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ECONOMIC POLICY

(CPRS paper on UK economy)

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CPRS Paper on the Economy of the UK

ECONOMIC POLICY

MAY 1979

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
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Economic Policy

10 DOWNING STREET

From the Principal Private Secretary

SIR KENNETH BERRILL

Thank you for your letter of 4 May. As I think you know, I took the view that since the Prime Minister wanted to have a political and strategic discussion informally with Cabinet colleagues on Tuesday afternoon, it would be helpful to her and them to have read your paper beforehand. So I submitted it.

A copy of this goes to Sir John Hunt.

K.R.S.

8 May 1979

Covering CONFIDENTIAL

CABINET OFFICE

Central Policy Review Staff

70 Whitehall, London SW1A 2AS Telephone 01-233 7765

From: Sir Kenneth Berrill KCB

Qa 04093

4 May 1979

Dear ~~Ken~~,

The CPRS Paper on the Economy of the United Kingdom

Following our conversation, Gordon Downey and I have cut down the length of the CPRS paper on the United Kingdom Economy by around a third and tightened up the presentation by using shorter sentences, etc.

You said that, in your view, this was the kind of paper which the Prime Minister would not want to have until early next week. If so, we have time on Tuesday to have another look at it and see if the chopping process has left it in an adequate state. But if events make you think that it should be put in straightaway, I am attaching it with a covering minute to the Prime Minister.

If there is more time, and if you have a chance to read it yourself and have any views, I should be most grateful for your comments.

I am sending a copy to John Hunt.

Yours ever

Ken

~~KENNETH BERRILL~~

K R Stowe Esq CB
10 Downing Street
S W 1

Att

Prime Minister.
You are having a general talk with Cabinet colleagues on Tuesday at 1430. This is helpful background reading. Do you wish to circulate it to colleagues? For Tuesday?
K.R.S.

Covering CONFIDENTIAL

Qa 04092

To: PRIME MINISTER

From: SIR KENNETH BERRILL

The Economy of the United Kingdom - Problems, Constraints, Opportunities

1. An important part of the remit of the Central Policy Review Staff is to advise Ministers collectively on major strategic issues. I attach a note by the CPRS on the problems and prospects for the United Kingdom economy in the medium term which you may like to see. The intention would be to circulate it to your colleagues.

2. I am sending a copy of this minute and the enclosure to Sir John Hunt.

KB

4 May 1979

Att

THE ECONOMY OF THE UNITED KINGDOM - PROBLEMS, CONSTRAINTS, OPPORTUNITIES

Note by the Central Policy Review Staff

Introduction

1. This paper reviews in brief the main problems, constraints and opportunities facing the economy of the United Kingdom over the next 4/5 years. It concentrates almost exclusively on domestic economic issues; foreign policy, defence and constitutional matters are raised incidentally, if at all.

Problems

2. The main problems of the economy are deep-seated and now widely recognised. We are rich in natural and human resources. Other industrial countries envy our self-sufficiency in North Sea oil and gas. But our industrial performance has been so poor for so long that in Western industrial terms we have now become a low productivity, cheap labour, country - see Annex A.

3. The main problems remain the same as they were pre-1974, only more so: inflation, industrial performance, unemployment (in that order). The Government's strategy is to break into the vicious circle by reviving personal initiative. Public expenditure and personal taxation are to be reduced; and strict monetary discipline observed. The aim is to revive investment, increase productivity and thus substitute improved growth and competitiveness for "stagflation" and relative decline. None of this can be instantaneous. During the first year or two, while inflation is wrung out, the disciplines may be painful in terms of growth and unemployment. It may well be the second half of this Parliament before the benefits begin to accrue. It will be important meanwhile both to stick to the strategy and to keep the longer term goals in the public eye.

Inflation, Industrial Performance, Unemployment

4. The Government is fortunate in having a national consensus that the order of priorities is inflation, industrial performance, unemployment. There is general agreement that high rates of inflation harm us as a trading nation, discourage investment, slow down growth, increase unemployment. There is a widespread fear of the social dissatisfaction and unrest which inflation brings.

5. There is also growing, if belated, understanding of where Britain has slid to as a trading nation; and how our living standards depend, long term, on the productivity of our manufacturing and service sectors.

6. The United Kingdom growth rate has been considerably below that of our major competitors. Our service industries have generally performed as well as their counterparts but British manufacturing industry, both in the private and the public sector, has not. Too often the story is one of low profits, low productivity, bad management/ labour relations, outdated machinery; and of products that fail to compete in price, quality, delivery time, and after-sales service. This is true not only of declining industries such as steel and shipbuilding, which are facing problems throughout the Western world. It is true also of industries whose products are still in demand (cars and the mechanical and electrical engineering industries generally) and even some of the industries of the future. If profits are adjusted for inflation, the position looks even worse.

7. Unemployment by postwar standards is very high. At present this is accepted with surprising equanimity. But there are problems ahead if new jobs do not emerge. Like many other industrial countries, our labour supply is expected to increase (by about 1 million over the next five years). In part this is due to the bulge of school leavers and the small numbers due to retire over the period; in part to the strong trend for more married women to go out to work. At the same time, we have the further

decline of some manufacturing sectors (e.g. shipbuilding) and the need to reduce labour in others (e.g. motor cars, steel, coal, railways). The effect on employment of rapid technological change (in particular the widespread use of microprocessors) is uncertain: everything depends on whether new opportunities are grasped. If unemployment were to increase sharply, the present equable acceptance might break down, especially in the Inner Cities, with large numbers of young coloureds unable to find jobs.

External Constraints

World Trade

8. There are major external constraints which the Government can do little to ease. First, the rate of growth of world trade. By the standards of the late 1960s and early 1970s, the prospects are not encouraging. Over the next five years, world trade may grow rather faster than in the depths of the recent depression but the situation is fragile. The outlook has been weakened by the Iranian revolution and the possibility that other OPEC suppliers may become more cautious in raising their oil output and exports.

9. The growth in world trade depends largely on the internal growth rates of the major industrial countries. There is every sign that output will remain well below productive potential. Oil supplies apart, expansion in key economies is constrained by fears of increased inflation, balance of payments problems, or both. The pace is set by the strong, surplus countries who are reluctant to raise their growth rates for fear of inflation. Countries in deficit cannot reflate or they will make the distribution of surpluses and deficits still more uneven and place their own currencies in jeopardy. The centre of the world economy, the United States, is inhibited through fears both of inflation and the possible effects on the dollar. These problems will be for discussion at the Tokyo Summit, but an early solution is not in sight.

Protection

10. The United Kingdom cannot escape by opting for widespread protection. Other countries do not see us as a 'special case' and would certainly retaliate. The industrialised world has agreed that there is a place for selective tariffs and quotas (particularly to smooth the run-down of declining industries) and for some use of non-tariff barriers (as in public sector purchasing). But a surge towards protectionism by the trading world generally or by the United Kingdom alone, would not be at all in our interests. It would mean reduced markets for our exports, the risk that the inefficient parts of British industry would relax behind the new tariff wall and the certainty that our standard of living would drop as the range of imports available was reduced.

Exchange Rate

11. The United Kingdom is now exposed to the 'Dutch disease' - the tendency for oil and gas revenues to raise the exchange rate and so, in the short term at least, to lower competitiveness. The Government's commitment to a strict monetary and fiscal stance will reinforce the strength of sterling. If our inflation rate remains higher than that of our competitors, the exchange rate must eventually weaken - but not necessarily enough to restore competitiveness. The extra oil revenues will play a major part in determining market expectations and the prospects are for world oil prices to rise quite markedly.

12. There are, of course, compensations. A higher exchange rate would lower inflationary pressures; and greater overseas confidence in sterling would make it easier to refinance part of the large volume of overseas debt which falls due for payment in the next few years. But, on balance, there is probably a case for trying to reduce the upward pressure on sterling by leaving more of the oil in the ground (depletion

policy); by investing more abroad (exchange control policy); and by reviewing the case for the the United Kingdom joining the European Monetary System as a third way of helping prevent sterling drifting too high.

