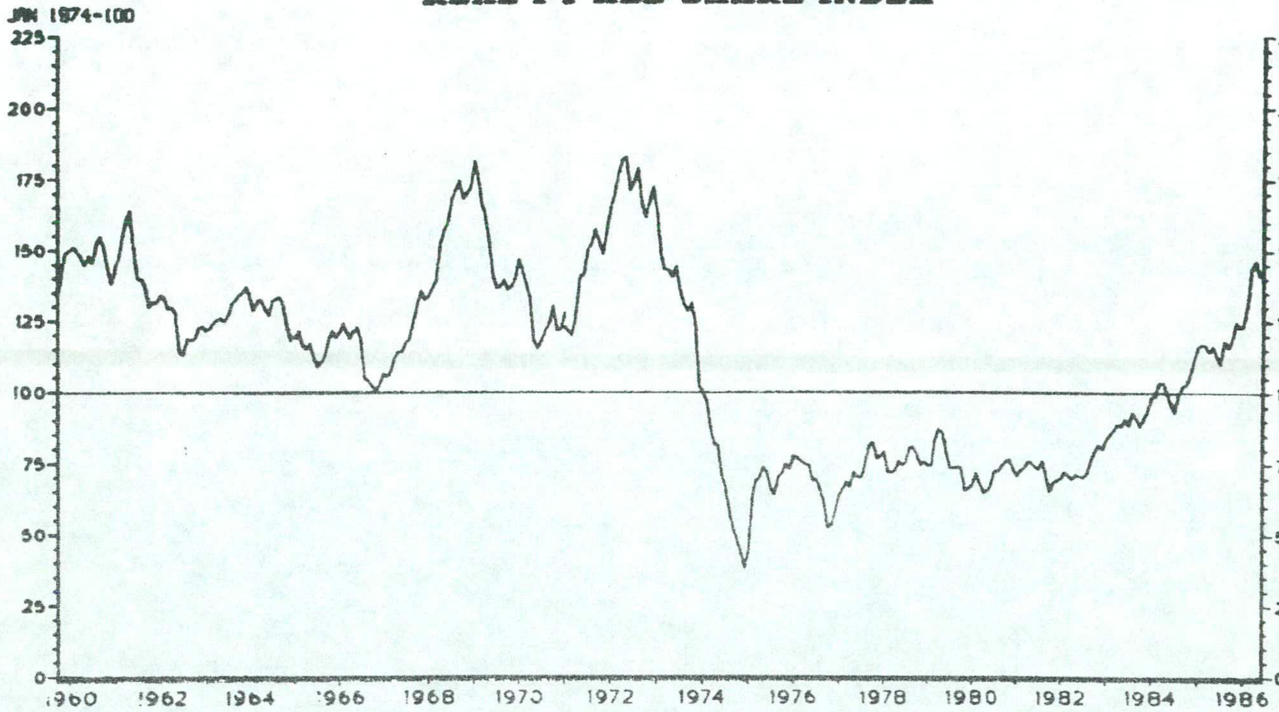
GREENWELLS BULLETIN (2)

My note to you last Friday on Gordon Pepper's recent lecture dealt among other things (in paragraph 10) with the strength of the stock market and the potential for further rises in its real value. You might like to see the attached chart. The first panel is the familiar chart from our monthly monetary note showing the real F T index, which is now close to its pre 1973 average. The second, less familiar, panel shows the real Dow Jones index. The level of this is by no means back to its pre-1973 average. There is no particular reason why the real value of the stock market in any country should return to the pre-1973 average, though it could well be the case that misguided policies in particular countries contributed to the particularly depressed levels between 1973 and the early 1980s. Nevertheless with sensible macro policies in the US, which could very well not be the case, there could be scope for further increases in the real Dow Jones index.