Balance of Payments

13. Paradoxically, while North Sea oil and gas (plus strict monetary and fiscal policies) are liable to keep sterling high, the balance of payments remains fundamentally weak and a real constraint on faster growth. This is because of our very high (and rising) propensity to import, especially to import manufactures. Until we have improved the attractiveness and competitiveness of British goods, reflation flows disproportionately into imports (creating jobs abroad instead of at home) and pushes the balance of payments into deficit. A serious balance of payments deficit would reduce the level of sterling and solve, temporarily, the 'Dutch disease' problem. But it is impossible to 'fine tune' the extent to which sterling would weaken and a plunging exchange rate would mean that the brakes have to be put on hard. Back to the familiar stop/go cycle which benefits no one - certainly not British industry.

The EEC

14. The Government's political commitment to the EEC is firm and more fundamental than any economic assessment. However, in financial contributions, the United Kingdom is a heavy net contributor rather than a beneficiary. It must be a prime aim to reduce this net contribution (by adjusting the CAP and the EEC budgetary system). A Government which is known to be fully committed to the European ideal may find it easier to influence Community rules in the United Kingdom's interest.

Opportunities

15. We have listed above the well known problems and constraints which face the United Kingdom economy. They are formidable. Yet the next decade remains a period of real opportunity. This is in part because of

North Sea oil and gas (though that brings its difficulties) and in part because the British people have, belatedly, come to recognise how far we have slid and what is needed to begin to restore the position. Ten years ago that was not the case - the view was that full employment and ever-expanding social services could and should be provided by increased public expenditure. That has now changed; new opportunities present themselves and they must be grasped.

Incentives

16. Central to the Government's strategy is a substantial reduction in personal direct taxation. It is now widely believed that present income tax rates act as an important disincentive to effort and there is a lot of (anecdotal) evidence to support that belief. Even the previous Administration accepted that United Kingdom tax rates, particularly at the upper and lower ends of the income spectrum, were too high. There are direct disincentive effects, a distortion of the systems for rewarding skills and effort (special perks and benefits in kind), and evidence of an insidious growth in the 'hidden economy'.

17. The first priority must be at least to index for inflation. (Statutory indexation at present applies only to the basic tax threshold.) After that, priorities should be -

(a) lift the tax threshold in real terms (to reduce the overlap with social security benefits, to improve the advantages of working over not working, and to ease the 'poverty trap';

(b) reduce the burden of the higher rates of tax;

(c) increase the threshold (or reduce the rates) of investment income surcharge, particularly for the elderly and retired.

18. (b) and (c) are not expensive, but should be related to some progress on (a). On (b), the CPRS view is that pulling out the higher rate bands (so that they apply to real levels of income comparable to those of five years ago) merits higher priority than reduction of the top rates. But there is a case on psychological grounds for an early reduction in the top rate.

19. Reductions in direct taxation have to be paid for. In the longer term, this may come from increased growth. But in the next year or two, assuming restraints on money supply and the PSBR, it will be necessary both to increase indirect taxation (and nationalised industry prices) and reduce public expenditure. Counter-inflation policy is a constraint on raising indirect taxation and nationalised industry prices and large savings in public expenditure take time to achieve (see paragraphs 22-28 below). This points to the Government putting before the public a medium term tax strategy explaining where they aim to get to in two or three years.

Industrial Performance

20. The Government's general stance is to create an overall economic climate which is conducive to greater industrial profitability and higher investment; and to remove barriers to industrial expansion. Its policies on fiscal incentives, the reduction of inflation, labour relations, employment protection legislation and unfair trade practices are all designed to contribute to these objectives.

(a) Fiscal incentives. The tax burden on manufacturing industry generally is not a problem at present, given generous investment reliefs and relief for inflationary pressures through stock relief. But the position of small firms will continue to require special attention. It has been improved recently, but there may still be scope for additional concessions to help small firms and those who invest in them.

(b) Industrial Financing. Over the past few years, lack of finance has not been a constraint on industrial investment, except perhaps for new small firms based on technological innovation. But this has been against the background of low growth. Industrial investment needs to return to comparable international levels, and to make good the years of low investment. This could put a much greater strain on the supply of available funds. There is room for action, both by the Government and the City (including the Clearing Banks) to encourage investment in industry. There is also a case for a more active involvement by the investing institutions in the companies to which the savings of their policy holders and pensioners are committed. A greater exchange of views and information between Government and the City institutions is desirable, given that they have so many objectives in common.

(c) NEDO and the Industrial Strategy. The work of NEDO's sector working parties is recognised by industry (CBI and unions alike) to have achieved some useful results. The value should grow in the years ahead. It is proving possible to assess past industrial performance and weaknesses; to share information on markets, export and import substitution opportunities; and to provide a channel of communication to Government on an industry basis with the joint involvement of employers and unions. It would seem right to build on this machinery.

(d) Support for Industry. Ministers should consider specific cases on their merits. Cost-effectiveness is important and market disciplines should never be ignored. But the implications for employment and the balance of payments of failure to provide transitional support in some cases could be very serious (e.g. ship-building). Similarly, in reviewing general and selective programmes of investment incentives Ministers will wish to take into account industry's repeated pleas for stability of policy.

Public Sector

Nationalised Industries

21. Nationalised industries are, in principle, expected to adopt a commercial approach but, as a group, are a long way from this at present. Economic pricing should be pursued wherever possible despite short-term effects on the price level. Derogations from this are damaging to the morale of the industry and store up problems for the future. There are, in practice, limitations on this policy since the public sector embraces many of the industries which are in trouble throughout Europe. Change is necessary, but there are real social constraints on its speed and direction. It is desirable, wherever practicable, that the costs incurred by such constraints are clearly identified (e.g. through the negotiation of a separate 'social responsibility' grant as with the railways and airways). Social constraints on the speed of adjustment should not be allowed to inhibit adequate investment or necessary technological change in those parts of the industry which are running efficiently.

Public Expenditure

22. Present plans, which were based on the assumption of a higher growth of GDP than now seems likely, provide for total public expenditure programmes to grow by about 2 per cent a year in volume terms over the next four years.

23. Substantial expenditure savings will be required to meet the Government's commitments on personal taxation and the present year's PSBR. (Most forecasts put the latter at about £10 bn. for 1979/80.) The extent of these savings will depend on the scale of sales of public assets (e.g. British Petroleum shares) which is decided upon.

24. Some savings were identified in the Election Manifesto (e.g. the Community Land Act, local authority direct labour, and an attack on waste).

But these, and other, savings will take time to come through. Capital expenditure is already largely committed for the current financial year. Staff cuts will clearly be needed - in local government as well as central. But in the short run redundancies can involve heavy offsetting costs. On transfer payments there are potentially large savings, but some of these would require contentious legislation (e.g. indexing benefits for prices alone rather than for the better of prices or earnings).

25. To achieve large public expenditure savings, the Government will need to consider urgently both a rigorous application of cash limits and policy changes on individual programmes.

Cash Limits

26. The present cash limits for 1979/80 allow for retail prices to rise by only $8\frac{1}{2}$ per cent in the year to the fourth quarter of 1979; and for pay to be in accordance with the guideline of 5 per cent plus £3.50p. underpinning. On reasonable assumptions about inflation and public sector pay settlements, these arrangements could imply a volume squeeze on public expenditure of about £500 m. in 1979/80. The Government will wish to consider whether it can go further than this. Cash limits are a good way of persuading spending authorities to test the cost-effectiveness of their programmes, and their use of staff. But they have their limitations particularly where staff cuts would be unacceptable (e.g. defence or police) or difficult to achieve without prior structural change (e.g. revenue and social security administration).

Specific policy issues

27. The following are among the major policy issues which will need urgent attention. (The list is not exhaustive.)

(a) Housing investment. There is still scope for switching from house construction to renovation and improvement.

(b) Economic pricing for nationalised industries. Further moves towards full economic pricing could substantially increase the revenue of these industries (particularly gas, electricity and telecommunications) and so reduce their net borrowing. Regard would need to be paid to economic effects, e.g. on exports, and on subsidy practices in competitor countries.

(c) Uprating of social security benefits. Long term benefits might be indexed to prices only in line with the present arrangements for basic rate personal tax allowances. This could be combined with similar indexation for higher rate thresholds and specific duties.

(d) Housing subsidies. The present system for subsidising housing is expensive, capricious and wasteful. The gradual elimination of housing subsidies could release substantial resources for reductions in personal taxation. The balance between the public sector (subsidised rents) and the private sector (tax relief for mortgages) would need to take account of the Government's policies for encouraging more home ownership.

28. Three general points:

(a) Expenditure commitments. The Government is committed to increased expenditure on defence, law and order and the health service. The need to ensure that resources are used effectively should apply to these services as to others. Some increases are built into existing plans. It will be important to consider the extent to which further expenditure is really required.

(b) Local authority expenditure. Control in this area raises the issue of relations between central and local Government. One approach would be to give local authorities greater discretion on the direction of their spending, but within tighter overall limits.

(c) Policy review. The machinery for the systematic and radical review of existing programmes, as opposed to proposals for incremental change, needs attention. Also the question of what other machinery, or systems, are required for eliminating waste.

Employment measures/regional policy

29. Employment measures. The present package is aimed at what was thought to be a particularly severe but short to medium-term recession. But cyclical unemployment has been overlaid by a growing 'structural' element. When vacancies increase this is having relatively little effect on depressed regions or on the numbers of unskilled adult males who are unemployed. It tends to benefit already prosperous regions and to draw new workers into the labour force. A review should identify the most intractable structural problems and, subject to EEC constraints, should channel training and incentives more selectively towards them.

Regional Policy. Over the past decades successive regional policies have been of doubtful value. The depressed regions of the United Kingdom are, if anything, becoming relatively less attractive to investors while their problems intensify as a result of shifts in the industrial structure of the economy. But the high value placed by industry on continuity in the structure of incentives, provide strong arguments for leaving regional policy relatively undisturbed.

Energy

30. Britain is fortunate among OECD countries in being virtually self-sufficient in energy. We shall for a time be a net exporter. But, despite this, our interests as a major trading nation coincide much more closely with the OECD than with OPEC countries. We have more interest in the expansion of world trade than in a high price for oil which harms world trade. Our hope must be that OPEC producers, particularly Saudi Arabia, will use their power over the price and supply of oil moderately and not hold back world economic activity or spur inflation. But this hope may not be fulfilled.

31. Investment in the energy industries has long lead times. Important decisions will soon need to be taken which will significantly affect the balance

of our energy supplies in the 1980s and 1990s. The main areas for review are -

(a) North Sea oil. Decisions need to be reached on the rate at which we choose to deplete our North Sea oil and gas resources. National priorities will not always coincide with the wishes of the oil companies. The Government is committed to an early review of the future role of BNOC. It will also need to take early decisions on North Sea oil taxation. This is important because it can both increase the scope for cuts in personal direct taxation, and maximise the balance of payments advantages from our oil.

(b) Coal industry. A healthy coal industry is vital to the long term security of our energy supplies. But the immediate financial position of the National Coal Board presents a depressing picture - a forecast loss in 1979/80 of some £300 million despite the benefit of recent oil price increases and the decision to increase power station coal-burn. A review of the long term strategy for coal is urgently needed.

(c) Coalburn and coalstocks. Our International Energy Authority commitment to a 5 per cent reduction in oil use will require the use of more coal at power stations. Ministers will wish to assure themselves that this will not reduce coal stocks to levels which might leave the Government vulnerable to threats of industrial disruptions (particularly next winter).

(d) Nuclear programme. Given the likely supply of coal, oil and gas, commitment to a nuclear programme is inescapable. But extremely delicate handling is required if this country is to avoid the opposition to nuclear power, which has so much embarrassed others. The Government will have to decide whether to proceed with the Pressurised Water Reactor, for which design work has already been authorised; the extent and timing of our commitment to the Fast Reactor; and the most suitable forum for public discussion of these sensitive issues.

(e) Nuclear industry. The nuclear industry is disorganised and demoralised through continuing uncertainty about its future. Its role and its relationship with the generating boards, and indeed the structure of the electricity industry as a whole, needs to be resolved as soon as possible.

Pay Bargaining and labour relations

32. Pay bargaining in the private sector is to be left to the companies and workers concerned, with the understanding that the Government will not rescue companies who run into trouble. This policy is to be buttressed by 'more open and informed discussion of the Government's economic objectives'. The 'national assessment' this spring was largely ineffectual. But it would be possible to build on the general concept, which was welcomed both by the CBI and the TUC. The aim of such a national forum would be to reach a broad consensus about the size of the pay increases which the country can afford, without endorsing a 'pay norm'. Discussions could perhaps be based, as they are in Germany, on an input of statistics and forecasts from one or more of the main independent economic institutes.

33. It will be worth trying to build on the TUC's earlier commitment to the target of an inflation reate of 5 per cent by 1982 (in practice they will find it difficult to disown it), and to develop the implication of this target for wage increases, possibly by adopting a three-year rolling approach. (This would, for example, make it clear that for one year at least earnings would need to grow more slowly than prices.)

34. In principle much the same considerations apply to the public trading sector. But in practice the Government cannot help being more directly involved. It will need to apply the additional discipline of cash limits on the sector's financing requirements. And it will want to prevent nationalised industries from financing large pay settlements from monopoly price increases.

35. In the rest of the public sector the Government, as paymaster, will have to take a view about the appropriate level of wage settlements. The following points are relevant to the approach to public sector pay in the medium term -

(a) It is not practicable for public and private sector pay to diverge for any length of time. All experience suggests that if one sector is deliberately held back problems are compounded elsewhere. Large catching-up awards are then taken as a reference point by other groups.

(b) This points to the continuing need for 'comparability' studies by some such body as the recently established Standing Commission. It is important that any such reviews should be conducted on the basis of genuine job-for-job comparisons with full account being taken of conditions of service other than pay and the demand and supply position for those skills in the labour market. Above, all, the reviewing body must not be allowed to identify itself with the cause of particular 'client' groups. This may be better achieved through a single review body with some continuity, than through a series of ad hoc reviews.

(c) There is some merit in seeking to synchronise public sector settlements towards the end of the pay round, when the 'going rate' for the private sector is established.

36. While this offers an approach to public sector pay in the medium term, the short-term problems are acute, largely because the large catching-up awards which are likely to come out of the present round of comparability studies will overstrain existing cash limits.

Summary of some main points

37. (a) There is a general consensus that the main problems facing the United Kingdom over the next 4/5 years are inflation, industrial performance, and unemployment, in that order.

(b) We must expect a relatively slow growth in world trade. Upward pressure on sterling could worsen our industrial competitiveness, though it also has compensations.

(c) The problem in the short term is to reconcile objectives on restoration of incentives through tax cuts, and reductions in the PSBR. A medium-term tax strategy is required.

(d) In the private sector of industry greater profitability is essential. Government should aim to foster a climate favourable to technological change, support this through fiscal incentives, and remove obstacles to adequate financing, particularly for smaller, innovative firms. There is scope for building on the existing NEDO tripartite machinery.

(e) In the public sector, economic pricing should be pursued, and 'social' costs separately identified. There is a limited role, albeit in a recast form, for a body like the National Enterprise Board.

(f) Public expenditure cuts on the scale required will require urgent consideration of how much can be achieved through cash limits, and how much will need to come from policy changes in individual programmes.

(g) In energy, important decisions are needed on North Sea oil (depletion, taxation and BNOC), the coal industry (particularly its uneconomic parts), the nuclear programme and industry.

(h) Pay bargaining and labour relations is a critical area. A national 'forum' could help to encourage consensus and responsible bargaining in the private sector and public trading sector. For the non-trading public sector, 'comparability' in some form still seems the best approach.

Conclusion

38. It will take time to win the battle against inflation, to reduce public expenditure, to lower direct taxation, to stimulate investment and improve competitiveness. During that time, all Government decisions should be related to the central strategy and the Government will need to watch carefully that it does not drift off course. It will need to keep the ultimate goal firmly in front of itself and the public and ensure that progress towards that goal is continuously monitored.

4 May 1979

SOME ECONOMIC INDICATORS FOR SEVEN MAJOR OECD COUNTRIES

	Real GDP in 1977 (1953 = 100)	Productivity Growth (average annual % increase) (a)		Consumer Prices (average annual% increase)		Unemployment (% of labour force) (b)	
		1964-73	1974-78	1964-73	1974-78	1970	1978
UK	184	3.2	0.8	5.8	16.1	2.6	5.8
Canada	304	2.4	0.6	4.1	8.8	5.7	8.4
France	314	4.5	3.0	4.8	10.0	1.7	6.2
Germany	314	4.7	3.2	3.8	4.2	0.7	4.4
Italy	301	5.4	1.1	4.4	16.0	3.2[c]	7.2[c]
Japan	717	8.9	3.4	6.3	8.2	1.2	2.2
USA	212	1.8	0.1	4.0	7.3	4.9	6.0

Source: OECD

Notes: (a) Average annual percentage growth rates of GNP/GDP per employee.