P.N.S

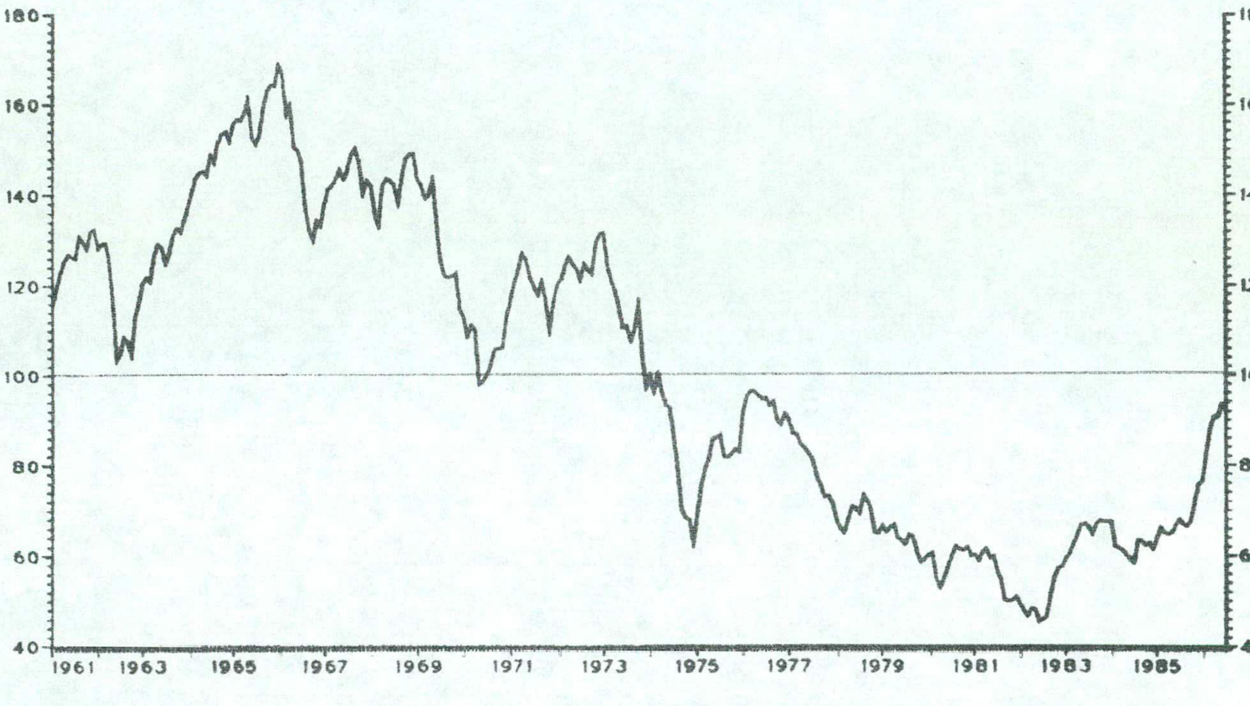
P N SEDGWICK

REAL FT ALL SHARE INDEX



REAL DOW JONES INDUSTRIAL INDEX

Jan 1974=100, deflated using CPI



LD/046

FROM: N G FRAY
DATE: 21 JULY 1986

MR SEDGWICK

GREENWELLS BULLETIN (2)

The Chancellor has seen and was grateful for your minute of 11 July.

Nigel Fray

N G FRAY

PMP

SM4/67

FROM: CATHY RYDING
DATE: 31 JULY 1986

MR SEDGWICK

cc Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Peretz
Mr Mowl
Mr S Davies
Mr Walsh
Mr Hannah
Ms Rowlatt
Mr Heath
Mr Walton

GREENWELL'S BULLETIN:
THE COST OF BORROWING FOR INVESTMENT IN FINANCIAL ASSETS

The Chancellor was most grateful for your minute of 10 July which he found very interesting.

2. Prompted by the comment in your paragraph 6 that in your view Pepper is probably correct in saying that there probably has been some narrowing of spreads on loans of given risk in recent years, but that the Treasury, together with the Bank should make strenuous efforts to get better data to establish whether this proposition is true, the Chancellor has asked how the Bank's general detective work is getting on. He would be grateful to know the latest state of play.

C.R.

CATHY RYDING

FROM: A ROSS GOOBEY
DATE: 17 SEPTEMBER 1986

Where?

CHANCELLOR

cc Ministers
Advisers

WIDER SHARE OWNERSHIP INCENTIVES

The Economic Secretary has made several suggestions as to how measures to speed the process toward wider share ownership might be packaged together.

2. There could be a "carrot and stick" approach to share issues. If a share prospectus invited subscriptions with a minimum below say £1,000, then, provided each applicant seeking allotments below that level were successful to some degree, capital duty would be rebated. If having invited such applicants, the issuing company failed to allot shares to all small applicants, not only would capital duty be payable, but also stamp duty on the allocations actually made. Those issues not aimed at the general public, (such as ROFs would have been), have a higher minimum subscription and would continue to be treated under the present regime.

3. Multiple applications should become a criminal offence, with a proven multiple applicant having his application monies confiscated.

?? 4. There might be a case for government subsidy to those companies with registered holders numbering more than 1 million.

ARG

A ROSS GOOBEY

1. I shd ~~[illegible]~~ be grateful if, ~~[illegible]~~ under the guidance of EST, MrR-G & [illegible] wd work up a package of proposals to encourage WSO, whether along these or other lines. 2. Is 3 practicable? It has much to commend it.

NL

BIF 26/9

c/ I actually asked for more than briefing. This note explains the background but I assume you wanted a little more than this. Do you want me to ask IR to do more work?

CR 22/9

Yes PSC. This misses the point entirely.* M

Inland Revenue

FROM: D M GREEN
DATE: 19 September 1986
Policy Division
Somerset House

PRIVATE SECRETARY TO THE CHANCELLOR OF THE EXCHEQUER

FINANCE ACT 1984 SHARE OPTION SCHEMES

1. You asked for briefing on the suggestion put to the Chancellor by Dixons at their recent lunch that the limits on share options under approved FA 1984 schemes were inadequate for 'go-ahead' companies.

* If you are not clear what he was, speak to me

2. As the Chancellor knows, the 1984 legislation allows companies to grant options up to 4 times earnings or, if greater, £100,000. 'Earnings' for this purpose excludes benefits-in-kind and other payments made without deduction of tax under PAYE.

3. When the conditions for the scheme were being drawn up in 1984, Ministers decided that it would be wrong to make the relief completely open-ended but that any limit should be pitched at a generous level which would in no way hamper companies wishing properly to reward their key employees.

4. There has been hardly any pressure since then for an increase in the limits. The only significant representation has come from the Institute of Directors, who have actually called for the limits to be abolished. The line has always been taken by Ministers that the present limits are very generous and no case is seen for any increase, especially in the light of the excellent take-up figures for the new relief.

Not allowed to start again

cc Mr Farmer
Miss Green
Mr Ellis
~~PS/IR~~

5. A number of people have made the point that employees with substantial overseas earnings not paid subject to PAYE are effectively restricted to options worth £100,000 and that the rules should be changed to allow such 'non-PAYE' emoluments to count as 'earnings' in order that the individual could benefit more under the 4 times earnings head. The Chancellor wrote to Mr Evelyn de Rothschild on this point about four months ago, explaining why it was decided to exclude 'non-PAYE' emoluments for FA 1984 limit purposes and pointing out that the £100,000 alternative was still very generous.

6. As a matter of fact the Investment Protection Committees, whose guidelines are aimed to prevent excessive dilution of equity at the expense of other shareholders, impose a stricter line for quoted companies than the letter of FA 1984 itself. Effectively they do not recognise the £100,000 alternative limit and recommend that for employees earning less than £25,000 the absolute limit should be 4 times salary.

7. The size of options that would qualify for tax relief was, naturally, one of the features of the scheme that attracted the most bitter criticism from the Opposition during the very lengthy Committee debates on the share option provisions in 1984.

D M GREEN

2816/19

b/f with further response

FROM: J J HEYWOOD
DATE: 25 September 1986

PS/CHANCELLOR

cc Mrs Lomax
Mr Scholar
Mr Farmer IR
PS/IR

INCENTIVISING EMPLOYEES WITH SHARES

1. The Financial Secretary has seen your minute of 24 September.

2. The Chancellor will be pleased to know that the Financial Secretary already has work in hand on this very point.

JEREMY HEYWOOD
Private Secretary

3772/019 NH

FROM: **M NEILSON**

DATE: 29 September 1986

1. MRS ~~LOMAX~~ RL 30/9

2. CHANCELLOR

cc PS Chief Secretary
PS Financial Secretary
PS Economic Secretary
PS Minister of State
Sir P Middleton
Mr Cassell
Mr Monck
Mr Moore
Mr Scholar
Miss Sinclair
Mr Ilett
Mr Cropper
Mr Ross Goobey

Thanks. Re selling, against EST (rather than FST) was a simple slip of the pen. My apologies. I'll rectify it. N.

PS. Although my error, the ES should have spotted it ...

WIDER SHARE OWNERSHIP: MULTIPLE APPLICATIONS

You asked whether making multiple applications a criminal offence was practicable (Mr Allan's minute of 18 September).

The making of multiple applications is already a criminal offence under section 15 of the Theft Act, which relates to obtaining property by deception. Following the BT sale the Department of Trade and Industry consulted leading counsel on whether The Theft Act could be used to prosecute multiple applicants. The advice received was that the position was clear. It was an offence dishonestly to obtain property by deception. In the case of share sales an applicant was only entitled to obtain "property" ie shares, by adhering to the rules made by the vendor. It would infringe the Theft Act to deceive the vendor by making multiple applications which the vendor had expressly precluded. The only cases where there was some doubt about the applicability of the Theft Act was where obviously false names - Mickey Mouse etc - were used, since it would be difficult to prove a genuine intention to deceive. The prosecutions successfully brought in the case of BT were under the Theft Act.

The question of practicability therefore becomes whether the Theft Act can be used successfully in many cases. The difficulties of course lie in identifying suspicious cases and in proving, beyond reasonable doubt, that the same individual is responsible for a number of applications. The techniques [redacted] used in the TSB sale go some way to help on this, but conviction remains difficult except in the most blatant cases.

We are currently working on the package of proposals to encourage wider share ownership also referred to in Mr Allan's minute.

Bob [illegible]

pp M NEILSON

B.I.P. 8/10

Inland Revenue

Policy Division
Somerset House

C/ I think this now covers the right point. IR advise Dixons are "labouring under a misapprehension". IR have spoken to Sarhami of Dixons direct about this + Dixons are now reassured

FROM: J D FARMER
DATE: 30 September 1986

PS/CHANCELLOR OF THE EXCHEQUER

CR 3/10

Good! Many thanks.

FINANCE ACT 1984 SHARE OPTION SCHEMES

1. Your minute of 26 September asked us to consider concern expressed by Dixons to the Chancellor that under the 1984 legislation, if after 3 years an option has been exercised, new options cannot be allotted for another 7 years.