(b) The figures are not comparable between countries owing to differences in definition.

(c) Italian unemployment rates for 1970 and for 1978 are not comparable owing to changes in definition.

CABINET OFFICE

Central Policy Review Staff

With the compliments of

Sir Kenneth Berrill KCB

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Telephone 01-233 7765

Qa 04090

To: MR LE CHEMINANT
From: SIR KENNETH BERRILL

cc Mr Stowe
Mr Vile
Mr Mountfield

1. Attached is a draft of the paper which the CPRS would think of putting to an incoming Conservative Prime Minister. I should be very grateful for any comments on the text and also your views on how this could best be offered. It could be put to an incoming Conservative Prime Minister on the first day or held up for a bit. It could be offered as a paper purely for the Prime Minister alone or with a suggestion that it might be circulated generally to the Cabinet. The inclination in the CPRS is towards suggesting distribution to the Cabinet.

2. The draft for an incoming Labour Prime Minister is necessarily different. Not only is their ethos different but they know the details of the UK's position only too well. The question is whether, before buckling down to more years of Government, they take time to stand back and look in a strategic way at some of the main difficulties they have struggled with in years past. One problem is that in the course of the Election campaign they have taken up positions on these issues which make it difficult to engage immediately in an objective strategic discussion.

3. Given this, it may well be that a returning Labour Prime Minister might not wish to engage his colleagues in such strategic discussion but it is worth putting the question to him. A draft of this is attached and again we would be grateful for any comments.

KB

1 May 1979

Atts

The Economy of the United Kingdom - Problems, Constraints and Opportunities

Note by the Central Policy Review Staff

Introduction

1. This paper reviews in brief the main problems, constraints and opportunities facing the economy of the United Kingdom in the medium term. It concentrates almost exclusively on domestic economic issues; foreign policy, defence and constitutional matters are raised incidentally, if at all. These clearly include areas of great importance - East/West relations, the North /South dialogue; Southern Africa and, more at home, Northern Ireland, Scottish Government, the problems of law and order. The emphasis of the paper is on the medium term (4/5 years) but the handling of shorter term issues may prove crucial for the attainment of medium term objectives.

Problems

2. The main problems of the United Kingdom economy are deep-seated and widely recognised. As the opening paragraph of the Government's manifesto stressed, we are rich in natural and human resources. Indeed, other industrial countries faced with the energy problems of the post-1973 world, envy our self-sufficiency in North Sea Oil and gas. But our industrial performance has been so poor

for so long that in Western industrial terms we have now become a low productivity cheap labour country - the third poorest in the EEC (Annex A gives some indicators for major OECD countries).

3. The main economic problems of the United Kingdom remain the same as they were pre-1974, only more so: inflation, industrial performance, unemployment (in that order). The Government's strategy is to break into the vicious circle by reviving personal initiative, reviving investment, increasing productivity and hence achieving greater growth and lower unemployment. Reduced burden of public expenditure and reduced burden of personal taxation are prerequisites. These, combined with severe disciplines on public sector borrowing and money supply increases are/ to substitute improved growth and competitiveness for "stagflation" and relative decline. None of this can be instantaneous and during the first year or two, while inflation is wrung out, the disciplines may be painful in terms of the effect on growth and unemployment. It may well not be until the second half of this Parliament that the benefits of the virtuous circle will begin to accrue in terms of rising real GNP and room for manoeuvre.

Inflation, Industrial Performance, Unemployment

4. But the Government is fortunate in having a national consensus that the order of priorities is inflation, industrial performance, unemployment. There is general agreement that high rates of inflation

harm us as a trading nation, discourage investment, slow down growth, increase unemployment. There is a widespread fear of the social dissatisfaction, unfairness and unrest which inflation brings.

5. There is also growing, if belated, understanding of where Britain has slid to as a trading nation and how our living standards depend, long term, on the productivity of our manufacturing and service sectors.

6. The United Kingdom growth rate has been considerably below that of our major competitors. This has not been caused by the performance of our service industries which have generally performed as well as their counterparts in other countries. The cause lies rather in British manufacturing industry both in the private and the public sector. There are, of course, many profitable, highly productive, high wage and modern British companies. But too often the story is one of low profits, low productivity, bad management/labour relations, outdated machinery, low investment and of products that fail to compete in quality, reliability, delivery time, and after-sales service. This is not only true of declining industries such as steel and shipbuilding, which are facing problems throughout the Western world, but of industries whose products are still in demand, e.g. cars and the mechanical and electrical engineering industries generally, and even some of the industries of the future. If profits were adjusted to take full account of inflation, the seriousness of the situation would be even more apparent.

7. By postwar standards, unemployment is exceptionally high. At present it is accepted with surprising equanimity, yet there are problems ahead if we fail to increase the rate of provision of new jobs. In common with many other Western industrial countries, our labour supply is expected to increase (by about 1 million over the next five years). In part this is due to the bulge of school leavers and the small numbers due to retire over the period; in part it is due to the strong trend for more married women to go out to work. Against this growth in the labour force we have the further decline of some manufacturing sectors (e.g. shipbuilding) and the need to reduce labour in others (e.g. motor cars, steel, coal, railways). Rapid technological change (in particular the widespread use of microprocessors) will reduce the demand for labour in its immediate impact in some areas, while creating jobs by its repercussive effects elsewhere. The balance is uncertain; everything depends on whether the opportunities are grasped. But if unemployment were to increase very markedly, the present equable acceptance might break down, especially in the Inner Cities, with large numbers of young coloureds unable to find jobs.

External Constraints

World Trade

8. The Government's attack on inflation, industrial efficiency and unemployment is subject to major external constraints which it can do little to remove. The first of these is the rate of growth of world

trade. By the standards of the 1960s and early 1970s, the prospects here are not encouraging. World trade may grow rather faster 1980-85 than in the depths of the recent depression but the situation is fragile. It has been weakened by the Iranian revolution and the possibility that other OPEC suppliers may henceforth be more cautious in raising their oil output and exports. A world in which oil was in short supply and increasingly expensive would be less likely to achieve good growth in output and trade.

9. The growth in world trade depends to a large extent on the internal growth rates of the major industrial countries. There is every sign that output will remain well below productive potential because, oil supplies apart, expansion in key economies is constrained by fears of increased inflation, by balance of payments problems or by both. The pace is set by the strong, surplus countries such as Germany and Japan who are reluctant to raise their growth rates for fear of inflation. Countries in deficit cannot reflate or they will make the distribution of surpluses and deficits still more uneven and place their own currencies in jeopardy. The centre of the world economy, the United States (a major trading nation and the dollar still the main reserve currency) is inhibited because of fears both of inflation and the possible effects on the dollar.

Protection

10. The United Kingdom cannot ease the constraints imposed by the slow growth in world trade by opting for protection. The industrialised world has agreed that there is a place for selective tariff and quotas (particularly to smooth the rundown of declining industries) and for some use of non-tariff barriers (as in public sector purchasing). But a surge towards protectionism by the trading world generally or by the United Kingdom alone, would not be at all in our interests. It would mean reduced markets for our exports, the risk that the inefficient parts of British industry would relax behind the new tariff wall and the certainty that our standard of living would drop as the range of imports available was reduced.

Exchange Rate

11. The exchange rate for sterling is an important determinant of the competitiveness of British industry. The United Kingdom is now exposed to the 'Dutch disease' - the tendency for oil and gas revenues to raise the exchange rate and so, in the short term at least, to lower competitiveness. The Government's commitment to a strict monetary and fiscal stance will reinforce this problem. If the United Kingdom's inflation rate remains higher than that of its competitors the exchange rate must eventually weaken - but probably not enough to restore competitiveness because, for the decade ahead at least, the extra oil revenues will play a major part in determining market expectations and the prospects are for world oil prices to rise quite markedly.

12. There are, of course, compensations. The higher exchange rate will lower the inflationary pressures and greater overseas confidence in sterling would make it easier to refinance part of the large volume of overseas debt which falls due for payment in the next few years. But, in general, the likely strength of sterling provides a case for trying to reduce the upward pressure by leaving more of the oil in the ground (depletion policy), by investing more abroad (exchange control policy), and by reviewing the case for the United Kingdom joining the EMS as one way of helping prevent sterling drifting too high.

Balance of Payments

13. Paradoxically, while North Sea oil and gas are liable to keep sterling at an undesirably high level, the balance of payments remains fundamentally weak and a very real constraint on faster growth. This is because of our very high (and rising) propensity to import, especially to import manufactures. Until we have improved the attractiveness and competitiveness of British goods, any reflation will flow disproportionately into demand for imports (creating jobs abroad instead of at home) and push the balance of payments into deficit. Reflation leading to a serious balance of payments deficit could always reduce the level of sterling and solve, temporarily, the 'Dutch disease' problem. But it is impossible to 'fine tune' the extent to which sterling would weaken and a plunging exchange rate means that the brakes have to be put on hard the familiar stop/go cycle which benefits no one - certainly not British industry.

The EEC

14. The Government's political commitment to the EEC is firm and more fundamental than any economic assessment. However, membership of the EEC does impose limitations on United Kingdom freedom of manoeuvre in many economic fields and in financial contributions the United Kingdom is a heavy net contributor rather than a beneficiary. It must be a prime aim to reduce this net contribution (by adjusting the CAP and the EEC budgetary system) and a Government which is known to be fully committed to the European ideal may find it easier to influence community rules in the United Kingdom's interest. There is certainly no time to lose, since in the longer term enlargement of the EEC will turn us from a poor to a richer member of the community.

Opportunities

15. The paragraphs above have listed the well known problems and constraints which face the United Kingdom economy. They are indeed formidable. Yet the next decade remains a period of real opportunity in part because of North Sea oil and gas (though that brings its difficulties) and in part because the British people have, belatedly, come to recognise how far we have slid and what is needed to begin to restore the position. Ten years ago that was not the case - the view was that full employment and ever-expanding social services could and should be provided by increased public expenditure. That has now changed; new opportunities present themselves and they must be grasped.

Incentives

16. Central to the Government's strategy is a substantial reduction in personal direct taxation. Although it is difficult to prove scientifically, it is now widely believed that present income tax rates act as an important disincentive to effort and there is a lot of (anecdotal) evidence to support that belief. The previous Administration accepted that United Kingdom tax rates, particularly at the upper and lower ends of the income spectrum, have had a damaging effect on economic performance. Apart from direct disincentive effects, there is distortion of the systems for rewarding skills and effort (special perks and benefits in kind), and evidence of an insidious growth in the 'hidden economy' (recently put by the Inland Revenue as possibly equivalent to $7\frac{1}{2}$ per cent of GDP).

17. The first priority must be to ensure that the real burden of direct tax is not increased by failure to adjust for inflation. (Statutory indexation at present applies only to be the basic tax threshold.) Thereafter the priorities in terms of improving incentives in our view should be -

(a) to lift the tax threshold in real terms, in order to reduce overlap with social security and supplementary benefit levels, to improve the comparative position of those in work vis-a-vis those out of work, and mitigate 'poverty trap' effects for the low paid in work;

(b) to reduce the higher rate burden, particularly in the upper ranges (senior management income levels) where compression over the last five years has been most severe; and

(c) to increase the threshold (or reduce the rates) of investment income surcharge, particularly for the elderly and retired.

18. Progress on (b) and (c) above, although much less expensive, should be related to some progress on (a) in order to secure an acceptable distributional spread. On (b), the CPRS view is that pulling out the higher rate bands (so that they apply to comparable real levels of income as five years ago) in general merits higher priority than reduction of the top rates. But there is also a case on psychological grounds for an early reduction in the top rate.

19. Reductions in direct taxation have to be paid for. In the longer term, this may come from increased growth. But in the next year or two, assuming restraints on money supply and the PSBR, the choice lies between increased indirect taxation and reduced public expenditure. There is scope for both but counter-inflation policy is some constraint on the first, and the second (without severe disruption) takes time to achieve (see paragraphs 23-29 below). All this points to a phased medium-term tax strategy.

<u>Industrial Performance</u>

20. The Government's general stance is to create an overall economic climate which is conducive to greater industrial profitability and higher

investment, and to remove barriers to industrial expansion. Its policies on fiscal incentives, the reduction of inflation, labour relations, employment protection legislation and unfair trade practices are all designed to contribute to these objectives.

(a) Fiscal incentives. The tax burden on manufacturing industry generally is not a problem at present, given generous investment reliefs and relief for inflationary pressures through stock relief. But the position of small firms will continue to require special attention. It has been improved recently, but there may be scope for additional measures.

(b) Technology. The United Kingdom is in many sectors a long way behind our competitors in the industrial application of up-to-date technology. There is a need to foster a climate favourable to technological change, whether this involves imitating the best practice abroad or genuine innovation. The former is in many areas more important than the latter.

(c) Industrial Financing. The evidence to the Wilson Committee indicates clearly that over the past few years lack of finance has not been a constraint on industrial investment, with the probable exception of new small firms based on technological innovation. However, for the Government's policies to be successful, not only must industrial investment return to comparable international levels, but it must also make good for years of low investment and outdated equipment. This could put a much greater strain on the supply of available funds. There is room for further action, both by the Government and the City (including the Clearing Banks) to encourage investment in industry and a case for a more active involvement by the investing institutions in the companies to which the savings of their policy holders and pensioners are committed. The banking/ property crisis of 1973/74 points to the need for a greater exchange of views and information between Government and the City institutions, given that they have so many objectives in common.

(d) <u>NEDO and the Industrial Strategy.</u> The work of NEDO's sector working parties is recognised by industry (including the CBI) and unions alike to have already achieved useful results. The value should grow in the years ahead. The assessment of past performance and weaknesses, the sharing of information on markets, export and import substitution opportunities and the channel of communication to Government on an industry basis with the joint involvement of employers and unions are proving worthwhile. The CPRS believes it would be right to build on this machinery.

(e) <u>Support for Industry</u>. Ministers should consider specific cases on their merits. Market disciplines will often be required, but the implications for employment and regional policy or the balance of payments of failure to provide at least transitional support in some cases could be very serious (e.g. shipbuilding). Similarly, in reviewing general and selective programmes of investment incentives Ministers will wish to take into account industry's repeated pleas for continuity and stability of policy in this area.

Public Sector

(a) Nationalised Industries

21. Nationalised industries should be given every encouragement to maintain a commercial approach. Wherever possible, economic pricing should be pursued despite any short-term effects on counter-inflation policies. Any derogation from this stores up problems for the future, and is extremely damaging to the morale of the industry. But there are, in practice, limits to the rigidity with which this policy can be pursued, for the public sector now embraces many of the more traditional industries which are in trouble throughout Europe. Change is necessary, but there are real social constraints on its speed and direction. It is desirable, wherever practicable, that the costs incurred by such constraints are clearly identified (e.g. through the negotiation of a separate "social responsibility" grant as with the railways and airways), and that constraints do not inhibit adequate investment or necessary technological change in those parts of the industry which are running efficiently.

(b) The National Enterprise Board

22. Whether or not the NEB is abolished as such, it seems inevitable that some similar institutional arrangement will be required. This is

partly because it will not be possible to complete the sale of all the NEB"s shareholdings for many years. There is also the question of industrial financing referred to in paragraph 20(c) above, where a body like the NEB can play the intermediary role which may on occasion be required.

Public Expenditure

23. Present plans provide for total public expenditure programmes (currently £65bn.) to grow by about 2 per cent in volume terms over the next four years. Three-quarters of the total is made up of pensions and other benefits (£16bn.) and education, health, environmental services (including housing) and defence (£7-9bn. each).

24. Given the likely limits on increases in indirect taxation, substantial expenditure savings may be required to meet the Government's commitments on personal taxation and the present year's PSBR. (Most forecasts put the latter at about £10bn. for 1979/80.) The extent of these savings will depend on the scale of sales of public assets (e.g. BP shares) which is decided upon.

25. Some savings were identified in broad terms in the Election Manifesto (e.g. the Community Land Act, local authority direct labour, and an attack on waste). But these, and other, savings will take time to come through. Much capital expenditure is already committeed for the current financial year and there are dangers in relying too much on cutting capital expenditure when the long-term objective is to improve the efficiency of public services as well as to check their growth. Staff cuts will be needed. But not all

of these are wholly within the control of central Government.and redundancies can involve heavy offsetting costs in the short run. There are potentially large savings in transfer payments, but some of these will require fresh and contentious legislation (e.g. indexing benefits for prices alone rather than for the better of prices or earnings).