2. Dixons are labouring under a misapprehension. The Finance Act 1984 provisions (in Schedule 10, paragraph 5) run:

> "The scheme must provide that no person shall obtain rights under it which would, at the time they are obtained, cause the aggregate market value of the shares which he may acquire in pursuance of rights obtained under the scheme or under any other scheme approved under this Schedule and established by the grantor or by any associated company of the grantor (and not exercised) to exceed or further exceed the appropriate limit".

---

cc Mr Ross Goobey

cc Mr Farmer
Miss Green
Mr Ellis
PS/IR

3. The words I have underlined make it clear that a company is at liberty to provide under its approved scheme for one employee to receive any number and size of individual options, so long as in total his outstanding options granted under the scheme (taken together with any outstanding options granted to him under a similar scheme by the same or an associated company) do not exceed the limit. Options granted earlier and already exercised do not enter into the reckoning.

4. A company is at liberty to operate a more stringent approved FA 1984 scheme than the statute requires - eg to stipulate that no individual may be granted more than one option in ten years. But such a stipulation would be most unusual; and Dixons own approved scheme does not contain any such rule.

J D FARMER

CONFIDENTIAL

RWP

FROM: ROBERT CULPIN
DATE: 3 NOVEMBER 1986

PSF counter briefing. Truth is ~~[illegible]~~ different! VL will spk bigger. NL. (PSF first)

CHANCELLOR

cc Economic Secretary
Sir P Middleton
Sir Terence Burns

Note
Ch discussed with Robert and Peter 4/11/86. AA

THE FT ON THE MARKETS

I should report that Philip Stephens has been given a loaded account of the Prime Minister's alleged attitude to recent market disturbances. So far as I know, he does not propose to make a special story of it; but bits may surface, for example around the reserves announcement.

2. He only retailed it to me in a fairly rambling way, as part of a conversation about something else. But the general drift was that the Treasury and Bank have been panicking, and wasting reserves, while the Prime Minister has been cool and calm.

Wholly untrue

3. The circumstantial detail included these points:

Not true

a. The Treasury and Bank favoured a second rise in interest rates in January. The Prime Minister stopped it.

b. The Treasury and Bank were greatly exercised in January and September/October about the decline in sterling. The Prime Minister was more willing to let the pound fall, in the expectation that it would come back of its own accord. ("This could be Walters' influence", said Stephens.)

True

not true

c. Correspondingly, the Prime Minister would now be relaxed if sterling went up again. The Treasury and Bank would prefer to avoid another sharp change.

half true half false

d. The Prime Minister was dead against the use of reserves to defend sterling, and had resisted it in September/October.

e. She is, however, much more concerned than the Treasury about the growth of credit.

RC

ROBERT CULPIN

3361/49

Plw

FINANCIAL SECRETARY TO THE TREASURY

FROM: J J HEYWOOD
DATE: 13 November 1986

PS/CHANCELLOR

cc PS/Chief Secretary
PS/Economic Secretary
PS/Minister of State
PS/Sir P Middleton
Mrs Lomax
Mr Scholar
Mr Ilett
Miss Sinclair
PS/IR

Ch
Need to wait for FST's further consideration
AA

Right. But I was not aware why was Sir EK asked to educate us?

UNQUOTED COMPANIES : EXECUTIVE INCENTIVES : MEETING WITH SIR EMMANUEL KAYE

As requested in Mrs Lester's minute of 9 October the Financial Secretary held a meeting with Sir Emmanual Kaye and Mr Patrick Burgess on 12 November to discuss the problem of incentivising employees with shares. Mr Lewis and Mr Farmer were present from the Revenue.

2. Sir Emmanuel opened by stating that he had in recent years formed a series of subsidiary companies, each being in the charge of a young entrepreneur who had put up his own stake. These entrepreneurs had each come to him with an idea and Sir Emmanuel had backed them by setting up a subsidiary into which they, in turn, put some capital. Sir Emmanuel thought it intolerable that when the value of the entrepreneur's stake increased in value, due to his efforts and ingenuity, this gain in value after 7 years should be treated as income and taxed at marginal rates of up to 60%. This effectively precluded the use of shares in unquoted subsidiaries of unquoted companies as a means incentivisation.

3. Sir Emmanuel argued that shares should not be seen as worker-remuneration but as worker-incentives. Hence, the tax treatment (under S.79 Finance Act 1972) was far too heavy. Indeed, he thought that a perfectly reasonable loophole which in practice had been widely used to mitigate the problem ("bonus shares") had been wrongly closed up in Finance Act 1986.

4. It was not clear from Sir Emmanuel's argument whether he was concerned about the high tax rate payable on the increase in the value of shares which entrepreneurs had bought themselves on the formation of a new company or whether he was concerned about the case where a parent wanted to motivate the management of its subsidiary by giving them shares in the subsidiary. Obviously, these are two quite different situations although both are caught by S.79.

5. Mr Burgess went on to propose a radical restructuring of S.79. The increase in the value of shares held by employees in unquoted subsidiaries of unquoted companies should, he argued, be treated not as income but as a capital gain for tax purposes unless in the "opinion" of the Inland Revenue that increase was the result of manipulation.