26. The Government will need to consider urgently both a rigorous application of cash limits and policy changes on individual programmes.

Cash limits

27. The present cash limits for 1979/80 allow for retail prices to rise by only $8\frac{1}{2}$ per cent in the year to the fourth quarter of 1979; and for pay to be in accordance with the guideline of 5 per cent plus £3.50p. underpinning. On reasonable assumptions about inflation and public sector pay settlements, these arrangements could imply a volume squeeze on public expenditure of over £500 m. in 1979/80. The Government will wish to consider whether it can go further than this. Cash limits are a good way of persuading spending authorities to test the cost-effectiveness of their programmes. They are probably the only way of achieving substantial staff savings. They may also be the only effective way of controlling total local authority expenditure. They are, therefore, a necessary technique for enforcing discipline and early restraint. But they have their limitations particularly where staff cuts would be unacceptable (e.g. defence or police) or difficult to achieve without prior structural change (e.g. revenue and social security administration).

Specific policy issues

28. If over the next few years substantial public sector savings are to be achieved the following are among the major issues which will need urgent attention. (The list is not exhaustive.)

(a) Housing investment. There is still scope for switching from house construction to renovation and improvement.

(b) Economic pricing for nationalised industries. Further moves towards full economic pricing could substantially increase the revenue of these industries (particularly gas and electricity) and so their ability to finance from internal resources. Regard would need to be paid to economic effects, e.g. on exports, and on subsidy practices in competitor countries.

(c) Uprating of social security benefits. Long term benefits might be indexed to prices only in line with the present arrangements for basic rate personal tax allowances. This could be combined with similar indexation for higher rate thresholds and specific duties.

(d) Housing subsidies. The present system for subsidising housing is expensive, capricious and wasteful. The gradual elimination of housing subsidies could release substantial resources for reductions in personal taxation. But its acceptability would depend on maintaining a balance between the public sector (higher rents) and the private sector (reduced tax relief for mortgages). It would, therefore, also need to take account of the Govemment's policies for encouraging more home ownership.

(e) Industrial support. The Government will wish to review current policies for both general and selective support for industry, and also for subsidising uneconomic parts of the nationalised industries. But, for reasons outlined in paragraph 20 above, savings in the short run, are likely to be relatively modest.

(f) Regional/employment schemes. These are discussed at paragraph 30 below. The justification for these schemes in their present form needs to be re-examined: again the possibilities for quick expenditure savings are limited.

(g) Local authority expenditure. Control in this area raises the issue of relations between central and local Government. One approach would be to give local authorities greater discretion on the direction of their spending, but within tighter overall limites.

29. There are two further points:

(a) Expenditure commitments. Apart from specific Manifesto commitments for additional expenditure (the Christmas bonus and the abolition of the earnings rule. there are important programmes for which the Government is generally committed to maintaining or increasing current levels of expenditure. This applies particularly to defence, law and order and the health service. The need to ensure that resources are used effectively should nevertheless apply to these services as to others. Some increases are built into existing plans. It will be important to consider the extent to which further expenditure is really required, particularly for additional manpower, rather than concentrating on getting existing resources into the most essential tasks.

(b) Policy review. The machinery for the systematic and radical review of existing programmes, as opposed to proposals for incremental change, needs attention. The PAR system is not working well and alternative arrangements to secure the objectives of PAR need to be developed. There is also the question of what other machinery, or systems, are required for eliminating waste and securing the best possible use of resources in local and central services.

Employment measures/regional policy

30. These programmes need to be reviewed in the public expenditure context in any case. But there are more fundamental questions related to the objectives and effectiveness of these programmes.

(a) Employment measures. The present package was originally put together to meet what was thought to be a particularly severe but short to medium-term recession. But cyclical unemployment has been overlaid by a growing "structural" element - so that even when vacancies increase this has relatively little effect on depressed regions or on the numbers of unskilled adult males who are unemployed. It tends to benefit already prosperous regions and to draw new workers into the labour force. A review should identify the most intractable structural problems and channel training and incentives more selectively towards them.

(b) Regional Policy. Over the past decades successive regional policies have been of uncertain value. The existing programmes are relatively unselective in their coverage and the margins between the incentives offered to different areas are in some cases very small. On the other hand the depressed regions of the United Kingdom are if anything becoming relatively less attractive to investors while their problems intensify as a result of shifts in the industrial structure of the economy. This, and the high value placed by industry on continuity in the structure of incentives, provide strong arguments for leaving the area of regional policy relatively undisturbed.

Energy

31. Britain is fortunate among OECD countries in being virtually self-sufficient in energy. We shall for a time be a net exporter. But despite this our interests as a major trading nation coincide much more closely with the OECD than with OPEC countries. We have more interest in the expansion of world trade than in a high price for oil which harms world trade. Our hope must be that OPEC producers, particularly Saudi Arabia, will use their power moderately and not hold back world economic activity or spur inflation. But this hope may not be fulfilled.

32. Investment in the energy industries is characterised by inherently long lead times. In the United Kingdom, this is exacerbated by problems caused by failure to complete major industrial projects on time. Important decisions will soon need to be taken which will significantly affect the balance of our energy supplies in the 1980s and 1990s. The main areas for review are -

(a) North Sea oil. A continuing high level of activity in the North Sea is clearly important. But decisions need to be reached on the rate at which we choose to deplete our North Sea oil and gas resources, and the manner in which we employ them. National priorities will not always coincide with the wishes of the oil companies. The Government is committed to an early review of the future role of BNOC. It will also need to take early decisions on North Sea oil taxation. This is important because it can both increase the scope for cuts in personal direct taxation, and maximise the balance of payments advantages from our oil.

(b) Coal industry. A healthy coal industry is vital to the long term security of our energy supplies. But the immediate financial position of the NCB presents a depressing picture - a forecast loss in 1979/80 of some £300 million despite the benefit of recent oil price increases and the decision to increase power station coal-burn. A clear programme for the closure of old high cost pits is needed. This will free resources for expanding output from low cost pits and for opening up new, highly productive fields.

(c) Coalburn and coalstocks. Our International Energy Authority commitment to seeking a 5 per cent reduction in oil use will be realisable only through using more coal at power stations. Ministers will wish to assure themselves that this will not reduce coal stocks to levels which might leave the Government vulnerable to threats of industrial disruptions (particularly next winter).

(d) Nuclear programme. Given the likely supply of coal, oil and gas, commitment to a nuclear programme is inescapable. But extremely delicate handling is required if this country is to avoid the opposition to nuclear power, which has so much embarrassed others. The Government will have to decide whether to proceed with the building of the Pressurised Water Reactor, for which design work has already been authorised, the extent and timing of our commitment to the Fast Reactor, and the most suitable forum for public discussion of these sensitive issues.

(e) Nuclear industry. The nuclear industry is disorganised and demoralised through continuing uncertainty about its future. Its role and its relationship with the generating boards, and indeed the structure of the electricity industry as a whole, needs to be resolved as soon as possible.

(f) Conservation. Investment in energy conservation can be at least as effective as investment in energy supply. Government initiatives to stimulate energy savings have tended to rely on publicity campaigns and financial incentives. Fully economic energy pricing is important but it is difficult to identify further effective stimuli unless a greater element of compulsion is introduced. Ministers will need to consider how far this would be acceptable.

Pay Bargaining and labour relations

33. Reducing inflation is the Government's prime objective. The battle against inflation could well turn on the rate at which earnings increase. In the present structure of the labour market, conditions for responsible free collective bargaining do not exist. The Government is committed to proposals for Trade Union reform, which could in time influence the

balance of bargaining power. But it is likely to prove a difficult and thorny path. (On picketing, for example, although there is a case for new legislation, the problem has been at least in part a failure to apply and enforce existing laws.)

34. The Manifesto makes it clear that, within the context of strict monetary and fiscal policies, pay bargaining in the private sector is to be left to the companies and workers concerned, with the understanding that the Government will not rescue those companies who run into trouble as a result of conceding excessive pay settlements. This policy can be buttressed by what the Manifesto calls "more open and informed discussion of the Government's economic objectives". The 'national assessment' this spring was largely ineffectual. But it would be possible to build on the general concept, which was welcomed both by the CBI and the TUC. The aim of such a national forum would be to reach a broad consensus about the size of the pay increases which the country can afford, without endorsing a 'pay norm'. Discussions could perhaps be based, as they are in Germany, on an input of statistics and forecasts from one or more of the main independent economic institutes. It will be worth trying to build on the TUC's earlier commitment to the target of an inflation rate of 5 per cent by 1982, and to develop the implication of this target for wage increases, possibly by adopting a three-year rolling approach. (This would, for example, make it clear that for one year at least earnings would need to grow more slowly than prices.)

35. In principle much the same considerations apply to the public trading sector. But in practice the Government cannot help being more directly involved. It will need to apply the additional discipline of cash limits on the sector's financing requirements. And it will want to prevent the exploitation by a nationalised industry of a monopoly position, though not at the expense of economic pricing.

36. In the rest of the public sector the Government, as paymaster, will have to take a view about the appropriate level of wage settlements. The CPRS suggests that the following points are relevant to the approach to public sector pay in the medium term -

(a) It is not practicable for public and private sector pay to diverge for any length of time. All experience suggests that if one sector is deliberately held back problems are compounded later. Large catching-up awards are then taken as a reference point by other groups.

(b) This points to the continuing need for 'comparability' studies by some such body as the recently established Standing Commission. It is important that any such reviews should be conducted on the basis of genuine job-for job comparisons with full account being taken of other conditions of service as well as pay and the demand and supply position for those skills in the labour market. Above all, the reviewing body must not be allowed to identify itself with the cause of particular 'client' groups. This may be better achieved through a single review body with some continuity, than through a series of ad hoc reviews.

(c) There is some merit in seeking to synchronise public sector settlements towards the end of the pay round, when the 'going rate' for the private sector is established.

37. While this offers an approach to public sector pay in the medium term, the short-term problems are acute, largely because the large catching-up awards which are likely to come out of the present round of comparability studies will overstrain existing cash limits.

Summary of some main points

38. This is not a comprehensive summary but it may be helpful to summarise some of the main points -

(a) The main problems facing the United Kingdom over the next 4/5 years are inflation, industrial performance, and unemployment, in that order.

(b) We must expect a relatively slow growth in world trade. Upward pressure on sterling could worsen our industrial competitiveness.

(c) The problem in the short term is to reconcile objectives on

restoration

of incentives through tax cuts, and reductions in the PSBR. A medium-term tax strategy is required.

(d) In the private sector of industry greater profitability is essential. The existing NEDO tripartite machinery should not be dismantled. Government should aim to foster a climate favourable to technological change, and to support this through fiscal incentives, and removing obstacles to adequate financing, particularly for smaller, innovative firms.

(e) In the public sector, economic pricing should be maintained, and "social" costs separately identified (if not eliminated). There is a limited role, albeit in a recast form, for a body like the NEB.

(f) Public expenditure cuts on the scale required will require urgent consideration of how much can be achieved through cash limits, and how much will need to come from policy changes in individual programmes.

(g) The UK's energy supplies in the 1990s depend on important decisions which, in view of lead times, need to be taken soon. Areas involved are North Sea oil (depletion, taxation and BNOC), the coal industry (particularly its uneconomic parts), the nuclear programme and industry, and conservation.

(h) Pay bargaining and labour relations is a critical area. A national "forum" could help to encourage consensus and responsible bargaining in the private sector and public trading sector. For the non-trading public sector, "comparability" in some form still seems the best criterion.

SOME ECONOMIC INDICATORS FOR SEVEN MAJOR OECD COUNTRIES

	Real GDP in 1977 (1953 = 100)	Productivity Growth (average annual % increase) (a)		Consumer Prices (average annual % increase)		Unemployment (% of labour force) (b)	
		1964-73	1974-78	1964-73	1974-78	1970	1978
UK	184	3.2	0.8	5.8	16.1	2.6	5.8
Canada	304	2.4	0.6	4.1	8.8	5.7	8.4
France	314	4.5	0.6	4.8	10.0	1.7	6.2
Germany	314	4.7	3.0	3.8	4.2	0.7	4.4
Italy	301	5.4	1.1	4.4	16.0	3.2 (c)	7.2 (c)
Japan	717	8.9	3.4	6.3	8.2	1.2	2.2
USA	212	1.8	0.1	4.0	7.3	4.9	6.0

Source: OECD

Notes: (a) Average annual percentage growth rates of GNP/GDP per employee.

(b) The figures are not comparable between countries owing to differences in definition.

(c) Italian unemployment rates for 1970 and for 1978 are not comparable owing to changes in definition.

PROSPECTS AND OPPORTUNITIES

Note by the Central Policy Review Staff

BACKGROUND

The situation facing Ministers is fragile and in some respects discouraging. There have been marked achievements over the last 2-3 years in certain areas - co-operation with the unions; financial and monetary control; a lowering of the inflation rate; the turnround in the balance of payments; and a start in correcting the balance between direct and indirect taxation. But the underlying problems are still unresolved. Inflation is now again tending upwards into double figures. It is well above the rate in some of our main competitors (notably Germany and Japan). Growth of output and productivity since 1974 has been under 1% on average, as compared with over 3% in France, Germany and Japan. Manufacturing has fared worse than the rest of the economy. Unemployment remains very high as compared with the 1960s or the early 1970s. And the deep-seated problems of the British economy - low productivity growth, poor competitiveness, bad labour relations, the incompatability of free collective bargaining and price stability - seem not much nearer solution than 5 years ago.

2. The room for manoeuvre is limited by the state of the world economy. The repeated attempts to concert international reflation have had little success. World trade and output are depressed. The prospect has recently been somewhat worsened by events in Iran and the possibility of continuing oil shortage. With continuing slow world growth and high unemployment rates in many countries, pressures for protectionism will grow . The UK cannot isolate itself from these trends, and it is in addition exposed to the "Dutch disease" - the tendency for North Sea oil flows to hold the exchange rate up and so to worsen competitiveness further. There is a case for selective import controls for certain products or industries. But the UK's long-term interests lie not in protecting industries threatened by international competition, but in improving their ability to compete.

3. Against this background, Ministers may wish to consider, at the beginning of a new term of Government, whether there is scope for some change of emphasis on certain fronts. This paper looks at four vital areas: (i) Pay and Industrial Relations, (ii) Public Expenditure, (iii) Taxation and Incentives, (iv) Measures to mitigate Unemployment.

PAY AND INDUSTRIAL RELATIONS

4. The Government has accepted that it must continue to have a policy for pay in both the private and the public sectors. The Manifesto suggests building on the two innovations of the last round - the Annual Assessment of the nation's economic prospects, and the Standing Commission on Comparability.

5. The Annual Assessment. The experience of the 1978-79 pay round suggests that there are dangers for the Government in declaring a norm which is below general expectations of the rate of inflation. However, it is clear that the successful achievement of the Government's and the TUC's objective of reducing the rate of inflation to 5% by 1982 will require some hard choices. In particular for one year at least earnings must grow more slowly than prices. There is of course always room for argument about the precise determinants of inflation. But unless the Government can develop tripartite discussions in the annual assessment to persuade the Trade Unions that earnings are a prime influence on subsequent levels of inflation, and thus to accept the need for restraint, it is hard to see how the joint objectives of the Government and the TUC can be achieved by voluntary means.

6. The discussions on the annual assessment this year were unavoidably compressed. It is important to consider how they could be more effectively conducted in the next round. Possibilities are:-

(a) There is a strong case for a three-year rolling approach. It is important to focus clearly on the implications of the 1982 target.

(b) An input of statistics and forecasts from the main independent economic institutes (acting separately or in conjunction) could be valuable. (Germany does something on these lines). This would provide neutral ground and help to avoid unrealistic discussion of optimistic scenarios.

(c) The discussions could be carried out more openly. One of the main purposes is to educate people generally - not just the Union leadership - to contain expectations within realistic limits.

(d) It would be possible to look rather more critically at arguments for biassing pay guidelines in favour of the low paid. Most of the low paid are not living in poor households. And special measures for the low paid aggravate problems on differentials between skilled and unskilled workers.

7. Standing Commission on Comparability. The Commission has its work cut out in the coming months. But although extension of its role is probably best taken slowly, there is a strong case for building up its status. A strong Commission should in future make it less likely that the pay of workers in the public services will fall seriously behind those in the private sector, with all the disruption which follows. A way will have to be found to keep individual public sector settlements regularly under review as part of a continuing programme.