6. The Revenue pointed out that the bonus shares loophole had been closed because Ministers had judged it right to prevent tax relief from going to areas where abuse had been prevalent. They also suggested that although approved share schemes could not be used by unquoted subsidiaries of unquoted companies (except where the scheme used the shares of the parent, which Sir Emmanuel had ruled out) it was nevertheless possible for unquoted subsidiaries to get exemption from S.79. This would be feasible if the shares used to incentivise employees were not restricted and formed only a minority of the total held other than by the parent.

7. The Revenue observed that Mr Burgess' proposal for an administrative discretion to be exercised would raise a variety of difficulties. It would inevitably provoke demands for the publication of guidelines explaining how the Revenue would exercise their discretion. What clear guidelines were suggested? Moreover, in order to verify that no manipulation had occurred it would not be sufficient for the Revenue's Technical Division to prove that the current valuation was fair. It would also be necessary to establish that that value had not been affected by manipulated non-arm's length transactions between parent and subsidiary. Even if this could be established, companies could be involved in the submission of substantial volumes of paper to back up every claim.

8. There was general consensus that S.79 did catch some cases where there was no manipulation. But it remained difficult to see how it could be amended without opening the flood-gates to wide-spread abuse.

9. The Financial Secretary said that he would look into Sir Emmanuel Kaye's suggestion, although no commitment could be made. In discussion with the Revenue afterwards, the Financial Secretary said that he wanted to see some help for unquoted companies in the Finance Bill but was not convinced that a relaxation of S.79 was the most efficient way of helping them.

JH

JEREMY HEYWOOD
Private Secretary

THROUGH A GLASS DARKLY

The recently announced bid by BTR Industries for Pilkington highlights one of the basic problems of modern capitalism. It is simply that those managements who take the long view are the most vulnerable.

BTR has an enviable record of buying averagely managed companies and improving their performance. BTR is in all kinds of industries and is as diverse a conglomerate as it is possible to find today; what holds it together is management flair and financial control. Its business is management. Pilkington is in glass and has been for over a hundred and fifty years: it is a family company, anchored in a community and its name is synonymous with excellence in its chosen field. However, maintaining such a position in an industry like glass requires planning and longish periods during which strategies can be deployed. Pilkington has been involved in various phases of long term development ever since the War, embracing the development of floatglass, its licencing, the expansion abroad by acquisition as the licences fell in and so forth. By general agreement it has done extremely well, particularly considering the difficulties the industry itself has been passing through, especially in Europe. Pilkington is now poised to reap the benefit of these years of work. This is precisely the moment chosen by BTR to strike. It is a shrewd move and exhibits delicate timing, the fine florentine hand of BTR's Chairman is stamped all over the bid.

It makes the case for non voting shares seem respectable. Why shouldn't a company like Pilkington keep voting control and yet have access to capital markets? What is so sacrosanct about shareholders having the votes? By and large if shareholders don't like something, they can vote with their feet. There are very few cases of successful revolts based on voting power. Of course votes count desperately when there are bids about but this is precisely the point - should they all count? It runs completely counter to current philosophy to question shareholder democracy, but given the way the British economy has behaved since the War it is perhaps time that everything is questioned. In our opinion, it is going to be a sad day for the economy if Pilkington disappears. If the institutions let this great company down, then it surely is time to question the present system of voting.

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THE FORTNIGHTLY

Number 34 19th November 1986

A cogent case for non-voting shares in the back page. ~~[illegible]~~ I take it that such shares, altho' however frowned upon, are still legally permissible — or will the SIB refuse a quote? R.

A FLAW IN CAPITALISM?

'Insider Trading' was perceived as a blemish on the face of capitalism; it now looks as though it could be a cancer.

Not everybody understands what is involved in the extraordinary outbreak of incidents which have rocked the security markets of the world during the past week or so. Following Mr Levine in Wall Street, who was clearly going to 'grass' on all his associates, we had the revelations concerning Mr Geoffrey Collier of Morgan Grenfell whose misdemeanours have come as such a shock to the City and now we have the explosion of the whole thing in the story of Ivan Boesky, whom, we are told, has made a settlement with the authorities in the U.S. at the staggering level of $100 million. The trio have bracketed the entire world market, it is clearly now just a matter of filling in not only the details but the evidence of all the other miscreants who must have been operating in between these three, either on their own or as part of various related conspiracies.

Observers have remarked that there was always insider trading and that stockbrokers grew fat on it in the 50's and the 60's. Yes and no. The scale of what occurred in those far off days was miniscule compared with what we are up against now. The present problem is the product of a completely new type of business which basically has only emerged during the last ten years. It is the mega Take Over activity in which all major companies other than those which are either private or nationalised are now involved whether they like it or not. This phenomenon with its huge volumes and vast windfall profits has inevitably generated an activity all of its own. Part of this is reasonably respectable, that is when it consists of intelligent anticipatory footwork but the temptation to carry it beyond this and over into the frontier of the illegitimate has clearly been irresistible. The winnings are just too enormous for them to be resisted.

So how can the trend be reversed? If the activity itself died down, then much of the illegitimate trading would die too. But this is unlikely to occur at least for the time being. So it must be left to the regulatory authorities to continue their hunt and to put up the penalties. Unfortunately it is doubtful whether this will deter many of those who have grown used to generating such large and agreeable profits. All that is going to happen is that people are going to be much more careful. They are not going to change their spots.

The Impact On The Customers

One immediate problem is that the level of confidence between corporate customer and adviser is bound to be strained by all this. The extreme example of Amalgamated Engineering, the leading British engineering company which a couple of months ago found itself the subject of an unwelcome bid from Turner

& Newall, is a case in point. The last thing that this well managed and successful company wanted was to be gobbled up in a bid battle. So it got itself advised by a leading merchant bank and a top firm of brokers in London. They put up a splendid defence. Unfortunately somebody slipped up and not all the AE shares, which were purchased as part of the defensive measures, were apparently put on the shelf to be publicly counted. As a result, there was a great rumpus, with the advisers concerned being reprimanded by the Take Over panel and AE was made vulnerable to a repetition of the bid which had just failed. The point was that under usual circumstances a bid cannot be tried again before a year has elapsed; in this case because of the error of the advisers, AE was made vulnerable to a further bid immediately.

It can be imagined how the AE Board felt. However, determined to keep their end up, they then went to the bank with the most aggressive record in the bid battle business, Morgan Grenfell, to defend them. Only a few days later, as we all now know, a senior official at the very bank they chose to go to was caught out, dealing in AE shares on an insider basis.

How do AE's directors feel now about the City? Presumably not very bullish. And here is a major point at issue. There are already many in industry who doubt whether the City's activities during recent years and particularly during the whole business of the 'Big Bang' have been geared to serving the nation's interests as such. It has seemed to them rather that the Square Mile has been playing its own speculative game. This was undoubtedly the feeling of many of those who attended the recent CBI Conference. It is all very well for Paul Johnson to lecture us on how servicing the financial markets is going to constitute this country's major business activity in the years to come and that in consquence we had better forget our old fashioned notions about industry and the rest. This position is now seen as absolutely ludicrous by those caught up in recent events. And indeed there is a certain air of unreality about the whole thing. An activity founded on so much transient and questionable creation of values could, it seems, just disappear like a puff of smoke.

The Link With Reality

This is all the more so when the frenetic advance of security markets in the U.S. and the U.K. is contrasted with what has actually been happening in the industries of these two countries. During the past five to seven years when the new bid battles have been at their height and the financial fortunes have been made on the back of so much restructuring and creation of debt, the capacity of both the U.S. and U.K. economies to maintain their position in international trade has visibly wilted. In both the U.S. and the U.K. the propensity to import has risen and the capacity to export has fallen. Governments, Central Bankers and politicians generally should ask themselves seriously whether they think that what has been going on has really been in the public interest. Germany and Italy, for example, have not been caught up in all this frothy business and their economies have, by contrast, improved their position.

Historically one of the major features of the boom which led up to the 1929 crash was that it didn't, in retrospect, appear to be the product of a genuine and healthy economic development. Thus the tremendous enhancement of capital values was left suspended in the air, an artificial creation of speculation rather than the outcome of genuine growth. When the balloon was pricked, it collapsed with frightening speed. As it did so, the real problems emerged. All the unsound schemes were revealed in their full weakness. It was left to Kenneth Galbraith to sum the situation up in his book 'The Great Crash'. At any point of time, he argued, business carries a certain amount of embezzlement in it. Only when the level of activity falls and trouble rises is the full extent of this revealed. He called it the 'bezzle', the full extent of which becomes apparent when the economic tide goes out. One is left with a nasty feeling that we are about to see the current 'bezzle' revealed in all its glory.

The Wider Impact

Moving aside these essentially economic arguments, the Boesky affair and the likelihood that it may yet spread to engulf other well known players, could have a major impact on the markets themselves. It has to be realised that one of the basic reasons stock markets rise is because of a general public perception that there are more good things to come. Good news feeds on more good news. The last seven or eight years has been a period of stock market appreciation, the like of which has never been seen before. Whatever else has been going wrong in the world this has been one major bright spot and particularly for the participants. Ivan Boesky could be the man who put this process into reverse. Now there could be bad news to succeed further bad news. The riders could find that the rollercoaster is going the other way.

This could result from the political reverberations which market players are now anxiously awaiting. Politicians are in the business of scenting the trail; they follow their noses. If there is going to be a public backlash against the yuppies who have been making it so richly (and now it seems so crookedly) then the politicians will be riding off to hounds after the scent. The Wall Street debacle of 1929 set off a political backlash which led to the New Deal and kept the Republicans out of office for twenty years. It may be an exaggeration to say that the same thing is going to happen again. But there are portents in all this. It must also be remembered that the Securities and Exchange Commission was set up by legislation passed in the wake of those events. A new move towards tighter regulation both in the U.S. and elsewhere, could well be a further result of the Boesky affair.