8. It would assist the Commission's task if there could be moves towards the synchronisation of public sector claims towards the end of the pay round.

9. Back-up measures. An approach to pay on these lines needs to be reinforced so far as possible within the voluntary framework. There are three issues which merit further consideration:-

(a) Monitoring the TUC's guidelines. If the agreement with the TUC is to be seen as credible, people will want to know how it is working. This must involve in some way monitoring the TUC's guidelines on negotiating procedures, conduct of disputes and the closed shop. Can Government adequately satisfy itself that the guidelines are proving effective, unless it is actively associated with the TUC in monitoring whether or not the guidelines are being effectively applied?

(b) Enforcement of existing law. A review should be made of the extent to which certain unacceptable features in the conduct of industrial disputes, eg secondary picketing, falls foul of existing law. This leads on to the question whether, without any question of new legislation, existing legislation could be more strictly enforced.

(c) Trades Union Reform. Ministers have made it clear during the Election campaign that they expect the Trade Union movement to put its own house in order. Areas where one might look for progress include trade union structure (there are still a large number of small and competing unions); secret ballots for the election of officers; and improvements in the quality and training of trade union staff.

10. General. It is essential to make every effort to make the voluntary approach stick, and to reinforce it so far as possible. If the voluntary approach were to break down, Ministers could be forced back sooner or

later to a statutory incomes policy and/or industrial relations legislation.

PUBLIC EXPENDITURE

11. Present plans provide for total public expenditure programmes (currently £65bn) to grow by about 2% a year in volume terms over the next 4 years. Three-quarters of this total is made up of pensions and other benefits (£16bn) and education, health, environmental services (including housing), and defence (£7-9bn each).

12. There are two pressures on these plans. First, the prospects for economic growth over the next 2 or 3 years are well below that on which the 2% rise in public expenditure was based. Second, there are a considerable number of specific new public expenditure commitments in the Manifesto, and also a pledge to reduce the burden of income tax. The situation could be made more difficult by the overhang of public sector pay settlements stemming from the comparability studies of the Review Boards and the Standing Commission.

13. In these circumstances, if resources are to be released for new priority public expenditure, it may be necessary to contemplate not only the rigorous application of cash limits but also policy changes to individual programmes. The current public expenditure survey is already in hand. It will be important to renew wide-ranging discussion of expenditure priorities as soon as possible.

14. Cash limits. The present cash limits for 1979-80 allow for retail prices to rise by only 8½% in the year to the fourth quarter of 1979; and for pay to be in accordance with the 5% plus £3.50p underpinning. The Government has already announced that no adjustments to cash limits should be made to accommodate higher price rises; that, at least for central Government expenditure, a substantial proportion of any higher settlement on pay would have to be absorbed within existing cash limits; and that the Government would not contribute through rate support grant more than its standard share of local authority current expenditure on pay.

15. On reasonable assumptions about inflation and public sector pay settlements, these arrangements could already imply a volume squeeze of £500m or rather over in 1979-80. It is unlikely that a tougher squeeze could be made to work in a financial year which has already begun. On the other hand, given the PSBR and taxation commitments, there is no room to go back on these decisions. In particular it will be important to ensure that exemptions are kept to a minimum.

16. Specific policy issues. The special Ministerial Group (which met only once prior to the Election) will doubtless be considering priorities, particularly in the light of Manifesto undertakings. It would be wrong to try in this paper to pre-empt their conclusions. But if it became evident that further savings are required, especially in the medium to longer term, the following are in the CPRS's view among the major issues which would merit urgent consideration:-

(a) Housing investment. There is still scope for switching from house construction to renovation and improvement.

(b) Economic pricing for nationalised industries. There is further scope for moving towards more economic pricing for nationalised industries, thereby increasing their revenues and thus their ability to finance from internal resources. Phased increases would have only marginal effects on the RPI but substantial benefits in terms of expenditure savings.

(c) Up-rating of social security benefits. Given the close links (on incentive and other grounds) between basic benefit levels and tax thresholds, it is sooner or later likely to be necessary to consider whether long-term benefits should be automatically increased by prices only, rather than as at present by the higher of prices or earnings. There is a case for a consistent indexation approach to benefits and personal tax allowances which could be associated with wider use of indexation in the tax system (eg the specific duties).

TAXATION AND INCENTIVES

17. The Government is committed to continue to reduce the burden of income tax. Ministers have in the last two or three years accepted that UK tax rates, particularly at the upper and lower ends of the income spectrum, have had a damaging effect on economic performance. Apart from real disincentive effects, there is also distortion of systems for rewarding skills and effort (through special perks and benefits in kind), and some evidence of an insidious growth in the size of the "hidden economy" (recently "guesstimated" by the Inland Revenue as possibly equivalent to 7½% of GDP). There was strong evidence during the election campaign that cuts in personal taxation would command widespread support.

18. The first priority must be to ensure that the real burden of direct tax is not increased by failure to adjust for inflation. (Statutory indexation at present applies only to the basic tax threshold.) Thereafter the priorities in terms of improving incentives in our view should be:-

(a) To lift the tax threshold in real terms, in order to reduce overlap with Social Security and Supplementary benefit levels, to improve the comparative position of those in work vis-a-vis those out of work, and to mitigate "poverty trap" effects for the low paid in work;

(b) to reduce the higher rate burden, particularly in the upper ranges (senior management income levels) where compression over the last 5 years has been most severe. This is made more acceptable by the Government's commitment to a wealth tax.

19. Progress on these priorities must be related in order to secure a reasonably fair distributional spread. On the second, the CPRS's view is that pulling out the higher rate bands (so that they apply to real levels of income comparable to 5 years ago) in general merits higher priority than reduction of the top rates.

20. In the medium term, assuming restraints on money supply and PSBR, reductions in the real direct tax burden can only be met by some shift in the balance towards indirect taxation or by reducing public expenditure commitments. There is scope for both, but counter-inflation policy is a constraint on the first, and the second will prove difficult to reconcile with the Government's aspirations.

21. This points to a phased medium-term tax strategy. There is a real risk on past experience that tax objectives will be subordinated to other commitments and constraints, ie that public expenditure will be pitched at too high a level in relation to the GDP growth actually achieved and that RPI constraints will prevent a shift to indirect taxation.

EMPLOYMENT MEASURES

22. The present set of employment measures has evolved as a response to what was initially regarded as a particularly severe cyclical recession. The special programme of employment measures (as distinct from training) started in 1975 and has grown rapidly to £530m.

23. The overall effects of these measures is hard to identify. Nor is it easy to trace their effect on the unemployment figures. (In recent months unemployment has been falling, despite the fact that the estimated number of jobs supported has also been falling with the phasing out of the temporary employment subsidy - the implications for what is happening to productivity are worrying, given the absence of growth.)

24. There is growing evidence of an increase in "structural" unemployment. This shows up particularly in the widening of regional unemployment

differentials as unemployment falls overall. There is also evidence that where new jobs emerge in the country generally, they are more likely to be filled by new entrants to the labour force eg married women than from the male unemployed. And there are still skill shortages even in areas of high unemployment. The longer that unemployment remains high generally, the more deep rooted these structural problems will become.

25. There is a case for reviewing present employment measures with a view to directing them more towards specific structural problems. Some possibilities are:-

(a) The present training schemes seem to be working well for semi-skilled and skilled manual workers, and have probably reached the limit of what training can do to eliminate skill shortages. Vocational preparation will make a useful contribution towards improving the general quality of the unskilled labour force, and preparing them in some cases for further training. But there are serious shortages of higher level skills such as draughtsmen, computer programmers and electronic engineers - all categories which are easily "poached", and where the private sector may be justifiably reluctant to do sufficient training of its own. The role of the MSC both in sponsoring training in these fields, and in offering training allowances at a realistic level, should be considered.

(b) There may be more scope for employment creation in the depressed regions by agencies such as COSIRA and the Development Commission whose operations, though at present small-scale are cost effective.

(c) Programmes designed to give certain groups particular priority in the labour market, eg the guarantee for the long-term unemployed, may be justified by the need, on both political and economic grounds, to prevent people from withdrawing permanently from employment. But they tend to have relatively high costs, and there is a clear need to be highly selective in defining priority groups of this sort.

END

Filmed at the National Archives (TNA) in London

February 2010