Meanwhile it has been evident that Wall Street has been driven by the Take Over phenomenon. Risk arbitrage has played an enormous part in this market phase. If, as seems likely, this kind of activity is now going to fall away there could well be a downwards rerating of the market as a whole. In that event it could be the trigger which finally got pulled and shot the ageing bull market clean through the heart.

RC2.97

AAP

takeovers

FROM: CATHY RYDING

DATE: 26 November 1986

MR NEILSON

cc PS/Financial Secretary
PS/Economic Secretary
Sir P Middleton
Mr Cassell
Mrs Lomax
Mr Ilett

THE FORTNIGHTLY - "THROUGH A GLASS DARKLY" - 19 NOVEMBER

I attach an extract from the latest edition of "The Fortnightly", which the Chancellor thought was a cogent case for non-voting shares. He takes it that such shares, although nowadays frowned upon, are still legally permissible - or would the Stock Exchange refuse a quote? The Chancellor would be grateful for your advice.

C R

CATHY RYDING

THROUGH A GLASS DARKLY

The recently announced bid by BTR Industries for Pilkington highlights one of the basic problems of modern capitalism. It is simply that those managements who take the long view are the most vulnerable.

BTR has an enviable record of buying averagely managed companies and improving their performance. BTR is in all kinds of industries and is as diverse a conglomerate as it is possible to find today; what holds it together is management flair and financial control. Its business is management. Pilkington is in glass and has been for over a hundred and fifty years: it is a family company, anchored in a community and its name is synonymous with excellence in its chosen field. However, maintaining such a position in an industry like glass requires planning and longish periods during which strategies can be deployed. Pilkington has been involved in various phases of long term development ever since the War, embracing the development of floatglass, its licencing, the expansion abroad by acquisition as the licences fell in and so forth. By general agreement it has done extremely well, particularly considering the difficulties the industry itself has been passing through, especially in Europe. Pilkington is now poised to reap the benefit of these years of work. This is precisely the moment chosen by BTR to strike. It is a shrewd move and exhibits delicate timing, the fine florentine hand of BTR's Chairman is stamped all over the bid.

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033/112

Bk with advice from FIM.

ECONOMIC SECRETARY TO THE TREASURY

FROM: P D P BARNES
DATE: 5 December 1986

PS/CHANCELLOR

cc PS/Financial Secretary
Sir P Middleton
Mr Cassell
Mrs Lomax
Mr Ilett
Mr Neilson

THE FORTNIGHTLY - "THROUGH A GLASS DARKLY" - 19 NOVEMBER

The Economic Secretary has seen your minute to Mr Neilson of 26 November.

2. The Economic Secretary is strongly in favour of non-voting shares being permitted. Anyone who does not like them need not buy them (or voting shares in the same companies).

PB

P D P BARNES
Private Secretary

4010/020

Comments on 12.

PPS in?

FROM: R MOLAN

DATE: 15 December 1986

MR ALLAN

cc Mr Monck
Mr Burgner
Mr Guy
Mr Cropper

LORD VINSON ON WIDER OWNERSHIP: MERGERS POLICY

Your note of 8 December copied to Mr Guy refers. (Copies attached for Mr Monck and Mr Burgner). I shall only deal with item 12 as item 9 is being looked at by PE.

(1) 2. ~~The~~ Current Government policy on mergers is that cases will be referred to the MMC for investigation primarily on competition grounds. ~~The MMC are required to~~ investigate and report whether the merger operates or can be expected to operate against the public interest. ~~Thus, the~~ burden of proof falls on the MMC to show that the merger would be detrimental and not, as Lord Vinson says, on the company to prove that it would be beneficial. ~~If the MMC find against a merger the Secretary of State for Trade and Industry can, if he agrees with their view, prevent it taking place.~~

(2) 3. As competition is the primary criterion for reference, certain big mergers involving conglomerates are unlikely to be referred to the MMC in the first place. ~~For instance, if a conglomerate bids for a large company producing whisky and that conglomerate is not involved in the whisky business there will be no competition grounds per se for making a reference.~~ Because of this, critics argue that the present policy is biased in favour of conglomerates who in Lord Vinson's terms are in the business of accumulating rather than disseminating power.

(3) 4. DTI are currently conducting a review of mergers policy and law. The first stage has involved an examination of changes possible within the existing law and the intention is Mr Channon will make an announcement about the conclusions reached in the near future. Reference policy has been under consideration during this stage and DTI officials favour the maintenance of the status quo.

5. The question of changing the burden of proof will be considered in stage 2 early next year which will examine possible legislative changes. ~~(The existing burden is enshrined in the Fair Trading Act.) It is impossible to predict what the outcome will be.~~

6. In conclusion, it may be somewhat premature to comment on the specific issues raised as these are being looked at in Government. At a more general level one might say that Lord Vinson's remarks imply greater interventionism whereas the thrust of Government policy is to leave the market to determine the shape of the company sector, except where competition may be impaired.

R MOLAN
IAE3

FINANCIAL SECRETARY TO THE TREASURY

FROM: J J HEYWOOD
DATE: 17 December 1986

PS/CHANCELLOR

I am content with this approach (para 11).
N.

cc PS/Chief Secretary
PS/Economic Secretary
Sir P Middleton
Mr Monck
Mrs Lomax
Mr Scholar
Mr Cropper
Mr Isaac IR
Mr Lewis IR
Mr Farmer IR
PS/IR

SECTION 79 FINANCE ACT 1972

The Financial Secretary has been considering, in advance of the Chancellor's meeting tomorrow, whether any action should be taken this year to reform S.79 Finance Act 1972. The Chancellor will recall that the problems with S.79 have recently been highlighted by, inter alia, the BVCA and by Sir Emmanuel Kaye (Mr Lewis' submission of 1 December and my note of a meeting with Sir Emmanuel Kaye of 13 November provide some of the background).

2. S.79 is designed to ensure that there is an income tax charge on gains from shares which directors and employees receive as part of their remuneration package. It is an anti-avoidance provision which remained on the statute books after the Labour Government repealed Lord Barber's share scheme tax concessions in 1974. However, the Revenue are convinced that this is not some historical relic but is a necessary bastion against abuse. It is clear to them that in the early 1970s, before S.79 was introduced, there was widespread abuse and there is no reason to suppose that the scope for this has now diminished. The Financial Secretary has no reason to disagree with the Revenue's analysis.

3. Sir Emmanuel Kaye is particularly worried that S.79 catches attempts to incentivise the executives of unquoted subsidiaries (of unquoted companies). If these executives are given shares in the unquoted subsidiary and S.79 applies, the increase in the value of the shares after 7 years, is treated as income and is taxed at marginal rates of up to 60%.

4. Although the Financial Secretary shares Sir Emmanuel's concern that genuine incentivisation attempts may be thwarted by the current legislation (and particularly his concern about founders' shares being treated in the same way) he is convinced that the asset value of unquoted subsidiaries can easily be manipulated.

5. Section 79 has also been of concern to the BVCA. It was originally thought that the limited partnership route would allow the BVCA's members to avoid any double charge to CGT and to remunerate venture capital managers through gains on shares in a way that was satisfactory to them. However, it now looks as though the limited partnership route would still leave the recipients of shares liable to income tax under S.79. Thus the BVCA representations remain on the table. I shall report on the outcome of the Financial Secretary's meeting with them in due course.

6. In addition to the recent comments from the BVCA and Sir Emmanuel Kaye, the Financial Secretary, the Economic Secretary and Mr Cropper met several tax advisers last week (Messrs Carmichael, Sutherland et al) and they in turn all thought S.79 was a real problem in that it inhibited genuine incentivisation schemes.

7. There is no real disagreement between the Financial Secretary and the Revenue on the one hand and the various individuals and bodies that have criticised S.79 on the other. There is a general

recognition that an anti-avoidance provision is necessary, but that this is a complex area and S.79 is a relatively blunt instrument which sometimes hits the wrong target.

8. One option might be to take up Sir Emmanuel Kaye's suggestion that the increase in the value of shares held by employees or directors in unquoted subsidiaries should be treated as a capital gain, and not as income, for tax purposes, unless in the "opinion" of the Revenue that increase was the result of manipulation. The Financial Secretary, however, thinks that this idea is a complete non-starter, giving the Revenue an ill-defined but very substanital degree of discretion.

9. The Revenue have also advised that they would find it very difficult indeed to work up any firm proposals for reform in this area for inclusion in the Finance Bill given that manpower resources are committed to the work on PRP. Even if additional people were drafted in, the Financial Secretary would attach a higher priority to the Nigel Forman/ESOP proposals for this year.

10. Mr Isaac has strongly recommended that because this is a highly complex area the Chancellor should announce in the Budget his intention to set-up a working group with outside representatives to review the whole Section. This group could include some of the tax advisers who came to see the Financial Secretary last week. This would probably mean that the Revenue would have to work up some form of document setting out the main issues for consultation.

11. The Financial Secretary is due to have a meeting with the BVCA on Friday and will find out how urgently they need to have a solution to the problem. Subject to that, the Financial Secretary would go along with Mr Isaac's recommendation.

JH

JEREMY HEYWOOD
Private Secretary

009/1289

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FROM: **JILL RUTTER**
DATE: **22 December 1986**

PS/CHANCELLOR

cc:
PS/Economic Secretary
Sir Peter Middleton
Mr Monck
Mrs Lomax
Mr Scholar
Mr Copper

Mr Isaac - IR
Mr Leiws - IR
Mr Farmer - IR
PS/IR

SECTION 79 FINANCE ACT 1972

The Chief Secretary has seen the Financial Secretary's comments on Mr Lewis's submission of 1 December recorded in his Private Secretary's minute of 17 December.

2 The Chief Secretary agrees with the Financial Secretary, that we should go along with Mr Isaac's recommendation for the announcement in the Budget of a working group with outside representatives to review the operation of Section 79. That will show that we are in touch in the problem. The Chief Secretary does not think that we are ready to find a solution in time for the next Finance Bill.

Jill Rutter

JILL RUTTER
Private Secretary